INTERNATIONAL EXPERIENCE IN THE FORMATION OF EXCHANGE RATES BASED ON MARKET MECHANISMS AND THE POSSIBILITIES OF ITS USE IN UZBEKISTAN

Samandarov Zukhriddin Raup o'g'li
Chief Specialist, Department for Organization of Academic Activities,
Tashkent State University of Economics (TSUE)
samandarovzukhriddin@gmail.com

Key Words: Foreign exchange market, exchange rate stability, interbank trading, currency liquidity, monetary policy, devaluation pressure, market mechanisms, transaction costs, transparency, central bank interventions, managed float regime, Uzbekistan economy, macroeconomic stability, exchange rate formation.

Introduction

Economic circumstances and conditions in the country, policy preferences play significant role in the choice of the foreign exchange regime. Therefore, main trade-offs among the choice of foreign exchange regimes are based on the conditions and credibility of policymaking and its institutions. In fact, there is no single ideal exchange rate regime which suits for all countries. The choice of exchange rate regimes is based on the relative weight of such factors mentioned above. Moreover, choice of exchange rate regimes varies over time that country changes its exchange rate regime based on the changing economic and political circumstances. In most of the cases, change in exchange rate regime in the country is driven by deficit in balance of payments, low economic growth and currency crisis.

Main part

Exchange rate regimes utilized in one country is quite different from those of others. In most of the cases, there are several factors based on which foreign exchange rate choices in the country is based on. The choice of exchange rate regime in specific country is based on the country's economic interest which based on the factors and circumstances including trade openness, size of the economy, structure of the production and exports, level of financial development and inflationary history.

Every foreign exchange regime has advantages and disadvantages (Table 5). Floating exchange rate regime is invulnerable to currency crisis. Moreover, this regime has the ability to absorb adverse shocks in foreign exchange rate regime and pursue independent monetary policy. Floating exchange rate regime has this advantage because of cost of high short-term exchange rate volatility and large medium-term swings. Hard peg exchange rate regime has the advantage of providing maximum stability and credibility for monetary policy. It has also advantage of low transaction costs and interest rates but suffer from the loss of lender of last resort role of the central bank. Main advantage of soft peg regime is that it provides stability by reducing transaction cost and exchange rate risk while maintaining nominal anchor for monetary policy. However, soft peg regime was undermined due to global capital mobility in the 1990s. Countries with open to international capital flows became vulnerable to currency crisis due to globalization. This, in fact, had a negative consequence on exchange rate volatility and higher inflation.

	Advantages	Disadvantages
Floating	Resistant to currency crisis Better deflection and absorption of adverse shocks High international reserves are not required	High short-term foreign exchange rate volatility Discretion in monetary policy may lead to inflationary bias
Soft Peg	Low interest rates Enables to manage effectively high inflation Enables stability and competitiveness	Prone to currency crisis Higher foreign debt is required High international reserves are required
Hard Peg	Encourages disinflation Low transaction costs and interest rates Not prone to currency crisis	High probability of liquidity risks because central bank loses its role as lender of last resort Shocks should be absorbed by economic activity rather than monetary policy

Table 1. Advantages and disadvantages of different foreign exchange rate regimes

By analyzing the advantages and disadvantages of each foreign exchange rate regime, it can be stated that each regime should be analyzed based on its impact stability, misalignment, vulnerability to currency crisis and shocks, and independence of monetary policy. Therefore, choice of exchange rate regimes varied across time due to economic condition and circumstances in the country.

Majority of developing countries choose soft peg regime to operate during 1991 when the globalization of companies started. However, by the end of 1999, due to globalization and international movement of capital inflows, the number of developing countries operating under soft peg regime reduced and they rather adopted hard peg regimes. This is due to the fact that soft peg regime was prone to currency crisis, requires substantial foreign debt to stabilize the foreign exchange rate. Therefore, the number of developing countries shifted from soft peg regimes to a floating or hard peg regimes. Number of countries that adopted such exchange regimes included Indonesia, Russia, Brazil, Thailand and Mexico that moved to floating regimes.

Moreover, emerging economies with larger economic size such as China, India and Chile avoided soft peg regimes. These countries adopted hard peg and floating exchange rate regimes to control over the capital inflows. Excessive movement in the exchange rate, vulnerability of the existing regime to currency crisis were among the reasons to shift from soft peg regimes. Therefore, it can be stated that countries that are open to international capital flows, soft peg regime is not suitable because it leads to currency crisis. For instance, due to soft peg regime adoption, several emerging economies in 1990s experienced currency crisis such as Mexico, East Asia, Russia, Brazil, Turkey and Argentina.

	1991					1999				
	DME	EME	O	Total	Percent	DME	EME	O	Total	Percent
Floating	10	10	20	40	25.1	10	16	52	78	41.9
Indep. Floating	8	2	11	21	13.2	8	13	29	50	26.9
Lightly Managed	2	8	9	19	11.9	2	3	23	28	15.0
Soft Pegs	11	21	62	94	59.1	1	14	48	63	33.9
Hard Pegs	1	2	22	25	15.8	11	3	31	45	24.2
Currency Board	1	1	0	2	1.3	1	1	8	10	5.4
Cur. Union/Dollar.	0	1	22	23	14.5	10	2	23	35	18.8
Total	22	33	104	159	100.0	22	33	131	186	100.0

DME : developed market economies
EME : emerging market economies
O : other countries

Table 2. Change in the choice of exchange rate regimes among developed and developing countries

In summary, choice of different foreign exchange regimes depends on the interests and economic situation of countries that function well in one country but does not in another. Floating exchange rate regime is appropriate for developed and emerging economies. Such emerging economies can be characterized as export/import operations are relatively small compared to GDP, fully integrated to international markets, strong prudential standards, diversified manufacturing sector and trade and well-developed financial markets. Hard peg foreign exchange regimes are better and suitable for the countries like Argentia and Bulgaria with monetary disorder, low credibility of policymakers to maintain stability, high inflation. In contrast, soft peg regime is more suitable for countries with weak links to international capital markets, underdeveloped financial markets, less diversified production and exports and stabilizing high inflation rate through exchange rate-based stabilization program such as Turkey.

Based on the analysis, the choice of exchange rate regime depends on the economic situation and circumstances in Uzbekistan. Currently, country experiences trade deficits (low export volume compared to high import volume), increasing inflation, less integration to international markets and underdeveloped capital and financial market (due to absence of capital market where enterprises can access to funds besides commercial banks). Soft peg regime is not suitable for Uzbekistan because of less open to international capital flows and can lead to currency crisis. Hard peg is not also suitable for Uzbekistan due to stricter control over the exchange rate based on specified laws. Floating exchange rate regime is not also suitable for Uzbekistan due to high international reserve requirements.

Conclusion

Therefore, intermediate exchange rate regime can be appropriate for Uzbekistan. While monetary policy is conducted by monetary authority in Uzbekistan, they can intervene into the foreign exchange market by monitoring money supply by directly influencing the interest rates. Moreover, this regime enables limited flexibility of absorption of foreign exchange shocks, maintaining stability and competitiveness of the national currency against foreign currency, and low vulnerability to currency crisis.

References

1. Yagci, F. (2001). Choice of Exchange Rate, Regimes for Developing Countries. Africa Region Working Paper Series No. 16.
2. Mussa, M. P. Masson, A. Swoboda, E. Jadresic, P. Mauro, and Berg, A. (2000). Exchange Rate Regimes in an Increasingly Integrated World Economy. IMF Occasional Paper 193.
3. Calvo, G. A. and Reinhart, C. M. (2002). Fear of Floating. Quarterly Journal of Economics, 117(2), pp. 379-408.
4. Yeyati, L. E. and Sturzenegger, F. (2001). Exchange Rate Regimes and Economic Performance. IMF Staff Papers, Special Issue 41.
5. Schaechter, A. M. R. Stone, and Zelmer, M. (2000). Adopting Inflation Targeting: Practical Issues for Emerging Market Countries, IMF Occasional Paper 202.
6. Edwards, S. (2001). Exchange Rate Regimes, Capital Flows and Crisis Prevention. NBER Working Paper Series, 8529.
7. Williamson, J. (2000). Exchange Rate Regimes for Emerging Markets: Reviving the Intermediate Option. Institute for International Economics.