IN THE DOLLAR WE TRUST: IS DE-DOLLARIZATION FEASIBLE IN UZBEKISTAN?

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Abstract. *The discussion about the end of the U.S. dollar dominance era was resumed by the world economic community with the outbreak of the military conflict between Russia and Ukraine and the subsequent Western sanctions against Russia. Some countries, due to restrictions, were forced to look for an alternative to settle payments, others were afraid of probable secondary sanctions. As a result, despite the active attempts of the leaders of the BRICS countries to trade in national currencies, the position of the dollar as a reserve and settlement currency has only strengthened.*

Numerous research studies reveal that dollarization is persistent to different extent in all CIS countries (Gevorkyan, 2023, Dabrowski, 2022; Dudkova, 2020; Usmanova, 2021). A handful of the studies examined dollarization processes in Central Asia, and the ones analyzing Uzbekistan are even fewer. The main objective of this paper is to fill this research gap. The applied research method is a qualitative analysis of the previous research studies on dollarization process. This approach enables a better evaluation of the current trends and dynamics in Uzbekistan and compares it to the stylized facts on dollarization. The results show that Uzbekistan experiences dollarization mainly due to unanchored inflation expectations of domestic residents, therefore low confidence in the domestic currency, the underdeveloped local capital markets, and the absence of alternative savings instruments. The Central Bank of the Republic of Uzbekistan has been trying to reduce the level of dollarization in the economy using various measures suggested in previous studies. A slight reduction in financial dollarization has occurred thanks to attractive interest rates on savings accounts in the local currency, however the impact on other dollarization types is still obscure. Further the study suggests certain measures on reducing dollarization.

Key words: *dollarization of economy; de-dollarization measures; monetary policy; development policies; economies in transition; Uzbekistan.*

Introduction.

Dollarization happens when a foreign currency (usually the U.S. dollar) is commonly used in transactions within a particular country, substituting the national currency. The transfer of savings into a foreign currency is a first sign of the beginning of dollarization in an economy and the widespread use of the foreign currency in the domestic money circulation. The second sign is the transition to payments in the foreign currency or setting prices in conventional units (c. u.).

Dollarization has become conventional for many developing countries and economies in transition all over the world so that people barely notice it. The use of the U.S. dollars as a means of payment and specifically as a store of value is not merely a tradition, but rather a ritual for the majority of population in these countries.

LITERATURE REVIEW

Dollarization and its taxonomy

Ponsot (2019) has classified four dollarization regimes based on quantitative and qualitative aspects. The first one measures how actively the foreign currency is used in monetary transactions. An economy can be fully or partially dollarized depending on the level of a local currency substitution. The second dimension focuses on the recognition of the foreign currency on both legal

and institutional levels. The author emphasizes that particularly institutional characteristics should be examined to adequately measure the state tolerance towards dollarization.

Ize and Parrado (2002), as well as Heysen (2005) propose a typology based on the use of a foreign currency by domestic residents and discuss payment, financial, and real dollarization. *Payment dollarization* is associated with a general acceptance of foreign currency as a mean of payment. *Financial dollarization* refers to holding assets in the foreign currency. In case, salaries/wages and prices for particular goods are set in a foreign currency, it is a signal of *real dollarization*. The World Bank (n.d.) pulls these factors into one term – *asset dollarization* and adds *liability dollarization* which is described in the research papers focusing on foreign currency debt obligations (Bitar, 2022; Murat, 2022). Liability dollarization refers to loans and other debt instruments in a foreign currency that can have an adverse effect on the balance sheet of a particular country when its domestic currency depreciates. Dollarization comes in different shapes and sizes, so a clear understanding of what type of dollarization is under consideration helps to identify its root causes and suggest correct policy recommendations.

Drivers of dollarization

Drivers of dollarization vary from country to country, as unique dimensions like history, culture, politics, daily life, and decision-making structures have a considerable effect on the process of dollarization (Eradze, 2022). However, the existing research literature suggests several common interdependent macroeconomic and institutional factors forcing private agents to demand a foreign currency.

The early studies on dollarization have main focus on triggers of currency substitution, i.e. real and payment dollarization (Yeyati, 2006). A volatile domestic currency followed by high inflation leads to the situation when economic agents lose confidence in the domestic currency and shift to a stable foreign currency (hard currency).

In the course of time, dollarization was treated as asset substitution and the economic literature concentrated on addition of models - portfolio view, market failure view, and institutional view (Yeyati, 2006). The portfolio view assumes the minimum variance portfolio approach suggesting that economic agents set their currency composition based on their desire to generate a stable return on their portfolios or at least minimize it's fluctuation (Basso et al., 2011; Ize and Yeyati, 2006). Thus, dollarization is viewed as an insurance arrangement, primarily when financial markets cannot provide alternative indexed instruments in national currencies. The market failure view suggests that dollarization can exist due to certain imperfections like "market frictions, information asymmetries, distortions induced by deposit or government guarantees" (Ize and Yeyati, 2003, p.41). An illustrative example is an attempt of banks to shift exchange rate risk to debtors by encouraging them to borrow in a foreign currency. Therefore, this model assumes that exchange rate and default risks are highly correlated unless adequate regulations are introduced. The institutional view assumes that a poor macroeconomic policy management increases dollarization. If institutions lack credibility or don't take any measures to protect a domestic currency, then a foreign currency provides confidence that residents need (Chang and Velasco, 2002). The relative simplicity, transparency, and credibility of foreign currencies like the U.S. dollar or Euro spur further dollarization in economies with under-developed financial markets. Inability to borrow in a domestic currency fuels further dollarization in liabilities due to the widespread and persistent "original sin" phenomenon in developing countries (Eichengreen et al., 2002). In addition, trade and financial linkages with the anchor country can attribute to dollarization (Windischbauer, 2016).

De-dollarization measures

It is admitted fact that high dollarization of an economy is associated with high risks, for example, changes in the U.S. interest rates cause major implications for financial conditions in a

highly-dollarized economy (Caballero and Upper, 2023). Post-Keynesian economics acknowledges the role of central banks in ensuring the stability of monetary, financial, and real sectors (Hein, 2023). However, the national regulator is not able to mitigate the systemic risk if the economy faces high dollarization. The hard currency shortage might cause liquidity risk that might be alleviated to a certain extent by draining liquid dollar reserves of commercial banks and a central bank's international reserves, and this consequently would lead to further dollarization (Balino, 2003). If liquidity inflow from exports or capital flow does not generate extra foreign reserves, inelastic credit supply might lead to continuous stagnation as the interest rate increases (Ponsot, 2019). These adverse effects of dollarization emphasis the importance of minimizing dollarization, as a complete de-dollarization is nearly impossible due to globalization and asymmetrical global power relations (Eradze, 2022).

Berg and Borensztein (2000) claim that understanding the reasons, measuring costs and benefits of dollarization, and assessing associated risks should be case-based. The one-size-fits-all approach does not work in specific characteristics of a dollarized economy (Reinhart et al., 2003). Many studies suggest that promoting the use of a domestic currency through credible and sustainable anti-inflationary policies and adopting regulations to discourage the use of a foreign currency are key necessary steps (Ize and Yeyati, 2006). Making a domestic currency more attractive is possible by lowering the risks and costs associated with its use. First and foremost is having low and stable inflation by moving towards well-designed and credible inflation targeting and more flexible exchange rate regimes to attain macroeconomic stability and ensure institutional credibility (Ize and Parrado, 2006; Windischbauer, 2016). However, this process requires considerable time and consistent efforts, and the national authorities have to commit to it in order not to undermine their credibility. Ize and Yeyati (2006) argue that a relatively stable exchange rate and inflation rate might not directly lead to de-dollarization due to the "dollarization hysteresis". A relative short-term macroeconomic stability might not change the expectations, especially in case of repeated high inflation. Hence, the authorities should work with the expectations and mindset of domestic residents as well to anchor inflation expectations. Regulations and legal barriers are another substantial leverage in reducing dollarization as they should focus on encouraging borrowing in a domestic currency in a soft manner allowing some flexibility, as tight rules on foreign currency borrowing might urge residents to look for borrowing sources other than commercial banks, resulting in less control and monitoring over dollarization and systematic risk (Anhert et al., 2021). Structural changes can take the form of higher reserve requirements for foreign currency deposits or higher interest rates on foreign currency loans. Higher reserve requirements for foreign currency deposits might not reduce the level of dollarization in case of the presence of foreign banks with access to funding in foreign currency (Eradze, 2022). However, the introduction of controls on accumulation of loans denominated in foreign currency might solve this problem (Basso et al., 2007). Restrictions or ban on the use of foreign currency can reduce dollarization, but this might have adverse effects, such as capital flight or dual exchange rate (Windischbauer, 2016). After reaching relative macroeconomic stability, the next step in lowering dollarization is development of local capital market as it provides a choice of public securities and other financial instruments denominated in a local currency that is an alternative to foreign currency assets (Reinhart et al., 2003; Zettelmeyer et al., 2010).

Discussion

The dollar's international role

The dollar with an unprecedented 46,56%-share in global payments remains the most used currency in international settlements, with the euro (23,25%) holding the second place according to the data from the monthly report tracking the market share of China's yuan within the international bank transfer system of the Society for Worldwide Interbank Financial Telecommunication (SWIFT,

2024). Despite China's largest foreign currency reserves in the world the yuan is ranked as the fourth most used currency with only 4% in global payments (SWIFT, 2024). The current surge in dollar-based SWIFT payments raises challenges to any attempt to end its dominance in global payments and fund transfers.

According to data of the Bank for International Settlements (2023) the role of the dollar in payments and other transaction is even more powerful – more than 80% of the global transactions is made in the dollars, because it is frequently used as a "vehicle" currency - currencies of different countries are exchanged in the foreign exchange markets not directly, but through the dollar (Waller, 2024). Moreover, the share of the dollar in foreign currency assets and liabilities of the global banking system has also remained strong at around 60% (Tombini, 2023). The dollar's attractiveness to private investors and businesses is especially important as a medium of exchange – its dominance is tracked in trade invoicing, global banking, international debt issuance, and foreign exchange transactions.The dollar also has a leading role as a unit of account as it remains the most popular "anchor currency" against which other countries try to limit their exchange rate volatility. As Waller (2024) states countries anchored to the dollar represent around 50% of the world gross domestic product (GDP).

The above mentioned proves, that the international movement against the dollar's global dominance, led by nations including China and Russia, has suffered a setback. The dollar continues to dominate by a large margin in the three main measures - a store of value, a medium of exchange, and a unit of account.

Dollarization in Uzbekistan

According to the Central Bank of the Republic of Uzbekistan (CBU) (2023) the U.S. dollars account for 30.4% of deposits due to the asymmetry between the exchange rate depreciation and expectations in the economy, and the absence of alternative saving instruments in the domestic currency, while loan dollarization is 43.6% due to a strong preference for the private sector to borrow in the hard currency and absence of hedging instruments.

High dollarization of a country's economy is seen as one of the main problems that impede the ability to control inflation (Khoshimov, 2020; Vargas, 2023). In the particular case of Uzbekistan dollarization limits the effectiveness of monetary policy (CBU, 2023). The existence of the shadow economy that tends to rely on cash transactions denominated mainly in the U.S. dollars makes the situation with dollarization even more complicated.

Experts and analysts admit that the dollarization level of Uzbekistan's economy is considerably high, but the country's sovereign credit rating remains stable due to sufficient gold reserves ($24.1 billion as of CBU report on March 1, 2024) to neutralize currency risks.

Among achievements of the local regulator is a gradual fall in the rate of financial dollarization owing to the increased required reserve ratio for foreign currency deposits (18%) and increased yield rate for deposits denominated in the local currency (CBU 2022).

Moreover, due to the regulations on banks' currency position, loans are currently granted primarily in the UZS, causing decrease in loan dollarization. Further reduction in loan dollarization is forecasted due to expensive external financial resources and restrictions on open foreign exchange positions (CBU, 2023).

Asset and liability dollarization of commercial banks in Uzbekistan are 49 and 51%, respectively (CBU, 2022). The gap between the two indicators is minor as the national regulator sets a limit on it to minimize systematic risks.

Although the national regulator is actively introducing various measures to curb the financial dollarization, unanchored inflation expectations and biases, distrust in the local currency cause a

strong dollarization hysteresis and even psychological dependence on the dollars among the domestic residents.

What is not mentioned in official reports is that real dollarization partially takes place among households (informal payment dollarization happens, for example, on secondary housing and auto markets). As it is also explained by Gondo et al. (2020), although wages and salaries are set in the local currency, remittances/money transfers in dollars represent a source of income for many households with little incentives to convert them fully into the domestic currency. It became a ritual for people to hoard the U.S. dollars in cash and rely on informal borrowing as they feel safe with "the legal tender under their pillow" (Missaglia, 2021, p.4). This informal saving and borrowing also partially stems from negative mindset about local financial institutions and financial illiteracy, which the government tries to change with the support from the World Bank Group (Ahunov, 2018).

Conclusion and Recommendations

The research results show that the reasons of dollarization in Uzbekistan are well-described in the previous studies on dollarization. De-dollarization measures implemented in the country also go in hand with recommendations in the main research literature. Uzbekistan economy is an example of informal partial dollarization. The main drivers of dollarization in Uzbekistan are unanchored inflation expectations and biases of domestic residents, the underdeveloped local capital markets, and the absence of alternative savings instruments.

In the special context of modern Uzbekistan with reforms in full swing, the recommendations are to continue further successful measures of the national regulator in reducing financial dollarization. The experience of other CIS countries proves that prudential regulations in the banking system, floating exchange rate, anchoring inflation expectations of domestic residents through generating confidence in Central Bank's monetary policy, reviewing interest rate policy in the financial market, prohibition on the use of foreign currency as a mean of payment or on setting prices in a foreign currency are effective in the de-dollarization process (Hobotova and Dolgonos, 2021). Some of the tools have been used by CBU, so the next step could be the provision of cheaper borrowing in the domestic currency through decreasing the interest rate, once the inflation-targeting goals are reached. The government should also focus on development of the financial capital market in order to boost the influence of money market interest rates on asset pricing and offer domestic bonds with longer maturity, so that domestic residents have other alternatives for hedging their assets (Al Rasasi and Cabezon, 2022).

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