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Domestic Debt Market of the Republic of Uzbekistan as an Alternative Source of Financing

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Abstract: This article examines that domestic debt market can play important role in financing government projects and other projects. Domestic debt markets help strengthen money and financial markets, boost private savings, and encourage investment. An efficient debt market aids economic growth and development through transfer of capital from savers to borrowers. It enhances the allocative efficiency of resources in the economy apart from assisting financial stability by improving monetary policy transmission.

Keywords: Domestic debt market, government securities, benchmark, yield curve, fiscal policy, monetary policy, risk, liquidity, depth of the market, regulator of market.

INTRODUCTION.

The importance of debt markets in growth of an economy is well recognized. More particularly in an economy of the size of Uzbekistan, the need for a domestic debt market is of great importance. There has been dire need to foster a sound and diversified debt market, which can efficiently perform the function of financial intermediation. An efficient debt market aids economic growth and development through transfer of capital from savers to borrowers. It enhances the allocative efficiency of resources in the economy apart from assisting financial stability by improving monetary policy transmission. Further, the experience from the Asian financial crisis underscores the importance of bond markets as excessive reliance on bank lending may increase systemic risk. Uzbekistan bond market has made some rapid strides in the last few years due to several initiatives by the central bank, government and other stakeholders. Nevertheless, while activity in the corporate bonds market has picked up, the Uzbekistan bonds market continues to be dominated by government bonds market.

A well-developed debt market invariably should have an appreciable depth, breadth, width, choice of instruments, resilience. The depth of the market indicates the level of magnitude to which it can handle large transactions without setting off sharp changes. The depth of the market is determined by the diversity in market participants and the heterogeneity in their responses. The width of the market is represented by the spread and the liquidity in the market. The wider the bid-ask spread, the less the liquidity and vice-versa. A developed market offers a bouquet of financial instruments (such as; fixed rate bonds, floating rate bonds, inflation indexed bonds, zero coupon bonds, etc.) to cater to the varied needs of the market participants and investors. The resilience of the market is indicated by the speed of dissipation of the price fluctuations that occur due to some shocks. It is generally believed that the deeper and broader

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are the markets more resilient they are and tend to display greater stability in responding to the financial and economic distractions.

Undoubtedly, the government has to play a crucial role in facilitating the development of domestic debt markets (Figure 1).

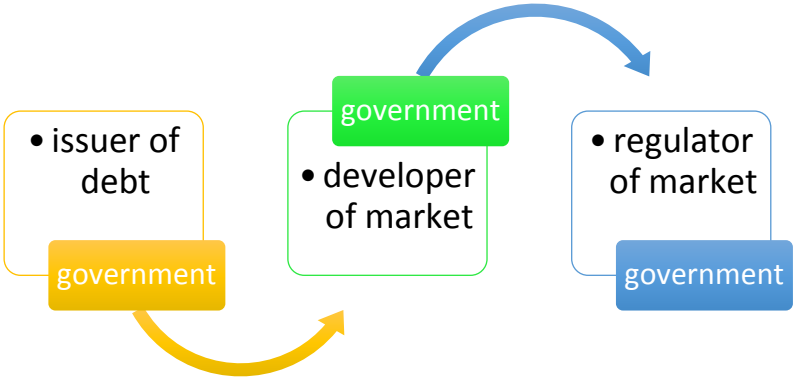


Figure 1. The role of the government in development of domestic debt market.

While as a developer of the market it can establish appropriate institutional framework by providing market infrastructure, as a regulator, it can take steps for systemic stability, market integrity for consumer protection. An efficient debt market is shaped by some factors which is shown in Figure 2.

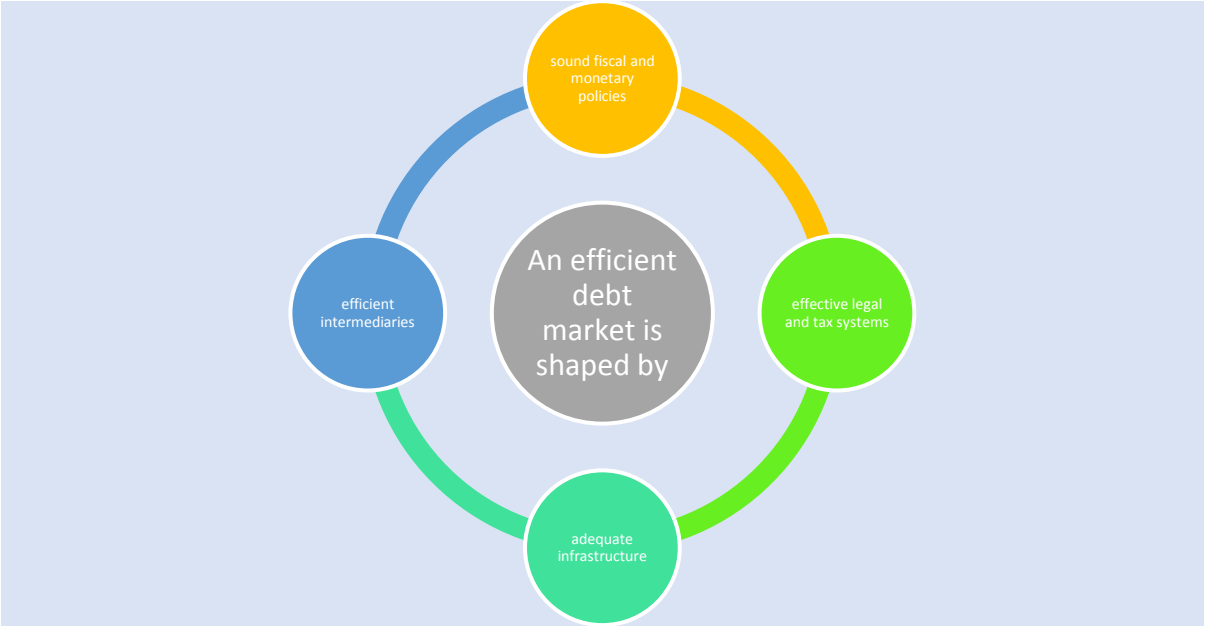


Figure 2. Four factors which contribute to an efficient debt market

Further, institutional framework for market efficiency involves: (i) regulator, (ii) primary dealers (PDs), (iii) market makers, (iv) market infrastructure, (v) clearing & settlement system, (vi) central counter parties (CCPs), and (vii) self-regulatory organizations (market associations), etc.

LITERATURE REVIEW.

Unstable economic environment characterized by hyperinflation, high volatility of output, lack of confidence in the institutions, and policies make it difficult to develop or sustain domestic debt market. As

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macroeconomic situation stabilizes and the government is able to achieve monetary credibility, the share of domestic debt in total debt should increase. A good strand of literature suggests that domestic debt and private savings were found to be closely associated.

Higher private savings are found to enhance the scope for domestic debt issuance while a larger supply of debt instruments provides incentives to increase private savings. Strengthening and expanding domestic debt, therefore, can form a potentially virtuous cycle of higher private savings and stronger and resilient markets. Private savings is one of the four important drivers of domestic markets (Figure 3).

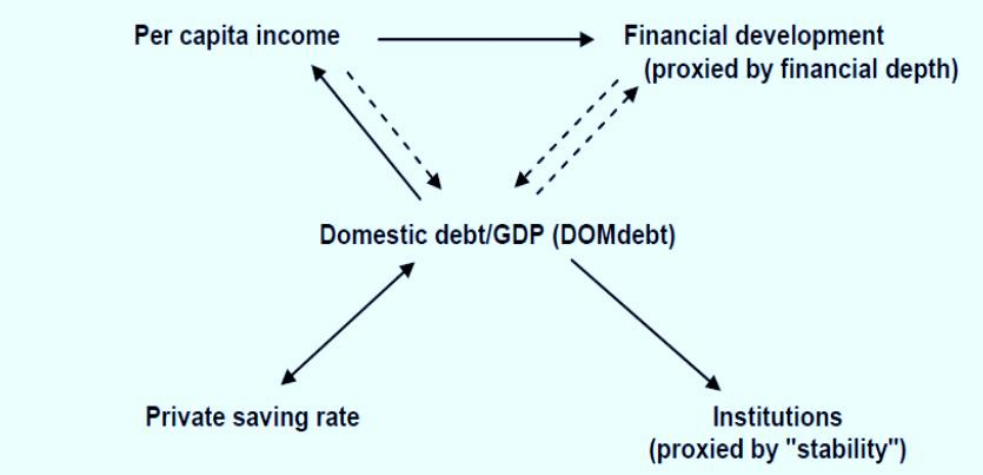


Figure 3. Drivers of domestic debt market.

Research shows that domestic debt is found to Granger-cause financial depth weakly and positively. However, financial depth has a significant impact of financial development on economic growth. Further, the quality and span of domestic debt market can have a substantial impact on the optimal size of domestic debt.

A higher level of domestic debt can likely be sustained without compromising growth if domestic debt; is issued in the form of marketable securities, bears positive real interest rates, and is issued to investors outside the banking system. It is established that institutional and retail participation in the government securities market boosts competition in the financial sector, both on the deposit taking side – as banks have to compete with government for individual and institutional deposits – and, on the investment side – as banks compete with other sector in public securities auctions. This increased competition should put downward pressure on banks' overheads and intermediation margins, partly alleviating the efficiency concerns associated with high bank holdings of domestic debt emphasized by Hakansson. [1]

Domestic debt markets help strengthen money and financial markets, boost private savings, and encourage investment.

First, government securities are a vital instrument for the conduct of indirect monetary policy operations and collateralized lending in interbank markets; the latter helps banks manage their own liquidity more effectively, reducing the need for frequent central bank interventions. Consequently, central banks operating in well-developed domestic debt markets do not have to rely as much on direct controls like credit ceilings, interest rate controls and high reserve requirements, all of which distort financial sector decisions and lead to financial disintermediation at the expense of private sector savings and investments (Pritsker). [2]

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Second, yields on government securities can serve as a pricing benchmark for long-term private debt issued by banks or enterprises and, hence, promote the development of a corporate bond market, which boosts competition in the banking sector (Hernandez and Valdes). [3]

Third, the availability of domestic debt instruments can provide savers with an attractive alternative to capital flight as well as lure back savings from the non-monetary sector into the formal financial system. The possible benefits here can go beyond saving mobilization and extend to a reduction in the size of the black economy, widened tax base, increased financial depth and improved perceptions of currency and country risk.

The reasoning is that bond markets could provide an alternative source of financing if other financing channels, such as bank financing, dry up. Greenspan stressed the importance of having multiple avenues of financial intermediation, which served the United States well during the credit crunch of the late 1980s when bond markets substituted for the loss of bank financial intermediation in a banking system crisis related to the real estate cycle. [4] This view has gained popularity in recent years, especially in the aftermath of the Asian financial crisis.

However, whether the bond market constitutes such an effective alternative source of financing depends crucially on there not being a high co-movement between bank lending, bond and equity financing in a domestic setting, and the absence of contagion in the international capital markets, especially for countries with open capital accounts.

ANALYSIS AND RESULTS.

Finance plays an increasingly important role in economic growth. In channeling savings to investment, the financial system contributes to economic performance through several channels – mobilizing savings, allocating funds to their most productive uses, monitoring managers and transferring and sharing risks. In modern economies, disruptions in the flow of credit are detrimental to economic activity and lead to unemployment, cancelled investment plans and even recession. Capital account liberalization and increasing globalization add an international dimension for capital flows. The development of debt markets might mitigate the adverse impact of financial crises or reduce the likelihood that a crisis will happen.

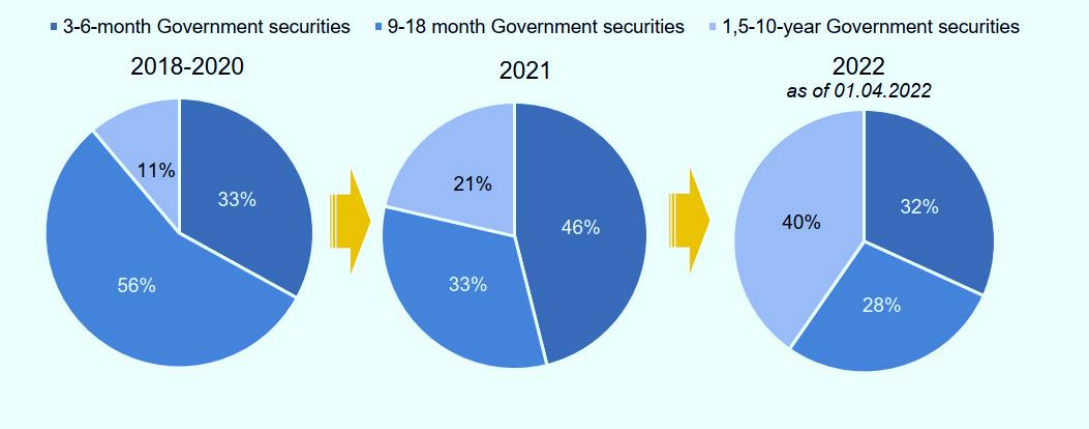


Figure 4. Treasury bills and bonds by maturity (% of total issuance).[1]

Domestic treasury securities were issued at the amount of UZS 0.6 trln through 3 auctions in 2018, UZS 1.5 trln through 15 auctions in 2019, UZS 5.0 trln at 22 auctions in 2020, UZS 4.9 trln, net amount - UZS

[1] Prepared by the author based information of the official website of the Ministry of Economics and Finance of the Republic of Uzbekistan.

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4.1 trln through 64 auctions. As of April 1, 2022 the Ministry of Finance had outstanding treasury bills and bonds amounting to UZS 4.8 trln (~USD 0.42 bn). In January-March 2022, in total, 17 auctions were conducted and the total volume of issuance of T-bills and bonds reached UZS 1.4 trln (~USD 0.13 bn). In the long term, Ministry of Economy and Finance aims at remaining committed to the development of the domestic government debt market, continuous diversification of debt instruments in terms of both tenor and tranche amount and gradually widening the investor base by working in collaboration with the Central Bank of Uzbekistan (Figure 4 and Figure 5). In these figures, nominal value of each bill and bond is equal to UZS 1.0 mln and all calculations are derived based on the nominal value of the securities issued.

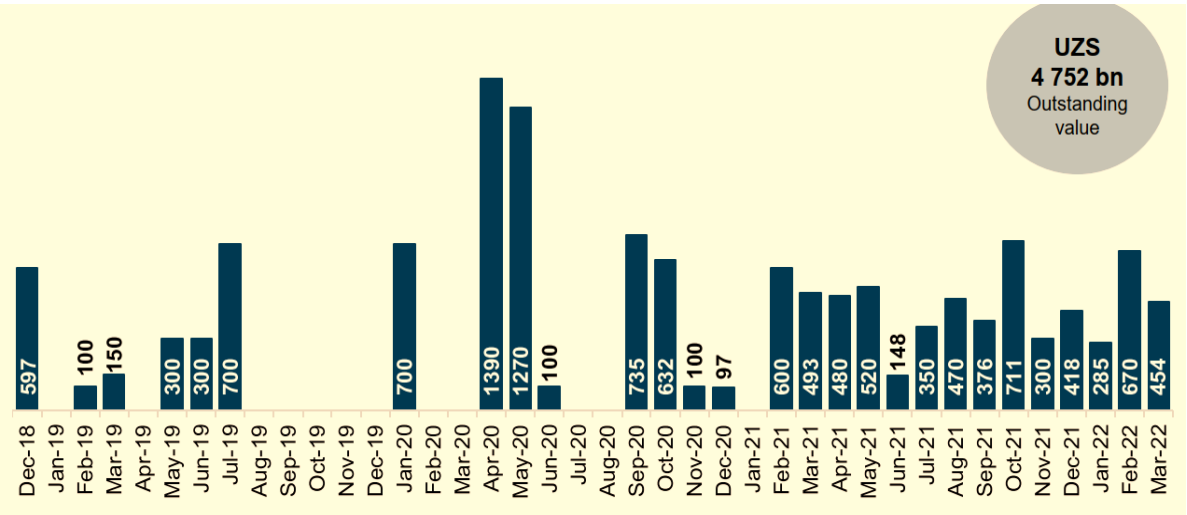


Figure 5. Domestic issuance volume dynamics of bonds and treasury bills.[2] (UZS, bn, as of 1 April, 2022)

A well-developed bond market also provides important benefits to the economy:

It provides a yield curve, a market-determined term structure of interest rates. The key use of the yield curve is to serve as a benchmark for pricing credit risk, bank loans and equities. For macroeconomic policymakers, the shape of the yield curve provides useful information about market expectations of future interest rates and inflation rates. The bond market is the base for developing efficient derivatives markets (forwards, futures, swaps and options) for managing financial risks at low cost.

It could lower funding costs for best quality borrowers, as intermediation costs are lower for bond than for bank financing. Borrowers on the borderline between investment and non-investment grade creditworthiness require more customized analysis, underwriting and structuring by banks, which are better equipped to assess such borrowers.

It introduces competition with the banking sector, perhaps reducing the dominance of banks in providing corporate financing. If banks themselves issue bonds, they will be subject to increased market discipline, with their performance being reflected in bond prices. This discipline may serve as a useful adjunct to official banking supervision.

It allows the transfer of risks through securitization. The bond market provides an important venue for banks to repackage loans and sell them as bonds (such as mortgage-backed or other asset-backed securities). This reduces banks' exposure to liquidity risk and mitigates their maturity mismatch.

[2] Prepared by the author based information of the official website of the Ministry of Economics and Finance of the Republic of Uzbekistan.

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CONCLUSIONS

Uzbekistan is finally moving forward to promote domestic currency debt markets to facilitate infrastructure investment. First, the government's ability to successfully increase reliance on the bond market as an alternative source of financing to bank loans and, second, their ability to implement fiscal consolidation as a means of freeing up bank lending and reducing upward pressure on interest rates. Uzbekistan will need to borrow increasingly in the domestic debt market if it is to meet this target. Development of domestic debt market in Uzbekistan should be planned and implemented on a long-term basis with a realistic policy sequence. It needs to be in sync with the banking sector reforms in order to alleviate systematic risk. Steps towards improving the transparency, reliability, accessibility, timeliness, and market diversification would help develop the bond market.

Uzbekistan should broaden the investor base by increasing the number and size of financial institutions that can invest in corporate bonds. It is crucial to note that market liquidity is a consequence of active participation of market players. New financial products and instruments are required to be designed to cater to funding and hedging needs of the market participants. They should be created in such a way that they do not result in risks in financial stability and do not jeopardize the interest of the ultimate end users/customers.

The lack of market interest, if any, must be introspected and debated seriously to draw up remedial action plan. To evolve a vibrant domestic debt market that is able to meet the growing financing requirements of the country's dynamic private sector, there is a need for effective co-ordination and co-operation amongst all the market participants. Further, a sound management of public debt could result in a decline in the debt requirements of the government, which in turn can offer greater market space and create greater demand for corporate debt securities. Obviously, systematic development of a well-functioning domestic debt market in Uzbekistan is likely to be a gradual process as experienced in several other countries.

In particular, improvements in market transparency such as accounting and disclosure standards, and the establishment of a legal and regulatory framework consistent with international best practice and with strong enforcement, will help investors to differentiate better among emerging markets at times of pressure and reduce contagion effects. The recent decline in the cross-correlation of the emerging debt markets could be partly attributed to international efforts in this area.

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