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Formation of The Exchange Rate Based on Market Mechanisms Is Important for The Economy

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Abstract: The formation of the exchange rate based on market mechanisms plays a crucial role in ensuring economic stability and efficiency. This study examines the key factors influencing exchange rate determination in a market-driven environment, highlighting the impact of supply and demand dynamics, monetary policy, and external economic conditions. The findings emphasize that a well-functioning market-based exchange rate system enhances trade competitiveness, attracts foreign investment, and contributes to overall macroeconomic stability. The research provides insights into optimizing exchange rate policies to support sustainable economic growth.

Keywords: Foreign exchange rate, floating exchange regime, soft peg regime, hard peg regime, trade balance, exports, foreign debt, dollarization, interest rate, international remittances, Uzbekistan.

Introduction: Foreign exchange is one of the key macroeconomic variables that influence the economic stability and growth. Developing and transition countries often experience increasing exchange rate against the national currency. Therefore, such countries utilized both government monetary policies and market mechanisms to stabilize the exchange rate and improve its contribution to the economic growth. Foreign exchange rate in Uzbekistan were problematic and increased continuously from the date of country's declaration of Independence. Stable currency regime facilitates entrepreneurship, boost the exports and increase the foreign exchange receipts while reducing the uncertainty for businesses . Exchange rate, in fact, is considered one of the key macroeconomic variables that determine the foreign trade such as stimulating exports and thus, achieving key macroeconomic performance such as reducing inflation.

During the early years of Independence, export potential of Uzbekistan was low and country's economy were largely dependent on import of goods due to low performance of manufacturing and production sector. Country established fixed exchange rate regime with stricter control of foreign exchange rate and tightened monetary policy under import substitution strategy. Although these strategies were focused on stabilizing the foreign exchange rate, it failed because foreign exchange rate continued to rise. The purpose of the study is to analyze the foreign exchange regime implemented in Uzbekistan, factors influencing its fluctuations and how to effectively manage them to contribute to economic stability and growth in the country.

Study used both secondary data analysis and empirical study. For secondary data analysis, study analyzed the trade balance, export volume, inflation, dollarization and foreign debt. Moreover, regression model is developed in order to test the relationship between foreign exchange rate and inflation, interest rate, foreign debt, export volume, trade balance and international remittances.

Findings of the study showed that foreign exchange rate regime in Uzbekistan was slowly evolved since achievement of Independence. Foreign exchange market is finally deregulated and liberalized in 2017 under Presidential Decree #5177 dated 02.09.2017. However, because of liberalization of the foreign exchange market, national currency devalued by 92.4 percent due to loosening artificially set exchange rate to actual price determined by demand in the country. Study results revealed that one of the reasons for sharp increase in inflation in Uzbekistan during 2017-2019 was due to financing of the national economy in foreign currency.

Empirical study showed that positive and significant relationship between foreign exchange rate and inflation and foreign debt but negative and significant relationship between foreign exchange rate and international remittances and trade balance. However, there is no significant relationship between foreign exchange rate and exports volume and interest rate meaning that those macroeconomic variables have no impact on foreign exchange rate in Uzbekistan.

Analysis also showed that the choice of exchange rate regime depends on the economic situation and circumstances in Uzbekistan. 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. Therefore, intermediate exchange rate regime can be appropriate for Uzbekistan.

Liberalization of foreign exchange market also led to shifts in monetary policy of Central Bank of Uzbekistan. Due to foreign exchange liberalization, reserve requirements set by CBU to commercial banks increased. This led to increasing inflation resulting in increasing foreign exchange rate. Therefore, forecasts of foreign exchange rate in Uzbekistan is largely dependent on inflation and balance of payments.

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