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Should Uzbekistan use international reserves for the infrastructure projects

Shakhzod ISMAILOV [1] **Makoto KAKINAKA** [2]

[1]"ML Yur Ekspress" Law Firm, Tashkent, Uzbekistan
[2] Graduate School for International Development and Cooperation, Hiroshima University, Hiroshima, Japan

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ABSTRACT

Uzbekistan has significantly increased its international reserves. As a result, the reserve adequacy ratio has become much higher than recommended by the international organizations. This, in turn, raise question on practicability of using excessive reserves for infrastructure projects. Analysis of possible opportunities and risks of using international reserves shows that Uzbekistan is keeping the right strategy on accumulation reserves.

Следует ли Узбекистану использовать международные резервы для инфраструктурных проектов

Ключевые слова:
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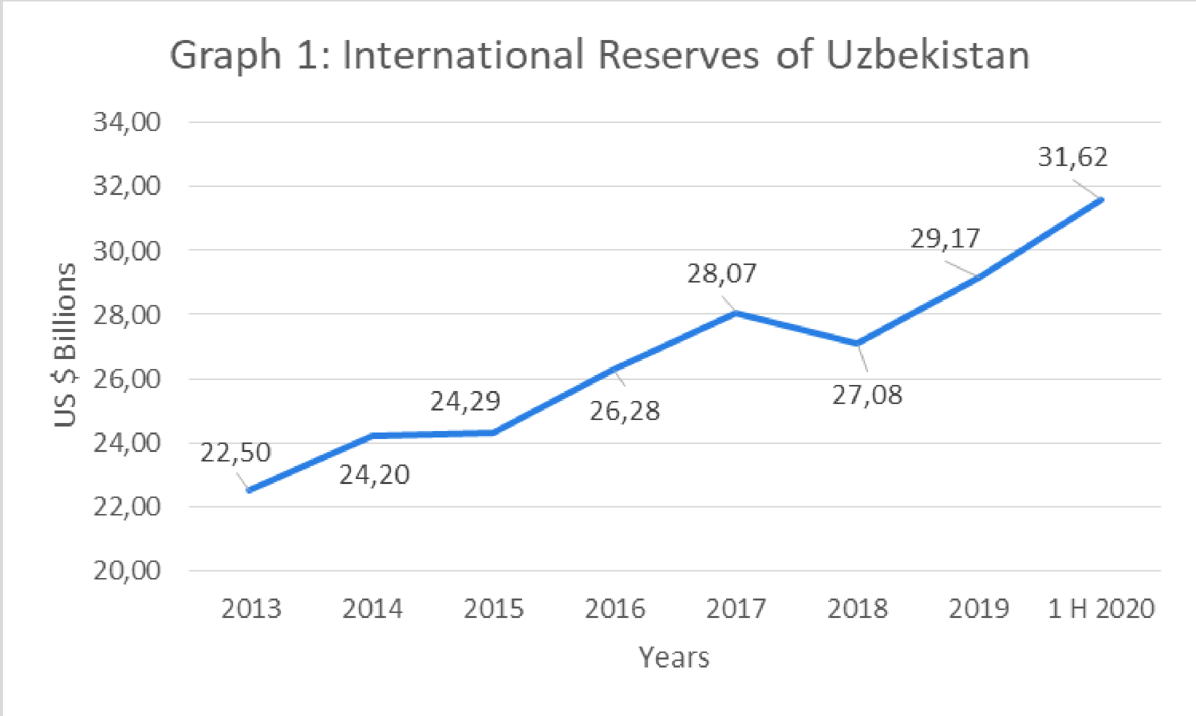
АННОТАЦИЯ

Узбекистан значительно увеличил свои международные резервы. В результате, коэффициент достаточности резервов стал намного выше рекомендованного международными организациями. Это, в свою очередь, поднимает вопрос целесообразности использования избыточных резервов для инфраструктурных проектов. Анализ потенциальных возможностей и рисков использования международных резервов показывает, что Узбекистан придерживается правильной стратегии по накоплению резервов.

[1] Master, Lawyer, "ML Yur Ekspress" Law Firm, Tashkent, Uzbekistan
Email: shah1985@iuj.ac.jp
[2] Professor, Graduate School for International Development and Cooperation, Hiroshima University, Hiroshima, Japan
Email: kakinaka@hiroshima-u.ac.jp

INTRODUCTION

Existing disturbances in the world economy push many countries to boost their international reserves. In this trend, the Republic of Uzbekistan is not an exception. Since 2013, there has been a 40.5 % increase in international reserves of the country (Graph 1). This, in turn, raise questions on the optimal volume and proper management of the international reserves, because poor management may lead to more economic troubles rather than possible benefits.



Source: World Bank Data: World development indicators; Central Bank of Uzbekistan

International Monetary Fund (IMF) suggests that States hold the international reserves to perform certain tasks, including:

- Support and maintain confidence in policies with exchange rate and monetary management;
- Limit external vulnerability by keeping liquidity in foreign currency to absorb possible shocks;
- Assure market players in ability of a country to meet its obligations;
- Support domestic currency by external assets;
- Support the government to meet its external debt obligations;
- Maintain reserves in case of emergencies (economical or natural)[4].

The Central Bank of the Republic of Uzbekistan Act defines the main objectives of holding international reserves. According to this Act, the Central bank holds international reserves at the level, sufficient for the implementation of the monetary policy, as well as for the ensuring settlements on international transactions[9].

According to the statistics of the Central Bank of Uzbekistan, as of July 1, 2020, international reserves of the country mainly consist of gold – 60.3% and foreign currency assets – 38.6%. For the last 8 years, the growth in the international reserves has happened mainly due to the current account surplus or the increase of the gold price. Only in 2017-2018, there was some contraction in the volume of international reserves because of shifting to more liberal exchange rate and trade regimes with the simultaneous sharp devaluation of its national currency from 4210 uzbek sum/US dollar up to 8100 uzbek sum/US dollar. However, consistent rise in the price of the gold from 2018 once again lead to the increase in the international reserves (Table 1).

Table 1
Macroeconomic data of Uzbekistan and gold price
end of period

Year	2013	2014	2015	2016	2017	2018	2019	1 half 2020
International Reserves, bln. US$	22.50	24.20	24.29	26.28	28.07	27.08	29.17	31.62
Current account balance (+surplus/ -deficit), bln. US$	-	2.52	1.07	0.29	1.48	-3.59	-3.25	-2.01
Gold Price, US$ per tr.ounce	1206.14	1186.97	1062.24	1149.95	1306.87	1281.27	1518.20	1769.87

Source: World Bank data: World Development Indicators, Central Bank of Uzbekistan, www.investing.com

Why Uzbekistan is continuously accumulating its international reserves?

Even if countries have high reserve adequacy ratio, they continue to increase their gross reserves. This raises the question of whether there is a need to accumulate further international reserves or it is time to use them in a proper way.

For example, total reserves of low income and lower middle income countries are enough to cover 6 months of import (as of January 2019), that is twice higher of recommended level. Moreover, their international reserves are four times higher than their short-term debt (as of January 2019)[11] although it is recommended to have just no less than the same volume of the short-term debt.

Economists still cannot reach a consensus regarding this issue. Some researchers argue that intense reserves accumulation can be a buffer from the volatility of capital flows. For example, Aizenman and Marion (2002) in their paper find out that States facing growing sovereign risk and high tax costs together with the inelastic fiscal liabilities prefer to accumulate larger international reserves[1].

Stiglitz (2006) emphasizes two important factors for the huge accumulation of the international reserves by the developing countries: recurring financial and economic instability in the world, and the way how International Monetary Fund handled with the East Asian crisis (1997). Countries lost their economic sovereignty, and moreover, the IMF policy made this economic shrinking much worse than without Fund's help[7].

Levy-Yeyati (2019) in his research also notes that accumulating reserves helps to reduce borrowing cost and by his estimations, marginal cost of existing reserves can be reduced by more than 50 %[5]

Other researchers argue that international reserves in some countries, especially in developing ones, have become too excessive. For example, Summers (2006), in his speech, argues that developing countries go beyond the necessary amount of reserve holdings and it represents the substantial opportunity cost. If this excessive amount could be invested either in global capital markets or in domestic infrastructure, it could bring much more profit for the country itself[8].

Rodrik (2006) in his paper states that developing countries have chosen costly strategy of accumulation excessive reserves instead of investing in capital-account management policies to reduce their short-term external debt. According to estimates, considering optimal spreads between the cost of borrowing foreign assets and yield on international reserves, the possible income loss to such States would amount approximately 1 % of Gross Domestic Product (GDP)[6].

The desirable volume of the international reserves of the country can be determined based on the two “how” and “what” questions: how flexible the exchange rate is and how economy is vulnerable to the capital and current accounts, as well as what is the size of the economy and what is the opportunity cost.

Uzbekistan is accumulating large international reserves for the same reasons as the other developing countries. Particularly, Uzbekistan’s huge reserves act as a buffer in the case of any financial and macroeconomic shocks. Authorities are continuing further capital account and exchange rate liberalization. Recently, Uzbekistan accelerated the tempo of integration in the global financial markets and such reserve buffers are necessary to protect small country from any disturbance in the world. Moreover, the country still has a low level of confidence in the international financial architecture, and last

Who manages international reserves in Uzbekistan and how reserves are managed?

According to the Central Bank of the Republic of Uzbekistan Act, one of the functions of the Central Bank is the management, accounting and storage of international reserves of the Republic of Uzbekistan, including the reserves of the Government by agreement.

Article 49 of this Act states that “International reserves comprise relevant assets of the Central Bank and the Government of the Republic of Uzbekistan.

The Central Bank forms international reserves on its balance sheets, including:

- Monetary gold;
- Special drawing rights and reserve position in the International Monetary Fund;
- Foreign currency;
- Securities issued or guaranteed by foreign governments, international financial organizations;
- Other assets included in international reserves in accordance with international standards.

The international reserves are holding at the level, sufficient for the implementation of the monetary policy of the Central bank, as well as for ensuring settlements on international transactions.”[9]

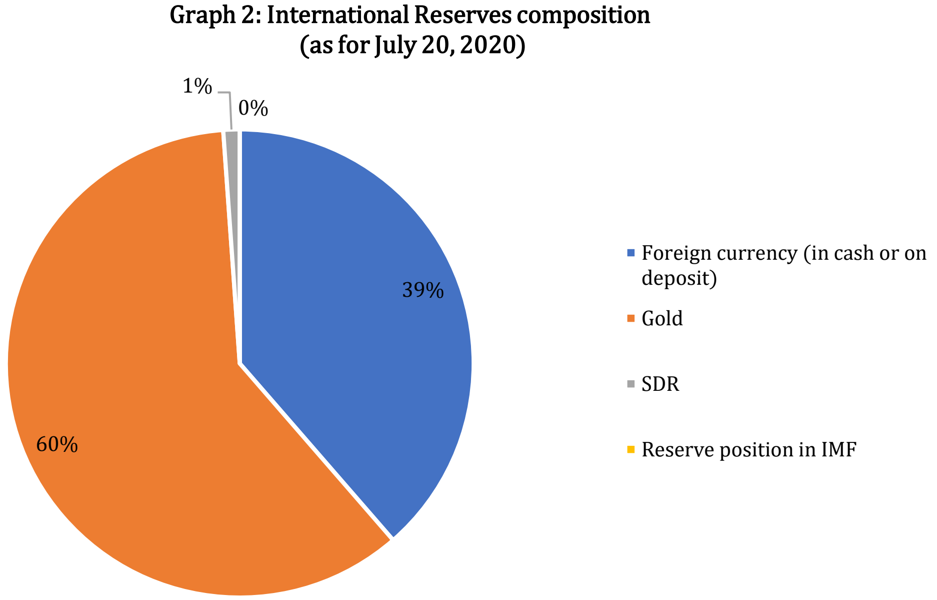
As the main objectives of the international reserves management are safety, liquidity and return, the Central bank of Uzbekistan holds reserves in the liquid assets that can be easily converted into cash within a short time.

Despite recent reform in the banking system and acceleration of the global integration, the Central bank of Uzbekistan is still conservative in the international reserves management. Actually, Central bank holds its reserves in gold and foreign currency (in cash or on deposits) (Graph 2).

The conservative strategy of the Central bank of Uzbekistan has a negative impact on the rate of return on investment. Gold from international reserves gives very low rate of return and its profitability mainly depends on the price change. Foreign currency on deposits also earn low rate of interest in the light of current condition in the international markets.

What is the adequacy of the international reserves of Uzbekistan?

According to the IMF Survey, the access of the low-income countries to capital markets is usually limited. The economy of the country might be shocked due to imbalance in the trade, decrease in the volume of foreign direct investment, foreign aid and remittance inflow.



Source: Central Bank of Uzbekistan: international reserves composition

These possible economical disturbances suggest that international reserves, in the worst scenario, should cover at least 3 months of imports. So called "the rule of thumb" to check the foreign reserves adequacy.

The empirical analysis, made by IMF economists suggests that international reserves that cover 3 months of imports or 100% of short-term external debt (the Greenspan-Guidotti rule) usually remain enough for countries with flexible exchange rates. Consequently, as better institutions and policies are, as less levels of reserves country needs, and vice versa[3]. This time is usually enough to overcome the disturbance in external payments. Additional benchmark to check the adequacy of the international reserves is the broad money to total reserve ratio and it should be no less than 20 %. It means that in emergency case no less than 20 % of the money supply (M2), in the short- or medium term, should be converted into foreign currency.

As of July 2020, international reserves of Uzbekistan reached 31.6 billion US dollars, which is sufficient to finance about 16-month import. This reserve adequacy ratio is much higher than recommended by the international organizations. At the end of 2019, broad money to total reserve ratio was 35.3% that is almost twice higher than required level. At the end of 2018, the short-term external debt to total reserves of the country was just 2.7% and it is more than enough in case of any shocks (Table 2).

Table 2
International Reserves Adequacy: The Republic of Uzbekistan
end of period

Year	2013	2014	2015	2016	2017	2018	2019	1 half 2020
International Reserves, (bln. US$)	22.50	24.20	24.29	26.28	28.07	27.08	29.17	31.62
Total reserves in months of imports	-	17.0	19	20	19	13	12	16
Broad money to total reserves ratio (%)	60.2 %	58.5 %	65.2 %	64.4 %	49.3 %	36.7 %	35.3 %	-
Short-term external debt (% of total reserves)	1.8%	2.0%	2.8%	2.3%	3.0%	2.7%	-	-

Source: World Bank data: World Development Indicators, Central Bank of Uzbekistan

Advantages and disadvantages of public investment in infrastructure.

The effect of public investment in infrastructure can be either advantageous for the economic growth or just wasted funds.

Right and well-targeted investment in infrastructure is a driver for economic growth and brings many advantages for a competitiveness of the national companies, and helps to minimize costs. For example:

- Improvement of infrastructure is a direct contribution to Gross domestic product;
- Better infrastructure reduces the production costs of companies and consequently increase their competitiveness;
- Infrastructure increases productivity, reduce transaction costs and make use of resources more efficient;
- Infrastructure facilitates access to customers and suppliers[10].

At the same time, limited influence of the public investment can occur because of significant deficiencies in the process of investment, such as poor decisions, bureaucracy, omissions during the project implementation and non-quantified expenses. According to IMF estimates, only 50 % of the public investment in developing countries in the period of 1980-2012 resulted in higher capital productivity[10].

Why Uzbekistan should be cautious in managing the International reserves?

There is no doubt that huge investment in infrastructure projects would have a strong influence on the economic growth, but only with required cautious policy for earmarked funding. Currently, despite the constant efforts of the Government, country's infrastructure suffers from lack of efficacy, heavy indebtedness and nontransparent subsidy schemes. On the financial side, major infrastructure services are provided by the public organizations, which have lack of credibility, usually with opaque financial and accounting systems. That is why, all concerns and possible issues should be carefully analyzed before investing international reserves in investment projects.

Moreover, Uzbekistan should foresee future revenues and expenditures of the international reserves based on the current account balance and capital inflows condition. Taking into account the influence of internal and external factors, the current account deficit at the end of 2019 amounted to 3.2 billion US dollar, or 5.6% of GDP. The current account deficit has financed by the capital inflow on financial account, particularly, by an increase in external borrowing, crediting the Uzbekistan's economy and foreign investment. Net external borrowings in the form of loans and borrowings more than doubled, having increased in a year by 5.6 billion US dollar to 22.1 billion US dollar at the end of the 2019 year. Uzbekistan is lowering current account deficit by selling non-monetary gold, which sometimes represents a large part of the export of goods. In 2019, the export of non-monetary gold accounted for 35.4 % of export of goods[2].

Uzbekistan should also consider carefully the capital inflows. Driven by increasing globalization, local authorities stimulates foreign investment by liberalizing the legislation and further deregulation of economic activities, especially in banking sector. As a result, foreign direct investment in 5 years almost tripled and by the end of 2019 reached 2.29 billion US dollars, while portfolio investment during the same period increased from 1.7 million US dollars to outstanding amount of 1.35 billion US dollars[2]. Portfolio investment is less stable than Foreign Direct Investment (FDI), because FDI signals long-lasting commitment. That is why, adoption of the strategy of accumulating international reserves helps to guarantee financial sector stability.

If Uzbekistan accumulates international reserves, primarily to keep liquidity as the key element of investment, it would be irrelevant to invest reserves in infrastructure. Infrastructure projects usually produce little revenue or with higher probability in developing countries, it could be just wasting reserve funds because of possible deficiencies in the process of investment.

Finally, investment of international reserves for infrastructure projects would lead to expanding money supply as foreign reserve assets have to be sold for local currency. This, in turn, requires sterilization by the Central bank of Uzbekistan to stabilize prices. As a result, it could impede to the monetary policy implementation and lead to higher public debt.

CONCLUSION

The empirical analysis shows that countries should hold international reserves enough to cover 3 months of imports, 100% of short-term external debt or broad money to total reserve ratio should be no less than 20%.

Some economists argue that this level of international reserves is enough and excessive amount, invested in global capital markets or in domestic infrastructure, could bring much more profit for the country itself. Others suggest that accumulation of the international reserves may reduce borrowing cost and simultaneously be a buffer from the volatility of capital flows.

At the same time, only right and well-targeted investment of the international reserves in infrastructure may be driver for economic growth. In other cases, it would be just wasting funds.

Based on possible opportunities and risks of using international reserves for infrastructure projects, we assume that Uzbekistan is keeping the right strategy on accumulation of international reserves. Such strategy increases the confidence for policy makers and markets as well. As infrastructure projects produce little or no revenue, such incautious policy may lead to economic disturbances.

However, if Uzbekistan further accumulates international reserves and enhances return on assets, local authorities may consider the use of international reserves to finance infrastructure in future.

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