BUILDING BLOCKS FOR DEVELOPING THE LOCAL CURRENCY BOND MARKET FOR THE GOVERNMENT OF THE REPUBLIC OF UZBEKISTAN

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ANNOTATION. *This article analyzes the key building blocks for developing the local currency bond market for the government of the Republic of Uzbekistan and how the development of the local currency bond market contributes to financial market stability. Local currency bond markets help to strengthen money and financial markets. An efficient debt market promotes economic growth and development by allowing capital to be transferred from savers to borrowers. It improves allocation efficiency of resources in the economy, in addition to helping financial stability by improving monetary policy transmission.*

KEYWORDS: *bulding blocks, local currency bond market, risk, liquidity, depth of the market, exchange rate volatility, currency mismatch, maturity mismatch, financial crisis.*

INTRODUCTION.

Well-developed and efficient domestic government debt markets also promote financial stability during times of crisis and provide several other economic benefits. The financial crises of the past two decades, including the disruptions caused by the COVID-19 pandemic, have highlighted how robust local currency bond markets can alleviate financial stress. They do so by enabling borrowing in the domestic currency and offering a hedge against currency risks. According to the guidance note of the experts of the International Monetary Fund and the World Bank – "the development of local currency bond markets is a cornerstone of broader capital market development that helps risk to be priced appropriately, allows participants in financial markets to better manage their portfolios, and provides a more effective conduit for monetary policy. These factors then help boost a country's long-term economic growth potential". [1]

Over the past ten years, emerging market and developing economies have seen an increase in the percentage of total government debt that is marketable in local currency. The circumstances for this increase were brought about by improved macroeconomic conditions and a heightened awareness of the significance of growing domestic debt markets.

Increased monetary tightening in the US in 2022 caused capital outflows from emerging economies and currency depreciation. This illustrates how vulnerable emerging markets are to shocks from around the world: when investors sell riskier assets and move their money to safer, more liquid assets – a phenomenon referred to as flight-to-quality and flight-to-liquidity – market liquidity declines.

Systemic financial crisis could arise from a combination of structural flaws in the market and a lack of liquidity. For instance, maturity and currency mismatches were extensively documented in the late 1990s as a significant structural problem in the financial markets, which aided in the Asian financial crisis of 1997–1998. Emerging markets are exposed to shocks because they have trouble borrowing from outside in their own currency or borrowing for a longer period of time. To address the financial fragility caused by these flaws, many nations have worked to build local currency bond markets that channel local currency funding, particularly longer-term tenors, to borrowers. As previously stated, maturity and currency mismatches are recognized as major reasons that will be cause capital flight, significant currency devaluation, and the depletion of foreign reserves in emerging economies with underdeveloped local currency bond markets.

In emerging countries, businesses and non-bank financial organizations obtain short-term loans from foreign banks while investing in long-term assets and/or providing long-term loans. As a result, their balance sheets reflect both long-term assets and short-term liabilities. During the financial crisis, when international banks refuse to roll over short-term loans, local businesses will encounter cash flow problems due to the "maturity mismatch" issue. Furthermore, because these economies lack a strong local currency bond market, the vast bulk of these liabilities will be denominated in foreign currencies. This will cause the "currency mismatch" problem. Conversely, some contend that the emergence of a local currency bond market could potentially increase uncertainty due to the increased participation of foreign investors in this developing bond market. It is found that when the percentage of foreign holdings rises above a certain threshold, the effect of a global shock on the local currency bond market is amplified. A currency mismatch for foreign investors could arise from an increase in the supply of local currency bonds in an emerging economy. Foreign investors' balance sheets will be impacted by a decline in the value of local currency bonds, which may lead to fire sales as a way for them to safeguard their investments before further losses from currency depreciation occur.

The development of a local currency bond market is significantly influenced by enabling conditions and six key building blocks that help evaluate its progress and ensure its effectiveness. Enabling conditions, such as a stable macroeconomic environment, sound fiscal policies, and institutional capacity, are essential for the proper functioning of local currency bond markets. After assessing these conditions, the local currency bond market framework can be used to gauge the current state of market development in individual countries and identify areas that require reform or policy intervention. The development of local currency bond markets is analyzed through six core building blocks that determine the market's depth, liquidity, diversity, and resilience.

LITERATURE REVIEW.

Studies have looked into the criteria necessary for the establishment of a local currency bond market. Burger and Warnock (2007) stated that the establishment of a local bond market is dependent on the rule of law and effective macroeconomic policy. They discovered that nations with stable inflation and strong creditor rights are more likely to have well-established domestic currency markets and a lesser reliance on foreign currency bonds. They claimed that improving macroeconomic performance and the creditor protection system would enable the establishment of a local currency bond market while lowering the risk of a crisis. [2]

According to Boukhatem (2021), macroeconomic and financial variables are more important than institutional factors in the short-term development of a local currency bond market. However, he discovered that a huge economy, significantly increased government spending, low inflation, a broader and deeper financial system, and improved bureaucratic quality are all relevant. [3]

Berensmann et al. (2015) shown that the expansion of a local currency bond market is related to the size of the economy, the involvement of the banking sector, trade openness, and an effective regulatory framework. [4]

Eichengreen et al. (2005) noted that due to underdeveloped bond markets, local currency-denominated bonds provide minimal liquidity when many economies experience high inflation and currency instability. Because of this dilemma, many economies are forced to issue short-term bonds in a foreign currency with a consistent value. As a result, if the local currency bond market is expanded to provide liquidity, these economies may be able to overcome the so-called "original sin." The term "original sin" refers to some economies' incapacity to borrow abroad using their own currency. [5]

ANALYSIS AND RESULTS.

Recently, Uzbekistan is advancing the development of local currency debt markets in order to stimulate investment in infrastructure. First, the government's ability to successfully increase reliance on the bond market as a substitute source of funding for bank loans; and second, their capacity to impose fiscal contraction as a way to curtail bank lending and lower interest rates. Uzbekistan will need to grow quickly in the domestic debt market in order to reach this goal. Realistic policy sequences should be followed in the long-term planning and implementation of Uzbekistan's domestic debt market development. To reduce systemic risk, it must adhere to banking industry regulations.

In 2021 the experts of the International Monetary Fund and the World Bank developed local currency bond markets guidance notes for countries as a recommendatory nature. According to the notes there should be enabling conditions and 6 building blocks in order to develop the local currency bond markets.

Since enabling conditions essentially define a nation's economic potential, they are essential to the success of agreed-upon local currency bond market reform efforts. In order to produce a more precise evaluation of the foundational elements for the growth of the local currency bond market, it is imperative to assess the type of enabling conditions present in the subject nation. The goals and order of reforms in policy can also be influenced by the status of enabling factors. However, even in the face of inadequate enabling conditions, bolstering the fundamental features of the local currency bond market building blocks can support a positive feedback loop since they will enhance macroeconomic discipline, which in turn can enhance the enabling conditions themselves. There is an inherent limit to the growth of domestic markets in nations with structural constraints, such as those pertaining to the size of the financial sector or the economy; instead, the main objective may need to be securing consistent, ongoing funding from the domestic market.

The enabling conditions consist of macroeconomic conditions, financing needs of the government, fiscal and debt position, monetary and exchange rate conditions, structure of the economy, financial sector soundness, debt management capacity and operating procedures. Each enabling conditions assess one to four according to the development of them. Here are the components of the enabling conditions:

– Macroeconomic Conditions - Overall stable macroeconomic conditions and a good past track record to broaden potential demand and enable primary dealer intermediating role with a broader universe of potential investors;
– Financing needs of the government - The government’s financing needs must form the basis of debt issuance. Local currency bond market development may be impaired in some lower income countries in which the availability of concessional borrowing makes the issuance of local debt more expensive;
– Fiscal and Debt position - High financing needs, and unsustainable debt trajectory may encourage debt management office to recur to interest rate controls and financial repression that undermine investors’ appetite;
– Monetary and exchange rate conditions - Stable inflation, interest rates and exchange rates reduce uncertainty for investors and enhance demand for government marketable debt;
– Structure of the economy - Small economies may struggle to build liquid markets, low saving rates may limit demand, high level of dollarization equally constraint local currency assets’ demand;
– Financial sector soundness - The financial sector needs to be well-capitalized and liquid. Any risks of financial sector instability would hamper the capacity of the banking sector to play its role effectively;
– Debt management capacity and operating procedures – debt management office

should have trained staff, resources, and an adequate organization structure.

Enabling conditions are crucial for the success of local currency bond market reforms and are key in defining a country's developmental prospects. To assess the foundational elements for local currency bond market growth effectively, it is important to consider the specific nature of the enabling conditions within the country being evaluated. The state of these conditions can influence policy priorities and the sequence in which reforms are implemented. Even in cases where enabling conditions are less than ideal, improving the basic functionalities of local currency bond market building blocks can still trigger a positive cycle–these reforms can enhance macroeconomic discipline, which in turn may lead to improved enabling conditions. For countries with structural challenges, such as a small economy or limited financial sector, there may be inherent limits to the development of the domestic market; in such cases, the primary goal might be securing stable, reliable financing from the domestic market.

According to the assessments of the enabling conditions of local currency bond market of Uzbekistan (Figure 1) the main problems with debt management capacity and operating procedures are not having sound governance arrangements and qualified staff in a responsible entity for debt management and problems with the preparation and publishing of a medium-term debt management strategy by an entity.

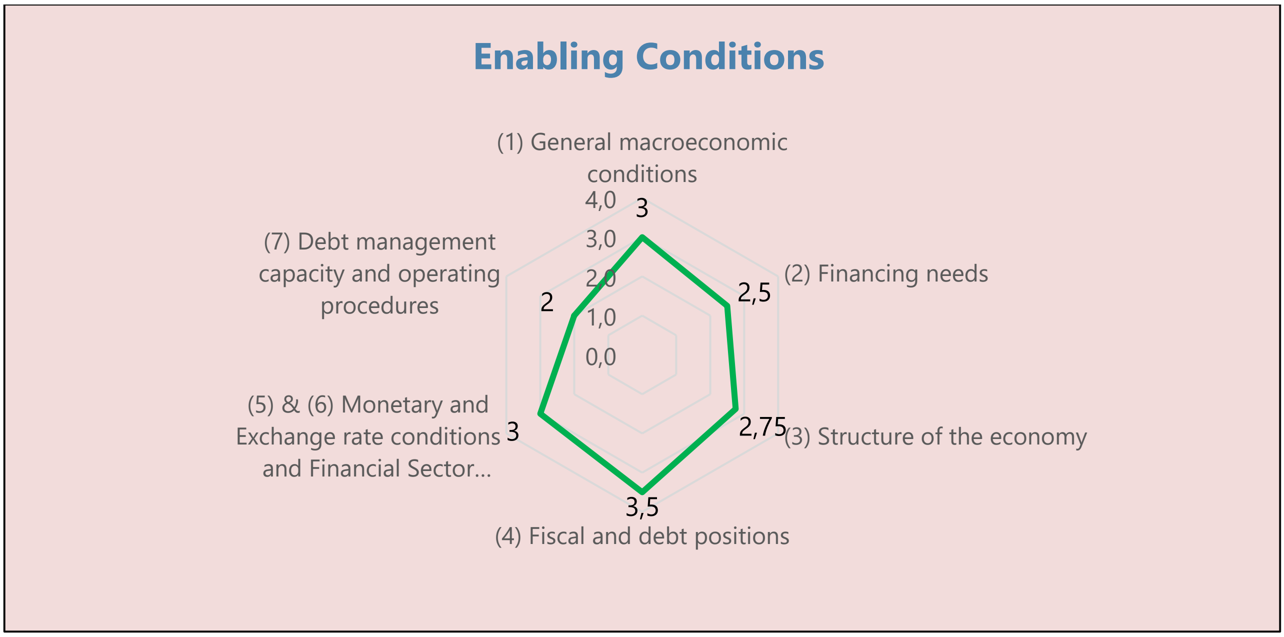


Figure 1. The assessment of the enabling conditions of the local government securities market of the Republic of Uzbekistan.[1]

[1] The figure was prepared by the author using the guidance notes of the International Monetary Fund and the World Bank.

The assessment highlights a balanced economic environment, with notable strengths in fiscal and debt positions (3.5) and macroeconomic stability (3.0), reflecting sound fiscal management and stable financial conditions. However, challenges persist in debt management capacity (2.0) and financing needs (2.5), indicating the need for improved operational frameworks and expanded access to funding. Strengthening these weaker areas, alongside efforts to enhance the economic structure (2.75), could foster a more robust and resilient economic foundation.

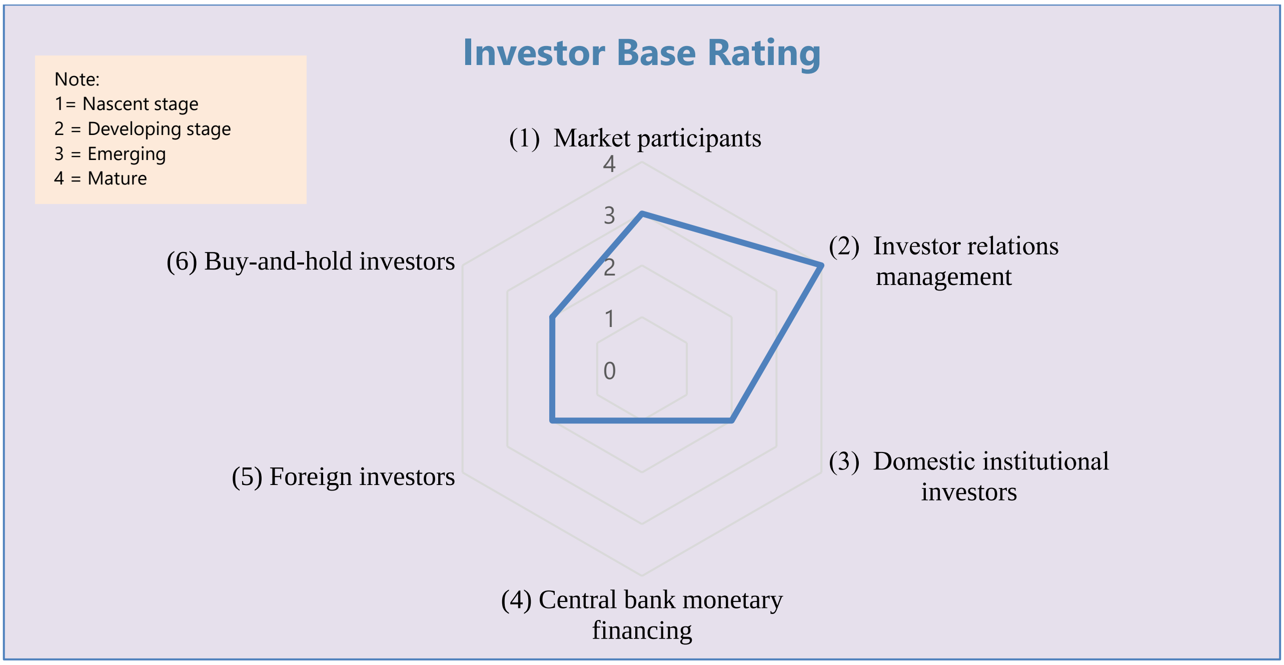


Figure 2. The assessment of the Investor Base of the local government securities market of the Republic of Uzbekistan.[2]

Figure 2 above shows the assessment of the Investor Base of the local currency bond market of the Republic of Uzbekistan. The development of a resilient and diversified investor base is critical for fostering stability and efficiency in government securities markets. Analysis of the current investor base reveals significant gaps and over-reliance on central bank monetary financing, with most components still in nascent or developing stages. While moderate participation from market participants exists, limited engagement by domestic institutional investors, foreign investors, and buy-and-hold investors hinders market depth and sustainability. Moreover, weak investor relations management further constrains market confidence and transparency.

To address these challenges, it is imperative to strengthen investor relations, promote participation from domestic and foreign investors, and attract long-term buy-and-hold investors

[2] The figure was prepared by the author using the guidance notes of the International Monetary Fund and the World Bank.

through targeted incentives and regulatory reforms. Diversifying funding sources away from central bank financing is also essential to build a market-driven ecosystem. By adopting these strategies, governments can enhance market liquidity, reduce volatility, and support sustainable growth in government securities markets.

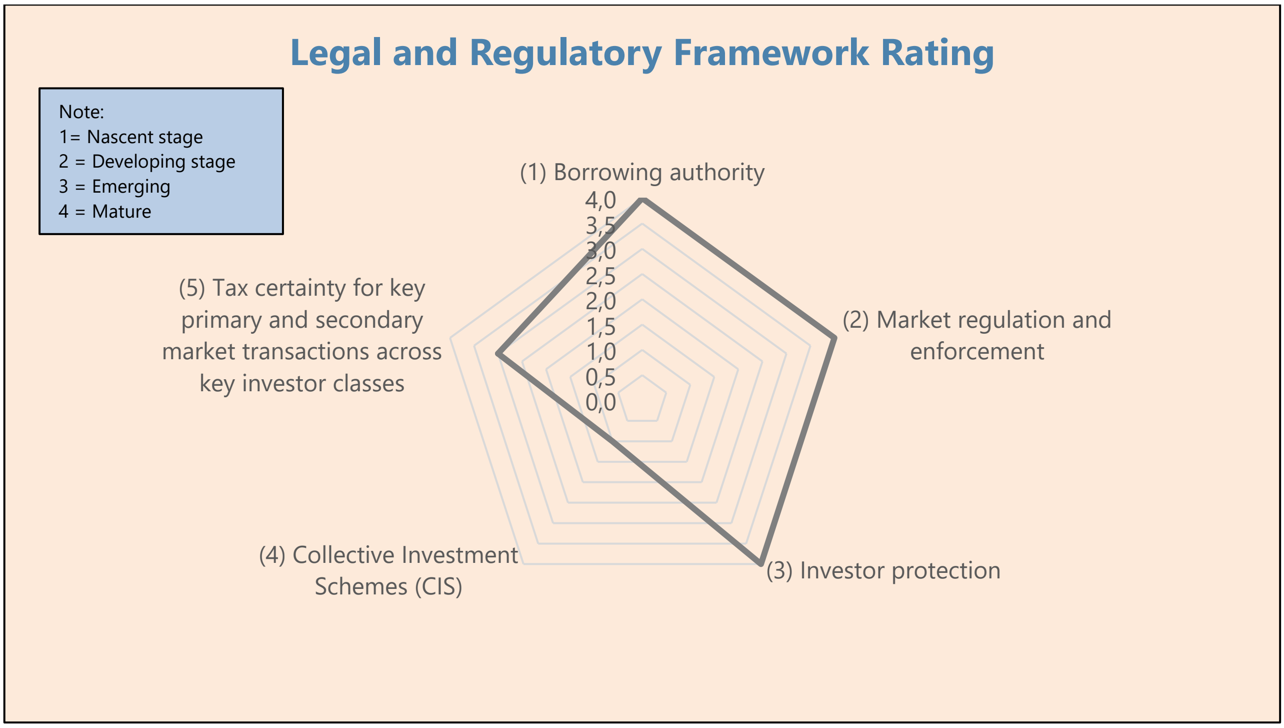
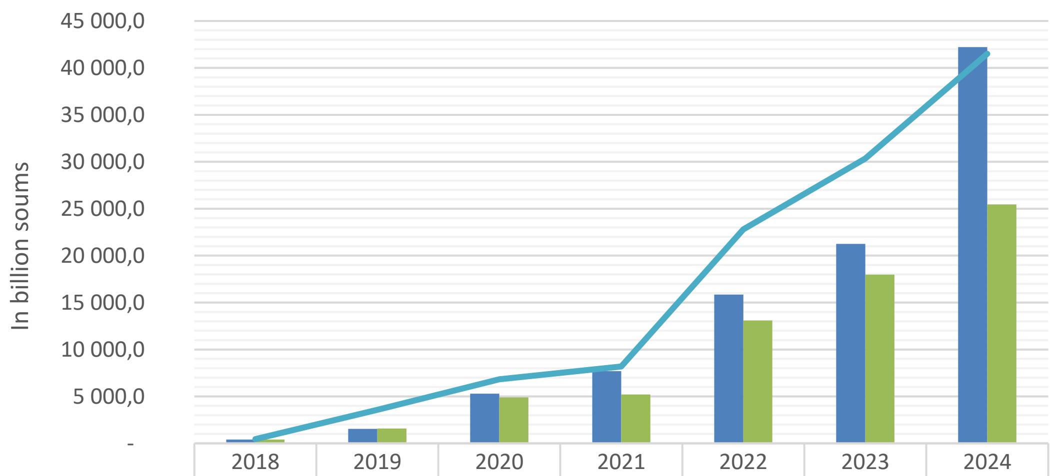


Figure 3. The assessment of the Legal and Regulatory Framework of the local government securities market of the Republic of Uzbekistan.[3]

According to the analysis (Figure 3) Uzbekistan's local currency bond market is in the early stages of development, with significant progress needed in several areas. The legal framework for borrowing authority is strong, allowing the government to issue bonds confidently. However, market regulation, investor protection, collective investment schemes (CIS), and tax certainty require improvement. Regulatory mechanisms are developing but need further strengthening, while weak investor protections undermine trust. The lack of a framework for CIS limits market depth, and uncertain tax policies hinder investment. To foster a competitive bond market, Uzbekistan should focus on enhancing investor protection, developing CIS, improving market regulation, providing tax certainty, and leveraging its borrowing authority. Addressing these gaps will help attract both domestic and international investors and support long-term economic growth.

[3] The figure was prepared by the author using the guidance notes of the International Monetary Fund and the World Bank.

Uzbekistan's local currency bond market has witnessed significant growth in recent years, driven by initiatives from the central bank, government, and other key stakeholders. Despite notable progress in expanding activity within the corporate bond market, the government bond market continues to dominate Uzbekistan's bond market landscape.



	2018	2019	2020	2021	2022	2023	2024
Volume of issuance	400,0	1 550,0	5 290,0	7 700,0	15 860,0	21 250,0	42 211,7
Amount of placement	404,9	1 582,2	4 902,6	5 214,4	13 100,6	17 980,8	25 454,1
Volume of submitted orders	450,8	3 573,1	6 823,3	8 189,4	22 806,6	30 349,7	41 503,6

Figure 4. Volume of government securities issued and placed by the Ministry of Economy and Finance of the Republic of Uzbekistan during 2018-2024[4]

Figure 4 illustrates the issuance and placement of government securities by the Ministry of Economy and Finance from December 2018 to September 2024. The data reveals notable trends and a growing demand for government securities denominated in the domestic currency. In December 2018, the Ministry announced the issuance of state securities worth 400 billion soums, of which 404.9 billion soums were successfully placed. However, the number of bidders was limited to only five, predominantly state-owned banks. By 2019, the government securities market saw substantial growth, with 1,582 billion soums placed, surpassing the announced volume by nearly 32 billion soums.

The trend of increasing activity continued in subsequent years. In 2023, a total of 17.9 trillion soums in government securities were placed, reflecting an increase of nearly 5 trillion soums compared to the previous year. For 2024, as of September 1, the issuance of state securities worth 42.2 trillion soums was announced, and 25.5 trillion soums were already placed. The analysis highlights a consistent and growing demand for government securities denominated

[4] The figure prepared by the author using data on the official website of the Currency Exchange of the Republic of Uzbekistan www.uzrvb.uz.

in the domestic currency. For example, in 2019, while 1,550 billion soums worth of state bonds were announced, requests for these bonds totaled 3,573 billion soums—more than double the issuance. Similar trends of demand outpacing the announced volume are evident in the following years, emphasizing the increasing appetite for domestic currency-denominated bonds.

Starting from 2021, the laws on the state budget, which are approved every year, have confirmed the limited net volume of the issuance of government securities (Table 1).

In table 1 below provides an analysis of the limited net volume of state securities issuance and the limited amount of public debt in each year's State Budget Laws. According to the table, the limited amount of state securities in 2021 is set at 5 trillion soums, and the limited amount of state debt is set at 5.5 billion US dollars.

Table 1.

Analysis of the determination of the limited net volume of Government securities for 2021-2025[5]

Years	Limited amount of public debt	Limited net volume of government securities	Legal basis
2025 year	5.5 billion US dollars	30.0 trillion soums	Law "On the State Budget of the Republic of Uzbekistan for 2025", 24.12.2024/No.1011
2024 year	5 billion US dollars	25.0 trillion soums	Law "On the State Budget of the Republic of Uzbekistan for 2024", 25.12.2023/No 886
2023 year	4.5 billion US dollars	17.0 trillion soums	Law "On the State Budget of the Republic of Uzbekistan for 2023", 30.12.2022/No 813
2022 year	4.5 billion US dollars	6.0 trillion soums (12.0 trillion soums)*	Law "On the State Budget of the Republic of Uzbekistan for 2022", 30.12.2021/No 742 /29.12.2022/No 811
2021 year	5.5 billion US dollars	5.0 trillion soums	Law "On the State Budget of the Republic of Uzbekistan for 2021", 25.12.2020/No 657

[5] The table prepared by the author using legislation documents on the official website of the National database of legislation of the Republic of Uzbekistan https://lex.uz/.

In 2022, although the limited amount of state securities was set at 6 trillion soums at the beginning of the year, it was changed to 12 trillion soums by the end of the year. For 2024, the limited amount of state debt was set at 5 billion US dollars, and the limited amount of state securities was set at 25 trillion soums. However, in 2024, the limited amount of state securities was set so far that the volume of issuance was 42.2 trillion soums and nearly 17 trillion soums above the limited net volume of the issuance of government securities. In our opinion, the limited net volume of the issuance of government securities defined by the law will change until the end of this year. For 2025, the limited amount of state debt is set at 5.5 billion US dollars, and the limited amount of state securities is set at 30 trillion soums which is the considerably higher than 2024 year's volume of local government bonds.

CONCLUSIONS

To strengthen local currency bond markets, the government should create an attractive environment for foreign investors while simultaneously enhancing macroeconomic stability. In order to tackle the original sin issue, the Republic of Uzbekistan should issue long-term bonds with various maturities and work to reduce its dependence on short-term foreign borrowing. The objective is to improve the country's ability to withstand external shocks and prevent exchange rate fluctuations that may result from sudden halts or short-term reversals in international capital flows.

Some theoretical studies link the growth of local currency bond markets to financial stability. The creation of a local currency bond market may contribute to an economy's financial stability by reducing foreign borrowing and boosting the diversity of bonds with varying maturities.

If developing economies maintain the majority of their liabilities in local currency denominated bonds, a fall in the local currency's value may not raise the likelihood of foreign capital outflows. As the local bond market grows, bank liquidity will improve. Furthermore, the availability of bonds with varying maturities and long-term maturity will address the maturity mismatch issue and eventually contribute to financial stability. Many emerging economies are significantly reliant on bank finance. They say that local currency bond markets help to deepen capital markets and balance financial systems by lowering reliance on bank financing.

A well-developed local currency bond market also delivers significant economic benefits:

It offers a yield curve, which is a market-determined term structure for interior rates. The yield curve is used primarily as a benchmark for pricing credit risk, bank loans, and equities. The shape of the yield curve provides useful information regarding market expectations of future interest rates and inflation rates for macroeconomic policymakers. The bond market serves as the foundation for the development of efficient derivatives markets (forwards, futures, swaps, and options) for low-cost financial risk management.

It allows for the transfer of risks through security. The bond market is an essential instrument for banks to bundle and sell loans. This decreases banks' liquidity risk and mitigates maturity mismatches.

The essence of the six building blocks for the development of a Local Currency Bond Market lies in their collective role in fostering a deep, liquid, diverse, and resilient market. Each building block–ranging from the money market to the legal and regulatory framework–plays a crucial part in ensuring the efficiency and stability of the bond market. A well-functioning Local Currency Bond Market requires a solid money market for liquidity management, a robust primary and secondary market for efficient bond issuance and trading, a broad and diversified investor base, reliable financial market infrastructure for seamless transactions, and a transparent legal and regulatory framework to protect market participants. Together, these elements create a foundation that not only supports the growth of local currency bond markets but also enhances economic stability, financial inclusion, and the effective transmission of monetary policy. The careful development and integration of these building blocks are essential for countries aiming to build a sustainable and successful local currency bond market.

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