CENTRAL BANK OF THE REPUBLIC OF

MONETARY POLICY REVIEW

Second Quarter, 2021

Tashkent, 2021

CONTENTS

INTRODUCTION

In Q2 2021, there were accelerated recovery of economic activity in the country, aggregate demand continued to grow faster than expected, and growth in most sectors reached pre-pandemic levels. In particular, in the first half of 2021, real GDP growth was **6.2%** compared to the corresponding period of last year.

The **industrial production and services** growth rates (8.5% and 18.3%, respectively) have reached their pre-pandemic levels while agriculture (1.8%) and construction (0.1%) did not demonstrate significant growth this year due to already high rates in 2020. More positive figures are expected in the second half of 2021.

In the first half of 2021, the volume of **private capital investments** increased by **15%** compared to the same period of last year. The **investments demand** was mainly driven by commercial banks' loans and foreign credit lines.

Due to the introduction of restrictive measures related to the pandemic, the **negative output gap** in the economy began to form in 2020 Q1 and reached its maximum level in Q2. Over the past **4 quarters**, gradual acceleration of economic activity and the aggregate demand growth has led to a **reduction in the negative output gap**. The negative GDP gap is predicted to gradually narrow and **close by the end of this year** provided that the current pace of economic activity growth remain during the second half of 2021 *(Figure 1)*.

The Central Bank has revised its medium-term forecasts of macroeconomic development, taking into account the macroeconomic results for H1, 2021 and the expected trends in external and domestic economic conditions.

According to the updated forecasts, real GDP growth by the end of 2021 is expected to be in the range of **5.8-6.8%** *(Figure 2)*, which is higher than the **preliminary** (4.5-5.5%) indicators estimated at the end of Q1 **by 1.0-1.3 percentage points**.

At the same time, further **fiscal stimulus** to the economy in 2021, the recovery of aggregate demand against the background of **unchanged** monetary conditions in Q4, 2020 and H1, 2021, the acceleration of **private investment** as a result of structural reforms to liberalize the economy will be key support factors of economic growth.

Figure 1. Output gap

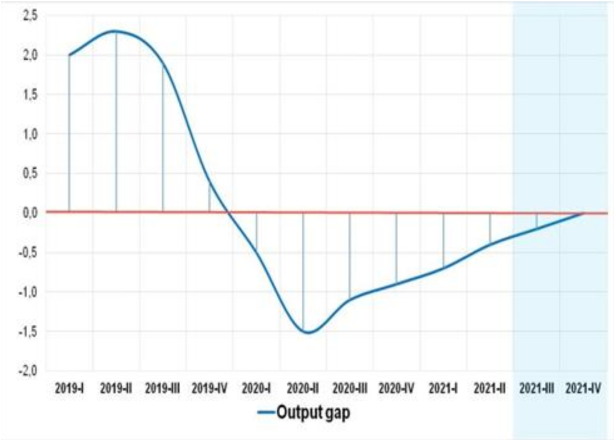
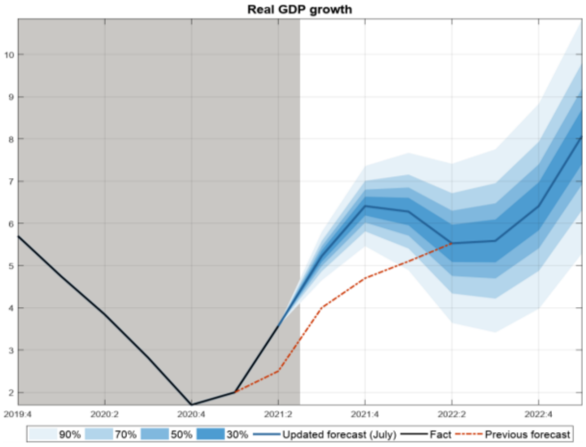


Figure 2. Real GDP growth forecast



Source: *Central bank forecasts*

This year, the **growth rate of the loans to economy** is projected at the level of nominal GDP growth (16-20%). At the same time**, the repayment** of previously issued loans is expected to **increase** due to improved income and financial condition in the economy.

The fact that the growth rate of loans provided to the economy is at the level of nominal GDP growth does not have a negative impact on the indicators of **financial stability** (the level of provision to the economy with financial resources).

The annual inflation rate was **10.9%** by the end of June and formed within the baseline forecast over the last three months.

New inflation forecasts for 2021 remain unchanged at **9-10 percent.** The inflation forecast for the end of the year will be achieved by maintaining relatively stable monetary conditions, changes in the monetary policy instruments, stable trends in the foreign exchange market, and accelerating measures with relevant ministries and agencies to reduce the impact of non-monetary factors.

According to forecasts, real growth in final consumer spending is expected to be around **7-8%**. In particular, household consumption is projected to increase by **7.5-8.5%** and government expenditures by **7-8%.** The increase of real growth in consumption is explained by the **emergence of deferred demand** as a result of the pandemic and the **recovery of household incomes**.

By the end of the year, the volume of investments in fixed assets is projected to grow by **13-18%**, in particular, the volume of public investments by **24-26%**, and the volume of private investments by **10-16%** *(Table 1).*

After a sharp decline in exports (excluding gold exports) as a result of the pandemic last year, domestic and foreign economic activity is expected to grow by **20-25%** and imports by **12-15%** this year.

It should be noted that the Central Bank tried to take into account the situation with the pandemic and vaccination in the world, economic conditions and the level of recovery of the main trading partners, potential internal and external risks and uncertainties when implementing medium-term macroeconomic forecasts.

At present, there are risks and uncertainties associated with the upsurge of the next wave of the pandemic in the world, the spread of **new variants** of coronavirus and, as a result, the implementation of local **restrictive measures** that is likely to have a significant impact on **economic activity** by the end of the year.

Table 1. Forecasts on changes in macroeconomic indicators for 2021
(as a percentage)

Indicators	**2020** (fact)	**Previous forecast**	**Updated forecast** (first half results)
Inflation rate	11.1	9-10	**9-10**
Real GDP growth	1.6	4.5-5.5	**5.8-6.8**
Final consumption	2.7	4.3-5.3	**7-8**
- households	*3*	*4.5-5.5*	***7.5-8.5***
- government	*2*	*6-6.5*	***7-8***
Gross capital formation	-8.2	2-4	**13-18**
- private	*-34.9*	*2.5-4.5*	***24-26***
- public	*2*	*1.5-3.5*	***10-16***
Exports *(excluding gold)*	-25.7	8-10	**20-25**
Imports	-12.8	6-8	**12-15**
Growth of loans to economy	34.3	20-22	**16-20**
Overall budget deficit *(as a percentage of GDP)*	4.4	4.4-5.5	**4.4-5.5**

Source: *Central bank forecasts*

In the future, the Central Bank will constantly update its forecasts and analysis, as well as take the necessary measures on monetary policy in response to changes in **macroeconomic conditions** and the **projected dynamics of inflation**.

I. INTERNAL MACROECONOMIC CONDITIONS

1.1. Recovery in economic activity and key macroeconomic indicators

In Q2 2021, the macroeconomic situation was formed within the **baseline and optimistic scenarios** of the monetary policy guidelines for 2021 and 2022-2023.

In particular, in the Q2 external and internal fiscal stimulus and the growth of loans to economy have led to a sharp increase in **economic activity** and **aggregate demand**.

The revival of economic activity also reflected an increase in trade and services income, operations through the banking system, money transfers and exports, as well as the number of contracts on the Republican Commodity Exchange.

Figure 1.1. Income from trade and services

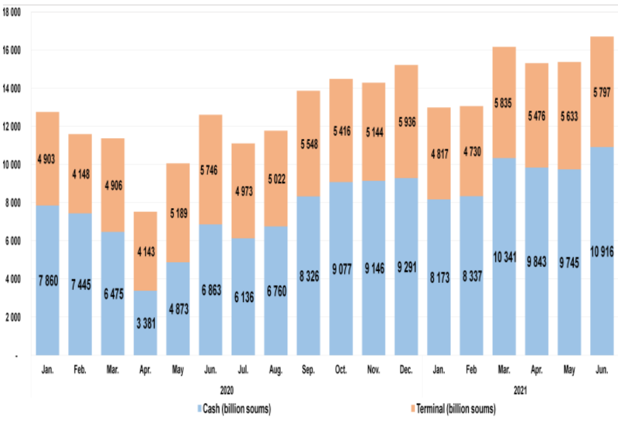
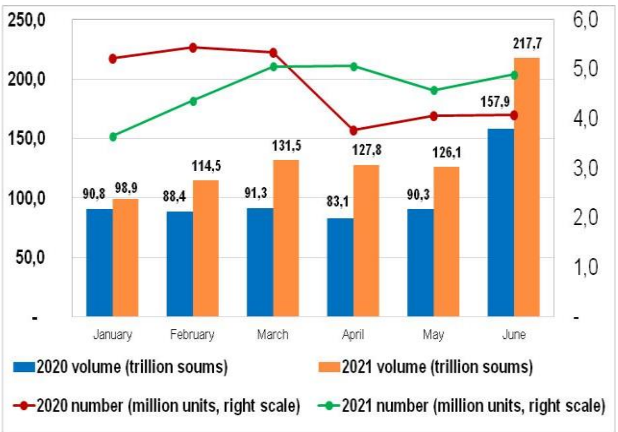


Figure 1.2. Number and volume of interbank transactions



Source: *Central bank*

Income from trade and services in the Q2 amounted to **47.4 trln.** sum, increasing by **57.0%** compared to the corresponding period of 2020 *(Figure 1.1).*

Also, in January-June 2021, cash income from trade and services increased by **1.4 times** compared to the same period last year and **1.6 times** compared to the same period in 2019.

This, in turn, indicates that the sectors of the economy that deal with cash (traditional markets and consumer services) have completely restored economic activity, jobs and incomes, having got out of the influence of the pandemic.

During this period, the volume of interbank transactions amounted to **471.6 trln.** sum and increased by **42.3%** (140.3 trln. sum) compared to the same period last year (270.6 trln. sum) *(Figure 1.2)*.

Also, in Q2 2021, the volume of contracts on the Republican Commodity Exchange increased by **22.4%** (3.9 trln. sum) compared to the Q1 and amounted to **21.6 trln.** sum.

The fast recovery of economic activity in the formal and informal sectors and the increase in incomes were also reflected in the gross domestic product indicators.

In particular, in H1 2021, the gross domestic product increased by **6.2%** compared to the same period last year *(Figure 1.3).* Such a high growth rate is relative, firstly, to the **low base effect** in January-June 2020, and secondly, to the support of aggregate demand in the economy due to **fiscal stimulus**, growth of **loans to economy** and an increase in **external demand**.

Figure 1.3. Real growth of GDP and its components

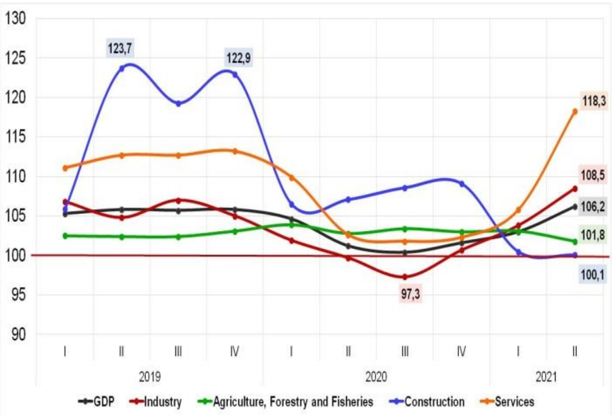
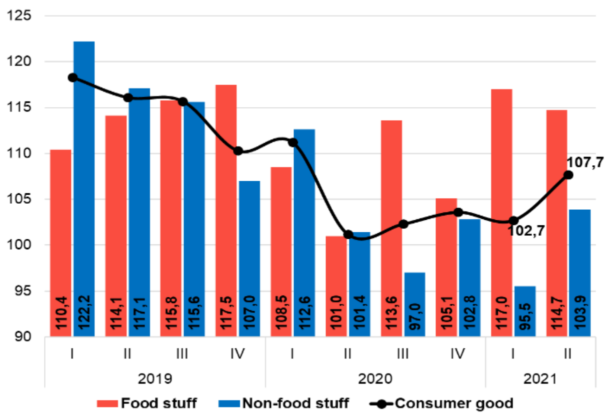


Figure 1.4. Change in the volume of production of consumer goods
(compared to the corresponding period of the previous year, as a cumulative percentages)



Source: *State Statistics Committee*

The increase of the demand in the economy, in turn, is also reflected in the growth in consumer goods production by **7.7 percent** compared to the corresponding period of the previous year, and in the turnover of retail trade by **9 percent**.

The **investment demand** growth was largely driven by commercial bank loans and foreign credit lines, and in the H1 the volume of capital investments increased by **5.9%** compared to the same period last year and amounted to **103.1 trln.** sum *(Figure 1.6).*

Figure 1.5. Dynamics of retail turnover

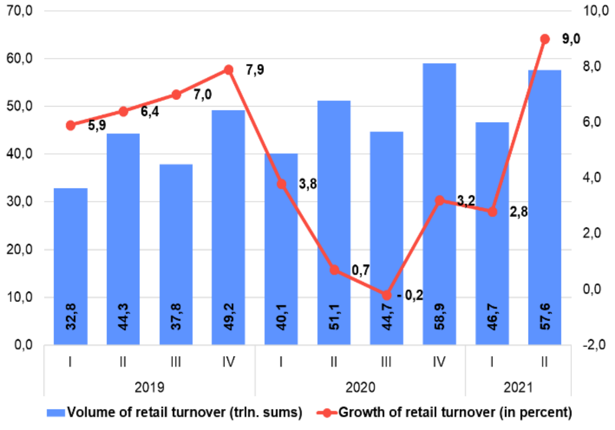
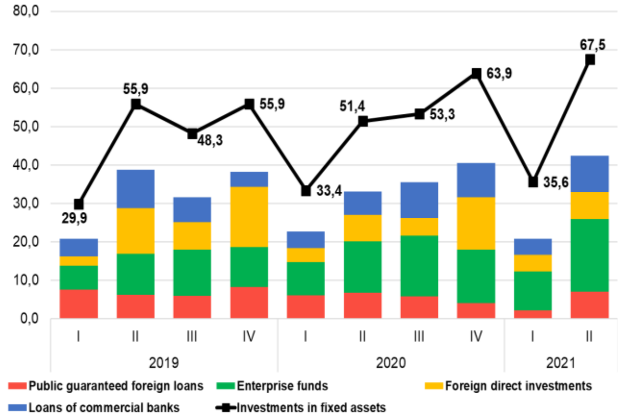


Figure 1.6. Volume and sources of capital investments

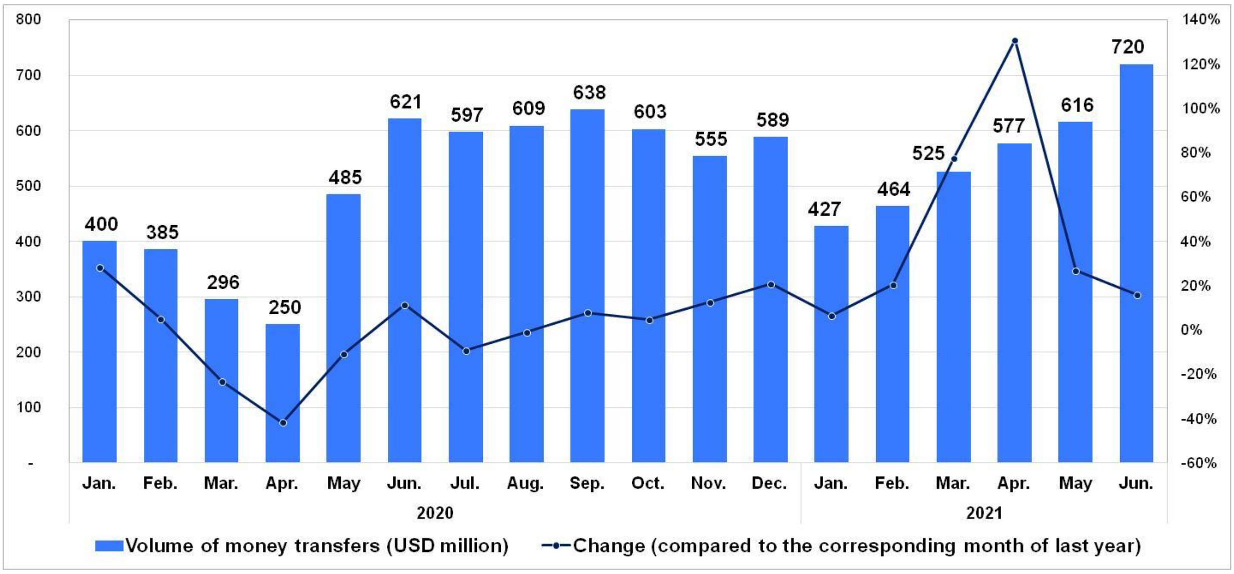


Source: *State Statistics Committee*

In H1 2021, **16.1%** of total investments in fixed assets were private investments and **83.9%** were public investments.

Although the share of **state-guaranteed foreign loans** in the structure of public investments remains high, it has declined compared to last year. In particular, the share of these loans in H1 2020 amounted to **65%**, while in the corresponding period of current year this indicator decreased to **55%.**

Figure 1.7. Dynamics of the volume of cross-border money transfers



Source: *Central bank*

In turn, the volume of private investments in H1 amounted to **86.5 trln.** sum, which is **15%** more than in the same period last year. The share of **enterprises' own funds** (33.6%), **bank loans** (15.8%) and **foreign direct investment** (13.1%) is relatively high in the structure of private investments.

The volume of remittances to our country, which is one of the factors in the formation of aggregate demand in the economy, was **1.4 times** higher than in the corresponding period of 2020 *(Figure 1.7).*

Against the background of the **recovery of economic activity** in Uzbekistan's main trading partners, alongside an increase **in the number of air travels** with Russia, the pace of growth in the volume of cross-border money is projected to be about **10-12%** by the end of this year.

1.2. Government expenditure and expectations

Since the beginning of 2021, **fiscal stimulus** has been actively continuing in order to support economic activity, increase household incomes and eliminate the consequences of the coronavirus pandemic.

In particular, in Q1 2021, the budget deficit amounted to **286 bln.** sum. In the Q2, the **deficit** attained to **4.2 trln.** sum *(Figure 1.8).*

At the same time, fiscal stimulus in the H1, taking into account the expenditures to the economy from extra-budgetary funds and other sources, on the one hand supported economic activity, on the other hand significantly increased demand inflationary pressures in the economy.

By the end of Q1 2021, the country's external debt amounted to **21 bln.** dollars and did not change significantly compared to the beginning of the year *(Figure 1.9).*

Figure 1.8. Budget revenues and expenditures *(billion sums)*

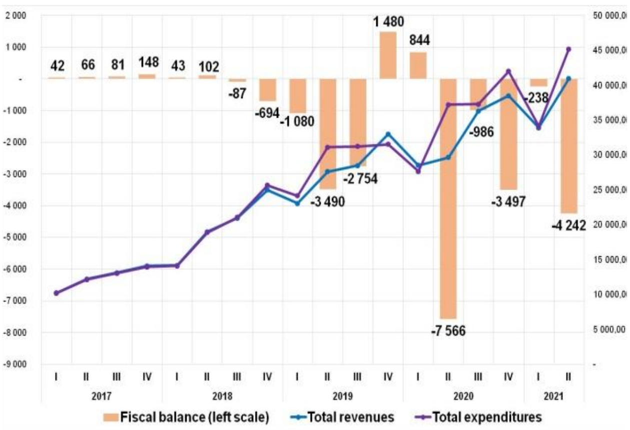
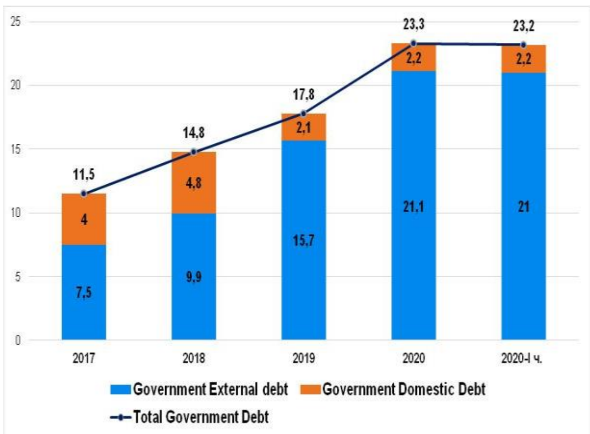


Figure 1.9. Domestic and external debt *(billion dollars)*



Source: *Ministry of Finance and Central Bank*

In turn, in the H1 the Ministry of Finance issued government securities to the domestic market in the amount of **2.2 trln.** sum. Total amount of bonds as of July 1, 2021 amounted to **3.2 trln.** sum.

In general, the increase in government financial spending over the past **6 quarters** along with monetary factors, led to the resumption of economic activity.

It should be noted that in 2020, public expenditures were directed to increasing the capacity of the health system to combat the pandemic, social support and economic recovery during the pandemic, and by the end of the year the **overall fiscal deficit** amounted to **4.5%** of GDP.

In 2021, fiscal policy will be aimed at further stimulating economic activity, returning to pre-pandemic real economic growth, supporting the population and certain sectors of the economy, including the development of family, youth and women's entrepreneurship. And at the end of the year, the overall fiscal deficit is expected to reach **5.4%** of GDP.

The role of fiscal policy in the current environment is also important at the international level, thus such a policy is hold in almost all foreign countries.

In the coming years, the **reduction of the deficit** due to the growth of budget revenues and the optimization of budget expenditures will play an important role in ensuring macroeconomic stability and achieving the **inflation target**.

Given that the fiscal support will impact on the economy with a **certain lag**, fiscal expenditures of H1 2021 will serve to increase economic activity in the H2 as well. At the same time, the increase in social spending during the year will have a positive effect on the growth of aggregate demand and income, and a negative impact on inflation.

Also, in the medium term, the optimization of government spending will have a positive effect on improving the balance of payments and will contribute to a balanced growth in aggregate demand in the economy.

1.3. Dynamics of loans to the economy

At the end of Q2 2021, credit investments in the economy rised by **5.9%** (17 trln. sum) to **304.8 trln. sum**. *(Figure 1.10)*.

In the H1, a total **of 79.1 trln. sum** worth of loans have been provided to the economy and it was **35%** more than in the same period last year.

Figure 1.10. Changes in loans to economy and its components *(trln. sum)*

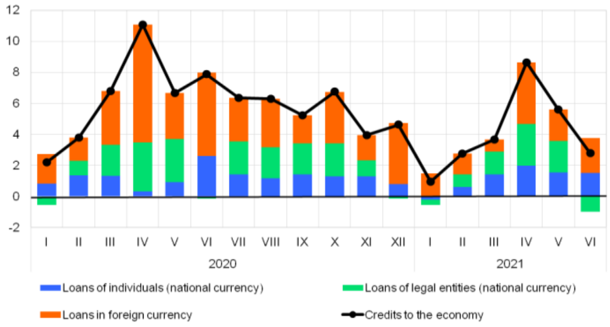
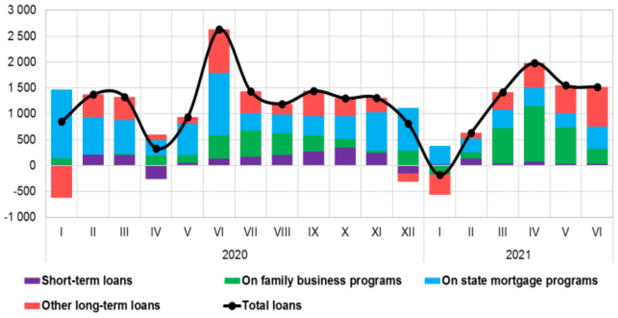


Figure 1.11. Change in loans to the individuals *(trln. sum)*



Source: *Central Bank*

The loan repayment rate increased from **56%** in H1 2020 to **72%** in the corresponding period of this year. This can be explained by the resumption of economic activity and the financial turnover of business entities.

In the Q2 loans to the individuals increased by **8.9%** or **5.1 trln. sum**, this is largely relative to the rise of mortgage loans under government programs for housing and the growth of loans for the development of family businesses *(Figure 1.11).*

Overall the growth of loans to the economy in the H1 of the year amounted to **8.7%** and was within the baseline forecasts of Central Bank.

The balance of credit growth is positive, on condition that the current pace of lending growth continues, it is expected that loans to the economy will increase by **16-20%** and will be **in proportion to nominal GDP growth** by the end of the year. This, in turn, allows minimizing the impact of monetary factors that can put pressure on macroeconomic and financial stability.

II. EXTERNAL ECONOMIC CONDITIONS

2.1. The situation with the pandemic and the recovery of external demand

The process of **economic recovery** in different regions of the world is not the same. According to international experts, if large-scale vaccination allows for a full recovery of normal economic activity, low levels of vaccination could delay economic recovery and return to pre-pandemic levels. There is a longer recovery process, mainly in countries with high levels of dependence on tourism and services.

According to data updated by the **World Bank** in June, the growth factors of the global economy in 2021 will be the emergence of delayed demand by China and the recovery of aggregate demand under the influence of large-scale financial stimulus to the US economy. The highest growth rate is expected in the Chinese economy - **8.5%** *(Table 2.1).*

Table 2.1. Economic recovery and economic growth in Uzbekistan's major trading partners

Countries	Real GDP growth rate before pandemic (2019)	2020	2021 (forecast)	Forecast of a return of real GDP growth to the pre-pandemic level	Proportion of vaccinated population (as of 20.07.2021)
Kazakhstan	4.5%	-2.6%	3.2%	4.8% (2023)	26%
China	6.0%	2.3%	8.5%	8.5% (2021)	43%
Russia	2.0%	-3.0%	3.2%	3.2% (2021)	23%
Turkey	0.9%	1.8%	5.0%	1.8% (2020)	46%

Source: *Global Economic Prospects. World Bank. June, 2021.*

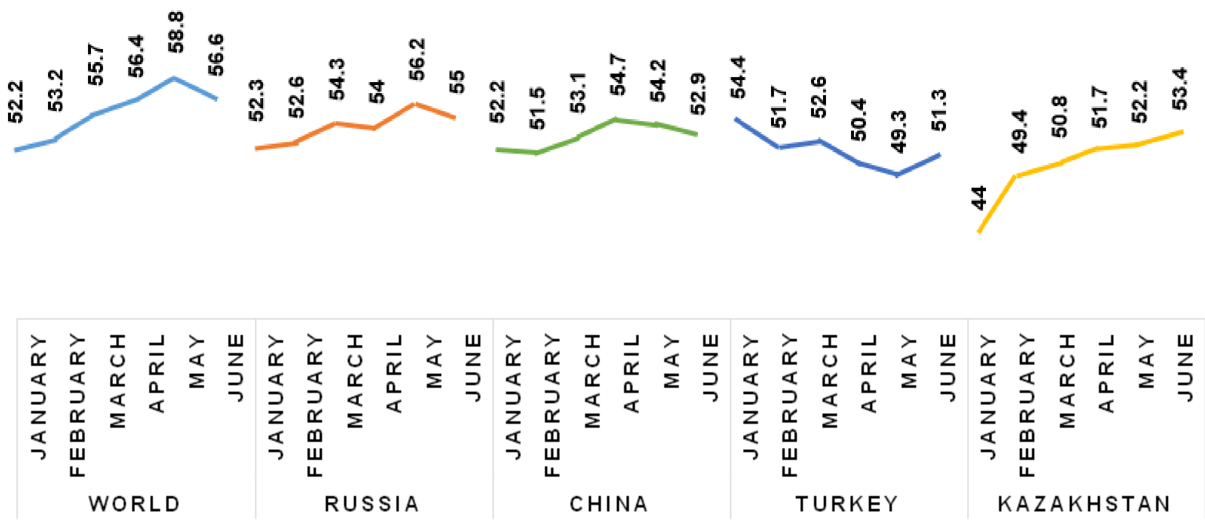
Since the beginning of the year, China's economy has been actively recovering. In H1 2021, China's foreign trade turnover increased by **37%** compared to the same period last year, exports raised by **39%** and imports by **36%**.

In May, there was a sharp increase in Chinese imports of food and petroleum products, which was reflected in the rise in prices for these goods on the world market.

Due to the increase of domestic demand and rise in energy prices, the economies of Uzbekistan's main foreign trade partners - Russia and Kazakhstan are expected to grow by **3.2%** each.

Since the beginning of 2021, there has been a growing trend in the **index of business activity** in the world economy. In particular, as a result of the transition of companies and entrepreneurs to the high growth phase of production, new orders and increased employment, business optimism began to form at a high level.

Figure 2.1. Monthly change in the business activity index in 2021



Source: *J.P.Morgan, IHS Markit.*

However, in June this year the index fell to **56.6** points. This is due to the fact that in many countries of the world the impact of the **third wave** of the pandemic is affecting the volume of production supply, and there are concerns about the reduction of domestic and foreign demand due to restrictive measures *(Figure 2.1).*

Currently, the volume of **international trade** is recovering rapidly. According to the **"trade barometer"** developed by the World Trade Organization, the index in May was **109.7 points** or **21.6 points** higher than last year. According to the organization’s forecasts, overall global trade growth will reach **8%** in 2021 (in 2020 it decreased by 5.3%).

2.2. Balance of payments and foreign trade dynamics

According to preliminary calculations of the Central Bank, in H1 2021, the deficit of the current account of the balance of payments amounted to **2.9 bln. dollars** and increased by **45%** compared to the same period last year (2 bln. dollars in January-June 2020). At the same time, the negative trade balance of **5.7 bln.** dollars was partially covered by the positive balance of **secondary income**.

The positive balance of secondary income amounted to **2.7 bln.** dollars, which is **28%** or **604 mln. dollars** more compared to the same period of the last year.

In light of the improvement in external environment for key export items the volume of exports is also growing.

According to the data of State Committee of Statistics, the volume of **exports** in H1 2021 amounted to **7.1 bln. dollars** and raised by **12.3%** compared to the same period last year.

In particular, the volume of exports, excluding gold and gas, in this period amounted to **5.5 bln. dollars** and increased by **38%** over the same period last year.

In the structure of exports, the **highest growth rates** compared to the same period last year were in exports of machinery and equipment (99.4%), non-ferrous metals and metal products (86.9%), textiles (62.9%) and cotton fiber (53.3%).

Exports (excluding gold) is projected to grow by **20-25 percent** this year as a result of the recovery of domestic and foreign economic activity following a sharp decline last year due to a pandemic.

In the context of recovery of aggregate demand in the world economy, the pace of prices growth in the key commodities markets is expected to continue. These expectations will lead to an improvement in forecasts for the country's main export positions.

In particular, in the structure of exports the exports of non-ferrous metals and their products (20-25%), chemicals (20-25%), textiles (25-30%) is projected to grow at a high rate.

In the H1 this year, the volume of imports amounted to **11.0 bln. dollars** and increased by **14.3%** compared to the same period in 2020. In the total volume of imports, relatively high growth rates were observed in imports of consumer goods (45.4%), ferrous metals and their products (23.5%) and chemical products (16.8%).

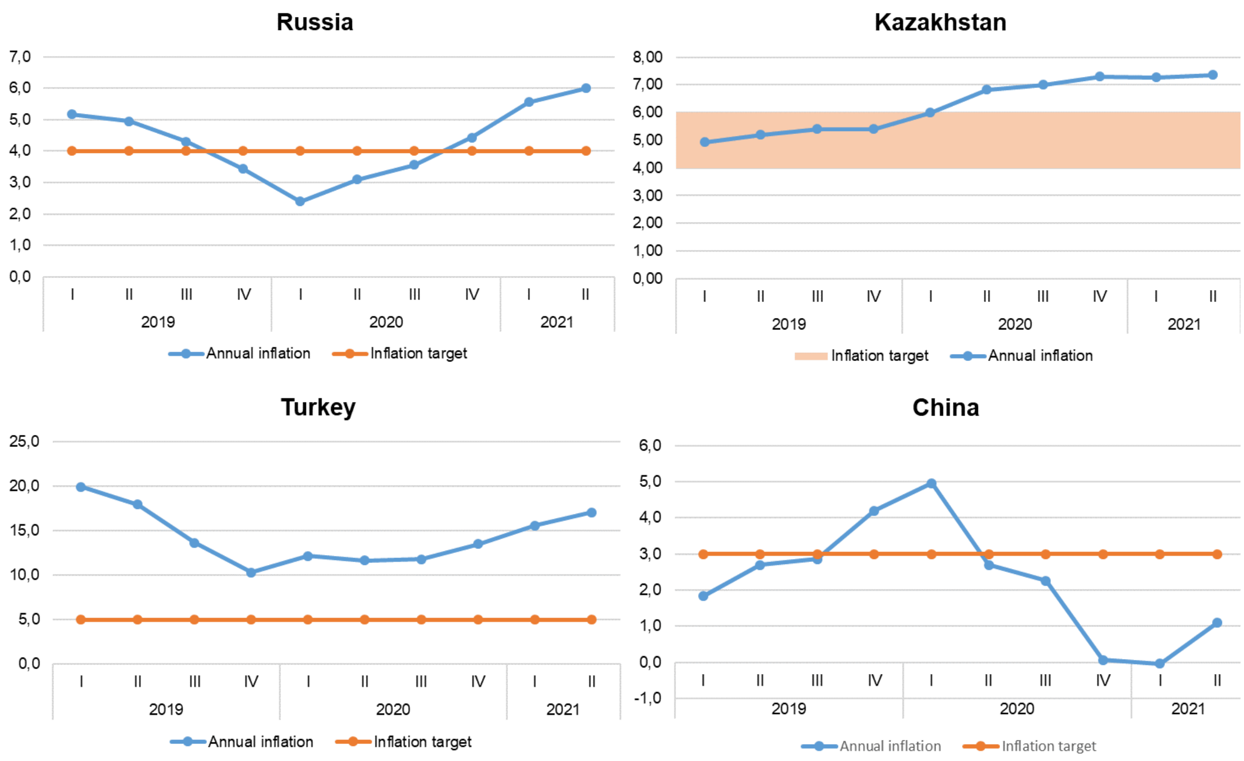
Imports is expected to increase by **12-15%** this year in view of the improvement in economic sectors and a sharp increase in aggregate domestic demand. In particular, by the end of the year, high growth rates are projected for the main positions of imports, including machinery and equipment (an increase of 30-40%), ferrous metals and their products (13-18%), food products (10-12%) and construction materials (17-22 percent).

In the context of increasing imports in proportion to economic activity, the main source of improving the current account balance is a significant raise in **foreign direct investment**. This, in turn, will play an important role in maintaining stability in the domestic foreign exchange market as well.

2.3. Inflation and exchange rates in major trading partners

In H1 2021, **inflation** in our main trading partners, Russia, Kazakhstan and Turkey, was **above** the target. This was relative to the rapid recovery of aggregate demand in the post-pandemic period, rise in energy prices, including oil, and a significant increase in prices for basic foodstuffs on world markets.

Figure 2.2. Changes in the consumer price index in major trading partners
(in percent, compared to the same period last year)



Source: *Central Bank data of relevant countries*

In Russia and Kazakhstan, the main factor of inflation was the rise in prices for basic foodstuffs, which have a high weight in the consumer price index.

In particular, in June 2021, the annual inflation rates in Russia, Kazakhstan and Turkey were **6.5%**, **7.9%** and **17.5%**, respectively. At the same time, the annual inflation rate was above the inflation target by **2.5 percentage points** in Russia, by **2.9 percentage points** in Kazakhstan and by **12.5 percentage points** in Turkey *(Figure 2.2).*

In **China**, meanwhile, the annual inflation rate, which equaled to **1.1%** in June, began to slow following the rise during four consecutive months since January. In particular, in **April-May** this year, the annual inflation rate was **0.9%** and **1.3%**, respectively.

The main factors behind the decline in inflation in China are the price decrease in **meat products**, which are widely consumed, and expectations of relatively stable **grain** prices due to the good summer harvest.

Overall, inflation in most developing countries continued to **rise** in June this year.

Figure 2.3. Inflation target, inflation rate and key policy rate dynamics in selected countries *(in percent)*

Countries	Inflation target	Inflation rate (June)	Central Bank policy rate						
			Jan	Feb	Mar	Apr	May	June	July
Russia	4	6.5	4.25	4.25	4.50	5.00	5.00	5.50	6.50
Kazakhstan	4-6	7.9	9.00	9.00	9.00	9.00	9.00	9.00	9.25
Kyrgyz Republic	5-7	14.2	5.00	5.50	5.50	6.50	6.50	6.50	7.50
Turkey	5±2	17.5	17.00	17.00	19.00	19.00	19.00	19.00	19.00
Ukraine	5±1	9.5	6.00	6.00	6.50	7.50	7.50	7.50	8.00
Armenia	4±1.5	6.5	5.25	5.50	5.50	5.50	6.00	6.50	6.50
Belarus	5	9.9	7.75	7.75	7.75	8.50	8.50	8.50	8.50

Source: *Central Bank data of relevant countries*

While most developing countries are trying to reduce inflationary pressures in the economy by **raising key rates**, given the **spiral nature** of high inflation and the potentially **secondary effects**, central banks of developed countries are in not to rush into tightening monetary policy, emphasizing that current inflation is temporary.

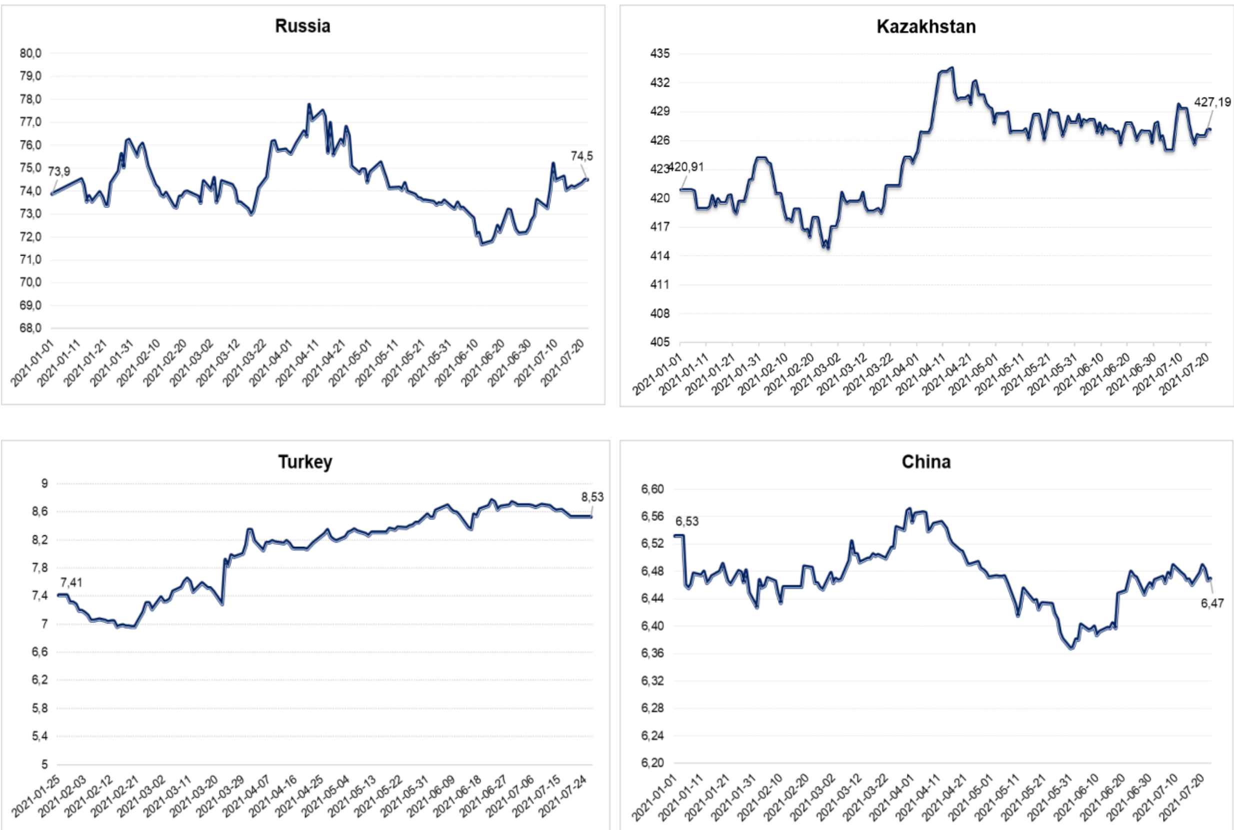
In particular, the **Bank of Russia** has raised the policy rate from **4.25% to 6.5%** since March this year, taking into account the current and projected level of inflation (Figure 2.3). Given the current inflation dynamics, the Bank of Russia retains the possibility of **considering to raise the policy rate further** in future board meetings.

The Central Bank of **Kazakhstan** raised the policy rate to **9.25%** on July 26 in response to a steady increase of inflationary risks both on the supply side and demand side.

In turn, in Turkey, Kyrgyz Republic, Ukraine, Armenia and Belarus central banks raised the key policy rates in H1 2021 and tried to reduce inflation by tightening monetary conditions in the economy.

In the dynamics of the exchange rates of the national currencies of major trading partners, in January-July 2021, there was a strong fluctuation in the **Turkish lira,** which weakened by **18.3%** *(from 7.2 to 8.5 liras per dollar)*. The delayed impact of the policy rate reduction by the Central Bank in 2020, high financial risks, large outflows of foreign capital, alongside macroeconomic instability are the main factors of the **sharp depreciation of the Turkish lira**.

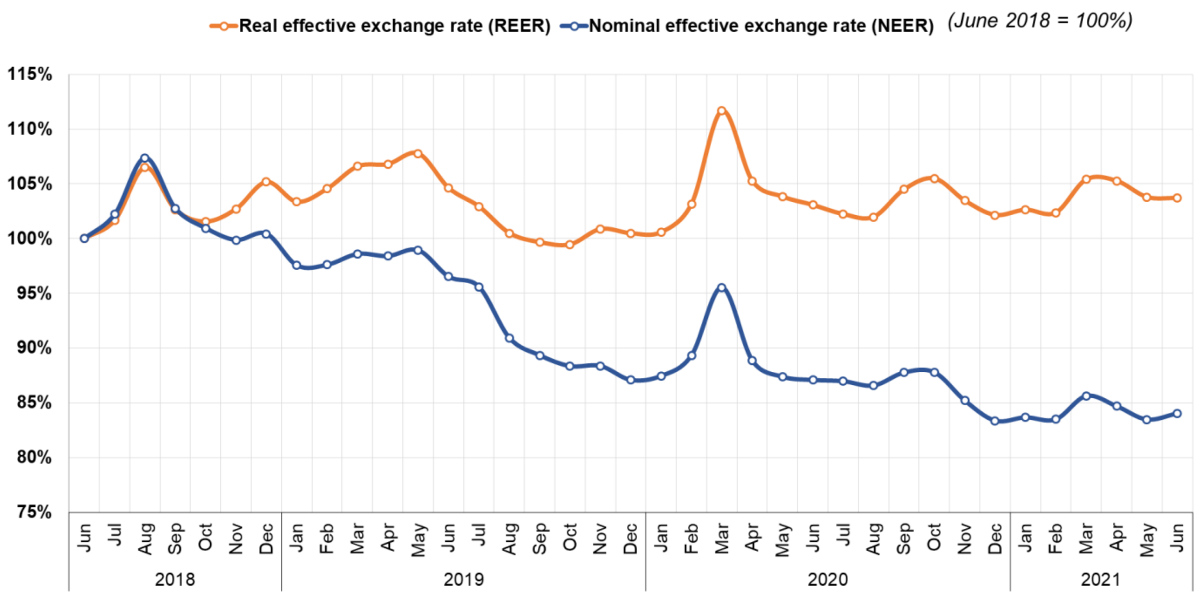
Figure 2.4. Changes in the exchange rate in major trading partners
(against the US dollar)



Source: *Central Bank data of relevant countries*

During the period under review, the Russian ruble and the Kazakh tenge depreciated by **0.8%** and **1.5%** against the US dollar, respectively, while the Chinese yuan, on the contrary, strengthened by **0.8%** *(Figure 2.4)*.

Figure 2.5. Real and nominal effective exchange rates of the sum



Source: *Central Bank calculations*

In turn, the real effective exchange rate of the sum **strengthened slightly** in March-April against the background of weakening national currencies of major trading partners, while in May-June the real effective exchange rate reached its long-term trend due to high inflation in the trading partner countries *(Figure 2.5)*.

Box

The scope of vaccination and its impact on global economic growth

The world community continues to combat the COVID-19 pandemic. Following the recession in early 2021, the incidence accelerated with the emergence of **new variants** of the virus and increased population mobility. A **new wave** of the COVID-19 has a negative impact on the recovery of the global economy, the growth rate of industrial production and the service sector. The vaccination process takes place at different speeds in different regions of the world.

Figure 1. The pandemic situation by countries in the world and the vaccination rate

Country	Number of vaccinated people	Share in total population	7-day average number of cases per million population	7-day average number of deaths per million population
Countries with high vaccination rates				
Malta	386 328	88%	467	0.0
Iceland	267 154	79%	66	0.0
UAE	7 684 876	78%	155	0.4
Uruguay	2 482 573	72%	86	1.9
Singapore	4 164 922	71%	17	0.0
Other countries and trade partners				
United States	186 474 836	56%	112	0.7
Turkey	39 047 910	46%	90	0.6
China	622 000 000	43%	0	0.0
Kazakhstan	4 944 498	26%	291	11.7
India	328 716 212	24%	28	0.7
Russia	33 185 732	23%	166	5.2
Ukraine	2 778 375	6%	24	0.6

Source: *OWID, JPMAM. As of July 20, 2021.*

An analysis by JP Morgan, a financial holding company of the US, shows that in emerging markets vaccination rates are significantly lower compared to the **prevalence of delta virus**. This may lead to the reintroducing or expanding travel restrictions in some countries.

The return of economic growth to pre-pandemic levels is largely determined by the activity and mobility of the population, which depends on the speed and scope of vaccination.

Figure 2. Forecasts of a return to pre-pandemic levels of economic activity in countries around the world

Countries	Google Mobility (retail, leisure)	«New Normal» model (50% of the population is fully vaccinated)	The forecast of a return of GDP to pre-pandemic levels by JPM
Philippines	-21.29	2023 Q3	2022 Q3
Mexico	-7.14	2022 Q1	2022 Q1
South Africa	-14.71	2022 Q2	2022 Q3
India	-20.07	2022 Q1	2021 Q3
Republic of Korea	5.00	2021 Q4	2021 Q2
Malaysia	-41.79	2021 Q4	2022 Q2
Brazil	-12.36	2021 Q4	2021 Q2
Argentina	-18.36	2021 Q4	After 2022
Indonesia	-9.43	2022 Q1	2021 Q2
Russia	0.86	2022 Q1	2021 Q2
Singapore	-21.29	2021 Q3	2021 Q3

Source: *JP Morgan, 2021*

According to a research by JP Morgan, the levels of vaccination to restore normal mobility vary from country to country. Some countries will return to pre-pandemic levels of economic growth by the end of this year, while others will not be able to recover from the consequences of COVID-19 until the end of next year.

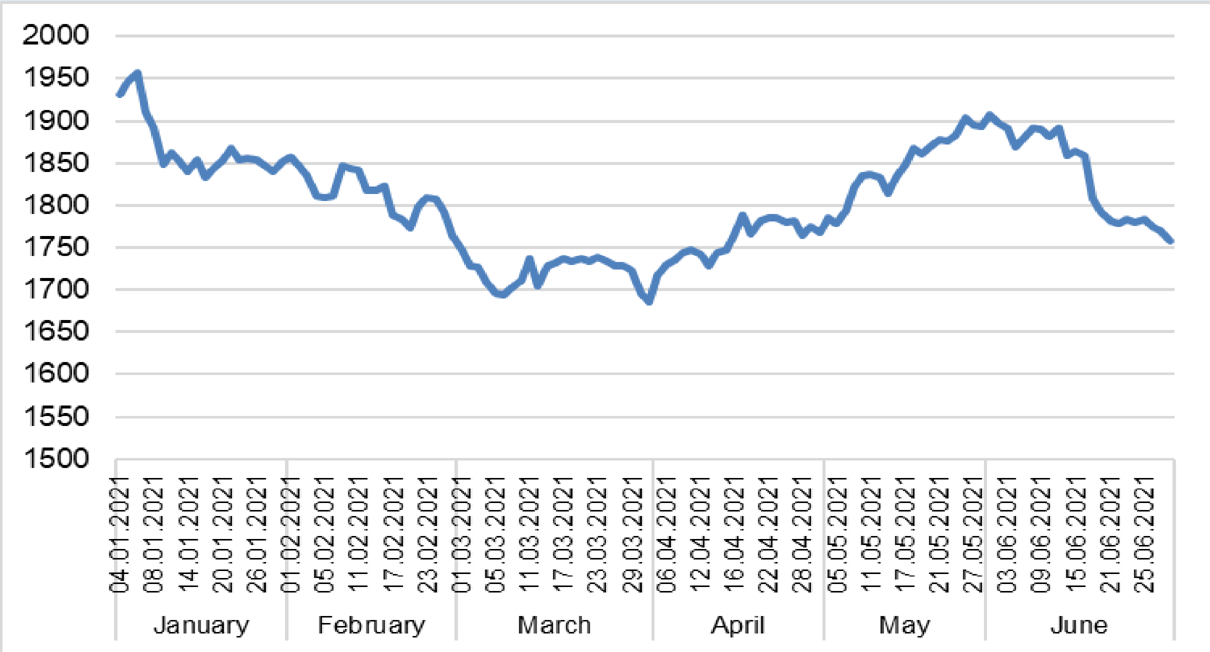
Box

The conditions in the world markets of Uzbekistan's main export commodities

Gold

While there was a steady increase in the price of gold in world market in the H1 of last year, in H1 2021 there was a downward trend. In particular, in the H1 of last year, gold prices rose by **16.5%**, while in January-June this year, gold prices fell by **9%** *(from 1,930.8 doll./troy oz. at the beginning of the year to 1,757.8 doll./troy oz. by the end of June) (Figure 1)*.

Figure 1. Changes in the price of gold on the world market
(USD per 1 troy ounce)



The main cause of the rise in gold prices in 2020 was the growing **risks and uncertainties** in the context of the pandemic. However, the recovery in the global economy in the H1 of this year, as a result of **the easing of restrictive measures in many countries** and **scaling up of vaccination**, has weakened investors' interest in gold as an alternative.

Consequently, there was a significant outflow of gold from the **Exchange Trading Funds (ETF)**. According to the World Gold Council, as of June 25, gold reserves of world stock exchanges decreased by **4%** (144.2 tons) compared to the beginning of the year.

The next dynamics of the gold price in the global market will depend on the trajectory of the coronavirus pandemic. According to analysts at BMO Capital Markets (a subsidiary of the Bank of Montreal in Canada), the average gold price in 2021 is projected at **1,815 doll./troy oz.** (almost unchanged from the previous forecast).

However, the forecast for 2022-2023 was reduced to **1,731 doll./troy oz.** and to **1,630 doll/troy oz.,** respectively. The main reasons for this reduction were a significant shortfall in the Quantitative Easing by the US Federal Reserve and a raise in interest rates.

On the other hand, the forecast of the American Goldman Sachs Bank on the price of gold is optimistic, and remained at **2,000 doll/troy oz.** The forecast is explained by the presence of investors' fears about rising inflation, decline on yields on U.S. government securities and a weakening dollar.

Natural gas

The persistence of stimulus policies aimed at economic recovery in the world's major economies has led to an active increase in commodity prices in the world market since Q2 2021. However, there are ongoing restrictions on the transportation of many raw materials.

In H1 2021, **natural gas** prices in the global market had an upward trend. This growth was relative to the recovery of demand in the post-crisis period and the decline in gas production in the United States, the world's largest market.

Natural gas prices on spot contracts rose **42%** from 2.6 doll./million BTU[1] at the beginning of the year to 3.7 doll./million BTU at the end of June. However, most of this year's growth was in the Q2, while growth in H1 year was just **1%**.

Figure 2. Changes in the price of natural gas on the world market
(in US dollars per 1 million British thermal units)

[1] **BTU - British thermal unit** is a measure of the heat content of fuels or energy sources.

In China, the largest importer of liquefied natural gas (LNG), imports in H1 of this year increased by 28% compared to the same period last year, which accounted for more than 40% of global growth in LNG imports.

The Energy Data Agency of the US Department of Energy projects that by the end of 2021, the average 12-month level of natural gas prices at Henry Hub (3.22 dollar per million BTU) will be nearly **60%** higher than in 2020 (2.03 doll./ million BTU).

Due to the sharp rise in prices in Europe, Gazprom has raised its forecast for the average export price of gas in Europe in 2021 from previous **200 dollars** *(170 dollars at the beginning of the year)* per thousand cubic meters to **240 dollars** per thousand cubic meters.

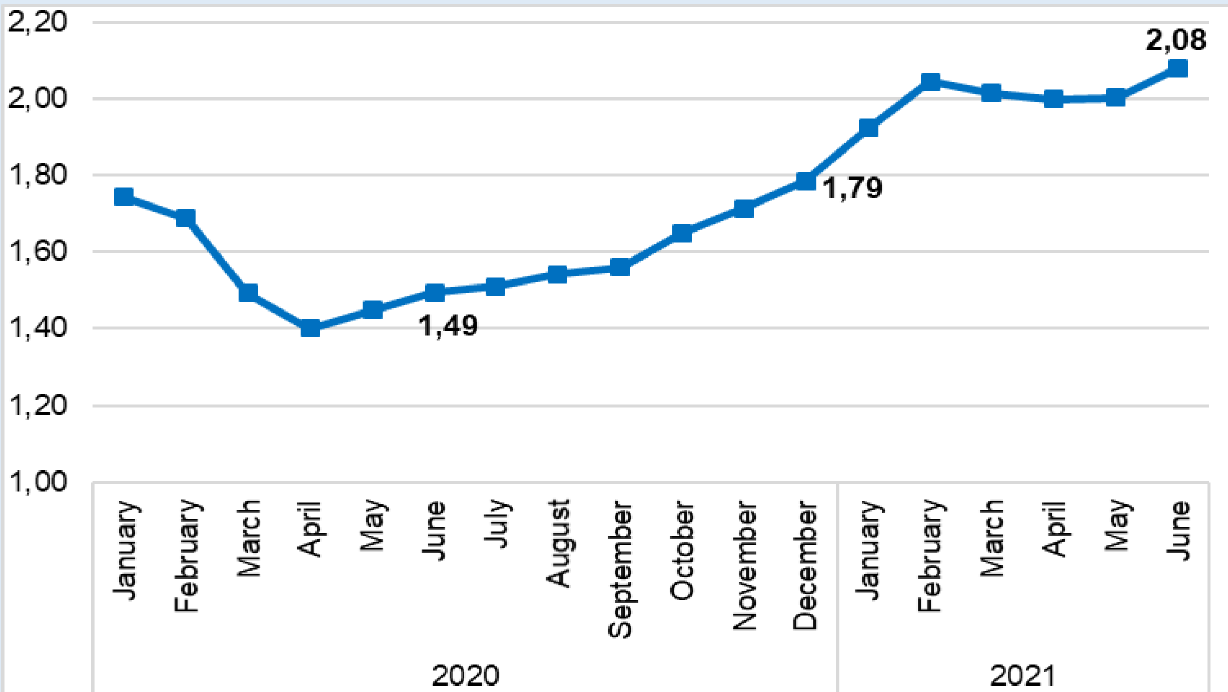
Cotton

In H1 2021, the price of cotton on the world market increased by **16.5%** (from 1.79 doll./kg at the beginning of the year to 2.08 doll./kg in June). While a significant increase in prices was mainly in Q1 (16%), cotton price began to decline in April, and by the end of June was 2.08 dollars for 1 kg *(Figure 3)*.

The main reason for the increase in cotton prices was the recovery of global gross consumption in the post-pandemic period. Moreover, the World Bank forecasts that global cotton consumption will increase by **8%** this season compared to the season of 2019/2020 and reach **24.5 mln. tons**.

Figure 3. Changes in cotton prices on the world market

(US dollars per 1 kg)



At the same time, the highest growth rates of cotton consumption were in China and India, and as a result of the rehabilitation of the textile industry, cotton consumption increased by **12%** and **22%**, respectively. The increase in cotton prices also reflects a decrease in supply, in particular, this season the global cotton production is expected to decline by **8%**. This is largely relative to the reduction of planted area in the US, India and Pakistan.

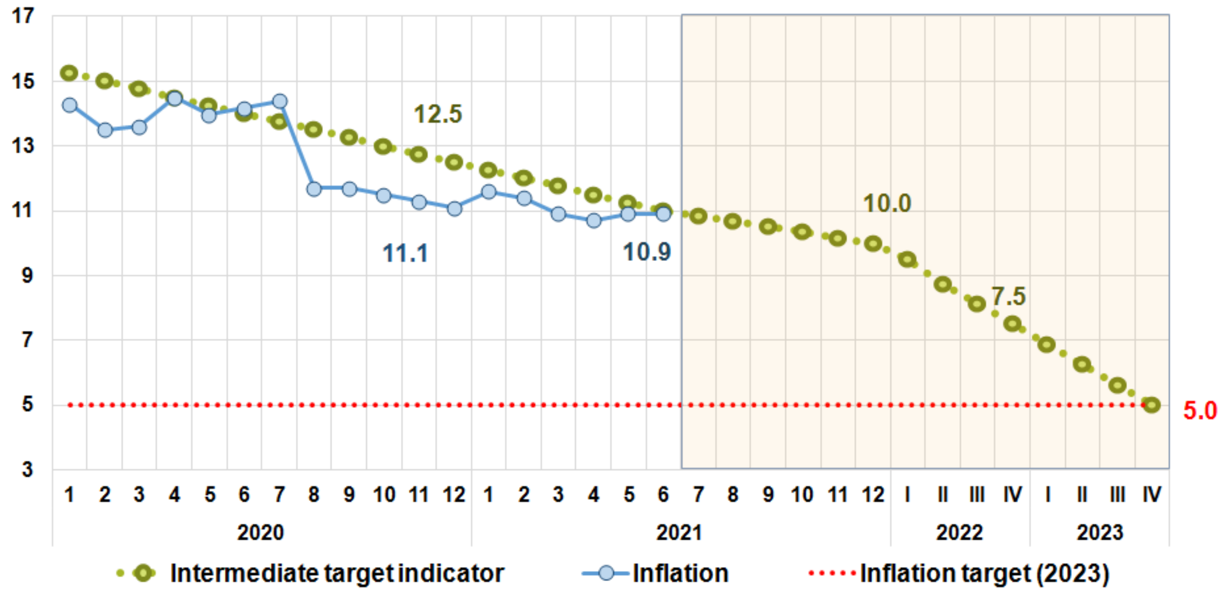
According to the World Bank, in 2021 cotton prices are expected to grow by **22-23%** compared to last year.

III. INFLATION RATE AND INFLATION EXPECTATIONS

3.1. Analysis of inflation dynamics and its components

At the end of June this year, annual inflation slowed down by **0.2 percentage points** from the beginning of the year **(11.1%)** and amounted to **10.9%** *(Figure 3.1).*

Figure 3.1. Trajectory of inflation target and intermediate target indicators



Source: *State Statistics Committee and the Central Bank*

When analyzing changes in consumer prices by key components, the high growth trends in food prices observed in the past period (14.7% per annum) are the main drivers of overall inflation.

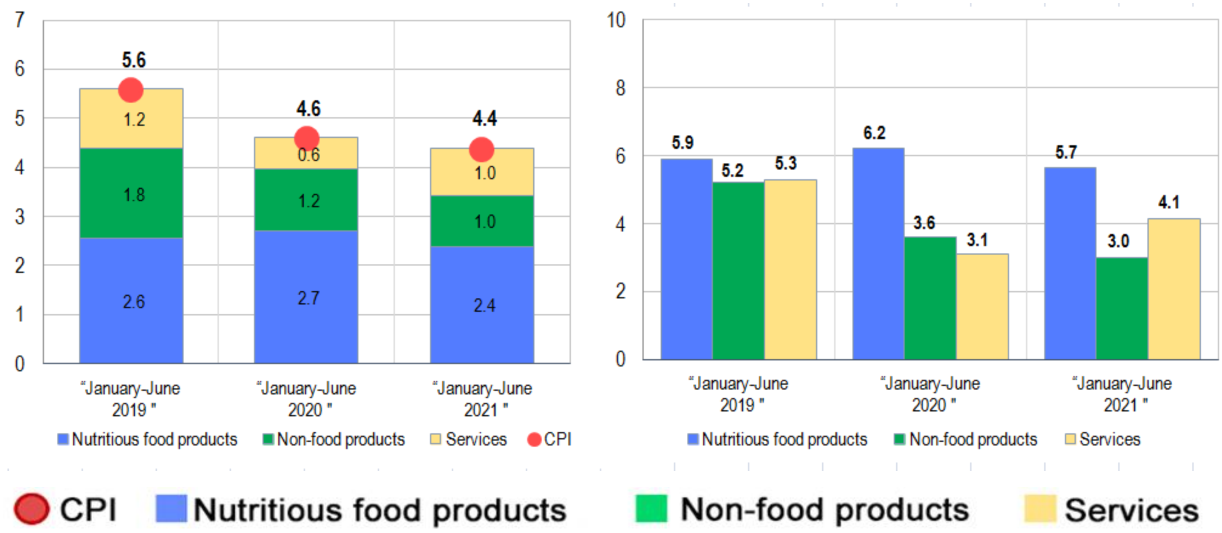
The annual increase in prices for non-food products and services was **8.2%** and **8.1%**, respectively, which had a reducing effect on overall inflation.

It should be noted that the increase in prices in January-June this year was lower than in the corresponding period last year. In particular, in January-June 2021, the overall inflation rate was **4.4%**, which is 0.2 percentage points lower than in the corresponding period of 2020 *(1.0 p.p. lower compared to the corresponding period of 2019) (Figure 3.2)*.

Also, the contribution of food (2.4%) and non-food stuff (1.0%) to total inflation during this period showed a declining trend compared to the corresponding period of preceding years.

However, in the services sector, price growth accelerated slightly, and the contribution to headline inflation (**0.4 percentage points** higher than in the corresponding period last year) amounted to **1.0 percentage point**. This is relative to the increase in prices for some transport services in the H1 of the year amid rising fuel prices, alongside increased tariffs for public preschools and cold water supply.

Figure 3.2. Headline inflation and its main components



Source: *State Statistics Committee of the Republic of Uzbekistan*

Core and reduced inflation

The central bank calculates the core and reduced inflation indicators, and constantly monitors their dynamics. These indicators are used to analyze inflation trends and the factors influencing it.

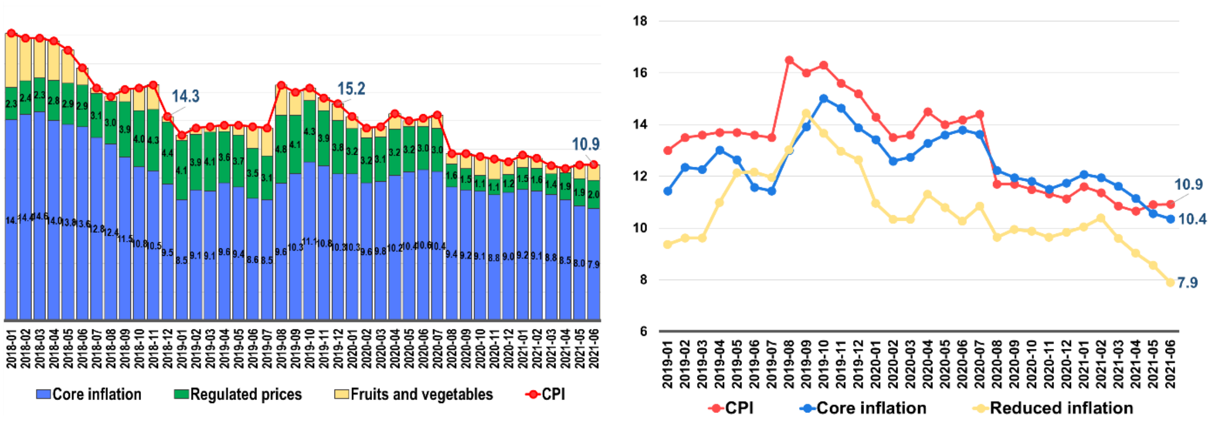
In 2021 Q2, the **core inflation** rate had been declining, and reached **10.2%** per annum in June, moreover, its share in total inflation decreased to **7.8 percentage points** (8.8 percentage points in March) *(Figure 3.3)*.

Reduced inflation[2] in this period also showed a declining trend, slowing to **7.9%** per annum in June (March - 9.6%).

In 2021 Q1, the contribution of regulated prices for goods (services) to headline inflation averaged **1.5 percentage points**, while in the Q2 it increased slightly to **1.9 percentage points**.

[2] **Reduced inflation** is calculated by excluding goods and services with large price fluctuations from the consumer price index (10 goods with the highest price increases and decreases).

Figure 3.3. Core and reduced inflation dynamics



Source: *Central Bank calculations based on data from the State Statistics Committee.*

3.2. Food products inflation

By the end of June 2021, the impact of the annual increase in food prices on overall inflation was **6.2 percentage points**.

Meat products from basic foodstuffs rose in price by annual **14.5%** in June this year, including beef (excluding boneless meat) by **15.7%**, lamb by **17.1%** and fresh fish by **9.5%**.

The dynamics of growth in meat prices in the past period is explained by a seasonal decrease in supply, including a decrease in the number of meat breeds of cattle and small ruminants and an increase in prices for feed for cattle breeding.

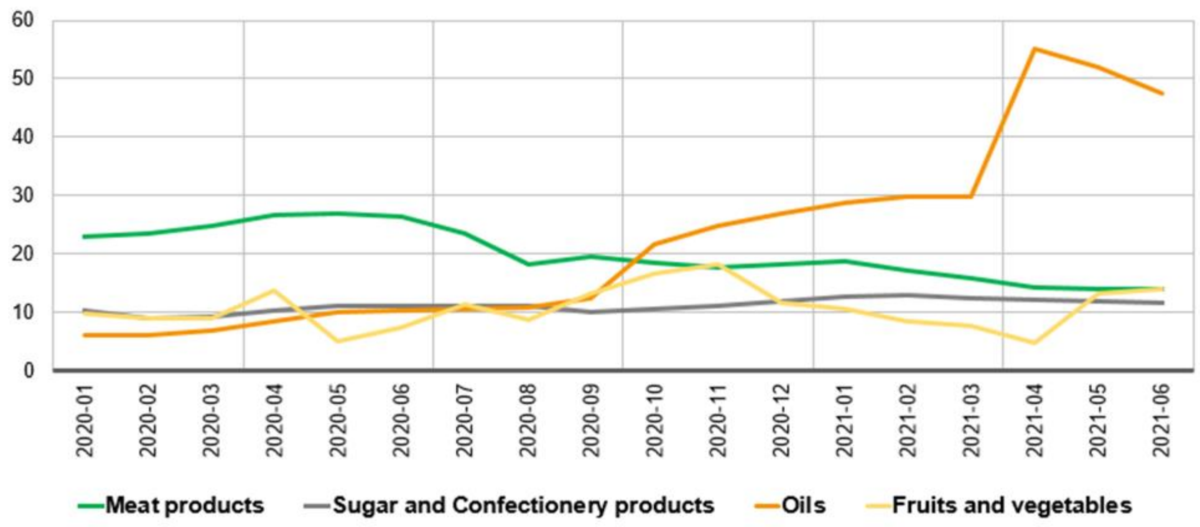
The relatively low rainfall in the lowland regions of the country this year has led to a decrease in forage in pastures. This, in turn, puts additional pressure on the prices of industrially prepared pet food.

At the beginning of April, the price of husk on the commodity exchange was **1,954 sums**, while in June it increased significantly to **3,296 sums.** The situation is the same with the prices for meal, which was about **2,850-2,900 sums** in April, and, on average, about **3,700-3,800 sums** during last three months.

If the current upward trend in feed prices remains, the efficiency of livestock farming in the future may further decline and this may put additional pressure on prices.

Significant increase in **sugar** prices (annual growth of 33.3% in June) had an upward impact on the prices of confectionery products (annual growth of 15.7%).

Figure 3.4. Changes in food prices



Source: *Central Bank calculations based on data from the State Statistics Committee.*

In the **sugar** segment of the Republican Commodity Exchange, there was an increase in prices for this product, as a result of a growing domestic demand. In particular, at the end of June, the average price of kilogram of sugar was **7,527 sums**, or **435 sums** (6.1%) more compared to the beginning of April.

Since the beginning of the year, the rising trends in **oil** prices in world markets have also affected oil prices in domestic markets. In particular, in April 2021, there was a sharp increase in the price of oil, the monthly price of **cottonseed oil** increased by **31%**, **sunflower oil** by **26.5%**.

The abolition of **value-added tax** payments on the production, import and sale of **oils from May** to the end of the year had a positive impact on prices in the domestic market. In particular, in May-June of this year, cottonseed oil fell in price by **5.5%** and sunflower oil by **3.2%.**

In general, in June 2021, the annual increase in the price of cottonseed oil was **61%**, while that of sunflower oil was **62%**. Expected trends in these products in world markets are listed in the box below.

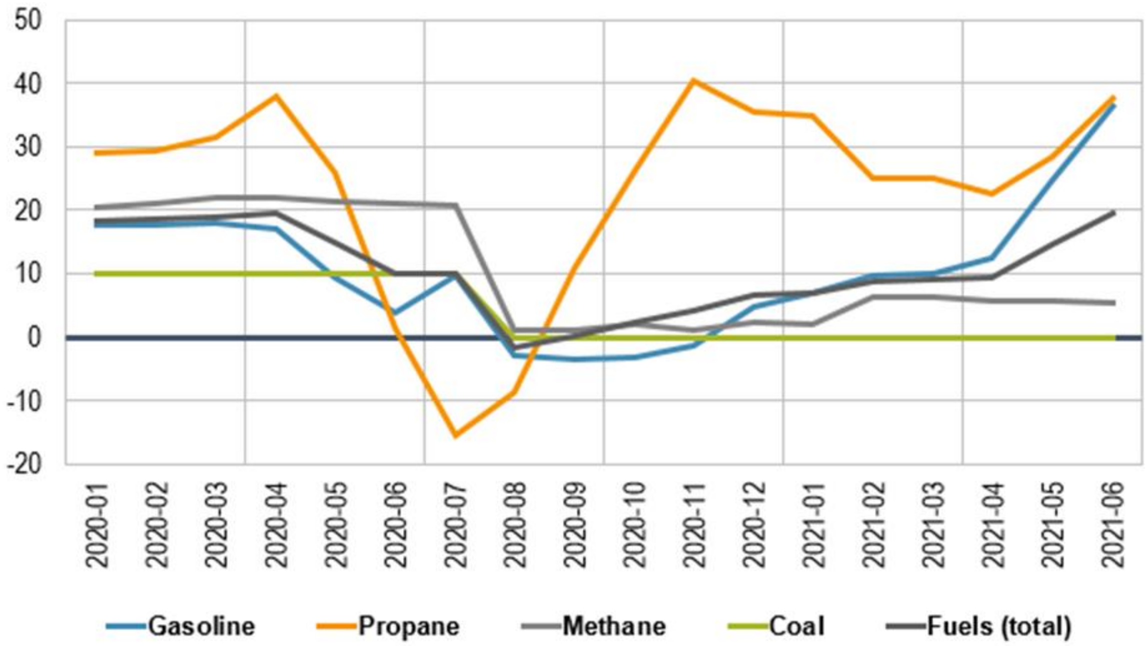
Unfavorable weather since the beginning of the year, interruptions and delays in the supply of agricultural products have led to high growth in prices for a group of **fruits and vegetables** in the composition of inflation. At the end of June, prices for fruits increased by **12.1%** annually and vegetables by **26.7%**. At the same time, in May-June, **seasonal decline** in prices for products in this group was not observed as expected.

In turn, **domestic and foreign demand** for basic food products is expected to **grow** in the medium term in the context of active economic recovery.

3.3. Non-food inflation

In the domestic market, **gasoline** prices are rising amid rising oil prices in world markets. In particular, gasoline prices raised by **17%** since the beginning of the year and during the Q2 rose by **7.8%**. **Propane** prices formed a downward trend during the Q1, but returned to the upward trend again in the Q2, increasing by **13%** *(Figure 3.5).*

Figure 3.5. Changes in fuel prices



Source: *Central Bank calculations based on data from the State Statistics Committee.*

Annual increase in the price of **construction materials** in June was **9%**, from which **cement** prices rose by **7%**. Price increase is slowed down compared to the previous year (in June 2020, prices for construction materials increased by 10.1% annually and cement prices by 16.6%).

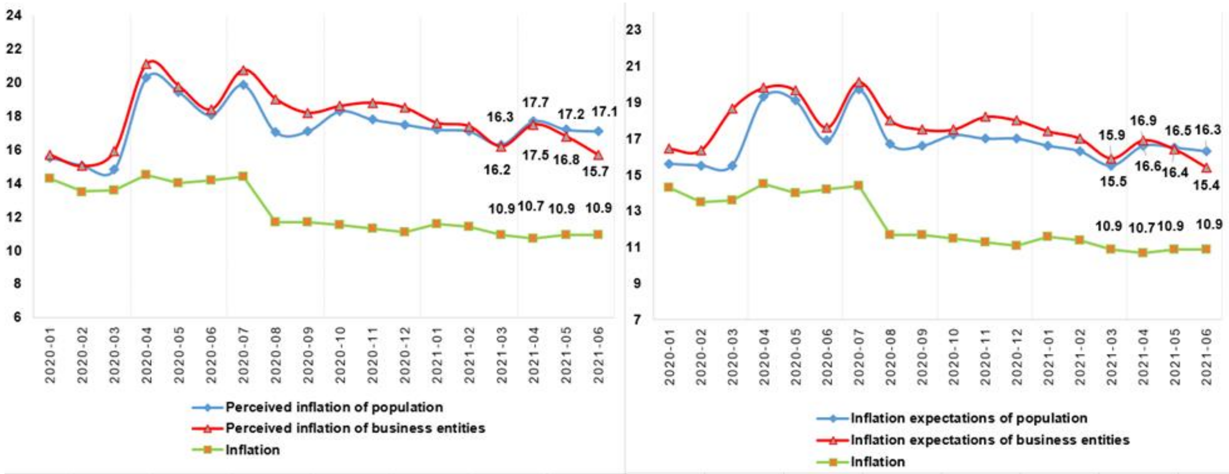
At the same time, prices for clothing, footwear and other non-food products were relatively stable during this period, and their future prices will depend on the resumption of flights to foreign countries, the continuity of supply chains and the dynamics of the national currency.

3.4. Inflation expectations

According to a survey conducted in the Q2 of this year, inflation expectations of the population and businesses had **a changing trend**. In particular, at the end of June 2021, inflationary expectations of the population amounted to **16.3%**, increasing by **0.8 percentage points** compared to March of this year. In turn, inflationary expectations of the business entities was **15.4%** and decreased by **0.5 percentage points** compared to March (Figure 3.6).

Inflation expectations of economic entities are slightly exceed the projected level of annual inflation, which is mainly due to the rise in prices for basic consumer goods above the overall inflation, high inflation rate and the depreciation of the national currency in previous periods.

Figure 3.6. Perceived inflation rate and dynamics of inflation expectations
(in percent)



Source: *Central Bank calculations based on the results of the survey on inflation expectations*

In turn, in Q2 2021, the inflation rate of the households was **stable**, while the inflation rate of business entities was **declining**. In particular, in June of this year perceived inflation of the population was **17.1%**, increasing by **0.8 percent points** compared to March 2021. At the same time, perceived inflation of business entities was **15.7%**, decreasing by **0.5 percentage points** compared to March 2021.

The **perceived inflation rate** of population and legal entities is **slightly higher than the annual inflation**, in which the increase in prices for goods and services purchased by them on a regular basis, in particular **basic foodstuffs**, played an important role. In particular, the significant rise in prices for **basic consumer goods** such as **vegetable oil** and **sugar** in

April-June 2021 played an important role in high inflation expectations of the population.

Figure 3.7. Inflation expectations by regions in 2021 Q2 *(quarterly average, in percent)*

Population		Business entities	
Namangan region	19.0	Tashkent city	18.3
Ferghana region	18.5	Ferghana region	18.2
Tashkent city	17.3	Sirdarya region	18.0
Tashkent region	17.0	Khorezm region	17.8
Bukhara region	16.6	Samarkand region	17.5
Sirdarya region	16.6	Tashkent region	17.4
Khorezm region	16.5	Andijan region	16.8
Republic (average)	**16.5**	Namangan region	16.6
Samarkand region	16.1	**Republic (average)**	**16.2**
Jizzakh region	15.8	Jizzakh region	15.6
Kashkadarya region	15.8	Bukhara region	15.5
Andijan region	15.5	Kashkadarya region	15.4
Surkhandarya region	15.2	Navoi region	14.9
Navoi region	15.2	Karakalpakstan Rep.	14.0
Karakalpakstan Rep.	14.4	Surkhandarya region	13.5

Source: *Central Bank calculations based on the results of the survey on inflation expectations*

Relatively high inflation expectations of population were observed in Namangan region (19.0%), Fergana region (18.5%) and Tashkent (17.3%), and the lowest rates were in Navoi region (15.2%) and the Republic of Karakalpakstan (14,4%).

Relatively high expectations of business entities were recorded in Tashkent (18.3%), Fergana (18.2%), Syrdarya (18.0%) and Khorezm (17.8%) regions, and the lowest rate (13.5%) was observed in Surkhandarya region (Figure 3.8).

When studying inflation expectations in major trading partner countries, it was observed that inflation expectations for the next period in these countries are formed above the current level of inflation and above the target.

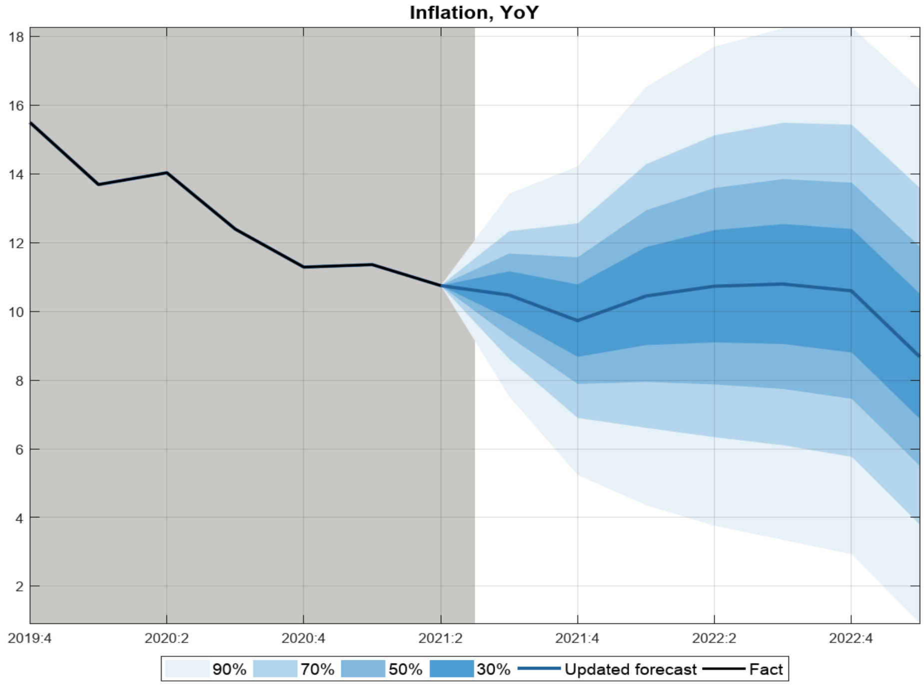
In particular, by June 2021, the annual inflation rate in Russia was **6.5%**, while inflation expectations were formed at **11.9%**.

The Central Bank will continue to study inflation expectations, which are one of the most important indicators in the economic decisions (consumption, savings or investment) of the population and business entities. At the same time, this indicator is one of the most important variables in the development of medium-term macroeconomic forecasts and plays an important role in making decisions in the field of monetary policy.

3.5. Inflation forecast, risks and uncertainties

According to the updated forecasts of the Central Bank, the annual inflation forecast for 2021 remained unchanged at **9-10%** *(Figure 3.9).*

Figure 3.8. Inflation Forecast *(in percentage, quarterly)*



Source: *Central Bank calculations.*

The inflation forecast for the end of 2021 will be achieved by maintaining relatively stable monetary conditions, changes in the set of monetary instruments, stable trends in the foreign exchange market, accelerating measures to reduce the impact of non-monetary factors with relevant ministries and agencies.

Although the FAO index that is an indicator of world prices decreased slightly in July this year, the dry weather observed in many countries in the H2 of the year is having a negative impact on agricultural production expectations for this year's harvest.

Given that a large part of the demand for consumer goods from sunflower oil, sugar and meat products is covered by imports, the rise in prices for basic consumer goods in Russia and Kazakhstan, as well as in the world market, may have an increasing effect on domestic commodity prices.

In general, a certain level of uncertainty and risks on internal and external conditions remain, and the inflation rate by the end of 2021 depends on formation of the above factors.

At the same time, the Central Bank makes appropriate decisions on monetary policy based on the level of inflation expectations in the economy, the current dynamics and forecast of inflation, alongside the characteristics of inflationary factors.

IV. MONETARY CONDITIONS

In Q2 2021, **the monetary conditions** were relatively tight against the background of **remaining** the Central bank's policy rate **unchanged**, the formation of the annual inflation rate with some fluctuations **around 11%,** alongside the cancellation of **the preferred interest rate policy** temporarily applied in the context of the pandemic following the raise of interest rates on loans and deposits in the economy, including real interest rates.

At the same time, during the Q2 there was **an increase in overall liquidity** in the banking system and, therefore, a significant fall in short-term interest rates in the money market as a result of fiscal stimulus. This, in turn, led to certain changes in the set of instruments for short-term liquidity regulation by the Central Bank.

In particular, as the liquidity in the banking system increased, the amount of **Central Bank bonds** and short-term **instruments of attracting liquidity** was increased in order to effectively regulate money market interest rates.

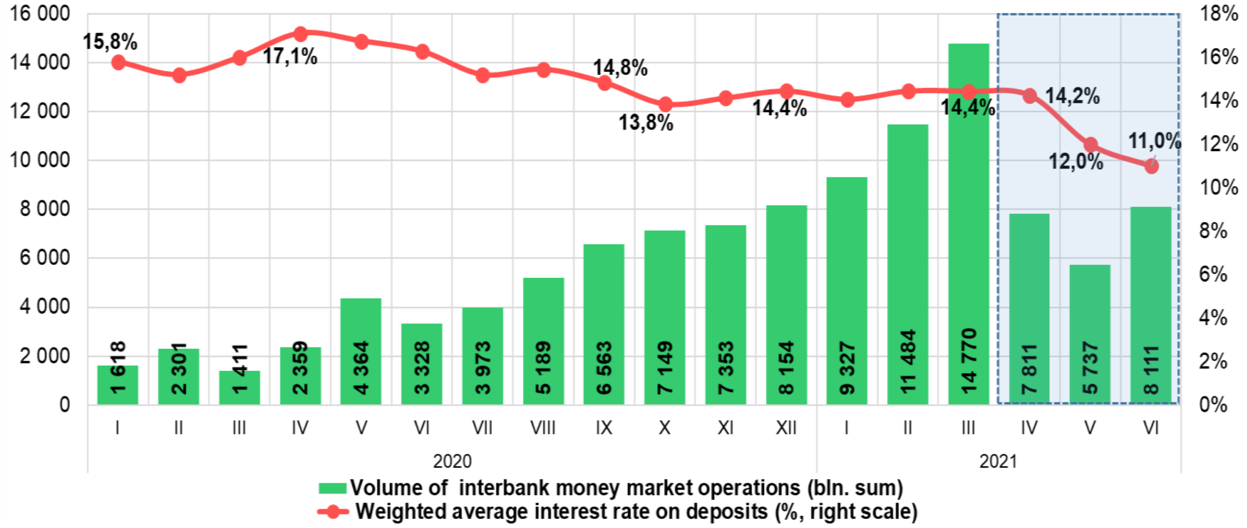
At the same time, with the beginning of the decline in money market interest rates, in May the limit on the balance of Central Bank notes was raised from **5 trln.** sum to **7.5 trln.** sum and two-week deposit auctions was increased from **100 bln.** sum to **200 bln.** sum. In June, in response to the continued increase in total liquidity and the continuing downward trend in interest rates in the market, the limit on the balance of Central Bank notes and two-week deposit auctions was increased to **10 trln.** sum and to **500 bln.** sum, respectively.

4.1. The main indicators of the interbank money market

In the Q2 of this year, there was an increase in the structural surplus of liquidity in the banking system and a significant easing of conditions in the interbank money market, moreover the average interest rate fell **to 11%** in June.

In turn, there was a significant decline in the activity of banks in the money market. Especially, during the Q2 of this year, total volume of deposit operations carried out in the money market amounted to **21.7 trln.** sum or **39.1%** (13.9 trln. sum) less compared to the first quarter (*Figure 4.1*).

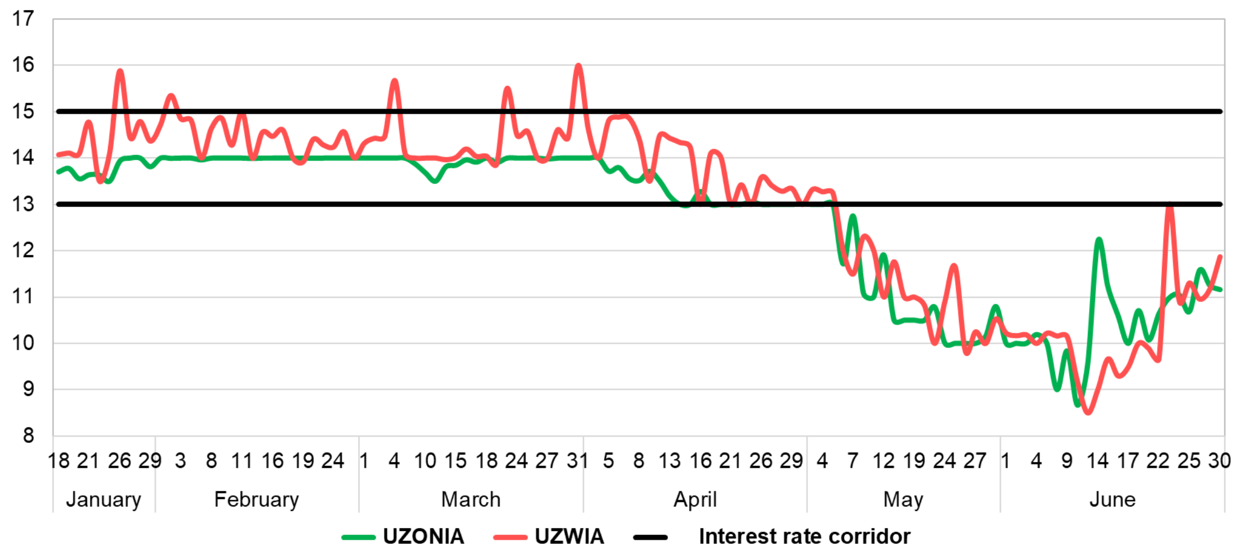
Figure-4.1. Volume of operations *(billion sums)* **and interest rates in the interbank money market**



Source: *Central bank*

In the Q1 of this year, these indices were formed within the interest rate corridor with some fluctuations, but as a result of a significant increase in total liquidity of the banking system, in the Q2 Uzonia and Uzwia indices **fell below the lower bound of the interest rate corridor** (*Figure 4.2*).

Figure-4.2. "UZONIA" and "UZWIA" indices of money market



Source: *Central bank*

This situation requires **the complete withdrawal of limits** on overnight deposit operations and the conduction of **an unlimited volume** of operations on a permanent basis in order **to increase the effectiveness of the Central Bank's interest rate corridor**.

Due to changes in monetary policy instruments and the acceleration of liquidity regulation practices, in the coming months money market interest rates are expected to be formed close to the Central Bank's policy rate within the interest rate corridor.

Effective regulation of interest rates on short-term operations in the money market is important for the **efficiency of interest rate channel** of the monetary policy transmission mechanism, since it allows decisions made on policy rate to be passed through to interest rates on loans and deposits effectively followed by influencing the decisions of the population and business entities on consumption, savings and investment.

As a result, the GDP gap and the impact of monetary factors on inflation will be reduced through the impact on aggregate demand.

In general, the Central Bank's monetary operations are aimed at **the formation of short-term resource prices in the money market**, and interest rates on long-term deposits are formed on **the basis of short-term interest rates and expectations on them,** alongside **the risk premium**.

Therefore, the Central Bank will constantly monitor the situation in the money market and take all necessary measures to ensure that interest rates are formed close to the policy rate within the interest rate corridor.

4.2. Monetary policy instruments

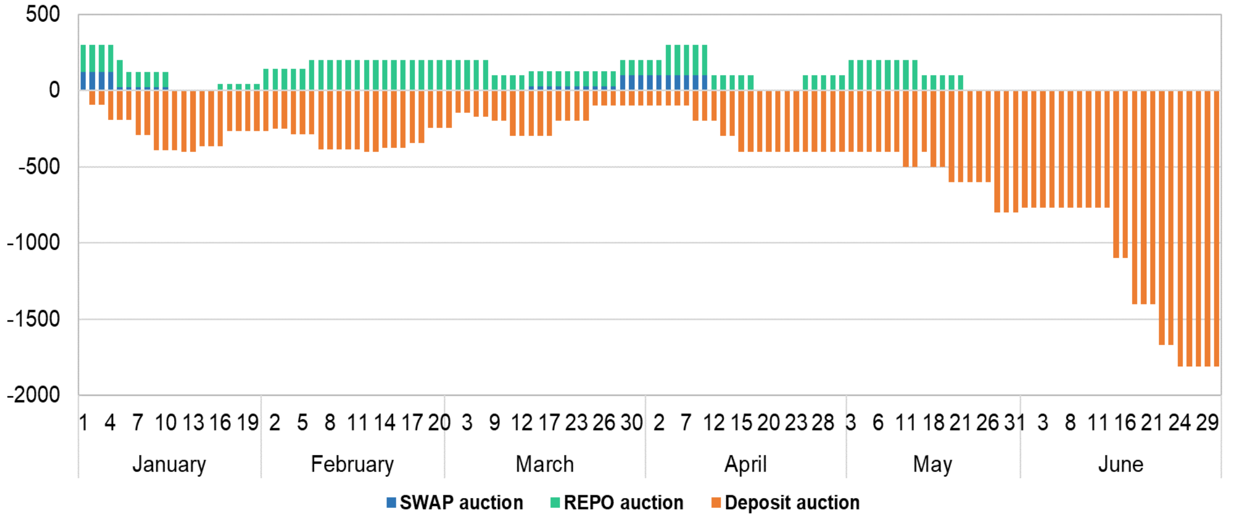
In Q2 2021, the Central Bank continued to actively use short-term monetary policy instruments to regulate the overall level of liquidity. These operations depended on the state of liquidity of the banking system and the level of compliance with the established standards by commercial banks.

At the same time, as a result of the rise in total liquidity during the quarter, the demand for deposit operations by banks increased sharply, while the demand for liquidity operations remained low (*Figure 4.3)*.

Due to the raise in the general level of liquidity, the demand for REPO and SWAP auctions fell sharply, while the demand for deposit auctions increased. In particular, since the second half of May, REPO and SWAP auctions have not been hold.

The volume of **deposit auctions** has been steadily increasing. In particular, the total volume of monthly auctions amounted to **800 bln.** sum in April, to **1.2 trln.** sum in May and to **3.1 trln.** sum in June. As of July 1, the stock of these operations amounted to **1.8 trln.** sum.

Figure-4.3. Daily average stock of Central bank's REPO, SWAP and deposit auctions *(billion sums)*

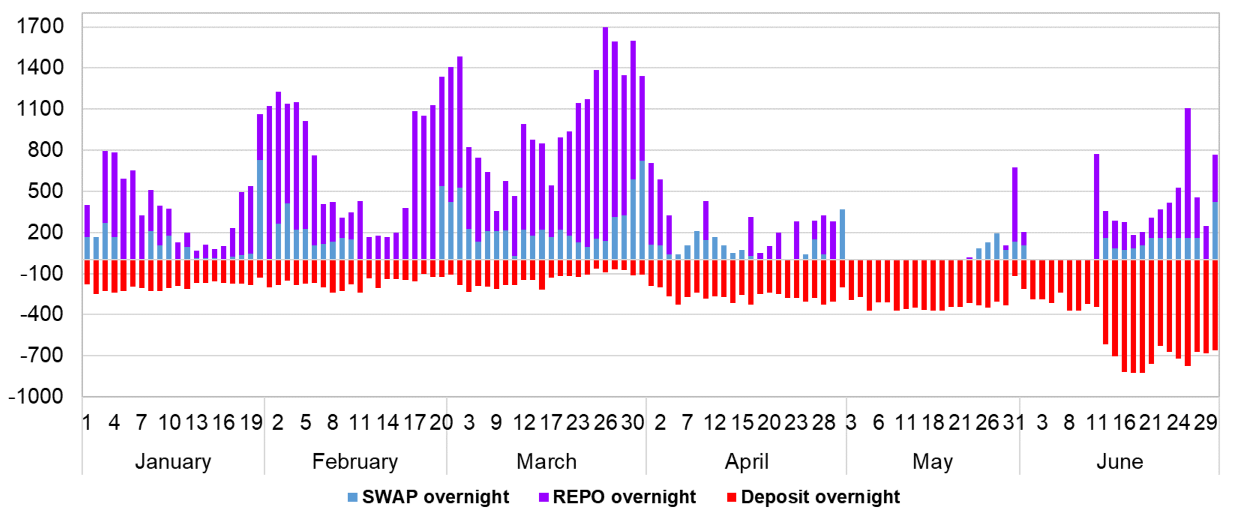


Source: *Central bank*

A similar situation was observed with the Central Bank's overnight operations, with an increase in the volume of overnight deposit operations and a significant decrease in demand for overnight REPO and SWAP operations during the Q2 of this year (*Figure 4.4*).

In particular, the average daily overnight REPO operations during the quarter amounted to **161 bln.** sum, overnight SWAP operations amounted to **70 bln.** sum and overnight deposit operations amounted to **381 bln.** sum.

Figure-4.4. Daily average stock of Central bank's overnight REPO, SWAP and deposit operations *(billion sums)*



Source: *Central bank*

It should be noted that based on the medium-term forecast of total liquidity, the demand for deposit auctions is expected to remain **stable** in the coming months and the volume of overnight deposit operations will **increase**. Due to the structural surplus in the liquidity of the banking system, the demand for liquidity operations of the Central Bank will remain **low**.

The Central Bank and the Ministry of Finance announced a schedule of bonds issuance in 2021 Q2, which allowed commercial banks to plan liquidity management practices in advance.

In particular, there was active issue of government securities, which amounted to **6.2 trln.** sum of notes by the Central Bank and **1.1 trln.** sum of bonds by the Ministry of Finance were issued (*Figure 4.5*).

As of July 1, 2021, **8.0 trln.** sum of Central Bank notes and **3.2 trln.** sums of bonds by the Ministry of Finance was available in circulation.

The yield curve of these bonds shows that the weighted average interest rates on securities with different maturities are formed to a greater extent not on macroeconomic expectations, but on the basis of the situation with the liquidity of the banking system at the time of issue and market demand *(Figure 4.6)*.

4.5-расм. Issuance of government securities *(billion sums)*

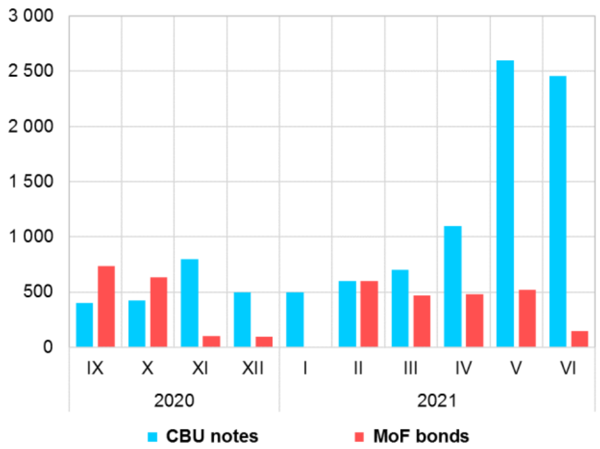
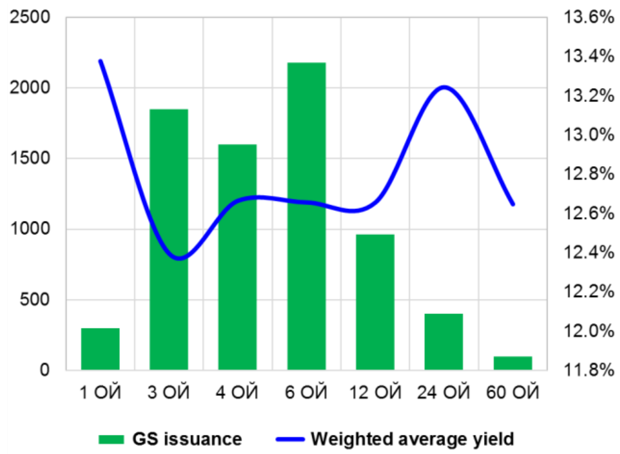


Figure-4.6. Yield curve of government securities



Source: *Central bank*

At the same time, the increase in the issuance of bonds and cooperation between the Ministry of Finance and the Central Bank on their issuance will serve to increase the volume of primary and secondary trades and the formation of **an effective "yield curve"** that provides information on macroeconomic expectations.

Further improvement of the set of monetary policy instruments, implementation of necessary measures for the development of the interbank REPO market and the secondary market of government securities are the important tasks on the agenda in the coming periods.

4.3. Analysis of deposit volume and interest rates

Interest rates formed in the interbank money market and inflation expectations of the population and businesses for the future play an important role in the formation of interest rates on deposits in the economy.

In particular, interest rates on time deposits of individuals in the national currency increased from **19.1%** in March 2021 **to 19.5%** in June this year. Interest rates on time deposits of legal entities in the national currency decreased **from 16.7%** in March **to 16.0%** in June (*Figure 4.7*).

Given the high level of demand for long-term monetary resources in the economy, the limited supply of long-term resources is reflected in the dynamics of growth in interest rates on long-term deposits.

The decline in interest rates on time deposits of legal entities is relative to the large deposits for medium-term by public sources and funds in the H1 of the year.

Figure 4.7. Nominal interest rates on time deposits in national currency

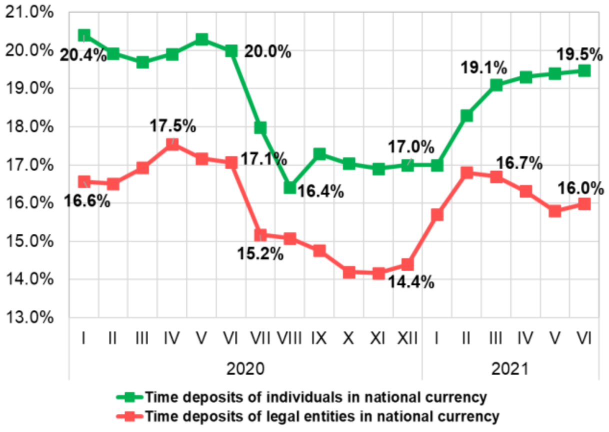
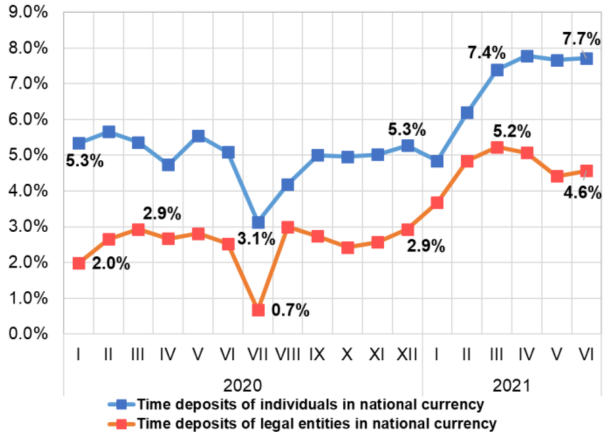


Figure-4.8. Real interest rates on time deposits in national currency



Source: *Central bank*

In the Q2, along with the growth of nominal interest rates on time deposits, there was a rise in real interest rates on deposits due to the stable formation of inflation in the economy at around 11%. At the same time, real interest rates on deposits of individuals increased **to 7.7%** in June (*Figure 4.8)*.

In June, **inflation expectations** of the population and businesses for the next period were **16.3%** and **15.4%**, respectively.

Given that economic entities proceed from their inflationary expectations when making decisions on consumption, savings or investment, real interest rates on household deposits remain positive at **2-3%**.

In 2021 Q2, the total money supply raised by **10.2%** and equaled to **116.1 trln.** sum. There was a seasonal increase in the volume of cash in circulation by **15.5%** (3.5 trln. sum) (*Figure 4.9)*.

Figure-4.9. Dynamics of broad money and its components *(trillion sums)*

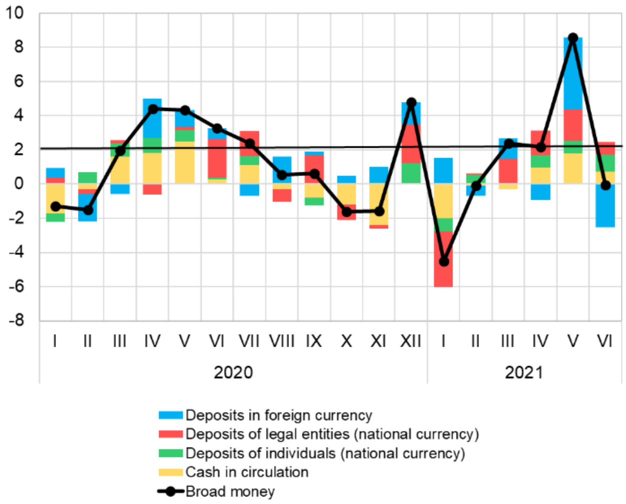
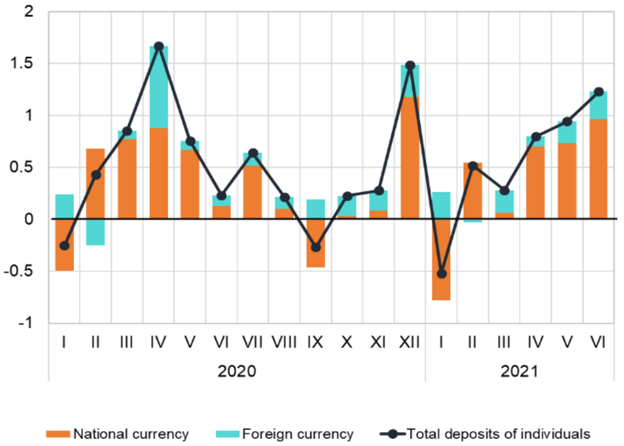


Figure-4.10. Change in deposits of individuals *(trillion sums)*



Source: *Central bank*

In turn, deposits in foreign currency increased by **2.1%** (equivalent to 0.8 trln. sum), while the total volume of deposits in the national currency increased by **13.9%** (6.4 trln. sum). The higher growth rates of deposits in national currency than in foreign currency will serve to **increase confidence in sum** in the economy, **a positive change** in exchange rate expectations and a further decline in the level of dollarization of deposits.

In general, in the H1, deposits in national currency increased by **9.3%** or **4.4 trln.** sum and deposits in foreign currency raised by 8.4% (equivalent to 2.9 trln. sum).

It should be noted that the change in the volume of money supply in the economy is seasonal, and similar dynamics in the current year was also observed in preceding years. In particular, the total money supply in Q2 2020 increased by **13.3%** (12.0 trln. sum), while in the corresponding period of 2019 this value increased by **10.9%** (8.7 trln. sum).

This situation can be explained by **the specificity of the activities of economic entities**, in particular, the high activity of savings, the temporary accumulation of funds in the accounts of exporting enterprises and the accumulation of funds by large enterprises for future expenses in the H1 of the year.

Based on the dynamics of previous years, business entities are expected to incur operating and investment costs at the expense of these funds in the coming months.

Significant growth dynamics was observed in the total deposits of **individuals**, which was met largely by an increase in deposits in the national currency. In particular, in the Q2, the total deposits of individuals in banks increased by **10.9%** and equaled to **30.4 trln.** sum, while deposits in national currency raised by **14.2%** (to 2.4 trln. sum) and deposits in foreign currency raised by **5.4%** (equivalent to 0.6 trln. sum) (*Figure 4.10*).

In general, in the H1 of the year, total deposits of individuals increased by **12%** (3.3 trln. sum). At the same time, the annual growth of total deposits of individuals amounted to **23.8%** (5.8 trln. sum), exceeding the annual inflation rate (10.9%) by **2.2 times** and changing in proportion to the growth trends of **real incomes of the population** (10.8% per annum).

Given the current real interest rates on deposits in national currency and the current stable dynamics of the exchange rate, deposits in national currency are expected to increase further in the coming quarters.

4.4. Analysis of interest rates on loans

The main factors in the formation of interest rates on loans in the economy are the inflation rate, the cost of resources in the money market, inflationary expectations of economic agents and the deposit interest rates formed on their basis.

Consistent with that, **prudential measures** taken in the formation of interest rates on loans in light of the pandemic, in particular, the cancellation of **the preferred interest rate** mechanism in the H2 last year, changes in credit **risk** assessment criteria in this year and increased **investment activity** in the economy and the growing demand for resources also played an important role.

In particular, interest rates on short-term loans in the national currency decreased **from 21.9%** in March **to 21.2%** in June, while on long-term loans increased **from 21.2%** in March **to 21.4%** in June (*Figure 4.11*).

The formation of interest rates on short-term and long-term very close to each other is explained by that the structure of long-term loans includes loans at relatively low interest rates on the basis of government programs.

In turn, during the quarter, interest rates on loans to individuals in the national currency increased **from 22.1% to 22.2%,** while there was a decrease **from 21.1% to 20.8%** on loans for legal entities (*Figure 4.12)*.

Figure-4.11. Nominal interest rates on loans in national currency

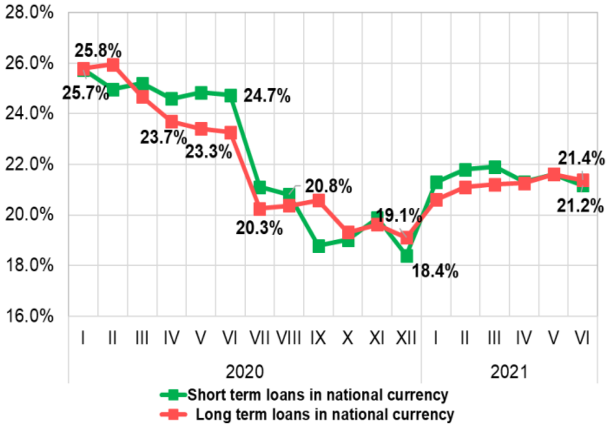
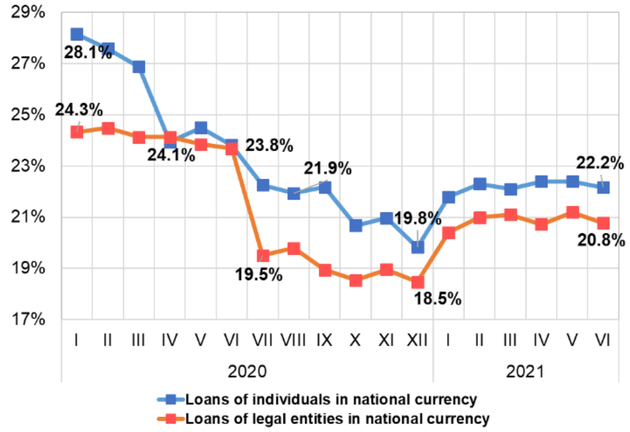


Figure-4.12. Nominal interest rates on loans in national currency



Source: *Central bank*

Box

International financial markets and changes in the monetary policy of foreign central banks

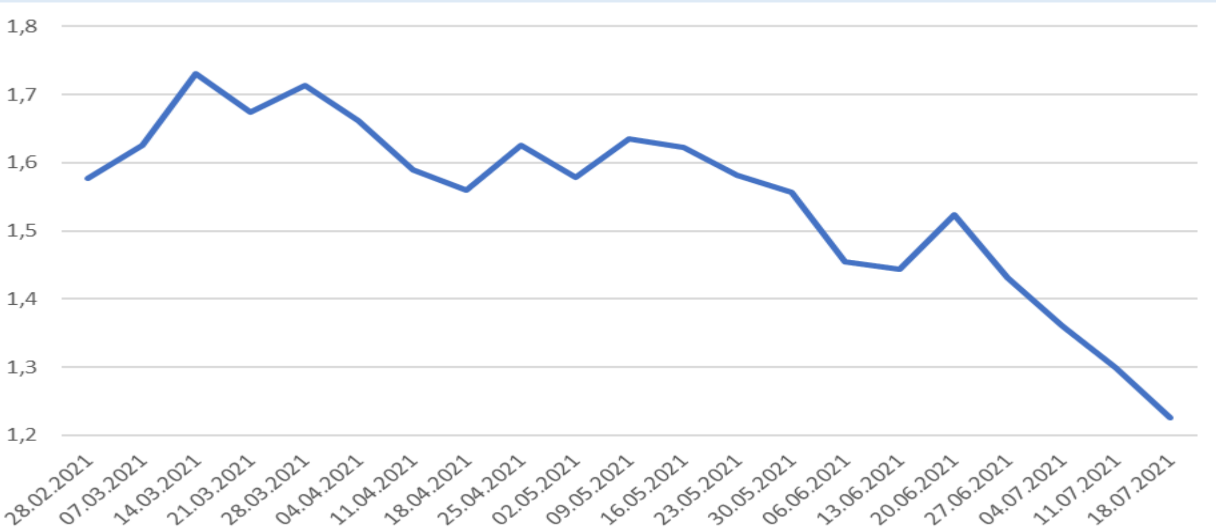
In 2021 Q2, the excessively easy policies of the central banks of developed countries, as well as vaccination and the improvement of expectations for economic recovery, led to **a moderate tightening of monetary policy** across many economies around the world. In particular, the Central Bank raised interest rate by **125 basis points** (1.25 p.p.) in Armenia and Brazil, by **150 basis points** (1.5 p.p.) in Kyrgyzstan, by **200 base points** (2 p.p.) in Ukraine and Turkey, and by **225 base points** (2.25 p.p.) in Russia.

In addition, the IMF predicts that the expected rise in US inflation due to the rapid economic recovery could lead to the policy rate increase by the FRS in late 2022 or early 2023. At the same time, the FRS indicates that **the terms of the stimulating monetary policy** will remain until 2023.

One of the factors that may indirectly affect the outflow of capital from Uzbekistan's partner countries is **the change in the yields on US government bonds**, as the main principle of investing in bonds is that market rates and debt securities yields are usually formed in opposite directions.

In particular, when interest rates rise, the value of fixed-yield bonds falls. This phenomenon is known as an **interest rate risk**. Currently, the FRS is keeping rates to a minimum. However, as noted, the recent rise in inflationary pressures may force the regulator **to tighten its policy**.

US 10-year Government Bonds Yield Curve



At the same time, market dynamics (the transition of capital from stock markets to bonds) led to a decline in the yield on 10-year US bonds **to 1.39%**. In May, this figure was just below **1.7%.** Despite the recovery of the US economy and rising inflation, yield is remaining high comparing to last year, even as generally it is declining.

High interest rates and high asset yields reduce risk returns for investors and lead to capital outflows from developing countries.

On the other hand, annual inflation in the U.S. could rise **to 5.4%** in June, prompting investors to switch to **less risky assets**.

It should be noted that despite relatively positive overall indicators, the level of uncertainty associated with the pandemic in the world, in particular the impact on the world economy, financial market dynamics and the overall macroeconomic situation through the **spread of new delta and lambda variants of coronavirus**, remains unclear.

Glossary

Administratively regulated prices	– prices that are developed not under the impact of the market drivers (supply and demand), but are fixed by the public administration authorities, organizations and enterprises by administrative way for certain goods (services) with the aim of restricting changes of their prices.
Anchoring of inflation expectations	– linking the forecasted inflation rates of the population and business entities for the next medium term to a certain quantitative indicator (inflation target).
Average weighted interest rate	– an average rate calculated with the account of the weight of the studied indicator in the aggregate volume. The share of each rate stake in the aggregate volume is taken as scales.
Balance of payments	– statistical report which reflects all economic transactions between residents and non-residents for a certain period of time.
Consumer demand	– a part of the aggregate demand in the economy related to consumer goods and services.
Consumer Price Index (CPI)	– an indicator of the change in the general level of prices for goods and services purchased by the population for consumption. The CPI is calculated as the ratio to the cost of fixed set of goods and services in the prices of the current period to its value in the prices of the previous (basic) period.
Core inflation	– inflation calculated without including changes of prices for certain goods and services, subject to the impact of factors which have a seasonal and administrative character (fruit and vegetable products, fuel, certain public transport services, communication services, housing and public utilities, etc.)..
Cross-border money transfer	– transfer of funds to or from the country through international money transfer systems.
Currency crisis	– sharp fluctuations in exchange rates in the foreign exchange market, the depletion of the country's foreign exchange reserves and the sharp imbalances in the balance of payments, as well as an increase of imbalances in foreign exchange and loan markets.
Currency interventions of the Central Bank	– participation of the Central Bank in the foreign exchange market by selling and buying foreign exchange with the aim of sterilization additional liquidity in the banking system formed as a result of the purchase of the monetary gold by the Central Bank with the aim of smoothening or prevention of sharp fluctuations of the exchange rate.
Current account	– a section of the balance of payments of the country which reflects the flow of goods, services, primary and secondary income (wages of employees, return on investments and others) between residents and non-residents.
Deposit auctions	– operations of the Central Bank to attract funds on the representative account of commercial banks at auction interest rates (usually for one or two weeks) in order to manage the overall liquidity of the banking system and temporarily withdraw excess liquidity from the banking system in the context of structural liquidity surplus.

Economic cycle	– a natural form of economic development, in which the rise in production, employment, GDP growth is replaced by periods of recession.
Financial market	– system of economic relations arising in the process of the exchange of economic benefits.
Financial stability	– the state in which the financial system effectively performs its functions, ensuring the redistribution of resources and financial risk management, there is no excessive volatility in the financial market (its segments), the smooth execution of settlements is ensured, as well as the ability of financial system to function in extreme conditions, preventing the impact of negative shocks, and to recover under stress.
Financial system	– a set of financial organizations and financial markets that provide with the help of various financial instruments the formation and use of funds from the state, organizations, and the population. At the same time, financial institutions (markets and financial organizations) carry out the redistribution of limited financial resources from one economic entity to another.
Gross domestic product deflator	– a change in the overall level of prices for goods and services produced and consumed in a country over a period of time.
Inflation inertia	– the tendency of inflation to return slowly to its long-term (equilibrium) level after the shock, which deviated it from this long-term level.
Inflation target	– a pre-announced target of inflation that lays the groundwork for long-term economic growth and price stability.
Inflation targeting regime	– the monetary policy regime, in which the Central Bank declares medium-term target for the inflation rate and focuses all its efforts on bringing current inflation to its target by applying monetary instruments.
Inflationary expectations	– assumptions of the population and entrepreneurs about the future inflation rate, which they take into consideration when making economic decisions. Proceeding form the inflationary expectations, producers and consumers, sellers and buyers elaborate their future monetary, financial and pricing policies, assess level of income, expenditure and expected volume of profit.
Interbank money market	– a system of organization and implementation of exchange trades of short-term transactions (as a rule, up to one year) for the placement and attraction of cash funds in the national and foreign currencies.
Interest rate corridor	- a system of approximation of short-term interest rates in the money market to the key policy rate (interest rate target) of the Central Bank; the upper limit of the interest rate corridor is the Central Bank's lending rate to commercial banks (usually the overnight rate), and the lower limit is the Central Bank's rate for attracting deposits from commercial banks.
Interest rate policy of the Central bank	– part of the monetary policy of the Central Bank, with the help of which the Central Bank influences the cost of financial resources and the level of interest rates in the economy, as well as the financial and investment decisions of the population and business. The interest rate policy is aimed at maintaining a certain level of interest rates in the economy in order to ensure positive real rates on assets of the national currency. A change in the central bank's interest rate affects

	the level of interest rates in the economy as a whole, which corresponds to investment/savings and therefore to aggregate demand.
Investment demand	– demand from business entities for physical capital objects (cars, equipment) and services used to maintain or expand its activities. Investment demand is a part of the aggregate demand in the economy.
Key interest rate	– the interest rate, which determines the interest rate for borrowing for commercial banks and the cost of borrowing for borrowers; the change in the key interest rate affects the interest rates in the interbank money market.
Liquidity of the banking system	– cash balances in the national currency on correspondent accounts of commercial banks in the Central Bank of the Republic of Uzbekistan.
Liquidity sterilization	– withdrawal of excessive liquidity from the banking system occurred due to the various factors.
Long-term money	– expression used in the economy to characterize finance for long-term (more than a year) borrowings (investments) or loans provided for a long time.
Macroprudential policy	- a set of active measures aimed at minimizing systemic risk in the financial sector or its individual sectors.
Monetary factors of inflation	– inflation factors which can be directly impacted by the Central Bank with the help of monetary policy instruments in the medium-term perspective.
Monetary policy	– a part of the monetary policy, conducted by the Central Bank of the Republic of Uzbekistan with the aim of ensuring price stability in the domestic market. Monetary policy is implemented through the use of monetary instruments to maintain liquidity in the banking system, interest rates and other monetary indicators at the target level.
Money supply	– an aggregate amount of cash in circulation and money in the bank accounts. To analyze money supply various money aggregates classified by the liquidity degree are calculated: M0 – cash in circulation; M1 – M0 + demand deposits in the national currency; M2 – M1 + term deposits, saving deposits and other deposits + deposits in foreign exchange.
Non-monetary inflation factors	– factors affecting inflation, which are beyond the influence of monetary policy of the Central Bank. This group includes external economic conditions, structural factors (the state of the basic funds, productivity and production efficiency, supply and qualitative parameters of the labor force, technological level of production, transport, logistics infrastructure, concentration of markets), legal regulatory environment, fiscal policy, factors on the part of supply of goods and services.
Output gap	– the difference between actual GDP and potential GDP. A positive GDP gap is called the inflationary gap, which indicates that the growth in aggregate demand outstrips the growth in aggregate supply, which possibly leading to inflation. A negative GDP gap is called a recessionary gap, which possibly leads to deflation.

Refinancing rate	– the interest rate of the Central Bank which is used in the transactions of the Central Bank with commercial banks to extend loans.
REPO operations	- operations of selling government securities to the Central Bank on the basis of a repurchase agreement of commercial banks for short-term borrowing or operations of selling securities to commercial banks for the purpose of managing the Central Bank's money supply and bank reserves (in this case, government securities act as collateral).
Reserve requirements of commercial banks	– funds deposited by commercial banks with the Central Bank in order to execute reserve requirements of the Central Bank. The minimum level of reserve requirements deposited with the Central Bank is determined by the regulations of the Central Bank, taking into consideration the objectives of monetary policy and depends on the size, type and term of deposits, other liabilities of banks. The amounts of reserve requirements the equal for all banks by each category of attracted funds.
Systemic risk	– is the risk of collapse of the entire financial system or the entire financial market, as opposed to the risk associated with any participant in the financial market, a group of participants or a separate component of the financial system.
Time lag	– indicator reflecting time backlog of one of economic events in comparison with another one, connected with it; a period of time between two connected events.
Transmission (transferring) channels of the monetary policy	– channels of impact of decisions in the field of monetary policy on the dynamics of prices and the economy as a whole. The process of gradual distribution of the signal of the Central Bank about retention or change of the interest rate and its future trajectory from segments of the financial market to the real sector of the economy and, as a result, to the inflation. The change in the interest rate level is transmitted to the economy through the following main channels: interest rate, credit, currency, asset prices and expectations.
Trend	– the main tendency in the indicator. Trends can be linear equations, described by various logarithmic, power, and so on. The actual type of trend is established based on the selection of its functional model by statistical methods or by smoothing the initial time series.

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