Central Bank
of the Republic of Uzbekistan

2024 Q1

MONETARY POLICY REPORT

Central Bank of the Republic of Uzbekistan

In implementing monetary policy, the emphasis is placed on achieving price stability and the medium-term inflation target of 5 percent

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SUMMARY

At the meeting on April 25, 2024 the Central Bank Board kept the policy rate unchanged at 14 percent per annum given that the impact of fundamental monetary factors on inflationary processes in the economy is gradually diminishing. In addition, the liberalization of certain regulated prices starting May 1 this year will probably have a one-time effect on headline inflation.

Headline inflation has been further declining since the beginning of the year, amounting to 8 percent year-on-year in March, with a substantial decrease in the food component. The price dynamics in external food markets have had a downward effect on imported inflation.

Due to continuing stronger demand and recent increases in certain regulated prices and tariffs, services inflation has been further rising in recent months.

Annual core inflation significantly decelerated to 7.6 percent in March, being lower than headline inflation since the beginning of this year.

Inflation expectations of households and businesses remain higher than the actual and projected inflation rates. Furthermore, the adjustments in regulated prices and the imposition of VAT on certain goods and services from April may lead to an increase in inflation expectations.

According to the updated macroeconomic forecasts, taking the above-mentioned factors into account, the headline inflation projection for 2024 under the baseline scenario has been revised upward to 9-11 percent.

The wider range of the forecast corridor is attributed to the difficulty of assessing the effects of tariff increases on the inflation expectations of households and businesses given mitigating measures such as lump-sum payments to the population due to tariff increases, as well as introduction of the social norm on energy consumption and the two-month grace period.

According to the estimates, at the upper bound of the inflation forecast, monetary conditions will still continue mitigating the impact of monetary factors on inflation and stimulating savings in the national currency.

There are strong expectations for core inflation to remain on a steady downward trajectory, and according to forecasts, core inflation will amount to 7-8 percent by the end of the year.

The revision of the headline inflation forecast reflects a higher increase in regulated prices than initially anticipated in the macroeconomic forecasts presented in the Monetary Policy Guidelines.

However, these changes, which have a one-time effect on prices in the economy, will reduce consumer demand to a certain degree and will not significantly affect the downward trend of inflation in the medium term.

Additional government measures aimed at increasing aggregate supply and reducing inflation, as well as the cumulative effects of prolonged relatively tight monetary conditions, will help curb inflation.

Economic growth accelerated to 6.2 percent in the first quarter of 2024, with high growth rates observed in the services, retail, and construction sectors, as well as increased investment activity in manufacturing and mining industries.

Demand for labor is significantly increasing. However, there is some segmentation in the supply of labor, with pent-up demand in high skilled sectors. Therefore, there is a higher wage growth in these sectors.

The real exchange rate of the national currency has depreciated by 0.9 percent since the beginning of the year, in line with its long-term trend. Considering the exchange rate and inflation forecasts in trading partners, no pressures on the real exchange rate are expected.

According to the updated forecasts, GDP growth is expected to range between 5.2 and 5.7 percent by the end of the year.

The revision of the economic growth forecast is associated with a relatively moderate consumer demand in the future due to structural changes in the expenditures of the population and business entities.

High activity in private investments, fiscal incentives, and the growing dynamics of household incomes, as in previous years, will continue to support the economic growth during this year.

The current tightness of the monetary conditions is resulting in a gradual moderation of credit growth rates and an acceleration of deposit growth through ensuring positive real interest rates in the economy.

In the coming quarters, the banking system's overall liquidity is expected to gradually shift from a structural surplus to a structural deficit, and these structural changes will be adjusted through monetary operations.

Meanwhile, should core inflation deviate significantly from its downward trajectory and inflation expectations of the population rise sharply, appropriate measures will be taken to adjust monetary conditions.

The Central Bank will place particular emphasis on the balance of supply and demand in the economy, inflation expectations and the pace of structural reforms while implementing a moderately tight monetary policy aimed at achieving the 5 percent inflation target.

I. MEDIUM-TERM MACROECONOMIC OUTLOOK

1.1. Macroeconomic outlook

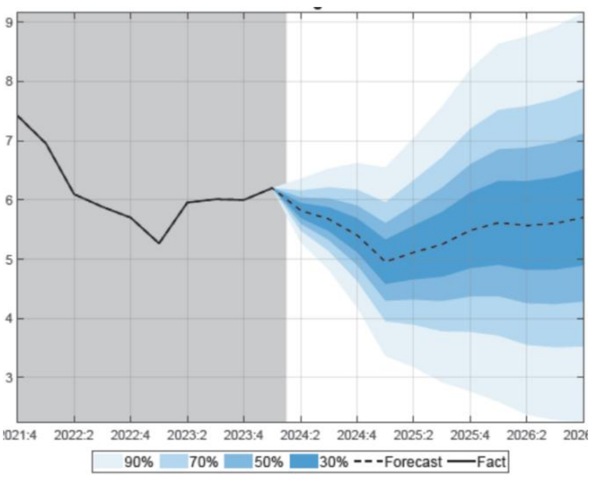
The Central Bank has revised medium-term forecasts of macroeconomic development taking into account the level of aggregate demand and supply in the economy at the end of the first quarter of 2024, expectations of some moderation of consumer demand in the future as a result of structural changes in the expenditures of households and business entities, outlooks for the economic development of trading partner countries, expectations on world prices for major export and import goods.

According to the updated forecasts, economic growth in 2024 is expected to amount to 5.2-5.7 percent. This figure has been revised slightly downward compared to the estimates in January of this year (Figure 1.1.1), which is mainly attributed to a certain optimization of future consumer demand due to structural changes in the expenditures of households and businesses.

According to the updated forecasts of the IMF and the World Bank, Uzbekistan's economy is expected to grow by 5.2 percent and 5.3 percent in 2024, respectively (Figure 1.1.2).

This year, on the demand side, economic growth is expected to be driven by the fiscal stimulus effects, household income, investment and export components.

Figure 1.1.1. GDP growth forecast, *percent*



Source: CBU calculations

Figure 1.1.2. GDP growth forecast for Uzbekistan by international financial organizations, *percent*

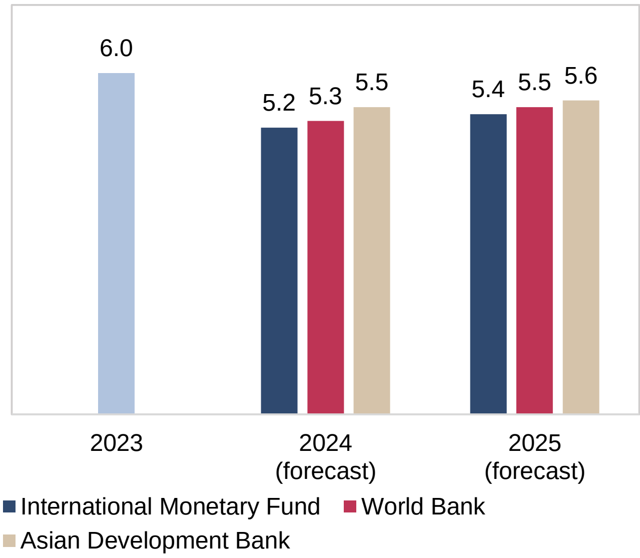


Table 1.1.1. Main macroeconomic indicators, *percent change*

Indicators	Actual		Forecast		
	2022	2023	2024	2025	2026
Inflation *(annual, end of period)*	**12.3**	**8,8**	**9-11**	**5-6**	**5**
Inflation *(annual average)*	11.4	10	9 - 11	7 - 9	5-6
Core inflation *(annual, end of period)*	13,8	8,5	7-8	4,5-5,5	4,5-5,5
Real GDP	**5,7**	**6.0**	**5,2 - 5,7**	**5-6**	**5,5 -6,5**
Final consumption expenditure	9,2	5,1	4-5	4,5-5,5	5-6
- private	*11,4*	*6,1*	*4-5*	*5-6*	*5-6*
- public	*1,3*	*1,4*	*1,5-2*	*1-2*	*2-3*
Exports	18,4	23,8	9 -12	8-10	8-10
Exports *(excluding gold)*	*21,6*	*4,2*	*12-14*	*10-12*	*12-14*
Imports	20,3	24,0	10-12	9-10	8-10
Cross-border remittances	2,1 p.	-32,9	8-10	11-13	10-12
Stock of loans	21,4	23,3	15-17	14-17	12-15

Source: CBU calculations

Foreign trade. According to the results of the first quarter of the current year, exports (excluding gold) grew in line with the baseline scenario of the forecast. Meanwhile, the continued geopolitical uncertainty, expectations of monetary easing cycle by the leading central banks by the end of this year, as well as an increase in demand for gold, in turn, are the key factors behind the price growth for this asset.

Moreover, higher uranium prices due to the increasing role of nuclear power in the world and higher copper prices owing to positive trends in China's manufacturing sector can also support the dynamics of non-gold exports this year.

However, as the price of cotton has returned to last year's levels after a sharp rise in the first few months of the quarter, there is still high uncertainty regarding its future trajectory.

Taking the above factors into account, overall export growth is projected to be 9-12 percent, with non-gold export growth of around 12-14 percent (Figure 1.1.3).

In the first quarter this year, there was a slightly lower increase in imports due to the high base generated by imports of vehicles last year. The growth of imports excluding machinery and equipment amounted to about 8 percent in the first quarter.

Growing imports continue to reflect the balance between consumption and investment activity.

Figure 1.1.3. Non-gold export growth, *percent*

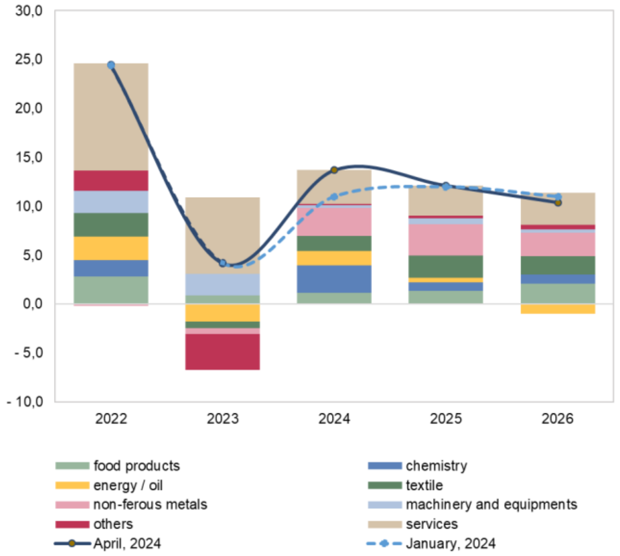
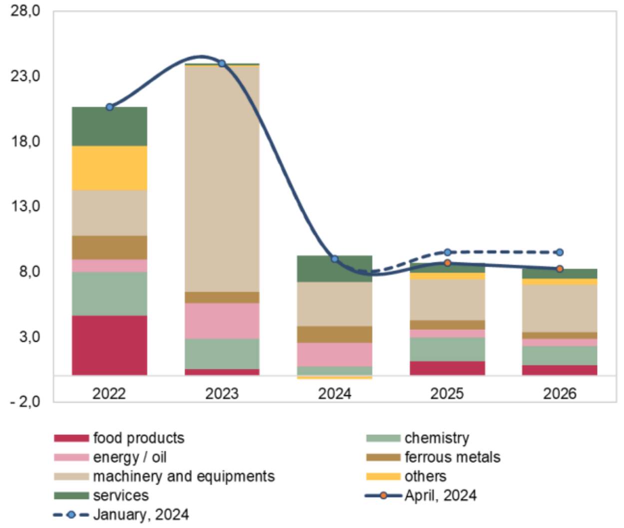


Figure 1.1.4. Import growth, *percent*



Source: Statistics agency, CBU calculations

This, on the one hand, is reflected in a decrease in food imports and on the other hand – in further increase in imports of energy resources, ferrous metals, as well as machinery and equipment amid ongoing intensive reforms and expansion of production capacities.

Given the current trends, the import growth projection was maintained at 10-12 percent (Figure 1.1.4).

Household incomes and labor market. Household incomes in the first quarter remained stable amid accelerating wage increase and growth of remittances in the economy.

Assuming no significant fluctuations in the exchange rate, remittances are projected to reach 12-12.5 billion dollars by the end of 2024 (Figure 1.1.1.6).

Meanwhile, due to taking into account the liberalization of some regulated prices and tariffs and, as a consequence, an acceleration of inflation, households' real disposable income may slightly decrease, and, accordingly, households' consumption may accordingly moderate (Figure 1.1.5).

The key factors supporting incomes will be additional targeted social transfers, wage growth, fiscal incentives and a rising trend of remittances.

Labor market activity will continue to increase, with services and trade remaining as the major sectors supporting market activity. However, labor supply remains structurally unbalanced relative to demand, potentially causing differences in wage growth across sectors of the economy.

Figure 1.1.5. Real growth of private consumption, *percent*

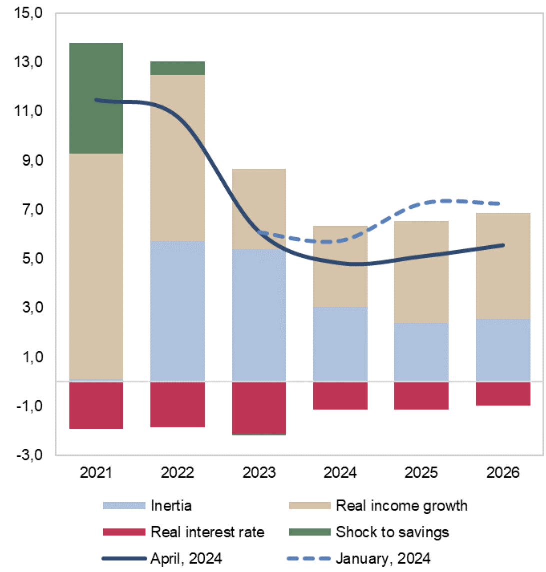
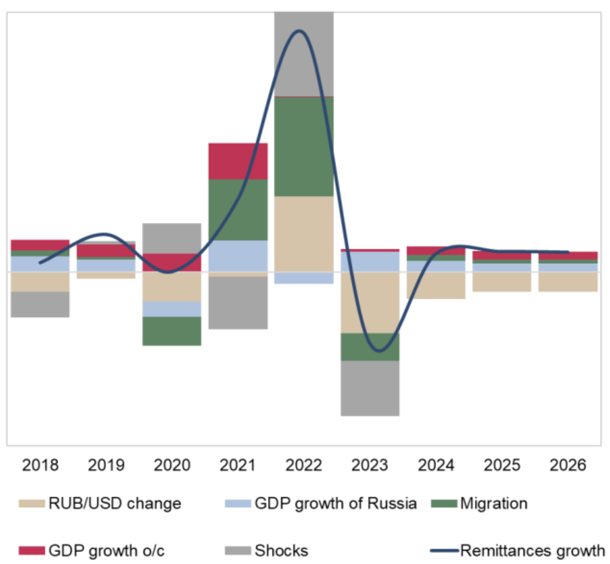


Figure 1.1.6. Forecast of cross-border remittance growth, *percent*



Source: CBU calculations

Investment activity. Starting from 2023, there has been a tendency for economic activity to shift from consumption to investment. In the first quarter, real growth in fixed capital investment amounted to 74.5 percent, which is significantly higher than the average of recent years.

Private investment, mainly foreign direct investment, will contribute to this year's overall economic activity.

In general, investment and exports are expected to support economic growth this year, despite some moderation in private consumption.

1.2. External economic outlook

As a result of improved global economic activity in the first quarter of 2024, global economic growth forecasts have been revised upwards. However, along with the reduction of fiscal stimulus, the level of tightness of financial conditions and the persistence of geopolitical risks remain the factors restraining economic growth.

Amid the improving economic situation, global commodity prices, including energy prices, are rising. This, in turn, may create a risk of slight acceleration in inflation over the forecast period.

Global economic activity continued to recover in the first quarter of 2024, and the global composite PMI reached 52.3 points at the end of March owing to the rapid expansion of industrial production and high activity in the services sector.

According to the IMF's April report, the global economic growth forecast for 2024 was revised up to 3.2 percent, yet this expectation is still historically low. High external borrowing costs, gradual fiscal consolidation, and geopolitical risks will continue constraining economic growth.

Figure 1.2.1. Composite PMI dynamics by individual countries

	2023									2024		
	apr	may	jun	jul	aug	sep	oct	nov	dec	jan	feb	mar
China	53.6	55.6	52.5	51.9	51.7	50.9	50	51.6	52.6	52.5	52.5	52.7
Russia	55.1	54.4	55.8	53.3	55.9	54.7	53.6	52.4	55.7	55.1	52.2	52.7
Kazakhstan	53.3	53.2	51.6	51.9	50.5	52.6	50.4	48.9	49.4	49.7	47.7	50.9
Türkiye*	51.5	51.5	51.5	49.9	49	49.6	48.4	47.2	47.4	49.2	50.2	50
USA	53.4	54.3	53.2	52	50.2	50.2	50.7	50.7	50.9	52	52.5	52.1
Eurozone	54.1	52.8	49.9	48.6	46.7	47.2	46.5	47.6	47.6	47.9	49.2	50.3
World	54.2	54.4	52.7	51.6	50.6	50.5	50	50.4	51	51.7	52.1	52.3

** Note: For Türkiye, the manufacturing PMI is presented, as the services PMI is not calculated for Türkiye*

Expectations for economic growth in developed economies have been notably improved.

U.S. output growth is accelerating amid improving demand. In contrast, the updated economic outlook for the Eurozone has been slightly lowered due to continued weak consumer demand and rising energy prices.

The economies of some major trading partner countries are also expected to grow significantly this year. Particularly in Russia, there was a rapid output growth in the first quarter of 2024 amid continuing strong demand. Russia's economic growth forecast for this year has been considerably raised to 3.1 percent (+0.5 p.p.) given the strengthening business environment and private consumption.

Trade and construction remain the drivers of economic activity in Kazakhstan, however, there is a slight slowdown in production and investment. Kazakhstan's economy is projected to grow by 3.1 percent in 2024.

China's manufacturing sector continues to improve rapidly, with the composite PMI reflecting sustained positive momentum amid recovering consumer demand.

As supporting consumption is one of the priorities of the Chinese government's strategy this year, private consumption is likely to continue rebounding in the country until the end of 2024. However, challenges in the housing sector are expected to persist. China's economic growth forecasts for 2024 remain unchanged at 4.6 percent.

Figure 1.2.2. GDP growth forecasts for 2024, *percent*

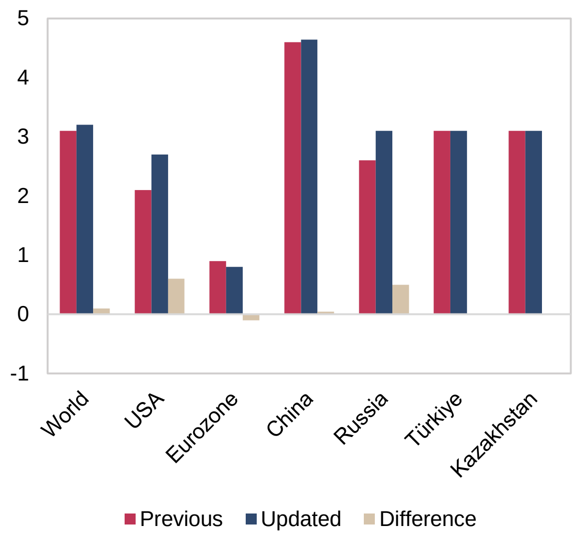
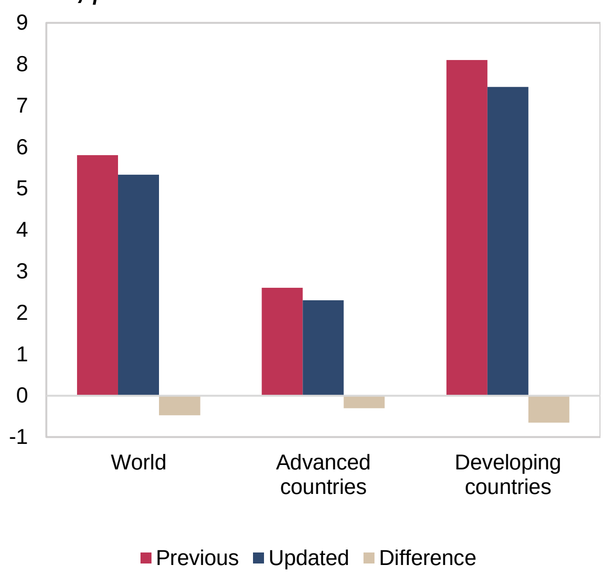


Figure 1.2.3. Inflation forecasts for 2024, *percent*



Source: «World Economic Outlook», IMF, April 2024.

Stable global economic activity is accompanied by a gradual slowdown in global inflation amid an increase in supply. The IMF in its April report lowered inflation forecasts for 2024 in both developed and developing countries (Figure 1.2.3).

Meanwhile, the price developments in some countries remain uncertain.

In Russia consumer activity remained strong owing to a significant increase in household incomes, leading to a slight acceleration of inflation in the first quarter. Nonetheless, the Bank of Russia expects inflation to decrease to 4-4.5 percent in 2024.

Annual inflation in Kazakhstan continued slowing in the first quarter, amounting to 9.1 percent at the end of March. According to the baseline scenario of the National Bank of Kazakhstan, consumer inflation is projected to range between 7.5-9.5 percent by the end of 2024.

Overall, the risk of global inflation spiraling somewhat increased due to uncertainty regarding oil prices, as well as an increase in the FAO index in March.

The International Energy Association has raised its oil price forecast for 2024 from 82 to 87 dollars per barrel due to the current production and export restrictions by OPEC+ countries.

A higher-than-expected (3.5%) U.S. inflation rate in March reduced the probability that the Federal Reserve will start monetary easing in June.

Global financial situation remains challenging amid high uncertainty. In particular, in March, the world gold price reached a new historic high due to worsening geopolitical situation in the Middle East and increased demand for gold by major central banks. As of the end of the first quarter, the price of precious metal rose by an average of 7 percent, and by 13 percent in annual terms.

In the future, geopolitical risks coupled with the expected easing of financial conditions by the end of the year will contribute to the further upward trend in gold prices.

1.3. Inflation forecast and inflation expectations

In recent quarters, both headline and core inflation continued steadily decelerating owing to the diminishing influence of fundamental monetary factors and external conditions on inflationary processes in the economy.

However, gradual increase of some regulated prices may have increasing pressure on inflation in the future.

Inflation rate has been decreasing over the past 12 months while monetary policy has been maintained tight.

Inflation has been declining over the past 12 months in the context of continued tight monetary conditions.

The tight financial conditions in major trading partners and lower inflation forecasts for the year-end, as well as the expected absence of strong pressure on the real effective exchange rate in the coming quarters, provides grounds for reducing the impact of external factors on domestic consumer prices.

Certain indexation of regulated prices and higher energy prices associated with ongoing structural reforms will lead to higher inflation in the regulated price component in 2024. This, in turn, is expected to have a one-time upward effect on headline inflation from the second quarter onward.

According to preliminary estimates, the initial effect of the increase in energy prices for households under the social norm on headline inflation is 2.4 percentage points (in particular, 1.2 percentage points for electricity, 1.0 percentage points for grid natural gas, and 0.2 percentage points for liquefied gas).

Since electricity tariffs for legal entities were increased last year and these changes are introduced only for households, their secondary impact is not expected to be strong. The secondary effect is mainly related to the extent of change in inflation expectations.

Tariff increases have already affected inflation expectations in the economy to a certain extent (due to the broad public discussion recently). Furthermore, the social norms and grace period options may help to mitigate the negative implications of the changes on expectations.

Assessment of the extent of changes in inflation expectations caused by tariff increases will require some observation time.

In the medium term, core inflation is projected to decline steadily.

However, imposition of value added tax on medical services, medicines and some utilities from April this year may slow down the downward trend in core inflation in the short term.

Figure 1.3.1. Core inflation forecast, *percent*

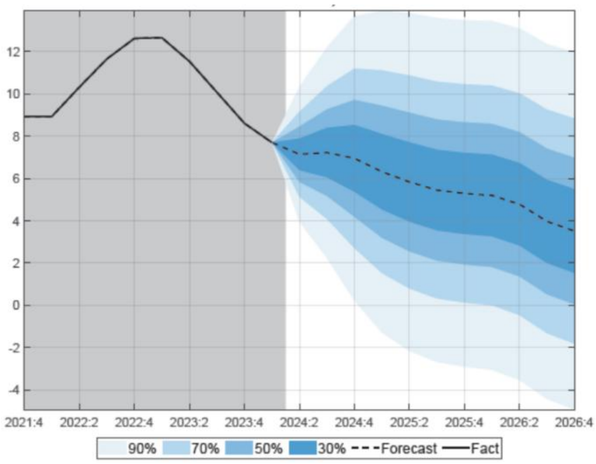
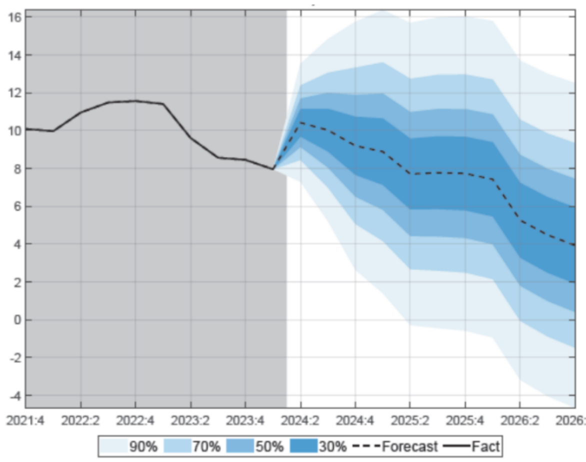


Figure 1.3.2. Headline inflation forecast, *percent*



Source: CBU calculations

In particular, these tax changes are expected to increase core inflation by additional 0.9 percentage points (1.0 percentage point to headline inflation) in the coming quarters with the possibility of a return to the downward trend from the fourth quarter.

Due to structural shifts in the expenditures of households and businesses caused by the tariff indexation, consumer demand is expected to moderate somewhat in the future. To some extent, this will serve to ensure the balance of supply and demand in the economy.

Along with reducing the impact of high growth of previous budget expenditures, compliance with budget discipline and execution of budget expenditures within the limits set at the beginning of the year in the future will be essential in preventing additional demand-side pressure on inflation.

In order to curb inflation expectations and reduce the secondary effects on core inflation, monetary conditions are maintained relatively tight. This, in turn, allows to reduce consumer demand to a certain extent amid stabilization of credit growth.

Also, in reducing the contribution of supply factors to the formation of domestic prices, the effectiveness of the government measures aimed at enhancing aggregate supply in the economy is of great importance.

Under these conditions, core inflation is expected to be around 7-8 percent by the end of 2024.

Given that winter-spring season of 2024 was favorable for agriculture compared to the previous year, prices for fruit and vegetable products are expected to be relatively stable this year, excluding seasonal fluctuations.

Figure 1.3.3. Decomposition of the median of the headline inflation forecast, *percent*

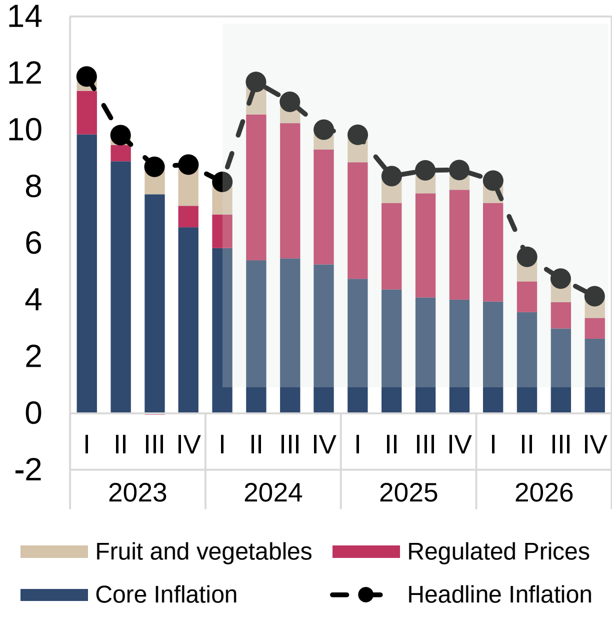
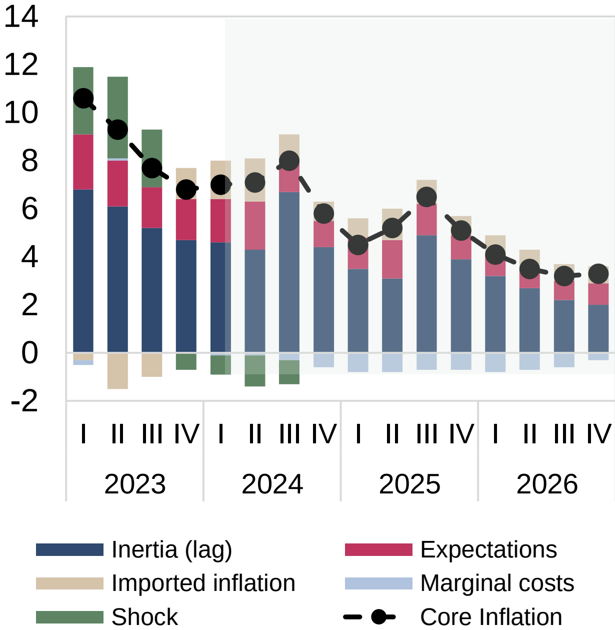


Figure 1.3.4. Decomposition of the median of the core inflation forecast, *percent*



Source: CBU calculations

Taking into account the above factors, according to the updated macroeconomic forecasts, the headline inflation will accelerate in the second quarter of 2024 due to one-off effects. As a result of continued relatively tight monetary conditions, headline inflation is expected to range between 9-11 percent by the end of the year.

The extension of the upper bound of the headline inflation forecast is attributed, on the one hand, to the fact that tariff increases will be higher than in the assumptions of previous forecasts and, on the other hand, to the relatively limited possibilities of estimating the secondary effects of changes through expectations, and more analysis is required in this respect.

Inflation expectations

In the first quarter this year inflation expectations of households and businesses continued their downward trend.

However, the pace of decline in expectations is slower than inflation deceleration, and the difference remains large.

In particular, according to the results of the survey conducted in March, inflation expectations of households for the next 12 months decreased by 0.3 percentage points compared to January and amounted to 12.8 percent.

Figure 1.3.5. Inflation expectations for the next 12 months, *percent*

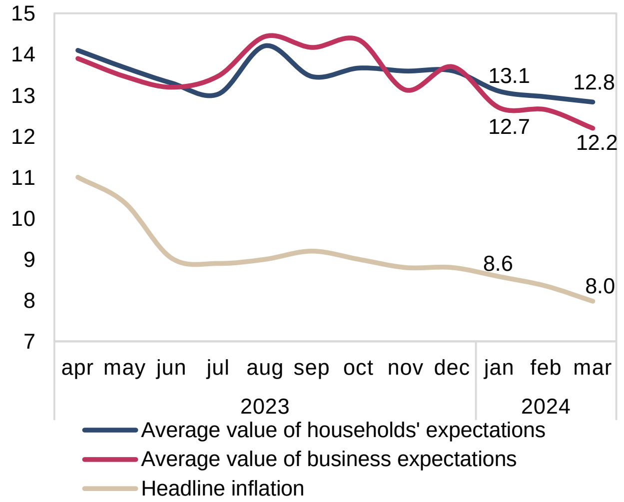


Figure 1.3.6. Factors of inflation expectations, *share of respondents, percent*

	2023									2024		
	apr	may	jun	jul	aug	sep	oct	nov	dec	jan	feb	mar
Exchange rate movements	45	47	50	59	70	65	59	58	60	55	56	61
Price increases in fuel and energy	31	32	33	36	43	45	49	43	47	49	54	50
Increased cost of utility services	21	21	22	32	27	34	36	38	37	39	39	42
Increased transportation costs	23	21	20	21	22	23	29	26	29	29	33	29
Price increase due to the monopoly	40	36	38	31	33	32	31	31	31	32	30	35
Increased wages and social benefits	50	36	40	32	36	30	24	38	33	32	28	29
Price increases in basic foods	30	25	25	24	23	26	25	24	24	24	22	26

Source: CBU calculations

Since the survey of inflation expectations in March was conducted before the announcement of energy tariff increases, the March results do not reflect the changes in tariffs.

Inflation expectations of households were mainly influenced by such factors as exchange rate movements, price increases in energy and utilities, and artificial price increases.

Expectations of business entities were lower than expectations of households and amounted to 12.2 percent in March (0.5 percent lower than in January). Exchange rate dynamics, rise in prices for energy and utilities, increase in transportation costs were noted as the main factors of inflation expectations of businesses.

1.4. Monetary conditions and monetary policy outlook

The Central Bank will continue measures aimed at ensuring relatively tight monetary conditions in the economy until the inflation decreases to 5 percent target and the risks of its sharp increase are eliminated.

In particular, by ensuring positive real interest rates in the economy, measures will be taken aimed at the stability (Figure 1.4.1) of the real monetary conditions index (Box 1).

Higher real interest rates starting from the second half of the current year and ensuring their positive difference in the next forecast period, in turn, support saving activity and, by restraining consumer demand, provide conditions for inflation to develop on the forecast trajectory and decrease to the target in 2025 (Figures 1.4.2-1.4.3).

Figure 1.4.1. Real Monetary Conditions Index

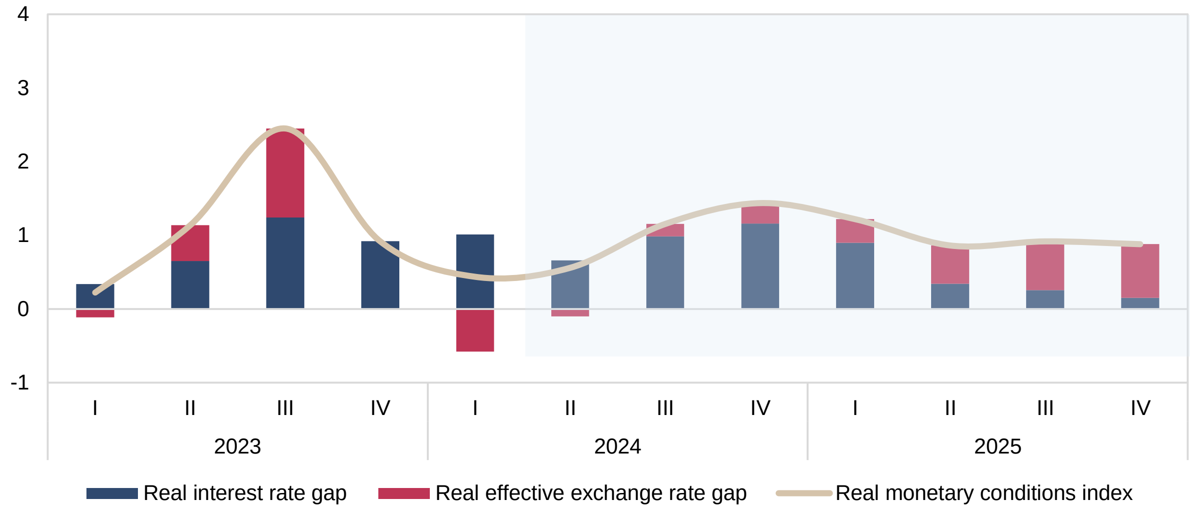


Figure 1.4.2. Real interest rate, *percent, per annum*

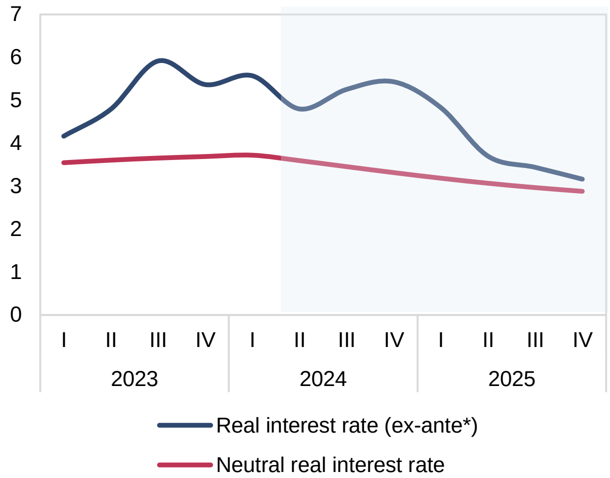
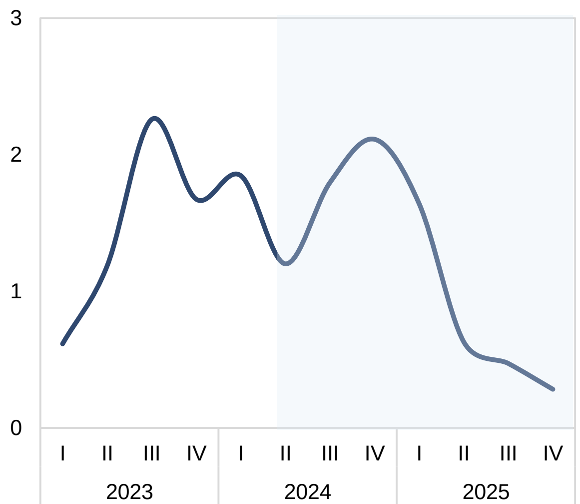


Figure 1.4.3. Real interest rate gap, *percent*



Source: CBU calculations
**Calculated based on rational inflation expectations 6 months from the current period.*

Weakening of the real effective exchange rate (REER) in the first quarter of this year has led to some easing of relatively tight monetary conditions in the short term. According to forecasts, due to exchange rate movements and inflation of major trading partner countries, the positive REER gap is projected to narrow in the next quarter, and from the second half of this year onward, monetary conditions are projected to shift to a tight phase (Figures 1.4.4-1.4.5).

In the coming quarters, total liquidity of the banking system is expected to gradually move from structural surplus to structural deficit, and these structural changes will be adjusted through monetary operations.

Under the conditions of structural deficit of the total liquidity of the banking system, the effectiveness of monetary policy decisions increases, serving to reduce the demand factors of inflation.

Owing to the provided monetary conditions, even at the upper bound of the inflation forecast, the impact of monetary factors on inflation will be restricted and savings in the national currency will be stimulated.

In the future, in case of risks of a sharp rise in households' inflation expectations and concerns of a significant deviation of core inflation from its trajectory, appropriate monetary policy measures will be implemented.

Figure 1.4.4. REER index

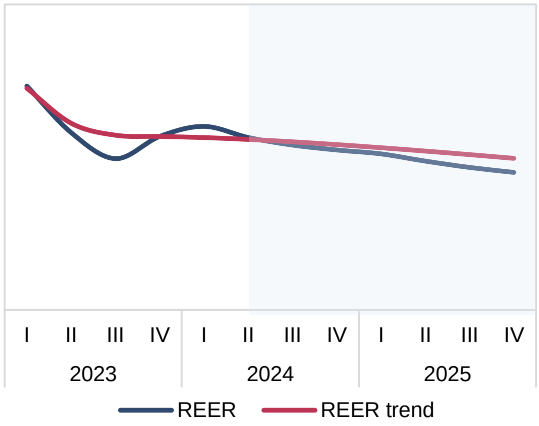
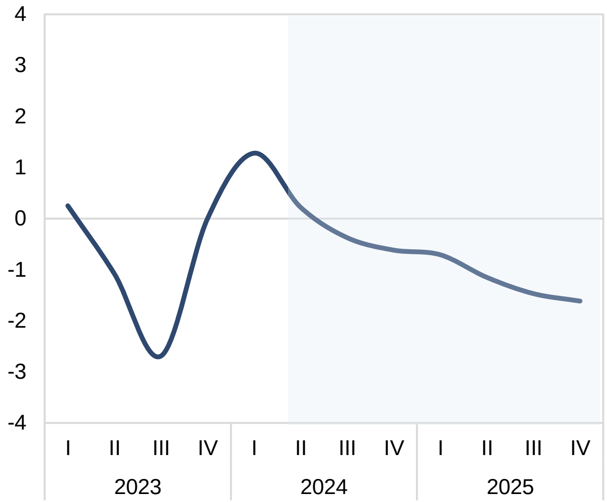


Figure 1.4.5. REER gap, *percent*



Source: CBU calculations

Box 1.

Real monetary conditions index

For quantitative assessment of monetary conditions, central banks calculate the **Real Monetary Conditions Index** (RMCI), which consists of two major financial indicators: the real interest rate gap (RIR gap) and the real effective exchange rate gap (REER gap).

The RIR gap refers to the difference between the current period RIR estimated on the basis of rational inflation expectations (6-month inflation forecast calculated by the central bank using an economic model) and the balanced (neutral) RIR. The neutral real interest rate is the long-term real interest rate that stabilizes inflation at a given target level and allows the economy to grow at its full potential (in the absence of all economic cyclical shocks).

A positive RIR gap implies tight monetary conditions in the economy, and a negative RIR gap indicates loose monetary conditions. This is explained by the fact that when the RIR gap is positive, the current real interest rate exceeds the neutral level, thus encouraging economic agents to save, reducing their consumption and thereby decreasing upward pressure on prices, and vice versa. A zero RIR gap means monetary conditions are in a neutral phase.

A REER gap refers to the percentage deviation of the REER index from its long-run trend (equilibrium level or inflation-neutral level). In general, any real economic indicator can be split into a trend and a gap. Trends cover long-term changes, while gaps cover business cycle dynamics (deviation of an indicator from its trend). Since trend and gap cannot be measured directly statistically, they are estimated on the basis of the dynamics of the given indicator using mathematical filters.

An above-trend REER index (positive REER gap) implies that a country's currency is undervalued in real terms relative to its trading partners and that monetary conditions are loose. Because in this state, the currency allows the country's exports to be more competitive in world markets and promotes economic growth. However, this creates inflationary pressures as imported goods become more expensive in the domestic currency. On the contrary, a below-trend REER index (negative REER gap) indicates that the national currency is overvalued in real terms and monetary conditions are tight.

Real monetary conditions index is calculated as a weighted average of the two above-mentioned gaps, namely the RIR and REER gaps (where the REER gap is taken with the opposite sign). The REER weight typically ranges from 0.2 (for closed economies) to 0.8 (for very open economies). Positive value of the RMCI means there are tight monetary conditions in the economy, while negative value indicates that the monetary conditions in the economy are loose. A zero RMCI implies that monetary conditions are neutral and there is no inflationary or deflationary pressure.

1.5. Uncertainties and risks in macroeconomic development

External risks and uncertainties

Risks to the world economic growth outlook for this year are relatively balanced. Previously expected risks of recession due to higher interest rates have not materialized in the world economy, and the world economic growth outlook for 2024 has been improved.

The faster-than-expected easing of inflationary pressures in many countries leads to relatively balanced inflation risks. Overall, along with these positive expectations, various risks remain regarding global macroeconomic developments.

Uncertainty in the global economy and major trading partners persists, and the price dynamics in world commodity markets continue to fluctuate rapidly, potentially having an adverse impact on the country's export earnings.

In addition to these factors, increased global fragmentation resulting in restrictions on the mobility of trade, capital, technology and labor poses risks to international cooperation and supply chain issues.

In addition, current global climate change, in particular increased floods and droughts, is putting upward pressure on global prices and increasing risks to food supplies.

Internal risks and uncertainties

In the current year, it is essential to consistently continue structural reforms in the national economy, in particular, to intensify privatization processes, to promote strong competitive environment in the domestic market, to ensure rapid growth of private investment and exports of goods.

Formation of services inflation above headline inflation in recent months and its upward trend may impede the reduction of inflation in the future due to the relatively low effect of monetary measures on inflation of this group.[1]

Imposition of value-added tax on medical services, medicines and some utilities from April may slow down the downward trend in inflation in the short term.

Ensuring continuous supply of energy resources is crucial to curb the effect of rising energy prices.

[1] On the one hand, services inflation is generated by the Balassa-Samuelson effect as a result of price increase in goods and wage growth (which occurred in previous periods), on the other hand, due to the high contribution of regulated prices in the services group, services inflation is more persistent and monetary instruments are less effective in reducing it.

Intensifying the process of fiscal consolidation and ensuring that the overall fiscal deficit is within the established level by the end of the year will prevent additional demand inflation caused by the effect of budget expenditures on domestic market prices.

Overall, uncertainties and risks emerging in the internal and external economic environment will be closely analyzed and monetary conditions will be appropriately adjusted based on updated macroeconomic forecasts.

II. CURRENT MACROECONOMIC ENVIRONMENT

2.1. Domestic economic activity and aggregate demand

In recent quarters, demand-side drivers of economic activity have shifted from consumption to investment. In the first quarter of 2024, the major factors boosting economic growth were a high increase in investments, particularly foreign direct investments, as well as a higher growth of exports as compared to imports in the context of favorable global price environment.

Economic growth. In the first quarter of the current year, economic activity accelerated significantly compared to the same period last year, and real GDP growth amounted to 6.2 percent. Among the economic sectors, the key contributors were the services and manufacturing sectors (Figure 2.1.1).

In particular, the contribution of the services and the manufacturing sectors to the economic growth reached 3.5 percentage points (2.8 p.p.in the previous quarter) and 1.8 percentage points (1.5 p.p.), respectively. Meanwhile, during this period, the contribution of agriculture to economic growth decreased to 0.4 percentage point (0.9 p.p.).

On the expenditure side, as a result of structural reforms in the economy, investments serve as the key driver of economic growth. In the first quarter of this year, there was a substantial increase in investments in fixed capital, and the share of investments in fixed capital amounted to 44 percent of GDP (in previous years this indicator averaged about 30%).

The sharp increase in investment is mainly attributed to the active attraction of foreign direct investments during the last two quarters. In particular, in the first quarter of this year FDI volume amounted to 2.7 billion dollars (31% of the total investment) (Figure 2.1.3).

In turn, the active inflow of foreign direct investment and its effective utilization are essential in enhancing the capacity and efficiency of the economy in the medium term.

However, in the short term, this may increase investment demand in the domestic market and generate pressure on prices, as well as raise demand for imports and, to a certain extent, widen the foreign trade deficit (Figure 2.1.2).

In order to reduce the pressure of investment demand on prices in the economy, the targeted and rational use of funds attracted to investment projects and the timely launch of projects are crucial.

After relatively low dynamics in recent years, in the current period there was a sharp increase in freight turnover, indicator of economic activity (Figure 2.1.4).

During the first quarter the situation in the labor market improved, including the number of vacancies and job seekers. The largest number of vacancies continues to be created in the retail trade, construction, catering, manufacturing and education sectors.

In addition, some structural imbalances between supply and demand remain in the labor market.

At the end of the first quarter of 2024, nominal wages increased by 19.8 percent. Particularly, amid strong demand for labor, wages grew rapidly in trade (24.4%) and information and communication (23.5%). There was a moderate wage increase in the construction sector (6.6%) due to an increase in the labor supply.

Given the level of employment and output in the economy, productivity growth lags behind wage increase in most service sectors. This, in turn, leads to inflationary pressures in the services sector.

No significant changes were observed in the trends of external labor migration in the first quarter of this year. In January-March, cross-border remittances grew by 8.6 percent year-on-year and reached 2.5 billion dollars.

Figure 2.1.1. Decomposition of GDP by production method

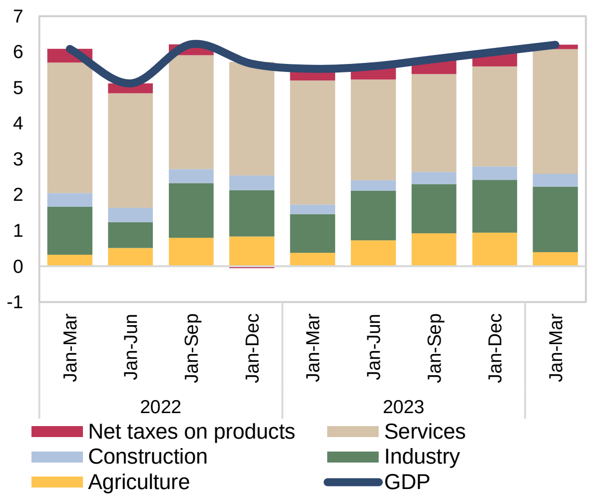
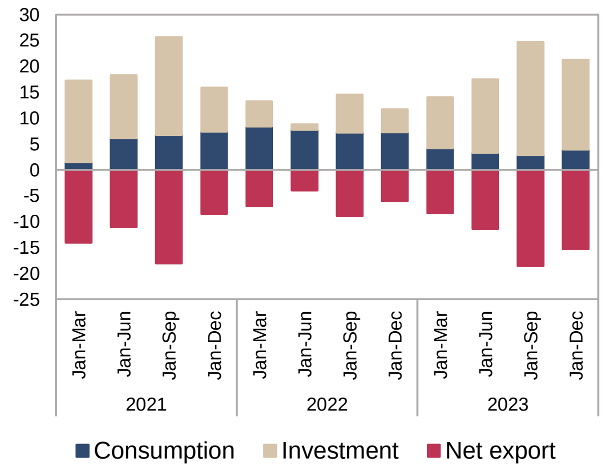


Figure 2.1.2. Contribution of expenditure components to GDP growth



Source: Statistics Agency.

Figure 2.1.3. Real growth of investments in fixed capital, *percent*

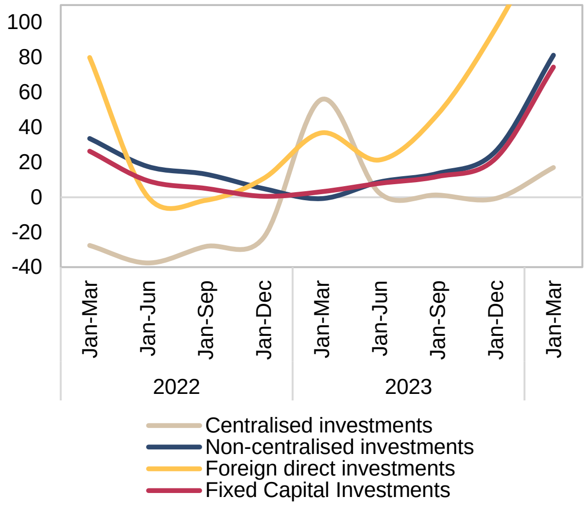
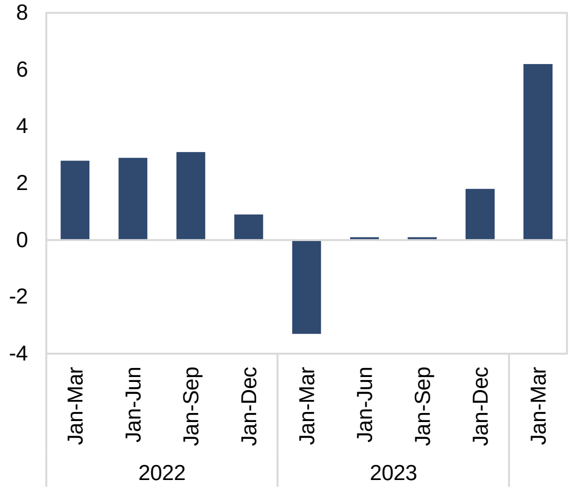


Figure 2.1.4. Real growth of freight turnover, *percent*



Source: Statistics Agency.

During this period, the growth of remittances was supported by the continuity of migration flows, as well as the stability of exchange rates of the main labor recipient countries.

Positive dynamics in remittances, income of the self-employed and wage increase in the economy served to boost the real incomes of households, rising by 11.5 percent in the first quarter.

In the first quarter, consumer activity developed along the long-term trend amid income growth. This is reflected in the indicators of cash receipts from retail trade and services (Figure 2.1.5).

Figure 2.1.5. Real growth of consumption activity, *percent*

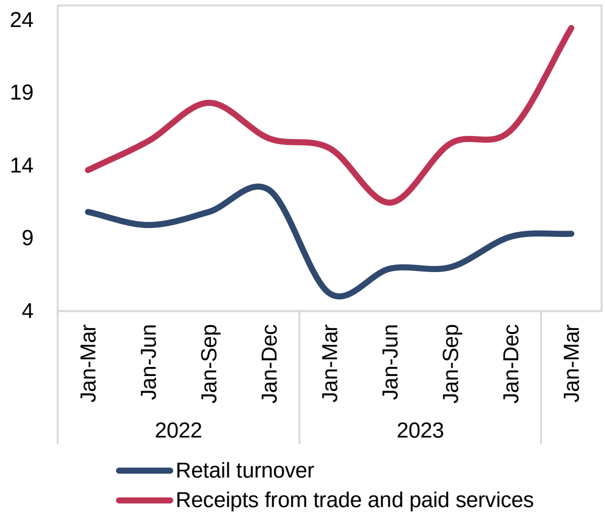
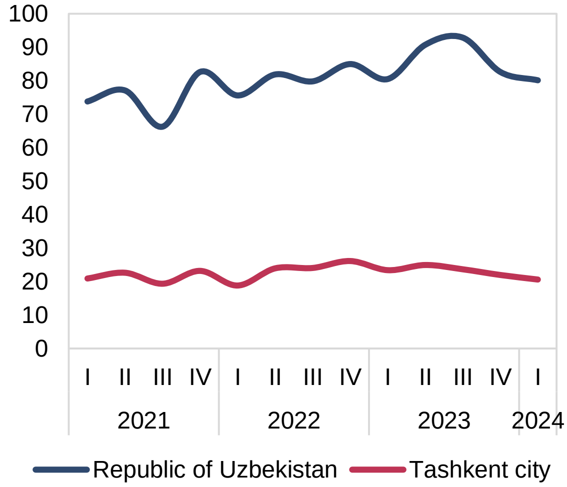


Figure 2.1.6. Number of real estate transactions, *thousand*



Source: Statistics Agency.

In recent quarters, the activity on the real estate market has been developing in different directions due to increased number of real estate sale and purchase transactions observed in most regions. In Tashkent, despite a considerable decrease in the number of transactions compared to the previous year, the dynamics is at medium-term level. In general, the activity on the real estate market has somewhat stabilized compared to recent periods (Figure 2.1.6).

Foreign trade and exchange rate dynamics. In the first quarter of this year, the volume of exports increased by 10 percent compared to the corresponding period of the previous year (9.6% growth in exports excluding gold). Export growth was mainly driven by higher gold and uranium prices and rising copper prices amid existing global uncertainties, while cotton prices have returned to last year's levels after a significant increase in February (Figure 2.1.7).

Also, as a result of weakening global demand and lower prices, the share of some export sectors, including non-ferrous and ferrous metals and products thereof, decreased.

In the first quarter, the growth of imports slowed down and amounted to 3.8 percent. A 9.5 percent decrease in food imports is attributed to lower global prices for meat, oil and wheat, as well as sufficient domestic reserves and production capacity. The same trend is observed in imports of chemical products (-3.7%). Imports of industrial goods (oil products, ferrous metals) have remained stably high (Figure 2.1.8).

Figure 2.1.7. Export dynamics in the first quarter of 2024, *percent*

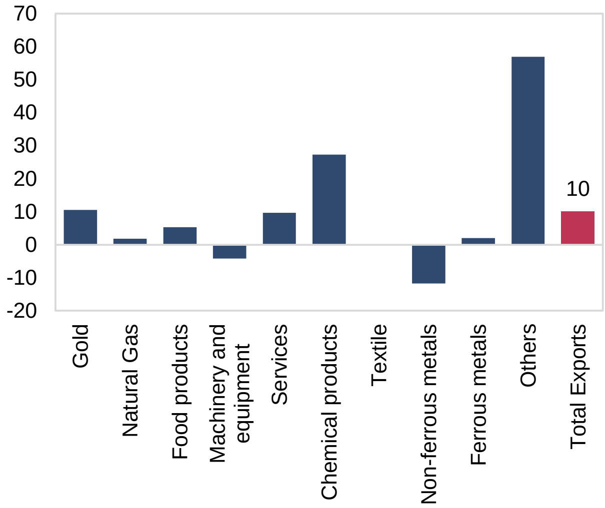
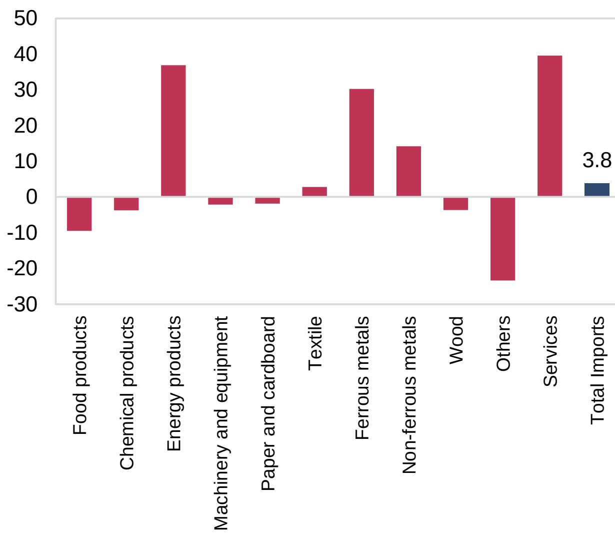


Figure 2.1.8. Import dynamics in the first quarter of 2024, *percent*



Source: CBU calculations based on the data of the Statistics Agency.

Fiscal sector. State budget deficit remained large in the first quarter, amounting to 19.8 trillion soums or 8.2 percent of GDP (Figure 2.1.9). This high deficit poses potential pressure on the financial health of the economy and reflects the large difference between government expenditures and revenues.

The positive fiscal momentum observed in recent periods (except for the third quarter of 2023) indicates the continuation of accommodative fiscal policy in the economy.

This, in turn, has contributed to the positive GDP gap through increasing aggregate demand during this period, resulted in GDP volumes above potential levels and a strong recovery in economic activity (Figure 2.1.10).

While large fiscal deficit can boost economic activity in the short term, it may have an adverse impact on potential growth and price stability in the medium term.

Closing this gap is essential to maintain sustainable fiscal and tax policies and to ensure long-term economic stability.

In the first quarter of this year, the real and nominal effective exchange rate indices declined by 0.9 percent and 4.5 percent, respectively, compared with December 2023 (Figure 2.1.11).

Figure 2.1.9. State budget revenues and expenditures, *as a percentage of GDP*

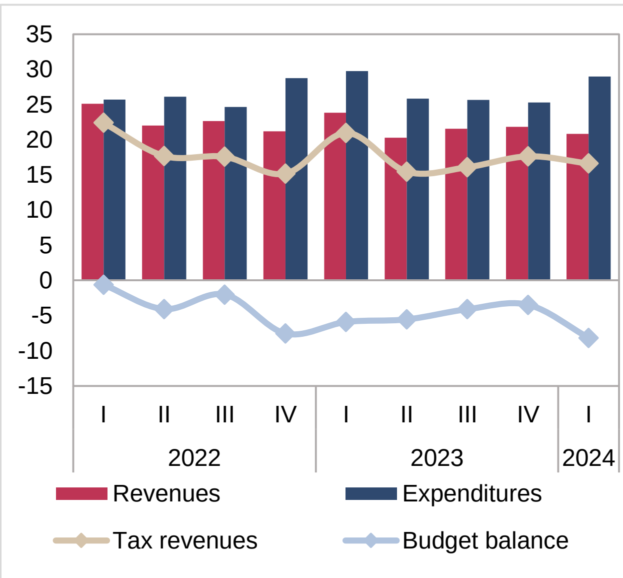
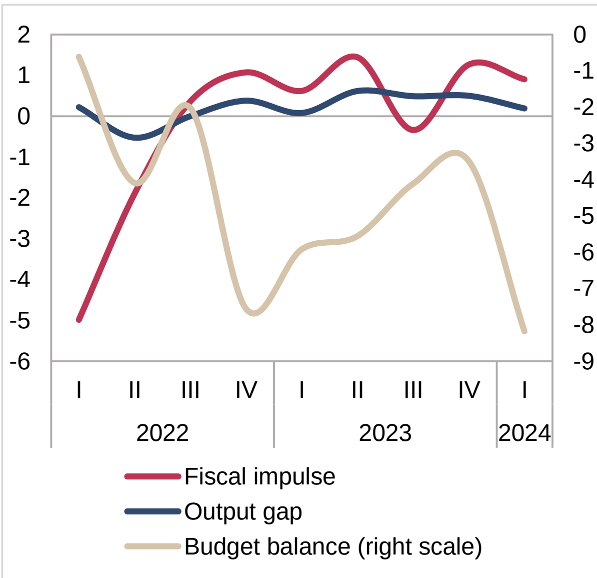


Figure 2.1.10. Fiscal impulse and output gap, *as a percentage of GDP*



Source: CBU calculations based on data from Ministry of Economy and Finance

Among the key factors behind the downward trend in the indices are the exchange rate dynamics of the national currency against the dollar and changes in the structure of the country's trade balance in 2023 (China's share in foreign trade turnover increased from 17.9% to 21.9%, Russia's share fell from 18.6% to 15.8%, and Türkiye's share decreased from 6.7% to 5.0%).

In the first quarter, the contribution of the Chinese yuan to the strengthening of the REER increased, while the pressure of the Turkish lira and the Russian ruble relatively weakened.

Month-on-month decomposition of REER movements indicates that in March 2024, the country's monthly inflation rate exceeded the price growth in trading partners (-1% in China, 0.4% in Russia, and 0.1% in Korea), causing the REER index to shift from the gradual weakening to the strengthening phase (Figure 2.1.12).

Figure 2.1.11. Real (REER) and nominal (NEER) effective exchange rate index, *relative to December 2022, percent*

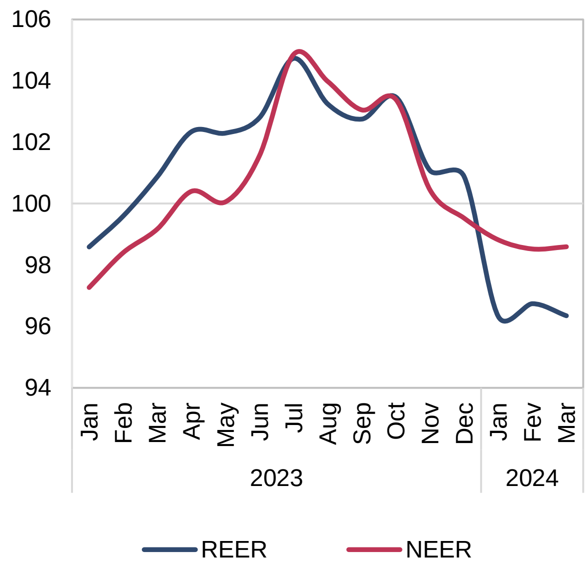
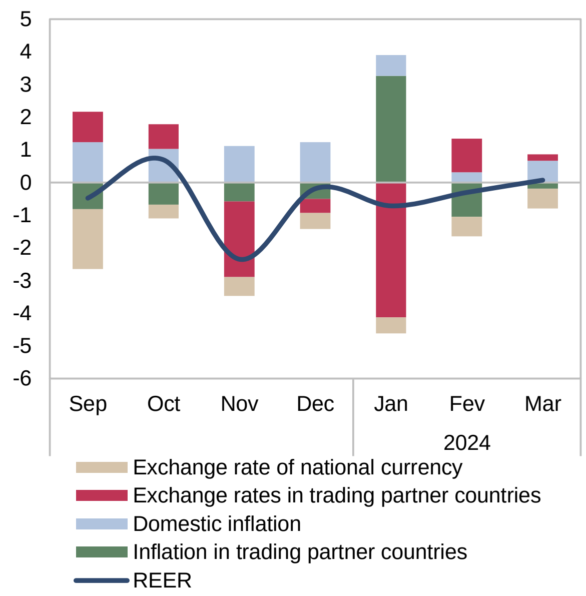


Figure 2.1.12. Decomposition of changes in real effective exchange rate index, *percent*



Source: CBU calculations.

Box 2.

Change in the terms of trade for Uzbekistan

In recent years, under the conditions of gradual integration of the national economy into the world economy, the price trends in the world commodity markets have started influencing significantly the volumes and growth rates of the country's foreign trade.

In the meantime, world prices in recent years have been highly volatile and multidirectional due to international economic uncertainty, thus having a direct impact on Uzbekistan's exports.

Volatility in export prices in 2022-2023 led to price and volume effects, contributing to the expansion of merchandise exports.

In 2022, the growth pace of merchandise exports (excluding gold exports) was maintained by the price effect, mainly driven by an increase in world prices for commodities, while in 2023, on the contrary, there was a volume growth in exports of some commodity groups, and the price effect decreased due to a decline in external prices.

In 2023, the effect of volume increase will not completely compensate for the decrease in the price effect due to production constraints in some industries (chemical industry) and reduced production of some goods (mainly energy resources).

The export price index calculated for 2021-2023 increased by 59.4%, driven by favorable gold prices in the world. During this period, the export price index, excluding gold, increased by 32 percent (Figure 1A for details).

Export growth is followed by a disproportionately high increase in imports. Unlike exports, the structure of imports is dominated by goods other than commodities, and the items of goods are significantly diversified. At that, the bulk of imports accounted for industrial (including intermediary) goods (75%), and the rest consists of final consumer goods (25%).

Machinery and equipment constituted the major part of the imports of goods and their share increased from 35 percent in 2022 to 43 percent in 2023. Increased imports of machinery and equipment of a capital nature will help maintain and expand the pace of production in the medium term. Under the alternative approach, preliminary estimates suggest the share of capital equipment and machinery is stable at around 60 percent.

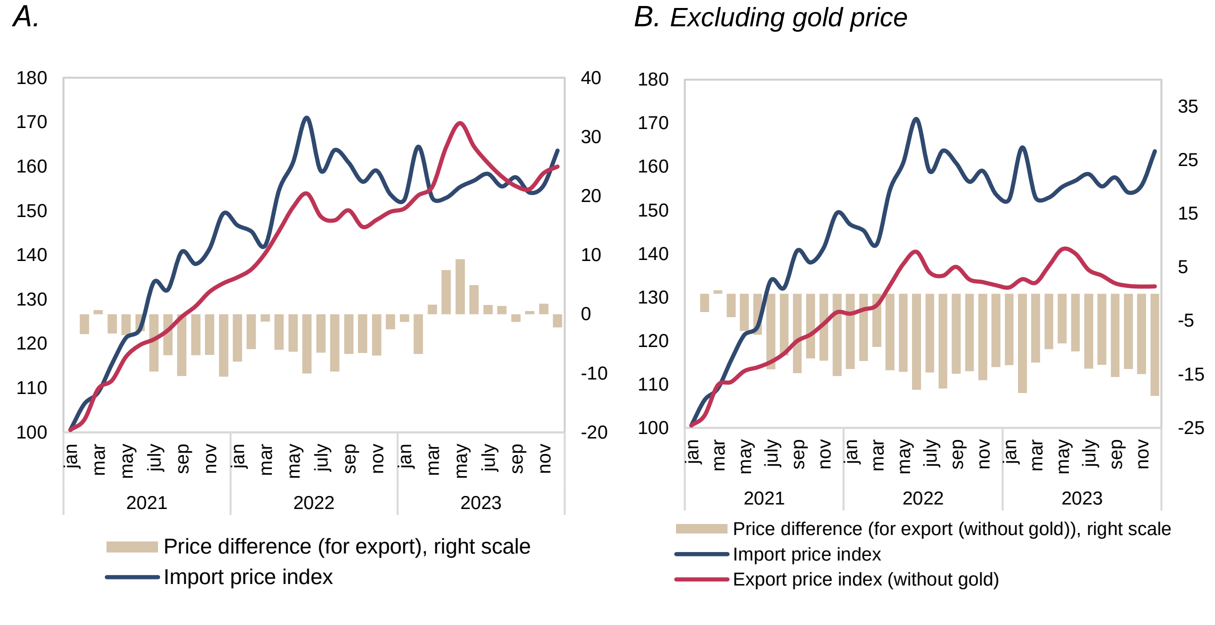
In 2023, the share of consumer machinery and equipment increased and the proportion of intermediary goods (including spare parts) fell slightly, however all categories continued increasing in absolute terms.

In 2023, the share of consumer machinery and equipment rose due to an increase in imports of motor vehicles (mainly cars), which more than doubled year-on-year.

A distinctive characteristic of this category of goods is their diversity (type, model, size) and high variability of prices across general categories of goods, therefore, machinery and equipment were not included in the calculation of the import price index.

Figure 1. Terms of trade for Uzbekistan

Jan 2021 = 100, discrepancy – p.p.



Source: CBU calculations based on data from Statistics Agency.

According to the preliminary estimate, the import price index increased by 63 percent between 2021 and 2023. While comparison of trade price indices in 2021-2022 indicates a rapid increase in import prices compared to export prices, in 2023, amid relative stabilization of world prices, the terms of trade for Uzbekistan improved (Figure 1B).

In addition, it should be noted that an increase in gold prices also has a significant positive contribution to the terms of trade. Excluding gold, the growth of prices for export products remains significantly lower than the dynamics of import prices.

Relatively low diversification of the export structure, high share of commodities and semi-finished products may affect the stability of the foreign trade balance in the future and competitiveness of products in international markets, and cause risks associated with the inflow of foreign currency to the domestic market.

A necessity for structural reforms in the economy implies the importance of reducing sensitivity to global commodity markets by expanding local production and developing non-commodity export sectors that contribute to the diversification of the economy.

2.2. Monetary conditions and inflation

The Central Bank continues implementing measures to ensure price stability. In order to achieve the 5 percent target over the forecast horizon, monetary conditions were maintained relatively tight in the first quarter of 2024.

The level of monetary tightness contributes to the slowdown in domestic inflation since the beginning of the year.

However, inflationary pressures persist in some sectors of the economy, in particular, as a result of strong demand and increases in some regulated prices and tariffs, there has been a steady acceleration in services inflation.

Inflationary processes

In the first quarter of 2024, the headline inflation continued declining and amounted to 8.0 percent year-on-year in March (Figure 2.2.1).

In this period, the share of goods and services with price increase lower than in the corresponding period of the previous year amounted to 67.8 percent of the consumer basket (Figure 2.2.2).

The main contributors to the decrease in inflation were food and non-food components. However, the acceleration of services inflation, observed in the previous quarter, continued in the first quarter of 2024 and had an accelerating impact on headline inflation (Figure 2.2.3).

Figure 2.2.1. Dynamics of headline and core inflation, *percent*

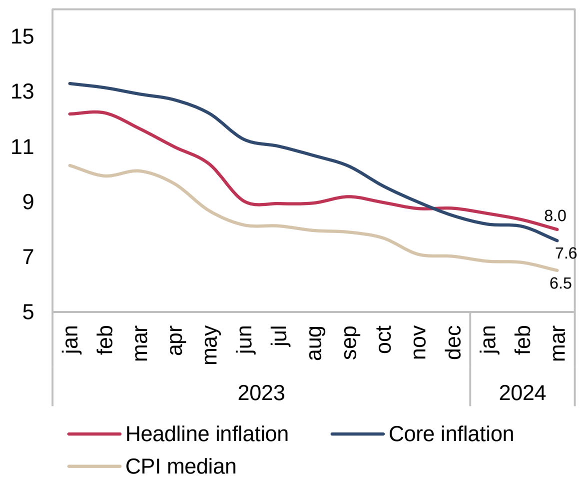
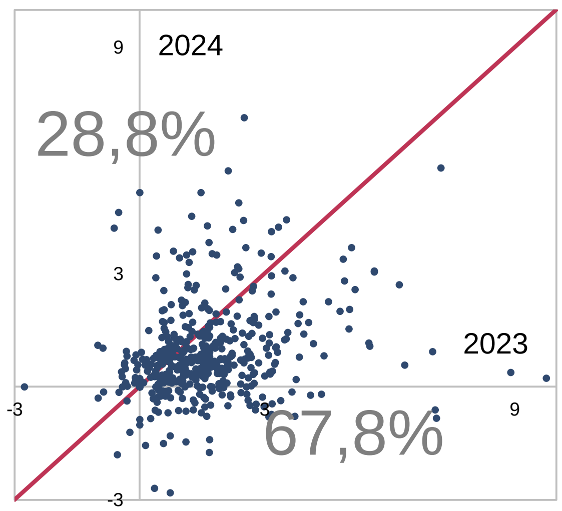


Figure 2.2.2. Comparative change in inflation of goods and services of the consumer basket in January-March, *percent*



Source: Central Bank calculations based on data from the Statistics Agency.

Downward trend in food inflation was also caused by stabilization of world prices for some basic consumer goods (wheat and vegetable oil) and vegetable prices.

During the first quarter, fruit prices had an upward contribution to headline inflation as a result of higher storage and logistics costs and last year's poor harvest due to abnormal cold weather (Figure 2.2.4).

In the services sector, there was a substantial increase in prices for some regulated public utilities, transportation services, private education and household services.

Annual core inflation continued declining and amounted to 7.6 percent, 0.9 percentage points lower than at the beginning of the year. In contrast, the high inflation of regulated prices and fruit and vegetable prices led to widening of the difference between headline and core inflation.

Higher inflation in the services sector and its upward trend may impede the reduction of headline inflation in the future due to the low sensitivity of inflation in this component to monetary measures.

The downward trend in the median inflation rate implies that prices in the economy are stabilizing in the majority of goods and services in the consumer basket.

However, the fact that the median rate is declining slower than the overall deceleration of inflation is attributed to the persistence of inflationary pressure in the economy, instability of dis-inflationary processes and relatively higher decrease in inflation of goods and services with greater weight in the consumer basket (Figure 2.2.5).

Figure 2.2.3. Decomposition of headline inflation, *percent*

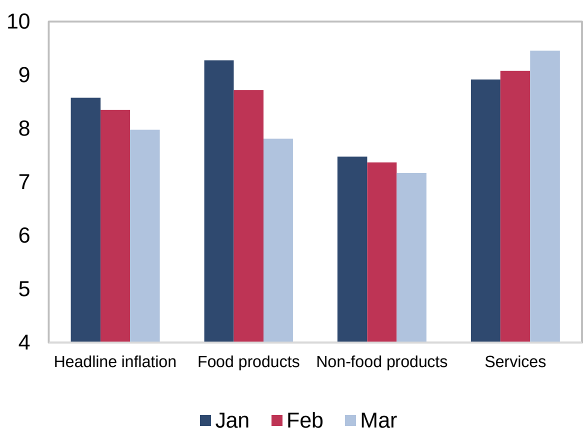
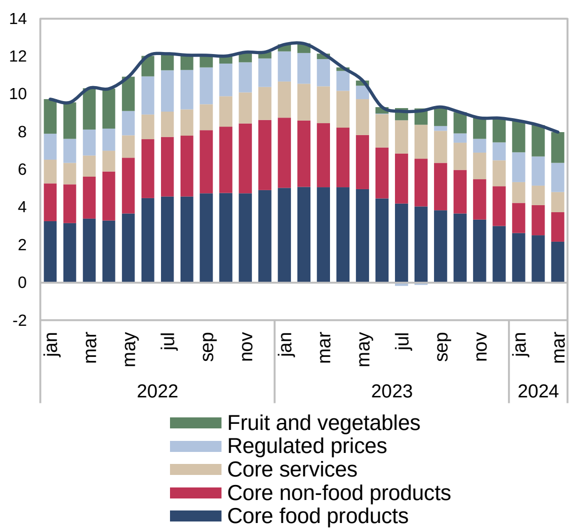


Figure 2.2.4. Decomposition of headline inflation, *percent*



Source: Based on the data of the Statistics Agency.

Figure 2.2.5. Distribution of inflation of goods and services in the CPI basket by percentage intervals, *percent*

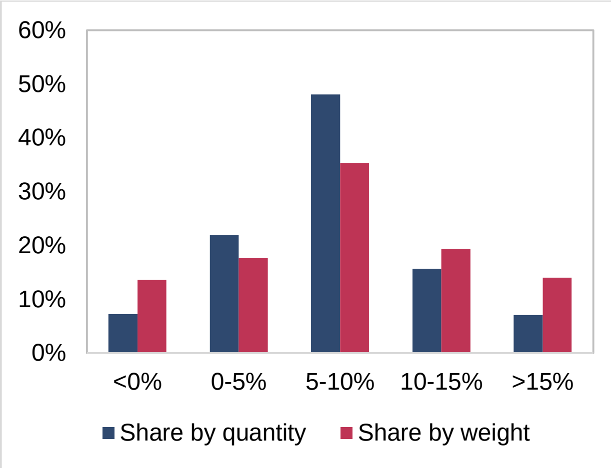
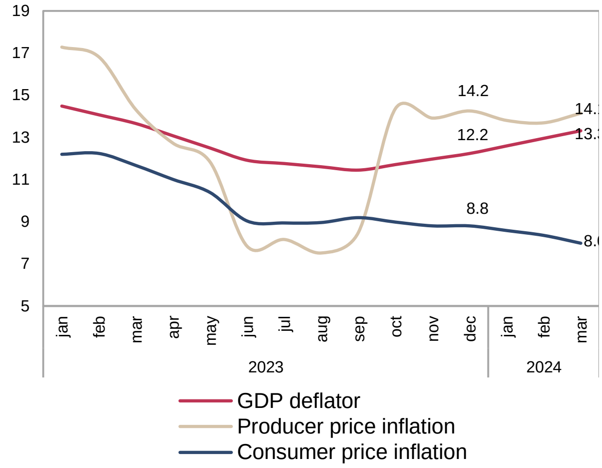


Figure 2.2.6. Dynamics of the consumer price index, GDP deflator and producer price index (PPI), *percent*



Source: Statistics Agency.

High price growth in the mining industry and the electricity, gas and water supply sectors resulted in the increase in the producer price index and GDP deflator (Figure 2.2.6).

The GDP deflator increase was also caused by high growth of the construction industry deflator.

Monetary conditions

Despite the slowdown of inflation in recent quarters, the restrictive stance of monetary conditions was maintained through keeping the policy rate unchanged.

Meanwhile, tight financial conditions in the world and constraints on external financial resources increase the demand for domestic resources. This accelerates the transmission from relatively tight monetary policy conditions to market interest rates.

In particular, as a result of increasing cost of external borrowing, the primary attention was focused on domestic resources, and in the first quarter of the current year, government securities of 10.2 trillion soums were issued (2.2 times more than in the corresponding period of the last year).

Since the beginning of the year, there was a slight fluctuation in the yield on government securities, ranging around 16-18 percent.

Rising costs of servicing public debt may serve to restrain intensification of fiscal stimulus and thereby reduce inflationary pressure in the economy.

In the first quarter of 2024, operations worth 77.9 trillion soums were carried out in the money market, and the activity increased by 4.8 percent compared to the corresponding period of the previous year. Meanwhile, an increase in the share of secured operations (interbank REPO operations) facilitates banks to fulfill the requirements on credit risk mitigation and liquidity management.

The money market UZONIA rate is developing within the interest rate corridor (Figure 2.2.7), remaining in a relatively tight phase of about 5 percent in real terms.

Furthermore, the changes introduced in the operational mechanism in February of this year (Box 3) serve for effective liquidity management by commercial banks (reducing their expenses and increasing their income), ensuring the continuity of the payment system, and have a positive impact on short-term rates in the interbank loan and REPO markets (Figure 2.2.8).

In March, interest rates on loans in the national currency amounted to 23.6 percent, 0.4 percentage points lower than in December. At that, interest rates on long-term loans shifted to the downward trajectory in the first quarter of the current year after increasing in the last quarter of 2023 (Figure 2.2.9).

During this period, the volume of loans to the economy increased rather marginally (by 0.2%) compared to the corresponding period of the previous year and amounted to 53.7 trillion soums, and the loan repayment rate reached 89.8 percent.

Figure 2.2.7. UZONIA rate, *percent*

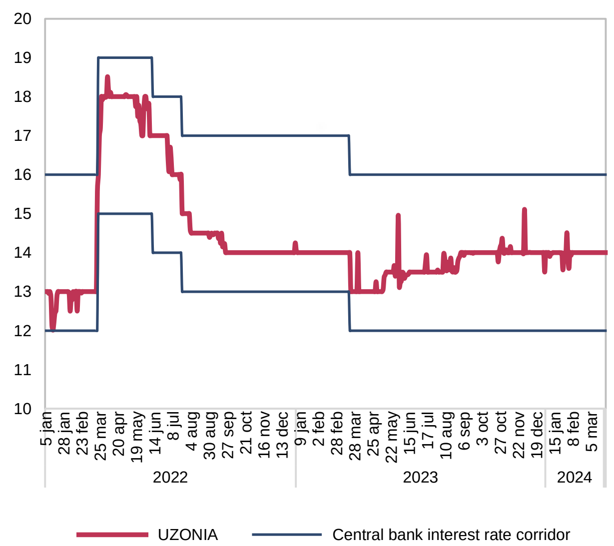
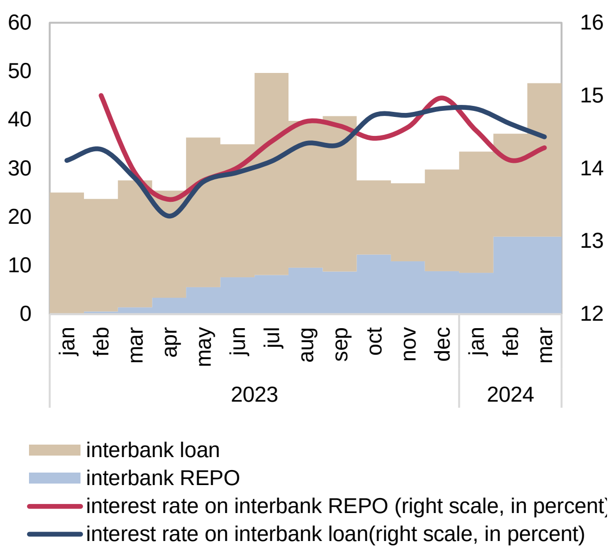


Figure 2.2.8. Volume of interbank money market operations, *trillion soums*



Source: CBU calculations.

Loan repayment is increasing, and as a result, the stock of loans growth slowed down to 0.9 percent compared to the beginning of the year and 18 percent year-on-year (Figure 2.2.10).

This situation can be explained by the fact that the growth of accumulated credit liabilities is gradually returning to the long-term trajectory. This will help to balance aggregate demand in the future and reduce the impact of monetary factors on inflation.

However, loan growth, mainly driven by retail loans, continues to support the current consumer demand along with increased fiscal stimulus.

As a result of macroprudential measures aimed at restraining high increase of certain types of retail loans in order to prevent systemic risks, growth of lending to households is slowing down, however, the pace of increase is still high (Figure 2.2.10).

Influenced by the strong demand for domestic financial resources, interest rates on term deposits in the national currency remained high in the first quarter this year (increased by +0.2 p.p. compared to December and amounted to 19.9 percent in March). There was an acceleration in the growth of deposits (Figure 2.2.11).

As of April 1, 2024, the level of deposits dollarization amounted to 29.8 percent (28.6% at the beginning of the year), and loans dollarization was 43.1 percent (43.6% at the beginning of the year).

Figure 2.2.9. Interest rates on loans in the national currency, *per annum*

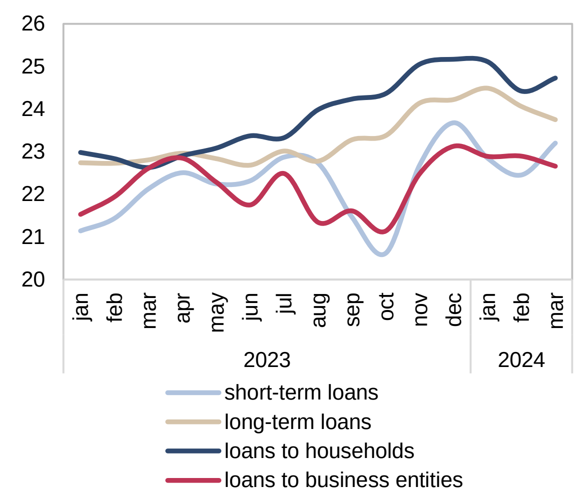
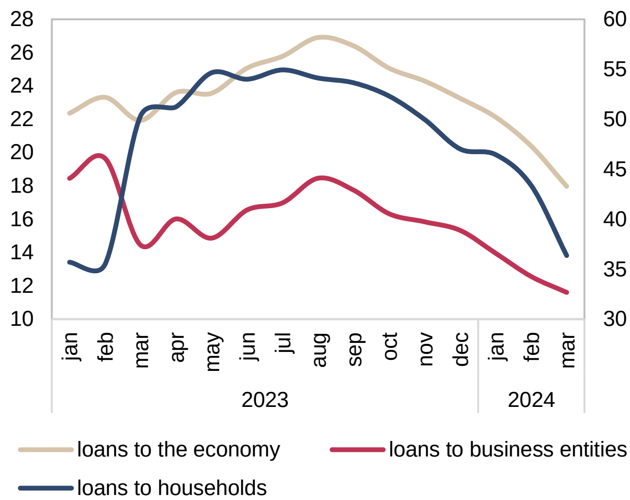


Figure 2.2.10. Change in the stock of loans to the economy, *annual percentage*



Source: CBU calculations.

Meanwhile, in recent quarters, the annual depreciation of the national currency against the US dollar has been around 8.5-9.5 percent, resulting in some easing of tight monetary conditions provided by high market rates (Figure 2.2.12).

Figure 2.2.11. Deposit growth and interest rates, annual percentage

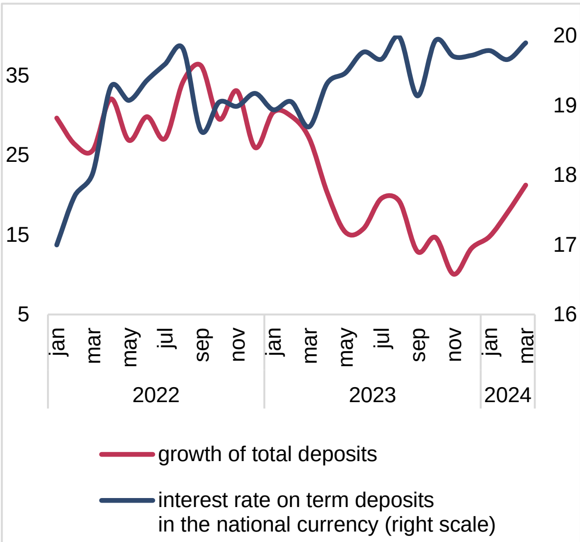
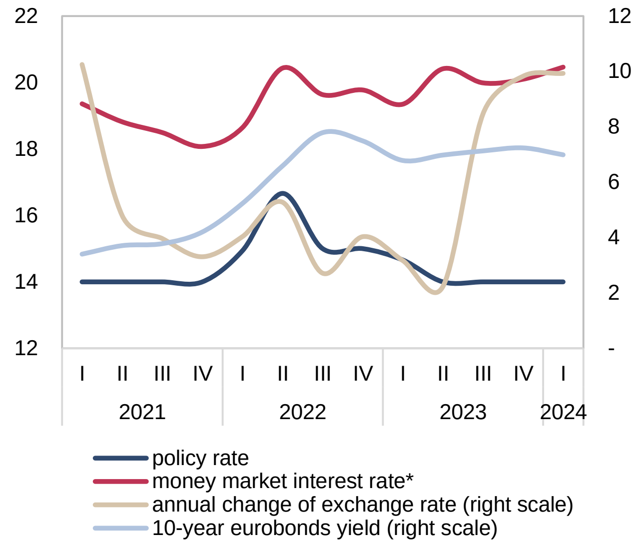


Figure 2.2.12. Monetary and financial conditions, average percentage

*(*average interest rates on the market for short-term loans and deposits)*



Source: CBU calculations.

Box 3.

Changes introduced in the operational mechanism of monetary policy

Based on the recommendations of international financial institutions and consulting companies, a number of changes were introduced in the operational mechanism in order to bring it in line with international standards, effectively regulate the liquidity of the banking system and facilitate the process of managing the own liquidity of commercial banks.

In particular, by the decision of the Board of the Central Bank, starting from February 26, an opportunity was provided to ensure the availability of interbank money market and REPO markets for 30 minutes after the closure of the banking settlement day, as well as to use the monetary operations of the Central Bank for 1 hour after the closure of the banking settlement day.

This enabled commercial banks to redistribute overall liquidity in the money market after the end of the settlement day and then resort to one-day operations of the Central Bank. These changes are expected to significantly improve the efficiency of liquidity management.

In addition, an intraday lending facility was introduced to provide liquidity to commercial banks, as well as overnight operations and credit auctions for up to 1 week on the basis of foreign exchange collateral. This serves to prevent liquidity disruptions in banks and ensure continuity of the payment system.

Based on the changes introduced in the monetary policy operations, appropriate amendments were made to the “Operational Mechanism of the Monetary Policy of the Central Bank of the Republic of Uzbekistan” and “Procedure of the Central Bank's operations in the money market”, and the existing regulatory legal documents were aligned with the requirements of this decision.

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