



## RESERVES TO AVOID CURRENCY RISKS IN THE CONTEXT OF MARKET RELATIONS

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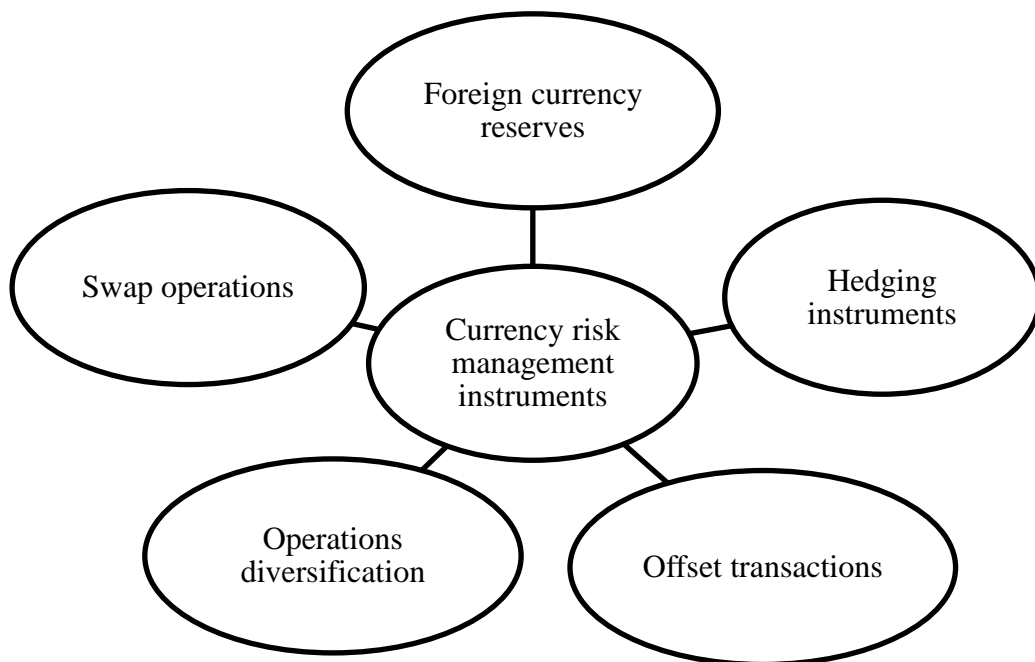
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<p><b>Received:</b> 28<sup>th</sup> June 2024  <b>Accepted:</b> 26<sup>th</sup> July 2024</p>	<p>The article describes instruments for managing currency risks in the context of market relations. The latest statistics on the relevant indicators are provided. Conclusions and suggestions are given on how to protect Uzbekistan from currency risks.</p>

**Keywords:** foreign currency reserves, hedging, swap, option, forward, futures, offset, diversification.

In the current state of international finance, currency risks pose serious challenges for both developing and developed economies. Currency risks, or exchange rate risks, arise due to fluctuations in the value of one currency relative to another. These fluctuations can affect the profitability of international investments and trade operations. For companies engaged in global trade, having stable reserves indicates low currency risk, allowing for more informed decision-making regarding currency-related activities.

In a market economy, companies and governments often use various strategies to mitigate currency risks associated with international operations. One such

strategy is maintaining currency reserves, which helps protect against adverse changes in exchange rates. Several widely used instruments are available to prevent currency risks. The main ones are listed below:



**1-picture. Elements involved in preventing currency risks**

Source: Author development



### Foreign currency reserves

Every country has its own gold and foreign currency reserves. Currency reserves are assets held by central banks in various currencies, serving the following purposes:

1. **Stabilizing the local currency:** Central banks can intervene in the foreign exchange market to stabilize their currencies by holding foreign currencies.

2. **Maintaining Liquidity:** During economic crises, reserves can be used to ensure that

**1-table**

**Foreign Currency reserves of some countries<sup>1</sup>**

Countries	Foreign currency reserves (in the US dollars)
China	3301320
Japan	1238541
Switzerland	755903
Russia	582000
India	619007
Uzbekistan	34564

Emerging economies are increasingly turning to foreign exchange reserves as a shield against global financial crises. By purchasing foreign currencies when conditions are favorable, countries can reduce excessive borrowing and mitigate the risk of currency depreciation after global shocks. This approach is supported by implementing credible monetary policies, which leads to an increase in the acceptance of local currency debt by foreign investors.

The experience of countries like Peru demonstrates the effectiveness of this strategy. After targeting inflation and accumulating substantial foreign reserves, Peru significantly increased the proportion of its government debt denominated in local currency. This not only reduced their currency risk but also enhanced their financial stability.

**Hedging Instruments:** Currently, in the financial markets, not central banks but rather institutional investors on stock exchanges play a significant role. In the unstable realm of international finance, currency risks are a persistent problem for investors and businesses. Hedging instruments are crucial financial

<sup>1</sup> Trading Economics (2024). Foreign Exchange Reserves. URL: <https://tradingeconomics.com/uzbekistan/foreign-exchange-reserves>

international trade and investments continue without disruption.

**3. Meeting International Obligations:** Reserves are necessary for repaying external debts and financing imports.

**4. Boosting Investor Confidence:** A healthy level of reserves indicates economic stability to foreign investors.

tools that protect against unpredictable currency fluctuations and thus reduce potential risks.

Hedging instruments are diverse, each with unique characteristics that cater to various protection needs. These include forward contracts, futures, and options, designed to mitigate the negative impacts of currency volatility<sup>2</sup>.

**2-table**

**Dynamics of Hedging Funds' Volume in the Financial Market**

Years	The size of market (trillion US dollars)
2010	1.78
2015	2.91
2020	4.53
2023	4.59
2024*	4.74

**Forward/Futures Contracts:** Agreements to buy or sell currency at a predetermined future date, providing assurance against market rate fluctuations.

**Currency Options:** Agreements that give the holder the right, but not the obligation, to exchange currency at a predetermined rate on or before a specified date. Strategic use of hedging instruments allows businesses to stabilize financial planning and protect against potential losses due to currency rate fluctuations. For example, an exporter facing the risk of foreign currency depreciation might use forward contracts to lock in the current exchange rate, thereby ensuring stable revenue streams.

Modern treasury operations utilize technology to develop effective currency hedging strategies. Tools that assist in the trading process are crucial for developing strategies that effectively reduce or even eliminate currency impact.

**Offset Transactions:** Financial operational efficiency is a key factor in managing currency risk. Offset

<sup>2</sup> Segal, T. (2021). Hedging Risk with Currency Swaps. Investopedia.



transactions involve taking opposing positions in the market to balance the initial trade impact. This can be achieved through various financial instruments, including options, futures, and swaps.

Offsets can be categorized into two groups:

- **Direct Offsetting:** Occurs when an investor takes an opposing position in the same asset to neutralize risk.
- **Indirect Offsetting:** Involves taking a position in a related asset to reduce the risk of the initial asset.

The primary advantage of offsetting transactions is risk reduction. By balancing the effects of market fluctuations, investors can protect their portfolios from adverse currency movements. Additionally, offset transactions provide liquidity and flexibility, enabling investors to respond swiftly to market changes. Effective offsetting requires a deep understanding of market dynamics and associated risks. Investors must consider the timing, volume, and type of positions to ensure optimal risk management.

**Operational Diversification:** Diversification is a key tool for ensuring the success of any investment activity. Operational diversification involves spreading business activities across different markets and currencies, thereby reducing dependence on any single economic region or currency. This strategy can take several forms:

- **Geographic Diversification:** Expanding operations across various countries to spread risk associated with any single market.
- **Product Diversification:** Offering a range of products that can balance business activities across different economic cycles and satisfy various markets.
- **Supply Chain Flexibility:** Investing in a flexible supply chain can reduce currency risks from the perspective of cash flows and revenues.
- **Currency Diversification:** Holding assets or liabilities in multiple currencies to hedge against potential losses in any one currency.

Businesses and countries that diversify their operations are better able to withstand fluctuating currency movements. For example, a company sourcing material from multiple countries can mitigate the impact of a decline in a single foreign currency. Advances in technology have facilitated the management of diversified operations. Real-time analysis and forecasting tools enable businesses and governments to make prompt decisions and rapidly adjust their strategies.

**Swap Transactions:** Among hedging instruments, swap transactions have a unique interpretation. Currency swaps are financial agreements where two parties exchange principal and interest payments in

one currency for principal and interest payments in another currency. The terms of the swap, including the principal amount, swap duration, and applicable interest rates, are established at the outset.

The primary purpose of currency swaps is to secure more favorable borrowing rates and protect against currency fluctuations. By locking in future exchange rates, companies and governments can more accurately forecast their cash flows and protect themselves from the volatility of currency markets.

Currency swaps involve exchanging principal amounts in two different currencies at the start and end of the contract. Although the principal amounts are exchanged, they are conditional, meaning they serve as a basis for calculating interest payments and are not physical exchanges.

Currency swaps offer several advantages:

1. **Protection Against Currency Exchange Risk:**\*\* They protect against negative currency movements that could affect the value of international investments and business operations.
2. **Access to Cheaper Financing:** Companies and governments can take advantage of more favorable borrowing rates in external markets, which can reduce overall financing costs.
3. **Flexibility:** Currency swaps can be tailored to the specific needs of the participating companies, providing customized solutions for managing currency risks.

As Uzbekistan continues to strengthen its market relations and expand its role in the global economy, addressing currency risk issues is crucial for both businesses and policymakers. By employing various tools, Uzbekistan can effectively manage exchange rate fluctuations and minimize their impact.

In addition to using tools such as foreign exchange reserves, hedging strategies, offsetting, and currency swaps, Uzbekistan could implement additional measures to further mitigate currency risks. By adopting a comprehensive approach to risk management, Uzbekistan can strengthen its market relations, attract foreign investment, and ensure economic stability.

The Central Bank of Uzbekistan can implement robust monetary policies to maintain price stability and effectively manage currency risks. This includes maintaining appropriate interest rate regimes, conducting open market operations, and managing liquidity in the financial system. Through prudent monetary policy measures, the central bank can influence exchange rates, reduce volatility, and create a favorable environment for businesses and investors.

A sound fiscal policy plays a critical role in minimizing currency risks. Uzbekistan could focus on maintaining



a balanced fiscal position, promoting responsible government spending, and ensuring a sustainable level of public debt. By avoiding excessive borrowing in foreign currencies, the country can mitigate risks associated with currency mismatches and reduce vulnerability to exchange rate fluctuations.

Uzbekistan can actively pursue export diversification to reduce dependence on key sectors or markets. By broadening the range of export products and exploring new markets, the country can mitigate risks related to demand changes and currency movements. Diversification provides a more stable revenue base and reduces vulnerability to external shocks associated with a limited export portfolio.

Attracting foreign direct investment (FDI) can offer additional opportunities for managing currency risks. By creating a favorable investment climate, stable regulatory framework, and investor-friendly policies, Uzbekistan can attract foreign capital flows. FDI not only brings in foreign currencies but also contributes to technology transfer, employment, and economic diversification. This diversification strengthens overall economic stability and reduces reliance on a single currency.

A strong and stable financial sector is essential for effective currency risk management. Uzbekistan could focus on enhancing the stability and robustness of its banking system through relevant regulatory frameworks, risk management practices, and capital adequacy measures. By ensuring transparency, implementing effective supervision, and promoting prudent lending practices, the financial sector can better withstand currency risks and contribute to overall economic stability.

Access to accurate and timely data is crucial for effective currency risk management. Uzbekistan could invest in improving its data collection, analysis, and reporting systems, particularly in areas such as currency flows, trade balances, and currency impacts. Reliable data access enables policymakers, businesses, and investors to make informed decisions and implement appropriate strategies to mitigate risks.

Uzbekistan could also collaborate with international organizations, neighboring countries, and regional forums to enhance its currency risk management practices. Participating in multilateral initiatives, sharing best practices, and engaging in policy dialogues can provide valuable insights and experience. International cooperation can also facilitate access to financing sources, technical assistance, and capacity-building programs.

In the context of market relations, managing currency risks is essential for ensuring economic stability, attracting foreign investment, and achieving

sustainable growth. Currency exchange agreements offer valuable tools for managing long-term investments and cross-border operations. By entering into agreements with partner countries, Uzbekistan can mitigate currency risks associated with foreign financing and reduce the impact of exchange rate fluctuations.

Diversifying trade and investment partnerships is another effective strategy for Uzbekistan. By expanding economic relations with multiple countries and regions, the country can spread currency risks across a broader range of currencies, thereby enhancing stability and resilience in market relations.

Furthermore, strengthening monetary and fiscal policies, promoting export diversification, encouraging foreign direct investment, and enhancing financial sector stability are key strategies that Uzbekistan can adopt to effectively manage currency risks. These measures create a conducive environment for economic growth while reducing vulnerability to exchange rate fluctuations.

Improving data systems and fostering international cooperation are additional steps Uzbekistan could take to enhance currency risk management. Access to accurate and timely data, combined with collaboration with international organizations and neighboring countries, provides valuable insights and support for implementing advanced risk management practices.

## **Conclusion**

Uzbekistan holds significant potential for economic development and market relations. By employing tools such as foreign exchange reserves, hedging strategies, offset operations, and currency swaps, along with adopting a comprehensive approach that integrates diversification, policy improvement, and international cooperation, Uzbekistan can effectively manage currency risks. Through these measures, the country can strengthen its economic stability, attract foreign investments, and create a favorable environment for stable growth in the global market.

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