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VOLUME 1 · ISSUE 1 · 2026

Contents

ECONOMICS AND MANAGEMENT

01 RESEARCH ARTICLE
Improving Lending Mechanisms and Risk Management in the Context of an Interest-Free Banking System
Ziyodullayev Islomjon Shavkatjon ugli
Tashkent State University of Economy, Tashkent, Uzbekistan
1–6 PAGES

02 RESEARCH ARTICLE
Improving Mechanisms for Attracting Investment in Industrial Enterprises
Ziyodullayeva Nodira Sultonmurodovna
Tashkent State University of Economy, Tashkent, Uzbekistan
7–11 PAGES

03 RESEARCH ARTICLE
Monetary Policy Transmission and Inflation Dynamics under Inflation Targeting in an Emerging Economy
Bakiyeva Iroda Abdushukurovna
Afrasiab University, Tashkent, Uzbekistan
12–16 PAGES

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Improving Lending Mechanisms and Risk Management in the Context of an Interest-Free Banking System

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ABSTRACT

The development of interest-free banking is increasingly seen as a way to broaden financial inclusion and mobilise savings of households and firms that avoid conventional interest-based products. However, replacing interest with trade-, lease- and partnership-based contracts changes the nature of the risks a bank carries, and risk management practices designed for conventional loans cannot simply be transferred. The aim of this study is to develop scientifically grounded proposals for improving lending mechanisms and risk management in an interest-free banking system, with particular reference to countries such as Uzbekistan where the regulatory framework for such services is still being formed. The study combines a systematic review of theoretical and empirical literature, comparative institutional analysis of the standards of the Islamic Financial Services Board and AAOIFI, and a structured qualitative assessment of the risk profile of seven financing contracts. The results show that murabaha and ijara concentrate credit and asset-related risks that are manageable with conventional tools, whereas musharaka and mudaraba shift equity-type, information and governance risks onto the bank, which explains their limited use in practice. A risk-adjusted profit-rate pricing model, a two-tier reserve system for smoothing returns to investment account holders, and a staged risk management framework are proposed. The findings can be used by regulators when drafting prudential rules and by banks opening interest-free windows.

KEYWORDS

Interest-free banking, Islamic finance, murabaha, musharaka, credit risk, risk management.

HIGHLIGHTS

- Interest-free lending transforms credit risk into asset and partnership risk.
- A contract-level risk matrix maps six risk types across seven financing modes.
- Risk-adjusted profit-rate pricing and reserves are proposed for new markets.

1. Introduction

INTEREST-FREE BANKING has moved from a niche segment to a significant part of the global financial system. According to the Islamic Financial Services Board, the assets of the Islamic financial services industry reached approximately US$3.4 trillion in 2023, with banking accounting for the largest share. The defining feature of this model is the prohibition of *riba*-interest and of excessive uncertainty-*gharar*, which requires every financing operation to be linked to a real asset, a service or a shared business venture.

For economies in transition, the interest-free model has a practical rather than only a religious dimension. A part of the population and of small businesses deliberately stays outside the banking system

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because it avoids interest-based contracts, and these savings remain in cash, foreign currency or real estate. In Uzbekistan, where the banking sector has been undergoing deep reform since the liberalisation of the foreign exchange market in 2017 and the adoption of the banking reform strategy for 2020–2025, the introduction of interest-free products is discussed as one of the instruments for increasing financial inclusion and attracting long-term resources. At the same time, the replacement of interest by trade, lease and partnership contracts fundamentally changes the risk structure of the lending process. In a *murabaha* sale the bank owns the commodity before reselling it, in an *ijara* lease it remains the owner of the asset, and in *musharaka* and *mudaraba* it becomes a partner sharing profits and losses. Credit risk is therefore combined with commodity price, asset ownership, rate-of-return and Shariah non-compliance risks. Empirical studies show that these differences have measurable consequences for stability and efficiency.

The aim of this article is to develop proposals for improving lending mechanisms and risk management in an interest-free banking system. To achieve this aim, the following objectives are set: (1) to systematise the theoretical foundations and the main financing contracts of interest-free lending; (2) to identify and compare the risk profile of these contracts; (3) to propose a risk-adjusted pricing model and reserve mechanisms; and (4) to formulate practical recommendations for regulators and banks in countries where this segment is at an early stage of development.

2. Literature Review

The theoretical foundations of interest-free finance are presented in the works of Iqbal and Mirakhor, who describe it as a risk-sharing system in which the return on capital is justified by the assumption of business risk rather than by the passage of time. In this view, profit-and-loss sharing (PLS) contracts - *musharaka* and *mudaraba* - represent the "ideal" form of Islamic financial intermediation, while sale- and lease-based contracts are permissible but secondary instruments. Empirical research, however, documents a persistent gap between theory and practice. Chong and Liu, analysing Malaysian data, found that only a small share of Islamic bank financing is based on PLS principles and that deposit rates of Islamic banks closely follow conventional interest rates. They concluded that, in practice, Islamic deposits are not substantially different from conventional ones. Similar observations led researchers to describe the dominance of *murabaha* as the "murabaha syndrome" of the industry.

The specific risks of interest-free banks were first systematised by Khan and Ahmed, who surveyed Islamic banks and identified rate-of-return risk, displaced commercial risk, Shariah non-compliance risk and the high operational risk of complex contracts as the main differences from conventional banks. Their classification became the basis of the Guiding Principles of Risk Management of the IFSB, which remain the key prudential reference for regulators. Archer and Karim showed that because investment account holders formally share losses, part of the bank's risks is transferred to them; however, competitive pressure forces banks to pay market-level returns, creating displaced commercial risk that must be covered by shareholders' capital. Studies of stability give mixed results. Čihák and Hesse found that small Islamic banks tend to be financially stronger than small conventional banks, whereas large Islamic banks are weaker, which they explained by the difficulty of adapting credit risk monitoring to a growing and more complex portfolio. Abedifar et al. showed that small Islamic banks have lower credit risk and that their borrowers are less sensitive to interest rate changes, partly due to religious motivations of clients. Beck et al. found few significant differences in business orientation, but higher cost inefficiency and better asset quality and capitalisation of Islamic banks, while Hasan and Dridi reported that Islamic banks were more resilient during the first phase of the global financial crisis.

Despite this extensive literature, most studies analyse mature markets of the Gulf countries, Malaysia and Indonesia. Much less attention has been paid to how lending mechanisms and risk management should be designed where interest-free banking is being introduced in a predominantly conventional system, with limited Shariah expertise, no specialised liquidity instruments and an evolving legal framework. This study addresses that gap by proposing a contract-level risk map and a set of mechanisms adapted to such conditions.

3. Materials and Methods

The study is based on a qualitative and analytical research design. The information base includes the standards and guidance documents of the IFSB and AAOIFI, regulatory documents of the Republic of Uzbekistan on the development of the banking system, reports of international organisations, and peer-reviewed empirical studies published in international journals.

3.1. *Research design*

Three methods were combined. First, a systematic literature review was used to identify the main financing contracts and risk categories. Second, comparative institutional analysis was applied to compare how these risks are treated in the IFSB framework and in conventional prudential regulation. Third, a structured qualitative assessment was carried out: each of seven financing contracts - *murabaha*, *ijara*, *salam*, *istisna*, *musharaka*, *mudaraba* and *qard hasan*-was rated by the authors on six risk dimensions using a three-level scale-low, medium, high, based on the contractual allocation of ownership, cash-flow and loss obligations described in the literature.

3.2. *Pricing and reserve model*

To make interest-free financing comparable with conventional loans in terms of risk coverage, the profit rate is decomposed into a benchmark component and risk premia, following the logic of risk-adjusted pricing used in banking. The proposed profit rate m for a financing contract is given by Eq. (1):

$$m = b + EL + k\cdot(h - b) + c + s \quad (1)$$

where b is a benchmark rate of return, EL is the expected loss rate, k is the share of economic capital required for the contract, h is the required return on shareholders' capital, c is the operating cost ratio, and s is a premium for contract-specific risks. The expected loss is estimated in the standard way, as shown in Eq. (2):

$$EL = PD \times LGD \times EAD \quad (2)$$

where PD is the probability of default of the client, LGD is loss given default and EAD is exposure at default. In interest-free contracts LGD depends strongly on the bank's ownership of the asset: in *ijara* it is reduced because the asset remains on the bank's balance sheet, whereas in *mudaraba* it may approach unity because the bank provides capital without collateral.

Returns to investment account holders are smoothed by a profit equalisation reserve (PER) and an investment risk reserve (IRR). The return paid to investment account holders in period t is defined in Eq. (3):

$$R_t = \alpha\cdot(1 - \mu)\cdot\pi_t + \Delta PER_t \quad (3)$$

where π_t is the gross return on assets financed by investment accounts, μ is the bank's profit share as *mudarib*, α is the share of investment accounts in the funding of these assets, and ΔPER_t is the transfer from (positive) or to (negative) the profit equalisation reserve.

4. Results

The analysis of contract structures shows that interest-free financing does not eliminate credit risk but redistributes it among several risk types. The results of the structured assessment are presented in Table 1.

Table 1. Risk profile of interest-free financing contracts (authors' assessment)

Contract	Credit	Market / price	Liquidity	Rate of return	Shariah	Operational
Murabaha (cost-plus sale)	High	Low–Med.	Medium	Medium	Medium	Medium
Ijara (lease)	Medium	Medium	Medium	Medium	Low	Medium
Salam (forward sale)	Medium	High	High	Medium	Medium	High
Istisna (manufacture contract)	Medium	Medium	High	Medium	Medium	High
Musharaka (joint venture)	Medium	High	High	High	Low	High
Mudaraba (trust financing)	High	High	High	High	Low	High
Qard hasan (benevolent loan)	High	Low	Medium	Low	Low	Low

Table 1 indicates that sale- and lease-based contracts carry a risk profile close to that of conventional secured loans: the main risk is the client's inability to pay deferred instalments, while price and ownership risks are concentrated in the short period between purchase and resale or are mitigated by the bank's ownership of the leased asset. This explains why these contracts dominate the portfolios of Islamic banks and why they are the most suitable starting point for banks opening interest-free windows.

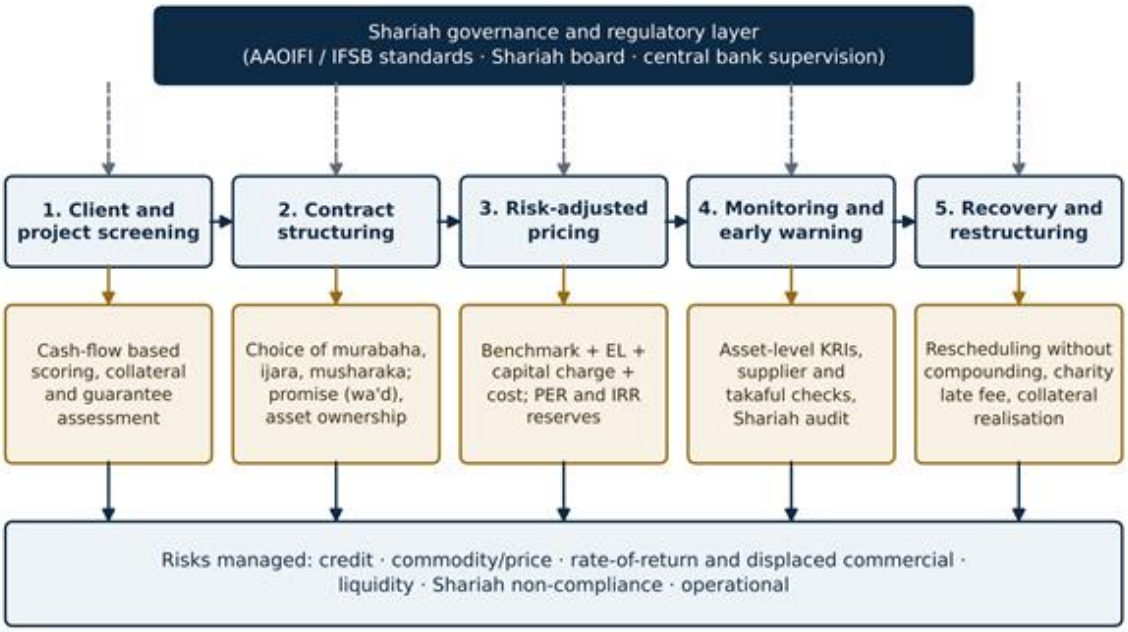
By contrast, partnership contracts shift equity-type and information risks onto the bank. Because the bank's return depends on the reported profit of the enterprise, problems of adverse selection and moral hazard become central, and the bank must monitor the business rather than only the repayment schedule. The high ratings for operational risk reflect the need for specialised staff, accounting control and Shariah audit. *Salam* and *istisna* combine credit risk with commodity and completion risks typical of agricultural and construction financing. Based on these results, the mitigation instruments that can be applied to each risk category were systematised (Table 2). The selection was limited to instruments that are permissible under AAOIFI and IFSB standards and can be implemented without a developed Islamic money market.

Table 2. Risk categories and permissible mitigation instruments in interest-free lending

Risk category	Source in interest-free lending	Proposed mitigation instruments
Credit risk	Deferred payment obligations; inability to charge penalty interest	Cash-flow based scoring; collateral (*rahn*) and guarantees (*kafala*); late-payment charges directed to charity
Market / commodity risk	Bank's ownership of goods before resale; price changes in salam	Binding purchase promise (*wa'd*) by the client; parallel salam; short holding periods
Rate-of-return risk	Fixed mark-up on assets versus market-driven return expectations	Shorter repricing periods; ijara with floating rentals linked to a benchmark
Displaced commercial risk	Pressure to pay competitive returns to investment account holders	Profit equalisation reserve (PER) and investment risk reserve (IRR), Eq. (3)
Liquidity risk	Absence of interest-based interbank market and lender of last resort	Sukuk-based liquidity buffers; Shariah-compliant central bank facility; maturity matching
Shariah non-compliance	Errors in contract sequence or asset ownership	Independent Shariah board; standardised documentation; internal Shariah audit
Operational risk	Complex multi-stage contracts; asset management functions	Automated contract workflow; takaful coverage of assets; staff certification

Combining the risk map with the pricing model in Eqs. (1)-(2) allows a bank to set different profit rates for contracts with different risk profiles instead of applying a single mark-up. For example, under identical client creditworthiness, *ijara* should carry a lower premium s than *murabaha* on movable goods because the bank retains ownership of the asset, whereas *mudaraba* requires the highest capital share k. The integration of these elements into a single process is shown in Figure 1.

Figure 1. Framework of integrated risk management in interest-free lending



The framework consists of five consecutive stages - client and project screening, contract structuring, risk-adjusted pricing, monitoring and early warning, and recovery and restructuring - each supported by specific tools and subject to the Shariah governance and regulatory layer. Information obtained at the monitoring and recovery stages is used to recalibrate scoring models and risk premia, closing the management cycle.

5. Discussion

The results are consistent with the empirical finding that Islamic banks rely mainly on sale- and lease-based contracts. The risk map in Table 1 offers an explanation for this pattern that goes beyond conservatism: partnership contracts require monitoring capacity and information quality that are costly to build, especially where corporate accounting is weak. For new markets this implies a sequenced approach in which banks start with *murabaha* and *ijara*, accumulate data on client behaviour, and only later expand to *musharaka*, for example in the form of diminishing partnerships for housing and equipment.

The proposed pricing model addresses a common criticism that Islamic banks simply copy conventional interest rates. Although a benchmark b is still needed, the explicit inclusion of expected loss and contract-specific premia makes pricing reflect the actual risks of each contract rather than a uniform interest equivalent. This is in line with Abedifar et al., who show that the risk characteristics of Islamic bank borrowers differ from those of conventional borrowers. The reserve mechanism in Eq. (3) is particularly important where competition with conventional banks is intense. As Archer and Karim argue, if displaced commercial risk is not recognised, regulators may underestimate the capital needed by interest-free banks. A transparent PER and IRR policy, disclosed to investment account holders, both protects depositors and limits the arbitrary smoothing of returns. For Uzbekistan, the analysis suggests several regulatory priorities: the adoption of legal definitions for the main financing contracts and for the bank's right to own and trade assets; a central Shariah advisory body to ensure uniform interpretation; prudential rules that adapt capital adequacy and provisioning to interest-free contracts in line with IFSB standards; and the creation of a Shariah - compliant liquidity facility. Tax neutrality is also essential so that the multiple sales involved in *murabaha* are not taxed more heavily than an equivalent loan.

The study has limitations. The risk ratings are qualitative and based on the contractual structure and existing literature rather than on loan-level data, which are not yet available for an interest-free segment in Uzbekistan. Future research should test the pricing model empirically once portfolio data accumulate.

6. Conclusion

Interest-free banking changes the nature of lending: credit risk is combined with commodity, ownership, rate-of-return, liquidity and Shariah non-compliance risks whose weight depends on the type of contract. Sale- and lease-based contracts are closest to conventional secured lending and are the most suitable for the initial stage of market development, while partnership contracts require stronger monitoring, governance and information systems. The study proposes three mechanisms for improving lending and risk management: a contract-level risk map that links each financing mode to permissible mitigation instruments; a risk-adjusted profit-rate pricing model that separates benchmark return, expected loss, capital cost and contract-specific premia; and a two-tier reserve system for smoothing returns to investment account holders. Together with a staged risk management framework, these mechanisms can help banks offer interest-free products without increasing systemic risk. Regulators are recommended to develop a dedicated legal and prudential framework, a centralised Shariah advisory function and liquidity instruments before large-scale expansion of the segment. Future research should focus on empirical calibration of the pricing model, the design of deposit insurance for investment accounts and the role of interest-free finance in small business lending.

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Author contributions. [Initials]: conceptualization, methodology, writing – original draft; [Initials]: formal analysis, writing – review and editing.

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Improving Mechanisms for Attracting Investment in Industrial Enterprises

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ABSTRACT

Attracting investment into industrial enterprises is a key condition for structural transformation, technological renewal and export diversification in emerging economies. In Uzbekistan, large-scale reforms since 2017 - currency liberalisation, a new investment law, special economic zones and the privatisation of state assets - have significantly improved the investment environment, yet many industrial enterprises still face high financing costs, a limited capital market and low transparency, which constrain their ability to attract long-term capital. The aim of this study is to develop scientifically grounded proposals for improving the mechanisms for attracting investment in industrial enterprises. The study applies a systematic literature review, institutional and comparative analysis of investment policy instruments, a factor model of enterprise investment and a composite investment attractiveness index based on normalised financial and institutional indicators. The results show that the investment attraction mechanism should be viewed as a three-level system linking state guarantees and incentives, regional and industrial infrastructure, and enterprise-level governance, and that the weakest link is often the enterprise level: financial reporting quality, project preparation and corporate governance. A system of indicators for assessing investment attractiveness, a matrix of barriers and instruments, and a set of practical recommendations are proposed. The findings can be used by government agencies, industrial zone administrations and enterprise managers in designing investment strategies.

KEYWORDS

Investment attraction, industrial enterprises, foreign direct investment, investment climate, attractiveness index.

HIGHLIGHTS

- Investment attraction is treated as a three-level macro–meso–micro mechanism.
- A composite investment attractiveness index for industrial firms is proposed.
- Enterprise transparency is the weakest link between policy and capital inflows.

1. Introduction

ATTRACTING INVESTMENT into industrial enterprises remains a key condition for structural change and sustainable growth. Industry is the sector in which new technologies, higher productivity and export capacity are created, and its modernisation requires large and long-term capital that domestic savings alone often cannot provide. For this reason, the question of how to attract and use investment effectively is central to the economic policy of emerging economies.

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Since 2017 Uzbekistan has implemented a broad programme of reforms aimed at improving the investment climate: liberalisation of the foreign exchange market, the adoption of the Law "On Investments and Investment Activity", the creation of free economic zones and small industrial zones, the development of public–private partnership and the gradual privatisation of state-owned enterprises. The Development Strategy "Uzbekistan - 2030" sets the goal of attracting large volumes of domestic and foreign investment into the economy, with a strong emphasis on industrial development. Nevertheless, a number of problems remain at the enterprise level. Many industrial firms rely mainly on their own funds and bank loans, the capital market is still small, and the quality of financial reporting and corporate governance often does not meet the expectations of strategic and portfolio investors. As a result, improvements in the national investment climate do not automatically translate into investment inflows to individual enterprises.

The aim of this article is to develop proposals for improving the mechanisms for attracting investment in industrial enterprises. The objectives are: (1) to summarise the theoretical approaches to the determinants of investment; (2) to define the structure of the investment attraction mechanism; (3) to propose a method for assessing the investment attractiveness of industrial enterprises; and (4) to formulate recommendations for state bodies and enterprises.

2. Literature Review

Theoretical approaches to investment can be divided into two groups: theories of domestic investment behaviour of firms and theories of foreign direct investment. Within the first group, the neoclassical model of Jorgenson links investment to the user cost of capital and the expected level of output, while the accelerator principle emphasises the role of demand growth. Fazzari et al. showed that investment of financially constrained firms depends strongly on internal cash flow, which means that imperfections of capital markets limit the ability of firms to invest even when profitable opportunities exist. This finding is particularly relevant for emerging economies with underdeveloped financial systems. In the theory of FDI, Dunning's eclectic paradigm explains the decision of a multinational company to invest abroad by a combination of ownership, location and internalisation advantages. Location advantages - market size, resources, labour costs, infrastructure and institutions - are the area in which host-country policy can have the greatest influence. The OECD Policy Framework for Investment systematises these policy areas, including investment policy, investment promotion and facilitation, competition, tax policy, corporate governance and infrastructure.

Empirical studies confirm that the benefits of investment depend on the absorptive capacity of the host economy. Borensztein et al. found that FDI contributes to growth only when the host country has a minimum threshold of human capital. Alfaro et al. showed that countries with well-developed financial markets gain significantly more from FDI. Javorcik demonstrated that productivity spillovers from FDI occur mainly through backward linkages with local suppliers, which highlights the importance of integrating domestic industrial enterprises into the value chains of foreign investors. Recent international reports emphasise that global FDI flows have become more volatile and increasingly concentrated in sectors related to energy transition, digitalisation and supply chain diversification. For Central Asian economies, this creates opportunities linked to near-shoring and the processing of local raw materials, but also increases competition among countries for investors.

The literature thus offers well-developed explanations of the determinants of investment at the national level, but less attention is paid to the mechanism through which national policy is transformed into investment at the level of a specific industrial enterprise. The present study addresses this gap by proposing a multi-level mechanism and an enterprise-level assessment tool.

SPECTRUM

3. Materials and Methods

The study uses a combination of qualitative and quantitative methods. The information base includes legislative and policy documents of the Republic of Uzbekistan, reports of international organisations, and peer-reviewed literature on investment determinants.

3.1. *Factor model of enterprise investment*

To identify the factors that determine investment of industrial enterprises, a factor model combining the accelerator, cost-of-capital and financing-constraint approaches is specified, as in Eq. (1):

$$I_{it}/K_{i,t-1} = \alpha + \beta_1 \Delta Y_{it} + \beta_2 (r_t - \pi_t) + \beta_3 CF_{it}/K_{i,t-1} + \beta_4 IC_t + \varepsilon_{it} \quad (1)$$

where I is investment in fixed capital of enterprise i in year t, K is the stock of fixed capital, ΔY is the growth of output (accelerator effect), $r - \pi$ is the real interest rate (cost of capital), CF is internal cash flow (financing constraint), IC is an index of the investment climate, and ε is the error term. The model is intended for estimation on enterprise panel data; the expected signs are $\beta_1 > 0$, $\beta_2 < 0$, $\beta_3 > 0$ and $\beta_4 > 0$, and a large β_3 would indicate binding financing constraints.

3.2. *Investment attractiveness index*

To assess the investment attractiveness of an individual enterprise, a composite index is proposed. Each indicator is first normalised using the min-max method, as shown in Eq. (2):

$$z_{ij} = (x_{ij} - \min x_j) / (\max x_j - \min x_j) \quad (2)$$

where x_{ij} is the value of indicator j for enterprise i. For indicators whose increase reduces attractiveness (for example, the debt ratio), the inverse form $1 - z_{ij}$ is used. The integral index is calculated as the weighted sum of normalised indicators, as in Eq. (3):

$$IAI_i = \Sigma_j w_j \cdot z_{ij}, \quad \Sigma_j w_j = 1 \quad (3)$$

where w_j is the weight of indicator j. The index takes values from 0 to 1. Weights are proposed by the authors on the basis of the literature and can be refined by expert methods, such as the analytic hierarchy process, when the index is applied in practice.

4. Results

The analysis of the theoretical approaches and policy documents made it possible to define the investment attraction mechanism as a system of interrelated instruments operating at three levels - macro, meso and micro and connecting the sources of financing with investment results. At the macro level, the mechanism includes legal guarantees for investors, the tax and customs regime, the framework for public-private partnership and macroeconomic stability. At the meso level, special economic zones, industrial parks, infrastructure and clusters reduce the costs of entry and create agglomeration effects. At the micro level, the enterprise itself must be ready to receive investment: it needs transparent reporting, a pipeline of prepared investment projects, a credit history and an adequate system of corporate governance. The analysis shows that reforms in recent years have focused mainly on the macro and meso levels, whereas the micro level often remains the bottleneck.

For the practical assessment of enterprise readiness, a system of indicators for the investment attractiveness index was developed (Table 1). It covers financial condition, production and technological potential, market position and institutional quality.

Table 1. System of indicators for the investment attractiveness index of an industrial enterprise

Block	Indicator	Direction	Weight
Financial condition	Return on assets (ROA)	Stimulant	0.12
	Debt-to-equity ratio	Destimulant	0.08
	Current liquidity ratio	Stimulant	0.06
	Operating cash flow to fixed capital	Stimulant	0.09
Production and	Degree of wear of fixed assets	Destimulant	0.10

technology			
	Labour productivity (output per employee)	Stimulant	0.10
	Share of innovative products in sales	Stimulant	0.07
Market position	Sales growth rate	Stimulant	0.08
	Share of exports in sales	Stimulant	0.08
Institutional quality	IFRS reporting and external audit (0/1)	Stimulant	0.10
	Corporate governance score	Stimulant	0.07
	Share of state ownership	Destimulant	0.05
Total			1.00

The indicator system gives a relatively high weight to institutional quality (0.22 in total), reflecting the conclusion that investors, particularly foreign ones, assess not only current financial results but also the reliability of information and the protection of their rights. The degree of wear of fixed assets is included as a destimulant because a high level of wear increases the volume of investment needed to modernise production, although it can also indicate a large need for investment.

Based on the three-level mechanism, the main barriers to investment in industrial enterprises and the instruments for overcoming them were systematised (Table 2).

Table 2. Barriers to investment in industrial enterprises and proposed instruments

Level	Barrier	Proposed instrument
Macro	High cost and short maturity of credit resources	Interest-rate compensation and guarantees for modernisation loans through development institutions
Macro	Frequent changes in tax and regulatory rules	Stabilisation clauses for large investment agreements; regulatory impact assessment
Meso	Uneven quality of infrastructure in industrial zones	Performance-based management contracts for zone operators; plug-and-play industrial sites
Meso	Weak links between foreign investors and local suppliers	Supplier development programmes and local content matching platforms
Micro	Low transparency and lack of IFRS reporting	Mandatory IFRS and audit for enterprises seeking state support; disclosure standards
Micro	Lack of bankable investment projects	Project preparation facilities; standardised feasibility study templates
Micro	Limited access to the capital market	Simplified listing for medium-sized firms; corporate bonds and IPOs of state stakes

5. Discussion

The results support the view, established in the literature, that the benefits of investment depend on the absorptive capacity of the recipient. The present study extends this idea to the enterprise level: even in a favourable national climate, an industrial enterprise with opaque reporting, outdated equipment and no prepared projects will find it difficult to attract capital. This explains why the micro level is identified as the bottleneck of the mechanism. The factor model in Eq. (1) makes it possible to test empirically whether investment of industrial enterprises in Uzbekistan is constrained by internal cash flow, as predicted by Fazzari et al.. If the coefficient on cash flow proves large and significant, priority should be given to measures that improve access to external financing - development of the capital market, leasing and guarantee schemes - rather than to additional tax incentives.

The investment attractiveness index has practical value for several users. Government agencies can use it to select enterprises for state support and to monitor the results of support programmes; industrial zone administrations can use it to evaluate resident companies; investors and banks can use it as a preliminary screening tool; and enterprises themselves can identify the areas in which they lag behind. The importance of supplier development measures follows from the finding of Javorcik that spillovers from FDI occur mainly through backward linkages. The study has limitations. The weights of the index are set by the authors and require validation through expert surveys, and the factor model has not yet been estimated because of the limited availability of enterprise-level panel data. These issues define directions for future research.

6. Conclusion

The mechanism for attracting investment in industrial enterprises should be considered as a three-level system in which state guarantees and incentives, regional and industrial infrastructure, and enterprise governance complement each other. Reforms that improve only the national investment climate are insufficient if enterprises are not prepared to receive investment.

The study proposes a factor model of enterprise investment, a composite investment attractiveness index with a system of thirteen indicators, and a matrix of barriers and instruments. The main recommendations include: linking state support to the adoption of IFRS reporting and corporate governance standards; creating project preparation facilities for industrial enterprises; developing the corporate bond market and the sale of state stakes through public offerings; introducing performance-based management of industrial zones; and implementing supplier development programmes that connect local firms with foreign investors.

Future research should focus on estimating the factor model on enterprise panel data, validating the index weights with expert methods, and comparing the effectiveness of different investment incentives across industries.

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Monetary Policy Transmission and Inflation Dynamics under Inflation Targeting in an Emerging Economy

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ABSTRACT

The effectiveness of inflation targeting in emerging economies depends on how strongly and how quickly changes in the policy rate are transmitted to market interest rates, credit, the exchange rate, expectations and, finally, inflation. In economies that have recently moved from a fixed or managed exchange rate and directed lending to a market-based monetary framework, these channels may be weak or distorted. The aim of this study is to assess the structure of the monetary policy transmission mechanism in Uzbekistan, which formally adopted an inflation targeting regime in 2020, and to develop proposals for strengthening it. The study applies a systematic review of theoretical and empirical literature on transmission in emerging and low-income countries, institutional analysis of the monetary framework of the Central Bank of the Republic of Uzbekistan, and a structural vector autoregression framework together with a forward-looking policy rule for future empirical estimation. The analysis shows that the exchange rate and expectations channels play the leading role, whereas the interest rate and credit channels are weakened by dollarisation, a high share of state-directed and subsidised lending, administered prices and shallow financial markets. A channel-strength assessment matrix and a set of measures are proposed, including the phasing out of preferential lending, de-dollarisation, development of the government securities market and improved central bank communication. The results can be used to improve the effectiveness of monetary policy.

KEYWORDS

Monetary policy transmission, inflation targeting, policy rate, exchange rate pass-through, dollarisation, SVAR.

HIGHLIGHTS

- Exchange rate and expectations channels dominate transmission in Uzbekistan.
- Dollarisation and directed lending weaken the interest rate and credit channels.
- An SVAR framework and a channel-strength matrix are proposed for evaluation.

1. Introduction

PRICE STABILITY is the main objective of modern central banks, and inflation targeting has become the dominant monetary policy framework in both advanced and emerging economies. Under this regime, the central bank sets a numerical target for inflation and adjusts its policy rate on the basis of the inflation forecast, relying on the ability of the policy rate to influence aggregate demand and expectations. The success of the regime therefore depends critically on the monetary transmission mechanism.

Uzbekistan has undergone a profound change in its monetary framework. After the liberalisation of the foreign exchange market in September 2017, the Central Bank of the Republic of Uzbekistan (CBU) began a

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transition towards inflation targeting, which was formalised by a presidential decree in 2019 and implemented from 2020 with a medium-term target of 5%. The policy rate became the main instrument, and the CBU introduced an interest rate corridor, regular monetary policy decisions and published forecasts.

At the same time, the economy retains features that complicate transmission: a significant share of loans and deposits in foreign currency, a large role of state-owned banks and of lending at preferential rates through government programmes, regulated prices for energy and utilities, and a relatively shallow money and bond market. Similar conditions in other emerging and low-income economies have been shown to weaken the impact of monetary policy. External shocks, such as the sharp rise in the CBU policy rate to 17% in March 2022 in response to regional turbulence, illustrate how the central bank must rely on the exchange rate and expectations to stabilise inflation.

The aim of this article is to assess the structure of the monetary transmission mechanism in Uzbekistan and to develop proposals for strengthening it. The objectives are: (1) to review the theory and empirical evidence on transmission channels; (2) to analyse the institutional factors that strengthen or weaken each channel; (3) to propose an empirical framework for measuring transmission; and (4) to formulate recommendations for monetary policy.

2. Literature Review

The modern understanding of the transmission mechanism was summarised by Mishkin, who distinguished the interest rate, exchange rate, asset price and credit channels. In the traditional interest rate channel, a rise in the policy rate increases real interest rates, which reduces investment and consumption. Bernanke and Gertler argued that the effect of monetary policy is amplified by the credit channel: tighter policy weakens the balance sheets of borrowers and reduces the supply of bank loans, raising the external finance premium. In open economies, the exchange rate channel is often the fastest. A higher policy rate tends to strengthen the domestic currency, which lowers import prices and reduces inflation through exchange rate pass-through. Calvo and Reinhart showed that emerging economies often show “fear of floating” because of high pass-through and foreign currency liabilities, which limits the flexibility of the exchange rate and increases the importance of this channel. New Keynesian theory emphasises the expectations channel: if the central bank is credible, announced policy and forward guidance shape inflation expectations and thereby current price-setting.

The empirical measurement of transmission is usually based on vector autoregressions, following Sims. Christiano et al. summarised the evidence for the United States: a contractionary monetary shock leads to a hump-shaped decline in output and a delayed fall in prices. For developing countries, Mishra et al. concluded that transmission is generally weaker and less reliable because of small formal financial sectors, limited competition among banks, dollarisation and the lack of central bank independence. The policy rule of Taylor, which links the policy rate to the inflation and output gaps, is widely used to describe and evaluate the reaction of central banks.

Studies of Uzbekistan and other Central Asian economies remain relatively few, partly because of the short history of market-based monetary policy. Most available analysis is contained in the publications of the CBU and the International Monetary Fund. The present study contributes by systematically assessing each transmission channel in the institutional context of Uzbekistan and by proposing a framework for its empirical evaluation.

3. Materials and Methods

The study is based on a combination of institutional analysis and an econometric framework. The information base includes the monetary policy documents of the CBU, legislative acts of the Republic of Uzbekistan and peer-reviewed literature on monetary transmission.

3.1. *Structural VAR framework*

To measure the transmission of monetary policy to inflation, a structural vector autoregression model is proposed. In reduced form, the model is written as Eq. (1):

$$Y_t = c + \Sigma_{i=1..p} A_i Y_{t-i} + B \cdot X_t + u_t \quad (1)$$

where Y_t is the vector of endogenous variables - the real output gap, consumer price inflation, the interbank interest rate, the nominal effective exchange rate and the volume of bank credit - X_t is the vector of exogenous variables, A_i and B are coefficient matrices, p is the lag length and u_t are reduced-form residuals. Structural shocks are identified through a recursive ordering or sign restrictions, which assume that a contractionary monetary shock raises the interest rate and does not increase inflation on impact. Impulse responses and variance decompositions show the speed and strength of each channel.

3.2. *Policy reaction function and pass-through*

The reaction of the central bank is described by a forward-looking rule with interest rate smoothing, shown in Eq. (2):

$$i_t = \rho i_{t-1} + (1 - \rho)[r^* + \pi^* + \varphi_\pi(E_t\pi_{t+h} - \pi^*) + \varphi_y \tilde{y}_t] + \varepsilon_t \quad (2)$$

where i_t is the policy rate, r^* is the neutral real rate, π^* is the inflation target, $E_t\pi_{t+h}$ is the expected inflation h quarters ahead, $\tilde{y}_t$ is the output gap, ρ is the smoothing parameter and $\varphi_\pi > 1$ is required for the Taylor principle to hold. Exchange rate pass-through to consumer prices is estimated by Eq. (3):

$$\Delta p_t = \alpha + \Sigma_{k=0..q} \gamma_k \Delta e_{t-k} + \delta \tilde{y}_t + \theta \Delta p^*_t + \varepsilon_t \quad (3)$$

where Δp is consumer price inflation, Δe is the change in the exchange rate, Δp^* is foreign inflation, and the sum of γ_k measures the long-run pass-through coefficient.

4. Results

The institutional analysis allowed each channel of the transmission mechanism in Uzbekistan to be assessed in terms of its relative strength and the main factors that limit it. The results of the assessment of individual channels are summarised in Table 1. The assessment is qualitative and is based on structural characteristics of the financial system rather than on estimated coefficients; it is intended to formulate hypotheses for the empirical model in Section 3.

Table 1. Assessment of the strength of monetary transmission channels in Uzbekistan

Channel	Strength	Supporting factors	Constraining factors
Interest rate	Moderate	Policy rate corridor; developing interbank market; market-based deposit rates	Preferential and state-programme loans; dominance of state banks; shallow money market
Credit	Moderate	Rapid growth of retail lending; prudential and macroprudential tools	Loans at subsidised rates; foreign-currency loans; collateral-based lending
Exchange rate	Strong	High share of imports in consumption; flexible exchange rate since 2017	Interventions related to gold sales; remittance-driven currency flows
Expectations	Growing	Regular policy decisions, published forecasts and press releases	Short track record of targeting; adaptive household expectations
Asset price	Weak	Gradual development of the stock and bond markets	Small market capitalisation; limited household holdings of securities

Table 1 shows that the exchange rate channel is likely to be the strongest and fastest. Because a large share of consumer goods, equipment and intermediate inputs is imported, changes in the exchange rate are quickly passed through to prices. The expectations channel is growing in importance as the CBU builds a track record and expands communication, but household expectations still tend to follow past inflation, which slows the disinflation process. The interest rate and credit channels are constrained by structural factors. When a substantial part of loans is issued at preferential rates through government programmes or is denominated in foreign currency, changes in the policy rate affect only part of the credit market, which forces the central bank to make larger changes in the rate to achieve the same effect on demand. Administered prices for energy and utilities create periodic inflation shocks that are outside the direct control

of monetary policy and can affect expectations. Based on this assessment, measures were developed to strengthen each channel (Table 2).

Table 2. Measures to strengthen the monetary transmission mechanism

Direction	Measure	Expected effect
Interest rate channel	Phase out preferential lending or move its subsidies to the budget transparently	Larger share of credit priced from the policy rate
Credit channel	Accelerate privatisation of state banks and increase competition	Faster pass-through of the policy rate to loan rates
De-dollarisation	Differentiated reserve requirements and deposit insurance limits by currency	Higher share of national-currency deposits and loans
Financial markets	Regular issuance of government securities across maturities; yield curve development	Benchmark rates for pricing long-term loans
Expectations	Forward guidance, publication of the policy rate path, surveys of inflation expectations	Anchoring of expectations around the target
Policy coordination	Predictable schedule for adjusting administered prices; fiscal–monetary coordination	Fewer supply-side inflation shocks

5. Discussion

The results are consistent with the evidence for emerging and low-income economies, where the exchange rate channel tends to dominate and the interest rate and credit channels are weaker. They also support the argument of Calvo and Reinhart that high pass-through makes exchange rate movements a central concern of monetary policy in such economies. For Uzbekistan, this means that the CBU must pay particular attention to the exchange rate and expectations in the short run, while working with the government to remove structural constraints that weaken the interest rate channel in the medium run. An important implication concerns preferential lending. Credit at subsidised rates may support specific sectors, but it reduces the share of the economy that responds to the policy rate and can push the central bank to keep rates higher than otherwise necessary. Moving such support to transparent budget subsidies would separate fiscal and monetary functions, in line with the principles of inflation targeting.

The proposed structural vector autoregression framework and policy rule in Eqs. (1)-(3) provide a basis for testing these conclusions. A finding of high and fast exchange rate pass-through, together with a weak response of credit to policy rate shocks, would confirm the hypotheses in Table 1. Estimates of the reaction coefficient φ_π would also show whether the policy rate responds strongly enough to expected inflation to satisfy the Taylor principle. The study has limitations. The assessment of channel strength is qualitative, and the econometric estimation is constrained by the short time series available since the adoption of inflation targeting, which also includes several large external shocks. As more data accumulate, the framework should be estimated with methods that allow for structural breaks.

6. Conclusion

The effectiveness of inflation targeting in Uzbekistan depends on strengthening the monetary transmission mechanism. The analysis shows that the exchange rate and expectations channels currently play the leading role, while the interest rate and credit channels are limited by dollarisation, preferential state-directed lending, the dominance of state banks, administered prices and shallow financial markets. To improve transmission, it is recommended to phase out preferential lending or make its subsidies transparent in the budget, accelerate the privatisation of state banks, reduce dollarisation through differentiated prudential requirements, develop the government securities market as a source of benchmark rates, and improve central bank communication through forward guidance and regular surveys of inflation expectations. Better coordination of administered price adjustments with monetary policy would reduce supply-side shocks.

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Future research should estimate the proposed structural vector autoregression and pass-through models on quarterly data, compare the results with other inflation-targeting economies in the region, and analyse how the transmission mechanism changes as financial markets deepen.

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