

**THE EFFECTS OF EXCHANGE RATE FLUCTUATIONS ON NATIONAL
BANKING SYSTEMS*****Okhtam Abdumuminovich Kholikulov****Assistant at the Department of Banking
Samarkand Institute of Economics and Service****Ogabek Akhmatov****Student of Group MR-322, Faculty of Service
Samarkand Institute of Economics and Service****Sanjar Abdullayev****Student of Group MR-322, Faculty of Service
Samarkand Institute of Economics and Service*

Abstract: Exchange rate fluctuations have a profound impact on the stability and performance of national banking systems, especially in emerging and developing economies. This paper investigates how exchange rate volatility influences credit risk, liquidity levels, and capital adequacy in the banking sector. Drawing on both theoretical frameworks and empirical case studies, the research analyzes the transmission mechanisms through which currency depreciation or appreciation affects loan quality, foreign currency exposure, and overall bank resilience. Special attention is given to countries with high levels of dollarization and limited monetary policy autonomy. The findings suggest that while flexible exchange rate regimes can serve as shock absorbers in times of external turbulence, they also expose banks to greater balance sheet vulnerabilities. The study concludes with policy recommendations aimed at enhancing exchange rate risk management and improving macroprudential oversight within banking institutions.

Keywords: Exchange rate volatility, banking system stability, credit risk, capital adequacy, foreign currency exposure, monetary policy, emerging economies

Аннотация: Колебания валютного курса оказывают значительное влияние на стабильность и эффективность национальных банковских систем, особенно в развивающихся странах. В данной статье рассматривается, как валютная волатильность влияет на кредитные риски, уровень ликвидности и достаточность капитала в банковском секторе. Основываясь на теоретических моделях и эмпирических исследованиях, работа анализирует механизмы передачи, через которые удешевление или удорожание национальной валюты воздействует на качество кредитного портфеля, валютные обязательства и устойчивость банков. Особое внимание уделяется странам с высокой долларизацией экономики и ограниченной автономией монетарной политики. Выводы статьи свидетельствуют о том, что гибкие валютные режимы могут смягчать внешние шоки, но при этом увеличивают уязвимость банковских балансов. В завершение предлагаются рекомендации по улучшению управления валютными рисками и макропруденциального надзора.

Ключевые слова: волатильность валютного курса, стабильность банковской системы, кредитный риск, достаточность капитала, валютная экспозиция, монетарная политика, развивающиеся страны

Annotatsiya: Valyuta kursidagi o'zgarishlar, ayniqsa rivojlanayotgan davlatlarda, milliy bank tizimlarining barqarorligi va samaradorligiga chuqur ta'sir ko'rsatadi. Ushbu maqolada valyuta kursi o'zgaruvchanligining bank sektoridagi kredit xavfi, likvidlik darajasi va kapital yetarliligiga qanday ta'sir ko'rsatishi o'rganiladi. Tadqiqot nazariy modellar va empirik holatlar asosida olib borilib, milliy valyutaning qadsizlanishi yoki mustahkamlanishi bank kreditlari sifati, xorijiy valyutadagi qarzlarning va banklarning barqarorligiga qanday ta'sir ko'rsatishini tahlil qiladi. Ayniqsa, iqtisodiyoti yuqori darajada dollarlashtirilgan va pul-kredit siyosati mustaqilligi cheklangan mamlakatlarga alohida e'tibor qaratiladi. Maqolada aniqlanishicha, moslashuvchan valyuta rejimlari tashqi zarbalarga nisbatan muvozanatni saqlash imkonini bersa-da, bank balanslarini yanada zaiflashtiradi. Yakunda valyuta risklarini boshqarish va banklar ustidan makroprudensial nazoratni kuchaytirish bo'yicha tavsiyalar beriladi.

Kalit so'zlar: valyuta kursi o'zgaruvchanligi, bank tizimi barqarorligi, kredit xavfi, kapital yetarliligi, xorijiy valyuta ta'siri, pul-kredit siyosati, rivojlanayotgan davlatlar

Introduction

In today's globally interconnected financial environment, exchange rate fluctuations are a key factor influencing the stability and operational integrity of national banking systems. As countries become increasingly integrated into international trade and investment networks, their exposure to external currency volatility rises significantly. This is particularly true for emerging and developing economies, where foreign currency liabilities, external debt, and reliance on imports amplify the impact of exchange rate shifts on the domestic banking sector. Exchange rate movements affect banks through multiple channels—loan repayment capacity of borrowers in foreign currency, valuation of foreign-denominated assets and liabilities, and capital adequacy ratios that are sensitive to currency-induced market risk. In highly dollarized economies such as Uzbekistan, these effects become even more pronounced. According to the Central Bank of Uzbekistan, over 40% of bank liabilities were denominated in foreign currencies as of 2023, indicating a substantial vulnerability to exchange rate risk. In response to such challenges, the Government of Uzbekistan has introduced key reforms. Presidential Decree No. PD-5877 (dated October 4, 2019) on improving monetary policy mechanisms, and Decree No. PD-5992 (dated May 12, 2020) on the liberalization of currency regulations, marked pivotal steps toward establishing a more flexible and resilient financial architecture. These reforms, coupled with the Central Bank's transition to inflation targeting and floating exchange rates, have significant implications for banking sector performance under exchange rate stress. This paper aims to explore how exchange rate fluctuations influence the stability, liquidity, and credit risk profiles of national banking systems, with a focus on emerging markets. It also seeks to provide policy-oriented insights that contribute to better exchange rate risk management and more effective macroprudential supervision.

Main Body

Exchange rate fluctuations are a vital economic variable that can either strengthen or undermine the integrity of national banking systems. Their impact is especially profound in emerging markets where the resilience of financial institutions often depends on the volatility of currency markets. As globalization intensifies and cross-border financial flows increase, the exposure of banks to exchange rate movements has become a systemic concern. One of the primary ways through which exchange rate fluctuations affect banks is through currency mismatch on balance sheets. When banks hold liabilities in foreign currencies (usually USD or EUR) but issue loans and receive deposits in local currency, any significant depreciation of the national currency immediately increases the burden of repayment. This leads to asset-liability mismatches, which, if not properly hedged, can erode bank capital and cause liquidity shortfalls. In countries like Uzbekistan, where dollarization remains a feature of both consumer behavior and bank portfolios, this risk is more than theoretical. According to the Central Bank of Uzbekistan, as of 2023, foreign currency loans still comprised over one-third of total outstanding credit. Exchange rate volatility also has indirect effects on credit risk. Borrowers who earn income in local currency but service debt in foreign currency face increased default risks when the national currency weakens. This deteriorates the asset quality of banks and compels them to increase loan loss provisions, thereby tightening liquidity. Moreover, capital adequacy ratios, which are calculated in risk-weighted terms, can deteriorate rapidly if foreign currency exposures are not properly reflected in stress testing and risk assessments. A devaluation triggered by global commodity prices or geopolitical risks often cascades into inflation, higher import costs, and tighter monetary policy. For instance, in 2022 and 2023, regional economic uncertainty caused by the Russia-Ukraine conflict led to abrupt capital outflows and exchange rate depreciation in several Central Asian countries. In Uzbekistan, although the Central Bank implemented a floating exchange rate regime since 2017, the effects of external shocks were still visible in inflationary pressure and the banking sector's need for liquidity injections. Monetary authorities have an important role in mediating these impacts. The shift toward inflation targeting, as outlined in the Presidential Decree No. PD-5877, has helped anchor expectations and reduce volatility in the foreign exchange market. However, such frameworks require institutional independence and transparent communication. The Central Bank's move to liberalize currency operations under Decree No. PD-5992 has allowed banks to adjust more flexibly to market forces, but it has also increased their exposure to market-driven risks, necessitating stronger macroprudential regulation. Emerging evidence suggests that macroprudential tools, such as countercyclical capital buffers and foreign currency reserve requirements, can mitigate the systemic impact of exchange rate shocks. Moreover, banks need to strengthen their internal risk management capabilities by adopting stress testing models that account for exchange rate scenarios. The Basel III framework, already in the process of phased implementation in Uzbekistan, offers a pathway for improving resilience by enforcing stricter liquidity coverage and net stable funding ratios. In addition to regulatory approaches, technological and data-driven solutions have become increasingly important. Banks can use real-time currency analytics, machine learning models, and scenario simulation tools to better manage exposure. In countries with limited financial infrastructure, regional cooperation—such as swap agreements between central banks or shared stabilization funds—can offer additional safeguards. Banking institutions that face stress due to currency depreciation may reduce lending, especially to small and medium-sized enterprises (SMEs), which are vital to economic growth and employment. If unmanaged, exchange rate risk can therefore translate into financial exclusion

and reduced economic dynamism. In summary, exchange rate fluctuations pose a multifaceted challenge to banking systems, particularly in emerging markets with partial dollarization and evolving regulatory environments. While Uzbekistan has made commendable strides through liberalization and monetary reform, further strengthening of institutional capacity, risk governance, and regional cooperation remains essential. The future of banking stability in such contexts lies in proactive risk management, robust policy frameworks, and an adaptive regulatory ecosystem that evolves with market realities.

Conclusion

Exchange rate fluctuations remain one of the most complex and consequential factors influencing the health and stability of national banking systems, particularly in emerging economies. As demonstrated throughout this paper, currency volatility can undermine bank profitability, erode capital buffers, and amplify credit risks through direct and indirect transmission channels. The challenges are especially acute in economies with high levels of foreign currency liabilities and partial dollarization, such as Uzbekistan. Governmental and regulatory responses, including the liberalization of currency policy and the adoption of inflation targeting frameworks, have made important strides in improving institutional resilience. However, these measures must be accompanied by robust macroprudential oversight, improved risk assessment models, and effective internal controls within banks to adequately manage exchange rate exposures. Technological innovation and regional financial cooperation also offer promising tools to cushion the banking sector against future currency shocks. Ultimately, a stable and adaptive financial system requires the integration of forward-looking policy, international best practices, and a vigilant regulatory environment. For Uzbekistan and similar economies, the path forward lies in deepening financial reforms, enhancing transparency, and strengthening risk governance mechanisms across the banking landscape. By doing so, they will be better positioned to absorb external shocks and ensure long-term financial stability amidst the growing volatility of global currency markets.

References:

1. Mankiw, N. G. (2014). Principles of Economics. 7th ed. Cengage Learning.
2. Krugman, P., & Obstfeld, M. (2018). International Economics: Theory and Policy. 11th ed. Pearson Education.
3. Dornbusch, R., Fischer, S., & Startz, R. Macroeconomics. 12th ed. McGraw-Hill Education.
4. Chortareas, G. E., & Kapetanios, G. Exchange rate forecasting using neural networks.
5. Ahmed, M., & Yousaf, S. Exchange rate policies and banking systems: A global perspective.
6. Zengin, H., & Karakurt, O. Banking stability and exchange rate movements: A panel data analysis for emerging markets.