

THE IMPACT OF FINANCIAL MARKET INSTABILITY ON THE REAL ECONOMY

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Abstract. This article examines the impact of instability in financial markets on the real economy. It analyzes the interconnection between financial markets and the real sector and explains how financial instability affects investment activity, production volumes, employment levels, and economic growth rates. Furthermore, the article assesses financial market instability as a factor that slows down economic activity and emphasizes the necessity of measures aimed at mitigating the negative consequences of such situations.

Keywords: financial markets, economic instability, real economy, investment activity, economic growth, credit conditions, capital flows.

Introduction. Financial markets are systems established in an economy for the buying, selling, and redistribution of money and capital resources. They serve as the main tools for attracting financial resources, managing risks, and promoting investment activities for real economy entities. Through financial markets, companies and the government mobilize funds to finance projects, expand production capacities, and develop service delivery, while investors direct capital to safe and efficient sources. Financial markets can be classified into several main types: money markets, capital markets, securities markets, foreign exchange markets, and derivatives markets. The money market deals with short-term financial resources (typically up to one year) and primarily ensures liquidity [1]. Key instruments of the money market include short-term government securities, interbank loans, and certificates of deposit. Long-term financial resources are traded in the capital market and are mainly used to finance production, infrastructure, and large-scale projects.

Literature review:

The securities market is a critical part of financial markets, enabling companies and government institutions to raise capital through stocks and bonds. Capital flow is facilitated through the primary market (issuance) and the secondary market (trading), providing liquidity for investors and a source of funding for companies. The foreign exchange market supports currency exchange and international trade operations, involving central banks, commercial banks, and export-import enterprises [2]. Additionally, financial markets support real sector activities through lending and insurance. Companies gain access to short-term and long-term credit via banks and microfinance institutions, which allows them to expand production and services. The insurance market helps mitigate risks, while the derivatives market, including futures and options, enables companies to hedge against financial risks.

The interconnection between financial markets and the real sector is realized through investor confidence, credit conditions, capital flows, and government financial policy. Stable financial markets enhance investor confidence, which in turn strengthens the attraction of capital to the real sector. Conversely, unstable financial markets can slow down economic activity and reduce investment activity.

The real economy encompasses economic activities within a country or region, including production, service provision, investment, and employment. The real sector utilizes production resources such as land, labor, capital, and technology to create goods and services [3]. From this perspective, the development of the real economy determines a country's overall economic potential and sustainable growth rates.

The real economy consists of two main components: the production sector and the services sector. The production sector includes industries such as manufacturing, construction, agriculture, and energy. Products created in these sectors are sold in domestic and international markets, increasing company revenues and creating employment opportunities. The services sector, on the other hand, covers areas such as transportation, healthcare, education, finance, tourism, and other service-oriented industries. This sector plays a crucial role in ensuring stability and improving living standards within the real economy [4]. The real economy is closely interconnected with the financial sector. Companies attract financial resources to expand production or implement new technologies, and this is carried out through financial markets: stocks, bonds, or bank loans provide capital to real economy entities. Conversely, the real sector supports financial markets through the sale of goods and services. For example, revenue generated from product sales is reflected in financial instruments, reinforcing capital circulation. The real economy also ensures employment growth and increased labor participation. The establishment of new companies or expansion of existing production capacities creates jobs and raises household incomes, which, in turn, stimulates consumption and investment activity. Thus, the real economy and financial markets maintain a mutually reinforcing relationship, shaping economic activity and stability.

The interconnection between financial markets and the real sector is one of the most important aspects of a modern economy. Financial markets are systems for buying, selling, and redistributing money and capital resources, playing a decisive role in financing production, services, and infrastructure projects. The real sector encompasses economic activities such as production, employment, service provision, and profit generation [5]. From this perspective, the mutual relationship between financial markets and the real sector is considered a fundamental factor for economic stability and growth.

Firstly, financial markets serve as a source of capital for the real sector. Companies and government institutions require capital to expand production, implement new technologies, construct facilities, or develop service provision. Financial markets provide the opportunity to raise this capital through stocks, bonds, and other securities. For instance, in the primary stock market, a company issues new shares to increase its capital, and investors purchase these shares, channeling funds into real economy projects. This process reduces companies' dependence on internal financial resources and enhances financial independence.

Secondly, financial markets enable risk management and efficient allocation of resources. Real sector entities often engage in long-term investments, which involve various economic and financial risks. Through capital markets, futures, options, and other financial instruments, companies can diversify these risks. For example, fluctuations in exchange rates may negatively affect exporting companies, but financial instruments allow them to minimize such risks. In this way, financial markets help ensure the stability of real sector activities.

Thirdly, financial markets create a link between investor confidence and economic activity. When markets are stable and transparent, investors perceive their resources as safe and direct capital to new projects. This facilitates the expansion of production capacities, creation of new jobs, and development of service provision. Conversely, in unstable markets, investors become cautious, leading to reduced real sector investments and slowing economic growth.

Fourthly, the connection between financial markets and the real sector is also manifested through lending. Commercial banks and other financial institutions provide companies with

short-term and long-term loans, supporting production financing. Favorable credit conditions stimulate real sector activities, whereas rising interest rates increase investment costs and reduce production rates. Therefore, the continuous flow and stability of resources through financial markets play a decisive role in real sector development.

Fifthly, the link between financial markets and the real sector is strengthened by government financial policy. Tax incentives, subsidies, and grants provided by the state serve as additional financial resources for companies. Moreover, government policies aimed at maintaining market stability and enhancing investor confidence—such as controlling inflation and interest rates, promoting lending, and supporting real sector projects through financial instruments—reinforce the connection between the real economy and financial markets.

The impact of financial instability on the real economy

Table 1.

Financial instability factor	Impact	Effect on the Real Sector and Economy	Example
Fluctuations in capital flows	Reduced or unstable availability of financial resources	Decreased investment activity; lower production volumes; slowed economic growth	Reduction in foreign investments; companies unable to finance new projects
Deterioration of credit conditions	Banks limit lending; interest rates increase	Delayed or reduced investment and production projects; lower employment levels	Commercial banks reduce short- and long-term loans; businesses face financing constraints
Decline in investor confidence	Investors shift to safer assets; avoid risky projects	Reduced investment in the real sector; slower creation of new jobs	Falling stock market prices; investors prefer government bonds or low-risk instruments
Volatility of market prices	Rapid changes in asset values	Affects company balance sheets and profits; delays investment decisions	Affects company balance sheets and profits; delays investment decisions
Rising interest rates	Rising interest rates	Higher investment costs for companies; reduced production growth	Banks raise lending rates; companies face higher financing expenses

Source: Author's work

The stability of financial markets and investor confidence are essential conditions for economic development. Factors of financial instability, such as fluctuations in capital flows, deterioration of credit conditions, and declining investor confidence, have a significant impact on real sector activities. Therefore, understanding these processes in detail is crucial for formulating economic policies and ensuring financial stability (Table 1).

Fluctuations in capital flows. Capital flows refer to the movement of financial resources into and out of the economy, both domestically and internationally. They provide financing for investment and production projects. Sharp changes in capital flows, such as a reduction in foreign investments or restrictions on domestic capital, can prevent companies from meeting their financial resource needs [6]. As a result, new production projects may not be implemented,

production volumes decline, and economic growth rates slow down. International experience shows that in both developed and developing countries, the continuity of capital flows is directly linked to investment activity and the stability of production.

Deterioration of credit conditions. During periods of financial instability, banks and other financial institutions become more cautious in lending. A sharp increase in interest rates or strict restrictions on credit availability limits companies' financial capabilities. For example, the inability of small and medium-sized enterprises to obtain short-term loans restricts production expansion and the creation of new jobs. Moreover, companies and investors may be unable to finance long-term projects, which reduces overall economic activity. When credit conditions worsen, production and investment decisions weaken significantly, undermining economic stability.

Decline in investor confidence. The stability of financial markets directly influences investor decisions. In unstable markets, investors become cautious and direct their resources toward safer, lower-yield projects. This leads to a reduction in capital allocation to real sector projects. A decline in investor confidence weakens the interconnection between the financial and real sectors, reduces production volumes, limits job creation, and slows economic growth.

When these factors operate together, they have a significant negative impact on economic processes. Sharp fluctuations in capital flows, tightened credit conditions, and declining investor confidence weaken real sector activities, reduce production volumes, and lower employment levels [7]. As a result, economic growth slows down, and the country moves further away from financial and economic stability. Therefore, maintaining stable capital flows, easing credit conditions, and strengthening investor confidence are among the top priorities of financial policy.

Conclusion. In conclusion, financial market instability has a significant impact on the real economy. Fluctuations in capital flows, the deterioration of credit conditions, and a decline in investor confidence lead to reduced investment activity, slowed production, decreased employment levels, and slower economic growth. Moreover, the close interconnection between financial markets and the real sector amplifies these effects: when financial instability constrains the real sector, production and service activities are hindered, and economic stability weakens. Therefore, ensuring financial market stability, improving credit conditions, and strengthening investor confidence are among the key priorities of state financial policy, playing a decisive role in maintaining the effective and stable functioning of the real economy.

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