

# **ASIAN DEVELOPMENT BANK**

## **PRIVATE SECTOR ASSESSMENT**

**FOR**

**UZBEKISTAN**

**September 2005**

This Private Sector Assessment was prepared by Cyril Lin, IFG Development Initiatives Ltd., and Jurgen Conrad, Asian Development Bank (ADB). The views expressed in this paper are those of the authors and do not necessarily reflect the views and policies of ADB, or its Board of Directors, or the governments they represent. ADB does not guarantee the accuracy of the data included in this paper and accepts no responsibility for any consequence of their use.

## CURRENCY EQUIVALENTS

(as of 30 June 2005)

Currency Unit	–	sum (SUM)
SUM1.00	=	\$0.0009
\$1.00	=	SUM1,113

## ABBREVIATIONS

ADB	–	Asian Development Bank
CBU	–	Central Bank of Uzbekistan
CDCD	–	State Committee on Demonopolization and Competition Development
CIS	–	Commonwealth of Independent States
CPI	–	consumer price index
CSP	–	country strategy and program
EBRD	–	European Bank for Reconstruction and Development
FDI	–	foreign direct investment
FSU	–	former Soviet Union
GDP	–	gross domestic product
GKI	–	State Committee for State Property Management and Entrepreneurship Support (Goskomimushchestvo)
IFC	–	International Finance Corporation
IMF	–	International Monetary Fund
JSC	–	joint stock company
NBU	–	National Bank of Uzbekistan for Foreign Economic Activities
OTC	–	over-the-counter
PRC	–	People's Republic of China
PSD	–	private sector development
RSE	–	Republican Stock Exchange
SJSC	–	state joint stock company
SME	–	small and medium-sized enterprise
SOE	–	state-owned enterprise
TA	–	technical assistance
VAT	–	value-added tax
WTO	–	World Trade Organization

## NOTES

- (i) The fiscal year of the Government ends on 31 December.
- (ii) In this report, "\$" refers to US dollars.

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## EXECUTIVE SUMMARY

### Policy and Institutional Environment for Private Sector Development in Uzbekistan

Uzbekistan is among the Central Asian countries with the most economic potential. However, since gaining independence in 1991, Uzbekistan's record in realizing this potential has been mixed. Gains in macroeconomic stability achieved immediately after independence were eroded in the late 1990s and early 2000s. Despite huge investments, economic imbalances worsened, exports contracted, and real growth of gross domestic product (GDP) slowed. Incomes and living standards have improved little since the early 1990s. With per capita GDP of \$370 in 2003, Uzbekistan was one of the poorest countries in the Commonwealth of Independent States (CIS). Growth has been extensive, based on large increases in inputs, rather than intensive, based on increases in productivity. Uzbekistan, initially one of the best economic performers in Central Asia and the CIS, is in danger of becoming a laggard.

Policy and systemic weaknesses have created inefficiencies that have weakened Uzbekistan's economic performance. In particular, industrial policy and the related economic implementation mechanism have constrained private sector development (PSD), undermining robust and sustainable growth. Since 2001, policy and institutional reforms have begun to improve macroeconomic conditions. In 2004, GDP expanded by 7.5% and exports grew by 30%, according to official figures. However, deeper reforms are needed to sustain growth.

Uzbekistan's industrial policy, which is based on import substitution, has a number of weaknesses. First, the range of sectors and products promoted and protected is extensive. Second, protection is enforced through a wide array of exchange and trade controls, which have increasingly closed Uzbekistan's economy since 1997. Moreover, these controls have driven many economic activities underground, contributing to capital flight and a decline in foreign direct investment. Although the Government has achieved some of its self-sufficiency and indigenous industrial development targets, the disadvantages of such a strategy in terms of high cost and lost opportunities are evident in sluggish industrial and GDP growth. Some of the new industries promoted by the Government have ceased operations, while the capacity utilization at many others is low. Industry's contribution to GDP growth has been inordinately small. Despite an aggressive and ambitious industrial policy, Uzbekistan has undergone deindustrialization since 1993—with industry's share of GDP declining from 26.6% in 1992 to 15% in 2003.

Despite some progress with market reforms, Uzbekistan continues to rely heavily on direct administrative methods of economic control and intervention, designed primarily to implement the industrial policy. The economic mechanism is basically supply-driven. The state's supply side controls on resource allocation and real sector output, rather than market demand, determine the direction and pace of economic development. Further, Uzbekistan has organized and managed industry through industrial associations, which impair competition and economic efficiency. The result is a discriminatory and segmented market with onerous regulatory requirements, bureaucratic red tape, and preferential access to inputs and distribution channels by members of industrial associations.

The types and scope of the mainly administrative methods and institutional arrangements used to enforce industrial policy are detrimental to PSD, competitive markets, and economic efficiency. The private sector in Uzbekistan, whether by design or default, performs a secondary or supplementary role to the state-controlled sector and the centrally determined economic plans. The private sector basically operates on the periphery of the economy.

Uzbekistan's economic potential will remain underexploited as long as the dynamism of the private sector is suppressed and excluded from the industrialization and modernization processes. As such, a major challenge for Uzbekistan is to unshackle PSD.

### **Profile and Development Dynamics of the Private Sector**

Important progress was made in privatization during 1991–1997, when almost all small enterprises were privatized and the privatization of medium enterprises began. Since 1997, however, privatization has slowed markedly. The state still owns or controls most key medium and large industrial enterprises. The same is true for many sectors considered strategic to the national economy, including cotton processing, energy, telecommunications, and mining.

The non-state share of GDP was 74.5% in 2003, while the private sector accounted for 42.3%, according to official statistics. However, a large part of what is officially reported as the non-state sector comprises enterprises in which the state holds a majority or retains control. The state's opaque mutual holdings and cross-holdings in enterprises leads to further underestimation of the size of the state sector. The little information available indicates a high degree of industrial concentration in Uzbekistan, with large enterprises accounting for 66% of GDP and 47% of employment in 2001. Small and medium enterprises (SME) accounted for only 15% of GDP and 9% of employment. Official data indicate that almost all large enterprises are state-owned or state-controlled. While formal employment in industry and agriculture has fallen, an increase in employment in the informal sector has partially offset this decline. The large and growing number of individual enterprises betrays the increasing informal nature of the economy as an unfavorable business environment drives enterprises out of the formal sector.

Agriculture in Uzbekistan has two important characteristics. First, the state owns the land and grants farmers only a time-bound right to use land, not full property rights. Second, the state heavily regulates the scale and types of activities, including controlling the amount of land that can be devoted to particular crops. These features suggest that (i) private operators, who are not private owners, undertake much of the agricultural production; and (ii) extensive state controls hamper private initiatives. The state's monopoly on the provision of critical inputs also hinders private enterprise in agriculture. Further, despite the relaxation of procurement controls since 2002, the state's powers in the procurement of important food and cash crops, and in controlling prices and quantities, also constrains the private sector.

SMEs have grown significantly since Uzbekistan's transition began. However, growth in small and microenterprises has accounted for most of the recent expansion, while medium-sized enterprises have declined. Overall, SMEs constitute a thin layer of the economy between the large enterprises and the substantial informal sector. In 2003, SMEs (including microenterprises) and individual entrepreneurs together accounted for 35.5% of GDP. Excluding individual entrepreneurs, SMEs' share of GDP was 16.4%. Industrial SMEs are conspicuously underdeveloped, with their share of industrial output and GDP at 17.0% and 2.5%, respectively. SMEs' share of exports (7.3% in 2003) is also very small. Employment generation by SMEs has been disappointing. Privately owned SMEs accounted for only 34% of SME industrial output and 32% of SME exports. As these numbers demonstrate that the state is dominant even in SME manufacturing. Private sector industrial SMEs account for only 5.6% of industrial output.

### **Factors Impacting Private Sector Development**

Uzbekistan made significant progress in macroeconomic stabilization in 1991–1996. Subsequently, the Government's industrial policy and the reliance on administrative means to

implement the policy increased macroeconomic imbalances. The Government's investment program has been financed largely through external borrowing, because domestic funds have been insufficient. Since the first half of 2000, the authorities have adopted tighter macroeconomic policies, including measures aimed at (i) liberalizing the currency system, (ii) reforming agriculture, (iii) broadening banking sector reforms, and (iv) unifying exchange rates. Current account convertibility was officially introduced in October 2003. However, new Government interventions, particularly in foreign trade, have hampered a positive response of enterprises to the reforms. Inflation has continued to fall. Consumer prices, according to official sources, rose 10.3% in 2003, significantly slower than the 1,600% in 1994 and 72% in 1997. However, international financial institutions have argued that inflation, as measured by the GDP deflator and the producer price index, remains high at around 45%.

Uzbekistan's industrial policy involves the organization and management of enterprises in most industries through industrial associations and state-owned joint stock companies (SJSC). This form of industrial organization and management facilitates direct and indirect state intervention. However, it undermines the creation of a dynamic and competitive corporate sector, as well as the development of the private sector. Industrial associations and SJSCs have three logically distinct (although functionally related) defects. First, their large size and market power hamper competition. Second, their internal organizational and decision-making structures militate against effective corporate governance of the associations (and SJSCs) and of their member enterprises. Third, the extent and modalities of state ownership and control give the Government disproportionately large control and governance powers relative to its shareholding.

Since 1999, the Government has adopted measures to encourage SMEs and PSD. However, the adequacy and effectiveness of these measures have been undermined by problems of coherence and commitment. Measures related to PSD do not constitute a coherent strategy or vision for the role of the private sector in the national economy. Further, the measures often are not implemented fully or at all, raising questions about the Government's commitment and credibility.

The country's financial markets are underdeveloped with financial services outside banking very rudimentary. The level of financial intermediation outside state-sponsored lending schemes is low. Household deposits totaled about 2.5% of GDP at the end of 2004. The state is extensively involved in the banking sector, which is highly concentrated. Seven state-owned or state-controlled banks accounted for an estimated 90–95% of the sector's total assets in 2003–2004. Four of these banks alone accounted for 67% of total banking sector assets at the end of 2004. Financial services outside the banking system are very underdeveloped. Only six companies are listed at the stock exchange, and institutional investors are largely absent.

The predominance of the Government's nonmarket mechanisms of economic management can largely explain the underdevelopment of Uzbekistan's financial markets. The Government uses these nonmarket mechanisms to direct financial resources, partly through banks, to priority sectors and enterprises in line with its industrial policy. Given their role in financial intermediation, industrial associations also might have crowded out or impeded the development of financial markets and the private sector. Further, banks still act as agents of the Government in enforcing monetary and fiscal policy by (i) controlling cash supply and liquidity, (ii) monitoring financial transactions, and (iii) automatically deducting outstanding taxes from depositors on behalf of the tax authorities. Overall, financial sector reforms have been very gradual. Despite significant technical assistance from development partners, the partial

privatization of the National Bank of Uzbekistan (NBU) and Asaka Bank, scheduled for completion by 2003, still are pending.

Two broad sets of issues need to be addressed in reforming the banking sector. First, the banking sector's soundness must be improved to reduce systemic risk and fragility. Second, the efficiency of the banking sector needs to be enhanced through greater reliance on market forces, commercialization, competition, diversification, and private sector participation.

Government policies have induced the most significant impediments to the development of the country's foreign trade and investment. The Government has imposed a broad range of foreign exchange and trade controls to protect infant industries. These controls are designed to support the industrial and import substitution strategy and to conserve foreign exchange. Extensive administrative restrictions, aimed at curbing shuttle (cross-border) trade, also are in place. This restrictive trade regime has impeded private sector involvement in foreign trade. Per capita FDI in Uzbekistan at \$3 is one of the lowest among CIS countries. A significant number of foreign investors have left Uzbekistan due to the deteriorating business environment.

In a 2003 survey of SMEs, the International Finance Corporation in Uzbekistan identified some of the major negative factors hindering the operations of enterprises. These included (i) administrative procedures (i.e., bureaucratic red tape), (ii) currency conversion, (iii) access to finance, (iv) taxation, (v) import and export restrictions, and (vi) heavy and aggressive taxes. Uzbekistan has one of the highest taxes-to-GDP ratios within the CIS. Corruption is also a serious problem, as in other CIS countries. Uzbekistan has made significant progress in establishing a legal and regulatory framework for businesses, though serious weaknesses remain in enforcement. The corpus of commercial laws is still limited in scope. The company law does not establish adequate corporate governance norms. Legal issues also impede investments. A state committee has been established as the antimonopoly agency. However, this agency does not understand adequately basic concepts of competition. It focuses excessively on price controls as a competition policy instrument, an unsurprising by-product of the industrial organization and management system.

### **Asian Development Bank's Private Sector Interventions in Uzbekistan**

Asian Development Bank (ADB) views PSD as an effective means to achieve its overarching objective of poverty reduction. ADB's support for PSD in Uzbekistan has focused on

- (i) developing institutions and strengthening the policy, legal, and regulatory framework for rural and microfinance; assisting farm and agribusiness privatization; and providing financial support for microenterprises and SMEs;
- (ii) supporting legal and regulatory reforms, as well as capacity building, in other areas of the financial sector, including insurance, banking, and securities markets;
- (iii) strengthening the policy, legal, and regulatory framework, and supporting capacity building, for corporate governance reforms, enterprise restructuring, competition policy, and foreign direct investment; and
- (iv) facilitating private sector participation in infrastructure and services.

ADB's assistance for PSD in Uzbekistan has included six public sector loans and a large number of grant financed technical assistance projects.

## Options for Future Private Sector Development Initiatives

The Government and its development partners have launched various initiatives to address the wide-ranging impediments to PSD. Additional initiatives to strengthen the enabling environment for PSD in agriculture could be considered. The most powerful stimulus to agricultural growth, as well as SME and rural PSD, would be to grant property rights to farmers, and to eliminate or reduce state controls over the scale and type of farm activities. In foreign trade, an initiative to encourage the acceleration of Uzbekistan's accession to the World Trade Organization might be useful. This would provide the policy discipline and time line for liberalizing markets and significantly reducing state intervention in the economy.

This report proposes four specific areas for ADB support:

- (i) **Market-Based Macroeconomic Management.** Development of markets and the private sector should be predicated on building the capacity and confidence of the Government to achieve its developmental and industrial policy objectives more effectively through market-based methods of macroeconomic management; and to abandon the direct administrative methods of control that are detrimental to efficiency and PSD.
- (ii) **Pilot Reform of One Industrial Association.** An integrated, comprehensive, and simultaneous reform of one industrial association, which represents the bulk of the light industry, should be undertaken. Instead of offering piecemeal reforms, the pilot reform would cover in a single package ownership, corporate governance, restructuring, competition, reliance on market mechanisms, resource allocation, trade liberalization, and SME and PSD.
- (iii) **Banking Sector Development.** The proposed initiative aims to accelerate the partial privatization and unbundling of NBU, Uzbekistan's largest commercial bank. Reforming this bank would be tantamount to reforming much of the commercial banking sector in the country. Policy lending should be removed and placed under a new development bank that could undertake public-private cofinancing in infrastructure development. The proposed initiative also would address the possibility of heightened competition due to the unbundling of NBU.
- (iv) **Performance of State-Owned Enterprises.** The proposal is premised on the fact that the Government intends to retain a sizeable state sector in the foreseeable future. The report recommends measures for improving the performance of state-owned enterprises, including better state asset management, corporate governance, commercialization, reliance on market mechanisms, and divestiture.

These proposed initiatives have been configured to be consistent with existing Government policies and announced measures. For coherence and synergy, they are subsumed within a reform framework aimed at establishing an efficient, internationally competitive, and market-based corporate sector. The emphasis is on improving the quality of the existing private sector, and the policy and institutional environment within which the private sector operates, rather than increasing the number of private firms.

## I. INTRODUCTION

1. The Asian Development Bank (ADB) undertook this study with the expectation the results would be incorporated into the country strategy and program (CSP) for Uzbekistan. Similar studies have been and will be conducted as part of CSP preparation for other developing member countries. This study aims to provide an assessment of the status of private sector development (PSD) in Uzbekistan, and identify the main constraints and priority areas for reforms. The study also suggests areas and actions for further development cooperation.

2. The private sector is widely recognized to be critical to Uzbekistan's economic development. However, little detailed and reliable information on the country's private sector is available. As a result, reconciling the often-divergent private sector assessments and recommendations of various stakeholders is difficult. This private sector assessment study attempts to start filling in the knowledge gaps about Uzbekistan's private sector by gathering and compiling as much relevant information as possible in Part II.

3. However, the main thrust of this study is the analysis and evaluation of the most important PSD trends and issues in Uzbekistan. PSD issues and options must be evaluated in the context of a country's overall policy and institutional environment. Since gaining independence from the former Soviet Union (FSU) in 1991, Uzbekistan has pursued a gradual approach to economic reforms. This has produced an economic system that differs in a multitude of policies and institutional arrangements from those established in most of its neighboring countries since the transition began. The Uzbek economic system is a regulated market economy that combines features of a centrally planned economy with elements of a market economy. This study acknowledges these systemic differences. Part III outlines the systemic framework for the private sector in Uzbekistan, while Part IV presents the specific PSD constraints within an economic system that is still largely state-controlled. A brief description of ADB's previous PSD interventions in Uzbekistan is in Part V. Part VI proposes approaches to PSD that are tailored to the peculiarities of the Uzbek economic system.

4. Given the peculiarities of the Uzbek economic system, a private sector assessment for Uzbekistan must differ substantially—in its analytical approach, presentation of factual evidence, and conclusions—from similar studies on other transition economies in which the dominance of the market already has been firmly established.

5. Work on this study began in 2004. In early 2005, a draft assessment was provided to the Government and other stakeholders to solicit comments. Subsequently, the assessment was revised to take into account written comments and additional data provided by stakeholders, including Government and private sector organizations. The study also incorporated oral comments by participants at two workshop presentations of the assessment, which were held in Tashkent in March and April 2005.

6. Discussions with numerous Government officials, representatives of domestic and foreign enterprises and businesses, and representatives of other development partners of Uzbekistan benefited this report greatly. ADB's Uzbekistan Resident Mission also provided valuable assistance. However, the views expressed in this report, as well as any errors, are the authors' and do not necessarily reflect those of the people or organizations that met and discussed with the authors.

## II. POLICY AND INSTITUTIONAL ENVIRONMENT OF PRIVATE SECTOR DEVELOPMENT

### A. Economic Performance and Transition

7. Uzbekistan is among the Central Asian countries with the most economic potential. It occupies a strategic position in Central Asia at the heart of the Eurasian land mass. Although Uzbekistan is double landlocked,<sup>1</sup> which poses transport difficulties in international trade, the country inherited from the Soviet period the best infrastructure in Central Asia. It has a relatively developed rail and road infrastructure, which has made Uzbekistan a vital regional hub. With a population of 26 million, the biggest in Central Asia, the country has significant human potential. The large size of its domestic market also affords opportunities for achieving economies of scale in the production of goods in which the country has a comparative advantage. Uzbekistan has sizeable domestic energy resources. During the Soviet period, its economy was geared mainly towards the production of raw materials and primary goods with relatively little heavy industrial production. As a result, the collapse of the FSU had fewer adverse impacts in Uzbekistan than in other countries of the Commonwealth of Independent States (CIS) with more developed heavy industry infrastructure that depended on the FSU's industrial system. Thus, the decline in output in 1991–1995 was shallower in Uzbekistan than in any other CIS country, with industrial output falling only 28%. The task of restructuring Uzbekistan's relatively underdeveloped heavy and manufacturing industries also was comparatively lighter.

8. Uzbekistan's record in realizing its economic potential since independence has been mixed. At independence, the country was one of the poorest in the CIS—and remains one of the poorest today. It depends heavily on raw materials production, such as gold, natural gas, and cotton; and on imports of food and manufactured goods. The collapse of the FSU led to serious economic dislocation as inter-industrial trade and transport links were disrupted. The output of 32 of 39 key industrial goods fell more than 55% during the recession in 1991–1995. Few off-farm jobs were available in rural areas, where poverty was extensive. Uzbekistan initially met the challenges of transition more successfully than most other CIS countries. It mitigated the transformational recession and output collapse, and began an economic recovery. The country achieved self-sufficiency in energy by 1995 and in wheat by 1998. Wheat production increased from less than 1 million tons after independence to a record 5.4 million tons in 2002, reducing wheat imports from 3.8 million tons to a negligible amount. A nearly threefold increase in crude oil production between 1991 and 1995 enabled Uzbekistan to eliminate petroleum imports, which had been \$475 million in 1992, by 1996. Uzbekistan also avoided the massive drop in living standards experienced by many other CIS countries. Its poverty rate of 27.5% (based on 2001 survey data)<sup>2</sup> was lower than in most other Central Asian countries. Uzbekistan's explicit and comparatively successful policy of ensuring that the basic needs (food, shelter, health, and education) of the population were satisfied despite the collapse of the FSU has been a notable achievement.

9. In 1996, Uzbekistan became the first CIS country to return to positive real growth, according to official statistics. Five years later, it also was the first to recover its 1991 pre-independence levels of output. Official statistics show that Uzbekistan's real growth of gross domestic product (GDP) averaged about 4% in 1996–2003, with industry expanding by 6.1% and agriculture by 5%. GDP growth was 4.2% in 2002 and 4.4% in 2003 (Table 1). Given

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<sup>1</sup> A country is double-landlocked if neither the country nor its immediate neighbors have direct access to a seaport.

<sup>2</sup> International Monetary Fund (IMF). 2005. *Republic of Uzbekistan: Interim Poverty Reduction Strategy Paper*. Washington.

population growth of about 1.5%, real per capita GDP has grown by an annual average of about 2.5% since 1996.

**Table 1: Growth Rate and Structure of GDP, 1995–2003**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Index, 1991 GDP = 100	81.6	83.0	87.3	91.1	95.0	98.6	102.7	107.0	111.7
GDP Growth, %	(0.9)	1.7	5.2	4.3	4.3	3.8	4.2	4.2	4.4
Industrial Growth, %	0.1	2.6	4.1	3.6	6.1	5.9	7.6	8.3	6.2
GDP Structure, %	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Industry, %	17.1	17.8	15.6	14.9	14.3	14.2	14.2	14.5	15.0
Agriculture, %	28.1	22.4	28.3	26.8	29.0	30.1	30.2	30.1	28.8
Construction, %	7.1	8.2	7.3	7.5	6.7	6.0	5.9	4.9	4.5
Services, %	34.6	37.2	36.4	36.4	36.6	37.2	37.3	38.4	38.3
Net taxes, %	13.1	14.4	12.4	14.4	13.4	12.5	12.4	12.1	13.4

GDP = gross domestic product.

Source: Centre for Effective Economic Policy.

10. However, the International Monetary Fund (IMF), which uses a higher inflation rate, estimated annual real growth in 1996–2001 at about two thirds of the official rate. Regardless of the exchange rate used, these estimates show that GDP in dollar terms was significantly lower in 2001 than in 1996. The IMF has estimated real GDP growth in 2003 to be around 1.5%, compared with an official figure of 4.4%. Many observers believe that the informal sector accounts for as much as 30–50% of the official reported GDP. Latest official data show that GDP grew 7.5% in 2004.

11. Even if actual real growth rates are in doubt, Uzbekistan has a number of important economic achievements since independence. However, these achievements are largely due to a costly transition strategy and institutional arrangements that are economically inefficient and, therefore, unsustainable in the long term. Further, the country's performance clearly has weakened since the late 1990s. Growth has been extensive, sourced mainly through growth of inputs, rather than intensive, based on increases in productivity and economic efficiency.

12. A state-engineered rise in domestic demand, through significant increases in state-directed investments, accounted for the positive GDP growth that resumed in 1996. The growth rate of investments in fixed capital accelerated sharply—from 2% in 1995 to 7% in 1996, 17% in 1997, and 15% in 1998—before declining dramatically to low single digits from 1999 onwards (Table 2). The annual rate of investment growth averaged nearly 7% in 1995–2003, yielding a cumulative increase of 70% over this period. Real GDP increased cumulatively by only 36.9% in this period. Despite receiving about 41% of fixed capital investment in 2002–2003,<sup>3</sup> the state sector's share of GDP has fallen continually and was only 25.5% in 2003, according to official statistics. As such, the efficiency of investments in the state sector is low.

13. Uzbekistan has also failed to develop its export potential. The resumption of positive growth in 1996 coincided with a dramatic fall in external demand. Export growth fell from nearly 25% in 1996 to about –5% in 1997 and about –20% in 1998. Except for near zero growth in 2000, export growth stayed negative until 2003. Exports grew by 30% in 2004, yielding a trade surplus of \$1 billion and a 30% increase in gold and foreign currency reserves. Stronger external demand and higher international commodity prices fueled the growth in exports.

<sup>3</sup> Centre for Effective Economic Policy (CEEP). 2003. *Uzbekistan Economy: Statistical and Analytical Review – Annual Issue 2002*.

**Table 2: Growth and Sector Distribution of Fixed Capital Investments, 1995–2003**  
(%)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Growth of Investments (in current prices)	2.0	7.0	17.0	15.0	2.0	1.0	3.7	3.8	4.5
Total Investment	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
State Sector	55.1	69.9	67.6	61.1	63.2	63.8	47.0	40.9	40.4
Non-State Sector	44.9	30.1	32.4	38.9	36.8	36.2	53.0	59.1	59.6
Total Investment	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Productive	68.1	67.1	64.5	85.9	57.5	57.5	63.1	57.1	65.1
Industry	45.1	37.9	31.7	28.8	32.6	29.7	38.9	32.4	28.4
Agriculture	8.4	5.9	6.7	6.0	8.2	5.7	5.5	5.8	4.4
Construction	0.5	0.7	0.6	0.4	0.3	0.5	0.6	0.4	0.6
Transport and Communication	7.5	17.7	21.0	19.6	13.0	16.7	14.0	10.0	21.7
Other	0.9	0.8	1.6	0.8	0.3	0.6	2.6	5.9	6.8
Nonproductive	31.9	32.3	35.5	41.1	42.5	42.5	36.9	42.9	34.9

Source: Centre for Effective Economic Policy.

14. Uzbekistan's economy, initially one of the best performers in Central Asia and the CIS, is in danger of becoming a laggard. In recent years, the growth rates of other Central Asian economies have begun to exceed Uzbekistan's.<sup>4</sup> The Uzbek economy grew by less than 20% in real terms in 1998–2002. Exports have contracted, and the diversification away from raw material exports has been insufficient. As macroeconomic imbalances grew in the late 1990s, important gains in economic stability made immediately after independence were eroded. Incomes and living standards have improved little since the early 1990s. With per capita GDP of \$370 in 2003 at the official exchange rate, Uzbekistan is one of poorest countries in the CIS.<sup>5</sup> Uzbek per capita GDP in dollar terms has fallen more than 40% since 1998, while Kazakhstan, the Russian Federation, and a number of other CIS countries have shown large increases. Uzbek workers are paid some of the lowest wages in the CIS at around \$40 per month, compared to \$120 in Kazakhstan and \$55 in the Kyrgyz Republic.<sup>6</sup> Although official statistics showed an unemployment rate of 0.6% in 2001, widespread evidence exists of significant underemployment and disguised unemployment. Over the past 5 years, employment growth has been mainly in the public sector, and in the individual and informal sectors. Formal employment in other sectors has fallen.

15. The underperformance of the Uzbek economy may be attributed to inefficiencies in allocating resources, and an unsustainable pattern of extensive growth. This is evident from a relatively low and constant GDP growth rate of about 4% since 1998, despite a high rate of investment. Given the rising capital and material intensity intrinsic to industrialization, the economy will need to accelerate its rate of investment or raise economic efficiency to maintain a constant rate of GDP growth and prevent a deceleration. However, Uzbekistan has a paucity of

<sup>4</sup> Although Armenia, Belarus, and Kazakhstan are the only other CIS countries to have recovered to pre-independence levels of output, though at a later date (in 2003), their output collapse was far more severe than Uzbekistan's. Their recent growth rates have been higher, as have been those of Azerbaijan, Tajikistan, and Turkmenistan.

<sup>5</sup> In terms of purchasing power parity, Uzbekistan's per capita GDP in 1999 was around \$2,700, above the Kyrgyz Republic's and Tajikistan's, but still one of the lowest in the CIS.

<sup>6</sup> European Bank for Reconstruction and Development. 2003. *Strategy for Uzbekistan*. London.

domestic investment resources, a low domestic savings rate, and limited scope for fiscal revenue growth. Heavy foreign borrowing to finance state-guaranteed lending to priority sectors has increased macroeconomic imbalances, and had to be reduced significantly. Government resources for its public investment program and social spending have been diminished considerably.

16. Two key components of Uzbekistan's transition strategy are the main causes of these economic inefficiencies: (i) the industrial policy, and (ii) the economic mechanism tailored to implement it. Both impede PSD and sustainable growth in the long term.

## **B. Industrial Policy**

17. The core of Uzbekistan's development strategy is an industrial policy aimed at establishing a more modern and diversified industrial economy that is less dependent on agriculture and natural resources. While this objective is entirely rational, industrial policy has been based on an import-substitution strategy designed to achieve self-sufficiency and eventually export growth in a wide variety of agricultural and industrial products selected by the Government. The "infant industries" to be protected and nurtured include food, cotton, oil, gas, automobiles, machine building, and electronic consumer goods. Protection through an extensive array of exchange and trade controls has increasingly closed Uzbekistan's economy since 1997. Exchange rate misalignments and restrictive controls have (i) stifled exports and economic growth, (ii) driven many economic activities underground, and (iii) contributed to capital flight and declining foreign direct investment (FDI). In addition, large public investment in targeted sectors, as part of the Government's industrial policy, led to an expansionary fiscal strategy that undermined macroeconomic stability.

18. From 1996 to 2003, industry accounted for an average of 34% of total investment in the national economy (or an annual average of 11% of GDP). The state dictated half of this investment. This ambitious investment program was focused on heavy machinery, fuel, gas, and chemical industries, as well as on selected enterprises that were part of the Government's industrial development program. State-directed investment was supported by the allocation of foreign exchange at a subsidized rate. In 2000–2001, an estimated \$1.1 billion—or 85% of all convertible currency allocated for imports of intermediate and investment goods—went to industry. Half of that investment went to machine building industries. To support priority industries, direct and indirect subsidies were used, including artificially low exchange rates, low energy prices, bread and other food items, and negative real interest rates on loans. In 2001, subsidies totaled an estimated 60% of GDP.

19. Although the Government achieved some of its self-sufficiency and indigenous industrial development targets, the high costs of the strategy and the lost opportunities it implied resulted in sluggish industrial and GDP growth rates. Gas and nonferrous metallurgy (mainly copper and gold), and to a lesser extent food processing, led industrial growth. Together, they accounted for more than half of industrial growth between 1996 and 2001. Production in subsectors such as oil, gas, automobiles, and electronic consumer goods was initiated or increased significantly. Some new industries were promoted in consumer goods (cars, TVs, VCRs, etc.), as well as in intermediate inputs (e.g., polyethylene). Technological modernization of some capital goods, such as agricultural machinery, was undertaken. The production of oil and gas was accelerated. As these industries came on stream, and the production of hydrocarbons simultaneously increased, they partially offset the severe decline in the output of old inherited industries. Output from many of these inherited industries had more than halved by 1995. Since 1996, however,

the output of 24 of the 39 key industrial goods declined by about 50%, while the output of the remaining 15 goods increased by 37% on average.

20. The experience of many of the new industries promoted under the Government's industrial policy has been mixed. Some have ceased operations, while the capacity utilization in many others is low. Automobile and agricultural machinery production, in particular, have significant idle capacity (80% and 70% capacity underutilization, respectively<sup>7</sup>). Television and VCR production virtually ceased by 2001 (Table 3).

**Table 3: Production of Selected Industrial Goods, 1997–2000**  
(units '000)

	1997	1998	1999	2000
Tractors	2.8	2.6	1.7	1.0
Cotton Harvesters	1.0	0.4	0.3	0.3
Cars	65.0	54.0	59.0	31.0
VCRs	141.0	50.0	7.0	0.0
TVs	268.0	191.0	45.0	28.0

Source: Kitain, A. 2003. *Uzbekistan: Creating an Environment for Enterprise Development*. Washington, DC: World Bank.

21. Uzbekistan's relatively low-cost domestic energy sources have been utilized inefficiently. The country has abundant coal and gas resources, as well as significant crude oil reserves and limited hydropower capacity. However, energy prices are below cost recovery levels as they serve as a subsidy to industry and the economy. As a result, cash flows of energy companies are low. Many cannot fully service the substantial foreign debts they accumulated over the past decade to finance investment aimed at making Uzbekistan self sufficient in energy. Moreover, production the oil and gas sectors has stagnated in recent years due to the lack of investment. The new Bukhara and modernized Fergana oil refineries are among the facilities operating well below capacity.

22. Despite receiving the lion's share of investments, industry has grown sluggishly at an average annual rate of about 5%.<sup>8</sup> Thus, the Government's attempt to engineer industrial-led growth of the national economy has not succeeded. Industry's contribution to GDP growth has been inordinately small. In 2000–2002, industry contributed less than 20% to the growth of real GDP. It accounted for only 0.15% of the GDP growth (3.8% overall) in 2000, and for only 0.4% of the GDP growth (4.4%) in 2003. Services, construction, and agriculture have accounted for more than 80% of the GDP growth since 1996. Despite huge investments in industry, Uzbekistan has undergone de-industrialization. The share of industry in GDP fell from 26.6% in 1992 to 22.4% in 1993 and to 17%<sup>9</sup> in 1994; and declined further from 17.1% in 1995 to 14.2% in 2000–2001, before rebounding slightly to 15% in 2003 (Table 1). The dislocations and transformational recession that followed the collapse of the FSU might explain the declining share of industry in GDP during 1992–1995. However, even when positive GDP growth had resumed, the share continued to fall after 1996 despite the Government's ambitious and aggressive industrial policy that included heavy investments in industry. In other words, the

<sup>7</sup> Kitain, A. 2003. *Uzbekistan: Creating an Environment for Enterprise Development*. Washington, DC: World Bank.

<sup>8</sup> The reliability and consistency of Uzbek industrial statistics is questionable. One issue concerns the number and scope of the subsectors covered. A number of foreign and domestic observers have suggested, for example, that some activities belonging to construction are included under industrial output statistics in some years to give a higher annual growth rate, and excluded in other years. This has not been verified by this study. However, the growth rates reported by some international financial institutions often differ from the official figures.

<sup>9</sup> EBRD. 1997. *Transition Report*. London.

decline in the share of industry in GDP for a decade suggests a secular trend, raising serious questions about the effectiveness and wisdom of Uzbekistan's industrial policy.

### C. Economic Mechanism

23. The other key source of inefficiencies in the Uzbek economy is its economic mechanism, which has been tailored to implement industrial policy through extensive state intervention in the economy. This mechanism comprises methods of economic control and institutional arrangements that are, in many respects, variations of the centrally planned system that operated in the FSU. Despite making progress with its market transition, Uzbekistan continues to rely heavily on direct administrative methods of economic control, as opposed to indirect market-based methods of control. The economic mechanism in Uzbekistan is basically a supply-determined system characteristic of a centrally planned economy, rather than a demand-driven one in which the market drives the economy through price signals. The state's supply side controls on resource allocation, and targets for real sector output, largely determine the direction and pace of economic development. State controls in the financial sector are used to support real sector output targets, as well as to achieve fiscal and monetary balances. The methods of economic control used in Uzbekistan include

- (i) centrally determined state targets for the production volume and rate of growth of key industries in the real sector;
- (ii) planning in physical terms, employing Soviet-type material balances (input–output matrices) to set physical output targets (albeit expressed in value terms) for key sectors and subsectors, and to determine intersectoral flows of key inputs and outputs;
- (iii) administrative, as opposed to market, determination and control of product and factor prices, including an overvalued exchange rate (at least until 2004), and artificially low interest rates and prices of raw materials, energy, and selected products;
- (iv) centralized state allocations of key material and financial resources, which result in the monopolistic position of the state and state-related economic entities;
- (v) sizeable subsidies to state-determined priority sectors and enterprises—although explicit subsidies financed by the state budget have been reduced from 20% of GDP in 1993 to less than 3% in 2001, implicit subsidies are still estimated at more than half of GDP;
- (vi) soft-budget constraints of state-owned and state-controlled enterprises, which enjoy preferential treatment in the allocation of inputs, access to markets, and insulation from competitive market forces; and
- (vii) exchange and trade controls, used as an airlock to insulate and protect domestic industries from the international economy.

24. Undoubtedly, market institutions and forces are now more developed than before independence. However, the state still dominates and heavily regulates the market and the national economy. The economic mechanism in Uzbekistan can be classified as a “regulated market model”, which historically has been used in reforming Soviet-type economies (Box 1). The underlying rationale of such a model is to subordinate the market to central planning—to regulate and manipulate the market so that it can serve as an instrument of plan implementation. Central planning is still believed to be superior to the market, though market elements are believed to enhance the performance of central planning. When the People's Republic of China (PRC) experimented with this model in the early stages of market transition in the 1980s, it was described as the “birdcage theory”: the market is caged and regulated by extensive state administrative controls to ensure that the “plan is primary, market is secondary”.

### Box 1: Regulated Market Model

All market economies are regulated, to varying extents, to ensure their efficient functioning (for example, by safeguarding property rights and contract enforcement) and equal opportunities and competitiveness in cases of market failures. The regulated market model, however, refers to an economic system where market forces and processes (even where failures do not occur) are subordinated to, or manipulated by, administrative controls to achieve specific outcomes. The principal methods of market regulation—or interference—within this model are (i) extensive state ownership of enterprises, which gives them monopolistic market power; and (ii) state-administered controls over prices and the allocation of resources. As such, the market is deliberately distorted to serve as an instrument of policy implementation by the state, with quantitative output objectives assuming primacy over economic efficiency.

The economic mechanism in Uzbekistan is in many respects similar to the Leninist New Economic Policy, introduced in the former Soviet Union (FSU) during the 1920s. After the failure of absolutist central planning without any role for markets during the War Communism period (1918–1921), a state-regulated market and market instruments were reintroduced and used by the state as a means for implementing central planning. In other words, a heavily regulated market became an instrument of the plan, rather than an autonomous and freely operating mechanism for efficient resource allocation and for determining the direction and pace of economic development. Although the New Economic Policy restored production, it was regarded as a short-term solution from the beginning. It was replaced by the Stalinist centrally planned system in 1928, which lasted more or less until the collapse of the FSU in 1991.

The centrally planned system achieved significant gains in production quantities, although not in quality, but at very high cost. As such, the system was “effective” only when huge material, capital, and human resources were available to underwrite extensive or factor augmented growth. Once the extensive sources of growth were depleted, Soviet economic performance deteriorated drastically, which contributed to the collapse of the FSU.

The Uzbek economic mechanism is also somewhat reminiscent of the “regulated market” model proposed by Czech, Hungarian, and Polish reformers in the 1960s and 1970s. This model was supposed to be a more economically efficient alternative to Soviet-type central planning, while retaining the primacy of state interventions. It incorporated features of the New Economic Policy, but went beyond it by incorporating state regulated factor (especially capital), as well as commodity markets, as allocation mechanisms for achieving centrally determined plan objectives. As these models contained serious conceptual flaws, they did not achieve the gains in economic efficiency that they were intended to achieve.

In 1978–1984, the People’s Republic of China (PRC) experimented with this model as part of the country’s economic reforms. The deficiencies of this model, such as huge “investment hunger” and economic inefficiencies, soon became evident. As a result, PRC authorities began to reduce the size and dominance of the state sector progressively, and to allow competitive markets to operate. The reforms in the PRC that have had the greatest positive impact on economic efficiency and sustained growth probably were (i) the growth of the non-state and private sectors; (ii) gradual, but persistent, introduction and liberalization of markets; (iii) subjecting state and non-state enterprises to increasingly deregulated market forces and competition in input acquisition and output decisions; and (iv) gradual, but persistent, liberalization of foreign trade and FDI.

Interestingly, when PRC policymakers were formulating market reforms in the 1980s, they singled out India as counterfactual. They identified India as an economy founded on private ownership, but with a heavily regulated market and economic system that had inhibited growth and technological progress. Given the ideological constraints at the time to large-scale privatization, PRC policymakers focused on developing and deregulating markets to enhance competitiveness among state and non-state enterprises. While postponing extensive privatization of state enterprises, they allowed a market-based, non-state (increasingly private) sector to develop, which outgrew the state sector over time and became the major engine for sustained near double-digit real GDP growth rates since. The decisive feature in the success of the PRC reforms was not the size of the fully privately owned sector. Rather, it was that private and state-owned enterprises were subjected to the discipline of an increasingly deregulated and competitive market environment. In the mid-1990s, privatization began to take place on a significant scale.

PRC policymakers’ continued concern with developing competitive markets was a major reason for the country’s accession to World Trade Organization (WTO). The PRC leadership accepted the somewhat onerous requirements for market liberalization and opening imposed by WTO, because these requirements were regarded as a means of imposing policy discipline in further market reforms.

The transition economy with the second highest growth rates after the PRC is Viet Nam, which similarly adopted policies encouraging private sector development, market deregulation, and trade openness.

25. However, the experimentation with this model by the PRC and other centrally planned economies demonstrated that, while it may be a tactical improvement over Soviet-type central planning, the gains are temporary and short-lived. In the absence of freely functioning markets, this model's rigidities and inefficiencies are exposed. Specifically, enterprises are not fully autonomous and commercialized or fully subjected to the rigor and discipline of competitive market forces. The highly regulated market is distorted, and prices do not convey accurate scarcity-preference signals. Moreover, market forces tend to undermine the consistency and stability of central planning.

26. Uzbekistan's industrial policy has included institutional arrangements that undermine enterprise autonomy and market competition. The organization and management of industry through industrial associations (also called production and trade associations) have impaired competition and economic efficiency (Part III).<sup>10</sup> This has resulted in a discriminatory and segmented market with onerous regulatory requirements, bureaucratic red tape in registering a company or complying with regulations, and preferential access to inputs and distribution channels by members of industrial associations.

#### **D. Implications for Private Sector Development**

27. An assessment of the issues and options for PSD in Uzbekistan must be made against this policy and institutional background. Official statistics show that the non-state sector accounted for 74.5% of GDP in 2003, with the private sector accounting for 42.3%. However, the non-state sector includes a large number of enterprises in which the state continues to exercise dominant control despite its minority shareholding. The private sector share is small for an economy that has been in transition for more than a decade. Perhaps even more important is that private enterprises operate in an unfavorable environment, where extensive state intervention hampers their development.

28. The private sector in Uzbekistan, whether by design or default, performs a secondary or supplementary role to the state-controlled sector and the centrally determined economic plans. The state directs or controls all economic activities that it regards as strategic or important to the national economy. The private sector operates in non-strategic areas and/or as an appendage to state-controlled entities in the strategic sectors. The private sector in Uzbekistan is not regarded as a major engine of economic growth—and has not been allowed to perform as such.

29. The subordinated and circumscribed role of the private sector in Uzbekistan's economic transition has three possible explanations:

- (i) The authorities have no clear or explicit policy bias against PSD, and the unfavorable environment for private enterprises is an "unintended" consequence of the priority the authorities attached to its industrial policy and the means employed to realize the policy. In this case, the authorities have underestimated the potentially critical role that the private sector can play in achieving industrial policy objectives, and the high costs of crowding out the private sector.
- (ii) An implicit policy bias against the private sector does exist, perhaps arising from anxieties that a robust private sector and market forces might threaten the state's ability to purposively guide and manage national economic development in the

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<sup>10</sup> Industrial associations were also a prominent feature of the Leninist New Economic Policy. They were then called "trusts," and were an organizational device for achieving centrally determined state plans and for ensuring state dominance in the industrial and national economy.

public interest. In this case, the authorities' view ignores theory and international experience, especially those of the dynamic East Asian economies. In East Asia, developmental states have successfully and effectively achieved their national economic and industrial policy objectives by relying on the productive efficiency and international competitiveness of the private sector, while employing indirect market-based methods of macroeconomic management to maintain stability.

- (iii) Some political elites are concerned that a competitive market and a developed private sector might undermine their ability to seek rents or pursue their self-interests. In this case, the problem is political and not economic.

30. The heart of the PSD problem in Uzbekistan, therefore, might be the country's industrial policy and the methods (including institutional arrangements and industrial organization) employed to realize its objectives. The fact that Uzbekistan has an activist industrial policy, however unpopular this concept might be among some foreign experts, is not the real issue. Rather, the issues or problems are fourfold:

- (i) The scope of Uzbekistan's industrial policy, and its definition of "strategic industries" that need some form of state direction, is so broad that it almost encompasses the entire economy. Nearly every sector in the Uzbek economy—banking, energy, agriculture, industry, trade, etc.—are subject to extensive state directives.
- (ii) Industrial policy has focused on import substitution to nurture some infant industries in which Uzbekistan might not have a comparative advantage. Thus, these industries are inefficient, uncompetitive, and unviable. A number of newly developed industries are operating well below full capacity due to supply and demand constraints.
- (iii) The direct, mainly administrative, methods (e.g., price controls and direct resource allocation) and institutional arrangements (e.g., industrial associations) used to enforce industrial policy are detrimental to PSD, the effective functioning of competitive markets, and economic efficiency—all critical to robust and sustainable growth.
- (iv) The private sector has not been utilized sufficiently as an instrument of industrial development. In fact, extensive state intervention in almost all sectors of the economy has discouraged private investment and employment generation.

31. Uzbekistan's potential for economic development will remain unrealized so long as the country's industrial policy and implementation methods do not change, since they suppress the dynamism of the private sector and exclude it from the industrialization and modernization process. Successful industrial policy entails "picking winners". International experience has shown that the ability of governments and politicians throughout the world to pick winners is very limited. Aside from instances of natural monopolies, public goods, or market failures, only the market is equipped to pick winners in the long term. Where state intervention through industrial policy has partially and temporarily succeeded, such as in the Asian tiger economies<sup>11</sup>, the private sector was relied upon to undertake and operate industries within the context of largely competitive domestic markets and open foreign trade.

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<sup>11</sup> The East Asian Tigers refer to the economies of Hong Kong, Singapore, South Korea and Taiwan; these territories and nations were noted for maintaining high growth rates and rapid industrialization between the early 1960s and 1990s.

32. The policies and institutional arrangements adopted by Uzbekistan might have been effective in mitigating the adverse economic impacts of the collapse of the FSU. Arguably, they might have been justified and even appropriate as emergency measures to cope with the crisis conditions immediately after independence. However, like a virtue that is pushed too far and becomes a vice, they are unsuitable in the longer term for robust and sustainable growth. Their retention has inhibited, rather than promoted, growth—and will continue to do so. The challenge for Uzbekistan is unshackle PSD.

### III. PROFILE AND DEVELOPMENT DYNAMICS OF THE PRIVATE SECTOR

#### A. Process and Pace of Privatization

33. At the time of independence, the private sector in Uzbekistan was practically nonexistent. Its development since 1991 was initiated through the privatization of small state-owned enterprises (SOE). Important progress was made in privatization during 1992–1997, when almost all small enterprises were said to have been privatized by 1995 and the privatization of medium enterprises began. By the end of this first phase of privatization, almost all small and medium-sized enterprises (SME) in retail trade, services, food industries, transport, and construction had been privatized.

34. Since 1997, however, privatization has slowed markedly. Most key medium and large industrial enterprises remain under state ownership or control. Case-by-case privatization of medium-sized and large enterprise started during the second phase of privatization around 1998, when the Government announced its intention to launch a mass privatization program with the aim of increasing the private sector's share of GDP to 60%. The program envisaged restructuring about 3000 state enterprises as corporations, and selling 51% controlling interests to private investment funds. The program had limited success, in large part due a lack of interested investors. To promote foreign participation in the case-by-case privatization of larger enterprises, the Bureau for Individual Privatization of Enterprises was established within the State Committee for State Property Management and Entrepreneurship Support (Goskomimushchestvo or GKI) with World Bank support. By 2000, however, the privatization of large enterprises and key industries, such as fuel, energy, and railway, still had not commenced.

35. The annual privatization plan in 2000 included the privatization of 167 enterprises, with the actual number privatized at 374.<sup>12</sup> In 2001, only about 20% of the 1,803 large and medium industrial enterprises operating at the time had been fully privatized. The Government still held stakes of 25% or more in the remaining 80% (Table 4). At the end of 2001, 35% of medium-sized and large industrial enterprises remained fully state-owned and had not even been restructured as corporations, while 10% were unincorporated private enterprises.

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<sup>12</sup> CEEP. 2003. *Uzbekistan Economy: Statistical and Analytical Review – Annual Issue 2002*.

**Table 4: Privatization of Large and Medium Enterprises, 2001**

	Industrial Enterprises	Percentage of Total	All Sectors	Percentage of Total
Large and Medium Corporatized	1,803	100	27,805	100
Of which:	999	55	4,654	17
100% Private	187	10	1,746	6
Up to 25.5% State-Owned	641	36	2,568	9
25.5%-50.5% State-Owned	10	0.6	102	0
Over 50.5% State-Owned	161	9	220	1
Uncorporatized <sup>a</sup>	804	45	23,151	83

<sup>a</sup> 35% of all uncorporatized industrial enterprises were 100% state-owned, with 10% of the remaining 65% privately-owned. This means about 20% of the total was private.

Sources: State Committee on Statistics, State Committee for State Property Management and Entrepreneurship Support, World Bank.

36. Official reports stated that privatization of companies in trade, construction, and machine building had been “mostly completed” by early 2002, while privatization of large-scale industries such as fuel, energy, and railway had not begun. Subsequently, with the issuance of Government resolutions on privatization of large enterprises and additional sale of state shares in (partially) privatized companies, the number of privatized enterprises increased to 1,912 during 2002.<sup>13</sup> In 2000–2002, approximately 3,410 enterprises were newly established under various ownership forms (Table 5). Large plants and enterprises were converted into shareholding entities, and smaller enterprises mostly transformed into private individual enterprises. Most of the latter were formed through the privatization of small production and service units (e.g., trade, catering, and other services) belonging to large enterprises.

**Table 5: State-Owned Enterprises Privatized, 1995–2003**

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Number of SOEs Privatized	8,537	1,915	1,231	451	448	374	1,449	1,912	1,519
Number of Non-SOEs Established: <sup>a</sup> including:	8,537	1,915	899	266	373	372	1,238	1,800	1,452
Joint stock companies	1,026	1,257	456	110	141	152	227	223	75
Sole proprietorships	6,036	420	260	103	156	103	827	1,252	981
Other types of Incorporation	1,475	238	183	53	76	117	184	325	396
Privatization Proceeds (SUM billion)	2.4	5.3	4.4	8.9	9.1	14.3	23.2	43.6	56.1

<sup>a</sup> Established on basis of private property.

Source: Centre for Effective Economic Policy.

37. By early 2003, only one large privatization transaction had been completed, although a few others were reported to be at advanced stages. The state remained the dominant owner of large enterprises. Less than half of all large enterprises were majority owned by the private sector. Most strategic industries, including energy, telecommunication, and mining, remained under state control. In April 2003, the Government issued a resolution titled “On the Program for the Denationalization and Privatization of Enterprises in 2003–2004.” In line with this resolution,

<sup>13</sup> Enterprises in the basic industries that were (partially) privatized included Elektrokhimprom, Navoiazot, Uzbekrezinotekhnika, the power plants in Tashkent and Ferghana, and the Sarddarya hydropower plant.

the authorities divested state property, unplaced state shares and stakes in the charter capitals of 972 joint stock companies (JSC) and 129 limited liability companies. For 2003, 1,519 enterprises (and other entities) were privatized, of which 9.3% were privatized through sales of shares and resulted in the formation of 75 JSCs.<sup>14</sup>

## B. Current Economic Landscape

38. This study was unable to find reliable disaggregated data on the private sector in Uzbekistan. Such data might not exist. Official statistics put the non-state and private sector share of GDP in 2003 at 74.5% and 42.3%, respectively. The European Bank for Reconstruction and Development (EBRD) estimated the private sector share of GDP in Uzbekistan at 45% for 2003.<sup>15</sup> Neither estimate is satisfactory or unambiguous as they do not explain clearly how the figures were determined. The Uzbek authorities explained that non-state enterprises are defined as those with less than 50% state holding, while private enterprises are defined as those 100% privately owned. However, many officially reported non-state enterprises have unplaced state shares, i.e. shares earmarked for privatization but not yet sold, and/or indirect state holdings. This means the state effectively remains the majority shareholder (Box 2). In addition, even in non-state enterprises where the state is clearly a minority shareholder, agencies often continue to exercise controlling rights and the dominant voice in corporate governance.

### Box 2: Classification of State, Non-State, and Private Enterprises

The process of privatization of medium-sized and large enterprises in Uzbekistan typically involved their corporatization into joint stock companies (JSCs) with shares divided into four blocs of 25%. Three of the blocs were designated for sale to insiders, outsiders, and foreigners, respectively; the remaining bloc was to be retained by the state. In most cases, employees and managers took up the 25% bloc for insiders. Over time, however, management gradually increased its shareholding. Such enterprises are classified as non-state. When the state directly or officially holds less than 50% of the shares, the enterprise is classified as private.

In practice, however, less than 20% of all medium-sized and large enterprises that were corporatized have been fully divested or privatized. The blocs allocated for sale to outsiders and foreigners usually have not been sold. In these cases, the state continues to hold the majority of shares. Still, since a percentage (25%) has been divested, these partially divested enterprises are categorized as non-state in the statistics—even though the state actually holds a majority of the shares through the officially registered 25% state holdings and unsold shares. This creates considerable confusion in the official statistics on the size of the state, non-state, and private sectors. Thus, a large part of what is officially reported as the non-state sector comprises enterprises in which the state has majority holdings. Further, several hundred medium-sized and large enterprises have not even been corporatized.

In a significant number of partially privatized enterprises, where the state directly holds less than 50% of the shares, the state often has additional indirect shareholdings through shares owned by partially privatized (e.g., non-state and private) enterprises in which the state also retains shareholdings. While the enterprise would be categorized as non-state or even private, the effective cumulated state shareholdings could constitute a majority. This leads to greater overestimation of the private sector.

The state's often opaque mutual and crossholdings in enterprise ownership also poses serious problems for corporate governance. Further, this creates moral hazards for anti-competitive behavior, as the shareholding of enterprises can be highly concentrated in only a few hands, or even in a single individual or entity. In fact, in many partially privatized enterprises where the state holds a nominal 25% share, it appoints trustees. This allows the state to retain a blocking right and exercise controlling rights and a dominant voice in corporate governance, which are much larger than the size of its official shareholdings.

<sup>14</sup> The largest number of state-owned enterprises SOEs privatized was in telecommunications (111), agriculture and water management (124), oil and gas (62), education (96), and health care (71).

<sup>15</sup> EBRD. 2004. *Transition Report*. London.

39. With the caveat on what non-state and private might mean in practice in terms of state ownership and control, the majority of Uzbekistan's enterprises belongs to the non-state and private sector. At the end of 2003, 90.8% of the 283,900 registered enterprises were non-state or private. The largest sub-group of non-state or private enterprises (39.7%) were farms. JSCs accounted for 1.8%, limited liability companies for 1.1%, and enterprises with FDI for 1.1% of the total (Table 6).

**Table 6: Distribution of Registered Enterprises by Forms of Legal Ownership, 2002–2003**  
(%)

<b>Form of Ownership</b>	<b>2003</b>	<b>2002</b>	<b>2002<sup>a</sup></b>	<b>Form of Ownership</b>
State Property	9.2	10.0	12.0	State Property
Various Types of Farms	39.7	37.0	30.0	Peasant and Farmers
Joint Stock Companies	1.8	2.9	4.0	Joint Stock Companies
Foreign-Invested Enterprises	1.1	1.1	6.0	Limited Liability Companies
Others	48.2	49.0	29.0	Sole Proprietorships
			19.0	Cooperatives and Noncommercial Firms

<sup>a</sup> The data for 2002 in the right column are from the Center for Effective Economic Policy. Note the differences in classification and inconsistency between the two sets of data for 2002.

Sources: State Committee on Statistics, Center for Effective Economic Policy.

40. Of all active enterprises, which is a subgroup of registered enterprises (some of which might not be active), non-state enterprises accounted for 74.5% of GDP (Table 7), 73.9% of industrial output, 99.2% of agricultural output, 88.8% of construction work, and 98.6% of retail trade turnover. Although JSCs and limited liability companies together accounted for only 2.9% of all active enterprises, they generate an overwhelming share of the output and employment.

**Table 7: Distribution of GDP and Sectoral Output by State and Non-State Sectors, 2003**  
(%)

	<b>State</b>	<b>Non-State</b>
GDP	25.5	74.5
Industry	26.1	73.9
Agriculture	0.8	99.2
Construction	11.2	88.8
Retail Trade Turnover	1.4	98.6
Paid Services	31.1	68.9
<b>National Employment</b>	<b>22.8</b>	<b>77.2</b>

GDP=gross domestic product.

Source: State Committee on Statistics.

41. Data on the size distribution of enterprises and industrial concentration in the Uzbek economy is scarce. The little information available indicates a high degree of concentration, with large enterprises accounting for 66% of GDP and 47% of employment in 2001 (Table 8). A study<sup>16</sup> of the performance of Uzbek industrial enterprises also found that production was highly concentrated in large enterprises. SMEs accounted for only 15% of GDP and 9% of employment. Medium-sized and large enterprises generated 86.2% of industrial output in 2003,

<sup>16</sup> Kim, B.S. and G. C-B. Fedyasheva. 2004. *Industrial Enterprise Rating Evaluation System*. CEEP. Tashkent.

according to official figures. Disaggregated data on the contribution of medium-sized and large enterprises to the output of industrial subsectors are not available.<sup>17</sup>

**Table 8: Distribution of GDP and Employment by Enterprise Size, 2001**  
(%)

	<b>GDP</b>	<b>Employment</b>
Large	66	47
Medium, Small, and Micro	15	9
Subsistence Farmers and Individual Entrepreneurs	19	44
<b>Total</b>	<b>100</b>	<b>100</b>

GDP = gross domestic product.

Source: State Committee on Statistics.

42. The State Committee on Economic Insolvency of Enterprises monitors all enterprises with state shareholding, as well as the more important enterprises that are classified as fully privatized (Table 9).

**Table 9: Enterprises Monitored by the State Committee on Economic Insolvency of Enterprises, 2004**

	<b>Number of Enterprises</b>
<b>Total</b>	<b>5,751</b>
Of which:	
Without State Shares <sup>a</sup>	1,326
Of which: Large	875
With State Shares	4,425
Of which:	
100% State-Owned	1,551
Large	837
Medium and Small	714
51–100% State Shares	729
Large	434
Medium and Small	295
25–51% State Shares	1,969
Large	1,127
Medium and Small	842
25% or Less State Shares	176
Large	89
Medium and Small	87

<sup>a</sup> Enterprises without direct state shareholding, many of which include indirect state shareholdings.

Source: State Committee on Economic Insolvency of Enterprises.

43. The enterprises covered by this monitoring system probably represent the backbone of the Uzbek industrial system and corporate sector. Data from the state committee show 4,425 enterprises with state shareholding, including 1,551 enterprises (35%) that are fully state-

<sup>17</sup> The statistical yearbooks only report total output (in physical terms) produced by medium and large enterprises in a number of key subsectors, such as (i) fuel and energy; (ii) chemical and petrochemical; (iii) mechanical engineering and metal working; (iv) timber, woodworking, pulp and paper; (v) building materials; (vi) glass and porcelain; (vii) light industry; (viii) food; and (ix) flour milling and feed mill. For these subsectors, which comprise the bulk of industrial production, medium and large enterprises can be assumed to account for the overwhelming share of production, with small (and micro) enterprises accounting for a very small share.

owned. Of these SOEs, the majority (53%) were large enterprises. Further, the state holds shares in an additional 2,874 partially divested enterprises, the majority of which are also large. Thus, almost all large enterprises in the country appear to be state-owned or state-controlled.

44. The State Committee on Statistics estimates formal employment in Uzbekistan at between 642,500 and 660,300 in 2001. Formal employment in industry and agriculture has fallen, with industrial employment declining from more than 1 million in 1991 to about 650,000 in 2001. The 38% contraction in industrial employment during 1991–2001 was nearly double the 20% contraction in industrial output, although the decline in formal industrial employment was partially offset by higher employment in the informal sector. Most of the increase in formal employment has been in the budgetary or public sector.

45. The State Committee on Statistics estimated the number of individual entrepreneurs at 2.8 million in 2001, including 500,000 in industry. However, the tax authority reported only 290,000 persons were registered as individual entrepreneurs in all economic sectors (or about 10% of the figure of the State Committee on Statistics).<sup>18</sup> Formal and informal employment in small, medium-sized, and micro-enterprises rose to more than 1 million by 1996, but almost halved in 1997 before gradually increasing again to about 800,000 in 2001. Employment generation by SMEs has been disappointing, while informal individual enterprises are increasing. The large and growing number of individual enterprises has increased the informal component of the economy.

46. In 2001, employment in non-state enterprises accounted for 77.2% of the national total. Individual enterprises and subsistence farmers, many of whom do not operate as registered enterprises, accounted for 19% of GDP and 44 % of total employment (13% in agriculture and the remainder in other sectors, mainly services).

### **C. The Private Sector in Agriculture**

47. Agriculture is the second largest sector after services in the Uzbek economy, with its share of GDP at 28.8% in 2003. Before Uzbekistan's independence, two formal organizations undertook agricultural production: state and collective farms, and individual household plots. The process of transition since 1991 has created new organizational and legal forms (Box 3).

48. Agriculture in Uzbekistan is characterized by two key features. First, the state owns the land. Farmers are given time-bound usufruct rights (right to use), not full property rights over land. Second, the state heavily regulates the size and types of activities, severely limiting the amount of land that can be devoted to particular activities. This heavy regulation leads to land fragmentation, inefficiencies due to the very small scale of operations, and irrational land use where restrictions prevent specialization according to comparative advantage. The combination of state ownership and regulation creates disincentives for investments to raise productivity. Further, these two features demonstrate that private operators, who are not private owners, generate much of agricultural production; and that extensive state controls hamper private initiatives. For these reasons, some observers have challenged the notion that much of agriculture belongs to the private sector.

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<sup>18</sup> A World Bank study argues that the total number of individual entrepreneurs and the number of individual entrepreneurs engaged in industrial activities are overestimated significantly, with actual numbers for the latter likely to be at most 71,000 (or 14% of the estimate of the State Committee on Statistics). Kitain, A. 2003. *Uzbekistan: Creating an Environment for Enterprise Development*. Washington, DC: World Bank.

### Box 3: Agricultural Organization in Uzbekistan

Before independence, state farms (sovkhoz) and collective farms (kolhoz) undertook agriculture production, with household plots playing a residual role. Sovkhozs, a form of state-owned enterprise, have been dismantled largely since independence. The main organizational forms in agriculture now comprise the following:

#### Collective Enterprises

Legal form: collective enterprise.

Land tenure: permanent collective possession (usufruct, not ownership)

Labor: labor contract with members and hired workers (nonmembers)

#### Cooperative (shirkat) Farm

Legal form: cooperative

Land tenure: permanent collective possession (usufruct, not ownership)

Labor: allotment of land and inputs, household contracts, shared benefits

#### Farming Enterprise

Legal form: various forms of legal entities

Land tenure: lease of 10–50 years

Labor: 1 household plus hired workers

Restrictions: size limits depending on type of activities; cattle less than 30 heads plus 0.3 ha per head in irrigated areas, or 0.45 in non-irrigated area, or 2 ha in desert area; vegetables, and fruits, less than 1 ha; wheat or cotton, less than 10 ha.

#### Farm

Legal form: not necessarily a legal entity

Land tenure: short-term lease of 3 years

#### Family (dekhan) Farm

Legal form: not necessarily a legal entity

Land tenure: lifetime possession

Labor: household workers plus only occasional hired labor

Restrictions: less than 0.35 ha in irrigated area or 0.5 ha in non-irrigated area or 1 ha in desert area

#### Household Plots

Land tenure: lifetime inheritable possession

Restrictions: less than 0.35 in irrigated area or 0.5 ha in non-irrigated area

Note: household workers include head of family, his/her spouse, children, parents, and other relatives of labor age, living together and undertaking peasant farming.

Source: Center for Effective Economic Policy.

49. Since 2000, agricultural production has been almost 100% non-state, according to official reports. The overwhelming share of agricultural output was accounted for by peasants, in terms of ownership forms, and by family farms in terms of organizational forms (Table 10). Cooperative and family farms together accounted for 80–85% of agricultural output. While farmers have permanent collective or household lifetime possession of land, their property rights are ambiguous, because land might not be freely sold or transferred.

**Table 10: Distribution of Agricultural Output  
by Ownership and Organizational Forms  
(%)**

Ownership Form	Rural Enterprises			Farmers			Peasants		
	2000	2001	2002	2000	2001	2002	2000	2001	2002
Agricultural Output	27.8	26.8	24.6	5.5	6.9	9.9	66.7	66.3	65.0
Ownership Form	Family Farms		Agricultural Enterprises		Farms				
	2002	2003	2002	2003	2002	2003			
Agricultural Output	64.1	62.4	25.9	23.5	10.0	14.1			

Source: Centre for Effective Economic Policy

50. The lack of clear property rights and tradable rights in land are not the only things that hamper agriculture. Other constraints include the state's monopolistic powers in the provision of critical inputs and powers in the procurement of important food and cash crops, as well as its control over prices and quantities. Since 2002, collective and private farms have been allowed to sell 50% of the cotton and wheat harvest outside the state procurement system at free auctions. Still, state procurement remains significant. In 2003, for example, the state procured 43% of the total spiked cereals production of 5,780,700 tons.

#### D. The SME Sector

51. The SME sector in Uzbekistan comprises four categories of enterprises, and two forms of farming activities (Box 4).

52. The SME sector has grown significantly since transition began. The number of active SMEs increased from 126,000 in 1999 to 230,000 in 2003. However, small and microenterprises have accounted for most of the recent growth of the sector, while the number of medium enterprises has declined.<sup>19</sup> As a result, the SME sector is dominated overwhelmingly by microenterprises, which accounted for 86% of all SMEs in 2003.<sup>20</sup> Nearly half of SMEs were in agriculture, the sector with the largest concentration, followed by trade and catering (23%). Only 10% of SMEs were engaged in industry (Table 11).

53. The SME and individual entrepreneurs sectors engaged 5,465,100 people in 2003. Excluding individual entrepreneurs, registered SMEs employed 1,045,000 persons. Small, medium, and microenterprises accounted for about 11% of national employment in 2003.

54. With 229,000 active SMEs, Uzbekistan has nine SMEs per thousand people. This figure is higher than in Kazakhstan and Russian Federation, which have about seven SMEs per thousand persons, and twice as high as in Ukraine, which has four SMEs per thousand persons. However, the figure is well below the European Union average of 37–46 SMEs per thousand persons.

<sup>19</sup> The number of small and microenterprises grew by 18% and 50%, respectively, in 1999–2001, while the number of medium-sized enterprises fell by 8%.

<sup>20</sup> State Committee on Statistics. 2004. *Statistical Review of the Republic of Uzbekistan in 2003*. Tashkent.

#### **Box 4: Definitions of Small and Medium Enterprises**

**Individual entrepreneur:** an individual resident of Uzbekistan who is involved in entrepreneurial activity based on a patent issued by the local authorities. Unlike in most other Commonwealth of Independent States countries, including Russian Federation, Ukraine, and Kazakhstan, individual entrepreneurs in Uzbekistan are not allowed to contract or employ other individuals.

**Microenterprise:** an enterprise or organization with an annual average number of employees of up to 10 in manufacturing and up to five in trade, services, and other non-manufacturing activities.

**Small enterprise:** a company with an annual average number of employees above that for a microenterprises, but not exceeding 40 in manufacturing; 20 in construction, agriculture, and other sectors of industry; and 10 in science, scientific servicing, retail trade, and other non-industry sectors.

**Medium enterprise:** a company with an annual average number of employees above that for small enterprises, but less than 100 in manufacturing; 50 in construction; 30 in agriculture, wholesale trade, public catering and other sectors of industry; and 20 in retail trade, services, and other non-industry sectors.

**Family (dekhan) farm:** a small-scale family enterprise involved in production and sales of agricultural products. It may exist as a legal entity or without legal establishment. A family farm that is not a legal entity cannot hire full-time employees. Nevertheless, taking into account the family-based structure and specifics of dekhan farms, the employment of relatives is considered as their personal contribution and is, as such, permitted.

**Private farm:** an independent economic entity established with the status of a legal entity engaged in agricultural production on land plots under a long-term lease.

Source: State Committee on Statistics and International Finance Corporation.

55. In 2000–2001, the SME and microenterprise sector recorded the highest sectoral output growth rate in the Uzbek economy, growing by 13% per year in 2000–2001. This far exceeded GDP growth of 4% and large enterprises output growth of 0.6%. During this period, SMEs and microenterprises contributed 39% of the GDP growth, compared with 11% for large enterprises. Despite this rapid growth, the SME and microenterprise sector still constitutes only a thin layer of the economy between large enterprises and the substantial informal sector. Large enterprises accounted for 66% of GDP in 2001 (Table 8). Subsistence farmers and individual entrepreneurs together accounted for 38%, while the SME and microenterprise sector contributed 15%. In 2003, SMEs and microenterprises, excluding individual entrepreneurs, accounted for 16.4% of GDP.

**Table 11: Size of Small and Medium Enterprise Sector, 1999–2003**

	1999	2002	2001	2002	2003
Share of Sector in GDP (%)	29.1	31.0	33.8	34.6	35.5
Of which:					
Small and Medium Enterprises	12.6	13.1	14.8	15.7	16.4
Individual Entrepreneurs	16.5	17.9	19.0	18.9	9.1
Number of Registered SMEs	159.7	183.0	201.9	239.5	263.8
Number of Active SMEs (1,000 units)	125.6	149.3	177.7	236.4	229.6
Number of Persons Engaged in SMEs (‘000 persons)				4,994.1	5,465.1
Number Employed in SMEs <sup>a</sup> (‘000 persons)	647.7	745.3	801.8	900.3	1,045.1
Share of Sector in Employment (%)	47.0 <sup>b</sup>	50.0 <sup>b</sup>	53.0 <sup>b</sup>	53.5	57.0
Of Which:					
Individual Entrepreneurs					6.1
Medium Enterprises					1.4
Small and Microenterprises					9.5
Share of SME In Sector Output (%):					
Industry Production	10.5	11.3	14.1	14.1	16.6
Agricultural Production	68.0	72.4	75.6	76.4	76.8
Fixed Capital Investment				28.2	7.4
Total Retail Trade	45.6	45.9	45.8	43.8	45.5
Paid Services	35.9	37.9	39.9	41.3	45.7
Exports	29.4	10.2	9.0	7.5	7.3
Imports	35.5	27.4	26.9	24.9	33.7
Number of SMEs Engaged in Foreign Trade (‘000 units)	2.4	2.8	2.5	2.7	3.3

GDP= gross domestic product, SME=small and medium enterprises.

<sup>a</sup> Excluding individual entrepreneurs.

<sup>b</sup> Figures from International Finance Corporation, which differ from those given in Centre for Effective Economic Policy.

Sources: State Committee on Statistics, Centre for Effective Economic Policy, International Finance Corporation.

56. SMEs accounted for 77% of national agricultural output in 2003, and for about half of sectoral output in retail trade and paid services. However, SMEs are conspicuously underdeveloped and insignificant in industry—their share of industrial output was only 17%. This means that industrial SMEs’ share of GDP was a miniscule 2.6%.<sup>21</sup> The SMEs’ share of exports is also very small, declining from 36% in 1999 to about 7% in 2003 (Table 11). Important factors in the dramatic decline of SME exports include (i) the backwardness of the clearing and settlement mechanisms, (ii) red tape, (iii) uncompetitive prices of products, (iv) lack of variety and innovativeness, and (v) low value-added.

57. The underdevelopment of industrial SMEs shows a strong correlation with the

<sup>21</sup> Given that SMEs account for 17% of industrial output, and industrial output share of GDP was 15%, the share of SMEs’ industrial output is 2.5%.

surprisingly small share of private sector activities among industrial SMEs. Privately owned SMEs account for only 34% of SME industrial output and 32% of SME exports (Table 12). The small share of SMEs in total exports shows a similar correlation with the small share of private sector activities.

**Table 12: Private Sector Share of Small and Medium Enterprise Output, 2003**

SME Sectors	Private Sector Share (% of SME Sectoral Output)
Industry	33.9
Agriculture	99.9
Construction	78.4
Retail Trade Turnover	84.8
Paid Services	91.6
Exports	31.5
Imports	26.3

SME = small and medium enterprise.  
Source: State Committee on Statistics.

58. These numbers show that the state sector is dominant even in SME manufacturing activities. As a result, private sector industrial SMEs account for only 5.6% of total industrial output and 0.8% of GDP.<sup>22</sup>

59. The underdevelopment of the SME sector of the Uzbek economy, as indicated by its low 16.4% share of GDP, can be attributed largely to the constraints facing the private sector generally. Constraints grow as the size of the enterprises increases, thus encouraging a movement towards smaller operations and the informal sector. A World Bank study<sup>23</sup> argued that enterprises underreport employment and the wage bill due to the complicated tax system in general, and high employment taxes in particular. The underreporting of formal employment allows enterprises to be registered as smaller-sized enterprises, giving them the option of using simplified taxation schemes. Stagnating or slow output growth and deteriorating financial conditions forced SMEs as well as large enterprises to shed labor. This accounts for the decline in formal employment by 700,000 in 1999–2001. Microenterprises, the only sector in which the number of enterprises and employment increased markedly during this period, absorbed much of the retrenched labor. The conclusion is obvious but still noteworthy: The less regulated informal sector has performed substantially better than the formal large enterprise and SME sectors in terms of output growth and employment generation.

60. This suggests that the business environment for the formal sector does not facilitate growth, because of unfavorable Government policies. Factors that have impeded the growth of the SME sector include (i) import compression due to the crackdown on shuttle trade, which restricted SMEs' access to inputs and supplies; (ii) restrictions on cash withdrawals by SMEs from their bank accounts; (iii) cumbersome inspection regime for SMEs; (iv) difficulties of SMEs in converting local currency to foreign exchange in their bank accounts, even with foreign exchange permits from the central bank; (v) lack of foreign exchange retention rights for trading entities that purchase SMEs' goods for export; (vi) difficulties in accessing investment and working capital credits from banks; (vii) opaque and complicated tax system; (viii) poor

<sup>22</sup> Privately owned industrial SMEs account for 34% of SME industrial output. With total SME industrial output accounting for 16.6% of national industrial output, privately owned industrial SMEs thus account for only 5.6% of national industrial output. The share of privately owned SME industrial output in GDP is derived by taking 5.6% of 15%, which is the share of industrial output in GDP.

<sup>23</sup> Kitain, A. 2003. *Uzbekistan: Creating an Environment for Enterprise Development*. Washington, DC: World Bank.

enforcement of laws, and corruption; and (ix) difficult creditors' protection that make banks reluctant to lend to SMEs. These constraints are discussed in greater detail below.

61. Since 1999, the Government has made some attempts to reduce the tax burden on SMEs, simplify registration requirements, and facilitate SME export. However, these measures have been insufficient to stimulate strong entry in, and development of, the private sector. The measures often are implemented weakly, and sometimes are contradicted by other measures and restrictions, such as those on cash withdrawal and access to foreign exchange.

#### **IV. FACTORS IMPACTING PRIVATE SECTOR DEVELOPMENT**

62. The relatively small size and underdevelopment of the private sector in Uzbekistan indicate that its potential to drive GDP growth, employment generation, and poverty reduction remain unexploited. The underdevelopment of the private sector in Uzbekistan can be attributed to an adverse policy and institutional environment. A wide array of restrictive regulations and controls throughout the economy has circumscribed PSD. The structure of the controls—ranging from banking to market entry to domestic and foreign trade—has been configured to support a transition strategy, and an industrial policy in particular, based on state-led development. This strategy relies on extensive state interventions, which leave little room for the private sector and market forces to function effectively.

##### **A. Macroeconomic Stability**

63. Uzbekistan faced severe macroeconomic imbalances following the collapse of the FSU. Although the country made significant progress in macroeconomic stabilization in 1991–1996, macroeconomic imbalances have increased since then.

64. The Government's ambitious industrial investment program, largely funded through external borrowing, has been a major source of macroeconomic imbalances since 1996. External loan commitments since independence total about \$6.6 billion, half of which has gone to industry and the energy sector. In addition to state guaranteed funding, industry received privileged access to foreign exchange at overvalued rates of the Uzbek currency (the sum) for import financing and debt servicing. About 85% of the \$1.3 billion in subsidized hard currency sales by the Central Bank of Uzbekistan (CBU) has been used for investment goods and imports by industrial enterprises.

65. Adverse external factors also contributed to worsening macroeconomic conditions. Most important were the 1996 fall in world market prices for gold and cotton, which were (and still are) Uzbekistan's most important export goods, and the 1998 Russian financial crisis.<sup>24</sup>

66. The reliance on administrative economic controls to achieve industrial policy objectives, as well as fiscal and monetary targets, distorted markets and contributed to macroeconomic

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<sup>24</sup> A sharp devaluation of the Russian currency and a default on government debt resulted in a sharp decline of economic activity in the Russian Federation. Given the strong trade links, this spilled over to the real and financial sectors of most countries in the region. Second-round effects on the Uzbek economy included the impact of trade restrictions imposed by neighboring countries to stabilize their economies.

imbalances.<sup>25</sup> In 1995–2000, Uzbek authorities introduced a system for converting local currency into foreign currency to enable the Government to control and allocate foreign currency resources. This was intended to control the importation of modern equipment and technology for priority projects in the energy sector, gold mining, automotive, and other “strategic” sectors as part of the Government’s exports promotion and import substitution policies. In early 1997, the Government formalized exchange controls, which included multiple exchange rates and restrictions on current account transactions. Instead of devaluing the sum in response to adverse external shocks and domestic development problems, the Government tightened the exchange rate regime. The degree of the resulting exchange rate misalignment was reflected in the widening of the gap between the black market exchange rate and the official exchange rate of CBU—from 90% in mid-1998 to 480% in February 2000. The growing foreign exchange misalignment was compounded by the Government’s expansionary fiscal stance to finance its ambitious industrial investment program. Uzbekistan recorded very high public sector deficits over this period, financed through foreign borrowing and credit of CBU. As a result, inflation remained high and the confidence in the sum was eroded further.

67. Despite a significant contraction in exports, administrative restrictions on foreign exchange for importers helped to contain the external current account deficit to around 0.7% of GDP in the late 1990s. However, unidentified capital flows indicate that unregistered imports and capital flight increased substantially, reaching 4–6% of GDP in 1998–1999.

68. Since the first half of 2000, the authorities have adopted tighter macroeconomic policies. Measures were taken to restrict money supply growth by tightening the fiscal stance. With state budget revenues and expenditures falling, the official state budget deficit was reduced to around 0.4% of GDP in 2003 (Table 13). CBU credits as a source of budget deficit financing were reduced and then discontinued in 2003.

**Table 13: Budgetary Expenditures and Revenues, 1998–2003**  
(% of GDP)

	1998	1999	2000	2001	2002	2003
Budgetary Expenditures	34.5	32.2	29.5	27.0	26.1	24.6
Budgetary Revenues	32.4	30.0	28.5	26.0	25.2	24.2
Balance	(2.1)	(2.2)	(1.0)	(1.0)	(0.9)	(0.4)

GDP = gross domestic product.

Source: Centre for Effective Economic Policy.

69. The decline of state budget revenues from 32.4% of GDP in 1998 to 24.2% in 2003 resulted mainly from falling direct and indirect taxes. The parallel decline of state budget expenditure from 34.5% of GDP in 1998 to 24.6% in 2003 was achieved largely through a reduction in social spending, although social spending remained significant. Another important factor was a decline in investment financing through the state budget. Further, explicit state subsidies were reduced to less than 3% of GDP in 2001. Likewise, explicit state guarantees for external borrowing by priority industries or enterprises also were reduced substantially. All this suggests that Government intervention in the economy declined.

<sup>25</sup> Although implicit taxation of agriculture and exports has been significant, the surplus available for investment has been insufficient to meet the Government’s investment program, which had to be financed to a large extent through external borrowing. External borrowing has mainly been used for ambitious investments in the energy sector (electricity, oil, and gas), infrastructure (telecommunication and transport), nonferrous metallurgy, machine building, and light and food industry.

70. However, implicit subsidies still amounted to more than half of GDP in 2001. About 40% of these implicit subsidies were granted to industrial enterprises in form of low input prices and access to foreign currency through an overvalued exchange rate. Due to a lack of available information, the level of implicit subsidies for subsequent years is difficult to estimate. Changes in the exchange rate regime, which are discussed below, suggest that implicit subsidies declined. However, major distortions of input and output prices for major industries and agriculture persist, which implies that indirect subsidies are still significant. As such, the Government still relies heavily on financial means, such as price policy, and other administrative measures to intervene in the economy.

71. Tight administrative measures, reduced public investment outlays, and restrictive policies against imports, supported by tight monetary and fiscal discipline, also have reduced the foreign debt.

72. To complement the official exchange rate, a special over-the-counter (OTC) exchange rate was introduced in July 2000 for interbank currency transactions and imports of consumer goods under license from CBU. Further, an official cash rate was introduced to allow individuals to exchange national currency into dollars at exchange points of commercial banks. Subsequently, the authorities adopted measures to bring the official exchange rate more in line with the black market rate through gradual, albeit substantial, devaluation. In October 2001, the official exchange rate and the OTC rate were unified by devaluing the official rate. By mid-2002, the spread between the OTC and black market exchange rates was reduced substantially, access to the OTC market expanded, export bans reduced, and complementary reforms in the banking sector initiated. Additional measures were adopted in 2003 to liberalize the foreign exchange market further. Restrictions on free access to foreign currency by businesses were officially abolished, and limits for individuals on purchasing foreign currency through authorized banks gradually were increased. The exchange rates on the domestic foreign currency markets were unified the same year. Current account convertibility was introduced officially in October 2003. Progress in foreign exchange market liberalization, however, was offset partially by other types of Government intervention, particularly in foreign trade.<sup>26</sup> This prevented a robust positive response of the enterprise sector to reforms in form of increased supply of goods and services.

73. The policy changes helped slow consumer price inflation from 27.6% in 2002 to 10.3% in 2003, according to official sources (Table 14). Foreign observers, however, argued that inflation remained high at around 45%, as measured by the GDP deflator and the producer price index.<sup>27</sup>

**Table 14: Consumer Price Index, 1998–2003**  
(%)

1995	1996	1997	1998	1999	2000	2001	2002	2003
304.6	54.0	58.8	17.9	29.1	24.9	27.4	27.6	10.3

Source: Centre for Effective Economic Policy.

74. CBU's monetary policy since 2000 has aimed to maintain low inflation and ensure macroeconomic and financial stability by setting aggregate monetary targets (reserves and broad money). The authorities report that market instruments have been used to limit growth of

<sup>26</sup> Some observers believe the Uzbek authorities did not want to risk a slippage of the current account into a sizable deficit. Therefore, at the first signs of significant increases of imports as a result of currency liberalization and devaluation, non-tariff barriers to foreign trade were introduced to replace previous exchange rate controls.

<sup>27</sup> World Bank. 2003. *Uzbekistan—Country Economic Memorandum*. Washington.

reserve money and money supply in light of increasing official gold and foreign exchange reserves. The introduction of current account convertibility, as well as favorable international prices for Uzbekistan's major export goods (cotton, non-ferrous metal, and natural gas), enabled the country's export volume to increase more than 30% in 2004. This produced a trade surplus of more than \$1 billion.

75. Still, the changing macroeconomic conditions were not necessarily favorable for the enterprise sector. Tighter monetary policies constrained domestic credit growth, which declined from about 90% in 2000 and 2001 to 3.8% in 2003. Bank lending to nonfinancial enterprises similarly declined. With price pressures persisting, the share of bank loans to GDP dropped from 40.5% at the end of 2001 to 37.8% at the end of 2002 and 32.6% at the end of 2003. This decline continued throughout 2004.

76. Price instability and counter-inflationary measures probably have had different impacts on the state-controlled and the private sector. Industries and enterprises controlled and favored by the state under its industrial policy would be less vulnerable to adverse macroeconomic conditions. Their preferential access to resources and funds (especially foreign exchange), which are still administratively allocated to a degree and usually made available at subsidized prices, would cushion the impact of macroeconomic pressures. Soft-budget constraints also would allow such enterprises to be less risk-adverse in production and investment decisions under volatile and uncertain economic conditions.

77. In contrast, private sector firms tend to face hard-budget constraints and be fully exposed to market forces. They would have been the most seriously affected by adverse economic conditions, such as paucity and higher costs of funds and weakening effective market demand. In addition to these direct (first order) adverse impacts of macroeconomic instability on private firms, indirect (second order) impacts caused by counter-inflationary measures, such as the tightening of monetary and fiscal stances, would have undermined private sector activities. For example, the Government's monetary and fiscal policies have relied largely on administrative instruments in the banking system, such as restricting cash withdrawals by firms and requiring banks to deduct automatically tax payments from the accounts of firms.<sup>28</sup> Another example was the Government's restrictions on access to foreign exchange and imports to conserve foreign exchange and maintain a positive trade balance, which seriously constrained private sector and SME activities.<sup>29</sup> These trade restrictions, however, were eliminated, since they are not in line with the obligations under sections 2(a), 3, and 4 of the IMF Article IV agreement on current account convertibility, which the Government signed in October 2003.

## **B. Industrial Organization and Management**

78. Uzbekistan's industrial policy involves the organization and management of enterprises in most industries through state-owned JSCs (SJSC) and industrial associations. The objective is to facilitate direct and indirect state intervention. This form of industrial organization and

<sup>28</sup> During discussions in early 2005, Government officials—in contrast to representatives of the enterprise sector—pointed out that all limits on cash withdrawals had been abolished. Further, the Government reported that control over enterprises' accounts payable, including tax and other obligatory payments, will be transferred gradually from the commercial banks to the tax and custom authorities in 2005.

<sup>29</sup> In 2004, ADB trade consultants found that the main purpose of the Government's repression of the SME sector's import requirements was to restrict demand for foreign exchange. The objective was to keep the gap between the black market exchange rate of the sum and the official rate below 20% of the official rate in compliance with an IMF Article VIII condition.

management undermines the creation of a dynamic and competitive corporate sector, and tends to crowd out of the private sector.

79. Industrial associations are a legacy of the Soviet-type centrally planned economies. SOEs were organized along branch lines and controlled by line ministries, who were responsible for setting and enforcing detailed plans for all aspects of an enterprise's activities. SOEs were cogs in the wheel of a vast state economic machine. Because they were merely implementing centrally determined plans, they were not responsible for their financial performance. The state subsidized losses and collected profits for redistribution.

80. In transition economies that engaged in widespread privatization of SOEs, line ministries became redundant. As a result, they were dismantled or downsized, and converted into sectoral developmental or regulatory agencies. In Uzbekistan, in contrast, much of the functions of former line ministries were retained due to the slow pace of privatization of large and medium-sized industrial enterprises and the Government's highly interventionist industrial policy. The line ministries were first converted into "concerns" (holdings), and later into industrial associations and SJSCs that report directly to the Government (Cabinet of Ministers). More than 50 industrial associations, including about 20 in consumer goods industries, were created in 1993–1999.

81. According to Article 77 of Uzbekistan's Civil Code, industrial associations are voluntary noncommercial organizations set up by legal entities (e.g., enterprises that are members of an association) to protect their property rights. An association's functions are assigned by its members and specified in its charter. The Government resolution that establishes the association determines its mission and objectives. The functions of an association include:

- (i) protecting the property rights of the association's members,
- (ii) coordinating members' activities,
- (iii) conducting investment and research and development policy for its members,
- (iv) managing development for members,
- (v) attracting foreign investors,
- (vi) coordinating foreign economic activities among its members,
- (vii) marketing its members' production in the domestic market,
- (viii) promoting member's production growth and diversification, and
- (ix) cooperating with antimonopoly committee on competition development.

82. Industrial associations and SJSCs were entrusted with state shareholdings of most of the member enterprises. The state usually holds at least 25% of the shares of a member enterprise. Since a Government resolution (No. 361) gives a shareholder with a 25% stake the power to veto any strategic or important decision by an enterprise's shareholder meeting or board, an association's shareholding of 25% can be exercised as a controlling stake. The state's share in industrial associations and SJSCs is usually not less than 51%, giving the Government the right to appoint and remove their directors and management. In some instances, a number of SJSCs have been incorporated into large organizations, such as national holding companies.

83. The highest decision-making organ of an industrial association is its board, comprising representatives from member enterprises. The board is headed by a chairperson, who is elected (or removed) by board members, subject to approval of the Cabinet of Ministers. Since the Government has the ultimate power of appointment or removal of an association's chairperson, the association and its member enterprises do not have full authority over the association they have established. Moreover, since an association has been entrusted with the

state's shareholdings in member enterprises, it is obligated to represent and act in the best interest of the state. As such, the association has a built-in conflict of interest between the interests of the state and of non-state stakeholders in the member enterprises.

84. SJSCs have functions and structure that are similar to industrial associations, and are also subordinate to the Cabinet of Ministers. In SJSCs, however, the Cabinet of Ministers decides on and assigns enterprises to be placed under an SJSC. SJSCs are also entrusted with state shares of constituent enterprises, but only for "temporary management." Unlike industrial associations, SJSCs receive some state shares of enterprises as a contribution to their authorized capital.<sup>30</sup> SJSCs, in turn, may issue shares of their own, with the state owning 51% of the shares and the rest available for sale. This allows the state to retain control over the constituent enterprises in a SJSC, while issuing additional securities to increase Government revenues and maintaining the privatization process. In some instances, SJSCs were integrated into larger structures, such as national holding companies, whose authorized capital comprised state shares in a number of SJSCs. Holdings, in turn, can issue shares of their own, of which 49% may be offered for sale. Thus, the Government can control enterprises and their management under a holding entity and its constituent SJSCs through a pyramidal structure.

85. The Uzbek authorities often insist that industrial associations are not state-owned. This might be formally true for associations in which the state holds only a minority stake directly. In practice, however, the state is usually the effective majority shareholder, either through shares designated for sale to non-state investors that have not been sold, or through cumulative indirect state holdings in member enterprises or in legal entities that own shares in them. Even more relevant and important, the Government effectively controls the associations and member enterprises. As such, the associations and member enterprises are similar to state enterprises in that the Government can, and does, exercise controlling rights no different from a controlling shareholder. The fact that associations and their member enterprises might operate relatively more autonomously and commercially according to market conditions than a SOE in the FSU period is separate from the fact that associations and their member companies are state-controlled.

86. The state's ownership, corporate governance, and control rights associated with its shareholdings in an enterprise are exercised by state trustees, who are appointed (or dismissed) by the Cabinet of Ministers in conjunction with the GKI. The state trustee is then a member of the enterprise's steering committee, or delegates membership to an appointed representative. According to a Government resolution (No. 361), the role of a state trustee includes: (i) safeguarding the state's rights and interests, (ii) attracting investment and renovation funds, (iii) promoting product competitiveness and diversification, (iv) preventing budget arrears and enterprise stagnation, (v) protecting shareholders' rights, (vi) increasing output and exports, (vii) ensuring efficient use of the Government's dividends retained at the enterprise, (viii) informing the Cabinet of Ministers of any significant decisions or actions by the enterprise, and (ix) any other functions imposed by the Cabinet of Ministers. If the state holds more than 25% of the shares, state trustees and trust managers are empowered to block any significant decision (ranging from appointment of management staff to reorganization of the firm) at the shareholders' meeting. Resolutions of the shareholders' meeting are invalidated if the state trustee did not attend.

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<sup>30</sup> An example is SJSC Uzkiemesanoat, which was allocated state property of 14 SOEs and other organizations, as well as state shares in 10 other JSCs, for formation of its authorized capital. SJSC Uzkiemesanoat also was entrusted with state shares in eight other JSCs for temporary management.

87. The organization and management of industry in Uzbekistan through industrial associations, SJSCs, and conglomerate holding entities undermines the creation of an efficient and competitive corporate sector and the development of the private sector. The shortcomings include:

- (i) Extensive direct and indirect (through pyramidal and cross-holding structures) state holdings in these organizations and in their member enterprises preserve the dominant role of the state in the economy, and maintains the well-documented inefficiencies and moral hazards (e.g., corruption, patronage, nepotism, and asset-stripping) associated with state-controlled enterprises.
- (ii) The large size of industrial associations, SJSCs, and holdings, and their preferential treatment in access to resources and markets, mean that they have considerable market power and share, giving them monopolistic powers to prevent enterprises outside these organizations—mainly private sector firms—from operating and competing equally.
- (iii) The apparatus of state intervention and support relying on administrative means—e.g., centrally determined allocations of resources and distribution of products, controlled prices, indirect subsidies, controls over foreign trade, etc.—significantly distorts the market and undermines the efficient allocation of resources in the national economy.
- (iv) State intervention in the operations and management of member enterprises mean that they are not subjected fully to market discipline, enjoy soft-budget constraints, and have insufficient incentives to improve their performance, particularly their efficient in use of resources at the micro-level.
- (v) The modalities and scale of state intervention in the management of the organizations and their member enterprises represent highly defective corporate governance structures and practices, undermining effective safeguards of property rights and efficient use of assets in the public interest (since shares of the state are ultimately those of the public).
- (vi) Industrial associations can act as regulator and operator in some instances. Although they do not have formal rights or powers to set industry regulatory standards, their monopolistic position and close links with the Government suggest they might play an important, albeit indirect, role in setting regulatory policies for their sectors.

88. Industrial associations and SJSCs have three logically distinct, although functionally related, features or defects. One is their large size and market power, which impedes competition. The second is their internal organizational and decision-making structures, which militate against effective corporate governance at the level of the associations (and SJSCs) and of the member enterprises. The third is the extent and modalities of state ownership and other rights, which give the state disproportionately large control and governance powers relative to its actual shareholding.

89. The conversion of some industrial associations into production and trade associations has been a notable recent trend, though it is not clear whether these associations represent a substantial change or merely a rebranding. The number of associations reportedly has been reduced since 2003 following Government measures to increase the share of the private sector in the economy (section C).

### C. Private Sector Development Policy Framework

90. Aside from measures that impact the overall policy, economic, and institutional environment in which private enterprises operate, three types of Government policies directly condition PSD in Uzbekistan. The first is privatization policy, which is still perhaps the most important, given Uzbekistan's current stage of transition. Many medium-sized and large enterprises, which form the backbone of the industrial system, have not been privatized. As such, privatization policy is a key determinant of the size, scope, and depth of the private sector. Moreover, the modalities and types of privatization directly determine the architecture of the private sector. Ownership patterns, corporate governance arrangements, and industrial concentration will have critical implications for the efficiency of the sector. The second are the sets of policies, laws, and regulations that govern the establishment and functioning of private firms. The third is policy on SMEs, which dominate the private sector in market economies.

91. The Government has launched a number of initiatives in the past few years to increase the pace and scope of privatization. In March 2001, a Government resolution identified 1,244 state-owned entities to be privatized. These included large enterprises and banks to be transformed into joint stock companies and made eligible for foreign investment, including 100% foreign ownership. The bulk of enterprises were to be privatized by selling a majority of their assets through the stock market, or through direct sales to strategic investors. In 2002, an additional 751 enterprises were added to the list.

92. Since 1999, the Government has also adopted measures to promote SME development, including (i) introduction of unified and simplified taxation for small enterprises, (ii) streamlined regulations, (iii) reduced business inspections, (iv) additional microcredit facilities, and (v) elimination of foreign exchange surrender requirements. In May 2000, a bill was passed with provisions for the protection of the rights and freedoms of entrepreneurs. In September 2000, a resolution was adopted to promote the creation and development of SMEs and farming enterprises by broadening their access to financial, technical, and material resources.

93. Some important measures to develop the private sector were adopted in 2003. Presidential Decree (No. 3202), titled "On Measures to Radically Increase the Share and Significance of the Private Sector in Uzbek Economy", was issued in January 2003. The decree called for accelerating the development of the private sector, and increasing its role and significance in the economy. This objective was to be achieved primarily through divestiture of state shares in privatized enterprises. The decree also introduced measures to enhance the operations of private enterprises. The key measures included:

- (i) a law on private enterprises, which establishes a system of privileges and preferences to promote the growth of the private sector in production and services, drafted and submitted to the Parliament;
- (ii) the State Property Committee's divestiture of the Government's 25% (or less) shareholding in JSCs to private investors through the stock market in 2003–2004;
- (iii) development of a privatization program for 2003–2005;
- (iv) revisions to requirements on the minimum size of capital funds (\$50,000) of open JSCs and maximum number of shareholders (50) of ordinary JSCs;
- (v) formation of a special commission, headed by a deputy prime minister, to improve the administration of privatized enterprises and transformation of JSCs that do not comply with regulations on capital funds;
- (vi) introduction of a 5-year income tax holiday on dividends earned by investors in

- partnerships and privatized enterprises;
- (vii) changes in procedures that had prevented boards and shareholders from making decisions without the agreement of state trustees or representatives; and
- (viii) improvement of corporate governance in JSCs by strengthening the powers and accountability of the shareholders meeting and management in appointments and business planning.

94. The decree also called for measures to improve the organization, management, and operations of associations, holding companies, and other economic complexes. It directed the special commission on improving the administration of privatized enterprises to develop and implement measures (i) to restrict the interference of associations and holding companies in the operations of member enterprises, (ii) to facilitate their ability to secure raw materials on the market directly, and (iii) to transfer on a competitive basis management of state shares to professionals.

95. Additional measures to improve corporate governance were introduced through the Government Resolution titled “On Measures to Improve Corporate Governance of Privatized Enterprises”, which was adopted in April 2003. This resolution established standardized regulations on the role and functioning of supervisory councils (boards) and public attorneys in JSCs. For enterprises and JSCs in which the state holds at least 26% of the shares, the resolution directed the GKI to develop a schedule for the phased transfer, on a competitive basis, of those state shares to professional (asset) management companies.

96. Another major privatization initiative was outlined in the Government Resolution titled “On the Program for Denationalization and Privatization of Enterprises in 2003–2004”, adopted in April 2003. This resolution contained measures for implementing some of the decisions contained in the January 2003 presidential decree. The resolution listed the different categories of enterprises in which state shareholdings are to be reduced “to the minimum” and foreign investment promoted (Box 5). Although the resolution asserted that the state will not have any stake in the authorized capital of denationalized enterprises, many enterprises were exempted from this. To encourage investment in privatized enterprises, imported spare parts and components were to be exempted from customs duties over the investment period. In line with this resolution, the authorities divested state property and unplaced shares in 972 JSCs and 129 limited liability companies. These shares were worth a combined SUM41.4 billion, or triple the amount in 2002.

97. In August 2003, the Government Resolution titled “On Additional Measures to Accelerate Privatization of State Low-Profitable, Unprofitable and Economically Insolvent Enterprises and Objects” was adopted. This resolution introduced new methods and procedures of competitive asset sales for unprofitable and unviable enterprises at zero redemption value. For example, 20 loss-incurring enterprises were transferred to private ownership on a competitive basis at a zero redemption value. Winning investors assumed existing liabilities and agreed to implement plans to sharply improve financial performance of the enterprises within 2–3 years. Further, state property shares in 415 JSCs and 71 additional items of state property were sold at the stock exchange through a step-by-step reduction of the offer price (i.e., a Dutch auction).

**Box 5: Lists of Enterprises to Be Denationalized and Privatized in 2003–2004 Program**

The Government Resolution “On the Program for Denationalization and Privatization of Enterprises in 2003–2004 (17 April 2003) included 3,726 enterprises and facilities to be denationalized and privatized. These were broken down into five groups:

Group 1: 1,391 enterprises (37.3% of the total), all of which were privatized earlier with the Government retaining a stake of 25% or less and the unplaced shares. These shares are to be sold to private investors.

Group 2: 645 state-owned enterprises and facilities (17.3% of the total), to be privatized. The percentage of state shares to be divested is not specified.

Group 3: 683 enterprises (18.3% of the total) in which 25–50% of shares (stakes in charter capital) are to be retained by the Government for “several” years. In this group, 308 enterprises have between 3% and 74% of unplaced shares due for sale to private investors.

Group 4: 644 enterprises (17.3% of the total) considered to have strategic importance to the national economy. The Government will retain at least 51% of their shares. In this group, 165 enterprises have between 1.6% and 49% of their shares unplaced, though these are subject for (eventual) sale to private investors. The priority for this subset of 165 enterprises is to improve their corporate management.

Group 5: 365 enterprises (9.8% of the total) with poor financial and operational performance. If these enterprises are not sold in full in 2003, they will eventually be liquidated with exclusion from the state register, and their assets and land sold on a piecemeal basis to other businesses.

98. While many initiatives and measures were aimed at facilitating privatization and improving the regulatory framework for private firms, some issues remain regarding the adequacy and positive impacts of these measures for PSD. The issues include:

- (i) **Coherence.** The many diverse decrees and other measures on privatization and PSD do not constitute a coherent strategy or vision for the role of the private sector in the national economy. In fact, past privatization and other PSD initiatives tended to be piecemeal and partial, and sometimes were contradicted by or inconsistent with measures and regulations in other areas. Measures and regulations in the financial sector, as well as in foreign trade and foreign exchange policy, have militated against PSD. As such, it is not clear whether the Government has a coherent strategy for, and vision of, PSD and harnessing the private sector’s potential in national economic development.
- (ii) **Policy Commitment and Credibility.** However piecemeal and partial, the corpus of privatization and private sector development measures introduced since the early 1990s, and in recent years particularly, could have increased significantly the size and dynamism of the private sector if they had been implemented fully. Many of these decrees and measures (as well as other economic reforms) often are not implemented in full or at all. Consequently, the Uzbekistan’s public, foreign investors, and development partners have questioned the commitment and credibility of the Government in PSD. With the Government’s reputation and policy credibility undermined, public officials, market participants, and other economic agents are emboldened to ignore the implementation of, and compliance with, policies.

99. In some instances, renationalization measures have been introduced that have undermined the coherence and credibility of the Government's privatization policy. In 1998, the Government sought to increase its shares in privatized enterprises to 25%. In 2001, the Government adopted a resolution (No. 119) that reduced the shareholdings of employees and other investors to increase the amount of state shares available for free sale.<sup>31</sup> More recently, in 2002, a Government resolution announced the intention to renationalize trading companies that have partly or completely changed their economic activities. The resolution also signaled the Government's intention to renationalize all privatized small enterprises in socially sensitive areas (e.g., shops, kindergartens, other social services) that have changed their main line of activities during the first 5 years following privatization.<sup>32</sup>

100. Uzbek authorities do not agree that the policy and regulatory framework in the financial, foreign exchange, trade, industrial, and private sectors have been unfavorable to PSD. During fact-finding and further discussions on this assessment, several Government representatives pointed out that the Government's legal and regulatory initiatives have favored increasing liberalization of the private and financial sectors. As evidence, they pointed to various measures, including the adoption of more than 70 normative acts since 2000 aimed at PSD and at protection of private sector interests. Some examples cited were:

- (i) The Government Resolution (No. 57) titled "On Facilitation of the Republican Coordination Council on Small and Private Entrepreneurship Development Stimulation", which was adopted in February 2000 and foresaw several measures in support of small and private enterprises;
- (ii) The Government Resolution (No. 65) titled "On Measures to Reduce and Streamline the Reporting for Small Business Enterprises", which was adopted in February 2000 and foresaw measures to curb the unauthorized introduction by ministries, agencies, and local governments of requirements for small enterprises to report additional information not specified in legislation; and
- (iii) The Government Resolution (No. 263) titled "On Measures of Further Liberalization of the Foreign Exchange Market", which was adopted in June 2001 and foresaw increasing volumes of cash and non-cash convertibility.<sup>33</sup>

101. In 2005, the authorities continued legal and regulatory work aimed at PSD. In March 2005, the privatization program for 2005–2006 was adopted by Presidential resolution, which updated the list of enterprises to be divested. The list comprised three categories of enterprises to be denationalized:

- (i) 1,385 enterprises and entities to be fully privatized through the sale of all remaining unsold state shares;
- (ii) 115 enterprises and entities in which unsold state shares are to be divested on a competitive basis at zero redemption cost given investment commitments by investors; and

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<sup>31</sup> This was done by increasing the shareholders capital through the addition of state assets (such as social facilities, outstanding Government loans, and dividends and privatization proceeds accruing to the state, which had not been transferred to the state) that had previously been left out of enterprises' balance sheets.

<sup>32</sup> This decision does not appear to have been implemented.

<sup>33</sup> Other such measures were: Government Resolution (No. 75) titled "On Measures of Further Support to Farmers, Private Entrepreneurs and Other Small Businesses", adopted in March 2000; the law titled "On the Guarantees of Freedom of Entrepreneurship Activities", enacted in May 2000; and Presidential Decree (No. 3366) titled "On the Improvement of Economic Management System", adopted in December 2003, which sought to reduce administrative interference on private businesses.

- (iii) 746 enterprises, regarded as strategically important, in which the state would retain majority shareholding of 51% or more, with the balance of shares to be divested.

102. The privatization program for 2005–2006 shows that the Government intends to retain majority control over a significant number of enterprises. Cotton processing and related industries account for the largest number of enterprises in which state intends to retain majority control (143 of the 746 enterprises), with large numbers also in the gas and electricity supply and distribution, machine building, and electrical equipment industries.

103. Another noteworthy recent measure was the Presidential Resolution (No. 24) titled “On the Program for Implementation of Targets and Task for Democratization and Renewal of Society and the Reform and Modernization of the Country”, which also was adopted in March 2005. Annex 6 of this resolution described the conceptual framework for realization of priority areas of market reforms and liberalization of the economy (Box 6).

104. Further, another Presidential Decree (No. 3619) was adopted in June 2005 to improve the legal protection of entrepreneurs. The decree establishes that only the tax authorities perform statutory audits (inspections) of financial-economic activity of enterprises. If such audits reveal any indication of violation of tax or currency regulations, audits may be performed by the tax and currency fraud department of the office of the Prosecutor General. Management and officials of the controlling authorities will be held personally responsible for undertaking unauthorized inspections. Another Presidential decree, also adopted in June 2005, outlines additional measures to stimulate microenterprises and small enterprises, chiefly through the introduction of a unified tax.

105. Whether these recent measures are part of a more coherent PSD strategy that the Government is committed to implementing, despite possible conflicts with its macroeconomic policy objectives and industrial sector management system, remains to be seen. The Government’s credibility issues outlined above would pose an additional implementation challenge. However, these legal initiatives and measures are at least valuable in their acknowledgment of some of the most important PSD constraints—and the fact that these constraints have not been addressed, despite the multitude of PSD initiatives and measures that have been announced over many years.

#### **D. The Financial System**

106. Uzbekistan faces a severe shortage of domestic financial resources. The level of financial intermediation remains very low. The ratio of broad money to GDP, which is frequently used as an intermediation indicator, fell from about 15% in 1997 to less than 10% in 2003 (Table 15). Public confidence in financial institutions appears to be weak. Bank deposits of private households were the equivalent of only 2.1% of GDP in 2003. Capital markets and nonbank financial institutions have yet to play a substantial role in financial intermediation. In 2003, the total transaction volume of the securities exchange was equivalent to only 0.8% of GDP. Insurance premiums totaled only 0.3% of GDP. Recent efforts by the authorities to increase intermediation have included measures to increase the range of banking services and broaden the outreach of the financial sector in remote areas, for instance, by creating more than 1,000 so-called mini-banks. Uzbek authorities claim that, as a result of these initiatives, the total deposits (not household deposits) grew from 8.0% of GDP in 2002 to 10.2% of GDP in 2004.

Household deposits grew from 1.4% of GDP in 2002 to an estimated 2.5% of GDP in 2004. However, this is still very low.<sup>34</sup>

#### **Box 6: Recent Government Measures on Private Sector Development**

Presidential Resolution No. 24 (“On the Program for Implementation of Targets and Task for Democratization and Renewal of Society and the Reform and Modernization of the Country”), dated 10 March 2005, Annex 6.

Objectives and Measures in Areas of:

##### **A. Support for Development of the Private Sector and Increasing Its Share in the National Economy**

- (i) Accelerating process and procedures of divestiture of state shares in enterprises (as specified in Presidential Resolution No. 29 “On the Program of Denationalization and privatization of Enterprises in 2005–2006”, and corporate management development;
- (ii) drafting of a Presidential decree and other measures to improve legal protection of private enterprises and curbing state intervention in their activities;
- (iii) overhauling the system of penalties applicable to enterprises and reducing sizes of penalties for minor infractions;
- (iv) increasing enterprises’ access to factor markets, distribution outlets and foreign trade, including the creation of commodities and raw materials exchanges at district centers; and
- (v) expanding microlending for small and private businesses, with technical assistance support of international financial institutions.

##### **B. Expansion of Operations for Developing Small Business and Farming:**

- (i) Enlarging the share of small business to at least 45% of GDP by 2007, through creation of a system of supplemental guarantees, privileges, and preferential policies for small business in areas such as taxation, permits, registration, and supplies; and
- (ii) developing farming enterprises in agriculture, involving conversion of poor-performing shirkats (farm cooperatives) into farm enterprises, regional rural employment creation programs; timely provision of loans to farming enterprises, and introduction of concessional lending by commercial banks to farmers, secured against future production intended for open sale; accelerated development of market infrastructure for supply of material and technical inputs and services; strict contract enforcement; and training of farmers in market-based business operations.

##### **C. Expansion of Reforms in the Banking and Financial Systems**

- (i) Upgrading the system of money circulation management;
- (ii) increasing investment volume in the real sector by enhancing the capitalization of banks, simplified procedures for realization of assets and/or loans from bankrupt enterprises, issuance by commercial banks of debt securities and asset-backed securities, adoption of a law on consumer lending, and review of authorized capital requirements for new commercial banks; and
- (iii) building up confidence in the banking system through measures such as transferring the tax and customs monitoring and payments collection functions from commercial banks to the Government’s financial, taxation, and customs agencies; improving customer service and ethical standards of commercial banks; and protection of confidentiality of clients’ data held by banks.

<sup>34</sup> Comparable ratios are 8.5% for the Kyrgyz Republic banking system, and almost 20% for the Kazakhstani banking system.

**Table 15: Financial Sector Indicators**

	1999	2000	2001	2002	2003
<b>1. Sector Outcomes</b>					
<b>Increased Financial Intermediation</b>					
Broad money (M3) as percentage of GDP	11.9	10.5	10.2	9.4	9.3
Banking sector assets as percentage of GDP	41.9	39.7	48.7	44.0	37.8
Insurance premiums as percentage of GDP	0.2	0.3	0.3	0.3	0.3
Capitalization of stock exchange as percentage of GDP	n.a.	3.6	5.2	5.9	4.4
Outstanding corporate bonds as percentage of GDP	0.0	0.0	0.0	0.1	0.2
<b>2. Sector Outputs</b>					
<b>Improved Financial Sector</b>					
<b>Soundness and Stability</b>					
Capital of banks as percentage of total assets	n.a.	41.5	38.6	35.0	29.8
Nonperforming bank loans as percentage of gross loans <sup>a</sup>	0.2	0.2	0.8	1.1	1.5
Foreign-owned banking sector assets as percentage of total	n.a.	n.a.	n.a.	n.a.	4.3
Number of commercial banks	35	35	38	36	33
Capital of insurance companies as percentage of total assets	93	85	58	79	90
Number of insurance companies	n.a.	n.a.	n.a.	28	n.a.
<b>Efficiency</b>					
Private-owned banking sector assets as percentage of total	n.a.	n.a.	n.a.	n.a.	10.0
Interest rate spread (lending-deposit rate)	10.5	9.5	0.5	(2.3)	3.5
Money outside banks as percentage of deposits	n.a.	60.3	47.6	46.0	53.9
Annual stock market turnover as percentage of capitalization	n.a.	14.5	10.2	9.4	17.7
Population per bank branch	n.a.	n.a.	31,600	31,200	31,200
<b>Access</b>					
Household deposits as percentage of GDP	n.a.	0.9	1.4	2.1	2.1
Number of companies listed at stock exchange	5	5	6	6	6
Number of corporate bond issues	2	4	2	7	18

GDP = gross domestic product.

<sup>a</sup> Includes loans officially classified as bad or loss. State guaranteed loans are per se classified as performing.

Sources: International Monetary Fund, Central Bank of Uzbekistan, Ministry of Finance, Asian Development Bank.

107. The low level of market-based external financing for firms is evident from data on the sources of investment funds. In 2003, the value of fixed capital investments was SUM1,867.4 billion. The state sector accounted for 40.4% of fixed investments and the non-state sector for 59.6% (Table 16). The largest single source of investment funds were enterprises' own funds (41.8%) followed by state-guaranteed foreign borrowing (19.2%), financing from the state budget under the state investment program (17.7%), and household savings (11.1%). Only 1.9% of fixed investment was financed through credits from commercial banks. Bank loans are primarily short-term, mainly to provide working capital and to finance trade.

**Table 16: Distribution of Fixed Capital Investments by Ownership Sectors, Economic Sectors, and Sources of Funds, 2002–2003**  
(% Distribution)

	2002	2003
Total Investments	100.0	100.0
Government Ownership	40.9	40.4
Nongovernment Ownership	59.1	59.6
Total Investments	100.0	100.0
Nonproduction Purposes	42.9	34.9
Production	57.1	65.1
Industry	32.4	28.4
Agriculture	5.8	4.4
Construction	0.4	0.4
Transport and Communication	10.0	21.7
Trade and Public Catering	2.6	3.4
Other Areas	5.9	6.8
Total Funding Source	100.0	100.0
State Budget	25.0	17.7
Enterprises' Funds	40.0	41.8
Population Savings	12.0	11.1
State-Guaranteed Foreign Investments	15.7	19.2
Centralized Credits of Banks	0.1	0.0
Commercial Bank Credits	1.5	1.9
Nonbudgetary Investments	0.3	0.4
Other Loan Proceeds	0.7	0.8

Sources: State Committee on Statistics, Centre for Effective Economic Policy.

108. The underdevelopment of Uzbekistan's financial markets must be seen in the context of—and can largely be explained by—the predominance of non-market mechanisms the Government uses to direct financial resources to priority sectors and enterprises in line with its industrial policy. These priority sectors and industries are invariably heavily controlled by the state, or even owned by the state (effectively, if not formally). This means that private firms are discriminated against in accessing finance. The state's dominance in the mobilization and intermediation of financial resources may have crowded out the private sector and the role of the market. Paradoxically, however, the private sector is so underdeveloped that its demand for funds is relatively weak, which probably limited the crowding out effect.

109. Industrial associations and other similar organizations, in turn, might have crowded out or impeded the development of the financial sector in Uzbekistan. These organizations play a key role in the allocation resources among and across member enterprises, effectively intermediating funds through an internal financial market. The financial resources of member enterprises might be deposited and transacted through the banking system, but the associations rather than banks decide on intermediation and allocation. Banks play a passive role as payments and clearing agents. Thus, under the current system of industrial management, significant amounts of financial resources might be intermediated outside the banking system or capital markets.

110. **Banking Sector Development.** In the 1990s, financial sector reforms focused on establishing a suitable legal and regulatory framework for the banking sector. The reforms also aimed to build the sector's institutional and technical capacity, which included market entry of private banks. As a result, some components of the legislation and regulation are broadly in line

with international standards. Other significant achievements include a well-organized payment and settlement system, efficient management information systems in leading banks, and a sophisticated trading platform for securities.

111. In 2000, additional measures were announced to continue financial sector reforms. In February 2000, a CBU Provision (No. 429) abolished all rules on requirements for commercial banks' credit policy. Commercial banks' credit business was allowed to be conducted on a commercial basis in line with the banks' credit policies and strategic objectives set by their supervisory boards. In March 2000, a Presidential decree (No. 2567) was issued to address the liberalization of, and reforms in, the banking sector. It included measures to prevent heads of ministries, local governments, and regulatory as well as law enforcement agencies from interfering in the activities of commercial banks, including the appointments of bank managers and decisions affecting a bank's loan portfolio. Based on the decree, the Government adopted the Resolution (No. 104) titled "On Additional Measures for the Reform of the Banking System" the same month. This resolution, among other things, outlined the continuation of banking sector privatization, and established a bank privatization and a bank restructuring agency.

112. The additional measures announced since 2000 to liberalize and reform the banking system include:

- (i) initiatives to universalize specialized commercial banks by increasing the number of entities using the banking system, the types of industries assisted by banks, and the variety of specialized services provided by banks;
- (ii) introduction of a concessionary microfinance program for SMEs and microfirms, farm, and high-technology projects;
- (iii) plans to reduce or eliminate restrictions on cash withdrawals;<sup>35</sup>
- (iv) abolition of the system of cash quota for commercial banks (with effect from the fourth quarter of 2002);<sup>36</sup>
- (v) cessation of the system of cash formation plans;
- (vi) measures to stimulate household deposits and lending to the real economy (with effect from 1 February 2003)<sup>37</sup> through, for example, a pro rata reduction in taxation of bank incomes based on increases in individuals' time deposits that would strengthen the banks' resource base;
- (vii) cessation of centralized loans by CBU to commercial banks (with effect from 2002) and to the Ministry of Finance to finance the budget deficit (with effect from 2003); and
- (viii) enactment of the Law titled "On the Treasury Execution of the State Budget" in 2004, which, among other things, terminated the commercial banks' existing functions on cash execution of the state budget (with effect from January 2006).

113. In January 2005, the Uzbek banking system comprised 32 commercial banks with 800 branches, including two state banks (the National Bank of Uzbekistan for Foreign Economic Activity or NBU and People's Bank), 1 state joint stock bank (Asaka Bank), 13 joint stock commercial banks (some with state shareholdings), 11 private banks, and 5 banks with foreign participation. In 2004, the Government's shareholdings in eight of the joint stock commercial

<sup>35</sup> Government Resolution (No. 280) "On Measures to Further Decrease Non-Bank Circulation of Money", adopted in August 2002.

<sup>36</sup> Government Resolution (No. 280) "On Measures for Further Decrease of Non-Bank Circulation of Money", adopted in August 2002.

<sup>37</sup> Government Resolution (No. 63) "On Measures to Improve Monetary Indicators Regulation Mechanisms", adopted in February 2003.

banks ranged from 1–15%. Uzbek authorities, however, reported that state shares in seven joint stock commercial banks were fully divested by early 2005: Tadbirkor (previously with 11.2% state shares), Uzprivatbank (10.6%), Trustbank (9.7%), Avabank (0.7%), Savdogarbank (0.3%), Gallabank (0.06%), and Ipak Yuli Bank (0.03 %). According to a Presidential directive in February 2005, UzZhilsberbank and Zamin Bank (both with state shares) will be merged to form a new bank specializing in housing finance. State shares in the new bank will be maintained at around 10–15%.

114. CBU has not been able to provide official data on the current amount of total assets and capital of the Uzbek banking system. However, banking sector assets probably increased in nominal terms from approximately SUM1,300 billion in 2001 to about SUM3,650 billion in 2003. However, this would constitute a decline of total assets as percentage of GDP from 49% in 2001 to 38% in 2004. Similarly, total capital of commercial banks likely increased from about SUM500 billion in 2001 to almost SUM800 billion in 2004 (and above SUM800 billion in 2004). However, this would constitute a decline of capital as a percentage of GDP and in dollar terms.

115. State involvement remains high in Uzbekistan's banking sector, which is highly concentrated. In January 2005, four banks had state shares of more than 50%: NBU, Halyk Bank, Asaka Bank, and Zamin Bank. The state owns 100% of NBU and Halyk Bank, 98% of Asaka Bank, and 67% of Zamin Bank. These four banks together accounted for 67% of total commercial bank assets, while the combined capital of these banks accounted for 84% of total commercial bank capital. NBU, the main gateway and conduit for state-guaranteed foreign loans to enterprises, alone accounted for 58% of total assets and 62% of total capital of the banking sector in January 2005. The state also seems to have sizable direct shareholdings in other banks, including Uzpromstroybank, Aloka bank, and Narodny Bank. In addition, the state has indirect shareholdings in these banks through shares held in these banks by state-owned banks and state-owned companies. This also applies to the JSC banks' minority shares, which the state might have divested by January 2005.

116. Foreign banks' participation is very limited, estimated at less than 5% of total banking sector assets. Two banks with foreign shareholding, ABN-Amro Bank and Uzdaewoo Bank, are partly financed by external funding agencies such as International Finance Corporation (IFC) and EBRD. Given their limited size and significance, foreign banks do not exert any significant competitive pressure on domestic banks, except possibly in foreign currency and trade business.

117. Moreover, the Uzbek banking system is highly segmented. The operations of most banks are narrowly focused on a few sectors and industries in which they have traditional links (and often personal connections) through direct or indirect shareholders of the respective banks. For example, Halyk Bank focuses on households, while Galla Bank specializes in servicing the grain sector. This narrow sector focus also seems to apply to most new banks, including Asaka Bank, which services the automotive industry.<sup>38</sup> In addition, most new private banks have a narrow regional outreach, which makes them vulnerable to interference from local governments.

118. The high degree of concentration and segmentation (or specialization) increases the risk concentration in loan portfolios of commercial banks, especially when most of a bank's lending is to member enterprises of an industrial association. In such cases, the bank's lending is concentrated on a single group of related borrowers. If the industrial association or its member

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<sup>38</sup> The Government has expressed its view that all Uzbek banks have universal banking licenses and, as such, are not specialized.

enterprises own shares in the bank, then lending to them also constitutes related party lending. CBU has established prudential norms related to single-borrower exposure and related party lending that are in line with international standards overall. However, the effective enforcement of these norms is not clear, especially in light of the complex ownership structures within the Uzbek industry.

119. The Uzbek banking system today does not constitute an efficient, commercial, and market-based mechanism for financial intermediation. Although progress has been made in recent years, financial market development and banking sector reforms have been gradual. The Government's continued use of the banking system as an instrument of direct, administrative control for achieving industrial policy objectives and fiscal and monetary policy targets, is a major impediment to the reform and development of the sector. Banks primarily serve as an instrument of the Government's industrial policy through administratively determined fund allocations. Banks also act as agents of the Government by enforcing other macroeconomic management and public administration objectives. Banks have been used to monitor and report on daily transactions and deposit levels of depositors on behalf of the tax authorities, and to automatically deduct outstanding tax from depositors to the treasury. Through restrictions on cash withdrawals and transactions, banks also have been used to enforce CBU's policies to curb inflation and currency devaluation.<sup>39</sup> These practices, however, apparently have been abolished, or are being phased out gradually. In early 2005, CBU reportedly developed a draft program on additional reforms in the banking sector. In addition to further privatization, the draft program includes the gradual transfer of functions on control over enterprises' accounts and obligatory payments from commercial banks to the tax and customs authorities.

120. Whether such measures are implemented or not, two broad sets of issues need to be addressed before the banking system can realize its potential in financing economic growth and PSD. The first set of issues concerns the banking sector's soundness.

121. **Banking Sector Soundness.** Official data on loan quality, capital adequacy, provisioning, liquidity, etc. is insufficient for an independent assessment of the sector's soundness. Commercial banks have borrowed abroad under the protective umbrella of state guarantees for external borrowing for many years.<sup>40</sup> These loans have funded a large proportion of bank lending to priority industries and enterprises (Box 7). The state also usually guaranteed such loans, mostly in foreign currency or foreign-currency indexed. Hence, banks were formally protected by a double guarantee, and did not carry much exchange rate risk.

122. The double state guarantee largely explains why the unification and large devaluation of the sum, mainly in 2000–2002, had only limited direct effects on the balance sheets of most large banks in Uzbekistan. The indirect effects of the devaluation (deterioration of balance sheets of their debtors, leading to an increase in nonperforming loans) have not yet been reflected adequately in financial reports of banks and financial statistics. Therefore, as of December 2004, only 1.9% of the total loan portfolio of the banking system was reported as

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<sup>39</sup> However, the Uzbek authorities dispute this. They insist that CBU never sets any limitations on cash withdrawal from deposits. The authorities state, moreover, that "nonbanking functions" undertaken by commercial banks ended with the adoption of the "Law on Bank Secrecy." But various development partners of Uzbekistan and other observers have widely reported these restrictions. The restrictions also were confirmed by interviews this study held with enterprises and bank officials and, most notably (although implicitly), by recent Government decrees that announced a discontinuation of these restrictions.

<sup>40</sup> Without state guarantee, loans of foreign banks would have included a prohibitively high risk premium.

nonperforming.<sup>41</sup> The single most important reason for this low figure is that all loans covered by a state guarantee are per se defined as performing.

#### **Box 7: Policy Lending and Nonperforming Loans**

Over the past few years, domestic banks have begun to build up a portfolio of private sector loans granted strictly on commercial criteria. Data on the relative share of policy and commercial lending is not available, however. Officials insist that policy lending is negligible. However, because the banking system has been used as a key instrument for industrial policy implementation, policy lending can be assumed to represent a significant proportion of lending. The Government channels much of its foreign borrowing for state-led investment through the country's six major banks. Nearly 75% of bank loans at the end of 2002 were guaranteed by the Government.

Even if policy lending declined as a result of the reduction in the scale of the public investment program and foreign borrowing since 2002, policy loans still would account for a sizeable share of the accumulated loan stock. For example, state-guaranteed loans accounted for about 85% of the loan portfolio of the National Bank of Uzbekistan for Foreign Economic Relations (NBU) at the end of 2003. Of those guaranteed loans, about 45% have "some" loan loss provisions (yielding a 10–20% loan loss provision rate). Government guarantees covered about 10% of NBU's lending in the past 18 months.<sup>a</sup> NBU is by far the largest bank in Uzbekistan with 58% of the banking sector's assets as of January 2005.

Since a large part of policy lending has been Government-guaranteed foreign and foreign currency-indexed lending, the devaluation of the sum exchange rate tends to increase the debt of the borrowing enterprises. This adversely affects loan performance and, in turn, the performance of the banks that have provided the loans. An estimated 60% of NBU's liabilities at the end of 2002 was in form of foreign credit, and NBU's lending-to-deposit ratio was estimated at over 200%. In principle, banks do not have to provision against Government-guaranteed loans. In practice, however, debt service arrears could cause liquidity problems. Combined with growing provisions on classified assets in the remaining non-guaranteed portfolio, this reportedly has lowered NBU's profitability with return on equity at just 6%. Total exchange rate liberalization would have resulted in NBU's nonperforming loans increasing to 15% of the total, according to NBU. NBU officials admit that the bank has an increasing number of borrowers who are having trouble meeting their Government-guaranteed loan obligations.

<sup>a</sup> Figures provided by National Bank of Uzbekistan for Foreign Economic Activities.

123. However, the financial situation of many companies and industries, which had privileged access to bank lending over the years, clearly has deteriorated recently. Confronted with an economic slowdown, these companies have seen their local currency proceeds eroded. Further, the exchange rate developments have tended to increase their foreign currency debt burden (expressed in local currency). Therefore, if state-guaranteed loans were properly classified, the share of nonperforming loans could reach an estimated 25–60% of the total,<sup>42</sup> which would be equivalent to 7–17% of GDP.

124. Anecdotal evidence suggests that some banks, when faced with nonperforming state-guaranteed loans, have been advised by the authorities to rollover such loans rather than request the Ministry of Finance to cover the loss. Such a response merely postpones a resolution and, based on international experience, risks aggravating the problem. Ultimately, the losses will have to be incurred by any or all of the following: the banks concerned, the state budget, or the enterprises concerned. Evidence also suggests that some banks have started to

<sup>41</sup> The share of all classified loans in the total loan portfolio has increased from 1.1% in December 1999 to 10.7% in December 2003. Classified loans include all nonperforming loans (doubtful or loss) and substandard loans.

<sup>42</sup> Little information is available to verify such estimates. The Government suggested not publishing estimates as long as official data is unavailable, while it declined to make relevant information available.

build up provisions against losses from guaranteed loans. However, provisioning constituted only about 6.1% of the loan portfolio in December 2004. While many loans are also collateralized, the execution of pledges is constrained by weaknesses in the legal and institutional framework for asset foreclosure and bankruptcy.

125. Regarding the capacity of commercial banks to absorb losses by writing off nonperforming loans, for instance, the Uzbek authorities cite the high capitalization of the banking system. The official capital adequacy requirement is 10% of risk-weighted assets, stricter than the 8% recommended by Basel Committee. CBU reports that commercial banks maintain an average capital adequacy ratio of 26%. While this constitutes a decline compared with the 29.8% reported for the end of 2003, it is still 2.6 times higher than the CBU requirement, and 3.2 times higher than the Basel requirement. This indicates that the overall banking system is sufficiently capitalized to absorb hidden losses on the order of 20% of the loan portfolio.<sup>43</sup> However, this does not necessarily apply to every bank, given the large exposure of individual banks to specific sectors, industries, and/or groups of borrowers. Further, if hidden losses are significantly above 20% of the loan portfolio (and if additional losses are incurred), the system undoubtedly would be in a serious crisis. Additional losses could occur as a consequence of further currency devaluation and/or an economic slowdown.

126. Therefore, future banking sector reforms will have to address the suspected portfolio quality issues related to the large portfolio of state-guaranteed loans on the balance sheets of major banks.<sup>44</sup> The outlined issues also shed some additional light on banking sector regulation, supervision, and enforcement. A multitude of laws and regulations has been adopted to bring banking sector regulation in line with international standards and best practices. In 2002, for instance, CBU approved a provision on corporate governance in commercial banks, which defined more clearly the roles, rights, and responsibilities of shareholders, councils, and boards of directors of commercial banks. In 2004, CBU adopted resolutions on internal control and internal audit in commercial banks, which modified and strengthened requirements in line with the Basel Committee's recommendations. However, CBU's role in enforcing banking sector regulation needs strengthening, especially regarding disclosure requirements, related party lending, and single-borrower exposure. The remaining weaknesses are presumably due to (i) capacity constraints; (ii) insufficient independence; (iii) specific constraints imposed by the Government's industrial policy, and the systemic role that banks and their regulator play within the established economic system; or (iv) because of a combination of these factors.

127. **Banking Sector Efficiency.** The second set of issues that must be addressed before the banking system can realize its potential in financing economic growth and PSD is the need to enhance the efficiency of the banking sector through greater reliance on market forces, commercialization, competition, diversification, and private sector participation. International experience has shown that extensive state ownership and policy-based lending invariably lead to inefficient resource mobilization and allocations, and weak balance sheets of banks. In Uzbekistan, the high level of state intervention has impeded the development of a competitive and market-based banking sector. These features and others create disincentives for using the banks, and contribute to a generally low level of confidence in the banking system, which has seriously undermined the banks' ability to mobilize funds.

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<sup>43</sup> A stress test conducted on CBU data by IMF in early 2004 found that a doubling of classified loans to about 21% could be absorbed by the system, although a few small banks might become insolvent. The overall risk-weighted capital adequacy of the banking system would remain at a comfortable 24%.

<sup>44</sup> The Uzbek authorities maintain that decisions on the extension of state guaranteed loans were made solely on a commercial basis by the commercial banks themselves. Still, the authorities acknowledge that the decisions were made with the endorsement of the Ministry of Finance, and were in line with the Government's industrial policies.

128. In recent years, the Government repeatedly has made announcements on its intention to reduce state interference in the operations of the commercial banks (paras. 111-113). The authorities claimed that, with the exception of prudential norms, all state requirements regarding commercial bank lending effectively were abolished in 2002. Since then, the authorities claimed, commercial bank lending has taken place exclusively on a commercial basis in line with the banks' credit policies and strategic objectives. The authorities also stated that, since 2002, a Presidential decree has prohibited ministries, other state agencies, and local governments from interfering in the activities of commercial banks. Further, the authorities asserted that cash quotas for commercial banks effectively were abolished by end-2002, and that all limits on withdrawal of cash from bank accounts by individuals and enterprises were discontinued in 2003. These (and related) measures represent important initiatives to improve the autonomy and efficiency of the banking system. However, some of these measures do not appear to have been implemented in full, while unconfirmed reports suggest that new regulations have been introduced that diluted the effectiveness of the original measures.<sup>45</sup> In fact, only moderate progress has been made in real terms, despite advances in strengthening financial intermediation in some areas, as well as sizable increases in most monetary aggregates, including banks deposits, total loans, and loans to SMEs and microenterprises, etc. (Box 8).

#### **Box 8: Recent Increase in Deposits and Credits**

The market reforms undertaken in the Uzbek banking system since 2000 have aimed to improve efficiency in raising deposits and widen access to more diversified banking services by building up confidence in the banking system. The authorities report that deposits in the banking system have increased as a result of these measures, growing 1.9 times from SUM170 billion in 2003 to SUM323 billion in 2004. Special attention was given to supporting small businesses, private entrepreneurs, and farms, according to the authorities. Commercial banks' loans extended to small businesses in 2004 totaled SUM354 billion, of which 29.7% (SUM105 billion) was short-term loans and 70.3% (SUM249 billion) was long-term loans. Of the loans to small businesses that were financed by the commercial banks own resources (without credit lines), SUM72 billion went to industry, SUM66.7 billion to agriculture, SUM57.5 billion to private working capital, SUM26 billion to construction, and SUM17 billion to other sectors. The network of "mini-banks" also was expanded, growing from 795 in January 2004 to 1,122 by early 2005.

129. The privatization of banks has been another key Government objective for many years. In October 1998, the Presidential Resolution (No. 2084) titled "On Measures for the Improvement of the Joint-Stock Commercial Banks' Activities", announced the decision to divest state-owned commercial banks. In January 2003, another Presidential Resolution (No. 3202) introduced measures for the divestiture of state shares in enterprises (including financial institutions) with 25% or less state shareholdings in their capital. The Government has stated repeatedly its intention to divest 49% of the state shares in NBU and 51% in Asaka Bank. The partial privatization of NBU and Asaka Bank, originally scheduled by 2003, still has not been completed, despite significant technical assistance from international funding agencies to facilitate the process.<sup>46</sup> In the case of Asaka Bank, a lower-than-expected valuation and tender amount reportedly have been the reasons for the delay. The Uzbek authorities report that a

<sup>45</sup> A case in point are reports of various enterprises, including enterprises with foreign direct investment, that the authorities have required enterprises in early 2005 to make salary payments through bank accounts, ostensibly as a means of boosting the levels of bank deposits.

<sup>46</sup> The Financial Sector Development Agency (FSDA), initially established with World Bank support in 1999, has played an important role in promoting bank privatization, transferring banking technology, and developing institutional capacity at large commercial banks. It also is the implementing agency for an ADB-supported project on small and microenterprise financing.

tender for the recruitment of a financial consultant will be made in 2005 to help prepare for the sale of 49% of Asaka Bank to a strategic foreign investor that can restructure the bank in line with international best practice. A draft resolution on the transformation of NBU into a joint stock bank also has been prepared and submitted to the Government in 2005 for review. NBU has conducted pre-privatization preparations, including the rationalization of the bank's activities.

130. **Capital Markets.** Financial services outside the banking system remain marginal and underdeveloped in Uzbekistan. This includes the capital market. The Republican Stock Exchange (RSE) was established in April 1994 in accordance with the Presidential Decree (No. 745) titled "On Measures for Further Deepening of Economic Reforms, Protection of Private Property, and Developing Business", and a supporting Government resolution (No. 36), both adopted in January 1994. A national depository was also established in 1994. The initial activities of the RSE were focused mainly on providing the infrastructure for the sales of state shares as part of the Government's privatization programs.<sup>47</sup> Such sales also were conducted through the formal over-the-counter (OTC) market. Secondary market trading mainly took place at the informal market to avoid taxes and high transaction costs at RSE and the OTC market. However, a Government resolution (No. 196) adopted in April 2003 restricted all secondary market transactions to official trading platforms, such as those of RSE and the OTC market.

131. The total transaction volume of the securities market, including trading in the secondary market, was equivalent to \$85 million (0.8% of GDP) in 2003 and about \$130 million in 2004. At RSE, the transaction volume reached SUM35.7 billion (or about 0.5% of GDP) in 2003, which included \$8.3 million in hard currency trades. Privatization shares accounted for 37.9% of transactions at RSE in 2003, initial public offerings and additional share issues for 17.1%, and secondary market trades for 34.8% (Table 17). Corporate bond transactions totaled SUM3.6 billion (10.2% of total turnover) in 2003, a 300% increase from 2002.

**Table 17: Structure of Republican Stock Exchange Market, 2003**

<b>Types of Securities</b>	<b>% Distribution</b>
Privatization Shares (on behalf of State Property Committee)	37.9
Shares of Additional Issues	17.1
Secondary Market	34.8
Corporate Bonds	10.2
<b>Total</b>	<b>100.0</b>
<b>Breakdown by Markets</b>	
Primary Share Market	61.4
Secondary Share Market	31.8
Corporate Bond Market	6.8
<b>Total</b>	<b>100.0</b>

Source: Republican Stock Exchange.

132. With support from development partners and the Frankfurt Stock Exchange, RSE established an advanced trading infrastructure (Xetra-system). Shares of several hundred companies are traded, although most of these do not have a listing. The first company was

<sup>47</sup> Unlike most other transition economies in the FSU and Central East Europe, mass privatization of SOEs in Uzbekistan did not involve the voucher system, employing instead direct sales of small SOEs to insiders (management and employees) as well as to outsiders with prices mainly directly negotiated. Shares of medium-sized and large SOEs also were divested through investment funds, to which individuals and institutional investors subscribed. The investment funds bought shares through primary and secondary markets.

listed at RSE in 1998. The growth of listing has been extremely slow; only six companies had a listing in June 2005.

133. The Center for Coordination and Control of the Securities Market is the state body responsible for regulating securities markets. The center is still attached to the GKI, the Government agency in charge of privatizing state shareholdings. This institutional arrangement is historically understandable. However, it leads to conflicts of interest for the regulator, and underlines that the equity market is still mainly seen as an instrument for sales of state shares under the Government's privatization programs. Other weaknesses in the legal and regulatory framework for securities markets include contradictions between different norms and insufficient disclosure requirements. Further, surveillance techniques appear inadequate, and enforcement is uneven. A national association of investment institutions exists, though it is viewed generally as an industry association rather than a self-regulatory organization. Similarly, neither RSE and the national depository are self-regulatory organizations.

134. **Other Nonbank Financial Institutions.** The Uzbek authorities agree that the development of nonbank financial institutions needs more attention. They report that since mid-1992, when the Law on Credit Unions was adopted, 20 credit unions have been established and their combined membership now exceeds 12,000. The assets of these unions tripled in 2004, reaching SUM3.5 billion (0.03% of GDP) by the end of the year.

135. The microfinance sector is relatively small and heavily dominated by commercial bank lending, despite the recent establishment of microbanks. The microcredits portfolio totaled \$42.5 million in 2003. Commercial banks accounted for 90.4% of this portfolio, an EBRD credit line 5.5%, microfinance institutions 2.7%, and rural finance organizations 1.4%. Tax incentives and targeted onlending funds, which the Government gave to banks, were the primary reasons for the dominance of banks in microfinance. An estimated 0.1% of the poor have access to microfinance services. The legal and regulatory basis for microfinance was reviewed in 2003 with support from Uzbekistan's development partners. A new law covering nondeposit-taking microfinance institutions and amendments to some other laws needs to be drafted and enacted.

136. The insurance sector is also small with total insurance premiums equivalent to 0.3% of GDP in 2002. Five partly or fully state-owned companies dominated the market in terms of premiums and contracts signed at that stage.<sup>48</sup> Only five of the 28 insurance companies had foreign participation. Sector concentration was high as each company focused in one area, e.g., foreign trade, agriculture, or small businesses. Mandatory property insurance was the dominant type of insurance, while life insurance was virtually absent. This was due mainly to Uzbekistan's track record of high inflation and repeated devaluations, which undermined contractual savings in general. The Ministry of Finance, which is the insurance regulator, reported that legislation and regulation of the insurance sector has been strengthened and brought in line with the standards of the International Association of Insurance Supervisors, with some transitional measures to take into account the national environment. Government representatives also stated that accounting standards for insurance companies have been harmonized with international standards.

137. Overall, the achievements and issues of financial sector development must be viewed in a larger context. The effective reform and development of a competitive and market-based financial system in Uzbekistan is contingent upon the reform of the Government's industrial

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<sup>48</sup> The Government did not make more recent figures available to the authors of this study.

policy. The implementation of this policy has entailed extensive state intervention in financial intermediation, essentially to channel financial resources to state-determined priority sectors and enterprises. This leaves little scope for more commercially and market-based financial institutions to develop. At the same time, financial intermediation within industrial associations and similar large industrial complexes—a key institutional arrangement in industrial policy—also undermines the development of the banking system, capital markets, and nonbank financial institutions.

## E. Foreign Trade and Investment

138. **Foreign Trade.** The trade and transport infrastructure inherited by the Central Asian republics from the FSU entailed significant economic interdependencies, including mutual dependence in water management and energy. As a double landlocked country, Uzbekistan is particularly dependent on transit through third countries.<sup>49</sup> Uzbek authorities frequently have closed parts of its borders due to periodic political and economic instability in some of its neighboring countries, as well as to restrict unauthorized imports and curb smuggling.

139. Exports declined continually between 1997 and 2002 (except for a very small increase in 2000), falling by 35% over the period. Still, Uzbekistan has recorded positive foreign trade balances since 1998, largely by repressing imports through severe restrictions on access to foreign exchange and nontariff barriers (including border post closure). In 2003, trade turnover increased 17.3% from the previous year to \$6.7 billion, yielding a trade surplus of \$760.8 million—the largest since 1995 (Table 18).

**Table 18: Trade Balance, 1995–2003**  
(\$ million)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Export	3,719.9	4,590.2	4,387.5	3,528.2	3,235.8	3,264.7	3,170.4	2,988.4	3,725.0
Import	2,892.7	4,721.1	4,523.0	3,288.7	3,110.7	2,947.4	3,136.9	2,712.0	2,964.2
<b>Balance</b>	<b>827.2</b>	<b>(130.9)</b>	<b>(130.9)</b>	<b>239.5</b>	<b>125.1</b>	<b>317.3</b>	<b>33.5</b>	<b>276.4</b>	<b>760.8</b>

Source: Centre for Effective Economic Policy.

140. The growth of foreign trade in 2003 officially was attributed to the adoption of measures aimed at promoting foreign trade. These included (i) simplification of procedures for enterprises' engaging in foreign trade; (ii) abolition of the requirement for preliminary registration of import contracts with the Agency for Foreign Economic Relations; (iii) exemption of taxes and duties, except for value-added tax (VAT), for foreign-invested enterprises producing finished consumer goods; and (iv) introduction of convertibility of the sum for current account transactions. In 2004, exports reportedly grew by an additional 30%, which can be attributed largely to increased external demand for commodities and higher international commodity prices.

141. Since the mid-1990s, the diversification of exports away from raw materials has been minimal, except for cotton fibers (Table 19). The commodity composition of imports also has changed relatively little aside from a decline in the share of foodstuffs and an increase in the share of services (mainly transport).

<sup>49</sup> For example, to avoid major detours, Uzbek traffic must transit through Tajikistan to get to or from Uzbek territory in the eastern part of the Fergana valley. The most direct road traffic from Samarkand to Tashkent also involves transit through Tajik territory.

**Table 19: Commodity Composition of Exports and Imports, 1995–2003**  
(%)

	1995	2000	2001	2002	2003
<b>Total Exports</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Cotton Fiber	48.4	27.5	22.0	22.4	19.8
Foodstuffs	1.7	5.4	3.9	3.5	2.7
Chemical and Plastic Products	2.5	2.9	2.7	3.0	3.1
Energy Resources	11.7	10.3	10.2	8.1	9.8
Nonferrous and Ferrous Metals	4.7	6.6	7.0	6.4	6.4
Machinery and Equipment	2.0	3.4	3.9	3.9	5.9
Services	7.7	13.7	14.6	15.9	14.4
Other Goods	21.3	30.2	35.7	36.8	37.9
<b>Total Imports</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>	<b>100.0</b>
Foodstuffs	18.2	12.3	10.8	12.5	9.9
Chemical and Plastic Products	9.3	13.6	12.7	15.1	12.8
Energy Resources	1.9	3.8	1.9	1.3	2.7
Nonferrous and ferrous metals	5.7	8.6	10.9	8.0	7.9
Machinery and Equipment	47.9	35.4	41.2	41.4	44.4
Services	5.0	8.5	10.3	10.6	10.2
Other Goods	12.0	17.6	12.2	11.1	12.1

Sources: Centre for Effective Economic Policy, State Committee on Statistics.

142. The direction of trade has changed markedly, with exports to and imports from non-CIS countries accounting for an increasing portion of the total (Table 20). Notably, Uzbekistan's intraregional trade with its immediate neighbors remains relatively small. Kazakhstan is Uzbekistan's largest trading partner in Central Asia, though its share of trade turnover in 2003 was only 4.4%.

**Table 20: Direction of Trade, 1995–2003**  
(%)

	1995	2000	2001	2002	2003
<b>Exports</b>					
CIS Countries	34.5	35.9	34.4	27.6	26.0
Non-CIS Countries	65.5	64.1	65.6	72.4	74.0
<b>Imports</b>					
CIS Countries	43.5	38.2	37.2	36.9	38.3
Non-CIS Countries	56.5	61.8	62.8	63.1	61.7

**CIS = Commonwealth of Independent States.**

Sources: Centre for Effective Economic Policy, State Committee on Statistics.

143. **Foreign Investment.** The authorities have promoted foreign investment, providing incentives for foreign investors and joint ventures. Net FDIs grew from –\$24 million in 1995 to \$167 million in 1997, a period of optimistic expectations about reforms in Uzbekistan. However, the imposition of a restrictive banking and foreign exchange regime in 1996–1997 created uncertainties about reform prospects. Problems in access to foreign exchange for profit repatriation and purchase of imported inputs, among other factors, precipitated a sharp and continuous decline in net FDIs between 1998 (\$140 million) and 2000 (\$74 million). A significant number of foreign investors ceased activities and left Uzbekistan. The East Asian and Russian financial crises in the late 1990s might have had contagion effects on FDIs in Uzbekistan. Still, Uzbekistan's per capita FDI at \$3 was already one of the lowest among the CIS countries. Moreover, FDIs in Uzbekistan continued to fall well after the Russian crisis of 1998, suggesting

that the adverse domestic business and economic climate was the main factor for the decline. In the second half of 2002, the unfavorable investment climate became even more difficult when the Government introduced severe tariff and nontariff barriers, including a crackdown on shuttle trade, which impeded trade. In 2003, FDIs accounted for 7.1% of total fixed capital investments.

144. As of January 2004, 3,539 enterprises with foreign investments were registered in Uzbekistan, 62.4% of which were active. The largest number of active enterprises was in industry (36.9%), followed by trade and catering (12.8%). The output of enterprises with foreign investments accounted for 15% of GDP in 2003, 15.2% of exports, and 29% of imports.

145. **Major Constraints.** Government policies have induced the most significant impediments to the development of Uzbekistan's foreign trade and investment. The Government has imposed a broad range of foreign exchange and trade controls to protect infant industries, as part of its industrial and import substitution strategy, and to conserve foreign exchange.<sup>50</sup> Trade controls have included non-tariff barriers against imports of consumer goods and a 30% surcharge on the value of goods (net of VAT) imposed on legal entities and combined VAT and customs surcharges on individuals of 90% (later reduced to 20% and 70%, respectively, with surcharges for legal entities abolished in January 2003). Extensive administrative restrictions aimed at curbing shuttle cross-border trade also are in place.

146. Administrative means have been used to enforce a highly controlled foreign exchange and trade regime. This has been a device for restricting and channeling foreign trade activities to designated priority sectors and enterprises, such as the industrial associations, SJSCs, and their member enterprises. As a result, private sector participation in foreign trade has been repressed, as shown by the small share of SMEs in foreign trade. While the number of SMEs engaged in foreign trade increased from about 2,400 in 1999 to approximately 3,300 in 2003, their share of exports fell from 29.4% to 7%. SMEs' share of imports fell dramatically from 35.5% in 1999 to 2.7% in 2002, before increasing slightly to 3.3% in 2003. According to the 2002 Business Environment and Enterprise Performance Surveys by the World Bank and EBRD, the SMEs' 3.3% share of exports in Uzbekistan is one third the regional average.

## F. Agricultural Development

147. PSD in agriculture is essential for the development of the private sector as a whole in Uzbekistan, as well as for balanced and sustainable national economic growth and poverty reduction. Uzbekistan is still largely an agrarian economy. Official data shows that agriculture's share of GDP was 28.8% in 2003, though this figure tends to underestimate the actual importance of the sector in the national economy for various reasons. First, artificially low prices for agricultural products determined by the state's monopolistic powers create relative price distortions that probably underestimate agriculture's share of GDP. Second, the relatively large industrial sector was developed in the pre-transition period under a non-market command system, which was part of the overall FSU economic system. After transition, the increasing reliance on market forces and economic development according to Uzbekistan's comparative advantage might reduce the prominence of industry and increase the importance of agriculture.

<sup>50</sup> In comments on a draft of this study, the Uzbek authorities argued that a need to restrict imports of internationally uncompetitive, overpriced, poor quality, and potentially harmful products compelled the gradualness of foreign exchange market liberalization. Controls in the foreign exchange and trade regime, therefore, were aimed at "rationalization" of imports, protection of domestic consumers, prioritization in the usage of foreign exchange, and achieving balance on the current account. However, the validity of these reasons is debatable. For example, the restriction of imports of sub-standard products and those potentially harmful to health can best be enforced through competition and/or regulatory product quality standards.

Third, the majority of the population resides in the rural areas, and agriculture remains the largest source of employment.

148. The potential of agricultural in Uzbekistan, however, is underexploited. As in other sectors of the economy, the excessive role of the state creates major impediments for private sector agricultural activities. Although farm restructuring continues, much of the “command and control” system of the FSU has been maintained in the agriculture sector. This system is a source for accumulating resources for state-led industrial development. Some of the more important features and impediments identified in a recent ADB study of the agriculture sector are described in paras. 149–155.<sup>51</sup>

149. First, the state procurement prices for cotton and wheat, the two major crops in the economy, are set artificially low (at about 50% of world market prices). This price policy is combined with high mandatory delivery quotas and ambitious production targets set by the Government. The failure of farmers to meet targets brings punishment through lower prices and possible eviction from the land. The Government effectively controls cotton marketing, although in theory the Tashkent commodity exchange offers an alternative marketing outlet. The implicit taxes imposed through suppressed cotton and wheat procurement prices are a major source of budget revenue, equivalent to about 10% of GDP. The suppressed prices imply a 57% tax on gross farm income from each hectare planted with cotton or wheat. If an additional implicit tax on farmers derived from inefficiencies in the Government’s monopolies is imputed, then the average tax rate on cotton and wheat farmers is about 75% of gross income.

150. Second, Government agencies ration more than 90% of farm inputs as a means of ensuring compliance with its cotton and wheat production targets. In addition, the availability of farm machinery, except for grain harvesters, continues to decline. Mechanical harvesting of cotton declined from about 60% in 1990 to less than 3% in 2003.

151. Third, directed credit dominates commercial lending to the sector. Government financing for cotton and wheat accounts for 90% of all lending to agriculture. Commercial lending is insignificant. A new system of financing cotton and wheat has been introduced for family farms. However, the application procedures are complex, and banks are used as an additional control lever to discipline farmers. In addition to channeling funds for cotton and wheat production, banks also collect taxes on behalf of the Government, often without the farmer’s knowledge.

152. Fourth, the retention of the FSU’s command and control system has meant the continued precedence of unwritten laws or verbal orders given by state agencies, most importantly at the local government level. Land is assigned to farmers in long-term leases, which local officials can revoke easily. Protection of private property and written contracts are difficult to enforce. Only in extremely rare cases would a court reverse a verdict by a local official as unjust, while most serious disputes never reach the courts.

153. Fifth, restricted cotton and wheat marketing, together with cost-plus pricing and a lack of progress in privatization, have undermined private activities and legitimate business opportunities in the formal sector, precipitating a shift to the informal sector. Official private agribusinesses and other rural business are enveloped in a complex web of formal and informal regulations that demand special connections to local officials.

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<sup>51</sup> ADB. 2005. *Uzbekistan - Agricultural Sector Review and Planning*. Manila.

154. Sixth, deteriorating irrigation service has increased soil salinity. More than 95% of crop production is irrigated with water the Government provides for free. However, the service has been deteriorating. About 65% of irrigated lands suffer from elevated soil salinity, and about 20,000 hectares are taken out of production annually due to high soil salinity.

155. One of the results of irrational farming policies, declining soil fertility due to planting of cotton and wheat, and reduced yields has been environmental degradation. Thus, farmers are trapped in a vicious circle of falling incomes and deteriorating rural infrastructure and services. Rural poverty is widespread, with about 70% of Uzbekistan's poor (or 4.5 million people) living in the rural areas.

## **G. Business Environment**

156. Two Business Environment and Enterprise Performance Surveys, conducted in 1999 and 2002, highlighted some of the main obstacles facing domestic and foreign enterprises doing business in Central Asia, among other transition and emerging market economies. The biggest obstacles identified in the surveys included (i) the limited access to, and high cost of, financing; (ii) punitive tax rates; (iii) inefficient tax administration; and (iv) macroeconomic instability. The surveys also highlighted the importance of sound legal systems and the rule of law in creating business climates conducive to the efficient operations of firms and PSD.

157. Many of the obstacles identified in the surveys for Central Asia are evident in Uzbekistan. This was confirmed in two comprehensive surveys of the business environment for SMEs in Uzbekistan that IFC conducted in March 2002 and March 2003. The 2002 IFC survey produced two key findings. First, the level of general legal and informational awareness of SMEs and individual entrepreneurs is low. Two thirds of SMEs were unaware of recent SME-friendly regulations, while a majority of SMEs poorly understand legislation governing SMEs and their rights as entrepreneurs. Second, significant regional variations exist in the importance SMEs attach to issues such as taxation levels and frequency of inspections, indicating the extent to which regional authorities determine the local business environment. This also suggests a high level of dissatisfaction with the arbitrariness of regional governments in implementing laws and regulations. The survey also found that SMEs encountered considerable administrative difficulties in starting or operating their business, with currency conversion, export and imports, taxation, and inspections ranking among the most problematic. SMEs also complained about the extensive and unusual powers given to banks in verifying SMEs' revenues, liabilities, and cash flow, as well as in reporting SMEs' operations to tax authorities and local governments. The other main findings of the 2002 survey were:

- (i) Almost all (99%) SME respondents were not engaged in foreign trade, because of problems with (a) currency convertibility, (b) inadequate Government measures to stimulate SME exports, (c) restrictive import regulations, and (d) complicated and contradictory foreign trade legislation.
- (ii) Taxation was regarded as one of the most significant barriers to SME development, and lead to revenue concealment. The tax burden was viewed as aggressive by SMEs, which paid up to 2005 an average of 23% of their gross revenues in taxes.
- (iii) Inspections were still conducted frequently (an average of 6.5 inspections and 13.7 days of inspection per year), although the number had fallen. More than 30 Government agencies are empowered to control and inspect businesses.

- (iv) Too many activities were subject to extensive, cumbersome, and often confusing requirements on licensing, certification, and standardization, which were often open to different interpretations.
- (v) SMEs did not regard banks as effective financial intermediaries. The most serious constraints included (a) legal restrictions on cash withdrawals, (b) bank bureaucracy, (c) occasional lack of cash in banks, (d) high interest rates, (e) excessive documentation requirements, (f) high collateral requirements, and (g) lack of long-term financing. Despite existing microcredit lines of international funding agencies, less than 1% of respondents had ever applied for hard currency credits.
- (vi) SMEs had limited access to information technologies. While they would be willing to pay for consultancy and other business support services, 99% of the respondents never used such services.

158. A follow-up assessment in March 2003 (based on 2002 data) found that the measures taken by the Government to improve the environment for entrepreneurs had mixed impacts. Despite the new measures, constraints remained including significant instability in tax legislation, increased impediments to foreign trade (e.g., rise in import duties), and increased severity of requirements in wholesale trade operations for SMEs and individual entrepreneurs. As a result, a significant share of enterprises went out of business. The 2003 survey found that the major negative factors impeding the operations of enterprises continued to be (i) administrative procedures (bureaucratic red tape), (ii) currency conversion, (iii) access to finance, (iv) taxation, and (v) restrictions on foreign trade. Difficulties with inspections and registrations decreased.

159. The heavy and aggressive tax burden cited in the surveys is a serious impediment for businesses. Uzbekistan has one of the highest tax-to-GDP ratios within the CIS. While the tax system is designed to ensure stable budgetary revenues, it also compromises enterprise viability (Box 9).

160. The Uzbek authorities have introduced measures to simplify the tax system and make it more transparent. Under a Government resolution (No. 159) adopted in April 1998, microfirms and small enterprises pay a single tax instead of multiple national and local government duties and charges. The single tax rate reportedly has remained stable over the past 3 years at 12% for enterprises in main industrial sectors and 30–50% for trade, supply, brokerage, entertainment, and other enterprises. Many enterprises have broken up their operations into smaller units to qualify for the simplified tax system for small enterprises.

161. The authorities, however, recognize that a number of shortcomings in the tax system need to be addressed, particularly the VAT exemption. Simplified and more efficient procedures for VAT offsetting reportedly will be developed in 2005 for reimbursing exporting enterprises their negative VAT balance.<sup>52</sup> In January 2005, a Presidential resolution (No. 2108) called for the development of a new tax code. The new code, among other things, will aim to (i) develop clear and transparent tax principles, approaches, and canons; (ii) decrease enterprise tax burdens and strengthening the incentive role of taxes in rational use of resources; (iii) ensure direct action of the tax code, and simplification of the tax system through unification of calculation and payment of certain taxes; (iv) align tax conditions for all taxpayers, including

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<sup>52</sup> For products subject to zero VAT, enterprises calculate zero VAT and the sum of VAT for inputs used in production, which is accepted as an offset against future claims. This means that enterprises incur a negative tax balance when they export their products.

abolishing unjustified exemptions and exclusions from the general tax regime; (v) ensure stability and predictability of the tax system to enable enterprises to reliably forecast their medium-term business environment; and (vi) improve tax administration, leading to higher collection rates and less tax evasion. The new tax code is being developed with the assistance of international experts to move Uzbekistan's tax system closer to international standards and best practices.

**Box 9: Impact of the Tax Policy and System on the Business Environment**

The tax system compromises enterprise viability in a number of ways, including:

- (i) nondeductibility of a number of essential costs under profit taxation that could result in significant profit tax obligations, even if an enterprise has no accounting profit or has incurred losses;
- (ii) treatment of increase in local currency equivalent of foreign exchange deposits (due to exchange rate devaluation) as capital gain subject to profit tax, leading to depletion of working capital;
- (iii) inadequate loss carry-forward provisions whereby bad debts are deductible with a 3-year lag (without inflation adjustment), and accrual-based tax collection despite widespread inter-enterprise payment arrears;
- (iv) unusually wide definition of property tax base (similar to asset tax), which effectively represents another form of investment returns tax, and thus duplicates the profit tax; and
- (v) value-added tax (VAT) cascading due to multiple tax exemptions, including VAT exemption of trading companies and small and microenterprises, which discourages exports as VAT is not zero-rated when exports are conducted through trading companies and small and microenterprises; soft currency exports also are not zero-rated.

The Uzbek tax system is highly volatile, because multiple changes in tax rates and tax bases are made each year, making the business environment unpredictable and unstable. Further, the tax system is fragmented and contradicts the principles of equal opportunities by discriminating according to type of enterprise and income source. Enterprises are subject to different tax regimes depending on economic sector, ownership, location, type of goods, and destination. Large enterprises are able to negotiate tax benefits on a case-by-case basis. The system is also differentiated by enterprise size, with the tax burden increasing with the size of enterprises. This creates incentives for enterprises to transfer profits to smaller enterprises. Tax benefits are granted to privileged enterprises, such as joint ventures, enterprises with foreign investments, and those included in the Government's investment program.

Source: World Bank.

162. In 2003, the Government adopted other reforms aimed at lowering barriers to enterprises. The key measures included (i) abolition of the cash plan; (ii) lifting of some restrictions on payments settlement system for import operations; (iii) improved procedures for enterprises in obtaining certain types of permits through a "one-window" registration system; (iv) current account convertibility; (v) curtailment of oversight functions of state agencies; and (vi) enacting the Law on Private Enterprise, which gives greater protection to private enterprises from double taxation.

163. Despite positive changes in the business environment brought about by these measures in 2003, an updated IFC assessment finalized in March 2004 (based on 2003 data) found that serious barriers to business persist—and many of these barriers are becoming more acute each year.<sup>53</sup> The survey found a disturbing trend: the share of surveyed entrepreneurs investing in their business had dropped steadily over the past 3 years from 53% to 19%. The respondents identified the key impediments to businesses as (i) instability of tax legislation, and the

<sup>53</sup> It remains to be seen if additional measures announced in the first half of 2005 (compare paras. 103-105) help to address these barriers.

nontransparent methods of calculating and paying taxes; (ii) banks operating more as controlling organizations than as effective financial intermediaries; and (iii) lack of transparency in selection criteria of inspections by Government agencies (although inspections are now more selective than all-inclusive). At the same time, SMEs reported that the modified “one-window” registration system generally has been effective.

164. Extensive and complex administrative regulations governing the opening and operation of businesses often create moral hazards for corruption. Like other CIS countries, corruption is a serious problem in Uzbekistan. Uzbekistan scored 2.9 in the 2002 corruption perception index published annually by Transparency International. Its 61st ranking out of 102 countries<sup>54</sup> placed Uzbekistan higher than Kazakhstan and Russian Federation, but far below countries in Eastern Europe. Administrative corruption in Uzbekistan includes the demand for unofficial payments from businesses to get access to public utilities, obtain necessary permits, and avoid repeated inspections.

165. Although significant progress has been made in establishing a legal and regulatory framework for the private sector, considerable weaknesses in enforcement remain. The corpus of commercial laws is still limited in scope, and provisions are open to conflicting interpretations. This is particularly true of the legislation on pledge and bankruptcy. For instance, inconsistencies and ambiguities are evident in the scope for reorganization proceedings and the priority of secured creditors in bankruptcy. The company law does not ensure adequate corporate governance and protection for minority shareholders. The main legal impediments to investments include (i) absence of efficient pledge registration, (ii) complex and sometimes contradictory legal rules coupled with insufficient implementation, and (iii) high level of discretion granted to government officials in interpreting the application of legislation.

166. Uzbekistan has made progress in developing a regulatory framework for competition policy. The State Committee on Demonopolization and Competition Development (CDCD) has been established with the objectives of (i) developing competition and entrepreneurship, (ii) regulating activities of monopolies, (iii) preventing abuse by firms with dominant market positions, and (iv) enforcing sanctions on firms who engage in unfair competition. The primary instrument of competition policy is the register of monopoly enterprises, defined as enterprises with market share of at least 65% (or under certain conditions, 35%) that are considered dominant. These enterprises are required to declare their prices and profits for CDCD approval. However, the basic concepts of competition are still inadequately understood, including those relating to the delineation of product and geographic boundaries. Further, CDCD focuses excessively on price controls as a competition policy instrument. Competition and regulatory policies, as well as the specific goals they are designed to achieve, have not been incorporated fully within the Government’s broader structural and macroeconomic reform process. CDCD’s potential role cannot unfold within the current system of economic management.

## **V. ADB’S PRIVATE SECTOR INITIATIVES IN UZBEKISTAN**

167. ADB views PSD as an effective means to achieve its overarching objective of poverty reduction. Sustainable economic growth, based on increased productivity, is the key to winning the war against poverty. The private sector will be the engine for economic growth, creating jobs and increasing incomes to lift people out of poverty.

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<sup>54</sup> This was a slight improvement over the 2001 score of 2.7, which placed it 71st out of 91 countries.

168. ADB's interventions in support of PSD in Uzbekistan have taken varied forms (Table 21). It has generally encompassed (i) developing rural and microfinance institutions, assisting farm and agribusiness privatization, and providing financial support for microenterprises and SMEs; (ii) supporting legal and regulatory reforms, as well as capacity building in other areas of the financial sector, including insurance, banking, and securities markets; (iii) strengthening the legal and regulatory framework for corporate governance, preparing enterprise restructuring, and developing the institutional framework for competition policy; and (iv) facilitating private sector participation in infrastructure and services.

**Table 21: ADB Activities for Private Sector Development in Uzbekistan**

Rural, Microfinance, and SME Development	Other Financial Sector Development	Corporate Governance, Enterprise Restructuring, and Competition	Private Sector Participation in Infrastructure
<ul style="list-style-type: none"> <li>• Rural Enterprise Development Project (Loan 1504-UZB)</li> <li>• Ak Altin Agricultural Development Project (Loan 1833-UZB)</li> <li>• Grains Productivity Improvement Project (Loan 2017-UZB)</li> <li>• Small and Medium Enterprise Development Project (Loan 1799-UZB)</li> <li>• Small and Microfinance Development Project (Loan 1963-UZB)</li> <li>• TA 4021-UZB: Developing Prudential Regulations and Supervision of Savings and Credit Unions</li> </ul>	<ul style="list-style-type: none"> <li>• TA 3352-UZB Strengthening of the Banking Sector</li> <li>• TA 3488-UZB Development of the Insurance Industry</li> <li>• TA 4146-UZB Financial Market Development</li> <li>• TA 5465-UZB Financial Sector Infrastructure Development</li> </ul>	<ul style="list-style-type: none"> <li>• TA 3562-UZB Corporate Governance Reform Program</li> <li>• TA 4062-UZB Enterprise Restructuring and Corporate Governance</li> <li>• TA 4147-UZB Demonopolization and Competition Development</li> <li>• TA 4265-UZB Strengthening the Policy and Legal Framework for FDI</li> </ul>	<ul style="list-style-type: none"> <li>• TA 4071-UZB Developing a Management Information System for Uzbek Teleco</li> </ul>

SME = small and medium enterprise, TA = technical assistance, UZB = Uzbekistan.  
Source: Asian Development Bank.

169. ADB's lending program in support of PSD in Uzbekistan has focused on developing enterprises in rural areas, inside and outside agriculture. The Rural Enterprise Development Project<sup>55</sup> (Loan 1504-UZB, approved in 1996, for \$50 million) sought to rehabilitate and modernize private enterprises, predominantly SMEs in agro-processing. The Small and Medium Enterprise Development Project<sup>56</sup> (Loan 1799-UZB, approved in 2000, for \$50 million) provided credit lines to finance selected SME investments. The Ak Altin Agricultural Development Project<sup>57</sup> (Loan 1833-UZB, approved in 2001, for \$36 million) includes strengthening of new rural business advisory centers to support private farming. The Small and Microfinance Development Project<sup>58</sup> (Loan 1963-UZB, approved in 2002, for \$20 million) helps to develop a viable and sustainable system of savings and credit unions, and includes a credit line to enhance microfinance services to small and microenterprises. The Grains Productivity

<sup>55</sup> ADB. 1996. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Uzbekistan for the Rural Enterprise Development Project*. Manila.

<sup>56</sup> ADB. 2000. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Uzbekistan for the Small and Medium Enterprise Development Project*. Manila.

<sup>57</sup> ADB. 2001. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan Technical Assistance to Uzbekistan for the Ak Altin Agricultural Development Project*. Manila.

<sup>58</sup> ADB. 2002. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Uzbekistan for the Small and Microfinance Development Project*. Manila.

Improvement Project<sup>59</sup> (Loan 2017-UZB, approved in 2003, for \$26 million) aims to establish support mechanisms to facilitate the development and growth of private farms and related agribusiness enterprises.

170. ADB also has extended a wide range technical assistance (TA) grants to develop the private sector in Uzbekistan. TA 3352-UZB: Strengthening of the Banking Sector,<sup>60</sup> approved in 1999 for \$1 million, helped to strengthen the capacity of NBU and Asaka Bank for SME lending. The TA also supported the development of a banking sector reform strategy and implementation plan. TA 4071-UZB: Developing a Management Information System for Uzbek Telecom,<sup>61</sup> approved in 2002 for \$400,000, assisted in developing such a system in preparation for Uzbek Telecom's envisioned privatization. TA 3488-UZB: Development of the Insurance Industry, approved in 2000 for \$300,000, helped to strengthen insurance sector legislation, regulation, and supervision. TA 3562-UZB: Corporate Governance Reform Program, approved in 2000 for \$700,000, aimed to strengthen corporate governance in large JSCs and financial institutions. The TA also helped to address other issues of financial sector development, including weak financial disclosure and insufficient protection of creditors' rights. TA 4062-UZB: Enterprise Restructuring and Corporate Governance,<sup>62</sup> approved in 2002 in for \$1,000,000, followed up on TA 3562-UZB by supporting the preparation of the restructuring of selected JSCs in financial distress. TA 4021-UZB: Developing Prudential Regulations and Supervision of Savings and Credit Unions<sup>63</sup> was approved in 2002 for \$400,000 and attached to the Small and Microfinance Development Project. TA 4146-UZB: Financial Market Development,<sup>64</sup> approved in 2003 for \$200,000, aimed to strengthen capital market regulation and supervision. TA 4147-UZB: Demonopolization and Competition Development,<sup>65</sup> approved in 2003 for \$300,000, supported capacity building in CDCD, and regulatory reforms in competition policy. TA 4265-UZB: Strengthening the Policy and Legal Framework for Foreign Direct Investment<sup>66</sup> was approved in 2003 for \$300,000. TA 5465-UZB: Financial Sector Infrastructure Development,<sup>67</sup> approved in 2005 for \$400,000, will assist in analyzing financial sector issues and developing a comprehensive strategy to address them.

## VI. OPTIONS FOR FUTURE PRIVATE SECTOR DEVELOPMENT INITIATIVES

171. As demonstrated in this report and in assessments by other development partners, the impediments to PSD in Uzbekistan are numerous and diverse. Therefore, a wide range of initiatives is needed to address them, from macroeconomic stabilization to specific measures in almost all areas of the economy. While numerous such initiatives have been undertaken, a number of additional initiatives could be considered. One is in SME development. Initiatives in this area have tended to focus on microcredit facilities and reducing trade barriers to enable SMEs to develop more vigorously. In addition to these and other SME promotion initiatives, an

<sup>59</sup> ADB. 2003. *Report and Recommendation of the President to the Board of Directors on a Proposed Loan to Uzbekistan for the Grains Productivity Improvement Project*. Manila.

<sup>60</sup> ADB. 1999. *Technical Assistance to Uzbekistan for Strengthening of the Banking Sector*. Manila.

<sup>61</sup> ADB. 2002. *Technical Assistance to Uzbekistan for Developing a Management Information System for Uzbek Telecom*. Manila.

<sup>62</sup> ADB. 2002. *Technical Assistance to Uzbekistan for Enterprise Restructuring and Corporate Governance*. Manila.

<sup>63</sup> ADB. 2002. *Technical Assistance to Uzbekistan for Developing Prudential Regulations and Supervision of Savings and Credit Unions*. Manila.

<sup>64</sup> ADB. 2003. *Technical Assistance to Uzbekistan for Financial Market Development*. Manila.

<sup>65</sup> ADB. 2003. *Technical Assistance to Uzbekistan for Demonopolization and Competition Development*. Manila.

<sup>66</sup> ADB. 2003. *Technical Assistance to Uzbekistan for Strengthening the Policy and Legal Framework for Foreign Direct Investment*. Manila.

<sup>67</sup> ADB. 2005. *Technical Assistance to Uzbekistan for Financial Sector Infrastructure Development*. Manila.

initiative aimed at strengthening the conditions for PSD in agriculture could be useful. The overwhelming majority of SMEs and microenterprises are in agriculture. ADB and other external funding agencies are engaged in, or contemplating support for, agricultural and rural development, addressing issues of farm agro-processing and marketing services and investment incentives.

172. **Agriculture.** The agriculture (rural) sector in Uzbekistan today accounts for the overwhelming share of private sector activities. As such, the private sector in the country is essentially the agriculture sector. As discussed in Part IV of this study, the agriculture sector accounts for the largest share of the non-state sector in terms of the number of economic entities (at 40%), while almost its entire output (99.2%) is classified as non-state. PSD in agriculture, therefore, would be a critical departure point for PSD in the national economy. As international experience has shown, rising incomes in a country's agricultural or rural sector provide a powerful stimulus to domestic demand for investment, and consumer goods and services. Further, increased agricultural productivity would generate greater backward and forward inter-industrial links, which are crucial to growth of SMEs operating as a nexus between the agriculture and nonagriculture sectors.

173. The lack of property rights and extensive state interventions related to the size and type of activities are the key constraints to agriculture operations. These features undermine efficiency and discourage investments. Initiatives to give property rights to farmers and eliminate or reduce state controls over the scale and types of activities would be powerful stimuli to agricultural growth, as well as SME development and rural PSD. These initiatives in agricultural, though probably difficult politically, might be relatively easier than SME and PSD initiatives in industry, banking, and foreign trade. State controls in these areas are indivisible from the Government's industrial policy, which lies at the heart of its development strategy.

174. The imperative in creating an institutional and policy environment more conducive to private sector activities in agriculture, especially in clarifying property rights and in liberalizing the production, price, and trade regime, is well documented in ADB's recent assessment of the sector. This private sector assessment study stresses what this report also has highlighted, i.e., the need to improve incentives, clarify property rights, enforce contracts, develop product and factor (labor and capital) markets, and promote competition within a more market-oriented regime. The assessment of agriculture also identifies the need to increase farm incomes by reducing taxes and increasing procurement prices.

175. **Foreign Trade Regime.** Initiatives in foreign trade also should be considered. The dismantling of restrictive controls over foreign trade is likely to be a slow, difficult, and incremental process, because the sector is an integral part of the Government's industrial policy. Initiatives to selectively address specific issues (e.g., relaxing controls on shuttle or cross-border trade, or promoting intraregional trade and cooperation in Central Asia) are important. However, an initiative to encourage and facilitate Uzbekistan's accelerated accession to the World Trade Organization (WTO) also could be considered. WTO accession would require Uzbekistan to liberalize markets and significantly reduce state intervention in the economy. No other single act could be as powerful and effective as WTO accession in promoting Uzbekistan's market transition and PSD. While the country's accession is not envisaged for the near future, the significance of any initiative that potentially could advance the process should not be underestimated or delayed. Such an initiative could involve a comprehensive review of the Uzbek economy, where it needs to go, how to get there, what the costs and benefits are, and how costs can be mitigated. At the very least, such an exercise

could provide Uzbek policymakers with an empirical and quantitative perspective on the opportunity costs of delays in WTO accession.

176. However, many of the obstacles to PSD stem from two related sources: (i) extensive state ownership and control, which crowds out private sector activities; and (ii) far-reaching policy and administrative restrictions that increase barriers for private firms to enter markets, gain access to resources, and operate profitably; as well as distort prices and markets. These factors derive from the Government's development strategy, in general, and its industrial policy, in particular.

177. The rest of Part VI of this study discusses some specific initiatives that could be considered to support reforms in industry, the financial sector, and the state enterprise sector, as well as in macroeconomic management. Reform in macroeconomic management is included, because market development and PSD should be predicated on building up the capacity and confidence of the Government to achieve its developmental and industrial policy objectives more effectively through market-based methods of macroeconomic management.

178. The proposed initiative in the industrial sector focuses on a pilot reform program for an industrial association that represents the bulk of light industrial production in Uzbekistan. Instead of offering piecemeal reforms, the pilot reform would cover in a single package ownership, corporate governance, restructuring, competition, market development, resource allocation, trade liberalization, and SME development and PSD.

179. The proposed initiative for the financial sector, among other things, seeks to accelerate the partial privatization and unbundling of NBU, Uzbekistan's largest commercial bank. Reforming this bank is tantamount to reforming much of the commercial banking sector in the country. Whereas other external funding agencies are supporting the privatization of NBU, the initiative recommended in this study seeks to facilitate the process by proposing that policy lending be removed and placed under a new development bank that could undertake public-private cofinancing in infrastructure development. This measure would then facilitate the reform process, which has been stalled for many years, in two key ways. First, it would address the Government's concern that it needs a vehicle for policy lending. Second, the removal of the policy loans would clean up the balance sheet, making the partial divestiture of NBU more attractive to investors. Through the proposed unbundling of NBU, which dominates the banking sector, this initiative also would address the need for greater competition.

180. The proposed initiative for strengthening the performance of state enterprises is premised on the fact that the Government intends to retain a sizeable state sector in the foreseeable future. Thus, the report recommends measures for improving the performance of SOEs, including better state asset management, corporate governance, commercialization, and market development, as well as additional divestiture.

181. These proposed initiatives have been configured to be consistent with existing Government policies and announced measures. To provide coherence and synergy, the initiatives are subsumed within a reform framework aimed at establishing a dynamic, efficient, internationally competitive, and market-based corporate sector. The emphasis, therefore, is on improving economic efficiency, not privatization or PSD. Privatization and PSD are regarded as key "inputs" for achieving the desired "output" of enhanced economic efficiency and robust growth. As such, the focus is on improving the quality of the existing private sector, and the policy and institutional environment within which they operate, rather than simply increasing the number of private firms.

## A. Framework for Private Sector Development Initiatives

182. Substantive PSD in Uzbekistan is difficult to envision without a fundamental change in the Government's overall transition and development strategy, particularly its industrial policy and related institutional arrangements. This is the first-order issue for PSD in Uzbekistan. Other constraints on PSD at the sectoral and enterprise levels, such as the reliance on administrative allocation of resources, restrictive banking practices, discriminatory fiscal and foreign trade policies, etc., are second-order issues. These follow logically from the Government's development strategy and industrial policy. To attempt to promote PSD without addressing the root source of these constraints—industrial policy—would be like Hamlet without the Prince. It would not have any substantive and long-term impact.

183. This does not mean that piecemeal interventions at the sectoral level, such as banking reforms, industrial restructuring, or microcredit facilities for SMEs, are not useful. Over time, their cumulative effects might lead to substantive reforms. However, in many instances, reforms and liberalization measures in Uzbekistan are contradicted by other restrictive measures that effectively negate the original measures—essentially giving with one hand and taking away with the other. Moreover, many reform decrees and measures have not been implemented seriously. This should not be surprising, since these market-oriented reforms would impair the implementation of the Government's industrial policy.

184. Underlying the Government's transition strategy and its industrial policy is a paradigm of state-led development. Some countries, such as the Asian tiger economies, achieved certain successes under such a paradigm in their early stages of development. Many others failed. The paradigm of state-led development is broad with many variants. International experience has shown that the economies that succeeded under such a paradigm (e.g., Taipei, China; Republic of Korea; Malaysia; and Singapore) pursued an export-led growth strategy, harnessed the dynamism of the private sector in development, and subjected domestic enterprises to the discipline of domestic and international market forces. This applies especially to the PRC since market reforms began in 1978. Not one economy succeeded under a state-led development paradigm without increasing reliance on a robust private sector and on market forces. Countries that failed with such a paradigm repressed the private sector and markets.

185. The state-led development paradigm is, of course, controversial, not least for its implications for the development of a civil society. Certainly, the paradigm often is not conducive to economic efficiency and macroeconomic stability. For these and other reasons, it is not sustainable in the long term. Policy discussions to effect a change in Uzbekistan's state-led development paradigm are important, and have been pursued by development partners since the mid-1990s. However, Uzbekistan is unlikely to abandon this paradigm in the near future. If this assumption is correct, the second-best solution would be to encourage the authorities to move towards variants of state-led development that have greater prospects for economic success.

186. Thus, the framework for further initiatives in PSD should be defined within the parameters of current political realities. It should recognize—and not seek to abolish—the core principles and premises in the Government's development strategy, such as its industrial policy and the state's key (sometimes direct) role in economic activities through shareholding in strategic enterprises and other measures.

187. Within this framework, however, the scope for PSD and market reforms is wide. The main focus of initiatives would be on reducing the scope of state ownership and control to the extent possible, as well as—and perhaps more importantly—moving from direct administrative methods of state intervention and control toward market-based methods. The key objective of these initiatives would be to create a market-based regime that subjects state-owned or controlled firms to market discipline as a means of enhancing their efficiency, and also provides equal opportunities for private firms to develop and compete. The underlying rationale of such an approach is that increasing the quantity of privately owned enterprises is insufficient to promote PSD. The number of privately owned entities in Uzbekistan is already significant. The main challenge is to improve their quality by improving the policy and institutional environment within which they operate. This approach recognizes that a significant number of firms are likely to remain under direct and indirect state ownership or control. Thus, a second-best solution is needed to improve their economic efficiency through commercialization and full exposure to the rigors and discipline of market forces and competition from the non-state sector.

188. This framework for PSD initiatives could comprise two components. First, the initiatives should be undertaken within a rubric or program for corporate sector development, rather than one aimed primarily at privatization or more direct PSD. The core issues in PSD in Uzbekistan is the poor quality of private firms, and the unfavorable policy and institutional environment in which they operate. The overall objective of such a program would be to create an efficient, competitive, and market-based corporate sector that could serve as the engine for, and as the microfoundation of, sustainable and robust growth in the long term. It would include initiatives to reform industrial policy, the industrial associations, and the banking sector. The program also would cover initiatives to improve the performance of the state sector through rationalization, corporate governance, and exposure to competitive market forces. These initiatives would be mainly pilot projects in selected areas to demonstrate to policymakers the benefits and feasibility of such reforms. A number of specific pilot projects are proposed further below.

189. Second, the framework needs to build up the Government's capacity—and confidence—in abandoning direct, administrative methods of economic control in favor of indirect, market-based methods. This is discussed below.

## **B. Capacity Building in Market-Based Macroeconomic Management**

190. Initiatives to support the Government's progress toward a more market-based development strategy and economic institutions should accommodate the Government's legitimate desire to purposively influence the pace and direction of economic development. Economic efficiency and control are neither mutually exclusive nor incompatible. These initiatives could involve two related sets of assistance: (i) building up the Government's institutional capacity in macroeconomic analyses and use of monetary and fiscal instruments, and (ii) correlated reforms of the financial sector and legal and regulatory framework.

191. Some of these initiatives already have begun with support from development partners. However, the prospects for earnest implementation of the second set of initiatives are likely to be greater if the first set is pursued on a broader scale and with greater vigor to build up the Government's confidence in market-based macroeconomic management. In particular, the use of better-trained economists and macroeconomic models would provide policymakers with a more objective and reliable assessment of the costs and benefits of particular policies and interventions. One possible initiative is a banking reform and capacity-building project to establish or strengthen the independence of the central bank. This could involve, among other things, (i) organizational and statutory safeguards for its independence, (ii) development of

monetary policy rules, (iii) targeting and operations, (iv) improved economic monitoring and analyses, and, possibly, and (v) moving regulatory and supervisory functions to a separate and independent body. Similar reform and capacity building initiatives could be pursued to strengthen the fiscal system, particularly the efficiency of tax administration and the stability of public finances, and move toward a public finance regime more conducive to PSD.

192. Progress towards reliance on market-based methods of macroeconomic management would entail and facilitate an inverse and corresponding movement away from administrative controls in the national economy. This would allow the private sector and the market to operate more freely, while subjecting state-owned or -controlled firms to market discipline. This is more likely to occur if the Government believes that its key economic objectives, especially in industrialization, can be met effectively within a more market-oriented regime with a robust private sector, rather than through extensive state ownership, intervention, and highly regulated markets. In policy discussions with the Government, international funding agencies appear to have had limited success in effecting a policy shift. Therefore, these dialogues on macroeconomic policy reforms perhaps could be supplemented and reinforced by specific pilot reforms that could demonstrate, through empirical experience and concrete outcomes, the advantages of a more market- and private sector-oriented approach to industrial development. These pilot projects would not attempt reforms on a broad scale, but would test and demonstrate the market and private sector options. If successful, these could help build the economic case and political capital for PSD and market reforms on a wider scale.

### **C. Pilot Project for Integrated and Comprehensive Reform of the Light Industry: Reform of an Industrial Association**

193. The industrial associations (also called production and trade associations) represent a microcosm—a perfect analogue—of Uzbekistan’s transition strategy and regulated market economic mechanism. They embody all the key features: (i) extensive (direct and indirect) state ownership and control, (ii) administrative methods for the preferential allocations of resources, (iii) concentration of production, (iv) monopolistic powers, and (v) a residual role for private sector activities. Weak industrial growth is testimony to their inefficiency. Industrial associations are also a major impediment to PSD in industry. They are the core of Uzbekistan’s industrial system and corporate sector. As such, the departure or entry point for the development of an efficient and internationally competitive corporate, industrial, and private sector in Uzbekistan should be the reform of the industrial associations.

194. Recent Government measures provide an opportunity for undertaking initiatives to reform the industrial associations. Three key measures are especially relevant: (i) the Presidential Decree (No. 3202) titled “On Measures to Radically Increase the Share and Significance of the Private Sector in the Uzbek Economy”, issued in January 2003; (ii) the Government Resolution titled “On Measures to Improve Corporate Governance of Privatized Enterprises”, adopted in April 2003; and (iii) the Government Resolution titled “On the Program for Denationalization and Privatization of Enterprises in 2003–2004”, adopted in April 2003. These measures, particularly the Presidential decree, apparently have contributed to a reduction of industrial associations, SJSCs, and holding companies, and to internal reorganization and restructuring among some associations.

195. A prime candidate for a pilot reform of an industrial association is the SJSC O’Zbelyengilcanoat, a majority state-owned association in the light industry. This SJSC accounts for the lion’s share of light industrial production in the country (Box 10). Just as industrial associations are a microcosm of the Uzbekistan’s industrial policy and economic

system, the SJSC is a microcosm of the country's light industry. Reforming the SJSC would have a number of benefits:

- (i) Because the SJSC accounts for the lion's share of Uzbekistan's light industrial production, reforming this SJSC is tantamount to reforming light industry.
- (ii) In most countries, the private sector and SMEs traditionally perform a key role in light industry and the production of consumer goods. Private firms and SMEs are better able to respond quickly to changing trends in consumer preferences and market demand. Reform of this SJSC, and the light industry sector, would facilitate easier entry and fairer opportunities for private firms and SMEs.
- (iii) The SJSC includes a number of private firms. This provides a basis for promoting PSD through improving the quality and performance of private firms, instead of relying primarily on further privatization, which could be a long process and subject to the availability of private investors.
- (iv) The SJSC is the largest consumer and user of raw cotton. Reform of this SJSC could involve reforms of the system of procurement and pricing for raw cotton—the main cash crop in Uzbekistan—which could enhance the efficiency and well-being of cotton producers in the rural areas, and contribute to income growth, employment generation, and poverty reduction in the rural sector.
- (v) Reform of the supply (and distribution) system in the SJSC, and the light industry sector generally, could serve as a prototype for eventual reforms of the system of administrative resource allocation and distribution.
- (vi) The SJSC is a major exporter of light industrial goods. Reform of the SJSC could involve reform of the light industry and consumer goods export regime to facilitate greater participation of private firms and SMEs in these exports, and serve as the prototype and pathway for the liberalization of the foreign trade regime in other sectors.

196. Some member enterprises of the SJSC O'Zbelyengilcanoat are facing serious financial difficulties in meeting its obligations on foreign currency and foreign currency-indexed debts secured under a Government guarantee. As such, the SJSC is of major concern to the Government, which believes that the reform and restructuring of O'Zbelyengilcanoat, if possible with the assistance of external funding agencies, is a priority. The SJSC is part of an ADB-supported TA project (para. 170), which mainly aims to improve insolvency and bankruptcy procedures. The TA also covers corporate governance issues. The component of the TA dealing with the SJSC is limited, however, to diagnostics of a selected and small subset of member enterprises. It aims to identify unviable enterprises that should be liquidated, and to develop restructuring options for others. No support or funding is provided under the TA for their restructuring. Nor does the TA address the reform of O'Zbelyengilcanoat as a whole.

### Box 10: State Joint Stock Company O'Zbekyengilcanoat

More than 300 enterprises and plants, comprising the overwhelming majority of key large and medium-sized enterprises in Uzbekistan's line ministry in charge of light industry before independence, were grouped into an industrial association in 1993–1994. The association was converted into state-owned joint stock company (SJSC) O'Zbekyengilcanoat in 2002. Since then, some of the original 300 enterprises and plants have left the association to form separate industrial associations.

O'Zbekyengilcanoat now comprises over 100 medium-sized and large enterprises, which are fully owned by the SJSC, as well as industrial subsector associations and about 100 small fully privately owned enterprises, in the cotton (textile), knitting, garment, wool, and porcelain industries. The SJSC includes 104 joint stock companies (JSCs): 62 enterprises in textiles, including 17 joint ventures; 14 enterprises in garment, including 1 joint venture; 22 enterprises in wool, including 8 joint ventures; 3 enterprises in porcelain; and 8 enterprises in infrastructure. Member enterprises in the SJSC are engaged in upstream and downstream activities—with the SJSC covering almost the entire spectrum of economic activities from producing and sourcing inputs, to production of final goods, and distribution and marketing. O'Zbekyengilcanoat is a highly vertically and horizontally integrated conglomerate. The SJSC is the largest domestic user of raw cotton, and has considerable market power in the procurement and pricing of this commodity.

The ownership structure of the SJSC is: 51% state shareholding (SUM3,825 million), 34.9% shareholding by foreign investors (SUM2,621 million), 11.5% shareholding by founders (SUM854 million), and 2.6% undistributed shares of founders (SUM200 million). Of the total charter capital of over SUM261 billion among its members, 91.4% belong to the joint ventures, 5.1% to JSCs, 0.7% to private enterprises, and 2.8% to state enterprises.

The main functions of the SJSC include (i) determination of strategy for development of the sector; (ii) improvement of product competitiveness, quality and diversification, and productive efficiency; (iii) creation of joint small enterprises, and provision of assistance in divestiture and privatization; (iv) technological renovation and modernization; (v) market research and trade promotion, domestically and overseas; (vi) introduction of modern information technology and communication systems; and (vii) staff training and development.

In 2003, light industry in Uzbekistan accounted for about 20% of gross domestic product, 55.8% of the volume of consumer goods manufacturing output, and a third of national industrial employment. The SJSC today accounts for the bulk of Uzbekistan's light industrial production. Its production volume has grown from SUM39.8 billion in 1997 to SUM386.9 billion in 2003, of which SUM171.5 billion (44.3 %) was consumer goods production. About 56% of output was semi-finished products and raw materials for the garment and knitting industries. Joint ventures accounted for 43.2% of the SJSC's total output and 16.5% of its consumer goods production. Exports of the SJSC grew from \$62.4 million in 1997 to \$213 million in 2003, of which joint ventures accounted for \$154.8 million (72.7%). Joint ventures, therefore, have been critical to the SJSC's operations. While joint ventures account for only 43% of total production, they account for the bulk of the charter capital and of exports.

Senior officials of SJSC O'Zbekyengilcanoat said they are seeking to rationalize its organization and production structure to improve performance. One of the options being considered is conversion into a production and trading company or a holding company. Some of its member enterprises reportedly are facing severe financial difficulties, including problems in meeting their considerable foreign exchange debt obligations accumulated under the Government's guaranteed foreign borrowing schemes.

Source: SJSC O'Zbekyengilcanoat

197. A pilot reform of this SJSC could aim to improve the performance of the light industry through strengthening market operations and competition. The options and measures that should be considered include:

- (i) The SJSC as currently configured should be dismantled and unbundled. Large member enterprises (including those that are fully or majority state-owned) should be operated as autonomous and commercialized JSCs, and allowed to compete against each other. Medium-sized and smaller member enterprises could be merged, on a voluntary basis, to form JSCs of sufficient size to achieve scale economies and undertake technological renovation.
- (ii) The SJSC itself should be converted into a noncommercial light industry trade and development promotion agency, providing advice to its member enterprises in production, marketing, technological change, export, and other areas. The trade and development promotion agency should also provide support and training to enterprises in corporate development and business planning, including corporate governance, external financing, and listing. In particular, it should assist private firms and SMEs in entering and operating within the sector. The trade and development promotion agency should be funded by members' subscription, although its initial funding could be through a grant from the Government or an external funding agency, complemented with TA for institutional capacity building.
- (iii) State shareholding in member enterprises should be divested fully or reduced to a minimum. The pilot reform project should collaborate with Government agencies in developing criteria on which enterprises should, or should not, have state ownership, and then develop an accelerated process for divestiture of state shares. Those that remain under full or majority state ownership should operate as JSCs under the same legal and regulatory framework as non-state JSCs.
- (iv) Administrative allocation of resources and preferential access to funds, inputs, and distribution channels should be abolished for former member enterprises, which should operate on a purely commercial basis and through market channels. The pilot reform project should help develop and strengthen the network and modalities for enterprises to directly secure inputs and sell outputs on the market, domestically and through foreign trade. The impediments to such access should be identified and resolved in collaboration with the Government.
- (v) The pilot reform should target a selected number of eligible JSCs for assistance in preparing them for listing. This would involve support in corporate reorganization, restructuring, management development, corporate governance development, and compliance with securities regulations.
- (vi) The pilot reform also could establish a dedicated credit facility for SMEs in the light industry sector to promote their market entry and further development.

198. Clearly, the entire corpus of objectives and measures cannot be achieved in one project, and will have to be completed through a phased and incremental process. In earlier phases, the pilot reform could involve a limited number of a cross-section of member enterprises, and focus on developing the appropriate policy and institutional environment before proceeding to the dismantling of the SJSC. The critical feature, however, has to be an integrated reform process across all areas and issues identified, even though the reform process initially might be limited to a selected subset of member enterprises. For the pilot reform to have an appreciable impact and meaningful demonstration effect, the member enterprises selected should be the larger ones with sizeable state ownership and significant exports.

#### D. Pilot Reforms in the Financial Sector

199. The Government's recent confirmation of its plans to divest up to 51% of state shareholdings in NBU and Asaka Bank provides a window of opportunity for pilot reform in the financial sector. Privatization of the Asaka Bank, with the EBRD mentioned as a potential investor, reportedly has stalled because the tendered price was below the Government's expectation. Clearly, support should continue to prepare and accelerate the privatization of Asaka Bank. The Government also holds minority shareholdings in other commercial banks. Initiatives should be made to encourage and assist the Government to divest all its shares in these banks, which might be (politically) easier to achieve. Even if this were achieved, however, their full privatization would not have a significant impact in reforming the banking sector due to their small aggregate share of assets and operations. These banks, if and when privatized, would still be operating in a sector dominated by the state banks. This anticipation should constrain the interest of potential investors and limit the price for privatizing additional shares.

200. In addition to ceasing state intervention in banking operations and allowing banks to operate as commercial concerns in line with market forces, substantive reform of the banking sector best can be achieved through reform of NBU, which accounts for the overwhelming share of the banking sector's assets and business. As such, reform and (partial) privatization of NBU effectively would mean the reform of a substantial segment of the banking sector in Uzbekistan. Therefore, banking reform initiatives should focus on reforming NBU.

201. Although the Government repeatedly has declared its intention to privatize NBU, little substantive progress appears to have been made in the preparation for the sale. Privatization of NBU presumably is a difficult step for the Government to take because of its dominance in the banking sector. Moreover, the privatization would mean selling the main channel for directed or policy lending, even if the scale of such lending has been reduced. The privatization of NBU would effectively convert a state bank with monopolistic powers into a private monopoly. These concerns need to be addressed, if the privatization of NBU is to be facilitated. Uzbekistan's development partners, particularly ADB, could accelerate this process through a pilot reform initiative that addresses these concerns explicitly. Options the initiative could consider include:

- (i) The unbundling of NBU, and separating out policy lending from commercial business.
- (ii) The formation of a new development bank to take over the accumulated stock of previous policy lending (including the Government-guaranteed lending in domestic and foreign currency) and any future policy lending. The new development bank should specialize in long-term lending in infrastructure and basic industries by promoting private sector participation through public-private cofinancing initiatives. The pilot reform could provide assistance, possibly including partial capitalization, of the development bank.
- (iii) Depending on the asset size of the commercial business remaining in NBU after policy lending operations are removed, the further unbundling of NBU for privatization into two banks: a retail commercial bank, and an investment bank to promote corporate financing and securities market development.
- (iv) A better valuation for NBU after the policy lending business has been removed from its balance sheet, strengthening its status as a purely commercial bank.
- (v) Privatization of the reformed NBU in stages, and listing on the stock market. Organizational and corporate developments, including the adoption of more advanced banking technology, risk management, and corporate governance, should be a major part of the pilot reform.

- (vi) A schedule of liberalization measures for the banking sector as a whole, including the cessation of Government interference and restrictive practices in banking operations (e.g., cash planning and limits on cash withdrawals, fiscal collection functions, etc.). This could be agreed with the Government as part of the pilot reform. This effort should involve the development or strengthening of an independent banking regulator.

202. A related initiative that could promote lending to SMEs would be the development of credit guarantee companies. Such an initiative could be complemented by efforts to help develop credit rating agencies, which would also promote securities market development.

203. The proposal to establish a development bank might be somewhat controversial. However, if the Government is not going to cease policy lending (even under other guises), then that policy lending must be open and transparent (and contingent liabilities clearly identified). Further, policy lending must be prevented from contaminating the balance sheets and asset quality of commercial banks, and private sector participation should be encouraged.

204. Financial intermediation through the capital market and nonbank financial institutions is very limited and needs to be developed. The infrastructure and regulatory framework do not appear to be the main barriers to securities market development. The main obstacles appear to be the paucity of firms of sufficient quality to attract investors, and the lack of incentives for firms to list. Firms often regard compliance with listing requirements and with higher corporate governance standards (which still need to be developed much further) as high transaction costs that outweigh the potential returns of raising capital in a market characterized by weak investor demand and low market price valuation. Initiatives to promote securities market development, therefore, should focus on the supply side and aim at increasing the number of firms eligible and willing to list. From this perspective, initiatives to promote capital market development will have to focus largely on corporate development as part of the initiatives in industrial and banking reforms, e.g., reform of industrial associations and banks.

205. Many of the transactions in the stock exchange involve sales of state shares. In the PRC, the phenomenal growth of the securities markets has been state-driven through partial divestiture of Government shares of JSCs through initial public offerings. These public offerings were highly successful, because of heavy investor demand fed by high levels of household savings and vigorous growth of the private sector. More importantly, however, the success derived from strong investor confidence in the Government's credibility and commitment to market reforms. Such confidence is absent in Uzbekistan. A greater commitment to reforms by the Government in Uzbekistan, especially in the privatization of large state enterprises with strong performance or potential, could be a powerful stimulus for securities market development. Thus, as pointed out earlier, securities market development is largely dependent on progress with reforms in the corporate sector.

206. Securities market development would also necessitate growth of institutional investors, such as nonbank financial institutions. A number of investment funds, established in the mid-1990s as vehicles for the privatization of SMEs, already exist. However, the shortage of attractive investment opportunities has stunted the growth of investment funds. An important initiative for promoting institutional investors would be to support the development of market-based insurance and pension business.

## E. Initiatives for Strengthening State Enterprises

207. Despite the Government's declarations that it intends to privatize a significant number of medium-sized and large enterprises, little progress has been seen in this area. Moreover, under the privatization plans announced in 2003 and 2005, the Government will retain majority or controlling stakes in many key enterprises without any plans for their divestiture in the foreseeable future. This means a very sizeable state sector in Uzbekistan is to be maintained. This sector represents the core of the country's industrial system, and accounts for the lion's share of assets in the national economy. It also forms a major part of what constitutes the corporate sector in Uzbekistan. No attempt to improve the efficiency and international competitiveness of Uzbekistan's corporate sector, or the national economy for that matter, can ignore the urgent need to improve this sector's performance.

208. Initiatives to strengthen the performance of the state sector are often controversial, and generally not favored by external funding agencies. The argument against such initiatives is that improving the performance of the state sector leads to moral hazards and weakens the Government's incentive to privatize. If the state sector's performance improves, then why privatize (aside from the political and social advantages of creating a democratic civil society)? The answer is that no empirical evidence exists that the performance of SOEs can be improved on a sustainable basis, though short-term improvements are possible. The shortcomings of state ownership, such as ambiguous property rights, defective corporate governance, corruption and nepotism, arbitrary political interference, soft-budget constraints, and numerous other weaknesses, are intrinsic to state ownership and undermine economic efficiency.

209. In only few instances the performance of SOEs has been improved, though in the short-run only. In the United Kingdom, privatization of basic industries and public utilities were preceded by reforms that improved their performance and facilitated their divestiture at a better price.<sup>68</sup> During Poland's transition, SOEs were compelled to restructure and improve performance, or be liquidated, when the Polish Government imposed hard-budget constraints and announced a fixed deadline for their privatization. This forced enterprise management to improve performance as the only means of achieving a successful privatization or face closure. The example presumably most relevant to Uzbekistan is the PRC. The PRC Government initially insisted on retaining full state ownership of strategic enterprises and industries. However, the inability to improve their performance eventually led to their partial divestiture through initial public offerings on domestic and foreign stock markets. Partial divestiture also facilitated the raising of large amounts of (private) external finance to fund restructuring and development. However, the partial divestiture of SOEs was preceded by efforts to improve performance through (i) better state asset management, (ii) technological renovation, (iii) corporate governance, and, above all, (iv) commercialization and exposure to market competition. For example, the airline, energy, steel, telecommunications, banking, and other monopolies and enterprises were unbundled into (state-owned) commercial entities that competed against each other before they were partially divested through listings. The exposure to market competition led to short-term improvements in performance. However, the partial privatization through listing—the participation of private investors and the discipline imposed by the securities market—was what delivered strong and sustainable improvements in

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<sup>68</sup> A case in point is British Steel, which was one of the worst performers in terms of productivity and profitability in its sector globally. As a first step, private sector management was established at British Steel. The new management was given a mandate to improve the firm's performance in preparation for privatization. By the time British Steel was privatized, its productivity was one of the highest in the world.

performance. At the same time, the remaining state shareholdings were increasingly placed under professional and commercial asset management.<sup>69</sup>

210. Singapore also provides a relevant example. Many large and so-called strategic enterprises have sizeable state holdings in Singapore, and still perform well.<sup>70</sup> However, these Government-linked companies perform well because they (i) are operated on a purely commercial basis with hard-budget constraints, without any preferential treatment, by professional management, and are fully exposed to domestic and international competitive market forces; (ii) are subject to a strong, professional, and commercially-oriented state-owned holding and state asset management company (Temasek); (iii) have significant private sector equity holdings; and (iv) are subject to a well-developed and effective legal and regulatory regime that protects property rights, requires high standards of corporate governance, and contains powerful safeguards against political interference and corruption.

211. These are the lessons of international experience that should inform Uzbek initiatives to improve the performance of state-owned or -controlled enterprises. The decisive factors are: (i) competition, (ii) market discipline, (iii) private sector participation, (iv) effective corporate governance, and (v) commercially-based professional asset management of state shares. Another key lesson from international experience is that the number of SOEs should be small and limited to enterprises and industries where market failure and externalities warrant state intervention. With a large number of SOEs, the state has difficulty focusing its limited resources on key enterprises that warrant some degree or form of Government intervention. Current plans of the Government of Uzbekistan for the privatization of SOEs are insufficient for an effective downsizing and management of the state sector.

212. An initiative to improve the performance of the state sector that could be encouraged and supported by external funding agencies might have the following components:

- (i) A reexamination of current plans for the divestiture of state shareholdings, with a view towards increasing the scope and pace of divestiture;
- (ii) Adoption of measures to restructure as corporations all SOEs, and subject them to the legal and regulatory framework governing non-state enterprises;
- (iii) Formulation of targets and measures for varying degrees of private sector equity participation in state-owned industrial enterprises and state-owned financial institutions, and for increasing the share of private sector investment in partially divested (or non-state, according to Uzbek terminology) enterprises;
- (iv) Formulation and gradual implementation of measures to abolish all preferential treatment and subsidies (explicit and implicit) for SOEs, and to provide statutory safeguards for their financial, managerial, and operational autonomy and independence;
- (v) Formulation of a plan and road map for the formation of a professional, commercial, and market-based corporatized state holding company to manage state assets, with options for contracting out management of some state assets to non-state companies;
- (vi) Formulation and pilot implementation of procedures for establishing professional management of SOEs, based on management contracts, through an open and

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<sup>69</sup> The Government of the PRC recently has begun to divest most of its remaining shareholdings, in part to finance the establishment of a national, fully funded pension system.

<sup>70</sup> An example is Singapore Airlines, which is majority state-owned and one the best-performing airlines in the world.

- competitive process, with statutory safeguards on the managerial and financial autonomy of enterprises; and
- (vii) Pilot listing on the stock market of a few large SOEs.

213. A key objective is to improve the corporate governance of state enterprises, i.e., improve the ways in which the state exercises its ownership, corporate governance, and control functions over state firms. This could reduce the moral hazards of rent seeking, patronage, cronyism, and corruption that tend to characterize state-controlled entities. Such an initiative could involve the transfer of ownership, governance, and control rights and functions of the large enterprises and strategic industries from Government ministries and departments to a newly created, corporatized, state-owned holding company. This company would be operated on a commercial basis and in line with international best practice in corporate governance. The large enterprises and strategic industries placed under the state holding company should be corporatized, operate under the country's company law, and adopt best practice in corporate governance. Restructuring and recapitalization of these enterprises should be undertaken only within an improved structure of property rights and corporate governance.

214. Such an approach has two potential advantages. First, it would enhance the performance, accountability, and transparency of the enterprises, if they are to remain under state control for the foreseeable future. Second, with an improved corporate governance system in place, they could be further or fully divested more easily and readily once political conditions allow. Indeed, this approach could build in features that could accelerate large and strategic enterprises towards listing.

215. An important initiative that could significantly improve the performance of large SOEs and strategic industries would be the introduction or enhancement of competition among state-owned or state-controlled firms within a given industry. This would involve breaking up monopolies and allowing some (state-owned or state-controlled) operators to compete within a regulatory framework to prevent collusion and anti-competitive practices. Sectors in which the state predominates should be opened up to non-state operators.