

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,¹ 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)² 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

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

² 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 2002–2003,³ 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.

³ 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.⁴ 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.⁵ 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.⁶ 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

⁴ 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.

⁵ 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.

⁶ 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, respectively⁷). 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%.⁸ 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%⁹ 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

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

⁸ 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.

⁹ 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).¹⁰ 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

¹⁰ 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 economies¹¹, the private sector was relied upon to undertake and operate industries within the context of largely competitive domestic markets and open foreign trade.

¹¹ 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 374.¹² 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.

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