

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.