

Improvement Project⁵⁹ (Loan 2017-UZB, approved in 2003, for \$26 million) aims to establish support mechanisms to facilitate the development and growth of private farms and related agribusiness enterprises.

170. ADB also has extended a wide range technical assistance (TA) grants to develop the private sector in Uzbekistan. TA 3352-UZB: Strengthening of the Banking Sector,⁶⁰ approved in 1999 for \$1 million, helped to strengthen the capacity of NBU and Asaka Bank for SME lending. The TA also supported the development of a banking sector reform strategy and implementation plan. TA 4071-UZB: Developing a Management Information System for Uzbek Telecom,⁶¹ approved in 2002 for \$400,000, assisted in developing such a system in preparation for Uzbek Telecom's envisioned privatization. TA 3488-UZB: Development of the Insurance Industry, approved in 2000 for \$300,000, helped to strengthen insurance sector legislation, regulation, and supervision. TA 3562-UZB: Corporate Governance Reform Program, approved in 2000 for \$700,000, aimed to strengthen corporate governance in large JSCs and financial institutions. The TA also helped to address other issues of financial sector development, including weak financial disclosure and insufficient protection of creditors' rights. TA 4062-UZB: Enterprise Restructuring and Corporate Governance,⁶² approved in 2002 in for \$1,000,000, followed up on TA 3562-UZB by supporting the preparation of the restructuring of selected JSCs in financial distress. TA 4021-UZB: Developing Prudential Regulations and Supervision of Savings and Credit Unions⁶³ was approved in 2002 for \$400,000 and attached to the Small and Microfinance Development Project. TA 4146-UZB: Financial Market Development,⁶⁴ approved in 2003 for \$200,000, aimed to strengthen capital market regulation and supervision. TA 4147-UZB: Demonopolization and Competition Development,⁶⁵ approved in 2003 for \$300,000, supported capacity building in CDCD, and regulatory reforms in competition policy. TA 4265-UZB: Strengthening the Policy and Legal Framework for Foreign Direct Investment⁶⁶ was approved in 2003 for \$300,000. TA 5465-UZB: Financial Sector Infrastructure Development,⁶⁷ approved in 2005 for \$400,000, will assist in analyzing financial sector issues and developing a comprehensive strategy to address them.

VI. OPTIONS FOR FUTURE PRIVATE SECTOR DEVELOPMENT INITIATIVES

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

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

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

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

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

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

⁶⁴ ADB. 2003. *Technical Assistance to Uzbekistan for Financial Market Development*. Manila.

⁶⁵ ADB. 2003. *Technical Assistance to Uzbekistan for Demonopolization and Competition Development*. Manila.

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

⁶⁷ ADB. 2005. *Technical Assistance to Uzbekistan for Financial Sector Infrastructure Development*. Manila.

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

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

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

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

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

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

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

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

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

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

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

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

A. Framework for Private Sector Development Initiatives

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

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

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

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

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

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

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

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

B. Capacity Building in Market-Based Macroeconomic Management

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

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

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

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

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

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

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

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

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

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

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

Box 10: State Joint Stock Company O'Zbekyengilcanoat

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

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

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

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

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

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

Source: SJSC O'Zbekyengilcanoat

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

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

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

D. Pilot Reforms in the Financial Sector

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

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

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

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

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

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

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

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

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

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

E. Initiatives for Strengthening State Enterprises

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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