

EXECUTIVE SUMMARY

Policy and Institutional Environment for Private Sector Development in Uzbekistan

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

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

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

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

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

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

Profile and Development Dynamics of the Private Sector

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

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

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

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

Factors Impacting Private Sector Development

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

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

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

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

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

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

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

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

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

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

Asian Development Bank's Private Sector Interventions in Uzbekistan

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

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

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

Options for Future Private Sector Development Initiatives

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

This report proposes four specific areas for ADB support:

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

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