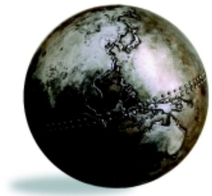


Uzbekistan

GDP growth of 4.4 percent in 1999 was maintained, although international prices for Uzbekistan's primary exports continued to be weak. Major structural reforms to sustain macroeconomic stability and growth are necessary, as well as policy measures to ameliorate the short-term social effects of these reforms.

RECENT TRENDS AND PROSPECTS

Despite the difficult macroeconomic environment and the repercussions from the Russian and Asian economic crises, real GDP grew by 4.4 percent in 1999, the same as the previous year (see figure 2.6). Growth was spurred mainly by agriculture and industry. The agriculture sector did not experience inclement weather as it did during 1996-1998, and hence witnessed an across-the-board increase in output that included cotton, the most important export crop. Agricultural output increased by 5.9 percent in 1999 compared with a 4 percent increase in 1998. However, the soft prices in international commodity markets for cotton and for gold, the other important export commodity, reduced total export earnings.

Industrial production increased by 6.1 percent, and construction services by 3.9 percent, boosting overall economic growth. Growth of the service sector also contributed significantly to real GDP growth, despite the government's policy of restricting imports of consumer goods that in turn constrained private trading. Nevertheless, by opening the service sector to private initiatives, this sector and nongovernment employment grew rapidly. The fiscal situation continued to improve in 1999 as the government maintained its efforts to reduce the budget deficit. The consolidated budget deficit contracted to 2.2 percent of GDP from 3.4 percent in 1998, reflecting progress in fiscal management.

Despite the tight monetary and fiscal policies maintained by the government, average monthly inflation was 1.9 percent, about 26 percent annually, as in the previous year. The principal cause of inflation was the rapid depreciation of the sum by about 27.3 percent during the year.

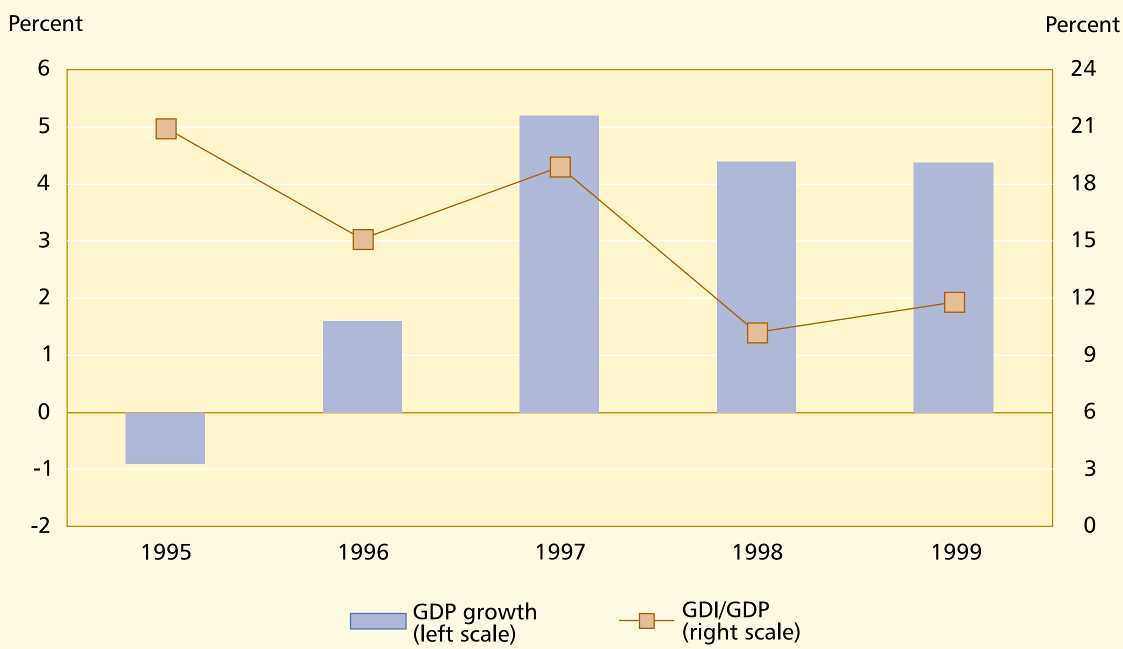
The balance of payments remained under pressure in 1999. The Russian crisis, a bad cotton harvest in 1998, and falling world commodity prices contributed to the substantial deterioration in external balances. The government responded by further restricting imports, tightening access to foreign exchange, and increasing foreign borrowing to finance public investments. Although the government continued to restrict the import of consumer goods, the current account deficit widened to 1.3 percent of GDP in 1999 compared with 0.6 percent in 1998. This was mainly attributable to the continued growth in imports, which increased by 10 percent in 1999 after a decline of 25 percent in the previous year.

Despite the deterioration in the current account deficit, gross official reserves stood at $1.2 billion at the end of 1999 (5.8 months of import equivalent), because of the surplus of $342 million in the capital account. This surplus resulted from the presale of gold to a foreign commercial bank for $150 million, and drawdowns on previously contracted debt during the year. Outstanding debt rose to $3.8 billion (25 percent of GDP) at the end of 1999, compared with $3.2 billion (24 percent of GDP) at the end of 1998. The debt-service ratio also rose to 11 percent in 1999, from 9 percent the previous year.

As announced by the government and decreed several times in 1998 and 1999, full liberalization of the foreign trade and exchange regimes is expected to be introduced in 2000, as well as comprehensive structural reforms in agriculture and banking. The government expects these changes to improve the growth outlook of the economy. In essence, renewed reform and stabilization efforts—in conjunction with the resulting higher export growth, substantial program lending by international financial institutions, and support from bilateral donors—would ease the foreign exchange constraint. This would allow faster import liberalization as well as a relatively stable exchange rate. Liberalization of the foreign trade and exchange rate regimes will bring upward pressure on inflation and force more rapid restructuring of the corporate and banking sectors.

Significant progress has been made in achieving macroeconomic stabilization, although recent external shocks have placed additional pressure on the economy. While some structural reform measures have been undertaken, much remains to be done. Major reforms in the recent past include increasing the state procurement prices for cotton and wheat by about 50 percent, writing off previous farm debts to the state budget, and rescheduling debts to input suppliers

Figure 2.6 GDP Growth and Gross Domestic Investment Ratio to GDP, Uzbekistan, 1995-1999



Sources: ADB (1999h); staff estimates.

until 2002. Farmers received a substantial reduction in tax burden, partly because various agricultural taxes were consolidated into a single unified land tax. Other tax relief measures included granting a three-year tax break to newly established private farms and establishing Rural Business Advisory Centers in all the rayons (counties) to provide business advisory and extension services to private farmers.

Prospects for 2000 are mixed. If the planned reforms occur in the foreign exchange and trade regimes, the temporary adverse macroeconomic consequences will likely slow GDP growth in the short run. However, once the relative price and structural adjustments are completed, real GDP is likely to grow steadily until the economy attains its full growth potential. GDP growth is therefore projected to contract to about 3 percent in 2000. The unification of the exchange rate will also lead to a one-time jump in the inflation rate. The fiscal situation is likely to be strained as the slowing of economic growth reduces tax revenues. The government's attempts to develop an effective social safety net—to protect the most vulnerable in society and provide financial assistance to critical industries negatively affected by the reform program—will also strain the fiscal situation. Nevertheless, the government's target budget deficit in the 2000 budget approved by Parliament is 3 percent of GDP. The International Monetary Fund deems this level of budget deficit temporary and sustainable.

Despite the strain on the internal balance, observers expect the external balance to improve somewhat in 2000, and to continue to improve gradually over the medium term. The deficit in the current account is expected to narrow to 1 percent of GDP in 2000 mainly because of the recovery in export growth. Once the reform program is implemented, a steady recovery in exports and an increase in imports should result. These will support much-needed technical renovations in the state-owned enterprise sector. Increases in energy and manufactured exports in the medium term, resulting from growing demand in neighboring countries, are projected to boost export growth. Because grain production has improved to levels of near self-sufficiency, grain imports will likely be modest. A surplus on the capital account would suffice to finance the current account deficit. Inflows of foreign direct investment (FDI) and long-term debt from multilateral and bilateral sources also are expected to increase, given the improved investment climate expected from the reform program.

With the completion of the foreign exchange and trade reforms in 2000 and the relative price adjustments, GDP growth is forecast to increase to 4 percent in 2001, with inflation contained at 20 percent per annum. The deficit in the budget is forecast to widen slightly to 3 percent of GDP in 2001; expenditures will be increased to support the social safety net necessitated by the economic reform program. The current account deficit is also anticipated to increase to 2 percent of GDP in 2001, mainly because of increased imports.

ISSUES IN ECONOMIC MANAGEMENT

The presidential decree of 1 July 1998 stated that Uzbekistan would introduce current account convertibility by the end of 2000. Significant efforts are under way to make this objective a reality. Introduction of current account convertibility would help increase exports and attract greater FDI. It would also stem the capital outflows that have troubled the economy since late 1996. The Partnership and Cooperation Agreement with the European Union of July 1999 was a significant step toward integrating Uzbekistan with the world economy. In an attempt to boost exports, the government cut the profit tax from 35 percent to 30 percent in June 1999. Simultaneously, it allowed payment of value-added tax to be delayed for up to 90 days on imported goods used in the production of exports. However, the multiple exchange rate system continued to restrain export growth and FDI.

The government's privatization program, especially for large-scale enterprises, appears to have encountered difficulties because of limited foreign investor interest. The main problem remains the government's reluctance to offer majority stakes to strategic investors. Other problems are unrealistic price expectations, a difficult investment environment, and falling commodity prices in world markets. The main concern is that, although the management of the corporatized and privatized enterprises is supposed to be autonomous, the ownership patterns and the current regulatory regime are not sufficiently developed to prevent state interference.

Financial sector reforms are being expedited under a $25 million World Bank loan approved in June 1999. The project aims to strengthen corporate governance in commercial banks, improve the supervisory functions of the central bank, and increase the openness of the sector to foreign entry. The key short-term issues for the government include continuing reforms in the financial and corporate sectors, adopting policies to stimulate noninflationary economy growth, and providing a social safety net program to offset the anticipated social costs of liberalizing the foreign exchange and trade regimes.

POLICY AND DEVELOPMENT ISSUES

Long-term growth prospects are promising. Rich natural endowments, the large stock of human capital, and centuries of tradition in commerce and trade bode well for a successful transition to a fast-growing market economy. The realization of this potential is the central development challenge. Creating enough opportunities to reduce unemployment and underemployment and absorb the growth in the labor force is critical. Unless a more robust and sustainable GDP growth rate is attained, it will not be possible to address this issue effectively, and the number of families living below the poverty line will increase. Authorities estimated that in 1998, 23 percent of the population were living below the official poverty line of Sum910 per capita per month which at market-exchange rates amounts to less than $5 per month.

The main objectives of the government should be the revival of economic growth and the diversification of the economy. The realization of both objectives hinges on accelerating reforms. An appreciation of this critical aspect is essential. First, while prospects for recovery in international prices of gold and cotton are more optimistic than they have been for several years, the cushion that was provided by attractive commodity export prices in the first few years after independence is no longer available. Higher foreign exchange earnings will depend on larger quantities of commodity exports and new export items. The fallout of the Russian crisis has made it clear that diversification of the export basket has become essential.

Second, cotton and grain yields remain abysmally low by international standards. Increases in production must come from augmented yields, which will require overhauling the incentive structure and, therefore, far-reaching agriculture sector policy reform.

Third, the gradual reform approach has not resulted in large-scale economic disruption, but neither has it yielded high growth or many new employment opportunities. Further, the diversification of the economy remains partial; new fast-growing export sectors have yet to emerge, and the potential of the traditional productive sectors has yet to be fully tapped. To revive growth and diversify the economy, it is imperative to speed up the reform process.

There appear to be some downside risks to the economy over the medium term. First, the Russian economy's recovery has been constrained by continuing political uncertainty, which has further eroded the confidence of private and official creditors. Recent allegations of widespread corruption and misappropriation of public funds could further intensify capital flight and accelerate the decline in FDI. This would in turn reduce the demand for Uzbekistan's exports, because about 45 percent of these exports still go to the former Soviet Union, mainly to Russia. Second, there is always the danger that a continuation of unfavorable world commodity prices for the two major export items, gold and cotton, would lead to a further postponement of the planned foreign exchange and trade reforms.