ECONOMIC ANALYSIS (SUMMARY)¹

1. Overview of Macroeconomic Policies and Performance

1. The policy model chosen by Uzbekistan after independence in 1991 was based on a gradual transformation of the economy, combining state control of key industries with gradual implementation of structural reforms. The primary policy goal was to arrest declines in output, welfare, and employment to maintain economic and social stability. The process of economic transformation focused on (i) privatization of small and medium-sized enterprises (SMEs); (ii) budget support to housing and social sectors; (iii) promotion of private ownership in services and small industries; and (iv) development of small private businesses. The government also began reforming key industrial and agricultural sectors and developing new export markets for its main commodities—cotton, precious metals, and hydrocarbons.

2. This gradual approach to economic reforms, coupled with strong support for social welfare and high international prices for cotton and other export commodities, allowed Uzbekistan to avoid the deep economic recession and social unrest typical of most countries of the former Soviet Union at the time. Uzbekistan’s output decline halted by 1996. By 2001, Uzbekistan’s growth performance in terms of percentage of 1989 output level was the best among the former Soviet Republics (Figure 1a).

Figure 1: Macroeconomic Performance of Uzbekistan

¹ This summary is based on Uzbekistan country chapters published in successive publications of the Asian Development Outlook, and data and publications of the government and other development partners.
3. In the second half of the 1990s, macroeconomic policy focused on import substitution through accumulation and channeling of public funds, including loans from the budget and Central Bank, to prioritized local industries. Increases in customs tariffs and excise duties for a number of imported consumer goods accompanied implementation of this policy.

4. In the late 1990s, Uzbekistan’s economy was affected by decreasing export revenues caused by falling international prices for its main export commodities (including cotton), and the 1998 Russian financial crisis. The gross domestic product (GDP) growth rate averaged 4.1% during 1998–2001 (Figure 1b). Inflation, although declining, remained high at 18%–29% during this period (Figure 1c). In response, authorities implemented tight monetary and fiscal policies during 1998–2001, accompanied by increased revenue collection and import controls.

5. These policies, together with improved export performance, resulted in a buildup of foreign exchange reserves, leading to a substantial accumulation of savings (Figure 1d). Stringent revenue collection and tighter expenditure controls resulted in the first fiscal surplus of 0.1% of GDP in 2003, reversing the trend of persistent fiscal deficits from 1994 to 2002. The government started developing mechanisms to transform savings into investments. The Fund for the Reconstruction and Development (FRD) of Uzbekistan was established in 2006, with the dual purposes of monetary sterilization and economic development.

6. Conservative monetary and fiscal policies continued in 2002–2003 and led to a relief in inflationary pressures. The rate of inflation fell to 10.3% by 2003, from an average of 28% from 1997 to 2002. Monetary stability was a prerequisite for the liberalization of the hard currency market. In October 2003, Uzbekistan became a signatory to sections 2(a), 3, and 4 of Article VIII of the Agreements of the International Monetary Fund (IMF), facilitating current account convertibility of the domestic currency. In 2004, the inflation rate fell to 1.6%.

7. Macroeconomic stability and continued resource accumulation allowed authorities to implement wide-ranging social reforms, focused on development of basic and secondary education, health care, and other related sectors. Uzbekistan developed its education system and significantly upgraded its health system, to make progress toward the Millennium Development Goals.

8. Macroeconomic adjustment, including tight fiscal policies, considerably reduced fiscal deficits, and prudent external borrowing policies improved debt indicators. Rapid industrialization became the main driving factor for the strong growth of the economy. Foreign capital investments grew significantly, with major investments in the state-dominated oil and gas and telecom sectors. By 2010, foreign direct investment amounted to $944 million compared with $88 million in 2005.

9. Sustained state-led economic growth has impacted on the population’s welfare. The poverty rate fell from 44.5% in 1994 to 16% in 2011, based on official statistics of the State Statistics Committee. Likewise, the Gini coefficient, as a measure of income inequality, decreased steadily from 0.50 over 2000–2006 to 0.35 in 2010.

2. Recent Economic Developments, 2009–2010

10. With its conservative approach to the global financial markets, high commodity prices, and the government’s anti-crisis program, Uzbekistan effectively avoided the financial crisis of 2008–2009, achieving growth of 8.1% in 2009, and 8.5% in 2010. The government’s timely and
appropriate macroeconomic policy responses to the impact of global financial crisis accounted for the country’s continued macroeconomic stability during this period. The anti-crisis program adopted for 2009–2012 to sustain growth and maintain economic balances mitigated the declining contribution of exports to growth (as a result of lower external demand in the crisis years) by increasing public and private investments. At the same time, the Central Bank of Uzbekistan responded with a steady depreciation of the exchange rate that revived exports and contributed to a 42% increase in foreign exchange reserves from 2009 to 2010.

11. In 2010, the government continued implementing infrastructure development programs aimed at developing rural areas and modernizing industry. The FRD and state-owned banks allocated about $6 billion for these programs. As a result, lending from banks jumped by one-third in 2010, and gross fixed capital investment increased significantly.

3. Economic Developments in 2011

12. In 2011, real GDP grew by 8.3%, mainly reflecting a favorable external environment, sustained public investment, and rising private consumption. High international prices for Uzbekistan’s main export items (gold, copper, cotton, and natural gas) generated considerable export revenues. Exports of goods and services rose by 31.3% to $14.2 billion. In addition, strong consumer demand in the Russian Federation contributed to a 25% rise in exports of passenger vehicles. Imports of goods and services rose by 26.5%, as continued state-led public infrastructure development and industrial modernization required larger volumes of imported capital goods. An improved trade balance and higher remittance inflows led to an increase in the current account surplus to 8.1% of GDP, compared with 6.6% of GDP in 2010.

13. Economic growth in 2011 was supported by robust investment performance, driven largely by public investment under the government’s industrial modernization and infrastructure development programs. The industrial sector grew by a robust 6.7%, albeit lower than growth of 8.3% in 2010, despite a slowdown in the fuel subsector. Nevertheless, all industrial subsectors grew—machinery and equipment, chemicals, construction materials, and the food industry collectively posted a growth rate of 11.9%. The rapid expansion in these sectors is attributed to strong external demand for metals and petrochemicals and continued industrial development. Construction grew by 8.5%, reflecting higher public construction during the second half of the year, which offset the slowdown in foreign investment-related construction activities. Public construction focused on housing, transport, and municipal and social infrastructure. As in 2010, the services sector remained a main source of GDP growth. Retail trade, communications, and financial services were top performers with a cumulative 22.3% growth rate, supported by strong domestic demand and low penetration rates (in the case of communications). The agricultural sector grew by 6.6%, supported by fruit and vegetable production and livestock breeding.

14. Limited exposure of the country’s financial system to world financial markets prevented the recent global financial volatility from affecting the banking sector. The banking sector also benefited from significant government injections aimed at strengthening bank capital and increasing lending, mostly to large state-owned exporting industries. The financial sector continues to have significant growth potential, since demand for financial services is strong and private sector access to finance is still limited (especially in microfinance, after the closure of credit unions in 2011). This is brought into evidence by Uzbekistan’s low of financial intermediation (measured by the ratio of broad money to GDP) of 23% of GDP.
15. Inflation in 2011 remained high at 13%–14%, according to estimates by the IMF and other sources (higher than the officially estimated inflation in Figure 1c). High foreign exchange inflows, high credit growth, currency depreciation, as well as increased private and public spending (including wage and pension hikes), boosted inflationary pressures in the country. The central bank attempted to curb inflation by issuing certificates of deposit (equivalent to 40% of the existing stock) to sterilize excess liquidity, while the government absorbed $1.6 billion of export revenues into the FRD.

16. Uzbekistan’s augmented budget, including the large FRD surplus, is estimated to have recorded an overall surplus of 3.2% of GDP. Revenue gains from higher commodity prices and improved tax administration offset the impact on the budget from higher expenditures arising from wage and pension increases and higher social outlays. External debt is estimated to have increased modestly to 16.6% of GDP from 16.0% of GDP in 2009, as the public investment program is being financed in part with foreign loans. Nevertheless, the external debt levels are within manageable levels, and net domestic public debt remains negative after taking into account large government deposits at the central bank.

4. Economic Prospects

17. Uzbekistan’s strong growth and robust macroeconomic stability is set to continue. GDP growth is forecast to rise by 8.0% in 2012 and 7.9% in 2013, as rising state-led investments will offset the expected decline in exports caused by any slowdown of the global economy. On the domestic front, therefore, continued public investment and infrastructure development will remain key drivers of economic growth. To this end, the government is implementing a $47.3 billion industrial modernization and infrastructure development program during 2011–2015, with significant investments planned in oil and gas, electricity generation, chemicals, metallurgy, and other strategic sectors. The program’s objective is to increase industry’s share in GDP from 24% in 2010 to 28% in 2015. The government plans to fund the program through a combination of external loans and foreign direct investment, domestic investment and borrowing, and FRD resources. Bilateral external financing from the People’s Republic of China, India, the Republic of Korea, the Russian Federation, and Turkey has already been secured for large projects in chemicals, hydrocarbons, and textiles, with about 23% of the program’s projects under implementation. Gross fixed capital formation, as a result, is forecasted to rise by 9.3% in nominal terms in 2012.

18. In late December 2011, the government issued a decree reducing the rates of several taxes, and extending the duration of several tax preferences and exemptions, mostly for SMEs in the services and agriculture sectors. This tax support is aimed at decreasing the tax burden of private businesses and is expected to contribute to increased activity in the various sectors.

19. Domestic consumption will continue to be supported by planned increases in public sector wages and pensions. In the case of spillover effects from the continued slowdown of the European and Russian economies, the government is expected to implement further measures to stimulate consumer demand, most likely through additional wage increases and welfare payments. Nevertheless, lower remittances and continued inflationary pressures are expected to moderate the growth in private consumption.

20. Inflation is expected to diminish only slightly, to about 9.5% in 2012 and 9.0% in 2013. Domestic inflationary pressures are expected to remain high, although imported inflation could be lower in the case of stabilization of global commodity prices. The authorities are also expected to contain inflation through price controls on food items and energy.
21. Money supply growth is expected to accelerate as the government increases wages and pensions, and banks increase their lending to the real sector. Further buildup of net foreign assets of monetary authority (at least in 2012) and continued foreign exchange interventions to depreciate local currency will put upward pressure on reserve money. This pressure is expected to be partially offset through increased open market operations by the central bank.

22. The budget, adopted by Parliament in November 2011, projects a deficit of 1% of GDP in 2012. The augmented budget surplus, after allowing for FRD transfers, is forecast at 4.0% in 2012 and 3.0% in 2013. The budget envisages substantial tax reductions and preferences, with the goal of reducing the ratio of tax revenue to GDP by 0.7 percentage points in 2012. On the expenditure side, the budget places a strong and continued emphasis on welfare and social development. About 59% of all expenditures are allocated to social security, welfare, health care, education, and culture.

23. The current account surplus is forecast to decrease to 7.5% of GDP in 2012 and 6.0% of GDP in 2013, as the trade balance weakens. Declining international prices for Uzbekistan’s main export commodities, coupled with weaker external demand, will adversely affect export performance. A key downside risk for the economy is the impact of the economic slowdown in the European Union on the Russian economy, the main trading partner of Uzbekistan. Weaker consumer demand in the Russian Federation will lead to lower exports (especially automobiles and food items) and remittances. In addition, a potential soft landing in the People’s Republic of China may reduce demand for metals and cotton from Uzbekistan. Imports are projected to increase gradually in 2012–2013, with demand mostly coming from public infrastructure development and the industrial modernization program, which requires large volumes of imported capital goods and equipment.

24. Net international reserves are expected to build further in 2012 (to $23 billion) and 2013 (to $25 billion), reflecting a continuing current account surplus and net capital inflows. External debt is forecast to reach 20.2% of GDP at the end of 2012 and 22.8% of GDP at the end of 2013, which is still modest by international standards.

5. Development Challenges

25. Uzbekistan has achieved significant development results delivered through prudent macroeconomic policies, budgetary and financial management as well as social development reforms. The government’s countercyclical policies ensured continued macroeconomic growth in 2010 and 2011. Nevertheless, to ensure sustained broad-based and inclusive economic growth, the country needs to address a number of critical constraints.

26. The government’s large-scale industrial modernization and infrastructure development program for 2011–2015 depends on the quality of public administration, governance, and transparency to yield the desired outcomes. The government’s commitment to these critical areas is crucial to ensure the efficiency of its industrial policy measures and avoid distortions in the distribution of public resources.

27. Effective banking supervision and improved prudential banking requirements will help guard against potential risks associated with rapid credit growth and greater bank lending to state-owned enterprises. Improving access to credit for SMEs will widen the range of banking assets while benefiting the broader population through creating job and entrepreneurship opportunities.
28. In the medium term, Uzbekistan’s traditional sources of economic growth—exports and investments—need to be diversified. The country’s dependence on commodity exports and related vulnerability to external shocks need to be managed through industrial diversification, with higher-value adding processing industries receiving priority public and private financing. To this end, the destination of investments needs to be diversified, as the bulk of existing foreign investments are directed at the natural resource sectors. To mobilize additional diversified investments, greater private sector participation is essential. This requires the creation of more enabling conditions for private sector growth, including further reduction of tax and administrative burdens, improvement of business and investment climates, as well as expanding access of businesses to credit. Trade liberalization would support the private sector significantly, while assisting the country’s cooperation with countries in the region and beyond.