Uzbekistan

Continued strong—but narrowly based—growth was driven by increased net exports, a pickup in workers' remittances, and productivity gains in agriculture. Major challenges over the medium term are to continue managing monetary and fiscal policies to cope with inflationary pressures, integrate the economy with the rest of the region (and world) via more open trade and investment policies, advance structural reforms in banking, restructure state enterprises, and remove state controls hindering private sector development. Further diversification away from the commodity and energy sectors would also help sustain growth.

Economic performance

The economy has shown robust performance over the past 3 years, and continued to do so in 2006, turning in GDP growth of 7.3% (Figure 2.7.1). Exports, too, showed real vibrancy, fueled by favorable price movements in international commodity markets (Figure 2.7.2), and to a degree, heady growth of noncommodity exports.

Productivity gains in the agriculture sector also contributed. The transformation of large, agricultural cooperatives, *shirkats*, into private farms nearly finished, with 666 of them becoming 74,000 small private farms during the year. This change has improved the incentive structure for production—and so productivity—especially in fruits and vegetables.

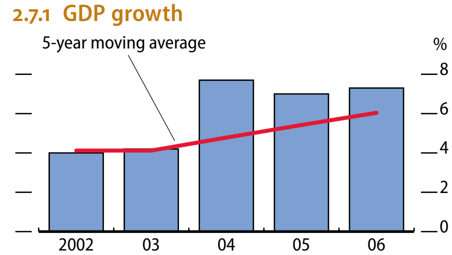
Vigorous export performance coupled with surging remittances has led to a huge current account surplus of 19.5% of GDP (Figure 2.7.3). Gross official reserves are reported to be equivalent to 12 month of imports.

The authorities have maintained a conservative fiscal stance over the past few years. In 2006, the consolidated state budget posted a small surplus at 0.5% of GDP compared to the planned deficit of 3% GDP. Continuation of the conservative external borrowing policy ("zero net borrowing"), has helped improve debt indicators.

Despite their cautious fiscal stance, the authorities have to tackle the risk of higher inflation due to the mounting foreign exchange inflows and rapid reserves accumulation. In 2005, partial sterilization led to a sharp increase in broad money supply of over 50%. In 2006, in order to tighten monetary policy, the central bank conducted sterilization operations using its own paper and treasury bonds. This brought money supply growth down to about 35% (Figure 2.7.4). Nevertheless, controlling money aggregates and associated inflationary pressures remain substantial challenges.

The Government established the Uzbekistan Reconstruction and Development Fund (URDF) in 2006 to absorb the excess liquidity. The total authorized capital for URDF is $1 billion, with $500 million already in place. The establishment of URDF is intended to help buffer the economy from price shocks stemming from volatile foreign exchange inflows. The remaining challenge now is how to channel the fund toward productive investments.

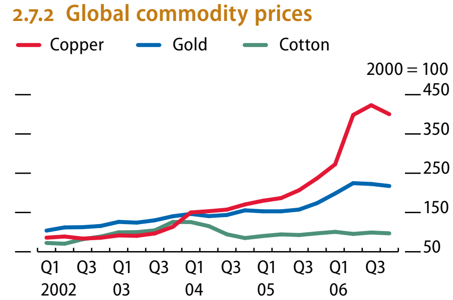
2.7.1 GDP growth



Sources: State Statistical Committee of Uzbekistan; staff estimates.

Click here for figure data

2.7.2 Global commodity prices



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 30 January 2007.

Click here for figure data

Official data indicate that consumer price inflation has declined since 2004, with the official inflation rate estimated to be at 6.8% in 2006. However, this is an area for debate, created by the gap between official and International Monetary Fund estimates for consumer price inflation (though the gap reportedly fell slightly in 2006). A technical assistance agreement recently reached between the Government and the Fund should help resolve the issues of inflation estimate.

Fiscal reforms continued in 2006 in the development of a treasury system. Steps were made to establish a consolidated Treasury Single Account for improvements in budget execution efficiency. The Treasury Law took effect in January 2006. A pilot treasury program introduced in 2005 in the region of Samarkand and Tashkent was extended to cover a total of six regions (*oblasts*). Many banking accounts in the commercial banks held by executing budgetary organizations were closed. As a result, this has eliminated the function of these commercial banks in budgetary execution.

Tax reform continued, to ease the burden on enterprises, broaden the base, and strengthen administration. Tax rates for personal income, corporate profits, dividends, and small and medium enterprises were further reduced, yet despite this, total tax receipts rose.

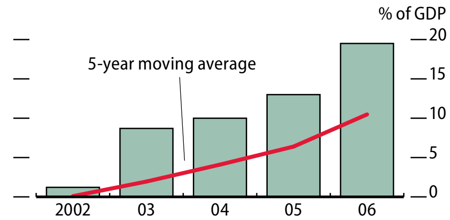
Banking sector reform could be faster, especially in privatizing large stated-owned banks. Total banking deposits are very low, reflecting the population's low confidence in the system. Banking regulations need to be further simplified and clarified to allow banks to operate commercially.

Despite official commitment to currency convertibility, it is reported that enterprises still face difficulty in converting local currency into foreign exchanges for trade. The authorities argued that the current convertibility continued, however, the introduction and implementation of the recently approved antimoney laundering policy imposed additional reporting requirements, and these may on occasions have delayed the process of meeting requests for foreign exchanges.

The Government is developing a comprehensive financial sector reform program. One component is to eliminate the distinction between cash and noncash payments. Currently, the civil code requires all transactions between enterprises to be settled in noncash form (bank transfers). Intended to combat the shadow economy, money laundering, and tax evasion, this requirement may have hit normal business activities.

The trade regime remains restrictive, ostensibly to protect domestic industries. Relatively high effective rates of protection for consumer goods, including discriminatory excise taxes and administrative restrictions on imports, have suppressed imports and encouraged informal trade—partly explaining the large current account surplus.

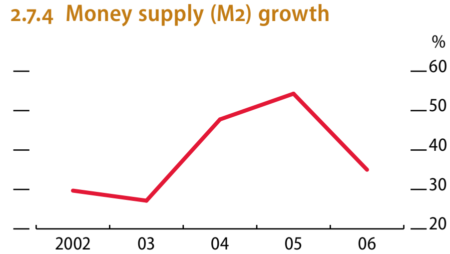
2.7.3 Current account balance



Sources: International Monetary Fund, *Regional Economic Outlook*, Middle East and Central Asia, September 2006; *Asian Development Outlook* database; staff estimates.

Click here for figure data

2.7.4 Money supply (M2) growth



Sources: International Monetary Fund, *Regional Economic Outlook*, Middle East and Central Asia, September 2006; *Asian Development Outlook* database; staff estimates.

Click here for figure data

Economic prospects

International prices of the country's major exports look favorable for the next couple of years. Following an estimated 7% increase in 2006, the cotton price is expected to continue climbing, reflecting a rundown of global stocks. Gold prices, too, seem set to rise further. In addition, the economy will likely continue enjoying the benefits of higher energy prices, after securing a significant increase in the export price of its gas.

External demand for exports should remain favorable, especially with the likely continued strong economic performance of the Russian Federation and neighboring transition economies. In the absence of major shocks, buoyant exports are seen boosting the economy. Growth in the forecast period is penciled in at over 7%. Trade and current account balances will likely maintain hefty surpluses. The associated increase in foreign exchange reserves will remain a major source of monetary expansion and an inflationary risk.

The Government is targeting inflation of 5–7% this year. The central bank intends to limit broad money supply growth to about 30% through sterilization and use of other indirect monetary instruments. The authorities intend, too, to maintain a prudent fiscal policy to combat inflation. Still, it will be difficult to achieve the inflation target, given the early stage of treasury debt market development, limited sterilization options, and rising pressures from wage and social expenditure increases.

Monetary control is rendered more difficult by exchange rate policy, because the authorities have allowed the domestic currency to depreciate in real terms to stimulate exports. In combating inflation, the Government may want to consider adopting a more flexible foreign exchange rate system, allowing nominal appreciation to resolve the difficulty of monetary control.

Over the medium term, the economy faces many challenges. Certainly, it has yet to realize its full potential. And to sustain current rates of expansion, more investment, especially from the private sector, will be required. The economy also needs to diversify to create the jobs needed by its relatively young and growing population.

Structural reforms are crucial, and will require the Government's continuing to open up the economy and integrate it with the rest of the world. This should introduce more competition, and improve productivity and efficiency. It is also crucial to establish a stable environment in which to attract investments from all possible sources. Banking reforms need to be accelerated, since the economy's full potential will only be achieved when banking mobilizes domestic savings and puts them to productive use. In this regard, it is crucial to build, and then keep, the trust of the population in the system.

The current favorable economic environment provides an opportunity to push through structural reforms. However, the same environment could also lead to a sense of complacency among policy makers. Commitment to economic reforms and transition to a market-based economy are crucial to sustaining the country's long-term development.

The Government's poverty strategy aims to reduce the poverty rate to 20% by 2010, to meet the Millennium Development Goals. Expected strong export growth may well help achieve the objective, but growth should shift from overdependence on external demand to investment. Both the quantity and quality of investments need to be raised, since public investment cannot do the job alone. Both domestic and foreign private investment will need to be welcomed.

The availability and quality of economic data provides a sound basis for economic management. Further improvements are necessary in access to and quality of the data. Improved economic data compilation and analysis will help provide a reliable picture of underlying performance.

2.7.1 Selected economic indicators

	2007	2008
GDP growth	7.4	7.1
Inflation	9.0	8.2
Current account balance (% of GDP)	10.0	9.2

Source: Staff estimates.