Uzbekistan

With a significant contribution from agriculture and robust external sector performance, Uzbekistan has enjoyed strong growth over the past 2 years. The authorities have made progress in macroeconomic adjustment, but have further scope for improving the consistency of the macroeconomic policy mix, particularly in regard to inflation-control measures and full adherence to provisioning of foreign exchange for current account transactions. The reform backlog in structural policies suggests that the economy is underperforming, despite its recent above-trend growth. Medium-term prospects, when viewed in an accelerated reform scenario, are bright. The main uncertainty is tied to the Government's commitment to undertaking the critical mass of reforms needed for private sector-led growth.

Economic performance

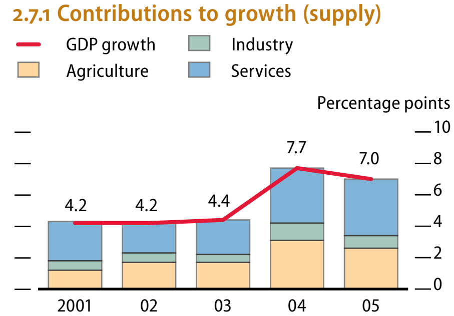
Economic activity experienced growth significantly above trend over 2004–2005. Gross domestic product (GDP) grew by 7.7% and 7.0% according to official estimates, as against an average of 4.2% in 1999–2003. Agriculture's contribution was helped by a record cotton crop (Figure 2.7.1). Industrial performance has improved over the past 2 years, with significant contributions from machinery, chemicals, and metals, in good part based on larger export sales. On the demand side, net export growth in 2005 remained resilient.

The elements in the macroeconomic policy mix lack consistency. Fiscal policy remained tight, with a better than budgeted outcome, and the external borrowing policy stayed prudent, but some estimates show that actual inflation was significantly higher than indicated by the official estimates. While the authorities were relatively successful in undertaking fiscal adjustment to address one source of inflationary pressure, they were less successful in bringing under control growth in monetary aggregates, which was the main source of this pressure in 2004–2005. Problems in implementing convertibility on the current account reappeared last year.

Fiscal consolidation reflected lower than budgeted expenditure. The 2005 budget had targeted a loosening of fiscal policy, with a deficit of 3.3% of GDP. In the event, a small surplus (0.1% of GDP) was posted owing to lower spending (Figure 2.7.2). The Government cut spending to make up for shortfalls in external financing and privatization receipts. The burden of cuts, as in the past, fell on centralized investment.

Monetary conditions remained loose. Aggregates expanded faster than in 2004, with broad money growing by 56% (Figure 2.7.3). This reflected the expansion of net foreign assets in a banking system in which the central bank has few options for sterilization. Net domestic assets also grew, reflecting primarily credit to the nongovernment sector as loans to farmers, which were previously made outside the banking system, were now coursed through it. The Government attempted some liquidity-

2.7.1 Contributions to growth (supply)



Sources: International Monetary Fund, Statistical Appendix of *Article IV Consultation with Republic of Uzbekistan*, 28 April 2005; staff estimates.

absorbing measures, including the introduction of reserve requirements on dollar deposits, but with little apparent effect.

Cash shortages were a problem in the first half of 2005, especially for the private sector, with restrictions on cash in circulation imposed by regulations intended to contain inflation and curb the activities of the shadow economy. The restrictions limit commercial banks' access to their correspondent accounts at the Central Bank of Uzbekistan, which in turn means that they are unable to meet fully their customers' needs for cash withdrawals. On 5 August 2005, a presidential decree was issued allowing commercial banks full access to their correspondent accounts and providing for the imposition of penalties on commercial banks that failed to meet customers' requests for cash. The Government has indicated that it is committed to containing inflation through control of monetary aggregates.

The divergence between official and alternative estimates of consumer price inflation has widened (Figure 2.7.4). According to the former, inflation picked up to 7.8% in 2005; however, estimates by e.g., the International Monetary Fund (IMF) indicate that the actual rate was higher (around 20%). IMF states that its estimates are consistent with other available information, including producer prices, GDP deflators, wage increases, growth in monetary aggregates, and utility price increases.

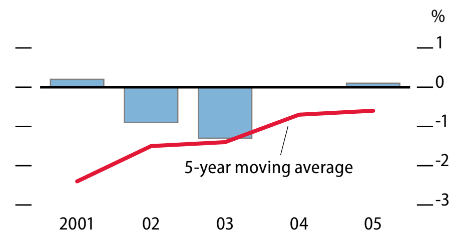
The large surplus on the current account in 2004 was augmented in 2005, as exports remained resilient, the trade surplus was sustained and private transfers surged (Figure 2.7.5). Increases in international gold prices, combined with volume increases in nontraditional exports, helped boost export earnings substantially even though world cotton prices fell. Import growth was also significant and would have been larger but for apparent problems in accessing foreign exchange.

The current account surplus for 2005 is estimated at about 10% of GDP. The large surpluses from 2003 have contributed to an accelerating accumulation of foreign exchange reserves, which are now estimated at 7 months of import cover. This would seem a comfortable position that raises the question of why limitations on foreign exchange availability have been imposed. At issue is the matter of reserves adequacy. IMF analysis of the balance of payments indicates that the external debt is sustainable in its baseline scenario. However, under certain severe but not implausible assumptions (lower GDP growth, lower export growth, and higher interest rates), stress tests indicated that the country's external debt dynamics could deteriorate rapidly.

Structural reforms have had a mixed delivery. Areas of progress include structural policies in the fiscal area including an ambitious public finance reform program and measures to improve incentives in agriculture. Areas with remaining lacunae between announced policies and real outcomes include privatization of large-scale enterprises, steps to strengthen the business environment, and banking sector reforms. Reduction of trade barriers, particularly nontariff barriers, is one area of minimal progress, if not outright regression.

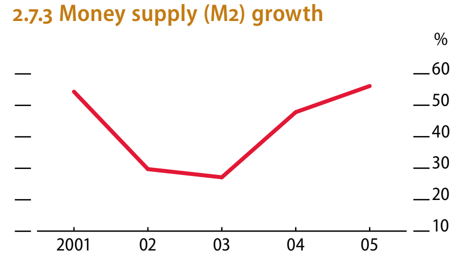
The Government has mapped out a comprehensive public finance reform program and is now putting it into effect. On the revenue side, steps initiated include a simplified tax structure (revision and consolidation of the tax code with reduction in discretionary rates and exemptions) and administration. On the expenditure side, early moves

2.7.2 Budget balance



Source: Ministry of Finance.

2.7.3 Money supply (M2) growth



Sources: Central Bank of Uzbekistan; International Monetary Fund, *Article IV Consultation with Uzbekistan*, June 2005; staff estimates.

have been made to set up a single treasury system and to address the problem of budget “fragmentation.” All of these measures will help improve fiscal transparency and lay the ground for a credible medium-term budget framework, currently in a rudimentary state.

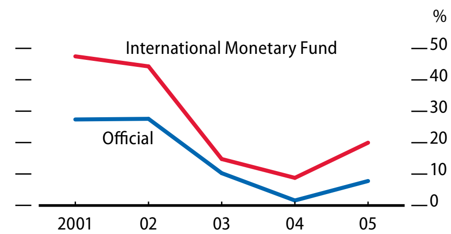
Incentives in agriculture are improving. In 2005, there were upward adjustments in the state procurement prices for cotton and wheat and accelerated restructuring of *shirkats* (agricultural cooperatives) to private leaseholds. While these changes have helped refocus the incentives for higher agricultural productivity—as reflected in higher agricultural output—headway in reducing state procurement quotas has been modest, and are explained by the Government’s concerns about the adverse fiscal implications.

Movement on the restructuring and privatization of large-scale enterprises remains slow. The authorities have indeed regularly announced achievements in terms of numbers of enterprises privatized, but the true extent is unclear as entities earmarked for sale to outsiders but remaining unsold are still counted as privatized. So far, only one transaction involving the privatization of a large-scale enterprise has been brought to closure. The Government’s reluctance to yield controlling shares of enterprises it considers strategic and the difficult business environment are two factors that have curtailed outside interest, especially from industrial-country investors. In 2005, however, the authorities responded to many of the issues affecting the business environment by issuing decrees, including reform of the inspections system. The Government has also acknowledged the prevalence of distortions in the banking sector and has said that it plans to eliminate them over the next few years. Many of them—such as the requirement that all transactions by enterprises must be settled in a noncash form, the obligation that all businesses must deposit their cash earnings in a bank account on a daily basis, and the involvement of commercial banks in tax collection and business oversight functions that are inappropriate for financial intermediaries—have contributed to low public confidence in the banking system. Another concern is that, while official estimates point to an insignificant level of nonperforming loans, the true picture is likely to be worrisome, particularly at the National Bank of Uzbekistan, the largest commercial bank. In 2005, a presidential decree was issued indicating a revised schedule for privatizing both that bank and Asaka Bank, the second largest.

Trade policy remains restrictive. Effective rates of protection against consumer imports are significant and excise tax rates on a wide range of consumer imports are higher than on domestic goods. Other regulatory “behind-the-border” barriers to trade include the regulation of wholesale and retail trade affecting the domestic marketing of imports. This regime imposes a heavy regulatory burden on individual entrepreneurs, in particular cross-border shuttle traders, who are an important source of supply for the private sector.

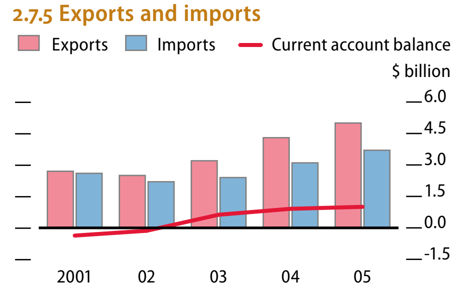
It is hard to find real evidence that the growth in GDP in recent years has had much impact on poverty incidence. According to household budget survey data, it remained at around 26% between 2000 and 2003: the headcount ratio declined from 27.5% in 2001 to 25.3% in 2002 before picking up again to 26.2% in 2003. This pattern is consistent with a shift

2.7.4 Inflation estimates



Sources: State Statistical Committee; Cabinet of Ministers; International Monetary Fund, *Regional Economic Outlook*, September 2005.

2.7.5 Exports and imports



Sources: International Monetary Fund, *Article IV Consultation with Republic of Uzbekistan*, June 2005; staff estimates.

in aggregate demand composition from consumption to net exports, though the limited reliability of expenditure-side data makes such findings conjectural rather than definitive.

Developments strongly suggest that the economy—despite the above-trend growth of 2004–2005—is underperforming relative to its potential, largely because of the reform backlog in structural policies. Implementation of the August presidential decree to end cash shortages will be a helpful step.

Economic outlook

Prospects for 2006 and 2007

The external environment will, it is assumed, remain favorable over the forecast period. Growth in the Russian Federation and other countries of the former Soviet Union, which together absorb a significant share of Uzbekistan's exports, is likely to remain strong. Cotton prices are seen as improving marginally and world prices for gold should stay high. Foreign direct investment inflows to the hydrocarbon sector from the People's Republic of China and the Russian Federation, which have already begun to make an impact, are likely to pick up further. The trade policy regime seems unlikely to change much in the near term. The convertibility restrictions that reappeared in 2005 are likely to be lifted and consequently foreign exchange availability should improve. Domestically, it is expected that fiscal policy will remain prudent and the recent rapid rise in monetary aggregates will be damped. Finally, it is assumed that there will be positive follow-through on the business regulatory reforms announced in 2005, leading, for example, to fewer business inspections.

In the absence of major shocks, external or domestic, the growth momentum from 2004–2005 is likely to carry over into 2006–2007 (Figure 2.7.6), albeit at a slackening pace, as the current direction and pace of reforms are maintained. On the demand side, net exports should continue to make a positive contribution to GDP growth as the external environment remains favorable, but imports are projected to pick up in 2006, provided that the authorities maintain currency convertibility. The contribution of investment will increase moderately as financing options remain limited. Government consumption is forecast to increase, consistent with the 2006 budget that envisages higher outlays on salaries and social sectors. The budget deficit for 2006 is projected at 1.8% of GDP.

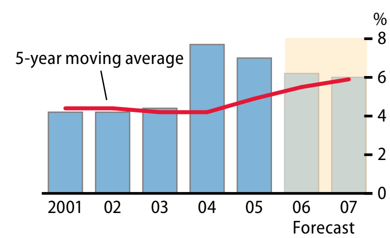
On the supply side, the growth in value added in agriculture is expected to moderate over the forecast period as the positive impact of transforming cooperative farms to private leaseholds wears off while the supply response from any further liberalization of the state procurement system for cotton and wheat takes time to gather pace. Industrial growth is expected to slow in the absence of significant changes in the investment climate, though hydrocarbons will be buoyed by foreign direct investment from the People's Republic of China and the Russian Federation. Services are likely to expand, with transport and construction among its fastest-growing subsectors. Consumer price inflation, following IMF estimates, is expected to slow as the Government focuses on controlling the expansion in monetary aggregates.

2.7.1 Selected economic indicators

	2006	2007
GDP growth	6.2	6.0
Inflation	9.2	6.0
Current account balance (% of GDP)	5.1	3.9

Source: Staff estimates.

2.7.6 GDP growth



Sources: State Statistical Committee of Uzbekistan.

Medium-term outlook

Two growth scenarios are possible. In a base-case scenario, macroeconomic policies would remain prudent while structural reforms continue to move slowly. In this scenario, improvements in the level and efficiency of investment would be patchy. With few financing options, the investment rate might not rise beyond 25% of GDP. On the efficiency side, over the past 2 years of high growth, the incremental capital-output ratio has declined. However, in the absence of efficiency-enhancing structural reforms, this reduction would not be sustained. Accordingly, the ratio would climb back toward the estimated level of 5.8 for 2002, as cited in the Government's Interim Welfare Improvement Strategy Paper. Growth would average 5.2% a year over 2008–2010.

In an accelerated-reform scenario, one focusing on strengthening both the content and implementation of structural changes, investment rates reaching 30% of GDP together with higher-quality investment could support a growth trajectory of 8% over the next 5 years. The incremental capital-output ratio would fall substantially, as structural reforms strengthen the business environment, boosting productivity growth in sectors with untapped export-oriented potential.

Such sectors include the agroprocessing and small-scale light manufacturing sectors. The *dekhan* (or household) farmers/entrepreneurs who account for the bulk of the country's fruit, vegetable, and livestock production could penetrate export markets with their products on a wider scale if they could strengthen links to processors and if they had greater access to investment and working capital. However, to do this, the input supply, financing, processing, and marketing systems centered on the state procurement system for cotton and wheat need to be revised to enable fair competition between state and private farms.

In the light manufacturing subsector, the share of private, small-scale enterprises is low, as is their share in export-oriented production. This is mainly due to the capital-intensive, import-substituting orientation of national industrial policy. A defining characteristic of this system is the market power and state patronage that members of industrial associations enjoy, advantages that make it difficult for nonmembers to compete. In addition, the heavy regulatory burden makes it costly for small private enterprises to operate in the official economy. Distortions in the banking system also add to the costs of operating in the official economy. Dismantling industrial associations, removing distortions in the banking system, and institutionalizing a system of business regulatory reform will allow small, private manufacturing enterprises to compete and to engage profitably in export-oriented activities. Such changes will also translate into higher employment growth.

The main uncertainty over the medium term is the Government's commitment to undertaking a critical mass of reforms needed for private sector-led growth, simply because recent strong and above-trend growth may engender complacency as to the need for deepening structural reforms. Another source of risk is the authorities' preoccupation with an industry-centric growth strategy that underinvests in agriculture and rural development. A third uncertainty is the low public confidence in the country's banks, which, unless strengthened, will continue to hamper the mobilization of domestic resources required for higher growth.