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October 1998

IMF Staff Country Report No. 98/116

Republic of Uzbekistan: Recent Economic Developments

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

REPUBLIC OF UZBEKISTAN

Recent Economic Developments

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Approved by European II Department

August 19, 1998

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Uzbekistan: Basic Data

Social and Economic Indicators	
Area (square kilometer)	447,400
Population (million, 1997)	23.7
Urban (percentage, 1995)	41
Population growth rate (percent, 1995)	1.89
Infant mortality rate (per 1,000 live births, 1995)	43
Life expectancy at birth (1995)	
Female	70.7
Male	64.3
Adult literacy rate (1995)	
Women	99.6
Men	99.8

	1993	1994	1995	1996	1997
GDP and prices					
Nominal GDP (billion sums)	5	65	303	560	962
Real GDP (percentage change)	-2.3	-4.2	-0.9	1.6	2.4
Consumer prices (percentage change, end period)	885	1,281	117	64	50
Consumer prices (percentage change, average)	534	1,568	305	54	72
GDP at factor cost (percentage shares)					
Agriculture	31	38	32	26	29
Industry	25	19	20	20	19
Construction	6	6	8	7	7
Transport and communications	10	8	8	9	9
Trade	7	8	6	8	9
Other services	22	22	25	29	27
General government finances (percent of GDP)					
Revenue	36.0	29.2	34.6	34.3	30.5
Expenditure, net lending, and extrabudgetary funds	46.4	35.3	38.7	41.6	32.8
Balance	-10.4	-6.1	-4.1	-7.3	-2.3
Money and credit (percent of broad money at beginning of year)					
Broad money	784	680	144	113	36
Net domestic assets 1/	323	125	72	94	91
Of which					
Credit to government	165	-155	-22	70	11
Velocity	4.2	6.8	8.5	7.2	8.1
Balance of payments 2/					
Exports (million U.S. dollars)	2,877	2,940	3,475	3,534	3,695
Imports (million U.S. dollars)	3,255	2,727	3,238	4,240	3,767
Current account balance (million U.S. dollars)	-429	118	-21	-980	-584
Current account balance (percent of GDP)	-7.8	2.1	-0.2	-7.2	-4.1
Gross official reserves (in months of imports)	3.8	5.9	6.9	5.4	3.7
Average official exchange rate (sums per U.S. dollar)	1.0	11.4	30.2	41.1	67.7

Sources: Ministry of Macroeconomics and Statistics, Ministry of Finance, and Central Bank; U.N. Statistics Division; and Fund staff estimates.

1/ Excluding valuation adjustments.

2/ Data for 1995-97 are not fully comparable with previous years due to the introduction of new statistical methodology.

Introduction

This report was prepared as background for the 1998 consultation between the International Monetary Fund and Uzbekistan, under the provisions of Article IV of the IMF's Articles of Agreement. The report covers mostly economic developments through 1997 and, when available, the first half of 1998.[2]

Chapter I analyzes economic growth in Uzbekistan during the transition, including its sectoral dimension. It compares growth in Uzbekistan with that of other transition economies and seeks to shed light on why Uzbekistan has suffered a smaller transformational recession than other transition economies. The report covers in Chapter II the existing arrangements for production and trade in agriculture, and estimates the costs for agriculture arising from state procurement and the multiple exchange rate system. Chapter III traces the effects of multiple exchange rates and other quasi-fiscal operations on the economy as a whole, including for industry, banks, consumers, and the budget. Finally, Chapter IV summarizes recent developments in employment, prices and wages, public finance, banking and monetary policies, external trade, balance of payments, as well as structural reforms, including the development of financial markets and the private enterprises.

A set of statistical tables updates available economic data series.

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[2]The report updates and expands on information made available to the public in 1997 in "Republic of Uzbekistan: Recent Economic Developments," IMF Staff Country Report No. 97/98 (Washington: International Monetary Fund, October 1997).

I. Understanding Uzbekistan's Output Performance, 1992-97 [3]

A. Overview

1. Uzbekistan's output record since independence has been exceptional when compared to that of most other transition economies. Its decline in official output between 1991 and 1997 was the lowest of any country of the Baltics, Russia, and the other countries of the former Soviet Union (BRO) (Table 1). In addition, Uzbekistan's "transformational recession" (Kornai 1994) was mild not only relative to the BRO average, but even relative to the average of the Central European transition economies (Figure 1). This is true regardless of whether output is measured in calendar time or "transition time."[4] Finally, Uzbekistan resumed moderate positive growth during 1996 and 1997, behind some fast reformers such as the Baltic countries, the Kyrgyz Republic and—recently—Azerbaijan, but ahead of many other BRO countries including Russia and Ukraine, where output stagnated or continued to decline.

2. Uzbekistan's relative success is particularly striking given the government's hesitancy to engage in rapid market-oriented reforms and sustained macroeconomic stabilization, i.e., policies that have been widely credited with contributing towards milder transitional recessions and quicker and stronger recoveries.[5] This raises a number of questions. How can Uzbekistan's output record be explained in light of its economic policies? Is it sustainable? As to the future, should the country depart from its traditional gradualist and state-led reform strategy, or was and is this strategy the key to Uzbekistan's continued success?

3. The objective of this chapter is to shed light on the reasons for Uzbekistan's relatively favorable output performance by combining evidence from several methodological angles.[6] Section B presents some background on Uzbekistan's initial conditions and policy record and identifies a number of potential explanations for the Uzbek output experience.

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[3] Prepared on the basis of a background study by Taube and Zettelmeyer (1998).

[4] Transition year zero is defined as the year in which central planning was decisively abandoned (Berg et al. (1998)). This is taken to be 1992 for the Baltics, Russia and other countries of the former Soviet Union, 1990 for Poland, Hungary and countries on the territory of the former Socialist Federated Republic of Yugoslavia and 1991 for the remaining Eastern European countries.

[5]Berg et al. (1998), de Melo et al. (1997), Hernández-Catá (1997), IMF (1998), Fischer, Sahay, and Végh (1996a, b), Sachs (1996), Åslund, Boone and Johnson (1996), Selowsky and Martin (1997), Wolf (1997) and World Bank (1996).

[6]The background paper by Taube and Zettelmeyer (1998), in addition, takes up Uzbekistan's future growth prospects under a variety of policy scenarios.

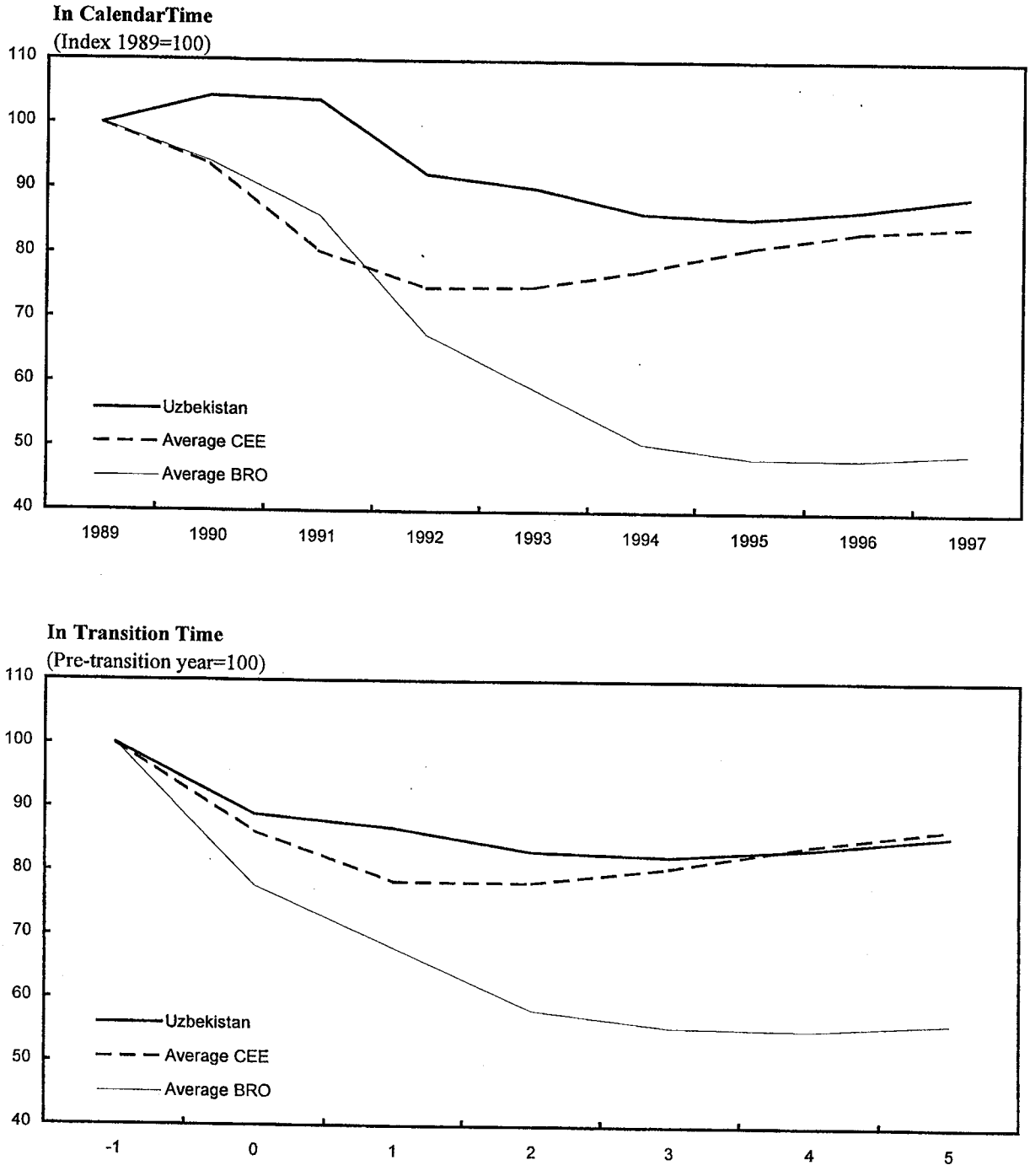
Table 1. Baltics, Russia and Other Countries of the Former Soviet Union: Output Paths, 1992-97

	Output Index (1991=100)						Cumul. loss,	Liberalization
	1992	1993	1994	1995	1996	1997	1991-1997 1/	Index, 1995 2/
Armenia	47.4	40.7	42.9	45.9	48.6	50.2	324.3	0.60
Azerbaijan	77.9	59.9	49.0	43.7	44.2	46.4	278.8	0.40
Belarus	90.3	83.4	72.9	65.3	67.2	73.9	146.9	0.50
Estonia	78.4	71.9	70.6	73.7	76.6	80.5	148.3	0.90
Georgia	55.2	41.2	36.5	37.4	41.3	45.4	343.1	0.50
Kazakhstan	94.7	84.7	74.0	67.9	68.3	69.7	140.8	0.60
Kyrgyz Republic	86.1	72.8	58.2	55.0	58.1	61.7	208.0	0.80
Latvia	64.8	54.4	55.5	55.7	57.2	60.7	251.7	0.80
Lithuania	80.4	66.7	59.2	60.5	63.6	67.5	202.1	0.90
Moldova	70.9	71.6	49.4	48.7	44.9	45.5	268.9	0.70
Russia	85.5	78.0	68.2	65.5	63.6	63.9	175.4	0.70
Tajikistan	71.1	63.2	49.7	43.5	31.2	31.9	309.5	0.40
Turkmenistan	94.7	85.2	69.2	63.5	61.6	46.8	178.9	0.20
Ukraine	90.1	77.3	59.6	52.3	47.1	45.5	228.1	0.50
Uzbekistan	88.9	86.9	83.2	82.5	83.8	85.8	**89.0**	**0.50**
BRO Average	80.8	72.1	62.0	59.4	58.8	59.9	207.0	0.62
excl. Uzbekistan	80.2	70.9	60.3	57.4	56.7	57.7	216.8	0.63

Sources: IMF; de Melo and Gelb (1997).

1/ Sum of differences between 1991 level and levels in 1992 through 1997, divided by 1991 level.
2/ Defined between 0 (no liberalization/structural reform) and 1 (full liberalization).

Figure 1. Uzbekistan and Other Transition Economies: Output Paths



Sources: Fund staff calculations.

After ruling out output measurement as the main reason for Uzbekistan's relatively good official output record (although not as a contributing factor), Section C examines potential explanations in the context of a panel regression of growth performance in 26 transition countries. The main result is that some of the variables identified in Section B—in particular, relating to Uzbekistan's low degree of initial industrialization and its primary commodity and energy production—do a good job of explaining the mildness of Uzbekistan's overall output decline; but they are less successful at predicting the *recovery* of output in 1996 (the last year included in the econometric sample period). In a final step, the chapter seeks to analyze the main components of output growth in Uzbekistan, and in particular of recent growth, at the *sectoral* level. Section D summarizes the principal results and concludes.

B. Background

Initial Conditions

4. Although among the poorer Soviet Republics, Uzbekistan began the transition with relatively favorable initial conditions. It was less deeply entrenched in the former Soviet Union's industrial-military complex than most of the other BRO countries. According to De Melo et al. (1997), it was the least over-industrialized economy of any of the 26 Central and Eastern European and BRO transition countries. Under the Soviet system, Uzbekistan specialized in cotton cultivation, gold mining, and the exploitation of other natural resources.[7] Together, cotton and gold accounted for more than 30 percent of GDP and 60 percent of total exports in the early transition years. With this output and export composition, Uzbekistan could quickly and relatively easily redirect its main exports to Western markets after its traditional trade and payments arrangements collapsed with the Soviet Union. In addition, while Uzbekistan was not as well-endowed in petroleum and gas reserves as, for example, neighboring Kazakhstan or Turkmenistan, it was able to develop its energy sector to become energy self-sufficient.

5. In the context of transition, this production structure could have offered important advantages in two respects. First, agricultural and natural resource commodities that could either be sold for hard currency or substituted for hard currency imports allowed Uzbekistan to relax the foreign exchange constraint, and corresponding import constraint, that plagued

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[7]Uzbekistan is well endowed with reserves of natural gas, oil, and coal, and has substantial deposits of gold, silver, copper, lead, zinc, wolfram, uranium, and tungsten. It is the world's fifth largest cotton producer and second largest cotton exporter (about 17 percent of world exports), and among the 10 largest gold producers. Agriculture has always been the key sector of the Uzbek economy, and a significant part of the industrial and services sectors depend on transporting and processing of agricultural commodities. At independence, agriculture's share in GDP was over 30 percent, and the sector's relative importance has remained high despite the government's efforts to diversify the country's economic base.

other economies in the region. Second, self-sufficiency (or near self-sufficiency) in energy might have constituted a particular advantage, especially in the early years of transition. Following independence, the centrally planned supplier relationships of the former Soviet Union were not quickly replaced by markets and international trade. Bilateral barter arrangements which some countries put in place in an attempt to maintain Soviet-era goods flows proved unreliable and were plagued by nonpayment problems, especially in the energy sector. These problems could be bypassed by maintaining an own energy supply.

6. Uzbekistan was also favored in one other aspect. Unlike a number of other BRO countries (Armenia, Azerbaijan, Georgia, Tajikistan), it did not suffer from additional output shocks due to war or civil strife. It has been estimated that each year in conflict has added 6.5 percentage points of GDP, on average, to the annual decline in output in transition countries since 1989 (World Bank 1996).

Investment Patterns and Industrialization Policies

7. Investment patterns during the transition have reflected the government's strong emphasis on industrialization and import substitution. By contrast, investment in agriculture has been relatively small. Staff estimates suggest that the overall investment rate fluctuated at low levels in the early transition years, but rebounded to about 20 percent of GDP in 1995 (Table 2), largely on account of higher investments financed by the budget and state-owned enterprises.[8] As under the Soviet system, outlays on new investment projects appear to have been given priority over expenditures geared to preserving and modernizing the existing capital stock.[9] A number of large investment projects were initiated by the government, generally in cooperation with foreign investors, in the energy sector and a few technologically advanced industrial subsectors. In addition to oil and gas exploration and exploitation, the government constructed and rehabilitated two refineries in Bukhara and Ferghana and is currently planning a large new oil-chemical complex in Shartan. Other prominent investment projects included gold mining and manufacturing of technologically advanced consumer goods, e.g., automobiles and electronics.[10]

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[8]Official investment data are very weak and need to be interpreted with caution, in part because they include current expenditures by the budget and state-owned enterprises.

[9]See Gavrilenkov and Koen (1994) and Easterly and Fischer (1995) who discuss problems related to this investment approach in the context of the former Soviet Union. With assistance from the World Bank, a public sector investment review was initiated in 1996, which, however, did not produce useful results because of the unavailability of data.

[10]The government has also financed a number of large construction projects including the restoration of tourist sites, hotels, and several new administrative and representational buildings.

Table 2. Uzbekistan: Saving and Investment Balances, 1995-97

(In percent of GDP)

	1995	1996	1997
Consumption	79.6	92.0	88.0
Non-government	47.0	57.5	62.8
Government 1/	32.5	34.5	25.3
Investment	20.6	15.1	16.0
Non-government	14.5	7.9	8.5
Government	6.1	7.1	7.5
Saving	20.6	15.1	16.0
National	20.4	8.0	12.0
Non-government	18.4	8.2	6.7
Government 2/	2.1	-0.2	5.2
Foreign saving 3/	0.2	7.1	4.0
Saving-Investment balances:			
Non-government	3.9	0.3	-1.8
Government	-4.1	-7.3	-2.3
Foreign	0.2	7.1	4.0
Memorandum items:			
GDP (in billion of sum)	303	559	962
Consumer price inflation (in percent, end period)	117	64	50
Real GDP growth (in percent)	-0.9	1.6	2.4
Real consumption per capita growth (in percent)	-16.3	15.2	-4.0

Sources: Ministry of Macroeconomics and Statistics; and Fund staff estimates and projections.

1/ General government expenditure and net lending minus investment.

2/ General government revenue minus current expenditure.

3/ Equivalent to the external current account deficit.

8. Despite the involvement of foreign enterprises in a number of the large investment projects mentioned above, foreign direct investment remained limited. Cumulative inflows probably did not exceed US$250 million through 1995, while inflows in 1996-97 are estimated at less than US$200 million per year, which would be less than both the BRO and the CIS average on a per capita basis.[11] This may be related to the government's restrictive foreign exchange and trade policies and other problems in the business environment (see below).

Structural Policies

9. Although some progress in structural reforms was made in the early years of the transition, domestic and external liberalization and enterprise restructuring and privatization have remained limited. In the early years, a significant number of prices were liberalized, explicit budgetary subsidies for consumers were abolished or reduced, residential housing was transferred to occupants (often at nominal fees), and many small enterprises and retail outlets were privatized. Privatization of medium and large enterprises did not begin until mid-1996, when the government initiated the Privatization Investment Fund (PIF) scheme with support from the World Bank. Some liberalization of the foreign exchange market and external trade was achieved in late-1995 and 1996 in the context of IMF-supported adjustment programs. However, most of these reforms were not sustained and some were reversed in 1997 (see below).

10. Throughout, the government has maintained control over large parts of the economy. In agriculture, the authorities control the production and marketing of the two most important crops, cotton and wheat. In industry, extensive support has been provided to keep state-owned enterprises afloat, including through budgetary onlending, low energy prices, directed credits at favorable terms, and priority access to foreign exchange at the favorable official exchange rate. Regulation is extensive, especially for small- and medium-sized enterprises, which also carry a heavy tax burden. Competition has remained limited in many sectors owing to the dominance of large state-owned enterprises. "Antimonopoly" policies have mainly taken the form of extensive price controls. Various restrictions on businesses and individuals have been maintained in the financial sector (e.g., on cash withdrawals and on the number of bank accounts).

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[11] Estimates of foreign direct investment are subject to considerable uncertainty. US$200 million is equivalent to less than US$10 per capita for Uzbekistan, compared to a CIS (BRO) average of about US$20 (35) for 1996 and US$23 (35) for 1997 according to IMF estimates. The EBRD (1998) estimates are much lower; it estimates Uzbekistan's net FDI at only US$50 million for 1996 and US$60 million for 1997. This translates to an average of less than US$3 per capita, as compared to a CIS (BRO) average of about US$26 (57) for 1996 and US$33 (69) for 1997, according to the EBRD.

11. Earlier progress in external liberalization was reversed in late 1996, when the government severely tightened foreign exchange and trade restrictions. This has resulted in a fragmented market for foreign exchange, with several official exchange rates and a curb market premium of around 100 percent. Import tariffs were raised, and an ex-ante import registration scheme was introduced. For a number of important consumer goods (e.g., flour, sugar and vegetable oil) price controls were intensified in mid-1997. The privatization program also suffered some reversals in the second half of 1997.

12. Uzbekistan's slow pace and (since late 1996) reversals in structural reforms are reflected in international comparisons of the state of transition, "economic freedom," and private sector development. In terms of *average* liberalization over the 1992-96 period, De Melo et al. (1997) rank Uzbekistan 21st out of 28 transition countries.[12] The EBRD (1997), which compares 25 transition economies according to a set of 8 criteria reflecting progress in specific areas of structural reform as of mid-1997, places Uzbekistan below the median in all 8 categories. In the categories "price liberalization" and "trade and the foreign exchange system" it is ranked 23rd. Within the BRO group, Uzbekistan is ranked below the median in all but one category.[13] Uzbekistan was given the second lowest ranking among all transition countries in the 1997 Freedom House Ranking, and listed as number 146 out of 156 countries in the "Index of Economic Freedom" prepared by the Heritage Foundation and the *Wall Street Journal*. Finally, the private sector share in GDP is estimated to have increased from about 10 percent in 1990 to approximately 30 percent in 1995, but probably remained below 50 percent in 1997, less than most other transition countries at this time.[14]

C. Elements of an Explanation

13. The previous section suggests three partly overlapping hypotheses as to why Uzbekistan has done relatively well in managing to avoid a large transitional recession: (i) favorable initial conditions, including absence of initial overindustrialization, production of primary commodities and endowment with energy resources (possibly in combination with certain policies, including the policy of energy self-sufficiency); (ii) a gradualist reform strategy that deliberately avoided "shock therapy" and maintained a large role for the state in both industry and agriculture; and (iii) an aggressive public investment program, particularly

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[12] See also De Melo et al.'s liberalization index for 1995, which is reproduced in Table 1 (last column) for the BRO countries.

[13] The exception is "Securities markets and nonbank financial institutions," where the country is given exactly the median grade.

[14] See EBRD (1997). The EBRD has estimated the private sector share in GDP at 45 percent in mid-1997. This estimate is more plausible than the government's official data which equate nonstate ownership with private ownership.

in areas of production in which the country traditionally lacked a technological capability and/or where goods are currently imported.[15] The first of these explanations is the one that has been emphasized by Fund staff in the past. The second explanation has some supporters both in Uzbekistan and outside and can be given a theoretical justification, although it contradicts most (but not all) empirical evidence on determinants of output in transition.[16] The third one, finally, is the preferred explanation of the Uzbek authorities.

14. The main objective of this section is to present a test of these rival hypotheses and analyze the extent to which they can account for Uzbekistan's output record. Before doing so, however, the extent to which this supposedly "exceptional" Uzbek record can be taken for a fact needs to be established, i.e., it must be checked whether Uzbekistan's output performance based on the official data might be the result of measurement problems.

The Role of Output Measurement

15. Measuring output in Uzbekistan has been difficult, in particular in the first few years following independence. Apart from methodological difficulties encountered when switching from the Net Material Product concept to the new System of National Accounts (SNA) and GDP, the statistical authorities had to cope with continued upward biases in reporting by state-owned enterprises (managers had incentives for being seen as meeting ambitious production targets), the effects of high inflation, large changes in relative prices, and the emergence of private sector activities which could not be easily captured through traditional data collection systems.

16. However, these problems have affected output measurement in most, if not all, transition economies. Arguing that Uzbekistan's relatively favorable measured output path can be partly or wholly attributed to problems with measuring official output requires that Uzbekistan systematically overstated its output figures *relative* to the transition (and BRO) country average. In principle, this could be because (i) there is truly an upward bias in the way Uzbek output is measured, or (ii) output measurement in Uzbekistan merely carries *less* of a *downward* bias than that in other transition countries.

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[15] This strategy could be referred to as "import substitution" (see Bruton (1998)), but this is not a term which the Uzbek authorities use or would agree with.

[16] On empirical evidence implicitly or explicitly contradicting gradualism, see the references given in the introduction; for an empirical study supporting gradualism, see Heybey and Murrell (1997). In order to justify gradualism theoretically (at least in some circumstances), it would be possible to invoke Blanchard and Kremer (1997), who emphasize the role of "disorganization" in the output decline.

17. As explained in detail in Chapter IV, there are reasons to believe that output growth in Uzbekistan might have been substantially overestimated in recent years. Fund technical assistance missions have identified methodological problems in the compilation of the national accounts, including an inconsistent treatment of informal sector activities over time, inappropriate procedures for dealing with the increased share of high-value commodities with low trade margins in organized retail turnover, and the use of the downward-biased consumer price index as a deflator for trade activities and subsidies. In addition, there are inconsistencies in growth estimates for specific sectors in 1997. However, it is unlikely that these problems alone could explain Uzbekistan's exceptionally mild transitional recession, and, in particular, the lower output decline during the *early* years. Moreover, the most recent (1997) annual growth estimate shown in Table 1 is based on IMF estimates which already attempt to correct for overestimation in the official data.

18. The second possibility, namely that Uzbekistan's output numbers overstate the true output decline to a lesser degree than those of other transition economies, seems more plausible ex-ante. It is well established that official statistics in transition economies tend to underestimate the activity of the newly emerging private sector.[17] The larger the share of the new sectors in total output, the larger the downward bias to GDP measurement. As a result, countries such as Uzbekistan, in which economic policies are geared to preserving—and, indeed, adding—to the official sector, will *ceteris paribus* suffer *smaller* downward biases to output measurement than transition countries where the private sector grows quickly.

19. This argument has empirical backing from output estimates based on changes in electricity consumption. According to these estimates, Uzbekistan's informal sector's share in GDP has remained low compared to that of most other transition economies. Johnson, Kaufmann, and Shleifer (1997) estimate the share of the unofficial economy for Uzbekistan at 9.5 percent for 1994 and 6.5 percent for 1995.[18] By contrast, the (unweighted) average for the BRO economies is 36.2 and 34.4 percent, respectively.[19] Table 3 shows the values of the Kaufman-Kaliberda output index for 1994 and 1995 for the BRO economies and compares output losses based on this index with those based on the output indices used in Table 1.

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[17] See Dobozi and Pohl (1995), Kaufmann and Kaliberda (1996) and Bloem, Cotterell, and Gigantes (1996). In the context of specific countries, see Berg (1993) for Poland, Gavrilenkov and Koen (1994) for Russia, and de Broek and Kostial (1998) for Kazakhstan.

[18] The estimate for 1995 is consistent with estimates from the Uzbek authorities, who put the share of the unofficial economy at about 6 percent of GDP in 1995 and about 10-12 percent in 1996 and 1997.

[19] The weighted average would be even higher, since the estimated shares for Russia and Ukraine are 40.3 and 45.7 percent for 1994, and 41.6 and 48.9 for 1995, respectively.

Table 3. Official GDP and GDP Estimates Based on Electricity Consumption

	1994 GDP Index (1991=100)			1995 GDP Index (1991=100)		Cumulative Loss 4/ 1991-95	
	Official 1/	KK 2/	DP 3/	Official 1/	KK 2/	Official	KK
Armenia	43	...	52	46	...	223	...
Azerbaijan	49	72	76	44	70	169	97
Belarus	73	67	71	65	60	88	108
Estonia	71	81	81	74	71	105	87
Georgia	36	44	50	37	44	230	173
Kazakhstan	74	70	74	68	64	79	92
Kyrgyz Republic	58	...	...	55	...	128	...
Latvia	56	67	67	56	67	170	121
Lithuania	59	57	57	61	53	133	154
Moldova	49	61	66	49	59	159	122
Russia	68	78	81	65	76	103	66
Tajikistan	50	...	...	43	...	173	...
Turkmenistan	69	...	...	64	...	87	...
Ukraine	60	73	76	52	68	121	83
Uzbekistan	83	85	87	82	82	59	51

1/ IMF data based on official statistics of country authorities (Source: IMF, see Table 1)

2/ Kaufman-Kaliberda methodology (Source: Johnson, Kaufmann and Shleifer (1997))

3/ Dobozi-Pohl methodology (Source: Dobozi (1996))

4/ The sum of differences between 1991 level and levels in 1992 through 1997, divided by 1991 level.

For 1994, we also show an alternative set of electricity-based estimates due to Dobozi and Pohl (1995).

20. Table 3 implies that if electricity-based GDP estimates are used to compare Uzbekistan with the other BRO countries, Uzbekistan stands out less than if official GDP data are used. However, even electricity-based output data indicate that Uzbekistan suffered the smallest output decline by both 1994 and 1995 and the smallest cumulative output loss through 1995 of any BRO country. This suggests that while measurement problems—particularly in comparator countries—may play some role in explaining Uzbekistan's relatively small output decline according to official data, they are not the main explanatory factor. The question is now whether other explanations are capable of narrowing the gap between the actual and "explainable" output path for Uzbekistan to a margin that can be reasonably attributed to measurement issues on the basis of Table 3.

The Role of "Special Factors"

21. We now turn to the role of the "special factors" which may have played a role in Uzbekistan and which were summarized at the beginning of this section in the form of competing hypotheses. A natural approach to shed light on these hypotheses is to test for the significance of the main variables emphasized by each in the context of a regression model which controls for potentially relevant codeterminants of output or growth (including, in particular, those variables which are stressed by the competing hypotheses).[20] Implementing this approach, however, is not straightforward.

- As the number of variables of interest clearly exceeds the number of data points available for Uzbekistan (5 or 6), one needs to work with a panel regression that estimates the effect of these variables on growth on the basis of the experience in many transition economies, not just Uzbekistan.

- In order to control for other potentially relevant codeterminants of growth, one requires a statistical model that not only accounts for the effects of the "special factors" implicit in the hypotheses outlined, but also for the effects of relevant policies and initial conditions other than the "special factors."

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[20] Note that this approach falls somewhat short of a formal test of these hypotheses as the null hypothesis in the context of a significance test is that the variables under scrutiny do not matter, whereas the null we are really interested in rejecting is that they do matter.

22. An existing model that incorporates these features is that of Berg, Borensztein, Sahay and Zettelmeyer (1998), who regress growth on macroeconomic and structural policies as well as a standard set of initial conditions using a panel of 26 transition economies. As Zettelmeyer (1998) shows, in spite of its generality, this model is *not* very successful in explaining why Uzbekistan did relatively well. Specifically, it systematically underpredicts Uzbek growth for every year between 1992 and 1996 (the sample period considered) with a particularly glaring predictive failure for 1994 (Table 4). However, it is also the case that, except for a variable capturing "overindustrialization" and variables controlling for structural reforms, the special factors addressed by the competing hypotheses formulated above are not reflected in this general model.

Table 4. Uzbekistan and BRO Average: Fitted and Actual Growth Paths (Berg et al. Model)

	1992	1993	1994	1995	1996
	Average of BRO Countries excluding Uzbekistan				
Actual growth	-25.8	-14.1	-13.3	-3.9	-0.2
Fitted growth	-24.7	-14.6	-12.3	-4.1	0.1
Residual	-1.1	0.5	-1.0	0.2	-0.3
Average of absolute residual	4.2	3.2	4.6	2.9	3.7
			Uzbekistan		
Actual growth	-11.1	-2.3	-4.2	-0.9	1.6
Fitted growth	-15.6	-6.4	-18.9	-4.7	0.0
Residual	4.5	4.1	14.7	3.8	1.6
Absolute residual	4.5	4.1	14.7	3.8	1.6

Source: Zettelmeyer (1998).

23. In response, Zettelmeyer (1998) extends the Berg et al. model by including a number of additional variables that might contribute toward explaining Uzbekistan's output experience based on the hypotheses formulated above.[21] These include variables measuring the production value of commodities that can be readily exported for hard currency (such as energy, nonferrous metals and agricultural variables including cotton), a variable capturing the degree of energy self-sufficiency and variables capturing public investment. On the basis of this extended model, two questions are asked: (i) which of the variables implicit in the hypotheses formulated at the beginning of this section matter, and which do not? (ii) to what extent do the surviving hypotheses explain Uzbekistan's growth performance? In the following, we limit ourselves to summarizing the answers to these questions; for technical details see Zettelmeyer (1998).

Which "Special Factors" matter?

24. The main results from the regressions of Zettelmeyer (1998) are as follows:

- upon rederiving the basic cross-country model after including the agricultural and natural resource variables listed above, the paper reports (i) a robust and significant positive effect of cotton production; (ii) a robust and significant *negative* effect of energy *exports;* (iii) a positive effect of energy self-sufficiency which, however, is significant only in some variations of the model; (iv) insignificant effects of nonferrous metal production when simultaneously controlling for cotton (but positive and significant effects when not).

- the contribution of the public investment variable is particularly weak. Not only is it far from being significant, but with one exception its t-values are consistently lower than those of all other variables, and it exhibits contradictory signs depending on whether it is normalized by GDP or population.

- As in Berg et al. (1998), the main variables driving the recovery are indices proxying market-oriented reforms. Although the model does not suggest that the speed of reforms matters *per se* (only the levels of the structural reform indices matter in the regression, not how quickly these are realized), this does imply that the faster a market environment is created, the better from the perspective of recovery.

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[21] These regressions use the official output data, as output estimates based on electricity consumption seem even more problematic for the purposes of a panel regression. For a discussion, see Taube and Zettelmeyer (1998).

25. On the basis of these results, one would conclude as follows. First, government investment seems to play a minimal role, if any, in explaining cross-country differences in growth in transition economies.[22] Second, as structural reforms are found to be the main engine of recovery, it is hard to make a case for gradualism on the grounds of the above results. Third, a number of the variables capturing commodity production and energy which were discussed in the previous section appear to matter when included in the extended model. The question is now to what extent these variables solve the "Uzbek Growth Puzzle," and whether the way in which they appear to act can be given a reasonable interpretation based on what was said about these variables in the background section. The latter is taken up in our conclusions below, the former in the section that follows.

How well is the Uzbek growth experience explained?

26. Table 5 compares fitted and actual growth since 1992 for Uzbekistan and an unweighted average of 14 BRO economies excluding Uzbekistan, based on one of two specifications of the extended (rederived) model presented in Zettelmeyer (1998).[23] As is apparent from the residuals for Uzbekistan, the extended model still has some difficulty in explaining why Uzbek output declined so little in 1994 and why it began to recover in 1996. However, the model does a satisfactory job in fitting the Uzbek experience in a least three respects. First, some residuals are now positive and others negative; thus, Uzbek growth during transition is no longer systematically underpredicted. Second, the model does at least as well—in fact, slightly better—in fitting the Uzbek path as it does in fitting the path of the average BRO economy. This can be checked by comparing the lines showing the absolute residuals for each transition year in the two panels of Table 5. Third, most of the difference between the Uzbek growth path and that of the average BRO economy is "explained" in Table 5, i.e., it is captured by differences in the fitted values rather than in the residuals.

27. This leads to the question of what drives the differences in the fitted values between Uzbekistan and the BRO average. The answer is given in the next table, which decomposes the fitted values into the contributions of the main groups of right hand side variables, i.e., policy variables, a standard set of initial conditions which includes the degree of overindustrialization and the additional agricultural and energy variables which were significant in the specification shown.

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[22] One important caveat applies, which is that the quality and consistency of public investment measurement across countries is questionable and this might bias the coefficient on public investment towards zero.

[23] Namely, his "Model B"; the alternative "Model A" leads to similar conclusions, except where noted below.

Table 5. Uzbekistan and BRO Average: Fitted and Actual Growth Paths
(in percent per annum)

	Transition Years				
	1992	1993	1994	1995	1996
	Average of BRO excluding Uzbekistan				
Actual growth	-22.3	-12.9	-13.4	-4.1	-1.0
Fitted growth	-22.2	-13.2	-12.6	-3.9	-1.4
Residual	-0.1	0.3	-0.8	-0.2	0.4
Average of absolute residual	2.3	3.1	4.1	2.9	5.3
	Uzbekistan				
Actual growth	-11.1	-2.3	-4.2	-0.9	1.6
Fitted growth	-11.6	-0.6	-8.4	0.2	-1.5
Residual	0.5	-1.7	4.2	-1.1	3.1
Absolute residual	0.5	1.7	4.2	1.1	3.1

28. Note first that Table 6 suggests that Uzbekistan's relatively favorable growth performance happened not because, but rather *in spite of* its macroeconomic and structural policies. On both counts, and particularly in the area of structural reforms, Uzbekistan's policies were worse for growth than in the average BRO economy. Instead, the positive difference in the fitted values of Uzbekistan and the BRO average originates from the variable groups "initial conditions" and "new variables." As regards the former, a further disaggregation of the initial conditions group (not shown) indicates that the differences in initial conditions are mainly due to the variables capturing overindustrialization and share of agriculture. As regards the latter, most of the favorable impact of the additional variables is concentrated on cotton (expressed as dollar value per capita). In the alternative specification presented in Zettelmeyer (1998), cotton shares the credit with the variable measuring energy self- sufficiency, which was not significant in the version shown here. However, the *total* growth advantage imparted by the commodity and energy variables is about the same in both versions: between five and eight growth points relative to the average transition economy, depending on the year.[24]

[24]Zettelmeyer (1998) also addresses an important methodological risk, which is that the new variables, which according to Table 6 impart such a positive effect on Uzbek growth, might

(continued...)

Table 6. Uzbekistan and BRO Average: Contributions of Major Groups of Variables to Fitted Growth
(in percent per annum)

	Transition Years				
	1992	1993	1994	1995	1996
	Average of BRO excluding Uzbekistan				
Macroeconomic policy	-1.8	2.1	2.2	1.5	1.7
Structural reforms	7.1	6.9	7.4	10.2	11.3
Initial conditions	-15.5	-9.8	-12.3	-6.6	-4.2
Constant	-7.8	-7.8	-7.8	-7.8	-7.8
War	-2.7	-2.7	-0.7	-0.2	-0.3
New variables	-1.6	-1.9	-1.5	-1.1	-2.1
Cotton	0.8	0.8	1.1	1.3	0.5
Non-cotton agric. commodities	-1.5	-1.9	-1.5	-1.7	- 1.9
Energy exports	-0.9	-0.9	-1.0	-0.7	-0.7
	Uzbekistan				
Macroeconomic policy	-6.8	0.8	0.7	0.8	0.6
Structural reforms	5.0	2.4	2.3	4.5	6.5
Initial conditions	-5.8	0.0	-8.9	-3.8	-3.8
Constant	-7.8	-7.8	-7.8	-7.8	-7.8
War	0.0	0.0	0.0	0.0	0.0
New variables	3.9	4.1	5.3	6.4	3.1
Cotton	4.8	4.8	6.2	7.8	5.2
Non-cotton agric. commodities	-0.9	-0.8	-0.9	-1.3	-1.3
Energy exports	0.0	0.0	0.0	0.0	-0.8

[24](...continued)
not actually be important in themselves, but merely *seem* important because they are effectively proxying something about the favorable Uzbek experience which we still have failed to measure. The most straightforward way to decide whether this could be the case is to reestimate the model after *excluding* Uzbekistan from the sample and see how this affects the outcome. Zettelmeyer (1998) shows that while the coefficients drop in value, they are, in economic terms, still quite close, and they still do a satisfactory job in fitting the Uzbek experience (out of sample). Moreover, a structural break test testing the equality of the models including and excluding the Uzbek samples does not reject equality. Under these circumstances, it is valid to interpret the results of Table 6 as reflecting the economic impact of the new variables rather than proxying an unmeasured "Uzbekistan effect."

A Sectoral View

29. We conclude our analysis of output developments in Uzbekistan by examining growth at the sectoral and subsectoral level. This serves both as a complement of our previous analysis of aggregate growth, and sheds some light on why growth turned the corner in 1996 and remained moderately positive in 1997.

30. As indicated above, overall output held up relatively well during the first few years of the transition and the economy started to grow in late 1995 and during 1996. However, production trends have been very diverse across and within sectors since independence (Tables 7 and 8, and Figure 2). Output in industry, transport and communication, and construction fell more than overall GDP, while agriculture and, in particular, the trade and services sectors performed relatively better. Within the industrial sector, output declined in a number of traditional subsectors, which, however, was partly compensated by sharply higher energy production and increases in output for a number of intermediate and final consumer goods. While this trend is hidden in the aggregated output data, it is clearly borne out by statistics on physical production volumes (Table 9).[25]

31. Industrial output performance in more recent years benefitted substantially from government efforts to promote domestic production of consumer goods in a few industrial sectors. During the past two years, these included, most prominently, manufacturing of television sets, VCRs, and automobiles. At the same time, the government was able to stabilize production in a number of industrial subsectors that continued to be dominated by large state-owned enterprises producing, for example, paper, cement, ferrous metals, and mineral fertilizer. In part, this may have reflected the continuing support through the budget and easy access to directed central bank and commercial bank credit on concessional terms. By contrast, and despite government support, output continued to decline in a number of other industrial sectors, including machinery (e.g., power transformers, tractors, cotton harvesters), raw materials and intermediate goods (e.g., window glass, cotton fiber), and consumer goods (e.g., refrigerators and freezers, cotton cloth, shoes, detergents, and vegetable oil).

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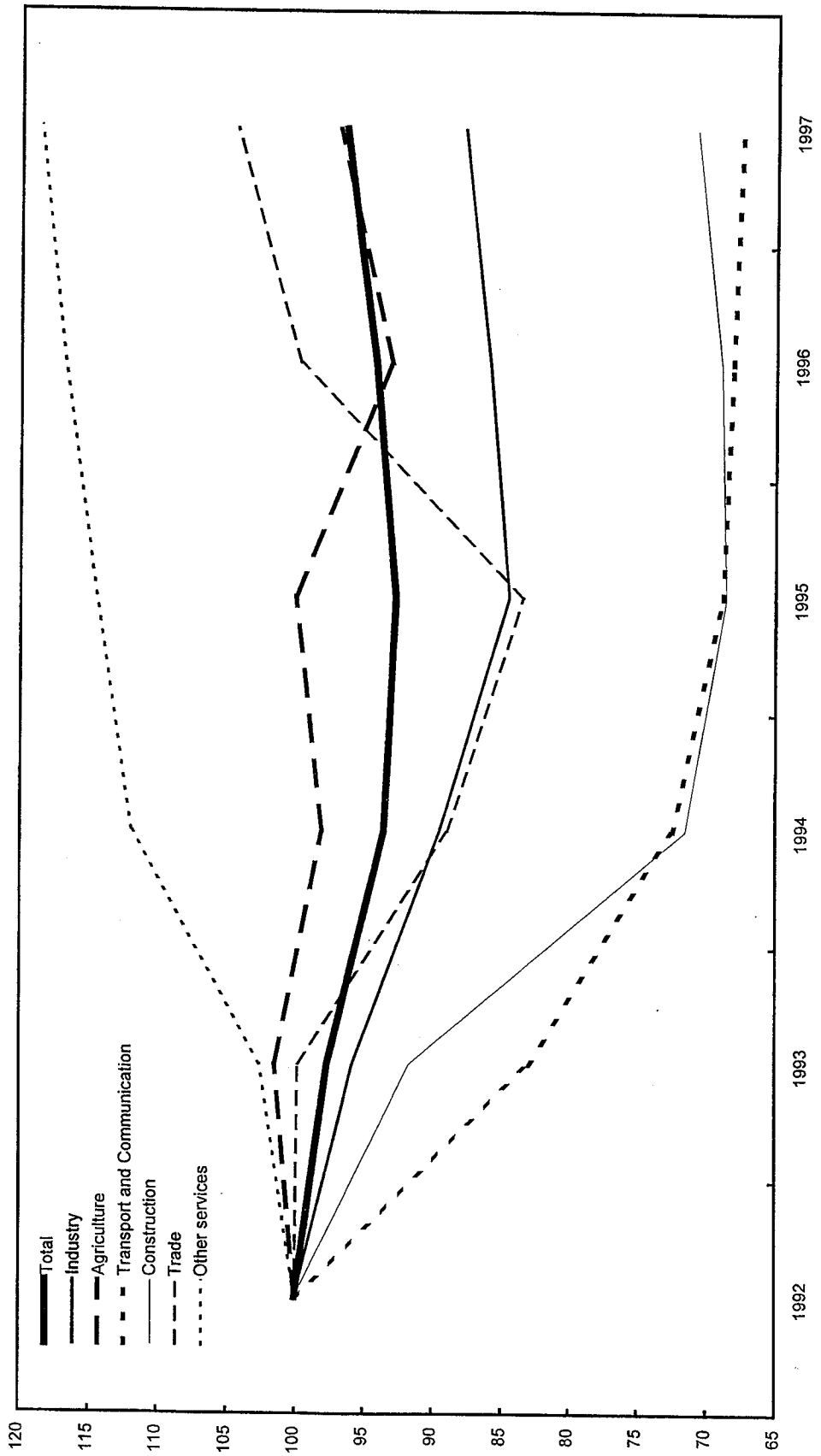
[25]For example, output fell dramatically in the case of paper, cement, mineral fertilizer, chemical production, power transformers, tractors, and cotton harvesters.

Figure 2. Uzbekistan: Real GDP Index by Sector
(Index 1992=100)



Sources: Ministry of Macroeconomics and Statistics; and Fund staff estimates.

Table 7. Uzbekistan: Real GDP Growth, 1992-97

	1993	1994	1995	1996	1997 Staff Estimate	1997 Official Estimate
	(In percent over previous year)					
Total	-2.3	-4.2	-0.9	1.6	2.4	5.2
Agriculture	1.5	-3.4	2.0	-7.0	4.2	5.8
Industry	-4.2	-6.6	-5.6	1.7	2.2	2.2
Transport and communication	-17.0	-12.7	-5.0	-1.0	-1.0	-1.0
Construction	-8.3	-22.0	-4.1	0.6	2.6	2.6
Trade	-0.2	-10.9	-6.2	19.5	4.7	17.1
Other services 1/	2.6	9.1	2.3	2.0	1.6	4.1
Indirect subsidies minus taxes	...	-2.5	-0.4	14.1	1.5	8.1
	(In millions of sums)					
Agriculture	1,421	22,356	85,113	125,383	248,195	264,150
Industry	1,140	11,031	51,735	99,713	159,084	157,334
Transport and communication	281	3,768	22,053	37,646	60,308	57,853
Construction	457	4,704	21,369	46,111	78,268	79,190
Trade	317	4,834	15,844	39,315	78,843	82,065
Other services 1/	999	12,845	66,878	130,243	227,182	221,329
GDP at current factor costs	4,615	59,538	262,990	478,410	851,880	861,920
Indirect taxes minus subsidies	481	5,340	39,798	80,662	110,258	125,431
GDP at market prices	5,095	64,878	302,787	559,072	962,138	987,351

Sources: Ministry of Macroeconomics and Statistics; and Fund staff estimates.

1/ Includes the government sector.

Table 8. Uzbekistan: Sectoral Contribution of Nominal GDP at Current Market Prices, 1993-97

(In percent)

	1993	1994	1995	1996	1997 Staff Estimates
Agriculture	28	34	28	22	26
Industry	22	17	17	18	17
Transport and communication	6	6	7	7	6
Construction	9	7	7	8	8
Trade	6	7	5	7	8
Other services 1/	20	20	22	23	24
GDP at current factor costs	91	92	87	86	89
Indirect taxes minus subsidies	9	8	13	14	11
GDP at market prices	100	100	100	100	100

Sources: Ministry of Macroeconomics and Statistics; and Fund staff estimates.

1/ Includes the government sector.

Table 9. Uzbekistan: Production of Selected Industrial Products, 1991-97

	Unit	1991	1992	1993	1994	1995	1996	1997
Machinery, raw materials, and intermediate goods								
Paper	thousand tons	20	16	13	8	9	11	8
Cement	thousand tons	6,191	5,935	5,277	4,780	3,419	3,277	3,286
Ferrous metal products	thousand tons	749	604	573	337	322	423	350
Mineral fertilizers	thousand tons	1,660	1,361	1,273	811	943	1,029	954
Plastics and synthetic resins	thousand tons	126	94	53	20	13	11	10
Fibers and chemical thread	thousand tons	49	33	23	13	8	6	7
Compressors	number	11,106	8,123	3,981	1,264	784	828	284
Power transformers	thousand kilowatts	6,771	4,621	2,590	1,106	780	535	398
Tractors	thousand	21	19	12	2	4	4	3
Cotton harvesters	number	5,800	2,350	2,155	651	1,121	863	1,049
Cotton sowing machines	number	1,800	1,800	1,350	970	330	470	411
Steel	thousand tons	860	688	611	364	367	466	379
Window glass	thousand square meters	2,537	3,130	2,807	1,122	2,130	1,499	5,123
Cotton fiber	thousand tons	1,532	1,404	1,258	1,385	1,238	1,164	1,125
Consumer goods								
Refrigerators and freezers	units	211,900	84,300	81,750	19,750	18,600	12,700	35,000
Automobiles	units	--	--	--	800	3,000	25,400	64,900
Television sets	units	1,100	9,200	16,400	51,800	64,900	139,650	268,450
Video recorders	units	2,100	18,900	6,500	23,900	25,300	100,000	140,600
Cotton cloth	thousand tons	392	484	482	480	456	445	425
Tricotage products	million units	95	93	98	96	34	46	50
Synthetic textiles	thousand tons	36	18	16	8	7	3	3
Socks and hosiery	million pairs	103	106	109	107	66	68	62
Shoes	million pairs	45	41	41	28	6	5	5
Soap	thousand tons	16	7	8	9	9	7	4
Detergent	thousand tons	36	18	16	8	7	3	...
Vegetable oil	thousand tons	400	325	291	360	340	232	237
Energy products								
Electricity	billion of kilowatt hours	54	51	49	48	47	45	46
Coal	thousand tons	5,948	4,681	3,807	3,845	3,054	2,837	2,946
Natural gas	billion of cubic meters	42	43	45	47	49	49	51
Oil and gas condensate	thousand tons	2,831	3,293	3,944	5,517	7,586	7,621	7,891

Source: Ministry of Macroeconomics and Statistics.

32. In agriculture, cotton production fell while grain output increased, in part as a result of government efforts to shift land to grain production so as to achieve food self-sufficiency. At the same time, there was a decline in livestock production from state-owned enterprises, while there was a favorable supply response from the private sector as regards output, and productivity, in livestock products as well as fruits and vegetables. Aggregate agricultural production fell sharply in 1996, mainly as a result of a poor cotton harvest, and partly rebounded in 1997.[26]

33. As regards services, Uzbekistan's output performance has been fairly similar to other transition countries where the previously repressed services sectors have often been the leading sectors of "new growth" (de Melo et al. 1996, World Bank 1996). The services sector started expanding in late 1995 and 1996, when the macroeconomic situation began to stabilize. Helped by trade liberalization and boosted foreign exchange earnings through favorable world market prices for cotton, imports of investment goods, intermediate products, and consumer goods increased substantially during this phase. As a consequence, domestic wholesale and retail activities thrived, especially in Tashkent. Many small private businesses and shops opened or extended their activities during this phase, including the large number of previously privatized small firms and retail outlets.

34. In summary, the recovery of aggregate production in 1996 was driven by (i) sharp growth in services, fueled by small-scale privatization and trade and foreign exchange liberalization in late 1995, which more than offset a bad cotton harvest; (ii) the government's success in arresting the industrial output decline, in particular in industrial subsectors that continued to be dominated by large state-owned enterprises. The continuing modest growth in 1997, on the other hand, was mainly the result of a partial rebound in agriculture combined with continuing, albeit much slower, growth in services, as consumer goods imports were restrained.

D. Summary and Conclusions

35. The purpose of this paper was to analyze why Uzbekistan's output performance has been so much more favorable, according to official data, than that of other transition economies. Four main explanations were evaluated: biases in output measurement, a gradualist approach to reforms, a policy of industrialization through ambitious public investment, and favorable initial conditions—possibly in combination with policies that built on these initial conditions. We also sought to shed light on recent positive growth by examining output at the sectoral level. The main findings are as follows:

- Biases in measurement play a role in exaggerating Uzbekistan's relative favorable output performance, but Uzbekistan's relative success does *not* appear to be an

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[26] For a more detailed discussion of agricultural production trends, see Chapter II.

artifact of measurement alone. Even according to output estimates based on electricity consumption, Uzbekistan experienced the mildest "transformational recession" of any BRO country;

- A cross-country regression model suggests that Uzbekistan's favorable output performance did not occur *because*, but *in spite of*, gradualist macroeconomic and structural policies which by themselves would have had detrimental effects on growth;

- Attempts to relate public investment to growth in the sample of transition countries including Uzbekistan give insignificant coefficients and conflicting signs;

- To a large degree, the mildness of Uzbekistan's transitional recession can be accounted for by a combination of its low degree of initial industrialization, its cotton production, and its self-sufficiency in energy;

- Uzbekistan's positive growth in the last two years was driven by growth in services, especially in 1996, and—to a lesser extent—a weather-related rebound in agriculture in 1997.

36. These results suggest that Uzbekistan's relative success has much to do with favorable initial conditions, and that the government's public investment program and gradualist reform strategy were *not* the driving forces of its relatively favorable output performance. This said, it is hard to pin down the role of policies in explaining Uzbekistan's mild transformational recession. While the results indicate that structural and macroeconomic policies would have been detrimental *by themselves* (with the notable exception of the brief period of liberalization during 1995/96), policies and initial conditions cannot be easily unbundled. One interpretation of the results is that Uzbekistan did relatively well in terms of aggregate output decline because it was successful at preventing the collapse of the (relatively small) industrial sectors by combining rigid state control with subsidies that were in large part financed by cotton exports, and by ensuring an uninterrupted supply of cheap energy. In other words, a set of policies which failed elsewhere as they could not be afforded—supporting the industrial sector through both credits and direct subsidies—may have been relatively successful in maintaining production *in combination* with Uzbekistan's favorable initial conditions, albeit at a high cost to consumers and growth in the medium term.

37. In conclusion, while the results stress the importance of favorable circumstances in explaining Uzbekistan's relative success, Uzbekistan's policies could share credit in two respects. First, Uzbekistan's brief liberalization period from late-1995 to mid-1996 might have generated an environment that allowed the rebound in services that drove positive growth in 1996 and (to a lesser extent) in 1997. Second, economic policies prior to this period, which by themselves would have aggravated the output decline, may have mitigated it

in combination with Uzbekistan's initial circumstances. The latter, however, does not imply that Uzbekistan's policies were optimal even in those circumstances. Not only did they ignore broader welfare issues such as consumers' choice and environmental degradation, but they failed to set the right incentives even from the narrow perspective of maximizing production, particularly in the agricultural sector. Most importantly, the same model that explains Uzbekistan's relatively successful past also suggests that in the absence of continuing market reforms Uzbekistan's future growth rates will hover in the range of -2 to +2 percent, while comprehensive external liberalization, price liberalization (including in agriculture) and improvements in the private sector environment could well lead to growth rates in the order of 6-10 percent within three years. As Uzbekistan's international environment normalizes, policies that may have mitigated the output decline in the special initial circumstances of Uzbekistan will almost certainly be harmful from the perspective of medium-term growth.

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II. Agricultural Producer Price Policies and Marketing Arrangements

A. Introduction

38. Since independence, Uzbekistan has pursued policies in support of rapid industrialization based on import substitution. On a net basis, resources have been channeled out of agriculture, which remains the key sector of the Uzbek economy, to finance an ambitious industrial investment program and to subsidize consumers, especially in urban areas. Resource extraction from cotton—Uzbekistan's most important crop and foreign exchange earner—has played a prominent role in this strategy. The authorities have taxed the cotton and wheat subsectors through a variety of implicit and explicit mechanisms, including the foreign exchange system, the state order system, low producer prices, and controls over agricultural collectives as well as marketing and processing organizations. All land has remained under government ownership, farm restructuring and privatization have been limited, and property rights have remained insecure. At the same time, substantial explicit and implicit support has been provided to agriculture through subsidization or free provision of inputs, preferential tax treatment, directed lending at favorable terms, and cancellation or rescheduling of tax and other arrears.

39. The maintenance of a complex, nontransparent system of direct and indirect controls and implicit and explicit taxes and subsidies has led to severe distortions in relative prices, disincentives to agricultural producers, and an inefficient allocation of resources both across sectors and within agriculture. This, in turn, has hampered growth and the exploitation of Uzbekistan's large agricultural production potential. At times, the provision of large directed credit through banks and budgetary onlending to compensate for the burden imposed on agriculture has contributed to large fiscal deficits, rapid monetary expansion, and inflation. Uzbekistan's slow export growth and poor balance of payments results can in large part be traced to problems in reforming and developing agriculture.

40. On balance, the agricultural sector has lost substantial resources in the past 5-6 years as a consequence of government policies.[27] There are clear and increasing **signals of distress**: cotton area yields have declined, the condition of agricultural infrastructure and machinery

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[27]"Milking the cow" is the expression a government official used to describe the government's policies toward agriculture. As regards cotton and wheat production, policies continue to resemble those of the Soviet Union. For an overview of agricultural policies under the socialist system see IMF et al. (1991). See also Schiff and Valdés (1995) who show that a large number of developing countries in the 1960s and 1970s failed to achieve macroeconomic stabilization and growth by "plundering agriculture" through similar policies. For general reviews on agricultural policies in transition countries see, for example, Brooks and Lerman (1995) and Csaki and Lerman (1996). Galbi (1995) provides an analysis of credits and subsidies in Russian agriculture since 1992.

has deteriorated, and a number of recently created new private farms have ceased to operate over the past two years. Average real incomes of the rural population have stagnated at best, and poverty has reportedly increased at least in some parts of the country (e.g., Karakalpakstan). Agricultural practices have contributed to a deterioration of the environment and the pollution and drying of the Aral Sea. They have also resulted in health risks in certain areas.

B. Agricultural Performance

41. Under the Soviet system, Uzbekistan's primary role was to produce cotton, fruits and vegetables, along with energy, gold, and other natural resources largely for export to other Soviet republics or CMEA countries. Agriculture was the most important sector of the Uzbek economy with a share in GDP of over 30 percent (IMF 1994, World Bank 1993).[28] Cash crop production depended on a large number of state farms (*sovkhoz*) and collectives (*kolkhoz*), with households being allowed to produce food crops mainly for subsistence purposes on small plots adjacent to their houses. After independence, agriculture has remained the key sector of the economy with an average share in GDP of around 25 percent (Chapter IV). The production and distribution of agricultural inputs (e.g., fertilizer, machinery) plus the transport and processing of agricultural produce accounts for a significant share of non-agricultural GDP. About 60 percent of the population live in the rural areas, depending mostly on agriculture for their incomes and employment. According to official data, approximately 3.5 million persons are employed in agriculture, equivalent to about 40 percent of the total number of all employees in the economy.

42. Since independence, the cumulative decline in agricultural output has been moderate, which has contributed to the relatively mild "transformational recession" of the Uzbek economy (Chapter I). However, in 1996, agriculture experienced an output decline of about 7 percent, which was followed by a partial rebound in 1997, primarily because of better weather.[29] Cotton—"the white gold"—is still the most important agricultural crop in Uzbekistan, despite the increase in the production of wheat as part of the government's

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[28]Detailed studies on agriculture prior to independence and during the first years of the transition are provided by Craumer (1995), Khan (1996), and Pomfret (1995).

[29]Owing to the poor quality of official data, there is a substantial margin of error in agricultural output measurement. The official output data for cotton are relatively reliable. However, fruits, vegetables, and livestock products are increasingly produced by small-scale private farmers who generally do not report to the statistical authorities.

policy to achieve national food self-sufficiency (Table 10). In large part, this policy entails shifting area under cultivation from cotton and fodder crops toward wheat. According to World Bank and other estimates, however, this switch runs counter to Uzbekistan's comparative advantage, which lies in the production of cotton and other crops (e.g., fruits, vegetables, rice) on irrigated land.[30] Combined, cotton and wheat account for about 70 percent of the area under cultivation.[31]

43. Investment in agriculture has been modest and much smaller than in other sectors. Official investment data provide a clear indication of government priorities as regards sectoral allocation. Over the past three years, the share of agriculture in total investment in the economy averaged only 7 percent, compared with a share of 38 percent for the industrial sector, which included large investments in energy (Table 11). As a consequence, and in part also reflecting the lack of imported spare parts and inadequate maintenance due to insecure ownership rights and lack of privatization, the capital stock (infrastructure and machinery) has deteriorated rapidly in recent years. Most investments in agriculture have been financed from domestic public sources, while foreign investment has largely been confined to a few joint ventures in processing and an agricultural machinery leasing company.

Cotton

44. Cotton cultivation in Uzbekistan expanded massively between 1960 and 1980, when the area under irrigation increased from 2.3 million to more than 4 million hectares. More than 2 million hectares of irrigated land were planted with cotton during the 1980s, which was the peak period of cotton cultivation. Prior to independence, most of the cotton fiber was shipped to other Soviet republics for processing. Since independence, cotton exports have increasingly shifted to western markets, including the United States and Europe.[32] In recent years, Uzbekistan has been the world's fifth largest cotton producer (with a world market share of 6 percent) and the second largest exporter (17 percent of world exports) (Table 12). Cotton export earnings peaked in 1995 at US$1.6 billion, significantly boosted by high world market prices. These earnings fell to US$1.4 billion in 1997, reflecting in part lower world market prices and the poor 1996 harvest. Although cotton's share in total exports declined to less than 40 percent in 1997, the "white gold" remained by far the single largest source of foreign exchange for the economy (Table 13).

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[30]It is estimated that, even on current low yields, farmers could achieve gross returns of more than US$600 per hectare of cotton, compared to less than US$500 per hectare of wheat.

[31]A number of other crops are also produced, including tobacco and silk cocoons. Since 1991, output of these crops has generally declined from already low levels (Table 10).

[32]About 10-20 percent of total production is used domestically.

Table 10. Uzbekistan: Production of Selected Agricultural Products, 1991-97

(In thousand tons, unless stated otherwise)

	1991	1992	1993	1994	1995	1996	1997
Raw cotton	4,646	4,128	4,235	3,938	3,934	3,350	3,641
Grains	1,908	2,257	2,142	2,467	3,215	3,549	3,788
Of which							
Wheat	610	964	876	1,363	2,347	2,737	3,073
Rice	515	539	545	498	328	445	394
Potatoes	351	365	472	567	440	490	686
Vegetables	3,348	3,494	3,039	2,975	2,713	2,481	2,348
Fruits	516	702	560	555	602	585	546
Grapes	480	439	381	353	621	474	505
Livestock and poultry	800	777	841	827	853	854	801
Milk	3,331	3,679	3,764	3,732	3,665	3,390	3,406
Eggs (millions)	2,347	1,898	1,788	1,574	1,232	1,057	1,075
Wool	25	27	27	25	20	15	15
Karakul/Sheepskin (thousands)	1,476	1,604	1,517	1,540	1,393	1,370	1,411
Silk cocoons	34	33	30	23	24	22	21
Tobacco	21	9	9	11	17	12	31

Source: Ministry of Macroeconomics and Statistics.

Table 11. Uzbekistan: Sectoral Shares in Investment, 1995-97

	1995	1996	1997
Total investment 1/	100	100	100
Of which			
Agriculture	7	7	6
Industry	49	34	31
Of which			
Energy	11	18	16
Other sectors	44	59	63
Memorandum items:			
Sectoral shares in GDP at current market prices			
Agriculture	28	22	26
Industry	17	18	17

Source: Ministry of Macroeconomics and Statistics.

1/ Investment may include significant current expenditures.

Table 12. Cotton World Production and Exports, 1992/93-1997/98 1/

(In thousand metric tons)

	1992/93	1993/94	1994/95	1995/96	1996/97 Estimate	1997/98 Forecast
World production	17,961	16,707	18,639	20,254	19,417	19,296
Of which						
United States	3,531	3,513	4,281	3,897	4,124	4,092
China	4,507	3,745	4,333	4,768	4,202	4,289
India	2,346	2,066	2,354	2,885	3,000	2,439
Pakistan	1,540	1,368	1,361	1,785	1,589	1,524
Uzbekistan	**1,274**	**1,321**	**1,258**	**1,250**	**1,034**	**1,176**
Turkey	574	602	628	852	784	718
World exports	5,575	5,815	6,176	6,065	5,768	5,687
Of which						
United States	1,132	1,494	2,047	1,671	1,495	1,633
Uzbekistan	**1,197**	**1,263**	**1,090**	**985**	**991**	**936**
Franc-Zone Africa	446	441	584	609	735	784
Australia	369	366	293	319	533	555
India	234	66	18	145	277	27
Pakistan	256	69	32	312	26	76
Argentina	65	69	197	266	290	218
Memorandum items:						
Uzbekistan/world production (in percent)	**7**	**8**	**7**	**6**	**5**	**6**
Uzbekistan/world exports (in percent)	**21**	**22**	**18**	**16**	**17**	**16**

Source: United States Department of Agriculture, Cotton: World Markets and Trade, May 1998.

1/ Season beginning August 1.

45. In the past few years the area under cotton has been lowered to 1.5 million hectares, which in part explains the decline in cotton output observed in recent years. A second important factor in 1996 and 1997 was the reduction in yields, reflecting the distorted incentive structure for cotton growers, including low remuneration for cotton pickers (Box 1), poor agricultural practices, and environmental degradation (Box 2). Although Uzbek cotton yields are still higher than in neighboring Tajikistan and Turkmenistan, they are below those in China and other countries where cotton is grown under similar conditions.[33]

Box 1: Cotton and Labor

Cotton cultivation is very labor-intensive. Under the Soviet regime, picking cotton was generally undertaken during a 2-3 month long campaign with the forced participation of students and teachers in exchange for very low remuneration. Reportedly, this practice—which involves child labor—still exists to some extent in Uzbekistan, partly because more and more agricultural machinery has fallen into disrepair. Since independence, agricultural wages have remained very low in U.S. dollar terms, and they have fallen sharply relative to those in industry and other sectors of the economy (Table 13 and Figure 3). Moreover, agricultural workers are often compensated partly in kind, while cash payments are delayed.

Although a labor shortage exists during the peak cotton harvesting season, there is otherwise considerable hidden unemployment in agricultural collectives. According to official information, about 800,000 persons are underemployed in agriculture (equivalent to almost 10 percent of the total number of employed persons in the country). The creation of more employment opportunities especially in the rural areas is of crucial importance, as about 50 percent of the rural population is below 18 years. At the aggregate sectoral level, labor productivity has declined since 1991, as overall output has fallen and the overall level of employment in the sector, as officially measured, has remained broadly the same.

[33]In recent years, Uzbekistan has achieved an average yield of about 750 kg of cotton fiber per hectare, compared to 340 kg in Turkmenistan and 880 kg in China (World Bank 1993; United States Department of Agriculture 1998).

Table 13. Uzbekistan: Cotton and Wheat Indicators, 1991-97

	1991	1992	1993	1994	1995	1996	1997
Total cultivated area (million hectares) 1/	4.20	4.22	4.23	4.24	4.17	4.01	4.14
Cotton	1.72	1.67	1.70	1.54	1.50	1.49	1.51
Grains	1.10	1.21	1.28	1.52	1.67	1.74	1.84
Of which							
wheat	0.49	0.63	0.70	0.96	1.16	1.33	1.47
Feed crops	1.07	1.01	0.97	0.88	0.73	0.52	0.69
Other	0.31	0.34	0.28	0.30	0.26	0.26	0.10
Production (in million tons)							
Raw cotton	4.65	4.13	4.23	3.94	3.90	3.35	3.64
Wheat	0.61	0.96	0.88	1.36	2.35	2.74	3.07
Yields (tons/hectare)							
Raw cotton	2.70	2.48	2.50	2.56	2.60	2.25	2.41
Wheat	1.25	1.54	1.26	1.42	2.02	2.06	2.09
Cotton exports (in million US$)	...	861	1,172	1,508	1,584	1,539	1,390
Total exports (million US$)	...	...	2,877	2,940	3,590	3,571	3,695
Cotton exports (in percent of total exports)	...	...	40.74	51.29	44.12	43.10	37.62
Cotton exports (in percent of GDP) 2/	...	24.11	23.00	26.50	15.80	11.29	9.63
Average wage in agriculture (in U.S. dollars) 3/	24	21	24	20	26	29	22
Average wage in the public sector (in U.S. dollars) 3/	18	18	29	27	35	53	55
Average wage in industry (in U.S. dollars) 3/	24	26	43	36	51	74	81
Average agricultural wage/average public sector wage (in percent)	133	115	82	77	73	55	40
Average agricultural wage/average industrial wage (in percent)	100	81	55	58	50	39	27

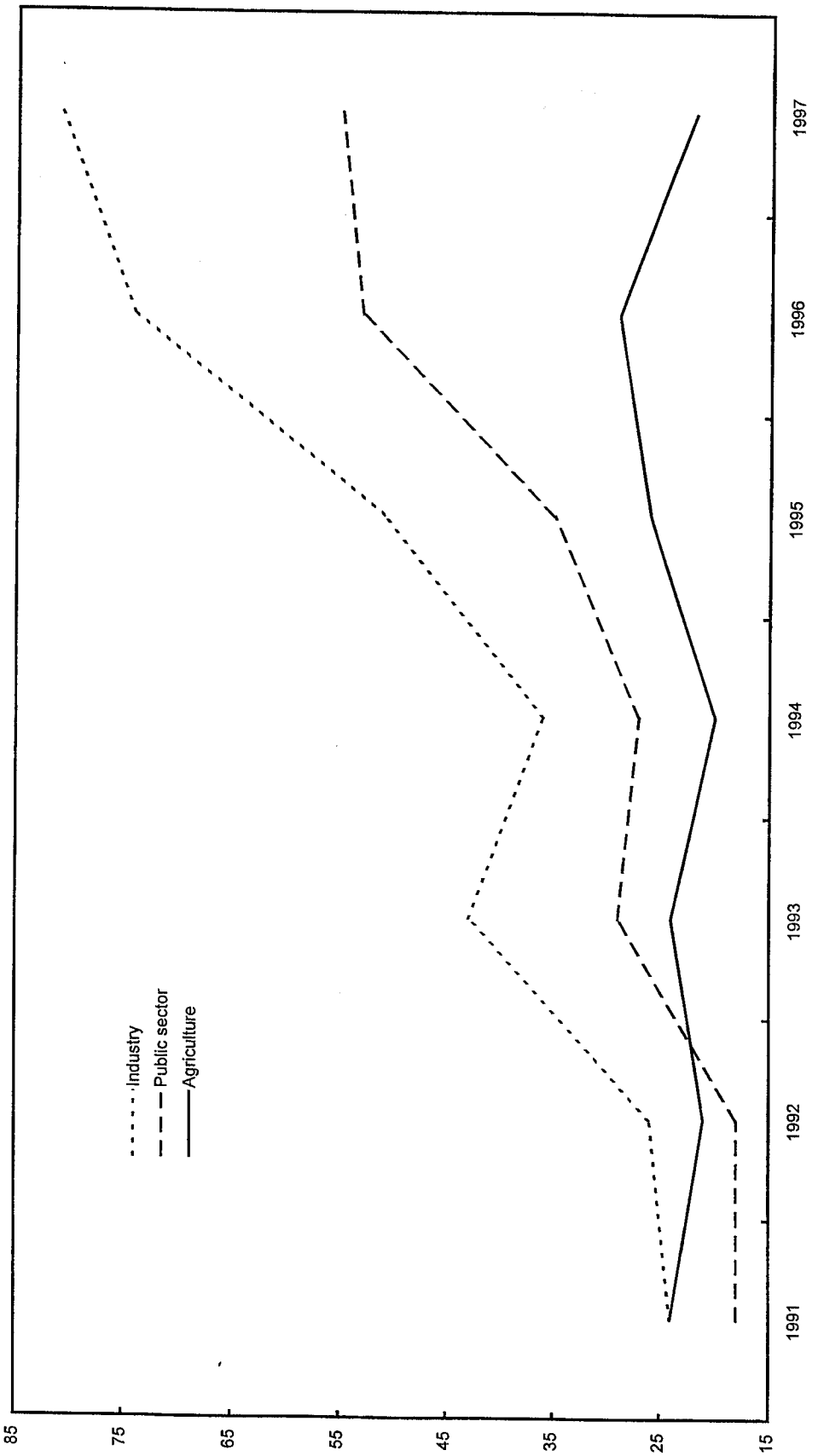
Sources: Ministry of Macroeconomics and Statistics; World Bank 1996; and Fund staff estimates.

1/ More than 90 percent of the cultivated land is irrigated, requiring that 80-90 percent of available water resources are used in agriculture.

2/ GDP converted at the official exchange rate.

3/ At the official exchange rate.

Figure 3. Uzbekistan: Average Wages, 1991-97
(In U.S. dollars)



Sources: Ministry of Macroeconomics and Statistics; and Fund staff estimates.

Box 2: Cotton Cultivation and its Environmental and Social Implications

Heavy use of fertilizers and pesticides in large-scale cotton irrigation has resulted in salinization, decreasing soil fertility, and falling area yields. Water use in cotton cultivation is excessive due to poor water management and low or unenforced water fees. Reportedly, cotton growers in parts of the country use 3-4 times as much water as in other countries.

The massive diversion of water from the two major rivers (the Syrdarya and the Amudarya) for cotton irrigation has contributed to the sharp decline in the supply of water to the Aral Sea, which is drying up. Once the world's fourth largest inland sea, it has lost about one-third of its surface area since the 1960s. In addition, the excess irrigation water that is drained off irrigated land is heavily contaminated with mineral salts and fertilizers, polluting what remains of the lake. The fishing industry has collapsed, and human health has also been adversely affected as both the supply and quality of drinking water has worsened. Owing to air pollution through wind-borne salts, there has been a large increase in respiratory and other diseases among the population around the Aral Sea. The natural climate around the Aral Sea has also changed. 1/

A regional program is being undertaken by Kazakhstan, the Kyrgyz Republic, Tajikistan, Turkmenistan, and Uzbekistan to reduce the ecological and social problems associated with the shrinking Aral Sea. This program is supported by the World Bank, the UN, and other donors. However, the implementation of this program is slowed down by divergent national interests and the region's complicated geography. The Aral Sea straddles the border between Kazakhstan and Uzbekistan and the Syrdarya and Amudarya flow through four countries—Tajikistan, the Kyrgyz Republic, Turkmenistan and Uzbekistan. With assistance from the World Bank and the Asian Development Bank, the Uzbek government also intends to improve cotton cultivation in the context of pilot projects in selected regions.

1/ On the environmental and social consequences of cotton cultivation in Uzbekistan see World Bank (1993).

46. Cotton procurement and processing remains essentially a monopsony of the government. The state-owned association *Uzkhlopkopromzbyt* in charge of these activities was established in December 1992, succeeding the previously responsible ministry for the cotton sector. It operates around 135 ginneries and more than 600 procurement points. The ginneries are in the process of being corporatized as open joint stock companies, in which the government intends to retain eventually only up to 25 percent of the shares. Up to 26 percent can be sold through the stock exchange, with the collectives of workers retaining the remaining ownership shares. The association itself holds around one third of the shares in the Pakhta Bank, which is the major provider of credit for cotton operations. So far, no cotton ginnery has been privatized, despite the fact that a number of foreign investors have indicated strong interest in this sector.

47. Following the poor 1996 crop, the government decided to provide substantial additional assistance to the sector. This included experimenting with a new technology (use of plastic foil) applied on slightly more than 10 percent of the area sown in 1997. However, while adding significantly to the already high production costs, only a moderate increase in yields was achieved. Overall, cotton output fell again significantly short of the target in 1997 (3.6 versus 4 million tons). Subsequently, the government openly acknowledged the problem of declining cotton yields. In a recent speech, President Karimov attributed this decline to "excessive spending, obsolete management, poor land reclamation and neglect in seed growing."

Wheat and Other Crops

48. The production of wheat has increased significantly since independence, reflecting primarily the substantial expansion in area under cultivation. According to official data, wheat output rose to slightly more than 3 million tons in 1997, equivalent to more than 80 percent of total grain output.[34] Official data suggest that wheat yields have increased somewhat in recent years, although they have remained low compared to those achieved in other countries (World Bank 1993). The wheat import bill rose sharply in 1996 when, at a time of high world market prices, the government replenished stocks. While the domestic production of 2.7 million tons in 1996 was well below the plan target of over 4 million tons, it was higher than the 1995 harvest (2.3 million tons).

49. Output performance of other crops has been mixed. According to official data, the production of potatoes has increased substantially in recent years, primarily because of an expansion in cultivated area. By contrast, overall production of vegetables has fallen sharply, reflecting in part a switch to potato cultivation in the collective sector and an inadequate

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[34]According to official statistics, the total grain harvest in 1997 was 3.8 million tons. It is estimated that Uzbekistan needs to produce at least 4.2 million tons of grains to meet domestic requirements.

measurement of private sector production in the official statistics.[35] Following the liberalization of marketing and abolition of state order prices in 1992-93, fruits and vegetables are now overwhelmingly sold in the bazaar, leaving state-owned food processing plants without adequate input supplies due to the significantly lower prices that they offer. According to the official data, tobacco output dropped sharply in 1992 and 1993, but has since rebounded from very low levels, largely reflecting increased producer prices and support provided through a joint venture in tobacco processing.

Livestock

50. Output and productivity performance in the livestock sector have been uneven. Overall, the subsector has experienced a sharp drop in the total number of animals (except cattle), and there has been a decline in fodder and feedgrain production, partly on account of the increase in the area planted with wheat. Productivity in the livestock sector fell sharply (e.g., milk yields per cow) on state farms and partially privatized but still government-controlled large-scale joint stock companies.[36] By contrast, production and productivity in private sector livestock operations improved, helped by the liberalization of marketing in the first 2-3 years of transition. Official and other sources estimate that by now up to 80 percent of livestock products are sold on the free market.[37] As in the case of fruits and vegetables, this has caused supply shortages for those dairy factories and meat-processing plants remaining under government ownership. These generally pay relatively low prices (noncash, and at times, delayed), while their private sector counterparts pay higher prices on a cash basis.[38] Cash withdrawal restrictions continue to exist and tax authorities have direct access to bank accounts, which are additional reasons for sellers to prefer cash payments.

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[35]Private sector fruits and vegetable production and bazaar sales, mainly from household plots, reportedly increased strongly in recent years. This, however, is not fully captured in the official statistics due to inadequate primary data collection methods. At the same time, production data reported by collectives and the few remaining state-owned enterprises are likely to show an upward bias because of pressures to meet plan targets. Therefore, the data for these crops as reported in Table 10 can only be regarded as broad estimates.

[36]For example, during 1991-96 the average annual milk yield per cow dropped from more than 3,100 kg to approximately 1,700 kg on government-controlled farms.

[37]Note, however, that the private sector accounted for a large part of livestock operations even prior to independence. Reportedly, small farms owned about 75 percent of all cows prior to 1991.

[38]In 1996, for example, state-owned milk factories paid 16-18 sum/liter, while the price on the free market was 30-45 sum/liter. Meat was purchased by state-owned factories at sum 80-110 per kilogram, while private processing plants paid sum 200 or more.

C. Property Rights Reforms

51. Following independence, all state farms were transformed into collectives. In 1997, there were approximately 1,400 collectives (called *shirkat*) that cultivate about 70 percent of arable land and produce virtually all of Uzbekistan's cotton and most of the grain. In recent years, a number of collectives underwent various forms of internal reorganization, which resulted in new forms of ownership, including joint stock companies, shareholder unions, and farmers' associations. All of these entities are de jure autonomous, but de facto continue to be tightly controlled by the government, which, for example, appoints the managers, and, at least for cotton and wheat, controls inputs, production, and marketing. Workers and collective members are generally paid low wages, partly in-kind, and at times with delay, which creates incentives to misuse inputs and divert part of the harvest from collective fields for private purposes.[39]

52. All land remains under state ownership. The government has granted long-term leases (up to 50 years) to private farmers, but leasing has so far been limited to small plots and land tenureship has generally remained insecure. By end-1997, about 30 percent (1.3 million hectares) of the total cultivated land (approximately 4.1 million hectares, mostly irrigated) was leased to farmers under the following schemes:

- Some 750,000 hectares were transferred to individual families for so-called "lifetime inheritable use" (i.e., land can be passed on to heirs). Such land cannot be sold or exchanged; while it may be pledged as collateral for a loan, this remains difficult.

- Approximately 180,000 hectares were leased by collectives to about 13,000 individual members.[40]

- About 20,000 private farms (*dehkans*) were established with an average of 20 hectares. According to official information, more than 1,000 of these farms had to close down during the past two years.

53. The Land Code has been amended several times since independence, and a new draft code is currently under preparation. Private ownership of land has remained a highly controversial issue in Uzbekistan, and according to the new draft code all land will remain

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[39]In 1997, the government reportedly deployed security forces to protect the grain harvest in some areas.

[40]These "family contracts" are highly restrictive: they have to be renewed annually and include a general obligation to increase yields and enhance the quality of the land as well as more specific stipulations on the type, quantity, and quality of agricultural products cultivated on the land; the sale of, and payment for, the produce; and labor compensation.

under state ownership. The new draft land code, which has been prepared in conjunction with draft laws on cooperatives and other farms, allows various types of short- and long-term land lease arrangements.[41] According to the World Bank's assessment, however, in their current form these laws hinder private sector participation in agriculture and they will not result in any material change for collectives and others in terms of land ownership, land and water use rights, and the transferability of these rights.

D. Producer Price Policies and Marketing Arrangements

54. The production of the two major crops, cotton and wheat, has remained tightly controlled by the government with the objective of channeling resources out of agriculture and into other sectors of the economy. The principal mechanisms used for this purpose have included state order purchases, low producer prices, and (quasi-) monopsonistic marketing arrangements. Marketing arrangements were strictly enforced, including with road blocks to control interregional shipments of commodities within Uzbekistan. Agricultural exporters have been implicitly taxed through the restrictive foreign exchange system and multiple currency practices. The latter have become increasingly important since late 1996, when foreign exchange restrictions were intensified and the differential between the official and curb market exchange rates increased to more than 100 percent.

55. Although the scope of state orders for cotton and wheat has officially been reduced, the authorities have de facto maintained a system that ensures sales of most of the cotton and wheat to the government at low state order prices. In the past few years, state orders were determined as percentages of **planned** output, and farms that did not meet the often unrealistic plan targets were forced to surrender the whole crop at the state order price.[42] In the past two years, purchases at state order prices were estimated at 60-70 percent of the total harvest for both crops. For 1998, the state order system was maintained unchanged from 1997.

56. In 1996 and 1997, the government had committed itself to pay state order prices equivalent to 70-80 percent of the average world market price to domestic cotton and wheat producers under the state order system. Cotton farmers, however, received about 50 percent of the world market price, if calculated at the official/auction exchange rate, and only

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[41]Two of these laws (on farming and peasants) were adopted by parliament and published in newspapers in early June 1998.

[42]Specific production targets are set for individual producers through the local administrations (see, for example, Resolution No. 441, dated December 13, 1996 for the 1997 cotton season). Nominally, state orders were reduced during the period 1991-97 from 95 percent to 25 percent in the case of wheat, and from 100 percent to 30 percent for cotton.

45 percent on the basis of the cash/commercial bank market exchange rate (Table 14 and Figure 4). Owing to the existence of (quasi-) monopsonistic marketing organizations (*Uzkhlopkopromzbyt* for cotton and *Uzchlebprodukt* for wheat), "contractual prices" for above-plan cotton and wheat sales in the past few years also remained well below world market price levels.

57. Through the state order system, low producer prices, and marketing controls for cotton and wheat, the government effectively placed a heavy implicit tax burden on the agricultural sector. Calculated at the auction exchange rate, this tax amounted to about US$800 million per year in 1996 and 1997, equivalent to almost 7 percent of GDP.[43] [44] As shown in Table 15, an **additional** implicit tax on agriculture, and in particular on the cotton subsector, was applied through the exchange system and the overvaluation of the currency. Preventing cotton proceeds from being converted at the 10-12 percent more depreciated official cash/commercial bank market rate created an additional implicit tax of US$125 million or about 1 percent of GDP. Moreover, basing, for illustrative purposes, the calculations on a hypothetical market-clearing exchange rate of sum 100 to the U.S. dollar, the implicit additional tax amounted to US$360 million or 2.5 percent of GDP in 1997.[45]

58. An implicit tax that was not explicitly incorporated in the analysis arises from the sale of cotton by-products (seed, lint) by the cotton marketing organization. The proceeds from the sale of these products are not passed onto the producers, except for about 25 percent of the cotton seed which farmers receive from the ginneries for the planting of the next crop. The remaining value of the seed and lint is used to subsidize consumers of cotton seed oil.

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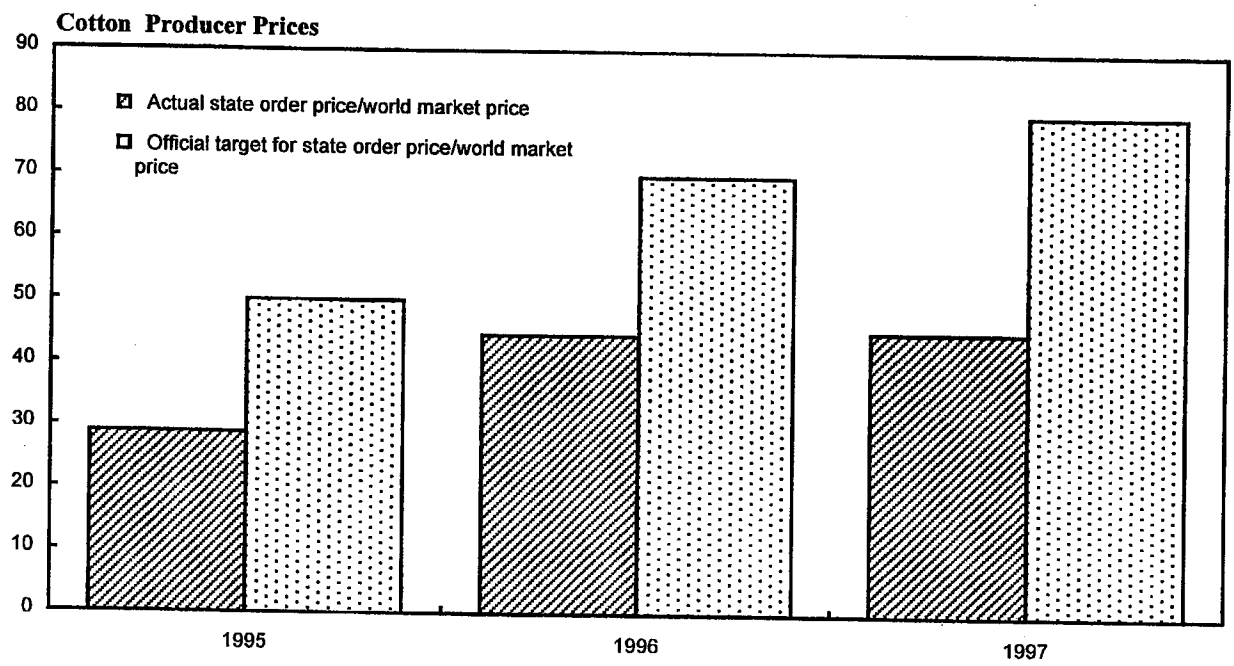
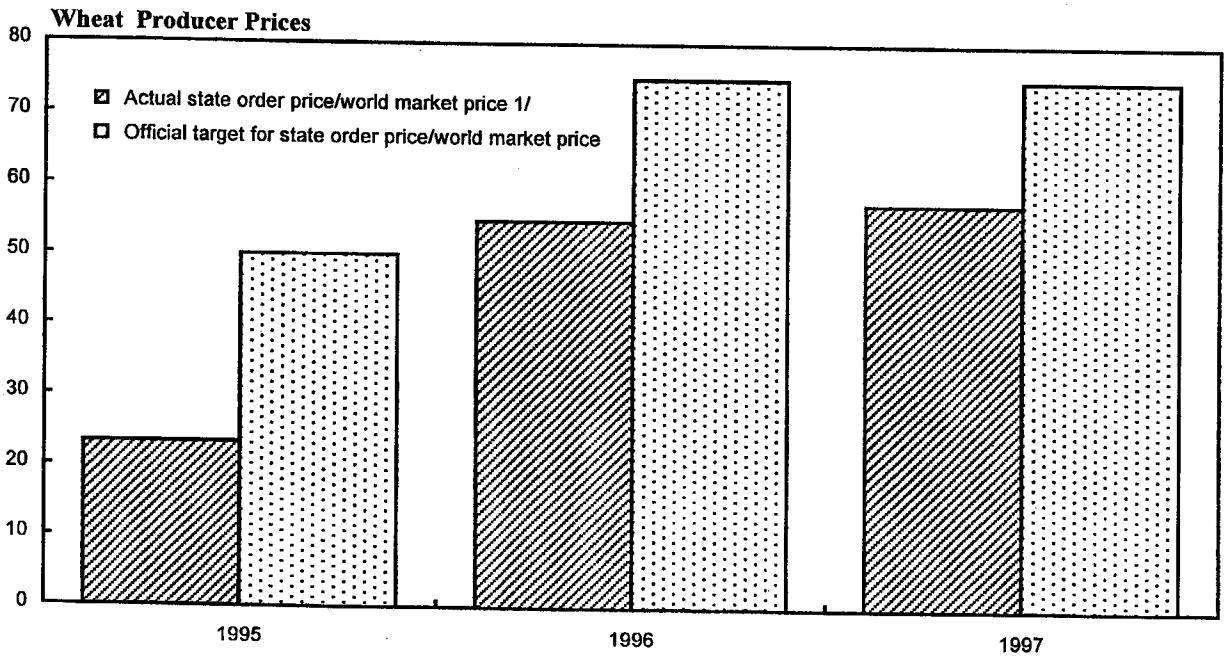
[43]Connolly and Vatnick (1994) estimated the implicit tax on the cotton sector alone at US$1 billion in 1992.

[44]To some extent the implicit tax on the cotton sector also reflects the existence of a quasi-monopoly for cotton exports, cotton export licencing, and the export tax on cotton (which was abolished effective November 1, 1997). Reportedly, there are inefficiencies in the operations of the cotton export trading companies due to the lack of competition, but it has not been possible to quantify how much of the total implicit taxation accrues because of this.

[45]The curb market rate averaged about sum 150 per U.S. dollar in 1997, while the cash/commercial bank rate averaged sum 74 to the U.S. dollar. In line with analyses undertaken by the World Bank and the Asian Development Bank, for all computations the fourth quarter average exchange rates were used as most sales of wheat and cotton occur in that quarter. GDP estimates were recomputed on the basis of average annual exchange rates (Table 15). Note that these hypothetical calculations are based on actual output data; under free prices output levels would likely be different.

Figure 4. Uzbekistan: Agricultural Producer Prices, 1995-97
(In percent)





Sources: Ministry of Macroeconomics and Statistics; and Fund staff estimates.

1/ At the official cash/commercial bank market exchange rate for the last quarter of the year.

Table 14. Uzbekistan: Cotton and Wheat Producer Prices, 1994-97

	1994	1995	1996	1997
Cotton fiber export price (in US$/ton) 1/	1,600	1,755	1,593	1,582
State order raw cotton producer price (in sum/ton)	1,260	6,900	12,260	19,503
Average non-state order raw cotton producer price (in sum/ton)	...	8,000	14,900	23,703
Cotton fiber (in sum/ton)	4,014	21,983	39,060	62,136
Cotton state order price/world market price (in percent) 2/	11	36	51	50
Cotton state order price/world market price (in percent) 3/	9	29	45	45
Cotton state order price/world market price (in percent) 4/	8	26	26	23
Official target (in percent) 5/	...	**50**	**70**	**80**
Wheat import parity price (in US$/ton)	...	265	251	235
Wheat world market price (US$/ton, USNo. 1 Hard Red Winter	150	177	207	160
Wheat world market price (in US$/ton) 6/	139	167	147	144
State order wheat producer price (in sum/ton)	460	1,690	4,440	7,140
Average non-state order wheat producer price (in sum/ton)	...	2,074	5,450	8,000
Wheat state order price/world market price (in percent) 2/	15	29	62	64
Wheat state order price/world market price (in percent) 3/	12	23	55	57
Wheat state order price/world market price (in percent) 4/	11	21	32	29
Official target (in percent) 5/	...	**50**	**75**	**75**
Memorandum items				
Average official exchange rate for the last quarter	22.7	35.0	48.3	78.1
Average cash/com. bank exchange rate for the last quarter	28.1	43.4	54.9	86.6
Average curb market exchange rate for the last quarter	29.6	48.0	95.5	172.0

Sources: Ministry of Macroeconomics and Statistics, Ministry of Agriculture and Water Resources; and Fund staff estimates and projections.

1/ F.O.B Uzbek border.

2/ At the average official exchange rate for the last quarter of the year.

3/ At the official cash/commercial bank market exchange rate for the last quarter of the year.

4/ At the average curb market exchange rate for the last quarter.

5/ Farm-gate price in percent of world market price.

6/ U.S. NO. 2 soft red winter wheat, excluding transportation costs (benchmark as used in the 1995 World Bank Rehabilitation Loan).

To some extent, the receipts from the implicit taxation of cotton producers are passed on as a subsidy to the domestic textile industry, which purchases cotton fiber at below world market prices.

59. Low domestic producer prices for wheat, in combination with price controls and subsidized wheat imports, due to the application of the overvalued official exchange rate, have been used to ensure low consumer prices for flour and bread. Urban consumers are the primary beneficiaries of this subsidy. Price controls and subsidized wheat imports provide strong disincentives for domestic farmers to increase production, while they encourage smuggling to neighboring countries where higher wheat prices are paid.

E. Subsidies

60. The implicit taxation of agriculture is to some extent offset by implicit and explicit state support which has included the subsidized or free provision of inputs (e.g., fertilizer, pesticides, fuel, water, electricity), investments financed from the budget, tax exemptions and preferences, directed credit from the central bank and commercial bank at concessional interest rates, and debt rescheduling at favorable terms or debt cancellation. Over the last two years, the government provided on average about US$700 million, or 6 percent of GDP, in support to agriculture through these mechanisms (Table 15). The implicit tax burden is thus quantitatively offset, at least in part, through subsidization. However, the subsidy mechanisms distort the incentive structure for agricultural producers even further, with detrimental effects not only for production and productivity, but also for the environment and the health of parts of the rural population.

61. On input subsidization, irrigation water was effectively provided free of charge prior to 1997, when low water tariffs were introduced. Foreign exchange for necessary imports of fertilizer and other chemicals has been provided at the official exchange rate, and these inputs have generally been provided by government monopolies at prices not reflecting economic costs. Overuse of chemical inputs and water has had a disastrous impact on the health of the rural population and the environment around the Aral Sea (Box 2). Uzbek farms reportedly use 3-4 times as much water for cotton irrigation than their counterparts in other countries, and fertilizer application rates are much higher than in countries where higher yields are achieved. Electricity tariffs have remained below their long-run cost recovery price or internationally comparable price, even if calculated at the overvalued official exchange rate. Despite the introduction of moderate water charges in 1997, the overall level of input subsidization has changed only little in the past few years.[46]

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[46]According to a World Bank estimate, input subsidies for cotton cultivation can amount to about $250 per hectare.

Table 15. Uzbekistan: Cotton and Wheat Taxation and Support, 1995-97

	1995	1996	1997	1995	1996	1997	1997
	At the official auction exchange rate Actual			At the cash/com. bank exch. rate 1/ (Hypothetical)			At a hypothetical market exchange rate 2/
Gross transfers out of agriculture							
Cotton 3/							
Gross transfer (in million sum)	31,706	20,424	36,222	46,041	29,210	48,534	67,962
Gross transfer (in percent of GDP)	10.5	3.6	3.8	10.6	3.9	3.9	4.7
Wheat 4/							
Gross transfer (in million sum)	15,399	17,010	28,153	20,064	21,059	33,690	50,258
Gross transfer (in percent of GDP)	5.1	3.0	2.9	4.6	2.8	2.7	3.5
Cotton and wheat combined							
Gross transfer (in million sum)	47,105	37,434	64,375	66,105	50,270	82,224	118,220
Gross transfer (in million US$)	1,345	774	825	1,524	916	950	1,182
Of which							
due to implicit exchange tax (in million US$)				179	141	125	357
Gross transfer (in percent of GDP)	15.6	6.7	6.7	15.2	6.7	6.6	8.2
Of which							
due to implicit exchange tax (in percent of GDP)				1.8	1.0	0.9	2.5
Support to agriculture							
Inputs (in milllion sum) 5/	9,599	19,235	27,279	10,284	20,018	28,172	29,580
VAT and profit tax exemptions (in million sum)	3,514	6,500	11,165	3,514	6,500	11,165	11,165
Interest rate and credit subsidy (in million sum) 6/	1,314	3,587	16,402	1,314	3,587	16,402	16,402
Other (in million sum) 7/	1,920	3,847	5,456	2,057	4,004	5,634	5,916
Total (in million sum)	16,346	33,169	58,299	17,168	34,109	61,373	63,063
Total (in million US$)	467	686	747	396	621	709	631
Total (in percent of GDP)	5.4	5.9	6.1	3.9	4.6	4.9	4.4
Net transfers out of agriculture							
In million sum	30,760	4,265	6,076	48,936	16,161	20,851	55,157
In million US$	878	88	78	1,128	294	241	552
In percent of GDP	10.2	0.8	0.6	11.3	2.2	1.7	3.8
Memorandum items:							
Wheat import parity price (in US$/ton)	265	251	235	265	251	235	235
Average official exchange rate for the last quarter	35.0	48.3	78.1				
Average cash/com. bank exchange rate for the last quarter				43.4	54.9	86.6	
Hypothetical market exchange rate							100
GDP (in billion sum)	302.8	560.1	962.2	434.9	748.1	1248.9	1442.7
Cotton excixe revenue (in million sum)	13,023	12,060	5,612	13,023	12,060	5,612	5,612
Cotton excise revenue (in percent of GDP)	4.3	2.2	0.6	3.0	1.6	0.4	0.4

Sources: Ministry of Macroeconomics and Statistics, Ministry of Agriculture and Water Resources; and Fund staff estimates and projections.

1/ GDP and gross transfers recomputed using the average annual official cash/commercial bank exchange rate.

2/ GDP and gross transfers recomputed using the hypothetical market exchange rate.

3/ Gross value is the difference between the actually paid producer prices and a producer price equivalent to 80 percent of the f.o.b. price. Conservatively assuming purchases at the state order price of 63 percent of the total harvest.

4/ Gross value is the difference between the actually paid producer prices and a producer price equivalent to 90 percent of the wheat import parity price. Conservatively assuming purchases at the state order price of 75 percent of the total harvest.

5/ Inputs include mainly water, electricity, and fuel, as well as chemical inputs. In 1997, excluding water charges.

6/ Includes also debt write-offs.

7/ Including capital investment outlays and machinery services, estimated at 20 percent of the value of other inputs.

62. An important quasi-fiscal subsidy arises from the provision of directed credits from the budget, central bank, and commercial banks on concessional terms. Repeatedly, agricultural arrears were dealt with through debt write-offs or concessional rescheduling, and new loans.[47] Rescheduling of arrears under negative real interest rates implied a substantial reduction in the net present value of the debt and constituted a hidden subsidy to the agricultural sector. The credit subsidy is estimated for 1997 at about sum 13 billion or 1 percent of GDP. Directed credits do not benefit all agricultural producers equally and tend to crowd out other, more profitable investment projects from the private sector. Large, inefficient collectives and state-owned enterprises were the primary beneficiaries of these credits.[48] By contrast, private farmers have often experienced problems in obtaining credits from commercial banks. This was in part because they found it difficult, or impossible, to use leased land as collateral, but also because the large state-owned banks, including the Pakhta Bank, were not prepared to service small farmers (Box 3). Large directed credits to agriculture have contributed, at times, importantly to excessive monetary expansion and balance of payments pressures, and played a major role in derailing in late 1996 the progress toward macroeconomic stability. At that time, the government lent about sum 20 billion (3.6 percent of GDP) to agriculture at an interest rate of only 10 percent, largely to clear agricultural arrears to other sectors and for the preparation of the 1997 cropping season.[49]

63. From the more narrow perspective of the budget, agriculture has been a major net drain. While providing large implicit and explicit subsidies, the budget has received in return only relative modest revenue from the cotton excise tax, which has only been applied to the nominal, and declining, state order portion of the crop. During 1997, the cotton excise tax revenue was only sum 5.6 billion, or 0.6 percent of GDP, compared to explicit expenditures on agriculture of about sum 33 billion, or 3.4 percent of GDP. A sizable loss of revenue

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[47]In late 1996, for example, agricultural arrears were partly rescheduled and partly written off and paid from the budget, including to the pension fund and the energy supplier, Uzneftegas. This exercise was repeated in early 1998 when the government decided to defer arrears of about 100 agricultural enterprises to the budget until the year 2000, and those to the pension fund and others to the year 2001. Other arrears were partly converted into an interest-free credit of the Ministry of Finance, with repayments due by the agricultural enterprises beginning in the year 2003 (Resolution of the Cabinet of Ministers "On Measures to Rehabilitate Agricultural Enterprises," February 1998).

[48]Typically, many of these loans are nonperforming. In the analysis presented here, it has been assumed that 50 percent of the net annual increase in lending to agriculture is not repaid and thus represents an unrequited transfer.

[49]At that time, the annualized central bank refinance rate was 60 percent and officially measured annual inflation was 64 percent.

results from agriculture being exempt from the VAT and from the application of preferential profit and land tax rates for agricultural collectives and enterprises.

Box 3: Agricultural Financing Through the Pakhta Bank

The Pakhta Bank is a specialized state-owned bank that finances agriculture, and specifically cotton sector operations. It was founded in 1991 as the successor of the former regional branch of the Soviet Agroprombank, and was incorporated as a joint stock company in 1995. It currently operates 186 branches plus 13 regional offices all over the country. In terms of assets, it is Uzbekistan's second largest bank (after the NBU). Although over the past couple of years it has sought to diversify its operations to become a universal commercial bank, its main activity has remained the financing of agriculture, which accounts for an estimated 80 percent of the loan portfolio.

In 1997, the Pakhta Bank and other commercial banks (e.g., NBU, Promstroibank) were required to sharply increase their lending to agriculture. As a consequence, Pakhta Bank's credits expanded by 160 percent in nominal terms; according to official information, the Pakhta Bank lent about sum 61 billion to agriculture. About 90 percent of all of Pakhta Bank's loans are government-guaranteed and these are officially classified as "good loans." By contrast, in 1994 a foreign auditing firm estimated that almost 40 percent of Pakhta Bank's loan portfolio was "substandard." In 1996, reportedly about 10 percent of the bank's total loan portfolio became delinquent due to the poor cotton harvest. The central bank repaid the Pakhta Bank for these loans, and the agricultural sector was provided with a repayment moratorium until the year 2000. In turn, Pakhta Bank was required to write off all overdue interest on these loans.

F. Conclusions

64. Macroeconomic and sectoral policies have caused severe financial stress for Uzbekistan's agriculture. On balance, massive resources have been channeled out of the sector since independence, as implicit and explicit taxation has generally outweighed the government support for agriculture. The net outflow was particularly large in 1995, when Uzbekistan benefitted from exceptionally high cotton world market prices, which were not passed onto producers. The net resource transfer declined, but remained substantial in the following two years, especially in 1997 when the implicit taxation through the exchange system is considered. Perhaps even more important, during 1996 and 1997 the incentive structure for cotton and wheat producers remained seriously distorted through producer price controls and the state-order system on the one hand, and the free or subsidized provision of inputs on the other hand.

65. Pursuing the goal of food self-sufficiency has run counter to Uzbekistan's comparative advantage. By contrast, the liberalization of the livestock subsector and the production of other crops (e.g., fruits, vegetables, tobacco) has resulted in efficiency gains and a modest favorable supply response from the private sector. Under free market conditions, the same could be expected for other crops, especially cotton. Based on a market-determined exchange rate, undistorted domestic price signals, fewer government controls, and more secure property rights, agricultural producers can be expected to chose to grow the

most profitable crop, increase productivity and use inputs more efficiently, and better preserve the land and the environment. Agricultural liberalization and privatization will reduce the financial problems within the sector and contribute to macroeconomic stabilization and sustained growth for the economy as a whole.

66. Uzbekistan's agriculture has a large growth potential that could be tapped once a different sectoral and macroeconomic policy framework is in place. In recent speeches, President Karimov announced that agricultural reforms are key to the Uzbek economy. However, he explicitly opposed private ownership of land, and instead emphasized the need to support and restructure cooperatives and joint stock enterprises in agriculture. The president said that cotton is of strategic importance to the nation and therefore it cannot be grown on private plots of land. For the time being, Uzbekistan's agriculture remains one of the most regulated among the transition countries.

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III. Quasi-Fiscal Operations through the Foreign Exchange System

A. Introduction

67. Since late 1996, the Uzbek Government has relied on a multiple exchange rate regime (MER), together with foreign exchange and trade restrictions, to promote rapid industrialization as well as other economic goals.[50] Exchange rates in official markets have been kept below market clearing levels, which in turn has required rationing and allocation of foreign exchange through administrative mechanisms. The implicit taxation of agricultural production through the exchange system and state orders (described in Chapter II) has been used to finance subsidies to industry, via preferential access to foreign exchange at favorable rates. Part of the implicit tax on agriculture has also financed a similar subsidization of imported consumer goods which were considered to be priority commodities, such as wheat and sugar.

68. Extending the analysis of Chapter II, this chapter analyzes the redistributive and quasi-fiscal effects of the present MER and marketing systems, by comparing the effects of the various official and unofficial exchange rates in place in 1997 with those of a hypothetical unified rate of 100 sums per U.S. dollar.[51] This chapter does not attempt to estimate the efficiency losses inherent in the present system, or the perhaps substantial long-term costs resulting from the negative impact of current policies on domestic and foreign investors, as well as on the financial support available from bilateral and multilateral sources. This chapter demonstrates that the current MER regime involves sizable implicit intersectoral transfers. These transfers penalize agriculture and the government while benefitting other sectors, including industry, households, and commercial banks.

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[50]This was in addition to the traditional use of directed and subsidized credit, and direct budgetary support, for priority sectors.

[51]The official (auction market) exchange rate was 67 sums per U.S. dollar on average in 1997, while the commercial bank rate averaged 74 sums and the curb market rate 140 sums per U.S. dollar. This chapter uses a hypothetical unified rate of 100 sums per U.S. dollar. This is for illustrative purposes only, to provide an idea of the magnitudes involved in the income redistribution which currently takes place through the exchange system. It should not be interpreted as a judgement by Fund staff about what would have constituted an equilibrium exchange rate for Uzbekistan.

B. Background and Summary of the Current System

69. According to the authorities, the primary rationale for the existing exchange and trade system has been to support a development strategy based on import substitution.[52] As described in Chapter I, the objective has been to build an industrial base in Uzbekistan over the next few years, in order to move away from the specialization imposed during the Soviet period when production was focused on cotton and gold. Under the MER system, foreign exchange resources have been allocated at preferential rates for the importation of capital goods, spare parts, and raw materials for the oil and gas, mining, manufacturing, and infrastructure sectors, in part to encourage foreign investment in these sectors. These activities are considered of strategic interest. A second reason for the MER system has been the government's desire to contain the cost of servicing foreign debt and paying for government imports, which have been minimized by the provision of foreign exchange for these purposes at the official exchange rate.

70. With an overly appreciated exchange rate, and a loose credit policy,[53] there has been strong pressure on the level of international reserves. To help maintain the level of international reserves, without a major tightening of credit policies or exchange rate correction, foreign exchange has been strictly rationed and trade controlled. Imports of consumer goods in particular have been compressed by an advance import contract registration requirement, restrictive licensing practices, controls on the allocation of foreign exchange, and import tariffs and quotas. At the same time, domestic manufacturing industries have been supported by the preferential allocation of foreign exchange as well as tax and customs exemptions.

71. The authorities have also been concerned that a substantial correction of the exchange rate would reignite inflation and contribute to social instability. By permitting only a gradual depreciation of the currency in official markets, the authorities have aimed to keep inflation down and preserve real wage levels. The application of the preferential exchange rate for imports of selected food items has been designed to help preserve social stability in the face of tight restrictions on imports of many consumer goods, and the heavy implicit taxation of the rural community.

72. Foreign exchange transactions take place in a number of segmented markets as discussed in detail in Chapter IV. The auction and commercial bank markets are the largest legal markets. Box 4 summarizes the main foreign exchange flows through these markets. In

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[52]On the characterization of the strategy as import substitution, see footnote 15 of Chapter I.

[53]Credit to industry was also designed to support rapid industrialization, while credit to agriculture was necessitated by the heavy implicit taxes imposed on that sector, which led to payments difficulties.

addition to the auction and commercial bank markets, there are other ways for importers to access foreign exchange in Uzbekistan. Since early 1998, an enterprise is allowed to use its foreign exchange earnings (after the 30 percent surrender requirement) to pay for imports or other obligations abroad. In addition, an illegal curb exchange market operates in both cash and noncash. The latter is used to make payments abroad through the transfer of sum-denominated domestic bank balances, in exchange for a corresponding transfer of hard currency assets held abroad. Transactions in the curb market are typically those needed to satisfy imports not covered by licenses, as well as other unauthorized transactions and capital flight.

Box 4. Sources and Uses of Foreign Exchange

Sources

Auction market:

- mandatory 100 percent surrender on exports of cotton, gold, and other centralized exports (official rate);
- net sales of official reserves of the CBU to commercial banks (official rate).

Commercial bank market:

- mandatory 30 percent surrender of noncentralized exports (official rate);[1]
- voluntary sales of up to 70 percent of noncentralized exports (up to 112 percent of the official rate);[2]
- sales by commercial banks of reserves bought at the auction from the CBU for selected transactions (auction rate).

Access to foreign exchange

Auction market:

- Eligible imports of capital goods, raw materials, and grains;
- Government purchases and external debt service;
- Imports of certain high priority consumer goods.

Commercial bank market:

- Imports of high priority consumer goods (112 percent of the official/auction rate).[3]

1/ Commercial bank rate since July 1998.

2/ There are no restrictions on the rate at which banks can buy foreign exchange. The selling rate, however, was limited to 112 percent of the official rate through June 1998. For simplicity, and given that during the relevant period the official and the auction exchange rates were very close to one another, this chapter refers to the official rate as the basic exchange rate, although for some transactions the auction rate was used.

3/ As of July 1, 1998, this 12 percent limit has been formally removed.

Main Distortionary and Distributional Effects

73. Figure 5 and Table 16 provide detailed breakdowns of the gains and losses to various sectors of the economy resulting from the existing MER and marketing systems. In estimating these gains and losses, the volume of foreign exchange transactions estimated for 1997 were recomputed using the hypothetical unified exchange rate and the result compared with actual transactions. The calculations assume that, together with the unification of the exchange rate, state orders and the ex-ante registration of import contracts are eliminated. While the figures presented are only estimates, they reveal the complicated system of implicit and explicit taxes and transfers (Box 5), and show who the net gainers and losers are from the current system.

Box 5. Multiple Exchange Rates

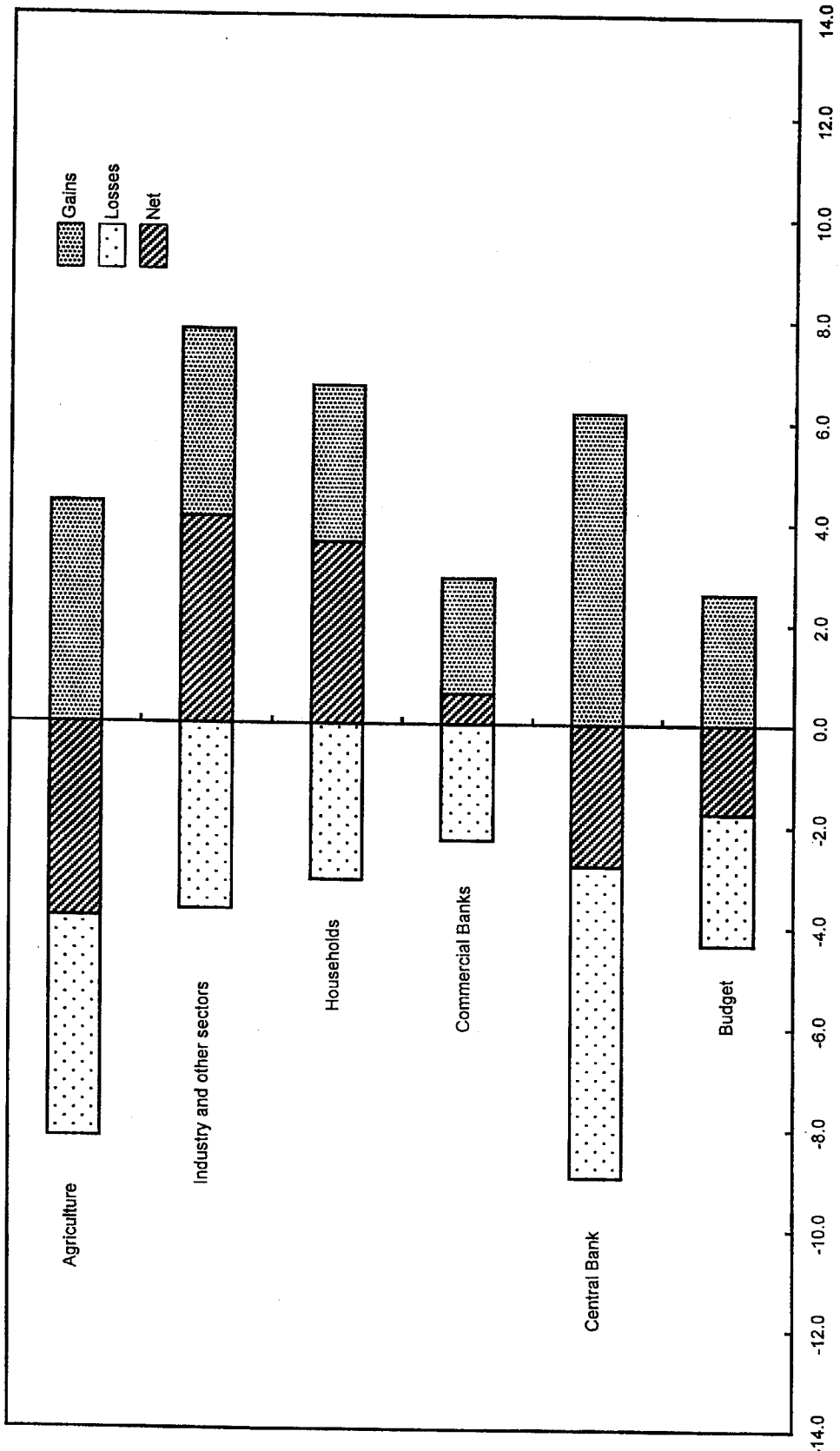
A system of MERs is tantamount to an array of taxes and subsidies. Economists have examined the occurrence of multiple exchange rates both theoretically and empirically for a number of countries, and have determined that MERs bring about economic distortions leading to inefficient patterns of production and consumption. These are in turn reflected in losses for sectors of the economy, the government, and the central bank.[1] Although MERs may help countries to achieve certain policy objectives over the short term, they invariably introduce new problems. In most cases, MERs are introduced as a response to external payments difficulties. Also, they are often introduced to counter the adverse impact on external current account transactions and the fiscal budget of an overvalued currency.

Once MERs are introduced, they need to be supported by a complex system of controls over international transactions, including requirements for the surrender of foreign exchange. The foreign exchange market becomes segmented and the economy loses flexibility, with the price system unable to signal relative scarcity and transmit incentives for efficient production. Because of the ad hoc nature of MERs, these systems require frequent adjustments, which in turn introduce further instability and complicate long-term planning by economic agents. A system of MERs makes exporters uncertain of the degree of protection they can count on; as a result, they become reluctant to invest.

[1]See, for example, Nita Ghei et al., "Parallel exchange rates in developing countries: Lessons from eight case studies" in Miguel A. Kiguel et al., *Parallel Exchange Rates in Developing Countries* (London and New York: MacMillan and St. Martin's, 1997).

74. The biggest loser is agriculture (almost 6 percent of GDP), where the combined effect of low producer prices and an unfavorable exchange rate for cotton and wheat have swamped the tax breaks and subsidies the sector receives. Other big losers have been the central bank (4 percent of GDP, due to subsidized credit and net sales of official reserves at an overvalued exchange rate), the budget (2½ percent of GDP, primarily due to agricultural subsidies and tax exemptions), and exporters (3 percent of GDP). The big gainers have been non-exporting—particularly import-competing—industries (9 percent of GDP, primarily from imports of capital and intermediate goods, and sales of foreign exchange earnings) and households (5½ percent of GDP, primarily through inexpensive wheat and other priority goods).

Figure 5. Uzbekistan: Gains and Losses from Multiple Exchange Rates
(In percent of GDP)



Sources: Table 16.

Effect on Agriculture and Other Exporting Sectors

75. The government's ability to transfer resources from agriculture to the industrial sector has depended on two factors: first, control of the crop production and marketing processes, especially for cotton and wheat; and second, control of the foreign exchange and trade systems. The taxation of the agricultural sector has created disincentives for producers that have been reflected in declining yields and poor crop quality. In addition, the distortions of relative prices as a result of the web of implicit taxes and subsidies have led to substantial inefficiencies in agricultural production.

76. Exports of traditional raw materials are basically undertaken by the state directly, or by state-owned trading enterprises.[54] All export receipts on these items have been subject to a surrender requirement of 100 percent at the official exchange rate. Primary producers have ultimately incurred the losses due to the unfavorable exchange rate and the state procurement system.

77. Exporters of nontraditional goods have suffered losses due to the 30 percent surrender requirement for export earnings at the official exchange rate.[55] The surrender requirement has not only made exports less profitable and competitive, but it has also encouraged capital flight through under-invoicing of exports and illegal cross-border trade. In addition, exporters have incurred losses on voluntary legal sales of foreign exchange at the commercial banks' exchange rate. To avoid these losses, exporters have been inclined to use their export proceeds to import virtually anything.

Effect on Investors and Other Importers

78. The overvaluation of the currency in the auction and commercial bank markets has created excess demand for foreign exchange, necessitating rationing. Industrial enterprises that import capital goods, raw materials, and assembly parts, together with external debt service associated with investment projects and government programs, have had access to foreign exchange directly from the auction at the official exchange rate, and have thereby received a large implicit subsidy, at the expense of administrative hurdles and delays.

79. Other eligible importers have obtained foreign exchange at the more depreciated commercial bank exchange rate. They have also enjoyed a subsidy, albeit a smaller one. Access to foreign currency from these official sources has been constrained by limits administratively determined by the Republican Monetary Commission.

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[54]Traditional raw materials are cotton, gold and other precious metals, ferrous metals, petroleum, and gas.

[55]Surrender is made at the commercial bank rate since July 1998.

80. Importers have had a strong incentive to resort to over invoicing in order to secure as much foreign exchange as possible at the auction or commercial bank exchange rates. Importers of goods not eligible for foreign exchange from official sources have been forced to resort to the curb markets. In these markets, they have paid a substantial premium, compared not only with the auction and commercial bank rates but also relative to the market clearing rate that would emerge in the absence of restrictions. Operating in illegal markets results in risks and costs and these have been passed on in terms of higher prices.

81. Additional costs that cannot be easily quantified arise from bureaucratic hurdles that importers have faced. One of the most important hurdles is the ex-ante registration of import contracts with the Ministry of Foreign Economic Relations (MFER). The MFER approves each contract individually, after determining whether the import is viewed as necessary by the government and whether price matches quality. Although the process should take no more than ten days, longer delays have often been reported, and the outcome of the review has been unpredictable. The registration has also created scope for rent seeking, which in turn may have increased import costs. Importers could avoid ex-ante registration by resorting to preshipment inspection, for a fee. In addition, substantial delays in customs processing have been reported, which resulted in additional storage costs, theft, and deterioration of perishable goods which have not been given priority for clearance. Importers have also incurred considerable costs in terms of time and resources in securing foreign exchange and import licenses.

82. The authorities' declared intention is to promote investments. However, investors have been affected by the obstacles described above in the process of obtaining foreign exchange and licenses for their imports and the resulting uncertainties. As a result, at times they have experienced difficulties in acquiring necessary inputs for production and in the repatriation of profits. There have also been restrictions on using funds deposited in local banks, both in domestic and hard currencies.

83. However, those investors that have been able to secure foreign exchange through official channels have benefitted from the favorable official exchange rate at which they repatriated profits and paid for capital goods and raw materials. Certain categories of investors have enjoyed tax benefits and trade-related exemptions (Chapter IV, Box 12). The current system, therefore, distorts the relative input, output, and transfer prices and consequently affects investment decisions. Some ongoing investment projects may not be viable and may not have been undertaken in the absence of these subsidies. Other investments may have been discouraged by the rent seeking, administrative complexities, and uncertainties under the current system. Also, large firms appear to have received preferential treatment at the expense of small businesses.

Effect on Households

84. Consumer goods imported at either the official or commercial bank rates have received substantial implicit subsidies, which may or may not have been passed onto consumers. To the extent that the savings were passed onto consumers, the overvalued sum has reduced the level of prices of selected goods, while the relatively slow adjustment of the two legal rates has reduced the rate of increase of those prices. The implicit subsidization has resulted in excess demand for officially imported consumer goods and their subsequent administrative rationing. Consumers have therefore been limited in their choice and have incurred costs such as queuing or searching for stores where goods are available. This situation has been exacerbated by the fact the present system makes it highly profitable to reexport these subsidized goods to neighboring countries. The authorities have imposed restrictions on reexports, tightened border controls, and sought to prohibit the resale of the basic goods imported by the state in the free market. For example, since mid-1997, wheat and sugar cannot be sold outside state shops.

85. Many consumer goods have been imported with foreign exchange secured through the curb market. The black market has been used for imports for which foreign exchange cannot be purchased on the official markets, as well as to satisfy foreign exchange needs for travel—beyond the small amounts converted through the banking system—and other invisible transactions.[56] Since the curb market rate commanded a premium of more than 100 percent during the period, this has entailed a significant implicit taxation of the corresponding transactions.

86. Whether individual consumers have gained or lost on a net basis depends on the weight of implicitly subsidized imported goods in their individual consumption baskets. However, abstracting from consumer choice and rationing issues, households, as a group, have been net beneficiaries of the present system.

Effect on Commercial Banks

87. Commercial banks have been among the beneficiaries of the system of multiple currency practices, as they have received high margins on foreign exchange transactions. These margins arise because, through June 1998, commercial banks could purchase foreign exchange at the official exchange rate and resell it at the commercial bank rate, a markup of 12 percent. More than two-thirds of the foreign exchange transactions of commercial banks are carried out by the National Bank of Uzbekistan, which is a state-owned bank.

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[56] Due to lack of information, it is difficult to estimate the size of the curb market.

Effect on the Government Sector: Quasi-Fiscal Operations of the Central Bank and the Fiscal Budget

88. In principle, the central bank should not have suffered losses or derived gains from the MERs, as (until July 1, 1998) it transacted only at the official/auction rate. However, during the period under analysis, central bank sales far exceeded purchases of foreign exchange from cotton and other centralized exports.[57] Central bank "losses" have resulted from the net sales of international reserves below a market-clearing exchange rate. The central bank has also lost through the provision of credit to agriculture and industry at subsidized interest rates.

89. In addition to the quasi-fiscal effects discussed earlier, the system of MERs has had a direct effect on both fiscal revenue and expenditure. The present system entails sizable revenue losses for the budget. As the cotton sector is already heavily taxed through an unfavorable exchange rate and the state-order system, this has precluded the levying of general taxes on its activity. An additional revenue of 11 billion sums (equivalent to 1.1 percent of GDP) could have been raised in 1997 if the VAT and profits tax had applied to agriculture. This would have more than compensated for the elimination of the present excise tax on cotton delivered under state orders, from which a revenue of about half that amount was collected in 1997. An important source of revenue loss for the budget under the present system has derived from the application of an overvalued exchange rate on nonbudgetary imports entering the tax bases. Revenues foregone on this account have stemmed mainly from the VAT, excises, and customs duties on imported tobacco and alcoholic beverages. Under the present system, VAT revenue has also been pressed by the valuation of "priority imports" by nonagricultural sectors at the official exchange rate.[58]

90. A number of budgetary expenditure items have been subsidized through MERs. Although interest payments abroad have represented a small proportion of total expenditure, the present system has resulted in some net savings for the budget. More important, the budget has saved on imports of investment goods for budget-financed projects, as well as on budgetary imports of foodstuffs and other consumer goods and services.[59] These savings, however, have been more than offset by public spending for the provision of equipment and

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[57]The central bank also acquires all locally produced gold against payment at gold's world price, converted at the official exchange rate.

[58]In addition, there would have been a second-order, lagged effect on goods which are partly produced domestically using imported materials and equipment.

[59]These imports include the cost of running embassies, payments of fees to international organizations, the import component of military expenditures, and imports of medicines and materials for the public health care system.

inputs for free or at subsidized prices to agriculture. These subsidies have been made necessary by the squeeze on agriculture caused by the exchange and marketing regimes. Budgetary savings would have resulted from the application of cost-recovery prices on inputs in conjunction with producer prices based on a market-clearing unified exchange rate.

91. To the extent that the households have benefitted from savings on the import of wheat and other basic foodstuffs at preferential exchange rates, exchange rate unification would have implied an increase in the relative price of the subsistence basket. This in turn would have required an extension of the social safety net to shield, through targeted budgetary transfers, the most needy from the adverse effect of higher food prices. Taking account of this additional expenditure, estimated at 8 billion sums in 1997, the combined net effect on the fiscal deficit from eliminating the MERs and trade restrictions still suggests the possibility of a very substantial "fiscal dividend" from a move to a unified, market-determined exchange rate in Uzbekistan.[60]

C. Concluding Remarks

92. Under the present MER system, agriculture and the budget have provided significant net transfers to industry, households, and commercial banks. As the central bank sold, in 1997, a substantial part of its exchange reserves at an exchange rate that underpriced foreign exchange, the central bank has also provided significant transfers to other sectors.

93. Although the present exchange and marketing systems have adverse effects on efficiency and economic growth, and thus the economy as a whole, some groups—those who have access to foreign exchange at favorable rates—have benefitted from the current regime. It is possible that, over time, some of the beneficiaries of the current system would gain by supporting reforms—including exchange rate unification—that would promote faster growth; they may benefit from accepting a smaller "slice" of a more rapidly expanding "pie." However, these groups may not support reforms if they do not perceive the advantages that reforms may bring for them. In addition, it is likely that those individuals who have benefitted most from the current system would lose from a movement to a more liberal system.

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[60]This finding for Uzbekistan is consistent with research results for several countries (e.g., Ghana, Mexico) where existing multiple exchange practices have been shown to generate fiscal losses. See Miguel Kiguel and Stephen O'Connell, "Parallel Exchange Rates in Developing Countries," *The World Bank Research Observer*, 10:1, February 1995.

Table 16. Uzbekistan: Gains and Losses from Current Multiple Exchange Rate Practices and Marketing System 1/

(In billions of sums; gain +, loss -)

	Agriculture	Industry and other sectors 2/	Households	Commercial Banks	Central Bank	Budget 3/
Exports of, and state orders on, cotton	-68.0	16.4			46.0	5.6
Exports of other centralized (energy)		-18.0			18.0	
Noncentralized exports		-10.0		10.0		
State orders on wheat	-50.3	10.1	40.2			
Gold purchases from producers		-25.0			25.0	
Imports of foodstuffs and consumer goods			37.2	-33.1	-14.7	10.6
Imports of capital and intermediate goods	5.9	36.4			-53.0	10.7
Purchases of forex by banks from auction				31.8	-31.8	
Payment of interest and other income abroad					-2.6	2.6
Subsidized equipment and inputs	29.6					-29.6
Curb exchange market operations		12.2	-12.2			
Domestic consumer goods priced at curb exchange rate		24.3	-24.3			
Effect on tax revenue 4/		2.3	19.6			-21.9
Subsidized interest on credit	16.4	10.9			-27.3	
VAT and profits tax exemption of agriculture	11.2					-11.2
Forgone social safety net expenditure			-8.0			8.0
Total	-55.2	59.6	52.5	8.7	-40.4	-25.2
In percent of GDP	-3.8	4.1	3.6	0.6	-2.8	-1.7

Source: Fund staff estimates on the basis of data provided by the authorities and independent sources.

1/ Based on 1997 data and comparison of average exchange rates with a hypothetical unified exchange rate of sum 100 per U.S. dollar.
2/ Includes industry, mining, trade, and nonfinancial services.
3/ Includes central and local governments and extrabudgetary funds, but not state-owned enterprises.
4/ On existing VAT, excises, import tariffs, and profits tax.

IV. Recent Economic Developments

A. Economic Activity, Prices, Wages, and Employment

Economic Activity

94. Uzbekistan experienced a smaller **cumulative output decline** since gaining independence in 1992 than most other transition countries. The research presented in Chapter I above suggests that it may have benefitted substantially from favorable initial conditions. These included a relatively low degree of overindustrialization and integration in the industrial complex of the Soviet Union, a large share of agriculture, and the dominance of cotton and other products (e.g., gold) that could be easily exported to western markets for hard currency following the breakdown of the Soviet Union and the subsequent payments crisis. Uzbekistan was also able to exploit its comparatively rich energy base (e.g., oil, gas).[61] Structural reforms started relatively late and remained slow, as the government sought to preserve many of the old production structures and institutions. Initially, this may have helped to keep up recorded output levels, although the cost of this policy in terms of consumer choice, environment, and future growth may have been considerable. The authorities also pursued a policy of protecting and subsidizing infant industries in consumer goods industries, including in some technologically more advanced subsectors (e.g., cars). As a consequence also of accommodating credit policies, output (as officially measured) held up relatively well in agriculture and many industrial sectors during the first 4-5 years of the transition.[62] In 1994 and 1995, Uzbekistan had benefitted from two relatively good cotton harvests and favorable world market prices for cotton and other exports.

95. In late 1995, the output decline was arrested and **the economy grew modestly** in 1996 and 1997 (Table 7 and Figure 6). In line with the experience of other transition economies, the resumption of growth in 1996 was led by a strong performance of domestic trade, which more than offset a decline in agriculture on account of a poor cotton harvest. As macroeconomic stabilization proceeded, domestic trade and services benefitted from external liberalization and the increased availability of imported consumer goods. Foreign direct investment inflows began to pick up and the business environment improved, especially for many privatized and new small- and medium-enterprises.

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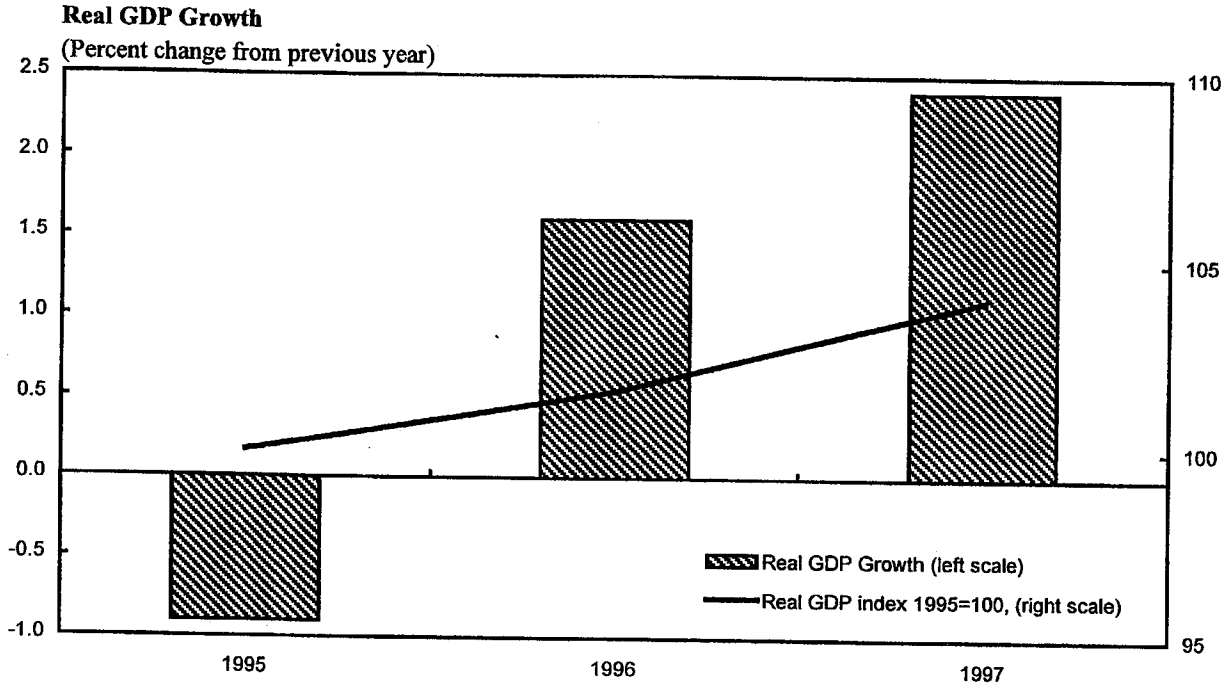
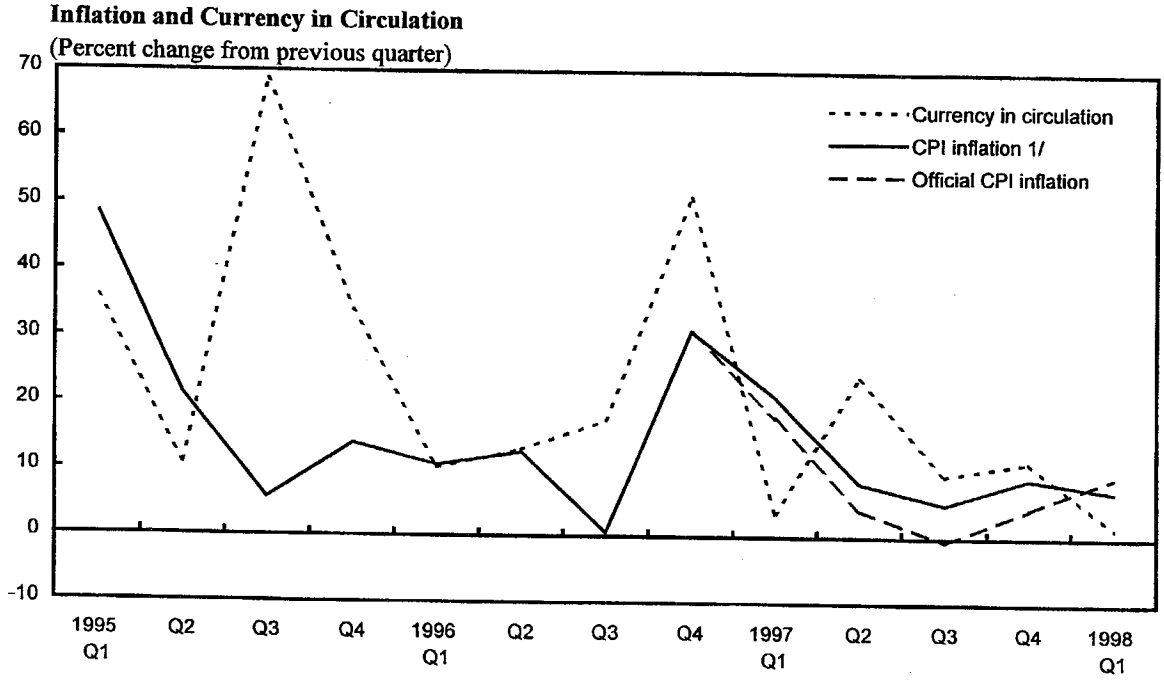
[61]For a detailed analysis of the determinants of output performance during the transition see Chapter I.

[62]For a detailed discussion of agricultural developments see Chapter II.

Figure 6. Uzbekistan: Real GDP Growth, Inflation, and Currency in Circulation, 1995-97





Sources: Fund staff estimates.

1/ As estimated by Fund staff.

Table 17. Uzbekistan: Consumer Price and Producer Price Inflation, 1993-98

(In percent)

	1993	1994	1995	1996	1997	1998 Q1
Consumer price inflation						
During the period	885	1,281	117	64	50	7
Annual average 1/	534	1,568	305	54	72	61
Producer price inflation						
During the period	1,919	1,422	215	72	40	4
Annual average 1/	2,545	1,428	499	107	52	43

Sources: Ministry of Macroeconomics and Statistics; and Fund staff estimates.

1/ Figures for Q1 1998 reflect period average inflation for the 12 months ending March 1998.

96. The nascent recovery, however, was dampened in late 1996, with a return to high inflation rates and intensified foreign exchange and trade restrictions. According to Fund staff estimates, **real GDP growth in 1997 remained modest** (2-2.5 percent), and was primarily the result of a rebound in agriculture because of better weather, while the compression of consumer goods imports stifled domestic trade. Many private small- and medium-sized enterprises increasingly experienced problems in obtaining foreign exchange and not only for consumer goods. Economic growth was also limited by persisting structural problems, including the lack of large-scale privatization and agricultural liberalization, and the dysfunctional banking system.

Inflation

97. After declining from high levels in 1995 and the first nine months of 1996, inflation accelerated sharply in the last quarter of 1996 when the banking system financed a large budget deficit and the clearance of interenterprise arrears (Table 17). In 1997, inflation may have been somewhat lower than the 64 percent recorded in 1996, although probably not to the extent shown in the official Consumer Price Index (CPI). Various indicators suggest that actual consumer price inflation in 1997 was at least 50 percent (Box 6). Officially measured consumer price inflation in the first quarter of 1998 amounted to about 7 percent as the rate of monetary expansion slowed and pension and public sector wage increases of 50-60 percent were deferred to July 1, 1998.

98. The CPI estimates do not capture the degree to which **inflation was repressed** by informal and formal price controls and limited through subsidies, including through the exchange system. In mid-1997, the sale of some major consumer items (e.g., flour, sugar) was restricted to specially licensed shops.[63] Prices of these and other items (e.g., bread) have remained remarkably stable (Tables 18 and 19). Some of these items have not always been available at the licensed shops, causing high search costs, queuing, and forced substitution.

99. As regards the PPI, there are also reasons to believe that it also understates inflation. Albeit improved, the new PPI continues to be based on accounting rather than on transaction prices.

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[63]Decree of the Cabinet of Ministers of the Republic of Uzbekistan No. 373, July 29, 1997, cites as the reason for the introduction of this measure the objective of ensuring better hygienic conditions for the sale of these food items, which also included vegetable and animal oil, powdered milk, and baby foods.

Table 18. Uzbekistan: Producer Prices, 1997-98 1/

(Monthly percentage changes)

	Weights	1997												1998		
		Jan.	Feb.	Mar.	Apr	May.	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
Producer Price Index (PPI)	1.00000	5.1	3.6	2.6	2.2	1.1	1.6	4.8	2.7	4.8	3.5	1.9	0.6	2.2	1.5	0.6
Fuel and power	0.28144	--	-0.4	--	-0.1	--	--	--	0.2	--	--	--	--	-1.1	--	--
Of which																
Electric power	0.14578	--	-0.7	--	--	--	--	--	0.5	--	--	--	--	-1.8	--	--
Oil extraction	0.00519	--	--	--	--	-0.9	--	--	--	--	--	--	--	-1.6	--	--
Oil refining	0.05946	--	--	--	--	--	--	--	--	--	--	--	--	-1.0	--	--
Gas industry	0.06336	--	--	--	--	--	--	--	--	--	--	--	--	--	--	--
Coal industry	0.00765	--	--	--	-0.8	--	--	--	--	--	--	--	--	-1.9	--	--
Ferrous and nonferrous metallurgy	0.11307	3.1	1.2	1.4	0.2	0.7	0.4	3.0	0.8	1.3	-1.4	--	--	-3.0	0.2	3.6
Chemical and petrochemical industry	0.05655	3.6	2.1	2.8	0.2	1.9	1.6	1.6	0.2	1.0	0.7	4.2	1.4	0.9	3.9	2.3
Machine building and metalworking	0.08107	7.6	6.4	2.9	0.7	0.6	0.3	1.3	0.7	0.7	2.7	1.4	--	8.5	1.6	0.4
Timber, woodworking and pulp industry	0.00896	2.5	11.3	1.7	3.4	1.9	2.5	13.2	7.2	0.3	1.0	0.8	0.6	2.2	4.2	3.4
Construction materials	0.05047	7.1	7.6	0.7	1.7	4.9	3.6	1.9	3.1	0.4	2.2	6.6	1.7	2.2	6.6	1.3
Light industry	0.19567	8.6	2.2	5.5	1.7	0.8	0.9	5.6	6.7	13.5	8.5	1.9	0.5	4.4	2.6	0.5
Food industry	0.08130	6.3	9.8	2.8	9.8	2.7	6.4	7.6	1.8	5.1	3.1	2.2	2.1	3.5	0.5	-0.8
Flour and cereals	0.06061	2.1	0.6	-0.3	1.7	--	--	23.3	--	0.2	--	4.4	--	-0.2	1.6	--
Fodder	0.00151	--	8.5	--	--	--	4.2	36.2	--	5.1	--	0.9	4.3	--	-0.2	--

Source: Ministry of Macroeconomics and Statistics.

1/ Prices are recorded on an accounting basis, thus not reflecting actual transaction prices.

Table 19. Uzbekistan: GDP and Sectoral Deflators, 1992-98

(In percent over previous year or same quarter of previous year)

	1993	1994	1995	1996	1997	1998 Q1
Total	1,075	1,229	371	82	68	36
Agriculture	791	1,528	273	58	99	70
Industry	907	936	397	90	54	21
Transport and communication	1,357	1,438	516	72	55	43
Construction	1,081	1,219	374	115	67	27
Trade	1,191	1,613	249	108	78	35
Other services 1/	1,081	1,078	409	91	63	18
Indirect taxes minus subsidies	...	1,039	648	78	44	80

Sources: State Committee for Forecasting and Statistics; and IMF staff estimates.

Box 6: Measuring Inflation in Uzbekistan

Since 1993, the Uzbek statistical authorities have made significant progress in developing and improving consumer and producer price indices.

Uzbekistan began to improve the measurement of inflation in 1993. The Soviet-style retail price index (RPI) was replaced by a Laspeyres-based consumer price index (CPI) in line with international standards and analogous to the switch undertaken in other transition economies (Koen 1995). Official CPI data have been made available to the Fund starting January 1995, although the authorities have not yet begun to regularly publish inflation data. Since 1995, the authorities have improved the compilation of the CPI, for example, by revising weights annually. In 1997, a new, Laspeyres-based producer price index (PPI) replaced the old wholesale price index, which was based on the Sauerbeck formula. The latter can produce a large upward drift in inflation, and in the case of Uzbekistan this may explain the sharp divergence between consumer and producer price inflation prior to 1997 (Table 17).[1]

Notwithstanding earlier methodological improvements, in 1997 official CPI data became less reliable, owing to both methodological and other problems. On methodology, the official CPI systematically and seriously underestimated actual consumer price inflation because of a lack of imputing prices of goods that are temporarily unavailable (including, but not limited to, seasonal items such as fruits and vegetables). In the case of seasonal goods, imputation is necessary to ensure that peak new-season prices are included in the index. While peak new-season prices were excluded, their subsequent decline was included.

The statistics authorities have acknowledged the existence of this methodological deficiency, and indicated that they will correct it. They have not, however, recomputed the CPI for 1997.

[1]On the problems in the use of the Sauerbeck formula, see De Masi and Koen (1995) and Lequiller and Zieschang (1994). For other reasons that could potentially cause divergence in consumer and producer price inflation, see Koen and Phillips (1993).

100. Prices of crude oil, natural gas and electricity remained controlled at below-cost recovery levels and were only partially adjusted during 1997 and the first quarter of 1998 (Tables 20, 21 and 22).[64] The important wholesale price of crude oil has not been adjusted since December 1996 and has fallen to less than 50 percent of the world market price, if calculated on the official exchange rate (Figure 7). Based on recommendations from the Antimonopoly Committee (AMC), the Ministry of Finance has continued to control prices of about 3,600 products of more than 800 enterprises at the national and regional level,

[64]The gasoline retail price (low quality A-76 and AI-76) was raised in July and a new retail price for domestically produced high-quality gasoline (A-92 and AI-96) was introduced in November 1997. Household electricity and gas tariffs were raised by 25 percent and 200 percent, respectively in August 1997. Effective February 1, 1998 telecommunications tariffs were raised. In the first half of 1998, gasoline prices were increased an additional 25-30 percent. In Tashkent, hot water and heating charges were doubled, cold water and sewer charges were more than doubled, and transport charges were increased 50 percent. (The staff does not have the data on changes in other regions.)

Table 20. Uzbekistan: Electricity Consumption and Real GDP Growth, 1991-97

	1991	1992	1993	1994	1995	1996	1997
Electricity consumption							
Consumption (in billion KwH)	54.1	50.9	48.9	46.4	46.2	46.5	47.0
Index (1991=100)	100	94	90	86	85	86	87
Growth (in percent)	...	-5.9	-4.0	-5.0	-0.5	0.8	1.0
Cumulative percentage change since 1991	...	-5.9	-9.7	-14.2	-14.7	-14.0	-13.2
Real GDP							
Index (1991=100)	100	89	87	83	83	84	86
Growth (in percent)	...	-11.0	-2.3	-4.2	-0.9	1.6	2.4
Cumulative percentage change since 1991	...	-11.0	-13.1	-16.7	-17.5	-16.2	-14.2

Sources: Ministry of Macroeconomics and Statistics; and Fund staff estimates.

Table 21. Uzbekistan: Selected Energy Prices, 1995-98 1/

(In sum per unit)

	Unit	1995				1996				1997				1998
		Jan. 1	Apr. 1	Jul. 1	Oct. 1	Jan. 1	Apr. 1	Jul. 1	Oct. 1	Jan. 1	Apr. 1	Jul. 1	Oct. 1	Apr. 1
Electricity														
Wholesale	Kilowatt hours	0.16	0.27	1.08	1.34	1.34	1.66	1.66	1.66	1.66	1.66	1.66	1.66	1.66
Retail	Kilowatt hours	0.10	0.10	0.30	0.70	0.70	1.25	1.60	1.60	1.60	1.60	1.60	2.00	2.00
Coal														
Wholesale	Ton	413	413	1,006	1,006	1,006	1,385	1,385	1,385	1,600	1,600	1,600	1,600	1,600
Crude oil														
Wholesale	Ton	260	260	1,428	1,900	1,900	3,700	3,700	3,700	5,100	5,100	5,100	5,100	5,100
Natural gas														
Wholesale	1000 cubic meters	125	125	565	1,130	1,130	2,220	2,220	2,220	2,600	2,600	2,600	2,600	2,600
Retail	1000 cubic meters	15	15	30	75	75	225	225	225	450	450	450	1,350	1,350
Petroleum products														
Gasoline (A-76), wholesale	Ton	10,400	10,400	11,700	15,600	15,600	19,500	19,500	19,500	23,400	23,400	26,000	26,000	32,500
Diesel fuel	Ton	7,006	7,006	9,120	11,065	11,065	15,985	15,985	15,985	16,563	16,563	16,563	16,563	16,563
Heavy oil (Mazut)	Ton	1,079	1,079	1,370	1,370	1,812	2,960	2,960	2,960	3,100	3,100	3,100	3,100	3,100
Gasoline														
Retail	Liter	8	8	10	12	12	15	15	15	18	18	20	20	25

Sources: Ministry of Finance; and Fund staff estimates.

1/ Prices include VAT and excise taxes, if applicable.

Table 22. Uzbekistan: Energy Prices, 1996-98

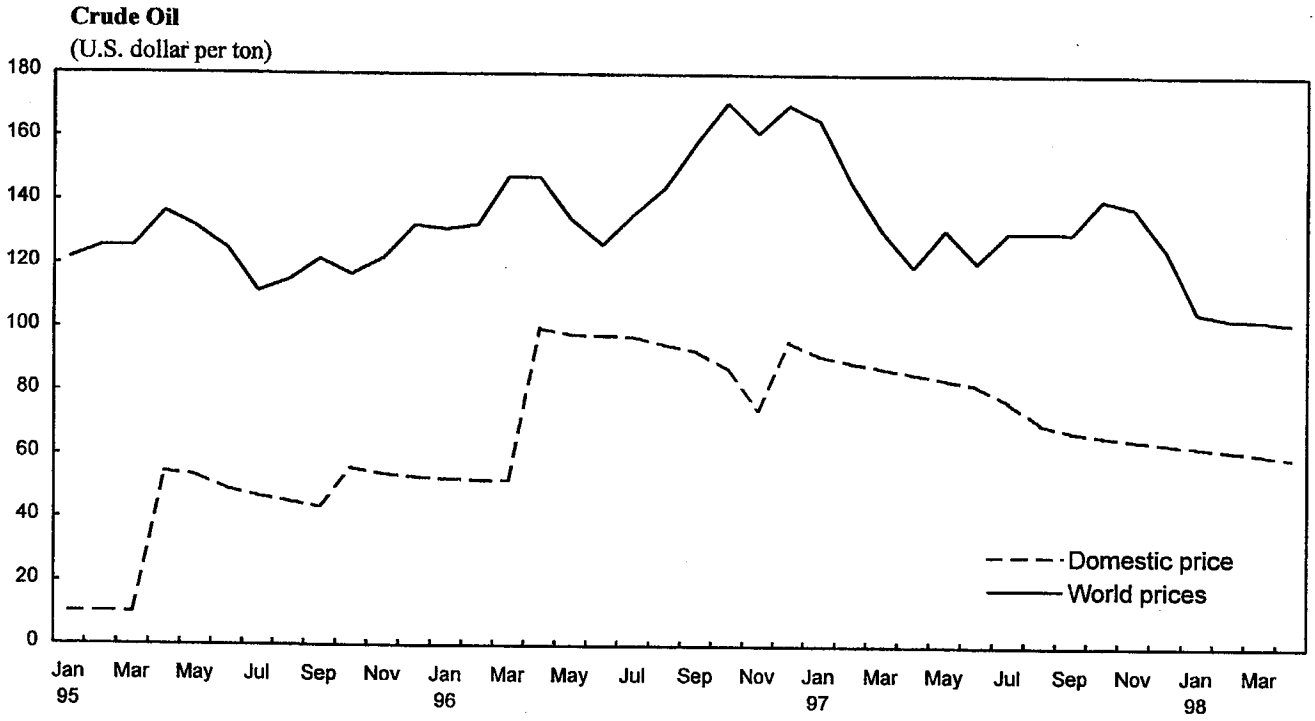
(Ratios) 1/

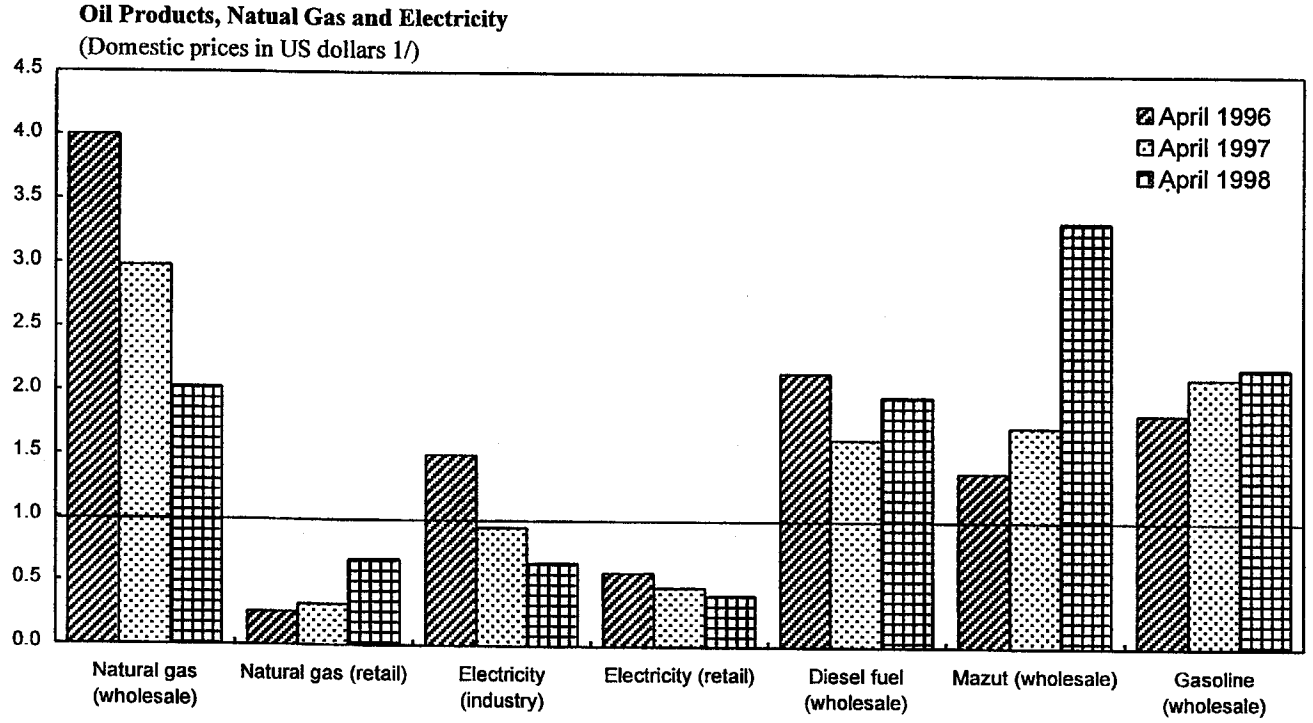
	April 1, 1996	April 1, 1997	April 1, 1998
Crude oil (wholesale; metric ton)	0.68	0.72	0.59
Natural gas (wholesale; 1,000 cubic meters)	4.00	2.92	2.03
Natural gas (retail; 1,000 cubic meters)	0.26	0.32	0.67
Electricity (industry; kWh)	1.50	0.93	0.65
Electricity (retail; kWh)	0.57	0.46	0.40
Diesel fuel (wholesale; metric ton)	2.15	1.63	1.97
Mazut (wholesale; metric ton)	1.37	1.73	3.34
Gasoline (wholesale; metric ton)	1.84	2.12	2.2

Sources: Ministry of Finance; and Fund staff estimates, based on auction market exchange rate.

1/ Domestic price in US dollars divided by the world market price for crude oil; the export parity price for diesel fuel, mazut and wholesale gasoline; and the long-run cost recovery price for gas and electricity as established by a EU/TACIS study.

Figure 7. Uzbekistan: Energy Pricing, 1995-98





Sources: Ministry of Finance; and Fund staff estimates, based on the auction exchange rate.

1/ Relative to export parity price for diesel, mazut, and gasoline, and to long-run cost recovery price for gas and electricity.

including in important sectors such as transport and agriculture.[65] Moreover, many wholesale markets remain dominated by large parastatal entities (e.g., Uzchlebproduct in the case of flour).

Wages and Employment

101. In 1997, the average public sector wage rose by 70 percent in nominal terms, after an increase by 102 percent in 1996 (Table 24). The sectoral differentiation in average wages became more pronounced, as, for example, the average remuneration in the financial services sector rose by about 100 percent. By contrast, the average wages in the budgetary sectors (e.g., education, health) rose by about 60 percent (Figure 8).[66]

102. Based on the official consumer price inflation data, the real average wage in December 1997 was about 40 percent higher than a year earlier (Table 25). The average U.S. dollar wage in Uzbekistan increased slightly in comparison with those of other medium-wage BRO countries if calculated on the basis of the official exchange rate (Figure 9).

103. According to official data, total employment increased somewhat in 1997. This reflected a broadly stable number of employees in the public sector and some growth in private service sector employment (Table 26). Officially reported unemployment has remained very low (0.4 percent), but the actual unemployment rate is estimated well above 5 percent. Official data also do not take account of the very extensive underemployment in many state owned enterprises and agricultural collectives.

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[65]These include, for example, the production of construction materials or furniture produced by one large enterprise in each of the 14 regions (Table 23). On price controls in agriculture see Section II.

[66]The concept of public sector in this section includes state-owned enterprises and budgetary organizations, but excludes internal and external security forces (as data are not available), joint ventures, and agricultural collectives. As the public sector still accounts for a very substantial part of the economy, these wages can be viewed as broadly representative for the country. However, they do not reflect payments in kind and additional informal sector income of employees.

Table 23. Uzbekistan: Monopoly Enterprises and Products, 1996-98 1/

	January 1, 1996		January 1, 1997		January 1, 1998	
	Number of Enterprises	Number of Products	Number of Enterprises	Number of Products	Number of Enterprises	Number of Products
Total	945	3,096	828	5,186	810	3,600
National level	147	288	144	292	130	270
Local level 2/	798	2,808	684	4,894	680	3,330
By sector						
Grain, flour, and bread	2	4	37	275	41	145
Coal	1	1	2	5	4	6
Gas	3	4	5	6	4	5
Foodstuffs	216	951	155	1,508	132	909
Light industry	89	286	55	225	57	171
Local industry	126	309	43	135	29	74
Petrochemical	50	190	12	52	12	47
Machine building	45	72	30	58	30	66
Building materials	150	338	97	1,624	87	895
Services	188	311	236	825	263	821
Others	75	630	156	473	151	461

Sources: Ministry of Finance; and Anti-Monopoly Committee.

1/ Officially defined as enterprises and products with a market share of 35 percent or more at January 1, 1996, and 65 percent or more thereafter.

2/ Monopoly enterprises or products in a local administrative area.

Table 24. Uzbekistan: Average Monthly Wages in the Public Sector, 1995-98

(In sum per month)

	1995	1996		1997		1998		
	Annual	Dec.	Annual	Dec.	Annual	Jan.	Feb.	Mar.
Overall average 1/	1,070	3,656	2,166	5,743	3,697	4,182	4,300	4,760
Industry	1,549	4,936	3,062	8,286	5,386	6,693	6,455	7,188
Agriculture	777	1,982	1,192	3,211	1,881	1,781	1,622	1,862
Transport	1,426	5,919	2,955	7,702	5,375	5,708	7,685	7,779
Communications	1,519	6,708	3,028	10,447	4,882	5,166	5,762	7,492
Construction	1,661	6,719	3,581	10,105	6,034	5,882	5,693	6,839
Trade and public catering	664	2,472	1,486	3,714	2,484	3,384	3,381	3,764
Information and computer services	1,713	8,909	4,029	15,976	6,322	5,392	6,088	7,797
Housing and communal services	1,082	4,007	2,271	7,549	4,036	4,713	4,740	6,003
Health care, physical training, social security	677	1,856	1,398	2,838	2,244	2,545	2,602	2,667
Public education	672	2,190	1,529	3,376	2,454	2,853	3,045	3,227
Culture and art	740	2,495	1,587	3,886	2,466	2,954	2,945	3,099
Science and scientific support	1,246	4,349	2,479	6,527	3,779	4,769	4,506	5,715
Financing and insurance	1,831	8,490	4,033	16,750	7,981	6,715	9,443	9,308
Administrative agencies	1,047	3,801	2,262	5,890	3,716	4,697	4,274	5,131

Source: Ministry of Macroeconomics and Statistics.

1/ Includes state owned enterprises and budgetary organizations, excluding internal and external security forces.

Table 25. Uzbekistan: Labor Market Indicators, 1991-97

	1991	1992	1993	1994	1995	1996	1997
Population (in thousand)	20,863	21,360	21,853	22,282	22,690	23,130	23,563
Population growth rate (in percent)	...	2.4	2.3	2.0	1.8	1.9	1.9
Working age population (in thousand)	10,234	10,463	10,707	10,963	11,222	11,508	11,826
Employment (in thousand)	8,255	8,271	8,259	8,150	8,449	8,561	8,680
Of which							
Industry	1,202	1,147	1,167	1,067	1,087	1,107	1,109
Agriculture and forestry	3,470	3,612	3,688	3,622	3,485	3,505	3,515
Transport and communication	400	367	348	342	348	358	360
Construction	680	598	561	520	528	539	550
Trade	470	452	456	565	705	713	715
Other services	1,978	1,939	1,909	1,871	1,897	1,940	1,952
Of which							
Information and computer services	12	8	6	3	4	5	5
Housing services	192	187	190	184	214	226	230
Health	493	497	495	486	487	498	500
Education	1,138	1,119	1,083	1,080	1,054	1,066	1,070
Credit and insurance	24	25	29	34	40	47	48
Management services	119	104	105	84	97	98	99
Official number of unemployed (in thousand)	...	...	29.0	29.4	31.0	33.8	35.4
Official unemployment rate (in percent)	...	...	0.3	0.4	0.4	0.4	0.4
Official number of persons on forced leave (in thousand)	...	...	...	...	241.0	237.0	...
Official number of vacancies (in thousand)	...	...	...	34.6	27.4	12.6	...
Memorandum items:							
Minimum wage (in sum per month)	0.2	1	9	70	175	417	675
Real monthly minimum wage (Index 1991=100) 1/	100.0	83.4	121.2	72.3	35.4	54.9	52.0
Minimum wage (in U.S. dollar per month) 2/	...	4.8	8.7	10.7	5.8	10.2	10.2
Average wage (in sum per month)	0.3	3	29	305	1,070	2,166	3,697
Real monthly average wage (Index 1991=100) 1/	100.0	78.1	154.2	116.7	94.6	124.2	123.0
Average wage (in U.S. dollar per month) 2/	...	10.9	26.4	38.0	35.0	52.0	55.4

Sources: Ministry of Macroeconomics and Statistics, Ministry of Labor; and Fund staff estimates.

1/ Based on staff inflation estimate for 1997.

2/ At the official exchange rate.

Table 26. Uzbekistan: Public Sector Employment, 1992-97

(In thousands)

	1992	1993	1994 1/	1995	1996	1997
Total 2/	4,743	4,647	4,338	4,109	3,897	3,835
Industry	1,094	991	923	851	771	720
Agriculture 3/	755	764	617	543	494	518
Transportation	283	269	258	262	257	251
Communications	48	46	44	43	44	43
Construction	501	463	429	385	363	339
Trade and public catering	426	406	360	308	238	169
Information and computer services	8	6	5	3	2	2
Housing and communal services	124	121	109	116	124	130
Health care, physical training, social security	464	471	472	465	456	447
Public education	803	829	850	857	862	878
Culture and art	67	65	62	63	63	63
Science and scientific support	59	52	45	43	37	35
Financing and insurance	25	27	34	36	42	48
Administrative agencies	81	86	85	86	91	97

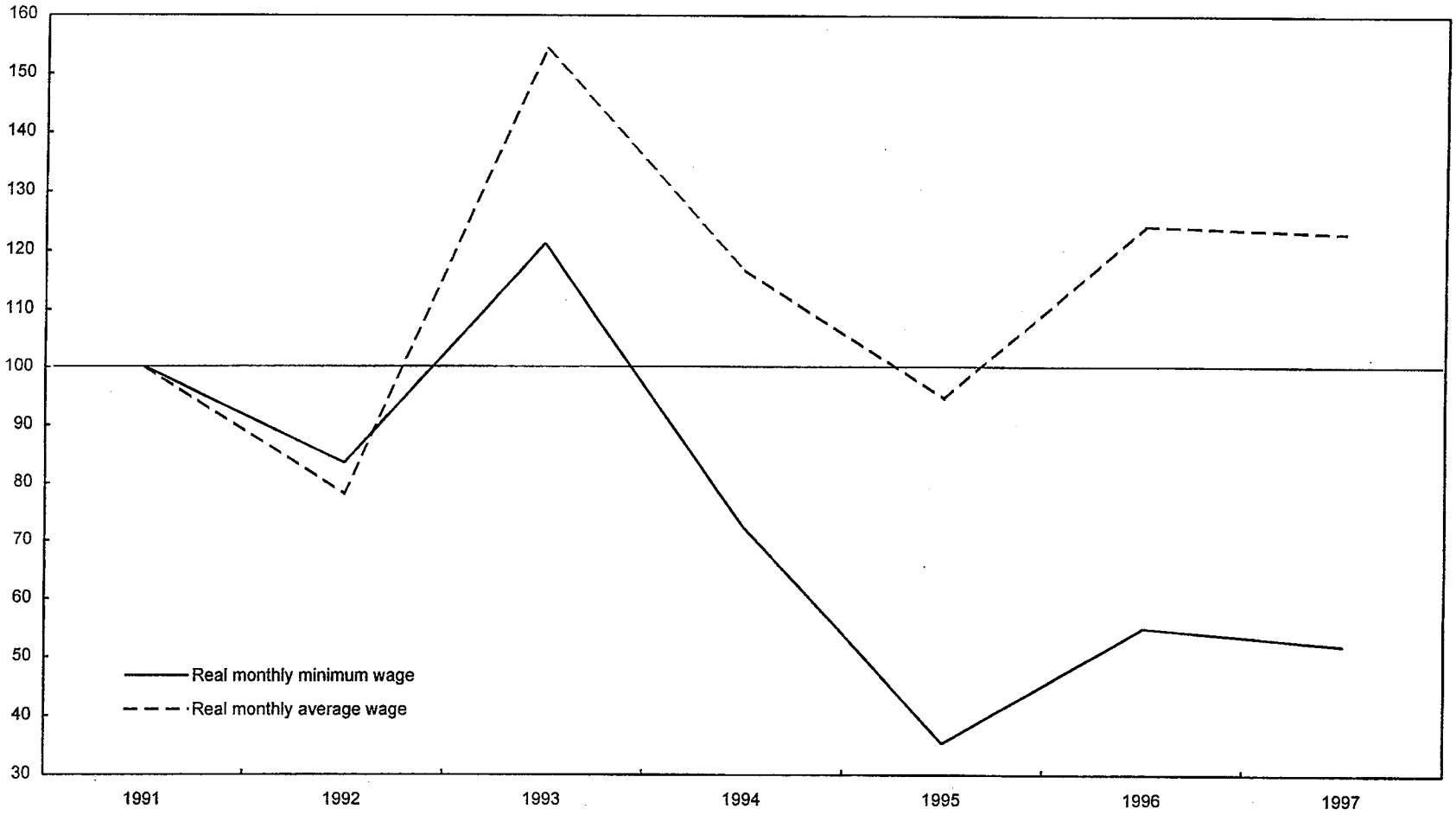
Source: Ministry of Macroeconomics and Statistics; and Fund staff estimates.

1/ Monthly average data available for January-August only.

2/ Includes state owned enterprises and budgetary organizations, excluding internal and external security forces.

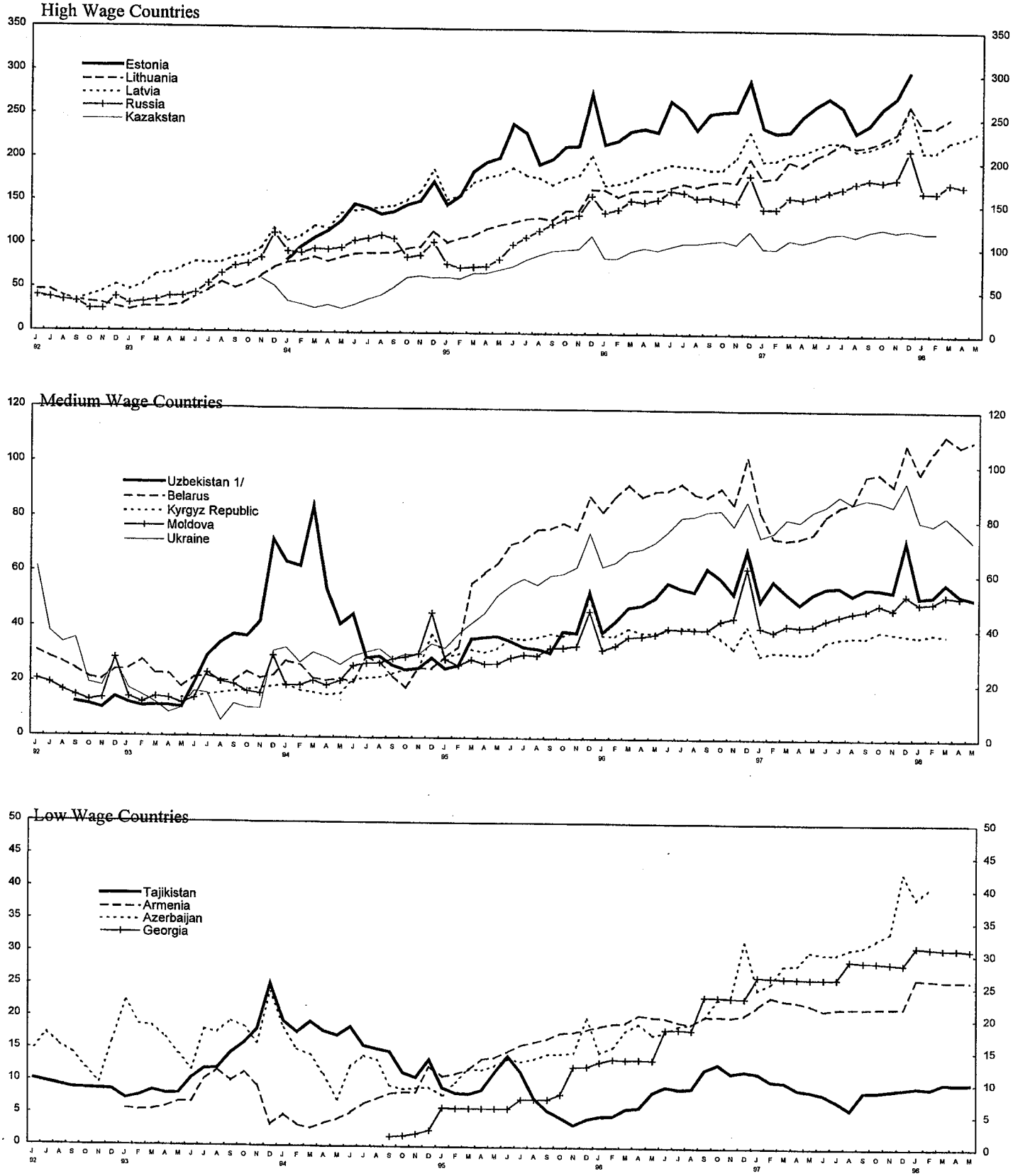
3/ Excludes agricultural collectives.

Figure 8. Uzbekistan: Real Average and Minimum Wage
(Index 1991=100)



Sources: Data provided by the authorities; and Fund staff estimates, based on official CPI data.

Figure 9. BRO Countries: Monthly Average Wages, June 1992 - March 1998
(In U.S. dollars, period average)



Source: National authorities.

1/ Dollar wages are based on official exchange rate.

B. Recent Fiscal Developments and Fiscal Policy Measures

104. **Fiscal developments in 1996.** After a relatively moderate budget deficit for the first nine months 1996, the government in the last quarter extended large credits to agriculture and other sectors to clear expenditure arrears, including wage, tax, pension and interenterprise arrears, that had been building during the year. This was, in part, a reaction to mounting financial difficulties in agriculture. At the same time, the government also cleared most of its own wage and other arrears. As a result, the (cash) budget deficit reached 15 percent of quarterly GDP in the last quarter of 1996, and 7.3 percent of GDP for the year as a whole compared with a budget deficit target of 3 percent of GDP. The budget deficit was financed mostly through the domestic banking system.

105. **The 1997 budget** (Table 27) introduced a number of revenue measures, including: (i) an increase in the standard VAT rate from 17 to 18 percent, albeit with the introduction of a reduced (10 percent) VAT rate on four food items; (ii) a 50 percent increase in the rates of the property, land, and mining taxes, with some expansion of their bases; (iii) a reduction in the standard profits tax rate from 37 to 36 percent; (iv) a new "ecological tax" of 1 percent on assets of nonagricultural enterprises; and (v) a ½ percent tax on enterprise revenues, earmarked for the pension fund. In addition, to strengthen tax administration and improve collection of tax arrears, the authorities created a special tax collection service within the State Tax Committee with the power to sell the property of delinquent enterprises.

106. Despite these measures, **total 1997 revenues** declined to 30.5 percent of GDP, which was 3.8 percentage points less than in 1996. The key factors behind the revenue decline were: (i) lower revenues from the profits tax owing to mounting financial difficulties of state enterprises, which, inter alia, resulted in the rescheduling of tax arrears of certain agricultural and other state enterprises for 3 years; (ii) lower collection of oil excises due to the policy of maintaining low wholesale oil prices, and the interenterprise arrears to the energy complex; and (iii) lower cotton excise tax revenues, largely as a result of the poor 1996 crop. This revenue decline was partially offset by higher revenues from the VAT (due to the increase in the standard rate, and delays in servicing tax rebates), land, property, and mining taxes (due to the above mentioned rate increase and base expansion), higher alcohol and tobacco excises, a good performance of the "ecological tax," the newly introduced water charges for irrigation, and the individual income tax (due to higher wages and some tax administration measures).

107. **Tax arrears** to the state budget declined modestly relative to GDP in the course of 1997, from 2 percent at the beginning of the year to 1.7 percent of GDP at the end of the year. In addition, about 0.5 percent of GDP of arrears were owed to the pension fund at end-1997, mainly by enterprises in the energy and agriculture sectors. Two recent decrees (one in January 1998 focusing on 108 agricultural enterprises slated for "restructuring," and one of February 4, 1998 related, in principle, to all enterprises) rescheduled tax arrears for selected enterprises over several years.

Table 27. Uzbekistan: Fiscal Operations of Consolidated Government, 1994-97
(In millions of sum)

	1994	1995	1996	1997
Revenues	18,936	104,812	191,551	293,676
Taxes on incomes and profits	5,629	34,210	75,384	109,142
Enterprise income tax	3,971	25,809	55,495	70,177
Individual income tax	1,659	8,401	19,889	38,965
Taxes on domestic goods and services	7,980	42,360	92,373	132,289
Value added tax	3,219	17,273	35,981	73,339
Excises	4,761	25,087	56,392	58,950
Cotton	3,209	13,023	12,060	5,612
Oil products	673	9,621	37,607	36,071
Other	879	2,442	6,725	17,267
Property, land and mining taxes	230	4,482	9,558	23,528
Property tax	100	1,984	2,816	7,610
Land tax	129	2,257	5,661	10,521
Mining tax	0	241	1,081	5,397
Customs duties and export taxes	765	2,808	3,104	5,519
Profits from the Central Bank	0	300	300	1,800
Other tax and non-tax revenues	4,333	20,652	10,832	21,398
Expenditure and net lending	21,620	115,317	222,940	317,350
Expenditure	21,620	113,741	202,558	317,350
National economy	1,585	13,079	26,209	39,898
Socio-cultural	9,388	36,385	69,119	111,180
Education	5390	22,407	41,241	69267
Health	2256	10,785	20,727	31,907
Other	1742	3,192	7,151	10,007
Other subsidies and transfers	1,257	10,420	22,254	31,064
Services	516	3,433	7,190	6,121
Allowances	595	4,304	14,103	23,354
Public transfers	145	2,683	961	1,590
State authority and administration	576	2,930	5,902	7,951
Investment	2,239	18,600	39,861	72,170
Interest, net	...	300	...	...
Other (including military)	725	32,027	39,214	55,087
Reserve	--	--	--	--
Net lending	...	1,577	20,382	--
Balance	-2,684	-10,506	-31,389	-23,675
Extrabudgetary funds	-144	-1,811	-9,666	1,990
External sector balance 1/	-1,152	-156	...	...
Consolidated balance	-3,980	-12,473	-41,054	-21,685
Financing	3,980	12,473	41,054	21,685
Domestic	3,609	6,717	43,975	19,453
Domestic banking system	3,126	4,250	38,362	12,536
T-bills outside banks	0	--	1,058	1,935
Privatization proceeds	483	2,467	4,556	4,982
External	0	4,918	--	--
Unidentified/Remaining gap	371	837	-2,921	2,232
Memorandum item:				
Wages and salaries	...	18,008	36,778	...

Sources: Ministry of Finance; and Fund staff estimates.

1/ In 1996, external sector balance was abolished and consolidated into the state budget.

Table 27. (cont.) Uzbekistan: Fiscal Operations of Consolidated Government, 1994-97

(In percent of GDP)

	1994	1995	1996	1997
Revenues	29.2	34.6	34.3	30.5
Taxes on incomes and profits	8.7	11.3	13.5	11.3
Enterprise income tax	6.1	8.5	9.9	7.3
Individual income tax	2.6	2.8	3.6	4.0
Taxes on domestic goods and services	12.3	14.0	16.5	13.7
Value added tax	5.0	5.7	6.4	7.6
Excises	7.3	8.3	10.1	6.1
Cotton	4.9	4.3	2.2	0.6
Oil products	...	3.2	6.7	3.7
Other	1.4	0.8	1.2	1.8
Property, land and mining taxes		1.5	1.7	2.4
Property tax	0.2	0.7	0.5	0.8
Land tax	0.2	0.7	1.0	1.1
Mining tax	0.0	0.1	0.2	0.6
Customs duties and export taxes	1.2	0.9	0.6	0.6
Profits from the Central Bank	0.0	0.1	--	0.2
Other taxes and non-tax revenues	6.7	6.8	1.9	2.2
Expenditure and net lending	33.3	38.1	39.9	33.0
Expenditure	33.3	38.1	36.2	33.0
National economy	2.4	4.3	4.7	4.1
Socio-cultural	14.5	12.0	12.4	11.6
Education	8.3	7.4	7.4	7.2
Health	3.5	3.6	3.7	3.3
Other	2.7	1.1	1.3	1.0
Other subsidies and transfers	1.9	3.4	4.0	3.2
Services	0.8	1.1	1.3	0.6
Allowances	0.9	1.4	2.5	2.4
Public transfers	0.2	0.9	0.2	0.2
State authority and administration	0.9	1.0	1.1	0.8
Investment	3.5	6.1	7.1	7.5
Interest, net	...	0.1	...	...
Other (including military)	1.1	10.6	7.0	5.7
Reserve	--	--	--	--
Net lending	...	0.5	3.6	...
Balance	-4.1	-3.5	-5.6	-2.5
Extrabudgetary funds	-0.2	-0.6	-1.7	0.2
External sector balance 1/	-1.8	-0.1	...	...
Consolidated balance	-6.1	-4.1	-7.3	-2.3
Financing	6.1	4.1	7.3	2.3
Domestic	5.6	2.2	7.9	2.0
Domestic banking system	4.8	1.4	6.9	1.3
T-bills outside banks	0.0	0.0	0.2	0.2
Privatization receipts	0.7	0.8	0.8	0.5
External	0.0	1.6	--	--
Unidentified/remaining gap	0.6	0.3	-0.5	0.2
Memorandum items:				
Period GDP (in million sums)	64878	302787	559072	962158
Wages and salaries as percent of GDP	...	5.9	6.6	6.7

Sources: Ministry of Finance; and Fund staff estimates.

1/ In 1996, external sector balance was abolished and consolidated into the state budget.

108. **Total expenditures** were 33 percent of GDP in 1997, about 6.9 percentage points less than in the previous year. Over half of this decline was traceable to the absence of budgetary onlending in 1997, and the remainder was due to a decline in the expenditure items "national economy" (which mostly comprises the large expenditures in the government's water sector) and "other expenditures" (which includes military outlays). There was also a significant decline in expenditures on state administration, but this item, due to its narrow definition, includes only a small portion of current expenditures of the general government.

109. In 1997, **the composition of expenditure** shifted in favor of investment, education and health care, and budget allowances. There was an increase in the share of budgetary investment in total spending from less than 18 percent in 1996 to 23 percent in 1997. This reflected the government's strategy to protect investment expenditures when reducing total spending. Similarly, the share of education in total expenditures rose from 18.5 to 22 percent, and the share of health expenditures rose from 9.3 to 10 percent, although they declined modestly as a percentage of GDP. Budgetary child allowances, despite tighter formal eligibility criteria, increased its share in total expenditures from 6.3 to 7.2 percent.[67] The share of wages in total expenditures rose from 16.5 to 19.5 percent, reflecting successive wage increases during the year. Nonwage current expenditures were monitored and cut when needed, and the budget abstained from lending to agriculture and other sectors. However, investment, external debt service, and some other budgetary expenditures were subsidized indirectly through the application of the most favorable exchange rate on their foreign exchange components (see Chapter III).

110. In 1997, **the cash budget deficit** was only 2.3 percent of GDP, a result significantly better than in 1996. With no foreign financing available, the deficit was financed mainly from the banking system (1.3 percent of GDP), treasury bills held by the nonbank sector (0.2 percent of GDP), and privatization receipts (0.5 percent of GDP). Extrabudgetary funds had a small surplus (0.2 percent of GDP), entirely due to the improved performance of the pension fund. This resulted from the new tax on enterprise revenues earmarked for the pension fund and somewhat scaled-down benefits for working pensioners (Box 7). In addition, there may have been some increase in expenditure arrears; in a speech in June 1998, President Karimov referred to large **wage and pension arrears** in certain regions.

111. For 1998, the authorities project **revenues** of 32.4 percent of GDP, an increase of about 2 percentage points over 1997 collection. This is to be accomplished by a combination of revenue measures, many of which were introduced with the new tax code which came into effect on January 1, 1998. These measures include: (i) raising the standard VAT rate to 20 percent from 18 percent; (ii) raising resource tax (land, water) rates from very low levels;

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[67]Eligibility for child allowances was significantly tightened through means testing and the administration was transferred to the local organizations "mahalas."

Box 7: Pensions and Social Assistance Programs

Uzbekistan's pension system remains essentially that of the former Soviet Union. There are three types of pensions: old-age, disability, and social family pensions (received by family dependents of a deceased person).

Old-age pensions. Eligibility for full pension for men requires 60 years of age, and 25 years of service; for women, it is 55 years of age and 20 years of service, with limits on the size of pensions. The maximum pension is 75 percent of the average wage over a five-year period or no more than seven minimum wages. There is a large number of occupations which qualify for early pensions. Also, a person may retire before the standard age limit, if the years of service criterion is met. And there are occupations which allow retirement up to 10 years earlier than the age limit. This has not yet translated into significant pressures on the pension budget due to the very young population of Uzbekistan. The government developed a proposal for long-term pension reform which aims to raise retirement age and allows a greater role for private pension funds as a complement to the public pension system.

Disability Pensions. Beneficiaries are divided into three categories: (i) disabled who depend on another person's assistance in daily life, (ii) disabled who do not need assistance, but cannot work, and (iii) disabled who can work. In addition, there are disability pensions for work injuries, and veterans' disability pensions. The length of service required for eligibility is reduced if an injury occurred at an early age.

Social pensions. Social pensions are paid to all dependent family members of a deceased. The amount of pension depends on the average wage and the length of service of the deceased. The main difference between social pensions and other types of pensions is that each dependent receives his/her social pension, usually at the level of 30-40 percent of the average wage. For example, a dependent wife and five children of a deceased would receive five separate social pensions whose combined value exceeds the average wage of the deceased.

There are three main social assistance programs: assistance to families with children under the age of 16, child allowances for families with children under the age of 2, and financial assistance to low income families.

Assistance to families with children under the age of 16 is the most important budgetary family assistance program, currently under the supervision of the Ministry of Labor. Until 1997, it was entirely untargeted and any family with children under the age of 16 was, in principle, eligible. However, in 1997, eligibility criteria were tightened to include income, and administration was transferred to local communities or "mahalas." Mahalas review applications and determine the families who are eligible and the amount of benefit according to a number of criteria which include income, ownership of land and health and marriage status, none of which are quantified; hence there is a great deal of judgment in actual application of eligibility criteria. The Ministry of Finance recommends a standard monthly benefit level of 1.5 minimum wages per family member, while standard duration of benefits is 6 months. Upon expiration of the standard period, mahalas review family situations and recommend continuation or ending benefits. In principle, the program is open-ended.

Child allowance for families with children under the age of 2 has two components: the first targets unemployed mothers with children under 2, and the second targets working mothers. Both programs pay the same amount of benefit: a monthly benefit of 1.5 minimum wages (sum 1,125) per mother, for the duration of 24 months. The program for unemployed mothers is paid out of the budget while the program for working mothers is paid by the enterprises where they work. For civil servants, these benefits are paid out of the budget.

Financial assistance to low income families is a program of income support for poor families. Since 1998, the program has been implemented by mahalas. The budget provides the funding and the Mahalas select and monitor beneficiaries based on a number of criteria including family income, ownership of land and ability to work, none of which is quantitative. Using these criteria, the mahalas judge each application and the financial situation of those families on a case-by-case basis. The monthly benefit received by each family can be no less than 1.5 minimum wages, and no more than 3 minimum wages. The benefits are granted for a standard period of three months at a time, with the annual maximum of 4 standard periods of benefits per year (equivalent to one year). The average duration of benefits is 1.5 standard periods or about 4.5 months. The program is open-ended as there is no set maximum period for receiving benefits by eligible families.

(iii) making mandatory a number of local fees which were earlier elective for municipalities (parking fees, trading permits, waste removal fees, etc.; (iv) imposing a 15 percent dividend tax, and reintroducing a 35 percent income tax on commercial banks from which they had been exempted;[68] and (v) reducing the standard profits tax rate to 35 percent from 36 percent.

112. On the **expenditure** side, the budget projects total expenditures of about 35.5 percent of GDP, an increase of 2.5 percentage points over 1997. This results from the large planned increase in "other expenditures," which includes military, from 5.7 to 7 percent of GDP, and some increases in expenditures on education, health care, subsidies and transfers (primarily budget allowances). At the same time, investments are projected to decline from 7.5 to 7.2 percent of GDP, as some large investment projects have been completed and donor support for others is lacking. The budget anticipated a 50-60 percent increases in pensions and wages as of July 1, 1998 (which were granted) and a further, somewhat smaller increase in the third or fourth quarter.

113. **The 1998 budget** targets a budget deficit of 2.4 percent of GDP,[69] to be financed from the domestic banking system (1 percent), the placement of government bonds to the nonbank public (0.6 percent of GDP), and privatization revenues. The pension fund is projected to continue to register surpluses, with the overall extrabudgetary balance projected to reach 0.7 percent of GDP. The budget is based on a projected real growth of GDP of 6 percent and an end-year CPI inflation target of 22 percent.

114. Despite preparations for the establishment of a **Treasury** in the Ministry of Finance, with the assistance of the FAD advisor and USAID advisors, progress has been limited. Draft State Finance and Treasury Laws have been prepared and are being discussed within the government.

C. Monetary Policies and the Financial Sector

115. Uzbekistan has a two-tier banking system, with the Central Bank of Uzbekistan (CBU) managing the official international reserves and lending to the government and commercial banks. The foreign assets earlier held by the Ministry of Finance at the National Bank of Uzbekistan (NBU) were transferred to the CBU in April 1997. However, the NBU continues to be the depository of a large proportion of official gold reserves and manages other exchange reserves on behalf of the central bank. Money and credit policies, as well as foreign exchange allocation, are determined by the Republican Monetary Policy Commission, which is headed by the Chairman of the CBU and includes representatives of various government agencies and the banking sector.

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[68]However, income from treasury bills remains tax exempt.

[69]After allowing for a surplus of 0.7 percent of GDP in the pension fund.

Monetary Developments

116. Reserve money, after growing a modest 15 percent during the first nine months of 1996, rose by 97 percent in the last quarter of the year (Box 8 and Figure 10). The latter reflected in part the financing of the budget deficit, which increased from less than 3 percent in the first three quarters of 1996 to about 15 percent of quarterly GDP, largely on account of lending to agriculture and the clearance of arrears. In the last quarter of 1996, reserve money also grew because of a substantial accumulation of foreign exchange reserves, due in part to the rationing of foreign exchange for current transactions.

117. This left commercial banks with very high excess liquidity at the beginning of 1997; in addition, reserve requirements were cut from 25-20 percent towards the end of 1997.[70] Although reserve money expanded in 1997 by only 18 percent, reflecting, inter alia, large NIR losses, the banking system had enough liquidity to expand its lending by more than 90 percent in terms of broad money in 1997, only slightly less than in 1996.

118. In 1997, the CBU continued its policy of providing **credit** to the major banks, targeted for onlending to priority sectors (Table 28). Central bank credit to the banking system increased by 108 percent in 1997, equivalent to 29 percent of reserve money at the beginning of the year. Two-thirds of this new net credit was directed to agriculture, and the balance to industry (Table 29). Although commercial banks typically onlend credits targeted to priority recipients without a formal guarantee from CBU, there is an implicit guarantee as banks are fulfilling official credit policy guidelines set by the Cabinet of Ministers rather than making their own lending decisions. The impact of this policy on the quality of banks' portfolios has not yet been assessed, in part because accommodating credit policies and relatively high inflation have masked the underlying problems.

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[70]The money multiplier reached 1.66 at the end of 1997, compared to 1.44 one year earlier.

Table 28. Uzbekistan: Reserve Money and Net Assets of the Monetary Authorities
(In millions of sums, end of period)

	1993	1994	1995	1996				1997				1998	
	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.
Net international reserves 1/	1,273	33,249	60,787	58,996	54,905	51,475	91,281	89,578	80,450	90,093	73,957	76,165	73,524
Gold 2/	542	16,344	37,888	22,059	28,470	31,723	57,593	72,670	73,738	78,345	63,615	59,485	53,553
Foreign exchange	731	16,905	22,889	36,937	26,436	19,752	33,688	16,907	6,713	11,749	10,342	16,679	19,971
Net domestic assets	987	-20,228	-22,464	-18,674	-11,955	-7,216	-10,009	-8,262	2,817	1,159	22,296	24,540	35,716
Domestic credit	2,705	7,263	4,724	7,672	10,355	17,414	55,314	58,830	66,265	76,095	85,222	92,170	101,016
Government, net	1,384	-169	-5,461	-4,717	-4,608	-2,449	33,482	32,208	32,781	35,176	39,837	38,764	35,699
Banks	1,292	7,405	10,150	12,357	14,928	19,824	21,789	26,579	33,434	40,869	45,341	53,350	65,263
Rest of the economy	29	27	36	32	36	39	44	43	50	50	44	56	54
Other items, net	-1,718	-27,491	-27,188	-26,346	-22,311	-24,630	-65,323	-67,092	-63,447	-74,936	-62,926	-67,630	-65,300
Of which: Valuation adjustment	...	...	...	...	...	...	...	1,146	2,573	-27,090	-18,239	-24,973	-26,980
Reserve money	2,260	13,021	38,323	40,322	42,950	44,259	81,273	81,315	83,268	91,253	96,253	100,704	109,239
Currency outside CBU 3/	696	7,517	21,344	25,308	30,027	32,659	53,887	60,516	62,780	68,265	74,674	76,891	85,687
Deposits of commercial banks	1,399	5,062	16,367	14,740	12,514	10,796	26,686	18,349	19,876	21,908	19,283	21,978	21,757
Required reserves	259	2,630	6,290	8,230	7,306	6,751	7,237	7,798	8,233	10,862	7,828	8,309	7,736
Correspondent accounts, net	1,140	2,432	10,077	6,510	5,208	4,045	19,449	10,551	11,643	11,046	11,454	13,669	14,021
Other deposits	166	442	613	275	409	803	700	2,450	612	1,081	2,296	1,835	1,795
Domestic currency	41	74	272	243	369	304	358	1,095	243	401	2,038	1,824	1,778
Foreign currency 1/	125	368	340	32	40	499	342	1,355	369	680	259	11	17
Memorandum items:													
Change in the quarter:													
Net domestic assets	649	-9,852	10,834	3,790	6,719	4,739	-2,793	1,746	11,080	-1,658	21,137	2,244	11,176
Credit to government, net	659	-4,916	-4,533	745	108	2,159	35,931	-1,273	573	2,395	4,661	-1,073	-3,065
Credit to banks	345	3,119	-2,020	2,207	2,571	4,896	1,965	4,790	6,855	7,435	4,472	8,009	11,913
Reserve money													
Percentage change in the quarter	...	...	33	5	7	3	84	0	2	10	5	5	8
Percentage change since beginning of year	...	...	225	5	12	15	112	0	2	12	18	5	13

Sources: Central Bank of Uzbekistan; and Fund staff estimates.

1/ Valued at current exchange rates.

2/ Gold valued at US$ 390 per ource until August 1995, US$375 from September 1995 to March December 1996, and at market prices thereafter.

3/ Revised from December 1994 onward to include currency in transit (former account 022); this change increased the amount of currency recorded with the offset recorder under *other items.*

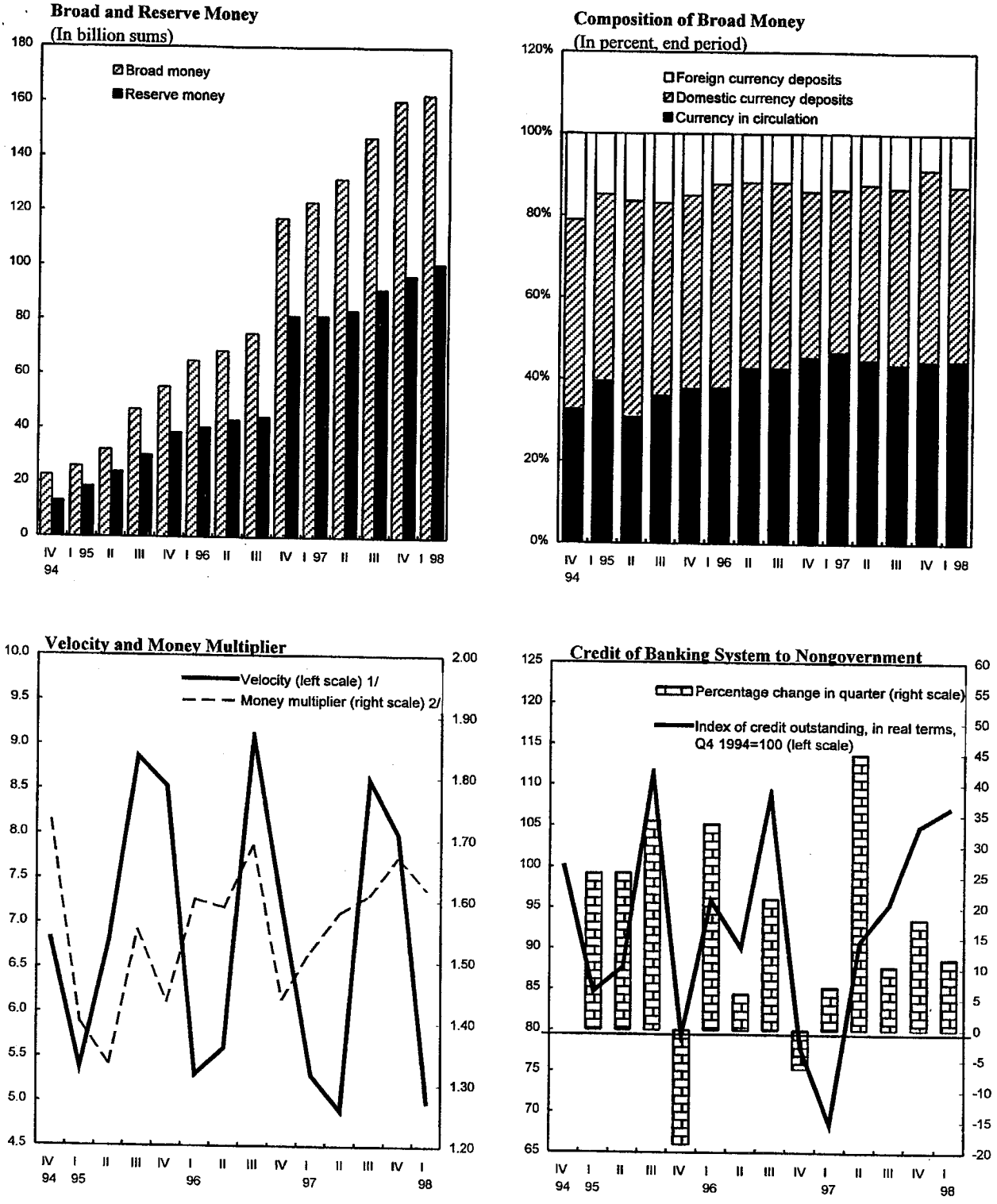
Table 29. Uzbekistan: Central Bank Credit Outstanding, 1996-98 1/
(In millions of sums, end period)

	1996	1997				1998
	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.
All banks 1/	21,808	26,579	33,434	40,869	45,480	53,692
Pahtabank	11,596	12,478	15,436	17,101	19,871	22,604
Promstroibank	4,220	5,710	6,752	7,979	10,218	13,168
Other	5,992	8,391	11,246	15,789	15,391	17,920
All sectors 2/	21,808	26,577	33,433	40,869	45,480	53,691
Agriculture	14,567	14,594	20,990	26,160	29,534	33,377
Cotton	8,482	7,413	9,798	10,716	13,717	16,361
Grain	5,534	4,095	6,097	8,773	8,547	9,485
Other	551	3,086	5,095	6,671	7,270	7,531
Industry	7,241	11,983	12,443	14,709	15,946	20,314
Food	1,492	1,527	2,431	2,767	3,937	4,277
Other	5,749	10,456	10,012	11,942	12,009	16,037

Source: Central Bank of Uzbekistan.

1/ Banks receiving directed credit from the Central Bank.
2/ Sectors receiving directed credit through commercial bank onlending.

Figure 10. Uzbekistan: Selected Monetary Indicators, 1994-97



Source: Data provided by the authorities; and IMF staff estimates.

1/ Annualized quarterly GDP/end-of-period broad money stock.
2/ Broad money/reserve money.

Box 8. Monetary Developments in 1996-98

(percentage changes) 1/

	1996			1997			1998
	Jan-Sept	Q4	Year	Jan-Sept	Q4	Year	Jan-Jun
				Monetary Authorities			
Foreign assets, net 2/	-36	41	5	-23	-23	-46	-15
Domestic assets, net 2/	52	56	108	35	30	65	28
Reserve money	15	97	112	12	6	18	13
				Banking System			
Foreign assets, net 3/	-10	29	19	-37	-17	-55	-10
Domestic assets, net 3/	46	48	94	63	28	91	18
Broad money	36	78	113	25	12	36	8
Memorandum item:							
Fiscal balance, *percent of GDP* (deficit -)	-3	-15	-7	-3	--	-2	...

1/ Excludes valuation adjustment. Percentage changes may not add because of rounding.

2/ Relative to reserve money at the beginning of the year.

3/ Relative to broad money at the beginning of the year.

119. The foreign reserve position of **commercial banks** deteriorated markedly during 1997, with their net claims on foreign residents (excluding long-term liabilities) becoming negative. During the year, the loan portfolio of banks (claims against the nonbank sector) increased by 76 percent, reaching sum 243 billion or 25 percent of GDP (Table 30).[71] Total credit to the nongovernment sector expanded by 86 percent to reach sum 200 billion at the end of the year. Commercial banks, mainly the NBU, were able to increase lending out of foreign lines of credit; the dollar-equivalent of such loans increased by 18 percent during the year. They also expanded credit on the basis of liquidity provided by the CBU and their free reserves.[72] The money multiplier increased to 1.66 at the end of 1997, from 1.44 one year earlier.

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[71]Close to 7 percent of the banks' portfolios consisted of commercial bank holdings of government bonds.

[72]Banks' deposits with the CBU, including free reserves, expressed in proportion of banks' domestic currency deposits, declined from 56 percent at end-1996 to 26 percent at end-1997.

Table 30. Uzbekistan: Broad Money and Net Assets of the Banking System

(In millions of sums, end of period)

	1993	1994	1995	1996				1997				1998	
	Dec.	Dec.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.	Sep.	Dec.	Mar.	Jun.
Net foreign assets 1/	1,350	37,067	70,720	61,146	65,535	54,734	108,706	120,315	94,145	82,761	64,654	62,682	60,294
Gold 2/	542	16,344	37,888	23,771	32,039	31,723	57,592	68,686	73,738	78,345	63,615	59,485	53,553
Foreign exchange	808	20,723	32,832	37,375	33,497	23,011	51,114	51,629	20,407	4,416	1,039	3,197	6,741
Net domestic assets	1,376	-14,554	-15,723	3,467	2,744	19,922	8,588	2,893	37,553	64,321	94,912	102,770	112,653
Domestic credit 3/	...	26,438	47,578	65,755	72,569	89,589	137,423	146,734	182,747	216,549	242,604	265,852	297,926
Government, net	477	-3,737	-8,424	-9,643	-7,732	-5,560	29,937	31,847	30,129	34,854	42,473	35,212	27,899
of which: Treasury bills	...	...	...	644	2,136	2,737	3,082	5,413	6,991	12,652	16,149	14,586	21,192
Nongovernment	...	30,175	56,002	75,398	80,301	95,149	107,486	114,887	152,617	181,695	200,132	230,640	270,027
Domestic	3,751	18,070	31,107	41,581	44,029	53,502	50,099	53,595	77,713	85,784	101,358	113,147	133,176
Onlending	...	12,105	24,895	33,817	36,272	41,647	57,387	61,292	74,904	95,911	98,773	117,493	136,851
Other items, net 4/	-2,852	-40,992	-63,301	-62,288	-69,825	-69,667	-128,835	-143,841	-145,193	-152,227	-147,693	-163,082	-185,273
Of which: Valuation adjustment	...	...	...	...	...	...	...	-11,304	-13,860	-48,927	-41,892	-50,524	-56,414
Broad money	2,726	22,513	54,997	64,613	68,279	74,656	117,294	123,208	131,698	147,082	159,566	165,452	172,946
Currency outside banks 5/	587	7,318	20,769	24,440	29,258	31,906	53,262	57,452	58,960	64,252	71,639	72,711	79,117
Domestic currency deposits	2,001	10,418	25,956	32,206	30,926	33,902	47,531	49,051	56,480	63,474	73,941	72,006	80,806
Foreign currency deposits 1/	138	4,777	8,271	7,967	8,095	8,849	16,501	16,706	16,258	19,357	13,986	20,735	13,023
Memorandum items:													
Change in the quarter:													
Net domestic assets	788	-5,000	4,736	19,190	-723	17,177	-11,333	-5,695	34,660	26,768	30,591	7,858	9,883
Credit to government, net	263	-777	646	-1,219	1,912	2,172	35,497	1,910	-1,718	4,724	7,619	-7,261	-7,313
Domestic credit to nongovernment	1,074	7,836	-7,170	10,474	2,449	9,472	-3,402	3,496	24,118	8,071	15,574	11,789	20,029
Broad money													
Percentage change in the quarter	...	...	21	17	6	9	57	5	7	12	8	4	5
Percentage change since beginning of year	...	...	158	17	24	36	113	5	12	25	36	4	8

Sources: Central Bank of Uzbekistan; and Fund staff estimates.

1/ Valued at current exchange rates.

2/ Gold valued at US$ 390 per ource until August 1995, US$375 from September 1995 to March December 1996, and at market prices thereafter.

3/ Revised from December 1994 onward to include foreign credits channeled through Uzbek banks, which previously were treated as direct foreign borrowing by Uzbek enterprises.

4/ Includes counterentry to onlending recorded under *domestic credit to nongovernment.*

5/ Revised from December 1994 onward to include currency in transit (former account 022); this change increased the amount of currency recorded with the offset recorded under *other items*

120. The relatively low ratio of bank deposits to GDP—about 9 percent at end-1997—provides an indication of the degree of financial disintermediation in Uzbekistan. In response to the restrictions on cash withdrawal from banks, direct access of the tax authorities to banks' deposits, and other factors contributing to the lack of confidence in the banks, large segments of the economy prefer to settle their transactions in cash rather than utilizing the banking system. **Currency** in circulation rose from 33 percent of broad money in 1994 to 45 percent in 1996 and stayed at that level in 1997. Income velocity of currency increased during 1997 from 7.2 to 8.1. The relatively small size of **deposits denominated in foreign currency** (the only available direct measure of currency substitution) reflected the lack of trust in the banking system, as a result of which the population and enterprises hold substantial amounts of foreign, mostly U.S. dollar, bank notes.

Interest Rates

121. The central bank's **refinance rate** remained unchanged at 48 percent during 1997 and the first half of 1998. Central bank credit to commercial banks is provided through credit auctions held three times a month. Emergency liquidity is provided occasionally, for up to two weeks, at an interest rate which is 1.3 times the refinance rate. The refinance rate is also used as benchmark for the ceiling on bank lending rates: regulations prohibit banks from charging interest in excess of 1½ times the refinance rate, or 72 percent in early 1998. Also, the CBU began using repurchase agreement operations (repos) in late 1997, on a moderate scale, to accommodate short-term liquidity needs of commercial banks using the refinance rate as reference rate.

122. In 1997, the annual **interest rate on government bonds**, including both primary issues and transactions in the secondary markets, stayed consistently below the officially recorded 12-month inflation rate (Table 31). There was a sharp decline of interest rates on treasury bills in July 1998. Although there has been a sizable spread between the rates for the borrowing and lending operations of commercial banks, available data indicate that a significant volume of bank transactions was conducted at interest rates that were negative in real terms (Tables 32 and 33). This was particularly the case for medium- and long-term operations, which are extended at subsidized rates to finance investments in priority sectors. Typically, these transactions involve on-lending by commercial banks of directed credits received from the central bank. At the end of February 1998, the commercial banks' portfolios included sum 11.7 billion of loans (7 percent of the total loan), mostly to state enterprises, with maturities of more than five years, yielding 11 percent per year on average. Variable interest rates have not been used in Uzbekistan.

Table 31. Uzbekistan: Yield of Government Bonds in Primary and Secondary Markets, 1996-98

(Annualized rate, average in month)

	1996	1997												1998						
	Dec.	Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.
															Preliminary					
Primary market 1/																				
91-day Treasury bills	41.2	38.2	38.5	33.6	33.6	33.8	29.6	28.1	28.4	28.6	28.7	28.7	28.7	28.7	29.4	29.5	29.6	28.7	27.5	20.9
182-day Treasury bills 2/	--	--	--	32.3	36.7	--	32.6	29.5	29.4	29.1	29.4	29.4	29.4	29.4	29.5	30.1	30.1	29.1	29.1	25.5
Secondary market 3/ 4/																				
91-day Treasury bills	15.5	23.0	22.0	28.6	25.2	22.6	20.9	18.3	20.7	26.0	26.1	26.2	23.9	27.4	...	...	...	...	...	...
182-day Treasury bills 2/	--	--	--	30.0	30.8	29.2	27.9	22.1	22.6	26.7	26.4	26.7	25.4	31.9	...	...	...	...	...	...
Memorandum items:																				
Central Bank refinance rate	60	48	48	48	48	48	48	48	48	48	48	48	48	48	48	48	48	48	48	48
								(In millions of sums)												
Treasury bills outstanding	4,140	...	...	7,765	...	...	11,912	...	...	15,611	...	...	19,143	...	...	19,155	...	...	28,100	...
Held by commercial banks	3,082	...	...	5,413	...	...	6,991	...	...	12,652	...	...	16,149	...	...	14,586	...	...	21,192	...
Held by rest of economy	1,058	...	...	2,352	...	...	4,921	...	...	2,959	...	...	2,993	...	...	4,568	...	...	6,908	...

Source: Central Bank of Uzbekistan.

1/ Based on weighted average auction prices.

2/ Introduced in March 1997.

3/ Since March 1997, based on weighted average auction prices.

4/ Since July 14, 1997, 91-day and 182-day T-bills are traded in the same secondary-market auction.

Table 32. Uzbekistan: Bank Interest Rates on Loans in Sums, 1996-98

(Weighted average, annual rate)

Maturity	1996	1997												1998		
	Dec.	Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
Short term 1/	38.5	35.1	23.2	27.4	32.9	33.7	28.1	30.9	35.9	29.0	35.2	33.1	29.3	34.1	...	..
Up to 30 days	32.4	41.8	12.7	39.6	41.0	41.6	15.9	43.1	44.9	38.6	40.4	36.7	34.8	37.6	39.0	40.5
31 to 60 days	...	...	...	41.2	41.6	44.7	30.7	37.1	34.3	38.3	40.8	36.9	35.5	33.5	36.2	37.9
61 to 90 days	...	...	...	26.9	33.8	33.4	29.5	29.2	27.9	23.3	37.0	30.4	31.6	32.9	37.3	38.5
91 to 180 days	43.4	48.4	43.8	33.2	44.8	42.0	35.6	32.3	39.9	42.2	42.5	32.0	27.5	38.4	30.1	39.3
181 to 365 days	49.7	40.6	39.8	16.4	26.7	29.8	32.2	30.0	39.7	28.3	29.9	32.4	28.0	33.3	31.9	35.5
Medium term 2/	...	...	...	15.9	43.3	14.2	22.8	16.1	26.8	20.2	22.2	22.0	17.7	15.6	...	...
1 to 2 years	...	...	...	34.9	47.4	38.0	15.1	37.5	27.0	32.8	37.4	35.2	33.4	33.5	29.6	20.6
2 to 3 years	...	...	...	20.8	12.8	4.8	8.6	8.6	30.2	8.0	20.5	15.9	12.5	7.8	21.6	14.5
3 to 4 years	...	...	...	11.6	12.5	32.5	36.1	26.1	32.9	20.9	36.8	30.5	15.3	...	28.8	27.5
4 to 5 years	...	...	...	14.9	7.2	16.5	32.3	29.7	22.6	22.5	12.0	13.1	17.7	21.8	28.3	24.5
Long term 3/	...	...	...	14.4	20.3	13.1	24.0	13.3	28.2	22.0	12.1	10.3	13.4	11.2	...	...
5 to 10 years	...	...	...	14.4	20.3	13.1	26.9	13.3	29.1	22.0	14.3	10.2	13.6	22.7	17.6	21.9
More than 10 years	...	...	...	7.5	7.5		7.5		17.5	17.5	2.7	33.1	5.8	17.5	12.5	12.5

Source: Central Bank of Uzbekistan.

1/ Weighted average of short term rates.

2/ Weighted average of medium term rates.

3/ Weighted average of long term rates.

Table 33. Uzbekistan: Bank Interest Rates on Deposits in Sums, 1996-98

(Weighted average, annual rate)

Type and Maturity	1996	1997												1998		
	Dec.	Jan.	Feb.	Mar.	Apr.	May.	Jun.	Jul.	Aug.	Sep.	Oct.	Nov.	Dec.	Jan.	Feb.	Mar.
Household deposits	28.0	21.6	29.1	14.0	18.0	14.0	17.5	14.6	18.1	18.2	10.9	11.8	14.8	10.8	...	...
Demand deposits	17.0	20.1	21.1	10.4	13.7	12.8	11.1	11.2	13.5	11.6	4.5	4.7	10.8	5.0	5.0	4.5
Savings deposits 1/	...	...	...	15.4	21.0	15.5	24.4	16.1	18.8	20.1	18.6	18.2	16.6	13.8	14.2	16.8
1 to 30 days	...	...	...	6.0	15.9	8.2	11.3	7.6	9.8	9.7	9.8	8.3	8.9	8.8	9.6	17.0
31 to 120 days	...	...	...	22.5	18.3	34.8	23.4	22.8	24.0	25.6	21.3	21.6	19.5	17.9	15.6	17.0
121 to 365 days	...	...	...	30.6	30.2	16.5	35.6	18.5	20.9	25.4	22.7	24.0	25.0	20.0	17.6	14.6
Over 1 year	...	...	...	20.0	22.6	38.9	30.5	12.3	32.7	36.0	23.6	17.6	27.9	36.8	37.9	32.7
Time deposits 2/	...	...	...	12.0	14.4	10.9	14.1	10.4	21.8	18.1	20.6	13.9	22.2	20.7	25.6	52.4
1 to 30 days	...	...	...	5.2	7.9	12.1	15.1	25.3	19.5	17.1	16.8	13.0	20.6	2.5	58.3	18.0
31 to 120 days	...	...	...	19.4	14.1	7.9	9.6	15.3	14.1	14.1	11.0	10.6	20.5	22.6	22.4	56.6
121 to 365 days	...	...	...	23.8	28.7	24.2	18.1	9.0	29.9	24.9	30.7	28.6	21.0	26.4	23.4	29.0
Over 1 year				35.1	26.7	34.8	43.4	38.2	38.7	36.6	13.3	9.4	32.7	17.7	17.7	21.5
Legal entities	10.9	12.2	10.8	9.7	11.1	4.3	5.6	4.9	3.8	5.8	5.4	5.3	7.2	5.8	...	...
Demand deposits	10.4	10.9	10.2	6.4	8.0	12.1	3.0	3.3	2.6	2.5	2.8	3.0	2.9	2.5	2.9	2.7
Savings deposits 1/	...	...	...	9.4	10.7	4.1	7.7	7.6	7.5	6.5	6.9	6.3	6.5	6.7	7.0	6.7
1 to 30 days	...	...	...	8.4	6.5	3.3	7.6	7.2	7.0	7.0	7.5	6.9	6.0	7.2	7.2	7.2
31 to 120 days	...	...	...	16.5	15.3	8.6	7.5	9.1	9.7	10.9	10.3	11.3	10.7	8.2	14.4	9.8
121 to 365 days	...	...	...	24.9	28.7	7.4	11.1	7.8	6.0	6.0	6.0	5.0	5.0	2.5	2.6	2.5
Over 1 year	...	...	...	16.5	19.4	18.9	17.5	17.5	16.7	18.0	...	...	17.5	2.5	2.5	2.5
Time deposits 2/	...	...	...	11.0	11.9	4.2	10.1	9.6	9.1	9.9	10.9	12.1	10.3	10.3	8.4	8.2
1 to 30 days	...	...	...	4.9	7.4	3.5	5.9	7.7	9.9	12.6	11.8	13.0	14.5	8.3	7.4	8.3
31 to 120 days	...	...	...	11.7	9.2	8.9	10.0	14.7	7.9	7.4	8.8	8.9	7.3	7.5	9.6	9.2
121 to 365 days	...	...	...	10.6	13.4	10.4	11.9	8.9	15.1	14.3	10.5	13.9	8.9	13.5	13.8	7.0
Over 1 year	...	...	...	25.9	30.8	9.0	10.4	9.3	9.7	29.7	29.4	23.0	13.8	7.9	8.6	8.1

Source: Central Bank of Uzbekistan.

1/ Weighted average of savings deposit rates.

2/ Weighted average of time deposit rates.

123. Commercial banks are authorized to receive deposits and make loans in foreign currencies. Although complete data series are not available, typical annual rates on deposits denominated in foreign currency in July 1997 were 14.3 percent for household deposits and about 4 percent for enterprise deposits. These rates were reduced to 4.3 and 1.6 percent, respectively, by January 1998. Typical interest rates on foreign currency-denominated loans ranged from 5-9 percent per annum in the second half of 1997.

The Banking Sector

124. As of April 1998, there were 31 **commercial banks** in Uzbekistan: two state banks (fully owned by the government), three state-owned joint-stock banks, 17 joint-stock commercial banks with capital participation of the government and state-owned enterprises, four joint ventures with foreign capital participation, four private banks, and one subsidiary of a foreign bank. Twenty-eight banks were licensed to carry out foreign currency transactions, but the bulk of foreign exchange transactions were conducted by the National Bank of Uzbekistan (NBU).

125. The NBU, which is government-owned and engages in a number of joint ventures with foreign banks, is the largest commercial banking institution in Uzbekistan. At the end of 1997, it accounted for nearly 70 percent of total commercial bank loans and about 70-80 percent of all transactions in foreign currency. Its dominant position is reinforced by the fact that Uzbekistan enterprises can hold no more than one bank account and operate with no more than one bank. However, enterprises are allowed to keep sum-denominated accounts in one bank and foreign currency holdings in another bank. Indications are that a large proportion of balances denominated in foreign currency are held with the NBU.

126. Development of commercial banking has been affected in Uzbekistan by direct government intervention in foreign exchange and financial markets. In addition to the rule limiting enterprises to one account, which seriously limits competition among banks, enterprise deposits can be withdrawn only for the payment of wages and travel expenses, in accordance with quarterly cash plans.[73] The most important commercial banks are controlled by the government and follow the credit policies set by the Republican Monetary Policy Commission, which gives priority to sectors in line with the agricultural and industrial policies of the government. In some cases, commercial banks have assumed an equity participation in nonbank enterprises; for example, Pakhtabank established a quartz processing enterprise in 1997. Foreign trade finance is mostly a domain of the NBU, and foreign investment in the banking area not related to the NBU is limited. Although there is no formal deposit insurance system in Uzbekistan, it is implicit for state banks. A case in point is the

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[73]This restriction does not apply for qualifying joint ventures with foreign capital participation.

retroactive indexation of saving deposits in the People's Bank in June 1995, with the state budget and the CBU paying for this indexation in installments through the year 2010.

127. In December 1997, **compulsory reserve requirements** at the central bank were reduced from 25 to 20 percent of deposits (for deposits over 3 years, the reserve requirements was kept at 10 percent). The liquidity impact of the measure was neutralized with the auctioning of treasury bills yielding interest 1.5-2 percentage points higher than the rates ordinarily paid in treasury bill auctions. This step resulted in an improvement in the income position of banks, since required reserves are not remunerated. Foreign currency deposits are not subjected to a reserve requirement at the CBU. During 1997, balances kept by commercial banks in correspondent accounts with the CBU exceeded by wide margins required reserves. This item includes free reserves, as well as balances deposited with the regional branches of the CBU to satisfy net liabilities that arise daily under the payments' settlement system.

128. In November 1996, the Board of the CBU adopted new **charts of accounts** for the CBU and the commercial banks. The new accounting system was introduced in March 1997 and has improved the quality of monetary statistics. However, commercial banks have experienced difficulty in using the new system, and only recently the new classification of accounts started to be introduced in the People's Bank. In addition, risk assessment, and the corresponding classification of loans in commercial banks' balance sheet, remains impaired by the fact that enterprises typically do not perform bookkeeping in accordance with internationally accepted accounting standards, and banks are inexperienced in risk assessment and risk management.

129. The **banking system** of Uzbekistan is characterized by a small number of relatively sophisticated banks (the NBU and some joint-venture and private banks) side by side with the successors of the former sectoral banks. This second group of banks is undercapitalized, has low-quality loan portfolios, and limited bank management skills. These problems are aggravated by (i) the absence of adequate legal instruments (bankruptcy procedures, assets sequestering, etc.) to protect the integrity of banks' assets, and (ii) the way banking activity is taxed (Box 9).

Box 9. How Banks are Taxed

In Uzbekistan, the profits of nonbank enterprises are liable to a 35 percent **profits tax**. Commercial banks also pay a 35 percent **income tax**, but they are overtaxed in two respects:

- the base of the tax on banks is not only profits, as under the profits tax, but **profits plus wages**; and
- provision for probable losses on bad debts are not tax deductible.

Conversely, banks can exclude from the base of the income tax the *gross* income derived from the holding of treasury bills. This makes treasury bills attractive to the banks, and helps to explain why banks keep in their portfolio about 75 percent of all treasury bills issued.

Banking Regulation and Supervision

130. In exercising banking supervision, the CBU relies on compulsory reserve requirements and **prudential ratios** (but not Basle ratios), against which banks are evaluated once a month. Although banks broadly conform to the CBU ratios, there remain serious weaknesses which are not apparent in the ratio matrix. The following are major drawbacks:

- Subjective assessments of portfolio quality are not made.
- Banks have not been required to make adequate risk assessment and on that basis provide for probable loan losses, and to recognize known losses. Also, there is no recognition of off-balance sheet commitments and contingencies.
- The quality of assets is significantly overstated as commercial banks routinely rollover most overdue loans instead of classifying them as in arrears.
- The capital of the large banks was paid in-kind, not in cash, raising questions about the market value of their assets. In addition, depreciation rates are low compared to international standards.
- Intangible assets and equity participation are fully counted as capital for purposes of the prudential ratios.
- There are no limits to a bank's lending to a client in relation to the borrower's capital.
- There are no rules precluding preferential access to credit by the shareholders of a commercial bank.

131. Banks' capital is likely to be seriously overvalued because risks and losses are underestimated, and thus the ratios are unreliable. Without a tradition of lending to small enterprises, banks tend to concentrate their loan portfolios in a limited number of large enterprises. This, together with the tradition of specializing the banking activity along sectoral lines, has prevented adequate risk diversification. Many commercial banks face serious solvency problems, being saddled with large number of nonperforming loans and having low net worth.

132. A resolution adopted by the CBU in August 1997 established a timetable, with quarterly floors, for commercial banks to reach a minimum paid-in capital of 2 million ECU (1 million ECU for rural and regional banks) by the year 2000. However, a presidential decree issued in April 1997 to stimulate the creation of private banks waived this minimum capital requirement for certain banks. Under this exemption, a number of small banks are in the process of organization.

133. In 1997, a regulatory framework was adopted by the CBU for the supervision of commercial banks, including procedures for the reorganization of commercial banks; requirements for reporting to the CBU; procedures for registration, licensing, and liquidation of banks; and penalties for violation of banking regulations. However, these regulations do not apply to the Association of Commercial Banks of Uzbekistan and the Business Fund.[74] A group of consultants started work in 1997 under the auspices of the World Bank and the Barents Group to advise the CBU on banking reform, with emphasis on banking supervision, rehabilitation, and banking legislation.

Financial Sector Development

134. Financial markets are still in the early stages of development in Uzbekistan. Until 1996, the only instruments available for the mobilization of savings were household saving accounts and term deposits at commercial banks. In March 1996, 91-day **treasury bills** were issued for the first time, and 182-day treasury bills started to be issued one year later. These bonds have no coupon and are sold at a discount in auctions held once a month by the Republican Currency Exchange (RCE).[75] The CBU services treasury bills as financial agent of the Ministry of Finance. As of April 1997 there were 14 banks authorized to operate in the

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[74]The Association of Commercial Banks is a trade association but performs a variety of financial and nonfinancial operations directly or through affiliated institutions. During 1996 and 1997, 50 percent (20 percent in the second half of 1997) of the income tax levied on banks was earmarked for the Association. The Business Fund receives 40 percent of the proceeds from privatization of state-owned enterprises and provides soft credit to some industries and sectors in a nontransparent manner.

[75]Typically a minimum price is set and bids either coincide with, or border on, this minimum.

bond auction as dealers on their own account and on behalf of their clients. A secondary market developed which created a degree of liquidity for these securities; secondary market auctions are held by the RCE four times a week, and both maturities are traded in the same auction. However, market penetration of treasury bills is still limited, with only 25 percent of the outstanding stock (or less than 1 percent of GDP) being held by the nonbank public in June 1998. This is due, inter alia, to (i) low yields compared to inflation and the high return on holding U.S. dollar bank notes; (ii) the lack of permission for the banks to sell the bonds to the public outside the auction; and (iii) the nonexistence of repurchase agreement operations (repo) operations between banks and the public, based on treasury bills in banks' portfolios.

135. Since late 1997, the CBU has been working on the development of repos, to be used in the future for purposes of liquidity management. The first repo operations were undertaken in January 1998, for periods not exceeding 15 days, at the CBU refinance rate, and on the basis of treasury bills. They were sought by banks as an alternative to the provision of liquidity under the more costly emergency facility. The CBU has also started preparations for the establishment of a Lombard window and an interbank money market based on CBU deposit certificates. The Lombard facility will consist of access by banks to central bank loans with a maturity of up to 3 months, with interest similar to the refinance rate, with the bank's liquid assets being used as collateral.

D. External Trade and Payments and the Exchange System

Balance of Payments—Main Developments

136. Balance of payments developments over recent years reflected in large part the authorities' emphasis on industrialization, development of import-substituting and targeted export-oriented industries, and diversification of domestic production. These efforts have resulted in a steady rise in the volume of imported capital goods and, since mid-1996, the compression of nonfood consumer goods imports through administrative measures. This trend, combined with unusually high food imports (mainly grains) turned a small external current account deficit of 0.2 percent of GDP in 1995 into a deficit of over 7 percent of GDP in 1996. In response to lower cotton prices and a disappointing cotton harvest in 1996, the authorities increased control over trade and foreign exchange from mid-1996 onward. As a result of the import compression, the trade deficit was nearly eliminated in 1997 despite only a modest increase in exports. Although the service account deteriorated because of increased net payments for transportation services and interest on external credits, the current account deficit declined to 4 percent of GDP in 1997. Net capital inflows were less than in 1996 because of smaller external credit disbursements and larger repayments. The overall capital flows were, however, dominated by the large swing in "errors and omissions," possibly reflecting reduction in short-term trade financing, increased capital flight, and unrecorded imports. Gross official foreign exchange reserves declined in 1997 by more than one-third or US$734 million, of which about US$240 million was due to revaluation of the gold stock

because of the decline in gold prices. The remainder of the loss corresponded to the financing of the balance of payments deficit. There was a further decline in official reserves during the first half of 1998 of US$136 million.

Merchandise Trade

137. In 1997 the trade balance narrowed to a deficit of 0.5 percent of GDP after a deficit of 5 percent of GDP in 1996 (Table 34), as exports grew by 3 percent in U.S. dollar terms, despite a fall in traditional exports receipts. Cotton exports decreased by 10 percent as a result of the poor 1996 harvest. Revenues from gold exports suffered mainly because of the timing of sales, as most sales took place after the fall in world gold prices began in June 1997. By contrast, energy exports, which had declined in 1996, recovered largely because of the improved payments capabilities of the neighboring importers of Uzbekistan's natural gas. The growth in overall exports was spurred by a 28 percent increase in "other exports," of which US$133 million was on account of exports of Daewoo cars. Since, however, car production is import intensive and many cars were sold domestically, the net effect of car production on the trade balance is limited.

138. The improvements in the trade and the current account balances in 1997 were largely driven by import compression—totaling 11 percent in dollar terms, as a result of foreign exchange and trade restrictions mainly on consumer goods, including foodstuffs. In particular, wheat imports declined from US$454 million in 1996 to US$157 million because of reduced volume, but also due to lower import prices.[76] Energy imports in 1997 declined from an already low level in 1996, as Uzbekistan became a net exporter of energy (Tables 35 and 36). Machinery imports grew by 21 percent in 1997, due partly to an increase of imports of component parts for car assembly by Daewoo as well as airplane imports worth US$180 million. Other imports decreased by 22 percent due to the tightening of restrictions.

Developments in Trade with Traditional and Nontraditional Trading Partner Countries

139. After the share of trade with Baltics, Russia, and other former states of the Soviet Union (BRO) had declined from 56 percent in 1993 to 28 percent in 1996, it increased to 32 percent in 1997 (Tables 37 and 38). Exports to traditional trading partners increased by 50 percent in U.S. dollars terms, corresponding to increases in all major export categories. This was due to the rise in the volume of cotton exports by 47 percent, exports of cars (for the first time), and the recovery of natural gas exports to their pre-1996 levels. At the same time, all categories of imports from traditional partners decreased, resulting in a 25 percent decline in value, in particular due to the fall in imports of food products, consumer goods, and machinery. Overall, the balance of trade with traditional trading partners improved from a

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[76]The value of imports in 1996 was unusually high (twice the 1995 level) due to stock building at the time of high world prices of wheat for reasons which are not fully understood.

Table 34. Uzbekistan: Balance of Payments, 1992-1997

(In millions of U.S. dollars)

	1992	1993	1994	1995	1996	1997
Current account	-236	-429	119	-21	-980	-584
Merchandise trade balance	-234	-378	214	237	-706	-72
Exports	1,424	2,877	2,940	3,475	3,534	3,695
Cotton fiber	861	1,172	1,508	1,584	1,539	1,390
Gold	...	559	375	611	906	738
Energy	...	...	...	436	277	528
Other	565	1,147	1,057	844	813	1,039
Imports	-1,658	-3,255	-2,726	-3,238	-4,240	-3,767
Foodstuff	-716	-625	-861	-618	-1,252	-786
Energy products	-315	-658	-674	-53	-45	-23
Machinery	...	...	...	-1,151	-1,542	-1,868
Other	-627	-1,973	-1,190	-1,415	-1,402	-1,091
Services, net	-4	-63	-107	-277	-272	-540
Shipment and transportation	8	-49	-62	-218	-165	-348
Travel	-1	1	-2	8	--	26
Interest	-11	-19	-22	-26	-73	-175
Other	--	4	-21	-41	-33	-44
Transfers	2	12	13	19	-2	29
Financial and capital account	224	858	-64	255	634	288
Direct investment, net 1/	9	48	73	-24	90	167
Loans						
Drawings	135	548	326	1,054	679	558
Repayments	-20	-166	-276	-563	-214	-362
Commercial banks	-96	-53	-91	-3	-1	432
Other capital	-161	9	-70	-209	80	-507
Errors and omissions	542	58	244	197	296	-185
Overall balance	530	487	299	431	-50	-480
Financing	-530	-487	-298	-431	50	480
Gross reserves (increase-)	-530	-492	-309	-578	-33	480
IMF transactions	--	--	--	158	83	--
Arrears	--	5	11	-11	--	--
Memorandum items:						
Current account balance						
In percent of GDP	-11.7	-7.8	2.1	-0.2	-7.2	-4.0
Gross official reserves	79	1,022	1,330	1,867	1,901	1,167
In months of imports	0.6	3.8	5.9	6.9	5.4	3.7
Price of cotton exports (US dollars/ton)	...	...	...	1,754	1,592	1,582
Price of wheat imports (US dollars/ton)	...	...	...	153	251	223
World gold price (US dollars/ounce)	343	360	384	384	388	331

Sources: Ministry of Finance; Ministry of Macroeconomics and Statistics; and Fund staff estimates.

1/ FDI in 1995 is negative due to one time large investment of an Uzbek insurance company abroad.

Table 35. Uzbekistan: Crude Oil and Oil Products Energy Balance, 1993-97

	1993	1994	1995	1996	1997
	(In thousands of tons)				
Domestic crude oil extraction	3,943.6	5,516.7	7,586.2	7,621.4	7,891.0
Oil and oil product imports	4,763.3	3,186.7	167.0	4.5	4.0
Crude oil	4,106.0	3,052.7	150.5	4.5	4.0
Gasoline	295.0	95.9	7.5	--	--
Diesel oil	354.0	38.1	9.0	--	--
Heavy oil	8.3	--	--	--	--
Oil and oil product exports	506.3	535.2	339.5	451.9	1,190.0
Crude oil	397.0	271.4	160.9	288.6	912.0
Gasoline	30.0	5.6	25.1	39.0	29.0
Diesel fuel	36.3	13.2	12.8	61.2	245.0
Heavy oil	43.0	245.0	140.7	63.1	4.0
Refinery losses	234.0	208.0	182.0	182.0	181.3
Domestic consumption of oil products	7,966.6	7,960.2	7,231.7	6,992.0	6,523.7
	(In percentage change over previous year)				
Domestic crude oil extraction	19.8	39.9	37.5	0.5	4.0
Domestic oil product consumption	-1.1	-0.1	-9.2	-3.3	-6.7
	(In thousands of tons)				
Net oil and oil product imports	4,257.0	2,651.5	-172.5	-447.4	-1,186.0
Of which					
Crude oil	3,709.0	2,781.3	-10.4	-284.1	-908.0
From former U.S.S.R.	3,898.0	2,781.3	-4.3	-4.5	...
From other countries	-189.0	--	-6.1	-279.6	...
Oil products	548.0	-129.8	-162.1	-163.3	-278.0

Source: Ministry of Macroeconomics and Statistics.

Table 36. Uzbekistan: Non-Oil Energy Balances, 1993-97

	1993	1994	1995	1996	1997
Natural Gas		(In millions of cubic meters)			
Domestic extraction	45,034	47,181	48,558	48,977	51,245
Exports	7,238	4,637	4,199	4,911	9,897
Imports	5,828	1,836	--	--	2,760
Stockbuilding and losses	4,956	3,961	4,257	4,786	158
Domestic consumption 1/	38,668	40,419	40,102	39,280	44,266
Coal		(In thousands of tons)			
Domestic extraction	3,807	3,845	3,054	2,837	2,947
Exports	137	81	81	78	30
Imports	674	129	11	12	27
Domestic consumption 1/	4,344	3,893	2,983	2,771	2,792
Electricity		(In millions of kilowatt hours)			
Domestic production	49,148	47,755	47,453	45,420	46,056
Exports	1,080	2,800	2,514	1,068	11,488
Imports	788	1,440	1,222	2,160	12,417
Domestic consumption 1/	48,856	46,395	46,161	46,512	46,985

Source: Ministry of Macroeconomics and Statistics.

1/ Calculated as domestic sources plus imports minus exports minus stockbuilding minus losses.

Table 37. Uzbekistan: Total Trade with Traditional Trading Partners, 1992-97 1/

	Exports					Imports				
	1993 2/	1994	1995	1996	1997	1993 2/	1994	1995	1996	1997
	In millions of U.S. dollars					In millions of U.S. dollars				
Total trade 3/	1,522.0	1,683.5	1,690.1	1,050.6	1,508.7	1,207.2	1,657.4	1,793.8	1723.4	1,268.2
Industry, including:	1,386.0	1,518.3	1,386.4	783.0	1,333.7	1,067.0	1,232.6	1,325.5	1,398.5	1,032.6
Electric power	45.7	253.9	90.5	...	...	8.0	215.4	16.5	...	...
Oil and gas industry	192.3	341.8	256.0	254.0	482.6	453.0	431.8	16.4	19.4	12.6
Coal industry	1.5	1.3	1.5	1.1	...	25.8	1.1	0.3	1.1	...
Other fuel	191.0	102.9	75.3	0.1	...	91.9	25.4	19.4	3.1	...
Ferrous metallurgy	13.8	8.0	20.3	13.8	7.2	139.9	126.8	201.1	219.7	223.5
Nonferrous metallurgy	75.7	65.5	39.3	22.8	47.5	33.5	32.2	22.1	31.3	13.2
Chemical and petrochemical industry	61.1	45.5	65.6	43.1	76.3	83.0	79.5	243.5	246.0	222.6
Machine building and metal working	111.3	85.6	100.0	63.9	206.6	63.0	71.8	521.8	505.1	401.5
Forestry, paper and pulp industy	2.5	0.7	1.0	0.5	0.8	32.3	68.6	71.2	78.6	43.1
Construction materials industry	6.9	14.2	19.9	11.6	17.6	16.3	30.0	50.0	36.0	23.6
Light industry	640.2	565.1	590.0	227.4	335.4	48.3	45.4	52.8	25.1	17.9
Food industry	43.2	31.8	97.2	92.2	154.9	68.7	58.0	99.3	108.4	62.7
Other branches of industry	0.8	2.2	30.0	52.5	4.8	3.2	46.8	11.2	124.7	11.9
Agriculture	23.2	32.6	130.7	107.2	4.1	50.8	183.9	83.2	119.2	106
Other activities 4/	112.8	132.6	173.1	160.4	170.9	89.5	240.9	385.1	205.7	129.6

Source: Ministry of Macroeconomics and Statistics.

1/ Traditional trading partners include the Baltic countries, Russia and other countries of the former U.S.S.R.
2/ In billions of rubles.
3/ Export and import figures do not reflect adjustments for service transactions, and for exports and imports not included in trade data, as well as other adjustments..
4/ Includes unclassified items. Derived residually.

Table 38. Uzbekistan: Total Trade with Nontraditional Trading Partners, 1993-97

(In millions of U.S. dollars)

	Exports					Imports				
	1993	1994	1995	1996	1997	1993	1994	1995	1996	1997
Total trade 1/	873	943	1677	2278	1852	975	1187	1809	3195	3255
Machinery, equipment, and transport facilities	103	66	8	66	73	161	331	784	1184	1690
Fuel, mineral raw materials, and metals	72	47	136	146	160	33	67	39	136	116
Chemical products, fertilizers, and rubber	39	26	42	67	31	82	59	179	344	349
Raw materials and processed industrial products (cotton included)	586	794	1467	1652	1379	26	26	46	93	--
Foodstuffs	2	6	21	6	7	612	620	506	1132	705
Industrial consumer goods	4	2	2	1	12	51	83	211	254	188
Other products	68	2	1	340	190	11	3	45	52	208

Source: Ministry of Macroeconomics and Statistics.

1/ Exports and imports exclude special exports (i.e., gold) and imports not included in trade data.

deficit of over US$600 million in 1996 to a surplus of US$200 million in 1997. Russia, Ukraine, and Kazakhstan were the main trading partners, jointly accounting for over 80 percent of the value of trade (Table 39).

140. After a gradual increase since 1993, the value of exports to nontraditional partner countries decreased by almost 20 percent in 1997 compared with its 1996 level (Table 40). This was the result of a 14 percent fall in the volume of cotton exports, while the unit prices remained stable, and a decrease in "other exports." Imports increased marginally in nominal terms. The fall in food and consumer products was offset by a 40 percent increase in imports of machinery and airplanes. Industrial countries, in particular in Europe, had the largest share in trade.

External Credits and Debt

141. Disbursements of external credits continued to decline from their peak of over US$1 billion in 1995 to US$581 million in 1997. Investment credits comprised the largest share of total new credits (95 percent), remaining broadly constant in nominal terms. The average maturity lengthened as long-term credits accounted for almost 80 percent of the total, with the balance being medium-term loans. As in 1996, no short-term disbursements were recorded, but there may have been some prefinancing of cotton exports. The composition of creditors changed substantially compared to previous years, with a marked shift to new commercial bank and trade credits, which accounted for 74 percent of the total value, while bilateral credits amounted to 23 percent and multilateral disbursements declined to only 3 percent of the total.

142. The stock of external debt reached US$2.6 billion in 1997, or 65 percent of exports of goods and services (Box 10). As a share of GDP, total debt increased about 1 percentage point to 18 percent. The average maturity of the debt lengthened. Although debt owed to commercial banks grew rapidly, official bilateral debt continued to comprise the largest portion (46 percent) of the overall stock. In contrast, debt to multilateral institutions and suppliers declined in nominal terms for the first time since independence. Total debt service as a share of exports of goods and services increased from 9 percent in 1996 to 14 percent in 1997, but remained below its 1995 level of 17 percent. Interest payments in 1997 grew in nominal terms with the growth of the stock of debt, whereas the amortization payments increased partly because of a one-time repayment to the European Union of US$77 million.

Table 39. Uzbekistan: Direction of Trade with Traditional Trading Partners, 1993-97 1/

	Exports					Imports				
	1993 3/	1994	1995	1996	1997	1993 3/	1994	1995	1996	1997
	In millions of U.S.dollars					In millions of U.S.dollars				
All countries 2/	1,522	1,683	1,690	1,051	1,526	1,207	1,657	1,794	1,723	1,360
Russian Federation	844.0	778.8	902.1	531.6	836.4	711.2	1,005.1	1,057.4	1,127.1	771.2
Ukraine	116.1	43.5	69.1	35.7	199.9	77.9	42.8	142.6	187.9	121.8
Belarus	47.6	21.6	42.8	31.5	15.3	25.7	8.5	64.4	79.3	29.0
Estonia	0.9	0.5	--	--	0.9	0.7	0.2	--	--	14.7
Latvia	1.5	6.6	--	--	10.6	6.5	6.5	--	--	43.6
Lithuania	11.8	16.1	--	--	6.0	3.6	7.7	--	--	33.9
Armenia	0.5	--	0.2	--	0.2	0.4	0.1	0.4	--	0.2
Azerbaijan	3.8	1.2	6.1	3.2	3.1	2.4	0.6	6.0	5.2	20.4
Kazakstan	257.1	311.8	271.5	119.8	197.7	207.4	208.1	303.1	251.6	196.3
Georgia	1.0	0.4	1.9	--	1.4	0.9	0.3	1.6	3.4	14.9
Moldova	3.6	1.4	2.9	2.1	1.2	1.0	0.6	4.0	3.4	7.6
Kyrgyz Republic	42.3	102.0	78.0	84.0	54.4	17.9	67.8	52.3	20.7	19.2
Tajikistan	91.8	225.3	162.7	68.3	106.4	15.3	164.9	71.3	25.9	63.6
Turkmenistan	100.2	174.3	152.8	174.4	92.8	136.2	144.2	90.7	19.0	24.0
	In percent of total									
Russian Federation	55.5	46.3	53.4	50.6	54.8	58.9	60.6	58.9	65.4	56.7
Ukraine	7.6	2.6	4.1	3.4	13.1	6.5	2.6	7.9	10.9	9.0
Belarus	3.1	1.3	2.5	3.0	1.0	2.1	0.5	3.6	4.6	2.1
Estonia	0.1	--	--	--	0.1	0.1	--	--	--	1.1
Latvia	0.1	0.4	--	--	0.7	0.5	0.4	--	--	3.2
Lithuania	0.8	1.0	--	--	0.4	0.3	0.5	--	--	2.5
Armenia	--	--	--	--	0.0	--	--	--	--	0.0
Azerbaijan	0.2	0.1	0.4	0.3	0.2	0.2	--	0.3	0.3	1.5
Kazakstan	16.9	18.5	16.1	11.4	13.0	17.2	12.6	16.9	14.6	14.4
Georgia	0.1	--	0.1	--	0.1	0.1	--	0.1	0.2	1.1
Moldova	0.2	0.1	0.2	0.2	0.1	0.1	--	0.2	0.2	0.6
Kyrgyz Republic	2.8	6.1	4.6	8.0	3.6	1.5	4.1	2.9	1.2	1.4
Tajikistan	6.0	13.4	9.6	6.5	7.0	1.3	9.9	4.0	1.5	4.7
Turkmenistan	6.6	10.4	9.0	16.6	6.1	11.3	8.7	5.1	1.1	1.8
	In percent of total									
Memorandum items:										
Russia and Ukraine	63.1	48.8	57.5	54.0	67.9	65.4	63.2	66.9	76.3	65.6
Baltic countries	0.9	1.3	--	--	1.1	0.9	0.9	--	--	6.8
Central Asian countries	32.3	48.3	39.3	42.5	29.6	31.2	35.3	28.8	18.4	22.3
Other countries	3.7	1.4	3.2	3.5	1.4	2.5	0.5	4.2	5.3	5.3

Source: Ministry of Macroeconomics and Statistics.

1/ Traditional trading partners include the Baltic countries, Russia and other countries of the former U.S.S.R.

2/ Export and import figures do not reflect adjustments for service transactions, and for exports and imports not included in the trade data, as well as other adjustments.

Table 40. Uzbekistan: Direction of Trade with Nontraditional Trading Partners, 1993-97 1/

	Exports					Imports				
	1993	1994	1995	1996	1997	1993	1994	1995	1996	1997
	(In millions of U.S. dollars)									
Total trade 2/	919.3	1,006.3	1,791.7	2,277.6	2,878.9	980.9	1,193.1	1,919.4	3,195.0	3,254.8
Current and former socialist countries 3/	195.1	115.6	91.8	184.6	164.7	112.0	192.4	278.9	178.7	220.0
Of which										
Asia	138.4	80.0	36.7	133.1	91.1	37.6	90.2	50.8	49.0	82.8
Europe	56.7	35.6	55.1	51.5	73.6	74.4	102.2	228.1	129.7	137.2
Industrial countries	449.5	710.7	1,002.4	1,521.9	1,298.4	567.7	818.0	841.0	1,650.4	1,552.1
Of which										
Asia	18.9	5.2	1.6	52.7	12.9	41.2	48.0	1.1	415.0	47.3
Europe	386.0	684.8	988.3	1,186.1	1,246.2	494.7	668.5	661.5	780.0	1,153.9
Western Hemisphere	44.6	20.7	12.5	283.1	39.3	31.8	101.5	178.4	455.3	350.9
Developing countries	184.2	158.9	312.3	426.4	347.5	298.9	142.9	523.0	1,164.7	538.9
Of which										
Asia	126.7	95.6	182.9	304.3	323.5	61.8	66.8	131.4	433.1	403.7
Europe	41.9	43.0	112.7	78.7	--	228.6	67.9	194.4	381.2	--
Middle East	15.6	20.3	16.7	39.9	23.6	8.5	8.2	196.9	309.7	113.6
Western Hemisphere	--	--	--	3.5	0.4	--	--	0.3	40.8	21.6
Other countries 4/	90.5	21.1	385.2	144.6	1,068.3	2.4	39.8	276.5	201.2	943.8
	(In percent of total)									
Current and former socialist countries 3/	21.2	11.5	5.1	8.1	5.7	11.4	16.1	14.5	5.6	6.8
Of which										
Asia	15.1	7.9	2.0	5.8	3.2	3.8	7.6	2.6	1.5	2.5
Europe	6.2	3.5	3.1	2.3	2.6	7.6	8.6	11.9	4.1	4.2
Industrial countries	48.9	70.6	55.9	66.8	45.1	57.9	68.6	43.8	51.7	47.7
Of which										
Asia	2.1	0.5	0.1	2.3	0.4	4.2	4.0	0.1	13.0	1.5
Europe	42.0	68.1	55.2	52.1	43.3	50.4	56.0	34.5	24.4	35.5
Western Hemisphere	4.9	2.1	0.7	12.4	1.4	3.2	8.5	9.3	14.3	10.8
Developing countries	20.0	15.8	17.4	18.7	12.1	30.5	12.0	27.2	36.5	16.6
Of which										
Asia	13.8	9.5	10.2	13.4	11.2	6.3	5.6	6.8	13.6	12.4
Europe	4.6	4.3	6.3	3.5	0.0	23.3	5.7	10.1	11.9	0.0
Middle East	1.7	2.0	0.9	1.8	0.8	0.9	0.7	10.3	9.7	3.5
Western Hemisphere	--	--	--	--	--	--	--	--	--	--
Other countries 4/	9.8	2.1	21.5	6.4	37.1	0.2	3.3	14.4	6.3	29.0

Source: Ministry of Macroeconomics and Statistis.

1/ Countries other than the Baltic Countries, Russia and other Countries of the former U.S.S.R.

2/ Exports and imports include service transactions and exclude special exports and imports and other exports and imports not included in trade data.

3/ Bulgaria, China, Czechoslovakia, Hungary, North Korea, Mongolia, Poland, Romania, Vietnam, and Yugoslavia.

4/ Not included elsewhere.

Box 10. Outstanding External Debt by Creditor
(In millions of U.S. dollars)

Type of Creditor	1992	1993	1994	1995	1996	1997
Multilateral	--	--	5	409	519	452
Bilateral	34	781	757	858	1,126	1,206
Commercial Banks	28	118	178	170	339	635
Suppliers	--	140	167	334	345	301
Total	62	1,039	1,107	1,781	2,330	2,594

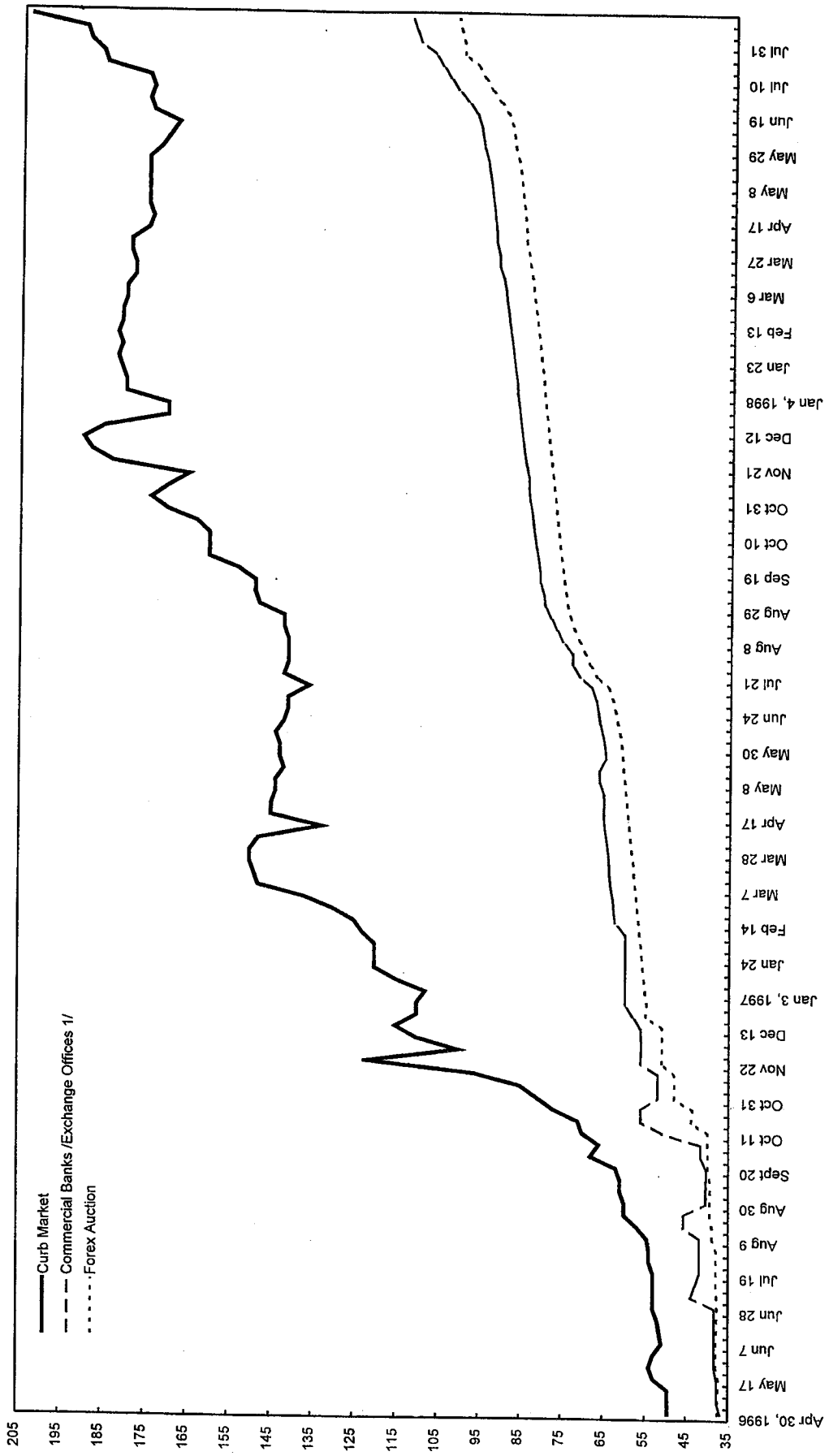
Source: Ministry of Finance.

Exchange Rate Policy Management

143. Since the introduction of the currency in 1994, the authorities have followed a managed-float exchange rate system by gradually depreciating the auction exchange rate. In the course of 1997, the currency depreciated by 46 percent compared to 55 percent in 1996. The real exchange rate depreciated by 12.5 percent based on the officially recorded inflation. The nominal exchange rate depreciation during the first five months of 1998 remained at about 2 percent a month, but accelerated to over 6 percent a month in June and July.

144. As the commercial bank and the cash rates in the exchange bureaus were administratively tied to the auction rate, their movement closely followed changes in the auction exchange rate. In 1997 and the first half of 1998, the spread between the auction and the cash exchange rate stayed within the 12 percent permissible margin. The margin between the auction rate and the curb market exchange rate widened at the end of 1996 due to a tightening of foreign exchange restrictions and fragmentation of the exchange system. During 1997 and the first five months of 1998 this spread remained well above 100 percent, but narrowed to about 90 percent in June and July with the faster depreciation of the auction exchange rate (Figure 11).

Figure 11. Uzbekistan: Nominal Exchange Rates, April 30, 1996 - August 17, 1998
(In sum per U.S. dollar)



Source: Central Bank of Uzbekistan.

1/ Since January 1, 1997, the cash rate coincides with the commercial bank rate.

Trade System

145. Following progress in trade liberalization in 1995 and the first half of 1996, policy reversals occurred in late 1996 with the introduction of ex-ante registration of import contracts as well as higher and additional import tariffs in response to a deteriorating balance of payments situation. Developments in 1997 and in early 1998 remained mixed. There was some, albeit limited, progress in the liberalization of exports. However, on the import side restrictions were further tightened. The direct involvement of the state in international trade continued to be extensive even by standards of transition economies. All cotton and gold exports, accounting for almost 60 percent of total exports in 1997, continue to be channeled through official marketing mechanisms.

146. Export licenses have been abolished for cotton, ferrous and nonferrous metals, and oil. They continue to apply to precious metals and stones, ores, arms and military equipment, uranium and radioactive substances and products, and instruments and equipment using radioactive substances. Export taxes were, in principle, eliminated as of January 1, 1998. However, the 50 percent excise tax on selected exports, introduced in 1996,[77] was extended in September 1997 to alcoholic and nonalcoholic beverages, waters and mineral waters, construction materials and cigarettes exported by intermediary or trading companies. In December 1997, an excise tax of ECU 3,000 per cubic liter of engine size was applied to exports of cars produced by the joint venture company UzDaeWoo. Export bans, already applied to cereals and bread products, flour, livestock and poultry, meats, powdered milk, tea, antiques and raw hides, were extended to sugar and ethyl alcohol in October 1997. A 15 percent prepayment requirement remains in effect for all exports with the exception of exports for hard currency from an enterprise's own production.

147. During 1997 and early 1998, barriers to imports were raised considerably (Box 11). While the maximum tariff rate (excluding cars) remains at 30 percent, overall import tariffs increased substantially in October 1997 and further in February 1998. As a result, the unweighted average tariff rate (excluding cars) increased from 17 percent in October 1996 to 28 percent in February 1998. While most consumer goods became subject to a 30 percent tariff rate, investment goods face very low tariffs and individual enterprises are often granted tariff exemptions. The minimum tariff rate was raised from 1 percent to 3 percent rate. In addition to basic import duties, excise taxes on imports, ranging from 5 percent to 35 percent, continue to be in effect. Previously levied on six groups of consumer products and cars, these excise taxes were extended to a further 20 groups of commodities in February 1998. This effectively raised the unweighted average import tariff (defined as the basic import tariff plus the excise tax on imports) to 36 percent. Special regulations apply to imports of alcohol.

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[77]A 50 percent excise tax initially applied to 10 categories of electronic home appliances and a 25 percent rate to all other reexports. Producers exporting their own production for hard currency were exempt.

Box 11. Uzbekistan: Import Tariff Regime

	Jul. 95	Mar. 96	Oct.96	Oct. 97	Feb. 98
			Summary of import duties (In percent)		
Average rate (excl. cars)	14	12	17	28	28
Average rate (incl. cars)	18	16	21	29	29
Maximum rate (excl. cars)	50	40	30	30	30
Maximum rate (incl. cars)	100	100	100	100	100
Number of bands (excl. cars)	6	4	5	6	6
Number of bands (incl. cars)	10	9	10	11	11
Tariff rate			Number of items within each band[1]		
1 (minimum tariff)	...	...	all other	--	--
3 (minimum tariff)	...	...	--	all other	all other
5	17 (0)	17 (0)	12 (1)	4 (0)	4 (0)
10	20 (2)	25 (2)	25 (2)	4 (0)	4 (0)
15	3 (0)	0 (0)	0 (0)	1 (0)	1 (0)
20	10 (0)	8 (1)	20 (1)	6 (0)	10 (0)
30	2 (2)	2 (2)	28 (2)	81 (6)	82 (6)
40	2 (1)	2 (1)	1 (1)	1 (1)	1 (1)
45	1 (1)	1 (1)	1 (1)	1 (1)	1 (1)
50	4 (2)	2 (2)	2 (2)	1 (1)	1 (1)
60	2 (2)	1 (1)	1 (1)	2 (2)	2 (2)
100	1 (1)	1 (1)	1 (1)	1 (1)	1 (1)
Total	62 (11)	59 (11)	91 (12)	102 (12)	107(12)

1/ Of which, the number corresponding to cars is indicated within parentheses.
Source: Ministry of Foreign Economic Affairs

Since July 1997, excise stamps were introduced for alcoholic beverages and tobacco products and a 10 percent excise on imported alcoholic beverages was introduced. This tax was increased to 75 percent later in 1997 and to 90 percent as of July 1, 1998.

148. Additional changes in import regulations took place in early 1998. The tariff rate on individual imports above the duty free limit was increased from 15 to 20 percent and a customs duty of 50 percent was introduced on shuttle trade and goods shipped to physical persons.

149. Securing approval of individual import contracts has been difficult or impossible especially for consumer and luxury goods in 1997 and 1998. A requirement for ex-ante registration of import contracts with the Ministry of Foreign Economic Relations (MFER) was introduced in late 1996 as a measure to regulate imports. In February 1998, this requirement was abolished for imports covered by importers' own foreign exchange resources, but continues to apply to all other imports. Without registration, importers are not eligible to purchase foreign exchange from official sources and imports are unable to clear

customs. Preshipment inspection was introduced as an alternative to ex-ante registration of import contracts in October 1997, albeit for a fee. Once an inspection agency approves the contract, registration with the MFER is to be automatic. Currently, 12 agencies conduct independent reviews of import contracts to check on quantity, quality, and the price of imported goods, as well as on other contract provisions. Six of the existing companies are joint ventures with foreign firms.

150. The state's involvement in import procurement has intensified since August 1997. The Ministry of Finance was granted the authority to establish limits on imports of basic food products for 1998, and foreign exchange is to be allocated primarily for goods that are not sufficiently available or not produced in the country, mainly wheat and sugar. A state agency (Uzbektenderconsulting) has been set up to organize tenders for food imports for state distribution, with the objective of reducing the costs of food imports for the state. The agency selects the firms which are allowed to bid in the tender. Successful bidders are eligible to obtain foreign exchange directly from the auction at the favorable official exchange rate. Thus, tenders have become another form of allocating import permits and foreign exchange.

151. The restrictions and taxes listed above do not apply uniformly across all enterprises. Enterprises with foreign investment and firms exporting goods of their own production for hard currency enjoy substantial privileges (see Box 12). In addition, exemptions are granted on an ad hoc basis to individual enterprises, especially to those involved in agriculture or gold mining.

Foreign Exchange System—The Present System

152. Since January 1, 1997 the foreign exchange system in Uzbekistan has been characterized by the existence of three legal exchange markets—auction, commercial bank and foreign exchange bureaus—where different exchange rates prevail (Table 41).[78] The government intervenes in each market by controlling the supply and demand for foreign exchange and by setting the exchange rate. The official exchange rate, computed as a weighted average of the previous week's auction and commercial bank rates, plus a discretionary component, is used primarily for accounting purposes.[79] In addition, there are illegal curb markets for cash and noncash transactions.

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[78]The commercial bank market is also referred to as the "out-of-exchange" or the "interbank" market.

[79]The weights are based on the volume of transactions in the auction and commercial bank markets.

Table 41. Uzbekistan: Foreign Exchange Markets and Rates as of July 31, 1998 1/

Exchange rate	Rate (sums per US$)	How the rate is determined	Sources of foreign exchange	Uses to which the rate applies	Size of market
Auction rate	100.32	In principle, market-determined but de facto a non-market clearing rate managed by the central bank 2/	Use of central bank reserves and compulsorily surrendered foreign exchange from centralized exports at the auction rate 3/ 4/	Primarily, imports of capital goods, raw materials; government purchases, servicing of external debt, official or government guaranteed 5/ 6/ 7/	Most important market segment
Official exchange rate	100.24	Weighted average of the auction rates and the commercial bank rates in the previous week 8/		Central bank purchases of gold from producers; calculation of customs duties; and for accounting purposes	
Commercial bank rate	112.36	In principle, freely determined at interbank market, de facto a non-market clearing rate managed by the central bank	(1) Banks' purchases from the central bank (possibly small); 9/ (2) surrender from nontraditional exports; (3) voluntary sales of foreign exchange by exporters (possibly small); (4) sales by firms, to settle tax and other payments (significant according to NBU)	Priority consumer goods especially, but not solely, by priority importers (e.g. large supermarkets)	Estimated by the staff at 15 percent; declining in importance since early 1998
Exchange bureau cash rate	114.05	In principle, freely set by commercial banks which own the bureaus, de facto a non-market clearing rate managed by the central bank	(1) Purchases from the CBU 9/ (2) cash purchases from the public (limited); (3) commercial banks' own resources	(1) Cash needs for (limited) invisible transactions; (2) cash for resale at illegal cash market	Small
Curb cash rate (illegal)	189.00	Market determined	(1) Cash acquired in the official cash market; (2) proceeds from under-invoicing of imports; (3) sales by visitors/returning residents; (4) hard currency earnings/savings of residents; (5) unrecorded border exports	Merchandise imports (mainly consumer goods) and invisible transactions for which cash foreign exchange is unavailable or difficult to obtain through official channels, and capital flight	Estimated at 8 percent by the Ministry of Macroeconomics and Statistics
Curb noncash rate (illegal)	At times significantly more depreciated than the curb cash rate	Market determined; discount to illegal cash rate is believed to reflect restrictions on withdrawals of domestic cash from bank accounts	Nonrepatriated proceeds of unrecorded or underinvoiced exports, as well as foreign exchange acquired by overinvoicing imports.	Imports for which there is insufficient access to foreign exchange through official channels (importers arrange for foreign exchange holders to import goods on their behalf)	Unknown, possibly substantial

Sources: Information provided by the authorities, market participants, and other observers.

1/ Prior to the Presidential decree of July 1, 1998, the auction rate was applied to the 30 percent surrender of noncentralized exports.
2/ Funds obtained at the auction rate are resold by banks at the auction rate plus 1 percent for the importation of capital goods and raw materials.
3/ Centralized exports include cotton, oil and gas, nonferrous metal, rolled steel, uranium and radioactive materials, and arms.
4/ The auction is open also to commercial banks to sell foreign exchange derived from other sources, but there is no incentive to do so.
5/ Also, commercial banks may obtain foreign exchange at the auction rate for reselling at the commercial bank rate to finance imports of certain consumer goods.
6/ There are bank-by-bank limits on access to the auction.
7/ The Republican Monetary Commission decides on elegibility on a case-by-case basis.
8/ The determination of the rate also contains a discretionary element.
9/ Restrictions on commercial banks' cash purchases from the auction exist.

Box 12. Uzbekistan: Trade Related Exemptions

Enterprises with foreign capital participation receive special treatment in Uzbekistan. Since July 1997, this category includes joint ventures, enterprises with foreign investment equal to 100 percent of the authorized capital, and subsidiaries and branches of foreign firms conducting business and investment activity. In order to be registered as an enterprise with foreign investment and therefore be eligible for the concessions, company's charter capital is required to be at least US$150,000 (lowered from US$300,000 in April 1998) and the foreign investment must comprise at least 30 percent of capital.

Since September 1, 1997 *enterprises with foreign investment exporting their production* receive the following benefits:

- exemption from export duties (before export duties were abolished in February 1998);
- permission to open trading houses abroad ;
- exemption from the 15 percent prepayment requirement;
- permission to export on consignment basis;
- exemption from registration of export contracts with the MFER;
- exemption from the 50 percent excise tax on exports of beverages, waters and mineral waters, construction materials, and cigarettes; and
- permission to keep sum and hard currency deposit accounts in more than one bank (since July, 1997).

Since November 1997 several concessions have been granted to *enterprises exporting their own products for hard currency* (whether or not they have capital):

- right to export own production on the basis of a bank guarantee, without down payment or a letter of credit;
- profit tax rate halved if exports account for at least 30 percent of total sales;
- exemption from excise duty and VAT if the export is to CIS countries for hard currencies (as of January 1, 1997).

However, these privileges do not apply to trade and intermediary companies and to companies exporting raw materials, in particular ferrous and nonferrous metals and products, precious metals, crude oil, and cotton fiber and lint.

153. The Central Bank of Uzbekistan (CBU) is the main supplier of foreign exchange in the **auction market.** Before 1997, the sources of foreign currency for this market were the compulsory 100 percent surrender requirement on centralized exports, and the 30 percent surrender on noncentralized exports.[80] In addition, official reserves were sold through the auction. All enterprises in need of foreign exchange would submit bids through their

[80]Centralized exports include cotton, oil and gas, nonferrous metals, gold, rolled steel, uranium and radioactive materials, and arms.

commercial banks.[81] Toward the end of 1996, exchange market pressures became acute despite a faster devaluation of the currency in the auction market. Since then, foreign exchange has been increasingly rationed by limiting access to the auction. Certain imports receive priority access to foreign exchange, while other imports are excluded from obtaining foreign exchange through official channels.

154. The turnover at the auction market in 1997 decreased somewhat compared to 1996 as a result of the creation of the separate commercial bank market for foreign exchange in January 1997 (Box 13). The sources of foreign exchange supplied to the auction market through the CBU are now limited to the CBU's use of its own reserves and proceeds of centralized exports, which account for over half of total exports. Transactions eligible for access to foreign exchange at the auction exchange rate include servicing external credits related to the financing of investment, government and government-guaranteed projects, and imports of machinery, raw materials, and assembly parts for production by exporters. Eligible importers place their bids through commercial banks, which charge a 1 percent margin for these transactions. Consumer goods imports that are considered to have strategic importance, such as wheat and sugar, can also obtain foreign exchange directly from the auction under the tender system.

155. In January 1997, the **commercial bank market** was formally split off with a separate rate that was until July 1, 1998 linked to the auction rate with a 12 percent margin. In 1997 and the first half of 1998, 30 percent of noncentralized export proceeds were to be surrendered to commercial banks,[82] rather than to the auction, at the official exchange rate. Banks sell their foreign exchange to importers of consumers goods, who are CBU license holders and have been allocated a foreign exchange quota. Banks also sell foreign exchange to their own foreign exchange bureaus. The banks were also permitted to sell foreign currency at the auction, although there was little incentive to do so. Some exporters sold foreign exchange in excess of the surrender requirement to commercial banks when in need of local currency. In such cases, the buying exchange rate was negotiated freely between the bank and the client, but was implicitly limited by the 12 percent maximum margin for the commercial bank selling rate over the auction rate. Exporters were also allowed to sell unsurrendered foreign exchange to other importers at the official exchange rate, although this may not have been attractive. When commercial banks' own resources were not sufficient to

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[81]The following transactions were eligible to apply for foreign exchange convertibility: imports of consumer goods backed by a license (patent); payments for imports of machinery, equipment and parts; repatriation of profits; payments of dividends or interest; payment of loans and other bona fide transactions.

[82]One hundred percent of export proceeds must be repatriated unless a special permission to hold foreign exchange abroad is obtained from the CBU.

cover all the imports authorized for their clients, the CBU at times sold foreign exchange to commercial banks for these specific purposes.

Box 13. Uzbekistan—Foreign Exchange Flows
(In millions of U.S. dollars)

	1996	1997
Auction market		
Foreign currency surrendered (estimate)	2,708	2,128
Change in official reserves (- increase) (excl. Valuation changes)	-33	480
Surrender and change in official reserves (estimate)	2,675	2,608
Foreign exchange sold at auction	3,196	2,861
Commercial bank market		
Foreign exchange surrendered (estimate)	...	470
Change in commercial bank reserves (- increase)	--	432
Surrender and change in reserves	...	902
Foreign exchange sold by commercial banks (excl. purchases from auction, gold)	...	573
Total (Auction and Commercial banks)		
Foreign exchange surrendered	2,708	2,598
Including drawdown of official reserves	2,675	3,079
Including drawdown of commercial bank reserves	2,675	3,511
Foreign exchange sold	3,196	3,434
Memorandum items		
Imports	4,712	3,767
Exports	3,531	3,695

Source: Central Bank of Uzbekistan and staff estimates.
1/ Excluding resources purchased from auction and onsold.

156. The amount of foreign exchange transactions that take place through the **foreign exchange bureaus** is estimated to be small. Exchange bureaus of banks are largely self-funded. Their main source of foreign currency is cash sold by foreign visitors or local residents returning from abroad supplemented by occasional sales to bureaus by their

controlling commercial banks.[83] The exchange rate at which the bureaus sold foreign exchange was also limited to the 12 percent margin vis-à-vis the auction rate, which in turn constrained the buying rate. In principle, any resident has a right to purchase foreign exchange at the bureaus for specified purposes, such as travel for business, medical expenses and pilgrimage. However, it has been generally very difficult to obtain foreign exchange at the bureaus.

Recent Changes in the Exchange Regulations

157. Several important changes were introduced to the exchange system in the first half of 1998. Since March 1, 1998, only the Ministry of Finance and authorized banks are allowed to provide guarantees for import payments while other ministries, agencies and local authorities have been explicitly prohibited from extending such guarantees. At the same time, the process for importers to obtain foreign exchange was modified. Presently, importers with own foreign exchange resources, such as own export proceeds or credits in hard currency, are exempt from ex-ante import registration with the Ministry of Foreign Economic Relations and most foreign exchange related controls. Holders of CBU conversion licenses[84] can buy foreign exchange within the limits of their quarterly quotas determined by the Republican Monetary Commission (RMC). Importers not holding a conversion license need to apply for a one-time permit to the RMC.

158. New regulations for imports and exports of cash foreign exchange by individuals were introduced on April 1, 1998. The ceiling on tax free imports of cash by residents and nonresidents has been increased from US$5,000 to US$10,000. Hard currency in excess of this amount is subject to a one percent fee. Customs declarations remain compulsory for imports of cash of any amount. Residents may now export up to US$1,500 (earlier US$500), and nonresidents amounts limited to the imports recorded in the customs declaration. Hard currency exports in excess of the above amounts are possible only with a special permit from the CBU.

159. Several modifications to the foreign exchange system were introduced on July 1, 1998. The 12 percent margin of the commercial bank rate over the official exchange rate was formally abolished, but this did not lead to a widening of the spread between these rates in July. Foreign exchange receipts from cotton and gold exports are to be fully surrendered at

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[83]In March 1997, some nonbank institutions, such as hotels, airlines and tourist agencies, were given the right to perform currency-exchange operations, if they held a CBU license and secured an agreement with authorized banks to service them.

[84]These include supermarkets, large- and medium- foreign subsidiary enterprises, and wholesale and state trade organizations with a well-developed retail network.

the official exchange rate to the CBU as before. However, proceeds from other centralized exports, as well as the 30 percent surrender requirement from decentralized exports, are to be sold to commercial banks at the prevailing commercial bank rate. Access to foreign exchange resources at the official exchange rate is to be limited mainly to budgetary operations.

E. Privatization and Private Sector Development

160. Progress in restructuring and privatizing medium- and large-scale enterprises was limited in 1997 (Table 42). At the beginning of 1998, less than 30 percent of the total of 11,800 enterprises were corporatized and partially privatized. As the authorities reviewed past privatization policies, the implementation of the World Bank-supported Privatization Investment Fund (PIF) scheme proceeded more slowly than expected. However, the authorities began to plan the sale of a few large enterprises on a case-by-case basis. This endeavor is also supported by the World Bank. Private sector development largely stalled, as foreign direct investment inflows remained low and small- and medium-enterprises were confronted with an increasingly difficult business environment.

Case-by-Case Privatization

161. The first enterprise chosen under the case-by-case privatization approach is the **Almalyk copper plant**, which also produces gold and silver.[85] The plant was valued by the government at sum 70 billion (equivalent to more than 7 percent of GDP). During 1997, it was converted into an open joint-stock company, and the government announced its intention to sell 40 percent of the shares to a foreign investor.[86] The issuance of the tender, however, has been delayed although the government, according to official information, had already received expressions of interest from 16 foreign investors. Two reasons for the delay were that the valuation studies had not been completed and the government had not yet defined the conditions for the marketing of gold. Moreover, the asking price may be too high, considering that the enterprise has accumulated much environmentally hazardous waste material, and that some of its products (e.g., copper, silver, gold) have experienced declining world market prices.

162. In 1997, the government also earmarked the large **Chirchik special alloy plant** for partial privatization. The sale was delayed because the government could not decide whether to sell a 35 percent stake in the whole plant, or to split it up first and then sell minority stakes

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[85]The other five enterprises that have been identified so far are UzKabel Power Telecommunication Cables, Tashkent Airport, Uzbek Airlines, Khalkaro Telekom, and Makhaliy Telekom.

[86]At the official exchange rate the 40 percent share is equivalent to about US$420 million.

Table 42. Uzbekistan: Corporatized and Partially Privatized Enterprises, 1992-97

	1992	1993	1994	1995	1996	1997
Number of state-owned enterprises existing prior to 1993	64,547	...	...	...	...	...
Of which						
Small	52,782	...	...	...	...	...
Medium	7,059	...	...	...	...	...
Large	4,706	...	...	...	...	...
Number of corporatized and partially privatized enterprises (in each year)	--	34,577	9,744	5,645	1,644	1231
Of which						
Small 1/	--	33,577	8,760	5,545	1,536	1131
Medium	--	600	614	50	108	100
Large	--	400	370	50	...	...
Number of corporatized and partially privatized enterprises (cumulative)	--	34,577	44,321	49,966	51,610	52,841
Of which						
Small 1/	--	33,577	42,337	47,882	49,418	50,549
Medium	--	600	1,214	1,264	1,372	1,472
Large	--	400	770	820	...	...
Share of corporatized and partially privatized enterprises in total (in percent)						
Of which						
Small	--	64	80	91	94	96
Medium	--	8	17	18	19	21
Large	--	8	16	17	...	...

Sources: State Property Committee, Ministry of Macroeconomics and Statistics; and fund staff estimates.

1/ Data for 1996 and 1997 include large enterprises.

in the newly created enterprises. In addition, the government has announced plans to sell 30 percent of the Tashkent city telephone network.

The Privatization Investment Fund (PIF) Scheme

163. When the scheme became operational in late-1996, it was envisaged to sell 30 percent of the shares of about 300 large enterprises to investment funds in a first implementation phase. It was further expected that in a subsequent second phase shares of 300 more enterprises would be sold. Progress in implementing the scheme has been substantially slower than originally expected, although more than 50 investment funds and management companies have been established so far, and about 100,000 individuals have bought shares in PIFs. During 1996 and 1997, 16 auctions were held and shares of about 150 enterprises were sold for a total of sum 1.3 billion. Of this amount, sum 1.1 billion was financed from concessional government credits.[87] Approximately 50 enterprises were offered but not bought by PIFs.

164. The implementation of the PIF scheme was hampered by changes in regulations and procedures introduced in mid-1997. These included the removal of a number of enterprises from the first list of 300 enterprises agreed upon with the World Bank, the refusal to lower minimum bid prices for enterprise shares that had remained unsold when offered for the first time, and the issuance of additional shares by the government to regain control over already privatized enterprises. The government also prohibited changes in management and shareholders' meetings in some instances. As of mid-1998, no agreement has been reached with the World Bank on the enterprises to be included in the list for the second phase of the PIF scheme.

165. Other privatization activities continued in the same way as in 1996. The National Stock Depository (VAKT) proceeded with the registration of enterprises and shares; 4,800 enterprises were registered at the end of 1997 (compared to 4,200 a year earlier).[88] The stock exchange continued to see only limited activity; turnover rose in nominal terms, but fell as a share of GDP from an already low level.

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[87]On the details of the PIF scheme see Itzhak Goldberg, et al. (1997), "The IPO-Plus: A New Approach to Privatization," Policy Research Working Paper No. 1821 (Washington: The World Bank, 1997).

[88]For background information on the VAKT, the Republican Stock Exchange, and the Republican Real Estate Exchange see International Monetary Fund, "Republic of Uzbekistan: Recent Economic Developments," Staff Country Report No. 97/98 (Washington: IMF, 1997).

Bankruptcy Proceedings

166. In 1997, the government undertook an inventory of a large number of corporatized joint stock enterprises with the objective of establishing their financial viability. Bankruptcy proceedings were initiated for a total of 145 enterprises, out of which 46 were liquidated. In addition, 104 agricultural enterprises were put under receivership. According to the government, these enterprises are financially viable in principle, as they have valuable assets such as land and irrigation systems. These enterprises received a substantial financial support package from the government, including the cancellation of arrears and deferral of outstanding obligations to the budget and pension fund beyond the year 2000 (see Section C).

Problems of Small- and Medium-Enterprises in Uzbekistan

167. The development of private small- and medium-enterprises (SMEs) in Uzbekistan has been hampered by several problems.[89] These problems include lack of access to foreign exchange (Box 14), complex business registration process, cash withdrawal restrictions, direct access of tax authorities to bank accounts, a high tax burden and a large number of taxes, and inadequate access to credit.

Business Registration

168. The process of registering a business in Uzbekistan remains complex and a business must employ a lawyer and an accountant for that purpose. Regulations change frequently and lack transparency. As soon as a business is registered, it is required to become a member of the Chamber of Entrepreneurs. They are required to prepare business development plans with the help of Uzinvestconsult, which is a state-owned enterprise with a quasi-monopoly status.

Cash Withdrawal Restrictions

169. Cash can only be withdrawn for wage payments and, to a very limited extent, for other transactions. There has been an informal conversion rate between cash and noncash sum, with reported spreads ranging from 20-50 percent, or higher.

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[89]According to official sources, about 137,000 SMEs were registered at the end of 1997, including in the industrial sector and in services. However, it is not clear how many of those registered are de facto operational. It is also not clear how many of those registered are privatized small enterprises or enterprises that have been created as a result of restructuring larger, formerly state-owned enterprises.

Box 14. A Crucial Problem for Small- and Medium-Enterprises: Lack of Access to Foreign Exchange

Small- and medium-enterprises had always found it difficult to obtain foreign exchange through official channels. Following the intensification of foreign exchange restrictions in late 1996, the access to foreign exchange through the central bank auction or commercial banks has become even more difficult.[1]

During 1997 and early 1998, many SMEs, slowed their business activities as they could no longer obtain foreign exchange to import raw materials or spare parts. Operating costs for existing and entry requirements for new enterprises increased, as SME were increasingly forced to purchase foreign exchange at the much more depreciated exchange rate in the curb market. A significant number of domestic SMEs has closed down, and the restricted access to foreign exchange was cited as the main reason for some foreign SMEs to withdraw from Uzbekistan. The restricted access to foreign exchange has forced a number of SMEs to engage increasingly in inefficient barter trade with enterprises in Russia or other countries. Such deals involve, for example, the export of food products (e.g., tomato paste) in exchange for raw materials for industrial production or consumer goods.

[1] A number of donor-supported SME development projects have also suffered from foreign exchange restrictions. For example, during 1997 they experienced long delays in converting domestic currency into foreign exchange for credit repayments made by SMEs in sum for US$-denominated loans. All credits provided by these projects to SMEs must be registered at the central bank. Reportedly, it has been difficult to register SME credits in certain sectors (e.g., to finance the import of minivans for a taxi enterprise).

Taxation

170. Banks continue to function as tax collection agents and thus do not enjoy much confidence among their customers. SMEs suffer from a high tax burden resulting from the taxes and fees, including the salary tax, the profit tax, and the membership fee for the Chamber of Entrepreneurs mentioned above.

Inadequate Access to Credit

171. SMEs find it difficult to borrow from commercial banks, in particular from the NBU. There exists an informal credit market, which is largely dollarized. In this market, small credits carry a very high interest rate (10-20 percent per month on a US$ basis). Donor-supported projects provide larger amounts of credit to SME (e.g., US$50,000 or more) at substantially lower interest rates (16-28 percent per annum).

F. Relations with the International Monetary Fund

172. Since independence, the IMF has provided financial and technical assistance to Uzbekistan. During 1994 and 1995, Uzbekistan received about SDR100 million under the Systemic Transformation Facility (STF). In December 1995, a 15-month stand-by arrangement was approved in the amount of SDR125 million, of which SDR65.5 million were disbursed during 1996. This arrangement expired in March 1997 without disbursement of the remaining balance.

173. During 1997 and the first half of 1998, the IMF continued to provide policy advice and technical assistance to Uzbekistan. Upon request from the authorities, periodic staff visits were held to discuss fiscal and monetary targets and to give advice on macroeconomic and structural policies. The Resident Representative provides liaison on a permanent basis. Technical assistance was provided in a broad range of areas. These included a long-term adviser to assist in the establishment of a treasury, and short-term assistance in statistics (e.g., money and banking, national accounts, prices, trade data, and balance of payments). Training was provided for a large number of Uzbek officials by the IMF Institute in Washington, the Joint Vienna Institute, and special training courses. The latter included a regional seminar on macroeconomic policy analysis and formulation in Tashkent in April/May 1998.