



# Uzbekistan Diagnostic: Assessing Progress and Challenges in Unlocking the Private Sector's Potential and Developing a Sustainable Market Economy

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**European Bank**  
for Reconstruction and Development



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**The diagnostics are led by the EBRD's Country Economics and Policy team,** drawing substantially on the expertise of sector, governance and political experts in the Economics, Policy and Governance department (EPG) and consulting widely with relevant experts across the EBRD when preparing the final product. The diagnostics are shared with the EBRD Board during the country strategy process and published during the public consultation period.

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## Uzbekistan Diagnostic

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# *Assessing Progress and Challenges in Unlocking the Private Sector's Potential and Developing a Sustainable Market Economy<sup>1</sup>*

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<sup>1</sup> This paper was prepared by Hans Holzhaecker from the Department of Economics, Policy and Governance (EPG) at the EBRD. Important contributions to the analysis were made by Umid Abdullaev, Aziza Zakhidova, Anastasia Rodina, Idil Bilgic-Alpaslan, Alper Dincer, Damin Chung, Tieman Alexa and Svenja Petersen. The authors are also grateful to numerous other colleagues in EPG for helpful comments and suggestions. This paper has also benefited from comments from EBRD colleagues in other departments, including the legal team and banking and from the Tashkent resident office in particular. The views expressed in this paper are those of the authors only and not necessarily those of the EBRD.

## Executive summary

This paper assesses the progress in Uzbekistan towards a well-functioning, sustainable market economy, and the challenges ahead. It provides a background analysis for the forthcoming EBRD Country Strategy for Uzbekistan and for the structure and prioritisation of ongoing and future investment activities and policy engagements in the country.

The main obstacle that holds back private sector growth is the **strong presence of the state in the economy**. Encouraging efforts are under way by the authorities to reduce the role of the state.

The main conclusions of the analysis are as follows:

- Fundamental steps to liberalise the exchange rate regime have been made. To some extent, however, cross-border investment flows are still hampered by regulations that need to be clarified or improved.
- The authorities have started to reduce state overregulation and interference in the economy, and the business climate has begun to improve. Property and other business rights are still not always well protected, not least due to the limited capacity of courts to review commercial and economic disputes.
- The preferential access of SOEs to resources such as land, infrastructure, financing and government procurement, and the de-facto execution of state functions by them such as standardisation and other regulations, put private businesses at a disadvantage and prevent them from fully exploiting their potential.
- Access to finance for private companies, especially SMEs, has been constrained by state-directed lending (mostly to SOEs) and insufficiently developed financial services and capital markets.
- The complex and distortive tax system, currently being reformed, strongly disadvantages businesses above a certain size and prevents them from growing further. Turnover taxes adversely affect the optimal positioning of businesses within value chains. Customs, licensing and the certification systems constitute serious barriers to foreign trade and need to be reformed.
- The predominantly inward looking economic model applied until recently hindered the integration of private businesses into global and regional value chains. However, Uzbekistan has begun to open up the economy and to reach out to its neighbours.

The report also presents scores, based on the EBRD's updated transition concept, for the six desirable qualities of a sustainable market economy – *competitive, well-governed, green, inclusive, resilient and integrated* – and a description of the main transition gaps.

Uzbekistan's history of stalled transition and hesitant reforms has left the country with one of the lowest aggregate scores across the six qualities among all EBRD countries of operations. However, the recent reform momentum has the potential to raise these scores significantly in the coming years and move Uzbekistan firmly in the direction of a sustainable market economy.

## 1. REFORM APPROACH AND RISKS

*Since late-2016, Uzbekistan has fundamentally changed. It has embarked on reforms aimed at supporting the private sector. While the roll out of these reforms was met with less resistance than anticipated, transition is still challenging, not least because of the magnitude of the task and the scarcity of qualified personnel.*

There was increasingly a widespread perception in the society in recent years in Uzbekistan that the economic model, which had evolved over the previous 20 years, had outlived its usefulness. President Mirziyoyev's February 2017 decree "Strategy of action" provided a blueprint for reforms. The decree linked the need to liberalise the economy to reform of the administrative and judicial systems. It lists the following as key pillars for economic reform:

- Reducing the state's presence in the economy,
- Strengthening the rights and the role of the private sector,
- Stimulating the development of small business and private entrepreneurship, and attracting foreign investment,
- Improving the investment climate,
- Improving relations and cooperation with the neighbouring countries in the region.

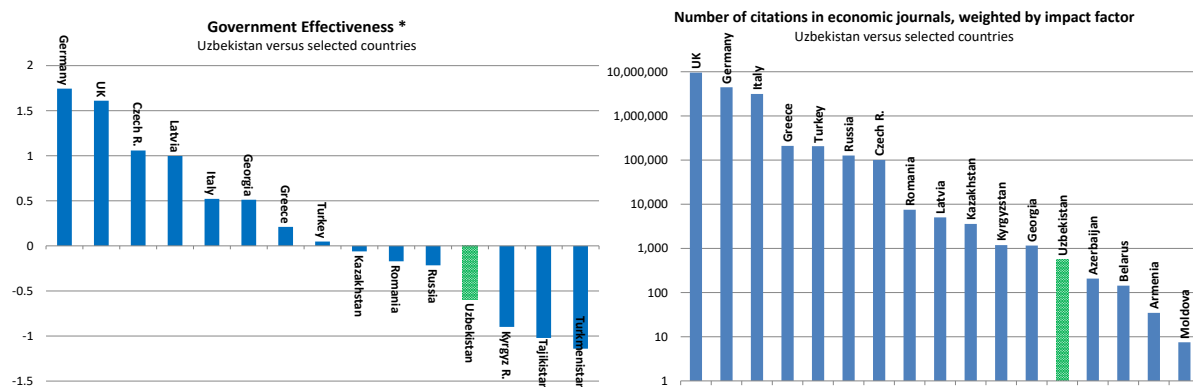
**Major steps towards delivering on these reforms have been taken**, among them:

- The sum enjoys free current account convertibility since of September 2017.
- The state's influence in non-strategic companies has been reduced, making it proportional to the state's shareholding.
- An anti-corruption law has been adopted.
- Non-scheduled inspections of companies have been limited by law and one-stop shops for business have been introduced.
- Tax reform has begun.
- Several Free Economic Zones have been created.
- A Foreign Investor Council is being considered.
- The government is working on new legislation on public-private partnerships and SMEs and on improvements to the law on state procurement.
- The way state investment programmes have been designed is being overhauled.

The progress made is acknowledged by the World Bank's 2018 Doing Business report: Uzbekistan is mentioned among the 10 best performing countries in 2018, ranked 74th out of 190 countries, up by 13 places from the previous year.

**Initial achievements have been impressive, but the sheer number of procedures that need to be changed, as well as their complexity, continue to make transition challenging.** Capacity building in government institutions and also the broader society will be crucial if the reforms are to succeed. Most reforms that have been announced have yet to be completed, while other major ones, such as tax and fiscal reform, banking and capital market reform, and tariff reforms are still to come. Administrative reform will be a major precondition for the successful implementation of reforms, given that Uzbekistan's government effectiveness was relatively low until recently, as reflected in the World Bank's global governance indicators (see chart 1). Uzbekistan's knowledge and expertise in dealing with economic and management issues in a market economy is also not very advanced yet, as evidence from counts of citations in economic journals shows (see chart 2).

Charts 1 and 2



\* Government Effectiveness captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government's commitment to such policies. The chart depicts the country's score on the aggregate indicator, in units of a standard normal distribution, i.e. ranging from approximately -2.5 to 2.5.

Sources: The World Bank, Worldwide Governance Indicators 2016; Ideas, November 2017, (<https://ideas.repec.org/top/top.country.sccites.html>).

**If reforms are not properly designed and implemented, the risk of loss of macro-economic and social stability arises.** The relocation of capital and labour across sectors in response to the adjustment of relative prices when distortions such as price controls and subsidies are removed could be disruptive, if not accompanied by the establishment of social safety nets and capacity building measures for making transition inclusive. Currency liberalisation has put the balance sheets of some key SOEs under pressure. This might in turn worsen the asset quality of the portfolio of suppliers and banks. Uzbekistan's external position could deteriorate, if the competitiveness of domestic producers is not strengthened and new export markets found. Complex structural reforms addressing a whole range of economic, legal, organisational and social issues will be needed to mitigate risks. If economic difficulties were to materialize, responding to slowing growth by loose fiscal and monetary policies could be tempting, but would not be sustainable in the longer run and would bear the risk of a hard landing later on.

**The authorities have taken measures to ease potential negative social side-effects of reforms** such as abolishing customs on socially important import goods to prevent a sharp rise in prices. A more fundamental approach will be needed to secure the smooth transition to a prosperous market economy, including labour market and social security reforms, education reform and overhauling the country's scientific and research institutions.

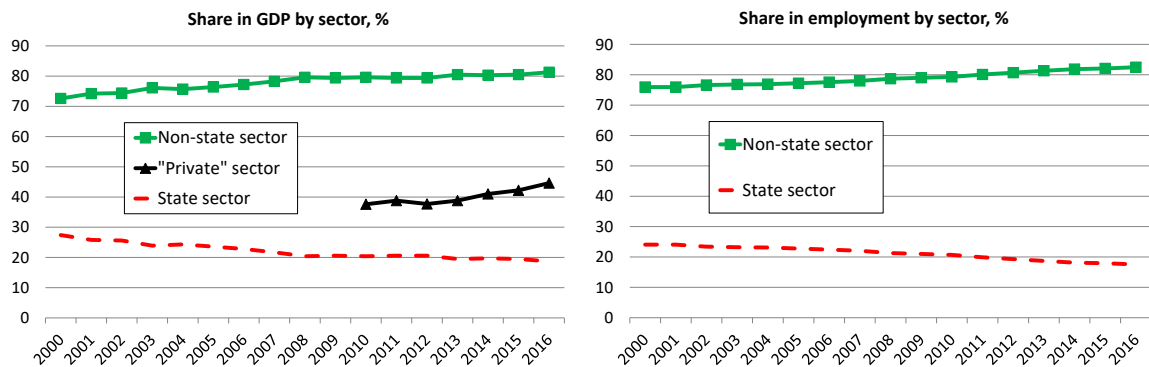
## 2. THE CURRENT SHAPE OF THE PRIVATE SECTOR

*The private sector has been growing over the past decade despite difficult circumstances, highlighting the potential for further development if reforms advance and obstacles are eased. The removal of distortions to markets will inevitably affect some businesses adversely in the short run and might force some companies out of business. However, this process of creative destruction will open the way for the majority of businesses to improve.*

**The share of the private sector significantly increased over the past decade.** According to best estimates, the private sector currently generates perhaps 50-60 per cent of GDP. The

official statistics methodology defines businesses with less than 100 per cent state ownership as non-state. They accounted for 81 per cent of GDP in 2016 (see chart 3), 82 per cent of employment (see chart 4), and 86 per cent of registered businesses, according to official data. This compares with 73 per cent of GDP, 76 per cent of employment, and 84 per cent of registered businesses in 2000. They were responsible for 83 per cent of fixed investment in 2016, up from 36 per cent in 2000. In industry, the share of the non-government sector in output increased to 94 per cent in 2016 from 36 per cent in 2000. Businesses that were 100 per cent in private ownership produced 45 per cent of GDP in 2016, up from 38 per cent in 2010. There are no data available for businesses with mixed private and state ownership.

Charts 3 and 4

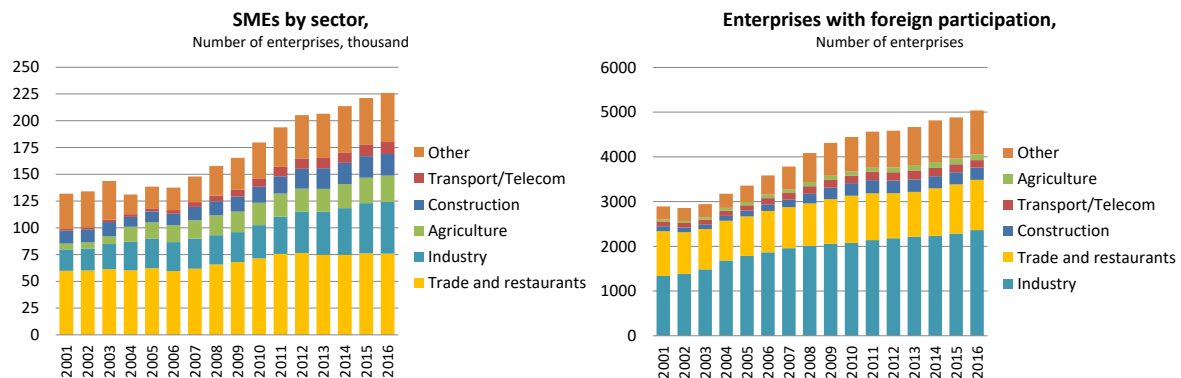


The state sector is here defined in line with the State Committee's methodology as businesses with 100 per cent state-ownership, the non-state sector as businesses with less than 100 per cent state-ownership and the "private" sector as businesses with 100 per cent private ownership.

Source: The State Committee of the Republic of Uzbekistan on Statistics.

**Thanks to their diversity and adaptability to difficult business environments, the role of small and medium enterprises has substantially grown.** The share of SMEs<sup>2</sup> in GDP rose to 57 per cent in 2016 from 31 per cent in 2000, according to Statistics Committee data.

Charts 5 and 6



Source: The State Committee of the Republic of Uzbekistan on Statistics.

The number of registered non-agricultural SMEs was about 225,000 in 2016 (see chart 5), increasing to 230,000 in 2017. They accounted for 82 per cent of registered enterprises in

<sup>2</sup> The SME sector in the definition used here comprises small enterprises with 21-50 employees and micro-enterprises with 1-20 employees (with the exception of the manufacture of refractories and of metal products for industrial use where the threshold was 100 and 200 employees, respectively until 2016). There are some industries, mostly in mining and agriculture, where SMEs are not defined.

2016 (87 per cent in 2000, but only 77 per cent in 2004 after de-registration of about 10,000 state SMEs). The SME share in employment increased to 78 per cent in 2017 from 50 per cent in 2000, and in investments it increased to 32 per cent from 13 per cent. Their share in value added in industry, construction and retail trade turnover grew to 45, 71 and 90 per cent, respectively, from 13, 40 and 75 per cent in 2001. Some of these trends may stem from breaking up larger companies into smaller units to avoid high tax rates, but most of the increase appears to represent actual growth in SME activities.

**Foreign-owned companies play a considerable role in industry, trade and telecommunications, but FDI inflows have been weak in recent years.** Businesses with participation of foreign capital accounted for 1.4 per cent of employment in 2016, versus 0.9 per cent in 2000, and 1.8 per cent of registered businesses, almost unchanged since 2000. There were about 5,000 registered businesses with foreign participation in 2016 (see chart 6). The strongest foreign participation was in industry (4.8 per cent of businesses), followed by trade (1.5 per cent) and transportation and telecoms (1.4 per cent). By comparison, the equivalent figures for Kazakhstan are 6.2, 12.8 and 8.8 per cent, respectively. The authorities have not published aggregate data for the share of foreign-owned companies in GDP. Anecdotal evidence suggests a significant presence of foreign firms in Uzbekistan's mining, automotive and telecoms industries. Turkish companies play an important role in textile processing, and Russian and Swedish companies in the telecom sector. Lukoil, the country's largest foreign investor, is implementing two large-scale investment projects in Uzbekistan's gas industry: Kandym-Khauzak-Shady and South-West Gissa. Uzbekistan's inward FDI stock stood at US\$ 9.3 billion in 2017, according to Unctad's World Investment Report. However, FDI inflows slumped to US\$ 133 million and 96 million in 2016 and 2017, respectively, down from about US\$ 600 million annually in 2012-2014.

**There are no reliable estimates of the size of the informal sector, but it is believed to be large.** Encouraging formalisation could open up opportunities for private sector growth and in parallel reduce poor business practices. One indicator of informal activity is the high share of self-employed persons. According to the State Statistics Committee, the total number of employed persons was about 13 million people in 2015-2016, including about 5.0-5.3 million self-employed, i.e., about 40 per cent. The self-employed are mostly exposed to informal employment and to the risks of job loss and social insecurity. Factors that pushed businesses into the informal sector include overregulation, the often contradictory, outdated and slow procedures for licensing and obtaining other permits, the high number of control inspections by state bodies, and currency convertibility issues.

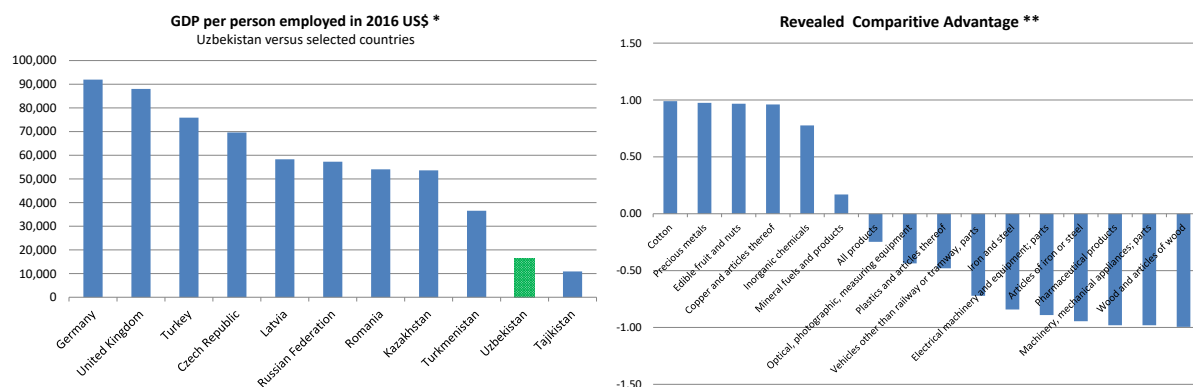
**Competitiveness and productivity of the private sector need to be enhanced.** Labour productivity data suggest that Uzbekistan's economic model that has been based on close relationships of private companies with SOEs, insufficient integration into global supply chains and low technology transfer and innovation, has kept productivity (see chart 7) and competitiveness underdeveloped.<sup>3</sup> Uzbekistan's advantages in foreign trade are currently highly concentrated on cotton, precious metals, fruits, fertilizers, with insufficient sophistication and competitiveness in other industries (see chart 8).

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<sup>3</sup> Uzbekistan is not currently included in the World Economic Forum's Competitiveness Report, a major source for international competitiveness comparison.



Charts 7 and 8



\*Converted to 2016 price level with updated 2011 PPPs

\*\* Net exports / trade volume in the respective industry (Exports – Imports) / (Exports + Imports), averages for 2014-2016; the industries in the chart account for 75% of the overall trade volume.

Sources: The conference board total economic data base; Trademap, author's own calculations.

### 3. KEY OBSTACLES TO PRIVATE SECTOR DEVELOPMENT

**Reforms have begun to unleash the potential of the private sector.** Measures to improve the business climate adopted include the simplification of registration and licensing procedures, the introduction of a one-window licensing and tax administration, and the sharp reduction of state inspections of businesses. Further administrative reform that clarifies the roles of the various state agencies and streamlines the functioning of the state has been announced and is needed to make the delivery of public goods more efficient. Deep structural changes such as fiscal reform, tax reform, and customs reforms are planned for 2018. Currency liberalisation, along with other reforms, will level the playing field, increase competition, and allow businesses to exploit their comparative advantages. This will particularly benefit smaller private companies, which up to now have had no preferential access to hard currency, foreign trade channels, credit and other types of government support.

**In order to release the potential of the private sector fully, a whole range of further reforms has to be undertaken.** The first, decisive reform steps on currency liberalisation have been made, but some issues remain to be clarified. In particular, the decree on currency liberalisation refers primarily to current account convertibility and the authorities still need to specify procedures regarding some other cross-border financial flows, for example, cross-border selling and buying of shares and domestic bonds. Financial market reform is crucial to help the economy succeed against import competition, which will intensify after the opening up of the country. Tax reform will also be of crucial importance.

#### 3.1 Foreign currency liberalization

*Lack of access to foreign currency has been the key obstacle to private sector development for many years, but fundamental steps have been made recently to liberalise the foreign exchange regime. Remaining issues, mostly with regard to capital flows, are expected to be resolved by during 2018. The introduction of the convertibility of the Uzbek Sum in September 2017 will likely be seen as a watershed in the history of post-independence Uzbekistan. A flurry of new legislation and measures to mitigate potential negative consequences of the currency liberalisation are being prepared.*

## **Background**

**After a period of foreign exchange and trade liberalization in 1995–96, Uzbekistan reintroduced a system of multiple exchange rates and restrictions on current account transactions in early 1997.** First created in response to growing balance of payment difficulties, the system later became an instrument to direct resources from traditional exports industries producing cotton, gold and minerals to new capital-intensive, import-substituting industries such as automotive, energy and chemicals. It was also used to subsidise socially important import goods such as pharmaceuticals. There were alternating periods of more restrictive currency regimes and periods of relaxation. In November 2003, the Government committed Uzbekistan to the provisions of the IMF article VIII on current account convertibility. The official exchange rate significantly devalued during 2003-2004, and the gap between the official and market exchange rates substantially narrowed until late-2008. However, when the global recession sharply reduced the demand for Uzbekistan's products and exports fell by one-third in 2009, the regime was tightened again.

**Multiple restrictions were in place between 2009 and September 2017.** The percentage of proceeds exporters had to surrender varied between 25 per cent and 50 per cent. Legal entities, including those with foreign investments, had to receive special permission from the authorities to obtain foreign currency. Individuals were allowed to purchase only small amounts of foreign exchange, most often for specific purposes such as study abroad. The government regularly instructed banks which transactions requiring currency exchange were allowed and which were not. Businesses seeking conversion often suffered from irregular and insufficient access and long delays.

**The system was costly to the economy and a severe obstacle to private sector development.** Exporters who had to sell a share of their foreign exchange earnings at the overvalued official exchange rate were de facto paying an implicit tax. Importers who were allowed to buy foreign exchange rate at the official rate were granted implicit subsidies. This to some extent helped diversify the economy and attract specific foreign investors, but competition suffered, resource allocation became increasingly inefficient, and rent-seeking thrived. The uncertainty regarding the availability of foreign exchange imposed a risk premium to doing business in Uzbekistan, and new foreign investment was discouraged, not least because profits could not be repatriated. Businesses and financial flows were pushed to the informal sector. The private sector suffered in particular, given that the beneficiaries of the system were mostly SOEs.

## **Liberalisation**

**On September 2, 2017, the President of Uzbekistan signed a decree on the liberalization of the foreign currency regime into law.** It came into force on September 5, 2017. Since then, Uzbekistan's foreign exchange rates are based on the rate prevailing on the Uzbek Republican Currency Exchange. Central bank intervention is intended to be limited and aimed only at preventing high exchange rate fluctuations. A President's resolution, signed in September 2017, directs the central bank to work out a road map for the stepwise introduction of inflation targeting.

**The President's September decree postulates current account convertibility.** Legal entities and (since October 2017) individuals, can purchase foreign currency for current account operations (import of goods, works or services, profit repatriation, payment of travel expenses and other current account payments) in commercial banks without restrictions. The mandatory surrendering of a certain share of foreign exchange proceeds has been abolished

for all exporters. Banks no longer need a separate license for conducting foreign exchange operations.

**Further clarifications are needed to facilitate foreign investment and allow the efficient functioning of capital markets.** For some financial account transactions, such as buying and selling of shares, or transfers between residents and non-residents of means other than those earned from current account operations, agents still face some obstacles converting sums into foreign currency. Free entry and exit of capital is a crucial precondition for attracting foreign investment and efficient capital markets. While retaining control over potentially damaging large capital flows, the authorities should come up with clarifications and procedures to remove unwarranted obstacles. The Presidential decree directs the central bank to draft a new law on foreign exchange regulation during 2018.

**The majority of businesses will strongly profit from the currency liberalisation.** The free access to foreign exchange will allow them to resort to more sophisticated imports needed for the development of the respective industry and find the proper place in international value chains according to their comparative advantages. The free float will allow the exchange rate to be in line with fundamentals. This will especially benefit exporters that previously suffered from being forced to exchange at least part of their foreign currency revenues at the overvalued official exchange rate. Foreign-owned companies will be able to repatriate their profits instead of being forced to re-invest or deposit their earnings with local banks independently of efficiency because they can't convert local currency into international exchange.

**The currency liberalisation will negatively affect sectors of the economy that had profited from the old system.** This includes businesses which were able to gain from the arbitrage between different exchange rates, importers of investment goods at the official exchange rate not hedged by foreign exchange income, and importers and consumers of some socially important consumer goods such as pharmaceuticals. A few key SOEs in the energy and oil and gas sectors are likely to be particularly affected. However, a flurry of legislative and administrative measures is envisaged by the authorities to deal with the potentially negative consequences of the currency liberalisation. These include measures to restructure some debt service obligations with the help of the Uzbekistan Fund for Reconstruction and Development, ensure the stability of the banking system, provide financial support to basic sectors of the economy, adjust customs rates in order to prevent the growth of domestic prices for imported goods, and strengthen state support for socially vulnerable segments of the population.

### 3.2 State presence in the economy

*State ownership has crowded out the private sector through its preferential access to land, infrastructure, credit, state support and contracts, and until recently also foreign exchange. Some SOEs also act as regulators and organisers of the industry they dominate. To free the potential of the private sector, SOEs have to be put on an equal footing and commercialised. Renewed privatisation efforts may bring benefits in the longer run.*

**The state is heavily present in key sectors of the economy.** According to official estimates, the state sector accounted for about 19 per cent of GDP, 6 per cent of industrial output, 20 per cent of external trade and 18 per cent of total employment in 2016. There were over 38,000 state-owned enterprises in 2016, 14 per cent of all registered non-farm enterprises. Officially, the state sector has minimal presence in construction, transport and communication sectors, makes a modest contribution to external trade and plays no role in agricultural output. The

state sector is however officially defined as businesses with 100 per cent state ownership, and a wider definition would likely indicate a more significant presence of the state in the economy. SOEs remain dominant in strategic sectors, including oil and gas refining, power generation and transmission, transportation and distribution (airlines, railways, public transportation), metallurgy and mining, telecommunications, agriculture (cotton processing) and automotive industry.

**The state used to micro-manage investments of SOEs.** The "Programme of major investment projects for 2017, implemented at the expense of the organizations' own funds", an attachment to the annual "Investment Programmes of the Republic of Uzbekistan", is a testimony of how detailed the state is engaged in approving individual projects of state companies: 58 pages of individual projects, most of them confirmed by decrees or resolutions of the President. However, the Presidential decree "On the introduction of a new order of the formation and financing of development programmes of the Republic of Uzbekistan" calls for reorganizing the way the country's investment programmes are put together and advocates a longer and more fundamental planning perspective. For 2018, no annual investment programme was adopted. Instead, ministries have been entrusted with the task to work out long-term strategies for their areas.

**The strong state presence is in part the result of the desire of the state to organise key industries through associations and large state-owned companies.** The structure of the state joint-stock concern "Uzfarm sanoat", for example, includes more than 90 different enterprises and organizations of the pharmaceutical industry. These may include either wholly or partially state-owned enterprises as well as private enterprises that are identified to be within the structure of a SOE and are de facto regulated by it. Uzbek Railways has been given the authority to regulate all matters related to railway transportation, establishing norms and standards, planning, designing, building, reconstructing, repairing and maintaining railways and railroad engineering infrastructure. The influence is carried out through the distribution of state orders, the granting of preferential treatment to member enterprises, support for obtaining credit, etc. Formally, these companies may have not been entrusted with such functions, but in practice certain functions of state administration are often delegated to them. The same state-controlled company thus simultaneously takes part in the development of regulatory standards, organizes their implementation and controls the work carried out on their basis. These multiple roles give SOEs conflicting incentives and risk creating opportunities to advance vested interests and capture the regulatory institutions in charge.

**A presidential decree initiating the "Program of transformation of state enterprises and other entities with majority state ownership" was announced on 14 May 2018.** The program is intended to be implemented in 2018-2020. The decree highlights a number of issues that need to be addressed in the SOE sector. Problems highlighted by the decree include: (i) participation of government officials in the management bodies of SOEs and resulting conflicts of interest, (ii) lack of a well-functioning system of management of the investment process in SOEs, (iii) non-transparency of SOE governance and lack of regular analysis of their performance, and (iv) inefficiency of the system of education of staff and management of SOEs, particularly in the area of corporate governance. The programme covers key sectors of the economy with significant SOE presence and is intended to cover the following SOEs: Uzbekneftegaz (oil and gas), Uzkiimyosanoat (chemicals, fertilizers), Uzbekenergo (electricity production and distribution), Uzbekhydroenergo (operation of hydro power plants), Almalyk Mining and Metallurgy Plant (mining, metals), Uzbekistan Railways (rail transportation), Uzbektelekom (telecommunications), Navoi Mining and Metallurgy



Plant (mining, metals), Uzbekistan Airways (airline and management of airports) and Halq Bank.

**The government has on numerous occasions indicated its willingness to reduce the degree of state presence in the economy.** The state divested 609 SOEs in 2016 and 848 in 2015, according to Statistics Committee data. The number of SOEs with 100 per cent state ownership fell to 39,082 by end-2016 from the peak of 39,530 in 2014, still a large number. The government has begun to launch IPOs and SPOs for some SOEs. Recent government decrees suggest that efforts to privatise SOEs will continue. The authorities are working on PPP legislation that would facilitate the participation of private companies, particularly in large infrastructure projects, and thus reduce dependence on SOEs. At the same time, one of the key decrees outlines the limits of the privatisation programme by listing a number of companies that are not subject to privatisation. These include major companies in transport, energy, natural resources, chemicals, vehicle manufacturing, agribusiness, two major state-owned banks and others. This indicates that a significant presence of major SOEs in a number of key sectors of the economy is to remain for some time; even then, the scope for commercialisation and levelling the playing field is substantial.

### 3.3 Governance and business environment challenges

*Uzbekistan has started tackling the challenging business environment. Further strengthening of property and other business rights and enhancing the capacity of courts to review commercial disputes are important steps towards better protection of private businesses.*

**Visible progress has been made in addressing some business climate issues, and the current status has to be assessed in the context of a rapidly changing environment.** Currency liberalization, as noted above, has been a major step towards an effective and enabling business environment. Among other measures, non-scheduled inspections of companies have been limited by law and waiting times for some permits have been reduced. There is now public-private dialogue, including through the Chamber of Commerce and a specialised web portal which collects comments on all new legal acts from interested parties. The government is working on public-private partnership legislation, a law on renewables and improvements to the law on state procurement. A Business Ombudsman has been established.

**Taxation and tax administration are among the areas most in need of reform.** The way tax obligations are defined strongly favours SMEs. While this is positive, the abrupt increase in taxation of companies not qualifying as SMEs hinders their growth beyond a certain size and provokes splitting of companies and suboptimal corporate governance. The government is now working on aligning definitions of micro, small and medium size enterprises with international practices. The structure of the tax system also impedes the creation of specialised businesses and optimal positioning in value chain due to the taxation of turnover instead of value added in many cases. The reform of the tax system has commenced and will likely to continue throughout 2018, at least.

#### **First steps of tax reform**

In June 2017, the government adopted a resolution aimed at improving tax legislation. The government plans to simplify tax administration and further limit tax inspections through the introduction of risk-based inspections. A Presidential resolution published in December 2017 revises rates of certain taxes and introduces some changes to the tax legislation. Corporate income tax (CIT) is unified with the infrastructure development tax (IDT). As a result, the new (combined) CIT rates have been lowered for commercial banks to 22 per cent

(previously: CIT 15 per cent, IDT 8 per cent) and for other entities to 14 per cent (previously: CIT 7.5 per cent, IDT 8 per cent). Personal income tax rates are reduced from 17% to 16.5% and from 23% to 22.5%, respectively. Fixed tax rates for individual entrepreneurs have also been decreased for a majority of activities. At the same time excise tax rates for production of alcoholic drinks and cigarettes and land tax rates both for legal entities and individuals were raised. Several tax exemptions were abolished, others, such as for venture funds, introduced. A number of tax incentives are abolished effective 1 April 2018, including tax incentives provided to entities, involved in localisation programs and rate reduction for corporate income tax and property tax for exporters. The list of deductibles for CIT purposes was amended to include certain expenses, such as expenses related to healthcare, contributions to non-state pension funds, a levy for fully depreciated equipment in use.

**Uzbek businesses are yet to widely embrace the benefits of business integrity.** Corporate governance of companies, in particular state-owned enterprises, is another area where further reform and implementation efforts will be needed. The State Committee for the Support of Privatised Companies and Competition and the Corporate Governance Centre are responsible for improvements in this area. Clarification of the functions and cooperation mechanisms for these entities would be beneficial. Informality is a major concern for businesses in Uzbekistan. A law on fighting Corruption was adopted in the early days of the current President's leadership.

**Administrative reform needs to deepen and the various state agencies need to be better coordinated to free the private sector from dealing with a multitude of regulatory bodies and contradictory regulations.** This is also required to streamline state support programmes for the economy, make them more efficient and ensure that vested interests will not find new niches for preferential treatment. The establishment of the State Investment Committee in March 2017 to lead the formulation and implementation of a unified state investment policy and attracting foreign investments is a positive development in the institutional framework. In August 2017, the State Fund for Business Support was created to provide financial support to SMEs via credit lines and guarantees. Lastly, a Commission for Support of Entrepreneurship and Business Environment Improvement was proposed, to oversee business environment improvements, coordinate relevant activities of state and municipal authorities and organise regular discussions of investment climate challenges. Chaired by the President, the Commission is to include all key Ministers and Heads of relevant State Committees and Agencies, business associations and SOEs, as well as mass media. Establishing a Foreign Investor's Council, which would cooperate with the government to promote foreign investment and address issues of concern for foreign investors, is also under discussion.

### 3.4 Financial sector challenges and access to finance

*To overcome state interference in credit decisions as well as lending to related parties, governance needs to improve, particularly in state-owned banks. State directed lending is distorting lending in favour of SOEs. Lending to SMEs is heavily based on collateral and insufficient for their needs. Non-bank channels for financing are little developed, though needed for providing long-term funding and equity to the private sector.*

**The state dominates the financial sector, to the disadvantage of the private sector.** Large state-owned banks (10 out of 28) hold close to 80 per cent of system assets (with the largest state-owned bank holding a 25 per cent share). State-owned banks until recently operated mainly as agents of government programmes, and disproportionately lend to state-owned

enterprises (over 50 per cent of their portfolios). The remaining banks – medium-sized banks (five with foreign ownership) and several small private banks – operate on a more commercial basis. The authorities currently consider only the privatisation of non-strategic state-owned banks, the privatisation of core financial institutions is not on the agenda at this stage. Directed lending practices in state-owned banks and foreign funding tied to the purchase of specific goods and equipment from specific countries undermine proper risk-based underwriting. Banks rely heavily on collateral and state support in lending decisions as well as in the assessment of loan quality. Both funding and lending are often made on sub-commercial terms. The resulting distortions are crowding out those parts of the private sector, which are not of strategic importance in the view of the government. Even in the absence of privatisation of state-owned banks, the private sector would greatly benefit from these banks behaving more commercially and being driven by markets.

**Despite double-digit credit growth over the last five years, access to finance is an issue for SMEs.** Uzbekistan's banking sector (179.7 trillion sum of assets as of 1 May 2017, according to CBU data or 72 per cent of 2017 GDP, 55 per cent of GDP credit penetration) is relatively large. However, the high concentration of the sector around state banks and state-directed lending constrains access to credit outside state programmes. SMEs are strongly constrained in accessing finance, according to survey results: only around one quarter of SMEs have a bank loan and more than 80 per cent finance their investments through internally generated funds, a share that is significantly higher than in other countries in Central Asia.

**The full effect of the devaluation of the official exchange rate on the banking sector remains to be seen.** System NPLs, reported to be under 1 per cent, are likely understated due to misleading classification (for example, only the scheduled repayment portion is counted as overdue vs. the equivalent outstanding amount of the loan), in some cases special treatment of overdue repayments by SOEs under state guarantee, and transfer of problem loans to off-balance sheet. The devaluation may place pressure on NPLs, especially in the largest state-owned bank (70 per cent dollarized, unlike the remainder of the sector, where dollarization is around 20 per cent), unless some exposures benefit from state-supported restructurings. Capital support measures have been announced, with a focus on state-owned banks. The government injected US\$ 500 million from the Fund for Reconstruction and Development and additional funds from Ministry of Finance into the banking system, primarily the state banks. Several private banks are in the process of strengthening capital.

**Measures are under way to improve operations in the banking system.** A President's decree issued in September 2017 outlines a range of reforms and initiatives to upgrade the banking system; beside capital and liquidity measures they address also areas such as risk management, bond issuance, IT systems and financial literacy. Banks will be freed from non-banking responsibilities (monitoring company receivables, etc.) and protected from government interference in lending decisions. With support from IFIs, a number of improvements are underway to upgrade the institutional capacity of the banking system and the legislative framework. The IMF will assist the CBU on stress testing and inflation targeting. The ADB and the IBRD are also providing assistance. The IFC helped to draft the law on credit bureau and assisted on strengthening the collateral registry system and will be providing pre-privatisation support to one state-owned bank. Governance reform will be of crucial importance as the government has traditionally imposed non-core functions including tax withholding and financial oversight of firms on the banks, which negatively affected the confidence in the banking sector.

**The financial sector in Uzbekistan is mainly represented by banking structures.** The insurance market, leasing market, and the stock market are poorly developed and often the players in these markets are directly or indirectly connected with banks (they are subsidiaries of banks). The total turnover on the Republican Stock Exchange Tashkent reached 298.6 billion sum in 2017, 0.1 per cent of GDP, after 299.8 billion sum in 2016, 1.8 times higher than in 2015, but still relatively low. Securities of 99 joint-stock companies were traded, of which 88 per cent were from the financial sector. The revival of the market in 2016 was owed to a programme aimed at reducing the state presence in the economy, which required joint stock companies to attract private equity.

**Further fundamental changes will be required in the longer run to make the financial sector an efficient source of funding.** These changes include: opening up the sector for new players; restructuring and privatising state-owned banks; strengthening supervision and central bank independence; and setting up new, non-bank channels for financial intermediation. Capital markets will need to play a larger role in providing private sector companies with equity, both to directly strengthen their financial power to develop and to make them more eligible for receiving credit once state-directed lending no longer plays an important role.

### 3.5 Constraints to cross-border connectivity and integration

*The opening up of Uzbekistan has the potential to reshape the geopolitical and economic landscape of Central Asia. Uzbekistan is not only reforming itself, but has also begun to reach out to its neighbours and deepen economic ties with the rest of the world. However, trade costs are high and connectivity, both hard and soft infrastructure, have to be upgraded to enable Uzbekistan to become a major regional hub for cross-border trade and foreign investment.*

**Uzbekistan is potentially a major regional player, but has not sufficiently exploited this potential yet.** With a population of 32 million, almost one-half of Central Asia's population, Uzbekistan has the preconditions to become a catalyst for regional integration. The location at important regional and transcontinental Eurasian transportation routes opens opportunities to establish the country as a major regional logistics, trading and production hub. Uzbekistan's trade openness looks relatively high, despite severe foreign trade restrictions and the import substitution policy. Imports of machinery, equipment, and pharmaceuticals kept imports of goods and services at 21.5 per cent of GDP in 2016, according to World Bank data, only somewhat below the average percentage for lower-middle-income countries<sup>4</sup> (27.3 per cent). Exports as a per cent of GDP stood at 20.6 per cent in 2016, versus 23.5 per cent for lower-middle-income countries. Major export destinations are Switzerland (mainly gold), China, Turkey and Kazakhstan, while top import origin from China, South Korea, Kazakhstan and Turkey. The devaluation of the official exchange rate by about 50 per cent in September 2017 will push nominal GDP in current dollars substantially down and therefore foreign trade, which is measured in dollars, in per cent of GDP significantly up. Uzbekistan's trade openness indicators will thus show rather high readings as a result. However, this might in part be explained by the presumably large share of the informal sector in the economy, not reflected in official GDP data. The foreign currency liberalisation will combine with the removal of other obstacles to foreign trade and foreign investment to move Uzbekistan further up the scale of trade openness and attractiveness for foreign investment.

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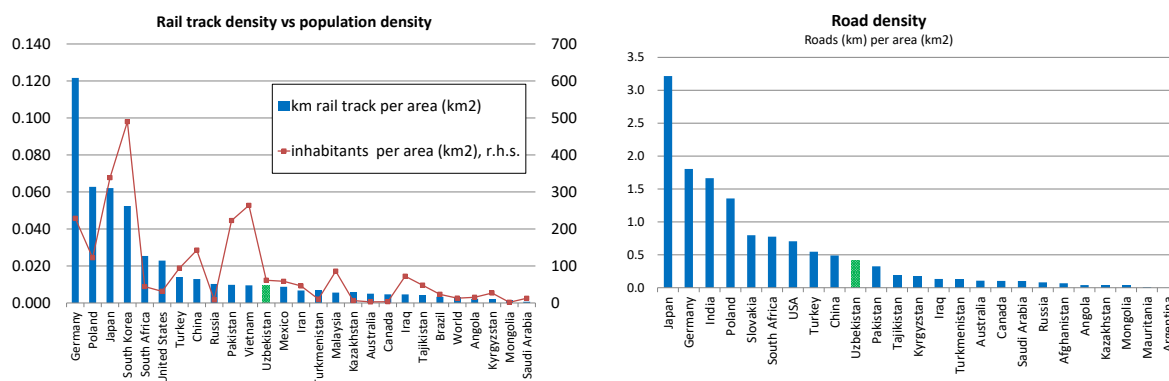
<sup>4</sup> Uzbekistan's GDP per capita at PPP was 6514 dollars in 2016, compared with average 6800 for lower-middle-income countries



**Soft barriers to trading across borders are substantial.** Lengthy procedures to obtain border and documentary compliance, as well as frequently changing regulations, continue to hinder international connectivity and put Uzbekistan behind its regional peers in terms of ease of trading. Uzbekistan ranks 147<sup>th</sup> in the trade freedom component of the Heritage Foundation's economic freedom index, which is a composite measure of average tariff rates and non-tariff barriers, the lowest among Central Asian countries. Moreover, the country currently has only four regional trade agreements in force (WTO), lower than the EBRD average of 17, limiting Uzbekistan's integration into regional and global value chains. The government has taken steps to ease customs and border clearance procedures, to introduce a single window for custom clearance, to lower documentation requirements, and to allow electronic submission of trade documents.

**Logistic bottlenecks remain a major deterrent to increasing connectivity.** Uzbekistan's logistics performance in 2016 has remained significantly below the average performance of its peers. The improvements in quality of domestic logistics services and competence of logistics personnel remained marginal. Improvements to support the development of international logistics services have been more significant, mainly due to steps taken to improve trade procedures. Ongoing work to develop a trade facilitation strategy and regional cooperation may support these efforts. Despite an extensive network of roads and railways, further development of the transport sector is constrained by regulatory obstacles and infrastructure investment needs. The country has 84,000 km long roads, of which 43,000 are paved. The length of highways is around 4,000 km, but quality remains poor, due to a limited maintenance budget and lack of an enhanced road asset management system. Uzbekistan's transportation network is broadly in line with population density (see chart 9) for a self-sufficient economy, but needs to catch up to overcome land-lockedness and to open new export markets and to establish itself as a transit hub

Charts 9 and 10



Source: World Bank, national statistic offices.

**Although there are no PPP schemes in the road sector, the government is exploring possible options.** Efforts continue to improve the rail lines and renew the rolling stock, with Uzbek Railways undertaking more than 50 investment projects to expand and rehabilitate the network. Billing and documentation requirements that are not harmonized with regional peers make regional cooperation in the rail sector difficult; efforts should be intensified to align them, as international forwarders face differing tariff policies and domestic subsidies across borders. Logistic companies report restricted direct access to Uzbekistan's state railways and are forced to operate through intermediaries. The country's air network quality is above the region's average; however to further promote air connectivity, work to integrate Navoi

airport with the Navoi international logistics centre and free economic zone (FEZ) needs to continue.

**Special economic zones play a major role in the government's global and regional integration efforts, but they need to be better endowed and connected.** In order to induce investments, the government has taken several steps, including the establishment of 11 new special economic zones (SEZs) in 10 regions, issuing tax holidays and customs waivers. Despite an increased interest in SEZs, the efficiency of these centres is constrained by lack of skilled human capital and the poor quality of utilities. Upgrading electricity supply and transportation infrastructure, integrating the SEZs with logistics centres, and improving administrative support, should help turn the SEZs into actual focal points of foreign investment, trade and production.

### 3.6 Other constraints for private sector development

**Insufficient and volatile electricity supply has remained a major obstacle to private sector performance.** While the waiting time for an electricity connection decreased from 28 days in BEEPS IV<sup>5</sup> to six days in BEEPS V and the share of firms that experienced power outages and their duration in BEEPS V decreased compared with BEEPS IV, the average number of power outages more than doubled to 15.3 in a typical month and the share of revenue lost due to power outages increased from 8.9 per cent to 16.0 per cent, the highest among the covered countries. The worsening supply reliability is caused by transmission bottlenecks as well as ageing and increasingly unreliable thermal power plants. Tariff reforms and stronger participation of the private sector are needed to improve the supply of infrastructure and electricity. The high energy intensity of Uzbekistan's economy aggravates the problem. At 280 kg of oil equivalent per thousand dollars GDP (constant 2011 PPP), Uzbekistan was the 9<sup>th</sup> most energy-intensive country worldwide in 2013, according to World Bank data. The average lower middle-income country reading was 115 kg in 2013.

**Complaints of entrepreneurs:** "Disconnections without warning, the voltage in the network does not correspond to 220V.", "3 times a week the light turns off, the chocolate melts in the cooling tunnel", "due to power and gas cut-offs in the autumn-winter period, the line stops", "light and gas are often switched off in winter, the production is standing, the room is cold", "when the light switches off, newly imported machines break down, there is a risk of quality loss"  
Frequent disconnections, low voltage in the network or lack of access to electricity and gas supply are key obstacles for business development and improvement of living standards in many regions.

**The regional development of Uzbekistan has been uneven.** Average GDP per capita in 2017 was 7761 sum, according to Statistics Committee data. At the same time it was only 4,389 in the Dzhizak region, but 12,962 in the developed Navoi region, and 15,806 in Tashkent city. Rural development, with private agribusiness at the core, will be of high importance to let transition and private sector development reach also remote areas.

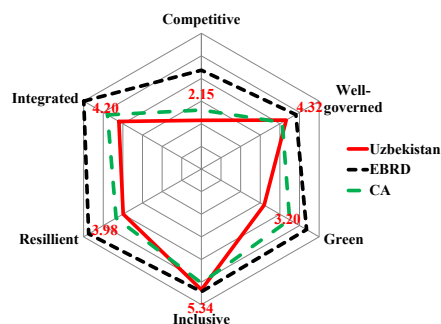
**Education, health care and labour market reforms are required for providing the private sector with a qualified labour force and for making Uzbekistan's transition to a sustainable market economy inclusive.** Life in Transition Survey data show that as many as 32 per cent of Uzbek respondents think that the main priority for additional government spending should be health care, followed by education (25 per cent) and assisting the poor (18 per cent).

<sup>5</sup> The EBRD is conducting the Business Environment and Enterprise Performance Survey (BEEPS) in partnership with the World Bank. BEEPS IV was published in 2009, BEEPS V in 2014. The BEEPS is a firm-level survey based on face-to-face interviews with managers. It examines the quality of the business environment. Five rounds of the survey have so far been implemented (1999, 2002, 2005, 2009 and 2012-14).

## ANNEX 1 – QUALITIES OF A SUSTAINABLE MARKET ECONOMY

In the EBRD's Transition Qualities (ATQs), Uzbekistan's scores below average in five of six transition qualities (competitive, well-governed, resilient, integrated, green, and inclusive). However, the scores are backward looking; the reforms currently under way may raise Uzbekistan's scores in future and help the country catch up on regional comparators.

**Uzbekistan's Transition Qualities**



Source: EBRD calculations

Note: The level of development within each of the qualities is measured from 1 to 10, with 1 meaning little or no progress and 10 representing the frontier.

The following pages provide brief snapshots of each quality.

**COMPETITIVE [ATQ = 2.15]**

**State interference, overregulation and a tax system that disadvantages company growth** over a certain threshold and discourages outsourcing have resulted in suboptimal company structures and corporate governance. This has combined with import substitution policies and the severe protection of the domestic market to keep competitiveness and innovativeness low. Insufficiently developed financial markets are also an obstacle to competitiveness.

**Market structures and institutions:**

**The domestic market was strongly protected until recently.** Currency convertibility was restricted and a multiple exchange rate regime in place until September 2017. High tariffs and excise taxes on various imports have yet to be reformed.

- **The dominance and preferential treatment of SOEs and incumbent foreign-owned companies** has hindered the entry of new firms as well as the development of existing ones. Restricted currency convertibility until recently severely affected profit repatriation, and was a major obstacle to FDI.
- **Volatile electricity supply, limited access to finance and little direct access to foreign markets negatively affected the competitiveness particularly of SMEs.** Foreign trade was largely monopolised by state-owned companies until recently. Competition from the informal sector and increasingly also import competition are also significant challenges for small businesses.
- **At around 29 per cent of GDP, credit to private sector / penetration is moderate compared to the regional peers.** Uzbekistan is ranked 55<sup>th</sup> out of 190 countries in Getting Credit according to the World Bank's 2018 Doing Business report.

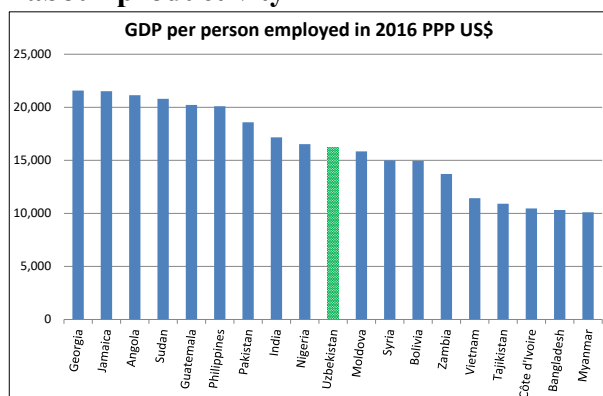
**Ease of Doing Business 2018:**

74<sup>th</sup> out of 186 countries, up by 13 places from the previous year

**Global Innovation Index 2015:** 122<sup>nd</sup> out of 141 countries

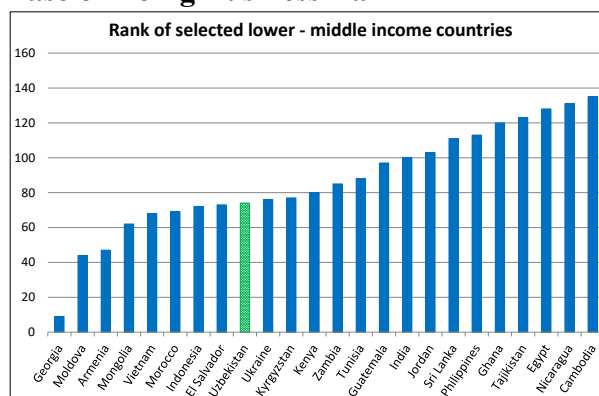
**Capacity to create value-added**

- **Labour productivity is comparable** to that of other major emerging market economies such as India. However, given outdated equipment and the many obstacles to doing business there remains much room for future productivity growth.
- **Levels of educational attainment are relatively high and** the country has a high rate of patent registrations per population. The shift towards a more knowledge-based economy is nevertheless difficult yet because of skills mismatches and a business environment not conducive for commercialisation.

**Labour productivity**

Source: The Conference Board (2017).

<https://www.conference-board.org/data/economydatabase/>.

**Ease of Doing Business Rank**

Source: World Bank Doing Business Indicators 2018.

<http://www.doingbusiness.org/rankings>.



**WELL-GOVERNED** [ATQ = 4.32]

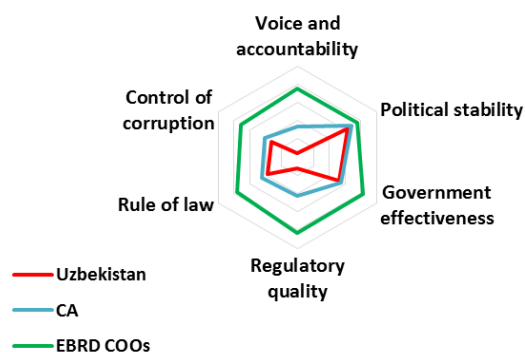
**The main obstacle that holds back private sector growth in Uzbekistan is the strong presence and involvement of the state in the economy.** Although the authorities have begun to reduce interference, it still negatively affects the business climate, constrains private sector access to resources, and distorts markets.

- **State companies need to be commercialised, and non-core functions divested.** State-owned companies and also business associations have to be freed from state functions such as industrial policy and standard setting.
- **Data availability or access to them is poor, both in the public and the corporate spheres.** Reporting requirements and methods are often outdated. To allow well-informed business activities, reporting standards have to be improved. This is an important precondition also for the establishment of well-functioning capital markets.
- There is progress in several areas of regulatory efficiency, including the **reduction in the number of procedures required for obtaining licences or real estate, reduction of inspections and introducing of e-government and one-window policies.** However, in other areas, especially on the local level, administration still needs to become more transparent and unbiased vis-a-vis special interests and regulation better targeted.
- **Informality is a top two concern for businesses in Uzbekistan.** Further streamlining the regulatory environment and decreasing costs of complying with business regulations and reporting should be one of the key tools here.
- **Anti-corruption issues are high on the government's agenda,** with an anti-corruption law being adopted in the early days of the current President's leadership. The law is supported by an anti-corruption action plan.
- **Enhancing the capacity of courts will be of particular importance to secure the rule of law in practice.** The proposed Academy of Justice aimed at ensuring proper education and training of judges is a welcome development.

Uzbekistan: 148<sup>th</sup> out of 180 countries in Index of Economic Freedom 2017 (The Heritage Foundation), with low scores in the regulatory efficiency and rule of law indicators.

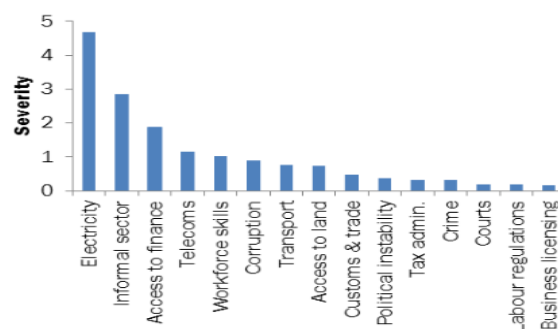
Uzbekistan: 156<sup>th</sup> out of 176 countries on Transparency International's 2016 Corruption Perceptions Index

Worldwide Governance Indicators



Source: World Bank, Worldwide Governance Indicators.

Business environment obstacles



Source: BEEPS V.

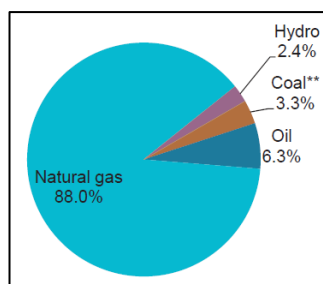
GREEN [ATQ = 3.20]

- **Uzbekistan has the second highest energy intensity in Central Asia and the second-highest carbon intensity after Turkmenistan.** Building emissions are one of the highest in the EBRD region<sup>6</sup>, with the residential sector accounting for around 40 per cent of total energy consumption followed by industry (23 per cent) and transport (8 per cent). Residential buildings consume nearly three times more energy than buildings in Spain, which has a similar climate.
- **Electricity and heat generation is currently dominated by natural gas** (75 per cent and 94 percent respectively). While the 2013 Presidential Decree on Alternative Energy aims to develop alternative sources of energy, the government is also supporting the increase of coal use in electricity generation to free up natural gas for export. Increasing the share of renewable energy sources would support the country to diversify away from hydrocarbons and help decarbonise the economy. Hydro power makes up 20.6 per cent of electricity production<sup>7</sup> but there is significant untapped potential in solar and wind energy.
- **The Aral Sea has been gradually shrinking**, losing 90 per cent of its volume since the 1960s, as a result of the diversion of the rivers feeding into the sea by Soviet irrigation projects. This has significantly increased salinity levels, and exposed huge swaths of land covered with salt and toxic chemicals which are spread around by the wind as toxic dust<sup>8</sup>.
- Central Asia was a major source of uranium in the former Soviet Union. Most of the mines were closed in 1995, but very **little remediation has been done**<sup>9</sup>. A recent agreement on the Strategic Master Plan developed by expert group under the International Atomic Energy Agency's guidance will provide a blueprint for environmental remediation of priority sites.
- **Uzbekistan is water stressed and vulnerable to the impacts of climate change, particularly in the agricultural sector.** Uzbekistan scores among the lowest 5 countries in the world (2<sup>nd</sup> percentile) in water productivity<sup>10</sup>. The Law on Water and Water Use from 1993 has been amended several times and includes provisions like water charges and basin administration but needs updating.

Potential for harnessing solar energy is significant with an average of **320 days of sunshine/yr**

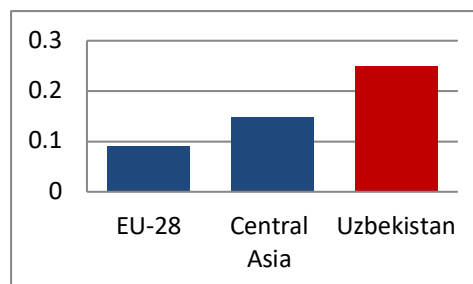
Technical energy savings in the residential sector is estimated at around **61 % of total consumption**

Share of total primary supply



Source: IEA, 2015.

Energy Intensity (TPES/GDP PPP)



Source: IEA, 2015.

<sup>6</sup> EBRD ATQs - GDP per unit of CO<sub>2</sub> emissions from residential buildings (from fuel combustion) (\$GDP/tCO<sub>2</sub>)

<sup>7</sup> IEA, 2015 Link: <http://www.iea.org/statistics/statisticsearch/report/?year=2015&country=UZBEKISTAN&product=ElectricityandHeat>

<sup>8</sup> [https://www.unep.org/greenconomy/sites/unep.org.greenconomy/files/publications/stocktaking\\_report\\_ige\\_centraasia\\_mongolia\\_final\\_web.pdf](https://www.unep.org/greenconomy/sites/unep.org.greenconomy/files/publications/stocktaking_report_ige_centraasia_mongolia_final_web.pdf)

<sup>9</sup> <http://www.ebrd.com/news/2017/plan-to-clean-up-central-asia-uranium-mining-legacy-signed.html>

<sup>10</sup> Aquaduct water stress index

**INCLUSIVE [ATQ = 5.34]**

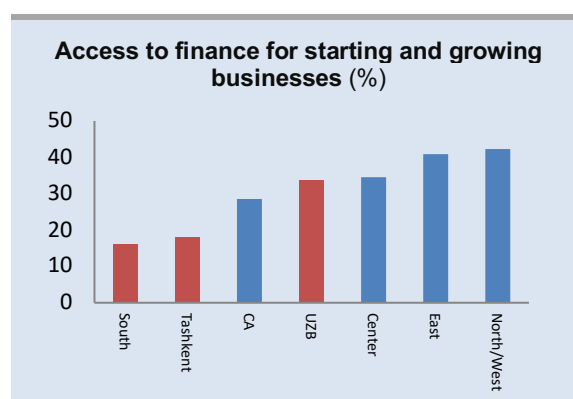
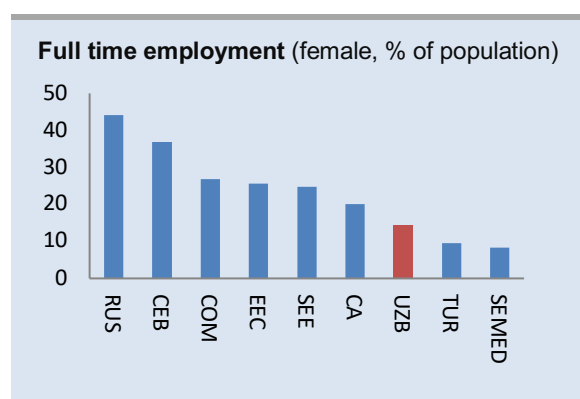
Low female labour market participation, restricted working conditions and difficulties in accessing labour markets pose substantial inclusion challenges particularly for women, less developed regions and young people in Uzbekistan.<sup>11</sup>

- **The majority of women are subject to vulnerable employment under self-employment or unpaid family work.** Femal participation rate was 48 per cent in 2016 versus 76 per cent for males according to the ILO methodolgy. However, only 14 per cent of working age women are employed full-time and work for only one employer.
- **Gender inequality in the labour market is exacerbated by laws restricting the industries in which women can work.** This is particularly the case in mining, construction, metalworking, manufacturing sectors where women are barred from performing jobs that are deemed hazardous. Ensuring the safety and health of both men and women workers is essential for achieving workforce diversity.
- **Anticipating and addressing labour market challenges has become a government priority.** As one of the youngest countries in Asia, with almost 60 per cent of the population under the age of 30, Uzbekistan will require a high rate of new jobs being added to the labour market.<sup>12</sup> However evidence shows a mismatch between the number of graduates and that of new jobs being created, particularly in technical disciplines and at tertiary level.<sup>13</sup>
- **Accessing business finance is particularly challenging for women, young people and individuals in Tashkent and southern Uzbekistan.** Large disparities in the country's regional development affect, among other issues such as employment and access to infrastructure and electricity also access to finance. Whilst access to finance for starting new businesses compares relatively favourably to other countries in Central Asia according to Gallup Survey data, they are characterised by substantial within-country differences.

Only a small fraction of women is employed full-time for one employer.

Laws restricting women's work in certain industries aggravate existing gender gaps in the labour market.

More than 80 per cent of adults in Tashkent and southern Uzbekistan report that they do not have access to finance to start and grow a business.



Source: Gallup World Poll's surveys from 2013 to 2016.

<sup>11</sup> There are not any labour force survey data available for Uzbekistan. The latest data about the labour market is from 2007 and based on employment office records. The figures used in this document are computed from the micro data for Gallup World Poll's surveys from 2013 to 2016.

<sup>12</sup> United Nations Development Programme. Country Info. About Uzbekistan.

<http://www.uz.undp.org/content/uzbekistan/en/home/countryinfo.html>.

<sup>13</sup> World Bank. 2014. Uzbekistan: Modernizing Tertiary Education. Washington, DC.

**RESILIENT [ATQ = 3.98]****Economic resilience**

- **Uzbekistan is significantly exposed to external shocks due to insufficient diversification and complexity of products.** While Uzbekistan's exports are relatively well diversified as measured by the 3 main exports in total export ratio, production complexity is low, however, and exports concentrated in mining and cotton products. This leaves the country exposed to commodity price shocks. The high weight of remittances in the population's income is another source of external shocks affecting Uzbekistan.
- **The banking system appears fairly resilient, but NPLs are likely understated.** Officially reported regulatory capital stood of the banking system at sum 15.4 trillion as of 1 October 2017, (unweighted) assets at 161.2 trillion and the NPLs were reported to be 1.1 per cent. The CAR was reported at 15.5 per cent. The capital was up from 9.9 trillion on 1 April 2017 thanks at least in part to state support.
- **Bank capitalisation concerns are partly mitigated** by the state's capacity to support systemic state-owned banks. Private banks are also seeking to raise capital.
- **The large share of state-owned banks**, their high exposure to state-owned companies, and weak underwriting practices linked to government policy vs. commercial considerations expose banking sector to credit risks.
- **While dollarisation levels are moderate** (40 per cent on loan side), some impact from devaluation is expected to flow into credit risks, contributing to deterioration of asset quality.

**Uzbekistan's 3 main export products** accounted for 36 per cent of total exports in 2012-16 (Trademap mirror statistics)

**Economic complexity index:** 97th out of 124 countries

**Electricity losses** are estimated to equal about 20 per cent of net generation.

**Energy Resilience**

- **Supply reliability is hampered by transmission bottlenecks and ageing and increasingly unreliable electricity generation plants.** Despite investments in transmission and distribution networks, electricity losses remain relatively high, estimated at 20 per cent of net generation. The impact of electricity outages on businesses is significant in Uzbekistan (6.6 per cent of annual sales), with higher impact in rural areas.
- **To ensure energy system resilience diversification of supply sources is important.** This could best be done through increasing the share of renewable generation and enhanced regional trade, and through efficiency improvements in industry and agriculture.
- Reducing dependence on gas for electricity generation by **converting gas-fired thermal plants to coal-fired or constructing new coal-fired power**, as has been suggested, **would cause significant negative externalities** and lock the country into reliance on highly polluting fuels for decades.
- **Uzbekistan's high energy intensity aggravates the problem of unreliable supplies.** At 280 kg of oil equivalent per thousand dollars GDP (constant 2011 PPP), Uzbekistan was the 9th most energy-intensive country worldwide in 2013, according to World Bank data. The average lower middle-income country reading was 115 kg in 2013.



**INTEGRATED** [ATQ = 4.20]

**Barriers to trading across borders are substantial.** Lengthy procedures to obtain border and documentary compliance, as well as frequently changing regulations, continue to hinder international connectivity and put Uzbekistan behind its regional peers in terms of ease of trading. FDI inflows were very low in recent years.

**External integration**

Uzbekistan's trade and investment openness was for a long time impaired by heavy regulation and restrictions both on current account and capital account convertibility.

- Lengthy procedures to obtain border and documentary compliance and frequently changing regulations put Uzbekistan behind its regional peers in terms of ease of trading. Uzbekistan ranks 147<sup>th</sup> in the trade freedom component of the Heritage Foundation's economic freedom index, which is a composite measure of average tariff rates and non-tariff barriers, the lowest among Central Asian countries.
- The country has 50 bilateral investment agreements; however obstacles to profit repatriation and also the repatriation of the principal due to the lack of currency convertibility recently severely constraint investment openness until.

Uzbekistan ranks 147<sup>th</sup> in the trade freedom component of the 2017 Heritage Foundation's economic freedom index.

FDI inflows were 133 and 96 million dollars in 2016 and 2017, respectively, according to Unctad data.

**Internal integration**

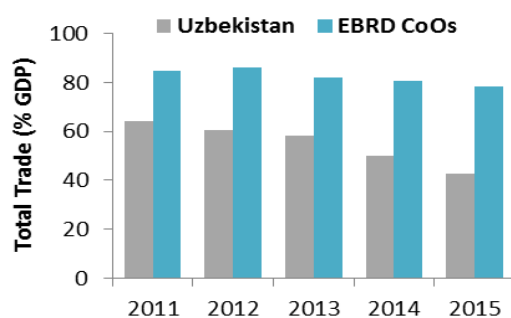
- Domestic transport:** Despite an extensive network of roads and railways, the overall condition of the transport infrastructure outside main economic centres has remained poor due to insufficient maintenance services. Uzbekistan's logistics performance is below the EBRD average due to lack of high-quality logistics services.
- Cross-border integration:** International logistics services, dominated mainly by foreign companies, remain inadequate due to inefficiencies in customs and border clearance. High cost of trading across borders hinders competitiveness and integration.

118<sup>th</sup> out of 160 countries on World Bank Logistics Performance Index 2016.

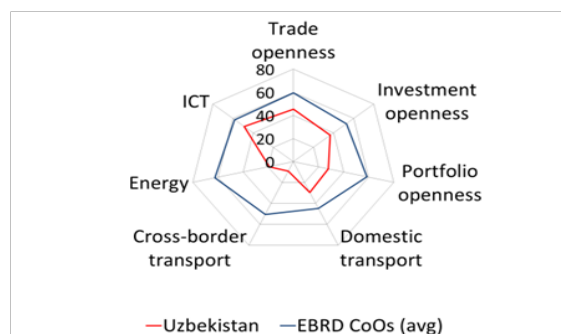
Cost of trading across borders: ranked 165<sup>th</sup> (index number) out of 190 countries

Broadband penetration: 48%

**ICT:** Although almost one-half of households have internet subscription (fixed and mobile), the ICT infrastructure is still owned monopolistically, and most services are limited to urban areas.

**External Integration**

Source: IMF WEO, EBRD calculations.

**Sub-components of integration**

Source: EBRD calculations.

## ANNEX 2: MACROECONOMIC PERFORMANCE AND OUTLOOK

**Economic growth in Uzbekistan eased to 5.3 per cent in 2017 from 7.8 per cent in 2016**, with data suggesting slower growth in construction, industrial output and agriculture. However, the lower readings likely reflect more proper accounting in order to improve the reliability of statistics. Exports grew by 15 per cent year-on-year in US dollar terms in 2017 and remittances from Russia surged by 42 per cent in US dollar terms.

**The foreign exchange regime has been liberalised.** Since 5 September 2017 the Central Bank of the Republic of Uzbekistan stopped administratively setting the exchange rate and devalued the official rate by 48 per cent to sum 8,100:US \$1 from sum 4,210:US\$ 1 set previously. Interventions serve only to prevent large fluctuations. The sum has been floating in a range of 7,980-8,140 to the dollar since.

**Average inflation accelerated from 8 per cent year-on-year in 2016 to 12.5 per cent in 2017, reaching 14.4 per cent by end-2017.** The impact of the currency devaluation on inflation has been relatively limited due to the fact that the unofficial exchange rate had already been much weaker than the official one prior to the exchange rate unification. Inflation is expected to remain in low double digits in 2018 and 2019 because of further price liberalisation and the resulting adjustment in relative prices.

**Credit growth has reaccelerated.** The central bank loosened monetary policy during the first half of 2017 but tightened it again prior to the run-up to the foreign exchange liberalisation in September. However, data for early 2018 point to a significant re-acceleration in credit growth thanks to sufficient liquidity in the bank system.

**Fiscal and external positions remained strong.** Uzbekistan's consolidated budget deficit is estimated to have remained below 1 per cent of GDP in 2017 and is expected to widen only slightly thanks to the unwinding of the government's housing and infrastructure programmes. Public debt is estimated to total about 25 per cent of GDP. The balance of payments was likely broadly balanced in 2017 thanks to foreign currency selling by exporters and also the population. The inflow of foreign direct investment (FDI) and investment loans totaled sum 16.3 trillion in 2017 according to official data, with 57 per cent invested in the oil and gas sector, 13 per cent in manufacturing and 10 per cent in telecommunications. Net international reserves stood at US\$ 27 billion in March 2018, and external debt at only around US\$ 16 billion (33 per cent of GDP).

**The economy is projected to grow by 5.1 per cent in 2018 and 5.3 per cent in 2019** on the back of increased investment and public spending on infrastructure, as well as export growth. However, the impact of deep structural reforms, including tax and customs reform and the overhauling of the role played by extrabudgetary funds, and changes in statistical methodology and data collection make forecasts subject to significant uncertainty.



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