The Uzbek Approach to Financial System Development: An Analysis of Achievements and Failures

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Abstract

This paper provides a detailed analysis of Uzbekistan’s performance in liberalising its financial system. Two major areas are considered in the paper. First, we review financial development reform in Uzbekistan from independence until 2006, including the banking sector, non-bank financial institutions and securities markets. Second, it examines the policy achievements and failures of the Uzbek path and the sequence of reforms in each of these areas. Policy recommendations are then offered to remedy the existing problems that we identify. This paper is first to make a detailed analysis of policy successes and failures in Uzbekistan financial reform.

Keywords: Financial reform; post-communist countries; transition; Uzbekistan

JEL Classification: E44, P21, P26, P34

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1. Introduction

The role of the financial system in economic development has long been at the centre of policy debate since the seminal work of Schumpeter (1936 (1911)). Although no unequivocal conclusion has been reached, the majority of economists appear to agree that the financial system plays a pivotal part in economic growth.

Since the former communist countries of the Eastern Europe and the Soviet Union began their transition towards market economies in late 1980s, a huge practical experiment has been under way. One of the facets of this real-world experiment was to test how countries with adequate (in comparison with third-world countries) economic development, but with undeveloped financial systems, would be able to cope with the demands of a market economy and foster economic growth. The results have been mixed. Some countries, particularly in Eastern Europe, largely succeeded in both developing a modern financial system and restoring economic growth, whereas others from the former Soviet realm have achieved much less.

Whilst the Eastern European financial development experience is well-known, the processes in other countries, such as those of former Soviet Central Asia, have received much less attention. This paper seeks to address this neglect by examining financial development in Uzbekistan. Although an embryonic literature does exist on this question (Akimov, 2001; Akimov, 2002; Akimov & Dollery, 2006), which has provided a synoptic description on the path of reforms, detailed analysis of financial sector reform achievements and failures in Uzbekistan has yet to be conducted. This forms the subject of the present paper.

The paper itself is divided into four major parts. Section 2 discusses economic policies and macroeconomic environment in 1991 to 2006. Section 3 reviews the evolution of Uzbekistan’s financial sector over the period 1991 to 2006, including an analysis of the banking sector, non-bank financial institutions and the securities market. Section 4 considers the current stage of development of the financial system as well as the problems faced by its participants. Moreover, it offers some policy recommendations for correction of policy failures and for future policy development. The paper ends with some brief concluding remarks in section 5.

2. Economic performance and policies in 1991 to 2006

Since the collapse of the Soviet Union and its administrative command system of economic management, independent Uzbekistan has embarked on a path of reform towards a market-oriented economy. In essence, it has adopted a gradualist approach to economic reforms. Three main stages can be identified: intensive reforms of 1991-1996, often described as ‘Uzbek paradox’; reform reversals of 1997-1999; and recent developments from 2000.
In the first stage, policies aimed at creating the basic infrastructure required for an independent state to function, as well as to adopt a legislative foundation for the implementation of market-oriented reforms, social protection, price liberalisation, inflation control and privatisation, followed by stabilisation of production, expansion of the private sector, introduction of a national currency, and promotion of structural reforms (Sirajiddinov 2004).

A notable characteristic of this period is that the majority of stated policies were implemented. Significant outcomes were achieved. For instance, Uzbekistan recorded the smallest output decline among ex-Soviet countries and registered output recovery earlier than the majority of the Commonwealth of Independent States (CIS) republics. Moreover, the authorities were able to liberalise prices with relatively small negative consequences for the population. A three-stage privatisation process was launched, with the first and partially second stage successfully implemented\(^1\). By contrast, structural reform policy and anti-inflation measures proved less successful.

The end of 1996 saw a fundamental change in Uzbek economic policies. The government responded to the internal and external shocks of 1996-1998, caused by poor cotton and grain harvests, a drop in price for major exports, and the Russian crisis. It softened monetary policy and introduced foreign currency rationing. Moreover, the authorities explicitly switched to an import substitution policy. Substantial directed credits were channelled into large import substitution projects. Certain categories of ‘priority’ importers received additional subsidies through low exchange rates.

There was little progress towards privatisation during 1997-1999. A programme of privatisation of large enterprises on a ‘case-by-case’ basis largely failed, since only one enterprise out of a planned thirty was sold to private investors. The creation of new small and medium-sized businesses was also slow, apart from basic consumer services (Pomfret 2006).

In spite of reform slowdown and reversals, positive real output growth continued over 1997-1999, with a growth recorded in all three years: 2.5 per cent in 1997, 4.4 per cent in 1998 and 4.1 per cent in 1999. Moreover, inflation was brought down to lower than 50 per cent in 1998-1999. The budget deficit was also reduced and fell under 3 per cent in all three years. The government continued to implement extensive social programmes, and to fund health and education at reasonably high levels.

The period since 2000 can be characterised as a period of largely unfulfilled promises by the Uzbek leadership in terms of liberalisation and reforms. At the 14th session of the Oliy Majlis in 1999, it declared a policy of comprehensive liberalisation. The priorities for economic reforms included a reduction in state intervention, the strengthening of legal protection for enterprises from such

\[^1\] During the first stage all housing as well as small businesses, primarily in the services sector, were privatised. During the second stage, the remaining small enterprises, a majority of medium and some large enterprises were to be privatised. The third stage envisaged de-nationalisation of the majority of large remaining enterprises.
intervention, and liberalisation of the foreign exchange market. Since 2000, the government slowly had begun to reduce the huge gap in different foreign exchange rates by devaluing controlled exchange rates. In light with the declared intentions for comprehensive economic liberalisation, in 2005 the programme of banking sector development was adopted that envisaged liberalisation and reform of the banking sector. The outcomes of this programme have been rather mixed.

The reforms in majority sectors did not proceed well. The privatisation of large enterprises did not progress well mainly due to unwillingness of the authorities to offer for sale sizeable stakes in those enterprises. Despite being one of the most important sectors of the Uzbek economy, agriculture remained largely unreformed. The former kolhozes (collective farms) of the Soviet era were re-named shirkats. However, their operations have changed little over the 15 years of Independence, as the staff and management continued to be appointed by regional councils.

The authorities continued a gradual reduction of direct tax rates. In 2004, the corporate income tax rate was reduced from 20 per cent to 18 per cent and further to 15 per cent in 2005. Deductions for social insurance were also decreased and simplified. The income tax rates for individuals were also reduced. However, the tax burden remained large in comparison to other transition and developing economies (Sirajiddinov 2004).

The Uzbekistan trade regime remained restrictive over the period. Although the government abolished non-tariff barriers as part of the IMF Staff-Monitored Programme, the effective tariff rates for consumer exports remained significant and were increased after 2002. Excise tax rates on several consumer exports were higher than on domestic goods (Asian Development Bank 2006). The tax regime discriminated against trade with some countries and against imports by individuals. Since 2002, the government introduced restrictions on trade, including the regulation of the wholesale and retail trades, which affected the domestic marketing of imports. These measures resulted in a significant increase in the price of imported goods, which strengthened the position of large, typically government-controlled retailers.

After 2003, exports rose due to increases in international gold prices, combined with an increased volume of non-traditional exports. As a result of restrictive import policies and boosted exports, a current account surplus has been recorded since 2002. This helped the government to accumulate a comfortable level of foreign exchange reserves. Foreign exchange management improved as a part of the IMF Staff-Monitored Programme. Multiple exchange rates were unified and convertibility for current account transactions was adopted at the end of 2003, although there are occasional reports of delays with currency conversion. Unfortunately, the unpredictable and dirigiste manner in which it was achieved harmed confidence in the financial sector. Moreover, the authorities did not voice an intention to pursue measures that would lead to opening the capital account.
Over the period, fiscal policy was prudent. This resulted in a gradual reduction of the budget deficit over 2000-2003, which turned into a surplus in 2004-2005. Following a zero net borrowing policy, the authorities reduced the gross public debt to about 38 per cent of GDP.

Starting from 2002, the government pursued a tight monetary policy. This helped to reduce inflation in 2003-2004. However, some observers (see, for example, Asian Development Bank 2006) had noted the increasing divergence between official and alternative estimates of consumer price inflation. The official level of the CPI was 7.8 per cent in 2005, whereas an alternative estimate indicated a figure of about 20 per cent.

There was a modest economic growth over the period of around 4 per cent in 2000-2003 increasing to over 7.0 per cent in 2004 to 2006, according to official estimates. Excellent cotton crops in 2004 to 2006, as well as a robust external sector performance (mainly driven by exports of state-owned enterprises), contributed to this growth.

Domestic savings improved over 1999-2006. The investment to GDP ratio decreased from a record high in 1996 to a low-moderate level of around 20 per cent. The share of foreign direct investments remained very low due to the unfavourable business environment.

The main economic indicators over 1991-2006 are presented in Table 1.

**Table 1. Main economic indicators 1991-2006**

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</thead>
<tbody>
<tr>
<td>GDP growth, %</td>
<td>-0.5</td>
<td>5.2</td>
<td>4.3</td>
<td>4.3</td>
<td>3.8</td>
<td>4.2</td>
<td>4.0</td>
<td>4.2</td>
<td>7.7</td>
<td>7.0</td>
<td>7.3</td>
</tr>
<tr>
<td>GDP per capita¹</td>
<td>667</td>
<td>515</td>
<td>528</td>
<td>543</td>
<td>558</td>
<td>574</td>
<td>590</td>
<td>608</td>
<td>647</td>
<td>684</td>
<td>725</td>
</tr>
<tr>
<td>GDP per capita²</td>
<td>1950</td>
<td>1506</td>
<td>1545</td>
<td>1589</td>
<td>1632</td>
<td>1679</td>
<td>1725</td>
<td>1777</td>
<td>1892</td>
<td>2001</td>
<td>2121</td>
</tr>
<tr>
<td>Domestic savings/GDP, %</td>
<td>23</td>
<td>19</td>
<td>20</td>
<td>17</td>
<td>19</td>
<td>20</td>
<td>22</td>
<td>27</td>
<td>32</td>
<td>33</td>
<td>34</td>
</tr>
<tr>
<td>Investments/GDP, %</td>
<td>27</td>
<td>22</td>
<td>20</td>
<td>18</td>
<td>16</td>
<td>20</td>
<td>20</td>
<td>24</td>
<td>24</td>
<td>24</td>
<td>22</td>
</tr>
<tr>
<td>FDI/GDP, %</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Inflation (GDP deflator, %)</td>
<td>91</td>
<td>66</td>
<td>39</td>
<td>44</td>
<td>47</td>
<td>45</td>
<td>45</td>
<td>27</td>
<td>16</td>
<td>21</td>
<td>22</td>
</tr>
<tr>
<td>Budget deficit (% of GDP)</td>
<td>-3.6</td>
<td>-2.4</td>
<td>-3.0</td>
<td>-2.6</td>
<td>-2.2</td>
<td>-2.1</td>
<td>-1.9</td>
<td>0.1</td>
<td>0.6</td>
<td>1.2</td>
<td>5.2</td>
</tr>
</tbody>
</table>

¹ Constant, year 2000 USD

² PPP method; in USD


### 3. Financial sector reform from 1991 to 2007

In common with the path of economic reform, we can distinguish three major phases in financial sector reform. Most financial sector reforms took place in the first stage of reform over the period 1991 to 1997. In second stage, which extended over the period 1998 to 2001, little progress was achieved. In final stage, which started in 2002, reform has progressed, although at an extremely slow pace and in an unsystematic manner.
3.1. Banking sector

The initial attention of legislators and policy-makers was directed at reforming the banking sector. This was largely because a few non-bank financial institutions that did exist at Independence were in an embryonic state. Taking into account the lack of expertise of policy-makers, it was probably the optimal approach to financial system development.

The Banking Act, introduced in 1991 by the Uzbek parliament, has been a cornerstone in the development of the banking and financial system of Uzbekistan. It paved the way for the formation of the two tier-banking system with new functions for the Central Bank; that is, the creation of a foreign exchange market, a securities market, an interbank money market and the establishment of a number of non-bank financial institutions (NBFIs) (Akimov, 2001).

As reforms in the economy and the financial system progressed, two new Acts (separate for the Central Bank and for commercial banks) replaced outdated legislation. Moreover, a number of other legislative documents were adopted to regulate the activities of non-bank financial institutions, the securities market and to protect investors’ rights.

Since Uzbekistan remained in the Russian rouble zone until the end of 1993, the Central Bank had limited monetary regulation powers. With the introduction of the permanent national currency – the soum in July 1994 - the manner in which the Central Bank conducted its refinancing policy has gradually changed. Initially, its policy was carried on in a fashion similar to the Gosbank of the former USSR, i.e. using direct methods of monetary control. The Central Bank issued loans to banks as well as direct to enterprises, often without taking into account the repayment ability of borrowers. During that period, indirect methods, such as the reference rate, were not considered by the Central Bank as a relevant component of monetary policy. However, gradually policy has changed, and the reference rate was used to attain macroeconomic stability, to maintain bank liquidity, and to provide support for selected priority sectors in the economy.

During 1994 and 1995 the reference rate was raised several times until it became positive in real terms and remained positive most of the time thereafter. The reference rate movements in comparison with consumer price inflation are presented in Figure 1.
Earlier in 1992, the Central Bank started to apply reserve requirements to the commercial banks as an instrument of monetary policy. Until 2005, reserve requirements were only applied to bank deposits in the national currency with rates gradually decreasing from a high 30 per cent to 15 per cent on short-term loans and 10 per cent on long-term loans. Reserve requirements on foreign currency deposits were introduced in January 2005 at a 5 per cent rate and, in October 2005, increased to 8 per cent. The decision of Central Bank of Uzbekistan (CBU) not to pay interest on the reserve deposits had a negative effect on the profitability of banks.

It is somewhat surprising to note that the commercial banks had for some time kept much larger volumes of funds with the CBU than the volumes required to comply with above-mentioned already high reserve requirements. This seems to have been brought about by several factors. In the first place, there were not many other safe and liquid options available, particularly before Treasury Bills were issued in 1996 and an interbank money market started to develop. A second reason was simply mismanagement by banks due to the absence of sufficient knowledge and skills needed in modern commercial banking practice.

Open market operations are a monetary instrument widely used in developed economies to influence monetary aggregates. However, it had not been effectively employed by the Central Bank of Uzbekistan. The CBU offered very limited scope of securities (chiefly zero-coupon short-term Treasury Bills) to a small group of financial institutions (almost exclusively banks). However, these securities had two major problems. Firstly, they yielded negative interest rates in real terms up to 2003. Secondly, they were often not re-paid in cash upon maturity. Instead, new issues were used to replace old ones. At some stage, the situation worsened to the point that the CBU forced some state-owned commercial banks to purchase Treasury Bills. The Narodnybank\(^2\) was often picked by

\(^2\) State-owned savings bank.
authorities as a major buyer since it had large amounts of excess liquidity generated from deposits of individuals.

In July 1996, a package of reforms of the payment system was introduced. As a consequence, the archaic Soviet method of manual payment handling was transformed to an electronic payments clearing system that covered all regions of Uzbekistan. Until 2003, the regional branches of all banks had to have separate accounts with the CBU. In 2003, one single account clearing system (with the CBU) was introduced.

In November 1996, the Board of the CBU adopted a new charter of accounts for the CBU and the commercial banks to replace the outdated Soviet accounting system. The new accounting system was introduced in March 1997 and improved the quality of monetary statistics and brought it closer to international accounting standards. In particular, (i) accrual basis of accounting replaced a cash basis approach; (ii) fair (market) value accounting principles were introduced for trading account securities; (iii) loan loss reserves were added as a counter entry for gross loans in the asset side of a balance sheet; (iv) fixed assets were to be recorded taking into account depreciation; and (v) new principles of accounting for foreign currency operations were set forward to reflect the facts that foreign currency operations no longer became a sole privilege of Vnesheconombank and its Uzbek successor National Bank of Uzbekistan.

The Central Bank encouraged commercial banks to undertake an audit based on IAS or GAAP by reimbursing their costs of audit for the financial year 1996 if conducted by a renowned international auditing firm. Since then, an increasing number of commercial banks have started to use the services of international auditors. It is ironic to note however that the Central Bank itself did not undergo an external audit until the 2002 financial year.

Prudential regulation and supervision functions have also fallen under the CBU. Regulations were first introduced in 1992 and determined the order of formation, planning and use of credit resources, in an attempt to overcome the lack of sufficient skills in commercial banks to manage liquidity and regulate risks. More systematic attempts to improve the quality of supervision were made in 1997, when a regulatory framework was adopted setting out various requirements for the reorganisation of the commercial banks; procedures for their reporting to the Central Bank, for the registration, licensing, and liquidation of banks, and setting penalties for violation of banking regulations. These reforms brought capital adequacy ratios in compliance with Basel I standards. However, serious attempts to introduce more recent Basel II requirements have not yet been made. This echoes the general poor level of risk management skills and regulations in the banking sector (Akimov & Dollery, 2006).

Since the Uzbek government saw the banking sector’s role as an important instrument in the implementation of the country’s import substitution policies, the sector was dominated by state-
owned and state-controlled banks. The assets of the three banks that are directly owned by the government comprised 65 to 80 per cent of the assets of the banking sector over the period 1996 to 2005. Among these three, the National Bank of Uzbekistan stands out. Since 1996, this giant bank has controlled over 50 per cent of assets of the banking system. At the same time, the share of all assets held by private and foreign banks combined never exceeded 10 per cent.

As shown in the Table 1, the number of banks over 1992-2006 remained fairly stable. This was mainly due to the fact that the CBU exercised caution in issuing licences to private banks. Moreover, access by foreign banks remained highly restricted. This allowed the Central Bank to tightly control the activities of Uzbek banks. In recent years the process of mergers and acquisitions took off in the banking sector. These were largely state-sanctioned and involved state-controlled banks.

Official statistics on non-performing loans over 1993-1999 have been extremely heartening with non-performing loans accounting for less than 1 per cent of total loans (see Table 2). One reason for these low figures is that the majority of non-performing loans were government-guaranteed loans and therefore were classified as good-quality assets. Another reason is that banks generally preferred rolling over or restructuring problematic loans rather than classifying them as non-performing. Since early 2000s, Uzbek government has dramatically reduced a number of new guarantees issued for local banks, which should force them to consider risk/return characteristics of each project more diligently.

Although figures for more recent years are likely to be closer to actual figures, it is still possible that they are underestimating the true extent of the problem (European Bank for Reconstruction and Development, 2005; Rabobank, 2006).

### Table 2. Banking sector indicators

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<tbody>
<tr>
<td>Number of banks (with foreign participation)</td>
<td>30</td>
<td>21(1)</td>
<td>29(1)</td>
<td>31(1)</td>
<td>29(2)</td>
<td>30(4)</td>
<td>33(4)</td>
<td>35(5)</td>
<td>34(6)</td>
<td>38(6)</td>
<td>35(6)</td>
<td>33(5)</td>
<td>31(5)</td>
<td>29(5)</td>
<td>28(5)</td>
</tr>
<tr>
<td>Asset share of state-owned banks %</td>
<td>21.7</td>
<td>15.9</td>
<td>46.7</td>
<td>38.4</td>
<td>75.5</td>
<td>70.6</td>
<td>67.3</td>
<td>65.8</td>
<td>77.5</td>
<td>80.4</td>
<td>73.7</td>
<td>70.0</td>
<td>67.6</td>
<td>65.2</td>
<td>na</td>
</tr>
<tr>
<td>Non-performing loans¹ (to total loans) %</td>
<td>na</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0.4</td>
<td>0.1</td>
<td>0.1</td>
<td>3.0</td>
<td>5.1</td>
<td>8.5</td>
<td>10.9</td>
<td>9.3</td>
<td>8.9</td>
<td>7.3</td>
</tr>
<tr>
<td>Loans under government guarantee/Total loans %</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>na</td>
<td>82.9</td>
<td>82.4</td>
<td>78.2</td>
<td>75.5</td>
<td>69.5</td>
<td>59.8</td>
</tr>
</tbody>
</table>

¹ Different sources used for 1993-1999 and 2000-2006, therefore dataset may be inconsistent

Source: European Bank for Reconstruction and Development (1995-2005); Avesta Investment Group (2006); Center for Effective Economic Policy (2006b); International Monetary Fund (2008) and author’s calculations

The issue of privatisation of state-owned banks has been discussed in policy circles since the early years of independence. However, little progress has been achieved to date largely due to a lack of political will. The schedule for privatisation of the two largest state-owned banks (Asakabank and NBU) has been revised a number of times since 1998, with the current proposition to sell the majority stake in them by 2009. No plans for privatisation of Narodnybank have been voiced.
The interbank money market was established by the authorities in early 1996 as part of the Central Bank’s development of the instruments of monetary policy. The interbank money market soon became an important source for a number of banks to solve their short-term liquidity problems. However, it did not fully regulate the flow of surpluses and deficits among the commercial banks of Uzbekistan since only Narodnybank was capable of consistently generating cheap funds on offer, which were, in turn, savings from the public. Further development of the interbank market took place in 2004 with establishment of the national interbank loan market. Twelve commercial banks were participants in the interbank market in 2005 (Center for Effective Economic Policy, 2006b). In spite of these developments, the Central Bank continued to exercise effective control over transactions and the terms of interbank loans.

Interest rates were negative in real terms from 1991 to 2002. Combined with the low confidence of the population in the Uzbek banking system, this created significant problems of attracting deposits from the public. Individuals hold national currency for transaction purposes but prefer to make savings in the form of foreign currency notes (primarily in US dollars).

Domestic credit was growing over the period 1993-2006. During the first three years the growth rate was substantially lower than the inflation rate. Combined with negative real interest rates charged for loans, banks were generally reluctant to expand their credit portfolios. The real loan rate remained negative until 2001. Banks thus preferred to provide loans in foreign currencies. The growth of credit in the banking sector was largely achieved by large banks that refinanced government-guaranteed credits issued by various international financial institutions. Table 3 shows the dynamics of credit and interest rates over 1992-2005.

Table 3. Credit, interest & exchange rate dynamics

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<tbody>
<tr>
<td>Domestic credit</td>
<td>bln. soum</td>
<td>4.4</td>
<td>27.4</td>
<td>49.4</td>
<td>142.6</td>
<td>215.6</td>
<td>387.0</td>
<td>520.6</td>
<td>982.9</td>
<td>1,961</td>
<td>2,798</td>
<td>3,127</td>
<td>3,410</td>
<td>3,853</td>
</tr>
<tr>
<td>Domestic credit % change</td>
<td>854.4</td>
<td>525.3</td>
<td>80</td>
<td>188.8</td>
<td>51.2</td>
<td>79.5</td>
<td>34.5</td>
<td>88.8</td>
<td>90.8</td>
<td>40.9</td>
<td>11.8</td>
<td>9.0</td>
<td>13.0</td>
<td>6.4</td>
</tr>
<tr>
<td>Treasury Bill yield</td>
<td>%</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>36.0</td>
<td>26.0</td>
<td>16.6</td>
<td>16.5</td>
<td>17.1</td>
<td>17.1</td>
<td>17.1</td>
<td>11.0</td>
<td>11.6</td>
<td>12.4</td>
</tr>
<tr>
<td>Deposit rate</td>
<td>%</td>
<td>30.0</td>
<td>60.0</td>
<td>90.0</td>
<td>28.0</td>
<td>14.8</td>
<td>13.1</td>
<td>13.5</td>
<td>18.8</td>
<td>21.2</td>
<td>26.0</td>
<td>23.0</td>
<td>18.5</td>
<td>15.5</td>
</tr>
<tr>
<td>Lending rate</td>
<td>%</td>
<td>-</td>
<td>-</td>
<td>-</td>
<td>100.0</td>
<td>105.0</td>
<td>49.7</td>
<td>28</td>
<td>33.1</td>
<td>32.7</td>
<td>27.6</td>
<td>27.6</td>
<td>33.4</td>
<td>28.1</td>
</tr>
<tr>
<td>Inflation rate</td>
<td>Consumer prices</td>
<td>%</td>
<td>885</td>
<td>1281</td>
<td>116.9</td>
<td>64.3</td>
<td>50.0</td>
<td>26.1</td>
<td>26.0</td>
<td>28.2</td>
<td>26.5</td>
<td>21.6</td>
<td>7.8</td>
<td>9.1</td>
</tr>
<tr>
<td>Producer prices</td>
<td>%</td>
<td>1919</td>
<td>1422</td>
<td>217.4</td>
<td>75.4</td>
<td>40.3</td>
<td>48.4</td>
<td>34.5</td>
<td>70.2</td>
<td>43.9</td>
<td>46.1</td>
<td>27.4</td>
<td>26.5</td>
<td>28.2</td>
</tr>
<tr>
<td>Official exchange rate, soums per USD</td>
<td>Year end</td>
<td>-</td>
<td>25</td>
<td>35.5</td>
<td>54.7</td>
<td>80.2</td>
<td>110</td>
<td>140</td>
<td>325</td>
<td>686.9</td>
<td>970</td>
<td>980</td>
<td>1058</td>
<td>1180</td>
</tr>
<tr>
<td>Average</td>
<td>-</td>
<td>-</td>
<td>30.6</td>
<td>40.1</td>
<td>66.5</td>
<td>96.9</td>
<td>125</td>
<td>237.8</td>
<td>428</td>
<td>772.7</td>
<td>971.5</td>
<td>1020.5</td>
<td>1114</td>
<td>1219.3</td>
</tr>
</tbody>
</table>

1 three-month bill yields during 1996-1998, six-month bills yields thereafter

2 data for 1991-2002 and 2003-2004 are from different sources
The 1991 edition of the Act ‘On Banks and Banking Activity’ envisaged the creation of a deposit insurance system, which was to be overseen by the Central Bank. The approach initially taken was that the government simply guaranteed deposits (i.e. that when losses occurred these were to be covered from the national budget). The Central Bank was then supposed to create a special reserve fund by accumulating insurance premiums. In July 1991, the CBU channelled insurance premiums on deposits from commercial banks to a special fund. However, this practice was soon discontinued, and in the new edition of the Act “On Banks and Banking Activity” no provisions for deposit insurance were made except for Narodnybank (the national savings bank) (World Bank, 1997).

Low confidence in the banking sector and consequent unwillingness by the population to hold their money in banks induced the authorities to return to the issue of deposit protection. In May 2002, the Parliament of Uzbekistan passed the bill that established a formal deposit protection system for small retail deposits.

3.2. Non-bank financial institutions

The development of non-bank financial institutions has been rather slow and started only in 1995. A number of state-owned and private insurance companies, as well as investment companies, were created. Although the range and quality of insurance services have steadily improved over the years, most of the insurance companies have had financial difficulties at various times. A new impetus to the development of the insurance market was provided by the adoption of a number of legislative initiatives since 2002 when insurance companies received substantial tax advantages to expand their activities.

The volume of insurance business was growing over 1999-2003. Insurance premiums increased 5.4 times during the period and in 2003 amounted to over 26 billion soum. The share of premiums from voluntary insurance increased at the expense of compulsory insurance premiums (Center for Economic Research, 2004).

The insurance market has been highly concentrated and dominated by state-owned insurance companies. As at 1st July 2007, they accounted for 53.5 per cent of the market (Orient Capital Management, 2007). The ratio of aggregate capital of the banking sector to aggregate capital of insurance companies amounted to 53 (times) at the end of 2003, which indicates significant relative underdevelopment of the insurance market (Center for Economic Research, 2004).

No notable attempts for the reform of the pension system in Uzbekistan were undertaken during 1991-2004. The sole pension fund remained state-run, and no private pension institutions were created. The pension payments were made from the national budget. At the end of 2004, the first (and rather weak) attempt to change the system was made with the adoption of legislation.
mandating compulsory employee contribution of 1 per cent of wages to the personal pension account was instituted. These accounts had to be held with the Narodnybank. The system was designed to ‘supplement budget-financed pensions’.

3.3. Securities Market

Debt instruments

The securities market in Uzbekistan has gradually developed since 1996. Until then, the only instruments available for the mobilisation of savings were household saving accounts and term deposits at commercial banks. In March 1996, three-month Treasury Bills were issued for the first time, and six-month Treasury Bills followed one year later. In 1998-1999 the government started to issue nine-month and twelve-month Treasury Bills. As evidenced in Table 4, the government has steadily reduced the number of issues and the volume of shorter Treasury Bills since the introduction of longer maturity bills.

Table 4. Percentage of Treasury Bills of each type in the market

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Three-month TB</td>
<td>100.0</td>
<td>32.5</td>
<td>18.1</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Six-month TB</td>
<td>67.5</td>
<td>62.6</td>
<td>39.3</td>
<td>38.8</td>
<td>43.6</td>
<td>45.0</td>
<td>23.7</td>
<td>13.0</td>
<td></td>
</tr>
<tr>
<td>Nine-month TB</td>
<td>19.3</td>
<td>38.7</td>
<td>30.7</td>
<td>30.8</td>
<td>30.0</td>
<td>28.9</td>
<td>26.1</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Twelve-month TB</td>
<td>21.8</td>
<td>30.5</td>
<td>25.6</td>
<td>25.0</td>
<td>47.4</td>
<td>60.9</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Central Bank of the Republic of Uzbekistan (2005:2)

Access to Treasury Bills was restricted to legal entities and residents of Uzbekistan. The depth of the market in Treasury Bills remained limited with only 19 percent of the outstanding stock held by the non-bank public in January 2005 (Central Bank of the Republic of Uzbekistan, 2005).

In 2003, the Uzbek government introduced medium-term Treasury bonds with eighteen month maturity terms. Since 2004, the volume of placements of these instruments has increased dramatically at the expense of short-term Treasury Bills. The volume of state securities in circulation over 2000-2005 is presented in Figure 2.
Another debt instrument available to the public was a certificate of deposit issued by banks. These have been on issue since 1995 and were relatively reliable, profitable and liquid financial instruments. For commercial banks, it was an additional method of attracting public savings. As at 1 January 2005, there were 193.4 billion soum\(^3\) worth of deposit certificates in circulation, issued by 22 banks. Yields on deposit certificates with one year maturity ranged from 14 to 27 per cent (Central Bank of the Republic of Uzbekistan, 2005).

A corporate bond market was activated in 2002, because regulatory changes removed restrictions on the size of corporate bond issues. The market for corporate bonds recorded rapid growth in 2003 and 2004. There were 23 issues of corporate bonds in 2003 worth over 16 billion soum. In 2004, the number of issues increased to 40 and were worth over 28 billion soum. However, since 2005, the market has registered a decline. Primary bond placements declined to 21 issues worth 11.5 billion soum in 2005, and in 2006 no issues were recorded. Two large primary bond placements were made in 2007 with the total value of 4.5 billion soum. In contrast, the volume of transactions in the secondary market has been on the rise over the 2005-2007 period to partly compensate for the poor primary market. The decline in primary placements was largely attributed to a decreased spread between bank loan rates and corporate bond interest rates, as well as limited knowledge by company managers of this form of financing (Center for Effective Economic Policy, 2006b; Delta Max Capital, 2006, 2007).

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\(^3\) Equivalent to 182.8 mln. US dollars
**Equity market**

The development of the equity market took off during the 1994-1996 period, together with the process of privatisation and deregulation. The privatisation of former small and medium sized state-owned enterprises involved participation of the so-called ‘privatisation investment funds’. These privately-owned funds purchased government stakes in privatised enterprises. In turn, the shares in the funds were available for investment by the general public. This large scale flow of IPOs had a significant impact on the market capitalisation of the stock market, which registered a more than four-fold rise in 1997. From 1998, number of new IPOs has substantially decreased. From 1998, large number of companies that completed initial placements of their shares delisted as they were no longer interested in complying with stock exchange requirements. This caused the slump in market capitalisation in 1999 and 2000. By September 1999, 86 privatisation investment funds had been licensed, of which 68 were actively purchasing enterprise shares. However, the pace of privatisation was slow, and the companies offered for sale had generally poor prospects for growth. This seriously diminished the development of a securities market. Moreover, lack of knowledge among participants and the general public, absence of reliable information on financial soundness of privatised enterprises, and poor legislative support acted as serious development constraints (Akimov & Dollery, 2006).

The dynamics of stock market capitalisation are presented in Figure 3.

![Figure 3. Stock market capitalisation dynamics](source)

Source: European bank for Reconstruction and Development (2003a; 2005b) and Center for Economic Research (2007)

The sole stock exchange is named RSE Tashkent (RSET) and was established in January 1994 by Presidential Decree. In 1996, it moved to new premises and acquired modern equipment. Since then, the Exchange has opened a number of regional branches, which have integrated access to a centre for settlement by means of a ‘real-time’ communication network.
The primary reason of establishing RSET was to service new issues of securities as part of the privatisation process. Although secondary trading picked up somewhat over the years, primary placements functions remain extremely important. As is evident from Table 5, the volume of transactions on the secondary market increased but at a slow rate.

Table 5. The volume of trading of shares on the securities market

<table>
<thead>
<tr>
<th>In bln. soum</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total shares sold</td>
<td>17.10</td>
<td>26.13</td>
<td>41.74</td>
<td>74.70</td>
<td>115.10</td>
<td>142.50</td>
</tr>
<tr>
<td>On primary market</td>
<td>6.23</td>
<td>12.26</td>
<td>16.33</td>
<td>53.90</td>
<td>62.10</td>
<td>88.70</td>
</tr>
<tr>
<td>On RSET</td>
<td>4.60</td>
<td>6.84</td>
<td>10.53</td>
<td>19.70</td>
<td>18.50</td>
<td>14.90</td>
</tr>
<tr>
<td>On OTC market</td>
<td>1.63</td>
<td>5.42</td>
<td>5.80</td>
<td>34.20</td>
<td>43.60</td>
<td>73.80</td>
</tr>
<tr>
<td>On secondary market</td>
<td>10.88</td>
<td>13.87</td>
<td>25.41</td>
<td>20.80</td>
<td>53.00</td>
<td>53.80</td>
</tr>
<tr>
<td>On RSET</td>
<td>0.63</td>
<td>1.10</td>
<td>4.60</td>
<td>12.40</td>
<td>22.80</td>
<td>26.30</td>
</tr>
<tr>
<td>On OTC market</td>
<td>10.25</td>
<td>12.77</td>
<td>20.81</td>
<td>8.40</td>
<td>30.20</td>
<td>27.50</td>
</tr>
</tbody>
</table>

Source: Center for Effective Economic Policy (2006b:35)

Most of secondary trading activity in listed shares takes place in an unregulated informal secondary OTC. The formal OTC trading system Elis Savdo is controlled by the National Bank of Uzbekistan and has an extremely small share in secondary trading (Akimov & Dollery, 2006).

An additional basic element of the securities market infrastructure - the National Depository Vaqt - was established in 1994. It acted as the major registration and depository system available in Uzbekistan to 1999. In May 1999, with the Government Resolution ‘On establishment and activities of a Central Depository’, a two-tier system of depositories was introduced. The National Depository Vaqt was downgraded to the status of a tier-two depository. Since 2000, the number of private depositories has increased to more than 30 entities, including 12 subsidiaries of the National Depository Vaqt. With increased competition the market share of Vaqt steadily decreased (Avesta Investment Group, 2005).

The number of financial intermediaries servicing the securities market grew over 2000-2002 by 15.2 per cent to reach 304 at the end of 2002. The dynamics of growth of financial intermediaries by type is presented in Table 6.

Table 6. Financial intermediaries in 2000-2002

<table>
<thead>
<tr>
<th>Type of financial intermediary</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment intermediaries (incl. brokerage and dealer firms)</td>
<td>71</td>
<td>91</td>
<td>101</td>
</tr>
<tr>
<td>Investment companies</td>
<td>12</td>
<td>11</td>
<td>10</td>
</tr>
<tr>
<td>Investment consultants</td>
<td>29</td>
<td>28</td>
<td>25</td>
</tr>
<tr>
<td>Depositories</td>
<td>31</td>
<td>35</td>
<td>30</td>
</tr>
<tr>
<td>Register holders</td>
<td>63</td>
<td>61</td>
<td>53</td>
</tr>
<tr>
<td>Privatisation investments funds</td>
<td>36</td>
<td>40</td>
<td>23</td>
</tr>
<tr>
<td>Managing companies</td>
<td>27</td>
<td>34</td>
<td>31</td>
</tr>
<tr>
<td>Investments funds</td>
<td>3</td>
<td>6</td>
<td>15</td>
</tr>
<tr>
<td>Nominal holders of securities</td>
<td>7</td>
<td>9</td>
<td>10</td>
</tr>
<tr>
<td>Other institutions</td>
<td>10</td>
<td>7</td>
<td>6</td>
</tr>
<tr>
<td>TOTAL</td>
<td>289</td>
<td>322</td>
<td>304</td>
</tr>
</tbody>
</table>

Source: Center for Effective Economic Policy (2003:31)
3.4. Comparative outcomes of financial reforms

The transition path of each nation is unique. The initial pre-reform conditions, institutional settings, size and structure of economies, and the reform appetite of political leaderships vary. It is thus often difficult to make good international comparisons for any set of economic indicators. Nevertheless, it is still worth doing albeit with careful selection of peers.

In order to compare the progress of financial reforms, four transition countries (Kazakhstan, Russian, Poland and Hungary), were chosen. All countries share a communist past with similar institutional settings, but have chosen rather different paths of reforms. For a comparable evaluation of progress in Uzbekistan, there is no better choice of comparator than Kazakhstan; both countries share geographical proximity, similarity in leadership style, identical pre-reform institutional settings; have good cultural ties and comparable population sizes.

As we can see in Table 7, Uzbekistan is the slowest reformer of the financial sector. It lags behind other four countries in terms of EBRD financial transition indicators and the index of economic freedom. State banks still dominate in the Uzbek banking sector, whereas the share of private sector and foreign participation in its banking sector remains much smaller than in the other four countries. The number of banks in Uzbekistan is comparable to other countries, if size of the economy is taken into consideration. Financial intermediation indicators for Uzbekistan are modest with lower loans to the private sector to GDP ratios and monetary aggregate to GDP ratios. The relative closeness of Uzbekistan to foreign capital is also evident in a lower FDI to GDP ratio. On the economic front, the Uzbekistan authorities were less successful in combating inflation; the level of GDP per capita remains the lowest as well. These statistics lead us to the conclusion that the financial system of Uzbekistan was relatively underperforming in providing its economy with much needed capital and fulfilling other vital support functions.

**Table 7. Indicators of financial development in Uzbekistan and selected transition economies in 2006**

<table>
<thead>
<tr>
<th>EBRD Transition indicators (out of 4)</th>
<th>Uzbekistan</th>
<th>Kazakhstan</th>
<th>Russian Federation</th>
<th>Poland</th>
<th>Hungary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking reform and interest rate liberalisation</td>
<td>2-</td>
<td>3</td>
<td>3-</td>
<td>4-</td>
<td>4</td>
</tr>
<tr>
<td>Securities market and non-bank financial institutions</td>
<td>2</td>
<td>3-</td>
<td>3</td>
<td>4-</td>
<td>4</td>
</tr>
<tr>
<td>Index of economic freedom (&gt;80 free, &lt;50 repressed)</td>
<td>45.8</td>
<td>60.2</td>
<td>52.4</td>
<td>59.3</td>
<td>65</td>
</tr>
<tr>
<td>Non-performing loans to GDP</td>
<td>3.0</td>
<td>2.4</td>
<td>2.4</td>
<td>9.0</td>
<td>2.0</td>
</tr>
<tr>
<td>Number of banks (including foreign-owned)</td>
<td>29 (5)</td>
<td>33 (14)</td>
<td>1189 (65)</td>
<td>61 (50)</td>
<td>36 (29)</td>
</tr>
<tr>
<td>Assets share of state-owned banks</td>
<td>65.2↑</td>
<td>0.2</td>
<td>70.0↑</td>
<td>83.3↑</td>
<td></td>
</tr>
<tr>
<td>Assets share of foreign banks</td>
<td>4.4↑</td>
<td>5.4</td>
<td>12.1↑</td>
<td>&lt;10%↑</td>
<td></td>
</tr>
<tr>
<td>Loans to private sector (% to GDP)</td>
<td>24.5</td>
<td>47.8</td>
<td>31.5</td>
<td>55.0</td>
<td>33.0</td>
</tr>
<tr>
<td>Market capitalisation (% to GDP)</td>
<td>4.3</td>
<td>54.3</td>
<td>103.4</td>
<td>44.0</td>
<td>37.0</td>
</tr>
<tr>
<td>Inflation rate (CPI)</td>
<td>14.2</td>
<td>8.6</td>
<td>9.7</td>
<td>1.0</td>
<td>4.0</td>
</tr>
<tr>
<td>M2 (% to GDP)</td>
<td>78.1</td>
<td>33.5</td>
<td>50.7</td>
<td>44.0</td>
<td></td>
</tr>
<tr>
<td>M3 (% to GDP)</td>
<td>15.2</td>
<td>53.7</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>FDI (net inflow) to GDP</td>
<td>1</td>
<td>8</td>
<td>3</td>
<td>6</td>
<td>5</td>
</tr>
<tr>
<td>GDP per capital (PPP, current int. $)</td>
<td>2189</td>
<td>9832</td>
<td>13205</td>
<td>14675</td>
<td>18154</td>
</tr>
</tbody>
</table>
Policy failures and recommendations for future reforms

Since Independence, Uzbek leadership has followed a path of gradual reform towards a market-oriented economy (Karimov 1993, 1995). According to official documents, adopted over 1998-2005, including the recent Programme for further restructuring and liberalisation of banking sector in 2005 to 2007, reforms in the banking sector implied: (i) liberalisation of the financial system; (ii) reduction in government intervention in the commercial activities of financial institutions; (iii) strengthening the capitalisation of commercial banks; (iv) improvement of the legislative environment; (v) restructuring banks' (bad) loans portfolios, including government-guaranteed non-performing loans; (vi) privatisation of the two largest state-owned banks; (vii) adoption of Basel II requirements for prudential regulation and supervision; (viii) transition to international accounting and auditing standards; and (ix) training and re-training of bank personnel (Cabinet of Ministers of Uzbekistan 1999; President of Uzbekistan 2005).

Since adoption of those documents, the government undertook some measures to implement these policies. In particular, capitalisation of smaller banks has been improved, a number of legislative measures were adopted to reduce government intervention and to improve the legislative environment. However, the majority of the above reforms have not been implemented. These ‘policy failures’ for banking sector, non-bank financial institutions and the securities market are discussed individually below.

4.1. Banking sector

In spite of recent positive trends, the banking sector in Uzbekistan has continued to experience serious problems that constrain its further development. By far the most serious problem in the banking sector in Uzbekistan has been frequent and widespread intervention of the state into the banking sector. This intervention takes a number of forms. Firstly, the Central Bank of Uzbekistan continues to be a governmental structure, which does not conduct its policies independently. All decisions of the Central Bank (and these are typically embodied in the relevant legislation) are designed to serve economic policy decisions of the government. In contrast, most developed market economies have independent central banks with clear tasks and benchmarks. This system allows central banks to pursue those stated goals more effectively and avoid being compromised by developmental and/or politically-motivated decisions in other areas.
Secondly, the CBU and other state structures (i.e. ministries and agencies) tightly control and intervene into the decisions of the commercial banks, both state-owned and private. A good example is the recent Presidential Decree (in May 2006) to rename the ‘private’ Tadbirkorbank the Microcreditbank, and grant substantial tax benefits to the bank for the provision of micro-credit to small and medium-sized businesses. Another channel of controlling the activities of private banks occurs by means of approving the appointments of senior managers in all banks. This means that often shareholders may find that they are not capable of hiring professional management for their bank if CBU officials believe those individuals may act ‘too independently’.

This dirigiste intervention by the state into the commercial activities of financial institutions, primarily banks, often leads to inefficient decision-making and should thus be curtailed. Commercial decisions, such as lending, should be made solely on the basis of risk-return assessment. In addition, corporate structure and human resource management should be based on corporate goals and strategy. Only in this way will banks will be able to achieve the goal of maximising shareholders’ wealth.

An important part of banking reform is the liberalisation of interest rates. Interest rates serve as the prices of the monetary resources. Keeping them at equilibrium assists in ensuring that the available funds are channelled into the most promising projects. It is crucial to keep interest rates positive in real terms at all times, otherwise saving and lending will be discouraged.

An additional problem in the banking system is that some policy makers (including those in CBU) are the reluctant participants in liberalisation efforts, as they lack regulatory competence of a managing modern banking system. The CBU uses the same approach to governance as that employed during the communist era. It intervenes in all spheres of banking through directives, orders and frequent (and disruptive) inspections. Often a method of ‘confidential directives’ is used if a policy of the CBU contradicts formal regulations. Commercial banks execute such orders (in fear of negative consequences) and have to take the blame for breaking formal regulations.

The procedures for appointing CBU’s senior management are also not transparent. To ensure that competent and committed people are employed for policy-making jobs, transparent and competitive selection processes should be employed.

The activities of the Central Bank remain largely opaque. No transparent procedures for the licensing or withdrawing of banking licenses are in place. For instance, the European Bank for Reconstruction and Development (2005a) and other international observers were shocked by the sudden withdrawal in March 2005 of the licence of the largest private bank at that time – the Businessbank - on the grounds of its violation of prudential standards. There is evidence that other banks also violate prudential regulations from time to time but are not penalised as harshly as the Businessbank (see, e.g. Avesta Investment Group, 2006). Neither the Central Bank of Uzbekistan nor other entities
publish regular statistics on monetary aggregates and banking sector, which greatly impedes their analytical efficacy (United Nation Development Programme, 2006).

Accounting standards and transparency of commercial banks remain a matter of concern. Although much has improved, accounting standards are still far from conforming to International Accounting Standards. The current accounting standards and disclosure requirements cause banks many potential problems, including, for example, non-performing loans. Accounting standards should continue to evolve in the direction of International Accounting Standards. This would help to provide a fair representation of the actual conditions of commercial banks. Moreover, it would assist in building confidence in the banking sector. Greater transparency of the operation of banks should also be encouraged.

Low confidence amongst the general population and private business is another problem that constrains the development of the banking sector. Three major reasons for this ongoing lack of confidence can be identified:

(i) Notorious past behaviour by the government towards the savings of the population is an important factor. Many people lost substantial amounts of money after the collapse of the Soviet Union, through the various currency conversions and numerous constraints on access to their money in the past;

(ii) Excessive legal responsibilities are placed on banks regarding tax enforcement and easy access by the law-enforcement agencies to the details and transactions of account holders. Current legislation, including the Act ‘On Bank Confidentiality’, obliges banks to provide account details to various law-enforcement agencies, including police, prosecutors, intelligence agencies, tax officers and other officials. No court ruling is required for gaining access; and

(iii) Ongoing problems of businesses and individuals to access their funds in their own bank accounts and secure cash withdrawals greatly undermines trust in the banking sector. In conducting a tight monetary policy, the CBU often restricts cash currency circulation by obliging banks (again by ‘confidential directives’) to restrict the amount of cash withdrawals from bank accounts both for individual account holders and businesses. The limited number of cash dispensers, together with the frequent lack of currency in these machines, constrains the development of plastic card operations. Restrictions on cash withdrawals create situation where many small and medium-size businesses run two separate cash records: a bank account and unreported cash (currency). The bank account is used to make all official payments, including taxes and wages. Unreported cash proceeds are used to pay for some of the goods and services, to top-up wages and profits, and even to pay bribes, if such a need arises. The advantage for business to use an unreported cash cycle resides in the ability to buy and sell a greater variety of goods and services at a lower price than by bank account in addition to obvious tax evasion. As a result, the value of cash and non-cash (i.e. bank account) money in the
economy has been different to the point that some firms (usually in retail sector) offered services of converting non-cash money into cash money. The conversion ratio varied over time depending on relative level of difficulty to access bank accounts and the conversion amount.

The problem of a general lack of confidence by the population in the financial sector is complex. Several remedial measures seem warranted. Abolishing over-zealous tax enforcement and other ‘confidence-undermining’ measures is strongly suggested. Banks should only be allowed to breach customer confidentiality where there is clear evidence of misconduct (such as tax evasion or money-laundering activity). Placing an embargo on the use of customer funds (which often happens) should be a last resort, and any blocked funds should be released only when claims by creditors are settled. Clear and easy access of bank customers to their own account should be guaranteed. It will be very difficult to promote the use of plastic cards without ensuring that clients have ease of access to cash dispensers at all times. In general, the Central Bank should conduct an open and predictable policy in ensuring the stability of the banking sector. Even with sound policy measures, restoring confidence will take time, and the authorities should not expect immediate results.

Although a large number of regulatory documents were issued during the period 1991-2006, there are still ‘grey’ areas (especially in relation to foreign trade and capital movements) that require the attention of policy makers. For instance, there have been cases when courts made decisions against commercial banks that had followed international practice in their foreign operations, but where no local regulations were in place. In addition, the large number of legislative documents that have been adopted over the years have created some contradictions between different regulatory requirements. Rapid removal of these contradictions is recommended.

Because the banking system is heavily influenced by the institutional environment in which it operates, problems with the legal system, which are typical for the economy as a whole, also apply to the banking and the financial sector. The country’s legal system is still in poor shape in relation to property and contract rights. Since the financial system greatly depends on an improved judicial system, property rights and contract rights should be firmly established and their legal clarity improved. Moreover, it is essential that their enforcement is impartial, transparent and fair. Without these basic legal conditions, both the development of the financial system (and indeed the economy as a whole) will remain greatly hampered.

Despite the declared intention to reduce its presence in the banking sector (through the sale of the National Bank of Uzbekistan and the Asakabank), the banking sector continues to be dominated by large state-owned and controlled banks. Competition in the banking sector remains limited. Empirical evidence from other transition economies tells us that this may negatively impact on the efficiency of banking sector (Bonin, Hasan & Wachtel 2005; Clarke, Cull & Shirley 2005). The liberalised entry of foreign banks should also help to assist in improving banks’ efficiencies by bringing in modern banking expertise and accelerating competition. However, it is important to ensure that the Central Bank of
Uzbekistan is capable of enforcing adequate control over foreign banks. Thus a gradual liberalisation is recommended, particularly by encouraging joint ventures with local banks. This should allow for a better transfer of expertise rather than the full sale of local banks or the sole establishment of branches of foreign banks.

In order to be successful in selling local banks to strategic investors - which has not been the case to date - it is important to ensure that investor rights are protected and that investors can exercise control over the management decisions of a purchased bank. Offers that do not ensure these prerequisites (as is the case of the National Bank of Uzbekistan where 49 per cent is offered while the rest is to remain in the state control) are unlikely to raise any serious interest from potential investors abroad.

Non-performing loans are likely to remain a serious problem in state-owned and state-controlled banks due to imprudent lending practices and governmental intervention in lending decisions. The government will have to ‘clean up’ the balance sheets of these institutions before these banks will be attractive to a foreign strategic investor. Since a large proportion of non-performing loans are government-guaranteed, the government may opt for an approach similar to ones adopted in Czech Republic and Bulgaria, where governments established asset restructuring agencies and took over non-performing assets related to state-owned firms (Saunders & Sommariva 1993). Moreover, the government should sell its stakes in those banks, which it owns indirectly (through its ministries or agencies). Since they may have similar problems to the NBU and Asakabank, the expertise accumulated from sales of those two institutions may help in the process. Taking into consideration the important role of savings bank in executing social functions of the government (e.g. pension and utility payments), as well as Kazakhstan’s experience, postponing the sale of the savings bank to a later stage may be advised until the point when other channels of delivering social functions are established (Akimov & Dollery, 2008).

In general, the low level of competence and skills in the modern banking (including management skills) continue to pose serious constraints to development of the Uzbek banking sector. Poor remuneration of bank employees is one of the contributors to the problem. Since the introduction of wage restrictions in state-owned commercial banks by the Central Bank, a large number of qualified personal have left their jobs. This is also a significant problem for the CBU itself. As a result, the ‘brain-drain’ of skilled staff has been high both in the Central Bank and in state-owned commercial banks.

Lack of competency in modern banking and managerial skills is also reflected in poor governance of the CBU and many commercial banks. Governance structures are excessively centralised; initiative, innovation and service development are thereby generally discouraged.

An additional serious problem resides in the limited opportunity for modern banking training in Uzbekistan. This applies to bank personnel at all levels. But perhaps senior management competency
remains the matter of greatest concern, taking into account the high level of responsibility of their positions. Since some appointees lack basic managerial and banking skills, questions for the impartiality and effectiveness of the appointment procedures should be asked.

There is no simple solution to the pervasive problem of a lack of modern banking knowledge and skills. This is a serious problem faced by banks in all transition economies. A comprehensive programme of training and skill transfer should be developed, including, but not limited to, organising regular seminars and on-site training with the participation of foreign experts. Moreover, the creation of joint ventures with foreign banks could assist in bringing much needed managerial expertise to the system. A point of crucial importance here is to keep the competency level of employees in the Central Bank at a level that is at least comparable to that in commercial banks, particularly in such important areas as the supervision of the banking sector.

Other problems related to the lack of expertise but that are worth putting into a separate category are the poor supervisory capability of the CBU and the lack of prudent risk management practices in the commercial banks that among other reasons lead to non-performing loan problems. The capacity of the Central Bank for this form of supervision should be strengthened. Establishing clear and transparent penalty procedures for the violation of prudential norms is warranted.

The Central Bank continues using direct instruments of monetary management, which are typically ineffective in modern banking. The CBU should gradually move away from direct instruments of monetary management in favour of more indirect instruments. It is important to ensure that an adequate infrastructure for this is developed.

The government taxes bank profits and wage bills, but does not allow banks to deduct these imposts from their taxable incomes. Profit tax in Uzbekistan is assessed by the authorities represented by the Tax Inspectorate and often bears no relation to actual profit. Many enterprises are overtaxed, even taking into account recent cuts in the rate of profit tax (Economist Intelligence Unit, 2003). The government should thus reconsider the system of taxation of banks. The system should be transparent and impartial and consistently applied, thereby encouraging prudent risk-management policies by the banks.

4.2. Non-bank financial institutions

Non-bank financial institutions generally experience similar problems to banks. A lack of commitment for reform from policy makers, poor skills, government intervention, and little trust from the general public, remain serious issues for the non-bank sector. Since the Uzbek government in general prioritised the development of the banking sector, the non-bank financial institutions remained in an embryonic stage of development. There are few legislative and regulatory documents that regulate the activities of non-banks. Information on the various institutions is almost totally non-existent. The insurance sector is even less transparent than the banking sector, its accounting standards are poor,
and disclosure requirements generally are absent. The supervisory function over insurance companies rests with the Ministry of Finance, and its capacity is questionable. There is much to be done to develop non-bank institutions, not only to the standards of developed countries, but those of advanced post-communist countries as well.

The pension system has remained in an early stage of development with only one state-owned pension fund operating. Pensions are financed out of the state budget and are supplemented by meagre accumulations on pension accounts held with the Narodnybank. Since only one percent of wages are channelled into the fund, and the interest paid on those accounts is very small (and can be negative in real terms), this system is unlikely to significantly reduce the burden on the national budget. Even if private pension funds were to be institutionalised, the poor development of the securities market would be a severe constraint on their development.

4.3. Securities market

The securities market is a crucial component of a well-functioning financial system. It provides an alternative to banks for companies in obtaining necessary financial resources. In Uzbekistan it remains under-developed. The scope, volume and liquidity of securities traded are low. This sector experiences similar problems to the banking sector, including tight control from the government. The Centre for Coordination and Control of Securities Market was established as an independent regulator, but was later acquired and remains part of the State Property Committee. Other problems include a lack of commitment for reform from policy makers, low competency on the part of market participants, and little knowledge and trust from businesses and the general public. However, there are sector-specific problems as well.

The fixed-income securities market is one such concern. Although the market for government securities has improved over the years in terms of its depth, it has advanced little in terms of access to the market (and remains limited) and transparency (statistics on volume, interest rates and regulations are not published). Trading volumes in the secondary market are also low. This market is of crucial importance since it is an instrument of modern monetary policy and also serves as a benchmark for other financial instruments in the country. Therefore, measures to improve liquidity, transparency and accessibility of Treasury instruments should be a priority for Uzbek authorities. Although less urgent than market for Treasury instruments, the development of a corporate debt market is still important. Since it is in a nascent stage at present, institution-building measures like introduction of legislation, the development of market infrastructure and promoting knowledge are suggested.

The equity market is in somewhat better shape. Adequate regulation, basic infrastructure and some level of acquired proficiency by market participants are in place. However, the slow privatisation of state enterprises, the low level of transparency, poorly defined property rights and their
enforcement, as well as the high level of commissions on the formal stock exchange are impediments to further development. In turn, without well-functioning securities markets, pension reform can not effectively proceed. Therefore, acceleration of privatisation, adoption of measures in improving the transparency of the sector, enhancing the investment literacy of general public and further development of market infrastructure can be advised.

Aspects of the technical implementation of the various policy measures of financial system development are beyond the scope of this paper. Nonetheless, passing reference can be made to two detailed studies on this matter, conducted by the World Bank (1993, 1997). Although some of the policy advice provided in the reports may be questioned, the range of options for technical implementation of the policies is comprehensive and can serve as a good guide to policy makers. While both studies are at least ten years old, many of the matters covered there are still topical for Uzbekistan.

5. Concluding remarks

Because Uzbekistan adopted a gradual approach to economic reforms, its reforms in the financial sector were also undertaken slowly. The initial period of intensive reform over 1992-1997 was followed by a dramatic reform slowdown and even reform reversals during 1998-1999. However, since 2000, the government has again begun to advance some reforms although with some obvious reluctance. Taking into account the political and economic situation at Independence, as well as the cultural and demographic peculiarities of Uzbekistan, the decision to adopt a gradual reform process seems justified.

The analysis of the Uzbekistan financial system over recent years is a difficult task. On the one hand, official statistics report achievements in financial reforms, such as introduction of new legislation, growth in various indicators, like bank assets, capital, loans or deposits. This may give a false impression of successes in policymaking and the steady progress to casual outsiders. However, occasional reports from ‘insiders’ provide a somewhat grimmer picture. The officials continue to intervene in the affairs of commercial banks by using confidential orders and tightening regulation. Predictably, this encourage rent-seeking activities and raises doubts over the government’s commitment to financial liberalisation.

In order to strengthen financial development, the implementation of the reformist policy measures in the following areas is recommended: (i) ongoing liberalisation and a reduction in state intervention; (ii) the privatisation of state-owned banks and insurance companies and the stimulation of competition; (iii) building confidence in financial service providers; (iv) an enhancement of reporting standards and the transparency of procedures; (v) upgrading the legislative environment and procedures; and (vi) an improvement in governance capabilities of managers and enhanced staff proficiency.
6. List of references


