Financial Reform in Uzbekistan[1]
ウズベキスタンにおける金融改革

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Introduction

Institutional capacity building in the financial sector of Uzbekistan has long been discussed. It has been studied in depth by a variety of international organizations as well as bilateral agencies including the World Bank, the Asian Development Bank (ADB), the European Bank for Reconstruction and Development (EBRD), the International Monetary Fund (IMF), the United States Agency for International Development (USAID), etc. A large amount of recommendations and detailed manuals have already been provided to the Uzbek authorities banks for enhancing the quality of their supervision and operations. In fact, it appears that they are almost completely inundated with so many detailed instructions and procedural manuals to digest.

Basic diagnosis

The unprecedented and turbulent developments in the economic and financial situation around 1992/1993 hampered development of financial intermediation at the early stage of the economic transition. In brief, there has since been little or practically no financial intermediation between the economic agents with fund surplus and those with fund deficit in Uzbekistan. (See Figure 1.) Domestic savings mobilization through the financial sector has been too small to be channeled to productive purposes; most savings remain dormant in the form of mattress savings in hard currencies. Meanwhile, banking skills in credit risk assessment for the corporate sector have not been well cultivated; as a result, the role of the financial sector as a channel of funds for industrial and commercial activities has been severely restricted except for the so-called directed loans. What is worse, the corporate sector, which requires not only financial resources but also entrepreneurship, marketing and accounting skills and, above all, a liberal business environment, failed to be viable in the present, highly regulated business conditions. Such fundamental conditions have, in turn, hindered development of sound and solid financial services of various kinds including the banking sector. Herein lies the basic problem with the Uzbek financial sector.

Figure 1: Financial Structure

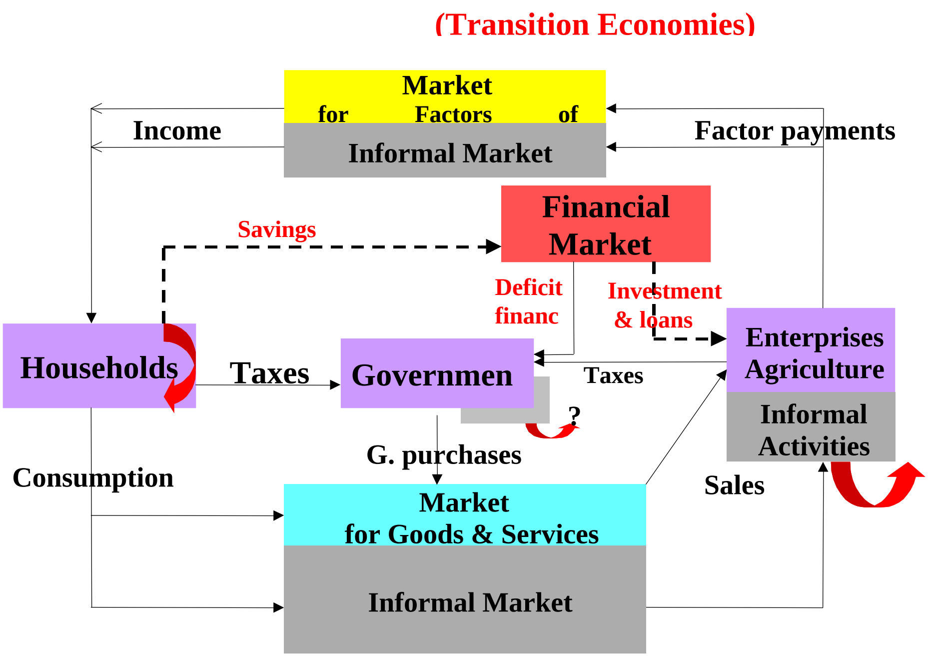

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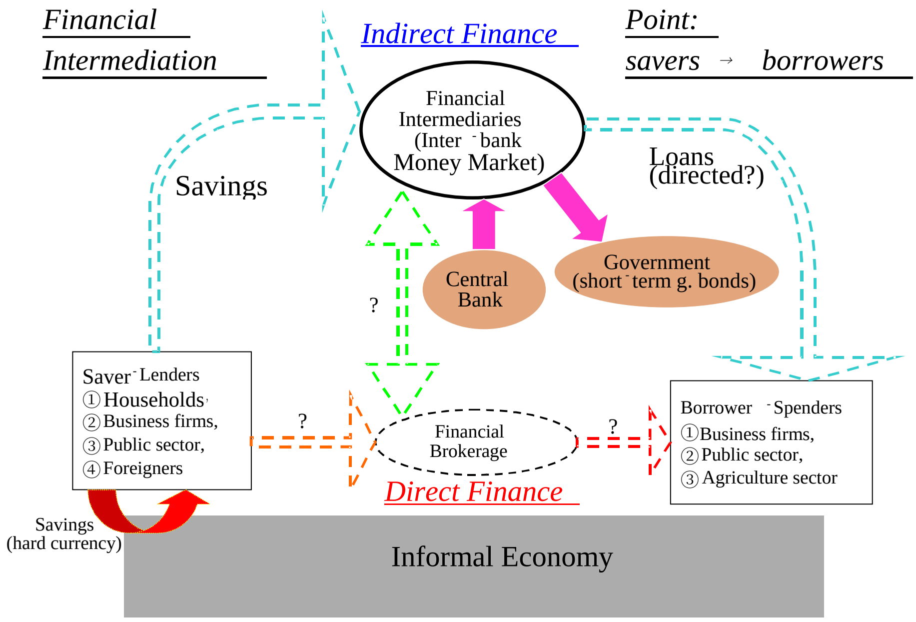
Figure 2: Indirect Finance



1. The overview of the financial sector

Since independence, Uzbekistan has implemented a series of financial reforms, including the legal set-up for introduction of the two-tier banking system, bankruptcy, and securities markets. Prudential guidelines for the banking business have also been introduced since the early stage of transition. The banking sector, despite being rudimentary and riddled with many problems as described in this memorandum, has shown remarkable transformation from the conditions that prevailed in the early 1990s, when there were virtually no banking services in the market economic sense.

In the meantime, there are signs of emergence of various non-bank financial services like insurance, credit cards, leasing, etc., but at this stage they still remain largely rudimentary. In the recent past, introduction of even deposit insurance and rating services have been under consideration and partially initiated.

Trading of securities is limited to government bonds of relatively short maturity. Stock exchanges have been established and now appear to be playing a major role as a primary market of stocks sold in connection with privatization of state-owned enterprises. However, they play only a limited role as a secondary market. Corporate bond issues have been rare (See Annex for further comments on the non-bank financial sector).

2. Basic problems

As mentioned earlier, confidence in bank deposit is yet to be established. The basic issues that have hampered development of the financial sector in general and the banking sector in particular are broadly classified to two. One is the low degree of confidence in the currency and the other is the low degree of confidence in the banking system as a whole.

Hyper-inflation in the early 90s severely eroded citizen's confidence in the domestic currency. Although inflation has since then greatly abated, it is still at a high level as compared with other transitional countries as well as with the domestic rate of interest. The currency has largely lost significance as a means of savings. Instead, hard currencies, especially the U.S. dollar, have assumed the role of preferred means of savings. The increase in money supply through such a process has undermined citizen's confidence in the currency further. As a result, hard currencies, in particular the dollar, have been hiding behind a variety of economic transactions, creating a situation of "currency substitution". There has been a sort of vicious circle over the years.

As to the banking sector, the moratorium in the early 90s left a strongly adverse influence by eroding citizen's confidence in the sector. Coupled with the high rate of inflation, savers were heavily penalized. The policy measure of indexation, which was initiated in 1996 to compensate bank depositors for the loss incurred during the era of hyperinflation (by revaluing the balance of savings account as of 1992 by four thousand times), is an good indication of the government's efforts to protect the interest of depositors and thereby restore confidence in the banking sector.

This indexation policy, however, should be cautiously evaluated because there remains substantial room for further improvement in deposit services. Even though household savings have sharply increased in the recent past, the ratios in the total resource base of the Uzbek banking system and in the GDP (at more or less 1%) still appear very low by international standards. This has obliged the banking sector to resort, as funding sources, to Central Bank credits, inter-bank borrowings, foreign borrowings, and/or corporate savings forced under the existing non-cash transaction regime whereby the corporate sector is compelled to use debit/credit account transfer as the only means of settling inter-enterprise transactions.

Additionally there is still a legacy of the Soviet banking system, whose major function used to be to act as a settlement agency for the national plan. Bank personnel were not equipped with the knowledge and technique of providing credit to private sector borrowers. The most profitable and safest investment is that in government securities. There has been little incentive for banks to attract savings, one result of which was poor service to customers. This picture of low financial depth in the banking sector vis-à-vis the whole economy can be seen in Table 1.

Thus, it is not only that financial intermediation has not been established but rather, the term "financial dis-intermediation" might better apply to describe the present situation. In other words, contribution of the financial sector has been extremely limited, to economic activities in general. (See Table 2 for the comparative status of the banking sector in Russia and the Central Asian Republics.)

3. Further complications

The situation of the banking sector has been further complicated by the following factors, some of which were briefly touched upon in preceding paragraphs but are elaborated on below.

First, the banking system has been heavily saddled with the so-called directed loans. Many directed loans have been extended, often accompanied by government guarantee, to projects designated as national importance or to clear public sector arrears. In addition, not a few enterprises are indebted in hard currency denominated loans. The domestic liquidity needs of some of these enterprises appear to have been often financed by the Central Bank's credits, directly or indirectly through the commercial banking system. But the present business conditions characterized by sharply depreciating exchange rates have adversely affected their viability. This could lead to a possibility of increase of non-performing loans in the banking sector in the near future and ultimately to fiscal burden (for comparative financial indicators of transition economies, see Table 3).

Apart from its impact on the banking sector, such quasi-fiscal operations damage the quality of fiscal management by incurring potential fiscal deficit and also distort financial discipline in general by creating moral hazards in both the creditors' and the debtors' minds.

Second, the multiple exchange rates in Uzbekistan have given misleading or even disturbing economic and financial signals to the market by imposing an implicit tax on exports and subsidy on imports. They have also diverted various economic activities to the informal economy, adding to tax collection problems by pushing them entirely outside the tax base, distorting resource allocation, and thus significantly obscuring the real economic landscape. These practices, together with the surrender requirement of foreign exchange earnings, have encouraged the formation of unofficial channels of foreign exchange transactions due to a serious shortage of foreign exchange in the official market.

From the financial and economic viewpoint, exchange-rate-related data are not reliable and do not serve as useful indicators for market-oriented activities; they only cause confusion. The multiple exchange rate practices also hamper good perspective and predictability for financial transactions. As a result, the national currencies, which circulate with high velocity as a means of payment but fail to serve as a means of storage of value, are losing even the role of the standard of value. In these circumstances, the effectiveness of monetary policy is considerably weakened.

Third, throughout the period of economic transition with highly inflationary conditions, the real interest rate is believed to have been generally negative. If this was the case with Uzbekistan, the situation of so-called financial repression might have dominated the Uzbek financial environment. In many countries under high inflationary pressure, considerably low (real) interest level discouraged savings and diminished financial resources available for productive activities, resulting in failure of financial inter-mediation. Although the refinancing rate at the Central Bank has recently been raised from 2.0% to 2.5% per month and deposit interest rates were raised, the problem of financial repression might still be continuing in view of obstinately enduring inflationary forces.

4. Technical assistance activities

In view of the difficulties Uzbekistan had faced, a number of TA projects have been provided for the financial sector development. The World Bank, together with the International Finance Corporation, has contributed to the improvement of the banking management practices including corporate governance; capacity enhancement for credit analysis, accounting and auditing, etc. on the basis of pilot operations for Asaka Bank, UzPromstroiBank, ZhilsberBank, UzDaewoo Bank, Andijan Bank, and Ipak Yuli Bank. They also assisted the government in devising strategic scenarios for the development of the financial sector as a whole (such as separation of bad assets from large state-owned banks with a view toward eventual privatization).

The ADB, focusing on two specific Uzbek banks (Pakhta Bank and Asaka Bank), identified the needs and problems and provided a hands-on TA for the purpose of institution building for credit appraisal, risk management and corporate governance. The ADB has already formulated recommendations for the strengthening of the Uzbek banking sector. It has also extended a TA for micro-credit schemes for Uzbekistan.

The USAID provided TA assistance to the Central Bank in an effort to strengthen the latter's institutional capability in enforcement of prudential regulations covering on-site and off-site supervision as well as in regulatory and accounting reforms. The USAID assistance also included preparation of detailed manuals for credit management by commercial banks. In the meantime, the EBRD has been providing pilot, program-based loans for development of medium-and-small businesses, coupled with institution building and training assistance for the commercial banks involved with the loan utilization. Japan has provided a variety of TA activities for training purposes through various educational institutions. In addition, focusing on the Uzbek Banking Association, the Technical Assistance Program for Commonwealth of Independent States (TACIS) has provided support to the commercial banking sector through seminars and training courses.

The above-mentioned TA contributions appear to be showing discernible effects on the financial sector as a whole. Although much scope remains for further improvement, it seems that the financial supervisors as well as commercial bank management and staff have become increasingly familiar with the basic concepts and principles governing such areas as credit policies and its management. Some government officials, Central Bank officers and financial managers are becoming increasingly aware of the need to take a strategic approach to financial sector reform, and to the issue of the disposal of non-performing loans arising from directed loans and quasi-fiscal operations in particular.

5. The Prospect

The strategic approach to the solution of the above-mentioned problems, however, still remains unclear. They relate to such issues as: (1) how the accumulated directed loans are to be dealt with; (2) how the banks and the borrowers are to cope with the likely deterioration of their loan quality arising from depreciation of the domestic currency; (3) how and where the banks are to reorient their operations to remain viable in the face of diminishing government intervention; and (4) how the sector is to attract foreign direct investment. Some Uzbek leaders are increasingly aware of the magnitude of these problems as well as the likely consequences they might cause if left unresolved. There are signs of momentum emerging among them toward a more constructive reform process.

Most recently, Uzbekistan concluded with the IMF a memorandum (the Staff Monitoring Program--SMP) of economic policies to be implemented by the government. The policy package described in the memorandum covers a number of important measures that will have significant implications for the development of the Uzbek financial sector. The measures will include substantially liberalized access to foreign exchange; gradual removal of the cash withdrawal restrictions; stricter control of money supply; maintenance of positive interest rates in real terms; and minimization of the public sector interference in commercial bank operations (except for enforcement of the prudential regulations). In short, the macro-economic distortions, which tended to impede healthy development of the financial sector would be eliminated if smoothly implemented.

Although Uzbekistan is still behind some other transitional countries in terms of deregulation, implementation of various macro-economic reform measures contained in the SMP will present a unique opportunity for the financial sector to consolidate itself and to emerge as an important vehicle to serve the economy. It will also prepare the ground for Uzbekistan to become an important member of the international financial community (See Table 4 for international commitments of transition economies).

Table 1. Domestic Credit to Private Sector and Broad Money (in % of GDP)

	1994	1995	1996	1997	1998	1999	2000
Uzbek	na(34.7)	na(18.2)	na(21.0)	na(17.5)	na(16.1)	na(14.7)	na(11.9)
Kazakh	26.6(13.1)	7.1(11.4)	6.3(9.5)	4.3(10.3)	5.4(8.6)	7.4(13.6)	10.6(15.3)
Turkmen	na(25.6)	na(18.8)	5.7(8.1)	7.8(10.2)	9.5(14.9)	na(12.7)	na(20.3)
Kyrgyz	na(12.7)	12.5(17.1)	8.7(14.3)	3.5(13.6)	5.3(14.4)	5.0(13.3)	na(11.8)
Tajik	na(81.7)	na(20.5)	4.0(8.3)	4.8(8.6)	7.7(8.1)	10.0(7.4)	11.3(8.8)
Russia	12.1(16.0)	8.5(13.9)	7.4(13.4)	9.4(14.8)	12.8(16.6)	11.5(15.5)	na(16.5)
Azer	na(55.9)	na(12.2)	na(11.3)	na(13.1)	na(10.6)	na(10.6)	na(11.6)
Armenia	na(13.0)	na(7.9)	na(8.3)	na(8.7)	na(10.0)	5.9(11.0)	7.5(14.8)

Broad money means M3 except for Kyrgyzstan and Russia where M2 has been adopted. (Source: EBRD Transition report (2001))

The data provided by the Uzbek authorities show that as of December 2001 the broad money was 612 billion sum (currency, 214 billion sum, demand deposits, 166 billion sum and quasi-money and others, 232 billion sum) and that the domestic credit to the non-governmental sector was 1,816 billion sum (368 billion sum in domestic currency and 1,449 billion sum in foreign currency). Assuming that the size of GDP in 2001 was approximately 4 trillion sum, the ratio of broad money to GDP was approximately 15.3% and the ratio of domestic credit to GDP is approximately 45.4%; however, statistical consistency cannot be ensured between the above EBRD data and Uzbek data.

Table 2. Financial Sector in Central Asia as of 2000

	Number of banks (of which foreign owned)	Bad loans (in % of total loans)	Capital adequacy ratio	Deposit insurance system	Secured transaction law	Securities commission
Uzbek	34 (6)	0.0	8%	no	Restricted	yes
Kazakh	48 (16)	2.1	8%	yes	Yes	yes
Turkmen	13 (na)	na	10%	no	Restricted	Yes
Kyrgyz	22 (6)	16.4	12%	no	Yes	Yes
Tajik	17 (4)	10.8	12%	no	Restricted	yes
Russia	1311 (33)	15.3	8%	no	Restricted	yes
Azer	59 (5)	Na(99: 37.2)	8%	no	Restricted	yes
Armenia	31 (11)	6.2	12%	no	Restricted	yes

(Source: EBRD Transition report (2001)

Table 3: Financial Indicators

	1996		1999		2000		
	Share of state-owned banks	Non-performing loans	Share of state-owned banks	Non-performing loans	Share of state-owned banks	Non-performing loans	EBRD index of reform
Uzbek	75.5	0.0	65.8	0.1	77.5	0.0	1.7
Kazakh	28.4	19.9	19.9	5.5	1.9	2.1	2.3
Turkmen	64.1	11.4	96.6	0.5	na	na	1.0
Kyrgyz	5.0	26.1	21.4	6.4	na	16.4	2.3
Tajik	5.3	2.9	6.9	15.8	6.8	10.8	1.0
Russia	Na	13.4	na	25.8	na	15.3	1.7
Azer	77.6	20.2	82.5	37.2	60.4	na	2.0
Armenia	3.2	22.6	2.4	4.3	2.6	6.2	2.3

(Source: EBRD Transition report (2001))

The "share of state-owned banks" shows the share of majority state-owned banks in total bank sector assets. "Non-performing loans" show the ratio of non-performing loans to the total loans. EBRD index of reform shows the degree of progress in the banking sector reform, scoring from 1 to 4; Hungary has a 4.0 rating, as compared with 3.3 for Poland, 3.3 for Czech Republic, 3.0 for Slovak Republic and 3.3 for Slovenia.

Table 4: International Commitments of Transition Economies (2001)

	WTO membership	IMF Article VIII status
Armenia	---	May 1997
Azerbaijan	---	---
Belarus	---	---
Georgia	June 2000	December 1996
Kazakhstan	---	July 1996
Kyrgyzstan	December 1998	March 1995
Moldova	July 2001	June 1995
Russia	---	June 1996
Tajikistan	---	---
Turkmenistan	---	---
Ukraine	---	September 1996
Uzbekistan	---	---

(Source: EBRD Transition report (2001))

Appendix

Non-Bank Financial Sector (NBFI)

Uzbekistan appears to have been most interested in development of the non-bank financial sector (NBFS). This appendix attempts to elaborate on this assue in more detail.

The non-bank financial institutions (NBFIs) are usually characterized by the nature of no deposit taking and no payment functions. The NBFI sector is also characterized by the weak regulatory environments. In contrast, because banks are crucial in ensuring that the financial system and the economy run smoothly and efficiently, the banking sector is strictly regulated by the supervisory agency(ies). The difference in regulatory environments, in turn, tends to encourage banks to use NBFIs as a tool for "loophole mining," i.e. a tool to get around the prudential regulations in the search for profits. However, it is also true that NBFIs provide a variety of complementary, auxiliary and peripheral financial services and often play an important role in financial intermediation. In recent times, financial innovation has increasingly intensified competition with the banking sector.

The regulatory environments differ among countries and there is no non-bank financial sector model as such. In this connection, it might be advisable for the relevant Uzbek agencies to undertake a comparative review of the experiences in other transition economies and developed countries. While admitting our hasty comments on this sector, however, securities and investments, insurance, pension management, and trust businesses are regulated less rigorously in many cases, because their impacts on the economy are regarded as not so direct as the banking sector. This is more conspicuous in the case of finance companies, leasing companies, and other financial institutions. In some cases, NBFIs tend to be abused by banks or parent companies as vehicles to evade financial regulations, resulting in financial irregularities and disturbances.

If the financial intermediation is tenuous and unreliable and savings are not channeled to productive economic activities by viable economic entities, financial services provided by NBFIs will turn out to be unproductive. The consolidation of the financial intermediation process, however, will help the NBFIs develop in a sound manner.

The following table **(**Table: The banking sector and NBFIs) is intended to compare the banking sector vis-à-vis the securities business, insurance, pension scheme, trust business, and other NBFIs.

In Uzbekistan, while the securities business represented by the activities in the capital markets remains considerably sluggish, the insurance sector appears to be dominated by state-owned enterprises. Despite accumulated TA activities provided by a number of international organizations, the pension scheme remains underdeveloped, mainly due to inflationary macroeconomic conditions and poor mobilization of domestic savings. In addition, the leasing companies and other NBFIs appear to be fragmented against the backdrop of the fragile business climate in the corporate sector and insufficient financial depth in the financial sector. Stabilization in macro-economic conditions and establishment of financial trust in the banking sector and financial inter-mediation are most likely to contribute to the development of a variety of financial services.

Table: The banking sector and NBFIs

Function/sector		Regulatory environment	Remarks
Banking (deposit-taking)		Strictly regulated	In addition to licensing and prudential supervision, deposit-taking institutions are monitored and also given regular on-site examinations. Due attention is also paid to their
Securities		Regulated	A commission is responsible for investor protection and market integrity. Securities brokers, dealers, and investment banks are major players in the securities market of bonds and stocks.
Insurance	Life	Regulated	One of the important institutional investors. A separate regulatory agency is responsible for overseeing sales practices, solvency margin to cover losses, and investment practices. Insurance companies have now faced with the competitive threat from the banking sector.
	Non-life		
Pension scheme		Regulated	A separate regulatory oversight is required to apply standards of reporting and disclosure of information and restrictions on investment practices. Another important institutional investor.
Trust		Regulated	Most trusts are managed by banks or other financial institutions. Investment trusts and mutual funds are included here. Another important institutional investor.
Finance company		Virtually unregulated	Finance companies raise funds by issuing CPs, bonds or borrowings and make loans to
Leasing		Virtually unregulated or	Two basic types of leases (finance and operating) depend on the use of an asset by the lessee, not the ownership. The finance-lease lessor, who is not responsible for maintenance and
Factoring		Virtually unregulated or	A "factor" buys selected accounts receivable from its customer and receives directly
Consumers loan		Virtually unregulated or	Loans are made to those consumers who cannot obtain credit from other sources and have to
Micro credit		Virtually unregulated or Weakly regulated	Micro-finance, initiated for the purpose of poverty alleviation, has been in the evolutionary process of both saving and lending. One crucial element is to provide micro-credit (individual or group lending) to the poor with income-generating activities and employment
Others		Virtually unregulated or	Money market dealers, Asset management, Investment advisory, Money changers, Rating houses, Accounting and legal advice, Custodian services, etc.