

Financial Development Policies in Uzbekistan: An Analysis of Achievements and Failures

***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 the present time to date, including the banking sector, non-bank financial institutions and securities markets. Second, it examines the policy achievements and failures of the Uzbek path and sequence of reforms in each of these areas. Policy recommendations are then offered to remedy the existing problems that we identify. The novelty of this paper that it is first to make a detailed analysis of policy failures in Uzbekistan financial reform.*

1. Introduction

The critical question of 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)) was published. 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 entrain. 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 demands of 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 did not achieve much.

Whilst the Eastern European financial development experience is well-known, the outcomes in other countries, such as those of former Soviet Central Asia, have received much less attention. This paper thus seeks to remedy this neglect by examining financial development in Uzbekistan. Although an embryonic literature does exist on this question (Akimov, 2001; 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 three major parts. Section 2 reviews the evolution of Uzbekistan's financial sector over the period 1991 to 2007, including an analysis of the banking sector, non-bank financial institutions and the securities market. Section 3 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 4.

2. Financial sector reform from 1991 to 2007

Uzbekistan has adopted a gradual approach to economic reforms. Three main stages can be identified: intensive reforms of 1991-1996, reform reversals of 1997-1999 and recent developments from 2000. Similarly, we can distinguish three major phases in financial sector reform. Most financial sector reforms took place in the first stage of reforms over the period 1991 to 1997. In second stage, which extended over the period 1998 to 2001, little progress has been achieved. In final stage, which started in 2002, the reform has progressed, although at an extremely slow pace and in an unsystematic manner.

2.1. Banking sector

The initial attention of legislators and policy-makers was directed at reforming the existing banking sector. This was largely due to the fact that the non-bank financial institutions were either in an embryonic state or completely non-existent at Independence. Taking into account the lack of expertise of policy-makers, it has probably the best approach possible 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 earlier, 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 a 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 similar fashion as 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 the period 1994 to 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.

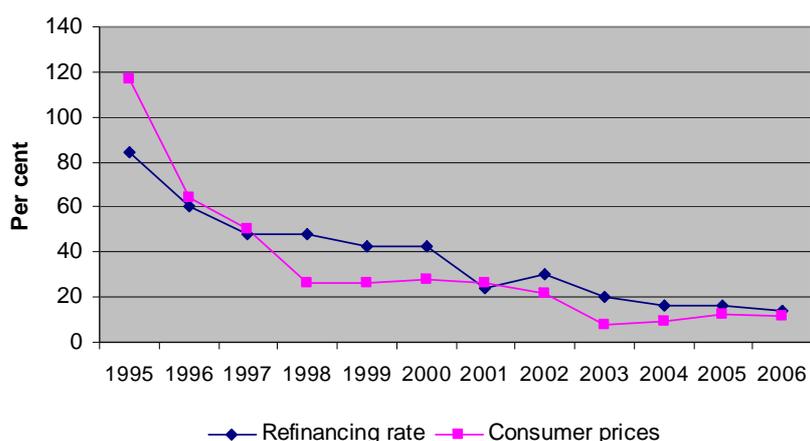


Figure 1. Reference rate dynamics

Source: European Bank for Reconstruction and Development (2003b, 2005b, 2007)

Earlier in 1992, the Central Bank started to use reserve requirements on the commercial banks as an instrument of monetary policy. Until 2005, reserve requirements were only applied to bank deposits in 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 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 their 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 had started to develop. A second reason was simply the 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 was never really employed by the Central Bank of Uzbekistan. The CBU offered very limited scope for securities that yielded negative interest rates in real terms up to 2003. Moreover, access to these securities was restricted. An additional feature that undermined the attractiveness of government securities was the fact that investors were often forced to purchase new issues of securities instead of being repaid in cash. At some stage, the situation worsened to the point that the CBU forced some state-owned commercial banks to purchase Treasury Bills. The *Narodnybank*¹ was a major buyer since it had large amounts of excess liquidity generated from deposits of individuals.

In July 1996, a package of reforms of payment system was introduced. As a consequence, the archaic Soviet method of manual payment handling has been 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. However, in 2003, one single account clearing system (with the CBU) was introduced (Akimov & Dollery, 2006).

That same year, in November 1996, the Board of the CBU adopted a new charter of accounts for the CBU and the commercial banks to replace completely outdated

¹ State-owned savings bank

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. Moreover, the Central Bank encouraged commercial banks to undertake an audit based on IAS or GAAP by paying the costs of audit conducted by international auditing firms for the financial year 1996. Since then, an increasing number of commercial banks have started to use the services of international auditors. However, it is somewhat ironic to note 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 Central Bank of Uzbekistan. In the first place, regulations were 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 1 standards. However, more recent Basel II requirements have not yet been introduced. This echoes the general poor level of risk management skills and regulations in the banking sector (Akimov & Dollery, 2006).

Since the Uzbek government saw banking sector's role as an important instrument in the implementation of the country's import substitution policies, the Uzbek banking sector was dominated by state-owned and state-controlled banks. The assets of the three banks that are directly owned by the government, for example, 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. However, the true figures were likely to be much larger, since a majority of non-performing loans were government-guaranteed loans and therefore were classified as good-quality assets. Indeed, only recently have senior government officials admitted that bad debt is in fact a problem (see Table 1), although official figures are still likely to underestimate the true extent of the problem.

Table 1. Banking sector indicators

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	
Number of banks (with foreign participation)	30	21(1)	29(1)	31(1)	29(2)	30(4)	33(4)	35(5)	34(6)	38(6)	35(6)	33(5)	31(5)	29(5)	28(5)	
Asset share of state-owned banks	%	21.7	15.9	46.7	38.4	75.5	70.6	67.3	65.8	77.5	80.4	73.7	70.0	67.6	65.2	na
Non-performing loans ¹ (to total loans)	%	na	0	0	0	0.4	0.1	0.1	3.0	5.1	8.5	10.9	9.3	8.9	7.3	

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 of privatisation of 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 2009-2010. 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 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 by the population in the Uzbek banking system, this had created significant problems of attracting deposits by banks from the public. Individuals preferred to hold cash for short-term transactions and hoard foreign currencies (primarily in US dollars) as a long-term investment.

Domestic credit was growing over the period of 1993-2006. However, during 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 credits issued by various international financial institutions. Table 2 shows the dynamics of credit and interest rates over 1992-2005.

Table 2. Credit & interest rate dynamics

		1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006
Domestic credit	bln. soum	4.4	27.4	49.4	142.6	215.6	387.0	520.6	982.9	1,961	2,798	3,127	3,410	3,853	4,100
Domestic credit change	%	854.4	525.3	80	188.8	51.2	79.5	34.5	88.8	90.8	40.9	11.8	9.0	13.0	6.4
Treasury Bill yield ¹	%	-	-	-	36.0	26.0	16.6	16.5	17.1	17.1	17.1	11.0	11.6	12.4	11.8
Deposit rate ²	%	30.0	60.0	90.0	28.0	14.8	13.1	13.5	18.8	21.2	26.0	23.0	18.5	15.5	15.0
Lending rate ²	%	-	100.0	105.0	49.7	28	33.1	32.7	27.6	27.6	33.4	28.1	21.2	19.9	21.0
<i>Inflation rate</i>															
Consumer prices	%	885	1281	116.9	64.3	50.0	26.1	26.0	28.2	26.5	21.6	7.8	9.1	12.3	11.4
Producer prices	%	1919	1422	217.4	75.4	40.3	48.4	34.5	70.2	43.9	46.1	27.4	26.5	28.2	24.0

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

²data for 1991-2002 and 2003-2004 are from different sources

Source: International Monetary Fund (2000); European Bank for Reconstruction and Development (2003-2007); Center for Effective Economic Policy (2005; 2006b) and Center for Economic Research (2007)

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 guarantee 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 consequently 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 retail deposits.

2.2. Non-bank financial institutions

The development of non-bank financial institutions market has been rather slow and started only in 1995. A number of the 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 years, most of the insurance companies 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. This gave further impetus to development of the insurance market.

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 over the period and dominated by state-owned insurance companies. As at 1st July 2007, their share 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 market amounted to the very high level of 53 (times) at the end of 2003, which means 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 single pension fund remained state-run and no private pension institutions had been created. The pension payments were made from the national budget. At the end of 2004, a first (and rather weak) attempt to change the system was made with the adoption of legislation when compulsory 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 ‘called to supplement budget-financed pensions’.

2.3. Securities Market

Debt instruments

The securities market in Uzbekistan has gradually developed over 1996-2006. Until 1996, 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. Moreover, since 1998-1999 the government started to issue nine-month and twelve-month Treasury Bills. As evidenced in Table 3, the government steadily reduced the number of issues and the volume of shorter Treasury Bills since the introduction of longer maturity bills.

Table 3. Percentage of Treasury Bills of each type in the market

	1996	1997	1998	1999	2000	2001	2002	2003	2004
Three-month Treasury Bills	100.0	32.5	18.1						
Six-month Treasury Bills		67.5	62.6	39.3	38.8	43.6	45.0	23.7	13.0
Nine-month Treasury Bills			19.3	38.7	30.7	30.8	30.0	28.9	26.1
Twelve-month Treasury Bills				21.8	30.5	25.6	25.0	47.4	60.9

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

Access to Treasury Bills was restricted to legal entities and residents of Uzbekistan. Moreover, 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 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.

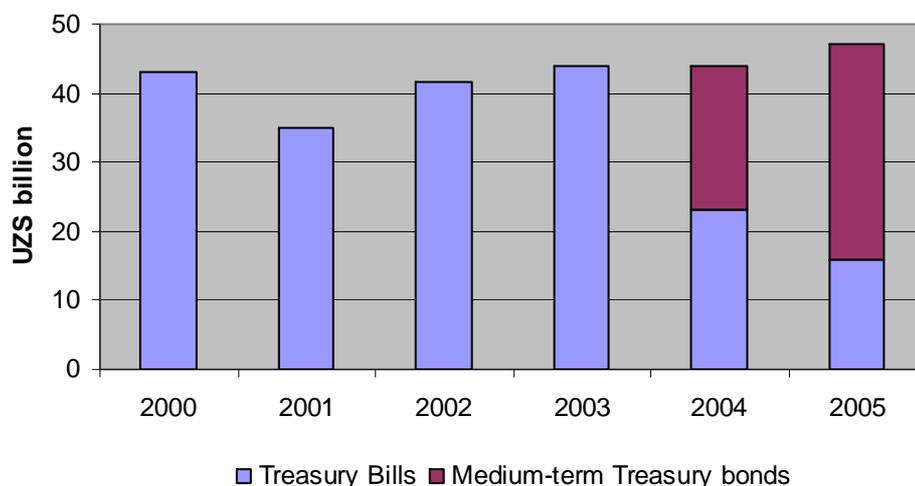


Figure 2. Volume of state-securities in circulation

Source: Center for Effective Economic Policy (2006a)

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 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).

Since 2002, corporate bond market was activated, because regulatory changes removed restrictions on the size of corporate bond issues. The market for corporate bonds recorded rapid growth during 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 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, whereas in 2006 no issues were recorded. Two large primary bond placements were made in 2007 with the total value of 4.5 billion dollars. In contrast, the volume of transaction 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).

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. By September 1999, 86 privatisation investment funds had been licensed, of which 68 were actively purchasing enterprise shares. However, the pace of privatisation was extremely 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 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.

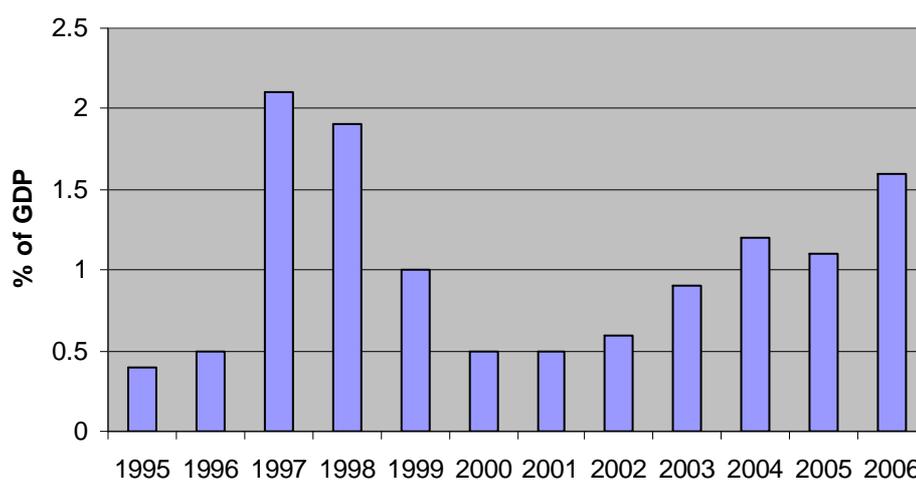


Figure 3. Stock market capitalisation dynamics

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

The sole stock exchange named RSE Tashkent (RSET) 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 had 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 4, the volume of transactions on the secondary market increased, but at a slow rate.

Table 4. The volume of trading of shares on the securities market

in UZS billion	2000	2001	2002	2003	2004	2005
Total shares sold on the securities market	17.10	26.13	41.74	74.70	115.10	142.50
On primary market	6.23	12.26	16.33	53.90	62.10	88.70
On RSET	4.60	6.84	10.53	19.70	18.50	14.90
On OTC market	1.63	5.42	5.80	34.2	43.6	73.8
On secondary market	10.88	13.87	25.41	20.80	53.00	53.80
On RSET	0.63	1.10	4.60	12.40	22.80	26.30
On OTC market	10.25	12.77	20.81	8.40	30.20	27.50

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

Most secondary trading in listed shares takes place in an unregulated informal secondary OTC. The formal OTC trading system *Elsis 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 5.

Table 5. Financial intermediaries in 2000-2002

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

Source: Center for Effective Economic Policy (2003:31)

3. Policy failures and recommendations for future reforms

3.1. Banking sector

In spite of positive trends in recent years, the banking sector in Uzbekistan has continued to experience serious problems that constrain its further development. These ‘banking failures’ require further elaboration.

By far the most serious problem in the banking sector in Uzbekistan is the 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 principle, and in common with most developed market economies, the Central Bank should be independent in its decision making capacities. Clear tasks and benchmarks should be established for its functioning. These tasks should not be 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, particularly the state-owned banks. Private banks are also subjected to tight control. A good example is the recent Presidential Decree (in May 2006) dealing with the renaming of the ‘private’ *Tadbirkorbank* to *Microcreditbank*, and granting substantial tax benefits to the bank for the provision of micro-credits to small and medium-sized businesses. An additional tool to control the activities of private banks occurs by means of approving the appointments of senior management in all banks. If a bank behaves ‘too

independently', the shareholders may find that they are not capable of hiring professional management for the bank since chairpersons and their deputies in all banks are subject to the CBU's approval and regular attestation.

This dirigiste intervention by the state into the commercial activities of financial institutions, primarily banks, should be curtailed. Commercial decisions, as well as decisions regarding corporate structures, should be a sole responsibility of banks. Lending should be made solely on the basis of risk-return assessment; in addition, corporate structure and human resource management must be decided exclusively on the basis of corporate goals and strategy. Moreover, interest rates should be steadily liberalised. They should also be positive in real terms at all times. The cross-subsidies in the banking sector, which involve such activities as paying interest on deposits from individuals above lending rates at the expense of high commissions, and low interest rates paid on companies' accounts, should be abolished.

An additional problem regarding the banking system is the lack of commitment and regulatory competence on the part of policy makers (including the Central Bank of Uzbekistan) to liberalise the sector. The CBU uses the same approach to the governance as that employed during the communist era by intervening into all spheres of banking through the directives, orders and frequent (and disruptive) inspections. Often the method of 'oral' orders is used if a policy of the CBU contradicts formal regulations. Commercial banks execute such orders (in fear of the consequences) and take the blame for breaking formal regulations.

This ubiquitous problem is related to formal lack of independence of the Central Bank as well as also transparent and competitive procedures for appointing its management. Competent and committed people should be employed for all policy-making jobs through a competitive selection process rather than through political patronage.

The activities of the Central Bank of Uzbekistan are very opaque to put it mildly. 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 actions by the government towards the savings of the population. Many people lost substantial amounts of money after the collapse of the Soviet Union, the various currency conversions, and numerous constraints to 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 current problems of businesses and individuals to access their funds in their own bank accounts and secure cash withdrawals. In conducting a tight monetary policy, the CBU often restricts cash currency circulation by obliging banks (again by 'oral orders') to restrict the amount of cash withdrawals from bank accounts. The

limited number of cash dispensers, together with the frequent lack of currency in these machines, serves to constrain the development of plastic card operations.

The problem of a general lack of confidence by the population in the financial sector is a complex problem. But several remedial measures seem warranted. In the first place, over-zealous tax enforcement and other ‘confidence-undermining’ measures should be abolished. 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. The 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 thus should not expect immediate results.

Although a large number of regulatory documents have been 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 requirements have been adopted over the years have created significant contradictions between different regulatory requirements. These contradictions must be removed as soon as possible.

Because the banking system is heavily influenced by the institutional environment in which it operates, problems with the legal system, which are topical 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, their enforcement must occur in an impartial, transparent and fair manner.

Without these basic legal conditions, both the development of the financial system (and indeed the economy as a whole) will remain greatly hampered.

The banking sector continues to be dominated by large state-owned and controlled banks. Accordingly, competition in the banking sector remains limited and should be enhanced. The government should dramatically reduce its presence in the banking sector, where its primary task is to sell the National Bank of Uzbekistan and the *Asakabank*. The entry of foreign banks should also be liberalised. This would help in bringing in foreign banking expertise and accelerate competition. However, it is important to ensure that the Central Bank of Uzbekistan is capable of enforcing adequate control over foreign banks and does not lose monetary autonomy. Thus a gradual liberalisation is recommended, particularly by encouraging joint ventures with local banks. This would allow for a better transfer of expertise rather than simply 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 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 the approach adopted in the Philippines, when the government took over liabilities related to non-performing projects. 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. As occurred in Kazakhstan, it would be advisable to postpone the sale of the savings bank to a later stage (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. 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. Poor remuneration is also a significant problem for the CBU itself. As a result, the 'brain-drain' of skilled staff was extremely high not only in the Central Bank, but also in state-owned commercial banks.

An additional serious problem resides in the limited opportunity for modern banking training in Uzbekistan. This involves bank personnel at all levels. But perhaps senior management competency remains the matter of greatest concern. Many appointees lack basic managerial and banking skills. This poses serious questions for the impartiality and effectiveness of appointment procedures.

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

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 will bring 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 comparable to that in commercial banks, particularly in such important areas as the supervision of the banking sector.

Other related problems 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 that lead to non-performing loan problems. The capacity of the Central Bank for this form of supervision should be strengthened. Clear and transparent penalty procedures for the violation of prudential norms should be established.

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 that an adequate infrastructure for this should be 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, encouraging prudent risk-management policies by the banks.

3.2. 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. In general, 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 a thus much to be done to develop non-bank institutions, not only to the standards of developed countries, but 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 give substantial relief. Even if private pension funds were to be

institutionalised, the poor development of the securities market would be a severe constraint on their development.

3.3. Securities market

The securities market in Uzbekistan also remains under-developed. The scope, volume and liquidity of securities traded are small. This sector experiences similar problems to the banking sector, such as tight control from the government (i.e. 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), 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) in terms of transparency (statistics on volume, interest rates and regulations are not published), and trading volumes in the secondary market. This market is of crucial importance since it is an important instrument of modern monetary policy, and also serves as a benchmark for other financial instruments in the country.

The equity market is in somewhat in better shape. There is adequate regulation in place, basic infrastructure and some level of acquired proficiency by market participants. 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.

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. Moreover, it is pivotal to the functioning of the Central Bank in conducting their monetary policies as well as to pension funds. In Uzbekistan, the securities market is still in an early stage of development. The development of the equity market vitally depends on the accelerated process of privatisation. Moreover, measures in improving the transparency of the sector, enhancing the investment literacy of general public and further development of market infrastructure must be adopted. Even more

attention should be directed towards development of debt instruments. Liquidity, transparency and accessibility of Treasury instruments are areas where urgent measures should be undertaken. Also important, but rather less urgent than Treasury instruments, is development of a corporate debt market. 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 required.

Aspects of the technical implementation of the various policy measures of financial system development are beyond the scope of this thesis. 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.

4. Concluding remarks

Because Uzbekistan adopted a gradual approach to economic reforms, its reforms in the financial sector reform were also undertaken slowly. The initial period of intensive reform over 1992-1997 was followed by a dramatic reform slowdown or even reform reversals during 1998-1999. However, since 2000, the government again began 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 little ground for optimism. The officials continue to intervene in the affairs of commercial banks by using confidential orders, tightening regulation, and, by so doing, encourage rent-seeking activities. This thus raises doubts over the government's commitment to financial liberalisation.

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