

Late Banking Transitions

Comparing Uzbekistan to Earlier Reformers

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Abstract

Uzbekistan is one of the late transition economies. This paper compares the early experience and challenges that Uzbekistan confronts in transitioning its banking system to market principles against the earlier experience with banking transitions from Poland, Russia, and Vietnam, and other relevant evidence from the literature. To that effect, the paper uses new data on Uzbekistan's banking sector, the data on past transition economies, and qualitative and quantitative evidence from the literature. Uzbekistan's latest experience with banking transition generates important lessons for countries that have yet to transition. Namely, how

much can a new transitioning country reasonably expect to accomplish within the medium term? Which banking reforms are the most essential and how should they best be sequenced? How can expectations about efficient capital reallocation be managed, access to finance made more equitable, and transition risks of financial instability be mitigated? What are the complementary reforms in the real sector, especially of state-owned enterprises and the competition framework, that need to happen in tandem for the new banking market to function properly?

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Late Banking Transitions: Comparing Uzbekistan to Earlier Reformers

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1. Introduction

In 2017, Uzbekistan embarked on an ambitious economic transition focused on economic liberalization and improving macroeconomic management. The reforms to date include trade and foreign exchange liberalization; price liberalization; reforms reducing taxes on private enterprises while broadening the tax base; public financial management reforms; and monetary and financial sector reforms (IMF 2021). Such reforms have put Uzbekistan on the list of many other current or former transition economies that have adopted market-based reforms, including some, such as Poland, Russia, and Vietnam, that began as early as the mid-1980s (Svejnar 2002; Mako 2020). A new central bank law and a banking law enacted in 2019 established the legal basis for a modern bank regulation and supervision. The government has introduced corporate governance requirements for state owned commercial banks (SOCBs) reforms and aims to privatize selected SOCBs following its Banking Sector Strategy and associated implementation roadmap (Presidential Decree 5992, dated May 12, 2020).

Taking stock of the transition experience in Uzbekistan's banking system and SOCBs can yield important lessons not only for the country itself, but also for many other developing countries thinking of transitioning their banking sectors toward a more market-based system. Many countries around the world have banking systems working within a centrally planned economy and/or banking systems dominated by SOCBs. Uzbekistan's latest experience with banking transition can provide important lessons for countries that have yet to transition. Namely, how much can a new transitioning country reasonably expect to accomplish within the medium term of four to seven years? Which banking reforms are the most essential and how should they best be sequenced? How can expectations about efficient capital reallocation be managed, access to finance made

more equitable, and transition risks of financial instability mitigated? What are the complementary reforms in the real sector, especially of SOEs and the competition framework, that need to happen in tandem for the new banking market to function properly?

This paper uses novel bank-level data from Uzbekistan to take stock of the ongoing transition of the Uzbekistan banking sector and particularly SOCBs, compare the early transition outcomes to those of former transition economies such as Poland, Russia, and Vietnam, as well as to the qualitative and quantitative evidence from the existing literature. It contributes to our understanding of the banking sector in Uzbekistan and how Uzbekistan's path so far reflects the experience of early reformers. To date, few studies have examined the role of state-owned banks in Uzbekistan, and to the authors' knowledge, there is no research that documents the ongoing transition in the Uzbekistan banking sector and SOCBs. Existing studies on Uzbekistan's financial sector focus on describing past and ongoing reforms using aggregate data. Detailed studies on banking sector development after the 2017 economic liberalization are missing and so are studies that would relate Uzbekistan's experience to date with that of former transition economies. This paper aims to fill this gap.

The remainder of this paper is organized as follows. Section 2 provides an overview of the literature on banking transitions and state bank ownership. Section 3 describes the data and research methodology. Section 4 discusses the results of our comparative analysis between Uzbekistan and the former transition economies of Poland, Russia, and Vietnam while linking the issues to detailed review of relevant literature. Section 5 concludes and offers some policy recommendations.

2. Literature Overview

Transition economies are countries that are moving from government-controlled and centrally planned economic systems to more market-based ones, driven by the private sector. The collapse of the Soviet system has triggered a mass transition from central planning to a market economy. For the transition economies, the old financial system typically entails high government ownership in the banking sector, given the role of the government in allocating resources through central planning. By contrast, a market-based economy calls for well-functioning financial intermediaries that mobilize resources efficiently and allocate capital to the most productive uses. An underdeveloped financial sector can misallocate resources (Pang and Wu 2009; Midrigan and Xu 2014), hamper firms' ability to innovate and adopt new technology (Cole, Greenwood, and Sanchez 2016), and significantly reduce national income (Wachtel 2001; Buera, Kaboski, and Shin 2015). Therefore, reforms of the banking sector and particularly state-owned banks take the center stage in the transition toward a market-based economic system.

Until the late 1980s, many developing countries took state ownership of commercial banks for granted because they considered banks, like many large state-owned enterprises, to be too strategically important to be entrusted to private hands (Hawkins and Mihaljek 2001). During the last quarter of the twentieth century and early twenty-first century, motivated by the "Washington Consensus" (Williamson 2009), the world trended toward a more liberalized financial system and less state ownership in the banking sector. Banking reforms focused on privatization and reducing state intervention in the financial system (Megginson and Netter 2003; Kikeri and Kolo 2005; Megginson 2017). While each developing country had its own motives for privatizing state-owned banks, main factors driving virtually all privatization programs included: poor performance of

state-owned commercial banks (SOCBs) and the need for frequent bailouts resulting from poor governance, risk management, and lending decisions; significant dependence on state funding; as well as a widely held perception that the presence of state-owned banks hinders development of the financial sector (Hawkins and Mihaljek 2001). Moreover, several studies show that extensive government ownership in the banking sector hinders financial development (and economic growth) because it lowers access to the formal banking system, lessens depth in the credit market, and decreases financial innovation (Barth, Caprio, and Levine 2000; La Porta et al. 2002; Cull, Martinez Peria, and Verrier 2018).

While all transition economies have faced the need to restructure and privatize state-owned banks, the transition has not always gone smoothly, and has been done at different speeds and under different modalities. Widespread privatization programs are often controversial and difficult to implement for a variety of reasons, such as political opposition—including resistance stemming from the doubtful success of past privatizations; actual or perceived negative distributional consequences; and political economy considerations (Bertay et al. 2020). Nevertheless, many studies have shown that bank performance typically improves after privatization (Boubakri et al. 2005; Clarke, Cull, and Shirley 2005; Otchere 2005; Bertay et al. 2020). But private ownership by itself is not a panacea for reforming a state-owned banking system. Five key lessons, among others, have emerged from privatization reforms. First, the most successful method of privatization is sale of a state-owned bank to strategic and reputable investors (Hawkins and Mihaljek 2001; Bonin and Wachtel 2002; Mako 2020) through an open and competitive bidding process (Clarke, Cull, and Shirley 2005; Megginson 2005) that is accessible to all investors, including foreign investors. Second, privatization of state-owned banks had a greater positive impact when it was total rather

than partial (Ehrlich, Gallais-Hamonno, Liu, and Lutter 1994; Megginson, Netter, and Chahyadi 2005; Bonin, Hasan, and Wachtel 2005; Beck, Crivelli, and Summerhill 2005). Third, privatization in certain cases (such as Hungary and the Czech Republic) required prior cleanup of state-owned bank balance sheets and operational restructuring, making the privatization the last and not the first step in the transformation process (Hawkins and Mihaljek 2001). Fourth, the benefits of privatization are weakest for countries where it was rushed the most, such as in Eastern Europe (Megginson and Netter 2001) and where it was not paired with institutional strengthening of the regulatory and supervisory framework (Azam, Biais, and Dia 2004; Reinhart and Rogoff 2013; Estrin and Pelletier 2018). Fifth, the success of banking sector reform is dependent on and supports the reform of the state-owned enterprise (SOE) sector. The above-mentioned elements of successful transformation apply even more when the banking sector is concentrated and underdeveloped, as shown by two papers that examine the privatization of banks in Uganda and Tanzania (Clarke, Cull, and Fuchs 2009; Cull and Spreng 2011).

A recent study covering about 500 bank privatization events in 70 countries in emerging and advanced economies during the 1995–2017 period shows that the majority of bank privatizations involved governments selling their equity publicly in their domestic capital markets, which has yielded significant state revenues (Bertay et. al 2020). Banks chosen to be privatized were consistently those underperforming in terms of profitability and quality of assets—although domestic banking crises did not emerge as the main reason for privatization. Following privatization, the private banks focused on corporate lending, increasing credit growth, working with lean buffers of liquidity buffers, avoiding a significant rise in non-performing loans (NPLs), and lowering operational costs.

The preceding arguments for state-owned bank privatization, however, do not imply that there is no role for state-owned banks to play in the economy. After the 2007–09 global financial crisis and during the recent COVID-19 crisis, state-owned banks have grown in importance. For example, state-owned banks have expanded both their assets and branch networks in the regions covered by the European Bank for Reconstruction and Development (EBRD) over the past decade and have become serious competitors to private banks, EBRD (2020) documents. Given the recent rise of state-owned banks, policy makers in developing countries are reassessing the optimal role of state interventions and ownership in the financial system (Melecky 2021).

There are sound justifications for state-ownership of banks in a market-based economic system. Because of market failures or profitability considerations, private financial institutions underserve certain market segments and thus provide the main rationale for state intervention (Atkinson and Stiglitz 1980; Stiglitz 1993; World Bank 2013; Fernández-Arias et al. 2020). For example, some state-owned banks focus on financing large infrastructure projects, in which the need for large amounts of long-term funding and the existence of external social benefits provide the rationale for state intervention (Levy-Yeyati, Micco, and Panizza 2007; Fernández-Arias, Hausmann, Panizza 2020). There are also state-owned banks that have a wide network in rural areas where private banks are not present, and act as a financial agent for the disbursement of government funds such as social subsidies. State-owned banks are also tasked with countercyclical lending during periods of crisis (Micco and Panizza 2006; Bertay, Demirgüç-Kunt and Huizinga 2015; Bertay et al. 2020; Bosshardt and Cerutti 2020; EBRD 2020; Panizza 2021). However, where market failures do exist, direct state ownership is not always the optimal solution. Government regulation and

contracting could be better alternatives than direct state ownership in banks to address the market failures (Shleifer 1998).

In practice, state-owned banks typically fail to have clearly defined developmental mandates for addressing market failures. Many have mandates that are vague and hard to measure, and thus difficult to establish key performance indicators by which to gauge accountability (Ferrari, Mare, and Skamnelos 2017; Fernandez-Arias et al. 2020). In many circumstances, in the absence of clearly defined mandates, state-owned banks compete with private banks for the same clients and businesses.

Importantly, the downside of state-owned banks is particularly problematic: state-owned banks typically face aggravated agency problems because it is hard to align the incentives of public managers with multiple tasks/mandates that are often very difficult to measure (Perotti and Vorage 2010; Cull, Martinez Peria, and Verrier 2018). As a result, many state-owned banks suffer from low operational efficiency and poor risk management. The unclear developmental mandates lead to capital misallocation and inefficient financial intermediation (Banerjee 1997; Hart, Shleifer, and Vishny 1997; La Porta, Lopez-de-Silanes, and Shleifer 2002; Barth, Caprio, and Levine 2004; De Nicolò and Loukoianova 2007; World Bank 2013; Melecky 2021).

How to optimize state ownership and interventions in the financial sector during economic transitions remains an important policy question as many developing economies struggle with low financial development and heavy state interventions in the financial sector (Beck, Demirgüç-Kunt, and Levine 2010; Beck and Cull 2013; World Bank 2013). State-owned commercial banks

represent, on average, about 18 percent of banking sector assets across all countries, but the share of state ownership varies substantially (Cull, Martinez Peria, and Verrier 2018). In many developing countries such as Argentina, Bangladesh, Belarus, Brazil, China, Ethiopia, India, Myanmar, Russia, Ukraine, Uzbekistan, and Venezuela, state ownership remains high in the banking sector (Cull, Martinez Peria, and Verrier 2018; EBRD 2020). For example, in the developing countries of South Asia, state-owned banks still dominate the financial system. While some of these state-owned banks serve certain developmental mandates such as countercyclical lending, they were also plagued by operational inefficiency and poor risk management, leading to resource misallocation in the wider economy (World Bank 2010, 2020). Against this backdrop, policy makers are eagerly looking for renewed evidence about how to optimally proceed with financial sector transitions and reforms of state-owned banks.

Existing studies on Uzbekistan's financial sector focus on describing past and ongoing reforms using aggregate data. For example, Akimov and Dollery (2008) and Ahunov (2015) document Uzbekistan's financial development reform and examine the developments and policy achievements using aggregate economic and banking sector indicators. Detailed studies on banking sector development after the 2017 economic liberalization are missing and so are studies that compare Uzbekistan's experience to that of earlier reformers. This paper aims to fill this gap.

3. Data and Methodology

We use bank-level supervisory data collected by the Central Bank of Uzbekistan to construct and analyze trends and risks in the Uzbekistan banking sector during the period 2017-2021, compare them to the experience of former transition countries in the relevant past periods, and relate the

resulting observations to the quantitative and qualitative findings from relevant literature. We use data from World Bank Global Financial Development Database to retrieve comparable indicators of financial depth, efficiency, and stability, and the World Bank Enterprise Survey, IMF's Financial Access Survey and World Bank Findex data to retrieve comparable indicators of financial access and inclusion. The data sources together with relevant periods that are being analyzed are described in the sources and notes of the presented figures. While the bank-level supervisory data from CBU are confidential, the authors secured the permission to publish the aggregated data by topic and ownership (state, private) indicator. The banking system indicators for Uzbekistan are summarized in Table 1 for the system in aggregate, and separately for SOCBs and private banks.

The paper uses the method of comparative analysis to compare trends and risks in Uzbekistan's banking sector since the beginning of its transition in 2017 to the corresponding data from the periods of banking transitions in Poland, Russia, and Vietnam. The three earlier transition countries are chosen because they present comparable structural features and constitute interesting counterfactuals for Uzbekistan. The EBRD's 1998 *Transition Report* ranked Poland as the top reformer—second only after Hungary, which began its transition earlier in a phased process that impedes comparability. Although ranked toward the bottom by the report, Russia is included because of its influence on the economic and financial systems of other former Soviet republics. Vietnam is included as an example of a “socialist-market” economy in Asia. As in Uzbekistan, the share of agriculture in the three comparator economies has been large and the three comparators have a relatively greater reliance on state-owned enterprises, even to date. In instances in which comparisons to the experience of these three former transition countries are not possible for some

banking microdata indicators, we compare the state-owned banks with the private banks in Uzbekistan to form an informative counterfactual.

4. Comparative Analysis

4.1. The Development of Uzbekistan's Financial Sector Relative to Former Transition Peers

In 2021, commercial banks account for more than 95 percent of total financial sector assets in Uzbekistan. Thirteen state-owned commercial banks (SOCBs), out of a total of 32 commercial banks, held 85 percent of banking sector assets and 88 percent of total credit as of the end of 2020 (figure 1, panel A). The three (six) largest SOCBs account for almost 50 (70) percent of total sector assets. The government is the sole shareholder or holds nearly all shares (more than 90 percent) of these SOCBs via various state agencies and public companies: the Uzbek Fund for Reconstruction and Development (UFRD), the Ministry of Finance (MoF), the State Assets Management Agency (SAMA), other public agencies, and state-owned enterprises. The UFRD is the largest SOCB shareholder because its funds have often been used to replenish the equity of SOCBs. However, as of 2020, the formal responsibility to exercise shareholder rights over SOCBs on behalf of the government and all its agencies was transferred to the MoF. In its banking sector strategy, Uzbekistan plans to privatize all but 3-4 SOCBs that should stay in public ownership for the foreseeable future and be mandated with double bottom line of both commercial and social objectives.

SOCBs traditionally focused on intermediating funds from the government to provide credit to priority sectors and state-owned enterprises at below-market rates. They funded their lending activities mostly by using the lines of long-term credit from the government, UFRD, and foreign banks, rather than local deposits. Until recently, almost half the SOCB loan portfolio comprised

loans to state-owned enterprises (SOEs), many of which distort competitive private sector development and are the subject of recent government reform.¹ Preferential (below money market rate) lending—about 80 percent of the total loan book in 2018—was provided to support priority segments such as national projects, low-income housing, and entrepreneurship, agriculture, and other targeted sectors. Such funding and loan structure suggest that SOCBs largely continue to channel public sector funding to public sector entities and policy directed loans. As such, SOCBs conduct only a limited assessment of borrowers' repayment capacity when originating preferential loans, mostly checking compliance with program eligibility criteria. This practice reflects the political mandate to grant those loans, as well as soft budget constraints stemming from the availability of UFRD funding and equity injections.

Private banks are small and have mainly served the private sector, mostly on commercial terms. The nineteen private banks in operation (two of which were licensed in 2020 and one in 2019) are very small, holding average equity of \$48 million.² SOCBs hold about ten times the total assets of private banks: the median size of private banks is \$110 million, compared with \$1,520 million for SOCBs. Their small size prevents private banks from realizing economies of scale comparable to SOCBs and reaching an efficient scale of operation—as evidenced by the significantly higher ratio of operational costs to assets reported by private banks (5 percent) compared with SOCBs (3 percent). The loan portfolio of private banks amounts to less than 60 percent of their total assets, on average, while liquid assets and interbank exposures amount to about 30 percent. Unlike

¹ See details in Iooty and Ospanova (2021). In July 2020, the government issued a presidential decree setting comprehensive milestones to promote competition in the country. The decree touches on the key constraints affecting the development of competition in Uzbekistan, including significant and distortive state aid and the significant presence of SOEs in competitive markets and the lack of a level playing field.

² The smallest private banks hold equity totaling only \$14 million, while equity ranges from \$60 million to \$130 million for the largest private banks.

SOCBs, private banks fund their operations mostly through retail deposits, which account for more than 60 percent of their liabilities. The remaining funding originates from foreign banks and international development financial institutions (about 15 percent), in addition to SOE and state deposits (about 9 percent).

There are virtually no financial sector alternatives to banks because nonbank financial organizations and capital markets remain underdeveloped. Microcredit organizations (MCOs), leasing companies, and pawnshops provide nonbank alternative sources of credit. There are 61 MCOs and 63 pawnshops operating in the market, accounting for just 0.2 percent of banking sector assets. MCOs provide microfinance (microloan, microcredit, and microleasing) services and factoring, while pawnshops provide short-term microloans backed by movable collateral (mostly gold). There are more than 100 leasing companies. Their leasing portfolio accounts for 1.7 percent of banking sector loans. The top five leasing companies have more than 70 percent of the market share. Capital markets are virtually nonexistent. The insurance sector is small, and the presence of state-owned insurance institutions is significant.³

Uzbekistan is at a nascent stage of its transition to market compared with earlier reformers. Although the private sector is not yet developed and vibrant, its transactions, investments, and innovations require adequate finance to boost productivity and equal access to economic opportunities—especially for existing and emerging micro-, small- and medium-sized enterprises (MSME) that need to expand for shared prosperity to take place (Gould and Melecky 2017). Even

³ Of the 28 insurance companies, the 3 largest state-owned companies account for 36 percent of total premiums. Major insurance products include compulsory motor insurance, compulsory employer's liability insurance, contractor's all-risk insurance, property insurance (against pledges and all types of catastrophes), agricultural insurance, and export credit insurance.

though the country lags its peers in financial deepening, the ongoing credit expansion appears too rapid, creating risks to financial stability (figure 2). As many other countries before, Uzbekistan thus faces a balancing act in its banking sector transition.

By a broad measure of financial deepening, Uzbekistan falls behind not only the aspirational averages for East Asia and Pacific (EAP) and Europe and Central Asia (ECA) countries, but also the averages for Commonwealth of Independent States (CIS) countries and lower-middle-income country (MIC) peers (figure 2, panel A). In parallel, Uzbekistan shows high bank concentration as well as a high share of loans to SOEs and government compared with the experience of former transition countries (figure 2, panel B). Such concentration weakens competition in financial intermediation because of excessive market powers that the biggest banks hold. The large share of lending to state enterprises by state banks funded from state (non-market) resources can further impair the allocative efficiency of the banking system.

Benchmarking the credit growth of Uzbekistan to the historical experience of transition countries shows that Uzbekistan may be growing credit too quickly. Economic transitions typically entail rapid changes in countries' macrofinancial systems that, if not managed properly, could trigger systemic vulnerabilities and instability. Fast credit growth is yet another factor that helps predict future banking crises, including in transition countries.⁴ In the early stages of their transition, Poland, Russia, and Vietnam grew their credit much less than Uzbekistan and still experienced banking crises and systemic instability (figure 2, panel D). Hence, Uzbekistan faces a tough

⁴ Caggiano et al. (2016), for example, find that excessive credit growth can trigger bank problems through a generalized deterioration in banks' asset quality (as a result of over-indebtedness of borrowers and loosening credit standards) and/or a reduction in liquidity (due to aggressive maturity transformation and reliance on wholesale sources of funding).

balancing act: to let its financial depth converge to that of peers while not converging too fast to crash (Gould and Melecky 2017; Cihak, Mare, Melecky 2021).

4.2. Banking Sector Links to the Real Economy

Because SOCBs have largely operated as public sector credit agencies—serving SOEs and priority sectors—much of the population and private firms lack access to suitable financial services. As in other former socialist countries, SOCBs have mainly acted as channels for the state to implement its credit plan and grant mostly subsidized lending to specific sectors and SOEs—rather than acting as true banks that allocate resources to the most productive uses based on market signals and considering risk and return. Until very recently, the boards of SOCBs were dominated by senior public officials who lacked the required knowledge and experience in banking as well as the time and operational independence to duly carry out their roles. Consequently, SOCBs lacked any proper corporate governance and risk management capabilities and relied on frequent recapitalizations by the state when liquidity or capital shortfalls emerged.

The banking sector has had little incentives to mobilize household savings. The history of cash shortages,⁵ non-core functions imposed on banks,⁶ restrictions on currency conversion, and disruptions in payment systems has eroded the public’s trust in the banking system and reduced

⁵ Mandatory encashment rules forced firms to surrender cash collections every few days. Surrender amounts were not based on actual cash collections by firms but a norm established by the authorities based on on-site audits of business activity.

⁶ Banks in Uzbekistan have performed non-core functions—such as tax administration, cash monitoring, and reporting on their clients—which has impaired bank-client relationships, lowered trust, and inhibited financial intermediation. While some of those functions are no longer required, others remain. In particular, according to the Joint Instruction N 2432 (CBU, MoF, Tax Authority) dated March 15, 2012, banks must decide on the amount and sequence of payments to be made from their client companies' main bank accounts with regard to government-related payments (tax, customs, and so on) and salary payments, in case there are insufficient funds to meet all bills.

demand for deposits. Broad money⁷ accounted only for about one-fifth of GDP—well below the range of 30 percent to 40 percent in Poland and Vietnam on average during 1997–2000 and two-thirds of GDP in countries at similar income levels by the end of 2018.⁸ By the end of 2020, the ratio of bank deposits to GDP stood at 19 percent in Uzbekistan. However, around 40 percent of deposits belonged to the government and SOEs. Because data are lacking, we cannot compare this structure to other early reformers where this issue may or may not have been similar. Bearing in mind this structural issue, during 1997–2000, bank deposits to GDP averaged about 30 percent in Poland, 13 percent in Russia, and 6 percent in Vietnam.

Access to financing for micro, small and medium enterprises (MSMEs) remains a significant challenge in Uzbekistan compared to peer countries. According to the World Bank Enterprise Survey, only about 22 percent of Uzbek firms had access to a loan in 2019, compared to the average of 28 percent for lower-middle-income countries and 38 percent for countries in developing Europe and Central Asia.⁹ Comparing Uzbekistan today to Poland and Russia in 1999 and focusing on “the degree to which financing is problematic for operation and growth of business,” the EBRD-World Bank Business Environment and Enterprise Performance Survey (BEEPS) indicates that about 20 percent to 30 percent of respondents in Poland and 40 percent of respondents in Russia perceived financing to be a “major or moderate obstacle” in 1999, compared with about 30 percent of respondents in Uzbekistan in 2019. The comparison indicates that Uzbekistan does not stand out historically. However, from today’s viewpoint, Uzbek MSMEs lack access to an appropriate

⁷ Broad money is a category for measuring the amount of money circulating in an economy. It is defined as the most inclusive method of calculating a given country's money supply, and includes narrow money along with other assets that can be easily converted into cash to buy goods and services.

⁸ Data source: GlobalEconomy.com.

⁹ Ownership of a bank account among MSMEs is about 84 percent, compared with the average of 95 percent for the ECA region.

range and quality of financial products that their counterparts in other countries at a similar income level enjoy—including digital account services, investment loans, agricultural loans, and factoring. One reason is that credit providers do not employ proper cash-flow analyses, credit risk management methods, or credit scoring systems in their lending decisions. They rely mostly on high collateral requirements and relationship lending.

In the absence of banking sector reform, including of corporate governance, risk management, and business models, the system could continue misallocating credit and, at some point, experience financial distress—which could compromise economic stability and hamper economy-wide reform efforts. Banks' business models need to transform to discourage the reliance on public sector funding and its repercussions for hampering efficient credit allocation and much-needed deposit mobilization. Privatization and restructuring of state-owned commercial banks can ensure more efficient allocation of capital to productive investments and wind down the practice of distortive directed lending that enables the survival of unviable (and politically connected) firms (Bussolo et al. 2019).

In this regard, insolvency and creditor rights (ICR) systems are widely recognized as important elements of financial system efficiency and stability—including during economic transitions (Balcerowicz, Gray, and Hoshi 1998). They enable creditors to better manage financial risk and other difficulties dealing with problem borrowers. The need for reform of the ICR systems stems from the many issues that weaknesses in effective ICR system create if not addressed adequately. These issues include: (1) posing major bottlenecks in efforts to reduce banks' exposure to problem assets and encouraging banks to keep nonviable borrowers afloat with extend-and-pretend

practices; (2) weakening repayment discipline; and (3) maintaining high levels of unresolved NPLs, making banks (and non-bank credit providers) reluctant to lend to new customers and keeping the banking sector from fulfilling its potential to support the economic recovery with credit (BIS 2017; World Bank 2020). When aggregate NPLs are rising, MSMEs are typically the most disadvantaged segment in emerging market and developing economies, experiencing credit rationing and rising lending rates (Feyen and Zuccardi 2020).

4.3. Credit Booms and Deepening after Economic Liberalizations

The 2017 economic liberalization triggered a credit boom at rates that may not be sustainable. The economic liberalization—notably involving the foreign exchange and trade regime liberalizations—pushed the banking sector into a frenzied credit growth driven by both demand factors (such as increasing retail and private sector demand) and supply factors (more state funding). After growing by 110 percent in 2017—partly due to local currency depreciation—credit grew at about 50 percent per year in nominal terms in 2018 and 2019, slowing down to only 30 percent in 2020 because of the COVID-19 crisis (figure 3, panel A).

Both SOCBs and private banks have experienced a credit boom (figure 3, panel B). Thirteen banks, including three large ones, doubled their balance sheets, and four small and medium banks tripled their balance sheets over 2018–20. Lending to the industrial sector and loans to individuals contributed the most to the 79 percent nominal credit growth over 2018–20—making up 23 percentage points and 19 percentage points of the 79 percent growth, respectively. Lending to agricultural, transport, communications sectors were not far behind, each with a 12-percentage point contribution rate. Overall, credit to the private sector in Uzbekistan grew from 12 percent to 30 percent of GDP from 2016 to 2019, an annual growth of around 6 percentage points of GDP.

This is more than three times the average annual growth experienced by other transition economies such as Poland, Russia, or Vietnam during the initial years of transition. Credit to the private sector (as a share of GDP) barely grew in Poland from 1990 to 1995, grew by 1.1 percentage points per year from 1996 to 2001 in Russia, and grew by 1.1 percentage points per year from 1992 to 1997 in Vietnam.

The room for aggressive lending in Uzbekistan opened further with the “cleanup” (a reduction) of policy lending from SOCBs’ balance sheets by the end of 2019. This was also a crucial reform to prepare banks for privatization. Traditionally, SOCBs have relied on frequent recapitalization by the UFRD when their capital buffers were depleted due to excessive lending. The removal of UFRD-funded SOE loans from the banking sector and the conversion of some UFRD loans to banks into equity at the end of 2019 boosted the capital buffers of SOCBs by about 8 percentage points. Unintentionally, the increased capital buffers supported further aggressive credit growth throughout 2020. Several banks (mostly SOCBs) exhibited rapid growth of their loan portfolios in 2020—at a rate of 50 percent to 80 percent.

Estimates for 2021 by the Central Bank of Uzbekistan (CBU) reveal signs of credit market overheating. The CBU estimated that the credit-to-GDP gap¹⁰ ranged from 2 percentage points to 5 percentage points over the past several years.¹¹ When a credit-to-GDP gap exceeds 2 percent, international standards typically call for the imposing of a countercyclical (add-on) capital buffer on the banking system. The broader macroprudential goal is to both contain the excess of aggregate

¹⁰ The credit-to-GDP gap is the deviation of the credit-to-GDP ratio from its long-term trend, as per the methodology proposed by the Bank of International Settlements.

¹¹ “Monetary Policy Review: IV quarter 2020,” Central Bank of Uzbekistan, 2021.

credit growth that builds systemwide risks and create an additional cushion for banks to be able to absorb much of the losses that can arise because of excessive credit growth (BCBS 2011). The CBU has also concluded that while the credit indebtedness of the population is relatively low, its growth rate is not in line with the income growth of the population, reflecting overoptimistic attitudes toward creditworthiness.

The strong credit boom, although precarious, helped boost the private sector's access to financial services. While the number of depositors gradually increased from 609 per 1,000 adults to 809 per 1,000 adults from 2015 to 2019, the number of borrowers from commercial banks almost tripled, from 57 per 1,000 adults to 152 per 1,000 adults (figure 4, panel A). By way of comparison, looking at Poland, the earliest data available from the IMF's Financial Access Survey indicate 824 depositors and 449 borrowers per 1,000 adults in 2008—suggesting that the number of depositors in Uzbekistan could be comparable to or even ahead of that of Poland in parallel times of transition, while the access of borrowers to financial services could fall behind Poland's transition experience.

World Bank Enterprise Survey data for 2019 indicate that only 5.8 percent of Uzbek firms see access to finance as a major constraint, well below levels for regional and income peers (17 percent and 26 percent, respectively). However, only 22 percent of surveyed firms report having a bank loan or credit line (24 percent in 2013), well below the 28 percent average for lower-middle-income countries and 38 percent for developing Europe and Central Asia. Over the past few years, the share of loans provided to small businesses and sole entrepreneurs has ranged between 30 percent and 40 percent of total lending, while the share of lending to individuals has been increasing more steadily. Despite these positive developments, banks continue providing a limited

range of credit products to MSMEs—most of them with high collateral requirements. Mid-sized firms have the greatest unmatched needs for finance and are more likely to be more credit-constrained compared with smaller and large firms (figure 4, panel B).

4.4. Institutional Reforms in Uzbekistan’s Banking Sector and the Global Experience

There is no strong rationale for having a large state commercial banking sector in Uzbekistan and other developing economies. Around the world, ownership of multiple commercial banks by the state is rare. The consideration of providing a “safe haven” against financial instabilities in the future, helping firms and households weather the impact of economic downturns, the presence of market failures, and the need for performing some developmental functions may provide a rationale for having one or very few state-owned commercial banks. However, the benefits of a strong SOCB presence should be weighed against the potential for distortionary effects in the longer term (EBRD 2020). These distortionary effects include misallocation of credit, impediments to the effective reallocation of capital and labor across firms and industries, and ultimately reduced productivity growth in the medium to longer term. Therefore, restructuring and privatization of most SOCBs is needed, and the few SOCBs that may remain in public hands must undergo governance reform, capacity building, and development of business process and lending technology commensurate with the envisaged dual commercial and social mandate (Fernández-Arias et al. 2020; Gutierrez and Kliatskova 2021; Melecky 2021). For instance, Fernández-Arias et al. (2020) suggest leveraging the intelligence-gathering role of development banks along the lines of the role that modern theories of financial intermediation assign to banks as institutions with a comparative advantage in producing and processing information. However, while private banks focus on information on private returns, public banks with social objectives could produce and organize information about social returns.

The experience of many countries shows that financial liberalization, when not paired with proper regulation and supervision, has led to banking crises. These studies show that the probability of banking crises conditional on financial liberalization is higher than the unconditional probability of banking crises (Hawkins and Mihaljek 2001, Angkinand, Sawangngoenyuan, and Wihlborg 2010; Reinhart and Rogoff 2013). The experience from individual transition economies highlights the importance of strengthening financial sector institutions for successful economic transitions. For example, Poland, one of the transition leaders in developing Europe and Central Asia, early on implemented numerous reforms to strengthen the financial sector’s institutional capacity and infrastructure—including developing prudential and supervisory regulation, passing a new securities law, and revising national accounting standards—and then proceeded with gradually privatizing the state-owned banks (Mako 2020). By contrast, Russia pursued privatization while leaving many gaps in financial market infrastructure unfilled. Its banking activity surged ahead of regulatory and supervisory capacity and Russia underperformed its peers in subsequent growth.

Unlike the former transition economies such as Poland, Russia, and Vietnam that started building their market and financial sector infrastructure early in their transitions, Uzbekistan is comparatively ahead on its path toward a functioning market system and operational financial sector infrastructure. However, amid the fast credit growth and high share of state-ownership in the banking sector, institutional capacity must be boosted to improve the private sector’s access to finance while mitigating the risk of a future banking crisis. Therefore, improving the CBU’s capacity to perform its proper “gatekeeper” function; improving its licensing, supervisory, and resolution frameworks; upgrading insolvency frameworks; and reforming state-owned banks will

be key to ensuring that only financially strong and reputable shareholders enter the banking system for the long term and fostering the safety and soundness of the financial system.

In 2019, Uzbekistan made strong progress in implementing structural reforms in the banking sector. In October 2019, the country enacted new laws with respect to the central bank, banks, and banking that provide a robust legal basis for developing a modern bank regulatory and supervisory framework.¹² In December 2019, large preferential loans to SOEs funded through UFRD resources were transferred out of the SOCBs' balance sheets back to the UFRD. This reform has considerably improved the capital positions of SOCBs, decreased exposure to foreign currency risk, and paved the way for further banking sector reforms and eventual privatization of most SOCBs. Further, the government took measures to wind down the practice of preferential lending with the introduction of interest rate subsidy mechanisms only where needed. All directed lending programs have been concentrated in three SOCBs that will remain in the public domain for the foreseeable future.

In 2020, the country adopted the 2020–25 banking sector strategy. The strategy's implementation roadmap includes; (1) actions to advance SOCBs' privatization and restructuring—most SOCBs are to follow a two-stage privatization process with support from an international financial institution(s) (IFI); (2) strengthening micro- and macro-prudential oversight of the financial sector; (3) the development of an ecosystem of nonbank financial providers—facilitated through the adoption of a new law on non-bank financial institutions; and (4) the adoption of a comprehensive strategy for financial inclusion.

¹² Miquel Dijkman and Eva Gutierrez, "Establishing a Fit-for-Purpose Banking Law in Uzbekistan," World Bank blogs, December 2019.

The ownership function for SOCBs and the oversight of SOCB restructuring and privatization were centralized in the MoF within a dedicated SOCB department. This department has five main objectives: (1) to minimize the scope for political interference and bring greater professionalism to the state's ownership role; (2) to promote consistency in applying corporate governance standards and in exercising the state's ownership role across SOCBs; (3) to achieve greater transparency and accountability in SOCB operations through better performance monitoring; (4) to decrease the state share in the banking sector through the privatization of selected SOCBs to strategic investors based on transparent and competitive international tenders; and (5) to conduct privatization with a systemic approach in mind to competitively serve various parts of the economy while ensuring the diversity of the banking system for purposes of economic stability. Strengthening the capacity of the MoF SOCB department is therefore crucial for effective implementation and coordination of the banking sector reform.

Several IFIs have been invited to work with some of the largest SOCBs to help prepare their privatization. The adopted strategy envisions privatization of at least six SOCBs by 2025, including full privatization of three SOCBs to strategic investors. This reform will increase the share of private banks in total banking system assets from 15 percent to 60 percent and their share of deposits in total bank liabilities from 40 percent to 60 percent. The IFIs have either started working or are in the process of negotiating cooperation with the largest SOCBs to ensure their due transformation and prepare them for privatization. The Hungarian OTP bank signed a memorandum with the Uzbekistan government in September 2021 to purchase a 75 percent stake in the Ipoteka bank¹³—a large SOCB that has been under transformation with support from the

¹³ See news coverage in [Reuters](#), [MIFT](#), [Financial Times](#). ¹⁴ See news coverage in [Gazeta.uz](#), [RBC](#), [Kun.uz](#).

International Financial Corporation (IFC). This transaction will be followed by OTP's purchase of the remaining stake of the Ipoteka bank within the next three years. In addition, two Russian banks intend to buy the entire stake in two small SOCBs.¹⁴

The central bank continues improving its regulatory and supervisory framework. Following the adoption of the laws on the central bank, banks, and banking, the CBU has self-assessed its regulatory and supervisory framework against the global standards (the Basel Core Principles) (BCBS 2012). The comprehensive assessment identified main weaknesses in the CBU's regulatory framework and supervisory approaches. Since mid-2019, the CBU has been addressing key prudential challenges (asset classification, capital), and implementing measures to bring all banks in compliance with the established rules. A draft risk-based supervisory manual has been developed, and gradual transition to risk-based supervision has been piloted with four banks. The CBU is in the process of preparing a system of early supervisory interventions to address problems at banks in a timely manner. Numerous regulations have been developed in accordance with international standards, including on bank licensing, corporate governance, risk management, large exposures, prudential reporting, and liquidity risk.

In line with the experience of former transition economies, financial sector reforms in Uzbekistan have been complemented by simultaneous reforms to support private sector development and strengthen the demand side of finance. In successful transition economies, policies that promote market-based competition, improve the business environment, and attract foreign investments have been adopted alongside banking sector reforms. In Poland, the rapid opening of markets,

¹⁴ See news coverage in [Gazeta.uz](#), [RBC](#), [Kun.uz](#).

liberalization of prices, and dismantling of monopolies gave a big boost to growth and helped the country start its economic recovery earlier than its regional peers. SOEs in Poland performed better than elsewhere because of uncompromising hard budgets imposed on SOEs with credible signals from the Ministry of Finance that the SOEs had to make it on their own or fail (Piatkowski 2018). At the same time, competition from imports was allowed—which compressed profit margins and imposed efficiency pressures on SOEs, bank lending tightened, and SOE management became motivated to exhibit good managerial abilities in anticipation of SOE privatization—which was delayed but inevitable (Pinto 2014).¹⁵ These policies supported the development of a private sector that the reformed and improved banking system can help to thrive and become more competitive. What ultimately determined the success or failure of transition for most Eastern European economies was not the restructuring of SOEs, whose share in the economy was fast declining anyway, but the pace at which the private sector grew. In Poland, the share of the private sector increased from initial levels of about one-quarter of GDP in 1989 to two-thirds of GDP by 1995.

In Uzbekistan, the private sector still suffers from low degree of competition, subdued firm productivity, and insufficient connectivity with international markets.¹⁶ Starting in 2017, the government began pursuing a series of reforms to promote competition,¹⁷ enhance connectivity with international markets,¹⁸ improve the business environment, and restructure SOEs.¹⁹ Aiming to complement ongoing banking sector reforms, the reforms to boost private sector development

¹⁵ See also Mako (2020) for detailed descriptions on key reforms supporting private sector development during the economic transitions in Poland, Russia, and Vietnam.

¹⁶ See Iooty and Ospanova (2021) for further details.

¹⁷ An Anti-Monopoly Committee was introduced in January 2019 to enhance competition through legal and regulatory and institutional changes (Presidential Decree 4126, dated 24 January 2019).

¹⁸ This includes the reduction of import tariffs and the improvement of trade facilitation to accelerate the accession process to the World Trade Organization (WTO) (Iooty and Ospanova 2021).

¹⁹ Notably, Presidential Decree 6096 aims to accelerate the reform and privatization of SOEs.

need to speed up to provide timely support. International experience suggests that, early on in its transition, Uzbekistan needs to introduce the concept of competitive neutrality and start implementing and enforcing its principles in the real and banking sector for a competitive private sector to emerge and ensure growth and wealth distribution are equitable (Menkhoff 1997; Wei and Wang 1997; Lin, Cai and Li 1998; Capobianco and Christiansen 2011; Watanabe 2020). Importantly, this includes breaking the noncommercial links between SOEs and SOCBs and tightening SOEs soft budget constraints (Wei and Wang 1997).

4.5. Reorientation of State-Owned Commercial Banks to the Private Sector

SOCBs have started their transition from a conduit for on-lending of state funds to SOEs on preferential terms toward financing the private sector and individuals. The share of loans provided to SOEs and budget organizations in total new loans have markedly decreased (figure 5, panel A). The transfer of UFRD-funded loans off the SOCBs' balance sheets at the end of 2019 triggered the dynamic that has remarkably decreased the share of SOE loans in the total *stock* of SOCB loans (figure 5, panel B). On SOCB loan books, the loans to SOEs have been replaced with loans to individuals and private companies. However, state-funded and state-directed lending to priority sectors has remained in place and is not captured in the SOE lending in figure 5.

The government has begun winding down preferential lending by SOCBs. If sustained, the winddown could help significantly reduce market distortions. Starting January 1, 2020, the government restricted all state-directed lending below the central bank's reference rate.²⁰ The measure also called for full liberalization of interest rates starting January 1, 2021, with the

²⁰ See Presidential Decree #5877, "Government loans for mortgage lending and the production of raw cotton and grains temporarily exempted."

introduction of interest rate subsidy mechanisms only where needed. Furthermore, only three SOCBs will be able to lend under public credit programs using funding from the state budget and UFRD.²¹ As a result of these and earlier measures, the outstanding preferential loans as a share of total SOCB loans decreased from 77 percent at the end of 2018 to 50 percent at the end of 2020 (figure 6, panel A) and commercial lending increased (figure 6, panel B). Effective implementation of this policy in the future will help reduce market distortions created by the preferential lending and contribute to improved monetary policy transmission.²²

Anecdotal evidence, however, suggests that considerable directed lending by SOCBs to the economy continues, including as part of the response to the COVID-19 crisis. Even during the COVID-19 crisis, several SOCBs lent aggressively in 2020, with their credit growing by 50 percent to 80 percent, compared with 25 percent in other banks. Although part of this credit growth happened under state programs funded by UFRD, another part was most likely directed by the state or state officials. A similar situation has been occurring at other SOCBs, albeit to a lesser extent. The fact that the “directed” loans are in most cases provided at “commercial” rates—that is, at or slightly above the CBU base rate—and do not officially fall under state lending programs makes them practically untraceable. These “hidden” directed loans contaminate the balance sheet of SOCBs and risk derailing efforts at SOCB restructuring and privatization. Because they are not properly underwritten, these loans may necessitate another round of SOCB balance sheet cleanups at high fiscal costs.

²¹ According to Presidential Decree #III-4498.

²² Two recent papers on Vietnam (Nguyen, Ngo, and Nguyen 2021) and China (Bashir, Yugang, and Hussain 2020) concluded that higher market concentration and higher state ownership in commercial banks weaken the effectiveness of monetary policy transmission. For Uzbekistan, the IMF notes (IMF Article IV 2021) that as long as Uzbek banks do not operate fully on market principles, the transmission of the policy rate to SOCB lending and deposits will remain limited, while the easy access to state funding and policy lending will undermine the effectiveness of the country’s monetary policy.

In 2020, the government started implementing its 2020–25 banking sector reform strategy focusing on improving the corporate governance of the SOCBs. The strategy is accompanied by an implementation roadmap to prepare at least 6 out of the 13 state-owned banks, representing 45 percent of assets in the banking sector, for privatization between 2021 and 2025. As part of improving the corporate governance of SOCBs, more than 20 new and independent board members have been appointed in SOCBs. Although private banks have on average smaller boards than SOCBs, their boards traditionally have included more independent, female, and foreign board members than the boards of SOCBs—but this gap is decreasing (figure 7). Independent, diverse, and empowered supervisory boards are the foundation of good corporate governance (Claessens 2006; De Nicolò, Laeven, and Ueda 2008; Cihak and Sahay 2018). Beyond regulations, laws on the books, or voluntary codes, enforcement of these measures is critical to creating an effective business environment and good corporate governance in transition economies, Berglof and Claessens (2006) highlight. However, political economy constraints in transition economies, resulting from the intermingling of business and politics, often prevent improvements in the enforcement environment and the adoption and implementation of public laws.

In Uzbekistan, much remains to be done regarding the corporate governance of SOCBs. Boards need to set up functional secretariats and specialized board committees, as well as enhance coordination and information sharing, among other needed improvements. Importantly, Chief Executive Officers (CEOs)—still politically appointed—must start reporting to boards and become accountable to them rather than individual government bodies or state officials. Moreover, lessons from the 2007–09 global financial crisis highlight the key role of a Chief Risk Officer

(CRO)—who should report directly to the board of directors—in safeguarding good bank performance during a crisis (Aebi, Sabato, and Schmid 2012). The CRO function typically was missing in earlier banking transitions and is largely lacking in later transitions—including that of Uzbekistan. Bank directors need to be held to high professional standards rather than the amateur standard that governs directors generally, Macey and O’Hara (2016) emphasize. They propose that all bank directors should be “banking literate,” possessing the specialized knowledge needed to monitor and control risk taking in financial institutions, which are fundamentally different than that of other entities because of the increasing complexity and opacity of bank activities. They also argue for “banking expert” requirements for risk committee members similar to the requirements on audit committees.

In Uzbekistan, weak governance in and with respect to SOCBs makes the state-run banks continuously underperform private banks in terms of profitability. The average pre-tax return on assets for SOCBs over 2015–20 was 1.6 percent, compared with 4.2 percent for private banks (figure 8, panel A). Similarly, the average net return on equity was 10 percent for SOCBs, compared with 25 percent for private banks. The lower profitability of SOCBs is mainly caused by smaller net interest margins (due to a higher share of preferential loans) and lower non-interest income (figure 8, panel B). On the upside, SOCBs benefit from lower operational costs thanks to the larger scale of their operations. At 50 percent on average during 2015–20, the cost-to-income ratio of SOCBs is much lower than the 70 percent average in peer countries (around 64 percent in developing Europe and Central Asia and 70 percent in lower-middle income countries—based on CBU and World Bank Finstats data). The low operational costs of SOCBs reflect their business model oriented toward corporations—large captive loans that are easier to originate and process.

But for the broader activity of commercial banking, SOCBs lack proper marketing, product diversity and innovation, technology in banking operations, and risk management. Moreover, low salaries that SOCBs offer match and attract staff who lack professional skills and specialization.

Low human capital in banking is a more general and urgent problem of Uzbekistan's banking system. Local banks try to address this gap by outsourcing training and building of corporate training centers. The state-owned banking academy is also introducing practical banking courses. Still, access to high-quality professional training is low—and more so outside bank headquarters—while the urgency of retooling and obtaining the latest skills is not felt enough by most in the local banking industry. Several studies highlight the importance of develop the human capital along with market conditions for a competitive banking environment to emerge (Borish, Long, and Noel 1995; Claessens 1998a; Claessens 1998b; Brandt and Li 2003; Bonin, Hasan, and Wachtel, 2014). Claessens (1998) highlights that strong institutions could help substitute for the shortage of banking skills in the initial stages of transition. Foreign investment and participation in banking is one way to speed up knowledge transfer and the needed upgrade of banking skills in the banking sector of transition economies (Bonin, Hasan, and Wachtel, 2014). But relying on future FDI is not a silver bullet. Many international banking groups rely on local staff capacity in their branching strategy and local human capital is thus part of the franchise value when international banking groups strategize about acquisitions in transition countries or greenfield investments.

The underdeveloped and uncompetitive nature of Uzbekistan's banking market is reflected in private banks' generous interest margins. Interest rate spreads on credit portfolios have been relatively high and increasing in private banks over 2018-2021, reaching almost 7 percent,

compared to 4.3 percent and 4.7 percent of median net interest margin for developing Europe and Central Asia and lower middle-income countries, respectively, based on CBU data. SOCBs' net interest margins are significantly lower but also increasing—reflecting a gradual shift from preferential to commercial lending.²³ The relatively high interest margins reflect both increased demand for credit (especially retail credit) in recent years and the relatively noncompetitive banking system. By bringing more competition, transparency, and financial literacy, the privatization and reform of the banking sector could lower the interest rate spreads and the currently high profitability of banks in the medium term (Barth et al. 2009; Anzoategui, Martínez Pería, and Melecky 2012; Love and Martínez Peria 2015; Chauvet and Jacolin 2017; Fungáčová, Shamshur, and Weill 2017). This competitive pressure may eventually reveal the need for banking sector consolidation—with possible trade-offs regarding the ultimate structure of the banking sector and its relationship to growth (Cetorelli and Cambera 2001; Claessens, and Laeven 2005).

The shortcomings in bank governance, “hidden” policy lending, and the low competitiveness of banks translate into banking sector inefficiency that drives credit and credit and capital misallocation (Barth et al. 2009; Bussolo et al. 2019). As a result, some sectors may receive much less credit than is desirable for their productive growth (figure 9). For instance, the industry and transport sectors—full of inefficient SOEs—could be overcredited by banks, especially by SOCBs. By contrast, some other sectors such as trade and services receive disproportionately less credit from SOCBs compared with private banks. The varying credit intensity of individual sectors plays a role though, and a deeper assessment is needed to identify potential credit gaps and overheating.

²³ The higher net interest rate margins of private banks can be partly explained by their higher risk-taking, and partly by the near-absence of preferential lending in the private banks' portfolio. Preferential lending is still significant, albeit decreasing, for SOCBs. The ratio of risk-weighted assets to total assets averaged 88 percent for private banks and 79 percent for SOCBs during 2018–20.

For instance, comparing the credit intensity (financial dependence) of industries in another financial market with fewer frictions could be more revealing (Rajan and Zingales 1998; Fisman, and Love 2007; Acharya and Xu 2017; Sharma and Winkler 2018; Lo Turco, Maggioni, and Zazzaro 2019)—including accounting for possible threshold effects (Manganelli and Popov 2013). Nevertheless, at this junction a comparison with private sector allocations could be also revealing. By the end of 2020, only 5 percent of SOCBs’ outstanding loans went to the trade and public food sector, compared with 22 percent of private banks’ outstanding loans. By contrast, nearly 50 percent of SOCBs’ loans went to the industry and transportation sectors—full of inefficient SOEs—compared with 35 percent of the private banks’ loans—suggesting possible overcrediting of these sectors.

4.6. Structural Challenges of Banking in Transition and Risks to Macrofinancial Stability

Aside from its high rates, the rapid credit growth is even more worrying because of poor credit underwriting standards, low risk management capabilities, and weak corporate governance at banks—especially in SOCBs. The limited financial strength of shareholders in the young private banks also adds to the worries. Should system-wide risks materialize, the government will be called to financially support both SOCBs and private banks—at a significant cost to taxpayers—to avoid a boom-to-bust reversal (Rosas 2006; Hett and Schmidt 2017; Gerhart and Vennet 2017; Grossman and Woll 2014).²⁴ Banking crises—including the way they are resolved—increase income inequality (Bodea, Houle, and Kim 2021).

²⁴ Hett and Schmidt (2017) find that with bailouts market discipline is weaker for government-sponsored enterprises (GSEs) and systemically important banks (SIBs) than for investment banks. Gerhart and Vennet (2017) highlight that bailed out banks hardly improve their performance indicators in the years following government aid, and that bailouts are not sufficient to restore bank health. Also, based on four case studies of the Irish, Danish, British, and French bank bailout during the global financial crisis, Grossman and Woll (2014) conclude that countries with close one-on-one relationships between policy makers and bank management tended to develop unbalanced bailout packages, while

Uzbekistan’s banks need to therefore strengthen credit origination and underwriting processes by paying increased attention to borrowers’ repayment capacity, which would naturally moderate their credit growth. Moderating credit growth is particularly important at banks earmarked for privatization that need to attract suitable strategic investors. Earlier experience of Eastern European transition countries is illustrative in this regard. Because of continued soft lending practices, the initial recapitalizations of Czech banks in early 1990s were followed by bailouts and did not result in positive outcomes (Bonin and Wachtel 1999). By contrast, in Poland, the bank-led enterprise restructuring program—implemented based on the revolutionary Act on Bank and Corporate Restructuring—enhanced the financial discipline of Polish banks and their risk assessment capacity. In turn, this enhanced discipline helped decrease and sustain the low volumes of nonperforming loans going forward (Borish, Ding, and Norl 1997). Hence, improving lending practices and risk assessment capacity is critical for mitigating moral hazard problems of continued state bailouts (Hett and Schmidt 2017; Gerhart and Vennet 2017; Grossman and Woll 2014).

The liquidity buffers of SOCBs are also being depleted by aggressive lending. Although the liability structure of SOCBs appears more long term and stable than that of private banks, SOCBs’ liquidity buffers have reached critically low levels due to rapid credit growth. The ratio of high-quality liquid assets to total assets decreased from 15.4 percent at the end of 2018 to 9 percent by the end of November 2020—with several banks falling below the minimum regulatory threshold of 10 percent (figure 10).²⁵ The liquidity position of several SOCBs worsened in 2020, also due to

countries where banks negotiated collectively developed solutions with a greater burden-sharing from private institutions.

²⁵ By the end of December 2020, the ratio increased to 12 percent as a result of eurobond issuance and other funding attracted by SOCBs.

reduced credit repayments because of credit deferrals provided by banks as part of COVID-19 mitigation measures. Drawdowns of current and deposit accounts, as well as the need to meet some off-balance sheet commitments, brought further liquidity strains. To mitigate these liquidity pressures, the central bank introduced liquidity support tools for banks (short-term liquidity support loans and irrevocable credit lines). The CBU also takes proactive measures to bring the banks into compliance with the established liquidity ratios and has strengthened the liquidity coverage ratio methodology as of February 2021 in line with the Basel III standards (BCBS 2013). Honohan (1997) urges that a rigorous application of the agreed global microeconomic regulation to transition economies should not be deferred—including in the face of political interference, which is the weak spot of any regulatory system.

To finance their operations, SOCBs rely mostly on credit lines from state and foreign banks, while private banks rely mostly on private deposits. As of the end of 2020, SOCBs mobilized 55 percent of their funding through credit lines—down slightly from the 63 percent in 2018 (figure 11, panel A). While more than 50 percent of those credit lines were funded by the government (MoF, UFRD) in 2018, this share declined to 30 percent in 2020. Existing credit lines are mostly provided by foreign banks and IFIs. Some SOCBs were also able to raise funding by issuing eurobonds. SOCBs funded less than 15 percent of their operations with private deposits of individuals and private firms. By contrast, private banks received more than half their funding (56 percent) from private depositors and relied on credit lines for less than 25 percent of their funding. Although deposits are not the main funding source for SOCBs, they still attract 72 percent of total deposits in the economy—just because of their size.

Their long-term funding enables SOCBs to lend long term, mostly to SOEs, while private banks have been constrained in long-term lending and consequently in supporting private investments. SOCBs' access to long-term credit lines helped them issue long-term loans to meet the financing needs of SOEs in sectors that require long-term financing such as transportation, communications, and industry. By the end of 2020, 47 percent of loans from SOCBs had a maturity of five years or more, compared with just 8 percent for private banks. Private banks relying on deposit financing cannot afford to take material liquidity risks from maturity transformation. As a result, private companies—especially medium-sized—could be deprived of adequate access to investment financing (World Bank Enterprise Survey 2019).

Even after state-owned banks are recapitalized by the government, operational restructurings must be achieved and privatization must not be delayed—otherwise further state capital injections might be required. One way to balance these risks is to provide recapitalizations in stages and contingent on meeting certain restructuring objectives (Andrews 2005). In Uzbekistan, SOCBs have enjoyed high capital buffers thanks to the 2019 cleanup of policy lending, but their buffers are being depleted extremely fast by aggressive lending (figure 12). The SOCBs used 7 percentage points of their capital in 2020 to extend additional loans—presumably also to counter the repercussions of the COVID-19 economic crisis, as was the case in other countries with large state-owned commercial banks, such as China, Germany, India, Russia, and Turkey (Gutierrez and Kliatskova 2021). While this could be the right role to play for those SOCBs that the banking sector strategy envisages to stay in public hands, SOCBs slated for privatization need to manage their portfolios carefully like proper commercial banks to attract respectable investors and show good performance after privatization (Boubakri et al. 2005; Omran 2007; Englmaier and Stowasser 2017; Bertay et

al. 2020). Instead, credit grew in six banks by more than 50 percent in the midst of the crisis, and another seven banks grew their credit by more than 30 percent (figure 12, panel B). These credit growth rates cannot be achieved with proper underwriting—not even in more advanced banking systems. The combination of weak governance and internal controls, and hidden policy lending, provides for double trouble when banks recklessly push out money and misallocate capital in parallel (Barth et al. 2009; Bussolo et al. 2019; Melecky 2021).

NPLs in the Uzbek banking sector have traditionally been low (1 percent to 2 percent) because: (1) loans to several large SOEs used to be restructured and granted regulatory forbearance in their classification; (2) many of the loans granted under public programs have long grace periods and their true quality is yet unknown; and (3) rapid growth of the loan portfolio obscures the signals of actual credit quality. As a response to the COVID-19 outbreak, temporary deferrals have been provided for loan repayments by firms and individuals (until October 1, 2020). The reported NPL ratios peaked at 6.2 percent in mid-2021, compared to 2.1 percent by the end of 2020. The modest increase in NPLs—which banks report after COVID loan deferrals have ended—may still not reflect the full effect of the pandemic and prior rapid credit growth²⁶ and thus overestimate capital buffers, risking continued aggressive lending without adequate loss-absorption capacity. Another problem with temporary deferrals is that they may lead to lower repayment discipline by borrowers, set expectations for banks that such deferrals might be “acceptable” for the supervisor in the future, and predispose future SOCB investors to expect such forbearance after privatization—such as in Mexico from the early 1990s (Gruben and McComb 1997). Correct incentives need to be built into the forbearance programs to achieve beneficial outcomes in the long term (Edwards 2021; Shi

²⁶ Several SOCBs underwent asset quality reviews (AQRs) in 2020 and 2021 as part of the banking system transformation efforts. These exercises may reveal additional capital shortages that will have to be addressed.

2021; Cherry et al. 2021). Proper risk provisioning at an early stage, as well as acting in a forward-looking manner regarding the allocation of profits, remain paramount for maintaining bank resilience during the COVID-19 crisis, Fidesser et al. (2021) argue.

In Uzbekistan, the highly concentrated and dollarized loan portfolios of the three largest SOCBs top up the exposure of the banks and the system to financial stability risk. By the end of 2020, the three largest SOCBs held large loans²⁷ that amounted to 46 percent of their total loan portfolio, with the five largest borrowers covering 26 percent of their loan portfolios on average. The portfolio concentration has declined from 64 percent in 2018 thanks to SOCB balance sheet cleanup from UFRD-funded SOE loans at the end of 2019. But it remains significantly higher than the 16 percent counterfactual for private banks (figure 13, panel A). The concentration risks could be alleviated by enabling a framework for syndicated lending, including with the participation of foreign banks (Gadanecz 2004; Godlewski and Weill 2008; Lin et al. 2012; Figini and Uberti 2013). High concentration coupled with the dollarized credit portfolios of large SOCBs (figure 13, panel B) expose the banks to greater solvency risks. Namely, a large currency devaluation could trigger the failures of large borrowers to repay their loans because borrowers in foreign currency may not always have foreign currency income to match the loan servicing obligations (Yeyati 2006; Neanidis and Savva 2009; Basso, Calvo-Gonzalez, and Jurgilas 2011; Buncic and Melecky 2013).

²⁷ The regulation defines a large loan as a loan that exceeds 10 percent of a bank's Tier 1 capital.²⁸ The share of Global Findex respondents who "saved at a financial institution" reveals that in 2017 Uzbekistan ranked the lowest in Central Asia with its 2 percent share—compared with shares of 3 percent in Kyrgyz Republic, 5 percent in Turkmenistan, 11 percent in Tajikistan, and 13 percent in Kazakhstan.

5. Conclusion

In 2017, Uzbekistan joined the latest cohort of transition economies. In the effort to transition its financial system to market principles, Uzbekistan started vital reforms in the banking sector and particularly began to restructure and privatize state-owned commercial banks. Historical evidence suggests that such financial liberalization should be matched with institutional strengthening to avoid costly financial crises. The CBU has been improving its regulatory and supervisory framework to that effect. Based on international experience, it is also important that the government complement banking reforms with reforms of SOEs and the business environment and by strengthening competition to create benefits for the economy.

Crucial reforms to help the banking system finance a successful transition to a market economy, while avoiding capital misallocation and destabilizing credit booms, include improving banking culture, strengthening credit risk management, mobilizing greater amounts and numbers of bank deposits, and developing additional and more modern financial products and solutions.

Improving banking culture. Banking culture is where corporate governance, directed policy lending, and human capital in banking meet. SOCBs—at least those at the top of the list for privatization—must be freed from political interference in their lending. All remaining official and “hidden” directed lending should be required by the CBU and MoF to be properly registered under the “directed lending portfolio” and reported in the SOCBs’ financials so that the supervisor (CBU), the owner (MoF), investors, and the public can monitor the dynamics of their volume and quality. The MoF needs to clearly define developmental mandates for SOCBs that will remain in public ownership, establish transparency and accountability mechanisms for the provision of “public

services” by SOCBs and the associated fiscal costs, and improve their digital capabilities (Melecky 2021). The relationship to and the influence of boards regarding SOCB management needs to be strengthened for the SOCBs to commercialize or, for those that shall stay in public hands for the foreseeable future, better perform their dual commercial and social objectives (Fernández-Arias et al. 2020). The human capital shortfalls in banking will need to be replenished with adequate access to modern training and education opportunities. Improving the public banking academy and further modernizing and tailoring its programs to the needs of various existing and aspiring banking professionals is one promising avenue.

Strengthening oversight of credit risk. Credit risk oversight by the CBU needs further improvements. The CBU should conduct thematic reviews related to credit quality (such as of bank underwriting practices). Over time, the CBU should build the capacity for conducting targeted horizontal reviews across banks of credit quality and asset quality. This initial review and gradual capacity building are needed to better understand the extent and dynamics of non-performing loans and the implications for bank capital buffers. CBU should improve the classification methodology for NPLs (or broadly, assets) to include a forward-looking dimension and enforce its application by banks—reflecting the methodology but not yet the complexity of the recent global reforms—such as the impairment requirements of International Financial Reporting Standard (IFRS) 9 Financial Instruments. It should also better oversee the quality of credit reporting to the registry and systems for sharing credit information (Jappelli, and Pagano 2002; Barth et al. 2009; Bennardo, Pagano, and Piccolo 2015; Cihak, Mare, and Melecky 2021; Bahadir and Valev 2021)—while closely monitoring possible trade-offs (Gehrig and Stenbacka 2007). The CBU should put pressure on all banks to strengthen corporate governance, internal

controls, risk management, and underwriting standards. Furthermore, it should continue strengthening its gatekeeper's capacity for banking market entry, supervision of banking operations, bank exit, and crisis preparedness.

Mobilizing greater amounts and numbers of bank deposits. Greater deposit mobilization is a big challenge for Uzbekistan. Uzbek banks are not as successful at deposit mobilization as they should be, including because of historical distrust of the public toward their services.²⁸ In tandem, the banking system is enjoying access to credit lines from the government—especially SOCBs—and, more recently, has managed to attract foreign debt financing in local currency (soms). The incentives for mobilizing domestic deposits are thus weak. In the medium to long term, Uzbekistan will need to rely on supplemental financing of its development through foreign savings. However, the mobilization of domestic deposits can make the funding structure of banks more resilient (Han and Melecky 2017) as well as help households and firms build financial wealth and self-insure against risks (World Bank 2014). In turn, more resilient households and firms lower the credit risk for banks.

Developing additional and more modern financial products and solutions. Development of additional financial products and solutions is warranted to address the needs of banks and their clients. There are several products that the market, with the help of authorities, could develop in the short term to help strengthen the efficiency and resilience of credit intermediation. For example, to help alleviate credit concentration risks and help the CBU implement tougher standards, a

²⁸ The share of Global Findex respondents who “saved at a financial institution” reveals that in 2017 Uzbekistan ranked the lowest in Central Asia with its 2 percent share—compared with shares of 3 percent in Kyrgyz Republic, 5 percent in Turkmenistan, 11 percent in Tajikistan, and 13 percent in Kazakhstan.

framework for loan syndication, including with foreign bank participation, could be further developed (Gadanecz 2004; Godlewski and Weill 2008; Lin et al. 2012; Figini and Uberti 2013). While recently the banks have been able to attract foreign financing in some, foreign currency financing will continue. Developing the hedging market (over-the-counter or organized through the stock exchange) could help mitigate banks' and borrowers' exposures to foreign currency risk (Alfaro, Calani, and Varela 2021). The agriculture sector is a major part of Uzbekistan's economy and a sector that can become competitive in the long term. Sustained competitiveness will require agri-financial products that the market could develop with the help of public policy—such as tailored financing reflecting seasonal specifics, and crop insurance to cope with climatological risks as well as mitigate the credit risk of agricultural financing (Clarke and Derkon 2009). Political economy factors, ad hoc resolution of operational challenges, and fraught commercialization of financial services are barriers that need to be overcome to truly spur such development of agri-finance products (Bernards 2022). To advance shared prosperity in Uzbekistan through connectivity to markets, the banking system should continue to promote fast digital payments and solutions to help with e-commerce and broader market integration (Mishra, Walsh, and Srivastava 2021).

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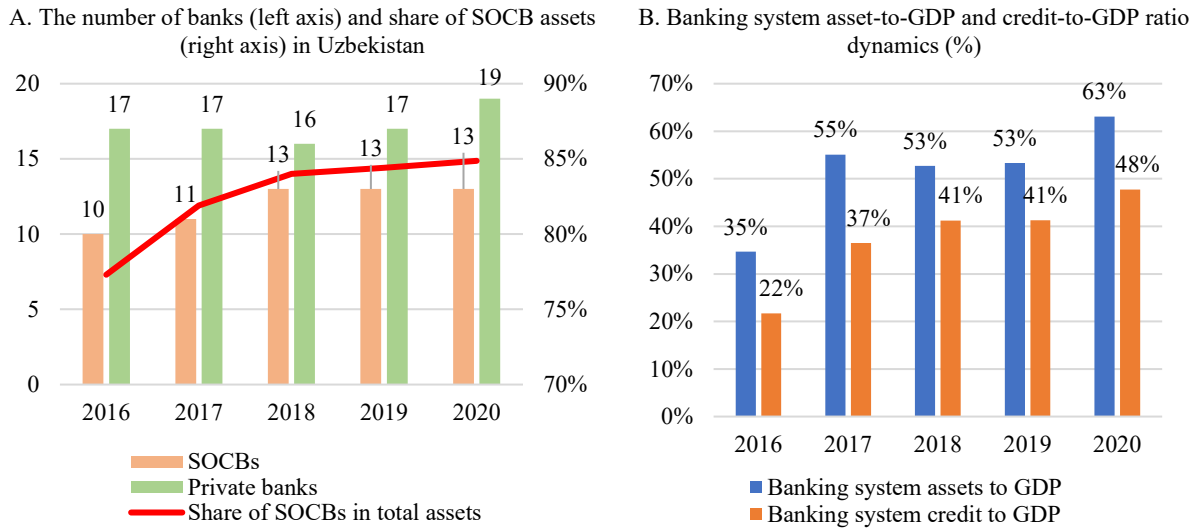
Table 1: Uzbekistan banking sector indicators: Aggregate, SOCBs, and Private banks

	2018	2019	2020	2021
Credit portfolio				
Credit portfolio growth	51%	58%	31%	18%
of which: state-owned banks	51%	62%	31%	15%
of which: private banks	55%	34%	30%	35%
Share of preferential loans to total loans	71%	58%	46%	39%
of which: state-owned banks	78%	64%	51%	44%
of which: private banks	18%	19%	11%	5%
Share of credit portfolio to total assets	78%	78%	76%	73%
Capital adequacy				
Total Regulatory capital to risk-weighted assets	16%	24%	18%	17%
of which: state-owned banks	15%	25%	18%	18%
of which: private banks	17%	18%	19%	17%
CET 1 capital to risk-weighted assets	14%	20%	15%	15%
Leverage ratio (Capital to assets)	9%	14%	11%	12%
Asset quality				
Non-performing loans to total gross loans	1.3%	1.5%	2.1%	5.2%
of which: state-owned banks	1.4%	1.5%	2.1%	5.4%
of which: private banks	0.7%	1.5%	2.0%	4.1%
Non-performing loans net of provisions to regulatory capital	5%	3%	4%	13%
Profitability				
Net interest income to average interest-bearing assets (NIM)	3.9%	4.3%	5.0%	5.0%
of which: state-owned banks	3.3%	3.7%	4.5%	4.3%
of which: private banks	7.3%	8.3%	8.5%	8.9%
Operating costs to net income (CIR)	49%	41%	36%	38%
of which: state-owned banks	49%	40%	34%	36%
of which: private banks	48%	45%	44%	45%
Return on assets	2.0%	2.2%	2.2%	1.3%
of which: state-owned banks	1.6%	1.8%	1.8%	0.7%
of which: private banks	4.2%	4.7%	4.3%	4.3%
Return on equity	16.2%	16.7%	10.3%	6.1%
of which: state-owned banks	13.1%	13.7%	8.4%	3.0%
of which: private banks	29.5%	30.8%	20.7%	20.2%
Liquidity				
Liquid assets to total assets	14%	14%	15%	19%
of which: state-owned banks	10%	11%	13%	15%
of which: private banks	33%	27%	30%	33%
Liquid assets to short-term liabilities	41%	40%	67%	47%
of which: state-owned banks	35%	37%	54%	43%
of which: private banks	57%	50%	142%	57%
FX exposure				
Net FX open position to Total Regulatory capital	8%	7%	4%	6%
Ratio of FX loans to total loans	56%	48%	50%	50%
of which: state-owned banks	59%	49%	51%	52%
of which: private banks	33%	38%	39%	37%
Ratio of FX liabilities to total liabilities	63%	58%	60%	57%
of which: state-owned banks	66%	60%	61%	59%
of which: private banks	48%	49%	51%	45%

Source: CBU, (End of period in percent)

Figures

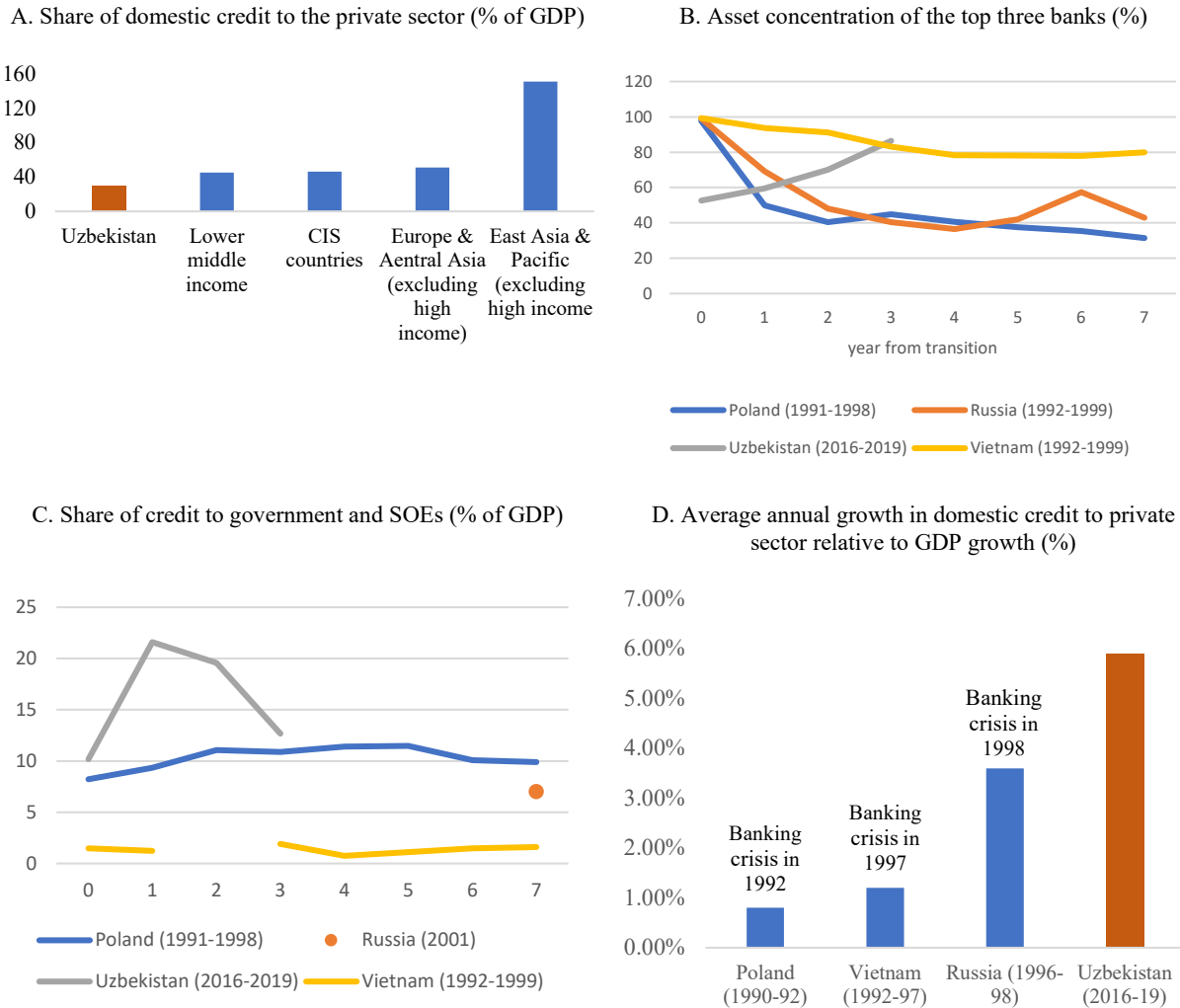
Figure 1. State-owned commercial banks have traditionally dominated Uzbekistan’s banking sector



Source: CBU Bulletin.

Note: CBU = Central Bank of Uzbekistan; SOCB = state-owned commercial bank.

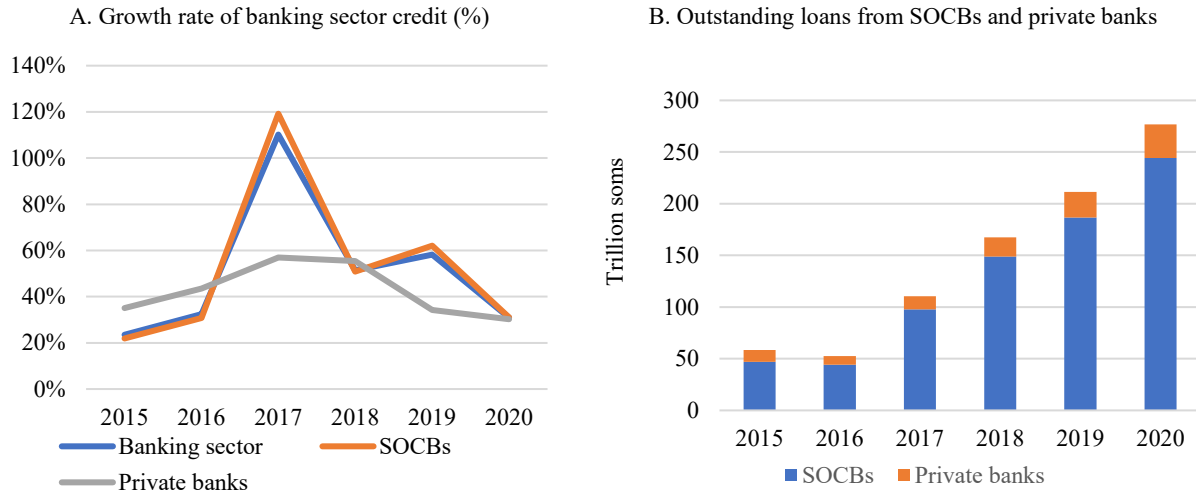
Figure 2. Uzbekistan lags its peers in financial deepening (panels A, B, C), but the country may be growing credit too fast, risking a possible banking crisis (panel D)



Sources: IMF, World Bank 2019. Laeven and Valencia (2014).

Note: For panel A, data are for 2019: In ascending order, developing Europe and Central Asia (ECA); developing East Asia and Pacific (EAP); CIS countries; lower-middle-income countries; Uzbekistan. The transition years for Russia is selected based on data availability. CIS = Commonwealth of Independent States; SOEs = state-owned enterprises.

Figure 3. Bank loans have grown sharply in recent years, with SOCBs accounting for most of the loans



Sources: CBU, World Bank staff calculations.

Note: CBU = Central Bank of Uzbekistan; SOCBs = state-owned commercial banks.

Figure 4. Access to finance has advanced on the back of fast credit growth, but challenges remain

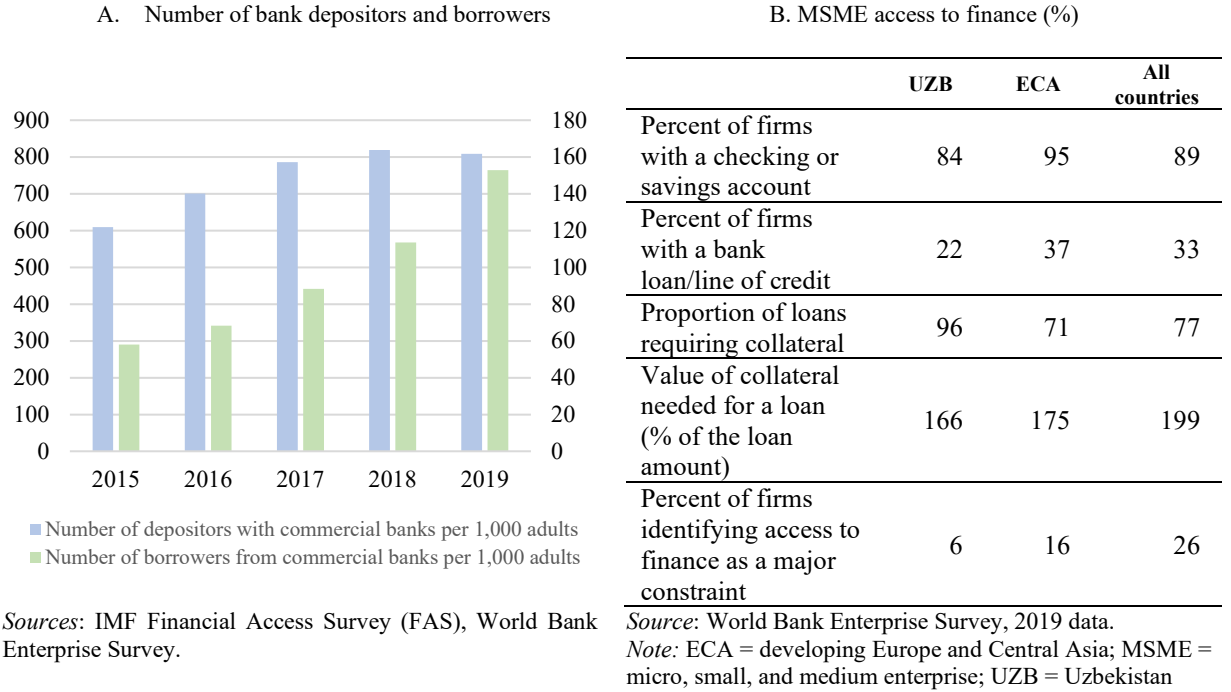


Figure 5. SOCBs have reduced exposure to SOEs and increasingly lend to the private sector

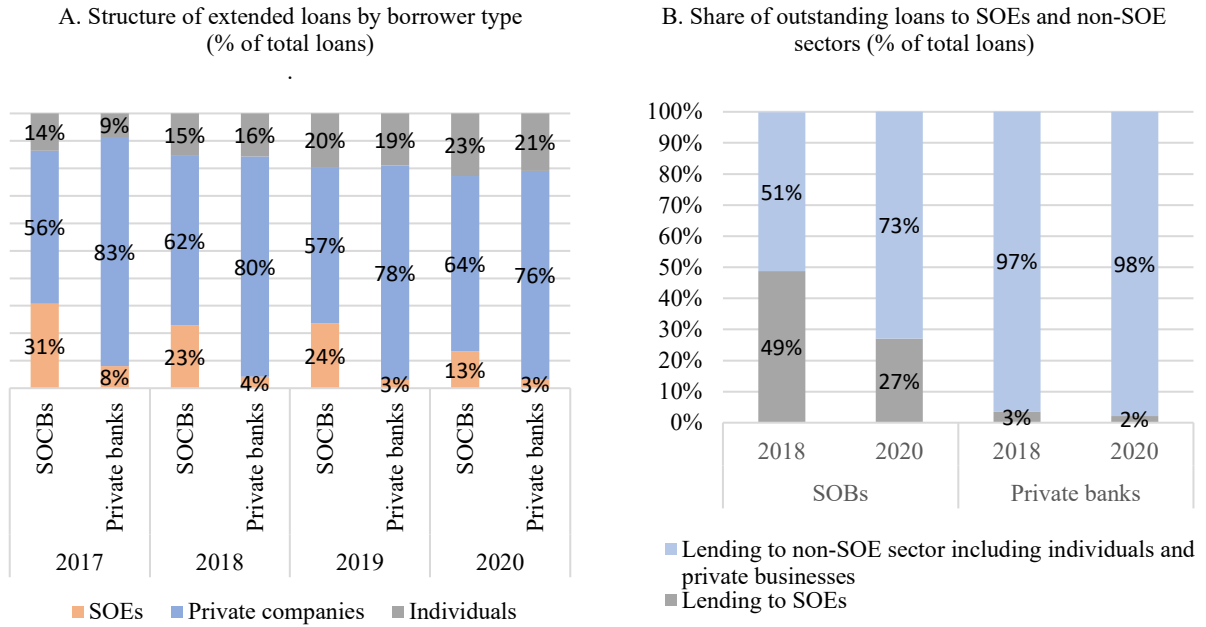
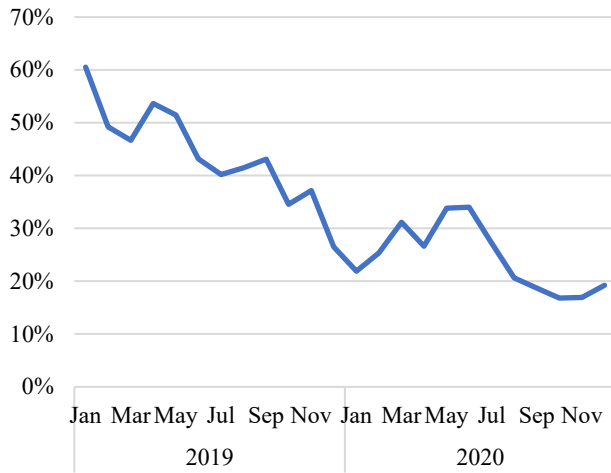
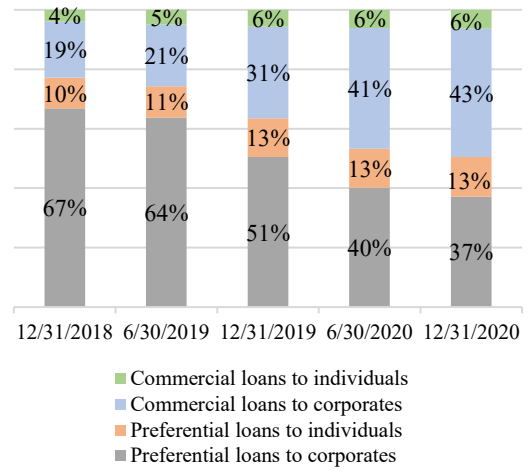


Figure 6. SOCBs have reduced preferential lending in recent years

A. Share of preferential loans in total new extended loans (%)
(percent)



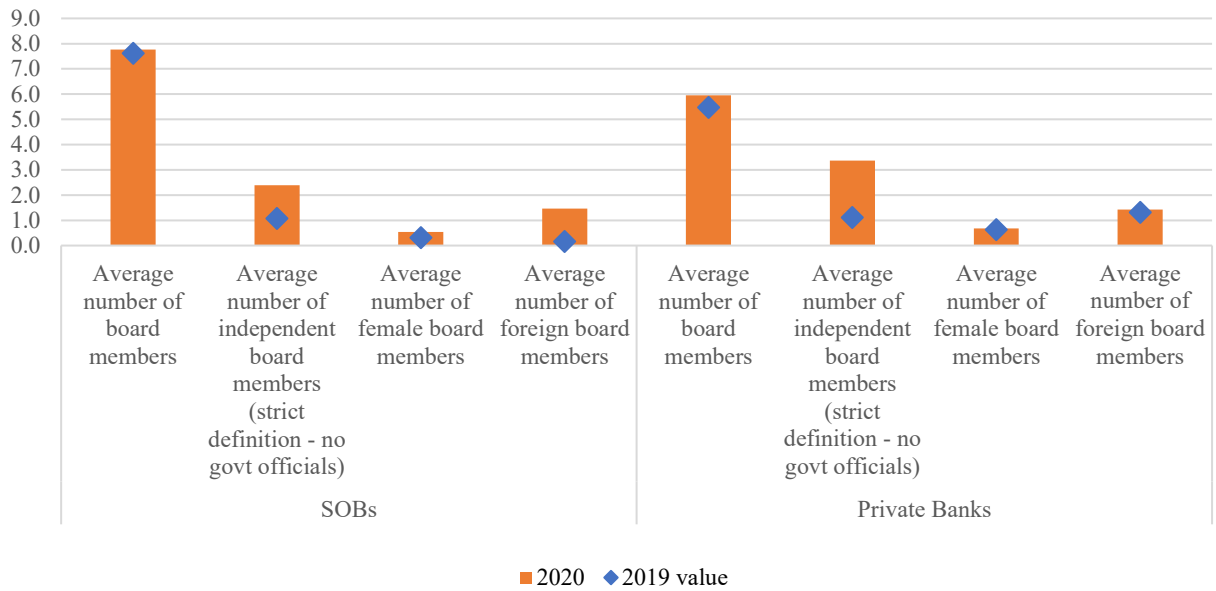
B. Share of preferential loans in total SOCB loans (%)



Sources: CBU, World Bank staff calculations.

Note: CBU = Central Bank of Uzbekistan; SOCBs = state-owned commercial banks.

Figure 7. SOCBs have fewer independent, foreign, and female board members than private banks, but have progressed to include more such board members

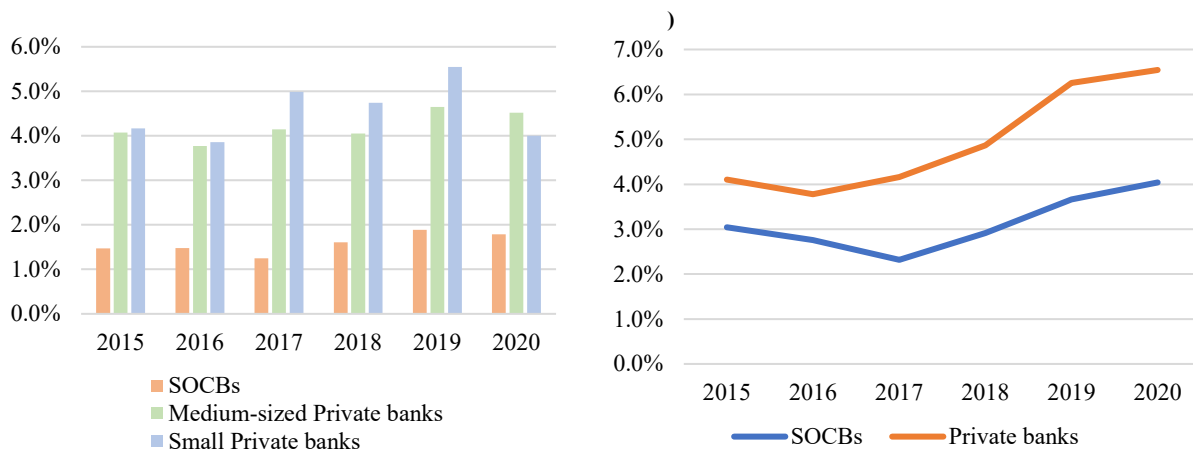


Sources: CBU data, World Bank staff calculations.
 Note: CBU = Central Bank of Uzbekistan; SOCBs = state-owned commercial banks.
 a. For the average number of independent board members, a strict definition is used, excluding all government officials.

Figure 8. SOCBs are much less profitable than private banks

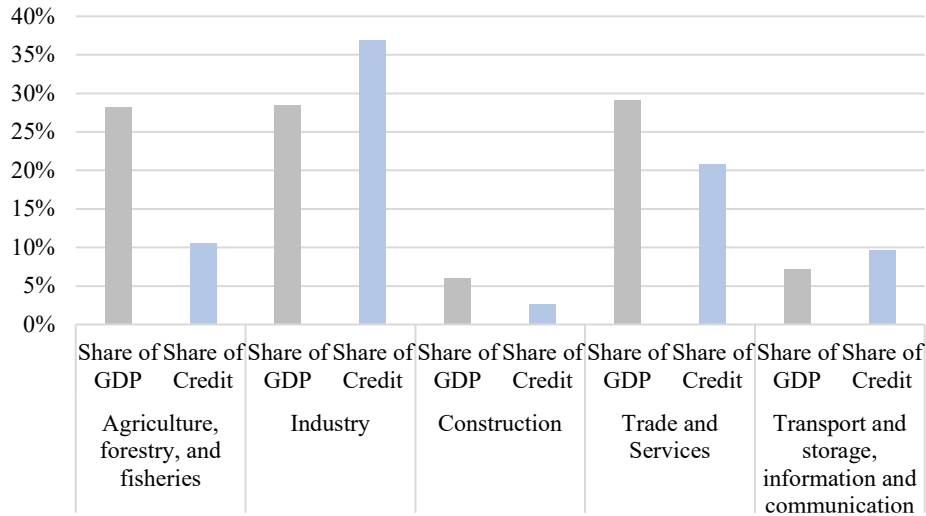
A. Pre-tax return on average assets (RoAA) (%)

B. Net interest margin (as a % of average total assets)



Sources: CBU, World Bank staff calculations.
 Note: CBU = Central Bank of Uzbekistan; SOCBs = state-owned commercial banks.

Figure 9. The trade and service sector receives less attention from bank lending than its share in the economic output of the country warrants

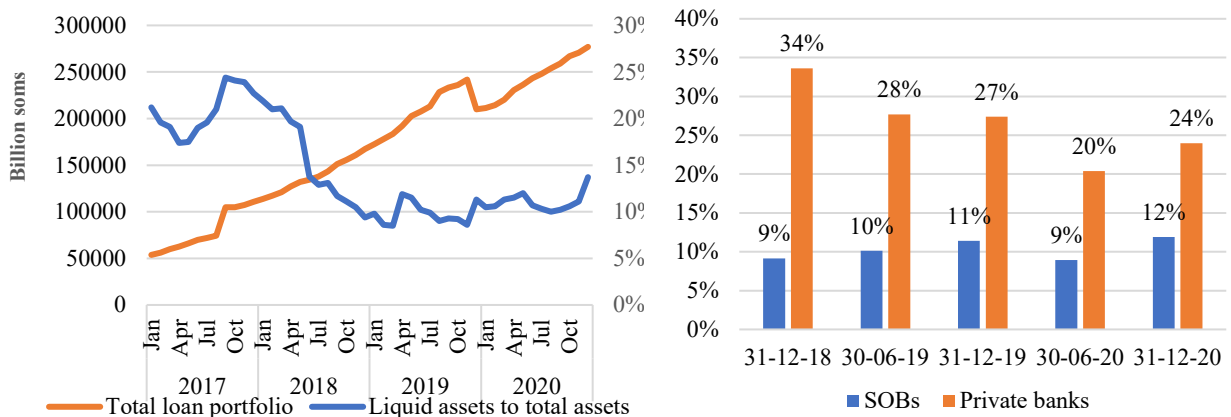


Sources: CBU, World Bank staff calculations.
 Note: CBU = Central Bank of Uzbekistan.

Figure 10. Liquidity buffers of SOCBs are low and decreasing

A. Total loan and liquidity position

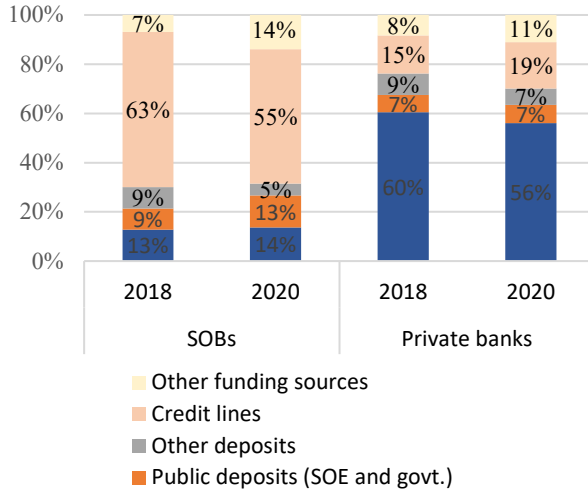
B. Share of liquid assets to total assets (%)



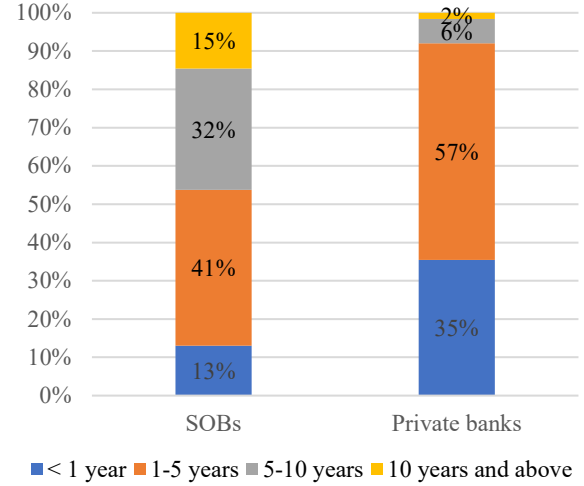
Sources: CBU, World Bank staff calculations.
 Note: CBU = Central Bank of Uzbekistan; SOCBs = state-owned commercial banks.

Figure 11. SOCBs rely heavily on funding by credit lines, which help them extend long-term loans

A. Funding structure of SOCBs and private banks (% of total non-equity funding)



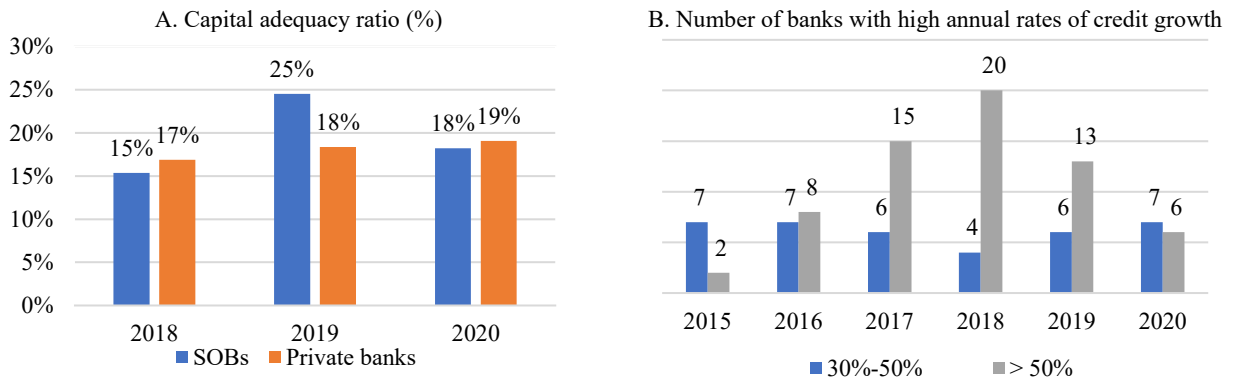
B. Maturity of corporate loans, 2020 (%)



Sources: CBU, World Bank staff calculations.

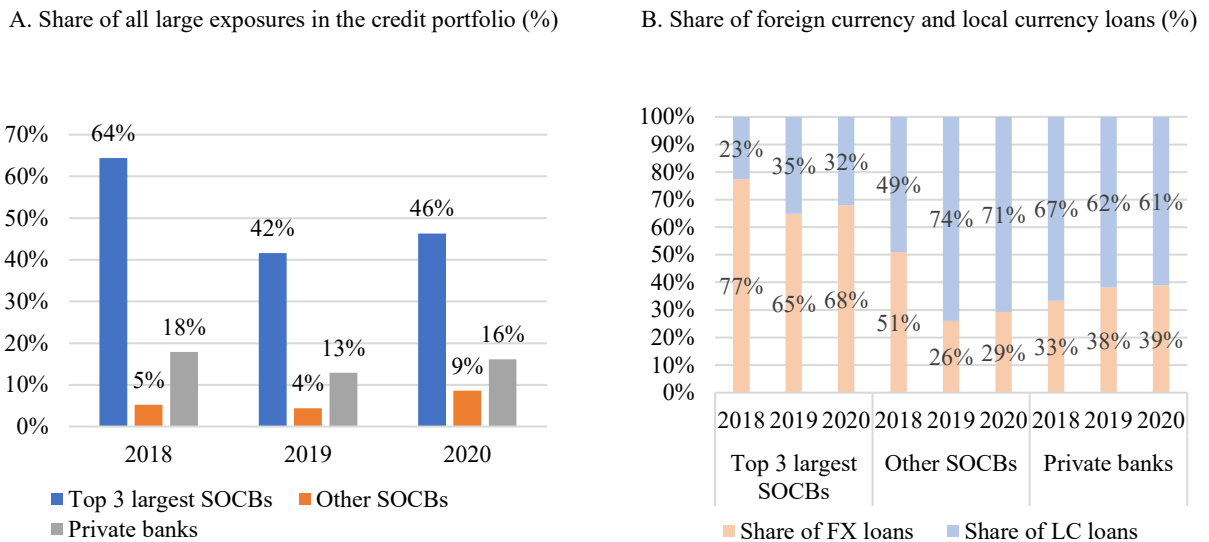
Note: CBU = Central Bank of Uzbekistan; SOCBs = state-owned commercial banks.

Figure 12. SOCBs appear well capitalized, but rapid lending is fast depleting capital buffers



Sources: CBU, World Bank staff calculations.
 Note: CBU = Central Bank of Uzbekistan; SOCBs = state-owned commercial banks.

Figure 13. Large SOCBs have highly concentrated and dollarized loan portfolios



Source: CBU, World Bank staff calculations.
 Note: CBU = Central Bank of Uzbekistan; SOCBs = state-owned commercial banks.