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MEMORANDUM OF THE PRESIDENT

OF

THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

THE INTERNATIONAL DEVELOPMENT ASSOCIATION

AND

THE INTERNATIONAL FINANCE CORPORATION

TO

THE EXECUTIVE DIRECTORS

ON A

COUNTRY ASSISTANCE STRATEGY

FOR

THE REPUBLIC OF UZBEKISTAN

February 22, 2002

Central Asia Country Unit
Europe and Central Asia Region

Last CAS Discussion: March 10, 1998
[SD98-14(IFC/SD98-7)] [1]

Currency Equivalent
(Exchange Rate effective February 1, 2002)

Currency Unit	= Sum	
US$1.00	= Sum	693.12 (official exchange rate)
US$ 1.00	= Sum	695.55 (commercial bank rate)
US$1.00	= Sum	1,550.00 (curb market rate)

Weights and Measures

Metric system

Fiscal Year

January 1 - December 31

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ABBREVIATIONS AND ACRONYMS

AsDB	Asian Development Bank
ASBP	Aral Sea Basin Program
CAS	Country Assistance Strategy
CIS	Commonwealth of Independent States
COM	Cabinet of Ministers
CPI	Consumer Price Index
EBRD	European Bank for Reconstruction and Development
ECA	Europe and Central Asia
EU	European Union
EU-TACIS	European Union - Technical Assistance for the Commonwealth of Independent States
ESW	Economic and Sector Work
FBS	Family Budget Survey
FSU	Former Soviet Union
GDP	Gross Domestic Product
GEF	Global Environment Fund
GNFS	Goods and Non-factor Services
GS	Goods and Services
GOU	Government of Uzbekistan
GNI	Gross National Income
GTZ	Gesellschaft für Technische Zusammenarbeit
IBRD	International Bank for Reconstruction and Development
ICWC	Interstate Commission for Water Coordination
IDA	International Development Association
IFC	International Finance Corporation
IFI	International Financial Institution
ILO	International Labor Organization
IMF	International Monetary Fund
JBIC	Japan Bank for International Cooperation
JICA	Japan International Cooperation Agency
KfW	Kreditanstalt für Wiederaufbau
LSA	Living Standards Assessment
MIGA	Multilateral Investment Guarantee Agency
NEAP	National Environmental Action Plan
ODA	Official Development Assistance
PRSP	Poverty Reduction Strategy Paper
UNDP	United Nations Development Programme
USAID	United States Agency for International Development
WEMP	Water and Environmental Management Project

This CAS was produced by a team that included: Kiyoshi Kodera, Dennis de Tray, Samuel Otoo, Kadir T. Yurukoglu, Ritu Anand, Kazuko Ogawa, Andriy Storozhuk, and David Pearce; and, in addition, Tunc Uyanik, Gerhard Botha, Mark Lundell, Janis Bernstein, Motoo Konishi, Ede Ijjasz-Vasquez, Raghuveer Sharma, Mansoora Rashid, John Langenbrunner, Jean-Charles Crochet, Masood Ahmad, Reema Nayar, and from IFC, Gorton de Mond and Eriko Ishikawa. Other members of the Bank Group-wide Uzbekistan Country Team also made valuable contributions throughout the process.

REPUBLIC OF UZBEKISTAN
COUNTRY ASSISTANCE STRATEGY

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EXECUTIVE SUMMARY

1. The FY02-04 CAS seeks to reconcile several difficult strategic, policy, and operational considerations. These include:

- Uzbekistan's current unsatisfactory overall macroeconomic framework and its uneven structural reform performance since end-1996;
- the recent deterioration in its creditworthiness;
- the still uncertain outlook for decisive policy change in the near term, despite recently improved prospects for a program of financial cooperation with the IMF;
- the lessons learned from experience with the last CAS, whose operational results were uneven and policy impact less than fully satisfactory;
- the country's large population and economy, its strategic location, and its economic importance regionally within Central Asia; and
- the government's interest in expanding cooperation with the World Bank Group.

Recent Economic Developments

2. Following the dissolution of the Soviet Union, Uzbekistan had the smallest decline in output of all the CIS countries according to official data owing, in part, to successful reorientation of its main exports (cotton and gold) directly to international markets, achievement of energy and food-grain self-sufficiency, and an initially low level of industrialization. Two years after embarking upon a comprehensive macroeconomic stabilization and structural reform program in late 1994, progress in liberalizing the foreign exchange and trade regime was reversed when, in early 1997, a system of multiple exchange rates and restrictions on current account transactions was introduced, with the aim of promoting import-substituting industries and conserving foreign exchange reserves.

3. While recent changes in the foreign exchange regime may presage a welcome shift in these policies, substantial liberalization of access to foreign exchange is still required to achieve current account convertibility. Significant distortions in foreign exchange allocation remain, reflected in a reduced but still large difference between the official and curb market exchange rates. Structural reforms have also been limited, despite several government resolutions, and failed to address adequately fundamental distortions in the incentive structure and resource allocation rigidities, especially in agriculture. With formal private sector activities unable to flourish in this environment and international standards of governance yet to take firm hold, business development in general and foreign direct investment in particular remain significantly below their potential, given Uzbekistan's human and natural resource base and its prospects as a regional economic hub.

4. The uneven economic performance has led to a deteriorating social outcome and considerable geographic disparity in income and well-being. Preliminary evidence suggests that Uzbekistan may be facing a significant poverty problem. Using an absolute poverty line, the general poverty headcount is estimated at around 31 percent of the population. Moreover, the levels and deteriorating trends of some health and education

indicators are of concern. There is also considerable regional variation in poverty and social indicators: rural areas, especially in western regions at the tail-end of irrigation command areas with insufficient or unreliable access to water, are much worse off and more vulnerable than those elsewhere in the country. The government is committed to fight poverty and has undertaken to formulate its approach in a Poverty Reduction Strategy Paper (PRSP).

5. In 2001, exogenous factors such as the worldwide economic slowdown and Uzbekistan's proximity to recent events in Afghanistan have negatively affected its economic performance and outlook. The worldwide economic slowdown has dampened demand for Uzbekistan's exports and depressed international commodity prices, with the price of cotton fiber, accounting for a third of Uzbekistan's merchandise export earnings over the past three years, having declined about 35 percent. The government needs to strengthen, broaden, and accelerate its reform program to counter these shocks and to realize its economic growth potential. The recent agreement with the IMF on a six-month Staff Monitored Program (SMP), which provides *inter alia* for the tightening of fiscal and monetary policies, the achievement of current account convertibility later this year, and the gradual reform of the agricultural state order system, is a welcome step in this direction.

Lessons from Past Experience

6. The 1998 CAS, addressing four key policy challenges where the government's reform agenda and the Bank's development priorities appeared to converge, proposed a Base Case lending program comprising ten operations totaling US$300-350 million and a modest program of non-lending activities, including three formal studies. The results, in terms of lending, non-lending activities and portfolio performance, were uneven and the outcome, in terms of policy impact, was less than fully satisfactory. Five loans totaling US$136 million were approved; two formal studies completed; and, portfolio performance was problematic, with three investment projects rated unsatisfactory at various points during the period. Several important lessons emerged from this experience, which have been factored into the design of the FY02-04 CAS. They include: (a) to select only projects for which there is genuine, broad-based ownership, empowered by the political will required to implement the proposed reforms; (b) to acknowledge explicitly that the amount of policy reform achievable within the scope or timetable of a single project may be limited; (c) to recognize that building the understanding needed to implement even limited reforms may take a long time; and (d), to accept that government decision making may take longer than in other countries, given complex internal institutional procedures and relationships.

7. As for IFC, the 1998 CAS assumed an improving private sector business environment and thus an increase in demand for IFC lending and investment. Unfortunately, neither assumption materialized and IFC's total investment portfolio totals only US$36 million, of which US$14.2 million has been disbursed. Most of the undisbursed portfolio comprises credit lines to local banks for on-lending to SMEs. Projects under implementation are generally performing well, although delays in accessing foreign exchange created problems in at least one project. IFC has devoted substantial resources to trying to help develop the private sector and to technical assistance for project

identification as well as capacity building in the financial sector. Despite these efforts, it has been difficult to identify bankable projects and attract foreign investors.

FY02-04 Country Assistance Program

8. Against this background, and overall goal of improving living standards and alleviating poverty in Uzbekistan, the key objectives of the FY02-04 CAS are: (a) to improve the policy framework for liberalization of the foreign exchange and trade regime, improved governance and transparency; (b) to strengthen the environment for private sector development, including foreign direct investment; (c) to enhance the efficiency of resource allocation and use in social infrastructure and services; and (d) to improve the maintenance and effectiveness of the country's extensive irrigation and drainage infrastructure. It envisages two lending scenarios: a Low Case, which assumes continued gradual implementation of structural reforms and no further deterioration in the macroeconomic framework; and a Base Case, which assumes, and would be triggered by, accelerated and decisive macroeconomic and structural reforms in five key areas.

9. The **Low Case**, totaling US$150 million, comprises five operations with crucial environmental, social, and disaster mitigation and/or prevention goals, whose effectiveness and impact are not dependent on the currently unsatisfactory foreign exchange and trade regime. Lending will be complemented by non-lending activities centered around selected *fiduciary* economic and sector studies (e.g. Country Procurement Assessment, Public Financial Accountability, Anti-corruption Diagnosis), completion of the ongoing Living Standards Assessment, and a Country Economic Memorandum and Energy Sector Review. Progress during FY02-03 would be evaluated against specific monitoring indicators, with triggers for continued lending in FY04 and beyond to be confirmed by mid-CY03.

10. If the government were to adopt an accelerated program of macroeconomic and structural reforms, including decisive liberalization of the current highly distorted foreign exchange, trade, and agricultural policy regimes, this could trigger a larger program of financial and technical assistance: a **Base Case** totaling US$300-350 million. Policy actions in five key areas (foreign exchange regime, private and financial sector development, agriculture, poverty alleviation including initial preparation of a PRSP, and public governance and transparency) would be required to achieve Base Case lending – in addition to the establishment and maintenance of a sound macroeconomic framework; and, continued Base Case lending would be subject to maintenance of a sound macroeconomic framework, satisfactory implementation of measures in the five areas noted above, and an overall judgment about the pace, depth and scope of the program of structural reforms. Although the government has requested budgetary and balance of payments financing in support of its latest plan to achieve current account convertibility by mid-2002, agreed in the SMP recently agreed with the IMF, the Base Case as now defined does not provide for adjustment lending. If the need arises and if the government establishes a program and track record of credible macroeconomic and structural reforms supported by an IMF financial arrangement, management would return to Executive Directors with a CAS Update outlining the government's new program and a recommended strategic response.

11. IFC's program would complement Bank activities to help improve the policy framework for private sector investment and trade through targeted technical assistance, including through an SME survey now underway under the new Swiss-financed Central Asia Private Enterprise Partnership (PEP) program. IFC will also continue its capacity-building support for the financial sector. If the business environment improves and if the privatization of banks, infrastructure, and large state enterprises accelerates, it would expect to provide both technical and financial support. IFC will also continue to target lending to SMEs and micro-enterprises through local banks, as well as possible direct lending to larger projects that may be viable under prevailing business conditions.

12. **IDA Eligibility.** Owing both to its per capita GNI level – below the IDA operational cut-off level for several years – and deteriorated creditworthiness, Uzbekistan, hitherto an IBRD-only borrower, is eligible to access IDA resources. An IDA Eligibility Paper for Uzbekistan was distributed to Executive Directors on November 20, 2001. Accordingly, planned FY02-04 lending will be financed equally from IBRD and IDA resources. Meanwhile, the authorities will soon start preparing an interim Poverty Reduction Strategy Paper (I-PRSP), for presentation by December 2002, with a full PRSP to follow during 2003-04.

Risks

13. Despite relatively comfortable foreign exchange reserves, Uzbekistan faces important short- and medium-term risks. These include: its external vulnerability to world commodity price fluctuations, especially cotton and gold, and interest rates, owing to its recent dependence on commercial bank borrowing; the potential fiscal impact of state-owned enterprise defaults on government guaranteed loans; and, the credibility of its reform program, as perceived by foreign investors. These risks would be mitigated, as far as the Bank and the FY02-04 CAS are concerned, by limiting new lending to US$150 million in the Low Case and US$300-350 million in the Base Case, financed equally by IBRD and IDA.

Issues for Board Discussion:

14. Executive Directors may wish to address the following questions:

- Are the strategic priorities outlined in the CAS appropriate?
- Is the design of the CAS, including the recommended Low and Base Case triggers and planned evaluation of performance in mid-CY03, appropriate?
- Are the size and content of the proposed lending and non-lending programs proportionate to the country's structural reform performance and prospects, and with the need for Bank/IDA financing?
- Is IFC's current emphasis on SME and micro-enterprise projects and technical assistance to develop the private sector, in preparation for full economic transformation, the appropriate strategy?

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COUNTRY ASSISTANCE STRATEGY
FOR THE REPUBLIC OF UZBEKISTAN**

I. COUNTRY CONTEXT

A. Introduction

1. This is the World Bank's third Country Assistance Strategy (CAS) for Uzbekistan. The first (Report No. 14019-UZ, dated March 3, 1995), covering FY96-98, was discussed by Executive Directors in March, 1995, and the second (Report No. 17376-UZ dated February 17, 1998), covering FY98-00, in March 1998. An outline of this CAS was discussed with the government in July and October, 2000; and, the draft CAS itself was discussed in mid-January, mid-March, July and September, 2001. Consultation with civil society groups took place in April, 2001.

2. **Background.** Of the 15 newly independent states that emerged from the breakup of the Soviet Union in 1991, Uzbekistan is the third largest in terms of population (about 25 million people) and the fourth largest in land area (447,000 square kilometers). Strategically located in Central Asia, at the crossroads of the ancient Silk Road between China and Europe, the area that is now Uzbekistan was for centuries one of the cradles of world civilization. Uzbekistan is rich in natural resources such as coal, copper, gold, natural gas, oil, silver, and uranium, and, with an educated population and a young and growing labor force, it has significant economic potential. Before and especially during the Soviet period, Uzbekistan was developed as a leading center for cotton production, exploiting the resources of the Amu Darya and Syr Darya rivers for irrigation. Primary commodities, including cotton fiber, still account for about 90 percent of merchandise exports, with cotton alone accounting for 30 percent. Despite the difficult terrain (60 percent is desert, steppe, or semi-arid land and only 10 percent is cultivated), agriculture accounts for about 30 percent of GDP and employs about 40 percent of the labor force. Uzbekistan's 2000 GNI per capita (World Bank Atlas method) is estimated at US$620, placing it among low-income economies.

3. **Social Outcomes.** This per capita figure masks a deteriorating social outcome and considerable geographic disparity in income and well-being. Initial evidence from an ongoing Living Standards Assessment (LSA) suggests that Uzbekistan may face a

significant poverty problem. Using an absolute poverty line, the general poverty headcount is estimated at around 31 percent of the population[2]. Moreover, the levels and deteriorating trends of some health and education indicators are of concern. There is also considerable regional variation in poverty and social indicators. For example, rural areas, especially in western regions such as Karakalpakstan and Khorezm at the tail-end of irrigation command areas with insufficient or unreliable access to water, are much worse off and more vulnerable than those elsewhere in the country. These regions also suffer from serious environmental degradation, the most visible manifestation of which is the Aral Sea environmental disaster. Severe water and soil salinity and serious deterioration in the irrigation and drainage infrastructure built during the Soviet period afflict the agriculture sector.

4. **Political Context.** Islam Karimov, the country's president since independence in 1991, was re-elected for another five-year term in January 2000 with 92 percent of the votes. Four political parties are represented in the unicameral parliament, but the legislature is still relatively weak. A very recent national referendum endorsed two proposed amendments to the constitution: to establish a bicameral legislature following the next general election due in 2004; and, to extend the presidential term to seven years. The authorities attach the highest priority to maintaining economic, social and political stability, based on their view that such stability is a necessary condition for full employment, economic growth, and, in turn, poverty alleviation. This is the principal stated reason for their gradual, step-by-step approach to structural reforms. The government has become concerned, especially since 1999, about threats to the country's stability posed by armed opposition groups. These concerns have led to tightened security, including physical barriers to the movement of commodities and people among otherwise integrated economies of the region.

B. Key Economic Developments

5. **Macroeconomic Developments.** Following the dissolution of the Soviet Union, Uzbekistan had the smallest output decline of all the CIS countries according to official data owing, in part, to successful reorientation of its main exports (cotton and gold) directly to international markets, to the achievement of energy self-sufficiency, and its initially low level of industrialization. Like other Central Asian countries, Uzbekistan faced a fiscal shock at independence with the loss of Union transfers, and inadequate fiscal adjustment resulted in large budget deficits and hyperinflation during 1992-94. In late 1994, the government embarked upon a comprehensive macroeconomic stabilization and structural reform program, supported by the IMF and the Bank. Inflation was brought down sharply and growth resumed in 1996 for the first time since independence.

6. However, during the last quarter of 1996, responding to emerging balance of payment pressures and a poor cotton harvest, progress made in liberalizing the exchange and trade regime was reversed, fiscal and monetary policies were relaxed, and the IMF program was suspended. In early 1997, a system of multiple exchange rates, together

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[2] When household consumption is adjusted for economies of scale, the estimated headcount ratio is about 24 percent.

with restrictions on current account transactions, was formally introduced with the aim of promoting import substituting industries, protecting foreign exchange reserves, restricting "low quality" consumer goods, and subsidizing basic food imports; and, in subsequent years, import substitution policies, combined with exchange and trade restrictions, were intensified. An increasingly overvalued official exchange rate, combined with higher foreign exchange surrender requirements, placed a rising tax on exports in order to subsidize imports of capital and priority consumer goods. Tight administrative restrictions on imports and access to foreign exchange were maintained in order to protect the domestic industrial sector from external competition. Financial policies have also been used to promote priority industries. While the general government budget deficit has been kept under control, credit policy has been relatively expansive, with negative real interest rates prevailing and directed credit going to selected enterprises.

7. The import-substituting industrialization strategy initially permitted Uzbekistan to achieve modest economic growth and employment generation while keeping inflation at moderate levels (see Table 1)[3]. However, by 2000, the unsustainability of such a policy course and the misallocation costs associated with it were becoming increasingly clear.

Table 1: Key Indicators
(in US$ million, unless indicated otherwise)

Item	*1996*	*1997*	*1998*	*1999*	*2000*	2001 est.
Merchandise exports	3,534	3,695	3,048	2,790	2,935	2,755
Merchandise imports	4,240	3,767	2,938	2,587	2,441	2,479
Merchandise trade balance	-706	-72	110	203	494	276
Current account balance	-980	-584	-103	-164	184	-33
Increase in reserves (gross)	33	-480	1	74	31	-113
Foreign direct investment (net)	90	167	140	121	75	76
Official exchange rate (average) sums/US$	40	66	95	125	237	423
Commercial exchange rate (average) sums/US$	..	74	107	160	450	682
Curb market exchange rate (average) sums/US$	59	147	216	516	767	1,078
Inflation (percent) CPI end period [a/]	64	50	26	26	28	27
GDP growth (percent) [a/]	1.7	2.5	4.3	4.4	4.0	3.8
GDP (at the official exchange rate)	13,949	14,745	14,989	17,079	13,502	11,204
GDP (at the indicative exchange rate)	13,949	10,706	10,716	8,669	7,666	7,338
Atlas GNI per capita (US$) [b/]	1,010	1,010	870	720	620	540
Atlas GNI per capita (US$, at the indicative exchange rate) [c/]	620	490	480	410	360	320
Debt outstanding and disbursed [d/]	2,389	2,778	3,221	4,737	4,344	4,533
Debt/GDP (percent, at the official exchange rate)	17	19	21	28	32	41
Debt/GDP [c/] (percent, at the indicative exchange rate)	17	26	30	55	57	62
Debt/Exports GS (percent) [e/]	61	69	94	151	127	140
Debt service/Exports GS (percent) [e/]	8	13	10	18	26	29
Debt service due next year/End-period gross international reserves (percent)	27	30	48	73	73	80

Source: Uzbek authorities, and Bank and Fund staff estimates.
[a/] Based on official statistics.
[b/] From 1996 to 1999 a synthetic conversion factor is used, and in 2000 the official exchange rate is used.
[c/] The indicative exchange rate is defined as a weighted average of the official (60 percent), commercial (10 percent), and curb market rate (30 percent) rates.
[d/] US$0.5 billion of debt to Russia, which is in dispute, and short-term debt, which at the end of 2000 stood at around US$0.3 billion, are included in all debt ratios.
[e/] GS – Goods and services, including income receipts and workers' remittances.

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[3] However, there is evidence to suggest that official statistics underestimate inflation and overstate growth.

Despite large investments in industry and infrastructure, financed in large part by foreign borrowing, industrial growth averaged only 1.3 percent during 1997-2000, consistently behind the overall official GDP growth averaging 3.8 percent over the same period. Underlying external and internal macro imbalances accumulated. The curb market premium over the official exchange rate soared from around 120 percent in early 1997 to 480 percent by the end of 1999. By 2000, the value of merchandise exports had declined 25 percent compared to 1996/97, highlighting fundamental international competitiveness and incentive problems facing Uzbek producers because of the distorted exchange rate policies and lagging structural reforms. Imports were compressed even more severely (by over 40 percent over the same period) through the use of a mix of foreign exchange and trade restrictions to reduce the current account deficits. Capital outflows of over US$300 million annually since 1997 clearly indicated sizable capital flight. As a result of significant commercial borrowing, partly to finance the industrialization strategy, external debt almost doubled during end-1996 and end-1999 and debt and debt service indicators declined sharply.

8. In early 2000, the government announced its intention to move forward with ambitious reforms in a number of areas, including current account convertibility. In May 2000, it took a first step towards unification of the official and commercial bank exchange rates, by devaluing the official exchange rate by about 55 percent in nominal terms. In July 2000, a new over-the-counter rate closer to the curb market rate was introduced and, over the next year and a half, gradually given more importance as a larger share of transactions was shifted to it. The official exchange rate was devalued by a further 200 percent until being unified with the over-the-counter rate in November 2001. In parallel, more transparent foreign exchange trading procedures were introduced, some obstacles to access to foreign exchange for consumer goods importers were eliminated, and limits on cash sales to individuals for foreign travel were increased. The elimination of mandatory foreign exchange surrender requirements for exports of manufactures by small and medium enterprises (SME), together with other SME-promoting measures (see paragraph 16), have also improved the environment for small businesses. Together with structural reforms in other sectors (see paragraphs 13-20), these changes in the foreign exchange regime may presage a welcome shift in policy priorities, from inward-looking industrialization towards export-oriented production.

9. However, the scope of the reforms must be dramatically increased to address the numerous remaining economic distortions and to achieve a sustainable macroeconomic framework. The unified exchange rate has not been allowed to float and there remain two legal exchange rates, with cash transactions by individuals taking place at a rate significantly more depreciated than the unified exchange rate. While the curb market premium over the official exchange rate fell from 380 percent in April 2000, when the exchange rate unification process was being launched, to about 124 percent in February 2002, it still remains very high. Substantial liberalization of access to the foreign exchange market is still required to achieve current account convertibility. Moreover, the economic adjustment to these devaluations has been incomplete, with some officially determined prices not yet reflecting the depreciated rate and some new price controls introduced. For example, the cotton procurement price for the 2001 harvest set in late 2000 was not increased following the 2001 devaluations, leading to a further widening of

the gap between the world market price of cotton and prices paid to farmers. The weighted average price of electricity in dollar terms, despite several increases during 2000-01, also declined between 1997 and 2001, from 2.5 to 1.1 cents per kwh at the official exchange rate and to 0.5 cents at the curb market rate, exacerbating financial difficulties in the energy sector. Overall, the government's economic strategy still relies on the implicit taxation of cotton and gold; and quasi-fiscal transfers, particularly through energy pricing and subsidized directed credit, remain extensive.

10. The overall business environment, despite some improvement for small and export-oriented enterprises, is riddled with exemptions and *ad hoc* preferences and remains difficult. The foreign trade regime, despite low weighted average tariffs, is also constraining, with export bans on some commodities preserving relative price distortions on the one hand, and burdensome import registration and certification procedures on the other hand. As a result, foreign direct investment inflows have been steadily declining. In 2000, they were less than a half their already low 1997 levels and amongst the lowest in per capita terms of all transition economies. Privatization revenues, at 0.1 percent of GDP during 1998-2001, are also well below potential.

11. Uzbekistan's external debt, after doubling between 1996-1999, is now significant (US$4.5 billion at end-2001) and repayment capacity has been adversely affected by the policies pursued as well as external shocks. Given the high share of commercial borrowing, the degree of concessionality is low, with the present value close to its face value. Debt service has also increased, almost tripling (to US$0.9 billion) in 2001 compared to 1996. After some improvement in 2000 due to a temporary export recovery, the external debt-to-exports and external debt service ratios are estimated to have increased again in 2001 (to 140 and 29 percent, respectively), as a result of a decline in export value due to the fall in world market cotton prices and increased borrowing from bilateral and commercial creditors. Nevertheless, gross international reserves which have been maintained at a comfortable US$1.2-1.3 billion in recent years (around five months of recorded imports of goods and services), have so far allowed timely debt servicing. The fiscal burden of debt is also potentially high, with the ratio of public and publicly guaranteed debt service to consolidated government revenues at almost 40 percent. Since a large part of total debt has been incurred by state enterprises guaranteed by the government, some of which may not be financially viable, there is a distinct possibility of the debt service falling on the budget. The general government budget deficit, under control in 1998-2001, may thus be masking an important source of vulnerability.

12. In 2001, unfavorable exogenous factors such as the worldwide economic slowdown and Uzbekistan's proximity to recent events in Afghanistan have had a negative impact on its economic performance and outlook. The economic slowdown has dampened demand for Uzbekistan's exports and pushed commodity prices down in world markets. In particular, a sharp fall (around 35 percent since end-2000) in the world market price of cotton fiber, which has accounted for a third of Uzbekistan's merchandise export earnings over the past three years, is causing substantial losses - only partially offset by a modest increase in the world market price of gold, the country's second largest export. The government needs to strengthen, broaden, and accelerate its reform program to counter these shocks and to realize its economic growth potential. The recent

agreement with the IMF on a six-month Staff Monitored Program (SMP), which provides for the tightening of fiscal and monetary policies, the introduction of current account convertibility later this year, the gradual reform of the agricultural state order system, further trade and price liberalization, the strengthening of the banking system, and improved transparency and quality of statistics, is a welcome step in this direction.

13. **Sectoral Developments.** Despite the large potential of Uzbekistan's agriculture, the current policy framework is severely constraining. Through the state order system for cotton and grain, the government continues to dictate cropping patterns in great detail, down through the *oblasts* (provinces) and *rayons* (districts) to individual farming units. The state also determines the prices to be paid for these crops, which are below international levels. These practices, in conjunction with the use of the overvalued official exchange rate to convert the export price of cotton into local currency, impose a huge implicit tax on the subsector and result in a large net transfer of resources from agriculture to the rest of the economy (estimated at 10 percent of GDP in 2000[4]). This transfer of resources is a major cause of rural poverty in Uzbekistan, and, in addition, severely constrains general economic growth in the rural areas and hinders the introduction of adequate irrigation and utility charges. The government has undertaken a program of institutional change in the sector, reorganizing the former *sovkhozes* and *kolkhozes* into new forms of collective farms (*shirkats*), with subdivisions farmed by extended families. It has also permitted the development of private farms (averaging 20 hectares in 2000) and, by expanding the former household plots of farm laborers, created a new class of smaller peasant (*dekhan*) farms (averaging 0.13 hectares in 2000), the latter being the main source of dynamism in the sector thus far. But even private farmers are subject to many of the same mandates, orders, and constraints as the *shirkats*. In 2000, the government exempted the exports of fruits and vegetables from foreign exchange surrender requirements, which markedly boosted export earnings. However, more comprehensive reforms are needed to address the serious incentive problems caused by the current agricultural pricing policy, input and output marketing arrangements (including export and import controls), state ownership of agricultural processing enterprises like cotton ginneries, and the non-tradability of land rights.

14. Since independence, self-sufficiency in energy has been a key government development objective. While its strategy so far has been to increase oil and gas production through public investments, an April 2000 presidential decree launched a new policy to attract foreign direct investment for the exploration and development of oil and gas deposits, with concessions of up to 25 years and various tax exemptions. Negotiations are at a fairly advanced stage with international oil companies for three prospecting blocks. More recently, the government announced plans to offer shares of eight oil and gas companies, including the national holding company, UzbekNefteGaz, and has hired an international investment bank to prepare the privatization of UzbekNefteGaz and four of its companies. In late 2000 and early 2001, the government also issued a series of decrees and resolutions to restructure and privatize the electric power sector. The Ministry of Energy has been split up into: (a) a joint-stock company, Uzbekenergo, responsible for the operation of power and coal facilities;

4 This estimated transfer is reduced to 5 percent if periodic debt write-offs are taken into account.

(b) UzEnergoNadzor, the regulatory body; and (c) the Ministry of Energy and Fuels responsible for overall policy. Accelerated privatization of Uzbekenergo's social infrastructure facilities and other non-core services is envisaged as well as four thermal power plants. While these first steps towards reforming the electric power sector are important, additional measures need to be taken. There remain serious flaws in the industry's structure; the price of electricity is extremely low relative to costs of operation and future investment needs; the regulatory framework needs strengthening; and, privatization apparently envisages continued majority ownership by the government. Furthermore, electric power and gas sector reforms need to be coordinated. Progress towards comprehensive restructuring of oil, gas and power will be a key test of the government's intentions in reforming the energy sector.

15. The government's overall reform strategy for public utilities includes: (a) decentralization of responsibilities to local authorities; (b) instituting new pricing and cost-recovery mechanisms; (c) encouraging private sector participation in developing infrastructure; and (d) phased elimination of subsidies, partially compensated by means-tested allocations. Several programs are now being implemented, including improved metering of water supply, natural gas, and district heating consumption. In December 2000, the Ministry of Public Utilities was restructured into an Agency of Public Utilities, with the goal of commercializing municipal and rural service providers. In the water supply and sewerage sector, the approach to decentralization and private sector participation is systematic and may be the best in Central Asia. The government has decentralized the management of urban water utilities to the municipalities and outlined principles of water tariff-setting policies. Some municipalities have started implementing these measures by completing Corporate Development Plans and introducing new tariff policies, with sharp hikes in residential tariffs (four- to five-fold since early 1999) reducing cross-subsidies and improving collection rates.

16. Improving the business environment remains a major challenge for the government. Enterprise restructuring is lagging due to currency restrictions, distorted relative prices, and state associations' dominance in marketing, procurement of input, and corporate governance. Although explicit budget subsidies to state enterprises have been largely eliminated, implicit subsidies are large, including commercial bank credit at negative real interest rates, administered allocation of foreign exchange to selected enterprises for priority imports at the overvalued exchange rate, and provision of energy at well below true market prices. Recent Bank and AsDB reports confirm important weaknesses in relation to corporate governance[5] and inadequate accounting and audit standards;[6] and, while there have been some improvements in the overall legal framework, such as the Law on Joint Stock Companies and Protection of Shareholder Interests, implementation remains inconsistent. Although small- and medium-sized enterprise (SME) development has for several years been a key priority for creating jobs and growth, the number of SMEs actually fell during 1997-99, owing to the weak

[5] *Draft report on Review of Corporate Governance in the Central Asian Republics,* World Bank, Washington DC, 2001.

[6] A recent report highlights numerous additional deficiencies in the accounting and auditing arrangements and practices in Uzbekistan: *Financial Management and Governance Issues in Uzbekistan,* Asian Development Bank, Manila, 2000.

enabling environment, including limited access to foreign exchange, discretionary government intervention, and distorted relative prices and other incentives. Since 2000, however, a concerted government effort has been made to reduce bureaucratic impediments to SME operations by reducing reporting requirements and the number of overseeing authorities and inspections, as well as simplifying taxes and eliminating foreign exchange surrender requirements. In addition, a large increase in subsidized credit has also been directed towards SMEs, and some restrictions on cash withdrawals from bank accounts (see paragraph 19) have been lifted for micro-enterprises. These measures have resulted in an increase in the number of SMEs registered in 2000, albeit from a low base and with unclear sustainability.

17. The privatization of medium- and large-sized enterprises is proceeding with mixed results, largely on account of the unfavorable macroeconomic environment and uncertain political will. While the government has ambitious plans for divesting its stakes in large, strategic enterprises (including the largest associations), it has made little progress to date. Foreign direct investment, ranging from US$3-$7 per capita per year and declining, is well below Uzbekistan's potential. In March 2001, the government announced some changes in its privatization strategy (COM Resolution No. 119), including: (a) the sale of up to 70 percent of Uzbektelecom's shares; (b) the sale of residual state shares in over 600 enterprises; (c) a decision to privatize parts of the electric power, cotton ginning, and railways sectors; and (d) the offering of a new, larger list of medium-sized enterprises for sale to Privatization Investment Funds (PIFs). On the other hand, a majority stake is offered in only seven of thirty eight large state-owned enterprises to which the government hopes to attract foreign investors. Thus, pending improvements in the overall macroeconomic and investment environment, and also in the strategy for privatizing the largest enterprises, it is doubtful whether the March 2001 changes will themselves suffice to attract significant foreign investment.

18. The development and modernization of the transport sector has also been a government priority, given the urban population's high dependence on public transport and the importance of domestic and international trade for the economy. In urban transport, the government has enacted a number of important reforms, including: separation of regulatory and operational responsibilities in the provision of services; introduction of competition through a program of bus route franchising and development of an appropriate regulatory framework; and, creation of an enabling environment for private sector participation in the provision of transport services. Restructuring of the railway, Uztemiryollari (UTY), has been proceeding and involves spinning off unrelated businesses, laying off redundant workers, and rationalizing tariffs. The process of corporatization of UTY companies has also begun. In the road and air transport subsectors, the government has focused on investments, including the modernization and rehabilitation of air traffic control and airline equipment and airport facilities, the rehabilitation of several trunk roads, and the construction of a key road link between the Fergana valley, Tashkent and, thus, the rest of the country. Except for urban transport, however, the transport sector is still dominated by state-owned enterprises and there is no appropriate financial, regulatory, and institutional framework for competitive provision of transport services. Also, given the absence of a Ministry of Transport, sector management and accountability for performance are weak.

19. Recent progress in the financial sector includes lifting the restriction that limited each legal entity to just one bank account, implementation of a computerized inter-bank payments system, adoption of international accounting standards by banks, and audits by international firms of an increasing number of banks' annual financial statements. The government is also following a set timetable to phase out bank cross-shareholdings, reduce limits of shareholdings by enterprises in banks, and increase minimum capital requirements. While some new banks (mostly foreign joint ventures) have entered the market, bank privatization is being initiated only now, with proposals for divestiture of significant state shares in the two largest banks, National Bank of Uzbekistan and Asaka Bank. However, banks remain the primary conduits for government-directed credit to enterprises at negative real interest rates. The large portfolio of government guaranteed loans poses a serious fiscal and commercial risk, given the financial distress and unprofitability of many state enterprises, and is an obstacle to bank privatization. At the same time, the separation of cash and non-cash transactions through restrictions on cash withdrawals from enterprise bank accounts severely constrains the intermediation of financial flows and inhibits development of the sector. It encourages informal transactions outside the banking system, undermines confidence in banks, tightens further foreign exchange restrictions, and imposes on banks an administrative burden of compliance monitoring. It is also a specific obstacle for SMEs' activities. Meanwhile, capital market development is still at a very early stage.

20. Recent reforms in fiscal management include a rolling three-year Public Investment Program, introduced in 1999, a new budget classification system, introduced with the budget of 2000, and greater consultation with parliament in the preparation of the annual budget. A Budget System Law has been passed and the government is seeking international technical assistance in introducing a treasury as a key step toward improving public cash management. Institutional arrangements with respect to budget preparation and execution, public disclosure and dissemination, and ex post independent audits remain weak or non-existent. Revenue reforms have focused on reducing marginal tax rates, unification of agricultural taxes into a unified land tax, introduction of a taxpayer identification number system for enterprises, and establishment of private pre-shipment customs inspections. However, progress remains slow in other areas such as setting up rules-based multi-year tax sharing arrangements with the regions, extending taxpayer identification numbers to individuals, developing compliance and audit tools, and upgrading the infrastructure of the tax and customs administration.

C. Poverty and Social Outcomes

21. Uzbekistan was one of the poorest republics in the Soviet Union, with the distribution of poverty showing a strong rural bias. Poverty increased significantly between 1989 and 1993, although the rise in poverty and inequality was less sharp in Uzbekistan than in the other Central Asian Republics.[7] Initial results from the on-going

[7] Milanovic, B,. 1998, *Income, Inequality, and Poverty during the Transition from Planned to Market Economy*, World Bank. This is the only study which provides a trend based on comparable data, but these data from the Soviet Family Budget Survey have serious limitations.

first nationally representative LSA suggest that around 31 percent of the population could be considered poor in 2000-2001 with consumption below an absolute poverty line. The relatively high poverty rate appears to be a combined result of low per capita incomes and a large inequality in distribution[8].

22. Rural poverty continues to be significant. Poverty in rural areas is at least 10 percentage points higher than in urban areas, and more than two thirds of the poor live in rural areas. Trends in average wages by sector also indicate a gap between the average agricultural wage and the average wage in every other sector. While in 1991-92 there was relatively little sectoral wage differentiation, by 1995 the average industrial wage was double the agricultural wage and is now five times the agricultural wage. Indeed, based on official data, the real average agricultural wage has fallen to 60 percent of its 1991 level, whereas the real wage in all other sectors has increased. Although wage data may not reflect incomes, various factors constrain agricultural incomes.

23. The most important of these factors is current agricultural policies, which result in large net resource transfers out of the agricultural sector, reducing rural incomes (see paragraph 13). State wheat and cotton procurement prices have consistently been below world market levels. For instance, the state procurement price in 2001 was about 65 percent of the world price at the official exchange rate and just 40 percent at the commercial bank rate, resulting in losses for agricultural producers and necessitating a major farm debt write-off by the government. Not only is there a transfer of resources through this implicit taxation of the agricultural sector, but there is also a loss in increased productivity that would come from price incentives. Available data indicate that the output value per hectare – and therefore potential incomes – of *dekhan* (peasant) farmers, who are not subjected to the onerous requirements on mandated areas under strategic crops (cotton and wheat) for state orders, are several times higher than that of cooperatives (*shirkats*).

24. In addition to rural-urban differences, there are considerable regional disparities. Households in Kashkadarya and Namangan oblasts as well as in Karakalpakstan have significantly lower standards of living than those in Syrdaya and Bukhara oblasts and in Tashkent city. Moreover, health outcomes are also often worse in the lower income areas, particularly in Karakalpakstan and Khorezm. There has been a sharp rise in tuberculosis incidence, most seriously in Karakalpakstan.

25. Profile of the Poor. The LSA provides the preliminary characteristics of poor households. Large households with children are more likely to be poor and three quarters of all poor individuals live in households with more than two children. However, the

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[8] Deficiencies in non-food consumption data in the Family Budget Survey which is used in the LSA have necessitated the use of a somewhat unorthodox methodology to estimate the poverty. While this methodology gives the most reliable estimates of poverty given the limitations of Uzbekistan's Family Budget Survey, it complicates international comparisons. Moreover it does not allow the calculation of the depth of poverty nor measures of inequality in consumption. According to an earlier, pilot household survey carried out in 1999 in the Fergana oblast (a region with above average income and socioeconomic indicators representing about 11 percent of the country's population), the poverty headcount based on the international poverty line of US$PPP2.15 was about 22 percent and the Gini coefficient of consumption was estimated at 0.4.

number of pension-aged persons in the household is associated with higher levels of welfare. Somewhat surprisingly, the poverty rate is highest among households headed by individuals with completed secondary education, which in absolute terms constitute the majority. Employment status is also an important determinant of poverty. Households with an unemployed head are more likely to be poor, but the working population constitutes a substantial proportion of the poor.

26. Although comparable data over time are limited, there is increasing evidence of deterioration in the quality of life, especially among the poor. Medical services, as well as secondary and higher education, have declined in quality and become more expensive. The use of informal payments is thought to be widespread and increasing and has particularly impacted access by the poor to social services.

27. Education enrollments have dropped significantly at non-compulsory levels since the start of transition[9] and the rural-urban disparity in schooling level has increased. The almost complete absence of resources for educational materials and school maintenance has led to progressive deterioration of education quality and education infrastructure. Education financing has given priority to maintaining existing teaching positions, although teachers' salaries have declined sharply in real terms. While government expenditure on education has been rising since 1997 and reached over 8 percent of GDP in 1999, it has been used mainly to pay teacher salaries and to construct new secondary educational institutions, to the neglect of other recurrent expenditure needs. Growing concern about rising unemployment among school leavers led to the adoption in 1997 of an education reform program, the National Personnel Training Program, aimed at reorienting the education system towards the needs of a market economy. The program includes some very positive changes, including an increase in the duration of compulsory education to twelve years, renewed efforts in in-service teacher training, and other actions to develop a more active and student-oriented form of pedagogy. But it does not address some of the fundamental needs of the education system – including the under-provisioning of basic education and the lack of incentives for efficient management of education programs. It also includes the introduction of a costly new form of secondary vocational education which is fiscally unsustainable and may not provide the flexibility that will be needed as the economy liberalizes and participates more fully in the global economy.

28. Health. The health status of the population is characterized by a mixture of long-standing problems: high prevalence of chronic non-infectious diseases, characteristic of developed countries, in parallel with communicable diseases, malnutrition, and reproductive health problems associated with developing countries. As in many other CIS countries, the rate of non-communicable diseases in older population cohorts has risen sharply. Unlike these other countries, however, overall life expectancy has not worsened markedly. Infant and maternal mortality have been of concern for the

[9] Kindergarten enrollments dropped from 37 percent in 1990 to 16 percent in 1999 (and as low as 9.5 percent in rural areas). The share of the age cohort attending upper secondary education fell from 73 percent in 1993 to 55 percent in 1996, until it became compulsory in 1997. There was a dramatic decline in the share of 19 year-olds in full time education (from 31 percent in 1992 to 19 percent in 1999); and enrollment rates in higher education fell from 18 percent to 8 percent between 1993 and 1999.

last few decades, and infant mortality is among the highest – together with other Central Asian countries – in the CIS . However, there are improvements in some maternal and infant health indicators (see Box 1), though data definitions vary and data reliability is unclear. On the other hand, there are still major challenges due to the lack of medical skills, particularly in rural areas, shortages of drugs, and failures in evidence-based diagnosis and treatment. Communicable diseases remain a major problem despite improving vaccination coverage, suggesting systemic weaknesses in the public health delivery system. Uzbekistan has experienced several outbreaks of infectious diseases, including tuberculosis, diphtheria, and viral hepatitis. The high prevalence of infectious diseases can be attributed to limited access to sources of safe water and the decline in water and sanitation services (which affects the poor the most), as well as poor environmental and sanitation practices. At the same time, new inequities have emerged, in part attributable to the drop in GDP since independence and the declining share of government health expenditure, falling from around 6 percent of GDP in the mid-1980s to 3 percent in 1999. As a result, out-of-pocket expenditures for health services and drugs have risen substantially, disadvantaging those on subsistence incomes.

Box 1: Gender in Uzbekistan

Like other CIS countries, Uzbekistan fares relatively well on gender indicators. Economic and political changes during the past decade, though, have had an impact on gender roles and women's status.

Socio-Political and Economic Status. Independence has brought a renewed interest in religion and traditional relations between the sexes. While women taken an increasingly active part in the activities of local communities (e.g., *mahallas, kishlaks*), these remain headed mainly by men. In 1998, there were 23 women in the Oliy Majlis, Uzbekistan's legislature (9 percent of the total); and the proportion of women in high administrative and management positions (e.g. Deputy Ministers) was about 18 percent. There is a trend toward increased female employment in the lower-wage social sectors. In 1997, women's average wages were 80 percent of men's, and 60-70 percent of the national average in fields where female employment predominates.

Health and Education. Anemia affects 60 percent of women, although the majority are only mildly anemic (45%). The contributing factors are inadequate nutrition, frequent births, and poor environmental conditions and potable water quality –some of which have worsened during the transition. The government has recently assigned special priority to protecting the health of mothers and children, as a result of which there are signs of improvements in some factors affecting maternal and infant health, notably: a marked rise in contraceptive use, resulting in fewer births; longer spacing between births; a lower birth rate among women over 35; declining abortion rates, and improved reproductive health services. These have probably led to reportedly declining rates of maternal, infant and child mortality and morbidity. While girls have equal access to both basic and higher education, actual enrollments show increasing inequality, especially at the higher levels of education. In 1999, for example, the share of female students at higher education establishments was only 37 percent.

Gender Policy. The government has undertaken numerous measures addressing gender policy: a 1995 Presidential Decree "On Enhancing Women's Role in Social and Government Development in Uzbekistan"; the appointment of a Deputy Prime Minister responsible for Women's Issues, similar appointments at the local government level (Deputy Khokims responsible for Women's Issues), and women's councils within *mahalla* committees. At the President's initiative, 1999 was declared the Year of Women and 2001 the year of Woman and Child. Within the framework of these initiatives, the government has adopted specific measures to protect women's health, including holding regular conferences of women's NGOs.

Sources: Center for Social Research "EXPERT," *Uzbekistan Gender Study in Transition*, October 1998; Center for Social Research "EXPERT," *Consultations with the Poor, National Synthesis Report*, 1999; UNDP, *Report on the Status of Women in Uzbekistan*, 1999.

29. A number of reforms have been launched in the last few years, including improved quality of primary care health services, early steps in the decentralization of health services management, and selective privatization of health service delivery. Efficiency gains thus far have been marginal, with a still fragmented system and consequent service overlaps. In the mid- to late 1990s, there was a reduction in hospital beds, with less expensive primary and outpatient care substituting for these services. Training and curricula for medical graduates have also been reoriented towards general practice, though the inherited input mix is still skewed towards hospital-based specialization. More recently, the government's reform priorities in primary, maternal, and child health care are being crowded out by another announced priority for emergency hospital services, which will serve the better-off urban populations. Privatization of health services and emerging private medical practice in a largely unregulated environment also generate some concern with regard to access, equity, and quality of services.

Box 2: HIV/AIDS in Uzbekistan

Until recently, Eastern Europe and Central Asia (ECA) had escaped the worst ravages of HIV/AIDS, but the situation has changed dramatically in recent years. At end-2000, an estimated 700,000 persons were infected with HIV in the ECA region, compared to an estimated 30,000 in 1995.

Against this background, recorded HIV infection rates in Uzbekistan (estimated at 779 at end-2001, up from 230 at end-2000) remain very low, although, as elsewhere in the region, there are worrisome signs of the potential for very rapid growth: for example, expanding use of drugs, especially in urban areas, against a backdrop of increasing joblessness and changing social and family norms. Moreover, international experience suggests that the actual number of people infected may be 5-10 times higher than officially recorded rates. The main sources of HIV infection and transmission in Uzbekistan to date are the use of injectable drugs, the cause of at least two recent localized outbreaks, followed more recently by sexually transmitted diseases. UNDP/UNAIDS and USAID are currently financing several small demonstration projects aimed at injectable drug users, including in prisons, at preventive activities among population groups most at risk, and at increased public awareness. In addition, the government, with technical assistance from UNAIDS, is currently preparing a draft National Strategy for Prevention of HIV/AIDS, which will be discussed at a national multi-sectoral forum in March/April 2002.

30. Social Protection. The lower poverty rates among pensioners suggest that, as in other countries, pensions succeed to some extent in reducing old age poverty. But the cost of this safety net is high. Pension spending is around 7 percent of GDP and tax rates to finance pensions represent almost 40 percent of payroll, with the result that the pension system is caught in a low compliance-high contribution rate trap. The government has recently embarked on a plan to improve administration of the pension system and is considering some changes in the pay-as-you-go pension system that would help improve its financial solvency. Without these improvements, the burden on working classes may grow, and poverty among pensioners may well increase in the future. In contrast to pensions, unemployment benefits, social assistance, and child allowances represented 2.4 percent of GDP in 1999. The government has adopted an innovative approach to target social assistance and child allowances through the use of *mahalla* (neighborhood) associations, a traditional Uzbek (pre-Soviet) social institution. This has kept administrative costs low, and broadly succeeded in targeting child allowances and social

assistance to the poor, although the low level of financing allocated, including the share of social assistance in total social expenditures, is low and declining.

Box 3: Labor Standards in Uzbekistan

Uzbekistan has signed a number of International Labor Organization conventions covering labor rights and standards, including those related to freedom of association and collective bargaining, abolition of forced and compulsory labor, and elimination of discrimination in terms of employment and occupation. Uzbekistan's constitution and laws recognize the right to voluntarily form trade unions. Union membership is optional and all trade unions are nominally independent of the state's administrative bodies. A law creating a legal framework for the establishment of non-governmental organizations (NGOs) was adopted in April 1999. While its laws prohibit forced and compulsory labor, including child labor, Uzbekistan continues the practice – widely used in many republics during the Soviet era - of mobilizing students and schoolchildren to help with the annual cotton harvest. The "Save the Children" Fund is currently carrying out a study on child labor.

D. Environment and Water Resources

31. Agriculture, a key sector of the economy in terms of both employment and growth potential, is almost totally dependent on irrigation, partly due to Uzbekistan's arid, essentially desert climate, and partly due to its erstwhile role as principal supplier of water-intensive crops (raw cotton and rice) to the entire Soviet Union. Since the 1950s, in particular, Uzbekistan's cotton sub-sector was expanded with little or no concern for cost, for the environmental effects of pumping water over extremely long distances from the Amu Darya and Syr Darya rivers to irrigated areas, or for the need to dispose of irrigated water through proper drainage systems. Natural and man-made calamities, such as the last two years' localized drought in Khorezm and Karakalpakstan, have highlighted the fragility of the overall environmental situation, the urgent need to improve water management within Uzbekistan and coordination between Uzbekistan and its neighbors, and the absolute necessity to reduce waste and increase the efficiency of water use for all purposes. Against this background, Uzbekistan faces three key water resource management challenges during the next few years: (a) salinity; (b) decaying irrigation and drainage systems; and (c) the competing demands of Uzbekistan's upstream neighbors for water that originates mainly in their territories (Kyrgyz Republic and Tajikistan).

32. In recent years, the increasing salinity of surface and ground water, due to improper drainage from irrigated fields, has significantly reduced the supply of clean water for both irrigation and human consumption, resulting in a progression of serious environmental problems exemplified by the desiccation of the Aral Sea (see Box 4). Due to their proximity to the Aral Sea and their location at the tail-end of major irrigation command areas, the populations of Karakalpakstan and Khorezm are the most severely affected both in terms of agricultural yields and health. In addition to salinity, large areas of arable land throughout the country are subject to serious erosion, pesticide and fertilizer contamination, and periodic water logging.

Box 4: Environmental Costs of Inadequate Water Management

Between 1960-90, annual water consumption, mostly for irrigation in the Aral Sea Basin, almost doubled, resulting in a large reduction in the flow of water to the Aral Sea. As a result, its level dropped by about 17 meters and surface area decreased by more than half. The virtual doubling of irrigated area during this period, mainly for cotton production, has created serious environmental problems, the most important and visible of which is increasing salinity of both land and water. The latter results from the inadequate design, construction and management of the irrigation and drainage systems, rising saline groundwater levels, and the discharge of saline drainage water into the canal and river system. About one-third of all irrigated land in Uzbekistan is estimated to be already saline, with yields decreased by about one-third. Potable drinking water is also in short supply in the lower reaches of the Amu Darya and Syr Darya rivers as a result of increased salinity. Crop losses and other damage due to salinity and the effects of the Aral Sea disaster are estimated at around US$0.5 billion equivalent annually. These environmental problems are most acute in delta areas where, in addition, desertification is severely affecting human and animal life and biodiversity.

33. The efficient use of water resources is also threatened by the very serious deterioration – leading to possible breakdowns – in the massive irrigation and drainage infrastructure built during the Soviet period, due to inadequate budget allocations and the weakening of management, operation and maintenance systems. Indeed, there is an increasingly serious risk that critical facilities, such as lift-pumping stations in Karshi and Bukhara, could suffer a catastrophic failure that would affect not only agricultural production but also the lives and welfare of several million people in these two regions.

34. The irrigation systems of the Aral Sea Basin were developed during the Soviet period without regard to the boundaries between what were then Soviet republics but are now five independent countries. Thus, several important water intake, storage, and distribution facilities for irrigation are located outside Uzbekistan. Conversely, some reservoirs and main canals in Uzbekistan supply water for irrigated land in adjacent states. More importantly, the two upstream countries, Kyrgyz Republic and Tajikistan, now use their water mainly for (hydroelectric) power generation in winter, owing to the now uncertain supply of coal and natural gas from Kazakhstan and Uzbekistan, which in 2000-01 resulted indirectly in insufficient water being available for irrigation downstream in Uzbekistan. Due to the lack of an agreed regional approach for the development of equitable, more efficient water allocation and management arrangements, these issues are currently being handled either on a costly, *ad-hoc*, case-by-case bilateral basis, or they remain unresolved, thereby disrupting agricultural production.

35. While macroeconomic and sectoral policy issues are a serious constraint to environmental improvement, the government has been making some progress with respect to Aral Sea Basin issues and has endorsed the National Environmental Action Plan (NEAP). Steps are being taken to implement NEAP recommendations to improve the quality of safe drinking water, reduce salinity and degradation of land, address the problems of municipal waste, and strengthen environmental management institutions. The elaboration of an agreed long-term and sustainable strategy for regional, basin-wide water allocation and management among the five Central Asian states is a key component of the GEF-financed Water and Environmental Management Project approved in mid-1998 (see Annex 13). However, key challenges remain, including the lack of coordination between environmental and sectoral agencies, as well as weak

implementation and enforcement capacity. Local droughts affecting Khorezm and Karakalpakstan in particular in 2000 and 2001 highlighted the fragility of the environment and the importance of adequate water management, including improved trans-boundary coordination and cooperation.

E. Governance

36. In a number of areas, especially transparency, accountability and institutional restraints on bureaucratic discretion, Uzbekistan's governance record, as evidenced by range of indicators, is weak. A 1999 Business Environment and Enterprise Performance Survey commissioned jointly by the World Bank and EBRD indicated that, although Uzbekistan rated fairly well on law and order, the extent of administrative corruption was significant. Specific problems identified by this and other surveys include: (a) the unpredictability of rules, regulations and policies that affect private business (e.g. firms' inability to anticipate changes in laws and/or policies, or not being consulted during the decision making process); (b) the fragmentation and inconsistency of rules governing economic activity in numerous separate laws, Presidential Decrees, and Cabinet of Ministers' resolutions; and (c) the paucity of relevant information and resultant difficulty in understanding what laws are pertinent. Many firms indicated that they were not confident that the government would protect their persons and property. The unreliability of the judiciary was also cited as a major problem. Finally, regulatory and policy obstacles were rated higher in Uzbekistan than in other comparable countries. These covered a wide variety of problems and included foreign exchange and trade rules, inflation, the uncertain costs of regulations, financing problems, and price controls. While the perceptions resulting from such surveys are necessarily subjective, they may be as important as objective indicators in determining economic outcomes because a country's investment climate is essentially determined by the perceptions of businessmen. Recent evidence cited in the Bank's *Anti-Corruption in Transition*[10] also confirms this view.

37. The key institutional weakness that accounts for Uzbekistan's poor governance record to date is the lack of public accountability. Public accountability is diluted by a political and economic system that is characterized by little or no oversight of public finances, a general lack of transparency in policy decision making and implementation, and a poorly developed civil society. One of the first steps towards improving accountability and transparency would be for the government to provide timely, reliable, and publicly available information on its financial position and overall economic performance (see Box 5). At present, fiscal transparency is limited to periodic budget reports to parliament; for example, public accounts are not subject to independent audit. Transparent and responsive institutions that encourage citizen participation should also be promoted.

[10] *Anti-Corruption in Transition: A Contribution to the Policy Debate,* World Bank, Washington, DC, 2000.

Box 5: Data Availability and Transparency in Uzbekistan

The overall lack of, and uneven quality of limited statistical data available in Uzbekistan are a serious constraint to analyzing the country's macroeconomic and structural reform performance. Statistical information in Uzbekistan is currently subdivided into three types: (i) public information; (ii) information for "official use"; and (iii) confidential information. Public information is very limited and is contained mainly in annual publications. The only official, regular publication is a quarterly *Report on Socio-Economic Development of Uzbekistan,* prepared by the Department of Statistics, Ministry of Macroeconomics, the government's economic planning agency. This publication contains a limited set of national accounts and industrial output aggregates, some relative measures of foreign trade (e.g., directions of foreign trade in percentages to total exports/imports), and social development indicators. Data on exports and imports, balance of payments, external debt, and fiscal and monetary accounts are classified as "for official use" or confidential, and access to such data is allowed only after clearance by the Cabinet of Ministers. Uzbekistan is also one of the few countries that does not have a country page in the IMF's *International Financial Statistics*, *Government Finance Statistics*, and other widely used statistical publications.

The unavailability of – or continued restrictions on access to – statistical data is unfortunate, given the large amount of technical assistance extended by international donors to improve the quality of Uzbekistan's statistical methodology and to equip statistical authorities. This technical assistance has been provided *inter alia* by: the Bank (through an IDF-financed capacity building project to re-estimate national accounts, recommend new data collection methods, and improve data storage and processing systems); numerous IMF missions and resident advisers (related to balance of payments, monetary statistics, consumer and producer price indices); Japanese International Cooperation Agency (JICA) (input/output balances); German GTZ (family budget surveys); and EU-TACIS (sectoral statistics).

Improvement in the public availability and quality of statistical information is a key prerequisite for successful implementation of this CAS and for more effective cooperation with the international financial institutions in general.

38. Uzbekistan's public sector administration remains weak and therefore susceptible to petty corruption. Recognizing this, the government reduced the size of the civil service by 20-25 percent in late 1998 in order to finance improved compensation for a smaller number of officials. It also adopted measures to reduce the frequency of some regulatory interventions by government agencies, e.g., in the small and medium enterprise sector. However, recruitment to and promotion within public service is still neither fully competitive nor based on merit; the state's regulatory and economic functions often overlap, and transparency in the accounting, reporting, and auditing of public resources needs substantial improvement.

39. The result has been extensive opportunities for rent-seeking provided by the current policy regime, the most egregious of which include: foreign exchange and trade controls; entry barriers for private industry; directed credit; state intervention in enterprise business decisions; and the still limited use of competitive public procurement and contracting. Uzbekistan needs to address its governance issues urgently in order to eliminate major barriers to business development, growth, and improvement in living standards.

F. Macroeconomic Prospects

40. Uzbekistan's medium-term prospects and creditworthiness depend crucially on actions to reduce its macroeconomic imbalances and limit the growth of external debt, as well as reforms to liberalize the economy and create conditions for accelerated private sector development and export growth. The recent agreement between the authorities and the IMF on a six-month Staff Monitored Program (SMP) may signify a shift from the previous overly cautious reform paradigm. However, the actual pace of future reform is unclear at this time. If the current slow pace continues, then the economy will likely stagnate as shown in the Low Case macroeconomic scenario. If, on the other hand, the pace is accelerated and the scope of reforms broadened, the economy is expected to achieve a sustainable growth path as illustrated in the Base Case scenario.

41. **Low Case.** The Low Case macroeconomic scenario for 2002-2005 assumes that the government gradually proceeds with minimal reforms in the two key areas – the foreign exchange and trade regime and agriculture. In particular, the government is assumed to gradually liberalize access to foreign exchange for enterprises and individuals, reducing the curb market premium over the official exchange rate and improving incentives for exporters, as well as to eliminate the state order system, to reduce mandatory state procurement of cotton and wheat, and to raise procurement prices to world market levels, thereby reducing the implicit taxation of agricultural producers. Progress in other areas of structural reforms is expected to be slower, however, and quasi-fiscal operations in some sectors may remain large (see paragraph 9). The Low Case scenario assumes that the government will be reluctant to abandon quickly all of the administrative controls over foreign trade and prices, eliminate directed credits and restrictions on cash circulation, raise energy prices to cost-recovery levels, float the exchange rate, and increase transparency and governance. The main features of this scenario are summarized in Table 2.

Table 2: Low Case Macroeconomic Scenario

	Actual	Estimate		Projection		
	2000	2001	2002	2003	2004	2005
Real GDP growth (percent)	4.0	3.8	2.0	2.0	2.0	2.0
Inflation (GDP deflator, percent change)	44.3	42.8	30.3	30.0	25.0	22.0
Export GNFS volume growth (percent) [a/]	6.3	1.5	2.2	3.0	2.5	1.7
Import GNFS volume growth (percent) [a/]	-3.8	8.6	1.0	1.4	1.7	1.5
Current account balance/GDP (percent) [b/]	2.4	-0.5	-0.9	0.2	0.9	1.2
Total external debt (US$ billion)	4.3	4.5	4.5	4.5	4.5	4.5
Total external debt/GDP (percent) [b/]	56.7	61.8	66.1	61.1	58.0	53.8
Total external debt/Exports GS (percent) [c/]	127.3	139.7	133.9	124.3	118.6	113.6
Total external debt service (US$ million)	904	929	924	897	871	876
Total external debt service/Exports GS (percent) [c/]	26.5	28.6	27.3	24.7	22.8	22.0
Gross international reserves (months of imports GS) [a/]	4.7	4.2	3.7	3.6	3.4	3.3
Total debt service due next year/Gross international reserves (percent)	73.0	79.6	83.7	80.4	80.7	83.0

[a/] GNFS – Goods and non-factor services.
[b/] At the indicative exchange rate.
[c/] GS – Goods and services, including income receipts and workers' remittances.

42. Implementation of the foreign exchange and agricultural reform measures is expected to allow Uzbekistan to achieve modest export growth. Cotton farming, which is depressed by state interference and low state procurement prices, will have improved price incentives to increase productivity and exports. A projected gradual recovery in the world market price of cotton fiber from the 2001 lows is also expected to improve the foreign exchange earnings of Uzbekistan's agricultural exporters. A less overvalued, unified exchange rate is expected to stimulate the export-oriented industries whose international competitiveness will improve. Smaller enterprises, no longer subject to export surrender requirements at an overvalued exchange rate, will particularly benefit from such measures. The Low Case scenario also assumes some decline in capital outflows as credible actions are taken to liberalize access to foreign exchange reduce distortions.

43. Such limited reforms, however, cannot increase exports sufficiently to improve Uzbekistan's debt carrying capacity. Given the heavy external debt service payments (averaging around US$ 0.9 billion annually during 2002-2005) and only modest export growth in the absence of full current account convertibility, the government will need to pursue a conservative borrowing policy. The external debt stock during 2002-2005 is expected to be stabilized at its estimated end-2001 level of about US$4.5 billion. This will permit the debt service to exports ratio, which jumped to an estimated 29 percent in 2001, to decline somewhat, although it will remain at over 20 percent of export earnings. The ratio of total external debt to exports of goods and services, which peaked at over 150 percent in 1999, is also expected to decline. Overall, provided external borrowing is prudently limited, Uzbekistan does not face an immediate solvency problem, and its creditworthiness, deteriorated in recent years, is expected to stabilize under the Low Case scenario, although international liquidity is likely to remain tight.

44. While minimal foreign exchange and agricultural reform reforms would prevent further deterioration in creditworthiness, they are not sufficient to put the economy on a sustainable growth path. Numerous obstacles to productivity growth and efficient resource allocation as well as the external financing constraint and import compression would have a depressing effect on economic growth. As a result, GDP growth, projected at around 2 percent in the Low Case, will remain below potential. In per capita terms, it will essentially stagnate, which in the longer term could put a stress on social stability. Controlling inflation under these circumstances is also likely to be problematic, and inflation as measured by the GDP deflator is assumed to remain above 20 percent per annum. The economy will also remain vulnerable to external shocks.

45. **Base Case.** If the SMP agreed with the IMF is successfully implemented and its reform momentum is maintained, and if the authorities adopt a comprehensive program of accelerated structural reforms, Uzbekistan can enjoy higher growth, better living standards and improving creditworthiness. The Base Case macroeconomic scenario assumes that such a comprehensive program of accelerated reforms is undertaken. Outlines of the Base Case scenario are summarized in Table 3.

Table 3: Base Case Macroeconomic Scenario

	Actual	Estimate		Projection		
	2000	2001	2002	2003	2004	2005
Real GDP growth (percent)	4.0	3.8	2.2	3.0	4.0	5.0
Inflation (GDP deflator, percent change)	44.3	42.8	30.3	20.0	15.0	10.0
Export GNFS volume growth (percent) [a/]	6.3	1.5	2.2	3.2	3.6	3.7
Import GNFS volume growth (percent) [a/]	-3.8	8.6	1.7	3.8	5.9	5.1
Current account balance/GDP (percent) [b/]	2.4	-0.5	-1.1	-1.1	-1.7	-1.9
Total external debt (US$ billion)	4.3	4.5	4.7	5.0	5.2	5.4
Total external debt/GDP (percent) [b/]	56.7	61.8	61.9	58.8	57.2	55.5
Total external debt/Exports GS (percent) [c/]	127.3	139.6	139.8	135.9	133.0	129.5
Total external debt service (US$ million)	904	929	903	896	886	898
Total external debt service/Exports GS (percent) [c/]	26.5	28.6	26.7	24.6	22.8	21.6
Gross international reserves (months of imports GS) [a/]	4.7	4.2	3.7	3.6	3.4	3.2
Total debt service due next year/Gross international reserves (percent)	73.0	77.9	83.0	79.3	78.9	80.3

[a/] GNFS – Goods and non-factor services.
[b/] At the indicative exchange rate.
[c/] GS – Goods and services, including income receipts and workers' remittances.

46. The Base Case will require the establishment and maintenance of a sound macroeconomic framework. This would include a tightened monetary policy consistent with bringing consumer and producer price inflation down to low double digits and a stable market-determined exchange rate, and a sustainable fiscal stance as indicated by limited consolidated budget deficits, sharply declining volume of quasifiscal transactions, and prudent public borrowing policies with external debt and debt service ratios improving compared to their current levels. In addition, the program would also further address macroeconomic and structural distortions stemming from the exchange restrictions, trade barriers, directed credit, state interference in production and marketing, quasi-fiscal operations in the energy sector, remaining barriers to private sector development, market monopolization, financial sector weaknesses, and inadequate governance and transparency.

47. The implementation of a credible reform package and financial support from multilateral and bilateral sources will improve business conditions for domestic private sector and make Uzbekistan a more attractive place for foreign investors. Foreign direct investment is projected to more than double by 2005 under the Base Case. Higher levels of private investment would lead to employment creation, productivity growth and strong exports. Increasing exports would generate foreign exchange earnings to maintain exchange rate stability via market instruments, expand essential imports and increase external borrowing to modernize the economy without jeopardizing the country's creditworthiness. The full benefits of these reforms would be seen in the medium-to-long run, but noticeable gains, notably in the agriculture sector, among SMEs and exporters, could be visible within a year. Annual economic growth under the Base Case is projected to gradually increase from 2 percent during the adjustment in 2002, to 5 percent per annum by 2005.

48. **Downside Scenario.** On the other hand, if the SMP fails and there is no further progress toward liberalization of the exchange rate and reduction of the implicit heavy agricultural taxation through state orders and low farm procurement prices, both output growth and exports are likely to be below those projected in Table 2. In this case, export volume will stagnate or continue to decline as during the past few years. This would require even further compression of imports and hence lower output growth. The maintenance of the exchange rate restrictions will discourage entry of new firms and private sector growth, adversely affecting employment. Under these circumstances, the decline in the living standards will continue and Uzbekistan's creditworthiness is likely to deteriorate further.

II. DEVELOPMENT STRATEGY AND PROGRAM

49. The government's development objective is to establish an economy that "combines fully the features of a market economy and a social economy, in order to merge the efficiency of economic advancement with social guarantees and justice."[11] The strategic objectives announced soon after independence included diversifying the economy from the cotton mono-culture to a more industrialized economy, expanding employment opportunities, and achieving energy and food security to protect the economy and population from major external shocks. The government has adopted a gradual, evolutionary approach to reforms, with an emphasis on first creating the legal and institutional foundations for economic reforms, gradually changing the ownership structure to lay the basis for a mixed economy, maintaining a strong role for the state as 'regulator' of the economy, and ensuring a strong social policy.[12] In line with the stated objectives of the government, the country achieved self-sufficiency in energy by 1995 and in wheat by 1998.

50. In early 2000, the government acknowledged that economic growth was at risk if reforms were not intensified.[13] It identified the main tasks ahead as liberalization of the economy and integration of Uzbekistan into the world economy. The priorities of further liberalization and deepening of economic reforms included reducing the state's functions and limiting its interference in enterprise economic activity, establishing the legislative framework and conditions conducive to rapid SME development and employment creation, deepening agricultural reforms, advancing financial system reforms, implementing structural transformation, and developing export potential to shift the economy from raw material exports towards finished goods exports. In line with this

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11 Karimov, I., 1993, *Building the Future: Uzbekistan – Its Own Model for Transition to a Market Economy*, Uzbekistan Publishers, Tashkent, p. 41.

12 In addition to Karimov (1993), the Government's overall development strategy and five principles of economic reform are also elaborated in Karimov, I., 1995, *Uzbekistan – Along the Road of Deepening Economic Reform*, Uzbekistan Publishers, Tashkent, especially pp. 10-11; as well as Karimov, I., 1998, *Uzbekistan on the Threshold of the Twenty-First Century*, St. Martin's Press, New York.

13 President Karimov's speech addressing Inter-ministerial Coordination Council on Reforms and Investments on February 1, 2000.

wide range of priorities, a number of decrees and resolutions were adopted during 2000-2001 that reflect the government's intention to proceed with economic reform.[14]

51. More recently, given Uzbekistan's IDA eligibility, the government has indicated its commitment to prepare a Poverty Reduction Strategy Paper (PRSP). As initial steps toward this goal, it sent delegations to participate in PRSP training workshops and seminars to learn about the process, its requirements, tools for formulating an effective and monitorable strategy, and the experiences of other countries. A working group comprising members of key ministries is expected to be formally established soon, which will outline the work program for the PRSP, including a timetable and consultative activities. The working group will also start compiling the national poverty profile, designing sectoral strategies, and conducting focus group sessions with stakeholder groups. The authorities' preparation of the PRSP will be supported by the findings of the ongoing LSA being prepared by the Bank, and by substantial technical assistance grant recently approved by the Asian Development Bank (AsDB). It is expected that an I-PRSP will be finalized in the fall and presented to the Boards of the IMF and Bank by December 2002, with a full PRSP to follow during 2004.

52. Meanwhile, the most recent statement of the government's strategic goals and its program covering 2001-03 is contained in the Cabinet of Ministers' Resolution No. 517, December 2000.[15] This builds on the president's speech to parliament earlier in the year and the "Program on liberalization and deepening of reforms in political, economic and spiritual spheres of the society, provision of national security" approved by the Presidential Decree of June 2, 2000. The priorities are:

- **Macroeconomic stability and balanced economic growth.** The government seeks to reduce inflation through tight fiscal and monetary policies. Fiscal reforms include improved budget and tax policies (shifting gradually to

[14] For example, on banking sector reform – Cabinet of Ministers' (COM) resolution of Feb. 19, 2000, "On the implementation of privatization of banks of the Republic of Uzbekistan under the World Bank's FIBL project," Presidential Decree No. UP 2564 of March 21, 2000 "On further liberalization and reform of the banking system." On privatization – COM resolution dated March 9, 2001, "On further denationalization and privatization of enterprises with participation of foreign investors in 2001-2002." On foreign trade – COM Resolution No. 261 of July 8, 2000 "On measures to increase decentralized exports of fresh fruits and vegetables in the year 2000." On the foreign exchange regime – COM Resolution of April 28, 2000, "On streamlining accounting and recording procedures related to foreign exchange and export-import operations," COM Resolution of June 22, 2001, "On measures to further liberalize the foreign exchange market," COM resolution of July 10, 2001 "On measures to organize the operation of the over-the-counter currency market," COM resolution of July 18, 2001 "On additional measures for liberalization of the OTC market," COM resolution of October 25, 2001 "On measures for unification of the exchange rates at the internal foreign exchange market". On the fiscal system – the Parliament's Resolution of Dec. 14, 2000, "On enforcing a Law of the Republic of Uzbekistan on budget system" (effective Jan. 1, 2001). On the energy sector – Presidential Decree No. UP-2812 of Feb., 22, 2001 "On furthering economic reforms in the energy sector".

[15] More details on the government's development program are contained in (i) Decree No. 296 of the Cabinet of Ministers of the Republic of Uzbekistan dated 10 June 1999 "On Measures to Implement Priority Directions of Deepening the Reforms and Transformations in the Society in the First Years of the 21st Century"; (ii) Public Investment Program 2000-2002; (iii) *National Strategy of Sustainable Development of the Republic of Uzbekistan*, approved by the National Commission of the Republic of Uzbekistan on Sustainable Development on October 30, 1999.

consumption-based taxes, expanding the tax base, simplifying taxes, rationalizing custom duty rates) and improving inter-government fiscal relations by increasing the role of local budgets. Sustainable, balanced growth is to be achieved by developing priority sectors through various policies such as improving the public investment allocation system, and providing the sectors with special tax and interest rates and other benefits. The government also envisages increasing the role of banks as intermediaries in priority sector investments.

- **Structural changes in the economy,** including sustainable operation and development of the fuel-energy complex and deepening agricultural reforms. The programs to achieve the structural changes envisage developing and modernizing selected priority industries/sectors for import-substitution and export-oriented production ("localization") through public investments and foreign resources. Another objective is to increase the processing of domestic mineral and agricultural raw materials. Comprehensive state planning is given a critical role in the government's industrial policies: in addition to preparing a medium-term investment program, the government has set a goal of putting together detailed development programs for key sectors of the economy as well as preparation of short- and medium-term material balances for main raw materials and manufactured products. Strong emphasis is also laid on the socio-economic development of the country's regions and on ensuring a stable inflow of foreign investment to the regions. In the energy sector, the program aims to attract foreign investment, develop energy-saving technologies, and promote alternative sources of energy. In the agricultural sector, the focus for the years to come is on developing and implementing the extension of the "Program for Strengthening Economic Reforms in Agriculture during 1998-2000." The basic outline of the new program envisages strengthening the autonomy of family/brigade units within agricultural cooperatives. The government also intends to encourage further the emergence of new private and *dekhan* farmers by distributing land of bankrupt collective farms and cooperatives, and improving farmers' access to rural credit, agricultural inputs, and equipment, with particular emphasis on the creation of alternative (non-state) sources of supply of agricultural machinery and inputs.

- **Formation of a mixed economy.** Better conditions for accelerated SME growth, particularly in export-oriented and import-substituting industries, is envisaged through the provision of incentives and state support to attract domestic and external financing, ensure non-discriminatory access to inputs and sales markets, and provide adequate legal protection. Plans to promote a competitive business environment include strengthening the regulation of natural monopolies and preventing their abuse of dominant market position, enforcement of sanctions against enterprises involved in unfair competition, and protection of consumer rights. *Measures to encourage development of the market infrastructure,* including market institutions and regulatory frameworks, are also being elaborated. In particular, in the banking sector, the goals are to increase capitalization and encourage entry by private and foreign banks. To expand commercial banks' resource base and increase lending, especially to priority sectors, the government is considering reforms to promote deposits through the introduction of a deposit insurance scheme and other incentives for private savings.

- **Liberalization of external economic activities and stage-by-stage liberalization of the hard currency market.** The government recognizes that liberalization of the foreign exchange regime is one of the most important conditions for stimulating exports. It plans to proceed towards current account convertibility in a phased manner.

- **Creation of a modern integrated infrastructure.** In the transport sector, the government intends to continue implementing its current program with the goal of developing domestic transportation routes that bypass neighboring countries, maintaining Uzbekistan's role as a regional transportation hub and ensuring reliable access to alternative seaports in Europe and Asia via trans-national transport corridors. The ongoing restructuring in the telecommunications sector will continue with the expected privatization of Uzbektelecom monopoly and the encouragement of competition in mobile phone and internet service provision markets to ensure Uzbekistan's access to world knowledge.

- **Sustaining improvement in living standards and strengthening social protection.** The government aims to achieve a steady rise in incomes through sustainable economic growth, regional employment/job creation programs, incentives for self-employment, micro-credits, and training programs. Social protection policies seek to improve the targeting of social protection through such measures as strengthening the use of local self-government bodies (*mahallas*), improving social assistance to vulnerable groups, and developing social infrastructure (in particular, medical service delivery for mothers and children, drinking water, and gas in the rural areas). The government also plans to encourage development of non-government pension funds.

53. **Assessment of the government program.** The government's overall goals, as outlined at independence and subsequently, are laudable. At issue, however, is the inconsistency between the vision for the country's overall development and the policies and programs being pursued, as well as the pace of reform implementation. The government's program essentially reflects a continuation of policies that have been pursued in the last four years, geared towards an industrialization strategy that relies on restriction of imports through a variety of exchange and trade controls, a large public investment program financed to a significant extent by foreign credit[16] (mainly export credits and official aid), and heavy implicit taxation of agriculture.

54. While the industrialization drive is understandable as a reaction to the narrow specialization (mono-culture, raw material orientation) of the Soviet era, international

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16 Public and publicly guaranteed foreign loans became an important source of financing of the annual investment program in recent years. Their share in total investments funded by centralized sources (state budget, public and publicly guaranteed foreign loans, extra-budgetary funds) increased from 5 percent in 1993 to 45 percent in 1999.

experience has shown that state-sponsored protectionist policies may provide short-term gains in growth and employment but that they ultimately can be very costly. Many countries that pursued import-substitution policies ended up with large unutilized capacity and an industrial structure that could not be supported. Moreover, these policies have an inherent bias against exports, reflected in the large currency overvaluation in Uzbekistan. This provides incentives to drive economic activity underground and to under-report exports. That is the more worrisome since it reduces the debt-servicing capacity of the country and makes the significant external borrowing that has accompanied industrialization less sustainable. Moreover, the industrialization is also financed through taxing agriculture via the state order system (as well as the foreign exchange surrender system for cotton exports). Raising of farm gate prices would be the most important step in poverty alleviation.

55. In addition, a general policy framework – as opposed to selective state support – that permits private sector development and the creation of new enterprises and new jobs is particularly important to absorb Uzbekistan's young, rapidly growing population. Several resolutions adopted over the last year reflect the government's intention to develop the SMEs sector, but sustainable SME development would be ensured only with economic liberalization and a competitive environment.

56. Another area of concern is continued government intervention in programming production decisions and extensive use of administrative controls, rather than reliance on economic incentives (such as prices and taxes) to influence the economy. Apart from their cost and inefficiency, direct controls imply a high degree of bureaucratic discretion and thus breed corruption.

57. The government's emphasis on creating the institutional foundation of a market economy is well-justified, but the gains from institutional changes will remain limited without fundamental reforms in the macroeconomic and structural policies that provide market-based relative price signals to economic agents, impose financial discipline on existing enterprises, and encourage the growth of new employment-generating enterprises.

58. The government, in discussions with the Bank Group and other development partners, continues to reaffirm its commitment to continuing structural reforms and gradual liberalization of the economy. In its opinion, many controls are still needed to prevent the criminalization of the economy in the face of weak or nascent market institutions, to ensure the availability of basic foodstuffs at affordable prices to maintain social stability, and to develop and promote the comparative advantage of Uzbek industry. The authorities emphasize that their difference of view with some development partners concerns not the *ultimate* objectives of its developmental agenda, but the pace and sequencing of the measures needed. While the pace and sequencing of reforms may indeed vary in some aspects, it is nevertheless important that their direction and a road map be clearly laid out and that the internal inconsistencies and constraints to implementation are removed as soon as possible. As a matter of priority, the government urgently needs to reassess its current policies and intensify implementation of those policy decisions that support the functioning of market mechanisms.

III. LESSONS FROM PAST EXPERIENCE

59. **Background**. The last CAS identified four key policy challenges where the government's reform agenda and the Bank's institutional priorities appeared to converge: (a) to liberalize the foreign exchange and trade regimes, thereby promoting *inter alia* financial sector development; (b) to strengthen the policy framework and incentives for private sector investment and trade, especially in agriculture; (c) to increase the efficiency of resource use in urban and rural infrastructure and services, including the social sectors; and (d) to address key national and, indirectly, regional environmental problems, especially in the Aral Sea Basin. It envisaged Base Case lending comprising ten operations totaling US$300-350 million. Given the government's gradual approach to structural reforms, some investment projects incorporated a pilot approach whereby reforms would be undertaken initially in a limited geographic area so that their benefits could be demonstrated first before their replication more broadly. For the same reason, three technical assistance projects were chosen for their expected contribution to longer-term institution building and development. The last CAS also included a modest program of non-lending activities, including three formal studies. IFC's activities to date and proposed strategy are summarized at paragraphs 64 and 82 below, and Annex 15.

60. **Results.** In terms of lending, five loans totaling US$136 million were approved during FY98-00 and are now being implemented. Three loans totaling US$83 million, were for investment projects (Tashkent Solid Waste Management, Health, and Urban Transport) and two totaling US$53 million were for technical assistance (Enterprise Institution Building and Financial Institution Building).[17] Thus, only half the number of operations and less than half the planned volume of lending actually materialized. Of the remaining five operations proposed: the Rural Enterprise Support Project was approved in December, 2001; the Bukhara and Samarkand Water Supply Project is presented with this CAS; the Karshi Pumping Stations Rehabilitation Project is due for negotiations very shortly; the Drainage project is under preparation; and one was dropped (Small Investment & Microcredit). Although the reasons for delay were mainly project-specific, several common issues emerged, including: insufficient political will for key reforms proposed; inadequate ownership of project content and/or design; unduly complex project design or overly ambitious policy framework; lengthy internal decision making; and, overall weak project preparation, coordination, and management. With the benefit of hindsight, it is also now apparent that the pilot approach advocated by the Bank was not always fully consistent with the government's cautious, incremental approach to structural reform; and that, given Uzbekistan's size, natural features, and almost total dependence on large-scale irrigation, the pilot approach to agricultural reform may not be practicable.

61. These delays have obviously been costly, both to Uzbekistan in terms of project benefits foregone and development effectiveness, and to the Bank in terms of the opportunity cost to its administrative budget. Moreover, the modest results achieved,

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[17] A US$75 million loan, for Rural Water Supply, Sanitation and Health, was approved in early FY98, but covered in the previous CAS.

including the limited resource transfer implied, fell short of what was foreseen. They were also not proportionate either to the size of Uzbekistan's economy and population or its regional significance within Central Asia.

62. The outcome for non-lending activities was somewhat more satisfactory. A retrospective Social and Structural Policy Review, undertaken jointly with the government, was completed during FY99 as planned and well received both within and outside Uzbekistan. Similarly, Uzbekistan's National Environmental Action Plan (NEAP), financed partly with Swiss bilateral assistance, was completed in FY99, disseminated widely throughout the country during FY00, and is now the operational framework for several ongoing externally-financed investment and technical assistance activities. In addition, a working paper on anti-monopoly and competition policy and an informal policy note on social costs of foreign exchange liberalization were completed during FY00. However, delays in launching the revised Family Budget Survey (FBS) – the object of significant German(GTZ)- and Bank-financed technical assistance – held up the Living Standards Assessment (LSA) planned for completion in FY00, and thus an update of Uzbekistan's poverty profile. Both are now well underway and the LSA is expected to be completed by early FY03. Finally, in addition to the three IDF grants originally foreseen, three additional grants were approved: for Pension Reform, jointly with an AsDB technical assistance grant; for Anti-Monopoly and Competition Policy Development; and for Environmental Management.

63. **Portfolio Performance.** Despite its modest size, portfolio performance has been problematic, with execution of the two largest investment projects (Cotton Subsector Improvement and Rural Water Supply, Sanitation and Health) and one technical assistance loan (Enterprise Institution Building) rated unsatisfactory during FY00. As a result, Uzbekistan's portfolio was slated for special attention under the Portfolio Improvement Program during FY01. Disbursements have also lagged: excluding the fully disbursed Rehabilitation Loan, cumulative disbursements totaled only US$136 million, or 43 percent of the US$313 million active portfolio, as of December 31, 2001; and, net transfers for the three years FY99-01 reached only US$12.2 million, US$13.3 million and US$16.2 million respectively. The main reasons for implementation delays are similar to those cited above for project preparation. There was also backtracking and/or insufficient progress in the overall policy environment; and, the development impact of at least two projects (Cotton Subsector Improvement and Enterprise Institution Building) is unlikely to be fully effective. Unfamiliarity with Bank procedures and the incompatibility of some government and Bank policies and procedures were also factors. Several actions have now been undertaken to improve portfolio performance. These include: (a) commencing FY00, annual Country Portfolio Performance Reviews (CPPRs); (b) an action plan for the entire portfolio as well as for individual projects; (c) enhanced implementation support by Country Office operational staff; and (d) for projects in problem status 12 months or more, a more aggressive approach to their restructuring and/or cancellation. (Annex 14 summarizes the results of the FY00 and FY01 CPPRs).

64. IFC. The 1998 CAS assumed an improving private sector business environment and thus an increase in demand for IFC lending. In the event, neither materialized and IFC's investment portfolio – totaling about US$36 million, of which US$14.2 million has

been disbursed – remains very modest. During the period, two new investments totaling US$2 million to support the development of SMEs were approved; two previous commitments totaling US$15.4 million to support manufacturing and leasing of agricultural machinery were cancelled; and two approved projects in the financial and manufacturing sectors totaling US$18.7 million were dropped. Most of the undisbursed portfolio comprises credit lines to local banks for small and medium-sized enterprises (SMEs). Given the relatively young and small portfolio, firm conclusions about performance may be premature. However, all IFC loans are current, except for one which experienced difficulties obtaining access to foreign exchange, although the project itself has generated the necessary local currency. On the other hand, despite substantial IFC technical assistance for project identification and capacity building in the financial sector, it has been difficult to identify bankable projects and to attract foreign investors.

65. MIGA's role to date and exposure in Uzbekistan has been constrained, like that of IFC, by the overall unfavorable climate for foreign direct investment (FDI). Its only transaction – a contract in the mining sector, with a US$10 million gross and net exposure – was recently cancelled.

66. **Summary.** The results of the last CAS, whether measured in terms of lending, non-lending, or portfolio performance, were uneven, and, compared to the admittedly ambitious policy goals, its impact was less than fully satisfactory. Until recently, little or no progress had been made with respect to foreign trade and currency liberalization or private sector development, and only limited gains recorded in terms of improved resource use in urban and rural infrastructure and services. On the other hand, there was some progress – *inter alia* through the GEF-financed regional Water and Environmental Management Project (WEMP) – in addressing key national (and increasingly urgent regional) environmental problems, especially water and energy in the Aral Sea Basin. The Urban Transport Project promoted and is reinforcing significant reforms in the urban passenger transport sector, which has experienced rapid growth in the number of small private operators. Similarly, the Tashkent Solid Waste Management Project is supporting improved waste collection performance and sanitary conditions in the city's residential areas, as well as important institutional development, enterprise management and tariff reforms.

67. Several important lessons have emerged from the Bank's experience to date in Uzbekistan, especially during the last CAS. These have been shared with the government authorities concerned and other stakeholders and have been factored into this third CAS. The most important are: to select only projects for which there is genuine, broad-based ownership, empowered by the political will required to implement the proposed reforms; to acknowledge explicitly that the amount of policy reform achievable within the scope or timetable of a single project may be limited; to recognize that building the consensus and understanding needed to implement even limited reforms may take a long time; and to accept that government decision making may take more time than in other countries, given complex internal procedures and institutional relationships.

IV. FY02-04 COUNTRY ASSISTANCE PROGRAM

68. **Overview.** The FY02-04 CAS seeks to reconcile several difficult strategic, policy, and operational considerations. These include, on the one hand, Uzbekistan's continued unsatisfactory overall macroeconomic framework, its uneven structural reform performance since end-1996, the recent deterioration in its creditworthiness, and, despite new, apparently improved prospects for a program of financial cooperation with the IMF during 2002, the still uncertain prospects for decisive policy change in the near term; and, on the other hand, the country's large population and economy, its strategic location, and its economic importance within Central Asia. Against this background, and overall goal of improving living standards and reducing poverty in Uzbekistan, the key objectives of the FY02-04 CAS are four-fold:

(a) to help prepare the analytical, policy and institutional framework for **liberalization of the foreign exchange and trade regime**, including related macroeconomic and structural policy measures, improved governance, and transparency of public finances;
(b) to continue to help improve the **policy framework and business environment for private sector investment and trade**;
(c) to continue to help improve the **efficiency of resource use in social and municipal infrastructure and services**, including the social sectors; and
(d) to help **maintain and improve the efficiency of the country's extensive irrigation and drainage infrastructure**, thereby preventing further environmental degradation and, in Karshi, reducing the risk of a potential humanitarian disaster with possible regional ramifications.

The CAS envisages two lending scenarios: (a) a **Low Case**, which assumes continued gradual implementation of structural reforms and no further deterioration in the macroeconomic framework; and (b) a **Base Case**, which assumes, and would be triggered by, accelerated and decisive macroeconomic and structural reforms in key areas.

69. The **Low Case**, totaling US$150 million during FY02-04, comprises five operations, including three carried over from the last CAS with crucial environmental, social and disaster prevention goals, whose effectiveness and impact will not depend directly on reform of the unsatisfactory foreign exchange and trade regime. This level of financing is only slightly more than was actually committed during FY98-00. Lending will be complemented by an enhanced package of non-lending activities centering around selected *fiduciary* and other economic and sector studies aimed at strengthening the analytical underpinnings of, and reinforcing government support for an accelerated pace of economic reform.

70. **Low Case Triggers.** As noted above, implementation of the Low Case lending program assumes continued gradual implementation of structural reforms and no further deterioration in the macroeconomic environment. Box 6 describes the monitoring indicators that will be used to evaluate progress during FY02-03 and the triggers for continued lending in FY04 and beyond. In practice, this implies that only three of the

five operations proposed – Bukhara and Samarkand Water Supply and Karshi Pumping Stations Rehabilitation and Public Finance Management Reform planned for FY03 – would be negotiated and presented to the Board by mid-CY03. Appraisal, negotiations and presentation of the remaining two operations – Drainage and Health II – would be subject to confirmation of compliance with the triggers for continued lending.

Box 6: Triggers for Low Case Lending Program

Monitoring indicators for lending during FY02-03 include:

- the stock of total external debt would not exceed the level of about US$4.8 billion;*
- foreign currency reserves would be maintained at a level sufficient to cover at least 100 percent of estimated annual debt service payments falling due during the following twelve months;
- portfolio performance would remain generally satisfactory, with at least 80 percent of projects rated fully satisfactory; and
- macroeconomic and financial data would be provided to the World Bank on a regular, timely basis.

Triggers for continued lending in FY04 , to be confirmed by July 1, 2003, include:

- progress towards unification of multiple exchange rates and liberalized access to foreign exchange by enterprises and individuals as indicated *inter alia* by:
  (a) sustained reduction in the curb market premium over the official exchange rate to less than 50 percent;
  (b) increase in the share of foreign exchange transacted through the inter-bank market; and
  (c) reduction in CBU's administrative control over the inter-bank exchange market;
- progress on key structural reforms, including a reduction in the scope of the state order system for cotton and wheat and liberalization of fruit and vegetable exports, as indicated by the following measures:
  (a) replacement of the state order system for cotton (mandatory cropping patterns, targets, and prices) by a state procurement system, under which mandatory sales to the state will not exceed 50 percent of the historical average of actual raw cotton production over the previous 3 years;
  (b) introduction of state procurement pricing for raw cotton at the level of 33 percent of the Liverpool Cotlook A Index price per ton of fiber, less costs to cover ginning and transport to final markets, currently estimated at US$300 per ton of fiber (excluding VAT). The farm gate price will be fixed in sums on the basis of the official exchange rate at the time the next season's price is announced;
  (c) extension of export permission on demand to any private purchaser of cotton and setting of foreign exchange surrender requirements for such exports at the level of decentralized exports, but no more than 50 percent; and
  (d) abolition of the requirement for commercial bank registration of fruit and vegetable export contracts and lifting of the foreign exchange surrender requirement for such exports for all farmers, traders, and other entities.

* The total external debt and debt service for the purposes of the trigger are defined in line with standard World Bank practice, i.e. external medium- and long-term public and publicly guaranteed debt, including debt in dispute, external private non-guaranteed debt, IMF credit outstanding, and short-term debt.

71. **Base Case.** If the government were to adopt an accelerated program of macroeconomic and structural reforms, including decisive liberalization of the current highly distorted foreign exchange, trade, and agricultural policy regimes, this would trigger a larger program of financial and technical assistance, namely a Base Case totaling US$300-350 million during FY02-04. Box 7 describes the additional policy actions that would be required to achieve Base Case lending – in addition to the establishment and maintenance of a sound macroeconomic framework (as defined in paragraph 46 above). Continued Base Case lending would be subject to maintenance of a

sound macroeconomic framework, to satisfactory implementation of the measures listed in Box 7, and to an overall judgment about the pace, depth and scope of the program of structural reforms. Examples of the latter would include: (a) adopting and publishing an action program to address key remaining administrative barriers to private business, based on independent survey results and monitored through periodic follow-up surveys; (b) reducing mandatory state procurement of raw cotton and wheat to no more than 30 percent of actual production, and permitting any private purchaser of wheat or cotton the unfettered right to export, using decentralized export procedures; and (c) continuing the ongoing energy sector reform program by improving the sector's structure, regulatory framework and privatization strategy and by implementing price increases for natural gas, electricity and petroleum in order to achieve cost recovery levels.

Box 7: Triggers for Base Case Lending Program

In addition to establishment and maintenance of a sound macroeconomic framework acceptable to the Bank, and compliance with the monitoring indicators for portfolio performance and provision of macroeconomic and financial data described in Box 6, eligibility for Base Case lending would require the following additional actions:

- achieve further progress towards a market-determined exchange rate by:
  - (a) unifying the official and over-the-counter (OTC) exchange rates;
  - (b) eliminating all quantitative restrictions on access to foreign exchange for enterprises and individuals;
  - (c) eliminating the foreign exchange surrender requirement for decentralized exports; and
  - (d) reducing the curb market premium over the unified exchange rate to less than 15 percent;
- promote growth of private business, including SMEs and the financial sector, by:
  - (a) eliminating restrictions on cash withdrawals and circulation; and
  - (b) eliminating directed credits;
- liberalize production, processing and sales of key agricultural crops by:
  - (a) continuing to price state procurement of raw cotton at the world market level using the formula in Box 6 except that the farm gate price will be set in US dollars and paid at the OTC exchange rate prevailing at the time of the harvest;
  - (b) introducing state procurement pricing of wheat at the world market level (as observed at the regional commodity exchanges), plus transportation costs;
  - (c) adopting and publishing a program to increase private sector participation in cotton ginning, including through privatization of majority stakes in cotton gins, and confirming that such gins will be subject to decentralized export procedures;
  - (d) adopting measures to increase user charges for supply of irrigation water to at least operation and maintenance costs of secondary and tertiary canal systems, based on actual consumption;
- strengthen the policy focus on poverty alleviation by:
  - (a) adopting an official poverty line and establishing systematic monitoring of living standards through the regular collection and analysis of data on income/consumption and non-income dimensions of poverty; and
  - (b) initiating preparation of a PRSP process, including a work plan, staffing and a timetable;
- improve public governance and transparency by:
  - (a) publishing detailed budget documents, and monetary survey, foreign trade, balance of payments and external debt statistics at least quarterly;
  - (b) agreeing to an anticorruption diagnostic surveys by an independent organization and to public dissemination of their results; and
  - (c) undertaking public financial accountability and procurement assessments in consultation with Bank staff.

72. Besides the five operations included in the Low Case, Base Case lending would comprise 3-4 additional investment operations proposed by the government, including

possible reinstatement of the Small Investment and Microcredit Fund project, a second rural enterprise support project, a possible electric power restructuring project, and a possible human resources/regional poverty alleviation project, totaling up to US$100-150 million in FY04, or later. Although the government has requested the Bank to consider budgetary financing in support of its most recent plan to achieve current account convertibility by mid-2002 (as recorded in the SMP agreed with the IMF), the Base Case as now defined does not provide for adjustment lending. If the need arises and if the government establishes a program and track record of credible macroeconomic and structural reforms supported by an IMF financial arrangement during FY02-03, management would return to Executive Directors with a CAS Update outlining the government's new program and a recommended strategic response.

73. **Financing.** Owing both to its GNI per capita – below the IDA operational threshold already for several years – and its deteriorated creditworthiness, Uzbekistan, hitherto an IBRD-only borrower, is eligible to access IDA resources. An IDA Eligibility Paper was distributed to Executive Directors on November 20, 2001. Accordingly, planned FY02-04 lending will be financed equally from IBRD and IDA sources.

74. **Detailed Description of Low Case Program.** The CAS' first objective (cf. para. 68 above) would be supported mainly through analytical work, supplemented by a proposed US$10 million technical assistance loan. Its third and fourth objectives would be supported by four investment projects totaling US$140 million, buttressed by an analytical program centering around fiduciary economic and sector work (cf. Table 4 below). The size of the lending envelope is deliberately modest because, in the current policy environment, the number of investment projects that can be achieve full development impact is limited. Accordingly, the four investment projects proposed are justified principally on environmental, poverty alleviation, social, and disaster mitigation and/or prevention grounds, and their effectiveness and impact are not dependent on the

Table 4. Low Case Lending and Non-lending Program, FY02 – 04

Lending Program

FY02	US$ m	Of which IBRD	IDA	FY03	US$ m	Of which IBRD	IDA	FY04	US$ m	Of which IBRD	IDA
- Bukhara /Samarkand Water Supply	40	20	20	- Karshi Pumping Stations Rehab.	55	30	25	- Drainage	20	10	10
				- Public Finance Mgt. Reform	10	10	0	- Health II	25	5	20
Subtotal	40	20	20		65	40	25		45	15	30
								Total FY02-04:			**150**
								Of which IBRD			**75**
								IDA			**75**

Non-Lending Program

FY02	FY03	FY04
- Living Standards Assessment (FY02-03) - Country Procurement Assessment - Country Economic Memorandum (FY02-03) - Demand-driven Policy Notes	- Country Financial Accountability Assessment - Energy Sector Review (FY03-04) - Public Expenditure Review (FY03-04) - Demand-Driven Policy Notes	- Anti-Corruption Diagnostic Survey - Demand-Driven Policy Notes

current unsatisfactory foreign exchange and trade regime. At the same time, they will enable the Bank to remain engaged as a credible developmental partner at an important stage in Uzbekistan's transition. IFC's program would complement Bank activities in private sector development under (b) above, with targeted technical assistance aimed at identifying and overcoming impediments to private sector development and building local capacity. In this context, a new IFC activity is the Swiss-financed Central Asia/Private Enterprise Partnership (PEP) program, whose first project last September was to provide financial analysis training in Ukraine to selected staff of UzbekInvestProject, designed to strengthen its capacity in investment project evaluation. More recently, PEP began a six-month field survey of Uzbekistan's SME sub sector, specifically impediments to growth and policy measures required to overcome them, the results of which are expected to be available by mid-2002.

75. **Liberalization of Foreign Exchange and Trade Regime, Improved Governance and Transparency.** Pending actual progress towards real foreign exchange and trade liberalization, Bank involvement in this key area would be entirely analytical, guided by the authorities' interest and commitment, including their willingness to make available the data required. Against this background, preparation of a *Country Economic Memorandum* is planned to start later in FY02, for completion in FY03. Second, a proposed *Public Finance Management Reform Project* (FY03) is designed to improve fiscal discipline and transparency, strategic resource allocation, and efficiency of resource use. This would be complemented by a *Public Expenditure Review* to be started in FY03 and completed in FY04. Third, a *Country Procurement Assessment* (FY02), a *Country Financial Management Assessment* (FY03), and an *Anti-Corruption Diagnostic Survey* (FY04) would be undertaken and completed. These *fiduciary studies* would contribute to improved governance and transparency and deepen the Bank's understanding in these areas.

76. **Private Sector Investment and Trade.** Until there is significant change in the macroeconomic policy environment, Bank involvement in this area would be through supervision of two ongoing technical assistance/institutional development projects (*Enterprise Institution Building Loan, Financial Institution Building Loan*). The recently approved Rural Enterprise Support Project will also be a test of the private, rural sector's response to a liberalized agricultural production, marketing, and trading environment. At the same time, IFC would continue its focus on micro enterprise and SME development and financial sector capacity building to help create true financial intermediation through the development of local financial institutions. This support will be provided by strengthening existing financial institutions through training and investment as well as through the creation of new intermediaries which will provide investment capital to micro enterprises, as well as non-banking financial services. The development of leasing, particularly micro-leasing, will be a key focus of IFC's PEP program. Direct lending to larger projects that may be economically viable under prevailing business conditions will also be considered. If the business climate improves and if privatization of banks, infrastructure, and major state enterprises accelerates, IFC would expect to provide both technical and financial support. The scope of IFC lending will ultimately depend on the pace of reform and the development of a more conducive private sector business environment.

77. **Reform in Infrastructure and Energy.** The proposed Bukhara and Samarkand Water Supply Project will help introduce international best practice public utility reforms (*inter alia* through a service contract executed by a private foreign utility operator) in two of Uzbekistan's largest cities, with expected demonstration benefits elsewhere in the country. It will also improve the level and quality of services in these two cities, especially in the poorest neighborhoods. In the **energy sector**, reform is expected to follow a two-step process: first, restructuring, which would include diagnosis of the sector, analysis of policy options, and implementation; followed by privatization, comprising valuation, tendering, negotiations, and transaction closure. The *Enterprise Institution Building Loan* will finance preparation for privatization of several energy sector-related enterprises included in the new COM Resolution No. 119 on privatization, including the necessary technical assistance and advisory services. As privatization of the sector is undertaken and strategic investors identified, IFC would work with investors and the government to structure the investments and provide the required investment capital. In addition, to understand medium- and long-term options, an *Energy Sector Review* would be initiated in FY03 and completed by FY04.

78. **Efficiency of Social Services.** The long-delayed *Living Standards Assessment* (LSA*)* would update the government, the Bank and the international donor community about recent trends in living standards in Uzbekistan, including its poverty profile and the causes and distribution of poverty. As the first-ever nationwide survey of living standards, it will help the government review its social protection/poverty reduction policies and programs which, to date, have tended to emphasize general price subsidies at the expense of more targeted assistance to those most in need. Analysis will be disaggregated by gender to the extent possible. The LSA will also provide valuable input into the preparation of Uzbekistan's PRSP. Second, a proposed *Health II Project* (FY04) is expected to continue support of the primary health care and financing reforms now underway under Health I, the main purpose of which is gradually to shift resource allocation from expensive inpatient care to more cost-effective outpatient services. IFC is already involved in a small private sector investment for the manufacture of medical supplies and pharmaceuticals and it plans to coordinate closely with the Bank in seeking similar future opportunities.

79. **Maintenance of Irrigation and Drainage Infrastructure.** To address the most urgent rural infrastructure problems – which, if unattended, could lead to humanitarian disaster and further environmental degradation – the Low Case includes an irrigation infrastructure rehabilitation project and a drainage project. The proposed *Karshi Pumping Stations Rehabilitation Project* (FY03) comprises rehabilitation of several lift pumping stations which, owing to inadequate maintenance since the early 1990s, require urgent remedial action. It would benefit the rural population in Kashkadarya Oblast, where more than 2 million people, many of them poor, depend entirely on water pumped from the Amu Darya River and delivered along the Karshi cascade for agriculture, drinking, and industrial use. It would also reduce the risks of failure of the cascade and thus of a possible social catastrophe involving the potential involuntary resettlement of over a million people in a country with little unused irrigable land. The project would also address environmental damage caused by excessive soil salinity. The proposed

Drainage Project (FY04), part of the Aral Sea Basin Program, would minimize further soil and water salinity of the Uzbekistan (right bank) side of the Amu Darya River through urgent infrastructure rehabilitation and reconstruction to improve disposal of drainage water; and also capacity building in operation and maintenance activities. The project's main beneficiaries would be over 300,000 people in the southern districts of Karakalpakstan, one of the poorest regions in the country, whose employment and incomes are threatened by increased water logging and salinity caused by inefficient operation and maintenance of existing drainage facilities. The project's environmental benefits would include improved water quality in the Amu Darya, reduced soil salinity, and enhanced biodiversity in two wetland areas/drainage lakes.

80. **Other Areas of Intervention.** In addition to these country-specific activities and operations, two global programs, the Global Environmental Facility (GEF) and Global Development Learning Network, and several regional economic and sector studies on issues common to Central Asia countries (for example, energy and water, transport and trade, community-driven development), will complement the Uzbekistan program.

81. **World Bank Institute (WBI).** WBI is undertaking a number of capacity building programs in Central Asia, including Uzbekistan, designed to improve knowledge and enhance capacity of major development stakeholders and also to support the PRSP process. Relying on its established wide network of local partners and in close collaboration with the ECA NGO Steering Committee, WBI plans to expand its civil society outreach program through national training courses and a regional workshop. It also plans to launch an "Attacking Poverty Program" involving two activities: a core course in Poverty Analysis for Policymaking and Development Debates. Governance and public sector reform issues will be addressed by WBI's Decentralization and Evaluation Capacity Building Programs. Finally, as part of its human development priority, core courses on pension reform and national seminars under the umbrella of Social Policy Reform in Transition Countries will be offered. An internet-based distance learning program is also planned.

82. **IFC.** While recent government decrees and initiatives to improve the business environment are encouraging, new direct IFC investments will continued to be limited until there is significant overall policy change. Meanwhile, IFC will continue its dialogue with the government to improve the business environment while, at the same time, implementing a strategy that focuses primarily on: (a) supporting SMEs, including micro enterprises through lines of credit to commercial banks; (b) capacity building in the financial sector through financial, including non-banking, intermediaries; (c) selected investments in sectors with significant export potential, such as natural resources, or which support the privatization process; and (d) providing technical assistance leading to new private sector investment, especially through the PEP initiative. (Details of IFC's existing and proposed FY02-04 strategy are contained in Annex 15). **MIGA** will continue to facilitate foreign investments in the country.

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[18] In the past two years, more than 500 participants from central and local governments, academia and civil society attended WBI training programs in the thematic areas of labor market, social sector, health sector reform, basics of market economy, intergovernmental fiscal relations, macroeconomic management, trade policy and WTO accession, corporate governance, and distance learning.

83. **Performance Indicators.** The Bank Group has agreed with the government on a set of country performance indicators designed to monitor progress toward meeting the four key objectives of the CAS (Table 5 below). For its own portfolio, the Bank will continue the practice of annual CPPRs and semi-annual mini-CPPRs. It will also continue regular consultations with other donors and members of civil society, and incorporate feedback from these parties, as well as from the government, in updating the strategy as circumstances dictate.

Table 5. PERFORMANCE INDICATORS

	Government benchmarks	Bank benchmarks
Poverty	• Poverty Reduction Strategy Paper. Poverty monitoring system in place.	• Poverty Assessment completed.
Macro and Governance	• Reduction of tax burden and improvement of tax incentives through the shift of taxation from production to consumption and simplification of tax and custom tariff system. • Reduction of inflation through reduction in the Central Bank's budget financing to no more than 0.5% of GDP, and an increase in the Central Bank's refinancing rate to the positive level in real terms. • Continued timely servicing of external debt with zero arrears accumulation.	• Increase in transparency, quality, and public availability of economic data. • Improvement in public expenditure as stipulated in the Public Finance Management Reform Project. • Gradual liberalization of access to foreign exchange for enterprises and individuals. • Completion of "fiduciary ESWs"
Social Sectors	• Capacity building in 3 regions for replication of health sector restructuring in remaining rayons/subregions • Implementation of new medical education curricula for General Practice physicians and universal nurses • Health sector rationalization plans developed and implemented in each region annually	• Increase numbers of pregnant women receiving tetanus immunization • Increase coverage of infants receiving hepatitis B vaccine • Capitation (1 line payment) fully implemented in pilot rayons for SVPs (primary health care facilities) • Placement of trained physicians and nurses in rural SVPs.
Rural/Agriculture	• Replacement of the state order system for cotton and wheat by a state procurement system, under which obligatory sales to the state will not exceed 50 percent of actual production.	• Preparation of a draft enactment regarding subrogation with respect to land use rights pledged as collateral. • Increase average quote for Uzbek cotton exported by 5% in value terms (relative to the average of the quotes for the other cotton traded by other major cotton-exporting countries traded on international exchanges).
Infrastructure	• Vodokanals of Bukhara, Samarkand, Urgench, and Nukus to increase revenue collection to cover operation and maintenance costs. • Involvement of private sector in the management and operation of vodokanals as stipulated in the Bukhara and Samarkand Water Supply Project	• Improve quality and access of water supply services to 1.1 million people living in urban areas (12% of urban population) and 1 million people living in rural areas (6.5% of rural population). • Improvement of the decentralization and financial policies in the municipal water sector as stipulated in the Bukhara and Samarkand Water Supply Project.
Private Sector Development	• Increase competition between commercial banks and boost efficiency and innovation of banking system by reduced market concentration; decreased sectoral segmentation of existing banks. • Improve prudential regulations and strengthen the supervision capacity of the Central Bank of Uzbekistan (CBU), including strengthened reporting capacity of the commercial banks and improved skills and organization of the Supervision Department of the CBU.	• Successful implementation of 15 enterprise plans and sale of 5 large scale firms to strategic investors. • Preparation/restructuring of two selected Uzbek banks for privatization.
Environment	• New procedures and guidance for reviewing environmental assessments and complying with environmental assessment and pollution control laws and regulations	• Preparation and adoption of revised policies, regulations, procedures, and/or guidance for improved compliance with environmental laws. • Increased public participation in environmental decision making
Implementation		• Improved disbursement ratios; development objectives met for all projects.

84. **Aid Coordination and Development Partners.** External aid and foreign direct investment is coordinated by the Cabinet of Ministers' Department for Coordination of External Economic Activity (DCEEA). The principal multilateral institutions involved in Uzbekistan are: AsDB, EBRD, EU-TACIS, and several UN Agencies (UNDP, UNDCCP, UNFPA, UNHCR, UNICEF, and WHO) (see also Annex 11). The main bilateral donors include: France, Germany (GTZ and KfW), Japan (JBIC and JICA), Kuwait (KFAED), Korea, Switzerland, and the United States. Except for Germany (KfW), Japan (JBIC), Kuwait (KFAED) and Korea, who all provide modest capital aid, most donor financing consists of technical assistance only. The key international NGOs active in Uzbekistan include: Counterpart Consortium, Eurasia Foundation, ICRC, Joint Development Associates (JDA), Mercy Corps, Open Society/Soros Foundation, NOVIB, and World Concern. The Bank enjoys close working relations with all these donors, mainly through their representatives in Tashkent. Bank coordination with the IMF, AsDB, and EBRD has been particularly close.

85. There has been no meeting of the Consultative Group for Uzbekistan since 1994, but formal and informal donor meetings for coordination and information sharing are frequent in-country. Theme meetings in Tashkent, whereby each donor coordinates a subject area or sector reflecting its comparative advantage, provide another forum for coordination. The Bank coordinates groups for the environment and financial sectors, and chairs the UN/UNAIDS Theme Group for HIV/AIDS.

V. CREDITWORTHINESS AND RISKS

86. With external debt doubling, debt service almost tripling and exports significantly lower since 1996, Uzbekistan's creditworthiness has weakened recently, affecting its ability to attract external financing from commercial sources on favorable terms. This also reflects uneven macroeconomic policy performance and the slow, uncertain pace of structural reforms, particularly the liberalization of the foreign exchange regime. In addition, the economy has become more susceptible to exogenous shocks such as droughts and commodity price declines. However, Uzbekistan's currently comfortable foreign exchange reserves (US$1.2 billion at end-2001) have so far helped it offset transitory shocks. It also has a large export potential, and a number of its products – gold, cotton, energy, and minerals – are highly valued in the international markets. Recognizing that the costs of maintaining status quo are rising with time and creditworthiness is suffering as a result, the authorities have recently tightened external borrowing and agreed on an SMP with the IMF. If the SMP is successfully implemented and a comprehensive program of accelerated reform follows, Uzbekistan's debt carrying capacity and creditworthiness are expected to improve. If, on the other hand, reforms lag, the government will be expected to limit new external borrowing so as to ensure no further deterioration in creditworthiness.

87. Nevertheless, Uzbekistan faces important short- and medium-term risks:

- <u>Credibility of reforms and inadequate adjustment</u>. For political reasons or otherwise, the government has not always followed through on announced reform, thereby compromising its credibility. A track record of consistent, comprehensive reforms will be essential if investors' perceptions are to be changed and if the full benefits of reforms envisioned under the SMP and beyond realized. Partial reform implementation and incomplete macroeconomic adjustment would pose a particular risk in the Base Case. For example, with the lifting of administrative restrictions on foreign trade, a failure to let the exchange rate adjust to market fundamentals may result in imports surge and an unsustainable increase in external financing needs.

- External vulnerability. Uzbekistan's economy remains poorly diversified, with primary commodities accounting for about 90 percent of exports. Thus, world commodity price fluctuations, especially of cotton and gold, affect export earnings. Uzbekistan is also vulnerable to an increase in international interest rates, given its recent dependence on external commercial borrowing.

- Fiscal and governance. While the budget has been kept in reasonable balance, it relies to a large extent on taxing state enterprises while providing off-budget subsidies to selected enterprises. There are at least three emergent risks: (a) that liabilities would fall on the budget once enterprise distress is translated into inability to service publicly guaranteed external and domestic debt; (b) that, with a deepening of enterprise reform and hardening of budget constraints, state enterprises may not be able to provide the current level of tax revenues; and (c) that an increase in balance of payments pressures could prompt further rationing of foreign exchange, leading to increased rent-seeking and government corruption.

- Financial sector vulnerability. As a result of pervasive state intervention and slow progress in restructuring and privatization, potentially serious problems exist in terms of the management, asset quality, financial soundness, and viability of Uzbekistan's banks. Moreover, the banking system is highly exposed to shocks, including the possible adverse impact of exchange rate unification. Given the high level of on-lending by commercial banks, widespread enterprise defaults could trigger a collapse of the financial system.

88. At December 2001, Uzbekistan's obligation to IBRD was US$237 million, about 0.2 percent of the total IBRD portfolio. However, as noted above, Uzbekistan's creditworthiness has recently weakened, and its Atlas GNI per capita has been below the IDA operational threshold for several years. In 2000, Atlas GNI per capita is estimated at US$620 and is expected to decline in dollar terms for the next few years. Based on income and creditworthiness considerations, the current CAS will limit the Bank Group's additional exposure to Uzbekistan during FY02-04 to US$150 million in the Low Case and to US$300-350 million in the Base Case, with a 50/50 Bank/IDA blend. [An IDA Eligibility Paper was distributed to Executive Directors on November 20, 2001 (IDA/SecM2001-0681]. Meanwhile, the CAS assumes that, at a minimum, the macroeconomic framework will not deteriorate and that the government will stabilize external debt stock. Given the risks, Bank staff will pay particular attention to monitoring the overall economic situation, especially the level and profile of external

borrowing, movements in the parallel exchange market premium, and foreign currency reserves.

VI. CAS PARTICIPATORY AND CONSULTATION PROCESS

89. In preparing the CAS, an outline of key issues was distributed in mid-CY00 and formed the background for initial discussions with the government led by the Country Director. An inter-ministerial working group, chaired by the Deputy Minister of Macroeconomics and Statistics, was formally established in July 2000, which subsequently prepared detailed comments on the draft CAS itself in early 2001. At the same time, the Deputy Prime Minister responsible for economic policy wrote to the Bank, expressing the authorities' concerns about the Bank's overall assessment and also the single Low Case lending scenario then proposed. In reply, a high-level Bank team led by ECA's then Chief Economist visited Tashkent in July 2001 for an additional round of CAS discussions. Given reforms to the foreign exchange regime then underway and in prospect, it was decided to postpone completion of the CAS until early 2002, partly to assess their impact and partly to provide additional time for the authorities' to establish a track record. Follow-up discussions continued in October 2001, during the Regional Vice President's visit to Tashkent, and in November 2001, during a visit by the Deputy Prime Minister to Washington. Unfortunately, despite this extended and extensive consultation process, the Bank's and the government's views about the country's recent macroeconomic performance and prospects, and also its deteriorated creditworthiness, still do not fully coincide.

90. As far as broader consultation and participation are concerned, Uzbekistan's civil society and institutions, including its parliament, media, and the small number of genuinely independent NGOs are still evolving. Given the high degree of governmental influence, in some cases control, of many aspects of the country's economy, CAS consultations with civil society posed special challenges. Notwithstanding these constraints, the Country Office, in addition to its continuous dialogue with members of parliament, media representatives, local and international NGOs, and members of the international development and investment community in Tashkent, arranged a series of CAS-specific consultations in late April/early May 2001, using a draft Executive Summary and the country manager's oral briefing as the framework.

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President

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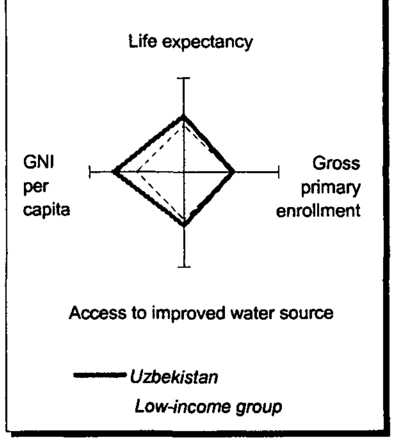
Washington, D.C.
February 22, 2002

Uzbekistan at a glance

1/17/02

POVERTY and SOCIAL	Uzbekistan	Europe & Central Asia	Low-income
2000			
Population, mid-year *(millions)*	24.7	475	2,459
GNI per capita *(Atlas method, US$)*	620	2,010	420
GNI *(Atlas method, US$ billions)*	15.3	956	1,030
Average annual growth, 1994-00			
Population *(%)*	1.6	0.1	1.9
Labor force *(%)*	2.7	0.6	2.4
Most recent estimate (latest year available, 1994-00)			
Poverty *(% of population below national poverty line)*	..	..	..
Urban population *(% of total population)*	37	67	32
Life expectancy at birth *(years)*	70	69	59
Infant mortality *(per 1,000 live births)*	19	21	77
Child malnutrition *(% of children under 5)*	19	..	..
Access to an improved water source *(% of population)*	85	90	76
Illiteracy *(% of population age 15+)*	1	3	38
Gross primary enrollment *(% of school-age population)*	100	100	96
Male	100	101	102
Female	100	99	86

Development diamond*

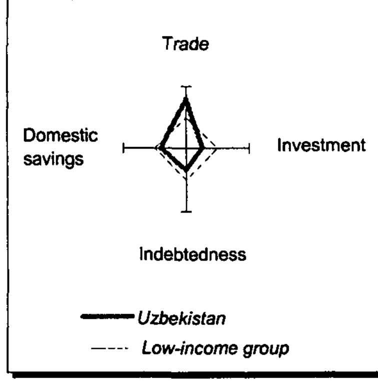


KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1980	1990	1999	2000
GDP *(at indicative exchange rate, US$ billion*	..	..	8.7	7.7
Gross domestic investment/GDP	..	32.2	17.8	11.1
Exports of goods and services/GDP	..	28.8	35.7	44.1
Gross domestic savings/GDP	..	13.2	17.3	16.6
Gross national savings/GDP	..	..	15.9	13.5
Current account balance/GDP	..	..	-1.9	2.4
Interest payments/GDP	..	..	2.0	3.2
Total debt/GDP	..	..	54.6	56.7
Total debt service/exports	..	..	17.7	26.5
Present value of debt/GDP	..	..	54.7	56.1
Present value of debt/exports	..	..	151.5	125.9

	1980-90	1990-00	1999	2000	2000-04
(average annual growth)					
GDP	..	-0.5	4.4	4.0	2.4
GDP per capita	..	-2.4	2.9	2.9	1.0
Exports of goods and services	..	-1.2	-8.1	9.2	4.3

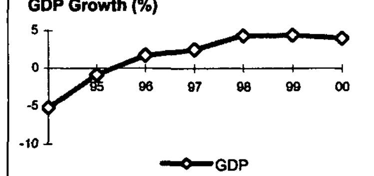
Economic ratios*



STRUCTURE of the ECONOMY

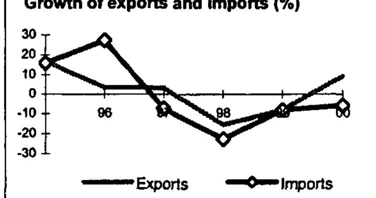
	1980	1990	1999	2000
(% of GDP)				
Agriculture	..	32.8	33.5	34.9
Industry	..	33.0	24.6	23.0
Manufacturing	..	..	10.5	9.7
Services	..	34.3	41.9	42.1
Private consumption	..	61.4	62.1	63.7
General government consumption	..	25.4	20.6	19.7
Imports of goods and services	..	47.8	36.3	38.6

GDP Growth (%)



	1980-90	1990-00	1999	2000
(average annual growth)				
Agriculture	..	0.1	5.9	3.2
Industry	..	-3.2	4.0	1.9
Manufacturing	..	..	..	..
Services	..	0.3	3.7	6.0
Private consumption	..	..	..	..
General government consumption	..	..	..	..
Gross domestic investment	..	..	..	..
Imports of goods and services	..	-3.3	-8.0	-5.8

Growth of exports and imports (%)

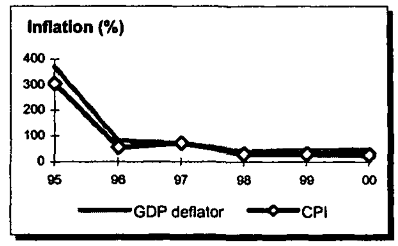


Note: 2000 data are preliminary estimates.

* The diamonds show four key indicators in the country (in bold) compared with its income-group average. If data are missing, the diamond will be incomplete.

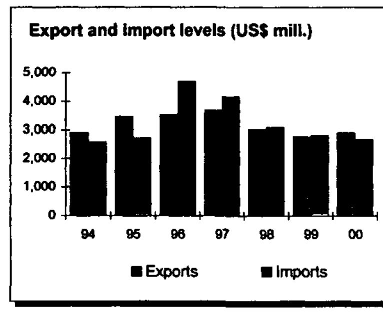
PRICES and GOVERNMENT FINANCE

	1980	1990	1999	2000
Domestic prices				
(% change)				
Consumer prices	..	3.1	29.1	25.0
Implicit GDP deflator	..	4.0	44.0	44.3
Government finance				
(% of GDP, includes current grants)				
Current revenue	..	..	29.3	28.5
Current budget balance	..	..	4.7	5.5
Overall surplus/deficit	..	..	-2.6	-2.1



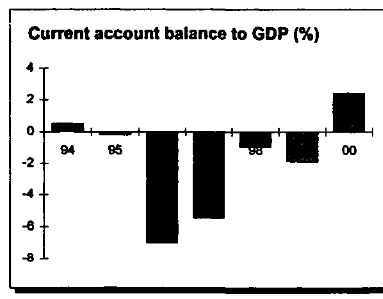
TRADE

	1980	1990	1999	2000
(US$ millions)				
Total exports (fob)	..	..	2,790	2,935
Cotton fiber	..	..	833	897
Gold	..	..	810	809
Manufactures	..	..	205	205
Total imports (cif)	..	..	2,841	2,696
Food	..	..	408	361
Fuel and energy	..	..	67	113
Capital goods	..	..	1,394	1,044
Export price index *(1995=100)*	..	..	79	88
Import price index *(1995=100)*	..	..	92	93
Terms of trade *(1995=100)*	..	..	86	95



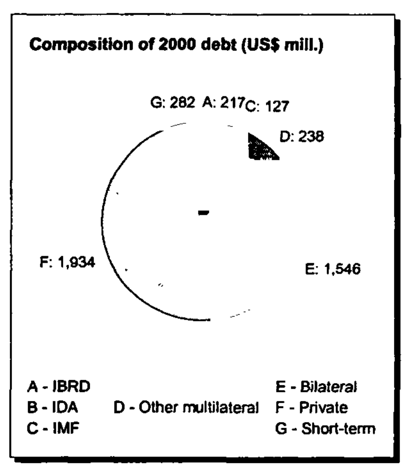
BALANCE of PAYMENTS

	1980	1990	1999	2000
(US$ millions)				
Exports of goods and services	..	..	3,099	3,383
Imports of goods and services	..	..	3,144	2,962
Resource balance	..	..	-45	422
Net income	..	..	-168	-251
Net current transfers	..	..	49	13
Current account balance	..	..	-164	184
Financing items (net)	..	..	263	-87
Changes in net reserves	..	..	-99	-97
Memo:				
Reserves including gold *(US$ millions)*	..	..	1,242	1,273
Indicative exchange rate *(local/US$)*	..	..	245.6	416.7



EXTERNAL DEBT and RESOURCE FLOWS

	1980	1990	1999	2000
(US$ millions)				
Total debt outstanding and disbursed	..	..	4,737	4,344
IBRD	..	..	203	217
IDA	..	..	0	0
Total debt service	..	..	555	904
IBRD	..	..	12	17
IDA	..	..	0	0
Composition of net resource flows				
Official grants	..	..	15	16
Official creditors	..	..	380	240
Private creditors	..	..	689	-75
Foreign direct investment	..	..	121	75
Portfolio equity	..	..	0	0
World Bank program				
Commitments	..	..	25	29
Disbursements	..	..	28	31
Principal repayments	..	..	1	5
Net flows	..	..	27	26
Interest payments	..	..	11	12
Net transfers	..	..	16	14



ANNEX 2 (B2)

Uzbekistan: Selected Indicators* of Bank Portfolio Performance and Management

As of 01/18/2002

Indicator	1999	2000	2001	2002
Portfolio Assessment				
Number of Projects Under Implementation a	7	8	7	8
Average Implementation Period (years) b	2.1	2.7	3.2	3.2
Percent of Problem Projects by Number a, c	28.6	37.5	14.3	12.5
Percent of Problem Projects by Amount a, c	52.4	56.7	10.1	8.9
Percent of Projects at Risk by Number a, d	42.9	50	42.9	50
Percent of Projects at Risk by Amount a, d	63.6	66.8	47.7	51.7
Disbursement Ratio (%) e	12.4	12	16.2	12.8
Portfolio Management				
CPPR during the year (yes/no)	Yes	Yes	Yes	No
Supervision Resources (total US$)	747	860	640	754
Average Supervision (US$/project)	106.7	107.5	91	107.7

Memorandum Item	Since FY 80	Last Five FYs
Proj Eval by OED by Number	3**	2**
Proj Eval by OED by Amt (US$ millions)	182	22
% of OED Projects Rated U or HU by Number	50	0
% of OED Projects Rated U or HU by Amt	88	0

a. As shown in the Annual Report on Portfolio Performance (except for current FY).
b. Average age of projects in the Bank's country portfolio.
c. Percent of projects rated U or HU on development objectives (DO) and/or implementation progress (IP).
d. As defined under the Portfolio Improvement Program.
e. Ratio of disbursements during the year to the undisbursed balance of the Bank's portfolio at the beginning of the year: Investment projects only.

* All indicators are for projects active in the Portfolio, with the exception of Disbursement Ratio, which includes all active projects as well as projects which exited during the fiscal year.

** One of the evaluated projects was not rated.

ANNEX 3 (B3)

Uzbekistan: IBRD/IDA Program Summary

As of 01/18/2002

Proposed IBRD/IDA Low-Case Lending Program [a]

Fiscal year	*Proj ID*	*US$(M)*	*Strategic Rewards [b] (H/M/L)*	*Implementation Risks [b] (H/M/L)*
2002	BUKHARA/SAMARKAND WATER SUPPLY	40.0	H	M
	RURAL ENTERPRISE SUPPORT[c]	36.1	H	H
	Result	**76.1**		
2003	PUB FIN MGMT REFORM	10.0	H	M
	KARSHI PUMPING STATIONS REHAB	55.0	M	M
	Result	**65.0**		
2004	DRAINAGE	20.0	M	M
	HEALTH 2	25.0	M	M
	Result	**45.0**		
Overall result		**186.1**		

a. This table presents the proposed program for the next three fiscal years.

b. For each project, indicate whether the strategic rewards and implementation risks are expected to be high (H), moderate (M), or low (L).

c. Rural Enterprise Support Loan is a carry-over from FY98-00 CAS and is not part of the US$ 150 mn. FY02-04 Low Case lending envelope.

ANNEX 4 (B3)

Uzbekistan: IFC and MIGA Program Summary, FY 1999-2002

	1999	2000	2001	2002
IFC approvals (US$m)	**44.3**	**2.0**	**3.0**	**0.0**
Sector (%)				
FINANCE & INSURANCE	68.0	15.0	100.0	
FOOD & BEVERAGES				
INDUSTRIAL & CONS PROD	32.0			
NONMETALLIC MINERAL		85.0		
Total	**100.0**	**100.0**	**100.0**	**0.0**
Investment instrument(%)				
Loans	97.0	64.0		
Equity	3.0	15.0		
Quasi-Equity		21.0	100.0	
Other				
Total	**100.0**	**100.0**	**100.0**	**0.0**
MIGA guarantees (US$m)	**10.0**	**10.0**	**0.0**	**0.0**

ANNEX 5 (B4)

Uzbekistan: Summary of Non-lending Services

Product	*Completion FY*	*Cost (US$000)*	*Audience*[a]	*Objective*[b]
ESW:				
Recent Completions				
Social and Structural Policy Report	FY00	199.0	G, B, D	KG, PS
Economic Note I (Social Cost of Currency Convertibility)	FY00	13.5	G, B, D	KG, PS
Economic Note II (Competition Policy)	FY00	25.0	G, B, D	KG, PS
Economic Note III (Assessment of Foreign Exchange Regime)	FY01/02	9.6	G, B, D	KG,PS
Country Assistance Strategy	FY02	399.2	G, B, D	PD
Underway				
Living Standards Assessment	FY02	264.0	G, B, D	KG,PS
Country Procurement Assessment	FY02	81.0	G, B, D	KG,PS
Community Driven Development	FY02	18.0	G, B, D	KG,PS
Country Economic Memorandum	FY03	292.0	G, B, D	KG, PS
Planned				
Country Financial Accountability Assessment	FY03	157.0	G, B, D	KG, PS
Public Expenditure Review	FY04	300.0	G, B, D	KG, PS
Demand-Driven Policy Notes	FY03/04	60.0	G, B, D	KG, PS
Energy Sector Review	FY04	214.0	G, B, D	KG, PS
Anti-Corruption Diagnostic Survey	FY04	100.0	G, B, D	KG, PD, PS
IDF Activities:				
Economic Statistics	FY01	80.8	G, B	KG, PS
Economic Policy Analysis	FY01	38.8	G, B	KG, PS
Public Procurement	FY01	80.1	G, B, P	KG, PS
Competition Policy	FY02	24.1	G, B	KG, PS
Environmental Management	FY03	56.0	G, B	KG, PS

a. Government (G), donor (D), Bank (B), public dissemination (P).

b. Knowledge generation (KG), public debate (PD), problem-solving (PS)

Uzbekistan: Social Development Indicators

	Latest single year			Same region/income group	
	1970-75	1980-85	1993-00	Europe & Central Asia	Low-income
POPULATION					
Total population, mid-year (millions)	13.9	18.1	24.7	474.7	2,458.7
Growth rate (% annual average for period)	3.0	2.5	1.8	0.1	1.9
Urban population (% of population)	39.1	40.7	36.9	66.8	31.9
Total fertility rate (births per woman)	5.7	4.7	2.7	1.6	3.7
POVERTY					
(% of population)					
National headcount index	..	..	..	..	..
Urban headcount index	..	..	..	..	..
Rural headcount index	..	..	..	..	..
INCOME					
GNI per capita (US$)	..	..	620	2,010	420
Consumer price index (1995=100)	..	..	548	182	138
Food price index (1995=100)	..	..	..	..	..
INCOME/CONSUMPTION DISTRIBUTION					
Gini index	..	..	33.3	..	..
Lowest quintile (% of income or consumption)	..	..	7.4	..	..
Highest quintile (% of income or consumption	..	..	40.9	..	..
SOCIAL INDICATORS					
Public expenditure					
Health (% of GDP)	..	..	3.4	4.3	1.2
Education (% of GNI)	..	..	7.7	5.1	3.3
Social security and welfare (% of GDP)	..	..	..	8.8	..
Gross primary school enrollment rate					
(% of age group)					
Total	..	..	100	100	96
Male	..	..	100	101	102
Female	..	..	100	99	86
Access to improved water source					
(% of population)					
Total	..	..	85	90	76
Urban	..	..	96	95	88
Rural	..	..	78	82	70
Immunization rate					
(% under 12 months)					
Measles	..	..	96	97	64
DPT	..	..	99	97	70
Child malnutrition (% under 5 years)	..	..	19	..	..
Life expectancy at birth					
(years)					
Total	..	68	70	69	59
Male	..	65	66	64	58
Female	..	71	73	73	60
Mortality					
Infant (per 1,000 live births)	..	45	19	21	77
Under 5 (per 1,000 live births)	..	..	29	26	116
Adult (15-59)					
Male (per 1,000 population)	254	219	227	289	288
Female (per 1,000 population)	147	116	125	127	258
Maternal (per 100,000 live births)	..	..	21	..	..
Births attended by skilled health staff (%)	..	..	98	..	..

Note: 0 or 0.0 means zero or less than half the unit shown. Net enrollment ratios exceeding 100 indicate discrepancies between the estimates of school-age population and reported enrollment data. Latest year for access to improved water source data is 2000.

2001 World Development Indicators CD-ROM, World Bank

ANNEX 7 (B6)

Uzbekistan: Key Economic Indicators

Indicator	Actual 1996	1997	1998	1999	2000	Estimate 2001	Projected 2002	2003	2004
National accounts (as % of GDP)									
Gross domestic product[a]	100	100	100	100	100	100	100	100	100
Agriculture	26	32	31	34	35	34	34	35	35
Industry	30	26	26	25	23	22	22	22	22
Services	43	42	43	42	42	43	43	43	43
Total Consumption	77	81	84	83	83	87	85	84	84
Gross domestic fixed investment	29	23	17	18	11	11	13	13	13
Government investment	7	7	7	7	6	5	5	5	5
Private investment	22	15	10	11	5	7	9	8	8
Exports (GNFS)[b,c]	28	37	31	36	44	44	49	49	49
Imports (GNFS)[b,c]	34	41	32	36	39	42	47	46	45
Gross domestic savings	23	19	16	17	17	13	15	16	16
Gross national savings[d]	22	17	16	16	13	11	13	13	14
Memorandum items									
Gross domestic product (US$ million)[c]	13,949	10,706	10,715	8,669	7,666	7,338	6,840	7,408	7,825
GNP per capita (US$, Atlas method)[e]	1,010	1,010	870	720	620	550	410	340	310
Real annual growth rates (%, calculated from the previous year's prices)									
Gross domestic product at market prices	1.7	2.5	4.3	4.4	4.0	3.8	2.0	2.0	2.0
Real annual per capita growth rates (%, calculated from the previous year's prices)									
Gross domestic product at market prices	-0.2	0.6	2.6	2.9	2.9	2.4	0.7	0.7	0.7
Balance of Payments (US$ millions)									
Exports (GNFS)[b]	3,862	3,987	3,372	3,099	3,383	3,217	3,351	3,616	3,802
Merchandise FOB	3,534	3,695	3,048	2,790	2,935	2,755	2,855	3,082	3,240
Imports (GNFS)[b]	4,767	4,424	3,417	3,144	2,962	3,074	3,233	3,427	3,560
Merchandise FOB	4,240	3,767	2,938	2,587	2,441	2,479	2,608	2,771	2,884
Resource balance	-905	-437	-45	-45	422	143	118	189	242
Net current transfers	-2	29	43	49	13	33	32	34	34
Current account balance	-980	-584	-103	-164	184	-33	-63	16	68
Net private foreign direct investment	90	167	140	121	75	76	83	88	92
Long-term loans (net)	655	165	627	1,069	165	234	7	25	36
Official	229	32	207	380	240	75	117	83	102
Private	426	133	420	689	-75	159	-110	-58	-66
Other capital (net, incl. errors & omissions)	185	-229	-663	-927	-327	-336	-93	-96	-172
Change in reserves[f]	50	480	-1	-99	-97	59	66	-33	-25
Memorandum items									
Resource balance (% of GDP)	-6.5	-4.1	-0.4	-0.5	5.5	1.9	1.7	2.6	3.1
Annual value growth rates									
Merchandise exports (FOB)	1.7	4.6	-17.5	-8.5	5.2	-6.1	3.6	7.9	5.1
Principal primary commodities[g]	3.5	-2.4	-16.8	-8.8	1.3	-12.9	-1.9	6.6	4.9
Merchandise imports (CIF)	71.5	-11.2	-25.4	-9.1	-5.1	1.4	5.1	6.1	4.0

(Continued)

Uzbekistan: Key Economic Indicators
(Continued)

Indicator	Actual					Estimate	Projected		
	1996	1997	1998	1999	2000	2001	2002	2003	2004
Public finance (as % of GDP at market prices)[h]									
Current revenues	34.3	30.3	31.2	29.3	28.5	27.1	28.6	28.2	28.2
Current expenditures	30.8	25.1	26.7	24.6	23.0	22.8	24.6	23.6	23.6
Current account surplus (+) or deficit (-)	3.4	5.2	4.5	4.7	5.5	4.3	4.0	4.6	4.6
Capital expenditure	10.8	7.4	7.8	7.4	7.8	6.7	7.1	7.0	6.9
Overall budget deficit	-7.3	-2.2	-3.3	-2.6	-2.3	-2.4	-3.2	-2.4	-2.2
Monetary indicators									
M2/GDP	21.0	17.5	15.4	13.6	12.4	11.8	11.8	12.1	12.4
Growth of M2 (%)	113.3	45.6	28.1	32.1	37.1	40.7	32.9	35.8	30.7
Private sector credit growth / total credit growth (%)	57.3	136.2	92.5	89.5	108.2	95.7	95.8	90.6	90.7
Prices									
Indicative exchange rate (US$/LCU)[i,j]	40.1	91.2	132.2	245.6	416.7	645.3	920.0	1,126.4	1,359.7
Consumer price index (% change)[j]	54.0	70.9	29.0	29.1	25.0	27.2	28.3	30.2	25.1
GDP deflator (% change)	81.6	70.5	39.0	44.0	44.3	42.8	30.3	30.0	25.0

a. GDP at factor cost
b. "GNFS" denotes "goods and nonfactor services."
c. At the indicative exchange rate. The indicative rate is a weighted average of official rate (60%), commercial bank/OTC rate (10%), and curb market rate (30%). For 1996 when the multiple exchange rate practice was less pronounced, the official exchange rate was used.
d. Includes net unrequited transfers excluding official capital grants.
e. Prior to the switch of Atlas GNI per capita calculations for Operational Guidelines to the official exchange rate in 2000, a synthetic conversion factor was used.
f. Includes use of IMF resources. A negative sign means an increase.
g. Gold, cotton fiber, and energy (mainly electricity)
h. Consolidated central and local government. Operations of extrabudgetary funds and quasifiscal operations of the government are excluded due to lack of reliable information.
i. "LCU" denotes "local currency units."
j. Period average

ANNEX 8 (B7)

Uzbekistan: Key Exposure Indicators

Indicator	Actual			Estimate			Projected		
	1996	1997	1998	1999	2000	2001	2002	2003	2004
Total debt outstanding and disbursed (TDO) (US$m)[a]	2,389	2,778	3,221	4,737	4,344	4,533	4,519	4,523	4,537
Debt to Russian Federation[b]	501	501	501	501	501	501	501	501	501
Short-term debt	92	419	147	626	282	282	282	282	282
Net disbursements (US$m)[a]	621	492	352	1,523	-244	188	-15	3	14
Total debt service (TDS) (US$m)[a]	302	512	350	555	904	929	924	897	871
Debt and debt service indicators (%)									
TDO/XGS[c]	61.3	69.5	94.4	151.3	127.3	139.6	133.8	124.3	118.6
TDO/GDP	17.1	25.9	30.1	54.6	56.7	61.8	66.1	61.1	58.0
TDS/XGS	7.7	12.8	10.2	17.7	26.5	28.6	27.3	24.7	22.8
Concessional/TDO	25.7	7.4	12.1	15.3	19.7	19.9	21.7	23.0	24.1
IBRD exposure indicators (%)									
IBRD DS/public DS	3.5	2.1	3.0	2.4	2.4	3.7	3.7	4.6	5.4
Preferred creditor DS/public DS (%)[d]	9.0	19.2	7.8	11.2	18.7	18.5	15.3	16.6	18.0
IBRD DS/XGS	0.3	0.3	0.3	0.4	0.5	0.9	0.9	1.0	1.1
IBRD TDO (US$m)	155	155	177	203	217	237	264	291	310
Share of IBRD portfolio (%)	0.1	0.1	0.1	0.2	0.2	0.2	0.2	0.3	0.3
IDA TDO (US$m)	0	0	0	0	0	0	4	15	31
IFC									
Loans	0	0	3	5	6	11	11	12	14
Equity and quasi-equity[e]	1	3	3	3	3	3	3	3	3
MIGA									
MIGA guarantees (US$m)	10	10	10	10	10	0	0	0	0

a. Includes public and publicly guaranteed debt, private nonguaranteed, use of IMF credits and net short-term capital.

b. In dispute since 2000.

c. "XGS" denotes exports of goods and services, including workers' remittances.

d. Preferred creditors are defined as IBRD, IDA, the regional multilateral development banks, the IMF, and the Bank for International Settlements.

e. Includes equity and quasi-equity types of both loan and equity instruments.

ANNEX 9 (B8)

Uzbekistan: Operations Portfolio (IBRD/IDA and Grants)

As of 02/14/2002

Closed Projects	3

IBRD/IDA

Total Disbursed (Active)	119.10
of which has been repaid	3.66
Total Disbursed (Closed)	181.00
of which has been repaid	10.10
Total Disbursed (Active + Closed)	300.01
of which has been repaid	13.73
Total Undisbursed (Active)	193.88
Total Undisbursed (Closed)	0.00
Total Undisbursed (Active + Closed)	193.88

Active Projects

		Last PSR Supervision Rating			Original Amount in US$ Millions					Difference Between Expected and Actual Disbursements[a]	
Project ID	Project Name	Development Objectives	Implementation Progress	Fiscal Year	IBRD	IDA	GRANT	Cancel.	Undisb.	Orig.	Frm Rev'd
P046043	RUR ENT SUPPORT	S	S	2002	36.1				36.1	0.1	
P050508	URBAN TRANSPORT	S	S	2000	29				28.1	6.3	
P009131	FIN INST BLDG	S	S	1999	25				18.2	6.8	
P009125	HEALTH I	S	S	1999	30				18.5	13.9	
P055159	ENT INST BLDG	S	U	1998	28				23.1	13.7	
P009121	RURAL WS & SAN	S	S	1998	75				42.4	3.4	
P049582	TASHKENT SOLID WASTE	S	S	1998	24				14.8	11.1	0.9
P009122	COTTON SUB-SECTOR IMPROVEMENT	S	S	1995	66				12.7	12.7	12.7
Overall result				Result	313.1				193.9	67.9	13.6

a. Intended disbursements to date minus actual disbursements to date as projected at appraisal.

ANNEX 10 (B8)

Uzbekistan:
Statement of IFC's
Held and Disbursed Portfolio

As of 12/31/2001

(In US Dollars Millions)

		Held				*Disbursed*			
FY Approval	*Company*	*Loan*	*Equity*	*Quasi*	*Partic*	*Loan*	*Equity*	*Quasi*	*Partic*
1996	ABN AMRO Uzbek	0.00	1.00	0.00	0.00	0.00	1.00	0.00	0.00
1999	Asaka Bank	10.00	0.00	0.00	0.00	4.92	0.00	0.00	0.00
1997	Core Pharm	2.68	0.50	0.00	0.00	2.68	0.50	0.00	0.00
1999	NBU-SME	15.00	0.00	0.00	0.00	0.58	0.00	0.00	0.00
2000	SEF Asia Granite	1.65	0.00	0.00	0.00	1.20	0.00	0.00	0.00
1999	SEF Elma Cheese	0.58	0.00	0.00	0.00	0.58	0.00	0.00	0.00
1997	SEF Fayz	1.33	0.50	0.00	0.00	1.33	0.50	0.00	0.00
2001	SEF Hamkorbank	0.00	0.00	1.00	0.00	0.00	0.00	0.00	0.00
2001	SEF Parvina	0.00	0.00	1.00	0.00	0.00	0.00	0.00	0.00
1995/00	UZBEK LEASING	0.00	0.90	0.00	0.00	0.00	0.90	0.00	0.00
	Total Portfolio:	31.24	2.90	2.00	0.00	11.29	2.90	0.00	0.00

Approvals Pending Commitment

	Loan	Equity	Quasi	Partic
SEF Hamkorbank	0.00	0.00	1.00	0.00

ANNEX 11 (B9)

Uzbekistan Country Program Matrix (FY02 - 04)
(Low Case Scenario)

Development Objectives	Diagnosis	Government Strategy	Country Performance Benchmarks	WB Group Instruments Ongoing	WB Group Instruments FY02-04	WB Group Benchmarks	Other Partners
Program Goal: Accelerate the transition from a command to a market-based economy, supported by competent market institutions that promote a sustainable, broad-based economic development while ensuring that human resources and social safety nets are protected and equitably allocated.							
A. HELP PREPARE THE ANALYTICAL, POLICY, AND INSTITUTIONAL FRAMEWORK FOR EVENTUAL LIBERALIZATION OF THE FOREIGN EXCHANGE AND TRADE REGIME, INCLUDING RELATED MACROECONOMIC AND STRUCTURAL REFORMS, IMPROVED GOVERNANCE, AND TRANSPARENCY OF PUBLIC FINANCES							
1. Accelerate Ongoing Stabilization and Liberalization while Strengthening Market Institutions	Macroeconomic stabilization incomplete and very fragile. Fund-supported macroeconomic program collapsed in 1996; an *agreement on an SMP only recently* reached. Widespread implicit subsidies and relative price distortions. Trade and exchange rate regimes are highly restrictive and discretionary. Public resource management needs to be strengthened.	Develop a medium-term policy framework that provides macroeconomic stability but permits continued public sector involvement in the economy. Industrialize, achieve self-sufficiency in key commodities, develop and strengthen export potential of the country, gradually liberalize foreign economic activities and foreign exchange market. Maintain a prudent fiscal and monetary stance as well as external borrowing policy to achieve and maintain macro stability as a cornerstone of sustainable growth.	Stabilization of annual inflation at under 20 percent per annum. Reduction in the Central Bank's budget financing to no more than 0.5 percent of GDP, and an increase in the Central Bank's refinancing rate to a positive level in real terms. Reduction of trade and exchange rate distortions. Continued timely servicing of external debt with zero arrears accumulation. Foreign currency reserves to cover at least 100 percent of scheduled annual debt service payments. Stabilization of fiscal deficit below 3 percent of GDP. Reduction of tax burden and improvement of tax incentives through the shift of taxation from production to consumption and simplification of tax and custom tariff system.	**IBRD Non-lending** - Macroeconomic Policy Notes (FY98) - Competition Policy IDF (FY00) - Economic Policy Analysis IDF (FY99) - Macro-monitoring (FY00-01)	**IBRD/IDA Lending** --Public Finance Management Reform Project (FY03) **IBRD Non-lending** - Macro-monitoring (FY02-04) - Demand-Driven Policy Notes (FY02 04) - Anti-monopoly IDF (FY02) - Country Economic Memorandum (FY03) - Public Expenditure Review (FY04) - Energy Sector Review (FY04)	Improvement in public expenditure as stipulated in the Public Finance Management Reform Project. Liberalization of access to foreign exchange for enterprises and individuals.	IMF's SMP and regular consultations with the authorities. USAID, GTZ, AsDB, Switzerland, France and UNDP technical assistance for macroeconomic management/capacity building activities. EU training for and upgrading of civil service. AsDB and UNDP technical assistance for aid coordination by Cabinet of Ministers.
2. Strengthen Institutional Capacity, Governance and Technology for Collecting, Processing and Publishing Economic and Financial Data, and Policy Formulation and Implementation	Weak institutional capacity for data collection, processing and analysis hampers policy formulation and decision making process. Basic transparency is lacking.	Strengthen capacity of *institutions in charge of data* collection, processing, and publication through provision of appropriate technical assistance. *Strengthen institutional capacity* for economic policy analysis.	Improvement in quality, timeliness, and public availability of economic data.	**IBRD Non-lending** - Economic Statistics IDF (FY98-01)	**IBRD/IDA Lending** - Public Finance Management Reform Project (FY03) **IBRD Non-lending** - Country Procurement /Financial Accountability Assessment (FY02-03) - Country Economic Memorandum (FY03) - Public Expenditure Review (FY04)	Increase in transparency, quality and public availability of economic data.	EU, JICA statistical capacity building technical assistance.

Development Objectives	Diagnosis	Government Strategy	Country Performance Benchmarks	WB Group Instruments Ongoing	WB Group Instruments FY02-04	WB Group Benchmarks	Other Partners
B. HELP IMPROVE THE POLICY FRAMEWORK AND INCENTIVES FOR PRIVATE SECTOR INVESTMENT AND TRADE							
1. Increase Private Foreign Investment and Strengthen Transparency	Cumbersome and complicated investment licensing and registration procedures. Lack of transparency in decision-making; inconsistencies in legislation. Difficult access to legal information and information on ownership of "privatized" companies. Discretionary and discriminatory system of incentives to foreign investors.	Simplify registration and licensing of investments. Improve transparency in decisionmaking and access to legal and economic information. Improve the business environment and the legal framework governing foreign investment.	Increase in private foreign investment.				EU-TACIS capacity building and support to Foreign Investment Agency.
2. Improve Effectiveness of Enterprise Privatization and Restructuring	Privatization of large-scale enterprises is delayed and remains incomplete. Little progress in restructuring of enterprises. Government believes in establishing holding companies to attract investment. Enterprise investment is guided by a state plan.	Improve legal and policy frameworks for private sector development. Increase equity ownership by the public through privatization and capital market development, and encourage entrepreneurship. Maintain post-privatization support program. Improved privatization should replace state-sponsored holdings and investment.	Adopt the Privatization Investment Funds Regulation as agreed with the Bank, including a new list of enterprises. Transparent case-by-case sale of selected large companies to domestic and foreign investors. Support the restructuring of privatized enterprises.	**IBRD/IDA Lending** - Enterprise Institution Building (FY98)	**IBRD/IDA Lending** - Continued implementation of Enterprise Institution Building Project **IFC Non-lending** - Technical assistance (consultant training and enterprise survey) through Private Enterprise Partnership financed by Swiss trust funds	Successful implementation of 15 enterprise plans and sale of 5 large-scale firms to strategic investors.	EU-TACIS capacity building and support to Foreign Investment Agency. EU-TACIS pre-investment support to Privatization Investment Fund. EBRD financing of Privatization Investment Fund. EBRD and AsDB lines of credit to SMEs.
3. Restructure Land Reform and Property Rights to Include a More Effective and Transparent Resource Allocation	Undefined property rights inhibit private investment and sound management of land and water resources.	Design and implement program of land reform and farm restructuring based on secure long-term tenure of land at household level, that promotes agricultural investment, efficient production, employment generation, and improved rural incomes. Provision of microcredit to individuals to encourage self-employment activities.	Strengthened legal framework for collateralization of moveable property and crops, and removal of current restrictions on access to cash in bank deposits.	**IBRD/IDA Lending** - Rural Enterprise Support I (FY02)		A draft enactment regarding subrogation with respect to land use rights pledged as collateral.	EU-TACIS support for land registration
4. Assure Agriculture Sector Efficiency by Public Sector Withdrawal from Market Activities	Excessive state regulation and control over farms and inadequate and distorted incentives impair markets and have undermined farm productivity. Low agricultural yield due mainly to lowland productivity and distorted incentive structure, including mandatory production	Improve competitiveness of production and marketing of cotton. Identify, reduce, and remove barriers to new entry into input supply and trade.	Pilot farm restructuring in 5 administrative districts, and replicate after evaluation. Replacement of the state order system for cotton and wheat by a state procurement system, under which obligatory sales to the state will not exceed 50 percent of actual production.	**IBRD/IDA Lending** - Cotton Subsector Improvement (FY95) - Rural Enterprise Support (FY02)		Increase average quote for Uzbek cotton exported by 5 percent in value terms (relative to the average of the other quotes for the other cotton traded by other major cotton-exporting countries	AsDB support for microcredits. AsDB economic and sector work on the grain sub-sector and lending for farm restructuring and on-farm irrigation structures (Ak Altin

Development Objectives	Diagnosis	Government Strategy	Country Performance Benchmarks	WB Group Instruments Ongoing	FY02-04	WB Group Benchmarks	Other Partners
	quota, and low producer prices.					traded on international exchanges).	district). EU-TACIS programs for agricultural extension and Ministry of Agriculture and Water Resources restructuring. Bilateral support for agriculture (Germany, Switzerland, Israel, USAID).
5. Improve Financial Sector Performance	Financial sector is non-competitive and subject to extensive public sector ownership and control including extensive use of directed credits. Government is actively engaged in directed credits and in guaranteeing industrial and agricultural credits. In some cases, 90 percent of a bank's portfolio is guaranteed. Given the guarantees, banks do not generally require collateral and often rollover payments due. Capital markets are underdeveloped and over controlled. System of accounting and audits is not consistent with international standards. The legal and regulatory frameworks for private pension providers do not exist.	Establish stable financial system based on market incentives rather than directed credit. Develop a strategy for a phased-in approach to reduce the government guarantees, and increase the coverage of the guaranteed portfolio through acquisition of collateral from the final borrowers. Establish a fully functioning capital market. Develop legal framework for voluntary private pensions and other forms of private social insurance.	Sound financial sector able to support private sector growth reflecting market criteria. Preparation of a comprehensive plan for restructuring banking system, including reduction of the National Bank's dominant role. Dismantling of domestic credit controls and introduction of regulatory measures to enable resolution of bad debts in the banking system. Introduction of international accounting standards for banks. Further refinement of legal and regulatory framework for introduction of voluntary private pensions. Increase competition between commercial banks and boost efficiency and innovation of banking system, by reduction of market concentration, and decreased sectoral segmentation of existing banks. Improved prudential regulations and stronger supervision capacity of the Central Bank of Uzbekistan (CBU), including stronger reporting capacity of the commercial banks and improved skills and organization of the Supervision Department of the CBU.	**IBRD/IDA Lending** - Financial Institution Building (FY99) **IFC Non-lending** - Training for two small banks financed by Japanese trust funds	**IBRD/IDA Lending** -- Continued Implementation of Financial Institution Building Project **IFC Non-lending** - Continued training for two small banks financed by Japanese and Irish trust funds	Preparation/ restructuring of two selected Uzbek banks for privatization.	EU-TACIS support to advisory services for commercial banking sector.
C. CONTINUE HELPING TO IMPROVE THE EFFICIENCY OF RESOURCE USE IN SOCIAL AND MUNICIPAL INFRASTRUCTURE AND SERVICES							
1. Improve Outcomes and Efficiency in the Health Sector	Health sector performance is weak because of rigidity and excessive planning. Current system is	Enhance the efficiency in the use of constrained resources, improve the quality of services	Improved access to and quality of basic health services in selected regions by improving training	**IBRD/IDA Lending** - Water Supply, Sanitation and Health	**IBRD/IDA Lending** - Health Reform II (FY04)	Increased number of pregnant women receiving tetanus	USAID and UK Know-How Fund co-financing of Health

Development Objectives	Diagnosis	Government Strategy	Country Performance Benchmarks	WB Group Instruments Ongoing	 FY02-04	WB Group Benchmarks	Other Partners
	plagued by misallocation of resources and overly centralized administration. Rise in out-of-pocket payments for health services and drugs disadvantages those on subsistence incomes. Privatization of health services and emerging private medical practice in a largely unregulated environment also generate concern with regard to access, equity and quality of services.	and their cost-effectiveness. Build capacity in 3 regions for replication of restructuring in remaining regions. Implement new medical education curricula for General Practice physicians and universal nurses. Develop and implement rationalization plans annually in each region.	curriculum for general practitioners and nurses, upgrading equipment, and improving sustainability through rationalization of facilities and incentive structures.	(FY98) - Health Reform (FY99)	**IBRD Non-Lending** -Living Standards Assessment (FY02)	immunization. Increased coverage of infants receiving hepatitis B vaccine. Capitation (1 line payment) fully implemented in pilot rayons for SVPs. Placement of trained physicians and nurses in rural SVPs.	Reform I Project.
2. Improve Infrastructure Services, Management, and Efficiency	Reduced investment due to fiscal constraints, insufficient maintenance, and poor management have undermined key economic infrastructure services. Rapid urbanization has exerted pressure on the urban water supply systems and sanitation systems have deteriorated. Transport sector is dominated by state-owned enterprises and overall sector management is weak. Except for urban transport, there is no appropriate financial, regulatory, and institutional framework for competitive provision of transport services.	Halt deterioration of urban and inter-urban infrastructure. Strengthen market incentives and institutions involved in service delivery. Privatize service providers where appropriate to improve efficiency., taking into account government capacity and framework for regulation of new private sector. Increase investment in development and rehabilitation of water supply and sanitation system. Increase cost recovery and cash collection. Introduce commercialization to finance investment and ensure proper management and maintenance.	Increased level of cost recovery and cash collection of service fees. Vodokanals of Bukhara, Samarkand, Urgench, and Nukus to increase revenue collection to cover operation and maintenance costs. Strengthened institutional capacity and managerial capacity. Increased operational efficiency. Development of competition whenever possible between service providers under sound institutional and regulatory framework. Expansion of privatization or private management of services. Involvement of private sector in the management and operation of vodokanals as stipulated in the Bukhara and Samarkand Water Supply Project.	**IBRD/IDA Lending** - Tashkent Solid Waste (FY98) - Water Supply, Sanitation and Health (FY98) - Urban Transport (FY00)	**IBRD/IDA Lending** - Bukhara/ Samarkand Water Supply (FY02) **IBRD Non-lending** - CDD Strategy (FY02)	Improved competitive bus route franchising system in main cities except Tashkent, including full cost recovery. Higher efficiency of urban bus transport operators. Increased capability of city administrations in planning and management of urban transport systems. Improved quality and access of water supply services to 1.1 million people living in urban areas and 1 million people living in rural areas. Improved financial policies in the municipal water sector as stipulated in the Bukhara and Samarkand Water Supply Project.	AsDB road and rail rehabilitation projects. EBRD-supported projects in waste management, railway and air transport. EU-TACIS project to improve Central Asia-Caucasus international transport to Europe.
3. Reform Energy Sector	Rapidly dwindling in the hydrocarbons sector; and significant investments needed to replace those reserves. In the power sector, the capability	Attract foreign oil companies to invest and prospect in the country; privatize gas production and transmission businesses. Reform the power and coal	Signing of agreements that conform with good international practice (whether as PSAs or as licensing arrangements) with international oil companies for exploration and production in three blocks.		**IBRD Non-lending** - Energy Sector Review (FY04)	Reduce quasifiscal transfers from the energy sector to the rest of economy by increasing cost recovery.	EBRD, EU-TACIS, PPIAF, GEF, AsDB

Development Objectives	Diagnosis	Government Strategy	Country Performance Benchmarks	WB Group Instruments Ongoing	FY02-04	WB Group Benchmarks	Other Partners
	of the present installed and operable capacity is barely sufficient to meet the demand, and significant investments are required for the rehabilitation and modernization of the energy system. Tariffs at market rates, translates into large amounts of implicit generalized subsidies to the rest of the economy.	sectors to attract private investment. Sign agreements with international oil companies for exploration and production in three blocks. Offer Uzbekneftegas and Uztransgas for privatization. Unbundle Uzbekenergo, create a regulatory authority for the sector, and offer designated assets for privatization. Reform tariff policy and tariff setting to depoliticize; and attract private investors	Creation of a regulatory authority for the sector Unbundling Uzbekneftegas and offering controlling stakes of its components for privatization. Reform of tariff policy and setting to demonopolicize; attract private investors.				
4. Improve Equity, Efficiency and Outcomes in the Education Sector	Attrition from basic education by vulnerable groups Shortages of basic teaching materials and equipment, and deterioration of physical infrastructure have led to declining student learning outcomes at all levels. Inequitable quality resulting from excessive reliance on local financing for essential education inputs. Inefficient use of resources. Too many teachers. Teachers paid too little. Lack of incentives for improved efficiency, resulting from an input-based rather than output-based financing formula, and fragmented and inconsistent responsibilities for different levels of government. Old-fashioned and costly approach to providing specialized labor-market skills. System needs to emphasize generic skills rather than specific skills.	Implement the National Program for Personnel Training to reorient the education system to the needs of the market economy. Extend the duration of compulsory education from 11 to 12 years Restructure educational programs at secondary and tertiary levels. A new program of three year academic lycea, attached to universities, to replace the current two year program for complete secondary education. Transform existing network of vocational secondary teknikums into a new network of professional colleges at the secondary level with flexible curricula intended to respond to local employment needs (expected to cover 90% of all secondary enrollments). Regrouping of higher education programs and expansion of selected programs of higher education. Provision of teacher training, development of education materials, reform of teaching and learning process to emphasize problem solving, teamwork etc. in lieu of retention of facts..	Improved school attendance by vulnerable groups. Improved provision of textbooks and other essential teaching and learning aids. Adequate levels of financing for key education inputs in all oblasts. Improved school maintenance. Reduced teacher/student ratios, increased teaching hours, higher teacher salaries Higher proportion of secondary enrollments in general education programs with modernized curriculum to meet needs of global economy.		**IBRD Non-lending** - Living Standards Assessment (FY02)		AsDB Textbook Development Project. AsDB Secondary Specialized Education Project. Proposed AsDB Education Program Loan UNDP/UNESCO review of sectoral reform options. EU-TACIS projects to restructure Ministry of Public Education.

Development Objectives	Diagnosis	Government Strategy	Country Performance Benchmarks	WB Group Instruments Ongoing	FY02-04	WB Group Benchmarks	Other Partners
5. Improve Social Protection of the Poorest and Vulnerable	Pension system reduces risk of old-age poverty but at high cost. Rise of dependency ratio associated with demographic changes means that financing problems will emerge in pensions system around 2010. The poor benefit disproportionately from child allowances and social assistance delivered through Mahallahs, although many poor are excluded and many better off households are covered. Coverage of unemployment protection is inadequate. Concerns with regard to rising open unemployment and negative social impact of transition.	Implement plan to improve pension administration. Transfer of collection functions to the Tax Committee. Use of financial models to forecast solvency of pension system under alternate scenarios of reduction in privileged categories. Improve record keeping and pilot benefit calculations. Social assistance and child allowances are now targeted schemes, financed from federal budget financing but provided locally through innovative system. Identify approaches to improving targeting of social assistance and child allowances delivered through Mahallahs.	Examination of options for systemic pension reform, both of public PAYG system and possible future mandatory funded pensions. Further improvements in targeting efficiency of social assistance and child benefit programs. Identification of options to mitigate the social cost of transition, in part through extension of well-targeted and effectively managed social programs.	**IBRD Non-lending** - Pension Reform Implementation IDF (FY00)	**IBRD Non-lending** - Living Standards Assessment (FY02)		AsDB TA on pension reform
6. Reduce Poverty and Inequality by Increasing Capability to Participate in Equitable Economic Growth	A revised, nationally representative household survey provides first initial snapshot into profile of poverty since transition. About 31% of the population could be considered poor in 2000-01 with consumption below an absolute poverty line. More than two thirds of the poor live in rural areas. Large households with more than two children, households headed by individuals with secondary education and unemployed individuals are most likely to be poor although the working population constitutes a substantial proportion of the poor. Available information suggests that inequality is high.	Further improve informational base for poverty monitoring and analysis. Prepare a strategy for improving living standards.	Development of poverty monitoring and analysis database, including further improvements in nationally representative household survey. Adoption of an absolute poverty line for the purposes of monitoring poverty. Build capacity to analyze poverty data Preparation of PRSP.	**IBRD Non-lending** - Economic Information IDF (FY98-01)	**IBRD Non-lending** - Living Standards Assessment (FY02) - WBI sponsored PRSP training and workshops - CDD Strategy (FY02)	Living Standards Assessment completed.	.AsDB TA to support preparation of Living Standards Strategy
D. HELP MAINTAIN AND IMPROVE THE EFFICIENCY OF IRRIGATION AND DRAINAGE INFRASTRUCTURE TO PREVENT FURTHER ENVIRONMENTAL DEGRADATION AND AVOID POTENTIAL HUMANITARIAN DISASTER							
1. Strengthen Local Governments and Communities' Ability to Manage and Maintain Rural Infrastructure	Rural social services and infrastructure are deteriorating and financial services are weak. Strengthen local governments' ability to plan and implement rural infrastructure programs.	Create institutions for participatory management of water resources and introduce partial cost recovery for irrigation services and water supply.	Strict water conservation supported by water pricing and farm restructuring. Adoption of procurement regulations and establishment of sound institutional framework for	**IBRD/IDA Lending** - Water Supply, Sanitation and Health (FY98)	**IBRD/IDA Lending** - Bukhara/ Sammarkand Water Supply (FY02) - Karshi Pumping (FY03) - Drainage (FY04)		ILO and UNDP (rural social infrastructure).

Development Objectives	Diagnosis	Government Strategy	Country Performance Benchmarks	WB Group Instruments Ongoing	WB Group Instruments FY02-04	WB Group Benchmarks	Other Partners
		Adopt program of rural public works, including road maintenance, gasification, communications, and water supply. Improve management, operational and financial sustainability of water supply and sanitation enterprises through introduction of international best practice.	competitive contracting of small infrastructure works. Development of local construction industry based on labor-intensive techniques. Increase in number of communities and water user organizations responsible for operation of rural water supply services. Signing of an experienced international operator to a service contract for Bukhara and Sammarkand vodokanals.		**IBRD Non-lending** - CDD Strategy (FY02)		
2. Reduce Industrial Pollution and Enhance Use of Natural Resources in Sustainable Manner	"Brown" environmental issues in the old and inefficient heavy industries. Unclear institutional responsibilities and overly complex and out-of-date environmental management systems. Limited public consultation and environmental awareness.	Promote industrial restructuring and modernization and strengthen the regulatory policy/institutional frameworks.	Revised pollution control regulations, and air and water quality standards.. New procedures and guidance for reviewing environmental assessments and complying with environmental assessment and pollution control laws and regulations..	**IBRD Non-lending** - NEAP (FY98) - GEF Transboundary Biodiversity (FY00)	**IBRD Non-lending** - Environment Management IDF (FY01)	Preparation and adoption of revised policies, regulations, procedures, and/or guidance for improved compliance with environmental laws. Increased public participation in environmental decision-making.	
3. Aral Sea Basin – Improve Disaster Preparedness to Minimize Losses from Natural Disasters	Resource base is deteriorating, especially with respect to salinity. Irrigation and drainage systems are inefficient and deteriorating. Formerly productive delta of the Amu Darya has become decertified.	Develop national water and salt management strategy, including policy, institutional and investment activities. Implement wetlands strategy under Aral Sea Basin Program.	Adoption of strategy and investment program. Improved habitat for endangered species.	**IBRD/IDA Lending** -- Drainage (FY04) **IBRD Non-lending** - GEF Aral Sea Basin Water/Environmental Management (FY98)		Continued successful implementation of the GEF Project.	USAID water supply, energy and water management policy issues and health. Netherlands water assessments, wetland restoration preparation, and capacity-building. EU-TACIS projects for interstate water agreements preparation, regional database, pilot programs, and on-farm management monitoring issues. Monetary aid by bilateral agencies (UNDP/ Canada/ Finland/ Switzerland/ UK/ Italy/ Denmark/ Sweden/ Japanese PHRD funds/Kuwait Fund).

ANNEX 12 (B10)

Uzbekistan: CAS Summary of Development Priorities

As of 01/18/2002

Network area	*Country performance*[a]	*Major issue*[b]	*Country priority*[c]	*Bank priority*[c]	*Reconciliation of country and Bank priorities*[d]
Poverty Reduction & Economic Management					
Poverty reduction	Good	Rural poverty, poverty monitoring	Moderate	High	Living Standards Assessment
Economic policy	Poor	Multiple exchange rates, trade and payment controls, transparency	Moderate	High	Country Economic Memorandum
Public sector	Fair	Efficiency of public resource use	High	High	
Gender	Good	Improved representation of women in all aspects	Moderate	Moderate	
Human Development Department					
Education	Fair	Declining enrollment rates. Efficiency, content to be brought in line with market economy	High	Low	AsDB takes lead
Health, nutrition & population	Fair	Efficiency and equity in service provision, quality	Moderate	High	
Social protection	Good	Inadequate targeting of vulnerable groups	Moderate	Moderate	
Environmentally & Socially Sustainable Development					
Rural development	Fair	Implicit taxation of agriculture through state orders over production and exports (cotton and wheat); dilapidating rural infrastructure	Moderate	Low	
Environment	Good	Aral Sea, poor water resources management, salinity	High	High	
Social development	Good	Lack of inclusive institutions	Low	Moderate	CDD Study
Finance, Private Sector & Infrastructure					
Financial sector	Poor	Directed credit, foreign exchange controls, health of banking sector	Moderate	High	Country Economic Memorandum
Private sector	Poor	Trade and foreign exchange controls	Low	High	
Energy & mining	Fair	Dwindling hydrocarbon reserves, dilapidated production and network infrastructure, energy pricing and revenue collection, large investment needs	High	Moderate	Government's priority shifted to high recently; recasting on-going operations to meet needs; ESW to understand long-term options.
Infrastructure - Water	Good	Dilapidated water supply infrastructure, low level of service, health risks, low efficiency, weak financial position of water utilities	High	High	
Infrastructure - Transport	Fair	Inadequate institutional and regulatory framework, low cost recovery, weak governance and slow privatization of state-owned enterprises	High	High	

a. Use "excellent," "good," "fair," or "poor."
b. Indicate principal country-specific problems (e.g., for poverty reduction, "rural poverty;" for education, "female secondary completion;" for environment, "urban air pollution").
c. To indicate priority, use "low," "moderate," or "high."
d. Give explanation, if priorities do not agree; for example, another MDB may have the lead on the issue, or there may be ongoing dialogue.

ANNEX 13: Aral Sea Basin Program (ASBP); and Water and Environmental Management Project (WEMP)

1. The **Aral Sea Basin Program** (ASBP), prepared by all five Central Asia countries with assistance *inter alia* from the UNDP, UNEP and the World Bank, was launched formally at an international donors' meeting held in Paris in June 1994. Its main objectives are: (a) to stabilize the environment of the Aral Sea Basin; (b) to rehabilitate the disaster area immediately surrounding the sea, including the populations directly affected in the three regions of Kyzl-Orda (Kazakhstan), Karakalpakstan (Uzbekistan) and Dashgovuz (Turkmenistan); (c) to help improve the management of land and resources in the basin; and (d) to strengthen institutional capacity at all levels to plan and implement community, investment and technical assistance projects. At the Paris meeting, international donors committed about US$ 32 million in grant funds for project preparation and technical assistance for the first phase of what is envisaged as a long-term (e.g. 20-25 year) program comprising eight defined areas and about twenty individual projects.

2. Against this background, a large number of studies, at both the national and regional level, and since the late 1990s several investment projects at the national level, have been initiated, with most of the former now completed and implementation of the latter now under implementation. In Uzbekistan, the US$120 million Rural Water Supply, Sanitation and Health Project -- located in Karakalpakstan and Khorezm, approved in 1998 and co-financed by a World Bank loan of US$ 75 million) , KfW and the Kuwait Fund - is one of the larger efforts to deal with the humanitarian, especially the public health, consequences of the Aral Sea disaster under the ASBP. Similarly, the proposed Drainage Project, planned for presentation in FY04, focuses directly on the environment and on improved water and salt management in Karakalpakstan on the right bank of the Amu Darya. Several other official and non-governmental donors – including EU-TACIS, UNDP, UNICEF, UNFPA, WHO; Canada, Germany (KfW), Netherlands, Sweden, Switzerland, United States (USAID); and Medicins sans Frontieres, Perzent, are involved in various activities mainly in Karakalpakstan within the ASBP framework.

3. At the regional level, the **Water and Environmental Management Project**, financed by the GEF, European Union, Netherlands, and Sweden, and for which the five-member-state International Fund for the Aral Sea (IFAS) is formally the implementing agency, provides a regional framework a number of inter-state technical assistance and investment projects (e.g. dam safety, trans-boundary water monitoring stations). However, its most important and ambitious component is a major regional study to develop longer-term, sustainable regional and national water and salt management strategies - to replace the current system of annual *ad hoc* water allocation and distribution arrangements inherited from the Soviet Union, which is slowly breaking down. The definition of this strategy will involve making of difficult strategic choices at the basin level, such as the balance between river protection (salinity, environmental flows to the deltas and Aral Sea) and irrigation and drainage needs; flow regulation through reservoir operation (energy-irrigation trade-offs); water allocation between and within the five states; and cost sharing for operations, maintenance, rehabilitation, and improvement of the existing infrastructure.

ANNEX 14: Improving Portfolio Performance –
Country Portfolio Performance Reviews (CPPR)

1. In October 1999, the first Country Portfolio Performance Review (CPPR) for Uzbekistan was held at the Country Office in Tashkent. At that time, the portfolio comprised seven loans and four IDF grants. Owing *inter alia* to slow disbursements overall and slow implementation of the two largest investment projects (Cotton Sub-sector Improvement and Rural Water Supply, Sanitation and Health) and one technical assistance project (Enterprise Institution Building) rated unsatisfactory, the portfolio had been placed on the Bank-wide watch list. The specific purposes of the first CPPR, attended by representatives of all the government and project implementation agencies concerned, as well as most Uzbekistan Country Team staff, were threefold: (a) to assess the overall performance of ongoing projects; (b) to identify and discuss common or systemic problems encountered by some or all projects; and (c) to recommend actions or measures required by the Bank or the Government to resolve these problems and other cross-sectoral issues. Common or systemic issues identified as areas requiring further improvement or further scrutiny included:

- The requirement that all contracts involving imports of goods or service be registered by the Ministry of Foreign Economic Relations and Trade (MFER) – a sometimes very time-consuming process that some project implementation units (PIUs) hoped could be either eliminated, or at least expedited for projects financed by the IFIs;
- The need for more consistent employment and compensation policies and procedures for the staff of PIUs of externally-financed projects, including more transparent recruitment procedures;
- The very limited utility of Special Accounts, owing to the restrictions on access to foreign exchange (whether in cash or bank transfer), even to cash in local currency;
- The need for enhanced training of PIU staff in World Bank policies and procedures

It was also agreed that a CPPR should be held annually, with implementation review meetings on a less formal basis at the Country Office in between annual CPPRs.

2. The second CPPR was held in January 2001. The agenda, developed jointly by Country Office and PIU staff, included discussion of the following: (a) a review of experience with MFER import contract registration since during 2000; (b) implications for Bank-financed projects of a new government limit of US$100,000 on advance payments for import contracts; (c) investment project cost sharing and local currency counterpart funding; (d) the need to ensure greater competition in selecting auditors for annual audits of project accounts, hitherto dominated by the big five international accounting firms; (e) the proposed development of a database of local experts and consultants in order to facilitate their participation in project preparation; and (f) the reported inadequacy of PIU staff salaries.

3. Based on the learning experience of the first CPPR, participants were better prepared in focusing on cross-sectoral and generic issues (rather than project-specific problems and achievements), and had clearly thought through possible practical solutions to these issues. There was a fair amount of sharing of information and experience, which will be encouraged not just on the occasion of a CPPR but throughout the year, perhaps supplemented by mini-CPPRs and other cross-sectoral meetings and seminars organized by the Country Office.

4. The topics discussed and possible solutions put forward during the meeting are presented below in matrix form. Naturally, the solutions cited are not decisive measures which will resolve problems once and for all, but will require further discussion with the ministries concerned and, in some cases, with the Cabinet of Ministers.

Issue	Specific Problem	Possible Solutions
1. Registration of import contracts at MFER	a) Substantial and unreasonable delays; b) MFER requests revision to contract price after contract signing	i) PIUs could consult with MFER in advance. ii) MOF and/or MFER should be represented on tender committees iii) Waiver of contract registration under IFI-financed projects. iv) Invite line and core ministry officials to procurement training.
2. Limit of US$100,000 for advance payment under import contracts	a)Advance payment exceeding this limit requires additional time	i) MOF should be represented on tender committees. ii) MFER/MOF approval of higher limit when needed during pre-tended phase, thus securing automatic waiver
3. Limited number of qualified auditors	a) Five international firms dominate audit of Bank-financed projects, often no competition, reduced quality, higher costs	i) Country Office will make available list of auditors from Kazakhstan and Russia which the Bank has certified as acceptable. ii) Bank will undertake an assessment of local audit firms in Uzbekistan and determine if any may be qualified to conduct audits for Bank projects.
4. More involvement of local experts in project preparation	a) Implementation problems could often be averted if local experts familiar with local conditions and institutions were more involved in	i) Country Office to compile database of local consultants who have worked on Bank projects. ii) Recommend to Bank project teams that local experts be involved during project preparation. iii) Bank teams and PIU staff to ensure that

	preparation.	MOF, CBU, MMS, and MFER are involved during preparation stage in order to avoid later misunderstanding or confusion regarding implementation
5. Counterpart funding	a) Counterpart funding not always available promptly. b) Too many clearances needed to make payments from counterpart contribution	i) Establish clear procedures for PIU to operate with the counterpart funds. ii) PIUs and parent ministry to ensure request for counterpart funds for the following year are made at proper time of budget cycle. iii) Signature authority procedures should be simplified.
6. Restrictions on payments to banks located in specified off-shore zones (since mid-2000).	a) If not worked out in a timely manner may result in rejection of the contract registration by the MFER.	i) Negative list of countries/off-shore zones should be made know at time tender ii) Since many companies have multiple bank accounts, PIUs should negotiate where to make payment.
7. PIU Salary Ceiling/Structure	a) If salary level too low, this results in low motivation and/or high turnover of PIU staff.	i) Government established a ceiling of US$500 equivalent in local curency as monthly salary or fee to PIU staff. Within this ceiling, each PIU is free to decide on its own salary structure.

5. Other comments and observations included:

- Overall, there needed to be more involvement and coordination by the four core ministries/agencies to ensure their effective implementation: MOF, representing the Borrower and thus ensuring that loan funds are properly and efficiently utilized; MFER, which registers import contracts financed by Bank loans; MMS, which prepares and sanctions the country's overall public investment program; and, the Central Bank of Uzbekistan, which is responsible foreign exchange-related issues. It was agreed that each of these ministries and the CBU should designate a contact person for issues relating to Bank-financed projects. There was also general agreement that PIUs and Bank teams should make more effort to inform and involve these four ministries earlier in the project cycle; and that the four ministries would also pay more attention to Bank-funded operations.

- Bank staff announced that a Financial Management Specialist (FMS) would be posted to the Almaty Regional Office in March 2001, which would greatly facilitate more frequent contact on FMS-related issues.

- For future procurement seminars, not only PIU staff but officials from MOF, MFER, and CBU dealing with Bank-financed projects should be invited.

ANNEX 15: Improving the Environment for Private Sector Development

1. Uzbekistan has significant untapped potential for developing its real sector, particularly small and medium enterprises (SMEs). Development of a vibrant private sector can be accelerated by: reducing governmental bureaucracy; moving rapidly to develop a free and transparent currency regime; establishing clearly defined property rights; developing a transparent and efficient legal and regulatory environment, including adjudication and enforcement mechanisms related to commercial transactions that comply with international standards; improving corporate governance; creating a competitive market structure; and, true financial intermediation through an independent banking and financial sector. While the government seeks to spur SME development and attract foreign investment, it has yet to create the necessary conditions to attract investment into an economy that currently falls far short of its potential as a regional economic hub. It actively courts foreign investment in productive activities, and provides some tax benefits to such undertakings (on a case-by-case basis), particularly if the production facilitates import substitution or is for export. However it also continues to control and interfere with important market segments, e.g., cotton, that could be of great interest to foreign investors. In addition, arbitrary and severely restricted access to foreign exchange, lack of local currency loans, cumbersome banking and payment systems as well as slow bureaucratic procedures discourage such investment.

2. Uzbekistan's banking system currently plays a role in both corporate tax enforcement and collection -- but a limited role in financial intermediation. Due to the very low domestic savings rate, there are limited local sources of funding to be intermediated besides government-directed lending. Private citizens do not deposit savings in banks and banks' domestic currency deposits are primarily captive demand deposits from corporate clients. To the extent that leading banks can attract foreign currency funding from bilateral or multilateral sources, the financial system is undertaking a limited intermediation function. However, credit analysis and supervision methodology still need to be developed through technical assistance.

3. A key element leading to this lack of intermediation in Uzbekistan's banking system is the distinction made between cash and non-cash transactions for enterprises. Cash withdrawals by legal entities are permitted only for purposes of payment of wages, pensions, and travel expenses. All other enterprise expenditures, for the purchase of any items, must be done by bank transfers. This distinction is the most serious constraint on the intermediation of financial flows, discouraging deposits and inhibiting the development of the financial sector, thus encouraging a large informal sector and a hard currency curb market. At the individual level, there is great distrust of the banking system due to losses that depositors suffered when the Soviet banking system collapsed. Those that have any savings would rather exchange the local currency into dollars at the curb rate and keep that in cash. Major purchases (cars and real estate) are done in cash dollars even if the receipt is in local currency equivalent.

4. The Uzbek Government has recently taken a number of promising steps towards creating more transparent and simplified procedures for business registration, licensing, and customs clearance. A "one-stop shop" procedure for business registration has recently been introduced and businesses, including joint ventures and 100 percent foreign-owned companies, no longer have to register separately with the Ministry of Justice, the State Tax Committee and the Ministry for Macroeconomics and Statistics. The Ministry of Justice has established a special department for reviewing complaints from private businesses and to provide assistance against unlawful interference in their activity from various government entities and local authorities. Private businesses actively resort to this appeal mechanism. In addition, customs procedures are being simplified in order to reduce unnecessary storage fees on the importer with no priority given even to perishable goods, and micro and small enterprises were granted the right to switch to a simplified taxation system. However, all import contracts still must be approved and registered by the Ministry of Foreign Economic Relations (MFER), unless the company uses its own hard currency and is not relying on government funding or guarantees, in which case, in theory if not in practice, MFER registration is not needed. Access to foreign exchange by enterprises remains difficult. Even for those international investors who register their projects through the appropriate channels and have been assured currency conversion, the paper work that needs to be submitted to be allowed a currency conversion is onerous and currency conversion applications are routinely rejected for insignificant errors. The foreign exchange authorities can delay the conversion process indefinitely, leaving investors with overdue payables and penalties. As a result, foreign suppliers charge more for goods sold to Uzbekistan to cover the increased payment risks they perceive.

5. The constraints which hamper the business and investment climate from a private and financial sector development perspective need to be removed. Such changes cannot be accomplished overnight, but a clearly defined plan and timetable for implementation must be developed with information about the expected goals, an action plan and intermediate steps to reaching the goals along with a timetable published, so all stakeholders will be able to monitor progress. The World Bank Group is ready to provide assistance in developing such an action plan and implementing these steps to spur economic growth. Such assistance would encompass a phased approach to address the following:

- **Internal convertibility,** by removing all restrictions on the use of cash.

- **Corporate governance and competition** by: (a) phased-in abolition of Resolution No. 361, which *inter alia* allows the state representative to defer any decision by the shareholders' meeting, if the decision "contradicts the interests of the state," with no definition of what might constitute a contradiction of state interests; (b) banning trade associations from all remaining interference in the procurement and marketing arrangements of privatized enterprises; and (c) strengthening supervisory councils to act as agents representing the interests of shareholders.

- **New entry of: (a) medium-sized local enterprises** by strengthening the Privatization Investment Funds (PIFs) and by making attractive and viable enterprises available to the PIFs; **and (b) small businesses** by removing administrative barriers to entry. Based on a published plan and timetable for implementation, the state should gradually reduce barriers by: simplifying procedures for legal entity registration and licensing of activities; simplifying investment project review and approval and eliminating review when not justified; eliminating existing administrative barriers to the flow of goods, capital and labor; radically reducing the number of inspection and monitoring bodies (first and foremost, for small businesses); and restricting departmental standard setting, except when required for strategic industries.

- **Clarification of property rights and strengthening of contract law enforcement** to provide certainty for investors in key areas, mainly energy, telecommunications and natural resources as well as in relation to ownership and the ability to transfer property rights.

- **Foreign exchange liberalization.** The principal policy obstacle to reform in Uzbekistan stems from the restrictions on access to foreign currency in a uniform and clearly defined manner, and the resulting multiple exchange rates. The unification of exchange rates is a necessary pre-condition for successful enterprise and banking reform as well as to growth and reform in other areas of the economy. It is also a necessary condition for the attraction of needed FDI.

- **Trade liberalization.** Trade liberalization should include the most urgent measures related to import contract registration, foreign currency access, commodity exchanges and the cotton trade. Competition could be addressed by strengthening the Anti-Monopoly Committee (AMC) as proposed in Bank staff's policy note on competition policy reform. The private sector's perception of the business environment and barriers to entry and expansion identified in the World Business Environment Survey conducted recently by the Bank's PSDBE need to be addressed.

- **Settlement of Disputes.** Uzbekistan does not have a uniform, transparent, well-defined method of settling disputes and lacks a judiciary trained in the adjudication of commercial disputes. The evolving legal system, particularly in relation to commercial transactions, is not well-developed, which often results in uneven and ineffective enforcement of property and contractual rights. Conflicting laws often create confusion and lead to inconsistent interpretation by both government officials and the judiciary. International arbitration is permitted, but only after a ruling has been obtained in the Uzbek courts. Under current law arbitration awards can be challenged in domestic courts, which are often reluctant to enforce foreign decisions. In response to concerns raised by the American Chamber of Commerce (AmCham), the government expressed interest in establishing a dispute settlement mechanism based on the UNCITRAL model law on international trade arbitration.

- **Adjustment of legislation to the business environment, and legal stability.** The legal framework in Uzbekistan is generally improving and many of the new laws and decrees appear to support private sector business development. Implementation of the laws and decrees, however, is often slow and is further complicated by the fact that the laws do not have direct application, and in many cases address readers to other laws and bylaws. This leaves significant leeway for bureaucrats to interpret the laws to suit their own purposes and creates confusion for local and foreign businessmen, who are not able to access all of the existing numerous "norms and standards." Many norms and standards are inherited from the Soviet system and do not consider the present capacities and abilities of the entrepreneurs. Most SMEs complain about an "over-regulated" environment and difficulties in running their business without violating these norms. It also has to be noted that the frequent issue of new laws, Cabinet of Ministers' Resolutions, Presidential Decrees, and other by-laws, as well as amendments to existing legislation, is very high and leaves an impression of instability of the legal environment.

- **Privatization.** The Government recently announced major changes in its privatization strategy (COM Resolution No. 119 in March 2001), in particular its intention to: (a) offer a controlling stake (at least 51 percent of shares) for some large enterprises such as Uztelecom; (b) offer all remaining shares for 1,200 medium-sized enterprises; (c) include for privatization new sectors such as power and railways; and (d) offer a new list of enterprises to the Privatization Investment Funds (PIFs). The Government needs to accelerate progress in the case-by-case privatization of large enterprises by finalizing transactions, including by making available majority shareholding to strategic investors. A number of companies are presently in the pipeline for privatization and at various stages of preparation. The prospects for the successful privatization of these enterprises are mixed, given the macroeconomic situation and investors' perception of lack of government commitment to privatization and freedom for enterprises to act without government supervision.

- **Reform in the mining sector,** which is underdeveloped because of the lack of sector reform and the dominant role of state enterprises. Uzbekistan has the second largest gold reserves in the CIS (after Russia) and the sixth largest in the world. Gold output estimated at 85 tons in 1998 was low, given the country's geological potential. The production of copper, lead, molybdenum, silver, tungsten, zinc, and uranium is also important to the national economy. Excepting the Zarafshan-Newmont gold project, mineral production is predominately by government-owned enterprises. The meager US$10 million of exploration investment by international mining companies in 1999 testifies to the need to improve the investment environment. Exploration expenditure in the gold sector could be a multiple of current levels following implementation of significant reform. Discussions which have been taking place with several foreign investors over the past few years are yet to result in concrete new investments.

- **Banking Sector Development.** The extent of government guarantees issued to support lending to selected sectors and enterprises through state-owned banks is increasing the banking system's volatility and risk, in addition to the creation of disincentives for prudent behavior and moral hazard. For some state-owned banks, these guarantees sometimes exceeds 90 percent of the banks' total loan portfolios. Currency unification would result in significant further depreciation in the sum and substantially increase the vulnerability of enterprises and banks, given the foreign exchange mismatch of financial positions of some of the major borrowers of the banks. In many cases, the banks do not require collateral or any other form of additional security when they acquire government guarantees. This situation exposes the government directly to credit risk. Another major risk factor is the off-balance sheet exposure of some banks (through guarantees and letter of credits), some of which is again covered by government guarantees. In some cases, the off-balance sheet exposure of banks may exceed their total capital.

6. In addition, the Central Bank of Uzbekistan (CBU) is providing direct funding to selected banks to finance specific government programs. Although the CBU confirmed that these loans are also fully guaranteed by the government, this could potentially increase the vulnerability of the CBU itself and limit its role as a lender of last resort. There are also other serious weaknesses in the banking sector in terms of: (a) credit screening, portfolio monitoring and, hence, overall asset quality; (b) risk and asset liability management; (c) corporate governance and internal audit; (d) adequacy of legal and regulatory framework, and enforcement issues; and (e) accounting practices.

7. Addressing some of the above issues, such as phasing out government guarantees and directed credits, will require joint and coordinated efforts by the government and the CBU and can only be phased in over time. Workout capacity would need to be developed in the banks, with guarantees replaced by collateral once loans to major borrowers are adequately reviewed and subsequently restructured.

IFC Activities and Investment.

8. The difficult business environment has limited the opportunities for IFC investment during the last CAS period and, without significant improvement, will continue to do so. Accordingly, IFC is pursuing a strategy that focuses primarily on: (a) providing technical assistance to improve the investment climate; (b) supporting the development of SMEs that lack access to credit and technical expertise; (c) building capacity in the financial sector by supporting financial intermediaries offering services and products needed to deepen the financial system and assist in making capital markets more efficient; and (d) pursuing selective investment in sectors with significant export potential, such as natural resources, or which support the privatization process. Partly to support this strategy, IFC has strengthened its field presence in Central Asia, with a sub-regional office in Almaty, supported by the new Southern Europe and Central Asian regional hub in Istanbul.

9. SMEs offer significant potential for IFC investment in Uzbekistan and they are an important catalyst for the development of the private sector. The Extended Reach Initiative allowed IFC to gain a better knowledge of this sector and resulted in four direct investments. IFC has also been able to better understand the problems and needs of SME borrowers, both in terms of technical assistance and credit facilities, and broaden its support to improve the business environment, credit lines channeled through financial intermediaries and directed technical assistance to SME borrowers. However, significant growth in the SME sector is difficult due to the current business climate and restrictive foreign exchange regime.

10. IFC's activities to foster SME and private sector growth will be expanded during the FY02-04 CAS period. Supported by the Swiss Government, IFC's Private Enterprise Partnership (PEP) is planning to develop a non-financial assistance program to promote private sector development, and SMEs in particular. The program will include: addressing industry-specific barriers to business development, particularly related to cross-border trade and agribusiness; technical assistance support to private and public sector institutions in specific areas related to the business environment (e.g., identifying and addressing administrative barriers, capacity building for business/industry associations); and improving private sector access to information and quality business support services (e.g., through capacity building to new or existing business services providers).

11. Assistance to <u>SMEs</u> is most efficiently channeled through local financial intermediaries. IFC has taken a leading role in the area of institution building in the <u>financial sector</u>. During the past three years, it has committed credit lines for on-lending to SMEs through four financial intermediaries, including two regional banks, the latter being supported by institution building technical assistance; and, over the next three years, it plans to focus on building the financial strength and technical expertise of existing banks, providing new credit lines to support SMEs, encouraging leasing operations and giving technical assistance to these institutions. If the business environment improves and the World Bank-supported program for privatization of large state-owned banks moves forward, IFC would expect to work closely with strategic investors by providing investment capital and credit lines. Leasing is one of the most efficient vehicles for providing capital assets to SMEs. IFC has provided support for development of the leasing industry by approving investments in <u>Uzbekleasing</u>, as well as providing technical assistance for the development of the country's leasing law. IFC will continue to support the development of the leasing industry through a regional PEP project . IFC will also be looking at opportunities to develop the private sector insurance industry. Technical assistance, based on securing donor funding, may also be provided to assist in broadening the range of financial sector services, including the development of debit cards and credit unions.

12. Agribusiness is of vital importance to Uzbekistan's economy. There is tremendous potential for development of downstream cotton processing: only 18 percent of the cotton crop is used for domestic value-added processing and manufacture. The involvement of the private sector into the seed cotton processing has been very modest so far, with only

two private ginneries in operation and two more scheduled for operation during 2002-03 (out of a total of 140 cotton ginneries in the country). The situation is similar for grain mills. This is due to the fact that both cotton and grains are considered to be strategic crops and the state maintains tight control over planting areas, seasonal financing, processing and especially marketing and exports. Grain exports are prohibited. The situation is somewhat more positive with the further processing of ginned fiber and grain flour, with a number of private companies and joint ventures engaged in producing cotton yarn and fabric and a large number of small scale private bakeries.

13. Due to the substantial deregulation of the livestock, fruits and vegetables sector, the private sector dominates the processing of meat and dairy products and production of juices, other non-alcoholic-beverages, and jams, purees, etc. Most agro-processing enterprises have been corporatized (with the stake of the state typically around 25 percent) and operate on increasingly commercial terms. Nevertheless, thirty five percent of total annual fruit and vegetables output rots in the field. Investment and technical assistance for the agri-processing sector could significantly increase the value added in this sector and provide for significant export earnings. In this area, IFC has taken the initiative to seek out prospective local agro-processing entrepreneurs and, through the use of donor assisted consultants, help them in the development of their project proposals. SME proposals in this area are currently referred to the banks participating in IFC's credit line facilities. In addition, IFC is providing technical assistance to the government in outlining the strategic directions for the development of the textile sector and other initiatives to attract foreign investors.

14. In natural resources, Uzbekistan has significant untapped potential, particularly gold, copper, oil, and gas. To date, most projects have been undertaken by government joint stock companies and have been funded internally. As the business environment improves and private sector projects develop, IFC will work with international sponsors and the government to facilitate the development of projects to extract and process these deposits. Together with the Bank, IFC could also consider the provision of technical assistance to improve the legal and regulatory framework that could facilitate more foreign investment into the natural resources sector.

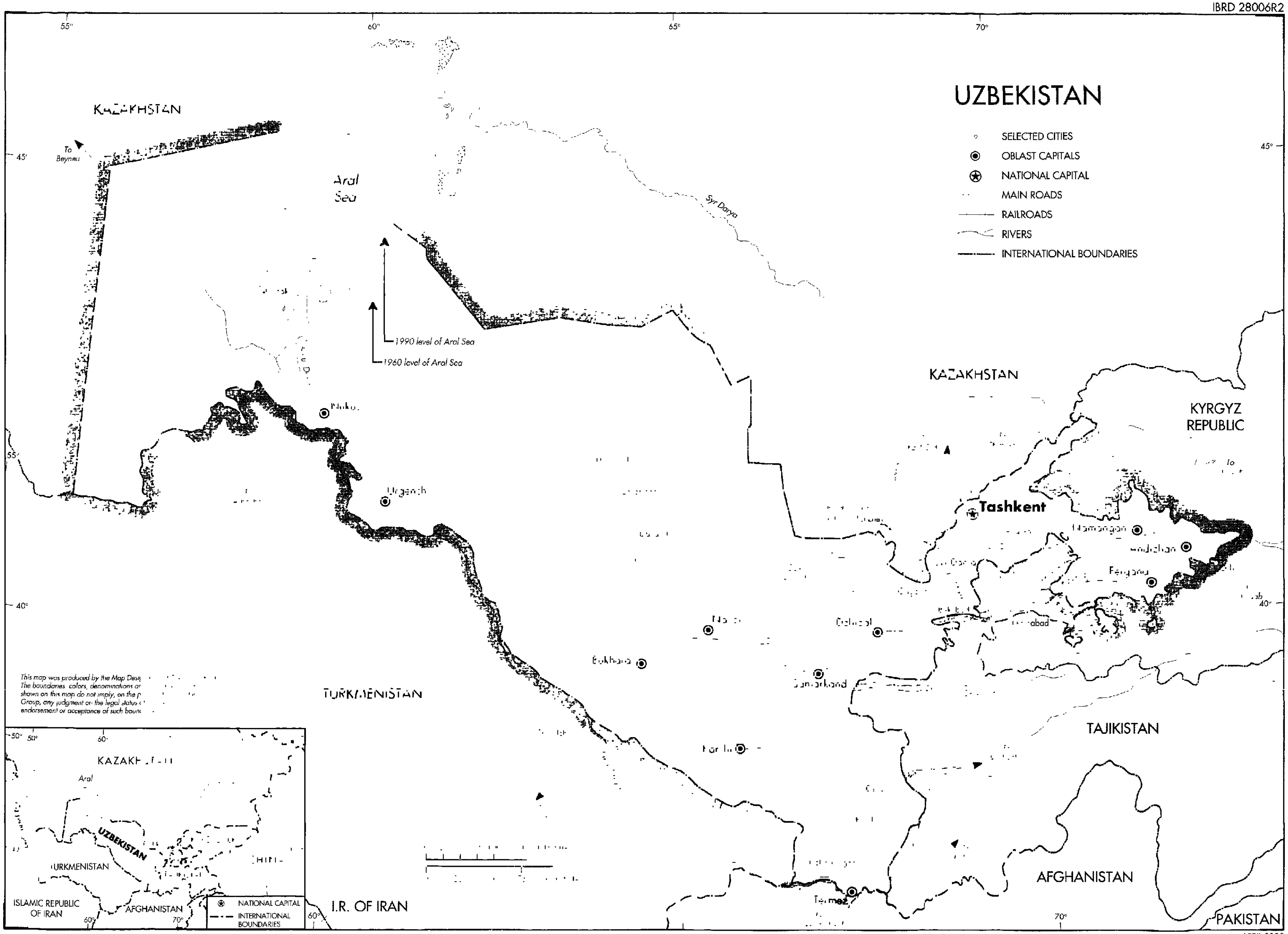
15. In telecommunications, IFC could consider supporting existing private operators in the cellular services market, and is now in the process of evaluating a potential pre-privatization investment in Uzbektelecom. At present, cellular operators face a number of challenges. The fragmented market consisting of five operators has hindered the ability of any one company to generate the critical mass of subscribers needed to justify significant investment in a nationwide network. Also, the convertibility issues noted earlier discourage the financing and import of the requisite capital equipment from abroad.

16. The government is undertaking the privatization of utilities along with some of the larger enterprises. Actual results to date, however, have been minimal due to investor reluctance to participate in the process in view of the lack of a strong legal and regulatory framework coupled with the difficult business environment. Once these privatizations take

place and strategic investors are identified, IFC would work with investors and the government to structure the investment and provide the required investment capital. New opportunities in power generation may also develop as a result of the February 2001 Presidential Decree which seeks private sector ownership and investment to renovate and modernize the country's facilities. The government views IFC's catalytic role in attracting foreign investment to this sector as important in addition to its potential role in providing technical assistance in the development of the required regulatory framework and encouraging good corporate governance. The pace of economic reform and currency liberalization will have a significant effect on IFC's ability to facilitate such investment.

17. Responding to the government's request to support the development of the private healthcare Sector in the country, IFC has conducted an overview of the current status of the sector and identified several potential investment opportunities. However, its ability to invest in the short term is limited by a restrictive foreign exchange regime and, in many cases, weak management capacity of prospective borrowers. During the CAS period, IFC will therefore focus on pre-investment technical assistance to already identified potential projects and, when appropriate, will facilitate financing through local financial intermediaries.

18. Technical assistance. During the last CAS, IFC technical assistance and support for SME projects have included work to identify potential investment opportunities in tourism, agribusiness, textiles and construction materials; a study to determine the potential for business incubation centers; support for SMEs in the development of modern accounting and MIS systems; and, a review of pre- and post-investment support for SMEs. IFC expects to continue providing results oriented technical assistance that will support the growth of the private sector.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