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MEMORANDUM OF THE PRESIDENT

OF THE

INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT

AND THE

INTERNATIONAL FINANCE CORPORATION

TO THE

EXECUTIVE DIRECTORS

ON A

COUNTRY ASSISTANCE STRATEGY

FOR

THE REPUBLIC OF UZBEKISTAN

FEBRUARY 17, 1998

CURRENCY EQUIVALENT

(Exchange Rate on February 13, 1998)

Currency Unit	=	Sum
Sum	=	US$0.0123
US$	=	81.32 Sum

GOVERNMENT'S FISCAL YEAR

January 1 - December 31

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
ASBP	Aral Sea Basin Program
CAS	Country Assistance Strategy
CIS	Commonwealth of Independent States
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
GOU	Government of Uzbekistan
GTZ	Gesellschaft für Technische Zusammenarbeit
IBRD	International Bank for Reconstruction and Development
IBTA	Institution Building and Technical Assistance
IFC	International Finance Corporation
IFI	International Financial Institutions
ILO	International Labor Organization
IMF	International Monetary Fund
JEXIM	Japan Export-Import Bank
KfW	Kreditanstalt für Wiederaufbau
MIGA	Multilateral Investment Guarantee Agency
NEAP	National Environmental Action Plan
ODA	Overseas Development Assistance
OECF	Overseas Economic Cooperation Fund (Japan)
PAYG	Pay-As-You-Go
PIF	Privatization Investment Fund
SME	Small and Medium Enterprises
TA	Technical Assistance
UNDP	United Nations Development Program
USAID	United States Agency for International Development

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SUMMARY

i. This country assistance strategy (CAS) has been prepared jointly by IBRD and the IFC, in consultation with the Government of Uzbekistan. Its presentation fully integrates the programs of the Bank Group. A private sector strategy attachment supplements the information provided on the Bank Group's approach to private sector development.

ii. The last CAS for Uzbekistan was prepared in early 1995 in a highly uncertain environment, setting out a strategy for the Bank program that drew heavily on the pattern of fast reformers in the region. However, that strategy has not worked well, as the Government is not prepared at this time to change the pace and intensity of its reform efforts. Despite good initial progress in achieving macroeconomic stability, the implementation of structural reforms has lagged substantially—particularly in the case of foreign and domestic trade liberalization. The Government's program, backed initially by the IMF's Structural Transformation Facility and an IBRD Rehabilitation Loan, and subsequently by an IMF stand-by arrangement, was entirely derailed in the last quarter of 1996 by the Government's decision to renege on key policy reforms and highly expansionary macro policies.

iii. Despite initial progress in reforming the economy, the Government retains a number of controls, including direct coordination of output decisions, allocation of foreign exchange and investment resources and wide discretionary powers in the microeconomic management of the economy. These actions, in our view, have created rent-seeking opportunities for certain vested interest groups and raise concerns about the overall environment for private sector development, public sector accountability and governance structure. The Government, however, disagrees with the Bank's understanding of their approach towards, and rationale for, economic management. The Government states that it remains committed to economic reforms and market liberalization, and that the speed at which the reforms proceed in Uzbekistan is merely a matter of deliberate and careful choice. But there remains a sharp disconnect between Government statements and the actual functioning of policies except in the area of macroeconomic stability.

iv. Given that Uzbekistan is highly cautious in liberalizing the economy, and that the partial nature of macroeconomic reforms creates severe risks to the viability of investments, the Bank's strategy is to create incentives for deeper structural reforms in Uzbekistan through carefully selected investment operations, in parallel with a continuing policy dialogue. IFC activities will complement IBRD's efforts on private sector development through project lending of about US$50-60 million per annum in the financial sector and export-oriented industries. As one of EDI's focus countries, we will also be using a variety of knowledge instruments to help open up the policy dialogue in a few key areas. This, combined with the Bank's proposed non-lending instruments will complement the learning achieved through investment operations.

v. In this vein, the Government and the Bank Group have agreed to work on four key challenges in the short to medium-term to support sustainable, broad based development with poverty reduction. These are: (a) *liberalizing* the trade and exchange rate regimes and minimizing distortions in the financial sector; (b) *improving* incentives for increased output and employment, particularly in agriculture; (c) *removing* the inefficiencies in resource utilization in the municipal services and infrastructure; and (d) *addressing* the environmental damage resulting from the mismanagement of natural resources in the Aral Sea Basin. IBRD and IFC will work closely to support Government's efforts in promoting private sector and capital markets development by providing both project lending as well as advisory services and policy dialogue.

Recognizing Government's past approach to reform, the Bank Group strategy has been designed with triggers to ensure links between Government performance and further Bank engagement.

vi. The CAS envisions three IBRD lending scenarios for Uzbekistan. Should the Government continue to have reservations about an agreement with the IMF but maintain basic macroeconomic stability and a policy framework consistent with the success of supported investment projects, as well as a fully satisfactory portfolio implementation record, we would continue to operate in the present (intermediate, or most likely scenario) mode. Under this scenario we commit a modest amount of about US$300-350 million in ten investment operations over the FY98-00 period (compared with US$306 million over the previous three years) in a series of pilot operations. However, shifting to a *high case* would require significant improvement in macroeconomic management (as evidenced by a new IMF arrangement) and a strong program of structural reform and liberalization, including liberalization of agricultural output prices throughout the economy; elimination of state orders on cotton and wheat; and unification of the exchange rates. We would then deliver up to three adjustment operations in support of the private sector, financial sector, and agriculture sector reforms, and ten investment operations totaling US$800-900 million over the FY98-00 period. A *low case scenario* would be triggered by the disintegration of macroeconomic stability and non-compliance with the intermediate case triggers; it would only allow for a few nonlending services and operations that focus on poverty reduction and environmental problems.

vii. The rationale for our choice of instruments (i.e., conventional investment operations) for enhancing policy dialogue rests on the premise that effective use of the foreign exchange provided through adjustment operations cannot be assured in the absence of a satisfactory macroeconomic framework. Investment operations, on the other hand: (a) provide flexibility in terms of the scope and size of a particular operation; (b) freedom to use an adaptable lending instrument approach if circumstances warrant; and (c) recognize the realities of the situation in Uzbekistan. The ability to scale the size and scope of the operation to the potential pay-off in terms of policy and institutional changes likely to be achieved makes pilot investment operations an attractive instrument.

viii. The rationale for the choice of sectors (selectivity) rests on two broad principles: (i) generating the greatest supply response and demonstration effect through strengthening the incentive and regulatory structure in agriculture; privatizing industrial enterprises; and improving the management and regulation of the financial sector; and (ii) improving the efficiency of public sector management and introducing cost recovery. In all scenarios, lending for poverty reduction and environmental problems will be maintained. Finally, the programs and activities of other donors, including the EBRD, EU, ADB, and OECF, are recognized by trying to make our operations both complementary and cooperative.

ix. Our nonlending program provides maximum flexibility at the request of the government in the composition, timing and content via provision for client-demand-driven-development strategy assistance: as and when there is internal consensus within the Government about a particular reform to be implemented the Government would like to approach the Bank for quick response assistance. The tasks under this rubric include informal notes, joint work on small, well defined tasks, policy seminars, study visits, and exchange of views with policy practitioners from other countries, which could be used to complement the lending program to maximize the demonstration and consensus building impact.

x. The IFC program will contribute to the objectives laid down in the CAS by focusing on the financial sector, agricultural equipment and agro-processing, and support to SMEs while recognizing that the scope and scale of their program will depend ultimately on the enabling environment, and hence demand, for private sector investments in the country. IFC is continuing to sponsor periodic

Investors' Conferences for Uzbekistan; the most recent was held in January 1998 in Tokyo. MIGA has currently 15 preliminary applications for total potential investments of US$500 million in finance, manufacturing, cotton, energy and mining; it has so far insured only one project (mining) in Uzbekistan.

xi. Uzbekistan's development program enjoys the support of a number of bilateral and multilateral donors, many of whose programs complement those of the Bank. Collaboration and coordination with other donors and international financial institutions (IFIs) is good and continues to strengthen—under both case-by-case and standing coordination arrangements. In the area of macroeconomic management, the Bank assistance program complements the efforts of other donors, particularly the IMF, USAID and Japan (JEXIM). While EBRD has taken the lead in provision of infrastructure finance, and ADB in education, the Bank has focused on supporting health and pension reforms. In providing support to the emerging private sector, IBRD and IFC have cooperated effectively with USAID, EBRD, ADB, EU-TACIS, UK-Know-How Fund and KfW. The Aral Sea Basin Program has been the focal point for donor coordination in supporting the Government's program to address environmental degradation in the region.

xii. The strategy proposed here has high risks in so far as that the Government may find it difficult to fully implement the reforms embedded in the pilot and demonstration projects, and even if it does so in the context of these projects, there may be further impediments in replicating these reforms throughout the economy. To address these risks, we have linked our level of assistance—even under the intermediate scenario—to the reforms and performance at the project level in the earlier years. We are not investing large amounts in these projects, but this will give us the opportunity to test government commitment to reforms, and positive results would provide the basis for encouraging the Government to move ahead more broadly. Thus, the strategy is a risky one but one that could potentially have large pay-offs over the medium term with a moderate level of engagement by the Bank.

Items for Board Discussion

xiii. Uzbekistan is pursuing a slow reform strategy and adopting policies different from those adopted by the neighboring countries. The intermediate case outlined here envisions a broad-spectrum of investment projects to support economic and institutional reform without the traditional macroeconomic conditionalities adopted as part of our engagement with other FSU countries. The proposed lending program is relatively heavily weighted toward infrastructure/municipal services and institution building, reflecting Government priorities and the emphasis on public sector reforms, as well as other development partners' activities in other key sectors. The Board may wish to consider the following questions:

- Is the Board comfortable with supporting this gradual-pilot-demonstration-replication approach to promote market-based economic reforms throughout the economy?

- Does the Board think that the lending program strikes an appropriate sectoral balance?

- Does the Board think that the strategy strikes an appropriate balance between risk and return and incorporates adequate risk management mechanisms? Have we calibrated our assistance carefully given the risks?

MEMORANDUM OF THE PRESIDENT OF THE INTERNATIONAL BANK FOR RECONSTRUCTION AND DEVELOPMENT TO THE EXECUTIVE DIRECTORS ON A COUNTRY ASSISTANCE STRATEGY OF THE WORLD BANK GROUP FOR THE REPUBLIC OF UZBEKISTAN

I. BACKGROUND

1. Situated at the cross-roads between Europe and China along the fabled "Silk Road", Uzbekistan has long been a center of east-west commerce and a much sought after prize in age-old struggles for commercial and political hegemony in this region. Each conquest left its imprint on the modern day nation, reflected in the cultural, ethnic, and religious mosaic which characterizes Uzbekistan today. Although its present day population (23 million, the largest of the Central Asian nations), is predominantly rural (60 percent), of ethnic Uzbek origin (71 percent), and Muslim (88 percent), there remains substantial diversity and a rich cultural heritage. Its average family income levels were, at independence, also relatively low, and remain so today (Box 1). As in other FSU countries, human development indicators are strong, with relatively long life expectancy (70.4 years in 1994), high adult literacy (98.7 percent in 1994), and low maternal mortality (17.3 per 100,000 births in 1994).

2. In this century, during its membership in the Soviet Union, Uzbekistan became the leading center of cotton production in the FSU and a major cotton producer on the world scene as the vast water resources of the Syr Darya and Amu Darya Basins were developed for use in irrigated agriculture in Central Asia. It also became a major gold producer (second largest in the FSU, eighth largest in the world) and producer of natural gas. Its industrial potential, however, apart from industry directly related to agriculture, was relatively less developed than in several neighboring states. Like the other Central Asian republics, it depended on budget transfers from the central government in Moscow to finance a substantial portion of its expenditures.

3. Uzbekistan declared its independence in August 1991 with the *de facto* dissolution of the Union. The former First Secretary of the Uzbek Communist Party, Islom Karimov, was elected President in December 1991, and a new constitution providing for a strong presidential form of government came into effect in late 1992. A referendum held in 1995 extended President Karimov's term until 2000. The President and most senior government officials and members of parliament are affiliated with the People's Democratic Party, which is the direct successor of the Communist Party. Decision making is highly centralized, with the President serving as the ultimate arbiter in his capacity as President and Chairman of the Cabinet of Ministers. There is at present no open political opposition or independent press. A recent independent public opinion poll[1] found a very high (absolutely and in relation to other Central Asian countries in which comparable polls have been taken) professed degree of public satisfaction with and

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[1] Wagner, Steven (1997). Public Opinion in Uzbekistan in 1996. International Foundation for Election Systems.

support for the Government and its policies. The survey also shows a very high degree of public support for maintaining a strong government hand in guiding the economy.

II. MACROECONOMIC PERFORMANCE, PROSPECTS AND EXTERNAL ENVIRONMENT

A. Recent Economic Developments

4. To achieve macroeconomic stability and address key structural rigidities, the Government in 1994 embarked on a comprehensive reform program, which was backed initially by the IMF's Structural Transformation Facility and an IBRD Rehabilitation Loan, and subsequently by an IMF stand-by arrangement. The program envisaged continuing financial stabilization and gradual, phased liberalization of external trade and payments regimes, and structural reforms encompassing privatization and restructuring of medium- and large-scale enterprises, liberalization and land reform/farm restructuring in agriculture, and reform of the financial sector. Considerable progress was made under the program in reducing the fiscal deficit, bringing down inflation, and re-establishing growth (see Table 1). These achievements notwithstanding, the reform program broke down during the fourth quarter of 1996. Fiscal and

Table 1: Macroeconomic Performance Indicators – 1992-1997[2]

	1992	1993	1994	1995	1996	1997e
Fiscal Balances (% of GDP)						
Revenues	31.3	36.0	29.2	34.6	34.2	30.0
Expenditures	43.4	53.6	33.3	38.1	39.8	33.8
Health & Education	14.7	13.4	11.8	11.0	11.1	10.2
Public Investment	0.0	2.2	3.5	6.1	7.1	7.4
Subsidies & Transfers	10.6	7.6	2.7	3.4	4.0	3.4
Net Lending	...	14.8	...	0.5	3.6	...
Extra-budgetary funds	-6.3	7.2	-2.0	-0.7	-1.7	0.2
Overall Balance	-18.4	-10.4	-6.1	-4.2	-7.3	-3.9
Current Account Balance (% of GDP)	-11.8	-7.8	2.1	-0.5	-7.9	-6.5
GDP Growth (% p.a.)	-11.1	-2.3	-4.2	-0.9	1.6	2.4
Inflation - CPI - eop			1281	117	64	40-50

Source: IMF

monetary policy were relaxed when net lending equivalent to 3.6 percent of GDP, financed by bank credit, was extended to finance the cotton harvest and to clear accumulated inter-enterprise

[2] Due to deficiencies in the coverage, accuracy, and accessibility of available data on Uzbekistan's economy, the data and projections presented in this section should be regarded as indicative and subject to higher than normal margins of error. The authorities acknowledge these problems and have requested assistance from the Bank and other donors to deal with them (see para 53).

wage and pension arrears. After declining to 0.5 percent of GDP in 1995, the current account deficit increased to almost 8 percent of GDP in 1996, or about US$1.1 billion. This was due primarily to substantial increases in the volume and unit cost of grain imports, substantial increases in payments for imported machinery associated with Uzbekistan's investment program and a stronger-than-expected economy, and some decline in all major categories of export receipts with the exception of gold. In conjunction with the relaxation of its financial policies, the Government sharply tightened restrictions on imports and access to foreign exchange. These restrictions were formalized in a system of multiple exchange rates early in 1997. As a result, substantial and widening spreads opened up between exchange rates in the auction, cash bureaus and curb market with the tightening of these restrictions. While the spread between the auction and cash bureaus rate has been limited administratively to 12 percent, since late 1996 the curb market rate has averaged over two times the rate established in the auction market.

5. The Government moved quickly in early 1997 to regain fiscal control. The consolidated budget deficit was reduced to about 3.9 percent of GDP, and tighter control of money and credit was reinstated. While the temporary loss of fiscal and monetary control late in 1996 caused some acceleration in inflation late in 1996 and early in 1997, the tight policies followed since early 1997 have been effective in returning inflation to its earlier downward trend. Restrictions on trade and payments were retained and controls were introduced on the sale of important food items which repressed inflation, however, and the stand-by arrangement with the Fund lapsed in March 1997 with substantial undrawn balances. A modest reduction in the current account deficit to 6.5 percent of GDP (US$910 million) is estimated for 1997, largely as a result of reduced foodstuff import quantities and unit costs and trade and payments restrictions which have sharply compressed imports not related to Uzbekistan's investment program. Reserve losses amounted to over one-third, bringing reserves to about 3.5 months of imports at year end.

6. Growth accelerated during 1997, although the extent of this acceleration is at present unclear. Early GDP estimates based on interim production targets suggest real growth of 5.2 percent or slightly more on the year. Adjustment of these estimates to reflect partial updated production data suggest a considerably lower figure, on the order of 2.4 percent for the year.

7. The Government has made generally satisfactory progress toward market institution building, sectoral development, and improving social protection. Much of the institutional framework needed for a market economy to operate is in place or in the process of development. Basic laws and regulations (e.g., on banking, bankruptcy, companies, etc.) have been enacted. A stock exchange and depository have been established. Small scale privatization has been substantially completed. An innovative program has been initiated with Bank technical assistance for mass privatization of medium and large scale enterprises through privatization investment funds (PIFs). Uzbekistan's banks are being required to adopt international accounting standards, and to submit to strengthened supervision and prudential regulations. Social protection expenditures—with the exception of pensions—have been trimmed to levels consistent with resources and eligibility requirements have been tightened to strengthen the correspondence between need and receipt of funds. The Pension Fund has been kept roughly in balance (although this has required the levy of additional taxes). Considerable emphasis has

been placed on investment in the modernization of the productive sectors of the economy. Public investment spending—mainly associated with the modernization of state enterprises—has increased substantially and rapidly. There has also been substantial investment in joint-ventures and in major state enterprises.

8. Less progress has, however, been made against benchmarks for the structural adjustment reforms (e.g. privatization, liberalization of agricultural prices, land reform and farm restructuring) of the program. While there have in general been few outright reversals in areas other than trade and payments, the pace and scope of reform have been disappointing in relation to the modest benchmarks envisaged at the outset of the reform effort. As a result, the state at present still retains and exercises wide discretionary powers in the microeconomic management of the economy, at relative prices that bear little relationship to market reference points. In these respects, the present situation bears a strong resemblance to the pre-independence economic system.

9. While good progress was made in updating certain elements of commercial law—the pledge law, the company law, and bankruptcy law—there remain several problems in the area of *pledge law* (see Attachment 1, Private Sector Strategy, para 8). Uzbekistan has also enacted a modern company law, and the *bankruptcy law* was amended in August 1996 with the active involvement of IFC, to reflect the concept of limited liability of shareholders in joint-stock companies and the priority of secured lenders over claims of other creditors. However, despite this progress, there remain uncertainties about, and inconsistencies in, the legal and regulatory framework, and a lack of a uniform system of law has undermined private sector confidence and created rent-seeking opportunities, therefore, adding to the cost of conducting business in Uzbekistan.

10. The information on the extent and nature of poverty in Uzbekistan remains incomplete. Data from a survey conducted in the late 1980s indicate that about 44 percent of the population lived below the unofficial poverty line of 75 rubles per capita per month—second highest among the Soviet Republics (see Box 1)—with a strong rural bias. These results were confirmed by a sample survey conducted in selected parts of the country in 1995, which indicated that Karakalpakstan (a semi-autonomous republic in the far western part of Uzbekistan) is the poorest part of the country due chiefly to its remote location and poor

Box 1: Living Standards in Uzbekistan

Family Budget Survey (FBS) data from the end of the 1980s indicate that gross per capita income in Uzbekistan was among the lowest of the Soviet republics, and that the share of the population living below the unofficial poverty line of 75 rubles per capita per month was the second highest, with around 44 percent of the working population below this line. The distribution of poverty also showed a strong rural bias, with around 57 percent of collective farm workers living below this line, and around 39 percent of workers. At the same time, the distribution of income was only slightly worse than the FSU average, with a Gini coefficient in Uzbekistan of 0.30 and in the FSU as a whole of 0.29. The FBS data are known to have a number of problems associated with the sampling method employed and valuation of own-produced food. The Government therefore is exploring collaboration with donors on modifications to the survey which should make it more representative, and a *Living Standards Assessment*, supported by the Bank, is planned for 1999.

resource endowment. Using the minimum wage as the threshold for an absolute poverty line, the incidence of poverty nationally was found to be 30 percent, of whom about 17 percent were very poor. The incidence of poverty was much higher in both rural and urban Karakalpakstan, with rates 69 and 49 percent, respectively. The estimated rate of severe poverty (defined as 50 percent of the minimum wage per capita) was 41 percent in rural and 27 percent in urban Karakalpakstan.

B. Macroeconomic Prospects

11. With growth in 1996 and 1997, the economy brings some modest momentum and several sources of potential strength into the coming years. It has a strong base of human, infrastructure and natural resources on which to build. Its central location in the region, relatively large population, and relative political stability render it attractive on these accounts to potential foreign development partners. It is relatively unencumbered with an overdeveloped, fundamentally uneconomic industrial base. It is relatively free of debt. And it has made progress in establishing some of the basic laws and institutions needed for a modern market economy (para 7). However, it also faces some difficult macroeconomic policy problems and tradeoffs as a result of the imbalances in its foreign exchange markets, deferred adjustment in most sectors of its economy, and the tougher environment now facing emerging market countries. How it copes with these will have a major impact on the extent to which it is able to capitalize on its inherent economic strengths.

12. Base Case Scenario: Slow Liberalization. The Base Case macro scenario assumes a continuation of the policies of the recent past, with very slow liberalization and structural adjustment, continuing efforts to maintain a modicum of fiscal and monetary restraint, and continuing relatively high saving and investment. Under this policy scenario, average real GDP growth over the projection period (1998-2007) would be relatively modest—averaging about 3 percent annually[3] (see Table 2). Growth would be driven by increases in investment under the Government's activist approach to industrial policy (see para 21). Productivity growth would

Table 2: Macroeconomic Scenarios

	Estimate	Base Case		High Case	
	1997	1998-00	2001-07	1998-00	2001-07
GDP Growth	2.4%	2.7%	3.0%	3.5%	5.9%
Consumption pc growth	-3.6%	-1.9%	0.6%	-0.6%	1.6%
Inflation	40.0%	25.8%	25.0%	18.3%	6.6%
Fiscal Balance	-3.9%	-3.5%	-2.4%	-3.4%	-2.7%
Current Account	-6.5%	-5.0%	-5.2%	-5.3%	-4.8%
Debt Service/ Exports	14.8%	15.9%	29.1%	14.6%	18.4%

[3] The scenarios presented here are based on the lower estimate of 1997 GDP growth. See para 6.

be relatively low. Budget deficits (3-4 percent range) and inflation (20-30 percent range) would be moderate to high and variable as efforts to establish firmer fiscal and monetary control would be hampered by lack of structural adjustment in the real and financial sectors of the economy. Overall, this would be a very uncomfortable scenario, confronting Uzbekistan's policy makers with a relatively unpalatable menu of tradeoffs between low or no consumption growth or high levels of indebtedness, with a perpetually tight balance of payments, low overall growth, and occasional bursts of inflation associated with temporary softening of enterprise budget constraints.

13. High Case Scenario: Strong Stabilization and Structural Reform. Under a High Case scenario, in which financial policies would be strengthened and backed by early liberalization of trade and payments regimes and resumption of structural reforms to increase the efficiency of utilization of resources, combinations of somewhat higher aggregate growth, higher productivity growth, higher consumption, lower inflation and lower indebtedness could be envisaged. The key reforms in this regard would be full domestic currency convertibility and establishment of current account convertibility in the foreign exchange market, elimination of quantitative restrictions on trade in favor of a modest level of relatively uniform tariff protection, liberalization of prices and marketing in agriculture, strengthened prudential regulation and supervision of a gradually-liberalized banking system, transformation of the system of tax administration to accommodate these changes without unduly sacrificing revenue, privatization of industrial and agricultural enterprises, and a strengthened social safety net to protect those who would be adversely affected by these other measures. In this decisive reform scenario, growth rates would rise gradually to perhaps 6 percent annually and inflation would decline into the 5-10 percent annual range in the first years of the next century.

14. There would, however, be some serious political barriers to reforms under this scenario. The segments of Uzbek industry that have benefited most from the protection afforded by current restrictions on trade and payments would be squeezed. Those consumers benefiting from the implicit subsidies conferred on them by the present multiple exchange rate system would also oppose the reforms, notwithstanding the countervailing social safety net measures. Budget pressures would intensify with the elimination of the controls (e.g., restrictions on conversion of deposits into cash) which currently reinforce fiscal revenue collection mechanisms. These are among the reasons cited by the authorities for proceeding on reform with caution (para 32) and may explain the attitudes expressed by the Uzbek public (para 3) concerning reform.

C. External Environment

15. As a primary commodity exporter, Uzbekistan is highly exposed to external shocks, including wide fluctuations in world prices for its major exports—cotton and gold. In addition, poor cotton and/or wheat harvests and/or low/high prices for cotton/wheat still have the potential to do serious damage to the economy. Regional stability will also be an extraordinarily important factor, affecting economic outcomes through trade linkages and factor flows in the region and economic policy via its impact on the Government's assessment of the

political and social risks of development policy alternatives. Severe setbacks in Asian countries could also have debilitating effect on Uzbekistan economy by eroding its competitiveness—especially when the Uzbek sum has been appreciating in real terms vis-à-vis its major trading partners—and through a reduction in foreign direct investment and availability of project finance at affordable interest rates.

III. UZBEKISTAN'S DEVELOPMENT AGENDA

16. The stated objectives of the Government's development policies and programs are to: (i) strengthen and maintain Uzbekistan's fiscal and balance-of-payments performance consistent with low inflation and prudent levels of external debt; (ii) achieve relatively rapid, sustainable economic growth; (iii) maintain a high level of development of human resources and social protection.

A. Macroeconomic Stabilization

17. The Government targets low double digit inflation and real growth of more than 6 percent within the next two-to-three years. On the fiscal front, it projects a fiscal deficit of 3 percent or less of GDP, which the authorities believe can be financed without recourse to external borrowing. To this end, strong revenue performance would be maintained on the basis of the new Tax Code, sustained improvements in tax administration, improved cost recovery, and the robust real growth it expects. On the expenditure side, the Government expects to continue restraint and rationalization of expenditure.

B. Rapid, Sustainable Economic Growth

18. Enabling Environment. The Government's agenda embraces the development of the laws, regulations, and agencies necessary for the establishment and management of a market economy. The Government recognizes that suitable policies and institutions are essential to promote growth. The program adopted in 1995 envisaged the gradual elimination of most restrictions on trade and payments by the end of 1996. The Government reaffirms its commitment to these objectives but, as of yet, has not announced a strategy or a timetable for liberalizing trade or phasing out multiple exchange rates and restrictions on currency convertibility. The Government has, in addition, announced its intention to seek membership in the World Trade Organization. It has not as of yet submitted its memorandum of policies to commence the formal accession procedure.

19. Financial Sector Development. The development of financial markets and institutions is accorded high priority by the Government. The GOU's objectives with respect to financial sector reform include the strengthening of the legal and regulatory framework for financial intermediation, adoption of internationally accepted accounting systems for banks, strengthened supervision of banks (with some attention to bank restructuring), and capital markets development. Over the last year, particularly as a result of the implementation of the Law on Banks and Banking Activity adopted in April 1996, there have been certain encouraging

developments. From late 1996, commercial banks started to set aside reserves against non-performing loans. All banks are now required to have annual audits performed by international accounting firms. The payment system has become fully automated, resulting in a major reduction of settlement times. A recent presidential decree called for increased private sector participation and reduced administrative interventions in the banking system.

20. Agriculture. Agriculture is the cornerstone of the Uzbek economy. It is a major foreign exchange generator, with cotton alone accounting for approximately 45 percent of merchandise export revenues, and a major source of income and employment. As noted above, 60 percent of the population lives in rural areas. The Government's agricultural development program envisages strengthening agricultural incentives by (i) phasing out state orders and liberalizing markets for cotton and wheat—paralleling earlier developments in markets for most other agricultural commodities, (ii) phasing out subsidies for agricultural inputs and state participation in the direct distribution of agricultural inputs and liberalizing distribution and trade, (iii) distributing land under long-term leases to individual farmers or groups of farmers, and (iv) promoting the efficient use of irrigation water and cost recovery. The program also envisages strengthening of support services for agriculture, including targeted support to cotton producers in improving the quality of Uzbek cotton for export, and overall improvement in research, extension and credit services available to farmers.

21. Industrial Development, Employment and Privatization. The Government's strategy envisages an active state role in enterprise restructuring, in coordinating production and investment decisions in strategic segments of Uzbek industry, and in attracting foreign investment. Accordingly, the Government has programmed (through the public investment program) and undertaken major investments in rehabilitation and new, greenfield industrial development projects. These projects are geared primarily, at least initially, to import substitution. Several major projects have been completed or are underway in energy (petroleum refineries, natural gas production and transmission, power), agro industry (textiles, cotton processing, agricultural machinery), and chemicals. Projects typically are financed, in part, by the domestic banking system.[4] With the re-imposition of controls on trade and payments and formal introduction of a multiple exchange rate system, these projects also typically qualify for priority access to imports and foreign exchange at the official rate.

22. The Government also has a number of programs intended to foster the development of small and medium enterprises. Subsidized credit and business assistance is available to medium enterprises from a Privatization Fund and to smaller, primarily rural enterprises through the Business Fund, both funded mainly from the proceeds from privatization. Credit lines and assistance financed by the European Bank for Reconstruction and Development (EBRD), Asian Development Bank (ADB), Japan Overseas Economic Cooperation Fund (OECF), and Central Asia-America Enterprise Fund are also available, although these funds are primarily accessed by firms at the upper end of the SME range.

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[4] Many projects also draw upon foreign debt and equity finance.

23. Privatization is the third pillar of Uzbekistan's strategy for industrial development. Its privatization program encompasses the complete divestiture of small enterprises (including houses and apartments) and the phased privatization of most medium- and large-scale enterprises. The framework for privatization of medium- and large-scale enterprises was considerably improved with Resolution No. 220 of the Cabinet of Ministers "On Measures for Organization of the Activities of the Investment Funds" of June 18, 1996. This Resolution provides the framework for the program of privatization through wholly private Privatization Investment Funds (PIFs) which issue shares and use the proceeds to purchase state shares in enterprises offered in auctions. Recently, the Government announced a case-by-case privatization program of large enterprises, which may attract foreign strategic investors.

24. Infrastructure. The Government's strategy envisages major investments in and restructuring of Uzbekistan's transportation and communications infrastructure. Development of water supply and sanitation is also a very high priority. The Government's main strategy is to provide a new set of incentives to transform the sector by (i) instituting new pricing and cost-recovery mechanisms; (ii) encouraging competition in areas such as road and air transport; (iii) encouraging the development of competitive support services such as gas stations, repair shops and spare parts supply for the private sector; and (iv) encourage private sector participation in developing the country's infrastructure.

25. Natural Resources and Environment. The desiccation of the Aral Sea is in many respects a metaphor for a much more comprehensive set of economic and environmental problems that afflict Uzbekistan with increasing urgency. The Government is currently identifying and prioritizing these problems in a National Environmental Action Plan (NEAP), now being prepared with support from the Bank and from other donors.[5] Many of the problems identified afflict agriculture and threaten its future productivity. Competition for water for alternative uses (primarily for power generation) from the upper basin states and salinization of land and water and waterlogging of land pose increasing threats to future agricultural production. Remedying these problems will require strict water conservation, supported by water pricing and farm restructuring, and substantial investment—also partially financed through water pricing—in rehabilitation of irrigation and drainage. In addition to these predominantly rural problems, "brown" environmental issues are concentrated in a number of industrial centers as a result of poor environmental performance of old and inefficient heavy industries. The solution to these industrial pollution problems is linked to industrial restructuring and modernization, along with strengthening the framework for environmental regulation.

C. Human Development and Social Protection

26. Health and Education. Expenditures on health and education have taken substantial "hits" in the post-independence expenditure cuts, declining from about 15 percent of GDP in 1992 to an estimated 10 percent of GDP in 1997, and from 34 percent of total expenditures in 1992 to about 30 percent in 1997. This has been inevitable given their weight in total spending and the

[5] See also paragraph 53.

steep cut in expenditures that had to be made to conform to the post-transfer budget environment. A sobering corollary, however, is that the quantity and/or quality of services available to the Uzbek public has declined and probably—given budget pressures—will continue to do so. It is noteworthy that in a public opinion poll that generally accorded the Government high marks (para 3), health services and the affordability of food were the two areas in which widespread dissatisfaction was expressed. A fundamental re-thinking of approaches to providing services and safety nets will thus be required to maintain human capital intact while adjusting to hard budget realities.

27. The Government's medium term reform strategy for education embraces increased emphasis on market needs in development of education programs, development of educational standards, development of new syllabi and curricula, improving evaluation of skills and training needs of teaching staff, improving quality assessment mechanisms in educational institutions, and introduction of new streams in vocational and post-secondary education. In health, the strategy aims to enhance the efficiency in the use of constrained resources, to improve the quality of services, to improve cost-effectiveness, and to target vulnerable groups. The strategy also recognizes the need for urgent reorganization in health financing, and the importance of health education and promotion.

28. Social Assistance and Poverty Alleviation. The Government is aware of the extent of poverty and wide divergence in rural and urban income. It maintains an extensive social safety net, which consists of various benefits, transfers and allowances amounting to about 3.4 percent of GDP in 1997, down from 10.6 percent of GDP in 1992. The main elements of the system are subsidies for central heating and urban transport, subsidies for housing and municipal services, and allowances paid to families, vulnerable groups (single mothers, children under 2, and pensioners), and low-income families. The latter are managed by local committees (*mahallahs*), which target payments on the basis of central guidelines as well as local knowledge and discretion. Government plans call for a phased elimination of subsidies, partially compensated by means-tested allowances.

29. Pensions. Uzbekistan, like most of the other FSU states of the region, operates a pay-as-you-go (PAYG) pension system. Pension expenditures are high by regional standards (i.e., about 6 percent of GDP, in comparison with 5.0 percent of GDP in Kazakhstan and 5.5 percent of GDP in Russia). This is in part due to the relatively limited reform of the Uzbek PAYG system to date, and the Government's efforts to maintain the real value of pensions. At the same time, there appear to be emerging financing problems with the unreformed system. The Government is thus considering a number of reform options for introduction of a three pillar system by complementing a streamlined version of the present PAYG system with mandatory and voluntary funded pillars.

Bank's Assessment of Government's Agenda and Areas of Difference

30. While good progress has been made (see para 7), much remains to be done in many areas of market liberalization and structural reform, as well as developing a coherent poverty reduction strategy. As in other countries in transition, serious inconsistencies in legislation,

weak administrative capacity to implement the law and considerable remaining scope for bureaucratic discretion in application of laws and regulations pose serious barriers to the development of stable, predictable commercial relationships (See Attachment, Private Sector Strategy, paras 6-8). Privatization of medium and large scale enterprises is still proceeding at a very slow pace. Fewer than 20 percent of existing medium and large scale enterprises have been privatized to date. Implementation of reforms in the provision of health and education is only beginning, and the Government still has yet to come to grips fully with the difficult financing and service quantity/quality tradeoffs it will have to face as a result of budget constraints. Continuing fiscal pressures will also require further adjustments to reduce the cost of the social safety net. In the area of pension reform, this will also require complementary development of the financial sector and regulatory capacity if the kind of systemic reforms the Government is considering are to succeed. Government institutions and processes have not yet been transformed to support the need of a market economy. Absence of efficient mechanisms for forging consensus, highly centralized decision-making, and fragmented and unresponsive local government in the oblasts are major deterrents to administrative and economic reform and promotion of private initiatives.

31. The greatest challenges, however, remain in the area of liberalization of the economy. Steps taken previously to liberalize trade and payments were, as noted above, reversed in late 1996 and the reversals remain in effect. State orders for grain (which were to have been eliminated for the 1997 crop year) and cotton (which were to have been eliminated for the 1998 crop year) reportedly will remain in effect for the 1998 crop year. The marketing of cotton (which was to be gradually opened to competition under the program agreed with the Bank) remains the preserve of the enterprises of the Ministry of Foreign Economic Relations. Wholesale trade in a number of foodstuffs (e.g., edible oil, sugar) recently were made subject to centralized Government procurement. Privatized industrial and agricultural enterprises generally remain subject, formally or informally, to the production plans of the enterprises from which they were formed and/or to formal/informal government coordination through line ministries, associations and holding companies. Bank credit decisions are still largely at Government direction. Virtually all foreign investment, including that financed by the IFC, occurs in the context of joint ventures with state-owned corporations.

32. The Government in discussions with the Bank and its other development partners reaffirms its commitment to continuing structural reform and eventual liberalization of the economy. It maintains, however, that the controls now in place are necessary—as a transitional measure—to prevent the collapse of output, to ensure the import of essential foodstuffs at affordable prices, and to enhance the productivity and promote the dynamic comparative advantage of Uzbek industry. The Government believes that corruption and criminality would become more serious if liberalization were undertaken before an effective market institutional framework was in place. What distinguishes Uzbekistan from most other adjusting ECA transition economies are not its ultimate objectives, the authorities emphasize, but rather the pace and sequencing of implementation of measures, particularly the liberalization of markets, toward these ends—the Uzbek "step-by-step approach" to economic reform. In our view, however, Government's decision to retain a number of controls, including direct coordination

of output decisions, allocation of foreign exchange and investment resources and wide discretionary powers in the microeconomic management of the economy, have created rent-seeking opportunities for certain vested interest groups and raise concerns about the overall environment for private sector development, public sector accountability and governance structure. There is also a sharp disconnect between Government statements and the actual functioning of policies except in the area of macroeconomic stability, which undermines confidence.

IV. BANK GROUP COUNTRY ASSISTANCE STRATEGY

A. Progress Under the Previous CAS

33. The previous CAS for Uzbekistan was discussed by the Board in March 1995. It envisaged investment and technical assistance support for strengthening basic market institutions, IFC financing and advice to support private sector development, addressing environmentally and poverty related water supply, health and sanitation problems in the area around the Aral Sea, strengthening of social protection and the provision of social services, and the strengthening of institutions and restructuring of agriculture. It also envisaged a gradual but time-bound structural reform program in agriculture, privatization and finance supported by adjustment lending as the principal vehicle for promoting growth.

34. At the time the previous strategy was discussed by the Board, there was a perceived window of opportunity to support an accelerated program of structural reform. A STF arrangement with the IMF was in place and discussions on a stand-by arrangement were underway. The previous strategy sought to capitalize on this opportunity by holding forth the prospect of substantial financial support from the Bank, the IMF and other donors. Although the risks were recognized, the Bank invested heavily in building and maintaining readiness to undertake adjustment lending. As noted above, this strategy did not succeed as both the intensity and the pace of reform it envisaged did not suit the political economy imperatives of Uzbekistan's Government.

35. The continuing divergence of views with the Government notwithstanding, the dialogue on the timing and degree of liberalization and structural reform has been increasingly candid and pointed. Much of the dialogue has been carried out in the context of preparation of adjustment operations that would support privatization and financial sector reform. Recently, at the Government's request, the Bank sponsored and conducted a two-and-one-half day seminar for the Government's senior-most officials responsible for economic policy on the experiences of other countries in liberalization and structural reform. In this seminar, Uzbek officials had an opportunity to discuss first hand with officials from other countries how these countries have come to grips with the same kinds of concerns that have impeded progress in Uzbekistan. Although this has not had an impact on policy, it has added credibility to the dialogue and improved inter-ministerial dialogue within Uzbekistan on development policy options.

36. As a result of the policy developments summarized above, lending—with the exception of a Rehabilitation Loan supporting the initiation of the Government's reform program—has been

limited to investment, engineering and TA operations. To date, the Bank group has financed 15 projects (IBRD 5, IFC 10) with a total project cost of about $800 million [IBRD—US$306 million, IFC—US$486 million (of which US$98 million for its own account)]. Experience with this element of the strategy has also been mixed, but satisfactory overall and improving. Operations have generally been two-to-three times more expensive and time consuming to prepare than in neighboring countries due to the multi-layered decision process through which all Government decisions pass. Recently, steps have been taken to reduce the number of layers of review through which Bank Group projects must pass. It is too soon to evaluate the effect of these changes, but preliminary signs are encouraging.

37. Implementation has been a problem. Although performance has improved considerably, one out of four IBRD projects currently in implementation have been rated unsatisfactory one or more times during implementation but all projects currently in implementation are now rated satisfactory. The one operation that has closed—*Rehabilitation Loan*—rated unsatisfactory at closing. Experience with these projects as well as with projects now under preparation suggests that through intensifying participation of stakeholders during project preparation, piloting, and designing projects to require that implementation arrangements be concluded early in the project preparation cycle, in combination with intensive supervision and early identification of problems, performance can be improved and life-cycle costs lowered.

38. Implementation of several of IFC's projects has been hampered by certain aspects of the legal framework related to the country's commercial and bankruptcy laws. To address these issues, IFC helped Uzbekistan draft a bankruptcy law and implement a number of changes in the legal framework for commercial transactions. IFC also helped Uzbekistan draft a mining code when it became apparent that the existing code was not adequate to attract new investments. Issues of foreign exchange regime, cotton price controls, competition policies and transparency in the regulatory process are often raised in the context of IFC projects in Uzbekistan. All projects currently in implementation, however, are now rated satisfactory.

39. While raising policy issues in the context of project financing is often an effective instrument for improving the overall business climate it may not always provide general solutions to investors' problems. IFC and IBRD have complemented project related advisory services with free-standing advisory services in the area of business environment for private investment, mainly through FIAS.

B. Strategic Focus and Approach of the FY98-00 CAS

40. Given that Uzbekistan is highly cautious in liberalizing the economy, the current Bank Group strategy is to identify a common set of sectoral opportunities and interventions where there appears to be a convergence between the GOU's agenda and the Bank's objectives and on which the Government has stated that it is prepared to act. The strategic approach proposed by the Bank Group is designed to address the Government's concerns about the possible negative consequences of reforms by demonstrating the benefits and consequences of policy and institutional reforms in the context of pilot investment operations (IBRD) and private sector investments (IFC), and through continuing dialogue. The Bank's financial assistance will be

modest to begin with—much lower than that accorded to other Central Asian countries in per capita terms—but there will be a great deal of experimentation, piloting and demonstration built into the conventional investment operations. The GOU has indicated that it agrees with this approach and that, if the policy and institutional reforms proposed in these operations prove successful in the limited areas and spheres of activities chosen, it would be prepared to replicate these reforms nationwide. If and when they do so, the Bank would be forthcoming with a much larger package of financial assistance.

41. In discussions held on the Bank Group's CAS for FY98-00, it was agreed that the Bank Group would focus on four key challenges facing the Uzbek economy in the medium term: (a) *liberalizing* the trade and payments regimes and minimize distortions in and promote the development of the financial sector; (b) *complete the liberalization of domestic trade and improve* incentives for increased output and employment in productive private sectors, particularly agriculture; (c) *remove* the inefficiencies in resource utilization in the municipal services, infrastructure and the social services; and (d) *address* priority environmental damage problems, particularly those associated with the mismanagement of natural resources in the Aral Sea Basin.

42. These areas have been chosen because progress in them would have a substantial ameliorating impact on constraints that bind heavily on Uzbekistan's low income families. Liberalization of trade and payments and domestic trade is likely to be particularly beneficial to the development of small and medium scale enterprises and agriculture, where the best prospects for growth of remunerative employment reside. The strategy entails direct poverty reduction interventions, including: (i) investing in provision of drinking water supply, sanitation and health in the poorest region of the country—Karakalpakstan—where the Aral Sea desiccation has made the lives of the people living in the region intolerable. In this region, environmental degradation has caused severe poverty. The proposed program for drainage will help reclaim agricultural land from salinity and enable the poor farmers to resume their productive activities. The project financed by the GEF will also contribute to improved environmental practices in the Aral Sea region; (ii) inclusion of Karakalpakstan as an area of emphasis in the pilot Social Transformation Fund (FY99); and (iii) inclusion of one of the poorest oblast (Ferghana) in the pilot component of the Health Reform project (FY98).

C. Linkage to Policy Performance

43. The Bank Group believes that the success of pilot operations and carefully selected private sector investment operations, backed by intensified dialogue and technical assistance to build the capacity for economic management will demonstrate the benefits of reform and thereby provide a solid basis for replicating these reforms throughout the economy. However, recognizing the risks involved in this approach, the strategy has been designed with well-defined triggers to ensure links between Government performance and further Bank Group engagement.

Table 3: Triggers for Lending Program

Prior Actions	Actions During Implementation
Intermediate Case	
(1) Maintain basic macroeconomic stability (as evidence, for example, inflation < 30%, budget deficits < 3% of GDP, non-interest current account deficits < 15% of exports) and a policy framework consistent with the success of supported investment projects.	
(2) Agreement with Bank Group on policy innovations including:	(2) Complete the implementation of the agreed actions, including:
(i) issuing Government order to restructure farms in six raions by transferring land titles to farmers;	(i) restructuring farms in six raions by transferring land titles to farmers;
(ii) issuing Government order to liberalize agricultural output pricing in six raions;	(ii) liberalizing agricultural output pricing in six raions;
(iii) rationalize health facilities and personnel in three oblasts;	(iii) rationalizing health facilities and personnel in three oblasts;
(iv) introduce cost recovery for water supply and sanitation in Tashkent and Bukhara;	(iv) introducing cost recovery for water supply and sanitation in Tashkent and Bukhara;
(v) privatize 300 enterprises through the PIF program.	(v) privatizing 300 enterprises through the PIF program.
	(3) Portfolio implementation: At most one-third of projects (by number) with unsatisfactory Implementation Progress (IP) rating; maximum of 40% of projects (by number) with unsatisfactory Development Objectives (DO) rating; and disbursement ratio of 13% in FY98, 15% in FY99, and 18 % in FY00.
High Case	
Meeting all requirements of the intermediate case. In addition:	
(1) IMF program in place, including unifying the exchange rate.	(1) Maintaining a unified exchange rate, and meeting agreed quarterly targets for fiscal deficit, net domestic financing, and credit to the private sector.
(2) Implementation of agreed structural reforms including:	(2) Maintenance/deepening of structural reforms including:
(i) issuing Government order for elimination of state orders on cotton and wheat.	(i) farmers' freedom in choice of cropping.
(ii) issuing Government order for liberalization of cotton export marketing.	(ii) liberalizing agricultural output prices throughout the economy.
(iii) privatization of 300 enterprises through the PIF program and designation of a total of 300 additional enterprises for privatization through PIFs.	(iii) completion of privatization of an additional 300 enterprises through PIFs.
(iv) elimination of de facto controls on the conversion of bank deposits into cash.	(iv) completion of restructuring of at least two state-owned banks, including at least 40 percent private ownership.
	(3) Portfolio implementation: No projects with unsatisfactory IP rating; maximum of 25% of projects (by number) with unsatisfactory DO rating; and disbursement ratio of 17% in FY99 and 20% in FY00, and thereafter.

44. The strategy envisages three IBRD lending scenarios for Uzbekistan. If the Government continued to have reservations about an agreement with the IMF but maintain: (a) a modicum of macroeconomic stability and policy framework consistent with the success of supported investment projects; and (b) fully satisfactory portfolio implementation record, including a disbursement ratio of 13 percent in FY98, 15 percent in FY99 and 18 percent in FY00, we would continue to operate in the present (intermediate, or most likely scenario) mode (see Table 3). Under this scenario we commit a modest amount of about US$300-350 million in ten investment operations over the FY98-00 period (compared with US$306 million over the previous three years) in a series of pilot operations. However, shifting to a *high case* would require a strong program of structural reform and liberalization which could be supported by a new IMF arrangement and Bank adjustment lending. Specific triggers for such a scenario include: liberalizing agricultural output prices throughout the economy; elimination of state orders on cotton and wheat; unification of the exchange rates; and sharply lowering the fiscal deficit and inflation. We would then deliver up to three adjustment operations in support of the private sector, financial sector, and agriculture sector reforms, as well as ten investment operations, totaling US$800-900 million over the FY98-00 period. A *low case scenario* would be triggered by the disintegration of macroeconomic stability and non-compliance with the intermediate case triggers; it would only allow for a few nonlending services and operations that focus on poverty reduction and environmental problems.

D. Country Program Elements

45. Portfolio Management. Under the intermediate scenario, the number of operations in implementation would increase from 4 to 7 by the end of FY 98, and would continue to increase by three operations per year thereafter. While implementation has been a problem, the trend is positive as a result of better project design (e.g., through use of pilots, more systematic participation and social analysis, more flexibility in design), intensive supervision and growing experience in working together. The Resident Mission is being strengthened to provide more on-site, on-demand supervision services, and the Government is considering the establishment of a Coordinating Unit for Project Implementation in the Ministry of Macroeconomics and Statistics. One of the main functions of this new Unit would be monitoring of project implementation and early identification of problems needing attention.

46. New Lending. In the intermediate case, the proposed IBRD FY98–00 lending program for the next CAS period would include up to ten operations totaling US$300-350 million, supporting incremental reforms in key sectors. This lending program would concentrate on:

- Utilizing the gradual and innovative approach to privatization through PIFs and initiating a new case-by-case privatization program for large strategic enterprises (***Enterprise Reform Institution Building***), as the cornerstones of further industrial enterprise restructuring along with institutional building in enterprise and financial sector.
- Strengthening financial sector institutions and infrastructure (***Financial Sector Institution Building***) would support the adoption of a new accounting

framework for banks based on international standards and would provide assistance with respect to bank supervision, bank restructuring, bank licensing, bank accounting, legal issues, commercial bank strategy development, credit risk assessment, bad debt work out, and capital market development.

- Restructuring farms (***Agricultural Enterprise Restructuring Project - AERP***) by starting in a few raions where land titles will be transferred to private farmers, policy impediments removed, and output pricing and marketing mechanisms liberalized; support services provided. Inasmuch as agricultural restructuring will have the biggest single impact on poverty reduction, successful implementation of AERP could be followed at the end of the CAS period with AERP-II, which would support replication of AERP.
- Piloting the rationalization of health facilities and personnel and improving the training of medical personnel in three oblasts (***Health Reform***).
- Addressing poverty alleviation with a pilot social fund that features modest infrastructure interventions in selected poor regions and stresses support to small- and medium-scale enterprises and micro-credit initiatives for the self-employed (***Social Transformation Fund***).
- Emphasizing cost recovery, institution strengthening, and privatization of municipal services (***Tashkent Solid Waste Management, Urban Transport, Bukhara-Samarkand Water Supply and Sanitation***).
- Introducing cost recovery and improved agricultural water management and irrigation system management (***Improvement of Irrigation Infrastructure***).
- Adopting alternative approaches to drainage improvement in order to mitigate the adverse environmental effects of increased soil salinity in the Aral Sea Basin (***Drainage***).

47. Under the intermediate case, IFC's program size is expected to be about US$50-60 million per annum for IFC's own account. IFC's investments are most likely to be concentrated in the financial sector and export-oriented industries. In the latter, IFC would encourage value-added processing of agricultural material and increasing productivity in the sector by introducing modern equipment and extension services. Together with Case Corporation from the US, IFC is financing three inter-related projects in the manufacturing of agricultural equipment, which will together produce cotton pickers and grain headers for mechanized harvesting of cotton and grain, provide leasing services for agricultural equipment, and provide after sales maintenance services for the equipment. This integrated multi-component project will introduce new technology, management know-how and market forces to the agriculture sector and accelerate its transformation to a market-based system. A fourth project in the area of agricultural machinery is currently under evaluation by IFC to produce tractors and other agricultural equipment. All four projects envision a strong localization program to produce locally up to 50 percent of the value of all parts and components which would benefit local suppliers through transfer of technology and employment generation.

48. Complementing IBRD, IFC is following an integrated approach to assist directly the development of SMEs. First, a special instrument has been designed for countries including

Uzbekistan—Extending IFC's Reach—to support small investments. One project in furniture manufacturing has already been approved through this vehicle and several other projects are at an advanced stage. Second, IFC is also exploring means to facilitate the growth of SMEs through large foreign investors that are already in the country by capitalizing on the their demand for auxiliary services and inputs. Third, IFC has initiated, in conjunction with EDI, courses in accounting and management for local entrepreneurs and is exploring opportunities to commercialize this program. Currently, IFC is working on a project to establish an Executive Training Center (ETC) in Tashkent to provide training courses and workshops for Uzbek managers in fields such as marketing, general management and accounting. ETC is also expected to provide business consultancy services for joint ventures, state-owned enterprises and SMEs, thus contributing to the development of an indigenous consulting industry. In addition, IFC will seek opportunities to address the financing needs of SMEs indirectly through credit lines to financial intermediaries and through its overall program in the financial sector.

49. Should the triggers points for a high case scenario be met, IBRD projects lending would be complemented with up to three adjustment operations supporting privatization, financial sector reform, and agriculture sector reform. This would bring IBRD lending up to US$800-900 million in thirteen operations. In privatization, the adjustment operation would support sales of shares in a substantial number of medium and large scale enterprises through the PIF program, and transparent case-by-case privatization of a smaller but still substantial number of large scale strategic enterprises. In finance, the adjustment operation would support bank restructuring, increased competition in banking, and capital market development. In addition, provided the Government is prepared to move ahead on the basic reforms of the agricultural sector, we would be prepared to support a strictly time bound program of reform through an ***Agricultural Sector Adjustment Loan***.

50. Under a high case scenario, the overall demand for IFC's services and the potential areas for IFC's involvement would also be expected to expand resulting in a program size of about US$80-90 million per annum. In addition to financial services and export-oriented sectors, the improved business climate is likely to generate investment opportunities in infrastructure and in projects oriented toward the domestic market.

51. MIGA currently has 15 preliminary applications for total potential investments of US$500 million in finance, manufacturing, cotton, energy and mining, however, to date has insured only one project (in mining).

52. Non-Lending Activities. Our resource commitment was relatively small during the previous CAS period. Traditional economic and sector work (ESW) was not a particularly effective device for advancing the reform agenda, however, informal notes, joint work on small, well-defined tasks, policy seminars, study visits, and exchanges of views with policy practitioners from other countries have had an impact on the quality of the dialogue and are desired by the client. The Government has requested that there be the maximum possible flexibility in the composition, timing and content of the non-lending program: as and when there is internal consensus within the Government about a particular reform to be implemented they would like to approach the Bank for quick response assistance.

53. The planned program is intended to provide this flexibility via provision for client demand driven ***Development Strategy Assistance***. Individual tasks under this rubric could, for example, provide analytical support and advice concerning alternatives for liberalizing trade and payments and/or on pension reform and/or on financing and other sectoral reform issues in the social services and social protection. The precise activities undertaken in this regard would be decided in consultation with the Government. In addition, the planned program also includes five pre-identified tasks which have previously been requested by the Government. These are: (***Data and Forecasting IDF***—which would support the government's efforts to strengthen basic government economic data and forecasting capability, ***Policy Analysis IDF***—which would support the strengthening of the Government's capacity to carry out analyses of macroeconomic policy options, ***Public Investment Policy Note***—which would examine the policies currently governing Uzbekistan's public investment program, ***Karakalpakstan/Khorezm Economic Report***—which examines the development issues and options confronting the Uzbek portion of the Aral Sea "Disaster Zone", and ***National Environmental Action Plan***—which maps out a prioritized program of action for dealing with the environmental problems facing Uzbekistan today. The last Bank economic report on Uzbekistan was completed in 1994. A brief ***Economic Update*** and a series of ***Macroeconomic Policy Notes*** are planned for FY98, following up on the recent high level policy seminar (para 35). The possible impact of the Asian countries financial crisis on Uzbekistan's competitiveness and its access to foreign direct investment, and measures to mitigate such impact will be analyzed in the context of a policy note to be discussed with the Government.

54. A ***Living Standards Assessment*** is planned to be completed in FY99, to assess the current nature and extent of poverty on a consistent basis and identify issues and evaluate options with respect to the Government's program for improving living standards in Uzbekistan. As one of EDI's focus countries, we will be using a variety of knowledge instruments to help open up the policy dialogue in a few key areas. This, combined with the Bank's proposed non-lending instruments, will complement the learning achieved through investment operations.

55. Should it be possible to operate in a High Case program, the IBRD would in addition stand ready, at the authorities request, to convene Consultative Group meetings for Uzbekistan. IFC is continuing to sponsor periodic Investors' Conferences for Uzbekistan. The most recent was held in January 1998 in Tokyo.

Box 2: EDI in Uzbekistan

EDI has identified Uzbekistan as a focus country over the next two to three years. Additional resources will be devoted to EDI-sponsored courses and seminars conducted for Uzbeks. The emphasis of EDI's activities will complement those Bank operations that are trying to demonstrate the "benefits and consequences of structural reform." Particular emphasis will be given to macroeconomic stability, agriculture restructuring, and privatization.

The EDI methodology is particularly well-suited to circumstances in Uzbekistan because of the need to: (a) emphasize the lessons of experience in other parts of the world; and (b) crystallize the experience that emerges from the pilot operations and the accompanying structural reforms. In particular, EDI plans to organize seminars on the experience of other countries on privatization and farm restructuring. EDI will also select one of the pilot operations and monitor it in order to synthesize the emerging lessons for Government.

56. Partnerships. Uzbekistan's development program enjoys the support of a number of bilateral and multilateral donors, many of whose programs complement those of the Bank. Collaboration and coordination with other donors and international financial institutions (IFIs) is good and continues to strengthen—under both case-by-case and standing coordination arrangements. In the area of macroeconomic management, the Bank assistance program complements the efforts of other donors, particularly the IMF, USAID and Japan (JEXIM). Support is given for the establishment of an independent Macroeconomic Policy Institute, macroeconomic and sector policy seminars for senior officials and through economic advisors to the Cabinet of Ministers, Ministry of Finance and the Central Bank. While EBRD has taken the lead in provision of infrastructure finance, and ADB in education, the Bank has focused on supporting health and pension reforms. In the case of urban infrastructure, for example, we have joined with EBRD in preparing the proposed ***Tashkent Solid Waste Management*** project. In providing support to the emerging private sector, IBRD and IFC have cooperated effectively with USAID, EBRD, ADB, EU-TACIS, UK-Know-How-Fund and KfW in providing training, SME lines of credit, establishment of Enterprise Funds (USAID, EBRD) as well as providing technical assistance to the Central Bank.

57. Co-financing operations have been undertaken with KfW, Switzerland, Kuwait Fund and OECF (yet to be finalized) for the recently approved Water Supply, Health and Sanitation Project for affected population in the Aral Sea region. Further co-financing operations are foreseen. In the area of rural development, EU-TACIS, GTZ, USAID, Israel and the Bank are co-operating in terms of sharing information on the respective experiences of Pilot operations and in complementing technical assistance needs in our proposed Agricultural Enterprise Restructuring project, e.g. Land registration with EU-TACIS support. In the development of the ***Social Transformation Fund***, the Bank enjoys close collaboration with UNDP and the ILO. KfW is also co-financing the Health Reform project.

58. The Aral Sea Basin Program (Box 3) is also a focal point for coordinating donor activities. A new organization (EC-IFAS) has been established and staffed and is now responsible for organizing and coordinating donors as illustrated through the recent successful organization of a Donor Participants Conference in Tashkent. The most active donors which collaborate

Box 3: Aral Sea Basin Program

The desiccating Aral Sea is the most visible and striking symptom of an unsustainable model of water and land management. Over-expansion of irrigation combined with indiscriminate and inefficient usage have led to rising salinization and desertification of densely populated river deltas. The Aral Sea Basin Program (ASBP), supported by the Bank and other donors, is aimed at stabilizing the environment of the Aral Sea Basin, rehabilitating the disaster zone around the sea, improving the management of the basin and developing the capacity of the regional institutions. The ASBP comprise a broad set of eight inter-linked program elements and 18 projects, including the proposed Uzbekistan Drainage Project (FY00). The preparation phase was completed in 1997. Bank-funded Water Supply and Sanitation Project has started in Turkmenistan and Uzbekistan, and a GEF project on water and environmental management for the basin is scheduled for presentation to the Executive Directors in FY98, including pilot activities in improving water use and development of a national water and salinity management strategy. Adoption of this strategy will have major implications for investment in irrigation, drainage and urban water supply.

periodically are the Dutch, EU-TACIS, UNDP, GEF/WB, USAID and many other bilateral institutions. Future potential donors are OECF, ADB, Canada and the Scandinavian countries. The World Bank continues to play central coordinating role through the Resident Mission and GEF related project management.

E. Country Program Monitoring and Risk Management

59. Strategic Risks. As noted above, the strategy outlined here is based on the working hypothesis, discussed with and agreed to by the Government, that policy-based pilot/demonstration investment projects, backed by a continuing dialogue—would be effective in advancing the structural reform agenda in selected areas. Inasmuch as this premise is untested, there are substantial risks that this approach will not work. In this regard, there should be no illusions about the results of Bank involvement and the risks inherent in this approach. To minimize them, the lending program has built-in triggers that would lead to an exit to the core scenario if Government's acceptance of the structural reforms built into these operations is not forthcoming. In each of the proposed lending operations there are clearly specified policy and institutional reform objectives along the lines indicated above (para 46). During CAS discussions with the Government, it was agreed that successful implementation of a pilot operation would lead to eventual broader structural and institutional reform in that sector as well as increased lending by the Bank Group. If, in the more detailed discussions with Government in the early stages of project preparation, there is no agreement on either the objectives underpinning any of the specific operations or such a link, we would not proceed with that particular operation. Further, operations in the final year of this CAS period (FY00) would be linked to progress achieved during the first two years of the period. For example, the continued preparation of the ***Drainage*** and ***Irrigation*** projects depends critically on the implementation of policy and institutional changes that have been agreed recently as part of the ***Agricultural Enterprises Restructuring*** operation. Similarly, we would be unlikely to proceed with the ***Samarkand-Bukhara Water*** project if the institutional changes agreed as part of the current ***Water Supply, Sanitation and Health Project*** are not reflected in Government's strategy.

60. Creditworthiness. Current debt and exposure indicators are well within prudent limits, debt service experience to date is good, and the Government has given every indication that it intends to maintain prudent external financial policies. The Government is strengthening its external debt management capability with support from the Bank provided by the Institution Building Technical Assistance (IBTA) project. Nonetheless, with loss of about one-third of its international reserves during 1997 and imports severely compressed, the near-term balance of payments situation will be tight. Furthermore, the economy is highly exposed to external shocks, including wide fluctuations in world prices for Uzbekistan's major exports—cotton and gold. Asian countries crises could also adversely affect the economy by eroding its competitiveness and through a reduction in foreign direct investment and availability of project finance at affordable interest rates. Under a "Base-Case-like" scenario the authorities would be likely to be confronted with relatively unattractive medium-term choices between very slow (i.e., less than 3 percent per annum) growth, unacceptably (and perhaps dangerously from a social perspective) slow or no per capita consumption growth, unacceptably high inflation,

and/or rapidly increasing external debt. Achievement of these modest targets could seriously be threatened should the economy become exposed to external shocks including those mentioned above. Depending upon how the Government makes these tradeoffs, debt could become a problem. Accordingly, borrowing and debt service capacity will be closely monitored over the CAS period.

V. CONCLUDING REMARKS

61. Uzbekistan has chosen its own pace, path and priorities for the transition to market based economy. While it is serious in maintaining macroeconomic stability it is more cautious in liberalizing the economy and removing microeconomic distortions. The previous Bank strategy has not worked well, as the Government is not prepared at this time to change the pace and intensity of its reform efforts. The proposed strategy is therefore based on demonstrating the benefits of reforms in key areas such as privatization of agriculture, enterprise reform and cost recovery in municipal services in the context of selected pilot investment operations (in addition to poverty reduction and environment operations). If the reforms in these pilot operations prove successful the Government will replicate them throughout the economy. The Bank has agreed with the Government that it will commit only modest financial resources under the current scenario of limited reforms but if the Government moves to implement broad-based policy reforms the financial support will increase significantly.

James D. Wolfensohn
President

By:

Caio K. Koch-Weser

Jannik Lindbaek

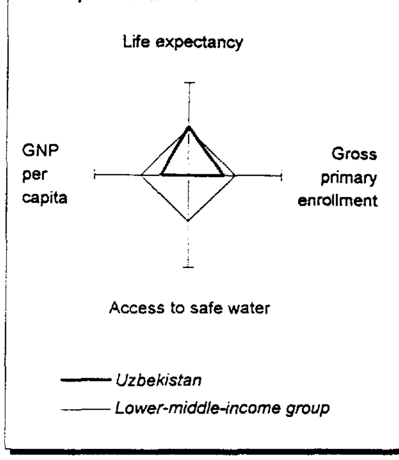
Attachment

February 17, 1998
Washington D.C.

Uzbekistan at a glance

8/20/97

POVERTY and SOCIAL	Uzbekistan	Europe & Central Asia	Lower-middle-income
Population mid-1996 *(millions)*	23.1	479	1,125
Atlas GNP per capita 1996 *(US$)*	1,010	2,180	1,750
Atlas GNP 1996 *(billions US$)*	23.5	1,043	1,967
Average annual growth, 1990-96			
Population *(%)*	2.1	0.3	1.4
Labor force *(%)*	2.8	0.5	1.8
Most recent estimate *(latest year available since 1989)*			
Poverty: headcount index *(% of population)*	..	..	..
Urban population *(% of total population)*	39	65	56
Life expectancy at birth *(years)*	70	68	67
Infant mortality *(per 1,000 live births)*	26	26	41
Child malnutrition *(% of children under 5)*	..	..	..
Access to safe water *(% of population)*	..	..	78
Illiteracy *(% of population age 15+)*	3	..	..
Gross primary enrollment *(% of school-age population)*	77	97	104
Male	78	97	105
Female	76	97	101

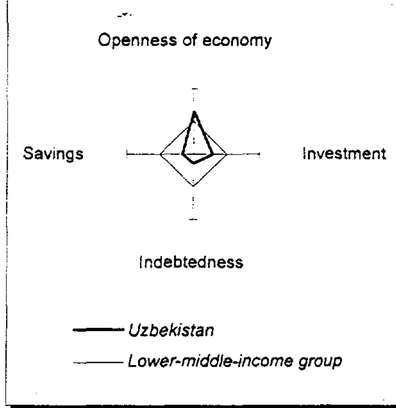


Development diamond*

KEY ECONOMIC RATIOS and LONG-TERM TRENDS

	1975	1985	1995	1996
GDP *(billions US$)*	..	..	10.0	13.6
Gross domestic investment/GDP	..	..	20.9	16.1
Exports of goods and services/GDP	..	..	38.0	30.5
Gross domestic savings/GDP	..	..	20.5	8.6
Gross national savings/GDP	..	..	20.4	8.2
Current account balance/GDP	..	..	-0.5	-7.9
Interest payments/GDP	..	..	0.3	0.8
Total debt/GDP	..	..	17.8	17.0
Total debt service/exports	..	..	6.4	6.9
Present value of debt/GDP	..	..	6.5	..
Present value of debt/exports	..	..	38.4	..

	1975-85	1986-96	1995	1996	1997-05
(average annual growth)					
GDP	..	..	-0.9	1.6	3.0
GNP per capita	..	..	-3.5	-1.0	..
Exports of goods and services	..	..	..	0.3	3.7



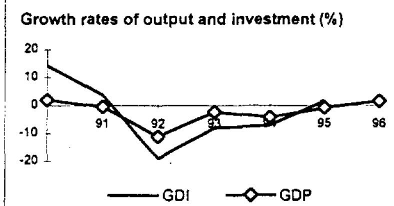
Economic ratios*

STRUCTURE of the ECONOMY

	1975	1985	1995	1996
(% of GDP)				
Agriculture	..	..	32.1	26.0
Industry	..	..	27.8	27.4
Manufacturing	..	..	..	..
Services	..	..	40.1	46.6
Private consumption	..	..	60.4	66.3
General government consumption	..	..	19.1	25.1
Imports of goods and services	..	..	38.4	38.0

	1975-85	1986-96	1995	1996
(average annual growth)				
Agriculture	..	..	2.0	-7.0
Industry	..	..	-5.6	1.7
Manufacturing	..	..	..	..
Services	..	..	2.3	2.0
Private consumption	..	..	..	..
General government consumption	..	..	..	..
Gross domestic investment	..	..	3.2	-0.1
Imports of goods and services	..	..	..	..
Gross national product	..	..	-1.8	1.1

Growth rates of output and investment (%)



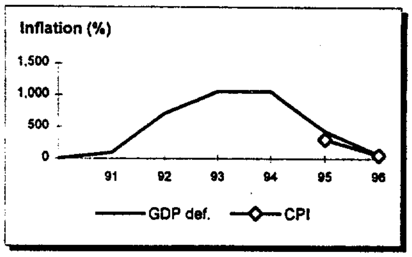
Note: 1996 data are preliminary estimates. Figures in italics are for years other than those specified.

*** 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.**

Uzbekistan

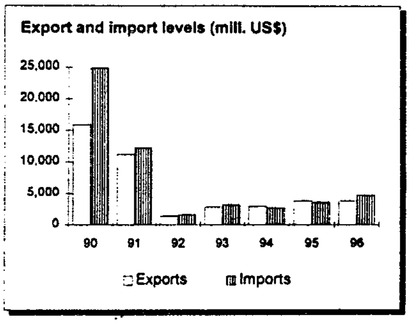
PRICES and GOVERNMENT FINANCE

	1975	1985	1995	1996
Domestic prices				
(% change)				
Consumer prices	..	..	305.0	54.0
Implicit GDP deflator	..	..	371.0	82.0
Government finance				
(% of GDP)				
Current revenue	..	..	34.6	34.2
Current budget balance	..	..	3.2	1.5
Overall surplus/deficit	..	..	-4.1	-7.3



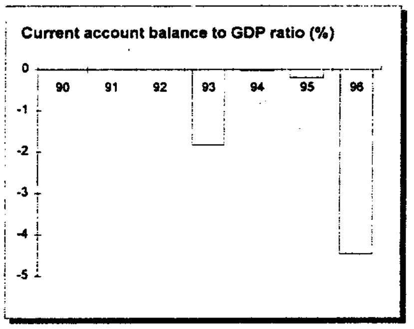
TRADE

	1975	1985	1995	1996
(millions US$)				
Total exports (fob)	..	..	3,806	3,781
Cotton	..	..	1,800	1,748
Gold	..	..	611	832
Manufactures	..	..	..	..
Total imports (cif)	..	..	3,597	4,712
Food	..	..	687	1,391
Fuel and energy	..	..	59	50
Capital goods	..	..	1,279	1,713
Export price index *(1987=100)*	..	..	..	..
Import price index *(1987=100)*	..	..	..	..
Terms of trade *(1987=100)*	..	..	..	..



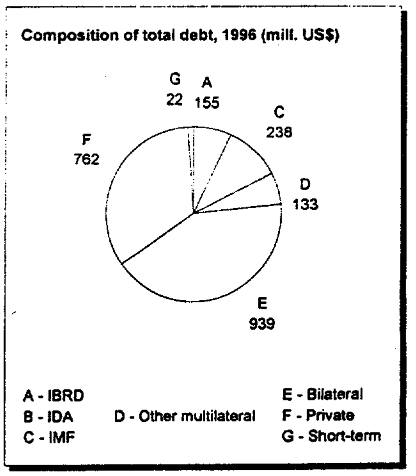
BALANCE of PAYMENTS

	1975	1985	1995	1996
(millions US$)				
Exports of goods and services	..	..	3,806	4,161
Imports of goods and services	..	..	3,848	5,175
Resource balance	..	..	-42	-1,014
Net income	..	..	-26	-69
Net current transfers	..	..	19	8
Current account balance, before official capital transfers	..	..	-49	-1,075
Financing items (net)	..	..	627	1,108
Changes in net reserves	..	..	-578	-33
Memo:				
Reserves including gold *(mill. US$)*	..	..	1,867	1,901
Conversion rate *(local/US$)*	..	..	30.2	41.1



EXTERNAL DEBT and RESOURCE FLOWS

	1975	1985	1995	1996
(millions US$)				
Total debt outstanding and disbursed	..	..	1,787	2,319
IBRD	..	..	157	155
IDA	..	..	0	0
Total debt service	..	..	243	298
IBRD	..	..	2	10
IDA	..	..	0	0
Composition of net resource flows				
Official grants	..	..	13	0
Official creditors	..	..	241	..
Private creditors	..	..	120	..
Foreign direct investment	..	..	-24	50
Portfolio equity	..	..	0	0
World Bank program				
Commitments	..	..	226	5
Disbursements	..	..	162	9
Principal repayments	..	..	0	0
Net flows	..	..	162	9
Interest payments	..	..	2	10
Net transfers	..	..	161	-1



Note: Estimates for economies of the former Soviet Union are subject to more than the usual range of uncertainty.
Government finance includes balance of extrabudgetary funds (net of transfers).

Uzbekistan Country Assistance Strategy:
Country Program Matrix (FY98-00)

(intermediate, most likely scenario)

Key Development Issues	*Diagnosis*	*Government Strategy/Action*	*Performance Benchmarks*	*Bank Group Instruments* *Lending*	*Bank Group Instruments* *Nonlending Services*	*Activities of Other Donors*
Program Goal: Adopt a gradual transition from a command into a market-based economy, supported by competent market institutions, to promote a sustainable, broad-based economic development while maintaining a high level of human resources and social protection.						
I. Liberalization of trade and payments regimes and minimizing distortions in the financial sector.						
Macroeconomic Management: Stabilizing and liberalizing the economy and strengthening market institutions.	Macroeconomic stabilization achieved, but very fragile. Fund supported macroeconomic program collapsed in 1996; no new agreement yet reached. Price controls still in effect for some critical commodities (e.g. cotton).	Develop a medium-term policy framework that provides macroeconomic stability but permits continued public sector involvement in the economy. Experiment with various elements of market liberalization on a pilot basis and apply results to the entire sector/economy.	Stabilizing annual inflation at under 30 percent per annum and fiscal deficit less than 3 percent of GDP.	Institutional Building TA (FY94)	High level seminars on key macroeconomic and structural policy issues. Study visits. Policy analysis IDF (FY98) Macroeconomic policy notes (FY98) Economic updates (FY98-00)	USAID, GTZ, and UNDP technical assistance for macroeconomic management activities. UNDP support for GOU's new Macroeconomic Policy Institute.
	Trade and exchange rate regimes are highly restrictive, and a multiple exchange rates system in operation. A distortionary system of import licenses and foreign exchange licenses privileges are highly discretionary.		Gradually remove trade and exchange rate distortions.		Policy note on public investment (FY98) Regional economic report (FY98) Support for WTO accession.	EU training for and upgrading of civil service. ADB and UNDP technical assistance for aid coordination by Cabinet of Ministers.
		Maintain a prudent fiscal and monetary stance to achieve and maintain macro stability as a cornerstone of sustainable growth.	Limit fiscal deficits to 3 percent of GDP and achieve a GDP growth of 3 percent per annum.			
	Payroll and other tax burden on enterprises to support pension system high, and high expenditures on pensions relative to demographic structure.	Examine and consider options for pension reform developed by Pension Reform Working Group.	Ensure adequate level of budgetary allocations for the social sectors and safety net and enhance the efficiency in use of such resources.			USAID support for pensions reform.

Key Development Issues	Diagnosis	Government Strategy/Action	Performance Benchmarks	Bank Group Instruments: Lending	Bank Group Instruments: Nonlending Services	Activities of Other Donors
Financial Sector and Pension Reform	Financial sector is non-competitive and subject to extensive public sector ownership and control including extensive use of direct credit.	Establish stable financial system based on market incentives rather than directed credit.	Prepare comprehensive plan for restructuring banking system, including reducing the dominant role of the National Bank.	Financial Sector Institution Building (FY99) IFC Credit line to support post-privatization and SMEs.	EDI seminars on financial sector reform (FY98). EDI seminars and training (FY99-00).	EU/TACIS support to advisory services for commercial banking sector.
	Capital markets are underdeveloped and over controlled. System of accounting and audits is not consistent with international standards.	Establish a fully functioning capital market.	Dismantle domestic credit controls and introduce regulatory measures to enable resolution of bad debts in the banking system. Introduce international accounting standards for banks.			
	The legal and regulatory framework for private pension providers does not exist.	Develop legal framework for voluntary private pensions and other forms of private social insurance.	Further refinement of legal and regulatory framework for introduction of voluntary private pensions.			USAID support for pension reform.
Improving institutional capacity for economic and financial data collection and processing, and policy formulation and implementation.	Weak institutional capacity for data collection, processing and analysis hampers policy formulation and decision making process.	Strengthening capacity of institutions in charge of data collection and processing through provision of appropriate technical assistance.	Improvement in quality, timeliness, and accessibility of basic economic data.		Data and forecasting IDF (FY98) Policy Analysis IDF (FY98)	
II. Completing the liberalization of domestic trade and improving incentives for increased output and employment by the private sector in productive sectors.						
Improving climate for private foreign investment.	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.	Simplify registration and licensing of investments. Improve transparency in decision-making and access to legal and economic information. Adopt a simpler and more transparent system of encouraging foreign investment. Strengthen the capabilities of the Foreign Investment Agency for investment promotion.	Increase in private foreign investment.		IFC private investors conferences. IFC Review of the Mining Code. IFC Review of Bankruptcy Code. FIAS Review of climate for FDI.	EU/TACIS capacity building and support to Foreign Investment Agency.

Key Development Issues	*Diagnosis*	*Government Strategy/Action*	*Performance Benchmarks*	*Bank Group Instruments* Lending	*Bank Group Instruments* Nonlending Services	*Activities of Other Donors*
	Discretionary and discriminatory system of incentives to foreign investors.					
Enterprise privatization and restructuring	Privatization is gradual and remains incomplete. Restructuring and privatization of large-scale enterprises lacks completion. The 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, encourage entrepreneurship. Maintain post-privatization support program. Improved privatization should replace state-sponsored holdings and investment.	Expand privatization by selling 100 to 200 more medium enterprises to Privatization Investment Fund. Initiate transparent case-by-case sale of selected large companies to domestic and foreign investors. Support restructuring of privatized enterprises.	Enterprise Institution Building (FY98) IFC packaging industry. IFC management consulting services for local entrepreneurs.	Industrial structure policy note (FY98)	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 ADB lines of credit to SMEs.
Agriculture Sector development	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 low land productivity and distorted incentive structure, including mandatory production quota, and low producer prices.	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 6 administrative districts, and replicate after evaluation. Free domestic trade across administrative boundaries. Phase out state orders for wheat and cotton over two years, and gradually raise prices for remaining state purchases to market levels.	Cotton Improvement (FY 96) Agricultural Enterprise Restructuring (FY98) IFC tractor assembly plant. IFC cotton processing project.	Agriculture sector notes (FY99)	ADB economic and sector work on agriculture sector. Bilateral support for agriculture (Germany, Switzerland, Israel, USAID).
Land reform and property rights	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.	Strengthen legal framework for collateralization of moveable property and crops, and remove current restrictions on access to cash in bank deposits.			EU/TACIS support for land registration.

Key Development Issues	*Diagnosis*	*Government Strategy/Action*	*Performance Benchmarks*	*Bank Group Instruments* — *Lending*	*Bank Group Instruments* — *Nonlending Services*	*Activities of Other Donors*
III. Removing the inefficiencies in resource utilization in the municipal services, infrastructure and the social services.						
Infrastructure Services	Reduced investment due to fiscal constraints, insufficient maintenance, and poor management have undermined key economic infrastructure 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.	Increase the level of cost recovery, strengthen institutional capacity, introduce competition whenever possible between service providers and expand privatization of services.	Tashkent Solid Waste Management (FY98) Urban Transport (FY99) Samarkand-Bukhara Water (FY00)	Infrastructure sector review (FY00)	ADB/ EBRD projects in infrastructure development and finance.
	Rapid urbanization has exerted pressure on the urban water supply systems and sanitation systems have deteriorated.	Increase investment in development and rehabilitation of water supply and sanitation system. Increase cost recovery and introduce commercialization to finance investment and ensure proper management and maintenance.		Water Supply and Sanitation project (FY98)		
Rural Infrastructure Development	Rural social services and infrastructure are deteriorating and financial services are weak.	Create institutions for participatory management of water resources and introduce partial cost recovery for irrigation services. Adopt program of rural public works, including road maintenance, gasification, communications, and water supply. Initiative on rural medical post upgrading.	Strict water conservation supported by water pricing and farm restructuring.	Improvement of Irrigation Infrastructure (FY00) Drainage Project (FY00) Social Transformation Fund (FY99) Health Reform I (FY98)		ILO and UNDP (rural social infrastructure).
Health	Health sector performance is weak because of rigidity and excessive planning. Current system is plagued by misallocation of resources and overly centralized administration.	Implement the key elements of the State Program of Health System Development, including enhancing the efficiency in the use of constrained resources, improving the quality and coverage of services, improving the cost	Improve access to and quality of basic health services in selected regions by improving training curriculum for general practitioners and nurses, upgrading equipment, and improving sustainability through rationalization of	Health Reform I (FY98) (with possible follow-up operation). IFC Intravenous fluids plant.	Health Sector Note (FY99)	KFW, USAID, and UK Know-How Fund co-financing of Health Reform I project.

Key Development Issues	Diagnosis	Government Strategy/Action	Performance Benchmarks	Bank Group Instruments: Lending	Bank Group Instruments: Nonlending Services	Activities of Other Donors
		effectiveness, and targeting expenditures for the most vulnerable groups. Reorient system of care, especially in rural areas, to focus on a basic package of services.	facilities and incentive structures.			
Education	Education sector is overly specialized and not geared to market based skill development. Shortages of materials and overcrowding of classrooms have led to declining performance.	Improve the provision of educational services, with particular emphasis on secondary education and on science, mathematics, and technology. Amend the Education Law. Implement the key elements of the National Program for Personnel Training.	Improved quality and availability of textbooks and other materials combined with less reliance on input norms for resource allocation. Curriculum reform, focused on skills for a market economy and with greater flexibility and decentralization of administration.			ADB education reform project. UNDP/UNESCO review of sectoral reform options. EU/TACIS projects to restructure Ministry of Education.
Poverty Alleviation and Social safety net	Nature and extent of poverty not clearly identified, but there are indications of deteriorating conditions particularly in rural areas. Concerns regarding rising open unemployment and negative social impact of transition.	Decentralize social assistance programs so they operate through local community structures.	Reform the Family Budget Survey to improve living standards, monitoring and use results in regional allocation of social assistance budget. Examine options for systemic pension reform, both of public PAYG system and possible future mandatory funded pensions. Mitigate the social cost of transition through extension of well targeted and effectively managed social programs.	Social Transformation Fund (FY99)	Living Standards Assessment (FY99) Social sector review (FY00) Comments on draft private pensions law.	UNDP and GTZ: support for reform of Family Budget Survey.

Key Development Issues	*Diagnosis*	*Government Strategy/Action*	*Performance Benchmarks*	*Bank Group Instruments*		*Activities of Other Donors*
				Lending	*Nonlending Services*	
IV. Addressing the environmental damage resulting from the mismanagement of natural resources in the Aral Sea Basin.						
Industrial Pollution	"Brown" environmental issues in the old and inefficient heavy industries.	Promote industrial restructuring and modernization and strengthen the regulatory framework.	Regulations on environmental liability; strengthen monitoring and enforcement.		NEAP Support (FY98) GCI Assessment.	
Aral Sea Basin	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 desertified.	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.	GEF Project in Aral Sea Basin (FY98), including national strategy, pilot activities in irrigation and pilot wetlands restoration. GEF Transboundary Biodiversity.		EU/TACIS pilot project for environment and agriculture (Aral Sea program). Netherlands cofinancing of GEF Water and Environmental Management.

Uzbekistan - Selected Indicators of Bank Portfolio Performance and Management

Indicator	1995	1996	1997	1998
Portfolio Assessment				
Number of Projects under implementation[a]	3	3	3	4
Average implementation period (years)[b]	.70	1.70	2.20	2.22
Percent of problem projects[a, c]				
by number	0.00	66.67	0.00	0.00
by amount	0.00	35.22	0.00	0.00
Percent of projects at risk[a, d]				
by number	0.00	100.00	33.33	0.00
by amount	0.00	100.00	22.83	0.00
Disbursement ratio (%)[e]	7.12	4.57	9.25	14.70
Portfolio Management				
CPPR during the year (yes/no)	No	No	No	No
Supervision resources (total US$ thousands)	166.21	579.00	330.61	205.7 [f]
Average Supervision (US$/project)	55.40	193.00	110.20	51.4 [f]

Memorandum item	Since FY80	Last five FYs
Projects evaluated by OED		
by number	...	1
by amount (US$ millions)	...	160.0
Percent rated U or HU		
by number	...	100.0
by amount	...	100.0

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.
f. Planned.

Uzbekistan - Bank Group Program Summary, FY 1998-2000

Proposed IBRD Intermediate-Case Lending Program, FY98-00

FY	*Project*	*US$(M)*	*Strategic rewards (H/M/L)*	*Implementation risks (H/M/L)*
1998	Agriculture Enterprise Restructuring Program	30.0	H	H
	Enterprise Institutional Building	28.0	H	H
	Health Reform I	25.0	M	H
	Rural Water Supply & Sanitation	75.0 [a]	M/H	M
	Tashkent Solid Waste Management	24.0	M/H	M
	Subtotal	**107.0** [a]		
1999	Financial Sector Institution Building	15.0	M	M
	Social Transformation Fund [b]	15.0	H	M/H
	Urban Transport	60.0	H	M
	Subtotal	**90.0**		
2000	Drainage	60.0	H	M
	Samarkand-Bukhara Water [b]	40.0	M/H	M/H
	Improvement of Irrigation Infrastructure	30.0	H	M
	Subtotal	**130.0**		
	Total, FY 1998-2000	**327.0** [a]		

a. Rural Water Supply and Sanitation Project for US$75 million was approved by IBRD Board on August 21, 1997; it is excluded from FY98-00 lending program, since it was covered by previous CAS.
b. Remains in lending program in low case scenario.

Uzbekistan - IBRD Lending Program

	Past			Current	Planned[b]		
Category	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**
Commitments (US$m)	226.0	0.0	5.0	182.0 [a]	90.0	130.0	130.0
Sector (%)[c]							
Agriculture	29.2	0.0	0.0	16.5	0.0	69.2	30.0
Finance	0.0	0.0	0.0	0.0	16.7	0.0	30.0
Multisector	70.8	0.0	0.0	0.0	0.0	0.0	0.0
Population, Health & Nutrition	0.0	0.0	0.0	13.7	0.0	0.0	40.0
Public Sector Management	0.0	0.0	0.0	15.4	0.0	0.0	0.0
Social Sector	0.0	0.0	0.0	0.0	16.7	0.0	0.0
Transportation	0.0	0.0	0.0	0.0	66.6	0.0	0.0
Urban Development	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Water Supply & Santitation	0.0	0.0	100.0	54.4 [a]	0.0	30.8	0.0
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Lending instrument (%)							
Adjustment loans[c]	70.8	0.0	0.0	0.0	0.0	40.0	0.0
Specific investment loans and others	29.2	0.0	100.0	100.0	100.0	60.0	100.0
TOTAL	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Disbursements (US$m)							
Adjustment loans[c]	64.3	95.7	0.0	0.0	0.0	0.0	0.0
Specific investment loans and others	1.5	3.9	7.5	31.9	36.2	27.2	42.3
Repayments (US$m)	0.0	0.0	0.0	0.0	0.4	0.8	1.6
Interest (US$m)	0.2	6.5	10.5	11.6	13.9	16.2	18.7

[a] Includes Rural Water Supply & Sanitiation Project for US$75 million, approved on August 21, 1997, as part of pervious CAS.

[b] Ranges that reflect the base-case (i.e., most likely) Scenario. for IDA countries, planned commitments are not presented by FY but as a three-year-total range; the figures are shown in brackets. A footnote indicates if the pattern of IDA lending has unusual characteristics (e.g., a high degree of frontloading, backloading, or lumpiness). For blend countries, planned IBRD and IDA commitments are presented for each year as a combined total.

[c] For future lending, rounded to the nearest 0 or 5%. To convey the thrust of country strategy more clearly, staff may aggregate sectors.

[d] Structural adjustment loans, sector adjustment loans, and debt service reduction loans.

Note:
Disbursement data is updated at the end of the first week of the month.

Uzbekistan - IFC and MIGA Program, FY95-98

Category	Past			
	1995	1996	1997	1998
IFC approvals (US$m)[a]	5.60	59.80	29.65	1.59
Sector (%)				
	0.00	0.00	0.00	0.00
Chemicals & Petrochems	0.00	0.00	13.00	0.00
Financial Services	100.00	2.00	20.00	0.00
Indust &,Consumer Svcs	0.00	0.00	27.00	0.00
Manufacturing	0.00	0.00	32.00	0.00
Mining & Metals	0.00	98.00	0.00	0.00
Timber, Pulp & Paper	0.00	0.00	8.00	100.00
TOTAL	100.00	100.00	100.00	100.00
Investment instrument (%)				
Loans	89.00	67.00	79.00	81.00
Equity	11.00	9.00	21.00	19.00
Quasi-Equity [b]	0.00	16.00	0.00	0.00
Other	0.00	8.00	0.00	0.00
TOTAL	100.00	100.00	100.00	100.00
MIGA guarantees (US$m)	50.00	50.00	30.19	30.19
MIGA commitments (US$m)	0.00	0.00	0.00	0.00

[a]Excludes AEF projects.
[b]Includes quasi-equity types of both loan and equity instruments.

Uzbekistan—Summary of Nonlending Services

Product	Completion FY	Cost (US$000)	Audience[a]	Objective[b]
ESW:				
Recent completions				
Trade Policy Note	FY96	27.8	G, B	KG, PS
Agricultural Taxation	FY96	11.1	G, B	KG, PS
Agricultural Sector Framework	FY96	51.4	G, B	KG, PS
Rural Infrastructure Review	FY97	23.0	G, B	KG, PS
Public Investment Review	FY97	128.8	G, B	KG, PS
Financial Sector Review	FY97	195.3	G, B	KG, PS
Agricultural Incentives	FY97	7.2	G, B	KG, PS
Strengthening Macroeconomic Policy Seminar	FY98	23.6	G	PD
Underway				
Macroeconomic Policy Notes	FY98	47.5	G, B	KG, PS
Country Assistance Strategy	FY98	82.4	G, B, D	PD
National Environmental Action Plan	FY98	20.0	G, B, D, P	KG, PD
Global Carbon Strategy	FY98	12.0	G, B, P	KG, PD
Public Investment Policy Note	FY98	20.5	G, B	KG, PS
Karakalpakstan/ Khorezm (Regional) Econ. Report	FY98	17.7	G, B	KG, PD
Economic Report	FY98	86.9	G, B, D, P	KG, PD
Planned				
Living Standards Assessment	FY99	251.2	G, B, D, P	KG, PS
Economic Update	FY99	85.0	G, B, D, P	KG, PD
Agriculture Sector Notes	FY99	100.0	G, B	KG, PS
Industrial Policy Note	FY99	10.0	G, B	KG, PS
Public Sector Expenditure Review	FY00	110.0	G, B, D	KG, PD
Economic Update	FY00	85.0	G, B, D	KG, PS
Social Sector Review	FY00	70.0	G, B, D	KG, PS
Infrastructure Sector Review	FY00	80.0	G, B, D	KG, PS
IDF Activities				
Public Procurement (IDF)	FY97	NA		KG, PS
Development of Securities Market (IDF)	FY97	NA		KG, PS
Improvement of Economic Information (IDF)	FY98	NA		KG, PS
Policy Analysis (IDF)	FY98	NA		KG, PS
EDI Activities: (including...)				
Reforming the Pension System in Transition	FY97	NA	G, P	KG, PS
Financing the Social Sectors	FY97	NA	G, P, B	KG, PS
Private Sector Development	FY97	NA	G, P	KG, PS
Financial System Reforms	FY97	NA	G, P	KG, PS
Banking System Development	FY97	NA	G, P	KG, PS
Project Management/Analysis Training for Trainers	FY97	NA	G, P	KG, PS
Public Expenditure Analysis and Mgmt (Regional)	FY98	NA	G, P, B	KG, PS
Stabilization during Reform	FY98	NA	G, B, P	KG, PD, PS
EDI/IFC Accounting Training Program	FY98	NA	G, B, P	KG, PS
Banking System Development for Policy Makers	FY98	NA	G, B, P	KG, PS, PD

a. Government (G), donor (D), Bank (B), public dissemination (P).
b. Knowledge generation (KG), public debate (PD), problem-solving (PS).

Uzbekistan Social Indicators

	Latest single year			Same region/income group	
	1970-75	1980-85	1990-95	Europe & Central Asia	Lower-middle-income
POPULATION					
Total population, mid-year (millions)	13.9	18.1	22.8	487.6	1,152.6
Growth rate (% annual average)	3.1	2.4	1.8	0.2	1.3
Urban population (% of population)	39.1	40.7	41.6	65.3	55.6
Total fertility rate (births per woman)	5.7	4.7	3.7	2.0	3.0
POVERTY					
(% of population)					
National headcount index	..	..	..	..	..
Urban headcount index	..	..	..	..	..
Rural headcount index	..	..	..	..	..
INCOME					
GNP per capita (US$)	..	..	970	2,220	1,670
Consumer price index (1990=100)	..	..	..	..	..
Food price index (1990=100)	..	..	..	..	..
INCOME/CONSUMPTION DISTRIBUTION					
(% of income or consumption)					
Lowest quintile	..	..	..	..	..
Highest quintile	..	..	..	..	..
SOCIAL INDICATORS					
Public expenditure					
(% of GDP)					
Health	..	..	3.5	..	..
Education	..	..	..	..	..
Social security and welfare	..	..	..	..	..
Net primary school enrollment rate					
(% of age group)					
Total	..	..	..	..	92
Male	..	..	..	..	..
Female	..	..	..	..	..
Access to safe water					
(% of population)					
Total	..	..	..	..	..
Urban	..	..	..	..	..
Rural	..	..	..	..	..
Immunization rate					
(% under 12 months)					
Measles	..	..	71	83	87
DPT	..	..	65	90	89
Child malnutrition (% under 5 years)	..	..	..	..	..
Life expectancy at birth					
(years)					
Total	..	68	70	68	67
Male	..	65	66	64	64
Female	..	71	72	73	70
Mortality					
Infant (per thousand live births)	..	45	30	26	41
Under 5 (per thousand live births)	..	..	48	35	56
Adult (15-59)					
Male (per 1,000 population)	..	..	209	289	253
Female (per 1,000 population)	..	..	101	116	148
Maternal (per 100,000 live births)	..	46	..	..	..

Uzbekistan - Key Economic Indicators

Indicator	Actual 1992	1993	1994	1995	Estimate 1996	1997	Projected 1998	1999
National accounts (as % GDP at current market prices)								
Gross domestic product	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0
Agriculture[a]	41.2	32.2	39.0	32.1	26.0	24.5	24.9	24.8
Industry[a]	42.0	32.2	25.8	27.8	27.4	26.4	27.3	27.7
Services[a]	16.8	35.6	35.1	40.1	46.6	49.0	47.8	47.5
Total Consumption	96.3	109.4	92.3	79.5	91.3	89.3	89.1	85.7
Gross domestic fixed investment	..	..	..	..	16.1	15.6	15.2	18.4
Government investment	3.6	2.2	3.6	6.1	7.1	5.9	5.7	6.1
Private investment (includes increase in stocks)	9.5	0.8	2.1	14.8	9.0	9.8	9.5	12.3
Exports (GNFS)[b]	33.8	84.7	46.2	38.0	30.5	28.9	27.9	27.8
Imports (GNFS)	43.2	97.1	44.2	38.4	38.0	33.9	32.1	31.8
Gross domestic savings	3.7	-9.4	7.7	20.5	8.7	10.7	10.9	14.3
Gross national savings[c]	3.7	-9.6	7.6	20.4	8.2	9.3	9.8	12.9
Memorandum items								
Gross domestic product (US$ million at current prices)	..	5095	5691	10026	13629	21301	22377	22653
Gross national product per capita (US$, Atlas method)	1010.0	990.0	950.0	990.0	1010.0	..	..	..
Real annual growth rates (%, calculated from 1987 prices)								
Gross domestic product at market prices	-11.1%	-2.3%	-4.2%	-0.9%	1.6%	2.4%	2.5%	2.7%
Gross Domestic Income	..	..	..	..	..	..	..	..
Real annual per capita growth rates (%, calculated from 1987 prices)								
Gross domestic product at market prices	-13.2%	-4.5%	-6.0%	-2.6%	-0.5%	0.5%	0.6%	0.8%
Total consumption	..	..	..	..	..	..	..	..
Private consumption	..	..	..	..	..	..	..	..

(continued)

Uzbekistan - Key Economic Indicators (Continued)

Indicator	Actual			Estimate		Projected		
	1992	1993	1994	1995	1996	1997	1998	1999
Balance of Payments (US$m)								
Exports (GNFS)[b]	1424.0	2877.0	2940.0	3806.0	4160.9	4021.5	4211.1	4491.1
Merchandise FOB	1424.0	2877.0	2940.0	3806.0	3781.0	3651.7	3818.8	4074.5
Imports (GNFS)[b]	1652.0	3299.0	2812.0	3848.0	5174.9	4708.6	4860.8	5146.3
Merchandise FOB	1659.0	3255.0	2727.0	3597.0	4711.7	3956.2	4066.5	4304.1
Resource balance	-228.0	-422.0	128.0	-42.0	-1014.0	-687.1	-649.7	-655.2
Net current transfers (including official current transfers)	2.0	12.0	13.0	19.0	8.0	2.0	10.0	10.0
Current account balance (after official capital grants)	-238.0	-429.0	118.0	-49.0	-1075.0	-876.9	-818.4	-890.2
Net private foreign direct investment	9.0	48.0	73.0	-24.0	50.0	84.0	120.0	125.0
Long-term loans (net)	60.9	606.5	10.6	633.3	704.0	224.2	567.1	661.3
Official	60.9	455.5	-39.9	279.8	242.3	-77.4	-56.2	-64.9
Private	0.0	151.0	50.5	353.5	461.7	301.6	623.3	726.2
Other capital (net, including errors and omissions)	698.1	266.5	107.4	17.7	354.0	151.0	147.6	161.9
Change in reserves[d]	-530.0	-492.0	-309.0	-578.0	-33.0	417.7	-16.3	-58.1
Memorandum items								
Resource balance (% of GDP at current market prices)	..	-8.3%	2.2%	-0.4%	-7.4%	-3.2%	-2.9%	-2.9%
Real annual growth rates (1987 prices)								
Merchandise exports (FOB)	..	..	..	..	..	..	..	..
Primary	..	..	..	..	..	..	..	..
Manufactures	..	..	..	..	..	..	..	..
Merchandise imports (CIF)	..	..	..	..	..	..	..	..
Public finance (as % of GDP at current market prices)[e]								
Current revenues	31.5	36.0	29.2	34.6	34.2	30.3	32.5	33.6
Current expenditures	43.7	32.3	26.4	25.0	30.8	28.4	30.3	30.6

(Continued)

Uzbekistan - Key Economic Indicators
(Continued)

Indicator	Actual			Estimate		Projected		
	1992	1993	1994	1995	1996	1997	1998	1999
Current account surplus (+) or deficit (-)	-12.2	3.7	2.8	9.6	3.4	2.0	2.3	2.9
Capital expenditure	6.3	14.1	8.9	13.8	10.7	4.9	6.3	6.7
Foreign financing	6.8	-1.8	..	1.6	-0.1	-0.6	0.1	1.0
Monetary indicators								
M2/GDP (at current market prices)	69.4	53.5	32.8	18.1	19.6	19.6	17.9	17.9
Growth of M2 (%)	..	784.7	680.3	158.1	100.1	70.1	21.4	28.4
Private sector credit growth / total credit growth (%)	..	..	..	..	..	77.8	23.7	27.8
Price indices(1987 =100)								
Merchandise export price index	..	..	..	..	..	..	..	..
Merchandise import price index	..	..	..	..	..	..	..	..
Merchandise terms of trade index	..	..	..	..	..	..	..	..
Real excha~ ~ rate (US$/LCU)[f]	..	..	..	..	..	..	..	..
Real interest rates								
Consumer price index (% growth rate)	..	..	1568.3%	305.0%	54.0%	66.4%	32.7%	25.4%
GDP deflator (% growth rate)	711.3%	1074.8%	1229.1%	370.9%	82.1%	66.0%	30.0%	25.0%

a. If GDP components are estimated at factor cost, a footnote indicating this fact should be added.
b. "GNFS" denotes "goods and nonfactor services."
c. Includes net unrequited transfers excluding official capital grants.
d. Includes use of IMF resources.
e. Should indicate the level of the government to which the data refer.
f. "LCU" denotes "local currency units." An increase in US$/LCU denotes appreciation.

Uzbekistan - Key Exposure Indicators

Indicator	Actual 1992	1993	1994	1995	Estimate 1996	1997	Projected 1998	1999
Total debt outstanding and disbursed (TDO) (US$m)[a]	60	1031	1244	1787	2319	2273	2168	1967
Net disbursements (US$m)[a]	61	698	210	554	584	-46	-104	-202
Total debt service (TDS) (US$m)[a]	5	30	138	243	289	575	538	447
Debt and debt service indicators (%)								
TDO/XGS[b]	..	..	..	46.1	55.3	56.8	51.2	43.5
TDO/GDP	..	20.2	21.9	17.8	17.0	10.7	9.7	8.7
TDS/XGS	..	..	..	6.3	6.9	14.4	12.7	9.9
Concessional/TDO	..	..	..	10.5	14.0	27.1	29.6	31.8
IBRD exposure indicators (%)								
IBRD DS/public DS	0.0	0.0	0.1	0.7	3.6	2.0	2.3	3.2
Preferred creditor DS/public DS (%)[c]	0.0	0.0	0.2	3.2	8.3	19.7	6.8	15.8
IBRD DS/XGS	..	..	..	0.0	0.2	0.3	0.3	0.3
IBRD TDO (US$m)[d]	0	0	1	157	155	165	176	188
Of which present value of guarantees (US$m)								
Share of IBRD portfolio (%)	0.0	0.0	0.0	0.1	0.1	0.1	0.2	0.2
IDA TDO (US$m)[d]	0	0	0	0	0	0	0	0
IFC (US$m)								
Loans								
Equity and quasi-equity /c								
MIGA								
MIGA guarantees (US$m)								

a. Includes public and publicly guaranteed debt, private nonguaranteed, use of IMF credits and net short-term capital.
b. "XGS" denotes exports of goods and services, including workers' remittances.
c. Preferred creditors are defined as IBRD, IDA, the regional multilateral development banks, the IMF, and the Bank for International Settlements.
d. Includes present value of guarantees.
e. Includes equity and quasi-equity types of both loan and equity instruments.

Status of Bank Group Operations in Uzbekistan
IBRD Loans and IDA Credits in the Operations Portfolio

Project ID	Loan or Credit No.	Fiscal Year	Borrower	Purpose	Original Amount in US$ Millions: IBRD	IDA	Cancellations	Undisbursed	Difference Between expected and actual disbursements a/: Orig	Frm Rev'd
Number of Closed Loans/credits: 1										
Active Loans										
UZ-PE-9121	IBRD42160	1998	REPUBLIC OF UZBEKISTAN	RURAL W.S. & SANITA.	75.00	0.00	0.00	75.00	0.00	0.00
UZ-PE-44942	IBRD40900	1997	REPUBLIC OF UZBEKISTAN	PILOT WATER SUPPLY	5.00	0.00	0.00	2.26	-.56	0.00
UZ-PE-9122	IBRD38940	1995	REP.OF UZBEKISTAN	COTTON SUB-SEC IMPRV	66.00	0.00	0.00	58.41	12.60	0.00
UZ-PE-9123	IBRD36500	1994	REPUB. OF UZBEKISTAN	INSTIT BLDG/TA	21.00	0.00	0.00	6.42	6.44	0.00
Total					167.00	0.00	0.00	142.09	18.48	0.00

	Active Loans	Closed Loans	Total
Total Disbursed (IBRD and IDA):	24.91	160.00	184.91
of which has been repaid:	0.00	0.00	0.00
Total now held by IBRD and IDA:	167.00	160.00	327.00
Amount sold :	0.00	0.00	0.00
Of which repaid :	0.00	0.00	0.00
Total Undisbursed :	142.09	0.00	142.09

a. Intended disbursements to date minus actual disbursements to date as projected at appraisal.
b. Rating of 1-4: see OD 13.05. Annex D2. Preparation of Implementation Summary (Form 590). Following the FY94 Annual Review of Portfolio performance (ARPP), a letter based system will be used (HS = highly Satisfactory, S = satisfactory, U = unsatisfactory, HU = highly unsatisfactory): see proposed Improvements in Project and Portfolio Performance Rating Methodology (SecM94-901), August 23, 1994.

Note:
Disbursement data is updated at the end of the first week of the month.

Uzbekistan - Statement of IFC's
Committed and Disbursed Portfolio
(As of January 31, 1998)

IFC Approvals

Project Name	Sector	Approval Date	Project Size Million USD	IFC				Participants	
				Loan	Equity	QE*	GSR**	Loan	Equity
Amantaytau Gold	Mining	03/17/94	6.4	0.0	0.0	1.2	0.0	0.0	0.0
UCLC LTD	Non-Bank Financial Institutions	06/28/95	24.0	5.0	0.6	0.0	0.0	0.0	0.0
Amantaytau II	Mining	03/28/96	355.0	40.0	4.4	7.5	6.9	85.0	0.0
ABN-AMRO Uzbek	Banking Institutions	04/09/96	10	0.0	1.0	0.0	0.0	0.0	0.0
SEF Fayz	Manufacturing	04/18/97	4.8	1.9	0.5	0.0	0.0	0.0	0.0
UZCASEMASH	Manufacturing	06/17/97	28.4	6.8	2.6	0.0	0.0	4.0	
UzCase Agrolease	Non-Bank Financial Institutions	06/17/97	17.5	5.0	1.0	0.0	0.0	5.0	0.0
UzCaseService	Manufacturing	06/17/97	24.6	6.4	1.6	0.0	0.0	5.0	0.0
Core Pharm	Pharmaceutical	06/30/97	12.2	3.4	0.5	0.0	0.0	3.4	0.0
SEF Bulungur	Manufacturing	10/23/97	3.3	1.3	0.3	0.0	0.0	0.0	0.0
Total			486.2	69.8	12.5	8.7	6.9	102.4	0.0

*QE+ Quasi Eqiity
** GSR= Guarantee, Standby and Risk Management

IFC Technical Assistance

Project Name	Project Description	Fiscal Year
Project Technical Assistance	Through its technical Trust Funds program, IFC funded a market and feasibility assessment for a proposed joint venture through the privatization of a state-owned cotton spinning mill	FY95
Private Sector Development	Advised the government on opportunities for developing automotive and farm machinery component industries	FY96
Private Sector Development	Organized a course in basic accounting for entrepreneurs	FY96
FDI	Conduct diagnostic review of climate for FDI (FIAS)	FY97
Consulting services	Perform feasibility study on establishing consulting services for private enterprises, with particular focus on transfer of technical skills and expertise to local consultants	FY97

Uzbekistan—CAS Summary of Development Priorities

Network area	*Country performance*	*Major issue*	*Country priority*	*Bank priority*	*Reconciliation of country and Bank priorities*
Poverty Reduction & Economic Management					
• Poverty reduction	Fair	Improving regional targeting of benefits; low growth potential under current policies.	High	High	
• Economic policy	Poor	Fragile macro stability; gradual liberalization; no agreement with IMF; occasional policy reversals.	Moderate	High	Government's gradual approach; pilot operations, NLS and policy dialogue.
• Public sector	Fair	Continued public sector participation in microeconomic management; public sector accountability; centralized decision making.	Moderate	High	Government's gradual approach; pilot operation. NLS and policy dialogue.
• Gender	Fair to Good	Equal participation and recognition.	Moderate	Moderate	
Human Development					
• Education	Fair	Financing and cirriculum reform; balance between primary, secondary and tertiary.	Moderate	Low	ADB taking lead on education.
• Health, nutrition & population	Fair	Financing and protocol reform; balance between primary, secondary and tertiary.	Moderate	Moderate	
• Social protection	Fair	Unsustainable pay and pension system; improved targeting of assistance and elimination of general subsidies in favor of targeted assistance.	Moderate	Moderate	
Environmentally & Socially Sustainable Development					
• Rural development	Fair	Liberalization of prices for both inputs and produce; freedom of choice of cropping; introducing competition in marketing and export of cotton; and land tenure security.	Moderate	High	On-going dialogue; pilot operations, and policy dialogue.
• Environment	Fair	Industry restructuring ('Brown"); Natural Resources Management (Aral Sea Basin)	High	High	
• Social development	Fair	Promoting participation by civil society; limited press freedom.	Low	Moderate	Government's political agenda.
Finance, Private Sector & Infrastructure					
• Financial sector	Fair	Faster liberalization; institution building.	High	High	But different approach. Pilot operation, NLS and policy dialogue.
• Private sector	Fair	Transparency of privatization program; legal and regulatory framework.	High	High	But different approach. Pilot cperation, NLS, and policy dialogue.
• Energy & mining	Fair to Good	Level-playing field for FDI.	Moderate	Moderate	
• Infrastructure	Fair	Creating competitive market for service providers; cost recovery.	High	High	

Attachment

UZBEKISTAN
PRIVATE SECTOR STRATEGY

I. INTRODUCTION

1. Uzbekistan embarked later than most CIS countries on economic reform and its approach to reforms has been more cautious than in most transition economies. In line with the pace of overall reforms, the growth of the private sector has also been slow compared to the rest of the CIS and Eastern Europe. Nevertheless, the share of the private sector in GDP has increased substantially since independence and according to some estimates is close to 50 percent at the end of 1997[1]. This growth has originated from (i) enterprise privatization; (ii) small-scale investment in new businesses; (iii) foreign direct investment in joint-ventures; and (iv) introducing the policies of market economics.

2. Privatization has been the main source of private sector growth in Uzbekistan. Small-scale privatization is almost completed. The privatization of medium and large scale enterprises has lagged, but in late 1996 the Government began to implement a mass privatization program based on Privatization Investment Funds (PIFs) program. The progress in privatization has been complemented by substantial advances in price liberalization and macroeconomic stabilization. Despite these positive trends, there are reasons to be concerned about the overall environment for private sector development. The Government continues to exercise a substantial degree of control on production, investment and prices through a variety of means. As a result of this restrictive environment, the growth of new small businesses and the amount of foreign direct investment the country has attracted have been relatively low. Uzbekistan has received US$450 million in cumulative total net FDI in the period 1992-96, among the lowest in per capita terms in the FSU[2].

3. This annex concentrates on impediments to private sector growth and ways in which the World Bank Group can contribute to private sector development in Uzbekistan. The structure of the paper is as follows: Section II contains an analysis of existing constraints to private sector development; Section III discusses investment potential and critical issues in key sectors; and Section IV outlines the role the World Bank Group can play in stimulating private sector growth.

II. CONSTRAINTS TO PRIVATE SECTOR DEVELOPMENT

4. ***Exchange and Payments System.*** The Government's controls on trade and payments are perhaps the main impediment to private sector development today. Despite its declared intentions to introduce full convertibility of the sum, the Government still maintains a strict system of foreign exchange allocation. Foreign exchange is treated as a strategic resource to be allocated according to national priorities, mainly to exporters and sectors employing high technology. Applications are scrutinized on a project-by-project basis for adherence to the Government's policy. In the process, investors are experiencing long delays in converting sums, which creates liquidity problems and

[1] EBRD, Transition Report 1997, p.14. The estimates of private sector share in GDP are subject to a great deal of uncertainty due to data limitations and differing definitions of private ownership.

[2] World Bank 1996, World Debt Tables; World Bank, International Economics Department.

gravely undermines their ability to function efficiently. In scrutinizing import contracts, the Government through the Ministry of Foreign Affairs, often interferes in import decisions taken by foreign and domestic investors suggesting alternative suppliers, prices and equipment. Moreover, current practices of allowing importers to prepay only up to 15% of the value of import contracts in hard currency are also hampering normal business operations. A number of foreign companies operating in Uzbekistan have developed localization programs aimed at increasing the local value-added of their production. With the existing restrictions on prepayment, these companies experience difficulties developing normal long-term relationships with Western suppliers, which conflicts with their plans to attract foreign manufacturers in the country as part of the implementation of localization programs.

5. In addition to difficulties in gaining access to foreign exchange, investors also complain about restrictions on the use of local currency. Companies may not simply withdraw their funds from banks to buy goods and services. They must obtain permission from banks and must resort to paying for inputs and other purchases by transferring account, or non-cash sums. The banks are prevented from authorizing withdrawals for most purposes other than paying wages. This results in unnecessary bureaucratic procedures in paying for daily corporate expenses. In addition, restrictions exist as to the amounts of sums that can be withdrawn for paying wages, which interfere with companies' expansion plans and their ability to attract skilled workers.

6. ***Governance and Legal Issues.*** The new political and economic institutions in Uzbekistan are in a critical phase of formation and development. As in other countries in transition, this phase is characterized by frequent changes in laws and regulations, inconsistencies among legislations, weak administrative capacity to implement the laws, lack of transparency and difficult access to legal information, and considerable bureaucratic discretion in interpreting and applying the rules. While most of these transitional problems are expected to disappear as skills are acquired through experience, there are some emerging tendencies in Uzbekistan's legal environment that give serious cause for concerns.

7. As a result of the uncertainties in the legal framework, many foreign and domestic investors have obtained special decrees which supersede the normal legal regime and "guarantee" their rights, privileges, and benefits. Since large or strategic companies have such decrees, all foreign companies seek to obtain one, even if legally not required. While these decrees may give some confidence by serving as a stamp of approval from the very high official level, their mere existence is creating a sense of insecurity for any company that does not have a special decree or license. Moreover, the resources spent on obtaining and issuing such decrees constitute an important transaction cost for doing business in Uzbekistan. This practice also weakens the development of the legal system in the country and the growth of a uniform system of law.

8. Uzbekistan's progress in updating certain elements of commercial law—the pledge law, the company law, and bankruptcy law—has been comparable to that of Kazakhstan and the Kyrgyz Republic but has been slower than most of Central and Eastern Europe. There remain, however, problems in the area of *pledge law* including: absence of a functioning central registry for the registration of non-possessory pledges; high notary or registration fees; and absence of any practice of perfecting a security and enforcing it. In the area of *company law*, Uzbekistan has enacted a modern company law that includes provisions for the protection of shareholders rights

such as the opportunity to be represented by proxy at meetings of shareholders and maintenance of share registries of companies by independent parties. These provisions, however, have not been accompanied by effective means for implementation and enforcement. The *bankruptcy law*, approved in May 1994, was amended in August 1996, with the active involvement of IFC, to reflect the concept of limited liability of shareholders in joint-stock companies and the priority of secured lenders over claims of other creditors. A bankruptcy committee has been established in the State Property Committee that can initiate the legal process to declare an enterprise bankrupt. As of end-1996, about 200 complaints had been filed with the courts at regional and national level. In about 130 of these cases the courts declared the enterprises, most of them small and medium companies, bankrupt.

9. ***Privatization and Property Rights.*** By the end of 1996, about 94 percent of all previously state-owned small enterprises had been transferred to private hands, typically to employee collectives. In addition, about 25 percent of the agricultural land had been transferred under various kinds of leasehold or use rights arrangements to family-based peasant farms or as household plots. Progress in the corporatization and partial privatization of medium- and large-scale enterprises has been more limited. An innovative privatization investment scheme based on Privatization Investment Funds (PIFs), designed to achieve transparent privatization, broad public participation and capital market development began to be implemented in late 1996. By December 1997, about 50 PIFs and 60 management companies have been established, out of which 12 to 15 are actively selling to the public and participate in auctions; shares in 157 enterprises have been sold.

10. Despite initiating an innovative privatization program, some recent steps by the Government tend to undermine previous achievements and to limit the capacity and the incentives of privatized enterprises to embark on post-privatization restructuring. These include: (i) retroactive changes in the list of enterprises targeted for privatization, which undermine confidence in capital markets; (ii) dilution of shareholdings of private parties which increases the state's share, representing attempts at "renationalization", and reverses the privatization process; (iii) transfer of shares to associations that are related to, or controlled by, Government ministries. Although the management of corporatized and partially privatized enterprises is *de jure* autonomous, in many cases Government control remains important. The state often reserves substantial rights with respect to the assets of privatized companies which makes it difficult for potential investors to understand what the property rights of the enterprises are.

11. ***Financial Sector.*** *The banking sector* is dominated by the state-owned National Bank of Uzbekistan (NBU) (by far the largest bank), People's Bank, Promstroibank and Pakhta Bank, which together control over 85% of the sector's assets. There is a second layer of 14 smaller state-owned banks with a strong sectoral orientation. The remaining commercial banks are small private banks, including some joint-ventures. The loan portfolios of a number of the larger, former sectoral banks are burdened with bad loans which could threaten their solvency. Competition within the sector remains weak and is further hindered by foreign exchange controls and restrictions on the number of enterprises' bank accounts. The credit risk assessment capacity of the banks is limited and most banks are as yet unable to operate according to market principles and impart financial discipline on the enterprise sector. Partly reflecting the banks' weak credit risk assessment capacity, the Central Bank still exercises considerable control over credit access.

Commercial banks in many cases act as implementing and controlling agencies of the Government, i.e. by playing a major role in enforcing tax, trade and wage regulations. This role is based on the requirement that an enterprise has a single bank account with its house bank[3]. Over the last year, particularly as a result of the implementation of the Law on Banks and Banking Activity adopted in April 1996, there have been certain encouraging developments. From late 1996, commercial banks started to set aside reserves against non-performing loans. All banks are now required to have annual audits performed by international accounting firms. The payment system has become fully automated, resulting in a major reduction of settlement times. A recent presidential decree called for increased private sector participation and reduced administrative interventions in the banking system.

12. ***Non-bank Financial Institutions and Securities Market.*** The setting up of the PIFs in 1996 as part of the privatization program has been the key new development in the non-bank area. There are a number of newly created insurance companies but the insurance firms with strong state participation, such as Uzbek Invest, continue to dominate the sector. The establishment of the Center for Coordination and Control of the Securities Markets (CCCSM) in April 1996, led to a number of important regulations and has improved conditions in the securities market. At the end of 1996, the Republican Stock Exchange (RSE) in Tashkent had listed stocks in 400 enterprises. Trading volumes, however, remain low, at about 0.5 percent of GDP in 1996, compared to the stock market performance of advanced reformers such as the Czech Republic (15 percent), Poland (4.1 percent), and Hungary (3.6 percent), but are similar to trading values in Russia (0.7 percent) and Lithuania (0.5 percent)[4]. Secondary trading has been sluggish up to now as trading in the RSE and off-market is limited to a handful of companies. Depending on the progress in case-by-case privatization and with the PIFs facilitating large scale privatization, it is expected that secondary market trading will expand rapidly. The number of companies registered with the National Share Depository (NSD) reached about 4,200 at the end of 1996. Due to significant transactions taking place outside the formal market, however, it has been difficult to keep up-to-date records of ownership of enterprises. Despite the recent efforts by the CCCSM, transparency in the stock market is in need of improvement; more specific information is required on information disclosure by companies.

13. ***Constraints on SMEs Development.*** Small and medium sized enterprises in Uzbekistan face a number of constraints on their development. *Limited access to capital* is one of their biggest problems. Although a significant amount of credit is being made available from institutions such as the Japanese Overseas Economic Cooperation Fund, the Central Asian-American Enterprise Fund (CAAEF), the Asian Development Bank (ADB), and the European Bank for Reconstruction and Development (EBRD), the country's small firms appear to suffer from a credit gap between US$3,000 and US$300,000. In addition, the Government has established a Business Fund, which is a government body lending largely from privatization receipts to SMEs at subsidized rates. The lending practices of this Fund are bound to have a generally distorting impact on the financial markets for SMEs credit. Short term working capital provision is commonly based on conservative banking criteria regarding the provision of types of collateral and guarantees, and long term capital

[3] This requirement has recently been lifted for enterprises with foreign participation.

[4] IFC, Emerging Stock Markets Factbook 1997.

access is made difficult by the practice of restricting most bank loans to a maximum of one year maturity.

14. *Complicated procedures and reporting requirements*, ambiguous regulations and taxation rules, and harassment by public agencies impose a particularly heavy burden on SMEs. Problems in acquiring foreign exchange and difficulties with instruments such as Letters of Credit make exporting very difficult and many businesses are thus limiting themselves to the domestic market and to the CIS where procedures are simpler.

15. As in many other transition economies, there is a weakness in *management skills* relating to the functioning of a market economy. Many bankers indicate that few entrepreneurs are able to formulate project proposals to an acceptable level of competence and quality. Further, the fact that a local consultancy profession is still only embryonic means that very limited expertise is available to advise on such work, although the newly established "Uzinvestproect Project" is an attempt to build up such local expertise.

III. INVESTMENT POTENTIAL AND SECTORAL ISSUES

16. ***Agriculture.*** Agriculture is the mainstay of the economy accounting for 27 percent of GDP in 1996. Since the breakup of the USSR, policies have focused on improving efficiency, privatizing farms, streamlining the cotton industry, and achieving self sufficiency in grain (mainly wheat). Uzbekistan is the world's fifth largest producer, and second largest exporter of cotton. Cotton harvests have averaged about 1.2 million tons of fiber for the past four or five years and cotton sales are the Government's most important source of hard currency, accounting for about 45 percent of exports. The dependence on cotton has major implications for Government policy. Poor cotton harvest and low world prices for cotton in 1996 were a major factor behind the Government's decision to introduce rationing of hard currency and to loosen credit and fiscal policies in the last quarter of the year. Reflecting the state's dependence on the cotton sector for revenues, the industry is heavily taxed through lower farmers' prices[5], an overvalued exchange rate, delays in payments to farmers and other means. The Government is the main buyer of raw cotton and is effectively in control of the processing industry.

17. ***Natural Resource.*** *Mining and metallurgy* accounted for one fourth of Uzbekistan's GDP in 1996. Of 2,700 important mineral deposits, only 940 have been developed to date. Uzbekistan has the fourth largest gold deposits in the world, as well as significant deposits of copper, zinc, lead, silver and tungsten. The country is also the world's third largest exporter of uranium. Gold mining has attracted the lion's share of foreign investment in minerals. One large joint-venture, the Zarafshan-Newmont gold leaching project, is already producing gold. Recently, the Government announced a plan for the privatization through an international tender of Almalyk Metallurgical Combinate, whose main activities are the mining and refining of gold, copper and zinc.

[5] Farmers are required to sell their raw cotton under a state order system whereby a significant share of the crop has to be sold to the state at a procurement price, which is substantially lower than the international price.

18. Uzbekistan is already an important producer of *oil and gas* and it is the only CIS country to have increased production since 1992. The country has substantial gas reserves and became self-sufficient in oil for the first time in 1995. The oil and gas industry faces two major challenges: a lack of modern processing facilities and limited transport options. The sector remains largely in state ownership, although a small number of joint-ventures are being established. Several new projects are aimed at building new facilities and modernizing old ones. The rehabilitation and the upgrading of Buhara refinery was completed in 1997 and the modernization of the Fergana refinery is underway.

19. ***Manufacturing.*** *Light industry* is a particularly important area for foreign and domestic investors. Although Uzbekistan is the world's second largest exporter of cotton, after the U.S., only 15 percent of the cotton fiber is processed domestically. The Government's investment program seeks to increase domestic processing of the cotton harvest to 30 percent, as well as to improve the quality of Uzbek cotton fiber. Most of the existing processing plants use old-fashioned technology and suffer from poor infrastructure, auxiliary equipment and maintenance. A serious problem is the lack of a reliable cotton quality evaluation and classification.

20. ***Machinery.*** The agricultural sector represents a substantial domestic market for agricultural equipment. Export potential to other economies in the region is also significant. CASE Corporation from the USA and IFC have invested in a joint-venture to produce cotton picking machines for Uzbek and Central Asian markets. Uzbekistan has also made substantial progress in developing a local automobile industry. The joint-venture with Daewoo began operations in 1996 and is already producing cars for domestic markets and export to the CIS countries. These new ventures create demand for parts and components, service and maintenance industries, and ongoing localization programs are opening new investment opportunities in the sector.

21. ***Chemicals.*** Uzbekistan produces an extensive range of chemical components, and several chemical enterprises have attracted foreign companies who are helping to upgrade the technology. Agricultural chemicals and fertilizers, as well as plastics and household chemicals, are the main focus of production for domestic consumption, while a significant export potential exists for potassium compounds.

22. ***Infrastructure.*** The country's large population, central location in the region and significant growth potential indicate a strong future demand for infrastructure services. The Government's strategy is to encourage private sector participation in developing this potential. However, important aspects of the regulatory framework are relatively undefined, which restricts the flow of private investment in the sector at this stage. *Transportation.* Although the road and railway infrastructure is reasonably well developed, much of the transport equipment is outdated and in disrepair, resulting in a decrease in the volumes of cargo and passenger transport. However, some of the recorded decline in the transport sector reflects a shift from public sector rail to private sector road transport, which is inadequately covered in the national accounts. Recently, significant reforms have been introduced in urban transport which form a good basis for the development of a competitive and commercial sector.

23. ***Telecommunications.*** At present the country has 1.5 million telephone lines, 80 percent of which are devoted to personal use and 20 percent to business and Government use. The

penetration rate is one of the lowest among transition economies (7 main lines per 100 population, compared to 12 in Kazakhstan, 17 in Russia and 30 in Slovenia[6]) and much of the equipment is outdated. The Government has opened the cellular market to competition and, with the assistance of several major foreign telecommunications companies, progress has been made in upgrading existing networks as well as installing new technology, particularly in the Tashkent area.

IV. WORLD BANK GROUP STRATEGY

24. The present economic environment in Uzbekistan presents both significant challenges and opportunities for the World Bank Group's work in the area of private sector development. On one hand, the partial nature of macroeconomic reforms and liberalization is associated with higher risks and imposes severe restrictions on the areas where economically viable projects could be implemented. On the other hand, carefully selected investment operations, in parallel with maintained policy dialogue, could be effective instruments in creating incentives and pressure for deeper structural reforms. Within this broad framework, the World Bank Group's involvement will be restricted to investment operations which:

- are highly visible demonstrations of the greater efficiency associated with private sector operations;
- while economically and financially viable, stand to benefit more from further economic liberalization, thus creating lobbying groups for faster and deeper reforms;
- are geared toward realizing the potential for productivity increase and growth in key sectors such as agriculture and mining, thus reducing the country's vulnerability to economic fluctuations—a major cause of macroeconomic instability and policy reversals;
- have a strong institution-building component, thus alleviating the Government's concerns about the private sector's inadequate response to reforms because of weak and undeveloped market institutions; and
- provide compensating support to sectors such as the SMEs which are particularly disadvantaged in the present economic environment.

25. The main risk of this approach is that its success is to a large extent conditional on the Government's positive response to incentives and pressure to reform. IBRD's use of pilot operations designed to demonstrate the consequences and benefits of reform could be an effective tool for reducing this risk. Pilot operations would provide IBRD with the ability to scale the size and scope of operation to the potential pay-off in terms of policy and institutional changes. IFC will seek opportunities to reduce the risks related to the Government's approach to reforms by (i) addressing critical policy issues early on in the project cycle; (ii) closely coordinating its investment plans with the implementation and outcome of IBRD's investment operations; and (iii) restricting the areas of its involvement to sectors that are less vulnerable to foreign exchange risk, i.e. export-oriented sectors.

26. Further opening of the economic environment, along the lines of the high case scenario described in the main text, would expand the opportunities for private sector development and

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[6] Source: International Telecommunications Union.

consequently the role of the World Bank Group in this process. Progress in the areas of liberalization of trade and payments, privatization of medium and large scale enterprises, and restructuring and privatization of the financial sector would be supported by several IBRD adjustment operations, as explained in the main text, resulting in an increase in Bank lending commitments. Reforms of this kind are also likely to generate an increase in the demand for IFC financing and services. Respectively, without such response, the areas which satisfy the above mentioned constraints would be depleted quickly, leading to reduction in the World Bank Group's involvement in private sector development in Uzbekistan.

Areas of Involvement

27. ***Policy Dialogue.*** IBRD continues to maintain an extensive policy dialogue on broader policy issues affecting different sectors. The focus is on promoting structural reform and liberalization and enhance policy dialogue primarily through investment operations on the premise that these operations would demonstrate the benefits of key structural reforms and would induce changes on a broader scale.

28. IFC is also involved in an active dialogue with the authorities over general and sectoral investment policy issues as part of its work on specific projects. Implementation of several of IFC's projects has been hampered by certain aspects of the legal framework related to the country's commercial and bankruptcy laws. To address these issues, IFC helped Uzbekistan draft a bankruptcy law and implement a number of changes in the legal framework for commercial transactions. IFC also helped Uzbekistan draft a mining code when it became apparent that the existing code was not adequate to attract new investments. Issues of foreign exchange regime, cotton price controls, competition policies and transparency in the regulatory process are often raised in the context of IFC projects in Uzbekistan. The Government has consistently demonstrated its willingness to assist in resolving some of these issues, however, usually in the framework of individual projects.

29. While raising policy issues in the context of project financing is often an effective instrument for improving the overall business climate it may not always provide general solutions to investors' problems. IFC and IBRD have complemented project related advisory services with free-standing advisory services in the area of business environment for private investment, mainly through FIAS. FIAS has conducted a diagnostic study of the environment for foreign direct investment in Uzbekistan and has suggested solutions to a number of policy impediments to foreign direct investment, including the restrictions on foreign exchange. The Government's reaction to the study has been positive and follow-up work in this area is possible, subject to further discussion with FIAS.

30. ***Privatization and Post-privatization.*** IBRD continues to prepare adjustment operations that support privatization and financial sector reform even though it is not possible to present these to the Board at this stage. While the Government has been hesitant to engage in broader structural reforms, there has been some progress in these areas. Preparation of the Enterprise Reform Adjustment loan has led to an innovative privatization program for some medium and large-scale enterprises. The program has created a privatization lobby and has spurred capital market development through widespread sale of shares to the public and the creation of private sector

investment companies. As a next step, the Government has asked for assistance (in the form of an institution building operation) with the privatization of several large and medium scale public enterprises on a case-by-case basis. The Enterprise Institution Building Project will support (i) case-by-case privatization by strengthening the capacity to privatize large and complicated enterprises transparently, (ii) enterprise reform by building institutional capacity for restructuring, and (iii) capital market development through assistance to develop secondary trading, capital market institutions and training. IFC is exploring opportunities to complement these efforts through technical assistance for the privatization of these companies and direct investments and credit lines for post-privatization restructuring.

31. ***Financial Sector.*** Preparation of the Financial Sector Adjustment Loan has confirmed the Government's interest in strengthening supervision and regulation of banks. As part of this work, IBRD has been implementing an active program of institution building supported by PPF resources and has maintained a dialogue on policy issues such as banking sector structure, foreign exchange and cash restrictions. The Financial Sector Institution Building Project would support the adoption of a new accounting framework for banks based on international standards and would enhance institutional capacity in the areas of bank supervision, bank restructuring and credit risk assessment.

32. Institution-building as a means of creating best-practice models for commercial banking, leasing, and fund management has been of the core of IFC's work in Uzbekistan. IFC has participated in the establishment of the first major commercial banking joint venture with an international partner, ABN-Amro Bank Uzbekistan. To address the scarcity of term finance for small and medium-sized companies, IFC is supporting an initiative to develop the leasing industry in Uzbekistan. The first leasing company in Uzbekistan has been established with IFC's participation. Furthermore, IFC is currently exploring a number of alternatives to provide a mechanism for the use of lease financing in the agricultural sector. To address the pressing needs of the emerging private rural sector for financing purchases of agricultural machinery, IFC established a leasing company with Case Credit Holding and the Uzbek Banking Association (UBA) as main shareholders.

33. IFC's future strategy in the financial sector will focus on support and resource mobilization for selected Uzbek banks to bring them to international standards and on institution building in the area of capital markets. At present, IFC is working on the setting up of on-lending facilities through local commercial banks targeting small and medium-scale enterprises and export-oriented industries in the private sector. The lines of credit will raise additional resources for the banking sector thereby allowing it to play a more effective role in the development of the private sector. They would also alleviate some of the negative effects of existing foreign exchange restrictions on companies' investment plans. Further reforms in the area of capital markets would create opportunities for IFC to focus its institution building efforts on establishing an investment bank, fund management and insurance companies.

34. ***Mining.*** Uzbekistan is currently the world's eighth largest producer of gold and has substantial gold reserves; it also has the potential to increase production significantly. IFC has helped finance a pilot plant/appraisal project to assess the feasibility of the Amantaytau gold mine, a potentially large new development. Following the completion of the pilot plant phase, IFC is

working on a project for the commercial development of the gold mine. IFC and IBRD have also provided assistance to the Government in the development of a mining code which would greatly facilitate foreign investment by making the sanctioning process transparent and avoid the need for case-by-case negotiations. MIGA has insured one mining project, the Zarafshan-Newmont gold leaching project, and has received a number of applications for guarantees in the sector. Recent movements in gold prices, however, are likely to delay some projects.

35. ***Agriculture and Agriculture Related Industries.*** Improvements in agriculture, and cotton related sectors in particular, could be a major source of growth for the Uzbekistan's economy. The World Bank Group is working on several investment operations designed to improve the productivity in the sector. The IBRD's Cotton Subsector Improvement Project aims at improving the technology used in the cotton industry; Uzbekistan is currently inviting tender offers to enhance the quality of the locally produced cotton seed. Issues of land privatization, output pricing, marketing mechanism and provision of support services would be addressed on a pilot basis through the Agricultural Enterprise Restructuring Project.

36. IFC's approach to the sector is to encourage value-added processing of agricultural material and increase productivity in the sector by introducing modern equipment and extension services. Together with Case Corporation from the US, IFC is financing three inter-related projects in the manufacturing of agricultural equipment, which will together produce cotton pickers and grain headers for mechanized harvesting of cotton and grain, provide leasing services for agricultural equipment, and provide after sales maintenance services for the equipment. This integrated multi component project will introduce new technology, management know-how and market forces to the agriculture sector and accelerate its transformation to a market-based system. A fourth project in the area of agricultural machinery is currently under evaluation by IFC to produce tractors and other agricultural equipment. All four projects envision a strong localization program to produce locally up to 50 percent of the value of all parts and components which would benefit local suppliers through transfer of technology and employment generation.

37. In the area of cotton processing, IFC is currently evaluating a ginning project. This would be the first new private ginning operation in the country and is expected to introduce competition and new market practices in the sector, to enable purchasing seed cotton directly from growers and suppliers, and exporting cotton directly to international markets. IFC is also examining opportunities to assist with projects for mineral fertilizers.

38. ***Infrastructure.*** IBRD is currently working on a Urban Transport Project whose principal objective is to improve, on a sustainable basis, the efficiency and cost-effectiveness of urban passenger transport operations in participating cities. The project is expected to contribute significantly to developing private sector activities in this area by introducing financial and administrative reforms and by creating fair competition in city public transport services and special arrangements to mobilize the potential of the private sector.

39. In the area of telecommunications, Uzbekistan has licensed six foreign and local joint-ventures to provide cellular telephone and paging system services. The main telephone system is being divided on a regional basis and major foreign operators are being invited to participate in

international tenders. A joint-venture agreement has already been signed for the Andijan-Fergana area. IFC is exploring opportunities to participate in the financing of these projects.

40. ***SMEs.*** In line with the Government's priorities, the World Bank Group is developing a set of initiatives to provide support to SMEs in a number of key areas. The Bank's involvement in this sector will mainly be through the SME Development Component (SMEDC) of the Pilot Social Transformation Fund. The SMEDC will aim to build up a range of ongoing initiatives, institutions and programs that will address legal, policy and regulatory issues, and also provide the kind of capacity raising services, programs and financing necessary to support SMEs.

41. Complementing IBRD's work in this area, IFC is following an integrated approach to assist directly the development of SMEs. First, a special instrument has been designed for countries including Uzbekistan—Extending IFC's Reach—to support small investments. One project in furniture manufacturing has already been approved through this vehicle and several other projects are at an advanced stage. Second, IFC is also exploring means to facilitate the growth of SMEs through large foreign investors that are already in the country by capitalizing on the their demand for auxiliary services and inputs. Third, IFC has initiated, in conjunction with EDI, courses in accounting and management for local entrepreneurs and is exploring opportunities to commercialize this program. Currently, IFC is working on a project to establish an Executive Training Center (ETC) in Tashkent to provide training courses and workshops for Uzbek managers in fields such as marketing, general management and accounting. ETC is also expected to provide business consultancy services for joint ventures, state-owned enterprises and SMEs, thus contributing to the development of an indigenous consulting industry. In addition, IFC will seek opportunities to address the financing needs of SMEs indirectly through credit lines to financial intermediaries and through its overall program in the financial sector.

BOX: TRAINING IN CENTRAL ASIA

The transition economies of the Central Asian Republics face many challenges as they move from a centrally-planned to a market-based system. Paramount among these challenges is the development of the private sector as the engine of recovery and growth. Such development requires qualified entrepreneurs and managers with the skills necessary to initiate and operate successful enterprises in a market economy. However, after seventy years of central planning, there are relatively few people in these countries with training and experience in financial management and international accounting practices, business planning and strategy development.

Recognizing this critical need, IFC and EDI, together with local institutions of higher education, have initiated courses for local entrepreneurs in basic financial and management accounting. Each two-week residential course is delivered by a combination of local and expatriate professors to thirty participants selected from a large number of applicants. The courses not only lay the foundations for understanding the concepts underlying generally-accepted accounting principles but also give participants an appreciation of the need to implement them in the operation of their own businesses.

During FY97 six courses were offered in Tashkent (Uzbekistan) and a pilot course was presented in the capital of Kazakhstan, Almaty. Once the program is firmly established in the various countries and local educators are fully trained to undertake delivery of the courses, it is envisaged that the private sector will take over these training programs. This stage has been reached in Uzbekistan, where IFC is currently working on a project to develop an Executive Training Center (ETC) in Tashkent to provide training courses and workshops for Uzbek managers in fields such as marketing, general management and accounting. ETC is also expected to provide business consultancy services for joint ventures, state-owned enterprises and SMEs.

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