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by

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The Financial System of Uzbekistan: An Evaluation of Twelve Years of Transition*

Alexandr Akimov and Brian Dollery **

Abstract

This paper examines the major challenges faced by Uzbekistan in restructuring its financial system to integrate with world financial markets. The paper provides a brief discussion of Uzbekistan's financial system prior to the collapse of former USSR. It reviews the reforms made by the Uzbek government since independence, covering the banking sector, non-bank financial institutions, and the securities market of Uzbekistan. The paper then focuses on the evolution of the Uzbekistan banking sector structure, policies of central bank and the approach taken to the privatization of state banks, as well as the steps taken to improve bank accounting standards and banking supervision. With respect to non-banking financial institutions, their development is reviewed, the structure and problems of current insurance market are discussed, and the approach taken to reform the pension system is presented. In the section on the securities market, the evolution of this sector is examined; state debt securities, corporate equities and bonds are considered in this evaluation, together with stock exchange trading and 'over the counter' markets. The paper concludes by evaluating recent policies in the light of the unified multiple exchange rates and liberalised access to foreign exchange for current account transactions.

Key Words: financial systems, transition, Uzbekistan

* The views expressed in this paper are those of the authors. They do not represent the views of any other party.

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1. Introduction

Transition economies may be defined as economic systems in the process of changing from an administrative-command economy to a market economy. This definition encompasses all Eastern and Central European countries and the former Soviet Union. However, each nation has had its own unique historical evolution, culture, initial conditions and capacity for transformation. Western academics as well as policy makers have tended to focus most of their attention to transition economics of Central and Eastern Europe, with less effort directed to the economies of Central Asia in general, and Uzbekistan in particular.

This paper examines the historical development and sequence of reforms of the financial system in Uzbekistan. It attempts to place the reform process in analytical perspective, with particular emphasis on financial development in Uzbekistan.

The paper itself is divided into three main parts. Section 2 provides a synoptic description of Uzbekistan's financial system prior to independence. Section 3 focuses on developments since independence, examining the banking sector, non-bank financial institutions, and the securities market. The paper ends with some brief comments in section 4.

2. Uzbekistan's Financial System before Independence

In order to have a clear picture of the financial structure of Uzbekistan before 1991, we must first consider the financial system of the Soviet Union, since the financial system of pre-independent Uzbekistan was an integral part of the communist financial system of the USSR. To analyse the Soviet financial system it is necessary to briefly consider how the financial system functioned.

The allocation of investments is an important function for any financial system to fulfil. In market economies, investment allocation is largely governed by a cost-benefit framework in which expected investment benefits are compared to estimated costs. Investment costs and benefits must be converted into present values using interest rates from financial markets. In the planned Soviet economy there were no financial markets, and these decisions were made by planners and enterprise managers.

All the other functions of the financial system were executed by the banking system. The reason for this is the extremely low level of development of non-bank financial institutions (NBFIs). Furthermore, the vast majority of banking services was provided by Gosbank (the State Bank), which combined the services of a central bank and those of commercial banks. However, owing to the absence of

money and capital markets, the Gosbank did not perform some traditional banking functions (i.e. open market operations, commercial paper transactions, and the like). It also undertook major functions such as granting short-term loans for working capital, overseeing enterprise plan fulfilment, and monitoring wage payments (as the centre for all accounts). Thus, enterprises held their accounts with the local branch of Gosbank, upon which they were dependent for short-term credit to finance inventories and working capital. Receipts were normally deposited with the Bank, and cash for wage-payments were drawn at the discretion of the Bank. In addition, profit remained in special accounts at the Bank.

Gosbank was the only provider of short-term credit, with interfirm lending strictly prohibited. Indeed, with the exception of small payments, all interfirm transactions were handled and supervised by Gosbank. Hence, Gosbank was in a unique position to monitor enterprise activities, as the single clearing agent and the sole source of short-term credit. In drawing up short-term credit plans and in controlling enterprise accounts, the Gosbank played a largely passive role, providing the credit necessary to implement the physical plans. As for short-term loans, Gosbank granted credit for specific targeted purposes.

Besides Gosbank, there were also a number of specialized banks, which fulfilled a complementary role to Gosbank. In the former Soviet Union these banks included

Promstroybank (supporting industry and construction), Agroprombank (supporting agriculture), Sberbank (the national savings bank), and Vneshtorgbank (for business involving foreign exchange transactions).

NBFIs in the former Soviet Union were very undeveloped. The only insurance company was Gosstrakh (State Insurance), entirely owned by the government. The variety and quality of its services was rather limited. There was also only one pension fund owned exclusively by the government. Other notable features of the financial system of the Soviet Union were the absence of a capital market for government debt, enterprise debt and equities, the absence of money markets and foreign exchange markets, restrictions on monetary circulation which, effectively, meant the absence of a universal payment system.

3. Uzbekistan's Financial System since Independence

3.1 The Banking Sector.

After Independence in 1991, departments of the Soviet banks located in Uzbekistan became the independent banks of the Republic of Uzbekistan. A law of the Republic "On Banks and Banking Activity" was adopted in February 1991, establishing the new structure of the banking system. This structure envisaged the creation a two-tier banking system, with the Central Bank of Uzbekistan formed from the Uzbekistan's department of Gosbank, as well as commercial banks based

on various non-state forms of property (i.e. private, corporate, cooperative, etc.). According to the Law, the Central Bank became subordinate to the Oliy Majlis (the Parliament of Uzbekistan), and main task and responsibilities were set to conduct monetary policy and bank supervision, and also to provide the country with its own payments system.

The Uzbekistan's department of Vneshtorgbank became the National Bank for Foreign Economic Activity of Uzbekistan (NBU). Other new banks emerged from former Uzbekistan branches of Soviet banks. The branch of Sberbank became Narodnybank (the national savings bank); and the branch of the Soviet Promstroybank (industrial and construction bank) became Promstroybank of Uzbekistan.

The legislation formed to regulate the banking system emphasised administrative measures of regulation. This was due to both of the background from which policy makers and legislators had emerged, and the unsophisticated state of the financial system at the time.

As economy and financial system developed, new two Laws were drafted to replace the outdated law. The law "On the Central Bank of the Republic of Uzbekistan" has been adopted as of 21st of December, 1995 and the new Law "On Banks and Banking Activity" was adopted on 25th of April, 1996.

3.1.1 The Central Bank and its policies

The main aim of the Central Bank, according to the new Law, has been set "...to ensure the stability of the national currency" (The Republic of Uzbekistan, 1995). The Central Bank has been forbidden to engage in commercial investing, and subsidizing particular banks or other organizations independently from their ownership. The Law "On the Central Bank" has also defined its status of independent from the state budget institution.

In 1997, foreign assets earlier held by the Ministry of Finance at the National Bank of Uzbekistan were transferred to the Central Bank. However, the NBU continues to be the depository of a large (though decreasing) proportion of official gold reserves on behalf of the Central Bank. Money and credit policies, as well as foreign exchange allocation, are determined by the Chairman of the Central Bank, with the involvement of representatives of various government agencies and the banking sector.

Monetary policy of the Central Bank.

The monetary policy of the Central Bank in early independence years was largely influenced by the fact that Uzbekistan remained in Russian ruble zone until the

end of 1993. Consequently, it had limited arsenal of tools and methods of monetary regulation. Nevertheless, since independence, monetary policy has become increasingly important as an instrument of economic regulation.

As mentioned earlier, in Soviet times, cash and credit plans were important ‘ingredients’ of overall plan and were aligned according to production plans. Since independence, there have been regular attempts to get rid of such planning. However, progress has been rather slow, and authorities have continued to intervene with the Central Bank’s responsibilities, rationing credit and manipulating money demand (Centre of Economic Research, 1997). The achievement of annual macroeconomic objectives on inflation and real GDP growth has been attempted through direct credit restriction by the Central Bank. Refinancing by the Central Bank has remained a more important instrument than reserve requirements and interest rate policy. The interest rate policy of the Central Bank differed significantly before introduction of the permanent national currency (in July, 1994) and after its introduction. Initially it behaved in very much the same manner as Gosbank of the ex-USSR. Since introduction of the national currency, refinancing policy has changed. It became more oriented towards the achievement and maintenance of macroeconomic stability and the support of banking sector liquidity.

In mid-1994, the refinancing rate has increased to 150% per year, and in March 1995, it increased further to 300%. It thus became positive in real terms. Since 1995, all refinancing credits have been granted via the interbank auctions. The refinancing rate has been revised on regular basis to reflect inflation rate expectations. In 2001 the rate was cut to 24% but the inflation rate has remained at the level higher than 25%. In 2002, the interest rate has been increased to 30%, a level above inflation rate (see Table 1).

Table 1. Interest & inflation rates

		1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Refinancing rate	%					84	60	48	48	42.6	42.6	24	30	30
Treasury bill rate	%													
3 monthly							36	26	16.6					
6 monthly ¹								27.5	20.4	15.0*				
Deposit rate	%	7	10	30	60	90	28	14.8	13.1	13.5	21.9	21.8		
Lending rate	%				100	105	49.7	28	33.1	32.7	25.8	26.2		
Inflation rate	%													
Consumer prices		169	910	885	1281	116.9	64.3	50	26.1	26	28.2	26.4	22	18.4
Producer prices		311	1300	1919	1422	217.4	75.4	40.3	48.4	34.5	88.8	90.8	41.1	

*Annualised average for Nov. 98

¹ Source: International Monetary Fund (IMF) (2000), EBRD (2003b)

In 1992 the Central bank of Uzbekistan (CBU) started to use reserve requirements for the commercial banks as an instrument of monetary policy to regulate the money supply. Reserve requirements have been applied to the national currency bank deposits only. However, although the Central Bank has a legal right to pay

interest on the reserve deposits, it has chosen not to do so. This was negatively reflected in profitability of banks.

At present, CBU continues to use the reserve requirement instrument. However, the initial rate of 30% for the loans with maturity up to 3 years has been cut steadily to 20% for local currency deposits. The liquidity impact of the measure was neutralised with the auctioning of Treasury bills yielding interest 1.5-2 percentage points higher than the rates ordinarily paid in Treasury bill auctions. This step resulted in an improvement in the income position of banks, since required reserves are not remunerated.

Open market operations were never really used by the Central Bank of Uzbekistan since magnitude of securities issued by the Central Bank was very small and access to these securities was restricted. Even when issued, the Central Bank securities earned negative interest rates in real terms that made them less than attractive to the limited number of players.

In common with other economies with the negative real interest rates and low confidence in banks (which in Uzbekistan was induced by the freezing of bank deposits during currency conversion in 1993-1994), Uzbekistan has been experiencing significant problems attracting deposits from the public. Individuals

preferred to hold cash for short-term transactions and foreign currencies (primary US dollar) as long-term investments (see

Figure 1). This explains high-level cash-to-broad money ratio (see Table 2).

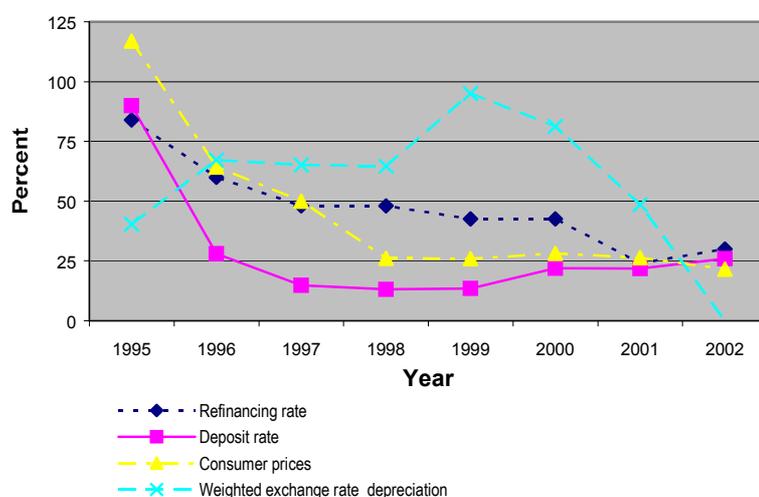


Figure 1. Inflation, currency depreciation and interest rates

Table 2. Monetary sector

		1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Broad money	mln.soums	61.1	347.2	2726	22513	54997	117294	170800	218752	288971	396180	611305	794697
Broad money (M3)	% change		468	785.1	725.9	144.3	113.3	45.6	28.1	32.1	37.1	54.3	30
Currency outside banks	mln. Soum			587	7318	20769	53262	71639	102659	127545			
Velocity			2.5	4.2	6.8	8.5	7	7.3	8.2				
Domestic credit			824	6216	26438	47578	137423	208116	363534	488953	923144	1761358	2485276
Domestic credit	% change			854.4	525.3	80	188.8	51.2	79.5	34.5	88.8	90.8	41.1
Broad money (M3) to GDP ratio	%		68.9	53.5	34.7	18.2	21	17.5	15.4	13.6	12.2	12.6	10.6

Source: EBRD (1995-2003), IMF (1998, 2000), CER (1997) and own estimates

The interbank money market was established by the authorities in early 1996 as part of the Central Bank's development of the instruments of monetary policy. The interbank money market quickly became an important source for a number of banks to solve their short-term liquidity problems. This made commercial banks more interdependent, which had a risk of contagion effect in case of failure of some individual bank.

The interbank market has not fully regulated the funds surpluses and deficits among commercial banks of Uzbekistan. The Narodny (savings) bank has been the only bank consistently generating cheap funds to offer to the market, reflecting its dominant position in attracting savings from the public. Almost half of funds on offer in interbank market have originated from the Narodny bank. The Central Bank effectively controls all transactions and the terms of interbank loans.

Payments system

In July 1996, a complete electronic payment clearing system was introduced by the Central Bank, covering whole Uzbekistan. Before this, very slow and unreliable payment clearances occurred, particular in provincial areas.

All national currency transactions are made using the clearing accounts of the CBU. The network of branches of the Central Bank cover all regions. Until 2003,

regional branches of all banks had to have separate accounts with the CBU. Since 2003, one clearing account (with the CBU) has been introduced.

Accounting standards

In November 1996, the Board of the CBU adopted a new charter of accounts for the CBU and the commercial banks. The new accounting system was introduced in March 1997 and has improved the quality of monetary statistics. However, commercial banks have experienced difficulties in using the new system. In addition, risk assessment, and the corresponding classification of loans in commercial banks' balance sheets, remain impaired by the fact that enterprises typically do not perform bookkeeping in accordance with internationally accepted accounting standards, and banks are inexperienced in risk assessment and risk management (IMF, 1998). Moreover, off-balance sheet reports require further enhancement, as they do not provide a comprehensive coverage of trade finance operations, operations with derivatives, and other contingent liabilities.

To encourage commercial banks to undertake an audit under international accounting standards and involving internationally recognised auditors, the CBU decided to pay for international audits of all Uzbek banks for the financial year 1996. Since then, an increasing number of commercial banks have started to use the services of international auditors. The Central Bank itself has not undertaken

external audits up to the financial year 2002, when the Deloitte and Touche won a tender to do its first audit.

Regulation and supervision

Regulation and supervision are important functions of central banks. The Central Bank of Uzbekistan made an first important step in this direction in 1992, by issuing the instruction “Rules to regulate the activity of commercial banks”. These rules determined the order of formation, planning and use of credit resources, trying to reflect the lack of sufficient skills in commercial banks to manage liquidity and regulate risks. Since that time, however, the rules have been revised several times.

In 1997, a regulatory framework was adopted by the Central Bank of Uzbekistan, including procedures for the reorganisation of commercial banks; requirements for the reporting to the Central Bank; procedures for registration, licensing, the liquidation of the banks; and penalties for violating banking regulations.

All commercial banks are required to submit on the monthly basis¹ twenty-one financial reports, including a balance sheet, income statement, cash-flow statement and other documents. The final report covers thirteen prudential ratios (3 capital adequacy, 1 liquidity, 3 lending, 3 securities investments and 3 insider operations ratios) that all commercial banks are required to comply with.

Capital adequacy ratios generally comply with current Basel requirements. However, the usual practice of Uzbek banks is to over-report the value of the capital. This is due to the fact that in many cases the shareholders contribution made in kind (as buildings, inventory, etc.). As there is no liquid market for such goods in Uzbekistan, valuation is somewhat difficult. In most cases, the value of such assets is made at the book value, which is often far different (higher) from marketable value. Latest proposals made by the Basel committee to change the approaches of calculation capital adequacy have not been reflected yet in the Central Bank's supervision regulations.

In general, requirements for the risk assessment of the portfolio are very weak. Banks are not encouraged to make objective risk assessments of the portfolio and, make provision and recognise loan losses on that basis. They prefer to rollover overdue loans instead of reporting them as non-performing, i.e. overstating the quality of banks assets.

In spite of a number of drawbacks, accounting standards and comprehensiveness of documents submitted to the CBU's supervision reports are among the most sophisticated in the former USSR.

3.1.2 Commercial banking sector

Uzbekistan's banking sector has played an important role in the implementation of the country's import substitution policies. A large proportion of the government's foreign borrowings for the state-led investment programme has been channelled through the six largest state-owned banks.

Table 3. Banking sector and stock market indicators

		1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002
Number of banks (with foreign participation)		30	30	21 (1)	29 (1)	31 (1)	29 (2)	30 (4)	33 (4)	35 (5)	34 (6)		
Asset share of state-owned banks	%		21.7	15.9	46.7	38.4	75.5	70.6	67.3	65.8	77.5		
Non-performing loans	% to total loans			0	0	0	0	0.4	0.1	0.1	0		
Stock market capitalisation	% of GDP						0.4	0.5	2.1	1.9	1	0.6	0.4

Source: EBRD (1995-2003)

As illustrated in Table 3, as at October 2003, there were 34 commercial banks in Uzbekistan: two state banks (fully and directly owned by the government), 2 state-owned joint-stock banks, 10 indirectly state-owned (via state-owned companies and organizations) joint-stock commercial banks, 15 private banks, 4 joint-stock banks with foreign participation and 1 subsidiary of foreign bank. 28 banks were licensed to carry out foreign currency transactions, but the bulk of foreign exchange transactions were conducted by the NBU. In addition, there are 8 representative offices of foreign banks registered in Uzbekistan.

The NBU, a state owned bank, is the largest commercial institution in Uzbekistan. At the end of 2001, it accounted for 75 percent of total assets, and 60 percent of total capital of banking system. Moreover, it accounted for nearly 70 percent of total commercial bank loans and about 85 percent of all transactions (including trade finance) in foreign currency. Foreign investment in the banking area not related to the NBU is limited.

The development of commercial banking has been affected in Uzbekistan by direct government intervention in foreign exchange and financial markets. Initially the rule limiting enterprises to hold accounts with one bank was introduced, which seriously undermined competition among banks. Moreover, enterprise deposits were allowed to be withdrawn only for the payment of wages and travel expenses, in accordance with quarterly cash plans. Both rules were abolished at a later stage (in 1998 and 2002 correspondingly) that should improve the competition among banks and increase the trustworthiness of the banking sector. However, cash plans were de-facto not completely abolished as secret “oral” orders of the Central bank officials forced the banks to limit withdrawals by enterprises. The system of cash planning seriously undermines confidence in the commercial banking system and should be dismantled. Banks should be fully delegated the responsibility for their own liquidity management. Two further reasons that induce people to stay away from the banks, and firms to reduce bank account activity to the minimum are the

tax-enforcing role of the banks for tax authorities and negative real return on savings (see Figure 1). Banks should only be required to breach customer confidentiality where there is evidence of misconduct (such as required in documenting possible tax evasion or money-laundering activity). Freezing up customer funds (which often happens) should only be a last resort and any frozen funds should be released only in connection with settlement of claims of other creditors.

Without action to bolster confidence in the banking system, there is a risk that dismantling the cash/non-cash restrictions will lead to a significant drain in the liquidity of the banking system, as enterprise managers seek to withdraw non-cash balances from their enterprise bank accounts.

The most important commercial banks are controlled by the government and follow the credit policies set by the Republic's Monetary Policy Commission, which gives priority to sectors in line with agricultural and industrial policies of the government.

Privatisation of state-owned banks

The issue of the privatisation of state-owned banks has been discussed since the early years of independence. However, little progress has been achieved to-date. In 1998, the government developed a strategy which encompassed the privatisation

of five banks initially. For the largest bank targeted for privatisation (NBU), it was initially envisaged to offer for sale only a stake of 40 percent (revised up to 49 percent in 2003), without management control being transferred to the strategic investor. In a second bank (Asaka), the government does not plan for the privatisation of more than 50 percent of equity. It is a precondition for the banks to be attractive candidates for strategic investment that the government make a clear policy statement that investors will be offered both management and board-level control in the banks; that up to 100 percent of each bank's shares will be offered for sale; that the government's post-privatisation approach to any minority stake will be that of a passive financial investor; and, set out in advance any specific veto rights that the government would like to retain so long as it remains an investor (World Bank, 2003).

The government has already prepared the legal basis for the institutional framework to govern the bank privatisation process by creating the Bank Privatisation Agency and preparing for the creation of an Asset Restructuring Agency to handle the management of the assets carved out of the bank during the course of privatisation. The government needs to establish the mandate of the Asset Restructuring Agency. It can either be a "parking lot" for the (mostly non-performing) debts of state enterprises or it can be a catalyst for the restructuring

and privatisation state-owned enterprises by actively enforcing creditor rights (World Bank, 2003).

Problems

The banking system of Uzbekistan is characterized by a small number of relatively sophisticated banks (the NBU and some joint venture and private banks), along with the successors of the formal sectoral (i.e. predicated on the financing of a particular sector of the economy) banks. This second group of banks is undercapitalised, and has low-quality loan portfolios and limited bank management skills. These problems are aggravated by (i) the absence of adequate legal instruments (bankruptcy procedures, assets sequestering, etc.) to protect the integrity of the banks' assets, (ii) the way banking activity is taxed, and (iii) restrictions on the wage rates of bank staff (in state-owned banks) imposed by the Central Bank in 1999.

The government taxes banks' profits and wage bills, but does not allow banks to deduct off-setting provisions from their tax liabilities. Profit tax in Uzbekistan is assessed by the authorities and often bears no relation to actual profit; many enterprises are thus overtaxed, even accounting for the cuts in the rate of profit tax (Economic Intelligence Unit, 2003).

The wage restriction problem particularly affected the relatively advanced state-owned banks with better-qualified personnel, such as the National bank and the Asakabank. A good proportion of qualified staff were forced to leave in the search of better-paid opportunities; either in the private sector, or even in other countries.

In 2000, the Government of Uzbekistan, under the pressure of international financial institutions, particularly IMF initiated a policy of unification of the multiple exchange rate regime. This led to a significant depreciation of the national currency (132% in 2000, 112% in 2001 and 34% in 2002). For large banks (particularly NBU) that provided foreign-currency loans this automatically resulted in deterioration of loan portfolio quality as many of their borrowers found themselves in difficulties to re-pay at the new exchange rates. Officials of those banks usually denied the resultant significant portfolio deterioration since a vast majority of those loans are in turn state-guaranteed. In principle, banks do not have to provision against government-guaranteed loans, but debt service arrears could nonetheless cause liquidity problems, particularly since current practice has been to capitalise accrued interest, thereby protecting the balance sheet but hurting operating incomes. Accrued interest in NBU's balance sheet, for example, grew from USD 79 million in 1999 to USD 133 million in 2001.

The government was typically reluctant to re-pay under the guarantee and pushed their own banks to restructure and rollover such loans. Under the pressure of

auditors, some of the banks in Uzbekistan published their auditor's report according to international accounting standards were forced to reconsider their provisioning policy against government-guaranteed loans in the event of exchange rate unification. Together with growing provisions on classified assets in the remaining non-guaranteed portfolio, this has substantially affected large banks profitability, with a return on equity in NBU 6 percent in 2001 and –20% in 2002. According to NBU's own estimate, non-performing loans (including those under government guarantees) might reach around 15 percent of the total loans, if currency unification is fully implemented.

Since 1999, domestic banks have begun to build up a portfolio of private sector loans, granted on strictly commercial criteria, benefiting in this respect from the institutional support provided under international financial institutions (IFI) credit lines. However, market-based finance remains largely underdeveloped and banks serve only a limited role in the intermediation of domestic savings. The IFI small and medium business (SME) lines are the most important source of funding for credit to smaller domestic enterprises, although the government recently set up a special budget fund to finance subsidised lending to SMEs (EBRD, 2003a).

3.2 Non-bank Financial Institutions

The formation of specialized NBFIs began in 1995 at the instigation of both the government and the private sector. These institutions included the Business Fund for financing small and medium sized business enterprises, the state insurance companies “Madad” and “Uzbekinvest”, UzaIG (joint venture of AIG and NBU), and a number of private insurance and investment companies. Unfortunately, the information available on this sector is very limited and there is no statistical data at all.

Since their establishment, the success of insurance companies has been controversial. On the one hand, the range and quality of services has steadily improved, but on the other hand, most of the insurance companies found themselves in financial difficulty at some point. The most ambitious project – a joint venture of the renowned AIG Corporation and National Bank of Uzbekistan (UzaIG) - has been in financial distress for a number of years.

One of crucial difficulties in assessing the activity of non-bank financial institutions is the absence or significant lack in regulations of this sector. There is no requirement to publish their financial statements in the local press (as for example in case of banks). Indeed, the accounting standards of NBFIs have not yet been reformed and are lacking in accuracy and presentation.

There were no significant attempts in Uzbekistan to reform the pension system. The single pension fund remains state-run and no private pension institutions have been created.

In late-1996, a new type of financial institution was created in Uzbekistan, called the Privatisation Investment Fund (PIF). Under this PIF scheme, it was envisaged to sell 30 percent of the shares of about 300 large enterprises to investment funds in a first implementation phase. It was further expected that in a second phase, shares of 300 more enterprises would be sold. Progress in implementing the scheme has been substantially slower than originally expected, although more than 80 investment funds and management companies have been established, and about 200,000 individuals have bought shares in PIFs. The number of PIFs and volume of their transactions have been steadily decreasing in recent years due to the fact that performance of partially privatised enterprises has been (with very few exceptions) very poor and consequently profitability of the PIF was low or negative. This resulted in sharply reduced interest in the PIF's activity among the investors.

3.3 Securities Market

Debt instruments.

The securities market is still in the early stage of development in Uzbekistan. Until 1996, the only instruments available for the mobilisation of savings were household saving accounts and term deposits at commercial banks. In March 1996, 3-month Treasury Bills (T-bills) were issued for the first time, and 6-month T-bills started to be issued one year later. The major aim of the issuing of State T-bills for the government was to finance budget deficits out of non-inflationary sources. For the Central Bank, it was an attempt to conduct open market operations to influence market liquidity and market interest rates. These bonds have no coupon and are sold at a discount in auctions held once a month by the Republican Currency Exchange (RCE). As of January 2000, there were 22 dealers (21 bank) authorised to operate in the bond auction as dealers on their own account and on behalf of their clients. A secondary market was created, providing a degree of liquidity for these securities; secondary market auctions are held by the RCE four times a week, and both maturities are traded in the same auction. However, market depth of T-bills is still limited, with only 25 percent of the outstanding stock (or less than 1 percent of GDP) was held by the non-bank public in June 1998 (IMF, 1998). This is primarily due to (i) low yields compared to inflation and the high return on holding foreign currency notes (mainly US dollars) (see Figure 2); (ii) the absence

of permission for the banks to sell the bonds to the public outside the auction; and (iii) the non-existence of repurchase agreement operations (repo) between banks and the public, based on the T-bills in banks' portfolios.

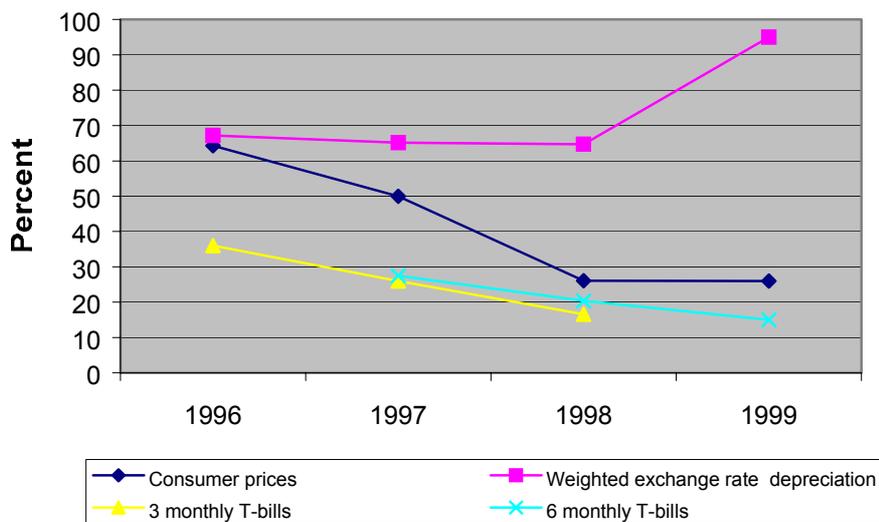


Figure 2. Comparison of T-bills rates profitability with inflation and currency depreciation rates.

Source: EBRD (1997-2000)

An additional debt instrument available for the public is a certificate of deposit of the banks. They have been in issue since 1995 and are relatively reliable and profitable financial instruments. As it is possible to claim repayment before maturity, they are also relatively liquid instruments too. For commercial banks they represent another method of attracting resources from the public.

According to the rules set by the Central Bank, two types of deposit certificates are being issued: a one-year term deposit certificate available to legal entities and a three-year term deposit (savings) certificates available to individuals only. Explicit restriction to free circulation of such securities between enterprises and individuals reflects the authorities' concern with cash and non-cash transactions as well as an attempt to reduce inflation by freezing up cash holdings in the form of deposit certificates.

In recent years there has been some activity on the corporate bonds market, as regulatory changes removed restrictions on the size of corporate bond issues. The major impetus to this was given by newly established international syndicate, consisting of 19 local and foreign banks and one NBFI, Carhill Asset Management Company. This syndicate began to develop a secondary corporate bond market in April, 2002 and has thus far organised dozens of bond issues worth more than UZS 6 billion. Recently a couple of larger banks, "UzJilSberBank" and NBU, started to develop similar services for their corporate clients. This is good option for the banks to keep their excess liquidity since most of the issues offer competitive interest rates. However, there are significant constraints in the development of the market. Perhaps the most important impediment is the small number of companies through which bonds would be demanded on the market. Another important constraint is the weak business environment in Uzbekistan in

general that does not encourage businesses to expand their activity. Moreover, investor protection concerns have been raised based on the inadequacy of financial disclosure and the absence of an independent and credible credit rating agency.

Equity market

From 1994 to 1996, the development of the stock exchange took place alongside the development of the market economy, including the privatisation and de-monopolisation process.

In Uzbekistan, it was announced that the gradual approach to structural reform would be adopted (Karimov, 1995). In line with it, the pace of privatisation has thus far been rather slow. Privatisation has been taken place in three stages. The first stage concentrated on housing units and small enterprises, mainly in the service sector, and was largely completed by 1995, with 90 percent of small enterprises being privatised. The second stage, which involved the creation of privatisation investment funds, began in late 1996 and is still being implemented. These privately owned funds purchased shares in selected medium- and large - scale enterprises. In turn, the public was able to purchase shares in the funds. The third stage, a case-by-case privatisation of large enterprises, began in 1998 but with limited results.

Today, the market for the shares of privatised enterprises is still small in terms of quantity, variety, and volume of transactions (see Table 3) conducted through the stock exchange. The slow pace of privatisation, as well as approach chosen for privatisation, has negatively influenced activity in equity market of Uzbekistan. Shares have simply been distributed among the companies themselves (in the form of bonuses), to selected foreign investors, outside shareholders, and to the state. Investors, who obtained shares in this way, had neither any real incentive nor any real opportunities to trade these securities. The low interest of potential investors in equities also reflects the absence of reliable information about the issuers of shares and the subsequent high risk of such investments. The situation was worsened by poor legislative support and a lack of knowledge and skills both by market participants themselves and the population of the country in general.

In the first case the situation was such, that until late 1996 the only two laws existed, which were “On Securities and Stock Market” and “On Economic Societies”. The regulations issued by the various regulatory bodies often contain obscure and even contradictory passages that complicated the functioning of the market. More recent legislation (the laws “On the Mechanism of Security Market Functioning” and “On Joint Stock Societies and Protection of Shareholders’ Rights”) has somewhat improved the situation, but not entirely. The most urgent improvements needed are definition as to the regulation of some types of

professional participants' activity, as well as removal of contradictions present in legal and regulatory documents. As at 1st May, 2000 the regulatory documents can be summarised as follows: 9 Laws, 11 Presidential Decrees, and 31 Orders of Resolutions of the Cabinet of Ministers of the Republic of Uzbekistan are in place.

The Republic's Stock Exchange "Tashkent" (RSET) – the only stock exchange in Uzbekistan – was established in January 1994. Since its establishment, activity has been mainly connected with servicing new issues of securities as part of the privatisation process. The volume of transactions on secondary market has been increasing, but the pace was rather slow. This was caused by a number of factors: (i) absence of reliable assessment of companies' performances whose securities are traded; (ii) low trust and knowledge of potential shareholders in stock market; (iii) failure by most joint-stock companies to pay reasonable dividends; and (iv) investors who own securities of well-performing companies prefer to hold securities rather than trade them. Since 2000, RSET started to calculate share index called "Tasix" (see

Figure 3). As volumes of trades and share prices remain volatile, the fluctuations of the index are extremely high.

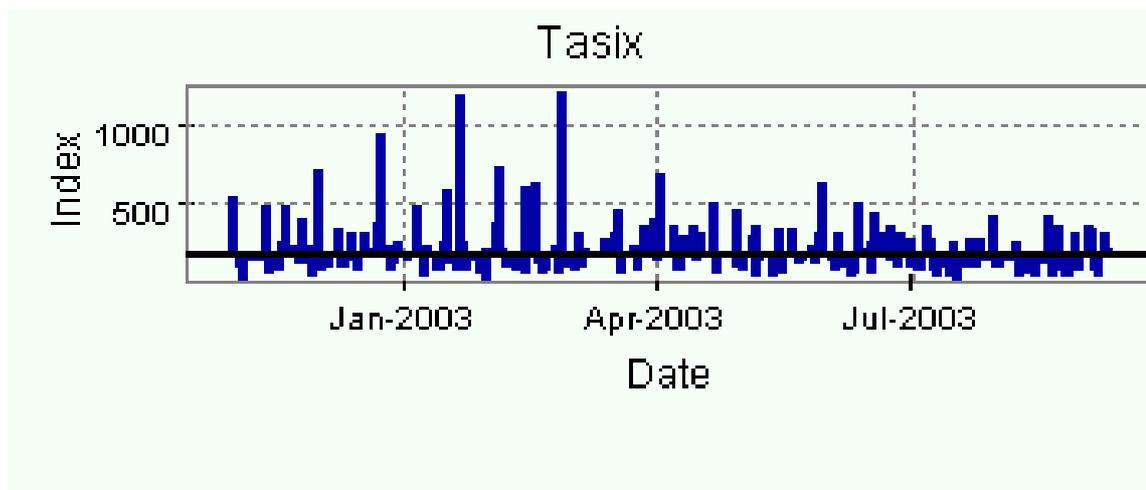


Figure 3. RSET index “Tasix”

Source: Stock Exchange “Tashkent”

There are currently 794 former state-owned enterprises whose shares are traded on the C-list of the RSET, the list designated for privatised enterprises that meet certain requirements², although all former state-owned enterprises are eligible for trading on the exchange and over-the-counter (OTC) market (Asian Development Bank, 2003).

Based on high listing standards³, only six companies, four of which are banks, are listed on the A-list of the RSET. Although B-list requirements are lower, no

companies have qualified for it (Asian Development Bank, 2003). Less than 1% of secondary trading in listed shares takes place on a formal OTC market “Elsis Savdo”, which is controlled by the National Bank of Uzbekistan. Most secondary trading of listed shares (about 81%) takes place on an unregulated informal secondary OTC “curb market”⁴. Transaction costs on the RSET are high (3.7%-5.7%) but have come down due to competition from the curb market. Significant decisions taken by RSET are subject to Centre for Coordination of Functioning of Securities Market oversight. Most securities participants are affiliated with the banking sector.

Depository - basic element of securities market infrastructure – was been established in 1994. It is currently the only registration and depository system available in Uzbekistan. Its main functions are to provide share registration, the dematerialised deposit of shares and transfer of ownership (settlement of securities) for transactions concluded through the Tashkent Stock Exchange.

Around 30 information analytical, consulting, rating, evaluating, and auditing organisations, more than 650 investment funds, management and investment companies, brokerage and dealer’s firms currently comprise other elements of the market infrastructure in Uzbekistan.

4. Conclusion

In 2002, the Government of Uzbekistan has signed a Memorandum with the International Monetary Fund, in which Uzbekistan pledged to unify foreign exchange regimes and liberalize its financial system. In particular, the rule limiting enterprises to one account, cash withdrawal limits, government's intervention into credit policy of commercial banks were be abolished.

To fulfil its obligations the Government of Uzbekistan has undertaken unprecedented measures. It decided to reduce demand for and encourage supply of foreign currency on the black market. Demand was reduced by putting tough constraints on the "consumers", which are predominantly small businesses (including so called "shuttle traders") that did not have access to official sources of FX. The supply of foreign exchange was encouraged by creating a shortage of local currency (through delays in wage payments) forcing the population to exchange their foreign currency cash savings to pay for everyday expenses.

Regarding financial sector liberalization, there have been a number of regulatory changes adopted, but the implementation of many of them has been uneven. The Central Bank used its time-honoured technique of sending "secret" or "oral" orders that in fact were opposing the implementation of "liberalizing" decrees. This seriously undermined trust in the commitment of Uzbekistan's authorities to

make necessary reforms and credibility of the government in the eyes of strategic foreign investors.

5. Notes

1. Latest revision has been made as of February, 2001
2. Paid in capital of UZS 200 mln., UZS 300 mln. total assets, 500 shareholders, one-year profitability. Slightly different requirements apply to banks.
3. Paid in capital of UZS 1 bln., UZS 1.5 bln. total assets, 2000 shareholders, three-year profitability. Slightly different requirements apply to banks.
4. In 2002, trading on the curb market was more than UZS 20 bln., compared to UZS 4.6 bln. For the RSET and UZS 600 000 for the “Elsis Savdo” (Asian Development Bank, 2003).

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