DOCUMENT OF THE EUROPEAN BANK
FOR RECONSTRUCTION AND DEVELOPMENT

STRATEGY FOR UZBEKISTAN

As approved by the Board of Directors on 4 March 2003

I. EXECUTIVE SUMMARY

Uzbekistan's progress towards implementation of the principles of Article 1 of the Agreement Establishing the Bank remains slow and characterised by setbacks. In the aftermath of September 11, the international community has renewed its interest in Central Asia. This focal position presented a good opportunity for the country to accelerate political and economic reforms, which the government has so far failed to use effectively.

In the economic sphere, the authorities made some progress by devaluing the official exchange rate to bring it closer to the parallel market rate, abolished several restrictions for access to foreign exchange and began to reform the system of state procurement in agriculture. However, several deadlines for currency convertibility, to be achieved under the IMF Staff Monitored Programme which was agreed in January 2002 but expired in August without being fully concluded, have been missed. Moreover, new trade barriers, the recent closure of borders with neighbouring countries on commercial activities and restrictions against the private sector have prevented a positive supply response to the exchange rate adjustment. Foreign direct investment flows are the lowest of all transition economies on a per capita basis, and the economy remains generally closed to competition, with a high degree of direct state involvement and control. As a result living standards have not improved over the past two years, while at the same time the resources available to the government for its public investment programme and for spending in the social sphere have diminished. If the authorities want to unlock Uzbekistan's rich economic potential it will be crucial that they embrace more fully and with more conviction the principles of open and free markets and private entrepreneurship.

Since last year the Government has introduced certain positive measures to show democratic progress. These included formal abolition of censorship, lifting restrictions on access to the Internet, registration of a human rights group and long prison sentences for law enforcement officials who were found guilty of torturing prisoners, measures aimed at moderating punishment of criminal offences, including the year-end amnesty and adoption of a new criminal code reducing the number of cases leading to death penalty. However, there are serious concerns regarding development of genuine multi-party democracy and pluralistic society and the situation with the rule of law and respect for human rights remains difficult. The overall political environment in Uzbekistan is not conducive to criticism of Government policies. The executive power is not sufficiently balanced by the legislature or judiciary. The judiciary is weak and it does not contribute to fighting pervasive corruption. Systematic violations of the freedom of religion, expression, association and assembly have been documented by human rights monitors. An area of major concern is arbitrary arrests and torture of detainees in order to obtain confessions or incriminating statements. The UN is investigating the situation in this area and the report of the UN Special Rapporteur on Torture concluded, on the basis of numerous testimonies he received during his fact-finding mission, that torture and similar ill-treatment is systematic in Uzbekistan.

Uzbekistan holds a strategic position in Central Asia. With its location in the heart of Eurasian land mass, large population and relatively good transport infrastructure, the country plays a critical role in the foreign trade of its regional neighbours, in particular the Kyrgyz Republic and Tajikistan. At the same time, Uzbekistan is double land-locked, bordering neighbours suffering from various degrees of political and economic instability and faces significant physical and policy-induced barriers in accessing international markets. Uzbekistan has reacted to the perceived threat to its security by closing its economy. The Bank is convinced, however, that a regional approach built around a few specific areas for joint action holds significant benefits to all countries of the region. Examples where this is possible include energy, water and regional transport infrastructure.

Uzbekistan is due to host the Bank's Annual Meeting (AM) in May 2003, shortly after the approval of this country strategy. The authorities expressed their commitment to provide free access to the AM for the participants and the guests, including the representatives of the NGOs and the media, invited by the Bank. The AM should be a forum for open debate. The Bank hopes that by facilitating a public and open debate, it can achieve a better understanding by the Uzbek authorities of the costs of the present policies for its own people and for Central Asia as a whole as well as the significant benefits that would flow from a more open approach.

In its current strategy, the Bank therefore proposes to continue the intensive policy dialogue with the Uzbek government over its future course of political and economic reform. In the conviction that Uzbekistan needs to take a number of critical steps to put the country on a path of sustained progress towards multi-party democracy and a market economy the Bank will look for progress towards the following benchmarks.

In the political sphere:

- Ensure greater political openness of the system and freedom of the media. The assessment of the situation in this area by the OSCE Representative on Freedom of Media would be an important factor in measuring actual progress made by the country;
- Open up the political processes to a variety of interests. Registration and free functioning of independent local NGOs, including those involved in the area of rule of law and protection of human rights, would be an essential element of this process;
- Improve the country's human rights record. This involves co-operation by the authorities in implementation of the recommendations to be made in March 2003 by the UN Commission on Human Rights based on the report of the UN Special Rapporteur on Torture.

In the economic sphere:

- Further progress in eliminating remaining foreign exchange distortions and the achievement of current account convertibility, as well as the implementation of the recently adopted measures to liberalise state procurement in agriculture;
- Opening of the economy to effective competition, including through the elimination of discriminatory barriers against foreign trade, improving conditions for entry of domestic businesses and protecting their property rights, acceleration of privatisation through the sale of at least a few large enterprises and determined efforts to attract more FDI;
- Adoption and first steps in implementation of a banking sector reform programme, moving towards fully market-based allocation of credit and providing the basis for privatisation of the main state banks;
- Evident progress in adjusting tariffs in public utilities towards cost recovery levels, most importantly in the energy sector.

The Bank will conduct a progress review within a year in the context of its Country Strategy Update, which will be examined closely by the bank's Board of Directors. Should no progress be made in these areas, the scope for new investments in Uzbekistan during the strategy period, both in the private and public sector, will be limited. Only through economic and political reforms can Uzbekistan hope to unlock its economic potential, which will in turn allow the Bank to mobilise additional financial support for the country. The Bank will continue to emphasise in particular the development of the private sector, in line with its mandate.

The following operational priorities emerge from these considerations:

(i) Support of private investment and entrepreneurship

For the development of SMEs, the Bank will consider a new credit line with local banks, as well as additional projects under its Direct Investment Facility. Although the parallel market foreign exchange premium has come down to close to 20 per cent in March 2003, the Bank will continue to finance only those SMEs able to demonstrate financial viability without benefit of access to subsidised foreign exchange. The Bank will continue to implement its micro-loan programme, providing unique access to cash loans for micro-businesses. One additional component of the Bank's work will be the continued expansion of the trade facilitation programme. Such an expansion will be facilitated by the provision of a first loss guarantee under the Central Asian Risk Sharing facility approved by the Board in July 2002. While extension of these programmes to additional partner banks is planned, this aim will be weighed against the creditworthiness of the targeted institutions, given limited scope for additional sovereign guarantees. The Bank with donor support will complement its financing SMEs with Turn Around Management (TAM) and Business Advisory Services (BAS) programmes.

Until convertibility is established, financing for larger private investments will concentrate on enterprises with sufficient export capacity to generate the foreign exchange needed to cover necessary imports and servicing foreign investment capital. These opportunities are most likely to be in the improved primary processing of raw materials for which there are standardised international markets, such as metals and textiles, and where Uzbekistan can make use of its cheap labour costs to achieve international competitiveness. Given the difficult operational environment, the Bank is willing to work with sponsors with closer links with the country. This will require due attention to corporate governance and transparency issues when reviewing the suitability of such sponsors as partners for the Bank.

The Bank remains willing to consider support for the government's privatisation programme but recognises that its ability to direct funding into these enterprises will continue to depend on the willingness of competent sponsors to invest in the country. The experience of recent years has shown that, unless the investment climate improves substantially, the interest of these foreign investors is likely to be limited.

(ii) Strengthening of financial institutions

It has to be recognised that the financial system in Uzbekistan remains very closely intertwined with the government's state-led investment policy, some of which is economically doubtful. If Uzbekistan were to move decisively towards market liberalisation and structural reforms, the banking system would undergo very significant adjustment, to deal with the large portfolio of state-guaranteed and doubtful loans and to re-orient lending policies towards the private sector. The Bank is willing to support this process through assistance in the privatisation of selected local banks and has already begun providing technical assistance to Asaka Bank in preparation for future privatisation. Suggested policy measures to deal with the existing loan portfolio will be co-ordinated closely with the World Bank, which is providing general advice to the government on bank privatisation and restructuring.

The Bank will continue to co-operate with the local banking sector in the context of its credit lines and provide institution-building TCs to pay for foreign banking advisors to improve credit skills, documentation and corporate governance. To the extent that the credit line and micro-programmes are expanded to include additional participating banks, this will help foster competition in the domestic financial market.

(iii) Critical infrastructure

The Bank recognises the critical role of infrastructure in improving market access for private enterprises and improving the economy's competitiveness. Transportation, municipal services and the energy sector are the most critical infrastructure bottlenecks in this regard. The Bank has already provided important support to the transport sector in the last strategy period. The energy sector, which will become an important focus of the Bank's public sector activities, is currently a source of significant quasi-fiscal deficits, and the Bank's focus on cost recovery will contribute directly towards saving public resources. The Bank will also continue its work with the municipalities in the waste and water sectors and stands ready to assist in the privatisation of telecommunications, should the government decide to move forward with this project. However, the Bank will proceed cautiously with all public sector operations, given the slow progress and difficulties experienced in implementing some of the existing projects and the limited additional foreign debt service capacity.

The Bank will continue to ensure that all Bank operations in Uzbekistan are subject to the Bank's Environmental Procedures and incorporate, where appropriate, Environmental Action Plans (EAP) into the legal documentation in order to address issues raised during due diligence.

The Bank will continue to closely communicate with other IFIs and the international community in general in order to form a common position on effective assistance to ensure consistent policy recommendations to the government.

LIST OF ABBREVIATIONS

ADB	Asian Development Bank
AM	Annual Meeting
BAS	Business Advisory Service
BEEPS	Business Environment and Enterprise Performance Survey
CARSSF	Central Asia Risk Sharing Special Fund
CBU	Central Bank of Uzbekistan
CDM	Clean Development Mechanism
CIS	Commonwealth of Independent States
DIF	Direct Investment Facility
EAP	Environmental Action Plans
EU	European Union
FDI	Foreign Direct Investment
FI	Financial Institutions
FY	Financial Year
GDP	Gross Domestic Product
GOU	Government of Uzbekistan
GSM	Global System for Mobile Communications
IAS	International Accounting Standard
IFC	International Financial Corporation
IFI	International Financial Institution
ILO	International Labour Organisation
IMF	International Monetary Fund
IMU	Islamic Movement of Uzbekistan
J-USBP	Japan-Uzbekistan Small Business Programme
KfW	Kreditanstalt für Wiederaufban
LTT	Legal Transition Team
MSE	Micro and Small Enterprises
NBU	National Bank for Foreign Economic Activity
NEAP	The National Environmental Action Plan
NGO	Non-Governmental Organisation
ODIHR	Office for Democratic Institutions and Human Rights
OSCE	Organisation for Security and Co-operation in Europe
OTC	Over the Counter
PCA	Partnership and Co-operation Agreement
PCF	Prototype Carbon Fund
RR	Resident Representative
SDTPS	Syrdarinskaya Thermal Power Station
SME	Small and Medium - sized Enterprises
TACIS	Technical Assistance for Commonwealth of Independent States
TAM	Turn Around Management
TFP	Trade Facilitation Programme
TRACECA	Transport Corridor of Europe-Caucasus-Asia
UNEP	United Nations Environment Programme
UNDP	United Nations Development Programme
UNG	UzbekNefteGas
USAID	United States Agency for International Development
UTY	Uzebek Railways
ZNJV	Zarafshan-Newmont Joint Venture

II. COUNTRY STRATEGY

1. THE BANK'S PORTFOLIO

1.1.1 OVERVIEW OF BANK'S ACTIVITIES TO DATE

Until 1999 the Bank's business volume with Uzbekistan was the largest amongst the Central Asian countries. While the current portfolio in Uzbekistan still represents a major share in Central Asia, the Bank's commitments in Kazakhstan have exceeded those in Uzbekistan since 2000. This largely reflects the difficulties of the macro-economic conditions and the unfavourable investment climate in Uzbekistan during the last few years.

The Bank is amongst the largest financiers (debt and equity) in Uzbekistan with a diversified portfolio. A significant share of the Bank's funding has been directed to financial institutions (34 per cent), natural resources (27 per cent) and transport (23 per cent) sectors. Most of the Bank's funding is in the form of debt (95 per cent of the Bank's portfolio) with only EUR 31 million in equity investment. The current disbursement ratio[1] is high at 84 per cent.

The business volume for 2002 was EUR 34 million comprising of TFP (EUR 22 million), Micro and Small Enterprises (MSE) lending (EUR 9 million), Uzbek Leasing (EUR 2 million) and a DIF project (EUR 0.5 million) with sovereign guaranteed operations for EUR 9 million and non-sovereign for EUR 23 million. All of them are classified as private sector.

Table 1: Uzbekistan: Overview of Bank's Activities to Date

	No.	Total Project Cost (EUR millions)	EBRD Finance (EUR millions)	Share of Commitments (%)	Share of Disbursed (%)
Debt	-	-	611	-	-
Equity	-	-	31	-	-
Private	-	-	54 %	-	-
Public	-	-	46 %	-	-
Energy Efficiency	1	27	15	2	44
Natural Resources	3	506	175	27	100
Power & Energy	1	45	28	4	85
Financial Institutions	7	271	221	34	76
General Industry	3	135	39	6	100
Municipal & Env. Inf.	1	47	19	3	40
Transportation	3	245	145	23	57
Totals	19	1,277	642	100%	84%

1.1.2 ASSESSMENT OF THE LAST STRATEGY PERIOD

The main operational focus of the last Strategy for Uzbekistan (BDS/UZ/01-1 (Final), 28 March 2001) concentrated on three areas: (i) support for private entrepreneurship; (ii) strengthening of financial institutions; and (iii) support for critical infrastructure. The Strategy also advocated intensified policy dialogue as well as selectivity in the

[1] Drawn commitment divided by total commitment

Bank’s public sector operations, aimed at supporting projects with particularly high transition impact, since there had been a lack of progress in economic and political reforms.

The Government’s failure to demonstrate a credible commitment to fundamental market-oriented economic reform has limited the attractiveness of Uzbekistan to private investors and thereby reduced the ability of the Bank to support the private sector outside the ongoing credit lines to SMEs. Nonetheless, the Bank signed four projects in the private sector during the Strategy period: one DIF project (SealMag); two projects within the framework of the new Japan-Uzbek Small Business Programme (J-USBP), Hamkor Bank and Pakhta Bank; and, one project to support non-bank financial institutions (Uzbek Leasing).

With regard to the Bank's support for privatisation and private sector project funding, the Bank maintained close contact with the Government on the progress of the privatisation programme. In particular the Bank sought to identify opportunities, especially with the privatisation of Uz Telecom and manufacturing companies. However, the Bank has not been able to make substantive progress in its privatisation objectives. While SealMag was signed during the period, the overall investment environment was not conducive to FDIs and the Bank did not find opportunities to invest along with foreign strategic investors (see Section 2 on Operational Environment).

The expansion of the Bank’s SME/MSE activities to include support to small and micro businesses was particularly important, given the role these businesses play in strengthening the constituencies for further economic reform and in creating much needed jobs outside the public sector. The inclusion of Hamkor Bank and Pakhta Bank in the participating banks enabled these institutions to build their capabilities of MSE lending and promoted further competition in the banking system.

During the Strategy period, the implementation of SME Credit Lines (I and II were fully committed and largely disbursed) have been successful and provided a valuable source of foreign exchange to the SMEs. Through these operations, the Bank continued to support entrepreneurship as well as strengthening the financial sector with the Bank's institution building TCs. In addition, the active utilisation of TFP during the Strategy period promoted private sector trade and trade-finance skills of the participating banks. The Bank also contributed to the strengthening of the non-bank financial sector through its increased stake in Uzbek Leasing, accompanied with its support for improvement in the leasing legislation.

In the public sector the Bank was able to leverage some important reform progress through its investments, both in the energy sector and in the transport sector. In the context of Andijan District Heating Improvement and Reform project, the Bank included covenants in the Loan Agreement concerning private sector participation in the management of the company, commercialisation and related tariff reform. The project also included a study on developing appropriate subsidy schemes to minimise the social impact of tariff adjustment. These covenants are being implemented. With regard to Locomotive Re-Powering project, the Bank’s involvement triggered organisational changes including the commercialisation of Uzbek Railways and the spin-off of non-core units, following a first project that included the formation of a new company and creation of an independent rail regulatory body. These projects were in line with the Bank's strategic focus on critical infrastructure in the last Strategy.

The Bank also intensified its policy dialogue on macro-economic and structural reforms, in close coordination with other IFIs. The Bank's President paid visits to Uzbekistan during the strategy period and met with President Karimov to discuss economic and political reform. Other members of senior management also met with key public officials to discuss reform priorities in macro-economic and trade policies, financial sector reforms and the reform of infrastructure. In August 2002, the Bank participated in a two-day seminar with the IMF, the ADB and WB as well as key government ministers on next steps in economic reform.

1.2 TRANSITION IMPACT OF THE BANK'S PORTFOLIO AND LESSONS LEARNED

1.2.1 Influence on the transition process so far

According to the Transition Impact Retrospective of 2001, the Bank's impact on the transition process in Uzbekistan has been "within range" at a low overall level of transition progress, underlining the fact that the slow progress with reforms has and continues to constrain the ability of the Bank to support transition. By sectoral sub-categories, the "within range" classification applies to the Bank's financial sector portfolio and its industry and commerce portfolio, whereas the Bank achieved higher than expected transition impact in the infrastructure sector. This is in line with Uzbekistan's reform profile, which has been relatively more advanced in infrastructure (where Uzbekistan performs similarly to the CIS average) than in the enterprise or financial sector (where Uzbekistan lags considerably behind the CIS average).

The financial sector and SMEs & MSEs

The Bank committed to date EUR 221 million to the financial sector in Uzbekistan. The SME Credit Line Programme (I and II) had a significant transition impact in developing the financial sector and SMEs. It has been one of the few efficient sources of funding available to Uzbek SMEs, as local banks are otherwise unable to provide long term finance. The projects supported the improvement in the credit assessment capabilities of the projects' participating banks. They also supported the SMEs' ability to prepare business plans. In all cases, the experience of the SME units dealing with the Bank's credit line has been disseminated across the other lending units of the participating banks. In addition, the Bank has been committed to bring more players onto the SME Credit Line Programme to encourage competition in the Uzbek banking system. The success of the Programme has been a key factor for the attraction of further funding from other international and private sector financial institutions (see also Section 3.2.1).

With regard to Micro and Small Enterprises (MSEs), the Bank in April 2001 commenced the "pilot phase" of the Japan-Uzbekistan Small Business Programme (J-USBP), which required the local banks to use their own resources while the Bank provided institution building TCs. In May 2002 the Bank launched a "full-scale" Programme, which incorporates foreign exchange credit lines in the amount of up to US$ 20 million to participating banks. Also as a new initiative, the Bank has signed a US$ 45 million Agreement of Co-operation with IFC to establish the Investment Co-operation Fund to co-financing MSE projects in Central Asia.

The Bank made equity investments in three financial institutions in the country (Uzbek Leasing, ABN AMRO and UzDaewooBank). The two banks, albeit small, had a significant impact on the sector through demonstration effects and increased competition, particularly for private sector clients. They operate without government guarantees and were not involved in directed lending. In addition, the Bank introduced the trade facilitation programme (TFP) to support exporters and importers through participating local banks.

The Natural Resource Sector

The Bank has committed a total of US$ 165 million, including an A/B loan structure, since 1993 to the Zarafshan-Newmont gold mine. It has become one of the most efficient, lowest-cost secondary mining operations in the world and Newmont retain operational and management control. The joint venture has set proper environmental standards for heap leaching. Much of the legislation on the extraction of natural resources has been developed for this project. It is one of the few joint ventures that has managed to satisfy both the Uzbek and the foreign investor interests well enough to warrant additional investment.

The Bank has contributed to the country achieving self-sufficiency in oil and oil products through financing of US$ 90 million for the modernisation of the Fergana Refinery. The refinery rehabilitation operation has included the provision of a desulphurisation unit to produce cleaner oil products. It enabled the refinery to switch to domestic crude oil which was developed several years earlier but had very high sulphur content. It also introduced environmental and safety measures to the refinery and significantly improved the refinery's standards in this regard. The project contributed to convince the Government to prepare a programme to split the oil and gas holding company into separate operations for future privatisation.

The Infrastructure Sector

In the power sector the Bank financed the Syrdariya Power Station to increase the capacity in the system with US$ 28 million and addressed issues relating to the sector’s commercialisation and ultimate privatisation. The Bank was closely involved in the policy dialogue with the government on the power sector’s reform. The project transformed the station into a joint stock company, which set a model for the unbundling and corporatization of the whole Uzbek power sector. The Bank has provided institution building TCs to improve the accounting system and rationalisation of the power tariff.

The Bank has been involved in the air transport sector in Uzbekistan through a US$ 36 million rehabilitation project at Tashkent Airport. The airport has been used for an important transit point for travellers from Europe to South Asia as well as supporting tourism in Uzbekistan.

In the railway sector, the Bank has co-financed with the ADB a project to assist the Uzbek Railways in developing a modernisation programme and financing priority investments. The Bank signed a US$ 40 million loan with Uzbek Railways for Freight Traction Renewal and Management Project to finance the modernisation of their locomotive fleet through the purchase of new electric freight locomotives, while the ADB financed US$ 70 million for track maintenance. Following this project, the Bank also financed Uzbek Railways' Locomotive Re-Powering Project. The Uzbek Railway is an important part of the trans-regional corridor called Transport Corridor of Europe-Caucasus-Asia (TRACECA) linking Central Asia into the world economy (see also Section 1.1.2).

In the municipal sector, the Bank financed the Tashkent Solid Waste Project. This is the first project to be funded externally and implemented by a municipality (the City of Tashkent). The project is providing institutional strengthening of the municipal services administration. As part of the loan conditionality, waste collection charges have been raised and initial steps have been taken to contract out waste collection via a tender process in two areas of the City of Tashkent.

The Bank financed a project to upgrade the efficiency of Andijan's District Heating System. The project provides for important transition impact by involving the private sector in the management of the company, commercialisation and related tariff reform. The project also included a study on developing appropriate subsidy schemes to minimise the social impact of tariff adjustment. In addition the project is the first Bank project that has directly accessed the carbon credit markets through the 1997 Kyoto Protocol's Clean Development Mechanism (CDM)[2]. The Prototype Carbon Fund's Investors Committee[3] approved the purchase of certified emissions reductions generated by the project.

Private Sector Manufacturing

The Bank has had limited success in supporting manufacturing and achieving transition impact to date. Of the private sector investments that the Bank has made in six entities, two have been unsuccessful.

[2] A mechanism that allows entities in industrialised countries to obtain carbon credits by financing emission reduction projects in developing countries.
[3] Committee comprised of private companies and governments to approve transactions under the CDM.

1.2.2 Financial Performance of Existing Portfolio

All projects in the public sector and those guaranteed by the sovereign are performing. Amongst the larger projects in the private sector, Zarafshan-Newmont Joint Venture and these SME credit lines without sovereign guarantee are also performing. However, other private projects in manufacturing struggled to perform.

The difficulty in estimating the quality of the portfolio under the current economic environment lies in projecting the impact of currency unification. The cost of debt service payments for projects in general will rise in local currency as the soum depreciates vis-à-vis the US dollar. For equity investments (5 per cent of the Banks portfolio) there is a risk that exit options in the current investment climate are limited.

1.2.3 Mobilization of Co-financing

The Bank has been focusing on co-financing projects that would promote regional co-operation. They include the projects with ADB in support of Uzbek Railways (see Section 1.2.1) and a Regional Power Transmission Modernisation project, which is under preparation. The Bank also co-financed projects in the financial sector (SMEs, ABN-Amro, Uzbek leasing, etc.). Mobilisation of commercial co-financing, however, continues to be difficult because of the absence of interest from foreign investors in the country.

1.2.4 Lessons Learned

The investment climate is an important element in increasing direct foreign investment to the country. The policies pursued by the Uzbek authorities have not been conducive to improvement in the investment climate and there has been a decline in FDI to Uzbekistan.

The multiple foreign exchange rates led to distortions and discouraged international trade. The Bank needs to take these distortions into account in evaluating the economic and financial returns and risks of projects. The problems associated with the two private manufacturing projects highlight, amongst other things, what has to change before private business can be efficient and profitable. These experiences have taught all parties involved the difficulty of implementing business plans and making reliable financial forecasts in early transition environments.

The SME credit lines have been successful both for supporting SMEs in Uzbekistan and for strengthening the banking sector through institution building and competition. Despite the exchange rate distortions, SMEs are providing a vital contribution to creating a culture of entrepreneurship and the credit lines have continued to perform reasonably well in the face of very significant exchange rate adjustment.

Uzbekistan is willing to co-operate with the Bank in the reform of public infrastructure and the Bank can achieve transition impact in this area. However, implementation and effectiveness of loans can be a slow process and project design needs to consider the trade-off between ambitious transition impact targets and risks to their realisation.

1.3 PORTFOLIO RATIO

The private/ public portfolio ratio has changed in favour of the public sector during the past two years due mainly to the absence of private investors and the signing of a large state transport project. The ratio was 54/46 at the end of 2002. The new strategy reflects the Bank's attempt to promote potential financing in the private sector (the financial sector and SMEs), whilst pursuing further public sector operations selectively. However, given the difficulty of the investment climate, expectations regarding a rapid improvement in the portfolio ratio remain modest.

2. OPERATIONAL ENVIRONMENT

2.1 GENERAL REFORM ENVIRONMENT[4]

Uzbekistan's progress in economic reforms has been slow and characterised by setbacks over the past two years. The authorities have adopted tighter macroeconomic policies since around 2000, including reduced external borrowing and the gradual devaluation of the official exchange rate to bring it closer to the parallel market rate. Access to foreign exchange has been partially liberalised and reforms of state procurement in agriculture have been initiated. However, this progress has been partially offset by new government intervention, in particular in the area of foreign trade. This has prevented a positive supply response to the reforms and thus economic growth and living standards have not improved. At the same time, the resources available to the government for public investment and social spending are diminishing, placing additional urgency on creating a better framework for private sector development.

2.1.1 Political conditions

See Annex 1.

2.1.2 Social conditions

Uzbekistan is one of the poorest countries in the CIS, with GDP per capita in 2001 of just US$ 370 at the official exchange rate[5]. In Purchasing Power Parity terms, Uzbekistan's GDP per capita in 1999 was around US$ 2,700, above levels in Kyrgyz Republic and Tajikistan, but still among the lowest in the CIS[6]. As many other poor CIS countries, it has a large rural labour force (around half of the total) and poverty is concentrated in rural areas.

By regional comparison, Uzbekistan appears so far to have avoided the extreme levels of poverty prevalent in some of the other poor CIS countries. At 27.5 per cent, it's national poverty rate appears to be lower than that in most other Central Asian countries, although internationally comparable data are not available. It's life expectancy rate has remained constant at just under 70 years since 1991 and is higher than in all other Central Asian countries.

Official unemployment in 2001 was only 0.6 per cent of the labour force (51,000 people), although there is evidence of significant underemployment in industry. The main areas of employment growth over the past five years have been in the public sector and among individual, informal enterprises, whereas formal employment in the productive sector has fallen. Estimates of potential job losses in industry and

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[4] The data in this section is drawn from a variety of sources, including communication from the Uzbek government, WB, IMF and the Economist Intelligence Unit. Uzbekistan remains one of the transition countries with the least open access to economic information. It does not meet the data dissemination standards of the IMF and has no page in the International Financial Statistics. The data for 2001 and 2002 in particular are taken directly from the authorities or reflect EBRD staff estimates and may not always be fully consistent with the series for previous years, which were taken from published IMF and World Bank documents.

[5] According to official statistics, GDP per capita has remained roughly constant in US dollar terms at the official exchange rate in 2002. Data in Annex 3 report GDP per capita using a weighted exchange rate, placing GDP per capita in 2002 at US$ 308.

[6] Data from the ICP project as reported in the World Development Indicators.

construction as a result of exchange rate unification and opening of the economy are in the range of 150-250,000, which would bring official unemployment to maybe 3-4 per cent of the labour force.

Uzbekistan spends comparatively more as a share of its GDP on health and education (around 7 per cent in 2001) as well as social transfers (around 6 per cent) than other poor CIS countries, facilitated by a much larger share of government revenues in GDP (28.2 per cent in 2001 and 25 per cent of GDP in 2002). However, there is significant scope for efficiency improvements in social spending, which will be important to realise, as revenues have continuously been falling as a share of GDP since 1998 and the implementation of structural reforms would place additional burdens on the budget (see section 2.2). Uzbekistan shares with other transition economies a high concentration of spending on staff costs in health and education, leaving too little for new equipment, the development of preventive health care and modernisation of the curriculum. Uzbekistan also operates a system of social transfers administered by a council of elders at the local level (the Mahallas), which has been credited with relatively high effectiveness in targeting the poor. However, such transfers were small (0.9 per cent of GDP in 2001) relative to other sources of household subsidies, including access to cheap gas, electricity and subsidised rent. These benefits are not allocated based on need[7] and benefited a far greater percentage of rich than of poor households. The World Bank has conducted a review of the incidence of social transfers as part of its recent Country Economic Memorandum (currently in discussion with the Uzbek authorities). A public expenditure review would be carried out in case Uzbekistan makes sufficient progress to warrant consideration of the World Bank adjustment lending.

2.1.3 Regional co-operation

Uzbekistan holds a strategic position in Central Asia. With its location in the heart of Eurasian land mass, large population and relatively good transport infrastructure, the country plays a critical role in the foreign trade of its regional neighbours, in particular Kyrgyz Republic and Tajikistan. At the same time, Uzbekistan is double land-locked, surrounded by neighbours suffering from various degrees of political and economic instability and faces significant physical and policy-induced barriers in accessing international markets. Uzbekistan has reacted to the perceived threat to its security by protecting its economy against imports from neighbouring countries, most recently through temporarily closing its borders with Kazakhstan and Kyrgyz Republic. The Bank is convinced, however, that a regional approach built around a few specific areas for joint action holds significant benefits to all countries of the region. Examples where this is possible include regional transport infrastructure, water and energy.

The transport infrastructure built under Soviet rule and the demarcation of borders between the former Soviet Republics has created significant interdependencies between them. For instance Uzbek traffic must transit through Tajikistan to get to or from the eastern parts of the Fergana valley, if a major detour is to be avoided. The Kyrgyz Republic's natural trade outlet from its part of the Fergana valley is through Uzbekistan as access to Bishkek and the Northern part of the country is blocked by high mountain ranges. All Central Asian countries rely on transit through third countries to access the

[7] For instance teachers, faculty staff and health care workers obtain a 50 per cent discount on all utility costs (water, heat, gas and electricity) at a total cost of 32 billion soum (around 30 million US dollars) in 2001.

world market and would thus benefit from the modernization of transportation routes from the region and political cooperation to reduce current charges.

The countries of Central Asia are also mutually dependent on each other in the area of water management and energy. The Kyrgyz Republic and Tajikistan are the source countries for the Syrdarya and Amudarya rivers, whose waters irrigate Uzbekistan's vast cotton fields. At the same time, the two upstream countries depend on Uzbekistan and Kazakhstan for winter supplies of fuel and electricity, as their hydro-power capacity is reduced in winter months. The Soviet irrigation and hydro-power infrastructure was highly integrated and regional trade in energy and water has persisted. However, such trade is currently conducted in non-transparent and highly political barter transactions, causing significant year-on-year volatility and supply disruptions. The benefits from moving to a commercially based system of regional energy trade would be large, as would be the move to a multi-year framework for allocating water quotas between upstream and downstream countries and developing adequate compensation mechanisms. Uzbekistan has taken a first domestic step in this direction by developing a system of user charges for water in urban areas – it now needs to pursue more actively the regional policy dialogue to come to an agreement on water allocation (see also environmental issues below).

2.1.4 Legal issues

Uzbekistan's commercial laws are generally limited in scope and their provisions open to conflicting interpretations. This is particularly true of the Law on Pledge and the Law on Bankruptcy. The registration and enforcement of pledges is still uncertain and costly. There are inconsistencies and ambiguities concerning, inter alia, the scope of reorganisation proceedings and the priority of secured creditors in bankruptcy. The Company Law does not ensure adequate corporate governance nor does it protect minority shareholders' rights.

Certain other laws are in the process of being adopted or amended, such as the existing legislation on leasing whose amendments will clarify the roles and responsibilities of lessors and lessees and will provide a clearer framework for lease operations. Such changes should make leasing a more attractive financial tool, particularly for small and medium businesses

The main legal impediments to investments by the Bank and other private sector investors in Uzbekistan remain : (i) the absence of an efficient pledge registration and enforcement system; (ii) complex and sometimes contradictory legal rules coupled with insufficient implementation; (iii) restrictions on currency conversions from local currency into foreign currency; and (iv) a high level of discretion granted to government officials to interpret the practical application of the legislative framework. In addition, there continue to be concerns about the readiness of courts to enforce foreign arbitral awards in Uzbekistan in accordance with the country's treaty obligations under the 1958 United Nations Convention on the Recognition and Enforcement of Arbitral Awards (the New York Convention). Institution building work in this area should be encouraged.

2.1.5 Integrity issues

Corruption in Uzbekistan is a serious problem, as in many other CIS countries. Uzbekistan scored 2.9 in Transparency International's 2002 Corruption Perceptions Index, ranked 61 out of 102 countries. This was a slight improvement over the 2001 score of 2.7, which placed it 71 out of 91 countries. With these scores, Uzbekistan was placed higher in the ranking table than Kazakhstan and Russia, but far below most countries in Eastern Europe.

One alternative source for cross-country comparisons is the Business Environment and Enterprise Performance Survey (BEEPS) commissioned jointly by the Bank and the World Bank in 26 transition economies and Turkey. According to the BEEPS, Uzbekistan shares with many other CIS economies the prevalence of administrative corruption, such as the demand of unofficial payments from businesses to get connected to public utilities, obtain necessary permits, avoid repeated inspections etc. The high density of government regulation in the country provides frequent opportunities for such administrative corruption. At the same time, the BEEPS does not suggest that administrative corruption is exceptionally high in Uzbekistan. The average share of bribes in sales in Uzbekistan in 2002 was 1.5 per cent, against a CIS average of 1.95 per cent. Moreover, during the past two years, access to foreign exchange as a major source of rent seeking has been greatly reduced (see Section 2.2).

Uzbekistan has a relatively large grey economy, although estimates vary widely from source to source. The most plausible estimates would put the grey economy at around 30 per cent of GDP, similar to Kazakhstan but probably slightly below levels typically found in the rest of Central Asia or the South Caucasus. The authorities recognise this as a problem, largely from a tax point of view, as they fear the decrease in the tax base as a result of enterprises going informal. However, the grey economy also fulfils an important role as an employer of last resort, particularly in subsistence agriculture. The large increase in informal employment in industry (see below) in recent years is a reflection of the weak business environment and should encourage the authorities to reduce barriers to SMEs operating officially. By the same token, recent administrative measures to increase the tax base by forcing all shuttle traders to register with the tax police risk affecting the main source of income for a large number of people.

2.1.6 Environmental issues

Uzbekistan remains in a difficult environmental situation. Poorly managed extensive farming, in particular large-scale and water/chemical intensive cotton production, developed during Soviet times has devastated human health and ecology of the Aral Sea Basin. Air and water contamination by chemical pesticides and fertilisers, used for cotton fields as well as water contamination by salinisation, due to the inefficient irrigation (it is estimated more than 50 per cent of irrigated area is affected by salinisation) have been a human health threat; drinking water available to the rural population tends to be polluted drainage water laden with salt and concentrated chemicals. Water has been diverted to irrigate 88 per cent of the cropped land (which is one of the world's highest irrigation rates) from the Amudarya and Syrdarya rivers, which feed the Aral Sea. Salinisation has led to acute soil degradation, and the Aral, once the fourth largest lake in the world, has rapidly shrunk. UNEP estimate the Aral's surface area is now just 25 per cent of that which existed before Soviet central planning began diverting the rivers. The key to improvement in the environmental situation in rural areas lies in agricultural reforms and the introduction of improved water management. Relative price adjustments that increase output and input prices should reduce the waste of inputs and help economise scarce water resources. However, a sustainable long-term solution to water management will only be possible on a regional level.

Uzbekistan's basic environmental law (Protected Natural Territories) was enacted in 1993. Other specific law on water and atmosphere have also been enacted in recent years. Further legislative development is steadily taking place. The National Environmental Action Plan (NEAP), approved by the Government, identifies a number of specific environmental issues including the deteriorating ecological conditions in and around the Aral Sea, desertification of the Amudarya Delta and the loss of biodiversity. The real issue is effectiveness of institutional and financial capacities to implement environmental law and policy in the country.

The Bank's environmental approach for the next two years will reflect the Bank's overall environmental strategy to seek environmental opportunities as well as mitigate potential environmental impacts associated with projects. Recently, the Bank has developed two district heating rehabilitation projects in the country which will result not only in an improvement of the local environment in the form of reduced atmospheric emissions, but will also improve social conditions and reduce global carbon dioxide emissions. Involvement of World Bank's Prototype Carbon Fund (PCF) in the projects will address global environmental issues as well as enhance the projects' financial viability. With emphasis on SME development through local financial institutions (FIs), the Bank will continue to support environmental management issues through FI due diligence training as well as monitoring FI's compliance with Environmental Guidelines.

Among other institutions, ADB will carry out country specific environmental analysis in Uzbekistan, as well as other Central Asian countries, with a technical co-operation programme. The World Bank/GEF have been implementing a Central Asia transboundary regional biodiversity project and water and environmental management in the Aral Sea Basin. The Bank will continue to co-operate with other organisations to generate synergies in the environmental assistance for the country. In particular, transboundary environmental issues such as the Aral Sea environmental problems, require close inter-agency co-operation.

2.2 MACROECONOMIC CONDITIONS RELEVANT TO THE BANK'S OPERATIONS

2.2.1 Economic developments

During the early years of transition, Uzbekistan experienced a shallower recession than all other CIS countries. There is some debate as to the causes of this distinctive pattern, with positive initial conditions (domestic energy resources, no significant Soviet-style heavy industry, the best physical infrastructure in Central Asia) and the more gradual implementation of reform probably both playing a role. However, the costs of Uzbekistan's chosen gradual reform and import substitution industrialisation strategy are becoming increasingly obvious. Since 1998, the country has grown by less than 20 per cent in real terms, against gains of 39 per cent, 20 per cent and 22 per cent in Kazakhstan, Kyrgyz Republic and Russia respectively (Chart 2). Many other CIS countries (Armenia, Azerbaijan, Tajikistan, Turkmenistan) have outperformed

Uzbekistan over the past five years. Industry, which has received the bulk of the huge subsidies generated by exchange rate and price distortions, has grown only moderately (1.6 per cent) since 1997 and has seen its share in GDP drop from 17 per cent in 1995 to only 14 per cent in 2001. According to official data growth in GDP was 4.2 per cent in 2002.

Chart 1

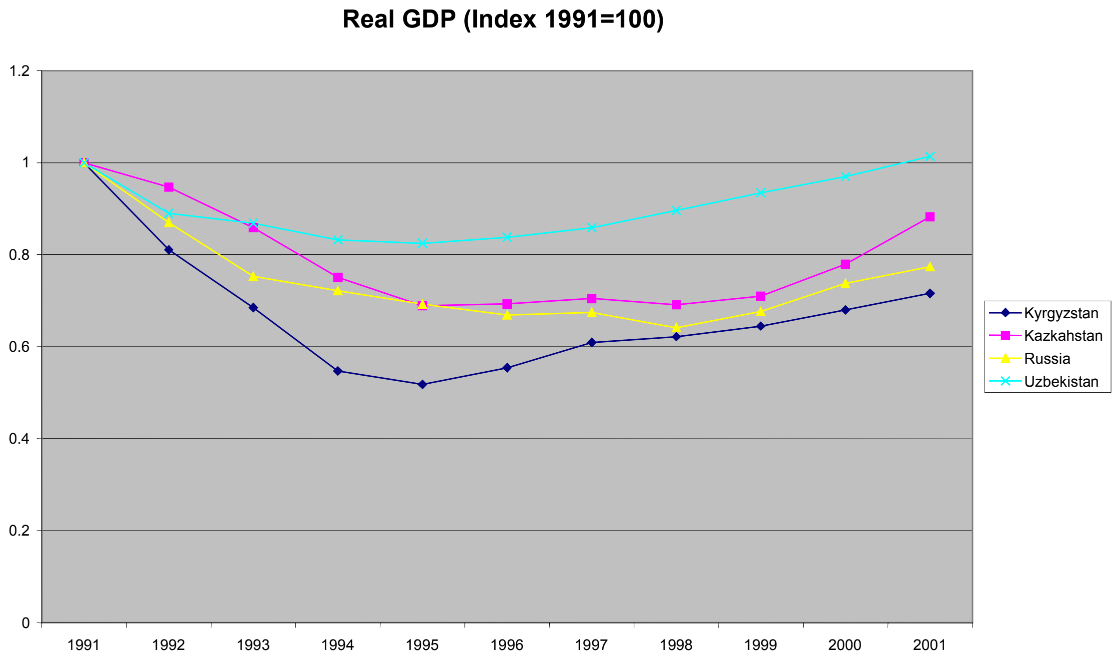


Chart 2

The relative deterioration in Uzbekistan's economic performance is even more striking when calculated in US-dollar terms. Since 1998, Uzbekistan's GDP per capita in US dollars has fallen by over 40 per cent, compared with large increases in Kazakhstan, Russia and a range of other CIS countries (Chart 4). This has major implications for consumer welfare. Uzbek workers are paid some of the lowest wages in the CIS (around US$40 per month in 2001 against US$ 120 in Kazakhstan or US$ 55 in Kyrgyz Republic).

Chart 3

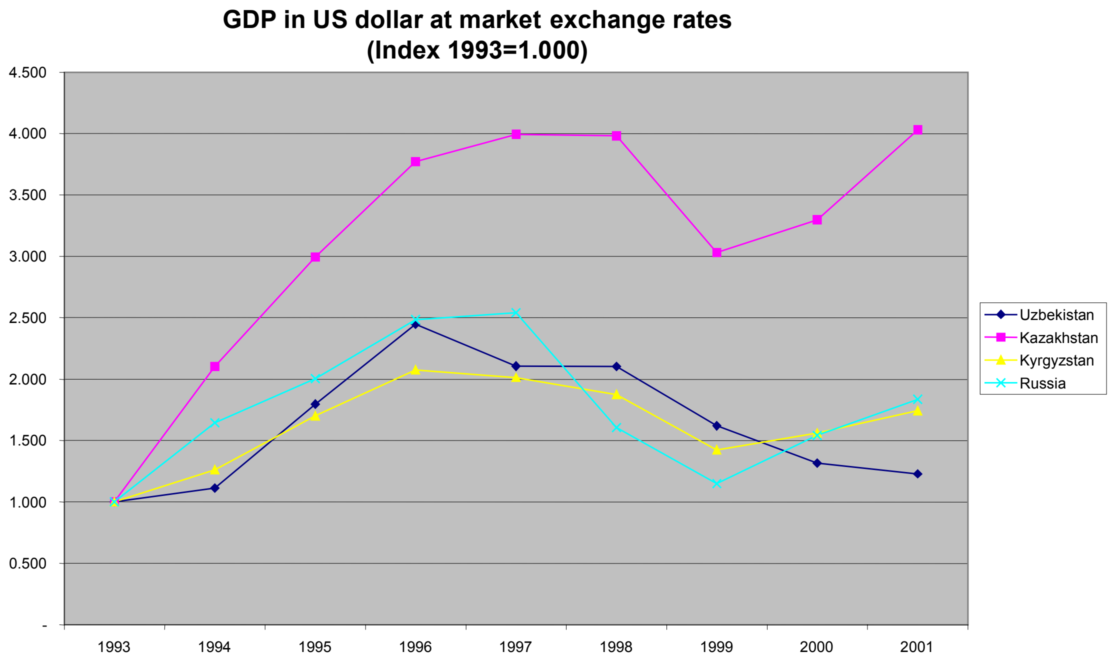
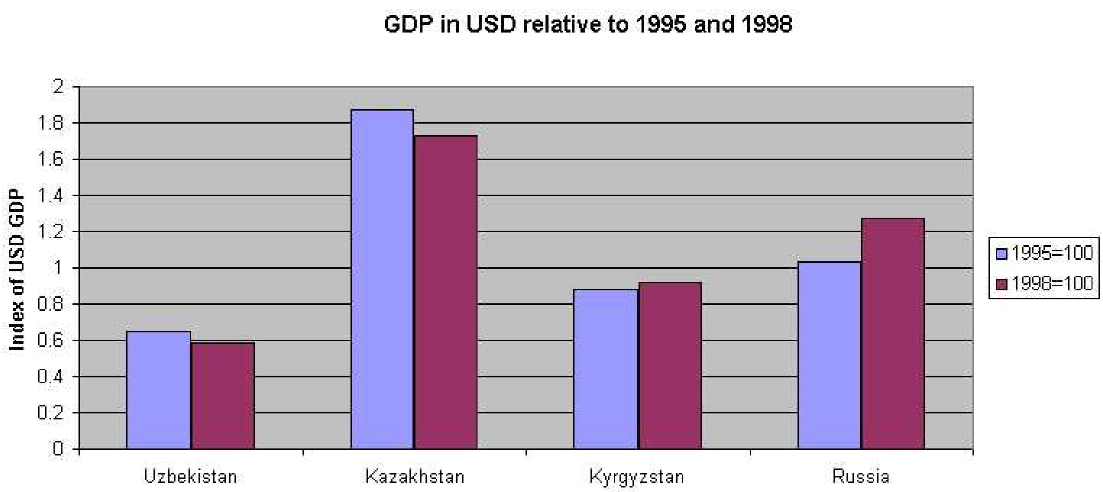


Chart 4

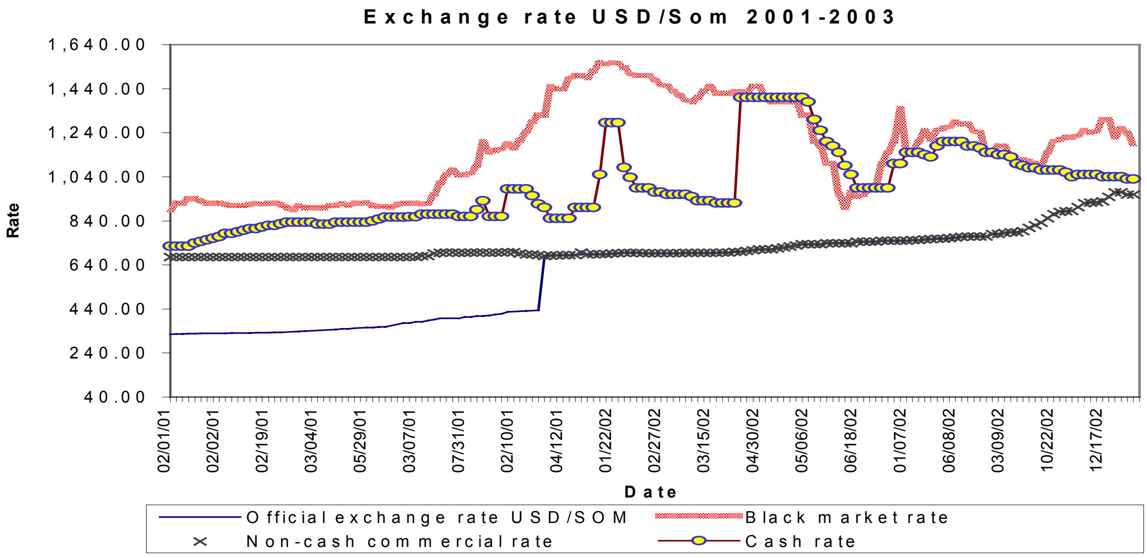


The substantial exchange rate devaluation reflects the accumulation of large macroeconomic imbalances during the 1995-2000 period. During these years, the country ran very high public sector deficits (peaking around 9 per cent of GDP in 1998 and 1999), financed with foreign borrowing and central bank directed credit. As a result inflation remained high, confidence in the soum was eroded and the black market premium soared to 400 per cent over the official rate. Since 2000, foreign borrowing has been more disciplined and the government has adopted tighter monetary and fiscal policies. In 2001-2002, the consolidated fiscal deficit has fallen to around 3 per cent of GDP (according to official data the deficit was just 0.8 per cent of GDP in 2002), and central bank financing of this deficit will be discontinued from 2003. This has been combined with reduced public sector investment, although the government has continued to allocate a significant proportion of spending to the social sector.

Uzbekistan reduced its foreign debt burden to reportedly US$ 4.35 billion at the beginning of 2003, around 85 per cent of which is public or publicly guaranteed. This was facilitated by the shift of the current account into surplus in 2002. However this shift was largely achieved through administrative measures; reduced public investment outlays; restrictive policies against imports; and, supported by a tight fiscal and monetary discipline. Given the relatively high cost of Uzbekistan's foreign borrowing (due to the low share of concessional IFI and bilateral lending in total debt), the ratio of debt to GDP would thus rise again from its present level of 55 per cent, unless growth rates increased substantially above the recent average of 4 per cent.

2.2.2 Exchange rate policies

Uzbekistan continues to operate a multiple exchange rate system (see chart below). The official exchange rate is applied to all budgetary transactions, foreign debt service, export surrender and import transactions. *In July 2000*, an Over-The-Counter (OTC) rate (non-cash rate in chart below) was introduced to apply to interbank currency transactions and imports of consumer goods under license from the central bank. *In July 2001*, the scope of the OTC rate was widened to include export surrender of most exports (except cotton, gold and some other natural resources) and debt service for all new foreign loans contracted and capital transfers. *In October 2001*, the official exchange rate and the OTC rate were unified at the more devaluated OTC rate. Since then, the official exchange rate has been further devalued, bringing the cumulative devaluation since the beginning of 2001 to around 200 per cent (i.e. the "official sum" is now worth only a third of what it was in January 2001). In producer price terms, this amounts to a real devaluation by around 100 per cent.



In addition to the official exchange rate, there is the cash rate, introduced in July 2000, at which individuals can exchange sum into dollars at exchange booths of commercial banks. The cash rate is currently around 10 per cent more depreciated than the non-cash, official rate. The total amount available to individuals through the cash outlets was increased in June 2002 to US$ 1500 per quarter and documentation requirements for such transactions (proof of foreign travel) were abolished. Finally, individuals and enterprises have access to foreign exchange on the parallel or curb market, where the premium in late February 2003 stood at just above 20 per cent over the official exchange rate, down from 123 per cent in January 2002 and within a striking distance of the target set under the IMF's Staff Monitored Programme.

Under the SMP, the authorities were committed to abolishing all remaining administrative restrictions for access to foreign exchange for non-cash transactions, but this commitment has not been fully implemented. In June 2002, all remaining restrictions on specific goods for which conversion was not recommended were abolished. As of 1 October, all licenses for foreign exchange conversion were abolished. Moreover, the authorities also abolished all wage caps in enterprises and restrictions on cash withdrawals from individuals or corporate bank accounts. However, enterprises still face numerous documentation requirements when accessing the non-cash market (the IMF recently counted 11 such requirements). The central bank continues to set the reference rate rather than letting it be determined in the interbank market as planned. Individuals are reportedly harassed by the police when trying to use the exchange booths at the commercial banks. These remaining restrictions have led to doubts over the sustainability of the recent reductions in the parallel market premium and renewed calls for the implementation of full currency convertibility.

The adjustments of the different exchange rates have had important distributional implications. Uzbekistan uses the forced surrender of export revenues (50 per cent for most exports, 100 per cent for exports of "centralised goods" such as cotton, gold and other natural resources) at the official exchange rate to redistribute resources to other sectors of the economy through subsidised imports (again at the overvalued official rate) and state guaranteed foreign loans. The reduction in the black market premium since 2000 is equivalent to a reduction in the implicit tax rate on centralised exports. The impact between 2000-2002 may have been equivalent to around 10 per cent of GDP. Yet the economy has not responded positively to the reduction of exchange rate distortions. Indeed, official balance of payments statistics show a further 10 per cent decline in exports for 2002 and a 15 per cent contraction in imports. The lack of a positive supply response is due to the persistent degree of state control over the economy – as elaborated in more detail below.

The main challenge in exchange rate policy is to move to a freely convertible exchange rate on all current account transactions. This would involve reducing the remaining documentation requirements for access to the non-cash rate, the floating of the exchange rate by the CBU and its determination on the interbank market and the use of monetary policy instruments rather than cash rationing to manage liquidity.

2.2.3 Macroeconomic outlook

Uzbekistan's macroeconomic performance over the next two years will depend crucially on whether the authorities decide to move towards currency convertibility and embrace fully the necessary structural reforms to lay the basis for sustained growth in the future. Were the authorities to follow such a path, there would be short-term adjustment costs, both in terms of output losses and for the budget. Yet, such temporary losses would be more than offset by medium-term gains resulting from the renewed attractiveness of the country for foreign investors and the release of Uzbekistan's domestic entrepreneurial potential.

The main macroeconomic impact on exchange rate unification and structural reform would be on the budget. The relative price adjustments will create fiscal pressures on both the expenditure and revenue side. Additional expenditures would arise from three main sources: i) the compensation of vulnerable households for the impact of higher food import prices; ii) the provision of temporary support to enterprises during the restructuring phase and of unemployment benefits to workers made redundant during restructuring; and iii) higher debt service payments for the budget directly and for those enterprises unable to service debts originally provided under government guarantees. Altogether, the fiscal costs of reform could amount to around 5 per cent of GDP in the first year (falling afterwards). Of these, debt service payments or provisions for non-performing state guaranteed loans comprise by far the largest chunk (around 2.5-3 per cent of GDP). Existing reform blueprints discussed with the government include subsidies to state-owned firms subject to an agreed restructuring plan, but these are explicitly viewed as temporary measures. Nonetheless, since revenues would probably also fall as enterprise profits are reduced and price adjustments reduce effective taxes on agriculture, there will be a need to significantly reduce budgetary expenditures in other areas, most importantly public investment. The international community will be called upon to provide assistance to cover any remaining financing gap in support of reform.

At the same time, reforms would generate significant medium-term gains. Given its rich resource endowments, Uzbekistan should be able to achieve growth rates in the order of 6-7 per cent per annum, or around 5 per cent per capita. Combined with renewed confidence in the soum, Uzbekistan should experience significant real exchange rate appreciation over the medium term and hence much reduced debt servicing costs. Moreover, it is clear that the maintenance of the present macroeconomic and structural policies would over time increase the costs of adjustment, but would not be able to delay it indefinitely.

2.3 KEY TRANSITION CHALLENGES

Uzbekistan faces an urgent need to adopt a credible and comprehensive economic reform programme, if the country is going to stimulate private investment and sustained economic growth. The critical benchmarks for progress in economic transition in Uzbekistan are:

- Further progress in eliminating remaining foreign exchange distortions and the achievement of current account convertibility and implementation of the recently adopted measures to liberalise state procurement in agriculture;
- Opening of the economy to effective competition, including through re-opening of all borders, the elimination of discriminatory barriers against foreign trade, improving conditions for entry of domestic businesses and protecting their property rights, acceleration of privatisation through the sale of at least a few large enterprises and determined efforts to attract more FDI;
- Adoption and first steps in implementation of a banking sector reform programme, moving towards fully market-based allocation of credit and providing the basis for privatisation of the main state banks;
- Evident progress in adjusting tariffs in public utilities towards cost recovery levels, most importantly in the energy sector.

The progress in exchange rate liberalisation and remaining challenges in this area were described in detail in section 2.2. The remaining challenges relating to the above benchmarks are reviewed in the remainder of this section.

2.3.1 Opening up to competition and private sector development

Trade policies

A corollary to adoption of a policy of import substitution is the fear of competition from abroad. To prevent a “flood of imports” from outside competing with the nascent domestic industrial sector, the authorities adopted high trade barriers against imports of consumer goods by both legal entities and individuals in August 2002. Legal entities were charged a 30 per cent surtax (net of VAT), while individuals faced a combined uniform VAT and customs surcharge of 90 per cent. These were later reduced to 20 per cent and 70 per cent respectively, and the surcharge for legal entities abolished again as of January 2003. However, a 20 per cent tax was retained for all re-exports from neighbouring countries.

In addition to tariff barriers, the authorities also clamped down heavily on shuttle traders through administrative means.[8] The main effect of these measures has been to shift trading activities across the border into Kazakhstan.[9] Consequently the border between Uzbekistan and Kazakhstan was closed to all non-family related travel in January 2003. Uzbekistan has doubly lost: as a result of higher domestic prices for consumers and as a result of the loss of the trading business and the income it provided to a large number of domestic entrepreneurs.

According to a recent IFC/SECO sponsored survey of SMEs in Uzbekistan, 99 per cent of smaller Uzbek firms are not engaged in any foreign trade activity at all. The monopoly position enjoyed by several larger domestic firms has justified the maintenance of price regulations in around one third of 270 such firms still subject to maximum sales margins or other types of price regulation. The lack of competitiveness that results from the lack of competition and low integration into the international economy is the key reason for the disappointing export performance despite the large devaluation. Exports have stagnated at US$ 3-3.2 billion since 1998, down from US$ 4 billion during the mid-1990s.

Uzbekistan needs to eliminate discriminatory trade barriers against shuttle traders and specific countries, and reduce the high levels of effective protection on finished products.

[8] Wholesale importers from August 2002 have to sell their products to licensed retailers with commercial storage facilities and cash registers, preventing shuttle traders (but also many domestic SMEs) from placing orders with wholesale trading companies. High capital requirements for licensed wholesalers have driven out many smaller trading businesses, whilst recent government announcements plan to provide VAT exemptions to state licensed wholesalers, further skewing the playing field against smaller trading businesses. The largest bazaar in Tashkent was closed by the police and will re-open as a market with only licensed retail outlets.

[9] According to the Kazakh customs service around 30,000 Uzbek citizens crossed into Southern Kazakhstan on a daily basis since the restrictions against shuttle traders were introduced in summer 2002.

Private sector development

Uzbekistan's private sector at 45 per cent remains relatively small in proportion to GDP. World Bank estimates put the share of SMEs (the majority of which are private) at 15 per cent of GDP and 9 per cent of total employment. The contribution made by the informal sector (individual entrepreneurs and private dekhan farms) is larger at 19 per cent of GDP and 41 per cent of employment respectively.[10] Since 1997, the number of SMEs and their total employment has fallen, while the number of informal entrepreneurs has increased dramatically. This move towards informality is indicative of the constraints faced by private businesses. In November 2002, the government adopted a decree announcing the possibility that privatised small-scale enterprises in social sensitive areas (such as shops, kindergardens and other social services) might face renationalisation if they were proven to have changed their main line of activity during the first five years following privatisation. The announcement has been interpreted as possibly leading to renationalisation of many businesses, particularly in growth areas such as entertainment ("billiard saloons") and internet cafes. So far, there is however no sign of implementation of the decree.

At the same time, it has to be recognised that the government has undertaken efforts over the past two years to reduce the tax burden on SMEs, simplify registration requirements and has allowed SMEs to export without being subject to foreign exchange surrender. Nonetheless, these measures have been insufficient to stimulate strong entry and development in the domestic private sector. Other restrictions, such as the close government supervision exercised over enterprises through the banking sector have prevented many prospective businesses from going formal and thus stunted their development opportunities. The recent measures against informal businesses particularly in the trade sector simply drive these entrepreneurs further underground and discourage entry into the formal economy. Interviews with affected business people published in the recent report on Uzbekistan by the International Crisis Group[11] confirm that the situation for many has been getting more rather than less difficult in recent months.

A key sector, where private initiative has so far been hampered by government restrictions is agriculture. Much agricultural production still takes place in collective farms, whose members do not have tradable land rights and who depend on the state for the provision of all critical inputs. This system has to some extent allowed Uzbekistan to maintain a relatively high level of agricultural production (contrary to neighbouring countries, where productivity has often plummeted as smaller farms face difficulties in reaping economies of scale) and supported the government-led shift out of cotton and into wheat production. However, with the entire cotton and wheat harvests being procured by the state at below market prices, there have been few incentives to increase productivity, improve farm incomes and stimulate rural development. Since the 2002 harvest, collective and private farms are now entitled to sell 50 per cent of the cotton and wheat harvest outside the state procurement system at free auctions. State procurement prices have also been raised to around 70 per cent of the world market

[10] According to official statistics, SMEs accounted for 35 per cent of GDP in 2002, but only 7.5 per cent of exports, against 29.1 per cent and 34.3 per cent respectively in 1999. The non-state sector, including collective farms made up 78 per cent of employment in 2002.

[11] Uzbekistan's Reform Program: Illusion or Reality?, Osh/Brussels, 18 February 2003. Available at www.crisisweb.org.

level (even if calculated at an indicative equilibrium exchange rate).[12] Implementation of these important reforms will be key to judge the extent to which the government is willing to reduce state control over this critical sector of the economy.

The large enterprise sector remains dominated by state ownership. Less than half of all large enterprises have been majority transferred to private owners. Even in those enterprises that were privatised during the mid-1990s, the state often retains a blocking minority and the management of the state stakes through the industrial associations ensures that the state retains an active interest in operational questions. The new privatisation programme adopted in 1998 has not been effective, largely because foreign investor interest has remained lukewarm, but also because the government's reluctance in many cases to offer controlling stakes. In January 2003, the government announced new efforts to reduce state influence in medium and large scale enterprises, by decreeing that all residual state stakes in such enterprises where the state holds less than 25 per cent of shares be sold during 2003-2004. Larger state stakes are to be transferred into trust management of the companies' current managers. Moreover, the role of the industrial associations and holdings, which have ensured continued control by line ministries over large enterprises, is to be redefined and their ability to interfere in enterprise decision making is to be reduced.

Since 2000, the government has significantly reduced its state investment programme, which in several large enterprises accounted for the bulk of their funding. At the same time, debt servicing costs have doubled in real terms. Several of the new joint ventures created under the import substitution programme are operating well below capacity (Uzdaewoo at 20 per cent, Uzcasetractor at 27 per cent and Uzcasemash at 5 per cent.). Several other enterprises, some of which may only now come on stream depend on the operation of these large joint ventures. It remains unclear, how many of these large companies would be viable at full market prices and with no government subsidies.

Uzbekistan needs to improve conditions for SMEs to make it attractive to register and operate in the formal economy. Tax reductions and reduced registration requirements are not enough in isolation. State intervention and control of productive activities needs to be reduced across the board to allow effective competition and a level playing field to be established.

2.3.2 Banking sector reform

Uzbekistan's banking sector has played an important role in the implementation of the country's import substitution policies over the past 7 years. A large proportion of the government's foreign borrowing for the state-led investment programme has been channelled through the country's six major domestic banks, all of which remain majority state-owned. The largest bank, the National Bank of Uzbekistan, accounted in 2001 for three-quarters of total assets and 60 per cent of total capital of the banking system. In total state-owned banks controlled 95 per cent of total assets, with the remaining 5 per cent distributed among private banks and credit associations. Foreign ownership is minimal, although 6 smaller banks are majority foreign owned.

[12] Cotton exports are subject to an additional implicit excise tax as a result of not being refunded the 20 per cent VAT. This tax, raising around US$ 100 million per annum, would need to also be abolished if true market level prices are to be reached for cotton farmers.

Among the large state-owned banks, foreign loans to industrial enterprises (mainly in manufacturing, the energy sector and some in the agro-processing industry) account for around two-third to three-quarters of total loans. As a result, domestic credit as a share of GDP was 37 per cent and total bank assets to GDP were 72 per cent, much higher than elsewhere in the CIS. However, taking out government guaranteed loans, total assets would shrink to around 30 per cent of GDP. Compared to non-guaranteed loans, total capital of the banking system is very large at US$ 730 million (around two-thirds of outstanding non-guaranteed loans).

The devaluation of the official exchange rate, at which debt repayments under the state-led investment programme are made, has significantly increased the debt burden of the domestic enterprise sector and in turn affected the financial performance of the large state banks. 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 instance grew from US$ 79 million in 1999 to US$ 133 million in 2001. Together with growing provisions on classified assets in the remaining non-guaranteed portfolio, this has lowered NBU's profitability, with return on equity just 6 per cent in 2001. NBU has reportedly also begun to build-up provision against loans guaranteed by the government in the event of exchange rate unification. According to NBU's own estimates non-performing loans (including those under government guarantees) might reach around 15 per cent of the total if currency unification is fully implemented.

Over the past two years, 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 IFI credit lines (see below). However, market-based finance remains largely underdeveloped and the banking sector serves only a limited role in the intermediation of domestic savings. Household deposits were reported at just US$ 133 million (at the official exchange rate) in early 2002 (1.6 per cent of GDP). The IFI SME credit 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.

Expanding market-based finance is therefore a critical challenge. At the same time, banking sector reforms will need to address the issue of how to handle the large portfolio of state-guaranteed loans on the books of the major banks. This is particularly important, if the banks are to be privatised to strategic investors, as planned by the government. A first step in this direction needs to be a full understanding of the performance of the entire portfolio of the major banks, including those loans extended under government guarantees. Only this will reveal the extent of recapitalisation (if any) necessary to make banks attractive for private investors. Subsequently, decisions will need to be taken on whether to carve out non-performing loans into a special restructuring agency, or whether to choose a decentralised approach whereby banks are incentivised to collect as much as possible of the outstanding loan book.

In parallel to dealing with the quality of the bank's balance sheets, the government would need to eliminate a number of restrictions, which impair the trust of the population in the domestic banking sector. With the abolition of cash withdrawal limits a first step has been taken in this direction, but a reduction in the bank's functions as monitors of enterprise and individual finances on behalf of the government (including the power to freeze accounts and pass on financial information to tax authorities) is equally critical.

Banking reforms that create the basis for the development of market based finance are key to improving the allocation of capital, hardening enterprise budget constraints and stimulating restructuring and assisting in rebuilding trust in the domestic currency and raising domestic savings.

2.3.3 Tariff adjustment and reform of public infrastructure

One of Uzbekistan's advantages over many other CIS countries at the start of transition was the inheritance of the most developed infrastructure in Central Asia. Tashkent was and remains one of the critical transportation hubs in the region and roads and railways extend to most parts of the country and are in fairly good condition. The power sector is in significant need of modernisation, as are municipal services. However, Uzbekistan benefits from the availability of relatively low cost domestic sources of energy. Yet, Uzbekistan has used this endowment inefficiently. Energy prices have remained far below cost recovery levels and are now the key source of subsidies for the rest of the economy. As a result, the cash flow of energy sector companies is poor and many of them may not be able to fully service the substantial foreign debts accumulated over the past decade to make Uzbekistan fully self-sufficient in energy. Moreover, production levels in the oil and gas sector have stagnated in recent years as a result of the lack of investment.

Energy sector reform

While Uzbekistan has abundant coal, and gas resources, as well as significant crude oil reserves and some limited hydro-power capacity, the country has used this endowment inefficiently by setting prices at levels significantly below cost recovery. For instance, power prices are currently around USc 0.7/kWh, whereas cost recovery for thermal power generation (which represents around 75 per cent of the total) would be around USc 3.5/kWh. Gas prices are around a third of long-run marginal cost and maybe one fifth of what Uzbekistan could earn by selling its gas to Russia. Crude oil prices are also set significantly below export parity levels.[13] Adding to these price subsidies implicit subsidies resulting from non-payment and operational losses in the energy sector as a result of underinvestment (particularly in energy and gas distribution), the total resource transfer out of the energy sector to the rest of the economy may have been as large as 30 per cent of GDP in 2000. While energy prices were raised significantly (between 20 and 50 per cent) in nominal terms since 2001, in real terms these increases are much less impressive and are fully compensated in US dollar terms by the devaluation of the exchange rate.

Tariff reform is therefore a key challenge in the energy sector and a pre-condition for making the sector attractive to outside investment. However, given the potential social implications of rapid tariff adjustments and their impact on the profitability of key other sectors in the economy, any tariff reform schedule will need to be phased in over time, and targeted subsidies to the most vulnerable groups may be required (possibilities include cash transfers or lifeline tariffs). Tariff adjustments would also contribute to and

[13] As crude oil is readily marketable for export, export parity is the appropriate opportunity cost. For gas and power where export options are more limited, long-run marginal cost may be a better benchmark for cost recovery.

attract investment for the improvement of energy efficiency. Uzbekistan's energy intensity was the fourth highest in the CIS (behind Tajikistan, Turkmenistan and Azerbaijan) in 1999 and around 6 times as high as in the European Union.

Uzbekistan is also considering privatisation of its oil and gas industry, presently structured under a state-owned holding company, Uzbekneftegas (UNG), with subsidiaries in exploration and production, transportation, processing and refining as well as distribution. International investment advisors are assisting the government to package these subsidiaries into attractive lots to put up for sale. In addition, two Production Sharing Agreements (PSAs) have been signed for exploration (UzPEK with UK-based Trinity Energy and a deal with Itera and Lukoil for gas development). However, foreign interest has so far remained limited, partially due to the macroeconomic environment, partially as a result of the chosen privatisation strategy.

The reform of the energy sector would have implications beyond the development of Uzbekistan alone. UNG owns part of the large gas pipeline from Turkmenistan to Russia and on to Europe, which is in significant need of modernisation. A restructured UNG would be in a stronger position to attract the necessary investments to maximise the country's own export and transit potential and cooperate effectively with Turkmenistan and Kazakhstan, other major gas producers in the region.

Transport and other critical infrastructure

Uzbekistan's landlocked geographical position and distance from major waterways makes the country extremely dependent on effective means of transportation to international markets. Population density is fairly high by regional standards, but parts of the country (particularly the west) are poorly integrated with the population centres around Tashkent and the Fergana valley. Significant investment by the Bank and other IFIs has already gone into modernising transport infrastructure and will continue to be required. This has motivated institutional reforms in the transport sector, particularly in railways, which single out Uzbekistan as one of the CIS countries with the Bank's highest score for progress in reform (a score of 3 in 2002 against a CIS average of 1.9).

The government has recently also announced its intention to begin reforming municipal utilities. In the 2003 budget, the government has planned for significant reductions in losses of municipal utilities, through price increases for heating, rent, water and waste water. The management of water utilities has been decentralised and the government has set up urban water user associations and introduced metering of water consumption. This already led to significant tariff increases since 1999, although tariffs in most areas remain below full cost recovery levels.

Below cost recovery tariff setting remains probably the key area of subsidisation in the economy and is a source of significant efficiency losses. In order to safeguard public resources, which are likely to come under strain as macroeconomic reforms progress, tariff reforms in the energy and municipal sectors should be accelerated and the conditions created for private investment in critical infrastructure. The Bank will continue to monitor progress in the area in the context of its own investments.

3. STRATEGIC ORIENTATIONS

3.1 BANK'S PRIORITIES FOR THE STRATEGY PERIOD

The Bank has accumulated a sizeable portfolio in Uzbekistan and the country will remain an important partner to the Bank in Central Asia. However, the scope for expanding investments significantly in Uzbekistan within the next two years may be limited under the current economic environment.[14] In the private sector, foreign direct investment (FDI) will remain limited without either currency convertibility or the macroeconomic stability supported by an IMF programme. Strategic investors will not be easy to mobilise to participate in the country's privatisation programme. This could delay planned investments by the Bank in support of privatisation. In the public sector, too, new lending will remain constrained by the sovereign borrowing capacity of Uzbekistan, given relatively high foreign debt levels, and by the slow progress in key areas, such as the commercialisation of critical infrastructure and the implementation of tariff reform.

The difficult operational environment calls for selectivity and flexibility in the Bank's operational priorities. In the private sector, the Bank will need to focus on export-oriented projects that would be least vulnerable to foreign exchange restrictions, and be willing to work with sponsors with closer links with the country. This will entail particular attention to governance and transparency issues as well as insistence on demonstrated viability of the project. In the public sector, the Bank will process operations selectively. The Bank will focus on projects that would directly benefit the population and loan proceeds of which could be clearly monitored. The projects need to generate adequate revenues to repay the Bank, thus mitigating budgetary liabilities.

The Bank will continue in its policy dialogue to promote key macroeconomic and structural reforms as indicated by the benchmarks outlined in the President's Recommendations. It will use its Annual Meeting to reinforce the key message that current economic policies are highly costly to Uzbekistan and to the region and to highlight the potential benefits that would flow from more open economic policies and enhanced regional dialogue and cooperation. The Bank will continue to work closely with the other IFIs and the international community to communicate consistent messages to the authorities and offer assistance in support of any credible, comprehensive and unambiguous reform programme.

The Bank will continue to ensure that all Bank operations in Uzbekistan are subject to the Bank's Environmental Procedures and incorporate, where appropriate, Environmental Action Plans (EAP) into the legal documentation in order to address issues raised during due diligence.

[14] See Annex 4-2 (B) for the Bank's current project pipeline

3.2 Sectoral Challenges and Bank Objectives

3.2.1 Support for private investment and entrepreneurship

Transition Goals

Support for private sector development and fostering entrepreneurship is the key to the successful transition to a market economy. Especially SME and MSE development represents one of the most effective ways to build a more commercially oriented environment in the private sector. It increases competition, create jobs and reduces poverty. In addition the Bank will aim to support transfer of know-how, and the introduction of best international standards through FDI, including in the context of the Government's privatisation programme. The Bank will continue to support foreign trade and international competition in Uzbekistan through its Trade Facilitation Programme (TFP).

Operational Priorities

SME and MSE Financing

The Bank will continue to support SMEs and MSEs by enhancing the Bank's projects currently in place. The current SME and MSE programmes have dual objectives of: (i) financing SMEs and MSEs; and (ii) strengthening the banking sector through institution building and enhancing competition. The latter objective overlaps with the second pillar of the operational priorities mentioned below. The programmes have successfully achieved both objectives thus far.

The Bank's SME programme has been the main provider and also one of the few commercial sources of medium to long-term funding available to SMEs, as local banks are otherwise unable to provide such finance. Since the establishment of the first framework in 1993, the Bank committed $ 180 million (SME I for $ 60 million and SME II for $ 120 million) to four commercial banks[15] for on-lending to local SMEs. To date, a total of $ 157 million has already been committed to 86 sub-projects, while US$ 149 million has been disbursed. The total project cost of these sub-projects is US$ 273 million, with the mobilisation ratio currently standing at 1.72. The average sub-loan size is US$ 1.8 million. The performance of the sub-loans extended under the facility has been satisfactory but reflects the difficult economic environment. The participating banks are concentrating more on smaller-sized sub-loans in recent period, due to the past experiences that they performed better than the larger-sized sub-loans. At present total arrears are about 5.5 per cent of the total disbursements. In light of the current difficulty in the economic environment, the Bank will continue to monitor closely the performance of subprojects (see Section 1.2.1 for Transition Impact of the financial sector).

The Bank is now preparing SME Credit Line III. The Bank identified NBU, Asaka Bank and Uzjilsberbank as the potential first participating banks. The project will build on the Bank's experience and lessons learnt from the SME Credit Line framework implemented in Uzbekistan since 1993. To promote further competition amongst banks,

[15] NBU, Asaka Bank, Uzpromstroybank and Pakhta Bank.

the Bank will also consider adding other medium sized private and state owned banks to the facility at a later stage. However, this will depend on financial criteria such as capitalisation, sound credit portfolio and sustainable profitability, as well as sufficient clientele and diverse branch network.

The Bank will continue to implement its MSE programme for micro-businesses. To date, almost 1,600 loans have been disbursed for a total amount of over US$ 5 million with an average loan size under US$ 4,000. The programme has maintained low level of arrears (2.2 per cent) with monthly disbursement of about 200 loans. The Programme is currently operating with "full scale" in nine cities and towns in Uzbekistan. It will also maximise co-operation and co-ordination efforts of the Bank and IFC under the Investment Co-operation Fund. Further expansion of the Bank's MSE programme, however, depends on progress being made in legal and regulatory reform as well as on the macroeconomic environment (see also Section 1.2.1).

In order to support SMEs and MSEs, the Bank will continue to provide assistance through the Turn Around Management (TAM) and the Business Advisory Service (BAS) programmes with donor support. They include a wide range of business advice, covering the development of business plans, marketing, accounting, quality control and management and information technologies.

Trade Finance for the Private Sector

The Bank will continue to extend the TFP, which provides guarantees against letters of credit of local banks to importers or exporters from Uzbekistan. The Bank will try to extend this programme to new participating banks, strengthen marketing, review regularly its pricing and tenor, and propose more innovative ways of guaranteeing commercial and political risks. The Bank will seek co-guarantee opportunities with export credit agencies, foreign banks active in trade finance in the region and IFIs. In this context, the Bank is discussing with the ADB the manner by which both institutions could co-operate in this field.

Equity investment in small enterprises - Direct Investment Facility

The Bank's first DIF project in Uzbekistan, US$ 0.5 million investment to a local printing company, was signed in June 2002. The company is developing a wide range of high quality printing services and provides to all customers including multinationals and local private corporations. It has achieved demonstration effect in promoting better business practices, IAS reporting and overall transparency in the sector. The Bank will continue to seek opportunities for small direct investments in enterprises with local entrepreneurs.

Use of Central Asia Risk Sharing Special Fund (CARSSF)

In 2002, the Bank created a first loss guarantee fund to significantly enhance the above operations (SME, MSE, TFP and DIF) in Uzbekistan, Kyrgyz Republic and Tajikistan[16]. Recognising the high risk, potential losses will be shared between the Bank and CARSSF contributed by donors. It will enable the Bank to include additional participating banks to the programmes and increase its own exposure several times. The

[16] Approved by the Board in July 2002.

Governments of Germany and Switzerland have so far contributed to CARSSF and its current size is about US$ 9 million.

Support for the Privatisation Programme and FDI

The Government embarked on a new privatisation programme for large state-owned enterprises and banks a few years ago, to date with little success. The Bank, however, remains willing to consider support for the programme. The Bank's ability to finance these enterprises will depend on the willingness of competent sponsors to invest. Privatisation of Asaka Bank, UzbekNefteGas (UNG) and UzbekTelecom are included in the programme.

The investment climate is the most important element in increasing FDI to the country. Until convertibility is established, the Bank will focus on funding private sector enterprises with sufficient export capacity to generate the foreign exchange needed to cover necessary imports and debt service.

The Banking Sector: The Bank intends to have a pro-active approach towards the restructuring and privatisation process of the Uzbek banking sector, with the ultimate goal of increasing the level of intermediation in the country. It will pursue this approach by working actively with Asaka Bank to create a demonstration case for successful restructuring and investment by a strategic foreign bank (see Section 3.2.2 below).

The Oil and Gas Sector: Investment in development and export of natural gas and in modernisation of transit gas pipelines depends on the co-operation with neighbouring countries as the only available transportation and export routes are Central Asian-Centre pipeline (Turkmenistan-Uzbekistan-Kazakhstan-Russia) and Bukhara-Ural pipeline (Uzbekistan-Kazakhstan-Russia). The Presidents of Uzbekistan, Turkmenistan, Kazakhstan and Russia pledged to co-operate in the gas sector in March 2002. In this context, the Bank may have an opportunity to support rehabilitation and modernisation of the Central Asia-Russia gas pipeline, depending on achieving transparency with respect to the transit tariff regime.

The government intends to privatise UNG by selling part of the equity to a strategic investor. BNP Paribas, financial advisor for the privatisation, has submitted a list of recommendations to the Government, and the Bank would consider to support privatisation through funding of a strategic investor or through pre-privatisation investment where appropriate milestones can be agreed. The Bank will also support private sector-led projects in the upstream sector under the recently developed PSA legislation. Although the Bank currently has only a small active project pipeline in the oil and gas sector, improved co-operation between Russia and the Central Asian countries provides some opportunities. Russia needs to develop new gas reserves and secure supply of gas for domestic and export markets. The continuing expansion of Russian oil majors abroad may lead to FDIs in the sector in the medium-term, although the Bank will continue to pay close attention to integrity and transparency issues in dealing with Russian corporates in the energy sector.

The Mining Sector: Mining is one of the main sectors of interest for foreign investors. Based on the good experience of the Zarafshan-Newmont gold mine (see Section 1.2.1), the Bank will seek opportunities to support private projects in the sector involving sound foreign sponsors. There is evidence of international companies renewing interest following reduced geopolitical risk in the region after the Afghanistan campaign and increased gold prices. The Bank may also consider financing the currently state-owned major mining companies such as Navoi Metals & Mining and Almalyk Metals & Mining in support of enhanced financial transparency and restructuring to make the plants more competitive in global markets. The Bank will ensure that transition impact is achieved through introduction of new technologies, sound business practices and adherence to the international environmental standards.

The Telecommunications Sector: The Bank has confirmed its commitment to support the Government in its objective of attracting a strategic investor into Uzbektelecom, the national incumbent telecommunications operator. Analysis of the company and the broader sector issues indicate the need for significant improvement in the company's operating and financial performance and processes, as well as further development of the legal and regulatory environment. Close co-operation is maintained with IFC and ADB who have jointly with the Bank committed to consider financing (at the time of privatisation or pre-privatisation as appropriate) once fundamental issues have been addressed. The IFIs and the Government have agreed, as a first step, to implement Technical Assistance Programmes, which will support both the company in its transformation and the broader sector issues. The proposal addresses the need to (i) improve the regulatory environment, (ii) implement modern management information and accounting system and (iii) develop a sound business plan for the Company. The Bank, through the Legal Transition Team (LTT), is proposing to take specific responsibility for the Regulatory Development Programme.

Reform of the telecommunications sector policy and regulatory framework has begun (largely supported by TACIS) and the government has announced its desire to continue with these reforms. While the TACIS programme for the sector ceased in 2001, much remains to be done in order to attract suitable strategic investors and create real competition. This involves work to strengthen the capacity and independence of the regulatory function, liberalisation, development of tariff re-balancing mechanisms, transparent and predictable licensing and interconnection policies, together with development of a modern framework for the provision of universal service. The proposed Bank's TC project will aim to assist with the implementation of appropriate reforms in these priority areas.

The Bank will seek opportunities to provide long-term financing to companies in the private sector. This, however, will be highly dependent upon improvements in the regulatory framework and stability in the broader macro-economic environment, including full currency convertibility and exchange rate predictability.

The Agribusiness Sector: The Bank's SME Credit lines financed a number of subprojects in the agribusiness sector (mineral water, juice, pasta, etc) thus far and will continue to fund viable projects in the sector. The emphasis on SME/MSE operations in the current Strategy should give increased opportunities to support such agribusiness projects through these facilities. The Bank will also investigate the possibility to work with foreign strategic partners in agro-processing as a way to promote foreign investment and transfer of know how.

With regard to upstream activities of the sector, the Bank will examine the introduction of agricultural financing scheme, such as the Grain Warehouse Receipt Programme, by which the Bank will share the risk of a local borrower with local participating banks, supported by the collateral of new crops stored in the grain warehouses. The implementation of recent reforms to the marketing of key cash crops such as grain and cotton will be a necessary precondition for the Bank to start developing structured trade finance operations in the sector.

3.2.2 Strengthening of Financial Institutions

Transition Goals

Since the banking sector has been a key vehicle for the state-led investment policy, the Bank's assistance to restructuring of the sector could be one of the most important contributions it could make in supporting economic reforms in Uzbekistan. Market-based finance is critical to foster a positive supply response to reforms. As the public gains confidence in the domestic banks, the process of monetization could deepen, contributing to macroeconomic stability.

The policy challenges in this respect are manifold including: (i) to discontinue directed lending; (ii) to improve the corporate governance and management capacity of the commercial banks; (iii) to upgrade the supervisory capabilities of the Central Bank; (iv) to solve the potential large portfolio of non-performing loans; (v) to privatise state-owned banks possibly with foreign strategic investors; (vi) to develop non-banking financial institutions; and (vii) to increase competition in the financial system and improve efficiency of financial intermediation.

The Bank will support the systemic changes in Uzbekistan's financial sector. It has to be recognised, however, that banking sector reforms are tied together with other key structural reforms. The privatisation of the banking system cannot proceed successfully until convertibility is introduced and while the banks remain burdened with directed credits to strategic industries to the Government. Moreover, the resolution of non-performing loans would best be pursued in the context of also pushing for enterprise restructuring. The Bank has made it clear in its policy dialogue that these issues will have to be addressed before the Bank participates in the bank privatisation programme.

Operational Priorities

Strengthening the Banking Sector

Credit Lines and TFP: The Bank will continue to promote competition in the banking sector through increasing the participating banks under the SMEs, MSE and TFP projects. This will further support the strengthening of the banking sector. In addition, the Bank will continue to support institution building in the sector through TCs to improve the bank’s credit assessment processes, auditing, management information systems, the development of new products such as trade financing, etc.. Such TC will be concentrated on newly approved participating banks under the various frameworks.

The SME credit lines (I and II) had a significant impact in developing the financial sector and SMEs. To the extent that the SME credit line and MSE programme are expanded the inclusion of additional participating banks will help foster competition in the domestic financial market. The Bank's willingness to take local banks' risk within the scope of the TFP strengthened the Uzbek banks' reputation abroad and reduced their transaction costs. The CARSSF (see Section 3.2.1) will contribute to enhance operations under SME, MSE and TFT facilities.

Bank Restructuring and Privatisation: If Uzbekistan were to move decisively towards market liberalisation and structural reforms, the banking system needs to undergo a significant adjustment process that would involve dealing with the large portfolio of state-guaranteed and possibly doubtful loans and re-orienting lending policies towards the private sector. The Bank is willing to support this process through policy dialogue in consultation with other IFIs.

The Bank's involvement in banking sector reforms has already begun through a strong institution-building programme in Asaka Bank, the second largest banks in Uzbekistan. Technical assistance is in place, to be implemented by a team of professional managers, focused on phasing out the state's influence and turning the institution into a sound commercial organisation. In parallel with this process, the Bank may consider making a pre-privatisation investment, while continuing to work with the bank's management and the authorities to attract a strong strategic investor. A mandate letter summarising the terms of the Bank's involvement in the privatisation of Asaka Bank was signed during the Annual Meeting in Bucharest in 2002 and due diligence on the bank is underway. This project will be an important transaction in the sector and will have a significant demonstration effect. The participation of strong strategic investors in the privatisation of the Uzbek state-owned banks is important. It will accelerate the transfer of banking skills and therefore create institutions capable of becoming effective competitors in the market, operating according to the best international standards and imposing financial discipline on the enterprise sector.

Development of Non-bank Financial Institutions

If the structural reform in the banking sector progresses, harmonised development of non-banking financial institutions, including leasing, mortgage, insurance, pension funds and securities investment funds and securities traders, is desirable. Such progress will help to (i) increase the efficiency of financial resource allocation, (ii) contribute to increase private savings, (iii) foster institutional investors and (iv) help deepening financial markets.

Although the Bank's experience in this sector has been limited to its equity investment in the Uzbek Leasing Company, it will seek opportunities for investment that could contribute to the development of non-bank financial institutions.

3.2.3 Critical Infrastructure

Transition Goals

A well-functioning infrastructure is a critical input into the development of a competitive private sector, as well as a key aspect of social welfare. At the same time, in many transition economies, including Uzbekistan, public infrastructure services are an important source of quasi-fiscal deficits, which create macro-economic risks as well as domestic price distortions. For both of these reasons, the Bank's involvement in the modernisation and institutional strengthening of critical infrastructure in Uzbekistan is important. The Bank will aim to select key areas for its involvement, including the energy sector, transport and municipal services, where reforms are particularly necessary and benefits for the country and the population are particularly large and hence the Bank can expect to achieve high transition impact as a result.

Improvement in these sectors could be enhanced with expanded trade and efficient use of resources in co-ordination with the neighbouring countries in the region. The Bank will place emphasis on developing projects with an element of regional cooperation and also seek opportunities to co-finance with other IFIs to make effective use of limited public funds.

Operational Priorities

Power

The Bank would aim to promote power trade among the Central Asian states leading to greater efficiency of power generation resulting in lower cost of power for the consumers in those countries. The Bank is in the process of considering two additional transactions in the power sector. The first transaction would involve co-financing with the ADB for the Regional Power Transmission Modernisation Project. The ADB approved a project in December 2002 for the Tajik components and an approval of the Bank's financing is expected for the Uzbek components. The aim of this project is to modernise the transmission systems of Uzbekistan and Tajikistan to enable the two countries to expand cross-border power trade. As part of this project the Bank is considering providing a sovereign guaranteed loan to Uzbekenergo, which will be implementing the project on the Uzbek side.

The introduction of third party access to the transmission grids of the two countries as well as transmission tariff methodology, to be achieved as part of this transaction, will be an important step towards the development of free trade in power across the region and may also have important secondary benefits in encouraging commercialisation of the domestic power market, creating the basis for private investment.

The second project contemplated by the Bank in the sector would support the refurbishment of two additional units at the Syrdarya Power Plant (Syrdarya II, see Section 1.2.1). This project is intended to promote the commercialisation of power supply as well as private sector involvement in the power sector. To this effect the Bank will work with Uzbekenergo, the current owner of the Station, to introduce a twinning arrangement for a portion of the station’s power sales. The Regional Transmission Project described above would complement this operation as third party access and transmission tariff pricing are the essential preconditions for power trading between private parties. In addition, the facilitation of cross-border power trade to be achieved under the Regional Transmission Project should enable Syrdarya Power Station, which sells a significant amount of power to Tajikistan, to start entering into direct power contracts with its Tajik customers.

Energy Efficiency

Uzbekistan is one of the most energy intensive countries among Bank's Countries of Operations (see Section 2.3.3). The main reason for this continued inefficiency is the low level of energy prices and tariffs and low cost recovery. This leads to waste on a massive scale and deters energy saving investments.[17]

The Bank will investigate opportunities for energy saving projects, primarily in the areas of district heating, power and selected manufacturing enterprises. The Bank will also invest in improved metering of gas, electricity, heat and hot water in the context of pushing for tariff adjustments towards full cost recovery.

In connection with these projects, the Bank will take advantage of the opportunities offered by the nascent market for greenhouse gas emissions reductions, in particular, through the Clean Development Mechanism (CDM). The resulting "carbon cash flow" would help enhance the Bank's projects, which reduce greenhouse gas emissions. The first test cases are district heating projects in Andijan and Tashkent. The buyer will be the World Bank's Prototype Carbon Fund (PCF) which has financed some preparatory studies.

The active pipeline is the Tashkent Heating Modernisation Programme scheduled for signing in 2003. The project will rehabilitate about one third of the city's network and will result in considerable savings of gas, water and electricity. In particular, the project will enable Uzbekistan to increase its exports of gas and the City to significantly reduce subsidy payments for the service. The city will be required to move tariffs to cost recovery levels by the end of 2006 and to create a safety net for the poorest households. The sale of CDM credits to the PCF will be bundled with that of the Andijan project.

Municipal and Environmental Infrastructure

The Bank will also continue its work with municipalities that would benefit directly the population. The next project proposed in the municipal sector is the Tashkent Water Supply Improvement Project. The project would make urgent investments to immediately upgrade the quality of potable water services in the City of Tashkent. Transition impact will be achieved through a programme of financial and operational management reforms, and through the possible introduction of private sector participation into the operations of the municipal water enterprise.

Transportation

In the last several years, the Bank has become increasingly active in the transport sector in Uzbekistan to support the rehabilitation of existing transport assets as well as the development of new market-oriented transport links, in particular with the railways sector (see Section 1.2.1).

Similar opportunities for the Bank to contribute to road sector needs and sector reforms will also be sought if the policy environment is receptive. However, the Bank will proceed cautiously and selectively in developing further projects in this sector, in light of the limited foreign debt service capacity of the country.

[17] In Eastern Europe, where power prices were adjusted more rapidly, energy intensity has been greatly reduced since the start of transition.

4. OTHER IFIS AND MULTILATERAL DONORS

The relationship between the Government of Uzbekistan and the IMF is critical for the country's relationship with the international investment community at large. Agreement with the IMF for a stand-by arrangement would provide credibility to the reforms that Uzbekistan needs, and some insurance to the government against any short-term volatility in its macro economy as a result of liberalisation. However, the IMF's Staff Monitored Programme, agreed in January 2002, has expired in August 2002.

The Bank has maintained information exchanges with other IFIs including the IMF and provided the Bank's Draft Country Strategy and its project pipeline, to ensure that the Bank's operation is complementary to the macro-economic stabilisation and reform efforts.

The ADB has approved to date loans totalling US$ 625 million for Uzbekistan. The Bank has been working closely with ADB for co-financing infrastructure projects (Uzbek Railways projects) and promoting together the regional co-operation in Central Asia. The ADB envisages an annual lending of an average of US$ 150 million over the next three years. If further reforms are implemented, the content and volume of ADB operations as well as lending levels would be adjusted to be responsive to emerging needs. It approved four projects in 2002, including the approval in December of US$ 109 million Education Sector Programme Loan and the Regional Power Transmission Modernisation Project which the Bank is expected to co-finance.

The World Bank's current portfolio stands at US$ 534 million. It has supported projects mainly contributing to the country's poverty reduction. The Bank co-financed Tashkent Solid Waste Project with the World Bank. The World Bank is not providing at present Structural Adjustment Loans (balance of payment and budgetary support loans) to Uzbekistan due to the slow reform progress and absence of programme arrangements between the IMF and the Government. The World Bank visited Tashkent in January for a discussion of its Country Economic Memorandum, which amongst others detailed the costs of present economic policies and argues for liberalisation.

The Bank, being an important financier in the region, plays a significant role in donor co-ordination both at HQ and the resident office levels. Regular consultation meetings take place in Tashkent amongst resident IFIs with the Bank's active participation.

Regional co-operation has been the area where the Bank closely worked with other IFIs, bilaterals and the Central Asian governments. The Bank has been promoting regional co-operation in cross-boarder trade, transport, power and water through supporting projects that could enhance such activities. The Bank actively took initiative to be involved in this efforts. They included participation in various meetings including CIS 7 meetings hosted by the Bank, the IMF, the World Bank and ADB; the Berlin meetings on Central Asia organised by UNDP and the German Government; and a recent regional co-operation meeting in Tashkent.

ANNEX 1

POLITICAL ASSESSMENT IN THE CONTEXT OF ARTICLE 1 OF THE AGREEMENT ESTABLISHING THE BANK

ANNEX 1: POLITICAL ASSESSMENT IN THE CONTEXT OF ARTICLE 1 OF THE AGREEMENT ESTABLISHING THE BANK

Since the adoption of the last country strategy for Uzbekistan in March 2001, the entire region of Central Asia has become a focus for international attention as a result of the terrorist attacks of 11 September and their aftermath. Uzbekistan has emerged as an important ally of the United States in its anti-terrorist campaign in Afghanistan.

The new political reality has opened up new opportunities for Uzbekistan to embark on political and economic reforms essential for its long-term prosperity and stability. The essential democratisation agenda in Uzbekistan includes: improving the country's human rights record; opening up the political processes to a variety of interests and parties; ensuring freedom of the media and fairness of the electoral process; and setting up a system of parliamentary checks and balances to the strong executive power.

In March 2002, in a joint declaration with the United States, Uzbekistan re-affirmed its commitment to the intensification of the democratic transformation of its society, both politically and economically. In the economic area, the Government has re-opened negotiations with the IMF, but has yet to agree an important stand-by agreement with them (see detailed economic assessment earlier in this document).

In the political field, during 2002, the Government took some steps designed to demonstrate progress towards democratisation. Those included:

- registration of the local Independent Human Rights Organisation of Uzbekistan (IHROU);
- an invitation of the UN Special Rapporteur on Torture to visit the country;
- passing long prison sentences against law enforcement officials found guilty of torturing prisoners;
- allowing Freedom House, a leading international human rights organisation, to open a local office in Tashkent;
- abolishing formal pre-publication censorship and lifting restrictions on access to the Internet;
- hosting the Fourth Central Asia Media Conference in close co-operation with the OSCE.

However, in practice the situation with regard to the rule of law and respect for human rights remains difficult. The overall political environment in Uzbekistan is not conducive to criticism of Government policies. The executive power, embodied in the Presidency, is strong and is not sufficiently balanced by the legislature or judiciary. Systematic violations of the freedom of religion, expression, association and assembly have been reported by human rights monitors. Arbitrary arrests and torture of detainees remain a major concern.

On 12 December 2002, the Danish Presidency of the EU welcomed the recent visit to Uzbekistan by the UN Special Rapporteur, but shared his concern that torture is used systematically in Uzbekistan. The EU called on Uzbekistan to agree that suspected coerced confessions should not be accepted on their own as a determinant of guilt; that material evidence and torture allegations should be taken into account in court decisions; and that, for a trial to be fair and to meet international standards, evidence other than confessions must be given due weight.

The US Mission to the OSCE has also welcomed the Rapporteur's visit and has noted that the Uzbek Government's co-operation, though mixed, has not overall been bad. Major reforms are necessary to redress the situation and the US is prepared to work with the Government of Uzbekistan to help effect these important reforms.
At the fourth meeting of the Cooperation Council between the European Union and Uzbekistan, the EU noted the EBRD meeting in Tashkent in May 2003 would focus international attention on the country and expressed the hope that by the time of the meeting Uzbekistan would demonstrate to the international community further political and economic changes.

The Uzbek authorities have on various occasions declared their commitment to democratisation and the rule of law. They argue that democratic changes should be introduced gradually and that radical moves may damage the sensitive fabric of traditional Uzbek society. The country, which has inherited a legacy of Soviet authoritarianism, is the most populous in Central Asia, with a large share of young population and a big and active Muslim community living in densely populated rural areas. Those circumstances cannot be ignored. It is essential, however, to pursue a consistent reform agenda moving forward in a credible way so as to constantly improve the situation on the ground. Genuine respect for democratic processes is a prerequisite for this transition.

Last elections and the separation of powers

The last parliamentary elections, characterised by the OSCE as not truly competitive, took place in December 1999. The one-chamber parliament (Oliy Majlis) is to be replaced by a two-chamber legislature when the current term of the Oliy Majlis expires at the end of 2004.

The only political parties represented in the Oliy Majlis are those supportive of Government policies. Two major opposition groups – Erk and Birlik - have been in exile since 1993 and continue to operate from abroad. The leader of Erk party was sentenced *in absentia* to 15 years imprisonment for allegedly participating in the organisation of an armed military incursion in August 2000.

President Islam Karimov was first elected in 1991 and was re-elected on 9 January 2000 against token opposition in an election, which - according to the OSCE - did not offer a real political alternative to the people of Uzbekistan. He received 92 per cent of votes, with a voter turnout of 95 per cent. The only other candidate for the Presidency announced on election day that he had voted for President Karimov. A referendum in January 2002 extended the presidential term of office from five to seven years.

Although the 1992 Constitution recognises the principle of the separation of powers, power is primarily concentrated in the executive branch of the Government. At the last session of the Oliy Majlis, in December 2002, President Karimov outlined the new parliament's powers. The new two-chamber legislature – to be elected in the general election in 2004 – is expected to approve the Prime Minister, the Prosecutor General, the Chairmen of the Supreme and Constitutional Courts and the Chairman of the

National Security Service. It is also expected that the President will not in future hold the position of Chairman of the Cabinet of Ministers.

Human rights conditions

Uzbekistan's human rights record remains very poor and has not improved substantially, notwithstanding some measures undertaken by the Government in 2002.

The Human Rights Watch organisation has prepared several updates for the Bank on the human rights situation in Uzbekistan. Major areas of concern, identified in those reports, relate to documented cases of torture in prisons and places of detention; continued religious persecution of independent Muslims; cases of persecution of human rights defenders; denial of registration to local human rights groups and political opposition parties; and cases of violations of the freedom of the media.

Regarding the question of torture, the UN issued a statement on the completion of the two-week fact-finding mission of the Special Rapporteur of the United Nations Commission on Human Rights on the question of torture, Mr Theo van Boven. During the Mission, conducted from 24 November to 6 December, the Rapporteur visited prisons, places of detention and psychiatric hospitals in various parts of the country. The Rapporteur was not able to visit the Jaslyk colony in Karakalpakhstan in a satisfactory and comprehensive manner. The Jaslyk prison became a centre of attention after several brutal deaths on its premises. Mr van Boven has been denied access to the National Security Service's lock-up in Tashkent.

The Rapporteur appreciated that the Government enabled him to carry out this important mission and he regarded his visit as a clear indication of increased co-operation between the Government and the United Nations in the field of human rights. Based on numerous testimonies he received during the mission, the Rapporteur arrived at the conclusion that torture or similar ill-treatment is systematic. Accordingly, he recommended a number of measures to improve the situation in expectation that the Government will follow up on the recommendations included in the report.

The campaign against independent Muslims continued in 2002 although the arrests of Muslims whose religious practices fall beyond state controls have declined. The end-of-year amnesty in 2002 included some members of religious groups such as Hizb-ut-Tahrir (Party of Liberation), who had been imprisoned for crimes against the constitutional order and national security. According to human rights monitors, however, there are still thousands of prisoners in Uzbekistan, held on religious and political charges.

The situation with the freedom of the media in Uzbekistan was assessed by the OSCE. The OSCE Representative on Freedom of the Media raised serious concerns regarding the developments in this field. He has pointed out that freedom of expression is envisaged in the Constitution but, in practice, there are no independent media outlets in Uzbekistan. Violations of press freedoms continued despite changes in the censorship policy. In May 2002 the Government abolished the post of the Head of the State Inspectorate for the Protection of State Secrets and disbanded the Committee itself. It appears, however, that the role of censor has been transferred to newspaper editors who engage in self-censorship.

There was no substantial change in the area of labour rights. Uzbekistan has ratified many of the ILO (International Labour Organisation) conventions, which have been identified by the ILO's Governing Body as being fundamental to the rights of human beings at work. These included treaties establishing the right to organise and bargain collectively, abolishing forced labour and eliminating discrimination in respect of employment and occupation. The laws of the country recognise the right to form trade unions. However, in practice the structure of trade unions has not changed significantly since the Soviet period. Uzbekistan is not a party to the ILO conventions in the area of elimination of child labour. As in previous years, there were reports of compulsory mobilisation of students and schoolchildren helping with the cotton harvest – a practice widely used in the Soviet era.

Uzbekistan is a member of the UN and the OSCE and has a reasonably developed national legislation incorporating provisions of many international treaties on human rights (including the UN Convention on Civil and Political Rights), which contain monitoring mechanisms envisaged in the agreements. An Office of Ombudsman was established in 1996 and there is a government-sponsored National Centre for Human Rights involved in monitoring and disseminating information on human rights. Despite the existence of these institutions and the corresponding laws, the situation requires a radical improvement.

External relations

The geopolitical situation of Uzbekistan, which is located in the heart of the Eurasian landmass, dictates in many respects its foreign policy orientations. This country of 25 million, with a significant economic potential, is land-locked and depends on its neighbours to reach external markets. An active member of the Central Asian Co-operation Organisation (CACO), comprising four Central Asian states (but excluding Turkmenistan), Uzbekistan continues to support measures geared towards establishing a unified security zone in the area around Afghanistan. 2002 saw an improvement in its important bilateral relations with Kazakhstan after the two countries agreed on the principles of delimitation of the common borders, which had been the subject of disputes in the past. The CACO is also pursuing a regional economic agenda to improve a co-ordinated use of water, gas, communications, transport and power. The Bank supported a regional Business Forum in Tashkent in November 2002 convened at the initiative of the four Presidents. An effective regional co-operation in Central Asia has yet to be achieved.

At the last Summit of the CACO in December 2002, Afghanistan was offered observer status in the organisation. Undoubtedly, stability and security in the entire region continues to be inextricably linked to the situation in Afghanistan. Moreover, Afghanistan remains a major source of drugs which are being trafficked via Central Asian countries. External security remains a concern for Uzbekistan, not least because of the news that the Islamic Movement of Uzbekistan (IMU) – a terrorist organisation with links to al-Qaida and responsible for military incursions into the region in 1999 and 2000 – has not been totally destroyed and continues to be potentially capable of launching additional terrorist attacks.

Although Uzbekistan has withdrawn from the CIS collective security arrangement and has allowed the US military presence on its territory as part of the fight against international terrorism, the country maintains good relations with Russia and other CIS countries. However, in December 2002, relations with Turkmenistan were damaged following the Turkmen authorities' raid on the Uzbek Embassy in Ashgabat. The official justification for the raid was the Embassy's alleged involvement in hiding the organisers of a recent assassination attempt on the Turkmen President.

In 1999 Uzbekistan joined GUUAM, a grouping of five CIS countries, also comprising Georgia, Ukraine, Azerbaijan and Moldova. In 2002 Uzbekistan suspended its membership quoting ineffectiveness of the GUUAM, but continued to be associated with the group. In December 2002 the US State Department proposed measures geared towards intensification of economic development among GUUAM members through increases in trade and transport, improved border and customs services and the common fight against terrorism, organised crime and drug trafficking.

ANNEX 2

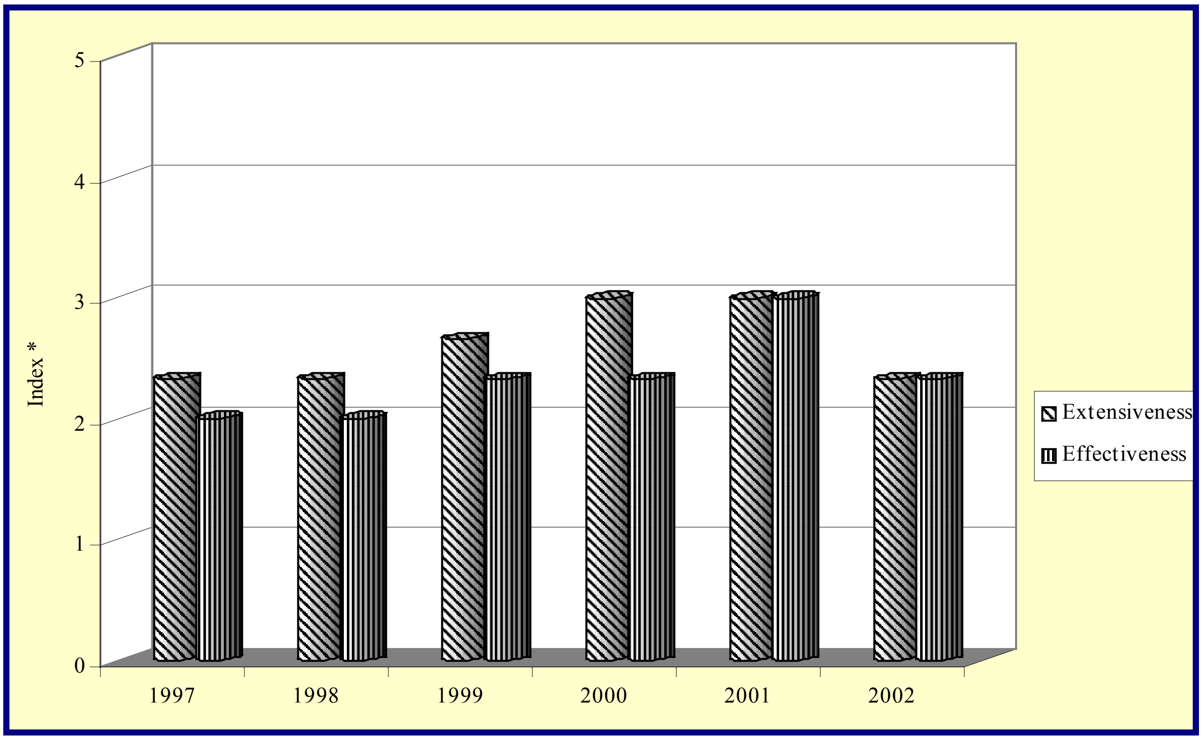
LEGAL TRANSITION

ANNEX 2 - LEGAL TRANSITION

COMPARATIVE ASSESSMENT OF UZBEKISTAN'S COMMERCIAL LAW

I Assessment Over Time

Extensiveness and Effectiveness of Uzbekistan's Commercial Law[18]



Source: OGC Legal Indicator Surveys; 1997 - 2002
**Note:* Indicators along the y axis range from 1 (little progress) to 5 (substantial progress)

Uzbekistan's commercial laws still fall short of standards that are generally acceptable internationally. Legal rules are not as clear and accessible nor as adequately implemented administratively and judicially as would be the case in more developed countries. Annual OGC Legal Indicator Surveys over the past six years confirm that this view is shared by lawyers familiar with Uzbekistan's commercial laws. As the chart above reveals, commercial laws have scored relatively low and were perceived as less adequate in the year 2002 than in the two previous years, such perception confirming the lack of confidence of local practitioners in the rule of law.

[18] The EBRD conducts a Legal Indicator Survey each year to measure the progress in legal reform in Central and Eastern Europe, the Baltic States and the Commonwealth of Independent States, as viewed by local lawyers and academics. The results of such survey are based on responses to the questionnaire sent out to lawyers practising in any given country. The survey represents their perception of the country's legal system and, in particular, the degree to which key commercial and financial laws have reached internationally acceptable standards (extensiveness) and to which extend these laws are implemented and enforced (effectiveness). The survey is based purely on local lawyers' perception of their own country legislation and does not represent EBRD's own view of these legal systems. In addition, it must be noted that each respondent is asked to answer the questionnaire for his/her country only, and not on a comparative basis.

II. Assessment in Other Transition Countries

Legal Indicator Survey - Commercial Laws				
Good:	Adequate:	Barely adequate:	Inadequate:	Detrimental:
None	Bulgaria Czech Republic Estonia Hungary Kazakhstan Lithuania Moldova Romania	Albania Armenia Belarus Bosnia & Herzegovina Croatia FR Yugoslavia FYR Macedonia Georgia Kyrgyz Republic Poland Russian Federation Slovak Republic Slovenia Ukraine Uzbekistan	Azerbaijan	Tajikistan

Source: OGC Legal Indicator Survey, 2002
Note: No country received a rating of "good"

Although Uzbekistan's normative laws do not yet approximate international standards and lack adequate institutional support to be fully implemented, Uzbekistan's commercial laws are generally comparable with those of the a number of other transition countries. Based on the 2002 OGC Legal Indicator Survey (see footnote 17), which measured the perception of lawyers familiar with Uzbek law, the commercial laws of Uzbekistan can be characterised as 'barely adequate' for supporting investment and other commercial activity.

LEGAL SECTOR ASSESSMENT

Bankruptcy

The main point of reference for bankruptcy procedures is the Law on Bankruptcy dated 28 August 1998 (the Bankruptcy Law). In addition, the Civil Code incorporates a section on bankruptcy and several governmental resolutions explain procedural issues of rehabilitation and bankruptcy procedures.

Present procedures in Uzbekistan are regarded as advocating the rescue of companies rather then the recovery of value from their business or assets. Legislation is held to be more favourable to debtors than to creditors. Bankruptcy procedures are not frequently used in practice. Even though the government has recently endeavoured to liquidate some insolvent state-owned companies through bankruptcy procedures, company rescues are still the preferred alternative in practice. The reason for this is that most medium-sized and large companies in Uzbekistan are state-owned, and the government seeks to keep insolvent entities afloat.

One problem area is the ranking of creditors. Private commercial creditors with or without security are generally hesitant to introduce winding up and/or rehabilitation proceedings, as on one hand priority is given to repaying obligatory payments to the state, as well as salaries and other non commercial obligations, and on the other hand enforcement of security can be problematic.

Capital Markets

A Securities Law was enacted in 1993. The Uzbek Republican Stock Exchange was established in March 1994 by a presidential decree. Public trading is regulated by the Uzbekistan Centre for Regulation of the Securities Market ("CRSM"). Public offerings require that a firm first submit the prospectus for review by the CRSM. The legal framework provides for trade in joint-stock company securities, government bonds (that is, treasury notes, both national and local), corporate bonds, and promissory notes (state, commercial, common, and transferable). Currently, the actual volume of trading remains relatively low and most securities are illiquid. The Uzbek government is said to have plans to boost trade volumes and liquidity through plans to enhance transparency in secondary market operations and by establishing transparent and efficient settlement, clearing, and registration.

The insurance sector in Uzbekistan is underdeveloped. It is regulated and supervised by the State Insurance Supervision Board. The Asian Development Bank ("ADB") is assisting Uzbekistan to establish and develop a working insurance system. Through a loan to Uzbekistan's State Insurance Supervision Board agreed in May 2000, the ADB aims to upgrade the institutional capacity of the Board as the regulator and supervisor, in order to ensure adequate supervision of insurance companies. In addition, Uzbekistan is in the process of reforming its pension system. From 1 January 2001, the State Pension Fund under the Ministry of Social Security has been transferred to a non-budgetary pensions fund. In line with the legislation, the new fund will be formed on the basis of insurance fees and obligatory deductions from the actual income from the sales of products by enterprises, establishments and organisations, as well as insurance fees from individuals running a business without setting up a corporate body and from farmers on a voluntary basis. The fund will also receive obligatory insurance fees from citizens, compensations in connection with taking early retirement and granting preferential pensions, fines for late payment of insurance fees and other deductions. Obligatory payments to the Pension Fund are to have the same status as state taxes and duties.

Concessions

Concessions in Uzbekistan are governed mainly by the 1995 Law of the Republic of Uzbekistan "On Concessions," (the "Concession Law"). Little information is available though, with regard to the use of concessions in Uzbekistan. In practice, several foreign investors have undertaken natural resources projects under the rules of the 2001 Law "On Production Sharing Agreements".

According to the Concession Law, a concession is defined as a permission issued on behalf of the State to a foreign investor for the performance of certain economic activities, by granting to such foreign investor property, land plots or subsoil areas on the basis of a concession agreement. According to the Concession Law, in transferring to a concessionaire the right of possession and use of property, land plots or subsoil, the State reserves the exclusive right to dispose of such property, land plots or subsoil. The foreign investor may only dispose of the product, or income generated as a result of the concession activities.

Concession may be granted either on the basis of a tender or by way of a direct concession agreement. The Concession Law contains a mandatory list of terms and conditions that must be included in a concession agreement. Under the Concession Law, the term of a concession agreement may not exceed 15 years. The Government of Uzbekistan has the right to extend such term at its own discretion. A concession agreement may not be terminated unilaterally, except where the concession authority discovers that the concessionaire provided false information at the time at which the agreement was entered into.

The concessionaire must make three types of payments in connection with a concession agreement: (i) a fee to register the concession agreement; (ii) a concession fee, as provided for by the concession agreement; and (iii) taxes and other payments required by Uzbek law. A concessionaire may freely dispose of its profit only after payment of the above-mentioned fees, taxes and payments.

The Government of Uzbekistan has the preemptive right to purchase the products from the concessionaire. This results in foreign investors being concerned that they will be forced to sell products at a price specified by the State and lower than the market price. According to the Concession Law foreign investors are to keep accounts and financials in accordance with the Uzbek law, which does not correspond with the international accounting standards.

One major single bottleneck of the Concession Law making it unattractive is the standard provision that disputes between a concessionaire and the concession grantor fall under the exclusive jurisdiction of economic courts of Uzbekistan. Parties to a concession agreement are not entitled to refer a dispute to international arbitration.

A Law on Production Sharing Agreement was adopted on 7 December 2001. Pursuant to such law, foreign investors can obtain exclusive rights to explore and produce mineral resources in Uzbekistan at their expense and risk by entering into a production sharing agreement. The adoption of the law means that there is no more need for production sharing agreements to be approved by specific Presidential Decrees and that the legal environment will hopefully be more predictable and stable for exploiting natural resources.

To date, the existing regulatory framework for both concessions and production sharing agreements has failed to attract major foreign investment to Uzbekistan's economy.

Corporate Governance

The Law on Joint Stock Companies and Protection of the Rights of Stockholders (the "Law on JSC") was adopted in 1996, which was based on the Russian model. In 2001, Uzbekistan promulgated a Law on Companies with Limited and Additional Liability extending the application of the standards of the Law on JSC to limited liabilities companies. Comparing to the company laws of other CIS countries, the Law on JSC seems to have laid good basis for promoting sound corporate governance practice in Uzbekistan. However, there remains room for improvement. For example, the existing rules are insufficient to prevent insider trading since there are no rules in place that prevent or punish the trading of shares where the seller or purchaser is using important information that has not been disclosed to the public. Also, the rules concerning financial disclosure to shareholders and to potential investors are insufficient. Accounting and auditing standards need to be improved. According to the Decree of the Cabinet of Ministers No 361 dated 22 August 1998, the Government introduced a rule, giving the State Attorney the power to suspend the decisions of the general meeting of shareholders. Such rule, however, contradicts to the Law on JSC under which there is no limitation on the decision-making authority of the general meeting of shareholders. Therefore, the validity of this rule remains to be tested.

Secured Transactions

Security rights over movable and immovable assets in Uzbekistan are governed by the Civil Code, which entered into force on 1 March 1997, and the Pledge Law of 1 May 1998.

Security over immovable assets (mortgage, which also applies to enterprises) requires a classical system of registration in the Land Registry and payment of notarial fees.

For security over movable tangible assets, there are two ways to secure an obligation under Uzbek law:

1) By transferring possession of the collateral to the creditor.
2) By marking or locking and sealing the collateral.

It is also possible for parties to create a security right in benefit of the lender without proceeding with such formalities (in particular for commodities in circulation) but as there exists no general system of registration of charges, the question of priority and enforcement remains highly hazardous for the creditor. State registration is required only when the charged assets themselves are subject to registration, for instance intellectual property rights, and vehicles.

Uzbek law remains quite rigid in terms of what the parties can agree: general description of the collateral is only allowed for security over commodities in circulation and processing. In all other cases, specific identification of charged property is required. Although the charging of future property is explicitly envisaged, it would seem that notaries would not accept to notarise agreements for security over future assets. A list of property and enterprises which may not be used as collateral is laid down by law and includes state property which cannot be privatised. Also, specific identification of the secured debt is generally required: the agreement must include details of the essence, and maturity date of the secured debt. Another serious impediment consists in the secured creditor’s priority which, in bankruptcy, would be preceded by unpaid wages, taxes and social security claims.

Finally, as in many other transition countries, enforcement remains unsatisfactory, being slow and uncertain (e.g., the court has the right to postpone the sale of pledged property up to one year upon the debtor's request). The law provides for sale of the pledged assets only at public auction, although there are reports of banks being granted extraordinary rights by which they may sell the secured property at their own order without addressing a court.

Telecommunications

A broad, modern but relatively general framework telecommunications law was enacted in Uzbekistan in 1999. This law sets out many of the internationally consistent principles of telecommunications sector regulation and is supplemented by a number of (sometimes-confusing) presidential decrees, cabinet resolutions and regulations governing the sector. While many of the modern regulatory principles are set out in those legislative instruments there are gaps and the legislative base would likely benefit from consolidation and rationalisation.

The telecommunications sector in Uzbekistan is regulated by the Communications and Information Agency of Uzbekistan (CIAU). CIAU is the successor of the Ministry of Communications and has the rank of a ministry and performs strategic policy making function, with its Director-General also being a Deputy Prime Minister of Uzbekistan. In addition, while the state's shareholding in Uzbektelekom (UT) appears to have been formally transferred to the State Property Committee (GKI), CIAU still participates to a certain degree in the management and operations of UT (and presumably its subsidiaries) through the UT management and/or supervisory board. Participation of a direct arm of government in strategic policy formulation, regulatory function and shareholder responsibility impacts upon independence and impartiality and has the potential to give rise to actual or perceived conflict of interest within the sector. This conflict is accordingly of significant concern and its resolution would do much add to the development of the sector and enhance investor confidence.

Whilst tariffs on basic telephony services are regulated, little progress has been made with respect to the implementation of a modern and comprehensive tariff policy or tariff setting mechanism. The Ministry for Finance and the Anti-Monopoly Committee participate in the tariff setting process by virtue of the status of telecommunications as a natural monopoly in Uzbekistan. A programme of tariff increases for local telephony is being carried out though there seems to be little apparent movement to decrease the generally artificially high international call rates. The profitable areas in UT are currently being used to subsidise the uneconomic areas and no serious activity to rebalance tariffs within the sector in Uzbekistan appears evident.

CIAU indicates that all telecommunications markets with the exception of international voice services were liberalised at the beginning of 2002. UT currently holds a five-year monopoly on international voice services, expiring in February 2007.

Whilst there is a modern and relatively internationally consistent licensing policy in place, the implementation of recent initiatives in this area appears to have lapsed somewhat and the practice does not necessarily mirror the rule.

The framework telecommunications law currently provides a relatively traditional definition of universal services. CIAU is responsible for designation of the universal service provider (currently UT) and for establishing a list of required universal services. Because telecommunications is still a natural monopoly in Uzbekistan, approval of the Ministry of Finance and Anti-Monopoly Committee is necessary before this list can be settled. The cost of UT's universal service objective is currently generally met by cross subsidisation from UT's more profitable offerings. Accordingly, further work to elaborate a modern universal policy and regime will be necessary.

There are currently six cellular operators licensed and providing services in Uzbekistan. In addition, UT has been granted a cellular licence and spectrum (450MHz and 1800MHz) has been reserved for allocation to them in the short term. With respect to allocation of spectrum, there is a procedure in place; however, as with the licensing process the current practice seems unduly burdensome with the participation of the Ministry of Defence and other governmental agencies in decisions with respect to solely civilian spectrum. In addition to its own newly granted cellular licence UT also has a shareholding in two competing cellular providers.

LEGAL REFORM PROJECTS

The EBRD is currently considering providing assistance to the authorities to implement a clear, predictable and modern telecommunications regulatory framework likely to attract private investment to enable the overall development of the telecommunications sector. It is intended that this project would address the implementation of the key international standards for the sector in the areas of interconnection, licensing, tariffing and institutional capacity.

ANNEX 3

SELECTED ECONOMIC INDICATORS

ANNEX 3: SELECTED ECONOMIC INDICATORS

Uzbekistan											
	1993	**1994**	**1995**	**1996**	**1997**	**1998**	**1999**	**2000**	**2001**	**2002**	**2003**
									Estimate	*Estimate*	*Projection*
Output and expenditure	*(Percentage change in real terms)*										
GDP	-2.3	-4.2	-0.9	1.6	2.5	4.3	4.3	3.8	4.2	4.2	2.5
Private consumption	na	na	na	na	na	na	na	na	na	na	na
Public consumption	na	na	na	na	na	na	na	na	na	na	na
Gross fixed investment	na	na	na	na	na	na	na	1.0	3.7	3.8	na
Exports of goods and services	na	na	na	na	na	na	na	na	na	na	na
Imports of goods and services	na	na	na	na	na	na	na	na	na	na	na
Industrial gross output	4.1	1.0	0.2	6.3	6.5	5.8	6.1	3.5	7.6	7.6	7.6
Agricultural gross output	1.3	2.2	2.3	-6.5	5.8	4.0	5.9	3.2	6.0	6.0	6.0
Employment	*(Percentage change)*										
Labour force (end-year)	-20.4	-1.4	3.7	1.4	1.4	1.4	1.0	1.1	1.6	na	na
Employment (end year)	-0.1	-1.3	3.7	1.3	1.4	1.4	1.0	1.1	1.5	2.4	na
	(In per cent of labour force)										
Unemployment (end-year) 1/	0.3	0.3	0.3	0.3	0.3	0.4	0.4	0.4	0.6	na	na
Prices and wages	*(Percentage change)*										
Consumer prices (annual average)	534	1,568	304.6	54.0	70.9	29.0	29.1	25.0	27.2	27.6	18.4
Consumer prices (end-year)	885	1,281	116.9	64.3	50.0	26.1	26.0	28.2	26.4	22.0	18.4
Producer prices (annual average)	2,545	1,428	499.0	107.0	52.0	48.4	38.0	61.1	42.2	na	na
Producer prices (end-year)	1,919	1,425	217.4	75.4	40.3	48.4	34.5	70.2	42.5	na	na
Gross average monthly earnings in economy (annual average)	1,204	833.3	278.2	92.4	76.2	49.0	33.4	47.4	na	na	na
Government sector 2/	*(In per cent of GDP)*										
General government balance	-18.3	-4.4	-4.1	-7.3	-2.2	-3.3	-2.6	-2.2	-2.3	-0.8	-3.5
General government expenditure	54.2	33.5	38.7	41.6	32.3	34.3	32.0	30.2	na	na	na
General government debt	na	na	na	23.1	26.6	32.9	50.2	60.9	64.8	na	na
Monetary sector	*(Percentage change)*										
Broad money (M3, end-year)	1080.1	725.9	144.3	113.3	45.6	28.1	32.1	37.1	54.3	25.0	15.0
Domestic credit (end-year)	854.4	525.3	80.0	188.8	51.2	79.5	34.5	88.8	90.8	41.1	20.0
	(In per cent of GDP)										
Broad money (M3, end-year)	53.3	34.7	18.2	21.0	17.5	15.4	13.6	12.2	12.6	10.2	9.3
Interest and exchange rates	*(In per cent per annum, end-year)*										
Refinancing rate	na	na	84.0	60.0	48.0	48.0	42.6	42.6	24.0	30.0	30.0
Treasury bill rate (3-month maturity)	na	na	na	36.0	26.0	16.6	na	na	na	na	na
Deposit rate (1 year)	30.0	60.0	90.0	28.0	14.8	13.1	13.5	21.9	21.8	na	na
Lending rate (1 year)	na	100.0	105.0	49.7	28.0	33.1	32.7	25.8	26.2	na	na
	(Soms per US dollar)										
Exchange rate (end-year) 3/	1	28.0	39.3	65.7	108.5	178.7	348.4	631.3	937.6	935.3	1228.6
Exchange rate (annual average) 3/	1.0	11.4	33.0	44.7	90.7	131.8	257.2	483.5	774.8	947.5	1143.9
External sector	*(In millions of US dollars)*										
Current account	-429	120	-21	-979	-584	-101	-163	182	-110	222	140
Trade balance	-378	214	237	-706	-72	111	203	494	276	323	500
Merchandise exports	2,877	2,940	3,475	3,534	3,695	3,049	2,790	2,935	2,755	2,510	2,700
Merchandise imports	3,255	2,726	3,238	4,240	3,767	2,938	2,587	2,441	2,479	2,187	2,200
Foreign direct investment, net	48	73	-24	90	167	140	121	75	83	65	70
Gross reserves (end-year), excluding gold	856	676	815	772	374	533	763	684	800	801	802
External debt stock	1,126	1,385	2,004	2,357	2,864	3,473	4,777	4,419	4,684	4,360	4,300
	(In months of imports of goods and services)										
Gross reserves (end-year), excluding gold 4/	na	na	na	2.0	1.0	1.9	2.9	2.8	2.6	3.0	2.6
	(In per cent of exports of goods and services)										
Debt service	na	na	na	9.2	13.4	10.9	15.9	25.3	25.7	28.5	24.6
Memorandum items	*(Denominations as indicated)*										
Population (annual average, millions)	21.9	22.3	22.7	23.1	23.6	24.0	24.3	24.7	24.9	25.6	26.0
GDP (in millions of soms)	5,113	64,878	302,787	559,072	976,830	1,416,157	2,128,659	3,255,567	4,868,413	7,469,300	9,446,473
GDP per capita (in US dollars)	234.0	255.4	404.4	541.0	457.1	448.6	340.5	273.2	252.0	308.4	317.8
Share of industry in GDP (in per cent)	22.3	17.0	17.1	17.8	15.6	14.9	14.3	14.2	14.2	na	na
Share of agriculture in GDP (in per cent)	27.8	34.5	28.1	22.4	28.3	26.8	29.0	30.1	30.2	na	na
Current account/GDP (in per cent)	-8.4	2.1	-0.2	-7.8	-5.4	-0.9	-2.0	2.7	-1.8	2.8	1.7
External Debt - Reserves, in US$ millions	270	709	1,189	1,585	2,490	2,940	4,014	3,735	4,006	na	na
External Debt/GDP (in per cent)	22.0	24.3	21.8	18.8	26.6	32.3	57.7	65.6	74.5	55.3	52.1
External Debt/Exports of goods and services (in per cent) / 5	na	na	na	60.9	72.1	102.4	149.1	128.3	140.8	na	na

Note: Data for 1993-00 represent official estimates of outturns as reflected in publications from the national authorities, the International Monetary Fund, the World Bank, the OECD. Data for 2001-2002 reflect EBRD evaluations, partly based on information from these sources.

1/ Officially registered unemployment. No labour force survey based estimates available.

2/ Includes extrabudgetary funds but excludes local government.

3/ Roubles per US dollar until 1993.Since 1996, dual exchange rates are in operation. Data show the weighted average of the official exchange rate (40%), the bank rate (30%) and the parallel market rate (30%). Starting from 2001 the weights have changed to official rate (20%), OTC rate (50%) and black market rate (30%).

4/ As a share of merchandise imports only for the year 1993.

5/ Figures 1993 refer to exports of goods only.

Prepared by Martin Raiser (ext. 7231)

ANNEX 4

PORTFOLIO STATISTICS

ANNEX 4-1: UZBEKISTAN: BANK'S ANNUAL BUSINESS VOLUME

(EUR million)

	1991-1994	1995	1996	1997	1998	1999	2000	2001	2002
Non-Sovereign	43.0	55.0	72.4	0.0	25.5	91.8	57.0	13.0	25
Loans	43.0	54.6	47.5	0.0	25.5	86.0	57.0	13.0	22
Equity	0.0	0.5	24.9	0.0	0.0	5.0	0.0	0.0	3
Sovereign	49.0	0.0	0.0	150.2	3.4	39.8	0.0	93.8	9
Private Sector Share (%)	100%	43%	100%	0%	13%	70%	100%	12%	100%
Non-Sovereign Share (%)	47%	100%	100%	0%	88%	70%	100%	12%	74%
Equity (%)	0%	1%	34%	0%	0%	4%	0%	0%	26%
Financial Institutions	49.0	31.7	41.1	0.0	12.4	86.0	25.0	13.0	33.0
Industry and Commerce	43.0	23.4	0.0	81.5	0.0	0.0	32.0	0.0	1.0
Infrastructure	0.0	0.0	0.0	68.7	16.5	39.8	0.0	93.8	0.0
Annual Business Volume	**92**	**55.0**	**72.4**	**150.2**	**28.9**	**131.6**	**57.0**	**106.8**	**34.0**

ANNEX 4-2: BANK OPERATIONS IN UZBEKISTAN

(A) SIGNED PROJECTS

(31/12/2002) EUR million

Name of Project	Signing Date	EBRD Finance
Zarafshan-Newmont Joint Venture	16/11/93	52.8
Uzbekistan SME Credit Line I - NBU	23/11/93	60.4
Zarafshan-Newmont JV Additional Facility	26/04/95	20.1
Uzbek Leasing International AO (equity)	28/08/95	0.5
Sergily Building Materials	05/03/96	9.7
ABN-AMRO Bank Uzbekistan (equity)	12/06/96	0.9
Kasansay-Tekmen Wool Products	18/07/96	23.1
Uzbekistan SME Credit Line II - Asaka Bank	17/12/96	30.2
Uzbekistan SME Credit Line II - NBU	17/12/96	60.4
UzDaewoo Bank Equity Investment	17/12/96	5.0
Fergana Refinery Rehabilitation	20/01/97	87.3
Syrdariya Power Plant Rehabilitation	05/11/97	28.0
Tashkent Airport Rehabilitation	18/12/97	36.2
Tashkent Solid Waste Management Rehabilitation	16/12/98	19.3
Regional TFP: Asaka Bank	22/06/99	3.5
Regional TFP: NBU (Guarantee & Pre-export)	22/06/99	18.8
Regional TFP: UzDaewoo	22/06/99	0.0
Kasansay-Tekmen Wool Products 2	17/09/99	5.4
Uzbek Railways Freight Traction Renewal & Management Project Direct	01/12/99	40.2
Uzbekistan SME Credit Line II - UzPromstroy Bank	01/12/99	15.1
Uzbek Leasing International Capital Increase	15/06/00	0.3
Uzbekistan SME Credit Line II - Pakhta Bank	14/12/00	15.1
Zarafshan Newmont Joint Venture- Third facility	14/12/00	15.1
Andijan District Heating Improvement and Reform	12/11/01	15.1
Locomotive Re-Powering Project	12/11/01	68.4
DIF - SealMag	28/06/02	0.6
J-USBP - Hamkor Bank	02/09/02	2.0
J-USBP - Pakhta Bank	02/09/02	7.0
Uzbek Leasing	30/12/02	2.0
TOTAL		**642.4**

ANNEX 5

BILATERAL ASSISTANCE

ANNEX 5: BILATERAL ASSISTANCE[19]

Canada

Funding for Canadian co-operation efforts with Uzbekistan is provided through the Canadian International Development Agency's (CIDA) Programme of Co-operation with Central and Eastern Europe. Uzbekistan, supported through a budget covering all eight Central Asia and Caucasus countries, receives a share of the annual C$ 4 to 6 million of bilateral funds for this group. This is supplemented with additional funding through CIDA's regional programming.

Priority sectors have included technical training, governance and water resources management. Notably, CIDA funds a five year $ 1.8 million dollar project with the Interstate Coordination Water Commission (ICWC) to promote good governance and environmental sustainability in the Aral Sea basin through the development of a water resources training network.

CIDA also finances a C$ 4 million Caspian Basin Greenhouse Gas Emissions Reduction Training Program with the goal of developing the management and operational capacity within key sectors to identify and develop greenhouse gas emission reduction projects that would meet the rules of, and could be funded under, the Kyoto Protocol's Clean Development Mechanism or Joint Implementation. Eligible countries are Uzbekistan, Azerbaijan, Kazakhstan, and Turkmenistan.

The Canadian government is currently undertaking a review of programming priorities for the region expected to be completed by mid 2003.

European Union

The European Commission adopted on 30 October 2002 a new strategy for Central Asia for the period 2002-2006. It includes a new Tacis (grant money for technical assistance) indicative programme for the period 2002-2004 with a total budget amounting € 150 million for the three years. Uzbekistan is part of this new strategy and will receive its share of this budget.

The European Commission approach put emphasis :
- on regional co-operation and national problems in their regional context (intra-regional trade , customs, drugs, energy, transport ,water);
- on issues that have come up after 9/11/01 border management, customs, but also drugs
- on poverty reduction to eliminate breeding ground for terrorism and to be focussed on certain target areas with a long term horizon (up to ten years).

The EU's co-operation objectives with Uzbekistan are based on the Partnership and Co-operation Agreement (PCA) with Uzbekistan which entered into force on 1/7/1999. Overall aim of the new EC assistance strategy will be to promote the stability and security of the countries of Central Asia, in particular through enhanced co-operation among neighbouring countries, and to assist in their pursuit of sustainable economic development and poverty reduction.

Objectives pursued will be to:

[19] Information was provided by the relevant authorities.

- promote conflict prevention.

- eliminate sources of political and social tension.

- improve the climate for trade and investment.

These objectives are to be pursued through three ‘tracks’ for Tacis assistance:

- **a regional co-operation programme** designed to promote good neighbourly relations and concerted work between the Central Asian countries using a pragmatic, ‘variable geometry’ format in areas where the EU has a strategic interest. These include transport and energy networks, sustainable use of natural resources (water, Kyoto Mechanisms) and implementation of international environmental conventions, justice and home affairs (border services, drugs). This track represents one third of the total budget.
- **a regional support programme, implemented at national level,** addresses the main common challenges to sustainable economic development and poverty reduction. It will focus on facilitating investment and trade through PCA implementation, facilitate WTO accession, statistics, and improved customs and border management, as well as reform of the education sector, particularly higher (general, professional and technical) education. For this track Uzbekistan will receive €29 million for the period 2002-2004.
- **pilot poverty reduction schemes** in target regions, focusing on long term poverty alleviation, community driven rural development, centred on the most vulnerable groups. The Autonomous Republic of Karakapalstan in Uzbekistan is provisionally a target area. Twenty per cent of the total budget is allocated to this track.

France

French Bilateral aid was EUR 4.56 million in 2000 and EUR 4.17 million in 2001.

Germany

Germany has committed EUR 154.7 million in Financial Co-operation mostly through KfW in the form of loans on IDA conditions and EUR 39.3 million in Technical Co-operation mostly through GTZ as grants. The future co-operation has to focus on the priority area, 'economic reforms and establishing a market economy' (in particular the financial system, promotion of small and medium sized enterprises (SME) as well as vocational training). Moreover the German government is prepared to support the envisaged Financial Co-operation projects 'Cargo Terminal Tashkent' and 'Electrification of the railway line between Tashkent and Angren'.

In the framework of ongoing Technical Co-operation projects, priority areas are the improvement of the living conditions of the people around the Aral Sea (Karakalpakstan) and assistance to vocational training. Projects in the health sector will be continued within the framework of regional co-operation.

Japan

Japan commenced bilateral assistance to Uzbekistan in 1991. Total ODA disbursements reached US$ 394.6 million at the end of 2000. This consisted of US$ 289.1 million (73 per cent) of loans, US$ 65.2 million of grant funds (17 per cent) and US$ 40.0 million of technical assistance (10 per cent).

The largest projects financed by Japanese loans were the Modernisation Project of Three Regional Airports (a total of JPY 18.4 billion committed in 1996 and 1999) and the Regional Communications Network Expansion Project (Phase II, JPY 12.7 billion committed in 1999).

In 2000, grant assistance was committed to the Tashkent Textiles Light Industry University (JPY 440 million), for the Food Production Capacity Enhancement Project (JPY 550 million), for the Human Resources Development Project (JPY 242 million) and other projects.

The priority areas of Japanese assistance are currently (i) transition to a market economy, (ii) infrastructure development and (iii) mitigating hardship in the social sector.

Spain

Spain has committed so far bilateral aid in excess of € 13,4 million, focused on health and water treatment sectors.

Switzerland

Based on the bilateral framework agreement on technical, financial and humanitarian co-operation signed in 2002 and the Regional Program Central Asia 2002-2006, the State Secretariat for Economic Affairs (**seco**) and the Swiss Development Co-operation (SDC) are both engaged in co-operation with Uzbekistan. Including regional activities covering Uzbekistan, funds amount to US$ 6-10 million per year and cover natural resources management, infrastructure, private sector development as well as macroeconomic policy and conflict prevention. They involve government partners on various levels as well as non-government partners.

A special priority is given to **infrastructure development** and **natural resources management**. US$ 9 million have been granted to co-finance a World Bank project to refurbish and improve the management of water supply networks in Buchara & Samarkand. US$ 7 million have been granted for the municipal water sanitation services in Nukus and a regional hydro-meteorological project based in Tashkent. Switzerland will also co-finance the EBRD District Heating Rehabilitation Project in Andijan with US$ 4.3 million.

Switzerland has also been supporting the **economic development** of Uzbekistan by financing credit guarantees and project preparation through the Public-Private Infrastructure Advisory Facility (PPIAF) as well as regional training and advisory programmes on the customs administration and international economic relations.

With respect to **private sector development**, Switzerland is currently supporting Uzbek SMEs through technical assistance projects and finance. In the past two years Switzerland funded a comprehensive survey of the Uzbek SMEs, developed a training programme for local consultants, and supported the development of the leasing industry. **seco** is also a shareholder of a private equity fund investing in Uzbekistan. As for the EBRD projects, Switzerland is contributing to the Central Asia Risk Sharing Support Fund (CARSSF) through its participation in the Trade Facilitation Programme. Further, **seco** is currently considering a contribution to the EBRD/BAS programme in Uzbekistan.

With regard to **macroeconomic policy**, **seco** has financed a regional technical assistance project in public debt management for Uzbekistan. The project aims at assisting the Uzbek government to improve the management of external debt and to strengthen the legal and institutional framework for public debt as warranted.

Turkey

According to the governmental protocol in 1992, Turk Eximbank allocated a credit line of US$ 250 million for Uzbekistan. In 1993, US$ 125 million of this line was fully utilised for the export of Turkish goods. The remaining amount of US$ 125 million was allocated to three big projects: the first and second phases of 'Construction of International Trade and Exhibition Centre' and the 'Sugar Factory' projects.

As a result of an excellent repayment record of Uzbekistan, an additional US$ 125 million was extended in 1995 with the second governmental protocol. Under this line, so far three projects have been financed: 'Integrated Woollen Products' project of Kasansay-Tekmen by means of a parallel financing with EBRD, 'Plant of Production of Midibuses, Trailers and Semi-Trailers' project, and a transportation project financed by IDB backed by Turk Eximbank. Both lines required the sovereign guarantee of the Uzbek Government. As a whole, disbursements have reached US$ 347 million.

Apart from those two governmental protocols, Turk Eximbank extended a total amount of approximately US$ 44 million credit to the National Bank of Uzbekistan for four projects -renovation of three hotels and an exhibition centre- in Uzbekistan in 2002. The hotel projects in question are aimed at satisfying the accommodation needs which will arise during the prospective EBRD Annual Meeting in 2003. Currently, the Loan Agreements for two of those projects have come into force.

As for the future work, Turk Eximbank will continue to take into evaluation the applications of Uzbek side on project basis.

United Kingdom

DFID Bilateral assistance to Uzbekistan was GBP 362,000 in 2001/2002 and is expected to be around GBP 660,000 in 2002/03. Since 1998 DFID have been providing technical assistance - of upto GBP 1.2 million by 2003 - in support of a World Bank Health Care Development loan. Uzbekistan is also benefiting from a DFID regional project on the institutional strengthening of civil society groups in Central Asia.

United States

Between 1992 and 2001 the United States allocated approximately US$ 286.18 million to programmes in Uzbekistan. In 2002 there was a one-time tripling of USG assistance to approximately US$ 160 million, following the 9/11 attack in 2001 and the war in Afghanistan. Priority has been given to training and exchange programmes that target Uzbekistan’s next generation of leaders. The United States support is also directed towards building the capacity of non-governmental organisations through a system of training and small grants, in addition to continued support for security and improved health care programmes.

USAID funds have focused on support to small business, democracy and governance, energy and environment and social sector reform. USAID is moving away from support for economic reform at the national level to private enterprise development. USAID is currently supporting fiscal and banking sector reform programmes as well as those to back WTO accession, an independent media, and participation in environmental conventions.

ANNEX 6

TC PROGRAMMES WITH BILATERAL ASSISTANCE

ANNEX 6-1: TC PROGRAMMES APPROVED WITH BILATERAL ASSISTANCE

Commitment Number	Fund Approved Date	Commitment Name	Sector Name	Euro Committed	Euro Disbursed
AUS-1999-06-02	07/06/99	Turnaround Management Programme - Fargana Yog Moi	Manufacturing	41,252	41,252
CA3F-2002-08-05	09/08/02	Andijan District Heating: Legal Services to prepare a MSA contract	Finance, Business	75,870	0
CA3F-2002-08-06	09/08/02	Andijan District Heating: Legal Services to prepare a MSA contract	Finance, Business	186,925	0
CAN-1995-08-10	02/08/95	Regulations for law on subsoil	Community/Social Services	36,223	36,223
DEN-1999-10-04	19/10/99	TurnAround Management Programme (TAM) - Tashkent Strojmaterialy	Manufacturing	42,982	42,982
EC-1993-07-27	20/07/93	Project preparation unit	Manufacturing	747,432	747,432
ECT2000-2002-06-02	27/06/02	Uzbek Railways: Implementation Assistance & Fleet Management - extension	Transport, Storage	277,159	100,194
ECT96-96-11-17	22/11/96	Post-privatisation Fund - fund manager	Manufacturing	999,817	999,817
ECT97-97-05-18	22/05/97	Post-privatisation Fund - ABN AMRO fund manager contract	Manufacturing	260,390	260,390
ECT98-2000-11-75	29/11/00	Uzbek Railways - Implementation Assistance & Fleet Management Study	Transport, Storage	14,897	14,897
ECT98-98-12-47	02/12/98	Tashkent Solid Waste Management Rehabilitation Programme - Management Support	Energy	722,167	722,167
ECT99-2000-09-72	29/09/00	Tashkent Solid Waste Management Rehabilitation Programme - Support for Municipality	Energy	41,672	41,672
ECT99-99-08-05	20/08/99	Uzbek railways - implementation assistance and fleet management	Transport, Storage	748,655	748,655
FRB-1993-03-04	05/03/93	Optimisation study of petroleum products distribution system	Manufacturing	46,193	46,193
GER-1993-05-04	12/05/93	Preparation of energy savings and efficiency project	Energy	177,337	177,337
GERK-1999-02-01	26/02/99	TurnAround Management Programme - Sankurtamirlash	Manufacturing	19,673	19,673
GERK-2000-08-07	01/08/00	TurnAround Management Programme (TAM) - Pod'emnik	Manufacturing	16,301	16,301
HOL-2002-04-02	16/04/02	Tashkent Solid Waste Management Rehabilitation Programme	Energy	33,985	0
JAP-1993-03-07	01/03/93	SME sector development - demand assessment and business plan preparation	Finance, Business	43,380	43,380
JAP-1993-10-51	17/11/93	National Bank financial facility for SME development - implementation support	Finance, Business	928,690	928,690
JAP-1994-06-23	01/06/94	Fergana refinery rehabilitation	Extractive Industries	438,319	438,319
JAP-1995-03-10	01/03/95	Procurement advisory services	Energy	246,772	246,772
JAP-1995-04-12	01/04/95	Preparation of Fergana refinery rehabilitation project - studies	Manufacturing	336,654	336,654
JAP-1995-04-13	01/04/95	Preparation of Fergana refinery rehabilitation project - project consultant	Manufacturing	222,814	222,814
JAP-1995-10-28	01/10/95	Financial facilities for SME development (Phase II)	Finance, Business	216,623	216,623
JAP-1997-04-10	03/04/97	Regional Bank Training Centre, Tashkent	Community/Social Services	685,529	685,529
JAP-1997-06-12	17/06/97	Development of commercial management system - Uzbekneftegas	Extractive Industries	350,000	350,000

Commitment Number	Fund Approved Date	Commitment Name	Sector Name	Euro Committed	Euro Disbursed
JAP-1998-07-23	29/07/98	Syrdarinskaya Thermal Power Rehabilitation Project Electricity tariff and collection mechanism	Energy	300,000	0
JAP-1998-07-24	29/07/98	Syrdarinskaya Power Plant - Development of accounting system	Energy	390,000	0
JAP-1998-12-35F	30/12/98	Japan-Uzbekistan Small Business Programme - Pilot	Finance, Business	4,800,645	895,139
JAP-1999-03-06	31/03/99	Tashkent solid waste management (ear-marked portion)	Energy	48,124	48,124
JAP-1999-03-07	31/03/99	Tashkent solid waste management - project management support (ear-marked portion)	Energy	510,861	425,231
JAP-2000-11-25	29/11/00	Tashkent Solid Waste Management Rehabilitation Programme - Landfill Engineering and Operations	Energy	509,970	431,088
JAP-2001-03-04	21/03/01	Uzbekistan leasing law project	Community/Social Services	59,264	59,264
JAP-2001-05-09	04/05/01	Tashkent solid waste management - project management support (ear-marked portion)	Energy	82,800	40,120
JAP-2002-04-01	16/04/02	Uzbek Railways (UTY) Assistance with Implementation of Railway Restructuring	Transport, Storage	1,000,000	0
JAP-2002-05-04	29/05/02	Andijan District Heating Management Contractor	Finance, Business	1,431,161	0
JAP-2002-10-13	22/10/02	Uzbekistan Asaka Bank Pre Privatisation Restructuring - Phase 1A Audit	Finance, Business	195,437	0
JAP-2002-10-14	22/10/02	Uzbekistan/Asaka Pre Privatisation Restructuring Phase 1B	Finance, Business	429,051	0
LUX-1998-12-02	15/12/98	TurnAround Management Programme - Pod'emnik	Manufacturing	29,343	29,343
SPA-1993-09-01	08/09/93	Project evaluation system for line of credit to SME's	Finance, Business	138,754	138,754
SWEF-2002-07-02	30/07/02	Tashkent DH Rehabilitation and Reform	Energy	199,300	0
SWI-1993-03-01	13/03/93	Cotton processing feasibility study	Manufacturing	442,793	442,793
SWI-1993-07-02	15/07/92	Seminar on the legal and democratic aspects of transition	Community/Social Services	11,733	11,733
TAI-1994-12-04	01/12/94	Regional Bank Training Centre, Tashkent (NB - untied)	Community/Social Services	22,748	22,748
TCS-2002-12-05	20/12/02	Identification of Agribusiness Investment Opportunities	Manufacturing	28,623	0
TUR-1993-02-01	25/05/93	SME sector development - demand assessment and business plan preparation	Finance, Business	32,626	32,626
UKB-1995-05-07	05/05/95	Preparation of Fergana - due diligence of borrower	Manufacturing	94,714	94,714
UKD-1999-10-25	19/10/99	TurnAround Management Programme (TAM) - Tashkent Strojmaterialy	Manufacturing	33,020	33,020
UKPF-2002-08-01	05/08/02	Andijan District Heating Tariff & Subsidy Reform Study	Finance, Business	120,000	0
USTD-1993-05-02	30/04/93	Kokdumalak oil field development project	Extractive Industries	64,060	64,060
USTD-1994-03-02	13/06/94	Digital overlay network	Telecommunications	40,007	40,007
USTD-1994-09-03	01/09/94	Digital Overlay Network joint venture (Phase II) - financial and legal advice	Telecommunications	162,167	162,167
WAL-1999-01-02	25/01/99	TurnAround Management Programme - Pod'emnik	Manufacturing	14,619	14,619
WAL-1999-03-03	03/03/99	TUrnAround Management Programme - Sankurtamirlash	Manufacturing	12,747	12,747
WAL-1999-05-05	21/05/99	TurnAround Management Programme - Fargana Yogi Moi	Manufacturing	13,833	13,833
WAL-1999-07-06	09/07/99	Turnaround Management Programme - Tashkent Strojmaterialy	Manufacturing	12,566	12,566