Research Reports and Briefs

Reports

Market Reforms and Macroeconomic Performance in Uzbekistan

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Introduction

This report summarizes some of the preliminary results of an ongoing large-scale research project aimed at assessing the impact of market reforms on macroeconomic performance in Uzbekistan. The project is sponsored by the Center for International Trade and Economic Research (CITER) at Central Michigan University. In designing the project I collaborated with several Uzbek economists, the Uzbekistan Banking Association, and the Center for Economic Research (CER) in Tashkent. Given the confines of this report, I focus here on two major areas of the project: structural adjustment/ privatization programs, and exchange rate dynamics in Uzbekistan. In order to provide a macroeconomic context for the research results however, it is necessary to briefly review the major economic trends in Uzbekistan.

Transitional Dynamics and the Uzbek Economy

After the demise of the Soviet Union Uzbekistan experienced difficulties common to the other new republics: the breakdown of central planning and interrepublican trade, highly monopolistic market structures, and high price inflation coupled with declining output and the loss of significant budgetary transfers. Moreover, in the early 1990s the Uzbek economy faced a serious deterioration in its terms of trade due to declining world prices of its two major export items, gold and cotton. The Uzbek government adopted a rather cautious and gradualist approach to market reforms by partially liberalizing prices, imposing new taxes, and enacting new laws on banking, property, and foreign investment, and also by privatizing some small enterprises and residential buildings.

Uzbekistan remained in the ruble zone for a while after the collapse of the Soviet Union. In November 1993, however, it was compelled to issue its own national currency, the *so'm* coupon, and in July 1994 a new currency, the so'm, replaced the so'm coupon. Yet due largely to the lack of a well-coordinated and comprehensive reform program, the implemented policies failed to stabilize the economy. High inflation in 1993 and 1994 and the freezing of bank deposits during the currency conversion created a confidence crisis in the Uzbek financial system (World Bank 1997).

On the foreign trade front, Uzbekistan continued to rely largely on cotton, gold and uranium exports and developed strong ties with Korea, Germany, Turkey and the USA. Because of the nature of these export items however, Uzbekistan's terms of trade have been subject to external shocks that tended to contribute to macroeconomic instability. The trade surplus of 1995 (estimated to be around $216 million) turned into a deficit of $348 million in 1996 due to low world cotton prices coupled with a poor grain harvest, which necessitated the import of grain at unusually high world prices.

Between 1997 and 1999 real GDP (gross domestic product) in Uzbekistan gradually increased from nearly $15 billion to $17 billion. Since 1999 the dollar value of output exhibited a steep decline, which pushed the real GDP below $9 billion in 2002. Concomitantly, real GDP per capita fell precipitously from $694 to $305. It should be noted that these figures reflect the rapid depreciation of the so'm vis-à-vis the US dollar and should therefore be interpreted with caution. Price inflation, on the other hand, has remained under control since 1995 and declined to 22 percent in 2002. A more alarming development has been the rising foreign debt, which reached \$4.7 billion in 2002, and the lack of sustained foreign direct investment (FDI). FDI in Uzbekistan varied between \$150 million and \$75 million over the past five years and per capita FDI remains among the lowest in the CIS countries. Meanwhile the Uzbek so'm depreciated rapidly to over 800 so'm per \$1 in 2002 (in terms of the official exchange rate of the Central Bank) from an average rate of 66 so'm per \$1 in 1997.

Structural Adjustment and Privatization Programs: Political Risk and State Power

Given the particularities of the Uzbek economy, the rejection of a fast-track reform program was the correct economic policy to be adopted in the face of the initial shocks of the Soviet debacle (Çeçen 1999). The 1990s witnessed the tragic results of these "shock therapy" programs in several ex-Soviet and East European economies where output declined precipitously, pushing large sections of wage earners below the poverty line. Since the Uzbek economy was highly specialized and heavily dependent on cotton monoculture, social instability would have erupted had rapid adjustments been introduced in rural areas where a large proportion of the population lived under the official poverty line. In fact, during the period of 1991-1997, due partly to these gradualist policies, output in Uzbekistan fell less than in any other republic of the former Soviet Union, and moderate growth has resumed since 1997.

Yet, while the preservation of state power and the public sector were a *sine qua non* for a less painful transition, the subsequent transformation of the industrial sector was equally crucial for economic growth. More specifically, once price inflation was put under control and a functioning financial sector emerged (in 1995-1996), the Uzbek government should have concentrated its efforts to rationalize its public sector, modernize its bureaucracy and the legal infrastructure, and limit the power of industrial monopolies in order to foster market competition and attract foreign investment.

In this context our empirical analyses highlight a number of important points. First, the monopolistic structure of the industrial sector has hardly been affected by market reforms; the market concentration ratios remain very high. This is not to say that the Uzbek government should have committed itself to a fast-track *nomenklatura* privatization (as was done in the Russian Federation). It would have been sufficient to break up some key industries into more autonomous smaller units and then to privatize these in order to foster more competitive pricing. Accumulated evidence demonstrates that transparent privatization of some medium-size industries, whereby the state surrenders management to private stakeholders, is critical for the success of privatization programs. Generally speaking, the marketing of minority shares does not induce much demand, particularly in developing economies with underdeveloped capital markets. The so-called "mass privatization" in Uzbekistan, however, involved for the most part partial privatization, and as expected, did not have much impact on the structure of the industrial sector.

Another constraint on privatization has indeed been the lack of private capital. Our econometric results demonstrate that foreign investment was strongly targeted in the privatization programs of medium- and large-size enterprises. Yet foreign investment remained low for two main reasons. First, wars and political violence in the region prevented foreign firms from committing large funds to privatization programs in Uzbekistan, a factor that is largely beyond the immediate control of the government. Second, the lack of currency convertibility and the existence of inefficient foreign exchange controls hindered the emergence of a strong export sector (Agafonoff and Sirojiddinov 1996).

Given the limited size of domestic markets and the low purchasing power of consumers, export-orientation should be regarded as the main engine of economic growth in Uzbekistan. Without fast growth, neither hidden unemployment in many sectors of the Uzbek economy nor stagnant wages can be remedied. Recently the Uzbek government attempted to eliminate the gap between the official exchange rate and the free market rate. This is a positive step in the right direction but the assumption that the current free market rate is necessarily the "fundamental equilibrium exchange rate" is theoretically incorrect. Hence, it can be argued that the exchange rate policies have been responsible for the deterioration of the current accounts and the rapid rise of foreign debt in Uzbekistan.

It is important to underline here that during the last decade "hot money" and capital flight have destabilized several developing economies and induced severe financial crises. Hence concerns on the part of government authorities over the viability of capital accounts are understandable. However, financial liberalization in the form of partial capital controls may be implemented more effectively to limit the effects of capital outflows. A complex and somewhat arbitrary regulatory system distorts relative prices and causes large welfare losses. It also induces corruption and nepotism. By distorting relative prices, the existing system discriminates against the investment goods sector. It also contributes to price inflation in domestic markets by transmitting the monopoly rents of some importers to consumer goods. In fact regression results on the determinants of price inflation reveal that the monopoly prices of the investment goods sector explain much of the variation in consumer prices.

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C. P. Skrine in Kashgaria

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From mid-1922 through the end of summer 1924, Clarmont P. Skrine served as British Consul in Kashgar (Qashghar/Kashi), Xinjiang. The appointment was somewhat accidental. As a member of the Indian civil service, he was really a Persian specialist. The consul in Kashgar, Percy T. Etherton, was going on leave, and a temporary replacement was needed. When Etherton did not return, Skrine's one year stretched into two. On returning home, Skrine drew upon his letters and diaries to publish articles (Skrine 1925a, 1925b) and what is still a very valuable book on Kashgaria, *Chinese Central Asia* (Skrine 1926).[1] He continued his career in the Indian civil service, his most important activity being in Iran in the 1940s, and after retirement wrote two more books, one surveying the activity of the first British Consul in Kashgar, the redoubtable George Macartney (Skrine and Nightingale 1973). Skrine's career has been examined in a solid biography based principally on his papers (Stewart 1989).

My first acquaintance with Skrine was as an undergraduate, when his book on Kashgaria was recommended to me. I became seriously interested in him when heading off to the mountains south of Kashgar in the mid-1990s. Skrine's explorations and mapping there were essential preparation for that trip; in fact I used his map of the "Kongur Alps" for navigation in areas rarely visited by outsiders since Skrine was there (Waugh 1998, 1999). The next step was to study the archive of Skrine's unpublished letters and notes. Of particular interest are his field dairy and letters, written weekly to his mother from Kashgar, in which he would go on, often at great length, about life at the consulate, his travels, the local officials and politics. Fortunately for us, his mother saved everything. Alas, only scraps of the voluminous correspondence of Skrine's wife, Doris (who was with him in Kashgar), seem to have been preserved.

My project is to publish for a general readership an edited selection of Skrine's letters and other materials from Kashgar. The letters are fresh and lively. He was a good observer, although naturally he had his "orientalist" biases. He also took photography seriously, and left behind some quite remarkable photographs of landscape and people. My book will include a generous selection of his

[1] There are several later editions which tend to omit the fold-out photographic panoramas of the original.