

SECTOR ASSESSMENT (SUMMARY): MULTISECTOR

Sector Road Map

1. Sector Performance, Problems, and Opportunities

1. **Public financial management.** Uzbekistan's latest public expenditure and financial accountability assessment was conducted in 2012, although it was not made public. The assessment rated public financial management well for (i) budget credibility, (ii) comprehensiveness, (iii) effectiveness in collection of taxes, (iv) predictability in the availability of funds for commitment of expenditures, (v) timeliness and regularity of accounts reconciliation, and (vi) availability of information on resources received by service delivery units. However, the assessment indicated a number of shortcomings in relation to public financial management: (i) relatively weak oversight of aggregate fiscal risk from several public sector entities; (ii) lack of public access to key fiscal information; (iii) lack of a medium-term fiscal framework to ensure a multiyear perspective in fiscal planning and budgeting;¹ (iv) lack of competition, value for money, and controls in procurement; (v) weak management of fiscal risks related to public sector enterprises, including weak control of payroll and non-payroll expenditures, poor quality and timeliness in preparing financial statements and audits, poor legislative scrutiny and lack of follow-up of external audits, and lack of transparency; and (vi) lack of coordination of aid. Uzbekistan's public financial management reforms were conducted under the Public Finance Management Reform Strategy, 2007–2018. The strategy envisaged developing a medium-term budgetary framework, developing a government financial management information system, improving transparency of budget preparation and monitoring, and gradually moving to International Public Sector Accounting Standards. The envisaged activities were only partially completed. While good progress was made in establishing financial management information systems for the treasury and the government, other challenges remain unaddressed. Many extra-budgetary funds were integrated with the treasury system and budget, but this integration was neither complete nor codified in the statutes. The treasury now consolidates cash balances, including extra-budgetary funds, on a daily basis through a treasury single account, except for accounts held for military and internal affairs, the Fund for Reconstruction and Development of Uzbekistan (UFRD), and accounts funded by foreign grants and loans using both domestic and foreign currency bank accounts.² A budget code was approved, and a unified chart of accounts was developed. Some progress was made to enhance competition related to procurement with the launched e-procurement system, but a comprehensive review of procurement laws has not been completed. Similarly, internal audit units have not been introduced in government agencies.

2. Fiscal discipline has not automatically resulted in improved monitoring of the fiscal position because of the lack of explicit long-term government strategic policies at the sector and national levels. The government has exerted total control over planning, which has led to negligence of

¹ Effective budget management requires a medium-term perspective, as a single-year perspective does not provide adequate flexibility to implement a government's development priorities. M. Cangiano, T. Currstine, and M. Lazare, eds. 2013. *Public Financial Management and Its Emerging Architecture*. Washington, DC: IMF. The OECD points to the importance of medium-term budgetary planning, particularly in cases where (i) capital projects with changing operational costs are implemented; (ii) programs come into effect toward the end of the year, and their full annual costs are not materializing in the initial year; and (iii) programs' spending implications are not visible in the given year but would become so in the following years. OECD. 2014. *Budgeting Practices and Procedures in OECD Countries*. Paris.

² On 18 December 2017, the government set up yet another off-budget fund (Fund for Financing State Development Programs) through Resolution No. PP-3437.

local government needs primarily because of the lack of a participatory approach in budget making and allocations for the local governments.

3. Large state-owned enterprises (SOEs) play a key role in all important sectors of the economy and require budgetary support to survive, which leads to a fragile fiscal situation. This was especially apparent during 2017 after the government initiated a comprehensive exchange rate reform, as the table illustrates. Improved performance of SOEs is therefore critical to create fiscal headroom for development expenditure. SOEs are active in key areas of the oil and gas, power generation, chemical, water supply, railway, banking, airline, and cargo industries. Some key SOEs—JSC Uzbekenergo (power generation), JSC Uzbekneftegaz (oil and gas), JSC Uzkimyosanoat (chemical), JSC Uzbekistan Temir Yullari (railway), and Uzbekistan Airways—were hit by the 2017 devaluation of the local currency that resulted from the exchange rate reform and their debt restructured. The lack of good corporate governance (based on international best practices) is a major area of concern affecting the performance and profitability of the SOEs.

Item	2015	2016	2017
Revenue and grant	34.3	32.1	31.6
Expenditure and net lending	35.6	32.7	34.9
Fiscal balance	(1.3)	(0.6)	(3.3)
Public debt	9.2	10.5	24.5

() = negative.

Note: The government's fiscal position includes the balance in the Fund for Reconstruction and Development of Uzbekistan.

Source: International Monetary Fund.

4. **Financial sector.** The basic elements of a market-based financial sector are in place in the country. Total assets of the country's 28 commercial banks increased by 92.0% in nominal terms between April 2017 and April 2018. Total assets reported to be \$21.6 billion by April 2018. At the same time, the total capital of all the commercial banks increased by 138%, during the same period reaching \$2.9 billion. Several banks received additional capital from the government in 2017. The banking sector was stable, as reported by the Central Bank of Uzbekistan (CBU), with financial soundness indicators at check. Regulatory Tier 1 capital to risk-weighted assets reached 16.5% by December 2017, and non-performing loans to total gross loans also remained low at 1.2% by December 2017.³ However, banks will require additional capital in future if lending to private enterprises increases as envisaged. Moreover, due to high concentration of bank loans with SOEs accounting for about 60%, banks' asset quality is fundamentally linked to SOEs' financial performance.

5. Domestic debt and capital markets remain marginal and underdeveloped. Private sector intermediation has yet to assume an important role. There is no active capital market for the issuance of speculative-grade debt by the private sector. The banking sector dominates the financial sector, and the banking system is highly segmented and concentrated. Ten majority state-owned or controlled banks account for over 82.5% of total assets, providing services to major SOEs primarily through directed lending. Private domestic and foreign banks deal with micro, small, and medium-sized enterprises. The state-owned banks are unusually dependent on non-deposit funding, manifesting their role in delivering and administering policy loans. The role of banks as agents for tax collection, government fiscal activities, and direct intervention in the

³ Uzbekistan: Selected Economic Indicators 2015-2019. IMF Press Release No. 18/168. 9 May 2018. (<http://www.imf.org/en/News/Articles/2018/05/09/pr18168-imf-executive-board-concludes-2018-article-iv-consultation-with-the-republic-of-uzbekistan>).

financial management of enterprises was one of the serious obstacles for private sector development. Further, these interventions disincentivize the provision of products and services on commercial terms.

6. The financial soundness indicators were not published until 2018, and they generally present an optimistic view of the past. The legal framework and practices of bank supervision still focus more on regulatory compliance than on risk management. The disclosure and the application of international accounting standards vary among the banks and require implementing emerging best practices in transparency and enforcing market discipline. The government still prefers meeting the unmet demand for credit through providing resources under new government programs. However, the economic viability of these new programs is questionable. Separating policy lending from commercial lending would provide incentives for the mobilization of savings and allow commercial banks to focus on lending on market terms.

7. **Power sector.** A reliable and sustainable energy sector is essential to economic growth and development. Uzbekistan is one of the most energy- and carbon-intensive countries in the world. Uzbekistan's household electrification rate is almost 100%, but its aging infrastructure and insufficient investment have increasingly widened the demand and supply gap and disrupted the supply of electricity, especially in rural areas. The government owns and manages the power sector in Uzbekistan through JSC Uzbekenergo as a state joint-stock company. JSC Uzbekenergo owns and operates an installed capacity of 10,140 megawatts (MW), of which 8,720 MW are thermal power plants and 1,420 MW are hydropower plants. Since 2011, JSC Uzbekenergo has adopted external auditing based on the International Standards on Auditing to enhance transparency. Full consolidation of financial statements based on the International Financial Reporting Standards is underway. In May 2017, as part of restructuring, the joint-stock company Uzbekhydroenergo was founded through a merger of hydro units owned by Uzbekenergo and Uzsuvenergo under the Ministry of Agriculture and Water Resources. This reform aimed for a consistent increase in the use of renewable energy, effective water resources management, and streamlined development of the hydro sector.

8. The exchange rate reform in September 2017 (para. 3) had significant negative impacts on JSC Uzbekenergo's financial position, largely from exceptional losses from revaluated foreign currency borrowings and increased interest expenses. JSC Uzbekenergo launched a financial recovery action plan to ensure financial sustainability, prioritizing (i) revenue increase by developing and implementing a new cost recovery tariff, and (ii) corporate restructuring including divestment. However, further efforts to improve JSC Uzbekenergo's performance are necessary. The utility needs to develop a strategy and build capacity to become more commercially bankable and attract private sector investment in the medium term. It needs to introduce a modern management system including good corporate governance principles and accounting standards. Uzbekistan and JSC Uzbekenergo will benefit from learning and adopting international best practices for tariff determination to improve efficiency and to ensure full cost recovery. Uzbekistan's electricity tariff has been low in absolute terms because of the low domestic cost of natural gas relative to international prices (the domestic gas price is about \$66 per 1,000 cubic meters, which is substantially lower than its export price). This has discouraged demand-side energy efficiency improvements. The government is committed to maintain tariffs at a level that covers operation and maintenance costs and capital cost.

2. Government's Sector Strategy

9. The Strategy of Actions on Further Development of Uzbekistan, 2017–2021 articulates the government's vision of an open and diversified economic structure, led by the private sector, and

improved resilience to macroeconomic shocks.⁴ The strategy recognizes the need to improve public sector management; the banking sector; and the financial performance of SOEs, including key SOEs in the power sector. One of the strategy's three priorities is to modernize the governance system, including greater ownership and transparency of budget process. This will result in a gradual transitioning to program budgeting with medium-term focus.

10. The government also plans to make SOEs regionally competitive and use the market mechanism to distribute resources and manage government assets. The government is committed to converting loss-making SOEs into profit-making entities. It plans to achieve this through restructuring and, for smaller SOEs, outright privatization. There is an ambitious economic reform agenda to stabilize the balance of payments and put the country on a sustainable growth path.

11. The Strategy of Actions on Further Development of Uzbekistan includes key policy reforms to address issues related to access to finance, especially by the private sector. In 2017, a series of government documents were adopted to reform the banking sector and make the CBU more independent.⁵ A systematic review of the entire legal framework applicable to banks was initiated in mid-2017 to identify and address inconsistencies and ambiguities. The government plans to improve banking supervision by moving to a risk-based approach, improving the quality of banks assets, and attracting additional investment.

12. Finally, the government is keen to improve its data analysis and dissemination systems through various initiatives to facilitate improved planning, monitoring, and evaluation of various government programs, including actions related to macroeconomic management. Improved data dissemination is also critical for efficient decision-making by private entrepreneurs.

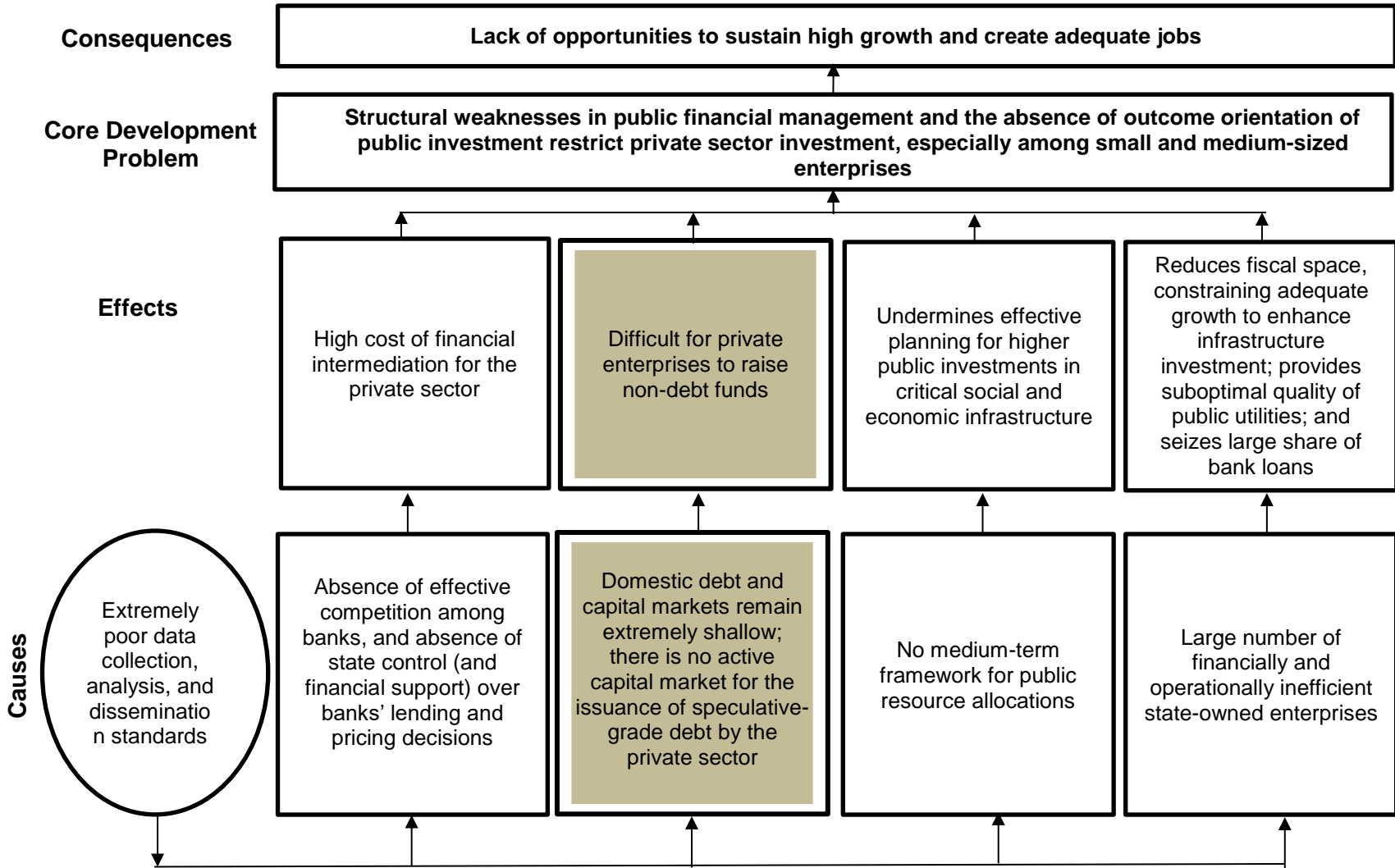
3. Asian Development Bank Sector Experience and Assistance Program

13. The Asian Development Bank (ADB) has gained considerable experience in the country and has a history of working with the country's public finance sector as well as involvement in the banking sector and with small and medium-sized enterprises, horticulture development, and the housing finance and power sectors. The proposed policy-based loan will focus on institutional reforms and support the government's reform agenda. The proposed program aims to support several critical reforms, including (i) adoption of the medium-term budget framework and corporate governance rules, (ii) regular public expenditure and financial accountability assessments, (iii) improved accounting standards and data dissemination systems, and (iv) risk-based banking supervision. The program will complement ADB's interventions in the finance and power sectors and improve future investment opportunities for the private sector. It will also align with lessons learned from completed projects, which suggested having a comprehensive and more coherent approach to developing the country's economy. ADB will coordinate its assistance with the World Bank and the International Monetary Fund to improve economic management and will harmonize its efforts with other international donors and development partners to support the government's reform agenda.

⁴ Government of Uzbekistan. 2017. *Presidential Decree No. 4947: The Strategy of Actions on Further Development of Uzbekistan*. Tashkent.

⁵ Government of Uzbekistan. 2017. *Presidential Decree No. 3270: Measures to Further Develop and Improve the Soundness of the Banking System*. Tashkent; and Government of Uzbekistan. 2017. *Presidential Decree No. 3272: Further Improvement of Monetary Policy*. Tashkent.

Problem Tree for Multisector



Notes:

1. Poor data standards affect core development problem directly as well as indirectly through other causes.
2. The shaded boxes are not covered under the program.