ADB

Concept Paper

Project Number: 51350-001
January 2018

Proposed Programmatic Approach and Policy-Based Loan for Subprogram 1
Republic of Uzbekistan: Economic Management Improvement Program

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Asian Development Bank

CURRENCY EQUIVALENTS
(as of 29 November 2017)

Currency unit	–	sum (SUM)
SUM1.00	=	$0.0001236
$1.00	=	SUM8085.11

ABBREVIATIONS

ADB	–	Asian Development Bank
GDP	–	gross domestic product
SOE	–	state-owned enterprise

NOTE

In this report, "$" refers to United States dollars.

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PROGRAM AT A GLANCE

1. Basic Data			**Project Number:** 51350-001
Project Name	Economic Management Improvement Program (Subprogram 1)	**Department/Division**	CWRD/CWPF
Country	Uzbekistan	**Executing Agency**	Ministry of Finance
Borrower	Republic of Uzbekistan		

2. Sector	**Subsector(s)**	**ADB Financing ($ million)**
✓ **Public sector management**	Public expenditure and fiscal management	250.00
	Total	**250.00**

3. Strategic Agenda	**Subcomponents**	**Climate Change Information**	
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded	Climate Change impact on the Project	Low
Regional integration (RCI)	Pillar 1: Cross-border infrastructure		

4. Drivers of Change	**Components**	**Gender Equity and Mainstreaming**	
Governance and capacity development (GCD)	Institutional development Public financial governance	No gender elements (NGE)	✓
Partnerships (PAR)	Implementation International finance institutions (IFI)		

5. Poverty and SDG Targeting		**Location Impact**	
Geographic Targeting	No	Nation-wide	High
Household Targeting	No		
SDG Targeting	Yes		
SDG Goals	SDG8		

6. Risk Categorization: Complex

7. Safeguard Categorization **Environment:** C **Involuntary Resettlement:** C **Indigenous Peoples:** C

8. Financing

Modality and Sources	**Amount ($ million)**
ADB	**250.00**
Sovereign Programmatic Approach Policy-Based Lending (Regular Loan): Ordinary capital resources	250.00
Cofinancing	**0.00**
None	0.00
Counterpart	**0.00**
None	0.00
Total	**250.00**
Note: An attached technical assistance will be financed on a grant basis by the Technical Assistance Special Fund (TASF-OTHERS) in the amount of $1,000,000.	

I. THE PROPOSAL

1. The proposed economic management improvement program aims to strengthen economic management in Uzbekistan and thus support macroeconomic stability and sustained high growth. Macroeconomic stability, in turn, implies stronger resilience to adverse economic shocks. This is of critical importance in Uzbekistan as the country is pursuing regional integration and economic diversification. The program will introduce important fiscal reforms to ensure fiscal sustainability; improve governance in state-owned enterprises (SOEs) to make their operations financially viable; improve access to bank finance by strengthening bank supervision so as to facilitate competitive financing of private sector operations (especially small and medium enterprises); and strengthen economic data collection, analysis, management, and dissemination systems to bolster economic decision making. The programmatic approach and policy-based loan will finance two subprograms to be implemented during 2018–2019. Attached transaction technical assistance will assist in implementing the program.

II. THE PROGRAM AND RATIONALE

A. Background and Development Constraints

2. Uzbekistan's economic growth has been strong in the past decade[1] and helped reduce poverty levels. Strong external demand and buoyant export performance of gas, gold, and copper, aided by high commodity prices, generated state budget revenues that financed large-scale public investment in infrastructure development and industrial modernization. The abundant remittances, mainly from Russian Federation, and consistent increases in public sector wages and pensions supported consumption growth. However, from 2013 onwards, declining global commodity prices, subdued growth in the People's Republic of China and, more recently economic downturn in the Russian Federation successively affected Uzbek exports, budget revenues and household incomes. In response, authorities implemented countercyclical fiscal and monetary policies to stimulate domestic demand. Consequently, gross domestic product (GDP) growth slowed only marginally from 8.1% in 2014 to 7.8% in 2016. However, growth is expected to have declined further in 2017, to 5.5%, as economy adjusts to adverse impacts of a significant devaluation of local currency. Rising inflationary pressures from devaluation subdued construction and service activities.[2]

3. In September 2017, the government initiated a comprehensive exchange rate reform to solve long-standing difficulties associated with limited access to foreign exchange and requirements to surrender foreign exchange, which brought parallel exchange markets and economic distortions. Several business surveys revealed that the lack of access to foreign exchange was for years a key deterrent to foreign investment and private sector development. The September reform thus aimed to promote foreign investment, private sector development, and exports. It allowed free access to foreign currency for private firms. However, this long-pending reform created many macroeconomic challenges. For one, high inflation and accelerated local currency depreciation inflated the credit risk of unhedged foreign currency borrowers, primarily large SOEs. In response, the government launched some complementary reforms, at a substantial cost, to facilitate a soft landing.[3] This poses yet another challenge, however – that of incurring these costs without risking fiscal and debt sustainability. Some areas that will require

[1] The real growth rate averaged 8.2% during 2006-2016.
[2] Inflation is expected to be 12.5% in 2017 and 13.0% in 2018, up from 8.0% in 2016.
[3] "Soft landing" refers to a situation where inflation is contained and the decline in growth is not significant.

stronger governance structures are discussed below.

4. **Large public sector and inefficient fiscal management.** The key deficiencies are: (i) a lack of medium-term strategic fiscal planning and coordination framework;[4] (ii) weak internal controls in important high-spending ministries; (iii) little comprehensiveness and transparency in the budget system; (iv) an inconsistent nomenclature leading to a mix-up of functional and economic classifications, or a budget nomenclature that is not consistent with the chart of accounts nomenclature; (v) low effectiveness and capacity of public institutions; and (vi) prevalence of large and inefficient SOEs. State and consolidated budgets are not based on long-term national and sector-specific strategic objectives and programs.[5] SOEs dominate all the important segments of the economy, and thus leave little space for the private sector. These include energy (power generation and transmission, and oil and gas refining, transportation and distribution), metallurgy, mining (non-ferrous metals and uranium), telecommunications (fixed telephony and data transmission), agriculture (cotton processing), machinery (the automotive industry, locomotive and aircraft production and repair), and transportation (airlines, railways, municipal public transportation). At present, Uzbekistan does not adhere to the Organisation for Economic Co-operation and Development guidelines on SOE corporate governance. SOEs are subject to domestic accounting standards and rules, which are still not fully comparable with International Financial Reporting Standards.

5. **Inefficient banking intermediation and supervision.** The banking system in Uzbekistan is still closely controlled by the state through a complex set of regulatory actions. Most banking assets remain in state-owned or state-controlled banks,[6] and most loans are directed by the government to develop certain pre-selected programs or sectors. The system includes three state banks, 11 joint-stock commercial banks, eight private banks, and five banks with foreign investments. Banks' corporate and retail deposits comprise only about 56% of their non-equity funding. Loans from the government and funding from international financial institutions are the two other important sources of non-equity funding. Moreover, state-owned banks have a strong influence over systematic loan growth and interest rates through their participation in state-run lending programs, and enjoy the privilege of servicing the domestic blue-chip companies. Consequently, banks cannot play the role of effective financial intermediaries, which inhibits the ability of citizens or private companies to obtain credit and other banking services.[7] Uzbekistan therefore has low levels of corporate and personal indebtedness. The ratio of domestic credit to GDP was about 26% by the end of 2016. Banking supervision, including capital and liquidity assessments, remains irregular. Hence, more focus should be put on developing banks, enabling them to provide much cheaper and more efficient financing for private investments.

6. Moreover, Uzbekistan's debt and capital markets remain extremely shallow. The domestic capital market is underdeveloped and does not help private entrepreneurs to raise funds. Similarly, the domestic private sector bond market transacts less than 0.5% of banks' liabilities.

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[4] Thus, there is no direction in priority setting, nor any attempt to prioritize expenditure across various ministries or government programs.

[5] Unsustainable finances of the government can have profound consequences for vulnerability. When the state's finances are perceived to be at risk of insolvency, investors demand higher risk premiums on government debt, which affects private demand via the interest rate. Vulnerabilities can also arise from uncertainties related to the outlook for public finances. Contingent liabilities of the government are an important source of such uncertainties. Government guarantees for depositors, borrowers, and state-owned enterprises are important sources of explicit contingent liabilities.

[6] The market share is almost 80% in terms of assets. Also, state-controlled banks have large loan exposures to SOEs.

[7] The World Bank's enterprise surveys in 2015 show that almost 75% of firms did not avail themselves of bank loans, and the value of collateral was on average 176% of the loan amount.

7. **Lack of transparent and efficient data dissemination systems**. Timely flows of correct socioeconomic data will remain an important driver of growth and change. Flows of data are important to create new economic paradigms, as envisaged by the government. Poor data standards are detrimental to private investment decisions, and equally important for prioritization of public projects. The data dissemination system is extremely weak in Uzbekistan, and will require significant strengthening to enable the Uzbek policy makers to make informed decisions in the areas of macroeconomic planning and management. This is equally important for foreign investors willing to invest in Uzbekistan.

8. The government was fully aware of these prerequisites before embarking on a journey to transform the economy into an open and diversified structure, and improve resilience to macroeconomic shocks. In February 2017, after Uzbekistan's first change in leadership in 25 years, the government adopted a 5-year national development strategy for 2017–2021. It sets five priority areas for reform: (i) governance and public administration; (ii) the rule of law and the judicial system; (iii) economic development and liberalization; (iv) social development; and (v) security, tolerance, and foreign policy. The strategy defines inclusive growth and continued economic diversification as key to its reform objectives. However, identifying specific reforms in each of these five areas and implementing those reforms will remain a major challenge for the government. The government will require technical and financial support from the development partners.

B. Policy Reforms and ADB's Value Addition

9. Given its long experience in designing and implementing policy-based loans in this region, covering similar areas, the Asian Development Bank (ADB) is well prepared to design the proposed program.[8] Moreover, complementarities between the proposed policy-based loan and ADB's energy sector intervention will make program implementation easier. The structural reforms require a long-term horizon to be implemented effectively. For example, introduction of a medium-term budget framework requires sufficient preparatory and implementation time. Thus, it is critical that the reforms are properly identified and sequenced. A programmatic approach is ideal for chronologically sequencing the reforms in a multi-year, explicit framing of required policy actions and objectives. It also enables alignment of policy actions with unavoidable realities and exogenous shocks. Moreover, the proposed modality plays a leveraging and catalyzing role in coordinating technical assistance provided by the development partners. The ADB team already had detailed discussions with officials from the International Monetary Fund and the World Bank in November 2017. It requested the government to share the policy matrix, when appropriate, with the International Monetary Fund and the World Bank to avoid duplications. The World Bank is currently processing a budget support program (development policy credit) for Uzbekistan.

C. Impacts of the Reform

10. The overarching development objectives of the country are macroeconomic stability and sustainable high growth facilitated. The effect of the reforms will be financing of public and private investment improved. The reform areas are (i) macroeconomic data collection, analysis, and

[8] ADB provided a loan of $20.7 million from its ordinary capital resources for the Public Finance Management Reform Project in Uzbekistan and an associated technical assistance grant of $600,000 for Supporting Public Finance Management Reform in Uzbekistan (ADB. 2007. *Report and Recommendation of the President to the Board of Directors: Proposed Loan and Technical Assistance Grant to the Republic of Uzbekistan for the Public Finance Management Reform Project*. Manila).

dissemination systems improved;[9] (ii) fiscal and financial management strengthened; and (iii) SOE governance and private sector operation improved.

D. Development Financing Needs and Budget Support

11. To effectively support the cost of fiscal consolidation and economic diversification measures, the government has requested policy-based loans totaling $500 million equivalent for 2018–2019, which will be structured into two subprograms of $250 million each to finance its reform costs, covering three output areas.[10] The loans will be provided through ADB's ordinary capital resources (regular).

E. Implementation Arrangements

12. The Ministry of Finance will be the executing agency of the program. The Central Bank of Uzbekistan, the State Committee on Statistics, and the Ministry of Finance are proposed to be implementing agencies. The proceeds of the policy-based loan will be withdrawn in accordance with ADB's *Loan Disbursement Handbook* (2017, as amended from time to time).

III. TECHNICAL ASSISTANCE

13. Transaction technical assistance of $1 million from ADB's Technical Assistance Special Fund (TASF-other sources) is proposed to be attached to the loan to help implement the policy actions under the loan.

IV. DUE DILIGENCE REQUIRED

14. Due diligence to be carried out during the program preparatory work is summarized as follows:

(i) **Safeguards.** The direct and indirect impacts of the proposed policy actions on the environment, involuntary resettlement, and indigenous peoples, if any, will be assessed.

(ii) **Economic.** The economic viability and sustainability of the program will be assessed, and the economic benefits of the proposed policy reforms evaluated.

(iii) **Governance.** Public financial management, procurement, anticorruption, and capacity issues and mechanisms will be agreed with the government as part of the program design. Institutional analysis will cover the key SOEs.

(iv) **Poverty and social.** No poverty, social, or gender issues requiring specific attention were identified. The program impact will indirectly benefit the poor. Gender impacts, if any, will be examined carefully.

V. PROCESSING PLAN

A. Risk Categorization

15. Each of the two subprograms is categorized as complex because each loan exceeds the $50 million threshold.

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[9] The deficiencies in data collection and timely dissemination will impact reforms in all the areas of macroeconomic management.

[10] A preliminary assessment of the cost of reforms was already carried out. However, the details of the cost of reforms (or adjustments) will be firmed up during the fact-finding mission.

B. Resource Requirements

16. The program will be processed by ADB sector staff with expertise in the public and finance sectors. Staff will dedicate an estimated total of 8 person-months to processing the program. A staff consultant will be required for 3 person-months to support the implementation of some first subprogram policy actions.

C. Processing Schedule

17. List of major milestones up to Board discussion.

Milestone	Expected Completion Date
Fact-finding mission	February 2018
Management Review Meeting	March 2018
Loan negotiations	April 2018
Board discussion	May 2018
Loan signing	May 2018
Loan effectiveness	May 2018

VI. KEY ISSUES

18. The key issues are that (i) extensive capacity development support will be needed to implement the proposed policy actions (especially those in the second subprogram), making the proposed technical assistance extremely important; (ii) the government will also need to comply with all the first subprogram's policy actions before Board circulation; and (iii) the total loan size will be justified based on development financing requirements.

DESIGN AND MONITORING FRAMEWORK
(Initial Draft)

Country's Overarching Development Objectives
Macroeconomic stability and sustainable high growth facilitated (*Strategy of Actions on Further Development of Uzbekistan*.[a]

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
Effect of the Reform Financing of public and private investment improved	To be accomplished by 2019: a. Local currency bank credit to private sector increased by at least 15% (2017 Baseline: TBD). b. Fiscal outlays to SOEs are reduced by 0.5% of GDP (2017 Baseline: TBD). c. Public spending from the state budget on capital expenditure increased by at least 2 percentage points of GDP (2017 Baseline: TBD).	Budget documents Annual report of the CBU	Continued commitment of the government toward reform momentum is not sustained.
Reform Areas under subprogram 1 1. Macroeconomic data collection, analysis, and dissemination systems improved	**Indicative Policy Actions** 1.1 GOU submitted an Action Taken Report to on the compliance status of the e-GDDS requirements covering the following areas:(i) disseminate the data required by e-GDDS punctually; (ii) provide an advance release calendar; (iii) provide detailed information on statistical practices; (iv) certify the accuracy of the metdata on an annual basis; and (v) use of standardized electronic reporting procedures by 2019 (2017 Baseline: Not in place). 1.2 Central Bank of Uzbekistan (CBU) approved, by 2018, consistent with e-GDDS requirements, a plan to publish regularly monthly, quarterly and annual data on monetary aggregates, inflation (overall and disaggregated level), important bank statistics, and balance of payments, foreign exchange reserves in its website starting from October 2018 (2017 Baseline: Not approved).	1.1–1.2 Annual Reports of MOF, and CBU.	Trained staff are not retained in the relevant departments during the entire period of the program, affecting successful completion of various policy actions.
2. Fiscal and financial management strengthened	2.1 GOU (i) approved, by 2019, a medium-term budget framework (MTBF); and (ii) notified adoption of MTBF for budget making beginning 2020 (2017 Baseline: Budget is not based on MTBF). 2.2 MOF submitted an action taken report by 2019 on the implementation of all	2.1–2.3 Annual Reports of MOF, and CBU.	

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
	12 budget standards, which are in line with IPSAS, for the preparation of 2020 budget. (2017 Baseline: Budget is not based on IPSAS). 2.3 CBU submitted by 2018 (i) Capital Adequacy Assessment Reports for NBU, People's bank, Asaka bank, Promstoybank, Microcredit bank, Ipoteka bank, Agro bank and Rural construction bank; Turon bank, and Aloqabank; and (ii) necessary recommendations based on these reports (2017 Baseline: Not in place)		
3. SOE governance and private sector operation improved	3.1 GOU approved, by 2018, Corporate Governance Rules based on *2015 OECD Corporate Governance Guidelines for SOEs* covering the following areas: (i) equitable treatment of shareholders and other investors; (ii) stakeholder relations and responsible business; (iii) disclosure and transparency; (iv) the responsibilities of the boards of SOEs (2017 Baseline: Not approved). 3.2 GOU submitted a status report, by 2019, on the divestment process for the selected non-core assets of SOEs and income earned from this process (2016 Baseline: Not in place). 3.3 GOU submitted the draft law on public-private partnerships to the Parliament by 2018 (2017 Baseline: Not prepared) 3.4 Uzbekenergo submitted, by 2019, IFRS compliant consolidated audited accounts for 2017 (2017 Baseline: Not submitted)	3.1–3.4 Annual Reports of MOF and Uzbekenergo	

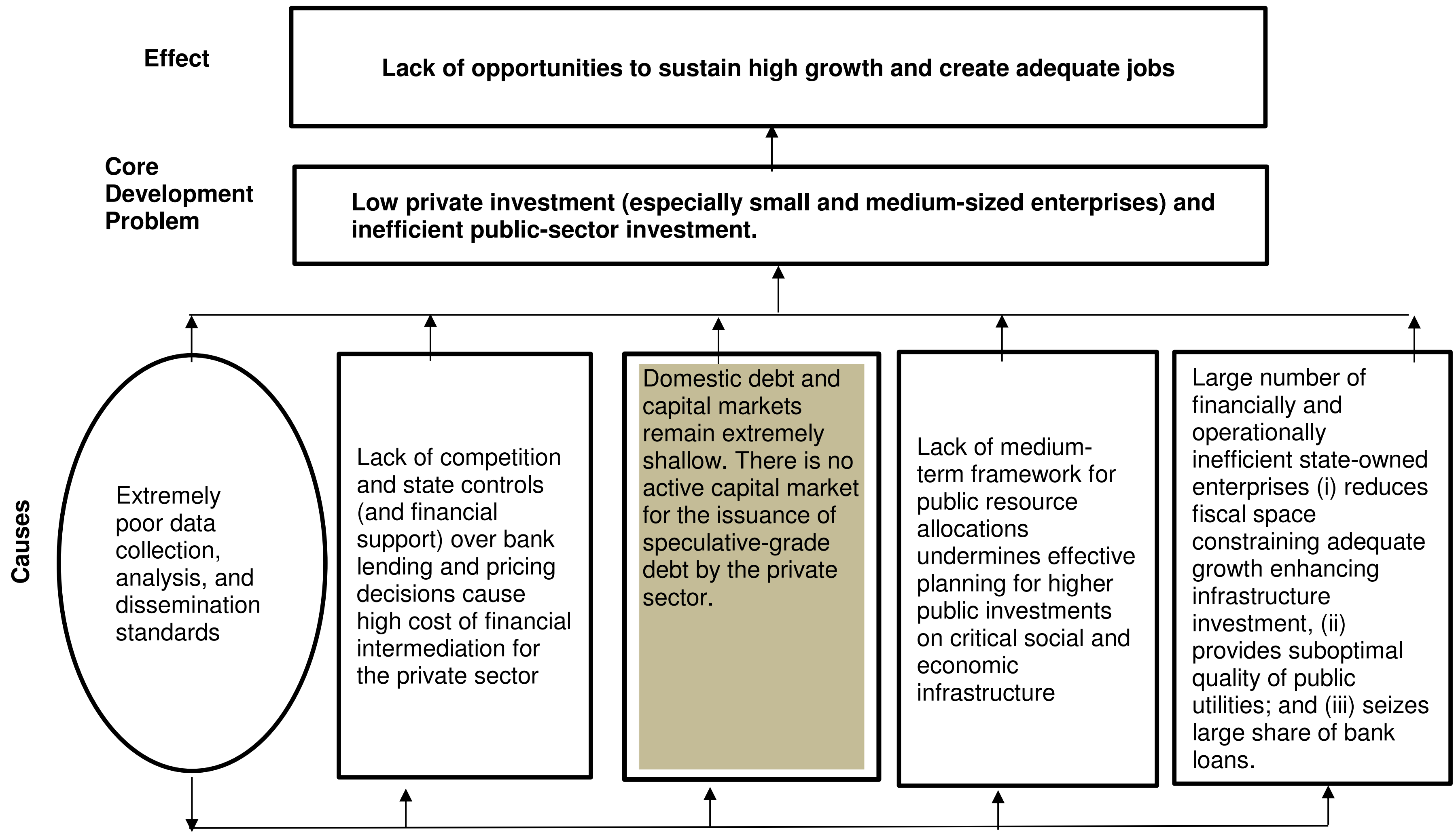
Budget Support ADB: Subprogram 1: $250 million (regular OCR loan) Subprogram 2: Indicatively $250 million (regular OCR loan)
Assumptions for Partner Financing: None

ADB = Asian Development Bank, CBU = Central Bank of Uzbekistan, GDP = gross domestic product, IFRS = international financial reporting system, IPSAS = international public-sector accounting system, MOF = Ministry of Finance, MTBF = medium-term budget framework, OCR = ordinary capital resources, SOE = state-owned enterprise, TBD = to be determined

[a] Government of Uzbekistan. 2017. Presidential Decree on Strategy of Actions on Further Development of Uzbekistan. (http://cis-legislation.com/document.fwx?rgn=94327)

Source: Asian Development Bank.

PROBLEM TREE



Notes: (i) poor data standards affect core development problem directly as well as indirectly through other causes; (ii) shaded box is not covered under the program.

LIST OF LINKED DOCUMENTS

http://www.adb.org/Documents/LinkedDocs/?id=51350-001-ConceptPaper

1. Initial Poverty and Social Analysis