ECONOMIC ANALYSIS

A. Introduction

1. The analytical framework for determining efficient and sustainable use of resources is based on relevant Asian Development Bank (ADB) publications, including the *Guidelines for the Economic Analysis of Projects* (2017).

B. Economic Analysis of Asian Development Bank's Policy-Based Loan to Uzbekistan

2. Uzbekistan is one of the fastest-growing economies in Central Asia and aspires to become an upper middle-income country by 2030. Its main challenge is to sustain its remarkable economic growth to create more jobs and improve its citizens' welfare.

3. Following political transition in 2016, the new government adopted midterm national development strategy for 2017–2021, which prioritizes regional integration, governance, economic liberalization, private sector development, and inclusive growth. The government has successfully introduced comprehensive and far-reaching foreign exchange and public administration reforms under the strategy in 2017, most notably unifying multiple exchange rates and introducing uninhibited access to foreign currency. The government also adopted International Monetary Fund General Data Dissemination Standards, confirming its intention to attract foreign investment through greater transparency.

4. To facilitate implementation of the development strategy, the government initiated a large-scale exchange rate reform in December 2017 to address long-standing challenges associated with limited access to foreign exchange, partial and cumbersome current account convertibility, and foreign exchange surrender requirements, which created an environment of multiple exchange rates and corresponding market distortions. In fact, for years, lack of access to foreign exchange was a key deterrent for foreign investment and private sector developed, as evidenced by multiple business survey. In this regard, the September reforms are aimed at promoting foreign investment, inducing private sector development, and strengthening the export potential. The reform entails market-based access to foreign currency for private sector and provides banks with more flexibility in negotiating terms of loans and charging commissions for foreign exchange transactions. Subsequently, starting from 5 September 2017, the foreign exchange market has been liberalized, resulting in significant devaluation of local currency against US dollar.

5. Preceding the reform, earlier in 2017, the government undertook a series of actions to mitigate risks emanating from exchange rate devaluation. To strengthen the resilience of banking sector, in June 2017, the government has injected additional $644 million into capital of several large state-owned commercial banks. The government also took several steps to address issues pertaining to high inflation attributed to exchange rate depreciation.[1]

[1] The year-end consumer price inflation was 18.9% in 2017, compared to 7.8% in 2016. Food prices jumped by 15.9%, driven largely by a 30.0% rise in meat and poultry prices, contributing 6.5 percentage points to overall consumer price index (CPI). Prices of other goods rose by 16.0%, adding another 5.7 percentage points to the CPI increase. Prices for gasoline, most of it imported, rose by 39.7% in the 12 months through November 2017, contributing 0.5 percentage points to overall CPI. Furthermore, in response to rising production and debt service costs, utility companies raised tariffs by 7.1% and adding 0.4 percentage points to CPI. In response to rising prices, the government introduced prices and tariffs monitoring system for socially important goods and services. To this end, the government also established a special fund to stabilize prices of socially important food products in domestic markets and abolished excise tax on imports of meat and flour products from September 2017. All these measures had fiscal implications.

6. The September exchange rate devaluation strained balance sheets of major taxpayers, particularly state-owned enterprises, prompting the need for additional tax holidays and exemptions, announced in the second half of 2017. While unification has probably increased receipts for some items, such as VAT, the overall impact on revenues was negative. At the same time, budget expenditures rose, with the continued downsizing of public administration offsetting some of the rise in outlays as government moved to mitigate the adverse impact of reforms on vulnerable groups and strategic industries. Consequently, the augmented budget, including the balance of Uzbekistan Fund for Reconstruction and Development (UFRD), is estimated to record a deficit of 3.3% of gross domestic product (GDP) in 2017.

7. In this environment, expectations of commensurate fiscal response to mitigate social risks, promote private sector growth and sustain delivery of key public services are very high, as evidenced by unprecedented review of 2018 state budget by both executive and legislative branches in December 2017. The expectations are further built up by numerous sector and thematic development programs, initiated by the government throughout 2017. However, the capacity of authorities to respond to new challenges in effective and inclusive manner is stifled by eroding fiscal space as lower global commodity prices throughout 2012–2017 reduced budget revenues amidst increasing public expenditures. These developments prompted the government to request programmatic lending support from ADB in June 2017.

8. The economic analysis of the proposed Economic Management Improvement Program demonstrates that project benefits considerably outweigh the costs. The key direct benefits considered are classified into three groups: First, higher public investment due to additional fiscal space attributed to (i) medium-term budgetary framework (MTBF) based budget making, and improved internal controls; (ii) reduced fiscal transfers to large state-owned enterprises (SOEs) over medium-term; and (iii) savings from greater efficiency and cessation of systemic leakages. Fiscal space created under the program, helps to raise public investment. Second, higher private investment due to improved financial intermediations, and crowding-in attributed to higher public investment on infrastructure. Improved private investment in the state leading to higher growth, and larger employment opportunities. Third, better service delivery due to improved performance of SOEs.

C. Development Financing Needs

9. Sharp devaluations in 2017 has led to increased budget expenditure. Government revenues and income of the Fund for Reconstruction and Development of Uzbekistan also declined. These adjustments were necessary to facilitate mitigation of the adverse impact of reforms on vulnerable groups; and ensuring smooth functioning of strategic industries including SOEs, banks and financial institutions. These additional budget expenditures and revenue losses are summarized in Table 1. However, this has resulted in a budget deficit of almost 3.3% of GDP in 2017 (as against a deficit figure of 0.6% in 2016). This has necessitated support from the development partners to support development financing needs protect key development spending during the time of hard budget constraint.

Table 1: Summary of Increases in Budget Expenditure Items and Revenue Losses (2017–2018)

No.	Description of adopted programs	Total projected need	
		Billion UZS	Million $
1	Support of banking sector	**5,149.6**	**643.7**
2	Measures to support price stabilization of products of social importance including:	**4,340.4**	**542.6**
	Fund for price stabilization fund of food products	2,400.0	300.0
	Compensation of cost escalation of imported pharmaceuticals due to the exchange rate increase of foreign currencies	1,680.0	210.0
	Prevention of drastic increase of tariffs of potable water (provision of subsidies to enterprises for covering the exchange rate difference of expenditures related to servicing the loans in foreign currency)	260.4	32.6
3	Abolishment or reduction of tax rates and customs payments including:	**2,870.0**	**358.8**
	Abolishment or reduction of customs payment rates (excise tax and customs fees)	2,200.0	275.0
	Reduction of tax rates on petroleum and diesel fuel	670.0	83.8
4	Moratorium on interest and principal payments, due for repayment of debts during September 2017–December 2018 in foreign currency, of state-owned enterprises from Fund for Reconstruction and Development and commercial banks	**1,772.8**	**221.6**
5	Measures to cover one-time additional expenditures of state-owned enterprises and budget entities due to the exchange rate policy liberalization and revision of tariffs of selected goods with regulated prices	**3,147.3**	**393.4**
	including:		
	Support of basic sectors in the conditions of currency market liberalization	535.6	67.0
	Coverage of additional expenditures of budget organizations in response to the increase of utility tariffs and prices of fuel and lubricants	2,611.7	326.5
	Total	**17,280.1**	**2,160.1**

Source: Government of Uzbekistan; ADB staff estimates.

D. Economic Benefits[2]

10. **Higher and productive public investment.** Amidst the ongoing reforms and the associated increases in budget expenditure of $2.2 billion (4.5% of the 2017 GDP), the government aims to enlarge the fiscal space to finance the projected public investments amounting to $4.2 billion in 2018.[3] In view of the government's medium-term development targets, the increasing public investments are expected to impact fiscal situation unless reforms are initiated to improve allocative efficiency of scarce public resources. The proposed loan facilitates adoption of the MTBF, improvement of internal controls in budgeting, and improved performance of SOEs. Improved performance of SOEs will eventually lead to lower fiscal transfers from the state budget. Fiscal outlays to SOEs (loans and equity together) constitute 4.5% of GDP in 2017. These policy reforms are expected to improve allocative efficiency of scarce public resources and

[2] See also Figure 1 below.

[3] The public investments comprise funding from the state budget (9.0% of total investments), state targeted funds (14.4%), UFRD (22.3%), and foreign investments and loans under the government guarantee (54.3%).

enable the government to align the budget resources with its medium-term development targets. This will certainly improve efficiency and outcome orientation of public investment. In addition, the creation of fiscal head room, through these reforms, will enable the government to finance the growing public social spending in social sector that are projected to increase to 56.4% (2018) from 54.5% (2017) of the state budget expenditures[4].

11. **Higher private investment.** The government-led investment is one of the key growth drivers in the country. Gross capital formation rose by 9.6% and 7.1%, respectively, in 2016 and 2017–mainly attributed to the government spending for social infrastructure, including housing and health facilities. The role of private investment in growth is presumably modest due to inadequate financial intermediation.[5] As a proxy for the private sector, small business and private entrepreneurship account for 32.0% of investments, 53.3% of GDP, and 78.3% of employment as of 2017.[6] In view of potential role of private sector in investments, the program promotes, through selected policy actions, the banking supervision, expansion of local currency bank credits to private sector (by restricting directed lending), and adoption of law on public-private partnership (PPP). More regular banking supervision–capital and liquidity assessments–aimed to improve banks' performance, enabling them to provide cheaper and more efficient financing for private investments. There are three other channels to promote private investment: (i) improved efficiency of public investment, especially on infrastructure will have a crowding-in impact on private investment; (ii) the PPP framework also facilitates the crowding-in of the private sector in infrastructure development investments; and (iii) improved economic management and consequent macroeconomic stability will be an important driver of foreign direct investment. These reforms are expected to have a significant impact on growth and employment opportunities through enhanced private participation in economic activities.

12. **Improved SOE Performance Leading to Better service delivery.** SOEs dominate important segments of the economy—energy, mining, metallurgy, telecommunications, and transportation. The adverse effects of the foreign exchange liberalization on SOE's financial performance led to SOEs' utility tariff adjustments without adequate improvement in service delivery. In 2017, tariff increases for basic utilities were significant–electricity (by 7.0%), natural gas (7.0%), water supply and sewerage (10.3%), hot water supply (4.7%), and heating (4.9%). Further adjustments are expected during 2018–2019. Considering the spending on utility and transportation and communication services account for 7.7% and 6.1%, respectively, of the average household consumption expenditure, the burden of reform costs is mainly passed onto over 6.4 million households as consumers of SOEs' services. In terms of service delivery quality, urban–rural disparities persist in the connectivity of households to key utilities. Centralized networks of water supply, sanitation, and gas cover 50.4%, 9.2%, and 62.5%, respectively, of the housing stock in rural areas in 2016. In contrast, 84.1%, 54.7%, and 85.6% of urban houses and apartments are connected to the water-supply, sanitation, and gas networks respectively. In addition to accessibility, the availability of utilities is characterized by frequent outages, undermining respective SOEs' performance. The program aims to improve financial viability of selected SOEs through promoting: (i) corporate governance rules based on 2015 Organization for Economic Cooperation and Development Corporate Governance Guidelines for SOEs; (ii) divestment of selected non-core assets; and (iii) introduction of international best practices in

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[4] Education (55.7% of public social spending in state budget), healthcare (27.3%), and social protection (9.0%) dominate the total social expenditures in the 2018 state budget.

[5] The World Bank's enterprise surveys in 2015 indicated the close to 75.0% of firms did not use banks loans and the value of collateral averaged 176.0% of the loan amount.

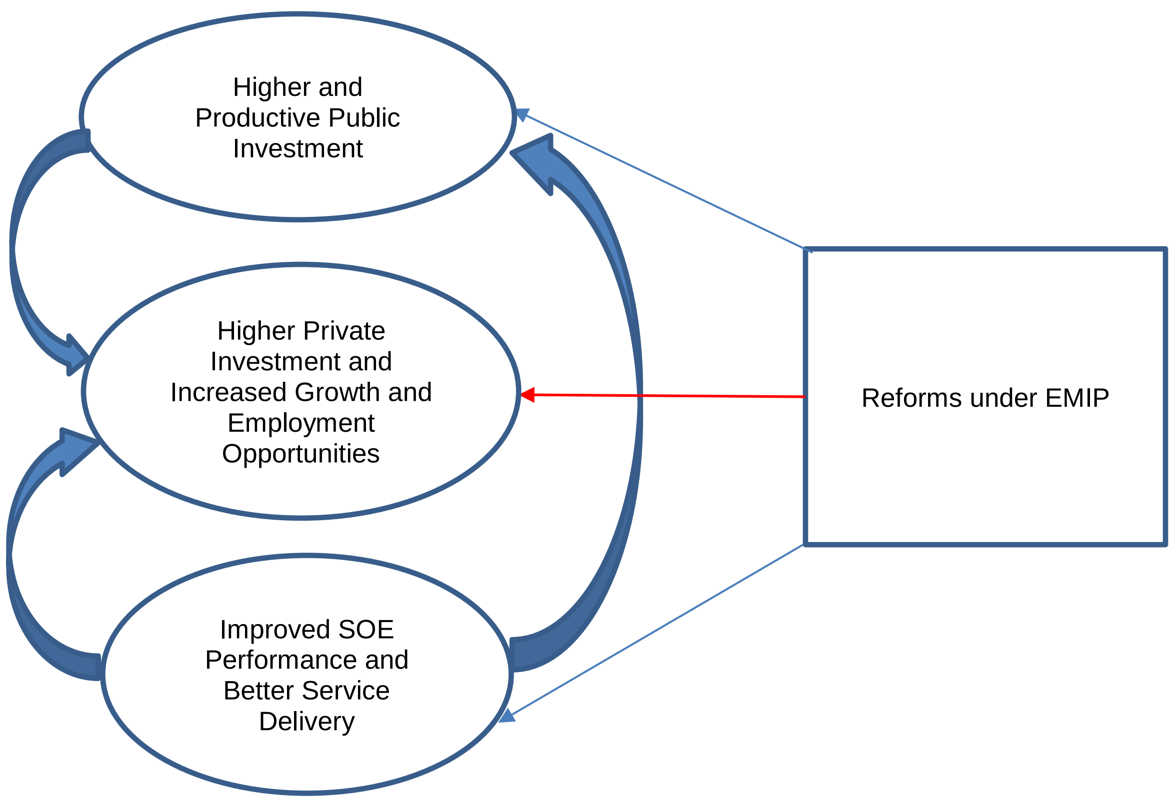
[6] Due to data constraint in estimating the role of private sector in the economy, including investments, small business and private entrepreneurship are approximated to the private sector.

accounting.[7] Improved financial flexibility, in turn, will help SOEs to improve service delivery in an inclusive manner. For example, it is expected that the ADB's support for JSC Uzbekenergo will lead to an improvement in thermal power generation efficiency—facilitating uninterrupted power supply to household and industries. This is an example of how improvements in upstream state-owned utilities can help downstream private enterprises.

13. **Government capacity.** Extensive capacity development support is needed to implement the proposed policy actions. Meeting the proposed policy actions under subprogram 2 will require strengthening of capacity of several line Ministries and the Central Bank of Uzbekistan. In this regard, the technical assistance of $1 million from ADB's Technical Assistance Special Fund (TASF-other sources) is proposed under the program.

14. **Economic risks.** The key economic risks are: (i) availability of the government's own resources for financing the planned reforms under the national development strategy; (ii) institutional instability due to ongoing reform initiatives in various sectors causing lack of clarity about interlinkages across various institutions/Ministries and responsibilities; and (iii) high staff turnover in government departments.

Figure 1: Economic Benefits of the Program[8]



[7] As of the beginning of 2018, the country has not adopted the Organization for Economic Cooperation and Development guidelines on SOE corporate governance, and SOEs remain subject to national accounting standards and rules that do not fully comply with international financial reporting standards.

[8] Note that improvements in upstream SOE utility companies will have positive impact on downstream private companies.