

5. **This paradigm has resulted in a gradual economic and a less severe social transition than that experienced in most countries of the CIS.** A policy of high public spending during the transition years has mitigated the impact on human capital and on the quality of infrastructure compared with other countries in the region. Market-oriented reforms have been slow and uneven and progressed only in the areas which matched Government's development model and where support for reforms has prevailed over vested interests (such as the introduction of current account convertibility in 2003, the realignment of energy prices, the privatization through lease-holding of collective farms, the adoption of measures to improve the business environment for small and medium-sized enterprises (SMEs) and the modernization of the treasury). In recent years, the Government also achieved a strong macroeconomic performance. However, in spite of high growth rates achieved in recent years, the cost of the gradualist approach to reform in Uzbekistan was an insufficient utilization of the country's economic potential. The emphasis on large capital intensive projects, many of which were in the public sector, and slow private sector development proved to be insufficient to create the number of jobs required to absorb the growth of the working age population.

II. COUNTRY CONTEXT

A. Political Background, Governance and Civil Society

6. **Uzbekistan has a strong executive system with few checks and balances.** After the break-up of the Soviet Union in 1991, the ruling Communist Party of Uzbekistan was restructured as the People's Democratic Party of Uzbekistan, with Islam Karimov retaining the leadership. A referendum in 1995 extended President Karimov's term of office until 2000. He was re-elected to the presidency in 2000 and in December 2007. The Organization for Security and Co-operation in Europe (OSCE) has criticized the elections as failing to meet international standards. At the same time, however, observers from a number of countries and other organizations assessed the conduct of the elections positively.² In 2005 following the suppression of the Andijan uprising, relations with the US and the European Union (EU) deteriorated. Following US criticism of the Uzbek government, cooperation between the two governments in many spheres was reduced and US assistance to Uzbekistan was considerably cut. The EU imposed sanctions in the form of an arms embargo and visa restrictions for senior officials. However, these sanctions were relaxed in October 2007 and are now being reviewed.

7. **Economic management and governance remain characterized by low transparency, and limited voice and participation of citizens.** The restricted dissemination of basic economic and social information, and questions regarding the reliability of some data, is a serious impediment to strengthening the accountability of the authorities, to encouraging public participation in policy-making debate and to allowing civil society to play a constructive role in contributing to the effective monitoring and evaluation of implementation and results of state programs. However, the Government

² OSCE/ODIHR, LEOM, Republic of Uzbekistan, Presidential Elections 2007, Interim Report (5-15 December, 2007).

has indicated that it is working to enhance information dissemination and increase involvement of civil society in the implementation of state programs.

8. **The activities of civil society have historically been tightly controlled.** In 2005, legal and administrative controls on non-governmental organizations (NGOs) were tightened and scores of NGOs were denied mandatory re-registration with the Ministry of Justice, and have been forced to close their operations. Despite this, a significant number of domestic NGOs continue to operate in the social, and, to some extent, the environmental spheres. The WBG has been able to continue operating a Small Grants Program, albeit with fewer potential beneficiaries. Recently, a number of international NGOs including Human Rights Watch and the International Red Cross have reached agreements with the Government paving the way to a resumption of their activities in the country. Moreover, there are emerging examples of more cooperative relations between civil society and Government representatives, particularly at the local level.

B. Regional Significance

9. **Uzbekistan is strategically located in the heart of Central Asia.** The design and development of much of Central Asia's transport, energy and irrigation infrastructure during the Soviet Union created extremely tight links of mutual dependency between the Central Asian Republics which were managed centrally in a borderless manner. Since independence, Uzbekistan has pursued a policy of national self-sufficiency. In the absence of the alternative effective arrangements, the coordinated management of the Regional infrastructure systems has been disrupted and the benefits of close economic integration and cooperation have been missed.

10. **Major opportunities for mutually beneficial cooperation in water-energy and inter-regional trade remain under-exploited.** The management of the water-energy nexus has become a highly controversial and sensitive issue between upstream countries (Kyrgyz Republic and Tajikistan) and downstream countries (Uzbekistan,³ Turkmenistan and, Kazakhstan⁴). Cross-border trade is complicated by unintegrated processes and procedures. Purely national solutions, particularly those that involve by-passing Uzbekistan, are expensive and potentially destabilizing. Regional powers including China, Iran, Pakistan and Russia have stepped up diplomatic efforts to engage with Uzbekistan, including in the context of the Shanghai Organization for Security (ShoS) and the Eurasian Economic Community (EurASEC). The International Financial Institutions (IFIs), including the World Bank, are providing support to the process of regional cooperation through the Central Asia Regional Economic Cooperation (CAREC) forum. Nevertheless, relationships with direct neighbors remain rather tense.

³ The two great rivers of Central Asia, Amu Darya and Syr Darya, with their tributaries are the main source of water for Uzbekistan, 95 percent of which is used in the agriculture sector.

⁴ Irrigation water is however less strategically important for development of Kazakhstan.

C. Economic Context

11. **Uzbekistan experienced a relatively modest decline in real GDP** (20 percent compared to more than 40 percent average in the CIS) between 1990 and 1995 following the breakup of the Soviet Union. The initial recovery of 1996-2003 was marked by modest but consistent growth (4 percent on average) followed by a strong economic rebound with average growth of 7.3 percent between 2004 and 2006 and 9.5 percent in 2007. Uzbekistan is among the few countries in the former Soviet Union (FSU) which have seen an increase in population during the transition years⁵ (from 21 to 26.8 million) in contrast to many countries of the CIS, which have seen a dramatic decline⁶ in population. As a result, it is only in recent years that per capita incomes have begun to increase significantly. With a gross national income (GNI) per capita (Atlas method) of US\$730 in 2007 (Table 1) and GDP per capita of US\$2,394 at purchasing power parity (PPP) Uzbekistan is classified as an upper low income country.

Table 1: Selected Macroeconomic Indicators, 2003-2007

	2003	2004	2005	2006	2007
Economy					
GDP, bln USD	10.1	12.0	14.3	17.0	22.3
GDP per capita, USD	396	465	547	643	830
GDP real growth	4.2	7.7	7.0	7.3	9.5
GNI per capita, USD, Atlas method	420	460	530	610	730
GNI per capita, PPP, current international \$	1651	1808	1970	2155	2,394
National accounts (% GDP)					
Exports of goods and services	37.3	40.2	37.9	37.5	40.3
Imports of goods and services	30.6	32.7	28.7	25.9	30.2
Consolidated Public finance (% GDP)					
Public Revenues	33.4	32.2	30.8	31.4	31.7
Public Expenditures and net lending	33.3	31.6	29.6	29.6	28.5
Fiscal balance	0.1	0.6	1.2	1.8	3.2
Augmented government balance	0.1	0.6	1.2	5.2	3.9
PPG Debt (Gov't debt)	41.5	35.5	27.0	20.8	13.2
Prices					
Consumer prices (official, eop)	3.8	3.7	7.8	6.8	6.8
Consumer prices (IMF, eop)	7.8	9.1	12.3	11.4	11.9
Balance of Payments					
CAB, as % GDP	8.7	10.1	13.6	19.1	19.3
FDI, as % GDP	0.7	1.6	0.6	1.1	3.3
Gross official reserves, mln USD	1659.0	2147.0	2895.2	4459.4	6613.9
Gross reserves (in months of imports)	5.1	6.3	7.9	10.7	13.5
Monetary					
M2, as % GDP	10.3	12.2	14.4	15.2	16.3
Credit to private sector, as % GDP	27.5	24.5	21.8	17.4	15.0

Source: Uzbek authorities, IMF and World Bank staff estimates.

⁵ Period between 1990 and 2000.

⁶ This is based on official information. A census has not been conducted for several years and the information may not be accurate.

12. **Economic growth is supported by stable macroeconomic management, promotion of sectoral investments identified as priority by the Government, favorable terms of trade and a buoyant external environment since 2003.** The industrial and manufacturing sectors are undergoing a process of public investment-led modernization, through active localization and import substitution programs, especially in strategic sectors, including car manufacturing, home electronics, machinery building and chemicals. Export growth has been driven by high commodity prices (including for cotton, gold and gas) and also by increased volumes of exports of industrial and manufacturing goods, particularly capital intensive goods (cars, airplanes, cement, electric cables, etc.) to the rapidly growing markets of key trading partners (Russian Federation, Kazakhstan, and others). Foreign Direct Investment (FDI) more than doubled between 2005 and 2007, albeit from a low base (FDI was estimated at 3.3 percent of GDP in 2007). Investment also flows to housing, retailing, food processing, light industry, textile, car manufacturing and supplies. The services sector is developing rapidly and asset prices are at historically high levels. The inflow of workers remittances from Russia and Kazakhstan give additional boost to domestic demand (remittances are estimated between 10-17 percent of GDP in 2007).

Figure 1. Contribution to GDP growth, 2003-2007

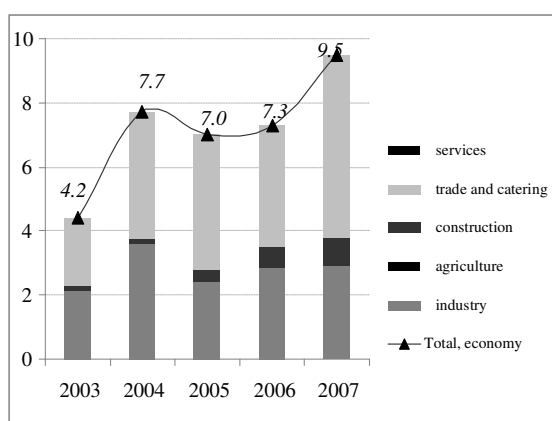
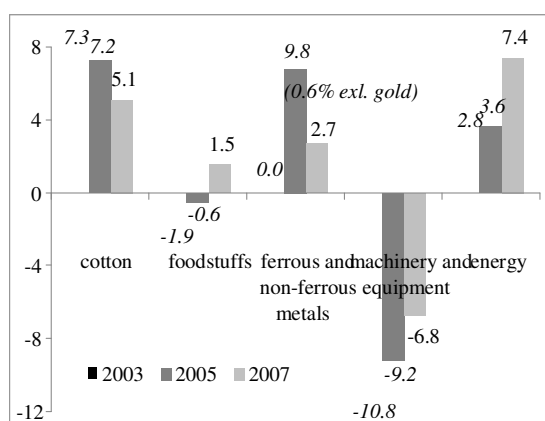


Figure 2. Net exports as % to GDP, 2003-2007



13. **Commodity price booms for major Uzbek exports account for a substantial share of economic growth during the recent period of economic expansion.** Uzbekistan remains a net exporter of energy, cotton and minerals and became a net exporter of foodstuffs in 2007 (Figure 1 and 2). Construction and services sectors also showed substantial economic growth in response to increased domestic demand, while growth in agriculture was lower than overall economic growth. The export expansion also caused growth in transportation and trade services. Uzbekistan has managed to capitalize on rapidly growing neighbors – China, Russia and Kazakhstan – to increase exports of machinery and chemical products to these and other countries.

14. **The resulting inflows of foreign exchange have considerably strengthened the external position over the past five years, but also created a dilemma for the authorities.** The current account has improved from small deficits in the late 1990s to an

average surplus of 14 percent of GDP in 2003-2007. Gross official reserves have risen in 2007 by 1.6 times compared to 2006, and were the equivalent of 13 months of imports. The exchange rate, which was depreciating in nominal and real terms, has recently started to appreciate. The large, partly unsterilized⁷, foreign exchange inflows, combined with a policy of nominal depreciation of the sum, have fuelled the growth of monetary aggregates, which have in turn put additional pressure on inflation⁸. Since 2004, broad money has been growing by close to 50 per cent annually. This, in combination with the global inflation pressures and continued adjustment in relative prices, complicates the task of the Central Bank in controlling inflation.

15. The fiscal position has also strengthened, supported by buoyant revenues from the commodity sector. Although the direct tax burden has steadily decreased, (e.g., the profit tax rates in commodity sectors declined from 18 percent to 10 percent during 2004-2007), the consolidated budget has been in surplus since 2003. Public debt has been reduced to less than one sixth of GDP in 2007 from over 40 percent in 2003. With current tight external borrowing policies maintained, the debt to GDP and debt service to exports ratios should decline further. The Government is expected to maintain fiscal prudence and keep the consolidated budget in surplus during the CAS period.

16. The outlook for 2008 is positive with real GDP expected to grow by 6-7 percent over the CAS period. These projections are more conservative than the official Government projections, in that they recognize that some of the current growth is based on the commodity price boom, itself fueling a strong demand for Uzbek exports of industrial goods and services (labor) from key neighboring trading partners, and that the official projections may be overoptimistic on the favorable impact in the short term of current gradualist reform policies. Nevertheless, it is expected that growth will continue to benefit from bringing under-utilized resources into production even if structural reforms proceed at a modest pace. Investment demand will continue to remain strong driven by modernization needs. In addition, to an active public investment policy, interest from private investors in some key economic sectors is also likely to be sustained. Indeed, Uzbekistan recently strengthened its ties with Russia and China and relations with many important trading and investment partners such as South Korea, Malaysia, India, Japan and the Arab States, are close. Private consumption, which grew at a modest rate of 3.8 percent over 2003-2007 when net exports and fixed capital formation grew at 11 and 35 percent on average over the same period, is projected to boost domestic demand from envisaged wage and salary increases and the likelihood of a gradual loosening (or at least no further tightening) of trade restrictions.

17. There are currently no major macroeconomic imbalances in Uzbekistan, but the authorities will need to be vigilant in the face of potential external shocks and continue to exercise prudence in managing the economy. The Bank's macroeconomic forecast for the CAS period provides for a gradual acceleration in the pace of expansion of domestic demand and a corresponding reduction in external surpluses. The rise in

⁷ The Capacity Building Unit (CBU) has sterilized some of the inflows, through the creation of a Reserve Fund (Fund for Reconstruction and Development).

⁸ The International Monetary Fund (IMF) staff calculates inflation using the authorities' source data and applying international methodology. The IMF is providing technical assistance to the authorities on National Accounts through a resident advisor in the Statistics Committee.

inflation as a result of increases in food and other commodity prices in 2007 is expected to continue in 2008 with a gradual decline in later years. This assumes the absence of serious external shocks and the continuation of gradual economic reforms. With fairly diversified sources of growth, strong external position, and the limited openness of its trade and financial sector, in the short term Uzbekistan may initially be in a better position than other more open economies to withstand adverse external shocks, including the current international financial liquidity crisis. Simultaneously, Uzbek banks have limited exposure to foreign banks, with modest external borrowing, thus running little risk of contagion from foreign banks suffering from the credit crunch.

18. **However, various distortions in the economy could undermine economic growth unless these issues are addressed.** In order to achieve the high growth rate envisaged by the authorities (about 8 percent), it is the WBG's view that additional reforms are needed. These include further liberalization of trade and exchange systems, particularly as regards the availability of imported inputs and the necessary foreign exchange, development of the financial sector and improvements in the business environment and investment climate, to stimulate private sector development. In addition, the currently strong external and fiscal positions may hide weaknesses in the economy if there were to be a reversal of the foreign exchange inflows. In the event of negative external developments, there is a risk of the reversal of reforms with a return to even more central control and protection in response to the external shock. In this regard, Uzbekistan is in a position to take advantage of the current buoyant economic environment for accelerating the implementation of structural reforms.

19. **Basic infrastructure may also emerge as one of the constraints to faster and more widespread growth in the future.** Uzbekistan has generally maintained its infrastructure (roads, irrigation network, electricity, gas distribution) in better condition than have some of its neighbors and has continued to invest in selected basic infrastructure projects throughout the transition period. Nevertheless, it is facing a major challenge going forward: the stock of infrastructure assets it inherited from the Soviet Union is extremely large for a country of Uzbekistan's GDP per capita and a large part of it may already be beyond its technical-economic life. As a result, the financing needs required to ensure that the provision and the quality of infrastructure services support future growth objectives will be immense in both urban and rural areas.

D. Poverty, Socioeconomic Inequality and the MDGs

20. **With per capita income of US\$730 (Atlas based) in 2007, Uzbekistan is an upper low income country.** Calculations based on a food-only consumption basket and a poverty line estimated at 2100 kilo calories per day suggest that slightly over one quarter of the population could still be considered poor (Table 3) in 2007.⁹ Given its large population, Uzbekistan accounts for a significant share of the poor in all of Central Asia, and its economic prospects are key to the region as a whole.

Table 2: Medium-term Economic Projections, 2008-2011

	2008	2009	2010	2011
	(percent change)			
Real GDP	8.0	7.0	6.5	6.0
Consumption (per capita)	7.5	6.5	6.2	5.6
Exports	15.2	13.8	10.8	10.3
Imports	27.8	13.3	9.6	14.2
GDP Deflator	17.0	15.0	12.0	10.0
Terms of trade	6.0	-6.6	-3.5	-2.4
	(percent of GDP)			
CAB	15.3	12.8	11.8	9.5
Budget revenues	34.9	34.6	34.5	34.5
Budget expenditures	30.0	29.8	29.4	28.9
Fiscal Balance	4.9	4.8	5.1	5.6
Public &				
Guaranteed Debt	11.1	9.7	8.7	8.1
Fixed investment	21.0	20.3	19.3	20.1

Source: Uzbek authorities, IMF and WB staff estimates.

21. **Based on available data, recent growth appears to have had a relatively modest impact on poverty reduction (Table 3).** In Uzbekistan a one percent increase in mean consumption leads to a one percent decrease in poverty, which is small when compared to the experience of other countries in the region.¹⁰ A disaggregated data analysis¹¹ shows that the consumption of households at the very bottom of the consumption distribution and the consumption of those who are at the top of the distribution improved much more than others during 2003-2006 period. Since there was not as much movement around the poverty line, the poverty elasticity of economic growth remains relatively modest.

⁹ The Bank's regional poverty study (Growth, Poverty and Inequality in Eastern Europe and Central Asia, October 2005) puts the share of people in Uzbekistan living on less than US\$2.15 a day (in Purchasing Power Parity terms) at 47 percent, comparable to levels in the Caucasuses or Moldova, but below levels in the Kyrgyz Republic and Tajikistan.

¹⁰ The average elasticity of poverty to growth in consumption per capita between 1998 and 2003 is -3.1 for Belarus, Kazakhstan, Russian Federation and Ukraine. In low income CIS, the average elasticity is closer to what is observed in Uzbekistan, at -1.4 (World Bank 2005).

¹¹ Based on 2007 Living Standards Assessment (LSA).

22. **The low elasticity is a reflection of the type of growth and its associated limited distributional effect across the population.** The findings from labor market analyses conducted under the LSA Update in 2007¹² suggest that key reasons for this relatively low growth elasticity, especially for the middle deciles, are constraints on

Table 3: Poverty Rates, 2000-2005

	2000-2001*	2002**	2003**	2004**	2005**
National	27.5	25.3	26.2	26.1	25.8
Urban	22.5	21.1	22	18.8	18.3
Rural	30.5	27.7	28.7	30.3	30

Source: Uzbekistan Living Standards Assessment, World Bank, 2002.

** Authors' calculations based on Household Budget Surveys. The poverty line used is based on a food only consumption basket, equivalent to 2100 calories per day, considered an acceptable minimum level for a wheat based diet such as in Uzbekistan.

greater private sector development in the formal sector and therefore dynamic job creation, and the persistence of underemployment in the informal sector. Although a generous system of public transfers and subsidies, as well as large flows of remittances contributed to reduction of extreme poverty, the population of the working age has grown considerably faster than formal sector employment since the mid 1990s.

23. **The overall improvement in the macroeconomic situation has therefore not been reflected in a widespread significant improvement in the standards of living of the population.** Because so many people still directly or indirectly derive their income from agriculture or agriculture-related activities in the rural areas, and because the traditionally labor-intensive micro- and small business private sector is limited to 45.7 percent of GDP, the recent upturn in overall economic growth has yet to be translated in significant and widespread improvements in many people's living standards. Greater economic liberalization, to allow increased imports of consumer goods and improve the environment for private investment, would contribute greatly to improve prospects for a more pro-poor growth.

24. **There are significant differences across regions – with rural areas showing more poverty than urban areas.** As shown by the LSA, rural poverty has a number of causes, including declining soil quality in some places, the absence of non-agricultural jobs in most rural areas, and generally lower access to public goods. Environmental conditions are also a particularly important factor in regional variation in poverty rates. Karakalpakstan and Khorezm are at the tail-end of irrigation systems with insufficient or unreliable access to water and have been severely affected by the Aral Sea crisis. Here, as well as in other parts of Uzbekistan, water logging and soil salinity have continued to reduce the ability of those in the rural communities to raise their incomes. With the tightening of budget constraints for state-owned enterprises (SOEs) and utility price adjustments in recent years, a newly emerging concern is the urban poor, particularly in smaller regional towns. This regional diversity also translates into persistent socioeconomic inequalities, although consumption inequality is moderate compared to the rest of the FSU (the Gini coefficient is estimated at around 0.368).

25. **Since independence, food-security policies increased self sufficiency and partly isolated Uzbekistan from the effects of the current global price increase.** Food imports are relatively small and related to specific items, such as vegetable oils.

¹² The World Bank, Report No. 40723-UZ.

Uzbekistan is a net exporter of fruits and vegetables and has achieved wheat self-sufficiency. The country officially imports relatively small quantities of wheat and flour from Kazakhstan because of quality considerations. However, the isolation from global price trends is not permanent and pressure on food prices will continue to increase. This will inevitably place an additional burden on the poor, particularly in urban areas. In rural areas, the impact will be less, since production for self-consumption in household plots (the so called “Dekhan farms”) is widespread.

26. Relative to its per capita income, Uzbekistan records favorable health outcomes. It has not seen the decline in life expectancy that has characterized several CIS states and MDGs in health appear achievable. However, a survey funded by the United Nations Children’s Fund (UNICEF) in 2006, reveals that infant mortality was still around 48/1000 in 2006. The Bank’s LSA further revealed that poor people’s access to health services, particularly the services provided by the hospitals, is impeded by significant out-of-pocket payments, and that the input-based financing system has led to significant regional inequalities in standards of service. Reforms in primary health care, supported by the WBG, have improved governance and accountability in the health sector, increased availability of funding and other medical inputs for rural PHCs and increased financial autonomy of SVPs. These reforms have resulted in improvements in quality and availability of health services as attested by beneficiaries’ surveys. Uzbekistan however still faces challenges in maternal health, nutrition, HIV/AIDs and TB. These last diseases have been spreading at an exponential rate in Central Asia and have emerged as a key challenge for public policy over the coming years.¹³ However, for these issues, appropriate policies and strategies have been developed and the Government has been effective in implementing them.

27. Results in education are also favorable. Uzbekistan’s spending on education remains high; equal to and even exceeding levels in some Organization for Economic Cooperation and Development (OECD) countries (although a significant part of this is investment in new vocational training institutions). This has allowed primary and secondary school enrollment rates to be maintained, although some concerns persist over the quality of education and also over attendance rates particularly in rural areas. Existing studies (including the Bank’s Public Expenditure Review (PER) further suggest that the cost-effectiveness and labor market relevance of spending, particularly on vocational secondary education, is low. Statistics on learning achievement based on a measurement of skills rather than knowledge carried out through a random statistical sampling of schools are not nationally available, and a systematic analysis of access issues has not been carried out. Further work is needed both to develop an adequate monitoring system and to improve targeting of government expenditures. The

¹³ The recorded HIV infection rates in Uzbekistan (estimated at over 3,500 at end-2003, up from 230 at end-2000) remain low. However, as elsewhere in the region, there are worrisome signs of very rapid growth due to expanding use of drugs, especially in urban areas. Moreover, international experience suggests that the actual number of people infected may be 5-10 times higher than officially recorded rates. The Government has approved a National Strategy for Prevention of HIV/AIDS, and successfully applied for a grant from the Global Fund against AIDS, Tuberculosis and Malaria (GFATM). Uzbekistan (together with Kazakhstan, Kyrgyz Republic and Tajikistan) is also an active participant in a US\$27 million Regional AIDS Control project to minimize the human and economic impact of HIV/AIDS epidemic.

Government, with support from the WBG and the Asian Development Bank (ADB), is increasingly focusing on student assessment and reforms in school governance.

III. COUNTRY DEVELOPMENT PROGRAM

A. Country Vision: the Government's WIS

28. **The Government of Uzbekistan has endorsed the MDGs.** For Uzbekistan, the main goal under the MDGs translates into a reduction of the poverty rate from 27.5 percent in 2000 to 14 percent in 2015. The Government has been increasingly concerned by the disconnect between the impressive economic results of recent years and the relatively modest reduction of poverty. Aggregated GDP growth in 2002-2005 was 24.9 percent, but the number of poor for the same period was reduced only by 2 percentage points.

29. **In response to this challenge, the Government approved its first Poverty Reduction Strategy paper (PRSP) – the Welfare Improvement Strategy (WIS)¹⁴ - in September of 2007.** The WIS is a national strategic document for the social-economic development of the country over the period 2007-2010. It was prepared by an interdisciplinary team of government experts under the leadership of the Ministry of Economy, with analytical support of the United Nations Development Programme (UNDP), ADB and the WBG. The WIS is a comprehensive framework to address poverty and living standards issues built on the policy of granting a greater role to market principles within a gradualist approach to structural reforms. It aims at improving the living standards of the population through sustaining a robust and inclusive economic growth, developing a modern and diversified globally competitive economy, enhancing the quality of public services and reducing inter-regional inequalities in socio-economic development.

Poverty Diagnosis:

30. **The WIS provides a candid assessment of poverty level and trends in the country relying primarily on the Household Budget Survey (HBS) data.** The quality of poverty monitoring and the capacity for poverty analysis, including that related to non-income dimensions of poverty and access to services, require further strengthening. Increased access to information and encouraging broad-based discussion of development challenges that the country faces, would enhance the possibility of analysis of the critical poverty-growth related issues and deepen the understanding of the linkages between policy actions and pro-poor growth.

¹⁴ The WIS was discussed by the Board in January, 2008.