Uzbekistan’s Financial System: Ten Years of Transition

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Transition economies are those that are in the process of changing their economic system from the administrative-command economy to the market economy. This is the key factor uniting all Eastern and Central European countries and the former Soviet Union. However, every country has had its own historical evolution, its own culture, initial conditions and ability for transformation. Therefore, it is very important to analyze the applicability of a general model to the particular case of each country considering its own specifics. Western academicians as well as policy makers have tended to focus most of their attention to transition economics of Central and Eastern Europe for a number of reasons. Unfortunately, less attention has been given to countries of Central Asia in general, and Uzbekistan in particular. This article is devoted to the history and sequence of reforms of the financial system in Uzbekistan. It provides a clear picture of specific issues, which have arisen in Uzbekistan and allows for a further discussion on the issues related to financial development in Uzbekistan with a higher degree of confidence.

I. Uzbekistan’s Financial System before the Independence:

In order to have a clear picture of the financial structure of Uzbekistan before 1991, we should first consider the financial system of the Soviet Union, since the financial system of pre-independent Uzbekistan was an integral part of the communist financial system of the USSR. To analyze the Soviet financial system it is necessary to consider how the financial system functioned.

The allocation of investments is an important function for the financial system to fulfil. In market economies, decisions of investment-allocation are largely governed by a cost-benefit framework in which expected investment benefits are compared to estimated costs. Investment costs and benefits must be converted into present values using interest rates from financial markets. In the planned Soviet economy there were no financial markets - such decisions were made by planners and enterprise managers.

All the other functions of the financial system were executed by the banking system. The reason for this is the extremely low level of development of non-bank financial institutions (NBFIs). Furthermore, the vast majority of banking services was provided by Gosbank (the State Bank), which combined the services of a central bank and those of commercial bank, but owing to the absence of money and capital markets, Gosbank did not perform some traditional banking functions (open market operations, commercial paper transactions, and the like). It did, however, perform major functions such as granting short-term loans for working capital, overseeing enterprise plan fulfillment, and monitoring wage payments (as the center for all accounts). Thus, enterprises held their accounts with the local branch of Gosbank, upon which they were dependent for short-term credit to finance inventories and working capital. Receipts were normally deposited with the bank, and cash for wage-payments were drawn at the discretion of the bank. In addition, profit remained in special accounts at the bank.

Gosbank was the only provider of short-term credit, with interfirm lending strictly prohibited. Indeed, with the exception of small payments, all interfirm transactions were handled and supervised by Gosbank. Hence, Gosbank was in a unique position to monitor enterprise activities, as the single clearing agent and the sole source of short-term credit.

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In drawing up short-term credit plans and in controlling enterprise accounts, Gosbank played a largely passive role, providing the credit necessary to implement the physical plan. As for short-term loans, Gosbank granted credit for specific targeted purposes.

Besides Gosbank, there were also a number of specialized banks, which were fulfilling a complementary role to Gosbank. In the former Soviet Union such banks included Promstroybank (supporting industry and construction), Agroprombank (supporting agriculture), Sberbank (the national savings bank) and Vneshtorgbank (for business involving foreign exchange transactions).

NBFIs in the former Soviet Union were almost undeveloped. The only insurance company was Gosstrakh (State Insurance), which was entirely owned by the government. The variety and quality of its services was rather limited. There was also only one pension, also owned by the government. Other important features of the financial system of the Soviet Union were the absence of a capital market for government debt, enterprise debt and equities, absence of money markets and foreign exchange markets, restrictions on monetary circulation which, effectively, meant the absence of a universal payment system.

The dominant financial institutions in market economies, banks (or the subgroup otherwise known as commercial banks, money deposit banks, or similar banks) operate the mechanisms that enable money to circulate. Their liabilities (bank deposits or a subset of deposits) act as money since they are fully liquid, and the banks operate the mechanisms for transferring money and making payments, especially check-clearing systems. By contrast, the main characteristics of monetary circulation in the former Soviet Union were as follows:

1. Bank deposits were not able to act fully as money since they were not fully liquid. During times of chronic shortages and quantity rationing, neither deposits, nor cash were freely exchangeable for commodities [Kornai 1980].
2. The circulation of money in centrally planned economies is formally divided into two circuits with two distinct types of money: “passive” money and “active” money. Passive money consists of bank deposits for ministries, large enterprises and other state bodies. These passive money deposits increase or decrease as a result of “transactions” determined by the plan, therefore, they are debit and credit accounting entries, and do not confer any real entitlement to their owners. Active money, by contrast, consists of cash used for payments between the state system (ministries, enterprises and other units) and the general population. These cash payments are used for wages and salaries, transfer payments, and other payments; while, in the opposite direction, individuals use cash for retail purchases, tax payments, and for accumulating savings deposits. The consequence of having two circuits is that the characteristic identified above (i.e., the failure of monetary instruments to act as money) varies: in the “passive” circuit, deposits were highly illiquid because their use was completely to the plan; while in the “active” circuit, the use of cash had a greater degree of autonomy, although it was still subordinated to rationing and other administrative controls.
3. Even within each circuit, the payment mechanism was significantly underdeveloped and cumbersome.
4. Deposits and cash were not convertible into foreign currency by enterprises and individuals.
II. Uzbekistan’s Financial System since the Independence:

a) The Banking Sector:

After Independence in 1991, the departments of the Soviet banks located in Uzbekistan became the independent banks of Uzbekistan. A law was passed in February 1991, establishing the new structure of the banking system. The new structure envisaged the creation a two-tier banking system, with the Central Bank of Uzbekistan formed from the Uzbekistani department of Gosbank, as well as commercial banks based on various non-state forms of property. The primary tasks of the Central Bank included tasks to conduct monetary policy and bank supervision and to provide Uzbekistan with its own payment system.

The Uzbekistan department of Vneshtorgbank became the National Bank for Foreign Economic Activity of Uzbekistan (NBU). Its task was to give effect to government policy in the field of international economic activity, to service external economic transactions and to accumulate the nation’s foreign exchange reserves.

The legislation formed to regulate the banking system emphasized administrative measures of regulation. This was understandable in view both of the background from which policy makers and legislators had emerged, and of the primitive state of the financial system at the time. Since then banking legislation and reforms have steadily been improving, although the pace of the improvements has been very slow.

In 1997, foreign assets earlier held by the Ministry of Finance at the National Bank of Uzbekistan were transferred to the Central Bank. However, the NBU continues to be the depository of a large proportion of official gold reserves on behalf of the Central Bank. Money and credit policies, as well as foreign exchange allocation, are determined by the Chairman of the Central Bank, with the involvement of representatives of various government agencies and the banking sector.

As of July 2002, there were 36 commercial banks in Uzbekistan (35 at the moment): one state bank (fully owned by the government), 4 state-owned joint-stock banks, 11 joint-stock commercial banks with the capital participation, 14 private banks, 4 joint-stock banks with foreign participation and 2 subsidiaries of foreign banks. 28 banks were licensed to carry out foreign currency transactions, but the bulk of foreign exchange transactions were conducted by the NBU.

The NBU, which is state owned (planned to be partially privatized in 2004) is the largest commercial institution in Uzbekistan. Today, it accounts for nearly 70 percent of total commercial bank loans and about 85 percent of all transactions in foreign currency. In addition, there are 9 representative offices of foreign banks registered in Uzbekistan.

The development of commercial banking has been affected in Uzbekistan by direct government intervention in foreign exchange and financial markets. In addition to the rule limiting enterprises to one account, which seriously limits competition among banks, enterprise deposits can be withdrawn only for the payment of wages and travel expenses, in accordance with quarterly cash plans. The most important commercial banks are controlled by the government and follow the credit policies set by the Republic’s Monetary Policy commission, which gives priority to sectors in line with agricultural and industrial policies of the government.

In December 1997, compulsory reserve requirements at the Central Bank (CBU) were reduced from 25 to 20 percent of deposits (for deposits over 3 years, the reserve requirements were kept at 10 percent). The liquidity impact of the measure was neutralized with the auctioning of treasury bills yielding interest 1.5-2-percentage points higher than the rates ordinarily paid in treasure bill auctions. This step resulted in an
improvement in the income position of banks, since required reserves are not remunerated. Foreign currency deposits are not subject to reserve requirements at the Central Bank.

In November 1996, the Board of the CBU adopted new charts of accounts for the CBU and commercial banks. The new accounting system was introduced in March 1997 and has improved the quality of monetary statistics. However, commercial banks have experienced difficulty in using the new system. In addition, risk assessment, and corresponding classification of loans in commercial banks’ balance sheet, remains impaired by the fact that enterprises typically do not perform bookkeeping in accordance with internationally accepted accounting standards, and banks are inexperienced in risk assessment and risk management.

The banking system of Uzbekistan is characterized by a small number of relatively sophisticated banks (the NBU and some joint venture and private banks) along with the successors of the formal sectoral (specified on financing of particular sector of economy) banks. This second group of banks is undercapitalized, and has low-quality loan portfolios and limited bank management skills. These problems are aggravated by (i) the absence of adequate legal instruments (bankruptcy procedures, assets sequestering, etc.) to protect the integrity of the banks’ assets, and (ii) the way banking activity is taxed.

b) Non-bank Financial Institutions:

The formation of specialized NBFIs began in 1995 at the instigation of both the government and the private sector. Such as the Business Fund for financing small and medium sized business enterprises, the state insurance companies “Madad” and “Uzbekinvest”, and a number of private insurance and investment companies. But the information available on this sector is very limited and there is no statistical data at all.

There were no significant attempts in Uzbekistan to reform the pension system. The single pension fund remains state-run and no private pension institutions have been created.

In late-1996, a new type of financial institution was created in Uzbekistan, called the Privatisation Investment Fund (PIF). Under this PIF scheme, it was envisaged to sell 30 percent of the shares of about 300 large enterprises to investment funds in a first implementation phase. It was further expected that in a second phase, shares of 300 more enterprises would be sold. Progress in implementing the scheme has been substantially slower than originally expected, although more than 80 investment funds and management companies have been established so far, and about 200 thousands individuals have bought shares in PIF’s.

c) Securities Market:

From 1994 to 1996, the development of the stock exchange took place alongside the development of the market economy including the privatisation and de-monopolisation process. Restructuring of corporate forms has led to the circulation of privatized enterprises’ shares.

Today, the market for these shares is still small in terms of quantity, variety, and volume of transactions conducted through the stock exchange. The low level of development of the market reflects to some degree the approach that has been taken to privatization. Shares have simply been distributed among the companies themselves, to selected foreign investors, outside shareholders, and to the state. Investors, who obtained shares in this way, had no real incentive or any real opportunities to trade these securities.
The low interest of potential investors in equities also reflects the absence of reliable information about the issuers of shares and the subsequent high risk of such investments. Although the Republic’s Stock Exchange “Tashkent” (RSET) – the only stock exchange in Uzbekistan – was established in January 1994, activity there is mainly connected with servicing new issues of securities as part of the privatization process.

Since 1995-1996, there have also been other types of securities issued in Uzbekistan: banks’ equities, deposit certificates, commercial bills and state’ treasury bills. But the availability of these securities is highly restricted (only three-year deposit certificates are available for individuals) and very few of these securities are issued.

In 2002, the Government of Uzbekistan has signed a Memorandum with the International Monetary Fund, in which Uzbekistan pledged to liberalize its financial system. In particular, the rule limiting enterprises to one account, cash withdrawal limits, government’s intervention into credit policy of commercial banks should be abolished. These measures indicate that some reforms in financial sector has pushed ahead; though their pace remains very slow. There is enormous scope of in-depth reforms to be applied by the government before effective financial system can be built.

References


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