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Preface

This paper is one of a series of three chapters chosen from the volume prepared for the ILO/UNDP multidisciplinary mission on ***Social Policy Review*** which was requested by the Government of Uzbekistan, and which took place over the period of 21 March to 21 April 1995, with Professor Keith Griffin as its Chief.

The volume provides a systematic and critical review of the macroeconomic and social policies in Uzbekistan. To our knowledge, this is the first attempt to provide a coherent policy framework which combines the objectives of social policy as an integral part of macro-economic reform. ***The main message of the report is that Uzbekistan should speed-up its pace towards economic reform, and at one and the same time, ensure that the social dimensions of reform are taken into account.*** Thus, the thrust of the argument is that sound social policy is a prerequisite for the success of economic reform. It should form an integral part of the overall development strategy, and not simply react to whatever negative consequences macro-economic policies may create. Social development policies must therefore be carefully designed to ensure that during the transition to a more market-oriented economy, average living standards are not allowed to deteriorate, thus threatening the whole process of reform and the prospects for long-run growth.

To implement this strategy, a number of ***policy reforms, institutional changes and investment programmes*** were recommended. The main objective of the ***programme of action*** is to identify a limited number of areas of intervention that would help to translate the major recommendations of this report into reality. The list is not exhaustive, but contains the critical elements of a social development strategy designed to support the process of reform. Four major programmes are proposed: (a) The creation of a Social Development Fund; (b) Launching a Social Assistance Programme; (c) Initiating a programme for National Capacity Building; (d) Improving the Data Base for Social Development.

An important question relates to the **finance strategy of these recommendations**. Despite the serious difficulties encountered during the transition from a centrally-planned to a more market-oriented economy, Uzbekistan finds itself in a relatively good financial position and thus has some room for manoeuvre in launching a more expansionist development strategy.

This report provides an excellent example of the way in which social policy could be integrated in a systematic manner into the framework of macro-economic polices. It also demonstrates the possibility of striking a balance between the requirements of rapid economic reform and social cohesion. We are confident that the relevance of this report goes beyond Uzbekistan especially to other Central Asian Republics.

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The Macroeconomic Framework and Development Strategy in Uzbekistan

1. Introduction

Uzbekistan began life as an independent country with a huge shock: it lost aid transfers from the Soviet Union equivalent to more than 19 per cent of its gross domestic product.[1] These transfers financed a large part of government expenditure and enabled Uzbekistan to support a wide range of public services and outlays on human capital. The results over the years were impressive. Adult literacy, for women and men combined, was 97.2 per cent. The average number of years of schooling was nine (or even higher), roughly equal for women and men. Life expectancy was high at 69 years and average incomes, while low by the standards of the USSR, were relatively high compared to that of neighbouring Asian countries. Accurate estimates of GNP per capita are difficult to obtain, but as an order of magnitude, $960 seems about right.[2]

In addition to the "aid" shock, there were serious problems arising from the disruption of existing trading patterns and, in the short-run, a deterioration in Uzbekistan's external terms of trade. In 1988, for instance, before the economic collapse and the political disintegration of the Soviet Union began, "foreign" trade accounted for 39.5 per cent of the country's GDP, of which 85.8 per cent was inter-republican trade.[3] Uzbekistan was dependent on the Soviet Union for imports of petroleum, which were provided at well below world prices. With independence came an increase in the price of imported oil and consequently a worsening of the terms of trade.

There were however some offsetting factors. First, foreign aid from non-Soviet sources increased very rapidly and by 1992 capital inflows were equivalent to eight per cent of GDP.[4] Second, trade volumes between Uzbekistan and the former Soviet Union recovered fairly quickly and a shortage of imported inputs which might have severely disrupted production did not occur. The payments system for trade with the former Soviet Union however remains a problem and this has helped to perpetuate a cumbersome set of barter agreements and trade controls. Third, in response to the rise in the relative price of imported petroleum, Uzbekistan has been able to increase the domestic output of petroleum and is now rapidly approaching self-sufficiency. Fourth, prior to independence the output of Uzbekistan's large gold mining industry was simply shipped to the Soviet Union: this can be regarded as an unrequited export or as an omitted element which helped to exaggerate the favourableness of the country's terms of trade. Now that Uzbekistan is independent it is earning about $700 million a year from gold mining, and production is rising rapidly. Finally, the external trade shocks combined with political independence gave Uzbekistan the incentive and the opportunity to seek out new trading partners: to search for cheaper sources of supply of internationally traded goods and services, to explore alternative sources of technology, to obtain (if desired) finance capital from abroad and to develop new export markets on a profitable basis.

Despite these positive aspects of the post-independence economic situation, Uzbekistan was not able to prevent the loss of part of its human capital. There was a considerable emigration of non-Uzbek (presumably Slavic) professionals and technicians that began before independence and continued thereafter. One estimate of net emigration is that it was 1.8 million persons in 1990 and 1.0 million in 1991.[5] Given that the total population is about 22 million people, this represents a loss of nearly 13 per cent in just two years. A second study reports "a million Russians holding key technical and managerial posts having left by 1993".[6] Official estimates however are much lower, namely, 274.4 thousand between 1990 and 1993. Even this figure represents a significant proportion of the Slavic population. Part of the exodus probably was due to economic factors (namely, actual or anticipated declines in real incomes), but political and social issues undoubtedly also played a part (namely, nationality/ethnic conflict and the fear that multi-lingualism would be replaced by exclusive use of Uzbek, particularly in the schools). The link between culture, human capital and development is in this case exceptionally close.

The overall performance of the economy since independence has been poor, although it has been less bad than that of the average for the countries comprising the Commonwealth of Independent States. The basic data are presented in Table 1. The reader is warned however that estimates of inflation, changes in output and population growth vary considerably from one source to another, and hence the figures in the table should be regarded as indicating orders of magnitude only.

It is evident from the table that the transition from a centrally planned to a more market-oriented economy has been accompanied by rapid inflation which in fact accelerated between 1989 (when prices were stable) and 1993 (when retail prices increased 851 per cent in one year). The rate of inflation declined in 1994, although retail prices still increased 746 per cent over the year. The rate of increase however was falling, so that by the end of the year prices were rising at the lower pace of 423 per cent per annum. Encouraged by these results, the International Monetary Fund and the government aimed to reduce the monthly rate of inflation to 2 per cent by the end of 1995.[7] This is equivalent to an annual rate of about 27 per cent. Unfortunately, however, inflation accelerated again during the first quarter of 1995 to roughly 13 per cent a month. This implies an annual rate of 333 per cent, which if it indeed materializes would be a major setback to the stabilization programme.

Output declined, not perhaps dramatically, but certainly very sharply. In the two years before independence growth on average was about 5.5 per cent a year, but in the few years since independence growth rates have been negative. Over the entire period 1991-1994 the cumulate decline in real GDP was 16.6 per cent. Unfortunately, as with inflation, the growth outlook for 1995 appears to be getting worse and it is quite possible that production will fall by an additional 10 per cent this year. If this does in fact occur, it means that output at the end of 1995 will be a quarter less than five years ago.

Consider, finally, what has happened to the real incomes of the people of Uzbekistan. The last column of Table 1 contains estimates of the yearly changes in real GDP per head, assuming the population growth rate was as indicated in the third column. As can be seen, real incomes rose on average 3.2 per cent a year in 1989 and 1990, but thereafter they fell, precipitously in 1992 and more moderately in the other three years. The cumulative fall in incomes was 24.4 per cent in just four years. A further sharp decline in average incomes this year could well cause severe hardship in certain sections of the community and possibly result in public manifestations of discontent, especially in urban areas.

It is quite evident that a resumption of growth in output and per capita incomes should be a very high priority. It is possible, even probable, that the national accounts underestimate the level of output and average incomes -- informal sector activities are not fully recorded, illegal activities such as drug transporting and production are unrecorded and the very substantial self-provisioning in rural (and urban) areas is not fully recorded -- but it is unlikely that the expansion of these three activities has been so rapid that the aggregate growth rates reported in Table 1 totally misrepresent the true picture. Uzbekistan undoubtedly confronts a situation of falling living standards and rising poverty, although lack of data makes it impossible to quantify the incidence of poverty, much less trace changes in the incidence of poverty over time.

Macroeconomic policy is made very difficult by the presence simultaneously of very rapid inflation and negative rates of growth. A socially conscious government may be tempted in such circumstances to relax efforts to stabilize prices and devote all its energies to stimulating the economy and "go for growth". This temptation should be resisted.

Table 1 Output, prices, population growth and real incomes, 1989 - 1994
(percentage change per annum)

	Retail prices	Real GDP	Population growth	Real GDP per capita
1989	0.7	4.5	2.4	2.1
1990	4.0	6.6	2.2	4.4
1991	105.0	-0.5	2.4	-2.9
1992	528.0	-11.1	2.4	-13.5
1993	851.0	-2.3	2.2	-4.5
1994	746.0	-3.5	2.3	-5.8

Sources: (a) 1991-94: Goskomprognozstat; (b) 1989-90: World Bank, *Uzbekistan Economic Memorandum*, Vol. 1: Main Report, 20 June 1994, Table 1.1, p.1.

2. The importance of price stability during the transition

The benefits of a market oriented economy depend upon the ability of producers and consumers to respond to changes in relative prices. Higher relative prices for some goods and services encourage producers to expand production and consumers to curtail demand. Lower relative prices, by reducing profits, provide an incentive to producers to reduce output and shift resources to other uses; consumers, on the other hand, will have an incentive to alter the pattern of consumption in favour of the now-cheaper products. Provided relative prices accurately reflect social costs and benefits, the reallocation of resources that occurs in response to changes in relative prices should lead to increased efficiency, higher total output and incomes and an improvement in the average standard of living.

Rapid inflation however hampers the operation of the price mechanism and makes it much more difficult to achieve the gains which a more market-oriented economy should make possible. This is especially true during a period of price liberalization in an economy that previously relied on administrative measures to allocate resources.[8] There are several reasons for this. First, rapid price inflation -- certainly a rate of inflation of 50 per cent per annum or more -- weakens price signals and hence reduces the power of the market mechanism to allocate resources efficiently. The reason for this is that when all prices are rising rapidly, it is difficult for producers (and consumers) to detect small changes in relative prices. Yet it is relative prices that matter.

Second, during periods of rapid inflation virtually all prices are rising, but not all prices are rising continuously. Prices change at different times throughout the year, some lagging behind for a while and then spurting ahead with a large price increase. The result is that relative prices change arbitrarily during the course of the year and the changes in relative prices can be very large. This adds to the difficulties producers face when making production and investment decisions. Rapid inflation introduces great uncertainty into the decision making process and this tends to dampen investment and lower the overall rate of growth. In this sense it is not possible in a market economy to ignore rapid inflation and "go for growth": stabilization is essential.

Third, rapid inflation inevitably is accompanied by arbitrary and hence inequitable changes in the distribution of income. Every change in relative prices entails both a change in the optimal composition of output and a change in the pattern of rewards and the distribution of income. When changes in prices are arbitrary, changes in rewards and incomes are arbitrary. Those on fixed incomes, e.g. pensioners, obviously suffer severely but ordinary employed workers also suffer when, for instance, changes in nominal wages lag behind changes in the average price of consumer goods. The same is true of small business persons (and others) who happen to be producing products whose prices temporarily are slow to adjust to changes in the general level of prices. The consequence is that the structure of incomes and the degree of inequality becomes unpredictable and totally irrational.

Finally, because of (i) the feebleness of price signals, (ii) the adverse effects of inflation on investment plans and (iii) arbitrary changes in the distribution of income, sustained, high rates of inflation are likely to result in political discontent which undermines support for the reform process as a whole. If average incomes are falling because of negative real growth, if investors are disgruntled because of an uncertain business climate, and if large numbers of households are angered by changes in the distribution of income that are unrelated to work effort, skills, entrepreneurship or considerations of equity, the benefits of reform soon will appear to be far less than the costs. Present sacrifices in favour of future gains will be perceived to be a poor bargain and there is a risk that the entire reform effort will grind to a halt. A reasonable degree of price stability is therefore a necessary condition for success, although price stability alone is hardly sufficient.

3. Strategic prices and an efficient composition of investment

Not all prices are equally important. Some prices are strategic in the sense that they influence the overall performance of the economy and not just the efficiency of resource use in a particular branch of industry. In the case of Uzbekistan we shall concentrate on five markets which have a major impact on macroeconomic efficiency and growth: the market for foreign exchange, the market for finance capital, the wage rate for low skilled labour, the price of water and the price of energy. A discussion of two other strategic prices, namely, the market for land and agricultural procurement prices, can be left for another occasion. If policy interventions ensure that these seven markets function well, the probabilities are high that macroeconomic performance will be satisfactory. Development policy should therefore focus on a limited number of price interventions where public action can be expected to have a high payoff.

3.1 The market for foreign exchange

The economy of Uzbekistan is highly dependent on foreign trade. The ratio of exports to GDP was 49.7 per cent in 1993, with the share of exports to the former Soviet Union falling and the share of exports to the rest of the world rising rapidly since 1991. The country relies on imports for foodstuffs and a wide array of basic manufactured consumer goods as well as for capital equipment, current inputs and spare parts. In 1993 the ratio of imports to GDP was 60.2 per cent. It is therefore vitally important that the foreign exchange market function properly. Two issues arise here, namely, price and access.

On the surface the balance of payment position appears to be strong. The trade account, which had a small deficit in 1992 and 1993, now is in balance (and possibly running a small surplus), there are large net capital inflows which cover the current account deficit and foreign exchange reserves are large and rising. Beneath the surface there are problems however. First, the official exchange rate has appreciated in real terms, thanks in part to large inflows of foreign aid and foreign private investment and in part to a decline in real incomes which has reduced the demand for imports. The appreciated exchange rate has made it more difficult for Uzbekistan's exports to be competitive in world markets and for domestic industries to compete with imported goods from abroad. Foreign capital inflows, in other words, actually have exacerbated the problems of structural adjustment through their impact on the exchange rate. Uzbekistan might be better off with less foreign aid.

Second, although there is an auction for foreign exchange, the price of foreign exchange actually is controlled by the government and not determined by market forces. The management of the exchange rate is achieved partly by determining the volume of foreign exchange that will be sold at auction and partly by regulating access to the foreign exchange auction. The latter, in effect, determines the demand for foreign exchange in the auction. Third, those denied access to foreign exchange at the official price have no alternative but to resort to the black market. The difference between the official exchange rate (until recently 25 sums per US dollar) and the black market rate (40 sums) is 60 per cent. That is, different users of foreign exchange pay very different prices and thus face very different incentives. It is highly desirable that the dual market for foreign exchange be unified and that access be widened to include everyone who has legitimate reasons for wanting to buy or sell foreign currencies.

Third, contrary to initial appearances, foreign trade still is managed by direct controls rather than by the price mechanism. There are no tariffs on imports but there still are import licenses. It would be better in fact to abolish import licenses (which create economic rents and consequently opportunities for corrupt practices) and to replace them with a modest tariff (say, a uniform rate of 10 per cent) which would provide some compensation to domestic producers competing against foreign imports for the appreciated exchange rate while generating government revenue that would help to reduce the fiscal deficit. In addition to import licenses there are taxes on many exports, notably on above-quota exports of cotton.

Fourth, there also are quantitative controls on exports. On January 1st of this year the government reduced the number of products subject to export quotas from 26 to 11.[9] This represents a decline of nearly 58 per cent in the number of products to which export restrictions apply. Unfortunately, however, this gives a misleading impression of the extent of trade liberalization. In fact, several major export products still are regulated in part by quotas, including cotton and natural gas. If one considers not the number of products but the proportion of total exports still subject to quotas, it transpires that the reforms have increased quota-free exports only from 26.9 per cent of the total to 35.4 per cent.[10] While this is not a negligible change, Uzbekistan still has a long way to go before exports can be traded freely.

Given the size and significance of the foreign trade sector in Uzbekistan's economy, it is vital that scarce foreign exchange be allocated to those who can use it most efficiently and that no disincentives be created that discourage people from earning more foreign exchange by expanding production for export. At present it appears that the market for foreign exchange, because of restricted access, discriminates against small businesses, the informal sector and small farmers, i.e., precisely those sectors where the return to investment is likely to be exceptionally high, and where there are promising possibilities for generating employment quickly. At the same time, export quotas are a severe obstacle and limit the amount of foreign exchange available. They should be abolished. It makes no sense to reduce artificially the supply of foreign exchange and then to allocate that foreign exchange inefficiently and inequitably.

Exchange rate policy, seen in this broad framework, is a top priority for market reform. A unified exchange rate, with free access and current account convertibility is one of the keys to increasing the level of investment, raising the productivity of capital, igniting economic growth and halting the decline in the standard of living.

3.2 The market for finance capital

Capitalism is about capital and a modern, market oriented capitalist economy cannot function properly without an efficient market for finance capital. A strong banking system, carefully regulated by government, whether privately or publicly owned, is an indispensable market institution. One is tempted to say that this is a *sine qua non* for an economy undertaking systemic change. That perhaps would be an exaggeration, but there is little doubt that a weak banking system makes the transition to a market oriented economy more difficult. Alas, Uzbekistan has a weak banking system.

The role of the banking system in a commercial economy is to serve as a financial intermediary, accepting deposits from those who have monetized savings and allocating credit to investors who have profitable projects which require more funds than they can mobilize from their own resources. If the banking system operates efficiently, it should contribute to a higher level of savings and, more important, to a more productive allocation of investment and hence to a faster rate of growth. (An inefficient pattern of investment is evident from the fact that in 1993, for instance, investment accounted for 23.8 per cent of GDP yet growth was negative.) Once again, as in the market for foreign exchange, the problems of the banking system can be grouped under two headings: price and access.

At the time of independence Uzbekistan inherited three large banks which facilitated financial transactions in agriculture, industry and foreign trade. Since then, 26 new banks have been created, including three that are private, another oriented toward the private sector and a fifth intended to encourage joint ventures with foreign enterprises. Uzbekistan thus has a two-tier banking system with a Central Bank occupying the upper tier, but with functions and responsibilities that are not yet entirely clear. The second tier banks, i.e., the commercial banks, continue to operate in a way similar to that under a central planning regime. Most of their loans are to state enterprises, many of which are in arrears on repayments, and hence the asset portfolios of the banking system include a substantial proportion of non-performing loans. The banking system, in effect, still is used to provide subsidies to cover the operating deficits of state enterprises.

One consequence of these practices is that the banking system is very fragile and without a continuous injection of credit from the Central Bank, the banking system probably would collapse. That is, it would go bankrupt. A second, equally serious consequence is that large sectors of the economy do not have access or have only very limited access to financial capital; they are unable to obtain loans to finance potentially profitable activities. The banking system, in other words, is not performing its crucial function of allocating capital to projects with the highest rate of return. Small and medium sized enterprises are starved of credit, as are private farmers and the informal sector. The results are that (i) finance capital is used to cover losses of state enterprises rather than increase investment, (ii) the expansion of a genuinely private sector is inhibited and restructuring is delayed and (iii) inequities are created, since those who are denied access to credit tend to be relatively small enterprises.

Quite apart from access, there is the question of price, i.e., real rates of interest. Nominal deposit rates are low and negative in real terms. Savers thus have little incentive to deposit funds with the banking system and while this may not have much effect on aggregate savings -- since the elasticity of savings with respect to changes in the real rate of interest may be low -- it will affect the form in which savings are held. Low deposit rates of interest will reduce the volume of deposits and make it more difficult for the banking system to perform its intermediation function.

Lending rates have varied but they, too, usually have been negative in real terms. In 1994, for example, the average lending rate of the Agricultural Bank, the largest in the country, was about 76 per cent a year, whereas retail prices rose 746 per cent that year. Thus those who have access to the credit market obtain finance capital at no cost. This makes it virtually impossible to allocate capital efficiently, to ensure that resources are used where they will be most productive. It also increases the demand for credit and where, as in Uzbekistan, the monetary authorities are accommodating, this increases inflationary pressure. The market for finance capital, in other words, is functioning poorly. Several reforms are desirable: (i) access to the banking system should be widened considerably; (ii) subsidies to state enterprises should not be channelled via the banking system but done in a transparent manner through the Ministry of Finance; (iii) nominal deposit rates of interest should be raised substantially so that savers receive a real rate of interest on deposits; (iv) lending rates should also be positive in real terms (at least 10 per cent per annum) and these rates should remain broadly constant for periods of time so that businesses can make investment plans with a minimum of uncertainty about conditions in the financial markets.

3.3 The wage rate

There is considerable slack in the labour market in the form of modest registered open unemployment, a large amount of part-time working, an enormous but unquantified amount of disguised unemployment in the state enterprises and surplus labour in agriculture. Government policies began to respond to this problem in 1992 when, for the first time, provision was made for the payment of unemployment benefits, an employment service was created and funds were set aside to finance training schemes. These programmes, while perhaps desirable, are totally inadequate to meet the scale of the problem and it is evident that a massive effort will have to be made to create more employment opportunities.

Our concern here is with the narrow question of wage determination. For most practical purposes there is no functioning labour market in large parts of the economy. Wages are government determined in the public sector -- the structure of wages being expressed as multiples of the legal minimum wage -- and even in the non-public sector, wages are heavily influenced by public sector wages. In an attempt to control inflation, the government has increased its intervention in the labour market further, thereby neutralizing the effects of supply and demand and moving away from its stated intention of creating a more market oriented economy. This in itself is a bit surprising.

The government has announced that the "quarterly increase in the wage bill of non-public enterprises will not be allowed to exceed the targeted increase in prices". Any excess wage payments "will be taxed at steep penalty rates".[11] This is described by government as an incomes policy although it might more accurately be described as a wage reduction policy. The implicit assumption seems to be that inflation in Uzbekistan is caused by cost-push pressures arising in the labour market. This clearly is an incorrect analysis: not only is there a large amount of excess labour in the economy but real wages have been falling (not steadily, but systematically) along with per capita income since independence.

The targets for inflation in 1995 are 4-5 per cent per month by the middle of the year and 2 per cent per month by the end. The actual rates of inflation, as we have seen, were well above this, namely, 17, 16 and 10 per cent per month in the first three months of 1995. Thus the incomes policy, if implemented, would impose a very sharp fall in real wages on ordinary working people. This cannot be good development policy given the current conditions in the country. Presumably the intention of the policy is to provide a strong incentive to enterprises to restrain wage increases, but this can best be done not by imposing a totally arbitrary incomes policy but by making it much more difficult for enterprises to finance wage increases by increased borrowing from the banking system. Banking reforms, not wage taxes, are what is required.

Indeed the government should be moving in the opposite direction, refraining from setting wages by administrative measures and instead allowing market forces to operate. This will necessitate not only banking reforms but also management reforms within the state enterprises, a subject we shall discuss below.

The general strategy should be to squeeze credit further and force loss making state enterprises to shed their disguised unemployment. If nothing else is done, this would increase open unemployment dramatically, which is socially unacceptable and economically unnecessary. Instead a guaranteed public works employment scheme (discussed below) should be organized to absorb people who would otherwise be unemployed. This public works scheme would concentrate on the construction of income earning physical assets, thereby raising the rate of investment and helping to restore growth. The credit squeeze would reduce the rate of inflation. The disguised unemployed in state enterprises (and in agriculture) would be transformed into construction workers. Part of the finance capital (bank credit) now used to pay the wages of the disguised unemployed in state enterprises could be used to finance the public works programme. There would be no net increase in credit and a net decline in (disguised) unemployment. The rate of inflation would fall and the growth rate would rise.

3.4 The price of water

Uzbekistan is a semi-arid country: the annual precipitation in Tashkent is only 393mm. Yet agriculture is by far the most important sector in the economy and water is very scarce. Only ten per cent of the country's land is arable and 95 per cent of the cultivated land is dependent on irrigation.

The major sources of water are two river systems -- the Amudarya and the Syrdarya -- which flow into the Aral Sea. Because of excessive withdrawals of water from these river systems, the Aral Sea is shrinking rapidly and the volume of water in the sea in 1993 was only 26.2 per cent of what it was in 1960. The shoreline has retreated 60-80 km., the seabed has been exposed and -- because of heavy use of chemical fertilizer and pesticides in cotton cultivation -- both irrigation water and drinking water have become heavily polluted, with serious consequences for the health of the population.

Water resources, the most precious component of Uzbekistan's stock of natural capital, have been badly managed. Water has been wasted, it has been polluted, it has been allowed to poison the land through salination, and worst of all, it has been allowed to damage the health of the people. No incentives have existed to encourage an efficient use of water. It has been treated as if it were a free good. Indeed, until this year, irrigation water literally was a free good. The government has begun to respond to this deplorable situation and has decided that water charges will be introduced in 1995 to achieve "at least 50 per cent operating cost recovery".[12] This is a small step in the right direction, but the objective must be to create a well functioning market in water as soon as possible. The health of the people and the prosperity of the agricultural sector depend upon it.

Several points are relevant here. First, the government has only announced its intention; a system of water charges is not yet in place. The creation of such a system should have high priority. Second, at the moment the intention is to cover only half of the operating costs of the irrigation system. There is no case on efficiency grounds for subsidizing water and the policy should be, as a minimum, to cover the full costs of operation of the system. Moreover, given that the terms of trade will soon turn sharply in favour of agriculture,[13] there is no case on grounds of equity to subsidize water.

Therefore, in future water charges should also cover the capital costs of the system. Incentives should be created to use the existing irrigation system more intensively and to maintain the system in good repair. The physical capital embodied in the irrigation system should not be treated as a free good. Finally, the revenues from water charges can make a useful contribution to the budget, compensating in part for the decline in agricultural quotas and the rise in procurement prices. Agricultural incomes should soon begin to rise significantly and water charges are a good way to tax these rising incomes and help finance essential public services.

3.5 The price of energy

Uzbekistan has been blessed with an abundance of energy resources in the form of natural gas, oil and coal. During the Soviet period, however, this important part of the country's stock of natural capital was not fully exploited. The natural gas industry was developed, but the petroleum sector remained fairly small and in fact Uzbekistan imported from the rest of the Soviet Union more than 60 per cent of its petroleum. Now that the country is independent, numerous opportunities to develop the energy sector exist, although there are a number of problems that must be faced during the transition. Our purpose here is merely to call attention to one important issue that arises during the transition to a market guided economy, namely, the question of the price of energy.

One of the characteristics of central planning during the Soviet period was the very low price of energy, including the price of oil. This affected patterns of production and consumption throughout the Soviet bloc, including Uzbekistan. Indeed the amount of energy required to produce one unit of domestic product was much higher in Uzbekistan than, say, in Japan, Western Europe and most other developing countries. This was a consequence of Soviet oil prices being only a fraction of those that prevailed in the world market. Even the United States, which by the standards of developed countries has a very low price of energy (because of low energy taxes), had a higher relative price of oil than Uzbekistan.

At the time, Uzbekistan seemed to benefit from the Soviet pricing and trading arrangements. As a net importer of petroleum, the low prices meant that the country enjoyed favourable terms of trade and a higher standard of living. The rise in import prices at the time of independence worsened Uzbekistan's terms of trade, created balance of payments problems and lowered average incomes. The disadvantages of the pre-independence arrangements however outweigh the advantages. First, the country failed to develop fully its natural resources. Second, the country failed to exploit its comparative advantage in the energy sector and generate higher incomes through exports at world prices. Third, after independence the country was left with an inefficient industrial sector that is dependent for its economic viability on the availability of cheap oil.

The task for the future is to reform the energy sector, push ahead quickly with an expansion of production and make certain that the government receives a reasonable share of the rents created by trading at higher world prices. Taxation of a flourishing and rapidly growing energy sector could in a few years contribute much to government revenues. It is equally important that the price of energy in the domestic market should reflect prices in the world market. At present both enterprises and households are subsidized by being supplied cheap energy, particularly fuel oil. Domestic prices should be raised to world levels so that individual enterprises that consume energy are forced to become competitive and the structure of the industrial sector that evolves reflects the true costs of production. Energy intensive industries will naturally be favoured in Uzbekistan and there is no need to increase the natural advantage they enjoy by artificially reducing energy prices through subsidies. The energy sector should be a source of development revenue for government, not a source of subsidy for old or new industrial enterprises.

4. The resumption of growth

Stabilization of the general level of prices and the creation of efficient markets in a few strategic sectors are central elements in a macroeconomic framework designed to achieve a smooth and rapid transition from a centrally planned to a market guided economy. The third element in the macroeconomic framework should be policies to resume growth and create employment opportunities. There are four issues we shall address: (i) creating space for the development and expansion of a small scale, labour intensive private sector, (ii) the transfer of ownership of existing state enterprises to the private sector, (iii) the transformation and expansion of the rural economy and (iv) the organization of a large public works programme to accelerate investment and create jobs.

It is widely believed, particularly in international financial circles, that price stabilization, privatization and market reforms will ensure rapid growth. That is, the spontaneous reaction of producers will bring about a swift increase in production once the institutions of a capitalist economy are in place. This is sometimes described as "the magic of the market". A less flamboyant statement of the same idea by the head of the World Bank's regional mission in Central Asia is that "the supply response to correction of price signals and institutional strengthening can be expected to be strongly positive".[14]

We are not so optimistic. We do not anticipate that price and institutional reforms alone will bring about "strongly positive" results. We do not believe in magic. Apart from changes in cropping patterns in agriculture in response to changes in relative prices, we do not believe that supply elasticities are high. The key to a resumption of growth is investment. Restructuring of the economy, i.e., a change in the composition of output, will require massive investments over an extended period of time. The speed of response to price signals depends on the level of investment and the productivity of capital. If the rate of investment is high, and if investment is channelled into highly productive sectors, supply will increase quickly, but if the volume and efficiency of investment are low, supply will respond slowly, even if there is price stabilization and market institutions are in place.

It is therefore important that development policy should concentrate on a relatively few sectors where there is a potential for a rapid increase in output and incomes. One such sector is the small scale private sector, including micro-enterprises and informal sector activities.

4.1 Creating space for the private sector

While it often is possible to increase output and incomes in existing enterprises by raising efficiency, the most promising source of growth in Uzbekistan is likely to come from the creation and expansion of new enterprises. The absence of a small scale, labour intensive private sector is a vacuum waiting to be filled. The fact that private initiative was virtually prohibited during the Soviet period -- except in the bazaar economy -- suggests that there are numerous opportunities for new entrepreneurs and business people, women as well as men, to engage in production and trading activities. There are many obvious possibilities, including the establishment of private restaurants, the development of tourist facilities (decent hotels, comfortable guest houses, transportation services, guides), the revival of a hand made carpet industry, the expansion of light manufacturing and the cotton textile industry (which at present processes only 15 per cent of the country's cotton), the expansion of food processing and other agriculture-related industries, the creation of small construction firms, etc.

Most such activities will be small in scale. They will not require large amounts of capital initially and many new activities -- particularly the micro-enterprises -- can be self-financed. Small enterprises typically are labour intensive and hence create a lot of employment per unit of output. The gestation period usually is brief, i.e., there is only a short lag between the commencement of investment and the beginning of the flow of output, and consequently the supply response is rapid. Finally, since entry into such activities is easy, competition is intense and prices to consumers are low.

Access to foreign exchange and to finance capital often are the most salient constraints to private sector investment and hence our previous discussion of the foreign exchange and capital markets is especially important in this context. Information also is essential so that entrepreneurs can learn where market opportunities and sources of supply exist. A lively business press, good telephone, radio and communications services and unhindered mass media all contribute to the development of a thriving small business sector. Lastly, Uzbekistan will have to develop a system of commercial law which protects private property rights and provides legal remedies when there are disputes. This will take time.

The government issued a decree in January 1995 providing equal rights for private and state enterprises, simplifying registration procedures and removing restrictions on the number of employees in private firms. The next step is to enforce the decree and to ensure that the police, tax authorities and local officials do not harass small traders, shopkeepers and other business people but rather encourage and assist them.[15] Space must be created for the emergence of a small scale, labour intensive private sector. This is an important component of "social policy" or, as we prefer to call it, general development policy. At present it cannot be said that Uzbekistan has shown by its actions that it truly wishes to have a large and dynamic private sector, despite its programme of privatization.

4.2 Privatization

One way instantly to create a private sector is to transfer ownership rights of existing state enterprises to non-state entities (cooperatives, workers' organizations, private individuals, partnerships or firms, foreign corporations). There may in some cases be microeconomic efficiency gains from privatization in this sense, but the macroeconomic benefits are somewhat doubtful. We do not share the enthusiasm of the international financial institutions for massive and rapid privatization of state enterprises and are not persuaded by their arguments that privatization is one of the keys to a successful transition.[16] The decisive thing, as argued above, is to increase investment and output. If privatization achieves that, it should be warmly welcomed; if it does not, it should be given a low priority. Let us consider the record of privatization so far in Uzbekistan.[17]

The first of two phases of privatization covers the period 1992-93; the second phase began in January 1994 and continues. Privatization in Uzbekistan covers several different types of property:

- housing;
- small scale enterprises engaged in trading and the provision of consumer services;
- local industries, often medium scale enterprises employing between 150 and 2,000 workers;

- large enterprises producing for national and international markets employing more than 2,000 workers; and
- land, both urban and rural.

During the first phase emphasis was placed on privatizing the stock of housing and small enterprises. By the end of 1994 over 96 per cent of the housing units had been turned over to the occupants, apparently with little difficulty and at only nominal cost to the buyers. In 1993, for example, the cost of a dwelling sold was only between 23.9 and 157.9 per cent of the average monthly wage.[18] Given that there are virtually no homeless people in Uzbekistan -- everyone has a place to live -- the transfer of ownership was neither inequitable nor administratively cumbersome. There may be marginal benefits from privatization, e.g., better incentives to maintain and repair structures, and certainly there can be no strong objection to the programme.

In principle there are also advantages to privatizing small state enterprises, although in practice several problems have arisen. First, few small enterprises were offered for sale to the public and consequently most people had no opportunity to acquire shares in an enterprise or to purchase the business outright. Second, most small enterprises were either given to the staff or sold to them at a price which one presumes was below the market clearing price. That is, assets accumulated in the name of the entire population were simply given away (in whole or in part) to a small minority of the population who happened to have a job in the enterprise. The resulting distribution of capital assets was arbitrary and almost certainly inequitable. As far as one can tell, there has been no resulting upsurge in growth that might justify such arbitrariness. Nor can this transfer of property rights be explained by a desire to experiment with schemes of workers' self-management, since there is no evidence of a serious attempt to promote a system of self-management.

Approximately 600 medium sized state enterprises also were privatized during phase one. Shares were allocated to the staff and the government, with the government usually holding a majority of the shares. To the extent that the government retained ownership, privatization was a misnomer; to the extent that public assets were given away to a privileged group of enterprise employees, privatization was inequitable. Significant gains in efficiency and growth have yet to materialize.

Even more problematical was the privatization of roughly 400 large state enterprises during phase one. As with the other asset distributions, shares were distributed between the government (which retained a majority holding) and the staff of the enterprise. The difference this time is that only the managers were given shares; ordinary workers in the enterprise received nothing. Only the credulous can believe this will encourage growth and only the gullible can think this is equitable. Some might attempt to justify Uzbekistan's experience with privatization on ideological grounds, but it certainly cannot be justified on the grounds that it improves the macroeconomic framework for growth.[19]

In phase two the intention is to privatize virtually all of the remaining large state enterprises. Given the experience so far, it seems a bit odd that this should be given high priority. It would be better, we think, to concentrate on creating space for new private enterprises to emerge (removing all obstacles to their expansion) and to assess seriously the merits and demerits of what has been achieved to date by privatization (examining the effects on growth, efficiency and equity). A period of pause and reflection would be valuable.

Meanwhile, much can be done to improve the efficiency, flexibility and competitiveness of the remaining large state enterprises. Nothing we say should be interpreted as an argument in favour of maintaining the status quo. The state enterprises urgently need to be reformed. They should become more autonomous. Management should be given more freedom to take decisions and then be held responsible for them. Workers should not be guaranteed employment regardless of their performance, and management should have discretion to hire and fire employees as necessary. Financial controls should be relaxed, managers should be instructed to maximize profits and firms allowed to retain profits for reinvestment after payment of taxes. State firms should be exposed to competition, both from imports and by allowing domestic and foreign private producers freely to enter into sectors from which they had previously been excluded. If the large state enterprises are to survive, all of this will have to happen, whether or not the firms are privatized. The mere transfer of legal title is unlikely to achieve much, at least in the short run, whereas genuine reform of the management and operation of state enterprises could result in fairly quick and large returns.

Finally, a brief word about the privatization of agricultural land. In principle a redistribution of collective land in favour of small farmers, either by sale or through long leases, has many attractions, and the experience of China shows that in practice such a redistribution can be highly successful.[20] Provided there are safeguards to maintain collective assets and to exploit economies of scale where they exist (as in many irrigation systems), there is no reason why privatization of agricultural land should not be highly advantageous in Uzbekistan and we encourage the government to experiment with alternative programmes of redistribution.

4.3 Growth of the rural economy

Indeed the prospects in agriculture for achieving rapid growth are very promising. This is a sector -- and happily a large and important one -- where a rapid supply response is likely, given appropriate policies. Agriculture has been severely squeezed since independence -- the resources transferred out of the sector being used by government to offset the termination of Union transfers. Despite the squeeze, agriculture has been remarkably resilient and has performed surprisingly well.

A number of reforms -- in institutions, prices and technology -- should lead to a rapid growth in output, and several of the reforms already are underway or have been announced. As implied above, we favour the creation of a small farmer system within a communal institutional arrangement. Land reform -- or land privatization if that is preferred -- is a desirable institutional change which should help to accelerate growth. The planned reduction in delivery quotas and the planned increases in procurement prices will turn the terms of trade in favour of agriculture (specifically cotton and wheat) and this will provide a further incentive to expand output. The introduction of water charges (discussed above), the removal of subsidies on fertilizer and pesticides, and the imposition of land taxes or leasehold charges will create incentives to use scarce inputs more efficiently. Finally, technological improvements in cotton cultivation which raise yields and improve quality could increase output and incomes quickly.

Agriculture thus could become a leading sector during the transition period. If this were to occur, the distribution of income among the population would change. The rural population would gain relative to the urban, and unless urban incomes resume their growth (say, through the expansion of small scale enterprises and the mounting of a public works programme), the decline in the urban sector's terms of trade would lower urban incomes absolutely, not just relatively. Poverty in urban areas might then increase. A reduction in rural-urban inequality implies that the Uzbek population (which is predominantly rural) would gain relative to the Slavic/non-Uzbek population (which is predominantly urban). If not handled carefully -- for example, if the real incomes of the non-Uzbek's are allowed to fall further -- this could result in social tensions and unrest. It might also lead to another wave of emigration of Russians and other Slavs, thereby depriving the country of part of its human capital.

The growth of the rural economy has the potential to raise not only average incomes in Uzbekistan but also the incomes of some of the poorest people in the country, the rural Uzbeks. The growth strategy, however, must be balanced and in particular young people newly entering the labour market must have a reasonable prospect of obtaining a job and earning at least a minimum livelihood. This is what makes a guaranteed employment programme so important.

4.4 A guaranteed employment scheme

Under the Soviet system all workers were guaranteed employment. Indeed, work was a duty of every citizen. This system had the advantage of providing everyone with a livelihood and giving everyone a sense of participation in the life of the community. But because workers were employed on farms, in state enterprises and in the public administration even when they were not needed -- even when they contributed little or nothing to output -- labour was often in surplus or in disguised unemployment. During the transition from a centrally planned system to a more market oriented economy there is a danger that open unemployment will increase, that the disguised unemployed in state enterprises will be made redundant and that as restructuring occurs, workers will be sent home (possibly on full pay) or offered part-time employment only. A market economy can be ruthless in depriving people of a livelihood, a job and a sense of participation in worthwhile activities. On the other hand, if a market economy functions well, resources will be used efficiently and average incomes are likely to be higher than otherwise.

A socially minded government, concerned about the well being of the people, might reasonably be hesitant to move ahead quickly with market reforms for fear that large scale unemployment would ensue. While the fear is legitimate, the hesitancy is not. It is possible within a market oriented economy to guarantee employment at the minimum wage to everyone seeking work. Moreover, an employment guarantee scheme can contribute to growth by using surplus labour to undertake income generating capital construction projects in both rural and urban areas.[21] Such projects can add to the country's infrastructure (roads, bridges, airports), repair urban structures and facilities, build schools and clinics, undertake on-farm improvements (repair and maintain irrigation facilities, plant orchards, reforest hillsides) and in a large number of ways add to the country's stock of physical capital.

The returns on properly designed and managed public works projects can be high. The gestation period is short. They provide a great deal of employment. Above all, public works projects enable the country to transform otherwise idle labour into capital formation and growth. A guaranteed employment programme can be a major component of a strategy designed to encourage a resumption of growth and, as explained above, this need not be inflationary.

5. Summary

The current macroeconomic framework has yielded disappointing results. Price stabilization remains elusive. Growth rates have been negative. Average incomes have declined. There has been large scale emigration of skilled and professional labour.

Evidently some adjustment of macroeconomic development policy is needed. We recommend, first, continued, indeed augmented, efforts to reduce the overall rate of inflation. Second, we recommend that efforts be concentrated on improving the price mechanism in seven strategic areas, namely, (i) the market for foreign exchange, (ii) the market for finance capital, (iii) the wage rate for low skilled labour, (iv) the market for water, (v) the market for energy, (vi) the market for agricultural land and (vii) the market for the most important agricultural commodities. The first five strategic markets have been the focus of this paper.

It is vital to the success of the reform process that aggregate economic growth be resumed quickly and that the benefits of growth be widely distributed among the working population. We recommend, third, that efforts be concentrated on creating space for the emergence of a large, labour intensive, small scale private sector. There are many obstacles to the rapid growth of small and medium sized enterprises and the removal of these obstacles should be given very high priority. Next, we recommend that there be a temporary pause in the privatization of large scale state industrial enterprises while an evaluation is conducted of the effects of phase one of the privatization programme on growth, efficiency and equity. There should be a shift of emphasis from privatization to increasing the efficiency of public sector industrial enterprises. We do not believe that further privatizations merit high priority at this time, given the other tasks faced by the government. Fourth, we believe that the transformation and expansion of the rural economy represents an opportunity for rapid economic and social gains and we recommend that rural development be given high priority. Finally, we recommend that a large scale public works programme be organized partly to provide employment and partly to accelerate capital formation. There is considerable slack in the labour market in the form of (i) disguised unemployment in state enterprises and the recently privatized enterprises, (ii) part-time employment, (iii) a modest amount of registered open unemployment and (iv) surplus labour in agriculture. A scheme to guarantee everyone a job would be socially and politically attractive while providing considerable economic benefit.

The macroeconomic framework we recommend thus rests on three pillars: price stabilization achieved through tight credit conditions, market reforms in a selected number of strategic areas and accelerated growth. These three pillars are equally important. A failure in any one area is likely seriously to weaken the entire edifice. Hence the importance of getting priorities right.

Notes

1. World Bank, *Uzbekistan: Adjusting Social Protection*, Washington, D.C., 20 December 1994, p.2. The ratio of union transfers to GDP rose steadily in the years before independence and then fell abruptly to zero. The average transfer during the 1980s was much less than 19 per cent.

2. The range of estimates of GNP per capita is exceptionally wide. At the top end is an estimate for 1991 of $2,790 in purchasing power parity terms (UNDP, *Human Development Report 1994*, New York: Oxford University Press, 1994). At the bottom end is an estimate for end 1994 of about 2,100 sum, which would be less than $100 when converted at the official exchange rate that prevailed at the end of the year. Note that the official exchange rate was 25 sum = US$1 until late March 1995, whereas the black market rate was 40 sum = US$ 1. In late March the official rate was devalued to 26.1 sum to the dollar.

3. Michael Kaser and Santosh Mehrotra, *The Central Asian Economies after Independence*, London: Royal Institute of International Affairs, 1992, p.64.

4. World Bank, *World Development Report 1994*, New York: Oxford University Press, 1994.

5. Michael Kaser and Santosh Mehrota, *op. cit.*, p.27.

6. Ahmed Rashid, The Resurgence of Central Asia: Islam or Nationalism?, London, Zed Books, 1994, p.95.

7. International Monetary Fund, "Note for the March 1, 1995 Consultative Group Meeting", Tashkent, mimeo., n.d., p. 4.

8. Keith Griffin and Azizur Rahman Khan, "The Transition to Market Guided Economies: Lessons for Russia and Eastern Europe from the Chinese Experience", in Bernd Magnus and Stephen Cullenberg, eds., *Whither Marxism? Global Crises in International Perspective*, New York and London: Routledge, 1995.

9. Government of Uzbekistan, "Statement on Economic Reform", a document prepared for the Consultative Group Meeting for Uzbekistan in Paris on 1 March 1995, Tashkent, February 1995.

10. Data supplied by the International Monetary Fund.

11. Government of Uzbekistan, *op. cit.*

12. *Ibid*.

13. See the working paper by Azizur Rahman Khan, "The Transition to a Market Economy in Agriculture in Uzbekistan."

14. Parvez Hasan, "Economic Reform, External Finance Requirements and World Bank's Role in Uzbekistan", remarks made at an international conference in London on "Doing Business in Uzbekistan, 25-26 October 1994.

15. See Simon White and Jesper Petterson, *A Report on the Legal and Regulatory Environment Affecting Small and Medium Enterprises (SMEs) in Uzbekistan*, UNDP, Tashkent, March 1995.

16. See, for example, World Bank, *Uzbekistan: An Agenda for Economic Reform*, Washington, D.C., 1993, Ch. 6.

17. For an analysis of similar problems of privatization in Mongolia, see Keith Griffin, ed., *Poverty and the Transition to a Market Economy in Mongolia,* London: Macmillan, 1995, Ch. 1.

18. International Monetary Fund, *Uzbekistan Economic Review,* Washington D.C., March 1994, Table 21, p.59.

19. *Not even the World Bank, an enthusiastic advocate of privatization, makes such claims. See World Bank,* Uzbekistan: Status Report on Structural Reforms, a report to the Consultative Group Meeting, Paris, 1 March 1995, pp. 4-6.

20. See, for example, Keith Griffin, ed., *Institutional Reform and Economic Development in the Chinese Countryside*, London: Macmillan, 1984.

21. See, for example, Keith Griffin and Terry McKinley, *Implementing a Human Development Strategy*, London: Macmillan, 1994, Ch. 5.