Country report **UZBEKISTAN**

Summary

Uzbekistan's commodity driven economy has benefitted from higher commodity prices and the economic recovery in Russia. However, official figures should be interpreted with caution. Economic policies continue to support growth which is fuelling inflation. Any headway towards economic liberalization is unlikely in the current political climate. President Karimov continues to rule the country in an authoritarian fashion and he is expected to continue to do so unopposed until he is no longer physically able to. As he is 73 years old, succession is an issue. Not addressing this effectively could lead to public unrest and political instability in due time. Although the current account shows a wide surplus, this is mainly due to the active government management of capital in- and outflows. With annual capital flight estimated to amount to more than the total amount of FX-reserves, capital flight poses a strong downside risk to Uzbekistan's external liquidity position in spite of external debt being low.

Things to watch:

- Succession of the president, as Karimov is ageing
- Poor governance and endemic corruption
- Global economic slowdown in light of Uzbekistan's commodity export dependence

Author: **Erwin Blaauw**
Country Risk Research
Economic Research Department
Rabobank Nederland

Contact details: P.O.Box 17100, 3500 HG Utrecht, The Netherlands
+31-(0)30-21-62648
E.R.Blaauw@rn.rabobank.nl

Uzbekistan

National facts		
Type of government	Republic	
Capital	Tashkent	
Surface area (thousand sq km)	6,221	
Population (millions)	28.0	
Main languages	Uzbek (74%)	
	Russian (14%)	
Main religions	Muslim (88%)	
	Eastern Orthodox (9%)	
Head of State (president)	Islom Karimov	
Head of Government (prime-minister)	Shavkat Mirziyoyev	
Monetary unit	soum (UZS)	
Economy		**2010**
Economic size	*bn USD*	*% world total*
Nominal GDP	39	0.06
Nominal GDP at PPP	86	0.12
Export value of goods and services	13	0.07
IMF quotum (in mln SDR)	276	0.13
Economic structure	*2010*	*5-year av.*
Real GDP growth	8.5	8.2
Agriculture (% of GDP)	22	25
Industry (% of GDP)	38	31
Services (% of GDP)	39	49
Standards of living	*USD*	*% world av.*
Nominal GDP per head	1368	14
Nominal GDP per head at PPP	3009	26
Real GDP per head	754	9

Social and governance indicators	rank / total
Human Development Index (rank)	102 / 169
Ease of doing business (rank)	150 / 183
Economic freedom index (rank)	163 / 179
Corruption perceptions index (rank)	172 / 178
Press freedom index (rank)	163 / 178
Gini index (income distribution)	36.72
Population below $1.25 per day (PPP)	n.a.

Foreign trade			2010
Main export partners (%)		*Main import partners (%)*	
Ukraine	24	Russia	23
Russia	16	China	16
Turkey	16	South Korea	16
Kazakhstan	8	Germany	9
Main export products (%)			
Energy			27
Gold			19
Cotton			12
Openness of the economy			
Export value of G&S (% of GDP)			34
Import value of G&S (% of GDP)			22

Source: EIU, CIA World Factbook, UN, Heritage Foundation, Transparency International, Reporters Without Borders, World Bank.

Due to limited data availability, the figures presented in this report should be treated as indicative.

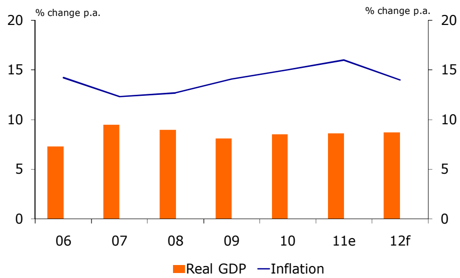
Economic structure and growth

Uzbekistan is a land-locked country located in central Asia. The country's growth performance has been very stable according to official figures, with real GDP expanding by between 8 and 9 percent during and after the 2008/2009 global economic slowdown that strongly and negatively affected the Russian and Ukrainian economies, Uzbekistan's main trade partners, as well. However, given Uzbekistan's dependence on the production and exports of a few commodities, the high growth rate seems highly unlikely and the official figures should therefore be interpreted with caution. Higher international commodity prices and the recovery of Russia and Ukraine have benefited the Uzbek economy. However, with another global slowdown anticipated, Uzbekistan's economic performance is could weaken more strongly than shown in the current estimates.
Uzbekistan's banking sector is one of the least developed in the former Soviet Union. The main banks are state-owned and are effectively lending arms of the government. As a result, commercial rationale is replaced by political rationale in making credit decisions. Although the state guarantees and a recent government capitalization render the banking sector in a decent shape, underlying balance sheet problems remain unexposed.

Political and social situation

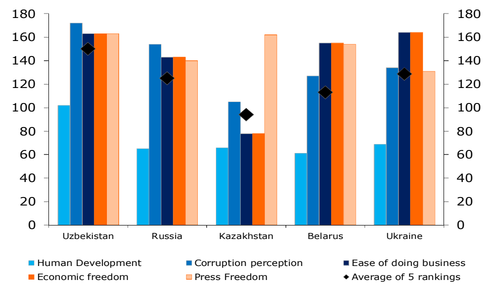
Uzbekistan's president, Islam Karimov, has been ruling the country since its independence in an authoritarian fashion. Power is highly centralized within the executive, and more specifically in the person of Karimov. Elections are held regularly –Karimov was elected for another 7-year term in 2007 - but are a farce, as they are manipulated by the government while any real opposition is absent.

Chart 1: Growth and inflation



Source: EIU

Chart 2: Social indicators



Ranking: a higher score indicates a worse performance. Source: See factsheet

Economic, religious and press freedom are strictly limited, as reflected by the country's dismal ranking on social indicators, the legal system in not independent and corruption continues to be endemic. Forced labor is also a problem that has led to Uzbekistan's cotton being banned from the US market in past years, although the US' stance has softened somewhat this year. As a result of Karimov's dominance of the political scene, the political situation has been very stable. But, as Karimov is 73 years old, succession is a key concern. Some arrangements are being put in place to allow an orderly transfer of power, appointing the leader of the senate as president in case Karimov in incapacitated. However, a sudden death of Karimov could result in a destabilizing power struggle amongst the elite. A prolonged period of political unrest, including social unrest is not unimaginable in that case. A "palace coup" scenario, where he is ousted by members of the elite while in office, is less likely, as Karimov has a proven track record of successfully securing his powers.

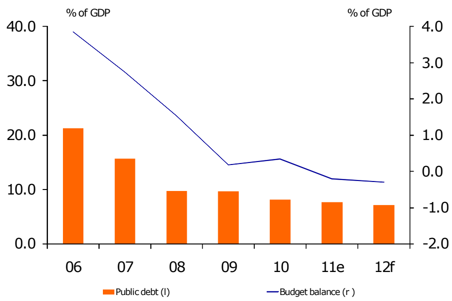
Economic policy

As the Uzbek economy continues to be managed in a Soviet manner, the government's presence in the economy is very strong. Economic growth will continue to be supported by expanding public investments in infrastructure and industry. The country's Fund for Reconstruction and Development plays and important financial role in this regard. Downside is, however, that mostly state-owned enterprises benefit from this fund's financing. Increasing public sector wages and social payments are other means of the Uzbek government to support the economy. In spite of the strong public spending, the government's finances remain in an acceptable shape. Public debt to GDP is low at 8% and the budget balance is anticipated to continue its worsening trend and start to show deficits in the coming years, although these are expected to remain limited to less that 0.5% of GDP. Inflation, usually in the double-digit territory, is rising as a result of expansionary policies and is estimated to increase from around 12% in 2007 and 2008 to 16% in 2011. In spite of repeated calls by the IMF to liberalize trade and payment systems and to adopt a more flexible exchange rate policy (currently targeted at a slow depreciation in order to support exports), progress on these issues is not expected.

Balance of Payments

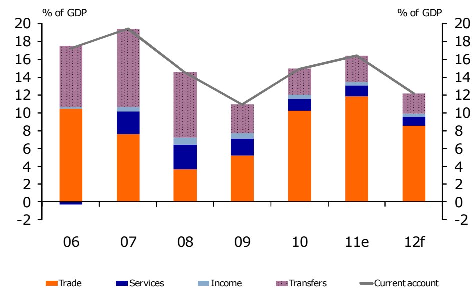
Uzbekistan has been consistently running large current account surpluses in the past years. This, however, is largely due to the tight government controls on capital flows, which suppresses capital outflows (imports) while supporting capital inflows (exports) by the means of tariffs and an undervalued currency and more worrisome, by limiting currency convertibility. The structure of the current account is vulnerable, as Uzbekistan depends on the export of a few commodities such as hydrocarbons and cotton, rendering it vulnerable to international commodity market fluctuations.

Chart 3: Public finances



Source: EIU

Chart 4: Current account



Source: EIU

Gold, another important commodity export offers some relief in this regards, as the price of gold tends to rise during times of international volatility. The sharp narrowing of the current account surplus during the global downturn (2009) is testimony to this vulnerability. Remittances inflows, another important source of foreign exchange, have fallen sharply since 2009 to about half the amount registered in 2007 and 2008 and are expected to remain subdued in the coming years. Net direct investment inflows are picking up again, but net portfolio flows remain negative. Meanwhile, given the size of capital flight relative to the stock of FX-reserves (97% in 2010 and an estimated 127% in 2011), capital flight remains a key balance of payments risk that strongly increases Uzbekistan's external liquidity risk.

External position

Uzbekistan's external position is sound. External debt is low at USD 4.2bn end-2010, which equals 11% of GDP. Only a slight increase to USD 4.3bn is anticipated for 2011 before a somewhat sharper increase to USD 4.6bn in 2012. However, as GDP growth remains steady and strong (according to official figures), this will still equal only 9% of GDP at that time. Short term foreign debt is low at below 6% of total foreign debt. Meanwhile, FX-reserves have been increasing again in 2010 and 2011, after having plunged by nearly 20% to USD 5bn in 2009. While only a slight increase of FX-reserves was witnessed in 2010, FX-reserves are expected to rise to USD 5.5bn this year before seeing a sharper increase to 6.9bn in 2012, mainly as a result of capital flight slowing from an estimated peak of USD 7bn in 2011 to USD 6.2bn in 2012.

Uzbekistan

Selection of economic indicators	2006	2007	2008	2009	2010	2011e	2012f
Key country risk indicators							
GDP (% real change pa)	7.3	9.5	9.0	8.1	8.5	8.6	8.7
Consumer prices (average % change pa)	14.2	12.3	12.7	14.1	15.0	16.0	14.0
Current account balance (% of GDP)	17.2	19.4	14.5	10.9	14.9	16.4	12.2
Total foreign exchange reserves (mln USD)	2979	4754	6237	5000	5158	5510	6910
Economic policy							
Budget balance (% of GDP)	3.8	2.7	1.5	0.2	0.3	-0.2	-0.3
Public debt (% of GDP)	21	16	10	10	8	8	7
Uzbekistan, Money market interest rate (%)	14.0	14.0	14.0	14.0	14.0	12.0	12.0
M2 growth (% change pa)	37	46	32	31	34	35	33
Consumer prices (average % change pa)	14.2	12.3	12.7	14.1	15.0	16.0	14.0
Exchange rate LCU to USD (average)	1219.6	1264.1	1320.4	1466.7	1587.2	1714.6	1842.8
Recorded unemployment (%)	0.8	0.8	1.0	1.1	1.1	1.0	0.9
Balance of payments (mln USD)							
Current account balance	2927	4326	4053	3579	5814	7450	6370
Trade balance	1774	1692	1021	1712	3980	5380	4490
Export value of goods	5615	8029	10298	10735	12010	13550	12890
Import value of goods	3841	6338	9277	9023	8030	8170	8400
Services balance	-53	572	768	621	525	550	500
Income balance	35	112	223	196	159	180	180
Transfer balance	1171	1951	2040	1050	1150	1340	1200
Net direct investment flows	174	705	711	400	700	900	900
Net portfolio investment flows	0	-489	-750	-550	-750	-800	-800
Net debt flows	-326	-170	-93	61	42	180	230
Other capital flows (negative is flight)	-1212	-1419	-1184	-4640	-5005	-7030	-6200
Change in international reserves	1564	2954	2737	-1150	800	700	500
External position (mln USD)							
Total foreign debt	4031	3923	3983	4109	4239	4430	4630
Short-term debt	158	196	211	144	240	260	260
Total debt service due, incl. short-term debt	1007	918	894	838	1110	1150	1200
Total foreign exchange reserves	2979	4754	6237	5000	5158	5510	6910
Key ratios for balance of payments, external solvency and external liquidity							
Trade balance (% of GDP)	10.4	7.6	3.7	5.2	10.2	11.8	8.6
Current account balance (% of GDP)	17.2	19.4	14.5	10.9	14.9	16.4	12.2
Foreign debt (% of GDP)	24	18	14	13	11	10	9
Foreign debt (% of XGSIT)	56	38	29	29	29	27	29
Debt service ratio (% of XGSIT)	14	9	6	6	8	7	8
Interest service ratio incl. arrears (% of XGSIT)	3	2	1	1	1	1	1
FX-reserves import cover (months)	7.7	8.5	7.7	6.4	7.2	7.5	9.1
FX-reserves debt service cover (%)	296	518	697	597	465	480	577

Source: EIU