

EBD/08/4

January 10, 2008

To: Members of the Executive Board

From: The Secretary

Subject: **Republic of Uzbekistan—Poverty Reduction Strategy Paper—Joint Staff Advisory Note**

Attached for the **information** of Executive Directors is the advisory note, prepared jointly by the staffs of the Fund and the International Development Association, on the Republic of Uzbekistan's poverty reduction strategy paper (EBD/08/3, 1/10/08). At the time of circulation of this paper to the Board, the Secretary's Department has not received a communication from the authorities of the Republic of Uzbekistan indicating whether or not they consent to the Fund's publication of this paper; such communication may be received after the authorities have had an opportunity to read the paper.

Questions may be referred to Ms. Eken (ext. 36511) and Ms. Bacalu (ext. 34816) in MCD.

Unless the Documents Section (ext. 36760) is otherwise notified, the document will be transmitted, in accordance with the procedures approved by the Executive Board, to the WTO Secretariat on Tuesday, January 15, 2008; and to the Asian Development Bank, the European Bank for Reconstruction and Development, the European Commission, and the Organisation for Economic Cooperation and Development, and the United Nations Development Programme.

This document will shortly be posted on the extranet, a secure website for Executive Directors and member country authorities.

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REPUBLIC OF UZBEKISTAN

**Joint Staff Advisory Note on the
Welfare Improvement Strategy for 2008–10¹**

Prepared by the Staffs of the
International Development Association and the International Monetary Fund

Approved by Shigeo Katsu (IDA) and David Owen and Martin Fetherston (IMF)

December 27, 2007

I. OVERVIEW

1. **The Government of the Republic of Uzbekistan formally adopted its first Welfare Improvement Strategy (WIS), covering the period 2008–10, in September 2007 and transmitted the document to the International Development Association (IDA) and the International Monetary Fund (IMF).** This strategy builds on the Interim Welfare Improvement Strategy (I-WIS) for 2005–10 that was presented to IDA and the IMF in April 2005, and reflects the lessons learned from the implementation of the interim strategy as well as the Joint IDA-IMF Staff Advisory Note (JSAN) on the interim strategy.² The WIS emphasizes prudent macroeconomic management, allocates a rising share of the budget to social sector expenditures, and contains measures to enhance the efficiency of government spending. It also attempts to prioritize government spending and begins to develop a framework for monitoring and evaluation.

2. **The WIS is built around a comprehensive framework for development and it provides for the transition from short-term planning and projections toward medium and long-term strategies.** It also provides a conceptual framework for regional development strategies and lays the basis for a more active participatory process in implementation. The overarching objective is to promote sustainable improvements in the living standards of the population, particularly of vulnerable groups. Economic growth rates averaging over 8 percent annually are projected for 2008–10. The poverty rate is projected to decline from 25.8 percent in 2005 to 20 percent in 2010. The high growth rates and the reduction of poverty are expected to result from further steps towards economic liberalization, rising

¹ The Welfare Improvement Strategy is the term used by the Uzbek authorities for the Poverty Reduction Strategy.

² IDA Report No. 32012-UZ, IMF Country Report No. 05/159, April 28, 2005.

investments in human and physical capital, and financial sector reforms. The objective of ensuring that economic growth benefits all regions of the country is an important element of the strategy.

3. **The WIS addresses some of the key recommendations of the JSAN on the Interim Strategy.** First, the strategy accords a somewhat greater role to market principles and describes measures to undertake structural reforms. There is a particular emphasis on improving the business environment. Second, it provides greater candor in assessing economic and social challenges facing the country. Third, the WIS discusses comprehensive measures to improve public sector management, including the streamlining of policy-making mechanisms and reforms to the public finance system. Fourth, the WIS begins to establish priorities in spending and in costing programs. Finally, the process of formulating the WIS has involved a higher degree of civic participation than in the past, and the authorities hope to build on this experience in the implementation of the WIS.

4. **The staffs recognize that the WIS reflects the authorities' gradualist approach to reforms, but note that the full introduction of market reforms under this approach may take many years.** In this sense the WIS represents a continuation of the existing strategy towards achieving self-sufficiency through import substitution and state led industrialization. It gives little indication, however, that mechanisms underlying this strategy such as agriculture state orders, a policy of import substitution known as the "localization program", the restrictive trade regime, and extensive management of the economy through parastatals, planning and administrative interventions would diminish significantly during the period.

5. **The implementation of the strategy and an assessment of its impact on the reduction of poverty as well as the achievement of Millennium Development Goals will be challenging:** (i) many measures proposed in the WIS lack specificity and clear prioritization, and need to be much better costed; (ii) the authorities recognize that the system for monitoring and evaluation of results clearly needs much further development, and are seeking technical assistance to strengthen this aspect of the WIS during implementation; and (iii) while staffs welcome a greater participation of civic society in the development of the WIS than was the case for the I-WIS, such participation is still less than desirable and the document does not illustrate how feedback was used to inform the strategy. Improving participation during implementation will be an important challenge going forward. The income poverty diagnosis is adequate, but could be enriched if access to data were eased (see below).

6. **It is encouraging that the Uzbek authorities intend to assemble a package of technical assistance to assist in the implementation of the WIS and the preparation of subsequent updates to the WIS.** The staffs are working closely with the authorities in defining the critical areas where assistance is required and will help find donor grants to finance it. Such TA will be used to address the technical requirements necessary to raising the standards of WIS formulation and implementation.

II. POVERTY DIAGNOSIS

7. **The staffs agree with the poverty overview presented in the WIS, but recommend that a further strengthening of the quality of poverty monitoring and the capacity for poverty analysis be key elements in the agenda for poverty work.** The WIS documents poverty trends up to 2005, primarily relying on the Household Budget Survey (HBS) data for this purpose. The HBS data reveal that poverty has declined from 27.5 percent in 2001 to 25.8 percent in 2005, during a period of relatively high economic growth. The WIS recognizes the small decline in poverty over time as a challenge, although the reasons for this trend are yet to be fully understood. The poverty analysis in the WIS identifies the rural population as having the greatest concentration of the poor, and indicates other population groups vulnerable to falling into poverty: large families with children, small-town and rural populations with no access to land or with only household plots, and the old and the disabled. Consumption inequality is moderate compared to former Soviet Union countries, although there are signs that it might be increasing. Inequalities at the sector level—the significantly lower preschool enrollment rates among rural children, the wide variation in higher education enrollment rates by gender and household wealth—are also discussed. The staffs agree with the WIS emphasis on programs targeted to the poor households to overcome inequalities, but caution that the design and successful implementation of such programs require making available comprehensive and transparent information.

8. **The income poverty analysis and the description of the characteristics of the poor are adequate, but could be enhanced with better data availability.** Because the raw HBS data have not been made available to local or international researchers in recent years, these data remain underutilized. The unusually strict restrictions on the use of HBS data are especially unfortunate because of the availability of highly qualified and motivated Uzbek researchers who, at the moment, have difficulties in carrying out policy relevant research because of inadequate access to information. Through increasing access to information and by encouraging broad-based discussion of development challenges that the country faces, the current analyses could be enhanced to explore (among other things) why and how the regional characteristics affect welfare levels; why the labor intensity of economic growth is relatively low; and how to improve the (pro-poor) targeting performance of social assistance programs and deepen the understanding of the linkages between policy actions and pro-poor growth. The authorities are also advised to strengthen monitoring of non-income dimensions of poverty and access to services.

III. MACROECONOMIC FRAMEWORK AND POLICIES

9. **The staffs concur with the favorable assessment of recent macroeconomic developments.** After an annual average of 7 percent in the past three years, GDP grew almost 10 percent in the first half of 2007 driven by services, industry, and transport and communications. Investment rose benefiting from the improved financial situation of

enterprises and some streamlining of bureaucratic procedures, while consumption was supported by increases in wages and salaries as well as remittances. Exports, especially to neighboring countries, continue to grow strongly, outpacing the growth of imports, and resulting in large current account surpluses. Foreign direct investment, mainly in the oil and gas sectors, picked up from a very low base. Official reserves continue to build up. The fiscal position remains strong, with a surplus projected for the general budget in 2007 and a further decline in government debt. However, inflation has remained high in double digits,³ partly driven by administrative price increases on services and surging food prices. The exchange rate continued to depreciate in nominal and real terms.

10. **Medium-term growth projections are achievable, but ambitious.** Over the medium term, the authorities project annual GDP growth of over 8 percent on average. They envisage the economic growth to be supported by active restructuring of the economy, continued economic liberalization, export-oriented policies, and development of the financial sector. Expeditious implementation of these policies as well as a stable macroeconomic environment are necessary to achieve high sustainable growth rates and reduce poverty.

11. **The main macroeconomic challenge is to contain inflation.** The authorities project inflation at 5 percent over the medium term. However, the WIS does not provide a clear analysis of how this target is going to be achieved. Moreover, the current higher inflation estimates by the staffs call for more prudent macroeconomic policies. The projected strong external position, including through continued large inflows of remittances, the rapid accumulation of official reserves, and the consequent monetary expansion accompanied by the envisaged large wage increases are also likely to fuel inflation. In the absence of developed financial markets and with insufficient monetary instruments to control money supply, greater exchange rate flexibility—including by allowing some nominal appreciation of the sum—could help take pressure off indirect monetary policy instruments and slow the monetary growth. The envisaged annual nominal depreciation of about 4 percent is unlikely to be supportive of anti-inflation efforts. To enhance monetary control and reduce inflation, exchange flexibility could be enhanced and the menu of indirect monetary policy instruments strengthened.

12. **The fiscal policies are moving broadly in the right direction and the staffs support the fiscal reforms outlined in the WIS.** The general budget is envisaged to be balanced over the medium term. In the short run, a tight fiscal stance is warranted to bring down inflation and fiscal policy should not be loosened by continued large increases in public sector wages and benefits as envisaged for 2008–10. Lower inflation would provide room over the medium term for higher social and infrastructure expenditures. The WIS contains a comprehensive discussion of envisaged fiscal reforms with concrete proposals, but would have benefited from reflecting the planned sequencing and the schedule of reforms. As noted, the budgetary process should improve with the introduction of medium-term

³ The IMF staff calculates inflation using the authorities' source data and applying international methodology.

budgetary planning; the ongoing treasury reforms should enhance the management of public finances; and the continuing tax reforms should reduce the tax burden and improve the business climate. The staffs would have welcomed an analysis of the impact of the planned tax measures on the budget revenue, which would help medium-term budgetary planning, and would caution against tax privileges and other preferences for specific industries and projects.

IV. STRUCTURAL REFORM

13. **The government has declared its support for structural reforms, but the lack of a specific timetable for implementation continues to be a weakness of the development strategy.** In the staffs' assessment of the interim-WIS, it was noted that the binding constraint on economic growth and poverty reduction lay in extensive state intervention and the close administrative management of many aspects of the economy.⁴ This approach has prevented the unleashing of private sector development potential of Uzbekistan to the full extent and dampened employment generation. The staffs therefore encouraged the authorities to be ambitious in designing the structural reform agenda for the WIS. In the view of the staffs, the reform agenda in the WIS may need to be accelerated if the transition to a market-based economy, even in a gradualist framework, is to be successful in significantly reducing poverty. Indeed, the current favorable macroeconomic position offers an excellent opportunity to move more boldly than proposed in the WIS on the structural reform agenda. The specific suggestions of staffs are:

Agricultural sector:

14. **The recent reform effort has focused on transforming large scale cooperative farms into private leasehold farms; nevertheless, the sector continues to be heavily dominated by state intervention.** The WIS acknowledges that poverty is deepest and most widespread in rural areas, and measures to sustainably raise rural incomes depend on further price and marketing liberalization. The staffs note that the government does not seem to be ready to phase-in the gradual introduction of measures in that direction, such as: (i) step-by-step reductions in the amount of cotton quota over the next three years; (ii) allowing cotton exports above the quota by private traders; (iii) an increase in the state procurement price for cotton by an amount that represents a reasonable offset for the high cost of ginning and wholesale marketing in Uzbekistan, compared with other countries; (iv) rebate on VAT on cotton bought for export; and (v) a removal from the conditions attached to leasehold agreements of any risk that lessees could lose their land through failure to fulfil state procurement quotas.

15. **The development of systems for measuring water used in irrigation and a move towards cost-recovery in water use in agriculture are strengths in the WIS.** The WIS

⁴ Joint IDA-IMF Staff Advisory Note (April 28, 2005).

also contemplates other reforms: (i) the strengthening of long-term lease rights to encourage farmers to make long-term capital investment in leased land; (ii) greater incentives for agricultural producers through better access to the essential material and technical resources, (iii) improvement of the system of private farmers' access to credit resources and the financial services market; and (iv) government support to various forms of training for farmers to improve their professional, technical, and management knowledge. However, greater specificity in the design and implementation of these reforms is required.

Trade:

16. **The WIS contains a candid discussion of the shortcomings of the trade regime and trade practices as well as the related disincentives to investment, including foreign direct investment.** It also notes that little revenue is collected through high tariffs and excises as exemptions, including individuals' exemptions, abound, which raises concerns about transparency and governance.

17. **Staffs welcome the authorities' commitment to greater openness of the economy, but note that to achieve sustained economic growth, reduce poverty, and channel investments to competitive sectors, a more liberal import regime is necessary in the medium term.** Among measures that could be considered is the abolition of the discriminatory excise tax regime on imports. Moreover, the WIS could discuss steps to review both the most favored nation (MFN) tariff schedule and other non-tariff trade barriers and simplify administrative procedures to reduce the time needed for importing. There is also the need to ensure unimpeded access to foreign exchange for imports. In addition, international integration and the availability of low cost imported inputs and technology are impeded by the localization program and the related trade protection. It would be important to announce a timetable for the reduction of such protection and to allow the localization program to lapse at the end of its legislative life in 2008.

Business climate:

18. **The WIS contains a series of measures—streamlining regulatory procedures, easing conditions for entry and exit of firms, reduction in the tax burden on enterprises—to consolidate the improvement seen in recent years in the business climate,⁵ but a supporting strategy and a prioritized plan of implementation are lacking.** The staffs suggest that the focus should be placed on a reduction of transaction costs, streamlining of customs procedures, and simplification of certification and licensing. Building stronger transportation links would provide new dynamism to private sector growth and thus contribute to further diversification of the economy and resilience to a risk of slow down in demand for Uzbek goods and services on the part of its trading partners.

⁵ The "Doing Business – 2008" acknowledges measures taken to ease regulations surrounding the starting and closing of businesses, cost of property registration, and reduction in tax burden on enterprises.

Financial sector:

19. **The WIS includes a list of financial sector reforms needed to enhance financial deepening and the role of banks in economic development, as well as to improve the transmission mechanism of monetary policy.** The staffs are of the view that, in addition to eliminating restrictions on cash withdrawals, the most urgent is the need to boost confidence in the banking sector by discontinuing the role of banks in financial oversight and in implementing government treasury operations. The ongoing Treasury system reform should facilitate this task. The staffs consider that as confidence in the financial sector grows, deposits will increase and more funds for lending would be available to the economy.

20. **However, engaging in wider-ranging reforms, including a reduction of the role for the state and liberalization of the financial sector, would be important for financial sector development.** The proposals in the WIS, in the view of the staffs, could go much further. In particular, the pace of privatization appears rather slow and the introduction of market pricing (liberal interest rates) for all lending is not envisaged. In addition to these measures, enhancing banking supervision and bringing the anti-money laundering/combating the financing of terrorism (AML/CFT) framework into line with international standards should also help to build trust in banks. The discussion of these issues in the WIS would have been strengthened had the document explicitly included a road map for the modernization and transformation of the financial sector over the next three years.

Governance:

21. **The WIS contains certain measures related to decentralization, administrative reform and improvements in the role of the legislature, particularly in oversight of the executive branch; however, measures to ensure greater public access to information and publication of data remain limited.** Uzbekistan remains somewhat of an outlier among developed and developing nations as regards disclosure of macroeconomic and sectoral data. Furthermore, weaknesses of the real sector data hamper analysis and forecasts. The WIS could have considered deeper measures to improve data quality as well as to increase transparency and availability of data, including through elimination of legal restrictions on the publication of macroeconomic data and of secret clauses and resolutions in legally binding documents. Moreover, a diagnostic on the sources of weaknesses in governance and measures to strengthen the rule of law would add greatly to the effectiveness and credibility of the WIS program in the area of governance and strengthen the fight against corruption.

Infrastructure:

22. **At various points in the WIS, the contribution of infrastructure to welfare improvement is noted, but the discussion would benefit from more detailed information.** Options being considered by the government to improve the quality and

efficiency of management and delivery of infrastructure and municipal services could have been more explicitly treated.

V. HUMAN DEVELOPMENT AND SOCIAL PROTECTION

23. **The staffs welcome the authorities' continued attention to education.** Efficiency, effectiveness, and financing issues will be the key implementation challenges. Goals have been established for increased access to pre-school education, but the methods of delivery and financing are still to be determined. In pre-school and general education, measures will have to be defined to deal with differentials between rural and urban areas in enrollment and provision of school supplies. The goals for vocational education are ambitious, but it is not clear how they would be financed. The higher education reforms envision increased enrollment and a focus on improving quality and modernizing the system, but careful attention will have to be paid to questions of financing and access, especially for the poor.

24. **Health care policy discussions rightly focus on further improving access to services, raising efficiency, and deepening overall reforms.** The WIS envisions improvements in primary, emergency and specialized health care, preventive health measures, and a gradual transition to output-based financing. To achieve stated objectives, particular attention will have to be paid during implementation to developing adequate financing arrangements and addressing the existing regional and rural-urban inequities in expenditures. Moreover, regional health managers need to be given flexibility and incentives to manage resources more efficiently and to ensure access of the vulnerable to health care.

25. **There is a need to develop specific actions to remove constraints against formal employment and to sharpen targeting in social protection.** The WIS contains clear and commendable labor market objectives, but the specific policy actions, regulatory changes and measures to achieve these objectives will have to be elaborated in the course of implementation. The staffs welcome the government's commitment to reducing non-targeting social benefits and to improving the capacity for their targeting. However, large general increases in benefits have taken place recently and the intention to decentralize social protection spending, which is commendable, would have to be supported by adequate monitoring to ensure effective targeting. The WIS focuses on the introduction of a minimum pension and refers to non-contributory benefits being paid currently from the Pension Fund. It would be necessary either to finance such payments through an explicit budgetary transfer or remove them from the Pension Fund if its sustainability is to be ensured.

VI. PARTICIPATION AND OWNERSHIP

26. **The WIS describes involvement of government agencies and bilateral and multilateral external development partners in the WIS development process, but lacks a discussion on building broader public ownership.** The information on collaborative analytical work to support WIS development is also commendably detailed and relevant. The WIS could have contained a more thorough discussion on the government's effort of building

a broader public ownership of the strategy. Specifically, the WIS lacks information on the stakeholders (outside the government) involved in the participatory process and does not detail the civil society groups, women's groups, ethnic minorities, policy research institutes and academics, private sector, and representatives from different regions of the country involved in the process. It also does not summarize the major issues raised during the participatory process and the impacts of the process on the content of the strategy. It would also have been helpful if the strategy gave a short description of the evolution of the participatory process over time, gave a frank assessment of the remaining problems and presented some specific actions that the government planned to undertake to strengthen the participatory process and the ownership of the strategy. Looking forward, the staffs suggest that the process of public participation be extended much beyond what has been achieved thus far, particularly involving civic groups and rural society.

VII. MONITORING, EVALUATION, COSTING, AND IMPLEMENTATION RISKS

27. **The staffs welcome the role being accorded in the WIS to monitor and evaluate programs and policies, but believe that a major task lies ahead in developing adequate indicators, mechanisms, and institutions.** The monitoring matrix, which contains indicators at different levels of aggregation, relevance and linkage to outcomes would need to be streamlined and prioritized. The mechanisms for tracking progress through indicators, providing information to policy implementers and managers, and developing feedback mechanisms between lessons from evaluation and adaptations to implementation are to be developed. Monitoring will have to be increasingly results-based. The Ministry of Economy is expected to play a central role in implementing the WIS and will have to be in charge of the monitoring and evaluation process; technical assistance will have to be directed to building capacity. It will also be important to integrate WIS implementation with existing decision-making processes within the government such as the budget cycle.

28. **The staffs note the need to carry out costing of WIS programs and projects and to place expenditures into a comprehensive medium-term budget framework (MTBF).** The WIS contains the costing for certain programs or investments, but more details are required. Since the magnitudes involved are very large and the investments are key to building the capacity for growth, further work remains to be done to prioritize expenditures and investments. Moreover, the estimates have to be integrated into an overall MTBF and a credible financing plan developed.

29. **The staffs believe that careful attention will need to be paid to implementation risks.** The WIS does not contain an analysis of the risks that the economy is likely to face over the medium term, and does not contain a discussion of the vulnerabilities of the economy and how macroeconomic policy should be formulated, for example, if terms of trade or external demand decline. The capacity of ministries and other public institutions to ramp up their implementation skills and methods to deliver a WIS of this degree of ambition would need to be examined and the areas for institutional strengthening identified.

VIII. CONCLUSIONS AND ISSUES FOR DISCUSSION

30. **The WIS represents a commendable effort that was prepared with speed and with a high degree of donor involvement, but could have benefited from a broader participation.** The authorities should take time to build ownership within the government and within society and to step up participation efforts, internalizing the results of participation. Moreover, implementation capacity within the government would have to be strengthened.

31. **As the focus shifts to implementation, the staffs encourage the government to pay particular attention to several areas.** These are (i) reinvigorating progress to a market economy through structural reforms; (ii) establishing clear priorities amongst policies, programs and investments through costing; (iii) establishing the methods and institutions for monitoring and evaluation; (iv) paying careful attention to emerging risks in implementation and developing mechanisms for dealing with them; (v) sharpening policy analysis in selected sectors and detailing the measures to be taken in support of sector goals; and (vi) strengthening participation.

32. **The staffs are encouraged by the authorities' recognition of the central importance of technical assistance and external advice in WIS implementation.** Clearly, the technical assistance requirements to support the implementation effort will be crucial. As noted, the staffs are engaged with the Uzbek authorities in defining the technical assistance required across the WIS agenda. The preliminary estimate of the cost of the package is US\$6 million over an implementation period of three to four years. For the successful implementation of the WIS, it would be greatly helpful if donors could indicate their willingness to make grant contributions towards the cost of this technical assistance package.

33. **Issues for discussion.** Do Executive Directors agree with the staffs' conclusions concerning (i) areas in which further strengthening of WIS policy analysis and design are needed; and (ii) measures for improving the implementation of the WIS—in particular, the role to be accorded to the costing of programs and policies, their monitoring and evaluation, and the explicit participation of civic society in the decision making process?