Uzbekistan

Growth reportedly accelerated in 2018, inflation jumped, and the current account slipped from surplus into a deep deficit. Growth is projected higher in 2019 and 2020 on expansion in industry and services. Tighter monetary policy is expected to slow inflation in 2019 and 2020 despite upward adjustments to utility tariffs. The current account deficit will persist but shrink slightly in 2020. Irrigation reform is essential to agricultural sustainability and climate proofing.

Economic performance

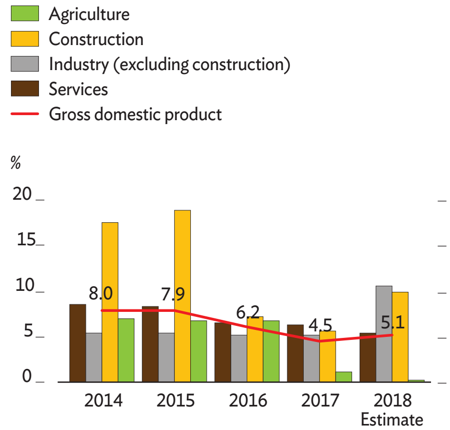
The government reported that growth accelerated from 4.5% in 2017 to 5.1% in 2018 on faster expansion in industry, construction, and investment. The figure for 2017 has been revised down as the government revisited GDP data, including growth rates, dating back to 2010.

On the supply side, growth in industry excluding construction doubled from 5.2% in 2017 to 10.6%, driven by increases of 6.4% in manufacturing and 28.2% in mining and quarrying (Figure 3.8.1). Construction expanded by 9.9%, up from 6.0% in 2017, with gains in housing and production facilities. Growth in services slowed from 6.4% to 5.4% last year, with smaller increases in transport and trade. Expansion in agriculture dropped from 1.2% in 2017 to 0.2% as poor rainfall cut cereal harvests by 12.5% and crop production more broadly by 4.7%.

Investment was the main driver of growth on the demand side. Expansion in gross fixed capital formation jumped from 7.1% in 2017 to 18.1% largely on higher investment in manufacturing, housing, energy, and mining fueled by a 36.6% surge in foreign investment and lending for fixed capital. In real terms, public consumption rose by an estimated 4.0%, as did private consumption by 3.0% on nominal wage increases that averaged 25.0% (6.4% in real terms) and nominal pension increases that averaged 22.6%.

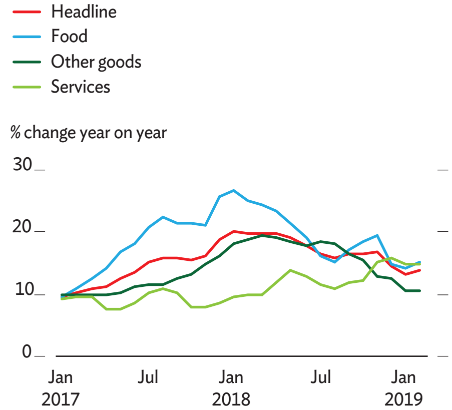
Average inflation accelerated from 13.7% in 2017 to 17.9%, reflecting the continuing impact of foreign exchange liberalization in the last quarter of 2017 and the first half of 2018 (Figure 3.8.2). Adding to inflation were utility price increases, price liberalization for bread and other basic goods, higher wages and pensions, and rapid credit growth, all occurring in 2018. Inflation rose despite exchange rate

3.8.1 GDP growth by sector



Sources: State Statistics Committee; ADB estimates.

3.8.2 Monthly inflation



Source: State Statistics Committee.

This chapter was written by Begzod M. Djalilov of the Uzbekistan Resident Mission, ADB, Tashkent.

stability, monetary tightening, the cancellation of customs duties on imports of basic foodstuffs, and better logistics and facilities for fruit and vegetables.

The consolidated budget surplus, reflecting balances of the state budget and specialized public funds, narrowed from 0.7% of GDP in 2017 to 0.5%. Ambitious development spending for social programs raised expenditure from 23.0% of GDP in 2017 to 26.2%, while tax reform is estimated to have raised revenue from 23.7% to 26.7%. The augmented government balance—combining the consolidated budget and policy-guided operations such as on-lending by the Uzbekistan Fund for Reconstruction and Development and recapitalization for state-owned enterprises and banks—is expected to record a deficit equal to 2.5% of GDP.

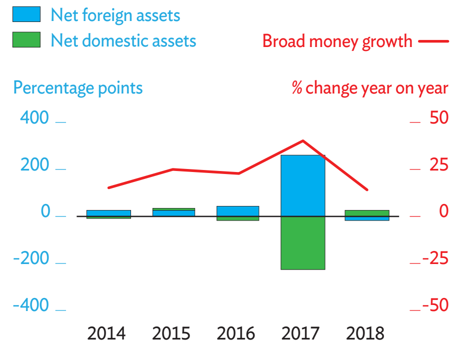
Responding to inflationary pressures, the Central Bank of the Republic of Uzbekistan raised the refinancing rate from 14.0% to 16.0% in September and subsequently adopted new instruments to manage liquidity, including auctions of deposits and government securities. These measures helped slash broad money growth from 40.2% in 2017 to 14.4%. Bank assets expanded by 28.7% in 2018, and credit jumped by 51.4% as the government channeled credit at preferential rates to selected sectors such as housing (Figure 3.8.3). The assets of banks with state ownership expanded by 32.0%, and their lending by 52.2%.

The Uzbek sum depreciated by 2.5% against the US dollar in 2018 despite the central bank selling $3.8 billion in US dollars during the year. Demand for foreign exchange reached $10.4 billion, mainly for imports to supply manufacturing and construction.

The current account balance recorded a deficit equal to 7.0% of GDP, reversing a surplus of 2.9% in 2017 (Figure 3.8.4). Exports of goods and services grew by 13.6%, with exports of services rising by 22.4% and of hydrocarbons by 65.8%. Imports of goods and services jumped by 39.6%, reflecting a 64.6% increase in imports of machinery and equipment to modernize industry and infrastructure. The resulting trade deficit was $5.3 billion. Remittances in the first 9 months of 2018 were $3.8 billion, 80% of which came from the Russian Federation.

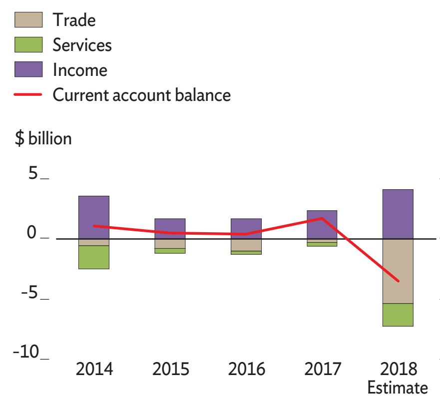
Lower foreign investment into hydrocarbons cut foreign direct investment by 14.2% in 2018. Foreign reserves slipped from $28.1 billion at the end of 2017 to $27.1 billion a year later, still providing cover for 17 months of imports (Figure 3.8.5). Higher foreign borrowing hiked external debt from 26.5% of GDP in 2017 to 34.7%. This prompted the Ministry of Finance to strengthen its management of external debt. In December 2018, it adopted the Debt Management and Financial Analysis System of the United Nations Conference on Trade and Development to monitor government debt obligations and grants, as well as private external debt that it does not guarantee.

3.8.3 Contributions to money supply growth



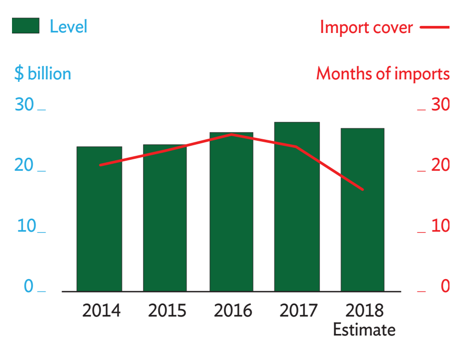
Source: The Central Bank of the Republic of Uzbekistan.

3.8.4 Current account components



Sources: International Monetary Fund; ADB estimates.

3.8.5 Gross international reserves



Sources: International Monetary Fund; ADB estimates.

Economic prospects

Growth is forecast to improve further to 5.2% in 2019 and 5.5% in 2020, boosted by higher infrastructure spending, an improved investment climate, expected gains in exports, and a pickup in agriculture (Figure 3.8.6). The main risk to macroeconomic stability stems from persistent credit expansion, which could revive inflationary pressure and push the current account further into deficit.

On the supply side, growth in industry is expected to slow to 5.5% in 2019, reflecting slower expansion in the production of machinery and petrochemicals for agriculture, and in mining and quarrying primarily for export and construction. Industrial sector growth is forecast to recover to 6.0% in 2020. Construction is forecast to expand by 9.0% each year, sustained by government expansion of urban infrastructure and services. Periodic increases in wages and pensions, and of spending for social assistance, are projected to expand services by 5.5% each year by boosting trade and transport. Growth in agriculture is forecast to accelerate to 4.0% in 2019, thanks to ample rain and structural reform in cotton and wheat, and 4.5% in 2020. Ongoing farm and agro-processing reform should boost exports.

On the demand side, growth will come mainly from investment as gross fixed capital formation rises on further improvement in the investment climate and government-led investment to modernize manufacturing, mining, power generation, transportation, and housing. Private consumption is expected to benefit from wage growth. Net exports are anticipated to remain a drag on growth in 2019 and 2020.

Inflation is projected to decelerate to 16.0% in 2019 and further to 14.0% in 2020 as lending growth under state programs slows and as further streamlining of customs procedures facilitates imports (Figure 3.8.7). Inflationary pressure will persist, however, from the lagged effects of a November 2018 rise in energy prices, further hikes to electric power and natural gas prices planned for June 2019, consequent adjustments to wages and pensions, and upward revisions to customs duties on imports. The central bank will pursue a phased transition to inflation targeting, aiming to reduce it to single digits by 2021. To contain inflationary pressure, monetary and fiscal authorities must coordinate their actions to mitigate the impact of liberalized prices for agricultural products and of protracted growth in credit.

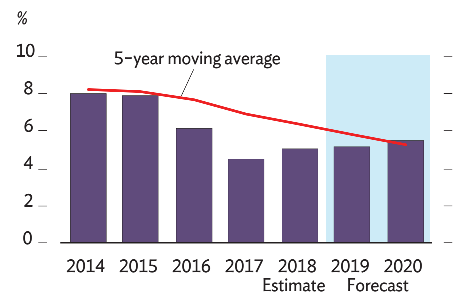
Growth in broad money is forecast to slow to 13.0% in 2019 and 12.0% in 2020 as growth in credit falls by half to 25.0% and then drops to 15.0% (Figure 3.8.8). In 2019, the central bank will limit preferential lending under state programs and further modify capital requirements for commercial banks when extending credit. Considering the continued impact of hikes in 2018 on utility tariffs and further tariff adjustments

3.8.1 Selected economic indicators (%)

	2019	2020
GDP growth	5.2	5.5
Inflation	16.0	14.0
Current account balance (share of GDP)	−7.0	−6.5

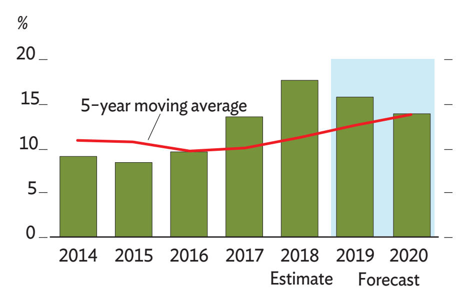
Source: ADB estimates.

3.8.6 GDP growth



Source: *Asian Development Outlook* database.

3.8.7 Inflation



Source: *Asian Development Outlook* database.

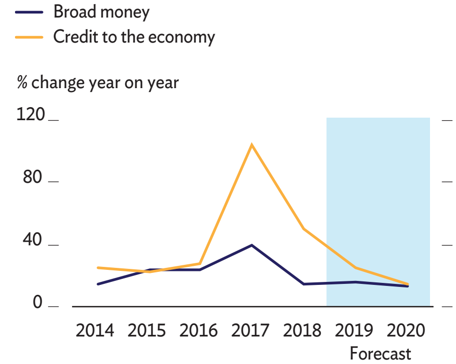
planned for 2019, the central bank has set its inflationary target at 13.5%–15.5% in 2019 and kept its refinancing rate at 16.0% in January 2019. It envisions developing money market instruments such as short-term deposits, swaps, and repo auctions—and issuing bonds that pay in 1, 3, 6, and 12 months—to manage liquidity in 2019 and 2020 while expanding its sterilization of foreign exchange inflows to keep monetary policy tight.

The consolidated fiscal balance is forecast to remain at the equivalent of 0.5% of GDP in 2019 and 2020 (Figure 3.8.9). The augmented fiscal deficit is projected to narrow to 2.0% of GDP in 2019 and 2020, reflecting the planned reduction in policy-guided lending, in particular on-lending by Uzbekistan Fund for Reconstruction and Development, to curb inflationary pressure from credit growth. As a part of tax reform, the government adopted in January 2019 a flat 12.0% individual income tax, introduced value-added tax on companies with revenue above SUM1 billion, and reduced the corporate income tax rate from 14.0% to 12.0%. Revenue in the consolidated budget is forecast to reach the equivalent of 30.0% of GDP in 2019 and 2020 as expenditure, mainly capital spending on infrastructure, remains at 29.5%. The restructuring of state-owned enterprises, the major contributors to the state budget, will create challenges for revenue, which the government plans to address through tax reform that brings more private firms into the tax base.

The current account deficit is expected to remain high at 7.0% of GDP in 2019 before narrowing slightly to 6.5% in 2020 (Figure 3.8.10). Exports of goods are forecast to grow by 10.0% in 2019 and 12.0% in 2020, reflecting expectations of higher gold prices, stable demand for natural gas from the People's Republic of China, expanded agricultural exports to the Russian Federation and other neighbors including Kazakhstan, and further processing of cotton fiber into textiles. Imports of goods are projected to rise by 25.0% in 2019 and 20.0% in 2020 as demand generated by infrastructure projects and the continued modernization of industry boost imports for these sectors. The risk of wider current account deficits persists as credit growth may further encourage imports of capital goods.

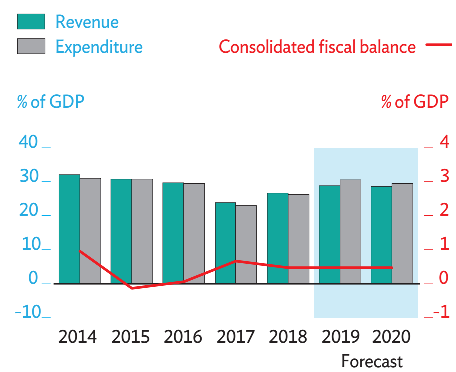
External borrowing for state-led development programs is projected to push external debt to the equivalent of 35.0% of GDP in 2019 and 2020 (Figure 3.8.11). Foreign investment will likely increase as well. Uzbekistan received a sovereign rating in December 2018 and issued its first eurobond in February 2019, providing for Uzbek corporations a benchmark for access to international capital markets.

3.8.8 Broad money and credit growth



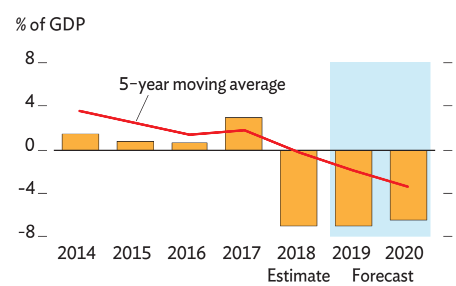
Sources: The Central Bank of the Republic of Uzbekistan; ADB estimates.

3.8.9 Fiscal components



Sources: International Monetary Fund; ADB estimates.

3.8.10 Current account balance



Sources: International Monetary Fund; ADB estimates.

Policy challenge—reforming irrigation

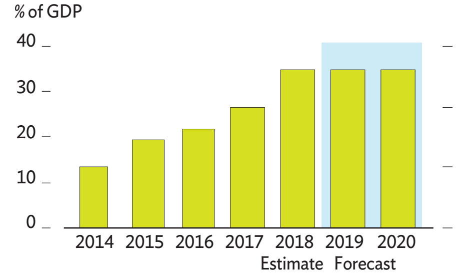
Agriculture is critical to the livelihoods of the half of Uzbeks who live in rural areas. It provides 27.3% of all jobs and contributes nearly one-third of GDP. Rapid population growth averaging 1.9% per year from 2005 to 2019 has put stress on the country's limited environmental resources, exacerbating land degradation and water shortages that constrain agricultural output.

A study by the International Food Policy Research Institute and the Center for Development Research estimated that over half of cropland suffers soil salinization caused by extensive irrigation, and that the resulting ecosystem changes and suppressed agricultural output cost Uzbekistan about 4% of GDP annually. In this arid climate, drought and water shortages are a constant threat. Precipitation in most areas averages less than 600 millimeters per year, and high temperatures can reach 49° Celsius in some areas, requiring river-fed irrigation. According to the Ministry of Water Resources, available water resources declined from 64 billion cubic meters (m^3) in 1991 to 59 billion m^3 in 2018, and population growth almost halved per capita availability from 3,048 m^3 to 1,589 m^3. In 2018, agriculture received nearly 90% of the water supply.

To address salinization and diminished water resources, the government is rehabilitating the irrigation system with investments worth $350 million last year and this year. It is providing incentives to adopt more water-efficient technologies. Suppliers of imported drip and sprinkler irrigation systems are exempted from customs duties for 5 years, and farmers that adopt them are similarly exempted from land tax. At the end of 2018, farmers were applying water-efficient technologies on more than 328,000 hectares. Drip irrigation currently supplies only 43,000 hectares, though, because of the high cost of introducing it. To encourage adoption, the government decided this year to award drip-adopting cotton farmers a one-time payment of $950 per hectare.

Despite their benefits, measures implemented in an ad hoc fashion allocate resources inefficiently. Over the next 2 years, the government should accelerate the creation of long-term strategies for agriculture and water resource management and develop an even broader plan for mitigating and adapting to climate change. These strategies should prioritize farmers' access to extension services and finance for machinery, and strengthen the security of their land tenure, to promote more efficient use of land and water resources. In addition, as water resource management cannot be undertaken on a national scale in isolation from the broader regional context, Uzbekistan should promote water resource management and climate proofing across borders through collaboration with its neighbors.

3.8.11 External debt



Sources: The Central Bank of the Republic of Uzbekistan; ADB estimates.