Changing for the Better:  
The Path to Upper-Middle-Income Status in Uzbekistan

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As a low-middle-income country with a gross domestic product (GDP) per capita of US$1,715 and a population of 30 million (nearly half of all of the Central Asian population), Uzbekistan has seen stable economic progress since the mid-2000s, both in terms of growth and poverty reduction. Growth has averaged 8 percent per year since 2004 and extreme poverty has declined from 27 percent in 2000 to 15 percent in 2012. Encouraged by this outstanding growth performance, the Uzbek authorities have set an ambitious goal for the country—to join the group of upper-middle-income countries by 2030. This note discusses the main challenges that the government is likely to face and the structural transformations that the economy will have to undergo to achieve this objective.

What Has the Uzbek Economy Achieved in the Last 20 Years?

Over the past 20 years, Uzbekistan has followed a unorthodox economic development model based on an import-substitution strategy and a considerable state presence in the economy. With limited integration into the global economy and prudent macroeconomic management, the Uzbek economy grew strongly over the past decade and showed resiliency during the global financial crisis. GDP growth averaged 8 percent per year over the period 2004–12, while GDP per capita grew on average 6.4 percent per year over the same period. Benefiting from rising international prices for its commodities and favorable terms of trade, Uzbekistan increased its exports of commodities selectively (gold, gas, and cotton) to select market destinations.

As income per capita doubled in real terms in less than a decade, absolute poverty was almost halved and declined from 27 percent in 2000 to about 15 percent in 2012. One of the most visible structural transformations in Uzbekistan over the last 20 years has been the gradual change in the structure of the economy away from agriculture (mainly cotton) in the late 1990s toward a greater reliance on industry and services by 2012. The export and import structures also changed dramatically over the last 20 years as the economy diversified. The share of noncommodity exports (for example, cars, trucks, fertilizers, plastics, and foodstuffs) expanded from 10 percent in total exports in 1992 to 23 percent in 2012. The import structure has also diversified, with a shift away from food and energy in 1992 to mainly capital goods and raw materials (machinery, equipment, and chemicals) related to public investment projects (figure 1). In addition, trading partners have also been diversified geographically, that is, away from the Russian Federation—from 55 percent of trade in 1992 to 29 percent in 2012—to other Commonwealth of Independent States (CIS) countries, which was 18 percent in 2012, of which Kazakhstan’s share was 11 percent, China’s was 12 percent, the Republic of Korea’s was 8 percent, the European Union’s was 7 percent, Turkey’s was 5 percent, and Afghanistan’s was 4 percent, among other destinations.
What Additional Structural Transformation Will Be Needed?

The Uzbek authorities have started to articulate a long-term vision; the main objective of the vision is to define the strategic choices that would put Uzbekistan on the path to become an industrialized upper-middle-income country by 2030. This implies that the economy will have to grow on average at 6 percent per year for the next 17 years to achieve a GDP per capita of $4,900 by 2030. This is an ambitious
goal; there are very few countries in the world that have managed to sustain such high rates of economic growth for such an extended period of time. Out of 101 middle-income countries in 1960, mostly located in Europe, only 10 became high-income countries by 2008. The majority of other countries have fallen into the “middle-income trap.”

At the same time, Uzbekistan’s ambitions are commendable because prosperity will bring about better opportunities not only for businesses, but also and most importantly for its people. But it is important to understand the steps that will need to be climbed at each stage of development. The World Economic Forum (WEF) provides a useful framework to understand these different stages (WEF 2012). In this framework, in the first stage, the economy is factor driven and countries compete based on their factor endowments—primarily unskilled labor and natural resources. Firms compete on the basis of price and sell basic products or commodities, with their low productivity reflected in low wages. Maintaining competitiveness at this stage of development hinges primarily on well-functioning public and private institutions, well-developed infrastructure, a stable macroeconomic environment, and a healthy and well-educated labor force. Countries at this stage usually have a GDP per capita of less than US$2,000.

Significant structural transformation will take place as the country moves up the development ladder from a factor-driven to an efficiency-driven economy. At this transition stage, with GDP per capita between US$2,000 and US$3,000, a country becomes more competitive and productivity and wages will rise with advancing development. Countries then achieve the efficiency-driven stage of development, where GDP per capita reaches a higher threshold between US$3,000 and US$9,000, and they must begin to develop more efficient production processes and increase product quality because wages have risen and they cannot increase prices. At this point, competitiveness is increasingly driven by higher education and training, efficient goods markets, well-functioning labor markets, developed financial markets, the ability to harness the benefits of existing technologies, and a large domestic or foreign market. Finally, as countries move into the innovation-driven stage, where GDP per capita reaches levels in excess of US$17,000.
wages will have risen by so much that businesses will be able to sustain those higher wages and the associated standard of living only if their businesses are able to compete with new and unique products. At this stage, companies must compete by producing new and different goods, using the most sophisticated production processes and by innovating new ones.

Where Is Growth Likely to Come From?

Since 1996, the government of Uzbekistan has been promoting an import-substitution strategy heavily driven by state investments. This strategy has been implemented through state support often channeled through directed credit to state-owned or state-controlled enterprises (SOEs), high import duties and excises, and through nontariff barriers such as foreign exchange control and an overvalued official exchange rate for import of SOE's capital goods. While this policy has proved highly effective in maintaining high rates of economic growth so far, the question is, how much longer can this economic model be sustained?

Econometric analysis suggests that additional attention should be on improvements in government effectiveness and private investment (table 1). Improvements in government effectiveness are likely to have the highest impact on economic growth in Uzbekistan because an increase of 1 percentage point in the government effectiveness indicator would lead to an additional 2 percentage points of real GDP growth. The government should also give consideration to promoting further trade liberalization in the economy since currency exchange liberalization introduced at the end of 2003 had a strong positive impact on growth.

How Will a Changing World Affect a Changing Uzbekistan?

In an increasingly multipolar world, a new phenomenon is emerging: developing country growth has steadily diverged from advanced economy growth since the late 1990s, reflecting improved policy frameworks. Over the next two decades, the international development environment will change and will be much different from that of the past decades. Growth will be increasingly driven by Eastern investors and less so by Western consumers. The world will continue to witness more dramatic changes in coming decades, including developing countries’ role in the global context, the emergence of new growth poles and intensified links among developing countries, and further sectoral shifts within developing countries.

Led by the fast-growing emerging economies, developing countries contributed two-thirds of global growth in the past five years with rising intra—developing country trade. Notwithstanding their rising global weight, emerging economies remain developing countries that continue to face major development challenges. The case of Uzbekistan is no different, and progress in economic and living standards will require not only a good understanding of how Uzbekistan is likely to be affected by a changing global environment, but also policy and institutional reforms to foster the required structural economic transformation.

Uzbekistan will need to ensure accessibility to key trade partners in a competitive way. As the World Development Report 2009: Reshaping Economic Geography (World Bank 2008) illustrates, Eurasia (excluding Russia) is a region with low density, long distances, and many divisions. Uzbekistan also has these problems, and is now largely geographically and economically isolated from the world’s most dynamic centers and cannot benefit from increased integration with high-income countries, or witness the emergence of urban centers that reinforce economic diversification and house large numbers of consumers and producers. In this context, to increase its chances of participating competitively in world markets, Uzbekistan needs to consider ways to develop

Table 1. Uzbekistan: Two-Step Least-Squares Regression of GDP Growth (1998–2012)

<table>
<thead>
<tr>
<th>Dependent variable: GDP growth</th>
<th>Growth of private investment</th>
<th>Growth of government investment</th>
<th>Government effectiveness</th>
<th>Terms of trade</th>
<th>Trade liberalization dummy since 2004</th>
<th>Growth of labor force</th>
<th>Constant</th>
<th>Wald chi^2</th>
<th>R-squared</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>0.080* (0.048)</td>
<td>0.098*** (0.035)</td>
<td>0.034* (0.019)</td>
<td>-0.024* (0.014)</td>
<td>2.947*** (0.595)</td>
<td>1.474* (0.861)</td>
<td>3.825*** (0.241)</td>
<td>396.7</td>
<td>0.95</td>
</tr>
<tr>
<td></td>
<td>0.106*** (0.026)</td>
<td></td>
<td></td>
<td></td>
<td>3.186* (0.318)</td>
<td>-0.691 (0.552)</td>
<td>2.118 (1.396)</td>
<td>637.1</td>
<td>0.97</td>
</tr>
<tr>
<td></td>
<td></td>
<td>0.367*** (0.349)</td>
<td></td>
<td></td>
<td>3.697*** (0.234)</td>
<td>-5.44* (0.283)</td>
<td>7.009*** (1.878)</td>
<td>585.9</td>
<td>0.96</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>1.288** (0.560)</td>
<td></td>
<td>2.072*** (0.309)</td>
<td></td>
<td>9.619*** (0.786)</td>
<td>957.9</td>
<td>0.987</td>
</tr>
</tbody>
</table>

Source: Authors’ own calculations. Notes: Instruments are years and export price index, instrumented (endogenous) variables are growth of private and government investment, number of observations is 13. The heteroskedasticity robust standard errors are reported in brackets with significance levels: *** - 1%, ** - 5%, * - 10%. (a) The Government Effectiveness variable captures perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the government’s commitment to such policies. (see The Worldwide Governance Indicators (WGI) dataset available at http://info.worldbank.org/governance/wgi/resources.html#intro)
institutions that could help it become more integrated with the global economy (World Trade Organization [WTO] accession; strengthening the rule of law and property rights; and reviewing logistics impediments for intra- and interregional trade are a few examples); improve infrastructure to connect to world markets; and concentrate on incentives to attract capital and knowledge (for example, special economic zones to foster agglomeration economies and diversification).

Despite some success in diversifying the Uzbekistan economy, important goals have not been met and there are significant opportunity costs and risks to the country’s development strategy that question its long-run sustainability. Upon independence in 1991, Uzbekistan inherited one of the lowest standards of living in the Soviet Union; the economy was reliant on raw materials such as cotton, gold and natural gas, while heavily dependent on imports of oil, wheat, meat, and most manufactured goods. Against this background in the mid-1990s, the government began implementing a long-run strategy to transform the economy from heavy dependence on agriculture and natural resources to a modern industrial economy. Initially this strategy was import substitution based, but recently has become more export-oriented and focused on nurturing selected infant industries (in which Uzbekistan might not have a comparative advantage) organized in state-controlled industrial associations and state-owned joint-stock companies through open-ended protection.

The global environment for growth in the medium-term has become more challenging. A prolonged period of lower growth in advanced economies, for example, would mean slower growth in markets for Uzbekistan exports. Financial sector challenges, heightened risk aversion, and large sovereign debt refinancing needs in many advanced economies also point to a period of less abundant and costlier capital over the coming years. A more challenging and uncertain medium-term outlook for global growth means that Uzbekistan will need to focus more on domestic policies and reforms that can remove structural impediments to growth and generate enough jobs for the rapidly expanding labor force. The challenge will be not just to support rapid growth, but to do so through systems that also encourage greater equality of opportunities, greater competitiveness, and respect for the environment.

Weaker external demand and likely lower commodity prices for exports in the short or long term would negatively affect economic growth and call for diversification of Uzbek export toward higher value-added goods and services. However, securing access to foreign markets for growing manufacturing and food exports would require accession to the WTO, especially because Uzbekistan’s major importer of manufacturing goods—Russia—has recently joined the WTO. This would, however, require changes in government policy, because the current practice of supporting enterprises with subsidies through directed credit, high trade protection, and other measures may not be feasible under WTO rules. Ease of doing business, particularly in terms of institutional and infrastructure support for exporters and domestic businesses, will become crucial to sustain growth.

Sustainable growth also will require significant structural change, because future growth will have to rely more and more on productivity increases. However, the country faces serious structural reform bottlenecks; the Uzbek authorities’ continue to delay critical reforms that hamper private business incentives and improvements in productivity, making long-term growth unsustainable. Widespread government controls, particularly on prices, and trade restrictions resulted in resource allocation distortions, increased transaction costs, and inefficiency. They also have costly welfare impacts and encourage informality. While measures have been taken recently to support small and medium enterprises (SMEs), increase utility tariffs to cost recovery levels, and simplifying some business registration procedures, the business and governance environment indicators rank among the lowest in the world.

Is Uzbekistan on Track to Achieve Its Objectives?

So, can Uzbekistan become an upper-middle-income country by 2030? Yes, it can. But perhaps a more important question is whether this will be easy. The government’s approach toward achieving its goals is to continue the gradual transition to a more market-oriented economy, to ensure an equitable distribution of growth among regions, and to maintain infrastructure and social services. What will be critical for the success of these strategies is how well they are implemented. There are still significant obstacles affecting the operation of firms, including cash and foreign exchange controls; excessive government participation in the economy; major regulatory obstacles to trade; and cumbersome licensing and permit frameworks. In addition, Uzbekistan’s trade policies are among the most restrictive in the region, and they continue to be an important impediment to regional trade. At the same time, governance and transparency remain important areas where progress is needed. The limited availability of key economic, financial, and social data makes it difficult for those interested in Uzbekistan to know and understand the main strengths and opportunities of the economy.

At the same time, there are important distortions in agriculture that hamper productivity growth such as implicit net taxation and mandatory cropping patterns in cotton and wheat. The total value of the implicit tax on cotton production through depressed output prices well below world market prices tended to significantly exceed the total value of input subsidies, thus imposing a net implicit tax on cotton production estimated at around 30 percent of farmers’ gross
cotton revenues in 2003 and 2004, which is much higher than corporate and personal income taxes. Cotton production could be increased at no cost to the budget if input subsidies and output taxes were reduced by equivalent amounts. With state procurement prices for cotton and wheat increasing since 2005, net implicit taxation has been slightly reduced. However, the distorted input and output prices that lead to waste and large allocation inefficiencies clearly remain a problem constraining productivity growth. Besides distorted relative prices, mandatory cropping plans also lead to inefficient land use and choice of crop. Farmers cannot respond to changes in international prices as they must comply with state cropping and production plans. In a modern market economy, there should be no room for this type of controls.

Uzbekistan also needs to carefully consider how to secure competitive access to key trade partners. Limited by history and geography, the country is now largely isolated from the world’s most dynamic centers. As an example, in the post-Soviet era, countries that were closer to the European Union market benefited from the increased integration of the region and witnessed the emergence of urban centers closer to Western Europe that reinforced economic diversification and housed large numbers of consumers and producers. By contrast, agglomeration dynamics in Eurasia were attenuated by the long distance to leading world markets, which favored the consolidation of capitals and a few other leading cities (Coulibaly et al. 2012). The region, and Uzbekistan in particular, needs a clear vision and strong commitment to cooperative solutions to create a policy environment conducive to connectivity infrastructures (for example, road corridors and broadband networks).

If Uzbekistan uses its policy levers to remove critical structural constraints, it will be successful in achieving its objective of becoming an upper-middle-income country by 2030—but that is not to say it will be an easy path.

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References