

POLICY BRIEF



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Microfinance in Uzbekistan: Current State and Future Prospects

Introduction

A common effect of the Soviet Union's break up has been the hardship faced by most layers of the society in the new republics as the integrated Soviet trade, industry and agriculture system unraveled and the accompanying transport and energy infrastructure fragmented. Compounding the distress has been the difficult but desirable transition from the decades-old dysfunctional governance and economic system of the USSR. Even though some of the new republics tried to mitigate the unfavorable effects of transition by regulating the speed of change into a market economy, they could not prevent the appearance of poverty, especially at the rural areas and the so-called company towns.

In Uzbekistan, an agricultural economy and a rural society, where over 60% of the population live in rural areas, particularly those transition measures directed to farm restructuring are likely to have short-term adverse effects that would require additional tools, such as microfinance. The development of microfinance in Uzbekistan can meet two key national objectives concurrently in rural as well as urban areas: poverty reduction and employment generation. Through those, microfinance can ease the migration pressures as unemployed rural population is not as compelled to seek jobs abroad or in urban areas. The micro-enterprises are essential building blocks of a market-oriented economy, exploiting local competitive factors, and the feasible ones growing into SMEs. Aside from alleviating economic and social pressures during transition, microfinance will serve as an essential component of the drive for market economy and decentralized governance.

I. International Experience with Microfinance

Let us clarify what microfinance is before going any further in the discussion: it is essentially a combination of financial products (micro-credit, micro-leasing, micro-insurance, micro-savings, and money transfers) targeting specific client

groups. Recipients of these services are generally representatives of micro-business and economically active but poor citizens. The majority of them have limited access to the standard financial products provided by traditional financial institutions (banks), which do not generally invest in initiatives of micro-entrepreneurs and low-income individuals.

In the 1950-1970s, governments in developing countries and the donor community experimented with subsidized agricultural credits to small and low-income farmers as an effort to boost productivity and income levels. Since the mid-1980s, subsidized credits have been subject to criticism, since most programs have focused exclusively on social needs while they have proven financially unviable and unsustainable.

As the need for an approach that would take both the market and the social context into consideration became more apparent, new organizations, known as microfinance institutions (MFI), began focusing on low-income populations. MFIs thus switched focus from subsidies to targeted aid to the poor and helped establish local institutions which were both financially and operationally stable.

The first micro-credit program to focus on group loans was the Grameen Bank, which was launched in 1976 by Mohammed Yunus in Bangladesh. Today, the Grameen Bank has more than 2.4 million clients. The scheme has also made a significant contribution to macro-economy as 48% of the poor families which have obtained credits have managed to overcome the poverty line.

Gradually, traditional financial institutions also underwent gradual change. For instance, Bank Rakyat of Indonesia, a state-run rural bank, reorganized its branches into a vast network of rural banks which today provide various commercially-oriented financial services focusing on non-targeted and non-subsidized loans in addition to savings schemes developed exclusively for rural needs.

In the late 1990s, MFIs increasingly contributed to the overall financial sector by boosting profits and expanding public access to financial services in general when they began reorganizing themselves into microfinance banks. Decades of experimentation now has shown that the key to success of microfinance programs which focus both on social and commercial principles is to achieve cost recovery while increasing the client base at the same time. Therefore, a disciplined management of costs at all levels is key to ensuring the financial viability of MFIs.

Today microfinance programs worldwide tend to provide commercial services. Yet, practice has shown that for transition economies, with dire social problems and weak financial institutions, there is a specific need to maintain the balance between social and income objectives and principles of microfinance.

II. The Case of Uzbekistan: Urgency of Microfinance Programs

There are a number of arguments why microfinance can be an integral component of the strategy of reforms which are being currently implemented by the government in Uzbekistan. These arguments lead us to recommend the development of the sector as an urgent and important initiative in the country:

- 1) *Microfinance can be an effective instrument for providing public employment and reducing poverty, especially in rural areas, which is the leitmotif of government's social policy in the years to come.*

Microfinance programs can meet the significant demand for small loans arising

in the course of agricultural reforms. New private farmers will need such loans to develop their farms, purchase equipment, seeds and fertilizers. While traditional financial institutions cannot provide small loans due to the high cost of small transactions, lack of traditional collateral and high risk of small agricultural business, microfinance can be tapped into for meeting such demand.

2) Microfinance can be an effective instrument for addressing new employment challenges.

Microfinance is an effective tool for creation of self-employment opportunities. Microfinance programs in Uzbekistan have already drawn more than 70,000 clients, with nearly 200,000 persons employed in supplementary activities¹. Despite the inadequate legal underpinning and semi-legal existence², micro-credit programs of international organizations and donors have involved more than 40,000 clients. Two groups are visibly distinct among overall micro-credit recipients - small traders and agricultural producers. Given the low mobility of agricultural labor, microfinance could be promoted as an important long-term and effective instrument to resolve the problems of employment in Uzbekistan.

Uzbekistan is an agrarian country with more than 60 percent of the population employed in agriculture. Since 2004, across-the-board reforms underway in the country have focused on dissolving loss-making *shirkats* (collective farms)³ and replacing them with newly established private farms. The implementation of these reforms would lead to the release of rural labor, which can aggravate unemployment problems at the national scale. Experts estimate that between 600,000 and 900,000 persons annually would be released from the farming sector and would need to be absorbed by the labor market. For the moment, government programs have been inadequate in solving employment problems. The total number of new jobs created annually is less than half of the labor force which is released.

In Uzbekistan today, employment problems are aggravated by demographic trends. Given the high birth rates that began in the mid-1980s, almost 800,000 people join the labor market annually in Uzbekistan, while only 120,000 leave it. Rural youth account for nearly 60-73% of the total growth at the rate of approximately 680,000 people. Experts are projecting even higher birth rates in Uzbekistan for the next few years. The employment situation is particularly difficult in rural areas⁴. In 2004, rural residents accounted for 73.4% of individuals registered at employment offices against 60-65% in previous years. This increasing trend of employment problems in rural areas leads to the urgent need for adequate microfinance programs.

3) Micro-credits aimed at servicing small entrepreneurial initiatives may become a means to reducing the flow of out-migration in the short term.

Uzbekistan today is witnessing a significant and growing flow of labor migrants primarily to Russia and Kazakhstan. According to some estimates, temporary labor migration constitutes more than 90 percent of overall population movements in the countries, while the number of labor migrants exceeds 1 million persons per year⁵. Most labor migrants consist of low-income population groups⁶ who would stay in the country and attempt to start their own small businesses if they had better access to financing.

4) The government's commitment to develop entrepreneurship will lead to a significant increase in demand for additional finances as well as new instruments for funding the business sector in the years to come.

A number of decrees and resolutions⁷ of the President of Uzbekistan adopted in June-August 2005 signal a new stage of long-term government strategy for

facilitating the development of entrepreneurship, which in turn is the main consumer of microfinance services. The major categories of micro-business distinguished by legislation and government statistics are: individual entrepreneurs, micro-firms with no more than 20 employees in manufacturing sector, no more than 10 employees in service and other non-manufacturing sectors, no more than 5 persons in wholesale and retail trade and public catering.

A distinct feature of micro-business development in Uzbekistan is the shortage of equity, which hinders the prospects of seeking external sources of funding and loans. Microfinance is an instrument which can increase the value of small and micro businesses which provide goods and services to local markets. According to expert estimates, 1.9 million micro-businesses in Uzbekistan need micro-credit. The demand for micro-credits in entrepreneurial activities amounted to UZS 290 bln. (USD 257 mln.)⁸ in the year 2005.

Survey findings illustrate that NGO-MFI loans effectively enhance the sustainability and profitability of micro-businesses given the simplified application systems for credits. Thus, 71% of NGO-MFI clients have increased their turnover and 60% have increased their profits, enabling their businesses to move up scale.⁹ Setting up and facilitating microfinancing does not require large financial allocations by the government because household (private) savings can serve as financial sources for chartered capital of the new MFIs, while their profit can be the source for expanding microfinance activities.

5) *MFIs can boost savings in Uzbekistan.*

Currently, commercial banks account for more than 90 percent of financial intermediation in Uzbekistan, while their crediting capacity is limited due to low capitalization. This leads to the need for new sources of investment to service new areas of activities that have emerged in the growing economy. To promote such new opportunities, the liberalization of the financial sector and establishment of new types of financial intermediaries are required. Such priorities are reflected in the government Program for Development of the Banking Sector in 2005-07, prepared by the Central Bank, Ministry of Economy, and Ministry of Finance.

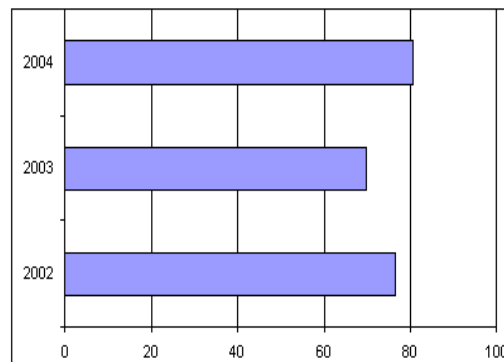
The principle of group mandatory savings within the micro-credit programs can be viewed as alternative and additional forms of savings. Such nation-wide schemes could be new and stable financial sources of investment programs.

6) *Development of microfinance is important for social stability and cohesion.*

Extremism and destructive behavior of disgruntled groups are probably the most negative and hazardous impacts of market failures in the transition economies of the Central Asia. It arises from a mix of social, economic, and political factors, and law enforcement by itself is not sufficient to counter it. There is an urgent need to organize alternative processes of social

Figure 1.

Micro-credits provided from Commercial Banks' Resources as Share of Total Micro-credits, %



Source: "Microfinance in Uzbekistan" analytical report by Center for Economic Research, 2005.

cohesion, and microfinance can play a part in that regard.

A main reason of social instability is lack of employment opportunities for socially vulnerable population groups. At the moment, some entrepreneurs are meeting their needs for small seasonal loans in alternative informal markets where interest rate reach 20-30% per month. Government instituted and supported microfinance will substitute these legally and economically dysfunctional schemes.

7) Microfinance is a tool for improving the role of women in business.

While it is very difficult for women to access the banking system, the microfinance survey shows that gender does not play a role in micro-credit awards. Hence, growing role of microfinance in the country will increase the role of women entrepreneurs.

Moreover, it will expand women's employment opportunities, as the survey has shown that women entrepreneurs tend to recruit female employees and provide employment for women in their families.

III. The Current State of Micro-Financing in Uzbekistan

Micro-credit programs in Uzbekistan were initiated by the United Nations Development Program (UNDP) in 1998 through the implementation of two pilot projects in Kashkadarya and Karakalpakstan. Those projects supported the establishment of three non-governmental MFIs. The main goals of the projects were to expand access to financial resources for the low-income groups, and to assist them in trade, small-scale production, and micro-businesses based on family assets.

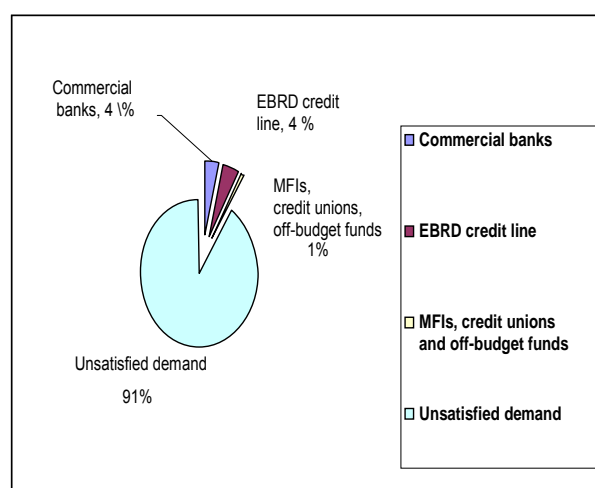
Those projects led to the adoption of national legislation "On Measures for the Development of Microfinance in the Republic of Uzbekistan" (Decree # 309 of August 2002).

Currently, microfinance services are provided by commercial banks, savings and credit unions, non-government microfinance institutions (NGO-MFI), and credit lines of off-budget funds (such as the *Dehkan* and Farming Entities Support Fund, the State Employment Fund) and from international financial institutions (EBRD, ADB).

Interest rates and amounts of credit vary considerably depending on the type of financial institutions dealing with micro-credits. The factual average micro-credit of commercial banks is the equivalent of \$2,500-3,000 whereas credit unions provide not much more than \$1,000

Figure 2.

Micro-credit market in Uzbekistan, 2005



Source: "Microfinance Development in Uzbekistan"- Center for Economic Research, 2005 and data by Central Asia Microfinance Alliance (CAMFA).

and NGO-MFIs offer a maximum of \$150.

Commercial banks are not interested in microcrediting due to high transaction costs and high risk of micro-credit transactions. The interest rates of the banking micro-credits are preferential and cannot be higher than the refinancing rates of the Central Bank¹⁰. In practice, these terms imply an outright loss for banking micro-credits and contradict the nature of banking – even despite the tax privileges granted for micro-credit services.

The advantages of micro-credits from off-budget funds are obvious: low interest-rate, opportunity to obtain credits in cash, generous timeframes and a long grace period. Micro-credits of off-budget funds (especially the Employment Fund) are most attractive for agriculture and for establishment of start-up capital. However, limited credit resources in general (and of the Employment Fund in particular)¹¹ reduce the volume of off-budget funds and their microfinance coverage.

Activities of credit unions are strictly regulated and aimed at the more affluent clients. The non-banking sector, represented by NGO-MFIs is mainly based on donor financing. Although the prime cost of credit funds is zero or almost zero, the interest rates charged by NGO-MFIs are relatively high (4-6.5% per month). It is because NGO-MFIs are limited by their interest income and donor grants for increasing the volume of their loan capital and expanding microfinance activity. If they gain access to diversified financial sources, they can lower their interest rates.

In sum, microfinance in Uzbekistan is not widely developed and consists mainly of micro-credits and insignificant micro-leasing. Microfinance institutions across the country cover only 9% of the demand. Therefore, a huge market exists for new MFIs in Uzbekistan.

Table 1. Eligibility Requirements for Micro-Credits in Uzbekistan

	July, 2000	January, 2004	January, 2005	January, 2006
Commercial banks				
Average loan amount	Soum 1,025,000 (\$3,150)	Soum 2,620,000 (\$2,700)	Soum 2,660,000 (\$2,600)	Soum 2,300,000 (\$1,900)
Interest rate	6-10.6% per annum	5-24% per annum	2.7-16% per annum	3-16% per annum
EF credit line				
Average loan amount	-	-	Soum 900,000	Soum 650,000
Interest rate	-	4-11% per annum	3-8% per annum	2.7% per annum
EBRD credit line				
Average loan amount	-	\$2,000	\$2,831	\$2,400
Interest rate	-	36-42% per annum	16-56% per annum	24-36% per annum
NGO-MFI				
Average loan amount	\$85	\$115	\$146	\$136
Interest rate	6.5-7% per month	4 -6% per month	5-7.5% per month	4.5-6.5% per month
Credit unions				
Average loan amount	-	-	Soum 1,100,000 (\$1,000)	Soum 1,400,000 (\$1,170)
Interest rate	3% per month	3-10% per month	3.3 – 4.2% per month	4-8% per month

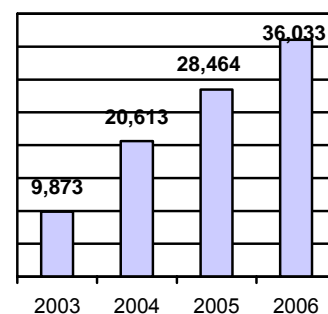
Sources: the Central Bank of the Republic of Uzbekistan – data on commercial banks and credit unions; European Bank for Reconstruction and Development Office and www.j-usbpc.com – data on the EBRD credit line; CAMFA – data on NGO-MFI.

Analysis has shown that the NGO-MFI model is the most promising one for

enhancing the potential of microfinance in Uzbekistan – especially, in easing the access of poor groups to micro-credits. Unlike commercial banks and credit unions, NGO-MFIs influence the employment and incomes for the poorest people. In practice, NGO-MFI micro-credits are not only more accessible in general but are accessible equally in cities and farming communities and thus can help reduce social divisions between rural and urban communities, as well as lower the pressures for migration towards urban areas or abroad.

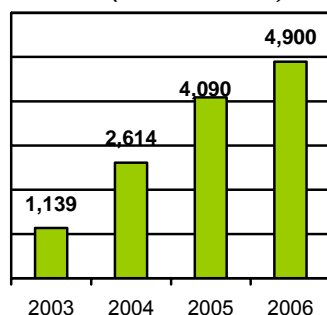
Although NGO-MFIs have demonstrated robust growth trends (Fig. 3, 4, 5), these entities face the biggest hurdles and have not been able to fulfill their full potential as of yet.

Figure 3. Active NGO-MFI clients in Uzbekistan (people).



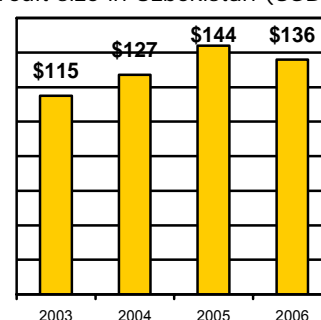
Source: CAMFA

Figure 4. NGO-MFI credit portfolio in Uzbekistan (USD thousand).



Source: CAMFA

Figure 5. Average NGO-MFI micro-credit size in Uzbekistan (USD).



Source: CAMFA

Among the hindrances to the growth of NGO-MFIs, the following can be noted:

- *Lack of legislative and regulatory frameworks*, especially with the expiration in late 2005 of Resolution # 309. According to interviews conducted by the CER with experienced NGO-MFIs, donors will refrain from investing into the microfinance sector of Uzbekistan even if the funds were available until the legal status and mandates of NGO-MFIs are clarified by law. The lack of regulatory framework also curbs the growth, both in numbers and in activities, and limits their loan capacity by preventing them from diversifying the sources of borrowing (commercial bank loans, corporations, etc.).
- *Further taxation*. NGO-MFIs were granted tax benefits until 2006, which facilitated their growth, particularly in rural areas, where they covered the most remote areas of Uzbekistan inaccessible to other financial institutions. Analysis has shown that although the majority of NGO-MFIs are operationally sustainable. However, if tax liabilities are introduced, they will not be able to accumulate essential funds needed for keeping focus on socially-oriented targets, which, as a rule, are generally unprofitable.

In the meantime, a distinct feature of existing micro-credit programs in

Uzbekistan is their social objective. They have proven effective in addressing poverty and unemployment, alleviating social tensions in regions where birth rates are high, and creating sustainable sources of income for micro-business, individual entrepreneurs as well as the persons with unregistered business. At the same time, NGO-MFI activities are financially viable: in general, repayment rate of micro-credits currently stands at 96-98%.

Table 2. Assessment of Current microfinance Potential in Uzbekistan

An indicator of microfinance's depth of outreach is measured by the ratio of average micro-credit size to GDP per capita. This is about 10% in Uzbekistan, indicating that only the very poor groups are covered. In Eastern Europe, this ratio is about 25%.

Another indicator is that of coverage, measured by the percentage of poor population who use microfinance. In Uzbekistan only 0.6% of the poor used microcredits.

Index	2003	2004
Total volume of micro-credits provided by microfinance institutions as a share of GDP, %	0.65	0.71
- micro-credits provided by banks	0.42	0.35
- micro-credits provided by the Employment Fund	0.0	0.0
- micro-credits provided by the EBRD	0.2	0.3
- micro-credits provided by microfinance institutions	-	0.04
- micro-credits provided by credit unions	0.03	0.02
Banks' micro-credits as a share of the total volume of credits provided by the banks to the real sector of the economy, %	-	1.2
Micro-credits provided by all types of microfinance institutions as a share of the total volume of credits provided by the banks to the real sector of economy, %	-	2.4

Source: "Microfinance Development in Uzbekistan", Center for Economic Research, 2005

IV. Role of Donors

International donor organizations have played, and can continue to play, a decisive role in establishing, facilitating, and developing microfinance in Uzbekistan. Some donors have provided start-up capital and funded transaction costs in the early stages, with the MFIs set up with their support continuing their independently operations subsequently. Among these donors are NOVIB (Netherlands Agency for Technical Cooperation and Development, which assisted the establishment of Sabr NGO-MFI), DFID (UK's Department for International Development), which provided start-up capital for Barokot [the largest MFI in Uzbekistan] and U.S. Department of Agriculture, which provided support to the establishment of PAD MFI.

Other donors continuing supporting microfinance sector of Uzbekistan include ACTED (France-based international NGO), ADB/JFPR (Asian Development Bank jointly with Japan Fund for Poverty Reduction which are financing innovative techniques for poverty reduction in Karakalpakstan), United Nations Development Programme (UNDP), and the U.S. Agency for International Development (USAID). The programs of UNDP and USAID are distinct in scale

and consistency. In addition to its two projects in Kashkadarya and in the Republic of Karakalpakstan, UNDP is currently piloting innovative microfinance programs in Kashkadarya and Surkhandarya, testing new microfinance products under business incubators in Shahrisabz (micro-credits for farmers) and Angor cities (micro-leasing for farmers). USAID is providing technical assistance to a number of MFIs within the framework for establishment of an Association of Microfinance Institutions in Uzbekistan. Jointly with ADB, USAID is also supporting the further development of credit unions in the framework of World Council of Credit Unions (WOCCU).

Other donors are increasingly expressing interest in microfinance in Uzbekistan. For instance, World Bank is interested in implementing microfinance programs in Samarkand and Bukhara in close contact with branches of Khalq Banki, one of the major banks of Uzbekistan. In its strategy for 2005-2007, EBRD identified the establishment of a microfinance bank in Uzbekistan as a strategic objective

VI. Recommendations

Based on the above background information and analysis, this *Policy Brief* concludes that a comprehensive microfinance support program needs to be elaborated by the Government which should include the following components:

1. *A legislative and regulatory framework to ensure the transparency, consistency and sustainability of microfinance programs.* Such a framework should include incentives for all types of MFIs, spell out clear registration procedures to gain full legal recognition. It is also essential to permit household deposit contributions as a source for the charter capital of new MFIs to be established in the law.
2. *Extension of preferential taxation status.* Considering the infancy of microfinance in Uzbekistan and its potential for alleviating social problems, it seems reasonable to extend preferential income taxation accorded to microfinance institutions. We should note that income tax privileges were granted to commercial banks in the 1996-1997 period in order to support the development of the banking sector.
3. *New pilot projects.* New pilot projects are needed to strengthen the status and scale of microfinance in Uzbekistan. These should introduce new products and further consolidate existing microfinance models by expanding to new regions of the country. Donors should be encouraged to experiment with new microfinance pilot programs (micro-insurance, micro-leasing, micro-savings, etc.) that could be implemented within the framework of the government's poverty reduction strategy. If the pilot projects are successful, their experience can be replicated on a national scale while amending legislation to facilitate accordingly.

For instance, the favorable experience in the area of micro-credit services in Uzbekistan opens the possibility for large-scale introduction of pre-tested micro-credit schemes. Based on them, the Ministry of Labor and Social Welfare estimated that they could be used for easing employment problems in 51 areas in the country.

4. *Appropriate interest rate policy.* International experience shows that subsidizing or strictly regulating interest rates in the area of microfinance undermine the ability of microfinance institutions to perform effectively and competitively. Given the current demand for micro-credits in Uzbekistan today, it is not necessary to regulate the interest rates. An increase in the number and

an expansion in scale of microfinance institutions, as well as the improvement of the quality of their performance, will lead to further reduction of interest rates to the level most favorable for entrepreneurs (3-4% monthly).

Conclusion

Despite its considerable importance for Uzbekistan, the microfinance sector remains at an embryonic stage of development and requires further improvements in both quality and quantity. Current demand trends will require the establishment of around 20 microfinance institutions in the short term. By 2010, the total number of microfinance institutions should reach 80.

In order to attract both national and international investors to this sector, it is necessary to develop and adopt a nurturing legal framework, extend preferential taxation regime and to pilot new projects and initiatives (including some with government participation). In order to establish a financially sustainable and efficient microfinance market, it is necessary to attract local financial institutions. That would significantly strengthen the competitive environment and the extent of financial intermediation, reduce interest rates, and promote socio-economic development in Uzbekistan.

¹ Findings of a sociological survey conducted by the TAHLIL Center of Social Research in the Spring of 2005, revealed that micro-credit programs provided employment opportunities for on average 2-3 members of the same family. (As quoted in Survey conducted by Center for Economic Research in the framework of preparing the National Report on “Development of Microfinance in Uzbekistan”, supported by UNDP, Tashkent, Spring 2005.

² International (donor) micro-credit programs often operate as NGO-MFI. Yet, according to the Civil Code, NGOs cannot provide credit services. The lack of the official legal status prohibits NGO-MFI (the most socially oriented institutions in microfinance) from borrowing capital from external sources (loans from commercial banks, corporate institutions and so on), and thus limits their lending capacity.

³ According to the Concept of Private Farm Development adopted by the Decree # 3342 of the President of Uzbekistan issued on 27.10.2003 and Resolution # 476 of the Cabinet of Ministers issued on 30.10.2003. It is expected that 1,020 shirkats or 55% of the total number of shirkats will be transformed to the private farms in 2004-2006.

⁴ Total fertility rate was 20.5 per thousand population in 2004 against 19.8 in 2003, and was heavily skewed towards rural areas. Cities account for 31.1% of births, while rural areas account for 68.9% of births.

⁵ According to data provided by the “TONG” NGO in 2002-2004, nearly 1 mln. people migrated abroad in search of jobs outside the country (the average age of a migrant is 35 years old).

⁶ According to official statistics, there are 6 dependants per person with permanent source of income in low-income rural families.

⁷ Registration procedure and regulation of business activities is significantly streamlined and tax burden is reduced.

⁸ Exchange rate of Central Bank of Uzbekistan in June, 2005 was USD 1 = 1112.75 soums.

⁹ Sociological survey conducted by the *TAHLIL Center of Social Research* in the Spring of 2005 (in the framework of preparing the national Report on “Microfinance Development in Uzbekistan”).

¹⁰ Central Bank refinancing rate was set at 16% per annum on December 21, 2004.

¹¹ Due to the decreased mandatory deduction for Employment Fund from 1.5% in 2002 to 0.5% in 2005.