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UZBEKISTAN'S TEXTILE INDUSTRY: HOW TO IMPLEMENT DEVELOPMENT POTENTIAL?

This policy brief is a logical continuation of a similar 2006 UNDP publication titled *Problems and Prospects of Development of the Textile Industry of Uzbekistan,* which provided analysis for the improvement of the current state and development potential of the textile sector, and also proposed relevant recommendations.

The authors would like to express their appreciation to the UNDP Uzbekistan office and project staff for the support they provided in preparation of this policy brief, and all participants of the September 22, 2010 roundtable, which involved ministries and agencies, and private sector representatives. Their discussion of the problems and future prospects of development of the textile industry in Uzbekistan provided the basis for this brief.

This policy brief is dedicated to the analysis of the current state and potential of Uzbekistan's textile industry, as well as its competitiveness and development challenges.

The document illustrates that the main factors limiting the sector's development are the difficulties companies have in accessing high-quality raw materials at acceptable prices, the relatively high costs of long-term loans, and barriers impeding foreign trade transactions.

This policy brief also includes recommendations related to the improvement of government regulations of the textile industry.

INTRODUCTION

The textile industry is amongst the most developed industrial sectors in Uzbekistan. Companies within this sector produce yarn, thread, gray cloth (woven and knitted fabrics), and finished fabrics. Knitted products and apparel, and production of clothes and household items are continuing in their development. Why the development of this economic sector is so significant is primarily related to the country's availability of its own raw materials (cotton, silk, wool) and the relatively high labor intensity textile manufacturing requires, which is important from the perspective of addressing employment issues and improving living standards.

International experience shows that with a favorable environment, the output of the textile industry may explode. Deep processing of raw materials significantly increases the value-added, which further increase the incomes of households, companies, and government, and facilitates high rates of growth in exports and a reduction in imports (of finished apparel). It is not a coincidence that the national government has set an objective to increase the domestic processing rate of cotton up to 50% of output.[1]

Government policy focuses on developing the sector, but numerous serious problems persist. Problems are related to both the inadequate cotton deep processing capabilities and the non-competitiveness of the final output in the product chain—fabrics and apparel. Cotton fibre and yarn continue to be the main export items, which means the country is delivering products with low added value to the external market.

The focus of this brief is an analysis of these circumstances of price-related and non-price related factors influencing the domestic textile industry's competitiveness, and recommendations related to government policies which can focus on its improvement.

The authors have included supporting information found in this policy brief using the following sources:

- The findings of the survey on textile industry experts (representatives of O'zbekengilsanoat, Tashkent Institute of Textile and Light Industry, O'zpaxtasanoat, foreign trade companies, the representatives of consulting companies, etc.). Twelve individuals were surveyed in total.
- The findings of the survey of managers and specialists of the textile and apparel companies. In total the representatives of eleven textile companies in Tashkent city, Tashkent oblast, and Ferghana valley were surveyed.
- Official statistical data, received by the State Statistics Committee and O'zbekengilsanoat SJSC;
- Publications, which incorporate other countries' experiences and describe the current state of the textile industry of Uzbekistan.

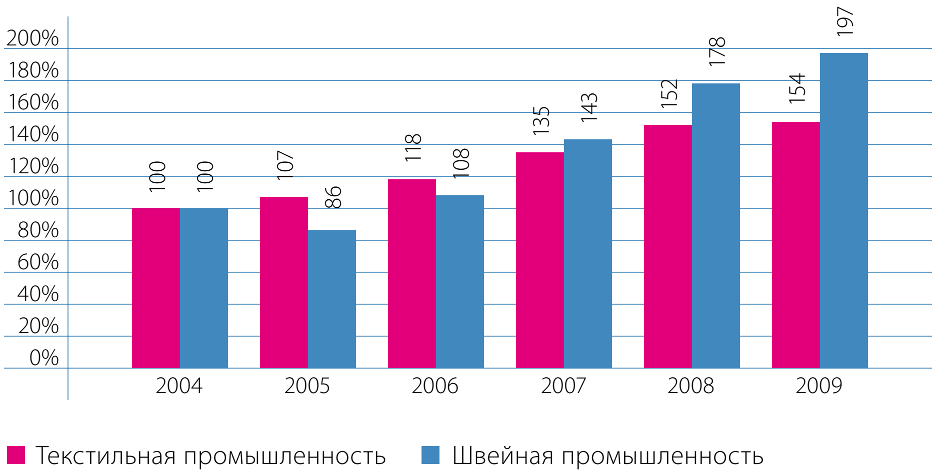
It should also be noted that a policy brief on *Problems and Prospects of the Textile Industry* was published under the auspices of the UNDP. That document contains an analysis of the main problems in the sector's development including limited access of Uzbek textile companies to raw materials, high tax burden of textile companies, low-tech production of fibre and other textile products. Most of these problems remain relevant today. The range of issues proposed for exploration in this policy brief has been expanded from the original. For example, topics now include the issue of availability of raw materials for not only spinning mills but also weaving and cloth manufacturing, as well as issues of commercial loans to textile companies, and the sales of textile products.

1. THE CURRENT STATE AND DEVELOPMENT POTENTIAL OF UZBEKISTAN'S TEXTILE SECTOR

The textile sector (which includes textile and the apparel industry, according to the economic classification in Uzbekistan) is a **rapidly developing sector of the country's economy.** The following data illustrate this:

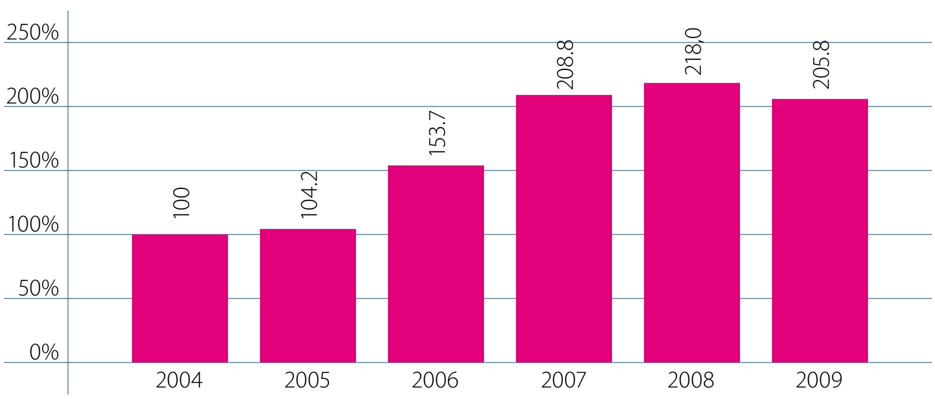
1 See: http://gov.solutions.uz/ru/business/invest/90.

Figure 1.1.
Increased output of textile sector in dollar terms (2004, 100%)



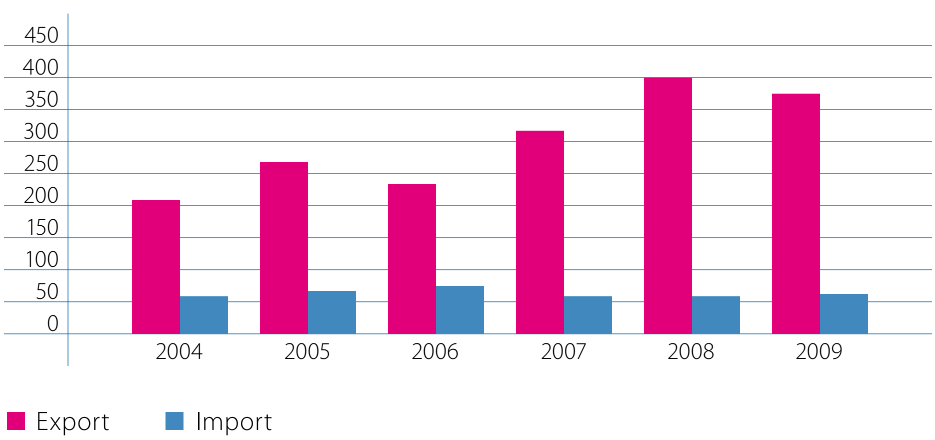
Sources: *State Statistics Committee of Uzbekistan, O'zbekengilsanoat* SJSC.

Figure 1.2.
Increased output of O'zbekengilsanoat SJSC (2004, 100%)



Sources: *O'zbekengilsanoat* SJSC.

Figure 1.3.
Exports and Imports of O'zbekengilsanoat SJSC companies (USD million)



Source: *O'zbekengilsanoat* SJSC.

Between 2004–2009, the textile industry's output in dollar terms, according to the State Statistics Committee of Uzbekistan, has increased 1.5 times, and clothing manufacturing doubled.[2] Companies belonging to the O'zbekengilsanoat SJSC, the association of textile companies, which manufactures the bulk of the sector's output, doubled their production during the 2004–2009 period.[3]

- Between 2004–2008, exports of O'zbekengilsanoat increased by 76.1% from USD 213 million to USD 375.5 million.

At the same time, **the potential of the textile sector is not adequately exploited:**

1. Although the output of the textile and clothing industry increased in monetary terms over the last five years, **the share of this sector in the economy is approximately 2–2.5%.** This is quite a low indicator for a country with its own commodity base.

2. The specific feature of the textile sector of Uzbekistan is its **dominance of primary textile production and low degree of processing raw materials.**

Although deep processing of raw materials is profitable and Uzbekistan is 5th in the world for cotton output, only 20.4–21.5% of total cotton output was consumed domestically in 2005–2007 (because there is no data on cotton stocks, this indicator was estimated as the difference between cotton output and its exports). In 2008, this figure increased to 39.6%, but went down to 28.2% in 2009. A higher percentage of non-exported cotton in 2008–2009 may be explained both by increased domestic consumption and an increase in stocks due to the global economic crisis.[4]

Uzbekistan accounts for merely 0.8% of the global volume of cotton consumption[5], which speaks to the huge potential for the sector's development. Subsequently, although Uzbekistan's share in the global output of cotton fibre is 4%, its share in the global output of cotton yarn is 0.7%.[6] Uzbekistan's share in the production of fabrics and linen, finished knitted products, and clothing is even less, with only 50% of domestically produced yarn being used domestically.[7]

The greatest divide in the value chain is in the production of fabrics. Between 2004–2009, the output of cotton fabrics declined 2.6 times, while the production of knitted linen (including lower increase in value-added) increased 2.3 times over this period (see Table 1.1). In many respects, this divide is caused by most investments primarily being channeled towards the production of knitted linen because lower risk and lower capital investments are required. Thus, the development of weaving should become a priority of government policy, which could provide incentive for developing cloth manufacturing.

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2 Hereinafter—based on calculations by average annual rate of the Central Bank of Uzbekistan.
3 The research group could not obtain precise absolute figures of the output of the textile industry, as the data of the State Statistics Committee very strongly differs from the data of Uzbekengilsanoat SJSC. The authors believe that it is because the State Statistics Committee maintains statistical registeration of the manufacturing data based on OKONH codes, while a company, coded by OKONH as a textile company, can engage in not only the textile business (also a company without OKONH code of the textile industry can manufacture the products of this sector). The data of O'zbekengilsanoat SJSC include only the information of member companies of its organization, which changes depending on changes in the number of members. It is assumed that relative trends of the sector's development are generally accurate and reflect stable growth of the sector in the last five years.
4 Authors could not find data on cotton stocks.
5 United States Department of Agriculture, October 2009.
6 Estimates based on http://www.aptma.org.pk/Pak_Textile_Statistics/gpyarn.asp and data from the State Statistics Committee of Uzbekistan.
7 Estimates based on data of the State Statistics Committee of Uzbekistan for manufacturing and exports of cotton yarn.

Table 1.1.
Production of Cotton Fabrics and Linen in 2004–2009

	2004	2005	2006	2007	2008	2009
Cotton fabric output, thousand m^2	346,169	258,347	176,048	158,638	126,103	130,783
Knitted linen output, tons	6,170	7,260	8,454	10,437	11,387	14,566

Source: State Statistics Committee of Uzbekistan

The income of the textile industry can be significantly increased through deep processing of the raw materials and then selling them as finished products. According to the estimates, **the greatest value-added increase in the value chain of the textile industry comes from sewing finished knitted and clothing items.** For instance, while 1 kg of cotton costs USD 1.4 in the domestic market, apparel produced thereof will fetch USD 16 on average, and knitted products about USD 5.4.

As a result of the low rate of deep processing of raw materials, **the textile exports of Uzbekistan are insignificant;** international comparisons illustrate this, too. While in 2008, the textile exports of Uzbekistan amounted to USD 0.4–0.5 billion, Chinese textile exports topped USD 185.2 billion, Turkey—USD 23.6 billion, India—USD 22.4 billion, and Bangladesh—USD 12.1 billion.

Being a lead exporter for products with low value-added, such as cotton (12.2% of sales on the international market[8]) and cotton yarn (10–15% of sales on the international market[9]), Uzbekistan in essence, deprives itself of the opportunity to manufacture and export more expensive products, as their sales could significantly increase the country's export earnings. Furthermore, the large-scale domestic production of fabrics, knitted products, and apparel would enable hard currency savings by reducing the imports of similar products.

Up until now, international experiences show that when using their own competitive advantages and creating favorable investment climates, substantial development of the textile industry can be achieved in a relatively short period of time. For instance, China had a coupon-based distribution of clothing between 1954–1983. It wasn't until the large-scale reforms conducted starting in 1978 that facilitated a significant increase in the output and exports of sales. While Chinese clothing exports totaled USD 700 million in 1978, it reached USD 2.1 billion by 1985, USD 6.8 billion by 1990, 24 billion by 1995, and USD 185.2 billion by 2008.

Earnings from the exports of finished clothing in Bangladesh increased from USD 3.3 million in 1980–1981 to USD 1.2 billion in 1991–92, and to USD 12.1 billion in 2008. In India the textile exports totaled USD 5.1 billion for 1990–91, USD 8.4 billion in 1995–96, and 22.4 billion in 2008. Turkey's textile exports grew from USD 595 million in 1979 to USD 23.6 billion in 2008.

These examples illustrate that Uzbekistan has a substantial untapped potential for development of its textile and apparel industries. Estimates show that a reduction in cotton exports by 100,000 tons leads to a reduction of hard currency earnings by USD 140 million (at 2008 prices). If this volume of cotton and yarn produced thereof is kept domestically, then fabrics and linen can be produced in value of nearly USD 400 million. If 50% of these fabrics and linen is exported, and 50% is left for the domestic market, then these garments and knitted products

8 United States Department of Agriculture, October 2009.
9 Estimates based on data from http://www.aptma.org.pk/Pak_Textile_Statistics/cwecy.asp and the State Statistics Committee of Uzbekistan.

Table 1.2.
Losses and benefits for hard currency balance and government revenues from processing additional 100,000 tons of cotton and manufacturing finished products

	In-kind	In monetary terms, USD	Hard currency balance, USD	Additional government revenues, USD	Notes
Cotton					
Sales of cotton fibre, kg	100,000,000	**140,000,000**	-140,000,000		
Yarn					
Carded yarn, kg	44,000,000	110,000,000			As 10% on sales, as corporate tax, turnover taxes, VAT, etc.
Combed yarn, kg	37,500,000	120,000,000			
Total yarn output		**230,000,000**		23,000,000	
Fabrics and linen					
Bleached fabrics, sq. m	198,000,000	217,800,000			As 10% on sales, as corporate tax, turnover taxes, VAT, etc.
Dyed linen, kg	36,375,000	181,875,000			
Exports of fabrics and linen (50%)		199,837,500	+199,837,500		
Supply of fabrics and linen into domestic market (50%)		199,837,500			
Total output of fabrics and linen		**399,675,000**		39,967,500	
Apparel and knitted products					
Apparel, pcs	66,000,000	396,000,000			
Knitted products, pcs	90,937,500	136,406,250			
Exports of apparel and knitted products, 20%		106,481,250	+106,481,250		As 10% on sales, as corporate tax, turnover taxes, VAT, etc.
Domestic sales of apparel and knitted products, 80%		425,925,000	+425,925,000		
Total output of apparel and knitted products		**532,406,250**		53,240,625	
Result					
Total changes in exports			+166,318,750		
Hard currency savings thanks to import-substitution			+425,925,000		
Total changes in hard currency balance and increasein government revenues			**+592,243,750**	**+116,208,125**	

will be worth USD 523.4 million. If apparel and knitted product manufacturers export merely 20% of their output (current proportion), then, their export earnings amount to USD 306.3 million.

The remaining products (USD 625.7 million) can be sold in the domestic market, which will also mean a reduction in imports by the same amount, thus, a reduction in hard currency expenditures by this amount. In actuality, hard currency savings will be higher than the aforementioned USD 625.7 million, as imported clothing is more expensive than domestically produced ones, at least because of transportation costs and customs duties.

Furthermore, thanks to the manufacturing of finished products, the government will generate revenues in the form of taxes on the manufacturing of these products as well as taxes on trading companies. The total amount of additional revenues will be USD 166.5 million.

The following is notable:
a) Along with the development of the apparel industry, the percentage of exports within its output will imminently increase. As global experience shows, this sector can be transformed into the main source of export earnings.
b) The development of the apparel, weaving, and knitted sectors will facilitate job creation and overall improvement of household incomes.
c) Increased output and domestic trade will facilitate higher household income and the development of other economic sectors.

2. COMPETITIVENESS AND DEVELOPMENT PROBLEMS OF UZBEKISTAN'S TEXTILE SECTOR

As illustrated in the previous chapter, Uzbekistan's potential in textile production is not fully utilized with the country's manufacturing of fabrics and apparel underdeveloped. Furthermore, the country's processing of cotton into yarn can and should also be significantly increased.

The development prospects of Uzbekistan's textile industry depend on its competitiveness. To this end, it is important to analyze those factors supporting or hindering the country's competitiveness and its existing problems with regard to textile and apparel manufacturing.

2.1. Access to Cotton

The main factor, which affects the development of the sector, is the **unhindered access companies have to quality raw materials at affordable prices.** It is explained by the high percentage of raw materials in the composition of costs of the companies in the industry. In the composition of the costs of the textile industry of Uzbekistan, the percentage of expenditures on raw materials is 63.6%, in silk manufacturing it's 75.7%, and for apparel and knitted product manufacturing it's 70.5%.[10]

Meanwhile, when it comes to **accessing cotton fibre,** local manufacturers are facing the following challenges:

1. **The requirement that domestic companies buy cotton at world market prices.** It was a government decision that cotton prices for local companies be set based on international prices (Liverpool cotton exchange) minus 15%, which actually equals the savings on transportation costs. If a foreign buyer purchases and takes away cotton from the terminal, he/she pays almost

10 Source: O'zbekengilsanoat SJSC.

the same price as a local company. Thus, Uzbek textile companies manufacturing for the domestic market have really no competitive advantage based on the input prices of raw materials compared to foreign manufacturers. Furthermore, a lack of opportunity to buy cotton based on futures contracts (with pre-set prices) amid constant fluctuations of world prices complicate processes of planning and decision-making for spinning mills.

2. **The requirement cotton buyers pay with hard currency.** According to current rules [11], all manufacturers producing for the domestic market can only buy cotton with hard currency. Considering on-going difficulties related to the convertibility of domestic currency, it appears that this measure is a significant hindrance for textile producers manufacturing for the domestic market. Furthermore, excessive export-orientation of yarn, fabric, and other semi-finished product manufacturing (because of the need to generate hard currency to buy cotton) does not help advanced the processing of these commodities and manufacturing of products with higher value-added.

3. The **introduction of zero-rate VAT on cotton.** According to a recent decision, cotton sold by Uzbek ginneries in the domestic market, starting harvest for 2010, is levied by VAT at zero rate. [12] This means that starting the 2010 harvest, the domestic price for cotton for exporter spinning mills will increase up to 20%, as zero VAT implies no VAT refund on exports. Similar problems arise for domestic users of cotton yarn now paying VAT: they cannot deduct the amount of VAT they paid earlier for cotton. Considering that cotton accounts for 60–70% of the cost of yarn, this hike in price of raw materials will lead to a sharp reduction in the competitiveness of domestic yarn production.

Before the decision to introduce zero-rate VAT on cotton, companies had problems **caused by a lack of VAT deductions,** i.e. buying cotton fibre with VAT included in the price, then exporting yarn or another product, the company first had to divert its hard currency, buying cotton with the additional VAT, then, after exporting the products, had to wait for their VAT refund. It is notable that VAT for cotton is paid in hard currency, while the refund is in local currency, which also increases company costs.

4. **The inability to reserve required varieties and types of cotton.** Spinning mills often do not find the varieties and types of cotton needed in adequate quantities in the cotton terminal. Companies either have to buy available raw materials, wait for new batches, or look spend their energy searching for their materials in terminals spread throughout the country. Because of a lack of cotton of the right grade and variety, yarn manufacturers have to use available raw material, which decreases the quality of their output, increases manufacturing costs, and ultimately reduces the country's domestic manufacturing competitiveness. There are also cases where the cotton grade has been overstated at certification. Buyers may disagree with the officially declared quality of cotton, and can even do independent laboratory tests but it does not enable them to buy it at lower price: they can only buy or refuse to buy.

Furthermore, competitiveness of the Uzbek spinning industry is decreasing because of the inconsistency of the cotton sold with the technology used. For instance, most domestic spinning mills use pneumospinning technologies. International prices for yarn manufactured using this method are lower than for products manufactured with ring-spinning technology. Respectively, yarn from lower grades of cotton must be manufactured at pneumatic spinning mills. Currently 95% of Uzbek cotton is certified as superior grade, thus, spinning mills have to buy expensive cotton, which interferes in their generating

11 President Resolution #733 dated November 21, 2007, on Measures for Improvement of Sales of Cotton to Domestic Users and Development of the Textile Industry.

12 According to the President Resolution #1398 dated September 3, 2010, on Organization of Timely and Quality Harvesting of Cotton—Harvest of 2010.

good profit margins. Furthermore, the mix of 4–6 types of cotton is essential to produce good-quality yarn. Usually there is no range at the depots, thus, finished products are often not as of high quality as they could have been.

The problem of local manufacturers' limited access to cotton was aggravated in 2005–2007, when domestic sales decreased by more than one-third compared to 2004. Exports went down in 2008–2009 but it is difficult to tell how this led to an increase in domestic use, as there are no data on cotton stocks.

Table 2.1. Output, Exports, and Imports of Cotton in 2004–2009

	2004	2005	2006	2007	2008	2009 [A]
Output of cotton fibre, tons	976,997	1,184,248	1,171,242	1,124,803	1,174,047	1,055,300
Cotton exports, tons	662,200	938,198	932,548	882,626	709,600	757,560
Cotton imports, ton	745	241	3	89	51	No data
Difference between the indicators of output, imports, and exports of cotton	**32.3%**	**20.8%**	**20.4%**	**21.5%**	**39.6%**	**28.2%**

A) The data on exports of 2009 in-kind was estimated based on published data on exports of cotton in monetary terms found in the Compendium on Statistical Review of Uzbekistan 2009, average cotton prices for 2008 and price adjustment coefficient, estimated based on indices of Cotton Outlook of 2009/2008 and 2008/2007.

Source: State Statistics Committee of Uzbekistan

In accessing **cotton yarn and fabrics,** local producers face the following challenges.

1. **Yarn and fabrics are sold in the domestic market for hard currency at international prices or even higher.** To facilitate the inflow of hard currency earnings, companies selling yarn, fabrics, and other semi-finished cotton products, can sell their products for hard currency in the domestic markets, which is equated to exports. This practice leads to yarn and fabrics being sold at world prices within

Table 2.2. Output, Exports, and Imports of Cotton Yarn and Fabrics in 2004–2008

	2004	2005	2006	2007	2008	2009
Output of cotton yarn, tons	171 352,0	170 826,6	165 932,7	178 934,0	166 712,9	173 920,2 [A]
Exports of cotton yarn, tons	65 754,6	69 587,2	81 645,2	101 004,1	82 888,7	115 338,4
Imports of cotton yarn, tons	14,9	1 030,0	834,0	755,2	450,8	193,7
Percentage of cotton yarn retained by local manufacturers	**61,6%**	**59,9%**	**51,3%**	**44,0%**	**50,6%**	**33,8%**
Production of cotton fabrics, thousand sq. m	346 169	258 347	176 048	158 638	126 103	130 783
Exports of cotton fabrics, thousand sq. m	96 671	69 973	74 674	78 026	72 699	64 575
Imports of cotton fabrics, thousand sq. m	1 202	902	714	323	175	1005
Percentage of fabrics retained domestically	**72,4%**	**73,3%**	**58,0%**	**51,0%**	**42,5%**	**51,4%**

A) One-thread yarn.

Source: State Statistics Committee of Uzbekistan the domestic market. Yarn and fabrics bought for hard currency must be used only for manufacturing export-bound products. Notably, exports of yarn and fabrics are less problematic than domestic sales involving hard currency, the reason being that after exports the company immediately receives documents from customs authorities and can claim their VAT refund. At the same time, a company selling yarn or fabrics domestically for hard currency, must receive from the buyer documents that the raw material bought was used for manufacturing export-bound products, which requires time and effort.

While yarn is sold domestically for soums, yarn manufacturers cannot expect VAT refunds (from purchase of cotton, electricity, etc.), which they would have been eligible for in the case of exports. Furthermore, manufacturers have to pay tax, i.e. difference between VAT received minus VAT deducted. This leads to higher domestic prices, which hinders further processing of yarn within Uzbekistan's borders. As a result, domestic prices for cotton yarn and fabrics are often higher than export prices.

2. **An inadequate supply of quality fabrics and yarn for soums due to the excessive export incentives.** Currently, textile companies exporting 80% or more of their output are exempted from property tax, thus, to obtain this exemption they must sell their output for hard currency. The percentage of yarn left within the domestic market decreased from 61.6% to 33.8% between 2004–2009, of its output plus imports minus exports. This meant that manufacturers using yarn had no option but to import this raw material which resulted in the sale of domestic cotton fabrics going down by 3.7 times due to the reduction of production and decreasing domestic sales (from 72.4% to 51.4% of output). As a result, there is not enough good quality cotton inputs left in the domestic market, in particularly, this means very few bleached and colored fabrics are produced.

Notably, after the adoption of the President's Resolution # PP-1050, textile companies have alternatives to the exports of semi-finished products: manufacturing finished fabrics and finished apparel, and knitted products. In this case, there are even more exemptions than under PP #733, as manufacturers of non-food consumer goods are exempted not only from property tax but also corporate tax, and the duration of these exemptions has been extended one year longer—up to January 1, 2012. However, substantial capital investments and time is needed for spinning companies to start manufacturing finished goods.

Thus, **Uzbek manufacturers, selling in the domestic market, despite availability of domestically grown cotton, are actually deprived of any advantages in accessing cotton compared to manufacturers from countries without domestic cotton production.** Furthermore, the country's manufacturers face additional difficulties buying raw materials. This circumstance is a major hindering factor in the country's ability to realize its potential in this sector.

The main reason for this phenomenon is **excessive incentives for exports of cotton and its products with low value-added.** As a result, only 20% of cotton output was sold within the domestic market in 2005–2007 and as a result, between 2004–2009, the share of domestic sales of cotton yarn and fabrics decreased significantly. This then creates a shortage of raw materials for companies involved in the more advanced processing of cotton.

2.2. Access to Capital

On the one hand, textile companies' access to capital is significantly eased, as:
- There are numerous incentives for foreign investors;
- Imports of equipment are exempted from customs duties;
- Commercial banks make loans at preferential rates, etc.

But on the other hand, companies in the sector are facing a range of barriers.

1. **Disadvantages of investment (long-term) loans from Uzbek banks for the development of capital-intensive production.** Taking long-term loans at the existing interest rate is not profitable.: **Instead what most banks offer are short-term loans (up to 3 years)** coupled with **high interest rates** (above 10% in hard currency).

This means that **mandatory sales of hard currency earnings** are reduced by payment of loan interest not even by repaid principal. That is, when earning hard currency, the company has to sell it to the government, then buy it back to repay most of the debt, which, considering current difficulties related to convertibility, leads to higher costs of debt servicing.

Increasing investment lending in the textile sector is also hindered by existing regulations on **limiting loans to one sector within the loan portfolio of a commercial bank.** This problem can be resolved if the textile sector is not regarded as a singular category but as three sectors: 1) yarn production, 2) fabric and linen production, and—3) apparel.

Finally, there is another problem when it comes to long-term loans to the sector. Overdue loan payments cause many difficulties for the company. One difficulty is obtaining a bank guarantee to purchase cotton: the company is left without working capital and raw materials to continue production, which further worsens its financial status. Even if the company has an export contract and letter of credit or bank guarantee, it cannot get a short-term loan for working capital or a guarantee from an Uzbek bank, having overdue long-term loan payments. Already struggling, this actually results in the company forfeiting the opportunity to improve its financial status.

Lack of attractive lending conditions affects investments into capital-intensive manufacturing for spinning mills and weaving. Below are the estimates of hypothetical investment projects.

Spinning mills. In order to buy equipment for the production of 5000 tons of yarn per annum, approximately USD 5 million is required. In order to obtain a loan with 10% APR over 3 years, USD 500,000 must be paid in interest annually and USD 1,666,700 repaid in principal. This means that USD 0.1 per kg of yarn is repaid in interest and USD 0.33 per kg is repaid in principal while operating at full capacity. Considering the average price of yarn is USD 2.2 per kg, a loans add an additional 19.5% to costs. It should also be noted that this figure is quite optimistic, as it can take even several years for a manufacturer to bring their operation up to full capacity, while loan interest starts from the first month of provision.

Weaving production. In order to buy sufficient equipment for the production of 20 million sq m of bleached fabrics, an investment in the amount of USD 20 million is required. Obtaining a loan with 10% APR over 3 years, USD 2 million must be paid in interest annually and USD 6,666,700 repaid in principal. Once the operation has full capacity, earnings from sales will amount to USD 22 million per annum. Thus, the cost of a loan in this case is 39.4%. Considering that operating at full capacity is unlikely within the first year, the cost of loan servicing becomes even higher, thus, the attractiveness of investing in the sector goes down.

Considering the average price of yarn is USD 2.2 per kg, the cost of a loan is 19.5%.

For comparison, the cost of a loan for the apparel industry (over a 3-year period) is about 3%.

These estimates indicate that **the main reason for the underdevelopment of weaving production in Uzbekistan is the high cost of investment loans.** At the same time, the development of the weaving sector is a key factor for the development of apparel manufacturing, which generates the highest value-added. Respectively, without special government support for investments into weaving production, it is difficult for this sector and the apparel sector to develop successfully. Notably, for increasing investments in apparel production government support is not required, as this sector is the least capital-intensive.

2. **Taxation of the portion of sales earmarked for loan repayment.** Manufacturers of finished products, starting with fabrics, are exempted from corporate tax. Manufacturers of semi-finished products are not. If a spinning mill takes a loan for equipment upgrades, it can deduct only the amount equal to the depreciation of the new equipment from the taxable base. But commercial banks usually issue loans for no more than 3 years, which is less than the cost recovery period of the equipment. As a result, the funds that companies need to pay to the bank are considered taxable income. This is a substantial problem, as today spinning mills are encouraged to manufacture high value-added products. But they will not be able to start manufacturing finished products immediately as they will instead bank and government loans using revenues from yarn production.

3. **Customs duy on the imports of spare parts for equipment.** In order to obtain exemption from customs duty on spare parts, it is essential that procurement contracts be included for these spare parts. The problem lies in the fact that one cannot know when purchasing equipment which spare parts and components will be needed a few years down the road. Average customs duty on components is 10% and VAT is 20%. These payments significantly increase the cost of imported components and affect production costs.

4. **Other complexities in importing equipment includes** the length of import procedures and the bureaucracy in dealing with customs authorities.

> Sometimes we import many small components in a container. A TNVED code (foreign trade commodity classification code) must be assigned to every part. This is very burdensome. Some components must be certified. Some certification laboratories do not exist in our city and we have to send them to Tashkent. It takes a lot of time and we cannot afford for them to take away the entire container.

From interviews with textile companies.

> Sometimes we import some spare parts or materials by air, when we need them urgently. This is very expensive. But customs officers, finding inconsequential mistakes in the documents, pick at it and refuse to clear the goods. These mistakes will not do any harm to the state. State Customs Committee should be more flexible.

Consolidated from various interviews with textile companies.

2.3. Foreign Trade Operations

Non-cotton fabrics, accessories, and auxiliary materials are mostly imported by textile companies. Manufacturers face the following problems during the import process:

1. **High import duties on a number of fabrics, which are not produced in Uzbekistan.** For instance, fabrics from synthetic fibres, which are not manufactured in Uzbekistan (TNVED codes—5512–5513), are levied by 30% customs duties and 20% VAT. This increases the cost of fabrics by 56%.
2. **High costs of import transactions.** At the start of the global economic crisis, currency convertibility issues in Uzbekistan worsened. For months, companies were unable to convert their funds to buy raw materials, and they were unable

to import raw materials or buy them from the domestic market using hard currency, therefore failing to make competitive finished products.

The most significant barriers on exports include[13]:

1. **100% down payment requirements on export contracts.** Because of this, many potential export contracts are not made, as foreign buyers are often not happy with such strict seller rules.
2. **100% fines for overdue payments** for exports contracted by the Buyer, even if the payment was finally received.
3. **Complicated procedures and long periods for waiting on VAT refunds on exports.**[14]
4. **Overstated official exchange rate of the soum,** which is a disincentive for exports.
5. **Underdevelopment of pre-export financing.** Banks do not make loans under future hard currency earnings under export contracts (even with collateral such as the guarantee of the buyer's bank or letter of credit). Factoring in when banks yield the right of demand on contracts and receivables has not been developed in the country's regulations and policies.

Discriminatory approaches to trade institutions contribute to an acute problem in foreign trade transactions and promoting finished products into markets.

This, among other things, hinders the import of raw materials required for textile companies. According to current regulations, either companies or private entrepreneurs can import goods or inputs for their own needs on preferential terms. Private entrepreneurs, however, do not have the right to resell products as wholesale. They must sell them as consumer goods to final users.

On August 2009, the Cabinet of Ministers issued the Resolution on the *Measures for Further Development and Modernization of Textile Companies and Increasing Output of Domestic Non-food Consumer Goods for 2009–2011,* publishing the list of TNVED codes for raw materials exempted from customs duties. The result being that it is not lucrative for apparel manufacturers to import small components of clothing in small batches, whereas wholesale traders, which could import an entire assortment of accessories, must pay all taxes and duties.[15]

Textile companies face an equal degree of problems because of discrimination towards intermediaries in the sales of finished products. Manufacturing companies can claim VAT refund on exports, while trading companies or export companies cannot claim this benefit. This does not encourage the development of the trade business. If properly supported, trading companies could become the vehicles for exports of many products manufactured in Uzbekistan.

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13 For expert and company survey results, see also: Policy Brief on Improving the Mechanism for Regulating Export-Import Transactions and Improving the Effectiveness of Customs Control by the Center for Economic Research, Tashkent.

14 Inter alia, there are cases where VAT is not refunded, such as if a company is overdue in taxes, even if the amount of these arrears is less than the refundable amount.

15 It is absolutely clear that wholesale traders will import textile accessories only to sell it to domestic clothing manufacturers: their discrimination is not justified.

3. RECOMMENDATIONS ON IMPROVEMENT OF STATE REGULATION OF THE TEXTILE INDUSTRY

Based on the findings of this study, the following recommendations are made to improve state regulation of Uzbekistan's textile sector.

3.1. Improving Access to Cotton

- **Facilitate cotton trade development through commodity exchange.** This leads to wider access for textile companies to raw materials of the right quality and volumes, reduced costs of businesses to search and select raw materials, and the saturation of the domestic market with quality cotton, which ultimately leads to greater processing of cotton and overall improved development of the sector. The recommendation is to implement a commodity-based mechanism of sales for raw materials based on the following policy and regulations amendments;
- **Base cotton sales within commodity markets in domestic currency.** Cotton prices may be set in U.S. dollars but the payment must be made in soums using the rate of the Central Bank of Uzbekistan on the date of transaction. This reduces the need of spinning mills conducting their transactions in hard currency, thus increasing their interest in the sales of products in the domestic market.
- **Reduce the minimum sales price of cotton in the commodity markets from the Liverpool exchange by 15%, and bring it down to the Liverpool Exchange rate minus 35–40%.**[16] **This will help tremendously,** considering the need to compensate for the losses of the textile companies due to the introduction of the zero rate of VAT on cotton with a harvest start date of 2010. The transaction price for cotton will be determined in an open auction between intermediaries of the exchange. This will enable spinning mills in Uzbekistan to gain a competitive advantage by paying lower costs in resources. It should be noted that the proposed prices with discounts are to be the startup prices at exchange auctions, real prices of cotton will be higher.
- **Implementation of a mechanism for future contracts for purchasing cotton with a harvest date of the following year.** This will enable domestic companies to reserve cotton of their preferred grade/type and plan their operations with more certainty. Futures system may function based on inquiries of local cotton users. In the period preceding the general agreement between Paxtasanoat and foreign trade companies, companies could make a request to buy cotton specifying quality and other characteristics. Currently, these applications are considered in the general agreement and in forming a projected balance of production and distribution of cotton. A part of cotton earmarked for domestic sales will be the basis for futures contracts, which may be bought by textile companies. Intermediaries and trading businesses buying cotton futures on the? mercantile exchange, can play role by reserving the cotton needed by companies, if the latter do not have the working capital to buy it in advance. Buyers of the futures must have right to resell the contracts at market price only within the Republican Commodity Exchange.
- **Abolition of the division of quotas of external trade companies on exporting and selling cotton using hard currency within the domestic market, creating a unified in-kind plan for the sale of cotton.** In case domestic spinning mills cannot buy cotton of the quality they need through the exchange, they should have the ability to form contracts with a foreign trade company to buy cotton using hard currency. Considering the introduction of zero-rate VAT on cotton, it is recommended that for cotton with a harvest start date of 2010, domestic buyers are granted **35% discount from the price of the Liverpool exchange.** This will enable Uzbek manufacturers to access cotton at a preferential price compared to foreign companies.

16 The legislation grants 5% discount for buying cotton but it is currently not granted.

- **Reforming the state quota and processing of cotton.** In many respects the textile industry depends on the agricultural industry's effectiveness and productivity. To this end, it is extremely important to start transitioning from a state quota and distribution towards a free market for cotton. As illustrated by the international examples previously stated, the liberalization of the cotton sector increases incentives for agricultural producers to enhance the yield and quality of cotton.

3.2. Increasing manufacturer access to products with high value-added to cotton

- **Adoption and implementation of a special government programme to encourage the development of the weaving industry.** This programme is essential because of the large amount of investment needed for the start-up of a weaving company, more compared to spinning mills or knitted products manufacturing. This programme should not be limited to tax incentives for fabric producers. It should require that investors be provided access to manufacturing infrastructure, financial and other support for launching new large-scale companies. Development of the weaving sector will generate a huge impetus for advancement of the apparel industry and facilitate increased output and exports in this sector.
- **Abolition of property tax for all companies in the sector.**[17] This decision will result in the saturation of the domestic market with high-quality yarn, linen, and cotton fabrics. One of reasons for the deficit of these products within the domestic market using soums is because companies can obtain property tax exemptions by increasing their exports. An alternative to this decision may be lowering the percentage of exports where textile companies are exempted from property tax, from 80% to 50%.
- **Expanding the list of TNVED codes, which grant exemptions on imports, including a wider range of fabrics and accessories, which are not manufactured or manufactured in small quantities in Uzbekistan.** This relates to suits, jeans, and mixed fabrics. Currently, Resolution #236 of the Cabinet of Ministers on Measures for Further Development and Modernization of Textile Companies and Expanded Production of Domestic Non-food Consumer Goods for 2009–2011, exempts some commodities for production of fabrics and finished products from customs tarrifs. This list needs to be expanded to include fabrics, a large range of dyes, and accessories. This benefit will be even more transparent and easy to administer, if the codes are determined on a sub-group level (up to 4-digits of TNVED).
- **Exempt not only companies specialized in production of non-food consumer goods components, raw materials, and parts but also all importers regardless of their activities and ownership forms.** This will facilitate the development of the domestic market of these products and reduction of costs of textile companies in accessing raw materials.
- **Abolition of customs tariffs on equipment parts imported for repairs and take-back materials used in the textile industry.** This will facilitate uninterrupted delivery of components and raw materials for textile companies and enhance the reliability of equipment operation throughout manufacturers' facilities' lifetimes.

3.3. Expanding access to capital

- **Abolition of mandatory sales of hard currency earnings proportional to the amount earmarked for purchasing raw materials, parts, equipment, and spare parts, imported by textile companies and repayment of principal of loans in hard currency.** This will enable companies to increase their delivery of high quality raw materials and equipment used for manufac-

17 Presently, these companies include manufacturers of finished consumer goods and those companies exporting at least 80% of their output are eligible for this exemption.

turing finished products, timely repayment of hard currency loans, and stay on top of equipment maintenance.

- **Encouraging upgrading and purchasing of new equipment for textile companies.** Banks should be encouraged to make long-term loans to the sector's companies to buy equipment. These incentives may be in the form of government reimbursement of expenses of investors for these purposes, for instance, by co-financing part of the interest rate on long-term loans or leasing.

3.4. Facilitating Sales of Finished Textile and Apparel Products

- **Equalize textile manufacturers and other textile exporters in terms of taxation and rights for tax incentives.** Firstly, tax incentives and benefits should be granted to wholesale trading companies and for manufacturers exporting domestic products: this is specifically about reimbursing VAT in sales of export-bound products. This will facilitate an increase in the exports of sector's companies, as in many cases trading companies have better skills and more working capital for marketing products sold in local and international markets than do manufacturing companies.
- The latter will therefore have savings by reducing expenditures on non-operating activities. Implementation of this proposal will also facilitate an increase in product turnover of textile companies and reduce their inventories. There is no major difference for the government, with regard to who is exporting products: the manufacturer or trader: the country will generate hard currency in any case.
- **Support Uzbek textile companies in promoting their products in external and domestic markets.** This function, in addition to promoting investments and representation of interests of the industry in the government, will also become the basis for unifying organization, which supports and represents textile companies; today O'zbekengilsanoat SJSC is this organization. Services which the organization provides includes access to information, marketing in the domestic and external markets, and investment promotions to engage entrepreneurs in collaborations with represented companies. Furthermore, O'zbekengilsanoat SJSC, jointly with the MFA, and MFERIT, must work more actively to present the Uzbekistan textile sector's current investment opportunities and potential projects to interested parties abroad.