CHAPTER 11

Connectedness and Inequitable Access to Formal Financing in Uzbekistan

Kobil Ruziev

Introduction

According to official statistics, Uzbekistan's aggregate economic growth rate has remained consistent at around 5–8% for most years since the early 2000s. At face value, the country's sustained aggregate growth figures appear to vindicate authorities' choice for slow and gradual market-oriented reforms, intended to prevent a drastic deterioration of living standards and aimed at strengthening social welfare whilst also building the country's industrial base. For a country with an abundant supply of well-educated and cheap labour, one would expect Uzbek authorities to build their industrial strategy around labour-intensive industries. However, the country's growth model was based on large investments in capital-intensive sectors of the economy instead. Constrained by limited investable resources, the government treated these industries, primarily in

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the natural resources sector, favourably by, for example, granting them direct credit from the banking sector. As a result, practically all of the improvements in per capita income levels from 1996 through 2016 stemmed from an increase in the capital-to-labour ratio; ironically, the employment rate actually fell from 71 to 63% during this period (Trushin, 2018).

The government's disregard for institutional reforms curtailed economic opportunities for a broader cross-section of society, also hindering the emerging private sector's growth prospects (which, by definition, is labour-intensive). This happened mainly because the government failed to promote the rule of law and protect the sanctity of private property, thereby impeding the allocation of important scarce resources to their most productive uses. Credibly committing to reforms in these areas facilitates greater private sector participation in wealth creation. This, in turn, will induce more sustainable capital accumulation, augment aggregate economic growth, and render it more inclusive.

This chapter focuses on demonstrating why fostering the equitable distribution of bank financing to enterprises is important to facilitating firm and, subsequently, aggregate-level economic growth. Herein, I also show why this may not be achieved without the government's credible commitment to improving the quality of institutions that promote market-based signals to access scarce resources such as formal financing.

The remainder of this chapter is organised as follows. The next section briefly synthesises relevant mainstream economic theories and empirical findings explaining why enterprise access to bank financing is important to promoting economic growth. The mainstream literature does recognise the unequal distribution of formal financing amongst enterprises of various sizes, but views market and information imperfections as major causes of this misallocation. I then provide a contrast, outlining a complementary explanation for this phenomenon, put forward by institutional economists who argue that social and political factors play equally important roles alongside information imperfections to explain the inequitable distribution of bank financing. The findings from the second and third sections then inform the focus of the discussion that follows, which analyses the links between institutions, informality, and the allocation of bank financing in Uzbekistan. Next, I move on to briefly discuss some additional factors that exacerbate the allocation of formal financing in the specific context of Uzbekistan. The final section summarises my conclusions from this chapter.

Why Enterprise Access to Bank Financing Matters for Growth

One need not be an economist or a finance expert to appreciate that banks constitute an integral part of modern market-based economies. Yet, whether and through what transmission channels banks may enhance economic activity and facilitate economic growth require a more nuanced discussion.

The emergence of private property and property rights and, thus, the development of money and monetary transactions greatly enhance opportunities for exchange and trade, which, in turn, translate into the division of labour and, hence, economic efficiency (Drake, 1980). However, in the absence of financial intermediaries such as banks, the opportunity to finance trade and investment projects is effectively limited to entrepreneurs' own funds, since collecting and assessing pertinent information on projects' viability and borrowers' creditworthiness can be prohibitively costly to savers. Individually, savers may not possess the time and the means to collect relevant information on projects and economic conditions; moreover, they may not have the necessary expertise to analyse this information and to monitor and enforce the terms of loan contracts. Thus, because of high information and transaction costs, not all available savings will be mobilised to finance trade and investment projects.

Banks, therefore, emerge as one of the first and most important financial intermediaries to tackle information and incentive problems (Heffernan, 2010). They accept short-term liquid deposits from savers, against which they advance long-term loans to businesses. By offering a return on deposits, banks encourage saving, thereby increasing the supply of external credit and reducing its cost to businesses. Borrowing short to provide liquidity to savers and lending long to finance firms' risky but profitable investment decisions—that is, maturity transformation—is one of the key functions of these institutions vis-à-vis facilitating growth. By pooling and diversifying risks, financial intermediaries also increase the savings rate, improve resource allocation, ameliorate capital accumulation, and, ultimately, affect long-run economic growth (Levine, 1997). By increasing the stock of financial assets, banks also encourage further financial development, opening a country up to international financial markets. Banks also manage the payment system in an economy. By processing

debits and credits associated with all exchange transactions, banks speed up transactions thereby facilitating trade.

Reflecting on the growth of trade and industry in eighteenth century Scotland, Adam Smith, the Scottish philosopher and father of modern economics, partly attributed that growth to the establishment of public banks in Edinburgh at that time. He asserted that 'the trade and industry of Scotland … have increased very considerably during this period, and the banks have contributed a good deal to this increase' (Smith, 1776, p. 358).

Coase's (1937) seminal work on the nature of the firm can also be applied to explain the rationale for the emergence of banks as firms specialising in financial intermediation—that is, as agents between savers and borrowers. A firm structure allows banks to assign tasks to bank officers and coordinate their efforts in gathering and assessing information on business projects, managers' behaviours, and economic conditions more efficiently and profitably, incentivising the emergence of financial intermediaries (Heffernan, 2010). Financial intermediaries help economise on aggregate information costs, since borrowers are assessed and monitored by intermediaries, not by individual savers (Diamond, 1984). By concentrating large amounts of deposits and loans in their books and having access to privileged information on current and potential borrowers, banks can achieve economies of scale and scope to reduce transaction costs as well as various other costs arising from information asymmetries. In market economies with perfect competition, banks can channel scarce financial resources to investments with the highest possible net present value. Since enterprises investing in the latest technologies tend to be more productive and offer higher investment returns, this can lead to increased investments in newer technologies and higher productivity and overall economic growth (Cameron, 1967; Gerschenkron, 1962).

In turn, a lack of access to formal finance hinders investment and growth because some profitable entrepreneurial initiatives may not be financed, and firms will operate at suboptimal levels despite having high capital productivity (Claessens & Perotti, 2007). Studies show that financial development helps enterprises overcome liquidity constraints and improve their growth potential (Levine, 2005; Love, 2003). Moreover, evidence also shows that financing from formal rather than informal sources of credit associates with faster firm growth (Ayyagari et al., 2008).

In short, the key channels through which financial intermediaries facilitate economic growth can be summarised as follows: generation and

expert evaluation of information; diversifying, pooling, and trading risks; mobilising savings; allocation of scarce financial resources to the most profitable uses; provision of liquidity; offering a return to both savers and borrowers; and managing the country's payment systems to facilitate the exchange of goods and services (Casu et al., 2022; Heffernan, 2010; Levine, 1997). Although some historic instances indicate that economic growth can occur without financial development (e.g., the former centrally planned economies reached a considerable degree of economic development without much financial development) and financial development may not always lead to economic development (e.g., although some offshore territories have sophisticated and internationally competitive financial systems, economically they are still underdeveloped [Beim & Calomiris, 2001, p. 71]), the broader theoretical underpinnings and empirical support for the argument 'financial development facilitates economic growth' remain relatively strong. As Levine (1997, p. 688) put it: 'the predominance of theoretical reasoning and empirical evidence suggests a first-order relationship between financial development and economic growth.'

Factors Affecting the Inequitable Distribution of Bank Financing

In their seminal works, (Modigliani & Miller, 1958; Miller & Modigliani, 1961) argued that, under perfectly functioning market conditions, enterprises should be indifferent to alternative sources of external financing, including when borrowing from banks or issuing their own shares on the stock market; furthermore, all projects with a positive net present value should be financed. However, in emerging economies where the financial system is less developed, out of all possible sources of external financing, businesses most often rely on bank loans (Cressy & Olofsson, 1997). Interestingly, the theoretical and empirical literature demonstrates that, in response to incomplete and partial information, financial intermediaries ration the supply of formal credit, the distribution of which is skewed towards larger enterprises and against younger and smaller firms (de la Torre et al., 2010; Demetriades & Andrianova, 2004). At the aggregate level, an unequal distribution of bank financing affects investments and growth since some profitable entrepreneurial initiatives may not receive external financing (Claessens & Perotti, 2007).

Conventional explanations of this phenomenon emphasise information imperfections as the major causes of the inequitable and suboptimal allocation of bank credit to businesses. The argument is that smaller and younger enterprises are less likely to possess acceptable collateral, are often informationally opaque, and face stiffer competition on product markets; these factors affect the predictability of cash-flow forecasting by banks (Mina et al., 2013). Despite smaller and younger firms accounting for a large share of enterprises, banks are unable to fully utilise the law of large numbers to exploit economies of scale and enjoy the associated diversification benefits when lending to them (Beck, 2013). Thus, lending to these enterprises is viewed as a higher risk, leading to a lower supply and a higher cost to bank loans for these businesses (Berger et al., 2001).

More recently, institutional economists put forward a complementary explanation. They argue that social and political factors play equally important roles alongside information imperfections in explaining the inequitable distribution of bank financing. According to this view, the business decisions of both enterprises and financial intermediaries respond not only to market prices but also to rules and regulations that shape and influence incentivising and constraining mechanisms. Impersonal public and private bureaucratic organisations, which operate under the rule of law, facilitate the process of exchange, production, and investment by enforcing rules, regulations, and contracts (Acemoglu et al., 2005; Goldsmith, 1995; North, 1990; Weber, 1968). The variations in business environments across countries primarily arise from the heterogeneity of country-specific constraints and incentive mechanisms, resulting from differences in the form, pace, and depth of institutional reforms (Acemoglu et al., 2005).

Modern market-based economies are composed of anonymous markets, impersonal bureaucratic organisations, and communitarian institutions that depend upon interpersonal networks (Bauernschuster et al., 2010; Dasgupta, 2005). The interrelationships between these layers of the economic structure are dynamic and change with the level of economic development (Stiglitz, 2001). Bureaucratic institutions in underdeveloped markets usually lack credibility, weakening market-based incentivising and constraining mechanisms, and causing inefficiencies in exchange transactions. As a result, the role of bureaucratic institutions can be partly replaced by webs of interpersonal networks capable of growing in importance in terms of production and exchange relations (Stiglitz, 2001).

Thus, a network of exclusive interpersonal and reputation-based relationships emerges to resolve allocative and redistributive questions, including the allocation of formal financing to enterprises. More specifically, the political elite with their vested interests affects economic outcomes formally through red tape and informally through individual connections.

Growing international evidence demonstrates that political connectedness plays an important role in gaining access to formal financing (Bartlett, 2023; Boubakri et al., 2013; Cull et al., 2015; Faccio, 2006; Faccio et al., 2006; La Porta et al., 2002; Li et al., 2008). Entrenched elites may influence business environments by adopting formal rules and regulations to protect their rent-seeking interests and create unfavourable operational constraints for enterprises. This can result in a culture of favouritism, corruption, and bribery, further suppressing market-based impersonal exchange and resource allocation (Fedderke et al., 1999).

The literature offers competing views on the potential influence and ultimate impact of corruption and rent-seeking behaviour on allocative efficiency and social welfare (Aidt et al., 2008). Some researchers (Blackburn et al., 2009; Duvanova, 2014; Li, 1998; Manion, 1996) argue that, at least in theory, more productive firms are also more successful in generating a greater surplus. They can, therefore, better afford to offer bribes and kickbacks to gain advantageous access to scarce resources, including access to bank credit, possibly resulting in socially beneficial outcomes at the aggregate level. However, the strength of this argument relies on several weighty assumptions. Such assumptions include the following: the relationship between bribe-giving and bribe-taking parties is purely transactional; soliciting bribes is costless; and entrepreneurs who can generate surplus from their normal business operations can transparently 'bid' for resources in open auctions. These assumptions, however, ignore the fact that the nature of relationships between corrupt public officials and entrepreneurs is often interpersonal and enduring, whilst their dealings are almost always murky and may not always require immediate and one-off pecuniary exchanges.

Furthermore, soliciting bribes is also not costless for corrupt bureaucrats, since there is a danger that they may be caught in the process. Relative to the risk of being caught, the pecuniary rewards of accepting bribes from unfamiliar entrepreneurs remain small. Thus, bureaucrats are more likely to cooperate with entrepreneurs whom they know and trust in order to minimise the risk of being caught (Bartlett, 2023; Becker, 1968;

Ryvkin & Serra, 2012). Such factors reinforce the rationale for collaboration between bureaucrats and entrepreneurs who know and trust each other. As such, having the right interpersonal connections, which can be repeatedly used intertemporally to gain access to resources, becomes more valuable than simply affording explicit monetary payments as bribes.

Notably, not all entrepreneurs have economically beneficial interpersonal networks, whilst the most valuable economic networks can also be the most exclusive. Moreover, belonging to a network may open access to other networks, given that some entrepreneurs will be members of multiple networks. For example, regardless of the competitiveness of their projects, some entrepreneurs may gain access to bank credit through their connections with government officials. More importantly, the interpersonal and exclusive nature of such networks indicates that a small number of strategically well-connected entrepreneurs may seize a disproportionately large share of scarce resources and opportunities, resulting in further allocative inefficiencies (McKean, 1992). This clearly compares unfavourably to anonymous market-based exchange systems, which are more efficient because 'the best' buyers or sellers may not be part of exclusive networks (Serageldin & Grootaert, 2001). Therefore, corruption and rent-seeking practices are not only economically costly, but are also morally repugnant since they rely on insider–outsider distinctions and suffocate the equality of opportunities (Bowles & Gintis, 2002).

Institutions, Informality, and the Allocation of Bank Financing in Uzbekistan

The collapse of the former Communist regimes in Eastern Europe and the former Soviet Union (FSU) in the late 1980s and early 1990s led to profound economic, political, and social changes in those countries. The transformation process, which became popularly known as 'transition', attempted to build a modern society in which political decisions and social norms would be forged by democratic values, and economic relations would be determined by market forces; the latter, in turn, would be shaped by the mixture of anonymous markets and impersonal bureaucratic organisations operating under the rule of law (Kornai, 2000; Rose, 2001). When Uzbekistan became independent in 1991, the government decided to transform its centrally planned economy to a market-based economy, as did other countries in transition in Eastern Europe and the FSU. However, unlike its transition economy counterparts, Uzbekistan

undertook partial economic reforms, which were implemented gradually and slowly (Ruziev, 2021).

Although the strength of market-based signalling and incentivising factors intensified whilst bureaucratic organisations have become more established since the 1990s, the latter still fail to operate impartially and according to the law in Uzbekistan. Resulting from a leadership change (following the sudden death of late President Islam Karimov), since 2016 socio-economic reforms have accelerated in the country (Ruziev, 2021). However, due to Uzbekistan's low starting point vis-à-vis reforms, the country remains one of the least-reformed economies amongst its transition economy counterparts. In this regard, the European Bank for Reconstruction and Development's (EBRD) assessment of transition quality (ATQ) indices can be particularly useful in describing Uzbekistan's progress, especially since 2016, towards building credible and impersonal bureaucratic institutions and a well-functioning economy which relies on market signals and healthy competition.

Figures 11.1 and 11.2 illustrate two relevant ATQ indices—namely, the 'well-governed' and 'competition' indices—comparing Uzbekistan's progress in relation to other countries in transition in the years 2016 and 2022. The values of the 'well-governed' and 'competition' ATQ indices employed in Figs. 11.1 and 11.2 range from 1 to 10, where 10 corresponds to the standards of an advanced market economy (EBRD, 2023). The 'well-governed' index measures the quality of institutions and the processes they support. More specifically, this index captures the quality of economic and political institutions, integrity standards, the rule of law, and control of corruption. The 'competitive' index, by contrast, captures countries' attempts to move from a state-driven decision-making mechanism to one guided by market signals, focussing on economic structures that promote competition, choice, and fair prices. The effective allocation of external financing to entrepreneurs based on the market principles of risk and return is also captured in this index.

In Figs. 11.1 and 11.2, the 2016 values of the 'well-governed' and 'competitive' indices, measured along the horizontal axis, are plotted against the 2022 values of the same indices measured along the vertical axis. The upward sloping solid line in both figures represents a 45-degree angle, which helps to visualise countries' relative progress. For example, if a country's 'well-governed' index was the same in 2016 and in 2022, the country would lie on that 45-degree line; if the index improved (or, alternatively, deteriorated) during this period, the country would be located

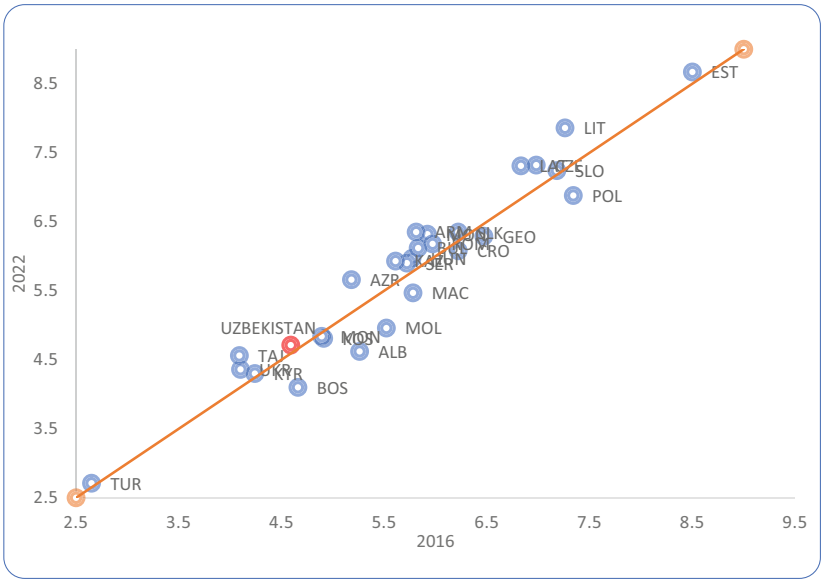

Fig. 11.1 The assessment of transition qualities: the well-governed index in selected transition economies, 2016 and 2022 *Source* EBRD (2023)

above (or below) the line. Figures 11.1 and 11.2 clearly show that, although Uzbekistan made some progress in both indicators between 2016 and 2022, the country's overall position compares poorly in relation to most transition economies in the sample.

The literature demonstrates that, under such conditions, entrepreneurs and bureaucrats rely more on their exclusive interpersonal networks to resolve allocative and redistributive questions relating to financing, investment, production, and exchange (Stiglitz, 2001). Individuals working in otherwise impersonal bureaucratic organisations personalise their positions by using the rigidity of rules and regulations as an excuse for rent-seeking. As a result, entrepreneurs are less incentivised to use prices, rules, and regulations as signals; instead, they resort to a variety of interpersonal networks to personalise relationships with impersonal bureaucrats, leading to the misallocation of resources. Rose (2001) describes economies with these characteristics as suffering from organisational failure.

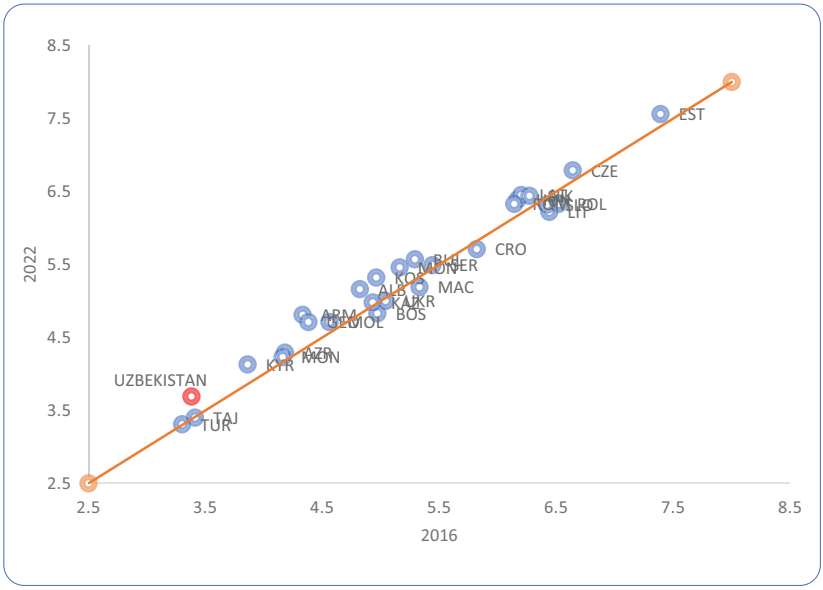

Fig. 11.2 The assessment of transition qualities: the competitive index in selected transition economies, 2016 and 2022 *Source* EBRD (2023)

A growing body of quantitative and qualitative empirical research investigating socio-economic changes in Uzbekistan provides a consensus view that Uzbekistan closely matches this description (Hornidge et al., 2011; Ilkhamov, 2007; Oberkircher, 2011; Rasanayagam, 2011; Ruziev & Midmore, 2015; Urinboyev & Eraliev, 2022; Urinboyev & Svensson, 2013; Urinboyev et al., 2018; Veldwisch & Bock, 2011).

For example, Hornidge et al. (2011) argue that Uzbekistan's top-down governance approach with its weak accountability and transparency encourages personalising public office and the arbitrary exercise of power as commands and directives pass through the hierarchical bureaucratic structures. The blurring of the boundaries between public office and private interests serves as a mechanism for private rent-seeking (Ilkhamov, 2007) and leads to the informalisation of both state and society (Rasanayagam, 2011). Some aspects of this informalisation manifest themselves in the use of informal patriarchal patronage networks as well as norms and values such as authority, obligation, and reciprocity

not only as tools of governance but also as means to gain access to scarce resources. Some scholars (e.g., Ilkhamov, 2007; Trevisani, 2011) rather convincingly demonstrate that interpersonal patronage networks, already played an important role in matters of resource allocation under central planning only to deepen during the transition, spreading from formal bureaucratic and enterprise structures to community-level informal institutions. Whether vertical (patron–client) or horizontal (client–client), these networks provide an opportunity for the redistribution of resources, including bank financing, in the interests of network members.

Veldwisch and Bock (2011) also show, through the example of water management for agricultural use in the Khorezm region, that along with the official water distribution managers, members of informal patronage networks, such as village or town mayors, neighbourhood leaders, and individuals with close connections to government officials, significantly influence the distribution of water resources. Since water is a vital input in irrigation-dependent farming in Uzbekistan, the ability to access this scarce resource associates with prestige and power (Oberkircher & Hornidge, 2011, p. 411). Whilst reverting to traditional norms of reciprocity can represent a natural response to the uncertainty created by transition, it also carries its own drawbacks. Due to their exclusive nature, interpersonal networks often serve to benefit members at the expense of the broader society. Turaeva-Hoehne (2007) argues that mutual reciprocity associated with interpersonal networks, which are governed by informal norms, also inhibits innovation and risk-proclivity, factors deemed important to promoting economic growth.

Studies analysing Uzbekistan's economic, social, and legal transformation from the perspective of the sociology of law (e.g., Urinboyev & Eraliev, 2022; Urinboyev & Svensson, 2013; Urinboyev et al., 2018) also show that informal transactions in Uzbek society are widespread. Such research demonstrates that some informal transactions, which can be labelled corrupt practices under the law, are morally accepted as gifts according to informal norms. For instance, Urinboyev and Svensson (2013, p. 387) described some of these informal practices as 'palliative' mechanisms, which arise to compensate for the state's failure to support the country's infrastructure and welfare systems. Thus, Urinboyev et al., (2018, p. 53) suggest that economies and societies in countries in transition like Uzbekistan can be regarded as a state where formal and informal institutions compete for power and resources, thereby creating alternative 'legal orders' and norms to regulate transactions. In addition, Urinboyev

et al. (2018) also make an important observation about the peculiarity of the Uzbek context: the state is a powerful actor in Uzbekistan in matters relating to maintaining security and preventing social and political instability, but it is weak vis-à-vis enforcing the rule of law and service delivery.

The detrimental impact of informality and corruption, which disrupt and distort market-based price signals, on firms' access to formal financing and, subsequently, their performance are also well established in the relevant empirical literature in economics (e.g., Frye & Shleifer, 1997; Hunt & Laszlo, 2012; Seker & Yang, 2014). For example, some empirical studies (Ruziev & Webber, 2019; see also Bartlett, 2023) based on large-scale enterprise survey data from transition economies show that a disproportionate share of formal financing is channelled to large enterprises, limiting the flow of formal bank credit to small- and medium-sized enterprises (SMEs). Although market and information imperfections are conventionally viewed as major causes of this misallocation, these studies empirically demonstrate that connectedness to exclusive interpersonal networks significantly improves the chances of receiving bank credit and that the benefits of these links are stronger for well-established and larger SMEs. A similar empirical case study for Uzbekistan (Ruziev & Midmore, 2015) also demonstrated that enterprises with access to exclusive interpersonal networks are a) less likely to express a need for bank financing, but b) more likely to apply for it, and c) enjoy a much higher loan application success rate. More importantly, econometric estimates show that, although being connected to strategic networks improves enterprises' access to bank financing, receiving bank financing does not associate with their growth.

Enterprise Access to Formal Financing: Some Additional Factors

In the previous sections, information imperfections and the quality of institutions were discussed as the primary factors contributing to the inequitable distribution of formal financing to enterprises. In what follows, I add additional factors associated with financial underdevelopment to this list. First, an important factor that exacerbates enterprise access to bank loans in countries with underdeveloped financial systems is credit rationing. When screening loan applications and making loans to businesses, banks often require collateral in order to reduce their

moral hazard and other risks associated with default. In principle, we can assume that banks always grant loans if acceptable collateral is available; any concerns about the character of borrowers or the feasibility of projects to be financed would be incorporated into the rate of interest as a risk premium. However, selling collateral in the event of default carries additional transaction costs to banks. More importantly, in their seminal work, Stiglitz and Weiss (1981) showed that, in markets with imperfect information, raising interest rates and/or collateral requirements would increase the riskiness of lenders' credit portfolios, either by discouraging safer borrowers (an adverse selection problem) or by inducing borrowers to invest in riskier projects (a moral hazard problem). As a result, rather than charging higher interest rates and/or requiring more collateral, it makes more economic sense for banks to ration the supply of loans to businesses.

The next factor requiring a more in-depth discussion is the level of financial development. Unfortunately, the level of financial sector development in emerging economies, where enterprises depend on bank loans more than any other source of external financing, is lower, which carries implications for enterprise access to bank financing. Poor access to financial services in developing countries may be due to high fixed costs associated with the provision of financial services and tight entry regulations (Claessens & Perotti, 2007). More importantly, emerging economies also lack a sufficiently large pool of domestic savings (which is attributed to the paucity of their income levels) that can be efficiently mobilised to meet the demands of external financing.

At the time of the collapse of the Communist regime in Eastern Europe and the FSU, both the levels of per capita income and the financial development in these countries were much lower than those in advanced economies. The situation in Uzbekistan was far worse since its per capita income was 62% of the USSR average in 1988 (second lowest in the USSR; Ruziev et al., 2007, p. 9). Whilst many post-Communist countries embraced market-oriented reforms in the early 1990s, the reform process was gradual and progress consistently slower in Uzbekistan until late 2016, when the pace of reforms accelerated. Although Uzbek authorities' cautious approach to transition prevented an economic collapse and averted major social upheavals in the country in the 1990s, economic growth remained weak in the 1990s, only picking up pace in the first half of the 2000s.

The banking sector remains one of the least reformed and underdeveloped sectors of the economy in Uzbekistan. The government often uses the banking sector to channel externally and internally generated loans to priority sectors in the economy. Bank loans are extended almost exclusively to state-owned enterprises and joint ventures at preferential rates, leaving a large proportion of enterprises credit-starved (Holzhacker, 2018). Because of the low income levels, the banking sector also does not have a sufficiently large pool of domestic savings to mobilise for enterprises, such that banks rely heavily on government deposits and loans, which constitute more than half of the banking sector's loanable funds (IMF, 2018, p. 33).

Another strong indicator of financial repression manifested itself in the foreign exchange market. A multitiered exchange rate regime was in place primarily from July 1994, when the national currency was launched, until September 2017, when the official exchange rate was finally liberalised after President Mirziyoyev came to power. Before the liberalisation of the foreign exchange market, three exchange rates existed: the official rate, the bourse rate, and the black-market rate. Just a few weeks before the liberalisation of the market in September 2017, the official exchange rate was around 4100 *so'ms* per US dollar, the bourse rate stood at around 8500 *so'ms* per US dollar, and the black-market rate was around 8400 *so'ms* per US dollar.

While the government managed to achieve an impressive 8% average economic growth rate in the period 2004–2016, which was two times higher than the comparable 1993–2003 figure, and accelerated structural reforms after Mirziyovev took over the presidency in 2016 including in the banking sector, Uzbekistan remains one of the least economically and financially developed countries in the post-Communist world. To illustrate this reality, Figs. 11.3 and 11.4 show the improvements made in Uzbekistan's levels of per capita income and financial development in 2011 and in 2021, when the latest relevant data were available, comparing them to those of other post-Communist economies. Specifically, per capita income data rely on purchasing power parity (PPP) based on current international dollars (Fig. 11.3), whilst financial development (Fig. 11.4) is measured by examining domestic credit in the private sector as a share of gross domestic product (GDP), an imperfect but popular measure of financial development. These figures show the relative progress made by Uzbekistan in these two measures between 2011 (horizontal axis) and 2021 (vertical axis), alongside other countries'

performance. When a country's position lies above the solid 45-degree line, this indicates that the country made progress in 2021 compared with 2011 and vice versa.

Figures 11.3 and 11.4 indicate that Uzbekistan improved its per capita and financial development levels between 2011 and 2021. More specifically, although Uzbekistan sustained one of the highest growth rates amongst the post-Communist economies since the mid-2000s, it only resulted in modest improvements in *per capita* income levels in the period 2011–2021 when compared with other countries in the sample. Figure 11.4 indicates that the ratio of domestic credit extended to the private sector relative to GDP increased from around 10% in 2011 to around 36% in 2021. This is a noticeable improvement, although one caveat is in order. This indicator does not provide sufficient information about the breadth and the quality of the financial depth, and neglects other important factors such as the sources of banks' loanable funds and the proportion of economically active entities responsible for utilising the available formal financing.

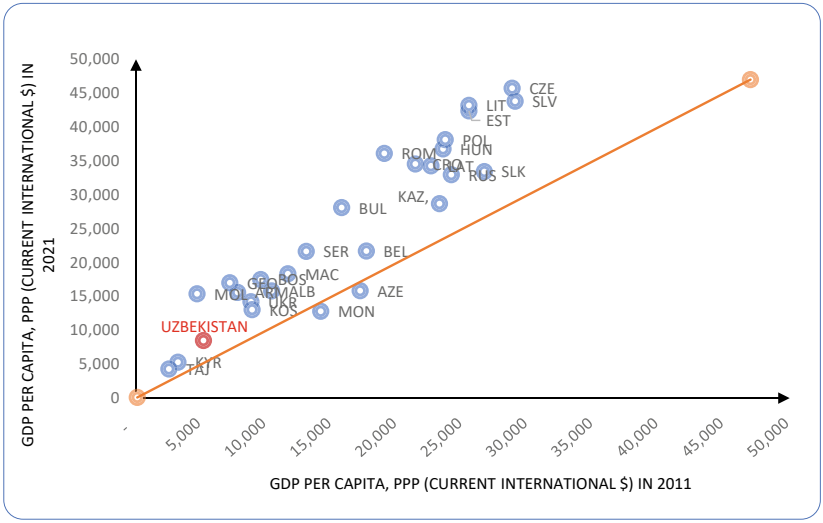

Fig. 11.3 Per capita income levels in selected countries, 2011 vs 2021 *Source* World development indicators (2023)

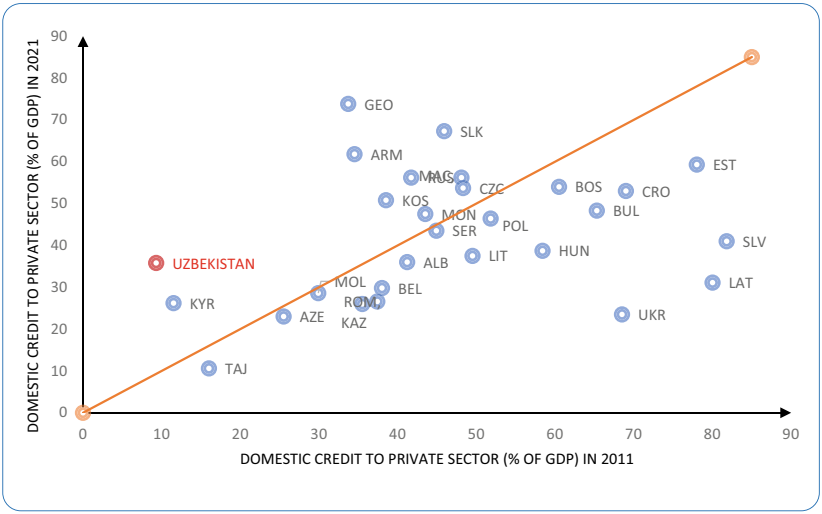

Fig. 11.4 Financial development over time in selected countries, 2011 vs 2021 *Source* World development indicators (2023)

Indeed, according to firm-level enterprise survey data by the World Bank (2023b), despite enterprises relying heavily on bank loans to finance their investments in Uzbekistan, only a small portion of them (about one-fifth) reported having access to bank credit. Furthermore, banks do not engage in the significant intermediation of private sector savings either, whereby 'financial intermediation is low, constraining access to financing' (IMF, 2022, p. 9). For example, in December 2021, domestic private sector deposits accounted for only 20% of banks' loanable funds (which were formed primarily from non-resident borrowing and deposits [27%], i.e., borrowing from international financial markets, followed by government borrowing and deposits [20%], i.e., borrowing from the government, banks' own capital [16%], interbank borrowing [7%], and other funds [10%]) (IMF, 2022, p. 12).

Whilst hard evidence on how financial underdevelopment can exacerbate the impact of interpersonal networks on the already skewed distribution of formal financing remains lacking for Uzbekistan, Ruziev and Webber (2019) found that, in post-Communist economies, the impact of interpersonal connectedness on resource misallocation is stronger when

the resources in question are in relatively short supply. This suggests that the supply of formal credit, limited in emerging economies like Uzbekistan, is distributed in favour of those capitalising on bureaucratic links, with consequences on resource misallocation.

Conclusions

The belief that a centrally planned system associated with wastefulness whilst a market-based system yields an efficient allocation of resources was central to post-Communist economies' decisions to transform from a centrally planned to a market-based system. Whilst this may well be true in principle, various forms of inefficiencies also occur in market-based systems, especially in the provision of financial services to businesses. Empirical research thus far clearly demonstrates that the distribution of formal financing skews towards larger enterprises and against younger and smaller firms in market-based economies.

Conventional explanations for this apparent inefficiency emphasise market and information imperfections as major causes of misallocations. However, more recent literature indicates that institutional and political factors also play a crucial role in matters concerning resource allocation, including the allocation of bank financing. In countries where market mechanisms remain weak and institutions responsible for upholding the rule of law lack credibility, a small number of strategically well-connected entrepreneurs may seize a disproportionately large share of scarce resources and opportunities, resulting in further allocative inefficiencies. This clearly compares unfavourably with anonymous market-based exchange systems, which are more efficient because 'the best' buyers or sellers may not be a part of exclusive networks. Corruption and rent-seeking practices are not only economically costly, but also morally repugnant given that they suffocate equality in opportunities.

Growing empirical evidence from transition economies suggests that well-connected enterprises, despite having low capital productivity, account for a disproportionately large share of formal financing. This clearly indicates resource misallocation. The situation in Uzbekistan is no exception. In fact, since the impact of interpersonal connectedness on resource misallocation is stronger when resources are in short supply, we can argue that enterprises in Uzbekistan face more challenging conditions due to credit rationing and the poor quality of financial intermediation in the country.

Looking ahead, it is essential that policymakers implement and credibly commit to fundamental reforms aimed at improving the quality of institutions that promote market-based incentive mechanisms. This would ensure a more equitable distribution of financing to its most productive uses, including in the labour-intensive sectors of the economy. This will ultimately help create jobs and drive economic growth in a more inclusive and sustainable way.

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