POLICY BRIEF: MICROFINANCE AS AN ECONOMIC DEVELOPMENT TOOL IN UZBEKISTAN

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International History of Microfinance

Microfinance essentially consists of a combination of financial products (micro-credit, micro-leasing, micro-insurance, micro-savings, and money transfers) targeting specific client groups. Recipients of these services generally represent micro-business and economically active, but poor citizens. The majority of them possess limited access to the standard financial products provided by traditional financial institutions and 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 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 (MFIs), began focusing on low-income populations. Microfinance institutions switched focus from subsidies to targeted aid to the poor and helped establish local institutions which were both financially and operationally stable.

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

In the late 1990s, microfinance institutions 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 cost recover remains key to the success of microfinance programs which focus both on social and commercial principles while increasing the client base at the same time. Therefore, a disciplined management of costs at all levels ensures the financial viability of microfinance institutions.

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.

Uzbekistan: A Brief Background

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 former Soviet Union. 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 in 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 usually 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. Microfinance can ease the migration pressures as the unemployed rural population is not as compelled to seek jobs abroad or in urban areas. The micro-enterprises help build a market-oriented economy, exploiting local competitive advantages, and fostering the feasible ones’ growth into small and medium enterprises or SMEs. Aside from alleviating economic and social pressures during transition, microfinance serves as an essential component of the drive for a market economy and decentralized governance.

Uzbekistan: Why Microfinance Programs?

Microfinance can be an integral component of the strategy of reforms currently being implemented by the government in Uzbekistan and the sector should be developed as an important initiative in the country. Microfinance can be an effective instrument for providing public employment and reducing poverty, especially in rural areas, which is the main motivation of government’s social policy. 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 for meeting such demands of the Uzbek population.

Microfinance can be an effective way of addressing new employment challenges in Uzbekistan. Microfinance functions 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 activities. Despite the inadequate legal underpinning and semi-legal existence, micro-credit programs of international organizations and donors have involved more than 40,000 clients. Small traders and agricultural producers especially benefit from the programs. Given the low mobility of agricultural labor, microfinance could be promoted as a long-term solution to the problems of employment in Uzbekistan.

Since 2004, wide-sweeping reforms underway in the country have focused on dissolving loss-making collective farms 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 people annually would be released from the farming sector and would need to be absorbed by the labor market. For the moment, government programs cannot adequately handle this. The total number of new jobs created annually covers less than half of the newly-released labor force.
In Uzbekistan today, demographic trends exacerbate employment problems. 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 60-75% of the total growth at the rate of approximately 680,000 people. Experts project even higher birth rates in Uzbekistan for the next few years. 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 microfinance programs.

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 witnesses 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 year. Most labor migrants consist of low-income population groups who would stay in the country and attempt to start their own small businesses if they had better access to financing.

The government’s commitment to develop entrepreneurship will lead to a significant increase in demand for additional finances as well as the instruments for funding the business sector in the future years. A number of decrees and resolutions 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 billion or $257 million in 2005.

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

Microfinance institutions can enhance savings in Uzbekistan as well. 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 priorities are reflected in the government Program for Development of the Banking Sector in 2005-2007, 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.

Development of microfinance is also an important tool 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 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 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 rates reach 20-30% per month. Government instituted and supported microfinance will substitute these legally and economically dysfunctional schemes.

Finally, 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. Furthermore, 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.

The Current State of Microfinancing 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 microfinance institutions. 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, August 2002).

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

Interest rates and amounts of credit vary considerably depending on the type of financial institutions dealing with micro-credits. Commercial banks offer micro-credit of about $2,500 to $3,000, whereas credit unions provide not much more than $1,000. Such advantages as low interest-rate, opportunity to obtain credits in cash, generous timeframes and a long grace period characterize micro-credits from off-budget funds. Activities of credit unions focus on the more affluent clients.

The non-banking sector, represented by NGO-Microfinance institutions, mainly functions on donor financing. Although the prime cost of credit funds is zero or almost zero, NGO-Microfinance institutions’ charge relatively high interest rates (4-6.5% per month). Generally, interest income and donor grants limit the volume of their loan capital and expanding
microfinance activity. If they gain access to diversified financial sources, they can lower their interest rates.

Overall, microfinance in Uzbekistan consists mainly of micro-credits. Microfinance institutions across the country cover only 9% of the demand. Therefore, a huge market exists for new microfinance institutions in Uzbekistan. The NGO-Microfinance institution model increases the potential of microfinance in Uzbekistan—especially, in easing the access of poor groups to micro-credits. Unlike commercial banks and credit unions, NGO-Microfinance institutions influence the employment and incomes of the poorest people. In practice, NGO-Microfinance institution micro-credits remain 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 toward urban areas or abroad.

Obstacles to Microfinance
Although NGO-Microfinance institutions demonstrated robust growth trends, these entities face the biggest obstacles and have not been able to fulfill their full potential for the following reasons.

First, lack of legislative and regulatory frameworks has caused problems. Donors will refrain from investing into the microfinance sector of Uzbekistan even if the funds were available until laws clarify the legal status and mandates of NGO-Microfinance institutions.

Second, taxation also plays a role. NGO-Microfinance institutions 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. The majority of NGO-Microfinance institutions are operationally sustainable. However, if tax liabilities are introduced, they will not be able to accumulate essential funds needed for keeping the focus on socially-oriented targets.

In the interim, a distinct feature of existing micro-credit programs in Uzbekistan remains their social objective. They have proven effective in addressing poverty and unemployment, alleviating social tensions in regions with high birth rates and creating sustainable sources of income for micro-business, individual entrepreneurs as well as people with unregistered businesses. At the same time, NGO-Microfinance institution activities are financially viable: repayment rate of micro-credits currently stands at 96-98%.

An important 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, for example, 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 micro-credits.

The Role of Donors in Uzbekistan’s Microfinance Programs
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 microfinance institutions set up with their support continuing their independently operations subsequently. Among these donors are NOVIB (Netherlands Agency for Technical Cooperation and Development), which assisted with the establishment of Sabr NGO-Microfinance institution.
DFID (United Kingdom’s Department for International Development) provided start-up capital for Barokot, the largest microfinance institution in Uzbekistan. The U.S. Department of Agriculture provided support to the establishment of PAD microfinance institution.

The programs of UNDP and USAID remain distinct in scale and consistency. In addition to its two projects in Kashkadarya and in the Republic of Karakalpakstan, UNDP currently pilots innovative microfinance programs in Kashkadarya and Surkhandarya and tests new microfinance products under business incubators in Shahrisabz (micro-credits for farmers) and Angor cities (micro-leasing for farmers). USAID provides technical assistance to a number of microfinance institutions within the framework for establishment of an ‘Association of Microfinance Institutions in Uzbekistan’. Jointly with ADB, USAID also supports the further development of credit unions in the framework of World Council of Credit Unions (WOCCU).

Other donors increasingly express interest in microfinance in Uzbekistan. For instance, World Bank hopes to implement 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.

The Future of Microfinance in Uzbekistan

Various improvements could be made to enhance the microfinance program in Uzbekistan. First, as mentioned previously, a legislative and regulatory framework will ensure the transparency, consistency and sustainability of these programs. This framework should include incentives for all types of microfinance institutions and clearly articulate all registration procedures necessary to gain full recognition. It’s also important to permit household deposit contributions as a source for the charter capital of new microfinance institutions.

Second, preferential tax status should be extended. Given the nascent state of microfinance in Uzbekistan and its potential as a tool of economic development, it seems reasonable to extend preferential income taxation to microfinance institutions.

Third, new pilot projects should continue to be initiated in order to strengthen the importance and scale of microfinance in Uzbekistan. These should further aggregate existing microfinance models by expanding to new regions of the country. Donors should be encouraged to experiment with new microfinance pilot programs that could be implemented within the framework of the government’s poverty reduction strategy. If the pilot projects are successful, they could easily be replicated on a nation-wide scale.

Conclusion

Despite its considerable importance for Uzbekistan, the microfinance sector remains at a nascent stage of development and requires further improvements in both quality and quantity in order to be a successful tool of economic development. By 2010, some experts have proposed that 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 establish a financially sustainable and efficient microfinance market. Local financial institutions must also be attracted, as their involvement would enhance competition, reduce interest rates, and promote economic development in Uzbekistan.