Global financial inclusion challenges for banking system of Uzbekistan

Aliqoriev, Olimkhon

Institute of Forecasting and Macroeconomic Research

5 December 2013

UDC 339.727(575)

JEL Classification: G01, G20, G21

GLOBAL FINANCIAL INCLUSION CHALLENGES FOR BANKING SYSTEM OF UZBEKISTAN

Olimkhon ALIQORIEV
PhD in Economics, Senior Researcher, Institute of Forecasting and Macroeconomic Research (IFMR) under the Cabinet of Ministers of the Republic of Uzbekistan
E-mail: aliqoriev@ya.ru

Summary. This paper examines the current status and trends of the banking system of Uzbekistan, assesses the development potential of commercial banks and provides scientific and practical implications for improving the balance and stability of banking system of Uzbekistan based on the qualitative and quantitative analyses and the identified problems.

Аннотация. В статье рассматривается современное состояние и тенденции развития банковской системы Узбекистана, оценивается потенциал развития коммерческих банков и предоставляются научные и практические выводы для улучшения сбалансированности и стабильности банковской системы Узбекистана на основе качественных и количественных анализов и выявленных проблем.

Анотація. У статті висвітлено сучасний стан та тенденції розвитку банківської системи Узбекистану, досліджено потенціал розвитку комерційних банків і надано наукові та практичні висновки для поліпшення збалансованості та стабільності банківської системи Узбекистану на основі якісних і кількісних аналізів і виявлених проблем.

Key words: *banking system, commercial bank, development potential, financial access, economic indicator, financial services, gross domestic product.*
Ключевые слова: *банковская система, коммерческий банк, потенциал развития, доступность финансовых услуг, экономический индикатор, финансовые услуги, валовой внутренний продукт.*
Ключові слова: *банківська система, комерційний банк, потенціал розвитку, доступність фінансових послуг, економічний індикатор, фінансові послуги, валовий внутрішній продукт.*

Introduction. Nowadays the deepening of economic reforms and multilateral liberalization of the economy, which is an integral part of territorial integration and globalization at the international level, composite institutional changes occurring in the economy of developed and developing countries. Currently, one of the world's most advanced levels of market infrastructure, of course, is the banking system.

In the context of the ongoing global financial and economic crisis, the implementation of the last years of modernization and structural transformations of economy and the anti-crisis program was the support for the stability of the banking system of Uzbekistan. This helped to avoid many of the problems faced by some countries of the CIS (Commonwealth of Independent States).

The experience of advanced countries suggests the need to rely on market mechanisms for financing, especially on the banking system. On the basis of conceptual framework, as John Bonin and Paul Wachtel noted [2, p. 1]:

The role of the financial sector in all economies is to channel resources from primary savers to investment projects. A strong consensus has emerged in the last decade that well-functioning financial intermediaries have a significant impact on economic growth. Modern economies have a wide range of market-oriented institutions for facilitating this process. In planned economies, this process was conducted by administrative arrangements and there were few market-oriented elements of the financial sector. The only ubiquitous financial institutions in the pre-transition planned economies were banks, which acted as record-keepers for the planning process and payment agents among state entities rather than as financial intermediaries. Although these banks had the appearances of real banks, they did not function as banks would in a market-oriented economy.

Therefore, the role of this segment in the financing of economic development is extremely high. Simultaneously, on the base of modern market mechanisms there is financial inclusion. On the one hand, according to Fardoust, Kim, Sepúlveda financial inclusion is important because it leads to balanced economic growth. As clearly articulated by the G-20 leaders, strong, sustained, and balanced economic growth is essential to ensure continued global economic recovery in the short term and durable global economic prosperity for all in the longer term. On the other hand, financial inclusion facilitates innovation. Innovation, often led by entrepreneurs and SMEs (small and medium enterprises) especially in the developing economies, is one of the key drivers of enhanced productivity and growth [5, p. 531].

At this time, the banking system in the economy of Uzbekistan plays a very important role since its effective activity influence on other industries. The President of Uzbekistan Islam Karimov noted that, "the banks are, figuratively speaking, a blood-vascular system that nourishes all our economy on the state of which depend the financial and economic stability in the country" [10, p. 47]. The banks for ensuring the healthy functioning of economy have to carry monetary funds to the entities of the economy effectively and, the Central bank as heart of the system on the principle of priority regulates the process of money distribution. It is clear that in the period of external negative effects the banking system, like human cardiovascular system, experiences additional stress and suffers most acutely, as it would affect the whole economy.

Development of the banking system of the Republic of Uzbekistan was carried out in stages of the first years of independence under intense government scrutiny. Today, the experience of Uzbekistan in ensuring the stability of the banking system as a pledge and a necessary condition for economic growth deserves the attention of the world community.

However, innovative development of the banking sector is still weak, insufficiently capitalized and not able to provide all the necessary services. Although the majority of loans of commercial banks are long-term, their volume for financing the real sector of the economy is insufficient, as in Uzbekistan, the share of loans to banks and other borrowed funds in the structure of sources of investment in fixed capital remains low.

Commercial banks have not still sufficient own and borrowed resources to be involved actively and widely in the investment process aimed at modernizing the economy. The main reason for this is that the ratio of the total capital of the banking system in the country's gross domestic product (GDP) is still low. The reason for this may be the higher growth rate of GDP of Uzbekistan compared with the rate of growth of the main indicators of the banking system over the period. According to the above indicators can be concluded that the commercial banks of Uzbekistan will not affect the reproduction processes.

In this regard, the overriding objective is the development of a plan of specific measures to improve the system. It should be adequate to the requirements of modernization of the economy.

Solving this issue depends on majority of factors, consequently: assessing qualitative and quantitative characteristics of the banking system, developing policy proposals for improving the balance and stability of banking system of Uzbekistan. Innovation breakthrough needs sources of "long", sound money. In addition to mechanisms to strengthen the resource base of the banking system, there are numbers of other tools to attract "long" resources in the economy.

In international practice to assess the level of development of the national banking system relative to the size of the economy on the index of provision by banking services, as well as its components:

1. Institutional provision of banking services (geographic and demographic outreach of banking services: bank branch network, automatic teller machines (ATMs));

2. Financial provision of banking services (financial instruments: assets, deposits, loans);

The indicators in the G20 Financial Inclusion Indicators capture significant elements of access to and usage of financial services. The G20 Financial Inclusion Indicators currently consist of data on several indicators spanning the three dimensions of financial inclusion – access to financial services, usage of financial services, and the quality of products and the service delivery [6]. The data sources include the World Bank Group (WBG), International Monetary Fund (IMF), OECD National Financial Literacy and Inclusion Surveys and Organization for Economic Cooperation and Development (OECD) special surveys).

These indicators give evidence of the penetration of financial capital in the business and concerns not only of each company, but every citizen of the country. Evaluation of institutional provision of banking services characterizes banking infrastructure of the country in terms of the coverage degree of population. To assess the level of financial provision of banking services is used the ratio of total assets, loans and deposits to GDP. This indicator, in general, allows us to give a comparative description of the financial provision of country by banking services.

Institutional Measures on Further Reform of Banking System. Since gaining its independence, Uzbekistan has started to create a two-level national banking system that is adequate to the requirements of the market economy and effective redistribution of financial resources. In the period from 2000 to 2012, Uzbekistan continued to reform and improve the stability of the banking system to meet modern requirements of economic development. To this end, the following programs have been adopted:

- Program of reforming the banking system for 2000–2003 (Decree of the Cabinet of Ministers on March 24, 2000, №104);
- Program for further reform and liberalization of the banking sector for 2005–2007 (Decree of the President of the Republic of Uzbekistan on April 15, 2005, №PP-56);
- Program of deepening the reform and development of the banking system of the Republic of Uzbekistan for 2007–2010 (Decree of the President of the Republic of Uzbekistan on November 7, 2007, №PP-726);
- The anti-crisis program for 2009–2012, which provided further increase in the level of capitalization and strengthening the financial stability of banks in the country with an allowance for the changing situation in the world market;
- Comprehensive measures to further reform and improve the stability of the banking system in the country for 2011–2015 and to achieve high international rating indices (Decree of the President of the Republic of Uzbekistan on November 26, 2010, №PP-1438).

Quantitative and Qualitative Characteristics of Banking System Development. The implementation of effective measures and reforms in the national banking system was reflected in a dynamic and stable growth of its key indicators. As a result of the measures taken to strengthen the financial stability of banks in 1994–2000, total capital of banks increased to 14,2 times in 2012 compared with that of 2000, and 43,5 times as at 2012 amounted to 6,2 trillion UZS (Uzbekistan sum) [4]. The capital adequacy ratio is 24,3 %, which is 3 times accepted international standards of the Basel Committee on Banking Supervision [13].

In recent years, high rate of capital growth (124,3 % in 2012) is observed in the dynamics of their gradual decline. This in turn causes a high enough level of capital ratio of the banking system to GDP – 6,4 % in 2012 for the years of 1991–2012, the ratio of capital to GDP ratio of commercial banks in the country did not have a clear positive trend [3]. The reason for this may be due to the higher growth rate of GDP of the Republic compared with the rate of growth of the main indicators of the banking system over the period.

The growth of the total capital of the banking system during the global financial crisis contributed:

- The establishment and improvement of the minimum capital requirements of commercial banks in the euro equivalent (Decree of the President of the Republic of Uzbekistan №PP-726 on November 7, 2007; Decree of the President of the Republic of Uzbekistan №PP-1317 on April 6, 2010);
- Increased capitalization of the six major banks (Uzprostroybank, Agrobank, Asakabank, Kishlokkurilishbank, Microcreditbank, Halkbank) to 550 billion UZS in during 2008–2010, mainly by public funds;
- Providing up to December 31, 2009 in the form of tax credits exemption from income tax for businesses and individuals on the shares of banks, reduction of the taxable base in the amount of funds allocated for the purchase of these shares and the activation of over-the-counter and exchange trading of securities of commercial banks (Decree of the President of the Republic of Uzbekistan №PP-1317 on April 6, 2010).

In addition, one of the factors in evaluating the stability of the banking system is the current liquidity level, which for a number of years was more than 65 percent (in 2012 – 65,5 %). This is 2 times higher than the established minimum level (30 %) [13].

A stable state of the country's banks, increasing confidence in the banking system, as well as real income growth are a strong foundation to attract deposits free cash flow of population and economic entities.

In strengthening the resource base of banks, mainly from domestic sources, commercial banks take action on a wide attraction of free funds of population and legal entities in the banking turnover. Given the demand of the population, now commercial banks offer more than 250 convenient and attractive types of deposits.

As a result, the volume of total deposits of commercial banks in 2000, compared with 1994 increased by 4,3 times, in the period of 2000–2012, and in 2012 increased by 98,3 times which reached 22,8 trillion UZS, which is 31,5 % more than that of 2011 [4].

The growth in deposits at banks contributed:

- The growth of real income and exemption from taxation of interest income from deposits, which contributed to the transformation of deposits into profitable financial instrument (Decree of the President of the Republic of Uzbekistan on April 6, 2009, №PP-1090);

- Providing 100 % government guarantee on all deposits of individuals in banks, which has led to increased confidence in the domestic banking system and the smooth cash flows from current accounts (Decree of the President of the Republic of Uzbekistan on November 28, 2008, №UP-4057);

- Exemption from legal entities in 2009 for a period of five years from the tax on interest income received from the placement of deposits and debt securities of commercial banks for a term exceeding 1 year (Decree of the President of the Republic of Uzbekistan on July 28, 2009, № PP-1166);

- The introduction of differentiated reserve requirements regulations of the Central Bank to corporate deposits from September 2009.

Particularly with high rates household deposits increased, which for the period 1994–2000 increased by 5.6 times, and in 2012 amounted to 8,3 trillion UZS. In 2012, the growth of bank deposits amounted to 34,6 %, indicating increased confidence in the banking system. It is significant that while in 1991 13,8 % of all investments in the country amounted to funds from the public, and then in 2012 this indicator rose to 20,6 % [3].

The share of household deposits in total deposits of commercial banks increased from 12,4 % in 1991 to 36,3 % in 2012, respectively, while the share of corporate deposits decreased from 87,6 % to 63,7 % [4]. Among the constraints to further expand household deposits in banks include the availability of non-bank circulation of cash.

Expansion of the resource base of the banking system of Uzbekistan has increased the volume of loans to the real sector of the economy. During the years of 1994–2000, the volume of credit investments increased 20,1 times over the years 2000–2012 to 33,6 times and in 2012 totaled 20,4 trillion UZS. During 1994–2000, the assets of the banking system increased 13,2 times and in 2012 compared to 2000 of 37,5 times and reached 35,7 trillion UZS [4].

The bulk of these loans were allocated to the investment objectives for the modernization of production, technical and technological renovation, and maintenance on the basis of current technology competitive products.

There have been positive developments in the credit and investment activities of banks. It should be noted that while in 1991, the share of loans granted by commercial banks for more than 3 years of the loan portfolio was 23,9 %, while in 2012 the figure was more than 76,8 % [3].

As of January 1, 2013, the country operated 29 commercial banks of which 3 are by state, 13 by joint stock companies, 9 by private capital and 4 by foreign capital. The total number of banks operating in the country, with 2,6 thousand in 1991, increased to 9,5 thousand in 2012.

Analysis of the results of the 2013 Financial Access Survey conducted by the International Monetary Fund shows that the access to and use of financial services indicators, especially the commercial bank branches per 100,000 adults is 49,7 in Uzbekistan, which is the highest in Central Asia. For comparison, the indicator is 3,3 in Kazakhstan, 1,1 – in Ukraine, 38,2 – in Russia and 11,4 – in India, 9,6 – in Indonesia, 18,4 – in Korea, 19,9 – in Malaysia, 7,7 – in China and 9,8 – in Singapore [7].

The main problems of the financial system include:

1) Despite the fact that the majority of commercial bank loans are long-term (70 %), their capacity to finance the real economy is not sufficient, the share of bank loans and other borrowings in the structure fixed asset investment was 11,4 % [12]. The value of this indicator, for example 27,2 % in Belarus, 12,1 % in Kazakhstan, 13,3 % in Russia and 16,1 % in Ukraine [11]. This indicates a lack of involvement of the banking sector in reproductive processes.

2) Despite the high rate of growth of the main indicators of the banking system, their ratio to GDP remains inadequate, suggesting the need for further scale-up of the sector to ensure sustainable long-term growth.

a) The reduction ratio of banking assets to GDP from 51,6 % in 2000 to 37 % in 2012. By the end of 2012 the share of banking assets to GDP was 79,4 % in Russia, 46,1 % in Kazakhstan and 79,9 % in Ukraine [1]. Also 136,7 % in Korea and 14,2 % in Indonesia [8].

b) Credit investments relative to GDP in Uzbekistan rised 21,1 % in 2012 [3]. By the end of 2012, the share of total credit investments in the GDP was 41,1 % in Russia, 41,8 % in Kazakhstan, 80,2 % in Ukraine, and 152,7 % in China, 168,7 % in Korea, 134,5% in Malaysia, 99,5 % in Singapore, 76,6 % in India and 42,6 % in Indonesia [14]. The reason for the low level of the indicator in Uzbekistan is the rapid growth of GDP and the low level of financial intermediation of banks.

On the two indicators of the banking system in the country has one of the lowest among the CIS countries.

c) Commercial banks have not yet possessed sufficient own and borrowed resources to active and more involved in the investment process aimed at modernizing the economy. The main reason for this is that the ratio of the total capital of the banking system in the country's GDP is still low (6,4 % in 2011). In comparison, by the end of 2012 the figure was 10,1 % in Russia, 6,6 % in Kazakhstan, and 11,9 % in Ukraine [1]. Also 12,2 % in Korea and 6,3 % in Indonesia [14].

3) The presence of non-bank cash turnover also reduces the effect of ongoing monetary policy limits the ability of the banking system to expand lending to the real sector of the economy and restrain the level of financial intermediation in the country.

4) The necessary is to increase the efficiency of the accumulation of surplus funds of the population and their transformation into investment. Despite the dynamic growth of deposits and their role as a source of resources remains at a relatively low level. Deposits from the public in relation to GDP in Uzbekistan were up 8,6 % in 2012 [4]. This figure was 21,2 % in Russia, 11,3 % in Kazakhstan, and 25,8 % in Ukraine [1]. These data are evidence of the existence of substantial reserves to raise the volume of available funds in banks, which requires the implementation of measures to enhance the attractiveness of deposit accounts for the subjects of the economy.

Conclusion. Despite the positive results obtained in the country's monetary area, there are a number of problems and constraints to increase the effectiveness of the monetary policy and its impact on economic processes. Primary is necessary to highlight two important effects of the global financial market on the banking system of Uzbekistan.

First, the relative isolation of the Uzbekistan banks from the international financial markets and the low proportion of their foreign borrowings as compared to other countries, to protect the banking system from the negative processes are taking place in the global financial markets.

Second, which is also a positive character – are systematic and comprehensive measures taken by the Government of Uzbekistan to support and regulate the financial sector. Over the years, the Government has provided significant support to banks during the financial and economic crises. Regulators constantly monitor the banking system. And this experience has a positive effect on the regulation of the banking system – particularly in the sense that any default on foreign loans of banks in Uzbekistan was not, in contrast to other countries.

However, these factors are not a guarantee that the Uzbekistan banking system is protected from risk. Risks exist, and they are connected. First of all, the quality of assets, that is, the financial condition of borrowers and their ability to service the loans. The issue of asset quality could be crucial for the banks in the coming years due to the rapid growth in lending.

In recent years, Uzbekistan, in the framework of anti-crisis program began the transfer of bankrupt enterprises under the control of the banks. But in order to evaluate the real effectiveness of this method of recovery of the real sector, it takes a long time.

Also, there are a number of risks associated with the fact that major trading partners and consumers of goods produced in Uzbekistan are countries whose economies have been more seriously affected by the crisis. However, the situation has shown that the economy of Uzbekistan as a whole is integrated into the global economy, with a lesser degree – the financial sector, and to a greater extent – the manufacturing sector. Therefore, it is impossible to completely nullify the negative effect of the problems that arise in trading partners.

References

1. According to the website of the Central Banks in Kazakhstan, Ukraine and Russia.

2. Bonin, John and Wachtel, Paul. Financial Sector Development in Transition Economies: Lessons from the First Decade. Financial Markets, Institutions & Instruments. New York University Salomon Center, Published by Blackwell Publishing Inc., V. 12, No. 1, 2003, p. 1.

3. Calculated based on the official data of the State Committee of the Republic of Uzbekistan on Statistics. http://www.stat.uz and official data statistics of the Central Bank of the Republic of Uzbekistan. http://www.cbu.uz.

4. Calculated based on the official data statistics of the Central Bank of the Republic of Uzbekistan. Retrieved from http://www.cbu.uz.

5. Fardoust Sh., Kim Y. and Sepúlveda C. Postcrisis Growth and Development: A Development Agenda for the G-20. Washington D.C.: World Bank, 2011, p. 531.

6. G20 Financial Inclusion Indicators. Retrieved from http://databank.worldbank.org/data/download/g20fidata/G20%20Set%20Methodology.pdf.

7. International Monetary Fund: Financial Access Survey (FAS Report). Retrieved from http://fas.imf.org.

8. International Monetary Fund: Financial Soundness Indicators (FSI) 2012. Retrieved from http://www.fsi.imf.org.

9. Information Search System of the National Legislation Database of the Republic of Uzbekistan. Retrieved from http://www.lex.uz.

10. Karimov, I. A. The Global Financial-Economic Crisis, Ways and Measures To Overcome It in the Conditions of Uzbekistan. Tashkent: O'zbekiston, 2009, p. 47.

11. Official data of the National Statistical Committee of the Republic of Belarus. Retrieved from http://www.belstat.gov.by; Kazakhstan Development Institute of Industry. Retrieved from http://www.kidi.kz; official data statistics of the Ministry of Economic Development of the Russian Federation. Retrieved from http://www.economy.gov.ru; official data statistics of the State Statistics Service of Ukraine. Retrieved from http://www.ukrstat.gov.ua.

12. Official data of The State Committee of the Republic of Uzbekistan on Statistics. Retrieved from http://www.stat.uz.

13. Official data statistics of the Central Bank of the Republic of Uzbekistan. Retrieved from http://www.cbu.uz.

14. World Bank Data. Retrieved from http://data.worldbank.org/indicator.