Knowledge Sharing Project

Draft 3

Industrial Development and Export Promotion Policy of Uzbekistan

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Foreword

It is widely recognized that the development gap between the developing and developed countries may be partly attributable to the knowledge gap between the two. Acknowledging this gap, the Korean government has actively supported a number of cooperation programs on sharing Korea's development experience with the other countries to help their economic advancement.

Uzbekistan is one of the closest countries to Korea in view of geographical and economic manner. Compared to other CIS countries, Uzbekistan's economic performance was relatively strong with a modest decline in output by transition economy standards. In the early 1990s, the decline in GDP was estimated to be only half the average of the Baltic states and former Soviet republics. Since 1996 Uzbekistan has experienced steady economic recovery, averaging around 4% of annual growth rate in the following years and 7.7% in 2004. In spite of the above achievements, Uzbekistan is facing challenges that the Uzbekistan government should deal with for a sustainable economic growth and industrial development.

Through the 'knowledge sharing project with the Republic of Uzbekistan, the Korean government has engaged in collaboration with the Uzbek government by offering policy guidance for strategies of developing the manufacturing sector and export promotion in Uzbekistan. With support from the Ministry of Finance and Economy of the Republic of Korea, Korea Development Institute (KDI) has conducted a research work in cooperation with the Center for Effective Economic Policy (hereafter CEEP) of the Ministry of Economy of Uzbekistan.

Moreover, KDI would like to express gratitude to Dr. Kyung-Hoon Lee, project director and Professor of Seoul National University, Mr. Seung Ho, advisor and former ambassador, Dr. Young-Ki Lee, project manager and Professor of KDI School and all the members of the project team. We also thank the researchers of CEEP and numerous Uzbek government officials who willingly spared their time to discuss and share their expertise.

Policy recommendations in this report are based on Korean experiences and thus should be interpreted as the views of outsiders. The responsibility for the opinions and recommendations contained in this report are solely those of the authors.

It is hoped that this project will make contributions to economic development of Uzbekistan. It is also hoped that this will serve as an opportunity to promote mutual cooperation between Korea and Uzbekistan.

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1. Brief Overview of Uzbekistan Economy

a) Transition Economy

Of the 15 Commonwealth of Independent State (CIS) countries, Uzbekistan is the third largest in terms of population at 25.2 million and the fourth largest in terms of land at 447,000 square km.

Since its independence in August 1991, Uzbekistan has followed the so called “Uzbek Model” to bring about a gradual transformation to a market economy while adopting a development strategy aimed at accelerated industrialization using direct and substantial government guidance. The government has played an extensive role in the economy and has been involved in a wide range of economic activities. However, reform progress has been slow.

Although the Uzbekistan government’s intervention in its currency as well controlling of prices and quantities in major industrial sectors enabled the country to avoid the sharp output drop experienced in other transition economies, the country has experienced below average growth in national income and industrial activities in the post-transition period. GDP per capita in 2000 was the third lowest and per capita net FDI is now the lowest among the CIS.[1)]

<Table1> Trend of GDP Growth of Uzbekistan

	2001	2002	2002	2003	2004
GDP Growth, %	3.8	4.2	4.0	4.4	7.7

However, as a result of favorable developments in the world market for Uzbek’s major export items, such as gold and cotton since late 2002, economic growth accelerated significantly in

1) According to a report by the World Bank, “Republic Uzbekistan Country Financial Accountability Assessment,”(2004, p1), the per capita GDP in dollar terms as of 2000 was $2360. However, it has decreased drastically due to the following sharp devaluation of the soum currency.

2004. Uzbekistan's economy recorded GDP growth of 7.7% in 2004 with a sizable trade surplus of US $1 billion, largely due to a 30% growth in exports of cotton, gold, automobiles, and other natural resources.[2)]

b) Reform toward a Market System

It may be the optimum path for Uzbekistan to move toward a market economic system to ignite the creative potential of Uzbekistan's people. To that end, the Uzbekistan government has been striving to make progress in deregulation and liberalization in the areas of financial, foreign exchange, trade, and privatization

Policy recommendations by international institutions such as the World Bank, IMF, EBRD include measures aimed at further liberalization and improvement of the general investment climate. In January 2005, the Uzbekistan government announced a comprehensive reform program aimed at deepening the process of economic liberalization and promoting the rapid growth of the private sector. The reform package includes measures to improve the business environment by enhancing systems for protecting the rights of private businesses. It also seeks to accelerate privatization, financial sector reform, improvement of tax legislation and tax administration.

However, based on Korea's experience in moving toward a market economy which spans over four decades tells us that, despite strenuous efforts, it can not be achieved in a short period of time because it requires time for the market players to learn market principles and also because there are always conflicts of interest among different parties that oppose change and the rule of game.

c) Risk Factors and Constraints

In the early stages of transition, the Uzbekistan economy was supported by the expansion of exports of raw materials and agricultural products. However, with its heavy reliance on exports of low value-added products like cotton, gold, and other natural resources, the Uzbekistan economy may face a limitation in enhancing employment and income level in a sustainable way.

In addition, the Uzbekistan economy is vulnerable to risks associated with adverse movements in the terms of trade due to fluctuations in world commodity prices as well as changes in the weather condition that can impact agricultural production.

2) Uzbekistan Economy, CEEP, June 2005 and "Statement by IMF Staff Mission to the Republic of Uzbekistan,"IMF, March 2005.

d) Uzbekistan's Development Goals and Strategies

The Uzbekistan government has set the following policy goals: raise the income level, expand employment opportunities, and promote social welfare. In order to achieve the economic goals, the Uzbekistan government will seek to pursue strategies aimed at:

- Reforming toward market-friendly system
- Promoting manufacturing and export sector
- Developing high value-added industries

In order to increase employment opportunities and income and to secure sustainable engines of growth, the Uzbekistan government has chosen the strategy of promoting high valued manufacturing and export sectors.

Uzbekistan's policy goal is to develop modern production system to take advantage of the abundant agricultural products or natural resources and produce high-value added export products.

e) Condition for Industrialization

In implementing its industrialization strategy, Uzbekistan has both advantages and disadvantages.

[Uzbekistan's Advantages]

Relative to Korea when it was in the earlier stages of development, Uzbekistan is, in a way, much better positioned to pursue industrialization. The country has many key elements for industrialization already in place such as rich natural endowments, well-educated abundant labor force, and strong industrial base in a few key industries as well.

(1) Experience in key industries

In fact, Uzbekistan has relatively rich experience in key industries such as machineries, metallurgy, natural gas, petroleum, and chemicals since the Soviet period. Uzbekistan exported a substantial amount of machineries including agricultural equipments such as tractors. Currently, manufactured goods such as automobiles and textiles take a lion's share of Uzbekistan's exports.

In this regard, Uzbek's solid industrial experience affords the country a significant competitive edge relative to Korea in its early stage of industrialization when the industrial base was virtually non-existed.

(2) Rich Natural Resources

Korea has to import literally 100% of its energy and raw materials for manufacturing export products. However, Uzbekistan's rich natural resources such as gold, oil, gas, minerals, and cotton may place the country in a substantial competitive edge in the world market for manufactured goods using such domestic resources.

Uzbekistan is now the world's second-largest cotton exporter. Uzbekistan has the fourth largest gold deposit and is the 7th largest gold producer in the world. Its copper deposit is the 10th largest, uranium the 7th largest in the world, and coal deposit the second largest in Central Asia.

Most of the natural resources have been exported, either unprocessed or processed at a low level of value added, thereby weakening the nation's international competitiveness and hindering industrial development and economic growth.

(3) Rich Human Capital Resource

Uzbekistan's 26.9 million population is very young with an average age of 24 years and possesses a very high educational background.[3] Its potential workforce accounts for 50% percent of the population. The well- disciplined, friendly, and industrious work force is potentially a strong base for the nation's industrialization.

General perception is that most of the underdeveloped economies suffer from the lack of naturally endowed resources, and this difference in endowment determines the national discrepancy of income level. Korea's experience, however, attests that regardless of the availability of natural endowments, the speed of economic development can be accelerated by maximum use of the limited resources in most efficient way.

In this respect, although it is suffering from the aftermath of its system transition, the future of Uzbekistan's economy seems to critically hinge on how efficiently the country can mobilize the richly endowed productive resources.

[Uzbekistan's Disadvantages]

Uzbekistan seriously lacks experience in the area of market economy. The country needs a market-friendly legal system and business practices. It also needs entrepreneurship and managerial know-how compatible to the market system.

3) Uzbekistan is one of the countries with highest level of education with the literacy ratio of 99.3%. About 20% of the population received secondary school education.

Furthermore, Uzbekistan requires higher-level production technology, expansion of production capacity including replacement of obsolete production facilities and new investments in the manufacturing sector. Expansion of infrastructure for industrialization is another critical need.

[Geographical Location of Uzbekistan: Obstacle or Opportunity?]

Uzbekistan is located at a key point that connects Asia, the Middle East, and Europe. Uzbekistan was historically at the center of the Great Silk Road. However, the country is as they say “double land-locked” with no territorial waters. This unique geographical location of Uzbekistan is considered as a major obstacle to international trade due to its lack of direct access to sea transportation.

Although Uzbek is land-locked, there are large potential markets nearby such as China, India, Russia, and other European and CIS countries connected by land transportation system. Furthermore, Uzbekistan has an ambitious plan to expand its current roads and railways to rebuild the old Silk Road. In addition, it is participating in a special UN Program aimed at expanding international trade through strengthened cooperation for transition between the adjacent countries[4)].

When these projects are successfully completed, Uzbek will be interconnected with the future potential markets of China, India, Russia and other countries, and its geographic situation of being “land-locked” can be turned into an opportunity to expand international trade. In this regard, rebuilding a modern “Great Silk Road.” will be an utmost task for Uzbekistan for its accelerated and sustainable industrial development.

4) Islam Karimov, Uzbekistan on the Threshold of Twenty-first Century , Korean version, 1999, p186~188

2. Suggestions for Establishing Economic Development Strategy

Basic Directions for Industrialization

The Uzbekistan government aims at advancing the nation's industrial structure, which is primarily centered on industries for raw materials and agricultural products, in order to manufacture high value-added goods utilizing its rich endowment of natural resources and high quality human resources.

In this report, the following basic directions are emphasized for Uzbekistan to vitalize the market economy and achieve economic advancement through accelerated industrial development.

1) Fostering an open market system
2) Vitalizing the private sector
3) Establishing market-compatible institutional settings
4) Expanding industrial infrastructures
5) Promoting small and medium-sized enterprises

The following summarizes the policy recommendations proposed by the team of Korean experts in areas of economic development strategy in general, industrial development and export promotion, macroeconomic management, financial reform, taxation and fiscal expenditure management, and international trade policies.

The policy recommendations are mainly focused on the manufacturing sector development and export promotion based on Korea's experience. Therefore, direct application of the recommendations may require further modification for Uzbekistan in different environment.

2-1. Overview of Uzbek's Development Strategies and Lessons from Korea's Experience

[Reforming the Agricultural Sector]

Considering Uzbekistan's present economic conditions and resource availabilities, the main emphasis of its economic policies needs to be put on the derivation of supply responses. As have been clearly demonstrated in the experiences of China and Vietnam, quick supply responses can be expected with execution of reforms in the agricultural sector with such policy measures as changes of ownership structure, improvement of terms of trade, reduction of heavy taxation, strengthening of farmers' autonomy, and increase of policy supports.

Of course, the reform in the agriculture needs to start with wide distribution of land ownership to farming population. But land redistribution per se will not be enough to achieve an equitable and efficient an agrarian structure, instead it needs to be accompanied by supporting measures such as development of local markets for both inputs and outputs.

Administrative decentralization and commercialization could be two possible ways to achieve this. Also important is the improvement in the terms of trade of agricultural products, which can be achieved by increasing procurement prices, reducing state purchases and eliminating foreign exchange surrender requirements.

[Export Promotion Strategy]

In addition to reforms in agricultural sector, a comprehensive review of present development strategy is also called for. Taking Uzbekistan's economic size and its level of industrialization into consideration, adherence to import-substitution-based policy can hardly be the appropriate approach to achieve successful diversification of its industry. Eventually Uzbekistan has to switch its policy stance toward export promotion, which needs to be executed on a gradual basis with such measures as establishment of export-processing zones (EPZs).

Uzbekistan has had some success in macro-economic management, especially considering the low fiscal deficit and a balanced current account. Under any circumstances, high inflation would involve large economic and social costs. However, for macro-economic management, a transition economy's specific conditions need to be properly considered. In general, the inflation in transition economies are caused by such factors as undervalued exchange rate, large relative price changes, freeing of controlled prices, and wage-pull inflation. In case of Uzbekistan, the wage-pull is less likely due to strict wage controls, but all the remaining factors may be in place. Especially, due to delayed price liberalization and continued state intervention in economic activities, sectoral adjustment has yet to conclude.

Considering this condition, a moderate level of inflation may be admissible. Considering that a number of commodity prices including cotton and wheat are yet to be further liberalized, the adjustment process of these relative prices may easily accompany inflationary pressure. But careful consideration should be paid in the management of aggregate demand not to bring forth a recession.

[Promoting SMEs]

For the derivation of quick supply responses as well as for a successful of system transformation, promotion of small and medium enterprises(SMEs) is one of the indispensable prerequisite. The importance of SMEs lies not only in creation of new industries complementing the production activities of large-sized key industries. They can make great contribution to employment creating new jobs, geographically dispersed. Compared with key industries with large-sized firms, SMEs generally requires relatively less amount of capital, which implies that they can generate swift supply response.

The improvement of the business climate needs to be enhanced by simplifying licensing procedures, removing government control over bank deposits and cash withdrawals, providing business services and training, supplying information on market conditions or opening up new trading routes and helping to provide tailor-made loans and supporting services. For manufacturing SMEs, the policies adopted by Korea in the early 1980s can be a reference.

In addition to adopting legal and institutional arrangements for promoting SMEs, setting up a long-term plan with clear policy objectives may be the best policy tools which establish consistency in polices. Furthermore, other important policies include establishing a system to disseminate technology and information, providing HR training services for SMEs, and encouraging cooperative relations between prime contractors and subcontractor, etc.

[Establishing Special Industrial Zones]

In fact, a number of East Asian countries have successfully achieved a gradual shift from import-substitution export-based industrial zones with EPZs policies. The importance of the zone is not confined inside of the zone. The efficiency gains outside the EPZ is to be generated by backward linkages, reflecting the existence of technology spillovers through FDI. The development of human resources and technology spillovers through foreign multinationals provided a basis for development of domestic firms.

To attract investments in export processing zones, provision of fiscal and financial incentives such as lengthy tax holidays with minimal restrictions in terms of profit repatriation and foreign exchange controls are basic requirement. Also, the provision of quality social infrastructures is a prerequisite in attracting FDIs.

Development of EPZs can be an efficient way to promote exports, but it can take some time for the desirable effects of the policy to materialize. That is why domestic industrial policies based upon market protection may well be in place for the time being. But these target industries should not be selected by government’s discretion. Rather, the choice should be made on an industry level, not on a firm level. Additionally, even though domestic markets may be protected from imports, a competitive environment needs to be created.

The industrial zone can be specialized for the small and medium-sized enterprises (SMEs). The SME-specialized industrial zone can achieve multiple purposes of SME promotion, export promotion through the enhanced productivity and competitiveness from the scale and scope economies obtainable from the industrial sites. For that purpose, plant sites, transportation system, electric power, water, telecommunication, environmental processing facilities should be supplied to the firms in the special zones on the long-term, low-cost basis.

In addition, agencies for import & exports processing, institutions specialized in the gathering and supply of the information on foreign markets and technologies, financial institutions, vocational training institutions, R&D facilities, logistics center, medical center, housing facilities for workers, and other welfare facilities should be provided within the industrial zones.

Most importantly, a maximum degree of freedom should be allowed to the firms in the special industrial zones with regard to the business license, investment, financing, repatriation, export and import activities, foreign exchange transactions. The liberal business environment of the special industrial zones greatly enhance not only the SME business activities but also FDIs which will bring new capital, technologies, and managerial know-how to Uzbekistan.

Uzbekistan is preparing for the accession to WTO in the near future. Once accepted as a member of WTO, Uzbekistan will face much restriction in employing the desirable policy tools for industrial development. Therefore, it is desirable for Uzbekistan before joining to WTO to take an advantage of a greater degree of freedom in providing government supports aimed at promoting domestic industries and export sectors.

2-2. Industrialization and Export Promotion Strategy

[Uzbekistan's Manufacturing Sector]

Although Uzbekistan has been performing well in terms of macroeconomic development and BOP level, its manufacturing industries remain quite weak. Export performance in the manufacturing sector has been rather disappointing compared to that of natural resources such as cotton, gold and gas etc. The share of manufacturing sector in GDP remains around 17%.

Uzbekistan's manufacturing sector seems to be less competitive due to various causes. Firstly, many production resources (financial and human) are allocated inefficiently to the manufacturing sector especially light industries. Secondly, there seems lack of effective incentive systems for export business. Thirdly, the start-ups of new manufacturing business in Uzbekistan seem to be very much constrained due mostly to the lack of capital for investment, technology, and favorable infrastructures such as appropriate industrial sites. Excessive regulations and direct and indirect costs associated with business activities are also working as preventive against freer and profitable business activities.

However, Uzbekistan's great potential for industrialization is in its affluent and well-educated labor force, rich natural resources, and solid industrial experience in the aero, machinery, and chemical sectors. The country's industrial potential will be further strengthened when market principles and mechanism are respected and a more free entry and exit of businesses are allowed.

[Policy Recommendations for Industrial Development]

Based on Korea's experience in industrial targeting, it is advised that, rather than targeting specific industries for development, the government should allow the market to identify competitive industrial sectors based on comparative advantage.

However, manufacturing and export sectors can benefit greatly from rather simple but well designed support measures including:

- increased financial availability from organized financial institutions,
- favorable tax and tariff arrangements
- strengthened infrastructure for industrialization
- strengthened nation-wide R&D base
- establishment of industrial bases and free export zones

The Uzbekistan government needs to apply effective trade promotion policies by introducing financial assistance for manufacturing exports, especially in the SME export sector. Secondly, Uzbekistan may consider the Korea's "sequencing" in its industrial development, starting from labor intensive industries (taking advantage of relative abundance of cheap and well-educated labor) and creating industrial demand for the next generation industries (heavy and chemical industries).

The government should consider changing their strategies to develop industrial complexes either near big cities or along the major transportation axes.

"Entrepreneurship" should be enhanced by the government. In order to help SMEs to start their businesses, the government should introduce a financial system that can give them more privileges such as preferential allocation of bank lending for SMEs, credit guarantee system for SMEs.

In order to secure the necessary financial resources, the Uzbekistan government may consider borrowing from international financial institutions. To obtain their support, the government needs to prepare a reasonable plan that lays out a roadmap for industrial development and trade promotion. By the same reason, Uzbekistan should be able to induce necessary FDIs by creating a favorable business environment.

In order to help foster new SMEs, it might be useful for firms to seek out technical alliances with foreign counter parts. In order to assist SMEs' overseas marketing efforts to promote exports, the Uzbekistan government can strengthen or introduce trade promotion bodies like Korea's Trade Promotion Association (KOTRA) and the General Traging Companies(GTCs). These institutions will greatly help private firms, especially SMEs with limited capability in marketing and information gathering to explore foreign markets.

[Precautionary measures]

Some of the policy measures adopted by Korea in the earlier stage of industrialization may not be directly applicable to Uzbekistan in light of the strengthened trade regime under the WTO to which Uzbekistan is seeking entrance in the near future.

Under the WTO, government support for specific industries is no longer allowed or subject to countervailing actions by foreign governments. This does not mean, however, that the government should completely not promote market and resources allocation. Under the WTO, the government can play the role of facilitator to enhance industry-wide competitiveness.

Such form of government support can come in the form of non-discriminatory and functional ones to encourage private investment in R&D and human resource development to strengthen the country's industrialization capacity.

2-3. Macroeconomic and Financial Policies

[Mid-term Planning]

In order to promote manufacturing and export sectors, the Uzbekistan government may consider to introduce very comprehensive and coherent development plan like Korea's Five-Year Economic Development Plan. It contained the macroeconomic projections based upon the target level of the growth and required capital formation and the financing plan.

The emphasis has been placed on predicting domestic saving, current account, and the external financing. To make the plan credible and facilitate external financing, the Economic Planning Board complemented the macroeconomic projections and the financing plan with the detailed policy set in Korea.

[Investment Policy]

The targeting of growth and investment presupposes the active government intervention in the market. Such an activist policy can justified when there is serious market failures that hinder investments and the public investment has the significant positive external effects.

In this regard, active public investments in social infrastructure such as industrial complexes, transportation and telecommunication systems, research and development, and human capital can be justified.

[Sound and Stable Macroeconomic Management]

The macroeconomic stability based upon the sound monetary and fiscal policy is an ingredient of success in achieving a high growth through increased savings, investments, and lower inflation. Policy of maintaining the corporate saving high and stable is also crucial for high investment under capital market imperfections.

However, there will always be conflicts between the expansionary policies favoring investments for industry promotion and the policies to secure macroeconomic stability. For the policy makers in the developing economies, it is an utmost task to strike a balance between the two. To this end, a carefully designed overall economic management is needed and the mid-term plan mentioned earlier may be effective as a comprehensive framework for economic management.

[Financial Reform Policies]

The financial intermediation is still immature in Uzbekistan and cash restrictions and tax enforcement are placed on the bank accounts. The banking system should undergo a major structural reform to intermediate financial resources between the surplus and deficit units.

The capital market in Uzbekistan needs to be strengthened not only to diversify corporate financing sources, to enhance the efficiency of financial intermediation, and to facilitate privatization of the state owned enterprises, but also to provide the savors and investors with opportunity to diversify risk exposure.

Uzbekistan can learn from the Korean experience that the greater the role of government in the financial market, the less efficient the national resource allocation and the greater the moral hazard problem in corporate financing and investment behaviors which may ultimately lead to weak corporate and financial structure fragile to external shocks.

2-4. Taxation and Fiscal Expenditure Policies

Judging from the relatively lower ratio of government expenditures to GNP in Korea, one may conclude that the role of government in Korean economic development was small.

However, the effect of fiscal and tax policies on Korean economic growth was much great than that suggested by the simple budget/GNP ratios. In fact, Korean government had supported industries to promote economic growth through the active fiscal management and tax incentives.

It should be noted that the lower tax burden on the private sector thanks to the lower tax ratio and the various tax incentives had greatly contributed to the growth of Korean industries and economy during the earlier period of economic take-off.

There have been various tax incentives in Korea. The most important among them are special depreciation, investment tax credit and tax free reserves. A tax holiday was extensively used until its abolition in 1981.

The Korean government has maintained a strong fiscal discipline for more than four decades. All line ministries are expected to spend within the limits set by the National Assembly through the appropriation process. All government borrowings should receive prior authorization from the National Assembly.

Korean government established the principle of “Expenditure within Revenue,” or the balanced budget principle. It acted as self-discipline imposed on the budget authorities against imprudent management of the budget. This principle kept the public debt to a minimal level and indeed became a ground for the fiscal soundness. This stern and rigid government stance to the budget deficit results in a very sound fiscal balance as long as the general account of the central government is concerned.

Korean experiences of the government role in the economic development cannot be directly applicable to other countries such as Uzbekistan with different economic environments.

Nevertheless, some policy lessons for Uzbekistan can be drawn from Korean experience:

- Maintaining the fiscal balance,
- Maintaining the budget size and tax burden ratio at the current level,
- Streamlining the expenditure structure with the particular emphasis on the SOC investment,
- Streamlining the tax system and tax administration
- Cautious but active use of tax incentives particularly for the FDI and SME’s.

[Restructuring the fiscal expenditures]

For the fast development, provision of the SOC is vital. In this respect, the importance of the SOC cannot be underestimated in case of Uzbekistan. Uzbek government should try to increase the share of the SOC investment in the fiscal expenditure. Government may be able to increase the SOC expenditures by tapping the increased budgetary room made available from the enlarged size of budget due to the economic growth. In doing so, much caution should be given so as to keep the fiscal balance.

[Reforming the tax system]

As recognized by the Uzbek government, excessive tax burden may block vitality of the private sector, thus hindering rapid economic development. Therefore, strenuous efforts should be made to lower the tax burden on private sector ratio to the current level.

The current system of taxing on the use of natural and water resources and the personal income tax brackets need to be changed for enhaced efficiency and fairness.

The current system of collecting corporate taxes by debiting from the company's bank accounts needs to be changed if Uzbek government intends to facilitate private business activities by allowing them greater f freedom in liquidity management. Such change will not only improve the private business climate but also allow more resilience in bank management. The efficiency of tax collection can (should) be improved by strengthening the tax administration.

[Utilizing tax incentives]

Korea relied much on the tax incentive measures in the development. It seems that various tax incentives are actively used Uzbekistan. There are caveats for this, however:

First, tax incentives sometimes do more harm than the benefit. The distortion of the resource allocation caused by tax incentives may be bigger than expected. Therefore, although the active use of tax incentives is necessary, the abuse should be avoided.

In addition, Uzbek's choice of tax incentive system may be much restricted by the WTO regime when Uzbekistan get access to the WTO in the future. However, without subject to the WTO regulation, the incentive schemes can be utilized to promote the manufacturing and export industries can be applied to induce FDIs and for the small and medium sized firms which are greatly desirable in Uzbekistan.

2-5. Harmonization of Industrial Policy and Trade Liberalization

The Uzbekistan government should furbish various institutional and legal systems to implement and support industrial development policies. Although the experience of the Korean government may shed some important light to provide useful policy implication, it is also very important to recognize that the underlying economic circumstances, especially the world trading system, were vastly different from those of the Uzbekistan government.

In that regard, the foremost important point is the establishment of the World Trade Organization (WTO) that has substantially strengthened the disciplines for government policies in relation to international trade. In other words, the Uzbekistan government is facing a much more complicated and rule-based trading system than the Korean government did throughout its development periods of 1970s to 1980s.

Moreover, the Uzbekistan government is currently in the middle of negotiation for the WTO accession. Therefore, many parts of the experience by the Korean government in terms of trade policies should be translated into the updated strategies under the WTO context.

The institutional development is imminent not only to support domestic industrial development programs but also to effectively prepare the market liberalization through the WTO accession. The institutional development should be undertaken in two dimensions: 1) preparation and elaboration of the legal system and 2) organizational restructuring for trade policies.

As regards enhancing the legal system for trade policies, trade remedy systems should be sufficiently augmented so as to be implemented to protect import markets in a manner consistent with the WTO disciplines. The Uzbekistan government should adopt and improve trade facilitation measures to reduce costs involved in international transactions particularly as a double land-locked country.

To properly implement various economic partnership agreements with other CIS countries while not incidentally injuring domestic industries by circumvention of third countries' exportation, the Uzbekistan government should also establish detailed rules of origin systems.

Organizational restructuring for trade policies requires more specific delineation of jurisdictions and authorities of different governmental bodies. Trade policy implementation in particular and economic policy implementation in general require efficient and effective capacity building mechanisms to deal with constantly changing global economic environments.

For more specific policy measures, there are several issues to be considered in the context of WTO accession negotiation. A non-market economy status should not be accepted to avoid unnecessarily disadvantageous treatment in terms of anti-dumping actions. The Uzbekistan government should clarify in the accession negotiation how much benefit as a transition economy would be guaranteed for itself. The Uzbekistan government also needs to consider the preparation of trade adjustment assistance (TAA) program.

In terms of actual government support measures for exportation, the Uzbekistan government should consider the preparation of export financing programs or tax exemption. But, legal obligations under the WTO Subsidy Agreement should be considered for implementing these kinds of supports.

Lastly, establishment of free export (processing) zone where relevant companies are strategically gathered to take advantages of positive externality and economies of scale can be an efficient policy tool to promote economic environment for exportation. In general, this policy is WTO consistent because it does not violate any particular provision or obligation under the Subsidy Agreement.

3. Other Lessons from Korea's Development Experiences

[Fostering an open market system]

One view of Korea's economic miracle, and East Asia's economic growth in general, stresses taking a market friendly policy stance and the relative openness of the foreign trade sector. According to this view, an open economy that is integrated with the world is likely to have access to foreign markets, capital, and managerial and technology know-how.

Compared to the advanced countries, Korea had premature market systems. It should be mentioned, however, that one of the key success factors of Korea is that it had a far more market-friendly economic system and incentive structure than any other developing or less developed countries.

The quality of institutions and the openness of the economic system explain better the performance of East Asian countries. Good institutional settings compatible with the market principles will promote business activities in most efficient and competitive ways. An open economy increases competition in its domestic market and forces domestic producers to follow market signals and to increase efficiency and productivity to increase profitability.

This makes a substantial difference between Uzbekistan and Korea. Korea's economy is more based on a market system compared to Uzbekistan in transition from the previous socialist regime. Korea's government-led development strategy in the past was based on a market economy and private incentive system. Although the government outlined an economic development plan or established export targets, business decisions for production, investment, employment, procurement, and so on were totally left to the private sector.

The appropriate government role for the rapid growth is to provide a competitive climate for private enterprises, keep the economy open to international trade, and maintain a stable macro economy. The structural reforms and competitive pressure matter most for the investment climate and economic growth of Uzbekistan. The foreign exchange liberalization, removal of foreign trade barriers, price flexibility, banking sector reform, support of private investment and entrepreneurship, transparency seem to be utmost task for Uzbek government to build business-friendly environment

Although striving to move toward a market system, Uzbekistan still seems to exhibit remnants of past socialist regime, thus hindering innovative production activities in the private sector. It is, therefore, an utmost task for the Uzbek government to introduce and expand market elements and principles, thereby increasing private initiatives in production and investment.

[Fostering the Manufacturing Sector]

Interestingly, it seems generally perceived in Uzbekistan that people prefer the trading businesses to the manufacturing business, and this works as an obstacle to the development of the manufacturing industries.

Such preference of Uzbek people toward merchant activity might be deeply rooted in the nation's old tradition since the period of Silk Road. However, more important cause of people being less inclined toward manufacturing could be rooted in Uzbekistan°Æs unfavorable environment against this sector.

For example, manufacturing businesses require much more capital investment, production technology, and managerial know-how than commercial businesses. In addition, if there is more regulation, obstacles, and/or uncertainties associated with manufacturing, it will be less attractive.

Many lower-quality clothes and other manufactured items are imported (or smuggled) and sold in bazaars. It seems that, although these items could have been domestically produced at comparable prices and quality, imports are widespread since it is more profitable than producing it domestically.

However, the potential for manufacturing can be found in the streets of Tashkent where many small-scale shops are actively engaging in manufacturing products. This observation may indicate that the manufacturing business will be rapidly growing in Uzbekistan once favorable business environment is provided.

To promote manufacturing, Uzbekistan needs to make domestic production of these items more profitable by making it easier to start up new businesses, to mobilize required capital, and to introduce new technologies and managerial know-how.

At an early stage of industrial development with limited domestic resource and little experience in market economy, it seems inevitable for Uzbekistan to rely more on foreign sources of these production factors. It seems, therefore, that an aggressive inducement of foreign direct investment will be necessary and would greatly contribute to this end.

[Lessons from Korea's Heavy and Chemical Industry Drive]

During the 1970s, Korea had pursued extensive promotional policy for the heavy and chemical industries (HCI) such as machineries, shipbuilding, automobiles, and petro-chemicals. The "Big Push" for HCI needs two conditions of scale economies in production and an elastic supply of labor to the modern sector to yield external economies.

However, Korea's HCI-drive policy is really controversial. Although the policy have resulted in higher growth during the period and formed a base of the current industrial deepening, it caused, at the same time, various distortions including hyper-inflation, unbalanced growth, and concentration of economic power in a few business groups.

Learning from the costly lesson of the HCI drive, Korean government made a fundamental shift in the economic policy since the early 1980s from the industrial-targeting strategy to liberalization policy which was to respect market mechanism economic activities including investment, resource allocation, foreign trade, and financial transactions.

[The Limit of Government Role]

When the market is immature, the government can play an important role not only in promoting a well-functioning market by introducing market-compatible institutional settings but also in resource allocation via coordinating role of the government.

One can learn from the Korean experiences that such coordinating role may degenerate into the collusion between the political circle, government, and the business. To prevent the deterioration of the coordinating behavior, Uzbek government should develop institutional structures aimed at fostering the so-called the "contest-based competition" in which firms competed for economic rewards, such as access to credit based on the economic performance.

While the government may play an active role in promoting social infrastructure when the market failure prevails, its role should be limited to a rule maker and a referee rather to make the market fair and competitive.

[Moral Hazard Problem]

As witnessed from Korea's experiences, government support of targeted industries or firms or frequent bail out of the troubled firm may induce serious moral hazard problem.

Under the belief that the government would bail them out in case of financial distress, many big Korean firms pursued excessively aggressive business activities in investment and financing.

In order to obtain government subsidy given based on export or investment volume, Korean firms used to undertake even unprofitable investment projects or to rely excessively on debt financing. Such pervasive corporate behavior led Korean firms to economically and financially non-sustainable situation, which ultimately caused the economic crisis in 1997.

It will be a challenge for the Uzbekistan government to provide support through incentives and subsidies to promote industries and export sectors without causing similar moral hazard problem in the business sectors.

The moral hazard problem can be minimized by strengthening the discipline that the troubled firms are restructured or liquidated rather than being bailed out by the government.

[Enhancing the Role of the Think Tanks]

From the early period of economic development, Korean government established many government research institutes. The Korea Development Institute (KDI), the leading economic “think tank” in Korea, was established in 1972 by the government to support the nation’s economic policy making and implementation[5)].

The need for government think tanks in Uzbekistan may be no less than that in Korea since it is in a critical transitory process toward a market economy. The recent reorganization of government research institutes will greatly strengthen the role of think tanks in Uzbekistan. However, greater efforts may be necessary to enhance their leading role and function by further strengthening their policy research capacity.

Based on Korea’s experience, the scope and depth of the role and function of government think tanks should be significantly affected by how higher level policy makers are determined to fully utilize them in identifying national agenda, outlining a vision, and formulating necessary policy strategies.

Furthermore, close co-operation and on-going policy consultation with foreign economists or research institutes, and international organizations will greatly enhance the research capacity of think tanks. Their views sometimes work as a very persuasive and neutral opinion on some politically controversial issues stemming from a conflict of interest among vested interest groups.

[Expanding Economic Statistics]

In socialistic economy, the central government’s economic plan is based on information produced by and retained within the government. Other production and distribution units simply follow orders from the planning authorities.

5) The KDI was established as an independent body. While working closely with the government, KDI has maintained its autonomy and objectivity in the policy research activities. Its separate budget allows KDI to be able to recruit qualified and committed researches by offering them very attractive incentives.

However, information is the key element in the market economy allowing private businesses to make investment, production, and sales decision efficiently and effectively. Without the relevant information readily available, market participants may not be able to make the best business decisions.

In this regard, Uzbekistan seems to seriously lack information available to the market. Much of the necessary information and/or statistics are not produced or retained within the public sector. Some of the statistics produced by the public sector are not available to the general public. Some available information is inadequate for market economy. In this regard, creation and expansion of necessary information is an imminent task for Uzbekistan in order to have well-functioning market mechanism.

[Saemaul Undong and Spiritual Reform in Korea]

From a historical perspective of Korea's economic success, the Saemaul Undong should be given attention in regards to its contribution to changing the public's way of thinking and behaving. Prior to the 1970's, Korea's rural sector had suffered from sluggish development and income growth relative to the urban sector. Improvement in agricultural productivity was slow relative to the industrial sector.

In such situation, the "Saemaul Undong (New Village Movement)" was initiated by former President Park Chung Hee in the early 1970s to modernize rural areas. The Rural Saemaul Undong was a movement of loving our country and people, sacrificing private interest and devoting ourselves to the welfare of the nation. The aim of the programme was to achieve stability and prosperity through hard work and cooperation. Rural Saemaul Undong was dedicated to rural development and matched the desire of the rural population for a better future. The goal of Rural Saemaul Undong was to improve the living environment, to change old ways of thinking, to raise the income level, and to modernize the pattern of living in rural areas[6)].

The essence of Saemaul Undong was to promote cooperative development efforts among villagers, guided by competent and highly motivated village leaders (called Saemaul leader) with government aid through technical and financial assistance and the training of the Saemaul leaders.

Three main principles of the Saemaul Undong were Diligence, Self-help, and Cooperation. While the Saemaul Undong was based on the spirit of "self-help" by the villagers, the government provided required materials such as cements, reinforcing steel, etc.. Examples of Saemaul Undong projects included raising of livestock, improvement of agricultural technology, cultural and welfare projects. After the remarkable success of the Rural Saemaul Undong, the movement was spread all over the country and "Factory Saemaul Undong" at

6) Myungsuk Lee, Korean Rural Development Movement, Saemaul Undong, mimeo, April 28, 1990

enterprise level became widespread.

The Saemaul Undong provided a turning point in changing the public's way of thinking from pessimism or defeatism after the Korean War to a mind of "잘 살아 보세(Let's work harder to be better-off)." Until the mid 1980s, the Saemaul Undong became a driving force to change the way of thinking and working in Korean society. In this regard, the Saemaul Undong should not be overlooked in evaluating Korea's economic miracle.

Chapter 1

Uzbekistan's Development Strategy and Lessons from Korea's Experience

1-1. Introduction

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Chapter 1

Uzbekistan's Development Strategy and Lessons from Korea's Experience

Il-Dong Koh
KDI

1. Introduction

1-1 Forward

Among the republics of the former Soviet Union, Uzbekistan has demonstrated one of the most successful cases in riding out the initial shocks from independence, as well as, the subsequent system transformation. Compared to other CIS countries, Uzbekistan's economic performance has been relatively strong with a modest decline in output by transition economy standards. In the early 1990s, the decline in GDP was estimated to be only half the average of the Baltic states and former Soviet republics. Since 1996 Uzbekistan has experienced steady economic recovery, averaging around 4% of annual growth rate in the following years and has become one of the first countries to overcome the decline of production among the CIS countries.

Despite a generally positive relationship between the extent of liberalization and economic performance, Uzbekistan has been an outlier showing the best output performance among former Soviet republics. The Uzbekistan model of gradual economic reform has offered support to many opponents of "shock therapy," while creating a "puzzle" for advocates of rapid economic transition. Uzbekistan's success is largely due to its heavy reliance on the production of raw materials such as gold and cotton, which are relatively easy to export to non-CIS markets. Also, Uzbekistan's relatively lack of industrialization during the Soviet era might have been another factor that helped to prevent a decline in production after its independence. It may also be attributable to Uzbekistan's unique path toward system transformation, as well as, its efforts in pursuing self-sufficiency in energy and staple grain.

In spite of Uzbekistan's successful recovery from the initial shocks from independence and system transformation, there were a number of side-effects. For instance, its upturn was not as dramatic as other neighboring countries, which had gone through more thorough and fundamental reform. Uzbekistan's import-substitution policies, which were urban-based capital-intensive and favored large-sized enterprises, led to some problems in the promotion of SMEs, as well as, private entrepreneurs and the agricultural sector. Other factors such as over-dependence on cotton and gold export, which are affected by fluctuations in world prices, also suggest a re-examination of the present development model. There might arise certain constraints in the sustainability of the present pattern of growth unless the current import substitution strategy is redressed and more market-oriented economic reforms are actively pursued .

Also, the role of Uzbekistan's government needs to be realigned. Though direct government control created a more stable environment for the economy, which faced serious interruptions after separating from the Soviet division of labor, the slow moving reform process did not create a favorable environment for promoting new private enterprises or entrepreneurial activities in general. Considering these constraints and limits, the time has come to reconsider the current policy approach in order to realize the potential for a faster and broader-based growth.

This paper examines Uzbekistan's development model with comparison of that of Korea. Of course, the initial conditions of the two countries at the early stage of development are quite different such as natural resource endowment, geographical situation, domestic political system as well as international relations. But there are still a lot of areas where policy lessons and implications can be drawn from the experience of one country. Especially, Korea's export promotion policies at the early stage of its economic development process have a certain amount of bearing on Uzbekistan, which needs to switch from the import-substitution to export promotion to broaden its long-term growth potential.

1-2 Historical Review of Uzbekistan's Economy

Uzbekistan as part of the Soviet Union was born out of a feudalistic society, which was economically and socially backward relative to other European parts of the Soviet Union. During the Tsarist era, large parts that constituted present Uzbekistan remained under the direct rule of autocratic vassals. Tashkent was always developed to be an urban center and to become the administrative and industrial center of Central Asia. The rest of the remaining parts of the country were overwhelmingly rural except such regions as Bukhara, Samarkand and Khiva. A mixture of low density herding and farming existed in much of Uzbekistan, while high density mixed farming existed in the Fergana Valley (Pomfret, 1999).

With its accession to the former Soviet Union, Uzbekistan's economy had been integrated into the Soviet's regional division of labor to meet the Soviet's common market needs. On the whole, Uzbekistan's main role was to supply primary products, especially cotton. Specialization in cotton became particularly pronounced in the decades following 1960 when the areas for growing cotton were expanded and mechanization of cotton farming was pursued.

In spite of Uzbekistan's proven reserves, other primary products, such as minerals or energy products were not developed during the Soviet era. Also, over-concentration in cotton production led to a decline in grain production to the point where Uzbekistan became reliant on food imports from other parts of the Soviet Union. However, the rapid expansion of the cotton sector began to show diminishing returns in terms of output per hectare as well as creating huge environmental problems, highlighted by salinization of large areas and shrinking of the Aral Sea. Due to excessive mono-cultural cultivation of cotton, Uzbekistan had to import a large part of consumer products, machinery and equipment from other republics of the former Soviet Union. Following independence and separation from the Soviet division of labor, Uzbekistan needed to diversify its economic structures, and also to redress the problem of mono-cultural farming.

Uzbekistan has mainly had a rural economy and a limited modern manufacturing base. Its industrialization began in the middle of the World War II, since it was geographically distant from the battlefront in the European continent. Several key industrial plants were moved from western parts of the USSR to Uzbekistan between 1941 and 45. In the postwar period, Soviet planners that favored building upon existing strengths tended to locate new industrial projects to Uzbekistan, especially in and around Tashkent, to take advantage of existing production facilities and relatively well-developed social infrastructure as well as better living conditions. Consequently, Tashkent has become the center of politics, culture, as well as industry in Central Asia.At the time of the Soviet Union's breakup at the end of 1991, Tashkent was the fourth largest city in the USSR with a population of around two million and the only real metropolis in Central Asia.

Ethnically, Uzbekistan has been relatively less diverse, having a much smaller proportion of ethnic Russians among its total population compared with Kazakhstan.[7)] But the Slavic minority tended to hold technical positions in urban areas, and thus, enjoyed higher economic status. This, however, does not necessarily indicate that it has been a result of discrimination against Central Asian ethnic groups, but rather due to their preferences for traditional lifestyle and consumption patterns, with greater opportunities to supplement income through home production and informal activities.[9)] Since independence, Uzbekistan has been trying to maintain distance from Muslim fundamentalists in an effort to prevent ethno-religious conflict at the border.

Prior to its independence, the standard of living in Uzbekistan was much lower than the average among former USSR republics.[9)] In 1990, about 70% of the population had a total income per capita lower than the minimum for subsistence. In Russia and Ukraine, the corresponding figure was about 30%. However, due to the socialistic legacy as well as Muslim tradition, income distribution does not seem to have been uneven compared to other developing countries. But the regional disparities in cash income and living standards have been quite noticeable between Tashkent and other region.

7) In Uzbekistan, ethnic Uzbek accounted for about 71% and Russian was only 8 %, while in Kazakhstan the proportion of Kazakh population was 40% and Russian was as much as 38%.

8) There are some indication that local nationalities had greater opportunities to pursue education and training, but they often chose to work in lower paid and lower prestige service and agricultural sectors (Lubin, 1984).

9) See UNDP and CER (2005-II).

2. The Transition Process and Development Strategy of Uzbekistan

2-1. An Overview of System Transformation

Generalizing the optimal process of transformation is not easy, largely because every country is different, and so exhibits different initial conditions. The initial conditions of an economy in transition involves, at least three aspects. The first one is the country's economic structure, such as industrial structure, degree of urbanization and avaliable natural and human resources. The second factor is legal and institutional aspects that can foster an effective market economy and allows the functioning of factor and product markets as well as capital markets. The third one is the macroeconomic situation, such as the extent of monetary overhang, fiscal deficits and indebtedness. Of course, there are various other non-economic factors that affect the process of transformation. Especially, important are the domestic and international political situation, as well as social traditions, ethnical composition and a society's system of conflict resolution.

With these given initial conditions, market-oriented reforms in the context of system transformation can be separated into two stages (Linn 2005). The reform measures in the first stage include macroeconomic stabilization, price liberalization, trade liberalization and the privatization of SMEs. These reforms can be implemented fairly early in the transition process, while leaving those reforms that take much more time to implement for the second stage.

The second stage generally requires the implementation of reforms that build new institutional capacity through complex transactions or politically difficult measures. This includes privatizing large state-owned enterprises that are strategically significant to the national economy, enforcing property rights, creating an effective legal and judicial system and public administration, opening capital markets and introducing social safety nets. Based on these reform measures, a steady development of competitive enterprises and financial organizations can be expected. In pursuing these policy objectives, political reform as well as external financial support from international financial institutions for example, is needed.

The general observation on the economic performance of transition economies of former Soviet Union or Eastern Europe has been that the more extensive and rapid the reforms, the faster and stronger the recovery. Even if the initial recession may be deepened after taking a "shock therapy" approach, the foundations for building a market-oriented economic system has been laid by the reforms. To be sure, the initial conditions are critical in determining the economic condition as well as the adoptability of reforms at the initial stages of transformation. However, its impact on the economy would gradually diminish.

Though general consensus regarding the inter-relationships between the speed of transformation and the dynamics of economic recovery can be found, it is not easy to find any agreement on the appropriate speed and sequencing of reforms. It has become apparent that some of the countries in Central Europe and from the former Soviet Union erred in quickly pushing ahead their implementation of reforms during the initial stages, while not considering their specific initial conditions. For countries that were not historically based on a market economy and democracy, taking the approach of shock therapy would easily lead to serious economic chaos and social disorder for an extended period.

Accordingly, China is quite often referred to as a successful case in which the speed of transformation has been more measured and deliberate. Vietnam is also frequently mentioned as taking a more gradual approach. But the question still remains open whether a country with a more highly industrialized economic structure can be successful at controlling the speed of reform, taking consideration of the inter-dependent nature of its industrial structure.

On the whole, Eastern European and former Soviet Union countries have experienced a more complex transformation process compared to East Asian countries, such as China and Vietnam. That is, these countries have experienced transformation in three different areas simultaneously, including transitions in their economic and political system, and changes in the range of their economic activities. In transitioning from a socialistic economic system toward a market-oriented economy, changes in their political system were simultaneously pursued by CIS and Eastern European countries. Moreover, as the CMEA and Soviet division of labor were broken up, their economies integrated into the international division of labor or at least at the regional level fairly rapidly. Compared with these countries, transformation in the political system or changes in the international division of labor were either very limited or non-existent in both China and Vietnam. Obviously, this played a decisive factor in allowing East Asian countries to manage the speed of economic system transformation.

Compared with CIS countries, Central European countries such as Hungary, Poland, Czech were characterized by better initial conditions. The initial shocks that came from the existing division of labor both domestically and internationally were less severe for Central European countries than those of CIS countries. Moreover, their historical ties to Western European countries allowed these countries to integrate into the international division of labor much more efficiently. Further, there was less conflict arising from the political transformation, since partial reforms were already implemented during the pre-transformation period. Also, international financial institutions (or IFIs) provided extensive financial and technical support early in the transformation compared to CIS countries. Some countries in Central Europe were able to promote SMEs taking advantage of existing private sectors which had been preserved under their less strict socialistic economic system. Another aspect of their success has been their ability to attract large amounts of direct foreign investment ahead of their eventual accession to EU.

The CIS countries, in addition to having worse initial conditions, faced a much stronger negative impact from disintegration. Especially, the smaller CIS countries were hardest hit.

Their industries and agriculture were cut off from supplies and markets. Their transport links suffered disruptions and their subsidies from Moscow were cut off. They had to introduce new currencies and new governmental structures and in many cases they experienced civil war or cross-border conflicts. In addition, with their geographic situation of being land-locked and distant from markets, the small CIS countries faced the greatest challenge integrating into the world economy. The large CIS countries, Russia and Ukraine, also encountered great difficulties from disintegration and subsequent integration, but in lesser degree than the smaller countries, given their size and access to external markets.

A country's initial condition is a critical determining factor at the early stage of system transformation, but it becomes a less significant factor as transformation progresses. Linn (2005) draws a very interesting observation in comparing the transition of three small, poor countries: Albania, Georgia and the Kyrgyz Republic. Albania experienced a brief and relatively shallow recession, followed by a sustained recovery, while Georgia more so than the Kyrgyz Republic, lost large shares of their economies and recovered only slowly.

In the case of Albania, the country's very poor initial conditions in terms of its extreme communist heritage and somewhat disorganized and weak governance and institutions led to some problems at the initial stage of transformation. But, Albania was able to better manage the transformation after quickly undertaking trade liberalization and actively pursuing a private sector-driven market economy. But there were two additional factors that alleviated the potential friction associated with market-oriented reform: financial support from IFIs and EU, and absence of political disintegration.

On the other hand, Georgia and the Kyrgyz Republic, like other CIS countries, also started with relatively poor initial conditions, but probably somewhat better than those of Albania. However, both countries suffered severely after having to economically disintegrate from the Soviet Union. In addition, severe civil conflict followed in Georgia, while Kyrgyz had great difficulty in gaining access to markets due to its land-locked geographical situation. Though both countries had a reasonable reform record and benefited from substantial IFI support, neither had the expectation of integrating into the Western European market in the near future, which otherwise might have played an important role in attracting FDI as well as the introduction of new legal and institutional arrangements.

Here, we can draw some policy lessons for Uzbekistan from the experiences of Georgia and Kyrgyz Republic, which share a number of common factors with Uzbekistan. Firstly, Uzbekistan's land-locked geographical situation posses high constraints to accessing international market. Moreover, in case of Uzbekistan, the financial support from international community was much smaller than Georgia or Kyrgyz Republic. But there are two distinct factors that allowed Uzbekistan's transformation to be relatively smoother and more gradual: political stability and absence of heavy debt. The importance of political stability during economic transition is quite apparent when considering Uzbekistan's economic performance. Against this background, the paper seeks to further examine Uzbekistan's transformation process in the following chapter.

2-2 Uzbekistan's Initial Response to the Shock

<The Shock of Independence>

Following independence, Uzbekistan faced several exogenous shocks as it was undergoing system transformation and disintegrating from the former Soviet Union. First of all, a shock was caused by the disruption of domestic as well as international trade. The Soviet Union's break up resulted in the division of labor collapsing, which was the severance of the traditional supplier-customer relations among republic. Moreover, inter-republic, which had thus far been domestic transaction, became an international one. Trade within the USSR, which totaled as much as 14% (Pomfret, 1995)[10] of GDP in the years before independence, declined rapidly in 1991 and 1992. This hand practically become non existent with the demise of the ruble zone in November 1993. Also the collapse of COMECON (CMEA) severely hampered trade with other socialist states. As examined in the previous chapter, even though a shock to trade had been widely observed among other countries in transition, due to their deep integration into the Soviet division of labor, the shock impacting the republics like Uzbekistan turned out to be much more severe, than those impacting other East European countries.

Uzbekistan was also affected by a drastic deterioration of the external terms of trade. Trade among Soviet Republics as well as with other socialist states, which had traditionally been carried out based on concessional price terms was no more following the transformation of involved countries. Especially, price hikes in energy and foodstuff, which had been imported from other former republics, caused serious economic instability. Furthermore, the country experienced another price shock following the liberalization of domestic and international prices, which resulted in many inefficient firms going bankrupt.

The third shock was caused by the loss of budgetary subsidies from the Soviet Union's central government. For instance, in 1991, the amount of budgetary subsidies that Uzbekistan received from the Soviet Union was 21% of its GDP. With dissolution of the Union and its independence, all of the budgetary subsidies stopped practically overnight.

Lastly, the country suffered another shock in the form of brain drain. In Uzbekistan, the population proportion of ethnic Slavic, such as Russians and Ukrainians, was relatively small, but many people of this ethnicity held core positions in technology as well as state-owned enterprises management. With its independence, a majority of these workers tried to return their countries of origin, in spite of the social and economic risks. In fact, in 1991-93 at least three

10) 4 In other study, this ratio was estimated to be 19% (Griffin, 1996).

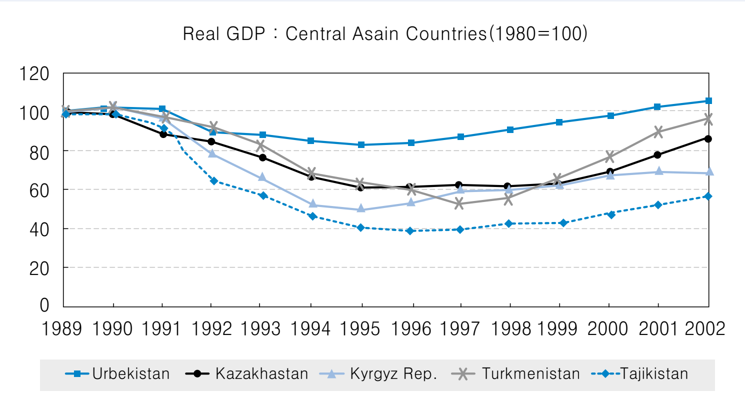
hundred thousand professional who held a major share of technical and managerial posts left the country, thus making the restructuring of the national industry even more challenging.

<Policy responses>

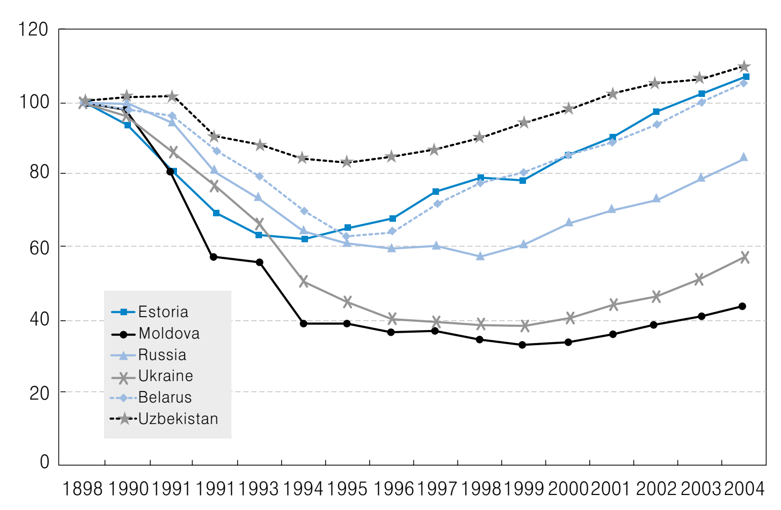
In response to these shocks, Uzbekistan took a policy model different from that adopted in most other transitional economies and recommended by IMF and World Bank in order to undergo economic transformation. Like other transition economies, the international financial institutions emphasized quickly liberalizing prices and markets both domestically and internationally, privatizing enterprises and drastically reducing state control. Also maintaining macro-economic stability using tight fiscal and monetary policies after the liberalization and privatization was generally recommended (CER and UNDP, 2005).

Instead of introducing new legal and institutional arrangements that would be compatible with a market economy, it emphasized supporting the operation of production activities in an effort to prevent supply shortages and protecting consumer markets, gradually reforming the system of state-controlled economy (UNISEF 2003). However, this economic approach had been the object of sharp criticism. Generally, Uzbek's predicament was that the gradual reform approach was deepening the supply-led contraction, as consequence of the so-called downward spiral of production decline. So, once trapped in the vicious circle, the economy would lose its vitality and not be able to break out of the vicious cycle on its own.

<Figure 1-1> Changes in Real GDP: Central Asian Countries



<Figure 1-2> Changes in Real GDP: CIS Countries



Fortunately, Uzbekistan's conditions did not worsen as predicted. The country's contraction was much milder in scale compared to other Central Asian countries (see Figure 1). Once the economy bottomed out in 1995, it was able to sustain a moderate GDP growth rate of about 4% in the subsequent years.

Uzbekistan's relatively mild production contraction and early upturn were quite notable among CIS countries (see Figure 2). In fact, Uzbekistan became the first country among the CIS countries that was able to surpass its 1989 level of GDP in 2001.

Uzbekistan's economy had advantages and disadvantages in riding out the shocks. One of the fundamental problems that Uzbekistan faced after independence was being able to secure economic stability by becoming less reliant import of oil and staple grain. That is why Tashkent stepped up its efforts to secure self-sufficiency in these strategic commodities. Another constraint factor is its geographical situation of being double-land locked, and this also limits country's ability to integrate into the international division of labor. This geographical condition would lead to a heavier burden in transport costs of external trade, as well as diplomatic and security costs to find and maintain trading routes to sea.

On the other hand, Uzbekistan's low-level of industrialization provided some advantages from the shock of transformation and independence. It is generally acknowledged that the speed of system transformation is difficult to manage in more industrialized countries due to the interdependent nature of sectors and enterprises.

<Table 1-1> Major Economic Indicators of Uzbekistan

	Unit	1998	1999	2000	2001	2002	2003	2004
GDP	US$ billion	15.0	16.4	13.8	11.5	9.7	10.0	10.6
GDP per capita	Dollar	630.4	678.6	557.4	456.0	379.8	382.9	400.4
GDP growth rate	%	4.3	4.4	4.0	4.5	4.2	4.4	7.7
Unemployment rate	%	0.5	0.4	0.4	0.4	0.5	0.6	1.2
Inflation	%	29.0	29.1	24.9	27.3	23.9	12.7	3.2

Source: CIS Statistical Committee(http://cisstat.com); Global Insight(September 2004), *PlanEcon Review and Outlook- the Former Soviet Republics.*

Also, heavy dependence on exporting primary commodities such as cotton and gold were advantageous in adopting to the changed economic environment. Most manufactured products of former socialist states were so low in quality that they were not marketable in the international markets. Compared to manufactured or highly processed commodities, low-processed or primary products were relatively easy to sell in the international market. These readily marketable export commodities and expansion of domestic production of oil and grains, which otherwise require large amounts of foreign exchange to import, allowed Uzbekistan to meet its foreign exchange demand with relative ease.

Against this background, the government adopted a strategy that would allow it to transform the economy from heavy dependence on agriculture and natural resources to a modern industrial economy. The government's strategic objectives of its economic policy announced soon after independence included diversifying the economy from the cotton mono-culture to a more industrialized economy, expanding employment opportunities, and achieving energy and food security to protect the economy and population from major external shocks. In line with the stated objectives of the government, the country achieved self-sufficiency in energy by 1995 and, afterwards, sufficient increase in grain production.

As shown previously, Uzbekistan's GDP decline during 1991-1995 was relatively mild compared to other republics of the former Soviet Union. As the economy began to enter a recovery phase in 1996, GDP grew at a moderate but steady growth rate. Uzbekistan was able to avoid a serious transformational recession, instead having one that was shortest in period and mildest in degree among any of the republics of the former Soviet Union.

<Table 1-2> Energy Balance of Uzbekistan

	1993	1994	1995	1996	1997	1998
Domestic Oil Production	3,944	5,517	7,586	7,621	7,891	8,104
Import of Oil and Its Products	4,762	3,153	250	11	0	0
Domestic Consumption of Oil Products	8,201	7,368	6,961	6,547	6,520	6,934
Net Import of Oil and Its Products	4,258	2,009	-500	-939	-1,190	-948

Source: IMF (2000)

2-3 Reform Process

<Price Liberalization and Privatization>

Uzbekistan first underwent price liberalization in 1991, and then more fundamental price reform proceeded as market reform was accelerated in 1994-96. Energy prices were realigned in 1996 but it remains substantially lower than world market prices. Wheat and cotton price controls also remained in place for a long time, and in the case of cotton, prices are still controlled by the public sector. In fact, Uzbekistan’s constraints on price liberalization have been closely tied to the slow progress in privatization.

The pace of privatization has been relatively slow compared to other CIS countries. Consequently, the share of private sector’s contribution to GDP as well as revenue from privatization has been smaller in size. Like other economies in transition, privatization for housing and small businesses had been done at an early stage. But the privatization of big enterprises continues to be slow, which is partly due to the shortage of domestic saving and the limited number of potential buyers.

<Table 1-3> Share of Private Sector’s Contribution to GDP (CIS Countries) (unit: as % of GDP)

	1998	1999	2000	2001	2002	2003	2004
Uzbekistan	45.0	45.0	45.0	45.0	45.0	45.0	45.0
Russia	70.0	70.0	70.0	70.0	70.0	70.0	70.0
Ukraine	55.0	55.0	60.0	60.0	65.0	65.0	65.0
Kazakhstan	55.0	60.0	60.0	60.0	65.0	65.0	65.0
Georgia	60.0	60.0	60.0	60.0	65.0	65.0	65.0

Source: EBRD (2004).

<Table 1-4> Privatization Revenues of CIS Countries (Cumulative) (unit: as % of GDP)

	1998	1999	2000	2001	2002	2003
Uzbekistan	2.6	2.6	2.8	2.9	3.5	4.1
Russia	3.5	3.6	3.9	4.3	4.7	5.4
Ukraine	2.3	2.9	4.3	5.5	6.0	6.8
Kazakhstan	13.0	14.8	15.6	16.1	16.6	18.0
Georgia	21.8	22.7	23.0	23.1	23.3	23.6

Source: EBRD (2004).

After its independence, Uzbekistan was required to redefine ownership of state-owned properties prior to undergoing privatization. The ownership of large state-owned enterprises (SOEs) had been changed in two steps. In the early 1990s, many of the line ministries were changed into branch associations, and then starting in the mid-1990s, some of these associations were gradually reorganized into joint-stock companies for privatization.

Currently, some of these associations have also privatized firms as members, and joint ventures with foreign firms as new entrees. However, generally the associations are not conducive to privatization of their members. In spite of continuing to transform SOEs into stock companies, business decisions to set prices, output and investment are often not market-based, especially those in the commercial manufacturing and services sector. Corporate governance has yet to be established not only for SOEs and state ‘trade associations’ but also for firms that were reorganized into joint stock companies.

For the privatization of large-sized SOEs, the government created private ‘Investment Funds’ in 1996. The structure and role of the Funds are similar to those of transition economies in Eastern Europe.[11] And again, in 1998 the government also initiated a case-by-case privatization scheme. But in both instances the results of privatization have not substantial.[12]

Presently, Uzbekistan’s privatization classifies all the state owned companies into three groups, as different standards applied according to the classification. The first group comprises

11) In other words, the Funds bought in shares of medium and large scale SOEs, and the public’s ownership of those SOEs are secured by purchasing the shares of these Funds. Thus, the role of Funds is similar to that of holding company.

12) In 2004, privatization revenues were estimated at EUR 57 million, which includes a number of large scale enterprises such as Akhangarant Cement and Uzcable. Also in 2004 there was a significant increase in the number of small enterprises opened up to private investment, a process technically considered as privatization by the Uzbekistan authorities.

of production facilities which can be offered for privatization. Production facilities classified in the second group are in difficult financial condition. Their ownership can be transferred on the basis of zero redemption value. Finally, companies in the third group are to remain in the public sector due to their strategic importance in the national economy.[13] In other words, the Uzbekistan government has made it clear that it would maintain public management of those companies in strategically important sectors, such as electricity, chemical industries, cotton-spinning, etc.

The progress of Uzbekistan's privatization, in particular of large enterprises, has been slow compared to other CIS countries, let alone relatively advance transition economies in the Eastern Europe. Slow progress in privatization would naturally bring about the government's deep intervention in the management of large enterprises. This explains why the state-owned sector still continues to be supported by preferential tax and trade regulation, notably through the so-called localization program. In the manufacturing sectors, a notable exception is the textile and garments sector which also benefits from tax preferences, and continues to attract foreign investors.

Considering the fact that in the absence of a competition law[14], privatization would have created domestic monopolies, having a negative impact on employment with very little contribution in the creation of value added. But this cannot be used to justify intervention in privatization.

Government continues to intervene in the agriculture sector, as privatization in this sector has been extremely slow. The government has kept its prior dualistic land distribution policy that combined a large number of family plots[15] producing high-value foods including livestock and a limited number of large state farms and shirkats[16] mainly specializing in cotton and grains. In 1999, a new type of 'commercial family plots' system, which was called 'dekhkan' was introduced. Under the dekhkan system, life-long leases were allowed and the ownership of land can be inherited but not transferable to a third party. In 2004, the number of dekhkan amounted

13) The first group consists of 1,385 production facilities, which are either joint-stock companies or limited-liability. Number of production units in this group amounts to 115. And the third group consists of 746 companies, at the beginning of 2005 (CEEP, CERE, and USAID 2005).

14) This law was promulgated in most economies in transition only towards the end of the 1990s)

15) The number of this family plots amounted to 3.2 million units in 2001 with total acrage of about 400,000 ha. Thus an average size of family plot was only 0.125 ha.

16) Shirkat is a system of partial lease. Many kolkhozes (collective farms) have been divided up into their former production units (e.g. grain, cotton, vegetables etc.) which now form one shirkat. Most shirkats consist of 4 to 5 former brigades and uses 50 to 60 ha land. The shirkat leases the land for ten years. Every shirkat has a chairman, who acts as the tenant towards the kolkhoz or the shareholding. He distributes the land of the shirkat to the shirkat members. Contracts are usually signed for one year and most plots are between one and five ha in size. The size of the plot depends, firstly, on the number of shirkat members between whom the land has to be divided and, secondly, on the family size of the tenant. Sourece: Julia Eckert, Georg Elwert (1996), "Land Tenure in Uzbekistan," http://www.mekonginfo.org/mrc/html/eckert/eck2_4.htm

to 1.8 million units with a total acreage of 290,000 ha, which means that the average size is only 0.16 ha. Since 1998, the insolvent shirkats were reorganized into medium size private farms (pudrat) of 20 hectares on average that received land lease rights of up to 50 years. This pudrat sector expanded rapidly and now comprises 55,000 farms that control an acreage of 1 million hectares, about twice the amount of land under the control of 3.2 million family plots of dekhkan (UNDP, 2004).

Even though the state procurement quotas for output had been abolished for most agricultural products by the second half of 1990s, the system is more or less still in place for cotton and wheat, which accounted for the major portion of agricultural production. Cotton farmers had to sell most of their products at low official prices. In 2002, the procurement quota was changed to reflect actual and not planned output. Even though crops were not subject to state orders, the whole cotton industry is still under the control of government organization of "association," owning cotton ginneries and flour mills wielding monopolistic power. As far as cotton production is concerned, the system of association is still maintained up to now, with production targets and price controls (UNDP & CER, 2005-II).

<Public finance and social safety net >

Unlike most CIS economies or other transition economies in Eastern Europe, Uzbekistan managed to avoid a drastic drop in government revenues during early transition period. This may be partly due to stronger system of tax administration than other CIS countries but the slow progress in privatization could be a big reason as to why they have been able to maintain state revenue temporarily. In socialist states, traditionally the main source of state budget has been SOEs. Once they were privatized and the state-controlled price system was abolished, the government lost its main source of revenue. That is why the slow progress in privatization can contribute in preventing a large budget deficit.

<Table 1-5> Fiscal Balance of Uzbekistan (unit: % of GDP)

	1991	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004
Government Expenditure	52.7	49.7	46.4	35.3	38.7	41.6	32.5	33.1	32.0	28.5	26.0	25.2	24.2	23.7
Government Revenue	49.1	31.4	36	29.2	34.6	34.3	30.1	30.1	29.2	29.5	27.0	25.8	24.6	24.6
Budget Balance	-3.6	-18.3	-10.4	-6.1	-4.1	-7.3	-2.4	-3	-2.8	-1.0	-1.0	-0.6	-0.4	-0.9

Source: UNDP & CER (2005) and CEEP&CERE (2005)

In the transition economies, in spite of the substantial drop in revenue, demand of public expenditure could not be subdued. Thus, a large public deficit was incurred during the transition period in most former socialist states. Uzbekistan also incurred large budget deficit owing to continued public expenditure immediately after independence. In 1992, for instance, the budget deficit amounted to 18.3% of GDP. This was done to maintain aggregate demand and to prevent supply shocks becoming demand shocks especially during the first half of 1990s. But from 1994, the budget deficit had been contained within a single digit. Uzbekistan's relatively strong budget revenues at the initial stage of transformation allowed the government to maintain a relatively high level of public spending.

Since the mid-1990s, tax revenues declined for various reasons, including a reduction in tax rates to stimulate domestic producers, the introduction of simplified tax system for agricultural producers and SMEs, and reduction of tax base as a result of new tax breaks. Despite of a reduction in revenue, consolidated budget revenues in Uzbekistan were relatively high compared to other CIS countries prior to 2000. Beginning in the 2000s, however, Uzbekistan's fiscal size became smaller than other CIS countries. As government revenues have declined in recent years, expenditures have had to be compressed accordingly.

<Table 1-6> Government Expenditure of Other CIS Countries (unit: as % GDP)

Country	Government Expenditure
Berlarus	42.0
Georgia	17.8
Kazakhstan	22.1
Kyrgyz Republic	28.1
Moldova	32.0
Russia	37.0
Ukraine	34.1

ource: EBRD (2004)

While the narrowly defined budget deficit was well contained, and remained under 2.5% of GDP since 1997, the public sector's overall fiscal stance, including state enterprises, became more expansionary, especially in 1997-1999, as relatively high investments averaging 29-30% during 1996-2001 to support economic growth were to a large extent financed through publicly guaranteed external borrowing. Moreover, given Uzbekistan's reliance on commercial borrowing, the degree of concessionality of Uzbekistan's external debt is low and debt service high. The high levels of debt and debt servicing contribute to slow down economic growth, and leave the economy vulnerable to shocks (World Bank 2003).

Poverty was not unknown in Uzbekistan prior to the transition and indeed Uzbekistan was one of the poorest republics of the Former Soviet Union (UNDP&CER, 2005-II). Since independence, compared with other CIS countries, Uzbekistan seems to have put more emphasis on social welfare. Reform of social safety net has been geared toward better targeting of expenditures to those in need, within the context of reducing administrative costs and overall subsidies to the population.

Uzbekistan's government expenditures on health and education indicators look favorable compared with other CIS countries. The current social security system provides income transfers to the needy, child and maternal benefits, and assistance to the elderly. It also offers free basic health services and free primary and secondary education. Considering the drastic decline in state revenue, it is doubtful whether such high level of expenditure for social development can be sustainable in the future.

<Table 1-7> Expenditure on Health and Education (unit: as % of GDP)

	1998	1999	2000	2001	2002	2003
Uzbekistan	9.8	8.1	11.1	9.1	8.5	11.3
Russia	7.4	6.6	6.3	6.4	6.6	n.a
Ukraine	6.5	5.3	5.9	6.5	8.0	8.6
Kazakhstan	6.2	6.1	5.3	5.3	5.3	5.4
Georgia	1.0	0.8	N.a	1.0	1.6	1.2

Source: EBRD (2004).

<Financial reform>

Financial reform remains very limited and a number of old socialist systems are still in place. For instance, deposits at commercial banks are vulnerable to such an extent that the tax authority can make withdraws from accounts without depositors' consent for the purpose of tax collection.

The financial intermediation by banking sector is very limited and the coverage of banking services for small firms and individual entrepreneurs is still narrower. Even though, the government has created institutions to provide credit to new private ventures, such as the Business Fund established in 1995, the system's real effects have been evaluated to be generally limited.

As far as privatization is concerned, the financial sector is no exception. Though there are now private banks in Uzbekistan, the majority of the large banks are still state-owned. In 1998 the government planned to limit public ownership in commercial banks, but this policy was suspended indefinitely afterwards.

<Table 1-8> Asset Shares of State-Owned Banks in CIS Countries (Unit: % of total bank assets)

	1998	1999	2000	2001	2002	2003
Uzbekistan	67.3	65.8	77.5	n.a	n.a	91.0
Ukraine	13.7	12.5	11.9	11.8	12.0	9.8
Kazakhstan	23.0	19.9	1.9	3.5	5.2	5.1
Georgia	0.0	0.0	0.0	0.0	0.0	0.0

Source: EBRD (2004).

Until recently, progress on banking reform has still been limited. Tax authorities continue to debit bank accounts without prior authorization from the client. As is shown in the following table, the money supply has been on the decline in Uzbekistan, and restrictions on cash in circulation were introduced for the purposes of tax enforcement in the informal sector. This measure has impeded key functions of the payments system and lowered confidence in the financial system.

<Table 1-9> Change of Money Supply (end-year) (Unit: % of GDP)

		1998	1999	2000	2001	2002	2003
Uzbekistan	M_3	15.4	13.6	12.2	12.4	10.6	12.1
Russia	M_2	17.0	14.6	15.7	18.0	19.7	24.2
Ukraine	M_2	15.0	16.6	18.5	22.1	28.5	35.8
Kazakhstan	M_2	8.6	13.6	15.3	17.1	19.2	21.0

Source: EBRD (2004).

Corporate governance and transparency of asset quality in the financial system have not sufficiently improved. Confidence in the banking sector was further damaged by the sudden withdrawal of Business Bank's license in March 2005, the largest private bank in the country. With further financial and banking sector reforms can unlock Uzbekistan's significant economic potential and allow the commercial banks to operate on a full-fledged basis. (EBRD 2005)

Regionally, the deficiency of financial institution is worse in rural areas, where banks do not serve depositors, but serve the state in monitoring funds, which reflects the Soviet legacy of so called "ruble control."

In Uzbekistan, the government sector still remains as the major source of finance, where the role of planning as well as rationing of national savings for investment is played by the government. Until now, the expansion of private savings has been limited due to slow development in the private sector, as well as insufficient protection of private property rights.

<Trade Liberalization in External Sector>

With slow progress in privatization coupled with the government's import-substitution growth strategy, there is little room for trade liberalization. In Uzbekistan, restrictive trade and foreign exchange policies were kept in place until tariffs were simplified and reduced in the mid-1990s. All foreign exchange earned from exports were turned over to the state bank and then allocated to importers at a preferential rate by the central authority, which means that the Soviet system of foreign exchange centralization had been still in place for a large part.

<Table 1-10> Trade and Foreign Exchanges of Uzbekistan (Unit: % of GDP)

	Unit	1997	1998	1999	2000	2001	2002	2003	2004
Export	US$ billion	4.0	3.2	3.2	3.3	3.3	2.8	3.1	4.8
Import	US$ billion	4.2	3.1	3.1	2.9	3.1	2.5	2.1	3.9
Trade balance	US$ billion	-0.2	0.09	0.1	0.3	0.2	0.3	1.0	1.0
Current account balance	US$ billion	-0.58	-0.04	-0.2	-0.01	-0.29	0.02	0.54	0.69
Foreign reserves	US$ billion	1.17	1.17	1.16	1.07	0.78	0.71	1.10	1.00
Exchange rates (Period average)	soum/US$	66	95	125	232	424	771	971	1,020

Source: CIS Statistical Committee(http://cisstat.com); EIU(2004), *Country Profile: Uzbekistan*; EIU(December 2004), *Country Report: Uzbekistan*; Global Insight(September 2004), *PlanEcon Review and Outlook-the Former Soviet Republics.*

There has been some streamlining of the foreign exchange regime since 2000 and the gap between the official and black market exchange rate has been substantially reduced. However, the government still maintains restrictions on current account convertibility and foreign trade through a system of import controls and non-tariff barriers. These restrictions, in place since late 1996, have created disincentives for exporters and compressed imports.

Moreover, new trade barriers with the recent closure of borders with neighboring countries on commercial activities and restrictions against the private sector have prevented a positive supply response to the exchange rate adjustment. This environment has limited the attraction of FDI, which is the lowest of all transition economies on a per capita basis. Thus the economy remains generally closed to competition, with a high degree of direct state involvement and control (EBRD, 2003)

Still Uzbekistan's trade regime is among the most restrictive within the group of transition countries, which aggravated the investment environment. But starting in late 2002, the authorities have introduced a number of discriminatory administrative restrictions on imports. Uzbekistan has made progress in current account convertibility under the IMF's Articles in October 2003 with termination of multiple exchange rate adopted in 1997. However, widespread restrictions on domestic currency in circulation were further tightened in October 2004, which undermine the benefits that could be derived from current account convertibility.

A further manifestation of the policy of curbing informal transactions has been the persistent restrictions on external, as well as, domestic trade. Despite Uzbekistan's continued engagement in various regional and multilateral trade, only limited progress has been made in bilateral trade relations, and several additional restrictions were imposed in 2004, in particular on the trade by individual entrepreneurs.

2-4 Import Substitution Strategy

Once the macroeconomic crisis had been stabilized in the mid-1990s, the country turned its attention on long-term development strategy. Entering a recovery phase, Uzbekistan focused on system reforms and seemed to consider a policy shift towards a more liberal approach.[17] In stead of outward-looking development strategy, Uzbekistan adopted a development strategy that placed priority on diversifying the economy through a process of domestic industrialization led

<Table 1-11> CIS Countries' Share of Industry in GDP (Unit: %)

	1998	1999	2000	2001	2002	2003
Uzbekistan	14.9	14.3	14.2	14.1	14.1	n.a
Russia	29.9	30.8	31.4	28.1	26.5	n.a
Ukraine	25.2	27.2	26.7	27.1	30.5	31.0
Kazakhstan	23.9	23.9	25.2	25.2	25.3	n.a
Georgia	12.3	13.0	13.7	12.2	12.4	13.3

Source: EBRD (2004).

17) For instance, An IMF stand-by arrangement was signed in 1994, trade was partially liberalized in 1995, current account convertibility was planned for 1996 and large loans were obtained from the international financial institutions.

by large enterprises, which were under government control (UNDP 2004). In spite of these efforts, it seems there is little to show for it as the share of industry in GDP has been gradually declining for the past 6 years.

This approach may have been promoted on the back of the successful import substitution program in achieving self-sufficiency in oil and grains. Moreover, the success in achieving self-sufficiency in oil and grain reduced Uzbekistan's demand for foreign exchange, which gave it some room to rely on import substitution policy. In other words, if its economic vitality was not dependent on earnings from foreign exchange, it should have committed more active involvement in the international division of labor with export-oriented approach.

Also changes in the international economic environment influenced Uzbek's decision to adopt import substitution. At this moment, external conditions were not as favorable as in the first half of the 1990s. Uzbekistan was seriously hit by external shocks due to the deterioration of its terms of trade in the second half of 1990s.[18] Another significant event that led Uzbekistan to pursue an import-substitution policy was the Russian financial crisis in August 1998, as there was serious concern of "contagion effect" following the drastic devaluation of the ruble. Also cotton harvest during 1998-9 was poor coupled with continuing decline in world cotton and gold prices.[19] All these factors might have driven Uzbekistan toward liberalization and external opening.

<Table 1-12> Exchange Rates of Uzbekistan and Russia (Annual Average) (Unit: per 1 US dollar)

	1994	1995	1996	1997	1998	1999	2000	2001	2002	2003
Uzbekistan	11.4	33.0	44.7	90.7	131.8	257.2	360.7	646.3	885.0	995.6
Russia	2.2	4.6	5.1	5.8	10.0	24.6	28.2	30.1	31.8	29.5

Source: EBRD (2002 and 2004)

In most developing countries, when economic development is initiated, there may always be some opposition against trade liberalization especially from those with vested interests. At times, protecting markets can take on national meaning, such that inflow of foreign commodities or foreign capital may be interpreted as outflow of national wealth.

Uzbekistan's geographic condition may have been another factor that worked against external liberalization. Being double land-locked, its accessibility to international markets is severely constrained. High transportation costs, as well as political and security costs involved in

18) Especially serious was the cotton crisis of 1996 that entailed a 15 percent drop in domestic production and a drop in world prices.

19) That was the major factor of 25 percent decline in Uzbekistan's terms of trade between 1995 and 1999.

securing inland routes to reach sea ports may be a serious hindrance. Of course, Uzbekistan can secure regional markets in other Central Asian countries. Uzbekistan can also find alternative trade partners in the region, such as China, Turkey, or Iran with favorable terms of trade.

As shown in the following chapter, Uzbek's policy has a number of similarities with that of Korea's policy promoting the heavy and chemical industry based on import substitution in the 1970s. However, Korea's government did not intervene in the market as directly or extensively as Uzbekistan's. Nevertheless, the support measures put in place to protect favored industries, as well as, fiscal and financial measures were more or less the same.

Under an import substitution strategy, the Uzbekistan government controlled many of the economic choices and inter-sectoral allocation of resources. In all these cases the government put forth economic targets, through 'indicative plans' which, reportedly served as output targets in many cases. The government also had significant control over many enterprises, public or privatized, and over the production of cotton and grain. The main long-term objective of such state-led development strategy was to diversify the economy and reduce its export dependence on cotton. In this model, the domestic market absorbed much of domestic output. The imported investment and intermediate goods needed for industrial modernization were financed through exports of cotton, gold and other commodities.

<Table 1-13> Composition of Export and Import by Commodities (1998-2003) (Unit: %)

	1998	1999	2000	2001	2002	2003	2004
←Export→							
Cotton	38.6	27.3	27.4	28.3	26.6	19.8	25.5
Oil	7.9	11.5	10.4	11.5	8.1	9.8	12.4
Machinery & Equipment	4.2	3.2	3.4	3.9	3.9	5.9	7.4
Others	49.3	58.0	58.8	56.3	61.4	80.6	54.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0
←Import→							
Machinery & Equipment	47.2	44.8	35.4	41.2	41.4	44.4	46.0
Chemical and Plastics	12.4	11.7	13.6	12.7	15.3	12.8	12.5
Foods	15.6	13.1	12.3	10.8	12.6	9.9	6.8
Others	24.8	30.4	38.7	35.3	30.3	32.9	34.7
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: EIU(December 2004), Country Report: Uzbekistan, and CEEP , CERE and USAID (2005)

In an effort to promote the domestic industry the government adopted several important policy measures. In early 1997, the Uzbekistan government introduced a multiple exchange rate regime, and centralization of foreign exchange at the central bank. Access to foreign exchange at the official rate was ensured to selected enterprises importing essential inputs, while non-priority firms had to compete for limited supplies of foreign exchange at the bank or in the open market, both of which were far less favorable than the official rate.

Uzbekistan continued to maintain state orders for cotton and grain production on the basis of statutory prices which were much lower than international prices[20)] to secure the foreign exchange needed for the imports of the protected industries. The priority sectors[21)] had been further protected from foreign competition through tariff and non-tariff barriers. Thus, external liberalization was much more limited than in neighboring Kazakhstan and Kyrgyzstan while recourse to import compression remained common. Also cheap credit was given to priority sectors through the central bank and state-controlled commercial banks.

When Uzbekistan pursued its import substitution policy, the servicing of foreign debt service was sustainable and inflation was more or less under control. Since 1996 investment as a share of GDP remained at 20%. It was not lower than other economies in transition but not high enough to maximize its growth potential.

<Table 1-14> Gross Investment and Saving Rates (Unit: % of GDP)

	1995	1996	1997	1998	1999	2000	2001	2002	2003
Gross Domestic LInvestment (A)	24.2	23.0	18.9	20.9	17.1	19.6	21.1	21.8	20.8
Total Domestic Saving (B)	27.1	22.7	18.7	19.9	17.3	19.4	20.0	22.4	26.7
Balance (B-A)	2.9	-0.3	-0.2	-1.0	0.2	-0.2	-1.1	0.6	5.9

Source: UNDP and CER (2005-I).

In fact, the resources transferred to target industries, such as petro-chemical, automobile, food processing, transportation, etc., were indirectly financed with proceeds from the agricultural sector, via dual exchange rate system and artificially low statutory prices applied to agricultural sector. Based on this, it is suggestive that, to support import substitution industries, reforms in the agricultural sector had been delayed. Also the distortions associated with state controlled

20) During 1995-9, the price paid for state orders for cotton averaged 54 percent of the world market price if the comparison is based on the official exchange rate or 21 percent if the comparison is done on the basis of the curb market rate (IMF 2000).

21) For instance, they were the automotive, chemical, and some mechanical industries, etc.

prices, interest rates, and exchange rates greatly lowered welfare.

Economic development aimed at diversifying production based on import substitution have been supported by favorable external economic environment, and some productivity gains in the agricultural sector. A recent survey showed that GDP growth rate was about 7.7% in 2004, coupled with a sizeable current account surplus (CEEP, CERE, and USAID 2005). In spite of these economic achievements, a number of measures need to be taken to reinforce its growth potential, including improvement of investment environment, deregulation of foreign trade, and financial market as well as currency circulation.

3. Korea's Experience and Policy Implications for Uzbekistan

3-1 Introduction

Korea's economic growth in the last 40 years, with its per capita GNP raised from about US$80 in the early 1960s to over US$14,000 in 2005, has been almost unprecedented. Many factors have contributed to Korea's rapid economic growth. The literate population capable of learning skills quickly together with the export-oriented industrialization strategy enabled the economic take-off in the early 1960s. Since the 1980s, policy emphasis has shifted to promoting the role of the market in resource allocation by fostering competition and reducing direct government intervention. In this section, Korea's economic development history will be reviewed in an effort to derive some lessons and policy implications for Uzbekistan.

<Initial Conditions>

In the early 1960s when Korea launched its firms Five-Year Economic Development Plan, the economic condition was much inferior than Uzbekistan became independent in early 1990s. Korea had borne the historical burden of Japanese colonialism for 36 years between 1910 and 1945 and then national division into two parts, North and South Korea. During the Japanese occupation, the limited size of industrial bases were concentrated in the North, while the Southern part was exclusively specialized in agriculture and mining and manufacturing facilities were almost negligible. Furthermore, during the 3-year long Korean War the existing production facilities, regardless of whether in the North or in the South, were completely devastated. In other words, when Korea started economic development, there was no ground for industrial activities and the economy had to be rebuilt from the ash of war. Also the endowment of natural resources was extremely poor.

There was another constraint that forced Korea to have strong ties with international market. Korea had to import all the domestic consumption of oil and natural gas. Even though the peninsula was endowed with some of mining resources, but they were mostly located in the northern part of the peninsula. Shortage in the endowment of natural resources, turned out to be a severe restriction for its economic survival, but it later became a springboard to make advancement to the world market.

Under such inferior conditions, there was another burden that Korea had been saddled with, which was population pressure. In early 1960s, annual population growth rate reached almost 3%. There was widespread unemployment, and underemployment was also rife in agricultural sector, which constituted nearly two-thirds of the population.

Like other less developed countries, the market economic system and policy apparatus were in an extremely under-developed state. Korea for the first time introduced market economic and democratic political systems when the new constitution was first promulgated in 1948. Thus legal and institutional arrangements were either artificially implanted or yet build newly. But these newly erected legal and institutional conditions were still seriously challenged as consequence of national division and the ensuing Korean War. Due to the legacy of Japanese ruling, undesirable government intervention in private business activities were widespread and many of government's essential roles for the protection of the people were neglected due to resource shortages, institutional underdevelopment, or bureaucratic inertia.

<Export-Oriented Development Strategy>

Against this backdrop, the political leadership that came into power in 1961 advocated economic development adopting an export-oriented development strategy. This was an appropriate choice for a small economy lacking in natural resources but abounding in labor which could be easily mobilized to produce simple, labor-intensive manufactured goods for the overseas market.

Export-oriented development strategy is not a unique model adopted exclusively by Korea. Rather, this strategy has been widely applied by most East Asian countries for the industrialization and development of their economy. East Asian countries are in general deficient in natural resource endowments, which means that they lack in readily exportable commodities. On the other hand, they are in need of foreign exchanges to import oil, grain, and other basic materials. Moreover, most East Asian countries are densely populated with high density farming at rice. To support the oversized population, they need high value-adding activities. Once adopting export-oriented growth model, they need to import not only basic materials but also capital goods, parts and components etc. That is why the growth rate of trade is much higher than that of GDP.

In East Asia the technology transfer and capital movement has exhibited unique pattern. Starting from Japan, manufacturing technology has been transferred to NIEs, and then to other Southeast Asian countries and China. This pattern of economic development of the whole region with stepwise technology transfer according to the level of economic development has been dubbed to be "geese-flying pattern." In other words, Korea's industrialization based upon export-oriented growth strategy was facilitated by this type of region-specific technology transfer in East Asia.

Moreover, due to Korea's geographical condition of peninsula, ocean transportation was easily available, which is also true for most East Asian countries adopted export-oriented strategy. This geographical condition which is generally taken for granted in East Asian region makes a start contrast with mostly land-locked countries in Central Asia. Also the accessibility to the US market based upon Korea's close political relations with the US, was another factor to pursue export promotion.

These external or given conditions were very important factors for a successful implementation of export-oriented development strategy. But the prime locomotive for a successful execution of the model was the strong will of political leaders, active participation of its people, and design of appropriate economic policies which needs to be implemented consistently for an effective outcome.

3-2 Korea's Experience

<Export-led Takeoff in the 1960s>

For the implementation of export-oriented growth strategy, the Korean government organized a strong economic planning agency, which was called Economic Planning Board. Also, institutional arrangements were established to mobilize what resources were available. The nation's tax administration was strengthened and official interest rates were drastically raised to make the real rates sufficiently positive. These measures eliminated the large fiscal deficit and substantially increased the nation's financial savings. As a means to encourage foreign capital inflow, the government also provided repayment guarantees to foreign lenders for domestic business firms.

With a view to promoting exports, the multiple exchange rates were switched into a uniform exchange rate system in 1964 and the Korean won was devalued by nearly 100%. In addition, many export incentives were instituted. For instance, short-term export credit was made available at a preferential rate and tax rebates were allowed on raw materials imported for the production of exports. Direct subsidies and tax reductions/exemptions were given to export activities and an export-import link system was operated. Furthermore, a number of free trade zones were established, customs procedures were simplified, and overseas marketing was supported by information services of the Korea Trade Promotion Corporation.

All of these measures enabled Korean exporters to do business, in effect, under a free trade regime or probably on a more favorable basis. Under a highly favorable external environment to the growth of Korean manufactured exports, the outward-looking development strategy was a great success, exports at current prices rose at an annual rate of 40% between 1962 and 1971.

<Industrialization in the 1970s>

Entering into the 1970s, the Korean government further geared up its effort for economic development putting everything into promoting exports. The targets of major economic indicators such as GDP growth rate, yearly trade volume, inflation rate, etc. were taken into account in the Five-year Economic Plan. Export Promotion Meeting and Economic Situation Review Meeting were presided by the president on a monthly basis. Also in the early 1970s, in order to modernize and promote the self-development of rural areas, the Saemaul Movement (New Village Movement) was initiated by the government. During the 1970s, the growth of Korea's commodity export was quite remarkable. Various policy measures were mobilized in an effort to drastically increase exports, which was the prime engine of Korea's economic growth.

By the end of 1970s, the Korean economy was suffering from serious internal and external macroeconomic imbalances. Inflation had accelerated, and the second oil price shock was a heavy blow to the balance of payments, which had already been deteriorating due to weak exports. Following the first oil price shock, the industrialized nations raised protective barriers against light-manufactured goods from developing countries. Moreover, the emergence of China and other second-tier NIEs was seen as a serious potential threat to Korea's continued export-led growth. Under these circumstances, the government thought that promoting the heavy and chemical industries (HCIs) would help develop an indigenous defense industry, and at the same time, upgrade the export structure, thereby killing two birds with one stone.[22] The overriding objective of the tax, credit, interest rate, and trade policies of the 1970s was to promote HCIs, including the iron and steel, non-ferrous metal, shipbuilding, general machinery, chemical and electronics industries.

While tax incentives for exports were reduced in the early 1970s, Korea's trade policy was also geared to protect favored industries by limiting the import of competing goods. However, the most powerful means of supporting favored industries was credit allocation through the banking system on concessional terms. In order to finance large-scale HCI investment projects, a National Investment Fund was set up in 1974 by mobilizing public employee pension funds and a substantial share of banking funds. Because these funds proved insufficient, the banks, which were practically owned by the government, were directed to make loans to "strategic" industries on a preferential basis. During the latter half of the 1970s, the share of policy loans in domestic credit extended by deposit money banks rose steadily, from 40% to the 50% level.

Owing to this strong and concerted support given by the tax, trade and credit policies, manufacturing investment during the late 1970s was predominantly directed to HCIs. Such disproportionate incentives, together with over-optimistic assumptions regarding world trade prospects led to excessive investment in some areas. They include motor vehicles, heavy power-generating equipment, heavy construction equipment, vessel diesel engines, electronic exchangers, heavy electrical equipment, and copper smelting. In order to correct this situation, the government intervened in 1980 and coordinated negotiations among firms for the relinquishing of projects or reduction of capacity with mergers in some cases.

In addition to creating inefficiencies in investment, the HCI promotion policy gave rise to serious sectoral imbalances and complications in macroeconomic management. First, as the government-favored HCI projects preempted limited financial resources, credit to other industries was unduly squeezed. Moreover, because of the huge capital requirement and weak business position of small and medium-sized firms, the new HCI projects were "granted" to

22) The HIC promotion policy had been officially adopted with in the 3rd Five-Year Plan, which started in 1972.

large business groups, contributing to the concentration of economic power among a few large firms.

< Economic Liberalization since the 1980s>

Toward the end of the 1970s, it became so obvious that economic growth could not be sustained under the inflation, which was running at the annual rate of almost 20%. The government was finally determined to tackle the inflation problem, and in the spring of 1979, shortly prior to the second oil price shock, adopted a comprehensive stabilization package including restrictive fiscal and monetary policies and investment adjustments in the heavy industries. Before the anti-inflationary measures were seriously implemented, the second oil price shock hit the economy, which strikingly exposed Korea's macroeconomic imbalances. With the overvalued exchange rate, fixed to the U.S. dollar from 1975-79 despite a large disparity between the two countries' inflation rates, exports in 1979 recorded a negative growth in real terms and the current account deficits were widening.

In this situation, Korea chose to tackle the problem of external imbalance first by substantially depreciating the exchange rate and by adopting a flexible exchange rate system in the early part of 1980. However, in the early 1980s, Korea's economic policy gave top priority to fighting inflation. In the belief that restrictive demand management alone would be overly depressive, the government relied on incomes policy as well. Such policies included setting informal wage guidelines, stabilizing the government's purchase price of major grains and controlling interest rates and dividend payouts. The realistic exchange rate management had a favorable effect: the current account deficits dropped substantially starting from 1982. Consumer price inflation also decreased considerably from an annual rate of 25% during 1980-81 to 7% in 1982, and below 3% during 1983-87.

There is no denying that economic liberalization increases efficiency by promoting competition and eliminating distortions in the allocation of resources. After the problems caused by the government's overzealous promotion of HCIs in the 1970s, Korean policymakers strongly felt the need for trade and financial reforms as well as the realignment of other industrial incentives. In pursuing economic liberalization, a step-by-step approach was adopted. Emphasis on liberalization was continued in the 1990s as well. Major areas emphasized and identified for institutional reform included the fiscal system, the financial sector, and administrative regulations.

In the early 1980s, the promotion of "strategic" industries with preferential credit and tax treatments gave way to a more indirect and functional support of industries. The Industrial Development Law of 1986, which replaced the existing individualized industry promotion laws, defined how the government might intervene to rationalize industries when market failures occurred.

Certain arrangements were in place to promote growth industries. But the Korean government encourages specialization through indirect incentives designed to promote technological advancement instead of direct market intervention. The other area is declining industries for which the government may intervene in the phasing-out process. In this selective intervention, minimizing government discretion and seeking wide consensus is considered critical. Under the law, nine industries have been designated so far for rationalization for two or three years.[23] The rationalization packages included subsidized credit for upgrading capital equipment, mergers, barring entries, and long-term supply contracts.

With the completion of the five-year import liberalization program in 1988, the import liberalization ratio rose to over 95%, from 80% in 1983. According to the subsequent import liberalization plan for 1990-1997, quantitative restrictions have been all lifted except for a few livestock items. Together with the reduced quantitative import restrictions, the average nominal tariff rate was gradually lowered from 24% in 1983 to 13% in 1989 and 8% in 1994. By 1994, tariffs on industrial products were brought down to 6% through annual cuts, while those on agricultural products were lowered to 17%. Many product-specific laws stipulating approval and inspection procedures for imports have often been blamed for excessive documentation requirements and delays. These laws have also been streamlined to conform to international standards, even though they still remain a source of trade disputes.

Some labor-intensive industries have been seriously affected by these import liberalization measures, which coincided with the rapid deterioration of Korea’s export competitiveness in the late 1980s. On the other hand, there are indications that Korean firms have responded to import liberalization with a more aggressive stance toward technological development, quality improvement and vertical intra-industry international specialization.

Liberalization in the financial sector was also persistently pursued during the the 1980s. Between 1981 and 1983, the government divested its equity shares in all nationwide city banks, transferring ownership to private hands. Financial services provided by different intermediaries were diversified and were made increasingly to overlap. Furthermore, entry barriers into financial markets were lowered, making possible the establishment of new nationwide city banks, commercial banks specializing on small and medium-sized firms, and many non-bank financial institutions. Progress has also been made in the area of monetary and credit management. The relative share of policy loans has declined since the government has reduced the National Investment Fund (NIF) and, more recently, the automatic short-term export credit. In 1984, financial intermediaries were allowed to determine their own lending rates within a given range, according to the creditworthiness of the borrowers.

23) They include automobiles, diesel engines, heavy electrical equipment and heavy construction equipment for promising industries, and textiles, ferrous-alloys, dyeing, fertilizer and shoes for declining industries.

< Delayed reform and Financial Crisis in 1990s>

Reform efforts had been continuously exerted in the 1990s in an effort to adopt the changed domestic and international economic environment. But Korea's economic reform in the 1990s turned out to be far from sufficient in the depth and scope. Due to delayed reforms, the Korean economy fell into an abyss in the wake of the East Asian financial crisis in 1997. Reforms in the 1990s have mainly focused on relaxing regulations on the operation and business boundaries of financial intermediaries and on foreign exchange and overseas capital transactions. The four-stage interest rate deregulation plan announced in 1991 has been seriously implemented, so that most interest rates are now determined autonomously by individual intermediaries. The burden of providing policy loans by commercial banks has also been reduced, as specialized banks with the support of the government become mainly responsible for them. The growing size of non-performing loans and the poor governance structure of commercial banks, however, have constrained more ambitious financial liberalization.

The Korean crisis was triggered by a series of corporate bankruptcies in 1997. A large number of chaebol bankruptcies, which were considered to be "too big to fail" contributed to generating a great shock in the market. Korean industries are actually very vulnerable to such unfavorable external environment as the weakening of the Japanese yen and a sharp deterioration in the terms of trade. Responsible for this weakness, apart from the concentrated export structure on a handful of major products, include high corporate debt-equity ratios, the practice of extensive cross repayment guarantees among affiliated firms of large business groups, and inefficiencies of corporate investments resulting from poorly conducted project evaluation.

When foreign investors started to cash their investment and leave the market, while the supply of foreign exchange was almost discontinued, it was beyond the capacity of the Bank of Korea to defend the currency value. Furthermore, a substantial portion of the reserves was lent to the overseas branches of Korean banks to prevent them from defaulting on their borrowings. The "usable" foreign exchange reserves shrank to a mere US$ 7 billion level by the end of November 1997. There was no other option than requesting a bail-out program of the IMF, if Korea was to avoid outright defaults on its external debts.

With the financial assistance of the IMF's bail-out, the Korean government swiftly executed reform programs mainly in four areas, which were government and public sector financial system, corporate sector, and labor relations. With all-out effort to redress the structural problems, the Korean economy began to show recovery from 1999 and finally graduated from the bail-out program sooner than anticipated. All these experiences show the significance of economic reform process when they are implemented in a timely manner. When reforms are delayed, the economy regardless of the surrounding circumstances will be severely penalized at great economic costs.

3-3 Major Features of Korean Economic Development

The success of the Korean economy owes much to getting the “fundamentals” right. Macroeconomic policy, though not satisfactorily geared to stability, has been disciplined by the export orientation of the economy. Accumulation of human capital must have been critical for the take-off and the subsequent sophistication of the economy. Backed by a rapid increase in domestic savings, investment in physical capital also expanded at a high rate, contributing greatly to growth. On the other hand, Korea’s economic growth has, to a large extent, been driven by the rather authoritarian government and big chaebols. By reducing various uncertainties prevailing in the early stage of development, government guidance and intervention was actually effective in mobilizing resources for the best growth performance. However, continued government intervention accompanied by increasing risk of government failure, weakening of the financial sector, and the unchecked leveraged growth of large chaebols has become the root cause of the current financial crisis.

<Macroeconomic Management and Foreign Exchange Policy >

Being convinced that macroeconomic stability facilitates sustained economic growth, Korea’s macroeconomic policies have been conforming to economic stability since the early 1980s, if not over the whole course of economic development since the early 1960s. Not surprisingly, Korea’s macroeconomic polices have been frequently and significantly affected by external environment as well as domestic sectoral polices as in many other small open economies. In certain cases, monetary and fiscal policies were exploited to finance export or investment in strategic industries even under high inflationary pressure. Nevertheless, the signals of any major macroeconomic imbalances have become obvious through the performance of the external sector, and the government has reacted rather quickly to correct or reverse those macroeconomic imbalances.

In particular, exchange rates were realigned to be largely compatible with stable real effective exchange rates in response to a deteriorating current account balance. Monetary and fiscal polices were also tightened to be consistent with overall economic stabilization and improvement in export competitiveness. Such agile policy responses helped Korea to avoid major economic crises or collapses until recently.

During 1990-91, Korea’s inflation in terms of consumer prices accelerated to around 9%, due to economic overheating and the strong demand for wage increases from the labor unions following the Declaration of Democratic Reform in 1987. Since then, inflation has come down to a 5-6% range with the help of disciplined monetary and fiscal management as well as deceleration in wage increases. Every year during 1993-96, the consolidated budget balance registered surpluses: this sound fiscal operation sharply contrasts with most other countries. Korea’s macroeconomic stability, however, was totally shattered by the foreign exchange crisis of late 1997.

With the adoption of the Market Average Exchange Rate System in 1990, the market forces were allowed to play a part in determining the exchange rate within a specified range. Korea's exchange rate has been managed so that it would not seriously weaken the competitiveness of exports, which is understandable given the continued export-orientation of economic management. The real effective exchange rate, which takes into account the exchange rates of all the major trading partners as well as their inflation rates relative to domestic inflation, has been rather stable, particularly when compared with those of Latin American currencies. Nevertheless, it has been observed that when the Japanese yen fluctuates against the U.S. dollar, the Korean won has typically remained much closer to the dollar in the short run rather than maintaining a constant effective exchange rate. In more recent years, evidences also show that the Korean exchange rate was, to a degree, influenced by the capital account balance. Actually, this was why the Korean won was overvalued during 1996-97 when the Japanese yen was weak relative to the U.S. dollar and foreign capital inflow was substantial.

<Investment in Human and Physical Capital>

Education contributes to economic progress in various ways. It enhances the quality and employability of labor, one of the major productive factors. Science and technical knowledge as well as entrepreneurial ability are enhanced by education. Education also contributes to growth by increasing labor mobility, promoting division of labor, encouraging people to be more responsive to changes in environment, and removing social and institutional barriers to economic development, all of which help resource allocation.

A large pool of educated manpower certainly played a critical role in the consequent takeoff of the Korean economy. Essential in this role was a strategy to make the best use of resources available. In Korea, it was an export-oriented industrialization strategy that allowd to make full use of abundant, inexpensive but educated human resources. Even though Korea boasts of good quality of labor, the initial condition of human capital at the time of liberation was much inferior to Uzbekistan. But the drastic improvement of educational base in the following years have laid firm ground for continued economic growth.

Korea's school enrolments at all levels increased extremely rapidly from 1945 to 1965, except during the period of the Korean War. The enrollment rate in primary school had expanded drastically with its liberation from Japanese occupation in 1945.[24)] Again the enrolments at the higher levels followed afterwards. Enrolments in secondary schools, with the background of increasing numbers of students graduated from primary schools, rose from 267,000 in 1951 to 740,000 in 1952. Thanks to the strong growth of school enrolments, in 1960 about 56 percent of the adult population had received some primary education, whereas 20 percent had even obtained some secondary schooling. This makes a stark contrast with the fact that in 1945 about

24) In 1946, the following year of the Liberation, primary school enrolments jumped from 1.4 million to 2.2 million.

87 percent of adults had never received any formal schooling (Lee 1997).

By the early 1960s, as a result of its early investment in education, Korea already had a substantial stock of human resources. In 1960 the educational attainments of Koreans far exceeded those of the populations of developing countries, but still much less than the OECD average. But entering into 1990s, Korean's average year of schooling even exceeded the average of the OECD countries as a whole.[25)]

With the expansion in school enrollment rates, there has been substantial improvement in the quality of education.[26)] By 1990, Korea seems to have accumulated well-educated human capital, at least at primary and secondary levels, compared to most of the countries in the world.

Throughout Korea's rapid development period, expenditures for education had increased continuously. Total expenditures for education were estimated to be 8.8 percent of GNP in 1968, which had increased to become 10.8 percent of GNP in 1990. But the substantial part of this education spending is financed by private sources. For the period from 1968 to 1990, for instance, more than 63 percent of total education expenditures were financed by private sector.

For a developing country, industrialization has to follow the footsteps of forerunners and Korea also had to go through the process of catch-up. In general, the ability to adopt the advanced technologies from developed economies is considered directly related to the human capital stock.?In Korea, the adaptation of the inflows of the advanced foreign technology was possible with well-educated labour force. For this purpose, particularly important secondary education, which was the cornerstone of its ability to learn and adopt Western technologies in order to develop new exports.

Korea is one of the countries with a very high investment-GNP ratio. Investment in machinery and equipment together with construction activities add to the country's stock of physical capital, which is the most important productive factor together with labor. Growth of developing countries is mainly constrained by the inadequate accumulation of physical capital. Much of export capacity expansion in the 1960s as well as heavy and chemical industry building in the 1970s in Korea were made through foreign borrowing, since national savings alone could not fully finance all the capital investments. By the second half of the 1980s, Korea's national savings rate has reached over 35%. Still, the strong investment activities of Korean firms have resulted in the net use of foreign capital in many years as manifested in large imports of capital goods and the current account deficits.

25) The average years of schooling of the population aged 15 and above more than doubled from 4.2 years in 1960 to 9.9 years in 1990, exceeding the OECD average of 9.02 (Lee 1997).

26) Although it is very difficult to measure the quality of education, schooling quality is often measured by the scores of internationally comparable tests of pupils' achievement in cognitive skills such as numeracy, literacy and scientific reasoning.

Korean policymakers believed that external borrowing could play an essential developmental role and would not cause any major problem as long as it generates future debt servicing capacity instead of being used for current consumption. Until the 1970s, inflows of long-term foreign capital were mainly public and commercial loans. In view of the worldwide debt crisis in the early 1980s, policy efforts shifted toward more equity type inflows like foreign direct investment. Also, as a way of improving borrowing terms, syndicated loans by banks (for re-lending to domestic firms) coupled with overseas bond issues were encouraged. So far during the 1990s, however, foreign portfolio investment and to a lesser extent foreign direct investment have replaced the role of other types of loans. Beginning in 1992, foreign investors were allowed to purchase individual Korean stocks in the domestic market within a specified ceiling, before it was lifted under the IMF bail-out program. The bond market has also been gradually opened, starting with convertible bonds issued by small and medium-sized firms and international trust funds for investment in Korean bonds.

<Economic Power Concentration and Financial Sector Problems>

One of the most prominent phenomena in the process of Korea's economic development was the rise of large business conglomerates (chaebols). This may partly be ascribed to the fact that Korea's economic development strategy was based on promoting heavy and capital industries, which require large amounts of capital. With limited domestic capital, concentration of economic power in the hands of several key industries was rather natural outcome and government support for these industries with such measures as tax incentives and subsidized credits contributed to deepening of their economic power. They have extensively diversified their business portfolios. Constrained by the small domestic market, and motivated by huge capital gains from real estate holdings, they moved constantly to newly emerging industries. Chaebols have contributed a lot to the enhancement of the nation's industrial structure. With the extensive diversification of their business interests, together with the strong government backup, willing to both provide concessional loans and serve as a risk-sharing partner, chaebols have been aggressive in developing new products and markets and undertaking other large and risky projects.

However, there has been increasing concern over the concentration of economic power centered around chaebols. First, concentrated economic power is feared to bring about increased political power and distort government policies. Chaebols may also be too big to fail with its costly consequences like moral hazards and sacrifices of the financial sector. Second, many chaebol-affiliated corporations often have a market-dominating power in their business lines. Making use of this position and the extensive business diversification of chaebols, these firms may be involved in practices that constrain fair competition and abuse conflicts of interest for the benefit of the entire group. Third, chaebols may infringe on the interests of smaller firms and minor stockholders. With cross repayment guarantees and cross shareholding among member corporations, they tend to limit the access of smaller firms to credit and dividend receipts for small stockholders. Finally, the internal efficiency of chaebols is also seriously doubted. Cross-subsidization among member corporations is likely to cause inefficient allocation of resources, and managerial control concentrated in the chairman often leads to rigidity, red tapes, and a lack of a countervailing power checking the dogma and authoritarianism of the owner/manager. Furthermore, aggressive competition among chaebols for market share and size has often led to wasteful overinvestment and duplicative investments in some industries. Concerned over the concentration of economic power and weak corporate capital structure, the government has urged chaebols to raise capital in the equity market, to dispose non-operating real estate, and to specialize in a few industries. They have actually been restricted in using bank credit, and cross shareholding and repayment guarantees have also been regulated. These measures, however, have generally been ineffective.

In spite of continued reform efforts in the financial sector, Korea's financial markets were saddled with such problems as adverse selection, moral hazards, lack of long-term credit, and contract enforcement, which are quite prevalent in developing countries. In this situation, government intervention in the financial system may be justified for a more effective implementation of development policies.

As the economy develops and becomes more structurally complex, however, the task of the government to direct the allocation of resources becomes increasingly challenging. The ambitious promotion of heavy and chemical industries in the 1970s led to a substantial departure from Korea's factor endowment, and the resulting investment inefficiencies incurred heavy cost to the economy. The cost was apparent in expensive industry rationalization programs and corporate bailout packages and accumulated non-performing loans in the banking sector. Financial liberalization has been an important policy agenda since the early 1980s. However, the serious problems in the banking sector, which could not be left to banks to solve, rendered excuses for continued government intervention in the financial sector. The results were weak governance of private banks, restriction of competition among financial institutions, delayed financial liberalization and external opening, and poor services and profit performance.

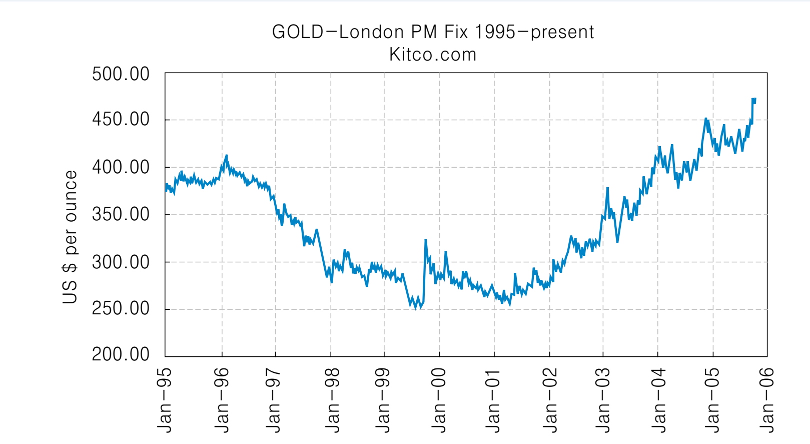
4. Policy Recommendation for Sustained Growth

4-1 Introduction

For Uzbekistan's economy, the fundamental issue is how to regain its growth potential. Since 1996, Uzbekistan has achieved positive growth at an annual rate of 4%. Even though growth in 2004 turned out to be exceptionally high, it greatly benefited from the favorable international environment along with an improvement in its terms of trade. As shown in Figure 3, international gold prices have been rising since the beginning of 2001. Cotton prices have also shown an upward trend since 2002.

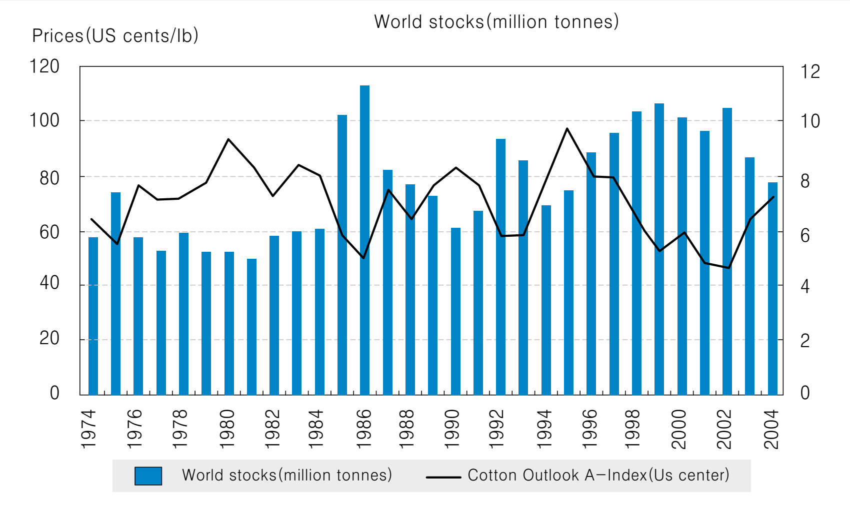
External conditions, however, are volatile and there is no guarantee that the favorable conditions will continue in the years to come. Moreover, an average 4% of annual growth rate too low to prevent or redress potential socio-economic problems. Obviously, great attention must be placed on preventing higher unemployment.

<Figure 1-3> Changes of Gold Price



Due to its unique transformation strategy, Uzbekistan has been able to successfully prevent mass unemployment, but the risks still exist. In the underdevelopment agricultural sector, unemployment is generally rampant. When restrictions on inter-regional movement are lifted, many of these underemployment will become open. Further, restructuring of state owned enterprises, which are generally over-staffed, is another source of further job loss. There are other factors that can increase labor, such as natural growth of population and female labor participation.[27)]

<Figure 1-4> Changes of World Cotton Production and Price



These have been very common phenomena in most transition economies, not only in Eastern Europe or CIS but also in East Asia. China, which has been in transition for last 25 years, still faces potential unemployment risk, which is one reason it still maintains constraints on inter-regional population movement. In Uzbekistan, due to delayed privatization and restructuring of SOEs, and continued control of inter-regional movement, the potential risks of increased unemployment have yet to be confronted.

Furthermore, a fundamental problem in the Uzbekistan economy, which is yet to be resolved, is diversifying its industry and export commodities. Considering other Central Asian or CIS countries, a country with around 27 million population is not a small state. Due to its relatively large population size, it has potential for scale of economies. Uzbekistan's population advantage would allow it to promote industries for domestic market and hopefully allow it to export to neighboring small-sized, less industrialized CIS countries.

27) According to UNDP estimate, as a result of fast population growth in the past, the working age population will continue growing at a sustained pace until 2008 which means that at least until that year the Uzbek economy will have to generate an additional 254,000 jobs a year, mostly in rural areas. Additionally, 675,000 workers will need to find another job in the non-state sector during 2003-2007. Third, agriculture is still affected by a considerable labor surplus estimated to amount to 650,000 workers (UNDP, 2004).

To change the growth potential, two things need to be reinforced: resources and institution. Resources involve human resources and capital accumulation. Institutional factors include reforms and new legal and institutional arrangements. Of course, macro-economic stability is needed to achieve sustained growth which is critical in attracting foreign capital, that can supplement shortage of domestic saving as well as inducement of technology. Based on these economic fundamentals, an appropriate development strategy will allow Uzbekistan to achieve its objective of economic development and industrialization.

4-2 Agricultural Reform

For sustained growth, design of long-term development strategy is critical. Considering the needs of fundamental changes in legal and institutional arrangements as well as in the industrial structure, generation of quick supply response is urgently needed to prevent socio-economic eruption. Considering their limits in resource availability and potential risk of mass unemployment, promotion of agricultural sector and SMEs to derive quick supply response is especially important. Since promotion of SMEs is to be examined more in detail in the following chapter, present discussion is to focus on agricultural sector.

As was shown in Chapter 3, property rights have gradually been transformed in Uzbekistan during the 1990s. The ownership of agriculture land is still in the hands of the state, while farmers have been given its user right. Uzbekistan's agricultural organization is based on a dual structure: reorganization of collective farms into large collective enterprises and distribution of land use right to individuals. The land leased to individuals was reorganized into small-scale household (dekhkan) farms at a later stage. Although the family leasehold (pudrat) system was further developed within the large farms (shirkats) by the end of the 1990s, while being given certain financial autonomy, they are still state control in term so production plan and state procurement system.

To derive supply responses in the agricultural sector, at least several factors need to be considered: ownership structure, terms of trade, heavy taxation, farmers' autonomy, and policy support.

First of all, the institutional arrangement in agriculture should evolve towards wide distribution of land ownership to farming population. In Uzbekistan, it is not clear whether the agricultural sector is to be reorganized into family farming or agricultural cooperatives with shares owned by farmers. There are certain potential risks of completely privatizing land. It may result in uneven distribution of land, which may not be acceptable in egalitarian biased Muslim society like Uzbekistan. But this may not be the main cause for the delay in privatization. All the more important is supply response and the employment opportunity. Another factor that would delay privatization of land is farmers' willingness to stay dependent on shirkats in order to get subsidized inputs (Amelina and Gershenson 2002).[28)] In spite of these constraints, the study by Brooks and Lerman (2001) indicates that effective level of transferability is more important than actual title to land.[29)]

Land redistribution per se will not be enough to achieve an equitable and efficient an agrarian structure, instead it needs to be accompanied by supporting measures such as development of local markets for both inputs and outputs. Administrative decentralization and commercialization could be two possible ways to achieve this. Indeed, once the shirkats are transformed, they may become important in promoting labor-intensive rural industrialization as was the case in Chinese township enterprise at the beginning of transformation.

Improvement in the terms of trade of agricultural products can be achieved by increasing procurement prices, reducing state purchases and eliminating foreign exchange surrender requirements. In addition to improving the terms of trade, a very critical precondition for generating a supply response in agriculture is reducing the high tax burden. The stagnation experienced in Uzbekistan's agricultural sector may stem from the "draconian taxation of agriculture" especially in the cotton sector. Moreover, the inability to change production technology and shift the output mix can be considered to be additional constraints in improving production efficiency. All these constraints explain why Uzbekistan's agricultural sector cannot expect to achieve the kind of supply response generated in China (Pomfret 2000).

The farming sector tends to be financially weak condition, which is why this sector is usually highly supported with state budget in developed countries. In contrarily, in Uzbekistan, surplus from the agricultural sector is transferred to support favored industries. This may be justifiable, since there is an urgent need of industrial diversification and industrialization. But improving the income earning in this sector can create large demand for industrial product. Since it is very labor-intensive, assigning greater priority to agriculture would have a major impact on labor absorption. To promote the agriculture sector, public investments is needed to overhaul the irrigation systems and to create new infrastructure. Also, financial provisions for farmers such as micro-credits are needed.

4-3 Export-Oriented Development with EPZs

Considering Uzbekistan's economic size and its level of industrialization, continuing to pursue an import-substitution-based policy can hardly be the appropriate approach to achieve successful diversification of its industry. However, shifting its policy toward export promotion may be a difficult process with the potential risk of great opposition from those with invested

28) The observation by Amelina and Gershenson (2002) was made in Russian farms.

29) The study was conducted on the background Turkmenistan.

interests in favored industries. Furthermore, a change in thedevelopment strategy would mean the realignment of all economic policies, such as allocation of domestic credits, current account convertibility, tax and budget management, and even privatization.

Considering all these challenges and impacts of a policy change, a sudden policy shifts is neither feasible nor desirable for Uzbekistan, under present circumstances. A change in its fundamental policy stance has to be pursued on a gradual basis. That is, at least during the interim period, policies for export promotion have to coexist with current policies protecting domestic markets, which should be phased out eventually. Since these two opposing policy stances cannot be accommodated under a unified institutional framework, a possible option to pursue the two opposing policies in the same national territory is geographical division. Certain parts would adopt the export promotion policy, while for other parts would continue to apply existing policies. In essence this is nothing more than establishing export-processing zones (EPZs) or special economic zones (SEZs) where a new environment that operates under a different set of economic institutions and polices.

In fact, a number of East Asian countries have established EPZs in an effort to shift from import-substitution based to export-based industrialization in the mid-1960s. Taiwan had been the first country to do so in 1966 and then followed by Korea in 1970.[30] Also other East Asian NIEs such as Singapore and Hong Kong have followed suit. Then China began to establish Special Economic Zones (SEZs). Once China adopted its open-door policy in late 1978, four SEZs were set up in 1980. In the 1970s, the EPZs were mostly found in Asian NIEs, but in the latter half of 1990s, EPZs had been established in more than 90 countries (Kusago and Tzannatos 1998).

Although both EPZs and SEZs are supposed to attract FDI in export manufacturing, they do have some differences. The policy objective of EPZs is mainly to enhance a country's productive capacity in manufactured goods, especially for the world market. In addition, other goals include the creation of new jobs, training of skilled workers, and transfer of technology. SEZ and EPZ are both variations of a free trade zone, but the SEZ is a more comprehensive economic zone and is considerably larger in size than the EPZ.[31] The SEZ generally occupy a much larger space than the average EPZ which were often less than 10 square kilometers. In addition, the SEZs are also intended to serve as an environment for testing new reforms of enterprise management, finance and labor matters, which, if found successful, could be applied throughout the country (Ota 2003).

30) The idea of modern EPZ was initially an Irish invention. After the first EPZ began operation at Shannon Airport in Ireland in 1959. The first Asian EPZ established at Kaoshiung in 1966 and Korea's first EPZ at Masan was established in 1970.

31) For instance, the original zone of Shenzhen SEZ, for example, had an area of 327 square kilometers.

<Process and Considerations in the Creation of EPZs>

To establish an export processing zone, as well as, to maximize the benefits, a country should exhibit prior potential comparative advantage production, which can drive foreign firms to invest in manufacturing products for export. In most developing countries, inexpensive labor can provide investment incentives. This is true for Uzbekistan as well. Also important is establishing international freight routes so that products can reach important markets. Even though export freights are generally transported by sea, well developed inland routes, such as railways or highways, can also serve as infrastructure for international transportation, depending on a country's geographical condition.

In most cases, investments in an export processing zone are given fiscal and financial incentives. In general, investments in export processing zones are provided with lengthy tax holidays with minimal restrictions in terms of profit repatriation and foreign exchange controls. The government also does not intervene by implementing measures such as import controls, overvalued exchange rates, subsidies especially to domestic industries Although every country has its own specialty in terms of legislative, there are no big differences in fiscal and physical incentives. This might be due to the fact that competition is made on a global level.[32)]

Also, the provision of quality social infrastructures is a prerequisite in attracting FDIs. In addition to making inexpensive land available, there are a variety of social infrastructures that are needed such as water and sewage systems, transportation network, supply of electricity, communication network and banking and insurance facilities.

<Table 1-15> EPZs (SEZs) Tax Systems of Asian Transition and Socialist Economies

	China	Vietnam	North Korea
Corporation Income Tax	15%	10~15%	10~14%
Individual Income Tax	5~45% of progressive rates with exemption under US$ 145	10~50% of progressive rates with exemption under US$253	4~20% of progressive rates with exemption under US$950
Customs	Commodity imported for export processing	Commodity imported for export processing	Commodity imported for export processing
Tax Holidays	Full exemption for the first 2 years and 50% for the next 3 years	Full exemption for the first 2 years and 50% for the next 2 years	Full exemption for the first 3 years and 50% for the next 2 years

Source: respective country's investment promotion bruchures

32) Major areas of divergence are on matters respecting permission of sales to domestic markets (Kusago and Tzannatos 1998).

With success in economic development, the host country's interest in EPZs may gradually decline. In early stage of industrialization, EPZs provide better opportunity for employment and foreign exchange earnings. With industrial development and economic growth, the advantage of EPZs will become insignificant as the business environment in non-EPZs will sufficiently improve to attract FDI in general ways. This has been clearly demonstrated by the case of Korea and Taiwan, both of which experienced gradual decline in the interest of enclaved type of development (Kusago and Tzannatos 1998).

<Korean Case: Technological Transfer and Learning Opportunity>

At the initial stage of Korea's economic development, FDI played a relatively minor role in economic development. However, Korea's export-led growth strategy co-existed with policies to attract FDI and establish new relations with foreign investors in the early 1960s.[33)] Foreign multinationals contributed greatly to Korea's technological capabilities. One of the most successful cases can be found in the Masan Export Processing Zone (EPZ).

Like other EPZs, Masan EPZ also provided an industrial estate where land, utilities, transport facilities.[34)] The Masan EPZ also allowed the duty-free entry of goods destined for re-export. One of the great contributions that Korea could derive from this EPZ was technology transfer. The development process of the Korean semiconductor industry also shows the important role of EPZ. In the mid-1960s, U.S. firms began to assemble transistors in Korea in order to take advantage of its cheap labor.[35)] Following the lead of U.S. firms, Japanese firms entered into joint ventures with Koren firms.[36)] Since the beginning of the 1970s, many Japanese firms producing related parts have also established subsidiaries in the Masan EPZ. This laid the firm ground for Korean firms such as Samsung, LG and Hynix later to become leading producers of DRAM in global market.

The relative importance of the zone declined by the mid-1970s. Nevertheless, about 9,000 workers and technicians employed at the Masan EPZ had benefited from overseas training programs until 1993. More importantly, subcontracting outside the Masan EPZ increased significantly, contributing to production of value-added of products by foreign investors. These efficiency gains outside the EPZ, induced by backward linkages, reflecting the existence of technology spillovers through FDI. The development of human resources and technology

33) But a major change occurred in the early 1980s when Korean economy began to exhibit the negative effects of the Heavy and Chemical Industry Plan of the 1970s. The new industrial strategy, adopted in the early 1980s, was based on an attempt to upgrade Korea's industrial structure as a whole by moving into more technology- and skill-intensive sectors. A key component of this technology upgrade was recognized to liberalize FDI.

34) Builuildings were also supplied by the government at highly subsidized rates.

35) For instance, some of the representative firms made investment then was Comy (1965), Fairchild (1966), Signetics (1966), and Motorola (1967).

36) They were such as Toshiba (1969), Sanyo (1970), and NEC (1970).

spillovers through foreign multinationals provided a basis for development of domestic firms (Wang 2002).

<Domestic Industrial Policy>

Development of EPZs can be an efficient way to promote exports, but it can take some time for the desirable effects of the policy to materialzie. Attracting enough FDIs has various challenges and diffusing domestic technology occurs in the long-run. Thus, revitalizing the domestic economy through genuine reforms is all the more important for the national economy. The lesson from East Asia's economic success is that domestic reform should go along with SEZ or EPZ policies.

Uzbekistan has clear advantages in promoting its domestic industries. Uzbekistan, whose population accounts for about half of Central Asia, can take advantage of the regional markets in Central Asia as well as its domestic market. But Uzbekistan's industry is still not sufficiently competitive, which is why there continues to be government intervention. But targeting which industries to protect should be give due consideration. In choosing which industry to protect, government's discretion may not be avoided. But the choice should be made on a industry level, not on a firm level, in which the institutionalization of industrial policies are needed for certain period of time.

Additionally, even though domestic markets may be protected from imports, a competitive environment needs to be created. If the Uzbekistan government continues intervening in industry for an extended period, then it is certainly possible that what happened in Korea with over-concentration of economic power can also happen in Uzbekistan. Korea's big companies were given preference in order to promote HICs, which led to huge economic costs and became one of the principal causes of the financial crisis in 1997.

4-4 Macroeconomic Management

Uzbekistan has had some success in macro-economic management, especially considering the low fiscal deficit and a balanced current account. But increasing deficit in quasi-state budget still poses some concerns. Though stable, inflation remains comparatively high and should be gradually reduced. Inflation is 'costly' as changes in relative prices weigh down on profits/wages, raise uncertainty, and reduce aggregate investment. Under any circumstances, high inflation would involve large economic and social costs. However, for macro-economic management, a transition economy's specific conditions need to be properly considered.

In general, the causes of inflation in transition economies are summarized into the following: undervalued exchange rate, large relative price changes, freeing of controlled prices, and wage-pull inflation. Many argue that inflation in transition economies is largely the result of the initial over-depreciation of their currencies. This inflation is not the outcome of the usual wage-price spiral induced by devaluation, but, rather, it is the result of the workings of the law of one price, or commodity arbitrage, which creates domestic inflation to reestablish purchasing power parity.

The large relative price changes suggest that transition process involves the adjustment of thus-far distorted relative prices. Price readjustment during transition thus occurs as some prices increase by large amounts and others either remain constant or increase by relatively smaller amounts due to the downward inflexibility.

Also, high inflation can occur as a consequence of lifting price controls, such as government and municipal services, utilities and rents, and energy. In general, these price controls were not fully lifted during the initial price liberalization stage, so there would be price hikes as the transition proceeds.

Finally, in transition economies, nominal wages have generally tended to increase more rapidly than CPI plus productivity growth. This may be the result of poor corporate governance or as a consequence of wage adjustment. In some countries, this has been prevented implementing such measures as indexing of wages or tripartite negotiations between the government, labor unions and representatives (Brada, and Kutan 1999).

In case of Uzbekistan, the wage-pull is less likely due to strict wage controls, but all the remaining factors may be in place. Especially, due to delayed price liberalization and continued state intervention in economic activities, sectoral adjustment has yet to conlude. Considering this condition, relatively high level of inflation is admissible.

Considering that a number of commodity prices including cotton and wheat are yet to be further liberalized, the adjustment process of these relative prices may easily accompany inflationary pressure. But careful consideration should be paid in the management of aggregate demand not to bring forth a recession (UNDP 2004).[37)]

37) Based upon such reason, UNDP (2004) suggested that 11-12 % in the developing countries, while the optimal threshold for inflation is generally recognized to be 1-3 % a year in the industrialized countries.

5. Korea's SMEs Promotion Policies and Policy Implication of Uzbekistan

5-1 Introduction

For a successful implementation of system transformation, especially industry restructuring, the promotion of small and medium enterprises(SMEs) is one of the indispensable prerequisite. In socialist economic system, most of production plants were constructed in large scale with vertical and horizontal integration, thus forming an industrial complex. With nationalization and collectivization, small and medium industries had been either scrapped or merged into large firms.

The importance of SMEs lies not only in creation of new industries complementing the production activities of large-sized key industries. They can make great contribution to employment creating new jobs, geographically dispersed. Compared with key industries with large-sized firms, SMEs generally requires relatively less amount of capital, which implies that they can generate swift supply response. Thus, SMEs can act as one of the locomotive of the economies in transition. In fact, in China, the township enterprises, which were nothing more than handicrafts, had been main provider of lively energy to its economy at the initial stage of its economic development immediately after it executed open-door policy in the late 1970s. Especially important is that the sprout of these small firms laid the firm ground for endogenized economic development in the following years.

The importance of SMEs in national economy cannot be overlooked regardless of the level of economic development. In the beginning stage of economic development, the small indigenous firms with big success would grow in size and technical upgrading to join the group of leading industries. With the deepening in industrialization the role of SMEs is still profound in the sense that production of leading industries are on the basis of parts and components supplied by SMEs. The development of SMEs in Korea has followed a unique path due to its course of overall economic development. Promotion of heavy and chemical industries, which favors large conglomerates brought about side effects of neglecting SMEs in 1970s. This became a big burden to Korean economy in the following years and promotion of SMEs afterwards involved large amount of state budget and also brought about complicated issues in industrial relations between large frims and SMEs. Due to the big difference in the initial conditions between Uzbekistan and Korea, especially in economic structure and level of economic development, Korea's SMEs promotion experience and related government policy may not directly applicable to Uzbekistan, but a number of lessons and important policy implications can still be derived from the former's case.

5-2 Economic Development and SME Policies in Korea[38)]

<SME Policies in the 1960's and 1970's)

The evolutionary process of Korea's SME policy needs to be understood in the context of Korea's economic development. The Korean economy has gone through great and economic transformation since the inception of the first Five-year economic development plan in 1962. The Five-year plan essentially shifted Korea's development strategy from an import substitution to an export-oriented one. The partial opening up of trade enhanced both Korea's efficiency and international competitiveness, as it encouraged the inflow of technical know-how, HR skills and talent, as well as, enabling economies of scale and reducing relative prices of investment goods. Earnings from exports coupled with foreign loans were used to finance the import of capital goods and raw materials to expand Korea's export industry, which was the catalyst for economic growth.

Until late 1960s, most of Korea's manufacturing firms were not larger than today's medium-sized firms. Quite different from Uzbekistan, the number of state-owned companies was very rare in manufacturing sector and they were founded by private fund. Some of these firms later on emerged to be chaebol. It cannot be denied that some of them had been largely benefited from government support, especially with HIC promotion programs during the 1970s. On the whole, the growth of Korea's leading companies, such as Samsung, Hyundai, LG, had gone through the process of "the survival of the fittest" with fierce domestic and international competition.

During 1962-1971, Korea's GNP grew at an average annual rate of 8.78%. However, during this period, Korea's small and medium sized industries began to decline generally. In particular, the share of business, employees, and value added of SMEs in the mining and manufacturing industries began to fall beginning in the early 1960s until 1971, as some SMEs grew into bigger companies and larger factories began to be constructed. The government pursued a series of polices aimed at promoting SMEs. Korea's economic development policies in the first half of the 1960s centered on building a strong foundation for industrial development, and in the preceding years, petrochemical, metallurgical, and machinery industries were promoted. However, greater support given to larger companies became a policy issue, and so, measure were taken to increase support to SMEs on a selective basis. Though the importance of SMEs were heightened during this period, actual support for SMEs was not sufficient enough.

By the 1970s, Korea's export-driven development strategy centered on promoting the heavy and chemical industries. Accordingly, vast amounts of investment were diverted to

38) For further discussion concerning this issue, please refer to Seong (1993).

shipbuilding, automobile, iron and non-ferrous metal industries, further decreasing available resources for SMEs, including labor. The promotion of HCIs not only undermined the importance of SMEs, but also exposed the vulnerability of SME sector. Again, though policy measures were implemented to support SMEs, they were not enough to achieve further growth. For instance, a law was enacted to enable SMEs to produce specialized products or operate as a subcontractor. In 1979, the Small and Medium Industry Promotion Corporation (SMPIC) was established to provide various programs for SMEs including financial aid, management and IT, and training, to modernize SMEs. In 1981, a law was established to encourage public sector organizations to purchase products from SMEs.

<SME Policies in the 1980's>

Korea began to reap the fruits of its export-driven strategy, as exports reached $21.0 billion in 1981, compared to $1.4 billion in 1971. However, SMEs continued to play a smaller role in the economy, as their share of total exports steadily declined. The 1980 ushered in a more active and intensive period of policy focus for the SME industry. First, the government established legal and institutional foundations for the protection and promotion of SMEs. The amended 1982 Constitution, for instance, states that the 'protection' and 'promotion' of small businesses shall be the government's 'responsibility' and 'duty'. Besides granting such extraordinary legal status, the Korean government actually has pursued a vigorous SME promotion policy since the early 1980s, introducing various support programs as well as making requisite institutional rearrangements. In 1982, a long-term plan was drawn up setting out the policy objectives and identifying fundamental problems facing SMEs along with possible policies to address these problems. Consequently, a package of policy measures in the form of both direct and indirect support followed.

First of all, in order to expand the base for further growth, a support program was established to promote SMEs that exhibited promising potential in targeted industries, by helping select SMEs modernize production facilities, enhance management, and increase technological capacity. In particular, policy focus was placed on strengthening high value added production and technological innovation. As a way to foster innovation and commercialization of new technologies, funding programs to help start ups were established, and collaborative relations between academia, government and business were encouraged. The Korea Institute of Economics and Technology (KEIT) became an information resource center for providing managerial, economic, and technical knowledge to SMEs. In 1982, the Small Business Training Institute was established to provide HR education and training for SME employees, and enhance the R&D capabilities of SMEs.

Second, to support stable SMEs, a set of measures were implemented to expand the scope of tradable products of SMEs, as well as, protect them. For instance, measures were introduced to encourage cooperative relations between prime contractors and subcontractors, as well as, strengthen existing ones. A system was created to make more effective and efficient the supply network between prime contractors and subcontractors. In addition, a fund was launched to strengthen the financial standing of SMEs.

Third, government support also came in the form of financial assistance. The government created favorable environment so that SMEs were able to access loans more easily. For instance, loans for capital investment in export industries were made available to faciliate the import of technology, R&D activities, and even equipment investments. The Korea Credit Guarantee Fund guarantees loans the full appraised value of the collateral, which amounts to one billion won for each firm with a guarantee rate of 1.0% for SMEs compared to 1.5% for larger firms. Financial support also came in the form of tax breaks, which are greater for SMEs compared to large firms. For instance, depreciation ratios are 50% larger for SMEs, and even a 100% depreciation rate is given to some select SMEs, such as those relocating to rural areas. Other tax incentives are given to firms that participate in cooperative projects or joint programs, and firms that merge are exempt from income tax, purchase tax, registration tax, and value added tax. Also, a investment reserve program was introduced to induce capital investemtn by SMEs, in which investments are given a three year tax moratorium, while 15% of a firm's total assets is recognized as losses for every year, assuming that the rate represents capital investment.

Fourth, to pursue a more balance growth, the government policy attention on regional development of specialized industries by supporting the creation of industrial complexes and relocation of firms in rural areas. The government provides funding for infrastructure, and financial assistance to firms in these areas through loans for factory construction and equipment purchasing.

However, the effects of such devoted policy efforts were mixed at least until lately. Although Korea's SME sector has been expanded notably since the mid 1980s, with steadily rising shares of SMEs in GDP, employment, and exports, such expansion was not accompanied by a substantial quality upgrading the Korean government aimed at. Toward the periods between 1987-1991, government policy was focused on increasing productivity and improving the quality of SMEs, as part of its overall strategy of modernizing the industrial base, which would encourage more exports and import substitution. In pursuing this, the basic policy approach rested on elevating the role of SMEs in the economy, increasing the adaptability of SMEs to new changing economic environment (opening up of economy), and strengthening government support of SMEs. In fact, SMEs grew faster than large firms between 1986-1988. In 1989, an act as passed to carry out SME restructuring, encourage technical innovation, increase productivity, and upgrade manpower.

<SME Policies since the 1990s>

Due to the active SMEs promotion polices since early1980s, Korea's SME sector has been expanded notably since the mid 1980s, with steadily rising shares of SMEs in GDP, employment, and exports. But such expansion was not accompanied by a substantial quality upgrading the Korean government aimed at. Although a group of technically competent, innovative SMEs started to spring up since early 1990s, the sweeping majority and increasing portion of SMEs remained to operate in the traditional low-tech industrial areas, producing a low-price commodity type of products under a subordinate contract with larger firms. Actually, productivity differentials between large firms and SMEs have increased in industries where technological competitiveness matters most.

Together with the financial crisis of 1997, however, there came a dramatic turnaround of such long-term trend. Some SMEs went bankrupt due to the severe credit crunch entailed by the crisis, but many Korean SMEs managed to change such a financial ordeal into a chance to greatly improve their financial status and cash flow. In addition, in endeavor to strengthen their competitive edges in a more proactive way, a substantial portion of SMEs started to increase investment in R&D and IT as well as stepping up their efforts to strengthen cooperation with overseas enterprises and to enter foreign markets. Overall market conditions have also changed in such a way to induce or support such self-redemptive efforts by SMEs.

As a result of financial and corporate restructuring, many Korean financial institutions came to find making loans to qualified SMEs more attractive. Also, large companies also came to change their attitude towards SMEs beginning to refrain from abusing their superiority towards their related SMEs, and instead trying to expand their cooperation with SMEs.

All these fundamental changes in Korea's SMEs culminate in the forming-up of a group of new technology-based small firms. Fostered amid the dramatic start-ups and venture boom, this group of SMEs emerged to make another pillar of Korea's growth locomotive, along side with a small number of big leading firms afflicted with Chaebols.

No doubt that the latest economic crisis was an epochal event that vindicated the potentials of Korean SMEs and the prospect of Korea's diversifying competitiveness base. Despite all these progressive developments, however, innovative SMEs with an independent and sustainable competitive base are quite limited in Korea compared to other advanced countries. It may be fair to say still that the absence of dynamic and innovative SMEs is a major weakness of Korea's industrial structures. Most SMEs in Korea are engaged in the production of technologically unsophisticated parts and components under a passive subcontract relationship with larger companies. Even with the best possible outcome from the ongoing structural reforms in Korea, the performance of SMEs is unlikely to improve markedly because of the grave elements of market failure intrinsic in the SME sector. To the extent that new phase of economic development ahead requires a diversification of production and a broader base of industrial power and technological capabilities, there is a strong imperative for Korea to develop a comprehensive and innovative strategy to nurture a substantial pool of autonomous and innovative local SMEs.

The Korean government launched economic reform programs in order to cope with the financial crisis. Reforms in the financial sector were most comprehensive and drastic. The transparency of corporate governance structure was improved. Policy programs to support innovative SMEs were developed. Except for the time during the crisis when the government increased credit guarantee to prevent a chain bankruptcy of SMEs, SME policy was concentrated on the promotion of innovative SMEs.

5-3 Uzbekistan's SME Policy

As in other cases of Uzbekistan's economy, it is not easy to get a real picture of SMEs due to lack of information and unique standard of classification applied for SMEs. According to Uzbekistan's standards of classification, SMEs are defined as follows:

Individual Entrepreneurs
Micro Firms (0-10 employees)
Small Enterprises (10-40 employees)
Medium Enterprises (40-100 employees)

Industry-wise, individual farms in the agricultural sector (private dekhan farms) are also classified as SMEs, in addition to manufacturing, trade, and service industries.

As of August 1, 2004, about 270 thousand SMEs have been incorporated in Uzbekistan. Thus SME sector employs more than 55% of the labor force and accounts for 35% of GDP (Embassy of Uzbekistan to US, 2004). But this evaluation is somewhat misleading due to the inclusion of individual entrepreneurs and micro-firms and agricultural private farms.[39] The number of SMEs and their total employment has fallen in the latter half of 1990, especially since 1997, while the number of informal entrepreneurs has increased dramatically. This move towards informality is indicative of the constraints faced by private businesses. According to the statistics released by Uzbek government, the number of SMEs is on the rise since 2000. There are three national laws which define the legal framework for the SMEs activity: "On Private Enterprises," "On Enterpreneurship," and "On Guarantees and Freedoms for Enterpreneurial Activity." In general, these laws are known to be regulation-biased, instead of support and promotion because it is not an easy task for small firms and private enterpeneurs to fulfill the conditions defined in those regulations.

Uzbekistan came to recognize the importance of SMEs' role in national economy and began to step up its effort for their promotion since 2002. In late 2002, Uzbek government simplified incorporation system with the introduction of "one stop shop" and later on introduced single tax in an effort to simplify the complicated existing tax sysem and tax burden of SMEs. In addition to reduction of the tax burden on SMEs, simplification of registration requirements, SMEs have been allowed to export without being subject to foreign exchange surrender.

39) World Bank(2004) estimates the share of SMEs (the majority of which are private) at 15 per cent of GDP and 9 per cent of total employment.

According to the report by CEEP, The activity of small enterprises in 2004 was characterized by their increased contribution to the economic growth of the country, creation of new jobs and increase of the population's income. The share of small enterprises in GDP in 2004 grew by 0.5 percentage points and amounted to 5.3%, while the share of microfirms increased by 1.6 percentage points and made up 13.3% in comparison with the previous year. The share of individual businesses in GDP decreased by 1.5 percentage points in comparison with 2003 due to the decrease in the share of dekhkan farms by 6.0 percentage points in the total volume of agricultural production, amounting to 17.0% . Stable growth of the share of SE in the GDP was extensively connected with the increased production of added value by small enterprises (growth by 5.5 percentage points) and particularly by microfirms (growth by 1.6 percentage points).

The positive shifts were observed in the development of SMEs in 2004, due to the measures aimed at the improvement of the macroeconomic and business environment. Its further development is considered of strategic importance as a priority in the realization of economic reforms. It is practically impossible to solve the problem of stable economic growth as well as social issues without the stable development of small and private businesses. The President of Uzbekistan has charged the government with achieving a share of small business of not less than 45% by the year 2007(UNDP & CER, 2005).

5-4 Policy Implications from Korean Experience

In Korea, those policy for the promotion of the heavy and chemical industries in 1970s had a serious negative impact on the SMEs. Even though Korean government initiated a strong support for the SMEs in early 1980s when it stepped up its efforts for macro-economic stability and external liberalization, the adverse effects accumulated in the 1970s lasted for an extended period.

The structural weakness of Korea's SMEs in material and machinery industries has been a drag on its economic growth. Since the major export industries in Korea are essentially assemblers, requiring a great deal of parts and high tech parts to produce finished goods, the quality of the finished products are very dependent on subcontractors. The material, components, and machinery industries are still underdeveloped, so many subcontractors need to import core materials, components, and machinery. In fact, the proportion of imported materials, parts, and machinery reaches nearly 80%. Hence, Korea's rapid rise in exports has been accompanied by a rapid rise in imports. This leaves the external competitiveness of large companies very much dependent on SMEs, who are supplying their parts and components. For instance, domestic suppliers that produce only a few products are not willing to supply SMEs which need specialized products at small quantities. This makes Korea's economy very sensitive to international market conditions. Whereas, Japan has a good balance of both large companies and SMEs.

The supply chain connecting large companies and smaller subcontractors has been relatively underdeveloped in Korea, as the export-driven policy focused on growing large companies. The level of technological and managerial capabilities at SMEs is low, and much more so with even smaller firms. Overall, this results in significant constraints on the development of an adequate subcontracting system. One policy solution was to consolidate the coordination of subcontractors to create economies of scale. But the greatest challenge for SMEs may be their ability to make technological advancements. As competition becomes more intense, it is becoming more critical in today's global economy to upgrade innovative capabilities in technology, especially among SMEs. Hence, R&D continues to be a critical part of businesses. In Korea, a large amount of new technologies that have been introduced have been imported, whereas the US and Japan, lead in the innovation of new technologies. In fact, in early 1990's, the share of SMEs in Korea engaged in R&D activities was less than 10% of the total number of SMEs in manufacturing. Also, the R&D to sales ratio of SMEs was less than 0.3%. There was gradual increase of this figure as Korean economy transforms into more knowledge-based and technology-intensive industries.

Entering the 1990s, Korea's SMEs had put much emphasis on the improvement of their competitiveness and technological capabilities, as well as strengthening relations with large firms. However, policy approach on the issue of SMEs needs to be reexamined from being objects of protection to being sources of industrial and competitive growth in the Korean economy. To achieve this, policy must be focused on strengthening the competitiveness of well performing SMEs, and helping weaker firms transition to more promising markets. At the same time, regulation must be geared towards promoting fair and competitive environment between large firms and SMEs. In addition to effective competition, policy attention needs to be placed on upgrading the level of technology and manpower at SMEs. Though the government should play an active role, it should not have to bear unnecessary risks and responsibilities of SMEs. So, the government should create environment conducive to nurturing entrepreneurial activity, but not shoulder additional risks.

Since the situation of SMEs in Uzbekistan is totally different from that of Korea during its early development, the issues surrounding Korea's SMEs center on international competitiveness whereas Uzbekistan's policy needs to focus on creating an environment for fostering SMEs which have long been suppressed during the socialist era. In spite of these limits, Korea's experiences should be considered as Uzbekistan tries to promote manufacturing industries that are international competitive. Interestingly, Uzbekistan's import substitution-based policy since mid-1990s has common characteristics with that of Korea's experience in promoting the heavy and chemical industries.

To accelerate growth and expand employment opportunities, Uzbekistan need to urgently promote SME sector and informal sector enterprises (ISE). Indeed SMEs and ISEs can play a greater role as a source of a labor-intensive growth, as confirmed by the positive response to the initial reforms introduced by the government in this area in 2000. The government simplified and speeded up the procedure for the registration of SME-ISE, improved their access to credit, foreign financing, raw materials and marketing channels, eased licensing and inspection procedures, introduced a simplified tax system and opened up opportunities for SME exports. The supply response was encouraging, as in 2001 alone, SMEs created 370,000 new jobs. These initial steps to improve the business climate need to be enhanced by simplifying licensing procedures, removing government control over bank deposits and cash withdrawals, providing business services and training, supplying information on market conditions or opening up new trading routes and helping to provide tailor-made loans and supporting services.

Further, the Uzbekistan government needs to take into consideration that strict control and regulation of small-sized business activities can lead to expanding the underground economy. Recently, the measures applied to informal businesses particularly in the trade sector have worked to drive these entrepreneurs further underground and discourage entry into the formal economy. In other words, strict regulation of SMEs can end up driving business activity from formal to informal sectors. These kinds of tax regulations in the SME or informal sectors can have overall negative impact on tax proceeds. Like other economic policies, maintaining consistency in the design of policies is critical for promoting SMEs. This is a precondition for the government to enhance faith and trust of the business group.[40)]

Generally,, measures that promote SMEs have fallen far short of stimulating strong entry and development in the domestic private sector. Other restrictions, such as close government supervision over enterprises through financial intermediaries such as banks sector have prevented many prospective businesses from going formal, and thus, have limited development opportunities. Reforms that create an economic environment favorable for SMEs need to be implemented, such as improving the macroeconomic and business environment, encouraging small entrepreneurship through efficient tax administration coupled with banking reforms to provide small enterprises with easy access to loans, and forming an effective legal assistance system.

For manufacturing SMEs, the policies adopted by Korea in the early 1980s should be seriously considered. In addition to adopting legal and institutional arrangements for promoting SMEs, setting up a long-term plan with clear policy objectives and an action plan that is viable may be the best policy tools which establish consistency in polices. Furthermore, other important policies include establishing a system to disseminate technology and information, providing HR training services for SMEs, and encouraging cooperative relations between prime contractors and subcontractor, etc.

40) In fact, when the Uzbekistan government began to actively support SMEs in the latter half of 2002, it announced a decision to make it possibile for privatized small-scale enterprises in social sensitive areas (such as shops, kindergartens and other social services) could be re-nationalized if they changed their main line of activity during the first five years following privatization. This has been interpreted as a possible re-nationalization of many businesses, particularly in growth areas such as entertainment (for instance, billiard saloons) and internet cafes. There is no clear indication that this decision was actually executed but its negative impact on business activities could not be overlooked.

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Chapter 2

In Search of Uzbekistan's Industrialization and Export Promotion Strategies

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Executive Summary

1. Overview of Korea's Industrial Development

Korea has been transformed from one of the least developed countries in early 60s into one of the leading industrial countries in the world during the last 40 years. Korea achieved its industrial development through export-oriented strategies. Korea had to take advantage of its abundant labor force. Though Korea's industrial development seems to be a government-led one, Korea pursued its economic development and continues to do so by recognizing its comparative advantages. In the early stages, Korea allowed market conditions to select specific industries that the government should support.

The following lessons can be drawn from Korea's industrial development for the Uzbekistan government. Firstly, there is no need to pre-select "appropriate" industries - the market will choose the "right" ones. Secondly, a well-educated and cheap labor force gives Uzbekistan a competitive edge. Thirdly, simple trade promotion policies can bring about industrialization in a country. Fourthly, "entrepreneurship" should be enhanced by the government.

2. Korea's Industrial Development I :Export Promotion in the 1960s

During the 1950s, Korea adopted import substitution policies. From 1964, however, the government focused on export-oriented policies rather than on import substitution. The government policies for export promotion included improving relevant laws, offering exporters preferential financial treatment and devaluing the Korean won. As important, the President personally encouraged export policies. Major industries that were developed during this period included labor-intensive industries such as wig-making, artificial eyelashes, textiles, and plywood. Korea transformed itself from a traditional agriculture-based economy into a manufacture-leading economy in the span of only 10 years.

3. Korea's Industrial Development II: Developing H&C Industries in the 1970s

One should remark the importance of "sequencing" in the process of Korea's industrialization. That is, its transition from light industries to heavy and chemical industries. In fact, labor-intensive industries, based on their success in 1960s, started to rely on materials produced by heavy and chemical industries in 1970s. As a result of pursuing the Heavy and Chemical Industries Development Plan during the 1970s, Korea succeeded in diversifying its export structure with heavy and chemical products. The following questions can be raised for Uzbekistan in light of Korea's experiences.

Can and will Uzbekistan follow Korea's "sequencing" of industrial development, starting from labor intensive industries (taking advantage of relative abundance of cheap and well-educated labor forces) and creating industrial demand for next generation industries (heavy and chemical industries)? What measures can be considered appropriate for promoting exports, especially manufacturing exports? Some of these may include export credit, industrial complexes, trading companies to assist SMEs export their products

4. Development of Korea's Automotive Industry

At the beginning, the industry assembled imported CKD parts, and so Korean car-makers relied on imported technologies and even on imported capital. Early components and parts were technologically simple and labor intensive. Gradually, more technologically advanced and capital-intensive parts were localized. The following questions can be raised for Uzbekistan in light of Korea's experiences in developing an automobile industry. For instance, determining which components to localize: labor intensive or capital intensive. And finding out how to support SME part makers (small entrepreneurs)?

5. Development of Korea's Textile Industry

At the beginning, the clothing industry succeeded in transforming from an import substitution industry into an export industry. After the clothing sector acquired sufficient competitiveness, the Korean textile industry gradually expanded its industrial base to develop upstream sectors such as textile fabrics and textile filaments. The following questions can be raised for Uzbekistan based on Korea's experiences in developing textile industry. How to take advantage of the labor force's competitiveness? Is the Uzbekistan textile industry ready to attract Korean textile firms (especially apparel firms) to enhance their competitiveness?

1. Introduction

The Uzbekistan economy has recently performed well in terms of economic growth and balance of payments. Since its performance is largely based on favorable international prices for commodities, which Uzbekistan produces such as cotton and gold, the basis of the good performance seems to be fragile.

In order to secure more stable and more sustainable economic performance, the Uzbekistan government seems to be determined to develop manufacturing industries and to promote the export of their products. Accordingly, the Uzbekistan government has approached the Korean research team under the Knowledge Sharing Program in order to gain more knowledge about Korea's experiences. In particular, how to develop manufacturing industries and how to promote manufacturing exports.

Considering this, a large part of this report analyzes and draws policy lessons from Korea's industrial development process, particularly, focusing on the first two decades of its industrial development history in the 1960s and 1970s. The reasons are twofold as to why this report has taken this approach. Firstly, given the large difference in the level of industrial development between the two countries, Uzbekistan and Korea, the lessons drawn from those periods seem to be adaptively applicable to Uzbekistan at the present. Secondly, the non-availability of data on Uzbekistan's industrial production and export by industry has reduced the scope of the analysis, though it is preferable to try to compare industrial development processes of the two countries.

Considering the desires of the Uzbekistan government, the report sometimes deals with specific issues more in detail; e.g. SME policies, policies for establishing industrial complexes etc. The second chapter tries to capture a condensed picture of Korea's industrial development while keeping in mind the need to draw appropriate lessons for Uzbekistan. The third and fourth chapters summarize Korea's history of industrial development during the 1960s and 1970s, respectively. The third chapter focuses on analyzing Korea's export promotion policies implemented at the beginning of its economic development and evaluating their outcome. The chapter examines Korea's SME policies during the 1960s in more detail. The fourth chapter explains the objective and outcome of the "Heavy and Chemical Industries Development Plan." The chapter tries to introduce major contents of some related policies such as establishing industrial complexes, creating General Trading Companies and providing policy loans.

The fifth and sixth chapters closely look at the development history of two industries, namely the automobile and textile industries. The reason why the automobile industry was chosen is to show Korea's gradual approach in developing the industry, although the Uzbekistan government seems to favor a rather "leap-frog" style approach. The textile industry was chosen for the purpose of showing the important role played by apparel industries in Korea's industrial development and export growth, although the importance of the industry seems to be rather neglected in Uzbekistan.

2. Overview of Korea's Industrial Development

2-1. Going from No Where to a World Leader

Korea was one of the least developed countries in terms of industrial development in early 60s. However, it has been transformed into one of leading industrial countries in the world during the last 40 years.

<Table 2-1> Korea in 1960 and in 2004

	1960	2004
GDP per capita	82	14,162
Manufacturing sShare (% in GDP)	14.4	32.0
Major Industries	Wigs Eyelashes Clothes Plywood	Shipbuilding (world no.1) Automobile (no.5) Semiconductor (no.3) Steel (no. 5)

2-2. Export-oriented Industrialization

Korea's industrial development was achieved through export-oriented strategies. During the 1960s and 1970s, Korea achieved the development of major industries, in which export growth outpaced GDP growth. This resulted in the rapid increase in the share of exports in GDP.

<Table 2-2> Share of Exports in the GDP (%)

1960	1965	1970	1975	1980	1985	1990	1995	2000
3	9	14	28	34	34	30	33	38

2-3. High Dependence on Human Capital

Korea, which had nothing to rely on when it embarked on its economic development, had to take advantage of its abundant labor forces. Fortunately, right labor forces, unskilled and skilled, were there to support appropriate industries.

1960s: unskilled and cheap labor forcesfor labor intensive industries

1970s: skilled labor forces (engineers) for heavy and chemical industries

1980s: researchers and scientists for technology-oriented industries

2-4. Government-led but Respectful of Market Mechanism

Korea's industrial development seems to be characterized as having been government-led. It was government-led in the sense that the government mobilized various measures to support industrial development. But, Korea has been pursuing economic development by taking into full consideration the conditions of comparative advantage that have been imposed by international economic environments. The industries with a comparative advantage have had to be actively integrated into international markets where they have confronted harsh competition. At an early stage when the government played an important role in supporting industries, Korea let market conditions select specific industries that the government should support. This has helped them to acquire veritable competitiveness. In other words, the government tried to intensify market conditions by subsidizing industries with comparative advantages. Although the government deliberately selected specific industries to support, namely heavy and chemical industries, during the 1970s, that decision was based on the government's anticipation of where Korea's comparative advantage lied at that time. As market mechanism is increasingly emphasized these days, the conditions of comparative advantage are gaining much more respect than ever.

2-5. Similarities and Differences between Korea and Uzbekistan at the Dawn of Industrialization

□ Similarities

Firstly, in comparing Uzbekistan's present situation with that of Korea's early in its development, both countries are characterized by an inexpensive and well-educated "human-capital." Secondly, both countries do not benefit from rich domestic markets which can be a good source of development for manufacturing industries. Thirdly, the two countries have threatening competitive super industrial powers to overcome: Japan for Korea in 1960s and China for Uzbekistan at the present Fourthly, they inherited some industrial legacies after their independence from colonial rule: Korea from Japan, Uzbekistan from Russia. Unfortunately, the legacies were not found to be useful at all, because they were given to them in a rather disrupted form.

□ Differences

Firstly, Korea did not have any reliable natural resources at the outset of its industrialization whereas Uzbekistan is endowed with rather abundant natural resources. However, we can say that there are pros and cons about the presence of natural resources. Though it can provide at least basic capital in the initial start of industrialization, it can also take away the most capable "human capital" from infant industries. Secondly, Korea implemented a very export-oriented industrialization policy. For example, it quickly adjusted key macroeconomic variables to promote trade (lowering interest rates, depreciating national currencies, etc.). Uzbekistan does not seem to have applied appropriate measures in the manufacturing sectors yet for this purpose. Thirdly, Korea was focused on industries that had a comparative advantage while respecting market mechanism, whereas Uzbekistan's government plays a relatively more controlling role in the market. Fourthly, Korea was able to apply aggressive supporting measures in the past. However, Uzbekistan will be forced to choose only WTO-friendly measures now, because it is seeking to be a member of WTO.

3. Historical Summary of Korea's Industrial Development I: 1960s: Export Promotion and Light Industries

3-1. Export-oriented Policies over Import Substitution

□ Promoting the "Exports First" Policy

Through the 1950s and 1960s, the 3rd-world movement and nonalignment movement promoted by newly independent countries significantly influenced developing countries to adopt domestic-market oriented import substitution policies. As the military regime was inaugurated in 1961, Korea also established the 5-Year Economic Development Plan and put priority on converting a system that was dependent on foreign aid to an economy that was self-supporting. To do so, the country developed industries based on import substitution and expanded social overhead capital, such as electric power, transportation and telecommunications. Promoting exports was considered a short-term and transitional policy to stabilize the economy rather than a policy to develop the economy. However, considering the situation of foreign markets and Korea's industrial level at that time, it was difficult to immediately export products. Instead, the government thought that it would be better to substitute imported goods with domestic products, improve the international balance of payments and then increase jobs, thereby making the import substitution-based industries capable of exporting products.

In 1964, however, the government focused on export-oriented policies rather than on import substitution. That was because foreign currency became a bigger issue in light of foreign aid being suspended, sharply reducing the foreign reserves. Self-confidence played another role in changing policies. Though agricultural and mineral products accounted for 80% of the total exports in the 1950s, the share of industrial products rose to 45% in 1963, which gave Koreans confidence. Also, import substitution-based industries ended up increasing the demand for foreign currency due to heavy dependence on imports for raw materials. In addition, the export circumstances of developing countries matured as the UN decided at the general meeting to establish an organization for developing trade in 1964.

Another key policy for export-oriented industrialization was to make the most of Korea's high-quality manpower. Korea needed capital more than anything else in order to induce potential workers that were unemployed to participate in production. With this in mind, the government resorted to direct inducement of foreign capital in the public sector and selective inducement of foreign capital in the private sector by guaranteeing payment. This contrasted with many other developing countries which attracted foreign direct investment (FDI) on a large scale.

□ Establishing an Export Support System

One of the government efforts to promote exports was improving the relevant laws. In 1967, the government enacted the Trade Transaction Act, which combined the Trade Act, the Export Promotion Act and the Provisional Measure Act on Payment of Export Promotion Subsidy under one law. It promoted systematic trade by converting the import-export business system from a registration based one to a license based one. It also classified import-export items into the categories of approval, permission and prohibition, as well as requiring trading companies to report on quantity and value of their exports twice every year. Also, the Minister of Trade, Industry and Energy required the notification of standard prices and the highest and lowest prices of imports and exports. The government also made clear its intention to maintain export creditability by establishing regulations that prevented exporters from conducting illegal transactions by exporting products totally different from those on the contract or by marking false origins.

To promote exports, the Bank of Korea enacted relevant financial regulations and began to offer exporters preferential financial treatment. In 1962, export finance regulations were established to smoothly finance the purchase of raw materials, production, and shipping, as well as, settle earnings from exports. Also, systems to supply short-term financing were established, such as the Foreign Currency Denoted Supply Financial System, the System to Guarantee Payment of Imported Raw Materials for Manufacturing Export Goods in 1963 and the Local L/C system in 1966. The general interest rate was 24% in 1965, while the interest rate for export related financings was 6.5%, the level of competing countries, widening the interest rate gap up to 17.5%. In order to facilitate investment in export industries, systems to supply mid-to-long term financings were provided, such as funds for fostering the export industry in 1964, funds for converting to facilities for exports in 1965, and foreign currency loans for importing facilities for export industries.

The government also revised the foreign exchange system to promote exports. In 1961, it tried to promote exports by devaluing the Korean won from 65 won to 130 won against the dollar, but failed to enhance price competitiveness because of inflation. In 1965, the government began to establish a consistent export inducement system, by completely amending the foreign exchange system which had been maintained since the 1950s. First of all, the multiple exchange rate system, which was applied differently according to items and uses, was converted to a unitary floating foreign exchange system in order to reflect the actual value of the won. As a result, the Korean won, which was fixed at 130 won against the dollar, was devalued by almost 100% to 256 won.

Among the direct export support policies in those days were the exclusive right to export system, the payment of export promotion subsidy and the export-import link system. The exclusive right to export system allowed exclusive exports for one year for the company which exported over 10,000 dollars of new products based on the L/C, or was exploring a market that was over 30,000 dollar-worth. The same was applied to the company which planned to export 50,000 dollars of new products or to explore a market 100,000 dollar-worth annually. Among the industries included traditional wallpaper, apples, pears exported to Taiwan, eyelashes exported to Europe and rice chips. Export promotion subsidies were offered from 1961, 25 won against one dollar in case of new products and 20 won in case of companies exploring a new market. However, this system was abolished in 1965 to reflect realistic foreign exchange rates. The export-import link system gave the right to export popular items by linking export records.

This system, which existed until 1955 and was reestablished in 1961, allowed imports of 35 export promotion items within the scope of 5% of export value. The period between 1960 and 1962 was a period of political upheaval when imports were controlled and the shortage of supplies was serious. Since in those days, any import guaranteed profits, trading companies tried to export anything to get import rights. This system, however, was abolished in 1965 when foreign exchange rates were realized.

□ Export Industries

When most exports consisted of primary goods, the government systematically promoted bonded processing export in order to expand the export of industrial products. Also, the government facilitated investment, by supporting the initiative to transform existing small and medium-sized enterprises (SMEs) into exporters and designating specialized export industries. Noting that there were sufficient idle workers and that wages were low, it designated bonded processing factories under the Customs Duties Act and set up import and export procedures needed for the Trade Act. This allowed Korea to secure the capability to export when it had no base for exporting industrial products. The government also commissioned banks to give import licenses and established the Korea Bonded Processing Export Association to encourage the allocation of raw materials, thereby streamlining import procedures of raw materials for bonded processing. As a result, there was phenomenal growth in the exports of garments, gloves, silver ware, radios, fishing nets and toys.

Though bonded processing needed the participation of Japanese companies, efforts to make SMEs exporters were also made. The government chose SMEs that could be converted into exporters and supported funding to purchase raw materials for manufacturing export goods. It allocated separate funding to increase importing materials and to expand facilities, as well as, offering subsidies to supporting technical guidance in order to lower export costs. In 1964, 150 companies were chosen to receive support for training technicians and recruiting foreign technicians.

Also, an industrial complex for exporters was established to promote efficient investment. In 1964, the Act for Development of the Export Industry Complex was established in order to facilitate the exchange of market information and promote joint exports. The complex in Guro, Seoul was set up. Until 1967, 31 companies occupied the complex, including 18 firms run by Koreans abroad, 11 domestic firms and 31 foreign enterprises.

□ Creating an Export Atmosphere

In implementing polices of developing countries, the intentions of decision makers at the highest level is significant. The fact that the President personally encouraged export policies gave companies and the people the impression that export was the only way to go forward, and this approach had a great effect. From 1964 to 1979 when $100 million of exports was recorded, the President personally presided over export promotion meetings every month, which demonstrated the government's strong intention. Accordingly, export-led industrialization could be consistently promoted and discussion on substantive matters made it possible to focus government policies on exports. However, there were side effects such as hasty implementation of alternative policies, sacrifice on the part of other industries and government intervention in the economy. However, the fact that the President led the export-oriented policies played a considerable role in maintaining the policies and raising the importance of exports among the public.

In 1964, “Export Day” was established in order to commemorate Korea acheiving 100 million dollars in exports, and the President personally granted the “Tower of Export” to the exporters which had achieved high export records. This contributed to creating an export atmosphere and enhancing the spirit of employees at export companies. Also, to concentrate efforts to increase exports on the part of the business circle, the role of KITA was facilitated and export activities were strengthened, by enacting in 1962 the Export Association Act for 15 major marine, agricultural and industrial items. The export association participated in concluding agreements for the maintenance of export and import orders, promoting export of goods, conducting market surveys, arranging transactions and promoting joint exports. The association was helpful in implementing government policies in an efficient way, by functioning as a forum for discussing corporate grievances and seeking solutions between the government and representatives from the business circle.

□ Exploring Foreign Markets

In 1962, the government set up KOTRA to assist businesses in exploring foreign markets. Initially, it considered establishing a government agency which explored foreign markets, while taking exclusive charge of small share of exports. For fear of competition with the private sector, however, it set up a government-invested agency which was exclusively in charge of doing research on foreign markets and promoting the Korean economy and products overseas. Foreign branches were also established in New York, LA, Hong Kong and Bangkok.

Noting the need for trade, the government also promoted cooperation with other countries. Though international trade had by this time been founded on GATT, Korea couldn’t receive most favored nation treatment because it was not a GATT member. Accordingly, Korea opened the way for foreign markets through trade agreements with major countries. Korea reached a trade agreement with the U.S. in 1956, Taiwan and Thailand in 1961, Vietnam in 1962, and Japan in 1966. And in 1967, Korea finally joined GATT removing trade barriers to exports.

One of the most remarkable import policies was the measure to change the positive list of import items into a negative list in 1967. Though Korea suffered severe international imbalance of payments because its imports exceeded exports, the country took this action. The reason was that Korea needed to make the domestic import substitution industry more competitive and stabilize prices by importing goods. Also, there was need to enhance international status of Korea through entry into both GATT and the IMF and to continuously expand exports.

□ Major Industries That Were Developed

Major industries that were developed during this period include labor-intensive industries such as wigs, artificial eyelashes, textiles, and plywood. These were not pre-selected as targets before the plan but selected by entrepreneurs themselves based on international market conditions.

□ Major Tools for Export Promotion Policy

1. Exporting firms were allowed to retain foreign exchange earnings for the purchase of imports.
2. Exporting firms were exempted from import controls and tariffs.
3. The state-controlled banks provided financial support for exporters at preferential rates.
4. Tax concessions were granted to exporters.
5. Fiscal policy focused on generating surpluses that could be channeled to key industrial firms.
6. A sliding-peg system of exchange rate adjustment was adopted to prevent a real appreciation of the Korean won.
7. The government set export targets, which influenced firm behavior.
8. Successful exporters received awards from the president.

3-2. Dramatic Change: from a Traditional Agriculture-based Economy to a Manufacture-leading Economy

During the 1960s, the Korean economy underwent complete structural change. In 1961, as Korea still had a traditional economic system, agriculture was the leading sector in the economy. Korea being divided into two countries north and south - right after independence from Japanese occupation accentuated the situation. Because ruling authorities during Japan's colonization preferred to concentrate almost all industrial activities in the North whereas the South was the source of food supplies for Japan. Deprived from manufacturing activities, leading export products in South Korea came from agriculture until 1961, representing 28.6% of the total export. The export of primary sectors including agriculture, fishery and mining occupied almost 3 quarters of total exports, which left manufacturing only 27.7%.

<Table 2-3> Structural Change in Korea's Export (1961-71)

	1961	1966	1971
Agricultural Products	28.6	9.6	4.3
Fishery Products	19.2	10.4	4.6
Mining Products	24.5	22.5	2.2
Manufacturing Products	27.7	67.5	88.9
Total	100.0	100.0	100.0

Source: Cho, Soon (1991)

However, this situation changed dramatically when the government led by Park Chung Hee implemented two economic plans (1962-66 and 1967-71) during the 1960s successively. During these periods, export grew 43.9% and 33.8%, respectively, at the annual average while manufacturing exports increased 70.0% and 43.3%. In 1971, manufacturing exports accounted for 88.9% of the total exports. Korea transformed itself from a traditional agriculture-based economy into a manufacture-leading economy in the span of only 10 years. One should be interested in the reasons why this dramatic change occurred in the Korean economy. What happened? The Korean government at that time implemented several economic measures to promote manufacturing activities and exports. The first one was depreciating the national currency. In May 1964, the Korean currency rose against the US Dollar from 130 Won per Dollar to 256 Won per Dollar. The depreciation rapidly raised the competitiveness of Korean products in the international markets. This launched Korea's exports at a rapid speed. The second one was introducing an interest rate structure very favorable for industrial activities. In fact, the government raised the savings interest rate from 15% to 26.4% at the annual basis in 1965 in order to induce domestic savings and capital formation at home. However, the government raised the lending rate from 14% to 24%. Consequently, this reverse interest structure that favored lending against saving was one of the major elements in promoting manufacturing activities. The third one was establishing an institutional system for promoting industries. Many industry specific promotion acts were adopted by the government during the 1960s, such as the machinery promotion act in 1967, the electronics promotion act, the automobile promotion act and the petro-chemical promotion act in 1969. These measures, especially the first two, were not very popular politically in developing countries, even though they were indispensable changing the economic system from an inward-looking agricultural one to an outward-looking manufacturing one. The strong leadership maintained during the 1960s enabled the Korean government at that the time to implement these unpopular measures successfully.

3-3. How to Promote Small and Medium Enterprises (SMEs)

□ Why are SMEs Important for Industrial Development?

They play important roles in terms of industrial development including; major sources of industrial employment, provide materials/components to big manufacturing companies, require machines/materials made by heavy & chemical industries, sources of creative industrial techniques, base for future industrial power. The Korean government, recognizing their role for industrialization, has actively implemented various measures for promoting SMEs from the beginning of its industrial development.

□ Measures for Promoting SMEs Adopted in 1960s

1. The Bank for Small and Medium Enterprises was established for the purpose of providing financial assistance only for SMEs in August 1961.

2. Special measures for protecting SME-specific markets
   - A law that prohibited selling specific imported products was introduced in May 1961
   - A law that intended to restrain over-heated competition among SMEs and to expand markets for SMEs was introduced in December 1961
3. The law for establishing a cooperative association among SMEs was introduced in December 1961.
4. Consulting assistance for enhancing management skills
5. Policies for transforming domestic-oriented SMEs into export-oriented were pursued from late 1964
6. The law for developing industrial complexes for exporting industries was introduced in order to accomodate SMEs in December 1964
7. Centers for handicraft industries were established and policies for promoting locality-specific industries were adopted from 1965
8. Efforts for attracting foreign capital to be provided for SMEs were actively made from 1965.
9. The regulation controlling lending activities of financial institutions including all banks was amended in 1965 (All banks were forced to allocate at least 30 percent of their lending money to SMEs).
10. The contracting system reserved only for SME associations was introduced into the government procurement system from 1965.

<Table 2-4> Comparison of SMEs'Role between Uzbekistan and Korea

Indicators	Unit	Uzbekistan in 2004	Korea in		
			1963	1973	1998
Share of SMEs in GDP	%	35.6	52.8	46.3	48.0
Number of Employed by SMEs	Thous. persons	6,038.3	-	-	-
Share of employed by SMEs in the total number of employed in economy	%	60.9	66.4	68.9	70.5
Number of Employed:		-	-	-	-
Small Enterprises	Thous.	359.2	-	-	-
Micro Firms	persons	989.8	-	-	-
Individual Entrepreneurs	Thous. persons	4689.3	-	-	-
Number of New Jobs in small enterprises	Unit	427,571	-	-	-
Number of Acting small enterprises per	Unit	9.2	-	-	-
1000 persons					

□ SME-specific Industries in Korea

Some SME-specific industries were identified during the 1960s and they were protected from competition by large enterprises.

1. Industries that do not necessitate large capital equipments
2. Industries producing parts and components
3. Industries processing raw materials
4. Labor-intensive industries

□ The Basic Act for Small and Medium Enterprises

The Basic Act for Small and Medium Enterprises was adopted in 1966 in order to better organize all the policies for promoting SMEs.

<Major contents of the basic act for SMEs>

1. Enhancement of SME structure
   a. rationalizing management
   b. promoting technical progress and establishing a specialized organization for technical assistance
   c. improving product quality
   d. improving working environment
   e. modernizing equipments
   f. promoting business reorientation
   g. organizing cooperative efforts among SMEs and developing local SMEs
   h. optimizing company scales
   i. promoting specialization and business affiliation with large enterprises
   j. rationalizing logistic system for SMEs
2. Correction of SMEs' disadvantages
   a. optimizing subcontracting business
   b. protecting SME-specific businesses
   c. establishing a mutual aid system
   d. promoting exports
   e. reserving SME-specific businesses in the government procurement
   f. controlling import competition
3. Special measures for small enterprises
4. Financial and fiscal assistance
   a. securing SME-specific financial resources
   b. optimizing tax system
5. Public and cooperative organizations for SMEs
   a. organizing association of SMEs
   b. expanding the government agency for SMEs
   c. introducing the council for SME policies

□ Financial Support for SMEs in Korea

The Korea government has preferred financial assistance to tax incentives in terms of promoting SMEs. In Korea, there have been two major policy measures designed to provide financial assistance to SMEs. The first one is the credit ration scheme for SMEs that obligates all commercial banks to lend more than a certain proportion of annual incremental loans to SMEs. The obligatory ratio increased from 30% to 45% for nation-wide banks during 1980-1992 and 55% to 80% for locally based banks in the same period. The other is a credit guarantee system to compensate for the lack of sufficient collateral provided by SMEs. Since the Korea Credit Guarantee Fund was established in 1976, credit guarantees have expanded greatly and evaluated as one of the most efficient and powerful policy measures. In addition, in 1989, the Korea Technology Credit Guarantee Fund was also established in order to support new technology development and the commercialization of products researched and developed by SMEs.

3-4. How to Promote SMEs' Exports

SMEs were very active in export market when Korea started its industrial development. They have maintained their share of total exports at almost above 30%. However, SMEs are rather inactive in exports in Uzbekistan. Their exports should be promoted through more appropriate policies.

<Table 2-5> Share of SMEs in Total Exports (%)

Uzbekistan		Korea				
2003	2004	1962	1971	1981	1991	2004
6.9	7.3	32.1	32.3	31.0	39.9	35.6

□ How to Provide Marketing Assistance for SMEs' Exports

In 1962, the government set up KOTRA, initially the Korea Trade Promotion Corporation, to assist businesses to explore foreign markets. Initially, it considered establishing a government agency to explore foreign markets, while taking exclusive charge of a small portion of exports. For fear of provoking competition with the private sector, however, it set up a government-invested agency, exclusively in charge of researching on foreign markets and promoting the Korean economy and products overseas. Foreign branches were also established in New York, LA, Hong Kong and Bangkok. Since then, KOTRA has opened an extensive worldwide network of overseas Korea Trade Centers (KTC). Some 103 KTCs are operating in 74 countries as of now. KOTRA also runs 13 regional branch offices in Korea.

□ KOTRA's Functions for Promoting Exports of SMEs

KOTRA plays an intermediary role by introducing overseas buyers to the most appropriate business partners in Korea through its wide-ranging inquiry network as well as business meetings held year round. KOTRA provides buyers visiting Korea with assistance in arranging business meetings with Korean companies and collecting information on Korean products and suppliers. KOTRA also dispatches groups of Korean exporters abroad to explore global markets with the help of local Korea Trade Centers. KOTRA organizes international exhibitions in Korea as well as large-scale Korean product shows in strategic markets abroad. In addition, KOTRA arranges the participation of domestic companies in similar events overseas through its "Korea Pavilions". KOTRA operates the Cyber Business Center at its Seoul headquarters where overseas buyers can hold online business meetings with domestic companies regardless of time and location. Further, KOTRA gathers and diffuses information by providing domestic and foreign firms with trade-related information gathered by its local and overseas networks. It also provides an extensive range of information resources such as business directories, tariff schedules, periodicals and much more.

□ Industrial Complexes for Export-oriented Enterprises

In 1964, the Act for Development of the Export Industry Complex was established in order to facilitate exchange of market information and promote joint exports, as well as, to set up the complex in Guro, Seoul. Until 1967, 31 companies occupied the complex, including 18 firms run by Koreans abroad, 11 domestic firms and 31 foreign enterprises.

□ Free Export Zones

In 1970, the Act for Development of Free Export Zones was introduced. Masan, a southern port city in 1970 and Iksan, a transportation center in 1973 were chosen as the first free export zones. The primary objective behind establishing FEZs was to attract FDIs in manufacturing industries. Korea has introduced various incentives for attracting FDI companies in these FEZs.

<Incentives provided in FEZs>

1. Tax incentives
   a. exemption of corporate taxes and income taxes (taxes on dividends) for several years (ex: 7 years) after initial investments in FEZs and reducing those taxes by half for additional years (ex: 3 years)
   b. exemption of land related taxes (acquisition, registration and asset taxes) for a long period (ex: 15 years)
2. Rent incentives
   a. complete exemption for certain FDI firms (hi-tech, large amount of FDI etc)
   b. differentiated rent-reduction schedule depending on the proportion of exports to total sales for domestic firms

3. Tariff-related incentives
   - when importing their products from FEZs into domestic markets, the products are supposed to be levied by tariff
   - but, tariff is exempted for the products made by using domestic equipments and materials
4. Other incentives
   a. guaranteeing free transfer of the principal of initial investment and dividends
   b. financial assistance for employment and training
   c. marketing assistance
   d. other administrative assistance

3-5. How to Promote Development of Light Industries in Uzbekistan

Up to now, light industries have never played a leading role in Uzbekistan, neither in terms of production/investments nor in terms of exports (share in production: 20%, share in exports: less than 20%). However, considering that human capital is a source of competitiveness in Uzbekistan, light industries may be able to play a more important role in Uzbekistan economy, if they are well assisted by the government's industrial policies. For example, a Turkish company, in the textile industry, is successfully expanding its business. In addition, we can expect that light industries may be able to save in transportation costs, which is a major weak point of the Uzbekistan economy.

<Table 2-6> Structure of Investment by Industry and by Sources of Origin (%)

	Domestic	Foreign
Industry-Total	100	100
Electric Power Industry	9.5	6.6
Fuel Industry	20.3	4.4
Metallurgy	16.4	5.5
Machine-Building	3.2	1.5
Light Industry	20.7	49.2
Food Industry	5.0	3.6
Chemical & Petrochemical	7.6	9.2
Construction Materials	2.0	0.8
Other Sectors	15.3	19.1

In fact, we can find that foreign companies are interested in investing in light industries in Uzbekistan. Almost half of FDI is invested in light industries, whereas the proportion of domestic investments in these industries remain very low (around 20%). As the reasons for this discrepancy between domestic and foreign investments, one may argue that investment in light industries might be less regulated. On the other hand, another reason may be that foreign companies expect light industries to have a more prosperous future than other industries.

The Uzbekistan government seems to under-estimate their potential efficiency. In fact, when comparing the current efficiency level, light industries are compelled to be estimated less productive than heavy & energy industries, because the latter have access to better machines and human capital.

Some policy solutions to increase the productivity of light industries are already suggested in the following (CEEP, Uzbekistan Economy): to increase cost competitiveness and to improve quality of their products. We can add another measure for that purpose such as increasing financial support to these industries.

3-6. How to Efficiently Organize Policies for Trade Promotion and Policies for Industrialization

□ Role of the Ministry of Commerce, Industry and Energy

The Ministry of Commerce, Industry and Energy (MOCIE) is the ministry responsible for policies concerning industry, trade, energy and resources. This ministry was initially launched as the Ministry of Commerce in 1948 when the first Korean government was inaugurated. At the time, it took charge of primary industries such as fisheries and mining as well as secondary and tertiary industries including manufacturing and commercial activities. The energy section was separated off from the ministry as an independent ministry named Ministry of Power and Resources in the 1970s to better cope with the oil crisis. However, later on, the energy and resources section was re-integrated into the ministry to efficiently implement industrial policies. The ministry played an efficient and effective role in terms of developing manufacturing industries as well as promoting manufacturing exports as it had both missions at the same ministry.

□ Lessons for Uzbekistan

It would be preferable for the Uzbekistan government to consider establishing a ministry similar to Korea’s MOCIE, because too many government bodies at the present seem to be involved in the matter of formulating and implementing strategies for export promotion and industrial development. This new ministry might be able to efficiently organize the program of developing manufacturing industries and strategies for export promotion at the same time.

4. Historical Summary of Korea's Industrial Development II: 1970s: Developing Heavy and Chemical Industries

4-1. Launching "Heavy and Chemical Industries Development Plan"

□ Why Heavy and Chemical Industries?

The building up of heavy and chemical industries was symbolized by the "Heavy and Chemical Industrialization Declaration," initiated in January 1973 by President Park. It targeted the following six industries as top priority industries: steel, petrochemicals, shipbuilding, industrial machinery, nonferrous metals, and electrical industries. Despite the first oil shock in 1973, which seemed to pose insurmountable difficulties on the Korean economy, satisfactory achievement in terms of economic growth and export expansion encouraged the government to pursue the original lines of the heavy and chemical industries promotion scheme. One should remark the importance of "sequencing" in this process: transition from light industries to heavy and chemical industries. In fact, labor-intensive industries, based on their success in 1960s, started using materials produced by heavy and chemical industries in 1970s. For instance, apparel and textile industries required petrochemicals, electronic appliances required steel and nonferrous metals, all light industries required industrial machinery, and so on.

□ How to Foster Heavy and Chemical Industries

In order to foster the electronics industry, special laws were enacted, electronic industrial centers were established, model factories for electronic industries were constructed and technologies were developed and instructed. Technicians and engineers were trained and companies that invested in the electronics industry received government support. It was a highly motivated plan, a plan that aimed at fostering the electronics industry as a main exporting industry, which would allow Korea to leap forward as an international base for producing and supplying electronics along with Japan and Taiwan. In 1972, an electronics industrial complex was constructed in Ku-mi, and funds for fostering the machinery industry were provided, as well as, foreign loans for introducing technology and establishing joint investments with the U.S. and Japan. Japan's anti-dumping measure covering color televisions limited exports to the U.S., which provided the opportunity to attract concentrated foreign investments and transfer technology. Thereby, the electronics industry was able to secure its position as an exporting industry.

In developing the shipbuilding industry in 1976, the government had the goal of becoming tenth in the global market. The government concluded that since shipbuilding was labor-intensive and a declining industry in western economies, it would be possible to secure global competitive power in a short time. But large shipyards to build ships did not exist, and the Hyundai Heavy Industries was constructing a dock on the beach, so it was a very difficult situation. The government totally supported KSEC which existed at the time, and increased domestic demand by supporting domestic ships. The government also established the Shipbuilding Research Institute in efforts to secure technicians.

The machinery industry consists of industrial facilities and equipment industries, which makes it a difficult industry for a developing country to foster. But Korea had high demand at the time for facilities needed to develop the economy, and so the government decided to promote the machinery industry as an exporting industry and substitute imports with domestic products. The Machinery Industry Promotion Law was enacted, and it was decided that 89 import machines would be localized and 22 machinery industries would be selected for localization. As a result, machine tools, sewing machines, and motors were selected for export industrialization. When the Seoung-ri Machinery Corporation concluded a $1.3 million contract in Afghanistan to export weaving machine plants on a deferred payment basis, it provided an opportunity to confirm the possibilities of exporting machinery. The expansion of the domestic market must precede machinery exports, and so the government led the process of substituting imports with domestic products by sublating the bulk of factory construction, making public announcements on the standard localization rate for each industrial facility, and regulating the imports of machinery over $1 million which should be reported beforehand.

The auto industry is a synthetic assembly industry that has industrial ripple effects and front-and-back effects. Because of these characteristics, the auto industry was the first industry that the government started localizing. But since securing production volume fit for economic standards was difficult, it was also difficult to gain competitive power. Also, in order to establish a mass production system the auto industry needed to be fostered as an export industry, but because of the limited demands in the domestic market, it was difficult to gain competitive power in exports.

The shipbuilding industry and electronics industry, which depended on labor and foreign technology and investments, grew into export industries without any noticeable trials or errors. But the machinery industry and auto industry, which need accumulated technology based on the domestic market, could not meet the government's goal for export industrialization. Both industries went through troubles of developing technology and creating circumstances fit for economic development standards.

□ Promoting for High-quality Export Products

In order to make high quality products, the government expanded various education and training programs for managers, technicians and engineers, and sponsored contests for precision and campaigns for making first class products. The government also encouraged technicians and engineers to win prizes in the International Vocational Training Competition. Through the 1970s, product standardizations and campaigns for supervising product quality were spread among the industries through the establishment of the Industry Promotion Office. Also, the government hastened to accumulate technologies by inviting foreign technicians to teach, and transferring technologies through foreign investment lines.

In order to localize raw materials for export products, market shares needed to be secured first by exports of manufactured products, and then the materials industry was made into a globally competitive industry. This way, expenses were saved rather than if the procedure had been the other way around. For example, chemical fiber yarns such as nylon and acrylic were localized and were widely used in the domestic industry, but export industries avoided using localized yarn. But in 1970, import restrictions were invoked on raw materials for export products, and the chemical fiber yarn industry was restored from the brink of becoming an insolvent industry, and was able to establish the basis for supplying localized yarn and develop new technologies.

When Korean products emerged in department stores across Europe and the U.S., they were criticized as cheap products not worth their price. Because of the lack of awareness of Korean products, Korean products had to be cheaper than Japanese to be sold, even if the product quality was similar. Other problems were that designs were not fully matured, finishing touches on products were poor, and packaging was shabby, which prevented the products from being sold at their full price. The government established the Design Package Center to develop new designs, transfer technologies, and to develop packaging materials.

4-2. Evaluating HCI Development Strategies

The rather unexpected satisfactory outcome was largely due to two major favorable developments in the world economy. Firstly, the appreciation of both the Japanese yen and German mark helped Korean industries to gain a greater competitive advantage in international markets. Secondly, the massive entry of Korean construction firms into Middle Eastern countries, whose demand for construction increased rapidly, allowed Korea to procure a substantial amount of foreign exchange that was badly needed.

<Table 2-7> A New Jump in Export Structure

	1971	1976	1981
Primary Products	13.9	12.2	10.4
Light Industries	72.1	57.9	45.6
Heavy & Chemicals	14.2	29.8	44.0
Total	100.0	100.0	100.0

4-3. Lessons and Questions from Korea's Experience

Based on Korea's experience in export promotion and industrialization, one can raise several questions for Uzbekistan. Can and will Uzbekistan follow Korea's "sequencing" in terms of industrial development, starting from labor intensive industries (taking advantage of relative abundance of cheap and well-educated labor forces) and creating industrial demand for next generation industries (heavy and chemical industries)? Is the Uzbekistan government ready to foster entrepreneurship, especially in supporting SME entrepreneurs? What measures can be considered appropriate for promoting exports, especially manufacturing exports?

Export credit
Industrial complexes
Trading companies for assisting SMEs to export their products

4-4. How to Make Industrial Complexes Efficient and Effective

In order to provide the industrial sites for those who wanted to invest in heavy and chemical industries, the government decided to establish industrial complexes in various regions in Korea. To do this, the Industrial Base Development Promotion Act was enacted in 1973, according to which 13 heavy and chemical industry complexes were established throughout the country to accommodate plants in steel, petrochemicals, industrial machinery, automobiles, and electrical industries. The industrial complexes were provided with advanced infrastructure such as ports, highways, electricity, water, telecommunications, etc. Additional incentives for the firms wanting to set up their plants in these complexes were provided: credit for investment, tax incentives, consulting services, etc.

□ The First Industrial Complexes in Korea

<Kuro & Bupyung>

They were export-oriented industrial complexes established in the vicinity of Seoul, the capital city. They accommodated light industries in the early 1960s. Kuro industrial complexes have been transformed, and is now the headquarter of Korea Industrial Complex Corporation, managing body of industrial complexes.

<Ulsan>

This industrial complex was created to induce heavy & chemical industries. The complex has a port, an expressway & a railway line. It is currently the site of Hyundai industrial complexes.

<Pusan(Busan)>

The industrial complex had the main international port. Mostly, light industries (especially shoes & textiles) came to invest in this complex.

□ Why Were Industrial Complexes Constructed near Big Cities?

It was because big cities had location-specific comparative advantages such as abundant human resources, product markets, efficient logistics including port facilities, highways, railways etc. For example, industrial complexes in Seoul Metropolitan Area such as Kuro, Banwol, Incheon, Sungnam are well connected to Incheon port, Gyeongin highway, Gyeongin railway & Gimpo Airport/Incheon International Airport. The industrial complexes in Southeast industrial belt in Korea such as Masan Export Zone, Changwan, Onsan, Ulsan, Pohang are also well served by Pusan Port, Seoul-Pusan highway, Seoul-Pusan railway & Pusan International Airport.

<Table 2-8> National Industrial Complexes in Korea (1984)

Industrial complexes	Land Area (ha)	Number of Factories	Employment (1,000 Person)
Masan Export Zone	58.8	79	36.4
Kuro	299.2	408	101.1
Banwol	635.5	668	34.8
Kumi	1,047.6	230	51.1
Changwon	2,260.0	177	45.8
Onsan	1,319.0	15	5.5
Iri	114.1	107	14.2
Yeochun	1,647.5	33	5.5
Total	9,300.6	1,717	292.4

Source: World Bank, 1986

□ What went into Developing Industrial Complexes?

Firstly, land was provided by the Ministry of Construction and Transportation(MOCT) or local government. Secondly, all the facilities for companies' activities such as access roads, industrial water supply, electricity, communication system, pollution control, land scraping and other facilities(e.g. schools, housing, recreation, medical centers) were also provided by MOCT and/or public utility corporations such as Korea Land Development Corporation, Water Resource Development Corporation, and Agriculture Promotion Corporation. Thirdly, financial support was given to companies by the central or local governments.

4-5. To Promote Exports: General Trading Company System

After the oil shock in 1973, the global economy fell into stagflation, and the sluggish economies of the advanced countries raised trade barriers and made it difficult for industries to develop new markets. Domestic companies which depended on low-wage labor lost global competitive power. And to benefit from export financing, manufacturing companies started to import and export, and export companies started to manufacture. The profits from expertise and specialization disappeared and the export industry was flooded with many small export companies, causing excessive competition. Moreover, active investments in heavy chemicals brought the need for exports, since the domestic market was very limited. The government felt that in such conditions an efficient overseas distribution network was needed. Thus, the General Trading Company System was born in 1975.

<Table 2-9> Position of GTCs in the Korean Economy

(Unit: US $100 million)

	1977	1986	1991
(A) Sales of GTCs	22.0	206.1	445.7
(B) Nominal GNP	374.3	954.4	2,080.0
A/B(%)	5.9	21.6	15.9
(C) Exports of GTCs	24.9	140.3	303.3
(D) Total Exports	100.5	347.1	718.7
C/D(%)	24.8	40.4	42.2
(E) Imports of GTCs	3.2	34.2	108.7
(F) Total Imports	108.1	315.8	815.3
E/F(%)	3.0	10.8	13.3

Source: Management Efficiency Institute

In 1975, requirements for the general trading house was over $1 million in exports, and over 10 overseas branches. In competing in international bidding, general trading houses received priority claims, received low-interest prime rates from banks and expansions in working capital for the marketing of overseas branches. General trading houses played a leading role in exports and especially contributed to the exports of plants and heavy chemicals. In 1982, exports by general trading houses took up 50% of total exports. The general trading house system made many contributions, and one of them was developing new markets through completing requirements in the number of overseas branches and target countries for exports. It also contributed in improving the information and technologies of domestic companies and training professional manpower. But the side effects of the general trading house system were conflicts with small and medium sized companies and derangements in market orders by excessive competition between general trading houses. In the 1990s, supports for exports were cut down sharply and exporting became diversified, withering the power of general trading houses.

4-6. Providing Financial Assistance

□ Policy Loans in Korea

The allocation of credit by the government through the banking system was the most powerful means of supporting priority industries. Banks, practically owned by the government, were directed to make loans to strategic industries on a preferential basis. During the latter half of the 1970s, the share of policy loans in domestic credit rose steadily from 40% to over 50%. In order to finance investments in heavy and chemical industries, the government took control of available funds at all banking institutions, including commercial banks. In addition, during this period, and also under strong inflationary pressures, the government had almost complete control over prices - even the price of fast foods, wage rates, and even dividends by firms to stockholders. Under these circumstances, Korean firms were almost under total government control in terms of their investment plan and financing scheme, etc.

<Table 2-10> Regulated and Market Interest rates (%)

Rates / Year	General bank Loan rate	Curb rate	Average borrowing Cost(manufacturing)	Consumer Price Inflation
1970	24.0	49.8	14.7	15.4
1975	15.5	41.3	11.3	25.4
1980	23.4	44.9	18.7	28.7
1985	11.5	24.0	13.4	2.5
1990	11.5	18.7	NA	8.6

Source: Bank of Korea

Whereas the government played an active role in mobilizing and providing investment funds for companies, the government's contribution to investment has been decreasing in Uzbekistan. It would be necessary to find new financial sources for investments

<Table 2-11> Structure of Investments by Source of Funding (%)

	2000	2001	2002	2003	2004
Total	100	100	100	100	100
State Budget	29.2	21.5	25.0	17.4	14.9
Funds of Enterprises	27.1	31.0	40.0	41.1	43.2
Population's Savings	12.0	10.3	12.0	13.7	12.4
Foreign Investments Guaranteed by State	19.8	23.2	15.8	17.8	14.5
Direct Foreign Investments	3.4	4.8	4.7	7.1	10.0
Others	8.5	9.1	2.5	3.0	5.0

Source: State Statistics Committee of Uzbekistan

5. Development of Korea's Automotive Industry

5-1. Starting Businesses

In spite of its relatively short history, the Korean automobile industry has beaten the odds to become a model of rapid progress and success. The industry's fast-paced growth has been characterized by increasing localization and the assimilation of foreign production processes and technologies. In the meanwhile, domestic market was highly protected from imports of assembled foreign cars. To exemplify this growth, one need only look at the figures: Production grew from a mere 29 thousand units in 1970 to a peak level of 3.1 million units in 2000. The growth of Korea's automobile industry has been impressive as that of Japan's in the early days. Japanese automobile production increased from 32 thousand units in 1950 to 5.3 million units and to 13.5 million units in 1990. At the beginning, the industry was at the preliminary stage of assembling largely imported CKD parts, with local suppliers mostly catering to the domestic after-sales service market. Korean car-makers started their businesses relying on imported technologies and even on imported capital, most of their technological partners being Japanese makers.

<Table 2-12> Technological Partners for Korean Automobile Assemblers

	Year	Technological	Model	What Transferred
Sainara	1962	Nissan	Bluebird	Technology&Investment
Shibal	1963	Isuzu	-	Technology&Investment
Shinjin	1966	Toyota	Corona	Technology&Investment
Asia	1965 1967	Renault Fiat	- Fiat124	Technology&Investment
Hyundai	1968	Ford(England)	Cortina	Technology&Investment
Kia	1959	Honda	Truck	Technology&Investment

Source: MOCIE

<Table 2-13> Trend of Automobile Production in Korea

Year	1960	1970	1980	1990	1995	2000
production (thousand units)	0	29	123	1,269	2,526	3,115

Source: Korea Automobile Manufacturers Association(KAMA)

5-2. Development Stages of the Korean AutomotiveIndustry

□ Stage I: Simple Assembly of Knock-Down Components (1962-73)

Korea’s inception in the automotive industry began with the simple assembly of imported parts, which entailed the localization of some parts such as batteries and tires. Once this initial phase of rather easy catching-up was complete, a further step toward localization imposed ever-increasing challenges upon the local capital and technical manpower. In an effort to accelerate the domestic content, the government announced “The Basic Plan for the Promotion of the Automobile Industry” in 1969.

<Table 2-14> Localization of Automobile Components(1968)

Assembled				
Localization (38.19%)				Imports (61.81%)
Engine part (5.75%)	Chassis (8.34%)	Body (19.95%)	Electric parts & others(4.15%)	Engine Transmis
Fuel Pipe Fuel Hose Air Cleaner Fuel Tank Fan V-Belt Muffler Radiator	Pedal Brake Part Parking Brake Wheel Cap Tire & Tube Spring Shock Absorber	Bumper Head Lamp Door Handle Window Molding Seat Silencer Weather Strip Trim	Heater Radio Lamp Battery Wire Harness Cable Wiper Switch Vault	Propeller Shaft Steering Front Axle Rear Axle Brake System Door Hood & Fendor

Note: Model Corona assembled by Shinjin Motors in 1968

Early components were technologically simple and labor intensive parts. Gradually, more technologically advanced and capital-intensive parts were planned to be localized

<Table 2-15> The Domestic Content Ratio in Korean Auto Industry

Year	1966	1967	1968	1969	1970	1971	1972
ratio(%)	21	23	27	38	52	58	60

Source: KAMA

<Table 2-16> Localization Plan for Passenger Cars Set out in 1969

Additional Localization & major Components	1969(Starting year)	1970	1971	1972	Total
	38%				38%
Total		20 %			58%
Rear Axle		6 %			
Hub & Drum		6 %			
Clutch		2 %			
Electric Parts		6 %			
Total			17 %		75%
Front Axle			6 %		
Steering System			2 %		
Gear Box			8 %		
Engine Parts			1 %		
Total				25 %	100%
Engine				15 %	
Body				10 %	

□ StageII : Establishment of an Industrial Base for Volume Production (1974-82)

The main objective of the second stage was to develop indigenous car models with full domestic content, thus departing from the simple assembly on a semi-knock-down basis. The government plan aimed at ultimately building the industry to be a major export industry. The new strategy called for the production of the so-called “people’s car” by three designated manufacturing firms, Hyundai, Kia, and Saehan. These firms were requested to produce newly designed models with a limited engine capacity of 1.5 liters and with domestic content reaching 95 percent or higher.

Another major move on the part of government took place in 1981 when the auto industry was restructured. Isolated from foreign competition, there were remarkable inefficiencies mainly caused by under-utilization of capacity and a failure to achieve optimal economies of scale. Persistent problems in the industry brought these unfavorable conditions into the open. The problems were especially highlighted when the nation was hit by the second oil crisis which whipped up a tremendous negative impact on the national economy as a whole. Car production almost halved in 1980, while truck production suffered a steep dive as well. The government attempted to come to the rescue by implementing some survival measures for the industry.

□ StageIII : Advances in Mass Production and Promotion of Automobile Exports (1983-present)

The government's actions in 1981 were based on "The Rationalization Plan of the Automobile Industry," a plan which essentially reduced the number of passenger car producers from three to two. At this time, it seemed an important task for the automobile industry to meet the high demand for automobiles in the domestic and overseas markets and to directly compete with foreign makers. Thus the industry began to reorganize itself in order to create a more comprehensive mass-production system. Fortunately, along with the recovery of the domestic and international economic conditions after 1982, Korean firms took advantage of the favorable market conditions. Korean producers started increasing their production capacity. Capacity doubled in two years from 337 thousand units in 1983 to 683 thousand units in 1985. Furthermore, Korea's automobile industry established its first bridgehead in the international market when Hyundai successfully set up businesses in North America. In 1984, the first year of Korean volume car exports, the Pony became the most successful foreign car in the Canadian market, with sales exceeding 24 thousand units. The next year saw the success replicated in the U.S. when Hyundai established itself there for the first time. The company exported 314 thousand units in 1987, which made the company the fourth largest vehicle exporter in the U.S.. Daewoo and Kia Motors Company also entered successfully into the U.S. market through their partners' dealer network in 1987.

Recently, market diversification was essential for the growing production of the automobile industry. Efforts have increasingly been directed at finding new export markets, particularly in the emerging markets of Europe and Asia. Further, more attention will be paid to the expanding domestic market, which provides a safeguard against possible shocks occurring from the instability in foreign markets.

<Table 2-17> Development of the Korean Automotive Industry

(Thousand units, percent)

	1970	1980	1990	2000	2004	Annual growth rates ('70
Domestic Sales	21.2	104.5	954.3	1,430.5	1,094.7	12.3
Export (A)	-	25.3	347.1	1,676.4	2,379.6	20.8
Imports	-	-	-	11.4	34.7	-
Production	28.8	12.31	1,321.6	3,115.0	3,469.5	15.1
A / B	-	20.6	26.3	53.8	68.6	-

Source: Korea Automobile Manufacturers Associations (KAMA)

5-3. Similarities and Differences between Korea and Uzbekistan

□ Similarities

- Starting with knock-down assembly
- Starting with foreign technology and foreign capital
- Some industrial legacies that could support its development: auto parts for Korea, machine industries for Uzbekistan (to be verified)
- Government plan for localization of parts and components
- Foreign market: North America for Korea, Russia and Central Asia for Uzbekistan

□ Differences

- Localization from which components: technologically simple and labor intensive for Korea, but technologically advanced and capital intensive for Uzbekistan (to be verified)
- Many SME part makers (small entrepreneurs) for Korea, how about Uzbekistan?
- Private entrepreneurs played a leading role with support from the government in Korea, however, the government plays the main role in Uzbekistan.

6. Development of Korea's Textile Industry

6-1. Introduction

For over three decades, the textile industry has been leading Korean exports since the 1960's. The Korea's textile export industry increased from 389 million dollars in 1970 to 18,440 million dollars in 1995 with an annual growth rate of 16.7%. The success of this industry was based on Korea's competitive advantage in low wages, which allowed it to mass-produce goods for low and medium price segments. In the 1990's, the Korean textile industry was confronted with a number of serious difficulties in achieving their goal of becoming the world's largest exporter of textiles. The annual growth rate of average wages in the manufacturing sector was 15% from 1987 to 1997. In addition, the Korea currency substantially appreciated in the late 1980's and early 1990's. Nevertheless, the textile industry has still been a major export industry in Korea.

<Table 2-18> Top 10 export items (%)

Rank	1970		1980		1990	
	Item	Share	Item	Share	Item	Share
1	textiles	40.8	textiles	15.9	textiles	11.7
2	plywood	11.0	steel sheet	4.1	semiconductors	7.0
3	wigs	10.8	ships	3.5	footwears	4.6
4	iron ores	5.9	man-made fabrics	3.2	ships	4.3
5	electronic goods	3.5	audio equipment	2.8	visual equipment	4.1
6	confectionery	2.3	tires, tubes	2.7	steel sheet	3.8
7	footwears	2.1	woods	2.7	synthetic fabrics	3.6
8	tobaccos	1.6	miscellaneous	2.6	computer	3.3
9	iron products	1.5	semiconductors	2.5	visual equipment	3.0
10	metal products	1.5	visual equipment	2.4	vehicle	3.0
Total	-	81.1	-	42.4	-	48.3

6-2. Development Process of the Korean Textile Industry

Up until the early 60s, Korea's textile industry was in a stage of import substitution. At the very beginning, the clothing industry succeeded in transforming from an import substitution industry into an export one. The clothing industry remained the leading sector for the whole textile industry until the 1980s.. After gaining sufficient competitiveness in the clothing sector, the Korean textile industry gradually expanded its industrial base to include upstream sectors such as textile fabrics and textile filaments. Here again, the clothing industry was the source of demand for the latter sectors. Natural fibres experienced a glut and faced new challenges of replacing outdated plants and improving the quality. On the other hand, man-made fibres underwent rapid import substitution as the production of nylon filament and viscose yarn began during the First Five-Year Economic Development Plan during the period 1962-66.

<Table 2-19> Importance of Clothing Industry

(Million US $, %)

	1970	1975	1980	1985
Textiles(A)	389	1,870	5,014	7,004
Clothing(B)	213	1,148	2,827	4,074
B / A	54.7	61.3	56.4	58.2

Source: Ministry of Trade and Industry

The textile industry began to emerge as a major export industry as Korea shifted to export-oriented industrialization during the Second Five-Year Economic Development Plan during the period 1967-1971. The Tentative Act on Textile Industrial Facilities was enacted in 1967 to facilitate, restructure, and replace old plants. From 1968, the production of man-made fibres and yarns began to increase rapidly. Exports of textile goods soared, making Korea one of the 'Big Three' during the 70s, along with Hong Kong and Taiwan.

The exports of textile goods grew rapidly and steadily during the 70s, despite the interruption of the First Oil Shock. Man-made fibres and yarns led exports, while polyester recorded the highest growth rate in production and export. Korea's exports, however, met difficulties as developed countries began to restrict imports from developing countries through the Multi-Fibre Arrangement (MFA) in 1974. Latecomer developing countries were also embarking on the export of cheaper textile goods utilizing low wage labor.

To cope with these difficulties, modernization and increasing the energy-efficiency of production plants was pursued during the Third Five-Year Economic Development Plan during the period 1972-76. In 1979, the government enacted the Textile Industry Promotion and Modernization Act, to allow for the expansion of capacity, to promote the replacement of old plants, and to develop technology and human resources. The early industrialization of the heavy and chemical industries during the latter half of the 70s however, put pressure on the textile industry due to raising wages. During the relative period of stagnation in the early 80s, Korea's textile industry also stagnated, experiencing a decrease in exports in 1982 and 1985. This was followed by the 'three-lows boom" (low dollar, low interest rate, and low oil price) from 1986, during which the textile industry hit the 10 billion dollar export mark in 1987-first as a single industry. Since 1989, however, exports have decelerated drastically, recording a 3.1% decrease again in 1990. The annual growth rate of exports averaged no more than 3% in the early 1990's.

Rapid wage hikes and a worsening shortage of labor together with the appreciation of the Korean currency have often been pointed out as responsible factors.

<Table 2-20> Korea's Textile Exports in the World

(Billion US $, %)

	1962	1972	1982	1987
World Exports(A)	120	301	922	1,500
Korea's Exports(B)	0.1	7.1	59.2	141.1
B/A	0.1	2.4	6.4	9.4
Rank	27th	14th	6th	3rd

Source: UN Trade Statistics

Korean firms and the government are trying to overcome the difficulties through structural adjustment. Firms have been investing in automation, renewal of plants, and the development of high technology. They have also been transferring production sites overseas for older industries. These efforts have been supported by government policies, by subsiding investment and R&D, and by encouraging the transfer of production sites.

<Table 2-21> Production and Exports of Korean Textile Industry

	1970	1975	1980	1985	1990	1995	2000
Production (Billion Wons)	259	1,751	6,255	10,852	19,545	35,060	39,387
Import (Million Dollars)	248	1,182	1,203	1,512	3,548	6,493	5,880
Export(A) (Million Dollars)	389	1,870	5,014	7,004	14,714	18,440	18,410
Total Export(B)	835	5,081	17,505	30,283	65,016	125,058	172,300
A/B(%)	46.6	37.3	28.6	23.1	22.6	14.7	10.7

The industrial structure of Korea's textile is thus currently undergoing a rapid change while the growth rate is slowing down somewhat. Between 1970 and 2000, production in Korea's textile industry grew at 18.2% annually, but production increased only by 2.4% from 1995 to 2000. Exports of Korean textile products have increased by 13.7% annually for the last thirty years, while exports of those products have not increased at all during 1995 - 2000 period.

6-3. Status of Korea's Textile Industry

The textile industry was no doubt a leading sector of Korea's export-oriented industrialization through the 60s and 70s. It accounted for 22% of increase in value-added, 34% of increase in exports, and 25% of increase in investment during 1970-75 period.

<Table 2-22> Shares of the Textile Industry in the Korea'sManufacturing Sector
(% on value-added basis)

	1970	1975	1980	1985	1990	1995	2000
Production[a]	14.8	18.9	15.3	13.7	11.5	10.0	8.2
Exports	38.7	34.4	28.6	23.1	22.6	14.7	10.7
Employment	20.2	25.3	24.8	20.7	18.5	17.0	15.2

Source : Korea Federation of Textile Industries, Statistics of Textile Industry, various annual issues.

In spite of the relative decline since 1975, the textile industry is still extremely important in the Korean economy, accounting for 8.2% of value-added, and employing 15.2% of the total labor force within the manufacturing sector as of 2000 (Table 5). It also accounts for 10.7% of exports, and records a 12.5 billion dollars trade surplus.

6-4. Faced with Structural Difficulties

Starting from the 1990s, however, Korea's textile exports declined drastically, faced with strong competition from newly industrializing countries such as China and Vietnam. Meanwhile, rapid wage increases and worsening shortage of labor along with the appreciation of the Korean won currency have only undermined the industry's competitiveness. In order to overcome these difficulties, Korea's textile industry is in the process of transferring its production facilities such as textile machines and plants into low wage countries such as China, Vietnam, Bangladesh, etc.

□ How to Promote Textile Exports

The Korean government did not provide textile industries with industry-specific trade promoting measures. However, the government helped Korean textile companies to establish their cooperative association, the Korea Federation of Textile Industries, in May 1967. KOFOTI, a nationwide organization of textile enterprises and organizations, plays the role as a bridge between the textile-related local companies and foreign buyers by organizing textile trade fairs in Korea and overseas, as well as assisting Korean textile companies to participate in world renowned trade exhibitions.

7. Policy Recommendations

7-1. To Establish Industrial Complexes for SMEs

Considering that there exist a comparative advantage in terms of abundant and well-educated labor forces, which are underused, and that Uzbekistan produces a lot of cotton that can be used as a basic material for textile industry, the most efficient policy tools for the purpose of developing exporting industries would be establishing industrial complexes for SMEs. Especially, it is preferable for Uzbek government to locate light industries such as clothing, leather processing and textile industries, which are labor intensive, in order to take advantage of well-educated but inexpensive labor forces.

In case that industrial complexes for SMEs are established in Uzbekistan, Korean SMEs of light industries will be able to come to invest in those industrial complexes because they are looking for the best places for their relocation.

□ How to Make Industrial Complexes Efficient & Effective

In order to make industrial complexes for SMEs more attractive for (foreign/domestic) companies, the Uzbekistan government should find locations providing the following conditions.

easy to recruit workforces(skilled or unskilled)

easy to ship products(markets, highways, railroads, ports)

well-connected to public utilities(electricity, water supply, communication)

providing proper living facilities for managers(schools, housing & medical centers)

Furthermore, the government should provide financial assistance for investment and tax incentives during a determined period for the companies investing in these industrial complexes.

□ How to Provide Proper Incentives for SMEs in Uzbekistan

We can find some policies already announced for this purpose in Uzbekistan such as limiting governmental intervention in the activity of private enterprises, widening the access of private enterprises to the resource market and marketing and providing financial support and additional tax preferences. However, in order to make these proposed policy objectives, the Uzbekistan government should implement the following measures.

providing sufficient financial support when starting SMEs

providing technological assistance

providing marketing assistance(domestic & overseas)

giving additional incentives for exporting SMEs

7-2. Basic Policy Directions for Promoting Industrial Exports

As long as environments for market economic system are improved and efficient and effective export promotion policies are applied, it is foreseeable that appropriate light industries, which can take advantage of underemployed good labor forces, will be able to prosper in Uzbekistan. However, reflecting upon Korea's experiences for developing exporting light industries in the early 1960s, it is recommended for the Uzbek government to respect the following basic policy directions. Firstly, there is no need to pre-select "appropriate" industries, rather let the market choose the "right" ones. Secondly, comparative advantage should be respected: Uzbekistan's competitiveness lies in its well-educated and inexpensive labor forces. Thirdly, simple trade promotion policies can bring about industrialization in the country. Fourthly, "entrepreneurship" should be enhanced by the government.

7-3. To Expand Government Investment for Industrial Development

As public enterprises and semi public enterprises occupy the largest part of industrial activities, it is hardly expected that private sectors can mobilize sufficient funds for starting manufacturing industries. Thus, it is necessary for the government to expand its investment for industrial development particularly at the early stage of industrialization.

Whereas the government played an active role in mobilizing and providing investment funds for companies in Korea, the government's contribution to investment has been decreasing in Uzbekistan. It would be necessary to find new financial sources for investments

7-4. How to Develop Auto-part Industries

As Uzbekistan has a car maker that has international competitiveness and is successfully exporting assembled cars to foreign countries such as Russia, it is very reasonable to think of developing auto-part industries.

When Korea was developing auto-part industries during the late 1960s, it started with parts and components that were relatively simple and labor intensive. In the process of doing so, Korean auto-part industries were able to acquire necessary basic technologies very rapidly and managed to localize most of parts and components in the lapse of less than 10 years. In Uzbekistan on the contrary it seems that the automobile industry wants to localize technologically advanced and capital intensive in advance. It is recommended for the Uzbek government to localize technologically simple and labor intensive respecting its comparative advantage.

At the beginning of Korea's developing automobile industry, there were many SME part makers (small entrepreneurs), it is also advised that the Uzbek government to give more chances to small entrepreneurs to take part in thisindustry.

7-5. How to Develop Textile Industries

Uzbekistan, having the advantage of competitiveness in cotton, seems to be embarking on developing upstream textile sectors. At this stage, we might pose some questions about appropriate policies for the development of textile industries in Uzbekistan. What about the competitiveness of Uzbekistan's labor forces It is highly recommended that the Uzbek government develop downstream textile sectors, which can exploit abundance of well-educated and inexpensive labor forces. As seen above, foreign companies is successfully running their business by combining upstream and downstream sectors in Uzbekistan.

Moreover, considering that the domestic apparel market is flooded by cheap Chinese products, it would not be very hard to develop clothing industries which can substitute those Chinese products.

If the Uzbekistan textile industry can attract Korean textile firms (especially apparel firms), it can rapidly acquire competitiveness to compete against those Chinese products.

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Chapter 3

Macroeconomic and Financial Policies for the Industrialization of Uzbekistan: Lessons from Korean Experience

Chapter 3

Macroeconomic and Financial Policies for the Industrialization of Uzbekistan: Lessons from Korean Experience

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Executive Summary

The Uzbekistan government implemented its industrialization and social development based on the strategy of resource allocation through the control of product and factor prices. These active interventions in the allocation of resources used to retard economic growth, but the Uzbekistan economy has improved in the past two years. Based on rich resources and market reform, the Uzbekistan government aims to develop its industrial structure by fostering priority sectors that utilize prevailing raw materials to produce products with high value added. The following macroeconomic and financial policies are recommended as a way of achieving sustained high growth.

[Targeting growth] In order to achieve high investment and high growth, we suggest the establishment of a very comprehensive and coherent plan like Korea's Five-Year Plan. The Five-Year Plan played a key role in Korea's development. It contained the macroeconomic projections that took into account a growth target and the required capital formation, as well as a financing plan. Emphasis was placed on predicting domestic savings, the current account, and external financing. To make the plan credible and facilitate external financing, Korea's Economic Planning Board complemented the macroeconomic projections and the financing plan with a detailed set of policies.

[Investment Policy] The targeting of growth and investment presupposes the activist investment policy. Korean policy makers have used policies in the exchange rate, tax, and credit allocation to provide incentives for investment. Such an activist, sometimes interventionist, policy is justified when investment has significant external effects or when market failures hinder investment. A government's active investment in social infrastructure and human capital is the best example.

[Virtuous Cycles among Saving, Investment, and Growth] The virtuous cycles among saving, investment, and growth are key for attaining high growth. Many think that high investment leads to high growth, citing Korea's experience. However, empirical analysis suggests that investment responded positively to output growth and growth preceded savings in Korea. Korea's national savings policy was mainly the high investment cum high growth policy in addition to the demographic policy such as fertility control. Macroeconomic stability based on sound monetary and fiscal policy is another ingredient of a successful savings policy, as higher public savings and lower inflation lead to higher national savings. The policy of maintaining high and stable corporate savings is also crucial for achieving high investment in the presence of capital market imperfections.

[Financial Policies] The banking system in Uzbekistan is different from that in Korea. Uzbekistan has many small banks, whereas Korea had a few large banks in the beginning of its economic take-off. Uzbekistan has adopted a universal banking system, while Korea adopted a specialized banking system. However, financial intermediation in Uzbekistan has been retarded due to high inflation and cash restrictions and taxes on bank accounts. The banking system should undergo very significant structural adjustments to facilitate the intermediation of financial resources between the surplus and deficit units.

[Market-Friendly Approach] At the initial stage of Korea's development, the market was neither developed nor functioning well. However, the World Bank assessed that Korea's growth was market-friendly. In a market-friendly approach, the appropriate role of the government for achieving rapid growth is to ensure the following: adequate investment in human capital, competitive climate for private enterprises, open economy to international trade, and economic stability.

Structural reforms and competitive pressure matter most for the investment climate and growth of Uzbekistan. The following reform agenda are recommended: liberalization of the foreign exchange regime, removal of foreign trade barriers, price flexibility, banking sector reform, support of private investment and entrepreneurship, and transparency.

One can learn from the Korea's growth and market experiences, especially in terms of the government's role when markets are incomplete and missing. The government can play the role of the market's coordinator by arranging an institutional framework for cooperation and information exchange, when the market is not functioning well. However, the cooperating role of the government may lead to collusion between the government and businesses. To avoid the deterioration of the cooperative behavior, the Northeast Asian economies combined cooperation with competition by developing institutional structures in which firms competed for economic prizes, such as access to credit. This is called the contest-based competition.

[Lessons from Korea's Heavy and Chemical Industrialization] Korea's industrialization of heavy and chemical industries was pursued under special circumstances in the early 1970s. The 'Big Push' needs two conditions — scale economies in production and an elastic supply of labor — in the modern sector to yield external economies. The achievements of Korea's heavy and chemical industrialization are really controversial because the Big Push resulted in high growth but with various distortions. In the 1980s, the government increasingly placed more attention on market mechanisms including trade and financial liberalization.

1. Introduction

The Uzbekistan economy has performed greatly since 2003. The real GDP growth rose to 7.7% in 2004 from 4.4% in 2003, owing to rapid export growth. The favorable external conditions raised the prices of major export items such as cotton and gold. The recent improvement in its macroeconomic performance can also be attributed to the reform measures implemented by the government. Since 2000, the government has corrected the overvaluation of the Soum, tightened monetary and fiscal stances, and adopted more conservative borrowing policies. It has also been engaged in liberalization and privatization with the help of international financial institutions such as the IMF, World Bank, and EBRD.

Since the country's independence on 31 August 1991, the Uzbekistan government has gradually transformed its centrally planned economy into a "socially-oriented market economy." So far it has adhered to the following policy directions: (i) implementation of import-substitution based strategy to reduce imports and achieve economic independence; (ii) diversification of industrial structure from raw material sector to a modern and high value added sector; (iii) the strengthening of export potential to increase foreign exchange reserves and maintain a stable currency; (iv) the promotion of employment opportunities and living standards. Overall, the structural transformation was to be achieved by investing in priority sectors following an import substitution based strategy and attracting foreign investment.

Almost the same development strategy adopted by Uzbekistan was adopted in other developing countries including CIS countries. However, literature suggests that the government-led investment in priority sectors following an import substitution based strategy created various distortions in the market. Korea was not an exception. Although exports played an important role in Korea's high growth, an import substitution based strategy was adopted in the heavy and chemical industrialization during the 1970s.

The paper intends to provide macroeconomic and financial policy suggestions for Uzbekistan based on Korea's experiences in industrialization. Chapter 2 reviews the current macroeconomic situation and financial market development in Uzbekistan. Chapter 3 outlines growth targeting with reference to Korea's Five-Year Plan. Chapter 4 discusses how to finance investment based on Korea's experiences. Chapter 5 deals with the development of financial markets as a conduit for domestic investment. Chapter 6 discusses the market-friendly approach to economic development with reference to Korea. Finally, chapter 7 concludes by summarizing the policy suggestions for Uzbekistan.

2. Current Economic Development in Uzbekistan

The Uzbekistan government's industrialization and social development strategy was based on allocating resource through the regulation of product and factor prices (World Bank, 2003). As a result, the domestic currency was overvalued. Interest rates were kept low despite high inflation. The prices of energy, raw materials, and agricultural products were maintained below market levels to subsidize other sectors. The enterprises, private and public, were little exposed to market competition under the centralized production target and state distribution system that were characterized by extensive price regulation and soft budget constraints. The government's active intervention in the allocation of resources had a retarding affect on economic growth. Nonetheless the Uzbekistan economy has improved in the past two years.

2-1. Features of Macroeconomic Development

In 2004, the growth rate of real GDP increased sharply to 7.7%, from 4.4% in 2003, due mainly to the rapid growth of exports. The trade surplus expanded from 0.8 billion US dollars in 2003 to 1 billion US dollars in 2004. Surprisingly, the boost in the real growth was accompanied by moderate inflation. As a result of tight monetary and fiscal policies, consumer prices increased by 3.7%, from December to December of the previous year, which is slightly lower than 3.8% in 2003. Although the consumer price inflation stabilized at a moderate level, the producer price index kept increasing at a high rate of 26.5% in 2004.

The recent superb macroeconomic performance that has been characterized by higher growth, lower inflation, and larger trade surplus can be attributed to both favorable external conditions and sound macroeconomic management.

First, exports have turned around to grow rapidly since 2003 from negative growth during 2001-2002. Exports grew 25% and 30% in 2003 and 2004, respectively. The sharp turnaround of exports could be explained by the sharp depreciation of the Soum and gradual trade and financial liberalization. The CBU (Central Bank of Uzbekistan) exchange rate of the Soum vis-à-vis the US dollar rose 6 times during 1999-2002, but the substantial difference between the CBU exchange rate and that of the exchange offices remained until 2002 (see Table 3-1). During 2003-2004, the Soum depreciated further, closing the difference between the official exchange rate and exchange rate at the exchange offices. The remarkable depreciation experienced during the last five years contributed to a sharp increase in exports during 2003-2004 by strengthening export competitiveness and ensuring the convertibility of the current account. But, inflationary pressure emerged due to high import prices. The favorable development of external conditions also helped stimulate exports. For instance, gold and energy prices increased strikingly in 2004, thereby increasing the shares of metals and energy carriers among total exports.

<Table 3-1> Exchange Rate of UZS vis-à-vis the USD

Period	Exchange Rate of CBU	% Change, year to year	Exchange Rate of Exchange Offices	% Change, year to year
2000	236.6	89.9	450.1	183.5
2001	422.9	78,8	829.0	84.2
2002	770.8	82.3	1093.8	31.9
2003	979.4	26.0	995.1	-9.0
2004	1058.0	8.0	1062.5	6.8

Source: *Uzbekistan Economy*, Center for Effective Economic Policy, No. 8, March 2005.

Second, fiscal and monetary policies remained restrictive in order to attain a lower inflation target. The budget deficit was maintained below 1% of GDP since 2000, recently reaching 0.4% of GDP. According to the World Bank (2003), real public sector deficits including state enterprise borrowing were much higher than the consolidated state budget deficit. In 1998-1999, the real public sector deficits were as high as 10% of GDP, while the consolidated state budget was around 2% of GDP. The real fiscal deficit was reduced to below 4% in 2001, resulting from a large decline in state enterprise investments.

In 2003, the CBU changed its method of monetary control from regulating cash into managing the money supply based on the dynamics of net domestic assets and international reserves. The CBU ceased to finance the budget deficit. Inter-bank deposit transactions were used the most as a tool of monetary policy to control the money supply. These transactions were conducted at auction-based interest rates. The compulsory reserve requirements of 20% that paid no interest were applied to the accounts of legal entities in the national currency, and not applied to funds in the foreign currency, deposits of private individuals and funds attracted by issuing deposits, saving certificates or mortgage bonds. As a result, the broad money growth rate declined from 54.3% per year in 2001 into 29.7% per year in 2002 and 27.1% per year in 2003.

Table 3-2 shows changes in the interest rate. The rates for loan and deposits rose to contain inflationary pressures and the refinancing rate was so high that it exceeded the loan rate during 2000-2002. However, rising interest rates along with accompanying monetary restraints seemed not to have been the main factor in causing the sudden drop in inflation in 2003. The real interest rate has been negative in terms of the producer price inflation. The rapid decline of inflation after peaking in 2002 is greatly due to the declining trend of foodstuffs prices during the same period. Furthermore, the annual growth rate of broad money increased drastically from 27.1% to 47.8% reflecting the sizable current account surplus and the consequent net accumulation of foreign assets by the CBU. This could reflect the increase in the demand for money due to high GDP growth, strengthened currency convertibility, and lower inflation.

However, higher money growth may lead to higher inflation.

<Table 3-2> Changes in the Interest Rate in Uzbekistan (%. per annum)

Period	Refinancing Rate	Short-term Loan Rate[1)]	Fixed-term Deposits of Legal Entities[1)]	Fixed-term Deposits of Individuals[1)]	CPI Inflation	Producer PriceInflation[2)]
2000	32.3	25.7	12.9	32.2	28.2	70.3
2001	26.8	28.0	16.0	38.1	26.6	43.9
2002	34.5	32.2	19.2	40.2	21.6	46.1
2003	27.1	28.1	17.1	36.2	3.8	27.4
2004	18.8	21.2	11.3	34.5	3.7	26.5

Note: 1) Weighted average on loans or deposits in national currency.
2) December to December.
Source: *Uzbekistan Economy*, Center for Effective Economic Policy, No. 8, March 2005.

Third, favorable external conditions and sound macroeconomic management affected savings and investment, which contributed to a larger current account surplus. Table 3-3 shows the demand composition of Uzbekistan's GDP. The ratio for private and state consumption stayed slightly above 60% and 18%, respectively, so that the gross domestic savings ratio was slightly under 22% during 2000-2002. However, the savings ratio began to rise rapidly with export growth and moderate inflation. The savings ratio increased sharply from 22% in 2002 to 31% in 2004. In contrast to the jump in the savings ratio, the domestic fixed investment ratio stayed at 22% during 2002-2004.

<Table 3-3> Demand Composition of GDP in Uzbekistan (%)

Period	Final Consumption		Investment		Net exports
	Private	State	Fixed Investment[1)]	Changes in Inventories	
2000	61.9	18.7	24.0	-4.4	-0.2
2001	61.5	18.5	27.9	-6.8	-1.1
2002	60.2	18.0	22.1	1.0	0.6
2003	55.6	17.5	22.1	-0.9	6.2
2004	51.7	17.1	22.1	1.8	7.3

Note: 1) including net purchasing values.
Source: *Uzbekistan Economy*, Center for Effective Economic Policy, No. 8, March 2005.

Sluggish investment, as the investment ratio remained constant amid the jump in savings, raised serious concerns over the long-term growth of Uzbekistan. Though the growth rate of domestic fixed investment continued to increase from 0.9% in 2000 to 5.2% in 2004, investment growth was lower than GDP growth, as the export boom led to high growth in 2004.

Table 3-4 shows Korea’s macroeconomic development. The Korean economy underwent low growth and very high inflation as it adopted an import substitution based strategy in the 1950s. Then it grew over 7% after adopting an export promotion strategy in the 1960s. It sustained high growth over three decades until the crisis in 1997, while experiencing some business-cycle fluctuations.

<Table 3-4> Macroeconomic Overview of the Korean Economy

(Annual Averages)	54-61	62-71	72-81	82-91	92-2000
Real GDP Growth (%)[1)]	4.1	8.7	7.3	8.9	5.9
CPI Inflation (%)	21.1[2)]	7.2	17.4	5.2	4.6
Current Account (Billion U.S. dollars)	-0.3[3)]	-0.4	-2.0	1.8	3.3
Gross Saving Ratio (%)[1)]	10.9	15.9	24.4	34.3	34.4
Gross Domestic Investment Ratio (%)[1)]	11.1	20.1	29.5	32.2	32.9

Notes: 1) Data up to 1970 are compiled at 1975 price and by old national income accounts.
2) Seoul CPI.
3) Trade balance on customs basis.

During the first and second periods of the plan (1962-71), average annual growth rate rose to 8.7%, but annual inflation was subdued at 7.2%. The gross domestic investment ratio almost doubled compared with the previous period. During the third and fourth periods of the plan (1972-81), the average growth rate declined a bit despite the rapid rise in investment, and inflation rose drastically due to two oil shocks. The widening deficit in the current account due to the oil price hikes and high investment emerged as a primary concern. Then the government adopted the policy of macroeconomic stabilization to control the rampant inflation in the 1970s. With monetary and fiscal tightening, inflation began to go down and soon growth picked up. Furthermore, the current account turned into a surplus from deficit due mainly to favorable developments in external conditions since 1986, namely the so called ‘three lows’: low oil prices, low international interest rates, and low dollar. Growth began to slow down as the favorable external conditions began to fade-out. The outbreak of the economic crisis in 1997 further aggravated the economic slowdown. But it should be stressed that high growth had been accompanied with single digit inflation except in the 1970s during the oil price hike.

2-2. Financial Market

The banking system is comprised of the CBU and 32 commercial banks with 805 branches throughout the country. The CBU regulates and supervises the activity of commercial banks, credit unions, and pawn shops. As of January 1, 2005, the commercial banks consist of 3 state banks, 11 private banks, 5 banks with the participation of the foreign capital, and 13 joint stock banks. However, the banking sector is retarded. Excluding state-sponsored lending, financial intermediation is weak, even compared to other transition countries (Nicolo, Geadah, and Rozhkov, 2003). In particular, 70% of the banks' loan portfolio consisted of state-guaranteed foreign loans, but such loans will be at fiscal risks, if not properly managed. Furthermore, the substantial devaluation raised their burden in servicing the debt.

<Table 3-5> Structure of the Use of Money Income of the Population in Uzbekistan

(% of money income)

Year	Money Income	Of which used for			Cash Remainder
		Consumption Expenditure	Compulsory Payments and Mandatory Contributions	Bank Deposits, Purchases of Securities and Hard Currency	
2003	100	78.7	7.8	9.2	4.3
2004	100	76.9	7.8	14.3	1.0

Table 3-5 shows the structure of the use of the money income of Uzbekistan's population. The compulsory payments and mandatory contributions occupied 8% of the money income in 2004, while bank deposits, and purchases of securities and hard currency occupied 14% of the money income in 2004. The main problem in the current banking system is that household deposits at the banks remained below 2% of GDP, implying that a significant portion of money income is used to buy hard currency. The hesitant behavior of households to make bank deposits is attributable to the CBU-administered cash planning system and banks' tax enforcement. The central bank relied on cash plans rather than an interest rate policy to manage liquidity and cap inflation, while the banks operated as agents for the state tax authority. In addition, the inconvertibility of the current account, which has restrictions on the withdrawal of deposits and foreign exchange, has contributed to the development of the black market for foreign exchange, as well as capital flight.

Considering the potential risks and severe retardation caused by the state-directed lending and prevalent government interference, the 'Program for the Next Stage of Reforming the Uzbekistan Banking System for 2003-2004' was formulated in July 2003 to enhance the efficiency of the banking system. The major contents of the Program are as follows:

- Further improvement of market tools of monetary policy and encouraging non-cash settlement
- Exchange rate unification in the domestic foreign exchange market and the introduction of Soum convertibility for current international transactions
- Reduction of direct government participation in the authorization of commercial banks' capital
- Stage-by-stage removal of uncharacteristic functions from commercial banks, including responsibilities for collection, recording and control of accounts, control of cash administration by economic agents, etc
- Formation of a legal base for bank holdings and groups and pawn-shops, and also improvement of the normative base for activity of credit unions, etc

The privatization of banks is on going. With the help of the measures taken to expand the access of entrepreneurs to loans from banks, total assets of commercial banks increased 7% in 2003 and 22% in 2004, reaching UZS 5.4 trillion, as of January 1, 2005. Bank loans increased by UZS 751 billion or by 13.4% in 2004. And individual deposits increased by UZS 323 billion or 32% due to low inflation and more favorable conditions for individual deposits.

There was a significant increase in the issuance of deposit and savings certificates by commercial banks, as well as, stocks and corporate bonds. A total of UZS 146.3 billion of stocks and corporate bonds were issued in the securities market in 2004, or a 30.3% increase compared to the previous year.

Uzbekistan needs to establish a virtuous cycle of financial development and macroeconomic stability. Although the annual consumer-price inflation fell under a single digit rate, the annual producer price inflation is still over 20%. To achieve macroeconomic stability, annual inflation should be moderate at a single digit in the medium to long term without direct controls on private holdings of the cash. The various measures to regulate cash withdrawals from the bank might help curb inflation in the short term, but people have become increasingly reluctant to make deposits at banks that the authorities heavily regulate. Despite the Reform Program for the Banking System, progress has been slow. The consequent retardation of financial intermediaries deters investment and production, aggravating the supply shortage and adding to the inflation pressure in the medium term.

3. Growth and Investment Targeting

The Uzbekistan government plans to maintain the current growth rate of 7-8% for the long term. Achieving the growth target depends mainly on industrial development. The government is paying attention not just to industrial growth but also to the efficiency and competitiveness of its domestic industry. It aims to develop the industrial structure by producing products with high value added using prevailing raw materials. That is fostering priority sectors based on rich resources while focusing on market reform. According to the long-term industrial development plan, industrial share in GDP will increase strikingly to 30% in 2010, which is close to the level of newly industrialized countries.

3-1. Uzbekistan's Industrial Development in Comparison with Korea

The Uzbekistan's production structure changed toward the direction of raising the industrial share and reducing the agricultural share during the past five years, as shown in Table 3-6. The industrial share in GDP increased by 2.9% points during 2000-2004, while the agricultural share decreased by 3.3% points during the same period. Looking at the annual changes, the industrial pattern started to change from 2002 with a rapid recovery in exports. In other words, the development of the production structure reflected not only technological progress but also improvement in the economic situation of major trading partner countries. Industrial production grew by 9.4% in 2004, outstripping overall GDP growth. The machinery industry grew by 34.5%, construction materials by 8.2%, light industry by 5.2%, fuel industry by 5.8%. It should be noted that the investment ratio stayed put during the rapid industrial development period of 2003-2004.

<Table 3-6> Production Structure of GDP in Uzbekistan (%)

Period	Agriculture	Industry	Construction	Services	Net Taxes
2000	30.1	14.2	6.0	37.2	12.5
2001	30.2	14.2	5.8	38.2	11.9
2002	30.1	14.5	4.9	37.9	12.6
2003	28.6	15.8	4.5	37.4	13.7
2004	26.8	17.1	4.5	37.6	14.0

Source: *Uzbekistan Economy*, Center for Effective Economic Policy, No. 8, March 2005.

The Uzbekistan government adopted a gradual approach to industrial transformation. At the first stage (1991-1995), the government emphasized the development of important raw materials, which consisted of extracted materials and some import-substituting products. It maintained protectionist measures as part of its industrial policy. For instance, it regulated energy prices to support the profitability of major industrial products. Also, the government was very cautious in privatizing large enterprises. At the second stage (1996-2000), the government emphasized investment in industrial sectors. The structural transformations were backed by the government's support of priority projects that aimed to promote exports and import substitution. The state budget became one of the key channels for making investments in the industrial production. At the third stage (2000-2004), the government emphasized market reforms. The privatization of large enterprises, the restriction of state property monopoly, and the growth of the private sector became major directions of reforms. The tight policies were taken to liquidate inefficient production and reform management structures. The liberalization of the foreign exchange policy and the reduction of the government role made enterprises increasingly reliant on their own funds.

<Table 3-7> Industrial Origins of GNP in Korea (composition, %)

	1962	1965	1970	1975	1980
Agriculture, forestry and fishing	43.3	42.9	30.4	24.2	14.4
Mining	2.0	2.0	1.6	2.0	1.4
Manufacturing	9.1	11.0	17.8	21.6	28.8
Light	6.8	7.4	10.4	12.3	14.1
Heavy	2.3	3.6	7.4	9.3	14.7
Others[1)]	45.6	44.0	50.1	52.3	55.4
GNP	100.0	100.0	100.0	100.0	100.0

Note: Data prior to 1970 are based on 1975 constant market prices. Data beginning from 1971 are based on 1980 constant market prices.

1) Others include wholesale and retail trade, restaurants and hotels, social and personal services, transport and communications, and construction.

Table 3-7 shows the development of Korea's production structure. Economic development since the early 1960s can be described as having been export-oriented industrialization, since the growth was led by exports of manufactured goods. The rapid expansion of the manufacturing sector was roughly counterbalanced by the rapid contraction of the agricultural sector. The share of agricultural, forestry, and fishing products in GNP decreased from 43% in 1962 to 30% in 1970, while the share of manufacturing products increased from 9% in 1962 to 18% in 1970. The Uzbekistan's production structure in 2004 is similar to Korea's production structure in 1970. If Uzbekistan follows the path that Korea followed in the 1970s, the share of the primary sector will decline by a half and the share of the manufacturing sector will double to

30% within a decade.

It should be noted that the 1970s were the period of Korea's heavy and chemical industrialization, which brought about various distortions in the economy. The rapid expansion of capital-intensive industries in a labor-abundant economy raises issues of economic efficiency because the Big Push toward heavy and chemical industries accompanies excessively protectionist policies and extensive government intervention. Although Korea succeeded in developing the industrial structure and overcame the oil price hikes in the 1970s, it witnessed mounting inflationary pressures and severe imbalances and distortions in the domestic economy.

Exports represent the comparative or competitive advantage of the products made in Uzbekistan. The Uzbekistan's export/GDP ratio was over 30% in 2004, while Korea's was slightly over 10% in 1971 in Korea. Table 8 shows the export structure of Uzbekistan. The exports of cotton fiber occupy almost one fifth of the total, followed by exports of energy carriers and metals. As the exports of raw material account for around 40%, it could be said that Uzbekistan still has an advantage in the exports of raw material related products. Exports of chemical and machinery products comprise only about 10%. Exports of services that are mostly transportation services amount to over 10%.[41] But it should be noted that "others" in Table 3-8 amount to over 30%.

<Table 3-8> Commodity Share of Exports in Uzbekistan (%)

Commodity	2003	2004
Cotton Fiber	19.8	18.1
Foodstuffs	2.7	3.8
Chemical Products, Plastics, and Plastic Goods	3.1	4.7
Energy Carriers	9.8	12.4
Non-ferrous and ferrous Metals	6.4	8.6
Machinery and Equipment	5.9	7.4
Services	14.4	11.8
Others	37.9	33.2
Total	100	100

Source: State Statistics Committee of Uzbekistan.

41) Imports of services also amount to around 10% of the total imports.

Table 3-9 shows Korea's export structure by major commodity groups. The share of primary product exports declined drastically from 45% in 1964 to 17% in 1970, while the share of light industry exports increased from 45% to 70% during the same period. Korea succeeded in promoting exports of light manufacturing products with the adoption of an export-oriented growth strategy in the early 1960s. The share of light manufacturing exports began to decline in the 1970s with the adoption of heavy and chemical industrialization. The share of heavy and chemical products increased from 13% in 1970 to 42% in 1980. Comparing Uzbekistan in 2004 with Korea in 1970, we find that the industry share and the share of heavy and chemical exports are almost the same. The major difference is the export share of the primary products and light manufacturing. Korea switched quickly to light manufacturing exports when introducing export promotion policies, but Uzbekistan still significantly relies on exports of raw materials. Thus, it could be said the industrial sector in Uzbekistan, despite its share of 17% in 2004, is not well prepared to export light manufacturing goods compared to the Korea's industrial sector in 1970.

<Table 3-9>. Export Structure by Major Commodity Groups in Korea (%)

Year	Primary Products	Heavy & Chemicals	Light industry		
			Total	Textiles	Non-Textiles
1964	45.4	9.2	45.4	27.7	17.7
1970	17.5	12.8	69.6	39.3	30.3
1980	11.7	41.8	46.4	29.1	17.6
1990	4.9	56.6	38.5	22.7	15.8
2000	2.8	81.0	16.2	10.9	5.3

3-2. Uzbekistan's Long-Term Plan versus Korea's Five-Year Plan

Uzbekistan set up the Millennium Development Goals (MDGs) in 2000, which aims at reducing poverty in half by 2015. The main sources for achieving the 2015 target will be due to more efficient use of resources and strengthened competitiveness of industries through the intensification of its liberalization, reduction of market imbalances, and a more efficient functioning of public institutions. To achieve the MDGs, GDP should grow 7.5-8% in 2005-2010. Economic policies needed for such high growth include the following (IMF, 2005a):

- Reduction of tax burden and restriction of government intervention in the economic processes
- Acceleration of economic liberalization, primarily in the spheres of financial policies and foreign trade
- Simplification of the regulatory and legislative framework to attract material assets of the

population into economic circulation
- Overcoming of structural disproportions on the macro and micro levels
- Elimination of inequality in the sphere of taxation and monetary policies, and access to material and financial resources
- Stage-by-stage achievement of conditions and requirements related for the entrance of Uzbekistan into the WTO, including the narrowing of the gap between the levels of domestic and world market prices on energy resources and payment for water resources.

The macroeconomic projections were based on the condition that the reform measures would be implemented. In Table 3-10, GDP growth is projected to reach 8-8.5% per year on average during 2007-2010. Annual average industrial growth will be 11-13% and the share of industry in GDP will increase to 19-20%. Also, investment and exports will grow by 10-12% per year. Monetary policy will aim at keeping inflation at 4-5% a year.

<Table 3-10>. Macroeconomic Projections in Uzbekistan (%)

Indicators	2003	2004	2005	2006	2007-10
GDP Growth	4.4	6.0	6.4	7.5	8-8.5
Per capita GDP Growth	3.2	4.9	5.3	6.4	7-7.5
GDP Deflator Inflation	24.3	18.5	12.0	9.9	5-6
CPI Inflation	3.8	4.9	6-7	5.8	4-5
Gross Saving Ratio	26.7	25	25	26	26-28
Investment Growth	4.5	6.5	7.7	8.1	10-12
Consolidated Budget Revenue/GDP	32.7	28.7	28.4	28.2	26-27
Unified Social Payment/Wage Fund	37.2	33.0	32.0	29.5	27.5
Industry Growth	6.2	8.2	9.2	10.7	11-13
Agricultural Growth	5.9	4.5	4-5	4-5	4-5
Non-state Sector in GDP	74.5	75	77	80	85
SMEs in GDP	35.5	36.8	38.3	41.3	45-50
Exports Growth	24.6	9.6	10	11	10-12

Source: IMF (2005a).

The MDGs and the macroeconomic projections of Uzbekistan are very general with policy outlines and sequencing not clearly set. In a recent advisory note to the Interim Poverty Reduction Strategy Paper prepared for Uzbekistan, the World Bank and IMF "urge the authorities to strengthen the macroeconomic foundation of the strategy and develop a comprehensive and realistic medium-term macroeconomic framework" (IMF, 2005b, p.6). They advise that "the macroeconomic overview should be substantially strengthened, and provide analysis of dynamics and interrelationships between the key domestic and external balances, the authorities' policy responses and existing macroeconomic vulnerabilities" (IMF, 2005b, p.6). They also ask that "to be workable and credible, the reform program needs to be specific and prioritized and its impact adequately evaluated," since many proposals are very general (IMF, 2005b, p.5).

Economic growth can be sustained with appropriate capital accumulation and technological progress. High investment leads to high growth that cannot be sustainable without technological progress. Unfortunately, the determinants of technological progress are not well understood. They encompass not only investment on research and development but also institutional reforms that facilitate market mechanisms, a stable macroeconomic environment, financial development, and etc. Recognizing the multi-faceted aspects of sustained growth, the Uzbekistan government also makes every effort to stimulate investment, develop the industrial structure, and increase production efficiency.

The overall efforts to sustain growth and investment were outlined in Korea's Five-Year Economic Plan. Korea established the Economic Planning Board in 1961 and implemented a series of five-year economic plans from 1962 until 1996. Indeed, Korea's economic take-off took place with the institution of the First Five-Year Plan that laid down the groundwork that allowed Korea to switch from an import substitution strategy into an export-driven one. The first five-year plan (1962-66) focused on the development of basic industries for import substitution and expansion of social overhead capital. The export-oriented industrialization started with the implementation of the second plan (1967-71) that focused on the development of labor-intensive light manufacturing. The main thrust came as Korea deepened its industrial structure through the promotion of heavy and chemical industries beginning from the third plan (1972-76) to the fourth plan (1977-81). Korea was able to sustain high growth in the 1970s despite the oil shocks by adhering to the high investment strategy.

The Five-Year Plan played a key role in Korea's development. It contained the macroeconomic projections based on growth targets, required capital formation, and financing plan. Emphasis was placed on predicting domestic saving, current account, and the external financing. To make the plan credible and to facilitate external financing, the Economic Planning Board complemented the macroeconomic projections and the financing plan with a set of detailed policies. Thus the plan itself helps to maintain consistency in government policies and make them more credible as well as to provide policy directions.

The Plan was established in the following steps. The first step was to target a real growth rate based on labor force and labor productivity projections. The second step was to calculate the required investment to achieve the growth rate target, while taking into account the estimated incremental capital output ratio. The third step was to forecast inflation and translate the real target for output and inflation into the nominal target. The final step was to forecast domestic savings disaggregated into household, government, and corporate savings. The foreign saving can be a residual. However, the five-year plan contained detailed projections for the current account and detailed projections for external debt including the allocation of short-term and long-term debt and their projected debt service payments.

The Five-Year Plan was comprehensive in being able to check the balance and coherence among various sectors. It was completely different from the socialist model of central planning in which the resources were distributed by the government at controlled prices so that no market existed basically. The long-term planning directed the economic development when markets existed and played an important role in resource allocation. If the government controls some prices, then resources can be allocated in the unofficial market.

The First and Second Plan was a comprehensive resource plan. But the function of planning changed from resource planning to policy planning starting in the Third Plan, because it became increasingly hard for the government to control resource allocation with the rapid growth of the private sector. The Plan presented major policies and major investment projects and emphasized empirical researches on the impacts of major policies. Starting from the Fifth Plan, the Plan became indicative as it stressed gathering of consensus and disclosure of future direction on important policy issues. The Seventh Plan (1992-96) was the last, as the Economic Planning Board and Ministry of Finance merged in 1994.

In order to effectively implement the Plan, Korea introduced a formal system of monitoring and evaluation in 1962 with the institution of the Five-Year Plan. All central government agencies were required to prepare a basic annual management plan and submit it to the Office of Planning Coordination in the Prime Minister’s Office. These plans would be coordinated and consolidated before the annual budget estimates were made for the new fiscal year. After each government agency’s management plan was adjusted, each government agency had to prepare and submit the revised management plan to the Office of Planning Coordination. All projects and programs approved in the final management plan were subject to performance monitoring and evaluations.

Each government agency was first required to monitor and evaluate the implementation of the projects and report to the Office of Planning Coordination on a quarterly basis. The Office evaluated the reports with help of the Economic Performance Evaluation Group, which comprised of university professors and, then it was reported to the President in a quarterly meeting. If a project needed corrective measures after being evaluated, the Office of the Prime Minister would send modifications to each agency. This practice changed in 1981 due to conflicts in the budget process. The Office of Planning Coordination was abolished and the Bureau of Evaluation and Analysis was created within the Economic Planning Board to carry out economic planning, budgeting, and performance evaluation in a consistent way without conflicts.

Should Uzbekistan, which transformed from a centrally planned economy to a market economy, adopt the Medium-term plan? If the plan allocates resources at controlled prices as in the past, then such a plan should not be pursued. If the plan aims to develop a comprehensive and coherent medium-term macroeconomic framework and set up an overall resource budget for proposed policies, then such a plan can be useful in checking the feasibility and priority of proposed policies within the macroeconomic projections including growth, investment and saving, trade and balance of payments.

3-3. Investment Policy in Korea

The targeting of growth and investment presupposes the activist investment policy. Korean policy makers have used public investment, tax, and credit allocation policies to provide incentives for investment. The government put efforts to provide infrastructure and various tax incentives in association with private investment. It allocated credit at negative real interest rates at the risk of financial repression. Such an activist, sometimes interventionist, policy is justified when investment has significant external effects or when market failures are hindering investment. Active government investment in social infrastructure and human capital is the best example. In addition, uncertainty and irreversibility in investment decisions justify large investment incentives to compensate the opportunity value of waiting for profitable investment (Dixit and Pindyck, 1994).

It is well known that the high growth of East Asian countries was based on its own growth model that was quite apart from market-oriented standard ideals. Table 3-11 summarizes the differences between them. The government played an important role in allocating resources. The business-government relationships were very close. The government controlled financial markets and owned most upstream industries. The international capital flows were regulated until the 1990s.

Although the government's initiative in key investment projects should have merits, the achievements of the third and fourth plan based on the strong drive (Big Push) toward heavy and chemical industrialization are really controversial because the Big Push resulted in high growth but with various distortions. Despite the merits of a high investment policy, the government was not able to choose the 'right' industry and target the 'right' amount. Although exports continued to play a key role in enhancing investment efficiency, there seemed to be limits to the investment-induced growth due to socio-economic changes and industrial sophistication. Occasioned by dissatisfaction with the role of government intervention in resource allocation the main focus of the fifth plan (1982-86) shifted away from government intervention toward market mechanism including trade and financial liberalization

<Table 3-11>. East Asian Anomalies

Institutional Domain	Standard Ideal	"East Asian" Pattern
Property Rights	Private, enforced by the rule of law	Private, but gov't authority Occasionally overrides the law (especially in Korea)
Corporate Governance	Shareholder ("outsider") control Protection of shareholder rights	Insider control
Business-gov't Relations	Arms' length, rule based	Close interactions
Industrial Organization	Decentralized, competitive markets With tough anti-trust enforcement	Horizontal and vertical integration in production (chaebol); gov't-mandated "cartels"
Financial system	Deregulated, securities based, with free entry. Prudential supervision through regulatory oversight	Bank based, restricted entry, heavily Controlled by gov't, directed lending, Weak formal regulation
Labor markets	Decentralized, De-institutionalized, "flexible" labor markets	Lifetime employment in core Enterprises (Japan)
Int'l capital flows	"prudential" free	Restricted (until the 1990s)
Public ownership	None in productive sectors	High in upstream industries

Source: Rodrik, D., Growth Strategies, NBER WP #10050, 2003.

4. How to Finance Investment?

Investment should be financed by domestic and foreign savings. Countries with low domestic savings depend on foreign savings in the form of foreign direct investments and foreign debt. However, countries with high growth are characterized by high investment and savings. They invest more to grow more. They need to save more to invest more. The previous section discussed about the role of Korea's Five-Year Plan in which investment and savings were combined to produce high growth. If the investment required for high growth cannot match the savings, then foreign debt problems that emerge become a bottleneck to the growth. The virtuous cycles among savings, investment, and growth are the key to high growth.

4-1. Savings and Investment: Uzbekistan versus Korea

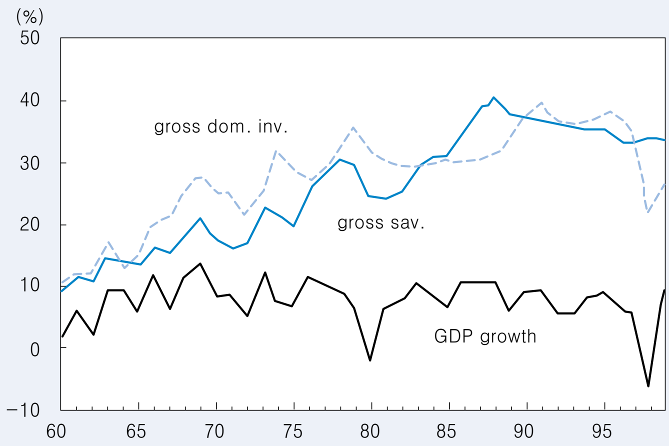
Table 3-3 shows the savings and investment ratio in Uzbekistan. The savings ratio was slightly under 22% during 2000-2002, but it jumped to 31% owing to export growth and moderate inflation in 2004. In contrast, the investment ratio declined during 2000-2002 and stayed at 22% thereafter. The stagnant investment implies that investment growth remained below GDP growth, thereby weakening the growth potential. Increased savings will not stimulate domestic investment if savings is used mostly for compulsory payments, mandatory contributions, and purchases of hard currency, real estate, and etc, as shown in Table 3-5.

Figure 3-1 shows the trends for saving and investment ratios that supported high growth in Korea. Since the recently compiled data for national income accounts based on the SNA method start in 1970, data for the 1960s was compiled at 1975 prices. The two series are not directly comparable, but it seems useful to integrate them.

Korea's gross saving ratio more than tripled from 9% in 1960 to around 35% in the 1990s. Korea's gross domestic investment ratio also more than tripled from 10% in 1960 to around 35% in the 1990s. Although savings and investment increased together, the investment ratio used to be higher than the saving ratio except for the latter half of the 1980s and the post-crisis era, creating chronic deficit in the current account and external debt problem.

It is notable that Korea's savings and investment ratio was only 9% and 10% in 1960 when the Korean economy took off, and then, rose to 18% and 25% in 1970, respectively. In the previous section, it is noted that the Uzbekistan economy in 2004 is similar to the Korean economy in 1970 in terms of their industrial structure. In terms of savings and investment, Uzbekistan's savings ratio in 2004 is almost twice the Korean savings ratio was in 1970, but Uzbekistan's investment ratio in 2004 is lower than Korea's by 3 percentage points. Uzbekistan faces the problem of a stagnant investment ratio, and the likelihood that the savings ratio would decline when exports lose steam.

<Figure 3-1> Trends in Savings, Investment, GDP Growth in Korea



Note: Savings and investment as percentage of gross national disposable
Income: The data up to 1970 represents 1975 prices and is not comparable with data after 1970.

4-2. Korean Experience on Investment, Growth, and Saving

How then was Korea able to attain the rapid rise in both investment and savings? How can investment be raised even with low savings? Does high investment lead to high saving? How can be savings encouraged? Many questions can arise in relation to the virtuous cycles among savings, investment, and growth.

Many think that high investment leads to high growth, while citing Korea's experience. However, there is ample evidence showing that investment responded positively to output growth in Korea.[42] Although an increase in savings is expected to result in higher growth, savings typically follows growth (Carroll and Weil, 1994). Although there is debate on whether growth precedes investment, few would dispute that growth preceded savings in Korea. Generally, anticipation of growth would increase investment that actually activates growth, leading to a rise in savings and higher investment. The high correlation between savings and investment in Figure 1 may imply that both are affected by a common third factor such as high

42) Distinguishing the business cycle from the long-term trend. Serven and Solimano (1993) also found that output leads investment in an accelerator-like fashion during the course of a business cycle. Furthermore, the real business cycle theorists have recently argued that capital accumulation is a consequence, not a cause, of the growth process.

growth and policy reactions or restrictions on capital flows.[43)]

These findings suggest that it is not easy to promote growth by boosting either investment or savings. Despite growth's crucial role as a determinant of savings, it is not yet easy to establish a virtuous cycle of growth, saving, and investment because investment does not necessarily lead to growth. Therefore, there are general limitations in starting off the self-reinforcing process toward higher growth.

Korea's experience never suggests that high investment sets in motion the growth process with high savings. It suggests the importance of coherent and sophisticated policies that can support high growth with high savings and investment.

4-3. External Financing and Debt

Although Korea's high growth was associated with high investment and savings, it still had to rely on foreign savings since domestic savings was below investment. Foreign financing was the key ingredient in Korea's high growth policy mix since investment could not be maintained at a high level without foreign savings. The external debt accumulated with the persistent current account deficit until 1985, but it began to decline leading to a huge current account surplus due mostly to the drastic appreciation of the yen.

Uzbekistan also relies on foreign loans to finance domestic investment. External debt stood at 4.6 billion US dollars or 58% of GNI in 2002. Although the external debt began to decrease as the current account went to a surplus, the external debt is too large compared to GDP. Interestingly, the banks in Uzbekistan rely on foreign loans while domestic savings is much higher than domestic investment. In particular, 56% of fixed investment was financed by enterprises and the general population. Foreign investment and credits account for 25% of total funding source. Also, bank credit and other loans finance only 2.6% of domestic fixed investment. However, Uzbekistan does not need to rely on foreign loans since the trade account has run a surplus in recent years and domestic savings is much higher than domestic investment.

Korea had a different experience in terms of foreign financing. It depended on foreign borrowings to fill the short fall between domestic investment and domestic saving. In 1961 before the take-off, Korea's external debt stood at only 83 million U.S. dollars, 4% of GNP. By 1982 when Korea made every effort to overcome its external debt problem, it stood as the

43) Feldstein and Horioka (1980) interpreted the strong long-term correlation between savings and investment in industrial countries as evidence for international capital immobility. But Obstfeld (1986) argued that demographic and technological factors can move savings and investment in the same direction even if international capital are mobile. Taylor (1994) also stressed that the roles of relative prices and demographic factors.

world's fourth largest debtor country with external debt reaching 37 billion dollars, 54% of GNP. Over 75% of the increase occurred during 1966-69, when Korea was achieving double digit growth, and in the periods 1973-75 and 1979-82 during the oil shock.

In the very beginning most of the external financing was channeled through medium-term (one to three years) trade credit. After the First Five-Year plan, long-term (over three years) was launched, public and private loans began to increase rapidly, replacing trade credits. In the 1970s, the share of medium-term debt remained below 4% of total external debt, but short-term (less than one year) debt began to increase, replacing long-term debt. Short-term debt increased rapidly during the two oil shocks, implying that Korea had to mobilize short-term money and had difficulty securing long-term financing during those times.

In terms of debt distribution among the public sector, non-bank private sector, and banking sector, private debt began to exceed public debt in 1966. In the 1970s, private and public debt remained of comparable size. In the 1980s after the debt crises at developing countries, public loans exceeded private loans to a large extent and bank loans began to increase rapidly.[44)]

Interestingly, foreign direct investment remained insignificant in Korea's external financing. This may be explained by concerns about the Japan's dominance over Korea's industry once foreign direct investments were allowed. The external financing policy in regards to Japan was rooted in historical experience; in that Korea unlike other East Asian countries was once colonized by Japan. This was maintained even after the capital markets began to be opened in the 1990s. Foreign direct investment (FDI) was less than 10% and foreign portfolio investment (FPI) was more than 80% of capital inflows. In contrast, FDI constituted 50% and FPI only 24% of net capital flows in other East Asian countries in 1994.

Without foreign financing, Korea surely would not have been able to grow as rapidly and, more importantly, would not have been able to weather the two oil shocks. In particular, Korea experienced severe setbacks in 1980 due to hikes in oil prices and political uncertainty following the assassination of President Park who led the rapid development of the Korean economy. Surprisingly, Korea succeeded in borrowing extensively via public and bank loans and its economy avoided contraction.

How did Korea succeed in borrowing abroad during such times of crisis in the early 1980s when Latin American countries suffered severe crises? Korea's debt/export and debt/GNP ratio were comparable to those of debt crisis hit countries. In hindsight, it can be said that the successes of high investment and high growth policies gave countries leeway to borrow heavily. Some clues were provided in the previous discussion. The high investment did bring about a rapid rise in domestic savings, although domestic savings varied by a wider margin. Foreigners

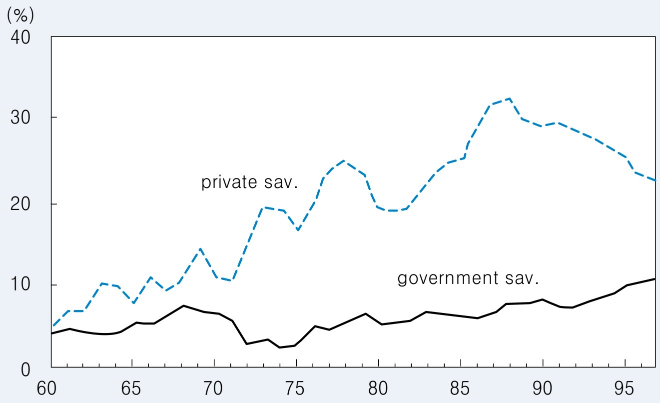
44) Borrowing by Korean enterprises with branches abroad was not included in total debt. It increased to be critical enough before the financial crisis in 1997, causing the Bank of Korea to accumulate new external debt including borrowings by overseas branches of Korean banks and businesses.

still had confidence in the Korean economy, which was sustaining high growth and high savings. And foreign savings was obtained on grounds of well-designed and government-guaranteed investment plan.[45] These empirical findings go along with the explanations given above that Korea took on foreign borrowings to fill the short fall between domestic investment and domestic savings. In other words, external financing was the residual. While Korea depended on foreign savings to finance the current account before the opening of the capital markets, Korea's situation was different in the 1980s, especially in the latter half of the 1990s. The capital flows affected domestic savings, and thereby, the current account as the capital markets opened.

4-4. National Saving Policy

Korea's savings ratio was barely over 10% in the early 1960s, but rapidly rose thereafter to peak at 40% in 1988, while the savings ratio stagnated in Latin America and even declined in Sub-Saharan Africa during the same period. This dramatic increase in the savings ratio aroused attention of other developing countries, which were attempting to follow Korea's development pattern. Moderate inflation and a convenient and secure banking system are essential for achieving savings. Many studies have been done on the savings behavior in developing countries including Korea. These studies concluded that growth and demographics are important determinants of savings. For instance, Masson, Bayoumi, and Samiei (1998) examined determinants of private savings using pooled data for a large sample of industrial and developing countries and found that demographics and growth are important determinants of private savings. They also found that increases in per capita GDP raise savings at low income

<Figure 3-2> Private and Public Savings in Korea



45) For instance, Balassa and Williamson (1991) and Cooper (1994) argue that Korea had no effective constraints on external borrowing.

levels but decrease it at higher income levels. In addition, the studies found that interest rates and terms of trade have positive, but less robust effects. And that private savings is partially offset by changes in public savings and (for developing countries) foreign savings. Studies on Korea’s savings behavior showed similar results, which suggest that important role of growth, income, demographic factors such as dependency ratio, and public saving.

The decomposition of national savings provides further insights to national savings policy. Figure 3-2 shows the private and public savings ratio. Due to a policy of achieving macroeconomic stability, the government saving ratios maintained an upward trend, even with a temporary decline in the first half of 1970s. The government savings ratio increased with a rise in private savings ratio up to 1988, after which the government savings ratio continued to rise but private savings ratio started to decline. The decline in private savings beginning in 1988 stemmed from a slowdown in growth and demographic changes. The negative relationship between private and government savings is also expected under the Ricardian equivalence principle or forward-looking consumer behavior. Most studies on Korean and international savings behavior over the past decades mentioned above suggest that a partial offset of public savings on private savings.

<Figure 3-3> Decomposition of Private Savings

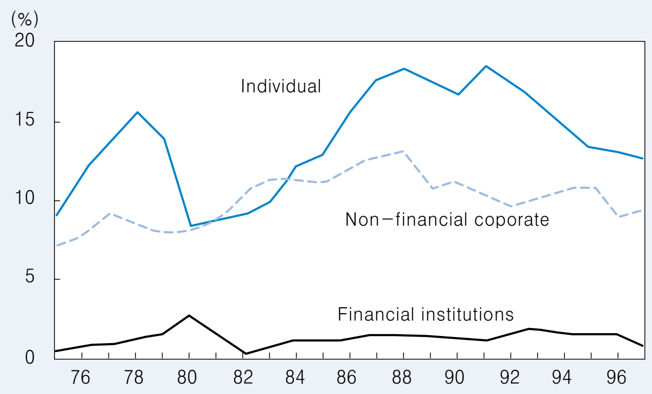


Figure 3-3 decomposes private savings by individuals, non-financial corporate enterprises, and financial institutions. Although individual savings changed in the same direction as with non-financial corporate savings, the latter was relatively stable compared to the former. Savings by financial institutions were even more stable than non-financial corporate savings. When financial market imperfections hinder firms from borrowing, corporate investment tends to be financed by corporate savings. In this regard, high and stable corporate savings is one of the channels that work to sustain high investment.

In sum, Korea's national savings policy centered on achieving high investment cum high growth policy and demographic policy such as fertility control. Macroeconomic stability based on sound monetary and fiscal policy is another ingredient of successful saving policies, as higher public savings and lower inflation lead to higher national savings. Maintaining the trust of savers in financial institutions with through governmental protection and regulation also promotes savings and facilitates financial intermediation. If financial markets are not working well amid capital market imperfections, a policy of maintaining high and stable corporate savings are also crucial for achieving high investment.

The World Bank study on the East Asian miracle (1993) points out various factors for the high savings; financial and tax incentives, creating postal savings and pension plans, forced savings, restrictions on consumer credit, and etc. Such policies can certainly increase domestic savings, but not significantly since the direct effect of each proposed policy can be offset by secondary and indirect effects.

5. Financial Policies for Development

The previous section examined key variables of savings, investment, and external debt in order to better understand the financing of economic development. It stressed that the consistent and credible policies can ensure virtuous cycles among savings, investment, and growth. Savings are channeled into investment through financial intermediation; therefore, developing a financial system is very important for the efficient mobilization and deployment of resources.

5-1. Banking Sector: Uzbekistan vs. Korea

The Uzbekistan banking sector underwent reform and liberalization. 11 banks were privatized and further privatization is in progress. The commercial banks consisted of 3 state banks, 11 private banks, 5 banks with the participation of the foreign capital, and 13 joint stock banks, as of January 1, 2005. The government plans to reduce their direct participation in the authorization of capital for commercial banks. In contrast, Korea's had only five nation-wide private banks, which later became state-owned banks with the implementation of the economic development program in 1961. The privatization of commercial banks was delayed until the early 1980s.

Although all of the five commercial banks were state-owned in the early 1960s in Korea, there was fierce competition among the banks to attract deposits because the government evaluated the management on the basis of deposits outstanding. In Uzbekistan, banks suffer from severe cash restrictions and are responsible for uncharacteristic functions such as tax collection, recording and controlling of accounts, controlling of cash administration by economic agents, etc. However, Korean banks were not given responsibility of such duties.

In addition, while Uzbekistan adopted a universal banking system, Korea adopted a specialized banking system. Thus, many banks that specialized in agricultural loans, SME loans, consumer loans, housing loans and foreign exchange services were established in the 1960s in Korea. Bond and equity markets played a minor role in Korea's economic take-off. Financial markets began to develop in the 1970s with the establishment of investment companies and activation of the corporate bond market and measures for public offering by corporations.

The development of a financial system reflects economic circumstances and historical background surrounding of a country. Therefore, the banking system of transitional economies could be different from that of Korea. Uzbekistan has many small banks, but Korea had a few large banks in the beginning of its economic take-off. No matter what the institutional differences between the two countries are, financial intermediation was more activated in Korea in the early 1960s when export-oriented development was launched, compared to Uzbekistan's present situation.

In Uzbekistan, 70% of the banks' loan portfolio is state-guaranteed foreign loans; therefore, the banking system was not mobilizing domestic financial resources through private savings. Household deposits at banks remained below 2% of GDP, because the banking sector did not provide incentives for households to make deposits since they were prevented from depositing at banks by cash plans and taxes on bank accounts. In Korea, deposits and loans accounted for about 75% and 60%, respectively, of total assets of commercial banks in the 1960s. The government began to promote foreign loans with the Foreign Capital Inducement Law, as well as, streamlined relevant programs and institutions in 1960.

Comparing the financial intermediation situation in Uzbekistan during the recent years and in Korea during the early 1960s strongly suggests that Uzbekistan's banking system should undergo very significant structural adjustments in the area of intermediate financial resources between the surplus and deficit units. With institutional support in the form of credit lines given by international financial institutions, commercial banks have begun to build up private sector loans, which were being granted based on strictly commercial criteria since 2002 (EBRD, 2003). As the banking sector intermediates only a small portion of domestic savings, a curb market would develop in Uzbekistan as it did in Korea during the 1960s and 1970s.

5-2. Monetary, Exchange Rate, and Financial Policies in Korea

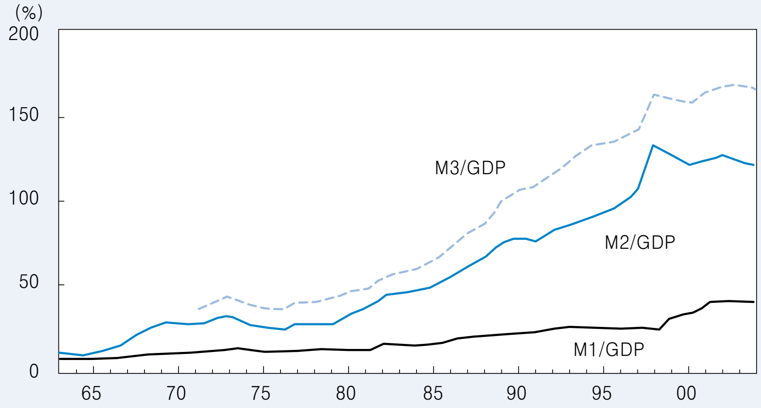
Although Korea's financial market was more developed and more market-based in the initial stage of its economic development than Uzbekistan's financial market is now, it is well known that the Korean government intervened pervasively in the credit market to encourage investment as much as the Uzbekistan government has. Korea succeeded in deepening its financial market, starting from the banking sector and spreading into the non-banking sector and equity and bond markets, before deregulating financial markets during the early 1980s. Figure 4 shows Korea's financial deepening by the monetization ratio. The ratio of the broad money (M2) to GDP was only 10% of GDP in 1960, but it reached 121% in 2004. The ratio of total liquidity (M3) to GDP showed a similar trend.[46)]

The government regulated financial markets by amending the Bank of Korea Act and the Banking Act in 1962. The Monetary Board became subject to the influence of the Ministry of Finance and the government retook ownership of the five commercial banks. The specialized banks for agricultural loans, SMEs loans, consumer loans, housing loans, and foreign exchange services were established in the 1960s. The entry barriers to foreign banks were lifted in 1967. The monetization ratio declined in the early 1960s, as the authorities re-tightened the money supply to control inflation (Figure3-5). The deposit and lending rates were held below the

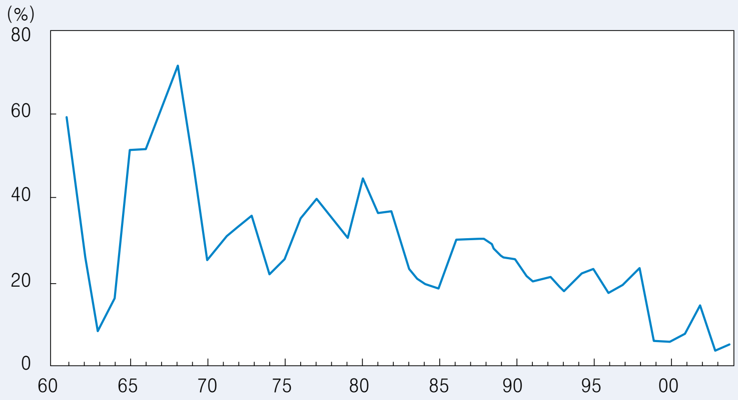
46) M2 includes monetary liabilities issued by all Depositary Corporations and M3 includes monetary liabilities issued by the Korea Securities Finance Corporation and Life Insurance Companies as well as Depositary Corporations.

market clearing rates so that real interest rates became negative. With negative real interest rates, deposit withdrawals from the banks increase, and the money found its way into informal markets. Thus, financial markets were repressed in the early 1960s.

<Figure 3-4> Korea's Financial Deepening

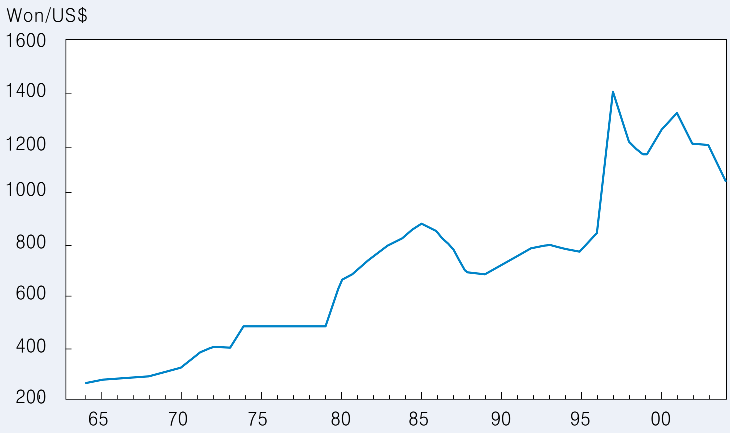


<Figure 3-5> M2 Growth



Several views on the financial repression were provided. Professor Gustav Ranis argued that financial repression was appropriate to implement import substitution strategies in early stage of development. Professor Arthur Bloomfield who drafted the original Bank of Korea Act argued that the financial repression and heavy reliance on foreign savings were inevitable because the per capita income was so low as to hinder domestic saving. In contrast, Professor Gurley and Professor Shaw argued that the financial repression was brought about because policy makers seldom had trust in market mechanisms and did not recognize fully the importance of price stability. In May 1965, the financial reforms were implemented to overcome the adverse situation of financial repression, following the advices of Gurley and Shaw. The interest rate on one-year time deposits jumped from 15% per annum to 26.4 % per annum to attract private savings into the banking sector from the informal money market operated at the market interest rates. However, loan rates cannot be raised for fear of a slowdown in investment. Depreciation of the domestic currency is shown in Figure 3-6.

<Figure 3-6> Exchange Rate (Basic Rate)

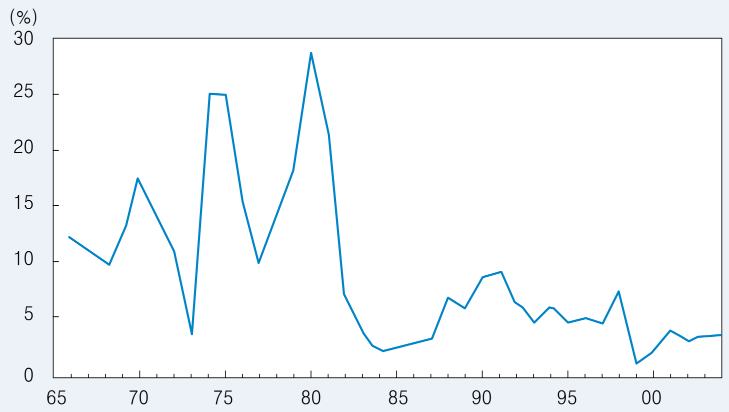


The upward adjustment of interest rates brought about a rapid increase in bank deposits; consequently, annual M2 growth exceeded 50% in 1965 and reached 72% in 1968. The M2/GDP ratio tripled during 1964-1968, while the M1/GDP ratio rose 50% during the same period.[47] The sharp rise in both the deposit rates and monetary growth raised concerns of lower investment and higher inflation. Indeed, the CPI inflation increased from 1969, as shown in Figure 3-7. As deposit rates were higher than loan rates, banks suffered. As such, deposit interest rates have been adjusted downward several times since 1968.

The government intervention in credit allocation can be justified by market failures. Under asymmetric information, banks cannot allocate loans to the highest bidders, but rather to those most likely to repay the loan. In this situation, financial restraints and credit allocation can work to reduce default rates and increases social returns to lending (Stiglitz and Uy, 1996). The World Bank study (1993) on the “East Asian Miracle” described Korea’s intervention in the credit market as a success story. The government influenced credit allocation by enforcing

47) M1 = Currency in circulation + demand deposits & savings deposits with transferability.

<Figure 3-7> CPI Inflation



regulations that would improve private banks' project selection, creating long-term credit development banks, and directing credit to specific sectors. Korea has imposed several regulations to strengthen the solvency of financial institutions.

In the 1970s, the focus of financial policies shifted to the development of non-bank financial institutions. Investment and financial companies, mutual savings and finance companies, credit unions and mutual credits, and merchant banking corporations began operating in the first half of the 1970s. Several measures to develop the stock market such as inducement of public listing and practice of sound management by enterprises, and ownership concentration between bank credit and business, were implemented. Figure 4, however, shows that financial markets were not deepened in the 1970s. This could be explained by high inflation related to the two oil shocks along with high M2 growth. In other words, increased financial intermediation in non-banking financial market was associated with high inflation. Despite severe imbalances in the current account, the exchange rate was fixed during 1974-1979 to help reduce import costs and servicing burden of external debt.

Financial market was also repressed due to the heavy and chemical industrialization policies that required subsidizing financing. Table 3-12 shows the policy loan defined as all of financial loans, fiscal funds, and foreign borrowings provided on a subsidized and concessionary basis with respect to the availability of funds and lending terms of interest rates, maturities, guarantees, and etc. Policy loans from fiscal sources account for 10% of the total, hence, policy loans from financial institutions played greater role. Both the growth and the share of policy loans increased in the latter half of the 1970s.

<Table 3-12> Policy Loan Trends

	1962-66	1967-71	1972-76	1977-81	1982-86
Growth of total loans [1] (Annual average, %)	24.26	49.66	32.21	36.66	22.75
Growth of policy loans [2] (Annual average, %)	16.04	41.60	32.93	38.83	17.25
Policy loans/total loans(%)	65.19	44.14	53.74	57.13	55.83

Note: 1) Loans from deposit banks and development institutions
2) Includes loans from development institutions, fiscal funds, National?Investment Funds, and policy loans from financial institutions.
Source: Bank of Korea report, and Lee (1994).

The government's intervention in the credit market, however, has not come without cost. Toward the end of the 1970s, it produced severe distortions in the allocation of resources and brought about internal and external imbalances in the economy. If the government holds real interest rates on loans and deposits too low for too long, then there can be over investment and financial savings can be discouraged. To correct over-investment and other distortions, a new set of policies centered on market mechanisms through financial liberalization was implemented.

Financial deregulation commenced with the removal of various restrictions on bank management and the privatization of commercial banks in the early 1980s. The monetary and exchange rate policies were also enhanced. Although the government continued to set ceilings on bank loans and deposits, it decided to switch from direct credit controls to indirect ones. As the exchange rate system changed from a dollar-peg to a basket-peg system in 1980, the won/dollar exchange rate was adjusted upward and given more flexibility. A series of measures deregulating interest rates and loosening controls on international capital flows were implemented. This led to sharp declines in money growth rates and inflation. During 1980-85, M2 growth declined from 45% to 18% per year and the inflation rate of consumer prices declined from 29% to 2% per year.

The favorable external conditions during 1986-88, so called 'three lows' (low oil price, low dollar, low international interest rates), led to an increase again in money growth and inflation. M2 growth rose to 30% per year as the current account recorded a surplus. However, monetary expansion did not directly add to inflation, as the won currency appreciated with the current account surplus. The exchange rate system was switched to a more flexible Market Average Exchange Rate System in 1990. Annual inflation rose gradually until it peaked at 9% in 1991. Both money growth and inflation slowed down in the 1990s. Owing to these developments in financial policies, financial markets have deepened significantly since 1980 and continued until the financial crisis in 1997.

6. The Market-Friendly Approach to Industrialization

The previous section focused on the role of the government and the market in mobilizing financial resources through the banking sector. The financial market should be developed to facilitate financial intermediation through reform and liberalization in Uzbekistan. However, the government's interventions as in Korea are justified when the market is not functioning well or market failures exist. The Korean government intervened in the credit market to some extent. However, the World Bank's research on the growth of East Asian countries concluded that East Asia's high growth "was primarily due to the application of a set of common, market-friendly economic policies, leading to both higher accumulation and better allocation of resources" (World Bank, 1993, Forward).[48)]

In a market-friendly approach, the appropriate role of the government in trying to achieve rapid growth is to ensure adequate investment in human capital, competitive climate for private enterprises, an economy open to international trade, and economic stability. This market-friendly view of "getting fundamentals right" challenged the revisionist view of "getting prices wrong" that emphasized government intervention in the allocation of resources (Amsden, 1989; Wade, 1990). There is enough controversy on whether Korea really followed a market-friendly approach or not. Korea is described as one of the "developmental states" in which powerful bureaucracies intervened in the market. But it is possible for an authoritarian state to empower elite technocrats and key leaders of the private sector, to build a business-friendly environment, and maintain competitive principle among firms. Regardless of Korea's real policy directions, there seems to be a consensus that the policies should be market-friendly. Many international financial institutions such as the IMF, World Bank, and EBRD recommended a market-friendly approach for Uzbekistan's development.

6-1. Structural Reforms

The countries transitioning to a market economy from a centralized planning one were recommended to aggressively implement structural reforms. Many studies on the growth of transition economies concluded that structural reforms and competitive pressure mattered most for the investment climate and growth (Loukoianova and Unigovskaya, 2004; Bastos and Nasir, 2004).

48) While the World Bank (2003) holds the market-friendly view for Korea's high growth, some economist such as Young (1994) and Krugman (1994) challenged this view. They took the initiative by contending that East Asian miracle was a myth because high growth was explained by capital accumulation rather than total factor productivity growth (TFPG). At the same time, many economists investigated the empirical evidence on the sources of growth by regressing the neoclassical growth equations and found ample evidence on the sources of East Asian high growth.

The neoclassical approach of "getting prices right" emphasizes the principles of protection of property rights, market-based competition, appropriate incentives, sound money and etc. The reform program suggested for Uzbekistan by the World Bank, EBRD, and so on adheres to the market-friendly approach of "getting fundamentals right." They recommended the following reform agenda: liberalization of the foreign exchange regime, removal of foreign trade barriers, price flexibility, banking sector reform, support of private investment and entrepreneurship, transparency and etc.

Considering that Uzbekistan is in the process of transitioning from a centralized planning economy to a market economy, such recommendations as listed in the above should be well taken. But their actual implementation may differ depending on their respective political and economic situations. The first-order of economic principles of the market economy should be developed into high-order principles of economic management. In that regard, the following Korean experiences may be a good reference, since Korea had its own experiences on the growth and markets.

6-2. Korean Experiences on Growth and Market in the 1960s and 1970s

The external and internal economic conditions that confronted the Korean economy have changed so frequently that the political economy considerations of the policy makers produced policy settings which sometimes acted contrary to the directions in which the market reacted. The labor and capital markets were directly influenced by the growth policies, whether they were interventionist or market-conforming. Firms and households behaved differently according to changing prices, as shown by the saving and investment behavior. The dynamics between policies and markets is the focus of the study.

In the early 1960s, the military government pursued efficiency in economic management through the centralization of the political power and economic decision-making. It introduced the Five-Year Plan to realize the efficiency through centralization. With long-term planning the government could play the leading role in the market by investing in the social infrastructure and stimulating exports through export subsidy, devaluation, the export target system, and a negative system for imports. With centralization of power, interest groups and the legislature could not exert much influence on the government, as the operation of the government itself was controlled.

How did growth policies affect markets? Did the government intervene in markets so much as to mobilize resources inefficiently? If the Five-Year plan is just an indicative plan, then resources can be allocated according to the market mechanism that was not developed fully. Korea's Five-Year plans were not just indicative plans, but long-term plans to achieve growth targets through the centralized power that intervened in the market more often than not. However, market distortions were limited, compared with many other developing countries, and markets were allowed to operate (World Bank, 1993). Labor market was far from interventions that restricted labor mobility or suppressed the wage level, because it was in excess supply in the 1960s. In contrast, capital markets were in excess demand with the result that they have been frequently controlled. The government directed credit at preferential interest rates and managed exchange rates at an appreciated level, but interest rates and the won/dollar exchange rate were adjusted upward to reflect market conditions in May 1965 following the advice of Gurley and Shaw. But interest and exchange rates were readjusted downward from 1968, as inflation went up and growth slowed down.

The Korean economy was faced with several difficulties around 1970. The rapid growth during 1966-69 was followed by economic downturn, as it brought in rapid wage increase, high inflation and large current account deficit. Politically, the passage of a constitutional amendment in 1969 that removed the two-term limit on the presidency increased public disenchantment with Park’s rule in which economic development took priority to democratic development. Furthermore, the external environments turned very unfavorable. Nixon’s Guam doctrine in 1969 signaled the partial withdrawal of the U.S. army from Korea. Nixon’s switch from the Breton Woods system of fixed exchange rate system into the floating exchange rate system, the so called Nixon shock, was followed by protectionist trends in world trade.

Responding to unfavorable developments in external and internal situations, the government established the third five-year plan of 1972-76 that aimed at attaining developments of the rural sector, exports, and the heavy and chemical industries. Although the third plan stressed price stability and regional and sectoral balance in economic development, it turned out to be biased towards high growth with tightened controls on prices and interest rates. The Emergency Measures Regarding Economic Stability and Growth of August 3, 1972 replaced all existing corporate debts with unofficial lenders with new arrangements favorable to the borrowers. In March 1973, a law that prohibited sales at greater than ceiling prices was passed and a 3% cap on price increases was imposed. In early 1973, the Heavy and Chemical Industry Plan was announced.

The Big Push model that originated from Rosenstein-Rodan (1943) needs two conditions of scale economies in production and an elastic supply of labor to the modern sector to yield external economies (Krugman, 1992). Korea’s Big Push had limitations, however, at least for two reasons. First, scale economies in the heavy and chemical industries could not be realized due to the lack of backward and forward industrial linkages and insufficient domestic and foreign demand, particularly with the Second Oil Shock and worldwide recession during 1980-81. Second, rapid wage growth was pronounced for skilled labor, indicating that Korea was not a labor surplus economy in the late 1970s. The heavy and chemical industrialization increased demand for skilled and educated labor whose supply was not elastic.

The general consensus was that the Big Push led to high growth despite two oil shocks in the 1970s, but with misallocation of resources and excess capacity in the heavy and chemical industries in microeconomic structure and high inflation, a rising current account deficit, and increasing external debt in macroeconomic structure. The fifth five-year plan (1982-86) took priority on the price stability since the policymakers at that time thought that growth would not be sustained without price stability.

6-3. Contest-Based Competition

One can learn from the Korean experiences on the growth and market that the government can play some role when markets are incomplete and missing, but the excessive interventions create distortions. The World Bank study on the East Asian growth (World Bank, 1993) introduces the concept of contest-based competition as the key factor for high growth. When markets are not functioning well in developing countries, the government can play the market's coordinating role by arranging institutional framework for cooperation and information exchange. In capital markets where the information asymmetry is the salient feature, capital is allocated by screening and evaluation process. When scale economies and externalities exist in investment, the government can intervene to yield substantial benefit. However, the cooperating role of the government may degenerate into the collusion between the government and the business. To avoid the deterioration of the cooperative behavior, the Northeast Asian economies combined cooperation with competition by developing institutional structures in which firms competed for economic prizes, such as access to credit. This is called the contest-based competition.

The well-known contests were export contests for the preferential loans. In this case exports became the performance criteria. A success in the export market is a good indicator of the competitiveness. However, many cases for the cooperation need the presence of a high-quality civil service to evaluate the performance of the project. Another example is the institution of the Office of Planning Coordination in early stage of development.

Organizing contest to combine the benefits of cooperation and competition is more complicated than relying in free market competition. The contest should satisfy three requirements for success: rewards, rules, and referees. World Bank (1993) stressed that "Rewards must be substantial enough to elicit broad participation and energetic competition. Rules must be clear-cut so that contestants know which behavior will be rewarded ? and which will be punished. Finally, competent, impartial referees are crucial." (p.94). The effective implementation of contests was possible in the Northeast Asia due to its unique institutional traits. The civil servants were competent, and less corrupted. Efforts were made to shield economic technocrats from the lobbying from politicians and interest groups. Furthermore, the government was so flexible as to abandon contests if the contests produced poor results and rely on the market mechanism if it developed.

7. Summarized Policy Suggestions

The Uzbekistan government implemented its industrialization and social development strategy through the control of product and factor prices. Accordingly, the domestic currency became overvalued. Interest rates were kept low despite high inflation. The prices of energy, raw materials, and agricultural products were maintained below market levels as a way to subsidize other sectors. The enterprises, private or public, were little exposed to market competition while operating under centralized production targets and a state distribution system characterized by extensive price regulations and soft budget constraints. These active interventions in the allocation of resources used to retard economic growth, but still the Uzbekistan economy improved during the past two years.

In 2004, the growth rate of real GDP increased sharply to 7.7%, from 4.4% in 2003. Rapid growth was achieved amid moderate inflation as a result of a tight monetary and fiscal policy. The savings ratio rose by a substantial margin, while investment was stagnant. As a result of the currency devaluation, the trade surplus expanded from 0.8 billion US dollars in 2003 to 1 billion US dollars in 2004.

The recent superb macroeconomic performance of higher growth, lower inflation, and larger trade surplus can be attributed to both favorable external conditions and sound macroeconomic management. However, changing external and internal conditions may dampen the macroeconomic outlook. In that, growth may slow down, as exports slow down. In recognition of the possible slowdown in growth, the Uzbekistan government made every effort to stimulate investment, develop the industrial structure, and increase production efficiency. The Uzbekistan government aims at developing the industrial structure by utilizing prevailing raw materials to produce products with high value added. In doing so, priority sectors based rich resources would be fostered, while focusing on market reform. According to the long-term industrial development plan, the industrial share in GDP will increase strikingly to 30% in 2010, which is close to the level of newly industrialized countries.

7-1.Targeting growth

In order to achieve high investment and high growth, we suggest the establishment of a very comprehensive and coherent plan like the Korea's Five-Year Plan. The Five-Year Plan played a key role in Korea's development. It contained the macroeconomic projections based on the target level of growth and required capital formation and financing plan. Emphasis was placed on predicting domestic savings, the current account, and external financing. To make the plan credible and facilitate external financing, the Economic Planning Board complemented the macroeconomic projections and the financing plan with a detailed set of policies. Thus, the plan itself acts as way to maintain consistency in government policies and make them more credible as well as to set policy directions.

The Five-Year Plan brought balance and coherence among various sectors. It was completely different from the socialist model of the central planning in which resources are distributed by the government at controlled prices. At the initial stage of economic development, market mechanisms were not developed. In this situation, the government intervened in the market more often than not. Even so, market distortions were limited, compared with many other developing countries, and markets were allowed to operate (World Bank, 1993). The labor market was far from interventions as labor mobility was restricted orwages were suppressed, because it experienced excess supply in the 1960s. In contrast, capital markets experienced excess demand since they were frequently controlled.

7-2. Investment Policy

The targeting of growth and investment presupposes the activist investment policy. Korean policy makers have used exchange rate, tax, and credit allocation policies to provide incentives to investment. Such an activist, sometimes interventionist, policy is justified when investment has the significant external effects or market failures hinder investment. A government's active investment in social infrastructure and human capital is the best example. In addition, uncertainty and irreversibility in investment decisions justify large investment incentives to compensate for the "value of waiting." It is well known that the East Asian high growth was based on its own growth model that was quite apart from the market-oriented standard ideal. The government played an important role in allocating resources. The business-government relationships were very close. The government controlled financial markets and owned most upstream industries. And international capital flows were regulated until the 1990s.

7-3. Virtuous Cycles among Saving, Investment, and Growth

The virtuous cycles among saving, investment, and growth are the key for high growth. Many believe that high investment leads to high growth, while citing Korea's experience. However, empirical analysis suggests that investment responded positively to output growth, and that growth preceded savings in Korea.

Korea's national savings policy was mainly the high investment cum high growth policy and demographic policy such as fertility control. Macroeconomic stability based on sound monetary and fiscal policy is another ingredient of a successful savings policy, as higher public savings and lower inflation lead to higher national savings. Policy of maintaining high and stable corporate savings is also crucial for high investment under capital market imperfections.

Though growth is the crucial determinant of achieving savings, it is not yet easy to establish a virtuous cycle of growth, saving, and investment because investment does not necessarily lead to growth. Therefore, there are general limitations in initiating the self-reinforcing process toward higher growth. The Korea's experience does not suggest that high investment sets in motion the growth process along with high savings. It suggests the importance of coherent and sophisticated policies that can support high growth with high savings and investment.

7-4. Financial Policies

Developing a financial system is very important for the efficient mobilization and usage of resources. The banking system in Uzbekistan is different from that in Korea. Uzbekistan has many small banks, while Korea had a few large banks in the beginning of its economic take-off. While Uzbekistan adopted a universal banking system, Korea followed a specialized banking system. Thus, many banks that were specialized in agricultural loans, SME loans, consumer loans, housing loans and foreign exchange services were created in the 1960s in Korea.

No matter what the institutional differences between the two countries are, financial intermediation was more developed in Korea in the early 1960s when export-oriented development was launched, compared to the financial intermediation nowadays in Uzbekistan. In Uzbekistan, 70% of the banks' loan portfolio was state-guaranteed foreign loans; therefore, the banking system was not mobilizing domestic financial resources through private savings. Household deposits at the banks remained below 2% of GDP, because the banking sector did not provide incentives for households to make deposits but rather disincentives households from depositing at the bank by enforcing cash plans and taxes on bank accounts. In Korea, deposits and loans accounted for about 75% and 60% of total assets of commercial banks. The government began promoting foreign loans after the Foreign Capital Inducement Law was amended. The government also streamlined relevant programs and institutions in 1960. The comparison of the financial intermediation between present day Uzbekistan and Korea in the early 1960s strongly suggests that the banking system should undergo very significant structural adjustments in the area of intermediate financial resources between the surplus and deficit units.

It is well known that the Korean government intervened pervasively in the credit market to encourage investment. Korea held deposit and lending rates below the market clearing rates so that real interest rates would be negative. The financial repression associated with negative real interest rates can increase financial risks, as demand for credit expands too much. However, it can be justified under market failures. Under asymmetric information banks cannot allocate loans to the highest bidders, but rather to those most likely to repay the loan. In this situation, financial restraints and credit allocation reduce the default rate and increase social returns to lending. Nonetheless, if the government holds real interest rates on loans and deposits too low for too long, then this could lead to over investment and discourage financial savings.

7-5. Wisdom of the Market-Friendly Approach

Uzbekistan is in the process of transitioning from a centralized planning system to a market economy. Uzbekistan's condition is very different from that of Korea during the early 1960s. These differences in the initial conditions should be seriously considered in offering possible policy lessons from Korea's experience of high growth. At the initial stage of Korea's development, the market was not developed and not functioning well. However, the World Bank assessed that Korea's growth was market-friendly. In the market-friendly approach, the appropriate role of the government for achieving rapid growth is to ensure the following: adequate investments in human capital, competitive climate for private enterprises, open economy to international trade, and economic stability.

Many studies on the growth of transition economies concluded that structural reforms and competitive pressure mattered most for the investment climate and growth. The neoclassical approach of "getting prices right" emphasizes the principles of property rights protection, market-based competition, appropriate incentives, sound money and etc. The reform program suggested for Uzbekistan by the World Bank, EBRD, and so on adheres to the market-friendly approach of "getting fundamentals right." They recommended the following reform agenda: liberalization of the foreign exchange regime, removal of foreign trade barriers, price flexibility, banking sector reform, support of private investment and entrepreneurship, transparency and etc.

Considering that Uzbekistan is in the process of transitioning from a centralized planning system to a market economy, such recommendations as listed in the above should be well taken. But their actual implementation may differ according to their political and economic situations. The first-order of economic principles of the market economy should be developed into high-order principles of economic management. In that regard, Korea's experiences may be a good reference. Korea had its own experiences on the growth and markets.

One can learn from Korea's experiences in terms of the government's role in growth and the market, especially when markets are incomplete and missing. When markets are not functioning well in developing countries, the government can play the market's coordinating role by arranging institutional framework for cooperation and information exchange. In capital markets where information asymmetry is the salient feature, capital is allocated through the process of screening and evaluation. When scale of economies and externalities exist in investment, the government can intervene to yield substantial benefits. However, the cooperating role of the government may degenerate into collusion between the government and business. To avoid the deterioration of the cooperative behavior, the Northeast Asian economies combined cooperation with competition by developing institutional structures in which firms competed for economic prizes, such as access to credit. This is called the contest-based competition.

Organizing contest to combine the benefits of cooperation and competition is more complicated than relying on free market competition. The contest should satisfy three requirements for success: rewards, rules, and referees. The effective implementation of contests was possible in the Northeast Asia due to its unique institutional traits. The civil servants were competent, and less corrupt. The economic technocrats were shielded from lobbying by politicians and interest groups. Furthermore, the government was flexible enough to be able to abandon contests if they produced poor results, as well as, being able to rely on the market mechanisms if it developed.

7-6. Lessons from Heavy and Chemical Industrialization in Korea

The industrialization of the heavy and chemical industries was pursued under special circumstances in the early 1970s. The rapid growth experienced by Korea during 1966-69 was followed by an economic downturn. This led to a rapid rise in wages, high inflation and a large current account deficit. Politically, the passage of a constitutional amendment in 1969 that removed the two-term limit on the presidency increased public disenchantment with Park's rule in which economic development took priority to democratic development. Furthermore, the external environments turned very unfavorable. Nixon's Guam doctrine in 1969 signaled the partial withdrawal of the U.S. army from Korea. Nixon's switch from the Bretton-Woods system of fixed exchange rate to a floating exchange rate, the so called Nixon shock, was followed by protectionist trends in world trade. Responding to unfavorable developments in external and internal environment, the government established the third five-year plan of 1972-76 that aimed at developing the rural sector, exports, and the heavy and chemical industries.

The Big Push needs two conditions - scale of economies in production and an elastic supply of labor - in the modern sector to yield external economies. Korea's Big Push had limitations, however, at least for two reasons. First, scale of economies in the heavy and chemical industries could not be realized due to the lack of backward and forward industrial linkages and insufficient domestic and foreign demand, particularly with the Second Oil Shock and worldwide recession during 1980-81. Second, rapid wage growth was pronounced for skilled labor, indicating that Korea was not a labor surplus economy in the late 1970s.

Although the government's initiative in key investment projects had merit, the achievements of heavy and chemical industrialization are really controversial because the Big Push resulted in high growth but brought about various distortions. Despite the merits of high investment policy, the government was not able to choose the 'right' industry and target the 'right' amount. Although exports continued to play a key role in enhancing investment efficiency, there seemed to be limits to the investment-induced growth due to socio-economic change and industrial sophistication. Due to the effects from the government's role in the allocation of resources, the main focus of the fifth plan (1982-86) shifted away from government intervention to market ?driven mechanisms including trade and financial liberalization.

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Chapter 4

Reform of Public Finance in Uzbekistan : Lessons from Korea

Chapter 4

Reform of Public Finance in Uzbekistan : Lessons from Korea

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1. Introduction

Korea is known for achieving rapid economic development. Accordingly, many researches exist examining the factors that made such growth possible. It is widely believed that Korea's development was government-led, outward-oriented, and unbalanced. If this is the case, then naturally we ask the following: What can we learn from Korea's experience? Have all the growth strategies been right? In other words, can any developing economy imitate Korea without any qualification?

Although Korea has been a true success, no country can achieve rapid growth by just following Korea's path for two reasons. First, each country's economic, social, and political environment may differ. Second, some of the strategies adopted by Korea would not be applicable. In addition, some strategies which were important factors of growth later became causes of problems. Therefore, much caution and discretion is needed when a country tries to emulate Korea's model of development.

With this in mind, we try to draw some policy suggestions for Uzbekistan by critically reviewing Korea's experience with particular emphasis on the fiscal system, or public finance. Public finance is the most important mechanism of ever countries' national activities. It consists of two parts — budget and taxation. The budget, which is the expenditure component of public financial activity, is not merely a document of the government's expenditure. It also reflects a nation's goals and objectives. By setting budget expenditure priorities, the government can affect resource allocation and alter the course of economic development. Taxation, which is the revenue side of public finance, also affects resource allocation and economic development. Taxes divert resources from private to public use.

As mentioned, the Korean government has played a central role in the country's economic development, although it has been the result of a number of other interacting economic, political, and social factors as well. Therefore, the Korean public financial system is naturally viewed to have contributed significantly in the course of development. There is, however, an opposite view as well. In other words, its contribution is not so big considering the fact that the size of the overall public sector has been relatively small.

It seems that Uzbekistan's fiscal system leaves much to be desired in spite of such merits as fiscal soundness, fairly well designed tax system, and so on. Although it is the assessment and evaluation by the international agencies such as IMF and World Bank, and not by the Uzbek authorities, we cannot but admit that it reflects the reality. Since we mainly focus on the role of public finance on growth, we do not have to analyze every aspect of it. However, we also could conclude that the current fiscal system should be ameliorated further in the area directly related with promoting growth.

This paper attempts to derive policy suggestions for the Uzbekistan government in the area of public finance, with emphasis on promoting economic growth. To do that, the paper examines Korea's public finance during its developmental period, while discussing its effect on Korea's economy and development. The paper focuses mainly on the time period beginning in the early 60's when development began to the early 80's when Korea's economy underwent a major structural shift. In addition, post-development policies adopted after those periods will also be discussed when necessary.

Following this chapter, the next chapter will detail and critically review Korea's public finance. In Chapter III, Uzbekistan's current system will be reviewed. In chapter IV, policy suggestions will be derived based on the analyses. And then the paper concludes.

2. Public Finance in Korea

2-1. Korea's Budget System

In this chapter, we focus on the contribution of the Korean budget system by analyzing two aspects of it —size and structure. In introducing the system, the scope of the budget, budgetary procedures and institutions will first be briefly explained.

A. Budgetary Institutions and Procedure

The budgetary procedure is divided into four stages: executive formulation and submission; National Assembly authorization; execution, and settlement of the budget. Each of these stages is interrelated and overlaps with each other.

The overall budgeting process including the formulation, execution, and settlement of the government budget had been under the jurisdiction of the Economic Planning Board (EPB), or as it is now referred to as the Ministry of Planning and Budget (MPB). The ministry's Budget Office carries out such functions as review of the budget proposal of each governmental agency, preparation of a comprehensive governmental budget proposal, and submission of the proposal to the National Assembly. The EPB was established to lead Korea's economic development in the early 60's, which gave its minister the status of deputy prime minister. The status of the head of the budget office was also elevated, as well. These two facts clearly show how much the Korean government recognized the importance of the budget system in the process of development.

Since the 1957 budget, Korea's fiscal year starts on January 1 and ends on December 31 (Initially, it was from October 1 to March 31). In principle, total expenditure in each fiscal year must be covered by total revenues of each fiscal year. With the exception of carried-over expenses and continued expenses, contracts and outlays from each fiscal year must be made within that year.

The National Assembly deliberates and decides on the national budget bill, and authorizes the closing of revenue and expenditure accounts submitted by the Board of Audit and Inspection. The budget is supposed to be passed by the National Assembly 30 days prior to the beginning of the next fiscal year. If the budget needs to be revised due to changes of circumstances after the budget has been made, then the government can prepare a revised supplementary budget and submit it to the National Assembly. The revised budget is subjected to the same procedure as the original budget[49].

49) The following procedure after the finalization of the budget is still valid: When the budget is finalized, the head of each central government agency submits to the minister of the EPB (MPB) a plan to implement the budget and a request for quarterly allocation of the budget covering revenues and expenditures, continued

The Board of Audit and Inspection, which reports directly to the President, functions as an independent constitutional agency. The Board supervises the closing of revenue and expenditure accounts and reports the results to the President and the National Assembly. The Board has been entrusted to issue orders to rectify improper spending or to punish any governmental personnel involved.

B. Scope of the Public Sector[50]

The public sector in Korea is comprised of the central government, local government, a wide variety of special accounts including public enterprises, and extra-budgetary funds.

The central government budget consists of three main instruments, the General Account, Special Accounts and Public Funds. The General Account, commonly referred to as “the budget,” is the basic account for major governmental expenditures such as foreign affairs, defense, law enforcement, education, welfare, and economic development. Revenue from all national taxes are directed to this account except for some earmarked taxes such as the rural development special tax and education tax.

Unlike the General Account, Special Accounts are established to fulfill specific objectives and have their own sources of revenue that are earmarked exclusively for those objectives. However, in cases where these accounts do not have sufficient revenue, funds are often transferred to them out of the General Account.

Following changes in economic conditions, many special accounts have been established and abolished. The number of special accounts increased to twenty nine in 1970 from only two in the first fiscal year of 1948. After 1970, it began to decrease, and currently there are twenty two special accounts including the Fiscal Financing Special Account, five Enterprise Special Accounts, and sixteen “Other” Special Accounts.

The Fiscal Financing Special Account is important because in principle, all government loans are made through this account. The five Enterprise Special Accounts are essentially organized along departmental lines such as railway, postal, government purchase, agency management, and grain management services. Some of the most conspicuous among the “Other” special accounts include accounts for road and transportation facilities, rural development, special tax management, energy and natural resources, environmental improvement, and two special accounts for transfers to local governments; one for regional development and another for

spendings, and authorizations for contracts incurring government debt.
On the basis of these requests, the minister of the EPB (MPB) prepares a quarterly budget allocation plan and presents it to the State Council together with the monthly funding program. This plan requires the approval of the President. The minister allocates funds to each central government agency in accordance with this plan and informs the Board of Audit and Inspection.

50) Since there has been only minor changes in the structure of the scope, the current structure will be explained.

primary and secondary education.

Public funds are established in order to allocate a certain amount of money needed to achieve specific government objectives, primarily through the operation of revolving loans. Currently, there are forty three public funds (in 2003). The activities of these funds are exempt from deliberation or approval by the National Assembly. However, the National Assembly does receive reports on the implementation plan for these funds. Nevertheless, the budget for public funds should be taken into account when analyzing the macroeconomic effects of governmental fiscal activity because these funds account for much of the overall deficit in the public sector[51)].

Korea's local government consists of nine provinces, six special cities with provincial status, and sub-level local administrative units such as cities (towns), counties, and districts. Korea's local governments had been under the direct control and supervision of the central government. But the election of governors and mayors in June 1995, they were given full autonomy. The local government's budget includes a general account, education special account, and local public enterprise special accounts covering such activities as water supply, hospital administration, and transportation.

C. Fiscal Policy

1) Trend of the Government Expenditure

As mentioned above, Korea's development was government led. In such cases, it is usually expected that the government sector as a share of GDP (or GNP) is either very big or keeps increasing. This is not the case in Korea. In actuality, the share has been around 20% and has not exceeded 25%. Let's look at this in more detail.

In the early 1950's, the share of the government sector in the economy was quite small — general government expenditures as a share of GNP averaged about 12% during the 1953-55 period (see <Table 4-1>). The very low share found during this period is largely attributable to an antiquated tax system, inefficient tax collection, heavy dependence on foreign aid, and negative government savings rate.

General government expenditure as a share of GNP peaked at 21.7% in 1962 due to an

51) In 90's, several major changes of the public funds were made. First, to improve the government grain management system, the government abolished the problematic Grain Management Fund in 1994. Second, the Public Money Management Fund (PMMF) was introduced in 1994. According to PMMF act, surplus financial resources from major pensions, public funds, and Savings Account at Postal Services are to be deposited into the PMMF for the purpose of absorbing the burden of policy loans and securing sufficient resources to spur economic growth without resorting to additionally increasing taxes.
From 1999 on, Korean government has tried to decrease the number of public funds because it has been pointed out that too many public funds will do harms on fiscal trnsparency, accountability, and efficiency. As a result, it is reduced to 51 in 2003 from 106 in 1994.

expansionary policy adopted by the newly established military government. A rapid expansion of government expenditures followed. This sudden shift toward a expansionary economic policy, however, brought on inflation, which in turn forced the government to drastically curtail the rate of growth of general government spending in 1963 and 1964.

By the end of the 1960s, however, the share of government in GNP rose sharply, accounting for an average of 19 % during the 1967-69 period. The system of tax administration was overhauled to improve tax collection, a global personal income tax scheme was introduced, reliance on foreign assistance was reduced, and the government savings rate increased considerably.

The ratio of general government expenditure to GNP, which remained relatively low at about 16-18% throughout the 1970s, gradually recovered to the 20% level during the 1990's and currently stands at around 22%.

<Table 4-1> General Government Expenditure as Percentage of GNP

Year	Percent	Year	Percent
1953	9.3	1975	17.6
1954	13.0	1980	19.7
1955	12.4	1985	20.7
1960	19.8	1990	21.9
1965	14.5	1995	25.4
1970	18.3		

As is shown, government sector as a share of GNP has been small with a high of 22-23%. Comparing these figures with those of U.S. and Japan, as well as high spending countries like Germany and Nordic countries, one could easily see that the share is indeed small in Korea.

The reason behind this seemingly unexpected result, especially since Korea has to spend so much on defense, is rather simple. The Korean government curbed expenditure in certain areas such as social welfare. Furthermore, the government offered too many tax incentives, which reduces the size of government expenditure, instead of offering subsidies. This measure was used heavily by the government to promote growth and not to make the size of the government seem smaller than it actually was, though it can not be denied that it has helped reduce the size of the government.

If only the size and share of a government is considered, then the likely conclusion would be that fiscal policy did not contribute much to in Korea's rapid growth. However, there is much reservation on this argument. It should also be noted that the low excess burden caused by the low tax burden ratio and contribution from tax incentives for growth did exist. Thus, it must be concluded that the role of fiscal policy may have been modest but not small.

2) Fiscal Balance

Along with size, fiscal balance is an important characteristic of a country's balance. It is particularly important because it can be a barometer of a country's macroeconomic policy. Generally, a deficit is more expansionary than a balanced increase in expenditure.

The Korean government has maintained strict fiscal discipline for more than four decades. All line ministries are expected to spend within the limits set by the National Assembly through the appropriation process. All government borrowings are supposed to receive prior approval from the National Assembly. This strict and rigid budgeting approach has led to a very sound fiscal balance as long as the government's general account is concerned (see < Table 4-2>).

<Table 4-2> Korea's Fiscal Balance

(Unit: 100 Million Won)

Year	General Account		Consolidated Budget		GDP[2]
		% of GDP		% of GDP	GDP[2]
1972	239	0.6%	-1,925	-4.6%	42,119
1975	882	0.9%	-4,661	-4.5%	102,955
1980	3,192	0.8%	-11,737	-3.1%	381,484
1985	-472	-0.1%	-7,133	-0.9%	820,621
1990	2,126	0.1%	-15,782	-0.9%	1,787,968
1995	11,119	0.3%	12,415	0.3%	3,773,498
2000	5,138	0.1%	65,270	1.3%	5,219,592

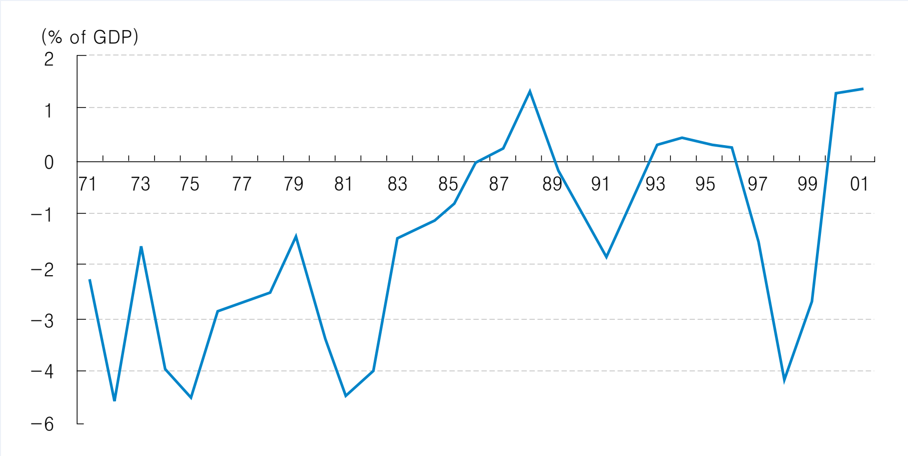
Note: 1) The figures for 1997 include foreign borrowings totaling 5 billion dollars from IBRD and ADB.

2) Figures are in current prices.

Source: National Statistical Office, Korean Statistical Information System, http://www.nso.go.kr
The Bank of Korea, Economic Statistics Yearbook

There is however a bit of difference when considering a consolidated central government budget. Since the 1970s and into the early 1980s, the consolidated central government persistently ran a budget deficit. On average, its share reached 3 % of GDP during this period (See Figure 4-1). Major factors behind the deficits included: high level of transfers to the agricultural sector, heavy investments in social infrastructure, and various subsidies to promote heavy and chemical industries.

<Figure 4-1> Budget Surplus/Deficit of the Consolidated Central Government



Source: Koh (2002)

A fundamental change in economic policy stance took place in the early 1980s. In reacting to the high-growth policies of the 1970s, new policy objectives with the aim of “Liberalization and Stabilization,” in the 1980s placed high priority on achieving equity, balance, and stability.

One important principle in fiscal management was established in this period. It was the principle of “Expenditure within Revenue,” or the balanced budget principle. While not formalized in a law or a regulation, it acted as a self-imposed discipline mechanism on the budget authorities against imprudent management of the budget. This principle kept public debt at a minimum level and indeed became the foundation for fiscal soundness the following years until the outbreak of the economic crisis.

With the economic crisis, all these things had to be changed abruptly. Huge expenditure needs occurred such as fiscal support to financial institutions, public assistance to the poor (almost doubled after the crisis), unemployment insurance payment (unemployment rate rose to 7% in 1998, which had been below 3% up until 1997.)

As a result, the consolidated budget, which remained more or less in balance before the crisis, went into a deficit in 1998, over 4% of GDP. The ratio of government debt to GDP rose from less than 10% in 1996 to 16% in 1998.

Beginning in 1999, the Korean government made consistent efforts to contain the growth in expenditure. Thanks to the dramatic rebound of the economy and the rapid growth in revenues, the budget recorded a surplus of 1.3% of GDP in 2000 and also in 2001 and 2002. It seems that fiscal soundness is back.

While strict fiscal discipline enabled the Korean government to maintain the size of government debt at a manageable level, and afforded the government some room to maneuver when the crisis hit, still there were some deficiencies. Koh (2002) first points out that the budget structure is extremely fragmented. In particular, there are many extra-budgetary (or off-budget) accounts that are not controlled by MPB and MOFE. Second, the budgeting and financial planning focuses mainly on the current fiscal year, and so lacks a medium- to long-term view. Third, information on expenditure outcomes does not usually appear in budget documents. Thereby, a more performance-based budgeting system is needed. Fourth, the cash-based accounting system makes it difficult to assess the true costs of fiscal activities and the financial health of the government. These must be considered for the reform in the future.

3) Structural Characteristics of Public Expenditures

Finally, the structure of the budget also characterizes a country's budget. In Korea, the allocation of limited public resources has been severely distorted by the extraordinary defense requirements. The defense budget accounted for about 25 to 30% of the central government's budget since the late 1950s. Since 1990, however, it has been gradually reduced to 16%. The remaining portion, about 15% or less of GNP , has been used to meet budgetary needs such as general administration, education, economic services, and social development. Rather consistently, about 15% of the general government budget has been allocated to general administration.

During the 1960's, the most serious obstacle to the country's development was shortage in social overhead capital. Accordingly, various public investment projects were implemented during this period.

In the 1970s, under the so-called heavy and chemical industry drive strategy, the government heavily supported certain industries such as steel, shipbuilding, machinery and electronics. "Economic development" thus took priority in spending limited public resources. In addition to these kinds of direct expenditure, many tax incentives were used. More detailed analysis on this aspect will be given in the next chapter.

A fundamental change in Korea's economic policy stance took place in the early 1980s. In reacting to the high-growth policies of the 1970s, new policy objectives in the 1980s placed high priority on achieving equity, balance, and stability. However, only minor structural changes can be observed in the government's expenditure pattern during this decade. One important reason for this was the tight budgetary policy that prevailed during 1982-86. Consequently, room for increasing social development was even more limited. Beginning from 1987, however, this trend showed signs of increasing.

However, in 1989 fiscal year (which was the first budget of the 6th republic), we can see a significant change in the functional spending structure. The share of the budget for defense was sizably reduced whereas the budget for social development was increased by as much as 5.5 percentage points. This dramatic increase in expenditure for social development came mainly from the construction of housing and community development projects. The shares of expenditure in health, social security and welfare were almost unchanged between 1988 and 1989. The pattern of change of the budget structure is summarized in <Table 4-3>.

<Table 4-3> Structure of Expenditures (Korea)

Year	General	Defense	Social[a]	Education	Economic	Others[b]	Total
1975	16.6	22.9	12.4	13.6	32.4	2.1	100.0
1980	12.9	25.4	13.8	14.8	28.8	4.3	100.0
1985	14.6	21.6	15.3	16.3	25.6	5.2	100.0

Notes: a) Social services include health, social security and welfare, housing and community development, and other community and social services.

b) Others include interest payments and emergency relief expenditures.

Heller and Diamond (1990) provide an important international comparison of budget structures. As somewhat expected, the results of the study imply that Korea's public expenditure structure by category of function is quite different from the international average. Due to a large part to Korea's defense burden and the budget's small size, non-defense public expenditures as social and economic development have been lower compared with the international average.

Using international cross-sectional data, Diamond and Heller carried out a regression on the share of expenditure by functions on various national attributes. By using each country's actual historical data in the estimated equations, each country's "normal" shares in each expenditure by category were calculated, which is shown in the <Table 4-4>. The index numbers in the table represent the ratio of Korea's actual shares to its estimated shares predicted by their estimated equations. Thus, an index number which is greater than 100 can be interpreted as an indication of Korea spending more on that category compared with the international norm.

According to this table, expenditures on national defense during all periods and public utilities during 1975-77 exceeded the world average by extremely wide margins. All other categories showed significant downward biases. Expenditure on education, particularly in the 1980s, was relatively close to the international average, but expenditure for other social development initiatives, as expected, was far below the international "norm". In particular, indices for health were observed to be extremely low, though show an increasing trend. Indices for social security and welfare were also very low.

One very surprising result of this analysis was that the Korean government's expenditure on economic development-related projects was very small compared to other countries in spite of its emphasis on industrialization. Expenditure on agriculture and other primary industries was relatively high, though the indices are far below one hundred. Also, the results for expenditure categories of economic development have been relatively stable over time with one exception. The results for public utilities dropped drastically in the 1980s. As was explained in the main text, these results are due to huge defense expenditures.

<Table 4-4> International Expenditure Comparison Indices

	1975-77	1978-80	1981-83	1984-86
General public services	59.6	59.3	70.5	69.8
Defense	143.6	161.5	176.6	161.7
Education	50.9	61.8	91.0	99.6
Health	11.3	13.6	19.4	31.3
Social security and welfare	28.3	29.9	38.1	29.3
Housing and community amenities	33.9	25.1	18.8	24.0
Agriculture, forestry, fishery	54.0	61.9	52.0	71.9
Mining, manufacturing, construction	31.6	44.5	54.4	41.5
Electricity, gas, water supply	182.7	52.5	17.5	23.5
Transportation and communication	46.9	33.3	38.7	40.9

2-2. Korea's Tax System

How can a tax system be "optimally" designed to raise revenue to finance necessary government expenditures? This question must be at the center of the economic policies in many countries. In developing economies, one more function is required — that is, taxes themselves must promote rapid economic growth. In other words, taxes should raise the appropriate amount of funds, and promote economic growth, presumably with tax incentives, while at the same time meeting the so called principles of taxation — efficiency, equity, and simplicity. In this chapter, Korea's tax system will be critically reviewed against these criteria. In the following we briefly review and describe Korea's tax system, and discuss topics such as the result of past tax reforms, direct measures used to contribute to the growth, tax incentives and tax administration.

A. Brief History of Tax Reforms and Tax Policy

1) Period from Independence to War Rehabilitation

Like many other countries in the world, the history of Korea's tax system conforms with that of capitalism. In this sense, the shape of Korea's tax system were already being formed in the late 19th century, which was further developed and at the same time distorted during Japanese colonization.

However, that system was far from "modern." The modernization of Korea's tax system first began in 1948, when the government was formed. In that year, the tax law committee was founded and eight fundamental tax acts were enacted. Some of the major acts include the Income Tax Act, Corporation Tax Act, and Liquor Tax Act. After that, ten additional tax acts, including the Inheritance Tax Act and Commodity Tax Act were enacted.

A number of changes in the tax system were needed due to the Korean War (1950-1953). These changes were aimed at trying to generate additional revenue required to finance the war. In this regard, the Land Tax Act and Temporary Tax Revenue Expansion Act were introduced in 1950, while a number of existing tax acts such as the Income Tax Act were revised. As the war continued, further reform of the tax system, especially with respect to collection, was carried out. To do so, the Special Measure for Taxation and Temporary and Land Income Tax Act were enacted in 1951. As a result, the land income tax replaced the general income tax as the main source of tax revenue.

With the armistice of 1953, emergency wartime tax measures were normalized, especially to meet the needs of economic reconstruction. These efforts were intinitiated by H.P. Wald's Report and Recommendation on Korea's Tax System, which was published in August, 1953.

Following the suggestions from Wald's report, the tax system was reformed. Subsequently, the Special Measure for Taxation and the Temporary Tax Revenue Expansion Act were abolished, while the textile tax was made part of the commodity tax and the license tax was transferred from the central government to the local governments. The income tax system was divided into scheduled taxes at flat rates and global taxes at progressive rates.

In order to increase tax revenue, the government introduced three new taxes in 1958: an education tax (levied as a surtax on personal income tax), an asset revaluation tax, and a foreign exchange tax. The last tax, which was introduced to absorb gains resulting from differences between the official and market exchange rates, was abolished in 1963.

The tax reforms initiated by the Democratic Party Government in 1960 generally reduced direct tax rates, while indirect tax rates were raised. In addition, tax exemptions and deductions designed to promote exports and capital accumulation were increased substantially.

2) Period of Take-Off and Liberalization

In 1961, right after the coup, the Military Government began to work on structural tax reforms and measures to improve the administration of taxes. The Temporary Measure for Tax Collection and the Special Measure for Tax Evasion Punishment were enacted in order to collect delinquent taxes. The government also revised the Income Tax Act, the Corporation Tax Act, and the Business Tax Act, as well as, established a new tax accounting system.

Then at the end of the same year, the government made general reforms on the tax system, placing emphasis in the following areas: elimination of irregularities in tax administration, establishment of long term foundation, modernization of tax system, and strong support for the First Five-Year Economic Development Plan. The basis of the reforms were simplifying tax administration, enhancing efficiency of revenue collection, promoting private savings and investment, establishing an equitable tax system, and cultivating local tax sources.

With this in mind, improvements were made in all of the major tax acts. Then the Adjustment Law for National and Local Tax and the National Tax Appellate Application Law were introduced in 1962. These tax reforms, which were implemented in 1961-62, established many features of the present Korean tax system. As a result of these reforms, there was a large increase in tax revenues.

In 1966, there was an important change in Korea's tax history. On March 3rd, the National Tax Administration (NTA) was established. Its main functions have been the assessment and the collection of internal taxes. The establishment of the NTA marked the beginning of Korea's modernization of its tax administration.

In 1967, further sweeping changes were made in the tax system. These reforms were an integral part of the government's effort to promote rapid economic growth through the Second Five-Year Economic Development Plan. Twelve of the nineteen existing tax laws were modified extensively and a new Real Estate Speculation Control Tax Law was instituted. The basis of these reforms was to promote further economic development and tax equity as well as, to rationalizing tax administration. The reforms also focused on establishing a more systematic approach to tax laws.

In 1974, the government undertook tax reform measures primarily to improve income distribution. Income redistribution was a particularly important policy issue, because the oil shock in 1973 affected low income groups most heavily. The major features of the reform were as follows: A full-scale global income tax system was introduced. Generous personal exemptions were also allowed to reduce the tax burden of low income earners. A new tax rate structure also lightened the tax burden of low income earner, but increased the burden on those in the high income brackets. Also, a new capital gains tax was also introduced to replace the Real Estate Speculation Control Tax which had been in effect since 1968.

In December, 1976, the government carried out a large scale tax reform and introduced a

Value Added Tax (VAT) and Special Excise Tax. Eighteen new tax laws were enacted or amended under the reform as well. This tax reform was mainly aimed at improving stable national life, meeting fiscal requirements for the Fourth Economic Development Plan, and modernizing the tax system. The objective of modernizing the tax system was accomplished through this reform.

The 1976 amendments to the internal tax laws generally went into effect in January, 1977, except for the Value Added Tax Law and the Special Excise Tax Law, which went into effect on July 1, 1977.

The traditional indirect tax system, which included a cascade type business tax, was replaced by one mainly consisting of a consumption-type VAT and a supplementary special excise tax. This was primarily to simplify the tax administration and to promote exports and capital investment. A single, a flexible rate of 10% was applied to all items subject to a VAT. This reflected the proposals put forth by J.C. Duignan, Dr. C.S. Shoup, and Professor A. A. Tait, who made significant contributions to the development of a new excise tax law based on a self-compliance system. Tax on entertainment and food, which had been a local tax item, was incorporated into the national tax system. The registration tax, which had been treated as a national tax, was converted as a local tax starting January 1, 1977.

3) Reform in the 80s

Unlike the 1960s and 1970s, there have been no major tax changes during the 1980s and up until 1987, excluding minor revisions to the tax laws. In this period, major changes were made in two areas — tax incentives and curbing of land price hikes. As new industries, firms, or individuals were being added to the list of beneficiaries coupled with the expansion of new types of incentives to the existing stock of incentive schemes complicated the tax system, inequities in tax burden among individuals and sectors emerged. Further, the influence of tax preference measures may have begun to be lessened. Accordingly, the Korean government began to remove the tax incentives by announcing as a guideline the principle of low tax-low exemptions, in 1982.

To curb land price hikes, two new taxes— the aggregate land tax (the global landholding tax) and the excessive land value tax— were introduced. In addition, non-tax measures were also implemented. An important aspect of the measures was the introduction of a new system of assessing land value, upward adjustment of the assessment ratio, establishment of introduction of a ceiling on the holding of residential land, and adoption of the system to retake development profits.

4) Reform in the 90s

In 1994 and 1995, there were major tax reforms in Korea. The 1994 tax reform was designed to establish an advanced tax system that introduced low tax rates and a broader tax base. By pursuing a lower-rate and broader-based policy mix in line with the tax reforms implemented in the U. S. in 1986, the Korean government planned to establish a tax system horizontally more equitable.

Among the many measures to achieve these goals, some of the most important include:

i) Income tax became more of a comprehensive income tax with the incorporation of interest and dividend income into the global income tax system (This has been applied since the beginning of 1996). Until 1995, interest and dividend income were assessed and withheld at a rate of 20%, separate from global income. The improvement in the income tax system was expected to enhance tax equity for taxpayers with income from different sources.

ii) A self-assessment system for individual income taxes was introduced and went into effect on income reported in 1996. This worked to further simplify the process of tax administration.

iii) Corporate tax rates were reduced to improve the international competitiveness of domestic industries. As a result, the corporate tax rate of firms with income greater than 100 million won per year were reduced to 30 % from 32 %.

Along the same line, the tax law amendment in 1995 also, lowered the tax burden and widened the tax base. For this, individual income tax brackets were adjusted (see table A1). At the same time, the corporate tax rate was further reduced by 2 % (see table A2).

C. Evaluation of Korea's Tax System

In this subsection, we evaluate Korea's tax system post tax reforms. Critically reviewing and evaluating the tax reforms serves as the basis for policy suggestions in the case of Uzbekistan.

1) Tax Revenue

As was pointed out, the major function of a tax system is to secure enough funds for expenditures. We would like to see whether Korea's tax system has served this purpose well. As a result of much effort by the government to raise revenue, the share of total (national and local) tax revenue as a percentage of GNP, or the tax burden ratio, increased from 6-7% in the mid-1950s to 20-21% in the 1990s, as can be seen in <Table 4-5>. Although it actually decreased after the economic crisis in 1997, it recovered to a level of 21-22 % in recent years. The overall tax burden as a percentage of GNP, however, is still considered to be low compared to that of other countries.

The increasing trend in the tax burden was not smooth until the mid-1960s. This was partly due to fluctuations in economic activity as well as to decreases in revenue from extensive tax incentives and major tax reforms that reduced the tax rate of personal and corporate income taxes. In addition to the increases in the level of exemptions in personal income taxes. For example, the fall in the tax burden ratio during 1963-65 was caused by economy's poor performance in the early 1960s.

This trend, however, stabilized after the establishment of the National Tax Administration

(NTA), currently the National Tax Service (NTS), except for a decrease during 1972-1973, which was believed to be the result of extensive tax reforms and the Emergency Decree on Economic Stabilization and Growth (the so-called “August 3rd Special Measure”) in 1972.

Indeed, the establishment of the National Tax Service was not only a turning point in the history of tax administration in Korea but it also enabled an increase in revenue. One interesting point is that the tax burden ratio increased even during a deep recession. Cooper (1994) argued that this may be due to the target revenue approach adopted by the NTS. In other words, if a decrease in tax revenues is expected due to a recession, then more stringent efforts would be made in collecting taxes.

<Table 4-5> Total Tax Revenue As a Percentage of GNP

(Unit: %)

Year		Year	
1955	6.2	1980	17.9
1960	10.3	1985	17.3
1961	9.7	1990	19.7
1964	7.1	1995	20.7
1965	8.6	2000	18.7
1966	10.7	2001	20.7
1970	14.3		
1975	15.3		

Source: National Bureau of Statistics, *Major Statistics of the Korean Economy*, 1998.
The Bank of Korea, *Economic Statistics Yearbook*, 2002

2) Impact on Growth: Overall effect

One of the major functions of fiscal policy is to stimulate economic growth. Particularly for less developed countries, it is believed that governments should provide tax incentives for savings, capital formation, and export promotion to achieve rapid economic growth. Indeed, in such growing economies as Korea, the above-mentioned tax incentives have been widely used. What interests us is whether Korea’s tax system, which used many of those incentives, contributed much to rapid economic growth.

There has been plenty of discussion about this, yet little rigorous analyses can be found. Among the existing research, Trella and Whalley (1991, 1992) are considered the most prominent. According to Trella and Whalley, tax reforms in Korea have “probably facilitated rather than fueled high growth." This conclusion is based on their findings that the rate of GDP growth in each phase in which major tax regime changes occurred has been consistently been high.

They concluded that Korea's tax system has played a relatively modest role, accounting for 3.0 to 4.2% of growth between 1962 and 1982, with only 3.6% between 1962 and 1972. This is equivalent to a 0.26 percentage point contribution to the growth rate over the period 1962-1982 (which is about half of the counterpart in the two sector model).

Thus, the contribution of tax to the growth rate is indeed "small!" This interpretation, however, is open to criticism. This interpretation is questioned by Krueger (1992). Krueger noted that an increase of half a percentage point in the growth rate would be a major achievement for many other countries. Moreover, the study does not consider the secondary effects of taxes, e.g. reducing the budget deficit and the rate of inflation. Therefore, Krueger argues that the isolated direct effect of taxes, excluding all of these indirect effects, cannot be but small. In other words, taxes "may" have had a substantial impact on Korea's growth contrary to Trella and Whalley's conclusion.

It would be very difficult, however, to analyze the tax's true contribution by capturing all of these effects. Admittedly, taxes are limited in a way as a tool for growth, since its primary function is really to provide funds for the public good. Taking this into account, it is more appropriate to see whether taxes contributed more to growth than other policy tools. To do so, we now look at tax incentives. Among the many tax incentives implemented in Korea the most important include the special depreciation, investment tax credit and tax free reserves. A tax holiday was extensively used until its abolition in 1981. In what follows, more detailed explanation of tax incentives will be given.

3) Equity

Suffice to say that equity is one of the most important factors in evaluating a tax system. However, Korea's tax system leaves much to be desired in terms of a more equitable system, both vertically and horizontally. Despite continuous efforts by the Korean government, there has been little improvement in making a more equitable system.

For this, Korea's tax structure needs to be examined. Consumption and income taxes comprise the major revenue sources of the central government while property related taxes are the main source for local governments. Since its introduction in Korea in 1977, the VAT has become a major source of revenue in Korea. Even today the VAT accounted for 25.9% of total national tax revenue in 2000, making it the largest single tax in Korea. Although the personal income tax accounted for the largest share in 1998, due to the recession after the crisis, the VAT became the largest share again in 1999. On the other hand, income tax and corporate tax accounted for 19.5% and 20% in 2000, respectively.

As can be seen in <Table 4-6>, which shows the structure of the national tax system, Korea was once heavily dependent on domestic indirect taxes on goods and services which accounted for 52.4% of the central government's total tax revenue in 1980, which was the highest. In 2000, however, its share substantially decreased to around 35%. On the other hand, taxes on income and profits accounted for only 24.3% of the total national tax revenue in 1975, which was the lowest, and then increased to 32.8% in 2000. The share of the central government's tax revenues on international transactions, all composed of customs duties on imports, has also gradually decreased to 5.4% in 2000 from 17.2% in 1980.

Taxes on wealth (property) at the national level in Korea, such as the inheritance and gift taxes, assets revaluation tax, and securities transaction tax, are hardly significant in terms of being sources of revenue. The revenue from the above taxes comprised only 3.9% of the central government's total tax revenue in 2000 (see <Table 4-6>). Although wealth taxes at the local level such as the acquisition tax, property tax, registration tax, city planning tax, fire service facilities tax and automobile tax are major fiscal resources for local governments, revenue from wealth taxes as a percentage of total tax revenues of both governments is considered to be low by international standards.

<Table 4-6> Structure of National Taxes

(Unit: %)

	As % of total national taxes										
	1970	1975	1980	1985	1990	1994	1995	1996	1997	1998	1999
Taxes on income, profit and capital gains	35.0	24.3	25.5	28.7	37.5	36.0	35.9	33.3	33.0	35.7	28.7
Social security contributions	0.8	1.0	1.2	1.7	5.1	8.8	8.7	10.3	10.2	13.4	13.6
Taxes on property	2.5	3.9	0.6	0.7	2.4	3.2	2.6	2.0	2.1	1.8	3.7
Taxes on goods and Services	46.5	51.1	52.4	49.0	38.4	38.5	37.0	38.0	37.6	34.7	38.3
Taxes on international transactions	13.8	14.4	17.2	16.2	13.0	6.7	7.4	7.3	7.3	4.9	5.3
Other taxes	1.3	5.5	3.0	3.8	3.6	6.8	8.4	9.1	10.0	9.5	10.1
Total	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0	100.0

Source: Ministry of Finance and Economy, Government Finance Statistics in Korea, 1980, 1991, 1995, 1997, 1999, 2000

These facts, i.e., the largest share captured by VAT (as well as consumption in general), relatively lower share by income and property taxes, explain one important characteristic of the structure of tax in Korea. In other words, the Korean government relies very heavily on indirect taxes. As seen in the second column of <Table 7>, more than 60% of total tax revenues, both at the national and local level, came from indirect taxes until the mid-1980s, though the share decreased to 48.7% in 2000.

What do these imply? These imply that Korea's tax system is still considered to be vertically inequitable because indirect taxes are (generally) more regressive than direct taxes. As a matter of fact, most researches studying the incidence of taxes showed that direct taxes are progressive while indirect taxes are slightly regressive.

There are several researches on the incidence of taxes in Korea. According to them, indirect taxes in Korea are generally regressive, except in the case of special excise taxes. These results conform with our expectation. For example, Heller (1981), Han (1982), Hyun and La (1993), and Sung (1999) all showed such results. For special excise taxes, however, the results are split. Most of the research showed that the special excise tax is regressive, although this tax was introduced to offset the regressivity of the VAT (cf. Hyun and La (1993))

There is not much research on the incidence of direct taxes. Hyun and La (1993) and Sung (1999) all showed that the income tax is progressive. The latter also showed that the tax burden became more regressive after the crisis in 1997. In terms of property tax, Kwack et al. showed that it is progressive under the "new" view, while it is regressive under, the "old" view.

<Table 4-7> Characteristics of the Tax Structure, 1980 - 2000

(Unit: %)

	Direct taxes to to total taxes	Indirect taxes to to total taxes	National taxes to to total taxes	Local taxes to total taxes	Local taxes to GNP1)
1980	36.9	63.1	88.3	11.7	2.1
1985	39.3	60.7	87.8	12.2	2.1
1990	49.5	50.5	80.8	19.2	3.6
1995	54.7	45.3	78.8	21.2	4.4
2000	51.3	48.7	81.9	18.1	4.0

Sources: Bank of Korea, Economic Statistics Yearbook, 1991, 1996, 1998.
Ministry of Finance, Government Finance Statistics in Korea, 1991.
National Bureau of Statistics, Major Statistics of the Korean Economy,

We have only talked about vertical equity. Korea's tax system is regarded as horizontally inequitable as well. In particular, the inequality of the tax burden between self-employed and employees is serious. Many analyses on tax evasion showed that more than 50% of self-employeds' income is not reported while that of employees is nearly fully reported (see Yoo (1997)).

4) Efficiency and Simplicity

It is hard to tell which tax is relatively efficient or not, unless further rigorous empirical research is done. Unfortunately, there has been little done. In particular, research on excess burden (or dead weight loss) which is essential to evaluate efficiency, is scarce. Thus, in this section, we will limit our discussion to corporate taxes by introducing analyses on the marginal effective tax rate, which will enable us to evaluate distortions in the allocation of resources.

There are several researches on the marginal effective tax rate and the cost of capital. Since we cannot introduce all of them here, we will mention the results from Kwack and Yoo (1994) and its implications on the neutrality of corporate taxes in Korea.

What interests us in this paper is the distortion in the allocation of resources caused by tax incentives. That will be explained now. In Table 13, effective tax rates by asset type are presented. As can be clearly seen from this table, the effective tax rates of buildings and construction are higher than those of machinery and equipment. This is a notable example of the distortion[52].

As a final discussion on efficiency, it should be mentioned that Korea's tax system has not served well as a device for correcting externalities. Environmental taxes have not yet been introduced. The Liquor Tax and Tobacco Consumption Tax are not high enough to correct the externalities caused by drinking and smoking. This is why a rate increase in these taxes is widely discussed these days. Also, taxes on petroleum are considered insufficient to correct the problems of pollution and congestion. In particular, the big difference in the rates of special excise taxes between diesel and gasoline result in a price difference and cause distortion.

For simplicity, the current tax system in Korea leaves much to be desired. There are at least three main causes for this. First of all, there are too many taxes (31 as was shown in the previous section). Second, terms used in tax codes are very difficult to understand by the general public. And third, having too many tax incentives can increase the complexity so that even beneficiaries are quite certain of their benefits. Such complexity leads to a high cost of both compliance and administration. These in turn, become one of the sources of tax evasion and corruption.

52) This is considered to be the result of the fact that most of the tax incentives were applied only to investments on machinery and equipment. However, since direct tax incentives such as the tax holiday (reintroduced in 1975) are applied regardless of asset type, effective rates of buildings and construction became fairly low during the late 1970s. Although the effective rates of buildings and construction have been higher than those of machinery and equipment, the actual costs of capital of the former have been lower than those of the latter. This was shown in Kwack (1985) and Kim (1991). It is argued that the tax holiday was the main reason behind this phenomenon (see Kim (1991) for details).

C. Tax Incentives

1) Overview of Tax Incentives

Before discussing each tax incentive in detail, let us present a brief historical review of Korea's major tax incentive policies. In the early phase of the country's development, tax incentives played a relatively limited role in influencing business investment behavior, largely because of the prevailing market imperfections. It was only after 1966, the year in which the National Tax Administration was established, that tax incentives began to play a significant role in Korean economic development.

In the 1970s, more diversified and sophisticated tax incentives were provided during the course of the so-called heavy industrialization phase of the Korean economy, while incentives for export promotion were actually reduced in the early 1970s. During that decade, even though direct allocation continued to play a major role as the government increasingly let market forces play a bigger role in the allocation of resources, tax incentive policies began to receive increasing emphasis. Particularly in 1974, there was a major tax reform and all major incentives were unified and rearranged under the title of 'Special Tax Treatment for Key Industries' in the Tax Exemption and Reduction Control Law (TERCL).

In the 1980s, tax incentives began to be used less than before under the perception that they were being overly abused. First, some industries were removed from the beneficiary list. The 60% special depreciation system was completely abolished. The tax holiday option was abolished and the investment tax credit option was confined only to the machinery and electronics industries. At the same time, the investment tax credit rate was reduced to 6% (10% for investments using domestic capital goods) from 8% (10%). Effective from 1983, it was again halved to 3% (5% for investments using domestic capital goods) reflecting the downward adjustment of the statutory corporate tax rate.

After the Uruguay Round and the subsequent launch of the WTO, the aforementioned trend of declining tax incentives accelerated. Even in light of this and other unexplained changes however, many tax incentives are still in effect today. For example, there are major incentives such as reserves for investment for small and medium-sized enterprises, investment tax credits, and various incentives to induce foreign direct investment. In what follows, major tax incentives will be introduced in detail.

2) Depreciation Rules

Korea's tax laws still maintain a traditional textbook depreciation system which tries to be exact in allocating the acquisition cost of a unit of capital over the actual period of its service. With few exceptions, fixed assets employed by corporate firms can be depreciated by either a fixed amount, or fixed assets employed directly in the production activities and depreciated by the proportion of actual production (production method). No other depreciation methods are allowed.

The Enforcement Ordinance of Corporation Tax Law provides detailed tables of an asset's useful life by asset type and industry. In addition, the ordinance stipulates a 10% scrap value which cannot be depreciated. The asset's useful life, listed in the ordinance are estimates of actual physical asset's useful life, although they have been slightly shortened a few times.

3) Tax Holiday

A very generous tax holiday system was introduced with the enactment of the Corporation Tax Law in 1949. According to this system, selected industries were classified into one of two groups. Based on this, two different tax holiday schedules were applied. The first group, which included oil refining, shipbuilding, iron and steel-making, copper refining, cement manufacturing and chemical fertilizer manufacturing industries, was given a five-year corporate tax exemption of 100%. The second group, which included most of the mining and plate glass manufacturing industries, was given a three-year corporate tax exemption of 100%. During the early 1950s these incentives seem to have had only a limited effect, largely due to the Korean War and the negligible development of the heavy industries in the first group.

In 1954, benefit levels were substantially reduced and, after some minor changes, tax holidays for the key industries were completely abolished in 1968 (after an extensive revision of the Corporation Tax Law in 1967). Effective from 1969, however, a longer tax holiday of six years with full exemption and a 50% exemption in the ensuing three years was given to the livestock breeding industry. Effective from 1970, a five-year full tax exemption was granted to naphtha-cracking and a few other related firms located in the petrochemical industrial park in accordance with the TERCL. Tax holidays were abolished in 1981, and have not been reintroduced.

4) Investment Tax Credit

The investment tax credit system was first introduced in 1968 as part of the package of reforms under the Corporation Tax Law enacted in 1967. A 6% investment tax credit was given to qualified firms operating in selected industries. The eligible industries included shipbuilding, iron and steel, chemical fertilizer, synthetic fibre, automobile, machinery, straw pulp, food processing, petrochemicals, electronic equipment, electrical machinery and equipment, construction, and some mining industries. This system replaced the tax holiday provided by the old tax law. Since tax holidays generally do not influence the level of investment in the replacement or expansion of production facilities, they may have had some distortional effects on the behavior of firms. In the sense that the introduction of investment tax credits was an improvement, but the actual benefit level was substantially reduced.

Effective from 1970, the TERCL provided a 6-10% investment tax credit for machinery and equipment investment to the iron and steel manufacturing industries, with the higher rate being applied to larger firms. With the tax reform of 1974, which went into effect in the following year, the two tax credits were replaced by special tax treatment for key industries.

5) Incentives for Export Promotion: Tax-free Reserves and Special Depreciation

From the earliest stage of Korea's economic development, the importance of foreign exchange was fully recognized by policy-makers, and so foreign exchange earning activities enjoyed substantial tax privileges, especially in the 1960s. In 1960, a 30% corporate tax exemption was allowed on income from export businesses, and a 20% exemption was allowed on income from the sale of goods and services to foreign military forces based in Korea in addition to foreign currency income earned from tourist business. In the following year, this system was reinforced by raising the exemption rate to 50% covering all foreign-exchange-earning activities.

This incentive system played an important role in Korea's export-oriented industrialization in the 1960s. A 50% exemption on corporate taxes sounded very drastic and could have provoked counteractive protectionist measures from some importing countries, even though the absolute level of the effective corporate tax rate for exporters after the exemption was high, mainly due to the high inflation rate, the relatively low tax depreciation rate, the high discount rate, and the high statutory tax rate (30-45% plus surtaxes at the margin). However, the effective tax rate differential between exporting and domestic sectors created by the exemption was substantial and resources were favorably allocated to export sectors.

This system was replaced in 1973 by a two tax-free reserve system, which set up reserves for losses coming from export businesses and overseas market development. The reserve for overseas marketing was actually introduced in 1969, but until 1973 its application was limited to 'green return' corporations that included public corporations that were formally listed on the stock market, and firms approved by the government for accurately reporting taxes. In 1973, this limitation was removed and so, all corporations engaged in export business were made eligible for this benefit. According to this system, 1% of total exports (2% for small and medium-sized firms) can be deducted from the amount of taxable income for tax-free reserves. After a two-year grace period, the amount is evenly spread over the following three years and added to the amount of taxable income.

The export loss reserve system was introduced in 1973. Its level was the same as the reserves for overseas marketing, except for the method of calculating the maximum reserve amount. Under this system, the reserve amount could not exceed the lesser of either 1% of total exports (2% for small and medium-sized firms) or 50% of profits from export business.

Effective from 1977, a tax-free reserve system - reserves for price fluctuation - was added to the list of tax incentives for export promotion. The maximum amount that could be reserved for taxable income deduction was 5% of the inventory asset value at the end of the accounting period. The reserved amount was added to the amount of taxable income after a one-year grace period.

Finally, export incentives were provided in the form of a special depreciation. Although this system was first introduced in 1962, export industries only began to receive special benefits from it in 1963. Machinery and equipment directly employed by foreign-exchange-earning activities could be depreciated at a rate of 30% higher than the corresponding statutory rate. Effective from 1967, two different special depreciation rates were applied to the export share in total sales: if the share was 50% or more, a special depreciation of 30 per cent was allowed; and if the rate was less than 50%, the applicable rate was 15%. Effective from 1971, the special depreciation rate for firms whose export shares were less than 50% was calculated by applying the formula (30% x export share x 2).

6) 1997 Economic Crisis and Tax Incentives

The economic crisis started in late 1997 has forced the government to initiate a series of comprehensive economic reform measures to overhaul the economy. As a part of such reforms, the government made a number of changes in the tax laws to facilitate the restructuring process, stimulate investment and consumption, and broaden the tax base and tax revenue.

(1) Tax measures for restructuring

One of the most important reasons behind the crisis was excessive borrowing by firms. Thus, the financial restructuring of the corporate and financial sector was inevitable. And tax liability should neither discourage nor prevent companies and financial institutions from undergoing necessary restructuring. Therefore, the government has exempted or reduced taxes on asset transactions used for the purpose of corporate and financial restructuring.

Tax incentives to encourage and accelerate restructuring were mostly granted to transaction-related taxes, such as capital gains tax, acquisition tax, and registration tax. These incentives were intended to bring about corporate mergers and acquisitions, business divisions, asset swaps, alienation of business assets, and contribution by company owners. For example, profits resulting from a re-valuation of corporate assets after a merger or acquisition were eligible for deferral from corporate income tax until the alienation of the re-valued assets. Corporate mergers and acquisitions are also exempt from the registration tax.

(2) Stimulating investment and consumption

The withdrawal of foreign capital was one of the principal factors that precipitated Korea's economic crisis. Therefore, restoring the confidence of foreign investors and attracting foreign investment took on great priority.

To attract foreign direct investment (FDI), the Foreign Investment Promotion Act (FIPA) was enacted in 1998. In May 1999, provisions dealing with tax incentives for inducing foreign direct investment (FDI) was subsumed into the Special Tax Treatment Control Law (STTCL).

The principal objective of FIPA is to attract FDI by creating a more liberalized and favorable business environment for foreign businesses and providing tax incentives to certain types of FDIs. Under FIPA, foreign businesses and investors that made an investment in advanced technology are eligible for exemption from individual and corporate income taxes for the first 7 years as well as a reduction of 50% for the next 3 years. In addition, foreign businesses and investors are granted exemption from a number of local taxes (i.e., Acquisition Tax, Property Tax, Aggregate Land Tax, and Registration Tax) for a minimum of 5 years as well as a reduction of 50% for the next 3 years. Imported capital goods are also eligible for full or partial exemptions from customs duty, the special excise tax, and VAT.

With the additional measures to attract FDI, Korea opened up the long-protected real estate market completely to foreign investors in June 1998. In an effort to attract large-scale foreign investment, the government also introduced a Foreign Investment Zones (FIZ). Unlike in the past when the national government granted tax incentives to induce FDIs in pre-designated areas, the FIPA has given local governments autonomy to designate FIZs upon request from foreign investors based on the amount of investment and the number of expected jobs to be created as a result of FDI. Foreign invested companies that are designated as FIZs are eligible for government support and tax benefits.

Tax incentives were provided to small and medium-sized companies to stimulate employment and technology investment. They include tax exemptions on stock options, tax credit and exemptions on R&D, lower special excise tax on consumer electronic goods and automobiles, lower automobile tax, and lower capital gains tax. For example, for employees of venture capital companies who take stock options, the individual income tax on income from stock options is exempted.

7) Evaluation

What are the impacts of such tax incentives? Have they really contributed much to the growth of the economy as intended? The answer is neither affirmative nor negative. Almost all the research examining the cost of capital and effective corporate tax rate in Korea shows that they have been somewhat effective, but not very much (see Kwack and Yoo (1994), and Yoo (1998)). As can be seen in <Table 8> and <Table A1>[53)], there had been some tax reduction effects, though to a small extent. Yoo (1995) showed that investment tax credits and accelerated depreciation were powerful. Other measures, particularly the policy loan (credit support), have been argued to be far more effective than tax incentives (see Cho and Kim, 1994).

53) This table summarizes the effective marginal tax rates according to the asset types

D. Tax Administration[54]

Currently in Korea, the administration and policy-making of national taxes is under the general jurisdiction of the Ministry of Finance and Economy (MOFE), which also has the National Tax Service as an external organization. The Office of Tax and Customs of the MOFE plans the tax policy and the drafts the tax laws, while the National Tax Service is in charge of tax administration. The National Tax Tribunal was established as an independent organization under the Ministry of Finance on April l, l975, to examine and preside over tax appellate cases. It is now a part of the MOFE.

Although often ignored theoretically, tax administration is very important, since tax policies cannot be effective without proper support of tax administration. This is well explained in a comprehensive survey on tax administration by Bird and Casanegra de Jantscher (1992). As indicated, tax administration in Korea has improved much since the foundation of the NTS. Nevertheless, there is still much room for future improvement as can be seen from the following discussion. In spite of the government's past efforts to improve tax administration, reform must be pursued.

In what follows, a historical review of Korea's tax administration is presented. Then, two of many specific issues related with tax administration will be discussed in order to check the effectiveness and efficiency of Korea's tax administration.

1) The Evolution of Tax Administration in Korea

Since the National Tax Service was founded in 1966, the role of tax administration has become increasingly important. The main role of the tax authority in the early years of its founding was to collect as much revenue as possible so as to fund government initiatives for rapid economic growth. Since there was a lack of transparency in the tax base at the time, many policy tools available to administer taxes such as tax audits, were fully enforced to maximize tax revenue. The tax authority was widely perceived as successful in achieving this primary goal in the 1960's and 1970's. However, tax administration at the time did not rely on a scientific process and so, taxpayers often criticized that tax administration was unfair and subjective. Since the tax base was not transparent and was assessed by the agency, tax evasion became widespread among taxpayers which used all possible means. Especially, horizontal inequality between the income of salaried workers and that of self-employed workers became a big issue in tax policy for a long time.

The National Tax Service has existed under a hierarchical structure made up of a three tier organization, since its foundation in 1966. The three divisions include the national office,

54) Again, the current system is introduced because there have not been many changes.

regional office, and field office. National and regional offices are responsible for policy making and evaluating the administration of taxes, while field office carry out various activities regarding taxpayers including tax audit, collection, etc. The total number of offices in each division has varied greatly over time. In 1966, when the National Tax Service was founded, it consisted of one national office, 4 regional offices, and 44 field offices. However, as the number of taxpayers continued to increase over times, additional regional and field offices were established. Consequently, the number of regional offices and field offices was 7 and 136, respectively in 1997. The tax authority's organization was based on tax items, which are income tax division, value added tax division, property tax division, etc. This organizational structure had been maintained until 1999.

In 1999, the tax administration was fundamentally reformed. A major goal of this reform was to induce taxpayers to voluntarily comply under self-assessment. The organization of the tax authority was reorganized that its structure was based on functions rather than tax subjects. Also, each taxpayer's information on income and expenditure was integrated into one database at the tax authority. The tax authority was renamed as the National Tax Service to demonstrate the tax services for taxpayers in 1999. Recent studies indicate that the tax administration reforms in 1999 led to more efficient resource allocation as well as greater trust of the tax authority among taxpayers. Therefore, tax administration after the reforms of 1999 may have entered a different paradigm. In this sense, tax administration in Korea can be divided into two periods; one is pre-reform period of 1966-1999, and the post-reform period after 1999.

2) Cost of Tax Administration

Administrating tax is not free of charge. There are two types of costs. The firs is administrative costs resulting form the collection of tax revenue, and the second is compliance costs by taxpayers. Korea's tax administration is examined from the perspective of these costs.

We show the cost of tax administration by comparing administration costs (equivalent to the total budget of NTS) per 100 won of collected taxes over 1991 - 2000 in <Table 4-9>. The cost of tax administration was within a range of 0.90 - 0.99 won per 100 won of collected taxes before the reforms in 1999. However, the cost of tax administration has sharply decreased since the reforms, which cost 0.8 in 2000. It indicates the lowest cost over the history of tax administration.

It is generally agreed that Korea's tax administration is efficient from the perspective of comparative analysis. For example, the average level of cost associated with tax administration in OECD countries is about 1 to 1.5%. However, such a view should be taken with a grain of salt because this index is crude and may not be totally useful in determining the tax cost effectiveness, as a low index can be due to an increase in revenue.

It is relatively hard to evaluate Korea's tax administration from the perspective of compliance costs by taxpayers without reliable estimates. Little empirical evidence is available to measure the exact costs in tax compliance by taxpayers in Korea, so comprehensive analysis in this field is needed. One empirical study by Kwack (1994) shows rough estimates; tax compliance costs per collected tax revenue was between 0.1-8.7% for individual income tax, 0.43-7.7% for corporate income tax, and 0.05-0.9% for value-added tax.

<Table 4-8> Tax Administration Cost

(Unit: won)

Year	Administration Cost Per 100 Won
1991	0.99
1992	0.98
1993	0.96
1994	0.90
1995	0.91
1996	0.93
1997	0.91
1998	0.91
1999	0.84
2000	0.80

Source: National Tax Administration, various years

Korea's tax administration has been criticized in terms of economic efficiency, even though there is no strong empirical evidence to support this criticism due to limited research. Based on the data explained so far, we could only conclude that Korea's tax administration still needs to be enhanced further even though tax administration costs have declined greatly, because tax compliance costs are still high.

3) Arrears

Tax arrears is one of the most serious problems faced by tax authorities. The amount of tax arrears was estimated to be about 8% of determined revenue during the 1990's. Also, almost 48% of tax arrears were written-off as being uncollectable due to taxpayers' bankruptcies or disappearances in 1997. <Table 4-10> shows the size of tax arrears over time. The proportion of total amount of tax arrears with respect to total revenue is around 16% in 1997. Moreover, we find that the amount of tax arrears has increased over time. In this regard, Korea's tax administration is said to be inefficient.

<Table 4-9> Tax Arrears

(Unit: %)

Year	Tax Arrears / Total revenue
1995	15.11
1996	14.74
1997	16.41
1998	20.96
1999	21.35

After looking at the administrative costs and tax arrears and seeing that there is still much room for improvement, we again arrive at the conclusion that further reform of Korea’s tax administration is necessary[55]. This should provide an important lesson to Uzbekistan continuous efforts to improve the tax administration are always necessary.

55) There are opinions that the tax administration reform is needed because there is certain degree of distrust toward tax authority by general tax payers. This kind of distrust is caused by following aspects. First, the tax burden between wage earners and the self-employed is unequal, because the tax authority has difficulty in administering evidence-based taxation. This horizontal inequity makes taxpayers feel that tax administration does not function properly. Second, there is wide-spread perception even among ordinary tax payers that tax evasion is all right. It may be due to the sufferings that general public had to endure in the past (by despots, colonialists etc.). Third, it is believed that corruption in tax administration is significant, because tax officers are likely to use too much discretion and subjective judgment in interpreting the tax code. These factors make taxpayers distrust tax administration, and the tax authority has realized that dramatic reform in tax administration is needed.

3. Review of Uzbekistan's Fiscal System

3-1. Budget System

A. The Budget Process[56)]

1) Current Budget

The MOF deals with a large number of budget holders. There are in effect two budget processes. The first broadly covers current expenditure, and the second covers investment expenditure under the Public Investment Program (PIP). The current budget process begins when the MOF issues its budget circular in May or June, for the recurrent republican and oblast budgets. The MOF receives budget requests from over 100 primary budget holders and 14 oblasts (consolidated with the budget request of their subordinate rayons.) The COM indicates areas of particular priority, such as education, at the beginning of the budget preparation process.

Until recently there was no initial resource envelope based on a macroeconomic framework nor were expenditure ceilings specified to line ministries when calling for their budget requests. The MOF uses some macroeconomic indicators - prepared by the Ministry of Economy (MOE) - to determine an ex-ante expenditure ceiling so that a certain ratio of government expenditure to GDP is not exceeded. However, these parameters are not part of a coherent macroeconomic framework within a formal macroeconomic model. For the first time in the 2005 budget process expenditure ceilings were set for sectors. This is an important step forward in the budget process. However the process of setting ceilings will require further development and formalization. In particular, it is important that the COM approve ceilings for institutions and not just functions, and that the process of setting ceilings should be codified in the BSL or in regulations issued by the MOF based on the BSL. The budget preparation process still consists of a bottom-up approach involving line ministries simply aggregation individual budget requests by budget institutions (BIs). Unrealistic demands for budget resources have to be scaled back by the MOF without in having sufficient data at its disposal to make coherent decisions. Moreover the analysis of the budget requests takes place by the corresponding sector departments of the MOF and there is no overall view of the budget priorities.

Budget requests are based upon standard cost norms and historic allocations. The budget proposals submitted by BIs contain requests on the basis of four major economic categories: wages; taxes and social security contributions; capital expenditure; and other current

56) This part is an excerpt from the World Bank Report No. 31014-UZ, pp 46-51

expenditure. BIs prepare their requests mostly with reference to nationwide applicable pre-determined cost norms and standards. In some cases the norms are still based upon legislation dating back to before 1991.

A draft budget of broad functional classifications is approved by the COM and Oliy Majlis. After reconciling the revenues and expenditures with a deficit target, the draft budget is presented on a very aggregate functional basis successively to an interministerial committee, the COM and finally the Oliy Majlis for approval (usually by December). The State Budget approved by the Oliy Majlis and the COM consists of only ten expenditure items (by broad functional categories - see example of 2004 budget) and thirteen revenue items by main revenue sources together with total revenues (including subventions) and expenditures of each oblast.

Evaluation and accountability require a different classification and greater detail. While substantial additional documentation on the performance of the economy is presented to the Oliy Majlis, the presentation of the budget does not allow the Oliy Majlis (or the COM) to make an assessment of the effectiveness of the allocation of resources (or provide strategic guidance on resource allocation, given that approval is granted at the end of the budget process), and even less to require accountability for their use. The budget does not show either the sectoral breakdown of the investment nor the expected volumes of expenditure to be financed by external borrowing or grants.

The detailed budget is prepared after approval by the Oliy Majlis. Once this process has been completed a second (arguably the real) budget process begins. Since the budget approved by the legislature does not assign resources to institutions and economic categories, it is only following the approval of the budgets that the negotiations and allocation of budgets of institutions at the central level takes place by the MOF, often during the first weeks of the year for which the budget has been approved.

2) Investment Budget

There is no integrated evaluation of investment and current spending in each sector. The lead agency for the investment budget is not the MOF but the MOE, which is responsible for the PIP. Although MOF officials are involved in this process and all projects are formally subject to a process of appraisal, they are not evaluated together with other public resources being assigned to a particular sector within a budgetary envelope for the sector. In addition, a number of basic decisions in the PIP are taken outside the formal budget process (for example, a priori decisions on the number of schools and hospitals to be constructed). There is also no mechanism for the consideration of the impact of future recurrent cost implications (beyond the next budget year) of new investments.

The PIP has a short term perspective. Two three year PIPs were prepared for 1999-2001 and 2000-2002, but for 2003 and 2004 have been prepared only on an annual basis, and are not based upon explicit medium term priorities or linked to broader national or sectoral programs.

Separation of PIP and external financing promotes the view that such resources are additional of free. A significant proportion of the PIP is financed from external borrowing, the existence of the PIP in its present form promotes the view that foreign financing is ‘ free’ money apart from the budget. Although the appraisal of PIP projects does include an assessment of the ability to repay the loans, these are not taken into account as part of the budgetary envelope available for spending by institutions.

3) Budget Classification

The budget classification used does not follow international standards. The functional classification is a mix of functional elements and economic categories, and the economic classification is limited to four categories, as noted above. Currently, a new budget classification consistent with GFS 2001 has been developed with the assistance of the IMF and US Treasury. It is expected that this will be implemented for the 2006 budget and that, in addition, a programmatic budget classification will be implemented from 2007.

4) Transparency and Budget Presentation

Transparency in the budget process needs to be improved. The current budget preparation process is not transparent and suffers from the fragmentation of the budget. Greater transparency can be achieved through the presentation of the budget by organizational and economic classification, together with comparative data for the previous year and forecasts for the succeeding two years. While the development of high quality documentation may take place over a number of budget cycles, it is important in principle that the assumptions and main policy lines underlying budget choices are clearly presented to the Government, Parliament and the public.

Transparency and accountability would be enhanced by the publication of Budget documentation. Publication is standard international practice in virtually all countries in the world, and is also consistent with the recommendations of the Country Economic Memorandum and the CFAA. The decision of the Government to begin publishing the details of budget execution for 2003 is very welcome and institutionalization of this practice would be an important step forward in transparency.

5) Budget Execution Arrangements

Fragmented organizational arrangements for the budget make implementation difficult to monitor. Budget execution takes place through the Central Band of Uzbekistan (CBU) and the banking system, using authorities issued by the MOF and the Oblast Finance Departments. The CBU estimates that there are 120,000 Government bank accounts. There is a lack of separation between the release of the authority to spend and the release of cash to spending units. Budget appropriations are released through transfers from higher to lower level bank accounts. These procedures allow spending agencies and intermediate government institutions to build up idle cash balances, thus increasing the MOF's gross borrowing requirement.

There is uncertainty in the availability and timing of funds. In principle, budget funds are released to spending agencies on the basis of monthly expenditure plans. Although funds are released over the whole year in accordance with the approved budget, to keep cash under control, these releases are not automatic and are prioritized by the MOF or the Oblast Finance Department. The timing of availability of funds is determined in part by the availability of revenue (dependent on seasonal or local fluctuations) at the relevant level of decision-making (MOF, oblast or rayon). The need for prioritization in release of cash makes control of execution a source of political and economic power, and subject to lobbying and rent-seeking. The resulting uncertainty as to the timing of the release of funds generates incentives to cash hoarding and the accumulation of idle balances by budget organizations. Cash management is further complicated by the rationing of cash (M0) by the CBU to the banking system. Even when funds are made available through the baking system to the bank accounts of BIs, theses are unable to make payments in cash to final recipients. As a result, arrears of several months have occurred in wage and pension payments in some areas.

6) Budget Fragmentation

Uncertainty and lack of funds leads to a fragmentation of the budget. The uncertainty on the availability of financing, both at the stage of approving the budget and also during budget execution, has led to a number of strategies by institutions to protect the resources allocated to them through the fragmentation of the budget. This fragmentation is manifested in a number of ways.

Creation of Extrabudgetary Funds. The first is the creation of extrabudgetary funds. Theses funds have been created with their own sources of income, and most of the smaller ones cover current expenditures such as maintenance, repairs or subsidies in different sectors, which are precisely the items being squeezed under the current budgeting process. The creation of extrabudgetary funds for theses purposes is a substitute for an effective budget process and reflects an inability to prioritize. If an overriding need for maintenance staff incentives or any other expenditure is recognized, this should be provided for through the normal budget process. There are arguments for maintaining the larger funds, but only if theses are subject to standard budget preparation and review and audit processes as recommended by the CFAA. It is recognized that the Government is making efforts to reduce the number of extrabudgetary funds, but in this context the creation of a new fund for basic education is a cause for concern, because of the way in which this substitutes for the normal budget process.

Extra-budgetary accounts in the banking system weaken fiscal control. Spending agencies use extra-budgetary accounts (established under decree 414) to manage their own resources. While such arrangements facilitate cost recovery, the high number of extra-budgetary bank accounts maintained by BIs create loopholes in fiscal control.

B. Fiscal Policy

1) Fiscal Balance

Currently, as was the case in Korea, Uzbekistan has maintained sound fiscal balance even thought the size of the general government looks relatively big. As shown in <Table 4-11>, the general government accounts for about 32-35% of GDP, which is not small for a developing economy. This is due to (relatively) big expenditure on welfare and education. But the size of the government itself does not appear to be a big problem because the Uzbekistan government is now reducing it while still maintaining fiscal balance (<Table 4-11>). At the end, maintaining fiscal balance is very important for Uzbekistan.

<Table 4-10> General Government Expenditure in Uzbekistan (In percent of GDP)

	2000	2001	2002	2003	2004
Total revenue and grants	36.8	34.5	35.7	33.1	32.3
Total expenditure and net lending	38.9	36.0	37.2	33.9	32.0
Overall balance (- deficit)	-2.5	-1.3	-1.9	0.1	0.4

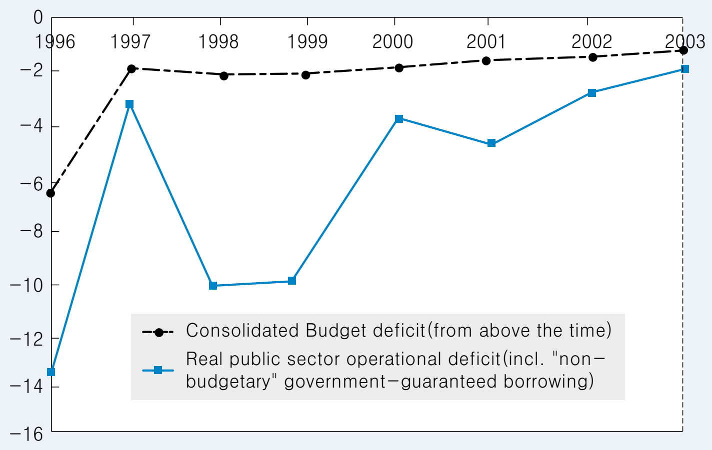
Sources: Uzbek authorities; and IMF staff estimates.

In this regard, IMF gave the following advice.

Directors recommended the authorities for a tight fiscal performance in 2004, and a prudent 2005 budget, while cautioning that expenditure restraint will need to be maintained. They were encouraged by the progress toward the establishment of a unified treasury system and plans to move toward a comprehensive Medium-Term Budget Framework. Directors supported the reduction in quasi-fiscal outlays in the energy sector through increases in the electricity tariffs, while stressing the need for appropriate measures to address the social impact of theses increases.

Although the current fiscal balance is sound, this was not the case in the past. As can be seen in <Figure 4-2>, it was quite large in the late ‘90’s. The efforts made by the Uzbekistan government to reduce the fiscal deficit should be considered as remarkable.

<Figure 4-2> Narrow and Broad Government Deficits, 1996-2003



2) Structure of Expenditure

As for the structure of the budget, relatively greater emphasis is placed on welfare expenditure and education. The World Bank points out that the payroll tax to provide funds for welfare programs is so high that it has becomes a real burden for the firms[57]. Although there is not a priori standard or criterion to judge whether a country's welfare expenditure is too big or too small, placing priority to expenditure for SOC now for rapid development would be appropriate. For example, Korea during its development, the share of expenditure on economic development (mostly SOC) was much bigger while expenditure on welfare was much smaller compared with Uzbekistan.

As can be seen from the following two tables, the share of education expenditure is very big compared not only with Korea but also with other OECD countries. Though certainly education or investment in human capital is very important, this seems to be too big of a burden for the Uzbek economy.

57) In 2003, the payroll tax rate was 35.0% for the Pension Fund, 1.5% compulsory payment to the Employment Assistance Fund, and 0.7% to the trade unions fund. Employee wages are levied a 2.5% mandatory insurance fee, and legal entities are levied a 0.7% sales tax for the pension fund.

<Table 4-11> Structure of Expenditures (Uzbekistan: % to GDP)

Indicators	2000	2001	2002	2003	2004
Expenditure	29.5	27.0	25.8	24.6	22.9
Social Sphere	10.4	10.2	9.8	9.3	9.1
Social Protection	2.3	2.1	2.0	2.1	1.8
Expenditure for economy	3.0	2.3	2.3	3.0	3.1
Expenditure for financing centralized investment	6.0	5.0	4.7	3.3	2.7
Maintenance of state power bodies, management and court bodies	0.6	0.6	0.5	0.5	0.6
Other expenditures	7.2	6.8	6.5	6.4	5.6

< Table 4-12 > Public Expenditure of Education compared with OECD

Country	As (%) of GDP	As (%) of expenditures
Uzbekistan	8.4	22
OECD average	5.1	13

Source: Uzbek authorities and staff calculations. OECD data from Education at a Glance, 2001

< Table 4-13> Public Expenditure on Education

	Recurrent	State Budget Investment	Foreign-Financed[1]	Total Public Expenditure
1995	7.4	0.4	0.0	7.8
1996	7.4	0.1	0.0	7.5
1997	7.1	0.3	0.0	7.4
1998	7.6	0.3	0.0	7.9
1999	7.5	1.8	0.0	9.3
2000	6.7	2.5	0.1	9.4
2001	6.8	1.0	0.3	8.1
2002	6.7	1.9	0.2	8.8
2003	6.5	1.8	0.2	8.4

1) Converted at the official exchange rate.
Source: Uzbek authorities and World Band staff calculations

3-2. Tax System

A. Tax Structure and Tax Revenue

Overall, the tax system in Uzbekistan seems to be well-established. Currently, there are seven national taxes; income (profit) tax on legal entities, income tax on physical entities, value-added tax, excise tax, tax on natural resources, environmental tax, tax on usage of water resources. In addition, there are six local taxes; property tax, land tax, tax on infrastructure development, tax consumption of petrol, diesel fuel and liquefied gas for transport facilities, duty for the right to trade, including license-related duties for the right to trade in certain types of commodities, registration duty on both legal and physical entities involved in entrepreneurial activity.

In terms of individual taxes, here are some of their characteristics: i) The tax rates for property tax, land tax, excise tax, tax on usage of natural resources, tax on usage of water resources are all determined by the cabinet, and not by law. ii) Income tax brackets are based on the minimum wage. iii) Tax on the usage of natural resources and tax on the usage of water resources are rather user fees.

<Table 4-14> Income Tax Rates: Uzbekistan

Amount of Aggregate Income	Sum of Tax
Up to fivefold the amount of the minimum wage	13 per cent of the sum of income
From fivefold (+1 soum) up to tenfold the amount of the minimum wage	tax charged on fivefold the amount +22 per cent of the sum exceeding fivefold the amount of the minimum wage
From tenfold (+1 soum) the amount of the minimum wage and over	tax charged on tenfold the amount +32 per cent of the sum exceeding tenfold the amount of the minimum wage

The tax burden ratio in Uzbekistan was relatively high at 28.5 % of GDP in 2000, compared to the average rate of 22% in CIS countries. There has been a gradual downward trend since then, and came down to the average level of CIS countries last year. The legislation of taxes is very complex, and it is frequently revised. Uzbekistan's tax revenue structure is heavily dependent on indirect taxes (see <Table 4-16>), which may cause inequality.

<Table 4-15 >Structure of Revenues of the State Budget: Uzbekistan (% to GDP)

Indicators	2000	2001	2002	2003	2004*
Revenues	28.5	26.0	25.2	24.2	22.5
Direct Taxes	7.5	7.4	6.8	6.4	6.0
Indirect Taxes	16.0	13.5	13.8	14.0	13.8
Resource Payments and Property Tax	2.8	2.4	1.9	2.3	2.6
Social Infrastructure Development Tax	0.3	0.3	0.5	0.4	0.4
Other Revenues	1.9	2.4	2.2	1.1	0.9

Source: Ministry of Finance of the Republic of Uzbekistan
*-projected figures

Some tax incentives are actively used, although there is not enough information to reach definite conclusions. For example, a joint venture involving foreigners is allowed five years of tax holiday. Based upon the information and explanation above and Korea’s experiences, some policy suggestions will be made in the following chapter.

B. Tax Administration[58]

The organizational structure of Uzbekistan’s tax administration is fragmented. Like many other countries in the region, different departments are organized by function, type of tax, and type of taxpayers, with overlapping and often conflicting responsibilities. To improve the tax administration’s operating efficiency, a new structure should be created along functional lines. This would include departments in charge of key tasks such as return filings and payment, collection and enforcement, audit, appeals, and taxpayer services. Subsidiaries in large corporate groups, including large public enterprises report to local tax offices rather than being handled centrally in one tax office.

Communication between the collection agencies and Ministry of Finance is improving. The collection agencies have developed a matrix of management report which is provided to the tax policy department at the Ministry of Finance. However, the present information system precludes the provision of useful information which would enable more detailed analytical work on tax policies and processes.

58) This part is heavily drawn from the World Bank report No. 31345-UZ, report No.25923-Uz

Collection agencies are investing in information technology. To increase the timely flow of information, tax authorities have been investing in the development of management information systems. STC has a unified collection system which links local, oblast and headquarters by a satellite. SCC is investing $24 - $27 million to develop and implement a unified management information system throughout Uzbekistan. Legal entities have a unique tax identification number and all citizens over the age of 18 years also have a unique taxpayer identification number. The Presidential Decree which came into effect on January 1, 2004 has been a step forward toward increasing efficient use of information technology by allowing electronic signatures.

The complexities of a tax policy may discourage compliance. In common with other transition economies, Uzbekistan faces a major challenge in enforcing existing tax policies without stifling the development of legitimate economic activity. One crude measure of determining the level of acceptance of a tax system by taxpayers is estimating the amount of tax collected through the courts or administrative enforcement orders. One estimate, provided by the Ministry of Finance indicated that between 11 and 15% of taxes are collected through theses mechanisms. This places both an administrative burden on the tax administration system and creates a cash flow problem as a result of the gap between the due date and actual collection of tax revenues.

In Uzbekistan, the commercial banking system continues to act as a tax enforcement mechanism. While tax collection is a normal function of commercial banks, tax enforcement is not a recognized function and undermines confidence in the financial system. For example, the STC can withdraw funds directly from an entrepreneur's account, without prior notice. Further, taxes have priority over cash withdrawals of wages, which, in turn could be a cause of wage arrears. While the withdrawal of funds is automatic, a firm's tax accountant is required to file a return and have payments stamped and confirmed by the relevant authority, which must be presented to other agencies such as the statistical office. That increases compliance costs. In considering this, the Government has developed an amendment to the Tax Code which would restrict access of the STC to taxpayers' banking information with the support of a US Treasury Advisor[59]. This is an important piece of legislation which could contribute to building confidence in Uzbekistan's banking sector.

3-3. Role of the Government

As was pointed out, Korean government played a major in the process of the development. Although its size was small, it used to reach every corner of economic activities of the state,

59) Under the draft legislation, banks would have to respond (i) to an encashment order, signed by the Head of the local STC or (ii) to a tax demand issued by a Court.

even private. This is also true of in Uzbekistan. According to the observation by the World Bank, The role of the government in Uzbekistan is very high. The observation by the World Bank is as follows :

> Despite the reduction in the size of fiscal and quasifiscal operations over the years, the role of the state in the Uzbek economy remain very high. The state continues to be involved in a wide range of off-budget economic activities managing whole sectors of the economy such as cotton growing. Instances such as when the authorities require enterprises to perform special works, for example by providing employees for cotton picking, point to a much larger influence of the state than is indicated by the quantifiable fiscal and quasifiscal operations. If control over the economy through parastatal industrial associations, local authorities (hokims), and state-owned commercial banks, as well as heavy regulatory burden are added, the reach of the state is greater still. The choice of instruments for state intervention also leans towards direct intervention, administrative measures and service provision by the state rather than private sector provision where it may be viable. The administrative and regulatory pressure on the economy in some areas such as trade regime and domestic cash management has been on the increase in recent years. As international experience, and Uzbekistan’s own growth and living standards performance over the past decade indicate, such a high level of state intervention is not consistent with rapid, sustainable economic growth.

As in Korea, it may be inevitable in the early stage of the development since the market in every sector is not established well. It, however, will work as a serious drawback in the later stage of the development as can be also seen in the Korean experience. Thus, the reduction of the government intervention is necessary.

4. Policy Suggestions

Although the information on Uzbekistan's public finance is scanty, we nonetheless try to offer some policy suggestions based on Korea's experiences. It should be pointed out, however, that it is not our intention to make policy suggestions to every area of public finance. Our suggestions will be limited to the area directly related with development and growth.

In reforming a transition economy like Uzbekistan, it is important to understand the role of public finance properly. Since public finance is not that important under a communist regime, since (nearly) every asset and property is owned by the nation (government). For example, what would be the use of taxes in such a situation? By definition, residuals from whole products after allocation according to the needs of individuals belong to the government. A tax system and budgeting are meaningful when private ownership exists. Taxes are a forced transfer of private property to the government so that they can provide public goods.

This is the reason why almost all transition economies experienced difficulty in carrying out reforms (develop) on their fiscal systems. Uzbekistan is not an exception to some extent, although some parts are well organized and streamlined. Suggestions here should be directed toward those areas where further improvement is necessary.

4-1. Reform of the Budget Process

Among many areas of the budget system, the optimal and transparent use of expenditure is the most important in allowing the budget to contribute properly to economic growth. This point was clearly made by the World Bank on their suggestions for reforming the budget process. The argument by the Bank is as follows:

> Budget management processes in Uzbekistan create considerable risks to the Government. The first risk is a policy risk; it is the risk that policies passed by Parliament are not implemented through the budget. The second risk, a budget and financial management risk, is the possibility that funds are not spent according to their intended use. This risk is compounded by a large share (about 25 %) of off-budget resources not subject to budget scrutiny.
>
> In Uzbekistan, the policy risk is significant owing to process and institutional breakdowns between policies and budgeting. The greatest challenge in the reform of Uzbekistan's public finances is to make the transition from institutions inherited from the centrally planned economy, to ones in which policy making is linked to budgeting. Much of the reform process requires fundamental changes, largely outside and beyond the Ministry of Finance. First, the Government should clarify the long term role of the public sector in the economy, with a view to accelerating the transition towards a market-based

economy supported by transparent and accountable public institutions. While economic and sector policies are developed, institutions should be established at the center of government to coordinate strategic policy choices. Spending ministries should be reorganized along functional lines and include under them many of the state institutions which deal directly with the MOF. New budgeting processes and the establishment of the Treasury, will of course require work within the MOF.

There is also a high risk that funds may not be used for their intended purposes, as the budget lacks comprehensiveness and limited budget information prohibits meaningful budget scrutiny. The present budget is not comprehensive and the budget process is fragmented. Extra-budgetary funds account for one quarter of state budget expenditure and are not subject to the same scrutiny as the budget. In addition, the formulation of investment budget is a separate process; there is no mechanism for consideration of the impact of future recurrent costs in evaluating new investments, nor is there a mechanism for debt recording of externally financed investments.

The CFAA recommends that no new extra-budgetary funds be created and that existing funds should be subject to the same rules for budget preparation, review and audit as the budget. In addition, the process for recurrent and investment budget preparation should be merged with due consideration of recurrent costs and debt impact in later years.

The transparency of budget documentation also needs to be significantly improved. The present budget classification is rudimentary and insufficient to analyze the development of policy or serve as a basis to hold spending units accountable through budget execution. Transparency and accountability would be enhanced by the publication of budget documentation which includes the budget, macroeconomic forecasts and explanation of the main budgetary measures.

In Uzbekistan, the present budget execution arrangements are inefficient and non-transparent; exposing the government to the risk (a) that payments are not made in accordance with the budget, (b) that payments are not made on a timely basis and distort the implementation of government activities and (c) that finance officials have insufficient information to make the most effective and efficient use of cash. Disbursement takes place through numerous government bank accounts held in commercial banks. This makes budget implementation difficult to monitor and liquidity impossible to manage. Numerous extra-budgetary accounts further weaken liquidity management, budget execution monitoring and control.

In recognizing such problems, the World Bank suggests the following reform proposals. They are classified into three categories-short, medium, and long term.Short Term (within one year) measures include adopting a fully revised budget process for the 2006 budget. So, new extra-budgetary funds should not be added, and so on.

Medium term (one to three years) measures are as follows:

Establish a high level committee of the COM responsible for overseeing the budget process and presenting strategic choices to the COM.

Extrabudgetary funds should be subject to the same rules as the rest of the budget.
EBAs should be limited to the payments for paid services and not allow budget surpluses.
Review the norms and regulations governing budget allocations.
Reorganization of the MOF.
Multi-year PIP process should be reinstated and coordinated by MOF.
Transparent operational rules and procedures should be developed for the Treasury control of budget execution.
All extrabudgetary funds and accounts should be included in the Treasury.

Long Term (over three years) are as follows:

Strengthen the role of ministries in policy making and reorganize ministries into a small number of functional based ministries.
Reform of the financing of local governments.

The current author generally agrees on such suggestions. Particularly, it is very important to streamline extra-budgetary funds considering Korea's experiences. As was shown in Korea's case, extra-budgetary funds (public funds) have been extensively used. There has been criticism due to the discretionary and even wasteful use of funds, since they are less tightly controlled than the regular budget. This is case of failure in Korea. Uzbekistan should not follow such path. Therefore, extra-budgetary funds should be under the control of congress like the regular budget, at least.

Compared to Korea's case, one more suggestion could be made. The second risk mentioned above could be resolved by introducing a new ministry (or agency) which deals with the budget exclusively. The EPB in Korea's case is such an example. At the same time, ministries should have more independence from the President's party. It is a legacy found widely in transition economies where the party has control over the cabinet. In carrying out reform, such a structure is not effective.

4-2. Restructuring Expenditures

As shown in the previous two chapters, the structure of Korea's public expenditure was characterized by the heavy defense burden and great emphasis on economic development. Whereas, welfare expenditure accounts for a large portion of public expenditure. Further, expenditure on education is relatively big in Uzbekistan. This is a striking difference.

Is it then, always right to follow Korea's model by lowering the proportion of welfare expenditure dramatically? It is not necessarily so. First of all, it would not be possible because most of welfare expenditures are entitlements. Second, Korea's path might not be the "best one" while it was not totally a "bad one". As was pointed out in chapter II, welfare was “sacrificed” in some sense for promoting rapid development, and Korea would later pay a price for such a policy. Education is also important for growth.

However, the importance of SOC cannot be underestimated. To achieve rapid development, the provision of SOC is vital. Therefore, the Uzbekistan government should try to increase the share of SOC by keeping the expenditure on welfare and education under the control for a while. As the economy grows, the size of the budget will grow as well. Then, there will be room for new expenditure. And it is suggested that such increases in expenditure should be mainly on the SOC. In doing so, great caution should be taken so as to maintain fiscal balance.

Also, the welfare programs themselves should be streamlined. As shown, pay roll taxes place too much of a burden on firms. In such programs, inefficiencies in the administration and transmitting mechanism are usually found (Korea is not an exception). Thus, by streamlining welfare programs, the goals of the program could be accomplished with less expenditure.

<Table 4-16> SOC before and after Development in Korea

	Electric Power(GWh)	Transportation			Num. Of Telephone Subscription (Thousand)
		Railroad(km)	Road(km)	Pavement Rate(%)	
1960	1,697	4,583.8	27,169	3.7	87
1961	1,773	4,630	27,169	4.1	77
1962	1,979	4,695.7	27,169	4.7	127
1980	37,239	6,007	46,951	33.2	2,705
1981	40,207	6,045	50,337	34.1	3,263

4-3. Streamlining of the Tax System and Tax Administration

Chapter III shows some of Uzbekistan’s problems in the tax system and tax administration. These problems should be reformed to achieve not only development but also an efficient tax system. As is clear from Korea’s experiences, continuous reform in the tax system is inevitable because there is no perfect tax system. It should evolve as the economic and social environment changes. Besides, it was clearly shown that Korea’s current tax system still has much room for further improvement even after the drastic reform efforts. As for tax administration, the same applies. In spite of the continuous reform efforts, tax administration in Korea is far from perfect. Therefore, it is not too early to reform the tax system in Uzbekistan. Suggestions for reform are as follows.

First of all, continuing efforts to maintain the tax burden ratio at the current level is necessary. For economic development, too great of a burden on the private sector may not be desirable. Since, the Uzbek government has already determined that the current level of the tax burden ratio to be optimal, that decision should be respected.

Second, tax rates should be determined through legislation (in other words, defined by law), because of its representative form of goverment. Therefore, the current system in which the cabinet sets the tax rate should be reformed.

Third, taxes on the usage of natural resources and water resources act as user fees rather than taxes. Thus, they should be converted to fees. Further, the abolition of the former should be seriously considered to promote rapid growth.

Fourth, personal income tax brackets are based on the minimum wage. The minimum wage, however, changes every year. Therefore, under the current system, tax brackets are changed every year. This causes at least two problems: difficulty in tax revenue forecasting and unnecessary complexity.

Fifth, banks should no longer be used as tax enforcing agencies. That should be left as a role for the STC, while the banking sector should be used a way to allocate funds.

4-4. Tax Incentives

Excerpts of Uzbekistan's tax code show that many tax incentives are actively used. Also, chapter II shows that Korea relied greatly on these measure during its development, though their overall effectiveness is not all that clear. Therefore, tax incentives should be utilized actively to promote rapid growth.

However, there are caveats. First, tax incentives sometimes do more harm than good. The distortion of resource allocation caused by tax incentives may be bigger than expected. Therefore, although the active use of tax incentives is necessary, over usage should be avoided.

Second, many of the tax incentives (i.e., holiday and free reserves taxes) would be prohibited under the WTO. Since Uzbekistan is trying to enter the WTO, serious limitations on the use of tax incentives can not but be placed. On the other hand, they should be used to attract foreign direct investment which Uzbekistan is seeking. As a matter of fact, Korea has actively used tax incentives to induce FDI in the aftermath of the economic crisis in 1997. This should be considered seriously.

Third, some tax incentives targeting small and medium sized firms should be used because at the current stage, those firms would serve as the base of Uzbekistan's industrialization and growth in the future. It should not be a serious problem under the WTO.

4-5. Reducing the Government Intervention

As was pointed out, the role of the government in the Uzbek economy is very high, as was the Korean government in the past. Although inevitable to some degree, too much goverment intervention is not desirable because it will only distort resource allocation and growth potential in the long run. Therefore, the rolr of the government should be restricted tosuch basic functions as the provision of the public good, correction of externalities, income redistribution and ensuring macroeconomic stability.

To do that is not easy and requires time. In Korea, it took several decades to reduce the government intervention to the current level , which is not regarded as fully satisfactory. It is not too late, however, to start it. In doing so, gradual approach is appropriate because sudden change may cause unnecessary confusion. At the same time, enhancing transparency and accountability of the public sector should be carried out at the same time.

5. Summary and Conclusion

As was indicated, it is generally acknowledged that Korea's rapid growth was based on a government-led, "unbalanced" growth model, where resources were concentrated on a few targeted leading sectors (export industries and heavy and chemical industries) at the beginning stages of development, while other sectors were "sacrificed." In other words, all of available policy tools including monetary, fiscal, and regulatory were utilized to boost those sectors and attain the target growth rate ultimately.

If this is true, we naturally would expect that the size of Korea's public sector (budget and tax system) to be very big. In this paper, we show that this is not the case. In Korea, the tax burden ratio has been low and budget size has been small.

However, we cannot merely conclude that the government's role in economic development has been small due to these reasons. First of all, it should be pointed out that the above argument only considers the relative share of expenditures and tax burden, and does not measure their actual impact. In other words, the real effect of fiscal policy on Korea's economic growth can be greater than this analysis suggests.

Next, it should also be noted that almost all government activity, not just expenditure, has been aimed at economic development. It can even be argued that providing proper national security while placing a smaller than average tax burden actually helps the private sector to concentrate on achieving high growth. Finally, Korea's government has supported industries to promote economic growth through other measures other than ordinary government expenditures such as tax expenditure (tax incentives) and financial subsidies (credit rationing or policy loans).

It was shown in this paper that Korea's tax system, which has undergone many reforms, still has room for further improvement regarding the provision of funds for public goods, efficiency, equity, and simplicity. Although it did contribute to Korea's rapid growth, its scope of contribution is limited. This calls for further reform of Korea's tax system.

What can we learn from Korea's experiences discussed so far and what could Uzbekistan adopt? It is not easy to identify them because Uzbekistan's economic environments as well as other characteristics may differ from Korea's 45 years ago. In terms of public finance, however, we were able to make some policy suggestions based on the Korea's experiences. They are as follows: Maintaining fiscal balance, maintaining budget size and tax burden ratio at the current level, streamlining the expenditure structure with particular emphasis on SOC expenditure and reforming welfare programs, streamlining the tax system and tax administration, cautious but active use of tax incentives particularly in the areas of FDI and SME's, and the reduction of the government intervention. These may not include every policy suggestion, but definitely includes the major ones.

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<Table A1> Individual Income Tax Brackets (1995)

Tax Rate	Brackets	
	Before	Revised
10%	~ 10 million won	~ 10 million won
20%	10 ~ 30	10 ~ 40
30%	30 ~ 60	40 ~ 80
40%	60 ~	80 ~

<Table A2> Corporation Tax Rate (1995)

Tax Year	Tax Rate (private corporation)
1995	income $\leq$ 100 million won: 18% (19.35%) income $>$ 100 million won: 30% (31.50%)
1996	income $\leq$ 100 million won: 16% (17.20%) income $>$ 100 million won: 28% (30.10%)

<TableA3> Changes in the Effective Marginal Tax Rate (All Assets)

Year	Statutory Tax Rate 1) (A)	Effective Tax Rate Ⅰ 2) (B)	Effective Tax Rate Ⅱ 3) (C)	Tax Reduction Effect (A-B)	A-C	C-B
1960	.330	.300	.319	.030	.011	.019
1961	.242	215	.237	.027	.005	.022
1962	.220	.189	.216	.031	.004	.027
1963	.275	.227	.269	.048	.006	.042
1964	.330	.281	.324	.049	.006	.043
1965	.330	.284	.324	.046	.006	.040
1966	.385	.328	.377	.057	.008	.049
1967	.385	.319	.372	.066	.013	.053
1968	.495	.436	.453	.059	.042	.017
1969	.495	.434	.449	.061	.046	.015
1970	.495	.438	.454	.057	.041	.016
1971	.450	.395	.414	.055	.036	.019
1972	.400	.311	.375	.089	.025	.064
1973	.430	.369	.437	.061	-.007	.068
1974	.430	.342	.435	-.002	-.005	.003
1975	.530	.451	.543	.079	-.013	.092
1976	.530	.428	.531	.102	-.001	.103
1977	.530	.380	.517	.150	.013	.137
1978	.530	.36	.503	.164	.027	.137
1979	.530	.359	.504	.171	.026	.145
1980	.530	.383	.508	.147	.022	.125
1981	.530	.405	.530	.125	.000	.125
1982	.504	.454	.502	.050	.002	.048
1983	.437	.394	.439	.043	-.002	.045
1984	.437	.378	.393	.059	.044	.015
1985	.437	.395	.397	.042	.040	.002
1986	.437	.386	.392	.051	.045	.006
1987	.437	.397	.398	.040	.039	.001
1988	.437	.397	.403	.041	.034	.007
1989	.437	.395	.404	.042	.033	.009
1990	.437	.402	.407	.035	.031	.004

Notes: 1) Corporate tax rate × (1+inhabitant tax + defense tax rate).
2) Effective tax rate considering all tax incentives.
3) Effective tax rate considering depreciation allowance only.
Source : Kwack and Yoo, Tax Incentives and Economic Development, 1994.

Chapter 5

Strategy for Harmonization of Industrial Policy and Trade Liberalization

Chapter 5

Strategy for Harmonization of Industrial Policy and Trade Liberalization

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I. Evolution of Trade Policies and Systems in Korea

International trade is an indispensable element for explaining Korea's economic development during the past three decades, marking a remarkable accomplishment that has amazed many economists[60] and policy makers. Major events and elements of trade policies for the Korean government are summarized below.

1. Accession to the GATT and Import Protection

1-1. Korea's Accession to the GATT

The Korean government first sought to join the GATT in 1950, when it eagerly tried to be recognized as an independent state in the international community after liberation from Japan. At that time, the Korean government delegation sent to Torquay, England finished the GATT accession negotiation and signed the relevant documents. This first attempt, however, failed when the Korean government could not complete the requisite domestic ratification procedures due to the Korean War during 1950-1953.

The GATT regime underwent substantial changes to more explicitly embrace development issues during the late 1960s. The efforts to demonstrate a more forceful commitment to the interests of developing countries within the GATT system led to the adoption of the new provisions, Articles XXXVI - XXXVIII, as Part IV of the GATT. In addition, the GATT as a whole tried to be perceived as a more favorable forum for developing countries. For example, the 1964 GATT publication titled "The Role of GATT in Relation to Trade and Development" emphasized considerable legal freedom for developing countries, such as non-reciprocity, infant

60) Professor Robert Lucas, 1995 Nobel laureate in economics, wrote that "simply advising a society to 'follow the Korean model' is a little like advising an aspiring basketball player to 'follow the Michael Jordan model'". Robert E. Lucas, Jr., 'Making a Miracle', 61 Econometrica 251 (1993), at 252.

61) Robert E. Hudec, Developing Countries in the GATT Legal System (Trade Policy Research Center, 1987) 59-60.

industry protection for industrial development, and balance-of-payment protection measures.[61] These factors clearly demonstrated a strong GATT policy to expand its membership with developing countries. Moreover, in terms of the legal disciplines of the GATT, the late 1960s was probably the lowest point in the GATT's history. During the period of 1959 - 1970, the GATT dispute settlement activities had dramatically declined, becoming virtually dormant in the late 1960s.[62] Such developments created undoubtedly a more favorable environment for developing countries to consider joining the GATT. In fact, the GATT membership was the highest during the 1960s, in which 39 countries acceded.[63]

Against this favorable backdrop, the Korean government resumed its effort to accede into the GATT in 1965 when it vigorously pursued export promotion as the primary element of its economic development policy. The revision of the GATT to include Part IV to deal with developmental issues also played an important role in inducing Korea to reconsider accession into the GATT at that time. After extensive internal discussion on the potential economic benefits and costs, the Korean government finally submitted its accession application to the GATT Secretariat on 20 May 1966, and conducted the tariff negotiations with 12 contracting parties from September to 2 December 1966.

Korea officially acceded to the GATT in 1967, in accordance with Article XXXIII of the GATT.[64] More specifically, on 16 December 1966, the Council of Representatives adopted the "Report of the Working Party" for the GATT accession. After the Korean government completed the domestic ratification procedure, the "Protocol for the Accession of Korea" to the GATT entered into force on 14 April 1967. On the other hand, Korea invoked Article XXXV for non-application of GATT with respect to Cuba, Czechoslovakia, Poland, and Yugoslavia. These Article XXXV invocations were all simultaneously withdrawn in September 1971.

Korea began its formal participation as a contracting party at the Tokyo Round of multilateral trade negotiations, although it was as a minor player. Subsequently, Korea joined the four so-called 'Side Codes': Subsidies Code, Standards Code, Customs Valuation Code and Anti-Dumping Code.

Korea had never joined the sectoral agreements on bovine meat, dairy products and civil aircrafts, nor the Agreement on Import Licensing Procedures as a plurilateral agreement. Korea

62) Robert E. Hudec, The GATT Legal System and World Trade Diplomacy (2nd edn, Butterworth Legal Publishers, 1990) 235-250.

63) The statistics for the accession to the GATT by the period is as follows:

Years	1948-1949	1950s	1960s	1970s	1980s	1990-1994	Total
Number of Acceding Countries	19	17	39	9	11	33	128

The accession to the GATT was also substantially increased in the early 1990s during which the Uruguay Round negotiation had been conducted.

64) GATT, "Korea - Accession under Article XXXIII: Decision of 2 March 1967', BISD, No.15 (1968) 60.

joined the Agreement on Government Procurement during the Uruguay Round and implemented it only from 1 January 1997, while all other signatories except for Hong Kong applied it from 1 January 1996.[65)]

1-2. Import Protection under Article XVIII:B

Since its accession to the GATT in 1967, Korea had imposed various import restrictive measures in accordance with the balance-of-payment (hereinafter "BOP') exception under Article XVIII:B. In fact, it was the BOP exception that pushed the Korean government to apply for the GATT accession despite serious concerns regarding the consequences of import liberalization. As of 1988, the Korean government still maintained such measures on 358 items, including beef.

Korea began importing beef in 1976 and conceded a 20 percent bound tariff in 1979 under the GATT. In October 1984 when the price of domestic cows plummeted, the Korean government limited commercial imports of beef to the general market in order to protect domestic beef farmers, and even high-quality beef for the hotel market beginning in May 1985. Between May 1985 and August 1988, virtually no commercial imports of beef took place. Incidentally, Korea had accumulated, for the first time in its history, a trade surplus since 1986, until it was later reversed in 1990.

<Figure 5-1> Trend of Balance of Payments in Korea[66)]

65) WTO, Agreement on Government Procurement, Article XXIV:3. Hong Kong also had one more year for implementation to apply from 1 January 1997.

66) Bank of Korea, Statistics Database <http://www.bok.or.kr> (visited on 2 April 2003).

On 16 February 1988, the American Meat Institute filed a Section 301 petition and the USTR initiated a Section 301 investigation on 18 March 1988. Australia, New Zealand and the US also brought complaints against Korea to the GATT dispute settlement system and thereby three panels were separately established, although the memberships of the panels were identical. The Korean government decided to address the three panels separately because it thought it would be more advantageous to deal with complainants one-by-one, rather than confront all three counterparts simultaneously. Interestingly, the Korean government was permitted to bring a foreign private counsel to assist its oral hearings during the panel proceedings.

On the basis of the BOP Committee’s consultation and the IMF’s opinion, the panel held that the import restriction by Korea was not consistent with the GATT and could not be justified under the BOP exception of Article XVIII:B. The panel rejected the Korean government’s argument that this issue should be handled by the BOP Committee not by the dispute settlement panel.[67)]

Accordingly, the panel recommended that Korea eliminate the import measures on beef and hold consultations with Australia, New Zealand and the US to work out a timetable for the removal of import restrictions on beef that had been imposed on the basis of BOP exception. This panel report was circulated to the GATT Contracting Parties on 24 May 1989. Korea repeatedly objected to adopting the panel reports in the subsequent Council meetings held on 22-23 June, 19 July and 11 October 1989, raising serious reservations about some of the panels’ findings and conclusions. In particular, Korea argued that the panels had prejudged the results of the BOP Committee’s work by making a ruling on the compatibility of BOP restrictions before the BOP Committee could even reach a conclusion.

On the other hand, in September 1989, the USTR made a positive determination on the Section 301 investigation regarding Korea’s beef import sanctions, and subsequently announced that if there were no substantial movement toward a resolution by mid-November, a proposed retaliation list would be published. In response to this threat of Section 301 retaliation, Korea finally agreed to adopt the panel’s reports at the Council meeting on 7 November 1989, when the BOP consultation was indeed concluded. As a consequence, Korea agreed to repeal Article XVIII:B by 1 January 1990. On 21 March 1990, Korea signed a memorandum of understanding with the US on beef imports and formally exchanged the letter on 26 April 1990, which terminated the Section 301 investigation. Noting that the remaining restrictions were largely concentrated in the agricultural sector, Korea was permitted by the BOP Committee to phase-out the remaining restrictions or otherwise brings them into compliance with GATT provisions

67) The case raised an important issue of a proper jurisdictional dichotomy between panel and committees. For more detailed discussion on the institutional balance, see Frieder Roessler, “The Institutional Balance between the Judicial and the Political Organs of the WTO’, in Marco Bronckers and Reinhard Quick: New Directions in International Economic Law - Essays in Honour of John H. Jackson (The Hague: Kluwer Law International, 2000) 325. See also Dukgeun Ahn, “Linkages between International Financial and Trade Institutions - IMF, World Bank and WTO”, 34 (4) Journal of World Trade 1 (2000), at 16-23.

by 1 July 1997. However, the BOP Committee's decision on the transition period was later superseded by the Agreement on Agriculture in the Uruguay Round.

The consequence of the Korea-Beef I case legally brought the completion of Korea's liberalization of imports. Although some import restrictive measures, notably the "Import Diversification Program' to limit imports from Japan, remained in practice, a legal justification for overall import constraints was no longer available. Subsequently, by abrogating the Import Diversification Program on 30 June 1999, the Korean government abolished all the legal and practical grounds to constrain imports.

1-3. Import Diversification Program

<Table 5-1> Number of Items Subject to the Import Diversification Program

Year	Number of Items			Liberalization Rate
	CCCN 4 level	CCCN 8 level	CCCN 10 level	
1980	195			69.3
1982	209	913		76.6
1984	168	590		84.9
1986	159	414		91.5
1988			344	94.8
1990			268	96.3
1991			258	97.2
1992			258	97.7
1993			258	98.1
1994			230	98.6
1995			204	99.0
1996			162	99.3
1997			127	99.9
1998			88	99.9

*Source: Ministry of Commerce and Industry
**Note: The increase of the number of the items subject to the Import Diversification Program is due to the amendment of HS code on January 1, 1990.

Despite accession into the GATT in 1967, the Korean government maintained various import restraints primarily due to its balance-of-payment problems. The chronic foreign debt problems aggravated by the heavy chemical industry promotion policy starting from 1973 and the first oil shock in 1974 in fact strengthened import restrictions. It was only in 1977 when the total value of exports exceeded $10 billion that a serious effort to liberalize imports was undertaken. In 1978, three major import liberalization measures were implemented in May, July and September.

In May 1978, as a safeguard mechanism for major import liberalization, the Korean government effectively applied the Import Diversification Program that was first introduced concerning 7 product items in 1977. Subsequently, the Executive Order of the Trade Transaction Act was amended to include Article 21:3 that stipulated discretionary import restriction of products from countries with which Korea had a trade deficit. The legal foundation for the Import Diversification Program was later replaced with Article 19.2 of the Foreign Trade Act. Article 35.5 of the Executive Order of the Foreign Trade Act provided more specific legal support for the Programme that was employed to address country specific trade imbalances.

The Import Diversification Program basically targeted the imports from Japan. After liberation from colonial rule in 1945, Korea resumed economic relations with Japan since 1965. Bilateral trade with Japan, however, caused huge trade deficits for Korea that often intensified political tension stemming from its rooted colonial history. The Import Diversification Program was, therefore, devised from inception to address potentially too dependent trade structure on Japanese imports. When Korea experienced the largest trade deficit with Saudi Arabia in 1982, the Import Diversification Program was modified in 1983 to apply to the country with the largest trade surplus “in the past five years”. The sole aim of this amendment was to single out Japan as a potential target for the system. As a result, products from countries other than Japan had never been subject to the Import Diversification Program.

Although the Import Diversification Program began with 7 product items in 1977, it soon included 100 additional items by May 1978, and then 107 more items were added by the end of 1978. But, the problem of the Import Diversification Program was already raised when intermediary products and machinery which fell under the program were harming the competitiveness of domestic production. Accordingly, the product coverage under the Import Diversification Program was focused on final consumer products, rather than intermediary products that were used in subsequent manufacturing process. The Korean Government allowed various exceptions to the Import Diversification Program. These have been granted for production facilities, parts and components in connection with the Foreign Investors Industrial Parks; sample products for domestic production; and materials for producing exports. In addition, the Import Diversification Program also covered divergent products for which import substitution policies were undertaken. This function of the Import Diversification Program, however, was not as crucial as its role of addressing unbalanced trade deficits.

The product coverage was continuously increased until 1981 and then gradually reduced with the plan of phasing it out by June 1999. The Import Diversification Program was formally terminated when the last 16 product items including VCRs, mobile phones, colour televisions, automobiles, and camera were removed from the list.

The Japanese government had requested repeatedly the repeal of the Import Diversification Program, alleging that it violated GATT obligations particularly, Articles I, XI and XIII. Since the Korean government repealed Article XVIII:B for restrictive measures on imports in 1990[68)], the legitimacy of the Import Diversification Program under GATT obligations was indeed questionable. But, the Japanese government never brought a formal complaint to the GATT dispute settlement system regarding the program. Instead, the Japanese government relied more on political and diplomatic channels. For example, Japan raised the issue at the ministerial level.

<Table 5-2> Liberalization Schedule of the Import Diversification Program Under the IMF Program

Items to Be Liberalized (113 Items as of Dec. 18, 1997)	Due Date
25	Dec. 30, 1997
40	July 31, 1998
32	Dec. 31, 1998
16	June 30, 1999

As an effort to improve bilateral economic relations and also to cope with a new trading system established by the Uruguay Round of negotiations, the Korean government decided to reduce the number of products covered, which stood at 258 items, by half during a five year period beginning in 1994. The long term plan for the Import Diversification Program prepared in December 1993 left open for future reform in 1999 and thereafter. But, with the accession to the OECD in 1996, Korea agreed to eliminate the Import Diversification Program by the end of 1999. Negotiation for accession into the OECD took place between November 1995 and July 1996, as well as, evaluation of seven sectors and policy reviews in four areas. As one of area of policy review, the issue of trade was discussed, and the Import Diversification Program was scheduled to be phase out by the end of 1999.

68) Dukgeun Ahn, "Korea in the GATT/WTO Dispute Settlement System: Legal Battle for Economic Development", 6 *Journal of International Economic Law* 597 (2003), 603-606.

2. Experience under the WTO System

2-1. Trade Disputes

The Korean government's experience in settling trade disputes under the GATT system is fairly limited. Korea was challenged only once under Article XXIII of the GATT in 1988 and once again later pursuant to the Tokyo Round Anti-Dumping Code in 1992. In the former case, *Korea - Restrictions on Imports of Beef ("Korea - Beef I')*, however, had an enormous impact on Korea's subsequent trading system, as Article XVIII:B which covered import restrictions, was dismantled. In the latter case, *Korea - Anti-Dumping Duties on Imports of Polyacetal Resins from the US ("Korea - Polyacetal Resins')*, also set an important precedent for the inchoate Korean trade remedy system.

In 1978, Korea brought its first case as a complainant under Article XXIII against the European Communities regarding a safeguard action. This case, *EC - Article XIX Action on Imports into the U.K. of Television Sets from Korea*, did not, however, produce an actual ruling since Korea agreed with the European Communities on a voluntary export restraint arrangement and withdrew its complaint in 1979. Since the late 1980s, Korea began to participate in the GATT dispute settlement procedures as a third party. The first case as a third party was *US - Section 337 of the Tariff Act of 1930*[69], in which the European Communities brought a case

<Table 5-3> GATT Disputes Involving Korea

Case Name	Complainants	Panel Decision	Notes
As Respondent			
Korea-Restrictions on Imports of Beef	Australia, New Zealand, US	BISD 36S/202,36S/234, 36S/268 (adopted on Nov. 7, 1989)	Cases under Article XXIII
Korea-Anti-Dumping Duties on Imports of Polyacetal Resins from the US	US	BISD 40S/205 (adopted on April 27, 1993)	Case under the Tokyo Round Anti-dumping Code
As Complainant			
EC - Article XIX Action on Imports into the U.K. of Television Sets from Korea	Korea	None (Settled)	Cases under Article XXIII

69) GATT, BISD, No.36 (1990) 345, adopted 7 November 1989.

against the US concerning a discriminatory patent protection mechanism. In that case, Canada, Japan and Switzerland also joined as third parties. When the US intellectual property system was challenged in the GATT dispute settlement system, the Korean government seemed determined to exercise its third party rights because it came right after Korea was targeted under Section 301 for ineffectively protecting US intellectual property rights.[70] The second case was EEC - Regulation on Imports of Parts and Components[71] in which Japan challenged the European Communities' anti-circumvention duties on certain manufactured products. In this case, Korea was a third party along with Australia, Canada, Hong Kong, Singapore and the US.

Furthermore, Korean government officials also occasionally contributed to panel works for GATT dispute settlements. In 1973, Mr. Eun Tak Lee was elected as one of the four panelists in the *UK - Import Restrictions on Cotton Textiles* case. Mr. Ki-Choo Lee later worked as a panelist for *EC - Refunds on Exports of Sugarand EEC - UK Application of EEC Directives to Imports of Poultry from the US*.

Under the GATT system, Japan has been perceived as "one of those countries that leaned toward pragmatism as opposed to other countries, notably the US, that favoured legalism". Obviously, Korea was even more pragmatic. It tried to avoid formal dispute settlement or litigation as much as possible.

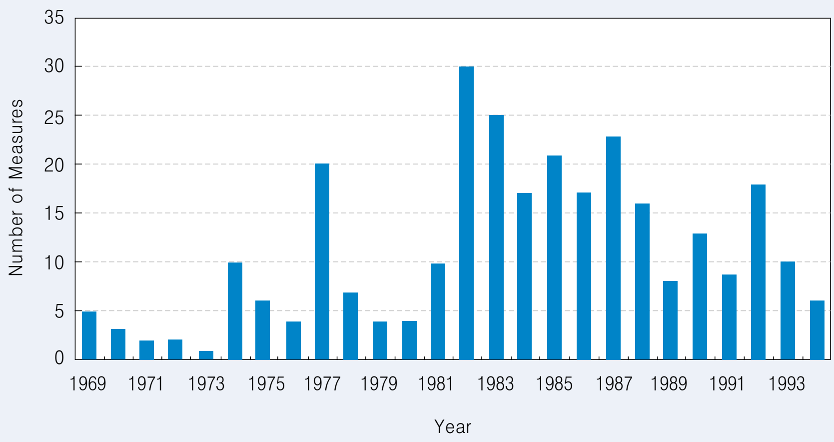
The fact that Korea rarely utilized the GATT dispute settlement system, however, should not be misunderstood to imply that Korea had experienced little difficulty dealing with foreign trade barriers under the GATT system. As illustrated in Figure 2, exports from Korea during the GATT era routinely faced various trade restrictive measures by other GATT contracting parties, particularly the US, the European Communities, Canada and Australia. From 1960 to 1994, at least 291 foreign trade remedy measures against Korean exports were reported, about 94% of them imposed by the aforementioned countries. Furthermore, among 98 Section 301 cases initiated from 1975 until the end of 1994, Korea had been targeted ten times.[72]

70) The section 301 investigation was terminated on 14 August 1986 when the US government concluded an agreement with Korea that would dramatically improve protection of intellectual property rights. US Fed. Reg. 29445, 14 August 1986.

71) GATT, BISD, No.37 (1991) 132, adopted 16 May 1990.

72) These cases include: Thrown Silk Agreement with Japan (301_12), Insurance (301_20), Non-Rubber Footwear Import Restrictions (301_37), Steel Wire Rope Subsidies and Trademark Infringement (301_39), Insurance (301_51), Intellectual Property Rights (301_52), Cigarettes (301_64), Beef (301_65), Wine (301_67), Agricultural Market Access Restrictions (301_95). After the WTO was established in 1995, one more Section 301 case was initiated against Korea regarding Barriers to Auto Imports (301_115) in October 1997. See USTR, Section 301 Table of Cases: Initiated Cases <http://www.ustr.gov/html/act301.htm> (visited 9 April 2003).

<Figure 5-2> Trade Remedy Measures against Korean Exports (1960 - 1994)[73)]



Considering such turbulent experiences and history, the Korean government was astonishingly hesitant to utilize the GATT dispute settlement system to cope with chronic foreign trade barriers. This may be explained partly by the fact that the Korean government lacked sufficiently competent officials to deal with the legal technicality of the GATT dispute settlement system. Korea's different legal culture, which considered legal confrontation as a way of ending diplomatic or normal relations, may also have some validity in explaining Korea's significant aversion to raising complaints during the GATT period. But, it seems more importantly linked to the fact that Korea typically ran vast trade surpluses, at least in terms of trade in goods, with those major countries that had routinely imposed trade remedy measures. The substantial trade surpluses in major foreign markets generally undermined Korea's political positions in asserting its legal rights under the GATT and led to a high propensity to avoid any legal confrontation. In other words, the persistent trade imbalance seemed to play a key role in setting the overall attitude towards the legal settlement of disputes under the multilateral trading system. It also explains why Japan as a trading partner has constantly recorded huge trade surpluses against Korea, and hardly ever brought up any trade remedy measures against Korean exports, especially since the 1980s.

73) Statistics drawn from N. Han et al., Cases of Trade Disputes of the Korean Industries (Seoul: POSRI, 1999, in Korean) 37.

<Table 5-4> Trade Remedy Measures against Korean Exports by Countries[74)]

	1960s	1970-74	1975-79	1980-84	1985-89	1990-94	Total
US	1	2	8	29	39	17	96
Canada	1	2	4	12	11	3	33
EC	2	10	22	7	19	12	72
Australia	0	0	3	36	14	19	72
Japan	1	4	4	2	2	0	13
Others	0	0	0	0	0	5	5
Total	5	18	41	86	85	56	291

The Uruguay Round of negotiations crucially augmented the GATT dispute settlement system, rectifying several systemic problems by instituting, inter alia, a quasi-automatic adoption mechanism, an appellate procedure and a single unified system. Generally speaking, the new WTO dispute settlement system has so far turned out to be a very effective and reliable instrument in resolving trade disputes among member countries. As of 31 March 2003, 286 cases have been brought to the WTO dispute settlement body. Among them, 69 panel and Appellate Body reports were adopted, while 40 cases were resolved through mutually agreed solutions, and 24 cases were settled or inactive.[75)]

Under the WTO system, the Korean government became less averse to raising complaints, and has become considerably more active in asserting its rights through the dispute settlement mechanism. Incidentally, since the mid 1990s, trade balances with those major trading partners have reversed and showed substantial deficits. For example, Korea’s trade deficit with the US began to occur from 1994 and remained throughout 1997, reaching $8.5 billion in 1997. This trend was again reversed in 1998 primarily due to the financial crisis which caused imports to plummet. Although there were some differences in the magnitude of the trade imbalances, the overall trends of trade balance were very much the same with respect to other major trading partners. As of March 2003, Korea has brought seven complaints to the WTO dispute settlement system while having been challenged by 12 complaints. The details of the relevant cases are discussed below.

74) N. Han et al., Cases of Trade Disputes of the Korean Industries (Seoul: POSRI, 1999, in Korean) , 39.

75) WTO, WT/DS/OV/12, dated 7 April 2003, ii. See also Kara Leitner and Simon Lester, “WTO Dispute Settlement 1995-2002: A Statistical analysis’, 6 JIEL 251 (2003).

(1) Korea as Respondent

As of March 2003, Korea had 12 complaints on 9 distinct matters, as summarized in Table 3. It should be noted that complainants against Korea have so far been raised mostly by the US and the European Communities. The only two other complaints were filed by Australia and Canada. Since the Korean government commenced litigation of WTO cases in Korea - Taxes on Alcoholic Beverages, it seems predetermined to go all the way in the dispute settlement system, at least if contested by other members.

<Table 5-5> WTO Cases Involving Korea as Respondent

Cases Name	Complainant	Dispute Number
Korea - Measures Concerning the Testing and Inspection of Agricultural Products	US	DS3 & DS41
Korea - Measures Concerning the Shelf-Life of Products	US	DS5
Korea - Measures Concerning Bottled Water	Canada	DS20
Korea - Laws, Regulations and Practices in the Telecommunications Procurement Sector	EC	DS40
*Korea - Taxes on Alcoholic Beverages (Korea - Soju)	EC, US	DS75 & DS84
*Korea - Definitive Safeguard Measure on Imports of Certain Dairy Products (Korea - Dairy Product)	EC	DS98
*Korea - Measures Affecting Imports of Fresh, Chilled and Frozen Beef (Korea - Beef II)	US, Australia	DS161 & DS169
*Korea - Measures Affecting Government Procurement	US	DS163
Korea - Measures Affecting Trade in Commercial Vessels	EC	DS273
Korea - Anti-dumping Duties on Imports of Certain Paper from Indonesia	Indonesia	DS312

* Cases for which panel reports were issued.

1. Settlement by Consultation: Not Yet Ready to Litigate

Korea was a respondent in some of the very early cases in the WTO dispute settlement, which concerned somewhat unfamiliar obligations under the SPS and TBT Agreements. The US made a consultation request against Korea on 6 April 1995 (DS3) and basically on the same matter again on 24 May 1996 (DS41). Both cases were suspended because the US did not take additional steps.

On 5 May 1995, the US made a consultation request regarding the regulation on the shelf-life of products (DS5). This case was settled with a mutually acceptable solution. The Canadian request for consultation regarding the Korea's regulation on the shelf-life and disinfection treatment of bottled water was also settled with a mutually satisfactory solution (DS20). These four complaints were based on the SPS and TBT Agreements in addition to the GATT and could be settled promptly.

On 9 May 1996, the European Communities requested consultation, alleging that the procurement practices in Korea's telecommunications sector were discriminatory against foreign suppliers, and that the bilateral agreement with the US was preferential (DS40). The parties also agreed on a mutually satisfactory solution during the consultation.

The Korean government basically tried to settle the first five complaints, rather than actually litigate the cases. This is partly because the merits of the cases were relatively clear and partly because the economic stakes at issue were not substantial. In addition, the Korean government was not sufficiently prepared to handle the newly instituted WTO dispute settlement system in regards to the procedural aspect, as well as, being unfamiliar with the legal issues concerning the SPS and TBT Agreements in the substantive aspect.

2. Full Litigation: Fight to the End

The very first case in which Korea went through the whole WTO dispute settlement procedure was the *Korea - Taxes on Alcoholic Beverages ("Korea - Soju')* case (DS75 and DS84). The European Communities and the US contended that the Korean liquor tax of 100% on whisky and 35% on diluted soju were not consistent with the national treatment obligation under Article III of the GATT. Basically, this case was considered as a "revisited' *Japan - Taxes on Alcoholic Beverages ("Japan - Shochu')* case (DS8, DS10 and DS11), in which the Japanese tax system, which discriminated against imported alcoholic beverages over shochu, was found to be in violation of Article III of the GATT. As a legal strategy to distinguish this case from the *Japan-Shochu* case, the Korean government tried to inject more antitrust law principles and experts in the panel proceeding because a large price gap between *soju* and whiskey might be deemed to represent a non-competitive relationship of pertinent products in the antitrust law context.

The panel and the Appellate Body held that the Korean taxes on *soju* and whisky were discriminatory and the Dispute Settlement Body (hereinafter "DSB') adopted this ruling on 17 February 1999. The reasonable period for implementation was determined to be 11 months and two weeks, that is, from 17 February 1999 to 31 January 2000. Subsequently, Korea amended the Liquor Tax Law and the Education Tax Law to impose flat rates of 72% on liquor tax and 30% on education tax that entered into force on 1 January 2000. The DSB recommendation was successfully implemented a month earlier than the due date.

This case caught the attention of the Korean public about the role and influence of the WTO dispute settlement system. The media and newspapers closely covered every step pertaining to this case, from the consultation request to the panel proceeding and the Appellate Body ruling. It was not just because this case was the first WTO dispute settlement proceeding for Korea, but also because the popularity of the product concerned, soju, was probably incomparable to any other product in Korea. Despite objections by the general public as well as by *soju* manufacturers, the Korean government amended the tax laws to substantially increase liquor taxes on *soju*, instead of reducing the liquor tax on whisky to the original level on *soju*, in order to eliminate the WTO-illegal tax gap while minimizing the potential adverse impact on public health and consequent social costs. In 2000, the tax revenue from the liquor tax, $1.72 billion, accounted for 2.4% of the total tax revenue. The share of the tax revenue from soju increased from 17.3% in 1999 to 23.2%, whereas that from whisky was reduced from 10.8% to 8.3%. By experiencing the impact of the WTO dispute settlement decision probably at the deepest and widest level of daily life, this case played a crucial role in enhancing Korea's awareness of the WTO.

This case also contributed to allowing the procedural practice of permitting private counsels in a dispute settlement proceeding, particularly a panel proceeding. The Korean government was not yet capable of dealing with the complexity of WTO litigations, and thereby, was very eager to rely on assistance from foreign private counsel. Since the Appellate Body already ruled in favor of allowing private counsel in appellate proceedings and since the panel in the *Indonesia - Auto* case had already allowed private counsel in a preliminary ruling on 3 December 1997, the panel composed on 5 December 1997 in Korea-Soju did not oppose to the Korean government's request. After the panel was confirmed in regards to the permissibility of allowing private counsel in the *Korea - Soju* case, it has become an element of well-settled dispute settlement practices under the WTO system.

The first dispute settlement case under the Agreement on Safeguards also involved the Korean safeguard measure concerning dairy products (DS98). On 12 August 1997, the European Communities requested consultations with Korea regarding the safeguard quotas that went into effect on 7 March 1997 and was to remain in force until 28 February 2001. The panel and the Appellate Body held that the Korean safeguard measures were inconsistent with the obligations under the Agreement on Safeguards. The DSB adopted those rulings on 12 January 2000 and the reasonable implementation period was agreed to expire on 20 May 2000. Korea, through its administrative procedures, effectively lifted the safeguard measure on imports of dairy products as of 20 May 2000.

Since its inception in 1987 to 1994, the KTC had relied more on safeguard measures than on antidumping measures to address injury to domestic industries incurred by imports. During 1987-1994, the KTC engaged in 25 safeguard and 12 anti-dumping investigations that resulted in 16 safeguard and 8 antidumping response measures. After this case, however, the KTC markedly abstained from using safeguard measures, but it substantially increased anti-dumping actions. For example, from 1997 to 2002, there were only 4 safeguard investigations and 46 anti-dumping cases. Accordingly, subsequent safeguard actions by the KTC appeared seriously disciplined by the WTO dispute settlement system. The safeguard mechanism in Korea was further elaborated with new laws and regulations on trade remedy actions.

On the other hand, it was reported that imports of dairy products at issue was reduced by about $70 million during the period in which the safeguard measure remained in force. This result, along with the outcome from the *Argentina - Safeguard Measures on Imports of Footwear ("Argentina - Footwear')* case whose proceedings were conducted almost concomitantly, raised an important systemic issue for the WTO safeguard system. In the *Korea - Definitive Safeguard Measure on Imports of Certain Dairy Products* case, the termination of illegal safeguard measures pursuant to DSB's recommendation was undertaken only 9 months prior to the original due date of the measures. In the *Argentina - Footwear* case, the implementation of DSB's recommendation by repealing the safeguard measure coincided with the original due date of the measure. Thus, the experience from these early safeguard cases raised an imminent need to consider a more expeditious or accelerated dispute settlement procedures.

On 1 February 1999, the US requested consultations with Korea in respect to a dual retail system for beef ("*Korea - Beef II*'; DS161). On 13 April 1999, Australia also requested consultations on the same basis (DS169). On 10 January 2001, the DSB adopted the panel, and the Appellate Body reported that the Korean measures were inconsistent with WTO obligations. The concerned parties in the dispute agreed that a reasonable implementation period would be 8 months, and would thus, expire on 10 September 2001. The Korean government subsequently revised the "Management Guideline for Imported Beef' to abolish the beef import system operated by the Livestock Products Marketing Organization. In addition, on 10 September 2001, the Korean government eliminated the dual retail system for beef by entirely abolishing the "Management Guideline for Imported Beef'. Thus, Korea considered that it fully complied with the DSB's recommendation in this case.

In terms of policy implementation, the *Korea - Beef II* case made an important contribution to underline the national treatment obligation for domestic regulations and their *de facto* application. Unlike the *Korea - Soju* case that addressed relatively clear discriminative treatment through vastly different tax rates, this case set an important precedent for a much broader scope of the national treatment principle, especially dealing with a retail distribution system often convoluted by ingenious regulations.

The only dispute settlement case concerning the Agreement on Government Procurement ("GPA') to date is the *Korea - Measures Affecting Government Procurement* (DS163). On 16 February 1999, the US requested consultations regarding certain procurement practices of the Korean Airport Construction Authority ("KOACA'). The panel ultimately ruled that the KOACA was not a covered entity under Korea's Appendix I of the GPA, even if the panel noted that the conduct of the Korean government with respect to the US inquiries in the course of pertinent negotiation "[could], at best, be described as inadequate". The US did not make an appeal and the panel report was adopted on 19 June 2000. One of the important lessons from this case for the Korean government was that it revealed athe discrepancy between its organizational mechanism for governmental offices used for decision making structures and the

WTO concession practice based on the institutional “entities’ in the context of the GPA. Korea’s Government Organization Act prescribes various governmental entities that actually constitute mere positions of certain level. Moreover, the Korean government has often established a special “task force’, “group’, or “committee’ with specific mandates, whose legal foundations are obscure. This issue of how to determine the scope of covered entities in relation to a newly established governmental organization may require a more elaborate approach in the context of the GPA.

On 24 October 2000, the Committee of European Union Shipbuilders Associations filed a complaint under the trade barriers regulation (“TBR’) procedure concerning divergent financial arrangements for Korean’s shipbuilding industries. Although the Commission was mindful of the extraordinary situation in Korea that was caused by the financial crisis in 1997, it found that parts of corporate restructuring programs and taxation assistance for shipbuilding companies constituted prohibited subsidies within the scope of the WTO Agreement on Subsidies and Countervailing Measures (“SCM Agreement’). Subsequent to the affirmative determination of the TBR procedure, the two parties had two rounds of bilateral negotiations in August and September 2002. On 21 October 2002, the European Communities made a formal request for a consultation with Korea under the WTO dispute settlement system on various corporate restructuring measures for the shipbuilding industry, alleging that they constituted prohibited subsidies under the SCM Agreement.

This case was merely the beginning of a much more controversial trade conflict in regards to the corporate restructuring programs undertaken by the Korean government as part of the IMF program to overcome the financial crisis. On 25 July 2002, the European Commission initiated a countervailing investigation on Korea’s semiconductor producers, alleging that the governmental intervention in terms of debt-for-equity swaps and debt forgiveness for pertinent companies acted as illegal subsidies. Apart from the EC’s action against the Korean government, the US had also closely monitored the Korean government’s roles in financial and corporate restructuring programs. Concerning various aspects of corporate restructuring programs for Korean semiconductor manufacturers, the US authorities initiated a countervailing investigation in November 2002 that ended up with a preliminary determination for countervailing duties up to 57.73%. As of 21 March, 2003, it was reported that the European Commission would also make a preliminary countervailing determination of 30-35% on basically the identical matter. These concomitant actions in the two major markets, if sustained in the final determinations, would risk the whole fate of the third largest semiconductor producer in the world. Furthermore, the legal validity of those actions would have significant implications for many other Korean industries that experienced similar restructuring programs in the course of the IMF program during the past few years. The Korean government seems to have no other choice than resorting to the WTO dispute settlement process to vindicate the legitimacy of its systemic and structural measures adopted during the IMF program. The outcome of the WTO dispute settlement related to this dispute would certainly be an interesting and important addition to the WTO’s jurisprudence.

3. Overall Comments

Considering the experience so far as a respondent in WTO dispute settlements, the reaction by the Korean government appears to show a typical pattern as an average WTO member. For half of the complaints, Korea tried to settle the trade disputes without resorting to legal procedures. But, as it gained more experience and the WTO jurisprudence became more sophisticated, Korea has become determined to take a more legalistic approach in dealing with complaints by other members.

When engaged in a WTO legal proceeding, Korea has been in full compliance with DSB recommendations. For all three cases in which Korea was found to be inconsistent with the WTO Agreements, Korea fully implemented the DSB recommendations within the determined or agreed reasonable periods of time, even in politically loaded areas such as taxes and agriculture. It is also noted that Korea made appeals for all three cases in which the panels found some violations of its own measures. Lastly, it should also be noted that the areas challenged by other member countries are fairly diverse, ranging from SPS and TBT measures to government procurement, safeguard, domestic taxes and retailing distribution systems. This starkly contrasts the cases in which Korea has brought complaints, which concentrated mainly on antidumping measures. Overall, the dispute settlement experience of Korea as a respondent in such divergent areas under the auspices of the WTO has played a significant role to enhance the public's recognition of the importance of multilateral trade norms in all aspects of economic activities and policy making.

(2) Korea as Complainant

Until 2001, Korea's complaints in the WTO dispute settlement system focused primarily on US antidumping measures. Five out of the total six complaints concerned antidumping matters and five of the complaints were against the US. Only one case was against the Philippines and the other case was concerned safeguard measures. In other words, Korea's complaints to the WTO dispute settlement system up to 2001 can be simply summarized as exclusively being concentrated on trade remedy issues, predominantly US antidumping measures.

This tendency has changed since then. In 2002, Korea was one of seven other members that filed the only WTO complaint against the U.S. safeguard actions in the steel industry. In 2003, Korea brought complaints against the US and the European Communities concerning countervailing measures imposed on semiconductors manufactured by Hynix. After the European Communities challenged Korea for assisting the shipbuilding industry during the financial crisis, Korea followed with a suit against the European Communities' program for the shipbuilding industry under the Temporary Defense Measure. In 2004, Korea requested another consultation regarding the EC assistance program for the shipbuilding industry.

<Table 5-6> WTO Cases Involving Korea as Complainant

Cases Name	Respondent	Dispute Number
US - Imposition of Anti-Dumping Duties on Imports of Color Television Receivers from Korea	US	DS89
*US - Anti-Dumping Duty on Dynamic Random Access Memory Semiconductors (DRAMS) of One Megabit or Above from Korea (US-DRAMS)	US	DS99
*US - Anti-Dumping Measures on Stainless Steel Plate in Coils and Stainless Steel Sheet and Strip from Korea	US	DS179
*US - Definitive Safeguard Measures on Imports of Circular Welded Carbon Quality Line Pipe from Korea (US-Line Pipe)	US	DS202
Philippines - Anti-Dumping Measures regarding Polypropylene Resins from Korea	Philippines	DS215
*US - Continued Dumping and Subsidy Offset Act of 2000	US	DS217
*US - Definitive Safeguard Measures on Imports of Certain Steel Products	US	DS251
US - Countervailing Duty Investigation on Dynamic Random Access Memory Semiconductors (DRAMS) from Korea	US	DS296
European Communities - Countervailing Measures on Dynamic Random Access Memory Chips from Korea	EC	DS299
European Communities - Measures Affecting Trade in Commercial Vessels	EC	DS301
European Communities - Aid for Commercial Vessels	EC	DS307
Japan - Import Quotas on Dried Laver and Seasoned Laver	Japan	DS323

* Cases for which panel reports were issued.

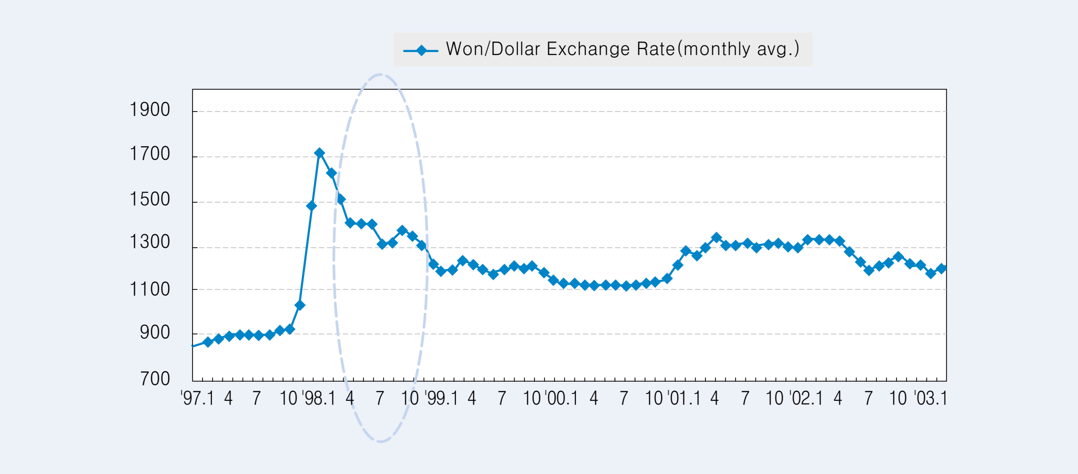
While Korea had been challenged in the WTO dispute settlement system from a very early period[76], Korea appeared quite hesitant to bring complaints against other WTO member countries. It was only in July 1997 that Korea began to use the WTO dispute settlement system to file complainants. The first WTO case Korea brought to the DSB was in respect to US antidumping duties on Samsung color television receivers. On 10 July 1997, Korea requested a

76) In 1995, three consultation requests were brought against Korea. The first two requests for Korea - Measures Concerning the Testing and Inspection of Agricultural Products (DS3) and Korea - Measures Concerning the Self-Life of Products (DS5) were made on April 6 and May 5, 1995.

consultation, alleging that the US had maintained an anti-dumping duty order for the past 12 years despite the cessation of exports as well as the absence of dumping. Subsequently, in response to the US preliminary determination of 19 December 1997 to revoke the anti-dumping duty order, Korea withdrew its request for a panel. On 27 August 1998, the US made a final determination to revoke the anti-dumping duty order which had been imposed on Samsung color television receivers since 1984. At the DSB meeting on 22 September 1998, Korea announced that it definitively withdrew the request for a panel because the imposition of anti-dumping duties had been revoked.

For a similar case regarding anti-dumping duty orders on DRAMS, however, the US did not readily revoke the orders and, on 6 November 1997, Korea requested the establishment of a panel. The DSB established a panel at its meeting on 16 January 1998. On 19 March 1998, the Director-General completed the panel composition, and subsequently Korea's first panel proceeding as a complainant began. The Panel found the measures at issue to be in violation of Article 11.2 of the WTO Anti-dumping Agreement. The US did not make an appeal and the DSB adopted the panel report on 19 March 1999.

<Figure 5-3> Won/Dollar Exchange Rate Trends[77)]



Incidentally, this first "win' as a complainant in *US - DRAMS* came just 11 days after Korea lost its first WTO litigation as a respondent in *Korea - Soju*. This somewhat fortunate timing of winning a WTO case contributed to alleviating the general concern and resistance of the Korean public about the fairness and objectivity of the WTO dispute settlement system. The two parties agreed on an implementation period of 8 months, expiring on 19 November 1999. At the DSB

77) Bank of Korea, Principal Economic Indicators (March 2003). See also <http://www.bok.or.kr> (visited 25 March 2003).

meeting on 27 January 2000, the US stated that it had implemented the DSB recommendations by amending the pertinent Department of Commerce (“DOC’) regulation, more specifically, by deleting the “not likely’ standard and incorporating the “necessary’ standard of the WTO Antidumping Agreement. The DOC, however, issued a revised “Final Results of Re-determination’ in the third administrative review on 4 November 1999, concluding that, because a resumption of dumping was likely, it was necessary to leave the antidumping order in place. On 6 April 2000, Korea requested the referral of this matter to the original panel pursuant to Article 21.5 of the DSU and the European Communities reserved its third-party right. On 19 September 2000, Korea requested the panel to suspend its work and, on 20 October 2000, the parties notified the DSB of a mutually satisfactory solution to the matter, involving the revocation of the anti-dumping order at issue as the result of a five-year “sunset’ review by the DOC.

This case was the first case ever in which Korea won a favorable panel decision since entering the GATT/WTO. Although it took one and half more years for the US to satisfactorily comply with the DSB recommendation after the panel report, the sheer fact of winning a WTO dispute concerning chronic trade barriers put up by major trading partners gave the Korean government confidence in the new WTO dispute settlement system. Unfortunately, however, the dismal implementation by the US after the panel proceeding compromised a relatively newcomer’s confidence in the effectiveness and fairness of the WTO dispute settlement system. In any case, US - DRAMS clearly led the Korean government to adopt a more legal approach by utilizing the WTO dispute settlement system to address foreign trade barriers in subsequent cases. In other words, the experience and confidence gained from this case clearly led the Korean government to move toward the direction of “aggressive legalism’ in handling subsequent trade disputes.

The *US - Anti-Dumping Measures on Stainless Steel Plate in Coils and Stainless Steel Sheet and Strip from Korea (“Korea-Stainless Steel’)* case dealt with two separate anti-dumping actions by the US authorities concerning stainless steel plates in coils (“plate’) and stainless steel sheets and strips in coils (“sheet’). For the antidumping case on plates, the DOC selected 1 January to 31 December 1997 as the period of investigation. The DOC issued the preliminary dumping margin of 2.77% for Korean exporters including Pohang Iron and Steel Company (“POSCO’). But, the DOC later issued the final dumping margin of 16.26%. The anti-dumping case for sheets covered 1 April 1997 through 31 March 1998 as the period of investigation. The DOC issued the preliminary dumping margin of 58.79% for Taihan steel company and 12.35% for other Korean exporters including POSCO. After allegations of miscalculation, the dumping margin for POSCO was revised to 3.92%. But, the DOC issued the final dumping margin of 58.79% for Taihan and 12.12% for other Korean exporters including POSCO. Regarding these anti-dumping measures, the Korean government requested consultations with the US on 30 July 1999 and a panel was establishment on 14 October 1999. The European Communities and Japan joined the panel proceeding as third parties. So, the panel was established on 19 November 1999 but actually composed on 24 March 2000.

The underlying economic situation for this case is remarkably aberrational. The pertinent investigation periods saw unprecedented fluctuations in the exchange rates caused by the financial crisis. As illustrated in Figure 3, the value of the Korean currency, Won, fell by half in just three months. The WTO panel found that the methodology adopted by the DOC to deal with such abnormities, including double currency conversion and the use of multiple averaging periods, were not consistent with the WTO obligations. Without appeal from the US, the DSB adopted the panel report on 1 February 2001. They had agreed on a reasonable period of 7 months, which expired on 1 September 2001. On 28 August 2001, the International Trade Administration of the DOC issued the "Notice of Amendment of Final Determinations' on the relevant anti-dumping duty order, in which the recalculation of dumping margins substantially reduced anti-dumping duties. At the DSB's meeting on 10 September 2001, the US announced that it had implemented the DSB's recommendation and Korea acknowledged its satisfactory implementation.

This case showed how vulnerable exporters might be in terms of anti-dumping actions when exchange rates fluctuate abnormally. Since calculating dumping margins allow for various price adjustments to find "ex-factory' prices but none for volatile exchange rates except for averaging, unstable exchange rates can cause serious distortions when calculating dumping margins. This systemic problem may leave exporters in developing countries that experience volatile exchange rates more exposed to additional risks of being targets of anti-dumping actions. Based on Korea's experience during the financial crisis, in which foreign exchange rates fluctuated at more than a normal or reasonable level, member countries may consider suspending antidumping actions at least within a certain range of dumping margins that reflects potential methodological errors. In other words, members may consider an increase of the current de minimis level during periods of exchange rate abnormalities.

On 13 June 2000, Korea made its fourth consultation request, again with the US, in respect to the definitive safeguard measures imposed on imports of circular welded carbon quality line pipes. The definitive safeguard measures actually imposed by the President on 11 February 2000 was much more restrictive than that recommended by the International Trade Commission ("ITC'), disproportionately harming the largest suppliers, i.e., Korean exporters. The exemption of Mexican and Canadian suppliers from the safeguard measure led them to become the largest and third largest suppliers.

Korea deemed that the US's procedures and determinations that led to the imposition of the safeguard measure, as well as the measure itself, contravened various obligations under the Agreement on Safeguards and the GATT 1994. The panel was established on 23 October 2000 and composed by the Director-General on 22 January 2001. Australia, Canada, European Communities, Japan and Mexico reserved their third party rights. In the panel report circulated on 29 October 2001, the panel concluded that the US measure was imposed in a manner inconsistent with WTO obligations. In the Appellate Body proceeding, the Korea's argument on the permissible extent of a safeguard measure was accepted, which seems to be one of the key findings for the WTO's jurisprudence on safeguard measures.

It should also be noted that this appellate proceeding was the first WTO dispute settlement litigation handled entirely by Korean government officials. It was a substantial development for Korea in terms of capacity building for carrying out WTO dispute settlements, particularly considering the previous cases in which foreign legal counsels played primary roles in WTO litigations. Moreover, when considering the fact that Korea is one of the WTO members that contributed to allowing the use of private counsel in a dispute settlement proceeding, the outcome of the US - Line Pipe appellate proceeding substantially enhanced the self-confidence and capacity of Korea's legal expertise.

When both parties agreed on a reasonable implementation period which expired on 1 September 2002, the arbitration under DSU Article 21.3 was suspended. The US government agreed to increase the inquota volume of imports to 17,500 tons and lower the safeguard tariff to 11%, with the termination date set at 1 March 2003. But, considering the original due date of the safeguard measure that was set at 24 February 2003, the practical impact of the WTO dispute settlement system was to increase the in-quota volume from 9,000 to 17,500 tons only for the period between 1 September 2002 and 24 February 2003. While the latter measure remained in place until the end of February 2003. Thus, this case again illustrated the systemic problem found in implementing safeguard disputes.

On 15 December 2000, Korea requested consultation with the Philippines concerning the dumping decision of the Tariff Commission of the Philippines on polypropylene resins. This anti-dumping order was actually the first anti-dumping measure by the Philippines against Korean exporters, since the first anti-dumping investigation against Korean electrolytic tinplates was dismissed for a lack of merit. The Tariff Commission of the Philippines imposed the provisional anti-dumping duties on polypropylene resins ranging from 4.20% to 40.53%, and the final duties at a slightly lower level. Following the consultation on 19 January 2001 under the purview of the WTO dispute settlement system, the Philippines withdrew the antidumping order on 8 November 2001 and Korea did not pursue further action in the DSB. This case is so far the only trade dispute for Korea which was elevated to the formal dispute settlement procedure as opposed to a developing country.

The fifth WTO complaint by Korea against the US was also related to anti-dumping matters. On 21 December 2000, Korea, along with Australia, Brazil, Chile, European Communities, India, Indonesia, Japan and Thailand, requested consultations with the US concerning the amendment to the Tariff Act of 1930, titled "Continued Dumping and Subsidy Offset Act of 2000' or usually referred to as the "Byrd Amendment'. By distributing the anti-dumping and countervailing duties to domestic petitioners, the Byrd Amendment aimed to create more incentives to bring trade remedy actions. As the third frequent target for anti-dumping and countervailing measures in the US market, Korean exporters were very keen on the outcome of this case.

The panel was established following requests from 9 member countries, which was later merged with a panel requested by Canada and Mexico. The panel and the Appellate Body found that the Byrd Amendment was inconsistent with the Anti-dumping and SCM Agreement. Furthermore, the panel suggested that the US bring the Byrd Amendment into compliance by repealing it. The arbitrator concluded that the "reasonable period of time" for the US should be 11 months from the date of the DSB's adoption, which set the expiration date on December 27, 2003. The US had later mutually agreed to push back the expiration date with Thailand, Australia and Indonesia, respectively, to December 27, 2004. On 15 January 2004, Brazil, Chile, the EC, India, Japan, Korea, Canada and Mexico requested DSB authorization to suspend concessions pursuant to Article 22.2 of the DSU. Article 22.6 arbitration is currently under way.

Ironically, a subsidiary company of a Korean manufacturer received a substantial "offset' disbursement under the Byrd Amendment. Zenith Electronics owned by LG Electronics received a disbursement of $24.3 million in 2001 and $9 million in 2002 from anti-dumping duties collected on Japanese television imports. The offset payment made to Zenith Electronics in 2001 was indeed more than 10% of the total disbursement of $231.2 million in 2001.[78] In 2002, the total disbursement under the Byrd Amendment was increased to $329.8 million.[79]

On 20 March 2002, Korea requested consultation with the US regarding the definitive safeguard measures on the imports of certain steel products and the related laws including Section 201 of the Trade Act of 1974 and Section 311 of the NAFTA Implementation Act. The DSB established a single panel to include complaints by other members such as the European Communities, Japan, China, Switzerland, Norway, New Zealand and Brazil. In addition to most complainants that reserved third party rights, Chinese Taipei, Cuba, Malaysia, Mexico, Thailand, Turkey and Venezuela also participated as third parties in the proceeding. On 25 July 2002, the Director-General composed the panel. Chinese Taipei later determined to become a more active participant and made an independent consultation request with the US on 1 November 2002.

Concerning this US Section 201 action, the Korean government made the first trade compensation request pursuant to Article 8 of the Agreement on Safeguards. When the US government did not agree on satisfactory compensatory arrangements, several WTO members, such as the European Communities, Japan, Norway, China, and Switzerland, notified the Council for Trade in Goods of a proposal to suspend concessions. Instead of proposing a suspension of concessions, the Korean government notified the Council for Trade in Goods of the agreement that the 90-day period set forth in Article 8.2 of the Agreement on Safeguards

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78) US Customs and Border Protection, "CDSOA FY2001 Disbursements Final', <http://www.customs.ustreas.gov/xp/cgov/import/add_cvd/> (visited 10 April 2003). On the other hand, it is noted that only two ball bearing companies, Torrington and MPB (The Timken Company), received more offset payments in gross than Zenith Electronics in 2001. Their total disbursements amount to $62.8 million and $25 million, respectively. But, the disbursement for Zenith Electronics is the second largest one in terms of individual claims, following $34.7 million offset payment for Torrington in relation to ball bearings dumping from Japan.

79) US Customs and Border Protection, "CDSOA FY2002 Disbursements Final', <http://www.customs.ustreas.gov/xp/cgov/import/add_cvd/> (visited 10 April 2003).

and Article XIX:3(a) of the GATT shall be considered to expire on 19 March 2005. This agreement to postpone potential retaliation for about three years, however, practically eradicates any real impact on balancing trade interests, since the original safeguard measure is supposed to end on 20 March 2005. In other words, the Korean government tried to avoid the possibility of actually exercising the suspension of concession against one of its major trading partners without DSB authorization, while it still maintained a political gesture that it exercised a legal authority specifically enunciated under the Agreement on Safeguards.

The panel concluded that all US safeguard measures at issue were inconsistent with at least one of the WTO obligations for safeguard measures. The Appellate Body upheld the panel's final conclusions. On December 4, 2003, the President of the US had issued a proclamation that terminated all of the safeguard measures subject to this dispute, pursuant to section 204 of the US Trade Act of 1974.

In addition to these cases already completed, Korea is currently working on several major WTO disputes that have originated from the same root causes - the government's intervention during the financial crisis. The Korean government played a significant role in overcoming the financial crisis by undertaking various economic restructuring programs that covered corporate as well as financial and exchange areas. Some of these programs were challenged by other members as being illegal subsidies under the WTO Agreement. In particular, the third largest semiconductor manufacturer in the world, Hynix, was subject to countervailing duties of 44.29% in the US market and 34.8% in the EC market. The Korean government brought the complaints against these measures. Also, in retaliation to the EC's challenge in regards to governmental assistance in the shipbuilding industry, the Korean government brought the two complaints to the WTO dispute settlement system.

As described above, Korea had major problems regarding US anti-dumping practices. In some sense, Korea's experience as a complainant in the WTO dispute settlement system almost exclusively against US anti-dumping practices until 2001 is puzzling, because during the period of 1 January 1995 to 20 June 2002, it was the European Communities that initiated the most anti-dumping investigations against export products from Korea. It actuality South Africa and India imposed the most anti-dumping measures.[80)] This seems to imply that the US market still plays an unbalanced and economically important role for Korea. Currently, Korea is actively engaged in pushing to revise the Anti-dumping Agreement in the Doha Development Agenda.

For five cases in which a dispute was settled and implemented, the major problem Korea faced was the inability to ensure prompt and effective implementation by a respondent. The implementation for the *US - DRAMS and US - Line Pipe* case was in fact not much more than

80) WTO, "Statistics on Anti-dumping', <http://www.wto.org/english/tratop_e/adp_e/adp_e.htm> (visited 9 April 2003).

<AD Actions against Korea (From 01/01/95 to 30/06/02)>

	Argentina	Australia	EC	India	South Africa	US	Others	Total
AD Initiation	9	11	21	18	13	19	54	145
AD Measures	6	4	9	13	13	11	18	74

the mere expiration of the original trade remedy measures. *US- Byrd Amendment* case created another difficult situation in which Korea had to either take retaliatory measures against a major trading partner and risk disastrous economic consequences, or abstain from exercising its WTO authority for retaliation and risk political not merely economic fallout.

This raises concerns over the effectiveness and fairness of the WTO dispute settlement system, especially since WTO litigations require sizeable financial and human resources. In particular, the lack of legal systems to represent private parties' interest along the line with Section 301 and TBR procedures would inevitably result in WTO members such as Korea being less than enthusiastic about resorting to legal activism, because government officials in charge of WTO disputes may not have an incentive to incur all those costly procedures merely win on "paper'.

2-2. Trade Consequences from the Financial Crisis

As the third major currency crisis of the 1990s, the outbreak of the Asian financial crisis in since June 1997 brought severe economic turmoil to many Asian countries, especially Indonesia, Korea and Thailand.[81] The unprecedented macroeconomic disturbances in these economies were stabilized within a relatively short period through various governmental policies as well as assistance programs by the International Monetary Fund (IMF) and other international organizations. For example, on August 23, 2001, the Korean government declared that Korea had successfully gone through the IMF program by repaying all its remaining loans.

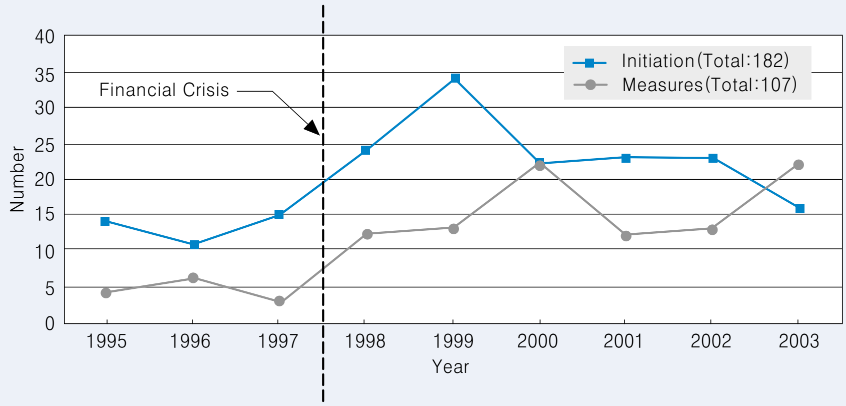
Although these countries were normally considered to have successfully overcome the macroeconomic turmoil and capital account crises, the impact of the crisis on the terms of trade left in their wake has only become more visible in recent years when related trade disputes were raised at the WTO. The systemic trend of trade remedy actions against IMF borrowers after the financial crises is discussed below. It is followed with a brief analysis on the coherence between the IMF program and the WTO disciplines.

(1) Trade Friction after the Financial Crisis

The economic situation left after the financial crisis has lead to trade problems primarily in two ways: anti-dumping and anti-subsidy. Turbulent exchange rate fluctuations rendered exports from countries suffering from the financial crisis more vulnerable to anti-dumping actions. Moreover, the government's role in the corporate and financial sector restructuring invoked anti-subsidy actions from major trading partners.

81) There were the currency crises in the European Monetary System (EMS) of 1992-1993 and the Mexican peso crisis of 1994-1995.

<Figure 5-4> AD Actions against Korea



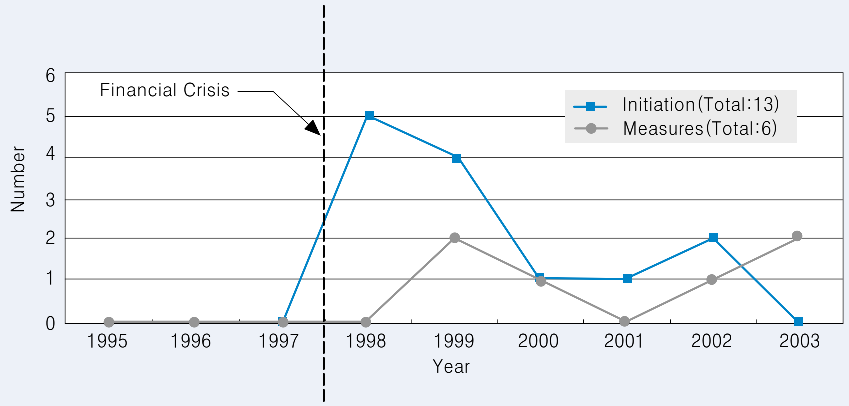
For example, as shown in Figure 4, anti-dumping actions against exports from Korea increased remarkably since late 1997. Among 182 anti-dumping investigations against Korea until 2003, 27 cases were initiated by India, followed by the US (22), the European Communities (21), China (16), Australia (15), and South Africa (13). In terms of actual anti-dumping measures, countries including India (19), South Africa (14), the US (12), the European Communities (11), China (10), and Argentina (9) frequently imposed anti-dumping measures against Korea.

Likewise, as illustrated in Figure 5, countervailing actions against Korea were also considerably increased after the financial crisis. Indeed, there was no countervailing action against exports from Korea before the financial crisis. But, in 1998 and 1999, five and four countervailing investigations were initiated, respectively. Among the total 13 countervailing investigations, the US and the European Communities initiated 6 cases each and one investigation was initiated by South Africa.[82)]

These trade frictions inevitably increased the number of disputes involving Korea under the WTO system. One of the US anti-dumping actions directly related to exchange rate fluctuations during the financial crisis was challenged by the Korean government. Then, in October 2002, subsidy disputes concerning the role of the Korean government in the aftermath of the financial crisis was initiated the EC. The complaint asserted that various assistance and measures for the shipbuilding industry undertaken as part of Korea's restructuring programs should be regarded as illegal subsidizes. This case invoked two counter-complaints by Korea against the European Communities regarding similar kinds of governmental assistance in the shipbuilding industry.

82) During the period of 1995-2003, India was subject to the most countervailing investigations (39), which was followed by Italy (13) and Korea (13).

<Figure 5-5> CVD Actions against Korea



Moreover, measures by creditors to salvage one of the major semiconductor manufacturing companies in Korea, Hynix, were countervailed both in the US and in the European Communities with duties of 44.29% and 34.8%, respectively. Korea also challenged both measures through the WTO dispute settlement system.

(2) Trade Liberalization by Korea under the IMF Program

Korea's economic liberalization policies undertaken pursuant to the mandates of the IMF program consisted mainly of three parts: foreign exchange liberalization, capital account liberalization, and trade liberalization. First, a freely flexible exchange rate was adopted by abolishing daily exchange rate bands. The Korean government implemented the first stage of foreign exchange liberalization on April 1, 1999 by liberalizing foreign currency transactions by companies and financial institutions. The second stage of implementation was initiated on January 1, 2001 by permitting foreign currency transactions by individuals. Second, capital account liberalization policies included, inter alia, eliminating restrictions for foreigners' access to domestic money market instruments and corporate bond markets, permitting foreign financial institutions to participate in mergers and acquisitions of domestic financial institutions, and increasing the ceilings on aggregate foreigners' ownership of listed Korean shares. Third, Korea's trade policy adopted further liberalization measures such as the termination of the Import Diversification Program and abolition of trade related subsidies.

Despite the substantial difficulties in addressing the falling foreign exchange reserve, the Korean government continued to liberalize trade under the IMF program. In that regard, the Korean government agreed not to make purchases under the Stand-By Arrangement with the IMF that would increase the IMF's holdings of Korea's currency subject to a repurchase quota of beyond 25%, if Korea imposes or intensifies import restrictions for balance of payments reasons at any time during the period of the Stand-By Arrangement.

Moreover, as a part of the comprehensive economic policy program for structural reforms, the Korean government agreed to set, at the time of the first full review, a timetable in line with WTO commitments to eliminate trade-related subsidies, restrictive import licensing and the import diversification program. It also committed to streamline and improve transparency of import certification procedures. On the letter of intent dated December 24, 1997, the Korean government confirmed its intent to accelerate import liberalization and eliminate trade-related subsidies. To facilitate further liberalization, it categorized three types of trade measures: trade-related subsidies, import liberalization and financial services liberalization. With regard to trade-related subsidies, the Korean government agreed to abolish three subsidies that were due to be terminated by the end of 1998 under the purview of the WTO, as well as, remove an administrative subsidy program.

Abolition of Trade-Related Subsidies

The first subsidy repealed under the IMF program was a tax concession for "Reserves for Export Losses," which compensated losses incurred by export businesses under Article 16 of the Tax Exemption and Reduction Control Law. The reserves set aside to compensate losses by a resident or a domestic corporation, which dealt foreign currency, had been counted as a loss when the taxable income fell within a certain limit (that of an amount equivalent to 1% of its foreign currency receipts or 50% of its income, whichever was less). The amount allocated in the reserves was added back to the resident's or corporation's gains in three-year instalments from the year following the year in which the reserves were counted as a loss. In the case of export businesses, this began two years following the year in which the reserves were counted as a loss. This tax concession was granted since March 3, 1973. The second subsidy abolished was a tax concession for "Reserves for Overseas Market Development" under Article 17 of the Tax Exemption and Reduction Control Law that promoted overseas market development by businesses earning foreign currency. Reserves set aside for overseas market development had been treated as a loss when calculating the taxable income in the same manner as the reserves for export losses. This tax benefit was maintained since July 31, 1969. The third subsidy eliminated was a tax concession for "Tax Credit for Investment in Facilities" to encourage investment in facilities for small and medium enterprises or to develop technology and manpower under the Tax Exemption and Reduction Control Law. Under this tax program, various tax credits were provided for investment in facilities for small and medium enterprises, facilities for technology and manpower, and housing for employees. Also, tax credits were granted for businesses that relocated to a provincial region, or underwent a conversion or reorganization. This tax concession started from December 30, 1970 and subsequently expanded in 1976, 1985 and 1990. Another program was abolished by the approval of the National Assembly.

Import Liberalization: Termination of Import Diversification Program

In addition, at the end of 1997 when the Korean government reached an agreement with the IMF on economic reform programs that would receive financial support, it made a commitment to repeal the Import Diversification Program by the end of June 1999. After the Korean government reached a stand-by arrangement with the IMF in an effort to overcome the financial crisis on December 3, 1997, 11 “Letters of Intents” were exchanged to elaborate the structural reform programs in the course of restructuring and recovery process. By the Letter of Intent dated December 18, 1997, the Korean government committed to accelerate the phasing-out of the Import Diversification Program by June 1999, six months earlier than the due date committed to the WTO. Pursuant to this agreement, the Korean government removed 25 items by the end of 1997, 40 items by the end of July 1998, 32 items by the end of 1998, and finally the remaining 16 items - primarily in industrial machinery, electrical and electronic equipment, and automotive sectors - by the end of June 1999. As part of a restructuring program committed to the IMF, the Korean government successfully implemented the scheduled liberalization, as indicated in Table 2, or the complete phasing-out of the Import Diversification Program.

Financial Service Liberalization

The Korean government has a binding commitment with the WTO to liberalize its financial services market as agreed with the OECD. This commitment was announced in the WTO Financial Services Committee on January 30, 1998. On January 19, 1999, The Korean government submitted the revised services offer consistent with the OECD commitments to the WTO.

3. More Trade Liberalization: FTA Policies

Since FTA arrangements inevitably discriminate products from non-party countries, Korea whose economy heavily relies on exports was not favorable to bilateral or multilateral FTAs. This explains why Korea remained one of the last few WTO Members without any kind of FTA. This passive, if not hostile, attitude towards FTAs by the Korean government dramatically changed to one that was seeking embrace as many FTAs as possible. As summarized in Table 7 below, the Korean government has currently engaged in FTA negotiations or preliminary joint studies with more than 20 countries. In fact, the Ministry of Foreign Affairs and Trade of Korea created a new bureau composed of four subsidiary divisions to specialize in FTA related matters. In other words, the Korean government's trade policy now squarely embraces bilateral or FTA policies as much as, if not more than, multilateral policies.

The main feature of the current FTA policies of the Korean government is a so-called "simultaneous multiple FTA negotiation" strategy. In other words, Korea tries to have as many FTAs as possible at the earliest possible time. The current FTA - or FTA negotiating - partners

<Table 5-7> Progress of FTA Negotiations as of June 2005

FTA Partner	Progress
Chile	Entry into force on April 1, 2004
Singapore	Concluded April 16, 2005.
Japan	Scheduled to conclude by the end of 2005
EFTA(Switzerland, Norway, Liechtenstein, Iceland)	Scheduled to conclude by the end of 2006
ASEAN (Brunei Darussalam, Cambodia, Indonesia, Lao People's Democratic Republic, Malaysia, Myanmar, Philippines, Singapore, Thailand, Vietnam)	Scheduled to conclude by the end of 2006
Canada	Agreed to begin FTA negotiation on June 1, 2005
India	Scheduled to complete joint study for FTA by the end of 2005
Mexico	Scheduled to complete joint study for FTA by the end of 2005
MERCOSUR (Argentina, Brazil, Paraguay, Uruguay)	Beginning joint study for FTA
China	Working to begin joint study for FTA
US	Working to begin joint study for FTA
Russia	Working to begin joint study for FTA

encompass a wide variety of countries spanning from developed partners such as Japan and Canada to developing countries such as Chile and ASEAN. They also include inter-regional partners such as Chile and Mexico as well as intra-regional partners such as Japan and Singapore. This policy, in principle, aims to make up for time lost from the relatively late entry into the FTA race. This strategy also contributes to enhancing Korea's bargaining leverage since Korea can always turn to many other potential FTA partners.

Although initiation of FTA negotiations is undertaken simultaneously, FTA negotiations are normally concluded and applied in a sequential manner. Therefore, sequential conclusion and application of FTA negotiations entail different economic consequences to industry sectors depending on the order and timing of FTA arrangements. For example, the agricultural sector in Korea has gone through long and difficult industry restructuring processes with huge social and financial costs particularly after the conclusion of the Uruguay Rounds. In the sense that the current FTA negotiations with Japan raise delicate questions about how this industrial restructuring process should be modified because, unlike other FTAs, the agricultural sector appears to be one of the major beneficiaries for Korea. This problem would be alleviated if the conclusion and application of FTAs can be undertaken within a shorter period of time.

Another feature is that the Korean government is very keen to incorporate the so called "WTO plus" approach for FTA negotiations. In addition to eliminating tariffs for various products with FTA partners, Korea typically focuses on, inter alia, investment, trade in services - especially for telecommunication services, intellectual property protection, cooperation in science and technology. It implies that the Korean government is generally more willing to incorporate a broader range of liberalization policies. This change in the overall view toward trade policies may have significant implications not just on future bilateral trade liberalization but also on multilateral trade policies.

Furthermore, a very controversial issue emerged recently concerning FTA negotiations. That is how to address "internal" trade between South and North Koreas in the context of FTAs. Since internal trade between South and North Koreas has been growing, it has drawn a considerable amount of attention in recent FTA negotiations. The Korea-Singapore FTA first made a formal recognition of "internal" trade between North and South Koreas. Despite various controversial issues raised by some other countries, the arrangement under the Korea-Singapore FTA would make an important precedent for future FTA negotiations involving Korea.

II. Institutional Development To Support Trade Policies

The Uzbekistan government should furbish various institutional and legal systems that will allow the government to implement and support industrial development policies. Although the experience of the Korean government may provide valuable policy implications, it is also very important to recognize that the underlying economic circumstances, especially the world trading system, were vastly different from those faced by the Uzbekistan government. In that regard, the foremost important point is the establishment of the World Trade Organization (WTO) that has substantially strengthened the disciplines for government policies in relation to international trade. In other words, the Uzbekistan government is facing a much more complicated and rule-based trading system than the Korean government did throughout its development periods of 1970s to 1980s. Moreover, the Uzbekistan government is currently in the middle of negotiations for WTO accession. Therefore, the experiences of the Korean government in terms of trade policies should be translated in consideration of updated strategies under the WTO context.

1. Caveat for Import Substitution (versus Export Promotion) Policies

There is general tendency of trade policies, particularly at an early stage of economic development, to favor import substitution as opposed to export promotion. Import substitution policies are generally easier to implement from the government's perspective since export promotion may not be successful unless private sector competitiveness does not support government policy initiatives. Also, import substitution policies typically induce less opposition or more support from domestic industries because competition in the domestic market would be reduced, and thereby, benefit domestic companies. Often, import substitution policies are financially more desirable for a government since raising trade barriers can increase government tariff revenues whereas providing subsidies for export promotion raise government budget costs.

But, import substitution policies may induce protective trade policies by raising trade barriers for domestic industries. Once protective trade policies are implemented for a certain industry sector, the government may easily succumb to similar requests from other industry sectors. If such a chain reaction is set off, and competitiveness begins to decline, it can be very difficult to escape from this downward spiral. Therefore, export promotion policies are generally preferred to import substitution policies to enhance an economy's global competitiveness.

This is indeed what happened to the Korean economy. The Korean government initially focused its trade policies on import substitution to promote domestic production and accumulate foreign currency savings, especially dollars, to obtain other essential economic resources such as oil, steel, machinery, and so on. But, Korea quickly recognized that the domestic market was too small to absorb or consume the manufactured products. Thus, the Korean government shifted its focus on trade policies from import substitution to export promotion.

The primary objective of export promotion is to enhance the competitiveness of the domestic economy to a global standard, instead of blocking import competition for domestic markets. Import substitution can be achieved even without an upgrade in quality, but export promotion normally brings about an improvement in production quality, cost reduction or quality upgrade or both. Moreover, export promotion policies often involve various trade facilitation measures to eliminate unnecessary obstacles for trade, which leads to systemic restructuring of institutional mechanisms. Therefore, it should be emphasized that the primary direction for trade policies should be export promotion, instead of import substitution, at least in the mid and long term economic development.

In Korea, from 1962 when the Economic Development Plan was first launched, the focus of trade policies was shifted from import substitution to export promotion.

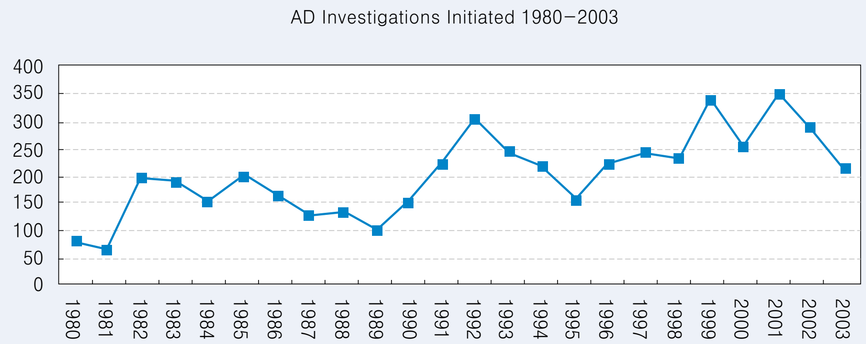
2. Improvement of a Legal System

Institutional development is imminent not only to support domestic industrial development programs but also to effectively prepare the liberalization of markets through WTO accession. Institutional development should be undertaken in two dimensions: 1) preparation and elaboration of the legal system and 2) organizational restructuring for trade policies.

2-1. Augmenting Trade Remedy Systems

As regards to enhancing the legal system for trade policies, trade remedy systems should be sufficiently augmented so as to protect import markets in a manner consistent with the WTO.

<Figure 5-6> AD Investigations Initiated 1980-2003



Trade remedy actions including anti-dumping, countervailing and safeguard measures are still frequently used to provide temporary protection for domestic industries that need a certain amount of time to adjusted to import competition. For example, as shown in Figure 6, anti-dumping investigations have been actively utilized by most of the countries even including developing countries in recent years.[83] The Uzbekistan government should consider developing

83) Between 1995-2004, the most frequent anti-dumping user is India that initiated 383 investigations. Following the US and European Communities, Argentina and South Africa are the fourth and fifth frequent anti-dumping users. See Cliff Stevenson and Ilaria Filippi, “Global Trade Protection Report: Update 2004” (Jan. 2005).

trade remedy systems that can actually offer WTO consistent trade protection.

In Korea, the Korea Trade Commission, a specialized institution that handles trade remedy systems was established in 1987, almost 20 years after it joined the GATT. The trade remedy regulations are still in the process of elaboration to incorporate continuous developments in FTA, WTO and dispute settlement rulings.

- Elaboration of Laws and Regulations

Pursuant to the WTO agreements, anti-dumping, countervailing and safeguard laws and regulations should be elaborated to be able to provide transparent procedural and substantive legal systems. In many developing countries, the trade remedy rules are merely the translated WTO agreements. But, they are by far short of concreteness and specificity to be actually used by pertinent government authorities, and thereby many of their measures were found to be in violation of the WTO disciplines due to a lack of transparency. Therefore, in addition to the broad language and provisions regarding the trade remedy systems, the Uzbekistan government should prepare detailed guidelines and regulations that are sufficiently concrete to be implemented.

The WTO's jurisprudence on interpretation of the Anti-dumping Agreement, Subsidy Agreement and Safeguard Agreement is already quite comprehensive. The elaborated rules and criteria found in the WTO dispute settlement system regarding the implementation of those trade remedy systems should also be examined and reflected into the administrative guidelines for administering authorities, if not in the statues or regulations.

Improving Organizational Support System for Trade Policies

In addition to elaborated legal systems, specialized institutions in charge of trade remedy investigations should be prepared as soon as possible, since the management and operation of trade remedy procedures demand substantial expertise and experiences. Many developing WTO members have difficulty in accommodating sufficiently articulated institutions to handle complex procedural and substantive requirements of WTO trade remedy systems. Moreover, reasonable institutional settings are required for WTO-consistency. In this regard, there are two models are typically adopted by WTO members: the US model that segregates the functions of calculating dumping and determining its harm and the EC model that integrates both functions into one governmental body. In the US, the dumping calculation is conducted by the Department of Commerce while harm determination is conducted by the International Trade Commission. This model was also adopted by China before it restructured the Ministry of Commerce and gave it both functions. On the other hand, the trade directorate of the European Commission is in charge of both functions. The Korea Trade Commission (KTC) also follows the EC model, although the two functions were separated in the early period of the KTC.

However, other countries such as Japan have not established any specialized institution to manage trade remedy systems. In other words, the trade remedy procedures are handled by ad hoc groups comprised of relevant government officials from various ministries. This model is, however, not strongly recommended for the Uzbekistan government, because the major drawback of having ad hoc groups is the difficulty found in gathering the expertise of managing the trade remedy systems. Although countries such as Japan can manage trade remedy systems with ad hoc groups since it has rarely invoked trade remedy measures, the Uzbekistan government may need to rely on trade remedy systems to protect import markets for a while. So, there is a need to establish a specialized institution for trade remedy systems.

2-2. Adopting Trade Facilitation Measures

To reduce costs involved in international transactions, especially since Uzbekistan is a double land-locked country, trade facilitation measures should be adopted and improved. Most of all, the implementation of trade facilitation measures requires transparency for customs administration.

- Facilitation of Customs Procedures

Firstly, customs procedures such as the classification, valuation, and certification should be facilitated. Customs classification typically causes the implemented of arbitrary policies at the border, impeding stable trade relations. This problem still lingers even at developed country customs procedures. (Refer to Box 1. Customs Classification Dispute in the WTO) similarly, customs valuation has also been a typical area where the implementation of arbitrary and unjustifiable policies is prevalent.

The administrative benefits of for having a flat tariff system as opposed to a differentiated tariff system should be carefully considered so as to apply in broader areas. Governments of developing countries tend to emphasize the revenue from tariff revenues as an important source of government revenues. So complex differentiated tariff systems that are normally designed to maximize tariff revenues are established, in which often higher tariffs for products with more import volume are imposed with higher tariffs, although those products can be important production inputs. These differentiated systems often entail arbitrary customs procedures impeding stable trade relations. In Korea, the uniform flat tariff system was adopted in 1984 to facilitate trade.

- Simplification of Export/Import Procedures

Remaining laws and regulations for international trade, especially for exports and imports, should be simplified to mitigate administrative costs incurred from trade. Although the recent economic reform measures substantially mitigate administrative burden from international transactions, various regulatory and administrative steps need to be streamlined. In particular, the Uzbekistan government should establish administrative environments in which foreign investors can find international transactions from/to Uzbekistan comfortable or at least not disadvantageous.

- Reduction of Costs for Customs Administration and Border Measures

Costs for the administration of customs and border measures should also be reduced to minimize transaction costs incurred from international trade. Due to the geographical situation, the Uzbekistan economy is inevitably subject to high transportation costs. Thus, the cost disadvantages incurred from Uzbekistan products should be attenuated by reduced customs fees and other charges at the border.

Box 5-1. Customs Classification Dispute in the WTO: European Communities - Customs Classification Of Certain Computer Equipment[84]

This dispute concerns customs classification of certain computer equipment associated with local area networks in the European Communities ("LAN"), namely: 1) "LAN equipment," such as network or adaptor cards, along with devices such as hubs, bridges, routers, repeaters, LAN switches, and various cables and modules, and 2) "multimedia PCs [personal computers]." According to the US, during the Uruguay Round of negotiations and for a short period after its conclusion, the European Communities classified LAN equipment and PCs as automatic data processing ("ADP") machines or parts and accessories. As part of the Uruguay Round, the European Communities had set its tariff rates for ADP machines at 4.9 percent, while the accessories thereof were subject to a 4 percent duty. However, in May 1995, the European Commission adopted a regulation that classified LAN adapter cards as telecommunications apparatus, a category subject to generally higher duties, in the range of 4.6 to 7.5 percent. This regulation was adhered to by EC customs authorities, including those of the United Kingdom and Ireland. Moreover, according to the US, authorities in certain EC member states began classifying other LAN equipment as telecommunication apparatus as well. With respect to multimedia PCs, in April 1996, a United Kingdom tribunal upheld a customs administration determination classifying a certain type of PC as a television receiver, thereby subjecting those machines to a 14 percent tariff. Furthermore, in June 1997, the European Commission adopted a Regulation for the classification of personal computers as ADP machines subject to the tariffs noted above. However, those PCs with multimedia capabilities were subject to higher tariff rates of up to 14 percent.

84) WTO, WT/DS62, 67, 68/AB/R (adopted on June 22, 1998).

The US argued that these changes in classification resulted in tariff rates for the products at issue that are "less favourable" than those bound in the European Communities' GATT Schedule LXXX, in violation of GATT Article II:1. The Panel found that the European Communities violated GATT Article II:1 with respect to LAN equipment, but it rejected the U.S. claim with respect to multimedia PCs. The Appellate Body, however, reversed the Panel's finding that the concept of "legitimate expectations," drawn from the "non-violation" remedy, is relevant to the interpretation of a Schedule in the context of a violation complaint under GATT Article II. It also reversed the Panel's conclusion that the European Communities violated GATT Article II with respect to its classification of LAN equipment.

Korea is especially active in this matter as a major exporting country. It is currently leading international efforts to deepen trade facilitation initiatives.

2-3. Implementing Rules of Origin System

To properly implement various economic partnership agreements with other CIS countries while not incidentally harming domestic industries by circumventing another countries' exports, detailed rules of origin systems should be established. CIS countries maintain previous economic relationships through various sectoral and regional economic partnership agreements among themselves, in which products are imported at zero or a substantially preferential level. But, without a proper system for rules of origin, these arrangements may be subject to serious circumvention problems, particularly, by imports from China or other developing countries.

Moreover, once the economic development plan is underway, Uzbekistan's scope of regional trading partners would increase to include more non-CIS countries. For example, Korea may be a good candidate country for establishing an FTA since the industry and trade structures of the two countries can be complementary. In the case two countries agree to an FTA, rules of origin would be critical in effectively implementing the free trade arrangement.

The rules of origin system is still left to the individual country's choice. Although the WTO aims to harmonize those individual rules of origin systems through the "Agreement on Rules of Origin", such initiatives under the auspices of the WTO have not yet been established and would not be accomplished in a foreseeable future. Therefore, it is important to assess Uzbekistan's industrial situation so that the overall principles for establishing the rules of origin can be set forth - preferably for major industry sectors.

Since rules of origin are typically customized depending on industry specifics and trade structures of trading partners, it is hard to generalize the principles that can work across the sectors of the Uzbekistan economy. But, the sectors to be protected normally demand more rigorous rules of origin. Thus, for example, considering the comparative advantages of Uzbekistan’s economy in the textile and clothing sectors, the rules of origin for this sector should be more conservative than those for other sectors. In other words, the criteria setting the threshold value for the textile and clothing sectors should be higher than those of other sectors in order to sanction potential circumvention in this area.

Korea has experienced serious difficulty in handling problems related with complicated rules of origin as FTA partners have increased. Currently, issues related to the rules of origin are the most difficult technical matters for businesses as well as the Korean government for FTA policies.

3. Restructuring Government Organizations Related to Trade Policies

There is no rule about what kind of government structure works better for implementing trade policies. Different countries have adopted different governmental systems and their performances show vast differences depending on which countries are using which type of system.

Generally speaking, there are three types of governmental structures for trade policy. The most typical is to establish a ministry that has jurisdiction over both trade and industry policies. Japan's Ministry of Economy, Trade and Industry follows this model and Korea has also adopted this model. The other widely used model is a ministry that has jurisdiction over both trade and foreign affairs. Australia's Department of Foreign Affairs and Trade is the typical example. Currently, the Korean government has the Ministry of Foreign Affairs and Trade that is in charge of most of trade negotiations. The US has a very unique form of specialized institution that deals with trade policy, the US Trade Representatives (USTR). While most of the trade negotiation functions are delegated to the USTR, domestic trade policy issues are addressed by the Department of Commerce and US International Trade Commission.

Normally, the model that combines jurisdiction over trade and industry policies tends to work better for governments that try to implement industrial promotion policies closely linked to trade policies. This model is typically adopted at an initial stage of economic development. The second model is normally adopted when the focus of trade policies shifts from industrial promotion to trade negotiation.

3-1. Specific Delineation of Jurisdiction and Authority Regarding Trade Policies

- *Trade Policy Coordination Mechanism*

Organizational restructuring for trade policies requires more specific delineation of jurisdiction and authority comprised of different governmental bodies. As the scope of the WTO continues to grow, matters of trade policies often involve multiple governmental ministries that tend to have difficulty in coordinating their decisions. Furthermore, the implementation of trade policies demands ever more intricate policy coordination as the scope of trade policies have expanded vastly. And, trade policies typically raise sectoral conflicts between sectors that benefit and sectors that do not. Therefore, for more effective trade policy implementation, organizations related to the jurisdiction and authority over trade policies should be clarified. In addition, an efficient policy coordination mechanism linking different ministries should be established.

This problem of policy coordination is indeed not specific only to transition economies such as Uzbekistan, although the degree of problems may be more severe during economic reforms. For example, in Korea, until the late 1990s, policy coordination problems in terms of trade policies were very rare. With tightly planned economic development programs and strong political leadership, policy conflicts among different ministries were instantly resolved from a top-down approach. However, political democracy was enhanced and the private sector economy was expanded, room for one-sided instruction for policy conflicts were substantially reduced. At the current stage of Uzbekistan's policy regime, this policy coordination issue may not be imminent. Yet, this issue may be raised during the course of the country's impending WTO accession, when the liberalization of markets needs to be undertaken in much broader sectors.

- Decision Making Procedure for Trade Policies

When the Uzbek economy further advances its transition and economic reform measures, trade policies inevitably incorporate more private business influences as well as conflicting interests between governmental agencies. Although a country's political leadership may play a key role in the final decision making in such cases, a more institutionalized decision making procedure would enhance the legitimacy of policy decisions that often entail politically difficult and yet economically beneficial consequences.

An important element to establish a decision making procedure for trade policy matters is to prepare a mechanism that reflects more diverse economic interests. More often than not, a government is not certain about their industrial position or interests due to different opinions and conflicting requests from business sectors. Therefore, the establishment of a system to monitor diverse industry interests and take them into consideration when making policy decisions would be very useful in managing the implementation of trade policies.

Another important element in this regard is to clarify who has the final authority to make decisions, as well as, responsibility over the decision. Often, a decision making procedure would leave uncertainty in the final authority due to political risk to expose a political leader during controversial public debates related to trade policy agenda. In a sense, Korea is still struggling to address this problem properly. But, unless this issue can be addressed squarely, trade policy implementation may incur huge policy costs due to the lack of timely decision making.

The Korean government recently established the "National Economic Advisory Council" to facilitate economic policy coordination

3-2. Mechanism for Capacity Building Programs

Trade policy implementation in particular and economic policy implementation in general require efficient and effective capacity building mechanisms to deal with constantly changing global economic environments. At an early stage of development, utilization of international resources to make up insufficient domestic resources should be considered. Also, capacity building mechanisms should be incorporated as integral parts of internal systems. In Korea's case, training systems for government officials at foreign countries have turned out to be very useful especially for trade policy areas where understanding by policy makers of global economic situations is crucial.

- Need for International Cooperation

Currently, many OECD or WTO members provide various support for capacity building programs by developing countries. Although the Uzbekistan government seems to utilize some of those programs, it may try to more actively take advantage of them by making a proposal on, for example, contents, scope or size of capacity building programs.

- Building Internal Systems

It is also important to have internal mechanisms to promote continuous capacity building programs. This is not a unique issue in the area of trade policy, but an issue for all governmental organizations. Nevertheless, the need for such internal capacity building programs appears more conspicuous since the global economic environment keeps changing.

Korean government officials working above a depute director level are almost without exception educated at foreign graduate schools. In addition, there are numerous on-the-job training opportunities that are required as part of their job

III. Policy Implementation

1. Issues Relating to WTO Accession

It is imperative for the Uzbekistan government to prepare the accession to the WTO. Such preparatory works would involve various economic reform measures as well as market liberalization. Generally speaking, it would be desirable to facilitate such structural transition by gradually implementing economic reform policies that would mitigate economic and social costs to accommodate the WTO systems. At the same time, the Uzbekistan government may still take full advantage of non-WTO member status by adopting various governmental support programs to promote domestic production and industrialization. For more specific policy measures, there are several issues to be considered in the context of WTO accession negotiations as discussed below.

1-1. Article XVIII:B (Balance of Payment) Exception

GATT Article XVIII:B stipulates that government assistance by developing countries for the purpose of economic development are except. First, Section A of this provision permits developing countries, which can only support low standards of living and are in the early stages of development, to modify or withdraw a concession to promote the establishment of a particular industry. Coverage is broad for the "infant industry protection exception", to modify the existing concession for developing countries. But, when this exception is invoked, the invoking developing country should provide compensatory adjustment to other affected countries. Unless such compensation is accepted, the affected countries are free to modify or withdraw substantially equivalent concessions initially negotiated with the invoking country which has taken the action.

Second, Section B of the provision provides a "balance of payment exception". "In order to safeguard its external financial position and to ensure a level of reserves adequate for the implementation of its programme of economic development", a developing country member can "control the general level of its imports by restricting the quantity or value of merchandise permitted to be imported". As explained in Chapter 1, this provision has played a key role for the Korean government to protect its import market for more than two decades after accession to GATT in 1967. This balance of payment exception may be considered as a way to temporary safeguard of Uzbekistan's import markets. As a developing country with potential problems in the balance of payment, Article XVIII:B may be invoked to maintain various import protective measures that are deemed necessary for economic policy reasons.

However, a WTO Member cannot simply invoke this exception by self-declaration. Instead, the invocation of this exception provision should be approved by the Committee on the Balance of Payment. Moreover, its status in terms of balance of payment would be annually or regularly reviewed by the Committee on the Balance of Payment until the Committee reaches a consensus that the pertinent member is no longer eligible for the balance of payment exception.

Under the WTO system, this provision is still invoked for some developing countries, notably transition economies such as Romania, Slovak Republic and Bulgaria.[85] India maintained various import restrictive measures under this provision, but the US took this issue to the WTO dispute settlement system.[86]

Third, Section C permits safeguard measures to protect infant industries. Instead of an overall exemption, this provision allows a specific measure that places a cap on imports of the product or products concerned from increasing substantially above a normal level. Exemption was granted under this provision to Cuba, Haiti, India and Sri Lanka. Some countries including Greece, Indonesia, and Malaysia notified certain import regulations taken for development purposes under Article XVIII:C.[87] This provision, however, has not been utilized much lately since there are other trade remedy actions that are easier to invoke and achieves basically the same purposes.

1-2. Non-market Economy Status

Some WTO members maintain domestic regulations by being designated as a non-market economy, and thereby, carry out pertinent trade remedies, particularly anti-dumping, procedures. The US and the European Union are typical cases. But, other countries including Korea also use non-market economy provisions notably against China. Uzbekistan, as a transition economy, may be classified as a non-market economy. This non-market economy provision has been one of the most controversial accession negotiation agendas for China.

15. Price Comparability in Determining Subsidies and Dumping

Article VI of the GATT 1994, the Agreement on Implementation of Article VI of the General Agreement on Tariffs and Trade 1994 ("Anti-Dumping Agreement") and the SCM Agreement shall apply in proceedings involving imports of Chinese origin into a WTO Member consistent with the following:

85) WTO, WT/BOP/R/44 (Nov. 24, 1998).

86) WTO, India - Quantitative Restrictions on Imports of Agricultural, Textile and Industrial Products (WT/DS90/R, and WT/DS90/AB/R, adopted Sep. 22, 1999).

57) WTO, Analytical Index: Guide to GATT Law and Practice, 507-509 (1996).

(a) In determining price comparability under Article VI of the GATT 1994 and the Anti-Dumping Agreement, the importing WTO Member shall use either Chinese prices or costs for the industry under investigation or a methodology that is not based on a strict comparison with domestic prices or costs in China based on the following rules:

(i) If the producers under investigation can clearly show that market economy conditions prevail in the industry producing the like product with regard to the manufacture, production and sale of that product, the importing WTO Member shall use Chinese prices or costs for the industry under investigation in determining price comparability;

(ii) The importing WTO Member may use a methodology that is not based on a strict comparison with domestic prices or costs in China if the producers under investigation cannot clearly show that market economy conditions prevail in the industry producing the like product with regard to manufacture, production and sale of that product.

(b) In proceedings under Parts II, III and V of the SCM Agreement, when addressing subsidies described in Articles 14(a), 14(b), 14(c) and 14(d), relevant provisions of the SCM Agreement shall apply; however, if there are special difficulties in that application, the importing WTO Member may then use methodologies for identifying and measuring the subsidy benefit which take into account the possibility that prevailing terms and conditions in China may not always be available as appropriate benchmarks. In applying such methodologies, where practicable, the importing WTO Member should adjust such prevailing terms and conditions before considering the use of terms and conditions prevailing outside China.

(c) The importing WTO Member shall notify methodologies used in accordance with subparagraph (a) to the Committee on Anti-Dumping Practices and shall notify methodologies used in accordance with subparagraph (b) to the Committee on Subsidies and Countervailing Measures.

(d) Once China has established, under the national law of the importing WTO Member, that it is a market economy, the provisions of subparagraph (a) shall be terminated provided that the importing Member's national law contains market economy criteria as of the date of accession. In any event, the provisions of subparagraph (a)(ii) shall expire 15 years after the date of accession. In addition, should China establish, pursuant to the national law of the importing WTO Member, that market economy conditions prevail in a particular industry or sector, the non-market economy provisions of subparagraph (a) shall no longer apply to that industry or sector.

Source: WT/L/432.

As indicated in the above article (a)(ii), “if the producers under investigation cannot clearly show that market economy conditions prevail in the industry producing the like product with regard to manufacture, production and sale of that product”, importing countries can adopt their own methods of calculation instead of using domestic prices in China. This is a typical way for applying a non-market economy condition to exaggerate dumping margins. In other words, once an economy from where a product is exported is viewed as a non-market economy, its domestic price is not considered to represent the normal value. Accordingly, “constructed value” is calculated typically based on information available from competing companies in importing countries. Thus, dumping margins in cases involving non-market economy cases tend to be much higher than otherwise would be.

Therefore, a non-market economy status should not be accepted to avoid unnecessarily disadvantageous treatment in terms of anti-dumping actions. Practically, Uzbekistan’s non-market economy status would critically depend on Russia’s arrangement for accession. However, even if Russia joins the WTO as a non-market economy, this arrangement should be seriously renegotiated. China currently resorts to bilateral pressure and agreements to revoke a non-market economy status in its accession protocol.[88] On the other hand, at least in the US market, imports from NME would not be subject to countervailing challenges under their own domestic regulations.

Even in Korea, imports from China are occasionally subject to NME provisions and thereby are imposed with much higher anti-dumping duties.

1-3. Benefit under Transition Economy or Developing Countries Status

The Uzbekistan government should clarify during accession negotiations how much benefit would be guaranteed as a transition economy. Although there are special and differentiated treatment provisions in many of the WTO Agreements, this status has important implications, especially in terms off or subsidy policies and agricultural market access as well as intellectual property protection. It is not clear whether or how much special treatment Uzbekistan is eligible for under special treatment provisions for the Subsidy Agreement, even if it is recognized as transition economy. If Uzbekistan can secure the rights under the Subsidy Agreement, which that is applied from the accession date, it can formally provide export and import substitution subsidies for seven years as well as certain other actionable subsidies. For countries considered as a least-developed country, export subsidy policies may be utilized until its per capita GNP reaches $1,000. For agricultural market negotiation, the Doha negotiation tries to establish special regimes for cotton produced in less developed country Members although the specific arrangement is should be to be finalized at the end of the Doha negotiation. In other words,

88) As of July 2005, around 20 countries, including Australia, bilaterally agreed with China not to use the non-market economy provision in its WTO accession protocol.

special and differential treatment applied to render for developing countries would be important especially in regards to subsidy policies and agricultural policies. It can be also very important when it comes to the TRIPS Agreement.

In case of China's accession, for example, China explicitly agreed to eliminate all subsidy programmes falling within the scope of Article-3 of the Subsidy Agreement upon accession. The Uzbekistan government should be cautious in accepting such a commitment.

Korea could secure a developing country status during the Uruguay round negotiation, at least in terms of Agreement on Agriculture, and consequently exemption for tariffs on rice. Although the Korean government has tried again to secure a developing country status in the context of the Doha negotiation, the outcome is not clear yet.

1-4. Trade Adjustment Assistance

Lastly, the Uzbekistan government needs to consider the preparation of trade adjustment assistance (TAA) program. Market liberalization incurred by the WTO accession and undertaken as part of economic reform policies would inevitably make comparatively disadvantageous sectors marginalized. To mitigate opposition from those marginalized sectors, trade adjustment assistance programs may be considered.

TAA programs were first established in the US under the Trade Expansion Act of 1962 for the purpose of assisting workers and firms dislocated as a result of a policy that reduced barriers to foreign trade. As a result of limited eligibility and usage of the programs, criteria and benefits were expanded under title II of the Trade Act of 1974. The Omnibus Budget Reconciliation Act of 1981, reformed the program for workers as proposed by the Administration. The amendments, particularly in program eligibility and benefits, were intended to reduce program costs significantly and to shift the focus of TAA from income compensation to job training for temporary layoffs and other adjustment measures for the long-term or permanently unemployed.

But, key focus should not be placed on compensation for impacted sectors, but rather on the facilitation of industrial structural adjustment. Rationalization of compensation for aggrieved sectors often entails serious political conflict that causes unreasonable economic costs for governments to bear. Properly devised TAA programs can mitigate unnecessary economic costs resulting from trade policy measures, which would be essential in Uzbekistan's economic development. The Korean government is currently trying to get approval from the National Assembly for the first TAA regulation.

2. Government Supports for Exports

2-1. Export Financing

Box 5-2. EXIM Bank related Dispute in the WTO: Korea - Measures Affecting Trade in Commercial Vessels[89)]

This dispute concerns the following measures related to alleged subsidies provided by the Korean government to the domestic shipbuilding industry, and to capital goods more generally:

1) The Act Establishing the Export-Import Bank of Korea ("KEXIM"), as well as any decrees and other regulation, that are alleged to "specifically allow and enable" KEXIM to provide Korean exporters of capital goods with financing at preferential rates.
2) The pre-shipment loan ("PSL") and advance payment refund guarantee ("APRG") schemes established by KEXIM.
3) The granting of PSLs and APRGs on an individual basis by KEXIM to Korean shipbuilders, including Samho Heavy Industries, Daedong Shipbuilding Co., Daewoo Heavy Industry, Daewoo Shipbuilding and Marine Engineering, Hyundai Heavy Industries, Hyundai Mipo, Samsung Heavy Industries and Hanjin Heavy Industries & Construction Co.

The European Communities allege that these measures constitute prohibited subsidies under SCM Agreement Part II (Articles 3.1(a) and 3.2) and/or actionable subsidies under SCM Agreement Part III (Articles 5(c) and 6.3(c)).

The WTO Panel ruled that since the KEXIM legal regime, including the APRG program and PSL program, do not "mandate" the conferral of a "benefit," these measures "as such" are not inconsistent with SCM Agreement Articles 3.1(a) and 3.2. But, the panel concluded that certain KEXIM guarantees under the APRG and PSL program are prohibited export subsidies contrary to SCM Agreement Articles 3.1(a) and 3.2.

89) WTO, WT/DS273/R (adopted April 11, 2005).

2-2. Tax Exemption for Trade Promotion

Tax exemption for the purpose of increasing competitiveness of domestic products by reducing production costs is another typical trade policy measure. So, the Uzbekistan government may consider the reduction of tax burden or even tax exemption to promote more exports. But again, legal obligations under the WTO Subsidy Agreement should be considered for establishing tax exemption schemes.

Box 5-3. Tax Exemption Related Dispute in the WTO: US - Tax Treatment For "Foreign Sales Corporations"[90]

Complainant: EC
Respondent: U.S.
Third Parties: Barbados, Canada, Japan

This dispute concerns certain tax exemptions in the U.S. tax code. Typically, US tax laws operate on a worldwide basis. As such the US asserts the right to tax all income earned worldwide by its citizens and residents. The US also taxes any income earned by foreign corporations within US territory, but generally does not tax "foreign-source" income earned by a foreign corporation outside the US.

These general rules are altered for Foreign Sales Corporations ("FSCs"). FSCs are foreign corporations in charge of specific activities with respect to the sale or lease of goods produced in the US for export outside the US. For FSCs, certain provisions of the tax code exempt a portion of export-related foreign-source income from U.S. income tax (the main provisions are found in Sections 921-927 of the Internal Revenue Code). To determine the amount of FSC income that qualifies for the exemption, the FSC tax regime divides FSC income into two general categories: 1) foreign trade income, based on transactions involving the export of U.S. goods and 2) all other foreign source income, which includes dividends, royalties and the like. The FSC exemption applies only to certain qualifying transactions within the first category of income. Specifically, qualifying transactions of "foreign trade income" encompass the sale or lease of "export property" or the performance of services related to that sale or lease. In turn, "export property" is defined as "property manufactured or produced in the US by a person other than an FSC, sold or leased by or to an FSC for use, consumption or disposition outside the US, and of which no more than 50 per cent of its fair market value is attributable to imports." Moreover, to be classified as foreign trade income, the FSC must be managed outside the

90) WTO, WT/DS108/R and WT/DS108/AB/R (adopted March 20, 2000).

US and certain economic processes relating to the qualifying transactions must take place outside the US. Under the regime, an FSC has the option of applying any one of three methods to calculate its foreign trade income from qualifying transactions, two of which are certain "administrative pricing" rules.

The Panel found that the FSC exemptions constitute a subsidy contingent upon export performance in violation of SCM Agreement Article 3.1(a).

Korea repealed four subsidy programs including certain tax exemption programs for small and medium size enterprises when the WTO was established with much more rigorous subsidy disciplines.

2-3. Developing Free Export (Processing) Zone

Lastly, establishment of free export (processing) zones where relevant companies are strategically gathered to take advantages of positive externalities and economies of scale can be an efficient policy tool to promote an economic environment for exports. In general, this policy is WTO consistent because it does not violate any particular provision or obligation under the Subsidy Agreement. Companies within a free export zone typically benefit from infrastructures of free export zones, instead of direct government subsidy programs. This policy is also desirable in that it does not arbitrarily cause a bias in government subsidy policies to affect competitive relationship among pertinent companies.

Another advantage of this measure is to promote export activities so that various regulatory obstacles impeding exports can be highlighted and thereby eliminated more efficiently. Also, this policy can nurture strong interest groups to share similar economic concerns, which later can contribute to the formulation of more open policies and not protective schemes that would risk domestic competitiveness.

Korea actively utilized free export (processing) zones to promote export companies or activities. These programs as such have never been challenged by other trading partners throughout GATT/WTO history.

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Appendix 1

GATT Article XVIII*

Governmental Assistance to Economic Development

1. The contracting parties recognize that the attainment of the objectives of this Agreement will be facilitated by the progressive development of their economies, particularly of those contracting parties the economies of which can only support low standards of living* and are in the early stages of development.*

2. The contracting parties recognize further that it may be necessary for those contracting parties, in order to implement programmes and policies of economic development designed to raise the general standard of living of their people, to take protective or other measures affecting imports, and that such measures are justified in so far as they facilitate the attainment of the objectives of this Agreement. They agree, therefore, that those contracting parties should enjoy additional facilities to enable them (a) to maintain sufficient flexibility in their tariff structure to be able to grant the tariff protection required for the establishment of a particular industry* and (b) to apply quantitative restrictions for balance of payments purposes in a manner which takes full account of the continued high level of demand for imports likely to be generated by their programmes of economic development.

3. The contracting parties recognize finally that, with those additional facilities which are provided for in Sections A and B of this Article, the provisions of this Agreement would normally be sufficient to enable contracting parties to meet the requirements of their economic development. They agree, however, that there may be circumstances where no measure consistent with those provisions is practicable to permit a contracting party in the process of economic development to grant the governmental assistance required to promote the establishment of particular industries* with a view to raising the general standard of living of its people. Special procedures are laid down in Sections C and D of this Article to deal with those cases.

4. (a) Consequently, a contracting party, the economy of which can only support low standards of living* and is in the early stages of development,* shall be free to deviate temporarily from the provisions of the other Articles of this Agreement, as provided in Sections A, B and C of this Article.

   (b) A contracting party, the economy of which is in the process of development, but which does not come within the scope of subparagraph (a) above, may submit applications to the CONTRACTING PARTIES under Section D of this Article.

5. The contracting parties recognize that the export earnings of contracting parties, the economies of which are of the type described in paragraph 4 (a) and (b) above and which depend on exports of a small number of primary commodities, may be seriously reduced by a decline in the sale of such commodities. Accordingly, when the exports of primary commodities by such a contracting party are seriously affected by measures taken by another contracting party, it may have resort to the consultation provisions of Article XXII of this Agreement.

6. The CONTRACTING PARTIES shall review annually all measures applied pursuant to the provisions of Sections C and D of this Article.

Section A

7. (a) If a contracting party coming within the scope of paragraph 4 (a) of this Article considers it desirable, in order to promote the establishment of a particular industry* with a view to raising the general standard of living of its people, to modify or withdraw a concession included in the appropriate Schedule annexed to this Agreement, it shall notify the CONTRACTING PARTIES to this effect and enter into negotiations with any contracting party with which such concession was initially negotiated, and with any other contracting party determined by the CONTRACTING PARTIES to have a substantial interest therein. If agreement is reached between such contracting parties concerned, they shall be free to modify or withdraw concessions under the appropriate Schedules to this Agreement in order to give effect to such agreement, including any compensatory adjustments involved.

   (b) If agreement is not reached within sixty days after the notification provided for in subparagraph (a) above, the contracting party which proposes to modify or withdraw the concession may refer the matter to the CONTRACTING PARTIES which shall promptly examine it. If they find that the contracting party which proposes to modify or withdraw the concession has made every effort to reach an agreement and that the compensatory adjustment offered by it is adequate, that contracting party shall be free to modify or withdraw the concession if, at the same time, it gives effect to the compensatory adjustment. If the CONTRACTING PARTIES do not find that the compensation offered by a contracting party proposing to modify or withdraw the concession is adequate, but find that it has made every reasonable effort to offer adequate compensation, that contracting party shall be free to proceed with such modification or withdrawal. If such action is taken, any other contracting party referred to in subparagraph (a) above shall be free to modify or withdraw substantially equivalent concessions initially negotiated with the contracting party which has taken the action.*

Section B

8. The contracting parties recognize that contracting parties coming within the scope of paragraph 4 (a) of this Article tend, when they are in rapid process of development, to experience balance of payments difficulties arising mainly from efforts to expand their internal markets as well as from the instability in their terms of trade.

9. In order to safeguard its external financial position and to ensure a level of reserves adequate for the implementation of its programme of economic development, a contracting party coming within the scope of paragraph 4 (a) of this Article may, subject to the provisions of paragraphs 10 to 12, control the general level of its imports by restricting the quantity or value of merchandise permitted to be imported; Provided that the import restrictions instituted, maintained or intensified shall not exceed those necessary:

   (a) to forestall the threat of, or to stop, a serious decline in its monetary reserves, or

   (b) in the case of a contracting party with inadequate monetary reserves, to achieve a reasonable rate of increase in its reserves.

   Due regard shall be paid in either case to any special factors which may be affecting the reserves of the contracting party or its need for reserves, including, where special external credits or other resources are available to it, the need to provide for the appropriate use of such credits or resources.

10. In applying these restrictions, the contracting party may determine their incidence on imports of different products or classes of products in such a way as to give priority to the importation of those products which are more essential in the light of its policy of economic development; Provided that the restrictions are so applied as to avoid unnecessary damage to the commercial or economic interests of any other contracting party and not to prevent unreasonably the importation of any description of goods in minimum commercial quantities the exclusion of which would impair regular channels of trade; and Provided further that the restrictions are not so applied as to prevent the importation of commercial samples or to prevent compliance with patent, trade mark, copyright or similar procedures.

11. In carrying out its domestic policies, the contracting party concerned shall pay due regard to the need for restoring equilibrium in its balance of payments on a sound and lasting basis and to the desirability of assuring an economic employment of productive resources. It shall progressively relax any restrictions applied under this Section as conditions improve, maintaining them only to the extent necessary under the terms of paragraph 9 of this Article and shall eliminate them when conditions no longer justify such maintenance; Provided that no contracting party shall be required to withdraw or modify restrictions on the ground that a change in its development policy would render unnecessary the restrictions which it is applying under this Section.*

12. (a) Any contracting party applying new restrictions or raising the general level of its existing restrictions by a substantial intensification of the measures applied under this Section, shall immediately after instituting or intensifying such restrictions (or, in circumstances in which prior consultation is practicable, before doing so) consult with the CONTRACTING PARTIES as to the nature of its balance of payments difficulties, alternative corrective measures which may be available, and the possible effect of the restrictions on the economies of other contracting parties.

(b) On a date to be determined by them* the CONTRACTING PARTIES shall review all restrictions still applied under this Section on that date. Beginning two years after that date, contracting parties applying restrictions under this Section shall enter into consultations of the type provided for in subparagraph (a) above with the CONTRACTING PARTIES at intervals of approximately, but not less than, two years according to a programme to be drawn up each year by the CONTRACTING PARTIES; Provided that no consultation under this subparagraph shall take place within two years after the conclusion of a consultation of a general nature under any other provision of this paragraph.

(c) (i) If, in the course of consultations with a contracting party under subparagraph (a) or (b) of this paragraph, the CONTRACTING PARTIES find that the restrictions are not consistent with the provisions of this Section or with those of Article XIII (subject to the provisions of Article XIV), they shall indicate the nature of the inconsistency and may advise that the restrictions be suitably modified.

(ii) If, however, as a result of the consultations, the CONTRACTING PARTIES determine that the restrictions are being applied in a manner involving an inconsistency of a serious nature with the provisions of this Section or with those of Article XIII (subject to the provisions of Article XIV) and that damage to the trade of any contracting party is caused or threatened thereby, they shall so inform the contracting party applying the restrictions and shall make appropriate recommendations for securing conformity with such provisions within a specified period. If such contracting party does not comply with these recommendations within the specified period, the CONTRACTING PARTIES may release any contracting party the trade of which is adversely affected by the restrictions from such obligations under this Agreement towards the contracting party applying the restrictions as they determine to be appropriate in the circumstances.

(d) The CONTRACTING PARTIES shall invite any contracting party which is applying restrictions under this Section to enter into consultations with them at the request of any contracting party which can establish a prima facie case that the restrictions are inconsistent with the provisions of this Section or with those of Article XIII (subject to the provisions of Article-XIV) and that its trade is adversely affected thereby. However, no such invitation shall be issued unless the CONTRACTING PARTIES have ascertained that direct discussions between the contracting parties concerned have not been successful. If, as a result of the consultations with the CONTRACTING PARTIES no agreement is reached and they determine that the restrictions are being applied inconsistently with such provisions, and that damage to the trade of the contracting party initiating the procedure is caused or threatened thereby, they shall recommend the withdrawal or modification of the restrictions. If the restrictions are not withdrawn or modified within such time as the CONTRACTING PARTIES may prescribe, they may release the contracting party initiating the procedure from such obligations under this Agreement towards the contracting party applying the restrictions as they determine to be appropriate in the circumstances.

(e) If a contracting party against which action has been taken in accordance with the last sentence of subparagraph (c) (ii) or (d) of this paragraph, finds that the release of obligations authorized by the CONTRACTING PARTIES adversely affects the operation of its programme and policy of economic development, it shall be free, not later than sixty days after such action is taken, to give written notice to the Executive Secretary[91] to the Contracting Parties of its intention to withdraw from this Agreement and such withdrawal shall take effect on the sixtieth day following the day on which the notice is received by him.

(f) In proceeding under this paragraph, the CONTRACTING PARTIES shall have due regard to the factors referred to in paragraph 2 of this Article. Determinations under this paragraph shall be rendered expeditiously and, if possible, within sixty days of the initiation of the consultations.

Section C

13. If a contracting party coming within the scope of paragraph 4 (a) of this Article finds that governmental assistance is required to promote the establishment of a particular industry* with a view to raising the general standard of living of its people, but that no measure consistent with the other provisions of this Agreement is practicable to achieve that objective, it may have recourse to the provisions and procedures set out in this Section.*

14. The contracting party concerned shall notify the CONTRACTING PARTIES of the special difficulties which it meets in the achievement of the objective outlined in paragraph 13 of this Article and shall indicate the specific measure affecting imports which it proposes to introduce in order to remedy these difficulties. It shall not introduce that measure before the expiration of the time-limit laid down in paragraph 15 or 17, as the case may be, or if the measure affects imports of a product which is the subject of a

91) By the Decision of 23 March 1965, the CONTRACTING PARTIES changed the title of the head of the GATT secretariat from “Executive Secretary” to “Director-General”.

concession included in the appropriate Schedule annexed to this Agreement, unless it has secured the concurrence of the CONTRACTING PARTIES in accordance with provisions of paragraph 18; Provided that, if the industry receiving assistance has already started production, the contracting party may, after informing the CONTRACTING PARTIES, take such measures as may be necessary to prevent, during that period, imports of the product or products concerned from increasing substantially above a normal level.*

15. If, within thirty days of the notification of the measure, the CONTRACTING PARTIES do not request the contracting party concerned to consult with them,* that contracting party shall be free to deviate from the relevant provisions of the other Articles of this Agreement to the extent necessary to apply the proposed measure.

16. If it is requested by the CONTRACTING PARTIES to do so, *the contracting party concerned shall consult with them as to the purpose of the proposed measure, as to alternative measures which may be available under this Agreement, and as to the possible effect of the measure proposed on the commercial and economic interests of other contracting parties. If, as a result of such consultation, the CONTRACTING PARTIES agree that there is no measure consistent with the other provisions of this Agreement which is practicable in order to achieve the objective outlined in paragraph 13 of this Article, and concur* in the proposed measure, the contracting party concerned shall be released from its obligations under the relevant provisions of the other Articles of this Agreement to the extent necessary to apply that measure.

17. If, within ninety days after the date of the notification of the proposed measure under paragraph 14 of this Article, the CONTRACTING PARTIES have not concurred in such measure, the contracting party concerned may introduce the measure proposed after informing the CONTRACTING PARTIES.

18. If the proposed measure affects a product which is the subject of a concession included in the appropriate Schedule annexed to this Agreement, the contracting party concerned shall enter into consultations with any other contracting party with which the concession was initially negotiated, and with any other contracting party determined by the CONTRACTING PARTIES to have a substantial interest therein. The CONTRACTING PARTIES shall concur* in the measure if they agree that there is no measure consistent with the other provisions of this Agreement which is practicable in order to achieve the objective set forth in paragraph 13 of this Article, and if they are satisfied:

    (a) that agreement has been reached with such other contracting parties as a result of the consultations referred to above, or

    (b) if no such agreement has been reached within sixty days after the notification provided for in paragraph 14 has been received by the CONTRACTING PARTIES, that the contracting party having recourse to this Section has made all reasonable efforts to reach an agreement and that the interests of other contracting parties are adequately safeguarded.*

The contracting party having recourse to this Section shall thereupon be released from its obligations under the relevant provisions of the other Articles of this Agreement to the extent necessary to permit it to apply the measure.

19. If a proposed measure of the type described in paragraph 13 of this Article concerns an industry the establishment of which has in the initial period been facilitated by incidental protection afforded by restrictions imposed by the contracting party concerned for balance of payments purposes under the relevant provisions of this Agreement, that contracting party may resort to the provisions and procedures of this Section; Provided that it shall not apply the proposed measure without the concurrence* of the CONTRACTING PARTIES.*

20. Nothing in the preceding paragraphs of this Section shall authorize any deviation from the provisions of Articles I, II and XIII of this Agreement. The provisos to paragraph 10 of this Article shall also be applicable to any restriction under this Section.

21. At any time while a measure is being applied under paragraph 17 of this Article any contracting party substantially affected by it may suspend the application to the trade of the contracting party having recourse to this Section of such substantially equivalent concessions or other obligations under this Agreement the suspension of which the CONTRACTING PARTIES do not disapprove;* Provided that sixty days' notice of such suspension is given to the CONTRACTING PARTIES not later than six months after the measure has been introduced or changed substantially to the detriment of the contracting party affected. Any such contracting party shall afford adequate opportunity for consultation in accordance with the provisions of Article XXII of this Agreement.

Section D

22. A contracting party coming within the scope of subparagraph 4 (b) of this Article desiring, in the interest of the development of its economy, to introduce a measure of the type described in paragraph 13 of this Article in respect of the establishment of a particular industry* may apply to the CONTRACTING PARTIES for approval of such measure. The CONTRACTING PARTIES shall promptly consult with such contracting party and shall, in making their decision, be guided by the considerations set out in paragraph 16. If the CONTRACTING PARTIES concur* in the proposed measure the contracting party concerned shall be released from its obligations under the relevant provisions of the other Articles of this Agreement to the extent necessary to permit it to apply the measure. If the proposed measure affects a product which is the subject of a concession included in the appropriate Schedule annexed to this Agreement, the provisions of paragraph 18 shall apply.*

23. Any measure applied under this Section shall comply with the provisions of paragraph 20 of this Article.

Ad Article XVIII

The CONTRACTING PARTIES and the contracting parties concerned shall preserve the utmost secrecy in respect of matters arising under this Article.

Paragraphs 1 and 4

1. When they consider whether the economy of a contracting party "can only support low standards of living", the CONTRACTING PARTIES shall take into consideration the normal position of that economy and shall not base their determination on exceptional circumstances such as those which may result from the temporary existence of exceptionally favourable conditions for the staple export product or products of such contracting party.

2. The phrase "in the early stages of development" is not meant to apply only to contracting parties which have just started their economic development, but also to contracting parties the economies of which are undergoing a process of industrialization to correct an excessive dependence on primary production.

Paragraphs 2, 3, 7, 13 and 22

The reference to the establishment of particular industries shall apply not only to the establishment of a new industry, but also to the establishment of a new branch of production in an existing industry and to the substantial transformation of an existing industry, and to the substantial expansion of an existing industry supplying a relatively small proportion of the domestic demand. It shall also cover the reconstruction of an industry destroyed or substantially damaged as a result of hostilities or natural disasters.

Paragraph 7 (b)

A modification or withdrawal, pursuant to paragraph 7 (b), by a contracting party, other than the applicant contracting party, referred to in paragraph 7 (a), shall be made within six months of the day on which the action is taken by the applicant contracting party, and shall become effective on the thirtieth day following the day on which such modification or withdrawal has been notified to the CONTRACTING PARTIES.

Paragraph 11

The second sentence in paragraph 11 shall not be interpreted to mean that a contracting party is required to relax or remove restrictions if such relaxation or removal would thereupon produce conditions justifying the intensification or institution, respectively, of restrictions under paragraph 9 of Article XVIII.

Paragraph 12 (b)

The date referred to in paragraph 12 (b) shall be the date determined by the CONTRACTING PARTIES in accordance with the provisions of paragraph 4 (b) of Article XII of this Agreement.

Paragraphs 13 and 14

It is recognized that, before deciding on the introduction of a measure and notifying the CONTRACTING PARTIES in accordance with paragraph 14, a contracting party may need a reasonable period of time to assess the competitive position of the industry concerned.

Paragraphs 15 and 16

It is understood that the CONTRACTING PARTIES shall invite a contracting party proposing to apply a measure under Section C to consult with them pursuant to paragraph 16 if they are requested to do so by a contracting party the trade of which would be appreciably affected by the measure in question.

Paragraphs 16, 18, 19 and 22

1. It is understood that the CONTRACTING PARTIES may concur in a proposed measure subject to specific conditions or limitations. If the measure as applied does not conform to the terms of the concurrence it will to that extent be deemed a measure in which the CONTRACTING PARTIES have not concurred. In cases in which the CONTRACTING PARTIES have concurred in a measure for a specified period, the contracting party concerned, if it finds that the maintenance of the measure for a further period of time is required to achieve the objective for which the measure was originally taken, may apply to the CONTRACTING PARTIES for an extension of that period in accordance with the provisions and procedures of Section C or D, as the case may be.

2. It is expected that the CONTRACTING PARTIES will, as a rule, refrain from concurring in a measure which is likely to cause serious prejudice to exports of a commodity on which the economy of a contracting party is largely dependent.

Paragraph 18 and 22

The phrase “that the interests of other contracting parties are adequately safeguarded” is meant to provide latitude sufficient to permit consideration in each case of the most appropriate method of safeguarding those interests. The appropriate method may, for instance, take the form of an additional concession to be applied by the contracting party having recourse to Section C or D during such time as the deviation from the other Articles of the Agreement would remain in force or of the temporary suspension by any other contracting party referred to in paragraph 18 of a concession substantially equivalent to the impairment due to the introduction of the measure in question. Such contracting party would have the right to safeguard its interests through such a temporary suspension of a concession; Provided that this right will not be exercised when, in the case of a measure imposed by a contracting party coming within the scope of paragraph 4 (a), the CONTRACTING PARTIES have determined that the extent of the compensatory concession proposed was adequate.

Paragraph 19

The provisions of paragraph 19 are intended to cover the cases where an industry has been in existence beyond the "reasonable period of time" referred to in the note to paragraphs 13 and 14, and should not be so construed as to deprive a contracting party coming within the scope of paragraph 4 (a) of Article XVIII, of its right to resort to the other provisions of Section C, including paragraph 17, with regard to a newly established industry even though it has benefited from incidental protection afforded by balance of payments import restrictions.

Paragraph 21

Any measure taken pursuant to the provisions of paragraph 21 shall be withdrawn forthwith if the action taken in accordance with paragraph 17 is withdrawn or if the CONTRACTING PARTIES concur in the measure proposed after the expiration of the ninety-day time limit specified in paragraph 17.

Appendix 2

Summary Table of Ongoing Accession[92]

Country	Application	Working Party Establishe	Memorandum	First/Latest* Working Party Meeting	Number of Working Party Meetings	Goods Offer		Services Offer		Draft Working Party Report**
						initial	latest*	initial	latest*	
Afghanistan	Nov 2004	Dec 2004								
Algeria	Jun 1987	Jun 1987	Jul 1996	Apr 1998/ Feb 2005	8	Feb 2002	Jan 2005	Mar 2002	Jan 2005	Feb 2005
Andorra	Jul 1999	Oct 1997	Mar 1999	Oct 1999	1	Sep 1999		Sep 1999		
Azerbaijan	Jun 1997	Jul 1997	Apr 1999	Jun 2002/ Oct 2004	2					
Bahamas	May 2001	Jul 2001								
Belarus	Sep 1993	Oct 1993	Jan 1996	Jun 1997/ Sep 2004	6	Mar 1998	May 2004	Feb 2000	Nov 2004	Jul 2004 (FS)
Bhutan	Sep 1999	Oct 1999	Feb 2003	Nov 2004	1					
Bosnia and Herzegovina	May 1999	Jul 1999	Oct 2002	Nov 2004/ Dec 2004	2	Oct 2004		Oct 2004		
Cape Verde	Nov 1999	Jul 2000	Jul 2003	Mar 2004/ Dec 2004	2	Nov 2004		Nov 2004		Oct 2004 (FS)
Ethiopia	Jan 2003	Feb 2003								
Iraq	Sep 2004	Dec 2004								
Kazakhstan	Jan 1996	Feb 1996	Sep 1996	Mar 1997/ Nov 2004	7	Jun 1997	May 2004	Sep 1997	Jun 2004	Sep 2004 (FS)

92) In alphabetical order.

Country	Application	Working Party Establishe	Memorandum	First/Latest* Working Party Meeting	Number of Working Party Meetings	Goods Offer		Services Offer		Draft Working Party Report**
						initial	latest*	initial	latest*	
Lao People's Democratic Republic	Jul 1997	Feb 1998	Mar 2001	Oct 2004	1					
Lebanese Republic	Jan 1999	Apr 1999	Jun 2001	Oct 2002/ Jul 2004	3	Nov 2003	Jun 2004	Nov 2003	Jun 2004	Jun 2004 (FS)
Libyan Arab Jamahiriya	Jun 2004	Jul 2004								
Montenegro	Dec 2004	Feb 2005	Mar 2005							
Russian Federation	Jun 1993	Jun 1993	Mar 1994	Jul 1995/ Apr 2005	27	Feb 1998	Feb 2001	Oct 1999	Jun 2002	Oct 2004
Samoa	Apr 1998	Jul 1998	Feb 2000	Mar 2002	1	Aug 2001		Aug 2001		Jun 2003
Saudi Arabia	Jun 1993	Jul 1993	Jul 1994	May 1996/ Jun 2004	12	Sep 1997	Jun 1999	Sep 1997	Jun 1999	Jun 2004
Serbia	Dec 2004	Feb 2005	Mar 2005							
Seychelles	May 1995	Jul 1995	Aug 1996	Feb 1997	1	Jun 1997		May 1997		Jun 1997
Sudan	Oct 1994	Oct 1994	Jan 1999	Jul 2003/ Mar 2004	2	Jul 2004	Feb 2005	Jun 2004		Sep 2004 (FS)

Country	Application	Working Party Establishe	Memorandum	First/Latest* Working Party Meeting	Number of Working Party Meetings	Goods Offer		Services Offer		Draft Working Party Report**
						initial	latest*	initial	latest*	
Tajikistan	May 2001	Jul 2001	Feb 2003	Mar 2004	1	Feb 2004		Feb 2004		Apr 2005 (FS)
Tonga	Jun 1995	Nov 1995	May 1998	Apr 2001	1	Apr 2001	Jun 2003	Apr 2001	Jun 2003	May 2004
Ukraine	Nov 1993	Dec 1993	Jul 1994	Feb 1995/ Mar 2005	14	May 1999	May 2002	Feb 1997	Jun 2004	Mar 2005
Uzbekistan	Dec 1994	Dec 1994	Oct 1998	Jul 2002/ Jun 2004	2					
Vanuatu	Jul 1995	Jul 1995	Nov 1995	Jul 1996/ Oct 1999	2	Nov 1997	Nov 1999	Nov 1997	Nov 1999	Accession Package Oct 2001
Viet Nam	Jan 1995	Jan 1995	Sep 1996	Jul 1998/ Dec 2004	9	Jan 2002	Apr 2004	Jan 2002	Apr 2004	Nov 2004
Yemen	Apr 2000	Jul 2000	Nov 2002	Nov 2004	1					

* As of the date of this document.

** Most recent Factual Summary (FS), draft Working Party Report or Elements of draft Working Party Report.

Appendix 3

Timetable of Completed Accessions

Country	1. Ecuador		2. Mongolia		3. Bulgaria		4. Kyrgyz Republic		5. Latvia	
	Date (m/y)	Time Since Memo	Date (m/y)	Time Since Memo	Date (m/y)	Time Since Memo	Date (m/y)	Time Since Memo	Date (m/y)	Time Since Memo
Application	09/92		07/ 91		09/86		02/96		11/93	
Working Party Established	10/92		10/91		02/90		04/96		12/93	
Memorandum	05/93		01/92		07/93		08/96		08/94	
1st Meeting of Working Party	07/93	2 months	06/93	1 year 5months	07/93	1 month	03/97	7 months	03/95	7 months
Draft Working Party Report	10/94	1 year 5 months	12/94	2 years 11 months	05/94	10 months	04/98	1 year 8 months	12/96	2 years 4months
Report Adopted by Working Party	07/95	2 years 2 months	06/96	4 years 5 months	09/96	2 years 2 months	07/98	1year 11 months	09/98	4 years 1month
Report Adopted by Council	07/95	2years 2 months	07/96	4 years 6 months	10/96	3 years 3 months	10/98	2 years 2 months	10/98	4 years 2 months
Membership	07/96	2 years 8 months	01/97	5 years	12/96	3 years 5 months	12/98	2 years 4 months	02/99	4 years 6 months
Total Time	**3 years 4 months**		**5 years 6 months**		**10 years 3 months**		**2 years 10 months**		**5 years 3 months**	

Country	6. Estonia		7. Jordan		8. Georgia		9. Albania		10. Croatia	
	Date (m/y)	Time Since Memo	Date (m/y)	Time Since Memo	Date (m/y)	Time Since Memo	Date (m/y)	Time Since Memo	Date (m/y)	Time Since Memo
Application	03/94		01/94		07/96		11/92		09/93	
Working Party Established	03/94		01/94		07/96		12/92		10/93	
Memorandum	03/94		10/94		07/97		01/95		06/94	
1st Meeting of Working Party	11/94	8 months	10/96	2 years	03/98	11 months	04/96	1year 3 months	04/96	1 year 10 months
Draft Working Party Report	11/98	4 years 8 months	04/99	4 years 6 months	02/99	1 year 10 months	07/99	4 years 6 months	08/98	2 years 2 months
Report Adopted by Working Party	04/99	5 years 1 month	11/99	5 years 1 month	10/99	2 years 6 months	07/00	5 years 6 months	06/00	6 years
Report Adopted by Council	05/99	5 years 2 months	12/99	5 years 2 months	10/99	2 years 6 months	07/00	5 years 6 months	07/00	6 years 1 month
Membership	11/99	5 years 8 months	04/00	5 years 6 months	06/00	3 years 2 months	09/00	5 years 8 months	11/00	6 years 5 months
Total Time	**5 years 8 months**		**6 years 4 months**		**4 years 1 month**		**7 years 10 months**		**7 years 2 months**	

Country	11. Lithuania		12. Moldova		13. China		14. Armenia		**15. FYROM**(Former Yugoslav Republic of Macedonia)	
	Date (m/y)	Time Since Memo	Date (m/y)	Time Since Memo	Date (m/y)	Time Since Memo	Date (m/y)	Time Since Memo	Date (m/y)	Time Since Memo
Application	01/94		11/93		07/86		11/93		12/94	
Working Party Established	02/94		12/93		03/87		12/93		12/94	
Memorandum	12/94		12/96		02/87		04/95		04/99	
1st Meeting of Working Party	11/95	11 months	06/97	6 months	10/87	8 months	01/96	9 months	07/00	1 year 3 months
Draft Working Party Report	06/97	2 years 6 months	07/99	2 years 7 months	12/94	7 years 10 months	03/97	1 year 11 months	05/02	2 years 11 months
Report Adopted by Working Party	10/00	5 years 10 months	12/00	4 years	09/01	14 years 9 months	11/02	6 years 7 months	09/02	3 years 5 months
Report Adopted by Council	12/00	6 years	05/01	4 years 5 months	11/01	14 years 11 months	12/02	6 years 8 months	10/02	3 years 6 months
Membership	05/01	6 years 5 months	07/01	4 years 7 months	12/01	14 years 12 months	02/03	6 years 10 months	04/03	4 years
Total Time	**7 years 5 months**		**7 years 4 months**		**15 years 5 months**		**9 years 3 months**		**8 years 3 months**	

Appendix 4

Sector Specific Commitments in Services of Members who have Acceded to the WTO

	1. Bulgaria	2. Kyrgyz Rep.	3. Latvia	4. Estonia	5. Georgia	6. Albania
Professional services	×	×	×	×	×	×
Computer and related services	×	×	×	×	×	×
Research and development services	×	×	×	×	×	
Other business services	×	×	×	×	×	×
Postal services		×			×	×
Courier services		×	×	×	×	×
Telecommunications - valued added	×	×	×	×	×	×
Telecommunications - basic	×	×	×	×	×	×
Audiovisual services		×			×	
Construction services	×	×	×	×	×	×
Distribution services	×	×	×	×	×	×
Educational services	×	×	×	×	×	×
Environmental services	×	×	×	×	×	×
Financial - insurance	×	×	×	×	×	×
Financial - banking + other financial services	×	×	×	×	×	×
Health services		×	×	×	×	×
Social services	×	×	×	×	×	
Tourism services	×	×	×	×	×	×
Recreational services	×	×	×	×	×	×
Transport services	×	×	×	×	×	×
Limitations on National Treatment	×	×	×	×	×	×

	7. Croatia	8. Moldova	9. China	10. FYROM
Professional services	x	x	x	x
Computer and related services	x	x	x	x
Research and development services	x	x		x
Other business services	x	x	x	x
Postal services		x		x
Courier services	x	x	x	x
Telecommunications - valued added	x	x	x	x
Telecommunications - basic	x	x	x	x
Audiovisual services			x	
Construction services	x	x	x	x
Distribution services	x	x	x	x
Educational services	x	x	x	x
Environmental services	x	x	x	x
Financial - insurance	x	x	x	x
Financial - banking and other financial services	x	x	x	x
Health services	x	x	x	
Social services	x			
Tourism services	x	x	x	x
Recreational services	x	x		x
Transport services	x	x	x	x
Limitations on National Treatment	x	x	x	x

Appendix 5

Status of Uzbekistan Accession Working Party

The Working Party on the accession of Uzbekistan was established on 21 December 1994. Uzbekistan submitted its Memorandum on the Foreign Trade Regime in September 1998 and a first meeting of the Working Party was held in July 2002. Uzbekistan began bilateral market access negotiations with interested Members on the basis of initial offers in goods and services submitted in September 2005. The third meeting of the Working Party took place in October 2005.

Application Received	8 December 1994	PC/W/20
Working Party Established Chairperson: H.E. Mr. Hyuck Choi (Republic of Korea)	21 December 1994	PC/M/11
Memorandum	21 October 1998 27 October 1998 26 October 1998	WT/ACC/UZB/2 Add.1 Add.2 & Corr.1
Questions and Replies	12 October 1999 27 April 2000 19 January 2001	WT/ACC/UZB/3 Add.2 Add.3
Meetings of the Working Party	17 July 2002 29 June 2004 14 October 2005	3 formal meetings
Other Documentation		
(a) Additional Questions & Replies	20 April 2001 16 September 2003 26 November 2003 1 June 2004 21 April 2005	WT/ACC/UZB/4 WT/ACC/UZB/8 WT/ACC/UZB/9 WT/ACC/UZB/10 WT/ACC/UZB/13 & Add.2
(b) Agriculture (WT/ACC/4)	1 June 2004 21 September 2005	WT/ACC/SPEC/UZB/1 Add.1
(c) Services (WT/ACC/5)		
(d) SPS/TBT (WT/ACC/8)	16 September 2003 2 June 2005 16 September 2003 2 June 2005	WT/ACC/UZB/5 (TBT) Rev.1 WT/ACC/UZB/6 (SPS) Rev.1

(e) TRIPS (WT/ACC/9)	16 September 2003 7 October 2005	WT/ACC/UZB/7 Rev.1
(f) Legislative Action Plan	6 July 2004 5 September 2005	WT/ACC/UZB/12 Rev.1
Market Access Negotiations		
Goods Offer	2 September 2005	WT/ACC/SPEC/UZB/2
Services Offer	7 September 2005	WT/ACC/SPEC/UZB/3
Factual Summary		
Draft Working Party Report		