

## ISSUES OF FINANCIAL SECTOR DEVELOPMENT IN THE CENTRAL ASIAN COUNTRIES

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### Abstract

This article is devoted to the consideration of the issues related to the development of the financial sector in Central Asian countries as a factor of sustainable development. In addition, the article analyzes the areas of banking system reforms in the countries of the region, the process of structural changes in the economy made through investments, problems with the improvement of the investment environment.

**Keywords:** financial sector, banking system, lending organizations, investment, national funds, structural changes, sustainable development.

### Introduction

The development of the financial sector in the countries of Central Asia is not just the result of economic growth, but also its cause. The relationship between the financial sector and economic growth has varied across the world. For example, in Scotland, Belgium, Russia, and Japan, the financial sector served to accelerate industrialization, while in England, Germany, and France, the development of industry has resulted in the financial sector development.

Currently the economic cooperation relations between Central Asian countries are developing. Such priority objectives as “Implementation of bilateral and multilateral proactive diplomacy with Central Asian countries” have been set in the Decree of the President of the Republic of Uzbekistan dated February 28, 2023 № PD-27 “On the state program for the implementation of the development strategy of New Uzbekistan for 2022-2026 years in the year of caring for people and quality education”<sup>1</sup>.

Formation of the national financial sector is an integral condition for the sustainable development of the countries of the region. The main goal is to eliminate distrust of the population and diversify the development of financial services. The rapid development and

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<sup>1</sup>Decree of the President of the Republic of Uzbekistan dated February 28, 2023 № PD-27 “On the state program for the implementation of the development strategy of New Uzbekistan for 2022-2026 years in the year of attention to people and quality education”// <https://lex.uz/docs/6396146>

expansion of lending activity, relying on the flow of foreign capital and export earnings, have promoted the introduction of a wide range of firms and households to the financial market in the initial period. However, investors do not have enough confidence in the financial and banking sector. The population prefers “traditional” ways of keeping savings, not relying on deposits. In emergencies and under force majeure circumstances people rely more on financial support from family and friends than on bank loans. In addition, despite the fact that the network of banking institutions is expanding in the regions, there are still not enough opportunities to use them in remote areas. The low level of inclusion of the financial system can cause the maintenance of inequality of incomes of the population, limited access to education and health services, as well as stagnation of human capital development.

### **Literature Review**

The economy needs an inflow of funds to create new types of production and modernize the existing ones, to fill the consumer market with the required goods and services, and ultimately to achieve the social goals of the development of society, assimilation of new techniques and technologies, as well as finding the sources for income. Such funds can comprise cash resources, bank deposits and shares, stocks, technologies, machines, equipment, patents, licenses, including trademarks, loans, and proprietary and non-property rights, including intellectual and industrial property. All these funds, assessed in the form of value, constitute the main essence of investments.

The economists Romash M.V., Shevchuk V.I. have provided different interpretations of the economic concept of “investment” which constitute the basis for developing main objectives<sup>2</sup>. It is necessary to include the formation of resources for the production stage of reproduction.

In addition, in the period of modernization and technological re-equipment of the modern economy, the formation of the following innovative resources is required:

- a) new types of equipment, new technologies, new materials, new levels of skills and knowledge;
- b) restructuring of the main institutions of current reproduction;
- c) creating a new structural system of capital;
- d) restructuring of economic systems and the entire national economy in terms of the composition;
- e) provision of resources to transfer the economic system to the path of innovation-based development. This task of investments is determined by the objective connection of investment factors with innovation-based factors, their participation in the research, technical and innovative activities;
- f) a group of social tasks related to the solution of the employment problem, the social sphere and other social effects of investment;
- g) regulation of priority areas of economic development.

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<sup>2</sup> Romash M.V., Shevchuk V.I. Investment financing and lending. - Minsk: “Knijny dom”, “Misanta”, 2004 -157 p.

According to this approach, the concepts of “investment” and “innovation” are closely related. This is also observed in the classification of investments by object:

- financial resources (cash, targeted bank deposits, shares, securities);
- material resources (machines, equipment);
- intellectual property (patents, know-how, technologies)<sup>3</sup>.

In addition, innovation is the area that ensures attracting investments for creation of a high-tech structure of the economy, development and introduction of new technologies, production and export of competitive products with high added value. However, the high speed and efficiency of economic development is based not only on the amount of invested capital, but also on its quality, which is provided at the expense of innovations. Furthermore, a high weight of investments in the creation of various non-production objects indicates their low quality. This can cause disruption of the economy and financial crisis in the conditions of non-competitiveness of products. The rapid development of the innovation-investment process leads to the diversification of the industry, modernization of the core sectors of the economy, thereby raising the return on invested capital. This is confirmed by the fact that approximately 50-70% of the GDP growth in developed countries is achieved due to the use of the advanced new technologies.

Some scholars and economists in their research papers have comprehensively studied the problem of reproduction of a new type of technology and its characteristics in terms of the characteristics of the market mechanism.

From the point of view of P. Samuelson<sup>4</sup>, investment means placing capital in order to obtain economic and (or) social benefits; expenses directed to the reproduction of capital (its expansion and support); current increase in the value of capital assets as a result of production activities in this period; the portion of income not used for consumption in this period.

Although various scholars provide different interpretation of the “investment”, their original meaning is as follows: investments are funds, intellectual property, buildings, structures, which are not used for current consumption in order to expand them in the future, as a result of which it is necessary to obtain economic, social and other benefits. All the given definitions of the “investment” concept constitute the basis for the conclusion that this goal can be achieved by investing in innovations. Therefore, as a result of innovation-based activity, economic, social and other results are obtained not immediately, but after a certain period of time. This corresponds to the concept of “investment”, which has a long-term nature.

### Research Methodology

The main provisions and principles of dialectics have constituted the methodological foundations of the research. In the process of researching the problems related to the financial sector development such research methods as the method of analyzing the

<sup>3</sup> Romash M.V., Shevchuk V.I. Investment financing and lending. - Minsk: “Knijny dom”, “Misanta”, 2004. 157 p.

<sup>4</sup> Samuelson P. Economics / translated from English - M.: NPO “Algon”, 1992. V. 1. - 333 p.

importance of foreign investment and loans, national savings, the method of collecting, processing and analyzing the data have been widely applied. Logical analysis, synthesis, generalization, induction and deduction, systematic approach to economic events and processes have been used to make relevant conclusions on the research results.

### Analysis and Discussion

According to the experts of the Institute of Macroeconomic Research and Forecasting, the development of the financial sector in Central Asian countries is not just the result of economic growth, but its cause. A 1% increase in the development of the financial sector has resulted in the increase in the economy by 0.5-0.25%. That is, there is a one-way relationship between the development of the financial sector and economic growth. Loans issued by banks have resulted in the economic growth, but economic growth did not promote creation of the additional demand for financial services. It is said that this is due to the insufficient development of the financial market, the lack of tools to attract money back into the sector and the low level of savings<sup>5</sup>.

It was noted that in order to become a high-middle income country at the next stage, it is necessary to further develop the financial sector and ensure that economic growth creates additional demand for financial services. This requires gaining financial popularity.

According to the analysis, Kazakhstan is the leader in the region in terms of the level of development of the financial sector<sup>6</sup>. As of April 1, 2022, 22 banks were operating in Kazakhstan. The share of five major banks in banking sector assets constituted 64.7%. Kazakhstan is followed by Uzbekistan in terms of the financial development level. As of May 1, 2022, 33 banks were operating in the country, 12 of which were state-owned and they accounted for 81% of the banking sector's assets.

Tajikistan and Kyrgyzstan are close to each other in terms of financial development. 14 banks were operating in Tajikistan and 23 were operating in Kyrgyzstan in 2021. Turkmenistan has the lowest level of financial development among the rest of the Central Asian countries. As of April 2022, 9 banks were operating in the country, 4 of which are state-owned.

The use of banking services for the population is largely characterized by the number of automated teller machines. The number of ATMs in Kazakhstan constituted 95.8 per 100 000 adult population in 2020, compared to the world average of 41.2, and increased by 1.5 times over 10 years. In other countries of the region the number of ATMs is small relative to the population (48.4 in Uzbekistan, 41.8 in Kyrgyzstan, 21.5 in Tajikistan), however this figure is rapidly increasing. Over 10 years, the number of ATMs per 100,000 adult population has increased by more than 3 times in Tajikistan and Kyrgyzstan, and by 11 times in Uzbekistan.

The banking sector depth, measured as the ratio of bank assets to GDP, is higher in Uzbekistan among the countries of the region, and according to the results of 2021, it

<sup>5</sup><https://kommers.uz/markazij-osiyodagi-iqtisodij-osish-moliya-sektoriga-bogliqmi-yoki-aksincha>

<sup>6</sup> Calculations of analysts based on IMF data.

accounts for 60.6% of the GDP (it was at the level of 32.9% of GDP at the beginning of 2017). The growth of bank assets, measured as the ratio of bank assets to GDP, has resulted in the rapid growth of lending in the country in recent years.

The loan burden on the economy increased from 20.6% to 44.4% in 2017-2021. Furthermore, the dominance of state-owned banks determines low levels of financial intermediation and limited access to finance<sup>7</sup>. The banking sector depth in Kazakhstan amounted to 46.9% in 2021. With the aim of improving the quality of the loan portfolio, the restructuring of the banking sector and the tightening of macroprudential supervision has caused a decrease in this indicator compared to 2017 (58% of GDP). The banking sector depth in Kyrgyzstan has grown significantly over the past 10 years due to the growth in the volume of loans issued (from 34% at the beginning of 2010 to 48% on April 1, 2022). Lending in Tajikistan has lagged behind economic growth, causing the ratio of bank assets to GDP to decline from 28.0% of GDP in 2011 to 22.7% in 2021.

With the exception of Kazakhstan, the countries of the region have not sufficiently integrated into the world financial system. This fact limits the inflow of foreign capital to Central Asian countries. The formation of a full-fledged regional financial market is currently seen in a separate perspective, but it can help countries join the global financial market. Herewith backlogs are still emerging - the international financial center "Astana" is operating, necessary measures are being undertaken to reduce barriers for regional and foreign investments.

Further development of the financial sector will help deepen regional integration and end resource dependence. Lack of banking services limits the development of the private sector, especially small and medium enterprises. Experts note the lack of services such as trade financing, loan guarantee, insurance<sup>8</sup>. Creation of developed financial intermediation provides an incentive for the development of trade and investment relations not only within the region, but also with neighboring countries.

For inclusive growth of the regional economy financial sector development, like increasing access to banking services, should also comprise non-banking services, including capital markets, insurance companies and other non-banking financial institutions<sup>9</sup>. As a result of low demand for savings services in the region, insurance products are still not popular.

Domestic funds possess a huge potential to be used to finance economic development in the conditions of limited foreign direct investment in non-raw materials sectors of the economy. In addition to the development of financial services (bank, stock exchange, insurance),

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<sup>7</sup>IMF (2022) Republic of Uzbekistan. Staff Report for the 2022 Article IV Consultation. Country Report No. 2022/189. Available at: <https://www.imf.org/en/Publications/CR/Issues/2022/06/22/Republic-of-Uzbekistan-2022-Article-IV-Consultation-Press-Release-taff-Report-and-519919> (Accessed 12 July 2022).

<sup>8</sup>Das, R. U. (2018) The Central Asian Republics, in Cho, J. —W. and Ratna, R. S. (eds.) The Asia-Pacific Trade Agreement: Promoting South-South Regional Integration and Sustainable Development. United Nations ESCAP, pp. 209–264. Available at: <https://doi.org/10.18356/24f1ac70-en> (Accessed 30 March 2022).

<sup>9</sup>World Bank (2016) Risks and returns: Finding financial trade-offs for inclusive growth in Europe and Central Asia. Review. Available at: <https://documents1.worldbank.org/curated/en/983201481822358394/pdf/110764-WP-RUSSIAN-v2-PUBLIC-Risks-and>Returns-Over%20view-RUS.pdf> (Access date July 12, 2022).

attraction of population savings enables formation of reliable sources of economic growth (Figure 1).

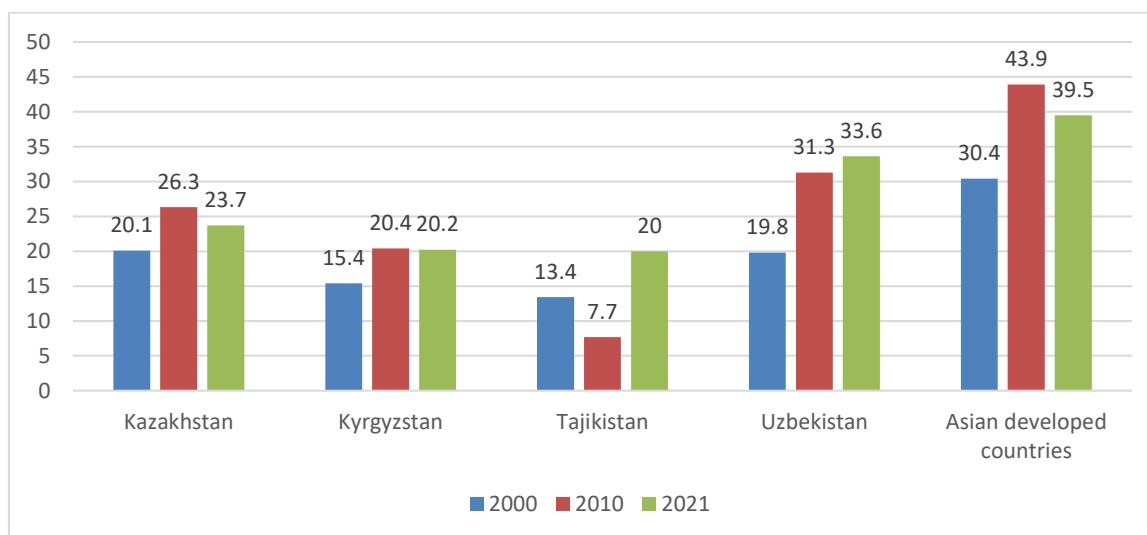


Figure 1. Gross national savings<sup>10</sup>

The structural reforms of national economic systems require the countries of the region to consolidate all their efforts. The share of thermal energy complex goods, metal ores, and agricultural raw materials in their export is high. The increase in the price of raw materials in the previous decades has not been used to fully diversify the economy. As before, the economies of Central Asian countries are strongly linked to price fluctuations in raw material markets. Implementation of structural changes requires political will, undertaking gradual actions on set goals.

### Conclusion and Proposals

Improving the investment and business environment, including the development of small and medium-sized enterprises, attracting domestic and foreign investors, as well as creating an attractive environment for enhancing competitiveness of economic sectors play an essential role. Cooperation based on mutually beneficial interests and advantages of the countries of the region enables to reduce production costs, establish regional cooperative relations, and increase the processing of exported products.

Remittances (money transfers) are also a resource for the development of individual countries of the region. The growth of industrial potential and the service sector, together with the creation of highly productive jobs and the system of professional development and qualification upgrading will create an opportunity to reduce the dependence of countries on remittances and, at the same time, to strengthen social stability.

<sup>10</sup> Compiled by the author based on the IMF data.



The domestic financial sector should be the basis for comprehensive development of economic sectors of the countries of the region. In some countries, external funding must give way to domestic sources of leadership. First of all, the growth of savings will be possible under conditions of the increase in the living standard of the wide layers of the population and financial sector development.

International financial institutions will continue to act as accelerators of private investment and their flows may increase as institutional conditions improve. In addition to financial services, other services such as transportation, education, medicine, information technology, and tourism can help reduce dependence on raw materials. Time-related services will be the main driver of the growth of regional economies and they will enable to increase the openness of Central Asia and enhance productivity in the economy.

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