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## **RURAL FINANCE IN UZBEKISTAN: CHALLENGES AND OPPORTUNITIES**

**Annotation:** Growing demand for financial services, especially for smallholders in rural areas of developing and transforming countries is opening up challenges and opportunities for governments that they should consider for smoothing of rural poverty alleviation. By understanding of these calls the governments have started to develop incentives toward outreach of necessary financial services to the poor in rural population. Evidence from Uzbekistan has shown that in general government's incentives in expanding of affordable financial services to the poor were positive, however, there are still some concerns of reaching financial services to smallholders. In this paper, several financial innovations and theories have been explored and as an effective financial institution, credit cooperatives are proposed for linking smallholders to financial services.

**Key words:** Credit Cooperatives, Credit Finance Institutions, Microfinance, Rural finance.

Молиявий хизматларга талабнинг ўсиши, асосан қишлоқ ҳудудларининг ривожланиши ва мамлакатларни тубдан ислох қилиш, қишлоқ ҳудудларидаги камчиликларни осонлик билан камайтириш масалаларини ҳокимиятда эътиборга олиниши кичик ер эгалари учун катта куч ва имкониятларни очиб берапти. Ҳукумат ушбу талабларни англаган ҳолда қишлоқнинг кам таъминланган аҳолисига зарур иқтисодий хизматлар кўрсатишни янада яхшилашни бошлади. Ўзбекистон ҳукумати томонидан кам таъминланганларни рағбатлантириш, иқтисодий хизматларда имкониятларни кенгайтириш ижобий яқунланди, шундай бўлса ҳам кичик ер эгаларига молиявий хизматлар кўрсатилмоқда. Бу илмий мақолада, бир канча иқтисодий янгиликлар ҳамда назариялар тадқиқ этилган ва молия институтларининг самарадорлиги шундаки, кредит кооперацияларини кичик бизнесни молиявий хизматлар билан боғлашни таклиф қилишлигидадир.

**Таянч иборалар:** Кредит кооперациялари, Кредит-молия институти, Микромолиялаштириш, Қишлоқ иқтисодиёти.

Растущий спрос на финансовых сервисах, особенно для малых бизнесменов в сельского хозяйственных сферах на развивающийся и реформирующихся странах появилась спрос и шансы для государств которого они должны концентрироваться для регулирования бедности в пригородах. Понимая этих проблемах государство начал развивать дать поддержания особенно финансовых услуги для населена бедных которого живёт в пригородах. Данные из Узбекистана показывает, что общий государственных поддержания в

расширения дешёвой финансовой услуги для бедных было позитивно, несмотря на этого, есть некоторые рискованные получения финансовых услуги для малых бизнесменов. В этой статье, рассматриваются несколько финансовых нововведений и теорий и в качестве эффективного финансового учреждения предлагаются кредитные кооперативы для установления связи мелких хозяйств с финансовыми услугами.

**Ключевые слова:** кредитные кооперативы, кредитно-финансовые институты, микрофинансирование, сельское финансирование.

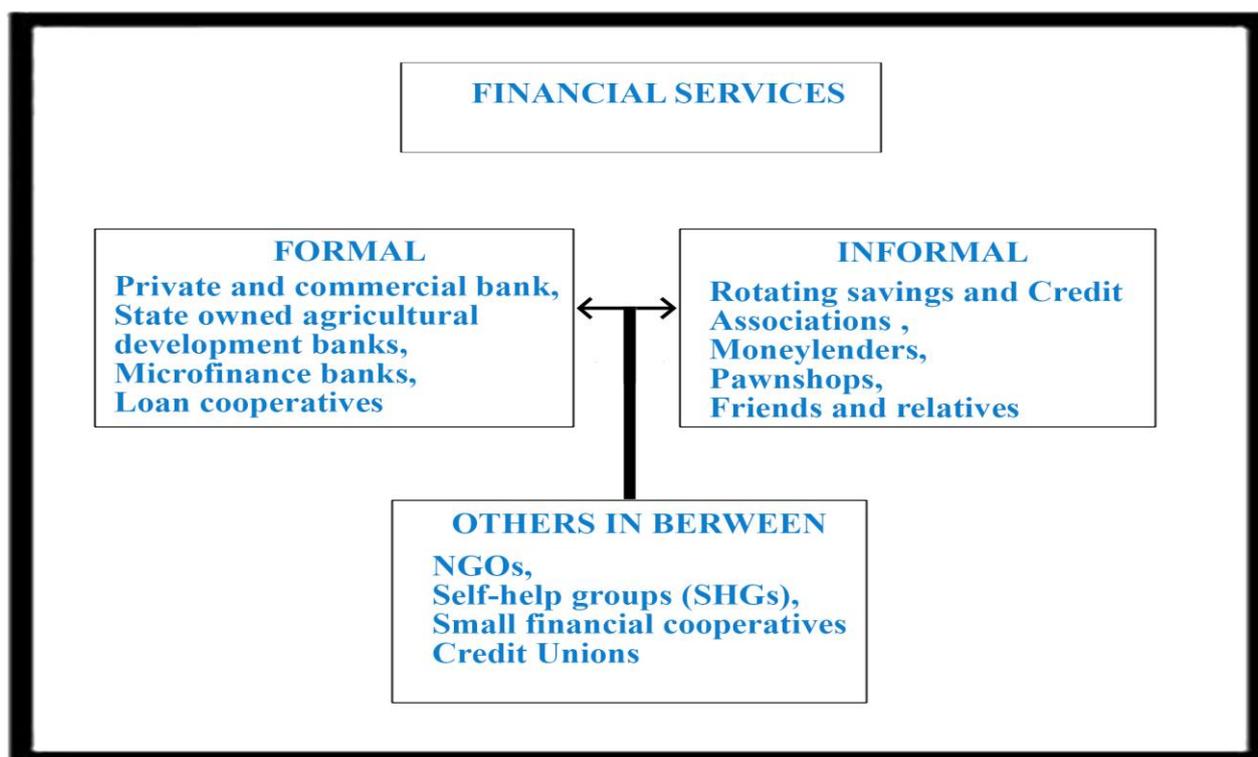
The importance of financial services in alleviation of rural poverty is one of the key issues that should be addressed in policies of developing and transforming countries. In order to better understand rural finance, first of all demand and supply sides of financial markets should be studied. The scientific literatures explore that there is a strong concern on the outreach and sustainability of financial services that targets poor, which in turn in many cases consists of smallholders in developing countries. Therefore, the status of financial service providers or financial institutions should be adjusted according to the needs of consumers (borrowers) of financial services.

In this paper, we have examined the theoretical background of rural finance, its development and current system in Uzbekistan, and have identified opportunities and challenges of development, and elaborated the appropriate policy recommendations that will help to further develop the rural finance system in Uzbekistan. The paper has been organized as follows. The next section discusses the theoretical background of rural finance. Section 3 has examined the status, legal framework of rural finance, microfinance and other traditional for-profit financial institutions in Uzbekistan. One of successful models - Cooperative Financial Institutions (CFIs) that will help unbanked layers of the rural population to outreach of financial services to unbanked layers of rural population has been described and offered in Section 4.

Theoretical background of rural finance. In this section we will do some literature review of both formal and informal service providers as well as other institutions between these groups. Rural Finance deals with providing financial services for people living in rural areas. There are several ways of reducing poverty through agriculture and nonfarm employment. However, in establishing of agriculture or nonfarm based type of businesses, there should be sufficient starting capital. In this case, provision of financial services to rural population becomes an important issue and it may be delivered through formal and informal financial institutions which are often blurred with the boundaries between categories.

Formal financial services may include include institutions such as public and private commercial banks; savings and loan cooperatives; microfinance banks; and

special-purpose leasing, hosing, and consumer finance companies. In general formal finance providers are supervised by central authorities. Informal finance providers include rotating savings and credit associations (ROSCA), money lenders, pawn-shops, friends and relatives. In turn, there are financial nongovernmental organizations (NGOs), self-help groups, small financial cooperatives, and credit unions in between formal and informal financial providers. (Fig. 1).



**Scheme 1. Rural financial services**

Financial constraints in agriculture are more pervasive than in other sectors because of the nature of agricultural activities. Financial contracts in rural areas include higher transaction costs and risks than those in urban settings due to the greater spatial dispersion of production, lower population densities, lower quality of infrastructure, and the seasonality and often high covariance of rural production activities. Hence, banks and other traditional for-profit formal financial institutions tend to limit their activities to urban areas or more commercial areas of the rural economy.

As Zeller states, from the experience of most developed countries, historically governments promoted agricultural credits with subsidized interest rates, and agricultural finance kept a low profile on the agenda of those governments. Recently, new paradigm of rural financial services such as microfinance, credit cooperatives is becoming one of the main strategies for most developing and transforming countries [1].

In 1976, when Muhammad Yunus in Bangladesh started the experiment of microfinance that led to the Grameen Bank, he focused on the very poor. As microfinance grew, it attracted the “economically active poor”, people who might be expected to take loans to run a small business, for example [2]. More recently with the drive for “financial inclusion”, attention has turned to the “unbanked” poor - poor people not using formal financial services of any sort (including microfinance, sometimes referred to as “semiformal” services). Just over half of the world’s adult population is unbanked, most of them poor: In Africa, four out of five adults are unbanked, and in South Asia, three out of five [3].

According to World Bank’s report, microfinance institutions (MFIs) open the menu of available contracts with new arrangements that substitute the collateral. They often have guidelines to favor groups - particularly women — excluded from borrowing through other channels. However, it works less well for crop activities, where all producers are subject to a common set of weather risks (when one cannot pay, often no one can pay) and where project gestation periods are long and share the same timing. Moreover, many microfinance organizations have targeting criteria for maximum landholding that restrict their lending to agricultural activities.

It should be noted that MFIs cannot however, provide the mainstay of rural finance. One of the fundamental challenges facing developing-country governments is promoting, improving, or even creating rural institutions to support a wide range of rural financial transactions. The role of government in supporting of rural finance institutions is huge; government-sponsored agricultural lending institutions have been successful in many now-developed countries such as Republic of Korea and Taiwan [4].

Another financial institution such as Cooperative Financial Institutions (CFIs) plays significant role in rural finance. Cuevas and Fischer give comprehensive description for CFIs. As they describe, CFIs include diverse member-owned financial intermediaries referred to as credit unions, savings and credit cooperatives, cooperative banks, and other terms that differ across regions of the world. Their institutional structure and governance, legal and regulatory status, and scale and services portfolio also vary widely across regions and especially between industrialized countries and developing economies. A most basic common denominator is that they collect deposits and do business often solely with members. Existing literature already supports the notion that CFIs serve many poor people, even though middle-income clients are also among their membership, a feature that in fact allows CFIs to reach poor segments of the population without necessarily compromising their sustainability. In many cases CFIs serve larger numbers of poor people than specialized (“targeted-to-the-poor”) microfinance institutions, without relying on donor support as the latter do [5].

Another group of financial service providers includes moneylenders and

pawnshops. They provide credit services by using their own capital. As local residents, they offer convenience and rapid response to borrowers, however at higher interest rate.

The last group of informal financial providers includes friends and relatives. Most people may borrow money from relatives and friends for their financial needs. There are, however, advantages and disadvantages of borrowings from family members and friends. Advantages may include less or even absence of interest rate, longer repayment times. On the other hand, those who lend will be more likely not secured comparing to banks and other lenders.

When governments promote any financial institutions, many factors should be taken into consideration, for example, it may include social, cultural and sometimes religious aspects of the population. There are many institutional innovations that may be applied to develop rural finance. According to Zeller, institutional innovation does not necessarily mean to create a new institutional type at the international level (as the pioneers of the cooperative movement did), but includes the adaptation of an existing institutional type to the constraints and potentials of a certain client group in a specific local environment.

Therefore, in general it is quite difficult to answer which financial institution is better or worse, unless we have no adequate comprehensive situation analysis.

Rural finance system in Uzbekistan. Uzbekistan is located at the center of Central Asia (CA) and surrounded by other CA countries such as Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and by Afghanistan on the south. Uzbekistan is the most populous country in the region with rich natural resources and agricultural base. As of 1 January 2017, Uzbekistan had a population of 32,121 million. After its independence in 1991, Uzbekistan has taken institutional and structural reforms in agriculture, a number of laws to encourage agricultural growth and rural development, including the Law on Farms, the Law on *Dehkan* Farms, the Law on Agricultural Cooperatives (*shirkat*), and the Law on Land Code have been issued. As a result of the transition, three types of farms were formalized in Uzbekistan: rural cooperatives (*shirkats*), independent private farms, and *dehkan* farms. However, the number of rural cooperatives has decreased substantially, mainly because of tighter government regulations and, presently majority of agricultural producers in the area are farmers. Government's incentives in supporting of farmers are being continued, since farmers produce main crops such as cotton and wheat. According to the survey, nowadays, all farmers that produce main strategic crops such as cotton and wheat can receive credit at 3 percent interest rate per annum. Mainly these credits are delivered by local banks and financed by a special fund of the Ministry of Finance for buying agricultural products. However, receiving of those credits involves additional costs related, to notary and assessing of collateral services, whereas most farmers cannot afford those costs.

Those who are not employed by farmers include *dehkan* farms (smallholders), who

own a small plot of land where they mainly grow vegetables and keep livestock. Given the small scale of production they are constrained by financial sources, and as a result majority of them migrated to urban areas or to neighboring countries such as Kazakhstan and Russia. Remaining family members of those who migrated or working outside of rural areas are dependent on remittance.

By realizing the importance of financial services that were needed to the poor, Uzbekistan has taken significant steps in establishing the legal framework for the development of microfinance. Microcredit programs in Uzbekistan were initiated by the UNDP in 1998 through the implementation of two pilot projects in the Republic of Karakalpakstan and the region of Kashkadarya. This experience informed the creation of a regulatory framework for the microfinance sector, as outlined by the Resolution of the Cabinet of Ministers of the Republic of Uzbekistan (2002) # 309 "On measures to develop microfinancing in the Republic of Uzbekistan" [6]. This paved the way for the expansion of microfinance by NGOs with the support of international donors, as well as the establishment of a legal framework for non-bank credit organizations.

Simultaneously, the law "On credit unions" was adopted in 2002 under the support of the World Council of Credit Unions and the Asian Development Bank, and by-laws to regulate and supervise the activities of the Credit Unions were formed. The initial establishment of the regulatory framework was the impetus for dynamic development of the sector for credit unions.

The financial sector of Uzbekistan comprises 29 commercial banks, including specialized Mikrocreditbank, 29 microcredit organizations (MCOs), 46 pawnshops, (from which 30 are operating in Tashkent city only) as of 1st January 2017 [7]. For MCOs microfinance is core business. According to Uzbekistan laws, MCOs are not allowed to attract deposits and cannot directly receive grants or loans from foreign companies and international organizations. Therefore, there is strong concern on developing of financial services in rural areas, where it will create opportunities for smallholders who are constrained by financial sources. Mikrocreditbank is licensed and regulated by Central Bank of Uzbekistan and represented throughout the country and receives subsidized government funding for provision of micro credits at lower rates of 3-7 % per annum in order to stimulate the establishment of small and medium business. There are overall 84 branches of Mikrocreditbank across the country with headquarter situated in Tashkent city [8].

Mikrocreditbank has branches in all regions of Uzbekistan and it offers several types of credits, such as consumer credit, credit for education in higher educational institutions (HEIs), mortgage credit and for startup business activities to legal entities as well as for private individuals. However, given the fact that all commercial banks in Uzbekistan, including Mikrocreditbank require collateral, for their financial products, most unbanked common people still are constrained from these financial services. As it was mentioned before, some additional financial innovations are needed for smooth alleviating of rural poverty in Uzbekistan.

In the next section we will give some recommendations of creating financial innovations.

Challenges and opportunities for development of rural finance. Given the discrepancy between demand and supply of financial markets in rural areas, the study highlights new challenges and opportunities for organizing credit cooperatives that have not been experienced in Uzbekistan. One of the interesting characteristics of rural communities in all regions of Uzbekistan is that people in rural areas are highly integrated with their relatives and neighbors. Hence this situation makes favorable condition for them to work in cooperation.

As previously mentioned after facing with an unemployment, most family members in rural areas of Uzbekistan tried to find opportunities in finding financial sources for their livelihoods and had to migrate either to urban areas or to other neighboring and foreign countries such as Kazakhstan, Russia, South Korea and many other countries in formal and informal way. It is rather difficult to calculate the real impact of remittance of those who migrated, however in general the incomes of rural families somehow stabilized. For instance, according to the Russian Central Banks report, from January 2010 to September 2013, remittances only from Russia to Uzbekistan reached 2.3 billion USD, which amounts to about 33 percent of all remittances. It shows that potential of remittances that could be mobilized to financial or rural cooperatives [9].

However, one of the most important aspects that should be considered is a lack of certainty either these remittances are sustainable in the long run. Therefore, there should be some alternative way for them. In this regard, credit cooperatives might be promising financial institutions for rural development.

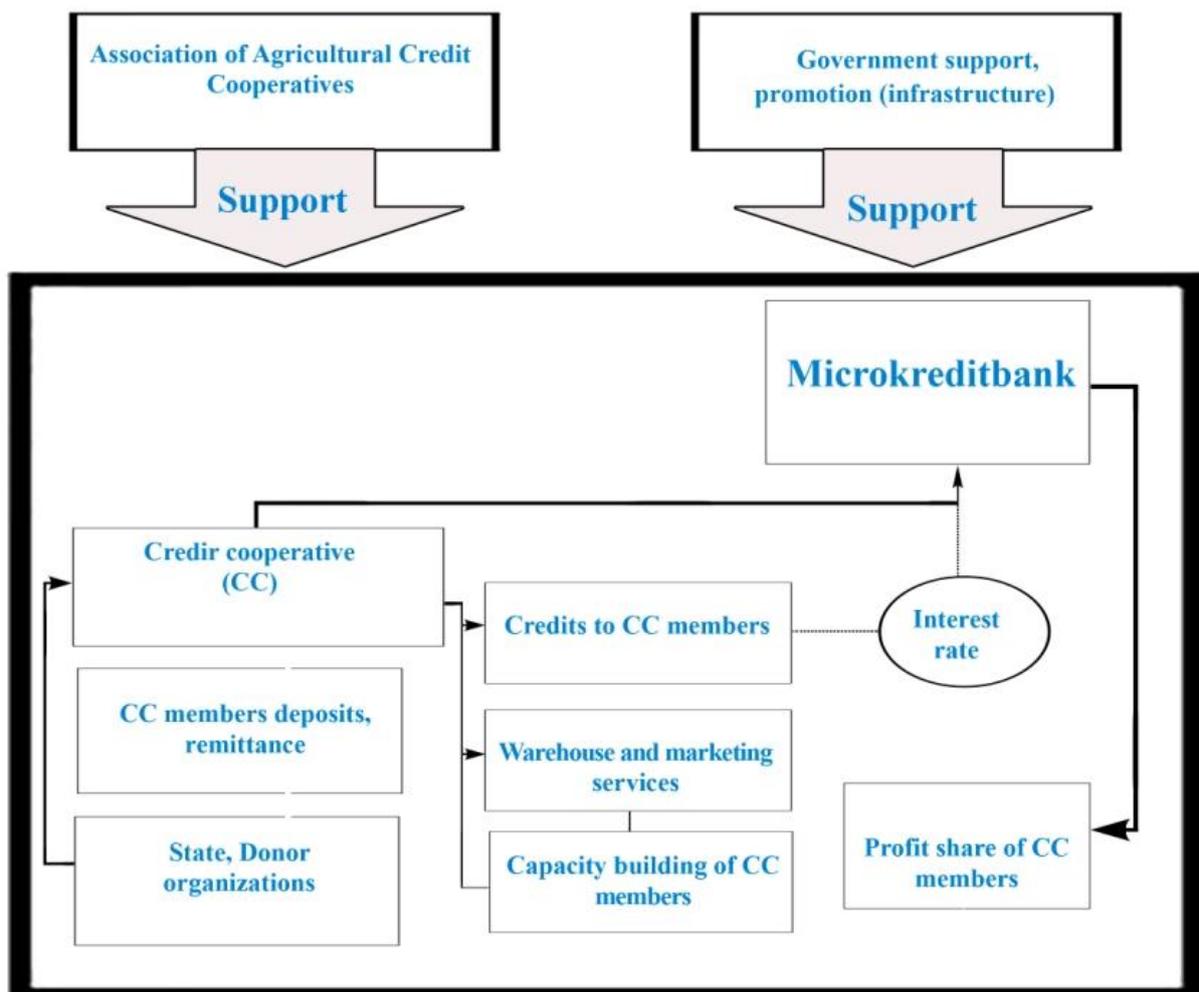
Financial Cooperatives are organized and operated according to basic cooperative principles: There are no external shareholders: the members are the owners; each member has the right to one vote. By mobilizing of remittance of migrants in affordable way it may create some basis for the accumulation of capital necessary for credit cooperatives, where migrants will stand as members of cooperatives.

The next challenge is about a proper utilizing of financial services of credit cooperatives. After choosing by voting of loan borrower who is cooperative member, he or she should have a necessary entrepreneurial skills and enough capacity to create additional income from using of loans offered. One of the criteria is that mutual benefits should be highly taken into consideration in the activity of financial cooperatives. In addition, given the specific characteristics of rural communities in Uzbekistan, other aspects of such as “principal- agent” problems might be reduced.

According to the model that we propose here, credit cooperatives apart from lending, receiving savings (deposits) will provide to its members such services as agricultural marketing, procurement of capital goods, and advisory services. Credit cooperatives pay from its funds the expenses of agricultural producer (farmer, small householder) that delivers its products to cooperative, in turn, it will sell the products of its entire members in the market at favorable prices. Therefore, transportation costs will be reduced. Credit cooperative will sell a large volume of products and from its income it will cover loans of borrowers.

Credit cooperative charges a margin for services rendered from the proceeds and the remaining funds may be sent to growers. Under the development, credit cooperative may provide guarantee for its members for loans at the bank when the members' needs on credit resources increase compared to the capacity of the cooperative.

Given the analysis results of developed countries, it is advisable to create a multi-level system of credit cooperatives in the long run. At the first level, which is a creation of district-level credit cooperatives, the organization works directly with clients. At the second-regional level, the unions and association of rural credit cooperatives would reallocate funds of credit cooperatives for the effective use of the funds (fund formation can occur irregularly in the territories). The interaction of agricultural credit cooperatives and regional associations could be developed as shown in the following scheme (Fig. 2).



**Scheme 2. The mechanism of interaction between the Credit Cooperatives (CC) and the regional Association of Agricultural Credit Cooperatives.**

With the development of the credit cooperatives, Association of Agricultural

Credit Cooperatives and Government officials should ensure the stability of the whole system and assist individual credit cooperative. Credit cooperatives, in turn will open an account in banks such as Mikrocreditbank that may be in the center of rural areas. However, it should be noted that Mikrocreditbank should act in the interests of credit cooperatives and government support is essential in this respect.

In addition, the association could represent the interests of the members at international level, for example in attracting financial resources -credits, grants and funds. The members of the association make mandatory contributions, established by the charter of the Association of rural Credit Cooperative, to create an insurance fund. Credit cooperative itself can also provide loan guarantees to its members and can provide funds to members of the Association financial assistance when they have needs for fund (in terms of interest-free credit and in terms of payment). Low levels of savings and the growth of remittances are the reserve and the basis for the creation of credit cooperatives in rural areas. Credit cooperative can be viewed by members as a source of additional income (not all members of the cooperative are active, i.e. in the use of credit resources) and it is more attractive compared to other types of organizations considering the availability of services, the ability to accommodate any amount of funds and the availability of credit, which is particularly relevant to the limited resource base.

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