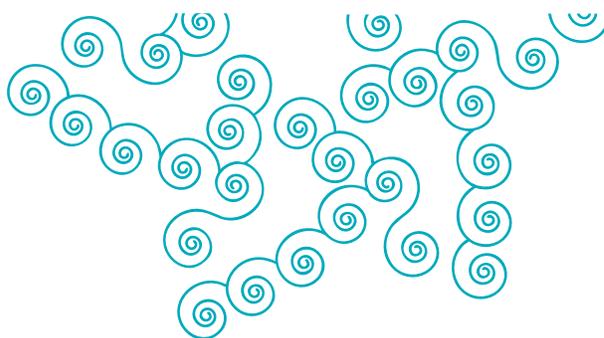


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Doing Business in Uzbekistan: Formal Institutions and Informal Practices

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Key Points

- Uzbekistan offers vast market opportunities to both foreign and domestic investors. Yet more than two decades after gaining independence from the Soviet Union, it remains neither economically prosperous nor politically free.
- The country's GDP has been growing consistently, averaging 8% annually over the past two decades. The growth, however, has been generated primarily by rising prices for gas, oil, cotton and gold. Wealth is spread unequally, with a small group of well-connected elites controlling the bulk of the economy.
- The country's informal politics are far more influential than the formal state, forcing foreign investors to navigate the web of complex paternalistic relations.
- Uzbekistan welcomes foreign investors – so long as they agree to play by the political regime's informal rules. Some foreign companies are expected to make payments to offshore regime accounts in Europe
- Violence, extortion, and intimidation of regime rivals and entrepreneurs are common occurrences in Uzbekistan.
- Once the regime decides to focus on a specific profit-making enterprise or a politically disloyal entrepreneur, it will find a way to appropriate or destroy the business. Both local and foreign investors can fall victim to the regime's extortion practices

Uzbekistan offers vast market opportunities to both foreign and domestic investors. Yet more than two decades after gaining independence from the Soviet Union, it remains neither economically prosperous nor politically free. The country's informal politics are far more influential than the formal state, forcing foreign investors to navigate the web of complex paternalistic relations. A small group of political elites uses state structures to control the country's abundant natural resources for their own benefit, while president Islam Karimov's

Economic Outlook

With a population of 28 million, Uzbekistan is Central Asia's largest market, offering transit routes to all countries in the region, as well as to Afghanistan. The country's GDP has been growing consistently, averaging 8% annually over the past two decades. In 2012, Uzbekistan's estimated GDP sat at \$51.17 billion, or \$3,600 per capita.² The growth, however, has been generated primarily by rising prices for gas, oil, cotton and gold. Wealth is spread unequally, with a small group of well-con-

Karimov's shadow authority is so pervasive that the formal legal institutions of governance have become irrelevant in political decision-making

influence is felt far beyond the formal realm of the presidency.¹ His decisions and preferences override all political and economic laws and regulations. Much of his influence is wielded indirectly with the sole intention of protecting the interests of his family members and a few of his closest political allies. Karimov's shadow authority is so pervasive that the formal legal institutions of governance have become irrelevant in political decision-making.

This paper analyzes a number of common methods employed by the ruling regime elites to obtain foreign and local business in Uzbekistan. Using the example of several foreign companies that have been expelled from Uzbekistan over the past decade, this paper demonstrates the mechanisms behind advancing the political regime's economic interests with the help of formal institutions or by simply intimidating businesses with the security forces. Violence, extortion, and intimidation of regime rivals and entrepreneurs are common occurrences in Uzbekistan. There have been a number of reports of the unwarranted arrest of foreign nationals, as well as cases in which local employees of foreign firms are arrested and forced to testify against their foreign employers.

nected elites controlling the bulk of the economy. Most of Uzbekistan's population lives in rural areas, and Tashkent has blocked urbanization by requiring restrictive residence permits and registrations. Uzbek citizens are not allowed to travel to some border areas, and those living outside Tashkent need a special government permit to go to the capital. Over 2.5 million Uzbek citizens work in Russia and Kazakhstan on a seasonal basis, sending remittances back to Uzbekistan.³ The president routinely announces ambitious development programs, however these have never led to greater prosperity for the majority of Uzbeks.⁴

Uzbekistan's Central Bank maintains strict currency controls, deeming it illegal for Uzbeks to possess US currency. But because of a large gap between official and black market exchange rates, most people prefer US currency. In 2003 Uzbekistan implemented Article 8 of the International Monetary Fund Treaty that enforces domestic currency convertibility, but since then has broken the regulation several times. All foreign investors are required to open accounts in local currency in addition to contributing hard currency investments. Furthermore, all businesses must convert half of their hard currency earnings into local currency.⁵ The government monitors any transaction exceeding \$100,000 in

order to prevent money laundering, however the reality of this means that only transactions for lower sums are monitored, while elites with political connections are able to make large foreign transactions without Central Bank oversight.

The government attempts to promote local producers ahead of imported goods. Uzbekistan has double taxation avoidance agreements with a number of its international trading partners, but refuses to join regional or international trade organizations. Indeed, Uzbekistan's exports have

excelled in securing the cooperation of businesses that are involved in the country's strategic sectors (energy, minerals, cotton) or that generate high profits because of a large consumer market. Some foreign companies are expected to make payments to offshore regime accounts in Europe. In return, foreign investors can expect "macroeconomic stability, favorable nature and climate, [a] convenient geographic location in the center of major regional markets [that are] integrated into the network of land and air communications, transportation and logistics system

Sometimes as part of wider anti-corruption programs, the government will purge Uzbek businesses and persecute Uzbek entrepreneurs who have not breached any laws

always exceeded its imports. In 2011, for instance, exports were valued at \$15 billion compared to \$10.5 billion for imports.⁶ Most export items are not taxed in Uzbekistan, but there are levies of up to 30% on imports. There is also a 20% VAT in local currency.⁷ Uzbekistan survived the negative effects of the global economic downturn in 2008-9 mostly thanks to its closed economy.

Transparency International ranks Uzbekistan 168th in a list of 177 countries, indicating that it is one of the most corrupt regimes in the world. Likewise, on the World Bank's ease of doing business scale, Uzbekistan is rated number 146 out of 189 countries. It scores the lowest in terms of "trading across borders," "getting credit," and "paying taxes." Finally, Uzbekistan is considered among the "worst of the worst" countries for civil liberties and political rights, according to Freedom House's democracy rating.

Formal Institutions and Informal Control

Uzbekistan welcomes foreign investors – so long as they agree to play by the political regime's informal rules. The regime is particularly inter-

[sic], [and a] diversified manufacturing base and intellectual and human capacity".⁸

Several international companies have shown a readiness to play by the regime's rules. The Swedish TeliaSonera telecommunications company admitted in 2012 that it paid a bribe to Gibraltar-based Takilant Ltd in order to receive 3G licenses in Uzbekistan. TeliaSonera has been criticized for allowing Uzbek authorities access to its network so as to keep tabs on anti-government activists.⁹ Similarly, the Israeli Metal-Tech Ltd was found guilty in December 2013 of making corrupt payments in order to obtain investment opportunities in the Uzbek molybdenum industry, according to White & Case LLP, the law firm representing the Uzbek government before the World Bank's International Centre for Settlement of Investment Disputes.¹⁰

The government's strict control of business in Uzbekistan is not limited to foreign investors or foreign companies. Sometimes as part of wider anti-corruption programs, the government will purge Uzbek businesses and persecute Uzbek entrepreneurs who have not breached any laws. In 2010, Karimov declared a war on oligarchs, blaming them for the huge gap between rich and poor, and for the resulting social tensions.¹¹

Karimov accused oligarchs of tax evasion and illegal appropriation of expensive goods. The president's hardline approach led one oligarch, Dmitry Lim, to flee the country, leaving behind a chain of bazaars and supermarkets. Another oligarch, Dmitry Dotsenovich, the owner of Royson, a company specializing in air conditioners, was accused of illegally importing goods from China and of failing to meet Uzbek production standards. His business was stripped of its license. The most scandalous arrest was that of Batyr Rakhimov, the (owner/CEO/head) of

been caused by Tashkent's decision to expel the U.S. military base in Karshi-Khanabad in 2005 and U.S. Congress's decision to prohibit assistance to the Uzbek government. Projections for the new GM plant in Tashkent include the annual production of 225,000 fuel-efficient Ecotec 1.2L and 1.5L engines for use in small GM passenger cars to be sold worldwide.¹³ GM's positive experience operating inside Uzbekistan must be largely credited to the improvement in U.S.-Uzbek relations that came about following the establishment of the Northern Distribution Network. By 2012, U.S. investors had

In 2010 Zeromax abruptly declared bankruptcy and shut down, leaving behind \$500 million in unpaid credit. Its German investors lost 130 million Euros

Kapital Bank, the 9th largest bank in Uzbekistan. Rakhimov was accused of committing financial crimes through the Kapital Bank, which had collaborated with Germany's Commertzbank AG, Austria's RZB AG, Turkey's Garanti Bank, and Russia's Sberbank.

Over the past decade, several other Uzbek entrepreneurs were arrested and had their businesses stripped, while others fled the country to escape prosecution. Most of those who were arrested or escaped Uzbekistan had foreign business partners, but this did not shield them from prosecution. Aside from arresting business owners, Karimov's regime also prosecuted their aides and managing directors. The anti-oligarch campaign was conducted very fast—and most Uzbek entrepreneurs were arrested within ten days. This led to further centralization of political power and control over the country's economy.

Karimov's regime has begun fostering closer political ties with other countries so as to boost economic and trade opportunities for itself. In 2011, during U.S. Secretary of State Hilary Clinton's visit to Tashkent, General Motors announced plans to open a second factory in Uzbekistan (25% belongs to GM, 75% owned by Uzbeks).¹² The announcement came following a thaw in US-Uzbek relations after several years of friction that had

poured over \$2 billion into Uzbekistan. There are 241 U.S. companies registered in Uzbekistan, including GM, Boeing, and Lockheed Martin.¹⁴ To date, GM is probably the most successful U.S. businesses operating in Uzbekistan. GM launched its operations 2007 after forming a partial alliance with Daewoo, a car manufacturer based in South Korea. By 2007 Daewoo had a near monopoly on car sales in Uzbekistan, producing several affordable models running on natural gas.

However, should a foreign investor not follow the regime's informal requests, they will likely encounter significant punishment from the Uzbek government, even if the retribution itself is likely to tarnish Uzbekistan's international image. Karimov's primary motive is to consolidate his power and possibly that of his close political allies – whoever that may be. If the regime feels threatened in any way by the presence of foreign business, or if the Uzbek partners of foreign companies develop political ambition, the regime will shut down that business. Roughly a dozen foreign companies have been expropriated by the Uzbek government within the past ten years. Among these was Spentex Industries, an Indian textile firm that launched Spentex Tashkent Toytepa, which was shut down before it even began operations in Uzbekistan in 2006. The company maintains that the Uzbek government made uni-

lateral changes to the agreement that eventually forced Spentex Tashkent Toytepa into bankruptcy.¹⁵ Indian investors lodged a claim for \$100 million in compensation, but it was not even processed by the Uzbek government. The regime uses the National Security Committee (KNB) to expropriate the funds and assets of foreign companies operating in Uzbekistan.

Wimm-Bill-Dann, a Russian dairy company, argued that the Uzbek government “de facto nationalized” the company in 2010.¹⁶ The com-

Both companies were accused of tax evasion shortly after Tashkent ousted the US military base at Karshi-Khanabad in 2005. Newmont is the world’s second largest gold mining company and had operated in Uzbekistan since 1992.¹⁸ MCT Corp had invested \$250 million in Uzbekistan, but was able to have some of its funds returned after pressuring the Uzbek government with prosecution in international courts and through negotiations with Richard Boucher, the assistant secretary of state and top U.S. official for Central Asia, during his visit to Uzbekistan in 2006.¹⁹

Foreign investors who come from countries on good political terms with Tashkent enjoy more favorable conditions, but if bilateral relations sour, the Uzbek government will shut down that country’s business interests

pany also claimed to have been approached by the KNB, who were intent on investigating its financial records. Wimm-Bill-Dann had entered the Uzbek market in 2004, but began experiencing troubles with the authorities in 2009, and was accused of tax evasion, embezzlement, and organized crime. The dispute over Wimm-Bill-Dann escalated into an international affair, with the Russian Foreign Affairs Minister addressing the Uzbek government on the matter. Kremlin pressure, however, did not convince the Uzbek leadership to change its mind.

UK’s Oxus Gold Plc, a gold mining venture affiliated with Uzbekistan’s Amantaytau Goldfields, was similarly charged with tax evasion in May 2011. According to British investors, these allegations constituted “an ongoing campaign to fabricate a reason to steal the last foreign assets in the mining industry in Uzbekistan”.¹⁷ Similar to other cases involving foreign firms, the Uzbek government refused to discuss the issue with Oxus, and charges are still pending.

US Newmont Mining, a former joint gold mining venture with Uzbek Zaravshan Newmont, and US mobile phone operator MCT Corp were both forced out of the Uzbek market in the mid 2000s.

In 2010 Zeromax GmbH, a Swiss-registered company, abruptly declared bankruptcy and shut down. The company had positioned itself as a conglomerate managing a range of commodities and services, including transportation, oil and gas sales, and agricultural products. There are numerous rumors around the company’s sudden demise, but the most common is that Karimov’s family decided to strip Zeromax of its assets. Zeromax left behind \$500 million in unpaid credit.²⁰ Its German investors lost 130 million Euros, equivalent to 40% of the total trade between Germany and Uzbekistan.²¹ Over 100 of Zeromax’s creditors urged the company to pay off its debt in 2012, but to no avail.

The Case of MTS

The Russian mobile phone operator MTS has become the latest victim of this extortionist business politics. In 2012 the company’s Uzbekistan-based subsidiary, Uzdurobita, was accused of providing poor quality service, breaking anti-monopoly laws, and tax evasion to the tune of \$264 million. The company’s managing directors were also accused of forming a criminal syndicate. MTS headquarters in Moscow insist

that the company's local staff were forced to sign false confessions to substantiate these charges.²² MTS was initially fined \$80 million by Uzbek authorities, but later the penalty grew to \$370 million.

The government suspended MTS's license for a few days in July 2012 and later for three months, leaving its roughly 10 million Uzbek subscribers – 38% of the total population – without mobile connectivity. On the black market, prices for SIM cards from other mobile service providers sky-rocketed, with some going for several hundred dollars. In the same month, Uzbek law-enforcement officials arrested the head of Uzdurobita, a Russian citizen named Radik Dautov. The Russian Foreign Affairs Ministry expressed concern over the development around MTS's Uzbek subsidiary, saying that it was watching the developments closely.²³ Dautov's wife wrote a letter to Russian president Vladimir Putin pleading for him to help her husband, who, she says, has been stripped of any legal protection in Uzbekistan.²⁴

In August 2012 Uzbek courts stripped MTS of all license to operate in Uzbekistan. In return, the company openly stated that it was a victim of the Uzbek government's deliberate interference in foreign business, which reflected a "decade-long pattern of inviting foreign investors into the country, creating profitable ventures, and then seizing those businesses based on false charges".²⁵ This included freezing the company's bank accounts, cutting Internet services to MTS offices, and conducting "illegal audits". MTS estimated that Uzbek authorities were hoping to seize up to \$1 billion of MTS's assets.

Because 30% of MTS was owned by American shareholders, the state of MTS in Uzbekistan was brought to the attention of the U.S. government. U.S. heads of the company urged the State Department to intervene in the process and to protect MTS's rights in Uzbekistan. Local MTS staff faced prosecution – a method used by Tashkent to extort bribes from the company. An official statement released by MTS says that actions against its Uzbek division constitute an "attack" on foreign business in Uzbekistan.²⁶ In the evolving saga involving MTS, Tashkent igno-

red negative international coverage and seemed indifferent to the plight of domestic consumers. The decision to revoke MTS's license came after several months of backdoor attempts to extort bribes from the company. The scandal could have been triggered by the deterioration of relations between Gulnara Karimova and MTS-Uzbekistan's head, Bekhzod Akhmedov.

The charges launched against MTS, however, were not a matter of Uzbek-Russian relations. Another Russian mobile service provider, Beeline, continued to function during the period in which MTS was being persecuted. In mid-August 2012 Russian Foreign Affairs minister Sergey Lavrov made a telephone call to his Uzbek counterpart, Abdulaziz Kamilov, to discuss a number of issues. During the conversation MTS was mentioned and both sides expressed hope that the issue would be solved as soon as possible.²⁷ In 2004 Karimova, who at that stage owned a controlling 74% stake in Uzdurobita, sold her shares to MTS for \$121 million.²⁸ At that time Uzdurobita had roughly 150,000 customers. In 2007, MTS acquired the rest of the shares for \$250 million.

Conclusion

In Uzbekistan, it is often difficult to identify which legal actions against foreign and local businesses are politically motivated. Once the regime decides to focus on a specific profit-making enterprise or a politically disloyal entrepreneur, it will find a way to appropriate or destroy the business. Both local and foreign investors can fall victim to the regime's extortion practices.²⁹ The regime regularly uses courts, government licensing agencies, and law-enforcement institutions to extort bribes and expropriate businesses. Often, foreign investors who come from countries on good political terms with Tashkent enjoy more favorable conditions inside the country, but if bilateral relations sour, the government will shut down that country's business interests in Uzbekistan. Foreign investors will encounter severe legal and financial problems, even if this harsh reprisal damages Uzbekistan's international image or bilateral relations with the investor's country.

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