MASTER’S THESIS

AN ANALYSIS OF INDUSTRIAL POLICY IN UZBEKISTAN

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INTRODUCTION

**Industrial policy** is one of the most misunderstood areas of government policy and its definition is therefore defined in different ways in literature, lacking a common definition.

Industrial policy has been debated for far too long. Some argue that industrial policy leads to economic growth and structural transformation while others argue that it may be captured by vested interests, leading to corruption and rent-seeking, or criticize industrial policy as “picking winners”. While some proponents and opponents of industrial policy argue whether countries should pursue industrial policies or not, Stiglitz and Greenwald (2014) emphasize that all countries have actually industrial policies because governments are inevitably involved in industrial policy to shape the economy both by what they do and what they do not. They say that industrial policy is needed because it shapes the structure of the economy.

The success of industrial policy is often associated with the economic development of East Asian countries. Some proponents of industrial policy often show this as a successful example of industrial policy, arguing that all of today’s rich countries also used industrial policies while developing. On the other hand, its opponents often argue by saying that even if industrial policies worked well in East Asia, they were a miserable failure in Latin American countries, so they blame those countries’ failure on their pursuit of industrial policies.

Indeed, industrial policy is risky but it is even riskier not to have it; otherwise South Korea (hereinafter: Korea) would still be the world champion in producing rice without industrial policy (Prasnikar, 2014; Stiglitz & Greenwald, 2014).

Korea is one of the most successful new industrialized economies in the world. It is a success story of economic development of the last half century with annual economic growth averaged 7.4 percent during the years of 1961 – 2014 (World Bank, 2016b). However, Korea used to be among the world’s poorer countries in the 1960s with GDP per capita which was comparable with levels in the poorer countries in Asia and Africa. In the early 1960s, the government of Korea wanted to transform the country from a traditional agriculture-based country into an industrial one. The government decided to play the key role in economic development and implemented a series of economic development plans from 1962 to 1996, which played an important role in the industrialization of the country (Savada & Shaw, 1992). The government provided various incentives to promote exports, created a good environment for foreign investors, and supported small and medium-sized enterprises. The export values of the country increased from USD 87 million in 1963 to USD 17.5 billion in 1980 (Mah, 2010) and then to USD 572.7 billion in 2014 (Korea International Trade Association, 2016). As a result, Korea significantly shaped the structure of its economy.

Industrial policy also played an important role in the economic development of Uzbekistan, making it competitive in the world markets.
Before Uzbekistan emerged as an independent state in 1991, it had long received a net subsidy from the central budget of the Soviet Union. The subsidy was suddenly cut off with independence. As the country’s industry was part of the Soviet Union’s industrial complex, the break-up worsened its traditional suppliers and customer relations. Uzbekistan’s economy had depended on cheap Soviet oil, and, in spite of its large agricultural sector, on food from elsewhere (Kotz, 2004). The economy of Uzbekistan was dependent on revenues from the exports of raw resources such as cotton at the time. However, from the very first day of independence, Uzbekistan selected its own way of development, the Uzbek Model of transition to socially oriented market economy. Since that time, the government has been promoting exports, creating a good environment for foreign investors, supporting small businesses and private entrepreneurs.

Consequently, Uzbekistan achieved significant successful results. For instance, it achieved the expansion of the export capacity and diversification of the economy successfully. The export volume increased 34 times (from USD 443 million to USD 15 billion) between 1990 and 2013. Also, Uzbekistan significantly changed the structure of the economy.

Today Uzbekistan is an industrial country that possesses a highly developed automobile, machine building, food processing, textile, pharmaceuticals, natural gas and oil processing, metallurgy and chemical industry. The economy of the country has been growing at a sustainable level for many years. The economy grew, on average, 7.1 percent in the last 16 years, or 8.3 percent in the last decade. According to the rating of World Economic Forum (2015), Uzbekistan is among five countries with the fastest growing economy in the world.

The main purpose of this master thesis is to find out more about industrial policy and make a contribution to its concept as industrial policy is misunderstood or misstated by some economists or researchers in literature. We will show that industrial policy is a vital part of government policies not only to promote the industrial sector in particular, but also to promote any other sectors that foster economic growth by creating a learning society and shaping the structure of economy when it is used properly. The thesis mainly focuses on the active role of governments in the economy in order to speed up the development and sectoral diversification, promoting market participants through different government programs, policies and other preferences that stimulate the growth and competitiveness of the economy for the long-term. Here, we gain insight into the theoretical approaches of economists and the experiences of Korea and Uzbekistan.

The objective of the thesis is to analyze the industrial policy of Uzbekistan, explore how the industrial policy is playing a role in the economic development of the country by creating a good business environment for all the domestic firms, small businesses, entrepreneurs, and society in general, evaluate the implemented industrial policy based on the theoretical approaches as well as empirical experience, and give suggestions to further improve the policy based on the issues found out if it is needed.

In this master thesis, the descriptive and quantitative research methods were used. Descriptive research was used to better understand and clarify the concept of industrial
policy and to show the importance of this policy based on the literature review. We used the quantitative method to analyze and interpret the numerical and statistical data. All the data were collected from the sources of books, international articles, journals, online databases of international organizations, working papers, e-libraries, different online webpages for financial and economic reports, and other sources. All the used sources are in the international language, English.

The master thesis contains three main chapters. The first chapter is a theoretical part, in which we will be familiarized with the concept of industrial policy, including different views and approaches by economist and researches. The second and third chapters are empirical parts. The second chapter gives macroeconomic overview and background information of Korea and analyses how the government has implemented the industrial policy since the early years of development. The third chapter also gives macroeconomic overview and background information of Uzbekistan, analyses the role of industrial policy in the economic development of the country, and evaluates it.

1 THEORETICAL CONCEPTS OF INDUSTRIAL POLICY

1.1 Definitions of Industrial Policy

Industrial policy is one of the most misunderstood areas of government policy. Therefore, the economic theory lacks a common definition of industrial policy. The term of industrial policy is not defined clearly; it means different things to different people. Therefore it is defined in different ways in the literature.

Rodrik (2008) defines industrial policy as policies which stimulate specific economic activities and promote structural change. He states that industrial policy is not about industry per se. Krugman and Obstfeld (1991) define industrial policy as an attempt by a government for encourage resources to move into particular sectors which the government views as important to future economic growth. For World Bank (1992), industrial policy is government efforts to change industrial structure to promote productivity-based growth. UNCTAD (2009, p. 4) defines industrial policy as a “concerted, focused, conscious effort on the part of government to encourage and promote a specific industry or sector with an array of policy tools”. According to Warwick (2013, p. 16), “Industrial Policy is any type of intervention or government policy that attempts to improve the business environment or to alter the structure of economic activity towards sectors, technologies or tasks that are expected to offer better prospects for economic growth or social welfare than would occur in the absence of such intervention”. Johnson (1984) defines industrial policy in a narrow sense, as a government activities which aim to support the development of certain industries in a national economy to maintain international competitiveness. On the other hand, John Pinder (in Peres and Primi, 2009, p. 13) defines industrial policy in a broader sense, as the policy that includes all kind of policies designed to support industry, including fiscal and monetary incentives for investment, direct public investment and public procurement programs, incentives for investment in research and development, major programs for the creation of “national champions” in strategic sectors, and policies to
support small and medium enterprises. For Stiglitz and Greenwald (2014), industrial policy are policies by which governments attempt to shape the structure of the economy, including the choice of techniques and the sectoral allocation of the economy. They state that governments are inevitably involved in industrial policies, in shaping the economy, both by what they do and what they do not. And industrial policy does not just mean industry. It can mean agriculture, modern agriculture, or the service sector.

So, what is the industrial policy about? Is it about manufacturing? The definition of industrial policy is broad today, because it includes both innovation, infrastructure and skills policies as well as targeted interventions boosting a specific sector, activity or cluster. Industrial policy is not only about manufacturing, it is also about high value added activities in services and agriculture (Organisation for Economic Co-operation and Development, 2013).

1.2 Arguments for Industrial Policy

The theoretical case for industrial policy is a strong one. The market failures which industrial policies target have long been at the core of the studies of the development economists. The conventional case against industrial policy rests on practical difficulties with its implementation (Rodrik, 2008).

Industrial policy faces several arguments (Table 1) and practical objections. There are mainly two practical objections to industrial policy. The first objection is the informational objection. According to this objection, it is not possible for governments to identify with any degree of precision and certainty the relevant firms, sectors or markets that are subject to market imperfections. The opponents of industrial policy often express this objection by saying “governments cannot pick winners”. The implication is that when there is no omniscience, for instance, an activist government will miss its targets, support economic activities that will not generate positive spillovers, and waste the economy’s resources. The second objection is that industrial policy triggers corruption and rent-seeking. Once governments are involved in the business to provide support to firms, it will be easy for the private sector to demand and extract benefits that distort competition and transfer rents to politically-connected entities. Businessmen and entrepreneurs spend their time asking for favours from governments, instead of looking for ways to expand markets and reduce costs. Therefore, the opponents of industrial policy find these objections sufficient to dismiss it, while the proponents point to East Asia and argue that successful industrial policy can obviously be implemented (Rodrik, 2008).

However, the first objection about governments’ inability to pick winners is irrelevant. Of course, governments have imperfect information, but so does the private sector. It is the information externalities generated by ignorance in the private sector which creates a useful public role even when the public sector has got worse information than the private sector. Also, regarding the second objection, the idea that governments need to keep private firms at arms’ length to minimize corruption and rent-seeking gets turned on its head. Of course, governments need to maintain their autonomy from private interests. But governments can
elicit useful information from the private sector only when they are engaged in an ongoing relationship with it (Rodrik, 2004).

Table 1. Arguments against Industrial Policy (IP) and counter-arguments for It

<table>
<thead>
<tr>
<th>Arguments against IP</th>
<th>Counter-Argument</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governments cannot pick winners.</td>
<td>Yes, the government cannot pick winners, but effective industrial policy is predicated less on the ability to pick winners than on the ability to cut losses short once mistakes have been made. In fact, making mistakes (picking wrong industries) is part and parcel of good industrial policy when cost discovery is at issue.</td>
</tr>
<tr>
<td>Developing countries lack the competent bureaucracies to render it effective.</td>
<td>Competent bureaucracies are a scarce resource in most developing countries, but most countries do have (or can build) pockets of bureaucratic competence. In any case, it is not clear what the counterfactual is. The standard market-oriented package hardly economizes on bureaucratic competence. As we have discovered during the last decade, and the expansion of the Washington Consensus agenda into governance and institutional areas indicate, running a market economy puts a significant premium on regulatory capacity. Industrial policy is no different.</td>
</tr>
<tr>
<td>Industrial interventions are prone to political capture and corruption.</td>
<td>Industrial policies can be captured by the interests whose behavior they aim to alter. But once again, this is little different from any other area of policy. In many countries, privatization has turned out to be a boon for insiders or government cronies.</td>
</tr>
<tr>
<td>There is little evidence that industrial policies work.</td>
<td>It is not true that there is a shortage of evidence on the benefits of industrial policy. To the contrary, it is difficult to come up with real winners in the developing world that are not a product of industrial policies of some sort.</td>
</tr>
<tr>
<td>What is needed is not industrial policy, but across-the-board support for R&amp;D and intellectual protection.</td>
<td>Supply-side innovation policies may have a role, but what constrains productive restructuring is a more fundamental feature of low-income environments: entrepreneurship in new activities has high social returns but low private returns.</td>
</tr>
<tr>
<td>And in any case international rules no longer leave scope for industrial policy interventions.</td>
<td>There is plenty of scope for industrial policies in the present international economic environment. In fact, contrary to general belief, the last two decades have seen a tremendous amount of industrial policy.</td>
</tr>
</tbody>
</table>

Market imperfections hinder the full private appropriability of social returns in growth-promoting investments. This problem would remain even when institutions are decent. Good governance has to be seen in part as the ability to generate and implement the policy initiatives needed to remediate the consequences of market imperfections. For example, Taiwan, Korea and China have developed not by suddenly perfecting institutions, but by coming up with the policies which overcame the market obstacles their investors confronted in modern tradable industries (Rodrik, 2008). Thus, the right model for industrial policy is strategic collaboration between the government and the private sector with the purpose of uncovering where the most significant obstacles to restructuring are and what kind of interventions are most likely to remove those obstacles (Rodrik, 2004).

Economic development is fundamentally about structural transformation, the transformation of human and physical capital and institutions in order to achieve increased productive capacity and growth. Historically, economic development and structural transformation from low-productivity activities to high-productivity ones was exemplified in the transformation from agrarian to industrial production (Lowitt, 2011).

The orthodox view of structural transformation remains largely based on the works of David Ricardo and the HOS model (Heckscher-Ohlin Model). According to them, developing countries should specialize in producing goods in which they enjoy a comparative advantage and accept a gradual and incremental path up the ladder of development and industrialization (Lowitt, 2011). The logic of comparative advantage is one of specialization, which raises overall productivity in an economy that is open to trade (Rodrik 2004). However, economic development necessitates diversification, not specialization - in other words, diversification is a key correlate of economic development. One of the reasons why rich countries are rich is in the light of the breadth of their economies and the diversification the goods they produce. Poorer countries are poor because they produce a narrow range of goods. Therefore, developing countries should learn how to do new things, not to focus on what one already does well. Countries which promote exports of sophisticated goods grow faster than countries which promote exports of less sophisticated goods. Countries are growing rapidly because they have large manufacturing sectors and their growth accelerations are because of structural changes in the direction of manufacturing (Lowitt, 2011).

The critics of neo classical approach believe that countries should defy their comparative advantage to develop and grow (Lowitt, 2011). It is true that at the beginning of their economic development, of course, countries should try to increase their exports from their existing industries as well as other non-traditional industries where they have comparative advantages (e.g., coffee in Vietnam, salmon in Chile, cut flowers in some countries in Africa). The widespread view is that these industries do not need any export help by the government as they are in line with the country’s comparative advantage. But this is wrong, because, in order to achieve success in exports, significant industrial policy is required even for comparative advantage-conforming industries, particularly if they are non-traditional ones. The basic problem is that export markets have high fixed entry costs, so smaller firms
and farmers, who are likely to dominate these comparative advantage-conforming industries, might not be able to stand. Direct export subsidies can offset the entry costs, however these subsidies are now banned by the World Trade Organization (hereinafter: WTO), except for least developed countries, and help therefore should be provided through other channels (Chang, 2009).

If a country is to keep the momentum of its export success in the longer run, it is not sufficient to rely on its comparative advantage-conforming industries. Particularly given the nature of the industries that developing countries probably begin their export drives with, export growth probably peter out soon after the initial stage and even a little rise in wages may undermine the country’s position in the world market. Therefore, sooner or later the country will have to upgrade its export industries into comparative advantage-defying industries, which entails even stronger industrial policy. Korea can be a good example of this. In the 1950s, Korea’s main exports were fish, tungsten ore, seaweed, and basic textiles and garments. In the 1960s, it developed non-traditional export industries such as plywood, wigs, cheap electronics assembly, and shoes, with the help of massive export support programs while upgrading the existing export industries (especially the garment and the textile industries). However, by the early 1970s, many of these export industries, (especially wigs and plywood) were hitting the wall, thus the government launched the Heavy and Chemical Industrialisation program by developing industries of steel, petrochemical, shipbuilding, automobile, high-end electronics, and others as export industries, though the country did not have comparative advantage in these industries at the time. Korea would not have sustained its export growth momentum beyond the 1970s without these industries (Chang, 2009).

Chang (2009) states that when we emphasize the importance of export for economic development, we have to abandon the dichotomy of “export promotion versus import substitution” which has dogged the debate of industrial policy for far too long. We have to debate how exactly to mix export promotion, infant industry protection, and free trade in a way that can help a country upgrade its industrial structure and develop fast (Chang, 2009).

The success of many East Asian economies (and most recently China), is often associated with industrial policy. Some proponents of industrial policy often show this as successful examples of industrial policy, arguing that also rich countries have often used industrial policy as part of their development strategies despite their promotion of free markets abroad (Donor Committee for Enterprise Development, 2014). On the other hand, the opponents of industrial policies often argue, saying that even if industrial policies worked successfully in East Asia, they were a dismal failure in Latin American countries, so they blame those countries’ lost decade1 on their pursuit of industrial policies. However, it is not true, because Brazil achieved remarkable economic growth rate of nearly six percent in the three-quarters century before 1980; industrial policies played an important role in Brazil’s success during this period. It should be noted that there were other reasons resulted in the

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1 The lost decade is the Latin American debt crisis which was a financial crisis that originated in the early 1980s (and for some countries starting in the 1970s).
lost decade in Latin American countries, e.g., their excessive indebtedness, the period of oil shock, low (even negative) real interest rates, macroeconomic shock (not a failure of microeconomic policies). Besides, Latin American countries pursued industrial policies in the form of import-substitution versus the export-led growth in East Asia (Stiglitz & Greenwald, 2014, p. 320). As Chang (2009) says, the failure to promote export enough was one of the key reasons why industrial policies in Latin America were not as successful as those in East Asia. In Latin America, economic growth kept hitting the balance of payments constraints. Chang (2009) also stresses that even Korea, with its huge export machinery and massive state supports for exports, found it impossible to export enough to finance its rapid rate of capital accumulation till the late 1980s, running a structural trade deficit.

Sometimes industrial policy can work, but sometimes not. The reason is related to the type of industrial policy. For instance, in Latin America industrial policy came in the form of import substituting industrialization with domestic markets closed to international competition. In Taiwan and Korea, the model was different. It was export based with incentives created to induce the development of export industries. Though there were certainly such differences in the implementation of the policy (e.g. inward looking versus outward looking), the main difference between the cases of the successful and unsuccessful industry policy is political. The difference lies in the objectives and functioning of the institutions implementing the policies and these are determined by the political system. The successful promotion of industry entails changes in the political equilibrium in such a way as to align the political incentives with those of society. Promoting industrialization, that is, to have an industry policy, is an endogenous outcome of the political choices of a society. Unless interests and institutions are aligned, industry will never be promoted, whatever the normative consequences are (Robinson, 2009).

As we have already mentioned, industrial policy is often associated with the development experiences of East Asian economies in the post-World War II period. However, successful industrial policy experiences in the late 20th century are not confined to only these countries. European countries such as Austria, France, Finland, and Norway, also pursued industrial policy (selective industrial policy) during this period. Certain local governments in Germany and Italy also pursued effective industrial policy, promoting particular “industrial districts” through directed credits, R&D support, and export marketing help. Interestingly, all these above-mentioned countries had high growth rates during the 1950s -1980s, although obviously this is not to say that industrial policy alone was responsible for their growth. While championing the free-market ideology during this period, the United States ran a huge industrial policy program under the guise of R&D support for defense and public health, too. As an example, between the 1950s and the 1980s, the government financed anywhere between 47 percent and 65 percent of national R&D spending, compared to around 20 percent in Korea and Japan, and around 30 percent in Europe. However, without public funding of R&D, many of the industries (aircraft, microchips, computer, internet, genetic engineering), where the United States still has technological edge, would not have developed (or even emerged at all). Besides, there are even more
success stories of industrial policy from the 19th and the early 20th centuries. In this period, all of today’s rich countries (except the Netherlands and Switzerland) practiced significant degrees of protectionism for substantial periods. Though these tariffs were not as systematically calibrated as the ones used in the late 20th century, they were certainly parts of selective industrial policy, as they were deliberately different across sectors. Besides tariff protection, many of these countries promoted targeted industries by providing subsidies, set up state-owned companies or public-private joint ventures for risky projects, regulated Foreign Direct Investments (hereinafter: FDI), and implemented various measures of industrial policy during this period (Chang, 2009).

Now, looking at all these facts, we wonder: if industrial policy is so bad, then, how is it that in every era, the fastest growing countries happen to be those with a strong industrial policy, i.e., Great Britain during the mid-18th century and mid-19th century, the USA, Sweden, and Germany during the late 19th and the early 20th century, Austria, Finland, France, Norway, and East Asia in the late 20th century, and China today (Chang, 2009).

Economic development is in essence about structural change. It involves producing new goods with new technologies and transferring resources from traditional activities to these new ones (Rodrik, 2008). Structural change is desirable not only for supporting higher productivity growth and per capita incomes, but also as it results in greater diversity in economic structure, lowering a country’s vulnerability to negative external shocks (Naude, 2010). Developing countries can never emerge from aid dependency if they are not able to use industrial policies which they will need to transform their domestic industries, diversify their economies and build up their own tax bases over time (Donor Committee for Enterprise Development, 2014). In order to shape the structure of the economy, industrial policy is thus needed (Stiglitz & Greenwald, 2014).

1.3 Stiglitz and Greenwald (2014) approach to Industrial Policy

As the main driver of economic growth, Stiglitz and Greenwald advocate the importance of learning and learning spillovers. As Stiglitz (2014a, 0:11) says, “What we have learned over the last several hundred years is that, more important than anything else for improvements in standard of living, are learning – learning about how to become more productive. If that is the case, then learning about how we can learn becomes all the more important. And making sure that firms, individuals, governments learn better becomes – should become the focal point of policy. So one of the objectives of industrial policy is trying to create within the market economy a more learning economy. That is to say, an economy that learns more, in which knowledge diffuses from firm to firm, where the gap between the best practices and the average practices are narrowed, and the gap between the developed countries and the developing countries is narrowed.” Stiglitz and Greenwald believe that one of the objectives of economic policy should be to create an environment which enhances both learning and learning spillovers.
According to Stiglitz and Greenwald, industrial policy are the policies by which governments attempt to shape the structure of the economy, including the choice of technique and the sectoral allocation of the economy, so as to achieve a learning society.

Market on their own do not create a learning society. The major insight of welfare economics of the past 50 years is that markets generally do not result in Pareto efficient outcomes on their own. By now, there is a rich catalogue of market failures, circumstances in which the markets may produce too much of some commodities or too little of another, or cause too little employment. So appropriately designed industrial policies may improve this. Therefore, one of the central reasons for industrial policies is that markets do not create a learning society themselves; the structure of the economy that stems from market forces results in less learning and less growth than there should or could be.

“Industrial policy is one of the instruments for helping the economy becoming a learning society. Almost every policy, every action of the government affects the way the economy, the way society learns – education, macro stability creates an environment in which people can focus more on learning. But industrial policy is focused on the issue of: How can we encourage sectors that learn more, sectors that have more learning spillovers to other sectors, technologies that have more capacity for learning? How can we increase the learning capabilities of individuals, organizations and society? That’s what industrial policy is concerned with.” (Stiglitz, 2014b, 0:10).

Stiglitz and Greenwald emphasize that governments are inevitably involved in industrial policy to shape the economy both by what they do and what they do not. For instance, if governments do not manage the macro-economy well, then it causes that more cyclically sensitive industries will be discouraged. If they use interest rate adjustments to stabilize the economy, then interest-sensitive sectors will suffer. If governments do not stabilize the exchange rate, nontraded sectors are encouraged then. Besides, governments play a central role in health, education, infrastructure, and technology in nearly all countries. And policies and expenditures in each of these areas, and the balance of spending among these areas shapes the economy too. Almost all actions undertaken by governments have some effects in shaping the economy. Markets do not exist in a vacuum, and every law and regulation which structure our economy shape the economy. All the regulations and rules, the legal frameworks and how they are enforced, affect the structure of the economy. For this reason, governments are, unwittingly, engaged in industrial policies for all time.

Stiglitz and Greenwald stress that a gap in knowledge, not just a gap in resources, separates developed countries from developing countries. Much of the difference in per capita income between these countries and the more advanced ones is because of the gap in knowledge. If this is the case, the strategies for development should be centered on promoting learning, closing the gap in knowledge between those countries. Policies which

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2 An economic state where resources are allocated in the most efficient manner. Pareto efficiency is obtained when a distribution strategy exists where one party's situation cannot be improved without making another party's situation worse. Pareto efficiency does not imply equality or fairness (Pareto Efficiency, n.d.).
transformed their economies and societies into learning societies would enable them to close the gap more rapidly, with noticeable increases in income. However, instead of promoting the learning sectors, the policies foisted on developing countries by the international economic institutions have actually discouraged the learning sector, which is the industrial sector, in many developing countries, particularly in Africa. As a result, Africa has suffered from deindustrialization over the past 30 years.

Stiglitz and Greenwald state that when governments use industrial policies to promote growth through learning, they have to simultaneously realize other economic and social consequences. Governments are worried about employment, distribution, and the environment, whereas the market is often not. Therefore, there is something wrong with market processes in the countries with persistent high levels of unemployment. The social cost of unemployment can be enormous, so governments should try to induce the economy to shift toward more labour-intensive sectors or to use more labour-intensive processes.

In other words, one of the objectives of industrial policy is not just growth by itself, but pursuit of other social objectives. So it is a pursuit of all the social objectives where the market pays insufficient attention. Industrial policies cannot be seen in isolation, they have to be seen as part of a whole portfolio of policies that governments have to pursue. In the areas of jobs, if people are going to learn, one aspect of learning is they have to be motivated by the possibility of a job. And if there are no jobs there, it is very hard to be motivated to do the kind of learning – particularly learning oriented how to perform in a market economy. So industrial policies and macro policies have to be linked together. There have to be strong macro policies that enable the economy to create jobs. But then of course there have to have industrial policies that create the kinds of jobs that people are qualified for (Stiglitz, 2014c).

Overall, Stiglitz and Greenwald illustrate four key objectives of industrial policy beyond creating a learning society, which are structural transformation, unemployment, environment, and inequality. For instance, the structural transformation of the economy is required for development. Market on their own are not so good at such structural transformation, partially because the sectors which are being displaced typically suffer large capital and income losses and are therefore not well placed to make the investment necessitated for redeployment. One of the main impediments to the flow of resources from one sector to other sectors is the lack of appropriate skills; more focus on learning would have led to policies which would have developed the relevant capabilities of the workforce.

Development entails learning how to learn. Stiglitz and Greenwald also emphasize the role of FDI in learning. FDI may also be one of the ways of acquiring knowledge. FDI has played an important role in some successful countries. FDI can be not only an important source of funds for some countries with limited access to finance, but also a way for praising the virtues in terms of the transfer of knowledge even in those countries with high saving rates. While some countries have been most successful in development with FDI, some have succeeded with little FDI (e.g., Japan and Korea).
There are both advantages and disadvantages of foreign firms in promoting learning. The advantages are that knowledge is gained by local people. They can learn to work with new technologies for instance. Also, local firms can benefit from this (foreign firms may bring knowledge which is locally unavailable and cannot be otherwise acquired). The disadvantages are that foreign firms might restrict the flow of knowledge across borders, i.e. using less advanced technologies in developing countries. In this case, FDI might not be the best way for developing countries to close the gap in knowledge with more advanced countries. Therefore, governments should know what kind of FDI is likely to be more beneficial when they try to create a learning economy through FDI. Spillovers from learning associated with one technology are more likely to be greater for nearby technologies. So, spillovers might be stronger across sectors with similar technologies than within the sector for different technologies.

In order to enhance the competitiveness of the learning sectors, government expenditures – subsidies to sectors or investments in R&D and education should be expanded. However, governments in developing countries, and even in developed countries, have a hard time to raise revenues. In the absence or lack of lump sum taxes, all taxes are distortionary, and so there is a real cost of providing such subsidies. It is therefore natural that governments attempt to shape their economy using tools which raise revenues rather than use the revenues. Tariffs and auctioned quotas can do that. Like targeted subsidies which may be the most effective way of promoting development and learning, trade policy (as part of industrial policy) may be an effective instrument too. Of course, there are static costs associated with such interventions, but the dynamic benefits can exceed these costs well.

But trade policy faces several problems. One of them is that there is the widespread theoretical presumption that support free trade, i.e. Adam Smith and his attack against mercantilism, Paul Samuelson, who formalized the welfare benefits of free trade, and David Ricardo, who developed the theory of comparative advantage. However, the stringent assumptions required to prove the result that free trade was desirable only highlighted the limited scope of the result. The analysis assumed perfect markets (perfect risk markets, perfect competition, full employment), and, most important from Stiglitz and Greenwald’s perspectives, no externalities or learning externalities. Free trade is not desirable when any of these assumptions is missed or dropped.

In a learning economy, free trade is not desirable in general. Growth and societal welfare is maximized with some trade intervention in order to encourage the learning (industrial) sector. Free trade is about trade liberalization. Developing countries which have grown more, may have achieved this because they have exported more (not because they liberalized); they may have succeeded in exporting more in the light of enhanced learning, which could have been impeded by liberalization.

For governments, it is desirable to intervene in the market, possibly through trade protection, so as to encourage sectors where there is more learning and more learning spillovers. Stiglitz and Greenwald call this the infant-economy argument for protection.
Learning benefits are likely to be particularly high for countries whose knowledge gap between themselves and the more advanced countries is large. Developing countries should protect their “infants” so that they can become more productive and competitive with the more advanced countries. Without providing protection, developing countries would be relegated to producing traditional goods that results in slow growth in productivity.

The industrial sector is subject to faster learning than agriculture. Protecting a learning sector (industrial sector) with large externalities results in faster growth and improved welfare and standards of living, supporting convergence between developing countries and the more advanced ones. But, not protecting it can results in stagnation. Thus, even if the economy never grows up fully, it may be desirable to provide such protection.

As the previous section of this chapter shows, industrial policies have been highly controversial and there are strong objections to it. Some of these objections which the opponents of industrial policy often frame are showing the failure of industrial policy in some countries and arguing that industrial policies are about picking winners. But they frame the question wrongly. The question is not whether industrial policies have failed in some cases, but whether they have succeeded in some instances. Indeed, there are few, if any successful countries that have not engaged in industrial policies. Even with some failures, average returns have been positive. It is true that industrial policies are inherently risky, but it is even riskier not to have an industrial policy. Good industrial policy entails risk taking, and with risk taking, of course, some failures should be expected. And industrial policies are not about picking winners. Industrial policies are about correcting market failures in general, and creating a learning society in particular. Now it is widely accepted that there can be important market failures arising from large negative externalities, such as from excessive risk taking in the financial sector or from pollution, and that there is an important role for government to correct these market failures. Except amongst the extreme right, there is a general consensus that, even if government interventions may not have been perfect, we are a lot better off because of these interventions, which have curbed air and water pollution. We worry here with an equally important set of positive externalities, and the role of government can be equally effective in correcting these externalities.

Indeed, there is plenty of evidence that a lot of countries have used industrial and trade policies successfully. For instance, in the nineteenth century the United States promoted the development of agriculture, which was the main industry at that time. If we look back on the history of telecommunication (from the first telegraph line to internet), we see that this entailed one form of support by government, or even the first browser was supported by the government. Moreover, the successful development of the most successful countries in East Asia is largely attributable to their recognition of the importance of learning and government’s role in promoting it. For example, Korea paid little attention to its static comparative advantage, which would have led it to focus on rice producing. However, Korea knew that even if it became the world’s most productive rice producing nation, its prospects would be finite. Korea knew that only by focusing on sectors on from which it
could learn, it could close the difference in knowledge with more developed countries, achieving the growth they aspired. Therefore, the country developed industrial, education, and technology policies, and succeeded by increasing its per capita income more than eightfold within the space of less than four decades.

If Korea had followed the dictates of the Washington Consensus policies, it would not have used industrial policies by eschewing it, and focused investments in education at the primary level. Consequently, it would have been a middle-income rice-growing country. History shows that not only countries like Korea which adopted industrial policies have done well, but also shows that countries like in Africa which eschewed industrial policies have suffered, leading to deindustrialization and low or negative economic growth.

Both today and historically, the most successful countries have used a different type of instruments as part of industrial policy; trade interventions have been amongst the most important ones. These countries have not only engaged in trade restrictions, but those restrictions were an explicit part of their growth strategies. Almost all the rich countries of today used tariff protection and subsidies to advance their industries; the USA and Great Britain are actually the countries which had used protection and subsidies most aggressively.

Certainly, all of these countries, including the East Asian tigers, engaged in trade, but it was promoting exports, expanding the learning sector, not trade liberalisation, opening domestic markets broadly to foreign imports. Sometimes trade interventions have not worked out well. They have sometimes been used as protectionist tools by special interests instead of redirecting society’s resources toward creating a learning society. However, the history of successful interventions suggests that failure is not inevitable. Countries will hopefully learn from the failures (and successes) of the past, and the returns from future interventions will probably be greater than those from past interventions.

Stiglitz and Greenwald state that well-designed trade policies, including those in East Asia, centered on learning and technology acquisition, have done a better job of promoting learning and growth than either of the extreme policies of full liberalisation or full autarky.

The role of industrial policy is especially important for developing countries in Africa and other regions, as they try to reindustrialize, to restructure their economies in order to become more integrated into the global economy and move away from too much dependence on the exports of commodity, to raise standards of income, reduce poverty and inequality, increase employment, and protect a fragile environment.

It should also be noted that countries cannot simply look to what other countries have done at similar stages of economic development, because history matters. Due to the changes in technology and the global marketplace, what worked, for example, for Korea fifty years ago does not mean that it may also work for another country in a similar position today. Also, given the difficulties of determining a country’s comparative advantage, countries should be careful about pursuing industrial policies that “defy” comparative advantage,
because it may not help much. And countries have to be strategic too, because history matters. They must take into account how enhancing capabilities today will have an impact on their potential for capability enhancement in the future.

As the measures and characteristics of industrial policy, Stiglitz and Greenwald suggest “broadband measures”, which would affect the economy as a whole. Some of these broadband measures are: 1) “low” exchange rate, where firms select a “winner” by themselves; 2) stimulation of industrial sector because of large spillovers to the rest of the economy; 3) stimulation of trade if it contributes to learning; 4) creating a good environment for FDI and outward bound investments, as it can also be an important role in learning; 5) offering programs for development of small and medium sized companies, which is an important measure to improve inter-generational disturbances (Prasnikar, 2014, p. 15).

2 POSITIVE STORY OF INDUSTRIAL POLICY FROM ABROAD: THE CASE OF SOUTH KOREA

2.1 Background Information and Macroeconomic Overview in South Korea

South Korea, officially the Republic of Korea, is a sovereign state in East Asia, constituting the southern part of the Korean Peninsula. Korea shares land borders with North Korea to the north, and overseas borders with Japan to the east and China to the west. Korea has a very attractive consumer market with population of 50.4 million (World Bank, 2016a) with a median age of 40.8 years and (CIA World Factbook, 2016a) literacy rate of 98 percent. Korea is the world’s 13th largest economy (USD 1.410 billion) and the 28th largest with per capita income (USD 27.971) (World Bank, 2014). Korea is the only country that went from a recipient of the Organisation for Economic Co-operation and Development (hereinafter: OECD) Development Assistance Committee’s aid and become a member of the donor committee. It is a global leader in the ship building, production of mobile handsets, LCD screens, memory chips, and it is the fifth-largest automaker (McKinsey Global Institute, 2013).

Korea is one of the most successful new industrialized economies in the world. It is a success story of economic development of the last half century with annual economic growth averaged 7.4 percent during the years of 1961 – 2014 (World Bank, 2016b). Indeed, the success of Korea’s economy in the past 40 years has been notable. Korea was among the world’s poorer countries in the 1960s with GDP per capita which was comparable with levels in the poorer countries in Asia and Africa.

In the early 1960s, the government of Korea wanted to transform the country from a traditional agriculture-based country into an industrial country. The government decided to play the key role in economic development as there was no other Korean institution which had the capacity (or resources) to direct such drastic change within a short space of time.
The Korean government hoped to take advantage of existing technology to be competitive in areas where highly industrialized countries had already achieved success (Savada & Shaw, 1992, pp. 140-141). Fortunately, Korea had skilled and unskilled labour forces to support appropriate industries and economic growth. Namely, unskilled and cheap workforce for labour intensive industries in the 1960s, skilled workforce (e.g., engineers) for heavy and chemical industries (hereinafter: HCIs) in the 1970s, and researchers and scientists for technology oriented-industries in the 1980s (Korea Development Institute [KDI], 2005). The government believed that the highly motivated and well-educated workforce would produce low-cost and high-quality products which could be exported to the USA and other countries, and profits earned from exports would be used for further expand capital (financial resources), create new jobs, and pay off loans eventually (Savada & Shaw, 1992, p. 141).

The main major goal of the government at that time was to establish a self-reliant industrial economy that would be independent from the massive waves of the United States’ aid. Modernizing the economy and maintaining overall sustained growth were additional goals of the government in the 1970s. Important economic policies were to increase employment, strengthen key industries and develop effective management systems. The reason was that Korea was dependent on imports of raw materials such as oil; the government’s major aim was to increase the exports significantly, achieving more international competitiveness and higher productivity. The emphasis of the early economic plans were given on infrastructure and agriculture, later on construction. Then the emphasis moved to light industry, electronics, and HCIs consecutively. As a result of these strategies, an export-driven economy developed (Savada & Shaw, 1992, p. 142).

The government combined the import substitution policy with the export-led approach, and chose a group of strategic industries (e.g., automobiles, shipbuilding, and electronics) to support. The government protected new industries by making the importation of such goods difficult, and later on, it created good conditions for the exports when those new industries developed. The export incentives were tariff exemptions for raw materials imported for the manufacture of export goods, a reduction of corporate and private income taxes for exporters, accelerated depreciation allowances, business tax exemptions, and etc. (Savada & Shaw, 1992, p. 142). After establishing the Economic Planning Board in 1961, the government implemented a series of economic development plans from 1962 to 1996, which played an important role in the industrialization of the country. These economic programs were based on a series of five-year plans (Savada & Shaw, 1992, p. 144).

The first five-year economic development plan (1962-1966) consisted of first steps toward the building of a self-sufficient industrial structure. The emphasis was given on the areas in electrification, fertilizers, synthetic fibers, oil refining, and cement. The second five-year economic development plan (1967-1971) emphasized the modernization of the industrial structure and rapidly building of import-substitution industries such as machinery, steel and
chemical industries. The third five-year economic development plan (1972-1976) succeeded in building an export-oriented structure rapidly by promoting HCIs such as iron and steel, household electronics, transport machinery, petrochemicals, and shipbuilding. The fourth five-year economic development plan (1977-1981) encouraged and fostered the development of industries which were designed to effectively vie in the industrial export markets of the world. These major strategic industries included skilled labor-intensive and technology-intensive industries, including electronics, machinery, and shipbuilding. The plan stressed largely HCIs such as petrochemicals, iron and steel, and nonferrous metal. The fifth five-year economic development plan (1982-1986) moved the emphasis away from HCIs to technology-intensive industries such as electronics, precision machinery, and information. The sixth five-year economic development plan (1987-1991) continued to emphasize the aims of the previous plan. The government intended to quicken import liberalization and to remove many types of restrictions and nontariff barriers on imports. The government pledged to continue removing direct assistance to specific industries and instead to increase manpower training and R&D in all industries, particularly the SMEs which previously had not been paid much attention by the government (Savada & Shaw, 1992, pp. 144-145). The seventh five-year economic development plan (1992-1996) was the last plan as the Economic Planning Board and Ministry of Finance merged in 1994 (KDI, 2005). Each of these economic development plans contributed greatly to industrialization and expanding the marketplaces of Korea.

Korea has been transformed from one of the least developed countries in the 1960s to one of the world’s leading industrial countries in the last 50 years. Korea could significantly shape the structure of its economy in the periods of 1965 – 2014. The dynamics of value added in the sectors of service, industry, and agriculture as percent of GDP in those years changed from 39.3 percent to 59.4 percent, from 21.3 percent to 38.2 percent, and from 39.4 percent to 2.3 percent respectively (Figure 1).

Figure 1. Value Added by Economic Sectors (% of GDP)

Source: Global Economy, South Korea Economic Indicators, 2016a.
Today, Korea’s semiconductor, IT, shipbuilding, automobile, steel making, and other industries are on the leading edge in global markets. Its global market share in semiconductors is 52.4 percent (with a market share rank -1st), TVs and displays is 42.1 percent (1st), smartphones is 37.6 percent (1st), shipbuilding is 35 percent (1st), automobiles is 8.8 percent (5th), and petrochemicals is 5.4 percent (5th). (Invest Korea, 2015). In 2015, Korea was ranked as the world’s most innovative country according to Bloomberg’s 2015 Global Innovation Index (Bloomberg, 2016).

Based on the statistics of 2014, the unemployment rate in Korea is 3.5 percent, which is one of the lowest in the world. The country’s international reserves are also significant (USD 364 billion or 26 percent of GDP), but are still much smaller than its external debt (31.5 percent of GDP) (Focus Economics, 2016). And the current account balance is USD 89.2 billion or 6.33 percent of GDP (World Bank, 2016c).

2.2 Industrial Policy in South Korea

2.2.1 Foreign Trade and Export Promotion

In 1961 Korea put priority on converting a system which was dependent on foreign aid to an economy which was self-reliant. Therefore, the government developed industries based on import-substitution. Export promotion was considered as a short-term instrument and transitional policy to stabilize the economy, not as a policy to develop the economy. The reason for such decision lies in the fact, that it was hard for the country to export products immediately due to its industrial level and the situations on foreign markets at that time. Instead, the government thought that it would be better to substitute imported products with local products, improve the international balance of payments and then create and increase jobs, resulting in making the import substitution-based industries capable of exporting products. However, the government focused on export-oriented policies rather than on import substitution in 1964. The reasons for this focus were that the foreign currency became a bigger issue because of foreign aid being suspended, resulting in a reduction the foreign reserves; the demand for foreign currency by import substitution-based industries increased in light of heavy dependence on imports for raw materials. There was also another reason that gave the government self-confidence to pursue export-oriented policies. The reason was the change in the share of industrial products in the total exports. The share of industrial products already rose to 45 percent whereas the share of only agricultural and mineral products was 80 percent in the 1950s (KDI, 2005).

Korea had to rely heavily on international trade as a major source of development, because it had little natural resources, and also a small domestic market. Also, it tried to diversify its trading partners not to become dependent only on a few markets (Savada & Shaw, 1992, p. 188). Therefore, the government promoted cooperation with other nations and opened the way to foreign markets through trade agreements with them. Korea reached trade agreements with the USA in 1956, Thailand and Taiwan in 1961, Vietnam in 1962, Japan in 1966. In 1967, Korea became a member of GATT (General Agreement on Tariffs and
Trade) and this memberships removed the trade barriers, which Korea had faced by that time, to export (KDI, 2005).

To promote exports, the Korean government provided direct and indirect incentives in financing, taxation and administrative control to the exporting companies. During the export promotion periods, the incentive measures included reductions in corporate and private income taxes; business tax exemptions, tariff exemptions and tax rebates on materials imported for the purpose of export production; financing of imports for producing goods for exports; accelerated depreciation allowances; foreign currency loans to finance exports on long-term credits; creation of many different reserve funds; a fund at subsidized interest rates to promote export industries and another to encourage firms to export; and export-import link system; export insurance; differential treatment of traders based on export performance; etc., of which we will see some of them in the below (Kwan, 1991).

In the early 1960s, the government gave the emphasis on the exports of the products of the labour intensive light industries, especially textile and garment industry, where the economy had a comparative advantage (Mah, 2010). Starting in 1961, the Tax Exemption and Reduction Control Law provided exporting firms with tax deduction measures. Beginning in 1964, tax benefits such as an 80 percent reduction of profit taxes were provided to profits related to exports. Starting in 1973, tax benefits were provided to the strategic HCIs, including iron and steel, shipbuilding, chemicals, and machinery, i.e. firms in these industries were exempted from domestic taxes through a full waiver of the profit taxes for the first three years and then an exemption of half of the profit taxes for the following two years. From the early 1980s, the government started offering tax incentives in order to support R&D. However, because of the WTO regulations on tax incentives, tax benefits which directly target export promotion are not allowed in the country nowadays (Inter-American Development Bank [IDB], 2015). The Bank of Korea enacted relevant financial regulations and started offering preferential financial treatment to exporters. In 1962, export finance regulations were established to easily finance the purchase of raw materials, production, shipping, as well as settle earnings from exports. Besides, systems to supply short-term financing were established, including the Foreign Currency Denoted Supply Financial System, the System to Guarantee Payment of Imported Raw Materials for Manufacturing Export Goods in 1963. To facilitate investment in export industries, systems to supply mid-to-long term financing were provided, i.e. 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 promoted exports by devaluing the national currency, Korean won, against the US dollar (KDI, 2005). For example, the exchange rate (won/USD) was devalued from time to time, that is, from 190 to 255 in 1964, to 317 in 1970, to 399 in 1972, and then to 484 in 1974. The exchange rate had been fixed at 484 won/USD between 1974 and 1980 (Mah, 2010).

In 1962, the government established Korea Trade Promotion Corporation (hereinafter: KOTRA) as a national trade promotion organization, which has been renamed Korea Trade-Investment Promotion Agency since 1995, to assist exporters collect information on
and enter new foreign markets. KOTRA and Korea International Trade Association (KITA), which was founded in 1946, worked as the institutions helping firms overcoming the export barriers such as the informational, motivational, and operational/resource barriers. Since that time, KOTRA has been facilitating the country’s rapid export-led economic development through various trade promotion activities such as foreign market surveys, SME export promotion, foreign investment in Korea promotion and business matchmaking, etc. (KDI, 2005; Mah, 2010).

In 1964, the Act for Development of the Export Industry Complex was enacted in order to facilitate the exchange of market information and promote joint exports (KDI, 2005). In 1965, the government selected some light industry products as those appropriate for export-led industrialization and promoted the exports of the manufacturers of those products such as plywood, cotton fabrics, raw silk, craftwork, leather, radio and electronic appliances, fisheries and mushroom cans, rubber products, clothes, wool products. In 1967, it was allowed for exporting companies to depreciate their machinery investment 30 percent more rapidly than that usually allowed for additional tax benefits (Mah, 2010). Besides, the government adopted other industry specific promotion acts such as the machinery promotion act in 1967, the electronics promotion act, the automobile promotion act and the petro-chemical promotion act in 1969, resulting in the increase in the share of industrial products in total exports, as well as in GDP (KDI, 2005). In 1969, the government introduced the export insurance scheme under the Export Insurance Act in order to protect firms against unexpected losses as they pursued increased exports. The government’s Export Insurance Fund covers these unexpected losses. The value of this Fund totaled about USD 1.7 billion (1.83 trillion won) in 2012 (IDB, 2015).

Korea was transformed from a traditional agriculture-based economy into a manufacture-based economy between 1961 and 1971. There were complete structural changes in the exports in the space of 10 years. For instance, in 1961 the share of agricultural products in total exports was 28.6 percent, or the share of primary sectors was 72.3 percent (agriculture – 28.6 percent, fishery – 19.2 percent, and mining – 24.5 percent) while the share of manufacturing products was only 27.7 percent. But in the span of 10 years it changed substantially. In 1971 the share of manufacturing products reached 88.9 percent while the share of agricultural products in total exports shrank to only 4.3 percent, or the share of primary sectors shrank to 11.1 percent (agriculture – 4.3 percent, fishery – 4.6 percent, and mining – 2.2 percent) (KDI, 2005).

The main thrust of the industrial policy of the country moved from the light industry to developing the high-value added HCIs during the 1970s. As the most important HCIs, the government selected iron and steel, non-ferrous metal, electronics, shipbuilding and chemical industries. As a result, the share of the HCIs in all industries rose from 23 percent in 1960 to 54 percent in 1980 (Mah, 2010). Also, the share of HCIs in total exports substantially changed between 1971 and 1981. The share of HCIs increased to 44 percent in 1981 from 14 percent in 1971 whereas the share of light industrial goods decreased to 46 percent from 72 percent (Table 2).
Table 2. Structural Change in Korea’s Exports during 1971 – 1981 (% of Total Exports).

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary Products</td>
<td>14</td>
<td>12</td>
<td>10</td>
</tr>
<tr>
<td>Light Industries</td>
<td>72</td>
<td>58</td>
<td>46</td>
</tr>
<tr>
<td>HCIs</td>
<td>14</td>
<td>30</td>
<td>44</td>
</tr>
<tr>
<td>Total</td>
<td>100</td>
<td>100</td>
<td>100</td>
</tr>
</tbody>
</table>


In 1975, the government started implementing the duty drawback scheme as an export promotion approach. In accordance with the Special Act for Duty Drawback, raw materials used for export goods were eligible for duty drawback for the first thirteen months after importation. Later on, starting in 1997, the Act changed this period to two years after importation. The drawback rate increased from 0.3 percent in 1975 to 2.6 percent in 1990; the amount of duty drawback was as low as 0.1 trillion won (USD 0.2 billion) in 1975 but it continued to increase to 4.3 trillion won (USD 4 billion) till 2013. However, as a result of the expansion of export values, the drawback rate shrank to 0.6 percent in 2013. The ratio of duty drawback and import tariff collection fluctuated between 17 percent and 27 percent during the 1990s and 2000s, and then the ratio of duty drawback reached 40.9 percent in 2013. As we can see, the amount of duty drawback is substantial and the government has been actively utilizing the duty of drawback scheme to promote exports (IDB, 2015).

In 1976, the government established the Korea Export-Import Bank (hereinafter: Korea EXIM bank), an official export credit agency, to provide export financing and guarantees to exporting firms. The government also imposed strict regulations on the local commercial banks till the 1980s. They provided export-related industries with policy loans at preferential rates which were lower than regular commercial rates. Also, Korea Development Bank supported selected industries. As a result, the share of policy loans rose from less than 40 percent of total bank lending in 1971 to 70 percent in 1978. However, the government decided to reduce policy loans in 1980. It officially liberalized most interest rates at the end of 1988. Policy loans are currently provided to SMEs, especially their research activities, and so are not directly related to export promotion (IDB, 2015).

Among all the incentive measures for export promotion, interest rate subsidies to exporting firms was one of the most important measures. As we can see from Table 3, the interest rates charged by the banks to the export-oriented businesses were considerably lower than the interest rates charged to commercial-oriented businesses. As an example, when the commercial interest rates reached 26 percent in 1965, exporting firms financed as much as 78 percent of their operating budgets from bank loans at 6.5 percent (Kwan, 1991).

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3 The amount of duty drawback divided by total export values.
Table 3. Bank Interest Rates in Export versus Commercial Loans

<table>
<thead>
<tr>
<th>Date</th>
<th>Export Lending</th>
<th>Commercial Lending</th>
</tr>
</thead>
<tbody>
<tr>
<td>April 1962</td>
<td>12.78</td>
<td>16.43</td>
</tr>
<tr>
<td>May 1963</td>
<td>8.03</td>
<td>15.70</td>
</tr>
<tr>
<td>March 1964</td>
<td>8.00</td>
<td>16.00</td>
</tr>
<tr>
<td>September 1965</td>
<td>6.50</td>
<td>26.00</td>
</tr>
<tr>
<td>June 1967</td>
<td>6.00</td>
<td>26.00</td>
</tr>
<tr>
<td>May 1973</td>
<td>7.00</td>
<td>15.50</td>
</tr>
<tr>
<td>January 1974</td>
<td>9.00</td>
<td>15.50</td>
</tr>
<tr>
<td>April 1975</td>
<td>7.00</td>
<td>15.59</td>
</tr>
<tr>
<td>August 1976</td>
<td>8.00</td>
<td>18.00</td>
</tr>
<tr>
<td>June 1978</td>
<td>9.00</td>
<td>19.00</td>
</tr>
<tr>
<td>January 1980</td>
<td>12.00</td>
<td>25.00</td>
</tr>
</tbody>
</table>


In 1981, the government started emphasizing the importance of R&D in its export-led growth strategy. The government moved the emphasis away from HCIs to technology-intensive industries from 1983. The emphasis on R&D resulted in an increase in exports of technology-based electronic goods since the late 1980s (Mah, 2010). In 1988 Korea’s annual trade exceeded USD 100 billion for the first time, making it the tenth largest trading country in the world (Savada & Shaw, 1992, p. 188).

In 1992, the government established the Korea Export Insurance Corporation (renamed Korea Trade Insurance Corporation since 2010) as an organization devoted to the export insurance scheme. Recently, this organization started covering not only export but also import contracts in order to secure natural resources and commodities that are critical to the Korean economy (IDB, 2015).

Export promotion policy implemented by the government proved to be very successful, exceeding everyone’s expectations. During 1960 – 1985, export growth averaged 34 percent a year. The annual export value grew from USD 33 million in 1960 to USD 30 billion in 1985, and then to USD 573 billion in 2014. Imports exceeded exports till 1985, resulting in the negative balance of trade. Exports exceeded imports between 1986 and 1989, and then imports started exceeding exports again from 1990 to 1997. However, starting from 1998 exports have been exceeding imports in all the years (except 2008) till today, making the balance of trade positive (Table 4).
Table 4. Export and Import of Commodities during 1960 – 2014 (Thousand US Dollar)

<table>
<thead>
<tr>
<th>Year</th>
<th>Export</th>
<th>Growth</th>
<th>Import</th>
<th>Growth</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Value</td>
<td>%</td>
<td>Value</td>
<td>%</td>
</tr>
<tr>
<td>1960</td>
<td>32,827</td>
<td>65.7</td>
<td>343,527</td>
<td>13.1</td>
</tr>
<tr>
<td>1965</td>
<td>175,082</td>
<td>47.1</td>
<td>463,442</td>
<td>14.6</td>
</tr>
<tr>
<td>1970</td>
<td>835,185</td>
<td>34.2</td>
<td>1,983,973</td>
<td>8.8</td>
</tr>
<tr>
<td>1975</td>
<td>5,081,016</td>
<td>13.9</td>
<td>7,274,434</td>
<td>6.2</td>
</tr>
<tr>
<td>1980</td>
<td>17,504,862</td>
<td>16.3</td>
<td>22,291,663</td>
<td>9.6</td>
</tr>
<tr>
<td>1985</td>
<td>30,283,122</td>
<td>3.6</td>
<td>31,135,655</td>
<td>1.6</td>
</tr>
<tr>
<td>1990</td>
<td>65,015,731</td>
<td>4.2</td>
<td>69,843,678</td>
<td>13.6</td>
</tr>
<tr>
<td>1995</td>
<td>125,057,988</td>
<td>30.3</td>
<td>135,118,933</td>
<td>32</td>
</tr>
<tr>
<td>2000</td>
<td>172,267,510</td>
<td>19.9</td>
<td>160,481,018</td>
<td>34</td>
</tr>
<tr>
<td>2005</td>
<td>284,418,743</td>
<td>12</td>
<td>261,238,264</td>
<td>16.4</td>
</tr>
<tr>
<td>2006</td>
<td>325,464,848</td>
<td>14.4</td>
<td>309,382,632</td>
<td>18.4</td>
</tr>
<tr>
<td>2007</td>
<td>371,489,086</td>
<td>14.1</td>
<td>356,845,733</td>
<td>15.3</td>
</tr>
<tr>
<td>2008</td>
<td>422,007,328</td>
<td>13.6</td>
<td>435,274,737</td>
<td>22</td>
</tr>
<tr>
<td>2009</td>
<td>363,533,561</td>
<td>-13.9</td>
<td>323,084,521</td>
<td>-25.8</td>
</tr>
<tr>
<td>2010</td>
<td>466,383,762</td>
<td>28.3</td>
<td>425,212,160</td>
<td>31.6</td>
</tr>
<tr>
<td>2011</td>
<td>555,213,656</td>
<td>19</td>
<td>524,413,090</td>
<td>23.3</td>
</tr>
<tr>
<td>2012</td>
<td>547,869,792</td>
<td>-1.3</td>
<td>519,584,473</td>
<td>-0.9</td>
</tr>
<tr>
<td>2013</td>
<td>559,632,434</td>
<td>2.1</td>
<td>515,585,515</td>
<td>-0.8</td>
</tr>
<tr>
<td>2014</td>
<td>572,664,607</td>
<td>2.3</td>
<td>525,514,506</td>
<td>1.9</td>
</tr>
</tbody>
</table>


According to the statistics of 2014, Korea is the world’s sixth largest exporter (USD 572.66 billion) and the ninth largest importer of goods (USD 525.51 billion), making it one of the largest trading nations in the world (Statista, 2016a, 2016b).

In 2015, Korea exported USD 526.9 billion worth of products around the world, which was 8.1 percent down compared to 2014. Top 10 export products accounted for 85.7 percent of the overall value of its total exports (Table 5). China is Korea’s largest trading partner; Korea’s exports to China amounted to USD 137.1 billion or 26.1 percent of its overall exports while its imports from China amounted to USD 90.2 billion or 20.7 percent of its overall imports (World’s Richest Countries, 2016a, 2016b).
Table 5. Korea’s Top 10 Exports in 2015 (Billion US Dollar)

<table>
<thead>
<tr>
<th>Products</th>
<th>Value</th>
<th>Share in total exports</th>
</tr>
</thead>
<tbody>
<tr>
<td>Electronic equipment</td>
<td>138.4</td>
<td>26.3%</td>
</tr>
<tr>
<td>Vehicles</td>
<td>69.1</td>
<td>13.1%</td>
</tr>
<tr>
<td>Machines, engines, pumps</td>
<td>62.1</td>
<td>11.8%</td>
</tr>
<tr>
<td>Ships, boats</td>
<td>38.4</td>
<td>7.3%</td>
</tr>
<tr>
<td>Oil</td>
<td>33.2</td>
<td>6.3%</td>
</tr>
<tr>
<td>Medical, technical equipment</td>
<td>32.5</td>
<td>6.2%</td>
</tr>
<tr>
<td>Plastics</td>
<td>28.2</td>
<td>5.4%</td>
</tr>
<tr>
<td>Iron and steel</td>
<td>20.2</td>
<td>3.8%</td>
</tr>
<tr>
<td>Organic chemicals</td>
<td>18.2</td>
<td>3.5%</td>
</tr>
<tr>
<td>Iron or steel products</td>
<td>11.2</td>
<td>2.1%</td>
</tr>
</tbody>
</table>

Source: D. Workman, *South Korea’s Top 10 Exports*, 2016.

Korea’s industrial development achieved through export-oriented strategies was remarkable. The country managed to achieve the development of major industries. At the same time, it successfully managed to diversify its trading partners, making the country less dependent on a few markets for trading. The USA and Japan were the major trading partners of Korea, making the country greatly dependent on these two markets. For instance, Korea exported 75.6 percent of the total exports to these countries in 1970 (Savada & Shaw, 1992, p. 189). However, the share of all exports going to these two markets shrank substantially. Korea exported to the USA and Japan only 18.2 percent (13.3 percent to the USA and 4.9 percent to Japan) of the overall exports in 2015 (World’s Richest Countries, 2016a).

Table 6. Exports of Goods and Services (% of GDP)

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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>3.2</td>
<td>8.3</td>
<td>12.9</td>
<td>25.3</td>
<td>30.2</td>
<td>29.8</td>
<td>25.9</td>
<td>26.7</td>
<td>35.0</td>
<td>36.8</td>
<td>49.4</td>
<td>50.6</td>
</tr>
</tbody>
</table>


As we can see from Table 6, the share of exports of goods and services in Korea’s GDP increased rapidly during 1960 - 2014. The share of exports of both goods and services increased from 3.2 percent in 1960, to 30.2 percent in 1980, and then to 50.6 percent in 2014, making Korean economy very dependent on exports.

2.2.2 Foreign Direct Investments

Korea is often taken as a development model for other countries due to its economic success over decades, interrupted only by the Asian financial crisis in 1997. Unlike in some other countries in the region, FDI did not play much role in the early stages of the
development of Korea. The government experimented with import substitution, export promotion, and then industrial policies in the form of HCI Promotion Plan (Nicolas, Thomsen, & Bang, 2013). However, when the financial crisis of 1997 started and effected the Korean economy, the government began to attract FDI aggressively (IDB, 2015).

In 1960, the government enacted the Foreign Capital Inducement and Promotion Act (FCIPA) to secure an adequate amount of foreign capital by allowing foreign investment inflows, regardless of type or amount, if the purpose of the investment was deemed appropriate. In 1966, the FCIPA together with other two laws merged into the Foreign Capital Inducement Law, which regulated inflows of foreign loans, direct investment and technology (Nicolas et al., 2013).

The government established Free Trade Zones (hereinafter: FTZs) (then called Free Export Zones (FEZ)) after 1970 in order to attract foreign investment in labour-intensive, high value-added manufacturing activities, thereby promoting foreign exchange earnings through increased exports and employment and advanced technological knowledge amongst local firms through technological transfer. In 1970, the Act for Development of Free Export Zones was introduced, and in the same year the government established its first FTZ in Masan. The government supplied transport facilities, utilities, lands, and even buildings at highly subsidized rates in the FTZ. In 1973, the second FTZ zone was established in Iri. The main objective to establish these zones was to attract FDI in manufacturing industries. The government has introduced many different incentives in order to attract FDI firms in the FEZs (KDI, 2005; Nicolas et al., 2013).

The government wanted to use FDI to ease the issues of balance of payments and to acquire needed technology and expertise. FDI was welcomed into the export sector of light manufacturing, particularly in the two FEZs at Iri and Masan (Kim & Hwang, 2000). However, after the government realized in the 1970s that FDI was needed to restructure the economy, it also began to allow FDI in heavy industry sectors with the primary purpose to support the exports (Kim, 2003).

In 1973, the General Principles on Foreign Investments was issued to direct foreign investment to sectors that were desirable for the Korean economy. Various tax reductions and exemptions were given to foreign investors in the areas open to FDI. However, foreign investors were also subject to various limitations according to the type of business. There were requirements for minimum investment and exports. Besides, many sectors were excluded for foreign investors, especially when they competed with local exporters in those sectors. By the same token, some strategic sectors that need better technology were not subject to export requirements (Nicolas et al., 2013).

In the early 1980s, the government recognized FDI as a key channel for acquiring advanced technology (Kim, 2003). In 1983, two laws – the Public Loan Inducement and Supervision Law, and the Foreign Capital Supervision Law – merged into the New Foreign Capital Inducement Law, reflecting less government controls on FDI (Nicolas et al., 2013).
1984, the government replaced the positive list system with a negative list system (in which all industries not listed were open for FDI approval) (Kim & Hwang, 2000).

In June 1993, the government announced a five-year FDI liberalization plan in order to continue the process of simplifying the regulations related to inward FDI, increase the number and range of sectors that are open to FDI, increase efforts to promote inward FDI. The Five-Year Plan was followed by another plan beginning in 1995 and by a 1994 Reform Plan for the Improvement in the Foreign Investment Environment (Nicolas et al., 2013).

When Korea joined the OECD in 1996, the government brought its FDI policies in line with international norms and standards by turning the Foreign Capital Inducement Act into the Act on Foreign Direct Investment and Foreign Capital Inducement (Kim, 2003).

Though Korea promoted FDI inflow to the country from the early years of development, it hesitated to actively attract FDI till 1997. However, when the financial crisis started in 1997, acquiring foreign exchange became the top priority of the government. For this reason, the government began to attract FDI aggressively (IDB, 2015).

In 1998, the government enacted the Foreign Investment Promotion Act (FIPA) to focus on creating an investor-oriented policy environment by improving foreign investment procedures, establishing an institutional framework for investor relations, and expanding investment incentives (Kim & Hwang, 2000). Furthermore, the government issued the Enforcement Regulation of the Foreign Investment Promotion Act, the Enforcement Decree of the Foreign Investment Promotion Act, Regulation on tax Reductions or Exemptions for Foreign Investment, Regulations on Foreign Investment and Technology Inducement, and the Special Tax Treatment Control Act (Kim, 2003).

Due to these promotions, the inflow of FDI increased significantly. For instance, the total volume of FDI reached about USD 40 billion between 1998 and 2000 while the total FDI was only USD 25 billion during 1962 – 1997 (Kim, 2003). Foreign multinationals contributed substantially to Korea’s net trade surplus, employment generation as well as to manufacturing production, accounting for 44 percent of the production of the domestic manufacturing sector during 1997 – 1999 (Nicolas et al., 2013).

In 1998, the government established the Invest Korea (IK), the Korea Investment Service Center (KISC) initially, as part of the KOTRA, to support the entry and establishment of foreign businesses in the country by providing comprehensive services to foreign businesses, including assistance with investment notification and corporate establishment, consultations, support for business activities, and etc. Currently, IK has 35 overseas offices and 62 investment-promotion specialists abroad in order to attract more investment. These overseas offices provide information on Korea’s investment environment to potential investors and do investment promotion activities (Invest Korea, 2016a). IK has been playing an important role in attracting FDI to the country, i.e., 79.5 percent (USD 15.1 billion) of the total FDI inflow in 2014 was attracted by IK (Invest Korea, 2016b).
Moreover, the government established the Office of the Foreign Investment Ombudsman in 1999 to serve foreign investors, aiming to resolve the grievances of foreign-invested companies operating in Korea. In the same year, the government set up the Committee on Foreign Direct Investment, which consists of representatives of many ministries and agencies, to review FDI policies and systems on a continual basis. The Committee makes main policy decisions on FDI and prepares an annual FDI Environment Improvement Plan (Nicolas et al., 2013).

Korea has started establishing Free Economic Zones (FEZs) since 2003. There are currently eight FEZs in the country. Besides, there are 989 industrial complexes, six Free Trade Zones (FTZs), 79 Foreign Investment Zones in the country (Invest Korea, 2016c).

As we mentioned earlier, the government began to attract FDI aggressively after the financial crisis of 1997 started. The government has provided many different incentives to foreign-invested firms to attract FDI since 1998, which include subsidized rental fees and corporate tax reduction. It strengthened the tax incentives to these firms by lowering the required minimal amount of investment in manufacturing and physical distribution service from USD 50 million to USD 30 million and from USD 30 million to USD 10 million respectively. Though the amount of FDI inflows decreased to about USD 4-5 billion for each year during 2001-2003, it increased again in 2004 because of the change in tax reduction scheme. Besides these provision of tax incentives and rental subsidies, the government also introduced a new cash grant system in order to attract foreign invested firms which are regarded as indispensable for R&D or hi-tech businesses (IDB, 2015). Cash grants are available for foreign investors that should meet the requirements of the 30 percent foreign ownership (and USD 10 million of minimum capital requirement for manufacturing) when they invest in any of the prescribed businesses such as high-technology business, parts or material manufacturing, new or additional facility investment contributing to job-creation (PwC, 2012) (Table 7).

Due to the good environment for FDI, the number of foreign-invested companies in Korea increased significantly. For instance, while the number of such companies was only 1678 in 1990, this number reached 3542 in 1997, and 15831 in April 15, 2014 (Invest Korea, 2016c). As a result, the total export of foreign invested companies was USD 113.2 billion, accounting for 20.2 percent of Korea’s total exports (USD 559.6 billion) in year 2013 and the total imports of foreign invested companies were 111 billion, accounting for 21.5 percent of Korea’s total imports (USD 515.6 billion) in 2013 (Invest Korea, 2016b).

The USA, Japan, the Netherlands, the UK and Germany are the top investors in Korea (PwC, 2012). The USA is the largest single-country whose share of FDI in Korea totals USD 49.8 billion (24.5 percent) of Korea's total stock of FDI since the 1960s. Japan has invested USD 32.8 billion (16.1 percent of the total), followed by the Netherlands with USD 21.7 billion (10.7 percent). The EU countries have invested USD 67.4 billion (33.1 percent of the total) (Embassy of the United States in Korea, 2013).
### Table 7. Foreign Investment Incentives

<table>
<thead>
<tr>
<th>Tax Reduction</th>
<th>Qualifications</th>
<th>Incentives</th>
</tr>
</thead>
<tbody>
<tr>
<td>High-tech status</td>
<td>- Contribute significantly to domestic economy and technology</td>
<td>- Income, corporate tax: 100 percent for 5 years, 50 percent for 2 years after that</td>
</tr>
<tr>
<td>Foreign Investment Zone</td>
<td></td>
<td>- Local tax: 100 percent for 15 years</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Customs: 100 percent for 5 years</td>
</tr>
<tr>
<td></td>
<td>Individual Type:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Manufacturing: FDI USD 30 million or more</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- R&amp;D center: FDI USD 2 million or more &amp; 10+ researches</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Complex Type:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Manufacturing: FDI USD 10 million or more</td>
<td></td>
</tr>
<tr>
<td></td>
<td>Individual Type:</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- Manufacturing: FDI USD 10 million or more</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- R&amp;D center: FDI USD 1 million or more &amp; 10+ researches</td>
<td></td>
</tr>
<tr>
<td>Free Economic Zone</td>
<td></td>
<td>- Income, corporate tax: 100 percent for 3 years, 50 percent for 2 years after that</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Local tax: 100 percent for 15 years</td>
</tr>
<tr>
<td></td>
<td></td>
<td>- Customs: 100 percent for 5 years</td>
</tr>
<tr>
<td>Land Support</td>
<td></td>
<td>- Reduction of rent fee</td>
</tr>
<tr>
<td></td>
<td>- More than 30 percent of foreign investors’ stock rate</td>
<td>- Support for infrastructure</td>
</tr>
<tr>
<td>Cash Grant</td>
<td>- More than 30 percent of foreign investors’ stock rate</td>
<td>5 percent to 40 percent of the foreign investment amount</td>
</tr>
<tr>
<td></td>
<td>- Manufacturing: Parts &amp; materials specialty or high-tech status</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- R&amp;D center: New R&amp;D facilities and 5+ researches</td>
<td></td>
</tr>
</tbody>
</table>


In 2014, Korea attracted FDI of a total of USD 19 billion, which was the largest ever in its history. It was a 30.6 increase compared to 2013. The EU, the USA and Japan were the top investors in 2014; the share of the EU, the USA and Japan in the total FDI were 34.2 percent (USD 6.5 billion), 19 percent (USD 3.6 billion) and 13.1 percent (USD 2.5 billion) respectively. The share of total FDI by industry in year 2014 were as follows: 58.9 percent (USD 11.2 billion) in service; 40.2 percent (USD 7.6 billion) in manufacturing; 0.1 percent (USD 16 million) in primary industry; 0.8 percent (USD 151 million in other industries (Invest Korea, 2016b).

We can see from Table 8 that the increase in the amount of FDI between 1970 and 2014 were tremendous. While the FDI in 1970 was only USD 76 million, this amount reached
nearly USD 2 billion in 1995. After the government has begun attracting FDI actively since 1998, the amount of FDI significantly rose to USD 8.8 billion in 1998, USD 15.5 in 1999, and then USD 19 billion in 2014.

Table 8. FDI Inflow (Million USD Dollar)

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</tr>
</thead>
<tbody>
<tr>
<td>USD</td>
<td>76</td>
<td>143</td>
<td>803</td>
<td>1,970</td>
<td>15,256</td>
<td>11,565</td>
<td>13,071</td>
<td>13,673</td>
<td>16,286</td>
<td>14,548</td>
<td>19,003</td>
</tr>
</tbody>
</table>

Source: IDB, Analysis of Experiences in Trade and Investment between LAC and Korea: Lessons Learned in Development, 2015, p. 23, Table 1a-2; Invest Korea, Invest Korea Annual Report 2014, 2016b.

2.2.3 Small Business Development

The SME policy framework in Korea began with governmental efforts to protect SMEs from dominance of large firms. Traditional SME policies were created in the 1960s and SMEs were protected from large firms during the industrial period in the 1970s and 1980s (Kim, n.d.). Though Korean’s GNP (Gross National Product) growth averaged 8.78 percent annually during 1962-1971, its small and medium-sized industries declined in general during this period. Especially, the share of employees, business, and value added of SMEs in the manufacturing and mining industries fell in the early 1960s till 1971, because some SMEs grew and became bigger companies and, at the same time, larger factories began to be built (KDI, 2005).

In the first half of the 1960s, the economic development policies gave emphasis on building a strong foundation for industrial development and so metallurgical, machinery, petrochemicals and other industries were promoted. Though the government pursued a serious of policies to promote SMEs and the importance of SMEs were heightened during this period, actual support for SMEs was not sufficient enough, as greater support was given to larger firms (KDI, 2005).

During the 1960s, the government created SME policies, by establishing a legal framework for assisting and fostering SMEs. For instance, the Bank for Small and Medium Enterprises was established for providing financial assistance only for SMEs in 1961. Special measures for protecting SME-specific markets were implemented, i.e., a law that prohibited selling specific imported products (May 1961) and a law that intended to restrain over-heated competition among SMEs to expand markets for SMEs (December 1961), and a law for establishing a cooperative association among SMEs (December 1961) were introduced. From 1964, policies for transforming domestic-oriented SMEs into export-oriented were pursued. In December 1964, the law for developing industrial complexes for exporting industries was introduced to accommodate SMEs. In 1965, centers for handicraft industries were established and policies for promoting locality-specific industries were adopted. From 1965, efforts for attracting foreign capital to be provided for SMEs were made actively. In 1965, the regulation controlling lending activities of financial institutions, including all banks, was amended; all banks were forced to allocate at least 30 percent of their lending

For the criteria of Korean SMEs, visit http://www.smba.go.kr/eng/smes/scope.do?mc=usr0001146
money to SMEs. In 1966, the Basic Act for Small and Medium Enterprises was adopted to better organize all the policies for promoting SMEs (KDI, 2005).

During the 1960s, some SMEs-specific industries were identified and protected from competition by big companies. They were the industries which did not necessitate large capital equipment, the industries producing parts and components, industries processing raw materials, and labour-intensive industries (KDI, 2005). In 1970s -1980s, the government began to foster SMEs as a player of supplying parts to the HCIs (Kim, n.d.).

In 1975, the government enacted the SME Systematization Promotion Act to support HCI. In order to promote HCIs, it was essential for intermediate parts to be easily supplied. This Act defined the role of SMEs as suppliers of intermediate inputs and the role of large enterprises as final good producers and facilitated the linkage between large enterprises and SMEs by establishing contract-base businesses. In 1976, the government established the Korea Credit Guarantee Fund, a public financial institution, to guarantee repayment of the SMEs commercial loans related to export. This fund guarantees up to seven billion Korean Won (about USD 6.3 million). In 2013, the amount of newly provided guarantees to exporting firms reached 11.4 trillion won (about USD 10 billion) (IDB, 2015).

In 1979, the government established the Small and medium Business Corporation (SBC) - a non-profit, government-funded organization – to implement government policies and programs for the further growth and development of SMEs. SBC operates financial and non-financial programs for SMEs. Through financial programs, SBC provides financing for SMEs to enhance their global competitiveness with advisory programs, such as training, consulting, marketing and global cooperation programs. Currently, SBC maintains an overseas network of over 68 partner organizations in 40 countries in order to assist SMEs internationally (Small & Medium Business Corporation, 2016).

The 1980s was more active period of policy focus for SME industry. The government established legal and institutional foundations for the promotion and protection of SMEs. For instance, the amended 1982 Constitution states that the “protection” and “promotion” of small businesses will be the government’s “responsibility” and “duty”. Besides granting such unusual legal status, the government actually pursued a strong SME promotion policy since the early 1980s. In 1982, a long-term plan was drawn up setting out the objectives of the policy and identifying problems confronting SMEs along with possible policies to address those problems. As a result, a package of policy measures in the form of both direct and indirect support followed (KDI, 2005).

To expand the base for further growth, the government established a support program in order to promote SMEs which exhibited promising potential in targeted industries, helping SMEs enhance management, modernize production facilities and increase technological capacity. The Korea Institute of Economics and Technology became an information resource center for providing economic, technical, and managerial knowledge to SMEs. Also, the Small Business Training Institute was established (in 1982) to provide human
resource education and training for SME employees, and enhance the R&D capabilities of SMEs (KDI, 2005).

The government also supported SMEs in the form of financial assistance. It created favourable environment for SMEs to access loans more smoothly. As an example, loans for capital investment in export industries were made available to facilitate the import of technology, R&D activities, and equipment investments. Moreover, it supported SMEs in the form of tax breaks, i.e., depreciation ratios were 50 percent larger for SMEs compared to large firms. Even a 100 percent depreciation rate was given to some SMEs (e.g., SMEs relocating to rural areas) (KDI, 2005).

In 1986, the SME Start-up Support Act was enacted. This Act simplified start-up procedures for SMEs and provided financial support and tax exemptions to start-up firms (IDB, 2015).

In the 1990s, the government pursued structural improvement of SME and moved its policy focus to autonomy, opening and competition with the inauguration of WTO. In 1995, the government enacted the Act on Structural Improvement and Management Stabilization of Small and Medium Business. In 1996, the Small and Medium Business Administration (SMBA) was established (Kim, n.d.). Since its foundation, SMBA has supported the country’s SME-led innovation as the dynamo of the national economy. SMBA’s strategic goals include creating jobs by promoting the growths of the startup and venture industry; strengthening the technological competitiveness of SMEs to create new growth engines; providing support for business management, including financing and marketing development; invigorating the base of the economy to promote shared growth; creating a policy environment friendly to SMEs (Small and Medium Business Administration, 2016). Hence, SMBA is the most important organization supporting Korean SMEs. It deals with almost all areas of government policy for SMEs.

Also, KOTRA, a leading trade and investment promoting organization, supports SMEs. KOTRA helps SMEs extend their business in foreign countries by providing them with foreign market information and consulting services, offering global business training, etc. (IDB, 2015).

Korea Federation of SMEs (KBiz), initially Korea Federation of Small and Medium Business when it was established in 1962, represents the interests of SMEs in Korea by supporting their growth and competitiveness and promoting a supportive business environment. This organization researches and analyses constraints confronted by SMEs, and as such enables the creation of informed policy suggestions. In order to help SMEs to enter global markets, it also supports members’ participation in foreign exhibitions, keep members informed of foreign trade regulations, and conduct overseas visits for business. Besides, KBiz’s Small and Medium Enterprise Mutual Fund, which was established in January 1984, provides short-term funding to SMEs to support business management and avoid insolvency (Asia-Pacific Economic Cooperation, n.d.-a; Korea Federation of SMEs, n.d.).
In 1993, the Korea Small Business Institute (KOSBI), Korea’s only research institute, was established to contribute to the formulation of SME policies and to the further growth and development of SMEs, and enhancement of SMEs’ global competitiveness through comprehensive research on issues related to SMEs (Korea Small Business Institute, 2016). Besides, KOSBI’s online portal, which also includes an online research library of information on SME policy, legislation, and research, encourages SME owners to share their experiences as well as challenges with each-other (Asia-Pacific Economic Cooperation, n.d.-b).

In 2011, the government established the World Class 300 Program with a goal to create 300 world-class companies by 2017\(^5\). It is a government project that aims to develop the Korean’s most promising young global companies. The World Class 300 targets SMEs with demonstrated technological innovation capability and provides them with support in R&D, marketing, management and personnel which will allow them to compete globally (Busan Haps Magazine, 2014). For instance, in 2015, 11 mid-sized and 19 SMEs were selected to be supported for 10 years (Business Korea, 2015).

In 2013, Korea EXIM bank launched the Support Program for SME Export Beginners. The aim of the program is to provide a launch pad for SME exporters that sell in the amount of less than USD 1 million in direct exports. The expected benefit of this program is to enable SME exporters to reach a critical large amount of export volume required to vie with global competitors. In order to maximize results, Korea EXIM bank is offering many different forms of financial and non-financial assistance to SME Export Beginners (Korea Eximbank, n.d.).

The government is also providing SMEs with policy loans for their R&D activities (but policy loans are not directly related to export promotion) in particular. For example, the Korea Technology Finance Corporation provides credit guarantees to promote R&D activities of SMEs. The accumulated amount of credit guarantees this organization provided to SMEs in 2012 reached about USD 220 billion (237.2 trillion won) (IDB, 2015).

The volume of exports of SMEs in total exports increased from USD 40.7 billion in 1994 to USD 102.9 billion in 2012. However, this share as a percentage of total exports declined from 42.4 percent to 18.8 percent (Table 9) respectively.

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<thead>
<tr>
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</tr>
</thead>
<tbody>
<tr>
<td>32.1</td>
<td>32.3</td>
<td>31</td>
<td>42.4</td>
<td>35.6</td>
<td>21.1</td>
<td>18.3</td>
<td>18.8</td>
</tr>
</tbody>
</table>


The volume of exports of SMEs in total exports increased from USD 40.7 billion in 1994 to USD 102.9 billion in 2012. However, this share as a percentage of total exports declined from 42.4 percent to 18.8 percent (Table 9) respectively.

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\(^5\) By 2020 according to some other sources.
Today SMEs play an important role in the Korean national economy. Based on 2012 statistics, SMEs includes 99.9 percent of all enterprises, 87.7 percent (66.4 percent in 1963) of total employment.

3 INDUSTRIAL POLICY IN UZBEKISTAN

3.1 Background Information and Macroeconomic Overview in Uzbekistan

The Republic of Uzbekistan (hereinafter: Uzbekistan), is situated in the center of Central Asia, so it is bordered by all the countries of the region. Uzbekistan is Central Asia’s most populous country and has a very attractive consumer market with population of 31.5 million, offering a young and generally well-educated workforce with a median age of 27.6 years, the literacy rate is 99.6 percent, and the unemployment rate is 4.8 percent. Uzbekistan is the 57th largest country and is the 73rd largest economy (USD 63 billion) in the world (CIA World Factbook, 2016b; World Bank, 2014).

Prior to Uzbekistan became an independent country in 1991, it had long received a net subsidy from the central budget of the Soviet Union. In the last few years of the Soviet Union, this subsidy increased rapidly from 7-9 percent of Uzbekistan’s GDP during 1987-1989 to 21 percent in 1991. The subsidy was suddenly cut off with independence. The country’s industry was part of the Soviet Union’s industrial complex, so the break-up worsened its traditional supplier and customer relations. Uzbekistan’s economy had depended on cheap Soviet oil, and, in spite of its large agricultural sector, on food from elsewhere (Kotz, 2004).

From the very first day of independence, Uzbekistan selected its own way of development, the Uzbek Model of transition to socially oriented market economy. It is based on five key principles: priority of economy over politics; the state is the main reformer; supremacy of the rule of law; strong social policy; step-by-step transition to market economy.

The government’s ultimate goal in that period was to prevent a sharp fall in output, unemployment growth, and a reduction in people’s income. The focus of economic transformation were privatization of SMEs and the housing and social sectors; the development of small private businesses; and comprehensive support to expansion of private ownership (Olimov & Fayzullaev, 2011).

Uzbekistan has implemented the economic development strategy largely based on import substitution and export promotion so far. With import substitution policies, the government aimed to promote the industrialization of the country and secure energy and food self-sufficiency. The government also intended to diversify its economic structure and reduce

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6 This is the extension of the article entitled “Industrial Policy in Uzbekistan” published in Prasnikar (2014)’s book.
7 Uzbekistan had imported 60 percent of its oil during the Soviet period. However, by 1995 the country had become self-sufficient in oil production, without involving any FDI. By the 2000s, Uzbekistan was also producing grain for about 90 percent of its domestic needs (McKinley, 2010).
dependence on revenues from the exports of cotton (Bendini, 2013). Moreover, the changes in the international economic environment also prompted the government’s decision to adopt import substitution policy. At that time, external conditions were not as favourable as in the first half of the 1990s. The country was hit by external shocks because of the worsening of its terms of trade in the second half of 1990s. Another significant event which led the government to pursue this policy was the Russian financial crisis in 1998, because there was serious concern of contagion effect following the drastic devaluation of the ruble. Besides, cotton harvest during 1998–1999 was poor coupled with continued decline in the world prices of cotton and gold (KDI, 2005).

As a result of the gradual implementation of reforms, Uzbekistan became the first among the Commonwealth of Independent States (CIS) countries to overcome the decline of the 1990s, achieving positive economic growth in 1996 (Jahon Information Agency, 2016a). Uzbekistan successfully achieved the intended results and managed to carry out important structural shifts in its economy: achieving self-sufficiency in energy and becoming a net fuel exporter; decrease in cotton production and its export, and increase in food production, achieving self-sufficiency in food; increasing the share of industry in GDP and share of machinery and equipment in industrial production and export (Popov, 2013). More importantly, Uzbekistan achieved enormous progress in the sphere of food security. Nowadays, the country’s agriculture not only covers domestic demand for food products, but also provides significant expansion of export capacity. As we can see, Uzbekistan has achieved dramatic changes in the dynamics and structure of economy, development of production and export capacity, level and quality of life, social sphere, etc. (Jahon Information Agency, 2016a).

The economy of the country has been growing at a sustainable level for many years. The economy grew, on average, 7.1 percent in the last 16 years, or 8.3 percent in the last decade (Figure 2). According to the rating of World Economic Forum (2015), Uzbekistan is among five countries with the fastest growing economy in the world during 2014–2015 and forecasts of growth for the next coming years.

Figure 2. GDP Growth Rate (% to the previous year)

<table>
<thead>
<tr>
<th>Year</th>
<th>GDP Growth Rate (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2000</td>
<td>3.8</td>
</tr>
<tr>
<td>2001</td>
<td>4.3</td>
</tr>
<tr>
<td>2002</td>
<td>4.0</td>
</tr>
<tr>
<td>2003</td>
<td>4.4</td>
</tr>
<tr>
<td>2004</td>
<td>7.7</td>
</tr>
<tr>
<td>2005</td>
<td>7.0</td>
</tr>
<tr>
<td>2006</td>
<td>7.3</td>
</tr>
<tr>
<td>2007</td>
<td>9.5</td>
</tr>
<tr>
<td>2008</td>
<td>9.0</td>
</tr>
<tr>
<td>2009</td>
<td>8.1</td>
</tr>
<tr>
<td>2010</td>
<td>8.5</td>
</tr>
<tr>
<td>2011</td>
<td>8.3</td>
</tr>
<tr>
<td>2012</td>
<td>8.2</td>
</tr>
<tr>
<td>2013</td>
<td>8.0</td>
</tr>
<tr>
<td>2014</td>
<td>8.1</td>
</tr>
<tr>
<td>2015</td>
<td>8.0</td>
</tr>
</tbody>
</table>

Source: UzReport Information Agency, Uzbek economy grows by 8% in 2015, 2016a; World Bank, GDP Growth (annual %), 2016d.

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8 “Contagion is the spread of market changes or disturbances from one regional market to others. Contagion can refer to the spread of either economic booms or economic crisis throughout a geographic region” (Contagion, n.d.).
3.2 Industrial policy in Uzbekistan

3.2.1 Foreign Trade and Export promotion

The Government of Uzbekistan has been giving privileges and preferences to exporters in order to support export activities since the early years of independence. The legislation of Uzbekistan includes the following tax preferences for exporters:

- value added tax;
- excise tax;
- income tax;
- property tax.

In accordance with the Article 212 of Tax Code of Uzbekistan, exporters are exempted from value added tax for material resources used for production of exported goods sold for free convertible currency. This measure is not applied to intermediary enterprises which export raw materials such as precious metals. According to the Article 230 of Tax Code, there is an exemption from payment of excise tax for exporters of excised goods which were defined by the Cabinet of Ministers of Uzbekistan (Ministry of Foreign Economic Relations, Investments and Trade of the Republic of Uzbekistan, 2016).

One of other preferences is the Decree “On additional measures for stimulation of producers of export-oriented goods” (No. UP-2613) adopted by the President of Uzbekistan in June 5, 2000. The Decree aims at expanding export capacity by supporting enterprises that manufacture exportable products, regardless of their form of ownership, harmonizing current tax exemptions and enhancing their stimulating impact on the increase in the production of export-oriented products. In accordance with the Decree, for enterprises-exporters, a procedure for payment of property tax and income tax has been established. The procedure depends on the share of exports of goods and works/services of own production for free convertible currency in the total sales (State Customs Committee of the Republic of Uzbekistan, 2014):

- when the share of export includes 15 to 30 percent – 30 percent reduction;
- when the share of export includes 30 and more percent – twofold.

Furthermore, in accordance with the Resolution of the President of Uzbekistan “On additional measures to stimulate the rapid development of the textile industry” (No. PP-1512 on 28.03.2011), enterprises of the textile industry were exempted from property tax till January 1, 2016 when they sold 80 percent or more of their output for free convertible currency. Moreover, a special foreign trade company “Uztadbirkorexport” was established in 2011. This company is designed to export goods produced by small businesses and private entrepreneurs. Its main tasks are: to assist small businesses and private entrepreneurs in exporting their products through direct export contracts, as well as through trading houses in foreign countries; to deliver technological equipment, components, spare parts, raw materials (if they are not produced in the country) through
the orders by small businesses and private entrepreneurs; to assist small businesses in the certification of their exportable goods, and provide them with information and consultation; etc. (Ministry of Foreign Economic Relations, Investments and Trade of the Republic of Uzbekistan, 2016).

To provide further encouragement and support for exporters, the government granted additional tax incentives for exporters, small business enterprises and companies involved in new investments and starting production of new products (Table 10).

Table 10. Decrease in Tax Rates

<table>
<thead>
<tr>
<th>Taxes</th>
<th>Tax rates in 1992-2009 (%)</th>
<th>Tax rates in 2014 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Legal entities income tax</td>
<td>45</td>
<td>8</td>
</tr>
<tr>
<td>Individual income tax</td>
<td>13-60</td>
<td>7.5-22</td>
</tr>
<tr>
<td>Value added tax</td>
<td>30</td>
<td>20</td>
</tr>
<tr>
<td>Single social payment</td>
<td>40</td>
<td>25</td>
</tr>
<tr>
<td>Single tax payment for small enterprises</td>
<td>15.2</td>
<td>6 (in industry - 5)</td>
</tr>
</tbody>
</table>


As we can see from Table 10, the tax decreases were considerable. Income tax for legal entities decreased from 45 percent to eight percent and value added tax from 30 percent to 20 percent.

The main export commodities of Uzbekistan include energy products, cotton, gold, mineral fertilizers, ferrous and non-ferrous metals, food products, textiles, machinery and automobiles. The main import commodities include food products, chemicals, ferrous and non-ferrous metals, machinery and equipment. Uzbekistan’s main trade partners are Russia, China, Kazakhstan, South Korea, Turkey, Germany, etc.

Thanks to export promotion, Uzbekistan achieved the expansion of export capacity and its diversification successfully (Figure 3 and Table 11). The changes from 1990 to 2013 were as follows: export increased 34 times from 443 million US dollars to 15087 million US dollars; eliminated dependence on monoculture export – cotton, whose share in the export reduced from 59.7 percent to 7.7 percent; the share of non-primary goods in total exports increased from less than 30 percent up to 72 percent.

Also, the export of high value added goods increased sharply in the last 10 years, in particular, the export of automobiles increased 11.6 times, cotton yarn – 4.1 times, knitted fabric – 114.8 times, fertilizers – 11.3 times (Ministry of Economy of the Republic of Uzbekistan, 2014).
As exports have exceeded import for many years, the nation’s foreign trade balance has been positive, so it has a sustainable current account surplus. Consequently, the government accumulated 15 billion US dollars in reserves of foreign exchange and gold (CIA World Factbook, 2016c).

### 3.2.2 Foreign Direct Investments

Foreign investment, especially FDI can play an important role in developing countries. They are one of the driving forces of the process of globalization. They can contribute to the economic growth of the transition countries significantly.

In the first years of independence, Uzbekistan did not have almost any foreign direct investment. So as to create a favourable investment environment for foreign investors, Uzbekistan adopted numerous laws and decrees including: the Law on Foreign Investments

Moreover, in April 2012, the President of Uzbekistan, Islam Karimov, signed a decree “On additional measures on stimulating attraction of foreign direct investments”. The document is aimed at creating maximum favourable investment climate for foreign investors, strengthening foreign direct investments and modern technologies, conducting direct investments to development of high-technologic production, further strengthening system of guarantees and preferences for foreign investors and enterprises with foreign investments.

According to this decree, newly established enterprises with the investment volume for at least USD five million are entitled to pay for 10 years those taxes\(^9\) which were in force at the time of registration. In addition to this, the president approved the procedure according to where investment projects worth more than USD 50 million and with the share of foreign investors is at least 50 percent, the construction of the necessary external engineering and communication networks is performed at the expense of budget funds and other domestic sources of financing (UzDaily, 2012a).

Enterprises that attract private FDI are exempted from property tax, profit tax for legal entities, tax for the improvement and development of social infrastructure, single tax payment, and mandatory payments to the republican road fund if they specialize in one of the areas of the following industries (UHY Hacker Young, 2014):

- building materials industry;
- chemical and petrochemical industry;
- coal industry;
- construction of power plants based on alternative sources of energy;
- food, meat and milk industry;
- glass and porcelain industry;
- hardware for production purposes;

\(^9\) The rule applies to taxes on the property, income taxes, the single social tax, single tax, for the improvement and development of social infrastructure, as well as mandatory contributions to the Republican Road Fund and Reconstruction Fund, refurbishment and equipping of educational and medical institutions.
- industrial production of poultry meat and eggs;
- light industry;
- machine tool and instrument industry;
- machinery and metalworking;
- medical industry and production of medicals for veterinary use;
- microbiological industry;
- processing and preserving of fish and fish products;
- production of electrical ferroalloys;
- production of packaging materials;
- production of radio electronic devices or computers’ components;
- silk industry;
- toy industry.

The above-mentioned tax privileges are granted up to seven years\textsuperscript{10} when the amount of FDI is as follows:

- from 300 thousand to 3 million US dollars – for the period of three years;
- from 3 million to 10 million US dollars – for the period of five years;
- over 10 million US dollars – for the period of seven years.

The above-mentioned tax-related privileges apply in the following cases:

- location of the enterprises is in all regions (city, town or village) of Uzbekistan, with the exception of Tashkent and Tashkent region;
- there is FDI by foreign investors (without receiving any guarantee from Uzbekistan);
- the share of foreign investors in the authorized capital of the enterprise is not to be less than 33 percent;
- foreign investment made in hard currency or as modern manufacturing equipment;
- reinvestment of at least 50 percent of the proceeds earned from the tax preferential treatment received during the applicable period is made into further development of the enterprise.

Other new privileges and incentives as well as conditions are given in the decree\textsuperscript{11}.

The measures for improving the investment environment that Uzbekistan has adopted have significantly increased the volume of FDI. In the first years of independence, while the share of FDI in gross investment was almost zero, it reached 85 percent in 2014; total investments to the economy has exceeded USD 100 billion, 35 billion of which are FDI (Embassy of Uzbekistan to the United States, 2015).

\textsuperscript{10} Tax exemptions for Navoi Free Industrial Economic Zone is up to 15 years depending on the amount of FDI.

\textsuperscript{11} Decree of the President of Uzbekistan “On additional means for stimulating foreign direct investment” (No. UP-3594) in April 11, 2005; Decree of the President of Uzbekistan “On additional measures to stimulate attracting foreign direct investments” (No. UP-4434) in April 10, 2012.
Thanks to the implementation of well-thought-out active investment policies, more than USD 3.3 billion foreign investments were utilized in 2015, of which 73 percent (USD 2.4 billion) was FDI (UzReport Information Agency, 2016a) while foreign investments and loans together in 2014 amounted to more than USD three billion, of which three fourth was FDI (UzReport Information Agency, 2015a).

Due to a favourable investment climate, 433 enterprises with foreign capital were newly registered in 2014 alone. The main mart of these new enterprises were established in the industry-219, trade and public catering-100, construction–18, agriculture–16, transport and communication–11, health, physical culture and sports–19, other manufacturing industries–46 (UzReport Information Agency, 2015b). Also, in 2015, the number of newly registered enterprises with foreign capital made up 494, such as 107 enterprises with the equity participation of the residents of China, 91 – Russia, 53 – South Korea, 41 – UK, 39 – Turkey, 22 – India, 20 – Kazakhstan. As a result, as of January 1, 2016 the total number of operating enterprises with participation of foreign capital exceeded 4.8 thousand (UzReport Information Agency, 2016b), including world famous multinational corporations such as General Motors, Mercedes-Benz, MAN, Isuzu Motors, PETRONAS, CNPC, LG, Gazprom, Nestle, Coca-Cola, Samsung, Lukoil, British-American Tobacco, Knauf, Carlsberg and many others are operating in the Uzbek market.

3.2.2.1 Special Industrial Zones

Today there are over 3000 free economic zones (FEZ) in more than 120 countries in the world. FEZ has become one of the most effective and promising forms of attracting investment for the development of economic and scientific potential. The system of preferences and privileges granted to investors are the most important aspect of the functioning of the FEZ.

To further stimulate the attraction of foreign investments, to create the most comfortable conditions for them and to use more effectively economic and investment potential, the following industrial zones were created in Uzbekistan too (Ministry for Foreign Economic Relations Investments and Trade of the Republic of Uzbekistan, UZINFOINVEST & United Nations Development Program, n.d.):

- Free Industrial Economic Zone “Navoi”;
- Special Industrial Zone ‘Angren’;
- Special Industrial Zone “Jizzakh”.

The Navoi Free Industrial Economic Zone (Navoi FIEZ) was established in the territory of Navoi region, one of the most developed industrial centers of the country, in December 2, 2008 in accordance with the Decree (No. UP-4059) of the President of Uzbekistan.

The Navoi FIEZ offers a wide range of opportunities to foreign investors to do business and provides all the necessary conditions for the establishment of industrial complexes with full production cycles (from raw materials to manufacturing of finished goods). The priority is given to establishment of a wide range of facilities for production of high-tech and globally
competitive products by introducing modern high-performance equipment and machinery, manufacturing lines and modules, and innovative technologies in the following industries and sectors: production of machinery and instrument-making products and components for cars; production of electrical goods and telecommunication equipment; production of medical equipment and pharmaceutical products; production of polymeric and plastic goods; and foodstuff processing and packaging.

The operation period of the Navoi FIEZ is 30 years with opportunity for prolongation. During the operation period of the Navoi FIEZ, a wide range of benefits and preferences are provided. Enterprises registered in this territory are exempted from property tax, income tax, the land tax, unified tax payment (for small businesses), mandatory contributions to the Republican Road Fund and off-budget Republican School Fund, depending on the amount of foreign direct investments. These tax preferences are available if the volume of FDI is as follows:

- from 3 million to 10 million Euros – for the period of seven years;
- from 10 million to 30 million Euros – for the period of 10 years. For the following five years, the rates of unified tax payment and income tax are fixed at the level of 50 percent of current rates;
- over 30 million Euros – for the period of 15 years. For the following 10 years, the rates of unified tax payment and income tax are fixed at the level of 50 percent of current rates.

Also, enterprises registered in the Navoi FIEZ are exempted from customs payments for imported equipment, raw materials, materials and components for the manufacture of exportable goods for the whole operation period of the FIEZ. Equipment, raw materials, materials as well as component parts for the manufacture of exportable goods, being imported into the Navoi FIEZ by its residents, regardless of the country of origin will be registered in the customs regime of free customs zone. Furthermore, customs payments (except customs clearance duties) and measures of economic policy will not apply to the goods imported for production needs.

The Angren Special Industrial Zone (Angren SIZ) was established in the region of Tashkent in April 13, 2012 in accordance with the Decree (No. UP-4436) of the President of Uzbekistan. The Angren SIZ offers favourable conditions and a number of opportunities to foreign and local investors to do business and provides all the necessary conditions for the establishment of modern high-tech and competitive production facilities. The operation period of the Angren SIZ is 30 years with opportunity for prolongation. During the whole operation period of the Angren SIZ, a wide range of benefits and preferences are provided. The residents of the Angren SIZ are exempted from income tax, property tax, unified tax payment, social infrastructure development tax, mandatory contributions to the Republican Road Fund, as well as customs payments (excluding customs clearance duties) for the equipment, materials, and components (which are not produced within the country).
imported into the Angren SIZ within the implementation of the projects in line with the list approved by the Cabinet of Ministers.

The aforementioned preferences are provided from three to seven years, depending on the volume of investments:

- from 300 thousand to 3 million US dollars – for the period of three years;
- from 3 million to 10 million US dollars – for the period of five years;
- over 10 million US dollars – for the period of seven years.

The Jizzakh Special Industrial Zone (Jizzakh SIZ) was established in the region of Jizzakh in March 18, 2013 in accordance with the Decree (No. UP-4516) of the President of Uzbekistan. The operation period of the Jizzakh SIZ is 30 years with opportunity for prolongation. During the whole operation period of the Jizzakh SIZ, a wide range of benefits and preferences are provided. The residents of the Jizzakh SIZ are exempted from income tax, property tax, unified tax payment, social infrastructure development tax, mandatory contributions to the Republican Road Fund, as well as customs payments (excluding customs clearance duties) for the equipment, materials and components (which are not produced within the country) imported into the Jizzakh SIZ within the implementation of the projects in line with the list approved by the Cabinet of Ministers.

The aforementioned preferences are provided from three to seven years, depending on the volume of investments:

- from 300 thousand to 3 million US dollars – for the period of three years;
- from 3 million to 10 million US dollars – for the period of five years;
- over 10 million US dollars – for the period of seven years.

3.2.3 Industrial Sector Promotion and Its diversification

The government of Uzbekistan has been supporting industrial sector of the economy since the independence. It has implemented various industrial programs to modernize and diversify the industrial output in this sector. For instance, in December 2010, “Program on priorities of industrial development in the Republic of Uzbekistan for 2011-2015” was adopted by the government of Uzbekistan. The implementation of the strategy allowed for the assurance of the stable, dynamic and balanced development of the national industry, in conditions of deepening structural reforms in key sectors, the diversification of manufacturing, and the growth of export potential, as well as further increase the efficiency and competitiveness of enterprises, through the modernization and the technical and technological renewal of the manufacturing processes they utilize. It was set that the program would include the implementation of 519 large-scale industrial investment projects whose total amount of USD 47.3 billion (Prasnikar, 2014).

The government also planned to take measures to ensure the “Program of structural reforms, modernization and diversification of production for 2015-2019”. The program includes 870 major investment projects worth USD 38 billion. The projects include the
creation of 415 new businesses, in addition to modernization, technical and technological renovation of 455 existing industrial facilities. According to preliminary calculations, the program implementation will (UzReport Information Agency, 2015c):

- accelerate the development of industries producing products with high added value, including engineering, chemical, petrochemical, textile and food industries, with the creation of about 1000 new industrial products;
- provide the growth of industrial production by 1.5 times during 5 years and increase the share of industry from 24 percent to 27 percent of GDP by 2020;
- provide further growth of high-tech exports and create 52 thousand new jobs.

In the framework of this program, in total 158 major investment projects with a total value of USD 7.4 billion were commissioned in 2015. As a result of introducing new production capacities, expanding the range and improving the competitiveness of products, and modernization, technical and technological renovation of existing production facilities, the highest rate of growth in production was observed in the industries of light (16.6 percent), construction materials (14.1 percent), woodworking (15.6 percent), pharmaceutical and medical (28.9 percent), and food (14.4 percent) (UzReport Information Agency, 2016c).

Also, in February 2015, the “Program of localization of production of finished products, components and materials for 2015 – 2019” was approved by the President, Islam Karimov. This program incorporates 600 projects, providing for the production of competitive, import-substituting and export-oriented products. The projects ensure deep processing of local mineral raw materials, production of 1225 most popular products. It is estimated that annual effect of import-substitution is USD 3.5 billion, creating new jobs of 13.3 thousand. Companies which implement the projects within the framework of the program enjoy a number of benefits (e.g., exemption from income tax, custom duties, tax on property) for a period of three years (Uzbekistan Today, 2016). In general, the production of 4000 types of import-substituting products were mastered under the programs of localization since 2000 (UzReport Information Agency, 2015d).

*Figure 4. Growth Rate (% to the previous year)*

Thanks to the industrial development programs, the sector of industry of the economy has also been growing at a sustainable rate. For instance, we can see from Figure 4 that the growth of annual industrial production in 2015 was 8.0 percent, whereas it was 8.3 percent in 2014, and 8.8 percent in 2013, making the average annual growth 8.8 percent during 2002 - 2015.

Also, it is planned that the volume of industrial production in 2016 will grow by 8.2 percent (UzReport Information Agency, 2016a).

As the government has been promoting industrial sector of the economy since the independence, the volume of industrial production grew more than 3.2 times during 1990-2014. We can also see from Figure 5 that structural reforms of economy provided growth of industrial production share in GDP from 14 percent in 2001 to 24 percent in 2014.

Figure 5. GDP Structure by Sectors of the Economy (in %)

![GDP Structure by Sectors of the Economy](image)


### 3.2.4 Small Business and Private Entrepreneurship

Today, the role of small business and private entrepreneurship in Uzbekistan’s economy is becoming important. One of the country’s highest development priorities has been to enhance conditions, benefits and advantages to small businesses and private entrepreneurship, and to provide comprehensive support to hasten their development. Therefore, the year of 2011 was declared as the “Year of Small Business and Private Enterprise” in Uzbekistan. Consequently, 35 thousand new small enterprises (excluding farms) were created in 2011 alone and all small business entities produced 54 percent of GDP (UzDaily, 2012b).

In the same year (August 24, 2011), The President Islam Karimov signed a decree “On additional measures to achieve the most favourable business environment for further development of small business and entrepreneurship”. The purpose of this document is

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12 Small enterprises, micro-firms, together with individual businessmen, are subjects of small business provided their conformity to the criteria. For more information, visit http://www.uzinfoinvest.uz/eng/faq/
further improvement of business climate, elimination of obstacles and barriers for the development of small businesses and private entrepreneurship, liberalization and accelerated progress towards deepening of market reforms and providing more freedom of entrepreneurship, increase of their role and share in the economy, development of export potential, and provision of employment and income of the population (UzReport Information Agency, 2011a).

Uzbekistan is well equipped with tax incentives and preferential loans for SMEs, and it is still developing and launching many different new programs to support them. Uzbekistan exempted newly started small enterprises from routine tax audits during the first three years of registration. It removed a large amount of administrative burden in the process of starting new businesses. It prepared several institutions to promote exports: zero percent tax on turnover from exports, preferential loans for exporting companies, and reduction of income and property taxes for exporting products (Korea Development Institute, 2012). The government reduced the single tax rate for SMEs a few times since 2005. The single tax rate is set in the amount of five percent in 2016, whereas it was 13 percent in 2005 (Jahon Information Agency, 2016b). Moreover, the rate of single social payment has been reduced from 25 percent¹³ to 15 percent since January 1, 2015 (UzReport Information Agency, 2014).

Furthermore, in 2013, the Fund for support of exports of small business and private entrepreneurship was established under the National Bank of Foreign Economic Activity of the Republic of Uzbekistan in accordance with the Resolution (No. PP-2022, August 8, 2013) of the President “On additional measures on support of export of small businesses and private entrepreneurship” (Fund for support of exports of small businesses and private entrepreneurship, 2016). The main objective of this Fund is to further expand the export potential of small businesses and private entrepreneurship and to provide financial, legal and organizational assistance in increasing the production of competitive and modern products and promote them for exports, to provide reliable support to exporters from external market risks.

In 2014 alone, this Fund provided legal, financial and organizational assistance to 2399 entrepreneurs to promote their goods and services to foreign markets. Consequently, contracts totaling USD 1.25 billion were concluded. Additionally, the export of goods and services of a total worth of USD 842.1 million were implemented by 699 business entities (UzReport Information Agency, 2015f). Also, in 2015 alone, the Fund provided legal, financial and organizational services to 3213 business entities to promote goods and services to foreign markets, resulting in the export of goods and services of USD 1.05 billion in total (UzReport Information Agency, 2016d).

Overall, due to the implementation of measures to support exports of small business and entrepreneurship, small business and private enterprises exported goods worth more than

¹³ For other taxpayers the rate of single social tax is amounted 25 percent. See Table 10.
USD 3.6 billion in 2014 (UzReport Information Agency, 2015g) while this figure was only USD 1.77 billion in 2010 (UzReport Information Agency, 2011b).

The government gives a substantial amount of credits to small businesses and private entrepreneurs every year. In the first 11 months of 2011, 3.7 trillion soums\(^{14}\) worth of credit, which was 1.5 times more than in the same period of the previous year, was allocated to small business and private entrepreneurship. In the first half of 2013, more than 3.7 trillion soums worth of credit was allocated, which was 1.3 times more than in the same period of 2012. Also, while this figure was over 9.2 trillion soums in 2014, which was 1.3 times more than in 2013 (UzReport Information Agency, 2015h), it reached 12.1 trillion soums in 2015, which was 1.3 times more than in the same period of 2014 (UzReport Information Agency, 2016c).

In 2014 alone, more than 26 thousand new small businesses (excluding farming enterprises) were created. The greatest number of small businesses was created in industry, trade and catering, and construction, consisting of 24.8 percent, 29.2 percent, and 12 percent of the total respectively (UzReport Information Agency, 2015g). Also, in 2015 alone, 26.9 thousand new small businesses (excluding farms) were created. The greatest number of small businesses were created in industry and other branches (36 percent), trade and catering (30.4 percent), and construction (11.2 percent) (UzReport Information Agency, 2016c). As a result, the total number of operating small business entities as on January 1, 2016 reached 207104 units, which is 5.7 percent more than the same period of the previous year. In 2015, the share of small business and private entrepreneurship reached 38.9 percent (34.8 percent in 2014) in total volume of industrial production, 87.1 percent (86.3 percent) in retail turnover, and 55.7 percent (51.5 percent) in services. They utilized 36.3 percent (or 14.79 trillion soums) of the total volume of utilized investments in the country during 2015 (UzReport Information Agency, 2016e).

Table 12. Dynamics of Small Business and Private Entrepreneurships (in %)

<table>
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</tr>
</thead>
<tbody>
<tr>
<td>GDP</td>
<td>31</td>
<td>35</td>
<td>42.1</td>
<td>50.1</td>
<td>54.6</td>
<td>56.7</td>
</tr>
<tr>
<td>Industry</td>
<td>12.9</td>
<td>10.8</td>
<td>10.9</td>
<td>17.9</td>
<td>23.1</td>
<td>38.9</td>
</tr>
<tr>
<td>Employment</td>
<td>49.7</td>
<td>56.7</td>
<td>69.1</td>
<td>73.9</td>
<td>75.6</td>
<td>77.9</td>
</tr>
</tbody>
</table>


As we can see, small businesses and private enterprises are becoming an important source of employment and value added for the economy of Uzbekistan. Today, this sector of the economy employs 77.9 percent of all the employed population in the economy. The dynamics of small business and private entrepreneurship development from 2000 to 2015

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\(^{14}\) Soum is the currency of Uzbekistan (the ISO 4217 currency code is UZS). The values of the loans in foreign currencies such as USD can be converted from UZS by using the exchange rates of the Central Bank of Uzbekistan. Visit [http://cbu.uz/eng/main](http://cbu.uz/eng/main).
were as follows: (1) the share of small business in GDP grew from 31 percent to 56.7 percent; (2) the share in industry grew from 12.9 percent to 38.9 percent; (3) the share in employment increased from 49.7 percent to 77.9 percent (Table 12). Besides, the share in exports increased from 10.2 percent in 2000 to 24 percent in 2013.

3.3 Evaluation of Industrial Policy in Uzbekistan

When Uzbekistan became an independent state, the International Monetary Fund (IMF) offered the Washington Consensus advice to the government. However, ignoring warnings from abroad, Uzbekistan selected its own way of development, the well-known Uzbek Model of economic development, so followed the policy of gradual transformation of the economy. Outside observers expected poor results from government’s unorthodox policies. But contrary to their expectations, the economic growth performance of the country during 1992-2001 was the best among the former Soviet countries (Kotz, 2004) in the light of the good implementation of economic reforms based on a gradual approach.

As we see, the industrial policies implemented by the governments of Korea and Uzbekistan have similarities. Similar to Korea’s experience, Uzbekistan has also been experiencing industrial policy in the form of both import-substitution and export promotion policies. The government established several institutions to support exporters through various trade promotion activities. It has provided various tax incentives to promote exports. Uzbekistan also adopted various laws to attract FDI into the country and established several FEZs, introducing many different incentives for FDI in these FEZs. Moreover, several organizations in the country are supporting the development of SMEs. Today SMEs in Uzbekistan play an important role in the economy like it does in Korea. These policies implemented by the governments of both Korea and Uzbekistan paid off, enabling them to achieve high sustainable economic growth per annum.

Now we will evaluate these policies implemented by Uzbekistan according to the broadband measures proposed by Stiglitz and Greenwald (2014). One of the broadband measures which Stiglitz and Greenwald suggest is to stimulate trade if it contributes to learning. Uzbekistan has been giving privileges and preferences to exporters in order to support export activities since the early years of independence. Thanks to export promotion, Uzbekistan achieved the expansion of export capacity and its diversification successfully (Figure 3 and Table 11). The changes from 1990 to 2013 were substantial: the volume of exports increased 34 times, that is, from 443 million US dollars to 15 billion US dollars; eliminated dependence on monoculture export – cotton, whose share in the export reduced from 59.7 percent to 7.7 percent; the share of non-primary goods in total exports increased from less than 30 percent up to 72 percent.

Another measure proposed by Stiglitz and Greenwald is to offer programs for the development of SMEs. The learning externalities associated with SMEs can be significant due to the high turnover of such firms. Uzbekistan has given a lot of preferences and tax incentives to support the development of small business and private entrepreneurship. The government is supporting them through several institutions, preferential loans, etc. Thanks
to the implementation of such measures, small businesses and private enterprises exported goods worth more than USD 3.6 billion in 2014 alone while this figure was only USD 1.77 billion in 2010. Their share in total volume of industrial production reached 38.9 percent in 2015 (34.8 percent in 2014). As a result, small businesses and private enterprises are becoming an important source of employment and value added for the economy of the country. Today, this sector of the economy employs 77.9 percent of all the employed population in the economy. In the span of the last 15 years (between 2000 and 2015), the successful changes have been achieved in the dynamics of development of small business and private entrepreneurship (Table 1).

Stiglitz and Greenwald also suggest that countries should offer a good environment for FDI and outward bound investment if it stimulates learning and manufacturing due to high spillovers to the rest of the economy. Uzbekistan has created a good investment environment for foreign investors. Thanks to the implementation of well-thought-out active investment policies and the measures for improving the investment environment in the country, Uzbekistan have significantly increased the volume of FDI. For instance, in the first years of independence, while the share of FDI in gross investment was almost zero, it reached 85 percent in recent years. Total investments to the economy has exceeded USD 100 billion, 35 billion of which are FDI. In 2015 alone, over USD 3.3 billion foreign investments were utilized, of which USD 2.4 billion (or 73 percent) was FDI. As of January 1, 2016, the total number of operating enterprises with participation of foreign capital in Uzbekistan exceeded 4.8 thousand. FDI is in essence useful if it stimulates learning and learning spillovers. As one example of FDI which stimulated manufacturing due to high spillovers to the rest of the economy, we can take an automobile manufacturing plant in Uzbekistan, which was established via FDI. When Uzbekistan started producing automobiles in 1996, most of the spare parts and components for automobiles were produced abroad. But today, most of them, including even engines, are produced inside the country. In other words, the establishment of one manufacturing plant resulted in the establishment of several other manufacturers with and without FDI. Besides, new specializations were opened to train specialists for these manufacturers at higher educational institutions and vocational colleges. Consequently, local manufactures as well as local people have gained new experience of production.

According to Stiglitz and Greenwald, industrial policy is needed to shape the structure of the economy, including choice of techniques and sectoral allocation of the economy. If that is the case, then, when Uzbekistan gained independence in 1991, the value added by the agricultural sector of the economy was 37 percent of GDP and the share of cotton fiber in total exports was about 60 percent (7.7 percent in 2013), making the country very reliant on revenue from cotton export. However, thanks to the successful implementation of the macroeconomic and industrial policies, the structure of the economy has changed substantially. The share of the value added by service and industry between 2002 and 2014 increased from 44 percent to 48 percent and from 22 percent to 34 percent respectively, while the share of agriculture decreased from 34 percent to 19 percent (Figure 6). As a
result, Uzbekistan became one of the few transition countries which managed to increase the share of industry in recent years.

*Figure 6. Value Added by Economic Sectors (% of GDP)*

![Diagram showing the percentage of GDP contributed by different sectors from 2002 to 2014.](image)

Source: Global Economy, *Uzbekistan Economic Indicators*, 2016b.

The policy model based on a gradual transition to a market-based economy also proved itself during the period of the global financial crisis. Uzbekistan managed to keep achieving sustainable economic growth rates during this period. The macroeconomic policies implemented in those years, structural and institutional transformations, and the substantial accumulation of state reserves enabled Uzbekistan to overcome the crisis successfully. For instance, compared to 2008, GDP grew by 8.1 percent, nominal monetary incomes by 36.4 percent, and the number of workforce employed in the economy by 2.7 percent in 2009.

**CONCLUSION**

In this master thesis, we showed how industrial policy can facilitate the diversification of the economy resulting in economic growth not only in the short run but also in the long run. In the theoretical part, we saw that economic development is about structural change, which entails the intervention of governments in the economy. Historical experience showed that industrial policies can work. We illustrated how industrial policies played an important role in the development of almost all of today’s rich economies. The empirical part clarified that the role of governments in the economy is crucial and showed how industrial policy help the economy achieve sustainable growth.

Uzbekistan has chosen its own strategy of a gradual transition to a market-based economy. If the government had accepted the Washington Consensus advice offered by the IMF, it would not have achieved its current position. Since the beginning of independence, the government has supported the industry in order to achieve the diversification of its economic structure and industrialization of the country. It has implemented various industrial programs to modernize and diversify the industrial output in this sector. As a result, industrial production growth rate averaged 8.8 percent during 2002-2015. The structural changes of the economy in recent years give the evidence of the progressive transformation of Uzbekistan from an agrarian country to a modern industrialized country.
Today, Uzbekistan is the most diversified economy in Central Asia and is the only country in the region producing a wide range of modern automobiles and trucks, high-quality agricultural machinery, buses, chemicals, construction materials, textiles, electronics and many other manufactured goods.

It should also be noted that today the external debt of Uzbekistan is about 16 percent of GDP, which is classified as less than moderate debt according to international criterion, while its internal debt is zero. In the last 15 years, Uzbekistan’s GDP increased by more than five times. It has retained a positive balance of trade and balance of payments, and a steady surplus of the state budget since 2005 (Uzbekistan Today, 2015). The economy has been growing at a sustainable level for many years, averaging 7.1 percent in the last 16 years, or 8.3 percent in the last 10 years, becoming one of the fastest growing economies in the world.

Taking into account that Uzbekistan has been implementing its industrial policy successfully, we suggest that it should continue implementing such policies. We believe that this will enable the country to move its position from a developing country to a developed (an advanced) country in the future.
REFERENCE LIST


