

Tajikistan

Country Economic Update
Spring 2017

Public Disclosure Authorized
Public Disclosure Authorized
Public Disclosure Authorized
Public Disclosure Authorized
Public Disclosure Authorized



Strong Growth with a Challenging Outlook



WORLD BANK GROUP

**Macroeconomics
& Fiscal Management**
Global Practice



TAJIKISTAN:

Strong Growth with a Challenging Outlook

Country Economic Update

Spring 2017

Government Fiscal Year: January 1 – December 31
Currency Equivalents: Official Exchange Rate Effective as of March 31, 2017
Currency Unit = Tajikistan Somoni (TJS)
US\$1 = TJS 8.2293
Weights and Measures: Metric System

Abbreviations and Acronyms

ADB	Asian Development Bank
AREAER	Annual Report on Exchange Arrangements and Exchange Restrictions
BT	Barqi Tojik
CHP	Combined Heat and Power
DIF	Deposit Insurance Fund
DPF-1	Development Financing Framework
EBRD	European Bank for Reconstruction and Development
EU	European Union
FDI	Foreign Direct Investment
FSMR	Financial Stability Monitoring Report
FSR	Financial Stability Report
FSSA	Financial System Stability Assessment
HPP	Hydropower Plant
IFC	International Finance Corporation
IFI	International Financial Institution
IMF	International Monetary Fund
L2TJK	Listening to Tajikistan Survey
MOF	Ministry of Finance
NBT	National Bank of Tajikistan
NPL	Non-Performing Loans
PFMMP	Public Finance Management Modernization Project
PIP	Public Investment Project
SOE	State-Owned-Enterprise
TajStat	Tajik Statistical Agency
TSA	Targeted Social Assistance
WBG	World Bank Group

Table of Contents

Foreword	v
Overview	1
A. Recent Socio-Economic Developments	2
Recent Political Events	2
Economic Growth and Inflation.....	3
External Sector.....	4
Social Sector	7
B. Macroeconomic Policies and Structural Reforms	9
Assessment of Fiscal and Debt Policies.....	9
Assessment of Monetary and Exchange Rate Policies.....	11
Ongoing Structural Reforms	13
C. Economic Outlook and Risks.....	15
Baseline Scenario	15
Risks.....	16
D. Focus Section: The Financial Sector Crisis	17
Financial Sector Overview	17
Developments.....	18
Reforms at the National Bank of Tajikistan.....	19
World Bank Group Activities in the Financial Sector	19
Annex 1. Selected Macroeconomic and Social Indicators, 2014-2019.....	21

Figures

Figure 1: Growth Financing Sources	3
Figure 2: Sector Value Added to Growth.....	3
Figure 3: Consumer Price Inflation	4
Figure 4: Current Account Developments.....	5
Figure 5: Current Account Components.....	5
Figure 6: Share of FDI by Sector, 2016	5
Figure 7: International Reserves.....	5
Figure 8: Average Wage by Key Sector.....	7
Figure 9: Poverty distribution in 2016.....	8
Figure 10: Share of Food in Total Consumption.....	8
Figure 11: Public Debt Composition.....	9
Figure 12: Money Supply Growth	12
Figure 13: Real Effective Exchange Rate Index.....	12
Figure 14: Poverty Rate Projection.....	16
Figure 15: Financial Intermediation.....	17
Figure 16: Capital and Non-Performing Loans.....	18

Tables

Table 1: Contribution to Real GDP Growth, 2013-2016.....	4
Table 2: Balance of Payments and Official Reserves, 2013-2016.....	6
Table 3: Consolidated Fiscal Accounts, 2013-2016.....	11
Table 4: Baseline Scenario: Selected Macro-Fiscal Indicators, 2016-19	16

Foreword

This edition of the Tajikistan's Country Economic Update (CEU) is part of a semi-annual series designed to monitor socio-economic developments in Tajikistan. It presents an analysis of political, economic and social developments, as well as the progress of and challenges with the implementation of structural reforms during 2016. It also includes a special section highlighting developments leading to the financial sector crisis. This edition's main authors are Bakhrom Ziyaev (Economist for Tajikistan) and Zarina Odinaeva (Senior Financial Sector Specialist). The CEU benefited from the valuable inputs provided by Alisher Rajabov (Poverty Economist), Anvar Ibragimov (Private Sector Consultant), Hasan Aliev (Public Sector Specialist), Madina Nurmatova (Private Sector Specialist), Naoko Kojo (Senior Economist), Nigina Alieva (Communications Officer), Sabrina Qandanova (Health Consultant) and Takhmina Mukhamedova (Energy Specialist). The authors are grateful for the guidance and comments provided by Jan-Peter Olters (Country Manager for Tajikistan) and Christos Kostopoulos (Lead Economist for Central Asia). Nasiba Saidova (Program Assistant in Dushanbe) and Sarah Nankya Babirye (Program Assistant in Washington, D.C.) provided administrative support. Nigina Alieva and Navruza Aliqulova helped with report dissemination.

*María De los Angeles González-Miranda
Practice Manager
Macroeconomics and Fiscal Management
Global Practice*

Overview

Tajikistan's economic growth accelerated in 2016, driving down poverty rates.

Despite continuing external challenges, economic output rose strongly in 2016 according to official estimates. Driven mainly by foreign-financed public and private investment, real GDP expanded by a robust 6.9 percent. At the same time, a protracted decline in real remittances and exchange rate depreciation in the context of an improving but still complex external environment led to a significant adjustment in the current account balance. Depressed trade activity resulted in a fiscal revenue shortfall, while the exchange rate depreciation contributed to a surge in non-performing loans (NPLs), reversing previous fiscal consolidation efforts and causing substantial disruption to the performance of the financial sector. On the upside, strong growth pushed down the poverty rate from 32 percent in 2015 to an estimated 30.3 percent by the third quarter of 2016, primarily driven by an increase in wage incomes. The expansion of the Targeted Social Assistance (TSA) program helped to reduce extreme poverty.

External headwinds were countered by fiscal stimulus and an accommodative monetary policy stance.

The authorities pursued expansionary fiscal policies in 2016, including through a considerable increase in foreign-financed capital investment in the energy sector, road infrastructure and projects related to the country's 25th anniversary of independence. The government also stimulated domestic demand by raising public sector wages and social transfers. The exchange rate, although depreciating, stabilized throughout the year following the introduction of administrative measures in February 2016. Monetary policy was accommodative, supporting a heightened demand for local currency as the exchange rate stabilized and wholesale transactions that were previously conducted in foreign currency switched to local currency. Domestic purchases of monetary gold and the introduction of a surrender requirement on ruble-denominated transfers drove an increase in international reserves. However, materialized risk in the financial sector and the subsequent bailout of Tajikistan's two largest banks at end-2016 resulted in a deterioration of fiscal and debt sustainability indicators.

Domestic vulnerabilities put the positive growth outlook at risk.

Although the external environment is expected to recover, risks to growth are weighted to the downside owing to rising domestic vulnerabilities. Lingering challenges in the financial sector, high state-owned enterprise (SOE) contingent liability risk and an uncondusive business climate weigh on economic growth prospects. Ongoing bank asset quality reviews may reveal additional capitalization needs while contradictory objectives and inefficiencies in the tax administration may potentially erode the tax base and deter new investments. A weaker-than-expected recovery in regional economies or delays in the expansion of the TSA program could derail poverty reduction efforts. Continuing challenges in accessing credit by pro-poor sectors of the economy will diminish the pace of both poverty reduction and job creation in low-skilled sectors like construction and agriculture.

A. Recent Socio-Economic Developments

Recent Political Events

The president's annual address was followed by a cabinet reshuffle.

As is customary, following the annual address of the president, Emomali Rahmon, the cabinet and other key entities were reshuffled in the beginning of the year. The Dushanbe administration as well as several ministries—including finance, transport and health and social protection—and the State Committee for State Property Management, among others, were all realigned.

The speech focused on challenges in the private and banking sectors.

In his annual address, President Rahmon emphasized the need to support domestic private sector development and entrepreneurship, especially given ongoing external economic challenges. He called on the National Bank of Tajikistan (NBT, the central bank) and the finance ministry to strengthen banking sector oversight and to undertake urgent measures to protect depositors' rights.

A new diplomatic relationship with Uzbekistan is anticipated.

The government is re-engaging with Uzbekistan following 25 years of diplomatic and economic tension. Uzbekistan's foreign affairs minister met with President Rahmon in Dushanbe in September 2016 and conveyed his country's willingness to "reset" relations with Tajikistan, including by boosting trade and restoring direct flights between the two countries. As a result, the first direct flight since 1992 between Tajikistan and Uzbekistan took place on February 10, 2017.

The Russian president's visit to Tajikistan reaffirmed strong bilateral ties.

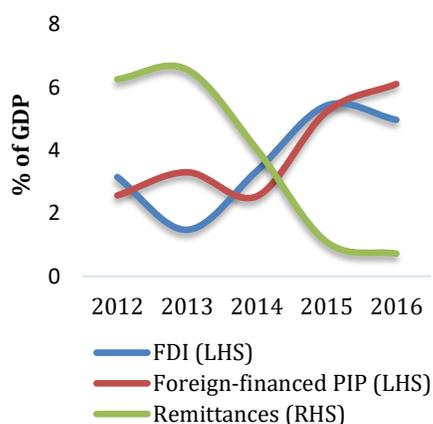
The president of the Russian Federation, Vladimir Putin, visited Dushanbe on February 27-28, 2017, on the occasion of the 25th anniversary of the establishment of diplomatic relations between Russia and Tajikistan. A number of cooperation documents were signed, including an agreement on the use of nuclear energy for peaceful purposes and a revision of a ban on travel to Russia by Tajik citizens accused of violating migration regulations. As many as 200,000 Tajik laborers have been affected by the travel ban; under the revision, waivers may be granted to those who committed minor violations. During the visit, Russian officials also expressed their readiness to support increased agricultural exports from Tajikistan to Russia, including through subsidizing the railway transportation of goods.

Economic Growth and Inflation

GDP growth accelerated in 2016, supported by foreign-financed investment

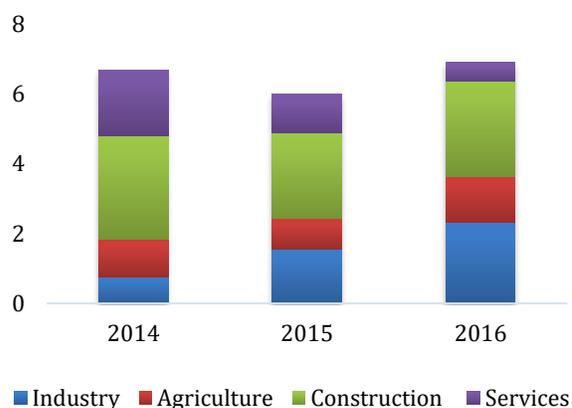
Annual real GDP growth accelerated to 6.9 percent in 2016 from 6.0 percent in 2015, according to official estimates. High levels of foreign-financed public and private investment—and an improvement in Tajikistan’s net export position—more than compensated for a decline in consumption (Figure 1). The latter was driven by a decline in household consumption, which was largely affected by a protracted currency depreciation in early 2016 and a further decline in migrant transfers by over 13 percent year on year in US dollar terms.¹

Figure 1: Growth Financing Sources



Sources: TajStat, MOF, NBT and World Bank staff calculations.

Figure 2: Sector Value Added to Growth (Annual percentage change)



Source: TajStat and World Bank staff calculations.

Low growth in the services sector was more than offset by strong construction and industrial output.

On the supply side, economic growth was driven by the construction and industry sectors, which recorded annual growth rates of 20.3 percent and 16.0 percent, respectively. Donor-supported public investment in the rehabilitation of hydropower plants and road infrastructure drove firm growth in the construction sector, while industrial output was supported by strong foreign direct investment (FDI) in coal and gold mining and processing as well as the food and textile industries. The economic contribution of agriculture to GDP was modest in 2016, with annual growth of 5.2 percent (Figure 2), largely reflecting enhanced efficiency gains and favorable weather conditions. Conversely, growth in the services sector slowed to 1.1 percent (from 2.4 percent in 2015) owing to weak foreign trade activity as imports contracted.

¹ According to broad definition published by Central Bank of Russia, in 2016 money transfers totaled US\$1.9 billion compared to US\$2.2 billion in 2015.

Table 1: Contribution to Real GDP Growth, 2013-2016
(In percentage points)

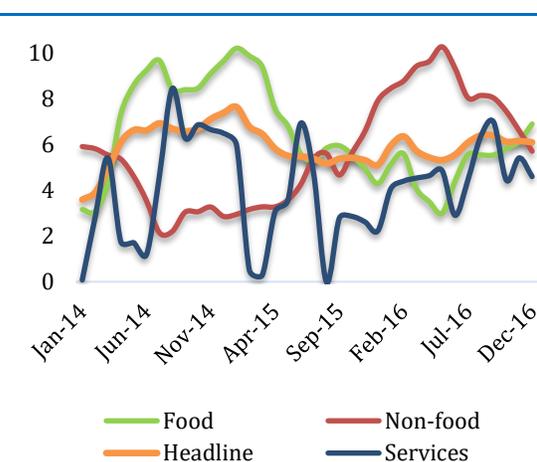
	2013	2014	2015	2016
Real GDP growth	7.4	6.7	6.0	6.9
Agriculture	2.0	1.1	0.9	1.3
Construction	1.6	3.0	2.5	2.7
Industry	0.6	0.8	1.6	2.3
Services	3.1	1.9	1.1	0.5

Sources: TajStat and World Bank staff estimates.

Domestic inflationary pressures were offset by easing global energy and food prices.

According to official estimates, annual consumer price inflation was relatively stable in 2016, averaging 5.9 percent compared to 5.8 percent in 2015 (Figure 3). The early 2016 currency depreciation contributed to a surge in non-food inflation, which rose to 8.2 percent in 2016 from 4.8 percent in 2015. Inflation in services climbed to 4.9 percent (from 3 percent in 2015), driven by a mid-year increase in public sector wages and pensions and utility tariff hikes in the fourth quarter. Food price inflation eased to 5 percent (down from 6.8 percent in 2015) thanks to benign global prices for grains, wheat flour and other staples.

Figure 3: Consumer Price Inflation
Annual percentage change



Sources: TajStat and World Bank staff estimates.

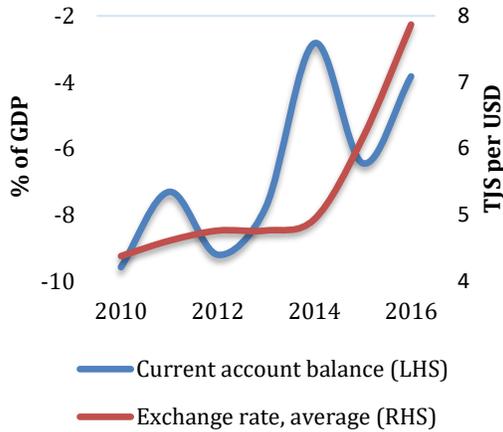
External Sector

The exchange rate adjustment drove a reduction in the in the external deficit.

Tajikistan's external position improved in 2016 largely as a result of contraction of consumer imports. The current-account deficit narrowed to 3.8 percent of GDP from 6.4 percent in 2015 (Figure 4). With consumer purchasing power restrained by lower remittance inflows and currency depreciation, import spending on goods fell by 8.9 percent year on year in 2016 (Figure 5). Conversely, export earnings rose by 20.8 percent year on year as domestic prices became more competitive, supported by new production capacity gains, largely in the minerals sector. However, earnings from key export commodities such as primary aluminum and cotton fiber declined by 4 percent and 15.1 percent, respectively—the former due to price effect and the

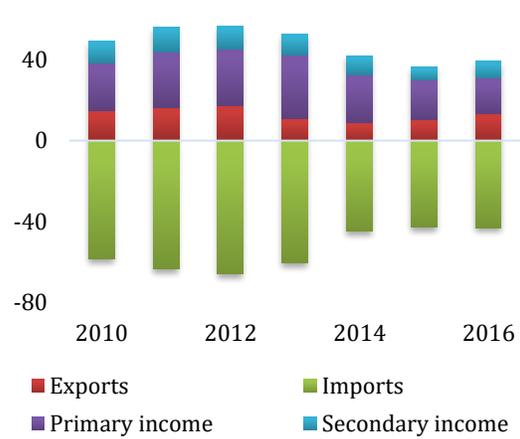
latter due to a volume effect (cotton prices were 3.4 percent higher in 2016 than in 2015).²

Figure 4: Current Account Developments



Sources: NBT and World Bank staff calculations.

Figure 5: Current Account Components
Percent of GDP

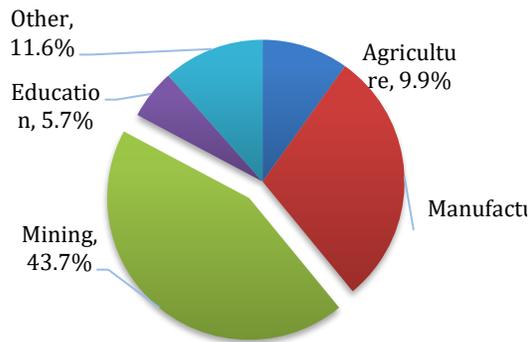


Sources: NBT and World Bank staff calculations

FDI inflows concentrated on the mining and manufacturing industries.

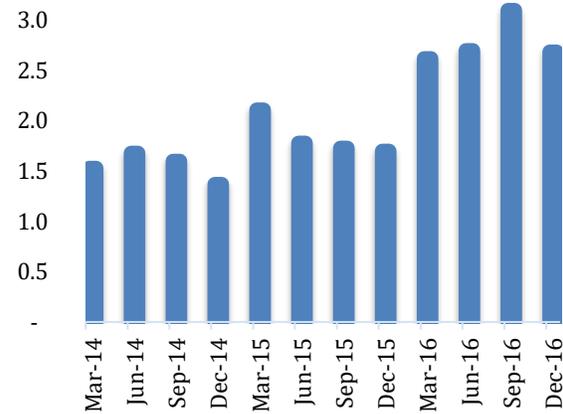
Inflows of FDI totaled 5 percent of GDP in 2016, down from 5.4 percent in 2015. The industries attracting the bulk of FDI in 2016 were mining and manufacturing (Figure 6). Around three-fourths of FDI inflows (74 percent) in 2016 came from China while other major sources were Russia (8.1 percent) and Switzerland (6.2 percent).

Figure 6: Share of FDI by Sector, 2016



Sources: NBT and World Bank staff calculations.

Figure 7: International Reserves
(Months of import cover)



Source: NBT

² Presumably, gold exports were also robust but this figure was not disclosed to the public due to confidentiality concerns.

Despite the observed improvement, external buffers remain insufficient.

A relatively stable exchange rate environment and new surrender requirements introduced on ruble-denominated remittances facilitated an accumulation of official reserves in 2016. International reserves held by the National Bank of Tajikistan (NBT) rose by over 30 percent year on year in 2016, reaching 2.7 months of import cover (Figure 7). However, despite this strong growth, reserve levels remained below the recommended threshold of 3 months of import cover. Moreover, the reserves basket is heavily dominated by gold, creating a concentration risk and raising exposure to global price volatility.

Table 2: Balance of Payments and Official Reserves, 2013-2016

(In US\$ millions)

	2013	2014	2015	2016e
Current account balance	-659.2	-261.2	-506.2	-264.7
Merchandise trade	-3,904.6	-3,001.1	-2,287.9	-1,912.8
Exports f.o.b.	573.3	526.8	572.0	691.2
Imports f.o.b.	4,478.0	3,527.9	2,859.9	2,604.1
Services	-283.2	-305.8	-241.4	-137.6
Primary income	2,664.4	2,183.8	1,526.2	1,213.6
Compensation of employees (net)	2,716.0	2,289.0	1,629.5	1,307.2
Secondary income	864.2	862.0	496.9	572.2
Capital and financial account balance	-57.3	-259.4	-329.9	-272.6
Capital Account	134.2	124.0	144.0	143.9
Foreign direct investment	-125.5	-309.3	-426.1	-344.1
Portfolio investment	1.2	-1.8	-0.1	0.0
Financial derivatives	0.0	0.0	0.0	0.0
Other short-term investments	-23.6	16.7	-66.7	-118.8
Change in Reserve Assets	-43.5	-88.9	19.0	46.5
Errors and omissions	333.6	-246.2	-111.7	-295.6
<i>Memorandum items:</i>				
NBT Official Reserves (months of import cover)	1.2	1.4	1.7	2.7
Nominal GDP (US\$ million)	8,506	9,242	7,857	6,922

Sources: Tajik authorities and World Bank staff estimates.

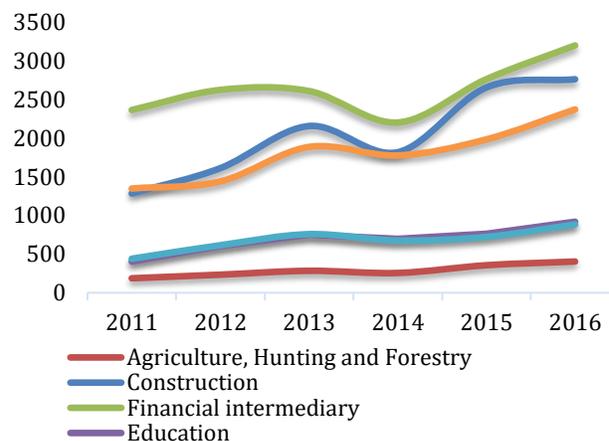
Note: Based on the 6th edition of the IMF's Balance of Payments and International Investment Position Manual (BPM6).

Social Sector

Labor market pressures are slowly easing.

The official unemployment rate remained low in 2016, at 2.3 percent, and labor market pressure has been slowly easing as employment prospects improve in migrant destinations. The number of job vacancies reached 9,200 in December 2016, 26.5 percent higher than in the year-earlier period.

Figure 8: Average Wage by Key Sector
Nominal somoni per month



Source: TajStat.

Furthermore, the number of applicants per vacancy fell from 11 persons in December 2015 to 9.2 persons in December 2016, underscoring easing labor market pressures. The economy created almost 59,000 jobs in 2016, more than half of which were classified as permanent. The share of temporary and seasonal jobs was relatively stable, hovering between 22 and 23.5 percent. When the pre- and post-Russian recession periods are compared, a significant shift is observed regarding wage employment, with jobs in agriculture falling by 3.1 percentage points in 2016 compared with 2014. Conversely, the share of wage employment in education and the health sector (including other social services) rose by 1.8 percentage points and 1.1 percentage points, respectively, in 2016. Agriculture continues to dominate the labor market but remains the lowest-paid sector (Figure 8). In contrast, the highest-paid industries are financial services and construction.

Weak remittance inflows slowed the pace of poverty reduction.

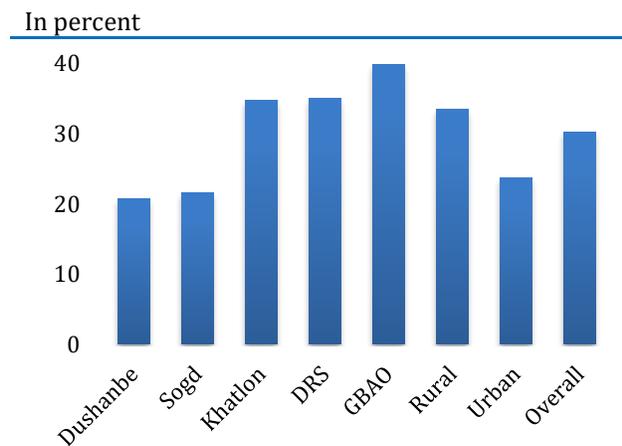
Although poverty reduction stalled during the first nine months of 2015, according to the seasonally-adjusted national poverty measure, some progress was made by the end of the year. Furthermore, the Listening to Tajikistan (L2TJK) household survey showed that incomes began to rise steadily in 2016 owing to increases in remittance inflows in Tajik somoni (TJS) terms, income from agricultural activities and self-employment, civil service wages, and student and pensioner benefits. These factors helped to drive down the national poverty rate from 32 percent in 2014 to 30.3 percent in the third quarter of 2016, with the rate of extreme poverty falling to 14 percent. The L2TJK survey also monitors the share of migrants returning to Tajikistan. This ratio has remained relatively stable since the launch of the survey in May 2015 at about 2 percent; the periods with the lowest share of returning migrants were in May-June 2015 and April-August 2016, when the share of returning

migrants fell to between 0.7 and 1.5 percent. Households have also recently indicated that a higher share of labor migrants are employed (rising from 83 percent between May and October 2015 to 86 percent in the same period of 2016). According to data from the Ministry of Labor, Migration and Employment, in December 2016 there were 517,308 Tajik migrants in Russia, a decline of 7 percent year on year.

The geographic distribution of the poor remains highly uneven.

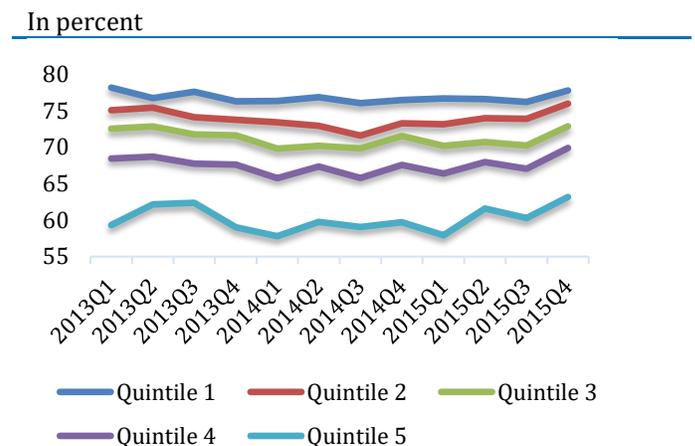
Levels of industrialization and urbanization are important determinants of the poverty situation in Tajikistan’s regions. The lowest number of poor households continue to be located in Dushanbe and Sogd, where most economic activity is concentrated (Figure 9). By contrast, the Gorno-Badakhshan Autonomous Oblast (GBAO), Khatlon and the Regions of Republican Subordination (RRP) persistently show poverty rates above the national average. In 2015-2016, the average poverty rate in rural areas was almost ten percentage points higher than that of urban areas. Although the seasonal nature of poverty is well known, it is important to note that the churning of poverty is unusually high in Tajikistan. In particular, it is striking that 48 percent of the population was poor during only some quarters of 2015; only 13 percent of the population was poor during the entire year.

Figure 9: Poverty distribution in 2016



Sources: TajStat and World Bank staff calculations.

Figure 10: Share of Food in Total Consumption



Source: World Bank staff calculations based on TajStat Household Budget Survey (HBS)

Still-muted global food prices benefited poor households.

Although its share has fallen steadily, food still accounts for more than 70 percent of consumption for poor and vulnerable households (Figure 10). Because a significant share of the food consumed in Tajikistan is imported, exchange rate volatility was a particular concern in 2015 and 2016. Higher prices for food imports could have been passed onto poor and vulnerable consumers, who would have been harmed disproportionately by rising food prices. However, this scenario did not materialize thanks to benign global prices for grains and wheat flour. Indeed, food and wheat flour price inflation ran below headline consumer price inflation in 2016.

B. Macroeconomic Policies and Structural Reforms

Assessment of Fiscal and Debt Policies

Overly-ambitious budget assumptions set the stage for a widening fiscal deficit.

Tajikistan’s fiscal standing deteriorated due to lower-than-expected revenue, insufficient mid-year adjustments to expenditure and an increase in foreign-financed public investment programs (PIPs). Despite various efforts by the government to contain the deficit—including spending cuts and increased scrutiny of low-priority current and capital outlays and an increase in non-tax collections—the fiscal deficit more than doubled in 2016, to 4 percent of GDP (from 1.9 percent in 2015). When the cost of the financial sector bailout is included, the deficit rises to 10.1 percent of GDP.

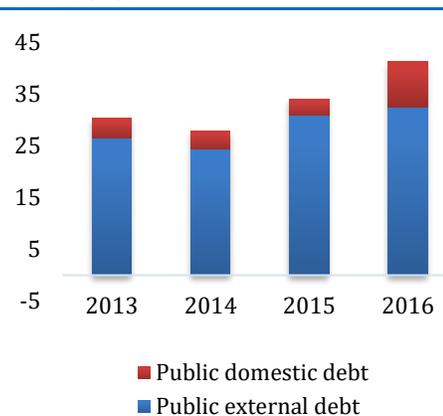
Revenue underperformed while expenditure was driven by foreign-financed public investments.

Overall revenue significantly underperformed across all major categories in 2016, reflecting weak foreign trade flows and depressed domestic business activity. Gross tax collections undershot the budget target by 7.3 percent with significant shortfalls in external value-added tax (VAT), income/profit taxes and social contributions. The shortfall was partially offset by strong collections of non-tax revenue, which over-performed by 43.4 percent as a result of higher collections of fines and penalties on retroactive cameral audits. Higher PIP grants—which rose by 31.4 percent year on year—also helped to contain the budget deficit. Expenditure was largely driven by foreign-financed PIPs (in the energy, transport and social sectors), outlays related to projects commemorating the 25th anniversary of Tajikistan’s independence and increase in the minimum wage, public sector wages, pensions and other social transfers. Core social and strategic capital spending (including for the Rogun hydropower plant) was ring-fenced. The government also honored its commitment to expand the TSA program to cover 40 districts.

The financial sector bailout increased the state budget burden

The level of total public and publicly-guaranteed (PPG) debt surged to 41.4 percent of GDP in 2016, from 34.1 percent in 2015 (Figure 11). New debt obligations were largely the result of domestic bond issuances for the financial sector bailout totaling 6.1 percent of GDP, also affected by the somoni depreciation. Nonetheless, external debt continued to comprise the bulk of the total PPG debt stock at 32.4 percent of GDP in 2016. The creditor profile is heavily biased towards China, which accounts for over half of the

Figure 11: Public Debt Composition
Percent of GDP



Sources: MOF and World Bank staff calculations

total external debt stock. Obligations to international finance institutions (IFIs) represent around one-third of external debt. In line with the Medium-Term Debt Strategy 2015-2017, in 2016 the government contracted loans with a 35 percent grant element while keeping total external debt below 40 percent of GDP.

**Weak compliance
limited access to IFI
budgetary support.**

With the exception of a US\$20 million credit tranche from the Eurasian Development Bank, Tajikistan did not receive budgetary support from IFIs in 2016. The World Bank, Asian Development Bank (ADB) and the European Union (EU) all suspended budgetary support disbursements to Tajikistan after policy milestones were missed and issues in the financial sector were deemed to have not been adequately resolved. The fiscal deficit was financed through a combination of new debt, monetization, the privatization of state assets and a drawdown of government deposits.

**Some progress was
made on addressing
SOE contingent
liabilities.**

In recent years, the government has made seeking to address some of the risks associated with the contingent liabilities of SOEs. These efforts continued in 2016 with the expansion of the dividend policy to incorporate SOEs with state majority ownership and the adoption of a Fiscal Risk Management Strategy. The strategy proposes a well-structured risk management framework to identify, monitor and manage risks stemming from the quasi-fiscal activities of SOEs.³

³ As of July 1, 2016, total outstanding balances on accounts payable of the largest 23 SOEs totaled 34.5 percent of GDP while accounts receivable totaled 6.9 percent of GDP. The national power utility, Barqi Tojik, continues to be the largest drain on the state budget, accounting for over 70 percent of total SOE liabilities.

Table 3: Consolidated Fiscal Accounts, 2013-2016

(In percent of GDP)

	2013	2014	2015	2016e
Revenue and grants	27.2	28.4	29.9	28.4
Tax revenue	21.1	22.8	22.0	20.6
Income and profit taxes	4.0	4.2	4.8	4.4
Payroll taxes	2.7	3.0	2.8	2.5
Property taxes	1.4	1.5	1.2	1.2
Taxes on goods and services	11.5	12.8	12.0	11.3
International trade and operations taxes	1.4	1.3	1.1	1.2
Non-tax revenue	3.6	4.0	5.0	5.3
of which extra-budgetary funds	1.7	1.6	2.1	2.5
Grants	2.5	1.5	3.0	2.5
of which PIP	2.0	1.5	2.1	2.5
Expenditure and net lending	27.7	28.4	31.8	38.5
Current expenditure	17.7	18.1	18.0	17.4
Capital expenditure and net lending	9.9	10.2	13.8	21.1
Overall fiscal balance (incl. PIP)	-0.6	0.0	-1.9	-10.1
Overall fiscal balance (excl. PIP)	0.7	1.1	1.2	-6.5
<i>Memorandum items</i>				
Total public debt	30.4	27.9	34.1	41.4
Nominal GDP (TJS million)	40,525	45,605	48,402	54,471

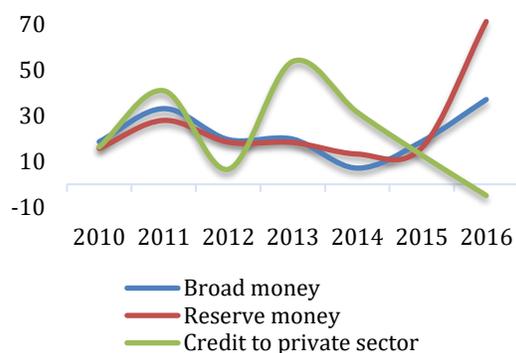
Sources: Tajik authorities and World Bank staff estimates.*Note:* Excluding the financial sector bailout, the overall fiscal deficit in 2016 (including PIP) was 4 percent of GDP.

Assessment of Monetary and Exchange Rate Policies

Monetary policy kept inflation in single digits.

The money supply grew rapidly in 2016 (Figure 12) owing to the introduction of surrender requirements on ruble remittances, domestic gold purchases, emergency liquidity support and a drawdown of government deposits. However, inflationary pressures were contained as a result of the de-dollarization of wholesale transactions formerly conducted in foreign exchange. Private sector credit continued to contract owing to banking sector instability and reduced business activity. Throughout 2016 and into 2017, the NBT tightened monetary policy by steadily raising the refinancing rate from 8 percent to 16 percent, reserve requirement rates for somoni and foreign exchange deposits from 1.5 percent and 7 percent to 3 percent and 9 percent, respectively, while also sharply stepping up sterilization. The liquidity support rate for emergency needs was also increased above the interbank rate by 200 basis points.

Figure 12: Money Supply Growth



Sources: NBT and World Bank staff calculations

Figure 13: Real Effective Exchange Rate Index

December 2009 index=100



Source: NBT.

Note: Index value above 100 indicates appreciation.

Exchange rates stabilized after the introduction of administrative measures early in the year.

The protracted decline in remittances, coupled with weak export earnings at the beginning of 2016, put significant pressure on exchange rates (Figure 13). The authorities responded in early 2016 by introducing several administrative measures including the closure of foreign exchange kiosks, the introduction of a 50 percent surrender requirement and the mandatory conversion of ruble remittances into somoni. These measures helped exchange rates to stabilize and converge for different market segments. The authorities shored up this framework by strengthening legal penalties for the illicit use of foreign exchange and increasing prosecutions with the help of law enforcement agencies. In 2016 the somoni depreciated by 11.2 percent vis-à-vis the US dollar, resulting in a cumulative depreciation of 35 percent in 2015-2016. This effectively reversed the real appreciation of the somoni from earlier periods, led by a policy change that favored a greater exchange rate flexibility. According to NBT estimates, the somoni was undervalued in real terms by around 3 percent at end-2016. However, in response to liquidity injections associated with the financial sector bailout, exchange rate pressures rebounded at the beginning of 2017.

Monetary and exchange rate policies have remained broadly in line with stated objectives.

Monetary policy was maintained in 2016 in line with the authorities' long-term objective of price stability and the notional target of keeping inflation in single digits (a goal achieved in recent years). The NBT introduced new monetary policy tools in early 2017 including linking certificate of deposit auctions to the refinancing rate, extending maturities by up to six months and offering overnight repurchase agreements to more efficiently manage daily liquidity needs. Tajikistan has a managed float exchange rate regime. However, the IMF's 2016 Annual Report on Exchange Arrangements and Exchange Restrictions (AREAER), classified the de-facto exchange rate regime in the residual category of "other managed arrangement." Due to still-

high levels of dollarization, the exchange rate continues to serve as a benchmark for determining the direction of monetary policy.

Ongoing Structural Reforms

Energy sector reforms remain at the forefront of the government's agenda.

The recently-adopted National Development Strategy-2030 prioritizes energy sector as one of the strategic goals in country's economic development agenda. Ongoing energy sector reforms aim to achieve energy security, reduce the winter energy deficit and improve the financial standing of Barqi Tojik (BT), Tajikistan's vertically integrated national power utility.⁴ Within the energy sector strategy, the government has:

- Initiated the rehabilitation of existing generation facilities, including:
 - ✓ The Nurek hydropower plant (HPP), the mainstay of Tajikistan's energy sector generating 70 percent of the country's total annual energy demand. The financing for the first phase of the Nurek rehabilitation, which will cost an estimated US\$350 million, was secured from the World Bank, the Asian Infrastructure Investment Bank and the Eurasian Development Bank.
 - ✓ The Golovnaya and Kairakum HPPs.
- Constructed or began construction of new generation facilities, including:
 - ✓ The 3,600 megawatt (MW) Rogun HPP on the Vakhsh River, with the river diversion officially inaugurated by the President in October 2016. The first two units of the Rogun HPP are expected to start generating electricity by mid-2019. The government announced a TJS 530 million money issue in April 2017 to finance the construction of the Rogun HPP.
 - ✓ Commissioned the 400 MW Dushanbe-2 Combined Heat and Power Plant (CHPP).
- Strengthened the power transmission network by constructing the North-South 500 kilovolt (kV) transmission line and rehabilitating major substations.

Initiated reforms aimed at improving the financial viability of the energy sector, including adopting the Power Sector Financial Recovery Plan in April 2017, which specifies comprehensive measures to improve BT's financial standing. These include utilizing a cost-recovery electricity tariff methodology, gradually increasing tariffs, improving bill collection rates, improving the

⁴ BT has incurred losses for many years due to a combination of factors including below cost tariff recovery and poor collection rates from SOEs and agriculture pumping stations.

efficiency of inventory management and repaying short-term commercial loans from cost savings, among other measures to improve the company's financial and operational performance. Development partners including the World Bank, ADB and EBRD will continue to support the government with the implementation of energy sector reforms.

Efforts to improve the business regulatory framework continued.

The government continued to implement reforms in 2016 to improve the business climate and encourage foreign investment. These included some actions to streamline the permitting system, business inspections and procedures for starting and operating a business. In June 2016 the Ministry of Health and the Ministry of Transport launched pilot programs allowing the electronic filing of documents to obtain permits. In July 2016 the government introduced a new Inspection Law with a risk-based approach for business inspections to ensure compliance (in contrast to a previous focus on revealing inconsistencies and imposing fines). To ensure a unified approach and to coordinate the activities of the various inspection bodies, the government established a Coordination Council on Inspection. Moreover, the government continued its efforts to simplify business registration procedures by integrating the information technology services of relevant agencies—including the Tax Committee, TajStat and the State Insurance and Pension Fund—into a one-stop-shop mechanism.

Public financial management reforms are progressing, but face delays.

In March 2016 the government established the Appeal Council, a platform for tax disputes, under the Tax Committee. Around 20 percent of cases were resolved in favor of taxpayers in its first year of operation. In mid-2016, the government also began the second phase of its Public Financial Management Modernization Project (PFMMP-2). The scope of the project was expanded to include public procurement, state audit and public administration reforms. However, due to technical reasons and delays related to the selection of consulting firms, progress has been limited to the establishment of a new data processing center and the continued strengthening of the e-filing system.

Health reforms are progressing extremely slowly.

After more than a decade, in 2016 the government finally adopted a resolution on per capita financing of primary health care service providers. The new framework, adopted in early 2016, envisages the more equitable allocation of funds for primary health care service providers based on the size of the population they serve. However, the introduction of Compulsory Medical Insurance, which has faced delays since 2014 due economic challenges, was delayed again in 2016. The next review is expected in mid-2017.

C. Economic Outlook and Risks

Baseline Scenario

Domestic vulnerabilities will weigh on economic growth prospects.

Tajikistan's real GDP growth rate is projected to decelerate in 2017 before gradually recovering in 2018-19. However, growth will remain below 2016 levels in 2017-2019. Lingering challenges in the financial sector, growing vulnerabilities in SOEs and an uncondusive business climate will weigh on the economy's growth prospects. Conversely, a gradual recovery in regional economies, the projected rebound of remittances and the restoration of bank lending, subject to comprehensive reforms, are expected to boost consumption and services growth over the medium term. A prudent monetary policy stance and improved policy transmission mechanisms will support the objective of keeping inflation in single digits.

The external position will remain vulnerable to exogenous shocks.

With FDI and debt inflows more than offsetting the current-account deficit, the overall external position is projected to be positive in 2017. Although the current-account deficit will widen considerably in 2017—driven by a pickup in domestic demand—over the medium-term, the revival of remittances and moderate price improvements for the country's principal export commodities—namely cotton and aluminum—should result in a slight reduction in the current-account deficit and boost fiscal revenue. To the extent that the macroeconomic management framework is enhanced to ensure prudence—and structural reforms to improve the business climate are sustained and accelerated—higher public and private inflows are expected to materialize. Foreign reserves are forecast to rise to above the benchmark minimum of three months of import cover.

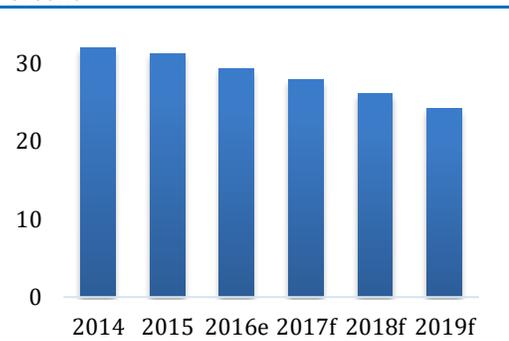
Fiscal adjustment will ensure sustainability.

The public sector outlook envisages that gradual fiscal consolidation efforts will help to ensure fiscal and debt sustainability. Driven by lower capital spending and a modest expansion of the tax base, the fiscal deficit is forecast to narrow gradually. Core social spending—including transfers to the most vulnerable—are expected to be safeguarded. However, public debt is projected to rise as a result of the costs associated with the financial sector bailout and new PIP-related external borrowing.

Poverty reduction will hinge on remittances and domestic wage income growth.

The poverty rate is projected to fall steadily (Figure 14), but this will depend heavily on economic recovery in Russia and domestic income growth. More favorable migration regulations will prop up outbound migration, supporting income growth for the most vulnerable households. The new Law on Social Assistance and the expansion of the TSA program are expected to assist in a further reduction of extreme poverty. The poverty rate is projected to fall from 31.3 percent in 2015 to 26.1 percent by 2018.

Figure 14: Poverty Rate Projection
Percent



Sources: TajStat and World Bank staff calculations.
Note: National poverty line in 2015 was TJS 167.76 per month.

Table 4: Baseline Scenario: Selected Macro-Fiscal Indicators, 2016-19
(In percent, unless otherwise indicated)

	2016e	2017f	2018f	2019f
Real GDP growth	6.9	5.5	5.9	6.1
Private consumption	-4.1	1.5	3.0	3.5
Government consumption	2.4	3.5	3.8	4.3
Gross fixed investments	21.2	11.8	11.8	11.8
Exports, goods and services	7.7	4.2	5.0	5.2
Imports, goods and services	-15.0	0.0	2.0	2.5
Consumer price inflation, period average	5.9	7.0	7.0	7.0
Current-account balance (percent of GDP)	-3.8	-4.7	-4.5	-4.4
Overall fiscal balance (percent of GDP) 1/	-10.1	-6.5	-5.4	-1.5
Government debt (percent of GDP) 1/	41.4	48.9	54.2	55.6

Source: Tajik authorities, and World Bank staff estimates and projections

1/Calculations include the financial sector bailout in 2016 (6 percent of GDP) and projected additional recapitalization in 2017 (4 percent of GDP) and 2018 (3.5 percent of GDP). Materialization of fiscal risks due to contingent liabilities of SOEs could increase these figures by an additional 8 percent of GDP over the medium term, but this is excluded from current calculations.

Risks

Risks to growth will remain weighted to the downside

Despite an anticipated improvement in the external environment, risks to economic growth remain to the downside. Substantial contingent liabilities among SOEs and a weak business environment—particularly with regards to a tax administration still plagued by contradictory objectives and inefficiencies in its implementation—will continue to hinder broad-based growth and may intensify debt-related risks. Ongoing asset-quality reviews at commercial banks may reveal new capitalization needs and further raise fiscal costs. A weaker-than-expected recovery among regional economies or delays

in the expansion of the TSA program could slow progress on poverty reduction. Finally, a combination of credit constraints and slow employment growth in pro-poor sectors such as construction and agriculture will remain a serious challenge to the government’s poverty reduction efforts.

D. Focus Section: The Financial Sector Crisis

Financial Sector Overview

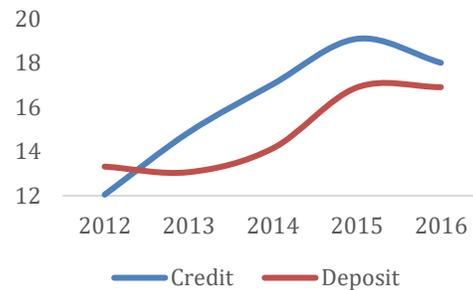
Tajikistan’s small financial sector is undercapitalized and heavily concentrated.

With an asset to GDP ratio of only 39 percent,⁵ Tajikistan’s financial sector is relatively small compared to those of other regional economies. The banking industry represents almost 90 percent of total financial sector assets and comprises 16 commercial banks, including one fully state-owned bank, two majority state-owned banks and six majority foreign-owned banks. The largest four banks account for more than 80 percent of total bank assets. The micro-finance sector is the second largest industry, represented by 34 micro-deposit organizations and 46 micro-lending organizations and funds. The size of the insurance and leasing sectors is small, while the capital market is limited to 91-day treasury bills and advisory services are virtually non-existent.⁶

Financial intermediation is limited.

Largely as a result of its troubled banking history and legacy of government interference in operational decisions—which have distorted the effective allocation of resources for years—Tajikistan’s deposit and credit penetration rates are below those of other regional economies. At end-2016, the ratio of bank deposits and credit to GDP stood at 16.9 percent and 18 percent, respectively (Figure 15)—significantly lower than the Kyrgyz Republic (23.4 percent and 20.4 percent) and Kazakhstan (39.7 percent and 28.1 percent). Although falling in recent years, interest rates remain high; deposit and lending rates stood at 16 percent and 25 percent, respectively, in local currency terms at end-2016. The interest rate margin was high (at over 9 percent), indicating low efficiency, limited competition and severe funding constraints.

Figure 15: Financial Intermediation
Percent of GDP



Sources: NBT and World Bank staff calculations.

⁵ Calculations are based on December 2016 data and include recapitalization.

⁶ In April 2017 Bank Eskhata issued the first corporate bonds in Tajikistan’s history in the amount of TJS 20 million.

Developments

Banking sector issues were evident even before the Russian crisis.

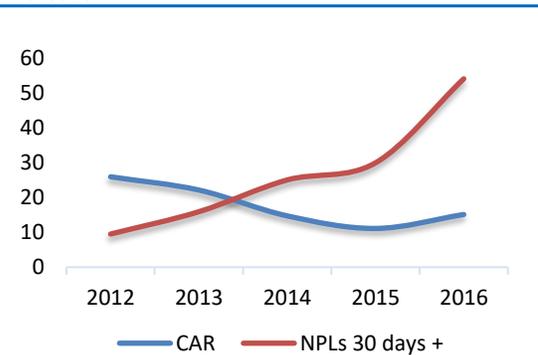
The banking sector in Tajikistan has a long history of weak performance, including a major collapse after independence, a largest bank resolution in 2004 and its bailout in 2012. The first signs of the 2016 financial sector crisis were evident in 2013, when the NPL ratio suddenly doubled to 15.9 percent, up from an average of 8 percent in 2010-2012. Risks related to poor lending practices, including directed lending and inadequate risk management were further magnified by shortcomings in corporate governance and low capitalization levels in key banks. The onset of recession in Russia in 2014-16 worsened the situation. A simultaneous fall in remittances depressed private consumption and squeezed profit margins in the domestic market. As a result, asset quality indicators deteriorated rapidly, with NPLs rising from 25 percent in 2014 to 54 percent by the end of 2016.⁷ The banking sector portfolio, characterized by high levels of unhedged foreign-exchange borrowers, suffered even more due to a sharp depreciation of the somoni (totaling more than 39 percent in 2014-2016).

High NPLs eroded capital to below the minimum threshold of 12 percent.

The banking system's reported aggregate capital adequacy ratio almost halved from 22.1 percent in 2013 to 11.5 percent at end-2015 (Figure 16). The failure of the banks to meet both their prudential and operational obligations triggered the assignment of a temporary administrator by the regulator for Fononbank in January

2016 and for Tajprombank and Tajiksodirotkbank in May 2016. These temporary administrators were extended several times as decisions were made in late 2016 and early 2017 as to whether the banks would be recapitalized or liquidated.⁸ Following the recapitalization of two banks (Agroinvestbank and Tajiksodirotkbank)—in the amount of 6.1 percent of GDP⁹—and with NBT's new regulatory mandate to supplement reserves, the capital adequacy ratio rose sharply, to 15 percent at end-2016 (from 6 percent in September 2016). Although the liquidity injection from the bailout propped up liquidity indicators, its distribution across the system

Figure 16: Capital and Non-Performing Loans
Percent



Source: NBT.

⁷ The rise in NPLs also reflects the reclassification of loans following an NBT audit in 2016.

⁸ Despite severe problems, Agroinvestbank was treated with forbearance with no temporary administration being assigned.

⁹ At the end of 2016, the Ministry of Finance issued bonds totaling TJS 3.3 billion with a five-year maturity and a 2 percent yield. Bonds were issued against posted collateral and equity acquisition in recapitalized banks.

remains uneven due to weaknesses in the interbank market. Two smaller banks, Tajprombank and Fononbank, were ordered into liquidation procedures in February 2017. The Deposit Insurance Fund (DIF) announced sufficient funds to cover state-guaranteed deposits (equivalent to TJS 17,5000 per individual). Although major IFIs had warned for years about the key weaknesses and risks that precipitated the crisis, a weak supervisory framework and political sensitivities prevented the timely provision of corrective actions.

Reforms at the National Bank of Tajikistan

The NBT is strengthening its regulatory framework.

Since May 2015 the NBT introduced a number of reforms to strengthen its supervisory response and build new mechanisms for macro-prudential policy, financial stability, bank resolution and consumer protection. A new management team is in place, and new staff members have been hired. The financial stability, risk management and consumer protection units have been established and the IMF, World Bank and EBRD are actively providing assistance to the authorities.

World Bank Group Activities in the Financial Sector

Ongoing support by the World Bank Group (WBG) to the financial sector in Tajikistan includes a wide array of subjects that fall into seven main categories:

- **Financial Stability.** In line with the recommendations of the Financial System Stability Assessment (FSSA),¹⁰ in 2015 the NBT established a Financial Stability Department, and in 2016 it was strengthened by an internal Financial Stability Committee. In March 2016, the first Financial Stability Monitoring Report (FSMR) was issued; quarterly reports were prepared throughout the year. In March 2017, the first annual Financial Stability Report (FSR) was approved by NBT Board. The authorities have decided to establish an inter-ministerial committee on the financial stability to include the NBT, the DIF, the Ministry of Finance and the Ministry of Economic Development and Trade
- **Bank Resolution Framework.** Draft legislation that introduces new instruments for crisis preparedness and rapid response is slated for government approval in the third quarter of 2017.
- **NPL Action Plan and Bank Stress-Tests.** Regulations were revised for more transparent reporting and the establishment of funds for loan

¹⁰ The FSSA is a joint product of the IMF and World Bank. The most recent report was prepared in May 2015.

loss provisioning. Stress tests were conducted for all 16 banks in 2016.

- Bank Resolution Plans. A model template was developed for contingency planning, but financing assistance may be needed from donors for further action.
- Consumer Protection. A consumer protection strategy was finalized for expedited adoption in March 2017 and relevant department has become fully operational within the NBT structure.
- Payment Systems. The new RTGS payment system is expected to be upgraded with new hardware and software in 2018.
- Insurance Sector. A new insurance law was approved in July 2016 and supervision over the sector was sifted to the NBT to be operational since January 2018.

Moreover, the International Finance Corporation (of the World Bank Group) has been implementing a series of projects in collaboration with other donors, particularly in:

- Strengthening the credit reporting system;
- Introducing a modern secured transaction system and on-line moveable collateral registry;
- Developing responsible microfinance practices and drafting of a microfinance strategy;
- Developing digital financial services and cashless operations;
- Strengthening advisory services for agriculture sector access to finance.

Despite significant progress, much remains to be done particularly with regards to the sustainability and regulatory measures discussed above. Based on ongoing consultations with the authorities, the WBG has identified five areas for further improvement: financial stability, supervision, consumer protection, insurance industry and deposit insurance fund.

Annex 1. Selected Macroeconomic and Social Indicators, 2014-2019

	2014	2015	2016e	2017f	2018f	2019f
	Projections					
(Percent, unless otherwise indicated)						
National Income and Prices						
Real GDP growth	6.7	6.0	6.9	5.5	5.9	6.1
Private consumption growth	1.8	-12.3	-4.1	1.5	3.0	3.5
Gross fixed investment (% of GDP)	4.6	5.4	6.1	6.5	6.8	7.2
Consumer price inflation, period average	6.1	5.8	5.9	7.0	7.0	7.0
Average exchange rate (TJS/USD)	4.93	6.17	7.84	...	...	...
(Percent of GDP, unless otherwise indicated)						
External Accounts						
Exports of goods and services	9.0	10.5	13.3	14.1	15.4	16.1
Imports of goods and services	44.8	42.7	43.0	44.7	47.1	49.2
Current-account balance	-2.8	-6.4	-3.8	-4.7	-4.5	-4.4
Foreign direct investment, net	3.3	5.4	5.0	4.5	4.0	4.0
(Percent of GDP, unless otherwise indicated)						
Consolidated Fiscal Accounts						
Revenue and grants	28.4	29.9	28.4	30.1	28.8	28.1
Expenditure and net lending	28.4	31.8	38.5	36.5	34.2	29.6
Overall fiscal balance 1/	0.0	-1.9	-10.1	-6.5	-5.4	-1.5
Primary fiscal balance	0.5	-1.1	-9.3	-5.7	-4.9	-1.1
Total public debt 1/	27.9	34.1	41.4	48.9	54.2	55.6
(Percent, unless otherwise indicated)						
Monetary Accounts						
Broad money growth	7.1	18.7	37.1	...	...	...
Reserve money growth	13.2	16.0	71.1	...	...	...
Private sector credit growth	31.5	12.7	-4.9	...	...	...
Refinance rate	5.5-8.0	8.0	8.0-11.0	...	...	...
(Percent, unless otherwise indicated)						
Social Indicators						
Population, total (millions)	8.3	8.5	8.6	8.8	9.0	9.2
Population growth (percent)	2.3	2.4	2.2	2.2	2.1	2.1
Unemployment rate (officially registered)	2.5	2.5	2.4	...	...	...
Poverty rate, (TJS 167.7/month)	32	31.3	29.3	27.9	26.1	24.2
Inequality (Gini coefficient)	30.8	27.5	28.0	...	...	...
Life expectancy (years)	69.6	69.4	...	...	...	...

Sources: Tajik authorities and World Bank staff estimates and projections.

Notes: An ellipsis (...) indicates that data are not available. 1/ Calculations include the cost of the financial sector bailout in 2016 (6 percent of GDP) and projected additional recapitalization in 2017 (4 percent of GDP) and 2018 (3.5 percent of GDP). Fiscal risks stemming from SOE contingent liabilities may result in an additional 8 percent of GDP increase over the medium term (this is excluded from current calculations).



Tajikistan
Country Economic Update | Spring 2017