

Document  
of Eurasian Fund for Stabilization and  
Development  
#000xx

Eurasian Development Bank  
Resources Manager of Eurasian Fund for Stabilization and Development

**APPRAISAL REPORT**

on Application

of Republic of Tajikistan

for Financial Credit

to be provided by Eurasian Fund for Stabilization and Development

in the amount of US\$ 40 million

November 2015

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Republic of Tajikistan  
*Fiscal year: 1 January –31 December*

**National currency exchange rate**  
(status as of 16.11.2015)

<b>Currency</b>	<b>Tajikistani somoni (TJS)</b>
1 EUR	7.1597
1 US\$	6.6355
100 AMD	1.3773
10 KZT	0.2156
10 KGS	0.9225
1 RUB	0.1027

**System of weights and measures: Metric**

CAT	Current account transactions
CPI	Consumer price index
EDB	Eurasian Development Bank
EFSD	Eurasian Fund for Stabilization and Development
FDI	Foreign direct investments
GDP	Gross domestic product
GIR	Gross international reserves
GNI	Gross national income
IMF	International Monetary Fund
MFT	Ministry of Finance of the Republic of Tajikistan
NBT	National bank of the Republic of Tajikistan
NIR	Net international reserves
PIP	Public investments program
RT	Republic of Tajikistan
SUE	State unitary enterprise
WB	The World Bank Group

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## Table of Contents

<b>1. MANAGER'S APPRAISAL REPORT</b> .....	<b>4</b>
<b>2. RATIONALE OF APPRAISAL</b> .....	<b>14</b>
BACKGROUND INFORMATION.....	14
ECONOMIC DEVELOPMENT - KEY PARAMETERS.....	14
ECONOMIC DEVELOPMENT OF RT IN THE CONTEXT OF DETERIORATING EXTERNAL ECONOMIC ENVIRONMENT .....	19
<i>GDP and Standards of Living</i> .....	19
<i>External sector and foreign exchange policy</i> .....	20
<i>Public sector</i> .....	22
<i>Monetary policies</i> .....	23
<b>APPENDIX 1.</b> .....	<b>25</b>
APPLICATION OF RT FOR EFSD FINANCIAL CREDIT OF US4 70 MILLION.....	25
<b>APPENDIX 2.</b> .....	<b>26</b>
ECONOMIC POLICY MATRIX FOR PROPOSED EFSD FINANCIAL CREDIT FOR 2015-2016.....	26
<b>APPENDIX 3.</b> .....	<b>32</b>
RT: KEY MACROECONOMIC PERFORMANCE INDICATORS .....	32
<b>APPENDIX 4.</b> .....	<b>33</b>
GRAPHS.....	33

## **1. MANAGER'S APPRAISAL REPORT**

This Appraisal Report provides an evaluation of the application of the Republic of Tajikistan (hereinafter - RT, the Applicant) for an EFSD financial credit (hereinafter - the Credit) in the amount of US\$ 70 million, submitted to the Eurasian Development Bank (EDB) on 17 February 2015 and contained in the letter # 2-1(b) -2/354 (hereinafter - the Application, Appendix 1 hereto). The main stated purpose of the Credit consists in providing support for the national budget in 2015 -2016.

Having examined the Application, the Manager hereby requests the EFSD Council to consider the following recommendations and following Appraisal Report:

1. The Application has been filed in compliance with the requirements of the Fund and is signed by the Minister of Finance, Plenipotentiary Representative of RT in the EFSD Council. The evaluation of the Application as part of the preparation of the Manager's Appraisal Report was hampered by the incomplete and belated provision to the Manager of information, specifically on banking statistics, balance of payments and forex market.

2. The Application conforms to the Mission of the Fund, its funding policies, the Fund lending procedures and conditionality, as defined by the Treaty on the Establishment of the Fund, Statute of the Fund and the Regulation on EFSD Financial Credits. The Government's anti-crisis program for 2015-2016, to be supported by the requested EFSD Credit, is focused on measures aimed at enhancing the sustainability of the economy facing internal and external shocks, through the implementation of prudent monetary and fiscal policies and structural reforms. It also contains measures to strengthen and improve the performance of the financial sector, increase efficiency and transparency of state enterprises and upgrade the investment climate. The program also provides for better targeting of social protection of the population and creation of new jobs, including for labor migrants coming back home.

3. Analysis of the overall context in RT enables the following conclusions and recommendations to be made:

3.1. The vulnerability of RT's economy exposed to external shocks remains extremely high. The deterioration in the economic environment in the region as a whole, and in the Russian Federation, in particular, has negatively impacted the national savings and external debt. The reduction in the volume of cash remittances by Tajik migrants, which in recent 15 years constituted a fundamental driver for economic growth of RT, has resulted in a slowdown in growth of consumption caused by reduction in the national savings volume, as well as by falling fuel and food import prices, and in declining standards of living of the population, despite the continuing GDP growth rates, which is due to high propensity to import in the domain of cash remittances. A noticeable reduction in imports amid the prevailing decline in domestic demand has led to a shortfall of budget revenues against the 9-month plan in an amount equivalent to 1.6% of GDP. The MFT intends to fund the estimated budget deficit for Q4 by reducing budget deposits, that are already on an extremely low level. Efforts undertaken by the government to curb sharp devaluation of TJS in the context of a significant reduction in the value of national currencies in most countries of the region, have led to an almost complete depletion of the liquid GIR resources, which complicates both further maintenance of the exchange rate, and ensuring effective public debt service performance. The weakening of the national currency, at a time of

growth of the external debt, has resulted in deterioration of the amount of foreign debt. The increase in the gross external debt during the first half of the current year by US\$ 285 million, along with the devaluation of the somoni, has raised its ratio to GDP from 47.7% of GDP to 53.2% of GDP. The limited export earnings (about 10% of GDP) and the lack of conditions for growth in cash remittances by migrants in the medium term, also promote risks of low influx of foreign currency to pay off external debt liabilities. If at the beginning of 2015 the level of external debt was 9% lower than the revenue from exports and cash remittances, by the end of the first six months it was 4.3% higher. Despite the fact that the size of the external public debt remains at an acceptable level, equal to 22.5% of GDP, the expected deterioration in the external debt status requires prudent fiscal and debt service policies.

3.2. GDP of RT in January-September of 2015 grew at a fairly steady pace. At the end of nine months, the economic growth rate was equal to 6.4%, compared to 6.9% in 2014 YoY. In the meantime, the role of the key growth driver moved over to investments, which grew significantly in 2013 and were used to considerably expand the industrial base of RT and increase the level of import substitution<sup>1</sup> (*Figure 1 in Appendix 4*). In 2015 during the period under review, the growth of industrial output increased by 12.8%, compared to 5.6% in the previous year. In the manufacturing and power industries, where most significant investments were made, the biggest growth was observed: from 1.4% (end of 9 months in 2014) to 12.1% (end of 9 months in 2015) and from 4.6% to 14 %, respectively. It should be mentioned that the main source of investment were FDIs and borrowed funds from China, whereas the share of public investments decreased from 46% in January-September 2014 to 40% in the current period (*Fig. 2*). Growth also benefited from the good performance of the farming sector, demonstrating a 5% increase, compared to 3% in the previous period.

3.3. Diminished cash remittances, which in the first six months accounted for 22% in dollar terms<sup>2</sup>, had an adverse impact on the status of wellbeing of the population (*Figure 3*). According to the estimates of the Manager, the growth rates of consumption in January-September shrunk, compared to the corresponding period in 2014, more than twice as low, down to 3.5%. Given that the growth rate of public consumption declined insignificantly during this period YoY, the slowdown in its growth was mainly due to a drop in private consumption. This is also evidenced by a 2.9% reduction in real disposable cash incomes of the population, compared to January-September 2014, recorded amid a positive real wage growth (+1.1%), as well as by almost complete absence of growth in household bank deposits (+0.6%, compared to +7.6% in January-September 2014)<sup>3</sup>. The development forecasts for the Russian Federation, where the overwhelming majority of cash remittances are generated by Tajik migrants, suggest that in 2016 the level of cash remittances is unlikely to exceed that of 2015, which, in the context of the

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<sup>1</sup> In particular, several cement plants, built with the assistance of Chinese capital helped to drastically reduce cement imports.

<sup>2</sup> According to the Balance of Payments of RT for the first six months of 2015 and the statistics of the Central Bank of the Russian Federation, the volume of cash remittances of Tajik migrants during this period dropped by 46.2%.

<sup>3</sup> At a fixed rate.

current downturn in the population's savings<sup>4</sup>, may lead to further reduction of their real incomes, a decline in the GDP growth rate in the medium term, and larger-scale poverty. In this case, the Government will face the challenge of having to implement radical structural reforms and to ensure adequate care for the poor, both by way of enabling the best possible business environment for creating new jobs and through targeted support programs, which will require increased budget spending.

3.4. In the first half of 2015, CAT and the financial account improved significantly. The CAT deficit decreased by US\$ 200 million from 9.4% of GDP in January-June 2014 to 4.4% of GDP in 2015 YoY. The drop in the inflow of cash remittances, given the significantly weaker TJS to US dollar exchange rate (by more than 20%), as well as putting into operation of a number of import-substituting facilities, resulted in a decline in demand for imports, their volumes falling by more than US\$ 500 million, i.e. 21.8%, against the first six months of 2014. At the same time, exports of goods and services increased by 19.7%, including exports of goods - by 34%. With substantial strengthening of the real exchange rate of TJS to RUB (by 21%), growth in exports cannot be accounted for as the result of improved competitiveness of Tajik producers, since it is to a large extent due to the growth of exports in gold<sup>5</sup> and aerial vehicles. No growth was observed in the traditional items of Tajik exports (with the exception of a slight increase in cotton exports). Improvement of the financial account (+8.5% of GDP, compared to 5.8% of GDP in previous year) was largely due to an increase in import payment arrears (growth in commercial credit inflows by US\$ 136 million), additional US\$ 75 million as FDIs, as well as a minor increment of US\$ 20 million in foreign loans.

3.5. Improvement of the CAT and financial account did not automatically replenish GIR, which, in particular, is due to the problems of exchange rate formation and related National bank interventions (*Fig. 4*). Considerable devaluation in the countries - trading partners in late 2014 - early 2015, and the determination of the RT authorities to prevent depreciation of the national currency, generated a strong pressure on the TJS exchange rate, thereby increasing the need for interventions by the National bank of RT, and thus reducing the size of GIR by US\$ 34 million, which is equal to about 7% of GIR in the beginning of the year. Given the low level of GIR (about 1.2 months of imports) and the reduced liquid portion of GIR<sup>6</sup> from 20% at the end of Q1 of 2014 down to 8.5% at the end of Q1 of 2015, the NB of GT decided to impose an administrative restriction on the exchange rate, which exacerbated the problem of multiplicity of exchange rates. In March 2015, the deviation of the market exchange rate from the official one was about 10% with blips of more than 13%. As the RUB was going strong in May-June of 2015, the variance of deviations diminished dramatically (4.9% on average), but the absence of a market mechanism for exchange rate formation brought about further expansion in disparities averaging through August-September 7,4% (*Fig. 4*).

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<sup>4</sup> In Q1 of 2015 real incomes grew by 4.1% at a time of some reduction in real wages, which implies resorting to savings for consumption. Yet, starting from Q2, the dynamics of these indicators changed to its exact opposite: the growth rate of real incomes turned negative, whereas that of real wages was back to its original status.

<sup>5</sup> The Manager does not have information on any amendments to the balance of payments, which renders it impossible to determine the portion exports in gold transacted by the Ministry of Finance and the National Bank, and makes it difficult to estimate the real input of this item into the actual improvement of the current account.

<sup>6</sup> Foreign currency. Reduction of the liquid portion of GIR is caused by the National bank interventions and an increase in the share of gold in GIR as a result of monetization of gold by the MFT and NBT.

- 3.6. Lack of transparency in the exchange rate formation policy, a decline in domestic demand, including for imports, low solvency and poor payment discipline of borrowers<sup>7</sup>, have become attributes of the deteriorating banking sector environment. The share of the overdue debt, which had been steadily growing over the previous 2 years, has now reached 15.2% at the beginning of October (compared to 9.3% and 11.5% at the beginning of 2014 and 2015, respectively). The share of bad loans in the banks' portfolio in September 2015 reached 29.3% (compared to 27.2% at the beginning of 2015). The higher credit risks and the diminishing resources of the banks amid the ongoing net outflow of capital from commercial banks and non-banking financial institutions, observed at the end of the first half of the year, in the amount of US\$ 105 million, compared to the inflow of US\$ 45 million in the previous year, motivated setting of higher real interest rates on loans and reduction of lending volumes. Lending to the economy at a fixed rate for the first 9 months of 2015 grew by 2.3%, compared to 16.6% YoY in 2014. The reduction is observed both in respect of foreign currency lending (0.2%, compared to 13% in the previous period), and loans issued in TJS (5.6% compared to 21.9% in the previous year).
- 3.7. One of the important obstacles hampering the development and consolidation of the financial sector is the practice of prescriptive lending, which requires the banks with government ownership to issue loans upon executive orders of the Government to businesses without proper appraisal of the risks and efficiency of projects. In addition to ousting private lending practices and build-up of bad debts, such prescriptive loans also cause increased budget spending and/or growing domestic debt of the Government due to the need to recapitalize banks. In 2012, the Government increased its domestic debt by borrowing TJS 700 million (2% of GDP) for recapitalization of the Agroinvestbank, one of the largest banks in the country actively involved in prescriptive lending<sup>8</sup>. The deterioration, currently observed in the banking sector, is also fraught with high risks of increasing pressure on the budget in case of need for support to be provided to state banks.
- 3.8. Given the high dependence of budget revenues of RT on external factors, the reduction in cash remittances of labor migrants and the shrinking demand for imports had a negative impact on the current budget formation exercise. Import taxes, which, over the past 4 years, on average accounted for about 37% of the total tax revenues of RT, in January-September of this year showed negative growth (-11.4% in nominal terms), and their share in GDP dropped from 9.2% at the end of 9 months in 2014 down to 7.6% in the current period. The increase in total budget revenues secured from domestic sources<sup>9</sup>, equal to 6.9% in nominal terms, was achieved owing to the steady growth of taxation of domestic goods and services (+10.4%) and non-tax revenues (+37.1%), which is due to both positive growth of all sectors<sup>10</sup>, and strengthening of tax administration, including through expansion of inspections of businesses and the increased number of penalties for non-compliance. Since the administrative measures were no longer

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<sup>7</sup> See para 3.4 above.

<sup>8</sup> Out of this amount, TJS 500 million was used to pay off bad debts and TJS 200 million - as a contribution of the Government to the statutory fund of the bank. As a result, the share of the Government in the authorized capital of the bank exceeded 51%.

<sup>9</sup> Tax and non-tax revenues.

<sup>10</sup> Except for paid services to the population, which dropped by 8,1% over 9 months following the contraction of effective demand.

effective and, given the lack of drivers to increase effective demand for imports, the Ministry of Finance of the Republic of Tajikistan expects a shortfall of the budget revenues by the end of the year in an amount equivalent to US\$ 100 million. It will require a complete withdrawal of the surplus funds accumulated over 9 months (TJS 789 million, or 2.3% of GDP)<sup>11</sup> to finance expenses and will reduce the Government deposits at the National bank, small as they are, which at the end of August were equivalent to a two months expense amount.

3.9. Reducing vulnerabilities of the RT budget to external shocks requires prompt diversification and improved efficiency of the economy, especially in the public sector, which, despite privatization efforts undertaken in the years following its independence, remains quite expansive. Most of the major state-owned enterprises in the country, which generate about 40% of gross value added, run at a loss, because of: inadequate pricing policies<sup>12</sup> pursued in respect of their products and services; inefficient expenditures due to poor structure of enterprises and social and charity-related responsibilities imposed on them; as well as mismanagement problems. According to the report of the Ministry of Finance of the Republic of Tajikistan at the year-end of 2013<sup>13</sup> total debt of<sup>14</sup> 24 largest state-owned enterprises monitored by the Ministry, amounted to an equivalent of 31% of GDP, which is ultimately indicative of the size of the Government's contingent liabilities. About 55% of this debt was accumulated by the stock holding company OSHC "Barki Tojik"<sup>15</sup> (BT), which is a reflection of poor corporate management practices, including the lack of proper metering of power supply and the resultant large commercial losses, low tariffs that do not cover the cost of electricity and other operational and technical problems. Bottom line, BT is the largest debtor to the budget in tax payments, and the company's quasi-fiscal deficit, determined as the difference between the cost of production and the current low tariffs, is equal to about 2% of GDP per annum. The number of enterprises that generate significant quasi-fiscal risks for the Government also includes SUE "Talco", Tajik Railway, and several state-owned banks. The risks of conversion of the Government's contingent liabilities, generated by SOEs, into direct liabilities, are also very high.

3.10. The size of tax revenue in RT, the lowest in the region among countries with similar incomes (*Fig. 5*), is largely influenced by an extensive system of tax and customs benefits, the effectiveness of which requires further assessment. According to the authorities, the total value of these benefits in 2013 was estimated at about TJS 4 billion, which was equivalent to half of the amount of taxes collected in the above period. The Manager hereby acknowledges that a certain portion of this amount is neutral to the budget (i.e., it reduces budget expenses by a similar

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<sup>11</sup> Net of the budget revenues and expenditures for the Public investment program.

<sup>12</sup> In accordance with the 2013 report of the Ministry of Finance of the Republic of Tajikistan on fiscal risks, due to setting of prices for goods and services below the level of costs of production, 24 largest state-owned enterprises lost TJS 874.6 million (2.2% of GDP), with its lion's share claimed by OSHC "Barki Tojik" which charged low tariffs for electricity supply.

<sup>13</sup> National statistical service does not publish data on the real sector financial performance results. The only source of information on the profitability of state-owned enterprises are reports of the Ministry of Finance of the Republic of Tajikistan, published with a significant delay.

<sup>14</sup> The total amount of arrears includes taxes payable and liabilities for plain and government-backed debts.

<sup>15</sup> State-owned national power utility engaged in production, transportation, transmission, distribution and sale of electricity and heat.

amount)<sup>16</sup>. However, a further cost-benefit analysis is required to evaluate opportunity cost for the budget. Tax benefits are provided both by the Tax Code and by the annual State Budget Law, granting the said benefits on a case-by-case basis, which is clearly at variance with international practice of offering equal opportunities for all businesses.

4. In view of the purpose of the Application of RT for a Financial Credit to be provided by the EFSD, the authorities of the Republic of Tajikistan and the Manager prepared the Economic Policy Matrix (hereinafter - the Matrix, Appendix 2 hereto) for support in the form of Financial Credit of the Fund, to be implemented in order to ensure improved sustainability of the budget system of RT through more efficient administration of public property, optimization of taxation policies, and improving the quality of management of public finances. The key measures, contained in the Matrix, are listed below.
- 4.1. Reducing budget risks created by public sector enterprises owing to their low profitability and high level of accumulated quasi-fiscal deficits. By providing the Credit, the Manager will support the Government in its efforts to prepare a Strategy for reduction of fiscal risks created by state-owned enterprises and to ensure implementation of measures contained therein. To improve transparency of the operation of SOEs, provision is made in the Matrix for audits to be performed in all large enterprises by independent licensed auditors or by the Audit Chamber and to extend the list of state-owned enterprises paying 10% of profits or dividends to the budget. Implementation of some of the Matrix measures will contribute to the financial recovery of OSHC "Barki Tojik" through improvement of the corporate financial accounting policies in compliance with relevant international standards, and development of a new methodology for managing electricity tariffs based on more sophisticated techniques of accounting of costs and losses in the power supply system.
- 4.2. Optimization of tax and customs benefits as a source of additional budget revenue. The Manager will support independent audit of customs and tax benefits to evaluate their cost-effectiveness, and based on the outcome, amendments will be offered to the relevant legislation to repeal the most ineffective benefits, and to incorporate the value of all such benefits in the budget proposals submitted to the Government and Parliament in the course of preparation and approval of the budget.
- 4.3. Maintenance of social security expenditures of the budget in the context of increasing risks of budget revenue volatility amid unfavorable external environment. For 2015 the Matrix provides for execution of the budget in respect of its social commitments at the level approved by the 2015 Budget Law (50.2% of total spending), and also for approval of the social sector budget for 2016 at a level of at least 50% of the total budget expenditures.
- 4.4. Improving the system of public finance management on the basis of automated management systems. The Matrix envisages implementation of a module for public sector contract monitoring, which will enable the Ministry of Finance of the Republic of Tajikistan to enhance control over authorized spending of budget funds, to increase predictability in allocation of resources and budget execution, and improve the quality of cash management. The measure, aimed at preparing

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<sup>16</sup> For example, many PIP credit/loan agreements make provision for the Government's contribution to the project financing in the form of exempting equipment supplies from import VAT,

automation of the process of salary accounting and payments in the budget system, will enable more stringent control over spending resources for this specific expenditure item, and reduction of the labor costs of budget organizations.

4.5. Improving foreign exchange policies to enhance the competitiveness of Tajik exports. The Matrix proposes adoption of a single exchange rate in order to reduce the NBT's interventions to support it and to increase GIR.

4.6. Consolidation of the banking sector to enable diversification of the economy and expansion of the tax base. A number of measures are envisaged to strengthen the role of the National bank in monitoring compliance with prudential banking standards by commercial banks and to ensure increased transparency of the banking system. The draft Matrix also contains a requirement to execute the schedule of debt repayment by AIB borrowers in the amount of TJS 500 million by the end of 2016. It was contemplated that the repaid amount would be used for encashment of the bills of exchange issued by the Government in 2012 to buy out the AIB bad debts and to prevent its bankruptcy; they are currently held by the NBT, and it enables the Government to ensure safety of its reserves and to improve payment discipline of the borrowers. However, at this point in time, the Ministry of Finance of the Republic of Tajikistan is pushing for removal of this requirement from the Matrix because of the high risk of non-compliance therewith, including because of the lengthy procedures for recovery of debts through judicial proceedings.

5. In summary, implementation of the Matrix measures will accomplish the following results: (a) improved sustainability of the budget sector as a result of preparation and implementation of the Strategy for quasi-fiscal risk management aimed at improving the quality of management of public enterprises; expansion of the tax base following audits and optimization of tax and customs benefits; providing information to legislative authorities on cost involved and effectiveness of the above benefits to enable economically viable decisions, and improvement of public finance management mechanisms; (b) preventing any reduction of spending on financing of social sectors, provided general control of total expenditure is ensured to fit within the approved budget deficit not to exceed 0.5% of GDP; (c) strengthening the banking sector through enhanced monitoring of compliance with prudential standards and adoption of adequate preventive measures by the National bank of RT; (d) improved quality of foreign exchange policy by establishing a single exchange rate, including for the purpose of retaining and replenishing GIR. However, the Manager points out that the effectiveness of the program's measures will materialize fully in the medium term, and will be more significant provided other public finance reforms, not included in the Matrix, are also activated, including in projects financed by the World Bank and other development partners.

6. Compliance by the Applicant with mandatory eligibility requirements for granting financial credits:

6.1. The Applicant is deemed to have completed all domestic procedures required for entry into force of the Treaty on the Establishment of the Fund, made an initial contribution to the Fund, as well as met other requirements to the Fund member state to qualify for a financial credit on terms and conditions as defined in the Statute of the Fund and relevant decisions of the Fund Council.

6.2. The Credit in question is the second one to be provided by the EFSD for RT. The Applicant has been honoring timely and in full its debt service obligations on the US\$ 70 million credit granted in 2010.

6.3. The Applicant has no outstanding external debt repayment or service liabilities towards any Fund member states or any major international financial institutions.

7. The Manager recommends to approve granting of the said Financial Credit to RT for budget support for 2015-2016 in the amount of US\$ 40 million, subject to the following conditions:

- Elimination of multiplicity of exchange rates;
- Execution of the AIB debt repayment schedule;
- Streamlining of the tax and customs benefits system is a mandatory requirement/benchmark to qualify for the second tranche.

8. The Manager recommends disbursement of the Credit in the 2015-2016 in two tranches, each of which should be drawn down subject to approval by the Fund Council of the Borrower's reports on compliance with tranche disbursement preconditions. The following amounts and reference dates are recommended for the evaluation of compliance with the requirements for the tranches:

	Tranche 1 01/09/2015	Tranche 2 01/07/2016	Total
Amount, US\$ million	20	20	40

*Note:* Credit amounts recommended in Table are indicative. They should not be considered as committing the Fund or its Manager to put up the above resources in amounts, per schedule or in forms as shown above.

9. The country eligibility limit of RT for access to resources of EFSD, as defined by the Fund Council (Decision of 25 February 2010), is equal to US\$ 170.3 million. With due account of the previously disbursed credit (US\$ 70 million), the recommended amount of this Credit does not exceed the above limit.

10. Pursuant to Appendix 1 to the Regulation on the Use of EFSD Resources for Providing Financial Credits, the Manager recommends to set the following financial conditions for the requested Credit:

- Interest rate: fixed, 1% per annum;
- Front-end fee: n/a;
- Commitment fee: n/a;
- Credit drawdown period, not to exceed 20 years, including grace period 5 years;
- Requirement of co-financing by Beneficiary: n/a.

11. The Manager points out the high risks, associated with implementing the program supported by this Credit, and recommends the following approaches to reduce them:

- (a) Potential further degradation of the macroeconomic situation in the key partner countries (including Russia and China), may accelerate the rate of decline in the standards of living of the population in the context of further reduction in cash remittances, exports and investments. These factors will have a negative impact on the balance of payments, the capacity of gold and

foreign currency reserves, as well as budget deposits, scarce as they already are, alongside with increasing expenditures on social protection of the population. The corrective actions, recommended by the Manager to the authorities, include increasing the flexibility of foreign exchange management policy and expediting reforms in the public sector to improve the financial condition and payment discipline of state-owned enterprises. Along with the promotion of surplus budget execution, these measures will improve the competitiveness of the Tajik economy, help to support international reserves and accumulate additional funds for social protection.

(b) Introduction of administrative control to manage foreign exchange markets amid the persistent pressure on the exchange rate, large-scale dollarization of the banking system and scarce foreign currency reserves in the context of the ongoing decline in economic activity, may contribute to exacerbation of the foreign exchange condition and result in banking system failure. It will negatively impact the pace of economic growth, will exacerbate the situation at enterprises, reduce budget revenues and slow down the reform progress. The attempts, currently undertaken to contain strengthening of the dollar through administrative measures and foreign exchange interventions by the NBT, have already led to reduction of the national gold and foreign currency reserves down to one month of imports, despite their replenishment during 2014 and early 2015 by way of transfer of non-monetary gold of the National bank of RT into the monetary category. Giving a generally positive evaluation of the exchange rate unification policy, pursued by the authorities since September 2015, the Manager believes that the absence of a clear-cut mechanism for its formation will prevent the monetary authorities from adequately responding to external shocks, which is clearly demonstrated by the weakening of the RUB exchange rate in November, resulting in increased exchange rate variance. The Manager recommends to the authorities adding flexibility to the exchange rate by setting the official exchange rate based on the currency exchange trading results, without either interventions (except for blip and surge events), or any correction factors for the official exchange rate. Conservative monetary and fiscal policies (including termination of budget deposits in commercial banks and raising refinancing rates) will have a limiting impact on price increases caused by devaluation. Downward pressure on inflation will also be exerted by the favorable global market food prices, which are currently at rock bottom in over five years.

(c) Slow progress in reforming public sector enterprises may contribute to further deterioration of RT's fiscal positions because of reduction in payments to the budget, increased tax arrears, larger-volume of contingent liabilities, and higher budget spending in support of these enterprises struggling with continued deterioration of their financial condition. The Manager believes that prompt preparation of a high-quality strategy for managing fiscal risks, and its unconditional performance, as provided by the Matrix, will expedite the reform process and improve the efficiency of the public sector. Yet, special attention should be focused on quickly finding solutions to the problems of system-forming enterprises, including OSHC "Barki Tojik" (BT). The importance of successful reforming of BT consists not only in enhancing its taxpayer role but also that of contributing to more rapid development of the private sector. According to the WB "Doing Business 2015", Tajikistan holds one of the last places in the world in access to electricity rankings (178th out of 189 surveyed countries), and in the joint EBRD-WB survey

Tajik entrepreneurs pointed out poor electricity supply as one of the most serious problems in doing business. Reorganization of BT, improvement of management of this company, including reduction of losses, and setting tariffs at the level of cost recovery, will increase the attractiveness of the sector for investors, improve the quality of services provided and provide access to electricity for all consumers.

(d) The slow reform progress in the banking sector, including lack of developments in restructuring of the AIB debt liabilities, as well as continuing prescriptive lending practices, will not only add to the budget expenditures for recapitalizing loss-making state-owned banks, but will also have a negative impact on the overall payment discipline of borrowers and the banks' attitude toward prudential standards amid softer requirements to banks involved in prescriptive lending. Termination of any government meddling in the operations of banks, strengthening of their capacity in credit risk assessment, enhanced independence of the NBT and its banking supervision authority, should be top priority for the authorities in ensuring improved operational stability of banks and their role in stimulating growth.

(e) Deterioration of the geopolitical landscape in the event of aggravation of the situation in Afghanistan and expansion of the influence of the Islamic State may also have an extremely negative impact on Tajikistan.

## **2. RATIONALE OF APPRAISAL**

### **BACKGROUND INFORMATION**

- 2.1. Tajikistan is a small (8.4 million people) and the poorest CIS country (GNP per capita in 2013 was equal to US\$ 990). The country's economy was seriously undermined by the civil war (1991-1997), and, despite a fairly rapid recovery in the post-war period, remains inadequately diversified and vulnerable to internal and especially external shocks. The dependence on cash remittances of labor migrants, working mainly in the Russian Federation, is critically high. The total volume of cash remittances up to 2014 accounted for more than 45% of GDP<sup>17</sup>, which is 5 times the amount of its export earnings. This had a positive effect and contributed to reducing poverty from 72% in 2003 to 34% in 2014.<sup>18</sup> However, such cash remittances increase the demand for imports, thus undermining the national balance of trade. The share of food imports in the consumer basket is over 60%. The export base is very narrow, and depends on external demand and prices for cotton and aluminum, though in recent years there has been some progress in its expansion with the addition of farming produce. The development of foreign trade is problematic both because of the geographic location of the country and due to insufficient liberalization of the transport sector. The local investment climate is not attractive enough for an active inflow of direct investments: according to "Doing Business 2015", RT ranked 166th out of 189 economies surveyed, with most of issues concentrated around access to electricity (178th place), taxes (169), and obtaining construction permits (168th)<sup>19,20</sup> The recent growth of investments is due to stepping up its cooperation with China.

### **ECONOMIC DEVELOPMENT - KEY PARAMETERS**

- 2.2. The model of economic growth that was formed in RT during the years of independence is extremely vulnerable to external shocks, because of its significant dependence on the current status of cash remittances of labor migrants and its high propensity to imports in the context of scarce accumulated gold/foreign currency and budget reserves. The recent high growth rates in 2000-2014, averaging 7.9% per annum, were supported by the ever-growing volumes of cash remittances of Tajik migrants that accounted for almost half of the GDP in 2013, whereas the economic base remained narrow and inadequately diversified. Given real GDP growth in 2013 to the level of 2.7 times the amount in 2000, the employment numbers for the period was up only 1.3 times, while the number of people who went abroad to work in recent years was estimated at more than 1 million.
- 2.3. The national foreign trade performance indicators reflect low grade of diversification of the economy: the level of exports in the past 5 years did not exceed an average of 17% of

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<sup>17</sup> 2007-2013, excluding 2009-2010, during which time cash remittances dropped to an average of 37% of GDP, which was due to the aftermath of the global financial crisis.

<sup>18</sup> In terms of the international poverty line, estimated at US\$ 2.5/day (converted on the basis of PPP).

<sup>19</sup> Compared with the previous survey, Tajikistan improved its position moving up by 11 points, mainly due to improvements in tax revenue (following adoption of the new Tax Code), and borrowing domains.

<sup>20</sup> According to another survey, BEEPS (EBRD-WB joint project of surveying business community), the main problems in doing business were hindered access to finance, tax burden, and administrative red tape. The top five key problems also include corruption and impeded access to electricity.

GDP, compared to 50% of GDP on average across all countries similar to Tajikistan in terms of income, and the value of imports over this period was four times that of exports. The narrow export base exacerbates the dependence of export earnings on volatile global market prices for cotton and aluminum, accounting for more than half<sup>21</sup> of the total exports of the country. Maintaining a low current account deficit (3.4% of GDP on average in 2010-2014), with a large balance of trade deficit (more than 40% of GDP on average over the period), was possible only thanks to the inflow of cash transfers in the context of low level of foreign direct investments and extremely scarce international reserves of the country, accounting for about one month of imports.

- 2.4. The main driver of GDP growth resides in the sector of retail trade and services, whose share in GDP is more than 40%, and whose active growth over the past decade has been boosted by increasing cash remittances and the related growth in disposable income of the population. The role of industry in economic development is constantly declining: since 2000 its share in GDP has dropped 3-fold down to 12%<sup>22</sup> in 2014. Stepping up of market reforms in agriculture in the past few years, which provided more freedom to dehkans (peasants) in managing land, and liberated them from the burden of cotton debts accumulated in the 1990s, facilitated expansion of production of certain agricultural crops, not conventionally grown in the Republic of Tajikistan, such as wheat, vegetables and potatoes, and improve the efficiency of the sector. The lack and high cost of credit resources, the practical lack of public aid and support services are the main obstacles to further development of the sector.
- 2.5. Despite privatization efforts undertaken in the years following its independence, the public sector in Tajikistan is still a very important economic component. According to the national statistical service, the state-owned enterprises employ about one-third of the total workforce, they generate about 40% of the value added and absorb about 50% of all investments in fixed assets.<sup>23</sup> State-owned enterprises dominate in such sectors as energy, industry, housing utilities, and some transport sub-sectors. Since there is no adequate financial accounting and reporting system in public domain, it is hard to estimate how cost-effective these enterprises are. According to the 2013 report of the Ministry of Finance of the Republic of Tajikistan on fiscal risks, 13 out of 24 largest state-owned enterprises monitored by the MF<sup>24</sup>, reported profits at the end of this year, all the other ones were loss-making. The total debt of these enterprises amounted to more than US\$ 2.5 billion, or almost one-third of the GDP for the relevant year.<sup>25</sup> About 55% of this debt

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<sup>21</sup> In 2008 their share in total exports was equal to 80%. The decline in the share is indicative of a certain degree of diversification of exports, including added food and farming produce, but also reflects a drop in the global prices for cotton and aluminum.

<sup>22</sup> According to ADB, in the past decade, the share of jobs in industrial enterprises has shrunk from 20% to 6%.

<sup>23</sup> WB, Tajikistan Policy Notes on Public Expenditure, Policy Note # 5 Fiscal Risks from State-Owned Enterprises.

<sup>24</sup> In 2008, the Ministry of Finance of the Republic of Tajikistan established a separate department specializing in monitoring fiscal risks of the largest state-owned enterprises. Currently, 24 out of 800 operating state-owned enterprises are included in the list of enterprises required to submit financial statements to this department.

<sup>25</sup> The total amount of arrears includes taxes payable and liabilities for plain and government-backed debts.

was accumulated by the stock holding company OSHC "Barki Tojik"<sup>26</sup>(BT), which is a reflection of poor corporate management practices, including the lack of proper metering and records of power supplied and the associated large commercial losses, low tariffs that do not cover the cost of electricity and other operational and technical problems. Thus, OSHC "Barki Tojik" is the largest debtor to the budget for tax payments, and the company's annual quasi-fiscal deficit is equal to about 2% of GDP. The number of enterprises that generate significant quasi-fiscal risks for the Government also includes SUE "Talco", Tajik Railway, and several state-owned banks.

- 2.6. The main factors that cause state-owned enterprises to run at a loss are misstatements in pricing of their products and services; inefficient expenditures due to poor structure of enterprises and social and charity-related responsibilities imposed on them, as well as mismanagement problems. Keeping these enterprises afloat in the context of total lack of or minor progress in reforms significantly increases the burden on the Ministry of Finance of the Republic of Tajikistan, which is responsible for servicing external debts of the large state-owned enterprises (Barki Tojik and Talco) and for containing the reduction in the revenue due to large tax arrears of public sector enterprises. According to the results of 2013, of the total amount of tax debt to the budget of TJS 885 million, the debt liabilities of the observed 24 state-owned enterprises accounted for 53%. The risks of conversion of the Government's contingent liabilities, generated by SOEs, into direct liabilities, are also very high.
- 2.7. The financial sector of Tajikistan is still in an early stage of development, therefore its input into GDP growth is limited. The depth of the financial market and monetization of the economy are lowest among the EFSD member countries: the value of the RT banking assets is 36% of GDP<sup>27</sup>. Compared to its neighboring countries, Tajikistan ranks low in the degree of penetration of loans and deposits. In 2014 deposits accounted for 14.2% of GDP, which is slightly higher than 13.1% in 2013. The size of loans provided to private sector companies in terms of their share of GDP increased from 19% in 2013 to 20.2% in 2014. In terms of "access to credit" the WB Doing Business 2015 survey ranks Tajikistan 116th among 189 countries. Improving access to credit resources, especially for small and medium-sized enterprises (SMEs), along with other measures, requires Tajikistan to comply with regulatory standards, build a credit culture, develop financial infrastructure, upgrade the system for secured transactions, and promote more effective risk management methods.
- 2.8. One of the important obstacles hampering the development and consolidation of the financial sector is the practice of prescriptive lending, which requires the banks with government ownership to issue loans upon executive orders of the Government to businesses without proper appraisal of the risks and efficiency of projects. In addition to ousting private lending practices and building-up of bad debts, such prescriptive loans also cause increased budget spending and/or growing domestic debt of the Government

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<sup>26</sup> State-owned national power utility engaged in production, transportation, transmission, distribution and sale of electricity and heat.

<sup>27</sup> In the Kyrgyz Republic, it is equal to 40% of GDP, in the Republic of Armenia - about 80% of GDP.

due to the need to recapitalize banks. In 2012, the Government increased its domestic debt by borrowing TJS 700 million (2% of GDP) for recapitalization of the Agroinvestbank, one of the largest banks in the country actively involved in prescriptive lending.

- 2.9. By the end of 2014, the share of bad loans in the banks' portfolio amounted to 27.2%, compared to 23% reported at the end of 2013. The aggregate capital adequacy ratio across the banking system decreased to 14.7% compared to previous 22.1%, the return on assets and the stated return on equity at the end of 2014, were negative, equal to 4.4% and 29.2%, respectively. Such negative indicators are attributed both to the overall poor performance of the system, and to the adjustments in the balance sheet and profit and loss account of the Agroinvestbank, reflecting the consequences of the bank's involvement in prescriptive lending transactions.
- 2.10. The current model of economic growth has a direct impact on the sustainability of the national budget of Tajikistan. Despite the tangible progress in improving tax administration practices in recent years, the level of tax revenues in the Republic of Tajikistan remains one of the lowest in the region (*add numbers*). More than half of these revenues are generated by various import fees and taxes from retail sales and services, their size depending to a large extent on the volume of imports of consumer goods and incomes of the population, supported by migrants' cash remittances. The loss-making status of many state-owned enterprises determines their minor role in the formation of budget revenues. The low level of tax revenues is, among other things, due to a large number of tax and customs benefits, which, according to the authorities, account for about TJS 4 billion<sup>28</sup>, or almost half of the collected taxes. Bottom line, the traditional surplus budget execution in the Republic of Tajikistan was possible in the past decade<sup>29</sup> due to the favorable external environment and conservative planning of budget spending, including for social sectors. As a result, the national budget expenditures for education and health per capita is considerably lower than on average for the region, which constitutes a threat of erosion of human capital.
- 2.11. One more constraint affecting the growth of social spending is the high share of capital expenditures in the national budget, which, in the context of limited budget revenues, pushes out current expenditures. The volume of investments reached its peak level in 2007-2008, accounting for almost 14% of GDP and 50% of all budget expenditures, which should be attributed to the beginning of implementation in 2007 of large-scale investment projects in the energy and road building sectors financed by loans granted by the Chinese government. Thereafter, in 2014, the share of capital investments diminished to 8% of GDP and 28% of total expenditures, but only due to a significant reduction in investment grants and loans from 8% of GDP in 2008 to 2.6% of GDP in 2014. Investment resources of the Government in that period, on the contrary, increased markedly from 3.7% of GDP on average in 2001-2006 up to 6.4% of GDP in 2007-2014.

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<sup>28</sup> The Manager hereby acknowledges that a certain portion of this amount is neutral to the budget (i.e., it reduces budget expenses by a similar amount); however, further analysis is required to evaluate the cost of this category of benefits.

<sup>29</sup> Exclusive of the Public Investment Program.

These indicators are the highest among countries with similar incomes. At the same time, the cost-effectiveness of these large-scale investments should not be considered as unequivocally high; at least, the investment upswing of the past decade has not impacted in any way the GDP growth. The plans of the Government of the Republic of Tajikistan to go ahead with budget funding the construction of the Rogun HPP project, its total cost estimated at US\$ 5-6 billion, generate very high risks both for overall fiscal sustainability and for the prospects of raising social spending to match regional average levels. The primary objective the authorities of the Republic of Tajikistan should pursue in the current context is increasing the efficiency of public investments and stepping up private sector development programs, which will facilitate privatization of some of the government functions or reduce the burden on the budget by developing of public-private partnerships.

- 2.12. Despite a noticeable reduction in the external public debt in the past five years from 34.4% of GDP in 2011 down to 22.7% of GDP, the debt sustainability of RT is exposed to serious risks associated with flaws and vulnerabilities of the current model of economic growth. Deterioration of the external environment with no visible progress in promoting structural reforms, with fragile government institutions and scarce international reserves, the risks only grow in size. The continuation of the policy of soft budget limitations and prescriptive lending increases the level of Government's contingent liabilities and, if risks do arise, will have a very negative impact on the budget and debt sustainability, especially in the absence of domestic debt market.

### 3. ECONOMIC DEVELOPMENT OF RT IN THE CONTEXT OF DETERIORATING EXTERNAL ECONOMIC ENVIRONMENT

#### *GDP and Standards of Living*

- 3.1 Amid the persisting high vulnerability of the Tajik economy to external shocks, the deterioration in the economic environment in the region as a whole, and in the Russian Federation, in particular, has negatively impacted the national savings and external debt. The reduction in the volume of cash remittances of Tajik migrants, which served as a driver of economic growth in the Republic of Tajikistan during the past decade, has resulted from a slowdown in consumption growth and lower living standards of the population at a time of growth of the GDP. A noticeable reduction in imports amid the prevailing decline in domestic demand has led to a shortfall of budget revenues against the 9-month plan in an amount, equivalent to 1.6% of GDP. The MFT intends to ensure balanced budget execution only by reducing budget deposits, which are already on an extremely low level. Efforts undertaken by the government to curb sharp devaluation of TJS in the context of a significant reduction in the value of national currencies in most countries of the region, have led to an almost complete depletion of the liquid GIR resources, which complicates both further maintenance of the exchange rate, and ensuring effective public debt service performance. Weakening of the national currency at a time of growth of the external debt has contributed to the deterioration of the foreign debt status. The increase in the gross external debt during the first half of the current year by US\$ 285 million, along with the devaluation of the TJS, has raised its ratio to GDP from 47.7% of GDP to 53.2% of GDP. The limited export earnings (about 10% of GDP) and the lack of conditions for growth of cash remittances by migrants in the medium term, also promote risks of low influx of foreign currency to pay off external debt. If at the beginning of 2015, the level of external debt was 9% lower than the revenue from exports and cash remittances, by the end of the first six months it was 4.3% higher. Despite the fact that the size of the external public debt remains at an acceptable level, equal to 22.5% of GDP, the expected deterioration in the external debt status requires prudent debt policies. In this regard, the Manager supports the recommendations of the IMF for the Government of Tajikistan to borrow funds only on soft terms with a substantial grant-element<sup>30</sup>.
- 3.2 GDP of RT in January-September of 2015 grew at a fairly steady pace. At the end of nine months, the growth rate of the economy was 6.4%, compared to 6.9% in the corresponding period of 2014. In the meantime, the role of the key growth driver switched over to investments, which grew significantly in 2013, and were used to considerably expand the industrial base of RT and increase the level of import substitution<sup>31</sup>. In 2015 during the period under review, the growth of industrial output increased by 12.8%, compared to 5.6% in the previous year. In the manufacturing and power industries, where most significant investments were made, even more rapid growth was observed: from 1.4% (end of 9 months in 2014) to 12.1% (end of 9 months in 2015) and from 4.6% to 14 %, respectively. However, the bulk of

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<sup>30</sup> The minimum size of the grant-element recommended by the IMF for Tajikistan should be equal to 35%

<sup>31</sup> In particular, several cement plants, built with the assistance of Chinese capital helped to drastically reduce cement imports.

investments were FDIs and funds borrowed from China, whereas the share of public investments decreased from 46% in January-September 2014 to 40% in the current period. Growth was also boosted by good performance of the farming sector, demonstrating a 5% increase, compared to 3% in the previous period.

- 3.3 Diminished cash remittances, which in the first six months accounted for 22% in dollar terms<sup>32</sup>, had an expressly adverse impact on the status of wellbeing of the population. According to the estimates of the Manager, the growth rates of consumption in January-September shrunk, compared to the corresponding period in 2014, more than twice as low, down to 3.5%. Given that public consumption during this period did not shrink, the slowdown in its growth was due to a drop in private consumption. This is also evidenced by a 2.9% reduction in real disposable cash incomes of the population, compared to January-September 2014, recorded amid a positive real wage growth (+1.1%), as well as by almost complete absence of growth in household bank deposits (+0.6%, compared to +7.6% in January-September 2014)<sup>33</sup>. The development forecasts for the Russian Federation, where the overwhelming majority of cash remittances are generated by Tajik migrants, suggest that in 2016 the level of cash remittances is unlikely to exceed that of 2015, which, in the context of the current depletion of the population's savings<sup>34</sup>, may lead to further reduction of their real incomes, a decline in the GDP growth rate in the medium term, and larger-scale poverty. In this case, the Government will face the challenge of having to ensure adequate care for the poor, both by way of enabling the best possible business environment for creating new jobs and through targeted support programs, which will require increased budget spending.

#### *External sector and foreign exchange policy*

- 3.4 Despite the negative external factors, in the first half of 2015, the state of the current account transactions (CAT) substantially improved. The deficit of CAT decreased by US\$ 200 million from 9.4% of GDP in the first six months of 2014 down to 4.4% of GDP in the first half of 2015. The improvement occurred amid a considerable reduction in cash remittances from abroad by US\$ 380 million. However, the drop in the inflow of cash remittances, given the significantly weaker TJS to US dollar exchange rate (by more than 20%), resulted in a decline in demand for imports, their volumes falling by more than US\$ 500 million, i.e. 21.8%. In addition to the reduction in domestic demand, imports also dropped due to putting into operation of a number of import-substitution facilities in the country<sup>35</sup>. At the same time, exports of goods and services increased by 19.7%, including exports of goods - by 34%. The growth of exports cannot be attributed to the improvement of competitiveness of Tajik

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<sup>32</sup> According to the Balance of Payments of RT for the first six months of 2015, and the statistics of the Central Bank of the Russian Federation, the volume of cash remittances of Tajik migrants during this period dropped by 46.2%.

<sup>33</sup> At a fixed rate.

<sup>34</sup> In Q1 of 2015 real incomes grew by 4.1% at a time of some reduction in real wages, which implies resorting to savings for consumption. Yet, starting from Q2, the dynamics of these indicators changed to its exact opposite: the growth rate of real incomes turned negative, whereas that of real wages was back to its original status.

<sup>35</sup> In the current year a number of cement plants were commissioned, which helped to dramatically reduce cement imports,

producers, as it is to a large extent due to growth of gold exports<sup>36</sup> and supplies of areal vehicles. No growth was observed in the traditional items of Tajik exports (with the exception of a slight increase in cotton exports). The structure does not reflect any qualitative improvement in the current account since the determined drivers of export growth are not sustainable or long-term.

- 3.5 The increase in the inflow of foreign investment offset the outflow of short-term capital via channels of the banking sector and non-banking financial institutions, which contributed to an improvement in the financial account. Improvement of the net inflow of capital financial account (8.5% of GDP, compared to 5.8% of GDP in previous year), was largely due to an increase in import payment arrears (growth in commercial credit inflows by US\$ 136 million), additional US\$ 75 million as FDIs, as well as a minor increment of US\$ 20 million in foreign loans. At the same time, banks and non-bank financial institutions transferred funds abroad and increased their assets in foreign banks, which amounted to a net outflow of capital of US\$ 105 million against the inflow (subtracting from foreign assets) of US\$ 45 million in the previous year. The growth of foreign assets, amid high domestic interest rates, is largely an indication of low efficiency of investments within the country. Improvement of the current account and growing inflows on the financial account did not provide the grounds for an increase in the GIR; in the first six months, their value dropped by US\$ 34 million, which is US\$ 10 million more than in the previous year. In the absence of potential applications for capital, NBT's interventions did not result in any reduction of the external debt or imports funding resources. The above manifested itself in large-scale statistical discrepancies totaling US\$ 217 million, which is more than 11% of all inflows on the current account<sup>37</sup>. According to the Manager, purchased foreign currency missed the road to the banking system and settled in the hands of the population, which is actually equivalent to internal leakage of capital. The dynamics of international reserves do not reflect the amounts the NBT spends on interventions, since gold monetization transactions, carries out in the current year, allowed to replenish the GIR.
- 3.6 The level and structure of international reserves reflect an extreme vulnerability of Tajikistan to external shocks. As of 01/07/2015, the level of reserves was equivalent to only about 1.2 months of imports. The efforts to retain the relative size were coupled to reduction of the nominal level of the international reserves. Drawing on the GIR liquid resources (foreign currency) for interventions dramatically deteriorated the GIR structure. The current value of the liquid portion of the GIR (US\$ 37 million) may prove insufficient not only for continued support of the exchange rate but also carries risks for meeting public debt liabilities.
- 3.7 Maintaining the level of the exchange rate with limited GIR resources resulted in development of the model of multiplicity of exchange rates. Significant devaluation in the countries - trading partners in late 2014 - early 2015 generated a strong pressure on the TJS exchange rate. The lack of flexibility in exchange rate policies and non-transparent mechanism of exchange rate formation required powerful interventions by the NBT. Given the scarce reserves, the NBT decided to impose an administrative cap on the exchange rate, which led to the formation of a

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<sup>36</sup> The Manager does not have information on any amendments to the balance of payments, which renders it impossible to determine the portion exports in gold transacted by the Ministry of Finance and the National Bank, and makes it difficult to estimate the real input of this item into the actual improvement of the current account.

<sup>37</sup> Acceptable statistical discrepancies are equal to a value, not to exceed 5%.

system of multiplicity of exchange rates. In March 2015, the deviation of the market exchange rate from the official one was about 10% with blips of more than 13%. As the RUB was going strong in May-June of 2015, the variance of deviations diminished dramatically, but the absence of a market mechanism for exchange rate formation brought about further expansion in disparities.

- 3.8 The Manager welcomes the exchange rate unification policy, pursued by the authorities since September 2015, and believes that the absence of a clear-cut mechanism for its formation will prevent the monetary authorities from adequately responding to external shocks, which is clearly demonstrated by the weakening of the RUB exchange rate in November, resulting in increased exchange rate variance. The Manager recommends to the authorities adding flexibility to the exchange rate by setting the official exchange rate based on the currency exchange trading results, without either interventions (except for blip and surge events), or any correction factors for the official exchange rate.
- 3.9 Lower global market prices and weaker domestic demand will curb the impact of devaluation on the accelerated inflation rate. Despite the currently ongoing appreciable devaluation, no explosive spikes in prices have been observed. This is largely due to the reduction of dollar prices for fuel and food imports. The slowdown in the rate of economic growth, expected in 2016, at a time of regional recession, will deter expansion of domestic demand. Consequently, termination of exchange rate control, subject to implementation of adequate monetary policy, will not bring about any significant price rise.
- 3.10 Weakening of the national currency, at a time of growth of the external debt, has resulted in deterioration of the amount of foreign debt. The gross external debt during the first half of the current year increased by US\$ 285 million, which at a time of the devaluation of the TJS, has raised its ratio to GDP from 47.7% to 53.2% of GDP. The limited export earnings (about 10% of GDP) and the lack of conditions for growth of cash remittances by migrants in the medium term, promote risks of insufficient inflow of foreign currency to pay off external debt. If, as of 01/01/2015, the level of external debt was 9% lower than the revenue from exports and cash remittances, by the end of six months its value already exceeded the foreign currency flow by 4.3%. Despite the fact that the size of the external public debt remains at an acceptable level, equal to 22.5% of GDP, the expected deterioration in the external debt status requires prudent debt policies. In this regard, the Manager supports the recommendations of the IMF for the Government of Tajikistan to borrow funds only on soft terms with a substantial grant-element<sup>38</sup>.

#### ***Public sector***

- 3.11 Given the high dependence of budget revenues of RT on external factors, the reduction in cash remittances of labor migrants and the shrinking demand for imports had a negative impact on the current budget formation exercise. Import taxes, which, over the past 4 years, on average accounted for about 37% of the total tax revenues of RT, in January-September of this year showed negative growth (-11.4% in nominal terms), and their share in GDP dropped from 9.2% at the end of 9 months in 2014 down to 7.6% in the current period. At the end of 9

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<sup>38</sup> The minimum size of the grant-element recommended by the IMF for Tajikistan should be equal to 35%

months 2015 the total budget revenue was equal to 30.2% of GDP, compared to 29% of GDP for the corresponding period in 2014. The above increase was due to a steady growth of taxes on domestic goods and services (15.5% of GDP compared to 15% of GDP), non-tax proceeds (5% of GDP compared to 3.9% of GDP) and investment grants (2% of GDP compared to 1% of GDP). The domestic revenues increased because of the growth of all sectors of the economy<sup>39</sup>, as well as due to the strengthening of tax administration systems, including as a result of expansion of the number of inspections of business entities and imposed penalties.

- 3.12 Budget spending in the period under review increased by 2 pp. of GDP to 29.9% of GDP due to a significant growth of capital outlays (from 7% of GDP to 9.5% of GDP), amid some reduction in current expenditures (by 0.4 pp of GDP). The increase in capital expenditures is mainly due to the intensification of construction of the Rogun HPP project and active disbursement of funds for PIP projects, which is responsible for the increase in spending by 1.9 percentage points of GDP.
- 3.13 As a result, due to the more energetic absorption of funds for the PIP, the overall budget balance decreased from +1.1% of GDP in January-September 2014 to 0.4% of GDP. The budget balance net of the PIP improved from 2.2% of GDP to 2.3% of GDP. Since the administrative measures were no longer effective and, given the lack of drivers to increase effective demand for imports, the Ministry of Finance of the Republic of Tajikistan expects a shortfall of the budget revenues by the end of the year in an amount equivalent to US\$ 100 million. It will require a complete withdrawal of the surplus funds accumulated over 9 months (TJS 789 million) to finance expenses and will reduce the Government deposits at the National bank, small as they are, which at the end of August were equivalent to a two months expense amount.

### *Monetary policies*

- 3.14 In the expired period of 2015, RT experienced a significant reduction in the growth rate of lending operations. The growth of fixed-rate loans to the economy during 9 months was 2.3% compared to 16.6% in the corresponding period of 2014. The reduction is observed both in respect of foreign currency lending (0.2%, compared to 13% in the previous period), and loans issued in TJS (5.6% compared to 21.9% in the previous year). It happened amid the increase in the refinancing rate (from an average of 5.36% for the 9 months of 2014 to 8% for the corresponding period in 2015), and some increment in real interest rates for loans along with retaining nominal interest rates and lower inflation. Higher costs of financial resources charged by banks have led to a contraction of demand for borrowed funds, especially among retail businesses, whose operations have diminished because of the declining purchasing power of the population.
- 3.15 Despite the reduction in lending growth, the share of bad loans in the portfolio of banks has increased significantly. By the end of 2014, the share of bad loans in the banks' portfolio was equal to 27.2%, whereas in September 2015 it amounted to 29.3%. These poor performance

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<sup>39</sup> Except for paid services to the population, which dropped by 8,1% over 9 months following the contraction of effective demand.

indicators are the result of the extensive practice of prescriptive lending, as well as the low solvency of business entities.

- 3.16 The sinking income levels of the population in the context of the lower inflow of cash remittances has led to changes in the structure of bank deposits shifting in favor of deposits by legal entities. If during 9 months in 2014 fixed rate deposits increased by 8.3%, given the deposits of legal entities and individuals grew at approximately the same rate (9.6% and 7.6%, respectively), in the expired period of 2015 , such deposits rose by 9.1%, while deposits of legal entities grew by 24.3%, and deposits by individuals - only by 0.6%.
- 3.17 A very high growth of the monetary base is observed in the country (12.7% in 8 months of 2015 compared to 8.6% in the corresponding period of 2014). The main growth driver was the increased money supply. During 9 months of the current year it has grown by 18.5% at the current rate, and by 10.4% at a fixed rate. During the corresponding period of 2014, its growth was equal to 5.4% at the current exchange rate, and 3.9% at a fixed rate, which is largely due to the growth of cash money supply, which has increased by 16.9% since the beginning of the year.

## **APPENDIX 1.**

**APPLICATION OF RT FOR EFSD FINANCIAL CREDIT OF US4 70 MILLION**  
(attached in separate file)

## APPENDIX 2.

### ECONOMIC POLICY MATRIX FOR PROPOSED EFSD FINANCIAL CREDIT FOR 2015-2016

(4 tranches, total amount US\$40 million)

**CT - Control Target**

**IT - Indicative Target**

Target	1st tranche (as of 01/09/2015) US\$ 20 million	2nd tranche (as of 01/07/2016) US\$ 20 million	Responsible authority
<b>1. Macroeconomic stability</b>			
1.1. CT. Maximum amount of liquidity provided to banks (end of quarter)	TJS 160 million as of the end of Q2 of 2015	TJS 160 million as of the end of Q2 of 2016	NBT
1.2. CT. NBT provides liquidity only to banks whose stability is supported by the capital adequacy compliant with the International Financial Reporting Standards and the regulatory requirements established by the NBT, and only provided such banks deposit highly liquid collateral.	Based on the NBT's financial statements for 8 months of 2015 on liquidity support loans and on compliance with prudential standards by the banks that have been provided liquidity, and listing the types of assets pledged as collateral.	Based on the NBT's financial statements for Q4 of 2015 and 6 months of 2016 on liquidity support loans and on compliance with prudential standards by the banks that have provided liquidity, and listing the types of assets pledged as collateral.	NBT
1.3. IT. Maximum amount of monetary base.	Not to exceed TJS 6.8 billion	Not to exceed TJS 6.8 billion	NBT
1.4. IT. Elimination of multiplicity of exchange rates.	Deviation from the official rate not to exceed +/- 2%	Deviation from the official rate not to exceed +/- 2%	NBT

<b>Target</b>	<b>1st tranche (as of 01/09/2015) US\$ 20 million</b>	<b>2nd tranche (as of 01/07/2016) US\$ 20 million</b>	<b>Responsible authority</b>
1.5. CT. Maximum budget deficit (with the exception of expenditures for PIP financed by foreign loans and grants).	Consolidated budget for 9 months (net of PIP) executed with zero balance (IT).	Consolidated budget for the year-end of 2015 (net of PIP) executed with a deficit not to exceed 0.5% of GDP.	MFT
1.6. CT. No overdue arrears of the national budget on wages and pensions.	Permanently	Permanently	MFT
1.7. CT. No regular external public borrowing.	Permanently	Permanently	MFT
1.8. CT. Maximum amount of external public borrowing.		As of 01/01/2016, the external public debt rose, compared to 01/01/2015 <sup>40</sup> , not more than by US\$ 6 million on net basis <sup>41</sup> .	MFT
1.9. CT. No overdue arrears on foreign debt.	Permanently	Permanently	MFT
1.10. CT. Minimum amounts, allocated as social expenditures.	In the 2015 budget - no less than 50.2% of the level of budget spending (net of PIP and expenditures for financing the principal of public debt)	Actual amount allocated for social sectors in 2015 was equal to no less than 50.2% of the level of budget spending (net of PIP and expenditures related to financing the principal of public debt). The approved budget for 2016 earmarks a share of at least 50% for social spending in the total expenditures section of the budget (net of PIP and expenditures related to financing the principal of public debt).	MFT
1.11. CT. No new issues of shares of JSC "Rogun HPP" for physical persons, residents of the Republic of Tajikistan.	Permanently	Permanently	Government

<sup>40</sup> As of 01/01/2015, the level of external public debt was equal to US\$ 1,932 million or 21.8% of GDP.

<sup>41</sup> This amount will be adjusted based on actual amounts of loans provided, including for budget support.

Target	1st tranche (as of 01/09/2015) US\$ 20 million	2nd tranche (as of 01/07/2016) US\$ 20 million	Responsible authority
1.12. IT. Regular publication of data on the overall external debt status of the economy broken down by sectors, on the debt of the Government's (including government-backed) and the NBT on a quarterly basis.	Quarterly	Quarterly	NBT, MFT
<b>2. Banking sector</b>			
2.1. CT. Improvement of the quality of monitoring by the NBT of compliance with prudential standards by commercial banks and imposing effective corrective action on non-compliant banks.	Submit NBT reports to EDB on compliance with prudential standards by banks and on corrective actions by NBT for 8 months of 2015.	Submit NBT reports to EDB on compliance with prudential standards by banks and on corrective actions by NBT for Q4 of 2015 and 6 months of 2016.	NBT
2.2. IT. Improve transparency and accessibility of information on the activities of the JSCs, including the banking sector.	Public access to information contained in the register is provided, including: <ul style="list-style-type: none"> <li>✓ Data on major shareholders is posted on the websites of ACB, Ministry of Finance of the Republic of Tajikistan, NBT</li> <li>✓ Discussions have been conducted with media outlets about the beginning of publication of the above information, including the website addresses where it is posted.</li> </ul>	<ul style="list-style-type: none"> <li>✓ Information has been published on direct ownership by major shareholders of other joint-stock companies, including banks or financial corporations.</li> <li>✓ Information has been disclosed on the nature and forms of business activities of banks describing potential shareholding in affiliated companies.</li> </ul>	Securities Control Agency, NBT
2.3. IT. Publication of the final report on the implementation of the Strategy for banking sector development for 2010-2015.		Final report on the implementation of the Strategy - published.	NBT
<b>3. Public sector</b>			

<b>Target</b>	<b>1st tranche (as of 01/09/2015) US\$ 20 million</b>	<b>2nd tranche (as of 01/07/2016) US\$ 20 million</b>	<b>Responsible authority</b>
3.1. IT. The debt repayment schedule of AIB borrowers to pay off the amount of TJS 500 million in favor of the MFT has been approved and is being executed in full.	As of 01/09/2015, an amount equivalent to 30% of the total debt has been repaid.	As of 01/07/2016, all debts have been repaid in an amount equivalent to 100%.	MFT / NBT / AIB
3.2. IT. Streamlining the system of tax and customs benefits through increasing transparency of information on their cost and repealing the ineffective preferences.	The Government approved the Terms of Reference and endorsed the expert, nominated by the Manager to carry out an independent audit of the above tax and customs benefits in order to evaluate their cost-effectiveness, and provided all the necessary information for such an audit.	The assessment of the cost of tax and customs benefits is included in the budget documents, submitted for consideration to the Government and Parliament as part of the process of adoption of the 2017 national budget and the budget execution report of 2015, and posted on the websites of MFT, Tax Committee, and Customs Committee. The Government submitted to the Parliament of the Republic of Tajikistan proposed amendments to the legislation regarding the repeal of the tax and customs benefits.	MFT / Tax Committee / Customs Committee / Ministry of Economic Development and Trade of RT
3.3. IT. Improve the quality of quasi-fiscal risk management system of the Government.	Report of the Ministry of Finance of the Republic of Tajikistan on quasi-fiscal risks for 2013 has been posted on the website of the Ministry of Finance of the Republic of Tajikistan. It was drafted on the basis of analysis of reports of 24 largest state-owned enterprises. The Ministry of Finance of the Republic of Tajikistan, together with consultants for the current projects, and based on recommendations provided by the Fund, prepared a Strategy for reducing quasi-fiscal risks.	Before the end of 2015, the Strategy was approved by the Government, and a plan of action for its implementation was also developed and approved. Implementation of the plan of action (specific activities will be agreed upon after the development of the Plan of Action is completed)	MFT
3.4. IT. Introduction of the requirement for an independent audit for all major SOEs by licensed auditors selected through a competitive bidding process or proposed		Before the end of 2015, the Ministry of Finance of the Republic of Tajikistan prepared and distributed a manual for organization of the process of selecting independent auditors for due diligence of the financial statements of state-owned enterprises.	MFT

<b>Target</b>	<b>1st tranche (as of 01/09/2015) US\$ 20 million</b>	<b>2nd tranche (as of 01/07/2016) US\$ 20 million</b>	<b>Responsible authority</b>
by the Audit Chamber.		The audit reports issued upon completion of the audit inspections are posted on the websites of the companies and the MF.	
3.5. CT. 10% of net profit of state-owned enterprises and 10% of dividends of OJSCs with government-owned share of more than 50% must be transferred to the budget.		Relevant Government resolution has been adopted	MFT
3.6. IT. Implement a system of public sector contract monitoring.	Implemented. EDB is in receipt of supporting documentary evidence.		MFT
3.7. IT. Computerization of the system for salary accounting and payments in public sector enterprises.	Overview of the processes for development of the module for managing salary accounting and payments in public sector enterprises has been completed.	Functional specifications have been prepared for the module for managing salary accounting and payments in public sector enterprises.	MFT
3.8. IT. Expanding the scope of applications of PFM electronic systems	On-line connection of at least 50 public sector organizations to the electronic system of PFM from workstations.	On-line connection of at least 500 public sector organizations (out of 600 available) to the electronic PFM system from workstations.	MFT
<b>4. Reform of energy sector</b>			
4.1. IT. Revaluation of fixed assets of OSHC "Barki Tojik" and its divisions.		Before the end of 2015, OSHC "Barki Tojik" submitted to the Government the results of revaluation.	Ministry of Energy and Water Resources of the Republic of Tajikistan, OSHC "Barki Tojik"
4.2. IT. Decommission all worn down and obsolete plant and equipment, that are beyond repair and inoperable.	Permanently, to completion	Permanently, to completion	Ministry of Energy and Water Resources of the Republic of Tajikistan, OSHC "Barki Tojik"

<b>Target</b>	<b>1st tranche (as of 01/09/2015) US\$ 20 million</b>	<b>2nd tranche (as of 01/07/2016) US\$ 20 million</b>	<b>Responsible authority</b>
4.3. IT. Identification of uncollectable receivables and payables with no funding sources of OSHC "Barki Tojik" and their write-off in due procedure.	The report prepared before 01/09/2015.		Ministry of Energy and Water Resources of the Republic of Tajikistan, OSHC "Barki Tojik"
4.4. IT. Development and approval of a new methodology for management of electricity pricing for specific enterprises (production, transmission, distribution).		Before the end of 2015, the Government of RT decided to develop a new methodology for tariff regulation with a view to its roll-out beginning 1 January 2017. As of 01.07.2016, the draft methodology has been developed and submitted to the Government for consideration	Ministry of Energy and Water Resources of the Republic of Tajikistan, OSHC "Barki Tojik"

## APPENDIX 3.

### RT: KEY MACROECONOMIC PERFORMANCE INDICATORS

	2011	2012	2013	2014				2014	2015	
				1 кв.	2 кв.	3 кв.	4 кв.		1 кв.	2 кв.
GDP (TJS million)	30 069	36 161	40 525	7 811	10 069	13 718	14 009	45 605	8 310	10 849
GDP (US\$ million)	6 322	7 588	8 492	1 629	2 029	2 699	2 608	8 965	1 525	1 564
Real GDP growth (% of previous YoY)	107,4	107,5	107,4	107,0	106,5	107,2	106,3	106,7	105,3	107,20465
Investments in fixed assets (% of previous YoY)		75,6	117,2	136,8	120,7	127,0	132,7	129,0	100,0	170,6
CPI (compared to last Dec.), incremental	9,4	6,5	3,7	2,4	4,5	5,6	7,3	7,3	1,5	2,6
Exports of goods and services (US\$ million)	1 158	1 644	1 571	184	171	228	254	836	181	244
Exports of goods and services (% of GDP)	18,3	21,7	18,5	11,3	8,4	8,4	9,7	9,3	11,8	15,6
Imports of goods and services (US\$ million)	4 239	5 273	5 671	1 022	1 304	1 319	1 312	4 957	813	1 006
Imports of goods and services (% of GDP)	67,1	69,5	66,8	62,7	64,3	48,9	50,3	55,3	53,3	64,3
Balance of trade (US\$ million)	-3 082	-3 629	-4 100	-838	-1 133	-1 091	-1 058	-4 121	-632	-763
Balance of trade (% of GDP)	-48,7	-47,8	-48,3	-51,4	-55,9	-40,4	-40,6	-46,0	-41,4	-48,8
Balance of CAT (US\$ million)	-171	-244	-67	-245	-103	246	-249	-352	-205	63
Balance of CAT (% of GDP)	-2,7	-3,2	-0,8	-15,0	-5,1	9,1	-9,6	-3,9	-13,5	4,0
National budget revenue (TJS million)	7 763	9 105	10 918	2 737	3 064	3 357	3 826	12 983	2 919	3 356
National budget revenue (% of GDP)	25,8	25,2	26,9	35,0	30,4	24,5	27,3	28,5	35,1	30,9
National budget expenditures (TJS million)	8 562	9 071	11 433	2 386	3 120	3 307	4 463	13 276	2 579	3 583
National budget expenditures (% of GDP)	28,5	25,1	28,2	30,5	31,0	24,1	31,9	29,1	31,0	33,0
National budget balance (TJS million)	-799	34	-515	351	-56	50	-637	-292	341	-227
National budget balance (% of GDP)	-2,7	0,1	-1,3	4,5	-0,6	0,4	-4,5	-0,6	4,1	-2,1
National budget balance, net of PIP (TJS million)	140,3	519,0	83,9	492	31	170	-497	196	383	-294
National budget balance, net of PIP (% of GDP)	0,5	1,4	0,2	6,3	0,3	1,2	-3,5	0,4	4,6	-2,7
TJS/US\$ exchange rate (average per period)	4,8	4,8	4,8	4,8	4,9	5,0	5,1	4,9	5,4	6,2
Credit to economy (TJS million)	4 800	5 493	7 531	5 113	7 051	8 945	6 498		7 051	8 945
Monetary base (TJS million)	3 829	4 318	5 362	4 143	4 940	5 820	4 489	4 489	4 940	5 362
Monetary base (% of last Dec.)	27,9	12,8	24,2	-2,0	1,9	8,5	6,4	6,4	2,9	14,1
Broad money supply (TJS million)	5 933	6 722	8 491	6 385	7 843	8 981	7 293	7 293	7 843	8 491
Monetary multiplier	1,5	1,6	1,6	1,5	1,6	1,5	1,6	1,6	1,6	1,6
Refinancing rate (for last month of period)	9,9	6,5	5,5	6,5	6,1	5,9	6,5	6,5	6,1	5,5
Gross international reserves (US\$ million), as of year-end	н.д.	н.д.		423	570	538	511	511	474	457
Gross reserves (months of current imports)	н.д.	н.д.		1,2	1,3	1,2	1,2	1,2	1,8	1,4
Net international reserves (US\$ million)	303	356	353	363	349	492	436	436	349	353
Gross external debt (US\$ million, as of year-end)	н.д.	н.д.		4 963	4 734	4 725	4 392	4 392	4 685	4 677
Gross external debt (% of GDP)	н.д.	н.д.		56,9	53,7	52,2	49,0	49,0	52,9	55,7
External public debt (US\$ million, as of year-end)	2 124	2 169	2 189	2 095	2 086	2 023	1 998	1 998	1 932	1 973
External public debt (% of GDP)	33,6	28,6	25,8	24,0	23,7	22,3	22,3	22,3	21,8	21,8

Источник: Тажстат, МФ РТ, НБ РТ, расчеты сотрудников ПФФК ЕФСР.

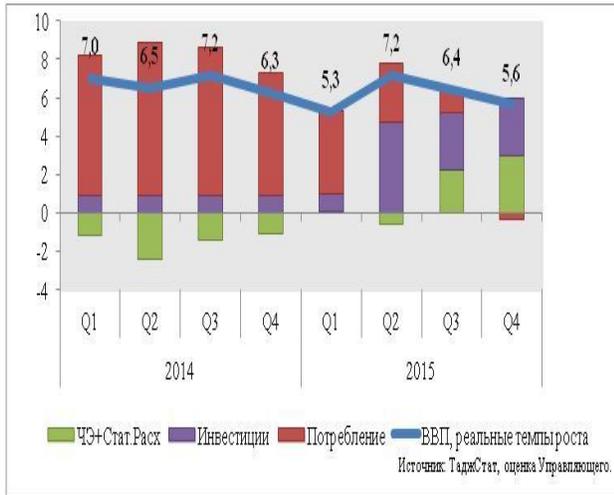
1/ с 2014 г. переход на РБП 6

2/ с 2014 г. - оценки Управляющего

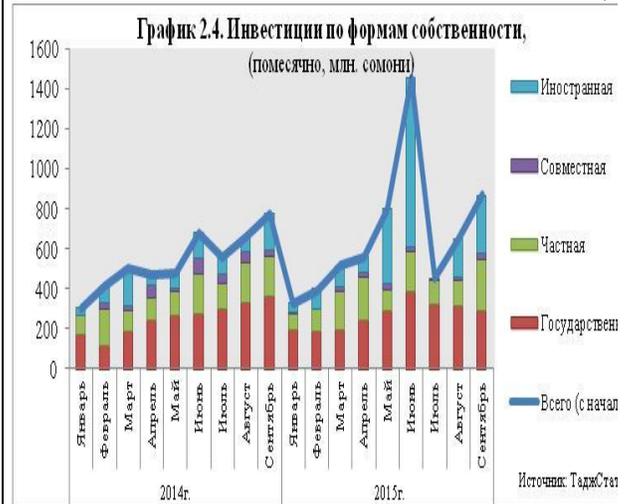
# APPENDIX 4.

## GRAPHS

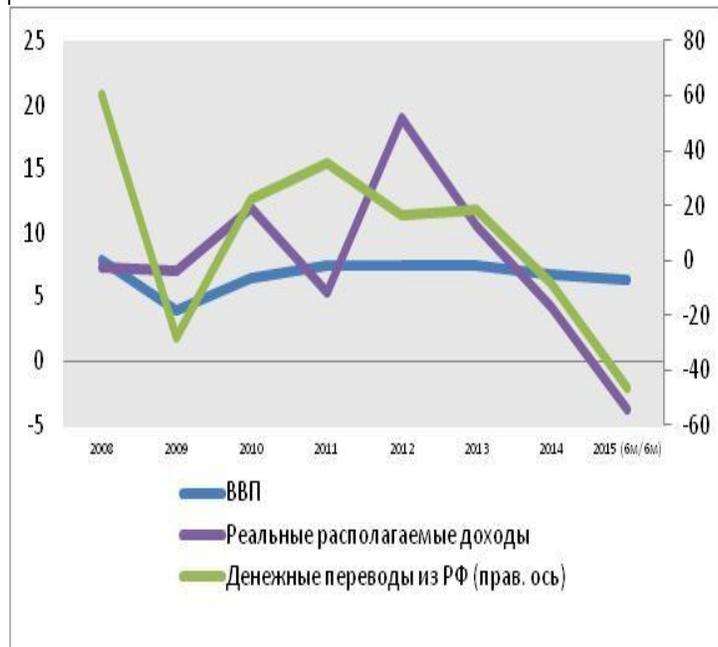
**Fig. 1. Formation of GDP (consumption)**



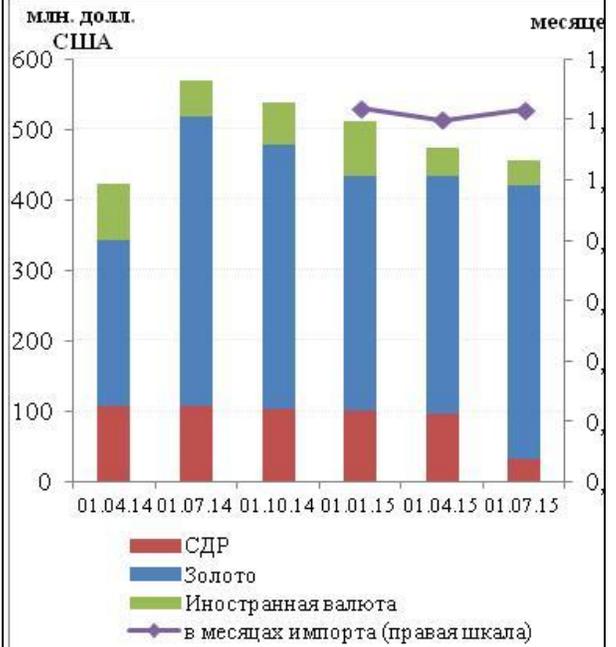
**Fig. 2 Investments (by types of ownership)**



**Fig. 3. Dependence of monetary incomes of population on cash remittances**



**Fig. 4. GDP cycles**

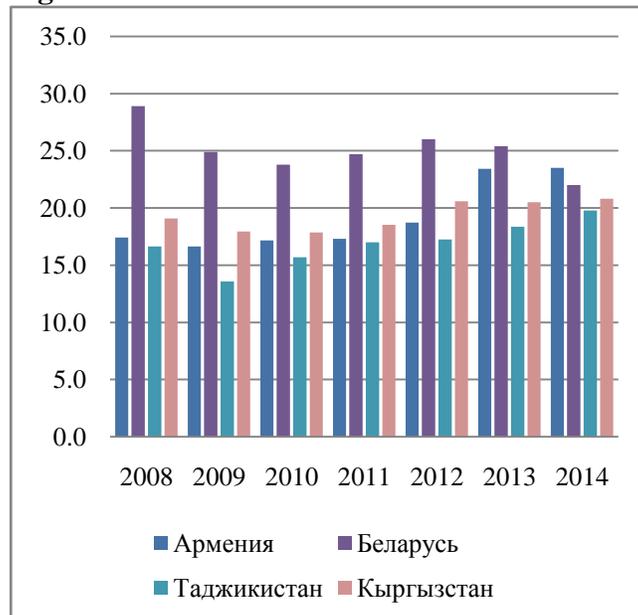


**Fig.5. Deviation of TJS market exchange rate from official rate,%**



Источник: НБТ, расчеты Управляющего

**Fig. 6 Low taxes in RT**



**Fig. 7. CPI change drivers**

