



## Concept Paper

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Project Number: 51066-001  
December 2019

# Proposed Programmatic Approach and Policy- Based Grant for Subprogram 1 and Technical Assistance Grant Republic of Tajikistan: Financial Sector and Fiscal Management Improvement Program

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Asian Development Bank

## CURRENCY EQUIVALENTS

(as of 1 December 2019)

Currency unit – somoni (TJS)

TJS1.00 = \$0.1032

\$1.00 = TJS9.692

## ABBREVIATIONS

ADB	–	Asian Development Bank
GDP	–	gross domestic product
IDIF	–	Individuals Deposit Insurance Fund
IMF	–	International Monetary Fund
MOF	–	Ministry of Finance
NBT	–	National Bank of Tajikistan
SOE	–	state-owned enterprise
TA	–	technical assistance

## NOTE

- (i) The fiscal year (FY) of the Government of Tajikistan ends on 31 December.
- (ii) In this report, "\$" refers to United States dollars.

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## PROGRAM AT A GLANCE

<b>1. Basic Data</b>		<b>Project Number:</b> 51066-001	
<b>Project Name</b>	Financial Sector and Fiscal Management Improvement Program (Subprogram 1)	<b>Department/Division</b>	CWRD/CWPF
<b>Country</b>	Tajikistan	<b>Executing Agency</b>	Ministry of Finance
<b>Borrower</b>	Ministry of Finance		
<b>Country Economic Indicators</b>	<a href="https://www.adb.org/Documents/LinkedDocs/?id=51066-001-CEI">https://www.adb.org/Documents/LinkedDocs/?id=51066-001-CEI</a>		
<b>Portfolio at a Glance</b>	<a href="https://www.adb.org/Documents/LinkedDocs/?id=51066-001-PortAtaGlance">https://www.adb.org/Documents/LinkedDocs/?id=51066-001-PortAtaGlance</a>		
<b>2. Sector</b>	<b>Subsector(s)</b>	<b>ADB Financing (\$ million)</b>	
✓ <b>Finance</b>	Banking systems and nonbank financial institutions		10.00
	Central banking systems		5.00
	Finance sector development		10.00
	Money and capital markets		5.00
<b>Public sector management</b>	Economic affairs management		10.00
	Public expenditure and fiscal management		10.00
	<b>Total</b>		<b>50.00</b>
<b>3. Operational Priorities</b>		<b>Climate Change Information</b>	
✓ Accelerating progress in gender equality		Climate Change impact on the Project	Low
✓ Strengthening governance and institutional capacity			
<b>Sustainable Development Goals</b>		<b>Gender Equity and Mainstreaming</b>	
SDG 1.b		Some gender elements (SGE)	✓
SDG 5.c			
SDG 8.10			
SDG 9.1			
SDG 16.6			
SDG 17.1, 17.3, 17.5			
<b>4. Risk Categorization:</b>	Low	<b>Poverty Targeting</b>	
		General Intervention on Poverty	✓
<b>5. Safeguard Categorization</b>		<b>Environment: C Involuntary Resettlement: C Indigenous Peoples: C</b>	
<b>6. Financing</b>			
<b>Modality and Sources</b>		<b>Amount (\$ million)</b>	
<b>ADB</b>		<b>50.00</b>	
Sovereign Programmatic Approach Policy-Based Lending (Grant): Asian Development Fund		50.00	
<b>Cofinancing</b>		<b>0.00</b>	
None		0.00	
<b>Counterpart</b>		<b>0.00</b>	
None		0.00	
<b>Total</b>		<b>50.00</b>	
<b>Currency of ADB Financing:</b> US Dollar			

## I. THE PROPOSAL

1. The proposed Financial Sector and Fiscal Management Improvement Program aims to support the Government of Tajikistan with reforms to create a more stable financial system, enhance access to financial services, and improve fiscal management to accelerate sustainable private sector growth. The program will (i) enhance banking sector stability, (ii) improve the enabling environment for the financial sector, and (iii) strengthen public financial management. The program is consistent with the Asian Development Bank (ADB) country partnership strategy for Tajikistan, 2016–2020 and ADB’s Strategy 2030, aligned with strengthening governance and institutional capacity.<sup>1</sup> The program will support the government’s reform agenda in the national development strategy up to 2030.<sup>2</sup> The policy-based financing will be a programmatic approach that includes two subprograms to be implemented during 2020–2021.<sup>3</sup>

## II. PROGRAM AND RATIONALE

### A. Background and Development Constraints

2. **Macroeconomic overview.** Tajikistan remains one of the smallest and poorest economies in Central Asia, with gross national income per capita of \$990 and a national poverty rate of 29.5% in 2018. Tajikistan is dependent on volatile remittance income, mainly from migrant workers in Russia.<sup>4</sup> Economic vulnerabilities are exacerbated by close correlation with the Russian business cycle, a poor business climate, weak fiscal management, low savings, poor domestic employment prospects, and long running difficulties in the financial sector. Gross domestic product (GDP) growth averaged 7.1% over 2016–2019, driven mainly by remittance funded consumption and the service sector. The fiscal deficit reached 4.8% of GDP in 2018, higher than approved in the fiscal strategy for 2017–2020.<sup>5</sup>

3. **Low private investment.** Private investment in Tajikistan declined from 6.2% of GDP in 2014 to 4.5% of GDP in 2017, below the regional average of 15.6% of GDP.<sup>6</sup> Domestic credit to the private sector fell from 23% to 12% of GDP over 2015–2018, far below the regional average of 63% of GDP, and is identified as a top constraint to private sector development.<sup>7</sup> Empirical analysis shows financial sector development has a statistically significant and relatively high impact on private investment.<sup>8</sup> Insufficient public investment, including in critical infrastructure (e.g. energy and water) and a skilled workforce, also limits private investment. Poor public investment management practices—e.g. project appraisal and costing and absence of suitable resource allocation plans, including a medium term budget framework—create gaps in infrastructure and services needed for private investment and supporting economic growth.<sup>9</sup>

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<sup>1</sup> ADB. 2016. *Country Partnership Strategy: Tajikistan, 2016–2020*. Manila; and ADB. 2018. *Strategy 2030*. Manila.

<sup>2</sup> Government of Tajikistan. 2016. *National Development Strategy of the Republic of Tajikistan for the Period up to 2030*. Dushanbe.

<sup>3</sup> The program, originally titled the Financial Sector Development Program, is included in ADB. 2019. *Country Operations Business Plan: Tajikistan 2020–2022*. Manila. An initial draft of the design and monitoring framework is in Appendix 1. Transaction technical assistance will be provided for program preparation (accessible from the list of linked documents in Appendix 2).

<sup>4</sup> The value of remittances has fluctuated between one-quarter and one-half of GDP in recent years.

<sup>5</sup> ADB. 2019. *Asian Development Outlook 2019: Strengthening Disaster Resilience*. Manila.

<sup>6</sup> International Monetary Fund (IMF). 2017. Press Release No. 17/429. Washington DC.

<sup>7</sup> World Bank. 2019. *Country Partnership Framework for the Republic of Tajikistan for the Period FY19–FY23*. Washington, DC.

<sup>8</sup> IMF. *Regional Economic Outlook: Middle East and Central Asia November 2018*. Washington, DC.

<sup>9</sup> World Bank. 2019. *Tajikistan Country Economic Memorandum*. Washington, DC.

4. **Banking sector instability.** The banking sector has not recovered from the 2015 crisis and is still characterized by a high percentage of non-performing loans (30% in the third quarter of 2019), two large insolvent state-owned banks (Agroinvest and Tojiksodirot bank), and customers' loss of access to bank deposits. The high cost of borrowing (with average interest rates over 26%) has dampened demand for finance and contributed to falling credit to the private sector. High borrowing costs (and interest rate spreads) are driven by lack of competition among banks, poor governance and weak regulation, high transaction and administration costs, asymmetric information on borrowers, and large risk premiums due to banks' risk perception. Bank liquidity appears sufficient (average liquidity ratio of 63% compared to minimum 30% requirement), suggesting that banks have funds available for lending, however these are majority short term liabilities (i.e. demand deposits), so cannot be used for long term loans.<sup>10</sup> Profitability of banks is low as a result, with return on assets 0.4% at the end of 2017. Given low credit access, firms resort to other options for raising capital, including selling assets and informal borrowing, constraining business growth.<sup>11</sup> The share of outstanding loans to state-owned enterprises (SOEs), many of which have financial difficulties, increased from 15% of total lending in 2012 to 25% in 2019.<sup>12</sup> Directed lending to SOEs has not been sufficiently corrected by the government, has crowded out private borrowing and investment, and increased the share of non-performing loans and overall financial system risk and instability, fueling borrowing costs.

5. **Insufficient deposit insurance.** The Individuals Deposit Insurance Fund (IDIF) provides coverage up to \$2,900 per person but does not have sufficient financing sources. Following the expected liquidation of the two large insolvent state-owned banks, IDIF has insufficient reserves to compensate depositors. Low domestic savings, a high share of cash in the money supply (only 2% of remittances are deposited), and a 20% drop in the total value of individuals' deposits over 2015–2019 all reflect the public's lack of confidence in the banking system.<sup>13</sup> A recent study found that knowledge of deposit insurance in Tajikistan encourages the use of formal channels for transmitting remittances and reduces dollarization.<sup>14</sup>

6. **Weak regulatory and supervisory framework.** The National Bank of Tajikistan (NBT) is responsible for supervising the financial sector as a whole and maintaining financial stability. Gaps in macroprudential regulation are leading to deficiencies with the NBT institutional framework, macroprudential surveillance and analysis, and policy tools.<sup>15</sup> Critical aspects of modern effective insurance regulation are missing, capital requirements for private insurers are extremely low, NBT does not have a complete set of existing regulations, and mandatory insurance laws have not yet been enacted.<sup>16</sup> Market regulations and institutional capacity and resources restrict NBT's supervisory role and financial market development.

7. **Undeveloped nonbanking financial sector.** Financial sector assets comprise 80% banking and 20% nonbanking (including micro-finance and insurance). The insurance industry is small—insurance penetration was 0.5% of GDP in 2018, compared with the emerging market

<sup>10</sup> National Bank of Tajikistan. 2019. *Review of the Banking System, June 2019*. Dushanbe.

<sup>11</sup> World Bank. 2018. *Tajikistan Systematic Country Diagnostic*. Washington, DC.

<sup>12</sup> National Bank of Tajikistan. 2019. *Banking Statistics Bulletin, August 2019*. Dushanbe.

<sup>13</sup> According to NBT, in 2018 the share of cash (M0) to money supply including cash, checking deposits and near money (M2) averaged 78%, which is significantly greater than peer countries with similar per capita income (25% average).

<sup>14</sup> IMF. 2017. *IMF Working Paper: Deposit Insurance, Remittances, and Dollarization: Survey-Based Evidence from a Top Remittance-Receiving Country*. Washington, DC.

<sup>15</sup> Macroprudential regulation refers to the use of policy tools to mitigate systemic risk in the financial system.

<sup>16</sup> ADB. 2013. *Technical Assistance to the Republic of Tajikistan for Investment Climate Reforms*. Manila; and ADB. 2017. *Technical Assistance for Islamic Finance for Inclusive Growth*. Manila.

average of 3%.<sup>17</sup> Firms and individuals make little use of financial services, partly because regulatory constraints limit the range of products available (such as insurance and Islamic finance), leading to higher financial intermediation costs.<sup>18</sup> No financial sector strategy has replaced the previous strategy for 2010–2015. The government securities market centers on issuance of only short-term government securities, i.e. treasury bills of 91 days. Volumes are small and the Ministry of Finance (MOF) can cancel planned auctions at any time.<sup>19</sup> MOF still imposes cut-off rates for treasury bills at 0.99%, so demand is close to zero, and does not provide a benchmark for corporate bonds. Deepening of domestic capital markets (where government securities are a key building block) expands the channels for the private sector to access capital.

**8. Poor fiscal management and taxation.** Increased government expenditure for the Rogun hydropower project and imports have increased fiscal and current account stress and distorted allocation of public funds. Total costs for Rogun are estimated to be greater than 50% of GDP; the government increased external borrowing to finance the project, including issuing \$500 million Eurobonds in 2017 at 7.1%. Subsequently, public debt rose from 27% of GDP in 2014 to 56% of GDP in 2018. The draft public financial management strategy for Tajikistan highlights objectives and key weaknesses, including (i) lack of an effective medium-term budget plan incorporating investment expenditure, (ii) low budget transparency, and (iii) poor financial reporting of SOEs including debts.<sup>20</sup> These constraints reduce the efficiency of public investment for high quality key economic infrastructure and services necessary for crowding-in private investment. Distortive tax collection practices, including in the financial sector, are a critical barrier to private sector development.<sup>21</sup> A recent survey found Tajik businesses must pay as high as 67% of profits in taxes and contributions, twice as high as any other country in the region.<sup>22</sup> Taxation of financial products, e.g. insurance and Islamic finance, also severely affects their viability.

## **B. Policy Reform and ADB's Value Addition**

**9. Policy reforms.** The government adopted a banking resolution framework and established the Financial Stability Council with representation from key ministries. However, the government needs to implement further institutional, legal and regulatory reforms to resolve the financial sector distress and improve the supervision, stability, and resilience of the sector. Financial sector and fiscal management reforms are critical to improve banks' ability to provide credit to the private sector, boost confidence, improve public investment management, increase private investment, and accelerate sustainable private sector growth. The proposed ADB program will focus on three key reform areas to address these issues.

**10. Reform area 1: Banking sector stability enhanced.** The proposed reforms will include: (i) strengthening the IDIF by establishing a standby financing facility with MOF for adequate fund capitalization, introducing differential deposit insurance for women headed households, and developing a fund investment policy; (ii) strengthening the NBT financial stability department, including the institutional framework, and developing macroprudential policy tools; and (iii) preparing a status report on bank lending to SOEs and policies to reduce the share of lending to SOEs (covering all banks).

<sup>17</sup> National Bank of Tajikistan. 2018. *Insurance Market of Tajikistan as of December 31, 2018*. <https://nbt.tj/en/sugurta-bozori-sugurtavi/2018/4-yum-kvartali-soli-2018.php>.

<sup>18</sup> ADB. 2016. *Tajikistan: Country Diagnostic Study*. Manila.

<sup>19</sup> ADB. 2016. *Country Partnership Strategy: Tajikistan, 2016–2020*. Sector Assessment (Summary): Finance (accessible from the list of linked documents in Appendix 2). Manila.

<sup>20</sup> Government of Tajikistan. *Public Financial Management Reform Strategy, 2019–2030*. Unpublished.

<sup>21</sup> World Bank. 2018. *Assessment of Tax Compliance Costs for Businesses in Tajikistan*. Washington, DC.

<sup>22</sup> World Bank. 2019. *Doing Business*. Washington, DC.

11. **Reform area 2: Enabling environment for financial sector improved.** The proposed reforms will include: (i) preparing and implementing a financial sector strategy, including steps to rehabilitate the banking industry and enable greater competition, incorporating gender aspects; (ii) developing the government securities market, including auctioning government securities at market price; (iii) improving the NBT supervision and regulatory framework to develop nonbanking subsectors; and (iv) implementing tax reforms for financial sector development.

12. **Reform area 3: Public financial management strengthened.** The proposed reforms will include: (i) preparing a medium term budget framework (including investment expenditures) and improving budget transparency and gender responsive budgeting and analysis, (ii) adopting cash basis international public sector accounting standards, and (iii) improving SOE financial reporting standards for MOF monitoring and analysis of fiscal risks.

13. **ADB engagement.** ADB is well prepared to design and implement the program, given experience with policy-based financing in Tajikistan and in similar policy areas in the region, incorporating lessons learned. The program builds on successful reforms initiated and accomplished under the ADB Investment Climate Reforms Program subprograms 1 and 2 for improving private investment.<sup>23</sup> A policy-based modality is most suitable for combining policy dialogue with technical assistance (TA) and diagnostic studies to support meaningful policy reforms in Tajikistan. A programmatic approach allows a degree of flexibility in aligning policy actions with the updated macroeconomic situation. The program will interlink proposed reform actions that follow a logically sequenced approach over subprograms 1 and 2, allowing sufficient lead time for reforms with multiple implementation stages. The government will fully adopt reforms under subprogram 2. ADB has been closely coordinating with development partners, including the International Monetary Fund (IMF) and World Bank Group, to discuss and identify key reform areas to accelerate and sustain medium-term growth.

### C. Impacts of the Reform

14. A key development objective in the national development strategy up to 2030 is “economic growth achieved through the expansion of internal factors of production, stimulated by investment and consumer demand on the basis of internal and external funding sources.”<sup>24</sup> The reform program aims to increase private sector investment through increased financing for the private sector and better managed public investment.

### D. Development Financing Needs and Budget Support

15. The program amount is based on Tajikistan’s development financing needs, to support the government’s growing financing requirements and fiscal shortfalls. The grant financing for the program will total \$100 million, comprising \$50 million for subprogram 1 and \$50 million for subprogram 2 from ADB’s Asian Development Fund resources.

### E. Implementation Arrangements

16. The executing agency for the program will be the MOF. The implementing agencies will be the NBT, MOF, IDIF, and the Tax Committee. ADB will help the MOF establish a suitable coordination mechanism between the executing and implementing agencies. The government will

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<sup>23</sup> ADB. 2015. *Report and Recommendation of the President to the Board of Directors: Proposed Loan to the Republic of Tajikistan for the Investment Climate Reforms Program*. Manila.

<sup>24</sup> Footnote 2. Page 17.

withdraw the proceeds of the program in accordance with ADB's *Loan Disbursement Handbook* (2017, as amended from time to time).

### III. DUE DILIGENCE REQUIRED

17. ADB will carry out due diligence during the program preparation, including:
- (i) **Safeguards.** The program is expected to be classified category C for all safeguard aspects, including the environment, involuntary resettlement, and indigenous peoples.
  - (ii) **Economic.** The economic analysis will explain the transmission mechanisms of the policy actions and expected benefits, which will be quantified and valued only if possible.
  - (iii) **Governance.** Public financial management, procurement, anticorruption, and capacity issues and mechanisms will be agreed with the government as part of the program design.
  - (iv) **Poverty and social.** No poverty or social issues requiring specific attention have been identified, and gender impacts will be examined carefully.

### IV. PROCESSING PLAN

#### A. Risk Categorization

18. Both subprograms are categorized *low risk*.<sup>25</sup>

#### B. Resource Requirements

19. ADB staff (8 person-months) will process the program. A staff consultant (4 person-months) has been hired to complete diagnostic analysis. A transaction TA grant of \$750,000 from ADB's Technical Assistance Special Fund (TASF-6) will support preparation and implementation of the proposed reform areas for subprograms 1 and 2 and capacity building.<sup>26</sup>

#### C. Processing Schedule

20. The table lists the major milestones.

**Proposed Processing Schedule**

Milestones	Expected Completion Date
Fact-finding mission	April 2020
Management review meeting	May 2020
Grant negotiations	June 2020
Board consideration	July 2020
Grant effectiveness	July 2020

Source: Asian Development Bank

### V. KEY ISSUES

21. The key issues are: (i) the government will need extensive TA and capacity development support to implement the proposed policy actions; and (ii) ADB will need to ensure close and effective development partner coordination, especially with the IMF.

<sup>25</sup> Based on the criteria in the ADB Staff Instructions on Business Processes for Sovereign Operations.

<sup>26</sup> Technical assistance for program preparation (accessible from the list of linked documents in Appendix 3).

**DESIGN AND MONITORING FRAMEWORK**  
(Initial Draft)

<b>Country's Overarching Development Objective</b>			
Sustainable economic development improves the standard of living of the population (National Development Strategy of the Republic of Tajikistan for the Period up to 2030) <sup>a</sup>			
<b>Results Chain</b>	<b>Performance Indicators with Targets and Baselines</b>	<b>Data Sources and Reporting Mechanisms</b>	<b>Risks</b>
<p><b>Effect of the Reform</b></p> <p>Private sector investment increased</p>	<p>By 2022:</p> <p>a. Private investment (percentage of GDP) increased by 2 percentage points (2017 baseline: 4.5% of GDP)</p> <p>b. Domestic credit to the private sector (percentage of GDP) increased by 3 percentage points (2018 baseline: 12% of GDP)</p> <p>c. Gross domestic savings (GDP less final consumption expenditure in percentage of GDP) increased by 2 percentage points (2017 baseline: -0.2% of GDP)</p>	<p>a. IMF Article IV</p> <p>b. World Bank World Development Indicators</p> <p>c. World Bank World Development Indicators</p>	<p>Government continuity and commitment to reforms is not sustained because of elections in 2020.</p>
<p><b>Reform Areas under Subprogram 1</b></p> <p>1. Banking sector stability enhanced</p> <p>2. Enabling environment for financial sector improved</p>	<p><b>Indicative Policy Actions</b></p> <p>By 2020:</p> <p>1.1 A standby financing facility for IDIF established by the MOF and differential deposit insurance for women headed households established by IDIF (2019 baseline: not implemented)</p> <p>1.2 Macprudential policy tools approved by the NBT (2019 baseline: not implemented)</p> <p>2.1 Regular auctions for government securities at market interest rates established by the MOF (2019 baseline: not implemented).</p> <p>2.2 MOF-amended tax code to remove distortive taxes on (i) insurance products, (ii) Islamic finance products, and (iii) the banking sector based on NBT</p>	<p>1.1 MOF decision</p> <p>1.2 NBT guideline</p> <p>2.1–2.2 MOF decision</p>	<p>Implementing agencies do not retain trained staff in the relevant departments during the program period, affecting successful completion of various reform areas and actions.</p>

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting Mechanisms	Risks
3. Public financial management strengthened	<p>recommendations (2019 baseline: not implemented)</p> <p>3.1 A 3-year rolling MTBF, with gender responsive budgeting, adopted by the MOF (2019 baseline: not implemented)</p> <p>3.2 SOE debt management plan and financial reporting standards approved by the MOF (2019 baseline: not implemented)</p>	<p>3.1 MOF annual budget</p> <p>3.2 MOF financial reports</p>	

#### Budget Support

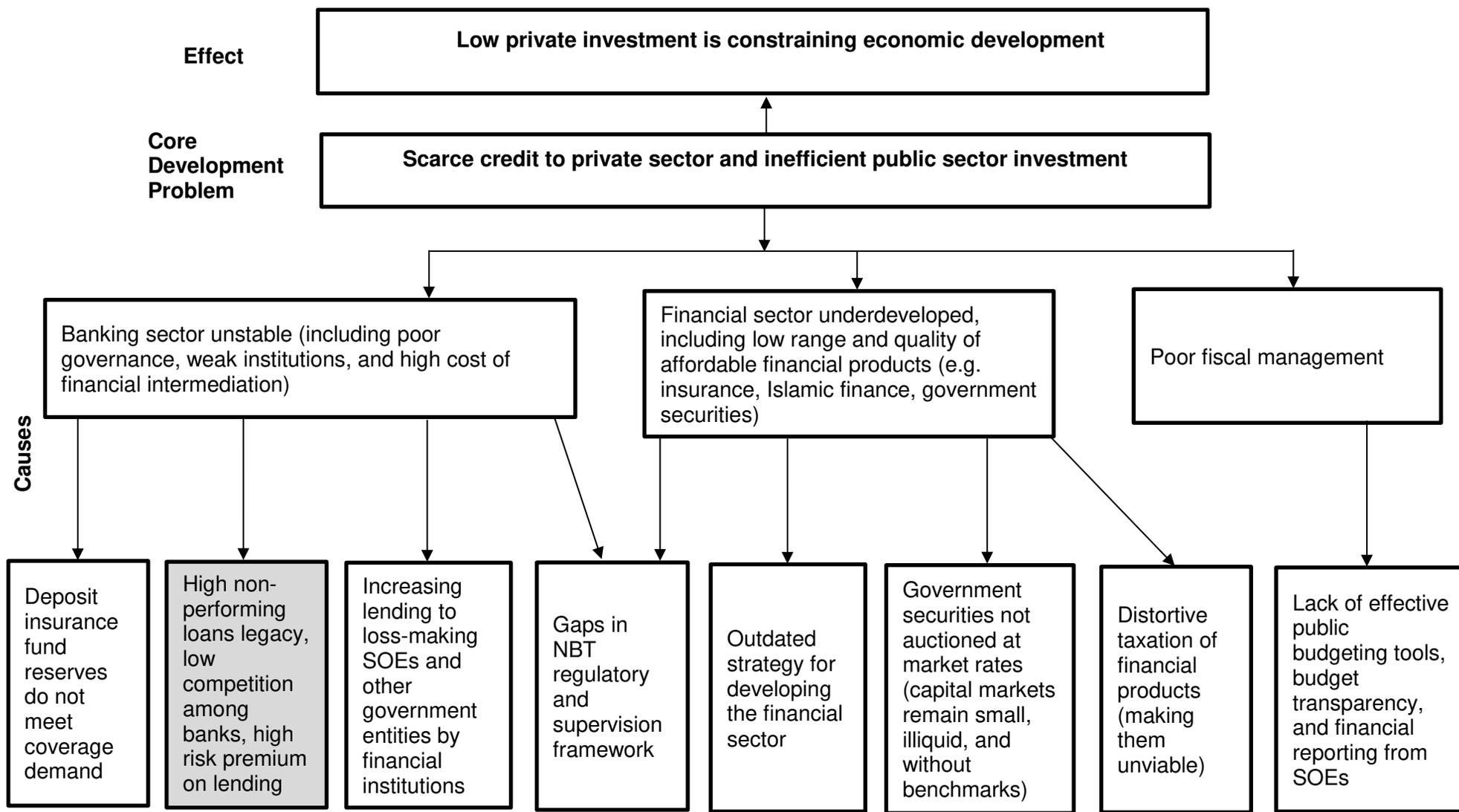
ADB: Subprogram 1: \$50 million (ADF grant)

ADB = Asian Development Bank, ADF = Asian Development Fund, GDP = gross domestic product, IDIF = Individuals Deposit Insurance Fund, IMF = International Monetary Fund, MOF = Ministry of Finance, MTBF = medium term budget framework, NBT = National Bank of Tajikistan, SOE = state-owned enterprise.

<sup>a</sup> Government of Tajikistan. 2016. *National Development Strategy of the Republic of Tajikistan for the Period up to 2030*. Dushanbe.

Source: Asian Development Bank.

**PROBLEM TREE**



Note: Shaded causes will not be directly addressed in the program scope.

**LIST OF LINKED DOCUMENTS**

<http://www.adb.org/Documents/LinkedDocs/?id=51066-001-ConceptPaper>

1. Initial Poverty and Social Analysis
2. Technical Assistance for Program Preparation