

Tajikistan

The economy expanded at a robust rate despite higher costs of oil and gas in 2006. Burgeoning remittances spurred demand, as supply shocks from higher oil, utility, and food prices pushed inflation back into two-digit territory. Medium-term economic prospects are promising, if the expansion in externally financed infrastructure projects is supported by the broad reforms of the development strategy, so creating a favorable environment for private sector-led growth.

Economic performance

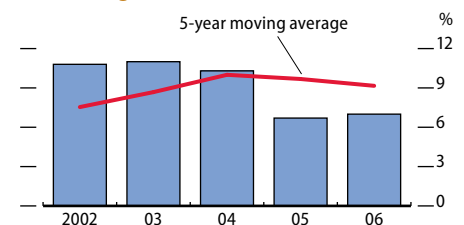
Aluminum and remittances, the mainstays of the economy, continued to drive growth (of 7.0%) in another strong year (Figure 2.5.1). Buoyed by spending of soaring workers' remittances, the subsectors of retail trade, transportation, and finance boosted services, though these inflows were strong disincentives for their recipients to continue working in their traditional occupation, agriculture. The protracted land-reform process and the long-standing issue of reforming cotton farmers' debts compounded the problem. The upshot is that agriculture in 2006 accounted for only 22% of GDP, down from 36% in 1991. Services and industry accounted for 50% and 28% of GDP, respectively.

A pickup in foreign direct investment financing for infrastructure projects and other construction investments, including a boom in private housing, lifted domestic demand, while a surge in aluminum exports (the main export commodity) underpinned strong export growth. More important, aggregate demand was driven by higher private consumption expenditure that, in turn, drew strength from the higher workers' remittances as well as a hike in domestic wages. The number of people finding better work opportunities outside the country and migrating, mainly to the Russian Federation, is on the rise, and the poor especially have benefited from remittances in terms of being able to afford a better standard of living. However, increasing dependence of family members on remittances, alongside sluggish private sector reforms, especially in agriculture, is hampering productivity improvements and risking failure to realize the country's economic potential.

The wave of remittances has not led to growth in the domestic savings or investment rates. Private investment is chronically low at 5.4% of GDP; public capital investment (mainly infrastructure projects) is also low. These levels are insufficient to sustain high growth. Incentives to channel remittances toward private investment are therefore needed to stimulate broader-based growth.

Inflation accelerated in 2006 into double digits after 18 months below that threshold (Figure 2.5.2). The preliminary estimate is a high 11.9%, from 7.1% in 2005. Supply shocks emanating from higher fuel prices and regional food prices, higher private spending, and increases in utility and transport tariffs, all played a part. Core inflation for 2006, as

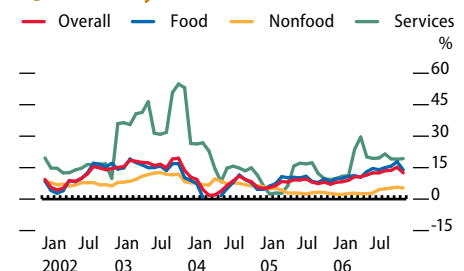
2.5.1 GDP growth



Source: State Statistical Committee of the Republic of Tajikistan, available: <http://www.stat.tj>, downloaded 30 January 2007.

[Click here for figure data](#)

2.5.2 Monthly inflation



Source: National Bank of Tajikistan, available: <http://www.nbt.tj/en>, downloaded 27 February 2007.

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calculated by the National Bank of Tajikistan (NBT, the central bank), which excludes major food items and utilities, was lower at 7.3%. Higher incomes and greater demand for staple foods and lower grain production contributed to a surge in food prices.

NBT signaled its concern about growing inflationary pressures by raising its refinancing rate in steps from 8.5% in August to 12% in December. Prior to this, it had lowered banks' reserve-requirement ratio from 15% to 12% in April in an attempt to reduce the cost of attracting deposits by commercial banks, increasing banks' liquidity. Reserve money grew by about 17%, adding even further to banks' ability to expand credit, helping to push up the money supply by 60% (Figure 2.5.3).

Weak institutional capacity and the underdeveloped nature of the financial sector severely hinder the conduct of monetary policy. NBT started to give more attention to managing growth of reserve money by holding frequent and regular meetings at the operational and policy levels.

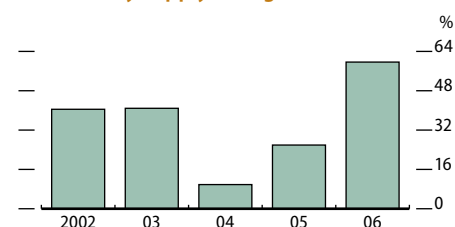
The fiscal situation was healthy in 2006, despite elections, as robust economic growth and better tax administration helped revenues exceed their targets and showed a 0.4% of GDP surplus (excluding the foreign-financed public investment program). Measures for enhancing tax collection introduced in 2006 included replacement of the sales tax on aluminum exports with a tax on aluminum processing, a higher value-added tax (VAT) threshold, and elimination of tax exemptions. But fiscal space is still tight. Expenditures on the social sector are rising, albeit from a very low base (8% of GDP in 2006 as against 5.5% in 2002). One way to enlarge the fiscal space is through improvements in expenditure efficiency and revenue measures.

Other sources of resource mobilization hold little promise. Grants are constrained because of heightened global competition for such funds. The scope for higher domestic borrowing is very limited and external borrowing is also restricted as the country is close to the sustainable ceiling for external debt. After a debt-equity swap with the Russian Federation in 2004 and a debt write-off by the International Monetary Fund (IMF) of \$99 million in 2006, outstanding external debt was brought down to 31% of GDP at end-2006 (Figure 2.5.4), from 108% in 2000. New borrowings for infrastructure point to the ratio rising again, offering little room for taking on additional debt if the authorities are to keep debt at sustainable levels.

IMF in September 2006 projected the deficit on the trade account for 2006 to be unchanged from the previous year, at \$0.5 billion. A higher import bill offset the export gain, reflecting higher oil and gas prices and imports for building the Sangtuda 1 hydropower plant. Exports strengthened mainly because of large price and volume increases for aluminum, even though Tajikistan did not benefit fully from international price rises due to production cost-sharing arrangements. In 2006, remittances leaped to an estimated \$1.2 billion from \$0.6 billion in 2005. IMF estimated the current account deficit at 4.2% of GDP (3.4% in 2005; Figure 2.5.5).

The somoni depreciated by 6.6% against the US dollar in 2006 (Figure 2.5.6). Despite the strength of the ruble and the euro—the currencies of the country's major trading partners—the somoni recorded a moderate depreciation of 3.8% in real effective terms due to inflation

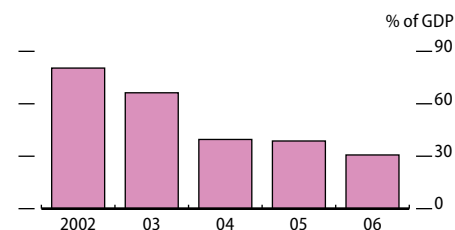
2.5.3 Money supply (M2) growth



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 28 February 2007.

[Click here for figure data](#)

2.5.4 External debt



Source: National Bank of Tajikistan.

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differentials. As a result, the country retained competitiveness in the European and Russian export markets.

The Government has a wide-ranging reform agenda. It is about to finalize a 10-year national development strategy, and, pursuing that strategy's vision, is drafting a poverty reduction strategy for 2007–2009. The latter strategy identifies as priorities promoting private sector development, strengthening public sector management, and improving health and education services.

The Government had public administration reform high on its agenda in 2006, and it took some steps to put through various measures, including reducing the number of ministries. It also made some headway with key reform measures that represent a fundamental shift for budgeting systems. The Medium-Term Budget Framework, to be pilot tested in 2007, allocates the state budget to sectors on the basis of strategic sector priorities. The central treasury established a cash management unit in April 2006 to enhance the efficiency of budget execution. In July, the Government launched public expenditure tracking surveys, with World Bank support. The authorities continued, slowly, to strengthen tax administration so as to bolster revenues and bring more of the informal economy into the tax net.

In the power sector, the utility attempted to improve payment collection, but low tariffs still make it difficult for it to allocate resources for operations and maintenance. Current steps to tackle the problem include gradually raising electricity tariffs to eliminate large operating losses at the utility and providing a compensatory mechanism for the poor against power hikes.

Banking supervision was further strengthened, and, in line with World Trade Organization commitments and to enhance competition in the sector, the authorities lifted legal restrictions on foreign banks. Minimum capital requirements for banks were increased to \$5 million and those that did not comply were merged or reorganized into nonbank credit institutions. Competition among nonbank financial institutions also improved, widening people's access to microcredit.

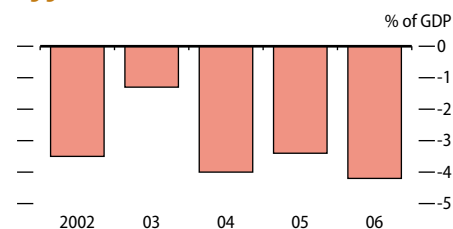
Economic prospects

Mixed price trends are predicted for the main traded commodities. Prices of aluminum have been supported by high demand but are expected to fall. Global prices for cotton, the second-largest export, are expected to rise by 18% cumulatively over the next 2 years. Prices for natural gas from Uzbekistan, the main supplier, were increased to \$100 per 1,000 cubic meters in early 2007 and this will have a marked impact on the import bill and domestic prices.

The economy is forecast to expand by 7.5% and 7.1% in 2007 and 2008. Externally funded investments in infrastructure, including energy and transportation, will boost aggregate demand, though the major source of growth will continue to be remittance-backed consumption.

On the supply side, services will continue to be an important source of growth, partly as a spillover from greater investment activity but mainly because of rising consumption. Aluminum production will continue to drive industry's contribution to overall growth, but cotton's

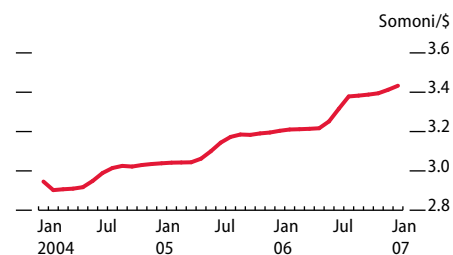
2.5.5 Current account balance



Source: International Monetary Fund, *Regional Economic Outlook, Middle East and Central Asia*, September 2006.

[Click here for figure data](#)

2.5.6 Nominal exchange rate versus US dollar



Source: International Monetary Fund, *International Financial Statistics* online database, downloaded 10 March 2007.

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contribution to agricultural growth is expected to diminish, despite favorable price dynamics. The timely resolution of cotton debt by implementation of the Road Map for the Farm Debt Resolution Strategy will be crucial to releasing agriculture from outmoded central planning-era practices.

To bring inflation back to single digits, NBT will work within the macroeconomic framework of IMF's policy support instrument (under discussion). However, the targets are ambitious and remain vulnerable to shocks in terms of trade, in particular from prices on energy and foodstuffs.

Fiscal policy will adhere to the budget framework that envisages a deficit of 1% of GDP in 2007 and 2008, excluding the externally financed public investment program. Tax reforms are likely to raise revenues but modest domestic borrowing will have to be made to offset the higher spending in the budget for 2007. Spending on infrastructure is set to rise due to cofinancing of large-scale infrastructure projects, while expenditures on social sectors will also increase (but at a slower pace than in 2006).

The size of externally funded projects will rise in the medium term to accommodate the new bilateral loans contracted in 2006 from the People's Republic of China. The loans finance construction of the north-south power transmission line and rehabilitation of the road that connects the major industrial cities of the country with Uzbekistan.

The external debt-to-GDP ratio is set to rise to 46.1% and further to 52.4% of GDP, in 2007 and 2008. The space for new borrowing is very limited as the external debt indicators are now hitting sustainability levels.

2.5.1 Selected economic indicators

	2007	2008
GDP growth	7.5	7.1
Inflation	7.0	5.0
Current account balance (% of GDP)	-4.8	-5.0

Source: Staff estimates.

Development challenges

The main challenge is increasing savings and productive private investment to sustain economic growth. There is hope though, since some recent developments seem to offer scope for greater private investment, including macroeconomic stability; surging remittances; the elimination of high fees on money transfers and so greater remittances channeled through banks; government attempts to attract foreign capital to infrastructure projects; and business regulatory reforms (including cutting much red tape).

Risks remain of course: macroeconomic stability is highly vulnerable to external shocks due to the economy's openness and narrow import dependence; spiraling remittances may create disincentives to work, especially in agriculture; and infrastructure projects may entail higher taxes on the private sector, possibly hurting its willingness to invest.