

REPUBLIC OF TAJIKISTAN

Social and Economic Development in the First Half of 2023 and Medium-Term Prospective*

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LIST OF ABBREVIATIONS

CA – current account of the balance of payments

CPI – consumer price index

EFSD Project Unit – Project Unit of the Eurasian Fund for Stabilization and Development

FDI – foreign direct investment

GDP – gross domestic product

NBT – National Bank of the Republic of Tajikistan

RT – Republic of Tajikistan

US – United States of America

VAT – value added tax

In the first half of 2023, Tajikistan's economy continued to grow at a high rate, driven mainly by the services sector, agriculture, and construction. Economic activity was also supported by high rates of growth in remittances. In the context of easing inflationary pressures, especially in the food group, the NBT lowered the refinancing rate. Rising imports caused a CA deficit. At the same time, the financial account of the balance of payments was also in deficit due to a decline in foreign direct investment and capital outflows, which led to a reduction in gross international reserves. The fiscal position improved as a result of higher growth in tax revenues from imports and the provision of grants by development partners. Key indicators for the banking sector suggest that it has maintained its relative stability against the background of strong growth in consumer loans.

Real Sector and Labour Market

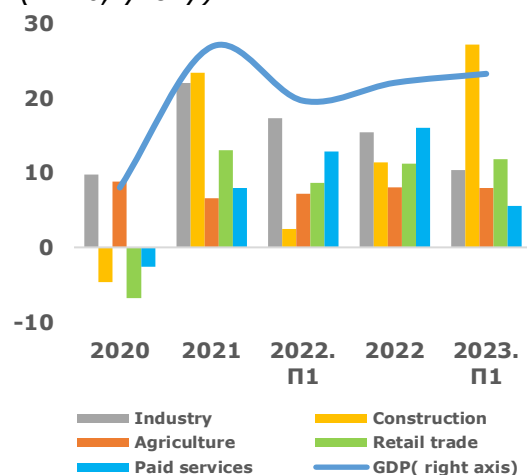
In the first half of 2023, economic growth accelerated due to the growth of services, construction, and agriculture. The short-term indicator of economic activity in the main sectors was 8.3% in the first half of 2023 compared with 7.4% in the corresponding period of 2022 (Figure 1). Services were the main growth driver, contributing 3.8 p.p. (2.8 p.p. in the first half of 2022). The contribution of industrial production was 0.8 p.p. (1.9 p.p.), of agriculture¹ – 1.4 p.p. (1.0 p.p.), of construction – 1.4 p.p. (0.8 p.p.), and of net taxes – 0.9 p.p. (0.9 p.p.). The main driver of growth is domestic consumption supported by, among other things, an increase in the inflow of remittances from RT citizens working abroad. A decline in the growth rate of industry had a dampening effect on economic growth in the reporting period. The growth rate of industrial production decreased from 17.3% in the first half of 2022 to 10.3% in the first half of 2023. At the same time, the growth rate of the extractive industry fell from 8.3% to 7.3% and that of the manufacturing sector from 17.9% to 14.2%.

The expansion of domestic public and private investment led to an acceleration in the growth rate of construction to 27.1%, from 2.5% a year earlier (half-year on half-year). The increase in public investment is due to the continued construction of the Rogun hydropower plant and other power facilities. The growth in private investment in agriculture, utilities, and trade was the result of a steady increase in household consumption of products from these sectors. Accordingly, high investment growth rates in the reporting period were recorded in agriculture (33.8%), in the production and distribution of electricity, gas, and water (18.3%), in mining (30.6%), and in wholesale and retail trade (32.3%). Among non-production facilities, residential construction grew significantly (by 31.4%).

In the first half of 2023, average monthly real wages continued to rise against the background of high economic growth and lower unemployment rate. In June 2023, compared with June 2022, the annual increase in the average monthly wages was 16.7% in nominal terms and 14% in real terms. In the first half of 2023, the RT officially registered labour force increased by 1.3% and the number of people in employment by 1.5%. At the same time, the officially registered unemployment rate fell by 9.5% to 1.9% of the labour force, compared with 2.1% in the first half of 2022. Labour migration puts pressure on the labour market and creates the conditions for wage increases in the private sector. This is confirmed by a 19.5% increase in wages in the real sector of the economy in June 2023 compared to June 2022. Salaries and wages in some service sectors such as transport, information and communication increased by more than 20%. Salaries in the public administration sector also rose faster than inflation. This led to a 17.7% increase in state budget expenditures on salaries and wages.

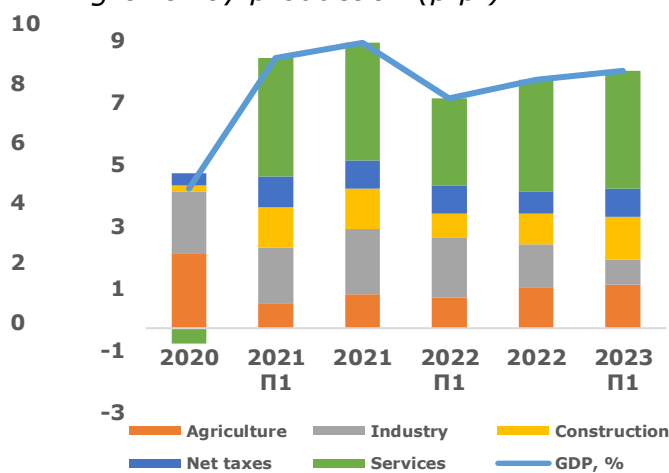
¹ Including forestry and fishing

Figure 1. Economic growth, by sector (in %, y-o-y)



Source: Tajstat

Figure 2. Decomposition of annual GDP growth by production (p.p.)



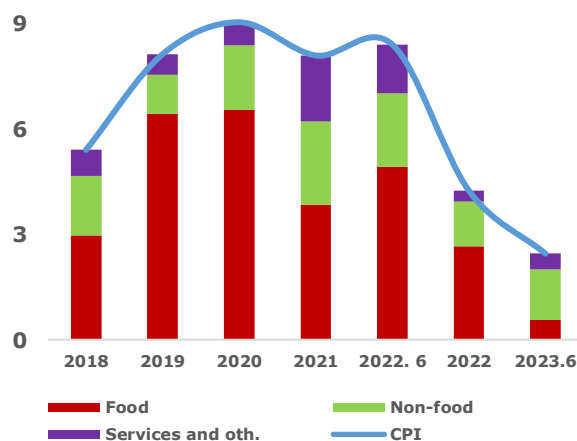
Source: Tajstat

Inflation and Monetary Policy

Inflation decelerated in the first half of 2023 due to a lower growth rate of food prices. Against the background of a slowdown in world food price growth, 12-month inflation declined to 2.4% by the end of June 2023 (from 4.2% at end-2022). The annual increase in food prices decelerated from 2.7% in December 2022 to 0.6% in June 2023. Over the same period, the annual rate of price increase for non-food products rose from 1.3% to 1.4% and for services from 0.3% to 0.5%. Taking into account the significant slowdown in inflation and the decline in the external inflationary background, the NBT decided to reduce the refinancing rate from 13.5% at the end of 2022 to 10% from 1 May 2023.

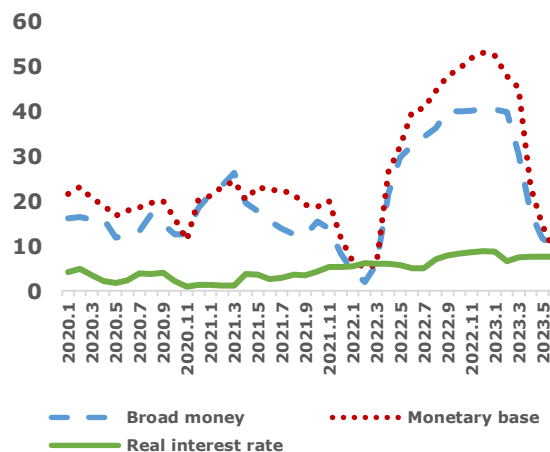
Monetary aggregates declined due to a decrease in cash in circulation and demand deposits against the background of NBT foreign exchange interventions. The base money at end-June 2023 declined by 8.8% compared to December 2022 (against an increase of 52.9% in 2022), mainly due to an 8.6% decrease in cash in circulation. Banks' provisions on NBT accounts fell by 10.7%. The broad money supply as at end-June 2023 decreased by 7.5% compared to December 2022 (against an increase of 40.4 in 2022). One of the factors that contributed to the decline in money supply compared to December last year was the withdrawal of liquidity through the foreign exchange channel by means of foreign exchange interventions of the NBT due to growing demand for foreign currency cash by households. That liquidity decline was partially offset by a draw-down on Government deposits held with the NBT in the reporting period. The decline in the money supply in the first half of 2023 led to a slowdown in money supply growth from 32.4% in June 2022 to 9.7% in June 2023 in annual terms.

Figure 3. Inflation (in %, y-o-y)



Source: Tajstat

Figure 4. Monetary indicators (in %, y-o-y)



Source: NBT, Tajstat

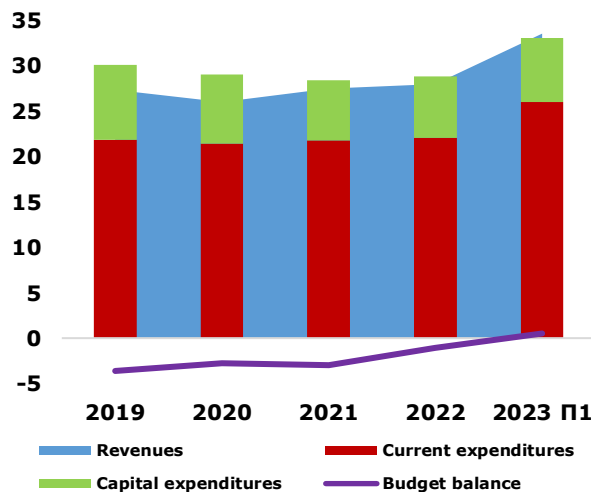
Budget Sector

The fiscal position improved in the first half of 2023 as a result of higher growth in tax revenues from imports and the provision of grants by development partners. In the first half of 2023, the state budget was executed with a surplus of 0.5% of GDP compared with a deficit of 1.1% of GDP in the first half of 2022. This was due to stronger growth in state budget revenues compared to expenditures. Total budget revenues increased from 29.2% to 33.5% of GDP, while total budget expenditures increased from 30.3% to 33% of GDP. However, two-thirds of the revenue growth is due to an increase in grants from development partners, from 2.7% of GDP in the first half of 2022 to 5.6% in the same period in 2023. Tax revenues increased by only 0.5% of GDP to 22.5%. This increase was due to a rise in VAT, excises, and customs duties as a result of higher imports in the context of stronger consumer activity financed by remittances from RT citizens. That was accompanied by a slight reduction in the personal income tax and profit tax, social tax and natural resources tax as a percentage of GDP. Non-tax revenues increased by 0.2 p.p. to 2% of GDP.

The expansion of the expenditure part of the budget was mainly geared towards increasing the financing of the real sector of the economy. Current expenditure of the state budget increased by 1.1 p.p. to 26% of GDP as a result of a rise in expenditures on goods and services of 2.8 p.p. against a decline in interest payments on debt of 1.5 p.p. and a decline in transfers to households of 0.3 p.p., while capital expenditures increased from 5.3% of GDP to 7% of GDP. This is due to higher financing of investment in the power and other industries, which is confirmed by the dynamics of expenditures according to the functional classification. In particular, financing of the fuel and energy sector increased from 5.2% of GDP to 5.7% of GDP, agriculture from 0.8% of GDP to 1.6% of GDP, transport and

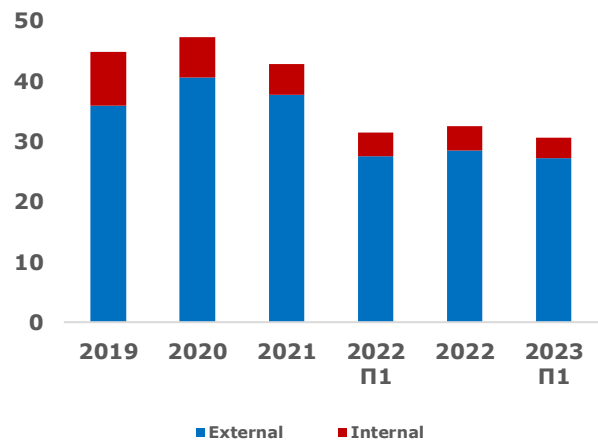
communication from 2% of GDP to 3.1% of GDP, while the financing of education, social insurance, and social protection remained unchanged at 12.4% of GDP.

Figure 5. State budget (in % of GDP)



Source: MF RT, Tajstat

Figure 6. Government debt (in % of GDP)



Source: MF RT, Tajstat

The RT government external debt decreased from USD 3,228.3 million (28.5% of GDP) at the end of 2022 to USD 3,209.4 million (27.2% of GDP) on 1 July 2023 against the background of rapid real GDP growth. Internal debt decreased over the same period from the equivalent of about USD 460 million (4% of GDP) to the equivalent of about USD 400 million (3.4% of GDP). Thus, the total government debt decreased from 32.5% of GDP at the end of 2022 to 30.5% in the first half of 2023 due to lower external and domestic borrowings.

External Sector

The balance of payments deteriorated in the first half of 2023 due to a CA deficit, lower FDI, as well as economic agents' demand for foreign currency, which led to foreign exchange interventions by the NBT and a drawdown on foreign currency reserves. In the first half of 2023, the current account deteriorated to a deficit of USD 237.1 million, compared with a surplus of USD 109.1 million in the first half of 2022. The main reason for the CA deterioration was the deterioration of the balance of trade in goods, which showed a deficit of USD 1,802.4 million against USD 1,187.6 million a year earlier. The deterioration in the trade balance was caused by the discontinuation of gold exports against the background of continued import growth. Exports of goods in the first half of 2023 dropped by 27.7% due to a decrease in exports of plant products, mineral products, textiles, and precious metals. In particular, gold exports virtually ceased due to the need to certify Tajik gold for export at the request of international markets. Imports of goods increased by 18.6% over the same period due to higher imports of plant products, prepared foods, mineral products, machinery and equipment. Remittances from RT citizens working abroad increased by 5% from USD 1,760.8 million in the

first half of 2022 to USD 1,849 million in the first half of 2023 within the framework of primary and secondary income of the current account. However, this could not cover the increase in the deficit of trade in goods.

The financial account of the balance of payments shifted from a surplus in the first half of the previous year to a deficit of USD 210.9 million in the first half of 2023 due to the outflow of other investment of USD 261.4 million. As part of other investment, non-financial organisations and households purchased cash in the amount of USD 230.3 million. Foreign direct investment of USD 49.4 million contributed to the reduction of the financial account deficit, however it was almost seven times lower than in the first half of 2022. The current and financial account deficit was partly financed by capital account inflows to the RT of USD 184.9 million.

Figure 7. World prices and REER (in %, y-o-y)

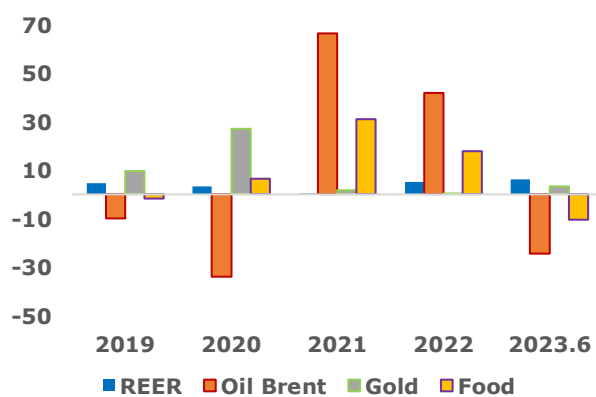
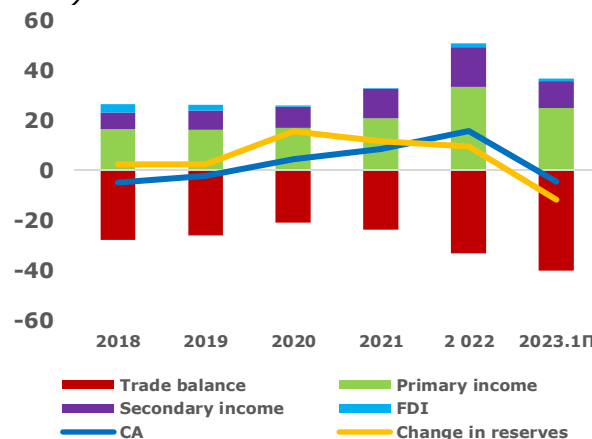


Figure 8. Balance of payments (in % of GDP)



Source: World Bank, national authorities, EFSD estimates

Source: NBT, Tajstat

The high CA deficit, combined with the demand of economic agents for foreign currency, created pressure on the exchange rate. In order to prevent excessive depreciation of the local currency in the first half of 2023, the NBT conducted foreign exchange interventions to sell currency. As a result, in the first half of 2023, the RT foreign exchange reserves dropped by USD 599.4 million to 7.1 months of imports of goods and services² compared with 8 months of imports in December 2022. Despite the NBT's interventions, the local currency depreciated against the US dollar by 7%. At the same time, the real effective exchange rate appreciated by 6.2% due to the somoni appreciation against the Russian ruble.

² Estimates of the EFSD Project Unit based on data on foreign assets as at the end of the period in the table "Monetary Review of the National Bank of Tajikistan."

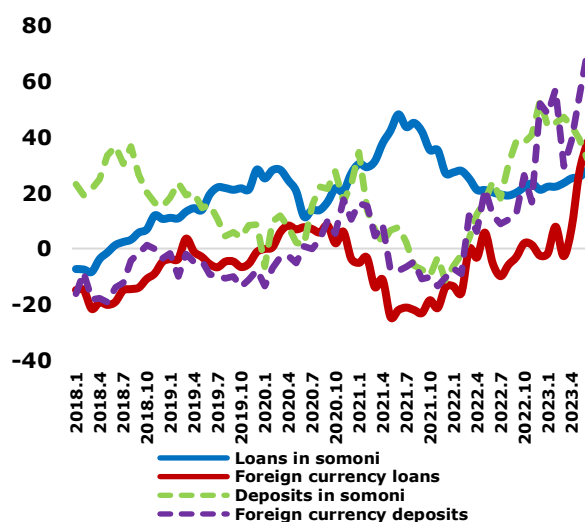
Financial Sector

The acceleration of economic growth in the first half of 2023 was accompanied by a sharp increase in consumer loans. The annual growth rate of the somoni loan portfolio of commercial banks accelerated to 30.9% in June 2023 against 11.5% a year earlier (Figure 9). This is the highest rate of credit growth in the last few years. However, most of this lending is provided in the form of consumer loans. In January–June, consumer loans increased by 40%, and their share in total lending increased from 39.5% to 56.3%. In January–June 2023, the average interest rate on local currency loans was 22.9% (24.1% in the same period in 2022). However, the average interest rate on loans issued in foreign currency in the first half of 2023 remained at the level of January–June 2022 at 12.2%.

Due to growing remittances, savings continued to increase. Total deposits with commercial banks increased by 47.9% during the last 12 months. Of these, local currency deposits increased by 32.2% and foreign currency deposits by 70% (64.4% in US dollar terms). The increase in deposits was due to the continued high growth rates of remittances, as well as the depreciation of the somoni against the US dollar. The weighted average interest rate on term deposits in the local currency increased from 10.3% per annum in January–June 2022 to 12.4% per annum in January–June 2023 due to depreciation pressures. As to term deposits in foreign currency, the weighted average interest rate declined from 3.5% to 3.4% per annum during that period.

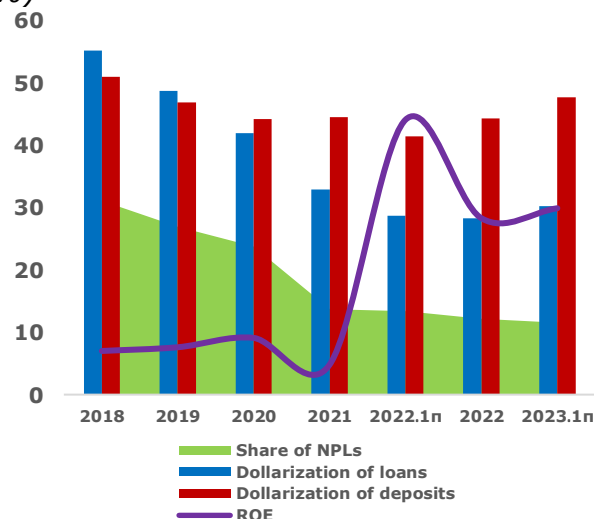
The financial performance of the banking sector showed continued stability against a background of significant credit growth. The financial soundness indicators of the banking system improved considerably. During the first half of 2023, the assets of the banking system increased by 36% and liabilities by 41%. At the same time, the share of non-performing loans in total loans decreased from 12.2% at the end of 2022 to 11.5% in June 2023. Provisions have been created in full for all non-performing loans. The return on assets during this period remained at the level of 5.9% and the return on equity increased from 28.3% to 29.9%.

Figure 9. Bank lending (in %, y-o-y)



Source: NBT

Figure 10. Banking sector indicators (in %)



Source: NBT

Medium-Term Outlook

According to the EFSD estimation, taking into account the actual developments in the first half of the year, economic growth in the RT would be 7.5% in 2023. In 2024–2026, the macroeconomic conditions in the RT would be determined by several important factors. Consumption would continue to be fuelled by remittances, and public investment would be supported mainly by external financing from development partners. These two factors would form the basis of economic growth. Given that, the economic growth rate in 2024–2026 would be 6.9–7.0% according to EFSD estimates, which is the potential economic growth rate as estimated by the EFSD. In the medium term, economic growth is expected to decline slightly compared to 2022–2023 due to lower remittance growth rates.

Taking into account the inflation dynamics in the first half of the year, the EFSD estimates 12-month inflation at 4.3% in 2023. The NBT's shift to a more neutral monetary policy and the decline in global inflation would contribute to keeping inflation in the RT within the NBT's targeted range ($6 \pm 2\%$) over the period of 2024–2026.

The current account balance would deteriorate, but would remain in surplus in the medium term due to the gradual recovery of gold exports. Remittances and external financing would help maintain the stability of the balance of payments in 2023–2026. At the same time, the international reserves would remain at a comfortable level of at least 6.7 months of imports of goods and services.

Against the background of lower tax rates, the state budget revenues are projected to decline from 28% of GDP in 2022 to 26.7% of GDP in 2026. Taking into account the dynamics of growth in current and capital expenditures in the first half

of 2023, the state budget deficit is projected to widen to 2.3% of GDP in 2023, declining to 1.1%–1.3% of GDP in 2025–2026 due to the need to start repaying the principal amount of Eurobonds.

Despite the decline in the budget deficit in the medium term, potential financing gaps could range from USD 132 million to USD 312 million in 2024–2026 due to the large financing needs of the RT public investment programme and the need to repay Eurobonds from 2025 onwards.

Risks to Medium-Term Outlook

The above outlook is mainly subject to downside risks associated primarily with external factors. The main risks include lower growth rates in the global economy and the Russian economy due to potential extension of geopolitical conflicts. This may affect the RT economy by reducing migration flows and remittance inflows, which in turn would discourage domestic demand growth. The improvement in the fiscal position may prove unsustainable due to the important role of grants in budget revenues. An additional internal risk factor in terms of inflation control and financial stability may be the excessively high growth rate of consumer loans.

Table 1. Forecast of key macroeconomic indicators

	2022 Actual	2023 Estimate	2024 Forecast	2025 Forecast	2026 Forecast
<u>National accounts and prices (in %)</u>					
Real GDP growth	8.0	7.5	6.9	7.0	7.0
CPI (December, y-o-y)	4.2	4.3	6.0	6.0	6.0
<u>Money and credit (end of period)</u>					
Broad money, percentage change	40.4	22.5	12.2	12.4	13.4
Policy interest rate	13.0	10.0	10.0	10.0	10.0
<u>Public finance (in % of GDP)</u>					
Revenues and grants	28.0	27.2	26.9	26.8	26.7
of which tax revenues	18.8	18.8	18.9	19.0	19.1
Budget expenditures	28.9	29.5	28.9	27.9	28.1
Current expenditures	22.5	21.8	21.8	21.9	22.2
Capital expenditures	6.6	7.6	7.1	5.9	5.8
Budget balance ("-" deficit/"+" surplus)	-0.9	-2.3	-2.0	-1.0	-1.3
<u>External sector (in % of GDP)*</u>					
Current account	15.6	1.4	1.3	0.9	0.8
Remittances	49.2	36.3	37.8	37.2	37.0
Foreign direct investment	1.5	2.1	2.7	2.7	2.7
Gross reserves, in months of imports of goods and services of the current year	8.0	7.3	7.2	6.8	6.7

Source: National statistics, EFSD Project Unit

ANNEX: "REPUBLIC OF TAJIKISTAN: ASSESSMENT OF THE EFFECT OF REMITTANCES ON THE ECONOMY"

Economic growth in the RF and the ruble exchange rate have a direct impact on the level of remittances in the RT, which in turn are the main transmission channel of shocks to the RT economy.

Net remittance inflows in Tajikistan have averaged 32% of GDP (2005–2022), the highest among other EFSD members. In 2014–2015, against the background of the depreciation of the Russian ruble and lower economic growth in the RF, there was a decline in remittances and a slowdown in real GDP growth in the RT. The next negative shock to the RT economy was during the pandemic in 2020, when, due to the restrictions imposed, operations in the non-tradable sector of the RF (services, construction, etc.) were suspended, which also affected trade and services, investment and remittances in the RT. In 2022, the decline in economic growth in the RF was expected to lead, through the main transmission channel, to a slowdown in real growth in the RT, but the actual effect turned out to be positive. The appreciation of the Russian ruble and an increase in the number of tourists from Russia contributed to higher capital inflows to the RT, including remittances.

Assessment of the impact on economic growth. The effect of remittances on the economic growth in the RT in the short term was assessed using a multiple linear regression model based on the least-square method (LSM). The results show that in the short term (up to 1 year), a 10% increase in remittances would lead to an additional 0.2–0.3% increase in GDP due to the effect on domestic demand. The importance of remittances for consumption (the main component of domestic demand) is also confirmed by a study by the International Labour Organisation (ILO), according to which remittances account for more than half of the income of more than 60% of households in Tajikistan and are the only source of income for 31%. The ILO study on remittances also shows that, on average, 57% of remittances are spent on primary consumption needs, mainly food, clothing, and medical care; 12% of remittances are saved for less than six months (short-term savings), and only 11% for more than six months (long-term savings). It should also be noted that the high propensity of households in the RT to consume through imports limits the effect that the inflow of remittances (around 30% of GDP in 2002–2022) could potentially have on the RT economy, if a significant part of them were channelled into savings and investment. According to the results of the regression analysis, in the long term (more than 3 years), a 10% increase in remittances negatively affects GDP growth by 0.1–0.2 p.p. The adverse effect can be explained by the moral hazard effect, when households receiving remittances are not interested in finding a job because they receive financial support from relatives.

Relationship between remittances and poverty in the Republic of Tajikistan. In Tajikistan, as remittances increased, the share of the poor decreased over time from 34.3% in 2013 to 26.3% in 2019. However, another

assumption is that remittances exacerbate income inequality. This assumption is partially confirmed by the dynamics of the Gini coefficient in the RT, which, according to the latest available data, increased from 0.31% (2017) to 0.44% (2018), implying an increase in income inequality between certain categories of the population. Remittances undoubtedly have a positive effect on household well-being, but their social costs may outweigh their economic benefits (Tolstokorova, 2009). In particular, the prolonged absence of family members is compensated for by regular remittances from abroad, but there are also negative consequences: emotional bonds are weakened; important family functions (including reproduction, socialisation of children, financial management, division of household labour) are changed; and the risk of divorce increases.

Effect of remittances on the balance of payments in the Republic of Tajikistan.

The RT trade deficit was largely covered by remittances throughout the period under review (2010–2022). In 2021–2022, the inflow of remittances supported the current account surplus and contributed to an increase in foreign exchange reserves (up to 8 months of import coverage in 2022), as the inflow of remittances and external financing from development partners provided the economy with foreign exchange to finance imports. If we compare the importance of remittances for the economies of Tajikistan and, for example, Armenia, it is obvious that over time (since 2015) the share of remittances in the GDP of the Republic of Armenia has fallen below 10% of GDP, and thus their impact on the economy has decreased. In the case of Tajikistan, the share of remittances in GDP remains above 25%. This is one of the reasons why Tajikistan's economy is more vulnerable to external shocks than other countries in the region and more dependent on the Russian economy – changes in the ruble exchange rate, as well as Russia's GDP growth rate, have a direct impact on Tajikistan's economic indicators.

Conclusions. Remittances from the RF are the main channel for transmitting shocks, both positive and negative, to the RT economy. Therefore, policies should aim at adjusting to the inflow/outflow of remittances through a more flexible exchange rate. The NBT is recommended to adopt a floating exchange rate policy aligned with the principles of capital account liberalisation and the conduct of an independent monetary policy. As part of long-term structural reforms, it is necessary to improve the labour productivity and competitiveness of the RT economy and to create new jobs.