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***BUILDING AND INTEGRATION OF CAPITAL MARKET  
IN REPUBLIC OF TAJIKISTAN***

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## INTRODUCTION

Many researches confirm a direct relationship between the development of financial markets and the economic growth of a nation. In financial markets (both money markets and capital markets) money is mobilized by intermediaries from local savers and foreign ones alike, and is then allocated to entities with productive opportunities. This structure is improved by monetizing more of the economy by tapping the informal sector, and by increasing the number and nature of financial institutions to include not only depository institutions but also capital market institutions. Developed nations have gone far in developing their capital markets while the emerging nations especially the Central Asian country's economies still face many challenges toward achieving this all important factor in economic development. Tajikistan is yet to begin its journey in developing its own capital market and that is the topic of this research.

Thus, this study aims at assessing the availability of potential demand for and supply of securities; and exploring the degree of government support in establishing the requisite investment environment, developing the legal framework, and in developing the capabilities for the trading in the market. The findings from the study as well as the recommendations will contribute to the understanding the way forward for the people assigned with the project of formulating a strategy for implementation of a capital market in Tajikistan. This study will continue to be relevant to market participants even after the capital market has been introduced

The transition process that began in 1989 in Central Europe, about 1991-1992 for the Baltics but generally later for the CIS countries, has been accompanied by transitional recession with a substantial decline in GDP. The path from the command economy to free-market system has been a difficult one for the countries of Central Asia. In the emerging transitional economies of Central Asia political and economic reform are interdependent. The Republic of Tajikistan became Independent in September 1991 and it's presently one of the CIS countries. With the fall of the USSR and the emergence of a new political situation civil war broke out. It contributed a great damage to the economy and social sphere of a young state. The socio-economic crisis in Tajikistan had a general character. The fall of industrial and agricultural production brought economic and political turbulences and finally huge poverty into the country.

The Republic of Tajikistan in the beginning of XXI century stood on the way of economic renaissance. Years of social cataclysms and instability left behind, as well as difficult years of peace building and new independent state construction. Tajikistan undergoes rapid process of economic, social and institutional reforms; by stages, it builds relations with many countries of the world and international organizations and become firmly established in the world and found its place in world community. Obviously the weakening of socio-economic stability in one country can have a negative affect on the stability of the development of the whole region and even on a global level. Therefore I oriented this thesis to analyze and represent the economy of Tajikistan as a part of Central Asian territorial integrity; key sectors for the purpose of globalization and integration; introduce the major macroeconomic indicators to value financial structure and find out weaknesses of economy so as to arrive at the conclusions.

### **STATEMENT OF THE PROBLEM**

It is well known that for a country to support and sustain its economic growth and development, it needs to develop its financial market. To achieve this goal, a country has to monetize more of its economy by tapping the informal sector and to broaden its financial sector by increasing the number and nature if financial institutions such as:

1. credit institutions – mainly banks and credit unions,
2. stock/equity markets, and
3. Bonds or debt markets.

**The subject** of this research is to find out what Tajikistan should focus on in developing strategy for establishing a capital market (both equity and bond markets), a feature that is absolutely necessary, yet conspicuously absent in Tajikistan. As well as the analyzing past and present socio-economic situation and creating basis for building a capital market in Republic of Tajikistan.

### **RESEARCH OBJECTIVE**

The objective of this research is to establish whether all the requisite ingredients for a successful capital market are already in place. I am aware of the challenges faced by the emerging markets especially in Central Asia region, and I was interested in finding out whether these challenges can be overcome in the case of Tajikistan. There are wide variety

of objectives and needs of analyze and evaluate the economic profile of the country, its problematic sides in infrastructure, strengths and weaknesses in financial system including legislative base, investment climate, privatization, banking evolution, government policy, specially necessary changes in the economy in order to find out important elements and necessary prerequisites for creation successful and stable base for capital market.

Each country is unique and we should expect each capital market to be unique too. Strategies that have been successful in some countries, especially the developed countries, may not necessarily be successful elsewhere. This study will try to establish that a securities market can be successfully introduced in Tajikistan.

## **CONCEPTUAL FRAMEWORK**

This paper examines two possible effects of financial globalization on the central banks and monetary policy strategies. 1) Volatility of net capital flows, foreign direct investments, portfolio investments, and higher volatility of exchange rates due to establishing a capital market (both equity and bond markets) in Tajikistan, 2) Increased uncertainty, and instability of global economy climate and impact of financial crisis into emerging economy.

This paper also examines the strengths and weaknesses of integration processes, business environment, monetary policy, legislation base, economy freedom indexes as well as different evaluative indexes given by International Monetary Fund, World Bank and other external partners, explore investment targeting strategy as “an appropriate monetary policy strategy in the global financial environment”.

## **RESEARCH QUESTIONS**

The objective of this paper is to capture the impact of integration on Tajikistan’s domestic financial system and monetary policy through an analysis of financial and economic developments and the policy responses they elicit. Specifically, the paper attempts to address the following key questions:

1. Does Tajikistan have an opportunities and sufficient number of potential issuers and buyers of securities to make a market?

2. Is the general environment conducive for a successful establishment of a capital market?

To answer these two questions, this paper carefully examines the evidence surrounding the economic conditions.

### **SIGNIFICANCE OF THE STUDY**

The main benefit of the study will be the identification of the benefits of the capital market to the economy of Tajikistan, and the related challenges to overcome for its establishment. The most beneficiary of the study will be the government body that will be charged with the regulation of the market. The body may use the results of the study in workshops, conferences, and reports to the cabinet under the draft law establishing capital markets in Tajikistan, respectively in Central Asia region.

### **ISSUE A CHALLENGE**

A major challenge for Tajikistan is to find a similarly effective focal point, either external or domestic, to promote needed structural and institutional reforms. Even with such a focal point, much remains to be done in the country in transition period that is being able for building a *capital or commodity market*, including continuing process on building the infrastructure of a market economy and ensuring adequate enforcement and implementation of its essential principles and practices.

### **RESEARCH METHODOLOGY**

1. Research Design. The research has been both qualitative and quantitative and present a survey focused on identifying the ingredients for introduction of a capital market in the country. Sampling for potential capital market created on the base of analytical method, correlation method, numerical-graphical method, diagnostic method, deduction and induction as well as evaluating dominates corporate entities and government bodies based on their annual turnover.

2. The analysis of the potential issuers was in terms of annual turnover, gearing ratio (the percentage of the total funds that belongs to the shareholders), and the type of



ownership (state-owned, foreign-owned, locally owned, or a combination of those). Investor analysis was based on current investment portfolio of those institutional investors.

3. Data was collected from periodic reports from mentioned bellow main sources: (i) IMF, (ii) WB, (iii) IFC, as well as by central banks, Ministry of Finance, Ministry of Economy and Trade, National Bank of Tajikistan, Tajikistan's Revenue Authority, Privatization Secretariat, and State Committee on Investments and State Property Management of the Republic of Tajikistan. Efforts will be taken to empirical knowledge of a number of countries in the world who have functioning capital markets.

### **LIMITATION OF THE STUDY**

Due to existing difficulties in data collection, a weakness of the methodology for determining reliable information on the magnitude of capital flows is scant. Information about potential individual investors was not available because most people would not freely discuss their incomes and savings. Even banks could not divulge such information. Finally, it appears that no previous such research was done on Tajikistan, and that makes it even more challenging for the study.

The **main reason** for choosing this theme is being of importance for developing the economy of Tajikistan and also, opportunity to take over some experiences and recommendations from the results of socio-economic growth of Visegrad-Group (V4) countries (in connection with having practically similar management system and experienced economic crisis), and application of these results on similar economic system of Tajikistan.

The **theoretical treatment** of the dissertation work is to describe the economy of Tajikistan since gaining Independence till today. The macroeconomic situation of the country is going to be analyzed with the purpose to create conditions for building capital market in the country. In this connection I would like to characterize the following chapters.

## **STRUCTURE OF THE DISSERTATION WORK**

*The study is divided into four chapters.*

**Chapter I:** Chapter one introduces the setting, the macroeconomic background, and the openness to cross cultural links in terms of integration and trade association. Therefore in the first chapter, I have explained all transition stages of the economy to Independent body and structure as main state unit, to point out to basic development stages of the country. As well as described the evolution in GDP, Influences of Remittances to economic growth, BOP, Rate of Interest, Monetary Sector and Central Government Budget deficit with prediction of the development of the whole Central Asian region and even to the World Economy. Chapter one also discusses literature related to the capital markets as obtained from other studies, books, articles, interviews with leading authorities.

**Chapter II** highlights the development of infrastructure in Tajikistan, role of Government and self-regulators, Basel Core Principles for effective banking supervision. This chapter reviewed non-bank financial institutions, foreign aid organizations with particular focus on Growth of Financial Sector, Privatization, Key characteristics of Tajik financial system and on the role of foreign direct investment (FDI). Their influences to the country's current development, the country strength, weaknesses and opportunities are identified and reviewed. Finally, an overall assessment is made of the policy and operational framework.

**Chapter III** represents the main body of the research that relates to Tajikistan's situation, the analysis of which is benchmarked to the rest of the world so as to arrive at the conclusions in chapter four. Finally, Chapter four shows conclusions reached from the findings and it also recommends the ways forward if the objective is to be realized.

Chapter III reviews the investment climate in Tajikistan and security market development, as well as policy and legal framework, along with an analysis of specific standards which apply to foreign investors and relevant laws and policies which are of particular interest or concern to foreign investors including implementation practices.

On the base of the finding of this analysis, **Chapter IV** presents some recommendations for the Government of Tajikistan and Donor Organizations to consider

core issues for improvement of the investment climate. In this regard, it is proposed that the national investment policy may be reconsidered in order to ensure a coordinated and consistent approach in the implementation of proactive measures in this area. The recommendations also address policy and administration issues concerning regulatory system reform including improvements in governance, transparency and accountability of governmental and local agencies, the judicial system as well as institutional design of investment-related bodies.

The **Dissertation Work is designed** to assess the stability of the financial system as a whole and not that of individual institutions. It has been developed to help Tajikistan identify and remedy weaknesses in its financial sector structure, thereby enhancing its resilience to macroeconomic shocks and cross-border contagion.

## BACKGROUND

**Tajikistan is a landlocked, low-income country with a population of about 7 million and a per capita GDP of less than \$600.** The poverty rate, while declining, is high—estimated by the World Bank at 57 percent in 2004. The country suffered greatly from the breakup of the Soviet Union and the civil war that followed in 1992. Peace was restored in 1997, followed by macroeconomic and political stabilization. Macroeconomic performance has since been fairly robust, albeit with a few lapses.

**Real GDP has expanded at an average annual rate of about 8½ percent during the last five years.** In this process, the sectoral composition of GDP has gradually shifted toward services and away from industry and agriculture, although the latter still accounted for about 20 percent of GDP in 2007 and almost 70 percent of employment, primarily in the cotton sector.

**Inflation, after falling to single digits in 2004–05, has accelerated in the past two years, reaching 20 percent at end-2007.** This was mostly due to a surge in international wheat prices and energy, but also reflected rapid monetary expansion from quasi-fiscal operations by the central bank associated with cotton sector financing. Fiscal performance on the other hand has been solid, the government having run small surpluses (excluding the externally financed public investment program) for the last five years.

**The current account deficit averaged about 3 percent of GDP during 2002–06, but tripled in 2007.** In the last few years, worker remittances—about 38 percent of GDP in 2007—have become the main source of foreign exchange overtaking receipts from cotton and aluminum exports. Most remittances originate in Russia, thus negative downturns in the Russian economy could substantially affect these inflows<sup>1</sup>. Reflecting the impact of pledges and guarantees for cotton financing, the NBT's international reserves fell to very low levels at end-2007 (about ½ month of imports or less than one fifth of dollar-denominated deposits). The national currency is de-facto pegged to the U.S. dollar.

**Government and political conditions.** The Republic of Tajikistan gained its independence during the breakup of the Union of Soviet Socialist Republics (U.S.S.R.) on September 9, 1991 and soon fell into a civil war. From 1992 to 1997 internal fighting ensued between old-guard regionally based ruling elites and disenfranchised regions, democratic liberal reformists, and Islamists loosely organized in a United Tajik Opposition (UTO). Other combatants and armed bands that flourished in this civil chaos simply reflected the breakdown of central authority rather than loyalty to a political faction. The height of hostilities occurred between 1992 and 1993. By 1997, the predominantly Kulyabi-led Tajik Government and the UTO had negotiated a power-sharing peace accord and implemented it by 2000.

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<sup>1</sup> Remittances are typically relatively stable and counter-cyclical (flows tend to increase in times of hardship in the recipient country), but are highly dependent on economic performance in the host country.

# I. THEORETICAL FOUNDATIONS OF CAPITAL MARKETS WITH RESPECT TO EMERGING MARKETS

The Capital market plays an important role in economic development on emerging countries. It is an important element of market mechanism, which reactions on changes of conditions are sensitive. The Capital market contributes on economic growth and allocates free cash flow into the branches of industry for the purpose to reach complete and effective investments. The capital market provides financing to meet the denomination, liquidity, maturity, risk (with respect to credit, interest rate, and market), and other characteristics desired by those who have a surplus of funds and those who have a deficit of funds.

On the problems of foundation for the Capital Markets in foretime were treated by famous scientists as Eugen von Bohm-Bawerk publication "Capital and Capitalizing", Wien 1884, F.Hayek (The Pure of Capital, Chicago 1941), J.M. Keynes "The General Theory of Employment, Interest and Money", 1936), J.A. Schumpeter "The Explanation of the Business Cycle", 1927.

In the second half of the twentieth century prominent economists have treated by capital market's problems, between them a special attention deserves by professors as **William F. Sharpe**, Professor of Finance, Emeritus, Graduate School of Business, Stanford University, Nobel Prize in Economic Sciences; **Harry M. Markowitz**, City University of New York, USA; **Merton H. Miller**, University of Chicago, IL, USA. *All of them have the Sveriges Riksbank Prize in Economic Sciences in Memory of Alfred Nobel, 1990.*

**Professor Frederic S. Mishkin, Governor of the Federal Reserve System** in Washington DC, USA said "*My initial interest in emerging markets countries focused on financial crises* (for example, Mishkin 1996, 1998a,b,c, 1999a,b,c, 2003; and Hanm and Mishkin 2000) cumulating in next book, *The Next Great Globalization; How Disadvantages Nations can harness their Financial System to get rich* (2006). Given him interest in monetary policy strategy, he broadened his research to monetary policy

strategies in emerging markets and transition countries (which are emerging market countries that were previously under the yoke of communism).<sup>2</sup>

*“Given my interest in emerging market countries, it seemed natural to study inflation targeting in transition countries that have recently emerged from communism. Transition countries are worth studying because of three unique features: 1) these are new democracies, 2) these nations are undergoing radical restructuring, and 3) they are very likely to enter the European Union and Economic and Monetary Union”*

**Frank J. Fabozzi**, Ph.D., CFA, CPA, is **Professor in the Practice of Finance and Becton Fellow at Yale University's School of Management**. He is the editor of the *Journal of Portfolio Management*, and editor and author of over 100 definitive finance books. Mr. Fabozzi sits on the board of directors of the BlackRock family of closed-end funds. In November 2002, he was inducted into the Fixed Income Analysts Society Hall of Fame and in 2007 was the recipient of the C. Stewart Sheppard Award. Between the famous books depend the “*Capital Markets; Institutions and Instruments*” Prentice Hall International, London 1996, “*Bond Markets, Analysis and Strategies*” written in 1996 includes “*The Handbook of Commodity Investing*”. Experts defines it "Anyone interested in commodities as an investment and just wants the pure facts (no hype) should find *The Handbook of Commodity Investing* very beneficial." (*About.com: Commodities*).

Another specialist in this sphere are **Roland Fuss**, PhD, is Professor of the Endowed Chair for Asset Management, European Business School (EBS), International University Schloss Reichartshausen, Germany; and **Dieter G. Kaiser**, PhD, is Director of Alternative Investments at Feri Institutional Advisors GmbH in Bad Homburg, Germany, where he is managing a dedicated commodities fund of hedge funds.

The increasing integration of the world economy and the growth of other developing countries have led to the growth of the interest to the CA countries. The above mentioned scientists treated on problems of “advanced markets and emerging markets”, as well as International Monetary Fund and World Bank.

With interest rates so low for so long, yields in the rich world have grown flat, stale and unprofitable. Investors have sought higher rewards on investments farther a field.<sup>3</sup> Faster

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<sup>2</sup> Frederic S. Mishkin “*Monetary Policy Strategy*” page 265.

growth, lower inflation and tighter public finance in most emerging markets have played a role, in addition, to greater appetite for risk among investors. And as the dollar-and Euro-dominated debt has grown more expensive, international investors have been drawn to local alternatives. Currency risk, after all, has an upside as well as a downside. Rich world investors have shown themselves willing to buy emerging market assets at higher prices, in local currencies and at lengthy maturities.

## **1.1. The role of Capital Markets in an economy**

Well-developed capital markets generate many economic benefits, including higher productivity growth, greater employment opportunities, and improved macroeconomic stability. The development of capital markets has introduced new discipline in policy making because market prices adjust instantaneously to new information. As a result, the quality of economic policy has improved greatly. Secondly, the cost of capital reduces as a capital market is introduced because often lenders and borrowers interact directly by bypassing the depository institutions that would otherwise cream off fat margins. There are also other two major benefits generated by the capital markets. First, because the prices of corporate debt and equity respond instantaneously to new information, changes in the outlook for an industry or company are quickly incorporated into share prices. The result is that such price changes dictate the direction to which capital will flow. Businesses with high returns attract inflows of capital while those with low returns lose even what they had. The end result is the improved allocation of capital. Second, the development of the capital market has helped distribute risk more efficiently – by transferring of risk to those best able to bear it – either because they are less risk averse or because the new risk is uncorrelated or even negatively correlated with other risks in a portfolio. Thus, the capital markets ensure that capital flows to its best uses and that riskier activity with higher payoffs are funded.<sup>4</sup>

The capital market provides financing to meet the denomination, liquidity, maturity, risk (with respect to credit, interest rate, and market), and other characteristics desired by those who have a surplus of funds and those who have a deficit of funds. The capital market as a whole consists of overnight to long-term funding. The short to medium end of

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<sup>3</sup> The Economist: December 17<sup>th</sup> – 23<sup>rd</sup> 2005

<sup>4</sup> William C. Dudley & R. Glenn Hubbard – How Capital Markets Enhance economic performance, 2004

the maturity spectrum is called the money market proper, and the long end is identified as the capital market. The financial instruments range from money market instruments to thirty-year or longer bonds in credit markets, equity instruments, insurance instruments, foreign-exchange instruments, hybrid instruments, and derivative instruments. There has been an explosion of innovation in the creation and development of instruments in the money and capital markets since about 1960 in both debt and equity instruments.

Finally, capital markets help to reduce economic volatility in that, because they use mark-to-market accounting, it is more difficult for problems to be deferred. Thus, pain is borne in real time, which means that the ultimate shock to the economy tends to be smaller. Deferral causes the magnitude of the problem to increase. Also, by providing immediate feedback to policymakers, the capital markets increase the benefits of following good policies, and increase the cost of following bad ones. As a result, the quality of economic policy-making improves over time, which helps to improve economic performance and macroeconomic stability.<sup>26</sup> In conclusion the improved allocation of capital and risk sharing facilitated by capital markets leads to superior economic performance. First, capital markets help improve the allocation of capital, thereby raising the average return on capital. Second, the capital markets facilitate in the allocation of risk and help provide a mechanism by which start-up companies can raise capital thus leading to higher productivity growth.<sup>5</sup>

### **1.1.2. Capital Market Environment in Emerging Economies**

In many emerging economies, the law offers minority shareholders little protection against insiders who do not have their interest at heart.<sup>6</sup> Breaches of a debt contract are easy to spot, but it is very difficult to notice erosion of a shareholder's claim. Such lack of investor protection shows a general scarcity of transparency and accountability. For the capital market to function well there must be low levels of corruption, low levels of political risk, high levels of property-right observance, clear legal and accounting codes, and high standards of corporate governance.<sup>7</sup> Emerging market risk factors include liquidity risks (small market with low trade volumes), clearing and settlement risks (with very high trade failures), political risks (political

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<sup>5</sup> William C. Dudley & Glenn Hubbard – How Capital Markets Enhance economic performance, 2004

<sup>6</sup> IBID

<sup>7</sup> The Economist: Economic Intelligence Unit: Business News 2006



instability, changes in taxation and dividends policies, restriction of repatriation of earnings, convertibility of local currency and foreign currency regulations) and lack of legal structure for investor protection.<sup>8</sup> These risk factors appear to be entrenched in many of the central Asian exchanges. Normal market forces do not appear to operate easily in Tajik exchanges. One problem is the lack of widespread communication facilities, which inhibit the dissemination of knowledge of timely market movements. A second problem is the tendency of many of the investors to view their shareholdings as long-term property, not to be sold. However, the more basic impediment to market development is the lack of public confidence in the integrity of the securities market. Corruption has been well entrenched both in government offices and private corporations.<sup>9</sup>

### **1.1.3. Problems of emerging markets**

*What is an emerging market economy?* A term “emerging market” coined in 1981 by Antoine W. Van Agtmael of the International Finance Corporation of the World Bank, an emerging, or developing, market economy (EME) is defined as an economy with low-to-middle per capita income. Such countries constitute approximately 80% of the global population, representing about 20% of the world's economies. Although a loose definition, countries whose economies fall into this category, varying from very big to very small, are usually considered emerging because of their developments and reforms. Hence, even though China is deemed one of the world's economic powerhouses, it is lumped into the category alongside much smaller economies with a great deal less resources, like Tunisia. Both China and Tunisia belong to this category because both have embarked on economic development and reform programs, and have begun to open up their markets and "emerge" onto the global scene. EMEs are considered to be fast growing economies.

*What an Emerging Markets Economy looks like?* Emerging Markets Economies are characterized as transitional, meaning they are in the process of moving from a closed to an open market economy while building accountability within the system. Examples include the former Soviet Union and Eastern bloc countries. As an emerging market, a country is embarking on an economic reform program that will lead it to stronger and more responsible economic performance levels, as well as transparency and efficiency in the

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<sup>8</sup> Thomas K. Liaw; *The Business of Investment Banking*, 1999

<sup>9</sup> *A New Direction for Emerging Markets*, S. Cohn, 2005

capital market. Emerging markets will also reform its exchange rate system because a stable local currency builds confidence in an economy, especially when foreigners are considering investing. Exchange rate reforms also reduce the desire for local investors to send their capital abroad (capital flight). Besides implementing reforms, an emerging market is also most likely receiving aid and guidance from large donor countries and/or world organizations such as the World Bank and IMF<sup>10</sup>.

Following robust growth earlier in the decade, capital flows to emerging markets fell sharply between mid-1997 and end-1998, in the wake of the financial crises that hit Asia and Russia. The recovery from the trough in the last quarter of 1998—when gross private financing to emerging markets had fallen to nearly a third of the level just prior to the Asian crisis—has been uneven. After remaining relatively subdued through 1999, gross private sector financing to emerging markets boomed in the first quarter of 2000, before dropping again in the second quarter. Moreover, this volatility has been accompanied by considerable dispersion in the composition of these flows, both across regions and countries, as well as by type of instrument.

One key characteristic of the emerging markets is an increase in both local and foreign investment (portfolio and direct). A growth in investment in a country often indicates that the country has been able to build confidence in the local economy. Moreover, foreign investment is a signal that the world has begun to take notice of the emerging market, and when international capital flows are directed toward an emerging market, the injection of foreign currency into the local economy adds volume to the country's stock market and long-term investment to the infrastructure.

For foreign investors or developed-economy businesses, an emerging market provides an outlet for expansion by serving, for example, as a new place for a new factory or for new sources of revenue. For the recipient country, employment levels rise, labor and managerial skills become more refined, and a sharing and transfer of technology occurs. In the long-run, the emerging markets economies overall production levels should raise, increasing its GDP and eventually lessening the gap between the emerged and emerging worlds.

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<sup>10</sup> World Economic Outlook; Focus on Transition Economies, October 2000

***Portfolio Investment and Risks.*** Because their markets are in transition and hence not stable, emerging markets offer an opportunity to investors who are looking to add some risk to their portfolios. The possibility for some economies to fall back into a not-completely-resolved civil war or a revolution sparking a change in government could result in a return to nationalization, expropriation, and the collapse of the capital market. Delicate exchange rate fluctuations could transform into an all-out devaluation resulting merely from investors speculating in the possibility of political disorder or losing faith in the banking system. Because the risk of an emerging market investment is higher than one of a developed market, panic, speculation and knee-jerk reactions are also more common - the 1997 Asian crisis, during which international portfolio flows into these countries actually began to reverse themselves, is a good example of how emerging markets can be high-risk investment opportunities.

***Local Politics versus. Global Economy.*** An emerging market economy must have to weigh local political and social factors as it attempts to open up its economy to the world. The people of an emerging market, who before were protected from the outside world, can often be distrustful of foreign investment. Emerging economies may also often have to deal with issues of national pride because citizens may be opposed to having foreigners owning parts of the local economy.

Moreover, opening up an emerging economy means that it will also be exposed to not only new work ethics and standards but also cultures as well: indeed the introduction and impact of, say, fast food and music videos to some local markets has been a by-product of foreign investment. Over the generations, this can change the very fabric of a society and if a population is not fully trusting of change, it may fight back hard to stop it.

Although emerging economies may be able to look forward to brighter opportunities and offer new areas of investment for foreign and developed economies, local officials of emerging markets need to consider the effects of an open economy on its citizens. Furthermore, investors need to determine the risks when considering investing into an emerging market. The process of emergence may be difficult, slow and often stagnant at times. And even though emerging markets have survived global and local challenges in the past, they had to overcome some large obstacles to do so.

There is significant evidence regarding an increase in global financial integration of emerging markets over the past two decades. It has also been reflected in the increase in the quantity of capital flows to emerging countries, as well as in the improvement in their structure and terms. This has had important implications for the countries' capital accounts and their economic growth. Less recognized, however, are the significant implications of such financial integration and the benign global financial market environment in which it occurred in recent years on the countries' budgetary positions.

A number of emerging markets have undertaken a range of structural reforms to reduce the cost of their external financing, for instance, by lengthening the maturity profile of debts, refinancing high-cost obligations with lower cost ones, or improving investor relations management. This occurred during a time when global interest rates declined; yield spreads narrowed; the US dollar weakened over the past four years, to the considerable benefit of countries whose debts are denominated in dollars, but which have broadly diversified export bases; and relatively high commodity prices boosted growth in many emerging markets and provided (directly and indirectly) additional revenues.

Looking ahead, there is a general expectation of a rise in global interest rates, reflecting both a rebound in global activity, policy factors, and further alignment in the currency markets. How these developments affect countries' external debt situations will depend on a variety of considerations: for instance, the impact of the rise in rates may be ameliorated to some extent by valuation changes attendant on any further dollar depreciation; the relationship between risk premiums and spreads may also change, reflecting changes in investor perceptions regarding the long-run prospects of these economies; and emerging market countries' growth will be affected by changes in the global economic environment. There is an added concern that the most vulnerable countries could be hit hardest by a change in external conditions, given that they tended to benefit most from the benign environment.

## **1.2. Globalization and markets Integration processes in Central Asia.**

Globalisation and Economic integration among countries, involving the formation of free trade areas, customs unions, common markets or full economic unions, has become a fact for most of developed or Western Countries. European Union (EU) as well as other

positive forms of economic integration have gone successfully and taken place in Latin America, the Pacific area via Trade Agreement (PTA), and in the NAFTA. This globalization and economic integration is still a desirable object in developing countries<sup>11</sup>.

International economic integration means full economic union among a group or groups of countries. Frequently this is also called 'total' economic integration in distinction of some other international arrangements involving closer economic cooperation or some degree of integration such as free trade areas, customs unions, and common markets.

“Globalization isn’t a choice. It is a reality. There’s just one global market today, and the only way you can grow at the speed your people want to grow is by tapping into the global stock and bond markets, by seeking out multinationals to invest in your country and by selling into the global trading system what your factories produce”.<sup>12</sup> Countries cannot thrive in today’s world without plugging into the global system, and they cannot survive unless they learn how to get the best out of this system. An economist once observed: “Poor countries with large investment needs, are no longer hamstrung by lack of capital. Savers are not confined to their home market, but can now seek investment opportunities that offer their highest returns around the world”<sup>13</sup>

Companies are no longer tied to the economic conditions and policies of the countries in which they are listed. The world’s 40 biggest multinationals now employ, on average, 55 % of their workforce in foreign countries and earn 59 % of their revenues abroad.<sup>14</sup> Globalization has also shifted the balance of power in the labor market in favor of companies. It gives firms access to cheap labor abroad; and the threat that they will shift more production offshore also helps to keep the labor demands low at home. All this is happening because securities markets have integrated globally, and the reason why they have integrated is that investors are acquiring international securities for higher yields and diversification. Companies now raise funds throughout the world. Reliable clearing and settlement are the backbone of such extension and expansion.

The challenge is all the greater in the Central Asia world. As regards the Tajikistan as well as other countries of Central Asia there have been several attempts for economic integration. Yet these attempts have not given any positive results. Unless a

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<sup>11</sup> SSRN: Social Science Research Network; “*The Structure of Banking Systems in Developed and Transition economies*”. January 20, 2000

<sup>12</sup> Ibid

<sup>13</sup> The Economist: October 25<sup>th</sup>, 1997.

<sup>14</sup> The Economist: Feb 25<sup>th</sup> – March 3<sup>rd</sup>, 2006

serious movement towards regional economic integration, Central Asian countries are under threats from the global market economy. This global economy now sets the rules for the economic policies which should be adopted by the region's countries. This economic integration is prerequisite for facing or achieving some level of globalization.

One of the most famous grease authorities Pescetto (1992) suggests the following three reasons for developing an efficient banking system. (a) Firstly, the banking system facilitates the efficient allocation of capital. Through credit risk analysis it ensures that only the most effective firms receive the necessary finance while imposing a strict budget constraint. Thus banking reform and privatisation are interdependent. (b) Secondly, the control of money supply and all its aggregates is a crucial function for a central bank. For the government to effect stabilising policy, control must be placed on money supply. (c) Thirdly, the supervision of the commercial banking system by the central bank is also of great importance, as is the continuing effort to bring informal markets into the legitimate economy.

Accordingly to the decision made on the Eurasian Economic Community (EURASEC) it is necessary to change a survival policy, which was used during the decay period of unitary state to the effective measures on mutually profitable cooperation by using capacity of all members of Central Asia.

Recently the most demanded products are: *coal, oil, natural gas, mineral potential, metals* and other basically mining and raw materials industries, which insure high economic growth for Central Asian Region.

### ***Central Asia countries in numbers***

In terms of Area	9 <sup>th</sup>
In terms of digging coal	10 <sup>th</sup>
Electricity production	9 <sup>th</sup>

In terms of capacity rare metals	1-20 <sup>th</sup> (depend of the kind of metals)
In terms of cumulative production gold <sup>15</sup>	9 <sup>th</sup>
In terms of cumulative vegetables production	16 <sup>th</sup>
In terms of cotton production	5 <sup>th</sup>
In terms of number of bovine animals	20 <sup>th</sup>

Source: IMF and estimates of the author.

Central Asian countries as well as Western or European countries would benefit from this Integration. Such integration expected to improve the terms of trade with the rest of the world and create a better global economic and political balance. As a result, East and European countries could be treated as an equal partner in our today's global world. They will not feel that they are merely weak partners who are subject to exploitation by other economic and political blocs.

A number of distinctive cultural features give the region a unity and justify the use of the term “emerging market”. A major advantage to integrate among the Central Asian countries is the region's similar agro-productive and technical industry etc. and homogeneous culture compared to many other areas of the world.

As the world’s most accommodate by electricity resources region, as well as rich of water supply, CA region has geopolitical, multilateral and structural fundamentals for building commodity market respectively capital market in region.

Central Asian waterlogged land could produce the cheapest electricity and also it has oil and mineral resources that are being rapidly depleted in other region of the world. In the case of other agricultural and extractive industries CA region have above-mentioned choices (see the Table) which could play an important role in widespread collaboration of enterprises, the development of infrastructure, and the increase in competitiveness of export products.

Obviously with capital raising and opportunities and perspectives for foreign investments in the mining sector into whole Central Asia, it will be possible to create the base for building a capital market, which could bring essential capabilities into region, expanding overseas into World economy.

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<sup>15</sup> Uzbekistan -90<sup>th</sup> , Kazakhstan-18,9<sup>th</sup> , Kyrgyzstan- 24<sup>th</sup> , Tajikistan -17

## PARTICIPATION IN INTERNATIONAL ORGANIZATIONS

However, reviewing all attempts of regional cooperation, alliances or integration among Central Asian countries in the last two decades I find big projects. Some of these projects are:

- Shanghai Organization of Cooperation (SOC)
- Commonwealth of Independent States (CIS)
- Organisation of Collective Security Agreement (OSCA)
- Organization “Central Asia Cooperation” (OCAC)
- The Collective Security Treaty Organization (CSTO)
- Euroasian Economic Community (EurAsEC)
- Central Asia Regional Economic Cooperation (CAREC)
- UN Special Programme for the Economies of CA (SRECA)
- BOMPA/CADAP
- The Silk Road Initiative

**Euroasian Economic Community (EurAsEC)** is the international economic organization, authorized for functions, concerned with the forming of common external customs frontiers of the states - founders (Belarus, Kazakhstan, Kyrgyzstan, Russia and Tajikistan) and for the elaboration of common external policy, common tariffs, prices and other components of common market. EurAsEC is the assignee of the Customs Union, created in accordance with the principles of the UN and international legislation. In 2003 EurAsEC has obtained the status of observer in the UN General Assembly.

**The membership in EurAsEC: TAJ, UZB, RUS, KAZ, KIG, BYE.** The Constitutive Treaty of the EuroAsian Economic Community was signed on October 10, 2000 in the capital of Kazakhstan, Astana, by Presidents of Belarus, Kazakhstan, Kyrgyz Republic, Russia and Tajikistan. In May, 2002 on the governments' request Moldova and Ukraine have got the status of observers in EurAsEC. On October 6, 2005, at the Summit of the "Central Asian Cooperation Organization (CACO)" the decision on joining the CACO with the EurAsEC initiated by the president of Uzbekistan was made by the heads of the member states of CACO in order to facilitate economic integration and development in Eurasia.

EurAsEc is an open organization. Any state, which accepts the obligations, stated in the Constitutive Treaty of the EuroAsian Economic Community and the list of other agreements within EurAsEC, determined by the Interstate Council, can become the member of EurAsEC. The priority focuses: *Transport; Power industry; Labor migration; Agro-cultural industry*

### 1.2.1. Prerequisites for building Capital Market in Tajikistan

The market reforms in the country and its integration into the globalization processes on the beginning period, but as it was mentioned above, it has all perspective to growth into needed level. Most experts believe that it is possible considering latest



economic development. Tajikistan has biggest opportunities of electricity and agricultural product exports, huge reserves of mineral resources, significant hydroelectric potential, unique bioclimatic conditions and labor resources represents a new market with substantial potential for growth. Its emerging economy grew an impressive 8.1 % during last five years, which was the biggest growth rate since getting independence.

Investments are important component of successful development of our economy. Therefore, protection of investments, decrease of risks, creation of transparent rules of doing business and other directions of forming the favorable investment climate are the main priorities. Nowadays Tajikistan slowing with many other economies in the world, took a turn for the worst in 2008. Of course, the main culprit dragging down the Tajikistan's economy was the global financial crisis and economic slowdown.

It is with these in mind that I continue, firstly with a brief discussion of the financial system in Tajikistan and the reform process, and secondly with an outline of the building and integration of capital market in Tajikistan.

Tajikistan has created favorable conditions for foreign investments, market structure support, and commercial finance, and banking system development. Specifically, the procedure for joint ventures registration and other ownership forms have been simplified; thus creating favorable conditions for foreign investors. According to new laws, enterprises with foreign investments are exempt from income taxes from 2 to 5 years depending on laid-down capital. The priority investments in the economy are: hydro-power engineering, the extraction and processing of precious metals, stones and polymetallic ores, telecommunication and infrastructure development, cotton processing, and agriculture production. Currently, companies from Canada, USA, Great Britain, Korea, Germany, Switzerland, Italy, Hungary and Russia are the biggest investors in the economy.

**Tajikistan is a member of the following UN organizations:**

- United Nations Educational, Scientific and Cultural Organization (**UNESCO**) *since 06.04.1993*
- Economic and Social Commission for Asia and Pacific (**ESCAP**) *since 31.07.1992*

- United Nations Development Programme (**UNDP**) *since 02.03.1992*
- International Monetary Fund (**IMF**) *since 27.04.1993*
- *Preparation work on country's WTO entry is going on. Agreement on signing the protocol*
  - memorandum about WTO entry with China, India, Turkey and Pakistan is achieved.
- Multilateral Investment Guarantee Agency (**MIGA**) *since 04.06.1993*
- United Nations Industrial Development Organization (**UNIDO**) *since 09.06.1993*
- Organization for Security and Co-operation in Europe (**OSCE**) *since 26.02.1992*
- World Health Organization (**WHO**) *since 04.1992*
- European Bank for Reconstruction and Development (**EBRD**) *since 14.09.1992*
- International Bank for Reconstruction and Development (**IBRD**) *since 27.04.1993*
- Economic Cooperation Organization (**ECO**) *since 21.05.1998*
- International Finance Corporation (**IFC**) *since 04.06.1993*
- International Development Association (**IDA**) *since 06.1993*
- International Labor Organization (**ILO**) *since 26.11 1993*
- International Organization for Migration (**IOM**) *since 26.11.1994*
- Food and Agriculture Organization (**FAO**) *since 02.11.1995*
- Asian Development Bank (**ADB**) *since 20.02 1998*
- Islamic Development Bank (**IDB**) *since 22.02.1998*
- World Customs Organization (**WCO**) *since 01.07.1997*

Central Asian countries have opportunity to integrate as other countries. Hence certain prejudice – *What form of integration could be used in CA?* Central Asia is different and different approaches are therefore needed here. Anyhow its start should not be different than these integration forms adopted in Europe or in Latin America, etc. The integration and globalization of Europe is a result of the common factors and behavior (e.g. flexibility, adaptations, trust and commitment) among these countries. The Central Asian countries too

have common factors, e.g. religion, language, customs, traditions, etc. but they are yet not able to integrate in order to create a balance in the globalization era.

*What forms of cooperation are the best applicable for the region?* Accordingly Vladimir Plastin, Professor of the Department of Oriental Studies of the Novosibirsk State University - first of all bilateral cooperation and then a broader scope.

According to Vyacheslav Piyarov, a legal consultant to Agroinvestbank “The time has come to develop a national corporate governance code of best practice in Tajikistan, it will improve the investment climate in the country and bring internal governance of the market players to international standards”

According to the evaluations of many experts, in the mid-term, the republic’s economy can expect slow, but most important, sustainable development (with progressive growth in its main indices. Tajik companies that want to improve their corporate governance currently lack national guidance on how to proceed. To help each other they need to organize a roundtable discussion that brought together government representatives and a variety of local stakeholders. The participants need to work together to develop a national corporate governance code that will make Tajik companies more transparent and attractive to foreign investors.

## **1.3. MACROECONOMIC BACKGROUND OF TAJIKISTAN**

### **1.3.1 Economy condition in the Early 1990**

The Central Asia republics constituted the poorest area of the Union of Soviet Socialist Republics (USSR), and Tajikistan was the poorest of them all. During the years under the central planning system, Tajikistan had a closed economy and after the fall of the USSR in 1991, economy of Tajikistan went through several high inflation phases, caused by the country’s economical and political instability, civil war and enormous budget deficit. After declaration of independence by Tajikistan in September of 1991, significant reduction of production and national income took place in the national economy. Tajikistan lost nearly 50% of its state revenue that had come as transfers from Moscow, as well as

barter arrangements that brought food from other republics in exchange for cotton and aluminum. The consecutive military-political calamities inflicted enormous damage to the national economy, having thrown the republic several decades back in its socio-economic development, and having aggravated the present difficult transition to market relations.

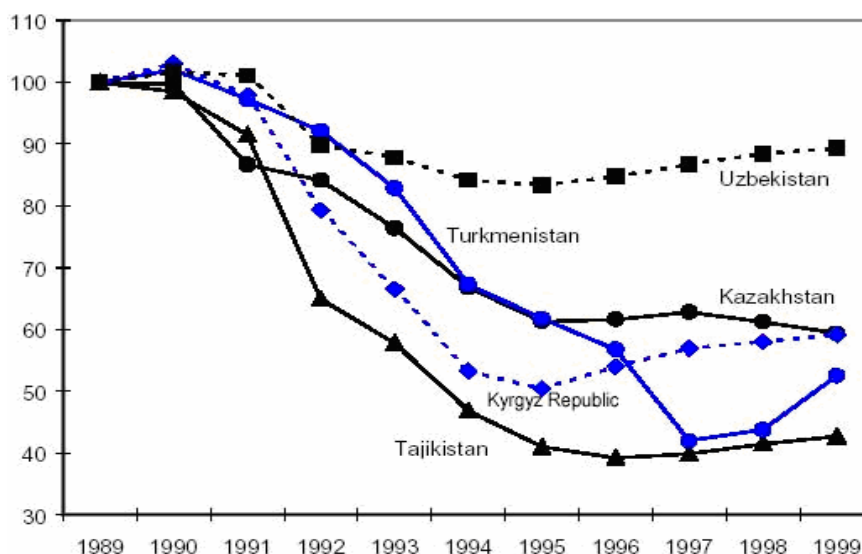
Tajikistan is located in a difficult geographical area. The country is land-locked, with no commercial access to the sea, mountain-locked by one of the highest mountains in the world and distance-locked far away from key markets – Europe and Russia. Therefore, the country is dependent on neighborly relations for market access and significantly affected by regional security issues, related to drug transit and the political situation in the region. Tajikistan's major export routes are through Uzbekistan and Kazakhstan to Russia. Concerns over regional security and drugs have repeatedly disrupted trade flows from Tajikistan through border closures with Uzbekistan.

The country's economy was in a severe recession, Tajik GDP having dropped by about 60% from the level of 1990, the year before the breakup of the Soviet Union. 80-90% of the population lived in poverty. The administrative capacity of the government was in shambles, incomparably worse than today. There were virtually no active foreign aid donors, except for those who provided humanitarian assistance. To make matters worse, Russia's financial crisis in August 1998 hit the prospects for the countries of the Former Soviet Union. So no end of Tajikistan's economic decline seemed in sight. In 1999 GDP in Tajikistan rose by only 3.7%. In the following years, growth was more significant (8.3% in 2000, 10.2% in 2001 and 9.1% in 2002), although it only concerns a narrow section of economic activity<sup>16</sup>.

**Figure 1.1 Trends in Real GDP in Central Asia countries:  
(1989=100)**

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<sup>16</sup> World bank report "Post-Conflict Emergency reconstruction Project" page 26, 1998



Source: Falkingham, 2000

The effects of the Russian crisis, which were transmitted through trade, international transfers, and the banking system, constrained growth in Tajikistan in 1999. In January –September of 1999 GDP increased by less than 1% on the corresponding period of 1998. Higher growth rates resumed only at the end of 1999, due to low base effect and an improvement in world market prices of aluminum, one of the most important export products of the country. As a result, GDP rose by 3.7% in 1999.

The early years of transition from a command to a market-based economy in Tajikistan witnessed a considerable decline in output. Similar to other CIS countries<sup>17</sup>, the contraction has been attributed to a variety of causes, including the dislocation of traditional domestic and international links, and cut-off of transfers from the center. However, growth resumed by 1998, averaging was about 10 percent a year during the period 2000-2004.

As one now looks back on Tajikistan's development since 1998, it turns out that the unexpected happened. President Rakhmon and his government established political stability. Rapid economic recovery began in 1999 and was sustained since then with average economic growth at levels between 7-9 percent per year. This helped to reduce the poverty rate significantly, even as it remains at a high level today (estimated at over 60%). There is now a significant donor presence and aid levels have increased. Economic management capacity, while still severely limited, has improved. In fact, Tajikistan has

<sup>17</sup> Commonwealth of Independent States (CIS) was founded on 8 December 1991.

been rightly hailed as a rare success story of post-conflict reconciliation and reconstruction, especially when compared with its immediate neighbor to the south, Afghanistan.

**Table 1.1 Comparative Economic Indicators in Central Asia countries.**

	<i>Tajikistan</i>	<i>Uzbekistan</i>	<i>Kazakhstan</i>	<i>Russia</i>
GDP (\$US bn)	2.8	16.0	77.2	984.6
GDP per capita (\$US)	401	594	5.016	6.018
GDP per head (\$US at PPP)	1,364	2.229	9.368	12.186
Consumer price inflation (av.%)	11.9	19.8	8.6	9.7
Current account balance \$US	0.0	2.6	-1.8	94.5
Current account balance (%of GDP)	-0.8	16.5	-2.3	9.6
Export of goods FOB	1.5	5.6	38.8	303.9
Import of goods FOB	-2.0	-3.8	-24.1	-164.7
External debt \$US	1.0	4.8	73.5	278.2
Debt service ratio, paid %	4.5	15.1	32.3	13.7

Source: Economist Intelligence Unit, Country Data; 2007.

Since getting Independence<sup>18</sup> Tajikistan has suffered not only from the impact of political, economic and social transition from a planned to market-led economy and the withdrawal subsidies from Moscow following the breakup of the FSU, but it has also experienced a civil war in 1991-97, followed by a long period of civil unrest. The civil war disrupted both agricultural and industrial production. Particularly hard-hit was the cotton industry, a key economic element in the Soviet era. The output of aluminum, Tajikistan's most important industrial product, has never approached the pre-independence level of the early 2000s.

The economy of Tajikistan was faced with various problems after the getting independence which is typical for countries in transition to a market economy: low level of incomes and savings; weak market institutions; an incomplete tax system; and in effectual

<sup>18</sup> The Republic of Tajikistan gained its Independence during the breakup of the Union of Soviet Socialist Republics (U.S.S.R.) on September 9, 1991.

economic structures. With the collapse of the Soviet Union, Tajikistan lost its traditional export markets and import sources, and budget transfers from Moscow. The republic's level of economic development deteriorated sharply: over the period 1991-1996, production volumes fell to 33.1% of their 1991 level; in 1997 GDP was down by more than 60 % on 1991; and the standard of living fell sharply. Signs of economic recovery appeared only in 1997 and 1998, when official statistics pit GDP growth at 1.7% and 5.3% respectively. This modest rise was a consequence of the end of the war and the restoration of basic economy stability.

Tajikistan has embarked on an active process of institutional reform, and market infrastructure is developing. The necessary legal basis for the development of market economy has been established and the system of economic management is being reformed. Much has been done to liberate foreign trade and open the economy. Consistent steps are being taken to join the World Trade Organization. The results achieved thus far are still far from satisfactory in terms of providing an acceptable standard of living for the population, 80% of which lives below the poverty line.

Since 2001, however, the country has enjoyed a period of robust recovery, with GDP growing at an annual average of 8% over the last four years. In 2004 alone, the Tajik economy grew by an impressive 10.6%, the highest growth rate since independence, with industrial production expanding by 14.4%, as higher global demand for aluminum boosted output at the TADAZ smelting plant, and agricultural output rising by 11.3%. This rise in productivity was supported by a dynamic consumer sector, with domestic demand strengthened both by a significant rise in average wages of some 29.1%, and by the sustained level of remittances from Tajik migrants (mostly located in the Russian Federation), which has in turn led to increased investment and contributed to the rapid expansion of the country's service sector. GDP growth has slowed down somewhat in the course of 2005, rising by an estimated 8.5% (IMF), largely as a result of lower aluminum and cotton prices, a global rise in the cost of fuel, and lower agricultural yields. The medium-term prospects for continued robust growth remain good, however, and this is reflected in the increase in government spending to 1.3 billion TJS in 2005, with 46% of this figure earmarked for social expenditure.

As noted above Tajikistan has actively participated in regional organizations such as the Euro-Asian Economic Community (EAEC), Shanghai Cooperation Organization (SCO), Central Asian Cooperation Organization (CACO), and Economic Cooperation Organization (ECO). The EU is also currently trying to establish a regional political dialogue with five Central Asian countries. These organizations have contributed to the harmonization of trade policies, reestablishing economic linkages, and ultimately to the accession to WTO membership. However, in the absence of the active participation of some of Tajikistan's neighboring countries, the benefit of regional cooperation is limited. Tajik traders continue to face delays at the border, high and frequent official and unofficial payments for border crossings and harassment of traders.<sup>19</sup>

This commitment to increased spending on, among other things, public-sector wages, student funds and pensions, is indicative of the priority afforded by the Tajik government to the issue of poverty reduction. A relative degree of success has already been achieved in this sphere, with the rate of poverty having decreased from 81% of the population in 1999 to 64% in 2004. Tajikistan has completed a three year Poverty Reduction and Growth Facility programme (PRGF), agreed and implemented with the support of the IMF, which has played an important role in helping to bring about the greater macroeconomic discipline demonstrated by Tajikistan in recent years. In terms of fiscal policy, this has manifested itself through both an improvement in the system of tax collection (particularly VAT on imports), and a relatively balanced budget (a deficit of 0.5% of GDP is envisaged for 2005) in spite of the marked increase in government spending in the social welfare sphere.

## **1.3.2. TRANSITION TO A MARKET-ORIENTED ECONOMY:**

### **Trends after Independence**

**Tajikistan's transition to a market economy has been challenging.** The implementation of structural reforms was delayed by the multi-year civil war that broke out after independence in 1992 and did not commence until 1997. The country inherits a difficult geography – it is land locked, resource poor, mountainous and faces an

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<sup>19</sup> These payments constitute more than 30 per cent of the total road transport costs from Dushanbe to Moscow, according to the recent IMF report. Cargo needs to be unloaded and reloaded on vehicles with Uzbek licenses plates at the Tajik-Uzbek borders.



unfavorable geo-political backdrop bordered by Afganistan and Uzbekistan. The civil war contributed to the deterioration of the physical infrastructure and an already weak institutional capacity. Despite strong economic growth, averaging 9.6 percent over 2000-2004, Tajikistan remains the poorest economy in CA (Central Asia) with a per capita GDP of \$ 470 in 2006. Poverty has fallen somewhat, but remains high at 64 percent and income inequality has widened since 1999<sup>20</sup>. Lackluster job growth due to demographic factors combined with delayed structural reforms makes it difficult for the population to find employment and earn sufficient income to meet basic needs, especially in the rural areas. A good segment of the population has found its way out of poverty through international migration, primarily to various parts of Russia and Kazakhstan.

Tajikistan has done well since the signing of the peace accord in 1997. It is among the few post-conflict countries that moved quickly from civil war to internal stability and to a functioning government. It has achieved remarkable economic success, averaging 10% growth a year for the past four years. Inflation is under control, the exchange rate stabilized, external debt cut in half, and poverty markedly reduced. Yet, Tajikistan remains the poorest and among the most fragile of the CIS countries, and a continuation of this bright picture is by no means assured.

Tajikistan experienced a drastic decline in output – averaging 20 percent a year during 1990-1994 (Table 1.2). The cumulative decline in real output during the same period was 69 percent. While all other CIS countries were undergoing recovery during 1995-1999, Tajikistan’s output continued to contract, declining by about 7 percent due to the civil war. By the end of the 1990s, the country began to show positive growth rates averaging 10 percent a year in 2000-2004 (the CIS-7 average growth was 7%). Although much of the growth in Tajikistan during the period is based on the recovery of traditional exports (cotton and aluminum), there are signs that new sectors, especially services, are also expanding. Despite these positive developments, output in 2004 was only about 68 percent of its 1990 level.

**Table 1.2. Real GDP Growth in the CIS-7 countries, 1990-2004**

	Average			Cumulative Growth			GDP
	1990-94	1995-99	2000-04	1990-94	1995-99	2000-04	1990-04

<sup>20</sup> According to the World Bank 2003 Poverty Assessment Update, the inequality of consumption expenditure increased from 0.33 in 1999 to 0.36 in 2003.

Armenia	-15.2	5.3	9.9	-63.2	29.7	59.9	78.0
Azerbaijan	-15.6	2.5	10.4	-58.1	11.7	63.8	86.7
Georgia	-24.1	5.9	6.3	-76.6	32.8	35.7	49.6
Kyrgyzstan	-11.4	3.4	4.6	-45.9	17.4	24.9	81.2
Moldova	-17.3	-5.9	5.5	-64.1	-26.8	30.3	35.1
<b>Tajikistan</b>	<b>-20.2</b>	<b>-1.2</b>	<b>9.6</b>	<b>-68.9</b>	<b>-7.1</b>	<b>57.8</b>	<b>67.7</b>
Uzbekistan	-2.8	1.7	2.9	-13.6	9.0	15.2	103.9
CIS (Incl. Tajikistan)	-15.2	1.7	7.0	-57.2	8.4	40.3	
CIS (Excl. Tajikistan)	-14.4	2.2	6.6	-55.2	11.1	37.5	

Source: World Economic Outlook (IMF, 2004)

While Tajikistan's real GDP has rebounded, some sectors (particularly industry) have not fully recovered to their pre-transition production levels. The sectoral contribution of industry and agriculture started declining in 1995, and has continued to be substituted by services, which contribute 35 percent of GDP. The changes in the sectoral composition of GDP are mainly explained by the stagnation of both the agricultural and industrial sectors compared to their pre-transition production levels.

**Diagram 1.1. Tajikistan: Change of GDP by sector**



Source: NBT and Author's own calculating.

Therefore, Tajikistan's economic performance should be further improved to achieve a higher standard of living for the population. Even with a real overall GDP growth rate of 5%, it would require 15 years for Tajikistan to reach pre-independence levels of GDP. According to Diagram 1.1, in 2002 Tajikistan has produced only 43.1% of its GDP in 1989. Moreover, population growth, as in the rest of Central Asia, is rapid. Although demographic increase slowed in the 1990s due to emigration and economic hardship, it remained in the range of 1.5 to 2% during the latter half of the decade. As a result, real GDP growth in per capita terms during the period was well below the overall GDP growth.

### 1.3.3. Gross Domestic Product (GDP)

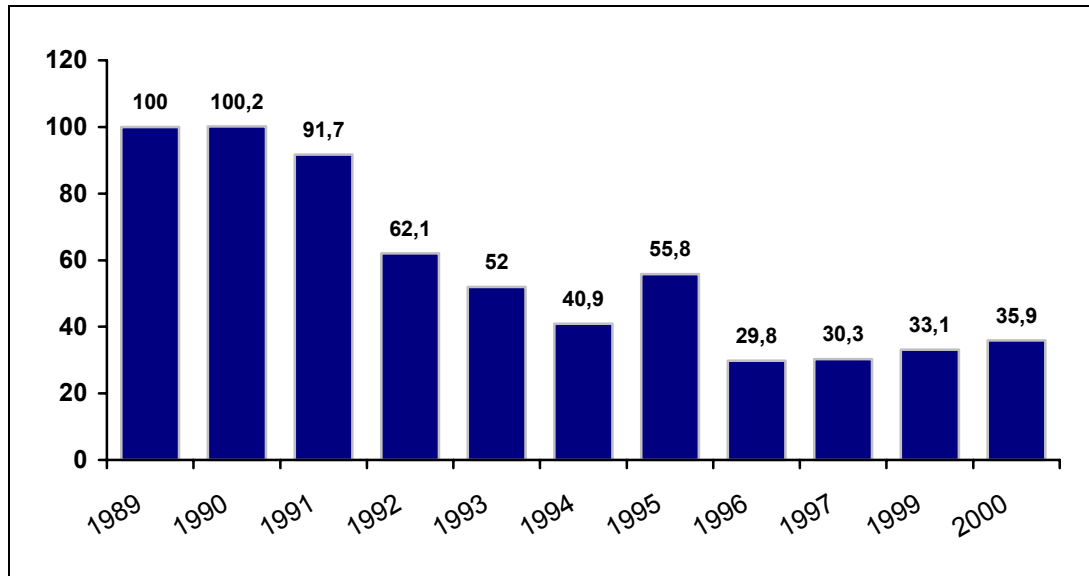
Tajikistan has one of the lowest per capita GDP (\$500) among former Soviet Union Republics and one of the poorest countries in the world. Only 5% to 6% of the land area is arable, though it accounts for approximately 60% of employment and 20% of GDP. Cotton is the most important crop. Services account for 50% and industry for 28% of GDP. Mineral resources, varied but limited in amount, include silver, gold, uranium, and tungsten.

Economic growth reached 10.6% in 2004, but dropped to 7.8% in 2007. Tajikistan's economic situation remains fragile due to uneven implementation of structural reforms, corruption, weak governance, widespread unemployment, seasonal power shortages, and the external debt burden. Continued privatization of medium and large state-owned enterprises could increase productivity. A debt restructuring agreement was reached with Russia in December 2002 including a \$250 million write-off of Tajikistan's \$300 million debt. The economy remains vulnerable due to external shocks because of volatilities in the prices for cotton, aluminum and energy. Remittances play a vital role for the economic wellbeing of the population, and it is estimated, that up to 1,000 Tajiks are working abroad, mainly in Russia, Uzbekistan and Kazakhstan.

The transition toward a market-based economy in Tajikistan and its economic performance after obtaining independence can be divided into two periods: (i) period of deep economic crisis (1989-2000); and (ii) period of initial growth and improving macroeconomic stability (2000- to date).

The main characteristics of *the first period* are a steep fall in GDP, high rate of inflation, substantial unemployment and a widespread increase in the incidence of poverty. Real GDP declined on average at about 15% per annum between 1992 and 1996. In 1996 the total volume of industrial and agricultural output constituted only 34% and 59% of their level in 1991 accordingly. In 1990 Tajikistan's GDP per capita was estimated to be around USD 1,050. Two years later, it dropped by half (USD 480 in 1992) and 4 years later it was only USD 177 (See Diagram 1.2.)

#### **Diagram 1.2. Real GDP Growth in Tajikistan, 1989-2000 (1.1989=100)**



Source: UNECE (2003), Economic Survey of Europe, p.112., Author's own calculating

Economic decline has also resulted in a dramatic increase in unemployment from negligible levels to a high percentage. Although the official rate of unemployment since independence was not more than 5% but the actual unemployment rate was close to 30%. The official statistics grossly underestimate actual unemployment for several reasons. The official data do not account substantial unemployment and underemployment in inactive state-owned enterprises and in rural areas. Moreover, many of the unemployed have not registered as such because of the low unemployment benefits, which are often less than the costs incurred in claiming them.

The slowing down of rate of economic development in Tajikistan particularly *after independence*<sup>21</sup> was due to the following main reasons.

*First*, the initial conditions of Tajikistan after gaining independence in 1991 were on the whole not very favorable for a sustainable development strategy. During the Soviet era Tajikistan had been one of the least affluent republics – in 1990 its GDP per capita was estimated to be the lowest in the Soviet Union. Besides that, like other Central Asian republics, it had (i) a low degree of industrialization and technological development; (ii) predominantly rural population; (iii) a higher degree of poverty than elsewhere in the FSU; and (iv) rapid population growth rate.

<sup>21</sup> The Republic of Tajikistan gained its Independence during the breakup of the USSR on September 9, 1991

*Second*, the break-up of the Soviet Union precipitated the collapse of inter-republic trade arrangements, sharply higher prices for imported fuel products, the sharp decline in demand from other FSU states and brought to an end the generous union transfers from Moscow which according to some estimates had been equivalent to 47% of the total government revenue.

*Third*, the political turmoil and civil war (1992-97) had both permanent and temporary effects on output and productive capacity. Besides damaging or destroying much of the economy's infrastructure, the war disrupted industrial and agricultural production, caused widespread dislocation of the population, all but eliminated foreign investment, and diverted the authorities' attention from much needed economic reforms. It resulted in the loss of about 60,000 lives and the displacement of over 850,000 people. The destruction of physical infrastructure was estimated at USD 7 billion.

*Forth*, there was a series of natural disasters, including flooding in 1992 and 1993 and flooding and mud slides in May 1996 that caused damage to infrastructure and productive assets. These shocks, along with other factors including weak economic management, are what contributed the severe economic crisis of the 1990s.

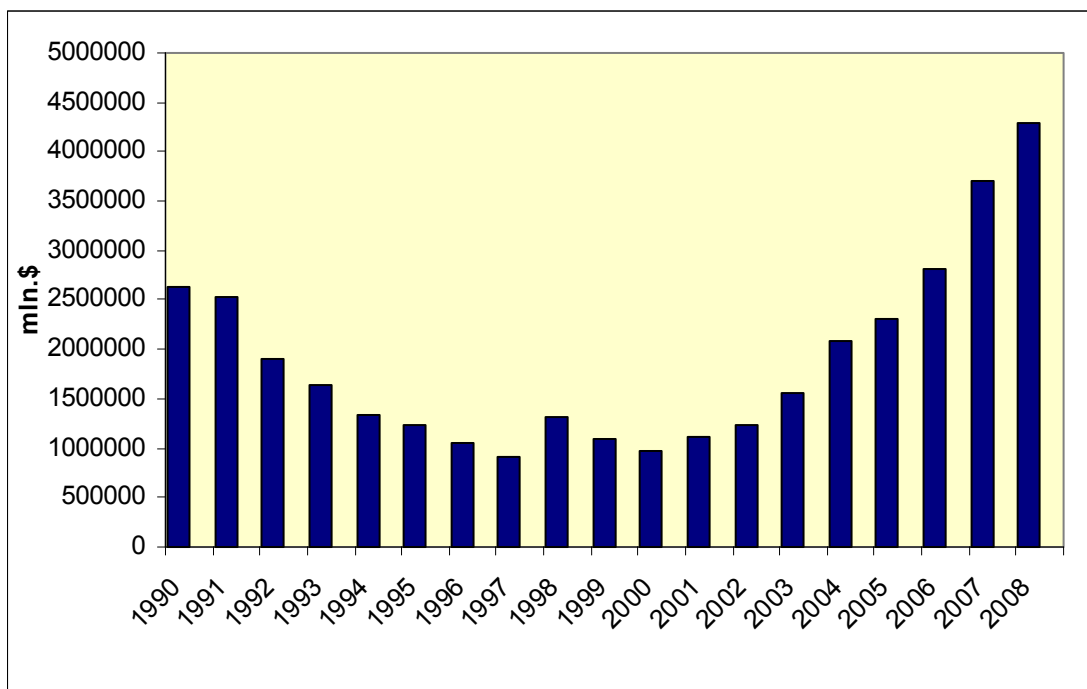
*The second period* related to the signing of a peace agreement between the Government and the United Tajik Opposition (UTO) in June 1997,<sup>22</sup> which established a basis for normalizing the situation. The process of national reconciliation enabled the Government to focus on an economic reform program, which was originally developed in 1996 with the assistance of the IMF and World Bank. The authorities were successful in controlling inflation, and reforms efforts were renewed, with reasonably significant achievements. After five consecutive years of economic contraction from 1992 to 1996, real GDP grew by 1.7% in 1997. GDP growth accelerated further in 1998 until the Russian crisis caused a sharp slowdown of the economy late in the year. Despite this economic downturn, GDP grew by a strong 5.3 % in 1998 (Diagram 1.3).<sup>23</sup>

### **Diagram 1.3. Real GDP Growth in Tajikistan, 1990 – 2008**

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<sup>22</sup> World bank report "Post-Conflict Emergency reconstruction Project" page 26, 1998

<sup>23</sup> EBRD "Strategy for Tajikistan", page 49: 2008



Source: EBRD “Strategy for Tajikistan”, page 49: 2008, NBT; Author’s own calculating

Tajikistan has one of the lowest per capita GDP (\$500) among former Soviet republics and one of the poorest countries in the world. Only 5% to 6% of the land area is arable, though it accounts for approximately 60% of employment and 20% of GDP. Cotton is the most important crop. Services account for 50% and industry for 28% of GDP. Mineral resources, varied but limited in amount, include silver, gold, uranium, and tungsten.

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A debt restructuring agreement was reached with Russia in December 2002 including a \$250 million write-off of Tajikistan's \$300 million debt. The economy remains vulnerable due to external shocks because of volatilities in the prices for cotton, aluminium and energy. Remittances play a vital role for the economic wellbeing of the population, and it is estimated, that up to 1,000 Tajiks are working abroad, mainly in Russia, Uzbekistan and Kazakhstan.

Tajikistan’s macroeconomic performance has improved significantly since 2000. Economic growth has been strong, particularly in the last four years (9.5 % growth on

average), supported by increased production of key commodities (mainly aluminum and cotton) and strong domestic demand fuelled by increasing remittances from Tajiks working abroad, mainly in Russia. In 2002 the total industrial and agricultural growth rates were 8.2% and 15.0 % respectively.

**Table 1.2 Tajikistan: Selected Macroeconomic Indicators, 2005-2008**

(Quota: SDR 87 million; Population: 7 million, 2007; Per capita GDP: US\$561; 2007)

	2005	2006	2007	2008
(Annual percent change, unless otherwise indicated)				
<b>National accounts</b>				
Nominal GDP (in million of TJS)	7,201	9,272	12,780	16,135
Nominal GDP (in million of dollars)	2,311	2,811	3,712	4,300
Real GDP	6.7	7.0	7.8	5.0
CPI Inflation (end of period)	7.1	12.5	19.8	15.0
Unemployment rate	2.1	2.3	2.3	2.3
(In percent of GDP)				
<b>Investment and savings 1/</b>				
Investment	14.8	13.7	22.0	20.8
Fixed capital investment	13.8	12.8	21.1	20.0
Government	7.8	6.8	14.1	14.0
Private	6.0	6.0	7.0	6.0
Gross national savings	12.1	10.9	10.9	10.9
Public	4.9	5.0	7.9	6.1
Private	7.2	9.4	2.9	4.8
Savings/Investment balance	-2.7	-2.8	-11.2	-10.0
(In percent of GDP)				
Revenue and grants 2/	20.1	23.6	21.6	22.4
<i>Of which: tax revenue</i>	16.6	16.5	17.8	18.5
Expenditure and net lending	23.0	21.9	27.8	30.4
<i>Of which: current</i>	15.1	15.0	13.6	15.4
Capital	7.8	6.8	14.1	14.0
Balance (excluding externally-financed PIP) 2/	0.5	0.8	1.6	0.0
Balance (including externally-financed PIP)	-2.9	1.7	-6.2	-8.0
Domestic financing	0.3	-3.3	-0.7	0.8
External financing	2.6	1.6	6.9	7.2
(12-month growth in percent of broad money, unless otherwise indicated)				
Net foreign assets of the banking sector 3/	-70.3	25.1	6.4	7.7
Net domestic assets of the banking sector 3/	129.6	87.5	112.7	40.8
Broad money 3/	30.2	63.4	78.8	24.7
Reserve money (12-month percent change)	29.2	49.2	40.3	23.8
Velocity of broad money (eop)	2.3	1.8	1.4	1.4
Interest rate (NBT bill rate, in percent)	7.0	7.7	7.3	...
(In million of \$US, unless otherwise indicated)				
<b>External sector 4/</b>				
Export of goods and services	601	656	767	856
Percent change	...	9.1	16.9	11.6
Import of goods and services	1,221	1,618	2,555	3,188
Percent change	...	32.5	57.9	24.8
Current account balance	-6.2	-79	-414	-429

Percent of GDP	-2.7	-2.8	-11.2	-10.0
Trade balance (in percent of GDP)	-26.9	-35.1	-45.1	-50.9
FDI (in percent of GDP)	2.4	2.3	4.3	4.2
Official transfers (in percent of GDP)	3.5	2.9	1.8	1.4
Total public and publicly guaranteed external debt	897	910	1,231	1,492
Percent of GDP	38.8	32.4	33.2	34.7
Gross official reserves 5/	91	111	107	169
Months of imports (excl. imports financed by loans from China)	0.9	0.7	0.5	0.8
<b>Memorandum items:</b>				
Nominal effective exchange rate (Index 2000=100)	58.7	54.8	50.6	...
Real effective exchange rate (Index 2000=100)	88.9	86.5	83.9	...
Average exchange rate (TJS per dollar)	3.12	3.30	3.44	...

1/ Private investment and savings are estimates. Investment includes changes in stocks.

2/ 2006 overall balance excludes the MDRI debt relief that is reflected in grants. PIP expenditure includes investment financed by loans from China.

3/ Actuals are based on official exchange rates.

4/ Starting from 2005, the export and import figures reflect the transition to tolling arrangement for aluminum exports. Therefore, the export and import figures are lower than earlier years.

5/ Gross reserves are net of the pledged deposits of the NBT.

Source: National Bank of Tajikistan and State Committee on Statistics of Tajikistan; [www.nbt.tj](http://www.nbt.tj), [www.stat.tj](http://www.stat.tj)

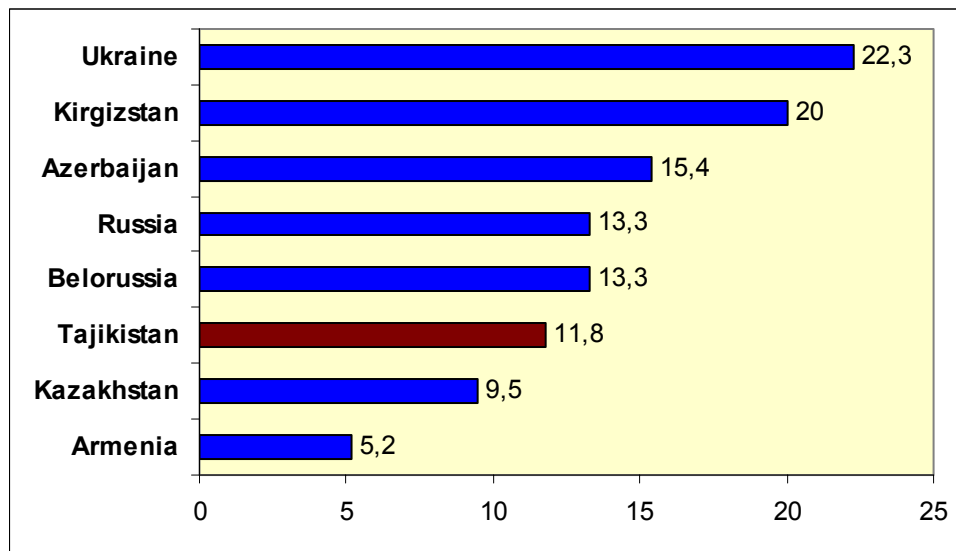
However, despite five years of relatively strong economic growth in Tajikistan, the effects of this recovery have not trickled down to the majority of population. Tajikistan is in danger of losing one of the important assets it has on which to build its future: its human capital. High levels of poverty (according to the World Bank, more than 80% of the population lives below poverty line), an inadequate of social protection, deterioration of health and education services, high rate of unemployment (according to unofficial sources, more than 30%) and extremely low level of public sector average wage (USD 10) are the country's top development agenda. 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.

### 1.3.4. Inflation



Hyperinflation had characterized all the FSU economies in the ruble zone after the breakup of the FSU. Many transition economies have succeeded in reducing very high inflation rates to 1520 percent annually. But few have succeeded in achieving inflation rates below 10 percent on a sustained basis. In 2008 inflation rate in FSU countries achieved this level:

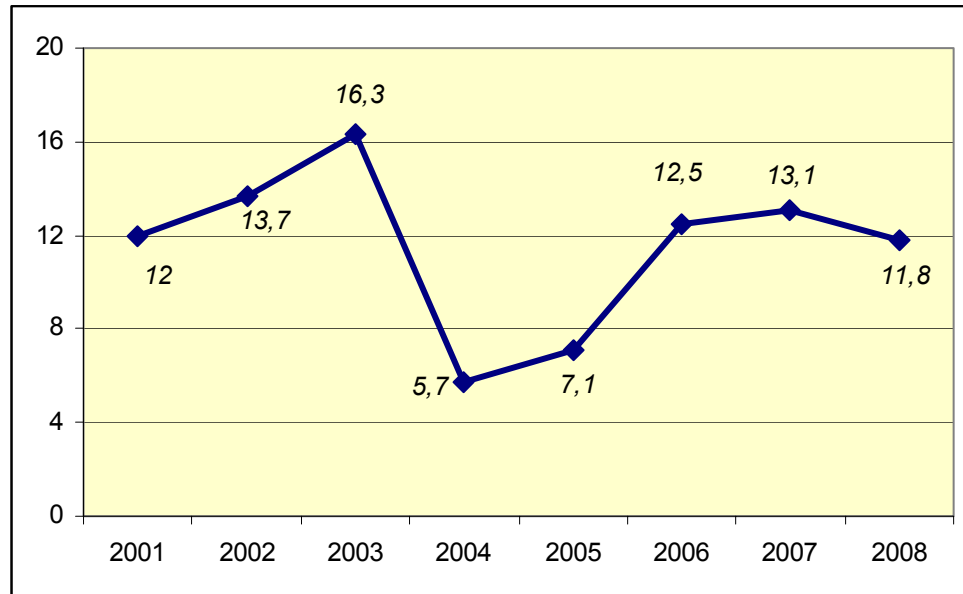
**FSU countries inflation, 2008**



Source: NBT and Author's own calculating. 2008

The major factors contributed to inflationary pressures in 2008 in Tajikistan were the income growth of the population relative to the growth of production and the increase of tariffs in services. Inflation pressured stem from higher food and fuel prices, increased utility and transport tariffs and strong consumer demand due to a near doubling in workers' remittances. In response to the inflation pressures, the NBT tightened its lending to the financial sector. Tajikistan has a managed floating exchange policy, intervening only to smooth out sharp fluctuation. The evaluation of annual inflation in Tajikistan during 1992-96 reflects the momentum of the broader economic crisis. In 1990, the inflation rate was 5.9%. After independence, inflation jumped to 1157% in 1992, remaining 418% through 1996 (See Diagram 1.4). Political instability, price liberalization, monetization of large fiscal deficit and the lax monetary policy were the main causes of high inflation in the country.

**Diagram 1.4. Inflation rate variation, 2001-2008**



Source: EBRD and Tajikistan: Transition Indicators. 2008; NBT 2009.

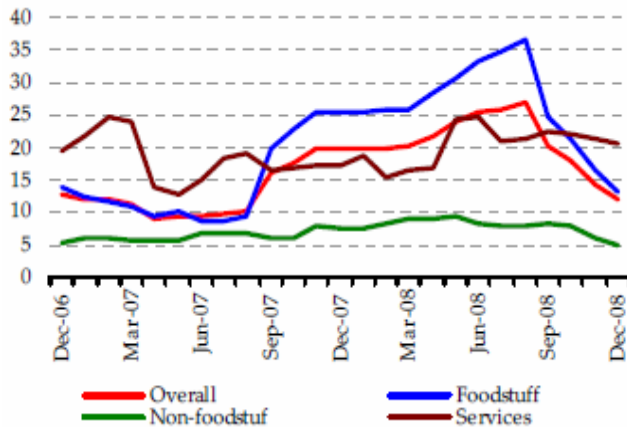
After 1991 economy of Tajikistan survived several explosion of high inflation provoked by civil war and huge budget deficit. Consequently country's financial structure was destroyed and personal savings were almost depreciated in value. Overall, economic activity slowed down substantially in the immediate aftermath of the Russian crisis on August 17, 1998. It was exacerbated by the global recession of 1998, which started with the Asian financial crisis in July 1997. Financial default was a hard hitting blow to the Tajik economy. The crisis cost a lot for Tajikistan: devaluation of tajik ruble, extreme rise of domestic prices, huge downward pressure on the balance of payment and heavy losing gross reserves of National Bank of Tajikistan.

Average inflation in 2007 was 13.1%, but the year-end rate came in at 19.7% (Figure 1.2A). Inflation pressure stemmed from higher food and fuel prices, increases in utility and transport tariffs, and strong consumer demand on the back of a near doubling in workers' remittances. Prices of wheat—the major staple—jumped in September 2007, following the pattern of price escalation in other Central Asian countries. (Tajikistan imported about one half of its wheat from Kazakhstan.) Wheat prices rose by about 80% in 2007, and were the main driver of inflation, as the weight of wheat is about one tenth of the consumer price index basket.

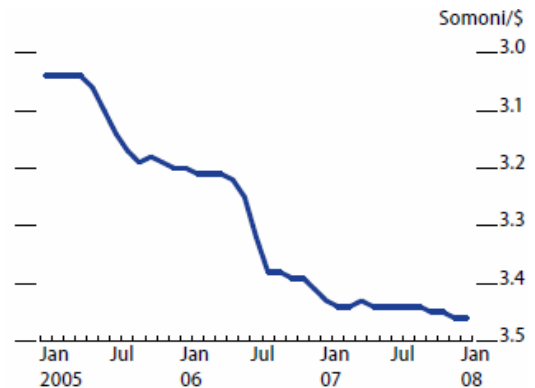
Utility prices climbed steeply in 2007. Natural gas prices rose by 60%, owing to higher prices for imports from Uzbekistan. Electricity tariffs saw a 50% adjustment, as part

of a multiyear plan to bring tariffs to levels that would justify badly needed investment in new generation capacity by foreign investors.

**Figure 1.2 A. Inflation 2006-2008**



**1.2 B. Nominal Exchange Rate 2008**



Source: National Bank of Tajikistan. 2008

In response to the inflation pressure, the National Bank of Tajikistan tightened its lending to the financial sector. Monetary policy, however, is constrained by weak institutional capacity, the underdeveloped nature of the financial sector, and the continued reliance on the central bank for directed lending, mainly to the cotton sector. Tajikistan has a managed floating exchange rate policy, intervening only to smooth sharp fluctuations. In 2007, the nominal exchange rate was stable at around TJS3.44/\$1 (Figure 1.2B).

## 1.4. The Current account in the Balance of Payment.

The official source of data on balance of payment in Tajikistan is the National Bank of Tajikistan (NBT). However, when the balance of payments first began to capture massive private transfers through the banking system, it became clear that Tajikistan depends largely on inflows of remittances from labor migrants. Within the last year, the role of outward labor migration and incoming remittances has been increasing for the socioeconomic development of Tajikistan. The estimated value of total remittances in 2006 through official channels in Tajikistan was 1.13 billion US dollar; the volume of foreign direct and portfolio investments in Tajikistan was equal to 385 million US dollar; and revenue of the state budget amounted to 487 million US dollar. So far, inflows of remittances through formal channels exceed all these financial indicators.

**In 2005 the current account deficit was \$ 86 million, having shown a general downward trend since the late 1990s.** In 2005 the overall balance of payment was \$14 million. The balance of payment showed a surplus through September 2008, largely because of an increase in remittances by 70 percent over the same period in 2007. The current account deficit averaged about 3 percent of GDP during 2002-2006, but tripled in 2007. In the few years, worker remittances – about 38 percent of GDP in 2007 have become the main source of foreign exchange overtaking receipts from cotton and aluminum exports. Most remittances originate in Russia, thus negative downturns in the Russian economy could substantially affect these inflows<sup>24</sup>. Reflecting the impact of pledges and guarantees for cotton financing, the NBT's international reserves fell to very low levels at end-2007 (about ½ month of import or less than one fifth of dollar-denominated deposits). The national currency is de-facto pegged to the US dollar.

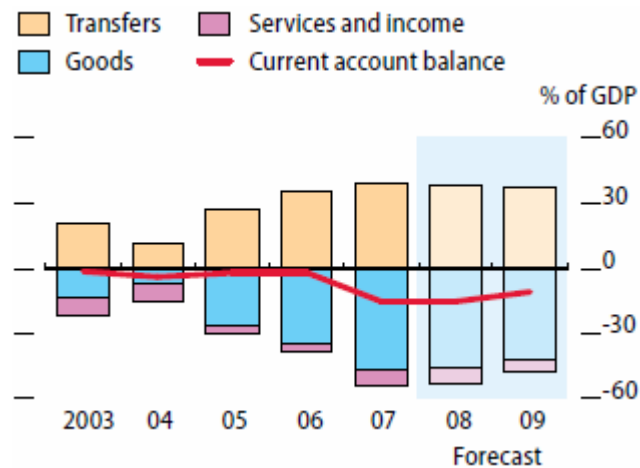
**The current account deficit widened sharply to 11.2 per cent of GDP in 2007, from 2.8 per cent in 2006.** This primarily reflected the increased imports of goods and services associated with public investment programmes funded by the Chinese Export-Import Bank. Strong remittance inflows (39 per cent of GDP in 2007) continued to offset the large trade deficit of 45.1 per cent of GDP in 2007. However, the reserves of the central bank – US\$ 348 million at the end of 2007 – were almost exhausted by pledges and guarantees (US\$ 241 million and US\$ 77 million, respectively) made against loans provided by foreign commercial banks for cotton pre-financing.

The current account deficit is set to be wide at about 15% of GDP this year and then moderate in 2009 (Figure 1.3.). Import growth will largely reflect the schedule for ongoing infrastructure implementation. Export growth is likely to decelerate, perhaps averaging about 10%, though workers' remittances are expected to continue rising healthily. Project loans and FDI are seen fully covering the current account deficit and providing moderate additions to official reserves.

### **Figure 1.3. Current account indicators. 2003-2009\***

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<sup>24</sup> Remittances are typically relatively stable and counter-cyclical (flows tend to increase in times of hardship in the recipient country), but are highly dependent on economic performance in the host country.



Source: International Monetary Fund.

Domestic demand was fueled by burgeoning private consumption expenditure and by rising project investment. Strong private consumption is evidenced by double-digit growth in consumer goods imports, as households receiving migrants' remittances spent more. Such recipients are also starting to invest in housing and in small businesses. Investment activity is mainly directed to large government infrastructure projects, which are funded by bilateral loans and foreign direct investment (FDI) on a joint-venture basis. Private sector FDI is yet to take off, against a background of multiple obstacles to doing business.

Progress on structural reforms has been patchy. In agriculture, the growing farm debt in the cotton sector and the protracted approach for its resolution and for implementation of comprehensive sector reform are symptomatic of difficulties. Also, poor farmer incentives and rent seeking continue to hobble a major part of the economy. In power though, the Government has started to adjust electricity tariffs to cost-recovery levels and to provide a compensatory mechanism for the poor.

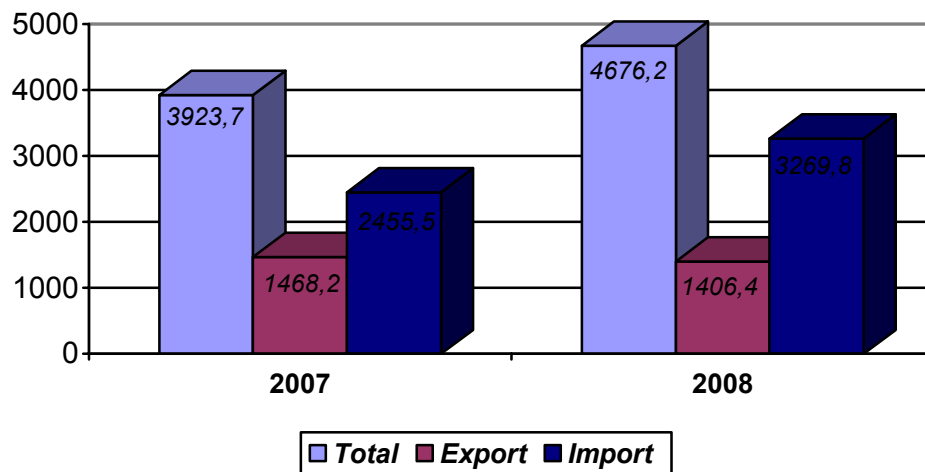
### 1.4.1. Foreign Trade Balance

Tajikistan remains dependent on sales of aluminium, cotton and electricity for most of its export revenue. Aluminium exports will increase only moderately in volume terms in 2008-2009, owing to capacity constraints, and revenue from these exports will suffer from a fall in global prices in 2009. Continued declines in raw cotton output will also dampen revenue from sales of cotton fibre. Combined with the impact of the domestic energy crisis on electricity output, these factors are expected to produce only sluggish growth in export revenue in 2008-2009. Although foreign investment into Tajikistan is increasing, it is

concentrated in infrastructure and energy, and is not expected to boost export revenue until towards the end of the forecast period. High global energy and food prices, in combination with the rising price of gas from Uzbekistan, will push import costs upwards in 2008-09, particularly in view of shortages of both power and food within the country. Imports of capital goods are likely to rise as development of the energy sector intensifies.

**Foreign trade activities:** For January-September, 2008 the foreign trade turnover for period made \$3 544,1 mln., of which 32,4% falls on the share of export and 67,6% of import. The trade balance deficit for this period reached \$1 250,5 mln., having increased against the same level of last years by 2,2 times (Diagram1.5.)

**Diagram 1.5. Tajikistan: Foreign trade for January-September 2008**



Source: National bank of Tajikistan; 2009

The Republic of Tajikistan had foreign trade relations with 68 countries of the world, from which 11- CIS countries and 57 - countries of the far abroad. Export of goods in January-February has made 247,0 million dollars, that is more by 18,8% or by 39,1 million dollars, than for the same period of 2006.

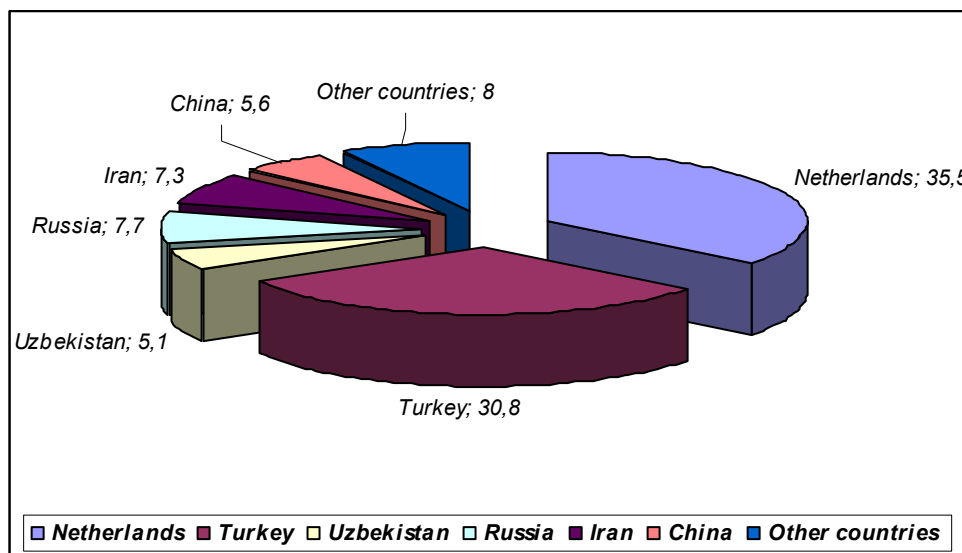
Import of the goods into the country has made 334,3 million dollars, that is more by 37,5% or by 91,1 million dollars, than January-February of the last year. As a whole, import has exceeded export by 35.3% or by 87,3 million dollars.

**Aluminum and cotton, the traditional economic mainstays, failed to drive expansion in 2007-2008.** Growth in aluminum output (up by only 1.5%), as well as in chemicals, was hit by higher prices of imported natural gas from Uzbekistan and by

electricity shortages stemming from shortfalls in hydropower generation. Cotton performed even worse: production fell by 4%, reflecting both a reduction in the planted area and declining productivity. The protracted approach to land reform and the lack of progress in solving the long-standing problem of a large debt overhang owed by cotton farmers created disincentives for production of that crop. Export of goods in January-February 2007 has made 247,0 million dollars, that is more by 18,8% or by 39,1 million dollars, than for the same period of 2006.

**The basic partners on export are:** the Netherlands, Turkey, Uzbekistan, Russia, Latvia, Kazakhstan, Switzerland, Afghanistan, Italy, Iran, China. (Diagram 1.6.)

**Diagram 1.6. Basic partner on export Tajikistan. 2008**

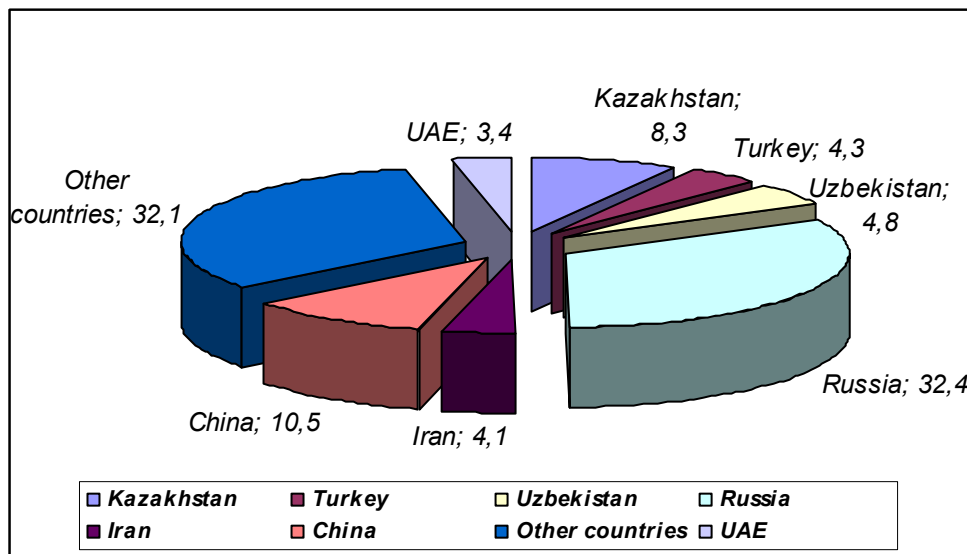


Source: National bank of Tajikistan; 2009

Rapid expansion elsewhere compensated. Industry nearly doubled its growth rate to 9.9%, with double-digit rates in almost all subsectors (except aluminum and electricity). Expansion in food processing, textiles, and construction materials was especially buoyant. The power shortages had little impact on food processing because it was given supply priority, for food security reasons. Robust growth in non-cotton sectors lifted agriculture's growth to 6.5% from 5.4% in 2006; the major drivers were higher production of livestock and of fruits and vegetables. Services sector growth of 8.0% was led by trade, construction, and finance, reflecting growing consumer spending and demand generated by an increasing range of infrastructure projects.

**Import in 2008** was carried out, basically from the CIS countries: Russia, Kazakhstan, Uzbekistan, Azerbaijan, Turkmenistan, Ukraine, Kyrgyzstan, Belarus. From the countries of the far abroad: China, Italy, the United Arab Emirates, Jamaica, Lithuania, Greece, Turkey and Latvia, Iran, Republic of Korea, Germany, Finland, Estonia, and the USA. (Diagram 1.7)

**Diagram 1.7. Basic import partner Tajikistan. 2008**



Source: National bank of Tajikistan; 2009

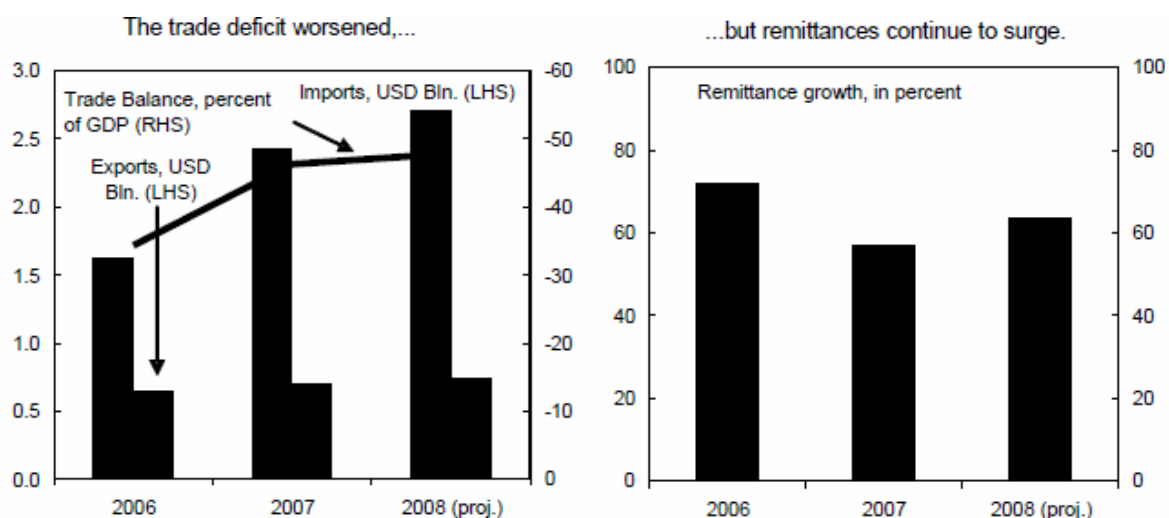
Tajikistan’s GDP increased 9.1 percent a year from 2000 to 2008, but the real growth of GDI (gross domestic income) was only 0.6 - 0.8 percent. This represented a terms-of-trade loss of 8.5 percent, the largest of any economy over the period<sup>25</sup>.

In January - September, 2008 foreign trade turnover of the RT, including the electric power and natural gas, has made 3544,1 million US dollars, that on 24,0 % is more than for January - September, 2007, or on 685,4 million US dollars. The negative trading balance has developed and has made 1250,5 million US dollars. Tajikistan had foreign trade relations with 92 countries of the world, from them 11 CIS countries and 81 countries of the far abroad.

**Figure 1.4. Trade Balance Deficit, 2006-2008**

<sup>25</sup> A portrait of Global Economy; World Bank report: page 195, 2008





Source: IMF; Country Report: No 08/382: December 2008

To the CIS countries in the foreign trade turnover belong 43,2 %, or 1532,3 million dollars, on the countries of the far abroad - 56,8 %, or 2011,8 million dollars. Deficiency of trading balance with the CIS countries has made - 1198,6 million dollars, with the countries of the far abroad - 51,9 million dollars.

**Export of goods** in January - September, 2008 has made 1146,8 million dollars, that on 4,8 %, or on 52,5 million dollars is more, than for the same period of 2007.

**Import of the goods** into the republic has made 2397,3 million dollars, that on 35,9 %, or on 633,0 million dollars is more than for January - September, 2007.

In comparison with August, 2008 export in September, 2008 has decreased for 11,9 %, and import 20,8 %. In export advantage belongs to the countries of the far abroad and makes 85,5 %, or 980,0 million dollars. In import - 57,0 %, or 1365,5 million dollars belong to the CIS countries. As a whole the volume of the foreign trade turnover in January - September, 2008 in comparison with January - September, 2007 with the CIS countries has increased for 18,3 %, or on 236,8 million dollars, and with the countries of the far abroad on 28,7 %, or on 448,7 million dollars.

**The share of the electric power** in the foreign trade turnover has made 3,2 %. On operative data of "Barki Tojik", in January - September, 2008 its **export** has made 3538,6 million kw/h. for the sum of 48,3 million US dollars.

**Import of the electric power** has made 3951,3 million kw/h. for the sum of 64,1 million dollars, that is on 32,5 %; or on 15,7 million dollars is more than export. The basic

power trading partner is Uzbekistan, which has delivered in January - September, 2008 of 3040,8 million kw/h., for the sum of 45,6 million dollars.

**Import of natural gas** into the Republic of Tajikistan has made 381,9 million cubic meters for the sum of 55,4 million dollars and has increased in relation to January - to September, 2007 at cost for 33,4 %, or on 13,9 million dollars, and on volume has decreased for 8,0 %; or on 33,3 million cubic meters.

**Export of cotton-fibre** to total amount of export of goods has made 7,1 %, it is sold abroad of 60,8 thousand tons for the sum of 81,9 million dollars, that in comparison with January - September, 2007, is less on 11,8 thousand tons and at cost is more on 3,8 million dollars. The cotton-fibre, basically, is exported to Russia (39,0 %), to Iran (26,3 %), Uzbekistan (8,8 %), Latvia (8,7 %), Bulgaria (6,0 %), Turkey (4,4 %), Belarus (3,8 %), Ukraine (2,5 %), China (0,3 %), the Great Britain (0,2 %). The average price for cotton-fibre in comparison with January - September, 2007 has increased for 270 dollars and has made 1346 dollars per ton.

From products of a phyto-genesis in export prevail fruits, by total cost in 23498 thousand dollars and vegetables - for the sum of 12151 thousand dollars, and in import wheat - on 34552 thousand dollars and flour - on 111710 thousand dollars. The basic partners **on export of goods** were: the Netherlands - 35,5 % from total amount of export, Turkey - 30,8 %, Russia - 7,7 %, Iran - 7,3 %, China - 5,6 %, Uzbekistan - 5,1 %, Afghanistan - 2,0 %, Switzerland - 1,7 %, Italy - 0,8 %, Kazakhstan and Latvia on 0,6 %, Belarus, Bulgaria and Poland - 0,4 %.

**Import** was carried out basically from the CIS countries: Russia - 32,4 % from total amount of import, Kazakhstan - 8,3 %, Uzbekistan - 4,8 %, Ukraine - 3,3 %, Belarus - 2,6 %, Azerbaijan - 2,5 %, Turkmenistan - 1,8 %, Kyrgyzstan - 1,2 %, from the countries of the far abroad: China - 10,5 %, Turkey - 4,3 %, Iran - 4,1 %, the United Arab Emirates and Lithuania - 3,4 %, Afghanistan - 2,2 %, Bosnia and Herzegovina and Italy - 1,7 %, India - 1,6 %, the USA - 1,3 %, the Republic of Korea - 1,2 %, Germany - 1,0 %, Greece - 0,9 %, Poland and Latvia - 0,6 %, the Great Britain and Australia - 0,5 %, Norway and the Netherlands - 0,4 % and others.

Significant excess of export over import was observed in trading operations with the Netherlands (396,7 million dollars) and Turkey (250,7 million dollars).

## 1.5. Remittances Inflow in Financial Sector of Tajikistan

Since market transition in 1991, Tajikistan has experienced high levels of migration. Early emigration was motivated by war and the conflict following independence, while more recent migration has been motivated by economic factors. There are different estimates of both the number of Tajik labor migrants working abroad and remittances they send to Tajikistan. Majority of Tajik labor migrants work in the Russian Federation. Official statistics seem to underestimate the actual number of labor migrants, but Tajik authorities acknowledge that about 400,000 of the country's labor migrants are in the Russian Federation. Russian estimations are significantly higher, exceeding 1.5 million<sup>26</sup>. According to the International Organization for Migration (IOM), more than 632,000 Tajiks had left their homeland and are working abroad<sup>27</sup>. (Population Oct. 2007 est.): 7,181,400.

Labor migrants' remittances have played an important role as one of the drivers of Tajikistan's robust economic growth during the past several years. The volume of official remittances has significantly increased since 2001 and now is estimated at \$1.5 billion (36% of GDP) in 2007<sup>28</sup>. Remittances have become the most important source of external financing for the balance of payments, have increased incomes, and as a result helped reduce poverty.

**Remittance Flows in Tajikistan:** Workers remittances reported in the balance of payment have risen sharply during the past few years and are large as a portion of GDP (see Figure 1.6.)

Until recently, less attention has been paid to the role of incoming remittances in the economy of Tajikistan. However, when the balance of payments (BOP) first began to capture massive private transfers through the banking systems, it became clear that Tajikistan depends largely on inflows of remittances from labor migrants. Within the last

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<sup>26</sup> *Asia-Plus Newspaper*. 2006. No. 51 (361). December 21.

<sup>27</sup> *International Organisation for Migration News*. 2004. p.19, June.

<sup>28</sup> Source: WORLD BANK

<http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/TAJKISTANEXTN/0,,contentMDK:20630697~menuPK:287255~pagePK:141137~piPK:141127~theSitePK:258744,00.html>

year, the role of outward labor migration and incoming remittances has been increasing for the socioeconomic development of Tajikistan.

The estimated value of total remittances in 2006 through official channels in Tajikistan was 1.13 billion US dollar; the volume of foreign direct and portfolio investments in Tajikistan was equal to 385 million US dollar; official development assistance (ODA), including humanitarian as well as technical assistance and other grants was 124 million US dollar; and revenue of the state budget amounted to 487 million US dollar. So far, inflows of remittances through formal channels exceed all these financial indicators.

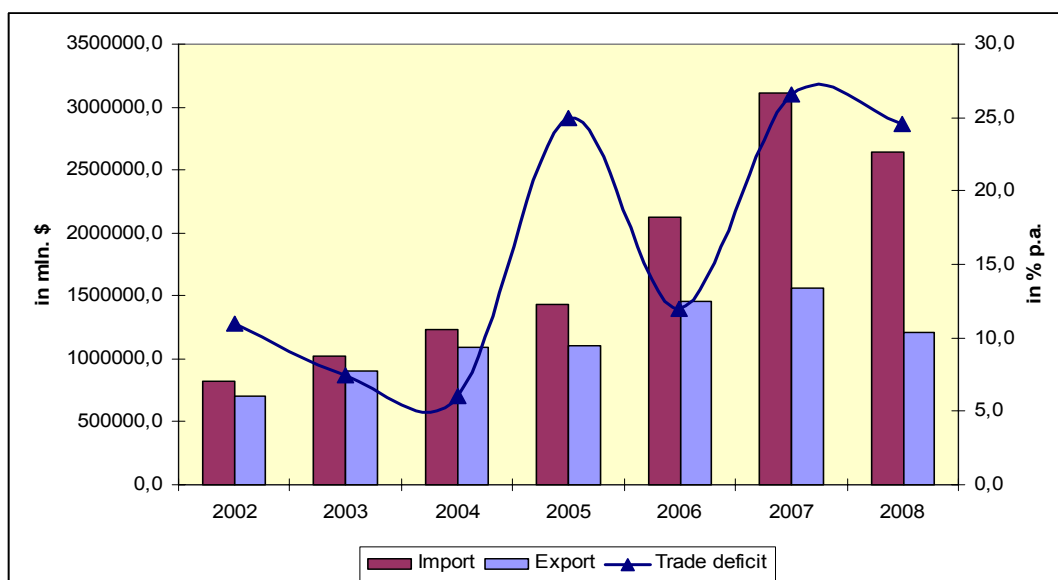
Increasing remittance inflow to Tajikistan has been influenced by two factors. First, there has been a swift increase in migration of Tajik workers to the Russian Federation because of its robust economic growth and quickly growing labor demand, due to a construction boom, coupled with large wage differentials. Second, the macroeconomic stabilization and strengthening of the financial sector, after the financial crisis of 1998-1999, created in the early 2000s a better environment for expanding financial services, particularly an increased activity of money transfer operators (MTO) and a surge in money transfers via this channel. This made a considerable part of long-existing flows visible for everybody. Both these trends developed further from 2004 to 2007.

The National Bank of Tajikistan (NBT), which is responsible for compiling BOP statistics, does not report data of migrants' transfers and compensation of employees due to lack of information. In particular, difficulties in determining residency issues make it impossible to present accurate figures. In the analytical tables of the SSCI (State Statistical Committee of Tajikistan), there is no indication of remittances anywhere in the BOP. NBT publishes data on remittances, but its methodology is not clear and the numbers do not match figures published in the official documents of the International Monetary Fund (IMF) and the World Bank (WB).

Following the collapse of the economic system based on the state property and central planning, shuttle trade largely replaced official trade – implemented by legal entites

– with regard to import and, later export of goods<sup>29</sup>. This modality required traders to bring with them large amounts of money (either in cash or via financial system channels) from Tajikistan to other countries. At present, nearly 80% of Tajikistan’s negative trade balance is covered by incoming remittances<sup>30</sup>. This analysis of Tajikistan’s foreign trade shows that for the period 2002-2006, external trade indicators had positive dynamics. (See Figure 1.5)

**Figure 1.5. External Trade of Tajikistan, 2002- 3Q 2008**



Source: Based on operative Customs Data for 2005 and Country Report of Tajikistan. 2007-2009. “The economist Intelligence” Unit.p.26.March.

In Tajikistan, domestic consumption exceeds the volume of domestic production for many goods, which leads to prevalence of import over export. According to the International Monetary Fund (IMF) estimation, the volume of imports in Tajikistan has been increased, on the average, at 15% per annum. Taking into account that a negative trade balance is mainly covered by incoming remittances, it would be difficult to imagine sustainability of the large trade deficit without this source of foreign exchange.<sup>31</sup>

<sup>29</sup> See, for example, the study on Central Asia: *Increasing Gains from Trade through Regional Cooperation in Trade Policy, Transport, and Customs Transit* (ADB 2006).

<sup>30</sup> Asia-Plus Newspaper. 2007.No 51(361). October 12

<sup>31</sup> At the same time, remittance inflows worsen the trade balance inasmuch as they lead to appreciation of the real exchange rate, boost imports, and reduce export.

### 1.5.1. Measuring Remittances in Tajikistan

As a result of an increase in outward migration, inflows of remittances to Tajikistan have also increased. Due to existing difficulties in data collection, weaknesses of the methodology for determining remittance flows and the presence of informal channels in Tajikistan, reliable information on the magnitude of remittances is scant. To tackle the issue of remittances and their impact on the economy of Tajikistan, it is necessary to analyze what the financial flows associated with remittances in the country are.

The following components of BOP statistics have been specially mentioned in this context (Adams and Page 2003; Harisson2003; Migration Policy Institute 2003):

- Compensation of employees;
- Worker's remittances;
- Migrant's transfers

According to the IMF's *BOP Manual*<sup>32</sup>, compensation of employees is a components of income, while workers' remittances are a component of capital transfers, which is part of the capital account.

1. *Compensation of employees* comprises wages, salaries, and other benefits earned by individuals in economies other than those in which they are residents, for work performed and paid for by residents of those economies.

2. *Workers' remittances* cover current transfers by migrants who are employed in new economies and considered residents there. A migrant is a person who comes to an economy and stays there, or it expected to stay, for a year or more. Workers' remittances often involve related persons.

3. *Migrants' transfers* are contra-entries to the flows of goods and changes in financial items that arise from the migration of individuals from one economy to another. The trend of remittances inflow in Tajikistan according to this methodology is presented in Table 1.3.

**Table 1.3. Remittance Inflow in Tajikistan's BOP (thousand\$), 2001-2006**

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<sup>32</sup> *Balance of Payment (BOP) Manual*, 5<sup>th</sup> edition, pp.70-75. International Monetary Fund.

	2001	2002	2003	2004	2005	2006
<b>Compensation of employees – net</b>	(153.7)	(295.8)	(12.1)	(37.3)	156.7	1,723.1
Credit (inflow)	183.2	149.5	49.8	25.5	1,442.0	3,854.8
Debit (outflow)	336.9	445.3	61.9	62.8	1,285.3	2,131.7
<b>Workers’ remittances – net</b>	(647.7)	65,487.7	81,595.9	133,067.3	321,028.0	622,141.1
Credit (inflow)	4,197.2	78,413.3	145,974.6	251,976.6	465,210.3	1,014,988.4
Debit (outflow)	4,844.9	12,925.6	64,378.7	118,909.3	144,181.7	392,847.3
<b>Migrants’ capital transfers – net</b>	15,172.0	45,397.4	13,870.0	25,500.0	0.0	99,866.4
Credit (inflow)	15,172.0	45,397.4	13,870.0	25,500.0	0.0	99,866.4
Debit (outflow)	0.0	0.0	0.0	0.0	0.0	0.0
<b>Total remittances – net</b>	14,370.6	110,589.3	95,453.8	158,530.0	321,184.7	723,730.6
<b>Credit (gross inflow)</b>	19,552.4	123,960.2	159,894.4	277,502.1	466,652.3	1,118,709.6
<b>Debit (gross outflow)</b>	5,181.8	13,370.9	64,440.6	118,972.1	145,467.0	394,979.0

BOP = balance of payments, NBT = National Bank of Tajikistan, US = United States, \$ = dollar.  
Source: BOP Department, NBT.

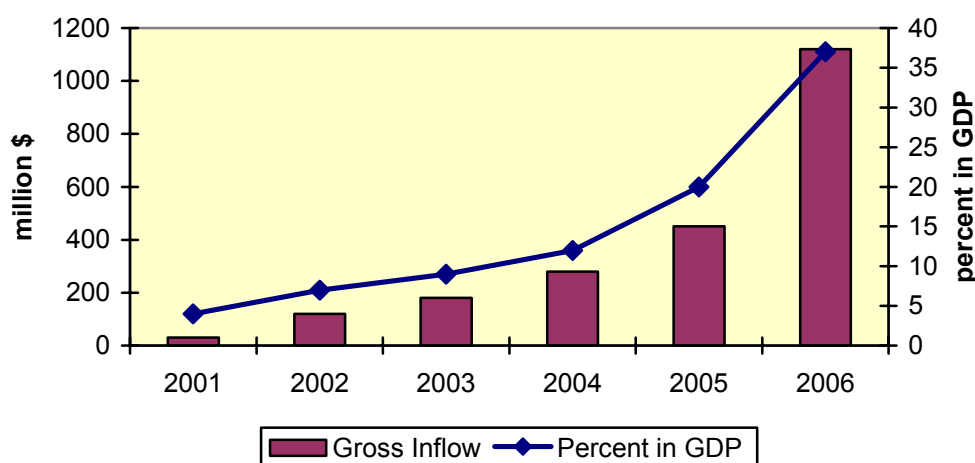
Incoming international money transfers recorded in Tajikistan’s BOP as remittances in fact represent a mixture of remittances and export proceeds. According to estimate of NBT specialists, such trade-related payments may represent up to 10-15% of incoming money transfers recorded as remittances, which would imply an overestimation of remittances in BOPs.

Based on a survey of banks and their clients, NBT has established the following statistical treatment of money transfers: all single transfers of less than \$1,000 plus 50% of transfers between \$1,000 and \$3,000 would be considered workers’ remittances; all transfers of more than \$3,000 and 50% of transfers between \$1,000 and 3,000 would be reclassified as exports.<sup>33</sup> However, it is not clear what the basis of this methodology is.

*Remittance inflows* to Tajikistan demonstrated very fast, exponential growth in 2002-2006. This dynamics has been mainly driven by inflow of remittances through formal channels. Until October 2002, there was a tax on incoming remittances in Tajikistan equal to 30%. Therefore, remittance senders favored unofficial transfers of money which were not tracked by surveys or by other means. After the abolition of this tax, a significant increase in inflows of remittances through official channels occurred. In 2003, the annual volume of remittances coming in through banks and MTOs to Tajikistan was equal to \$253.6 million, in 2004 - \$433.5 million, in 2005 – 664.0 million, and in 2006 - \$1,120.1 million.

**Figure 1.6. Gross Inflow of Remittances to Tajikistan, 2001-2006**

<sup>33</sup> Data of the National Bank of Tajikistan (NBT).



Source: NBT and estimated by author

Remittance inflows have become the second largest source of foreign currency for the country after exports of goods. In 2002-2006, remittances receipts grew much faster than exports of goods and services, FDIs, and ODA. The ratio of remittances to GDP (at market exchange rate) has also been growing. In 2002, it was at 6.4%, 2003 – 9.4%, 2004 – 12.2%, 2005 – 20.1%, and in 2006 inflow of workers’ remittances was preliminarily estimated at 39.1% of GDP. Importance of remittances relative to other sources of foreign exchange inflows shows their position in BOPs and the economy in general. In the tables below, the proportion of remittances in comparison with other sources of foreign income in Tajikistan is given. As it can be observed from the figures, there is a tendency for an increase of remittances’ share in the overall foreign currency inflow in Tajikistan, which amounted to 31.84% in 2006.

**Table 1.4. Major Sources of Foreign Exchange, 2002-06 (thousand\$)**

Title	2002	2003	2004	2005	2006
Exports of goods and services	768,137.2	994,724.7	1,219,841.3	1,254,434.4	1,646,013.6
FDI	36,066.4	31,649.7	272,025.1	54,479.3	385,178.6
International tourism	1,631.6	1,534.1	1,215.3	1,563.2	2,016.2
ODA	119,942.0	136,013.1	87,923.0	130,195.6	123,967.6
Workers’ remittances	78,413.3	145,974.6	251,976.6	465,210.3	1,014,988.4
Other	1,230.3	932.4	1,697.2	9,586.0	14,991.6
<b>Total foreign exchange</b>	<b>1,005,420.8</b>	<b>1,310,827.6</b>	<b>1,834,678.5</b>	<b>1,915,468.8</b>	<b>3,187,156.0</b>
<b>Remittances/total foreign revenue (in%)</b>	<b>7.80%</b>	<b>11.14%</b>	<b>13.73%</b>	<b>24.29%</b>	<b>31.84%</b>

FDI = foreign direct investment, ODA=official development assistance

Source: National Bank of Tajikistan [www.nbt.tj](http://www.nbt.tj): Department Balance of Payments.



Remittances play an important role in the balance of payment. Table 1.4. shows that if labor services are considered as export, migrants' remittance inflows rank second after aluminum and ahead of cotton fiber. They accounted for nearly one-third of merchandise exports and financed about 70 percent of the trade deficit fueled by imports induced by increased income associated with remittance since 2000. In 2002-2006, remittances receipt grew much faster than exports of goods and services, FDIs, and ODA. Remittances also tower above *foreign direct investment* and other transfers generated by official development aid flows. In 2005, gross remittance inflows doubled the stock of Tajikistan's inter-national reserves.

**Table 1.5. Balance of Payments, Tajikistan 2000-2005**

<i>Title</i>	<i>2000</i>	<i>2001</i>	<i>2002</i>	<i>2003</i>	<i>2004</i>	<i>2005</i>
<i>Trade Balance</i>	-23	-125	-125	-204	-151	-319
<i>Exports</i>	788	652	699	799	1088	1107
<i>of which: Aluminum</i>	424	398	399	430	563	563
<i>of which: Cotton</i>	92	71	128	193	162	144
<i>Imports</i>	811	777	824	1003	1239	1426
<i>Service Balance</i>	4	-8	-36	-54	-89	-117
<i>Net Income</i>	-36	-72	-57	-90	-78	-75
<i>Net Transfer</i>	37	131	184	329	236	432
<i>of which: Net Migrants' Remittances</i>	0	-1	65	82	133	321
<i>Inflows</i>	1	4	78	146	252	465
<i>Outflows</i>	-1	-5	-13	-64	-119	-144
<i>Current Account Balance</i>	-18	-74	-34	-19	-82	-79
<i>Financing:</i>						
<i>Net Public sector Borrowing</i>	39	6	14	32	-169	50
<i>FDI</i>	24	9	22	32	272	55
<i>Changes in Reserves</i>	1	-9	21	35	-54	-41
<i>Others</i>	46	-68	23	80	-33	-15
<i>Stock of International Reserves</i>	87	96	96	135	189	224
<b><i>Memorandum items:</i></b>						
<i>Gross remittances/Exports</i>	0%	1%	11%	18%	23%	42%
<i>Gross remittances/Trade Deficit</i>	3%	3%	63%	72%	167%	146%
<i>Gross remittances/FDI</i>	3%	47%	356%	456%	93%	852%
<i>Gross remittances/Net Borrowing</i>	2%	70%	560%	456%	-149%	932%
<i>Gross remittances/Gross Reserves</i>	1%	4%	82%	108%	133%	207%

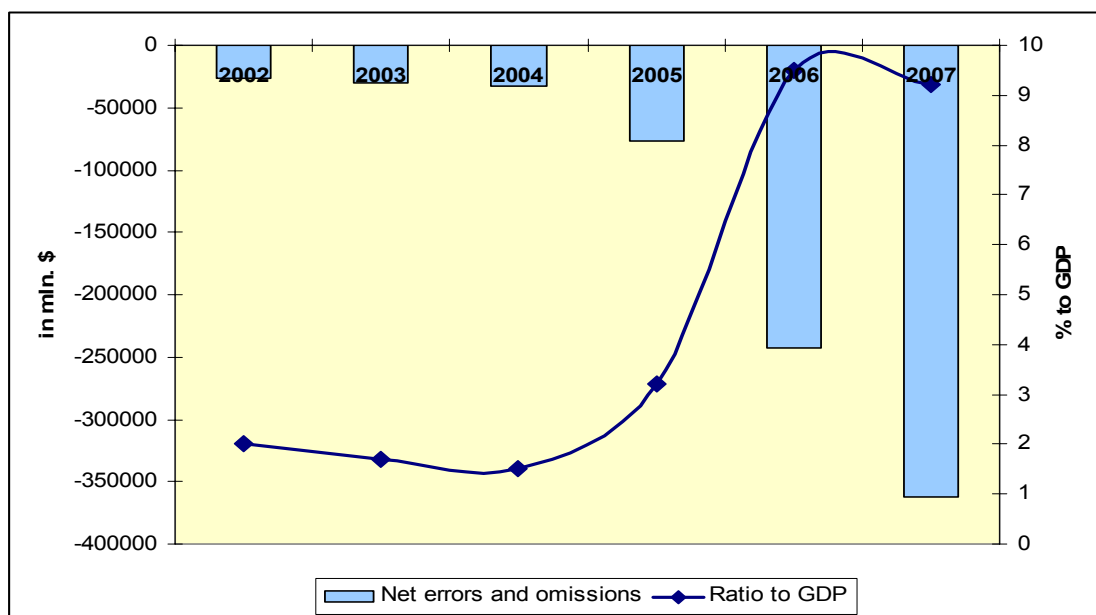
*Source: National Bank of Tajikistan [www.nbt.tj](http://www.nbt.tj), International Monetary Fund [www.imf.org](http://www.imf.org)*

In recent years remittances have been growing so quickly that they have become the second large source of foreign currency for the country after exports of goods. The estimated value of total remittances in 2006 through official channels in Tajikistan \$1,127

million<sup>34</sup>; while the volume of foreign assistance (ODA), including humanitarian as well as technical assistance and other grants) - \$124 million, revenue of the state budget amounted \$ 487 million. The volume of remittances through formal channels exceeds these types of foreign exchange inflows.

Some indirect information on informal transfers may be delivered from analyzing the BOP item on “Net errors and omissions”. This item, in essence, is a balance of all informal foreign currency transactions in the economy of Tajikistan. However, since 2003, one can notice a significant increase of this item indicating growing inflows of foreign currency to Tajikistan. It is unknown which components of informal flows contributed to this growth, but it is possible to presume that some part of this growth is related to informal remittance transfers.

**Figure 1.7. Net errors and omission in the Balance of Payments;  
2002-2007**



*GDP=Gross domestic product, NBT=National Bank of Tajikistan, US=United states, \$=US dollar.*

*Source: National Bank of Tajikistan and Author's own calculation.*

## 1.5.2. Economic Effects of Remittances

<sup>34</sup> Data of the National Bank of Tajikistan (NBT)

Remittances often have significant economic effects on recipient countries – including appreciation of the real exchange rate – increase savings and investment in both physical and human capital can boost aggregate demand and output through increased consumption and investment expenditures of recipient households, and the multiplier effect of these expenditures.

On the other hand, large remittance inflows can cause appreciation of the real exchange rate, lower competitiveness of export-oriented and import-competing sectors, move resources from tradable to non-tradable sectors, reduce exports, increase imports, and worsen the trade balance.

**Remittances can also promote the development of the financial sector in both sending and receiving countries** by inducing remitters and receivers to use financial services and by causing financial institutions to compete in the market for remittance transfer services and develop new products tailored to the needs of remitters and receivers.

The impact of remittances on economic growth in recipient countries is theoretically ambiguous. On one hand, remittances foster economic growth by promoting development of the financial sector and increasing investment in physical and human capital. On the other hand, large and sustained inflows of remittances can stifle economic growth by causing appreciation of the real exchange rate, reducing labor supply, and lowering competitiveness of export-oriented and import-competing sectors.<sup>35</sup>

Large and growing remittance inflows have mostly likely had significant effects on Tajikistan as well, however, it is impossible to assess these effects rigorously due to data constraints. The effects of remittances on household consumption, savings, and investment as well as poverty and inequality in Tajikistan are discussed in the companion report on remittances and poverty in Tajikistan prepared as part of the ADB study on remittances in Central Asia and South Caucasus.

One could identify several potential mechanisms of remittance influence on other economic variables in Tajikistan. Households receiving remittances could increase their consumption; therefore, private consumption could be positively affected by the

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<sup>35</sup> IMF and Agriinvestbank; "News" and "Publications" 2005, 2006, 3Q 2008

remittances. According to IMF estimation<sup>36</sup>, marginal propensity to import in Tajikistan is 0.65, which means that out of any additional US dollar, 65 cent is spent for the purchase of imported goods, so part of the remittances are spent to finance imports of consumer goods to the country. Arguably, one would not expect any considerable impact of remittances on investment into fixed capital.

RRS results show that in many households, inflow of remittances is positively associated with savings, so growth in remittances could cause growth of domestic savings. This does not mean, however, that increased savings results in growth of productive investments. Many household prefer to save by acquiring existing real estate. This is confirmed by the exponential increase in prices on apartments and houses in Dushanbe during the last several years. Obviously, this type of saving behavior does not contribute much to long-term economic growth<sup>37</sup>.

Taxes on imports are a key source of government revenues in Tajikistan. The State Customs Committee collects VAT, excises, and custom duties on imports, which together exceed 50% of total tax revenues. So, increase in imports driven by remittance inflows should result in growth of government revenues.

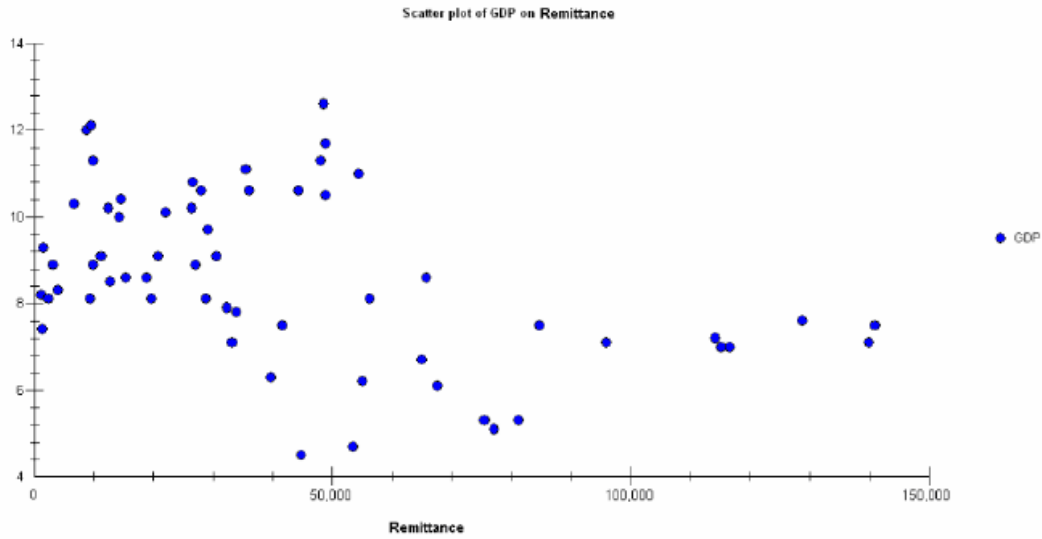
The scatter plot of GDP growth and remittances inflows, given in figure 1.8, suggests that there is no relationship between remittance inflow and economic growth in Tajikistan. Unfortunately, rigorous analysis of the impact of remittances inflows on the economic growth of Tajikistan is impossible because of lack of necessary data.

### **Figure 1. 8. Scatter plot of GDP Rates and Remittance Inflow in RT**

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<sup>36</sup> Data of the National Bank of Tajikistan (NBT).

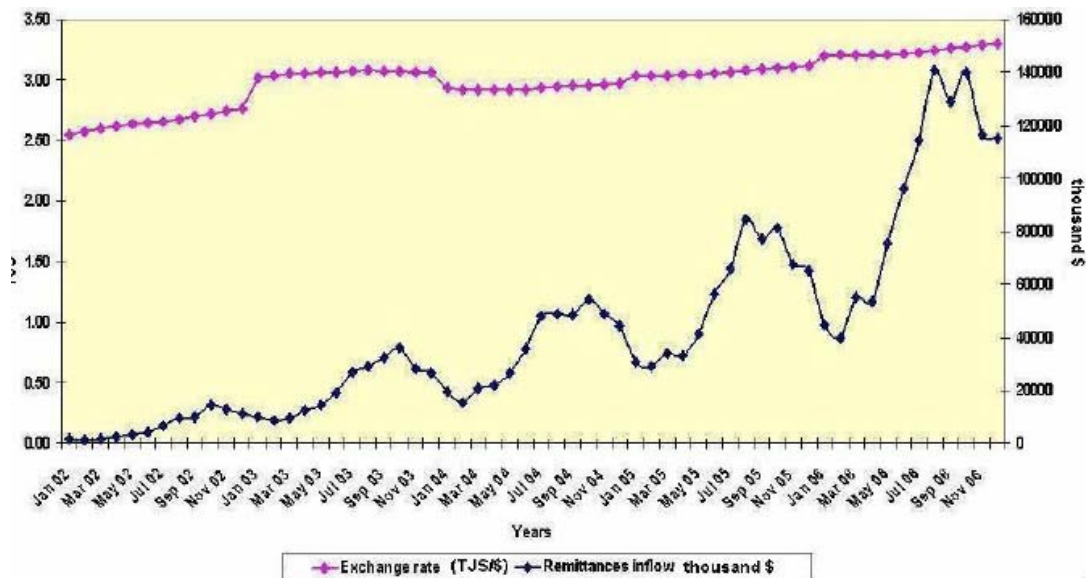
<sup>37</sup> Of course, growing prices on apartments create more incentives for residential construction, and one could see some signs of increased construction activity in Dushanbe, but so far this economic sector is by far not a major contributor to the country's gross domestic product.



Source: World Bank Report, EIU-TAJ, Country report, 2008.

As noted above, inflows of remittances increase supply of foreign exchange on domestic currency market. This may result in an appreciation of the national currency, which can negatively influence competitiveness of domestic production. In the case of Tajikistan, however, large remittance inflows do not seem to have caused an appreciation of the domestic currency. Although the US dollar has been depreciating against many other currencies, Tajikistan's national currency, the somoni, has been depreciating against the US dollar (Figure 1.9.).

**Figure 1.9. Remittance Inflow and Tax Rate in Tajikistan (2002-2006)**



NBT=National Bank of Tajikistan, SSCT=State Committee of Tajikistan, TJS=somoni (Tajikistan's national currency), US=United states, \$=US dollar.  
Source: NBT and SSCT.

In summary, it seems that inflows of remittances to Tajikistan:

- have some positive impact on personal consumption and savings,
- contribute to growth of import and indirectly leads to an increase in government tax revenues,
- do not have a significant impact on the exchange rate and economic growth

## 1.6. External Debt

**Tajikistan has had little success in developing domestic debt market.** The five post-soviet countries began the transition with little or no external or domestic debt. Where they have made some initial progress, these markets have been shallow and volatile, and in all but one (Armenia) have collapsed in the wake of the 1998 Russian financial crisis. Nevertheless, in some countries domestic debt is relatively large, although it is mostly held by central banks. Nonresident participation in domestic government debt markets has been minimal, although some domestic credit carries government guarantee<sup>38</sup>.

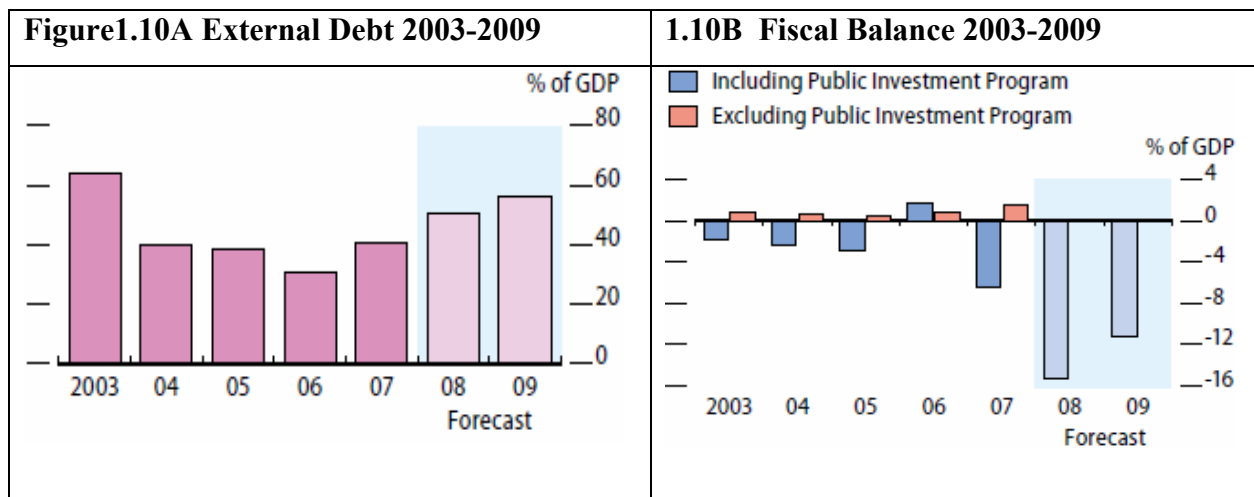
The country's large external debt (a total of USD 1 billion in 2003, which about one third owed to Russian Federation), virtually non-existent at independence, in 2001 was equivalent to 100% of GDP and the recent bilateral debt rescheduling agreements have reduced the debt stock to USD 982 million (82% of GDP) in 2002 and USD 1 billion (65% of GDP in 2003).

However, even with the rescheduling agreement with Russia, Tajikistan's debt-service costs remain a substantial burden on the government finances. The large debt complicates economic management and the cost of its servicing threatens fiscal stability. According to the IMF, debt repayments in 2005 alone, when Tajikistan resumes principle repayments on its debt to Russia, will account for about 25% of state budget revenue. Combined with a low domestic savings and investment rates and negligible foreign investment, high debt-service costs severally constrain the government's ability to boost economic growth.

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<sup>38</sup> Soon after 1991, as agreed with the creditors, Russia offered other CIS countries to take over 100 percent of all official foreign liabilities and assets of the former Soviet Union. With the exception of Georgia, these countries have enacted the so-called 'zero-option', and Georgia is expected to do so in the near future.

After declining for several years<sup>39</sup>, the ratio of external debt to GDP is set to rise to about 56% of GDP by 2009 (Figure 1.10). It was brought down to 31% of GDP in 2006 from more than 100% in 2000 by debt reduction agreements, including those with the Russian Federation and the International Monetary Fund, but external borrowing for the new transport and energy projects will take the debt ratio up again.



Source: International Monetary Fund; Country report 07/144; Ministry of Finance.2008

The budget for 2007 moved to an expansionary track to accommodate the financing of the PRS. Enlargement of the Public Investment Program (PIP) has led to a substantial widening of the overall fiscal deficit (to 6.4% of GDP) (Figure 1.10B). Excluding the PIP, the Government achieved a fiscal surplus of 1.6% of GDP. Social sector spending rose (albeit from a low base) aided by strong revenues, in turn supported by robust economic growth and better tax administration. The bulk of PIP spending is on infrastructure projects, mainly in roads and hydropower. Project loans from the People’s Republic of China accounted for much of the external financing of the PIP in 2007.

The current account deficit is estimated to have sharply widened in 2007 to 15.2% of GDP due to a much larger trade deficit. Imports grew at an estimated 39.2%, primarily for the infrastructure projects (but also greater imports of consumer goods). Much steeper oil and natural gas prices also contributed to the higher import bill. Export growth, in contrast, managed only 9.4% on poorly improving volumes of aluminum and cotton exports.

<sup>39</sup> In 1999 Moscow reduced Tajikistan’s debt to Russia over 50%, and write-off \$242 million out of Tajikistan’s bilateral debt in 2004. External debt was write-off by IMF of \$99 million in 2006.

Remittances grew strongly, as the boom in the construction and oil sectors in Kazakhstan and the Russian Federation continued to attract many Tajik workers. According to the latest estimates from the central bank, workers' remittances surged to an estimated \$1.8 billion in 2007 from the previous year's \$1.2 billion. The current account deficit amounted to an estimated \$476 million in 2007, financed largely by project loans and FDI. The official reserves rose by \$70 million to \$273.8 million.

Progress on structural reforms has been patchy. In agriculture, the growing farm debt in the cotton sector and the protracted approach for its resolution and for implementation of comprehensive sector reform are symptomatic of difficulties. Also, poor farmer incentives and rent seeking continue to hobble a major part of the economy. In power though, the Government has started to adjust electricity tariffs to cost-recovery levels and to provide a compensatory mechanism for the poor.

## **1.7. Central Government Budget**

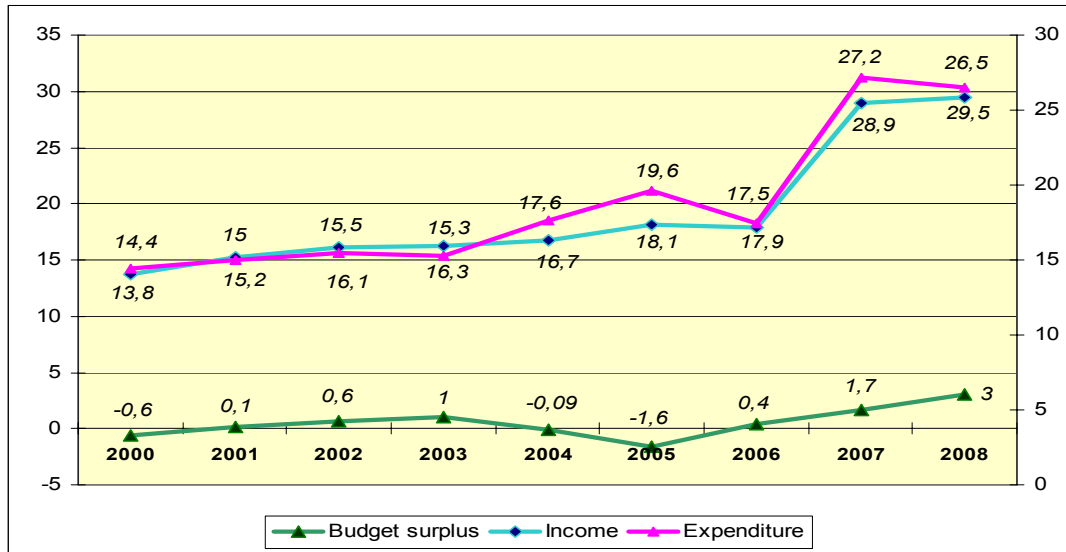
The relatively tight monetary policy pursued by the National Bank of Tajikistan since 2001 combined with nominal currency stability led to a significant lowering of inflation. End-year inflation fell from over 60% in 2000 to about 12.5% in 2002, although this was still in excess of the government's target of 9.5%. Moreover, improvements in fiscal management and, in particular, in revenue collection led to a narrowing of budget deficit from 3.8% in 1998 to near-balance in 2002 and the surplus of fiscal balance in 2003.

High inflation will remain the major concern of macroeconomic stability. The economic program calls for a 20% increase in the money supply (M2) in 2004. The shift of the monetary policy focus from the exchange rate to liquidity management had led to some nominal appreciation in the TJS/USD exchange rate. Further tariff adjustments in 2004 are made for the power sector as part of the restructuring program.

In 2005, the state budget of the Republic of Tajikistan was implemented in line with the trends of steady economic growth in the country. Tajikistan's budget surplus in 2008 amounted to 334 million 576.7 thousand TJS (over 96.32 million U.S. dollars).



**Diagram 1.8. Changes in State Budget (% of GDP)**



Source: National Bank of Tajikistan; 2009, and Author's own calculation.

Expenditure part of 2008 state budget was executed at 96.6%, representing 28.3% of GDP. In 2008, the budget surplus equaled to 1.9% of gross domestic products, which last year reached 17 billion 609.3 million TJSs (about 5.07 billion U.S. dollars). GDP growth was 7.9%, was noted at the meeting. The inflation rate last year reached 11.8%. Foreign trade turnover increased by 13.3% and amounted to 4 billion 549.6 million U.S. dollars.

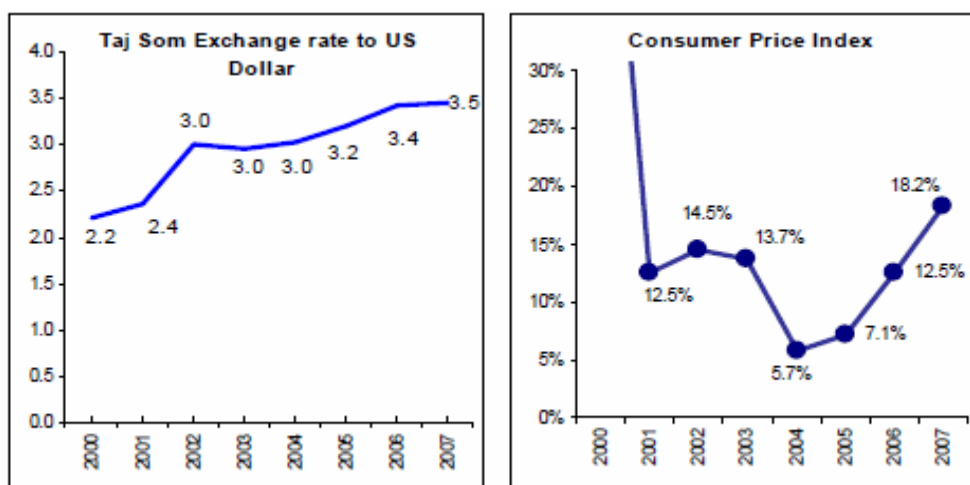
### **1.7.1. TAJIKISTAN'S NATIONAL CURRENCY: SOMONI - TJS.**

Besides, the unique situation formed in Tajikistan by that moment was that the country was using the cash currency of another country - Russia, and the old Soviet Rubles for bank operations. The huge difference between them had resulted in great damage to the financial system of the state. Systematic lack of payment of salaries, pension and aid, failure to pay through banks, external and internal debt of the state became the reality for the national economy. Because the cash currency circulating in the country was borrowed from Russia, the debt of Tajikistan to Russian Federation abruptly increased, while absence of currency reserves and non-convertible non-cash resources brought to destruction of internal financial market and rapid accumulation of the foreign debt. As a result, the government of Tajikistan made a decision to introduce the national currency - the Tajik Ruble (TJS).

**Weak institutional capacity and the underdeveloped nature of the financial sector severely hinder the conduct of monetary policy.** On the 2005 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

**National currency slides against the dollar.** Tajikistan such as Uzbekistan and Belarus are the only countries in the Commonwealth of Independent States (CIS) whose national currencies have fallen against US dollar in the first half of this year. NB Central Asia experts<sup>40</sup> say that in the case of Tajikistan, the trend has been caused by the trade deficit and the reluctance of savers to put their money in the bank.

**Table 1.6. Tajikistan: Exchange rate versus US dollar; 2000-2007**



Source: Microfinance Centre; Investor letter- Tajikistan: [www.mfc.org](http://www.mfc.org)

The exchange rate in Tajikistan slipped from 3.43 to 3.44 TJS<sup>41</sup> to the dollar in January-June 2006 while national currencies in other countries remained stable or strengthen. NB Central Asia observes say the TJS has continued to fall in value over many years firstly because Tajikistan imports more it exports – meaning that it is spending more foreign currency that it earns – and secondly, because people prefer to hold their savings in

<sup>40</sup> IWPR Institute for war and peace reporting; Newspaper; 27, Jul 2007; No337511

<sup>41</sup> National currency of Tajikistan -TJS is introduced since October 30, 2000. 1 TJS=100 dirams. The new monetary unit is named in honour of Ismoil TJS (849-907) - founder of the first centralized state of Tajiks – Samanids State.

hard cash, in the form of foreign banknotes, rather than depositing them into banks (Table 1.6)

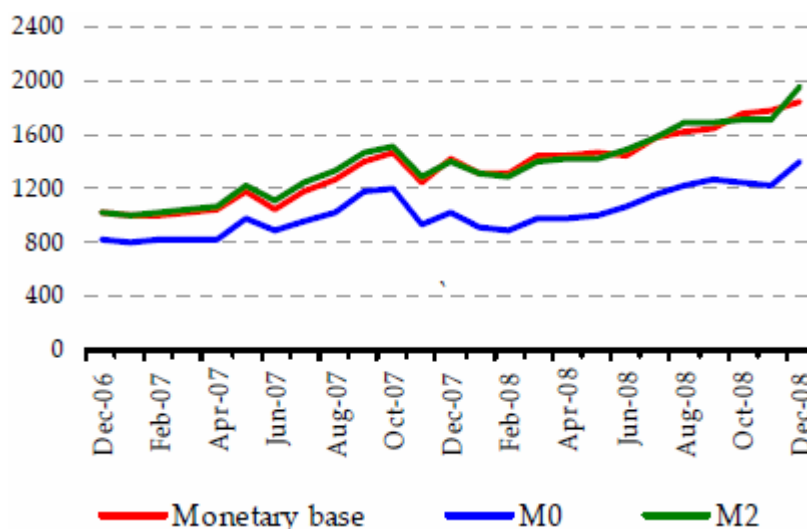
**In an environment of volatile world market exchange rates, the TJS depreciated vis-a-vis the US dollar by 7.1 percent.** The free managed floating exchange rate regime ensured the changing value of the TJS to be based on market principles, taking into consideration demand and supply factors. One main factor behind the depreciation of the TJS was the strongly negative balance of trade, which reached US\$ 323.6 million, with the US dollar dominating in external trade transactions as the unit of payment. At the same time, the increase of inflation contributed to the depreciation of the TJS, and the level of the real effective exchange rate mainly remained stable.

**Table 1.7. Official Exchange Rates of republics of the CA** (as on: 03/01/09)

<i>Country</i>	<i>Currency</i>	<i>\$ 1.00</i>	<i>€ 1.00</i>	<i>RR 1.00</i>
Kazakhstan	Tenge	119,84	152,12	4,42
Kyrgyzstan	Som	38,78	49,20	1,43
<b>Tajikistan</b>	<b>TJS</b>	<b>3,40</b>	<b>4,35</b>	<b>0,12</b>
Turkmenistan	Manat	14250,00	18141,68	525,87
Uzbekistan	Sum	1348,10	1792,16	49,75

However the exchange rate is in declined because Tajikistan has consistently run a trade deficit over many years. Last year, the deficit stood at more than 300 million dollars. The resulting shortage of foreign currency receipts from exports pushes up the market price of the dollar. The answer is to offer tax breaks to small and medium sized business to allow them to grow and to produce high-quality goods for exports to narrow the trade gap. The strengthened commercial sector would attract some of the money that migrants workers send back to Tajikistan. As a result of growth of the amount of time deposits in national currency at the rate of 44,6%, monetary aggregate M2 increased in compare to the beginning of the year by 20,3% and made 1 696,3 mln.TJS as of September 30 of 2008 (Diagram 1.9.)

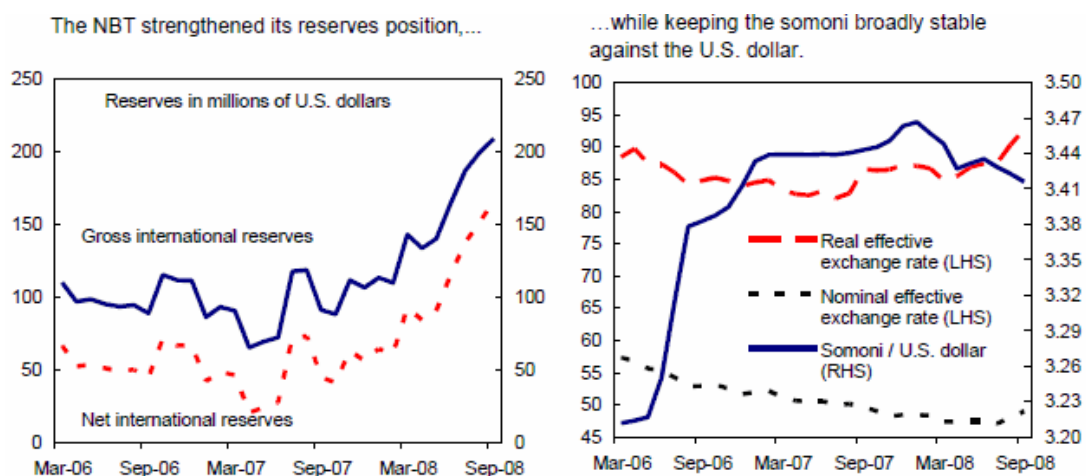
**Diagram 1.9. Changes of the volume of money (mln.TJS) 2006-2008**



Source: National Bank of Tajikistan; [www.nbt.tj](http://www.nbt.tj); 2009

Remittances are estimated at one billion dollars a year, most of it sent by expatriate workers who are away in Russia. Recipient families on average save half the money their relatives send them for future purchases of expensive items, but they still shy away from the banks and keep the money in cash. The fact that these foreign-currency holdings are not in circulation is another reason for the shortage of dollars. Therefore the cash sent home by migrant workers could be tapped to help stabilize the TJS, but that it is more important to develop the domestic stock and currency markets.

**Figure 1.11. National Bank of Tajikistan’s fiscal policy framework 2006-08**

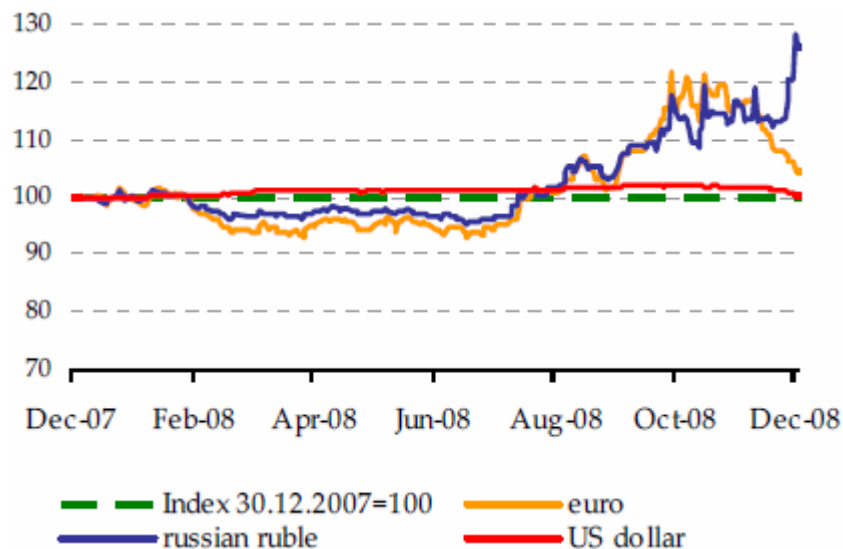


Source: NBT; International Monetary Fund and Tajik authorities

**The world financial crisis and its negative impact on economy of the countries,** a change of prices in the world market and other factors have led to financial and liquidity risks. Despite of this the rates of growth of the economy for the 9 months moved relatively stable. On the positive side, the global financial crisis has so far had little impact on Tajikistan’s financial sector because direct linkages are limited. However, remittances are projected to stagnate, and export demand to wane<sup>42</sup>.

For January-September 2008 the official exchange rate of TJS against US dollar had a steady tendency appreciated by 1,6%. The exchange rate of TJS to US dollar which set in the exchange market, on the base of market supply and demand appreciated by 2,8% (Diagram 1.10.) Also for this period the exchange rate of TJS against Euro became stronger by 1,9% and against Russian Ruble by 4,3%.

**Diagram 1.10. Somoni exchange rate against the foreign currencies  
2007-2008**



Source: National Bank of Tajikistan; Monetary review, March 2009

Tajikistan has followed a relatively strict fiscal and monetary policy, which has resulted in macroeconomic stability. However, government interference in the economy and massive corruption stifle economic growth and private investment. The government

<sup>42</sup> World Bank review. “Behind the financial crisis” March 19, 2009

has attracted state-led investment for major infrastructure projects rather than implementing the necessary economic reforms to attract private investors. Two-thirds of the workforce of Tajikistan is in agriculture, most of them pressured to grow cotton. Tajikistan struggles to implement agricultural reforms that would allow this two-thirds of the population to farm the crop of their choice. Income from narcotics trafficking, while difficult to quantify, has an increasingly visible impact on the Tajik economy.

## **CHAPTER SUMMARY**

This chapter describes what financial and capital markets are, the types of securities traded. It also highlights the requisite processes and capabilities to make the markets function. The chapter also describes the roles played by different regulators of the markets in their quest to make the markets safe, fair and efficient. We have seen also that globalization and integration of world economic systems can be tapped by any that is prepared to benefit his people. The economic benefits that accrue to the society by introducing capital markets have also been highlighted. We have also seen different experiences in varying societies and observed that each market can be unique with respect to the background environment such as the country's political direction, macroeconomic environment, the degree of transparency and accountability, and the general infrastructure for trading, clearing and settlement.

## **II. CHARACTERISTICS OF FINANCIAL SECTOR IN TAJIKISTAN**

### **2.1 Financial System of Tajikistan**

**Tajikistan remains one of the poorest countries in the world, with the lowest per capita GDP of the 15 former Soviet republics with a per capita income of US\$ 416 in 2008.** Consumer financial services in the country remain limited and savings mobilization is among the lowest in the world. The immediate post-Communist period saw a flourishing of banks; however, the sector has since undergone significant consolidation as many of these banks were unsustainable, with consequent implications on the access of the poor to affordable finance.

**The level of development of the Tajik banking sector is relatively low compared to other countries in the former Soviet Union and the Commonwealth of Independent Countries (CIS).** It is currently undergoing a profound stabilization and consolidation process that has resulted in the exit of insolvent banks and the divestiture of “Kredit - Invest” from AIB bank. Consequently, asset quality, the overall capitalization of banks, and the capital adequacy ratio have improved, and non-performing loans have declined. Although the banking sector is growing rapidly in terms of credit to the private sector, it still faces a lack-term financing, an inadequate deposit base, and low capacity to intermediate their capital base.<sup>43</sup>

**Achieving high rates of economic growth required a constant flow of investment into the real sector of the economy.** Under conditions of limited domestic savings, an additional source of capital is foreign investment, from foreign states, international financial institutions, and private companies. The transition from a planned, strictly regulated economy to a market-oriented economy is still in progress in Tajikistan. This is apparent in sectoral imbalances: the banking and service sectors are developing much faster than industry and agriculture.

**With regards to foreign investment, the state is gradually moving away from complete control over foreign investment toward the liberalization of investment**

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<sup>43</sup> World Bank “Tajikistan Policy Note” page 13.

**relations.** At the beginning of the 1990s, foreign investment was given a special status, which came with certain tax and customs privileges not granted to domestic investment as well as superior legal protection. The concept of investment activity has now been rethought. Equal rights have been given to domestic and foreign investment and there are unified standards for taxation and for conduct of external economic operations. Priority areas for attracting foreign investment have been determined, including the construction of hydroelectric plants, the building and repair of motor roads, agriculture, manufacturing, and mineral extraction. Since independence the legislative and regulatory framework for the establishment of a market-oriented economy in the country has been developed. The *Law on Privatization of State-Owned Property* encourages the participation of foreign investors in the privatization of the national economy.

### **2.1.1 Tajikistan's financial sector development.**

As noted, transition economies that have achieved faster financial development are those that have removed the foregoing impediments to financial development at a faster pace. These countries have made substantial progress in legal and judicial reform. They have also implemented rapid bank restructuring, decisively aided by effective corporate restructuring.<sup>44</sup> Tajikistan as one of transition country also built strong central banks and financial agencies implementing best-practice regulations and supervision, and overcame initial hesitations to private state-owned banks. As a result of liberalized entry of “fit and proper” financial firms, they have witnessed substantial entry of foreign banks in their markets. Foreign institutions have speeded up rationalization in the provision of financial services, and increased overall transparency and competition. Although the speed of banking development of this countries may have been increased by initial conditions and other characteristics more favorable than those facing CIS countries as the outset of transition, clear commonalities un the driving forces of financial development emerge among the most successful transition economies.

Tajikistan's financial sector has been dynamic growth in recent years, due to two driving forces: the consolidation of players, thanks to the enforcement of stricter minimum

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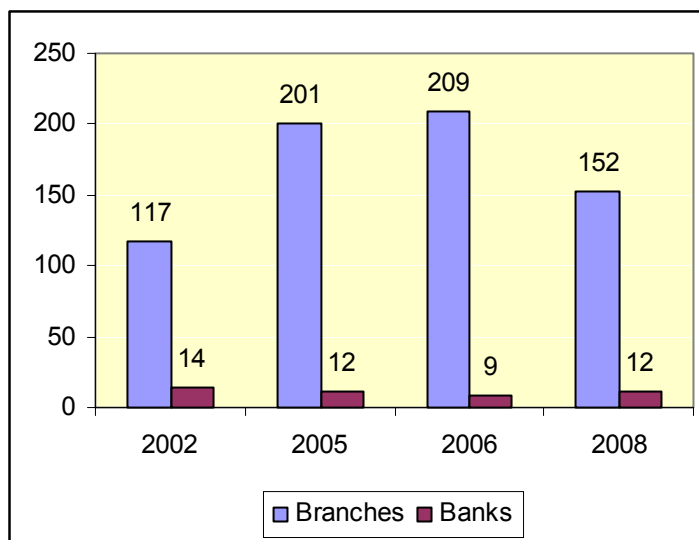
<sup>44</sup> See Djakov and Mirell (2002)



capital requirement<sup>45</sup>, and the entrance into the market of the new players, mainly micro-finance organizations as well as a few branches of foreign institutions (Chart 2.1 and 2.2)

There are 12 banks, 7 credit societies, 1 non-banking financial institution and 88 micro financing institutions in the Republic of Tajikistan as for October 1, 2008.<sup>46</sup> As for October 1, 2008 there are 152 branches and 70 departments of credit organizations operating in the Republic of Tajikistan.

**Chart 2.1. Evolution of number of banks and banking branches**



Source: National Bank of Tajikistan

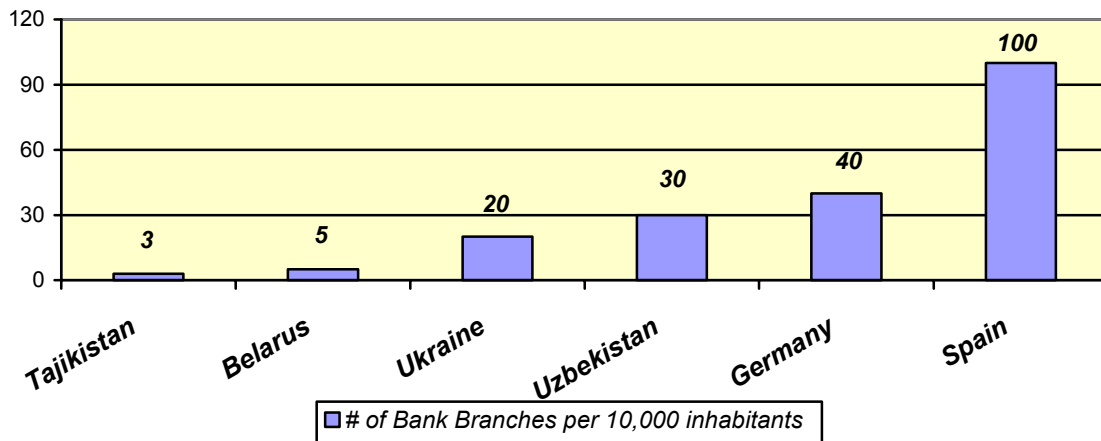
All commercial banks in Tajikistan have 152 branches or 2 branches per 100,000 people. However almost two third of branches are operated by Agroinvestbank or Orienbank. Leaving the two aforementioned banks aside, the average number of branches per bank is below 7. The branch density indicator is low by international standards, that is, well below its average value of 4.9 for low and middle-income countries<sup>47</sup>. Apart from the active banks, 5 commercial banks are in process of external administration, conservation or liquidation.

<sup>45</sup> Since January 1, 2005, the capital requirement has been \$5 million.

<sup>46</sup> In comparison with January 1, 2008 the number of operating banks increased for one bank (CJSC “Kazkommerzbank of Tajikistan”) and the number of micro financing institutions increased for 19 units.

<sup>47</sup> World Development Indicators (data 2004)

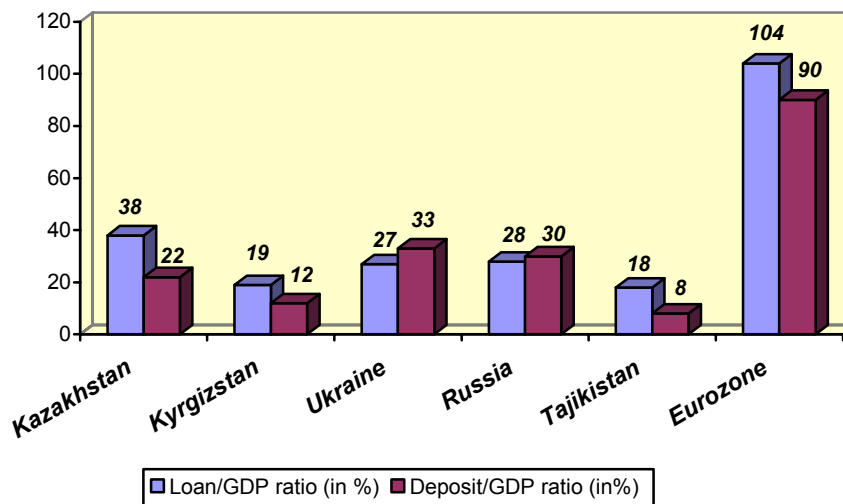
**Chart 2.2. Bank branch density is very low in Tajikistan. 2006**



Source: National Banks of the countries; National Banking Association and Central Banks.

The increase of the loan to GDP ratio (from 14% in 2002 to 18% in 2005) as well as deposit to GDP ratio (from 4% in 2002 to 8% in 2005) testifies to a rapid growth and a more role of the financial sector in the Tajik economy, albeit from a very low base. Nevertheless these indicators are still lowest among the Central Asian (CA) countries and well below Eurozone countries and shows the still limited development of this sector (see Chart 2.3)<sup>48</sup>

**Chart 2.3 Comparison of some indicators in the banking sector of selected countries 2005.**



Source: Annual and monthly Central Banks reports; Business Monitor International Ltd.

<sup>48</sup> World Bank, International Finance Corporation; 2005; Report number 2006 SME Tajik Survey p. 9

As for January 1, 2009 paid authorized capital of credit societies was TJS 518 895 921 and by the type of ownership are following:

	<i>National currency</i>	<i>In %</i>
State-owned	15 078 758 somoni	2,6%
Commercial	308 433 075 somoni	53,6%
Individuals	234 770 159 somoni	40,8%
Others	17 099 012 somoni	3,0%

### **Structure of assets and liabilities of banking system for January 1, 2009.**

- **Total assets** - 6169.1 million somoni against the beginning of year increased in 8,9%. Including a loan portfolio – 4674,6 million somoni as against the beginning of year increased in 24,4%.
- **Total liabilities** – 5081,9 million somoni as against the beginning of year increased in 1,5%; Including the deposits – 1923,7 million somoni as against the beginning of year reduced by 20,2%;
- **Balance of Capital** – 1087,2 million somoni as against the beginning of year increased in 64,6%.

Banking sector evaluation is the most important point for presentation an opportunities of financial structure development in Tajikistan. So far, I focused on banking system. I did so because comparison of banking sectors among transition economies are the most appropriate and because the banking sector is the most important sector for capital market. In the Tajikistan as well as in the most other transition economies, there are several “missing pieces” in financial development – namely the lack of development of non-bank intermediaries and capital markets. However, it is important to note that the development of domestic equity and private debt markets, as well as of nonbank financial institutions, does not appear to have played a major role in the first phase of financial development of the most successful transition economies. Development of private bond markets and nonblank

financial institutions, such as insurance and pension funds, appears to have gained momentum only recently.<sup>49</sup>

### **2.1.2. Reforms and privatization in the banking sector**

**The banking sector consists of the National Bank of Tajikistan and 12 commercial banks.** The sector is highly concentrated, with the four largest banks, Agroinvestbank (AIB), Orienbank, Tajiksoderatbank (TVEB) and the Savings Bank (Amonatbank), controlling about 85 % of assets and 70 % of household deposits. Three of these banks have been privatized, while Amonatbank remains state-owned. Amonatbank holds the largest share of household deposits and is the only bank that has a government guarantee on deposits. As successors to the Soviet era banks, these four banks have a large number of non-performing loans in their portfolios, about 94 % (including cotton loans) of total loans as of mid-2002. Furthermore, these banks have tended to stick to their respective sector orientation with the result that there is little competition among them.

**In Tajikistan individual banks purchased the system independently and started issuing their own cards<sup>50</sup>.** It utilizes a processing system of a bank in Russia. This system can read both Maestro and Russian Gold Crown (Chip Based). Orienbank and TVEB have made some progress with restructuring. International Financial Institutions (IFIs) have played a key role in improving the operational capacity and loan quality of Orienbank and TVEB through technical assistance, credit lines (in case of Orienbank) and new injections of capital (in case of TVEB). In contrast, Amonatbank, having the largest branch network, continues to function primarily as a fiscal agent for the Government, e.g. paying pensions and other budgetary disbursements and accepting tax payments, while AIB increasingly serves as a conduit for external financing of the cotton sector. As of June 2002, about 90 % of AIB's loan portfolio (11% of GDP) was to cotton producers. A large part of these loans are classified as non-performing.

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<sup>49</sup> See Bonin and Wachtell (2003)

<sup>50</sup> In Tajikistan there is only one bank (AIB) that operates and issues debit cards.

**The rapid growth of Tajik banks has brought new risk exposures to the system.** Albeit from a low base, bank deposits have grown very rapidly since 2004 – at accelerating annual rates that topped 110 % in 2007<sup>51</sup>. Net bank loans have also grown very rapidly, broadly matching the growth of deposits in 2007 (Figure 2.1)

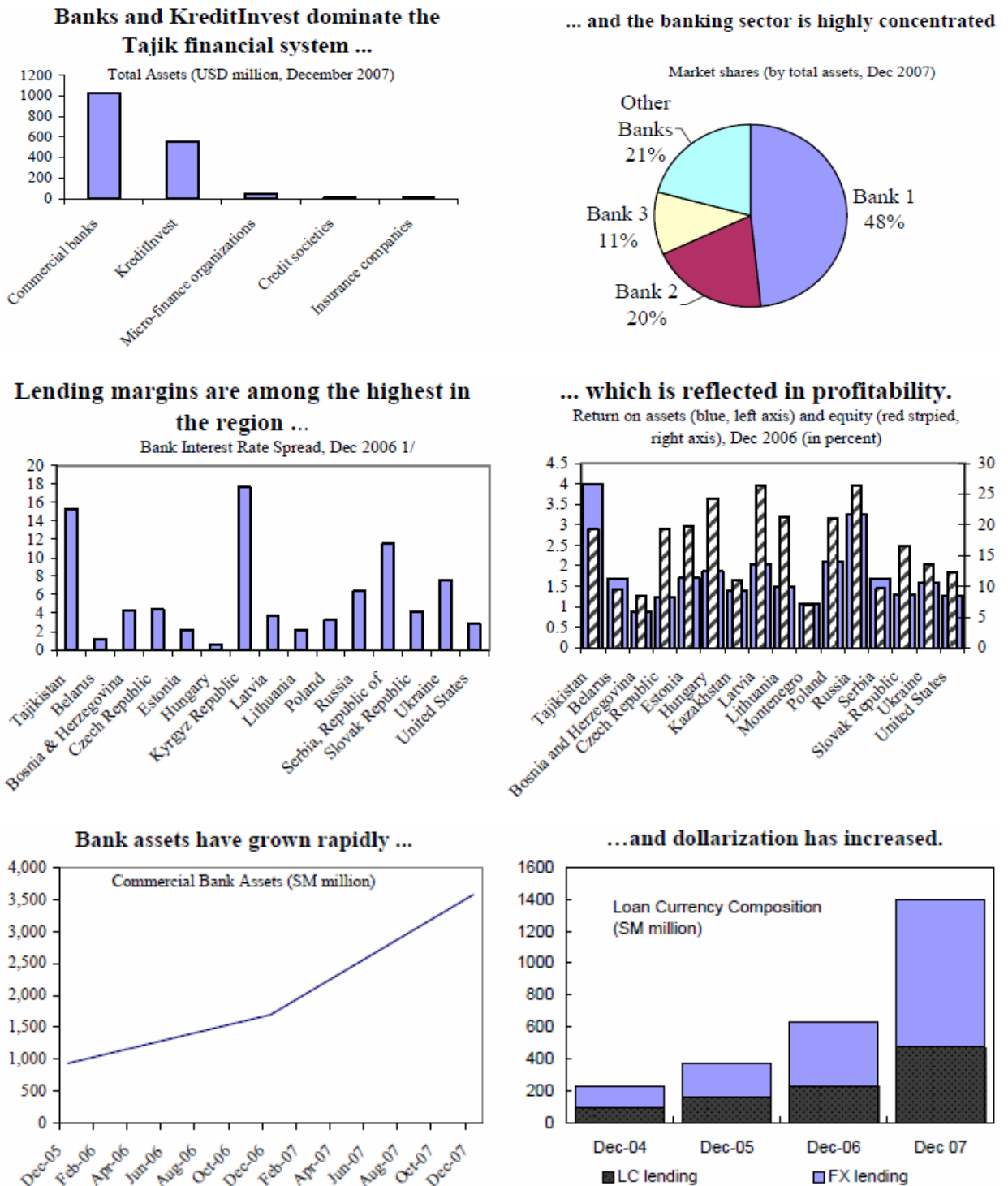
**In the absence of strong credit risk management capacities, the rapid growth in bank lending is a reason for concern.** While this credit growth support much needed financial deepening, an excessively rapid increase could lead to a build-up of unrecognized credit risk. In particular, the surge in credit to the agriculture sector in 2007 should be carefully watched given its poor loan repayment record (21% of the load to the sector were nonperforming at end-2007). More broadly, this expansion is taking place in the context of serious weaknesses in credit risk management practices, and in the governance, regulatory, and supervisory frameworks.

**Dollarization is rising, thereby increasing the vulnerability of banks.** Loans dollarization increased from 57 % at end-2004 to 68 % at end-2007. The main driving factor appears to be the evolving currency composition of banks' funding, which is increasingly skewed toward the dollar. It is a source of concern that there seems to be a lack of awareness by borrowers and banks of the exchange rate – induced credit risk – i.e., the risk of default by unhedged borrowers in the event of a sizable exchange rate depreciation – although the availability of foreign exchange from remittances could mitigate this risk.

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<sup>51</sup> Last year's growth rate reflects the impact of reclassification of bank liabilities associated with a shift between non-resident (foreign liability) and resident (deposit liability) accounts.

**Figure 2.1. Key Characteristics of the Tajik Financial System<sup>52</sup>**

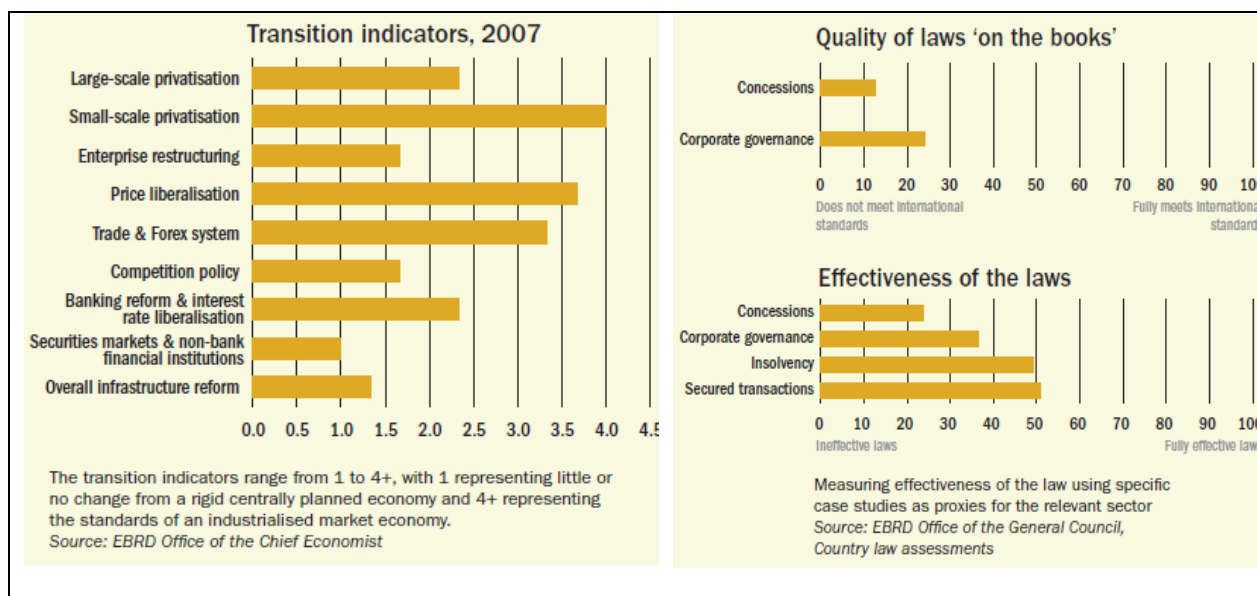


Sources: International Financial Statistics; National Bank of Tajikistan and Microfinance organization, 2008

<sup>52</sup> KreditInvest (KI) is a nonbank intermediary involved in cotton sector financing. It was established in 2003 as an asset management company to deal with the bad loans portfolio in the “good bank-bad bank” resolution of the formerly-state owned Agroinvestbank (AIB).

The banking sector has grown sharply in the past year with loans outstanding growing from 25 % of GDP in 2006 to 21 % in 2008. Nevertheless, there remains continued interference from the authorities to provide financing for specific purposes, in particular the cotton sector. The challenge is to secure regulatory independence and limit government interference in commercial banks activities.

**Table 2.1. Transition progress in Tajikistan**



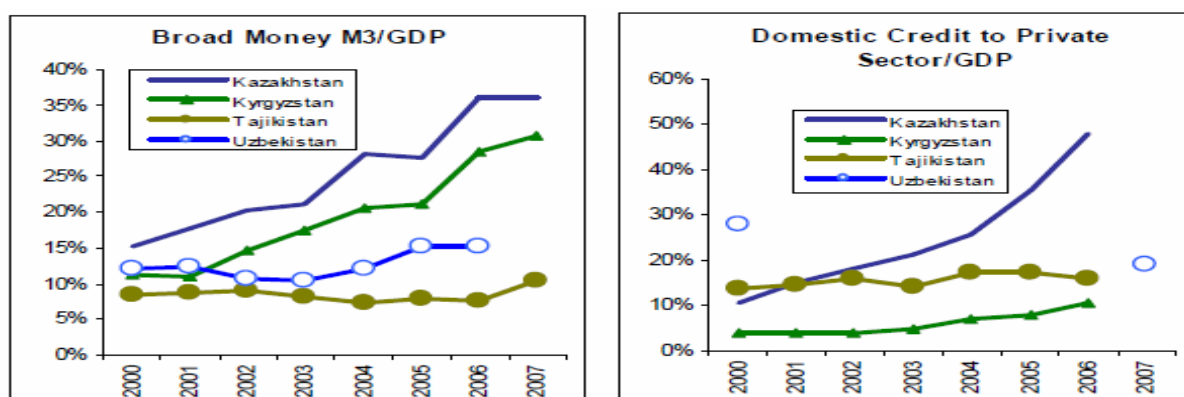
Source: World Bank Review; 2007

**Despite the rapid increase in intermediation, the banking system is not yet in a position to serve the needs of the economy.** Only about 45 % of bank assets were loans (net of nonperforming loans) at end-2007, and while deposit growth has been rapid, access to banks by the less-served population remains constrained<sup>53</sup>. In this vein, expanding access to financial services outside the main urban areas should be encouraged by, *inter alia*, replacing current licensing requirements for the opening of bank branches and agencies with less taxing NBT guidelines. Further, while the handling of workers' remittances is a profitable source of fee income, deficiencies in other services and products prevent banks from turning these funds into a stable source of financing.

<sup>53</sup> In 2006, in Tajikistan there were about 220 branches, translating into about one branch for every 30,000 people, which is low by international standards.

**The rapid accumulation of nonresident deposits without clear knowledge of their sources may expose the banking system to reputation and money laundering risks.** Between 2004 and 2007, deposits grew by more than 600 % with a third of a growth accounted for by nonresidents' foreign currency demand deposits; during 2007 those deposits displayed a very erratic pattern likely driven by changes to reserve requirement regulations. The bulk of those deposits reportedly accrue to a few accounts at the largest bank in the system. The authorities should investigate the sources of this funding to ensure that no illegal activity is involved<sup>54</sup>. At this point in time these funds do not appear to pose a liquidity risk as they are largely deposited in correspondent account abroad.

**Table 2.2. Effects of changing in the money supply in CIS countries: 2000**



Source: Microfinance organization, 2008

### 2.1.3 Risk Exposures of Tajik Banks

The banking sector is the most important financial sector in all transition economies. In most of them, several elements of financial development are missing – namely, nonbank intermediaries and capital markets. In theory, balanced growth in financial development, where bank and nonbank develop alongside capital markets in the most desirable scenario. In practice, the development of nonbank intermediaries and capital markets requires a sophisticated legal and regulatory infrastructure, a widespread credit and

<sup>54</sup> Tajikistan has not yet passed a law or regulations setting forth customer due diligence requirement and reporting of suspicious transaction, not has it established a FIU.



savings culture, and the institutional capacity for the efficient enforcement of financial contracts. As a result, Tajikistan as well as all other transition economies faces important trade-off in institutional capacity building. For the CIS countries, cost-benefit analyses of development in nonbank intermediaries and capital markets aimed at detecting components of financial sector reforms with the highest value added appear necessary in identifying policies likely to be successful in bringing the great divide.<sup>55</sup>

According to various sources, there is approximately \$1 billion circulating in the Tajikistan economy outside the banking sector. Having lost all their savings in the Soviet Union to the Russia ruble conversion in 1993, few people trust banks and hence hold money in their homes. However, the increase in deposits over the past year reflects growing confidence in the banking system. Personal deposits continue to increase and totaled \$200 million in November 2005, seven times more than in 2003. After the government cancelled the 30% fee for bank transfers by physical entities in November 2001, Tajik migrant workers have been more inclined to use official channels to send remittances from abroad to Tajikistan. Still, a large number of Tajik migrant workers use informal money transfer channels, or travel with cash.

To facilitate the free flow of financial resources the NBT cancelled the 30% fee on bank transfers in 2003, resulting in significant increase of remittance from Russia, Kazakhstan and neighboring. Deposits have increases almost sevenfold since 2003. At the end of 2007, volume deposits totaled almost \$700 million and only 24% were personal deposits. The continued trend of a free flow of financial resources throughout 2008 could generate more working capital for commercial banks to expand their credit portfolio in terms of credit size and duration. In general, local commercial banks issue 12-month loans worth more than \$100,000 at 24% APR, prohibitively expensive for most local customers to develop a new business.

### **Table 2.3. Basic Banking Sector Soundness; 2007**

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<sup>55</sup> Gianni De Nicolo; IMF Working Paper 03/2005 “Financial Development in the CIS-7”

	Kazakhstan	Kyrgyzstan	Tajikistan	Uzbekistan
Number of Banks (2007)	34	22	10	29
Asset share of state-owned banks (2006)	2%	3.4%	9.7%	54.4%
<b>Largest bank</b>	<b>Kazkommertz Bank</b>	<b>AsiaUniversalBan</b>	<b>Orien Bank</b>	<b>National Bank of Uzbekistan</b>
Bank assets/GDP (2007)	97%	30%	18%	36.2%
<b>Average Interest Rates (2007)</b>				
<b>Loans:</b>				
- local currency	15.5%	21.3%	21.4%	n/a
- foreign currency	12.5%	18.1%	18.4%	-
<b>Deposits:</b>				
- local currency	6.4%	4.7%	0.7%	-
- foreign currency	4.9%	2.2%	1%	-
Stock Market Capitalization as % of GDP	73%	3.1%	-	4.3%
Foreign Direct Investment, net (\$US mln)	2,235	50	80	194

Source: World Bank Review; 2007

The NBT has launched a campaign to encourage more Tajiks to open accounts, and although rising, the rate of consumer savings accounts remains low. As a result of low deposit levels at banks, few investors secure business or personal loans through banks, also partly due to high interest rates. Checking accounts do exist but are not widely used due to strict requirements on cash withdrawal procedures. The Government issues both bills and bonds, and according to legislation, foreigners can purchase them.

## 2.2 Interest Rate

**Despite the rapid increase in intermediation, the banking system is not yet in a position to serve the needs of the economy.** Only about 45 % of bank assets were loans (net of NPLs) at end-2007, and while deposit growth has been rapid, access to banks by the less-served population remains constrained<sup>56</sup>. In this vein, expanding access to financial services outside the main urban areas should be encouraged by, *inter alia*, replacing current

<sup>56</sup> In 2006, there were about 220 bank branches, translating into about one branch for every 30,000 people, which is low by international standards.

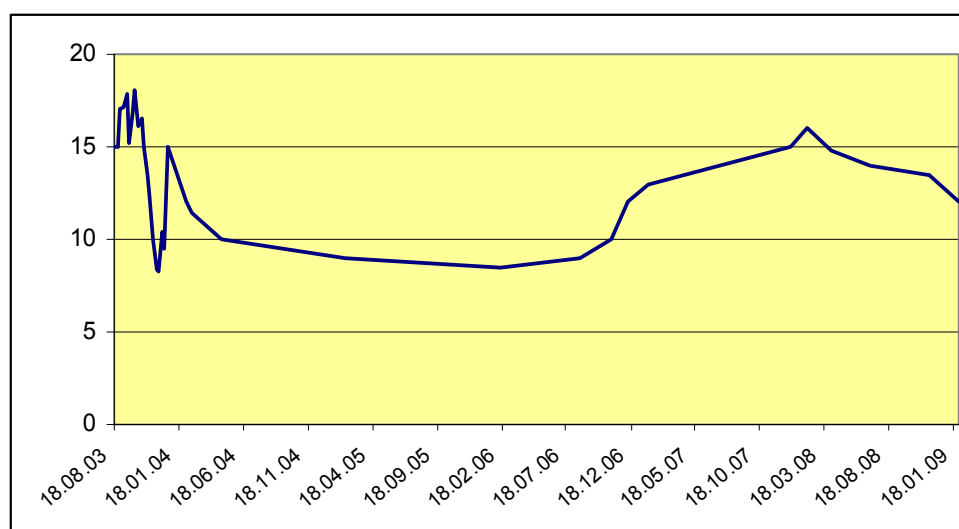
licensing requirements for the opening of bank branches and agencies with less taxing NBT guidelines. Further, while the handling of workers' remittances is a profitable source of fee income, deficiencies in other services and products prevent banks from turning these funds into a stable source of financing.

**Interest rate (refinancing rate) spread in Tajikistan was the highest in the region and could contribute to adverse selection of borrowers.** Average ex-ante bank spreads have stayed above 20 % both in somoni and foreign currency in the last few years – compared to an overall median worldwide of about 6 % in 2003<sup>57</sup>. The high spreads are given by three main factors:

- limited credit risk assessment and mitigation mechanisms;
- weak competition;
- deficiencies in the tools and infrastructure for liquidity management:

These spreads make more loans unaffordable for large sections of the economy because bank lending is directed to more risky, but higher yielding, projects.

**Figure 2.1. Interest rate changes (in % p.a.) 2003-2009**



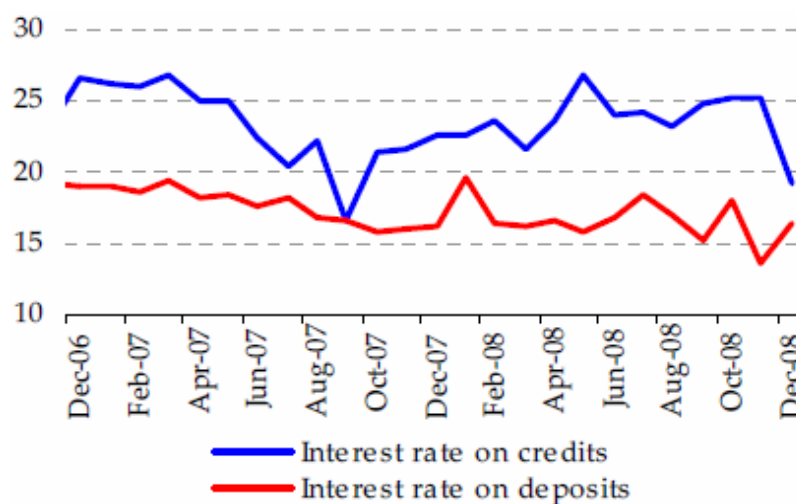
Source: National Bank of Tajikistan; Monetary sector report, 2009

In accordance with the Decree of the National Bank of Tajikistan dated 28 January, 2008 in order to increase an efficiency of the monetary policy promoting development of economy and to maintain a liquidity of the credit organizations of the Republic Tajikistan, the interest rate of NBT is reduced from 13,5 % to 12,0 % per annum.<sup>58</sup>

<sup>57</sup> Gaston Gelos, 2006, "Banking Spreads in Latin America," IMF Working Paper WP/06/44.

<sup>58</sup> Monetary sector report, National Bank of Tajikistan, 2009

**Figure 2.2. Average interest rates of deposits and credits (in % p.a.) 2008**



Source: Department of Banking Monitoring of NBT; March 2009

The weighted average interest rate on credits in 2008 was broadly stable, having made 23.1% in national currency and 21.8% in foreign currency (Figure 2.1)

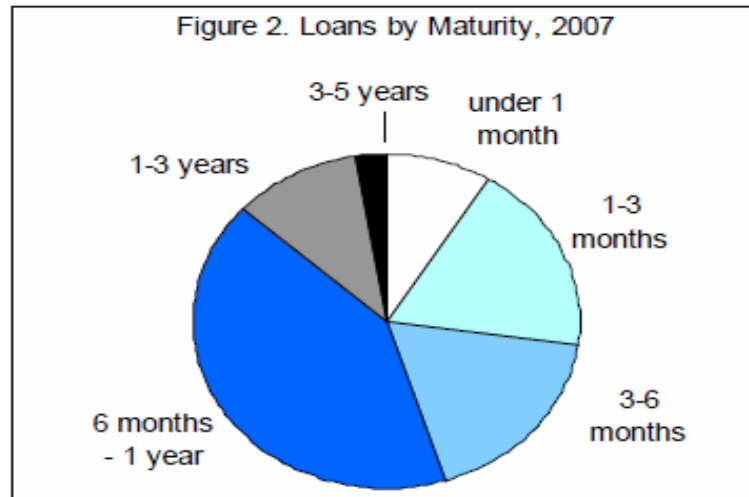
**The private sector has access to micro-credit, commercial credit, factoring and leasing instruments.** Some banks provide trade-financing services as well. In an effort to reduce barriers to competition, the Government of Tajikistan has paved the way for non-bank financial organizations and commercial microfinance. However, there is no credit bureau; much work is needed in strengthening creditors and shareholder rights.

**Loans to individuals and small and medium sized enterprises (SMEs), mainly for trading activities, have grown most rapidly, but commercial and industrial loans still account for more than half the outstanding volume (Table 2.3).** Loans to individuals and SMEs had a five-fold rise between end-2005 and end-2007 outpacing the growth of other sectors. Average loan maturity is about six months (Figure 2.2.), and average loan sizes in the portfolio of the top three banks range from \$10,000 to \$60,000 (25 to 150 times GDP per capita).

The relationship between entrepreneurs and financial institutions in Tajikistan is weak. Entrepreneurs do not perceive banks as reliable partners in addressing their needs of supporting their growth over time. This is partly a result of the low level of confidence of

the general public toward the banking system as a whole, as well as of the limited capability of the local banks to address their needs of their corporate customers.

**Figure 2.3. Loans by Maturity, 2007**



Source: IMF and Microfinance organization, 2008

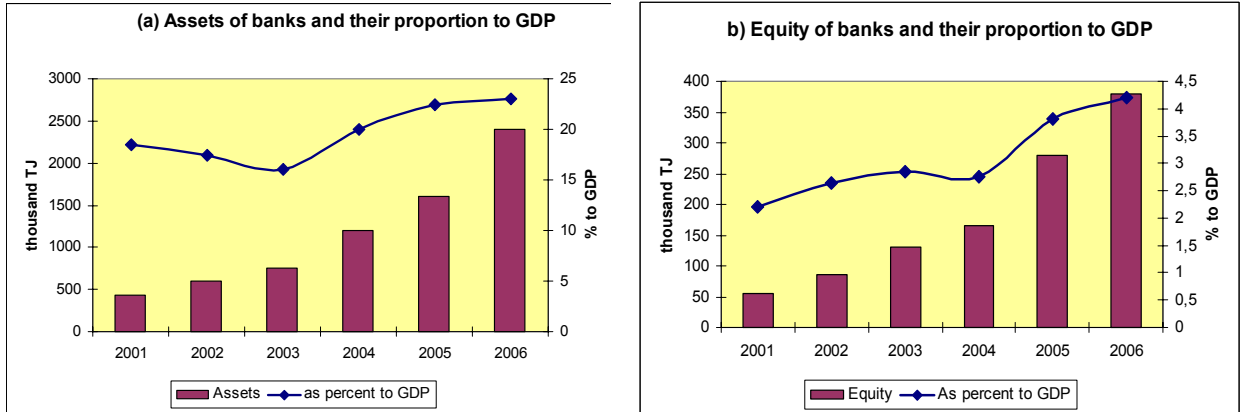
While banks' financing to agriculture is increasing, anecdotal evidence suggests that access by potential rural clients remains limited. The record of bank lending to agricultural SMEs has been particularly disappointing. This reflects products and procedures that are not adapted to the needs of farmers, serious problems in the use of agricultural land as collateral,<sup>12</sup> and maturity mismatches—shorter loan maturities than the length of most production cycles in agriculture.

The absence of a regular relationship between banks and entrepreneurs also explains to a great extent the limited size of the lending market. In fact credit, in particular toward SME, can only be extended when banks have developed long term relationship with this businesses, and can accurately assess the risks related to lending – in particular, credit risk. In this absence, lending is “rationed”, i.e., financial institutions tend to reduce their risk by limiting their credit exposure to a very short period, require high interest rates and high level of collateral.

On the other hand, Tajik banks face a complex market for funding, where although interest rates on deposits are in the range of 20%, they are not able to attract funds from individuals. Key cumulative indicators of the health of the banking system of Tajikistan

are provided in a number of figures that give a picture of the banking sector's development in Tajikistan.

**Figure 2.4. Banking Sector's Indicators, 2001-2006**



Source: Department of Banking Monitoring of NBT; 2007

One can see a considerable and fast expansion of total assets and equities of commercial banks during 2001-2006.

**The basic parameters of a monetary and credit system.** On preliminary data of the National bank of Tajikistan, for September 1st, 2008 the total sum of credit investments of banks of the second level in the basic sectors of economy (in national and a foreign currency) has made 4652,3 million somoni<sup>59</sup>. The delayed debts under loans of banks of the second level as of September 1st, 2008 has made 115,4 million somoni, from them 67,2 million somoni, or 58,2 % - in national currency, 48,2 million somoni, or 41,8 % - in a foreign currency.

**Banks appear profitable, adequately capitalized, and highly liquid but in the context of a weak supervisory framework.** Against a mandated minimum capital adequacy ratio (CAR) of 12 %, the average for the industry was 21.3 % at end-2007 (see Table 4 in Attachment)<sup>60</sup>. Notwithstanding additions to the capital base, reported ratio have fallen sharply (some 17 %age points since 2005) reflecting the very rapid growth of the loan portfolio; they still appear adequate but just barely (See stress tests in the Attachment). With intermediation margins at very high levels, returns on assets of Tajik banks are very

<sup>59</sup> The rate of national currency to US Dollar ( for 9 months)

2007 – official rate decreased to 0.5%

2008 – official rate became stronger on 1.6%

<sup>60</sup> CAR (capital adequacy ratio) is calculated according to the Basel I methodology.

high in international comparison (see Figure 2.1.) However, competitive pressures in the coming years are likely to increase as a result of foreign bank entry, already seen with a bank from Kazakhstan starting operations earlier in 2008.

**Table 2.4. Structure of credit investments of banks of a second level, as of September 1st, 2008**

	in thousands of TJS	in %, to the total
1. <b>Total credit investments</b>	4652280,5	100
1.1. Credits in national currency	2178625,4	46,8
1.1.1. Short-term	1971720,7	42,4
1.1.2. Long-term	206904,7	4,4
1.2. Credits in a foreign currency	2473655,1	53,2
1.2.1. Short-term	2121745,8	46,6
1.2.2. Long-term	351909,3	7,6

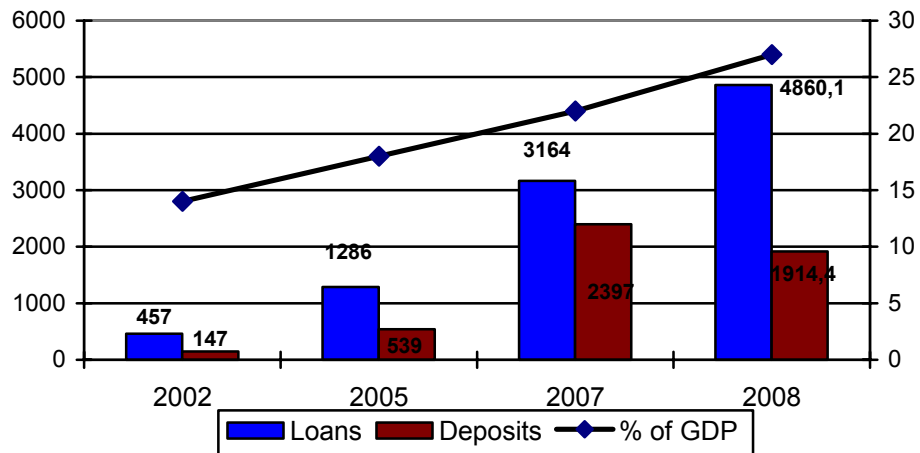
Source: National Bank of Tajikistan; 2008

**Lending:** *Growing at high place, but still limited.* As a result, the total amount of lending from 2002-2005 increased annually by 41,1% and reached 1.3 billion somoni (\$405 million) by the end of 2005 (see Chart 2.4.). Taking into account the average inflation rate during this period<sup>61</sup>, the real growth of lending totaled 31.1%.

**Deposits:** Significant development to be supported by an increase in the trust of people in the financial system. The volume of deposits also increased remarkably between 2002-2005 and amount to 540 million somoni (\$169 million), which represents an annual real growth rate of 48.5%. The growth in volume of deposits continued in 2006 and reached 690 million somoni (\$169 million) by June 2006.

**Chart 2.4. Volume of Loans and Deposits; 2002-2008 (in mil. TJS)**

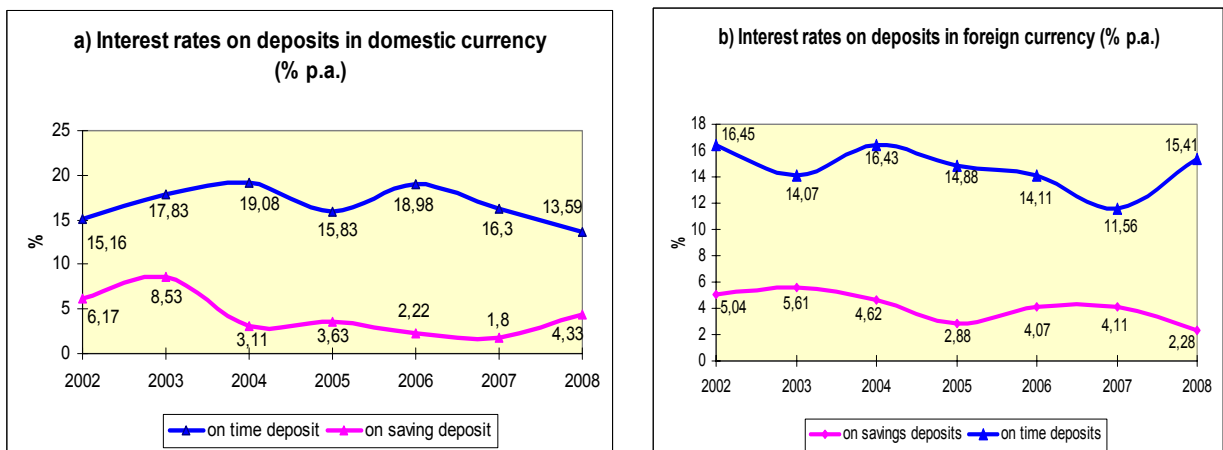
<sup>61</sup> Average inflation rate between 2002 and 2006 being 10.2%



Source: National Bank of Tajikistan

However, individuals still show limited trust toward the financial sector: 70.7% of deposits come from legal entities, while only 29.3% from individuals. In fact although banks offer quite high interest rates on deposits<sup>62</sup>, the overall population still prefers to keep cash in hands. Additional evidence of the limited trust towards the financial sector comes from the high flow of remittances from migrant workers: about 90% of these flows conveyed through financial intermediaries are withdrawn the same day they are received<sup>63</sup>.

**Figure 2.5. Interest Rates on Deposits in Tajikistan, 2002-2008**



Source: Department of Banking Monitoring NBT. 2007

Interest rates on deposits in domestic and foreign currency remained high in Tajikistan. Contrary to the theory of investments and migration of capital in the world

<sup>62</sup> Average interest rate for deposits from 6 months to 1 year amounted to 20.2% in local currency (TJS) and 13.8% in foreign currency in 2005 – NBT 92007)

<sup>63</sup> “Tajikistan”: economical perspective,” Asia-plus, 20.11.2006



economy there is no correlation between the inflow of foreign investments and domestic interest rates for the small and open economy of Tajikistan.

Interest rates on time deposits are low in comparison to the rates on credits and have a declining trend. Nominal rates are somewhat higher (around 10% per annum in national currency) for deposits with maturity above 12 months, but the share of such deposits in total amount is relatively small.

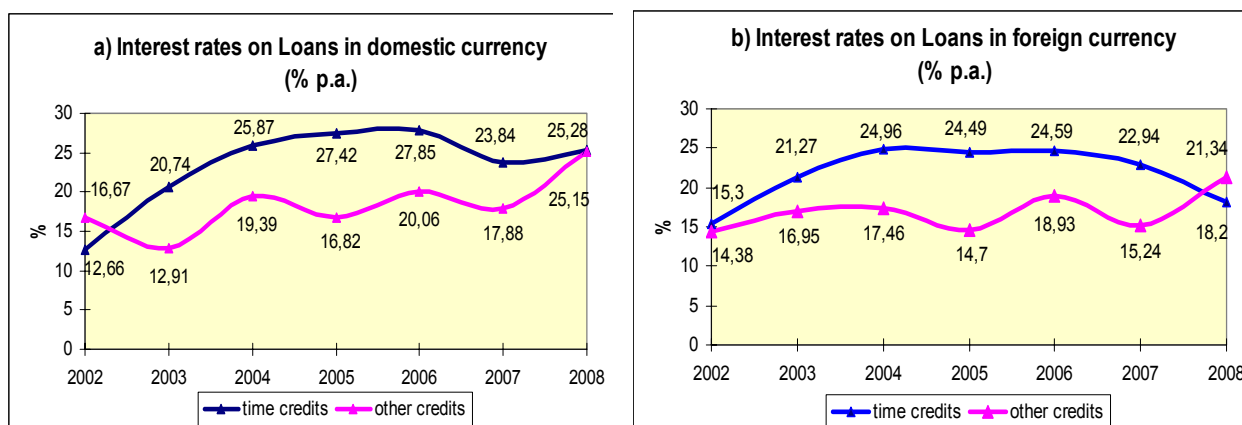
**Table 2.5. The average interest rates under the deposits involved by the credit organizations (for the period) (% , annual)**

	2008							
	Jan	Feb	March	April	May	June	July	Aug
<i>Under all deposits in national currency</i>	2,27	0,67	0,83	0,77	0,85	0,81	0,80	0,87
<i>Under deposits on demand</i>	1,83	0,48	0,62	0,63	0,61	0,62	0,58	0,70
<i>Under saving deposits</i>	2,01	1,58	1,70	1,46	2,71	2,04	2,29	2,58
<i>Urgent deposits</i>	19,52	16,31	16,23	16,54	15,89	16,71	18,46	16,95
<b>Under all deposits in foreign currency</b>	1,78	1,16	1,18	0,74	0,97	1,02	1,19	1,08
<b>Under deposits on demand</b>	0,21	0,19	0,29	0,16	0,17	0,18	0,24	0,17
<b>Under saving deposits</b>	2,51	4,10	4,22	3,87	4,37	4,20	4,12	4,34
<b>Urgent deposits</b>	11,33	11,35	9,89	10,58	12,75	13,99	14,36	17,00
<b>Representative rates on deposit</b>	11,45	7,10	7,73	6,44	8,26	6,26	8,13	6,39

Source: Department of Banking Monitoring NBT.

Interest rates on loans in domestic and foreign currency in Tajikistan are very high and do not allow the development of SMEs (small and medium entrepreneurs). Previously there were informal payments in the process of crediting in addition of formal interest rates. As a result loans became unacceptable for producers and processors of agricultural products. The only borrowers in such situation can be traders rather than real producers. However, the situation has improved in many commercial banks; most of them strive to tackle bribery. Another negative aspect in this field is the duration of credits. Commercial banks do not prefer to disburse long-term credits. Instead the short term credits with rapid terms of maturity are disbursed.

**Figure 2.6. Interest rates on Loans in Tajikistan, 2002-2008**



Source: Compiled from Banking Statistics Bulletin, Dushanbe

The banking sector of Tajikistan is relatively small. Now, in terms of ranking, the first three banks are Orienbank (in terms of total assets, liabilities, and deposits); Agroinvestbank (in terms of deposits of individuals and remittance transfer business); and Tojiksodirotbank that previously served only Tajikistan's foreign economic activity.

**Asset classification practices and provisioning rules may give an upward bias to reported profits and capital.** The reported NPLs (nonperforming loans) ratio has been on a rapid downward trend in the last few years falling from 21 % in 2004 to just 5 % in 2007. This reflects the expansion of the loan portfolio, but also a surprising fall in the stock of NPLs in 2007. Loan classification and provisioning rules were recently tightened<sup>64</sup>, but loopholes remain, which raises questions about the quality of assets and bank capital. Loans can be restructured once with no effect on classification<sup>65</sup>. Reclassification of loans into less-performing categories has occurred frequently as a result of onsite inspections. Provisions are relatively low (at about 40 % of NPLs), reflecting the high share of substandard loans in NPLs, provisioning requirements calculated net of collateral, and weaknesses in collateral valuation.

**Table 2.6. Financial Soundness Indicators, 2004 – 2007**

	2004	2005	2006	2007

<sup>64</sup> Regulation 139 of July 2005 requires that loans be classified into four past-due categories: substandard (1-30 days), doubtful (30-60 days), dangerous (60-180 days), and hopeless (180 days+). A 2 % general reserve is required on the performing portfolio, and provisions on the other classes are 5 %, 30 %, 75 %, 100 %, respectively. Provisions are calculated net of realizable collateral (with predetermined haircuts)

<sup>65</sup> Loans must be classified as at least substandard if restructured more than once. Restructured loans were 10 % of the total at end-2007.

<b>Capital Adequacy</b>				
Tier I capital as % of risk-weighted assets	38.7	34.2	27.8	19.4
Reported total capital to risk-weighted assets	44.7	37.9	30.4	21.3
Reported total capital to total assets	28.6	27.2	20.8	16.5
<b>Asset quality 1/</b>				
Nonperforming loans to gross loans	20.6	14.3	11.3	4.8
Nonperforming loans net of provisions to reg. capital	19.3	16.1	18.2	13.9
Provisions to nonperforming loans	47.2	36.8	27.8	40.5
Banks exceeding maximum single borrower limit 2/	3 of 12	2 of 12	1 of 9	1 of 10
<b>Earning and profitability</b>				
Reported return on assets (ROA)	2.9	4.7	3.8	2.7
Reported return on equity (ROE)	10.2	17.2	16.1	16.8
Net interest margin to gross income	40.0	43.6	49.8	57.8
Net interest margin to earning assets	9.1	8.9	8.5	7.4
Net interest expenditures to gross income	61.0	55.2	63.2	61.4
Salary expenditures to non-interest expenditures	25.8	27.1	21.6	25.7
<b>Liquidity</b>				
Liquid assets to total assets	36.9	30.0	39.9	39.9
Liquid assets to demand and saving deposits	113.5	80.2	84.0	112.6
Liquid assets to total deposits	71.2	54.9	57.9	61.3
<b>Sensitivity to market risk</b>				
Net open position in foreign exchange to capital (long is positive)	36.3	8.8	5.9	13.4
<b>Dollarization</b>				
Foreign currency loans to total loans	57.0	57.3	66.9	68.2
Foreign currency loans to total deposits	63.5	70.9	78.4	78.9

Source: National authorities; IMF

1/ Nonperforming loans include substandard (1-30 days), doubtful (30-60 days), dangerous (60-180 days), and hopeless (180 days +).

2/ Maximum single borrower limit is defined as 25 % of capital.

**According to the stress tests, which were conducted to evaluate the potential vulnerabilities of the banking system.**<sup>66</sup> The tests assessed the impact of a deterioration in the quality of credit portfolio, fluctuations in exchange and interest rates, and liquidity withdrawals. The reliability of the tests depends on the underlying quality of banks'

<sup>66</sup> Results of the stress-test in Attachment...

financial statements and there are reasons for concerns on this regard. The stress tests suggest that the banking system is broadly resilient to a range of extreme but plausible shocks, owing to banks' still adequate capitalization and high profits. The tests revealed limited, but rising, strain for most banks under most scenarios. Tajik banks are most vulnerable to credit risk, including indirect credit risk related to exchange rate fluctuations. In particular, the largest two banks appear vulnerable to a significant simultaneous deterioration in the financial health of their major borrowers.

If Tajikistan's banks could *attract remittance recipients to invest their temporary free financial assets into local banks*, the opportunities of the financial sector in creating of national economy would have increased. In addition, the cost of capital reflected in interest rates would decrease, boosting entrepreneurial activity and development of SMEs. Remittances can also help relax financial constraints of individuals; they might lead to lower demand for credit and have a dampening effect on credit market development. To convert remittance recipients into bank clients, banks should improve the quality of their services and offer specially designed products that would increase financial literacy among potential clients. To attract clients and increase the breadth of financial services to bank clients, measures must be directed at developing mobile banks that would directly establish contacts with potential bank clients in remote rural areas.

At present, in Tajikistan one can observe the formation of banking bureaucracy when the attitude of banks toward clients leaves a lot to be desired. Commercial banks are convinced that customers should approach banks but not conversely. They do not understand that the development of any banking institution relies on its ability to attract more clients and offer better services.

Remittance can serve as an instrument for establishing contacts with remittance recipient who can be their potential clients. This can be realized for example when commercial banks bring transferred remittances directly to the home of remittance recipients and later convince them that it would be better to keep their savings not "under the bag" but in bank account as a deposit. One problem among remittance recipients is that those savings that are not invested in banks as deposits directly influence the price of

durable goods in Tajikistan, particularly the coast of property. This phenomenon is known in economic literature as “money fetishism”.

To attract remittances into the financial sector of Tajikistan, it is important to understand how an ordinary labor migrant thinks. Most migrants do not want to work forever in the Russia Federation or other neighboring countries and, thus stay in a “vicious cycle”. By understanding this and their business ambitions, then commercial banks can approach labor migrants effectively and make them their clients. It must be mentioned that Tojiksodirobank has already started a new kind of credit incentive for labor migrants that is disbursed for the purchase of airline tickets to the Russian Federation and other countries. This is attractive for Tajiks. In addition to granting credit, banks also give a free credit card to migrants, hoping that they would be using it for money transfers and deposits. Another service that is demanded among most migrants at the present time is mortgage credit. Most labor migrants, after their return, desire to purchase a property in Dushanbe. However, the cost of property is growing very rapidly.

Under this circumstance, only Tojiksodirobank offers mortgage credits but its interest rates are very high, making such service unacceptable. Usually interest rates for mortgage credits should be a bit higher than the annual rate of inflation. However, in Tajikistan, to get a mortgage credit, one should pay first 40% of the sum of credit at the beginning and the rest should be returned within 3 years at 25% interest per annum.<sup>67</sup>

Taking into account the intensive urbanization in the cities of Tajikistan, an increase in municipal projects that will allow legal urbanization must be conducted. On this account, special attention should be given to bank clients who remit and keep their savings in banks. Analysis of urbanization process in the main cities of Tajikistan leads to the belief that allotments were sold mainly to those allotments that are being sold to migrants. Developing, therefore, a special project that will give preference to remittance recipients will positively influence and attract clients to the banks.

### **2.3. BASEL CORE PRINCIPLES FOR EFFECTIVE BANKING SUPERVISION**

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<sup>67</sup> “Tojiksodirobank” publications 2008; and IMF newspaper; 2007-08.

Although the 1999 Basel Core Principles for Effective Banking Supervision were used in the review and rating process, in the future the revised BCP will be the goalpost standard for banking supervision. Given the changes to the BCP, particularly the increased emphasis on sound governance and risk management, the NBT would be well served to address the issues cited herein while at the same time simultaneously measuring it self against the revised, more elevated standards.

**Institutional and macroeconomic setting and market structure—overview.** The central bank regulates and supervises most financial institutions. The NBT oversees all deposit-taking institutions as well as all the nondeposit-taking microcredit organizations. The banking system has undergone substantial consolidation in the last few years against the backdrop of tighter prudential regulations.

### **2.3.1. Preconditions for effective banking supervision.**

#### ***Macroeconomic policies***

**Relatively prudent macroeconomic policies have supported strong growth and broadly stable macroeconomic environment in recent years.** Real GDP has expanded at an average annual rate of about 8½ percent during the last five years, with the sectoral composition of GDP gradually shifting toward services. Inflation fell from double digits to 6–7 percent in 2004–05, but accelerated to about 20 percent by end-2007. Fiscal performance has been solid, with the government having run small surpluses (excluding the externally financed public investment program) for the last five years.

#### ***Public infrastructure***

**The legal framework governing Tajikistan’s financial sector is relatively young and untested.** Six laws govern the sector (i) the Law on the NBT (LNBT) (1996, amended 2001–02); (ii) the Law on Banks and Banking (LBB) (1998)<sup>68</sup>; (iii) the Law on Guarantee of the Deposits of Physical Persons (2003); (iv) the Law on Securities and Stock Exchange (1992); (v) the Law on Insurance (1994); and (vi) the Law on Microfinance Organizations (2004). There is no specific law for nonbank financial institutions; the latter are governed by the NBT Regulation No. 118 “On Credit Companies.” There is virtually no private ownership of real property, and land reform is a major component of needed future reform

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<sup>68</sup> See also NBT Instruction No. 132 “On order of regulating banks activity” (October 2004), and Government Decision No. 206 “On fixing of volume (quotas) of participation of foreign capital in banking system of RT” (May 2003)

of the legal and public systems. International accounting standards were introduced in 1999.

**The legal framework of the financial system has not been tested in the courts.** Challenges to the NBT's oversight and regulation are seldom, although the level of influence the financial sector has over prevailing regulation and NBT decisions is not clear. The local audit industry is shallow, and firms responsible for auditing banks are domiciled in neighboring countries.

#### ***Market discipline***

**The mechanisms for market discipline are nascent.** Banks are required to disclose financial statements which are audited annually by firms licensed by the NBT. No interim results are disclosed. By law the NBT sets the accounting standards, and the central banks and the industry adopted IFRS in 2006. However, international auditing standards are not required<sup>69</sup>. The incentive structure for hiring and removal of managers and Board members is not concretely established, and the tools for the exercise of market discipline (e.g., deposit mobility and general public education about bank soundness) are not evident.

#### ***Systemic protection/resolution***

**Bank resolution procedures remain *ad hoc*.** In the last 10 years the NBT has withdrawn 21 bank licenses and initiated 1 major bank restructuring. The latter, in 2003–04, involved a “good bank–bad bank” split of the then largest bank in the system, Agroinvestbank, which had suffered serious problems with its cotton sector exposures. Impaired claims amounting to some  $\frac{3}{4}$  of its total assets ( $7\frac{1}{2}$  percent of GDP) were transferred to a new asset management company, KI; a sizable portion of the remaining claims were underwritten by the government/NBT; and the rump bank was privatized. The new asset-management entity, however, has made little subsequent progress in resolving this debt.

**A limited-scope deposit insurance scheme is in place, but suffers a number of design flaws.** With the fund's balances equivalent to less than 1 percent of estimated insured deposits, the absence of contingency financing arrangements is a key weakness of the scheme. Other problems include the voluntary nature of the scheme, no cap on insurance coverage, and insufficient exclusion of bank shareholders and related parties from coverage. A number of revisions to this law are under consideration.<sup>2</sup>

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<sup>69</sup> The NBT has recently begun involving the banks' external auditors in high level discussions through tripartite meetings to discuss key issues and focus.

### **2.3.2. Main Conclusion and Recommendation:<sup>70</sup>**

#### ***Objectives, autonomy, powers, and resources (CP 1)***

**The powers of the NBT to license and supervise banks had been established in law, but these provisions have recently been repealed, and the only legal basis for the NBT supervision is a presidential regulation, which is contrary to best international practice and raises the important question of the level and effectiveness of enforceability.** The other provisions of the LNBT and the LBB apparently remain in force, however, and these provide a reasonable basis for supervision, although the LNBT, while addressing the stability of the banking system, does not specifically deal with safety and soundness concerns. The NBT is officially independent, although there is some evidence of interference by the Tajik politico-economic establishment. The NBT lacks a capital base to ensure its financial independence and its chairman is appointed for an indefinite term and can only be dismissed for ‘abuse of power.’ Staff professionalism is growing, resources are adequate, and staff turnover is low. There is no protection for either the NBT or its staff from being sued, nor are costs reimbursed should a lawsuit arise. There are no MOUs with other supervisors.

#### ***Licensing and structure (CPs 2–5)***

**Recent legal changes have weakened the effectiveness of the law on the use of the term “bank” and made it less clear.** Assuming that the NBT is still operating a licensing regime based de facto on the LNBT and the LBB, there are still legal shortcomings in the system, with no requirement to check on shareholders, directors and senior management, nor on the operational structure of the proposed bank. Practice is also seriously deficient with decisions made for reasons that are not clear and are not adequately minuted. Probity checks are not carried out on new shareholders, although holdings of more than 20 percent can be rejected for financial reasons, and there is no system of prior approval for investment holdings of banks, just a limit based on a percentage of capital.

#### ***Prudential regulations and requirements (CPs 6–15)***

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<sup>70</sup> World Bank and International Monetary Fund, Country Report No. 08/371; “Republic of Tajikistan: Financial System Stability Assessment” [www.imf.org](http://www.imf.org); [www.worldbank.org](http://www.worldbank.org); December 2008



**There are no capital charges for market risks and no consolidated capital requirements, although many of the other capital adequacy calculations are consistent with Basel requirements.** The NBT has taken action against banks in breach of capital requirements, but there is no formalized planning to deal with capital problems before they become critical.

**There is currently no regulation that deals with credit policies, although this area is covered in detail during on-site examinations.** There is an adequate, past-due based, regulation for provisioning, and large exposure limits are defined in terms of international norms, although there is evidence of frequent breaches of the rules. Connected lending rules give no powers to the NBT to require decision-making at a senior level without the connected person being present. There is no country risk, nor market risk regime, although in both cases such risks are minimal at present. Some supervision of liquidity and foreign exchange risk takes place, albeit more quantitative through verification of calculations and minimal, if any, review of the nature and effectiveness of the attendant risk systems. Other risks are monitored by an ‘internal control unit’ set up in banks at the behest of the NBT. The approach is more compliance than risk-focused, however. More needs to be done to develop management information systems in banks, as well as an effective internal audit function. There is no law or regulations setting forth customer diligence requirements and reporting of suspicious transactions for the prevention of money laundering or terrorist financing activities, nor has a FIU been established. A draft law is pending before Parliament.

#### ***Methods of on-going supervision (CPs 16–20)***

**A comprehensive set of returns has been developed by the NBT with the help of international consultants, and these consultants have also assisted with training for onsite examiners.** There is an annual on-site examination of each bank, with the prime focus on credit risk (the principal risk in Tajik banks), but some work on internal control matters as well as validation of off-site returns. There are regular contacts with senior management, ad hoc meetings with the chairman, but no regular meetings with the full board. There is no consolidated supervisory regime at present, although this will be needed soon as the financial system develops, and the NBT has been drafting a regulation to cover this.

### ***Information requirements (CP 21)***

**Banks have to have their accounts audited in accordance with IFRS and published annually.** The audit profession is not well developed in Tajikistan and many of the audits are conducted by staff based in adjacent countries. The effectiveness with which IFRS is applied is in doubt, given in part the cited issues surrounding timeliness and accuracy of asset classification by banks. International audit standards are not formally applied. Dialogue between the NBT and the audit profession is limited, although the NBT does license auditors (in the absence of any other body capable of doing the work).

### ***Formal powers of supervisors (CP 22)***

**The recent changes to the laws mentioned above call in question the foundation on which the NBT can take remedial action against banks.** Notwithstanding these changes, the NBT's powers in this area needed substantial strengthening. Although fines, staff changes, and business restrictions can be imposed, a bank cannot be put into liquidation without a prior period of temporary administration. There is no system of a structured remedial action approach triggered by specific events or any requirement for action to be taken on a timely basis. Although the NBT has taken action against banks in recent years, it is not always on a consistent and proportionate basis.

### ***Cross-border banking (CPs 23–25)***

**No Tajik banks are established outside the country, and only one foreign bank operates in Tajikistan, with a specialized role serving two embassies.** Nevertheless, since the Tajik authorities would like to see more foreign banks in the country, the NBT should develop the necessary regime to deal with this, including the ability to assess the effectiveness of a home country's supervision.

**Table 2.7. Summary Compliance with the Basel Core Principles**

Core Principle	Comment
1. Objectives, Autonomy, Powers, and Resources	The powers of the NBT to license and supervise banks are now based only on regulation and not law. The previous laws (which are being used de facto) provide a reasonable basis for supervision, but safety and soundness concerns are not specifically addressed. The NBT is officially independent, although there is some evidence of interference and there is not the capital to ensure financial independence. The chairman is appointed for an indefinite

	term and the reasons for his possible dismissal are not clear. Staff professionalism is growing, resources are adequate, and staff turnover is low. Neither the NBT nor its staff is protected from being sued, nor are costs reimbursed. There are no MOUs with other supervisors.
1.1 Objectives	Banking stability addressed, but not safety and soundness concerns.
1.2 Independence	Formally present, but vitiated by lack of capital to ensure financial independence and by interference from the Tajik establishment.
1.3 Legal framework	Inadequate following the recent revocation of NBT's legal powers to license and supervise banks and their replacement by a Presidential Regulation. Other parts of the relevant laws remain in place.
1.4 Enforcement powers	The laws give the NBT powers to levy a variety of sanctions against delinquent banks and obtain necessary information. These are presumably still available based on the Regulation mentioned above.
1.5 Legal protection	There is none, either for the NBT or its staff, nor are costs of any legal action reimbursed
1.6 Information sharing	The laws provide for this, but there are no formal MOUs in place with other supervisors.
2. Permissible Activities	The laws were previously satisfactory here, but recent changes have watered them down.
3. Licensing Criteria	Some of the building blocks for effective licensing are in place, but a number are missing and practice is seriously deficient
4. Ownership	Only ownership changes in excess of 20 percent have to be approved by the NBT, which carries out no probity checks, nor looks behind nominee shareholders.
5. Investment Criteria	There is no system of prior approval of investments by banks, just a limit based on a percentage of capital.
6. Capital Adequacy	Capital adequacy requirements are broadly in line with Basel, although there are no charges for market risks and no consolidated capital requirements. Action has been taken against banks in breach of requirements, but there is no forward planning to deal with capital shortfalls before they become critical.
7. Credit Policies	There is currently no regulation that deals with credit policies and management information in this area needs improvement
8. Loan Evaluation and Loan-Loss Provisioning	Provisioning is on a past due basis, and more needs to be done to establish forward-looking criteria in this area.
9. Large Exposure Limits	Large exposure limits are defined in line with international norms, but there is evidence of frequent breaches of the rules.
10. Connected Lending	The rules here do not give the NBT the power to require banks to take decisions on this at a senior level without the connected person being present.
11. Country Risk	There is no regime, although risks are minimal.
12. Market Risk	There is no regime, although, again, risks are currently minimal.
13. Other Risks	Some supervision of Foreign Exchange (FX) and liquidity takes place, and other risks are monitored by an internal control unit in each bank.
14. Internal Control and Audit	The role of the board is not clearly defined, nor that of the internal control unit or internal audit. The approach is compliance rather than risk-based.
15. Money Laundering	No regime is in place, although an anti-money laundering law is in draft.

16. On-Site and Off-Site Supervision	A comprehensive set of returns has been developed with the help of international consultants, who have also helped with the training of on-site examiners. Annual on-site visits focus chiefly on credit risk.
17. Bank Management Contact	There are regular contacts with senior management of banks, but only ad hoc meetings with the Chairmen and no regular meetings with the full board.
18. Off-site Supervision	A prudential reporting regime is in place and is being regularly improved.
19. Validation of Supervisory Information	Some validation of data takes place when on-site, but external accountants are not used.
20. Consolidated Supervision	No regime is currently in place, although a new regulation has recently been drafted.
21. Accounting Standards	Banks' accounts should be prepared in accordance with IFRS and published annually. The accounting profession is not well developed in Tajikistan, and the effectiveness with which IFRS is applied must be in doubt. International auditing standards are not applied.
22. Remedial Measures	Substantial improvements are needed, including placing the powers of the NBT again on a firm legal basis. A structured remedial response regime should be developed, as well as the NBT having the right to put a bank into liquidation and being required to act on a timely basis. Recent action has not always been consistent and proportionate.
23. Globally Consolidated Supervision	There are no Tajikistani banks established outside the country.
24. Host Country Supervision	Ditto
25. Supervision Over Foreign Banks' Establishments	The NBT should ensure that it has in place the legal powers and systems to supervise foreign banks established in Tajikistan effectively. This includes comprehensive 'fit and proper' tests and an ability to assess the effectiveness of home country supervision.

Source: IMF Work Paper "Implementation of the Basel Core Principles for Effective Banking Supervision "Experiences, Influences, and Perspectives"

## **2.4. Nonbank Financial Institutions; Microfinance organizations**

**Microfinance institutions (MFIs) have become an important segment of Tajikistan's financial system,** mainly due to the nature, structure and low density of the economy. MFIs primarily focused on humanitarian activities related to disaster relief after the end of the civil war in 1997. Recently, they are transitioning to commercial activities to support long-term economic development. The microfinance sector is characterized by several NGOs supported by IFIs and donor sponsored programs active in and throughout the regions of Tajikistan. Anecdotal evidence shows that there are about 200 organizations and entities with active programs on microfinance services, of which 25 are specialized

microfinance institutions. The outstanding portfolio of the microfinance sector is estimated at US\$30 million.<sup>71</sup>

**The deposit-taking MFIs are commercial entities, licensed by the National Bank of Tajikistan (NBT).** Their activities include taking deposits, extending micro-credit (secured and unsecured), and conducting other operations. The latter include cash operations, issuance of guarantees (provided that the maximum outstanding amount for a client not exceeding the size limitations applicable to micro-credits), issuing and accepting payment cards, opening and servicing accounts of individual and legal entities, and performing clearing and settlement operations. They can also engage in other activities including providing consultancy and information services to clients; financial leasing provided that the amount involved in a lease (less the imputed interest) to any one client not exceeding the size limitations applicable to micro-loans, borrowing money (whether secured by its assets or otherwise); acquiring claims with respect to payment obligations of a third party; and selling property acquired pursuant to the terms of pledge.

Lending MFIs are commercial entities licensed by the NBT, while micro-lending funds are non-commercial entities certificated by the NBT. The law stipulates that both lending MFIs and micro-lending funds can conduct the following activities: extending micro-loans (secured and unsecured); carrying out financial leasing transactions, provided that the amount (involved in a lease less the imputed interest) to any one client not exceeding the size limitations applicable to micro-loans; and providing consulting and informational services, including business development services, to its clients. They can also conduct other activities including borrowing money (whether secured by its assets or otherwise) from legal entities operating outside Tajikistan; borrowing money (whether secured by its assets or otherwise) from organizations licensed by the NBT; acquiring claims with respect to payment obligations of a third party; and selling property acquired pursuant to the terms of a pledge.<sup>72</sup>

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<sup>71</sup> This amount comprises \$12 million (EBRD assisted lending through commercial banks), \$15 million through a variety of MFIs and nonbank financial institutions, and \$3 million in projects including UNDP. These figures, however, do not include the credit societies licensed by NBT.

<sup>72</sup> The National Bank of Tajikistan, "Instruction #135, Norms regulating Activities of Micro-credit Deposit Organizations", March 2005.

**The MFO sector is growing fast and already provides services to a sizeable number of borrowers.** Lending by MFOs grew by more than 200 percent in 2006 and a further 120 percent in 2007. This growth has been possible mainly due to access to foreign microfinance credit lines. However the sector is still very small, with a \$50 million aggregate loan portfolio at end-2007, roughly equivalent to 10 percent of the commercial banks' portfolio. MFOs' client base is significant with more than 50,000 borrowers in 2007<sup>73</sup>.

There are three types of MFOs licensed under the 2004 law on microfinance:

- microcredit funds (38 institutions),
- microcredit commercial organizations (23)
- microcredit deposit-taking institutions (6)

Each type is subject to different regulatory requirements (e.g., minimum capital and types of services they are allowed to offer) and supervision processes, and can access a broad range of financing sources, including deposits and commercial borrowing.

MFOs, which hitherto have focused on financing commercial activities, are increasingly targeting rural clients. After commercial banks, MFOs are the second largest source of financing for trade, providing 12 percent of all financing to these activities. Given commercial banks' competition in urban areas, MFOs are looking to find unmet niches in rural areas. Rural credit from MFOs has significant constraints—loans are small, short term, and subject to rigid group lending procedures—although they are apparently adequate for the financing of small-scale agricultural activities, like agro processing.

## **Insurance**

**Despite rapid growth in recent years, the insurance sector is underdeveloped, highly concentrated, and the majority of companies are undercapitalized.** Total gross premiums were equivalent to 0.3 percent of GDP in 2006, one of the lowest in the region (Table 2.9). Fourteen insurance companies were operating in Tajikistan in 2006, including two state-owned that have a monopoly on compulsory classes of insurance and all government business. Two companies dominate the market, one private and one state-

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<sup>73</sup> Access to microfinance in Tajikistan remains limited compared to other countries. About 1 percent of the active population had access to microcredit in 2005, compared to 2.5 percent in Central and Eastern Europe.

owned, collecting 60 and 25 percent, respectively, of the premiums in 2006. To level the playing field and foster competition, the monopoly on compulsory insurance should be abolished.

**Table 2.9. Insurance Penetration and Density in Selected Markets, 2007**

	Premium Volume (in USD million)	Insurance Penetration (Premium in percent of GDP)	Insurance Density (Premium per capita, USD)	Population (in millions)
<b>Russia</b>	21504.3	2.27	150.9	142.6
<b>Turkey</b>	6618.3	1.62	89.3	74.2
<b>Ukraine</b>	2739.4	2.80	59.6	46.5
<b>Kazakhstan</b>	627.8	0.90	42.3	14.8
<b>Uzbekistan</b>	35.2	0.40	1.34	26.4
<b>Georgia</b>	39.4	0.40	5.43	4.2
<b>Tajikistan</b>	<b>21.0</b>	<b>0.30</b>	<b>1.18</b>	<b>6.5</b>

Source: IMF, Sigma and SISS

**Several factors hold back the development of the sector, including limited managerial experience.** The low insurance penetration reflects, *inter alia*, widespread poverty, a very skewed income distribution (e.g., growth of life insurance is dependent on the size of the middle class), and an out-of-date legal framework. Further, there is little understanding of the role reinsurance can play in reducing risk and managing loss exposures. Although the Tajik insurance sector has very limited capacity, some of the local companies retain all the business that they write, while others are only reinsuring single large risks on an optional basis.

## Leasing

**Leasing is an emerging source of finance, but the lack of long-term sources of funding is a major obstacle to its development.** The volume of leasing remains negligible (0.1 percent of GDP), with only 5 leasing companies in operation in mid-2007. According to operators in the sector, reluctance by financial institutions to invest in mid- and long-term projects hinders the growth of the sector. Leasing could be especially important for Tajik businesses without an adequate credit history, because it enables the financing of equipment based on collateral.

**The legal framework is satisfactory but there is room for improvement.** Leasing is governed by the civil code—with specific norms that supersede general norms for rent relationships—and the 2003 law on leasing, and regulated by the NBT. The legal

framework could be further strengthened by including in legislation provisions that allow for the releasing of equipment.

## **CHAPTER SUMMARY**

**Summarizing, the financial market in Tajikistan** is growing quickly from a very low basis. Largely, this growth is a consequence of macroeconomic stabilization in recent years, considerable strengthening of regulation of the sector, inflow of FDI, and maintained competitive environment. Still, the country's financial market is shallow and financial intermediation is insufficient to meet the country's need. Banks consider remittances only as a source of non-interest income and take only little effort to provide intermediary services to remittance senders and recipients. However, with the revival of consumer finance, growing competition in the banking sector, and adaptation of remittance-receiving households to contacts with the banking sector, changes for more successful financial intermediation seem to be interesting.

## **III. SYSTEM AND LAW PREDICTIONS FOR BUILDING A CAPITAL MARKET IN TAJIKISTAN**

### **3.1 Important elements for successful Capital Markets**



### **Government Support<sup>74</sup>**

For a successful capital market to be built and sustained there, must be a stable government. Then the government must be able to maintain control of the monetary and fiscal policies conducive for improving savings and investments. The country also must be able to attract foreign investments. The country must also have a respected and effective judicial system, together with a regulatory agency with powers to enforce the set laws. Finally, the country must have in place an equitable and effective tax system. These together with the requisite corporate governance, will make a foundation for public confidence in the market.

### **Infrastructure and Capabilities**

In order to create confidence in the capital market, institutions and persons must be able to rely upon adequate, competent advice from others. The development of trained, competent professionals requires government and private sector commitment to education and continuing training programs.<sup>75</sup> The establishment of a viable secondary market is also essential even before primary offerings by the government/private companies can be made. This is so because investors have to be given chance for exit whenever they choose to. There must be also a universal, reliable telecommunication network to facilitate instant communication. Access to all types of media and investment news is also essential. Lastly, there must be a clearing and settlement infrastructure. Timely and reliable clearance and settlement are the foundation for safe and efficient trading environment.

#### **Ingredients of a Good Capital Market**

1. Sufficient number of investment grade securities
2. Adequate information for investors
3. Talented and reputable brokers/dealers
4. Sufficient liquidity (adequate demand and supply)
5. Clearance mechanisms and back-office efficiency
6. Competitive transaction costs
7. Competitive automation (automated trading)
8. Modern regulatory framework

International accessibility – (language and communication), and international standard practices.

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<sup>74</sup> Professor Stuart R Cohn, Capital Market Development – April 2004

<sup>75</sup> Professor Stuart R Cohn, Capital Market Development – April 2004

## 3.2 Investment climate in Tajikistan

Foreign Direct Investments (FDI) has an important role to play in filling the gap between domestic savings and the high levels of investment needed to support economic growth in the CIS (Commonwealth of Independent States) countries over the medium term, among of which is Republic of Tajikistan<sup>76</sup>. Moreover, it provides external financing often (through not exclusively) in the form of equity rather than debt, frequently in the export or import-competing sectors, all of which contributes to an improved external position. The literature stresses the importance of FDI as a source of technology and management expertise<sup>77</sup>. Investment may involve creation of new firms or expansion/restructuring of existing firms. De novo firms are particularly important for growth in transition countries. However, creation of de novo firms in the CIS countries has thus far been low, reflecting entry barriers.<sup>78</sup>

**Increased foreign investment would greatly improve the situation of the Tajik economy**, but so far they have been mostly limited to “State” investments by Russia, China and, to a lesser extent, Iran. EU private investments in Tajikistan are almost negligible, mainly due to the uncertain legislative and fiscal framework, the weakness of the public administration, the lack of basic infrastructure and the endemic level of corruption in the country. This latter is an enormous problem at all levels of the Tajik administration and society. Many tajiks (their number is estimated to be approximately 600,000) have emigrated to Russia or Kazakhstan to find a job, and their remittances constitute a considerable proportion of the country’s GDP.

**Promotion of foreign direct investment.** Within the context of bilateral relation the Government of Tajikistan signed agreement on promotion and mutual protection of investments with a number of countries, which form the basis for the regulatory framework for investments activity in Tajikistan. At present more than 210 joint ventures are established in Tajikistan. The main areas of activities of joint ventures are textiles, output of necessary products, export-import operations, agro-processing, construction and construction materials, telecommunications, and mineral resources exploration.

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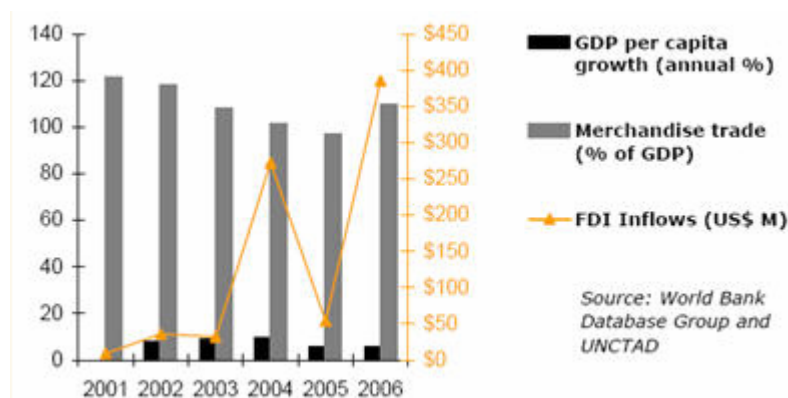
<sup>76</sup> FDI and the Investment climate in the CIS Countries; IMF, 2003; page 4.

<sup>77</sup> See, for instance, Borensztein and others (1998).

<sup>78</sup> For evidence concerning the creation of de novo firms in the CIS countries, see Havrylyshyn and McGettigan (2000) and Vandycke (2003)

Tajikistan presents selected opportunities for savvy investors willing to research and see first-hand market development activities and prospects. Tajikistan is the poorest newly independent state and one of the poorest countries per capita in the world. The Tajik government has shown interest in attracting foreign investment but seems unsure of how to implement much needed economic reforms, including incorporation of the country's considerable gray economy and sizeable remittances from Tajiks abroad. The Tajik government has committed to addressing Tajikistan's internal and external isolation, but progress is slow. Until Tajikistan addresses internal infrastructure impediments to investment, the system will not attract or support significant growth in FDI.

**Diagram 3.1. Foreign Direct Investment Inflows, 2001-2006**



Source: UNCTAD; Multilateral Investment Guarantee Agency: WB group 2008

**Despite Tajikistan's significant and consistent economic growth in recent years and its progress in various areas of economic reform** (such as privatization of most state-owned enterprises), investments rates, including FDI (foreign direct investments), have averaged only four percent of GDP between 2001 and 2004, despite the introduction of tax breaks, incentives for technological upgrades of production lines and full hard currency convertibility, and the private service accounts for only 50 percent of GDP private sector investment.

**Performance requirements/incentives.** Joint stock companies with foreign investments receive significant tax incentives that are not offered to private companies with domestic investments. The government does not formally impose performance requirements as a condition for establishing, maintaining, or expanding investment. There are few requirements for locally owned shares or reduced foreign sales over time. While there is no requirement to "buy locally," it is encouraged. Under the Law on Foreign

Investment, not less than 70% of employees in foreign-owned enterprises must be local employees.

The government does not impose geographic restrictions or conditions, but the topography and poor infrastructure of the country pose their own de facto restrictions. Transportation is difficult. Roads within Dushanbe and Khujand are substandard even by regional standards, and roads outside of major population centers are generally unpaved and poorly maintained. Weather also impacts travel, making overland travel to parts of the country (e.g., GBAO and Khujand via Anzob Pass) impossible for much of the year. Overland import/export requires patience and ingenuity as customs agents on neighboring borders frequently demand bribes.

**Right to private ownership and establishment.** The government wants to encourage business development but faces major obstacles in doing so, including its own practices. On one hand, the laws allow private entities to establish and own businesses and engage in almost all forms of remunerative activity. Foreign entities may establish, acquire, and dispose of interests in business enterprises. On the other hand, the old Soviet mentality still negatively impacts businesses. The average government inspector believes that certain activities are not permitted unless they are expressly allowed, and since laws are neither published nor uniformly applied and interpreted, businesspeople often find Tajikistan frustrating.

TajikStandart is the government agency that handles certifications of goods and services, calibration and accreditation of testing laboratories, as well as supervises compliances with state standards requirements. TajikStandart does not publish its fees for licenses and certificates, nor does it publish requirements for various businesses to allow businesspeople to find out what they are required to have to run their businesses. As a result, businesspeople are vulnerable to an individual tax inspector's interpretations of the requirements and the prices for them.

In addition, investors may need to work creatively to deal with unofficial barriers to success. Informal networks of clan-based, interrelated suppliers often exist, forcing would-be investors to "buy in" to the system. This hinders competition and sometimes constrains new investors from fully participating.

The government faces a daunting task to improve the operating environment. Any restructuring must be implemented at each sub-governmental level for each area of reform

(communication, expectations and patronage system, and so on). The Tajik government has begun reviewing these weaknesses and is making some improvements.

**Protection of property rights.** The mentality of the Soviet era has been slow to fade. Consequently, individuals may find it challenging to protect their property rights in a manner to which westerners are accustomed. With United States government assistance, the drafting of Part III of the Civil Code that addresses intellectual property rights has been completed. The World Bank has been working for several years to develop a mortgage program in Tajikistan, it is expected that the draft of mortgage law will be completed in 2006. However, people only own or lease the actual buildings on the land and not the land itself, and there are significant restrictions on using property titles as collateral. While an instruction on the order of legal registration of buildings exists to deal with ownership issues, private land ownership is still prohibited. (Note: according to the constitution the land is property of the state.)

Even when secured interests in property do exist, enforcement remains an issue. Investors should be aware that establishing title might be more complicated than in western countries, as it is often unclear who owns a title, making it more difficult to effectively transfer or acquire ownership. A system to record, protect and facilitate acquisition and disposition of property exists but needs improvement. After many banks failed or nearly failed as a result of the high default rate on mortgages, they began a policy of taking upwards of 30% off the top in service fees, with interest rates for repayment ranging from 12-18%. Finally, the legal system is not adept at quickly and efficiently settling disputes.

Tajikistan does not adhere to key international agreements on international property rights and there exists little real protections for patents, copyrights, trademarks and other intellectual property.

**Transparency of the regulatory system.** Tajikistan does not yet use transparent policies or effective laws to foster competition; in fact, cronyism, nepotism and corruption all work to create a business environment that favors those with connections to the government. Tajikistan's regulatory system lacks transparency and poses a serious impediment to businesses' operational abilities. Regulators and officials often apply laws arbitrarily, and are frequently unable or unwilling to make decisions without a supervisor's permission, leading to lengthy delays. Transparent executive documents are frequently inaccessible, leaving businesses and investors in the dark as to the rules of a particular game. Tajikistan has a tax code that presents a sound legal basis for the tax system;

however, it is undermined by inconsistent application that impedes development of small and medium enterprises. A new tax code came into effect January 1, 2005, which was compliant with WTO standards. Tajikistan is also working towards international accounting norms, however these have yet to be implemented.

Structural problems aside, the Tajik government needs to convey its goals and procedures to the inspectors and other government employees who interact with businesses daily. Bureaucratic hassles are common, and as long as Tajikstandart, the agency responsible for licenses and certificates, refuses to publish requirements for specific enterprises and prices for required documents, businesses will find it challenging to adequately cost such fees, and the mysteriousness of the requirements may leave businesses vulnerable to investigations of alleged violations.

**Efficient capital markets and portfolio investment.** Tajikistan's nascent banking sector faces numerous challenges: insufficient capital, limited banking services, mistrust as a result of banking system crisis in early 1990's. The banking structure in Tajikistan is two-tiered - National Bank of Tajikistan (NBT) performs central bank functions, and commercial banks represent the second level. The national currency, the TJS, was introduced in 1999. Estimated total assets of Orien Bank, the country's largest bank are \$15 million (regulatory capital).

**Six banks are public and five banks are non-public joint stock companies.** Total value of regulatory capital of all commercial banks in Tajikistan is approximately \$70 million. All banks, except for Amonat Bank (State Savings Bank) are privately owned.

The banking sector received a boost from capital amnesty held in 2003. According to data from the National Bank of Tajikistan (NBT) more than \$190 million (USD equivalent) was transferred to special tax-free accounts set up in several commercial banks in Tajikistan. Only four out of 11 commercial banks meet the NBT's requirement for minimum \$5 million regulating capital. A license withdrawal process for the remaining seven banks will begin if they fail to meet this requirement.

**To facilitate the free flow of financial resources the NBT cancelled the 30% fee** on bank transfers in 2003, resulting in significant increase of remittances from Russia, Kazakhstan and neighboring countries. Deposits have increased almost sevenfold since 2003; however, the dollar value remains very low. As of November 2005, volume deposits totaled to less than \$200 million, and only 30% were personal deposits. The continued trend of a free flow of financial resources throughout 2006 could generate more working

capital for commercial banks to expand their credit portfolio in terms of credit size and duration. In general, local commercial banks issue 12-month loans worth more than \$100,000 at 24% APR, prohibitively expensive for most local customers to develop a new business.

The private sector has access to micro-credit, commercial credit, factoring and leasing instruments. Some banks provide trade-financing services as well. In an effort to reduce barriers to competition, the Government of Tajikistan has paved the way for non-bank financial organizations and commercial microfinance. However, there is no credit bureau; much work is needed in strengthening creditor and shareholder rights.

### **3.2.1. Security and Stock Markets Development.**

**The stock market in Tajikistan was founded in 1994.** Since then, it has foundered due to the lack of new financial instruments. In 2000, the Government of Tajikistan established a Central Share Registry (CSR) within the Ministry of Finance of Tajikistan. The Registry records, monitors, and facilitates share purchase and sale for more than 400 stock companies. The bond market is limited to government emission of T-bills. The securities market in Tajikistan is under-developed; no regulatory system exists to encourage and to facilitate portfolio investment.

**Investment climate:** The business environment continues to suffer from corruption and excessive bureaucratic red tape related to licensing and taxes. According to the World Bank's "Doing Business 2008" report, the overall ranking of the country deteriorated from 133th place among 175 economies in 2007 to 153<sup>rd</sup> place among 178 economies in 2008, although there were some improvements in the procedures to start-up businesses<sup>79</sup>.

Tajikistan became a member of WB in 1993 and ADB in 1998. As a low-income country, with per capita GDP of US\$ 437 in 2007, Tajikistan receives highly concessional financing from the World Bank's International Development Association (IDA) and ADB's Asian Development Fund (ADF) in form of loans and grants. In fiscal year 2007, Tajikistan was eligible for 45 percent grant financing from IDA and 50% grant from ADF. In fiscal year 2008, the IDA and ADF grant financing was changed to 100 percent due to high risk to debt distress.

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<sup>79</sup> EBRD "Doing Business 2008" Country Report: Tajikistan, page 32.

The total joint ADB-WB active portfolio stands at US\$ 491 million in 2008. The top three sectors of portfolio's concentration include the agricultural and rural development, energy and transport sectors accounting for three-fourth of total commitment of the portfolio. Agriculture and rural development is a leading sector accounting for 33% followed by energy (21%) and transport (19%).<sup>80</sup>

There is no known cross-shareholding or stable shareholder arrangements. Hostile takeovers are rare and there are no built in protections against foreign takeovers. The reason for the scarcity of practices has less to do with openness to investment than the fact that most medium and large enterprises are state owned and controlled.

Unclear statements in some laws and regulations leads to misinterpretation, resulting in selective application of certain laws and regulations to take over or completely shut down companies.

**Foreign trade zones, free ports.** Tajikistan is a landlocked country whose neighbors demonstrate varying ability and interest in trade. Trade routes flow mainly through Uzbekistan, however, because of political tensions, Uzbekistan is not an ideal trading partner. For example, there are no regular flights between the Uzbek and Tajik capitals, despite a ready market. In some respects, however, the Tajiks have used this poor relationship as an excuse to avoid difficult but necessary improvements themselves.

It is hoped that a new opening along the Chinese border in Kulma, Murgab District (GBAO) will help facilitate increased trade with China. Transit times to the larger markets in Dushanbe remain long, however, and without upgrades in the transportation infrastructure, this new route will limit the potential from being realized. Several international financial institutions are planning projects to improve the road system. The United States Government is constructing a \$30 million bridge linking Tajikistan and Afghanistan, connected to a new road financed by the Japanese, which will increase trade and help develop the economy in the south. There is strong interest with Tajikistan's neighbors to south to cooperate on energy trade.

The Government enacted the Law on Free Trade Zones in 2004 and passed draft regulations to implement the law in 2005. The law is designed to attract foreign capital,

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<sup>80</sup> World Bank: CPPR (Country Portfolio Performance Review), The Asian Development Bank and the WB review operations in Tajikistan; 23 September 2008



investments, and technology, and to develop Tajikistan’s economic potential by setting favorable conditions for foreign investors including lower taxes, lower land leasing rates, lower duties on imports and exports, and special visa rules. The government has yet to announce the locations, but it is likely these zones will be created in Sughd and Khatlon provinces, because of the geographical advantage for free flow of trade to Uzbekistan, Kyrgyzstan.

WTO accession negotiations were launched in 2004 after intensive preparatory work conducted by the Tajik government with the assistance from the U.S. Government and other donors. In March 2004, the first round of multilateral negotiations on the accession of Tajikistan and a number of bilateral market access negotiations were conducted at the WTO Headquarters in Geneva. The Tajik government remains committed to WTO accession and implementing the necessary reforms required as accession conditions. President Rahmonov, in April, 2004, requested members of the Parliament give priority to adoption of laws that are aimed at bringing Tajikistan into compliance with the WTO agreements. Progress was made in 2005 on the Legislative Action Plan and Goods and Services Offers Market Access Negotiations. Working Party meetings market access negotiations will continue into 2006, moving Tajikistan closer to its integration into the world trading system.

In Tajikistan, the private sector faces an array of issues that hamper their growth. Legal and regulatory barriers often stifle the establishment and development of new firms and constrain enterprise access to finance, while rent-seeking bureaucrats drain entrepreneur’s time and resources, businesses lack effective access to due process and entrepreneurs lack access to business services and training opportunities for workers. The country’s weak institutions and poor governance do not provide an environment conducive to domestic and foreign private investment or efficient public service delivery, and weak public administration and the undeveloped financial sector hamper the nurturing of an investment climate needed for private sector development.

**Table 3.1 Structure of credit investments of banks of the second level as on 1.09.2008 (In % to a result)**

	Credit investments in national currency		Credit investments in foreign currency	
	Short-term	Long-term	Short-term	Long-term

<b>Total</b>	100	100	100	100
<b>Including:</b>				
<b>State enterprises</b>	1,0	40,8	5,0	0,1
<b>Agricultural enterprises</b>	12,1	8,9	4,1	25,6
<b>Private commercial enterprises</b>	60,9	28,1	76,2	50,1
<b>Private persons</b>	25,2	21,4	14,7	22,0
<b>Leasing</b>	-	-	-	2,2
<b>Others</b>	0,8	0,8	-	-

Source: National Bank of Tajikistan; 2008

To sustain economic growth over the medium and long-term, Tajikistan will clearly need to attract investment and further diversify its economy. Realizing this potential, however, will require significant improvements its investment climate, not only the continued modernization of its legal and regulatory framework, but the institutional capacity to implement the reforms they were intended to realize. Otherwise, the private sector in Tajikistan will continue to have to cope with an unclear and overly cumbersome regulatory and institutional framework that stifles competition, increases the cost and risk of doing business, and discourages innovation and risk taking.

**Openness to foreign investment.** Although the Government of Tajikistan is hungry for foreign investments, through 2004 it was only able to attract on average \$27 million per annum. President Rahmonov has made numerous public and private statements calling for foreign investment, particularly in the hydropower sector. However, his administration has yet to fully implement key reforms and regulations to create an attractive business climate. The Tajik Government still burdens the private sector with unnecessary costs and inspections, and creates substantial uncertainty and risk through non-transparent practices and unjustified barriers to competition.

To accelerate flow of foreign investments, the Government of Tajikistan adopted a Law on Foreign Investments in 1992. Although this law establishes the general investment conditions, it has many gaps and contradicts other legislation. According to existing legislation, foreign investments can be made through acquisitions, mergers, and takeovers by:

Owning a share in existing companies, either jointly with other Tajik companies or Tajik citizens;

- Creating a fully foreign-owned under the laws of Tajikistan;
- Acquiring assets, including shares and other securities;
- Acquiring the right for use of land and other mineral resources, as well as exercising other property rights either independently or in shared with other Tajik company(-ies) and citizen(s) of Tajikistan;
- Concluding agreements with legal entities and citizens of Tajikistan providing for other forms of foreign investment activity;

The judicial system recognizes the sanctity of contracts; however contract enforcements are poor, due in part to inadequate legal awareness and a non-independent court system. Tajikistan is party to a number of arbitration agreements and conventions, however does not have its own internationally recognized arbitration system. The courts do not always respect or uphold international arbitration rulings. A U.S. firm, currently pursuing all legal avenues in a dispute with Tajikistan, feels that the Tajik process has not been transparent or fair.

The Tajik Government's Economic Development Strategy for 2005-2015 emphasizes economic and industrial growth. The Strategy has no discriminatory effects on foreign-owned investors. According to the Civil Code (Article 1) there are no legal discriminations against foreign company and foreign entities. Practically all international agreements of Tajikistan have a provision for most favored nation's regime (climate).

Foreign investors can acquire real estate, however, private land ownership is still prohibited and land is property of the state. There are no legal limitations for foreign investors to buy shares on local stock exchange. The law on foreign investments guarantees foreign investors' right to buy shares on the local market, according to procedures set forth by the Ministry of Finance. Foreign investors' activity on the stock exchange is regulated by the Law on Security and Exchanges, which in turn refers to the Law on Foreign Investments. The foreign investments law has no articles that regulate professional activity of foreign investors on the stock exchange.

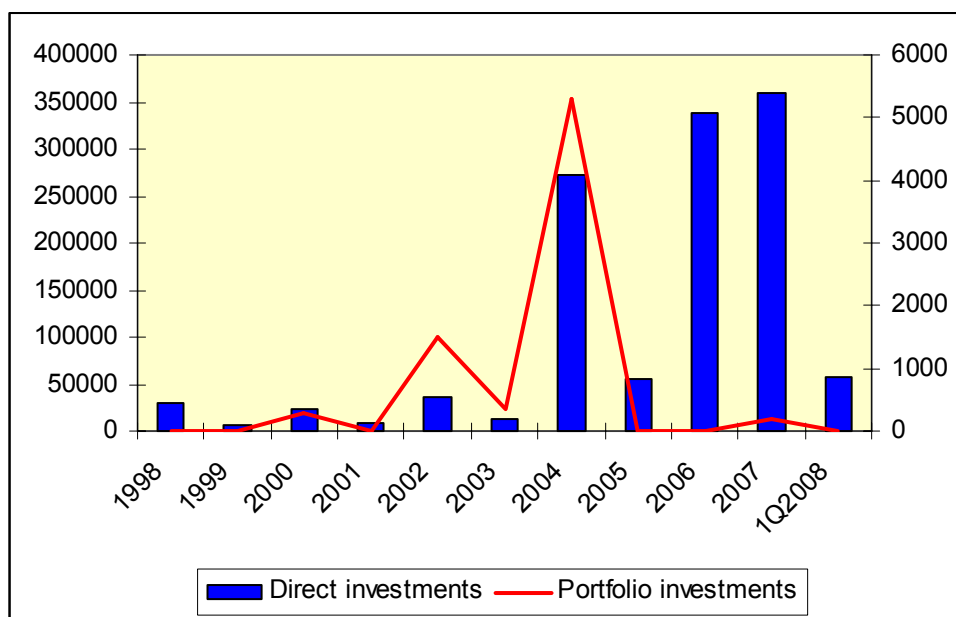
### **3.2.2 Foreign Direct Investment (FDI)**

Tajikistan does not have a foreign investment body empowered to deal with foreign investors directly, and there are no established criteria to screen investment proposals. Instead of working with a dedicated investment promotion agency, a potential investor has to go through a lengthy screening process by all concerned government agencies. In practice, a proposed statement of foreign investments forwarded to the Government of Tajikistan is circulated among the relevant government offices and ministries with instruction to review and express their formal opinion. If a Ministry objects to the proposed investment activity it forwards an official note to the Government. The criteria for screening include a background check on the company, person(s) representing the company, and identification of a financial source to comply with anti money-laundering regulations.

One of the facts confirming low interest of the world business-community in capital investments in the Tajik economy can serve the volume of foreign direct investments for the last five years. We shall consider, what countries (and in what size) put direct investments into Tajikistan. From 2002 till 2007 foreign direct investments (FDI) for the sum of 918 165,2 thousand US dollar have been involved. The sum of FDI of the CIS countries for all period has made 428 052,9 thousand US dollars -46,6 of %, and of the countries of the far abroad - 490 112,3 thousand US dollars - 53,4 %.

For the considered period the lowest inflow of FDI to Tajikistan was observed in 2004 (in same year the minimal volume of the Russian investments has been recorded also). In 2006 the size of FDI has grown in comparison with the last year in 7 times, including due to increase of Russian FDI - almost in 84 times. At the same time it is necessary to note, that very good parameter describing positive dynamics for 2006-2007, till today does not allow achieving an average level of investments counting upon the inhabitant across the CIS, in Russia, Kazakhstan, Azerbaijan.

**Diagram 3.2 Changes in flows on FDI and Portfolio investments:  
1998-2008 (in million \$US)**



Source: National Bank of Tajikistan; 2008

In 2006 the volume of cumulative foreign investments on one inhabitant in Russia has made about 300 US dollars, and in Tajikistan - 71,4 US dollars, i.e. it is less in 4,2 times. If to speak about foreign investments saved for years of independence, this gap increases up to fifteen times. Growth in FDI in economy of Tajikistan for 2005-2007 has been caused basically due to the Russian investments in water-power engineering (construction of Sangtuda HPS-1 - 137 million US dollar in 2007).

**If to analyze priority branches of attraction of FDI within the last several years the certain displacement of investment interests is observed.**

**For example, in 2004 the largest FDI have been directed in:**

- activity of banks - 2115,2 thousand US dollars, or 9,5 %;
- services of communication - 2881,5 thousand US dollars, 12,8 %;
- extraction of precious metals and ores of rare metals - 3380,8 thousand US dollars, 15,2 %;
- the chemical industry - 4060,0 thousand US dollars, 18,2 %;
- extraction of precious and semiprecious stones - 6426,0 thousand US dollars, or 28,7 %.

**In 2005 already in:**

- manufacture of the refined oil and fats - 2113,4 thousand US dollars, 3,9 %;
- manufacture of building metal products - 2243,9 thousand US dollars, 4,1 %;
- services of communication - 3916,4 thousand US dollars, 7,2 %;

- repair and construction of dwellings under orders of the population - 3978,0 thousand US dollars, 7,3 %;
- activity of the central bank - 4729,3 thousand US dollars, 8,7 %;
- retail trade - 6720,1 thousand US dollars, 12,3 %;
- manufacture of cellulose - 7610,7 thousand US dollars, 19,6 %;
- extraction of precious and semiprecious stones - 19155,0 thousand US dollars, 35,1 %.

**In 2006 FDI in extraction of precious and semiprecious stones have decreased, and power became the largest branch of an investment:**

- extraction of precious metals and ores of rare metals - 18406,6 thousand US dollars, 4,8 %;
- retail trade in foodstuff - 21065,6 thousand US dollars, 5,4 %;
- granting of other kinds of services - 32577,2 thousand US dollars, 8,5 %;
- communication - 49543,6 thousand US dollars, 12,8 %;
- manufacture, gathering and distribution of the electric power - 228023,2 thousand US dollars, 59,2 %.

**In 2007 volume of FDI in power was less, than in previous year on 62, 5 million US dollars:**

- construction - 106863,5 thousand US dollars, 27,5 %;
- communication - 39206,1 thousand US dollars, 10,1 %;
- manufacture, gathering and distribution of the electric power - 165446,1 thousand US dollars, 42,5 %.

From 2002 till 2007 the share of FDI of the Russian companies has made - 45,13 % (414 385,5 thousand US dollars). The second country on value - the "direct" investor is Cyprus - 15,55 % (142 735,2 thousand US dollars), i.e. the country with volume of investments, almost in 3 times smaller than in Russian.

Meanwhile, special activity of the Russian investors became obvious only in 2006 and 2007, when the size Russian FDI in total amount of direct investments has made 60,16 %, and 69,12 % accordingly. Data cited above show, that Russia is not only the major regional political partner for Tajikistan, but also the basic investor in development of the Tajik economy.

As to 2008, that, according to the State committee under investments and management of state property of Tajikistan, for the first quarter of the current year (2008), FDI for the sum of 1699 thousand US dollars have been involved to Tajikistan. Three largest branches of attraction of total amount of the foreign capital to Tajikistan for the considered period are power, industry and communication. The share of investments in development of power of Tajikistan has made 46,1 %, of industry - 15,3, of communications -10,3 %.

**This data testifies that diversification of foreign investments into economy of Tajikistan is at rather low level.** There are practically no investments in such most perspective branch, as “the industry of tourism” (international tourism, mountaineering, rock-climbing, international hunting, health programs, etc.), despite of available huge natural resources and the lowest capital investments. Scanty volumes fall to an agriculture, education and trade. The lowest relative density make capitals directed to such key economic branches, as education, public health services and transport. We shall notice in this connection, that at the reasonable approach in conditions of market economy last ways of a direction can certainly provide rather high profitability in Tajikistan. All this, in opinion of authors, is in the big degree consequence of an insufficient favorable investment climate, and also its estimation by foreign analysts.

**In this connection it is possible to note extremely small participation in investment process in Tajikistan of the countries of the European Union.** On the beginning of 2006 subjects of managing of such large country as France did not invest a dollar. Shares of percent define relative density of Germany, the Netherlands, Ireland, and Italy. A little lower volume of investments is in the Great Britain and Cyprus.

## **Objectives of FDI**

A) Government policy strongly favors FDI, realizing that it plays a vital role in the development of the country’s economy. In this regards, the Government puts emphasis in foreign investments as a means to develop new industrial activities as well as to modernize existing ones. Another priority for economic development in the medium term is the need to ensure the economy’s diversification to get away from heavy dependence on exports of aluminum and cotton. Creation of favorable conditions for FDI, therefore, becomes a crucial issue in the development strategy for forging international partnerships between

domestic and foreign enterprises/partners, including SMEs. FDI inflows will also facilitate the development of private sector companies which is one of the country's priorities.

**B) FDI inflows.** The civil war, security concerns and the overall unstable political situation have been the main reasons for a very low inflow of foreign capital to Tajikistan. Net FDI stock since 1993 amounted to \$166 million by the end 2001, the lowest among CIS countries (Table 3.2.). Foreign investors' interest has remained limited, and is concentrated in the textile, agribusiness and manufacturing sector with small-scale investments.

**Table 3.2. FDI inflows to Tajikistan (net)**

1993-2001			2001-		
Total			Total	Percentage	
Country	\$ million	Per capita	\$ million	Per capita	of GDP
Armenia	640	168	70	18	4
Azerbaijan	3,773	472	227	28	4
Kazakhstan	12,104	872	2,760	185	15
Kyrgyzstan	453	92	22	4	0.7
<b>Tajikistan</b>	<b>166</b>	<b>27</b>	<b>22</b>	<b>4</b>	<b>2</b>
Uzbekistan	987	40	71	3	0.9

Source: UNCTAD, IMF, central banks

**Sources of Foreign Direct Investment.** According to data from the State Statistics Committee, Tajikistan 1997- 2004 attracted \$224 million in foreign direct investments. In 2007 FDI in average, foreign direct investment flow ranges between \$30-36 million per annum. The largest direct investors in 2003, by country of origin are: Russia (\$10.9M), Cyprus (\$10.1M), Italy (\$3M), U.S. (\$2.5M), and Canada (\$1.2M). Top three investors by country of origin since 1997 are: UK (\$105.1M), South Korea (\$53.4M), and Italy – (\$50.0 M).

Top three destination sectors for foreign direct investments in 2003 are: chemical industry (\$10.1M); agribusiness (\$9.54M); and textiles (\$3.42 M). Since 1997, the top three destination industries for foreign direct investments are: mining (\$107.5M), textiles (\$65.1M), and production of yarn and clothing (\$54.5M). Current FDI stock is roughly 16% of GDP, annual FDI inflows are less than 1.3% of GDP.



British companies, including Nelson Gold Corporation operating the Zaravshan gold mine, were the main investors in the country comprising 44.9 percent of the total cumulative investment during 1993-2001. The second largest foreign investors is the Republic of Korea, with 23.6 percent of total investment, followed by Italy with 20.5 percent of the total cumulative investment. Luxemburg, Netherlands, China, Switzerland, and the Russian Federation are other investors in the country with a low level of FDI.

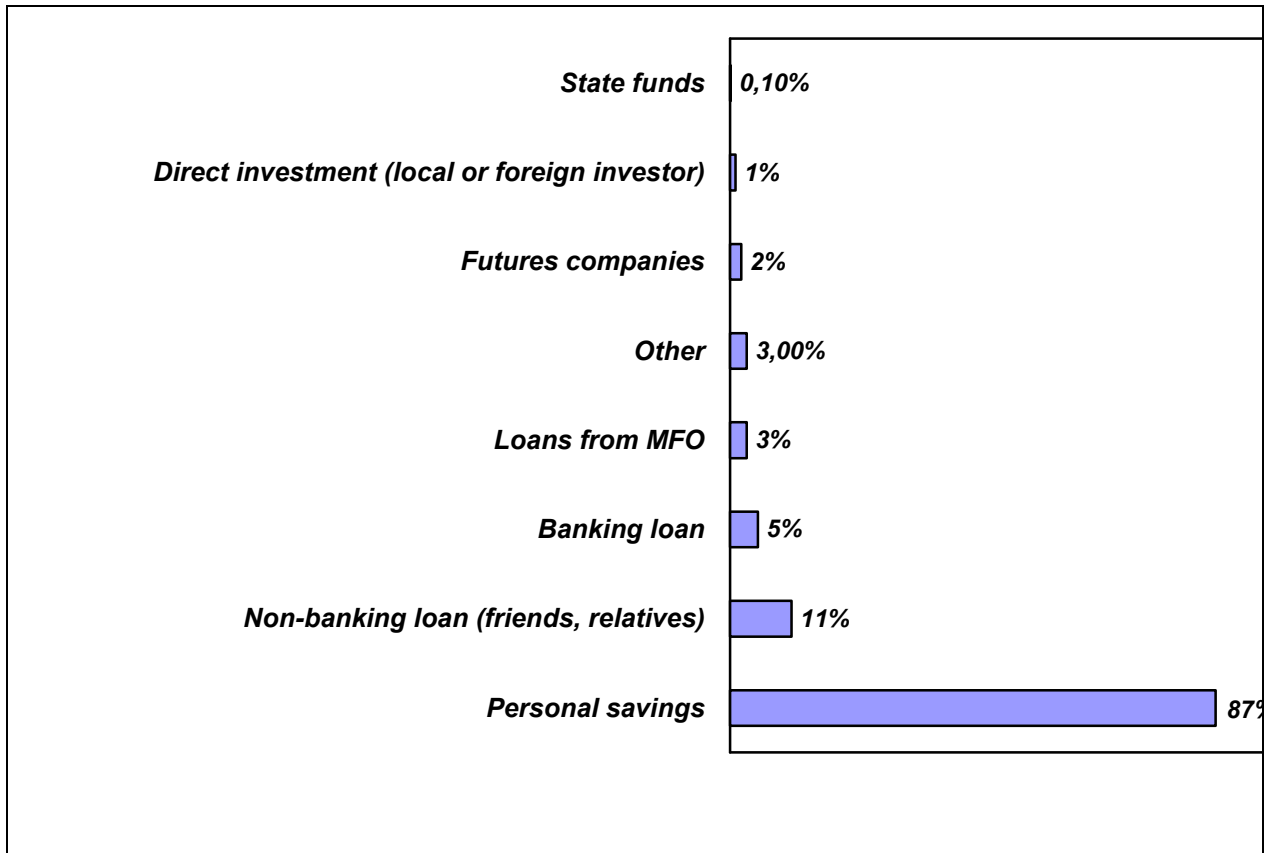
The National Bank has launched a campaign to encourage more Tajiks to open accounts, and although rising, the rate of consumer savings accounts remains low. As a result, few investors secure business or personal loans through banks partly due to high interest rates, and capital remains tight. Checking accounts do exist but are not widely used due to strict requirements on cash withdrawal procedures. The government issues both bills and bonds, and according to legislation, foreigners can purchase them.

Social and economic reform policy of the Government of Tajikistan of the last year has been focused on a solution of a key challenge – poverty reduction. Along with the creation of a social assurance system, the Government of Tajikistan seriously considers ensuring of entrepreneurs *laissez faire* and private sector development within its Poverty Reduction Strategy

**Investments:** There are mostly internal funds in Tajikistan. Entrepreneurs very seldom make investments into fixed assets. According to the survey made by World Bank in 2005, only 27% of the respondents made some investments. This figure has worsened in comparison to 2002, when about 40% of entrepreneurs made investments into fixed assets. The majority of entrepreneurs still use personal savings to conduct any investments. Only a small amount of entrepreneurs use banking or MFO loans (microfinance organization) to finance their investments into fixed capital. This situation is linked to the complicated access to external funding for SMEs (small and medium enterprises).

It is especially crucial for small and medium companies, since every second company (47.2%) made investment in 2005. Among those every third invested in building a new facility or production unit. But still personal savings represent their major source of funding for investment (see Chart 3.1). Broader access to external funding could stimulate faster growth of the companies contributing additionally to the economical development of the country.

**Chart 3.1 Investment mainly funded by personal savings (% of respondent).**



Source: International Finance Corporation; World Bank Group; 2005.

One of the terms of private sector development is creation of favorable conditions for business operation. This can promote the internal and external capital inflows to the national economy, creation of new jobs and increase of the population living standard. However, it is known, that creation of a favorable investment climate is not one step action, but is a long-term stage-by-stage process. This process involves implementation of the profound legal, structural and institutional reforms, as well as adequate infrastructure development to serve private sector. Already in 1992 the Parliament of the country adopted comparatively liberal Foreign Investment Law, which has given privileges and necessary guaranties to foreign investors. Adoption of this Law has shown the Government interest in foreign capital inflow and its hope to have in influence on the development of the national economy. However, the Government also realizes that the Investment Law, in itself, can not solve all problems which are an obstacle to inflow of the foreign capital.

One of the serious problems constraining effective application of the adopted law is absence of adequate mechanisms to put laws into effect. Usually, the main reason is

shortage of financial resources to develop and introduce mechanisms promoting application and implementation of laws.

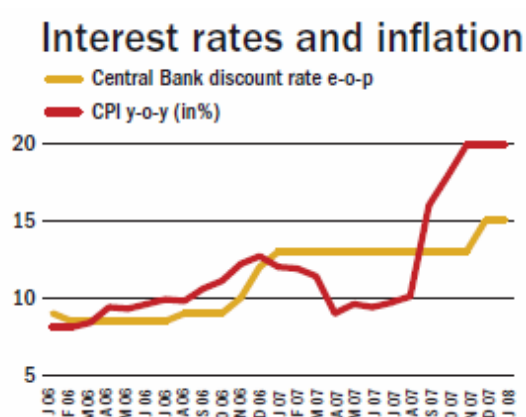
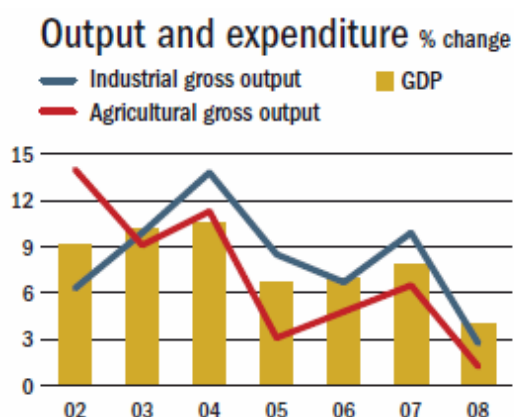
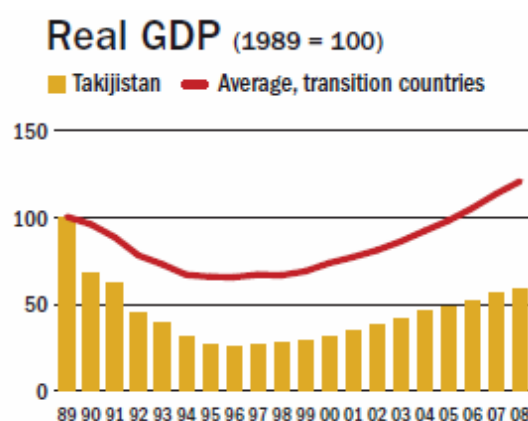
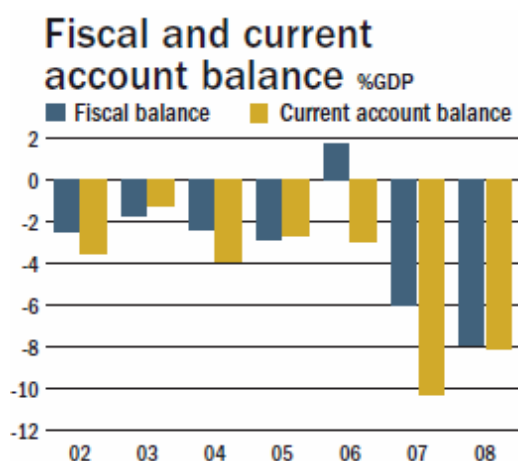
### **3.2.3 The portfolio of investments**

A well-functioning competitive environment is essential to encouraging investment to propel private sector development, job growth essential and poverty alleviation. Whether they are local entrepreneurs investing small sums in micro, small and medium-sized companies, or foreign investors investing more significant sums, they require a business climate that provides an effective and impartial legal framework and judicial regime, is not characterized by excessive government interference that raises their costs of doing business and increases their risk, and one that provides open access to information, so necessary for effective decision-making.

With so many potential investments location available, countries must act to create a well function and effective business environment. Investors must have the confidence that their property rights are protected and that they are free from harassment from rent-seeking bureaucrats and predatory behavior from larger, more well-connected business that would impede the growth of their businesses.

Despite Tajikistan's significant and consistent economic growth in recent years and its progress in various areas of economic reform (such as privatization of most state-owned enterprises), investment rates, including foreign direct investments (FDI), have averaged only four percent of GDP between 2001 and 2004, despite of introduction of tax breaks, incentives for technological upgrades of production lines and full hard currency convertibility, and the private sector accounts for only about 50 percent of GDP private sector investment.( Diagram 3.2)

### **Diagram 3.2. Tajikistan: Comparative indicators, 2002-2008**



Source: Annual report of NBT and IMF review; 2008

In Tajikistan the private sector faces an array of issues that hamper their growth. Legal and regulatory barriers often stifle the establishment and development of new firms and constrain enterprise access to finance, while rent-seeking bureaucrats drain entrepreneur's time and resources, business lack effective access to due process and entrepreneurs lack access to business services and training opportunity for workers. The country's weak institutions and poor governance do not provide an environment conducive to domestic and foreign private investments or efficient public service delivery, and weak public administration and the undeveloped financial sector hamper the nurturing of an investment climate needed for private and other sectors development.

To sustain economic growth over the medium and long-term, Tajikistan will clearly need to attract investment and further diversify its economy. Realizing this potential, however, will require significant improvements its investments climate, not only the continued modernization of its legal and regulatory framework, but the institutional

capacity to implement the reforms they were intended to realize. Otherwise, the private sector in Tajikistan will continue to have to cope with an unclear and overly cumbersome regulatory and institutional framework that stifles competition, increases the cost and risk of doing business, and discourages innovation and risk taking.

The general portfolio of the joint investment projects which are being at a stage of realization, in 2007 made 53 projects for a total sum of 1389,76 million US dollar, including 1249,09 million dollars are the external involved resources (89,88 %), 102,57 million dollars - the contribution of the Government (7,38 %) and 38,1 million dollars - other means (2,74 %).

**Credits:** In 2007 the greatest sum of means by a credit part of a portfolio of investments is necessary on Export-import Bank (Peoples Republic of China) - 603,55 million dollars that makes 43,43 % from the general budget of a portfolio of investments. Further follow the Asian Bank of Development - 201,95 million dollars (14,53 %), the World Bank - 118,10 million dollars (8,50 %), Islamic Bank of Development - 76,48 million dollars (5,50 %), the Kuwaiti Fund of Economic Development - 29,75 million dollars or 2,14 %, etc.

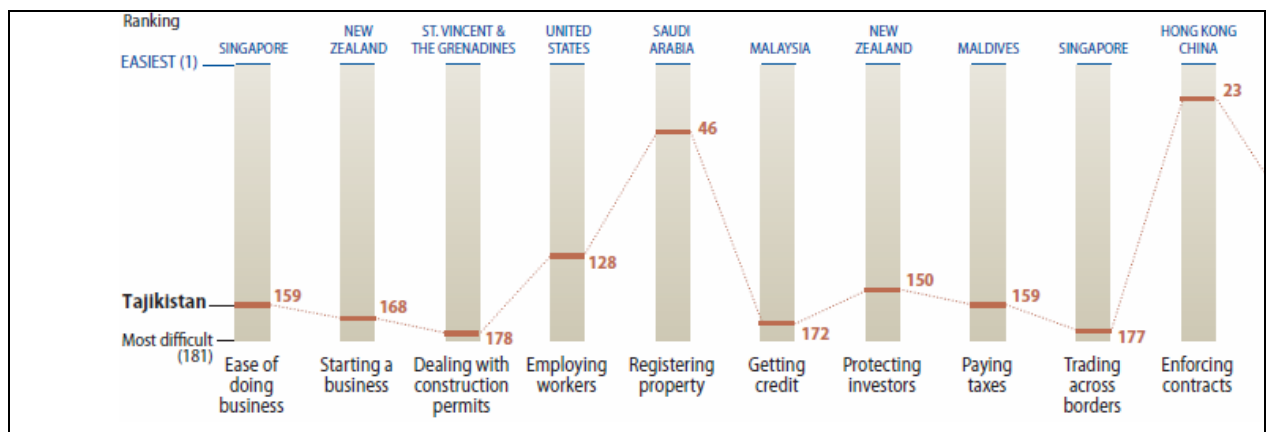
**Grants:** The analysis of grant part of a portfolio of investments of the Republic of Tajikistan shows, that the greatest assistance to development of the country, within the limits of the given kind of the help, renders the World Bank. In 2007 the obligation of the given international financial organization in the form of grants made 81,02 million dollars or 5,83 % from the general budget of a portfolio of investments (49,16 % from grant parts of a portfolio). Further on volumes of the rendered help it is necessary to mention grants of Switzerland - 26,18 million dollars (1,88 %), the grant of the German Bank of Development (KfW) - 10,29 million dollars (0,74 %), grant of the Islamic Republic of Iran - 10,0 million dollars (0,72 %).

For the period from 1997 prior to the beginning of 2008 the total sum of investment means according to the concluded Agreements has made 1813,46 million, including credit on realization of investment projects have made 1459,13 million dollars or 80,46 % from the general budget of investment resources, grant means have made accordingly 187,03 million dollars or 10,31 %, the contribution of the Government of the RT - 126,71 million dollars or 6,99 %, and other sources - 40,59 million dollars or 2,24 %.

For the same period the volume of development of investment means has made 1012,99 million dollars or 55,86 % from a total sum of the investment means provided by Agreements, including development of credit has made 850,31 million dollars or 46,89 %, development of grant means - 75,51 million dollars or 4,16 %, development of means under contributions of the Government of the RT - 69,13 million dollars or 3,81 % and development of means on other sources - 18,06 million dollars or 1,0 %.

For the considered period it has been mastered of credit of the World Bank for the sum of 338,75 million dollars, that makes 85,13 % from a total sum of credit resources under Agreements with the given organization. On credit of the Asian Bank of Development it is mastered 171,54 million dollars or 65,26 %, Islamic Bank of Development - 52,38 million dollars or 49,37 %.

**Chart 3.2. Tajikistan; Country Profile in comparison with other East countries: 2008**



Source: WB "Doing business Report"; [www.doingbusiness.org](http://www.doingbusiness.org)

Development of grants of the World Bank for the period 1997-2007 has made 21,43 million dollars, that correspond 20,72 % from a total sum of grants under Agreements with the given organization. Development of grants of Switzerland has made 16,27 million dollars or 59,01 %. Grants of Japan are mastered in the sum of 7,36 million dollars, or 65,42 % from the sum of the accepted obligations.

### 3.3. Development of investments for the period of 2002-2008

For the considered period as a whole annual development of investments has increased, in comparison with 2002 more than in 8 times. Thus the first sharp increase in

volumes of development of investment means was observed in 2004, that, in particular, is connected with the beginning of an active phase of realization of following projects: restoration of a rural infrastructure (World Bank) for the sum of 6,97 million dollars, rehabilitation of a highway of Dushanbe-Kurgan-Tyube-Dangara-Kulyab (Asian Bank of Development) - 6,96 million dollars, rehabilitation of social sector (Asian Bank of Development) - 6,06 million dollars, construction of highway Shkef - Zigar (Kuwaiti Fund) - 4.87 million dollars, etc.

Further reduction in volumes of development of investments is observed. In 2006 the volume of development of investment means was reduced in comparison with 2004 - to 18,19 million dollars, from 114,81 million USD to 96,62 million dollars, thus if the volume of development of credit resources has decreased from 109,22 million dollars to 76,28 million dollars, grant component of use of external resources has increased for 14,74 million dollars, from 5,59 million dollars in 2004, up to 20,34 million dollars in 2006. It has happened basically due to development of grants of the World Bank for the sum of 6,91 million dollars, of Islamic Republic of Iran for the sum of 5 million dollars and Catholic Fund for the sum of 2,49 million US dollar.

In 2007 in comparison with 2006 the volume of development of investment means has sharply increased (more than in 3 times) and has made 310,5 million US dollar. Such sharp increase in volumes of development of investments is achieved due to successful development of proceeds of credit of Export-import Bank (Peoples Republic of China) in the sum of 216,74 million dollars.

At the same time, in 2007 the increase in volumes of development within the limits of grant component of an investment portfolio, from 20,34 million dollars in 2006 up to 28,04 million dollars is also observed, that basically took place owing to increase in volumes of development of the grants given by the World bank (11,57 million dollars), the Government of Switzerland (5,06 million dollars), Catholic fund (6,23 million dollars) and the Swedish agency on development and cooperation (1,52 million dollars), etc.

### **The basic sectors on attraction of investments.**

The greatest share of obligations is necessary on infrastructural sectors: power - 447,99 million dollars, that correspond to 35,87 % from total amount of obligations under operating investment projects, and transport - 429,62 million dollars, or 34,39 %. On these

two sectors of an industrial infrastructure it is necessary of more than 70 % from total amount of all obligations under agreements in force.

It is necessary to note, that such great share of obligations of these two sectors takes place basically because of two projects, which are carried out due to the credit, given by Export-import bank of the Peoples Republic of China:

- Reconstruction, rehabilitation of a highway Dushanbe-Chanak (281,1 million dollars) in transport sector;
- Construction of high-voltage transmission lines - 500 Kvt. "South-North" (267,2 million dollars) in Power sector.

At the same time, it is necessary to note, what even without taking into account these two projects parameters of volumes of obligations and development of means in sectors Transport and Power remain on the first positions in comparison with other sectors. So, obligations on another seven projects in sector Power make 180,79 million dollars, and under seven projects of Transport sector - 148,52 million dollars. It once again proves that for the Government of the RT and the international financial institutions these two sectors are the most prior at the given stage.

Further, in decreasing order volumes of obligations follow: the Agriculture and Irrigation - 157,78 million dollars (12,63 %), Water supply and the water drain - 52,29 million dollars (4,19 %), Public health services - 52,26 million dollars (4,18 %), Education} - 52,25 million dollars (4,18 %), etc.

### **3.3.1. Investments into a fixed capital in 2008**

In January-September, 2008 it is used of investments into a fixed capital due to sources of financing in volume of 2559391,4 thousand TJS, that in 2,0 times is more than for the similar period of the last year (in actually established prices).

Priority kinds of activity is the power, which relative density makes 45,7 % from total amount of the basic investments.

On construction of objects of electric power industry it is mastered 1168629,6 thousand TJS of investments into a fixed capital, from them due to state and own means of the enterprises and the organizations - 84141,2 thousand TJS, or 7,2 %; of the foreign credit - 1084488,4 thousand TJS, or 92,8 %.



**Table 3.3. Structure of investments into a fixed capital on sources of financing in January-September, 2008**

	Investments into fixed capital (in thousands of TJS)		in % totally	
	2007	2008	2007	2008
Investments into a fixed capital including:	1270057,1	2559391,4	100	100
Internal investments	434502,6	760514,4	34,2	29,7
State budget + local budget	331179,9	592790,2	26,1	23,2
Funds of the enterprises and organizations	53579,7	82271,3	4,2	3,2
Funds of the population and others	49743,0	85452,9	3,9	3,3
External investments	835554,5	1798877,0	65,8	70,3

Source: National Bank of Tajikistan, IIIQ-2009

Development of investments on construction and reconstruction of hydroelectric power stations in January-September, 2008 is characterized by the following: on construction of Sangtuda HPS-1 it is used 531984,2 thousand TJS of investments into a fixed capital, that on 176586,9 thousand TJS is more, of Ragun HYDROELECTRIC POWER STATION<sup>81</sup> - 50710,8 thousand TJS, that on 46663,8 thousand TJS is more than level of the last year.

In January-September, 2008 on reconstruction of road "Dushanbe-Chanak" it is used 282940,0 thousand TJS of investments into a fixed capital. Reconstruction of the specified highways were carried out, basically, due to foreign credits - 96,3 % from total amount of the mastered investments.

The basic volume of development of investments is executed due to the Ministry of transport and communications of the Republic of Tajikistan - 69856,1 thousand TJS, or 2,7 %; the Ministry of power and the industry of the Republic of Tajikistan - 33430,4 thousand TJS, or 1,3 % from total amount of capital investments in the republic.

For January-September, 2008 on objects of industrial purpose it have been executed of investments for the sum of 1786753,4 thousand TJS, or 69,8 % from total amount of investments in the republic.

<sup>81</sup> According NationMasterEnciclopedia, Tajikistan on 10-th place by hydroelectric reserves.

**Commissioning of a fixed capital.** For January-September, 2008 due to all sources of financing it is entered of a fixed capital for the sum of 410021,3 thousand TJS. From them in GBAO - 2234,7 thousand TJS, or 0,5 %; in Khatlon - 113136,0 thousand TJS, or 27,6 %; in Sogd - 61119,9 thousand TJS, or 14,9 %; in Dushanbe - 139650,9 thousand TJS, or 34,1 %; in Districts of Republican Submission - 93879,8 thousand TJS, or 22,9 %; from total amount of a fixed capital of the republic put into operation.

On industrial purpose it is put into operation of a fixed capital for the sum of 146418, 2 thousand TJS, or 35,7 % from total amount of a fixed capital of the republic put into operation.

It is put into operation of a fixed capital due to following means: state - 212630,6 thousand TJS, or 51,8 %; the population - 85083,0 thousand TJS, or 20,8 %; societies with limited liability - 66405,0 thousand TJS, or 16,2 %; joint-stock - 8510,7 thousand TJS, or 2,1 %; foreign investments - 32698,2 thousand TJS, or 8,0 %; farmers' facilities - 2010,5 thousand TJS, or 0,5 %; collective farms - 1735,4 thousand TJS, or 0,4 %; Tojikmatlubot - 947,9 thousand TJS, or 0,2 % from total amount of a fixed capital of the republic.

**Construction of objects of welfare sphere.** On development of social sphere in January-September, 2008 it is directed 772638,0 thousand TJS, that makes 30,2 % from total amount of capital investments of the republic (in actually established prices).

For January-September, 2008 are put in operation apartment houses by a total area in 391606 square km. that on 78299 square km. is more than for the corresponding period of the last year.

Building construction in the republic basically is carried out by subjects of non-governmental sector, in which the significant share is occupied by the population and in January-September, 2008 they constructed habitation by a total area in 352054 square km., or 89,9 % from total amount of apartment houses put into operation.

Development of investment means on sectors in absolute and relative parameters. The total amount of the mastered means under operating investment projects from the beginning of their realization as on 12/31/2007 makes 558,44 million dollars. About 70 % of volume of the mastered means is necessary on two sectors - Transport and Power. The greatest volume of the mastered means at a rate of 214,83 million dollars is necessary on

the Transport sector, that makes 38,47 % from the sum of the mastered means. Further follow:

- Power - 172,88 million dollars (30,96 %);
- Agriculture and Irrigation - 67,95 million dollars (12,17 %);
- Education - 29,64 million dollars (5,31 %);
- Water supply and the water drain - 25,00 million dollars (4,48 %);
- Social security and employment - 20,56 million dollars (3,68 %);
- Public health services - 15,74 million dollars (2,82 %), etc.

The greatest percent of performance of obligations is necessary on sectors of Environment - about 93 %, Social security and employment - about 89 %, Education - about 57 %, Transport - 50 %. Rather low interest of performance of obligations in sector of the Government (9,89 %) speaks that the projects, which are carried out in this sector, such as the Regional project on modernization of customs and development of the infrastructure, financed by the Asian Bank of Development (13,88 million dollars), the Project of reforming of the public sector, financed by the World Bank (5 million dollars), the Project on strengthening of the national system on statistics, financed by the Swedish agency on development and cooperation and the World Bank (4,996 million dollars), are at initial stage of realization and development of means.

**Categories of charges of investments.** Research of structure of development of means on categories of charges for 2007 shows, that the greatest volumes of development of investments fall to section “Civil works and construction” in the sum of 272,00 million dollars, that correspond to 87,60 % of a total sum of the mastered means.

Further, in decreasing order follow volumes of the mastered means under sections: Materials and goods 10,31 million dollars or 3,32 %; Equipment - 8,84 million dollars or 2,85 %; Consultations concerning investments - 7,19 million dollars or 2,32 %; Training - 6,07 million dollars or 1,96 %; Charges on the maintenance - 1,86 million dollars or 0,60 %; Operational/constant charges - 1,73 million dollars or 0,56 %. On other categories, charges are rather insignificant.

The analysis of distribution of the mastered means by kinds of investments shows, that for 2007 the volume of payments on capital investments has made 291,15 million

dollars or 93,77 % from the sum of all means mastered in 2007, and on non-capital investments these parameters have made accordingly 19,35 million dollars or 6,23 %

Thus there is a situation when more than 90 % of financial assets of a portfolio of investment projects, basically are spent for creation and equipment of objects of an infrastructure and social sphere. Experts of the State Investment Committee consider that such picture is quite optimistic and justified, and testifies to an effective expenditure of external investment resources.

Following, on volumes of attraction and development of investment means, is Khatlon region on which obligations within the limits of investment projects for 2007 are equal to 67,12 million dollars, and development of financial assets has made 69,15 million dollars, rather high volumes of the financial parameters falling on Dushanbe (the sum of obligations - 68,69 million dollars, volumes of development - 46,65 million dollars), speak that in territory of capital are realized three projects on restoration of city system of water supply for a total sum of 43,07 million the dollars, and others two projects on reconstruction of city electric networks and reduction in losses of energy for a total sum of 32,89 million dollars. Further follow Sogd region, Districts of the Republican Submission and GBAO.

The greatest part of volumes of the mastered means of investment projects is necessary on a republican level and makes 43,50 %. Volumes of the mastered means in Khatlon have made 22,27 % from all volume of the mastered investment means, in Dushanbe - 15,03 %, in Sogd - 12,63 %, in Districts of the Republican Subordination - 5,23 % and least concerning region GBAO - 1,34 %.

## **3.4 Modernization of Tajikistan Law**

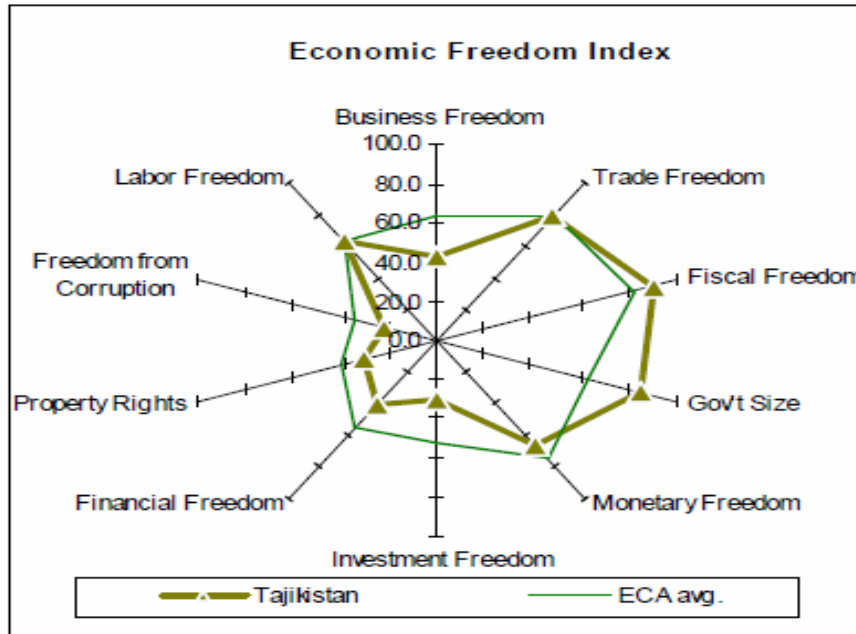
### **3.4.1 Legislation on Capital Market in Tajikistan**

The main legal provisions concerning securities markets in the Republic of Tajikistan are to be found in the Law on Securities and Securities Market adopted in 1992, as amended in March 2006, and in a series of regulations issued by the Ministry of Finance.

The stock market in Tajikistan was founded in 1994, though it appears to have floundered since then mainly due to the lack of new financial instruments. In 2000, the Government of Tajikistan established a Central Share Registry within the Ministry of

Finance to record, monitor and facilitate share purchase and sale for more than 400 stock companies. While a bond market does exist it is limited to government issued treasury bills.

**Table 3.4. Economic Freedom Index; TAJIKISTAN**



Source: The Heritage Foundation; Index of economic freedom, 2008.

American investigatory Center “Heritage Foundation” and the Wall Street Journal provides research ‘The 2008 Index of Economic Freedom’ covers 162 countries across 10 specific freedoms such as trade freedom, investment freedom, and property rights. By them Tajikistan’s economy is 54.5% free, according to the 2008 assessment, which makes it the world’s 114<sup>th</sup> freest economy.

There is currently no independent authority for securities market supervision in Tajikistan. The Law on Securities and Securities Market grants the Agency for the Development of Securities Market of the Ministry of Finance authority over securities market supervision, while the Central Bank is in charge of banking supervision (including microfinance organizations). There is no active *stock exchange* in Tajikistan.

Tajikistan scores well in fiscal freedom, government size, and trade freedom. The government imposes low tax rates, including a 13 percent personal income rate. Tajikistan’s significant challenges are reflected in its significantly weaker than average scores in business freedom, monetary freedom, investment freedom, financial freedom, property rights, and freedom from corruption. The regulatory environment is not protective of business, and laws are both restrictive and in consistent. Foreign investment faces many

regulatory hurdles as well as outright corruption. Tajikistan is rated one of the world's 20 most corrupt nations, and corruption seeps into most aspects of official life, from the courts to customs<sup>82</sup>.

*Tajikistan's economy is 54.5 percent free*, according to our 2008 assessment, which makes it the world's 114th freest economy. Its overall score is 0.7 percentage point higher than last year, reflecting slightly improved scores in four of the 10 economic freedoms. Tajikistan is ranked 20th out of 30 countries in the Asia–Pacific region, and its overall score is lower than the regional average.

Tajikistan scores well in fiscal freedom, government size, and trade freedom. The government imposes low tax rates, including a 13 percent personal income rate. Total government expenditures are equal to about 20 percent of GDP.

Tajikistan's significant challenges are reflected in its significantly weaker than average scores in business freedom, monetary freedom, investment freedom, financial freedom, property rights, and freedom from corruption. The regulatory environment is not protective of business, and laws are both restrictive and inconsistent. Foreign investment faces many regulatory hurdles as well as outright corruption. Tajikistan is rated one of the world's 20 most corrupt nations, and corruption seeps into most aspects of official life, from the courts to customs.

**Chart 3.3. Index of economy freedom, 2008**



Source: The Heritage Foundation; Index of economic freedom, 2008.

<sup>82</sup> The Heritage Foundation; Index of Economy Freedom: <http://www.heritage.org/index/countries.cfm>

**Business Freedom – 43.4%.** The overall freedom to start, operate, and close a business is restricted by Tajikistan’s regulatory environment. Starting a business takes an average of 49 days, compared to the world average of 43 days. Obtaining a business is relatively protracted.

**Trade Freedom -77.8%.** Tajikistan’s weighted average tariff rate was 6.1 percent in 2002. Some quotas, import bans and restrictions, non-transparent and poorly administered standards and certification requirements, inefficient and corrupt customs implementation, and weak enforcement of intellectual property rights add to cost of trade. An additional 10 percent points is deducted from Tajikistan’s trade freedom score to account for non-tariff barriers.

**Freedom from Government-84.1%.** Total government expenditures, including consumption and transfer payments, are moderate. In the most recent year, government spending equaled 23 percent of GDP. The government is trying to improve spending management. Despite progress in privatizing small and medium sized public enterprises, the private sector is developing slowly.

**Monetary Freedom- 65.8%.** Inflation is high, averaging 9.2 percent between 2004 and 2006. Relatively unstable prices explain most of the monetary freedom score. The government influences prices through regulation, subsidies, and numerous state-owned enterprises and utilities. An additional 15 percentage points is deducted from Tajikistan’s monetary freedom score to account for policies that distort domestic prices.

**Investment Freedom- 30%.** Corruption and a lack of transparency in government contracts and privatizations are among the substantial barriers to foreign investment. Investors face ownership restrictions and cumbersome procedures with regard to tax and business registration. The government has begun some large infrastructure projects that could improve the investment climate with foreign capital assistance. Remittance abroad of profits is allowed. Foreigners may purchase land under certain conditions. Residents (with some restrictions) and non-residents may hold foreign exchange accounts. Payments and transfers are subject to documentary requirements. Most capital transactions, including all direct investment transactions, require central bank approval.

**Financial Freedom- 40%.** Tajikistan's financial sector is small and underdeveloped. The government is trying to increase transparency and improve supervision and regulation. Consolidation has cut the banking sector by more than two-thirds since 1997; there were 12 domestic banks and the central bank at the end of 2005.

The four largest banks, including a state-owned bank, control 80 percent of deposits. All banks, except for Amonat Bank (one of the four largest) are privately owned. Non-performing loans are decreasing. The opening of the banking sector to foreign competition has caused three foreign banks to enter the market since 2006. The small non-banking financial sector includes several small insurance companies and one pension fund. Capital markets are negligible, and a securities market has been established but was not yet functioning as of June 2007.

***Property Rights- 30%.*** Protection of private property is weak. Judicial corruption is widespread, and the courts are sensitive to pressure from the government and paramilitary groups. In 2006, the authorities revived a Soviet-era plan for the reconstruction of Dushanbe, the capital. In the process, they have threatened to expropriate the property of thousands of families. Many residents and small businesses already have been resettled on land of unequal value, often on the outskirts of the city's center. Tajikistan's weak enforcement regime lacks criminal penalties for violations of intellectual property rights.

***Freedom from Corruption- 22%.*** Corruption is perceived as pervasive. Tajikistan ranks 142nd out of 163 countries in Transparency International's Corruption Perceptions Index for 2006. Tajikistan is one of the world's poorest countries, and corruption, particularly bribery and nepotism, is endemic. There is no legal provision for regular citizens' public access to government information.

***Labor Freedom- 62.1%.*** Inflexible employment regulations hinder overall productivity growth and job creation. The non-salary cost of employing a worker is high, and the rigidity of hiring and firing a worker creates a risk aversion for companies that would otherwise employ more people and grow. Regulations related to the number of work hours are not flexible.

### **3.4.2. Evaluative Indexes**

One of the important conditions to attract investments into the economy is country's high investment ranking. The higher the ranking, the higher the attractiveness for investors and lower the risk of investments. Improvement of the ranking lets country to attract the capitals of bigger and reliable investors.

In 2004 The International Finance Corporation and the World Bank had launched the project that assess investment ranking of countries "Doing Business". Since that time



the results of the project's research are published annually and provides objective measures of business regulations and their enforcement across 181 economies.<sup>83</sup>

The methodology assess the ease of procedure for starting a business, licensing, hiring and firing employees, registering property, getting credit, protecting investors, paying taxes, import- export operations, enforcing contracts and closing a business.

In December, 2008 *Consultative Council on Improvement of the Investment Climate* under the President of the Republic of Tajikistan had recommended to the Government of RT specific action plan to improve the indicators of the international ranking of the Republic of Tajikistan.

This plan is directed to improve the following international rankings of the country:

- «Registration of the enterprises»
- «Dealing with construction permits»
- «Protecting investors»
- «Closing a business»

Implementation of these actions has to be completed in May, 2009.

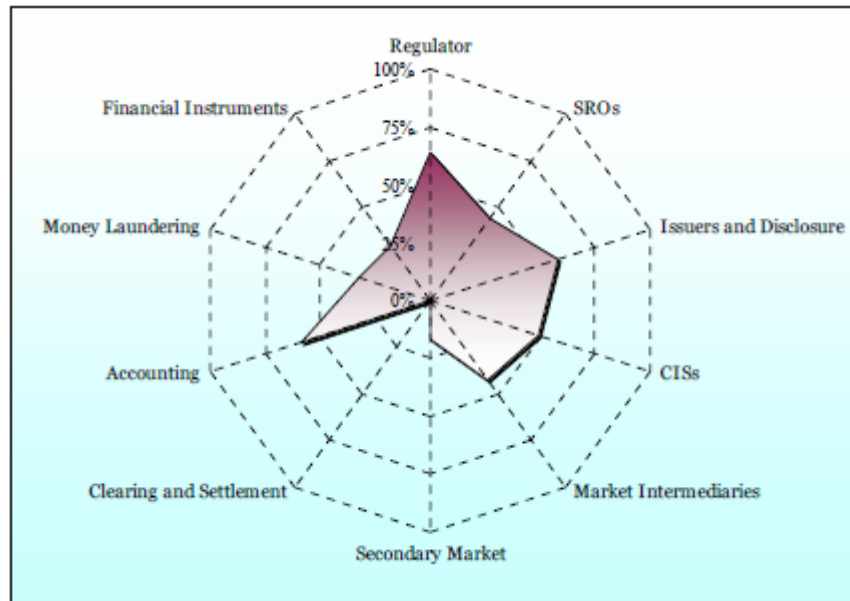
According to the EBRD Securities Markets Legislation Assessment conducted in 2007, the country was found to be in “very low compliance” with the Objectives and Principles of Securities Regulation published by the International Organization of Securities Commissions (IOSCO) – see chart below- showing a legal framework in critical need of reform.

Shortcomings have been highlighted in all areas under consideration: the regulator is not independent, the regulation of collective investment schemes is not yet contemplated by law and money laundering provisions are weak (although a new law on anti money laundering and counter terrorism financing has been under discussion for some time).

### **Table 3.5. Quality of security market legislation in Tajikistan - 2007**

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<sup>83</sup> World Bank review; [www.doingbusiness.org](http://www.doingbusiness.org); [www.tajikinvest.tj](http://www.tajikinvest.tj); 2009



Note: The extremity of each axis represents an ideal score, i.e., corresponding to the standards set forth in IOSCO's *Objectives and Principles for Securities Regulations*. The fuller the 'web', the closer the relevant securities market legislation of the country approximates these principles.

Source: EBRD Securities Market Legislation Assessment 2007.

In order to understand how securities market legislation works in practice, the EBRD recently concluded the 2007 Legal Indicator Survey ("the LIS"). Practitioners in the region were asked to comment on a hypothetical case study, advising an investor who lost his savings after buying shares in a national company's Initial Public Offering (IPO), misled by erroneous information in the prospectus. In particular, the Survey concentrated on effectiveness of prospectus disclosure requirements, private and public enforcement mechanisms and authority of the market regulator.

**Effectiveness of securities markets legislation is very low in Tajikistan.** The country lacks a functioning stock exchange and IPOs are not a common practice of corporate financing. The degree and the quality of disclosure in the prospectus are poor and although the law requires the prospectus to be registered upon the issuance of securities, this rule is generally not implemented. Further, there are no effective sanctions for breach of the law. The law provides for some course of court action but with very limited effectiveness: procedures are complex and the foreseeable recovery rate is low. Securities markets institutions are unable to provide the necessary support to court action while the experience of courts, prosecutors and securities market regulator in complex corporate law cases needs to be enhanced. Administrative measures are not deemed effective to

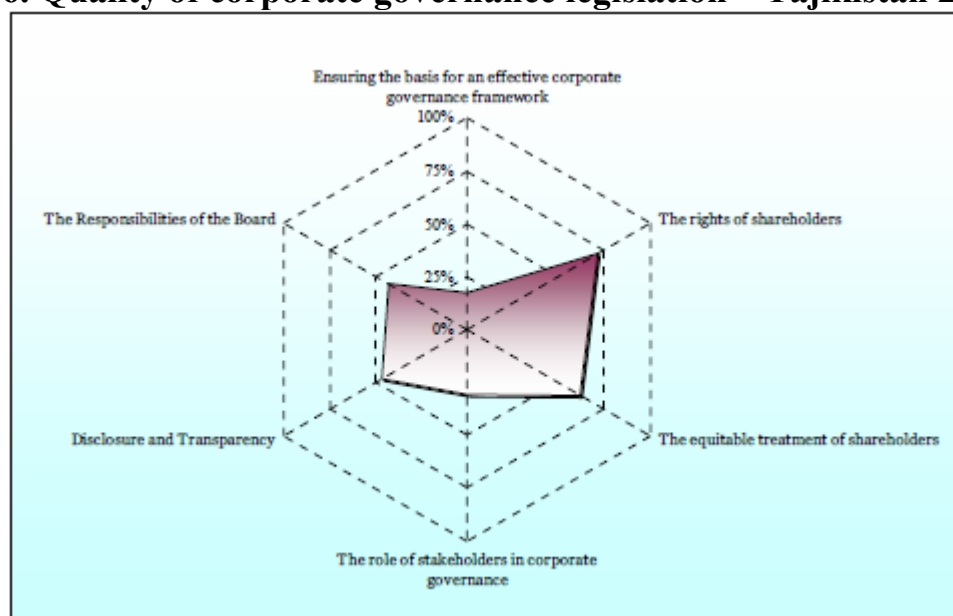
discourage illicit behavior and corruption is perceived as a problem. Finally the regulator lacks the necessary independence from the political sector and it has little sanctioning, investigative and rulemaking powers.

The authorities need to enhance the dialogue with the key market players (i.e. banks) for enhancement of the legal framework, concurrently addressing the problems related to law implementation and reforming the legal framework in line with international standards. The anti money laundering law also needs to be adopted in the near future. More importantly, it needs to be understood and supported with adequate training for bankers, lawyers, prosecutors and state officials.

### Company Law and Corporate Governance

The basic legislation on corporate governance in Tajikistan is entrusted in the new Law on Joint Stock Companies (JSC), which entered into force on 15 March 2007. JSC, together with more than 50 shareholders (i.e. open joint-stock companies), is organized under a two-tier system, where both the supervisory board and the management board are appointed by a general meeting of shareholders.

**Table 3.6. Quality of corporate governance legislation – Tajikistan 2008**



*Note:* The extremity of each axis represents an ideal score, i.e., corresponding to OECD Principles of Corporate Governance. The fuller the ‘web’, the more closely the corporate governance laws of the country approximates these principles.

*Source:* EBRD Securities Market Legislation Assessment 2007.

The authorities have taken major steps to improve governance in the corporate and banking sectors but substantial weaknesses remain. Notably among the reforms were the enactments earlier this year of a new Law on Joint Stock Companies, the establishment of a central share registry for all open joint stock companies and the privatization of medium and large companies. In particular, the new law incorporates much improved provisions on related-party transactions, major asset sales, meetings of shareholders and election of members of boards of directors—with clear fiduciary duties for them and other senior corporate officials. Nevertheless, the standard of corporate governance remains weak.<sup>84</sup>

According to the preliminary results of the EBRD's 2008 Corporate Governance Sector Assessment, under which the quality of corporate governance legislation is assessed, Tajikistan showed a low level of compliance with the relevant international standards (the OECD Principles of Corporate Governance). The results show some improvements since the last EBRD assessment, but many weaknesses still remain. Only the legislation detailing the rights of shareholders was found to be substantially in line with the relevant best practices. Instead, major shortcomings were found in the sections on the mechanisms for ensuring the basis for an effective corporate governance framework, the role of stakeholders in corporate governance, disclosure and transparency and the responsibilities of the board.

**Effectiveness of the system for both questions was assessed based on four principal variables: *complexity, speed, enforceability and institutional environment.***

The survey revealed that there are limited avenues allowing a minority shareholder to request disclosure in Tajikistan. Procedures are complex and the time needed for obtaining a court order is limited making enforceability a major problem. Judgments are, as a rule, difficult to enforce because there is no specific law on enforcement proceedings, and court executors do not have necessary enforcement machinery, especially against powerful defendants. The situation is similar when considering redress mechanisms. With regard to the institutional environment, the survey revealed that the framework on related-party transactions is weak, the competence and experience of courts, prosecutors and market regulator need to be improved, case law collections are not available and corruption and partiality of judgments are still reported as problems.

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<sup>84</sup> According to the 2006 enterprise restructuring and governance indicator of the European Bank for Reconstruction and Development, Tajikistan was rated at “2-” out of a possible “4+” with only one out of about 30 European and Central Asian countries ranked lower.

### **3.4.2.2. Concessions**

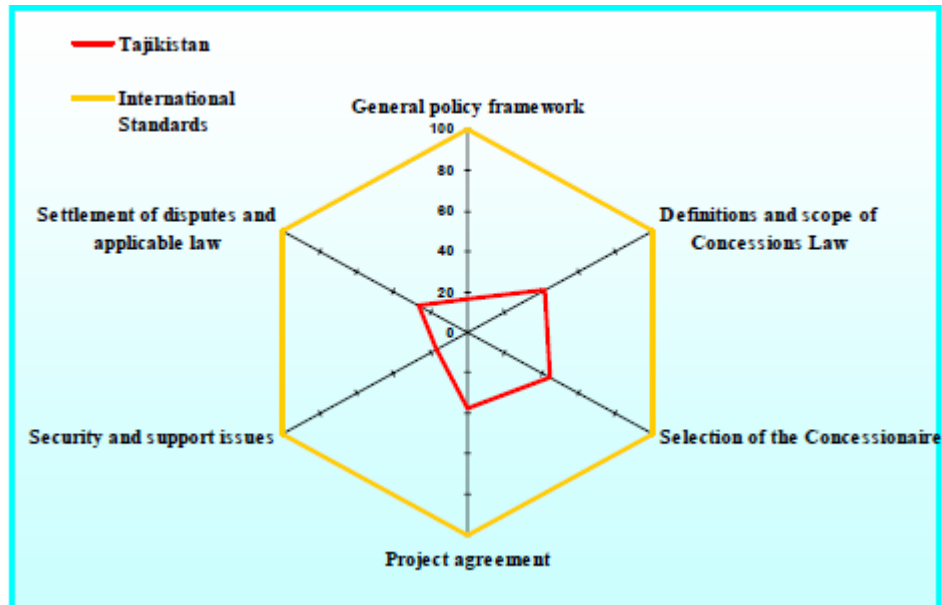
The Tajik Concession Law (the “Law”) was adopted in 1997. It was supplemented in 2000 by the Regulations on Concession Agreements and on Auctions and Tenders. Additionally, a Governmental Resolution lists objects that may be the subject of concessions while the Regulations on Procedure of Concession Contract Registration provide for the registration of concession contracts. There is no written policy framework document or reference promoting public-private partnership in Tajikistan although the Concession Law provides that the Government shall draw up priority investment programs.

Despite a seemingly extensive legislative/regulatory framework the regime is too vague in most of the core areas. Its definitions and scope of application need serious improvements (concession is defined as the "transfer of temporary exploitation of enterprises (associations) belonging to the state, land with right of extraction of minerals, construction of infrastructure, water resources and other natural resources not forbidden by the Republic of Tajikistan", which leaves the list of concerned sectors unclear.

The selection procedure requires further clarification. Even though regulations exist in this respect, they are in many respects repetitive with the Law. Amongst particular shortcomings one could mention the following: pre-selection procedure is not regulated or even mentioned, unclear grounds for direct negotiations (those are mentioned as possible in "exceptional cases", and subject to government decision), and no regulation of unsolicited proposals.

Even though the Law contains provisions on the project agreement, they lack the required flexibility for the negotiation of such agreements (e.g. the law provides for a priority of the state to purchase concession production, there are restrictions with regard to assignment of concessionaires' rights).

### **Table 3.7. Quality of concession legislation – Tajikistan 2007-2008**



*Note:* the extremity of each axis represents an ideal score in line with international standards such as the UNCITRAL Legislative Guide for Privately Financed Infrastructure projects. The fuller the 'web', the more closely concessions laws of the country approximate these standards.

*Source:* EBRD Concessions Sector Assessment 2007/8

Finally, the Law is not substantially developed as far as state support and financial securities are concerned. Also, the possibilities for choosing international arbitration are limited. There are, however, a certain number of positive elements such as the reference to the "mutual benefit", and "non-involvement in economic activity of the concessionaire". The Law also provides for notification to all participants of the tender results and for the right to challenge these. It also provides for the registration of project agreements. The 2007/2008 EBRD evaluation of concessions laws as they appear on the books (as opposed to how they work in practice) revealed that all of the dimensions of the concession framework have much room for improvement – see chart below.

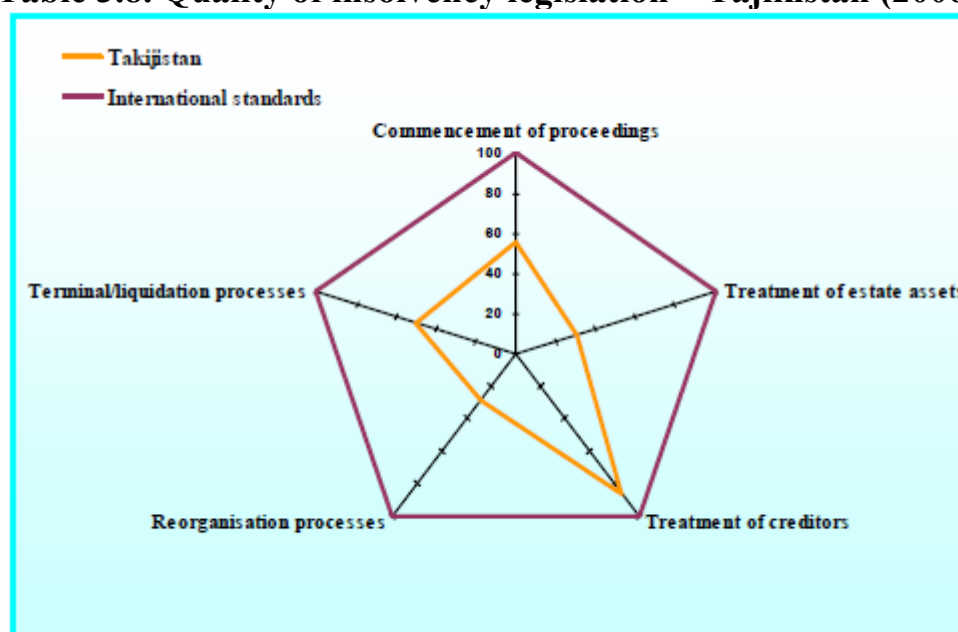
## **Insolvency**

Insolvency in Tajikistan is governed by the Law on Bankruptcy of Enterprises, which was adopted in 2003 (the "Insolvency Law"). The Insolvency Law replaced the Law on Bankruptcy of Enterprises of 1992, and represents an improvement over the former insolvency regime. However, the Insolvency Law still lacks many basic qualities recognized as essential to an effective and efficient insolvency system under international standards. In fact, as the graph below demonstrates, the most recent update to EBRD's Sector Assessment found that the Insolvency Law is in "very low compliance" with

international standards, confirming that Tajikistan’s Insolvency Law is in need of significant reform.

A key deficiency identified by EBRD’s Sector Assessment is the uncertainty surrounding commencement of insolvency proceedings. For example, the Insolvency Law contains vague financial condition criteria and complicated hurdles that must be overcome before the court will accept application to commence proceedings, and this uncertainty and lack of transparency have been confirmed in practice.

**Table 3.8. Quality of insolvency legislation – Tajikistan (2006)**



*Note:* The extremity of each axis represents an ideal score, *i.e.*, corresponding to international standards such as the World Bank’s Principles and guidelines for Effective Insolvency and Creditor Rights Systems, the UNCITRAL Working Group on “Legislative Guidelines for Insolvency Law”, and others. The fuller the ‘web’, the more closely insolvency laws of the country approximate these standards.

*Source:* EBRD Insolvency Sector Assessment 2006

In addition, the Insolvency Law fails to clearly describe the effects of opening a case on secured creditors. For instance, although the law provides for an automatic stay of actions against the debtor, the stay is vaguely expressed and is not clearly made applicable to secured creditors. There are no provisions for secured creditors to seek relief from the automatic stay and the law similarly fails to clearly preserve secured property rights after the case has been opened. As a result, all parties, including secured creditors, face uncertainty, delay and the likelihood of inconsistent outcomes that may persist even after the case has commenced.

The Insolvency Law also needs substantial reform to improve both liquidation and reorganizations processes. The law lacks provisions for avoiding pre-bankruptcy transactions and set-off of obligations between the debtor and its creditors. Likewise, the law does not provide for a clear discharge of debts and liabilities after proceedings have concluded. Insofar as reorganizations are concerned, the Insolvency Law also lacks provisions for ongoing financing for a reorganizing business, or for independent approval or supervision of a reorganization plan. Similarly, there is no requirement that material information in connection with a proposed plan be disclosed to creditors.

The Insolvency Law should be revised to address these problems, providing a sound basic framework for an insolvency system that promotes quick and easy access as well as clear and predictable results for all parties.

### **3.4.3. Integration tendencies on capital market in the region**

Tajikistan does not actively restrict funds conversion or transfer, although the National Bank of Tajikistan has been preparing a package of new regulation on this topic for two years. Currency can be freely exchanged; however it is often difficult to conduct large currency transaction, due to limited amount of foreign currencies available at domestic financial market. Investors are free to import currency.

As one now looks back on Tajikistan's development since 1998, it turns out that the unexpected happened. Rapid economic recovery began in 1999 and was sustained since then with average economic growth at levels between 7-9 percent per year. This helped to reduce the poverty rate significantly, even as it remains at a high level today (estimated at over 60%). There is now a significant donor presence and aid levels have increased. Economic management capacity, while still severely limited, has improved. In fact, Tajikistan has been rightly hailed as a rare success story of post-conflict reconciliation and reconstruction<sup>85</sup>.

What can be done if Tajikistan is to work its way out of the triple crises that it faces. Foremost, the government will have to grasp the seriousness of the situation and work on all fronts – political, economic and regional – to address the challenges it faces. It will have to contain the immediate macro-economic, food and energy risks, while also signaling a clear commitment to reform its economic structure and management. It will

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<sup>85</sup> IMF Economic Forum „Governing Global finance“, <http://www.imf.org/external/np/tr/2001/TR010405.HTM>



have to introduce greater transparency and accountability, achieve greater market-driven efficiency, and create more favorable conditions for private investors from outside the traditional elite. This means a major reversal of political and economic directions of President Rakhmon and his cabinet and will not be easy. But for someone who has created peace out of the ashes of war, who has forged progress out of disaster, and who has conveyed a sense of smart realism when confronted with great challenges in the past, this should not be an insurmountable task. It does require the recognition that the long term prosperity and stability of the country, and hence also of its elite, is possible only with fundamental change.

### **3.5. Tajikistan's Investment Climate in opinion of the international experts.**

The investment climate of the country - as set of conditions and rules of business dealing, is defined by the majority of foreign potential investors, proceeding from data of so-called country ratings. Certainly, methods of their drawing up, and also a set of used variables are ambiguous and often can be challenged. At the same time, as a rule, investors are not interested in the methodology, but in the position of the country in this or that rating. Very often decision-making on investment of means in economy is based on the analysis of various rating estimations. We have tried to generalize most popular of them.

1. One of the most known and popular ratings for the investor are annual reports of the *World Bank "Doing business"*, published from 2003. In these reports the countries are rated by the experts of the World Bank on a degree of transparency of processes, openness of economy and efficiency of economic mechanisms. According to last report of "Doing business", Tajikistan occupies 153rd position in an index of ease of business dealing among 178 countries of the world.<sup>86</sup>

2. According to the same institute, Tajikistan occupies 99th place in a rating of the World Bank among 178 countries of the world on a degree of the termination of business through procedure of bankruptcy.

3. American analytical center *Heritage Foundation* and the first business newspaper of the USA – "The Wall Street Journal" make an annual Index of economic

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<sup>86</sup> World Bank „Doing business 2009“ Central Asia Region.  
<http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/ECAEXT/TAJKISTANEXTN/0,,contentMDK:21895590~menuPK:258749~pagePK:2865066~piPK:2865079~theSitePK:258744,00.html>

freedom. According to a rating of 2008, Tajikistan is on the 114th place from 157 countries of the world - in a category of “basically not free countries”. The level of economic freedom in Tajikistan is estimated in 54,5 %. Freedom of business is estimated in 43,4 %, a freedom of commerce in - 77,8 %, fiscal freedom in - 89,3 %, freedom from the state in - 84,1 %, monetary freedom in - 65,8 %, investment freedom in - 65,8 %, financial freedom in - 40 %, the right to the property in - 30 %, freedom from corruption in - 22 % and freedom of employment in - 62,1 %.<sup>87</sup>

4. Brookings Institution - the American analytical center, has estimated a rating of weakness of 141 countries. Tajikistan has occupied 42nd place in a rating, having got in group of “weak countries”.

5. In the end of June, 2008 magazine Forbes publishes a rating of the Best Countries for Business. The magazine estimated 121 countries by such criteria, as a level and growth of gross national product, gross national product per capita, a condition of trading balance, a rate of inflation and unemployment, a degree of economic and personal freedom, system of the taxation and the legislation. A position of Tajikistan is 118th place from 121 possible.

6. The organization “Global economic forum” - the independent and noncommercial international organization created in 1971 in Geneva with the purpose of improvement of a condition of the world economic, counts a number of ratings. In particular, two indexes on the basis of which ratings of the countries are made; it is Global Competitiveness Index (GCI), and Business Competitiveness Index, (BCI). According to these indexes, each of the countries is estimated on quality of institutes, an infrastructure, macroeconomic stability, health and an elementary education, higher education and vocational training, efficiency of a commodity market and services, efficiency of a labour market, development of the financial market, a technological level, the sizes of the market, competitiveness of the companies and innovative potential.

According to last report (the report 2007-2008 included 131 countries). Tajikistan occupies 117th place from 131 on Global Competitiveness Index and 104th place from 131 on Business Competitiveness Index.

7. The world economic forum also rates the travel and Tourism Competitiveness Index. At calculation of this index it is taken into account: legal regulation of sphere, development of business-environment and infrastructure, human, cultural and natural

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<sup>87</sup> Analytical center „Heritage Foundation“ 2008; <http://www.heritage.org/index/country/Tajikistan>

resources for tourism, and also safety, quality of hygiene and health, etc. The International tourist rating of Tajikistan in 2008 is 110th place from 124 countries of the world.

8. In June 2008 the world economic forum has published the report and a corresponding rating the Enabling Trade Index 2008. The report is made on the basis of the analysis of such factors, as access to the market, customs regulation and a transparency of activity of regulating bodies on border, transport and communication infrastructure, and also business-environment. A trading rating of Tajikistan in 2008 is 104th place among 118 countries.

9. From the reports of the *World economic forum*, which characterizes business image of the country, we shall note the Global information Technology Report 2007 - 2008. In the Networked Readiness Index 2007-2008 rankings, Tajikistan occupies 98th place among 127 countries of the world.

10. Transparency International, engaged in estimation of a corruption level, counts a so-called index of perception of corruption. In annual monitoring a degree of corruption perception in 2006 Tajikistan has occupied 9th place on a level of corruption, and 5th place in 2007 of 179 countries of the world. In 2007 data have been included in an index of corruption perception about corruption in public sectors of 180 countries of the world.

11. The index of development of human potential is calculated by the *United Nations* and is intended for comparison of a level of literacy, for average life expectancy and specification of actual incomes in the country. In published by the United Nations *“Report on human development 2007-2008”* Tajikistan was given 122<sup>nd</sup> place from 177 countries of the world. The country has got in group of the countries “with an average level of development of human potential”.<sup>88</sup>

12. In May, 2008 the mass-media have distributed the information, that, according to data of experts of the Food and agricultural organizations of the United Nations (FAO), Tajikistan was included into the list of 22 countries of the world, to which because of increase of the world prices for the foodstuffs threatens famine.

13. In March, 2008 the *International organization “Reporters without borders”* has published the traditional annual list of the “enemies of the Internet”, i.e. the list of the countries supervising the Internet. The list of the basic countries recognized as enemies of

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<sup>88</sup> United Nations „Report on Human Development 2007-2008“, Tajikistan <http://hdr.undp.org/en/reports/global/hdr2007-2008/>

the Internet included 15 countries. Tajikistan is enlisted to the so-called additional list of 11 countries supervising the Internet.

14. Foreign Policy magazine and research center Fund for Peace in 2007 published “the Rating of instability of the states of the world – 2007” in which 60 countries have entered. The rating is made on the basis of twelve criteria - political, economic, military and social. In particular, demographic situation, presence of refugees, position with observance of human rights, power and control of special services, unity of the state elites and presence of external factors, for example, foreign occupation were estimated. On a level of instability in 2007 Tajikistan has 29th place from 60.

As we see, the international business ratings of Tajikistan continue to remain one of the lowest in spite of the fact that the state policy in the field of investments and business is open enough.

If to speak about the sum of "impressions", which is received by an analyst preparing materials for businessmen, it becomes obvious that we shall not expect positive changes. Here it is necessary think of drawing up of own ratings of an estimation of investment appeal of Tajikistan, based on objective factors, which can interest foreign businessmen, first of all from the point of view of reception of the maximal volume of profit.

One of the facts confirming low interest of the world business-community in capital investments in the Tajik economy can serve the volume of foreign direct investments for the last five years. We shall consider, what countries (and in what size) put direct investments into Tajikistan. From 2002 till 2007 foreign direct investments (FDI) for the sum of 918 165,2 thousand US dollar have been involved. The sum of FDI of the CIS countries for all period has made 428 052,9 thousand US dollars -46,6 of %, and of the countries of the far abroad - 490 112,3 thousand US dollars - 53,4 %.

## **CHAPTER SUMMARY AND CONCLUSION**

This chapter has analyzed the enabling environment related to the general macroeconomic situation, the legal system and structure (both current and the reform

agenda in place), the investment climate, qualitative and quantitative indicators of FDI and other investments and the requisite infrastructure for trade and settlement.

This Chapter also has demonstrated that the environment for the market is right as far as the fiscal and monetary policy observance is concerned. The judicial system is also under reform agenda already and sooner than later, it may be acceptable to modern standards. Governance issues are generally believed to be influenced right from the Top Office in the region. Currently good governance is well observed and it may only be inferred that participants will follow suit.

The communication infrastructure is basically in existence, what is required is to customize it to the capital markets requirements.

We can see from the findings that the setting is ready for the capital market to start but since there are many SMEs than those considered in the analysis, an over-the-counter market must be developed to augment the formal one. The OTC would be able to trade in securities issued by the not-good-enough companies until they matured to list in the formal market.

After all, Tajikistan is a member of CIS, EurAseC, IFC, FAO, UN organizations, MIGA, OSCE, ESCAP and soon being admitted into the World Trade Organization joining Kazakhstan, Uzbekistan, and Russia. These countries have common services connecting their trade interest and capital markets. Finally there is every reason to believe that a stock market in Tajikistan can be built in the same way.

#### **IV. PREDICTIONS ON SYSTEM AMENDMENT REGARDING TO INTEGRATION PROCESSES IN CENTRAL ASIAN REGION**

## 4.1. Conceptual framework and prioritization for Government of Tajikistan

The key impediments to investment, business development and growth in Tajikistan are risk, barriers to entry and the cost of dealing with government. It is useful to look at this issues in the context to following simplified conceptual rationale for selecting and prioritizing solution options.

Investors worry about the factors that are not within the control of the firm. Some of these are purely commercial but some can be determined or controlled by government policies, laws, regulations and administrative procedures.

**Risk.** It is the unknown or the unforeseen in Tajikistan that dissuades investors and entrepreneurs the most. Thus the element of the investment climate in the country, under or indirect control of the Government, which pose the greatest risk for the investors or entrepreneurs are the ones that need the highest priority attention from policy makers and the administration.

Of all the risks that entrepreneurs and investors perceive in developing countries, property rights are perhaps the most serious. This applies to both movable and immovable property. Country-level studies consistently show that less secure property rights are correlated with lower aggregate investment and slower economic growth. In a survey<sup>89</sup> of small manufacturing firms in five transition countries, the entrepreneurs reinvested less of their retained earnings in the business if they perceived their property rights to be insecure. Those entrepreneurs with the least secure property rights re-invested nearly 40 percent less of their retained earnings than those with the most secure property rights.

**Making contracts more enforceable.** In order for market to function there must be some means of assuring that promises will be kept. Every business transaction involves some form of agreement or contract, be they formal or informal. These could range from trading agreements, to capital purchases, financing agreements, shareholder agreements, the purchase or sale of real estate or even that of entire businesses. In every contract the

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<sup>89</sup> Property Rights and Finance, Johnson, McMillan and Woodruff, 1997.

parties deploy resources to fulfill the obligation under the contract. In the event of default, these resources are in jeopardy if the contract can not be enforced.

Third-party arbitration is an alternative option for contract enforcement in a weak court system if the institutional mechanisms for this practice are in place. The formation of business association or networks can be another enforcement mechanism in which reputation risk and loss of privilege can make contracts self enforceable. These association also provide third-party arbitration, e.g., in Russia and Ukraine.

***Privatization:*** Tajikistan has made several advances in the development of its private sector. Privatization of small enterprises has been completed, while divestiture of medium and large enterprises is ongoing<sup>90</sup>. More than half of state and collective farms have been dismantled and land certificates issued to private farmers. In spite of these advances, however, the state remains intricately involved in a wide range of commercial and productive activities, which continues to hinder the development of competitive markets. The delivery of public services, including social and economic services, remains inadequate for long-term growth and improvement of investment climate in region.

In general, *privatization* of small and medium enterprises (SMEs) from government ownership is complete. The privatization process began during the civil war (1997-1998), which limited potential international owners exposure and access to SMEs. Privatization of state property still continues, and although there are no limitations on foreign investor participation in privatization of state-owned assets, in many circumstances the decisions are made in favor of politically connected interest groups through behind-the-scene arrangements. The largest enterprises, belonging to Tajikistan's transportation infrastructure and electricity distribution and maintenance sectors, are still government-owned but are planned for privatization by 2007.

For acceleration of the privatization procedures and attracting the foreign investments to the economy of Tajikistan the Government of the Republic has adopted a Strategic Plan for privatization of medium and large enterprises and restructuring the subjects of natural monopolies and very large enterprises for 2003-2007. The main goal of the Strategic Plan is a gradual denationalization of all medium and large enterprises by the

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<sup>90</sup> Medium and large scale enterprises are still being privatized. Enterprises have been grouped into three categories. Category one covers 449 medium and large enterprises to be privatized through auction; category two covers a further 102 large enterprises to be privatized through tender procedures, and category three covers 37 strategic infrastructure and other enterprises.

end of 2007 for further enhancing the market reforms, creation of necessary conditions for more dynamic development of the private sector. The realization of this plan can allow attracting the local and foreign investments, forming the securities market, improving enterprises' assets use, creating new working places and increasing the employment level.

***Strengthening the financial sector.*** Despite significant improvement and consolidation, the banking sector still has a limited impact on economic development. The government should be more proactive in advocating increasing capitalization and will remain ready to support the entry of new (local) private and regional and international investors, including Russia and Kazakhstan and should seek further opportunities for equity participation, in order to strengthen the banking sector's capacity.

By present, 8 366 of 9 121 enterprises, including 7 602 small and 764 medium and large ones, are privatized in the Republic. Since the beginning of the year 1970 enterprises have been privatized in the Republic. It is planned to transmit 138 middle and large enterprises to the private property by the end of the year. It was reported to the «Asia-Plus» newspaper by the Chairman of the State Property Committee Sherali Gulov. «By present, 8 366 of 9 121 enterprises, including 7 602 small and 764 medium and large ones, are privatized in the Republic». According to his words since the beginning of the year 329 different objects of the total over 19 million TJS have been privatized whereas the year plan is 10 million TJS. As to the rent of the state property Sh. Gulov marked that 771 contracts had been signed of the annual over 2 million TJS. As a result, within 6 month period 789 000 TJS have been transferred to the state budget.<sup>91</sup>

The investment needs in infrastructure are considerable and remain critical to the country's developments as well as to the attraction of FDI, but progress is constrained by limited public resources and restriction on sovereign borrowing. The Government should consider financing non-sovereign infrastructure that produces cash-flow to meet debt repayments without recourse to sovereign guarantees. This could be the case in the hydropower sector, which should develop considerably in the coming years.

The Tajik economy began its rapid growth at 8-10 % per annum in 2000. Since then, regulation and taxation are still under reform. Economic indicators remain below the benchmarks of 1991, when Tajikistan gained its independence. The government has

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<sup>91</sup> Newspaper «Asia-Plus» November 2008;



increased revenue collection for its social expenditures, however, non-transparent administration and corruption in tax agencies results in tax fraud and nonpayments. The tax burden is placed on the private sector and companies who do actually comply, resulting in distorted competition.

Corruption and rent-seeking in Tajikistan is still high. Although bank deposits in 2005 more than doubled on a year-to-year basis, the informal economy is still quite substantial. According to some estimates, it equals half the GDP (\$2 billion).

**Fostering the private sector through:**

- Credit lines at the micro and SME level
- Direct loans and equity investments through the instruments of the ETC Initiative (Direct Lending and Investment Facilities)
- The Trade Facilitation Programme.

Strengthening the financial sector through equity investments, technical assistance and institutional building programmes to improve credit and financial management skills and corporate governance. Supporting public infrastructure projects in such sector as aviation, road maintenance, telecommunications, hydropower, municipal infrastructure, with limited recourse to a sovereign guarantee or by blending Bank resources with grants to achieve concessional terms of financing. Maintaining a constant policy dialogue to help improve the investments climate and the development of the private sector, in cooperation with the other IFIFs.

## **4.2. Issues and Recommendations for building Capital Market in Tajikistan**

Tajikistan has experienced an enormous increase in its inflation rate and decline in real output growth over the last decades. However, as a result of the successful implementation of monetary and exchange rate policies aimed at achieving low inflation and strengthening the balance of payments in the 1990s and till now real GDP growth is risen significantly. Tajikistan is often considered a country with unexplored opportunities. Unique bioclimatic condition, rich mineral resources, large hydroelectric potential and

labor resources all have the ability to become main factors in the production of competitive products that aids in the integration of the country's economy into the world economy.

As one now looks back on Tajikistan's development since 1998, it turns out that the unexpected happened. Rapid economic recovery began in 1999 and was sustained since then with average economic growth at levels between 7-9 percent per year. This helped to reduce the poverty rate significantly, even as it remains at a high level today. There is now a significant donor presence and aid levels have increased. Economic management capacity, while still severely limited, has improved. In fact, Tajikistan has been rightly hailed as a rare success story of post-conflict reconciliation and reconstruction.

Tajikistan does not actively restrict funds conversion or transfer, although the National Bank of Tajikistan has been preparing a package of new regulation on this topic for two years. Currency can be freely exchanged; however it is often difficult to conduct large currency transaction, due to limited amount of foreign currencies available at domestic financial market. Investors are free to import currency.

However, over the last 12-18 months, difficulties started to emerge. There are likely to shape the immediate future of the country in three key areas: in the political arena, in the economy, and in the regional context.

**In the political arena**, the success of pacification contained the seeds of long-term troubles. It is now clear that two elements were critical for successful peace making in Tajikistan: first, the wide distribution of "spoil" to the main combatant leaders and the opposition – this involved the allocation of privatized assets and of government positions; and second, the gradual centralization of power and stability, by assuring the buy-in of most major players and central government's control over the country's geographically, ethnically and politically fragmented territory<sup>92</sup>.

**In the regional context**, positive trends are undermined by negative developments. On the positive side, the defeat of the Taliban in Afghanistan after September 11, 2001 brought a dramatic reduction in security threats and permitted the

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<sup>92</sup> Stina Torjesen and S.Neil macFarlane, "R before D: the case of post conflict reintegration in Tajikistan", Conflict, Security & Development, Vol. 7(2), June 2007

establishment of a relatively open border between Tajikistan and its southern neighbor, even as Tajikistan's access to the Pakistani ports on the Indian Ocean remains limited by continuing insecurity in Afghanistan and by problems with infrastructure and transit. Another positive regional factor has been the strong economic growth during recent years among Tajikistan's Central Asian neighbors and of China and Russia. Central Asia is at the hub of a highly dynamic and rapidly integrating Eurasian supercontinent. This is a significant driver of growth for the region as a whole and also for Tajikistan. Finally, among the positives is the emergence of an increasingly active and effective regional economic coordination mechanism, the Central Asia Regional Economic Cooperation Forum (CAREC), which consists of eight countries in the broader Central Asia region and of six multinational institutions. CAREC supports regional economic integration by implementing regional trade, trade facilitation, transport and energy strategies.

However, two regional factors limit progress and create potential risks for Tajikistan. First, lack of agreement between Tajikistan and Uzbekistan about how to manage the highly integrated cross-border regional transport and energy infrastructure imposes many constraints on Tajikistan's ability to trade, and specifically limits its access to gas imports and its ability to market electricity exports. This forces Tajikistan to seek costly infrastructure and trading routes by-passing Uzbekistan. Second, there is the increasing threat of a regional water shortage, which may significantly raise the risks of regional tensions over the allocation of scarce water resources between upstream and downstream countries in the Aral Sea basin.

**As a result of the interplay of these political and economic forces Tajikistan now faces the threat of three actual or impending crises at once:**

**First**, there is the immediate and highly visible economic crisis caused by the closely interrelated threats to energy, water and food security that were so painfully brought to light during the winter 2007 and that recently have been compounded by the country's macroeconomic difficulties. At the root of the crisis is a combination of poor economic management, regional factors (barriers to trade and transit) and worldwide trends (food prices and global warming).

**Second**, and less visible so far, there is a potential crisis of political stability. Popular frustration about the economic hardships and about deterioration of public services has so far been kept in bonds by the safety valve of out-migration and by the fact that

Tajikistanis remember the suffering caused by the civil war and eschew violence to solve their problems. But these factors may be effectively resolved. A further risk to domestic potential stability may come from tensions among key power centers in the country, although the opaque political process and the absence of free and strong media in Tajikistan make it difficult to judge this risk.

**Third**, there is a crisis in the external perception of Tajikistan, reversing what had been an improvement in its reputation and credibility. The news from Tajikistan reported to the world in the international press and electronic media today is generally bad. And some diplomats even talk about Tajikistan as a “failed state”. This turns off foreign investors, undermines donor support and makes it difficult to attract good staff and consultants for externally funded projects.

In the face of this triple crisis there are some positive signs: First, the government has begun to address its macroeconomic and structural issues in connection with a new IMF program. Second, traditional aid donors are pulling together in the face of the emerging crises, as witnessed by the immediate joint response to the food and energy problems since last winter, and by the preparation of a joint donor assistance strategy, an important coordination process that is now starting. The willingness shown by President Rakhmon and his economic team to engage in this process is encouraging. Third, new aid donors (including China, Iran and Russia) appear to be developing a realistic assessment of government capacities to administer inflows of aid and appear ready to engage with the traditional donors in seeking common approaches for an effective support of Tajikistan.

### **Banking Reform and the Capital Market**

One of the most famous authorities Pescetto (1992) suggests the following three reasons for developing an efficient banking system.

(a) Firstly, the banking system facilitates the efficient allocation of capital. Through credit risk analysis it ensures that only the most effective firms receive the necessary finance while imposing a strict budget constraint. Thus banking reform and privatisation are interdependent.

(b) Secondly, the control of money supply and all its aggregates is a crucial function for a central bank. For the government to effect stabilising policy, control must be placed on money supply.

(c) Thirdly, the supervision of the commercial banking system by the central bank is also of great importance, as is the continuing effort to bring informal markets into the legitimate economy.

It is with these in mind that I described, firstly with a brief discussion of the banking system in Tajikistan and the reform process, and secondly with an outline of the building a capital market and integrate it in Central Asian region.

### **Regulatory Requirements on the Capital Market**

Regulation plays an important role in a fair and orderly functioning of the capital market. Parts of the market are more heavily regulated than other parts. Commercial banking, for example, is one of the most regulated parts of the financial services industries. This heavy regulation is based on the fact that large bank failures, due to either fraud or mismanagement, can destabilize banking markets and lead to loss of faith in the banking system – and therefore in the currency and money (as the liability of commercial banks). The capital market is a major source of funding for industries as well as infrastructural development.

**What can be done if Tajikistan is to work its way out of the triple crises that it faces.** Foremost, the government will have to grasp the seriousness of the situation and work on all fronts – *political, economic and regional* – to address the challenges it faces. It will have to contain the immediate macro-economic, food and energy risks, while also signaling a clear commitment to reform its economic structure and management. It will have to introduce greater transparency and accountability, achieve greater market-driven efficiency, and create more favorable conditions for private investors from outside the traditional elite. This means a major reversal of political and economic directions of President Rakhmon and his cabinet and will not be easy. But for someone who has created peace out of the ashes of war, who has forged progress out of disaster, and who has conveyed a sense of smart realism when confronted with great challenges in the past, this should not be an insurmountable task. It does require the recognition that the long term

prosperity and stability of the country, and hence also of its elite, is possible only with fundamental change.

### **Issues and Recommendation to Tajikistan's external partners**

*First*, they should not write-off Tajikistan as a “failed state”. The country is a “fragile state” in the sense that its public and private capacities, institutions and policies are weak and under pressure. However, there is no inevitability to the country's failure or its government's inability of managing a transition to a better future. Tajikistan is a regionally and geopolitically important country where principled, clear-sighted and constructive engagement is necessary and appropriate.

*Second*, the donor community, including China, Iran and Russia, needs to pull together in engaging the President and his government and in supporting the country at this critical stage. It appears that the government is open to a serious engagement and indeed most of the internal critics of the current political establishment look to the outside partners for strong engagement.

*Third*, the external partners should focus on a limited number of key steps that will signal the government's commitment to serious change: (a) effective implementation of the agreed IMF program (with its welcome emphasis on state-owned enterprise reforms in addition to the traditional macro economic stabilization measures); (b) reform of agricultural policies and institutions, especially in the critical cotton sector; (c) improvements in the investment climate, guided by a newly set-up Investment Council supported by the European Bank for Reconstruction and Development; and (d) effective engagement in the management of the immediate food and energy crisis.

*Fourth*, the international community should engage in helping improve the regional context which Tajikistan faces. This relates to the preparedness of the short term water and energy crisis, to cooperation on the long-term development of the region's water and energy resources, and to improvements in its transport and trade links with the rest of the world.

### **Issues and Recommendation to Government**

To further improve corporate governance, the government should:

1. Increase the transparency of ownership and control by publishing the names of significant owners of banks and other financial institutions (immediately for direct owners and over time for beneficial owners); placing on-line and making available to the public the names of company founders and company statutes filed with the business registry; and establishing a central registry of land use certificates with access made available through the internet; and
2. Subject by law all credit institutions to annual independent audits of their financial statements. This will extend the current requirement applicable to all open joint stock companies—including all private banks—to public banks (currently externally audited once every two years and closed joint stock company not subject to external audits).<sup>93</sup> Tajikistan also needs to license sufficient professional audit firms capable of auditing financial institutions.

**Tajikistan’s external partners can help bring about this change in direction.**

First, they should not write-off Tajikistan as a “failed state”. The country is a “fragile state” in the sense that its public and private capacities, institutions and policies are weak and under pressure. However, there is no inevitability to the country’s failure or its government’s inability of managing a transition to a better future. Tajikistan is a regionally and geopolitically important country where principled, clear-sighted and constructive engagement is necessary and appropriate.

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<sup>93</sup> Tajikistan has to begin adopting IFRS standards, and all financial institutions as well as other corporations are obliged to implement the IFRS – although the degree of enforcement reportedly varies across institutions.

improvements in the investment climate, guided by a newly set-up Investment Council supported by the European Bank for Reconstruction and Development; and (d) effective engagement in the management of the immediate food and energy crisis.

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**In sum**, Tajikistan faces three mutually reinforcing crises, each presenting severe challenges to the government and to the donor community on the ground. However, every crisis contains the seeds of opportunity. In the case of Tajikistan, the biggest opportunity now is that the current challenges will energize the government to move forward with urgently needed actions and reforms and will call attention to the need for effective and well coordinated support of the international community. Tajikistan's success in overcoming its current challenges will be critical for the long-term prosperity and stability of Central Asia.

## CONCLUSION

While the era of globalisation has been around for more than a decade, and has seen developments in information and communications technology unparalleled in modern economic history, for Tajikistan this is only the beginning. As a small and open economy, it is unavoidable that we will be affected by changes and shocks in the global arena. This was clear during the crisis; many of the triggers for policy changes were a result of global pressure and direction. In the past we have adopted defensive mechanisms to tackle these challenges and problems, but this strategy has proven costly and painful.



Looking forward, we recognise the need to be more active in coping with the shocks and pressures of the global economy. In order to be better prepared for such events, we have also recognised the need to build an early **warning system** that would alert us to external and internal risks, uncertainties and possible turbulence. In this light, the members of IMF and World Bank have attempted to develop self-help mechanisms as well as credible surveillance and peer review processes. At the regional level, Central Asian economies are working together to create deep and liquid condition for regional bond markets which could provide a predictable source of funding for the government, state-owned enterprises and private firms.

This bond markets may offer alternative investment opportunities for savers, and should increase the efficiency of the disintermediation process in Asia. Not only will efficient bond markets in Central Asia help mitigate the potential risk of double (currency and maturity) mismatches, they will also facilitate intraregional trade and investment and create a closer link among regional financial markets. Despite the recent positive developments, it is important that the authorities not become complacent in the effort to continue raising standards and improving practices in our financial system.

Further questions that arise include: what needs to be done so that we can be ready to meet future challenges? How can we better manage financial integration? Moreover, as a small open economy, to reap the full benefit of globalisation we need collective effort to create stable macroeconomic conditions, well developed financial systems, an effective early warning system and crisis resolution mechanisms. The 1991 crisis showed us that collective action is required to maintain growth and development in the world economy. The changes that Tajikistan has had to undergo - be they the change in the exchange rate regime, the search for the new anchor and framework for monetary policy, or the financial sector restructuring and massive capitalisation of banks - are but a single dimension, namely, the domestic front. The international front - where there arise the new demands and challenges of regional and global linkages - will open a new chapter for monetary cooperation.

Tajikistan has experienced an enormous increase in its inflation rate and decline in real output growth over the last decades. However, as a result of the successful

implementation of monetary and exchange rate policies aimed at achieving low inflation and strengthening the balance of payments in the 1990s and till now real GDP growth is risen significantly. Tajikistan is often considered a country with unexplored opportunities. Unique bioclimatic condition, rich mineral resources, large hydroelectric potential and labour resources all have the ability to become main factors in the production of competitive products that the aid in the integration of the country's economy into the world economy.

Tajikistan have to create liberal legislation with respect to foreign investors, their activity will rise, which will make it possible not only to retain the republic's export status, but also reinforce in (mainly be means of electricity, cotton and agricultural produce). But there are also several unsolved problems in this area, first and foremost, an integrated competitive environment for local producers and importers must be created, for attract foreign investments as basic point for creating capital market in Tajikistan in future.

The attraction of foreign investments, particularly from the private sector, is a key element of the republic's policy. For this purpose, it has to be eliminated tax-fiscal, administrative and other restrictions which interfere with attracting private and foreign capital, and additional measures should carry out to improve the investment climate in the country and reduce the risk s for investors. They include the above-mentioned widespread privatization of state enterprises, the development of infrastructure, and the increase in competitiveness of export products.

**Summarizing, the financial market in Tajikistan** is growing quickly from a very low basis. Largely, this growth is a consequence of macroeconomic stabilization in recent years, considerable strengthening of regulation of the sector, inflow of FDI, and maintained competitive environment. Still, the country's financial market is shallow and financial intermediation is insufficient to meet the country's need. Banks consider remittances only as a source of non-interest income and take only little effort to provide intermediary services to remittance senders and recipients. However, with the revival of consumer finance, growing competition in the banking sector, and adaptation of remittance-receiving households to contacts with the banking sector, changes for more successful financial intermediation seem to be interesting.

## **Issues and Recommendation to the Government and NBT**

To further improve corporate governance, the government should:

- Increase the transparency of ownership and control by publishing the names of significant owners of banks and other financial institutions (immediately for direct owners and over time for beneficial owners); placing on-line and making available to the public the names of company founders and company statutes filed with the business registry; and establishing a central registry of land use certificates with access made available through the internet
- Strengthen the governance and autonomy of the NBT. In particular, rules for the appointment, dismissal, and terms of office of the chairman and Board members should be spelled out and clear provisions on conflict of interest should be introduced in the law.
- Strengthen the legal framework for bank licensing, by reintroducing legal provisions on the NBT's authority to license banks, and allow the NBT to check on the suitability of beneficial owners of banks.
- Launch a program of issuance of government securities, which would help develop the bond market and strengthen NBT's monetary framework.
- Continue strengthening the bank regulatory and supervisory framework, including by submitting public banks to annual independent external audits.
- Bring the new draft laws on insurance, deposit insurance, and credit bureaus into line with international good practice and submit them to parliament.
- Strengthen the surveillance framework to monitor the build-up of credit risk in the banking system to ensure that problems, if and when they emerge, can be addressed promptly.

### **To donor organization and to commercial banks of Tajikistan**

- To developing infrastructure in Tajikistan for creating good business climate
- Support private sector development, including the areas of financial transparency and improvements in the regulatory framework;

- Creating an environment for financial sector development
- Support adoption of modernized legislation for commercial banks which would improve the quality of banking sector;
- Help innovator banks in introducing new technological platforms for carrying out banking operations;
- Provide technical assistance and, possibly, financial resources to the banks of Tajikistan for the development of financial products (e.g., mobile banking, home banking) that are attractive and affordable for potential investors
- Reduce corruption and discretionary controls in business operations
- Provide financial information and training to the clients of commercial banks and incorporate into schools' curriculum.

### **To Tajikistan's external partners**

*First*, they should not write-off Tajikistan as a “failed state”. The country is a “fragile state” in the sense that its public and private capacities, institutions and policies are weak and under pressure. However, there is no inevitability to the country's failure or its government's inability of managing a transition to a better future. Tajikistan is a regionally and geopolitically important country where principled, clear-sighted and constructive engagement is necessary and appropriate.

*Second*, the donor community, including China, Iran and Russia, needs to pull together in engaging the President and his government and in supporting the country at this critical stage. It appears that the government is open to a serious engagement and indeed most of the internal critics of the current political establishment look to the outside partners for strong engagement.

*Third*, the external partners should focus on a limited number of key steps that will signal the government's commitment to serious change: (a) effective implementation of the agreed IMF program (with its welcome emphasis on state-owned enterprise reforms in addition to the traditional macro economic stabilization measures); (b) reform of agricultural policies and institutions, especially in the critical cotton sector; (c) improvements in the investment climate, guided by a newly set-up Investment Council

supported by the European Bank for Reconstruction and Development; and (d) effective engagement in the management of the immediate food and energy crisis.

*Fourth*, the international community should engage in helping improve the regional context which Tajikistan faces. This relates to the preparedness of the short term water and energy crisis, to cooperation on the long-term development of the region's water and energy resources, and to improvements in its transport and trade links with the rest of the world.

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