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Summary

Economic growth slowed considerably in 2013 despite robust agricultural production as heightened uncertainty surrounding the political and security transition led to a slump in investor and consumer confidence. Agricultural output reached record levels for a second consecutive year in 2013 due to favorable weather conditions, with cereals production increasing 2.7 percent over the bumper crop of 2012. On the other hand, uncertainty surrounding the political and security transition led to a slump in investor and consumer confidence, thus resulting in a sharp slowdown in private investment and growth in the non-agricultural sectors. Economic growth in 2013 is estimated at 3.6 percent, down sharply from strong growth of 14.4 percent in 2012. Uncertainty remains over the security outlook after most international forces withdraw in 2014 and over whether a cohesive and broadly accepted government will take hold within a reasonable period of time following the April 2014 elections. Growth is projected to remain weak in 2014. A smooth political and security transition would help restore confidence in the economy and enable a pickup in growth in 2015.

Revenue collection weakened in 2013, while Afghanistan's large security expenditure obligations and high aid dependence pose the risk of crowding out important civilian operating and development spending. After a decade of strong revenue growth, domestic revenues declined to 9.5 percent of GDP in 2013 from 10.3 percent in 2012 and the peak of 11.6 percent in 2011. In nominal terms, revenues amounted to Afs 109 billion in 2013, almost level with the pro-rated figure for 2012. The decline in revenue collections is a result of the economic slowdown as well as weaknesses in enforcement in both tax and customs administration. In order to preserve fiscal sustainability, a concerted effort will be required going forward to improve revenue mobilization by strengthening tax and customs enforcement and by expediting introduction and implementation of the planned value-added tax. At the same time, given Afghanistan's extraordinary security expenditure obligations, safeguarding important civilian operating and development expenditures is a priority. As security expenditures have continued to grow, austerity measures in 2013 disproportionately affected civilian expenditures and the 2014 budget projects a considerable further increase in recurrent security expenditures.

In spite of the transition-related uncertainty and underperformance, Afghanistan will need to stay focused on its medium term structural reform goals. These include: (i) Ensuring fiscal sustainability by mobilizing revenue, securing grant assistance, and safeguarding non-security expenditures; (ii) supporting inclusive and job-creating private-sector led growth by unlocking the potential of the agriculture, services, and natural resource sectors and by tapping the potential of regional integration; (iii) improving upon the still low levels of human capital and skills; and (iv) continuing to strengthen institutions and governance. Reforms in these areas will be critical to reducing poverty and promoting shared prosperity through sustainable development while helping Afghanistan become more self-reliant in the long term.

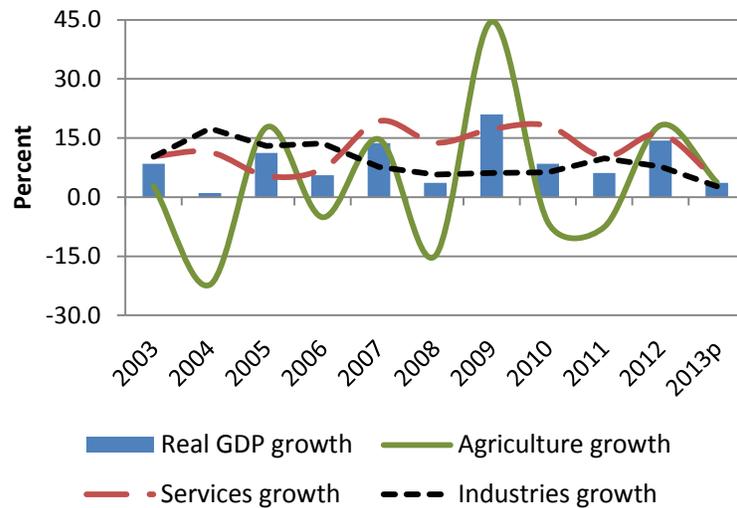
Recent Economic Developments

Economic growth slowed considerably in 2013 due to increased uncertainty, despite robust agricultural output.

After rapid growth in 2012, economic growth slowed considerably in 2013 with heightened uncertainty leading to a sharp slowdown in the non-agriculture sectors. Real (non-opium) GDP growth is estimated to have slowed sharply from 14.4 percent in 2012 to 3.6 percent in 2013. Growth in 2012 benefited from an exceptional agricultural harvest and rapid growth in the services sector. While agricultural output in 2013 exceeded even the bumper harvest of 2012, increased uncertainty surrounding the political and security transition has led to a slump in investor and consumer confidence and resulted in a sharp slowdown in the non-agricultural sectors. Agriculture accounts for about a quarter of GDP (excluding opium) and also has strong links to the rest of the economy, so that the robust agricultural output in 2013 would normally have buoyed overall GDP growth. However, with the services and construction sectors particularly hard hit by the slump in confidence, 2013 would mark the first year that a bumper agricultural output has been accompanied by overall GDP growth under 5 percent.

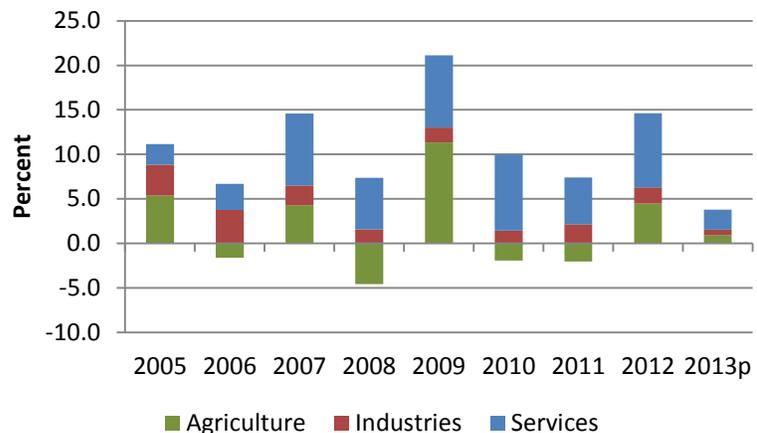
Agricultural output in 2013 reached record levels for a second consecutive year as a result of favorable weather conditions. Cereals production in 2013 is estimated at 6.5 million metric tonnes, an increase by 2.7 percent over the

Figure 1: Growth of real GDP and output sectors



Source: CSO

Figure 2: Sector contributions to GDP growth, 2005-2013



Source: CSO and Bank staff estimates

previous year and the highest level achieved over the past decade. Wheat production increased by 2.4 percent to 5.2 million metric tonnes, with both irrigated and rainfed production increasing further from the surge in 2012 (see Table 1). Other cereals such as rice, maize and barley also had higher yield compared to previous year. Given favorable precipitation particularly for the second harvest season in the year, the Ministry of Agriculture, Irrigation and Livestock (MAIL) also estimates very favorable horticulture – particularly fruits – and livestock output in 2013. While the record agriculture output in 2013 helped to counterbalance the overall confidence shock to the economy, it was up only modestly over the bumper harvest of 2012 and was thus not sufficient to fully circumvent the overall slowdown in GDP growth (see Figure 2).

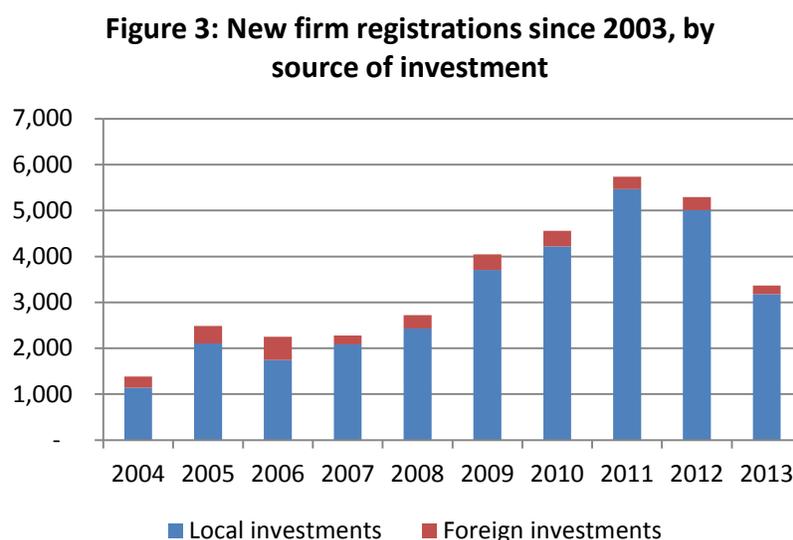
Table 1: Cereals production in the past 5 years (thousand metric tonnes)

	2009	2010	2011	2012	2013
Wheat	5,115	4,532	3,388	5,050	5,169
Irrigated	3,433	3,082	3,067	3,460	3,518
Rainfed	1,682	1,450	321	1,590	1,651
Other cereals	1,218	1,056	1,056	1,286	1,338
Total cereals	6,333	5,588	4,444	6,336	6,507

Source: Agriculture Prospects Report, MAIL

Private investment and growth in construction, manufacturing, and services slowed considerably in 2013 due to increased uncertainty. Heightened uncertainty about the political and security transition affected investor decisions to commit resources in Afghanistan in 2013. The number of new firm registrations fell sharply in 2013 to its lowest level in five years, with a reduction in both local and foreign new fixed investments

(Figure 3). The Afghanistan Investment Support Agency (AISA) registered approximately 3,100 enterprises in 2013, down 38 percent from around 5,000 in 2012. The reduction in new firm registrations in 2013 has taken place across all sectors, with construction and services particularly hard hit (Figure 4). Although no high-frequency data are available on firm inventories and gross fixed capital formation, new

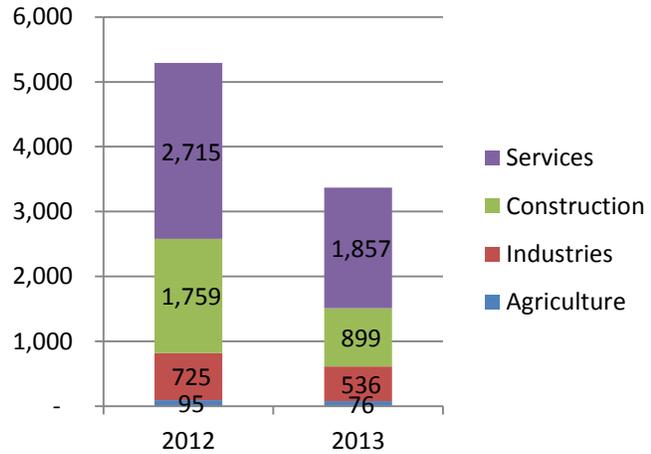


Source: AISA

firm registrations should be a relatively good proxy for business confidence and investment activity in the private sector. Decisions to establish new fixed investments in Afghanistan or to expand existing

investments, horizontally (expanding existing products) or vertically (investing in the supply chain), are highly sensitive to confidence in market conditions and the political environment. The number of new firm registrations would particularly reflect new fixed investments and vertical investments in the economy. Though this is not a perfect proxy for level of economic activity, it can fairly reflect the level of confidence of both local and foreign investors.

Figure 4: Number of new firms registered in 2012 and 2013 by sectors

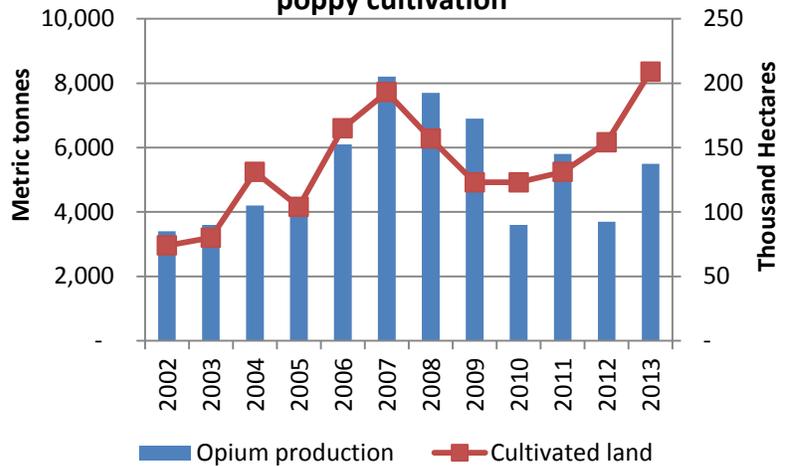


Source: AISA

Both opium production and area under poppy cultivation increased considerably in 2013, although this is not reflected in estimated non-opium GDP growth figures for 2013. According to UNODC data,

opium production increased by almost 50 percent to 5,500 tons in 2013, while the total area under poppy cultivation expanded by 36 percent to 209,000 hectares (Figure 5). Opium production in 2013 appears to have recovered from the decline in 2012 triggered by adverse weather and disease. While the total value of opium production at farm-gate prices remained at about 4 percent of GDP (or \$950 million) in 2013 due to a decline in the farm-gate price, the export value of

Figure 5: Opium production and area under poppy cultivation



Source: UNODC

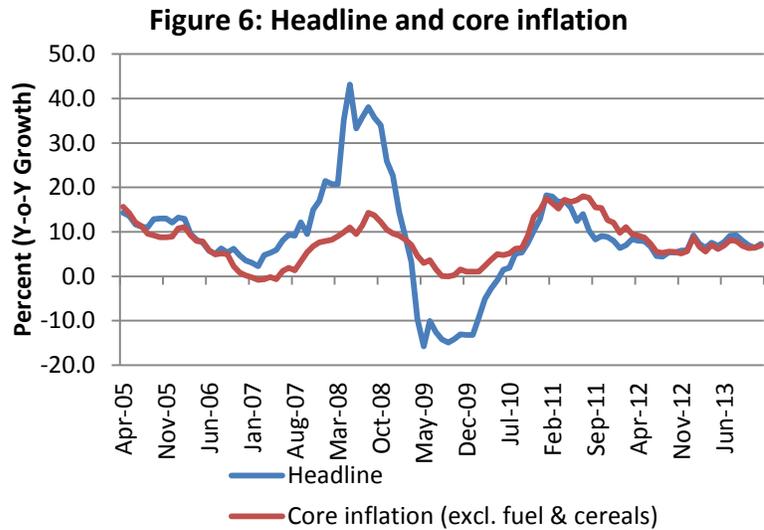
opiates (including drugs) increased from 11 percent of GDP in 2012 to 15 percent of GDP – or \$3.1 billion – in 2013. The UNODC estimates that the net value of the domestic market for opiates is far smaller, worth approximately 1 percent of GDP or \$200 million, compared to the net export value of opiates which is around \$2.9 billion. Despite substantial financial flows from opium production, analysis suggests that the contribution of opium to economic growth in the past ten years has been minimal, although it is likely to be an important source of livelihood for a segment of the rural population.

Inflation has remained in single digits throughout 2013

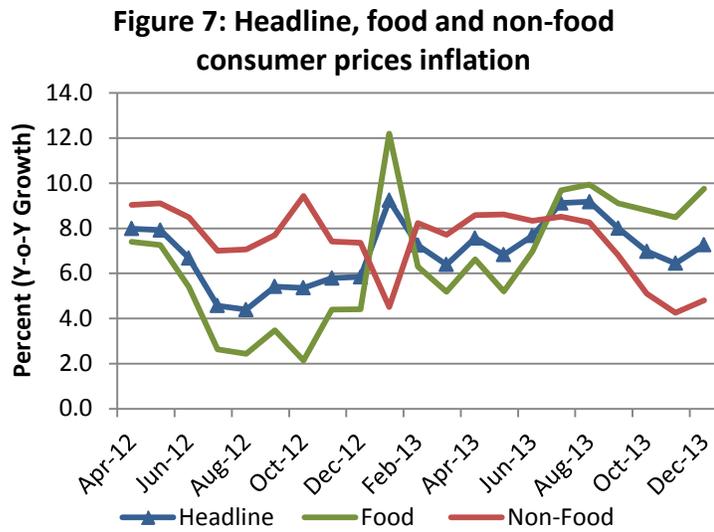
Consumer prices inflation remained below 10 percent throughout the year. Period-average headline inflation increased slightly to 7.7 percent in 2013, up from 6.3 percent in previous year, but remained in single digits throughout the year.

Further, as shown in Figure 6, Afghanistan has enjoyed a period of relative price stability in the last two years compared to the fluctuations and acute swings in prices which occurred during and after the 2008 world commodity price crises.

Food price increases exceeded non-food increases in the second half of 2013, in contrast to the first half of the year. The increase in food prices (year-on-year) was 9.8 percent in December 2013, up from 4.4 percent in December 2012. On the other hand, the increase in non-food prices moderated to 4.8 percent from 7.4 percent over the same period (see Figure 7). Looking at the food basket, prices of cereals rose by around 13 percent, while prices of fresh and dried fruits declined due to favorable horticulture output in 2013. Among non-food items, the prices of communication services have constantly decreased as a result of declining costs for internet services and increased competition between GSM service providers.



Source: CSO and Bank staff calculations



Source: CSO

Box 1: New Poverty Estimates for Afghanistan

On February 2, 2014, the Central Statistical Organization (CSO) released the results from the latest National Risk and Vulnerability Assessment (NRVA) household survey conducted in 2011-12. The results show that the national poverty rate in Afghanistan was around 36 percent in 2011-12, the same level measured in 2007-08 using the previous survey round (Figure 8). Furthermore, the results showed that inequality edged up. In particular, the Gini coefficient increased to 31.6 in 2011-12 from 29.7 in 2007-08, while the growth rate of per capita expenditure of the richest 20 percent of the population was three times as high as that of the poorest 20 percent as shown in Table 2. In addition, the bottom forty percent of the population commands only 21 percent of total consumption and more than 50 percent of the population is still vulnerable to becoming poor.

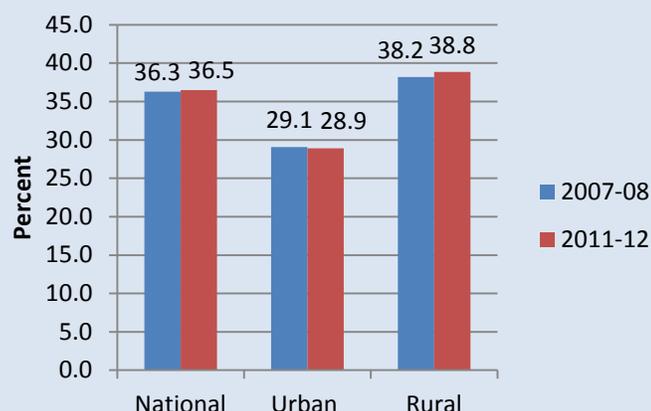
The lack of sustained poverty reduction in Afghanistan despite strong growth during 2007-11 merits further study. A number of factors could be contributing to the measured trends. First, the volatility of agricultural production would affect measured poverty trends since

agriculture accounts for more than half of employment. It is worth noting that 2010 and 2011, the two years preceding the 2011-12 survey, both featured negative growth in the agricultural sector. Second, pervasive underemployment likely affects the poverty impact of growth. Afghanistan faces a daunting demographic challenge, with around 400,000 new entrants into the labor force expected in the next few years.

Finally, the high dependency ratio, low levels of female labor force participation, and low labor productivity all contribute to shaping Afghanistan's poverty profile. High economic dependency due to demographic pressure is further aggravated by extremely low levels of female labor force participation (19 percent) and the overwhelming prevalence of vulnerable forms of

employment in informal and low productivity jobs (81 percent). Creating more and better quality jobs, especially in the agriculture sector, and improving economic participation of women remain the key constraints to poverty reduction and crucial milestones in promoting a more sustainable and inclusive economic growth.

Figure 8: Trend in poverty headcount, by residence



Source: NRVA 2011/12, CSO

Table 2: Mean real per capita consumption (at 2011-12 local prices), by poverty quintile

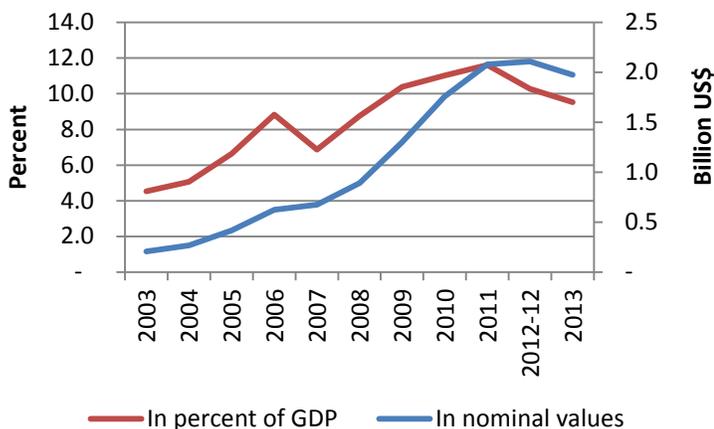
Quintile	2007-08	2011-12	Annual growth (%)
Poorest	984	1,019	0.9
2	1,414	1,515	1.7
3	1,818	1,971	2.0
4	2,412	2,645	2.3
Richest	4,294	4,863	3.2
Total	2,184	2,403	2.4

Source: NRVA 2011/12, CSO

Revenue collection weakened in 2013, while large security expenditure obligations and high aid dependence risk crowding out important civilian operating and development spending

After a decade of strong revenue growth, domestic revenue collection weakened in 2012 and further in 2013. Domestic revenues declined to 9.5 percent of GDP in 2013 down from 10.3 percent in 2012 and 11.6 percent in 2011 (Figure 9). In nominal terms, domestic revenues amounted to Afs 109 billion (\$1.9 billion) in 2013 compared to the 12-month pro-rated figure of Afs 109 billion (\$2.1 billion) in 2012. Both tax revenues and customs duties – which make up 48 percent of all revenues – declined as a share of GDP (see Figure 10). More specifically, income tax and sales tax revenues – which together represent 32 percent of revenues – decreased even in nominal terms, by 8.2 percent and 10.4 percent, respectively. Furthermore, non-tax revenues (mostly income from capital property and sales of goods and services) also declined as a share of GDP.

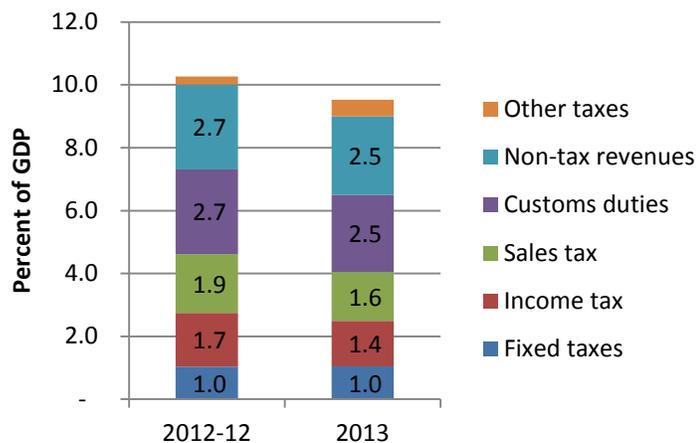
Figure 9: Domestic revenue performance since 2003



Source: AFMIS and MoF

The decline in revenue collections is a result of the economic slowdown as well as weaknesses in enforcement in both tax and customs administration. While the economic slowdown in 2013 is part of the explanation, weaknesses in enforcement and leakages are also part of the problem, particularly given that the decline in collections began in 2012 when economic growth was very strong. Increased uncertainty around the political and security transition has likely encouraged greater rent-seeking and tax evasion activity. Further, a shift in the structure of imports – away from luxury and other higher tariff items toward lower tariff items, in part due to the economic slowdown – is also likely to have impacted customs revenues. An

Figure 10: Domestic revenues in 2012 and 2013 (in percent of GDP)



Source: AFMIS

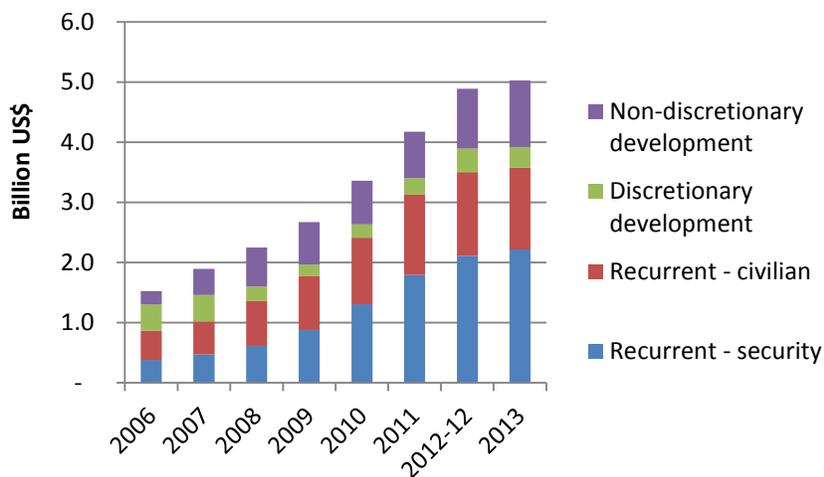
analysis of the figures suggests that part of the decline in customs revenues can be attributed to lower imports of fuel, vehicles, and other high-tariff items.

The Ministry of Finance introduced a number of measures in 2013 to stabilize revenues, reduce leakages, and improve administration. These measures included the implementation of a computerized risk management module, improving procedures for random post-verification of examination, introducing post-clearance audits, salary incentives for detection of non-compliance, and an increase in fuel valuation at customs. While the immediate effects of these measures have been modest to date, they have likely prevented an accelerated decline. Furthermore, the authorities have submitted a Tax Administration Law to parliament to enhance and strengthen procedures in tax offices for small, medium and large tax payers. The law details all requirements and procedures in regard to tax payments, documentation, dispute resolution, and tax penalties.

Public expenditures increased only very modestly in 2013 to 24.2 percent of GDP, with austerity measures particularly affecting civilian recurrent and discretionary development spending.

Afghanistan’s medium term fiscal framework is one where total budget spending is projected to rise over time as more off-budget spending (currently estimated to be as large as budget spending) comes on budget.¹ In 2013, however, total budget spending increased only very modestly to 24.2 percent of GDP (\$5 billion) from 23.8 percent (\$4.9 billion) in 2012. This is considerably lower than the previously projected budget spending of 26.7 percent of GDP for 2013 and is a result of austerity measures put in

Figure 11: Total Budget Expenditures, 2006-13



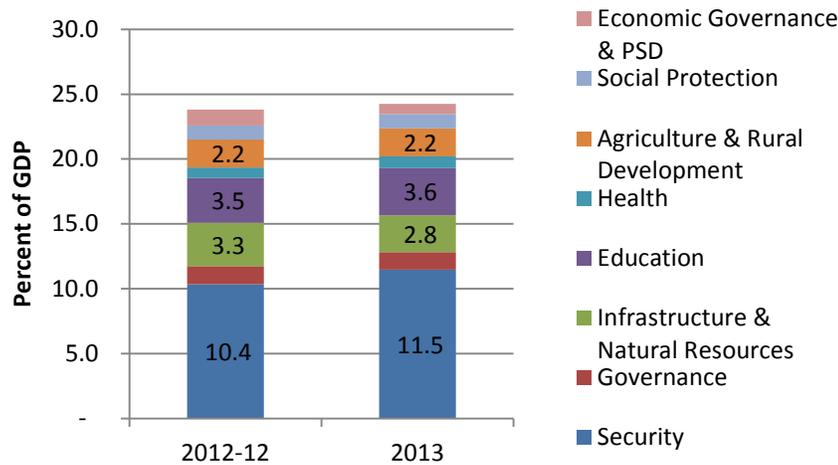
Source: AFMIS

place given the weak revenue collection and overall lower discretionary resources. The austerity measures have particularly affected civilian recurrent and discretionary development spending. Civilian recurrent spending declined to 6.6 percent of GDP in 2013 from 6.8 percent in 2012, whereas recurrent security spending increased to 10.7 percent of GDP in 2013 from 10.3 percent in 2012. Discretionary development spending declined by 0.2 percent of GDP in 2013, while non-discretionary development spending increased by 0.5 percent of GDP.

¹ The gradual move of off-budget spending into the budget is part of a medium term policy framework where Afghanistan’s public expenditure obligations are being consolidated within the budget. The World Bank’s analysis also indicates that on-budgeting of expenditures enhances their effectiveness and impact on economic growth and thus helps balance the medium term drawdown in aid.

Afghanistan’s large security expenditure obligations pose the risk of crowding out important civilian operating and development spending. With more security spending moving on budget, on-budget security expenditures increased to 11.5 percent of GDP in 2013 from 10.4 percent in 2012. Civilian expenditures, on the other hand, declined to 12.8 percent of GDP in 2013 from 13.4 percent in 2012, as the government tightened public spending following the mid-year review of the budget. Spending on sectors such as education, health, and agriculture & rural development increased modestly or held steady, while lower spending on infrastructure and economic governance accounted for most of the decline in civilian expenditures in 2013 (see Figure 12).

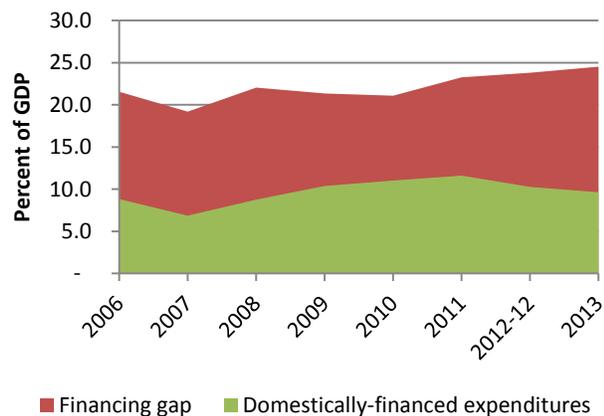
Figure 12: Core expenditures by sectoral shares, 2012 and 2013 (percent of GDP)



Source: AFMIS

While the grant share of budget financing is normally projected to rise due to the on-budgeting of off-budget spending, the decline in revenues has exacerbated this trend. Revenues financed 55 percent of recurrent expenditures and 39 percent of total core expenditures in 2013, while these ratios were respectively 60 percent and 43 percent a year earlier. As a result, the financing gap increased from 13.5 percent of GDP in 2012 to 14.9 percent in 2013. As Figure 13 shows, the financing gap for core budget has widened considerably since 2011, both due to the on-budgeting of off-budget spending (as expected), but also due to weakness in domestic revenue collection.

Figure 13: Financing gap and domestic financing for total core expenditures



Source: AFMIS and Bank staff calculations

Box 2: Budgeting in a period of transition: The 2014 (1393) budget

Afghanistan's budget for 2014 (1393) has features that traditionally have been a part of the budget, as well as features that are unique to the current circumstances.

First, the annual budget has traditionally featured allocations for development expenditures that are far in excess of likely spending. For example, in 2013, total budgeted development expenditure was about \$3 billion, while actual development spending turned out to be \$1.45 billion. Similarly, budgeted development expenditure for 2014 of \$2.6 billion is far in excess of likely actual spending. Low development budget execution has traditionally been a part of Afghanistan's annual budget and spending.

On the other hand, actual recurrent spending has traditionally been much closer to budgeted recurrent spending. In 2013, actual recurrent spending was about 5 percent lower than budgeted because of the austerity measures, as already discussed. In 2014, recurrent spending is budgeted to increase by 40 percent (or about \$1.4 billion) compared to actual 2013 recurrent spending. Most of this increase (\$1.1 billion) comes from higher recurrent security expenditures, whereas only \$0.3 billion comes from higher recurrent civilian spending. The budget assumes that domestic revenues in 2014 will be \$0.5 billion higher than in 2013. If such an increase in revenues does not materialize in 2014 (not unlikely given heightened uncertainty) and the large budgeted increase in recurrent security spending is not accompanied by a similar increase in grants, Afghanistan may once again find itself in a situation where austerity requires cuts in important civilian operating and development spending.

It is also worth making a broader point in this context. Off-budget spending is financed fully by grants whereas on-budget obligations are financed from a mixture of domestic

revenues and foreign grants. As more off-budget security spending moves on-budget, if the pace at which security obligations move on-budget exceeds the pace at which civilian obligations move on-budget, the competition from security obligations for domestic revenue and discretionary financing will increase, with the associated risk of crowding out important civilian operating and development spending.

Table 3: National budget in 2014 compared to 2013 (million US\$)

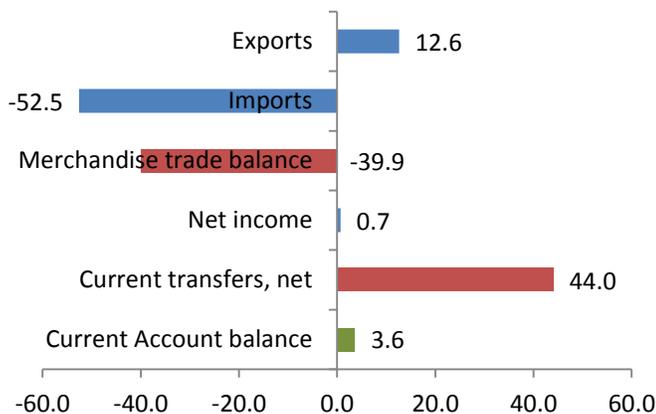
	2013Bgt*	2013Act	2014Bgt
Recurrent budget	3,775	3,575	5,008
Discretionary development	874	342	895
Non-discretionary development	2,159	1,107	1,746
Total core budget	6,809	5,025	7,649
Domestic revenues	2,488	1,974	2,489
Foreign grants	4,022	3,307	4,738
External loans/credits	54	25	49
Total financing	6,565	5,307	7,277

** 2013Bgt figures are initial budgeted figures.*

Foreign aid inflows continue to finance the large trade deficit and sustain foreign exchange reserves.

The trade deficit remained large but declined slightly in 2013 as slower economic growth and demand led to a moderation of imports. Total estimated imports – including both official and smuggling – declined by an estimated 4 percent, reducing the trade deficit from -42.4 percent of GDP in 2012 to -39.9 percent in 2013. Because of an exceptionally high level of unofficial trade in Afghanistan, official recorded exports are estimated to represent only one-fifth of total exports.² Total exports in 2013 are estimated at \$2.6 billion, of which around \$500 million were recorded by official sources. On the other hand, official imports were \$9.3 billion for 2013, while estimated total imports are \$10.9 billion. With the large trade deficit financed fully by foreign aid inflows, the current account was nearly balanced at 3.6 percent of GDP in 2013 (see Figure 14).

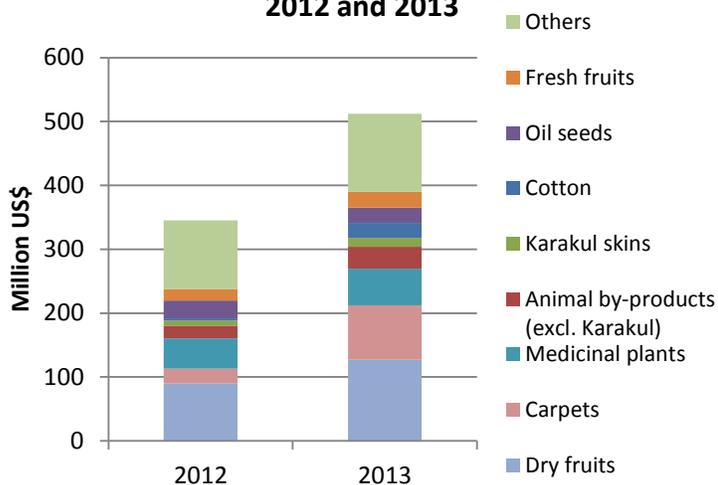
Figure 14: Current account balance for 2013 (in percent of GDP)



Source: IMF staff estimates

Official exports increased in 2013, most likely due to improved recording, but also possibly due to robust agricultural performance in the preceding year. Official exports grew by almost 50 percent in 2013 to \$512 million in 2013, compared to \$346 million in 2012. Dry fruits, carpets, medicinal plants, and animal by-products (such as wool, skin, etc.) were some of the items that saw a major increase in recorded exports (see Figure 15). As most export items in Afghanistan are agricultural commodities, or agriculture-related products, exports also depend on the previous year’s agriculture productivity. In

Figure 15: Official exports by product groups, 2012 and 2013



Source: CSO

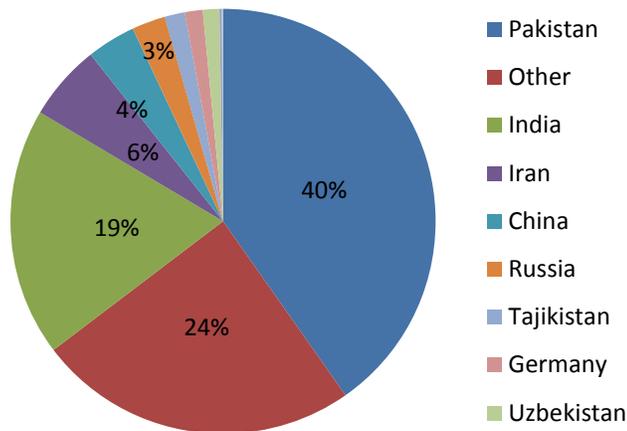
² The large difference between total estimated exports and official recorded exports is not explained by opium, but instead by unofficial non-opium exports.

particular, dry fruits and animal by-products are strongly impacted by agriculture performance in the previous year, as was the case in 2013.

According to official recorded export figures, Afghanistan's largest export destinations are Pakistan, India, and Iran. Figure 16 shows that exports to Pakistan, India and Iran represent around 45 percent of Afghan exports.

While official recorded exports are only a fraction of total estimated exports, the change in exports in 2013 is unlikely to have been affected by exchange rate movements. While the Afghani depreciated against the US dollar during 2013, it remained stable against Pakistani Rupee and the Indian Rupee and appreciated against the Iranian Rial during the year. As such, most of export trends in 2013 are likely to have been driven by structural factors, with the exchange rate likely to have played only a minor role if any.

Figure 16: Afghanistan's export partners in 2013 (percent share of exports)

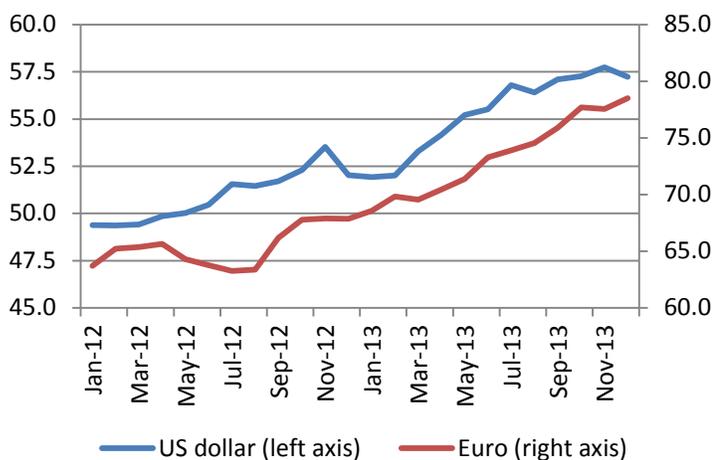


Source: CSO

The Afghani continued to depreciate against the US dollar and the euro in 2013. The nominal exchange rate depreciated by, respectively, 8.8 percent and 12.3 percent vis-à-vis the US dollar and the euro.

The period average exchange rate during 2013 was Afs 55.4 per US dollar and Afs 73.4 per euro. The depreciation is largely in line with expectations and is explained by a number of factors. First, as already discussed, other major South Asian currencies, including the Indian Rupee and the Pakistani Rupee, have also depreciated against the US dollar during 2013. The Afghani has thus remained relatively stable against these currencies. The real effective exchange rate depreciated only marginally by 1.3 percent during the year. Second, the drawdown in international security forces which started in 2012 and is continuing through 2013, can affect capital inflows and thus the exchange rate trend. Third, increased uncertainty surrounding the political and security transition could raise demand

Figure 17: Afghani exchange rate against the US dollar and the Euro



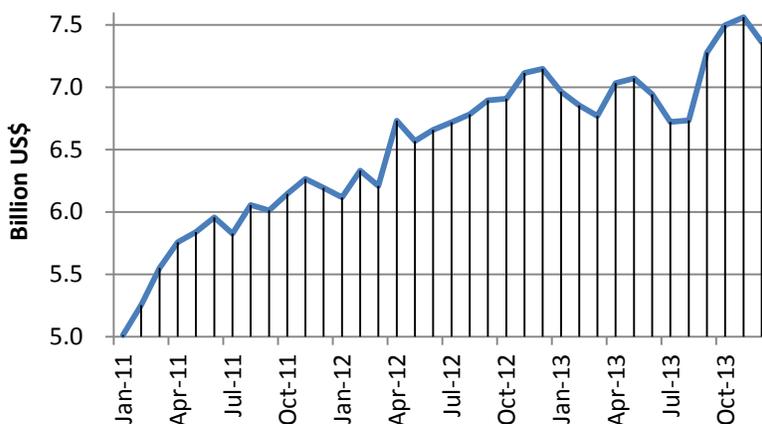
Source: DAB

started in 2012 and is continuing through 2013, can affect capital inflows and thus the exchange rate trend. Third, increased uncertainty surrounding the political and security transition could raise demand

for foreign exchange and lead to an increase in the pace of capital flight. Finally, official grants could be affected by slower policy implementation during the transition.

Foreign exchange reserves closed the year at nearly the same level as at end 2012. While fluctuating throughout the year, gross foreign exchange reserves were recorded at US\$7.4 billion in December 2013 compared to US\$7.2 billion twelve months earlier. Increased fluctuations in monthly reserves – as shown in Figure 18 – and plateauing of end-year reserves are not unexpected in light of the political and security transition. Foreign exchange reserves could be affected by a slowdown in capital inflows and foreign grants during the transition period, as well as any changes in the pace of capital flight. Nonetheless, the foreign exchange reserves are of the level that can finance around 7 months of imports, which is an adequate level given the size of the economy. However, if abrupt swings happen in foreign grants and net capital inflows to the economy, a prudent management of foreign exchange reserves will be critical during periods of heightened uncertainty.

Figure 18: Gross international reserves (billion US\$)



Source: DAB

Monetary and banking performance indicators have still not recovered from the Kabul Bank crisis.

Money growth picked up towards the end of the year but still remains lower than the pre-2010 levels. Reserve money growth – which is currency-in-circulation plus required reserves of the Central Bank – increased to 8.5 percent in November 2013, up from 2.3 percent in December 2012. Though the money supply increased in 2013, it is still significantly lower than what it was prior to the Kabul Bank crisis in 2010, as shown in Figure 19. The Da Afghanistan Bank (DAB) uses reserve money as the nominal anchor for its open market operations. It uses foreign exchange auctions to control money supply, while preserving a floating exchange rate regime. The Central Bank auctions, on average, around \$30 million per week to control excessive liquidity in the market. On the other hand, broad money (M2) – which is currency in circulation plus deposits in commercial banks (including transferable/demand, savings and time deposits) – grew by 9.5 percent in November 2013 and increased in percent of GDP from 32 percent in 2012 to 33 percent in 2013 (see Figure 20).

Figure 19: Reserve and broad money growth (12-month percent change)

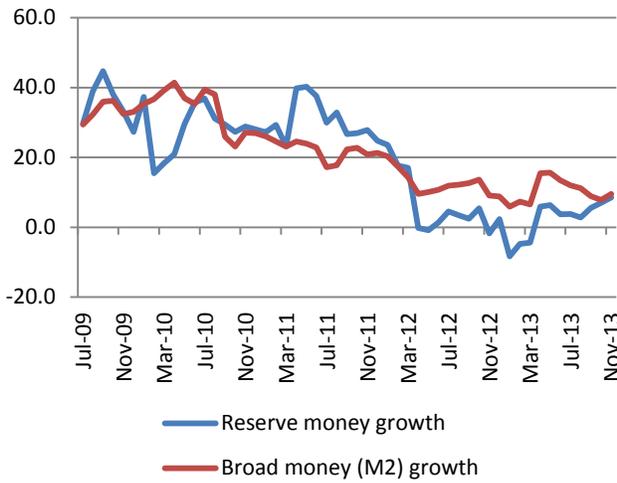
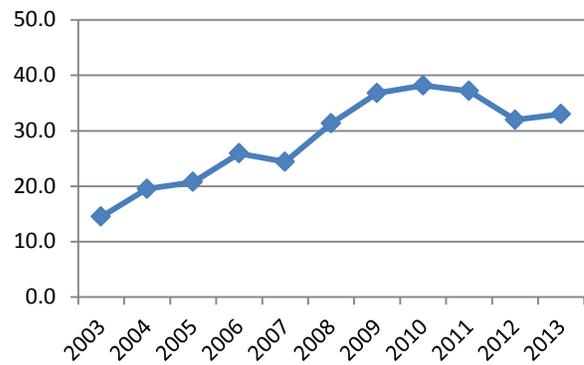


Figure 20: Broad money, M2 (in percent of GDP)



Source: DAB

The banking sector has still not fully recovered from the Kabul Bank crisis. Deposits of the banking sector marginally increased to Afs 198 billion (\$3.4 billion) in November 2013, up from Afs 187 billion (\$3.6 billion) in December 2012. In percent of GDP, total deposits of the banking sector have in fact declined from 16.1 percent in 2012 to 15.5 percent in 2013. Lending to the private sector, on the other hand, has remained steady at around 4 percent of GDP or \$820 million. Both total loans and loan-to-deposit ratio remain sharply lower than the pre-crisis levels, as indicated in Figure 21. Lower lending is also impacted, to a certain degree, by increased perceptions of uncertainty by businesses and lower non-agricultural growth that lead to reduced demand for credit.

Figure 21: Loans and deposits of banks (in billion US\$)

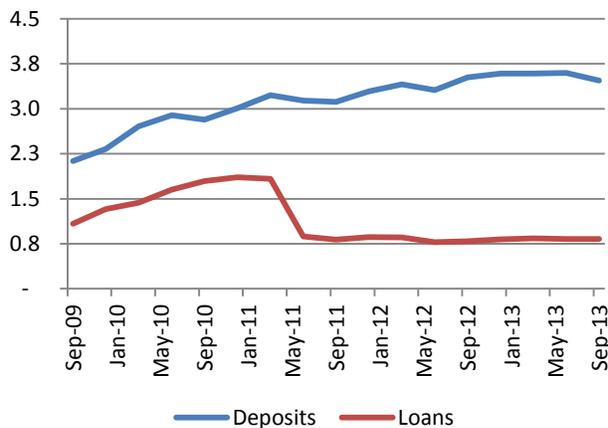
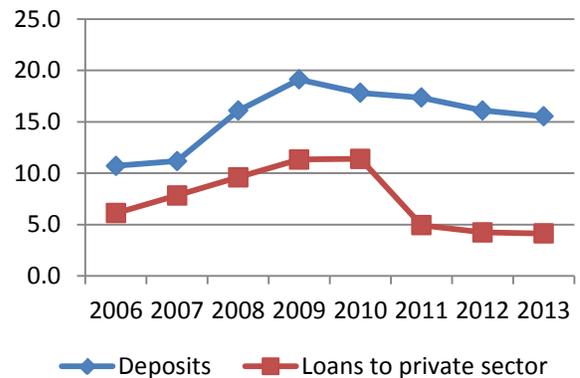


Figure 22: Loans and deposits of banks (in percent of GDP)



Source: DAB

The privatization of the New Kabul Bank is on-going. In early 2013, the Ministry of Finance rejected the only bid received from a local bidder due to the disqualification of the technical proposal. The privatization of the bank was relaunched later in the year, with a UAE-based and a US firm qualifying as approved bidders. The Ministry of Finance announced in December 2013 that Kru Capital won the bid for New Kabul Bank with a US\$28.5 million offer (including US\$20 million for capital injection). This bid now needs to be approved by the Cabinet, with the approval still pending.

Economic Outlook and Medium-Term Prospects

Economic growth is projected to remain weak at 3.2 percent in 2014 due to heightened uncertainty and lower agriculture output. Uncertainty surrounding the political and security transition is expected to persist through most of 2014, resulting in continued weakness in private investment and growth in the non-agricultural sectors. A smooth political and security transition would help restore confidence in the economy. At the same time, lower agriculture output is anticipated in 2014 as the winter precipitation has been assessed as less favorable. Taking into account the bumper harvest in 2013, agriculture output in 2014 is expected to be lower than in 2013, thus placing a further drag on growth prospects for 2014. Under these assumptions, real GDP growth is projected at 3.2 percent in 2014. In this context, public investment expenditures on essential infrastructure can provide an important prop for economic activity during this period of heightened uncertainty and also contribute to Afghanistan's medium term growth prospects.

Table 4: Medium-term Macroeconomic Framework, 2012-2017

	2012	2013	2014	2015	2016	2017
	<i>Actual/Estimates</i>		<i>----- Projected -----</i>			
Real GDP growth	14.4	3.6	3.2	4.9	5.0	5.1
Nominal GDP (bn US\$)	20.5	20.7	21.7	23.1	24.5	26.0
CPI inflation (period average)	6.4	7.7	6.1	4.4	4.8	5.0
Fiscal	<i>Percent of GDP</i>					
Revenues and grants	23.2	26.4	28.2	25.8	30.6	34.6
Domestic revenues	10.3	9.5	10.3	10.7	12.5	13.0
Foreign grants	12.9	16.9	17.9	17.8	18.2	21.6
Total core expenditures	23.8	24.2	28.6	29.7	30.6	34.8
Recurrent expenditures	17.1	17.2	21.7	22.8	23.5	27.5
Development expenditures	6.7	7.0	6.9	6.9	7.1	7.3
Overall balance (incl. grants)	-0.4	2.2	-0.4	-1.2	0.0	-0.3
External						
Trade balance	-41.9	-39.9	-38.0	-36.9	-35.5	-33.9
Current account balance (excl. grants)	-43.8	-39.8	-37.5	-36.2	-34.5	-32.4
Current account balance (incl. grants)	3.9	3.6	3.9	0.3	-2.1	-4.3
External debt	6.5	6.1	5.9	6.1	6.4	6.6

In the medium term, post-transition growth is projected at about 5 percent per year during 2015-16. This is less than the average growth of 9.4 percent per year during 2003-12 that was fueled by the surge in international aid and security spending. The post-transition growth outlook is contingent upon a relatively stable security environment, with agriculture and extractive industries likely to be among the significant sectors driving growth. Agriculture accounts for about a quarter of GDP and is also linked closely to other parts of the economy, such as food and beverages (which account for almost all of manufacturing), and parts of transport and retail. Afghanistan has the potential to build on this foundation by reviving its historical position as an important exporter of fruits, nuts, vegetables, and

other higher value-added products. This will require investments in irrigation and extension services to improve capacity, as well as efforts to build and improve downstream agro-processing activities. On the other hand, the extractive industries sector currently accounts for a very small share of GDP, but has significant potential in light of Afghanistan's deposits of copper, iron ore, and hydrocarbons. Unlocking this potential will require progress on the legislative framework as well as securing financing for the necessary infrastructure.

The medium term growth outlook is subject to serious risks which will need to be carefully managed.

Significant uncertainty surrounds the outcomes of the political and security transition in 2014. The fragile security environment has been a considerable constraint to private investment and growth. Continued violence, economic crime and systemic corruption also have often undermined progress in Afghanistan's governance and state-building agenda. Much will depend, therefore, on Afghanistan's success in achieving peace, stability and reconciliation. Without this, the growth prospects discussed above are unlikely to materialize.

Given the recent weakness in fiscal revenue performance, a concerted effort will be required from the authorities to improve revenue mobilization.

The medium term fiscal framework calls for an increase in revenues from 9.5 percent of GDP in 2013 to 11.1 percent in 2015 and 13.8 percent in 2018 (or just under one percentage point of GDP per year). In light of recent weaknesses in collections, the increase in revenues will require a concerted effort on the part of the Afghan authorities to (i) reduce leakages and strengthen customs administration; and (ii) expedite the introduction and implementation of the planned value-added tax (VAT). The natural resources sector also has the potential to contribute to revenues in the medium term, but the timeline for this has become more uncertain in light of recent developments in the sector.

Budget expenditures are expected to continue to rise from about 24 percent of GDP in 2013 to about 30 percent of GDP by 2016.

The increase in budget expenditures is largely a result of more spending moving on budget from previously being undertaken directly by donors. Afghanistan has considerable public expenditure needs in the areas of security, service delivery, building essential infrastructure, and operations and maintenance (O&M). Although more detailed analysis of public expenditures is needed, there appears to be limited space to adjust expenditures without adversely affecting growth prospects and social outcomes. The resulting financing needs of the budget are, therefore, likely to remain substantial for the foreseeable future. Moreover, channeling a greater share of development assistance through on-budget expenditures is expected to enhance the medium term economic impact.

Donors have committed to cover the budget financing gap, although these funds will be contingent on satisfactory progress on the TMAF, of which an important indicator is increasing domestic revenue.

The July 2012 donor meeting in Tokyo pledged \$16 billion in development aid for Afghanistan over 2012-16. Together with earlier pledges on the security side, this means annual aid of about \$8 billion—roughly equally divided between civil and security aid. This would cover the projected budget financing gap and allow the authorities to progress towards development and infrastructure targets. However, these funds will only be made fully available if the Government makes satisfactory progress on the TMAF. An important indicator in the TMAF is the increase in domestic revenue; to this end the

Government committed to increasing revenues over the medium term. The necessary improvements in revenue collection can only be achieved in Afghanistan by developing the mining sector, fostering private sector development, broadening the tax base and strengthening enforcement to reduce leakages. The current weakness in revenues therefore poses not only risks to long-term fiscal sustainability but also to the achievement of TMAF targets. As such, a concerted effort on the part of the Afghan authorities to regaining momentum in revenue generation and improve the current revenue outlook is of critical importance.

Structural Policies for the Medium Term

As Afghanistan moves forward with the unprecedented security, political and economic transition, its overall strategic goals are to achieve sustainable and equitable development while becoming more self-reliant by 2025. These strategic goals are articulated in the Government's document *Strategic Vision for the Transformation Decade* presented at the Tokyo Conference in 2012. A key part of addressing these goals would be to create jobs to reduce poverty and boost shared prosperity. In order to achieve its strategic goals, Afghanistan will need to address challenges in four key areas: (i) safeguarding sustainability by mobilizing revenue and securing grant assistance; (ii) supporting inclusive and job-creating post-transition growth by unlocking the potential of the agriculture and natural resource sectors and by tapping the potential of regional integration; (iii) improving upon the low levels of human capital and skills; and (iv) continuing to strengthen institutions and governance.

Maintaining macroeconomic sustainability in Afghanistan' highly aid dependent environment will require improving revenue mobilization while also securing grant assistance to meet its considerable financing needs. Afghanistan will continue to require substantial grant assistance for the foreseeable future. The projected total financing gap, while declining from more than 40 percent of GDP in 2012, will remain above 20 percent of GDP through 2025. In addition to securing the necessary grant financing, Afghanistan will also need to improve its revenue outlook. This will require a concerted effort to implementing its reform program supported by the IMF, ARTF, and IDA, which includes: (i) measures to reduce leakages and strengthen customs and tax administration; (ii) introduction and subsequent widening of the planned VAT; and (iii) progress on the legislative and regulatory framework for the extractive industries sector.

Supporting inclusive growth to reduce poverty and boost shared prosperity in the post-transition period will require ensuring that steady growth is accompanied by greater job creation. Poverty levels remain high in Afghanistan. A number of factors could affect the impact of growth on poverty reduction and the prospects for raising incomes of the bottom two quintiles of the population. First, the volatility of agricultural growth could considerably affect prospects for poverty reduction since agriculture accounts for more than half of employment. Second, limited overall employment generation and pervasive underemployment could limit the poverty impact of growth. Going forward, reducing poverty and boosting shared prosperity will require ensuring that growth is steady and that it is accompanied by greater job creation. With Afghanistan facing a demographic shift where about 400,000 new workers

are entering the labor force each year, generating jobs will be critical to improving incomes of the bottom quintiles of the population and reducing poverty and vulnerability of the population.

Agriculture is highly relevant to poverty reduction and job creation and improved irrigation should reduce volatility in the sector. Agriculture generates more than 50 percent of employment and 84 percent of the poor live in rural areas. However, poor irrigation means that agricultural production is also highly volatile. Furthermore, employment in agriculture is characterized by small family businesses, often producing merely for subsistence and seldom providing enough resources to sustain families throughout the year. Leveraging the potential of agriculture to create better jobs and reduce poverty will require investments in irrigation, extension services to improve the capacity of farmers, and progressively tapping opportunities to move into higher value-added products. Afghanistan has already achieved some success in introducing smart agricultural techniques in grain production—for example, the pilots on the System of Rice Intensification—which are likely to yield jobs, higher outputs, and require lower water and other inputs at the same time as delivering several environmental benefits.

The mining sector has significant potential for growth with modest employment impact, although there is a chance to enhance the impact of the sector through the resource corridor approach. Progress in establishing a favorable legal and regulatory environment in the mining sector should lead to significant growth of the sector if financing for related infrastructure investments can also be identified. Even so, the direct impact of mining on employment is likely to be modest, with the best-case scenario generating about 100,000 to 125,000 jobs over the next ten years. The resource corridor approach, however, provides an opportunity to enhance the impact of the sector. This approach rests on the idea of using mining development as an anchor for the infrastructure development that underpins the viability of the other sustainable activities. It combines necessary investment in mining infrastructure with the enhancement of objectives in local livelihood, social and environmental ideals and governance. This involves strategic planning and investment in supply chains which produce spillovers to other economic activities and synergies with private-sector investment.

Tapping the potential of regional integration could also become an important contributor to growth. Afghanistan lies at the crossroads of rapidly growing and resource rich economies in Central, South, and West Asia. A number of regional energy transit initiatives will require the direct participation of Afghanistan. These include the CASA-1000 project intended to carry Central Asian power to Pakistan and the Turkmenistan-Afghanistan-Pakistan-India (TAPI) pipeline intended to carry Central Asian gas to Pakistan and India. In addition, Afghanistan can tap the potential of growing transit trade in the region. Taking advantage of regional integration will require investments in infrastructure, improving customs facilities, and strengthening trade agreements.

Streamlining the business environment is an important priority for Afghanistan. Afghanistan ranks 164th (out of 189 countries) in the World Bank's *Doing Business* 2014 report. While the 2014 report recognizes a number of investment climate reforms (including reducing the time and cost of starting a business and implementing a unified collateral registry within the Central Bank), recent steps taken by AISA and the Ministry of Commerce (MoCI) point toward risks of reform reversals in other areas. In particular, MoCI has recently taken steps to reverse the merger of the licensing and central business

registry departments, which would reverse an important reform to unify and streamline the process of issuing trade licenses. Second, in August 2013, AISA revised its fee structure to increase licensing fees for several sub-categories of investment (consulting and construction). Immediately addressing these risks of reform reversals is an important priority within the overall goal of streamlining the business environment.

Improving literacy, skills and education in Afghanistan, especially in rural areas, is a key priority to meeting its development objectives. The stock of skills available to the domestic labor market in Afghanistan is extremely low in spite of significant improvements in school enrollment rates and education achievement over the past decade. The recent gains have only attempted to keep pace with lost opportunities during decades of conflict. Only one out of four Afghans aged 16 or above is able to read and write or has completed some formal level of schooling. Low human capital reduces the rate of return on physical capital, diminishes the profitability of investments, the adoption of new technologies as well as the structural transformation of the economy. It is therefore paramount that investments in education at all levels remain a priority in Afghanistan’s development strategy.

Finally, meeting Afghanistan’s development objectives will require continued strengthening of institutions and governance. Given Afghanistan’s governance environment, there is greater risk of a natural resource curse. A failure to credibly address transparency, accountability, and political economy risks—especially the balance of revenue flows between the central level and provinces and communities in which the mines are located—could result in a further deterioration of the governance and security situation. But beyond mining-related considerations, the challenges to establishing good governance are vast and progress is frequently undermined by the fragile security situation. The government’s decisiveness to strengthen the rule of law, public financial management systems, fight pervasive corruption, improve regulatory oversight and enhance the capacity for public service delivery will be critical in achieving Afghanistan’s development objectives.

Annex 1: World Bank Group Assistance to Afghanistan

IDA and the ARTF:

1. The International Development Association (IDA) and the Afghanistan Reconstruction Trust Fund (ARTF) are the main sources of World Bank financing of country priorities in Afghanistan. The ARTF is nearly five-fold larger than IDA and has been managed by the Bank since its creation in 2002; it is a key vehicle for providing Government with predictable and transparent on-budget financing. The ARTF also plays a critical role as a forum for policy dialogue between Government and donors. A 2012 external review of the ARTF concluded that the ARTF is “*fit for purpose*” and stands as a best-practice trust fund.
2. The World Bank is respected by Government and donors for its analytical and research products through economic sector work and technical assistance. In an environment where policy advice and assistance is essential, work in this area provides support for Government and donor decision making. It is expected that the World Bank will continue to play a leading role in terms of policy advice to Government through targeted, often cross-sectoral, analytic work. The Bank’s work on Transition Economics and Resource Corridors, together with its poverty analysis, has been instrumental in informing decisions of the Government and the donor community in this challenging transition period.
3. Since 2002, IDA has committed a total of \$2.7 billion in grants (83 percent) and credits (17 percent) in Afghanistan. Thirty-six development and emergency-reconstruction projects and four budget-support operations have been committed as of end-February 2014. In addition, the ARTF has generated \$6.94 billion from 33 donors, and committed \$3.06 billion for the government’s recurrent costs and \$3.07 billion for government investments programs. At end-February 2014 the active IDA portfolio was worth \$7.30 billion and the active ARTF investment portfolio was worth \$1.83 billion.
4. ARTF and IDA projects are managed with the same attention. All projects are eligible for processing under the Bank’s Special Considerations for fragile states and emergencies (incorporated into OP 10.00). In practice this has proved most useful to improve flexibility post-approval as all projects are processed under regular review procedures in order to ensure quality at entry. All Bank (IDA and ARTF) funds are channeled through the government’s budget and project accounting and reporting occurs at the central level.
5. In fiscal year 2014, the World Bank Board approved two new IDA-financed projects totaling \$100 million, plus additional financing for an existing project. The new projects included \$50 million for the Development Policy Grant and \$50 million for Access to Finance; the Financial Sector Rapid Response project received \$6.7 million in additional financing. A regional project – CASA-1000 – was approved in March 2014 by the World Bank Group’s Board of Executive Directors for total grant and credit financing of \$526.5 million. Of the total project financing for CASA-1000, Afghanistan receives \$316.5 million in the form of an IDA grant. The IDA commitments of \$220 million in FY14 ensure that IDA-16 is fully utilized.
6. In addition, in fiscal 2014 (through March 31), the ARTF approved \$74.8 million in recurrent cost financing (of which \$30 million was for recurrent cost baseline financing and \$44.8 million for the Incentive Program) and \$380 million for Investment Window financing, including the Second

Education Quality Improvement Program (\$125 million), the Third Emergency National Solidarity Project (\$200 million), the CASA Community Support Project (\$40 million) and the Non-formal Approach to Training, Education and Jobs in Afghanistan (\$15 million).

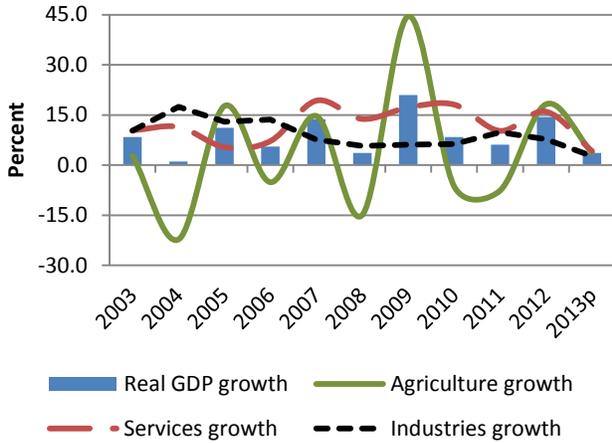
IFC and MIGA operations in Afghanistan:

7. IFC is following an integrated advisory and investment strategy focused on improving the investment climate, building capacity, and supporting selective investments in sectors with high development impact and job creation. IFC's investment portfolio in Afghanistan has more than doubled since FY08 - from around \$58 million to about \$131 million to date. Currently, IFC's portfolio includes two investments in the telecommunication sector (MTN - a joint project with MIGA-\$60 million and Roshan-\$65 million), one investment in the hotel sector (TPS-\$3 million), and two operations in financial markets (First Microfinance Bank-\$2 million equity, Afghanistan International Bank - trade facility). These investments have had a strong impact (in terms of access to finance and outreach), particularly in the microfinance and telecommunication sectors. Through the project with the First Microfinance Bank (FMFB)--the first licensed private sector microfinance bank in Afghanistan, IFC was able to reach over 64,000 borrowers (more than 25 % of the current market penetration) – 16 % of whom were women. Similarly, IFC has had significant impact in the telecommunication sector by improving mobile phone access and services to the poor through the investment in Mobile Telephone Networks (MTN) and more recently in Roshan Telecom. Going forward, IFC is looking to expand its investment program in Afghanistan in the areas of infrastructure, finance, manufacturing, and services.

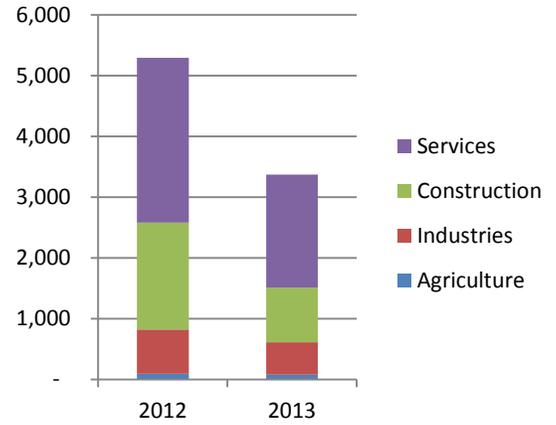
8. The Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group has \$155 million of gross exposure in Afghanistan, supporting telecoms and agri-business projects. MIGA recently launched the "Conflict Affected and Fragile Economies Facility" that will provide a first loss cover in fragile and conflict states, including Afghanistan. This will allow MIGA to greatly expand its work in these countries, while still meeting prudential limits. MIGA is currently supporting three projects in Afghanistan, of which one is a joint effort with the IFC in the telecoms sector (MTN) and the other two are MIGA-only (cashmere exporter, Traitex Industry and Mido Dairy).

Annex 2: The Afghan Economy at a Glance

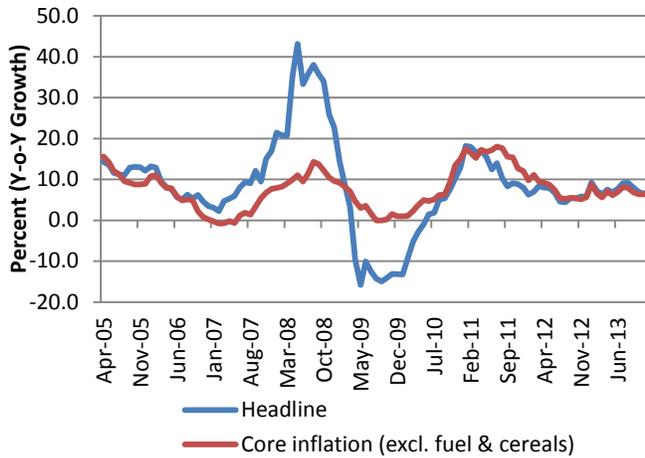
Growth declined in 2013...



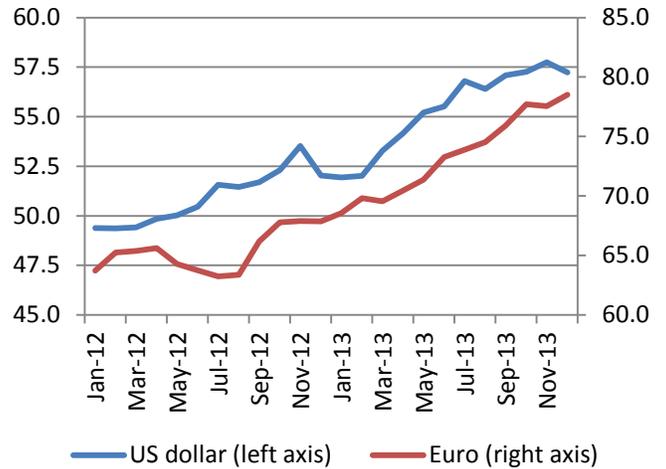
...due to lower investment in non-agricultural sectors.



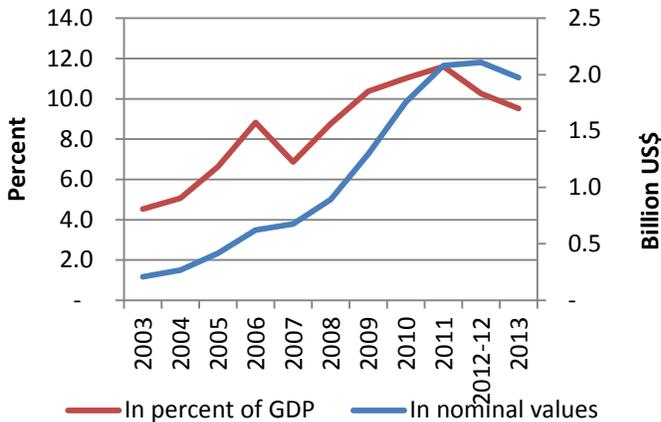
While inflation has been low and stable in 2013,



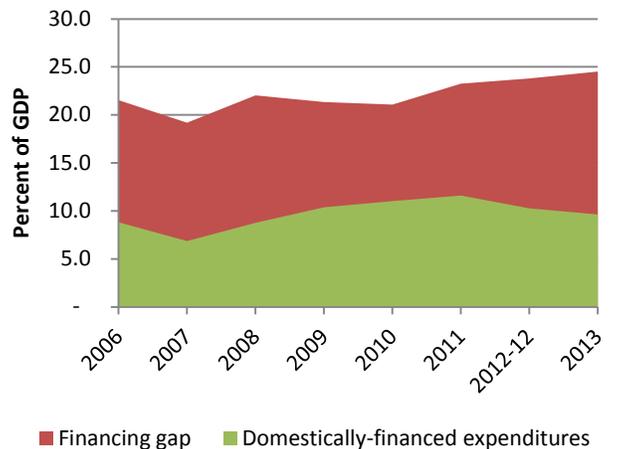
the exchange rate has constantly depreciated.



Domestic revenues have declined since 2011,



and the financing gap has increased.



Annex 3: Selected Economic Indicators

(% of GDP, unless indicated otherwise)	1389	1390	1391*	FY 1392*	FY 1393p	FY 1394p
	2010/11	2011/12	2012/13*	2013*	2014p	2015p
Real sector						
Nominal GDP (excl. opium; billion Afs)	730	856	1,060	<i>1,148</i>	<i>1,249</i>	<i>1,369</i>
Nominal GDP (excl. opium; billion US\$)	15.9	17.9	20.5	<i>20.7</i>	<i>21.7</i>	<i>23.1</i>
Real GDP growth (%)	8.4	6.1	14.4	3.6	3.2	4.9
GDP per capita (US\$)	561	616	688	...	...	...
Prices and money						
CPI inflation (period average, %)	7.7	10.2	6.4	7.7	6.1	4.4
Core inflation (excl. fuel & cereals, %)	9.8	14.6	6.6	7.0	6.0	4.1
Broad money (M2)	38.2	37.2	32.0	33.0	33.3	33.2
Fiscal sector**						
Domestic Revenue	11.0	11.6	10.3	9.5	<i>10.3</i>	<i>10.7</i>
Tax revenues	5.3	5.3	4.9	4.3	5.3	5.3
Customs duties	3.8	3.6	2.7	2.5	2.7	2.4
Non-tax revenues	1.9	2.8	2.7	2.5	2.8	3.0
Donor grants	11.6	11.1	12.9	16.9	<i>17.9</i>	<i>17.8</i>
Total Core Budget expenditure	21.1	23.3	23.8	24.2	<i>28.6</i>	<i>29.7</i>
Operating	15.1	17.4	17.1	17.2	<i>21.7</i>	<i>22.8</i>
Development	5.9	5.8	6.7	7.0	6.9	6.9
Overall Core balance (incl. grants)	1.9	-0.4	-0.4	2.2	<i>-0.4</i>	<i>-1.2</i>
Security spending	8.2	10.1	10.4	11.5	<i>14.2</i>	<i>13.4</i>
Fiscal sustainability ratio	72.8	66.5	60.2	55.2	<i>51.4</i>	<i>51.9</i>
External sector						
Exports of goods (billion US\$) /1	2.64	2.68	2.75	2.61	2.4	2.3
Imports of goods (billion US\$) /1	9.95	10.22	11.36	10.9	<i>10.7</i>	<i>10.8</i>
Trade balance	-45.9	-42.0	-41.9	-39.9	<i>-38.0</i>	<i>-36.9</i>
Current account balance (incl. grants)	2.8	3.1	3.9	3.6	3.9	0.3
Current account balance (excl. grants)	-48.5	-44.2	-43.8	-39.8	<i>-37.5</i>	<i>-36.2</i>
Gross reserves (million US\$)	5,550	6,209	6,771	7,362	<i>7,612</i>	<i>7,873</i>
Gross reserves (months of imports)	6.7	6.9	7.7	7.3	7.5	7.7
Total external debt /2	8.0	6.9	6.5	6.1	5.9	6.1
Memorandum items						
Nominal GDP (incl. opium; billion Afs) /3	747	896	1,086	<i>1,206</i>	...	...
Population (millions)	28.4	29.1	29.8	30.6	...	...
Exchange rate (Afs/US\$; period average)	45.8	47.8	51.7	55.4	...	...
Real effective exchange rate (depreciation = decrease in index)	114.4	126.2	127.0	125.3	...	...

Numbers in italics are projections/forecasts.

** All indicators for 2013 and onwards are computed for calendar year (Jan-Dec), except if otherwise indicated. For preceding years, the data corresponds to solar year (April-March), except if otherwise indicated.*

*** Fiscal year prior to 1391 spans over April-March, similar to solar year. Fiscal year in 1391 covers only 9 months, but the data has been prorated for 12 months. Fiscal year in 1392 and onwards corresponds to calendar year (Jan-Dec).*

/1: Estimates only; includes both official and unofficial (smuggling) trade.

/2: External debt excludes Russian Federation's loan. /3: Projected for solar year in 2013.