

WORLD BANK GROUP
AFGHANISTAN DEVELOPMENT UPDATE JANUARY 2020

Navigating a Sea of Uncertainty



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AFGHANISTAN DEVELOPMENT UPDATE

January 2020

Preface

The Afghanistan Development Update, which is published twice a year, provides a comprehensive report of the state of the Afghan economy. It covers recent economic developments and the medium-term outlook for Afghanistan. Each edition includes more in-depth analysis on specific focus topics.

The Afghanistan Development Update is intended for a wide audience, including policy makers, the donor community, the private sector, and the community of analysts and professionals engaged in Afghanistan's economy.

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The authors are grateful for the cooperation received from Government officials in sharing data and statistics and providing comments on draft versions of the report.

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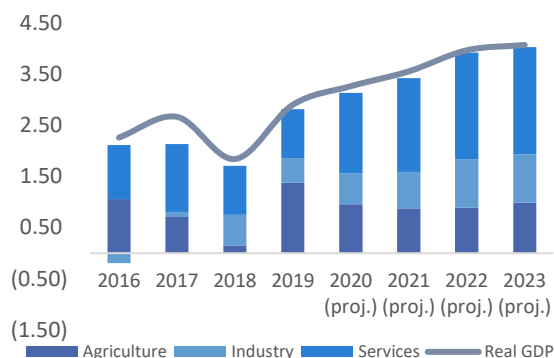
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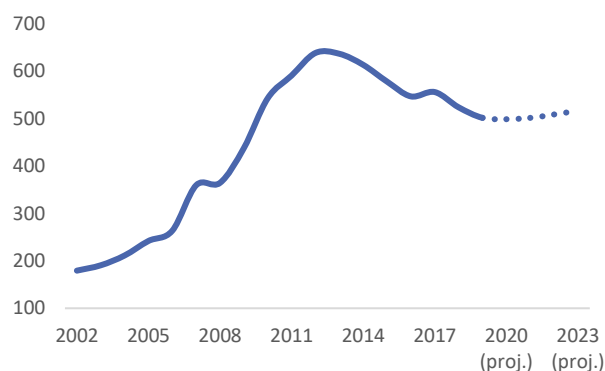
Key Messages in Charts

Recovery from drought saw a slight pickup in growth, but incomes are increasing only very slowly.

Real GDP Growth by Sector (Percent)



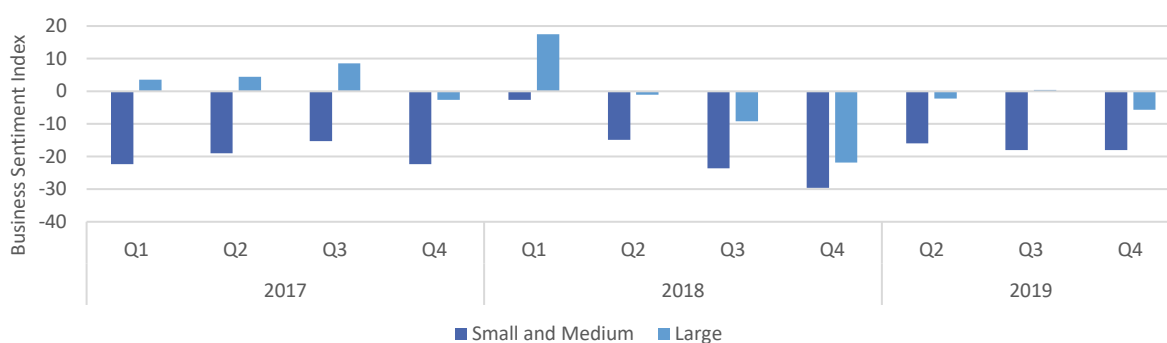
GDP per capita (US\$)



Source: National Statistics and Information Authority and World Bank staff forecast

Private sector confidence remained weak reflecting uncertainties regarding elections, peace talks with the Taliban, and prospects for continued international support.

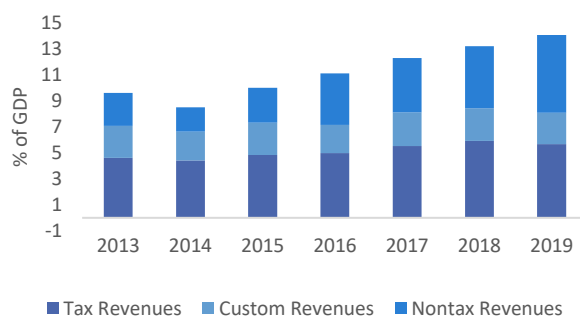
Business confidence by firm size (Index)



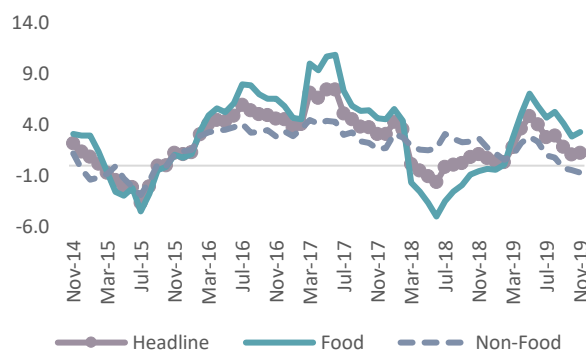
Source: Afghanistan Chambers of Commerce and Industries, Business Monitor Survey

Despite elections, overall macroeconomic management remained strong. Revenues grew and inflation remained moderate.

Revenue by source as % GDP



CPI Inflation (12 month percent change)



Source: Ministry of Finance, Afghanistan

Source: National Statistics and Information Authority, Afghanistan

Executive summary

Recent economic developments

Afghanistan's economy continues to reflect deep political uncertainty

Afghanistan currently faces a sea of uncertainty. Outcomes of the September 2019 presidential elections are not yet known, and preliminary results have been challenged. Insecurity continues, with government and insurgent operations imposing an increasing burden in terms of civilian casualties. Negotiations between the US and the Taliban have recently resumed, but prospects for and the contents of any eventual political settlement remain unclear. In the meantime, the duration and extent of continued international security support is being questioned. While international grants continue to finance 75 percent of public expenditure, current aid pledges expire at the end of 2020, with some major donors signaling intentions to significantly reduce support. This context of uncertainty has fundamental implications for the economy, with growth and investment constrained by weak confidence.

High growth in agriculture was offset by lower growth in industry and services

Afghanistan's economy is estimated to have grown by 2.9 percent in 2019. The agriculture sector grew rapidly, with easing of recent drought conditions and higher precipitation and snowfall during the winter season of 2018-2019. Broader political uncertainties dampened private sector confidence and non-agriculture growth.

While detailed household survey data is not available, poverty is expected to have worsened during 2019. The displacement crisis continued in 2019, with close to 400,000 Afghans internally displaced due to conflict and an additional 505,000 returning to Afghanistan, mainly from Iran, during 2019.

Inflation remained modest, with prices estimated to have increased by 2.3 percent over 2019 (period average). Food prices recorded an increase of 3.6 percent, mainly reflecting moderate increases in international grain prices. Non-food prices increased by just one percent mainly due to declining global energy prices.

A sharp decline in imports led to a smaller trade deficit

The trade deficit is estimated to have narrowed slightly (32.7 percent of GDP in 2018 to 31.4 percent of GDP in 2019) despite slowing export growth. Over the first three quarters of 2019, imports dropped by 8.2 percent (y-o-y) reflecting subdued domestic demand and stronger domestic agricultural output. Likewise, exports declined by 5.4 percent compared with the first three quarters of 2018. Weaker export growth reflected Afghani appreciation against major trade currencies and heightened trade tensions with Pakistan. Exports to Pakistan and Iran dropped by 28 percent and 43 percent respectively in the first nine months of 2019 compared to 2018 level.

Recent depreciation against the US dollar moderated

The afghani strengthened against the Pakistani Rupees (11.5 percent) and the Iranian Toman, (12 percent) over 2019, reflecting economic difficulties in the two neighboring countries. The afghani depreciated by 3.1 percent against the US dollar primarily driven by general strengthening of the US dollar (moderating a nine percent depreciation in 2018). The afghani remained stable against the Indian rupee (depreciation of two percent).

Fiscal performance remained strong in 2019

Fiscal performance continued to improve in 2019 despite elections. Total domestic revenues reached Afs 208.5 billion, meeting the mid-year budget review target. This record performance partly reflected large one-off revenue, including transfers of central bank profits totaling Afs 24 billion. Strengthened administration and governance also played an important role in avoiding a collapse in revenues (as seen during the last presidential elections). Strong domestic revenue performance was partly offset by a significant decline in grants (Afs 10 billion equivalent, more than one percent of GDP). Overall expenditures increased to Afs 422.3 billion (or 28.5 percent of GDP). The development budget execution rate reached 92 percent, despite precautionary cash-management measures being imposed over most of the year. The overall fiscal deficit for 2019 was Afs 15.9 billion, equivalent to 1.1 percent of GDP.

Weak confidence was reflected in monetary developments

Private sector credit of the banking system grew by an estimated three percent over 2019. Total bank loans to the non-financial private sector stood at 47.1 billion Afs in November 2019, equivalent to only 3.11 percent of GDP. The loan-to-deposit ratio slightly increased to 17.1 percent in November 2019 from 16.7 percent one year ago, but the increase was due to a contraction in loans reflecting weak economic conditions. Excess liquidity of banks remains massive, with 19 percent of bank deposits sitting in the central bank as excess reserves and 28 percent invested in central bank capital notes.

Outlook**Growth is expected to remain modest**

Growth is expected to slightly increase to 3.3 percent in 2020 as drought impacts further recede and private sector confidence recovers following the September 2019 elections. Growth over the medium term is projected to hover around four percent assuming continued improvements in political stability, no further deterioration in the security situation, and a gradual decline in international grants. With recovering growth, inflation is expected to accelerate to 3.5 percent in 2020 and stabilize around five percent over the medium term.

The fiscal deficit is expected to slightly increase in 2020 and over the medium term as revenue momentum stalls and grants gradually decline while expenditures increase (grants are expected to decline from 13.4 percent of GDP in 2020 to 10.4 percent of GDP in 2023). Domestic revenues are expected to remain at around Afs 209 billion in 2020, mainly reflecting exhaustion of one-off revenue sources. Expected implementation of VAT is estimated to bring in additional revenue of 0.8 percent of GDP in 2021, gradually increasing to 1.8 percent by 2023, partially offsetting the decline in grants. Deficits are expected to be financed by limited domestic commercial borrowing (sukuk) and external concessional loans.

External balance is likely to deteriorate over the medium term

The trade deficit is expected to grow, with continued export growth unable to keep pace with imports, which are expected to expand at around the pace of economic growth. In view of declining international grants and a further deterioration of the trade balance, the current account is expected to move into deficit, reaching around 3.4 percent of GDP by 2023. International reserves are projected to decline but remain at comfortable levels (around eleven months of import cover by 2023).

Risks and medium-term prospects

The growth outlook is subject to significant downside risks

The growth outlook is subject to substantial downside risks. These include further political instability following the presidential elections, deterioration of security conditions, premature and precipitous reduction in aid flows, and adverse regional economic or political developments. On the other hand, significant improvements in security conditions following a political settlement with the Taliban could help boost growth and private investment.

Reform efforts should focus on building private sector and donor confidence

Short-term priorities include continued implementation of business environment and anti-corruption reforms to help boost private sector confidence, mobilize investment, and ensure the continued confidence of the international community. For the international community, clear communication regarding future grant levels and the conditions under which this support would be provided can help reassure the private sector and focus government reform efforts towards shared priorities. Over the medium-term, reform efforts should focus on attracting additional investment in the agriculture and extractive sectors, which have the combined potential to deliver increased employment, exports, government revenues, and growth. To ensure that benefits of agriculture and extractives led growth are maximized and widely shared, continued investment is required in human capital, regional connectivity, expanded infrastructure, and an improved business regulatory environment.

A. Recent Economic Developments

1. Political and Security Context

Political uncertainty and violence worsened in 2019

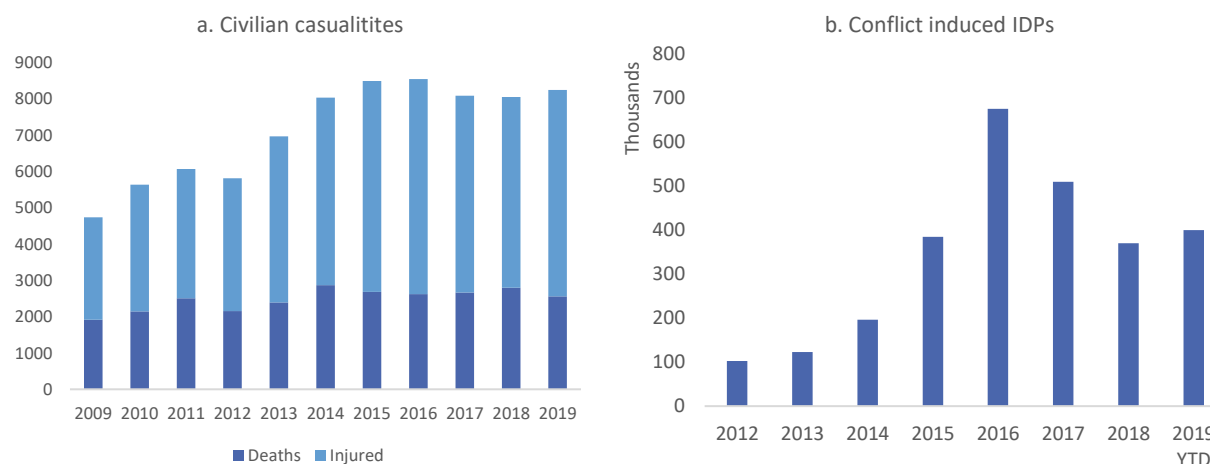
Afghanistan experienced intensified insecurity and political uncertainty through 2019. Presidential elections were held on 28th September, with voter turnout suppressed by widespread violence. The preliminary election results announced on December 22 were widely contested, and raised prospects of a second round of elections.

Civilian casualties in the first nine months of 2019 were higher than over the previous two years, reaching 8,239 (2,563 deaths and 5,676 injured). While election-related incidents were low during months leading up elections, civilian casualties on polling day were higher than in 2014. A total of 458 election-related civilian casualties (85 deaths and 373 injured) were registered in 2019, including 277 on polling day. More than 80 percent of election-related violence was attributed to anti-government elements.

Displacement increased, driven by intensified government and Taliban operations in the context of ongoing political negotiations. The number of IDPs increased from 369,700 in 2018 to more than 399,000 as of early December 2019. An additional 505,000 refugees returned to Afghanistan, mainly from Iran, during 2019.

Prospects for a political settlement with the Taliban and the contours of any potential peace agreement remain highly uncertain. Negotiations between the Taliban and the US, initiated in early 2019, were unilaterally suspended by the US in early September but have since resumed. Political uncertainty has been intensified by inconsistent messages regarding the potential drawdown of the international security presence. Current international security and civilian grant support pledges are due to expire in 2020, creating uncertainty regarding future aid levels and the sustainability of security and development expenditures.

Figure 1: Growing insecurity led to high civilian casualties and IDPs



Source: United Nations Assistance Mission in Afghanistan (UNAMA) and UNHCR
 Note: Conflict driven displacement data in 2019 as of 01 Dec 2019.

2. Real Sector Activity

Growth has been subdued since 2014

Insecurity and political uncertainty have driven subdued economic growth in Afghanistan since 2014. Large security and civilian aid inflows and strong agricultural growth saw the economy expand by an average of nine percent per annum over 2003-2013. Withdrawal of international security presence, deteriorating security, and political instability saw growth slow to 2.7 percent in 2014 and 1.5 percent in 2015. Growth recovered slightly over 2016 and 2017 with consistent reform progress and a stabilization of the political environment. Severe drought and intensifying political uncertainty saw growth again slow to just 1.8 percent in 2018.

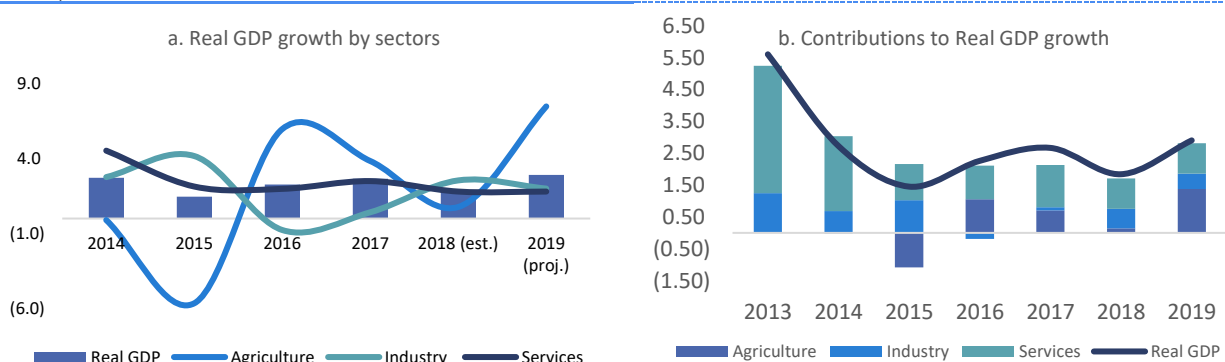
Moderate growth in 2019 reflected improved weather conditions amid weak confidence

Real GDP growth is estimated to have reached 2.9 percent in 2019, driven by easing of drought conditions and rapid agricultural growth. The impact of strong agricultural performance was offset by continued slow service and industry growth due to weak confidence in the context of political uncertainty and increasing insecurity.

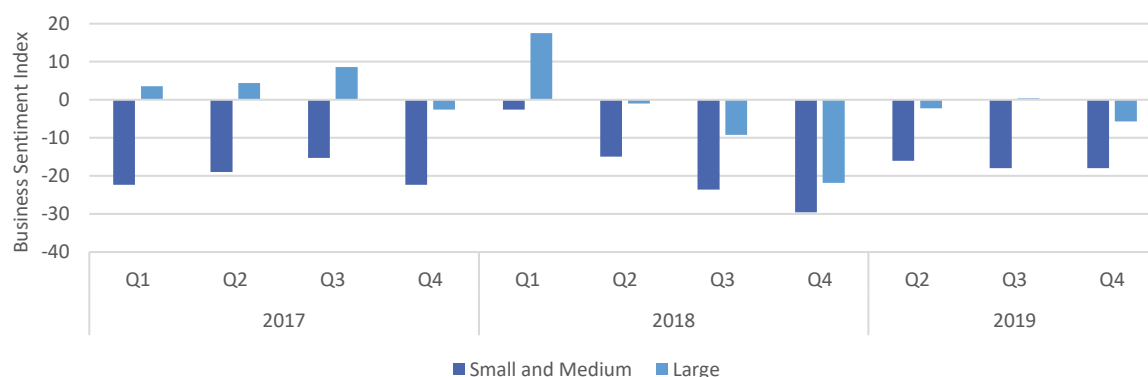
The agriculture sector is estimated to have grown by 7.5 percent, accounting for at least 1.37 of overall growth in 2019. Strong growth in the sector was mainly driven by production of cereals (16.6 percent growth). Higher precipitation and snowfall in the north-central provinces during the planting season of 2019 resulted in increased rainfed wheat cultivation. Higher precipitation also resulted in accelerated growth in fruit and industrial crop production. Production of fruits grew by five percent compared to a decline of 9.5 percent in 2018. On the other hand, growth in vegetables and other industrial crops moderated at around five percent following strong growth of 32 percent in 2018.

Industry sector growth remained muted in 2019, expanding by two percent compared to 2.5 percent in 2018. Increased agricultural production fed through into expanded agribusiness and agro-processing output, but overall growth of the sector was dampened by weak confidence. Growth of the services sector is estimated at 1.8 percent, similar to 2018. Service sector growth was driven by increased demand resulting from improved agricultural incomes, with the impact offset by overall weak confidence. While improving slightly over 2019, private sector sentiment remains negative, especially among small and medium firms.

Figure 2: Strong agriculture growth was offset by slower growth in industry and services
(percent)



Sources: National Statistics and Information Authority (NSIA) for 2013-17 data, World Bank staff projections for 2018

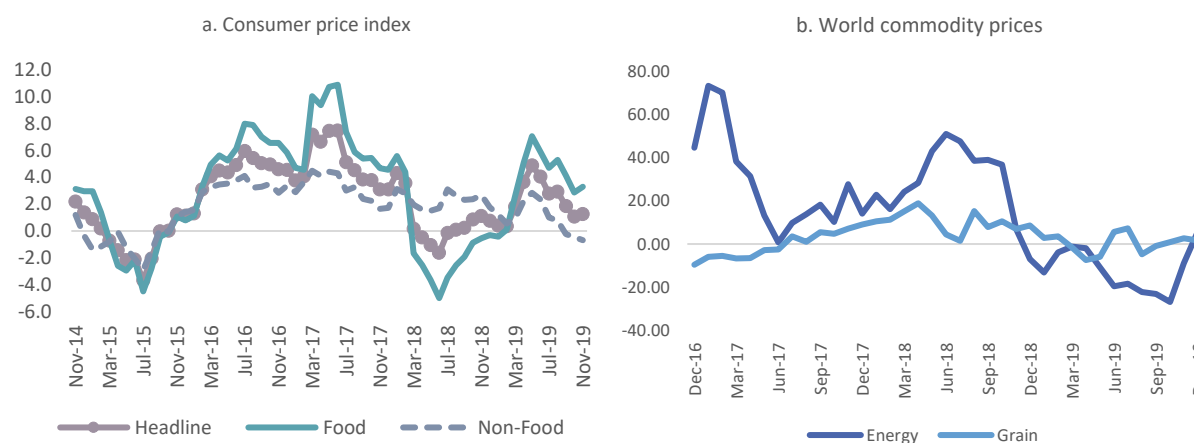
Figure 3: Political instability and violence continue to affect private sector confidence*(percent)*

Sources: Afghanistan Chamber of Commerce and Industry

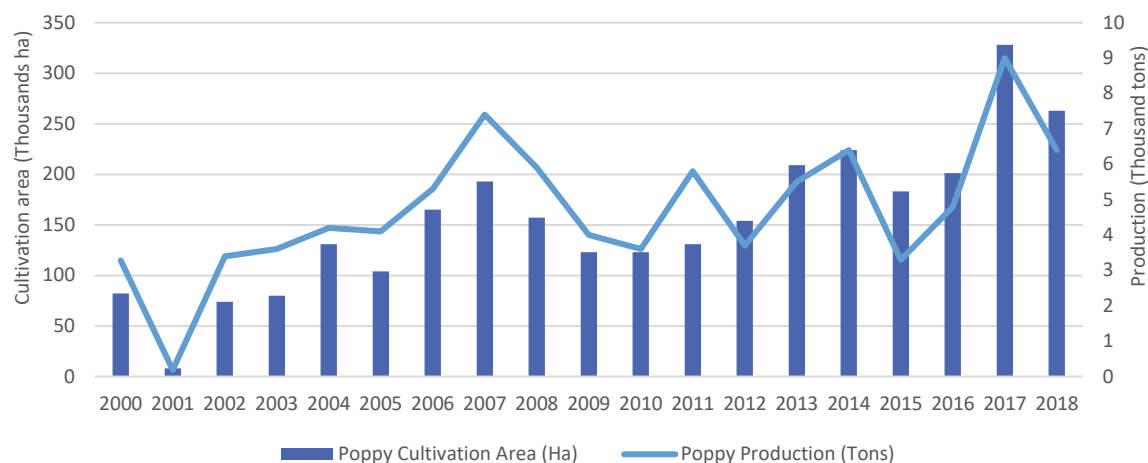
Inflation accelerated slightly, driven by higher international grain prices

Inflation accelerated slightly through 2019. Period average inflation was 2.1 percent as of November 2019, compared to 1.2 percent over 2018. Headline inflation peaked at 4.9 percent (y-o-y) in May. Inflation was mainly driven by increased cereal prices due to rising global prices, despite strong recovery in domestic production. On the other hand, vegetable prices saw a sharp decline during 2019 partially reflecting changes of import valuation by Pakistan customs for vegetable imports, resulting in lower vegetable exports compared to 2018. Non-food inflation also peaked in May 2019, averaging around 1.7 percent during Jan-Nov, 2019. Clothing prices increased most-rapidly averaging around five percent over the period while communication and housing, electricity and gas prices declined by 4.1 and 2.5 percent, respectively, reflecting lower international energy prices during 2019.

Period average inflation is estimated to have remained around 2.3 percent toward end of the year as low international energy prices offset increasing food and utility prices during the winter season.

Figure 4: Consumer prices increased more modestly than expected, reflecting lower energy prices globally
(12-month percentage change)

Source: Central Statistics Organization, and World Bank Global Economic Monitor (GEM)

Figure 5: Opium production dropped in 2018, from its peak in 2017*Opium cultivation area and production*

Sources: UNODC

Poverty is likely to have eased for some households with increased agricultural production

According to most-recent household survey data, 55 percent of Afghans continue to live below the basic-needs poverty line. Improved precipitation in the 2018-19 winter is expected to have had favorable impacts on rural livelihoods and allowed some internally displaced people to return to their origin communities. However, impacts of improved agricultural production on household incomes and consumption are expected to have been uneven. Continued population displacement in 2018 may have led to reduced or sub-optimally timed planting. In addition, with limited instruments to manage the flow of snowmelt into rivers and irrigation channels, flood risks and unpredictable access to water for cultivation may continue to threaten farm production and rural welfare.

3. Monetary and financial sector developments

Money supply growth picked up only slightly...

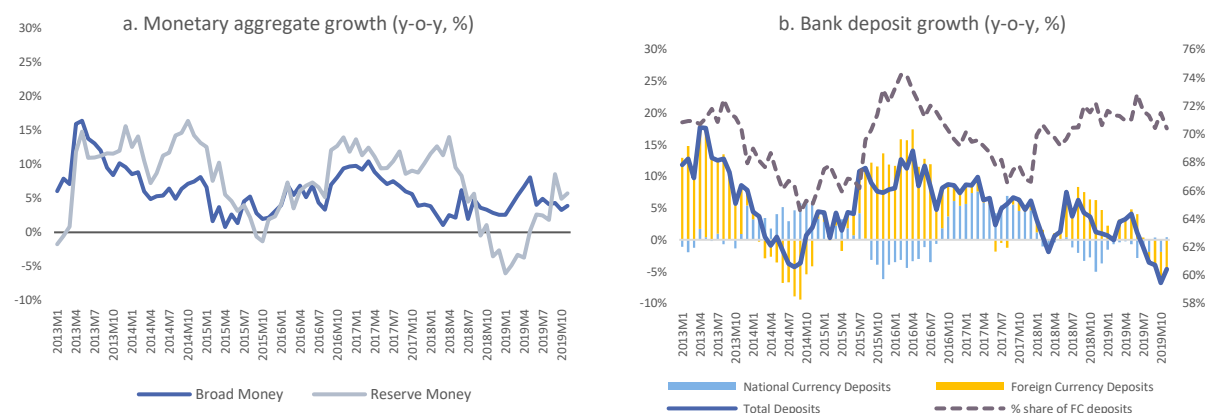
Slow growth in monetary aggregates reflects continued subdued economic activities and prudent monetary policy stance in 2019. Growth of broad money picked up slightly from 2.6 percent (y-o-y) at end-2018, reflecting a slow economic recovery, but remained moderate at 3.9 percent (y-o-y) in November. Reserve money supply, after contraction in January amid increased foreign exchange sales of the central bank, gradually recovered throughout 2019, recording 5.7 percent y-o-y growth in November.

... while bank deposits declined

Bank deposits, after a steady increase in the first six months of 2019, declined in the third and fourth quarters of 2019, recording a 4.6 percent drop in November compared to the level one year ago. Decline in bank deposits was driven mainly by foreign currency denominated deposits (-5 percent) while Afghani deposits remained close to the previous year's level. Despite the recent decline in foreign currency deposits, bank deposits remain as highly dollarized as three years ago, with foreign currency denominated deposits still accounting for 70 percent of total deposits. Total bank deposits stood at Afs 250 billion in November, equivalent to around 17 percent of GDP.

Figure 6: Money supply remained moderate and bank deposits declined

(y-o-y percent change)



Source: Da Afghanistan Bank

Private sector credit further contracted...

Weak business confidence has been translated into contraction of private sector credit of the banking system by four percent (y-o-y) in November. Decline in private sector credit was mainly driven by a 13.9 percent drop in foreign-currency-denominated loans. Foreign currency loans have been steadily declining since the Kabul Bank crisis in 2011 when a substantial proportion of loans were written off. Foreign currency loans stood at around US\$ 277 million in November, a 36 percent drop from around US\$ 430 million at end-2016, significantly bringing down the share of foreign currency loans to total loans from 69 percent to 50.6 percent over the same period.

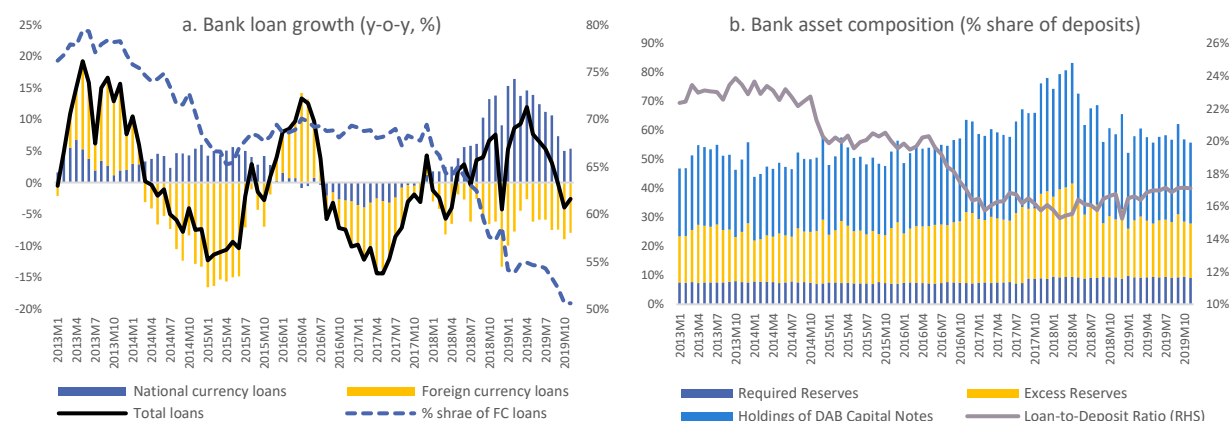
...as financial intermediary function of banks

Financial intermediation function of the banking system remains extremely limited. Total bank loans to the non-financial private sector stood at Afs 47.1 billion in November 2019, equivalent to only 3.17 percent of GDP. Private sector credit remains highly concentrated. In October 2019, 46 percent of total loans were provided to the trade sector, followed by services (19.9 percent) and industry (10.8

remains extremely weak

percent), and agriculture (3.5 percent). The loan-to-deposit ratio slightly increased to 17.1 percent in November from 16.7 percent one year ago, but the increase was due to a sharper contraction in deposits which reflects negative business sentiment. Excess liquidity of banks remains massive, with 19 percent of bank deposits sitting in the central bank as excess reserves and 28 percent invested in the central bank capital notes. A steady decline in the share of foreign currency loans and the continuation of high level of deposit dollarization together reflect weak confidence in economic prospects and the local currency value as well as increased risk aversion of banks in foreign currency lending, with most of borrowers fully exposed to exchange risks amid continued depreciation against the US dollars.

Figure 7: Bank loans declined while excess liquidity remains ample



Source: Da Afghanistan Bank

Financial soundness indicators show a mixed picture

The capital adequacy of the banking system remains above the threshold, with the ratio of capital to risk-weighted assets close to 26 percent in October 2019. The share of non-performing loans (NPL)s to total loans increased from nine percent at end-2018 to 14 percent in October 2019, reflecting weak economic conditions and the strengthened enforcement of asset classification regulations by the central bank. Profitability indicators of the banking sector slightly improved but remained weak, with the return on asset (ROA) increasing from 0.55 percent in December 2018 to 0.62 percent in October 2019.

Actions have been taken to strengthen the resilience of banks

In continuation to its previous efforts, the central bank has recently introduced new measures to strengthen the banking sector. DAB has intensified monitoring of the weak banks and enhanced enforcement of asset classification regulations through mandated portfolio clean-up and loan write-off. DAB has also de-licensed two foreign banks' branches. Modernization of the three state-owned banks and strengthening their corporate governance framework is underway. A presidential order was issued to establish the state-owned banks' ownership policy and the state-owned banks' ownership unit at the Ministry of Finance. This order also outlines the key elements towards a strengthened corporate governance framework for these banks that is fully aligned with the Banking law and the relevant regulations by DAB. In parallel, the Ministry of Finance has invested in upgrades of critical IT infrastructure in these state-owned banks, aiming to improve operational efficiency and mitigate the operational risks within these institutions. Finally, in support of digital financial services, DAB has issued a regulation to mandate all financial

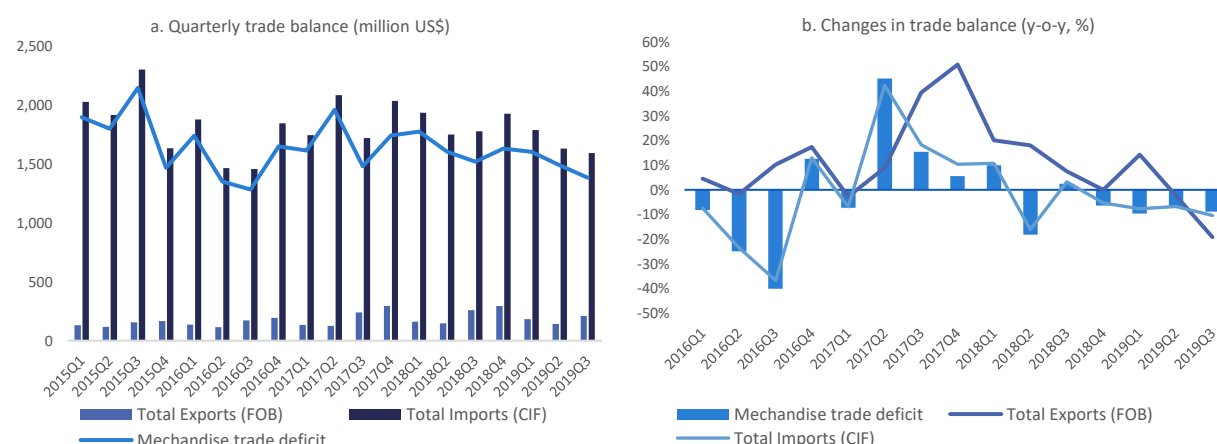
institutions to integrate with the Afghanistan Payments System—the country’s national payments switch.

4. External sector

The trade deficit has narrowed due to import contraction

A sharp drop in imports reduced the trade deficit in 2019, despite weaker exports. Total merchandise trade (on CIF terms¹) recorded a deficit of US\$ 4,474 million in the first nine months of 2019, an eight percent (US\$ 419 million) decline from the deficit level during the same period in 2018. Subdued domestic demand and improved domestic agriculture production have translated into an 8.2 percent drop (y-o-y) in imports in first nine months, while deteriorating economic conditions in major trade partners and increased trade tension with Pakistan also reduced exports by 5.4 percent (y-o-y).

Figure 8: Decline in imports narrowed the trade deficit in 2019 despite weaker exports



Source: National Statistic and Information Agency

Escalated trade tensions with Pakistan and an economic slowdown in Iran reduced exports

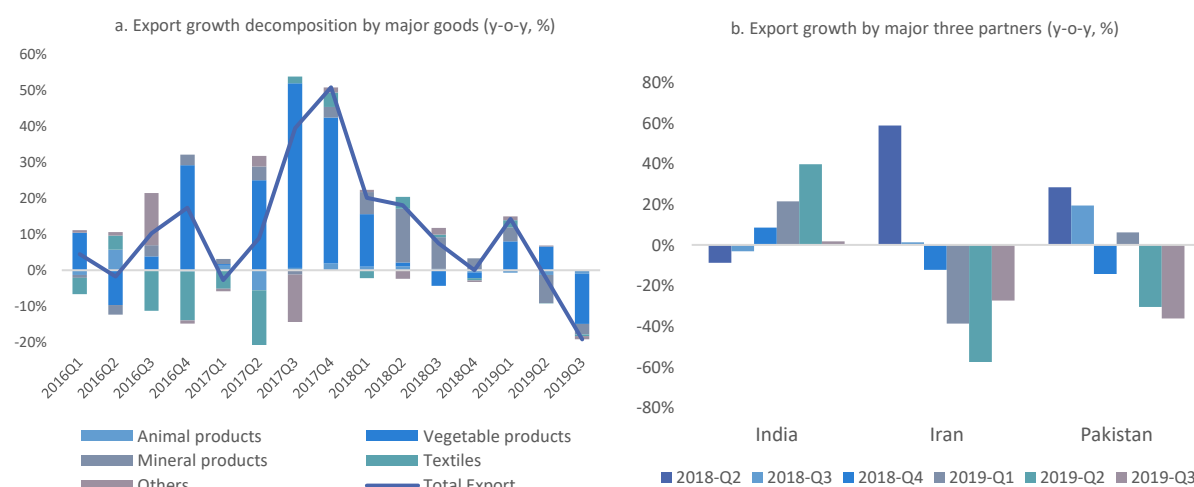
Exports are expected to have declined by around 5.5 percent in 2019. Export growth has been slowing since its peak in mid-2017. After a strong 28 percent increase in 2017, exports increased by 8.5 percent in 2018 and contracted by 5.5 percent (y-o-y) in the first nine months of 2019. Export performance has deteriorated throughout 2019, declining by 2.4 percent in the second quarter and 19.2 percent in the third quarter. Weaker exports reflected the appreciation of the Afghani against the currencies of some major trade partners and adverse impacts of the recent escalating trade tensions with Pakistan.

Decline in exports was driven by a large drop in vegetable and mineral exports. Vegetable exports increased by 10.2 percent (y-o-y) in the first half of the year amid improved agriculture conditions but plunged by 17.4 percent (y-o-y) in the third quarter, largely owing to higher valuation of major Afghanistan exports (pomegranate, apricot and grape) imposed by Pakistan starting in June. Among the vegetable exports, dry fruits remained the largest item in the export basket, comprising one-third of the total value of exports, followed by medical seeds (23

¹ CIF (Cost, Insurance and Freight).

percent), fresh fruits (eight percent) and saffron (five percent). Mineral exports also declined by 16.8 percent (y-o-y) in the first nine months. Vegetable and mineral products accounted for 77 percent and 10 percent of total exports. The impacts of the recent bilateral trade tension with Pakistan and a sharp economic slowdown in Iran have been reflected in a rapid decline in exports to these countries. Exports to Pakistan and Iran dropped by 28 percent and 43 percent respectively in the first nine months, compared to the same period of 2018. Exports to India, on the other hand, increased by 19 percent owing to increasing exports through the newly established air-corridors, partially offsetting lower exports to Pakistan and Iran. The top-two destinations—Pakistan and India—still accounted for more than 80 percent of total exports.

Figure 9: Decline in imports contributed to smaller trade deficit in 2019



Source: National Statistic and Information Agency

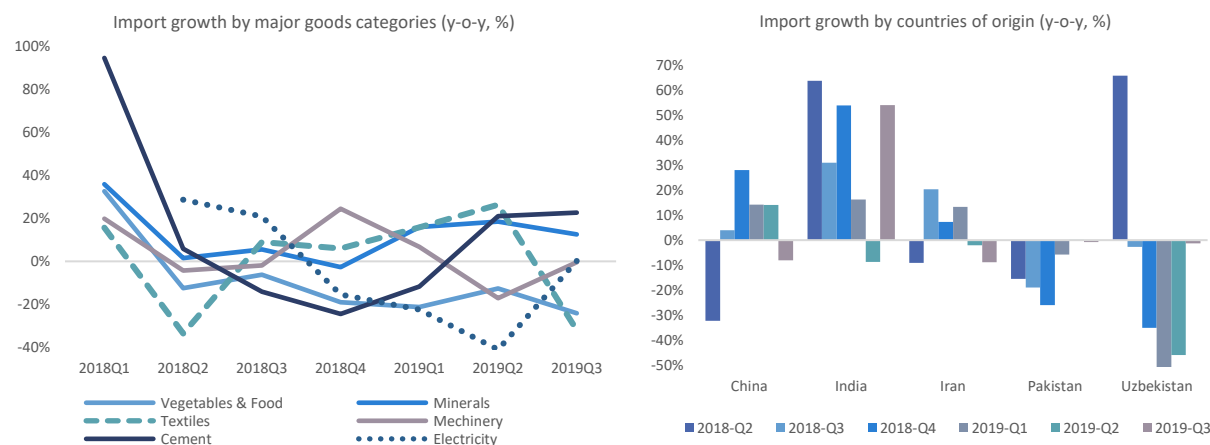
Sharp import contraction largely reflected strong agricultural production and lower electricity imports

Increased domestic agricultural production and weak economic conditions translated into import contraction in 2019. After a substantial slowdown from nine percent in 2017 to 0.9 percent in 2019, import growth (on CIF terms) turned negative for three consecutive quarters in 2019, recording an 8.2 percent drop (y-o-y) in the first nine months of 2019. Annual imports of goods are projected to have declined by around seven percent in 2019.

Weaker imports were largely driven by a sharp decline in vegetable imports, substituted by increased domestic agricultural production after the severe drought in 2018. Vegetable imports declined by 8.2 percent (y-o-y) in the first nine months of 2019 after a 19 percent increase in 2018, driven by a 28 percent drop in wheat imports which account for almost half of total vegetable imports. Import trends were varied. While cement imports increased by 12.4 percent, machinery and equipment imports dropped by 17 percent in 2019 through September. Mineral imports, including petroleum and gas products, increased by 16.7 percent over the same period. Electricity imports declined by two percent in volume and 23 percent (US\$ 51 million) in the US dollar terms. A combination of lower import prices of electricity (especially from Uzbekistan), higher domestic generation of hydro-electricity, and two incidents of destruction of transmission lines contributed to lower electricity imports in 2019.

Afghanistan's imports are dominated by oil products, flour and wheat, electricity, fabrics, spare parts, metal products, and cement, which together account for over 40 percent of total imports. Imports from Iran, China, and Pakistan comprise 50-55 percent of total imports. Import performance varied across the major countries of origin in 2019, showing robust increases in imports from China (six percent) and India (17 percent) but declining imports (-two percent) from Pakistan.

Figure 10: Decline in vegetable and machinery imports, particularly to Pakistan, drove weaker imports



Source: National Statistics and Information Agency

A small surplus in the current account is expected in 2019

Depreciation of the Afghani against the US dollar significantly slowed

The current account balance² is expected to have remained close to the 2018 level, recording a surplus of around three percent of GDP in 2019. The trade deficit in goods and services is projected to have narrowed slightly in 2019 due to import contraction but remained substantial at around 31.4 percent of GDP. Substantial aid flows continued to offset the large trade deficit, keeping the current account in a slight surplus. Worker's remittance, which stood at US\$ 323 million in the first six months, are expected to have partially contributed to the current account.

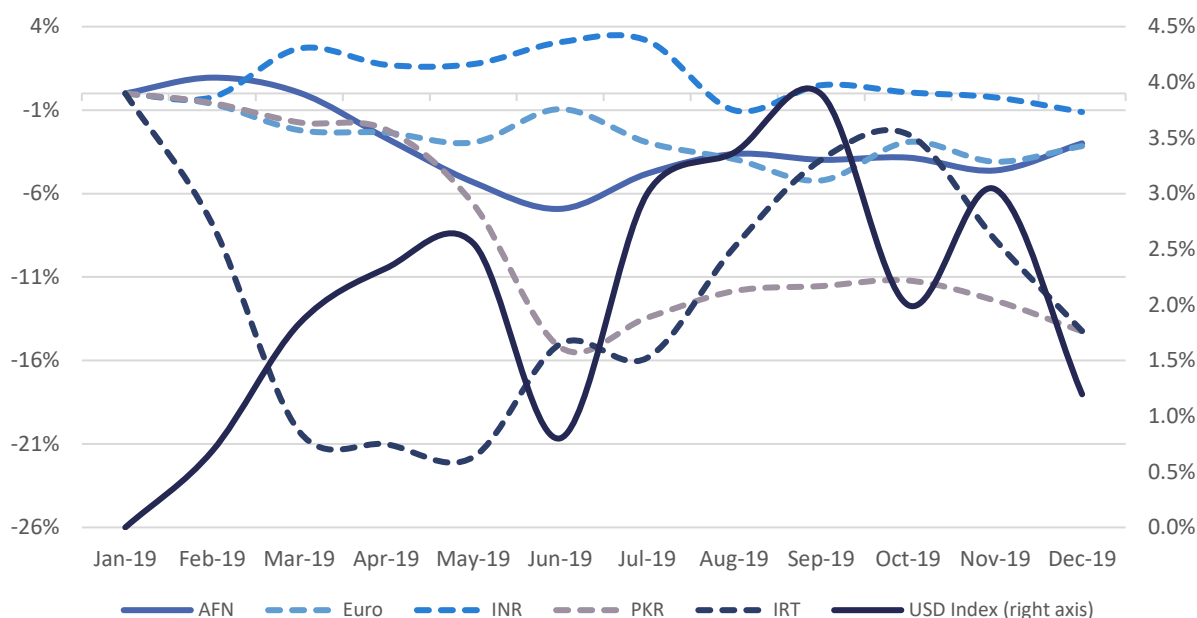
Depreciation of the Afghani has moderated in 2019, despite the elevated political uncertainty around the Presidential Election. The Afghani depreciated by 3.1 percent against the US dollar and remained stable against the Euro in 2019, a relatively moderate pace compared to nine percent depreciation against the US dollar and five percent against the Euro in 2018. Compared to the currencies of major trade partners, the Afghani has strengthened against the Pakistani Rupees by 11.5 percent and Iranian Toman by 12 percent respectively, reflecting economic difficulties in the two neighboring countries, while depreciating by two percent against the Indian Rupees. Central bank's intervention in the foreign exchange market amounted to US\$ 2,400 million in 2019 very close to 2018 level, despite less volatility in exchange rate movements.

² The definition of the current account balance in this report adjusts the official current account statistics of the central bank to account for the World Bank's estimates on the imports associated with in-kind transfers, off-budget grant flows and other international transactions that are currently captured by the errors and omissions under the official BoP statistics. Errors and omissions of the official BoP data remains significant, reaching US\$ 1,685 million in the first two quarters of 2019 and US\$ 2,892 million in 2018—equivalent to 10-15 percent of GDP annually.

International reserves continued to increase

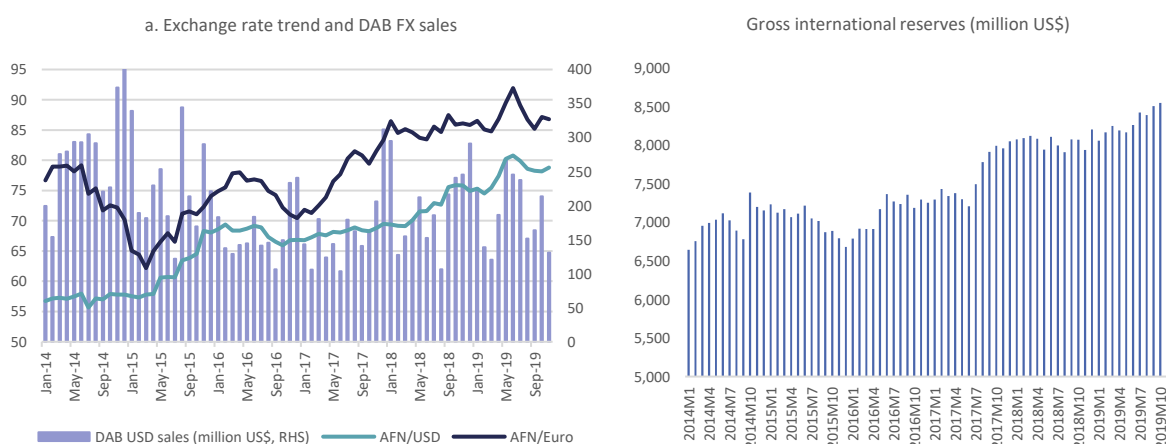
Gross international reserves continued to increase in 2019, reaching US\$ 8,553 million in October, reflecting the sound performance of the balance of payments and higher prices of monetary gold. The current level of international reserves is equivalent to 13 months of imports—an adequate level by international standards.

Figure 12: The Afghani appreciated against the currencies of most major trade partners in the region
Change in value of Afghani against major trading currencies (Index = January 2019)



Source: Da Afghanistan Bank

Figure 13: Depreciation of the Afghani slowed and foreign exchange reserves continued to increase



Source: Da Afghanistan Bank

5. Fiscal sector

Revenues reached a new high, driven by large one-off receipts

Headline revenues are estimated to have reached a new high of 14.1 percent of GDP in 2019, up from 13.2 percent of GDP in 2018. Strong revenue performance, however, largely reflected large one-off revenues and positive impacts on domestic customs collections from Afghani depreciation.

Total revenue collection reached Afs 208.5 billion, reflecting 12 percent nominal growth over 2018 collection. Domestic revenues were originally budgeted at Afs 188 billion with targets revised upward to Afs 209 billion during the mid-year budget review.

Central bank operating profits and depreciation supported overall revenue performance as tax revenue growth weakened

Strong revenue performance was supported by non-tax revenues including large one-off revenues, while core tax collections lagged. Non-tax revenues grew by more than 31 percent, reaching Afs 88.5 billion (42.4 percent of total revenue collection in 2019). Rapid non-tax revenue growth was largely driven by Da Afghanistan Bank operating profits from exchange rate depreciation (operating profits were transferred to the treasury account in two instalments of Afs 8.9 billion in month five and Afs 15 billion in month 12). This is part of a growing trend in which the Ministry of Finance relies increasingly on non-tax revenues (see also Box 1). Tax revenues amounted to Afs 84 billion, roughly the same as in 2018 compared to average growth of 12.5 percent during 2015-2018. The lack of growth was driven by relatively poor performance of LTO and STO. The LTO continuously missed its monthly target (including significant underperformance for four months) since month five while the STO missed its monthly target over five months. Revenue from international trade amounted to Afs 36 billion, an increase of around 0.8 percent of GDP compared to 2018. Low collections in two of the three major customs points (Herat and Balkh) were offset by higher collections in other customs points. Strong revenue collection from higher-performing customs points partly reflected Afghani depreciation against the US dollar.

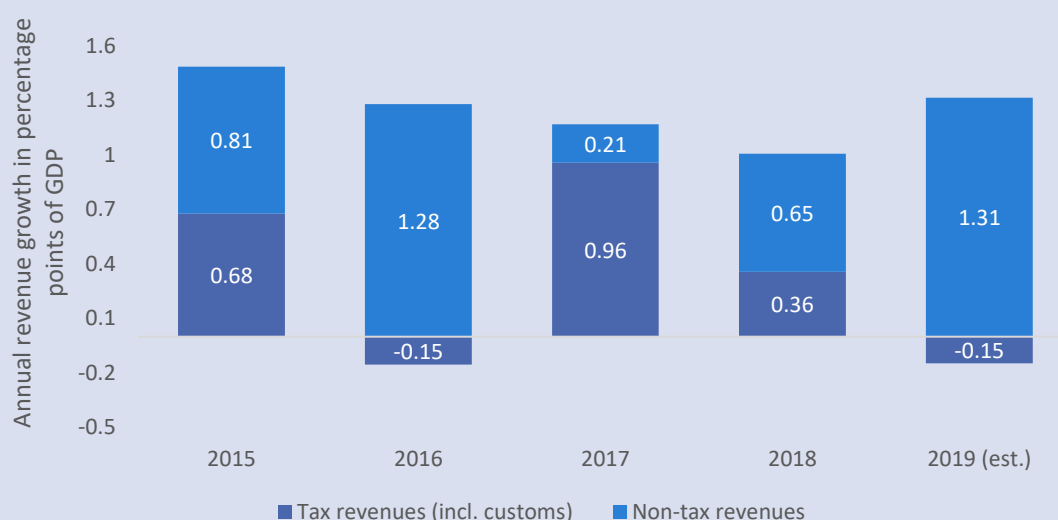
Elections in Afghanistan have historically been associated with sharp deteriorations in revenue performance, posing important fiscal and macroeconomic risks. Strong overall revenue performance through 2019 was supported by continuous monitoring of performance against monthly targets in each collectorate. Government was able to avoid precipitous declines in revenue through strengthened administration and governance, and mobilizing non-tax revenues to fill emerging shortfalls. New transparency measures saw the publication of regular reports on revenue performance.

Box 1: Revenue decomposition

Afghanistan's domestic revenues have been on an impressive growth path since the security transition and electoral period in 2012-2014. Since then, revenues have increased by around one percentage point of GDP each year (see Box 1). This is a phenomenal growth path compared with an average yearly revenue growth of 0.26 percentage points of GDP for IDA countries and an average *negative* revenue growth of 0.04 percentage points of GDP for Fragility, Conflict and Violence (FCV)-affected countries.

It is important to analyze what is driving this growth. As the figure below illustrates, revenue growth in Afghanistan was predominantly driven by an increase in non-tax revenue collection. Core tax collections (tax and customs) also improved considerably, but at a slower rate. The exception was 2017, when core tax collections increased by roughly one percentage point of GDP.

Figure 15: Non-tax revenues have driven revenue growth



Source: Afghanistan Financial Management Data (AFMIS), Ministry of Finance

Fiscal space is critical for development, and domestic revenues are of increasing importance for Afghanistan as it transitions towards self-reliance. The composition of domestic revenues matters, however. There is a minimum threshold of a tax-to-GDP of 15 percent that is associated with higher sustained growth and considered a minimum threshold for a state to function effectively. This threshold refers to tax revenues only and excludes social security contributions and non-tax revenues.

The rationale behind this is that tax revenues are compulsory and unrequited amounts payable to the government, whereas social-security contributions are typically associated with expected future benefits. Non-tax revenues, while contributing to fiscal space, can be less sustainable, in particular when relying on one-offs such as this year's transfers from Da Afghanistan Bank and collection of multi-year arrears from State Owned Enterprises. These non-tax revenues, compared to tax revenues, typically add significant fiscal stress during crises and are sensitive to political interference. Another major component contributing to non-tax revenues in Afghanistan are fees charged on government services, which represent on average 45 percent of non-tax revenue collection over the past five years. While such fees can promote performance and public service delivery, it also risks creating a patchwork of fees and distorting behavior of public agencies—confusing whether their main role is to collect revenue or to provide a service. Imposing fees on essential public services can also lead to under-consumption of those services, with negative social impacts.

At between four and six percent of GDP between 2016 and 2019, non-tax revenues are high compared to other FCV and IDA countries which on average collect 3.5 percent of GDP in non-tax revenues. Moreover, having increased from 22 percent in 2014 to 36 percent of total domestic revenue collected in 2018, non-tax revenues play a relatively more significant role in Afghanistan's tax mix compared to IDA and FCV countries where these revenues represent on average between 17 and 18 percent of total domestic revenue.

In summary, while Afghanistan has made outstanding progress in domestic revenue mobilization over the past five years, the trend of the increasing relative importance of non-tax revenues warrants attention. Afghanistan's next phase of consolidating fiscal space should focus on broadening the tax base and core tax collection, rather than further expanding collections from non-tax revenues.

Notes: International comparisons of revenue performance are based on staff calculations using available data for 2015-2017, drawing on the ICTD/UNU-WIDER, 'Government Revenue Dataset', 2019, <https://www.wider.unu.edu/project/government-revenue-dataset>. IDA supports countries defined as a GNI per capita below \$1,175 (in fiscal year 2020). In addition, it supports selected countries that are above this cutoff but lack creditworthiness to engaging in IBRD borrowing, the other credit facility offered by the World Bank. The World Bank maintains a list 'Fragile Situations'. These countries have either a harmonized average Country Policy and Institutional Assessment (CPIA) country rating of 3.2 or less, or the presence of a UN and/or regional peace-keeping or peace-building mission during the past three years. The significance of the 15 percent of GDP threshold is outlined in Gaspar, V; Jaramillo, L; Wingender, P. 2016. 'Tax Capacity and Growth: Is there a Tipping Point?' IMF Working Paper. WP/16/234. Comparisons of non-tax revenues between country groups are based on staff calculations using available data for 2015-2017, drawing on ICTD/UNU-WIDER, 'Government Revenue Dataset', 2019, <https://www.wider.unu.edu/project/government-revenue-dataset>.

Total expenditures grew modestly

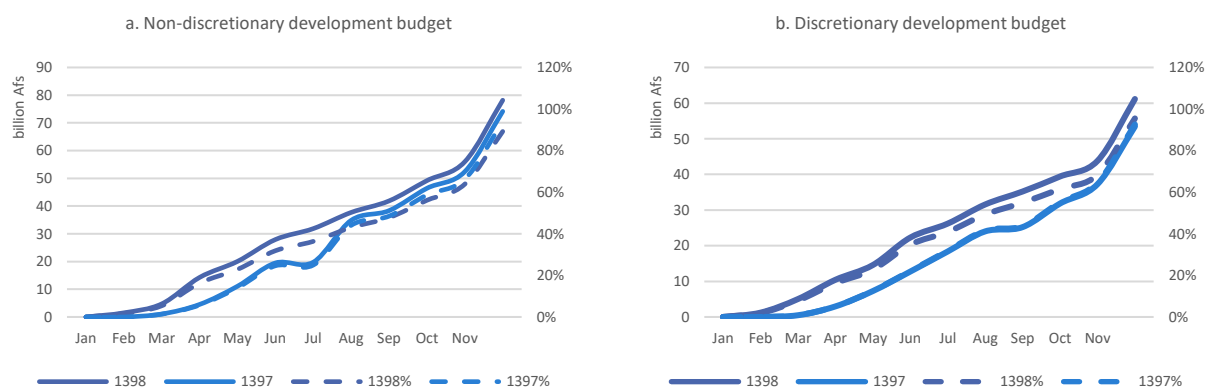
Total expenditures grew by 9.8 percent in 2019. Recurrent expenditures increased from 18.4 percent of GDP in 2018 to 19.1 percent in 2019 resulting in nominal growth of 9.2 percent. Operating expenditures growth was driven by both civilian and security expenditures in 2019. Civilian expenditures increased by around 11.3 percent in nominal terms, increasing from nine to 9.5 percent of GDP. Increase in civilian expenditures was mainly driven by wages and salaries, and social transfers (including pension) increasing by 15 and 17 percent, respectively. Security expenditures grew by 7.2 percent.

Development budget execution rates remained strong around 92 percent. Discretionary development expenditures, supported by high revenue collection and higher grants resulting from currency depreciation, increased by around Afs eight billion in 2019 achieving record high execution rate of 95 percent. Non-discretionary development budget execution reached only 89 percent compared to 94 percent in 2018 reflecting slower progress in implementing donor-financed projects.

The fiscal deficit reached one percent of GDP, financed from cash reserves

The overall fiscal deficit including grants reached Afs 15.9 billion (or 1.1 percent of GDP) in 2019 compared to a surplus of Afs 10.5 billion in 2018. On-budget inflows declined from Afs 209 billion in 2018 to Afs 198 billion in 2019 (14.8 percent of GDP to 13.4 percent of GDP in 2019). While discretionary grants declined by Afs 17 billion, non-discretionary grants increased by around Afs six billion in 2019.

Driven by high security expenditures, overall expenditures in Afghanistan remain at unsustainable levels. Total on-budget expenditures in Afghanistan are around 29 percent of GDP, including on-budget security expenditures of 9.6 percent of GDP. The wide gap between budget expenditures and domestic revenues is being financed through donor grants close to 14 percent of GDP.

Figure 16: Execution of the development budget remained strong in 2019*(Execution rate in percent, and total cumulative expenditures)*

Source: Ministry of Finance data

B. Outlook and Medium-Term Prospects

Growth prospects are subject to security developments and continued international support

Afghanistan's future growth prospects are highly sensitive to the security environment, the level of ongoing international grant support, and the pace of reform progress. Under a baseline scenario, we assume no significant change in the security situation, continued gradual reform progress, and a moderate decline in international grant support.

Under these assumptions, growth is expected to slightly increase to 3.3 percent in 2020 as investment confidence improves and the agriculture sector recovers from drought. Private investment confidence is expected to marginally improve as political uncertainty associated with presidential elections recedes despite no significant changes in the security environment. Government consumption and investment growth is expected to remain sluggish with increased revenue performance partly offset by declining grants.

Grants are expected to decline modestly

Overall grants are expected to gradually decline over the medium term both for on- and off-budget expenditures, from an estimated US\$8.2 billion in 2020 to US\$ 6.9 billion by 2024. Security grants are expected to decline from around US\$ 4.9 billion to US\$4 billion per year. Civilian grants are expected to decline from around US\$ 3.4 billion in 2020 to US\$ 2.7 billion in 2024. The share of grants delivered on-budget is expected to remain roughly constant, at around 30 percent and 40 percent for security and civilian grants respectively.

Expenditures are expected to grow gradually, financed by improved domestic revenues

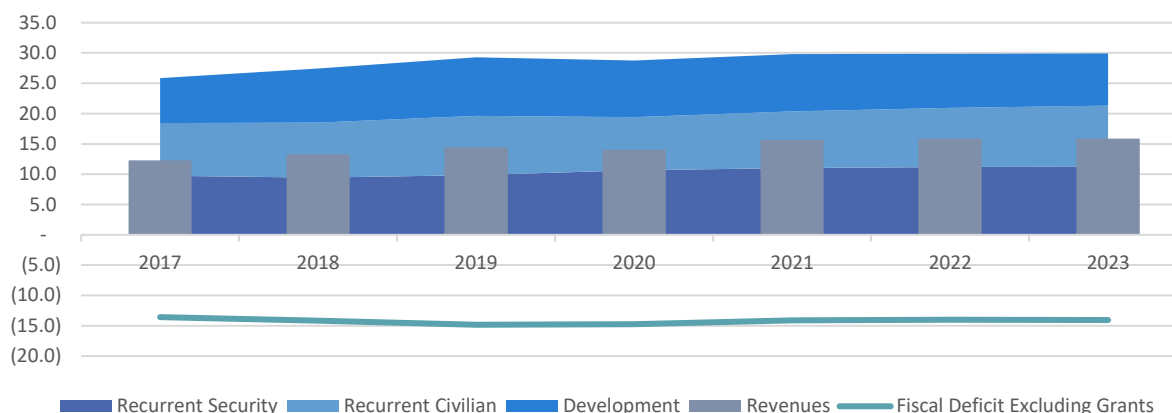
Small overall fiscal deficits, equal to between one and 1.6 percent of GDP, are expected over the medium term. Total domestic revenue collection is expected to gradually increase from 14.1 percent of GDP in 2019 to 15.2 percent in 2023, largely driven by the planned implementation of VAT in 2021. Security sector expenditures are expected to grow from around 9.6 percent of GDP in 2019 to 10.4 percent of GDP by 2023 as government takes on increasing responsibility for security services. Expenditure pressures will see growth in operations and maintenance and social transfer spending. Reflecting declining grants, discretionary development expenditures are expected to gradually decline to three percent of GDP by 2023 from 4.1 percent in 2019.

A small fiscal deficit is projected over the medium-term, financed by domestic sukuk issuance and concessional external borrowing

Small ongoing fiscal deficits are expected to be financed through limited domestic and external concessional borrowing. To mobilize domestic resources for public investment, the government is currently working on developing the legal framework for shariah compliant Sukuks expected to be issued in 2022. Additionally, concessional borrowing from multilateral and bilateral creditors is expected to reach US\$ 230 million per year by 2023, utilized to finance non-discretionary development expenditures.

Afghanistan will continue to rely on grants to finance its development needs. Rapid and significant reduction in grants would force difficult tradeoffs between important policy objectives. Fiscal sustainability, defined as domestic revenue as a share of operating expenditures of government, currently stands at around 74 percent and is expected to increase gradually to 78 percent by 2023.

Figure 17: Budgets will remain highly dependent on aid inflows
(Percent of GDP)



Sources: Ministry of Finance data, World Bank staff projections

Afghanistan's external position is expected to deteriorate over time with a deteriorating trade balance and declining international grants

In 2020, the trade deficit is expected to deteriorate slightly to 31.6 percent of GDP (from 31.4 percent of GDP in 2019). Merchandise exports are expected to continue growing in 2020, reflecting higher agricultural production and increased exports to India through established air-corridors. Merchandise imports are also expected to expand, reflecting general economic recovery. The trade deficit is expected to slightly decline to 30.7 percent of GDP by 2023, as imports continues to outstrip exports. As a result, the current account is expected to gradually deteriorate, exacerbated by declining international grants. The current account deficit is expected to reach around 3.4 percent of GDP by 2023. Over the same period, international reserves are expected to decline to around 11 months of imports.

The outlook is subject to substantial downside risks

The growth outlook is subject to substantial downside risks. Further political instability following recent elections or deterioration of security conditions would undermine any recovery in investment confidence, slowing growth. Current civilian aid pledges expire in 2020. While there is scope for gradual reductions in civilian grant support over the medium-term, precipitous reduction in aid flows would lead to a contraction of government spending, deteriorating access to services and infrastructure, and weakening private sector confidence. Adverse regional economic or political developments could negatively impact Afghanistan through reducing remittance flows, driving increased returnees and displacement, or placing pressure on the local security environment. On the other hand, significant improvements in security conditions following a political settlement with the Taliban could help boost growth and private investment.

In the short-term, continued implementation of business environment reforms can help boost private sector confidence and mobilize investment. At the same time, reform measures to address corruption and strengthen governance can also play an important role in ensuring continued international grant support. For the international community, clear communication regarding future grant levels and the policy and reform conditions under which international assistance will continue to be provided can help reassure the private sector and focus government reform efforts towards shared priorities.

In the medium-term, any substantial improvement in living standards or meaningful progress towards self-reliance depends on mobilizing new sources of growth and

achieving a step-change in economic performance. Medium-term reform efforts should focus on attracting additional investment in the agriculture and extractive sectors, which have the combined potential to deliver increased employment, exports, government revenues, and growth. To ensure that benefits of agriculture and extractives led growth are maximized and widely shared, continued investment is required in human capital, regional connectivity, expanded infrastructure, and an improved business regulatory environment.

	2017	2018	2019	2020	2021	2022	2023
Growth and prices	Actuals			--- staff projections ---			
Real GDP growth (%)	2.7	1.8	2.9	3.3	3.6	4.0	4.1
Nominal GDP (Afs billion)	1,376	1,409	1,482	1,583	1,711	1,864	2,033
CPI Inflation (period average, %)	5.0	0.6	2.3	3.5	4.5	5.0	5.0
Fiscal				percent of GDP			
Revenues and grants	25.3	28.0	27.4	26.3	25.9	25.7	25.6
Domestic Revenues	12.3	13.2	14.1	13.2	14.1	14.6	15.2
Foreign grants	13.0	14.8	13.4	13.1	11.8	11.1	10.4
Total Expenditures	25.9	27.3	28.5	27.8	27.6	26.9	26.7
Recurrent expenditures	18.4	18.4	19.1	19.0	18.8	19.1	19.5
Development expenditures	7.4	8.9	9.4	8.8	8.8	7.8	7.2
Overall balance (excl. grants)	(13.6)	(14.1)	(14.4)	(14.6)	(13.4)	(12.3)	(11.5)
Overall balance (incl. grants)	(0.5)	0.7	(1.1)	(1.5)	(1.6)	(1.2)	(1.1)
Financing	-	-	0.3	1.1	1.0	1.1	1.2
External				percent of GDP			
Trade balance	(33.7)	(32.7)	(31.4)	(31.6)	(31.6)	(31.2)	(30.7)
Current account balance (incl. grants)	2.2	2.7	2.9	2.4	(1.5)	(2.6)	(3.4)

Note: GDP figures for 2018 are WB staff estimate based on available data.

C. Focus Section: International assistance, macroeconomic management, and development outcomes in Afghanistan

1. Introduction

Afghanistan has achieved major gains since 2001

This note outlines some of the major gains that have been achieved in Afghanistan since the US-led intervention in 2001. The analysis is informed by comparisons to development progress and outcomes in other low-income countries over the same period.

Afghanistan remains mired in conflict and faces immense development challenges. However, donor and government programs executed in the context of rapid economic growth and sound macroeconomic management have supported rapid improvements in provision of basic public services and infrastructure over the past two decades. While progress has been uneven and data to assess progress is sometimes limited or unreliable, increased access to services and infrastructure has driven huge development gains, often far outpacing progress achieved in other low-income countries. Against many indicators, Afghanistan is now performing similarly to other countries at its level of incomes, while receiving similar levels of civilian aid. Development gains remain fragile, however, and continued international support will be required to avoid reversal of recent progress.

Section two outlines the extent of international assistance to Afghanistan since 2001. Section three reviews economic performance and overall macroeconomic management. Section four shows how access to services and infrastructure has improved. Section five shows how improved access to services has led to major improvements in development outcomes, including for women. The final section highlights continued weakness in governance and the need for ongoing international support.

2. International Support to Afghanistan

Afghanistan has received substantial international aid support since 2001

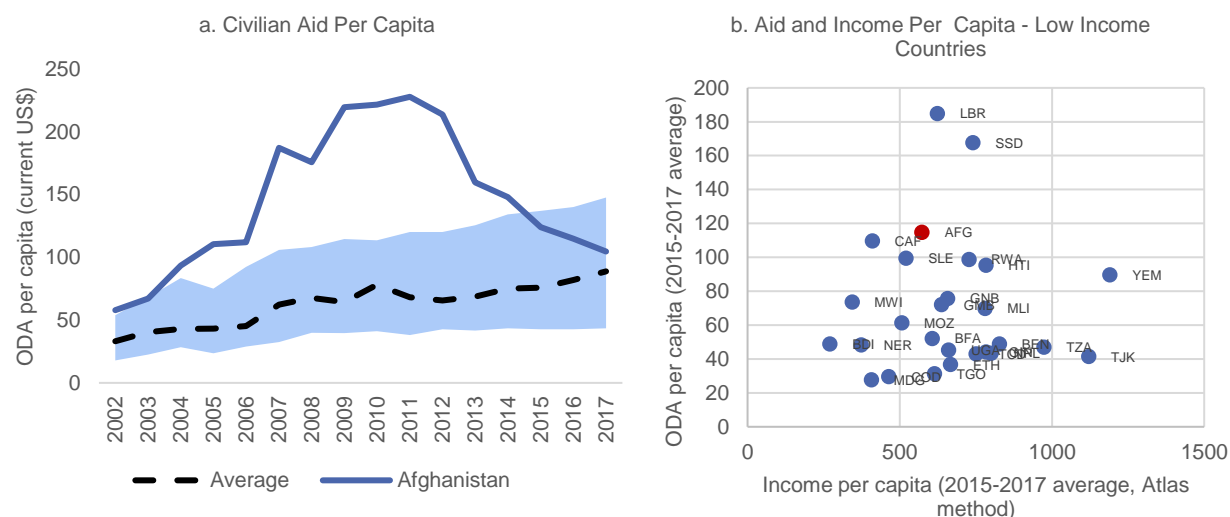
International support to Afghanistan since 2001 has taken several forms, including: i) direct military and counter-terrorism activity by international partners; ii) grant support to Afghanistan security agencies; and iii) civilian aid for development and reconstruction. While data constraints preclude detailed disaggregation, it is clear that civilian aid spending has constituted only a small share of total expenditure by the international community. For example, the Brown University Costs of War project estimates that the US has spent a total of US\$ 2 trillion in Afghanistan since 2001. This compares to total civilian aid spending from all international partners of around US\$70 billion since 2001, according to OECD DAC data.

Aid levels have been very high, but declined substantially over recent years

Relative to other low-income countries, Afghanistan has received very high levels of civilian aid during certain periods since 2001. Per capita civilian aid peaked in 2007 at US\$228. But civilian aid flows have since declined substantially, to around US\$105 in 2017 within the range of aid flows to other low-income countries. Afghanistan is receiving similar per capita civilian aid as several countries with significantly higher

incomes (Yemen, Haiti) and less aid than other countries at similar income levels (Liberia, South Sudan).

Figure 18: Afghanistan has received high levels of civilian aid, but flows have substantially decreased



Sources: OECD DAC, World Bank staff calculations

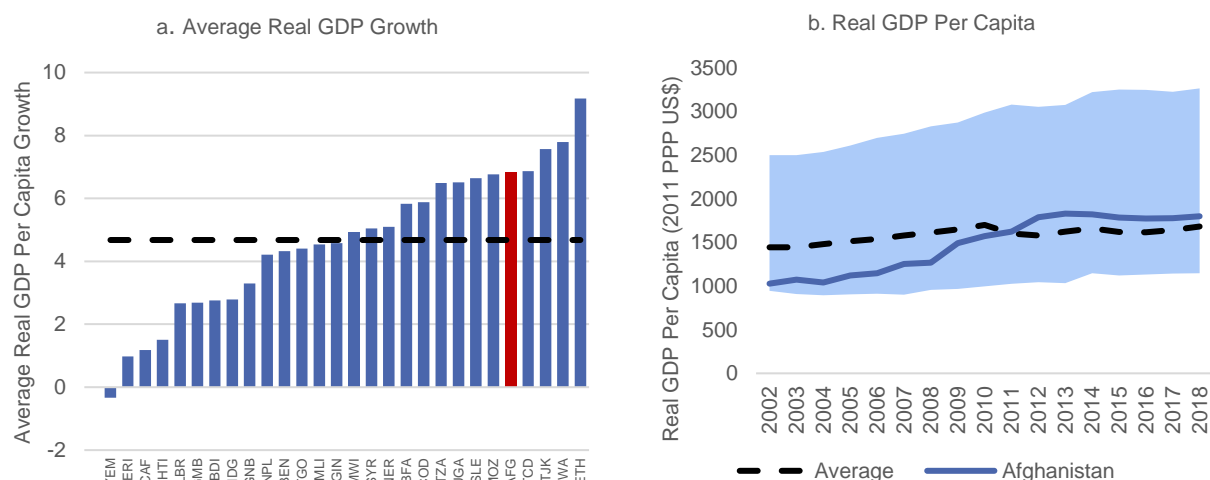
Note: Average is for all low-income countries. Shaded band shows 25th and 75th percentile.

3. Economic development and macroeconomic management

Afghanistan's economy has grown rapidly since 2001, driving much higher incomes

While recent growth rates have been modest, Afghanistan's economy has expanded considerably since 2001. Aid influx has spurred rapid growth in services, while restoration of infrastructure has supported recovery in broader production, especially agriculture. Afghanistan's average annual real GDP growth between 2001 and 2018 was among the fastest across low-income countries (averaging nearly seven percent). Real per capita incomes increased by 75 percent, with income per capita increasing from around 70 percent of the low-income country average to 107 percent of the low-income country average.

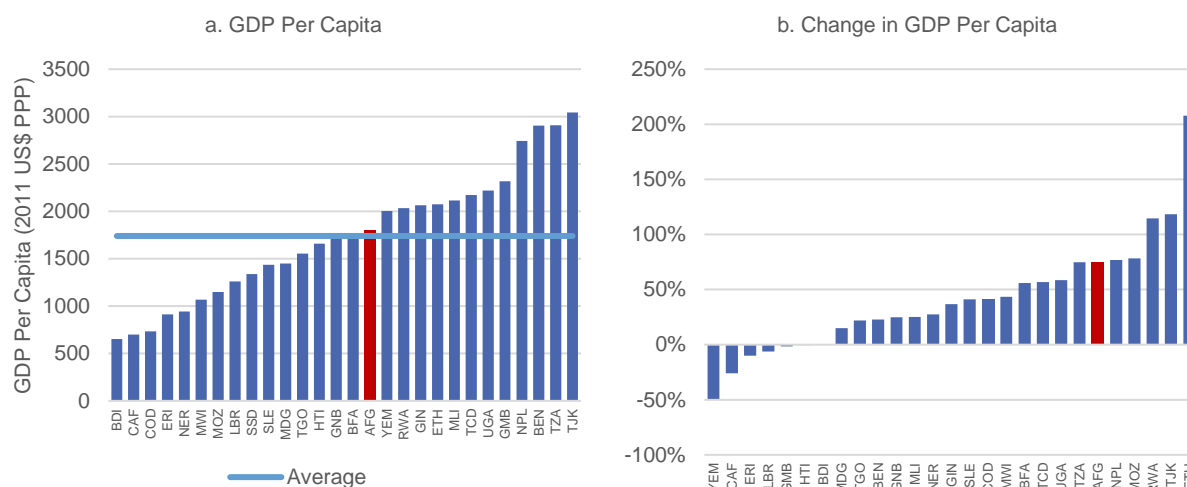
Figure 19: Afghanistan has experienced rapid economic growth, on average, since 2001



Sources: World Development Indicators

Note: Average is for all low-income countries. Shaded band shows 25th and 75th percentile.

Figure 20: Afghanistan's economy has grown faster than other low-income countries, and incomes are now above the low-income country average



Sources: World Development Indicators, World Bank staff calculations

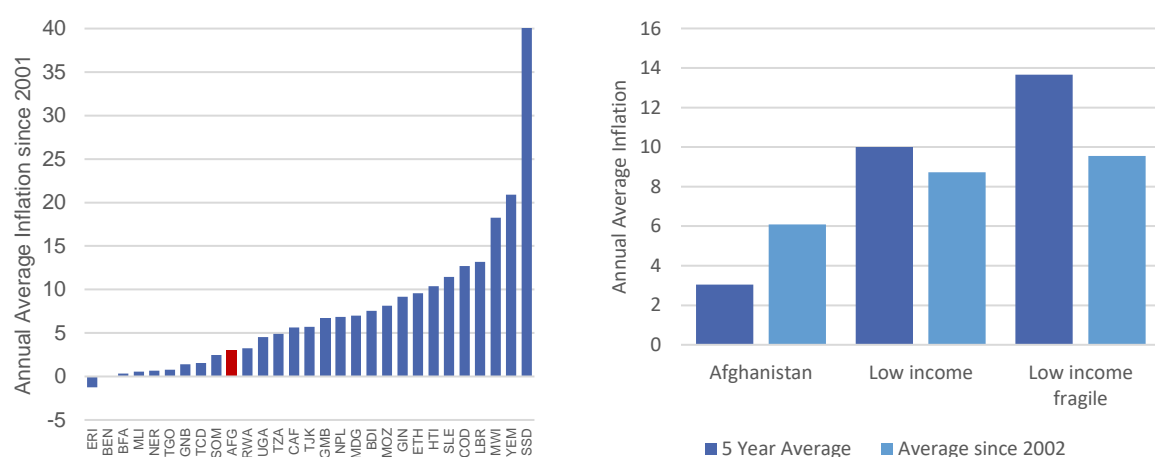
Through sound economic management, inflation has remained relatively low

With sound management of the money supply by Da Afghanistan Bank and the maintenance of overall fiscal discipline by the Ministry of Finance, inflation has remained moderate since 2002. Inflation in Afghanistan has averaged around six percent since 2002, compared to nine percent for low-income countries and around 10 percent of other fragile low-income countries.

Inflation has been particularly low in Afghanistan over the past five years, averaging just three percent, relative to 10 percent for low-income countries and 14 percent for fragile low-income countries.

Figure 21: Inflation has remained relatively low in Afghanistan

Average annual inflation (percent)



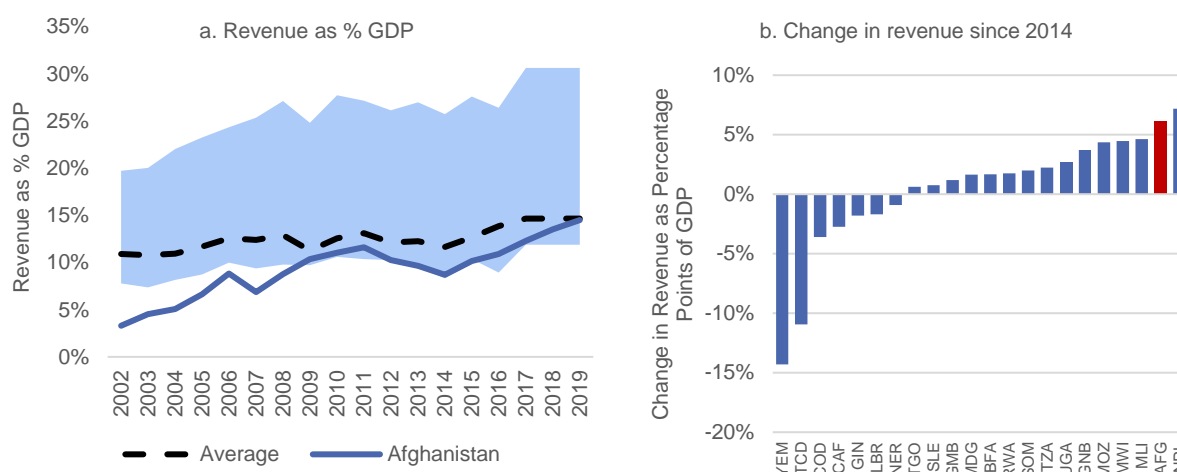
Sources: World Development Indicators

Government revenues have grown very rapidly

Since 2002, Afghanistan has seen remarkable growth in government revenues through the establishment of an effective revenue system. Unlike in many other low-income countries, revenue growth has been driven through taxation of dispersed economic activity, rather than taxation of natural resource projects. Revenues have grown from just three percent of GDP in 2002 to around 14.1 percent of GDP today – equal to the average for low-income countries.

Revenue performance has been especially impressive since 2014, when Afghanistan experienced a revenue collapse during the previous presidential elections. Since 2014, revenues have grown by around six percentage points of GDP. This is the fastest rate of revenue growth for any low-income country over this period, other than Nepal.

Figure 22: Revenues have grown from negligible levels to reach the low-income country average



Sources: ICTD/UNU-WIDER, 'Government Revenue Dataset', 2019, <https://www.wider.unu.edu/project/government-revenue-dataset>

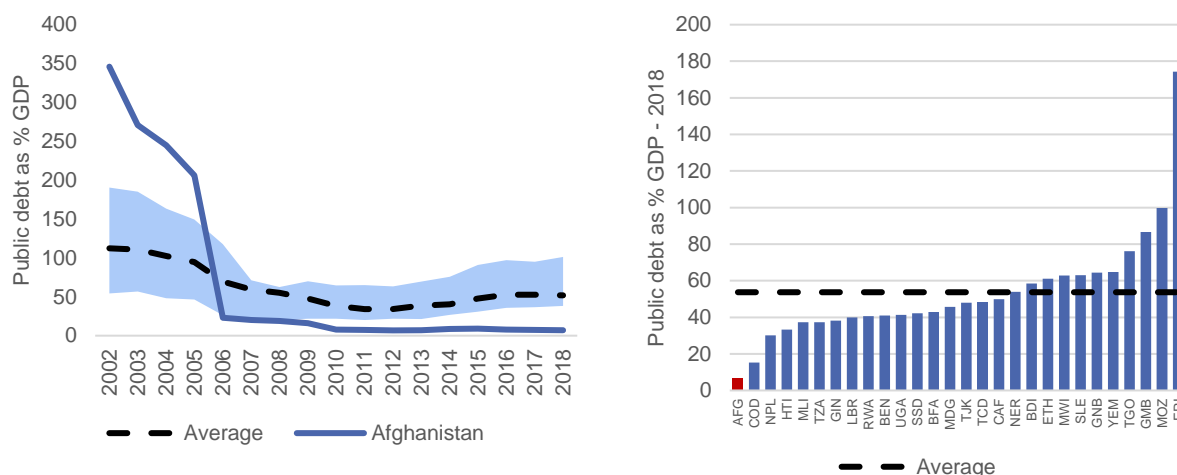
Note: Average is for all low-income countries. Shaded band shows 25th and 75th percentile.

Afghanistan has avoided accumulation of debt

Afghanistan had very high levels of debt at the time of the international intervention. Subsequent debt relief provided by international creditors saw debt levels fall to very low levels from around 2006. Since 2006, through prudent fiscal management and constraining budget deficits, Afghanistan has not accumulated significant debt. Afghanistan now has the lowest level of public debt of any low-income country. Over the past five years, Afghanistan has been one of only five low-income countries not to have experienced an increase in public debt.

Figure 23: Afghanistan has been unusual among low-income countries in avoiding re-accumulation of debt following debt relief in the 2000s

General Government Gross Debt as % GDP



Sources: World Economic Outlook database, World Bank staff calculations

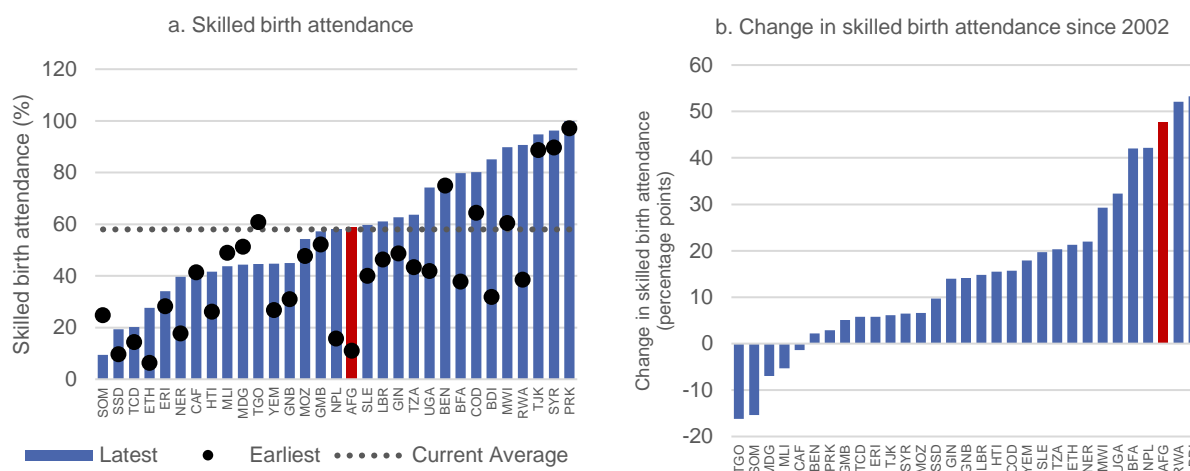
Note: Average is for all low-income countries. Shaded band shows 25th and 75th percentile.

4. Access to services and infrastructure

Access to services and infrastructure has expanded rapidly

Inflows of aid and rapid improvements in government revenues in the context of sound macroeconomic management have allowed enormous progress in delivering services, despite ongoing active conflict.

Access to health services have improved enormously. The proportion of births attended by a skilled medical professional has increased from just 11 percent in 2003 to around 59 percent in 2018. This is among the fastest pace of progress seen across any low-income country. The proportion of women receiving antenatal care has increased from 16 percent to 65 percent. Progress has been especially impressive in rural areas, where skilled birth attendance increased from four percent to 51 percent, while the proportion of women receiving antenatal care increased from eight percent to 61 percent.

Figure 24: There has been a rapid increase in skilled birth attendance

Sources: World Development Indicators, Afghanistan Health Survey (2018)

Note: Change is calculated as the difference between earliest and latest available data-points between 2002-2018. Time periods therefore vary by country.

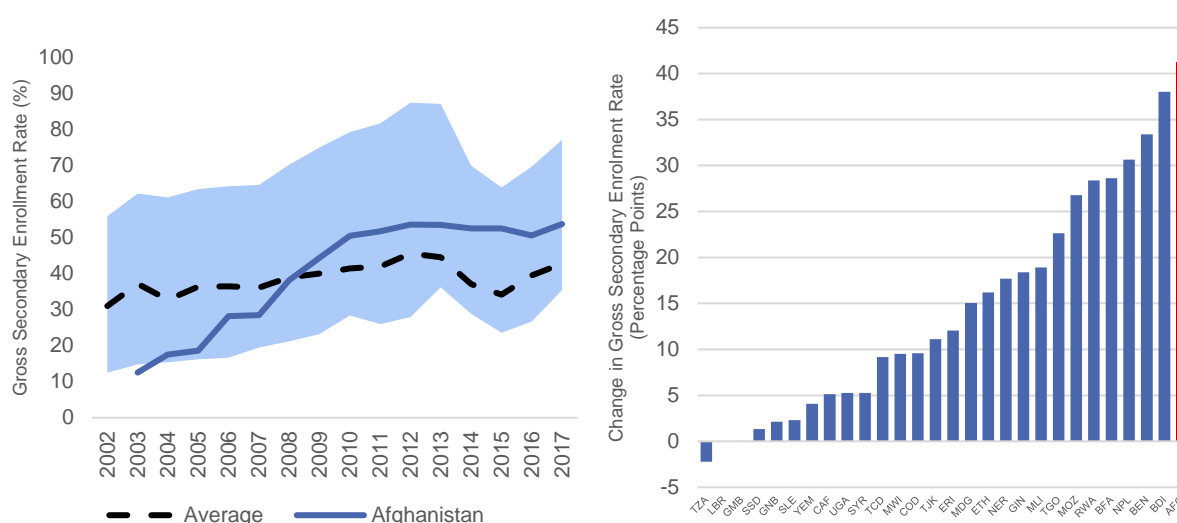
Access to education has also shown enormous improvement

The number of children attending primary and secondary school has grown rapidly since 2001. By 2016, the number of children enrolled in school was 9.2 million, up from around one million in 2001.³ Progress with improved access to secondary education has been particularly impressive. Around 1.7 million children and youth are now attending lower secondary school and 0.9 million attending upper secondary school. The secondary gross enrolment rate has increased from around 13 percent in 2003 to around 54 percent today, well above the low-income country average. This represents one of the fastest rates of increase in secondary enrolment rates seen in any low-income country.

Enrolment rates do not necessarily accurately reflect actual school attendance, as not all enrolled students attend school. Data on school attendance, however, also shows similar positive trends. Between 2007 and 2017, the net secondary attendance rate increased from 26 percent to 35 percent. Average years of schooling increased from 2.0 years to 3.1 years over the same period.⁴

³ World Bank (2018) Promoting Education During Times of Increased Fragility, World Bank, Washington DC.

⁴ Afghanistan Living Condition Surveys (2008, 2012, 2014, 2017).

Figure 25: Secondary enrolment rates have grown faster than in any other low-income country since 2001

Sources: World Development Indicators, UIS, World Bank staff calculations

Note: Average is for all low-income countries. Shaded band shows 25th and 75th percentile. Change is calculated as the difference between earliest and latest available data-points between 2002-2018. Time periods therefore vary by country.

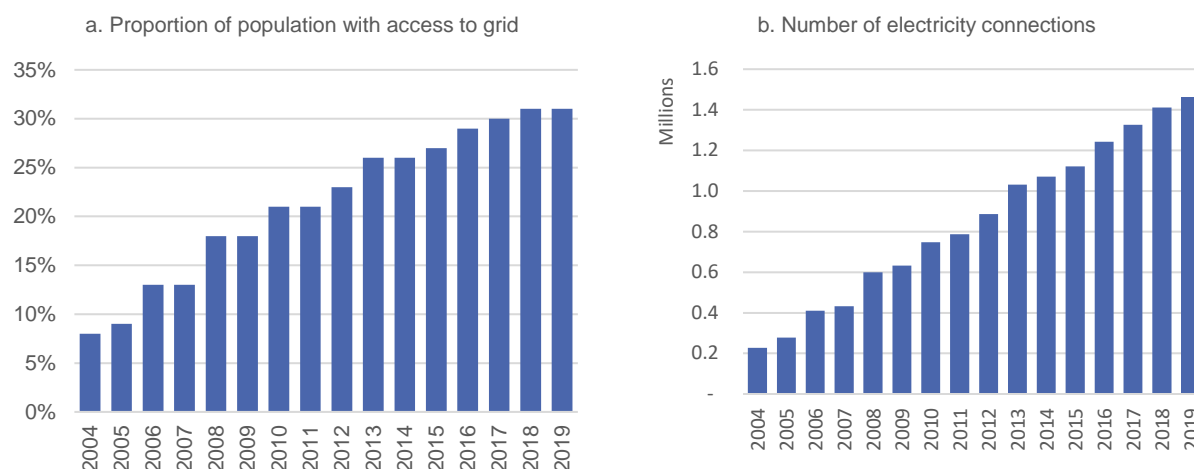
Access to basic infrastructure has also increased

Donor and government investment in infrastructure has also supported rapid improvements in access to basic services. Infrastructure expansion has also been supported by the establishment of conditions broadly conducive to private sector investment, for example in the telecommunications and solar energy sectors.

The proportion of Afghans with access to electricity has increased rapidly. The number of grid electricity connections has increased from around 228,000 in 2004 to 1.5 million in 2019. The proportions of Afghans with access to grid electricity has increased from around eight percent to around 31 percent between 2004 and 2019. In addition, around 60 percent of Afghans have access to electricity generated from off-grid solar units.⁵

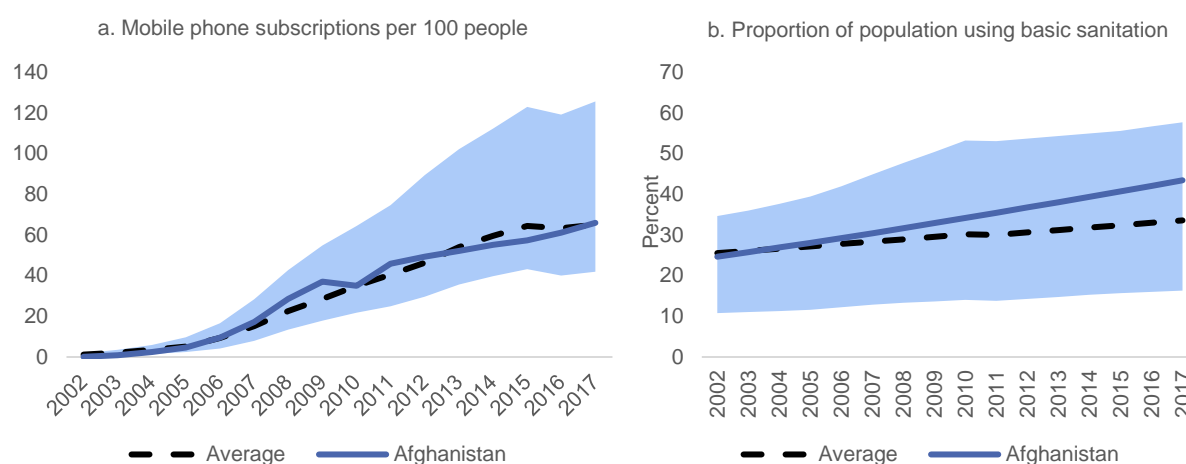
The proportion of Afghans with access to sanitation has increased from 25 percent to 43 percent, well above the low-income country average. Access to mobile phones has kept pace with the massive growth seen across the developing world, with the number of subscriptions increasing from just 0.1 per 100 Afghans in 2002 (about one-tenth of the low-income country average) to 66 per 100 Afghans in 2017 (equal to the low-income country average).

⁵ DABS connections data, ALCS 2016/17 data

Figure 26: Access to electricity has increased rapidly, including through expansion of grid connections

Sources: DABS data, DHS (2015), World Bank staff calculations

Note: Electrification rate is calculated using an assumed household size of eight people.

Figure 27: Access to other basic infrastructure has also increased rapidly

Sources: World Development Indicators, ALCS (2017)

5. Development outcomes

Development outcomes have improved rapidly, but much remains to be done

While poverty remains at unacceptably high levels, expansion in the provision of basic services and infrastructure in the context of a growing economy has driven rapid improvements in development outcomes since 2001. From lagging far behind, Afghanistan has caught up with other low-income countries against key metrics.

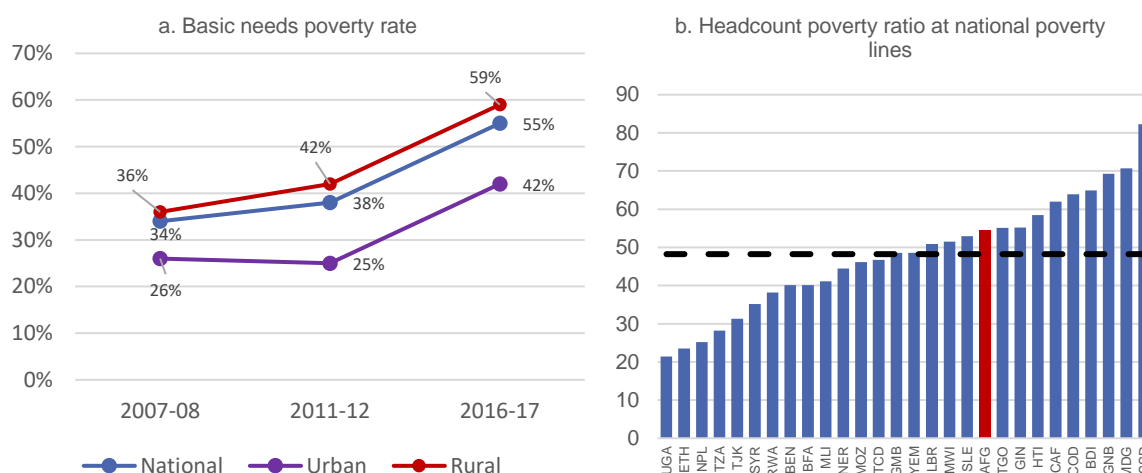
Poverty trends since around 2007 have deteriorated, from 34 percent in 2007-2008 to around 55 percent in 2016-2017, based on the national poverty line. Food insecurity and employment outcomes have also deteriorated, especially in rural areas. There is limited data with which to analyze trends in poverty before 2007, but it seems likely that rapid economic growth and increases in per capita income led to significant poverty reduction over that period. Rapidly increased poverty since 2011-2012 has taken place against the background of slowing economic growth and declining per-

capita incomes, reflecting the impacts of deteriorating security conditions, declining aid flows, political instability, and climate change.

Full data is not available to accurately compare poverty rates between Afghanistan and other countries using absolute international poverty lines. The rate of poverty in Afghanistan is similar to other low-income countries when using national poverty lines (which vary by country and are therefore not strictly comparable).

Figure 28: Poverty is unacceptably high, and has recently increased

Basic needs poverty as percent of population



Sources: World Development Indicators, NRVA 2007-08, 2011-12 and ALCS 2016-17

Health and education outcomes have rapidly improved

Improved health services, including maternal and child care, has led to a rapid decline in maternal, infant, and child mortality.⁶ Maternal mortality rates declined from 1,100 to 396 deaths per 100,000 live births between 2000 and 2015.⁷ The under-five child mortality rate has declined from 191 per 1,000 live births in 2007 to 49 per 1,000 live births in 2018.⁸ No other country has achieved such rapid progress in reducing child mortality over this period, with the number of deaths per 1,000 live births declining by 142 between 2007 and 2018.

Expansion in access to education has seen rapid improvement in literacy rates. The adult literacy rate has increased from around 32 percent in 2011 (when earliest data is available) to 43 percent in 2018. The youth literacy rate has increased from 47 percent to 65 percent over the same period. While the adult literacy rate remains below the average for Low Income Countries (55 percent), Afghanistan has seen very rapid improvement, at a faster pace than achieved by most low-income countries over the same period.

Reduced child mortality and increased access to education has driven rapid reductions in fertility rates. The total number of births per woman has fallen from 7.3 to 4.6

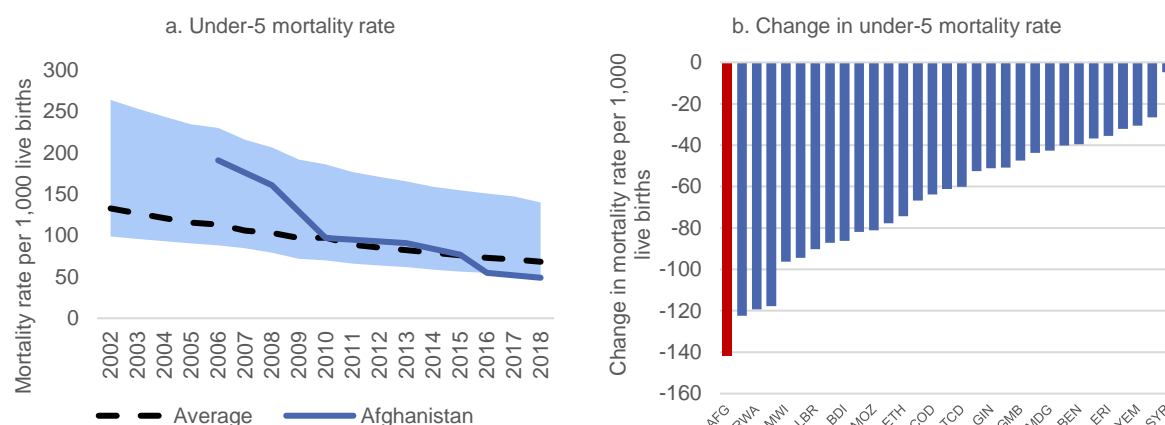
⁶ Statistics for some health indicators vary by source, reflecting weaknesses in data collection and different methodologies. Most indicators, however, show significant trends of improvement across all sources.

⁷ World Bank (2018) Progress in the Face of Insecurity: Improving Health Outcomes in Afghanistan, World Bank, Washington DC.

⁸ AHS (2006, 2015, 2018), NRVA (2008, 2013), AMS (2010), DHS (2015-2016)

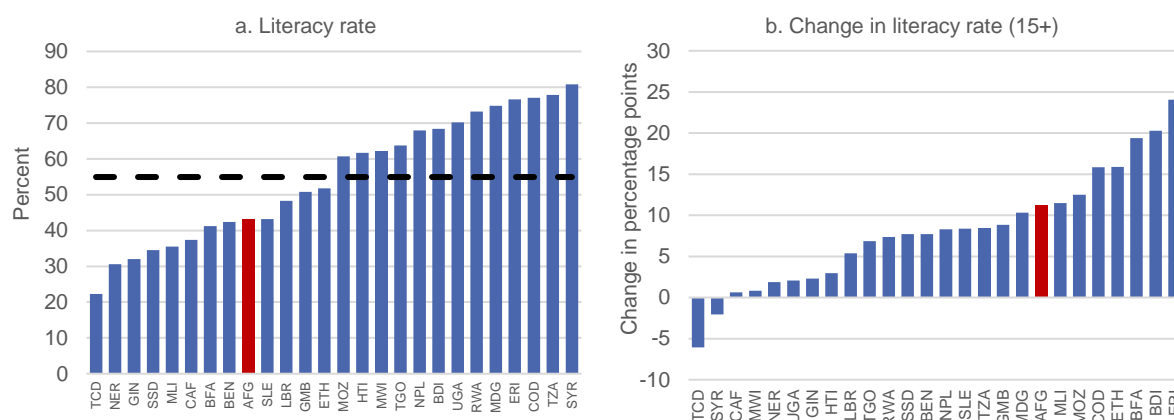
between 2002 and 2017.⁹ The adolescent fertility rate has also declined from 146 births per 1,000 women between the ages of 15-19 in 2002 to 69 in 2017 – a decline of around 52 percent. Afghanistan's total fertility rate is now around the average for low-income countries, and it has achieved the fastest reduction in fertility rates for any low-income country over the period.

Figure 29: Child mortality has declined in Afghanistan faster than in any other low-income country



Sources: World Development Indicators, AHS (2006, 2015, 2018), NRVA (2008, 2013), AMS (2010), DHS (2015-2016)

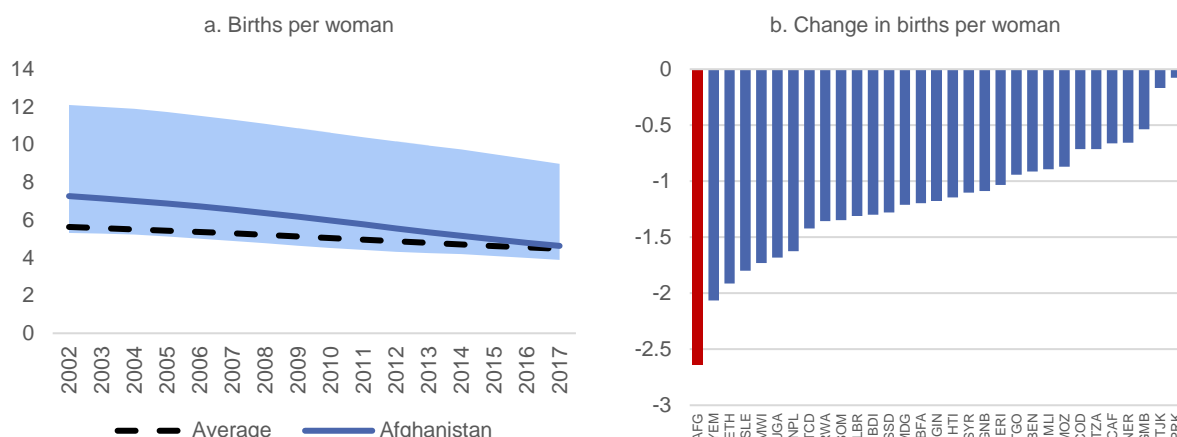
Figure 30: Literacy rates have rapidly increased



Sources: World Development Indicators, World Bank staff calculations

Note: Change is calculated as the difference between earliest and latest available data-points between 2002-2018. Time periods therefore vary by country.

⁹ World Development Indicators

Figure 31: Fertility rates have rapidly decreased

Sources: World Development Indicators, World Bank staff calculations

Note: Change is calculated as the difference between earliest and latest available data-points between 2002-2018. Time periods therefore vary by country.

Outcomes have improved for women

While women and girls continue to face major and unacceptable disadvantages in Afghanistan, important gains have been achieved. There is no significant difference by gender in measures of healthcare access, such as immunization rates.

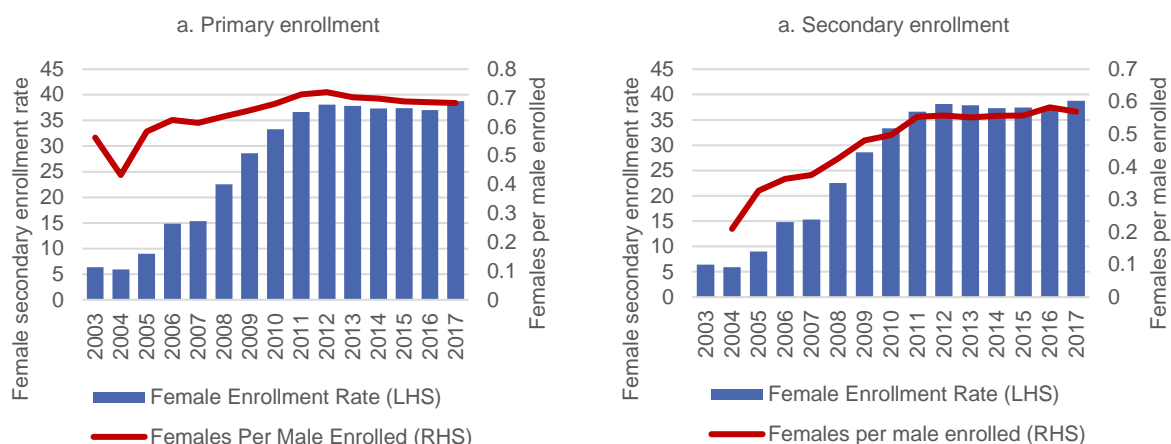
Important gaps in education access remain. But, until recently, enrollment rates for girls were increasing more rapidly than for boys, substantially reducing the gap in access to education. While the female secondary enrolment rate increased from around six percent in 2003 to 39 percent in 2017, the ratio of females per male enrolled in secondary education increased from 0.2 to 0.6. Attendance statistics show a similar positive trajectory, with the ratio of females per male attending secondary education increasing from 0.4 to 0.5 since 2007.¹⁰

Women are also increasingly represented in the public service and politics. Approximately 21 percent of all civil servants are now women, up from negligible numbers in 2001. Around sixteen percent of civil servants in the senior management group level are female (grades one and two).¹¹ Afghanistan now has strong women's representation in politics, from zero representation in 2001. Around 27 percent of parliamentary seats are held by women, higher than the average for low-income countries.

¹⁰ ALCS data (2008, 2017)

¹¹ NSIA Statistical Yearbook 2019

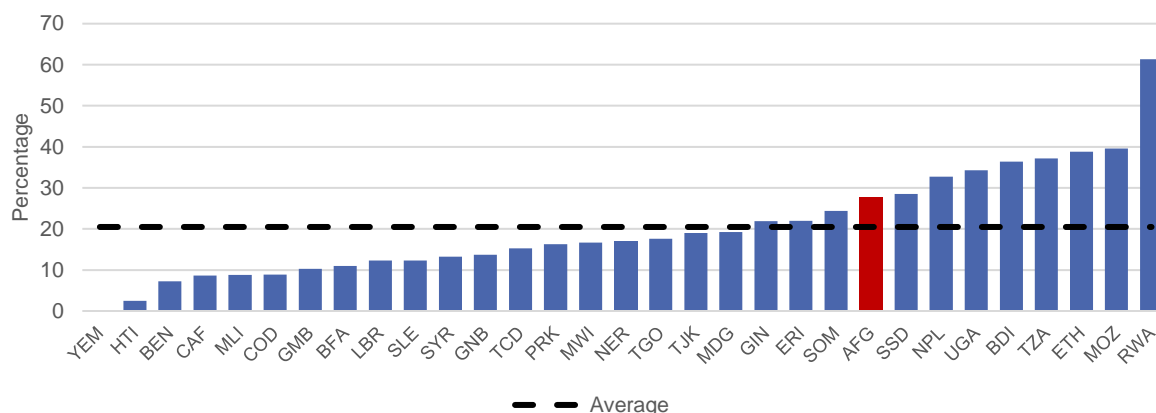
Figure 32: Females have increased access to education



Sources: World Development Indicators, World Bank staff calculations

Figure 33: Women have radically improved political representation

Percentage of seats held by women in parliament



Sources: World Development Indicators, World Bank staff calculations

6. Challenges

Afghanistan continues to face major challenges in governance

While overall macroeconomic management has been sound and development outcomes have generally improved, Afghanistan continues to face major challenges of governance. Institutions remain weak and corruption is widespread, feeding into grievances that drive conflict.

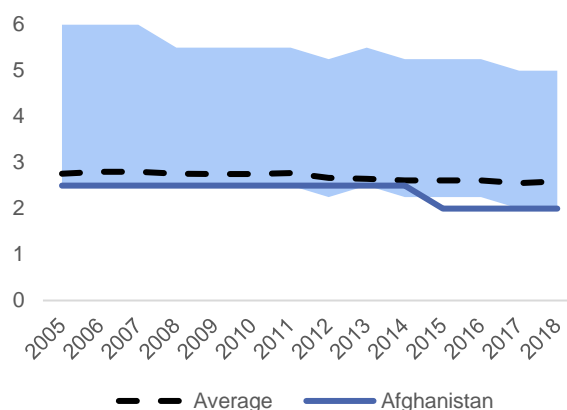
It is difficult to accurately measure the strength of institutions and governance. However, available data suggests that Afghanistan continues to perform poorly relative to other low-income countries, with little progress over time. The World Bank Country Policy and Institutional Assessments (CPIA) measure the quality of policies and institutions in all developing countries based on assessments by country experts drawing on a wide range of third-party data-sources. CPIA scores for Afghanistan against 'protection of property rights and rule-based governance' and 'transparency, accountability, and corruption in the public sector' show poor performance against other low-income countries and a deterioration in performance since 2005.

These findings are consistent with survey evidence showing increased prevalence of and concern about corruption. In the latest 2019 Asia Foundation Survey of the Afghan People, 97 percent of respondents believed that corruption was a problem for Afghanistan (up from 94 percent in 2006) and 91 percent believed that corruption was a problem in daily life (up from 73 percent in 2006).

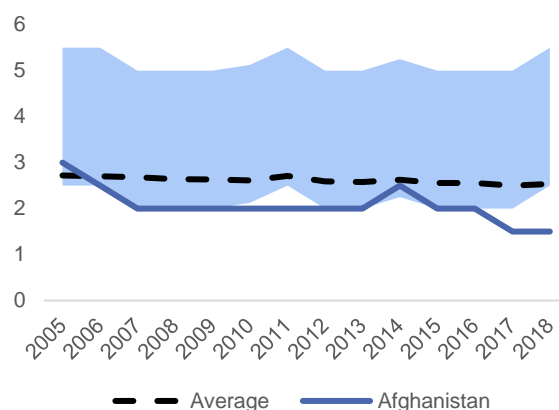
Figure 34: Governance remains weak

CPLA scores (0-6, higher = better)

a. Protection of property rights and rule-based governance



b. Transparency, accountability, and corruption in the public sector



Sources: World Development Indicators, World Bank staff calculations

Gains remain fragile

Many development indicators have shown deterioration since 2012, reflecting economic slow-down, increasing insecurity, periods of political instability, and the impacts of negative weather shocks related to climate change. Poverty rates have increased, employment outcomes have deteriorated, and there has been some reversal of gains in access to services, with the widening of gender gaps.

Self-reliance remains a long-term goal

While levels of civilian aid have recently declined, Afghanistan remains heavily reliant on international grant support. Grants continue to finance around 75 percent of total public expenditure and nearly 90 percent of security expenditure. Grants finance nearly half of the government budget. Further modest increases in tax revenues are possible through improvements in policy and administration. But tax revenues are now close to the average for low-income countries, and substantial additional revenue expansion will only come with accelerated economic growth over the medium-term.

Continued grant support is needed...

The development gains that Afghanistan has achieved over recent years will therefore only be sustained if reductions in grant support are gradual and carefully calibrated. A precipitous reduction in civilian grants would undermine the capacity of government to sustain service delivery, leading to deteriorations in education, health, and well-being. Rapid reductions in security grants would lead to either a decline in security sector capabilities or a deterioration in development outcomes. Without revenue growth, Government can only take on a larger share of security spending by squeezing out spending on services.

In order to maintain the confidence of the international community and provision of international grant support, Government needs to take decisive action to address

...but will depend on improvements in governance.

corruption and improve governance. Efforts should be taken in partnership between Government and the international community to: i) identify specific and measurable goals for anti-corruption and institutional strengthening that represent shared priorities; and ii) mobilize coordinated efforts to achieve those goals, drawing on international assistance as needed.

7. Conclusions

Much needs to be done, but much has been achieved

The international community has invested heavily in Afghanistan since 2001. A relatively small proportion of this investment has been in civilian aid for reconstruction and development. During certain periods, civilian aid to Afghanistan has been very high, but flows have recently declined to levels comparable with other low-income countries. Afghanistan's heavy aid dependence is now driven primarily by high security grants.

Strong macroeconomic management by government has established an enabling environment for improved development outcomes. Economic growth has been rapid, supporting rapid growth in incomes. Government policy has ensured that inflation has remained moderate, deficits have been limited, and public revenues have grown rapidly.

While progress against development outcomes has been uneven and often slower than expected or desired, important gains have been achieved. While poverty remains high and has recently increased, it is likely that incomes remain much higher than they were in 2001. Expanded access to health, education, and infrastructure has seen rapid improvements in outcomes, with Afghanistan catching up with other low-income countries against key development indicators. The position of women has improved, including through improved access to education and representation within the civil service and politics.

Nevertheless, these gains remain fragile. Many access and outcome indicators have shown deterioration since 2012, with deteriorating security conditions, declining aid inflows, and economic slow-down. Governance remains weak, and Afghanistan remains heavily reliant on grants.

In this context, international support must continue. A precipitous reduction in civilian grants will undermine the capacity of government to sustain the delivery of services that have substantially improved the education, health, and well-being of Afghans since 2001. Rapid reductions in security grants would lead to either a decline in security sector capabilities or a deterioration in development outcomes as security spending squeezes out spending on service delivery.

In order to maintain the confidence of the international community and continued provision of international grant support, Government needs to take decisive action to address corruption and improve governance. Efforts should be taken in partnership between Government and the international community to: i) identify specific and measurable goals for anti-corruption and institutional strengthening that represent shared priorities; and ii) mobilize coordinated efforts to achieve those goals, drawing on international assistance as needed.

Appendix Table 1: Macroeconomic Indicators

	2017	2018	2019	2020	2021	2022	2023
			est.	proj.	proj.	proj.	proj.
Output/Income							
Nominal GDP (billion Afs)	1,376	1,409	1,482	1,583	1,711	1,864	2,033
Nominal GDP (billion USD)	20.2	19.5	19.1	19.4	20.0	20.7	21.6
GDP Per Capita	556.3	524.2	502.0	499.0	501.8	509.1	517.0
Population (million)	36.3	37.2	38.0	38.9	39.8	40.8	41.7
Real Economy							
Real GDP Growth	2.7	1.8	2.9	3.3	3.6	4.0	4.1
Agriculture	3.8	0.8	7.5	5.0	4.5	4.5	5.0
Industry	0.4	2.5	2.0	2.5	3.0	4.0	4.0
Services	2.5	1.8	1.8	3.0	3.5	4.0	4.0
GDP Composition (% of GDP)							
Agriculture	18.6	18.4	19.2	19.5	19.7	19.8	20.0
Industry	24.0	24.1	23.9	23.7	23.6	23.6	23.6
Services	53.1	53.0	52.5	52.3	52.3	52.3	52.3
Prices (12 month % Change)							
CPI Inflation (period average)	5.0	0.6	2.3	3.5	4.5	5.0	5.0
CPI Inflation (end-period)	3.1	0.8	2.4	4.7	5.1	5.0	5.0
Core Inflation (Excl. fuel and cereals)	3.4	-0.9	3.0	5.3	5.8	5.0	5.0
Fiscal (% GDP)							
Total Revenue and Grants	52.7	57.5	56.7	55.1	51.4	49.5	47.9
Domestic revenues	12.3	13.2	14.1	13.2	14.1	14.6	15.2
Grants	40.4	44.3	42.7	41.9	37.3	34.9	32.6
Security grants	23.0	25.0	24.3	24.3	22.3	20.9	20.1
On-budget	5.5	6.0	5.4	5.8	5.8	5.5	5.3
Off-budget	17.4	19.0	18.9	18.5	16.5	15.4	14.8
Civilian grants	17.4	19.3	18.4	17.6	15.0	14.0	12.5
On-budget	7.5	8.8	8.0	7.3	6.0	5.6	5.1
Off-budget	9.9	10.5	10.5	10.3	9.0	8.4	7.4
Total expenditures	51.7	55.6	57.7	55.3	53.4	51.6	49.8
Security spending	25.7	27.2	28.3	27.3	27.0	26.6	26.1
On-budget security	9.7	9.4	9.6	10.0	10.1	10.3	10.4
Off-budget security	17.4	19.0	18.9	18.5	16.5	15.4	14.8
Civilian spending	26.0	28.4	29.4	28.1	26.5	25.0	23.7
On-budget civilian	16.1	17.9	18.9	17.8	17.4	16.6	16.3
Off-budget civilian	9.9	10.5	10.5	10.3	9.0	8.4	7.4
Budget balance	-0.5	0.7	-1.1	-1.5	-1.6	-1.2	-1.1
Budget balance excl. grants	-13.6	-14.1	-14.4	-14.6	-13.4	-12.3	-11.5
External Sector							
Total trade balance (% GDP)	(33.7)	(32.7)	(31.4)	(31.6)	(31.6)	(31.2)	(30.7)
Exports of goods (million US\$)	784	875	826	909	1,000	1,120	1,288
Imports of goods (million US\$)	6,737	6,596	6,161	6,362	6,588	6,849	7,128
Service trade balance (million USD\$)	(850)	(653)	(671)	(695)	(724)	(752)	(775)
Net current transfers (% GDP)*	45.7	47.9	46.4	46.0	40.4	38.3	36.4
Current account balance (% GDP)**	2.2	2.7	2.9	2.4	(1.5)	(2.6)	(3.4)
Financial account balance (% GDP)	0.6	(1.9)	(0.4)	0.0	0.9	1.6	2.2
Foreign exchange reserves (million US\$)	8,053	8,206	8,701	9,174	9,060	8,845	8,588
Gross foreign exch. res. (months of merchandise imports)	12	13	13	14	13	12	11
External debt (million US\$)	1,258	1,213	1,322	1,498	1,662	1,846	2,032
Exchange rate (Af/US\$, period average)	68.1	72.3	77.6
Exchange rate (Af/US\$, end-period)	69.5	75.0	77.5
Monetary and Financial Statistics							
Broad money (M2, billion Afs)	473.8	486.0	500.1	516.5	534.8	556.0	578.7
Total deposits (% GDP)	18.4	18.9	18.8	18.5	18.0	17.4	16.7
Total deposits (billion Afs)	253.3	266.1	279.4	293.4	308.1	323.5	339.6
Share of dollar deposits (%)	62.3	64.0	64.0	64.0	63.4	62.2	61.0
Credit to private sector, commercial banks (billion Afs)	47.7	45.7	47.0	48.6	50.3	52.3	54.4
Loan-to-deposit ratio (%)	19	18	17	17	17	16	16

Note: GDP figures for 2018 are WB staff estimate based on available data.

* World bank's estimate of international grants

** Adjusted for the World Bank's estimates on the imports associated with in-kind transfers, off-budget grant flows and other international transactions that are currently captured by the errors and omissions under the official BoP statistics

Appendix Table 2: Selected Fiscal Indicators

	2017	2018	2019	2020	2021	2022	2023
			est.	proj.	proj.	proj.	proj.
<i>in billion Afghanis unless otherwise stated</i>							
Domestic revenues	169.1	186.3	208.5	209.0	241.7	272.7	309.6
Tax revenues	75.9	83.5	84.0	91.0	112.7	132.2	155.6
Customs duty and fees	35.7	35.2	36.0	40.0	45.0	49.5	55.0
Nontax revenues	57.4	67.6	88.5	78.0	84.0	91.0	99.0
Donor grants	179.2	208.9	197.9	207.1	202.1	206.2	211.5
Discretionary grants	119.0	136.8	119.8	131.5	136.3	141.5	146.7
Nondiscretionary grants	60.2	72.1	78.2	75.6	65.7	64.6	64.8
Total expenditures	355.7	384.7	422.3	440.0	471.5	502.0	542.9
Recurrent expenditures	253.6	259.2	283.0	300.8	321.7	356.9	395.5
Security	133.9	132.3	141.7	158.9	173.0	192.0	211.5
Civilian	119.7	126.9	141.2	141.9	148.7	164.9	184.0
Wages and salaries	63.0	68.1	78.3	79.0	89.0	96.9	109.8
Operations and maintenance	29.1	25.0	24.3	23.3	25.0	28.0	30.5
Capital expenditure	2.8	3.2	2.9	2.0	4.0	5.6	6.1
Social transfers	23.0	28.5	33.5	35.0	30.0	33.6	36.6
Interest payments	1.8	2.0	2.2	0.7	0.7	0.8	1.0
Discretionary development	42.0	53.4	61.1	63.6	67.0	60.8	60.8
Nondiscretionary development	60.2	72.1	78.2	75.6	82.8	84.2	86.6
Discretionary balance	(7.5)	10.5	(15.9)	(24.0)	(10.7)	(3.5)	0.0
Overall balance	(7.5)	10.5	(15.9)	(24.0)	(27.7)	(23.1)	(21.9)
Financing	-	-	4.2	17.3	17.0	20.8	23.7
Debt	-	-	4.2	17.3	17.0	20.8	23.7
Domestic	-	-	(7.1)	(0.0)	0.0	1.2	1.8
External	-	-	11.3	17.3	17.0	19.6	21.9
<i>Changes in reserves</i>	(7.5)	10.5	(11.7)	(6.7)	(10.7)	(2.3)	1.8
Overall balance excluding grants	(186.7)	(198.4)	(213.8)	(231.0)	(229.8)	(229.2)	(233.3)
Revenues to recurrent spending ratio (%)	67	72	74	69	75	76	78

Appendix Table 3: Selected Fiscal Indicators

	2017	2018	2019	2020	2021	2022	2023
			<i>est.</i>	<i>proj.</i>	<i>proj.</i>	<i>proj.</i>	<i>proj.</i>
<i>in percent of GDP unless otherwise stated</i>							
Domestic revenues	12.3	13.2	14.1	13.2	14.1	14.6	15.2
Tax revenues	5.5	5.9	5.7	5.7	6.6	7.1	7.7
Customs duty and fees	2.6	2.5	2.4	2.5	2.6	2.7	2.7
Nontax revenues	4.2	4.8	6.0	4.9	4.9	4.9	4.9
Donor grants	13.0	14.8	13.4	13.1	11.8	11.1	10.4
Discretionary grants	8.6	9.7	8.1	8.3	8.0	7.6	7.2
Nondiscretionary grants	4.4	5.1	5.3	4.8	3.8	3.5	3.2
Total expenditures	25.9	27.3	28.5	27.8	27.6	26.9	26.7
Recurrent expenditures	18.4	18.4	19.1	19.0	18.8	19.1	19.5
Security	9.7	9.4	9.6	10.0	10.1	10.3	10.4
Civilian	8.7	9.0	9.5	9.0	8.7	8.8	9.1
Wages and salaries	4.6	4.8	5.3	5.0	5.2	5.2	5.4
Operations and maintenance	2.1	1.8	1.6	1.5	1.5	1.5	1.5
Capital expenditure	0.2	0.2	0.2	0.1	0.2	0.3	0.3
Social transfers	1.7	2.0	2.3	2.2	1.8	1.8	1.8
Interest payments	0.1	0.1	0.1	0.0	0.0	0.0	0.1
Discretionary development	3.0	3.8	4.1	4.0	3.9	3.3	3.0
Nondiscretionary development	4.4	5.1	5.3	4.8	4.8	4.5	4.3
Discretionary balance	(0.5)	0.7	(1.1)	(1.5)	(0.6)	(0.2)	0.0
Overall balance	(0.5)	0.7	(1.1)	(1.5)	(1.6)	(1.2)	(1.1)
Financing	-	-	0.3	1.1	1.0	1.1	1.2
Debt	-	-	0.3	1.1	1.0	1.1	1.2
Domestic	-	-	(0.5)	(0.0)	0.0	0.1	0.1
External	-	-	0.8	1.1	1.0	1.1	1.1
<i>Changes in reserves</i>	<i>(0.5)</i>	<i>0.7</i>	<i>(0.8)</i>	<i>(0.4)</i>	<i>(0.6)</i>	<i>(0.1)</i>	<i>0.1</i>
Overall balance excluding grants	(13.6)	(14.1)	(14.4)	(14.6)	(13.4)	(12.3)	(11.5)
Revenues to recurrent spending ratio (%)	67	72	74	69	75	76	78

Appendix Table 4: Selected Fiscal Indicators

	2017	2018	2019	2020	2021	2022	2023
			<i>est.</i>	<i>proj.</i>	<i>proj.</i>	<i>proj.</i>	<i>proj.</i>
<i>in billion USD unless otherwise stated</i>							
Domestic revenues	2.5	2.6	2.7	2.6	2.8	3.0	3.3
Tax revenues	1.1	1.2	1.1	1.1	1.3	1.5	1.6
Customs duty and fees	0.5	0.5	0.5	0.5	0.5	0.6	0.6
Nontax revenues	0.8	0.9	1.1	1.0	1.0	1.0	1.0
Donor grants	2.6	2.9	2.5	2.5	2.4	2.3	2.2
Discretionary grants	1.7	1.9	1.5	1.6	1.6	1.6	1.6
Nondiscretionary grants	0.9	1.0	1.0	0.9	0.8	0.7	0.7
Total expenditures	5.2	5.3	5.4	5.4	5.5	5.6	5.8
Recurrent expenditures	3.7	3.6	3.6	3.7	3.8	4.0	4.2
Security	2.0	1.8	1.8	1.9	2.0	2.1	2.2
Civilian	1.8	1.8	1.8	1.7	1.7	1.8	2.0
Wages and salaries	0.9	0.9	1.0	1.0	1.0	1.1	1.2
Operations and maintenance	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Capital expenditure	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Social transfers	0.3	0.4	0.4	0.4	0.4	0.4	0.4
Interest payments	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Discretionary development	0.6	0.7	0.8	0.8	0.8	0.7	0.6
Nondiscretionary development	0.9	1.0	1.0	0.9	1.0	0.9	0.9
Discretionary balance	(0.1)	0.1	(0.2)	(0.3)	(0.1)	(0.0)	0.0
Overall balance	(0.1)	0.1	(0.2)	(0.3)	(0.3)	(0.3)	(0.2)
Financing	-	-	0.1	0.2	0.2	0.2	0.3
Debt	-	-	0.1	0.2	0.2	0.2	0.3
Domestic	-	-	(0.1)	(0.0)	0.0	0.0	0.0
External	-	-	0.1	0.2	0.2	0.2	0.2
Changes in reserves	(0.1)	0.1	(0.2)	(0.1)	(0.1)	(0.0)	0.0
Overall balance excluding grants	(2.7)	(2.7)	(2.8)	(2.8)	(2.7)	(2.6)	(2.5)
Revenues to recurrent spending ratio (%)	67	72	74	69	75	76	78

