

October 2013

# Afghanistan Economic Update



Photo by Graham Crouch

*Poverty Reduction, and Economic  
Management, South Asia Region*

The World Bank

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## Summary

**Uncertainty surrounding the political and security transition in Afghanistan has led to a slowdown in economic growth in 2013, following strong growth in 2012.** Presidential elections are scheduled for April 2014 but uncertainty remains over multiple efforts to build broad-based alliances and about whether the resulting government will be sufficiently cohesive to make significant policy decisions. While the Afghan security forces have demonstrated competence in responding to security incidents, uncertainty persists about the security outlook after most international forces withdraw in 2014. In this context, investment and economic growth have slowed down. Agricultural growth in 2013 is also expected to be flat or slightly negative after a bumper harvest in 2012. Economic growth is projected at 3.1 percent in 2013. This follows strong growth of 14.4 percent in 2012 resulting from an exceptional harvest and rapid expansion in services. Growth is projected to remain weak in 2014 before picking up in 2015 assuming a smooth political and security transition.

**After a decade of strong fiscal performance, revenue collection has weakened in 2013, potentially delaying Afghanistan's path toward self-reliance.** Revenues amounted to Afs 48 billion in the first six months of 2013, down 11 percent in nominal terms from Afs 54 billion in the first six months of 2012. The decline in revenue collection is due to the economic slowdown, as well as leakages and weakness in administration, particularly in customs. The Ministry of Finance has introduced a number of measures to stabilize revenues, including changes in the leadership of the customs department. With the political uncertainty undermining enforcement, revenues are expected to remain weak at about 10-10.5 percent of GDP during 2013-14. In order to preserve fiscal sustainability, a concerted effort will be required going forward to improve revenue mobilization by strengthening tax and customs administration and by expediting introduction and implementation of the planned value-added tax. Afghanistan faces considerable expenditure needs in the areas of security, infrastructure development, service delivery, and operations and maintenance. Meeting these needs will also require significant grant assistance for the foreseeable future.

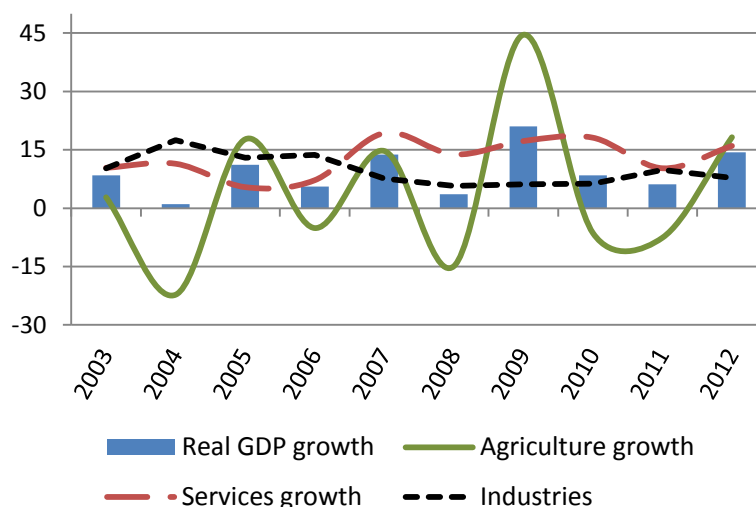
**In spite of the transition-related uncertainty and underperformance, Afghanistan will need to stay focused on its medium term structural reform goals.** These include: (i) safeguarding sustainability by mobilizing revenue and securing grant assistance; (ii) supporting inclusive and job-creating post-transition 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. 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 was strong in 2012, but there are signs of a considerable slowdown in 2013*

**The economy grew strongly in 2012, driven by an exceptional agriculture harvest and rapid expansion of the services sector.** Real GDP growth (excluding opium production) was 14.4 percent in 2012,<sup>1</sup> which represented a sharp uptick from 6.1 percent in 2011.<sup>2</sup> The strong performance was in large part due to an exceptional agricultural harvest supported by favorable weather conditions. Agriculture accounts for about a quarter of GDP (excluding opium) in Afghanistan and also has strong links to the rest of the economy. As a result, economic growth is influenced heavily by the volatile agricultural sector (Figure 1). Growth in 2012 also benefited from rapid expansion of the services sector, which accounts for about half of GDP.

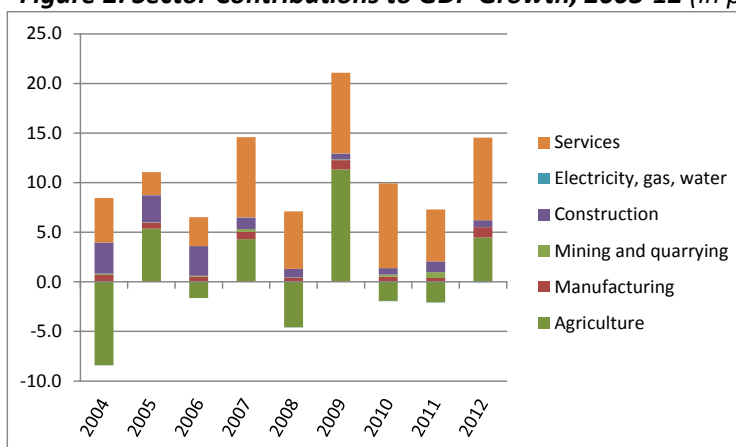
**Figure 1: Growth of Real GDP and Sectors (in percent)**



Source: Central Statistics Organization (CSO)

**Agriculture expanded by 18.2 percent in 2012, after two years of decline during 2010-11.** Cereal production, which accounts for about half of agriculture, grew 43 percent, thanks to timely and well-distributed rainfall throughout the year. Wheat production exceeded 5 million metric tons – a level last achieved in 2009. Furthermore, fruit production grew by 8 percent, triggering higher fruit exports during the last quarter of the

**Figure 2: Sector Contributions to GDP Growth, 2003-12 (in percent)**



Source: CSO and World Bank Staff estimates

<sup>1</sup> Afghanistan's statistics follow the Persian solar year (April – March). For example, SY 1391 (2012/13) spans April 2012 – March 2013, and is also denoted in this document as 2012 (i.e. the year in which it starts). The fiscal year was changed to the calendar year (January - December) in 2012, so that all projected data for 2013 onward correspond to the calendar year. The transition year 2012 covered 9 months (April-December), but the data has been projected over 12 months to enable comparability in the series.

<sup>2</sup> The growth rate for 2011/12 has been revised down from the earlier estimate of 7.3 percent.

year.

**The industrial sector grew by 7.7 percent in 2012, somewhat slower than the 9.8 percent growth in 2011, despite stronger growth in manufacturing.** The manufacturing sector expanded 7.3 percent in 2012, the highest rate since 2003. Food and beverages, which account for 95 percent of total manufacturing output, drove the strong growth of the sub-sector (Table 1). Production of basic metal products picked up markedly from a very small base as two steel mills in Kabul and Herat started production. Construction, which accounts for about 40 percent of industry, slowed somewhat to 9 percent in 2012 from 13.3 percent in 2011. Official figures also show a decline in the small mining sector, contrary to expectations. This is because production from the China National Petroleum Corporation (CNPC) concession in the Amu Darya basin was not covered in the 2012 national accounts survey although oil had started to flow in the last quarter of 2102.

**Table 1: Gross Domestic Product, Growth and Shares of Sectors**

	2010	2011	2012	2010	2011	2012
	Real Growth (percent)			Share of GDP (percent)		
<b>Agriculture<sup>1</sup></b>	<b>-6.4</b>	<b>-7.6</b>	<b>18.2</b>	<b>27.1</b>	<b>24.5</b>	<b>24.6</b>
<i>Cereals</i>	-9.2	-22.2	42.8	11.4	8.7	11.3
<i>Fruits</i>	22.6	10.3	8.0	2.5	2.9	2.5
<i>Livestock</i>	-1.1	3.0	0.5	4.3	4.1	3.3
<b>Industries</b>	<b>6.3</b>	<b>9.8</b>	<b>7.7</b>	<b>21.9</b>	<b>23.5</b>	<b>21.8</b>
Manufacturing	3.8	3.1	7.3	12.9	14.2	12.8
<i>Food and beverages</i>	3.8	3.1	5.1	12.4	13.7	12.3
Mining and quarrying	43.0	90.0	-1.1	0.6	1.3	1.0
Construction	7.7	13.3	8.9	8.2	7.9	8.0
<b>Services</b>	<b>18.1</b>	<b>10.3</b>	<b>16.0</b>	<b>51.0</b>	<b>52.0</b>	<b>53.5</b>
Wholesale and retail trade	3.2	8.4	27.0	7.5	7.5	8.2
Transport and storage	6.2	9.0	28.1	16.1	16.5	19.4
Communications	65.7	11.8	9.0	4.7	4.6	4.4
Finance, real estate, and business services	14.3	-44.4	3.0	2.3	1.2	1.0
	Real Growth (percent)			Total (Current US\$, billions)		
<b>Gross domestic product</b>	<b>8.4</b>	<b>6.1</b>	<b>14.4</b>	<b>15.9</b>	<b>17.9</b>	<b>20.5</b>

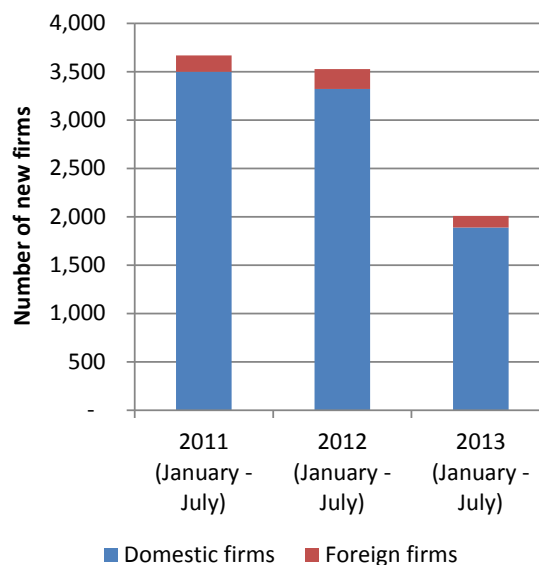
1: excludes opium production

Source: Central Statistics Organization

**The services sector expanded by 16 percent in 2012, another strong performance, driven by the brisk growth of transportation services and wholesale and retail trade activity.** The transportation sector, which has been heavily dependent on international military contracts, is currently benefiting from shipments abroad due to the repatriation of international forces. Also in this sector, with three 3G license holders starting to provide services in 2012 and 2013, the number of broadband subscribers reached more than 200,000 in the first quarter of 2013. This has increased the number of internet users in the country from 2 million people in 2012 to 2.4 million in 2013.

**Economic activity and private investment appear to be slowing considerably in 2013 as a result of increased uncertainty surrounding the political and security transition.** Increased uncertainty about the future political and security environment, in light of the presidential elections and withdrawal of international troops in 2014, is affecting investor decisions to commit resources in Afghanistan. During the first seven months (January – July) of 2013, only 2,000 new firms registered with the Afghanistan Investment Support Agency (AISA), compared to 3,500 new firm registrations over the same period in 2012 (Figure 3). The slowdown in new firm registrations appears to be across all sectors. Although no high-frequency data are available on firm inventories and gross fixed capital formation, new firm registrations should be a relatively good proxy to track economic activity in the private sector. In light of the slowdown, the government has recently endorsed a package of tax and other incentives for private investment, although the nature of the incentives are a source of concern (see Box 1).

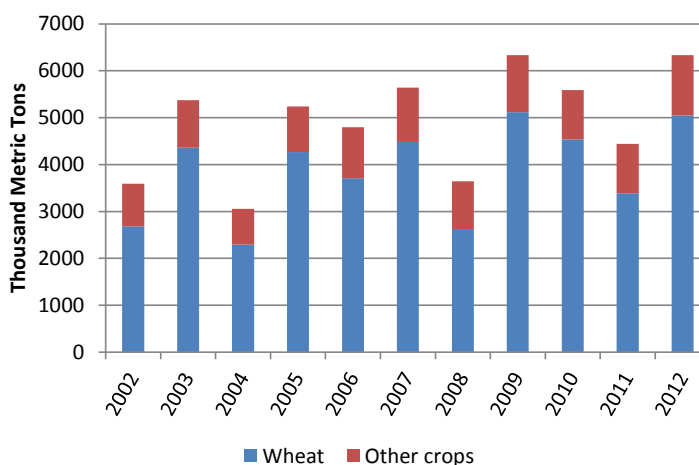
**Figure 3: Number of new firms established**



Source: Afghanistan Investment Support Agency

**While gross agricultural production in 2013 has been above average, it is likely to be below the high levels of 2012, so that a slight drop in agriculture value added is likely for 2013.** Cereal production is estimated to be above average in volume in 2013, as the wheat harvest both from irrigated and rain-fed areas will likely be close to that of 2012.<sup>3</sup> Nevertheless, real growth in agriculture is expected to be slightly negative because overall output will not be higher than the 2012 level. Negative real growth in the agriculture sector, coupled with slower growth in industry and services, are expected to lead to lower overall economic growth in 2013.<sup>4</sup>

**Figure 4: Cereal production 2002-2012**



Source: MAIL

<sup>3</sup> "Afghanistan Food Security Outlook", FEWS NET and WFP, July 2013

<sup>4</sup> The economic outlook is discussed in greater detail later in this report.



**Box 1: Afghanistan's New Investment Incentives: What are the lessons from international experience?**

In face of increased uncertainty and a slowdown in economic activity, the Afghan cabinet approved in July 2013 a series of incentives intended to encourage private investment. The package includes tax holidays of up to 10 years, subsidized land, public loans with 5 to 10 year maturity, and automatic licenses to artisanal and small-scale mining activities without going through the bidding process. These incentives are intended to boost investment through the transition period and are intended for new investments.

There is broad consensus that public policies can support the emergence of a vibrant private sector and develop an enabling environment for investment and entrepreneurship. In this context, international experience indicates that the most important roles for public policy are to: (i) create an enabling legal and regulatory environment for private investment; and (ii) undertake public investment in both hard and soft infrastructure in order to address the *coordination* and *information* externalities arising from private sector activities and to reduce the operation cost for firms.

Some governments have also attempted to use tax incentives, preferential credit for select sectors, and other fiscal incentives to subsidize private investment. The international experience with such policies has been that they mostly generate adverse incentives, encourage rent-seeking, and involve considerable fiscal costs. A World Bank policy paper (James, 2009) found that fiscal incentives are particularly ineffective in countries with weak investment climate. Tax incentives do not compensate for a weak investment climate and fail to foster new investments in such an environment. Such incentives benefit those investments that would have taken place regardless of any incentives. The cost of fiscal incentives arising from lost revenue far exceeds any possible benefits. The empirical evidence shows that lowering the tax rate from 40 to 20 percent increases foreign direct investment (FDI) by only 1 percent of GDP for countries in the bottom half of the investment climate spectrum, but can raise FDI by 8 percent of GDP in countries in the top half (James, 2010).

Fiscal incentives not only have limited impact on new investment but also entail a large administrative burden and create opportunities for rent-seeking and misuse. On the one hand, administering tax incentives have huge costs in terms of monitoring and control, which are often overlooked by policymakers. On the other hand, tax incentives encourage rent-seeking particularly when incentives are not granted automatically and are not part of the tax code. In fact, when eligibility for incentives is not based on clear criteria but is, instead, granted through special permissions by government agencies, it provides opportunities for rent-seeking and corruption. Firms will also seek illegal ways to qualify for tax incentives either by falsifying information or through other channels.

In light of the international experience, Afghanistan's new investment incentives pose the risk of not only creating distortions in the market (through offering tax holidays), but also generating opportunities for rent-seeking and nontransparent practices. First, established firms will have the incentive to close their businesses and re-start their operations under a new investment license in order to benefit from tax holidays and other benefits. Second, existing profitable companies may seek various channels to transfer their profits to new companies receiving tax holidays in order to avoid paying taxes. Third, the proposed incentives promote non-transparent processes particularly with small-scale and artisanal

mining. This will provide opportunities for rent-seeking, and will create distortions in the market by discriminating against competitive firms. Finally, these incentives will lead to unnecessary loss in domestic revenues, at a time when the government needs them the most. It is very unlikely that the incentives would generate indirect social and economic benefits in the medium-term that will compensate for the loss in revenue.

What other options does the government have in order to encourage private investment in the country? Afghanistan is ranked 168<sup>th</sup> in the World Bank's Doing Business Indicators. It performs weakly in areas such as property registration, investment protection, contract enforcement, trading across borders, access to electricity, construction permits, and resolving insolvency. These are some of the most important issues for private investment and any reforms in these areas will have the largest pay-offs in the medium- to long-term. Current tax rates are most likely not a binding constraint to private investment in Afghanistan, as the country has some of the lowest tax rates in the region. Instead, the lack of security and the weak investment climate are the binding factors for most foreign and domestic investors. Focusing on improving the investment climate rather than providing tax incentives would thus likely result in the highest payoff during the transition period.

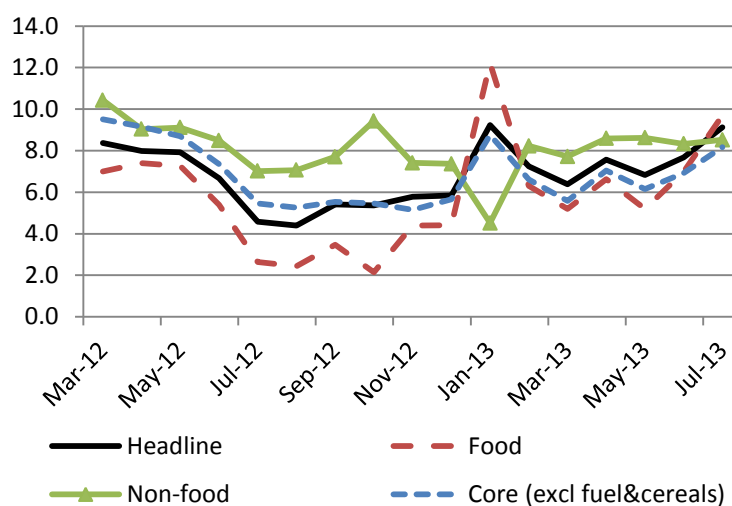
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- James, S. 2009. *"Incentives and Investment: Evidence and Policy Implications."* World Bank Investment Climate Advisory Services
- James, S. 2010. *"Providing Incentives for Investment: Advice for Policymakers in Developing Countries."* Investment Climate in Practice series note. The World Bank

#### *Inflation has remained in single digits in the first half of 2013*

**Consumer prices have remained below ten percent in the first half of 2013.** Period-average inflation in the first two quarters of 2013 was 7.5 percent, compared to 7.4 percent in the same period of 2012. Headline inflation reached 7.7 percent (year-over-year) in June 2013. Food and non-food price increases in the CPI were, respectively, 7.0 percent and 8.3 percent in June 2013. Non-food price increases have generally been higher than food price increases since mid-2011 as a result of the

**Figure 5: Monthly consumer prices inflation**



Source: CSO



downtrend in international commodity prices over this period. The rise in non-food prices is driven in large part by housing and clothing, which together account for about 28 percent of overall consumer spending. Core inflation (excluding fuel and cereals) – averaged 6.8 percent for the first half of 2013.

*After a decade of strong fiscal performance, revenue collection has weakened in 2013, thus potentially delaying Afghanistan's path to self-reliance*

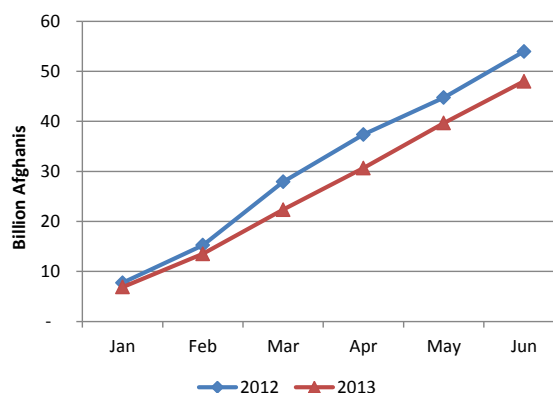
**Revenue performance has weakened in 2013, with collections lower than 2012 levels in nominal terms.**<sup>5</sup> Revenues amounted to Afs 48 billion during the first six months in 2013,

representing an 11 percent decline in nominal terms compared to Afs 54 billion over the same period in 2012.<sup>6</sup> In fact, total revenue collected in each month in 2013 was less than collections in the same month of 2012 (figure 6). The decline in collections has taken place across all

sources of revenue, including tax revenues, customs duties, and non-tax revenues. Customs and tax revenues during the first six months of 2013 were, respectively, 6.7 percent and 4.1 percent lower in nominal terms compared to their corresponding levels in 2012.

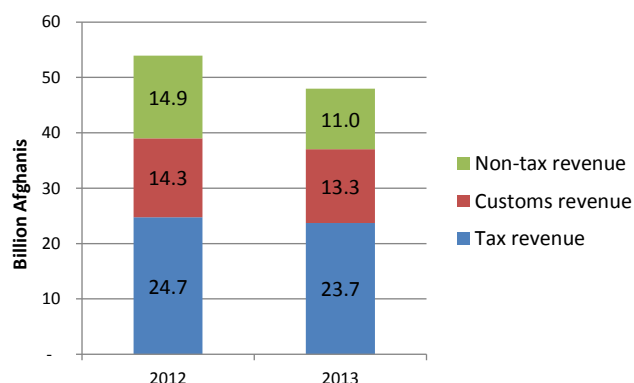
Sales tax and income tax are the largest sources of tax revenue in Afghanistan (see Figure 8). The decline in non-tax revenues is due lower income from capital property and sales of goods and services.

**Figure 6: Cumulative Monthly Revenues, first half of 2012 and 2013**



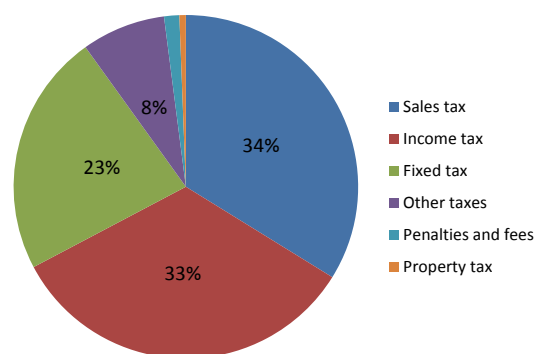
Source: Ministry of Finance, AFMIS

**Figure 7: Cumulative revenues, first half of 2012 and 2013**



Source: Ministry of Finance, AFMIS

**Figure 8: Tax revenue decomposition, first half of 2013**

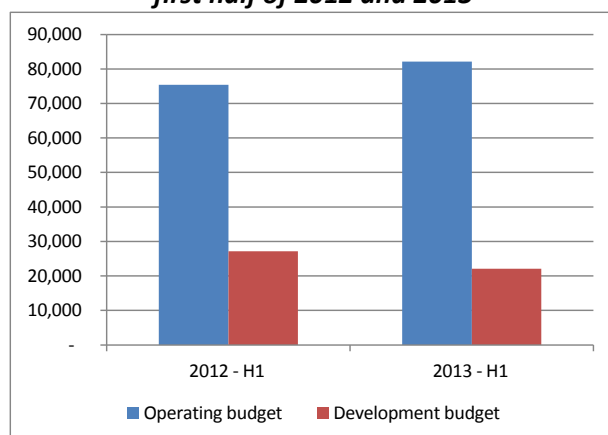


<sup>5</sup> The new fiscal year runs from December 21 – December 20, compared to the previous fiscal year that spanned March 21 – March 20. In order to allow for this transition, the 2012 fiscal year covered only 9 months, although figures for the fiscal year are projected over 12 months to facilitate comparison with other years.

<sup>6</sup> In order to ensure comparability, revenue figures for the first half of 2012 and 2013 are for the first six months of the calendar year in both cases.

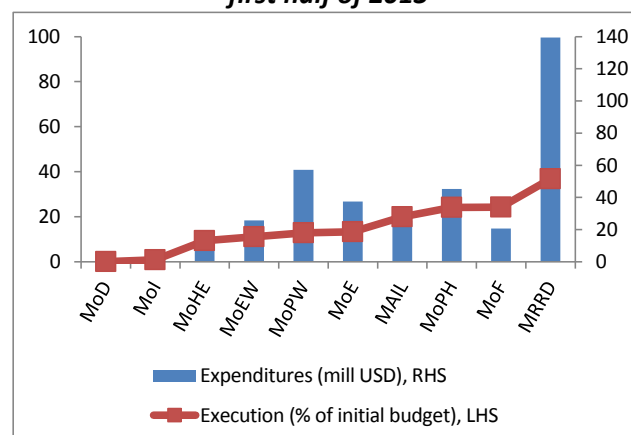
**With weak revenue performance in 2013 due to both the economic slowdown and weaknesses in administration, the Ministry of Finance has introduced a number of measures to stabilize revenues.** The decline in tax revenues in 2013 is in part a result of the slowdown in economic activity and changes in the structure of imports toward items with lower duties. However, weaknesses in administration and higher leakages, particularly in customs, have also played a significant part. The increased uncertainty surrounding the political transition has likely encouraged more rent-seeking behavior in customs administration. In this context, the Ministry of Finance has introduced a number of measures to stabilize revenues, reduce leakages, and improve administration. These measures include the implementation of a computerized risk management module, improving procedures for random post-verification of examination, introducing post-clearance audits, and salary incentives for detection of non-compliance. In addition, a number of additional revenue measures were introduced in April/May, including an increase in fuel valuation at customs, an increase in tariffs on cement and steel rods, and higher air travel fees. The effect of these measures has been modest to date.

**Figure 9: Expenditures, Million Afs, first half of 2012 and 2013**



Source: AFMIS and Bank Staff estimates

**Figure 10: Development Budget Execution, first half of 2013**



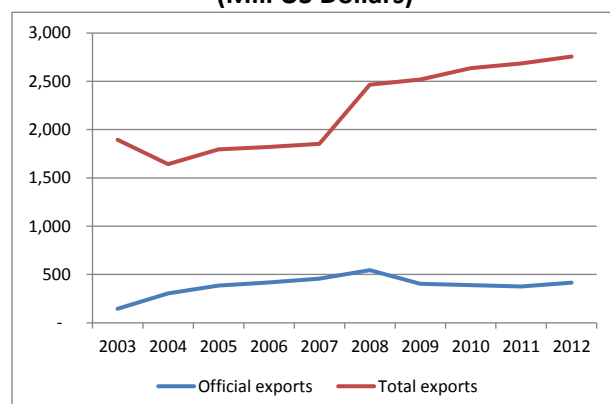
Source: MoF and Bank Staff estimates

**Operating expenditures increased during the first six months of 2013, as more spending moved on-budget, but execution rates remain low, particularly for the development budget.** Operating expenditures increased to Afs 82.1 billion in the first six months in 2013, compared to Afs 75.4 billion over the same period in 2012 (Figure 9). However, development expenditures actually declined to Afs 23.7 billion in the first half of 2013, compared to Afs 27 billion in the first half of 2012. Low budget execution continues to be a problem in Afghanistan and it has particularly affected development expenditures in 2013. Budget execution was only 36.4 percent of the operating budget and only 17 percent of the development budget in the first half of 2013, compared to 50 percent and 24 percent, respectively, in the first half of 2012. Among ministries with development budgets more than \$50 million, only three (ministries of health, finance, and rural development) have executed more than 20 percent through the first half of 2013. In nominal terms, the ministries that have executed the largest development budgets include MRRD (rural development), MoPW (public works), MoPH (health), and MoE (education). As a result of low development budget execution, the Ministry of Finance revised

downward the development budget in its Mid-Year Review to \$2.7 billion from the initial target of \$3 billion, while the operating budget remains unchanged.

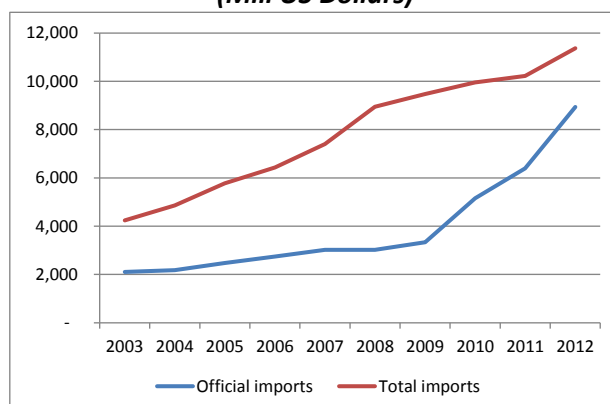
*Imports continue to exceed exports by a wide margin with official grants financing the deficit, while the flexible exchange rate provides an important anchor of sustainability in a period of increased uncertainty*

**Figure 11: Total and Official Exports, 2003-12, (Mill US Dollars)**



Source: CSO and IMF Staff estimates

**Figure 12: Total and Official Imports, 2003-12, (Mill US Dollars)**

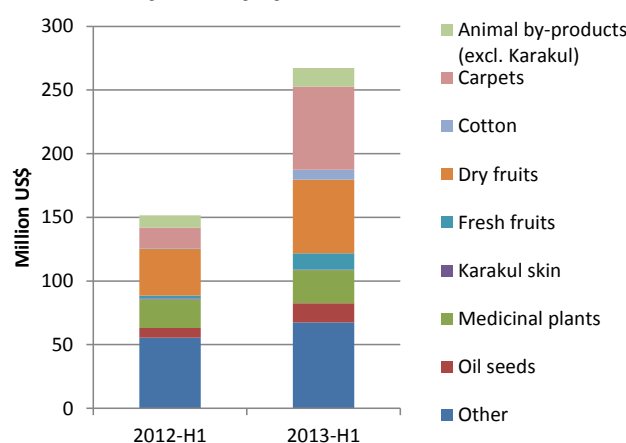


Source: CSO and IMF Staff estimates

**The trade deficit widened in 2012 as imports expanded faster than exports.** Total estimated exports increased by about 3 percent to \$2.76 billion in 2012, while total estimated imports increased by about 11 percent to \$11.4 billion.<sup>7</sup> The trade deficit widened to \$8.6 billion in 2012 from \$7.5 billion in 2011. The higher trade (and current account deficit) was financed fully by higher official grants, which increased to \$9.4 billion in 2012 from \$8.1 billion in 2011. Official exports, which are a much smaller order of magnitude compared to total estimated exports, grew at a more rapid rate of 10.3 percent to \$415 million in 2012.

**Official exports increased in the first half of 2013, most likely due to improved recording.** Official exports grew by 76 percent to \$267 million in the first two quarters in 2013 from \$152 million in the first half of 2012. This increase in official exports took place across most product categories (Figure 13). Exports of dry fruits rose by more than 50 percent to \$58 million and exports of carpets quadrupled to about \$65 million in the first six months in 2013. Exports of fresh fruits, which are usually low in the first half of the year and pick up in the

**Figure 13: Official exports by product categories, first half of 2012 and 2013**



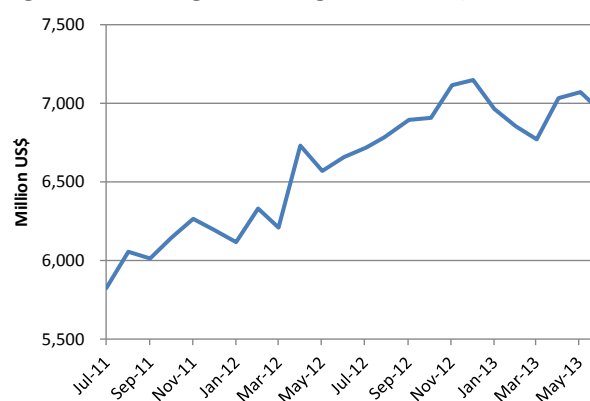
Source: CSO

<sup>7</sup> Total exports include official exports, estimated smuggling, re-exports, and sales to non-residents. Total exports differ very considerably from official exports in Afghanistan.

second half, were recorded at \$12.8 million in the first half of 2013 compared to only \$2.2 million in the first half of 2012. Other significant export items such as oil seeds, medicinal plants and animal by-products (such as wool and skin) also increased significantly in the first half of 2013.

**Foreign exchange reserves plateaued in the first half of 2013 after rising steadily over the last several years.** Gross international reserves declined from the all-time-high level of \$7.1 billion in December 2012 to \$6.7 billion in March 2013, before increasing to \$6.9 billion in June 2013 (Figure 14). The pause in foreign exchange accumulation is a break from the trend since 2006, but is not unexpected in light of the political and security transition. International reserves during this period can be expected to be affected by a slowdown in capital inflows and grants (due to a decline in foreign military spending or the pace of policy implementation) as well as any changes in the pace of capital flight. The International Security Assistance Forces (ISAF) announced that they have so far closed 700 of their military bases in Afghanistan, and now have only 100 military bases operational in the country.

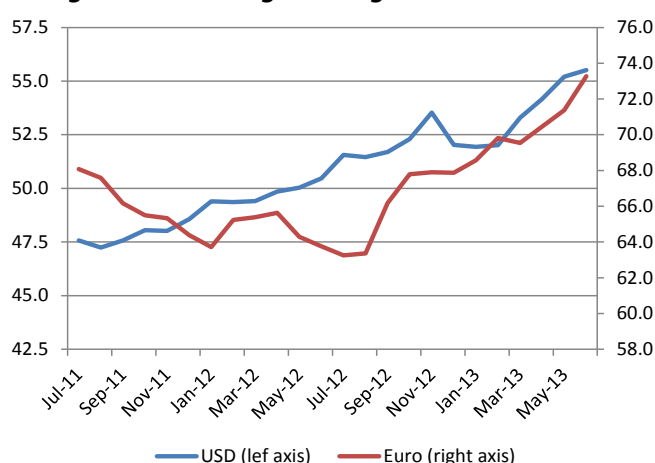
**Figure 14: Foreign exchange reserves ( million US\$)**



Source: DAB

**The Afghani has continued to depreciate against the US dollar and the euro** (see Figure 15). The nominal exchange rate depreciated by 3 percent and 6.7 percent, respectively, vis-à-vis the US dollar and the euro in the first two quarters in 2013 compared to the last two quarters in 2012. The average exchange rate moved to Afs 53.7 and Afs 70.5 in the first half of 2013 from Afs 52.1 per US dollar and Afs 66.1 per euro in the second half of 2012. The depreciation of Afghani comes as other major South Asian currencies, such as the Indian Rupee and the Pakistani Rupee, have also strongly depreciated against the US dollar in the second quarter of 2013. The Afghani-Pakistani Rupee exchange rate has remained stable throughout the year. Since the currencies of Afghanistan's major trading partners (including Pakistan, Iran and India) have strongly depreciated, prices of imports have so far not seen a hike. Prices of non-food consumer items – which are primarily imported – have increased only marginally and thus headline inflation has remained in single digits.

**Figure 15: Exchange rate against US dollar and euro**



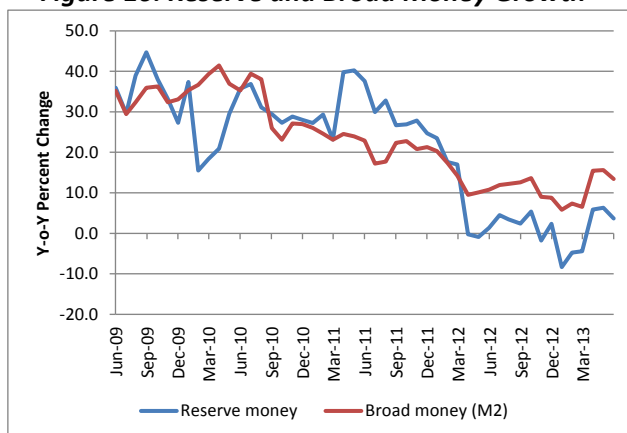
Source: DAB

**The exchange rate can be expected to be affected by a number of factors during the transition.** First, capital inflows can be affected by the drawdown in international security forces. Second, official grants could be affected by slower policy implementation during the political transition. Third, increased uncertainty during the political and security transition could raise demand for foreign exchange and lead to an increase in the pace of capital flight. In this context, the flexible exchange rate provides an important anchor of external sustainability.

*Monetary aggregates and the banking sector are still weighed down by the Kabul Bank crisis*

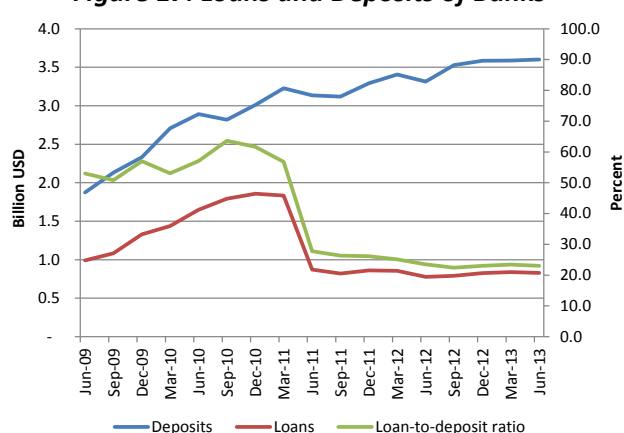
**Money growth has picked up slightly but remains subdued.** Reserve money growth fell to 2.3 percent (y-o-y) at end-2012 in response to lower demand for local currency in the wake of transition. Given the early stage of financial markets development in Afghanistan, the Da Afghanistan Bank (DAB) relies mainly on open market operations with reserve money as the nominal anchor. Reserve money picked up slightly to about 4 percent by June 2013, but remains subdued. The aftermath of the Kabul Bank crisis is still affecting money growth. Although broad money (M2) grew by 13.4 percent (y-o-y) in June 2013, up from 10.7 percent in June 2012, it still remains low compared to the 20-30 percent growth rates prior to 2012.

**Figure 16: Reserve and Broad Money Growth**



Source: DAB

**Figure 17: Loans and Deposits of Banks**



Source: DAB

**The banking sector has still not fully recovered from the Kabul Bank crisis which shook Afghanistan's nascent financial sector.** Despite marginal improvements, banking sector indicators are still below those of the pre-2010 period. Total assets grew to \$4.5 billion in June 2013, but remain below the \$5.4 billion level of 2010. Total deposits also grew modestly in June 2013, but lending by commercial banks remains subdued. Both total loans and the loan to deposit ratio remain down sharply from pre-crisis levels. As a response to the increased risk perception, amendments to the Banking Law were approved in March 2013 to improve regulatory oversight. Recent efforts to privatize New Kabul Bank have not yet yielded a result but efforts are ongoing to ensure that this takes place in a transparent manner.

## Economic Outlook and Medium Term Prospects

Economic growth is projected to slow considerably to 3.1 percent in 2013 and 3.5 percent 2014 due to the increased uncertainty surrounding transition and flat growth in the agricultural sector. Uncertainty surrounding the political and security transition is expected to persist through the middle of 2014, thus resulting in a slowdown in private investment and growth in the non-agricultural sectors. Furthermore, agricultural growth is expected to be flat or slightly negative in 2013 following the record harvest of 2012. Assuming a smooth political and security transition, investor confidence and growth in the non-agricultural sectors should pick up modestly in the second half of 2014 as uncertainty lessens. This, coupled with the assumption of favorable weather conditions for agriculture, should generate growth of about 3.5 percent in 2014. Public investment expenditures on essential infrastructure provide an important prop for economic activity during this period of heightened uncertainty and also contribute to Afghanistan's medium term growth prospects.

**Table 2: Medium Term Macroeconomic Framework, 2011-2016**

	2011	2012	2013	2014	2015	2016
	-----Actual-----	-----Projected-----				
Nominal GDP (billions of US dollars)	17.9	20.5	20.6	21.8	23.1	24.6
GDP Growth Rate	6.1	14.4	3.1	3.5	4.8	5.3
CPI (period average)	10.2	6.4	7.1	5.5	4.9	4.9
	<i>percent of GDP, except where noted</i>					
<b>Fiscal</b>						
Revenues and Grants	22.3	23.1	26.1	26.7	29.0	30.9
Domestic Revenues	11.6	10.3	10.1	10.6	12.1	12.6
Grants	10.7	12.8	16.0	16.0	17.0	18.2
Total Expenditures	23.6	23.8	26.7	26.6	28.6	30.3
Operating Expenditures	17.4	17.1	19.9	19.9	21.9	23.5
Development Expenditures	6.2	6.7	6.8	6.7	6.8	6.7
Operating Balance (incl. op. grants)	1.2	1.5	0.4	1.6	1.7	1.1
Overall Balance (incl. grants)	-1.2	-0.8	-0.6	0.0	0.4	0.6
<b>External</b>						
Trade Balance	-42.0	-41.9	-41.6	-39.5	-35.7	-33.0
Current Account Balance (excl. grants)	-44.2	-43.8	-41.5	-39.6	-35.5	-32.8
Current Account Balance (incl. grants)	3.1	3.9	2.5	1.8	1.2	0.7
Gross Intl Reserves (months of imports)	6.9	7.7	7.3	7.7	7.9	7.9
<b>Debt</b>						
Total External Debt	6.9	6.5	6.6	7.0	7.2	7.5

*Source: Afghan authorities and staff estimates*

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.

**The current fiscal revenue outlook has weakened, so that a concerted effort will be required from the authorities to improve revenue mobilization.**

In light of the recent weak revenue performance, domestic revenues are projected at 10.1 percent of GDP in 2013, rising to 12.6 percent by 2016. Weak revenue performance in 2013-14 is projected to result from a number of factors including the slowdown in economic activity, changes in the structure of imports, but perhaps more importantly, from higher leakages and weaknesses in administration, particularly in customs. Rent-seeking behavior appears to have increased in customs in light of the political transition. In light of recent developments, the increase in revenues to 12.6 percent of GDP by 2016 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 2012 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 US\$16 billion in development aid for Afghanistan over 2012-16. Together with earlier pledges on the security side, this means annual aid of about US\$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 to 15 percent of GDP by 2016 and 19 percent of GDP by 2025. Such level of revenue can only be achieved in Afghanistan by developing the mining sector, fostering private sector development, broadening the tax base and reducing the leakages at customs. The current decline in revenue 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 500,000 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.

**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 recent 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 US\$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-March 2013. In addition, the ARTF has generated US\$6.42 billion from 33 donors, and committed US\$2.88 billion for the government’s recurrent costs and US\$2.09 billion for government investments programs. At end-June 2013 the active IDA portfolio was worth US\$1.21 billion and the active ARTF investment portfolio was worth US\$1.88 billion.
4. ARTF and IDA projects are managed with the same attention. All projects are eligible for processing under the Bank’s Rapid Response to Emergencies policies (incorporated into OP 10.00). In practice this has proved most useful in streamlining procurement procedures, but in many cases new operations are processed under regular review procedures in order to ensure quality at entry. All Bank (IDA and ARTF) funds are channeled through the budget and project accounting and reporting occurs at the federal level.
5. In fiscal year 2013, the World Bank Board approved three IDA-financed projects totaling \$167.5 million. The new projects included US\$100 million for the System Enhancement for Health Project, \$12.5 million for Afghanistan Pension Administration and Safety Net Project and \$55 million for the Second Skills Development Project.
6. In addition, the ARTF approved \$232 million in recurrent-cost financing (of which US\$150 million was for recurrent cost baseline financing, \$50 million for the Incentive Program, and \$32 million for the O&M Facility) and \$349.82 million for investment window financing. The latter included a total of nine new projects: Afghanistan Rural Access Project (co-financing with IDA, \$107 million), National Horticulture and Livestock Productivity Project (\$50 million), Afghanistan Agricultural Inputs Project (\$74.75 million), a Preparation Grant for the Naghlu Hydropower Rehabilitation

Project (\$4.97 million), a Preparation Grant for the Second Skills Development Project (\$0.5 million), a Preparation Grant for the Afghanistan Resource Corridor Project (\$2.7 million), a Preparation Grant for the Kabul Municipal Development Program (\$5 million), System Enhancement for Health Action in Transition Project (co-financing with IDA, \$100 million), and finally a Preparation Grant for Higher Education System Improvement Project (\$4.9 million).

7. For fiscal year 2014, planned commitments are \$200 million from IDA, ensuring that the full IDA-16 is fully utilized. The first project, Development Policy Grant for Promotion Economic Growth and Fiscal Sustainability, was approved on August 8, 2013 for \$50 million. In addition, US\$1 billion are planned for operations under the ARTF including both the Investment and Recurrent Cost Windows.

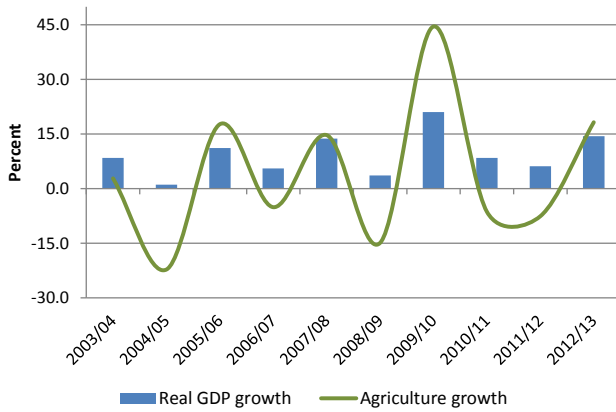
#### *IFC and MIGA operations in Afghanistan:*

8. The International Finance Corporation's (IFC) current committed investment exposure in Afghanistan amounts to US\$131 million in 5 companies in the telecommunications, hospitality, and financial sectors. In FY13, IFC committed US\$65 million in the telecom sector, thus doubling its portfolio of US\$70 million in FY12. IFC's investments in Afghanistan have contributed to increasing access and outreach in the financial and telecom sectors. IFC has an active Advisory Services program with seven active mandates amounting to a budget of US\$6.7 million in the following areas: (i) Access to Finance (Collateral Registry, Public Credit Bureau, Leasing Support); (ii) Investment Climate (Trade License Reform, Construction Permit Reform) ; (iii) SME Capacity Development (Business Edge SME Training); and (iv) PPPs(DABS Kandahar).
9. The Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group has \$139 million of guarantees outstanding in Afghanistan in support of telecoms (MTN cell-phone operations) and agri-business projects. IEG recently reviewed the MTN cell-phone project and endorsed its significant development impact, including connecting 4.6 million customers and supporting many thousands of SMEs. 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.

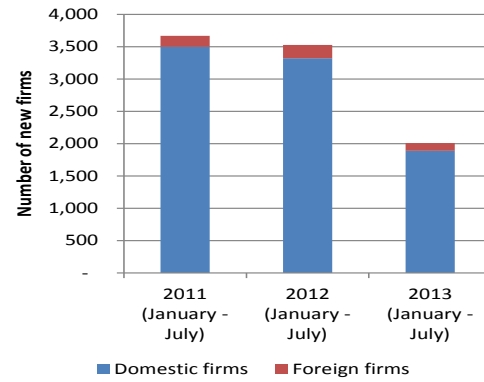


## Annex 2: The Afghan Economy at a Glance

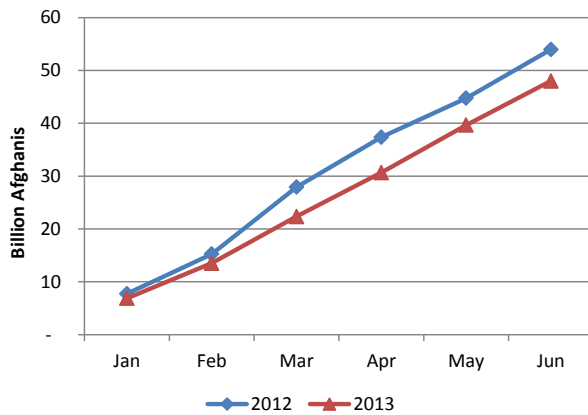
*Growth was strong through 2012...*



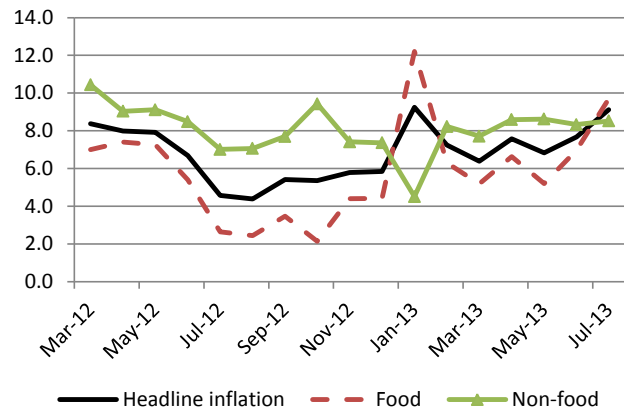
*...but a significant slowdown is underway in 2013*



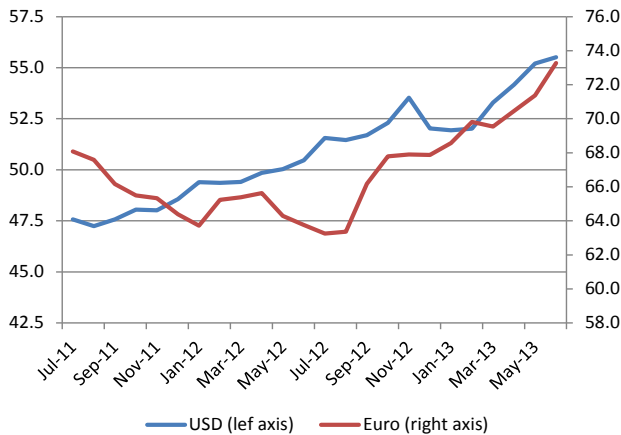
*Revenue collection has declined in 2013...*



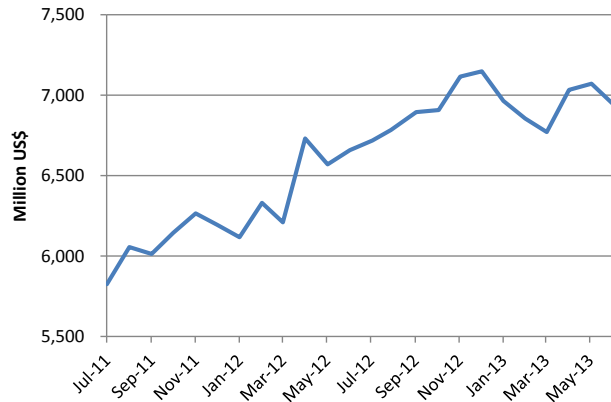
*...and inflation remains in single digits*



*The exchange rate has continued to depreciate...*



*...amid a flattening of international reserves.*



## Annex 3: Selected Economic Indicators

(% of GDP, unless indicated otherwise)

	1388	1389	1390	1391	1392	1393
	2009	2010	2011	2012	2013	2014
<b>Real Sector</b>						
Nominal GDP (excl. opium; billion Afs)	615	730	856	1,060	1,135	1,243
Nominal GDP (excl. opium; billion US\$)	12.5	15.9	17.9	20.5	20.6	21.8
Real GDP growth (%)	21.0	8.4	6.1	14.4	3.1	3.5
GDP per capita (US\$)	451	561	616	688	...	...
<b>Money and Prices</b>						
CPI inflation (period average, %)	-12.2	7.7	10.2	6.4	7.1	5.5
Core inflation (excl. fuel & cereals, %)	1.7	9.8	14.6	6.6	6.8	...
Broad money (M2)	36.8	38.2	37.2	32.0	32.7	35.5
<b>Government finance /1</b>						
Domestic Revenue	10.3	11.0	11.6	10.3	10.1	10.6
o/w: tax revenue	8.4	9.1	9.2	8.0	7.9	8.1
Donor grants	10.2	11.0	10.7	12.8	16.1	16.1
Total Core Budget expenditure	22.1	21.1	23.6	23.8	26.7	26.6
Operating	14.5	15.2	17.4	17.1	19.9	19.9
Development	7.6	5.9	6.2	6.7	6.8	6.7
Operating balance	1.2	3.3	1.2	1.5	0.5	1.6
Overall Core balance (incl. grants)	-1.6	0.9	-1.2	-0.8	-0.6	0.0
Security spending	7.3	8.8	10.1	10.3	11.0	11.7
Fiscal sustainability ratio	71.3	72.7	66.5	60.1	56.7	60.1
<b>External Sector</b>						
Exports of goods (billion US\$) /2	2.52	2.64	2.68	2.75	2.66	2.71
Imports of goods (billion US\$) /2	9.47	9.95	10.22	11.36	11.25	11.30
Trade balance	-55.6	-45.9	-42.0	-41.9	-41.6	-39.5
Current account balance (incl. grants)	1.6	2.8	3.1	3.9	2.5	1.8
Current account balance (excl. grants)	-58.5	-48.5	-44.2	-43.8	-41.5	-39.6
Gross reserves (million US\$)	4,267	5,550	6,209	6,771	6,555	6,767
Gross reserves (months of imports)	5.5	6.7	6.9	7.7	7.3	7.7
Total external debt /3	9.2	8.0	6.9	6.5	6.6	6.6
<b>Memorandum items</b>						
Nominal GDP (incl. opium; billion Afs)	633	747	896	1,086	1,196	1,304
Population (millions)	27.7	28.4	29.1	29.8	...	...
Exchange rate (Afs/US\$; period average)	49.2	45.8	47.8	51.7	...	...
Real effective exchange rate (depreciation = decrease in index)	100.5	114.4	126.2	127.0	...	...

/1: Fiscal year spans over April-March for years preceding 1391. Fiscal year for 1391 covers only 9 months, but the indicators have been projected over 12 months to facilitate comparison with other years. Fiscal year after 1391 is January-December.

/2: Estimates only; includes both official and unofficial (smuggling) trade.

/3: External debt excludes Russian Federation's loan.