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Afghanistan Economic Update

Photo by Graham Crouch

Poverty Reduction, and Economic Management, South Asia Region

The World Bank

Summary

One year into the transition process, Afghanistan sustains robust economic growth. *An exceptional harvest, supported by the launch of first large-scale mining activities, increased real GDP growth from 7.3 percent to an estimated 11.8 percent in 2012. Inflation dropped to 6.4 percent and continuing high levels of aid helped to build up further international reserves. So far, transition manifests itself predominantly in a loss of business confidence, reflected in lower private sector activity and a depreciating exchange rate. This compounds the already sluggish recovery of the banking sector from the Kabul Bank crisis which hit the country in 2010. Trends in public finance deserve attention: more on-budget aid poses challenges the Government's capacity to execute an increasing budget. Growth of domestic revenues is slowing due to lower performance in the collection of customs revenues.*

The medium-term outlook is tainted by uncertainty. *Political and security uncertainties are expected to limit private-sector growth in the coming years. Increased public spending, however, will continue to fuel demand for services and construction through 2013. Mining should contribute more noticeably to growth with the increase of oil production in Amu Darya. However, moderate rainfalls are likely, which would reduce this year's harvest to more a regular output and slow GDP growth to 3.1 percent in 2013. Assuming favorable weather conditions and peaceful elections, growth could pick up in 2014.*

The transition process exposes Afghanistan to a number of serious risks*, such as rising financing for public service provision. Security considerations aside, promoting sources of inclusive economic growth, especially agriculture, and strengthening domestic revenue mobilization will be important to mitigate some of these risks. In particular, a stronger reform effort in areas such as tax policy and customs is required to safeguard past gains in development. Finally, improvements in the legal and regulatory environment of mining could help to secure planned investment.*

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Afghanistan Country Context: Growing in Uncertainty

Afghanistan is in a state of transition. In mid-2010, the North Atlantic Treaty Organization (NATO) and the Afghan government agreed that full responsibility for security would be handed over to the Afghan National Security Forces by the end of 2014. The withdrawal of most international military troops as planned is expected to have a profound and lasting impact on the country's economic and development fabric. The drawdown is likely to be accompanied by a decline in international development assistance on which Afghanistan relied heavily since emerging out of conflict in 2001. While Afghanistan's international partners have pledged continued support through 2016 there is a growing sense of uncertainty about Afghanistan's stability and security in the months and years ahead.

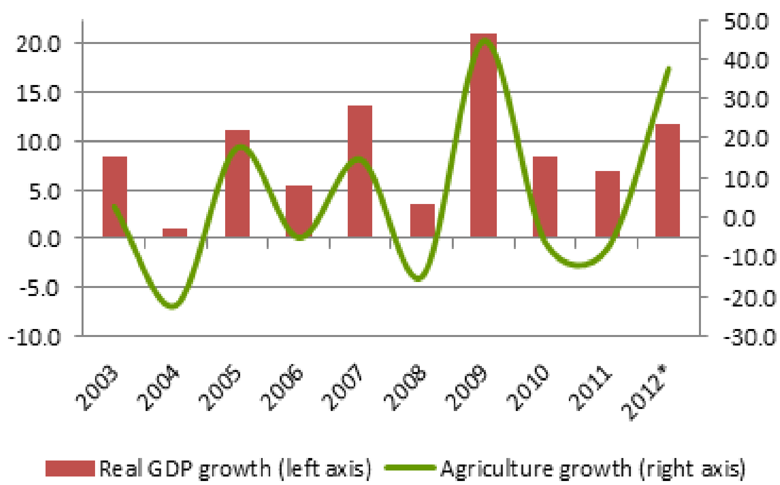
Preparations for the next presidential election are ongoing. The next presidential election is scheduled for April 2014. The outcome of the elections is very uncertain due to the fragmented political fractions in the country. There is widespread concern that the run-up to the election might be accompanied by increased insurgency activities which could undermine economic and development progress this year and in 2014.

Recent Economic Developments

One year into transition, Afghanistan's economy continues to grow

Real GDP growth increased from 7.3 percent in 2011[1] to an estimated 11.8 percent in 2012, thanks to favorable weather conditions and an exceptional harvest. Typically, agriculture accounts for one-fourth to one-third of GDP, depending on annual output. Wheat accounts for approximately 60 percent of agricultural output and is the most important licit crop in the country. However, around one-third of the wheat production is rain-fed, which

Figure 1: Real GDP and Agriculture Growth Rates



Sources: CSO and Ministry of Agriculture, Irrigation and Livestock

[1] Throughout this publication, the Persian solar year (March 22 – March 21) is expressed as the preceding calendar year ,i.e. 2010/11 is written as 2011.

makes agricultural output highly volatile and dependent on rainfall. Given agriculture's weight in GDP, economic growth tends to follow the same cyclical patterns as agricultural output (Figure 1).

Favorable weather conditions resulted in a substantial increase in wheat production. This brought wheat production close to self-sufficiency level, satisfying 93 percent of the domestic requirement. Afghanistan is typically deficient in wheat and depends heavily on food imports (Table 1).

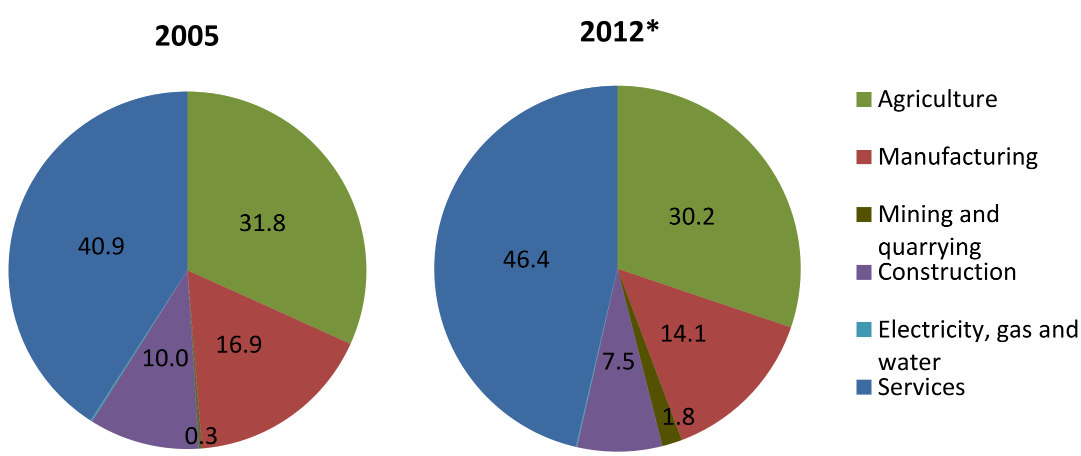
Table 1: Cereal Requirement (thousand metric tons)

	2008	2009	2010	2011	2012
Wheat	2,623	5,115	4,532	3,388	5,008
Irrigated	2,406	3,433	3,082	3,067	3,510
Rain-fed	217	1,682	1,450	321	1,498
Other crops	1,023	1,218	1,056	1,056	1,315
Cereal deficit	2,242	200	862	1,860	442

Source: Agriculture Prospects Report, MAIL

The mining sector showed dynamic developments in 2012. Historically small, the share of mining in aggregate output increased from 0.6 percent of GDP in 2010 to an estimated 1.8 percent in 2012 (Figure 2), owing to the start of oil production in the Amu Darya fields. The oil fields are currently producing around 1,950 barrels of oil per day and are expected to reach more than 4,000 barrels per day by end-2013. The expected contribution to the government budget through royalties and taxes is around US$250 million annually for the next 25 years. In addition, rehabilitation and reconstruction of eight gas wells in Sheberghan, operated by a state-owned enterprise, started in end-2012. The project will be completed within 18 months, and is expected to significantly increase the supply of gas to the fertilizing and power plant at Mazar-i Sharif.

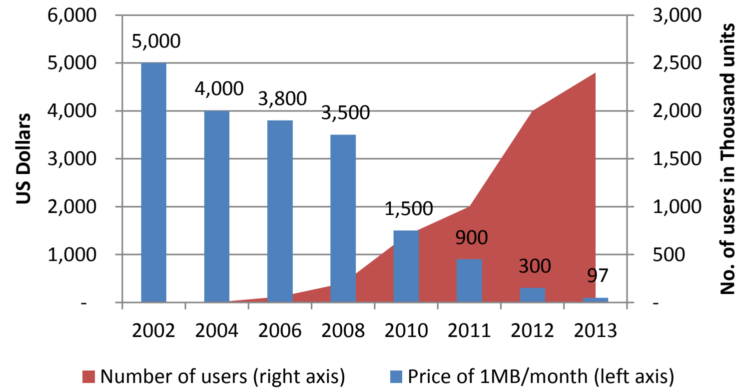
Figure 2: GDP Sector Shares (in % of GDP)



Source: Central Statistics Organization; and WB staff projections (*)

Positive developments in the services sector contributed to growth in 2012. The telecommunications sector (9 percent of total services) which grew at an average 60 percent during the last decade is forecast to record strong growth in 2012. The government awarded three 3G licenses during the year and these are expected to more than double the number of Internet users in the country, from 1 million users in 2011 to 2.4 million in 2013 (Figure 3). Moreover, Afghan Telecom—the corporatized public telecom company—drastically reduced its wholesale prices for Internet bandwidth. As a result average prices for internet services dropped from US$900 per megabyte in 2011 to US$97 per megabyte in 2013 (Figure 3). Other services also appear to do well, even though data are hard to come by: anecdotal evidence suggests that the transportation industry (31 percent of total services), which has been heavily dependent on international military contracts and development activities, is currently benefiting from higher contract volume for out-of-country shipments due to the drawdown of international forces and closure of military bases—clearly a short-term benefit.

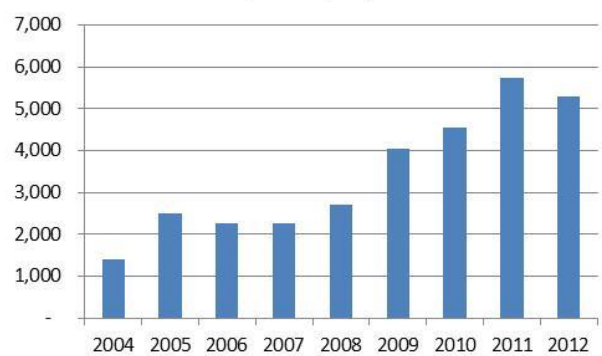
Figure 3: Price and Internet Usage since 2002



Source: Ministry of Communication and IT

A worsening security situation and heightened perceptions of uncertainty is affecting new investment. The number of newly registered firms declined by 8 percent in 2012 (Jan-Dec). In particular the construction sector experienced slower company growth: only 1,760 new firms were registered in 2012 compared to 2,630 in 2011. There is no reliable data on investment volume but the Afghanistan Investment Support Agency estimates that around US$8.9 billion have been invested since 2004, of which 47 percent was invested in services and 37 percent in manufacturing activities. Construction and agriculture sectors have received 14 percent and 2 percent of total private investment respectively.[2]

Figure 4: Number of newly registered companies per year



Source: Afghanistan Investment Support Agency

Opium production declined by 36 percent in 2012 compared to previous year, but stands higher than the 2010 production level.[3] The illicit production of opium continues to play a significant role in agriculture. By farm-gate price measurement, the opium economy in 2012 is estimated at around 3.3

[2] "Estimating Business Fixed Investment in Afghanistan", Afghanistan Investment Support Agency, May 2012

[3] Opium production is not included in the GDP figures in this section.

percent of GDP, or about twice that percentage (7-8 percent of GDP) if export earnings are reckoned in (Box 1). Nonetheless, the UNODC winter risk assessment survey in 2013 indicates that opium production is likely to increase across most provinces in 2013.

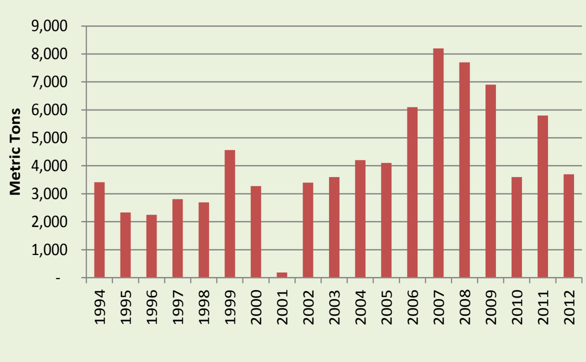
Box 1: Opium's Contribution to Afghanistan's Economic Growth

Afghanistan is the world's largest producer of illicit opium. The raw drug is considered the most important cash crop and provides livelihoods for many households in rural areas. But it also fuels conflict and undermines governance by providing income to insurgents and other criminal groups. Given the illicit nature of opium and the inherent lack of information, there are many misperceptions on its significance to the Afghan economy. A question which often arises, therefore, is how important is opium production really to Afghanistan's economy?

In terms of production and share of GDP, opium's importance has been declining since 2007, when it reached a record production of 8,200 tons. Nowadays, production is closer to 3,700 tons (UNODC, 2012), which amounts to 3.3 percent of GDP in farm-gate value, or 7-8 percent in export value—compared to 6.1 percent of GDP in 2007. However, measuring opium production as part of the national income is not straightforward. While the UNODC and the Afghan authorities survey opium production and prices, it is unclear how this should be figured into the national accounts. For instance, should the national accounts include only opium production? Or should they also include the value created in the processing and trading of the drug? How much of the value created is captured by the local economy, e.g., in farmers' income? How much of it is directly expatriated, and hence, has only minimal benefit for the Afghan economy?

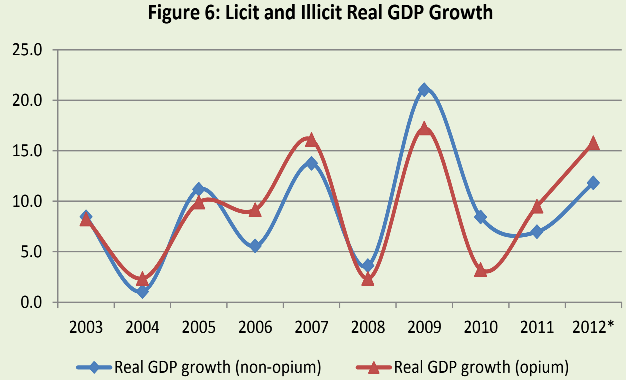
Opium exports are not recorded in the balance of payments in Afghanistan, which diminishes the Central Bank's monetary control. On the other hand, the drug income may overestimate per-capita income and thereby underestimate poverty in the country. Ignoring opium in economic analysis, therefore, has some advantages, depending on the objective of the analysis. Nevertheless, the data is principally available and reported by the Afghan Central Statistics Organization's national accounts publication. The CSO records the farm-gate value of opium production as agricultural output and, hence, disregards the value-addition from subsequent processing stages and trade.

Figure 5: Opium Production in Afghanistan (1994-2012)



Source: UNODC/MCN opium surveys

Figure 6: Licit and Illicit Real GDP Growth



Source: Central Statistics Organization

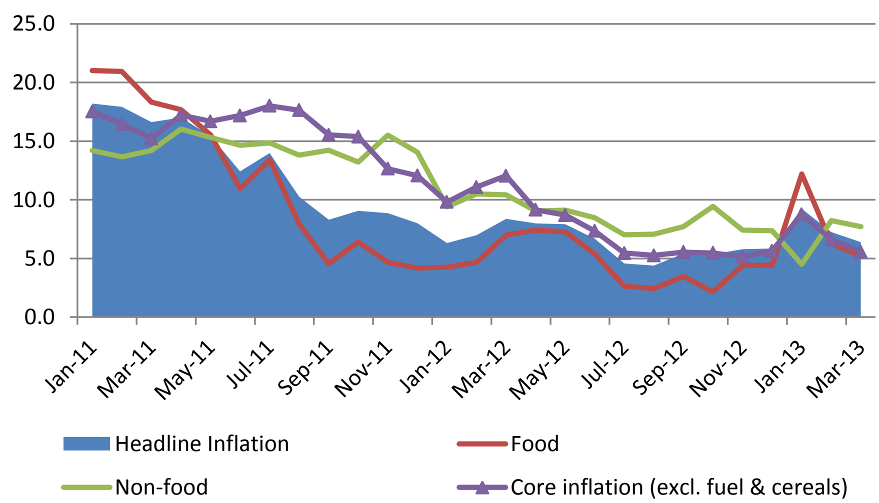
While the nominal difference between opium-GDP and non-opium-GDP is relatively small—an average of US$500 million each year—non-opium and opium GDP growth can differ by more than 5 percentage points in some years (Figure 6). However, average opium GDP growth has been only slightly higher than non-opium GDP growth: 9.4 percent compared to 9.2 percent, which suggests that between 2003 and 2012 opium has not been an important driver of economic growth.

That said, opium is still Afghanistan's single most important cash crop and therefore has significant implications for income and consumption of rural, poor households. This, in turn, adds to the complexity of finding the right approach to reducing opium production, which ultimately hinges on the development of alternative and competitive agricultural supply chains. During the transition years, opium production may grow temporarily because some households may increase production as a coping mechanism to make up for income loss from other economic opportunities generated by high aid flows.

Consumer price inflation retreated in 2012

CPI inflation dropped from 10.2 percent in 2011 to 6.4 percent in 2012. Declines in both food and non-food prices contributed to the decline in headline inflation. Core inflation – CPI excluding fuel and cereals – dropped from 14.6 percent in 2011 to 6.4 percent in 2012. Higher core inflation in 2011 compared to the headline was mainly due to a sharper decline in prices for fuels and cereals in that year, in line with international developments (Box 2).

Figure 7: Monthly CPI Inflation (2011-2012)



Source: CSO

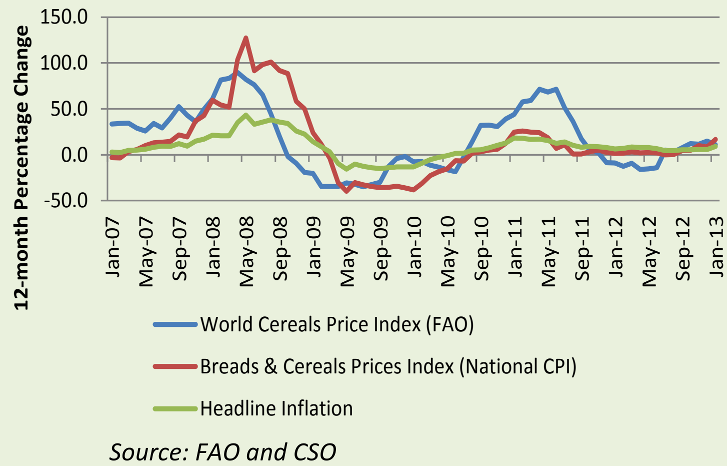
Box 2: Understanding Afghanistan's Inflation Pattern

Domestic inflation follows trends in global commodity prices. In particular, international prices for cereals and fuel have a strong impact on food and energy prices in Afghanistan (figures 8 and 9). Two major factors explain this pattern of inflation. Firstly, cereals and fuel together attract approximately 22.5 percent of consumer spending and thus have strong influence on the overall price level in the country. Secondly, Afghanistan is not self-sufficient in cereals; in years with poor weather conditions and harvest, the country imports most of its cereal requirements from abroad. Similarly, there is a strong dependence on fuel and oil imports, which will continue until the country's oil fields reach maximum production capacity in the next five years and can meet part of the domestic oil demand.

Another peculiarity of Afghanistan's inflation pattern is that the pass-through of changes in international commodity prices is significant not only in size but also in speed. A simple analysis of the cross-correlation coefficient between global prices (of both cereals and fuel) and overall domestic prices shows that it takes only about three months for international prices to impact domestic inflation.

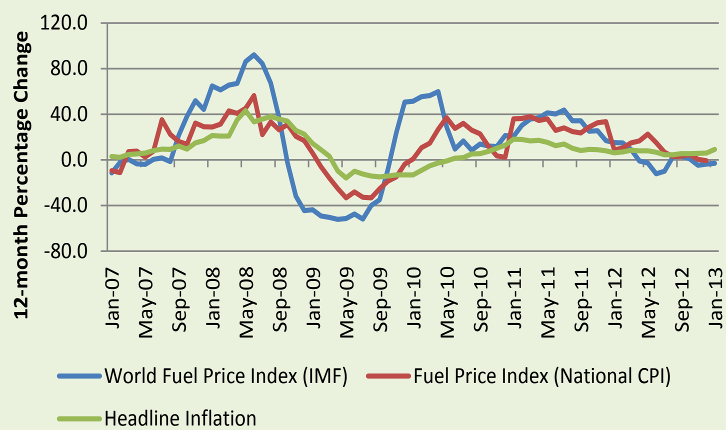
Considering that international price developments have such a large and

Figure 8: Global and Domestic Prices of Cereals



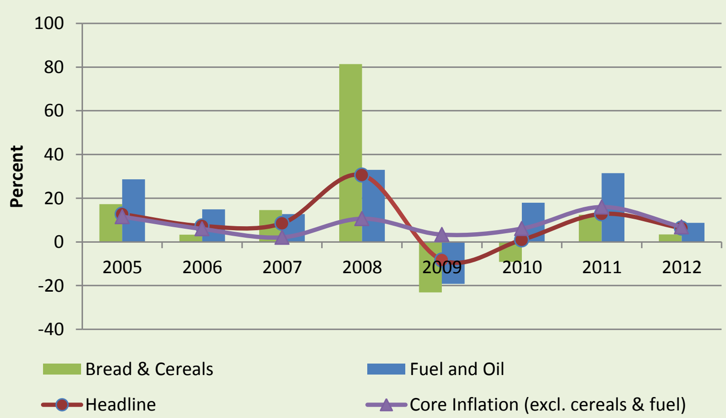
Source: FAO and CSO

Figure 9: Global and Domestic Prices of Fuel



Source: IMF and CSO

Figure 10: Core and Headline Inflation



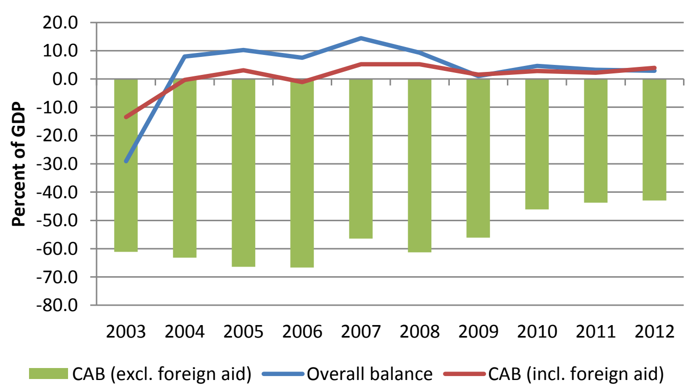
swift impact on national inflation, can core inflation (CPI excluding food and cereals) be used to predict long-term inflation? An analysis of past trends shows that in years where prices of cereals and fuel were exposed to large fluctuations—i.e., between 2007 and 2010—core inflation followed a rather smooth trend. For example, headline inflation reached a record high of 30.5 percent in 2008 and subsequently dropped to -8.3 percent in 2009, which was primarily driven by the 2008 world commodity price crisis. Yet core inflation remained at 10.6 percent and 3.3 percent in these two years (Figure 10). However, in 2011* where non-food and non-energy prices increased more sharply and the prices of cereals and fuel remained stable, core inflation was higher than headline inflation (15.9 percent compared to 12.8 percent). This implies that core inflation can be a good indicator of the level of prices, but only during times of strong volatility in cereal and fuel prices.

Note: Data in this box follow the Gregorian calendar year.

The terms of trade have deteriorated

Exports, estimated at US$2.6 billion, declined by 5 percent in 2012, in spite of a weakening currency. In contrast**,** total imports increased by approximately 5 percent, to US$11.2 billion in 2012, leading to a higher nominal trade deficit, of US$8.5 billion in 2012.[4] The Afghan export base has relatively few tradable products and these are heavily concentrated in a few markets. Dry fruits, which account for around one-third of official exports, declined by 21 percent. Carpet exports, another major export item, nearly halved to US$23 million in 2012. This trend is at odds with the depreciation of the afghani observed during 2012 (see below) which, in principal, should have led to a positive export response, at least at the margin. The lack thereof demonstrates Afghanistan's limited export capacity. The strong depreciation of the Pakistani rupee against the US dollar might have accounted for lower demand for Afghan carpets. Pakistan is traditionally the most important market for Afghan carpets, where they are processed and exported to European markets. The declining trend in dry fruits exports, however, seems to indicate a loss of competiveness in important EU markets.

Figure 11: Current Account and Overall Balance

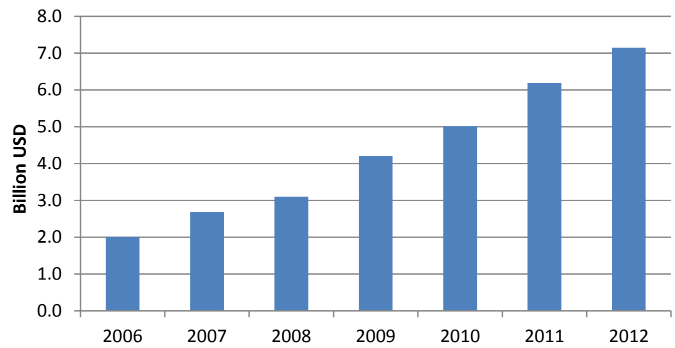


Source: IMF

[4] These estimates include both official and unrecorded trade (smuggling), as well transit exchanges, but they exclude opium trade. Forty percent of trade is believed to be unrecorded, mainly because of the weaknesses that exist in border security and customs. According to the Central Statistics Organization, official (recorded) exports declined by nearly 20 percent in 2012 (January through December), while imports increased by more than 30 percent. Official exports were recorded at US$346 million, which are less than 2 percent of GDP. Official imports, on the other hand, reached US$8.3 billion in 2012.

Afghanistan's external position in 2012 remains weak. The huge trade deficit of 43 percent of GDP was offset by large transfers—mainly foreign aid inflows—in the current account. Remittance inflows, believed to be large, are mostly informal and not captured by the balance of payments statistics. Foreign direct investment remained stagnant at around 2 percent of GDP. As result, the overall balance of payments in 2012 remained in surplus which contributed to a further accumulation of international reserves. Gross international reserves reached an all-time high of US$7.1 billion in December 2012 (Figure 12) but declined to US$6.5 billion by March 2013. The reduction in foreign exchange reserves in the first three months of 2013 could indicate decreasing capital inflows to the country due to a reduction in international troops' military spending.

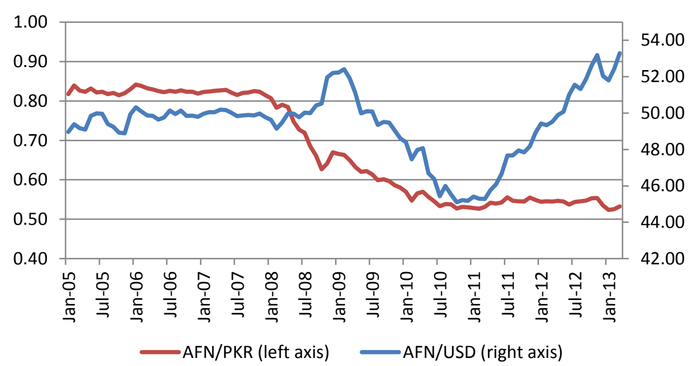
Figure 12: Gross International Reserves



Source: DAB

The exchange rate depreciated by 8 percent in 2012 (Figure 13). The afghani, which averaged Afs 47.9 to the US dollar in 2011, depreciated to Afs 51.8/US$1.00 in 2012. The depreciation was likely driven by increased uncertainty over security and the business environment, as reflected in increased demand for foreign exchange at the Central Bank auctions. However, the afghani remained stable against the euro and the Pakistani rupee. It exchanged at Afs 66.5 and Afs 0.54 on average respectively against both currencies in 2012.

Figure 13: Afghani Monthly Exchange Rate vis-à-vis the US Dollar and Pakistani Rupee



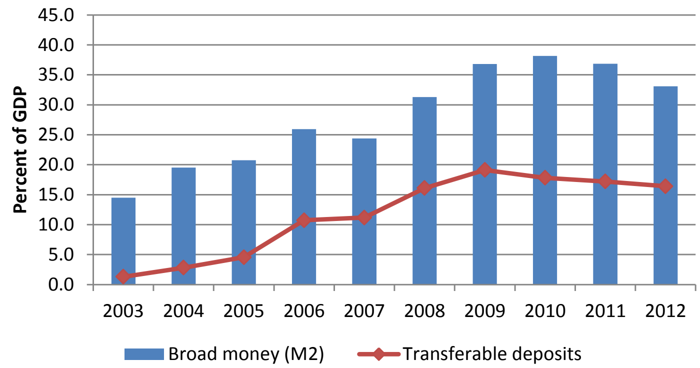
Source: Da Afghanistan Bank

Note: Both exchange rates are expressed as units of afghani against one unit of foreign currency.

Slow money growth amid shaky transition and sluggish recovery from the Kabul Bank crisis

Money demand was low in spite of strong economic growth and lower inflation. The Da Afghanistan Bank (DAB) curbed reserve money growth to 4 percent in 2012 in response to lower demand for local currency. Afghanistan has a highly dollarized economy, and given the loss of confidence in the afghani in the wake of transition, economic agents are even more encouraged to increase their foreign currency holdings. Given the nascent stage of financial markets in Afghanistan, the DAB relies mainly on open market operations with reserve money as nominal anchor. However, the DAB also maintains a managed floating exchange rate regime in order to limit excessive movements in the exchange rate. In November 2012, the DAB intervened in the foreign exchange market to limit abrupt depreciations in the exchange rate that had reached Afs 55.6/US$1.00 in the second week of the month. The DAB auctioned an average US$52 million per week in November, compared to around US$30 million on average in earlier months, to curb the exchange rate depreciation.

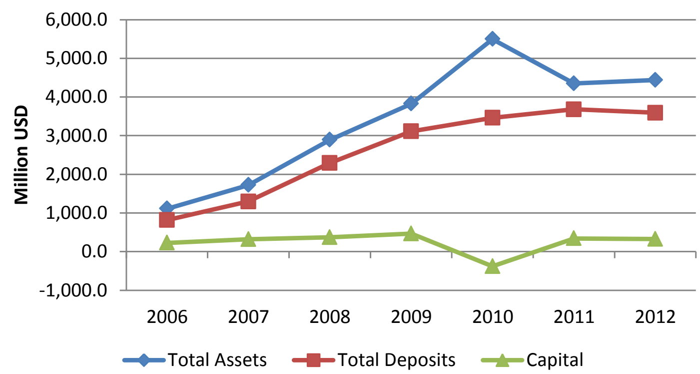
Figure 14: Broad Money and Transferable Deposits



Source: DAB

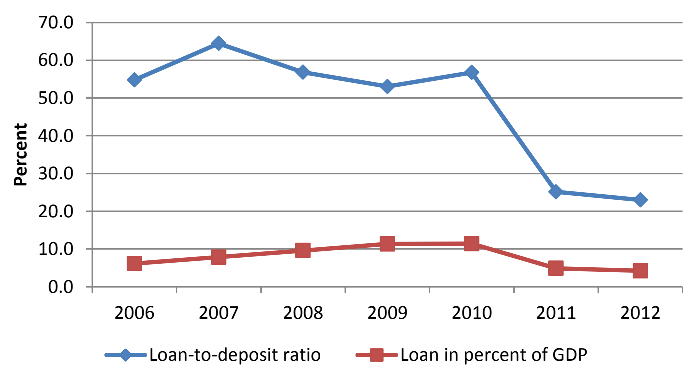
The aftermath of the Kabul Bank crisis is still affecting money growth. Broad money (M2) declined from 38.2 percent of GDP to around 33 percent in 2012 after the Kabul Bank crisis had shaken Afghanistan's nascent financial sector (Figure 14). Transferable/demand deposits which grew at an average 80 percent between 2005 and 2009 have slowed to an average 12.5 percent over the past three years. Prior to the crisis, the banking sector experienced strong growth (from a very low base), reaching US$5.5 billion in total assets and US$3.5 billion in total deposits in 2010 (Figure 15). In 2012, two years after the crisis, total assets of the banking sector had declined to US$4.4 billion. These developments demonstrate a loss of consumer confidence in Afghanistan's banking system. Compounding, trends in bank lending indicate both a change in the risk perception of the commercial banks and a declining performance of the banking sector. Growth of commercial loans, which averaged around 40 percent annually before the crisis, has plummeted to -20 percent since 2010. As a result, the loan-to-deposit ratio dropped from 56.8 percent in 2010 to 23 percent in 2012 (Figure 16).

Figure 15: Assets and Liabilities of the Banking Sector



Source: DAB

Figure 16: Banking Performance since 2006



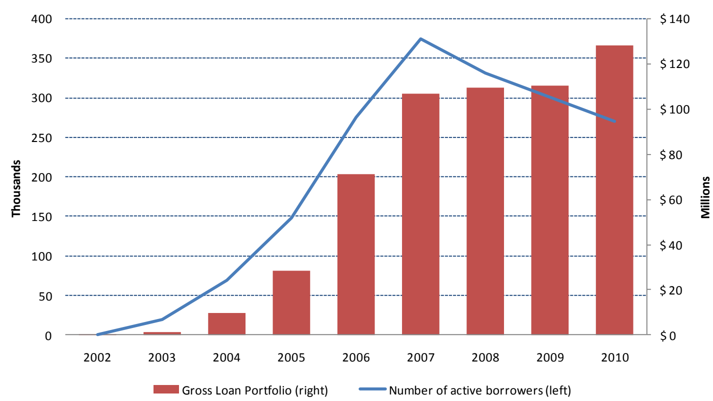
Source: DAB

The future of New Kabul Bank is yet uncertain. The former Kabul Bank's deposit liabilities and good assets, among them the country's largest branch network and electronic payment system for public salaries, were transferred to a bridge bank, New Kabul Bank (NKB, owned by the government of Afghanistan). The privatization process of NKB is ongoing: the authorities have rejected the only bid received and are now exploring alternative options to privatize. A key issue in the consideration of alternative options for privatization is the future of the civil service salary payment system. NKB – as the bank with the largest branch network - is responsible for processing the bulk of civil servants salaries across Afghanistan.

Amendments to the banking law are aimed at improving regulatory oversight. Following the Kabul Bank crisis, all major banks were subjected to forensic or special audits. The results indicated systemic fragility and vulnerability in all areas of banking governance and operations, including skills, internal controls, accounting, credit analysis, and compliance with regulations (in particular with regard to related parties lending and single obligor limit). Though sobering, some of these symptoms can be attributed to the early development stage of the sector, and the generally volatile business environment in Afghanistan, which prompted one of the few international banks, Standard Chartered, to cease operations in September 2012. Moving toward improved regulatory oversight and better integrate Islamic banking, the Council of Ministers approved amendments to the banking law in March 2013.

Trends in the microfinance sector remain a concern. The microfinance sector has been going through a deep consolidation phase since 2008, resulting in slower growth of the loan portfolio, a decline in the number of active borrowers, and the exit of several institutions from the sector (Figure 17). Just after the first signs of recovery emerged toward the end of 2012, two microfinance institutions reported severe difficulties and possible bankruptcy. Their likely demise will lead to a further reduction in size of the dwindling microfinance sector, with fewer borrowers and lower outstanding loans. Microfinance institutions are currently piloting a number of new financial products to better address the need to the Afghan population, including SME lending or sharia-compliant financial products. The sector remains dominated by First Microfinance Bank (FMFB), a commercial bank with a healthy standing, targeting small and medium enterprises. FMFB claims 54,000 borrowers (16 percent of them women), and a loan portfolio of US$23.6 million.

Figure 17: Microfinance in Afghanistan



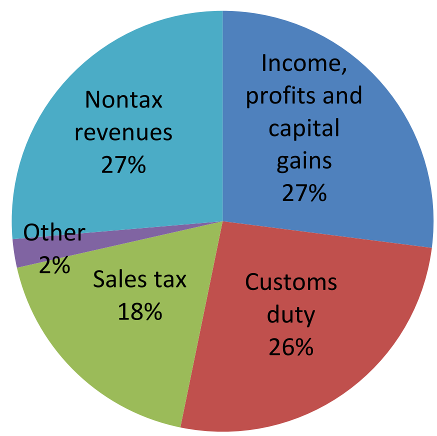
Source: MIX market website and Micro Banking Bulletin

Public Finances

Overall spending increased while revenue performance faltered in 2012

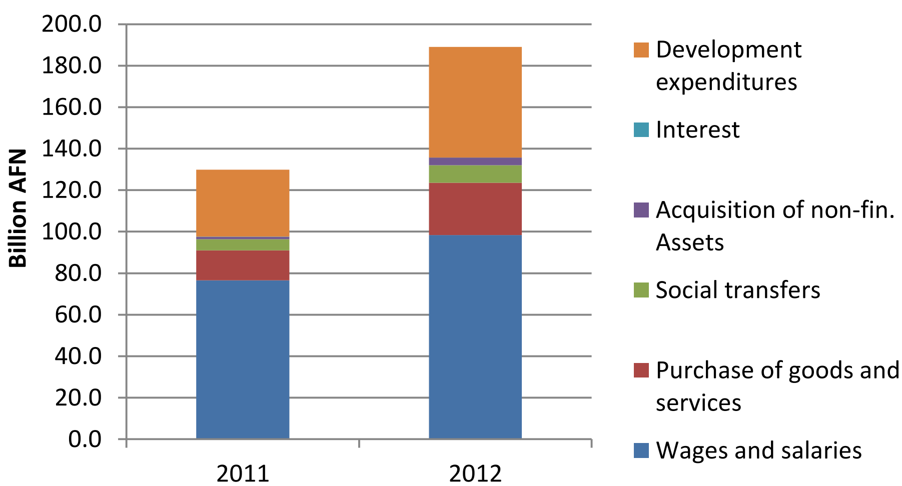
Public spending increased in fiscal year 2012. The Ministry of Finance shifted the budget cycle to a new calendar.[5] To allow for this transition, the 2012 fiscal year covered only nine months, so naturally 2012 spending was lower than total spending had it been a full fiscal budget cycle. However, compared to the first nine months of the previous fiscal year (April-December), public spending increased by 45 percent in 2012**.** Total spending amounted to US$3.7 billion in fiscal year 2012, of which 28 percent, or US$1 billion, represented development expenditures. Operating expenditures reached US$2.6 billion (72 percent of total budget)—increase of 40 percent over the same period in the 2011/12 budget. Wages and salaries, and the supply of goods and services, are the two largest components of the operating budget (Figure 19).

Figure 18: Domestic Revenues in FY 2012



Source: Ministry of Finance

Figure 19: Core Budget Comparison, 2011 and 2012



Source: Monthly Fiscal Bulletin 9, 1391; Ministry of Finance
Note: 2011 data only covers April – December in order to allow a fair comparison with the 2012 budget (April – December)

[5] The new fiscal year runs from December 21-December 20, as opposed to March 21-March 20.

The increase in public spending has been driven primarily by a larger security bill. Security spending increased to roughly US$1.6 billion in fiscal year 2012, showing a 48-percent increase over the nine months of the previous year. Security expenditures make up 60 percent of the operating budget. Nonetheless, non-security expenditures have also increased from US$1.5 billion to US$2 billion over the same period. Sectors such as infrastructure and natural resources, private sector development, health, and education have had higher increases in both operating and development spending.

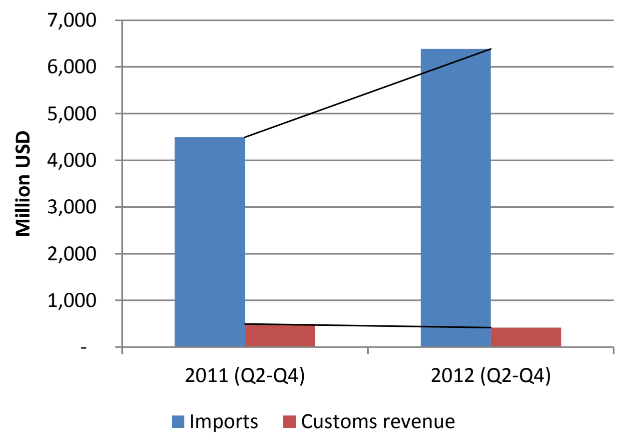
Budget execution improved in real terms in 2012. As in the year before, only half of the development budget was executed in 2012. Nominally, however, the government disbursed almost as much funds in the nine months (US$ 1 billion) as it did over the full 12 months of the previous year (US$ 1.1 billion). In the comparative nine months of 2011, the government disbursed around US$675 million in development expenditures. This implies an increase in the absorptive capacity for on-budget donor funding of 53 percent. The Ministry of Urban Development had the highest execution (65 percent) of development budget in 2012 (Figure 20). However, in nominal terms, Ministry of Public Work and Ministry of Rural Rehabilitation and Development executed the largest development budgets of around US$255 million and $245 million, respectively; these represent 57 percent and 58 percent of their allocated budgets. On the other hand, almost half of the ministries executed less than half of their development budgets. The two ministries of Education and Higher Education spent only 34 percent and 40 percent of their allocated development budgets in 2012.

Figure 20: Development budget execution by ministries

Source: Ministry of Finance

Domestic revenues increased nominally by 13.1 percent in 2012 but fell short of targets. Revenues reached Afs 81.7 billion (equivalent to US$1.6 billion) but missed the targets agreed with the IMF, mainly because of a lower revenue performance at customs. Customs revenues, which account for approximately one-fourth of total revenues and have continuously increased over the past decade, declined by 9.6 percent in spite of higher import volumes (Figure 21). While several factors could explain the shortfall, it is likely that a deteriorating governance environment at customs has contributed to the lower performance. The Ministry of Finance has undertaken administrative reforms to strengthen revenue collection, including changing leadership and senior staff of the revenue and customs department.

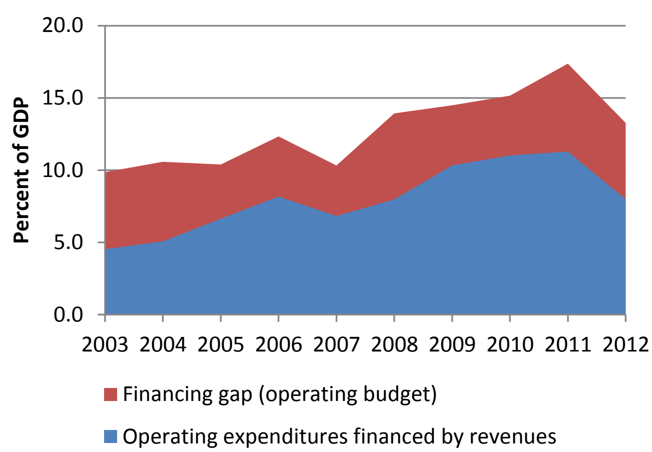
Figure 21: Imports and Customs Revenue performance (2011-2012)



Source: CSO (for imports) and MoF (for customs revenue)

Due to the shortfall on revenue, fiscal sustainability further deteriorated in 2012. The fiscal sustainability ratio, defined as domestic revenues over operating expenditures, declined from 65 percent in 2011/12 to 60 percent in 2012 (see Figure 22). However, the smaller budget and the shorter budget period narrowed the financing gap from 6.1 percent of GDP in 2011/12 to 5.3 percent in 2012, and was, as in previous years, financed entirely by donor grants. Domestic revenues financed approximately 40 percent of the operating budget and the development expenditures. Total donor financing thus reached 65 percent of the core budget in 2012.

Figure 22: Fiscal Sustainability (2003-2012)



Source: World Bank Staff calculation based on data provided by the Ministry of Finance

Box3: More Aid on Budget—Testing Government Systems in 2013

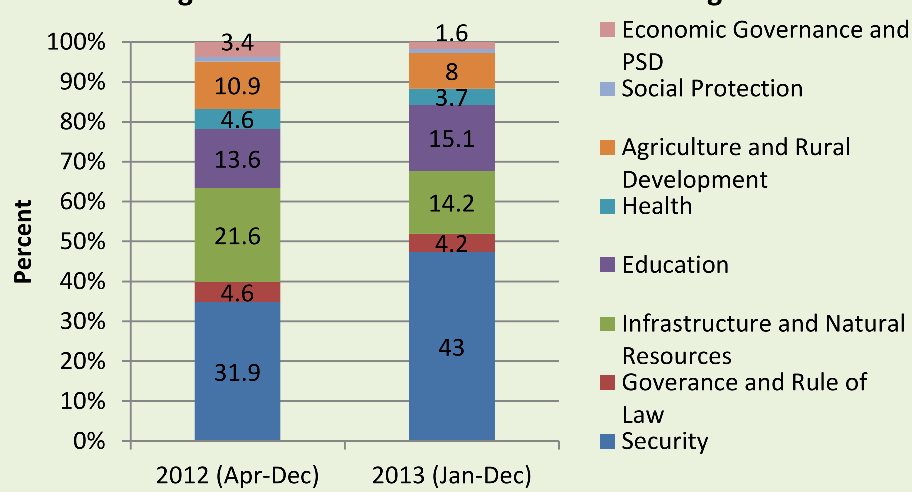
The Afghan government and the international community agreed at the Kabul Conference in 2010 to align 80 percent of donor spending with the National Priority Programs (NPPs) and to channel at least 50 percent of external aid through the budget. This was re-affirmed in the Tokyo Mutual Accountability Framework (TMAF) in 2012. In line with these commitments, on-budget funding is increasing. For fiscal 2013 the parliament approved a total budget of US$6.8 billion—an increase of 40 percent over last year's budget. Both, development and operating expenditures are set to increase. The operating budget, which makes slightly more than half of the total budget, amounts to 17.6 percent of GDP. The government expects domestic revenues to increase to US$2.5 billion (11.6 percent of GDP) this year, with increases in all sources of revenue. This could finance approximately 65 percent of the operating expenditures, with the remainder to be financed through donor grants. The government budgeted around US$4.1 billion in grants (for security and civilian expenditure) for this year, which is almost twice as much as in 2012. Nevertheless, the government still projects a fiscal deficit of around 1 percent of GDP, or US$250 million.

As expected during the transition process, allotments for the security sector increased and now assume 43 percent of the total budget allocation (Figure 23). In relative terms, security spending is crowding out spending in other sectors, except for education for which budget allocations increased in both nominal and relative terms. Budget allocated to education increased by 55 percent compared to last year. By contrast, the infrastructure and natural resources sector received less budget this year; the allocation decreased to approximately US$965 million from US$1.1 billion last year.

Table 2: National Budget (US$ million)

	FY 2012 (Apr-Dec)	FY 2013 (Jan-Dec)
Operating budget	2,673.80	3,775.50
Development budget	2,221.10	3,033.60
Total Budget	4,894.90	6,809.20
Domestic revenues	1,900.30	2,488.30
Donor grants	2,740.10	4,076.70
Budget balance	-254.5	-244.2

Figure 23: Sectoral Allocation of Total Budget



On-budget development expenditures increased by 25 percent this year. The discretionary budget amounted to US$875 million compared to US$700 million in 2011/12.

The large budget increase will pose significant challenges to budget execution this year. The authorities will need to exercise tremendous commitment towards improving country systems in order to ensure that execution does not fall below present levels. More emphasis should be placed on streamlining administrative procedures and building more project management capacities in the ministries.

Economic Outlook 2013 and Medium-Term Prospects

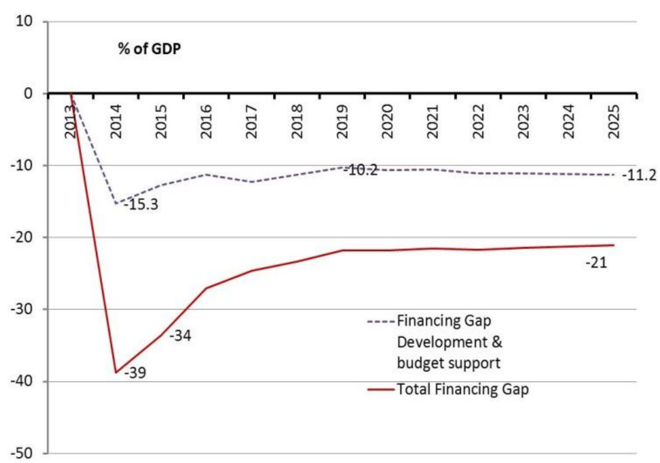
Economic growth is expected to slow in 2013 and 2014. Political and security uncertainties during the transition period will continue to take a toll on business confidence and investment. Increased public spending, however, will continue to fuel demand for services and construction through 2013. Mining should contribute more noticeably to growth with the increase in oil production in Amu Darya. However, moderate rainfalls earlier this year will likely bring a reduction in this year's harvest to a more ordinary output level and slow GDP growth to 3.1 percent in 2013. Assuming favorable weather conditions and peaceful elections, growth could pick up in 2014.

These developments are in line with medium-term projections.[6] The withdrawal of international troops is associated with a decline in security and civilian aid. Projections suggest that even with favorable assumptions, which hinge on good progress in mining and a relative stable security environment, real GDP growth may fall from the average of 10 percent per year experienced over the past decade to 4-6 percent during 2011-2018. Given Afghanistan's annual population growth of 2.8 percent, this would mean only limited improvement in average per-capita income, continuing high rates of underemployment and little progress in reducing poverty. Only growth at the upper level of the range of plausible scenarios would enable Afghanistan to meaningfully reduce poverty and achieve higher per-capita incomes. For example, with real GDP growth of 6 percent per year, average per-capita income—currently one of the world's lowest, at US$528 dollars—would take 22 years, or about a generation, to double.

In spite of the relatively optimistic growth prospects, Afghanistan's economy is exposed to some serious risks which need to be carefully managed. First and foremost, there is a lot of uncertainty attached to the upcoming elections in 2014 and the impact of the transition process on Afghanistan's security situation. The fragile security environment has been the single most binding constraint to private-sector investment and private-sector-led 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 it, the above-mentioned growth prospects will not materialize.

Substantial risks lie in rising fiscal financing needs. Ongoing analysis projects revenues to reach more than 16 percent of GDP by fiscal 2022 (from current levels of 11 percent).[7] However, expenditures are expected to grow much faster. Total government spending could rise to 39 percent of GDP over the next ten years, and potentially even higher in many of the intervening years (Figure 24). The increase in

Figure 24: Financing Need 2012-2025



Source: World Bank (2012): Afghanistan in Transition

[6] The World Bank, 2013. *Afghanistan in Transition. Looking Beyond 2014.* Washington, DC.

[7] This outlook assumes that the Aynak copper mine and the Hajigak iron mine commence operations as envisaged.

expenditure is largely a result of rising security spending for both operations and maintenance (O&M) and wages for the army and police, which are currently funded by donors outside of the budget. But it will also be driven by non-security spending, which will increase due to additional O&M liabilities associated with the handover of donor-built assets and with a rising government payroll, as the pay and grading (P&G) reform is completed and some additional expenditure is taken on to develop a senior civil service cadre at higher wages. Security spending is projected to be more than 15.2 percent of GDP in fiscal 2022 (about as much as total projected domestic revenue in that year), the civilian wage bill 4.8 percent, and the civilian nonwage O&M bill 7.2 percent.

Moreover, risks lie in the uneven distribution of aid impact. Aid has not been evenly spread across the country. Because of the choices made by donors, and the predominant role of stabilization and military spending, the conflict-affected provinces have had significantly higher per-capita aid than the more peaceful (and often poorer) provinces. As a result, the slowdown in aid is likely to be felt more acutely in the conflict-affected areas and in urban centers, most likely through a loss of wage-labor opportunities as military bases and provincial reconstruction teams (PRTs)[8] close. In urban centers, such as Kabul, wage levels of higher-qualified people might decline due to fewer opportunities in donor-financed projects. At present, with seven out of 30 PRTs closed, the available analysis and data do not suggest any significant impact, or it might be too small to influence (available) economic aggregates. Nevertheless, there are considerable political economy risks that deserve constant attention.

In order to mitigate some of these risks, donors have committed to cover the financing gap. The July 2012 donor meeting in Tokyo pledged US$16 billion in development aid to Afghanistan over the next four years. Together with earlier pledges on the security side, annual aid would amount to about US$8 billion—divided roughly equally between civil and security aid. This should help to cover the projected financing gap and allow the authorities to accelerate progress towards achieving the UN's Millennium Development Goals (MDGs) and other infrastructure targets.

Structural economic reforms over the next two years should focus on measures that promise the highest pay-off with regard to revenue mobilization. These include (i) creating an enabling legal and regulatory environment for private mining investment, (ii) introduction of the planned value-added tax, and (iii) deep customs reforms to reduce opportunities for rent-seeking at borders. Emphasis should also be placed in increasing the capacity of the administration to execute the budget and provide more transparency and accountability to governance systems, in order to increase government effectiveness. To this end, improved land acquisition and management processes could help to reduce delays caused by unresolved eminent domain issues.

A step in the right direction is the recent progress in improving the legal and regulatory environment for mining. Concerns around future directions in the mining sector have led to much controversy and long debate around the proposal for a new mining law. The law is expected to provide better security of tenure for investors and clearer guidance on licensing, tendering and other obligation. The new law is critical to concluding the pending Hajigak mining contracts and to attracting new investment in the sector. The submission of the new draft minerals law to Parliament is finally anticipated for mid-April, though there is some uncertainty over further changes to the law that could potentially undermine investment in the sector.

[8] PRTs are joint civilian-military diplomatic outpost at the provincial level which were established to improve security, to extend the authority of the Afghan central government, and to facilitate reconstruction.

Preparing for the Future post-2014

Security considerations aside, Afghanistan's future will in all likelihood rely on its natural resource abundance. Education levels are too low and the manufacturing sector too underdeveloped (in size and capacity) to expect leapfrogging the classic pattern of structural transformation in which a natural resource-based economy is transformed into a diversified and productive economy dominated by manufacturing and services. Currently the potential for productivity growth is the largest in the agriculture and the mining sector which suggests that Afghanistan is still at an early stage of structural transformation.[9]

The mining sector offers good opportunities for more growth. It is reasonable to believe that an improved security environment and a more favorable legal and regulatory environment in the mining sector would lead to the exploitations of more mines than those already factored in to the current projections. In a scenario with higher investment in mining development, growth could increase to 6.9% on average until 2025, and fiscal revenues could reach 2-4 percent of GDP in the early 2020s, depending on the number and scale of the exploited mines and the pace of their development.

Even so, the direct impact of mining is unlikely to be transformative. Mining is a capital-intensive economic activity and produces few jobs. In the best-case scenario, mining in Afghanistan could directly and through indirect effects generate about 100,000 to 125,000 jobs over the next ten years. This is a rather small number, considering that more than 400,000-500,000 people will be entering the workforce annually over the next five to ten years. With most of these jobs being for skilled and semi-skilled workers, with a relatively small proportion being unskilled and involving heavy manual work, the direct benefits for the poor and women will be very limited. [10]

On the other hand, there is a chance to multiply the impact of the mining sector by sequencing investment and reforms that are within the control of the government, the development community and the private sector. Such a sequence of action is articulated in the Resource Corridor approach which rests on the idea of using mining development as an anchor for the infrastructure 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.[11]

Realistically, however, agricultural development remains Afghanistan's biggest hope to achieve sustainable, inclusive growth. Afghanistan has a long tradition in horticulture and livestock production and used to be an important exporter of fresh and dried fruits, vegetables and nuts. But during the last three decades, while countries like China, India and Turkey heavily invested in modern agricultural technologies and experienced a "green revolution", three decades of conflict have brought destruction and disinvestment to Afghanistan's agricultural sector. To recapture its lost competiveness, Afghanistan

[9] The World Bank (2013 upcoming). *Afghanistan: Pathways to Inclusive Growth*. Washington, DC.
[10] As has been the case for generations.
[11] The World Bank (2012). *Resource Corridor Initiative—Technical Summary*. Washington, DC.

needs to invest heavily in irrigation systems, new production and post-harvest processing technologies—measures that could increase the country's agricultural productivity, which currently is below 50 percent of its pre-war level. Household-level data show that despite shortages of agricultural land in the country, a significant portion remains underutilized due mainly to lack of water and poor soil quality. Only 63 percent of farmers use fertilizer, a much smaller fraction uses pesticides or herbicides, and only few obtain information or advice on crops or planning methods.[12] From a positive point of view, the challenges offer ample opportunities for productivity enhancement through, for instance, investment in the rehabilitation of irrigation systems.

Agriculture is highly relevant to job and income growth. Workers employed in the agriculture sector represent 60 percent of total employment, meaning that three out of five workers have their main source of income in farm related activities. 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. To improve this situation would require mobilizing much of the Afghan population, the largely underutilized rural labor force, and stimulating development of markets, internal demand and, indirectly, the development of the non-farm sector.

Improving literacy, skills and education in Afghanistan, especially in rural areas, is a key priority to fostering inclusive growth. The human capital stock 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, moving forward on a sustainable growth trajectory will require strong institutions that govern private and public investments and the fair distribution of resources. Given Afghanistan's weak governance environment, there is a risk that the abundance of natural resources might not turn into a blessing but could be a bane for economic and political development. 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, fight pervasive corruption, improve regulatory oversight and enhance the capacity for public service delivery will ultimately determine Afghanistan's future growth prospects.

[12] The World Bank (2013 upcoming). *Afghanistan: Challenges and opportunities for inclusive growth—A labor market view.* Washington, DC.

Annex 1: World Bank 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 the 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, our 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$2.6 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$6.28 billion from 33 donors, and committed US$2.95 billion for the government's recurrent costs and US$2.95 billion for government investments programs. At end-March 2013 the active IDA portfolio was worth US$1.13 billion and the active ARTF investment portfolio was worth US$1.79 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 (OP 8.0). 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 2012, IDA approved two new grants worth 144 million. These included the Financial Sector Rapid Response and the Afghanistan Rural Access Project. In addition, the ARTF approved US$270 million in recurrent-cost financing (of which US$70 million was based on meeting the benchmarks of the ARTF Incentive Program 1389) and US$443.56 million for investment window financing for two new projects, the Second Judicial Reform and the Capacity Building for Results

Facility, and for additional financing operations on Horticulture and Livestock, Irrigation Rehabilitation and Development, and the Education Quality Improvement Program.

6. During fiscal year 2013, the World Bank Board approved two IDA-financed projects totaling $155 million. The new projects included US$100 million for the System Enhancement for Health Project and US$55 million for the Second Skills Development Project. Under the ARTF, new investment financing of US$307 million was committed in fiscal 2013, of which $207 million was for co-financing of the core IDA-financed national program, Afghanistan Rural Access Project, and $100 million was for a new operation on National Horticulture and Livestock Productivity Project.

7. For fiscal year 2014, planned commitments are $200 million from IDA, ensuring that the full IDA-16 is utilized, and $1 billion for operations financed by ARTF for both Investment and Recurrent Cost Windows.

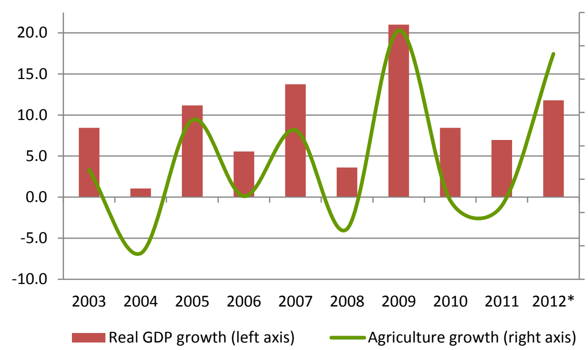
IFC and MIGA operations in Afghanistan

8. The Multilateral Investment Guarantee Agency of the World Bank Group (MIGA) has $150m of guarantees outstanding in support of MTN cell-phone operations in the country. IEG recently reviewed the project and endorsed the significant development impact from the project, including connecting 4.6 million customers and supporting many thousands of SMEs. MIGA is currently underwriting a $4.5m textile investment in Afghanistan that will have significant employment impact, including female employment. MIGA is developing a 'Conflict Affected and Fragile States 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.

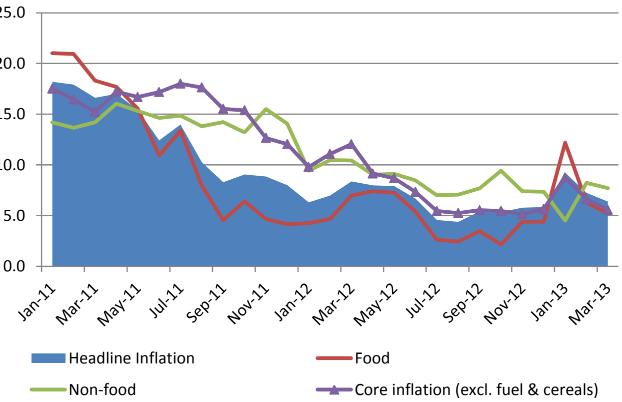
9. The International Finance Corporation's (IFC) current committed investment exposure in Afghanistan amounts to US$137 million in 5 companies in the telecommunications, hospitality, and financial sectors. IFC has an active Advisory Services program with six active mandates amounting to a budget of US$5.7 million in the following areas: (i) *Access to Finance*; (ii) *Investment Climate*; (iii) *SME Capacity Development*; and (iv) *PPPs*. In FY13, IFC committed US$65 million in the telecom sector and expected to commit another US$5 million in the manufacturing and financial sectors by end June 2013, 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.

Annex 2: The Afghan Economy at a Glance

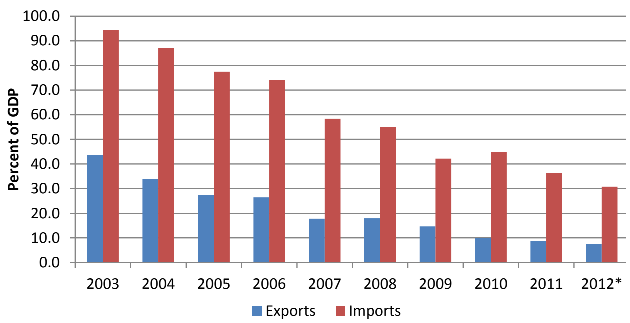
Growth has been strong, but volatile…



…and inflation is declining.

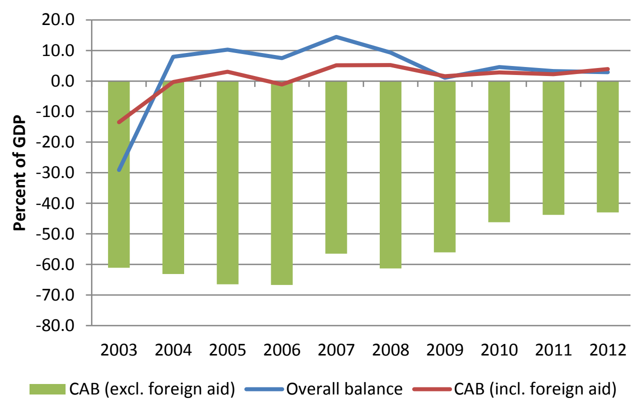


Trade is decreasing…

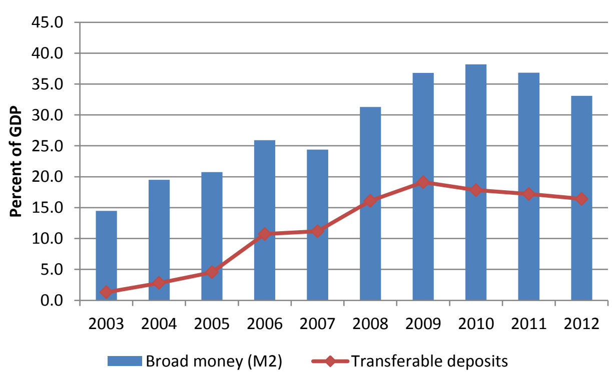


** Only official trade statistics; Numbers for 2012 are projections.*

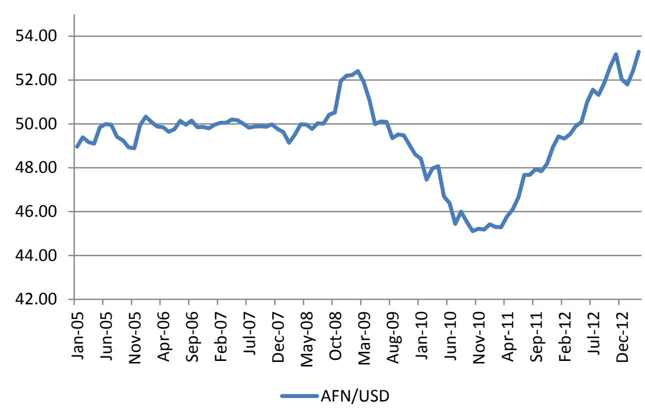
…but the current account is in balance thanks to large foreign aid inflows



Monetary indictors have degraded since the Kabul Bank crisis in 2010…



…and the exchange rate is depreciating.



Annex 3: Selected Economic Indicators

(% of GDP, unless stated otherwise)	1386 2007/08	1387 2008/9	1388 2009/10	1389 2010/11	1390 2011/12	prel. est. 1391 2012/13
Real Sector						
Nominal GDP (excl. opium; billion Afs)	490	519	615	730	864	1,023
Nominal GDP (excl. opium; billion US$)	9.8	10.2	12.5	15.9	18.0	19.8
Real GDP growth (%)	13.7	3.6	21	8.4	7.0	11.8
GDP per capita (US$)	338	342	408	507	557	595
Money and Prices						
CPI inflation (period average, %)	12.9	26.8	-12.2	7.7	10.2	6.4
Core inflation (excl. fuel & cereals, %)	4.3	10.6	1.7	9.8	14.6	6.6
Broad money (M2)	24.4	31.3	36.8	38.2	36.8	33.1
Government finance /1*						
Domestic Revenue	6.8	8.0	10.3	11.0	11.3	10.6
o/w: tax revenue	5.1	5.5	8.4	9.1	8.7	7.8
Donor grants	10.9	10.1	10.2	11.0	10.8	16.2
Total Core Budget expenditure	19.5	22.8	22.1	21.1	23.0	24.6
Operating	10.3	13.9	14.5	15.2	17.4	17.7
Development	9.2	8.9	7.6	5.9	5.7	6.9
Operating balance	1.2	0.3	1.2	3.3	0.9	5.1
Overall Core balance (incl. grants)	-1.8	-4.3	-1.6	0.9	-0.9	2.1
Security spending	5.1	6.0	7.3	8.8	10.0	10.7
Fiscal sustainability ratio	66.1	57.3	71.3	72.7	65.0	60.2
External Sector						
Exports FOB (billion US$) /2	1.85	2.46	2.52	2.64	2.75	2.61
Imports FOB (billion US$) /2	7.39	8.95	9.47	9.95	10.62	11.17
Trade balance	-56.3	-63.6	-55.7	-45.9	-43.6	-43.1
Current account balance (incl. grants)	5.2	5.3	1.6	2.8	2.2	3.9
Current account balance (excl. grants)	-60.6	-66.0	-58.6	-48.5	-45.9	-44.9
Gross reserves (million US$)	3,007	3,565	4,312	5,560	6,193	7,162*
Gross reserves (months of imports)	4.9	4.8	5.5	6.7	7.0	7.7*
Total External debt						
Total debt stock (billion Afs) /3	96.6	107.1	106.2	100.8	114.3	112.2*
Debt-to-GDP Ratio (%)	19.7	20.6	17.3	13.8	13.2	11.0*
Memorandum items						
Nominal GDP (incl. opium; billion Afs)	519	541	633	747	904	1,106
Population (millions)	29.1	29.8	30.6	31.4	32.4	33.4
Exchange rate, average (Afs/US$)	49.8	50.9	49.3	45.8	47.9	51.6
Exchange rate, end-year (Afs/US$)	49.5	51.9	48.0	45.3	49.5	52.5

** indicates values as of December 2012. Underlined numbers indicate forecasts or projections.*

/1: Fiscal indicators for 2012 have been projected over 12 months to facilitate comparison with previous years.

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

/3: official statistics by MoF.