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Executive Summary

Political events have overshadowed economic developments in Afghanistan in recent months. The protracted election process has compounded uncertainty building since 2013 from the political and security transition. An agreement on a national unity government signed on September 21 and the September 29 swearing in of the President and Chief Executive Officer provide Afghanistan with a way forward. The new government will need to quickly establish itself as a cohesive and effective unit in order to address the considerable development challenges with which Afghanistan is faced.

Economic growth, down sharply in 2013 from uncertainty over the political and security transition, is slowing further in 2014. Afghanistan experienced a sharp slowdown in economic growth to 3.7 percent (estimated) in 2013 from 9.4 percent per year during 2003-12. Uncertainty over the political and security transition led to a slump in investor and consumer confidence and a sharp reduction of new investment commitments in the non-agriculture sectors. Agricultural production was robust in 2013 but did not exceed the record levels of 2012. Several indicators point to a further slowdown of economic growth to about 1.5 percent in 2014. New investments in the non-agriculture sectors, specifically services and construction, appear to have been cut further in light of the protracted political uncertainty while agricultural production is expected to be down slightly from the record levels of 2012-13.

Afghanistan faces a deteriorating fiscal crisis, with declining revenues leading to an unfinanced fiscal gap in 2014. Domestic revenues have continued to weaken in 2014. Based on current trends, the authorities anticipate revenues of Afs 105 billion (\$1.82 billion) or 8.7 percent of GDP for fiscal 2014. This would be Afs 28.8 billion (\$500 million) short of the target set out in the approved 2014 budget. It would also represent a further decline from revenues of 9.7 percent of GDP in 2013, itself down from a peak of 11.6 percent in 2011. While the deteriorating economic slowdown is part of the explanation, increasing weaknesses in tax and customs compliance are a large part of the problem. In this context, despite austerity measures, the authorities have run down their cash balances and incurred arrears on O&M and discretionary development spending during the first eight months of 2014. Even with austerity measures, the unfinanced fiscal gap is estimated at about \$500 million for 2014. While part of this could be financed from cash balances, it is estimated that at least \$300 million in additional financing will be needed for 2014 to cover civilian salaries, pensions, and critical operating and development spending. If revenues do not reach the anticipated Afs 105 billion for the year or if projected donor grants linked to reform progress do not materialize in full, the financing gap and additional financing needed would be larger.

The new government of Afghanistan faces the dual challenge of restoring confidence in its economic prospects and addressing formidable medium term development challenges. In addition to stalled growth and the fiscal crisis, Afghanistan faces formidable medium term development challenges. These include aid dependence, job creation for 400,000 new entrants into the labor force each year, high and persistent poverty, low levels of human development, and high levels of corruption. Furthermore, fragility and conflict remain pervasive and undermine economic prospects as well as social cohesion and stability. Addressing these challenges will require reforms in three areas: (i) restoring fiscal stability; (ii) restoring confidence and creating private-sector jobs; and (iii) strengthening social cohesion and service delivery. Above all, high level commitment to tackle corruption and strengthen governance across the board will be critical to delivering on the success of reforms in these priority areas.

1. Recent Economic Developments

Protracted political uncertainty in 2014 has compounded the sharp slowdown in economic growth that began in 2013

1. **Economic growth fell sharply in 2013 as uncertainty over the political and security transition led to a considerable slowdown in the nonagricultural sectors.** Real (non-opium) GDP growth is estimated to have fallen sharply from 14.4 percent in 2012 to 3.7 percent in 2013¹. With uncertainty leading to a slump in investor and consumer confidence, growth weakened significantly across the board in the non-agricultural sectors, including manufacturing, construction and services. Growth in the services sector, which accounts for about half of GDP, fell from 16 percent in 2012 to 5.3 percent in 2013, driven by a sharp slowdown in wholesale and retail trade and government services. Transport and communications, which accounts for half of the services sector, also experienced weaker growth, but fared somewhat better from the continued repatriation of international forces and increased number of broadband subscribers. Evidence on roads and building constructed suggests that the construction sector also experienced slower growth in 2013. Meanwhile, manufacturing growth declined from 7.3 percent in 2012 to 2 percent in 2013, driven in large part by the food and beverages sector.

Figure 1: Growth of real GDP and output sectors

Source: CSO and Bank Staff estimates

Figure 2: Sector contributions to GDP growth

2. **Agriculture production was robust in 2013 but did not exceed the record levels of 2012.** Total agriculture value added in 2013 was about flat (declining very slightly by 0.2 percent) from the record levels of 2012. Given favorable weather conditions, the cereals sector (which accounts for 43

¹ The estimated economic growth of 3.7 percent for 2013 is for the calendar year and for the non-opium economy. It is thus different from the growth rate reported by the Central Statistics Office (CSO) for the 1392 solar year. The 2013 estimated growth also incorporates a number of additional adjustments based on supplementary indicators of economic activity.

percent of agriculture value added) grew by 2.3 percent in 2013, reaching the highest level achieved over the past decade. The fruits sector also grew by 2.3 percent, but livestock and other products declined by 1.7 percent and 4.5 percent respectively. Agriculture accounts for about a quarter of GDP and also has strong links to the rest of the economy, so that the robust agricultural output in 2013 would normally have buoyed overall GDP growth. However, with total agriculture production flat from the bumper level of 2012, it was not sufficient to counterbalance the overall slowdown in GDP growth in 2013 (Figure 2).

3. **The protracted political uncertainty has taken a further toll on Afghanistan's economy in 2014.** A number of available short term indicators on new firm registrations, imports, and fiscal and monetary trends indicate that the economic slowdown deepened during the first half (H1) of 2014. Private investment across all nonagricultural sectors appears to have dropped considerably in the first half of 2014 due to the increased uncertainty. Initial reports on the agriculture sector point toward another rich harvest in 2014, although overall agricultural production is expected to decline modestly. Economic growth could decline further to 1.5 percent in 2014.

Figure 3: New firm registrations, 2004-13

Source: AISA

Figure 4: New firm registrations, H1, 2013-14

4. **New investment activity dropped further across the board in the first half of 2014.** The number of new firm registrations had already fallen in 2013 to its lowest level in five years, with a reduction in both local and foreign new fixed investments (Figure 3). This downtrend worsened during the first half of 2014, when only half as many new firms were registered compared to the same period of the previous year (Figure 4). The further decline in new firm registrations occurred across all nonagricultural sectors, with construction and services particularly hard hit (Figure 4). Although no high-frequency data are available on firm inventories and gross fixed capital formation, new firm registrations should be a relatively good proxy for business confidence and investment activity in the private sector. Decisions to establish new fixed investments in Afghanistan or to expand existing investments, horizontally (expanding existing products) or vertically (investing in the supply chain), are highly sensitive to confidence in market conditions and the political environment. The number of new firm registrations would particularly reflect new fixed investments and vertical investments in the economy.

Though this is not a perfect proxy for level of economic activity, it can fairly reflect the level of confidence of both local and foreign investors.

5. **Both opium production and area under poppy cultivation increased considerably in 2013 – and is expected to remain at a high level in 2014.** According to UNODC data, opium production increased by almost 50 percent to 5,500 tons in 2013, while the total area under poppy cultivation expanded by 36 percent to 209,000 hectares (Figure 5). Opium production in 2013 appears to have recovered from the decline in 2012 triggered by adverse weather and disease. While the total value of opium production at farm-gate prices remained at about 4 percent of GDP (or \$950 million) in 2013 due to a decline in the farm-gate price, the export value of opiates (including drugs) increased from 11 percent of GDP in 2012 to 15 percent of GDP – or \$3.1 billion – in 2013. A number of factors could have contributed to the recent increase in poppy production, including (i) the introduction of new production technologies (e.g. irrigation); (ii) fewer

Source: UNODC

livelihood opportunities or the expectation thereof; and (iii) the rollback of international forces and associated counternarcotic efforts from the provinces. Although opium's importance in GDP has been declining over time (down from 13 percent of GDP in 2007 to 4.1 percent in 2013 at farm-gate prices), it is likely an important source of livelihood for a segment of the rural population.

6. **Poverty is high and persistent in Afghanistan.** According to the 2011-12 household survey, the poverty rate was 36 percent, meaning that about 9 million individuals (3 of every 8 Afghans) had consumption levels below the national poverty line. The national poverty rate remained substantially unchanged between 2007-08 and 2011-12. A number of factors could have contributed to this measured trend. First, the volatility of agriculture would affect measured trends, with the two years preceding the 2011-12 survey both featuring negative agriculture growth. Second, Afghanistan faces a daunting demographic challenge, with around 400,000 new entrants into the labor force each year and underemployment pervasive. Third, the high dependency ratio and low female labor force participation both serve as a drag on improving Afghanistan's poverty profile.

Consumer Price Inflation moderated in the first six months of 2014, driven by lower non-food price inflation, but food prices increased faster

7. **Consumer price inflation softened in recent months, mainly as a result declining prices for non-food items.** Headline inflation declined to 5.6 percent in June 2014 down from 7.3 percent in December 2013. Core inflation – which excludes cereals and fuel - declined even further from 6.9 percent in December 2013 to 3.5 percent in June 2014 (Figure 6). Inflation has remained below 10 percent in the past two years, with 12-month period-average inflation stabilizing at around 6.4 percent in June 2014 down from 12.8 percent in 2011. This downtrend over the last three years has been predominantly due to lower inflation for non-food items.

8. **Rental prices have fallen from a slump in the real estate market, while transport and fuel prices have increased strongly.** The economic downturn has impacted the real estate market in Afghanistan. While asset prices for real estate are not available, the slump is reflected in prices for housing and electricity which have been softening since mid-2013, with the year-on-year change reaching a record low of -9.1 percent in June 2014. On the other hand, prices for fuel and transport have increased strongly since January 2014, with the y-o-y increase reaching 20.1 percent in June 2014. With housing having a larger weight than transport in the CPI basket, overall non-food price inflation dropped from 4.8 percent in December 2013 to 1.4 percent in June 2014 (Figure 7).

Figure 6: Headline and core inflation

Source: CSO and Bank staff calculations

Figure 7: Headline, food, and non-food inflation

9. **Food price inflation remained high at around 10 percent in June 2014.** In spite of a bumper crop this year, prices for cereals increased by 11.4 percent (y-o-y) in June 2014. Afghanistan still relies on large imports of wheat and other cereals and even though global prices for wheat moderated, higher prices for fuel added to transportations costs. This was also reflected in prices of other food items which generally experienced a more moderate increase, except for prices of vegetables which increased 24.3 percent.

Afghanistan faces a deteriorating fiscal crisis, with declining revenues leading to an unfinanced fiscal gap

10. **Revenue collection has continued to weaken in 2014.** After a decade of strong revenue growth, domestic revenue collection declined to 9.7 percent of GDP in 2013 (\$2 billion in nominal terms), down from 10.3 percent in 2012 and 11.6 percent in 2011 (Figure 8). Current trends point toward a further decline in 2014. During the first 8 months of fiscal 2014, domestic revenues reached only Afs 62.4 billion (\$1.08 billion), below the amount collected during the first 8 months of fiscal 2013 (Afs 66.7 billion or \$1.21 billion). Based on this trend, the authorities anticipate revenues of Afs 105 billion (\$1.82 billion) or 8.7 percent of GDP by the end of fiscal 2014. This would be Afs 28.8 billion (\$500 million) short of the target set out in the approved 2014 budget. Even meeting the anticipated Afs 105 billion would require revenue collection to pick up to Afs 10.7 billion per month during the last four months of the year from Afs 7.6 billion per month during the first eight months.

Source: AFMIS and MoF

11. **The decline in revenue collection is a result of the economic slowdown as well as weak enforcement in both tax and customs administration.** While the economic slowdown is part of the explanation, weaknesses in tax and customs enforcement are a large part of the problem, particularly given that the decline in collections began in 2012 when economic growth was very strong. Increased uncertainty surrounding the political and security transition has likely encouraged greater rent-seeking and tax evasion activity. Collections across all categories (tax revenues, customs duties, and non-tax revenues) in 2014 have fallen far short of the budget target and have barely reached 2013 levels (Figure 9). There are indications that some taxpayers have withheld payments in light of the protracted elections impasse. On the other hand, lower imports and a shift in the structure of imports – away from luxury and other higher tariff items toward lower tariff items, in part due to the economic slowdown – has also impacted customs revenues.

Source: AFMIS

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

12. In light of the revenue shortfall, the authorities have run down their cash balances to pay for higher mandated security and social benefit spending during the first eight months of 2014.

Afghanistan's discretionary resources (revenues and civilian discretionary donor grants) go toward three categories of spending: security expenditures not financed by security grants, civilian recurrent expenditures (salaries, O&M, and social benefits), and discretionary development expenditures.² During the first eight months of 2014, the authorities ran down their cash balances by an estimated \$362 million as discretionary resources stagnated while discretionary spending increased. During this period, security expenditures not financed by grants increased by \$185 million compared to the first eight months of 2013. Civilian recurrent expenditures increased by \$102 million, mostly due to increases in martyrs and disabled pensions mandated by the new Martyrs and Disabled Law and due to higher one-time payments to families of security personnel killed in conflict. On the other hand, discretionary development expenditures actually declined by \$34 million. Furthermore, civilian O&M expenditures (which are chronically at inadequate levels in Afghanistan) declined by \$30 million.

Source: AFMIS

13. The authorities have committed to continuing with significant austerity measures through the rest of 2014. Afghanistan's 2014 budget had included significant increases in security expenditures, social benefits, and discretionary development projects. However, in light of the sluggish revenue performance, the Ministry of Finance has put in place a number of measures to curtail spending from budgeted levels. These measures include reducing overtime payments to civil servants, curtailing new discretionary development projects, and restricting salary increases, bonuses, and additional benefits. In August, the Ministry of Finance presented an austerity scenario for 2014 where social benefits would be restrained to about 50 percent of budgeted levels and discretionary development spending would be restrained to 38 percent of budgeted levels (no more than the 2013 level of discretionary development spending). However, the contribution to security would be maintained at 100 percent of budgeted levels. In order to address serious inadequacies in the budgeted level of civilian O&M, the austerity scenario included a 15 percent increase in civilian O&M spending from 2013.

² Since a large part of the development budget is tied to specific donor financed projects, the Ministry of Finance's expenditure management is limited to the use of its discretionary resources which finance recurrent and discretionary development spending.

Table 1: Fiscal Scenarios and Financing Gap for 2014

US Dollars (Millions)	2013 Actual	2014 Budget	Natural Progress Scenario 2014	Austerity Scenario 2014
Expenditures				
Security Recurrent	2,155	3,063	2,504	2,504
Civilian Recurrent	1,420	1,807	1,732	1,571
Wages and Salaries	865	906	863	863
O&M	325	215	343	343
Social, Capital, Contingencies	230	686	526	365
Discretionary Development	342	870	549	330
Revenues and Grants				
Domestic Revenues	1,975	2,324	1,823	1,823
Security Contribution	575	653	653	653
Security Grants	1,580	2,409	1,851	1,851
Civilian Grants	256	535	253	253
Discretionary Balance	(42)	(459)	(850)	(474)
Civil Aviation transition			50	50
Financing Gap			(900)	(524)

Source: Ministry of Finance and staff estimates

14. **Even with austerity measures, Afghanistan will need additional financing to cover civilian salaries, pensions, and critical operating and development spending.** In addition to running down cash balances to finance the \$362 million gap through the first eight months of 2014, the authorities have incurred arrears of about \$130 million on O&M and discretionary development spending. Without additional financing, the authorities will also have trouble making civilian salary payments during the remainder of 2014, which could adversely affect social stability. The austerity scenario presented by the authorities includes a financing gap of about \$500 million for 2014. While part of this could be financed from cash balances, it is estimated that at least \$300 million in additional financing will be needed for 2014 to cover civilian salaries, pensions, and critical operating and development spending. If revenues do not reach the anticipated Afs 105 billion for the year or if projected civilian grants linked to reform progress do not materialize in full, the financing gap and additional financing needed would be larger.

15. **In order to restore fiscal stability, it is critical that additional financing be accompanied by credible reforms to improve revenues.** Without credible reforms to improve revenue mobilization and growth prospects, the underlying problems will remain unaddressed and the fiscal crisis would likely recur in 2015. In particular, reforms are needed to strengthen both tax and customs enforcement and to broaden the tax base. Specific measures could include expediting implementation of the new Value Added Tax, reversing the reduction of the VAT rate from 10 percent to 5 percent, expediting implementation of key measures under the Customs Action Plan, and conducting effective risk-based tax audits to improve compliance. While these measures are critical to improve revenue mobilization in 2015 and beyond, they are unlikely to solve the problem or close the unfinanced gap in 2014.

The exchange rate remains stable, with aid flows financing the large trade deficit

16. **Official exports have remained unchanged in the first half of 2014 while official imports have declined sharply possibly due to poorer recording.** Official exports were recorded at around \$270 million in the first six months in 2014, almost the same level as in the first half of 2013. As shown in Figure 11, dry fruits, carpets and medicinal plants were the largest export items of Afghanistan in the

first two quarters of the year. Import data provided by the customs authority indicate a sharp decline in official imports in the first half of 2014 by 30 percent over the first half of 2014. However, a significant amount of trade remains unregistered in the country, suggesting that part of the decline in official imports could have been because of poorer recording.

Figure 11: Official Exports, H1-2013-14
(US\$, millions)

Source: CSO and ACD

Figure 12: Official Imports, H1, 2013-14
(US\$, millions)

17. **The trade deficit remains large, but is expected to narrow slightly.** Total imports (including both official and smuggling) are estimated to decline from \$10.9 billion in 2013 to \$10.6 billion in 2014, as a result of weakening demand in the economy. Total exports are estimated at \$2.4 billion in 2014, compared to \$2.6 billion last year. Because of an exceptionally high level of unofficial trade in Afghanistan, official recorded exports are estimated to represent only one-fifth of total exports. The historically large trade deficit is expected to narrow slightly from 40.8 percent of GDP in 2013 to 39.2 percent in 2014. As in previous years, the trade deficit is estimated to be fully financed by large aid inflows, so that the current account is estimated at 4.1 percent of GDP in 2014 (Figure 13).

Figure 13: Current account balance for 2014
(in percent of GDP)

Source: Staff estimates

18. **The exchange rate remained stable during the first half of 2014** after depreciating throughout 2013. As shown in Figure 14, the Afghani strongly depreciated against the US dollar throughout 2013 but has remained stable in the first six months of 2014. This is likely due to similar exchange rate trends for regional currencies including particularly the Pakistani Rupee. The Afghani depreciated by 10 percent and 14.5 percent, respectively, against the US dollar and the Euro between January and December 2013. However, it has remained stable since the start of 2014 against the two currencies. The exchange rate averaged Afs 57.3 against the US dollar and Afs 78.6 vis-à-vis the euro during the first six months of the year.

Figure 14: Afghani exchange rate against the US dollar and the euro

Source: DAB

19. **Foreign exchange reserves at the end of the first half of 2014 were slightly higher than a year ago, with increased fluctuations over the last year and half.** Gross international reserves were recorded at \$7.3 billion in June 2014, compared to \$6.9 billion in June 2013. This is equivalent to around 8 months of imports. Reserves declined from \$7.5 billion in November 2013 to \$6.9 billion in February 2014, but then recovered in the second quarter of 2014. Since 2002, foreign exchange reserves have increased consistently. While this accumulation of reserves has continued, a higher degree of fluctuations has been observed since the start of 2013. This is not unexpected in light of less steady capital flows during periods of higher uncertainty as has been the case over the course of the 2013-14 political and security transition. In case of more abrupt swings in foreign grants and capital flows, prudent management of foreign exchange reserves will be important.

Figure 15: Gross international reserves (billion US\$)

Source: DAB

Monetary and banking performance indicators reflect the economic slowdown

20. **Reserve money growth has remained strong in the first half of the year, but broad money growth has weakened.** Reserve money, which includes currency in circulation and commercial banks' deposits in the Central Bank, grew – on a 12-month comparison basis – by around 15 percent in June 2014. Reserve money is used as a nominal anchor by the Central Bank for its monetary policy and market operations. The Da Afghanistan Bank (DAB) uses foreign exchange auctions to control money supply in the economy. While reserve money growth increased from 11.6 percent (year-on-year change) in December 2013 to 15.2 percent in June 2014, broad money (M2) growth declined from 9.4 percent to 5.7 percent over the same period (see Figure 16). The decline in broad money growth is primarily due to a decline in demand deposits of the commercial banks. This indicates that although demand for money has remained strong in the economy, financial intermediation is still weak and has not recovered from the confidence shock that hit the financial sector following the Kabul Bank crisis in 2011.

Figure 16: Growth in monetary aggregates
(y-o-y percent change)

Source: DAB

Figure 17: Assets and liabilities of banking sector
(in billion US\$)

Figure 18: Deposits and loans of banks
(in billion US\$)

21. **Financial sector performance remains weak and confidence has not recovered from the Kabul Bank crisis.** The banking sector's liabilities have declined slightly due to a decrease in bank deposits (see figures 17 and 18). Total deposits of the banking sector declined from \$3.5 billion in December 2013 to \$3.3 billion in June 2014. Loans to the private sector remained steady at around \$830 million, but remain sharply lower than pre-crisis levels. Total assets of the banking sector declined slightly from \$4.4 billion in December 2013 to \$4.3 billion in June 2014. These indicators suggest that banking sector confidence has not recovered from the Kabul Bank crisis. The Central Bank reports that regulatory indicators of the overall banking sector such as profitability and regulatory capital ratios are generally satisfactory, although a number of banks continue to exhibit weaknesses. The banking sector posted a profit of \$23 million for the first half of 2014 (compared to \$4 million in the first half of 2013), although two banks posted a loss of \$7.8 million. It will be important to closely monitor weaknesses in the banking sector.

2. Economic Outlook and Medium-Term Prospects

22. **Economic growth is projected to pick up modestly from 1.5 percent in 2014 to 4 percent in 2015, contingent on reduced uncertainty and reforms to restore confidence.** The growth projections remain highly fluid. With the economy stalled in 2014, the timing and strength of any growth pickup depends on a reduction of the political and security uncertainty and improvement in the pace of reforms. The cohesion and effectiveness of the national unity government remains untested and parliamentary elections are scheduled for 2015. The political and security uncertainty is thus expected to persist through the first half of 2015 and serve as a drag on private investment and growth in the non-agricultural sectors. At the same time, generating significant growth from the agriculture sector in 2015 will require exceptional weather, given that agricultural production has already been strong during 2014. In this context, accelerating reforms to restore private sector confidence will need to take a lead in driving a resumption of growth in 2015. Furthermore, public development expenditures on essential infrastructure and service delivery will need to play an important role in propping up economic activity through the period of uncertainty. Restoring fiscal stability without sharp cuts in development expenditures will be critical. Under these assumptions, economic growth is projected to pick up to 4 percent in 2015.

23. **In the medium term, post-transition growth is projected at about 5 percent per year during 2016-18.** 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 political and security environment, with agriculture, services, 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.

24. **The medium term growth outlook is subject to serious risks which will need to be carefully managed.** The fragile political and 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.

Table 2: Medium-term Macroeconomic Framework, 2014-2018

	<i>(Tentative Staff Projections)</i>						
	2012	2013	2014	2015	2016	2017	2018
	<i>Actual/Estimates</i>		<i>Tentative Staff Projections</i>				
Real GDP growth	14.4	3.7	1.5	4.0	5.0	5.1	5.3
Nominal GDP (bn US\$)	20.5	20.3	21.0	22.6	24.4	26.4	28.5
CPI inflation (period average)	6.4	7.7	6.1	5.5	5.5	5.0	5.0
Fiscal	<i>Percent of GDP</i>						
Revenues and grants	23.1	23.5	25.1	27.4	28.9	33.1	34.8
Domestic revenues	10.3	9.7	8.7	9.6	10.8	11.6	12.8
Foreign grants	13.0	14.5	16.5	17.8	18.1	21.5	22.0
Total core expenditures	23.8	24.7	27.3	29.7	30.5	34.7	36.7
Recurrent expenditures	17.1	17.6	19.4	22.2	23.4	27.4	29.1
Development expenditures	6.7	7.1	8.0	7.5	7.1	7.3	7.6
Overall balance (incl. grants)	-0.5	-0.5	-2.1	-2.3	-1.6	-1.6	-1.9
External							
Trade balance	-41.9	-40.8	-39.3	-37.7	-35.5	-33.5	-30.3
Current acct balance (incl. grants)	4.2	3.7	4.1	0.3	-1.9	-3.7	-3.5
External debt	6.4	6.2	6.1	5.9	5.8	5.6	5.5

Source: Staff estimates, tentative and subject to revision

25. **In light of the deteriorating fiscal crisis, restoring fiscal stability will require immediate measures to improve revenue performance coupled with additional resources to cover the unfinanced gap.** Afghanistan needs to put together a plan to restore medium term fiscal stability. In light of the fiscal crisis, the authorities are still working on the 2015 budget and the revised medium term macroeconomic framework. A centerpiece of the plan needs to be immediate reforms to improve revenue performance. This will require (i) reducing leakages and strengthening tax and customs enforcement; and (ii) expediting implementation of the new value-added tax (VAT) with a 10 percent rate instead of a 5 percent rate. 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 weak progress in recent years. Tentative staff projections (predicated on strong reforms) call for an increase in revenues from 8.7 percent of GDP in 2014 to 9.6 percent in 2015 and 12.8 percent by 2018 (or about one percentage point of GDP per year). While this is an ambitious target, it will still leave Afghanistan with an unfinanced fiscal gap of about 2 percent of GDP during 2014-18 (in excess of the 20 percent of GDP gap already financed by existing commitments during this period). If additional resources are not identified to cover this unfinanced fiscal gap, Afghanistan will have trouble paying for civilian salaries and critical operating and development spending. A more aggressive expenditure austerity path would compromise development prospects and social outcomes as Afghanistan struggles to restore stability.

26. **Budget expenditures are projected to rise, with mandatory increases in security spending, so that more aggressive austerity would squeeze essential development spending.** Total budget

expenditures are projected to rise from 27.3 percent of GDP in 2014 to 30.5 percent in 2016. This increase is largely a result of more security and development 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). For example, delivering on goals to improve education outcomes will require hiring increasing numbers of teachers. Prioritizing these expenditure needs within the limited resource envelope will be critical to maintaining a pro-development stance. With social benefits for martyrs and disabled increasing significantly in 2014, the authorities will need to limit any further increases going forward. 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. In light of mandatory increases in security spending, a more aggressive expenditure consolidation path would directly squeeze essential civilian operating and development spending. 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.

27. **Donors have committed to considerable assistance for Afghanistan contingent on satisfactory reform progress, although additional resources and an acceleration of reforms will be needed in light of recent developments.** The July 2012 donor meeting in Tokyo pledged \$16 billion in development aid for Afghanistan over 2012-16. These funds, contingent on satisfactory reform progress under the Tokyo Mutual Accountability Framework (TMAF), would allow the authorities to progress towards development and infrastructure targets. Together with earlier pledges on the security side, this means annual aid of about \$8 billion—roughly equally divided between civil and security aid. However, recent developments indicate that as Afghanistan and the international community work to reaffirm their partnership, attention will be needed to both accelerate reforms and identify additional resources. Domestic revenue is an important indicator in the TMAF, so that any additional resources will require a clear turnaround in revenue performance by broadening the tax base, strengthening enforcement, fostering private sector development, and developing the mining sector. Even with these measures, additional resources will be needed to cover the unfinanced gap for 2014-18. Furthermore, additional resources may also be needed for security as the current spending projections are based on a drawdown in ANSF personnel size from 352,000 to 228,000 between 2015 and 2017, while security experts indicate that this drawdown is no longer likely to take place within that timeframe.

3. Structural Policies for Immediate and Medium Term

28. **The new government of Afghanistan faces the dual challenge of restoring confidence in its economic prospects and addressing formidable medium term development challenges.** Growth has stalled and a deteriorating fiscal crisis has emerged. Afghanistan also faces formidable medium term development challenges in the areas of aid dependence, job creation for 400,000 new entrants into the labor force each year, high and persistent poverty, low levels of human development and female labor force participation, and high levels of corruption. Furthermore, fragility and conflict remain pervasive and undermine economic prospects as well as social cohesion and stability. Addressing these challenges will require reforms from the new government of Afghanistan in three areas: (i) restoring fiscal stability; (ii) restoring confidence and creating private-sector jobs; and (iii) strengthening social cohesion and

service delivery. Above all, high level commitment to tackle corruption and strengthen governance across the board will be critical to delivering on the success of reforms in these priority areas.

29. **Restoring fiscal stability will require improving revenue mobilization, securing grant assistance, and prioritizing government spending.** The centerpiece of restoring fiscal stability is to improve revenue performance. This will require immediate and credible measures to reduce leakages and strengthen customs and tax compliance, expediting implementation of the new VAT law with a 10 percent rate, and progress on the legislative and regulatory framework for the extractive industries sector. Afghanistan will continue to require substantial grant assistance for the foreseeable future. The projected total financing gap (for both on-budget and off-budget spending) while declining from more than 40 percent of GDP in 2012, will remain above 20 percent of GDP through 2025. In order to ensure a pro-development stance of spending within a constrained resource envelope, it will also be important to prioritize expenditures through the development of a realistic and well-specified multi-year medium term expenditure framework.

30. **Afghanistan will need to restore investor confidence and create private sector jobs.** Restoring investor confidence will require addressing key weaknesses in the financial sector, investment climate, and land tenure system. If confidence can be restored, growth is expected to be driven by agriculture, the services sector, and over a longer term, extractive industries. As aid volumes are scaled down as a share of GDP, growth will need to be led increasingly by the private sector. The target is to support growth of 5-6 percent per year. This is less than the average growth of 9.4 percent per year during 2003-12 that was driven by investment in reconstruction, expansion of services fueled by aid, and occasional surges in agricultural production. Given its demographic realities, Afghanistan will need to aspire to create jobs for 400,000 new entrants into the workforce each year and reduce chronic underemployment. This is remarkably ambitious in an environment of fragility and volatility, so that a realistic target would be to hold the line on poverty during 2015-18.

31. **Agriculture is highly relevant to poverty reduction and job creation.** Agriculture accounts for a quarter of GDP and is also closely linked to other parts of the economy, including manufacturing (food and beverages) and services (transport and retail). Agriculture is also highly relevant to poverty mitigation and job creation, with more than 50 percent of the labor force tied to the sector. Driving agricultural expansion will require focusing on those subsectors with the greatest potential: irrigated wheat, livestock, and horticulture. Key policy and investment priorities include rehabilitating irrigation infrastructure and improved on-farm water management, supporting adoption of higher yielding varieties, and improving extension services.

32. **The mining sector has significant potential for growth with modest employment impact, although the impact of the sector can be enhanced through the resource corridor approach.** Although extractive industries currently account for a very small share of GDP, they have significant potential in light of Afghanistan's deposits of copper, iron ore, and hydrocarbons. Unlocking the potential of extractives will require progress on the legislative and regulatory framework as well as securing financing for the necessary infrastructure. Furthermore, a strong sector vision based on the Resource Corridor initiative can promote economic linkages by aligning actions and investments in four areas: physical infrastructure, livelihoods, environmental and social impact, and governance.

33. **Afghanistan will need to strengthen social cohesion and stability through improved and targeted service delivery.** Service delivery plays a dual role in Afghanistan: promoting social cohesion and trust in public institutions, while laying the foundation for job creation and growth. With levels of education, health, and infrastructure access among the lowest in the world, Afghanistan will need to continue expanding service delivery across the board. In spite of significant improvements in school enrollment rates over the past decade, only one out of four Afghans aged 16 or above is able to read and write or has completed some formal level of schooling. It is therefore paramount that investments in education at all levels remain a priority in Afghanistan's development strategy. At the same time, special attention will be needed in priority areas to enhance the impact on social cohesion and job creation within constrained resources.

34. **Afghanistan will need to tap the potential of regional integration to meet its energy and water needs and to explore opportunities for labor migration.** Energy and water will be critical for agriculture, mining, and urban development, with needs expected to far outstrip capacity. Addressing both energy and water needs will require prioritizing regional cooperation. Afghanistan will need to engage proactively to establish its role as a transit route linking energy-rich Central Asian countries with energy hungry South Asian countries. With four out of its five river basins part of international waterways, Afghanistan will need to engage actively with downstream riparian countries to secure necessary water resources. Finally, with domestic job creation expected to fall short of the growing labor force, Afghanistan should explore opportunities for labor migration to Gulf countries.

35. **Addressing challenges in the efficiency of service delivery will be critical in meeting the objective of expanding access in a fiscally constrained environment.** With unclear roles of provincial officials, service delivery takes place in a complex governance environment with multiple stakeholders and informal relationships. O&M arrangements are inadequate, with no overall asset registry and weak funding, budget arrangements, and capacity for O&M provision. Corruption levels remain a serious concern and have the potential to undermine improvements in public financial management. The capacity of core civil service is inadequate and reliance on parallel civil service is high. Finally, the institutional structures for both transport and irrigation investments are characterized by overlapping responsibilities and poor coordination. Efficiency improvements will thus need to come from clarifying the subnational governance framework (including removing overlapping institutional mandates), improving O&M systems, further strengthening public financial management, and improving the core civil service.

Annex 1: World Bank Group Assistance to Afghanistan

IDA and the ARTF:

1. The International Development Association (IDA) and the Afghanistan Reconstruction Trust Fund (ARTF) are the main sources of World Bank financing of country priorities in Afghanistan. The ARTF is nearly five-fold larger than IDA and has been managed by the Bank since its creation in 2002; it is a key vehicle for providing Government with predictable and transparent on-budget financing. The ARTF also plays a critical role as a forum for policy dialogue between Government and donors. A 2012 external review of the ARTF concluded that the ARTF is “*fit for purpose*” and stands as a best-practice trust fund.
2. The World Bank is respected by Government and donors for its analytical and research products through economic sector work and technical assistance. In an environment where policy advice and assistance is essential, work in this area provides support for Government and donor decision making. It is expected that the World Bank will continue to play a leading role in terms of policy advice to Government through targeted, often cross-sectoral, analytic work. The Bank’s work on Transition Economics and Resource Corridors, together with its poverty analysis, has been instrumental in informing decisions of the Government and the donor community in this challenging transition period.
3. Since 2002, IDA has committed a total of \$2.77 billion in grants (83 percent) and credits (17 percent) in Afghanistan. Thirty-six development and emergency-reconstruction projects and four budget-support operations have been committed as of end-February 2014. In addition, the ARTF has generated \$7.26 billion from 33 donors, and committed \$3.17 billion for the government’s recurrent costs and \$3.64 billion for government investments programs. At end-August 2014 the active IDA portfolio was worth \$835.98 million and the active ARTF investment portfolio was worth \$2.33 billion.
4. ARTF and IDA projects are managed with the same attention. All projects are eligible for processing under the Bank’s Special Considerations for fragile states and emergencies (incorporated into OP 10.00). In practice this has proved most useful to improve flexibility post-approval as all projects are processed under regular review procedures in order to ensure quality at entry. All Bank (IDA and ARTF) funds are channeled through the government’s budget and project accounting and reporting occurs at the central level.
5. In fiscal year 2014, the World Bank Board approved two new IDA-financed projects and additional financing for an existing project totaling \$106.7 million, plus the CASA-1000 regional project. The new projects included \$50 million for the Development Policy Grant and \$50 million for Access to Finance; the Financial Sector Rapid Response project received \$6.7 million in additional financing. A regional project – CASA-1000 – was approved in March 2014 by the World Bank Group’s Board of Executive Directors for total grant and credit financing of \$526.5 million. Of the total project financing for CASA-1000, Afghanistan receives \$316.5 million in the form of an IDA grant. The FY14 IDA commitments fully utilized IDA-16.

6. In addition, in fiscal 2014 the ARTF approved \$219 million in recurrent cost financing (of which \$110.90 million was for recurrent cost baseline financing, \$65.20 million for the Incentive Program, \$30 million for TMAF payment and O&M \$12.90 million) and \$580 million for Investment Window financing, including the Second Education Quality Improvement Program (\$125 million), the Third Emergency National Solidarity Project (\$200 million), the CASA Community Support Project (\$40 million), the Non-formal Approach to Training, Education and Jobs in Afghanistan (\$15 million), Kabul Municipal Development Project (\$110 million), and Kabul Urban Transport Efficiency Improvement Project (\$90.50 million).

IFC and MIGA operations in Afghanistan:

7. IFC is following an integrated advisory and investment strategy focused on improving the investment climate, building capacity, and supporting selective investments in sectors with high development impact and job creation possibilities. IFC's investment commitment in Afghanistan has more than doubled since FY08 - from around \$58 million to about \$135 million to date. Currently, IFC's portfolio includes two investments in the telecommunication sector (MTN - a joint project with MIGA-\$65 million and Roshan-\$65 million), one investment in the hotel sector (TPS-\$3 million), and two operations in financial markets (First Microfinance Bank-\$2 million equity, Afghanistan International Bank - trade facility). These investments have had a strong impact (in terms of access to finance and outreach), particularly in the microfinance and telecommunication sectors. Through the project with the First Microfinance Bank (FMFB)--the first licensed private sector microfinance bank in Afghanistan, IFC was able to reach over 64,000 borrowers (more than 25 % of the current market penetration) – more than 16 % of whom were women. Similarly, IFC has had significant impact in the telecommunication sector by improving mobile phone access and services to the poor through the investment in Mobile Telephone Networks (MTN) and in Roshan Telecom. Going forward, IFC is looking to expand its investment program in Afghanistan in the areas of infrastructure, finance, manufacturing, agribusiness and services.
8. IFC has an active Advisory Services program with seven active mandates in the following areas: (i) Access to Finance (Secured Lending, Leasing Support); (ii) Investment Climate (Trade License Reform, Construction Permit Reform) ; (iii) SME Capacity Development (Business Edge SME Training); and (iv) Strengthening Horticulture; and (v) Public Private Partnerships (DABS Kandahar).
9. The Multilateral Investment Guarantee Agency (MIGA) of the World Bank Group has \$84.2 million of gross exposure in Afghanistan, supporting telecoms and agri-business projects. MIGA recently launched the "Conflict Affected and Fragile Economies Facility" that will provide a first loss cover in fragile and conflict states, including Afghanistan. This will allow MIGA to greatly expand its work in these countries, while still meeting prudential limits. MIGA is currently supporting three projects in Afghanistan, of which one is a joint effort with the IFC in the telecoms sector (MTN) and the other two are MIGA-only (cashmere exporter and Traitex Industry).

Annex 2: The Afghan Economy at a Glance

Growth declined in 2013 and further in 2014...

...due to lower growth and investment in non-agriculture sectors.

Inflation remained below 10 percent...

...and the exchange rate remains stable in 2014.

Domestic revenues have been declining since 2011...

...while an unfinanced fiscal gap looms large in 2014.

Annex 3: Selected Economic Indicators

(% of GDP, unless indicated otherwise)

	1390	1391*	FY 1392*	----- tentative staff projections -----		
	2011/12	2012/13*	2013*	FY 1393 2014	FY 1394 2015	FY 1395 2016
Real sector						
Nominal GDP (excl. opium; billion Afs)	856	1,060	1,125	1,211	1,326	1,465
Nominal GDP (excl. opium; billion US\$)	17.9	20.5	20.3	21.0	22.6	24.4
Real GDP growth (%)	6.1	14.4	3.7	1.5	4.0	5.0
GDP per capita (US\$)	616	688	665	672	705	747
Prices and money						
CPI inflation (period average, %)	10.2	6.4	7.7	6.1	5.5	5.5
Core inflation (excl. fuel & cereals, %)	14.6	6.6	7.0	5.6	5.1	5.0
Broad money (M2)	37.2	32.0	33.0	32.5	33.8	34.9
Fiscal sector*						
Domestic Revenue	11.6	10.3	9.7	8.7	9.6	10.8
Tax revenues	5.3	4.9	4.7	4.2	4.6	5.2
Customs duties	3.6	2.7	2.5	2.3	2.5	2.9
Non-tax revenues	2.8	2.7	2.5	2.3	2.5	2.7
Donor grants	11.2	13.0	14.5	16.5	17.8	18.1
Total Core Budget expenditure	23.3	23.8	24.7	27.3	29.7	30.5
Operating	17.4	17.1	17.6	19.4	22.2	23.4
Development	5.8	6.7	7.1	8.0	7.5	7.1
Overall Core balance (incl. grants)	-0.4	-0.5	-0.5	-2.1	-2.3	-1.6
Security spending	9.7	10.0	10.6	11.9	13.6	14.2
Fiscal sustainability ratio	66.5	60.2	55.2	44.8	43.2	46.2
External sector						
Exports of goods (million US\$) /1	2,684	2,757	2,614	2,408	2,329	2,423
Imports of goods (million US\$) /1	10,220	11,366	10,895	10,674	10,842	11,097
Trade balance	-42.0	-41.9	-40.8	-39.3	-37.7	-35.5
Current account balance (incl. grants)	3.5	4.2	3.7	4.1	0.3	-1.9
Gross reserves (million US\$)	6,209	6,771	7,447	7,596	7,747	7,768
Gross reserves (months of imports)	7.3	7.1	8.2	8.5	8.6	8.4
Total external debt /2	6.9	6.4	6.2	6.1	5.9	5.8
Memorandum items						
Population (millions)	29.1	29.8	30.6	31.3	32.0	32.7
Exchange rate (Afs/US\$; period average)	47.8	51.7	55.4	57.6	...	...
Real effective exchange rate (depreciation = decrease in index)	126.2	127.0	125.3	122.7	...	...

Numbers in italics are tentative staff projections, subject to revision.

* All indicators for 2013 (1392) and onwards are calculated/estimated for the calendar year (Jan-Dec). Fiscal year 2012 (1391) covered 9 months, but the fiscal data has been prorated to 12 months, with all other 2012 data for the solar year. All data for years prior to 1391 span April-March and are thus for the solar year.

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

/2: External debt excludes Russian Federation's loan.