

# Afghanistan: Emerging from Transition

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September 4-5, 2015  
Senior Officials Meeting



**WORLD BANK GROUP**

# Objectives

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- Provide a basis for informed discussion on macro-fiscal issues at the SOM
- Review expectations and response to transition challenges
- Discuss economic impact of the transition process
- Present outlook for post-transition recovery
- Outline pertinent actions for the immediate future

## Pre-Transition 2002-2012: Significant economic and social progress from a very low base

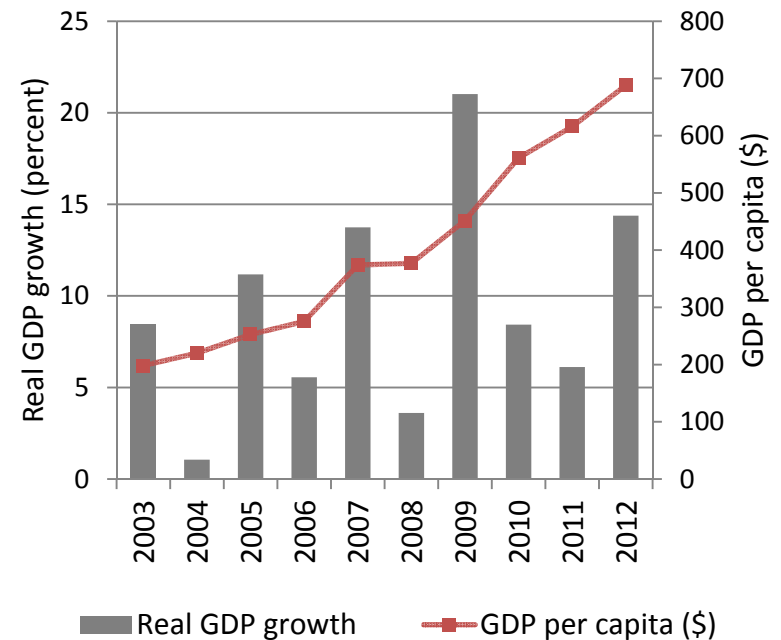
### Economic Progress:

- GDP growth averaged 9.4 percent during 2003-12
- GDP per-capita from \$186 in 2002 to \$689 in 2012
- Domestic revenues increased from 2.6% of GDP in 2002 to 11.6% of GDP in 2011
- Public financial management improvements enabled increases in on-budget expenditures from \$303 million in 2002 to \$4.9 billion in 2012

### Social Progress:

- School enrollment increased from 1 million (few girls) in 2001 to 9.2 million (3.6 million girls) in 2013
- Access to improved water source increased from 22 percent to 50 percent of population
- Life expectancy increased significantly over the same period
- Maternal mortality more than halved between 2001 and 2013

**Growth Performance during reconstruction decade was strong**



Source: CSO and Bank Staff

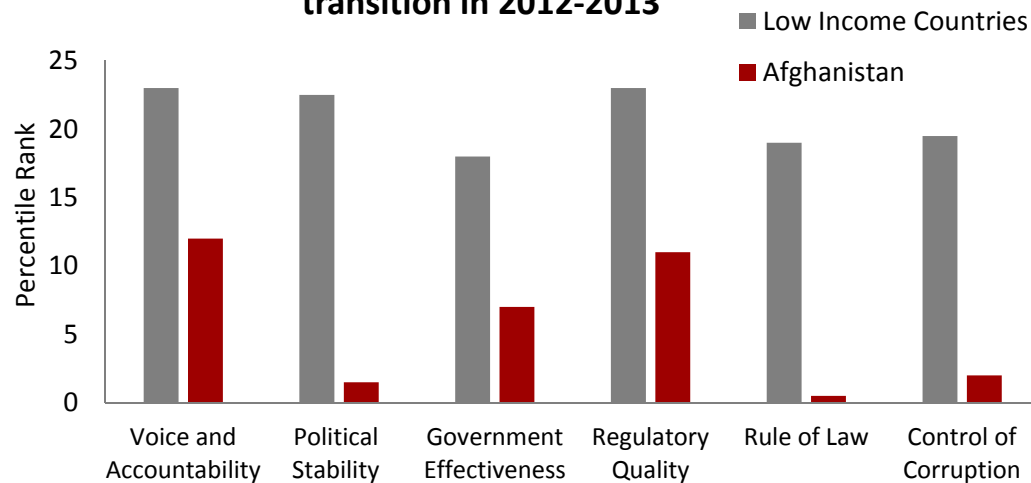
# Transition Challenges 2012-2014

## Exogenous Transition Factors

- Withdrawal of International Troops
- Decline in aid
- Closure of military bases and impact on local economy



## Large Governance vulnerabilities at the outset of transition in 2012-2013



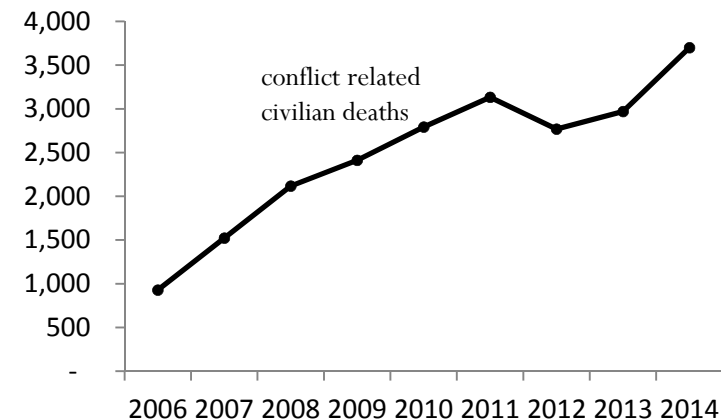
Source: World Bank

## Endogenous Transition Factors

- Slow reform progress during 2013 and 2014
- Protracted Elections and government formation



## ...and a population affected by high level of conflict and violence



Source: UNAMA

## Tokyo and Chicago response

### Slowing Growth Path:

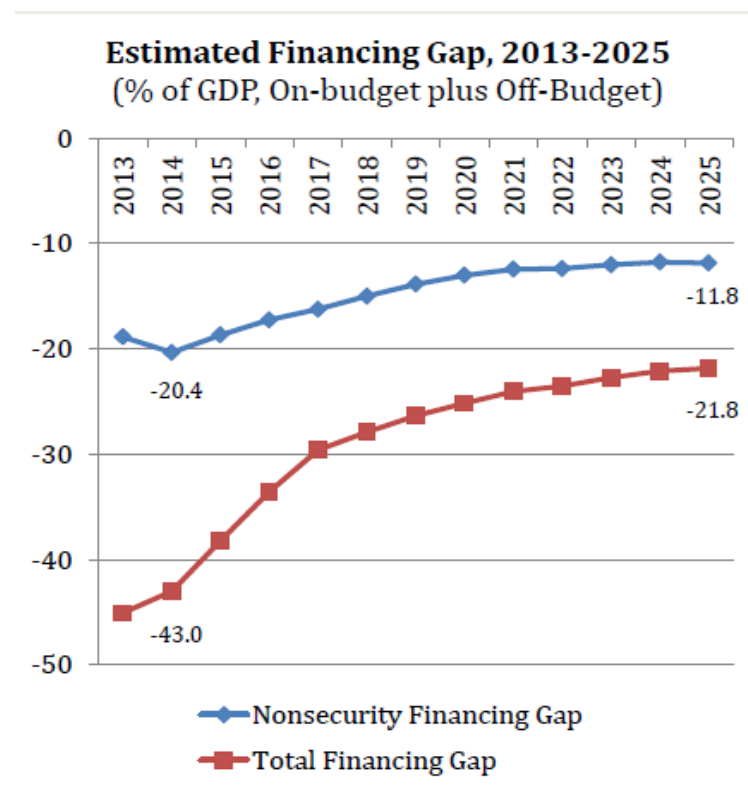
The economy was expected to slow down during transition. But improvements in security and political stability were expected to lead to a recovery beginning in 2015, albeit to lower long-term growth path (5 percent per year during 2012-18). Higher growth would be predicated on strong reform progress and investment in key economic sectors, e.g. mining and agriculture.

### Managing the Financing Gap:

Afghanistan's very significant security expenditures and development needs would require a combination of continued donor grant aid, improved revenue mobilization and better aid-effectiveness.

### Mitigating the Impact (Tokyo and Chicago 2012):

Donors pledged to deliver stable and predictable security and civilian aid, more on-budget assistance, and better alignment to National Priority Programs while Government committed to enhancing revenue reforms and strengthen governance institutions in order to mitigate the impact of the transition.



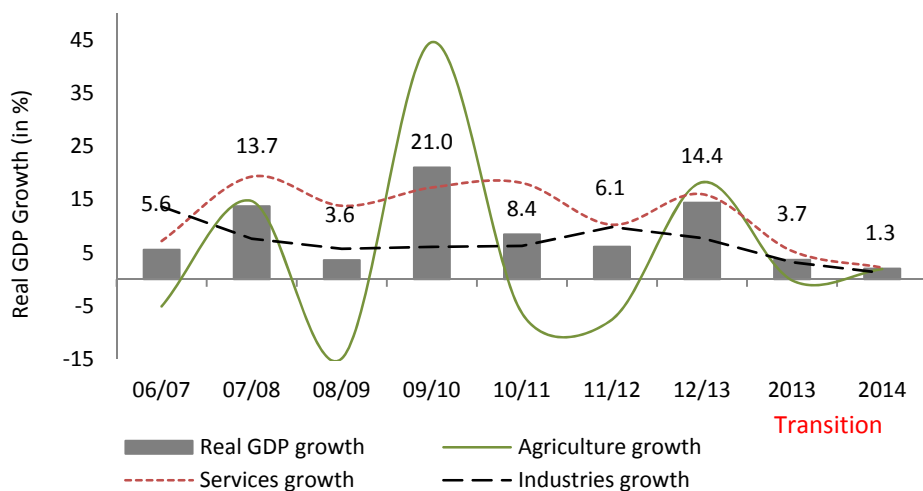
Source: World Bank, 2012 (pre-Tokyo and Chicago)

Note: Financing Gap refers to both on-budget and off-budget financing needs of the Government to maintain its projected expenditure path through 2025.

## Growth slowed down during transition as anticipated ....

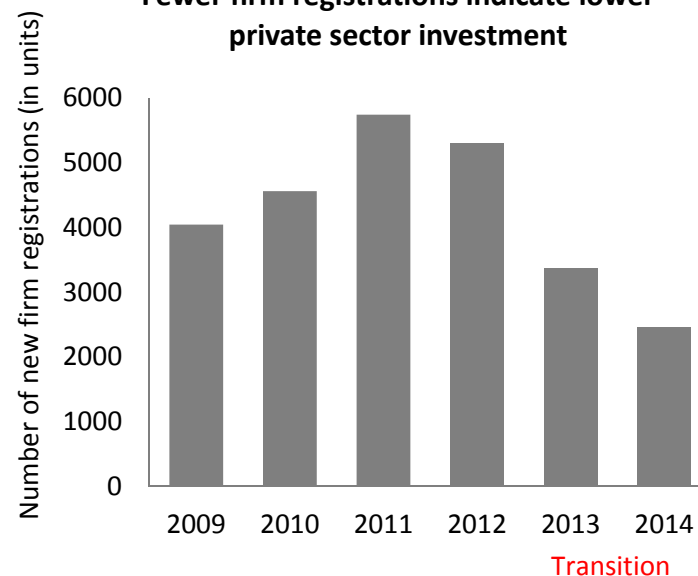
- Real GDP growth dropped to 3.7 percent in 2013 and further to 1.3% in 2014;
  - Decline in aid reduced demand for services
  - Political uncertainty and slow reform progress heavily affected business confidence and investment
- Illicit activities increased: Opium production grew by 72 percent (reaching 6,400 tons in 2014) since 2012, while area under poppy cultivation expanded by 45 percent

**GDP growth declined due to lower output across sectors**



Source: CSO and Bank staff, does not include opium

**Fewer firm registrations indicate lower private sector investment**

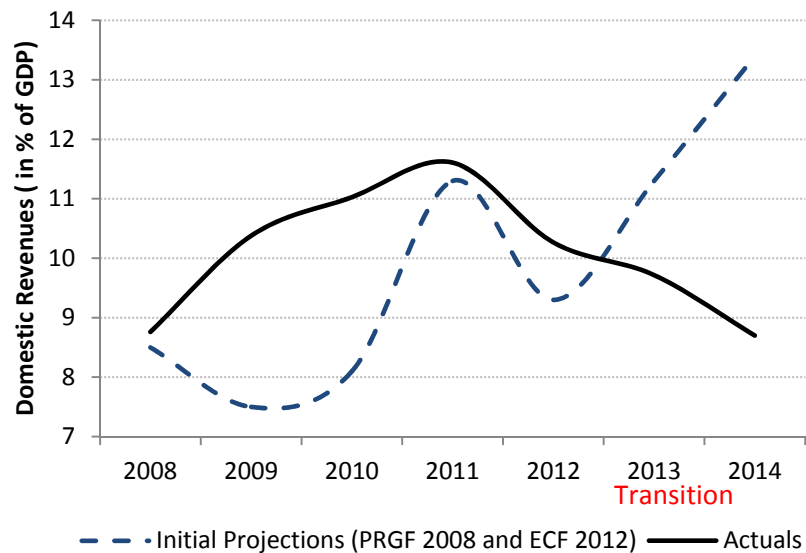


Source: AISA

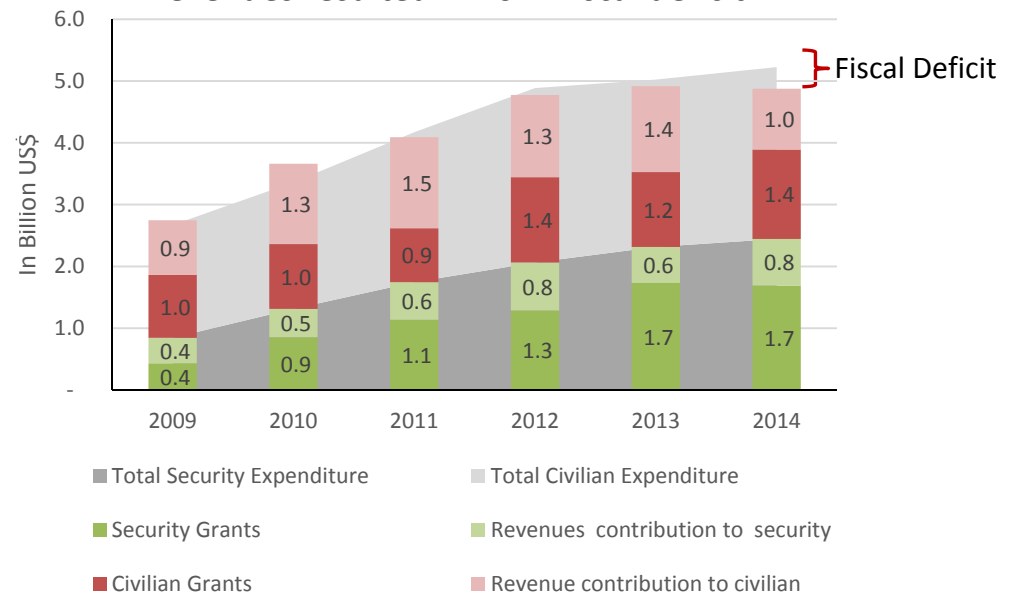
## ...but fiscal vulnerabilities were even more pronounced.

- Domestic revenues declined sharply from a peak of 11.6 percent in 2011 to 8.7 percent of GDP in 2014 due to the economic slowdown and greater governance vulnerabilities.
- Higher security expenditures and social benefit spending.
- Fiscal crisis 2014: Fiscal deficit amounted to \$351 million, even after accounting for exceptional budgetary assistance and expenditure restrains.

Domestic Revenues fell short of initial targets



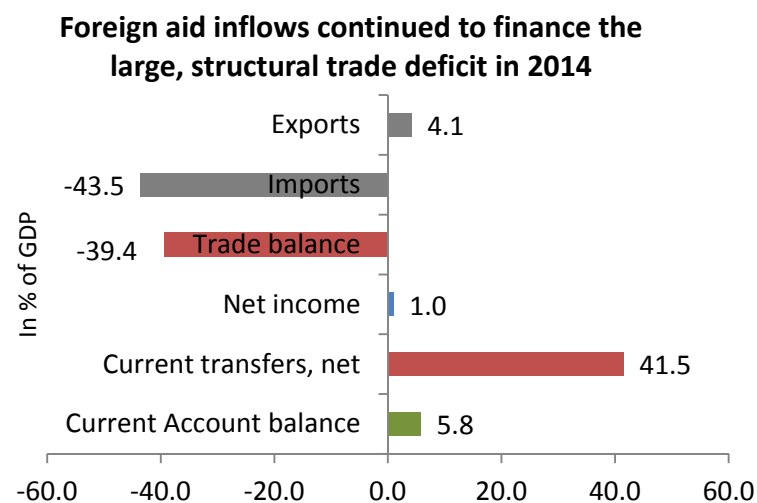
Higher security expenditures and lower revenues resulted in 2014 fiscal deficit



Source: Bank staff estimates

## Transition did not undermine macroeconomic stability

- While foreign aid declined between 2012 and 2014, it was still sufficient to keep the current account in surplus and offset the large trade deficit of around 40 percent of GDP.
- Afghani depreciated by nearly 20 percent vis-à-vis the US dollar between June 2012 and June 2015, mainly due to lower aid and net capital flows. The decline in global commodity prices and slowing domestic demand contained the pass-through effect on inflation.
- Foreign exchange reserve position remains comfortable and grew from US\$6 billion in early 2012 to over \$7 billion in mid-2015.
- In absence of new sources for capital inflows (export receipts, remittances, FDI) and continued dependence on imports, a further decline in aid may pose risks to the BoP in the future.



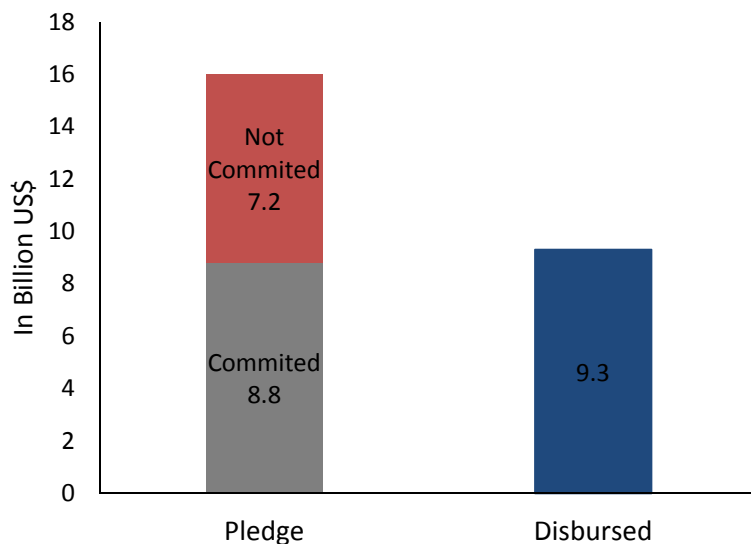
Source: IMF and Bank Staff estimates



## While challenges remain, aid delivery actually improved.

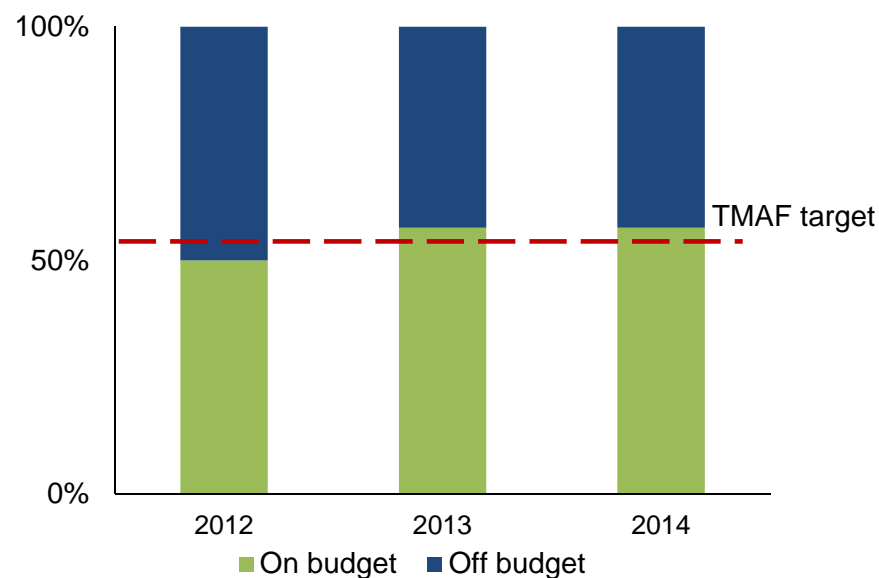
- Aid commitments and disbursements appear to be on-track with TMAF pledges.
- Goal to move 50% of all assistance on budget has been achieved.
- Donor grants have become more discretionary. Discretionary grants increased from 62% of total on-budget assistance in 2012 to 66 percent in 2014.
- Aid alignment to Government priorities continues to be difficult.

**More than half of TMAF pledges have been committed and disbursed**



Source: MoF

**In aggregate, more than 50 percent of aid is now on budget**

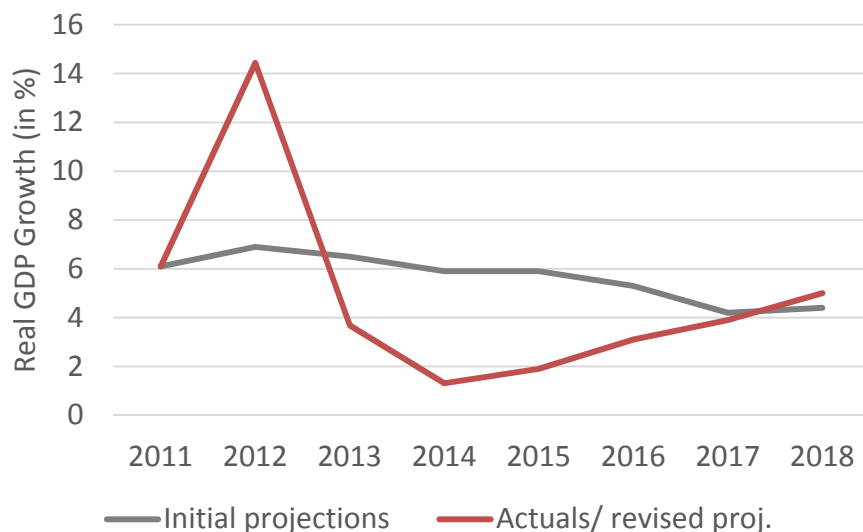


Source: MoF

## Post-Transition 2015-18: Much slower emergence from transition

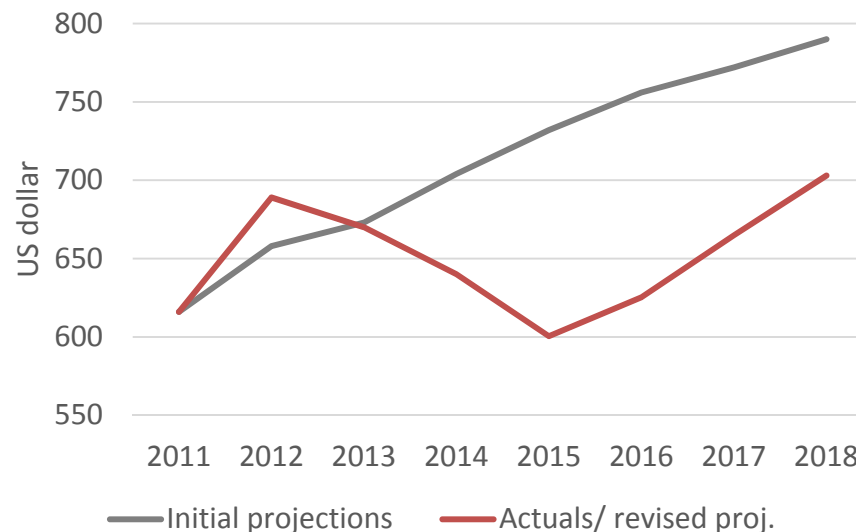
- The economy did not recover as expected in 2015. Increase in violence, continued political and reform uncertainty continue to inhibit investment.
- Growth is expected to remain sluggish over the medium-term. Real GDP growth is projected at 1.9 percent in 2015.
- Slow economic recovery has implications for the long-term: given demographic trends, much higher growth is now required to catch up and close the income gap.

**Economic recovery is slower than expected**



Source: Bank staff estimates/projections

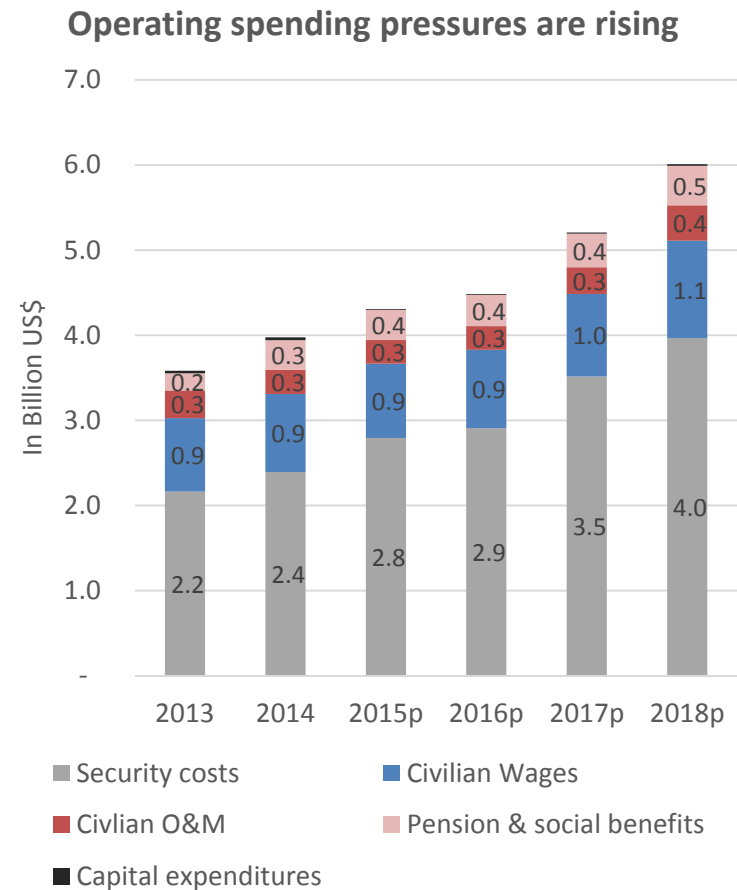
**Increasing per capita income in the future will now require even higher growth rates**



Source: Bank staff estimates/projections

## Fiscal trends remain challenging due to high expenditure pressures ...

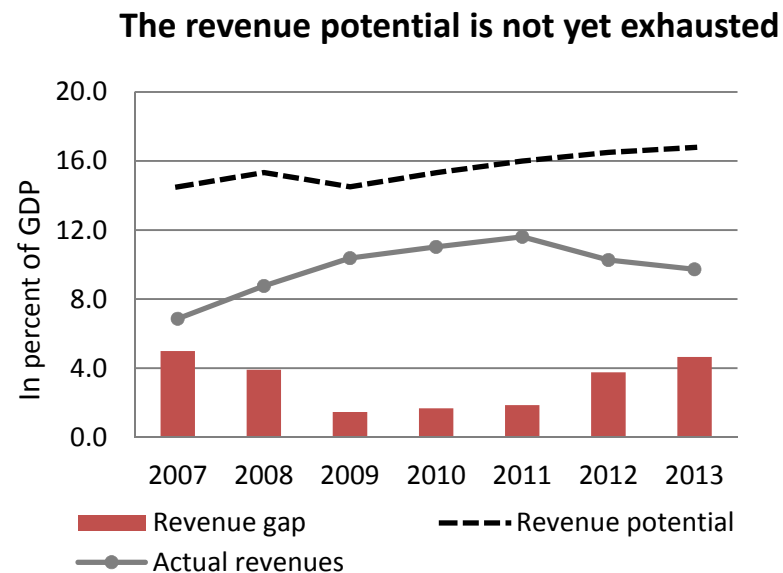
- Security costs have grown beyond initial Chicago projections. Government's contribution to security increased from \$583 million in 2013 to \$754 million in 2014, exceeding Chicago commitment (\$500 million).
- The existing security sector strategy implies an increase in budget-financed security operations.
- Pressures from increasing pension costs and growing benefits to families of martyrs and disabled are mounting in the medium-term.
- Wages will continue to represent a significant portion of the Government's budget. Civil service planning is not yet based on fiscal sustainability considerations.



Source: Bank staff projections

## and lower revenue collection and limited revenue potential.

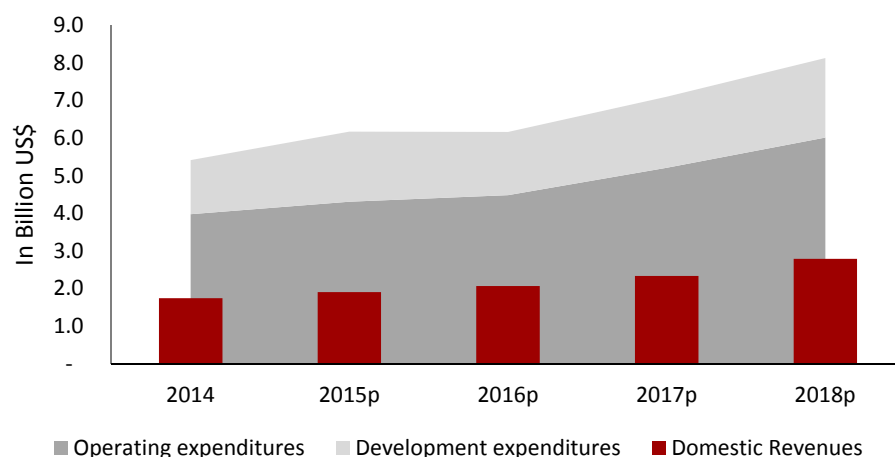
- Revenues as a share of GDP are expected to increase in 2015 but remain well below 2011 levels.
- New analysis suggests that reforms in tax compliance and enforcement efforts could increase revenue by 4-5 percent of GDP (revenue gap).
- The total economic revenue potential – that can be achieved through better tax policy and administration given the current economic structure and country characteristics - is estimated at around 16 percent of GDP. This is inadequate compared to Afghanistan's long-term financing needs.
- Increasing the revenue potential will require mobilizing new sources of growth and investment.



## Medium-term financing needs have increased

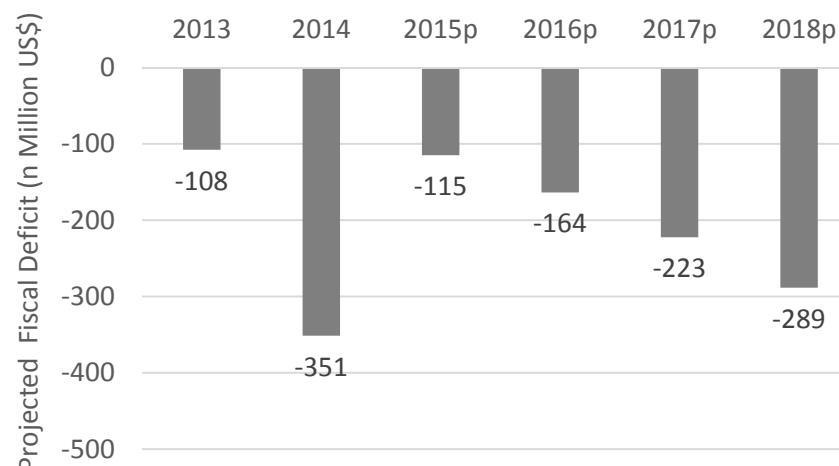
- The 2015 budget showed more realism and great effort to control spending through implementing cost-effective and revenue-enhancing measures.
- Lower revenue prospects, compounded by higher expenditure pressures, widened the projected fiscal deficit in the medium term. Higher commitments for (discretionary) donor grants or further fiscal adjustment is needed to balance the budget.
- Expenditure consolidation will be very difficult if the security situation does not improve and will further reduce the extremely tight space for poverty reduction and development.

**Domestic revenues only finance around a third of total expenditures**



Source: Bank staff projections

**Fiscal risks and adjustment needs have increased**



Source: Bank staff projections

Note:

## New momentum on macro-fiscal reform agenda

**An impressive number of ambitious reform initiatives are planned and anchored in commitments with international partners**

### ARTF Incentive Program 2015- 2017

- HR management, enforcement and business process in tax and customs administration
- Tax policy coordination and tax code
- Design and delivery system of pension and social benefits
- Land management and administration
- Business Licensing and registration
- Fiscal Deconcentration and Provincial Budgeting
- Performance Audits, Civil Society Accountability Instruments, Audit Follow-up mechanisms

### IMF SMP 2015

- New tax policy measures for 2015
- Banking supervision and regulation
- New Banking La
- Strengthening of AML/CFT legal framework
- Financial market development: Sukuk Law and secondary trading of existing instruments
- Privatization of New Kabul Bank
- Tax administration
- Fiscal regime for natural resources
- PFM reforms
- Anti-corruption efforts

### SMAF 2015

- Civilian systems of procurement, and financial transparency and accountability in security ministries
- Electoral reforms
- Anti-corruption measures and Civil service reforms
- Provincial budgeting policy
- Tax administration
- E-payments in Customs
- PFM Roadmap II
- Multi-year budget framework
- Investment climate reforms and PPP regulatory framework

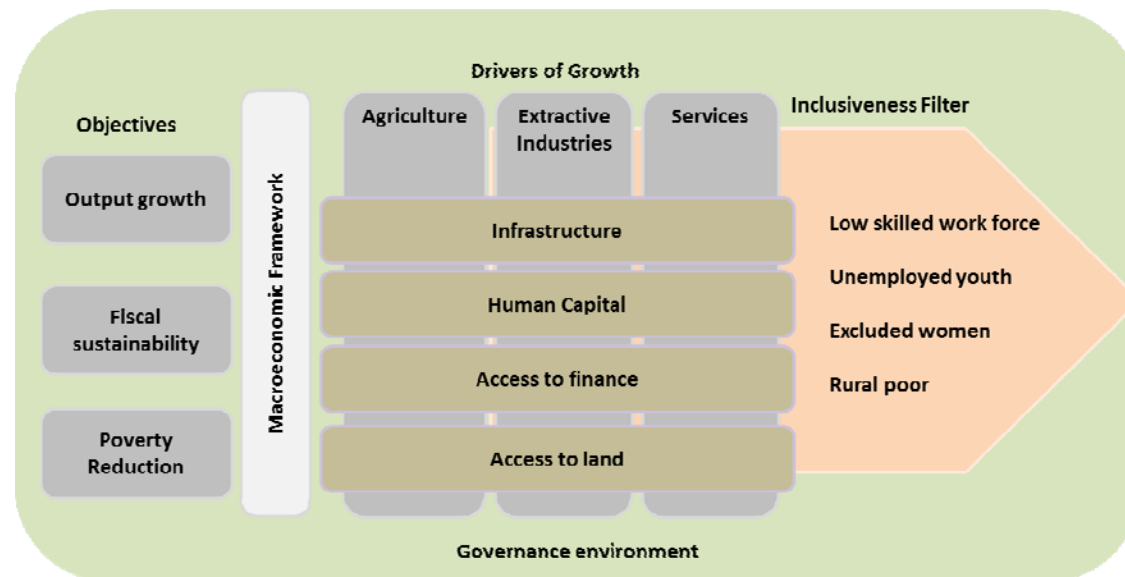
Note: Bilateral policy-based programs not represented here

## Reducing conflict and fragility will be a long-term effort

	Weak State, Political Institutions, and Governance	Conflict, Insecurity, and External	Social and Demographic
<b>Drivers of Fragility</b>	<ul style="list-style-type: none"> <li>• Incipient political institutions</li> <li>• Intra-elite bargaining</li> <li>• Competition over fewer resources (land)</li> <li>• Patronage and corruption;</li> <li>• poor local governance and second civil service</li> </ul>	<ul style="list-style-type: none"> <li>• Insurgency and Terrorism,</li> <li>• Local conflicts</li> <li>• Geopolitical involvement by outside countries and proxy conflicts;</li> <li>• Landlocked, mountainous terrain with illicit regional activities;</li> <li>• High ANSF cost and casualties</li> </ul>	<ul style="list-style-type: none"> <li>• Ethnic fragmentation worsened by conflict</li> <li>• Gender issues, risk of backlash</li> <li>• Refugees return may increase tensions</li> <li>• High population and labor force growth</li> <li>• Rapid urbanization</li> </ul>
<b>Possible Anchors of Stability</b>	<ul style="list-style-type: none"> <li>• Strengthening Government capacity and political institutions</li> <li>• Objective regulatory improvements</li> <li>• Stronger political accountability mechanisms</li> <li>• Robust and realistic growth model</li> <li>• Control of corruption</li> </ul>	<ul style="list-style-type: none"> <li>• Regional stability and integration</li> <li>• Peace agreement and territorial integrity</li> <li>• Affordable and realistic security sector strategy</li> <li>• Regional geopolitical progress would yield multiple benefits</li> </ul>	<ul style="list-style-type: none"> <li>• Local “bonding” social capital, War-weariness</li> <li>• Entrepreneurial, mobile population</li> <li>• Generational change</li> <li>• Social cohesion</li> <li>• Global connectivity and mobility</li> <li>• Progress on social indicators</li> <li>• Narrower gender gap</li> </ul>

## ...as will be promoting inclusive growth

- Improved infrastructure, human capital, access to land and finance, and investment climate will benefit job-creation and growth across the board.
- Agriculture: focus interventions on priority commodities and those that have largest growth and employment potential - irrigated wheat, horticulture crops, intensive livestock and agro-processing industries.
- Unlocking the potential of extractive industries will require progress on the legislative framework as well as securing financing for the necessary infrastructure
- Regional integration and migration could play an important role but prospects of both depend on external factors and are less predictable.





## Mitigating employment and poverty pressures

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- Afghanistan is still one of the poorest countries in the world. 35.8 percent of the population lived below the poverty line in 2011-12, with more than half of the population being vulnerable.
- Preliminary results from the 2013-14 household survey (ALCS) indicate an increase in poverty mostly due to the deterioration in the security environment and labor market opportunities.
- Demographic trends imply that 400,000 young people enter the labor force each year.
- The medium-term growth outlook is not favorable: Sluggish growth recovery and challenges to service delivery are likely to slow down the pace of human capital accumulation, reducing future prospects of growth and poverty reduction.
- Expanding direct household transfers and insurance schemes could reduce vulnerability of the poor, and increase productive investment at household level
- Investment in adult literacy and skills could improve mobility and productivity of existing labor force, enhance participation of the poor in the growth process, and better equip them to participate in civil society processes and initiatives.

## From SOM to 2016 Ministerial: Immediate challenges

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### **Articulate the needs for security and development assistance**

- Afghanistan security strategy and commitments need to be re-visited in light of the changes in the security situation and realistic assumptions for growth and fiscal developments.
- Commitments for development financing will likely need to remain at least at current levels. What can be achieved through further changes in aid delivery and programming?
- New National Development Strategy is required to provide clearer direction for donor financing.

### **Restore private sector confidence and stimulate investment NOW**

- Not only aid but investment opportunities will determine Afghanistan's growth prospects.
- Reforms underway will more likely show positive impact in the long-term. But by nature reforms can be disruptive in the short-term. Afghanistan can not afford to deter investment through unintended impacts or an uncoordinated policy approach. Close dialogue, consultation and communication on all key-reforms affecting businesses and markets will be critical.
- The current lack of policy predictability hinders strategic long-term investment decisions. Formulating the Government's vision and policy for economic development could enhance predictability and provide better guidance to domestic and foreign investors.

## From SOM to 2016 Ministerial: Immediate challenges

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### **Free-up fiscal space for expanding social safety interventions**

- Without additional financing, the only way to mitigate poverty in the short-term is to re-program the existing portfolio of development interventions.
- Explore opportunities for social safety interventions, including direct household transfers, and adult education initiatives with direct impact on poor households to strengthen service delivery and social cohesion

### **Achieve results on reforms**

- Recent plans and ambitions to reform are encouraging but need now to be very forcefully implemented.
- Exercise prudent controls over core expenditures. Efforts, such as procuring fuel centrally with higher controls, need to be increased to economize security spending.
- Navigating entrenched vested interests will require high-level political support as well as a sense of pragmatism and the need for confidence building along the way