AFGHANISTAN

FROM TRANSITION TO TRANSFORMATION II

July 2, 2013

Senior Officials Meeting

The World Bank

OUTLINE

- Development realities of Afghanistan
- Transition economics:
  Growth and fiscal sustainability
- Economic performance
  18 months into the transition
- Confirming Afghanistan's
  growth model
- Cross-cutting issues:
  water, land, governance
- Summary messages

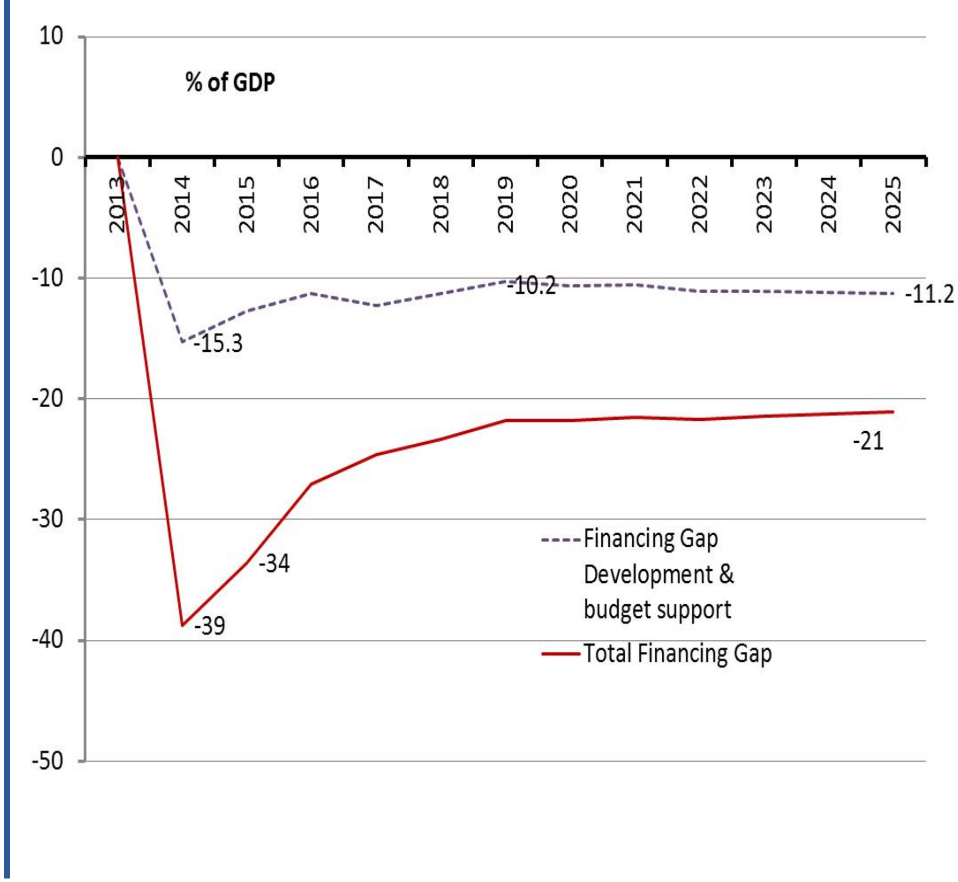
AFGHANISTAN HAS COME A LONG WAY...

- Progress in several human development dimensions has been substantial:
  - The percentage of population with access to improved water sources has increased from 22% in 2000 to 50% in 2011
  - Gross primary enrolment ratio has soared from 19% to 97% over the same period
  - Maternal mortality rate has almost halved between 2000 and 2011
  - Life expectancy has improved from 45 years in 2000 to 48.7 years in 2011
- However, poverty still remains high. 36% of the population lived in poverty in 2008, and this rate seems to have remained unchanged as of now.
- Literacy rate still remains very low. Only 26% of the population can read and write.

TRANSITION ECONOMICS (2012):
GROWTH AND FISCAL SUSTAINABILITY CHALLENGES

- World Bank analysis (2012) showed the likely impact of declining aid on economic growth under different scenarios: as long as the security situation improves, Afghanistan will continue to grow at lower but still respectable rates of 4-6% on average between 2011 and 2018 [Base], even if aid declines by 50% from its 2010 levels [Aid-].
- Rising security costs, wage bill and O&M liabilities will increase Afghanistan's financing needs. This will require continued donor support and a strong revenue mobilization effort.
- More money on budget can mitigate some of the transition impact but it will also require more attention to increasing the capacity for absorption and public service delivery.
- Better prioritization of public investments, particularly in infrastructure and mining development, is critical in terms of their strategic complementarity.

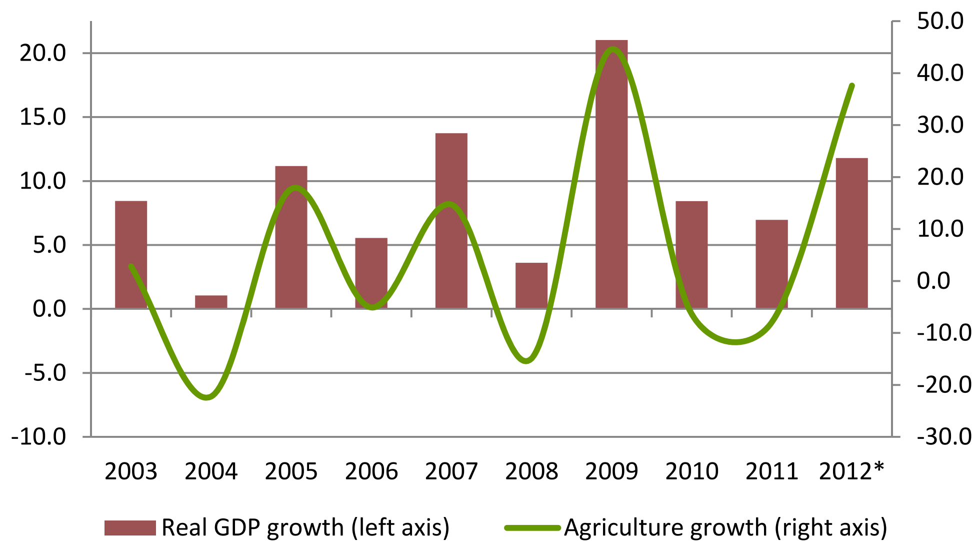
ESTIMATED FINANCING GAP 2013-2025



18 MONTHS INTO TRANSITION,
THE ECONOMY IS SLOWING DOWN AS EXPECTED

- Real GDP growth increased from 7.3% in 2011/12 to an estimated 11.8% in 2012/13, driven by an exceptional harvest. However, growth is expected to slow in 2013/14 in line with historic patterns of volatility and as result of rising uncertainty.
- Opium production declined in 2012 to 3.3% of GDP or US$700 million, but is expected to increase this year across most provinces.
- Slowdown in private investment: Data indicates that the number of newly registered firms declined by 8% in 2012, particularly in the construction sector.
- Inflation dropped from 10.2% in 2011/12 to 6.4% in 2012/13, due to declining both food and non-food prices.
- Exports declined by 5% in 2012 while imports continued to increase. Trade deficit widened to 43% of GDP
- Foreign exchange reserves reached an all-time high of US$7.1 billion in December 2012, but has declined to $6.5 billion in June 2013

REAL GDP AND AGRICULTURAL OUTPUT GROWTH (in percent)

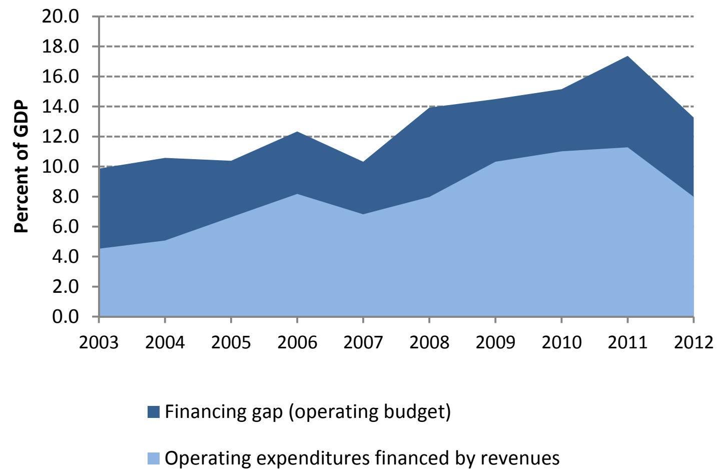


** 2012 figures are forecasts*

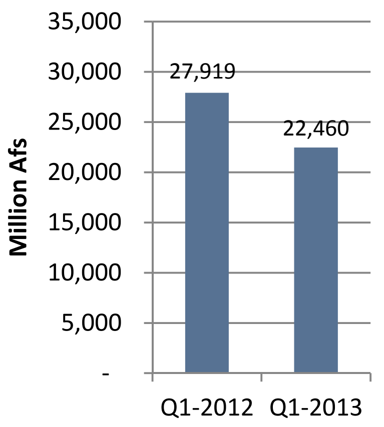
...AND THE FISCAL POSITION IS WEAKENING

- Expenditures increased by 45% in FY2012 (compared to first 9 months in 2011/12). Security expenditures accounted for almost 60% of the operating budget. Donors financed approximately 65% of the total budget
- Domestic revenues increased by 13.1% in 2012 but missed the revenue targets, mainly due to lower customs revenues, resulting in a drop of the fiscal sustainability ratio from 65% in 2011 to 60% in 2012.
- Budget execution remained constant in nominal terms (around 50%) but absorption effectively increased (because nominal spending increased)
- Revenues further declined by 19.6% in the first quarter of 2013. Measures have been implemented to reverse the trend. As a result, the decline in revenues slowed to -3.9% in April-May 2013 compared to the same period in 2012.
- For the next 18 months of transition, it will be critical to strengthen efforts for revenue mobilization.

FISCAL SUSTAINABILITY RATIO



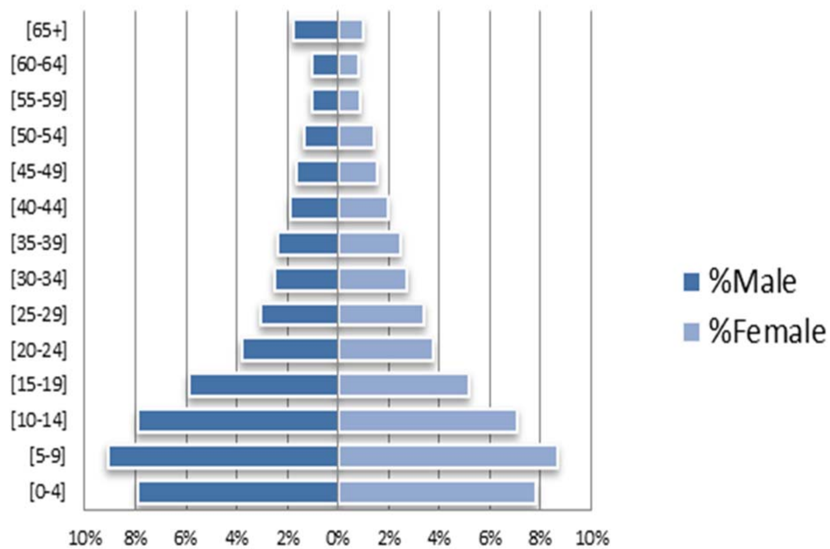
RECENT DOMESTIC REVENUE DEVELOPMENTS



FROM TRANSITION TO TRANSFORMATION:
THE REALITIES

- Afghanistan faces a number of growth and development challenges over the next decade:
  - Growth is expected to slow to an average 4.8% annually over the five years
  - The decline in aid will increase the need for foreign exchange earnings to finance future imports
  - Poverty remains stubbornly high at 36%
  - Increasing labor market pressures: an estimated 400,000 to 500,000 young people will enter the labor force annually
  - Low human capital and unskilled labor: out of 200,000 high-school graduates each year, less than half of them go to higher education and TVET. The remaining directly enter the labor market as unskilled workers
  - Persistent conflict and violence affect access to basic services, and human development

AFGHANISTAN POPULATION PYRAMID



LABOR MARKET INDICATORS

	Rural	Urban	National
Participation rate	71.46	48.84	66.53
Unemployment rate	7.35	10.47	**7.85**
Underemployment rate	**53.06**	21.51	**48.16**

CONFIRMING THE GROWTH MODEL

- In light of these challenges, Afghanistan growth strategy needs to give priority to:
  - maximize job creation and reduce poverty,
  - mobilize fiscal revenue,
  - produce foreign earnings
  - promotes stability and social cohesion.

- The objective is to move to high, sustained <u>and</u> inclusive growth.
  - ➢ focus on increasing growth by more fully employing people trapped in low-productivity activities or completely excluded from the growth process.

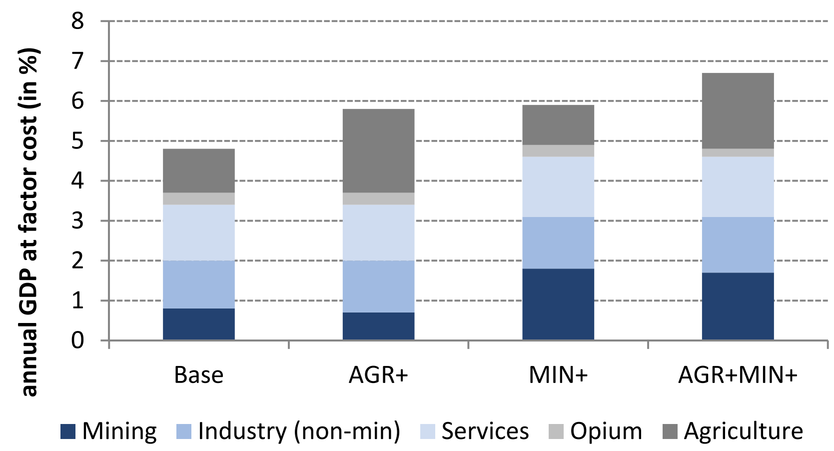
- Afghanistan's future growth model will likely rely on agriculture and extractive industries (EI)
  - Education levels are too low and the manufacturing sector too underdeveloped (in size and capacity) to expect leapfrogging the classic pattern of structural transformation in which a natural resource-based economy is transformed into a diversified and productive economy dominated by manufacturing and services.
  - ➢ This implies focus on rural development and agglomeration in or deriving out of mining areas

- Growing urbanization is only to be expected, and there is a need to balance attention between urban centers and rural areas.

HOW MUCH GROWTH CAN WE EXPECT WITH MORE INVESTMENT IN AGRICULTURE AND EXTRACTIVE INDUSTRIES?

- Lower level of aid will reduce growth to 4.8% on average until 2025
- Extractive industries offer good opportunities for more growth: with more investment in mining, growth could increase to 6.9% on average until 2025, and fiscal revenues could reach 2-4 % of GDP in the early 2020s
- Higher productivity in the agriculture sector could increase growth to 5.8 % (in comparison to the BASE case)
- Favorable developments in both sectors could lead to growth of 6.7 % or beyond, eventually replacing the role of aid in Afghanistan's economy
- However, growth is not automatic and is predicated on an improving security situation. Much needs to be done…

GROWTH SIMULATIONS: DECOMPOSITION OF ANNUAL, AVERAGE GDP GROWTH 2011/12-2025/26



Source: World Bank (2012)
Note: Figures report average, annual GDP at factor cost

THERE IS GOOD POTENTIAL FOR DEVELOPING AGRICULTURE AND EI

	AGRICULTURE	EXTRACTIVE INDUSTRIES (EI)
OPPORTUNITIES	▪ Poverty reduction: Poverty in rural areas accounts for 84% of poverty nationwide. ▪ Increase in household income: 42 % of all Afghan households rely on agriculture for their livelihoods ▪ Excess of labor supply mostly in rural areas (higher fertility) ▪ Rural development important to mitigate rural-urban migration pressure. ▪ Improves food security	▪ mobilizes large fiscal revenues: fiscal revenues could reach $0.7-1.5 billion p.a. by 2022-24 ▪ partially substitutes for foreign aid and mitigates the adverse BoP impact of decline in aid: foreign direct investment could amount $10-20 billion and exports could reach $10-12 billion p.a. ▪ triggers development in up- and downstream industries ▪ facilitates transfer of technology, brings in knowledge and skills, and provides employment opportunities
OPTIONS TO ENHANCE PRODUCTIVITY	▪ Increase investment in infrastructure (roads/irrigation) to reduce input and transportation costs ▪ Expand extension services & pilot innovations ▪ Enhance access to electricity to support agro-processing industries ▪ Support development of collateral markets (credit, insurance…) ▪ Strengthen legal and regulatory framework for land access (range)/ land market ▪ Quality control and certification	▪ Invest in infrastructure to reduce transportation and operation costs for mining companies ▪ Improve legal and regulatory environment to provide security of tenure and guidance on licensing, tendering and mining obligations ▪ Support interventions to encourage intake of national workforce in extractive industries (supply and demand side interventions) ▪ Support interventions to facilitate the provision of goods and services by domestic private sector to the extractive industries (local procurement and market linkages)

THREE WAYS OF BOOSTING JOB CREATION IN AGRICULTURE

50% of farmers are engaged in subsistence agriculture, with no access to markets. Raising productivity on land in use will predominantly increase income of households currently active in agriculture—but not necessarily create many new jobs. There are, however, ways to maximize job creation in agriculture:

1. EXPAND IRRIGATED AND CULTIVATED LAND

Part of the 4.5 million hectares of rainfed land can be turned into irrigated land depending on proximity to water sources and topography. Wheat productivity, for example, on irrigated land is approximately 3 times higher than productivity on rain-fed land.

2. FOCUS ON LABOR-INTENSIVE CROPS

Expanding irrigated area for the cultivation of other high-value crops, such as tree crops and cotton, would (almost) triple labor input requirements compared to wheat cultivation.

3. DEVELOP AGRO-PROCESSING VALUE CHAINS AND SUPPORT RELEVANT INFRASTRUCTURE

- Agro-processing industries are mostly labor-intensive
- Most agro-processing activities can be done in rural areas where primary products are locally available
- Supporting emergence of agro-processing industries will help create more jobs
- Enhancing access to electricity and developing road and other infrastructures are vital for the development of agro-processing industries

LABOR INPUT REQUIREMENTS FOR VARIOUS CROPS

CROPS	days/ha	Spring	Summer	Fall	Winter
WHEAT	60	XX	X	X	
TREE CROPS/HORTICULTURE	150-200	X	XXX	XX	X
COTTON	100-120	X	XX		

MAXIMIZING IMPACT:
RESOURCE CORRIDOR APPROACH

EXTRACTIVE INDUSTRY SECTOR DEVELOPMENT IS UNLIKELY TO BE TRANSFORMATIVE

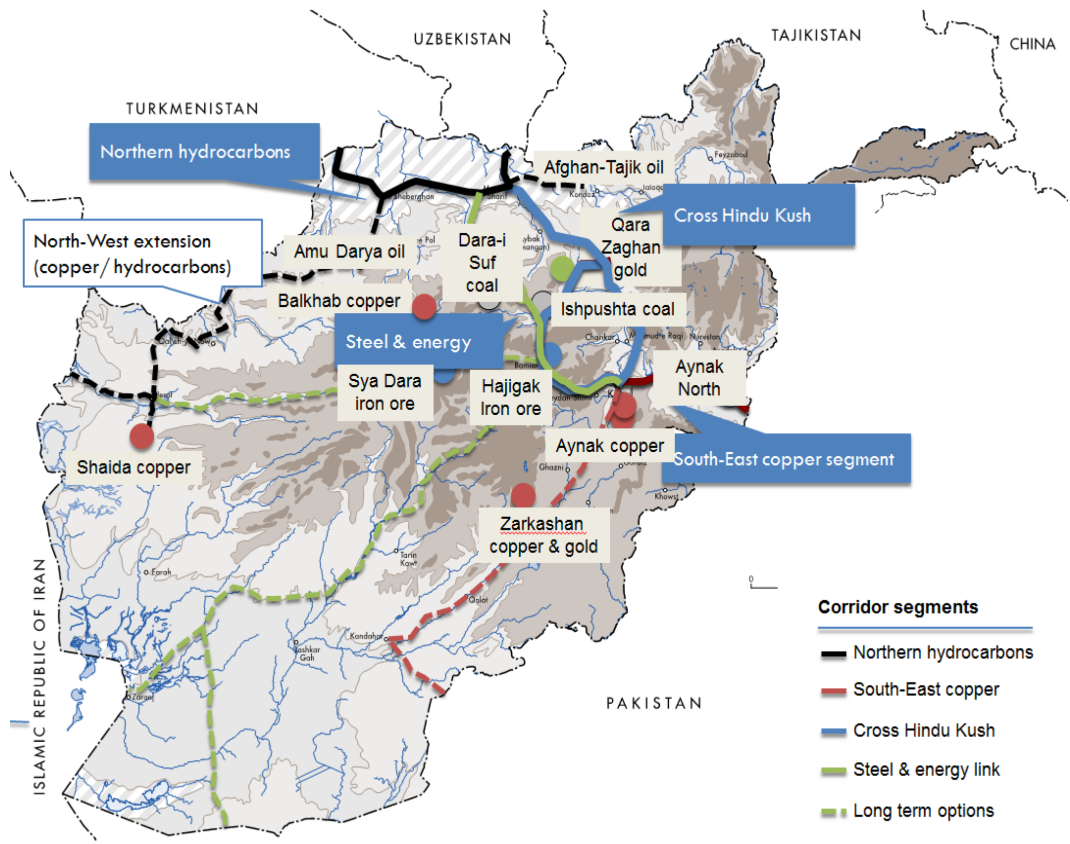
- EI generates revenues and foreign exchange earnings, but these do not perfectly substitute for aid
- Direct job creation will be modest (15,000 – 20,000) and the bulk of these jobs will be semi or fully skilled labor

RESOURCE CORRIDOR: LEVERAGING THE EXTRACTIVE INDUSTRY SECTOR

- Seek public and private sector synergies to prioritize investments
- Sequence and combine hard (i.e. infrastructure) and soft interventions to maximize economic benefits to the country (and avoid enclave industries)

PRIORITIZING INFRASTRUCTURE INVESTMENTS: CRITICAL ISSUE IN TRANSITION CONTEXT

- Infrastructure investments must be financially and economically feasible on their own merits (extractive sector help prioritize investments, not validate them)
- Consider flexible design (i.e. building a 220 kv transmission line which can be upgraded to 500 kv)
- Understand private investors infrastructure plans to (i) identify scope for incremental public investments and (ii) avoid publicly funding investments that could be privately funded



WATER AND LAND:
CENTRAL TO DEVELOPMENT

- Increasing water stress due to population growth, urban development, climate changes, agriculture and mining development.

- Water resources are limited

- Community development approaches to water development have reached their limits. The last large-scale water development dates back to the 1950s.

- Development and rehabilitation of large-scale hydraulic infrastructures will be critical for Afghanistan's economic development.

- Access to and efficient use of land resources are critical for Afghanistan's development

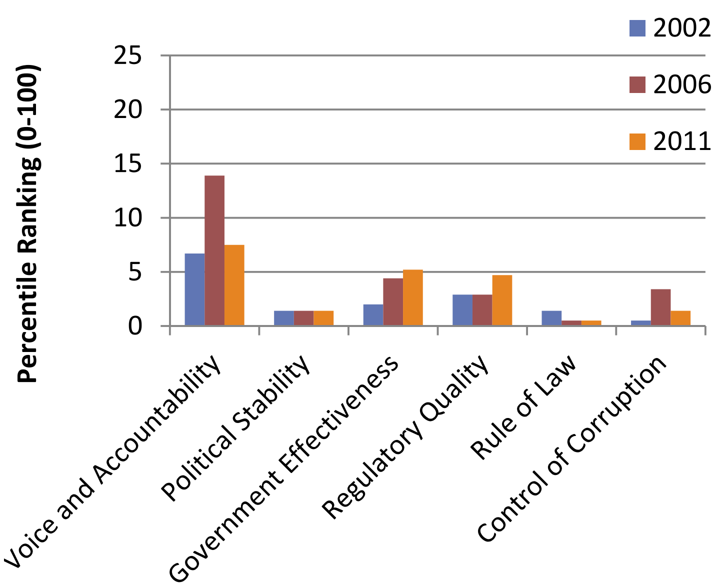
- Increasing demand for land for: agriculture development, commercial projects, public infrastructure, and mining sector development

- Areas for priority engagement: Institutional strengthening of land management authority, cadastral surveying and mapping for areas of priority areas for agriculture and mining, improving legal and regulatory framework for land management and acquisition.

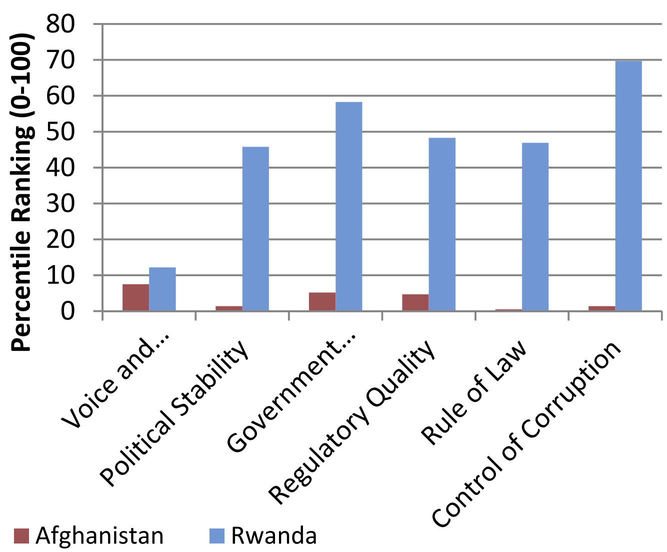
BUILDING STRONG INSTITUTIONS IS CRITICAL FOR ALL THESE DEVELOPMENTS

- Afghanistan's progress in institution building is slow. More concerning is that previous achievements were not sustained. The quality of institutions such as accountability, rule of law, and control of corruption has deteriorated between 2006-2011.
- Improving governance will be critical moving forward and is a necessary condition for attracting external investment and retaining donor confidence.

PROGRESS OF INSTITUTION BUILDING IN AFGHANISTAN



AFGHANISTAN IS FAR BEHIND OTHER POST-CONFLICT COUNTRIES



SUMMARY MESSAGES

- Transition dynamics have begun affecting economic and fiscal performance.
- Sustaining high growth will not be Afghanistan’s only challenge.
  Continued conflict and fragility, persistent poverty, increasing labor market pressures and a rising fiscal deficit need to be addressed.
- Security and foreign aid remain central to Afghanistan’s development progress.
  Donor’s commitment and engagement are critical for both economic and political stability in the country.
- Afghanistan’s future growth model will likely to rely on agriculture and mining.
  However, much needs to be done to unleash the growth potential in these sectors.
- In the meantime, it will be important to improve social safety nets and enhance investment in health and education in order to protect social cohesion.
- Land and water remain central to overall development in the country.
  It is time for comprehensive reforms to overcome constraints limiting access to land and water.
- Institutions matter for growth, peace and stability:
  Afghanistan’s progress and performance in Governance reforms has been slow and uneven.