AFGHANISTAN DEVELOPMENT UPDATE

October 2016

THE WORLD BANK
IBRD • IDA | WORLD BANK GROUP

AFGHANISTAN DEVELOPMENT UPDATE

October 2016

THE WORLD BANK
IBRD • IDA | WORLD BANK GROUP

Preface

The Afghanistan Development Update, which is published twice a year, provides a comprehensive report of the state of the Afghan economy. It covers recent economic developments and outlines the medium-term outlook for Afghanistan. Each edition includes a section that provides in-depth analysis on one or more specific focus topics. The lack of high-frequency data in Afghanistan makes it difficult to track economic activities on monthly or quarterly basis. Thus, proxy indicators are utilized when their quality is deemed satisfactory. Efforts are made to ensure that key analysis and forecasts are based primarily on reliable sets of data.

The Afghanistan Development Update is intended for a wide audience, including policy makers, the donor community, the private sector, the community of analysts and professionals engaged in monitoring the economy and Afghanistan's citizens at large.

This report was prepared by Omar Joya, Tobias Haque, Claudia Nassif and Aman Farahi. The authors gratefully acknowledge the useful inputs provided by Silvia Redaelli, Christina Wieser, Ahmed Tawfick Rostom, and other members of the Afghanistan country team. Deepak Mishra provided useful comments, for which the authors are grateful. Ehsanullah Nasiree assisted with the design and formatting of the document. Irfan Kortschak provided copyediting assistance. The report was prepared under the overall guidance of Shubham Chaudhuri (Manager for Macroeconomics & Fiscal Management, South Asia) and Robert Saum (Country Director).

The authors are grateful for the cooperation provided by Government officials who shared valuable data and statistics. The authors are particularly thankful to the Ministry of Finance for granting permission to include the material contained in the "Highlights of Achievements" Annex. The authors also gratefully acknowledge the comments and suggestions received from staff of the International Monetary Fund.

Table of contents

EXECUTIVE SUMMARY I

A. RECENT ECONOMIC DEVELOPMENT 1

1. Background 1
2. Real Sector Activity 2
3. External sector 6
4. Fiscal developments 9
5. Monetary and financial sector developments 11

B. OUTLOOK AND MEDIUM-TERM PROSPECTS 13

C. FOCUS SECTION I: OUTCOMES FROM BRUSSELS 16

D. FOCUS SECTION II: FRAGILITY AND POPULATION MOVEMENT IN AFGHANISTAN 24

APPENDIX I: WORLD BANK GROUP PROGRAM IN AFGHANISTAN 30

APPENDIX II: GOVERNMENT REFORMS IN 2016 32

LIST OF FIGURES

Figure 1: Civilian casualties remain high ... 1
Figure 2: Cereals production is projected to decline in 2016 ... 2
Figure 3: Industry and services contributed to the minor growth in 2015 ... 3
Figure 4: Number of firm and vehicle registrations ... 4
Figure 5: Opium output and area under cultivation increased in 2016 ... 5
Figure 6: Increase in poverty since the pre-transition period ... 5
Figure 7: Consumer prices increase as global commodity prices rebound ... 6
Figure 8: Exports increased in the first half of 2016 ... 7
Figure 9: Imports decreased in the first half of 2016 ... 7
Figure 10: The value of the Afghani: Depreciation in the first two quarters, appreciation in the third quarter ... 8
Figure 11: Real exchange rate has depreciated since 2012 ... 8
Figure 12: Revenue collection performance: A significant increase in the first 8 months of 2016 ... 10
Figure 13: Expenditures and financing: The first half of 2016 ... 11
Figure 14: Growth in monetary aggregates and commercial bank loans ... 12
Figure 15: The fiscal deficit (excluding donor grants) is projected to continue to grow ... 14
Figure 16: Security and civilian recurrent expenditure expected to grow substantially ... 17
Figure 17: On-budget recurrent expenditure needs exceed available revenues after security contributions ... 18
Figure 18: A high-growth strategy requires US$ 1 billion of new investment annually ... 20
Figure 19: The proportion of aid delivered on-budget determines whether the Government meets its investment needs ... 21
Figure 20: On-budget aid: More cost-effective, greater economic impact ... 22
Figure 21: The number of assisted returns to Afghanistan ... 25
Figure 22: Share of returnees in 2007, by district ... 25

LIST OF TABLES AND APPENDIX TABLES

Table 1: Gross Domestic Product, by output sectors, shares and real growth ... 3
Table 2: Public expenditure: 2015 and 2016 half-year comparisons ... 10
Table 3: Medium-term macroeconomic framework, 2012–19 ... 14

Appendix Table 1: Selected economic indicators ... 37
Appendix Table 2: Selected fiscal indicators ... 38
Appendix Table 3: Selected fiscal indicators ... 39
Appendix Table 4: Selected fiscal indicators ... 40

LIST OF BOXES

Box 1. Real exchange rate movements in Afghanistan are correlated with the levels of foreign aid ... 8

Executive summary

Security and development remain inextricably linked in Afghanistan, with the poor security environment continuing to exert a significant constraint on confidence, investment, and growth. As a result, in 2015, the economy grew at only 0.8 percent. In addition to the security situation, adverse weather conditions also constrained growth, contributing to a decline in agricultural production of 5.7 percent in 2015. Available data for the first half of 2016 indicate ongoing low levels of investment, with agricultural production expected to remain poor due to crop diseases and pests. Thus, in 2016, the growth rate is expected to reach only 1.2 percent, despite progress with a number of important initiatives that are expected to have a positive impact on Afghanistan's economic development, including Afghanistan's accession to the World Trade Organization and the opening of the Chabahar port in Iran. With the economic growth rate significantly lower than the population growth rate, it is expected that poverty will have increased in 2015 and that it is likely to continue to increase throughout 2016. In the medium-term future, economic growth is expected to gradually accelerate, increasing from 1.8 percent in 2017 to 3.6 percent in 2019. However, stronger growth in out-years is predicated on improvements in security, political stability, reform progress, and continued high levels of aid.

After declining steadily throughout 2015, consumer prices rebounded in the first half of 2016. This rebound was driven by a recovery in global energy and cereal prices and by the depreciation of the Afghani against major trading currencies. Against the US dollar, the Afghani depreciated by 3.8 percent in the first quarter of the year, followed by 0.3 percent in the second quarter, before appreciating by about 2 percent in the third quarter. Foreign exchange reserves declined throughout most of 2015, before increasing in the first half of 2016 to reach US$ 7.4 billion (or around 9 months of imports) by end of June 2016. This increase was largely due to the decline in imports as a result of weakening demand.

The fiscal situation remains stable. Revenue collection performed well throughout 2015, with domestic revenues reaching a value of 10.2 percent of GDP. Performance has remained strong into 2016, with domestic revenues collected in the first 8 months of 2016 standing at a value 30 percent higher than for the same period last year. This increase is largely due to improvements in tax administration and the implementation of policy measures that were introduced in the second and third quarters of 2015. Public expenditure in the first half of 2016 was 5 percent higher than in the same period in the previous year. While growing security costs and expanding civilian recurrent needs increased the operating budget spending by around 9 percent in the first half of 2016, development budget expenditures have fallen due to a decline in the performance of budget execution across most of Government institutions. A small deficit of 1.3 percent of GDP was recorded in 2015, with a balanced budget expected in 2016.

The international community reaffirmed its support to the Government of Afghanistan at two major international conferences during the year. At the NATO Warsaw Summit in July 2016, development partners pledged $4.5 billion per year in security grants for the next four years. At the Brussels Conference on Afghanistan in

October 2016, the international community pledged $3.8 billion per year in civilian donor grants for the same period. The sustained high levels of support indicate broad confidence amongst the international community in Afghanistan's development prospects and in the significant progress the Government has made towards achieving reforms. In particular, the Government has implemented significant positive reforms in the fields of anti-corruption, revenue collection, and private sector development. As discussed in the first focus section of this report, pledged levels of aid are sufficient to support substantial development gains. However, realizing such gains will require major efforts by both the international community and the Government. The international community will need to ensure that aid expenditures are fully aligned with government priorities, including through increasing the share of aid delivered on budget. The Government will need to pursue a range of vital policy reforms, to adopt a careful and strategic approach to all resource allocation decisions, and to pursue all available measures to increase fiscal space.

Despite the positive outcomes from the two conferences, civilian casualties remain at elevated levels and the number of Internally Displaced People (IDPs) is increasing, placing strains on the capacities of government agencies at all levels. Thousands of refugees are returning from Pakistan and, in lower numbers, from Iran and elsewhere, adding to the 1.2 million IDPs already located within Afghanistan. With slow growth, poor security, and increasing unemployment, especially in rural areas, communities are often ill-equipped to absorb returnees. This is leading to an increased incidence of displacement among returnees, a growing concentration of IDPs in informal settlements in urban areas, and increasing risks of a humanitarian crisis as winter approaches. The second focus section of this report provides recommendations for managing these risks, with measures including the mobilization of international support, the establishment of a consolidated social transfer program, the protection of IDP access to education and health, and the strengthening of urban infrastructure.

A. Recent Economic Developments

1. Background

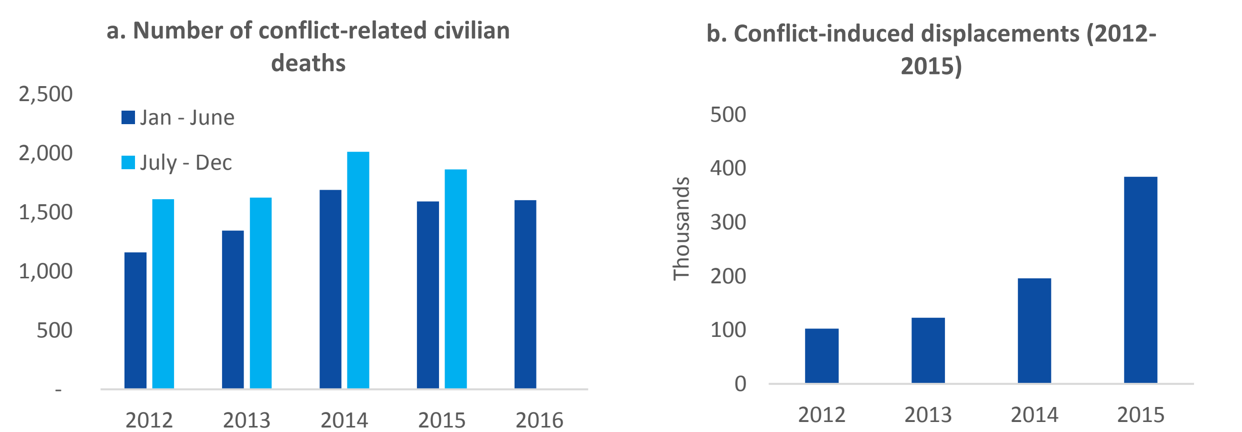
The political and security context continues to affect Afghanistan's economic and social outcomes

In 2016, the National Unity Government (NUG) continued to pursue its ambitious reform agenda, despite challenging security conditions. On October 4, 2016, the Government presented the new Afghanistan National Peace and Development Framework (ANPDF) at the Brussels Conference on Afghanistan (BCA), which was attended by representatives of around 70 countries and 30 international organizations. At this conference, development aid of US$ 3.8 billion per year for the next four years was pledged. In addition, at the NATO Warsaw Summit in July 2016, annual security funding of US$ 4.5 billion was pledged for the same time period.

These developments occurred in the context of a deteriorating security situation. Civilian casualties in the first half of 2016 remain high (see Figure 1). Also, for the first time since the fall of the Taliban in 2001, insurgents were able to temporarily seize parts of a large city, twice capturing Kunduz in northern Afghanistan, once in September 2015 and again in October 2016. Despite increasing violence, the Government was able to advance its reconciliation and peace agenda through a number of means, including signing a landmark peace agreement with a major armed opposition group, Hizbi Islami.

The deteriorating security situation has increased conflict-induced internal displacement to unprecedented levels. A shrinking asylum space within the international community and geopolitical changes at the regional level have recently spurred the return of thousands of Afghan refugees. It is estimated that returnees from Pakistan, Iran and elsewhere will increase the number of internally displaced people to around 1.2 million people by the end of 2016. In addition, an estimated 5 million Afghan refugees, including both registered and unregistered, remain in Pakistan and Iran.

Figure 1: Civilian casualties remain high



Source: United Nations Assistance Mission in Afghanistan (UNAMA) and UNHCR

2. Real Sector Activity

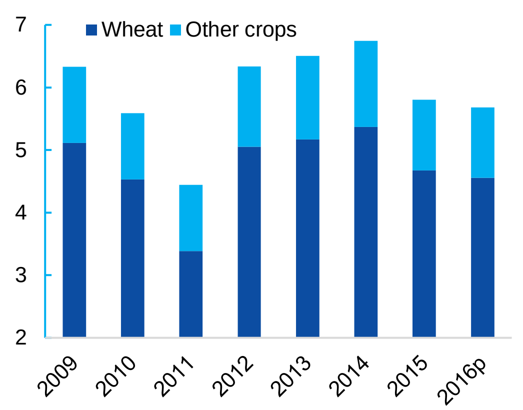
Growth continues to be constrained by insecurity and weak consumer and business confidence

Afghanistan's economy continues to experience the most sustained period of slow growth since it emerged from the conflict in 2002. According to official national accounts data released in May 2016, the economic growth rate slowed from 1.3 percent in 2014 to 0.8 percent in 2015. This is dramatically lower than the average rate of 9.4 percent recorded in the period from 2003 to 2012. The significant decline in growth since 2012 reflects the impacts of reduced aid and weak investor confidence in the context of increasing insecurity and continued political uncertainty. While on-budget aid has increased from around US$ 2 billion in 2012 to nearly US$ 3 billion in 2015, the proportion of aid delivered off-budget has declined. The total value of all aid, including both security and civilian aid and both on- and off-budget aid, is estimated to have declined from an annual average of US$ 12.5 billion in the period from 2009 to 2012 to around US$ 8.8 billion in 2015.

Agriculture contracted in 2015, with cereals production projected to continue to decline in 2016

In 2015, the deceleration in growth was primarily driven by the decline of the agriculture sector. Over the year, agricultural output fell by 5.7 percent, primarily as a result of the drop in cereals production (–14.2 percent). The production of both rain-fed and irrigated wheat, which account for almost 80 percent of Afghanistan's entire output of cereals, fell, mainly due to low rainfall. By contrast, the fruit output increased by around 7 percent. In 2016, the production of cereals is projected to decline by an additional 2.1 percent, with the per hectare yield of wheat falling by 8 percent due to crop diseases and pests. Total agricultural output is projected to decline by 0.5 percent in 2016, with some of the decline in cereals production being offset by an increase in fruit production.

Figure 2: Cereals production is projected to decline in 2016
(million metric tons)

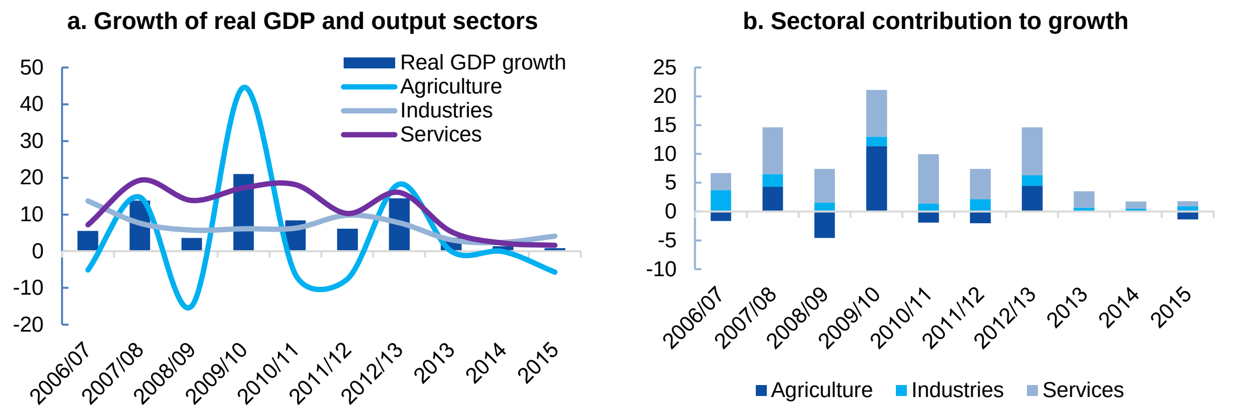


Source: MAIL (Wheat Production and Agriculture Condition Report, June 2016) and FAO (Crop Prospects and Food Situation, September 2016)

Growth in services continued to slow

The growth rate for services declined from 2.2 percent in 2014 to 1.6 percent in 2015. After contracting in 2014, the rates for transportation and wholesale and retail trade recovered in 2015, growing by 0.3 percent and 2.8 percent respectively. However, these rates are still well below historical averages (see Table 1). Other services sectors, including financial services (banking), government services, real estate activities and ownership of dwellings, continued to contract significantly over the year, offsetting most of growth generated in retail trade, communications and transport. Together these other services account for around 16 percent of GDP.

Figure 3: Industry and services contributed to the minor growth in 2015
(percent)



Sources: Central Statistics Organization (CSO)
Years from 2006 to 2012 refer to Solar Hijri years (April to March), while those from 2013 to 2015 are calendar years (January – December).

Industry grew strongly in 2015, led by construction

The industrial sector expanded over the year, with growth increasing from 2.4 percent in 2014 to 4.1 percent in 2015. This increase was driven by the strong growth in construction activities (7.9 percent) in both the public and private sectors. While public infrastructure investments have been sustained throughout the years, private construction growth may have been driven by the ongoing implementation of projects contracted during boom years. Manufacturing, which mostly consists of food processing and carpet production, recovered slightly after contracting last year, growing by a modest 0.7 percent. Without any large mining projects and without a pick-up in small-scale mining activities, the mining sector contracted for the second consecutive year. Afghanistan's only large mining project so far is in the Amu Darya oil basin which started its operations in 2013. However, this project has suffered a number of interruptions since it was first implemented.

Table 1: Gross Domestic Product, by output sectors, shares and real growth
(in percent)

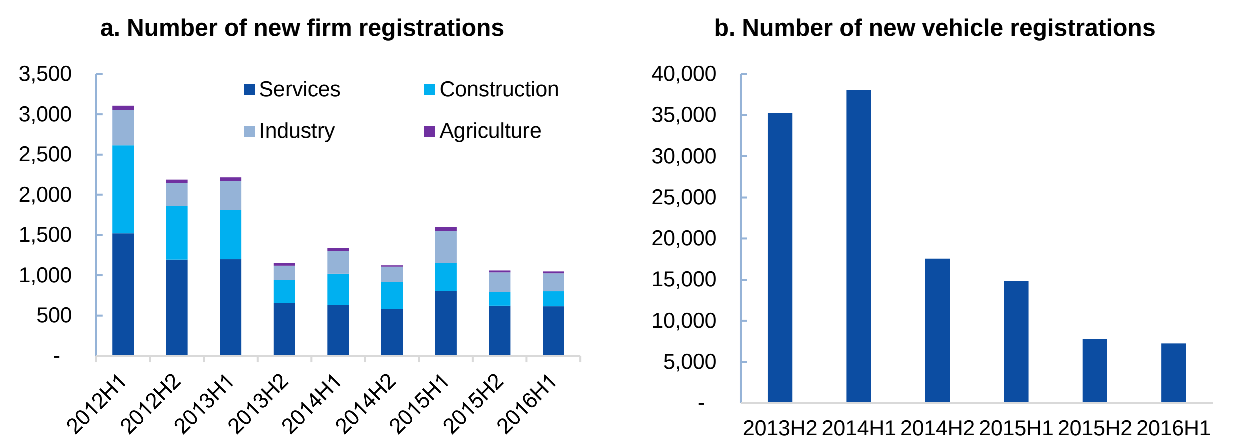
	Share in GDP			Real Growth, year-on-year		
	Average 2003-2012	2014	2015	Average 2003-2012	2014	2015
Agriculture	29.1	23.5	21.7	4.2	-0.1	-5.7
Cereals	12.7	12.1	10.5	6.8	3.7	-14.2
Fruits	2.4	2.9	2.7	7.8	18.5	7.2
Industry	25.0	22.3	23.3	9.8	2.4	4.1
Manufacturing	15.8	12.3	12.0	4.1	-2.5	0.7
Mining and quarrying	0.5	0.8	0.7	34.9	-2.2	-6.9
Construction	8.5	9.3	10.4	21.1	7.0	7.9
Services	45.8	54.2	55.0	12.9	2.2	1.6
Wholesale and retail trade	8.4	8.9	9.0	6.0	-2.9	2.8
Transport	14.9	7.6	7.3	14.8	-1.7	0.3
Communications	2.5	1.3	1.5	55.3	7.8	9.5
Financial services	1.5	0.9	0.7	16.5	-7.4	-14.6
Government services	9.8	14.0	13.6	19.1	8.0	-0.6
Gross domestic product (at market prices)				**9.4**	**1.3**	**0.8**

Source: Central Statistics Organization, re-estimated for the calendar years (Jan-Dec) by World Bank staff
Note: Sub-sectoral disaggregation is not exhaustive. Only selected sub-sectors are shown in the table. All figures exclude opium value-added.

Proxy indicators indicate limited new investments and weak economic activity in the first half of 2016

In the first half of 2016, the number of new firm registrations dropped by around 30 percent, with the decline occurring across all sectors.[1] This suggests that business confidence has not yet recovered, with potential new investments at lower levels than recorded three years ago. While this indicator cannot provide any information on the level of investment by existing firms, it may serve as a proxy for the degree of confidence of potential investors. The low level of investment suggests that potential investors may be delaying their investment decisions as a result of the overall political uncertainty and market conditions. Other proxy indicators, such as the number of new vehicle registrations, also suggest a decline in economic activity. In the first half of 2016, the number of new vehicle registrations, including for both passenger cars and cargo vehicles and for both private and publicly-owned vehicles, declined by about 30 percent compared to the same period last year, with the number substantially lower than three years ago.

Figure 4: Number of firm and vehicle registrations
(units)



Sources: Afghanistan Investment Support Agency (AISA), and CSO (Statistical Yearbooks)

A number of on-going initiatives have the potential to improve investment prospects

Afghanistan has now completed all of the World Trade Organization's (WTO) accession protocols, with the Parliament (Wolesi Jerga) ratifying the accession in June 2016. Following this, on July 29, 2016, Afghanistan was formally admitted to the WTO. This will have a number of benefits for Afghanistan, including facilitating transit, resolving trade disputes, providing access to global markets, and improving prospects for foreign direct investment. In May 2016, Iran and India signed an agreement to develop the Chabahar seaport, located in southeastern Iran on the Persian Gulf. This port will open a new transit route for Afghanistan, with the port having the potential to become the most important and cost efficient transit port for Afghanistan's trade. While both the WTO accession and the opening of the Chabahar port could improve Afghanistan's investment prospects, the security environment will determine the extent to which it will be able to read the full benefits of these trade infrastructure projects.

Opium production and the area under

Opium production increased in 2016. The United Nations Office on Drugs and Crime's (UNODC) latest survey shows both an expansion of about 10 percent in area under poppy cultivation and an increase of about 30 percent in opium yield per

[1] Due to lack of high-frequency data on private investment in Afghanistan, this Update uses the number of new firm registrations as a proxy for new investments and business confidence.

poppy cultivation increased in 2016

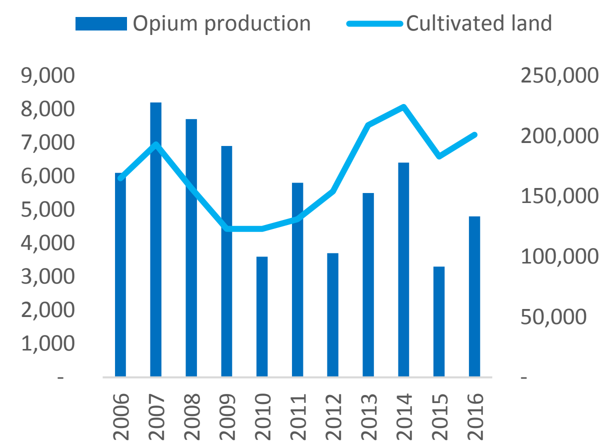
hectare. In marked contrast to the contraction of the licit agriculture sector over the year, opium production expanded significantly in all regions across the country, increasing by around 45 percent in total, from around 3,300 metric tons in 2015 to an estimated 4,800 tons in 2016. This increase is largely due to the absence of diseases that might adversely affect opium production.

Sluggish economic growth has resulted in a sharp increase in poverty

As a result of the sluggish economic growth and the deteriorating security situation, there are now about 1.3 million more Afghans living in poverty than in 2011/12. In 2013/14, 39.1 percent of Afghans were living in poverty, being unable to satisfy basic food and non-food needs. This was an increase from the 36 percent recorded just two years earlier, in 2011/12. The increase in poverty was especially severe in rural areas, where most of the population live. In 2013/14, the unemployment rate stood at 22.6 percent, up from only 13.5 percent five years previously, in 2007/08. Unemployment is particularly severe amongst low skill, illiterate workers, who historically are at greater risk of falling into poverty. Sluggish economic growth and continued demographic pressures exacerbate Afghanistan's unemployment situation. With an average annual population growth rate of 3 percent and with an estimated 400,000 Afghans entering the labor market each year, much higher economic growth rates are required to improve per capita incomes and to provide quality employment opportunities for the expanding workforce.

Figure 5: Opium output and area under cultivation increased in 2016

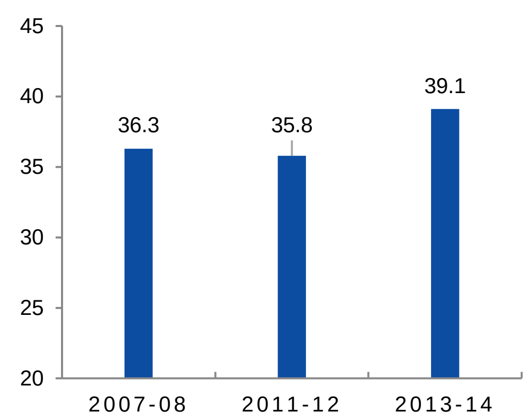
(left axis: metric tons; right axis: hectares)



Source: UNODC

Figure 6: Increase in poverty since the pre-transition period

(poverty headcount, in percent of population)



Source*:* Afghanistan Living Conditions Survey, 2007/08, 2011/12 and 2013/14 surveys

Consumer prices increased in the first three quarters of 2016

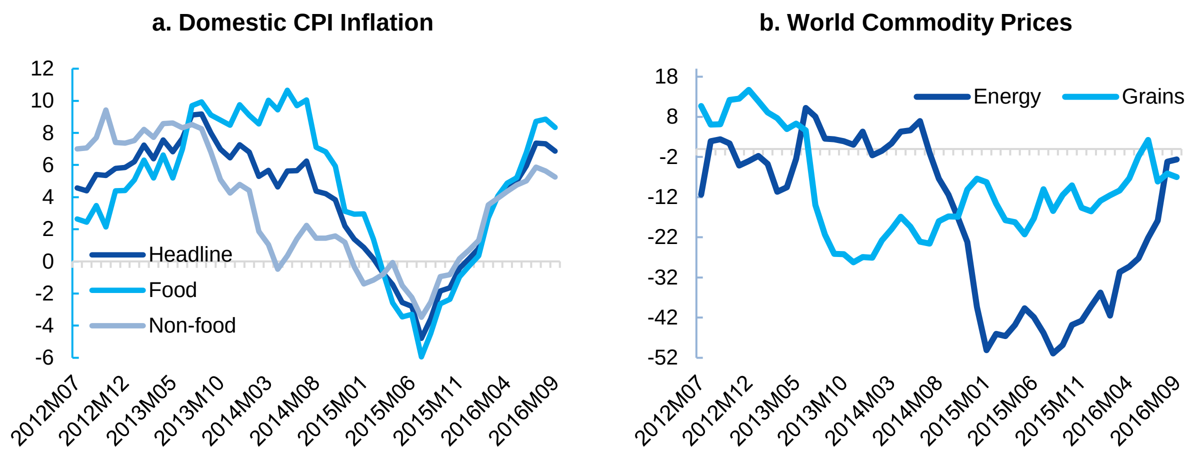
After falling for most of 2015, consumer prices increased rapidly in early 2016. As a result, the consumer price inflation increased from 0.2 percent (year-on-year) in December 2015 to 6.9 percent in September 2016. On a 12-month average basis, the inflation rate increased from a negative –1.5 percent to 3.6 percent between the same months. Both food- and non-food prices have contributed to the increase. Food prices increased from –0.3 percent (year-on-year) in December 2015 to 8.3 percent in

September 2016, while the increase in non-food prices was less steep, rising from 0.7 percent to 5.2 percent over the same period.

The surge in prices is likely to have been caused by the lagging effects of the currency depreciation

The surge in prices is likely to have been caused by the lagging effects of the currency depreciation which began in mid-2014, with Afghanistan's currency depreciating by around 20 percent against that of major trading partners in the period from June 2014 to June 2016. Given that most of Afghanistan's consumer goods are imported, with merchandise imports at around 40 percent of GDP, exchange rate movements have a significant impact on domestic prices. The effects of the currency depreciation on domestic prices was initially offset by the decline in global energy and food prices. However, as global energy and food prices began to rebound since the end of 2015 (see Figure 7), domestic prices have also started to increase.

Figure 7: Consumer prices increase as global commodity prices rebound
(12-month percentage change)



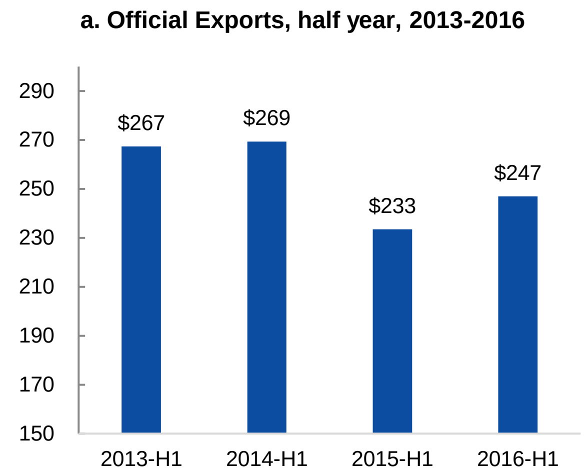
Source*:* Central Statistics Organization, and World Bank Global Economic Monitor (GEM)

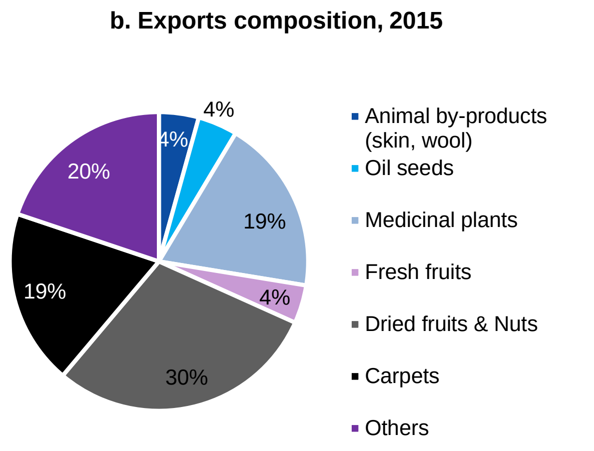
3. External sector

Exports increased in the first half of 2016

In the first half of 2016, exports increased by around 6 percent compared to the same period last year, with the total value of official exports standing at around US$ 250 million. The increase in exports was probably driven by a lagged effect of increased fruit production last year, with the fruit output increasing by more than 7 percent, in contrast to the decline in production of cereals. Together with fresh fruits, dried fruits account for almost a third of official exports. The performance of these exports in any given year is heavily influenced by horticultural performance in the previous year, due to the time required to process the fruits (drying). The export of fresh fruits has benefited from a recent increased demand from India, the largest market for Afghan fresh and dried fruits, with the increased demand resulting from preferential access recently offered by the Indian government. In 2015, dried fruits and nuts accounted for around 30 percent of total exports, followed by animal by-products (such as skin and wool), carpets, and medicinal plants (see Figure 8). Pakistan is the largest market for Afghan exports, importing a number of inputs for further processing and re-exporting. Thus, in 2015, around 85 percent of Afghanistan's exported carpets were sent to Pakistan for cleaning and washing before being re-exported elsewhere. India is the second largest market for Afghanistan's exports, mainly importing fruits, nuts and dried fruits.

Figure 8: Exports increased in the first half of 2016
(US$ million)



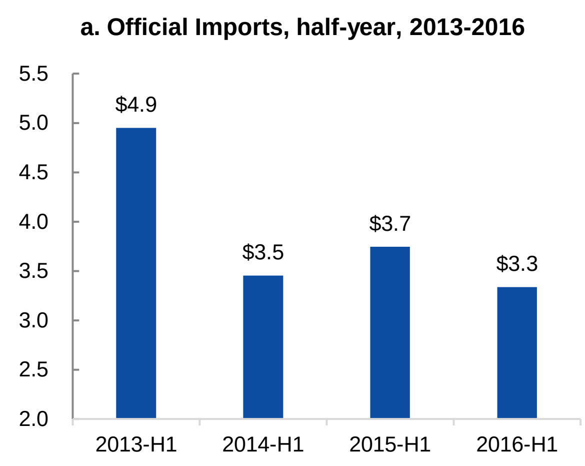


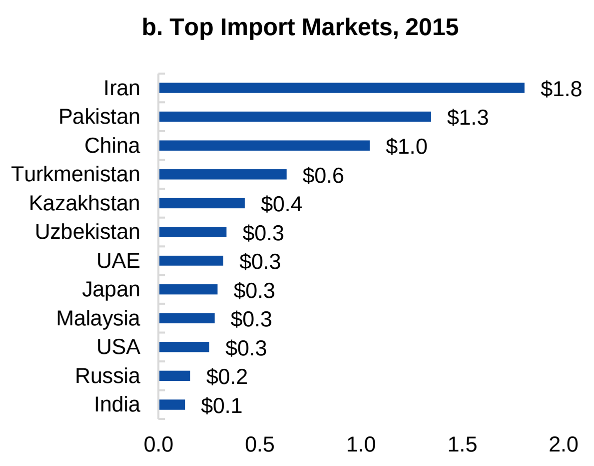
Source: CSO

Imports have declined due to weakening domestic demand

Official statistics show that the total value of imports stood at US$ 3.3 billion in the first half of 2016, a decline of around 10 percent relative to the same period in the previous year. The decline in imports is probably the result of weakening domestic demand and the currency depreciation, which has increased the costs of imported goods. Iran now surpasses Pakistan as the largest exporter of products to Afghanistan, with nearly one fifth of Afghanistan's imports originating from Iran in 2015. The trade deficit stands at nearly 40 percent of GDP, with this deficit financed by foreign aid and remittances.

Figure 9: Imports decreased in the first half of 2016
(US$ billion)





Source: CSO and UN COMTRADE

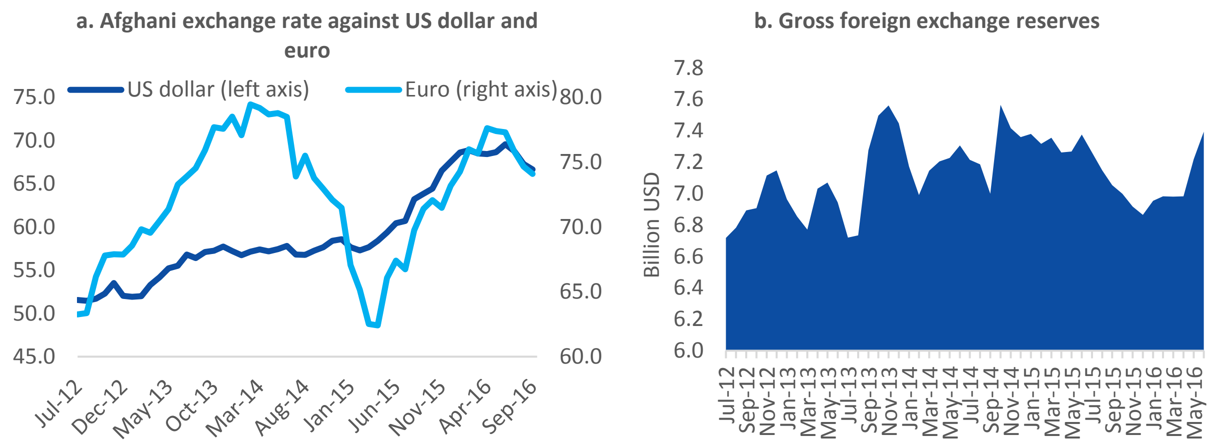
Afghanistan's currency depreciated in the first half of the year, before

In 2016, Afghanistan's currency depreciated in the first half of the year, before appreciating in the third quarter. On a quarter-to-quarter basis, the Afghani depreciated by 3.8 percent in the first quarter and by 0.3 percent in second quarter. The overall decline in the value of the Afghani began around early 2015, with this

appreciating in the third quarter

depreciation being the result of a number of possible factors, including: (i) a decline in foreign exchange inflows as a result of lower foreign aid disbursements; (ii) a decline in foreign direct investment and associated capital inflows; (iii) an increased tendency for households to hold their savings in US dollars; and: (iv) possibly, capital outflows associated with the increased levels of outward migration. However, this trend reversed in the third quarter, with the Afghani appreciating by around 2 percent relative to the US dollar. Thus, on balance, the Afghani appreciated by 1.3 percent against the US dollar in the period from December 2015 to September 2016.

Figure 10: The value of the Afghani: Depreciation in the first two quarters, appreciation in the third quarter



Source: Da Afghanistan Bank

Foreign exchange reserves increased in the first half of 2016

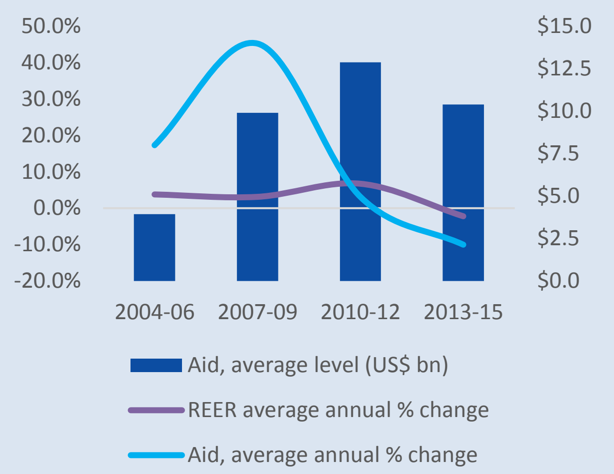
After having declined throughout most of 2015, gross international reserves increased in the first half of 2016. Thus, in June 2016, foreign exchange reserves stood at US$ 7.4 billion, up from the figure of US$ 6.9 billion recorded in December 2015. The increase in the reserves is mostly attributable to the decline in imports. The current level of gross reserves is sufficient to cover around 9 months of imports.

Box 1. Real exchange rate movements in Afghanistan are correlated with the levels of foreign aid

Figure 11: Real exchange rate has depreciated since 2012

(left axis: percent; right axis: US$ billion)

The real effective exchange rate (REER) depreciated by an average annual rate of 2.2 percent in the period from 2012 to 2015, with foreign aid to Afghanistan also declining over this period (see Figure 11). The REER is a measure of the strength of a country's currency relative to that of its trading partners, taking into account the inflation differentials between the country and its trading partners. An increase (appreciation) in REER means that a currency is stronger. As a general rule, an increase in this rate indicates a decline in a country's export competitiveness, with the prices of its exports increasing relative to those of its trading partners. By contrast a decrease (depreciation) in the REER would be indicative of an improvement in export competitiveness.



Source: World Bank staff estimates and calculations

In Afghanistan, export levels have remained largely unaffected by the recent depreciation in REER. This is likely because other factors, such as domestic supply-side constraints (access to finance, access to electricity, access to land, etc.), higher fixed costs (due to security challenges) and, more importantly, limited access to international markets, are more significant factors than currency competitiveness. This is the reason why economic growth in Afghanistan has not particularly benefited from real exchange rate depreciation since 2012.

A closer look at the REER shows that real exchange rate movements in Afghanistan are largely correlated with the level of international aid. Afghanistan experienced an exceptional inflow of foreign aid in the years after 2002. The increase of wages and prices in sectors supported by aid flows (such as construction and services) led to higher domestic prices relative to international prices, increasing the REER and making it harder for Afghanistan's emerging exports to compete on foreign markets. The aid-induced appreciation, together with other constraints in Afghanistan's business climate, may have well reduced the incentive to invest in export sectors which would explain today's low levels of exports – an effect very similar to the ones associated with the Dutch Disease effect. While this term was originally coined to describe the possible impacts of large inflows of natural resource revenues into an economy, the case of Afghanistan demonstrates that aid can have a similar impact.

The export sectors in Afghanistan continue to suffer from low capacity and capability – probably too low to overcome other investment climate constraints and expand in response to exchange rate movements in the short-term. In the long run, however, the depreciation may help to attract investment in export sectors.

4. Fiscal developments

Revenue collections increased significantly in 2015, with performance remaining strong throughout 2016

Following three years of poor performance, revenue collections increased significantly in 2015, with performance remaining strong throughout 2016. In the first eight months of the fiscal year, domestic revenues amounted to Af 90.4 billion,[2] nearly 30 percent higher than the figure recorded for the same period last year. Compared to the same period last year, tax revenues increased by 26 percent, while non-tax revenues increased by 70 percent. However, collected customs duties declined by 2.4 percent over the same period, reflecting the decline in imports.

[2] The figure excludes one-off transfers received by the Ministry of Finance in 2016. The Central Bank transferred around $150 million (Af 10 bn) of its profits to the Government – as guided by the Law – while around Af 4 billion were received from the New Kabul Bank and a numbers of SOEs managed under MAIL and Ministry of Urban Development. Given that these transfers do not constitute regular/ recurrent revenue streams for the Government, they are thus excluded from the definition of revenues in this document.

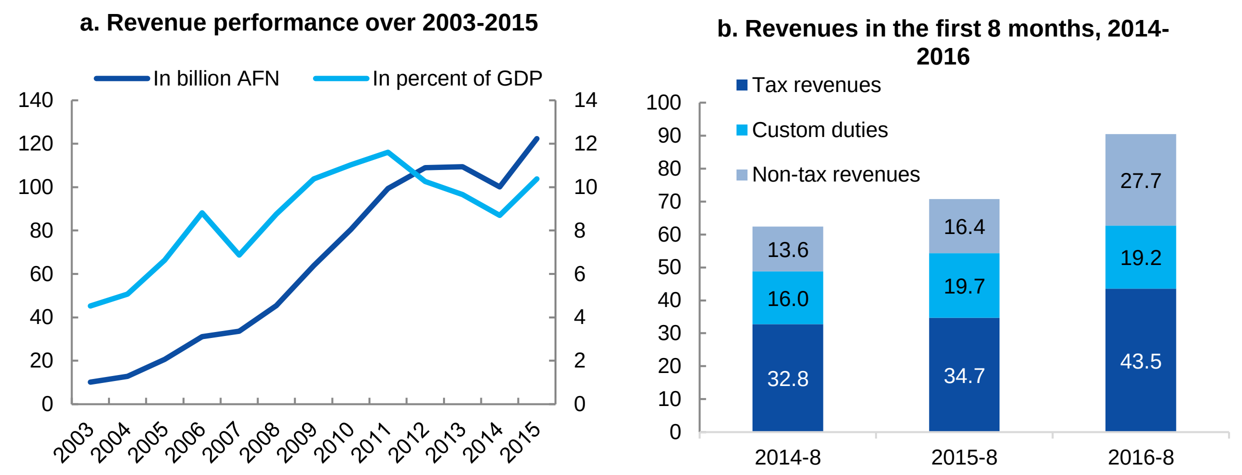
The increase is largely the result of improvements to tax administration and increased compliance

The increase in both tax and non-tax revenues is largely the result of: i) improvements to tax administration and increased compliance; and ii) the introduction of a set of new policy measures in the second and third quarters of 2015.[3] While some of the increase in non-tax revenues was the result of a temporary surge in government services, such as the increased demand for passports (on which the Government levies fees), it is expected that most of the other increases can be sustained. While in 2015 the collection of tax arrears contributed significantly to the overall non-tax revenue performance, this has not been the case in 2016.

By the end of the year, revenues are expected to exceed the budget target

Revenues are projected to reach 10.8 percent of GDP by the end of the year, exceeding the budget target of Af 133.5 billion for domestic revenues by around 5 percent. This will allow the Government to achieve a balanced budget and to increase cash reserves.

Figure 12: Revenue collection performance: A significant increase in the first 8 months of 2016
(billion AFS)



Source: Ministry of Finance (Afghanistan Financial Management Information System [AFMIS])

Expenditures increased in nominal terms, driven by increased security costs and recurrent spending

Table 2: Public expenditure: 2015 and 2016 half-year comparisons
(Af million)

Expenditures	2015-H1	2016-H1
Total recurrent	94,537	103,691
Security	54,339	61,135
Civilian	40,198	42,555
Wages & salaries	24,055	25,321
O&M	7,204	6,204
Capital expenditures	678	799
Pension and social transfers	7,658	9,815
Discretionary development	8,324	7,703
Recurrent + Discretionary development	102,861	111,394
Nondiscretionary development	25,419	22,583

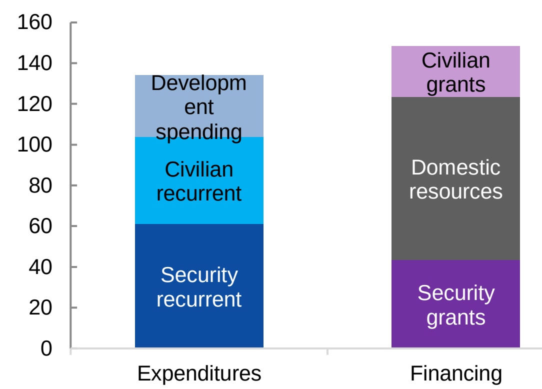
[3] The new measures introduced in 2015 include: (a) an increase in the business receipts tax rate from 2 percent to 4 percent; (b) the introduction of a 10-percent telecommunications fee on mobile phone top-ups; (c) an increase in the fuel fee from Af 1 per liter to Af 3 per liter; and (d) an increase in over-flight fees for traffic passing through Afghanistan's airspace

Total core expenditures	128,280	133,976

Source: Ministry of Finance (AFMIS)

In the first half of 2016, total public expenditures stood at Af 135 billion. This was an increase of nearly 5 percent compared to the figure for the same period last year. However, once the impact of increased inflation is factored in, the real growth in public spending was not sufficiently significant to have a positive impact on domestic demand. In the first half of the year, security spending increased by 12 percent, while recurrent civilian expenditures increased by 7.5 percent, compared to the same period last year. By contrast, development spending decreased by around 10 percent over the same period. The execution rate for the development budget was 16.8 percent in the first half of the year, down from the figure of 20 percent recorded for the same period last year. According to the Budget Performance Report for the first half of 2016, line ministries reported delays in the procurement review and approval processes as the most significant factor for the lower budget execution rate.

Figure 13: Expenditures and financing: The first half of 2016
(Af billion)



Source: AFMIS and Treasury Cash Report

5. Monetary and financial sector developments

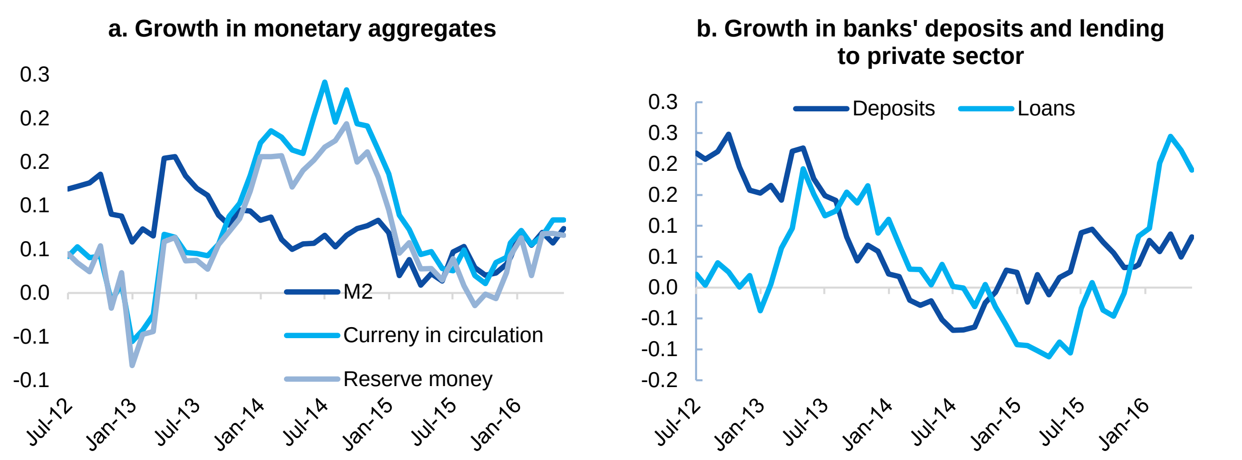
Money demand has increased, likely due to higher prices

The broad money (M2) growth rate, which includes currency-in-circulation and deposits in commercial banks, increased to 7.4 percent in June 2016 (year-on-year), up from the figure of 3.3 percent recorded in December 2015. The year-on-year currency-in-circulation growth rate also increased, from 4.1 percent to 8.3 percent over the same period. The increase in money demand is probably the result of increasing inflationary pressures. While money demand is growing in nominal terms, it may not necessarily be growing in real terms to suggest an increase in economic activity. In June 2016, deposits in commercial banks grew at an annualized rate of 8.2 percent. Although this is higher than the rate of 3.4 percent recorded in December 2015, it remains significantly lower than the double digit rates recorded in periods prior to 2013.

Commercial banks' performance has been mixed

Commercial bank loans to the private sector increased from around Af 47 billion (US$ 685 million) in December 2015 to around Af 51 billion (US$ 740 million) by June 2016. The increase is primarily triggered by loans denominated in the US dollar which increased by an annualized rate of 15 percent, as compared to only 1.4 percent for the Afghani denominated loans. The increase in the US denominated loans is largely the effect of currency depreciation which took place in the first two quarters of the year, inflating the value of assets held by commercial banks. In addition, the quality of banks' assets continued to deteriorate in the first half of 2016. The ratio of non-performing loans (NPLs) increased from 12.6 percent in December 2015 to 17.1 percent in June 2016, marking a record high since the Kabul Bank crisis in 2011. However, the ratio of net NPLs-to-capital has declined from 6 percent in 2012 to almost 3 percent in 2016. The net profit of the banking sector has increased dramatically to around Af 3 billion in the first half of the year, compared to the loss of about Af 1 billion recorded in the same period last year. Most of the increase in banking sector profits was derived from non-interest incomes.

Figure 14: Growth in monetary aggregates and commercial bank loans
(year-on-year percent change)



Source: Da Afghanistan Bank

The financial sector remains underdeveloped and is characterized by low level of financial intermediation

Commercial banks dominate the financial sector in the country. Other financial services remain underdeveloped, contributing only modestly to financial intermediation. While the assets of the banking sector amounted to 21.6 percent of GDP in June 2016, the value of credit intermediated from banks to the private sector stood at only 4 percent of GDP. The banking system remains highly liquid, with the liquid assets ratio standing at more than 70 percent for the past two years, reflecting the low level of intermediation. The government has been intensifying its efforts to develop and improve the oversight of the banking sector and to adopt prudential measures to assess its soundness.

B. Outlook and Medium-Term Prospects

Growth will increase marginally in 2016, to 1.2 percent

In 2016, the economic growth rate is expected to increase marginally, to 1.2 percent. Continued slow growth reflects weak confidence in the context of the deteriorating security environment and weak agricultural performance. Weak confidence is demonstrated by the lower number of new firm and vehicle registered in the first half of 2016 (see page 4). The weak confidence is largely the result of the failure to achieve major improvements in the security situation. The decline in imports in the first half of 2016 provides further evidence of weak demand. In 2016, agriculture's growth is projected to continue to decline, with a projected rate of –0.5 percent.

WTO accession and infrastructure projects could significantly improve prospects for private investment and business activities

Afghanistan's accession to the WTO, the opening of the Chabahar port in Iran as an alternative, low-cost transit route, the initiation of the Trans-Hindukush road connectivity project, and a number of other national and regional projects could significantly improve prospects for private investment and business activities. In addition, a number of important reforms undertaken by the Government in the areas of anti-corruption, revenue collection, and private sector development (see Appendix II) could help build confidence in the economy in the longer term, although their impact in the short term is likely to be limited. Regardless of these developments and reforms, however, unless security challenges and political uncertainty are addressed, they are likely to continue to constrain overall growth.

Growth is expected to gradually increase over the medium-term

Economic growth is expected to gradually increase to around 3.6 percent by 2019. Stronger growth in out-years is predicated on improvements in security, the achievement of political stability, a successful reform progress, and continued high levels of aid. The poverty rate is expected to remain high due to weak labor demand and security-related constraints on service delivery, despite some positive offsetting impacts from improvements to the performance of the agriculture sector and lower food prices.

A balanced budget is expected in 2016

Revenue collection performance is expected to remain strong during 2016, with domestic revenues projected to reach 10.8 percent of GDP. Total budget expenditure is expected to increase by around 2.4 percent of GDP, reaching a new high of 28.9 percent, with this increase driven by increases to on-budget security expenditure as the Government assumes an increasing level of responsibility for security functions. Civilian expenditures will also increase slightly, driven by increased development spending. Budget grants will increase commensurately, driven by increases to security aid. This will lead to a smaller deficit, which is projected to stand at 0.1 percent of GDP.

Over the medium term, fiscal outcomes are highly sensitive to the level and modality of aid commitments.

Over the medium term, fiscal outcomes are highly sensitive to the level and modality of aid commitments. Total budget expenditures are projected to increase from 26.5 percent of GDP in 2015 to 31 percent in 2019. This increase largely reflects the fact that security spending previously undertaken directly by international partners is being moved on budget. The growth of civilian expenditure reflects the maintenance of current service levels to an increasingly large population, as well as expenditure on essential infrastructure and the essential maintenance of aid-financed assets recently transferred to the Government. If the Government can sustain recent improvements to compliance and administration, domestic revenues are projected to increase to 12.2

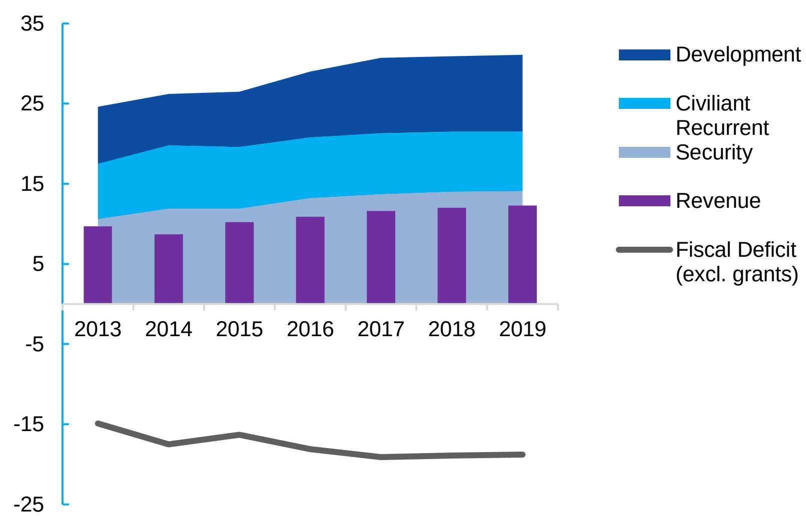
percent of GDP by 2019, although these domestic revenues will still only cover around 40 percent of budget expenditures. Afghanistan will need on-budget civilian aid to a value of about 19 percent of GDP to fund basic social services and development programs over the coming years.

Table 3: Medium-term macroeconomic framework, 2012–19

	2013	2014	2015	2016	2017	2018	2019
				Actuals/estimates	*---- Tentative staff projections ----*		
Real GDP growth (%)	3.7	1.3	0.8	1.2	1.8	3.0	3.6
Nominal GDP (Af billion)	1,133	1,151	1,205	1,300	1,403	1,520	1,638
CPI inflation (period average, in %)	7.4	4.6	−1.5	5.5	5.0	5.0	5.0
Fiscal							*In Percent of GDP*
Revenues and grants	24.1	24.4	25.2	28.7	30.3	30.6	30.9
Domestic revenues	9.7	8.7	10.2	10.8	11.5	11.9	12.2
Foreign grants	14.4	15.7	15.0	17.9	18.8	18.7	18.7
Total core expenditures	24.6	26.2	26.5	28.8	30.4	30.7	31.0
Recurrent expenditures	17.5	19.8	19.6	20.7	21.1	21.4	21.4
Development expenditures	7.1	6.4	6.9	8.1	9.3	9.3	9.6
Overall balance (incl. grants)	-0.5	-1.8	-1.3	-0.1	-0.1	-0.1	-0.1
Overall balance (excl. grants)	-14.9	-17.5	-16.3	-18.2	-18.9	-18.8	-18.8
External							
Trade balance	−41.6	−39.6	−36.7	−38.7	−37.5	−36.2	−36.6
Current account balance (incl. grants)	7.4	8.0	5.4	4.5	3.6	2.8	1.2

Source: World Bank staff estimates, tentative and subject to revision

Figure 15: The fiscal deficit (excluding donor grants) is projected to continue to grow
(Percent of GDP)



Prices are expected to remain stable and the current account to remain in surplus.

In 2016, the inflation rate is expected to increase sharply to around 5.5 percent, with this increase driven by the lagged effect of currency depreciation in 2015 and the first half of 2016 and by agricultural supply constraints. Despite the increase, at this rate, inflation remains within Da Afghanistan Bank's target range. By 2019, the current account surplus is expected to narrow to 1 percent of GDP, as a result of declining aid. Credit to the private sector is expected to expand, despite the continued slow economic growth, with the resolution of outstanding issues from the Kabul Bank crisis and continued policy efforts to support financial inclusion and improved financial sector corporate governance.

Medium-term prospects are subject to substantial downside risk

Afghanistan's macroeconomic framework remains heavily exposed to a range of downside risks, including: i) an unanticipated decline in aid, which would undermine fiscal sustainability and force difficult adjustments on the expenditure side; ii) a further deterioration in the security environment, which would undermine confidence and further slow growth; and iii) increased political instability, which would have highly unpredictable impacts on the security situation, business confidence, and external support. Continued progress with efforts to strengthen governance, to improve revenue policies and administration, and to establish a conducive environment for private sector growth underpin longer-term sustainability. The mobilization of the required aid will continue to depend on adequate performance in implementing the required structural reforms under the Afghanistan National Development and Peace Framework.

Structural transformation is required for long-term macroeconomic sustainability

With an average annual population growth rate of 3 percent and an estimated 400,000 individuals entering the labor market each year, much higher growth rates are required to improve per capita incomes and to provide quality employment opportunities for the expanding workforce. New sources of growth are needed to increase government revenues in the context of the expected normalization of aid levels over the longer-term and to generate the foreign exchange required to finance Afghanistan's large import bill. Even with optimal revenue policies and administrative settings, Afghanistan's upper-bound revenue potential stands at only around 17 percent of GDP, due to the undiversified economy and the continued heavy dependence on subsistence agriculture. At this level, it is well short of projected expenditure needs. Given low levels of human capital, substantial infrastructure deficits, and weak institutions, opportunities for structural transformation are limited in the short-term. Over the medium-term, increased human capital investment and improved agricultural productivity could drive significant economic growth and increase employment opportunities. The development of the extractives sector offers important opportunities for the generation of government revenues and foreign exchange receipts to replace the expected decline in aid.

C. Focus Section I: Outcomes from Brussels

The Brussels Conference on Afghanistan was held on October 4, 2016. This conference was co-hosted by the Government of Afghanistan and the European Union, with 70 countries and 30 international organizations and agencies represented. In addition to affirming ongoing support to the Government of Afghanistan and to the priorities expressed through the new Afghanistan National Peace and Development Framework (ANPDF), the international community pledged around US$ 3.8 billion of civilian aid annually over the next four years to support Afghanistan's continued development.

This level of aid support is adequate to sustain current levels of service delivery and to preserve development gains in Afghanistan. However, achieving higher growth rates with this level of civilian aid will require major efforts by both the international community and the Government. The international community will need to pursue all possible means to increase the proportion of civilian aid delivered on-budget in order to ensure alignment with government priorities, to maximize cost-effectiveness, and to magnify local economic impacts. The Government will need to implement a range of vital policy reforms, to adopt a careful and strategic approach to all resource allocation decisions, and to pursue all available means to increase its fiscal space.

How much aid does Afghanistan currently receive?

In 2016, grants are expected to total around US$ 9 billion for both security and civilian assistance. This aid includes both on budget and off budget aid.

In 2016, grants to Afghanistan are expected to total around US$ 9 billion, or 48 percent of GDP. Aid support is allocated for both security and civilian assistance and is provided both on- and off-budget. On-budget grants flow through government accounts, utilize government procurement systems, and employ the staff of government ministries. Off-budget grants are used to finance projects delivered completely independently of government systems. In 2016, grants have been evenly divided between security and civilian assistance, at around US$ 4.5 billion each. Less than 40 percent of the security and civilian grants in 2016 have been delivered on-budget.

How much aid is required to maintain existing services?

Afghanistan's on-budget expenditure needs are expected to increase over coming years.

On-budget security expenditures are expected to increase substantially over coming years, as the Government assumes a greater share of responsibilities for security. On-budget security expenditures are expected to increase from US$ 2.7 billion (14.3 percent of GDP) in 2016 to US$ 4.4 billion (18.3 percent of GDP) in 2020. On-budget civilian recurrent expenditures are also expected to grow. Even assuming no improvements to service quality or coverage, on-budget costs will increase from around US$ 2.8 to US$ 3.3 billion by 2020 as a result of population growth and increasing operations and maintenance needs resulting from the transfer of donor-built assets to the Government.

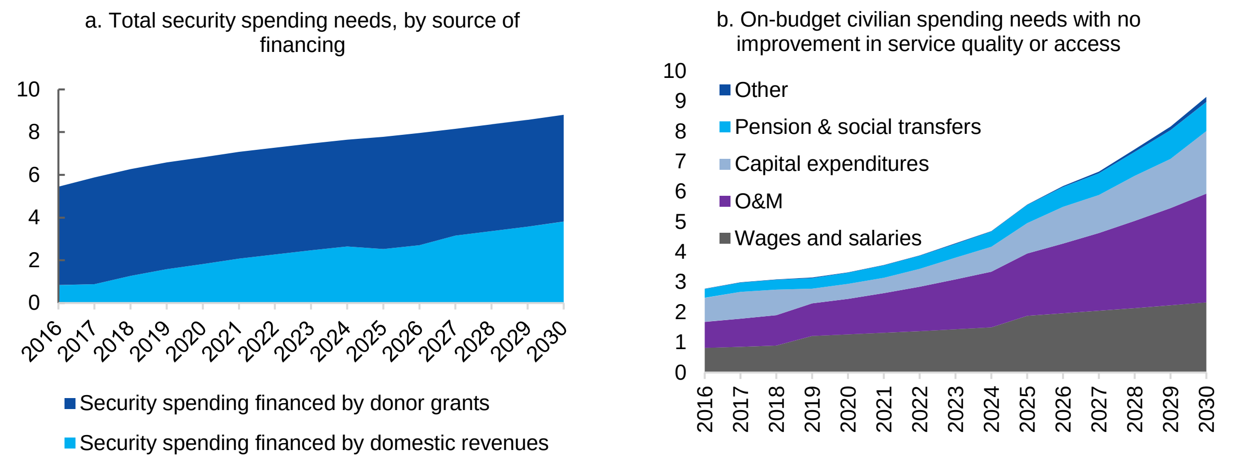
An increasing share of revenues will be absorbed by the security sector

Afghanistan has limited scope to finance the increased expenditures through domestic revenues. While there is some scope to increase government revenues to meet increasing expenditure pressures by improving tax policy and administration, domestic revenues are expected to reach only around 12.6 percent of GDP by 2020.

As discussed in the previous Afghanistan Development Update, the current structure of the economy imposes binding constraints on total revenue potential, with an upper-bound limit of around 17 percent of GDP, even with ideal policy settings and with full compliance.

Based on pledges at the 2016 NATO Conference in Warsaw, security grants are expected to reach US$ 4.5 billion annually for the next four years, with an increasing proportion of aid provided on-budget. However, the Government will also be expected to contribute more to security financing in order to sustain security expenditures that are not covered under the Warsaw financing commitments. Basically, these include all security expenditures other than those executed by the Ministry of Defense and the Ministry of Interior. The proportion of domestic revenue dedicated to security is projected to increase from 41 percent in 2016 to 60 percent by 2020. As a result, the domestic revenues available to finance civilian expenditure needs will not increase even in nominal terms, remaining at around US$ 1.2 billion for the next four years.

Figure 16: Security and civilian recurrent expenditure expected to grow substantially
(billion US dollar)

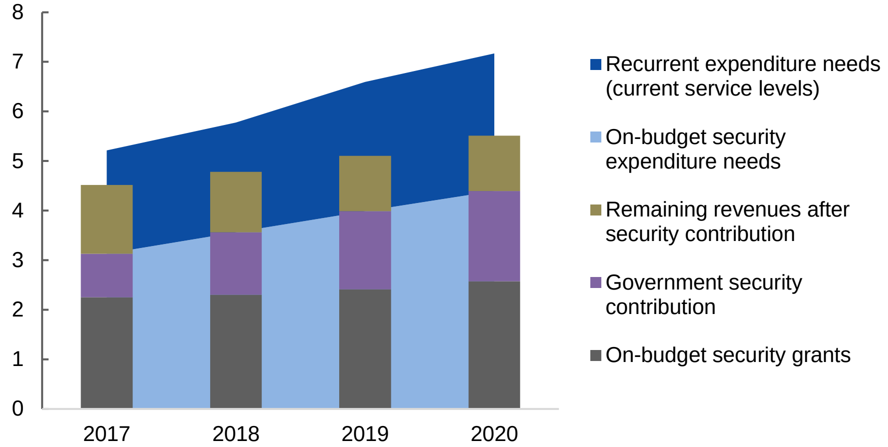


Source: World Bank staff projections

Substantial aid will be required to sustain existing service levels.

Given increasing civilian expenditure needs, the limited potential to increase domestic revenues, and the increasing security commitments, on-budget civilian grants to an average value of around US$ 1.2 billion annually are required just to sustain the existing levels of services. On-budget civilian grants to this order are required simply to prevent any decline in service quality and coverage, without any major new infrastructure projects or improvements in services.

Figure 17: On-budget recurrent expenditure needs exceed available revenues after security contributions
(billion US dollar)



Source: World Bank staff projections

How much aid is needed to support improved development outcomes?

Meeting existing cost pressures is not enough to generate any significant improvements to living standards.

A World Bank analysis conducted for the Brussels Conference examined the implications of different public expenditure profiles for future growth and development outcomes. This analysis shows that if public expenditure is only sufficient to finance existing levels of service delivery, the annual economic growth rate is likely to remain at around 4 percent for the next 15 years. With a population growth rate of around 3 percent, this level of economic growth would be inadequate to generate any significant improvements to living standards or to provide sufficient employment opportunities for the 400,000 Afghans entering the workforce each year. Stagnant economic and social outcomes would result in increased fragility and pose high risks to the gains achieved so far.

A coherent program of public investments and policy reforms could facilitate much higher growth.

A coherent program of public investments and policy reforms could facilitate much higher rates of economic growth. Based on the simulation results from an economic growth model, Afghanistan might be able to achieve average annual growth rates of 6.5 percent, driven by increased agricultural productivity, improved human capital, the development of extractive industries, increased connective infrastructure investment, and the establishment of a targeted social transfer system. Additional public investment in the following areas would be required to achieve the higher growth scenario:

- **Agriculture:** Agriculture remains the foundation of Afghanistan's economy. Agriculture employs 44 percent of the population, with 61 percent of households deriving income from this sector. Agriculture is highly integrated with the broader economy, with 90 percent of manufacturing dependent on agricultural inputs. Improved agricultural productivity and an expansion of the area of land under cultivation could contribute to 1.6 percentage points of GDP growth annually and create 1.2 million jobs over the next decade. The rehabilitation of land irrigation structures, improved water management, and the provision of the knowledge extension services required to realize agriculture's potential would require additional public investments of around US$ 300 million per year.

- **Human capital:** Since 2001, Afghanistan has dramatically increased its investments in human capital. However, there is still a long way to go. Only around half of children of school age attend secondary school, with literacy rates among the worst in the world, at 32 percent for adults overall and just 18 percent for adult women. There are significant concerns regarding the quality of education. There is also room to improve health outcomes, with life expectancies eleven years shorter than the global average. The low literacy rates among women contribute to high fertility rates and to the high population growth rate. The pace of progress in improving access to social services has slowed over recent years, with an increasing gap between the poor and non-poor and between rural and urban populations. Increased investment in human capital, especially through literacy programs for women, could result in increased labor productivity and increased average incomes by reducing the population growth rate. Increasing expenditure on education and health from 35 percent of total civilian spending to 50 percent would require additional public investments of around US$ 500 million per year.

- **Extractives:** Agriculture's contribution to government revenues will be limited by the fact that the taxable income in this sector is usually low. While there may be potential for horticultural export growth, growth will occur from a very low base, with the majority of agricultural development being import-substituting. Therefore, in the context of declining aid, it is necessary to develop the extractive sector to increase government revenue and to generate foreign exchange income. While the development of the extractive sector is subject to substantial governance risks, these risks can be managed through a phased, learning-by-doing approach, with a concentration of capacity within agencies responsible for contracting, monitoring, and regulating extractives investments. The full benefits of mining are only likely to be realized if the development of the extractive sector is carefully integrated within a broader development strategy. Extractives can facilitate broader economic development if mining investments are accompanied by infrastructure deployment that supports links to the agriculture and services sectors and improves regional connectivity. Public investments required to mobilize the mining sector would cost around US$ 350 million per year.

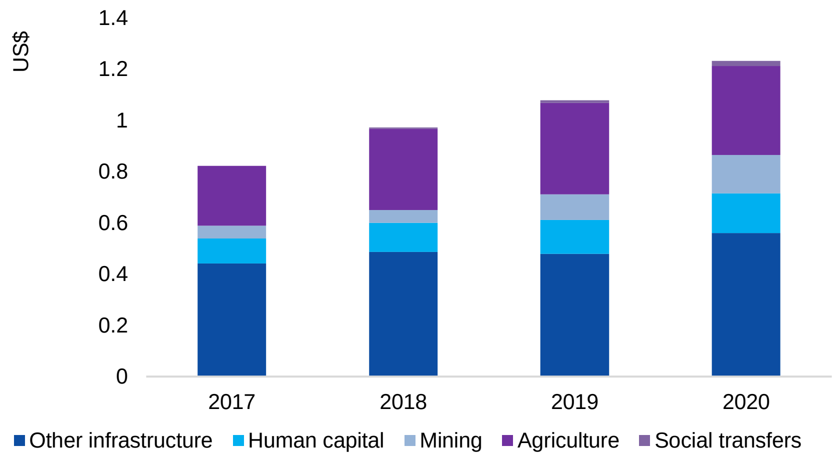
- **Trade and connective infrastructure:** Afghanistan has substantial potential to develop commodities exports, energy transit trade, and ICT connectivity. This potential is currently constrained by major infrastructure deficits and customs and border inefficiencies, including congestion at border crossings. Infrastructure investment and trade-related institutional reforms are required to support extractive and, to a lesser extent, agricultural exports. Investments in fiber-optic and transmission infrastructure could support energy transit and ICT connectivity. A program of infrastructure investments concentrated on addressing existing trade points and enabling the development of extractives and agricultural exports would cost around US$ 350 million per year.

- **Social transfers and managed labor migration programs:** A social transfer system costing only around US$ 20 million annually by 2020 could play a significant role in addressing Afghan households' unique exposure to negative shocks, eventually halving food poverty once fully implemented. Such a program could reduce the need for households to resort to negative coping strategies, such as reducing their investments in education or selling productive assets, in response to shocks. Thus, programs of this sort could lead to increased investment in human and physical capital, driving increases to productivity. A managed migration program could be introduced at negligible fiscal cost, with such a program having the potential to expand the range of receiving countries for Afghan migrants. If designed appropriately, such a scheme could strengthen incentives for human capital investment and capture benefits from a returning stream of migrants with new skills and international connections. Increased managed migration would also facilitate increased remittances, boosting household incomes and foreign exchange inflows.

Total on-budget aid of around US$ 2.2 billion per year would be required to enable higher growth.

As Figure 18 shows, the total value of the public investment required to implement a high-growth strategy is substantial, at around US$ 1 billion per year over the next four years. Given the gap between government revenues and recurrent expenditure needs, aid grants would be required to finance the necessary investments. This amount is additional to the US$ 1.2 billion of aid required simply to sustain existing levels of services, which implies a total on-budget civilian aid need of US$ 2.2 billion per year.

Figure 18: A high-growth strategy requires US$ 1 billion of new investment annually



Are aid pledges sufficient to enable higher growth?

A high-growth strategy will require a

As stated previously, the Brussels Conference pledged aid of US$ 3.8 billion per year to Afghanistan for the period from 2017 to 2020. These aid levels are sufficient to finance the investments required for higher growth, as outlined above.

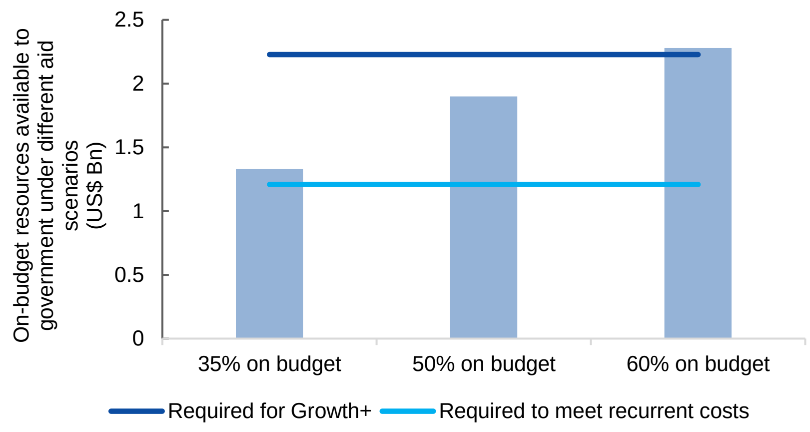
substantial increase in the proportion of aid delivered on budget

However, implementation of a high-growth strategy will require a substantial increase in the proportion of aid delivered on budget. Currently, only around 35 percent of civilian aid is provided on budget. Off-budget aid, which does not provide resources through government accounts and systems and which cannot be used to finance government salaries or operations and maintenance costs, will not enable the Government to address recurrent expenditure pressures while maintaining existing levels of service delivery. Off-budget aid is also unlikely to meet the investment requirements for higher growth for several reasons. Firstly, off-budget aid expenditure is less cost-effective. Off-budget aid typically involves a greater share of imported goods and services and the establishment of parallel management systems. The costs of the required investment may therefore be substantially higher than the estimates in this analysis, exceeding available resources. Secondly, it is often difficult to ensure that off-budget aid is used for projects that fully align with government strategies and priorities, given limited government oversight and its restricted involvement in planning processes. It can be expected that at least a certain proportion of off-budget aid will be used to facilitate the achievement of donor priorities rather than for the growth enhancing investment needs of government.

Increasing the proportion of aid delivered on-budget to 60% would enable a high-growth strategy.

As Figure 19 shows, the proportion of aid provided on budget will determine the extent to which the Government can address both recurrent expenditure pressures and growth-enhancing investment needs. With total civilian aid of US$ 3.8 billion per year and with 35 percent of that amount provided on budget, the Government will barely have sufficient resources to sustain existing levels of service delivery. Thus, unless a greater proportion of aid is delivered on budget, the Government will have no resources available for additional growth-enhancing investments. However, if development partners were able to provide 60 percent of aid on budget, the outcomes are transformed radically. The Government would be able to meet both recurrent expenditure needs and to finance the investment program required to achieve higher rates of growth.

Figure 19: The proportion of aid delivered on-budget determines whether the Government meets its investment needs



What are the implications for development partners and government?

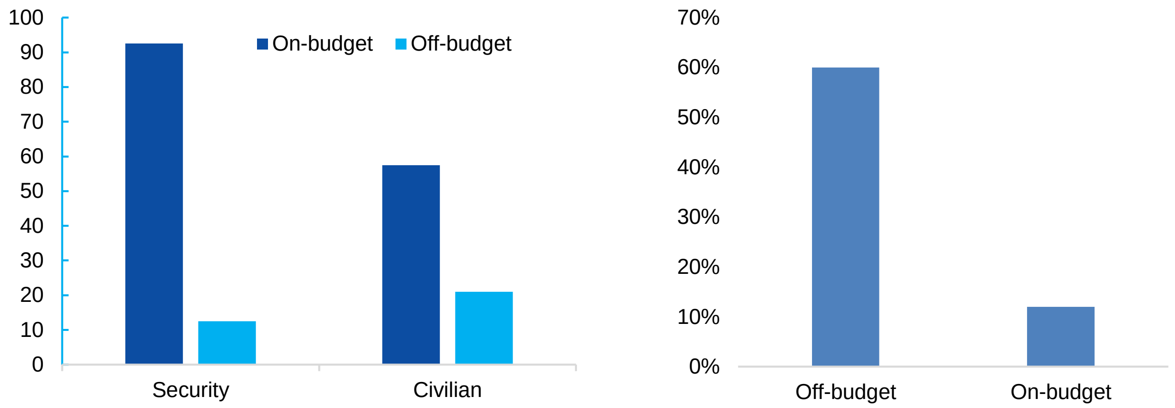
The international community should prioritize moving more aid on budget.

As stated above, the successful implementation of a high growth strategy depends on a significantly greater share of aid being delivered on budget. Donors may require changes or improvements to public financial management systems, including procurement and payroll systems or the implementation of anti-corruption measures before increasing on-budget support. These requirements could usefully be communicated immediately to the Government, with technical assistance provided to implement required reforms. Discussions regarding the need for increased on-budget aid should reflect the facts that that: i) Afghanistan's public financial management systems are relatively advanced and strong compared to other fragile or low-income countries; ii) opportunities for corruption also occur with off-budget expenditure; and iii) there is overwhelming evidence from Afghanistan and internationally that allocating aid on budget is both more cost-effective and has a greater positive impact on the local economy (including in terms of the creation of employment and private sector opportunties) than off-budget expenditure.

Figure 20: On-budget aid: More cost-effective, greater economic impact

a. Cents per dollar spent within the Afghanistan economy by modality

b. Estimated non-works costs as % project value (selected Afghanistan road projects)



Alignment is crucial when on-budget support is impossible.

In some cases, development partners may face restrictions regarding the proportion of aid they are able to provide on budget. In such cases, it will be vital to ensure that off-budget aid still provides the fiscal space the Government requires to make the necessary investments to facilitate higher growth and development. This could be achieved through close coordination between the Government and development partners in the planning of off-bduget projects, with aid provided only to finance programs that are specifically included in the Government's economic development plans.

Government must ensure spending aligns with development priorities and pursue measures

Given the tight resource constraints the Government faces, there is little room for misallocation or waste. It will be vital for the Government to develop a costed and comprehensive program of public investment that supports a coherent growth strategy. The alignment of aid spending with government priorities requires that those priorities are explicitly stated, well-articulated, and informed by careful analysis. While such measures will not eliminate the need for increased on-budget

to expand fiscal space.

aid resources over the short-term, the Government should pursue all available options to increase its fiscal space and to free up resources to implement its investment priorities. These options might include the following:

- **Improved revenue mobilization:** While the structure of Afghanistan's economy constrains the achievement of its full revenue potential, there remains scope to increase collections. Efforts to improve tax compliance, including through the roll-out of the SIGTAS system, should continue. The Government should pursue opportunities to encourage compliance by streamlining procedures for tax payments. More generally, efforts to improve the business environment and to build private sector confidence could encourage higher levels of investment and therefore support increased tax revenues.
- **Managing security costs:** The current trajectory of security expenditures is unsustainable, with these expenditures already squeezing the Government's fiscal space and reducing its ability to meet development needs. Security expenditures should be reviewed and measures implemented to ensure their long-term sustainability.
- **Improving public spending efficiency:** Public investment should be guided by consistent and realistic economic planning. Costed and prioritized investment plans that align with an overall economic strategy should be developed. Public investment management capacities should be improved, with these capacities concentrated within ministries and agencies most relevant to the achievement of improved growth.
- **Pension reform:** Unless it is reformed, the pension system will begin to impose fiscal costs by 2024. Reforming the pension system now could free up fiscal space equivalent to 0.7 percent of GDP with which to pursue priority development investments.

D. Focus Section II: Fragility and Population Movement in Afghanistan

Afghans have been enduring the adverse consequences of forced displacement for decades, with Afghanistan having the largest number of its people living as refugees in protracted exile of any country in the world. It is estimated that 2.5 million registered Afghan refugees remain in neighboring countries, with possibly an equal number of undocumented migrants with similar protection needs in Iran and Pakistan. Internal displacement is also significant problem, with an estimated 1.2 million internally displaced persons (IDPs) in need of humanitarian assistance.

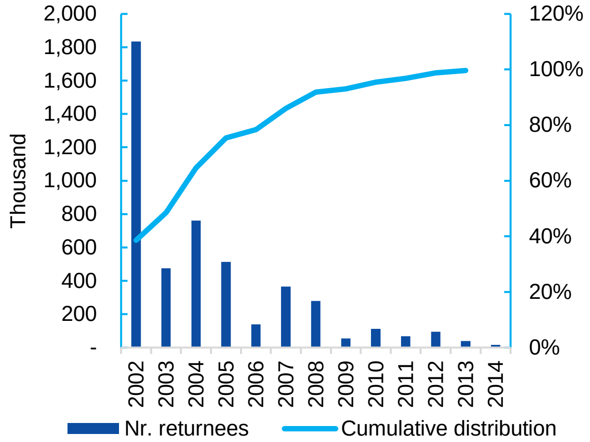
The deteriorating security situation has led to a sharp increase in displacement pressures in recent years. A shrinking asylum space at the global level and changes in the geopolitical equilibrium at the regional level have recently spurred the return of thousands of refugees and asylum seekers from Pakistan and, in lower numbers, from Iran and Europe. As of early September, in 2016, returnees from Pakistan alone account for 98,000 registered and 135,000 undocumented Afghans. An additional 400,000 are expected to return by the end of the year to join the increasingly large number of IDPs.

Many of these returnees are expected to require some form of humanitarian assistance, especially as the cold winter season approaches and many go without appropriate accommodation or shelter. However, the management and protection of the displaced people is being conducted in a challenging context, with the security situation remaining very volatile, the country lacking an effective system of safety nets and suffering from a severe economic slowdown that has triggered a three-fold increase in unemployment and pushed many Afghans below the poverty line. Moreover, a large proportion of the population at large still remains underserved in terms of access to basic public services. What are the possible implications and risks of such a sizeable population shock to Afghanistan? How can Afghanistan best absorb and successfully reintegrate displaced people under the current security and economic circumstances? What actions should the Government and the international community prioritise?

Learning from the past

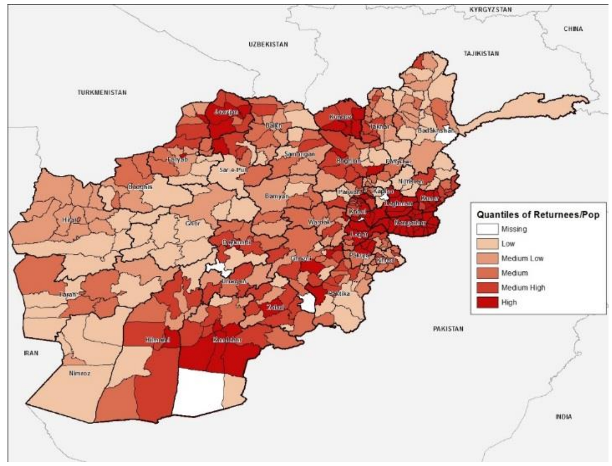
Afghanistan has a long history of protracted international displacement. Afghans fled by the millions in the aftermath of the Soviet invasion of 1979, mostly to Iran and Pakistan. While some returned to Afghanistan in the early 1990s following the tightening of asylum conditions in the recipient countries, Afghanistan's civil war and the rise of the Taliban resulted in a new exodus to neighboring countries. The fall of the Taliban regime in 2001 marked the beginning of a massive wave of returning Afghans. Thus, an estimated 20 percent of the total population currently residing in Afghanistan is made up of returnees.

Figure 21: The number of assisted returns to Afghanistan



Source: UNHCR Assisted Returns

Figure 22: Share of returnees in 2007, by district

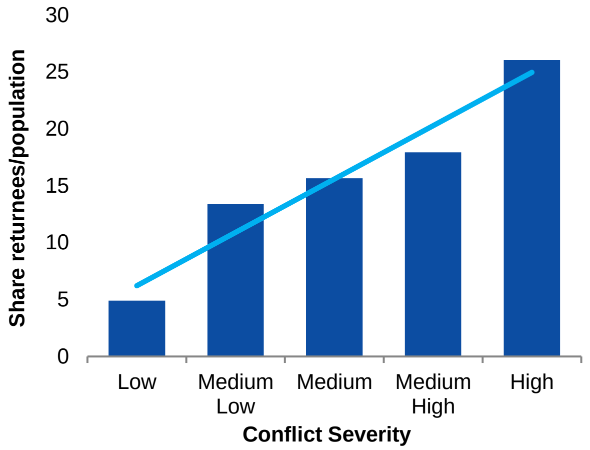


Source: UNHCR; CSO population statistics

The return of displaced people has been unevenly spread in terms of time and location, creating disproportionately large challenges to the absorption capacities of some districts and provinces (see figures 21 and 22). While the local impact of a massive influx of refugees on particular areas and their capacity to reintegrate these refugees depends on a range of factors, there is a real risk that shocks resulting from the influx have increased competition for resources or exacerbated pre-existing causes of conflict in a number of districts. In 2007, districts that had received the largest influx of returnees relative to the local population were most likely to suffer higher levels of insecurity (see Figure 23).

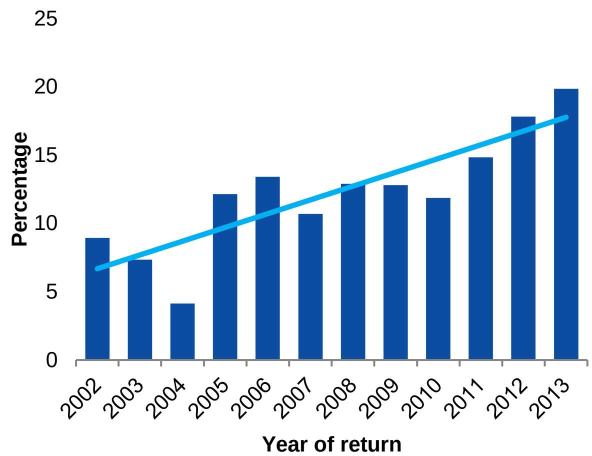
Over time, the intensification of conflict and the saturation of local absorption capacities have also resulted in a progressive increase in the incidence of secondary displacement among returnees. The incidence of internal displacement among the displaced people who returned in 2013 is twice as high as amongst those who returned in 2002, despite the fact that the number of returnees in 2002 was almost 50 times larger than in 2013 (see Figure 4). The increase in the incidence of secondary displacement among returnees indicates that Afghanistan's capacity to absorb and reintegrate these returnees is already overstretched. An increase in the number of returns from abroad is therefore likely to result in a consequent increase in the incidence of internal displacement. The continued deterioration of the security situation and the economic slowdown are likely to exacerbate the challenge of reintegrating more recent returns.

Figure 23: Correlation between returns and severity of conflict at the district level, 2007



Source: Authors' calculation based on UNHCR and SIOCC-UNDSS data

Figure 24: Share of IDPs among returnees by year of return



Source: Authors' calculation based on ALCS 2013-14

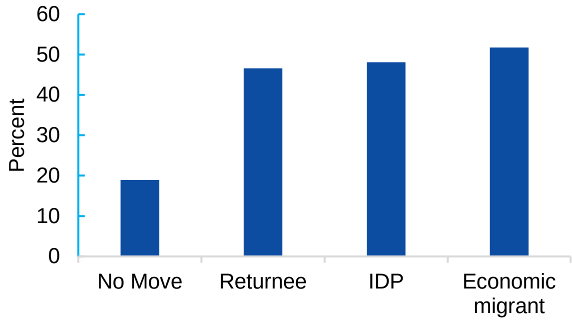
Displaced populations

An assessment of the welfare and the degree of integration of displaced households currently living in Afghanistan provides important insights into the challenges that future IDPs and returnees might face.

Irrespective of motives or causes, household mobility is associated with urbanization (see Figure 25). IDP and returnee households predominantly settle in urban centers, joining a throng of economic migrants leaving the rural areas in search of jobs and better access to health and education. IDP and returnee households are also more likely to have a literate household head than are households who did not move or households that have moved for economic reasons, reflecting the better access to education returnees might have had in asylum. However, as is the case for non-mobile households, IDP households have very poor labor market outcomes. In fact, heads of IDP households are more likely to be either engaged in vulnerable forms of employment or to be unemployed and/or underemployed. Returnee households are more likely to have a member working abroad and sending remittances, possibly taking advantage of networks established while in asylum.

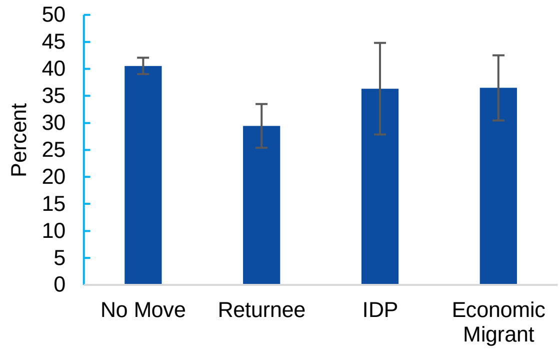
Poverty and vulnerability are widespread in Afghanistan. Irrespective of its causes and motivations, mobility is associated with a lower incidence of poverty (see Figure 26). Returnee households have a significantly lower poverty incidence than non-mobile households, with the poverty rate for returnee households standing at 29.4 percent compared to 40.5 percent for non-mobile households. However, this lower rate can be explained entirely in terms of levels of literacy and urbanization, with refugee households being more likely to have a literate household head and to live in an urban area than non-mobile households.

Figure 25: Urbanization rate by households' migration status



Sources: Authors' calculation based on ALCS 2013-14

Figure 26: Poverty rate by households' migration status



Notes: Vertical bar indicates the 95% confidence interval *Sources*: Authors' calculation based on ALCS 2013-14

The evidence suggests that the relatively high literacy and human capital levels of mobile households are the main determinants of their socio-economic advantage. In addition, irrespective of the motives or causes for migration, the risk of poverty for mobile households depends on the same factors that determine the risk of poverty in the population as a whole. Nearly 70 percent of Afghanistan's working age population is illiterate, with the illiteracy being highest among the poorest segments of the population.

Continued conflict and displacement could create further challenges to the accumulation of human capital. Available evidence from studies of former refugees residing in Afghanistan in 2013-14 shows that mobility during the decades before the fall of the Taliban was positively correlated with returnee literacy rates. Despite progress over the past decade, the supply and quality of Afghanistan's educational services lags behind that of neighboring countries. As a result, on average, Afghans who were born abroad had better access to education than Afghans of the same age who did not move, particularly in the case of older returning Afghans. On the other hand, internal displacement is negatively correlated with children's human capital accumulation. In particular, regression analysis shows that children aged six to 15 in IDP households are 8.5 percent less likely to be enrolled in school, with this disadvantage being particularly severe for the first two years of residence in a new location.

Recommendations

The available evidence suggests that push factors are the primary determinants for migration both within and outside Afghanistan. While migrants may choose where to go based on the opportunities and information available to them, departure itself is more often a necessity than a choice.

The past history of displacement and returns to Afghanistan indicates the potentially destabilizing effects of increasing population pressure on limited local resources. Given the increase in the incidence of secondary displacement among more recent waves of returnees, local absorption capacities appear to already be overtaxed. An increase in the number of returns from Pakistan, Iran, or Europe is likely to result in a cycle of secondary displacement, unemployment, instability, and further displacement.

The situation will require ***a well-coordinated and multi-faceted operational response*** to avert a potential humanitarian crisis as winter approaches. The international community should increase its advocacy to ensure voluntary, safe, dignified, and phased returns, as further population shocks have the potential to undermine civilian and military aid efforts and exacerbate conflict and insecurity. Peace and stability in Afghanistan are not only a pre-requisite for its development, they are also a global public good. If no single country or institution alone has the capacity to effectively assist Afghanistan to manage its displacement issues, the international community as a whole could mobilize resources to assist countries such as Pakistan and Iran that have borne the burden for decades. Similarly, the international community as a whole should support the development of legal channels to enable temporary economic migration and the more effective management of asylum requests, which could help Afghanistan overcome its current crisis and ease its structural challenges.

Secondly, the evidence suggests that factors determining poverty risks among mobile households are the same as those determining poverty risks among the general population. With Afghanistan experiencing widespread poverty and with the degree of destitution among mobile households being not dissimilar to that experienced by the rest of the population, it is better to target *needs* than to target *population categories*. This approach may reduce perceptions of unequal treatment, with these perceptions potentially exacerbating social fragmentation. An approach of this sort might be particularly important in the context of the Government and international community transitioning towards a developmental approach to the management of displacement issues. As the fiscal space for social spending shrinks, a consolidation of interventions could contribute to ***the development of a nationwide safety net system*** intended to enable households to cope with risk and possibly to reduce some of the causes of displacement.

Thirdly, priority should be given to minimizing any possible negative impact of displacement on human capital investments for future generations. The evidence suggests that low levels of human capital is the main factor determining the risk of poverty and that households are likely to respond to negative shocks by pulling children out of school. While a comprehensive safety net system could help to mitigate such negative consequences, bureaucratic barriers related to residency status and the transferability of school records could have a disproportionately negative impact on displaced and mobile populations. Moreover, given the prevalence of mobility and displacement in Afghanistan, priority should be given to ***investing in functional literacy and skills-development programs*** that have greater portability and that provide displaced individuals with greater access to economic opportunities, wherever their final location.

Lastly, the evidence suggests that migrants are likely to continue to converge towards Afghanistan's urban centers in search of better security, jobs, and services. The trend towards ***increased urbanisation*** requires immediate interventions by local authorities to increase shelter capacity and access to services. National and provincial authorities should recognize that, in the medium and long term, local integration in urban and semi-urban areas is inevitable. This integration requires adequate planning to maximize the returns from urban agglomeration. This planning should include the appropriate investments to improve connectivity and accessibility while ensuring access to basic services and a minimum standard of living.

References:

*The contents of this focus section are based on a joint World Bank – UNHCR note, titled "**Fragility and population movement in Afghanistan**", released in October 2016*

APPENDIX I: WORLD BANK GROUP PROGRAM IN AFGHANISTAN

1. The World Bank Group's program in Afghanistan is governed by the joint Interim Strategy Note (ISN) for FY 2012–FY 2014, which focuses on three themes: (i) building the legitimacy and capacity of institutions; (ii) equitable service delivery; and (iii) inclusive growth and jobs. The process for preparing the next country strategy, the Country Partnership Framework for Afghanistan (CPF), has been launched, and the Systematic Country Diagnostic (SCD), which informs the CPF by identifying the development challenges and opportunities, has been completed.

2. Since 2002, the International Development Association (IDA) has committed a total of US$ 3.60 billion in grants (86 percent) and credits (14 percent) in Afghanistan. Thirty-seven development and emergency-reconstruction projects and a budget support operation have been committed as of September 2016. In addition, the Afghanistan Reconstruction Trust Fund (ARTF) has generated US$ 9.2 billion of funding from 34 donors, and committed US$ 4.2 billion for the Government's recurrent costs and US$ 4.45 billion for government investment programs. As of the September 2016, the active IDA portfolio was worth US$ 1.27 billion and the active ARTF investment portfolio was worth US$ 3.1 billion.

3. The Bank also administers the ARTF, the World Bank Group's largest single-country multi-donor trust fund. The ARTF provides grant support to Afghanistan based on a three-year rolling financing strategy. Together, the IDA and the ARTF provide close to US$ 1 billion per year in grant resources (about US$ 200 million from IDA and about US$ 800–US$ 900 million from the ARTF). The ARTF is a key vehicle for providing the Government with predictable and transparent on-budget financing, providing a platform for policy dialogue between the Government and donors.

4. In FY 2016, the World Bank Board approved the Trans-Hindukush Road Connectivity Project to the amount of US$ 250 million, as well as additional financing for an existing project, the Second Customs Reform and Trade Facilitation Project, to the amount of US$ 21.5 million. Under the ARTF, six new projects were approved, including US$ 83 million for the Naghlu Hydropower Rehabilitation Project; US$ 6 million for DABS TA; US$ 50 million for the Higher Education Development Project; US$ 4.95 million for Land Management Support; US$ 5 million for E-Governance Digital CASA; and US$ 5 million for the Technical Assistance Project. Additional financing for existing projects included US$ 41 million for the Second Public Financial Management Project; US$ 45 million for the On-farm Water Management Project; US$ 70 million for the Irrigation Rehabilitation and Development; US$ 90 million for National Horticulture and Livestock; and US$ 57.26 million for the Third National Solidarity Project. Funds to a value of US$ 593 million were disbursed under the Recurrent Cost Window for the FY 2016.

5. The World Bank continues to engage in rigorous analytical work and to place a significant emphasis on policy dialogue. These non-lending activities have supported the World Bank's lending program and played a crucial role in informing the Government of its strategic choices and in advancing dialogue between the Government and its international development partners. In the last fiscal year, the ARTF Steering Committee endorsed the Research and Analysis Program (RAP), which aims to support the Government policy reform agenda and decision-making processes. The program creates an opportunity to introduce innovative ways of working with the Government, universities and local research institutions to introduce analysis and generate knowledge. As part of the RAP, the World Bank is currently engaged in a series of analytical works to enhance understanding of Afghanistan's growth and fragility challenges and to inform the development response of the Government and international development partners. The initial results of this work were presented at the Brussels Conference on Afghanistan in October 2016.

6. IFC's committed investment portfolio in Afghanistan has more than doubled, from around US$ 58 million in FY08 to around US$ 135 million in FY14. Currently, IFC's portfolio stands at about US$ 54 million and includes one investment in the telecommunications sector (Roshan), one investment in the hotel sector (TPS), and two operations in financial markets (First Microfinance Bank, Afghanistan International Bank). IFC's investments have had a transformational impact in terms of access to finance and outreach, particularly in the microfinance and telecommunication sectors. IFC's Advisory Services program has been

supporting the investment program in the areas of access to finance, small and medium enterprises (SMEs) capacity development, horticulture/agribusiness development and investment climate. At present, the focus of IFC's advisory work is on improving the investment climate through reforms to licensing, construction permits and other areas where reforms may result in improvements to Doing Business Indicators. IFC has also launched the pre-implementation phase of the Lighting Afghanistan Program, which aims to expand the off-grid market and to facilitate access by 180,000 households to affordable solar lighting solutions. In addition, IFC is increasing the supply of fresh and processed fruits through measures to improve compliance with market standards and to facilitate the integration of farmers into the value chain of leading agribusinesses, providing them with access to increased market opportunities. IFC will continue to seek new investment opportunities and to engage with local players in order to support the development of Afghanistan's private sector, particularly in the areas of infrastructure (energy), finance and microfinance, manufacturing, agribusiness and services.

7. The Multilateral Investment Guarantee Agency (MIGA) has US$ 154 million of gross exposure in Afghanistan, supporting telecommunications and agribusiness projects. In 2013, MIGA launched its Conflict Affected and Fragile Economies Facility, which is supports the agency's exposure in Afghanistan. MIGA currently supports three projects in Afghanistan, of which one is a joint effort with IFC in the telecommunications sector to support the telecom operator MTN. The other two operations are MIGA-only projects related to dairy and cashmere production.

APPENDIX II: GOVERNMENT REFORMS IN 2016

The following text is copied, without modification, from the document titled "Highlights of Achievements" originally submitted by the National Unity Government at the Senior Officials Meeting on September 5, 2015, and subsequently updated in September 2016.

The National Unity Government
Highlights of Achievements
September 2016

Introduction:
The National Unity Government (NUG) presented the first "Highlights of Achievements" in the Senior Officials Meeting (SOM) that was held in Kabul on 5 September 2015. Since then, the Government has continued to put into practice extensive reforms to enhance service delivery, curb corruption and introduce the new generation of administration to respond to the nation's development needs.
Selected highlights of government achievements over the past year include:

Political Stability and Advancement in Regional Cooperation

1. **Turkmenistan – Afghanistan – Pakistan –India Natural Gas Pipeline (TAPI):** Construction on the project started in Turkmenistan on 13 December 2015 and the pipeline is expected to be operational by 2019. TAPI presents an opportunity for regional cooperation on an unprecedented scale, linking the economies of the four countries. The pipeline aims to export up to 33 billion cubic meters of natural gas per year through a proposed pipeline, approximately 1,800-kilometer long, from Turkmenistan to Afghanistan, Pakistan, and India.

2. Afghanistan, India and Iran signed the **Chabahar Port** agreement on 24 May 2016. The project will build a transport-and-trade corridor through Afghanistan that could help halve the time and cost of doing business with Central Asia and Europe.

3. **TAP500** will transmit electricity from Turkmenistan to Pakistan through Afghanistan. The MOU for the tripartite power project of 500-KV line which was signed on 13 December 2015 in Mary, Turkmenistan held its first meeting was held in Islamabad on 12 April 2016. The ADB will establish project secretariat and provide technical assistance, including project assessment, feasibility study, technical design and other project preparation.

4. The **CASA-1000** project was inaugurated in May 2016 is expected to be completed by the end of 2018. CASA-1000 will move electricity between the Kyrgyz Republic and Tajikistan (477 kilometers) and from Tajikistan to Afghanistan and Pakistan (750 kilometers).
5. For the first time in the history of Sino-Afghan relations, **special railway transportation** of commercial goods between the two countries was launched on 25 August 2016. The train left Nantong in eastern China's Jiangsu province on 25 August 2016, carrying 84 containers. It will take 15 days to complete the journey, running via the Alataw Pass, Kazakhstan and Uzbekistan to Hairatan in northern Afghanistan. Two trains are scheduled to run each month, as part of China's "Belt and Road" initiative to improve Asian transport connectivity. The railway will take Afghan export items like marble, saffron, and dried fruit to China.

Anti-corruption, Governance, Rule of Law and Human Rights

1. The **Anti-Corruption Justice Center** opened in June 2016 and is already operational. The Center is reviewing more than 20 cases including some involving high Government officials.

2. A **one-stop-shop for issuing construction permits** has been established at Kabul Municipality. This will simplify administrative procedures, standardize services and boost efficiency in delivery.
3. The **National Procurement Committee** has approved 1250 contracts, valued at Afs 155 billion or (US$ 2,313,432,836). More than Afs 15 billion (US$ 223,880,595) has been saved in the approved contracts. 71 companies have been blacklisted, 70 of these companies been introduced to Attorney General Office for breaking the law, further 25 Companies are under debarment process. Over 150 million Afghanis in bid/performance securities forfeited and transferred to government's revenue account
4. Overall, 94.7 % of government officials including the Chief Executive Officer of the National Unity Government have **declared their assets** as per Article 154 of the constitution. The government is expanding asset declarations to cover senior officials in tax, customs, and revenue.
5. Ministry of education has addressed the problem of "ghost teachers" through the **newly established Teacher Registration and Payroll System** tracks.
6. The **High Council on Governance, Rule of Law and Anti-Corruption,** one of only two Councils led by President Ghani, met for the first time on July 28.
7. In the Attorney General's Office, an **Elimination of Violence Against Women/EVAW unit has been created** with a female prosecutor as director.
8. The 2016 **World Press Freedom Index** ranks Afghanistan higher than every neighboring country and 4th best among the 13 countries of South and Central Asia.

Legal reform for anti-corruption actions is accelerating

1. **The justice sector is being revitalized.** More than 600 judges have been changed. Over 100 Kabul city officials have had their passports seized on charges of corruption whilst investigations of municipal corruption are being prepared.
2. The Ministry of Interior has introduced a **computerized human resource information system** using biometric ID cards and electronic banking that is able to catch "ghost" workers.
3. Land and Water Administration (ARAZI) has **recovered 30,000 *jeribs*** (6000 hectares) of illegally seized land in 2016.

Restoring Fiscal Sustainability and the Integrity of Public Finance and Commercial Banking

1. On 20 July, the IMF Executive Board approved a three-year **Extended Credit Facility (ECF)**. This agreement comes after a successful nine-month Staff Monitored Program, which was completed in April 2016. The ECF covers reforms to fiscal management, banking, stateowned enterprises, and economic statistics.
2. Ministry of Finance has collected Afs 81.70 billion (US$ 1,219,402,985) in **revenues** in the first quarter of the current fiscal year (2016-17), exceeding the IMF target by 7 percent, or Afs 5.30 billion (US$ 79,104,478). This is an increase of Afs 26,68 billion (USD398,208,955) or 48 percent compared to the same quarter in the previous year.
3. A new **E-payment** system was introduced by the Afghan Customs Department and Da Afghanistan Bank allowing traders to pay custom duty electronically. E-pay automates the collection of customs duties, speed the release of goods, and is considered to be a best practice for modern customs administrations.
4. The **Automated System for Customs Data (ASYCUDA)** is now operational in 98 percent of customs locations.
5. **Standard Integrated Government Tax Administration System (SIGTAS)** is a computerized Tax Administration database system, which is deployed by ARD and it is being used for Tax payers

registration, process automation, Tax process simplification, procedures standardization, accurate Tax calculation, revenue data analysis, on time and accurate reporting, security and integrity of revenue data. With its full implementation, the corruption in tax payment process is highly reduced and it brings transparency in tax collection process. SIGTAS is currently implemented in Kabul LTO, MTO, STO.

6. Under the Presidential Decree (334) dated 26/02/1394, a committee is formed for receiving **bad debts** of the banks. The committee, chaired by Minister of Finance, developed a procedure for receiving bad debts in the first meeting. Following approval of the procedure file of each debtor of Afghanistan National Bank and Pashtany Bank were reviewed and decision was made for receiving their debts. Bad debts in an amount of US$ 1.35 million was received for Pashtany Bank while amounts of US$ 1.92 million were received for Afghanistan National Bank.

Reforming Development Planning and Management

1. Donors and government agreed on a **standardized rate scale** for on and off-budget contractors to level the playing field. Implementation is underway.
2. The government met all or most **performance triggers for budget-based support** from the IMF, World Bank, and USAID, including receiving a performance bonus from the World Bank's "Incentive Program."
3. The first annual **performance review of the public financial reform roadmap was completed** in August, 2016.

Social Inclusion and Ensuring Citizens' Development Rights

1. One of the ways the government of Afghanistan is showing its commitment to empowering women is by **appointing qualified female officials to key positions**. There are more women in senior government positions than at any other time in Afghan history. Three female ministers, nine female deputy ministers, one female governor, a female deputy attorney general, the first female deputy head of the High Peace Council, and two female peace council members have been appointed. Women will also represent Afghanistan as part of the negotiations team at the peace talks. In addition, three female ambassadors have been appointed to Indonesia, Norway and Switzerland.

2. An MOU was signed with the Republic of Azerbaijan to launch **Asan Khedmat,** a one stop shop solution for providing public services quickly, easily and in a transparent way. The Kabul center has been established and will soon provide residents access to twenty one services, including Tazkeeras (national ID cards), wedding certificates, driver's licenses, vehicle registrations.

3. The first phase of the **Jobs for Peace** program was completed successfully, disbursing over US$ 70 million and creating at least 2.6 million man-days of labor in poor communities.
4. The **Maintenance Cash Grant (MCG) program** was launched on 17 November, 2015 by H.E. the President. Under the pilot phase (December-July) US$ 31 million has been disbursed, reaching 3,800 communities and generating over 4 million labor days. 90 percent of the work on the ground is completed. NSP is in the process of implementing Italian funds for US$ 10+ million reaching 1,364 communities and generating 1.3 million labor days as well as US/ UK funds for US$ 42+ million reaching 6,297 communities with 6 million labor days. The MCG is helping with the maintenance of village-level infrastructure, including road and irrigation canals.
5. A nationwide program to **survey, register, and provide certificates of land** occupancy to irregular urban settlements was launched in five major cities. Over 6,000 properties have already been mapped by residents and are being registered for certificates in Herat, Jalalabad, Kandahar, Mazar-e-Sharif, Bamiyan and Kabul.

6. The government will construct **twenty-two small and medium irrigation dams** to increase smallholder's farm productivity; **six of which have already gone to tender**.
7. The **National Trust Fund for Cultural Heritage and Creative Industries** was launched by with an initial government contribution of US$ 750,000.
8. Almost US$ 61 million in **Agricultural Development Funds** loans have directly benefited more than 31,000 farmers.
9. **Rehabilitation of 1,953 kilometers in irrigation infrastructure** has led to substantial increases in water availability for more than 489,000 hectares of agricultural land.
10. The first-ever national **Demographic and Health Survey** provided new baseline information on education, maternal and child health, fertility, vaccination, malaria and HIV.
11. **970 thousand new students enrolled in schools in 1394/2015**. Total enrolment for grades 1-14 has now reached 9.4 Million and among this 39.3 % of these students are female. 195 schools were established. The total number of schools in Afghanistan is now approximately 16,800. Over 203,535 teachers were employed. 22 million textbooks were printed and distributed in 1394/2015.
12. **Approximately 58 million visitors have been provided health services** during the year 1394 which shows an increase of three million comparing the previous year 1393. Also about 1.2 million Antenatal services and about 7 million birth delivery services has been provided by health employees to women that shows a significant increase comparing year 1393.

Private Sector Development

1. Since the time Afghanistan joined the WTO in 2015, exports have increased to US$ 570 million in exports, **up by US$ 150 million** since 2013.
2. **Salma Dam was inaugurated** in June 2016 by Afghan President Ashraf Ghani and India's Prime Minister Narendra Modi. Salma will generate 42 megawatts of electricity for 40,000 rural families, will irrigate 80,000 hectares of farmland owned by 50,000 families, and will .
supply power to Herat city.
3. Approximately 28 hectares worth US$ 35 million have been sold to Alokozay Holdings to build six factories that **will directly employ an estimated 1,700 people** and create thousands of indirect jobs.
4. The **public-private partnerships (PPP) law** has been approved by the Cabinet.
5. **11 Private Sector Priorities** have been identified by Afghan Chamber of Commerce and Industries and 11 governmental committees formed to ensure and track their implementation.
6. **Foreign investment** has increased from US$ 51million to US$ 170 million in 2015.
7. The Afghan government promulgated a **new banking law** and strengthened oversight of the banking sector.
8. Afghan businessmen and women made new connections to regional and international markets, generating over US$ 79.5 million in **exports of fruit, nuts, and cashmere**.
9. New market linkages among agribusinesses, producers and farmers, have resulted in an additional US$ 325 million in **agricultural sales**.
10. Installation of **Kajaki's turbine 2** has been completed.
11. The operation and maintenance of the **Tarakhil Power Plant** has been transitioned to a private sector operator.
12. The contract for the **Kandahar Solar Power Plant** has been issued, representing the country's first competitive private-sector investment in energy infrastructure.
13. The **Jabal Saraj Cement Plant** is rehabilitated with an amount of 75 million Afghanis from state budget and inaugurated in April 2016 . The factory produces 100 tons of cement every 24 hours and

about 25,000 metric tons annually. Nearly 120 people are directly employed and 5,000 people are indirectly provided job opportunity.

14. Construction, installation and commissioning of **gas sweating plant in Sheberghan gas fields** was completed and inaugurated in March 2016 with minimum gas treatment capacity of 950 thousand cubic meters per day.
15. The High Economic Council (HEC) approved an **Open Access Policy** on 28 August 2016 that will give access to all private telecom investors to the fiber optic network or allow them to build their own network, breaking the Afghan Telecom monopoly. This creates the level playing field for the development of the telecom sector, reducing internet prices, increasing speeds and is a prerequisite for making Afghanistan the Asia round-about for data transit.
16. The Khwajah Rawash housing project was inaugurated on 2nd September 2016. The project was completed over a period of 4 years bearing a cost of AFN 6.3 billion which is equivalent to US$ 94.3 million. Implemented over an area of 40 hectares, Khwajah Rawash housing project includes 78 residential blocks and 2,014 apartments. The financing of the project was organized with the contribution of the people with advance payment scheme and the Ministry of Urban Development Affairs and Housing.

Appendix Table 1: Selected economic indicators

	2013	2014	2015	2016	2017	2018	2019
Income Levels				Proj.	Proj.	Proj.	Proj.
Nominal GDP (billion Af) /1	1,133	1,151	1,205	1,300	1,403	1,520	1,651
Nominal GDP (billion US$) /1	20.5	20.0	19.6	19.2	20.2	21.3	22.6
GDP per capita (US$)	643	632	620	611	608	612	630
Population (million)	30.7	31.6	32.5	33.4	34.2	34.9	35.7
Real Economy (% growth)							
Real GDP growth /1	3.7	1.3	0.8	1.2	1.8	3.0	3.6
Agriculture	0.0	−0.1	−5.7	−0.5	2.5	3.5	1.5
Industry	3.1	2.4	4.1	2.0	2.2	3.0	3.5
Services	5.3	2.2	1.6	1.4	1.4	2.9	4.3
Output gap (% of potential GDP)	7.5	3.0	-1.0	-3.8	-5.6	-6.0	-6.2
GDP Composition (% of GDP)							
Agriculture	23.9	23.5	21.7	22.3	22.4	22.5	22.5
Industry	21.2	22.3	23.3	23.5	23.5	23.5	23.5
Services	55.0	54.2	55.0	54.2	54.1	54.0	54.0
Prices (%, 12-month percent change)							
CPI inflation (period average)	7.4	4.6	−1.5	5.5	5.0	5.0	5.0
Core inflation (excl. fuel & cereals; p.a.)	7.0	2.4	−1.3	4.4	..	..	..
CPI inflation (end period)	7.3	1.4	0.2	6.5	..	..	..
External Sector (% of GDP, unless otherwise indicated)							
Exports of goods (million US$) /2	729	783	667	687	769	888	1,059
Imports of goods (million US$) /3	9,244	8,711	7,867	7,986	8,262	8,566	9,310
Trade balance	−41.6	−39.6	−36.7	−38.7	−37.5	−36.2	−36.6
Net current transfers	42.5	37.9	38.2	40.0	35.6	32.9	31.2
Current account balance	7.4	8.0	5.4	4.5	3.6	2.8	1.2
Gross foreign exchange reserves (million. US$)	7,447	7,360	6,864	7,500	7,600	7,700	7,800
Gross foreign exch. res. (months of imports)	7.8	9.8	9.0	9.5	9.2	8.6	8.2
External debt /4	6.7	6.5	6.3	6.6	6.6	6.3	6.1
Exchange rate (AFN/USD, period average)	55.4	57.4	61.4	67.8	..	..	..
Exchange rate (AFN/USD, end period)	56.6	58.1	68.1	67.0	..	..	..
Real effective exchange rate /5	103.5	103.4	98.5	92.5			
Monetary and Financial Statistics (% of GDP)							
Broad money (M2)	33.0	34.9	34.4	35.1	35.8	36.3	36.9
Total deposits	17.6	17.7	17.5	17.2	17.8	18.4	19.5
Share of dollar deposits (%)	68.0	66.0	71.5	..	..	..	..
Credit to private sector, commercial banks	4.2	3.8	3.9	4.2	5.0	5.8	6.8
Loan-to-deposit ratio (%)	23.7	21.6	22.2	24.4	28.1	31.5	34.9

Notes:
1/ National Accounts data exclude opium value added. The official NA numbers, originally based on the Solar Hijri year (Mar 20 – Mar 21) have been re-estimated for the calendar year (Jan-Dec).
2/ Exclude sales of goods to nonresidents in the country. 3/ Include estimated unofficial trade or smuggling.
4/ Incorporates committed but not yet delivered debt relief; excludes Russian Federation's loan.
5/ A decrease in index shows depreciation. Based on a weighted basket of currencies corresponding to nine major trading partners, incl. Pakistan, Iran, India, Euro area, Russia, UAE, Turkey and China. The weight for the US dollar is the residual trade share. Q2 2015 = 100.
Sources: Central Statistics Organization, Central Bank, World Development Indicators, IMF staff estimates, and Bank staff projections.

Appendix Table 2: Selected fiscal indicators

	2013	2014	2015	2016	2017	2018	2019
In Billion Afghanis, unless otherwise indicated				Proj.	Proj.	Proj.	Proj.
Domestic revenues	109.4	100.1	122.4	140.7	161.6	181.0	201.5
Tax revenue	52.4	51.8	59.5	69.4	80.2	85.2	90.1
Customs duty and fees	28.3	26.0	30.4	32.5	36.8	40.0	43.5
Nontax revenues	28.7	22.3	32.4	38.7	44.6	55.9	67.8
Donor grants	163.0	180.7	181.1	233.2	264.1	284.4	309.2
Discretionary grants	105.2	119.1	123.7	148.9	160.1	173.0	184.3
Non-discretionary grants	57.8	61.6	57.4	84.3	104.0	111.4	124.9
Total expenditures	278.3	301.0	318.8	375.2	426.2	465.9	511.2
Recurrent expenditures	198.0	228.3	235.9	268.9	295.9	324.7	353.2
Security	119.8	137.4	143.6	170.8	190.6	211.4	231.3
Civilian	78.3	91.0	92.3	98.1	105.3	113.3	121.9
Wages and salaries	47.9	52.7	54.5	55.8	59.4	63.3	67.4
Operations and maintenance	18.0	16.3	17.3	18.7	20.6	22.8	24.7
Capital expenditures	1.7	1.9	2.3	2.6	3.0	3.0	3.3
Social transfers	10.5	19.2	17.0	20.2	21.5	23.4	25.7
Interest payment	0.5	0.9	1.2	0.8	0.8	0.8	0.8
Discretionary development	19.0	9.9	18.0	21.3	26.3	29.9	33.1
Non-discretionary development	61.3	62.8	64.9	85.1	104.0	111.4	124.9
Discretionary balance (Recurrent + Disc dev.)	-2.4	-19.0	-7.8	-0.5	-0.5	-0.5	-0.5
Overall balance	-5.9	-20.2	-15.3	-1.3	-0.5	-0.5	-0.5
Overall balance excluding grants	-168.9	-200.9	-196.4	-234.5	-264.6	-284.9	-309.7
Revenues to recurrent spending ratio (%)	55.3	43.8	51.9	52.3	54.6	55.7	57.0

Sources: Ministry of Finance (AFMIS), and Bank staff projections

Appendix Table 3: Selected fiscal indicators

	2013	2014	2015	2016	2017	2018	2019
In Percent of GDP, unless otherwise indicated				Proj.	Proj.	Proj.	Proj.
Domestic revenues	9.7	8.7	10.2	10.8	11.5	11.9	12.2
Tax revenue	4.6	4.5	4.9	5.3	5.7	5.6	5.5
Customs duty and fees	2.5	2.3	2.5	2.5	2.6	2.6	2.6
Nontax revenues	2.5	1.9	2.7	3.0	3.2	3.7	4.1
Donor grants	14.4	15.7	15.0	17.9	18.8	18.7	18.7
Discretionary grants	9.3	10.3	10.3	11.5	11.4	11.4	11.2
Nondiscretionary grants	5.1	5.4	4.8	6.5	7.4	7.3	7.6
Total expenditures	24.6	26.2	26.5	28.9	30.4	30.7	31.0
Recurrent expenditures	17.5	19.8	19.6	20.7	21.1	21.4	21.4
Security	10.6	11.9	11.9	13.1	13.6	13.9	14.0
Civilian	6.9	7.9	7.7	7.5	7.5	7.5	7.4
Wages and salaries	4.2	4.6	4.5	4.3	4.2	4.2	4.1
Operations and maintenance	1.6	1.4	1.4	1.4	1.5	1.5	1.5
Capital expenditures	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Social transfers	0.9	1.7	1.4	1.6	1.5	1.5	1.6
Interest payment	0.0	0.1	0.1	0.1	0.1	0.1	0.0
Discretionary development	1.7	0.9	1.5	1.6	1.9	2.0	2.0
Nondiscretionary development	5.4	5.5	5.4	6.5	7.4	7.3	7.6
Discretionary balance (Recurrent + Disc dev.)	-0.2	-1.7	-0.6	0.0	0.0	0.0	0.0
Overall balance	-0.5	-1.8	-1.3	-0.1	0.0	0.0	0.0
Overall balance excluding grants	-14.9	-17.5	-16.3	-18.0	-18.9	-18.7	-18.8
Revenues to recurrent spending ratio (%)	55.3	43.8	51.9	52.3	54.6	55.7	57.0

Sources: Ministry of Finance (AFMIS), and Bank staff projections

Appendix Table 4: Selected fiscal indicators

	2013	2014	2015	2016	2017	2018	2019
In Billion USD, unless otherwise indicated				Proj.	Proj.	Proj.	Proj.
Domestic revenues	2.0	1.7	2.0	2.1	2.3	2.5	2.8
Tax revenue	0.9	0.9	1.0	1.0	1.2	1.2	1.2
Customs duty and fees	0.5	0.5	0.5	0.5	0.5	0.6	0.6
Nontax revenues	0.5	0.4	0.5	0.6	0.6	0.8	0.9
Donor grants	2.9	3.1	2.9	3.4	3.8	4.0	4.2
Discretionary grants	1.9	2.1	2.0	2.2	2.3	2.4	2.5
Nondiscretionary grants	1.0	1.1	0.9	1.2	1.5	1.6	1.7
Total expenditures	5.0	5.2	5.2	5.5	6.1	6.5	7.0
Recurrent expenditures	3.6	4.0	3.8	4.0	4.3	4.6	4.8
Security	2.2	2.4	2.3	2.5	2.7	3.0	3.2
Civilian	1.4	1.6	1.5	1.4	1.5	1.6	1.7
Wages and salaries	0.9	0.9	0.9	0.8	0.9	0.9	0.9
Operations and maintenance	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Capital expenditures	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Social transfers	0.2	0.3	0.3	0.3	0.3	0.3	0.4
Interest payment	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Discretionary development	0.3	0.2	0.3	0.3	0.4	0.4	0.5
Nondiscretionary development	1.1	1.1	1.1	1.3	1.5	1.6	1.7
Discretionary balance (Recurrent + Disc dev.)	0.0	-0.3	-0.1	0.0	0.0	0.0	0.0
Overall balance	-0.1	-0.4	-0.2	0.0	0.0	0.0	0.0
Overall balance excluding grants	-3.0	-3.5	-3.2	-3.5	-3.8	-4.0	-4.2
Revenues to recurrent spending ratio (%)	55.3	43.8	51.9	52.3	54.6	55.7	57.0

Sources: Ministry of Finance (AFMIS), and Bank staff projections