

**Bonn Conference on Afghanistan, December 5, 2011**  
**Statement by Mr. Masood Ahmed**  
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**On November 14, the IMF's Executive Board approved Afghanistan's request for a three-year program under the Extended Credit Facility (ECF).**

- The Afghan authorities and Fund staff have been in close dialogue over managing the Kabul Bank crisis that erupted in September 2010. Early on, a strategy to deal with the crisis was agreed upon. Some of the necessary steps were politically difficult but have now been implemented or are in the process of being implemented.
- The Fund considered these achievements sufficient progress to move forward with a program. Still, sustained efforts are needed to continue implementing the strategy, including in the area of asset recovery.
- The IMF's Executive Board could consider the first review by June 2012.

**Afghanistan will be in a fragile situation for some time. Fragilities are compounded over the next three to five years by the economic effects of the withdrawal of foreign troops and the challenges of longer-term economic transformation.**

- **Growth, employment, and poverty:** We estimate that the withdrawal of foreign troops from Afghanistan (by 2014) will reduce annual GDP growth by 2–3 percentage points or more per year. Troop withdrawal will also affect employment as about 100,000 or more jobs for Afghan nationals are directly connected to the foreign military presence. In a country with a per-capita income of US\$530 (2010/11) and a poverty rate of 36 percent (2007/08), this will slow progress on poverty reduction.
- **Fiscal pressures:** With lower growth, government revenues are also likely to suffer, while spending pressures mount, including from the need to take over security spending and the operations of the many donor-financed development projects. As a result, social spending will be squeezed further, and the objectives laid out in Afghanistan's National Development Strategy will be more difficult to achieve. In this environment, strict expenditure prioritization is needed.
- **External pressures:** A declining donor footprint will also require domestic and external adjustment. At present, Afghanistan's current account deficit of about 30 percent of GDP is fully financed by donor grants. Possibly more than half of donor grants are directly spent on imports that would not arise if it were not for these grants in the first place. Still, as these foreign inflows are reduced over the years, Afghanistan will have fewer resources to pay for imports and will need to reorient spending to domestic producers and grow its export base.

**The authorities' program, supported by the ECF, includes important reforms to address the challenges facing Afghanistan over the coming three to five years.**

- **Further raising domestic revenue.** The authorities have already successfully increased revenues from less than 7 percent of GDP in 2005/06 to over 11 percent in 2010/11. However, this still falls short of the 15–20 percent of GDP achieved in similar countries.
  - *The value-added tax is the next milestone.* The planned introduction of a value-added tax in 2014 would give a welcome boost to revenue collection of about 2 percent of GDP. This measure is a key component of the authorities' revenue strategy and they cannot afford any delays in this area.
  - *But fiscal sustainability is a distant goal.* The authorities aim to raise domestic revenues to the point where they fully cover the government's operating expenditures, from covering only half of these spending items today. Under current plans, it will take more than a decade to achieve this definition of fiscal sustainability. In the meantime, the fiscal outlook is highly vulnerable, and any adverse shock will compromise the government's ability to make adequate progress on its social and development objectives.
  - *And additional revenue measures are needed.* The authorities should consider options to broaden revenue sources, including, for example, introducing excises which are currently underutilized when compared to peer countries.
  - *Because debt financing is not an option,* as shown in the recent IMF-World Bank Debt Sustainability Analysis. While current debt levels are low, thanks to the debt relief granted by the international community, this could change very quickly if Afghanistan were to rely on debt financing of its fiscal deficit. Domestic borrowing would take away resources from the private sector and dampen growth. External borrowing, unless official borrowing on highly concessional terms, would be too expensive, and potentially aggravate underlying external imbalances.
- **Strengthening the financial sector**
  - *Afghanistan could not bear the fiscal burden of another large-scale banking crisis.* Afghanistan needs a financial sector that can promote private sector-led inclusive growth. However, the fiscal outlook is already fragile, and the government has no reserves or cushions to accommodate the costs of another large-scale bailout. Therefore, the authorities need to strike a balance between financial deepening and having a sound banking system.

- ***Strengthening governance***, including in the financial sector, and ensuring that the rule of law is being upheld is a key precondition for high and sustained inclusive growth.
  - *Asset recovery will help restore governance.* Further progress on asset recovery from former Kabul Bank shareholders and related parties is needed to minimize the fiscal costs of the crisis and make it clear that crime does not pay. This will be a key focus of the first review under the authorities' program.
  - *Legal actions are needed where crimes have been committed.* Accordingly, the authorities will implement their strategy to fully apply Afghan law, including in relations to any crime committed at Kabul Bank. This will be instrumental in establishing the rules on economic crimes and set incentives to play by these rules.
- ***Restoring financial sector stability*** will require enhanced supervision and a review of the legal and regulatory framework based on the lessons learned from Kabul Bank.
  - *Supervision has lagged financial sector development.* The central bank needs to step up supervision, building on the recent progress. This includes ensuring that the banking law and regulations are fully implemented and that violations are dealt with accordingly. Capacity in the supervision department is a concern, and we will work closely with the authorities in this area.
  - *The legal framework needs updating.* The authorities also plan to review the legal framework for banks and strengthen it in light of the lessons from the Kabul Bank crisis.
- ***Facilitating external adjustment.***
  - Afghanistan's *flexible exchange rate regime* will play an important part in this adjustment, at least initially. The real exchange rate is likely to depreciate to boost competitiveness.
  - *Governance reforms* and the authorities' plans to enhance the business environment will be equally important to ensure that Afghanistan's private sector can produce goods and services that are attractive both within and outside the country.
  - Lastly, the nascent *mining sector* offers a unique opportunity to build

an export base. However, the macroeconomic effects of the expected natural resource revenues need to be carefully managed, and the fiscal regime for the sector needs to ensure that rents are not captured by vested interests, but accrue to the government.

**Donor support will be needed for years to come.**

- The authorities have put forward a program that, if fully implemented, will go a long way toward managing the macroeconomic challenges Afghanistan is facing.
- To ensure the success of their program, they will also need continued donor support for years to come. Channeling a larger share of aid through the budget—once budget execution capacity has increased—could help make aid more effective in stimulating domestic economic activity.
- We, at the Fund, are committed to our engagement with Afghanistan in the context of the program and through our technical assistance—in the areas of revenue mobilization, expenditure management, banking supervision, financial sector stability, and statistical systems, to name just a few.

***Thank you very much for your attention.***

## Appendix—Macroeconomic Outlook and Challenges for Afghanistan<sup>1</sup>

*Afghanistan's macroeconomic outlook over the coming three to five years is challenging and subject to large uncertainties. GDP growth will be lower than the average of more than 10 percent achieved over the past decade and will depend critically on the impact of the withdrawal of foreign troops by 2014 and the security situation. Fiscal policy will come under pressure from lower revenues associated with slower growth and the need to take over security spending and the operating costs of projects currently run by donors. Lower external inflows—as the spending of foreign troops in Afghanistan falls and donor aid declines gradually—can also result in external pressures and will eventually require a shift of consumption and investment spending toward domestic sources. The nascent mining sector provides hope for an upside, but this will require a strong fiscal regime that ensures that rents are not captured.*

### The Outlook for Economic Growth

**The withdrawal of foreign troops is estimated to lower growth by 2–3 percentage points per year over the withdrawal period.** The military presence has contributed to economic growth through various channels. Spending by the troops has supported aggregate demand—including through civilian employment associated with the military presence—and, ultimately, has contributed to government revenue. The troops have also financed certain public spending directly, and their domestic spending has been associated with foreign exchange inflows, which have supported the exchange rate. A decline in the foreign military presence will reverse these positive effects.

**Real GDP growth could range between 5 and 7 percent over the coming three to five years.** This baseline scenario, assumes, however that the security situation stabilizes, thus allowing for private-sector economic activity to slowly expand. Climate-driven volatility in agriculture will translate into volatility in headline growth numbers, given that agriculture accounts for about 30 percent of GDP. Start-up investments in the nascent sector, if carried out under current plans, would support growth over the forecast horizon by 1 percentage point annually.

**Growing domestic demand would partially offset the adverse impact of the withdrawal of foreign troops.** Under the assumption of stable security, private-sector activity should pick up and partly offset the adverse impact of troop withdrawal. In particular, investment in the mining sector would boost growth, but will depend on a stable security situation. In addition, if donors channel an increasing share of their aid through the budget, this would ensure a better coordination of development assistance and better reflect national priorities, and thus support growth in Afghanistan. This positive effect could materialize even if the

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<sup>1</sup> For a more detailed discussion, see International Monetary Fund at <http://www.imf.org/external/pubs/ft/scr/2011/cr11330.pdf>

overall level of donor support declines, if the government succeeds in raising its expenditure execution capacity.

**A key assumption underlying the baseline scenario is that the political environment is stable and security does not deteriorate.** Should security deteriorate, domestic private-sector activity would be stifled; foreign direct investment, including in the mining sector, would be unlikely; and growth would be severely affected. The ensuing fiscal pressures could lead to a vicious circle that would set back Afghanistan's development aspirations for years.

### Fiscal Policy Challenges

**Afghanistan has enjoyed a high level of donor support over the past decade and is today very much dependent on these aid flows.** Despite an increase in the revenue-to-GDP ratio by 5 percentage points since 2005/06, domestic revenues still amounted to only 11 percent of GDP in 2010/11, covering just over 50 percent of the government's operating expenditures. The other half of operating expenditures is financed by grants, and the development budget is almost 60 percent grant-financed. This is in addition to the large donor-funded off-budget investments, which are estimated at 30 percent of GDP. Total donor support to the government and for government-type expenditures amounted to about 40 percent of GDP in 2010/11 (Figure 1).

**The fiscal challenges posed by the withdrawal of foreign troops are significant.** Over the next five years and beyond, the government needs to find ways to balance the takeover of externally-financed security spending and other expenditures, while increasing pro-poor and development outlays within tight budget constraints. With domestic revenue of 11 percent of GDP currently covering only about half of the government's operating expenditures, Afghanistan will need to make determined efforts at raising revenues to make ends meet. In this context, the objective of fiscal sustainability—defined as domestic revenues covering operating expenditures, sometimes called the “golden rule”—is a medium-term objective, and Afghanistan will be dependent on donor support for years to come. The government has very limited access to financing, and trying to close its financing gap by borrowing from the market would lead to a fast and unsustainable build-up of public debt.

**Increased revenue mobilization, in combination with continued prudence and restraint in spending, is a key pillar of the authorities' fiscal strategy.** In 2014/15, the introduction of a value-added-tax (VAT) is estimated to boost revenue by close to 2 percent of GDP, while the mining sector will add an additional 1 percent of GDP per year to revenues once the mines become fully operational. Achieving these objectives will require significant work on improving the institutional framework to ensure that taxes, including the VAT, are collected efficiently and that rents from the mining sector are not diverted.

**Security spending is a top priority, but limits the resources available to social and development spending.** Given the overarching importance of maintaining and improving security, the government must allocate significant budget resources to this area. Given the

projected resource envelope, the government intends to contain nonsecurity expenditure growth to about 10 percent per year over the next three to five years—less than or equal to projected nominal GDP growth—while safeguarding critical propoor spending, including on education and health. In addition, the government will have to take over projects currently run by donors. This will lead to growing operations and maintenance costs that constitute another source of fiscal pressures.

### Alternative Macroeconomic Scenarios

**Given the large uncertainties, Afghanistan’s macroeconomic outlook is best described by using plausible alternative scenarios.** Uncertainties arise from the growth outlook and the many spending pressures facing the government within a very tight resource envelope. Two alternative scenarios illustrate the sensitivity of the baseline projection to its main assumptions. The first alternative scenario (a “lower growth” scenario) examines the sensitivity of the macroeconomic framework to a lower-growth outlook, with the negative impact of the military withdrawal (transition) and challenges of economic transformation on growth being larger than assumed in the baseline. The second alternative scenario (a “lower grants” scenario) evaluates the economy’s prospects under more rapid donor grant withdrawal than previously assumed the transition/transformation phase.

**Under the “lower growth” scenario, transition and transformation would have a more negative impact on growth than assumed in the baseline.** Given the limited information on local content and fiscal multipliers, there is considerable uncertainty about the impact of transition and transformation on growth. The “lower growth” scenario traces the macroeconomic effects of transition and transformation, reducing growth by an additional 4–5 percentage points compared to the baseline. This would lead to lower fiscal revenues, which would reduce the government’s resource envelope even further, putting crucial security and development spending at risk. In this situation, donors are assumed to increase grants to the development budget in subsequent years to mitigate the adverse growth effects.

**In a “faster donor withdrawal” (or “lower grants”) scenario, a swifter donor exit in the transformation period compromises development spending and growth.** In this case, grants to the external and development budgets decrease at a faster rate than in the baseline, while the handover of security expenditures remains unchanged. The assumption is that donors continue funding the national security forces, but cut back their support to the broader economy. Part of this process of withdrawal involves moving large operations and maintenance expenditures onto the budget. This leads to rapidly rising fiscal deficits, reflecting spiraling expenditures and lagging revenue efforts due to a loss of donor support for vital reforms. Pressures will mount rapidly as the government will be forced to choose between its security and various development priorities.

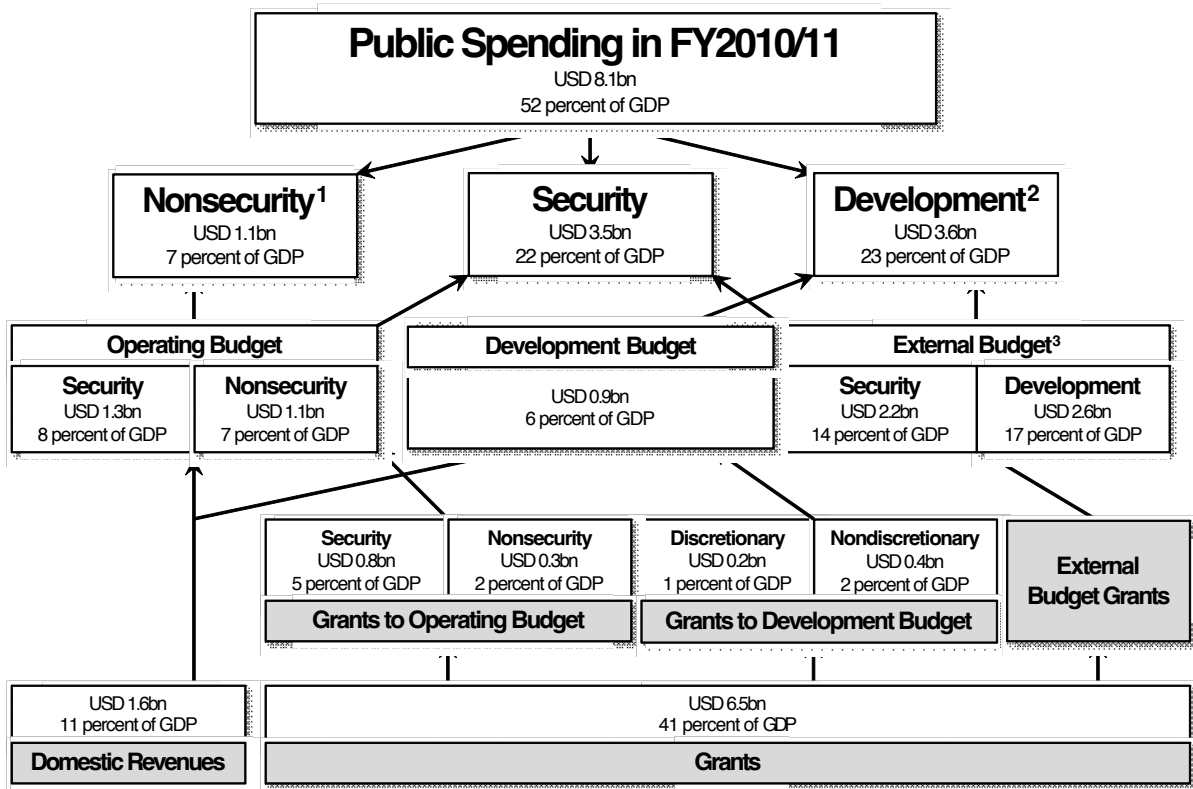
**In both alternative scenarios, the government is faced with much greater fiscal pressures than in the baseline scenario.** Under both scenarios, the annual fiscal deficit (including grants) is steadily increasing over the next five years to about 6 percent of GDP in the “lower growth” scenario and 12 percent in the “lower grants” scenario by 2016/17, while

public debt would reach about 30 and 40 percent of GDP, respectively, if market financing could be secured in these amounts (Figure 2). The domestic financial market is likely to be limited in its ability to provide to finance the government, the expected introduction of domestic securities (*sukuks*) notwithstanding. Access to external borrowing is also likely to be limited, and would be very costly. Leaving aside the question of availability of financing, a rapid buildup of debt as in the two alternative scenarios is not sustainable. Indeed, as the joint IMF-World Bank debt sustainability analysis shows, Afghanistan is at high risk of debt distress and should restrict any borrowing to highly concessional financing for specific projects with a clearly identified economic return (see the most recent Debt Sustainability Analysis<sup>1</sup>). Faced with such high financing needs, there would also be risks that the central bank would be called on to monetize the government deficit, undermining macroeconomic stability.

## Conclusion

**Managing Afghanistan's macroeconomic challenges will require a mix of domestic reforms and continued donor support.** Under their IMF-supported program, Afghanistan has put forward a reform strategy that aims to address the country's macroeconomic challenges. Governance reforms, including the financial sector, are intended to create an environment where the private sector can become the engine of inclusive growth. Safeguarding central bank independence, maintaining low inflation, and strengthening the financial sector including through improved supervision, are also needed to create an enabling environment for the private sector. Revenue efforts are focused on administrative reforms and introducing a VAT in 2014. In the public financial management area, the authorities seek to improve expenditure control and budget execution capacity, combined with prioritization of spending in the context of a medium-term budget framework. These efforts are essential, and some will take time to bear fruit. Continued donor support will therefore be needed to ensure that Afghanistan can make progress toward its social and development objectives.

**Figure 1. Afghanistan: Sources and Uses of Funds**

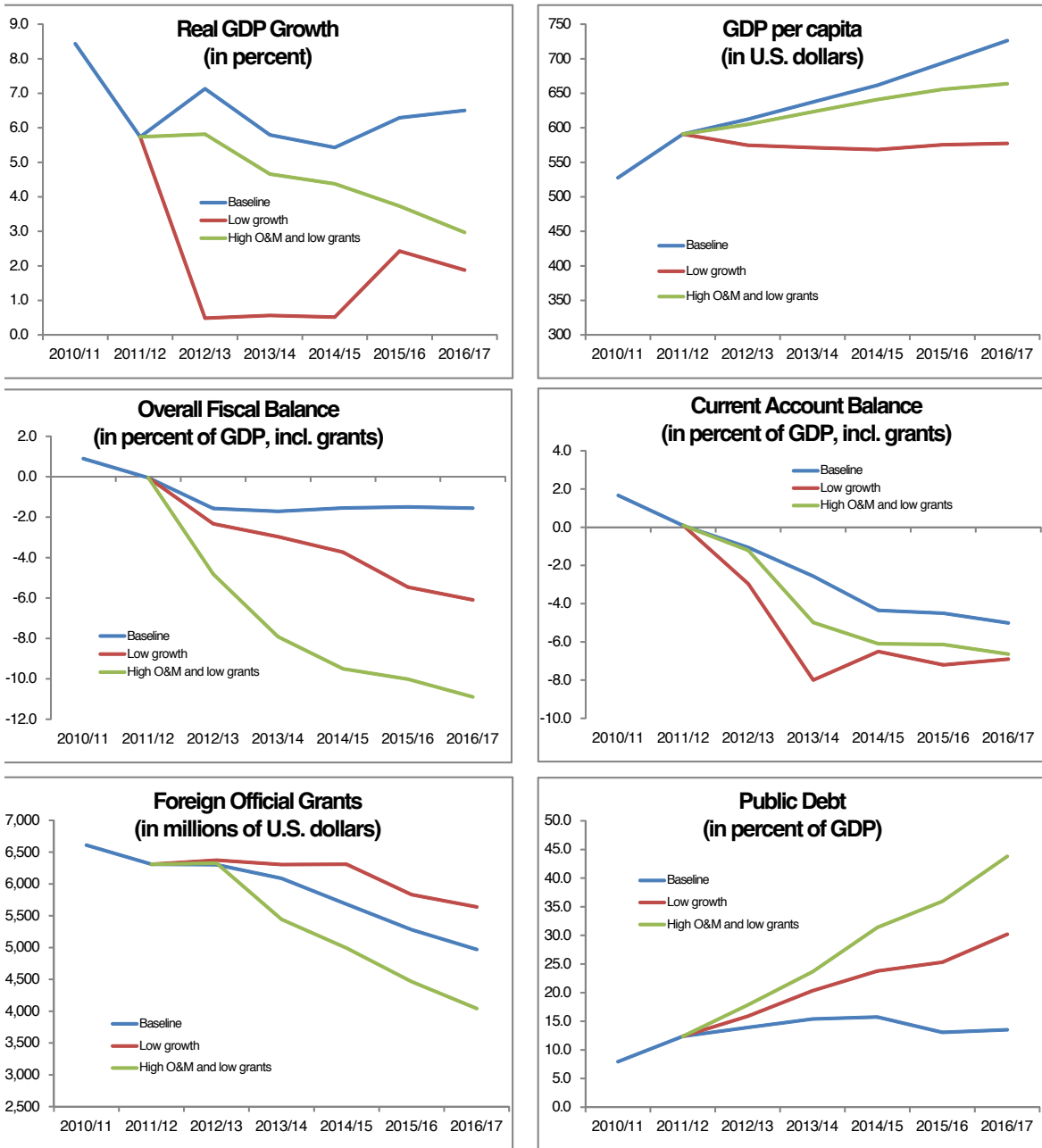


<sup>1</sup> This category covers spending on education, health and all other nonsecurity sectors across government.

<sup>2</sup> Development expenditures include significant noncapital security spending, e.g. private protection companies.

<sup>3</sup> Estimated local spending content ('cash impact') of external budget. 100 percent donor-financed.

**Figure 2. Afghanistan: Baseline and Alternative Scenarios**



Source: IMF staff simulations