Program Note: Islamic Republic of Afghanistan
April 2016

Background

Over the past decade, Afghanistan has made enormous progress in reconstruction, development, and lifting per capita income. The authorities have taken steps to lay the foundation for economic stability and growth, to reduce poverty, and to achieve social and development objectives despite a very difficult security situation and the challenges associated with building political and economic institutions. However, security conditions, political uncertainty, and weak institutions continue to constrain growth and weigh on social outcomes. The international community has delivered substantial financial support to fund development and security spending and pledged to continue doing so over the medium term. Donors will discuss aid for Afghanistan at two conferences this year, in Warsaw in July and in Brussels in October.

Afghanistan is one of the poorest countries in the world and relies heavily on donor grants. Per capita income for 2014 is estimated at about US$660, and the country ranks well below its neighbors on most human development indicators despite its progress toward meeting its social and development objectives and the Millennium Development Goals (MDGs). For example, child mortality has been reduced and school enrollment increased, albeit from very low levels—the enrollment rate for primary school is less than 40 percent. At the same time, achievements in some areas are below expectations: more progress is needed in reducing the number of children under the age of five that are underweight; in increasing access to potable water and sanitation; and improving literacy rates for men and women aged 15 to 24. Overall, the low implementation rate of the development budget impedes more rapid progress toward poverty reduction. Despite these challenges, Afghanistan became one of 20 fragile and conflict-affected states that have already met one or more of the MDGs.

Role of the IMF and IMF-Supported Programs

In 2001 Afghanistan's infrastructure and institutions were in disarray as a result of years of conflict and erratic policies. The most pressing economic tasks involved restoring economic stability and rebuilding institutions, against the challenging backdrop of an unstable security situation. The IMF became involved in Afghanistan in 2002, to assist in rebuilding economic institutions and to provide advice to the government on economic policies and reforms. The IMF has been providing technical assistance to develop monetary instruments, strengthen the central bank, modernize foreign exchange regulations, revamp tax and customs administration, establish a fiscal regime for the natural resources sector, enhance public financial management, and improve the national accounts, and price and balance of payments statistics.

With significant domestic efforts and donor support, Afghanistan has maintained macroeconomic stability, implemented important structural reforms, and built policy buffers—namely a comfortable international reserves position, low debt and inflation, and balanced budget and external current account positions, after grants. Improved economic performance and reforms implemented in key areas enabled Afghanistan to qualify for debt relief under the Heavily Indebted Poor Country Initiative in

January 2010, leading to a 96 percent reduction in Afghanistan's 2006 stock of external debt. Following this extensive debt relief, Afghanistan's debt burden was alleviated significantly—external public and publicly guaranteed debt amounted to $1.35 billion, or 6.6 percent of GDP, at end-2014.

The first IMF-supported program during 2006–10 was broadly successful in maintaining macro stability and promoting reform. Under the second three-year IMF arrangement which started on November 14, 2011, macro stability was preserved but reform implementation slowed. After the first program review in June 2012, subsequent reviews were delayed due to missed quantitative targets and slow pace of structural reforms. Notwithstanding delayed reviews, the IMF maintained a close dialogue with Afghanistan on economic policy and reforms through a set of informal quantitative targets and policy actions.

Developments in 2014

Afghanistan completed the first-ever peaceful transfer of power in the country's recent history in September 2014, with the conclusion of protracted presidential elections and establishment of the unity government. This transfer of power raised hopes and signaled the Afghan people's desire for change. The international community and key donors reaffirmed their partnership and commitment to Afghanistan's future at the London Conference in December 2014. They welcomed the new government's commitment to macroeconomic stability and reforms that will promote sustainable and inclusive growth.

However, political and security uncertainties associated with presidential elections and the drawdown of international troops have weighed on economic performance, weakening confidence, and slowing growth down from 14 percent in 2012 to 1.3 percent in 2014. Weak domestic demand, coupled with lower international food prices, has led to deflation. Subpar growth, deflation, declining imports, and lower tax compliance resulted in a decline in domestic revenue collection, while higher social and development expenditures added to spending. As a result, the treasury's cash position deteriorated and arrears were incurred. A deterioration in the banking sector's asset quality exposed vulnerabilities and weaknesses, with eight of 16 banks rated as weak.

2015 Staff-Monitored Program (SMP)

Against this background, IMF management approved a nine-month SMP aimed at addressing fiscal and banking vulnerabilities, preserving macroeconomic stability (low inflation, low debt, and a comfortable international reserves position), improving prospects for higher and inclusive growth, and providing a track record of policy implementation.

Under the SMP, fiscal policy focused on mobilizing domestic revenue to finance projected expenditure and rebuild the treasury's cash balance, monetary policy on preserving low inflation, and exchange rate policy on protecting international reserves and strengthening competitiveness. Financial sector reforms were enacted to help address some of the problems with weak banks, promulgate and implement the new banking law, amend the central bank law, strengthen banking supervision, and address weaknesses in state banks.

The SMP came to an end in December 2015 with its objectives largely achieved. Performance was satisfactory and both the first and second reviews were completed on time. All end-December 2015 quantitative targets were met and actions required by structural benchmarks completed.

Next Steps

While security challenges make it difficult to ignite private sector-led and inclusive growth to its full potential, striving toward it should remain a target and a guide for the Afghan government. To that end, the government should aim at eliminating regulatory and administrative barriers for businesses, improving infrastructure, and providing key business services, while strengthening in parallel macroeconomic management, financial sector, and economic governance structures.

Over the medium term, Afghanistan would continue to need substantial grant financing from donors to finance development and security needs, support the move toward fiscal sustainability, and enhance confidence in the Afghan economy.

In this context, the authorities have reiterated their interest in a financial arrangement with the Fund, stressing that a Fund-supported program would boost confidence and catalyze continued reforms supported by donor grants. They have called for such a program to be focused and tailored to the local context; to be linked to their upcoming National Development Strategy; to focus on the conditions for durable growth and poverty reduction; and to help secure continued foreign aid.