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Afghanistan

Economic Performance Assessment



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Afghanistan

Economic Performance

Assessment

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- A synthesis of key data indicators drawn from numerous sources, including the World Bank, the International Monetary Fund, the Millennium Challenge Corporation, the United Nations, other international data sets, and accessible host-country documents and data sources;
- International benchmarking to assess country performance in comparison to similar countries, groups of countries, and predicted values based on international data;
- An easy-to-read analytic narrative that highlights areas in which a country's performance is particularly strong or weak, to assist in the identification of future programming priorities.
- A convenient summary of the main findings, in the form of a Highlights Table and a Performance Scorecard (in lieu of an Executive Summary)

Under Contract No. GEG-I-00-04-00002-00, Task Order 004, 2006-2008, Nathan Associates continues to provide support to the EGAT Bureau by producing analytical reports evaluating economic growth performance in designated host countries. Through the same task order, Nathan is also developing a special template for countries emerging from crisis, assessing data issues in countries with large gaps in their data; conducting in-depth sector reviews based on the diagnostic analysis in the country reports; and providing other analytical support to the EGAT Bureau.

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Contents

| | |
|---|-----------|
| Highlights of Afghanistan’s performance | v |
| Afghanistan: Notable Strengths and Weaknesses—Selected Indicators | vii |
| 1. Introduction | 1 |
| Methodology | 1 |
| Data Quality and Format | 3 |
| 2. Overview of the Economy | 5 |
| Growth Performance | 5 |
| Poverty and Inequality | 7 |
| Economic Structure | 9 |
| Demography and Environment | 10 |
| Gender | 12 |
| 3. Conflict Risk | 13 |
| Social Indicators | 14 |
| Economic Indicators | 15 |
| Political and Military Indicators | 15 |
| Capacities of the State | 16 |
| 4. Private Sector Enabling Environment | 19 |
| Fiscal and Monetary Policy | 19 |
| Business Environment | 21 |
| Financial Sector | 23 |
| External Sector | 24 |
| Economic Infrastructure | 29 |
| Science and Technology | 30 |
| 5. Pro-Poor Growth Environment | 33 |
| Health | 33 |
| Education | 35 |

| | |
|--------------------------|----|
| Employment and Workforce | 37 |
| Agriculture | 37 |

Appendix. CAS Methodology

Illustrations

Figures

| | |
|--|----|
| Figure 2-1. Real GDP Growth | 6 |
| Figure 2-2. Share of Gross Fixed Investment in GDP..... | 7 |
| Figure 2-3. Human Poverty Index..... | 8 |
| Figure 2-4. Output Structure | 9 |
| Figure 4-1. Inflation Rate, 2002/2003 through 2005/2006 | 20 |
| Figure 4-2. Money Supply Growth..... | 21 |
| Figure 4-3. Trade as a Percentage of GDP..... | 25 |
| Figure 4-4. Annual Growth of Exports of Goods and Services | 26 |
| Figure 4-5. Aid as a Percentage of Gross National Income..... | 28 |
| Figure 4-6. Internet Usage | 30 |
| Figure 5-1. Life Expectancy at Birth | 34 |
| Figure 5-2. Public Health Expenditure, percent of GDP | 34 |
| Figure 5-3. Youth Literacy Rate | 36 |
| Figure 5-4. Annual Percentage Growth in Agricultural Output, 2002/2003 to 2005/2006..... | 38 |

Tables

| | |
|---|----|
| Table 1-1. Topic Coverage | 3 |
| Table 3-1. Component Ratings of Afghanistan's 2006 CAST Scores..... | 14 |
| Table 3-2. Core Ratings of Capacity of Afghan State Institutions, 2006..... | 16 |

HIGHLIGHTS OF AFGHANISTAN'S PERFORMANCE

| | |
|----------------------------|--|
| Economic Growth | Economic growth has averaged 17 percent since 2002, fueled by high levels of investment. However, private investment remains too low to drive growth and job creation. |
| Poverty | Seventy percent of the population lives on less than two dollars a day, and the country ranks near the bottom in UNDP's global Human Poverty Index. |
| Economic Structure | Services account for nearly 40 percent of GDP while employing one-tenth the labor force. Agriculture's share of GDP has declined steadily, although it still employs four out of five workers. |
| Demography and Environment | A large proportion of the population is very young, while adult literacy is low, at 28 percent. Migration to both internal and international destinations is common. |
| Gender | Gender inequalities are severe. Unlike in most countries, women's life expectancy (44 years) is lower than men's (45 years). The ratio of male to female gross enrollment is extremely high, at 2.0. |
| Fiscal and Monetary Policy | Government revenues have increased but still do not cover government expenditures. The Central Bank reduced inflation in 2005/2006 by slowing growth of the money supply. |
| Conflict Status | Afghanistan's score for 2006 on the Failed States Index falls in the "critical" category. Weak institutional capacity leaves the country vulnerable to a collapse. |
| Business Environment | Afghanistan is one of the world's most difficult places to do business. Problems include difficulty enforcing contracts, delays in registering property, high security costs, and corruption. One bright spot is the small amount of time necessary to start a business. |
| Financial Sector | The financial sector is underdeveloped. The ratio of broad money to GDP has increased but remains far below the median of the low income Asian countries. Credit information is virtually unavailable, and collateral and bankruptcy laws are weak. |
| External Sector | Nontariff barriers to trade keep trade's share of GDP relatively low, but exports grew by 10.7 percent in 2005/2006. Foreign investment remains low and dependence on foreign aid is high. Remittances are vital to the economy: they equaled 65 percent of the value of exports in 2005/2006. |
| Economic Infrastructure | Information technology and communications infrastructure is weak but improving dramatically. Less than a quarter of all roads are paved. |
| Science and Technology | Anecdotal evidence suggests that capacities to develop and apply science and technology are weak. |
| Health | Maternal mortality rate is among the world's highest at 1,900 deaths per 100,000 live births. The child immunization rate rose from 20 percent in 2000 to 61 percent in 2003, but remains substantially lower than in comparators. |
| Education | Youth literacy is low: only 51 percent of boys and 18 percent of girls can read. The pupil-teacher ratio is 65 to 1, far higher than the LI-Asia median of 35 to 1. |
| Employment and Workforce | Unemployment is one of Afghans' primary concerns, yet rigid employment regulations impede businesses' ability to hire workers. |
| Agriculture | Cereal yields have improved but remain well below the regression benchmark and the LI-Asia median. |

Note: The methodology used for diagnostic benchmarking is explained in the Appendix.

AFGHANISTAN: NOTABLE STRENGTHS AND WEAKNESSES— SELECTED INDICATORS

| Indicators, by topic | Notable Strengths | Notable Weaknesses |
|---|-------------------|--------------------|
| Growth Performance | | |
| Per capita GDP, current US dollars | | ✓ |
| Real GDP growth | ✓ | |
| Investment productivity – capital-output ratio (ICOR) | ✓ | |
| Gross fixed private investment, percentage of GDP | | ✓ |
| Poverty and Inequality | | |
| Human poverty index | | ✓ |
| Demography and Environment | | |
| Adult literacy rate | | ✓ |
| Youth dependency rate | | ✓ |
| Gender | | |
| Female gross enrollment rate | | ✓ |
| Conflict Status | | |
| Failed States Index | | ✓ |
| Fiscal and Monetary Policy | | |
| Government revenue, excluding grants, percentage of GDP | | ✓ |
| Overall government budget balance, percentage of GDP | ✓ | |
| Business Environment | | |
| Ease of doing business ranking | | ✓ |
| Rule of law index | | ✓ |
| Cost of starting a business, percentage of GNI per capita | ✓ | |
| Financial Sector | | |
| Credit information index | | ✓ |
| Legal rights of borrowers and lenders | | ✓ |
| External Sector | | |
| Present value of debt, percentage of GNI | ✓ | |
| Gross international reserves, months of imports | ✓ | |
| Aid, percentage of GNI | | ✓ |
| Trade in goods and services, percentage of GDP | | ✓ |
| Remittance receipts, percentage of exports | ✓ | |
| Economic Infrastructure | | |
| Internet users per 1,000 people | | ✓ |
| Telephone density, fixed line and mobile | | ✓ |

| Indicators, by topic | Notable Strengths | Notable Weaknesses |
|-------------------------------------|-------------------|--------------------|
| Health | | |
| Life expectancy at birth | | ✓ |
| Maternal mortality rate | | ✓ |
| HIV prevalence | ✓ | |
| Education | | |
| Youth literacy rate | | ✓ |
| Persistence to grade 5, total | | ✓ |
| Pupil-teacher ratio, primary school | | ✓ |
| Employment and Workforce | | |
| Rigidity of employment index | | ✓ |

Note: The chart identifies selective indicators for which Afghanistan's performance is particularly strong or weak relative to benchmark standards, as explained in the appendix. Details are discussed in the text. The separate Data Supplement presents a full tabulation of the data and international benchmarks examined for this report, along with technical notes on the data sources and definitions. The supplement is available at <http://www.nathaninc.com/projects/projectdetails.asp?pid=138&pfid=0&rpil=4&rid=9>.

1. Introduction

This report is one of a series of economic performance assessments prepared for the EGAT Bureau to provide USAID missions and regional bureaus with a concise evaluation of key indicators covering a broad range of issues relating to economic growth performance in designated host countries. The report draws on a variety of international data sources¹ and uses international benchmarking against reference group averages, comparator countries, and statistical norms to identify major constraints, trends, and opportunities for strengthening growth and reducing poverty. This study uses Cambodia and Mozambique as comparators because they, like Afghanistan, are low-income countries that endured prolonged conflicts. Both have now been at peace for more than a decade, and Afghanistan's performance can aspire to be like them within the next ten years. In addition, Afghanistan's performance is compared to median values of Asian countries and low-income countries in Asia (LI-Asia).

METHODOLOGY

The methodology used here is analogous to examining an automobile dashboard to see which gauges are signaling problems. Sometimes a blinking light has obvious implications—such as the need to fill the fuel tank. In other cases, it may be necessary to have a mechanic probe more deeply to assess the source of the trouble and determine the best course of action.² Similarly, the Economic Performance Assessment is based on an examination of key economic and social indicators, to see which ones are signaling problems. In some cases a “blinking” indicator has clear implications, while in others detailed studies may be needed to investigate the problems more fully and identify appropriate courses for programmatic action.

The analysis is organized around two mutually supportive goals: transformational growth and poverty reduction.³ Rapid and broad-based growth is the most powerful instrument for poverty reduction. At the same time, programs to reduce poverty and lessen inequality can help to underpin rapid and sustainable growth. These interactions can create a virtuous cycle of economic transformation and human development.

¹ Sources include the World Bank, the International Monetary Fund, the Millennium Challenge Corporation, the United Nations (including the Millennium Development Goals database), the World Economic Forum, and host-country documents and data sources. This report reflects data available as of early February 2007.

² Sometimes, too, the problem is faulty wiring to the indicator—analogue here to faulty data.

³ In USAID's white paper *U.S. Foreign Aid: Meeting the Challenges of the Twenty-first Century* (January 2004), transformational growth is a central strategic objective, both for its innate importance as a development goal and because growth is the most powerful engine for poverty reduction.

Transformational growth requires a high level of investment and rising productivity. This is achieved by establishing a strong *enabling environment for private sector development*, involving multiple elements: macroeconomic stability; a sound legal and regulatory system, including secure contract and property rights; effective control of corruption; a sound and efficient financial system; openness to trade and investment; sustainable debt management; investment in education, health, and workforce skills; infrastructure development; and sustainable use of natural resources.

In turn, the impact of growth on poverty depends on policies and programs that create opportunities and build capabilities for the poor. We call this the *pro-poor growth environment*.⁴ Here, too, many elements are involved, including effective education and health systems, policies facilitating job creation, agricultural development (in countries where the poor depend predominantly on farming), dismantling barriers to micro and small enterprise development, and progress toward gender equity.

In countries such as Afghanistan that have been plagued by conflict, there is also a critical interaction between security conditions and economic performance. Overt conflict, or even the risk of serious conflict, can adversely affect growth; conversely, an end to conflict should deliver a peace dividend. In addition to conflict affecting the economy, economic conditions can also exacerbate or help to ameliorate security problems. Thus, it is essential to view economic performance in Afghanistan through a conflict lens. Accordingly, this report includes a section on conflict risk; we also assess signs of how conflict may be affecting economic performance throughout the paper.

The present evaluation must be interpreted with care. A concise analysis of selected indicators cannot provide a definitive diagnosis of economic performance problems, nor simple answers to questions about programmatic priorities. Instead, the aim of the analysis is to spot signs of serious problems affecting economic growth, subject to limits of data availability and quality. The results should provide insight about potential paths for USAID intervention, to complement on-the-ground knowledge and further in-depth studies.

The remainder of the report presents the most important results of the diagnostic analysis, in four sections: Overview of the Economy; Conflict Risk; Private Sector Enabling Environment; and Pro-Poor Growth Environment. Table 1-1 summarizes the topical coverage. The appendix provides a brief explanation of the criteria used for selecting indicators, the benchmarking methodology, and a table showing the full set of indicators examined for this report.

⁴ A comprehensive poverty reduction strategy also requires programs to reduce *vulnerability* of the poor to natural and economic shocks. This aspect is not covered in the template since the focus is economic growth programs. In addition, it is difficult to find meaningful and readily available indicators of vulnerability to use in the template.

Table 1-1
Topic Coverage

| Overview of the Economy | Conflict Status | Private Sector Enabling Environment | Pro-Poor Growth Environment |
|---|--|--|--|
| <ul style="list-style-type: none"> •Growth Performance •Poverty and Inequality •Economic Structure •Demographic and Environmental Conditions •Gender | <ul style="list-style-type: none"> •Conflict Assessment •Economic Impact of the Conflict | <ul style="list-style-type: none"> •Fiscal and Monetary Policy •Business Environment •Financial Sector •External Sector •Economic Infrastructure •Science and Technology | <ul style="list-style-type: none"> •Health •Education •Employment and Workforce •Agriculture |

DATA QUALITY AND FORMAT

The breadth and quality of economic data collected for Afghanistan have improved over the past five years, but data for many indicators remain incomplete. Throughout this report, we note topics for which data are particularly sparse or problematic, but deficiencies persist in almost every topical area. Because robust economic data are imperative for sound economic planning, improving data quality should remain high on donors' lists of priorities.

For many indicators used in this report, data are presented for periods corresponding to the Afghan fiscal year—approximately March 21 to March 20. If the period in question is March 2004–March 2005, the period is referred to as “2004/2005.” Data collected from January to December are referenced accordingly (i.e., as pertaining to 2004 or 2005). In the IMF's World Economic Outlook database, data were recorded for single years, but cross-checks with other IMF sources and reports of Afghanistan's Central Bank revealed that the data in fact applied to the Afghan fiscal year.

2. Overview of the Economy

This section reviews basic information on Afghanistan's macroeconomic performance, poverty and inequality, economic structure, demographic and environmental conditions, and indicators of gender equity. Some of the indicators cited here are descriptive rather than analytical and are included to provide context for the performance analysis.⁵

GROWTH PERFORMANCE

Afghanistan has achieved good economic recovery and growth since 2002: non-drug real GDP grew by an average of 16.6 percent per year between March 2002 and March 2006.⁶ Growth slowed from 15.7 percent in 2003/2004⁷ to a still-high 8 percent in 2004/2005, then rebounded to 14.0 percent in 2005/2006, supported by the agricultural sector's recovery from the previous year's drought.⁸ The latter figure is more than twice the regression benchmark for a country with Afghanistan's characteristics (5.9 percent) and greater than the real GDP growth rates in Cambodia (13.4 percent) and Mozambique (7.7 percent) (both for 2005) (see Figure 2-1). Some of the initial growth is due to rebound from a wartime economic collapse, yet the 8 percent growth that the IMF predicts for 2006/2007 is due to continued strength in the construction and services sectors.⁹

The economy still suffers from decades of conflict and a series of governments that ignored prudent macroeconomic policies and the state's infrastructure. Despite steady recent economic growth, 2005/2006 per capita income is \$300.5 (in current U.S. dollars). This is well below the benchmarks of Cambodia (\$430.3), and also below Mozambique (\$331.4), and the median of low-income countries in Asia (LI-Asia) (\$547.5), all for 2005.

⁵ The Data Supplement provides a full tabulation of the data for Afghanistan and the international benchmarks, including indicators not discussed in the text, as well as technical notes for each indicator.

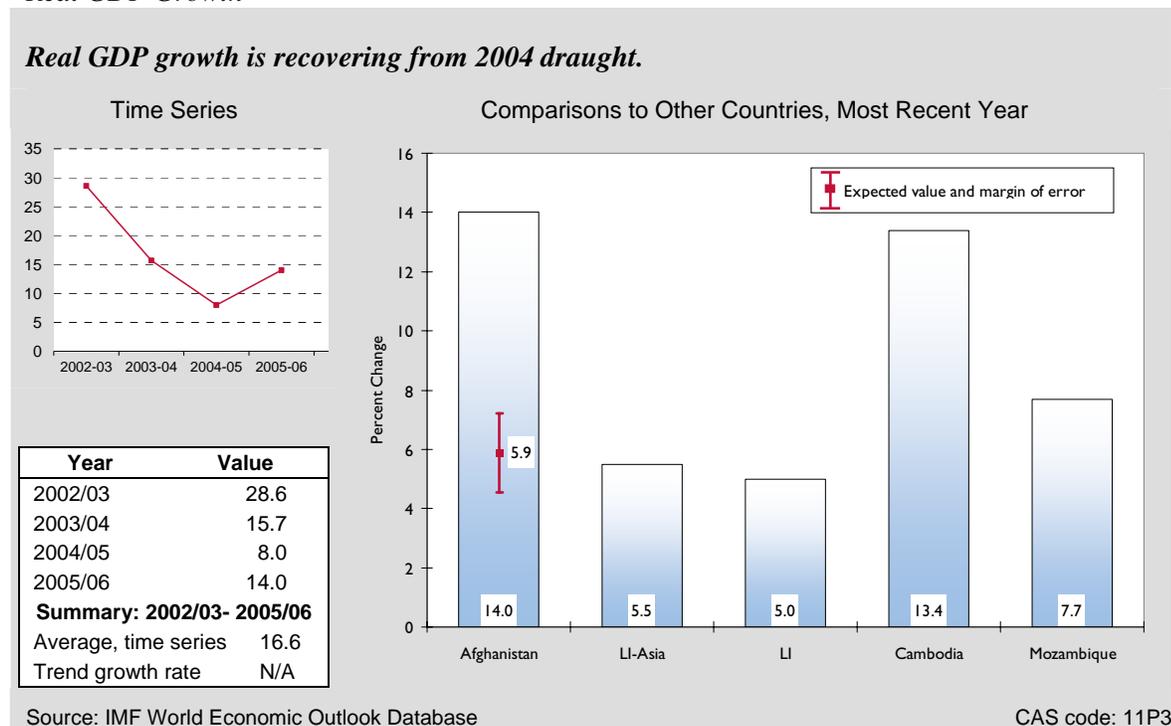
⁶ GDP statistics do not take into account poppy production.

⁷ This refers to the Afghan fiscal year, approximately from March 21, 2003 to March 20, 2004.

⁸ Da Afghanistan Bank, *Quarterly Economic and Statistical Bulletin: Quarter I, 1385 (2006-2007)*, August 2006, 8.

⁹ IMF, *Islamic Republic of Afghanistan – Statement of the IMF Staff at the Conclusion of the Mission for the First Review Under the Poverty Reduction and Growth Facility*, November 26, 2006. <http://www.imf.org/external/np/ms/2006/112606.htm>.

Figure 2-1
Real GDP Growth



Afghanistan's strong economic growth is fueled by high investment rates and strong investment productivity. Gross fixed investment averaged 40.1 percent of GDP for 2002–2006, with annual figures close to double those of all the comparators. This level of investment reflects international donors' assistance in intensive rebuilding of infrastructure and reconstruction (see External Sector, p. 24), and significant growth in the industrial sector (see Economic Structure, p. 9).¹⁰ Investment productivity is relatively high. A simple way to measure this is by examining the incremental capital–output ratio (ICOR), which shows the amount of investment needed per unit of extra output; a high ICOR indicates low efficiency. Afghanistan's ICOR of 2.4 is lower than Cambodia's (2.5), Mozambique's (3.5) and the LI-Asia median (4.5), showing that investment in Afghanistan is more efficient than in these comparators.

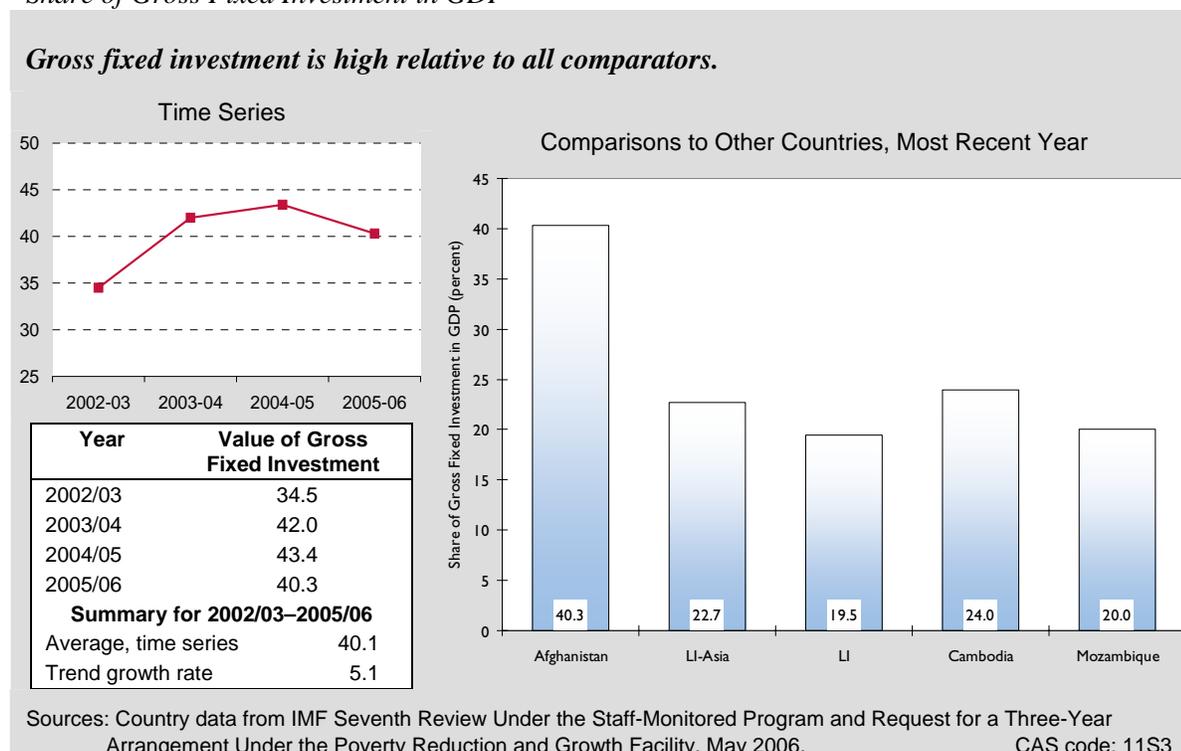
Gross fixed investment's share of GDP in Afghanistan is significantly stronger than all comparators. See Figure 2-2. Afghanistan's 40.3 percent is more than double the average of the LI countries. However, most of this is not private investment. Gross fixed private investment's share of GDP rose from 7.5 percent in 2002/2003 to 9.6 percent in 2005/2006, too low to drive growth and job creation. Afghanistan simply lacks the basic factors to induce investment: political and economic stability and security, unambiguous regulations, enforceable and reasonable tax rates, access to finance and infrastructure, and appropriately skilled workforce.¹¹

¹⁰ Da Afghanistan Bank, *Quarterly Economic and Statistical Bulletin: Combined Issue 1384 (2005-06)*, April 2006, section 1.1, no pp.; and Da Afghanistan Bank, August 2006, pp 8-9.

¹¹ World Bank, *Afghanistan: Investment Climate*, <http://web.worldbank.org/WBSITE/EXTERNAL/COUNTRIES/SOUTHASIAEXT/0,,contentMDK:20973586~pagePK:146736~piPK:146830~theSitePK:223547,00.html>, accessed February 10, 2007.

The Afghan government is taking steps to improve the business environment, but key challenges remain to be addressed (see Section 4).

Figure 2-2
Share of Gross Fixed Investment in GDP



POVERTY AND INEQUALITY

The Afghanistan government has yet to carry out a census or delineate a national poverty line. Although Afghanistan's National Development Strategy has been accepted recently as the Interim Poverty Reduction Strategy Paper (I-PRSP), no recent reliable data on poverty are available.

By most accounts poverty is a severe problem in Afghanistan. The *Afghanistan National Human Development Report 2004* presents the Human Poverty Index estimates for Afghanistan at 59.3 for 2004¹²—close to the average of the five worse-performing nations in the world, 60.6. See Figure 2-3. Additional evidence comes from a 2003 government survey of rural households and a subsequent World Bank analysis,¹³ which found that nearly 48 percent of the surveyed households fell below the study's proxy for the rural poverty line—the threshold for minimum daily food consumption expenditure.¹⁴ An estimated 70 percent of the population lived on less

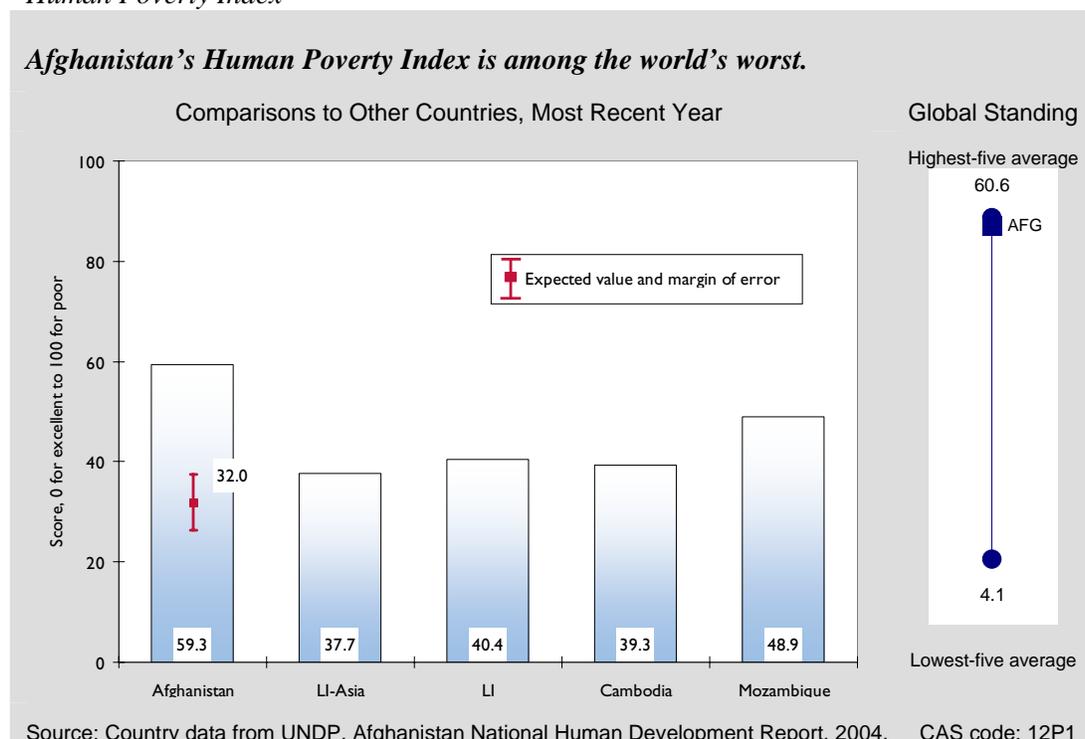
¹² United Nations Development Program, *Afghanistan National Human Development Report, 2004*, Chapter 2, p.23.

¹³ This is not a typical indicator, and thus the data is not present in the Data Supplement.

¹⁴ Christine Allison et al. *Afghanistan—Poverty, Vulnerability and Social Protection: an Initial Assessment*, World Bank, 2005, 27; survey data from Ministry of Rural Rehabilitation and Development, *2003 National Risk and Vulnerability Assessment in Rural Afghanistan*. The indicator is defined as “the

than \$2 a day in purchasing power parity terms in 2003.¹⁵ Although this is high in absolute terms, the rate is lower than that predicted by the regression benchmark (78.5 percent), or in the rate of Cambodia (77.7 percent for 2004) or Mozambique (78.4 percent for 2004). In addition, the proportion of the population living on less than the minimum dietary energy consumption was estimated at 20.4 percent during 2003, lower than all the comparators.

Figure 2-3
Human Poverty Index



According to the International Crisis Group's report on countering Afghanistan's insurgency, public discontent is growing at the lack of change among the most poverty stricken, particularly jobless youths. The most poverty stricken are also the most likely to be recruited by insurgents, and disillusionment encourages individuals to provide insurgents safe haven and support.¹⁶

The income distribution in Afghanistan, along with the high incidence of poverty, is also marked by a high degree of inequality. For 2003, the share of income accruing to the bottom quintile of

annual cost of the minimum daily caloric requirement recommended for rural Afghanistan." This was estimated at 2,100 calories per day. The threshold value was established as Af. 4,621 per capita per year, or \$0.30 per capita per day in 2003.

¹⁵ World Bank staff estimates, in a government/interagency report, *Securing Afghanistan's Future: Accomplishments and the Strategic Path Forward*, prepared for international conference March 2004, 3, Table 1.1.

¹⁶ International Crisis Group, *Countering Afghanistan's Insurgency: No Quick Fixes*, November 2006, i, and 12.

household is just 6 percent. This is below all the comparators, including the normal range of values predicted by the regression benchmark (7.9).

Afghanistan's high rates of poverty and inequality not only pose critical policy problems in their own right, but may destabilize the country and impede economic growth by heightening social and political tensions by creating risks that deter investment and by making it difficult to achieve consensus on reforms. Afghanistan's I-PRSP sets an ambitious goal: to ensure that Afghanistan meets all Millennium Development Goals in the next 15 years. It also outlines the government's antipoverty strategies for that period. Before the poverty diagnostics and profile can be outlined for the Poverty Reduction Strategy Paper, the government will need to complete its national vulnerability assessment and get baseline data on poverty.

Policymakers and donors must focus not only on stimulating investment and productivity, but also on ensuring that growth creates better opportunities for income and wealth generation in the poorer segments of society.

ECONOMIC STRUCTURE

The broad structure of Afghanistan's output shows a rising share of GDP in services and a declining share in agriculture. Afghanistan's services sector's share of GDP was 39.7 percent in 2005/2006, while agriculture's share was 35.9 percent and industry's 24.4 percent.¹⁷ These figures are comparable to those of Cambodia in 2004 (37.9 percent in services, 32.9 percent in agriculture, and 29.2 percent in industry). The structure of economic output has shifted since 2002/2003, when 49.8 percent of GDP was from agriculture, 20.1 percent from industry, and 30.1 percent from services. The 157 percent increase in transport and communications from 2002/2003 through 2005/2006, accompanied by an only 6 percent increase in agricultural production, is the main contributor to such a quick transformation of the economic structure.¹⁸ See Figure 2-4.

An estimated 80 percent of Afghanistan's labor force was employed in agriculture in 2004, with the remaining 20 percent distributed equally between the services and industry sectors.¹⁹ The percentage working in agriculture falls in line with Mozambique's (81 percent for 2003) exceeds the regression benchmark (69.4 percent), the median for LI-Asia (48.9 percent), and the figure for Cambodia (70.2 percent for 2001).

Comparing the output and employment structures, labor seems to be most productive in services, where a tenth of the workforce contributes nearly 40 percent of output, and least productive in agriculture, where 80 percent of the population produces just over a third of output. This interpretation is erroneous however, because of the fact that an estimated 2 million Afghans are

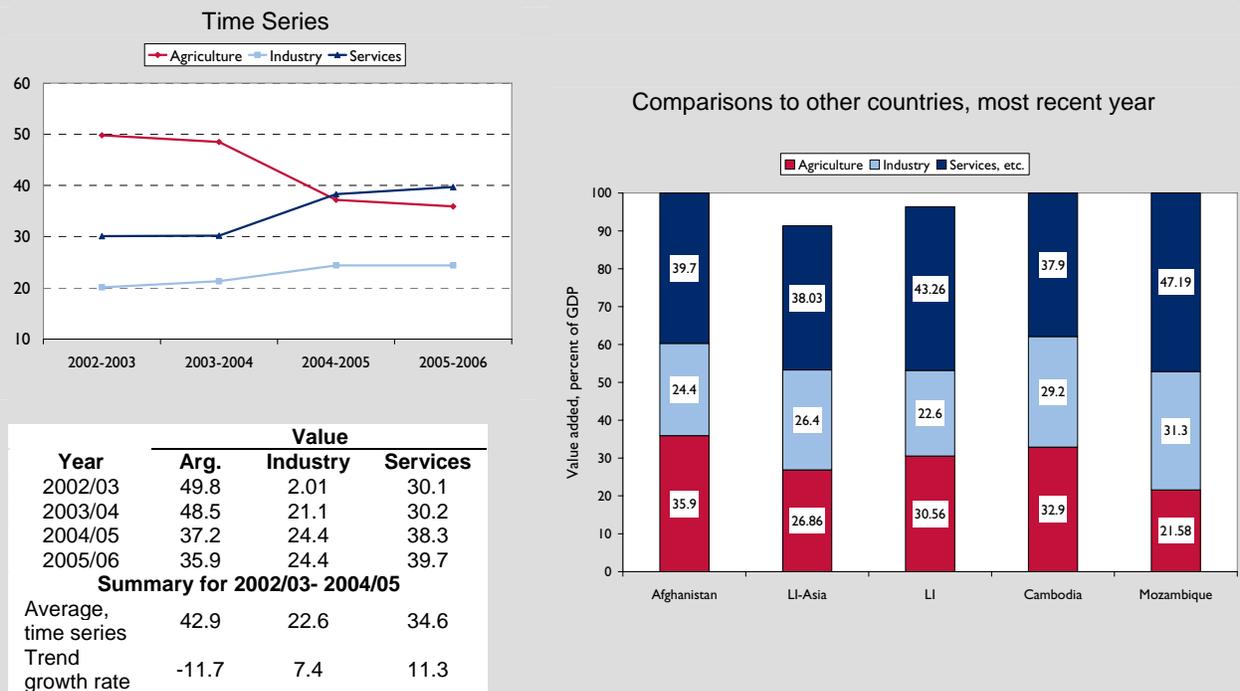
¹⁷ Da Afghanistan Bank, *Quarterly Economic and Statistical Bulletin, Quarter I 1385 (2006-2007)*, August 2006, 10.

¹⁸ IMF, Islamic Republic of Afghanistan: Selected Issues and Statistical Appendix, March 2006, 75, Table 3.

¹⁹ Not available in World Development Indicators. This estimate is from U.S. Central Intelligence Agency, Afghanistan, "The World Factbook," <https://www.cia.gov/cia/publications/factbook/geos/af.html>, accessed February 6, 2007.

involved in illicit opium cultivation,²⁰ which does not appear in national output statistics. When opium production is taken into account, Afghanistan's services sector contributed to 28.6 percent of GDP in 2005/2006, industry 17.6 percent, and agriculture 53 percent.²¹

Figure 2-4

*Output Structure***Services Sector share of GDP is Growing**

Source: Country data from Da Afghanistan Bank, Quarterly Economic and Statistical Bulletin August 2006.

CAS code: 13P2a-c

DEMOGRAPHY AND ENVIRONMENT

Afghanistan's most striking demographic feature is its exceptionally high youth dependency ratio of 1.1, defined as the proportion of youths to the working age population. Afghanistan's population was estimated at 25.0 million with an annual growth rate of 2.9 percent for 2006,²² with more than half of the population consisting of youth under the age of 15. This is of concern. Evidence shows that youth bulges that coexist with poor economic performance can be explosive and lead to national instability.²³ This also highlights the need to expand access to education.

²⁰ U.N. Office on Drugs and Crime, *Summary Findings of Opium Trends in Afghanistan 2005*, 1.

²¹ Calculations are based on value of opium exports from UNODC, 2005, 1 and 19; and relative size of opium production from IMF, *Islamic Republic of Afghanistan: Selected Issues and Statistical Appendix*, March, 2006, 48, Table III.4.

²² IMF, *World Economic Outlook*, April 2007 update. It is not clear whether this estimate accounts for refugee returns.

²³ Henrik Urdal, *The Devil in the Demographics: The Effect of Youth Bulges on Domestic Armed Conflict, 1950-2000*, World Bank, Social Development Paper No. 14, July 2004.

With the right policies and institutions, a rising share of working-age people in the population can boost economic growth in the long term.

The urbanization rate of 24 percent aligns closely with our regression benchmark. A large rural population, however, poses an additional challenge to increasing access to education among youth and working adults. This is evidenced in a very low adult literacy rate of 28.1 percent, a rate—although slightly higher than that of Cambodia (26.4 percent)—considerably below the benchmark for low-income countries in Asia and the rate predicted by our regression.²⁴

Migration is a vital survival mechanism for Afghans. Continued insecurity in many communities, limited agricultural production, and recurring droughts drive migration.²⁵ There were 1.9 million Afghan refugees in other countries at the end of 2005, while 142,505 people were displaced within Afghanistan.²⁶ Migration for income-generating purposes is also important to Afghanistan; the government's 2003 survey of rural households showed that one in five rural households had a family member who had migrated to pursue a higher income, most to Pakistan or Iran.²⁷ Migration cuts across all ethnic and socioeconomic classes, but it is most often able-bodied men who migrate and send remittances to their families.²⁸ At the same time, there have been significant population movements in the opposite direction—the Central Bank estimates that 3.5 million Afghans have returned from abroad since December 2001.²⁹ Donors and Afghan government policymakers must recognize that, given economic and security conditions, Afghans are unlikely to stop moving. They must take the costs and benefits of migration into account, including remittances, so that their medium-term poverty alleviation plans are more effective.

There is no data on Afghanistan's environmental indicators, but UNEP's environmental assessment, during 2002 and 2003, concluded that there are "deep" environmental problems, including deforestation, drought, and erosion.³⁰ The Afghan government seems to be making some effort to protect the environment. Since then, the government, with UNEP assistance, created the National Environmental Protection Agency (NEPA), the first of its kind in Afghanistan. And in 2005, the government passed laws aimed at protecting Afghanistan's wildlife, waterways, and forests, possibly the first conservation legislation in the country.

²⁴ World Bank, January 2007.

²⁵ Elca Stigter and Alessandro Monsutti, *Transnational Networks: Recognizing a Regional Reality*, Afghanistan Research and Evaluation Unit briefing Paper, April, 2005.

²⁶ UNHCR, *2005 Global Refugee Trends*, Field Information and Coordination Support Section, UNHCR Geneva, June 2006, Table 2. <http://www.unhcr.org/statistics/STATISTICS/4486ceb12.pdf>, accessed February 9, 2007.

²⁷ Data from NRVA 2003, in Negar Ghobadi, Johannes Koettl and Renos Vakis, *Moving Out of Poverty: Migration Insights from Rural Afghanistan*, January 2005, 7.

²⁸ Stigter and Monsutti, 5.

²⁹ Da Afghanistan Bank, April 2006, no pp.

³⁰ United Nations Environment Programme, Post-Conflict Branch Report, <http://postconflict.unep.ch/publications/afghanistanpcajanuary2003.pdf>

GENDER

Afghanistan's gender indicators highlight the profound challenges that the country must overcome. Women's lack of access to health care, education, and economic opportunities is reflected in the low female life expectancy at birth. In countries with an advanced level of human development, women live longer than men, typically five years or more. In Afghanistan, women live an average of 44 years, while their male counterparts reach 45 years of age. Although both figures are among the worst in the world, the average life expectancy for women in Afghanistan is particularly alarming because it is a departure from the global tendency of shorter life expectancy for men.

Female-headed households are a particularly vulnerable group. Estimates of the share of female-headed households range from about 16 percent in Kabul to 4–20 percent in three districts in Badakhshan.³¹ The World Bank's Nationwide Risk and Vulnerability Assessment reports that female-headed households are poorer than average.³²

Improving women's access to education and generating employment opportunities for women would lessen gender inequalities while enhancing the productive capacities of the country as a whole.

³¹ World Bank, *Afghanistan: National Reconstruction and Poverty Reduction – the Role of Women in Afghanistan's Future*, March 2005.

³² World Bank. *Afghanistan: National Reconstruction and Poverty Reduction – the Role of Women in Afghanistan's Future*, March 2005.

3. Conflict Risk

Conflict is detrimental to economic growth. According to a recent review of the literature on the links between conflict and growth,

The mechanisms through which conflict affects economic growth ... are many. First, the diversion of resources from productive to unproductive activities (Grossman and Kim, 1996; González, 2003). Second, the impact of conflict on investment in physical and human capital accumulation is not negligible once one takes into account that one of the most powerful incentives to invest is the capacity to ensure a secure return on investment (Lloyd-Ellis and Marceau, 2002). Third, while some authors point out that there is a positive relation between military expenditure and economic growth. . . increased military spending crowds out investment and may create a large fiscal burden for future generations (Deger and Sen , 1983; Klein, 2004).³³

Conflict's impact on growth is substantial in the short and longer terms: for example, one 1998 study found that during civil wars, GDP per capita declines at an annual rate of 2.2 percent relative to what it would have been in the absence of conflict; furthermore, if the war lasts one year, GDP is 2.1 percent less per year than it otherwise would have been in the five years after the war's end.³⁴ Another study, drawing on evidence from Spain's Basque Country, found that over a period of 20 years, GDP per capita was 10 percent less than it would have been in the absence of conflict.³⁵

In light of conflict's potentially significant effects on economic growth, we examine the risk for increased conflict in Afghanistan. We assess this risk using the Conflict Assessment System Tool (CAST) developed by the Fund for Peace (FfP). CAST assesses the extent to which states are vulnerable to violent internal conflict and societal dysfunction by rating 12 factors in three categories: social, economic, and political/military. Each indicator is scored on a scale of 1 to 10 (with 10 being the worst).

³³ Daniel Mejia, "Conflict and Economic Growth: A Survey of the Theoretical Links," *Webpondo*, September 2004. http://www.webpondo.org/filesoctdic2004/conflict_growth.pdf, accessed April 13, 2007.

³⁴ Paul Collier, "On the Economic Consequences of Civil War," *Oxford Economic Papers* 51 (1999), 168–83. <http://www.worldbank.org/research/conflict/papers/cw-consq.pdf>, accessed April 13, 2007.

³⁵ Alberto Abadie and Javier Gardeazabal, "The Economic Costs of Conflict: A Case Study of the Basque Country," July 2002. <http://ksghome.harvard.edu/~aabadie/ecc.pdf>, accessed April 13, 2007.

To rate countries, a computerized content analysis technique processes thousands of news articles and documents from approximately 12,000 sources around the world. The results of this analysis are combined with statistical data. Higher scores represent greater risk, with 120 being the maximum, or “state collapse.” A score of 90 or higher means that a country falls into the category of “critical.”³⁶

Afghanistan’s score for 2006 was 102.7, virtually unchanged from its 2005 score of 102.5. Cambodia and Mozambique’s scores for 2006 were 85 and 74.8, respectively. Table 3-1 shows the 2006 score broken down into 11 component indicators.

Table 3-1
Component Ratings of Afghanistan’s 2006 CAST Scores

| Category | Rating |
|--------------------------------|--------|
| SOCIAL | |
| Demographic pressures | 9.0 |
| Refugees and displaced persons | 8.8 |
| Group grievance | 9.1 |
| Human flight | 7.0 |
| ECONOMIC | |
| Uneven development | 7.5 |
| Economic decline | 7.6 |
| POLITICAL AND MILITARY | |
| Delegitimization of the state | 8.9 |
| Human rights | 9.0 |
| Security apparatus | 9.1 |
| Factionalized elites | 8.2 |
| External influence | 10.0 |

Each indicator scored 7 or higher on the 10-point scale, placing the entire country as well as each indicator into the alert or critical category.

SOCIAL INDICATORS

Afghanistan scores poorly on the demographic pressures indicator, with a score of 9.0. The youth bulge and large numbers of returning refugees that face unemployment (see *Employment and Workforce*, p. 37) can also contribute to discontent. The indicator for refugees and internally displaced persons (IDPs) received a score of 8.8 (see *Demography and Environment*, p. 10). Among the social indicators the worst performing is vengeance-seeking group grievance. With a

³⁶ The CAST Methodology is described in greater detail on the Fund for Peace’s website: http://www.fundforpeace.org/web/index.php?option=com_content&task=view&id=107&Itemid=145.

rating of 9.1, this is one of the most serious problems facing the country. Pashtun resentment of Tajik ethnic domination of the Afghan army and intelligence forces, as well as resentment of government centralization and of military attacks sparked violent anti-U.S. and anti-Karzai protests. Most troubling, suicide attacks, not known in Afghanistan until 2005 and totaling 27 that year, increased in 2006 to 139 attacks.³⁷ As in 2005, increasing violence is also preventing educated Afghans living abroad from returning to the country, slowing a positive trend that started in 2002 and resulting in a rating of 7.0 for human flight.³⁸

ECONOMIC INDICATORS

Most Afghans, however, still live in poverty, regardless of ethnic or tribal affiliation. Furthermore, Shiite Hazaras still suffer discrimination in employment.³⁹ This ethnic discrimination and differences between rural and urban economic levels contributed to a score of 7.5 for uneven economic development.

Although large amounts of foreign aid have led to improvements in the economy since 2001, the country remains extremely impoverished (see Growth Performance, p. 5 and Poverty and Inequality, p. 7). Poverty and the high dependence on foreign aid (see External Sector, p. 24) kept the score for the economy at a 7.6, despite recent high growth rates.

POLITICAL AND MILITARY INDICATORS

Weak central institutions, the deadly insurgency, and the continued presence of former warlords in key government positions contributed to the score for state legitimacy of 8.9. Corruption at both the national and local levels increased, and the population became deeply disillusioned with elected officials.⁴⁰ Despite successful local elections in 2005, provincial governors and other officials continued to be implicated in the drug trade and, in some areas, were accused of conspiring with the Taliban.

The deteriorating security situation continually challenged international efforts to rebuild the education and health care sectors. The public services indicator scored an 8.5. Attacks by Taliban members and other insurgents on newly built schools and hospitals highlight the significant challenges in rebuilding a state in the midst of an active insurgency. Although school attendance

³⁷ Burns, January 16, 2007.

³⁸ Internal Displacement Monitoring Centre, "Afghanistan: Fighting in the south sets off new wave of displacement," December 22, 2006, <http://www.reliefweb.int/rw/RWB.NSF/db900SID/ACIO-6WQJAU?OpenDocument> or IRIN News, "Violence fuels disillusionment and threatens reconstruction – UN", December 7, 2006, <http://www.irinnews.org/report.asp?ReportID=56648&SelectRegion=Asia&SelectCountry=AFGHANISTAN>

³⁹U.S. Department of State, Bureau of Democracy, Human Rights, and Labor, "Afghanistan," *Country Reports on Human Rights Practices, 2006*, <http://www.state.gov/g/drl/rls/hrrpt/2006/78868.htm>, accessed April 13, 2007.

⁴⁰ Radio Free Europe, "Afghanistan: President Karzai Discusses Worsening Security," November 9, 2006, <http://www.rferl.org/featuresarticle/2006/11/1a8dff61-de50-4525-9042-cbbbf1dc88cb.html>; and International Crisis Group, *Afghanistan's Endangered Compact*, January 29, 2007, 11 <http://www.crisisgroup.org/home/index.cfm?l=1&id=4631>.

has increased significantly since the fall of the Taliban in 2001, including girls' attendance, the increased number of students has strained the educational system, causing a shortage of teachers and materials (see Education, p. 35).

Abuse of human rights and the absence of the rule of law remain critical problems, thus earning a score of 9.0. Although international efforts to rebuild the army and police continued in 2006, tribal militias, insurgent groups, and the Taliban increasingly challenged the government's security apparatus. These factors contributed to a score of 9.1 for the security apparatus.

Finally, the highest possible score of 10.0 for external intervention reflects the ongoing presence of nearly 26,000 Coalition and NATO forces operating in the country and the importance of foreign aid to the economy. Additionally, Afghanistan's six neighbors are suspected of backing various warlords in Afghanistan. Kabul has repeatedly accused Pakistan, for example, of harboring insurgents (particularly Taliban) who cross into Afghanistan to destabilize it.

All the indicators point to the high risk of backsliding endangering the recent gains in economic growth. Donors should design projects that can address these risks and improve performance on these indicators.

CAPACITIES OF THE STATE

A country's ability to cope with the pressures described above depends on the strength of its institutions. Table 3-2 shows our ratings of the health of five core state institutions according to three criteria: legitimacy, representativeness, and professional competency. The ratings are on a scale of 0 to 5, with 5 the best.

Table 3-2
Core Ratings of Capacity of Afghan State Institutions, 2006

| Institution | Score |
|-----------------|-------|
| Leadership | 2 |
| Police | 1 |
| Military | 2 |
| Civil service | 1 |
| Judicial system | 1 |

Afghanistan is suffering from a lack of strong state institutions to cope with the insurgency. The civil service, judiciary, and police were rated as poor (1) while the leadership (executive and legislative) and military were rated 2, slightly better than a poor rating,

Although the new Afghan National Army has been gaining strength, thanks to an emphasis on military training and rebuilding efforts, particularly by the U.S. government, the army is dominated by Tajik and other non-Pashtun ethnic groups. Meanwhile, the Taliban exploits ethnic rivalries to recruit among the Pashtuns. The security forces risk losing legitimacy and representativeness if they do not take steps to increase their ethnic diversity.

The civil service is in need of internal reform because it is prone to bribery, corruption, and ethnic discrimination. Appointments are usually made inequitably, along tribal or ethnic lines, not on the basis of professional competency. After decades of brain drain, there are few skilled professional civil servants in the government. Similarly, the judiciary is fraught with corruption or, in many parts of the country, is nonexistent. Decisions are generally made according to a mixture of codified law, sharia law, and local custom. The judiciary also lacks sufficient ethnic diversity.

To bolster the state's ability to cope with factors that increase conflict risk, donors and the government should dedicate substantial resources to strengthening the five institutions profiled here. In addition, they should strive to eliminate ethnic discrimination throughout these institutions. One lesson learned from Mozambique's recovery is that local people need to drive reconciliation and reconstruction in order for these processes to be sustainable,⁴¹ and ethnic discrimination undermines broad-based support for them.

⁴¹ Susan Woodward, *Economic Priorities for Peace Implementation*, International Peace Academy Policy Paper Series on Peace Implementation, October 2002, 11.

4. Private Sector Enabling Environment

This section reviews key indicators of the enabling environment for encouraging rapid and efficient growth of the private sector. Sound fiscal and monetary policies are essential for macroeconomic stability, which is a necessary (though not sufficient) condition for sustained growth. A dynamic market economy also depends on basic institutional foundations, including secure property rights, an effective system for enforcing contracts, and an efficient regulatory environment that does not impose undue barriers on business activities. Financial institutions play a major role in mobilizing and allocating saving, facilitating transactions, and creating instruments for risk management. Access to the global economy is another pillar of a good enabling environment, because the external sector is a central source of potential markets, modern inputs, technology, and finance, as well as competitive pressure for improving efficiency and productivity. Equally important is development of the physical infrastructure to support production and trade. Finally, developing countries need to adapt and apply science and technology to attract efficient investment, improve competitiveness, and stimulate productivity.

FISCAL AND MONETARY POLICY

Government expenditure has risen from a very low base since 2002, growing from 8.5 percent of GDP in 2002/2003 to 15.5 percent in 2005/2006. Although only slightly higher than the comparable statistic in Cambodia (13.9 percent), and lower than that for Mozambique (22.6 percent), it exceeds the normal range for a country of Afghanistan's characteristics as predicted by the regression benchmark. Revenues have improved markedly—they accounted for 6.3 percent of GDP in 2005/2006, nearly double the percentage for 2002/2003 (3.2 percent)—they are still lower than the average for the world's five poorest performers (8.6 percent). Afghanistan's positive budget balance over the last four years would not have been possible without enormous support from donors (see External Sector, p. 24).

Recent developments, however, are encouraging: the income tax, instituted in September 2005, is making an increasing contribution to revenues,⁴² and domestic revenues exceeded initial targets in the country's Poverty and Reduction and Growth Facility program with the IMF. Nevertheless, spending pressure—from the taking over of certain expenditures formerly covered by donors, arrears for public employees, operating costs from the development budget, and persistent

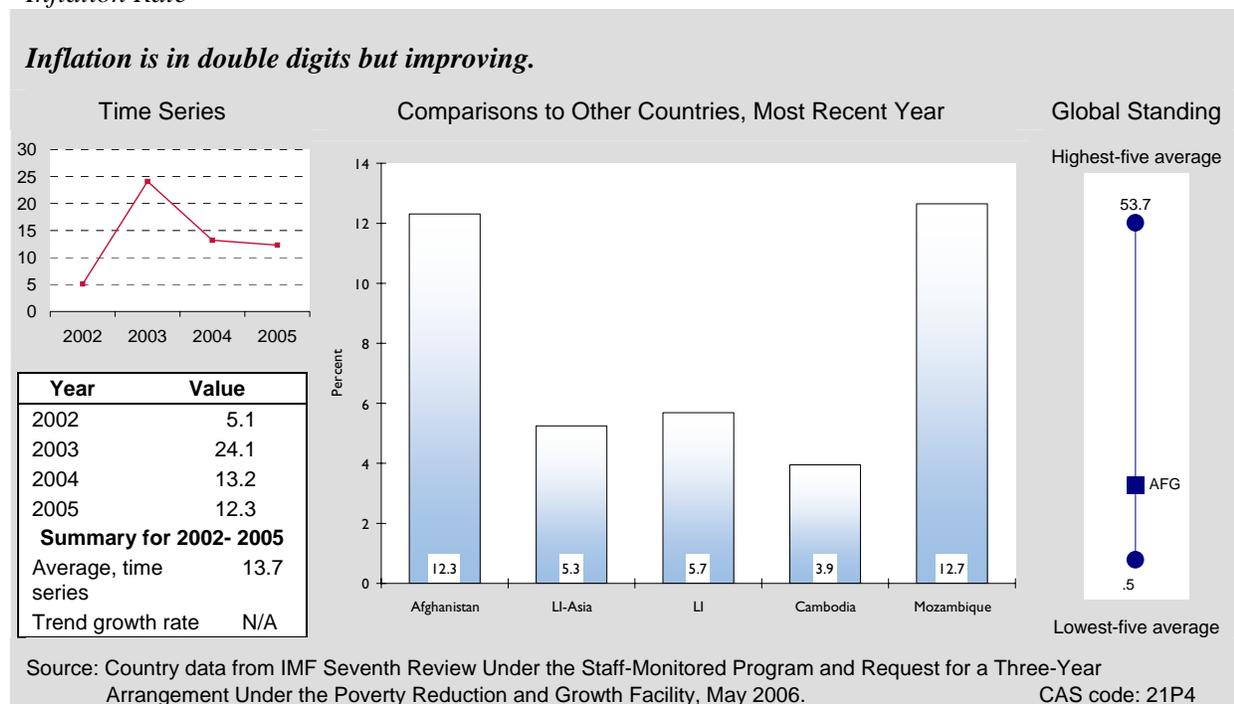
⁴² Da Afghanistan Bank, August 2006; IMF; November 2006.

security problems—remain strong.⁴³ Wages and salaries appear particularly problematic: they accounted for 38.9 percent of government expenditures in 2005/2006, which far exceeds their share in Cambodia (18.2 percent in 2004) and Mozambique (31.0 percent in 2005), and the medians for LI-Asia (25.3 percent) and all low-income countries (27.4 percent). Fiscal stability will depend on the government’s prudent management of spending, particularly the public payroll.

Inflation

At first glance, inflation appears worrisome: consumer prices rose by an average of 13.7 percent per year between 2002/2003 and 2005/2006, more than double the LI-Asia median of 5.3 percent (Figure 4-1).⁴⁴ Inflation has been driven by rising prices for food and non-food items, with particularly steep increases for non-food items between March 2004 and March 2006 (20.2 percent from March 2004 to March 2005 and 14.39 percent between March 2005 and March 2006). Major non-food contributors to inflation included rents, transportation, fuel, and housing prices, while a drought in 2004/2005 put pressure on food prices.⁴⁵

Figure 4-1
Inflation Rate



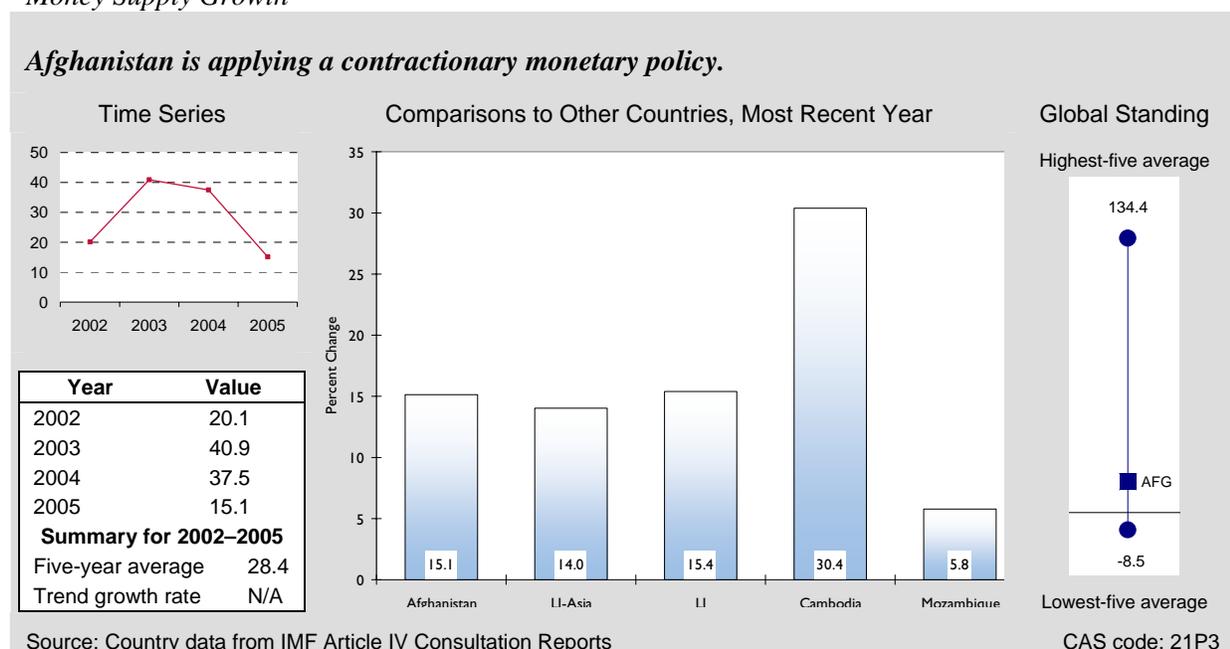
⁴³ IMF, November 2006.

⁴⁴ IMF, *Seventh Review Under the Staff-Monitored Program and Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility*, May 2006, 25. The inflation figures quoted for Afghanistan in this section are period averages using the consumer price index for Kabul.

⁴⁵ Da Afghanistan Bank, April 2006 section 1.2, no pp.; and DAB, August 2006., 11-17

Despite these pressures, inflation declined from 24.1 percent in 2003/2004 to 12.3 percent in 2005/2006. Improved management of the money supply has been fundamental to the decline in inflation. The money supply grew at more than double the rate of GDP in 2003/2004 and four times real GDP in 2004/2005, when the Central Bank pursued a policy of deliberate monetary expansion. Recognizing the role that money supply growth was playing in driving inflation, however, the Central Bank slowed money supply growth to 15.1 percent in 2005/2006, primarily through sales of foreign exchange to mop up excess liquidity (Figure 4-2).⁴⁶ Although the Central Bank's successful response to inflationary pressures is encouraging, the IMF projects that banks' growing liquidity and expansion of credit (Financial Sector, p. 23) will continue to be sources of inflationary pressures. Donors and other international advisers will need to work with Afghanistan's monetary authorities to ensure that sound management of the money supply continues.

Figure 4-2
Money Supply Growth



BUSINESS ENVIRONMENT

Institutional barriers to doing business, including corruption in government, are critical determinants of private sector development and prospects for sustainable growth. Afghanistan is one of the world's most difficult places to do business. The World Bank's composite index of Doing Business indicators ranked Afghanistan 162 out of 175 countries evaluated in 2006; by comparison, Cambodia ranked 143rd and Mozambique ranked 140th. Enforcement of contracts is one of the most problematic areas: it took 1,642 days to enforce a contract in Afghanistan in 2006, far more than in Mozambique, where it took 1,010 days; the LI-Asia median of 859.7 days; and Cambodia's 401 days. Time to register property in Afghanistan was also extremely high in

⁴⁶ Da Afghanistan Bank, April 2006, no pp.

2006. At 252 days, it was nearly five times the time required in Cambodia (56 days), six times that in Mozambique (42 days), and more than double the LI-Asia median (118.1 days). Business startup is a bright spot: the number of required procedures (3) and time to start-up (eight days) are among the world's lowest. The cost of starting a business is still high (67.4 percent of GNI per capita), but it declined from the previous year (75.2 percent). It is now lower than the LI-Asia median (71.5 percent) and the scores for Cambodia (236.4 percent) and Mozambique (85.7 percent).

Corruption and weakness in the rule of law are serious problems in Afghanistan. The World Bank's Control of Corruption Index, a scale of -2.5 (worst) to 2.5 (best), assigned Afghanistan a score of -1.37 in 2005. The index reflects public confidence in the rule of law, incidence of crime, the reliability of the judicial system, and enforceability of contracts.⁴⁷ Cambodia and Mozambique both scored better than Afghanistan on this indicator in 2005 (-1.12 and -0.67, respectively). Afghanistan's score has not changed much in the past three years, suggesting that the country has yet to make significant progress in the fight against corruption. Afghanistan's score in 2005 on the World Bank's Rule of Law index was -1.68, again lower than the scores for Cambodia (-1.13) and Mozambique (-0.95).

Security is particularly costly for firms in Afghanistan. Firms surveyed for the World Bank's 2005 Afghanistan Investment Climate Assessment for Afghanistan found that businesses spend close to 15 percent of sales on security infrastructure, compared to 13.9 percent in Cambodia, and far less in neighboring Pakistan and Tajikistan (2.2 and 3.4 percent, respectively). In Afghanistan, established firms spend an additional 3 percent of sales for protection payments to commanders, government officials, or organized criminals. New business entrants and potential investors that do not have established ties with powerful figures find the environment more intimidating, and the general climate of uncertainty about future conditions are often discouraged from investing⁴⁸.

Afghanistan's low scores on most of the CAS template's business environment indicators demonstrate that the country needs to improve business regulation and governance to develop the country's private sector. The Financial Sector, Economic Infrastructure, and Education sections highlight other areas in which improvements are needed to improve prospects for private sector development.

⁴⁷ Daniel Kaufmann, Aart Kraay, and Massimo Mastruzzi. *Governance Matters V*, World Bank, 2006. The Control of Corruption Index measures "the extent to which public power is exercised for private gain, including both petty and grand forms of corruption, as well as "capture" of the state by elites and private interests." It is used here in place of the corruption indicator in the CAS template, the Transparency International Corruption Perception Index because data for this indicator is not available for Afghanistan.

⁴⁸ Syed Mahmood, Samuel Munzele Maimbo, et al. *The Investment Climate in Afghanistan: Exploiting Opportunities in an Uncertain Environment*. World Bank, December 2005, 15. Cambodia data is from 2003, and is from the World Bank's *Enterprise Surveys* website, <http://www.enterprisesurveys.org/ExploreTopics/CompareAll.aspx?topic=crime>, accessed February 11, 2007. No data for security costs is available for Mozambique.

FINANCIAL SECTOR

A sound and efficient financial sector is a key to mobilizing saving, fostering productive investment, and improving risk management. Data for Afghanistan's financial sector are scant, but the information available shows that the sector is underdeveloped but advancing. A simple indicator of banking sector development is the degree of monetary deepening, measured by the ratio of broad money (currency plus bank deposits) to GDP. In Afghanistan, this ratio was 23.7 percent in March 2006,⁴⁹ higher than in Cambodia (19.5 percent) and just shy the ratio in Mozambique (24.6 percent), but still much lower than the median for LI-Asia (37.9 percent). Broad money has experienced double-digit growth every year since 2002/2003 (see Fiscal and Monetary Policy, p. 19). Although currency in circulation remains the largest component of broad money, deposits account for a small but increasing share: quasi-money, consisting of time, savings, and foreign currency deposits, accounted for 6.4 percent of broad money in March 2006, compared to 2.3 percent a year earlier. This growth signals that confidence in the fledgling banking system is growing.⁵⁰

Although reliable data on the volume of bank credit to the private sector are not available, access to finance is clearly a serious problem in Afghanistan. As the World Bank's December 2005 Afghanistan Investment Climate Assessment reported:

Afghanistan's financial system is just beginning to recover and businesses have almost no access to bank credit and only limited access to banking services generally. Most of the 12 commercial banks licensed to operate in Afghanistan are concentrated in Kabul and provide services primarily to international donors and businesses, foreign nongovernmental organizations, and foreign government agencies. Commercial banks in Afghanistan offer financing with a maximum tenure of financing of up to three years. There are a small number of nonbank financial institutions (11 microfinance institutions, one credit union, and one leasing company), but although growing, they are still nascent and can meet only a very small fraction of credit needs.⁵¹

Doing Business 2007 assigned Afghanistan a score of zero on its Depth of Credit Information index, which reflects the country's lack of credit bureaus or credit rating agencies. Afghanistan also scored zero on the Strength of Legal Rights index, which examines collateral and bankruptcy laws' protection of borrowers' and lenders' rights. The underdeveloped state of the formal financial sector leads many Afghans to conduct financial transactions through informal financial operators known as *hawaladars*, who may broker money transfers and short-term loans. Although the *hawala* system helps Afghan entrepreneurs meet many needs for financial transactions, neither the *hawala* system nor the formal financial sector provides the options for extended financing that the Afghan private sector requires for long-term growth.⁵² Developing and deepening the formal financial sector, including strengthening the sector's legal and regulatory

⁴⁹ Monetary data from Da Afghanistan Bank, August 2006; GDP from World Economic Outlook.

⁵⁰ Da Afghanistan Bank, April 2006, no pp.

⁵¹ Mahmood et al., vi. Da Afghanistan Bank's August 2006 Quarterly Economic and Statistical Bulletin reported the number of licensed banks as 13 (pg. 32).

⁵² Ibid, pg. 23.

framework, creating credit information mechanisms, expanding access to finance for SMEs, and deepening financial sector services in and outside of Kabul, are urgent priorities.

EXTERNAL SECTOR

Fundamental changes in international commerce and finance, including reduced transport costs, advances in telecommunications technology, and lower policy barriers, have fueled a rapid increase in global integration in the past 25 years. The international flow of goods and services, capital, technology, ideas, and people offers great opportunities for Afghanistan to boost growth and reduce poverty by stimulating productivity and efficiency, providing access to new markets and ideas, and expanding the range of consumer choice. At the same time, globalization creates new challenges, including the need for reforms to take full advantage of international markets and cost-effective approaches to cope with the resulting adjustment costs and regional imbalances.

Afghanistan's ability to import and export is hampered by cumbersome import and export procedures, but exports have grown in the past five years. The country runs only a modest current account deficit, but would run a much larger one without foreign aid. Indeed, dependence on aid has increased since 2002, despite significant increases in domestic government revenues. Foreign investment, an important potential driver of long-term growth, remains low because of problems in the business environment.

International Trade and Current Account Balance

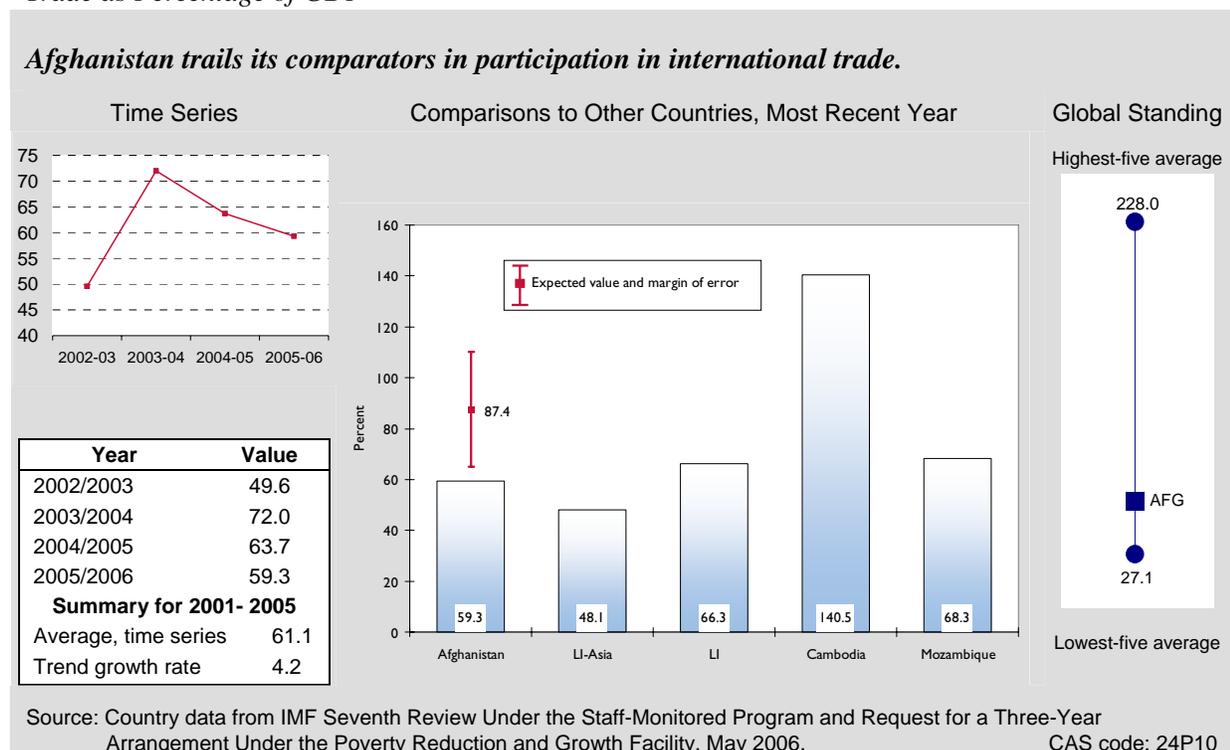
Trade data for Afghanistan must be interpreted with caution. Official records of imports and exports do not capture the large volume of imports and exports that go unrecorded (i.e., smuggled). Although hard statistics on smuggling are elusive, the Central Bank estimates that the value of smuggled goods equals 30 percent of the value of recorded trade.⁵³ Furthermore, official statistics do not include opium, of which exports to neighboring countries in 2005 equaled an estimated \$2.7 billion, or approximately 37 percent of Afghanistan's GDP for 2005/2006.⁵⁴ The trade data we use in this section were estimated by the IMF and do not include opium exports or exports related to United States or NATO military activities.

Afghanistan is far less active in international trade than many similar countries. In 2005/2006, trade flows (imports plus exports of goods and services) equaled 59.3 percent of GDP, \$4.5 billion. Although this figure exceeds the median for LI-Asia (48.1 percent), it is lower than Mozambique's 68.3 percent in 2004), much less than half of Cambodia's (140.5 percent in 2004), and well below the normal range for a country with Afghanistan's characteristics as estimated by the benchmark regression (Figure 4-3). Furthermore, imports are probably elevated because of imports by aid projects.

⁵³ Da Afghanistan Bank, August 2006, 49.

⁵⁴ Value of opium exports from United Nations Office on Drugs and Crime, 2005, 1; GDP at market prices from IMF, World Economic Outlook.

Figure 4-3

Trade as Percentage of GDP

The comparatively low share of foreign trade in GDP suggests the need for measures to stimulate trade, investment, and productivity in licit sectors of the economy. Of particular concern are cumbersome import and export procedures: *Doing Business* ranked Afghanistan 152 out of 175 countries in 2006 for ease of trading across borders, lower than its rank of 147 the previous year. Official costs to ship a container for export totaled \$2,500 in 2006, more than three times the total for Cambodia (\$736) and well above Mozambique's (\$1,516), while the time to export totaled 66 days, compared to 36 days for Cambodia and 39 days for Mozambique.⁵⁵ Furthermore, although the IMF noted with concern Afghanistan's reclassification of certain goods into two new, higher tariff bands, it still described the trade regime as "liberal and transparent."⁵⁶ Trade facilitation improvements rather than tariff reductions should be the top trade policy priority for Afghanistan.

Despite these barriers, exports are growing. The 10.7 percent growth in 2005/2006⁵⁷ exceeded the median for low-income countries (7.1 percent) and was well within the normal range of values predicted by the regression benchmark, although it was less than the high figures for Mozambique (23.8 percent) and Cambodia (22.4 percent) in 2004 (Figure 4-4). A few product groups dominate Afghanistan's exports: the Central Bank claims that carpets and rugs accounted for over 53 percent of exports in 2005/2006, followed by food items (27.1 percent, including fresh and dried fruits and nuts), and leather (8.1 percent). The overwhelming majority of

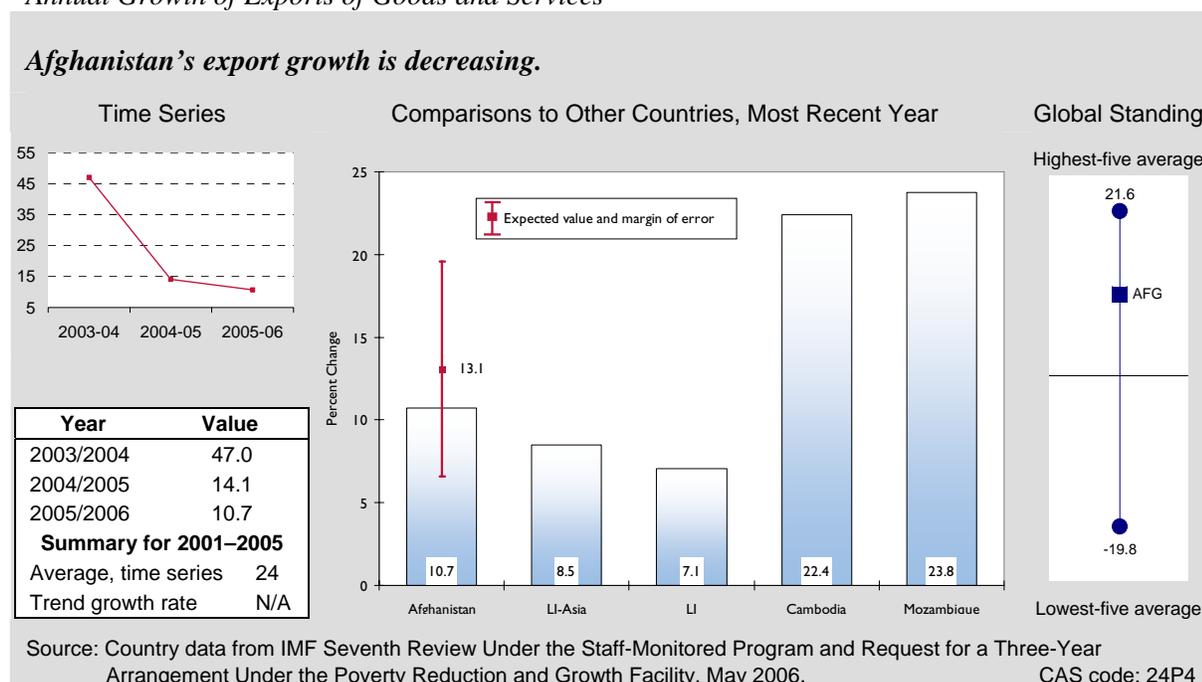
⁵⁵ www.doingbusiness.org, accessed February 1, 2007.

⁵⁶ IMF, November 2006.

⁵⁷ IMF, May 2006, 26.

Afghanistan's exports go to neighboring Pakistan (some 72.9 percent of exports in 2005/2006, up from 65.0 percent the previous year). The next most important destination, India, accounted for only 5.7 percent of exports in that same period.⁵⁸ The sectors in which Afghanistan specializes present strong growth opportunities: Afghanistan was once a leading exporter of dried fruits and nuts, and an important exporter of karakul (a type of lamb's wool). Exports of these products are growing again but have yet to reach pre-Soviet invasion levels.⁵⁹ Because the country remains dependent on a small basket of products and a few key markets, it is vulnerable to changes in world market conditions, domestic supply shocks, and demand shocks in the key export markets. Diversification of export products and markets is thus a high priority.

Figure 4-4
Annual Growth of Exports of Goods and Services



Real appreciation of the Afghani between 2002/2003 and 2005/2006—an average of 13.2 percent annually—may have dampened exports.⁶⁰ Annual appreciation slowed somewhat, however, by the end of this period (from 21.0 percent in 2002/2003 to 5.4 percent in 2005/2006). The slowdown in real appreciation reflects lower inflation and the Central Bank's efforts to maintain a stable nominal exchange rate through foreign exchange auctions, weekly at first, then biweekly beginning in February 2006.⁶¹

⁵⁸ Da Afghanistan Bank, August 2006, 53-55.

⁵⁹ Sayed Yaqub Ibrahim, "Afghanistan's Traditional Lambskin Fur Trade Revives," *EnvironmentNews Service*, May 26, 2006, <http://www.ens-newswire.com/ens/may2006/2006-05-26-02.asp>, accessed February 11, 2007, and Kathleen Trask, "Afghanistan," in *South Asian Free Trade Area: Opportunities and Challenges*, Nathan Associates/USAID, October 2005, 203.

⁶⁰ IMF, May 2006, 25.

⁶¹ Da Afghanistan Bank, April 2006.

Afghanistan's current account went slightly into deficit in 2005/2006 (-0.9 percent of GDP) after two years of modest surpluses (3.1 percent in 2003/2004 and 1.4 percent in 2004/2005). Its recent deficit is lower than the median for low-income countries (-4.3 percent) and than the deficits of Cambodia (-4.4 percent in 2004) and Mozambique (-10 percent in 2004). Yet without donor assistance, Afghanistan's current account deficit would be far larger— -42.6 percent of GDP. Although Afghanistan's dependence on foreign aid to finance the current account is not sustainable in the long term, the situation is less worrisome than it might appear for three reasons: (1) an elevated level of imports is understandable in light of the country's vast reconstruction needs; (2) official transfers are likely to continue at important levels in the near to medium term; and (3) the trade deficit appears to be declining (from -41.3 percent in 2003/2004 to -35.9 percent in 2005/2006).⁶² This suggests that Afghanistan is improving, albeit modestly, its ability to finance imports without external assistance.

Remittances from Afghans abroad are difficult to measure because they flow largely through the informal yet well-developed *hawala* system. According to IMF estimates of private current transfers (used as proxies for remittance flows), remittances equaled nearly 65 percent of the value of exports in 2005/2006.⁶³ This figure, although approximate, suggests that remittances play a substantial role in financing the current balance and the economy as a whole. In light of the importance of remittances, policymakers should seek to improve the security and efficiency of cash transfer mechanisms and develop programs to channel remittances toward productive investment.

Foreign Investment, External Assistance, and International Reserves

Afghanistan depends heavily—and increasingly—on foreign aid, despite impressive recent increases in domestic revenue collection (see Fiscal and Monetary Policy). Official development assistance equaled 38.6 percent of gross national income in 2005, an increase of more than six percentage points since 2002, compared to 10.4 percent in Cambodia and 20.8 percent in Mozambique. Afghanistan depends on foreign assistance to cover developmental and operational expenses and to narrow its current account deficit (Figure 4-5). Reducing dependence on aid through continued expansion of domestic revenues, carefully managed government spending, and increased foreign private investment must remain high priorities.

In addition to relieving dependence on aid, foreign direct investment can catalyze productivity gains by transferring technology, developing human capital, and enhancing access to global supply chains. Afghanistan's Investment Support Agency (AISA) and the World Bank's Multilateral Investment Guarantee Agency (MIGA) have identified four sectors with particular promise for attracting FDI: logistics and transport, food and beverage processing, textiles and carpets, and mining.⁶⁴ In 2005/2006, net FDI inflows equaled a higher percentage of GDP (5.17 percent) than in Cambodia and Mozambique (2.69 percent and 4.02 percent in 2004,

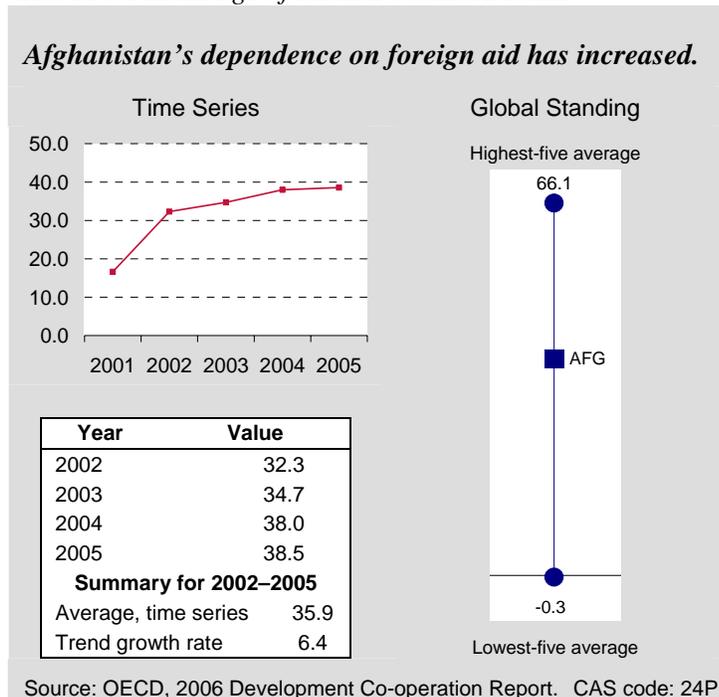
⁶² IMF, May 2006, 25.

⁶³ Private current transfers include individuals' remittances as well as current transfers between nongovernmental organizations.

⁶⁴ Multilateral Investment Guarantee Agency, *Investment Horizons: Afghanistan*, World Bank Group/MIGA, 2005.

respectively). This figure was boosted, however, by a one-off telecommunications transaction, and will likely be lower in 2006/2007.⁶⁵ To increase FDI inflows, Afghanistan will need to continue to make improvements across the full spectrum of investment climate factors, including security (see Business Environment).

Figure 4-5
Aid as a Percentage of Gross National Income



At the outset of 2006, Afghanistan's external debt was extremely high: including some \$10 billion in mostly Soviet-era claims from Russia, 148.4 percent of GDP.⁶⁶ In early 2006, however, Afghanistan's three Paris Club creditors—Russia, Germany, and the United States—announced their intention to forgive 100 percent of Afghanistan's debt to them.⁶⁷ After an initial cancellation of 80 percent of Russia's claims, the Paris Club agreed to cancel \$1.6 billion of Afghanistan's remaining \$2.4 billion of debt and to reschedule more than \$800 million.⁶⁸ The remaining debt will be canceled if Afghanistan qualifies for and meets program targets for the IMF/World Bank Heavily Indebted Poor Countries initiative. The full cancellation of debt could play a significant role in driving growth, because it would free up public and private resources for more productive uses. In addition, investors probably would likely perceive Afghanistan as a less-risky place to invest because of the lower risk of government default.

⁶⁵ IMF, May 2006, 13.

⁶⁶ IMF, May 2006, 35.

⁶⁷ "United States Provides Afghanistan Full Debt Forgiveness." <http://usinfo.state.gov/sa/Archive/2006/Feb/07-399497.html>, accessed February 2, 2007.

⁶⁸ Paris Club, Press Release, July 19, 2006, http://www.clubdeparis.org/en/news/page_detail_news.php?FICHER=com11533854280, accessed February 12, 2007.

International reserves were the source of additional encouraging developments: from 2002/2003 to 2005/2006, gross international reserves steadily climbed from 1.8 months of imports to 4.7 months. Central Bank Governor Noorullah Delawari has noted that donors' demand for domestic currency has been an important factor contributing to the rise in reserves.⁶⁹

ECONOMIC INFRASTRUCTURE

Improving Afghanistan's physical infrastructure—transportation, communications, and information technology networks—is essential to enhancing the country's long-term growth potential. Indeed, increased business activity requires a parallel expansion of airports, roads, rail lines, power lines, and other key support services for the private sector. Afghanistan's ability to capitalize on its geographical position as a land bridge connecting the markets of Central Asia and South Asia and boosting regional trade also depends heavily on large-scale investment in developing its infrastructure.

Although data on infrastructure for Afghanistan are limited, the data that are available suggest that the country's infrastructure assets remain weak, although important improvements have been made recently. In 2003, the most recent year for which statistics are available, 23.66 percent of all roads were paved. The government has made strides to improve the road network in the intervening years, and improvements in travel times are noticeable in some areas.⁷⁰ Yet a tremendous amount of work remains to be done.

Improving physical infrastructure can be risky in conflict-affected areas. Roads are particularly sensitive. For example, insurgents killed more than 30 construction workers during reconstruction of the Kabul–Kandahar road in 2003 despite security provisions.⁷¹

The telecommunications field has experienced rapid changes in the past few years. The World Bank's most recent statistics (2003) on total telephone density in Afghanistan, or the number of telephone mainlines and mobile phone connections per 1,000 people, put the number at eight. This number has increased dramatically in the interim, however, driven by the growth of cellular phones. There were some 2,000,000 cellular phone subscribers in late 2006, or nearly 8 percent of the country's 25.1 million people. Growth continues to be rapid: the telecommunications company Roshan reported in November 2006 that it was adding 1,000 subscribers per day.⁷²

Access to the Internet remains limited. The World Bank estimates that there was only one Internet user per 1,000 people in Afghanistan in 2004. This figure is far below the average for low-

⁶⁹ Speech at the London Donors' Conference, January 28–February 2, 2006, in Da Afghanistan Bank, April 2006.

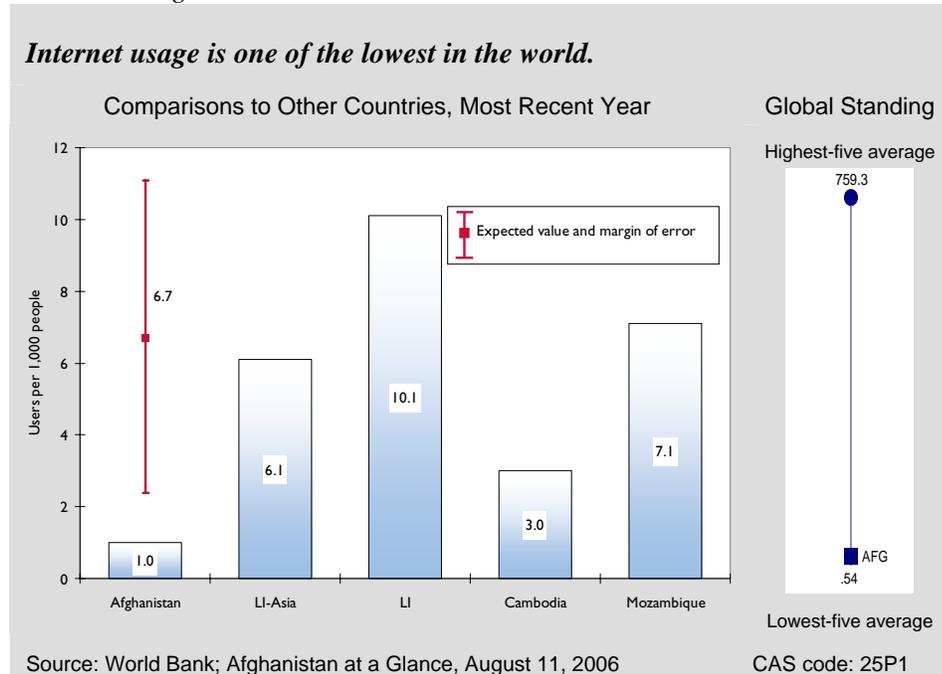
⁷⁰ World Bank, *Afghanistan Investment Climate Assessment*, 18.

⁷¹ Andrew North, 2004. "I've been Scared, I Don't Mind Telling You." *BBC News*, 5 October 2004. http://news.bbc.co.uk/2/hi/south_asia/3714332.stm. in Bray, John. "International Companies and Post-Conflict Reconstruction", The World Bank, Social Development Papers No. 22, February 2005.

⁷² Ivan Watson, "Cell Phone Towers Escape Afghan Violence," radio report on National Public Radio's *All Things Considered*, November 24, 2006. Accessed online at <http://www.npr.org/templates/story/story.php?storyId=6535365> on February 11, 2007.

income countries in Asia (six users), Cambodia (three users in 2004) and Mozambique (seven users in 2004) (Figure 4-6).

Figure 4-6
Internet Usage



SCIENCE AND TECHNOLOGY

Science and technology are central to a dynamic business environment and a driving force behind increased productivity and competitiveness. Even for low-income countries, transformational development depends on acquiring and adapting technology from the global economy. Lack of capacity to access and use technology prevents an economy from leveraging the benefits of globalization. Unfortunately, few international indicators are available for judging performance in low-income countries.

Harnessing science and technology to support transformational growth remains a challenge for Afghanistan. No data on science and technology indicators are available; the lack of data itself indicates limited capacity to acquire, adapt, and apply technology for improving productivity and prosperity. Weaknesses in the country's education system and telecommunications infrastructure also indicate a wide technology gap separating Afghanistan from many other countries. There are at least some indications, however, of a strong commitment by both the government and the private sector to increasing the country's access to and use of advanced technology. The World Bank reports that the government is developing strategies for restoring agricultural research and extension systems; the strategies focus on adapting research, strengthening demand for research

products, and defining public and private sector roles.⁷³ Government policies aimed at bringing in foreign investment are also expected to increase technology transfer and absorption.

⁷³ Ibid, page 103.

5. Pro-Poor Growth Environment

Rapid growth is the most powerful and dependable instrument for poverty reduction, but the link from growth to poverty reduction is not mechanical. In some circumstances, income growth for poor households exceeds the overall rise in per capita income, while in other cases, the poor are left far behind. A pro-poor growth environment stems from policies and institutions that improve opportunities and capabilities for the poor while reducing their vulnerabilities. Pro-poor growth is associated with investment in primary health and education, the creation of jobs and income opportunities, the development of skills, microfinance, agricultural development, and gender equality—all critical to Afghanistan’s recovery and long-term development. This section focuses on four of these issues: health, education, employment and the workforce, and agricultural development.

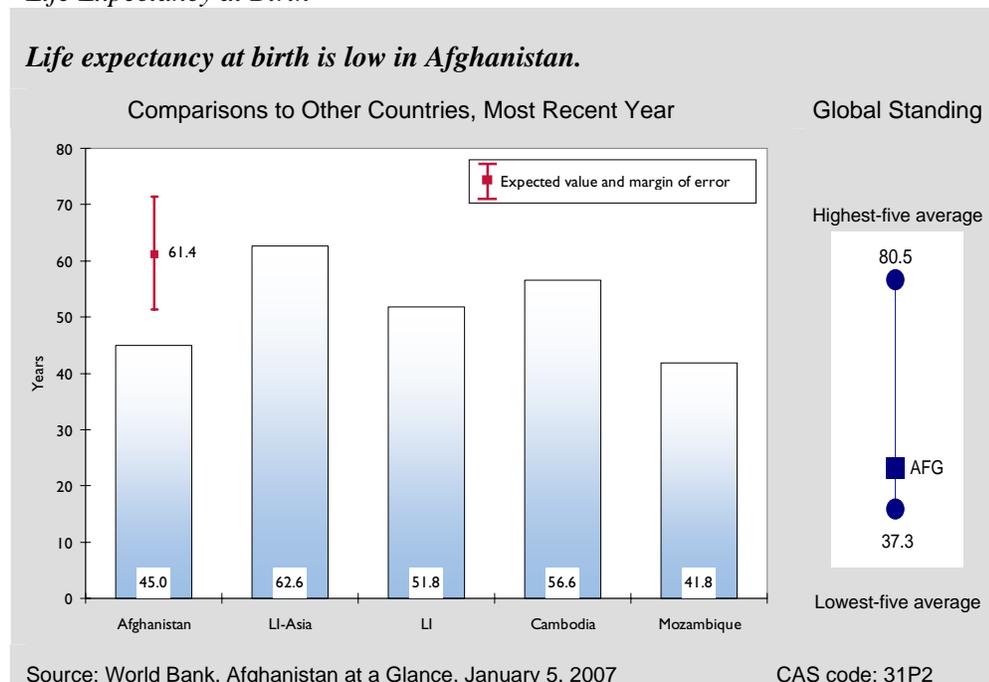
HEALTH

The provision of basic health service is a major form of human capital investment and a significant determinant of growth and poverty reduction. Although health programs do not fall under the EGAT bureau, an understanding of health conditions can influence the design of economic growth interventions.

Afghanistan indicators show very poor performance across the board. Life expectancy is the most common indicator of health conditions. The average life expectancy at birth in Afghanistan was 45 years (2005), below the expectancy in Cambodia (56.6 years in 2004) and the average for LI-Asia (62.6 years in 2004), and slightly better than in Mozambique (41.8 years)⁷⁴ (Figure 5-1). Afghanistan also has one of the world’s highest maternal mortality rates—1,900 maternal deaths for every 100,000 live births in 2000, far higher than in Cambodia (450 deaths in 2000), Mozambique (1,000 in 2001), and even higher than the average of the five worst-performing countries in the world (1,720). This statistic highlights Afghanistan’s low score on another health indicator, the percentage of births attended by a skilled health professional. During 2004, only 14 percent of births were attended by skilled health professionals, far less than in Cambodia (32 percent during 2001) and Mozambique (48 percent during 2004).

⁷⁴Mozambique’s life expectancy is low because of high HIV/AIDS prevalence; see UNAIDS, http://www.unaids.org/en/Regions_Countries/Countries/mozambique.asp.

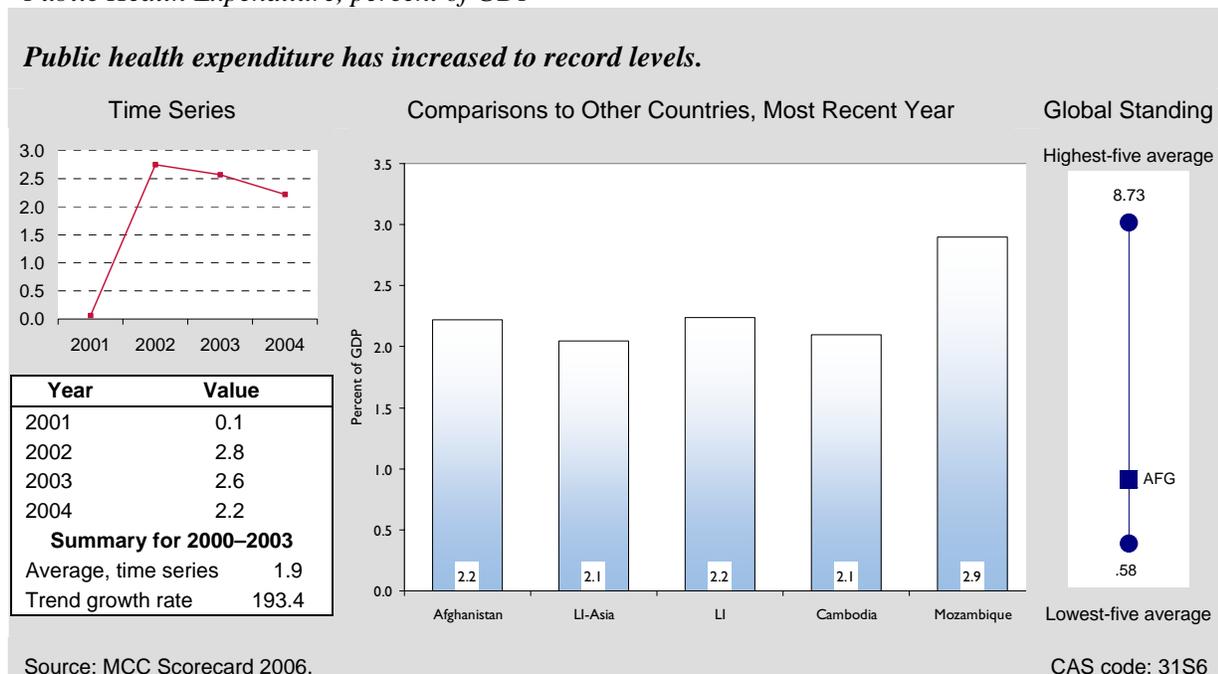
Figure 5-1
Life Expectancy at Birth



All these conditions reflect the two decades of war that made investment in basic health services impossible. But public health expenditure increased dramatically from 2000 to 2004, from 0.04 percent of GDP to 2.2 percent of GDP, thanks to donor agencies. This level is comparable to the most recent estimates for LI-Asia (2.1 percent), Cambodia (2.1 percent), and Mozambique (2.9 percent) (Figure 5-2). Fueled by this spending, child immunization rates climbed from 20 percent during 2000 to 61 percent during 2004. This is still worse than all the comparators, however—there is much work to be done.

Poor health conditions impede growth and contribute greatly to the persistence of severe poverty. Although multilateral and bilateral donors have been generous with support, including USAID, health problems cannot be addressed in a sustainable way without additional donor funding and the financial commitment on the part of Afghanistan's government. Allocating a larger share of government resources to the health sector will ultimately demand stronger revenue mobilization and economic growth (see Fiscal and Monetary Policy Section).

Figure 5-2
Public Health Expenditure, percent of GDP



EDUCATION

The scant evidence on the Afghanistan educational system shows that the decades of war devastated the educational system. The most strikingly poor indicator is Afghanistan’s youth literacy rate—only 34 percent in 2004, not even half the median for LI-Asia (79.3 percent) or the rate in Cambodia (83.4 percent for 2004), and below Mozambique’s rate (62.8 percent for 2002) and the normal range predicted by the regression benchmark (75.5 percent) (Figure 5-3).

UNICEF reports that more than 4.2 million children returned to school between 2002 and 2004,⁷⁵ yet the primary attendance rate reached only 54 percent in 2003.⁷⁶ Net primary enrollment rates for Cambodia (98 percent for 2004) and Mozambique (71 percent for 2004), the average for LI-Asia (84.2 for most recent year), and the rate predicted by our regression (82.1 percent) are all much higher. Moreover, the UN reports that disparities in access to education between rural and urban communities are acute; the increase in the attendance rate between 1997 and 2003 was 50 percent higher in urban areas than in rural areas.

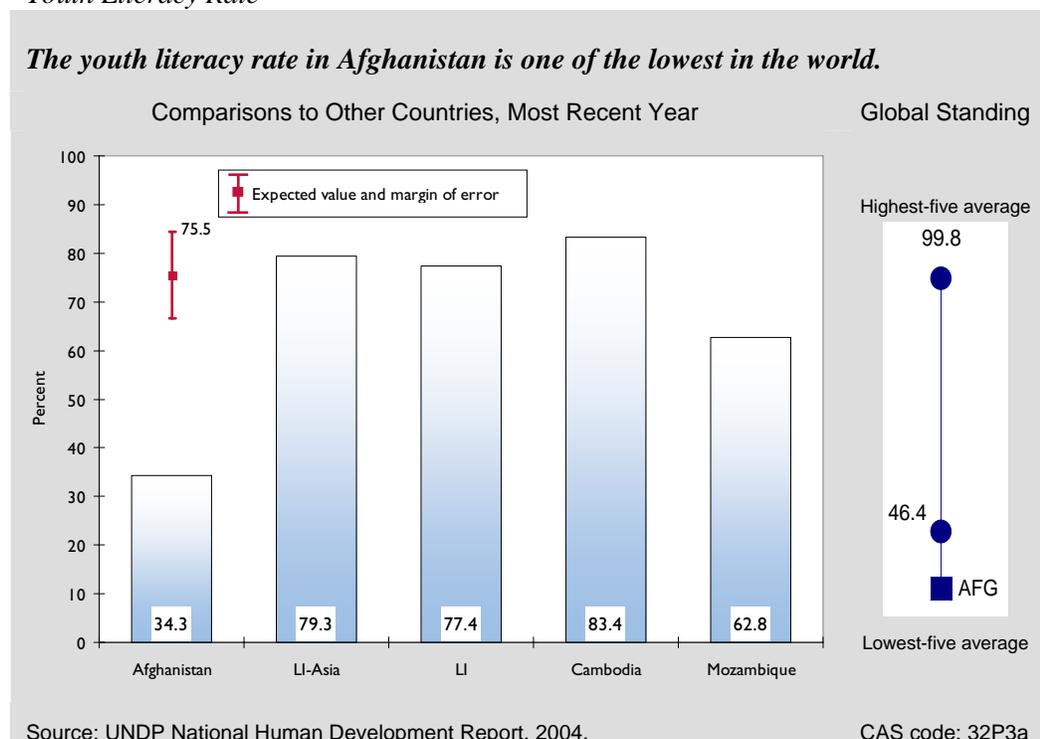
The rate of persistence to grade 5 was 45 percent (2003), meaning that more than half of all children who enroll in grade one do not complete five years of education. This rate, though marginally worse than that of Mozambique (2001), is significantly worse than that of Cambodia

⁷⁵ UNICEF, Afghanistan Educational Fact Sheet, February, 2005. http://www.unama-afg.org/news/_pr/_english/UN/2005/UNICEF-Education%20Fact%20Sheet.pdf

⁷⁶ Primary attendance is not a typical indicator. It is being used as a proxy for net primary enrollment; Millennium Development Goal Report, page 32.

(2004) and far behind the average rate for LI-Asia. Afghanistan's pupil-teacher ratio was 65.2:1 during 2004—twice as high as the ratio for LI-Asia.

Figure 5-3
Youth Literacy Rate



A further challenge to education is antigovernment elements' attacks on schools. Between January and July 2006, the Ministry of Education recorded 202 attacks on schools in 27 provinces that killed 41 students, teachers, and support staff. In 2005, there were 123 attacks on schools in 15 provinces, and 47 in 2004.⁷⁷ Such attacks reduce the number of children attending school: between April and June 2006, 208 schools were closed in Zabul, Helmand, Kandahar Ghazni, Khost and Paktika.⁷⁸

Donors and policymakers are called to continue and even expand their efforts to expand access and improve the quality of education. Education should be the highest priority for the Afghan government because Afghanistan has the highest proportion of school-age children in the world (see Demographic and Environment).⁷⁹ Ignoring the extent of educational deficiencies, combined with the population boom, can lead to fostering of conflict and failure in the provision of human capital, which is essential for sustained economic growth.

⁷⁷ International Crisis Group, *Countering Afghanistan's Insurgency: No Quick Fixes*. 2 November 2006

⁷⁸ "Education Under Fire", Ministry of Education release, August 2006.

⁷⁹ Millennium Development Goals Islamic Republic of Afghanistan, Country Report 2005. 33.

EMPLOYMENT AND WORKFORCE

Afghanistan's workforce is estimated at 15 million and growing at a rate of 2.3 percent per year.⁸⁰ If this growth holds steady, the economy will need to absorb approximately 345,000 new workers each year. These statistics, however, do not take into account the dynamics of migration (described in Demographics and Environment). The United Nations High Commissioner for Refugees estimates that more than 750,000 refugees, mostly working-age males, returned from Pakistan and Iran during 2005.⁸¹ This magnitude of influx cannot be absorbed by the current economy.

The World Bank's Rigidity of Employment index measures the difficulty faced by firms in hiring and firing workers. If government policies impose regulations that increase the cost of firing workers, employers delay hiring, and this diminishes job creation. Afghanistan's 2006 score of 46 equals the LI-Asia average and is better than Cambodia's 2006 score of 49. Nevertheless, the government's policy efforts in this regard must improve to generate adequate employment.

Neither the World Bank nor Afghanistan's government provides official unemployment data; however, the U.S. Central Intelligence Agency reports unemployment at 40 percent for 2005⁸²—a rate 20 times higher than that predicted by our regression for a country with Afghanistan's economic characteristics. Results of a national survey conducted by the Asia Foundation in 2006 show that unemployment remains the Afghan people's deepest concern.⁸³

High unemployment—particularly among young men—and the desperation that often accompanies it undermine progress, stability, and prospects for transformational growth. Donors' efforts to stem unemployment clearly must remain a top priority. The lesson learned from Mozambique's success in creating jobs, as a post-conflict economy, must be applied: donors and the government must allocate specific funds to employment creation, specifically to creating jobs in SMEs.⁸⁴

AGRICULTURE

Afghanistan is an agricultural country, and agricultural output has grown in absolute terms: it experienced double-digit growth every year between 2002/2003 and 2005/2006, albeit from a low base, with the exception of a severe downturn in 2004/2005 due to drought (Figure 5-4).⁸⁵

⁸⁰ There are significant discrepancies among sources: The World Bank reports a labor force of 5 million in 1990: <http://devdata.worldbank.org/genderRpt.asp?rpt=profile&cty=AFG,Afghanistan&hm=home>.

⁸¹ Returnee statistics from United Nations High Commission for Refugees, *2005 Global Refugee Trends*, <http://www.unhcr.org/statistics/STATISTICS/4486ceb12.pdf>, Table 18; mostly working-age males from, AREU, Stigter, Elca, and Alessandro Monsutti, *Transnational Networks: recognizing a Regional Reality*, Briefing Paper, April, 2005.

⁸² CIA Factbook, <https://www.cia.gov/cia/publications/factbook/geos/af.html>

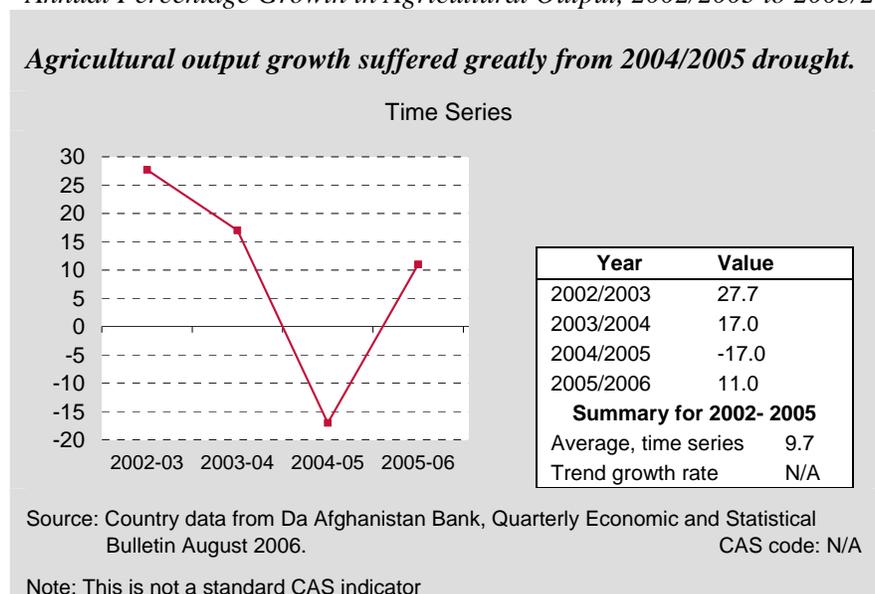
⁸³ Asia Foundation. Survey of the Afghan People: Afghanistan in 2006

⁸⁴ Woodward, Susan, *Economic Priorities for Peace Implementation*, International Peace Academy Policy Paper Series on Peace Implementation, October 2002.

⁸⁵ Da Afghanistan Bank, August 2006, 10.

Figure 5-4

Annual Percentage Growth in Agricultural Output, 2002/2003 to 2005/2006



Cereals are Afghanistan's most important licit crops; wheat alone covered 68 percent of the land cultivated in 2002. Cereal yields declined during the 1980s and 1990s but began to recover after the fall of the Taliban. They rose from 984 kg/hectare in 2000 to 1,906 kg/hectare in 2003, still far below the LI-Asia median of 2,831 kg/hectare, but comparable to Cambodia's yield for 2004 (1,999 kg/hectare) and higher than Mozambique's (959 kg/hectare). Other key crops include fruits, vegetables, oilseeds, nuts and pulses, and livestock products. Fruits occupy just 2 percent of cultivated area but are among Afghanistan's most valuable licit agriculture exports.⁸⁶ Dried grapes and almonds were the leading export products in this category in 2005.⁸⁷

An increase in agricultural productivity is necessary to improve the lives of the rural poor. Donors and government should focus on initiatives that introduce sustained production methods and technologies as a strategy for long-term growth. A number of fundamental constraints must be addressed to increase productivity over the long term, and a 2005 World Bank study reports that there is a "large degree of unanimity" on what these constraints are: lack of access to reliable irrigation, finance, and markets; poor knowledge and dissemination of improved production technologies; and the weak capacities of public and private sector agricultural institutions.

Insecurity of land tenure is also a major concern: in addition to discouraging investment, it raises the risk of quarrels over land and water. Such disputes have already been exacerbated by the return of millions of refugees and internally displaced people as well as the droughts. Solutions to this complex problem will be essential to promote agricultural development in the long term.⁸⁸

⁸⁶ Statistics for Afghanistan in the preceding five sentences from Byrd et al., 93 and 180.

⁸⁷ UN COMTRADE, accessed via ITC Trade Map, December 2006.

⁸⁸ Information in this paragraph and the preceding one from Byrd et al., 96.

Appendix. CAS Methodology

CRITERIA FOR SELECTING INDICATORS

The economic performance evaluation is designed to balance the need for broad coverage and diagnostic value, on the one hand, and the requirement of brevity and clarity, on the other. The analysis covers 15 economic growth–related topics, and just over 100 variables. For the sake of brevity, the write-up in the text highlights issues for which the “dashboard lights” appear to be signaling problems, which suggest possible priorities for USAID intervention. The accompanying table provides a full list of indicators examined for this report. The separate Data Supplement contains the complete data set for Afghanistan, including data for the benchmark comparisons, and technical notes for every indicator.⁸⁹

For each topic, the analysis begins with a screening of *primary performance indicators*. These Level I indicators are selected to answer the question: Is the country performing well or not in this area? The set of primary indicators also includes descriptive variables such as per capita income, the poverty head count, and the age dependency rate.

When Level I indicators suggest weak performance, we review a limited set of *diagnostic supporting indicators*. These Level II indicators provide additional details, or shed light on *why* the primary indicators may be weak. For example, if economic growth is poor, one can examine data on investment and productivity as diagnostic indicators. If a country performs poorly on educational achievement, as measured by the youth literacy rate, one can examine determinants such as expenditure on primary education, and the pupil–teacher ratio.⁹⁰

The indicators have been selected on the basis of the following criteria. Each must be accessible through USAID’s Economic and Social Database or convenient public sources, particularly on the Internet. They should be available for a large number of countries, including most USAID client states, to support the benchmarking analysis. The data should be sufficiently timely to support an assessment of country performance that is suitable for strategic planning purposes. Data quality is another consideration. For example, subjective survey responses are used only when actual measurements are not available. Aside from a few descriptive variables, the indicators must also be useful for diagnostic purposes. Preference is given to measures that are widely used, such as Millennium Development Goal indicators, or evaluation data used by the Millennium Challenge Corporation. Finally, an effort has been made to minimize redundancy. If

⁸⁹ The Data Supplement is available on line at <http://www.nathaninc.com/projects/projectdetails.asp?pid=138&pfid=0&rpid=4&rid=9> .

⁹⁰ Deeper analysis of the topic using more detailed data (Level III) is beyond the scope of this series.

two indicators provide similar information, preference is given to one that is simplest to understand, or most widely used. For example, both the Gini coefficient and the share of income accruing to the poorest 20 percent of households can be used to gauge income inequality. We use the income share because it is simpler and more sensitive to changes.

BENCHMARKING METHODOLOGY

Comparative benchmarking is the main tool used to evaluate indicators. The analysis draws on several criteria rather than a single mechanical rule. The starting point is a comparison of performance in Afghanistan relative to the average for countries in the same income group and region—in this case, lower-middle-income countries in Asia.⁹¹ For added perspective, three other comparisons are made: (1) the global average for this income group; (2) values for two comparator countries selected by the Afghanistan mission (in this case Cambodia and Mozambique); and (3) the average for the five best- and five worst-performing countries globally. Most comparisons are framed in terms of value for the latest year of data available. Five-year trends are also taken into account when they shed light on the performance assessment.⁹²

For selected variables, a second source of benchmark values uses statistical regression analysis to establish an expected value for the indicator, controlling for income and regional effects.⁹³ This approach has three advantages. First, the benchmark is customized to Afghanistan’s specific level of income. Second, the comparison does not depend on the exact choice of reference group. Third, the methodology allows quantification of the margin of error and establishment of a “normal” band for a country with Afghanistan’s characteristics. An observed value falling outside this band on the side of poor performance signals a serious problem.⁹⁴

Finally, where relevant, Afghanistan’s performance is weighed against absolute standards. For example, a corruption perception index below 3.0 is a sign of serious economic governance problems, regardless of the regional comparisons or regression result.

⁹¹ Income groups as defined by the World Bank for 2004. For this study, the average is defined in terms of the mean; future studies will use the median instead, because the values are not distorted by outliers.

⁹² The five-year trends are computed by fitting a log-linear regression line through the data points. The alternative of computing average growth from the end points produces aberrant results when one or both of those points diverges from the underlying trend.

⁹³ This is a cross-sectional OLS regression using data for all developing countries. For any indicator, Y , the regression equation takes the form: Y (or $\ln Y$, as relevant) = $a + b * \ln \text{PCI} + c * \text{Region} + \text{error}$ – where PCI is per capita income in PPP\$, and Region is a set of 0-1 dummy variables indicating the region in which each country is located. When estimates are obtained for the parameters a , b , and c , the predicted value for Afghanistan is computed by plugging in Afghanistan-specific values for PCI and Region. Where applicable, the regression also controls for population size and petroleum exports (as a percentage of GDP).

⁹⁴ This report uses a margin of error of 0.66 times the standard error of estimate (adjusted for heteroskedasticity, where appropriate). With this value, 25 percent of the observations should fall outside the normal range on the side of poor performance (and 25 percent on the side of good performance). Some regressions produce a very large standard error, giving a “normal band” that is too wide to provide a discerning test of good or bad performance.

STANDARD CAS INDICATORS

| Indicator | Level | MDG, MCA, or EcGov ^a |
|---|-------|---------------------------------|
| Growth Performance | | |
| Per capita GDP, in Purchasing Power Parity Dollars | I | |
| Per capita GDP, in current US Dollars | I | |
| Real GDP Growth | I | |
| Growth of labor productivity | II | |
| Investment Productivity, Incremental Capital-Output Ratio (ICOR) | II | |
| Gross fixed investment, % GDP | II | |
| Gross fixed private investment, % GDP | II | |
| Poverty and Inequality | | |
| Human Poverty Index | I | |
| Income-share, poorest 20% | I | |
| Population living on less than \$1 PPP per day/ \$2 PPP per day ⁹⁵ | I | MDG |
| Poverty Headcount, by National Poverty Line | I | MDG |
| PRSP Status | I | EcGov |
| Population below minimum dietary energy consumption | II | MDG |
| Economic Structure | | |
| Labor force or employment structure | I | |
| Output structure | I | |
| Demography and Environment | | |
| Adult literacy rate | I | |
| Youth dependency rate/ elderly dependency rate ⁹⁶ | I | |
| Environmental performance index | I | |
| Population size and growth | I | |
| Urbanization rate | I | |
| Gender | | |
| Girls primary completion rate | I | MCA |
| Gross enrollment rate, all levels, male, female | I | MDG |
| Life expectancy at birth, male, female | I | |
| Labor force participation rate, male, female | I | |
| Fiscal and Monetary Policy | | |
| Govt. expenditure, % GDP | I | EcGov |
| Govt. revenue, % GDP | I | EcGov |
| Growth in the money supply | I | EcGov |

⁹⁵ \$1 PPP for lower income countries and \$2 PPP for lower middle income countries

⁹⁶ Elderly dependency rate for Eastern Europe and Former Soviet Union countries and youth dependency rate for all others

| Indicator | Level | MDG, MCA, or EcGov ^a |
|---|-------|---------------------------------|
| Inflation rate | I | MCA |
| Overall govt. budget balance, including grants, % GDP | I | MCA, EcGov |
| Composition of govt. expenditure | II | |
| Composition of govt. revenue | II | |
| Composition of money supply growth | II | |
| Business Environment | | |
| Corruption perception index | I | EcGov |
| Ease of doing business ranking | I | EcGov |
| Rule of law index | I | MCA, EcGov |
| Regulatory quality index | I | MCA, EcGov |
| Government effectiveness index | I | MCA, EcGov |
| Cost of starting a business | II | MCA, EcGov |
| Procedures to enforce a contract | II | EcGov |
| Procedures to register property | II | EcGov |
| Procedures to start a business | II | EcGov |
| Time to enforce a contract | II | EcGov |
| Time to register property | II | EcGov |
| Time to start a business | II | MCA, EcGov |
| Total tax payable by business | II | EcGov |
| Business costs of crime, violence, terrorism index | II | |
| Senior manager time spent dealing with government regulations | II | EcGov |
| Financial Sector | | |
| Domestic credit to private sector, % GDP | I | |
| Interest rate spread | I | |
| Money supply, % GDP | I | |
| Stock market capitalization rate, % of GDP | I | |
| Credit information index | I | |
| Legal rights of borrowers and lenders index | II | |
| Real Interest rate | II | |
| External Sector | | |
| Aid , % GNI | I | |
| Current account balance, % GDP | I | |
| Debt service ratio, % exports | I | MDG |
| Export growth of goods and services | I | |
| Foreign direct investment, % GDP | I | |
| Gross international reserves, months of imports | I | EcGov |
| Gross Private capital inflows, % GDP | I | |
| Present value of debt, % GNI | I | |

| Indicator | Level | MDG, MCA, or EcGov ^a |
|--|-------|---------------------------------|
| Remittance receipts, % exports | I | |
| Trade, % GDP | I | |
| Trade in services, % GDP | I | |
| Concentration of exports | II | |
| Inward FDI potential index | II | |
| Net barter terms of trade | II | |
| Real effective exchange rate (REER) | II | EcGov |
| Structure of merchandise exports | II | |
| Trade policy index | II | MCA, EcGov |
| Ease of trading across borders ranking | II | EcGov |
| Economic Infrastructure | | |
| Internet users per 1,000 people | I | MDG |
| Overall infrastructure quality | I | EcGov |
| Telephone density, fixed line and mobile | I | MDG |
| Quality of infrastructure—railroads, ports, air transport, and electricity | II | |
| Roads paved, % total roads | II | |
| Science and Technology | | |
| Expenditure for R&D, % GDP | I | |
| FDI and technology transfer index | I | |
| Availability of scientists and engineers index | I | |
| Science & technology journal articles per million people | I | |
| IPR protection index | I | |
| Health | | |
| HIV prevalence | I | |
| Life expectancy at birth | I | |
| Maternal mortality rate | I | MDG |
| Access to improved sanitation | II | MDG |
| Access to improved water source | II | MDG |
| Births attended by skilled health personnel | II | MDG |
| Child immunization rate | II | MCA |
| Prevalence of child malnutrition (weight for age) | II | |
| Public health expenditure, % GDP | II | MCA, EcGov |
| Education | | |
| Net primary enrollment rate – female, male, total | I | MDG |
| Persistence in school to grade 5 | I | MDG |
| Youth literacy rate, all, male, female | I | |
| Net secondary enrollment rate | I | |

| Indicator | Level | MDG, MCA, or EcGov ^a |
|--|-------|---------------------------------|
| Gross tertiary enrollment rate | I | |
| Education expenditure, primary, % GDP | II | MCA, EcGov |
| Expenditure per student, % GDP per capita—primary, secondary, and tertiary | II | EcGov |
| Pupil-teacher ratio, primary school | II | |
| Employment and Workforce | | |
| Labor force participation rate, total | I | |
| Rigidity of employment index | I | EcGov |
| Size and growth of the labor force | I | |
| Unemployment rate | I | |
| Economically active children, % children ages 7-14 | I | |
| Firing costs, weeks of wages | II | EcGov |
| Agriculture | | |
| Agriculture value added per worker | I | |
| Cereal yield | I | |
| Growth in agricultural value-added | I | |
| Agricultural policy costs index | II | EcGov |
| Crop production index | II | |
| Livestock production index | II | |
| Agricultural export growth | II | |

^a Level I = primary performance indicators, Level II = supporting diagnostic indicators

^b MDG—Millennium Development Goal indicator

MCA—Millennium Challenge Account indicator

EcGov—Major indicators of economic governance, which is defined in USAID’s Strategic Management Interim Guidance to include “microeconomic and macroeconomic policy and institutional frameworks and operations for economic stability, efficiency, and growth.” The term therefore encompasses indicators of fiscal and monetary management, trade and exchange rate policy, legal and regulatory systems affecting the business environment, infrastructure quality, and budget allocations.