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Overview

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After more than two decades of conflict, a new opportunity emerged for the peaceful development of Afghanistan when the Taliban regime fell in late 2001 and a political agreement was reached between the various Afghan factions in Bonn in December of the same year. The years of fighting had started with the former Soviet Union's intervention in Afghanistan in December 1979 to support the communist regime that had taken power in a military coup in the previous year. The following 10 years saw fierce fighting, until the Soviet forces withdrew in 1989. In 1992, the Mujahedin took over Kabul and installed a new government. However, much of the country remained under the control of local warlords and it was in response to the growing lawlessness and increased factional fighting that the Taliban movement emerged. The Taliban took over Kabul in 1996, following heavy fighting between the various factions that left much of the city destroyed, and eventually controlled almost 90 percent of the country. They made little effort, however, to form a functioning civilian government or provide adequate public services. The U.S.-led military intervention in Afghanistan, following the tragic events of September 11, 2001, resulted in the collapse of the Taliban regime in late 2001 and the formation of a new government.

The Political Landscape

The 2001 Bonn agreement provided a road map for the creation of a peaceful, democratic state. An Afghan Interim Administration (AIA) was appointed and governed for six months until an Emergency Loya Jirga (grand council) of some 1,500 delegates could be convened in June 2002. The Loya Jirga chose a new Afghan Transitional Administration (ATA), headed by President Karzai, that was scheduled to remain in office for two years. The ATA was charged with preparing a new constitution and holding free and fair elections to elect a fully representative government. Following broad consultation with the Afghan people, a new constitution was adopted by a Constitutional Loya Jirga in late 2003, and signed into law in January 2004. Presidential elections were held in October 2004—a little over two years after the convening of the Emergency Loya Jirga. This was a challenging task, made even more difficult by the logistical and security concerns, including the need to establish a register of voters. The United Nations worked closely with the Afghan authorities to prepare for this major undertaking.

Coordination of Assistance

The enormous task of rebuilding Afghanistan has required the strong support of the international community. Even before the AIA came to office, the international community had organized a number of meetings on Afghanistan's reconstruction, starting in the fall of 2001. This included the creation of a Steering Group (SG)—cochaired by the United States, Japan, Saudi Arabia, and the European Union—of donor governments to enhance international political support for the reconstruction process and provide strategic guidance. In November 2001, the SG requested the World Bank, the Asian Development Bank (AsDB), and the United Nations Development Program (UNDP) to produce a preliminary needs assessment for Afghanistan's reconstruction. This assessment was presented at the International Conference on Reconstruction Assistance to Afghanistan in Tokyo in January 2002. The conference generated pledges of assistance for Afghanistan's reconstruction totaling $4.5 billion, with $1.8 billion in pledges for the first year. The Afghan government presented an updated needs assessment at a donors' conference held in Berlin in March 2004. This conference generated pledges totaling $8.2 billion in support for the period March 2004–March 2007, including pledges of $4.4 billion for the period March 2004–March 2005.

In the two years that followed the establishment of the AIA, the leadership and ownership of the reconstruction process were steadily transferred to the Afghan authorities. In early 2002, an Implementation Group (IG) was established, chaired by the government and with the AsDB, the UNDP, the Islamic Development Bank (IsDB), and the World Bank as vice-chairs, to facilitate the coordination of assistance. The Implementation Group meetings were held in Kabul in March and September of 2002. The SG/IG structure evolved in early 2003 into a normal Consultative Group (CG) mechanism and the first major CG meetings—Afghanistan Development Forum and Afghanistan High-Level Strategic Forum—were held in March 2003 in Kabul and Brussels, respectively.

The authorities strengthened their responsibility to coordinate and manage the reconstruction effort by adopting a National Development Framework (NDF) in 2002. The NDF focused on three pillars of development: (1) security and human development; (2) rebuilding physical infrastructure; and (3) enabling the creation of a viable private sector as the engine for sustainable and inclusive economic growth. For each of these pillars, broad sectoral programs have been developed, and individual CGs, which provide the framework for identifying and selecting individual projects within the overall resource envelope, have been established. This process culminated in the creation of the National Development Budget (NDB), which translated the broad priorities and programs of the NDF into detailed and prioritized development projects that are to be funded through the budget.

Role of the IMF

Starting in January 2002, at the request of the Afghan authorities, the IMF began to provide extensive policy advice and technical assistance in its areas of expertise.[1] The focus of this assistance was on ensuring the early establishment of sound foundations for economic management and macroeconomic stability in order to support a sustained economic recovery and facilitate the process of reconstruction. This assistance included helping the authorities to rehabilitate key economic institutions, in particular the Ministry of Finance (MoF) and the central bank, Da Afghanistan Bank (DAB). The IMF Fiscal Affairs Department has focused on improving expenditure management and the tax system. The IMF Monetary and Financial Systems Department assisted with the introduction of the new currency, central bank modernization, and, together with the IMF Legal Department, the preparation of new financial sector legislation. The IMF Statistics Department provided assistance on a new framework for macroeconomic statistics. In addition, a staff team from the IMF's Middle East and Central Asia, Fiscal Affairs, and Policy Development and Review Departments assisted the authorities in developing a macroeconomic framework to guide economic decision making aimed at achieving a sustainable, noninflationary recovery. Policy advice centered on issues crucial to a quick restoration of macroeconomic stability, including the formulation and execution of fiscal policy, the choice of currency arrangement, and the design and conduct of monetary policy. In early 2004, the authorities requested closer involvement from the IMF and an agreement was reached on a staff-monitored program (SMP), which provided a more detailed framework for economic policies for 2004/05. The main objectives of the SMP were to maintain macroeconomic stability and strengthen Afghanistan's institutional and administrative capacity to implement policies. The SMP was announced in the context of the donors' conference in Berlin in March 2004.[2]

[1]In August 2002, the IMF opened a resident representative office in Kabul, and in February 2003, Afghanistan cleared its arrears to the IMF.

[2]The SMP is described in the Afghan government's Memorandum of Economic and Financial Policies, which was posted on the IMF's website on March 24, 2004. The IMF Staff Report on the SMP was also posted on the IMF's website (www.imf.org/External/NP/LOI/2004/afg/01) on April 16, 2004.

Economic Developments and Achievements

From the outset, the Afghan authorities proved strongly committed to achieving financial stability and maintaining fiscal discipline to support the reconstruction and recovery of the economy. They also sought to establish transparency in government operations and to improve economic management. The economy would be based on liberal and open markets, led by private sector activity with low state intervention. Also, the external trade, payments, and exchange systems would be open and liberal; and private sector investment would be promoted. In their efforts to achieve all these goals, the authorities received the support of the IMF, the AsDB (Box 1.1), the World Bank (Box 1.2), various UN agencies, and numerous bilateral donors. This book provides an overview of the institutional and economic achievements in Afghanistan from late 2001 to early 2004.

Chapter 2 describes the strong economic recovery that took place during 2002 and 2003. Economic growth, excluding opium production, is estimated to have reached almost 30 percent in 2002/03 and to have continued at a rate of about 16 percent in 2003/04.[3] This recovery was most visible in agriculture, reflecting the end of prolonged drought, and in the construction and services sectors. Per capita GDP is estimated to have reached about $200 in 2003/04 (although it was still one of the lowest levels in the world).

As the formal economy recovered, so did the production of opium. This has had a profound impact on the economy, with the share of the opium sector in the economy estimated to be about half. The ban on poppy cultivation imposed by the Taliban in 2000 was very successful, but opium production quickly returned to the levels of the late 1990s. Apart from improved weather conditions and an increase in area under cultivation, the reemergence of poppy cultivation reflected the lack of alternative livelihoods and the limited control of the central government beyond Kabul.

Although donor assistance has been sizable, a comparison of aid levels with other recent postconflict countries suggests that aid flows to Afghanistan during 2002 and 2003 were relatively low. Disbursements were high compared with pledged amounts, but pledges were low compared with actual needs. Putting the country back on its own feet will continue to require sizable international assistance over the next several years. This assistance will need to be overwhelmingly in the form of grants to avoid possible future debt-servicing difficulties.

Chapter 3 traces the formulation and implementation of the government's budgetary policy. Afghanistan's fiscal policy, as embodied by the 2002/03 and 2003/04 operating and development budgets, was characterized by a strong commitment to respect fiscal discipline and refrain from monetary financing (the "no-overdraft rule"); the 2002/03 budget financing gap was entirely covered by donor support and the 2003/04 budget was based on the same principle. In 2002/03, expenditures are estimated to have reached $349 million—mostly for government salaries, including those of the provinces, and for the security and social sectors—while domestic revenues turned out much higher than expected, at $132 million. The execution of the 2002/03 budget was, however, seriously hampered by the breakdown of the fiscal system. Only a very small amount of the locally collected revenues were transferred to the center, and little information was available on provincial nonwage expenditures.

The 2003/04 operating budget adopted in March 2003 constituted a major improvement in procedures compared with the previous year. It envisaged a considerable increase in government expenditures, to $550 million, with the increase concentrated in the security and education sectors. It also targeted a sharp rise in domestic revenues, to $200 million. In the event, expenditures are estimated to have reached $451 million in 2003/04, while domestic resources are estimated to have reached $207 million. The $1.8 billion development budget of 2003/04 provided a program of both reconstruction and humanitarian projects, whose outcome would depend on the availability of donor support and the authorities' implementation capacities.

Chapter 4 offers more detail on the progress made in rebuilding fiscal institutions. The biggest strides were made in improving expenditure management—the area where it was most needed, so the government could execute the budget and provide a still very basic level of public services to the population. The authorities also made progress toward fiscal transparency and accountability. Difficulties

[3] Afghan solar year 1381 ran from March 21, 2002, until March 20, 2003, while the solar year 1382 ran from March 21, 2003, until March 19, 2004. The fiscal calendar runs according to the solar year. The solar year 1381 corresponds to the fiscal year 2002/03.

Box 1.1. Asian Development Bank in Afghanistan

Afghanistan was a founding member of the Asian Development Bank (AsDB) in 1966. By the time of the Soviet occupation in 1979 and the suspension of AsDB operations, Afghanistan had received nine loans from the Asian Development Fund (ADF) totaling $95.1 million and grant technical assistance (TA) totaling $2.5 million.

The AsDB resumed operations when the Afghanistan Interim Administration was installed in December 2001. Since then, it has been substantially engaged in assisting Afghanistan. During 2002, AsDB provided $15 million in capacity-building technical assistance grants, and administered a further $22 million in grant-funded pilot projects from the Japan Fund for Poverty Reduction (JFPR). In 2003, AsDB planned to provide an additional $10 million in capacity-building TA grants, and $43 million in grants from JFPR and the Kuwait Fund for Arab Economic Development. Through September 2003, the AsDB had committed a total of $300 million in a Postconflict Multisector Program Loan ($150 million), approved on December 4, 2002, and an Emergency Infrastructure Rehabilitation and Reconstruction Project (EIRRP) Loan ($150 million), approved on June 3, 2003. The EIRRP is assisting the government in restoring key infrastructure in Afghanistan's transport (roads) and energy (electric power and gas) sectors.

The AsDB approved a Country Strategy and Program Update (CSPU) for Afghanistan in June 2003 for 2003–05, for which $610 million was earmarked. The CSPU covered three broad sectors: (1) transportation (roads and civil aviation); (2) energy (power, gas, and petroleum); and (3) natural resources (agriculture, irrigation, and environment). Some $10 million per year in technical assistance is planned in various areas during 2003–05.

All these loans were concessional, with a grant element equivalent to about 60 percent and principal repayment starting only in 2013.

remained in fiscal management of the provinces, but efforts were made to increase the central government's control over provincial finances. These efforts were rewarded and significant amounts of revenues collected by the provinces were transferred to the center in 2003/04.

After improving financial management, the focus of reform shifted toward increasing revenue mobilization, with the objective that the operating budget should eventually be fully financed from domestic revenues. To achieve this, the authorities embarked on a comprehensive reform of customs policy and administration, as well as a reform of tax policy and administration. Only limited progress was made in the difficult area of civil service reform, while the restructuring of the state-owned enterprise (SOE) sector had yet to begin.

Chapter 5 provides an overview of the challenges and issues that the authorities faced in the area of monetary and exchange rate policy. To regain control over the issuance of money, the authorities decided early on to introduce a new national currency, which would also be an important symbol of national unity and sovereignty. Replacing all banknotes in a postconflict country such as Afghanistan within a fairly short period posed tremendous logistical challenges. Nevertheless, after some initial problems that led to a spike in inflation in the fall of 2002, they succeeded in this difficult endeavor sooner than many had thought possible. The introduction of the new currency was a crucial step in the authorities' efforts to establish financial stability.

At the same time, the central bank needed a framework to conduct an independent monetary policy. The authorities decided that the primary objective of monetary policy should be to achieve and maintain price stability and thus to instill confidence in the new national currency. To do so, the central bank aimed to control the domestic money supply, within the context of a floating exchange rate regime. While Afghanistan's existing economic conditions favored a floating exchange rate regime, the authorities nonetheless saw benefits in at least some degree of exchange rate stability to instill confidence in the new currency and to support price stability. Therefore, following the introduction and float of the new currency in early 2003, DAB aimed to limit exchange rate volatility and keep the exchange rate within a range, but without intending to resist persistent exchange rate pressures should these have emerged. Monetary policy was restrained, supported by the no-overdraft rule for the budget. As a result, inflation remained low in 2003 and early 2004. Moreover, in the absence of any major shocks, exchange rate stability was established with the exchange rate fluctuating at about Af 48 per U.S. dollar.

Box 1.2. World Bank in Afghanistan

Following the end of the Taliban era, the World Bank quickly resumed its long-standing relationship with Afghanistan, and in May 2002, it officially reopened its office in Kabul. Between April 2002 and September 2003, the World Bank committed $186.8 million in grants and an additional $128.4 million in no-interest loans ("credits") for development projects that included improving roads; increasing the power supply in Kabul; cleaning up municipal waste; repairing schools; and improving health services. These funds are also being used to strengthen public administration, and develop the national highway and civil aviation.

In addition, the World Bank administered a number of activities financed through separate trust fund facilities. These included projects funded by a $50 million grant from the Japan Social Development Fund (JSDF)—including community rehabilitation, local infrastructure development, and capacity building within the Ministry of Health. A number of projects were also funded by the World Bank Post-Conflict Fund, including teacher training programs implemented by nongovernmental organizations (NGOs), technical assistance in key areas requested by government, early impact projects and technical assistance in a range of priority sectors, and a database of expatriate Afghan experts. The World Bank has also acted as the administrator of the multilaterally supported Afghanistan Reconstruction Trust Fund (ARTF), which is used to cover recurring government costs and salaries as well as finance a number of new projects in areas such as microfinance, telecommunications, and infrastructure.

In March 2003, the World Bank finalized its Transitional Support Strategy (TSS) for Afghanistan, designed to support the government's National Development Framework. The TSS outlined the World Bank's assistance to Afghanistan over a period of 18 months to 2 years. The strategy focused on four key areas: improving livelihoods; assisting with the government's fiscal strategy, institutional development, and management; supporting governance and public administration reform; and helping to enable private sector development in Afghanistan. The TSS envisaged operations amounting to $470 million over 2003/04 and 2004/05.

The renaissance of the financial sector will be vital to Afghanistan's economic development. Chapter 6 describes the parlous state the financial sector had reached by the end of the Taliban period, and the progress that was made during 2002 and 2003. The central bank had inherited the legacy of Soviet-style banking and its sole function had become to print money to cover budget deficits. The existing six commercial and development banks had virtually ceased to function and they had lost the public's confidence. With a dysfunctional banking system, money traders—that is, hawala service providers—had become the only providers of most banking services. During 2002 and 2003, the central bank made important progress in restoring some key functions, especially in the areas of monetary policy, payments, and supervision. To underpin DAB's transformation and to enable the entry of new commercial banks, a new central bank law, which provided DAB with autonomy, and a banking law were enacted in September 2003.

Looking Ahead

Overall, the Afghan authorities made solid progress in the two years since the Bonn Agreement in improving economic management and achieving macroeconomic stability under very difficult circumstances. Of course, difficulties and risks remain in a number of areas. Restoring security throughout the country remains a key priority. To a large extent, this has been achieved for Kabul and its immediate surroundings with the help of the International Security Assistance Force (ISAF), but the government's control over many regional areas is still very limited. This situation complicates macroeconomic management and prevents reconstruction from taking place outside Kabul. Without security, and progress in reconstruction, the country could become dominated by poppy cultivation, sending Afghanistan back into a downward spiral of violence and corruption. Another key priority is to maintain the engagement of the international community. This will be important both for the restoration of security and the reconstruction process. Donor support will continue to be needed for some time. It is to be hoped that the impressive progress in reconstructing Afghanistan over the past two years will serve to persuade the international community that its contribution has been, and will continue to be, more than worthwhile.