



ISLAMIC REPUBLIC OF AFGHANISTAN

SELECTED ISSUES

December 2017

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ISLAMIC REPUBLIC OF AFGHANISTAN

SELECTED ISSUES

November 21, 2017

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MEASURING THE FISCAL REVENUE COST OF CONFLICT IN AFGHANISTAN¹

A. Overview

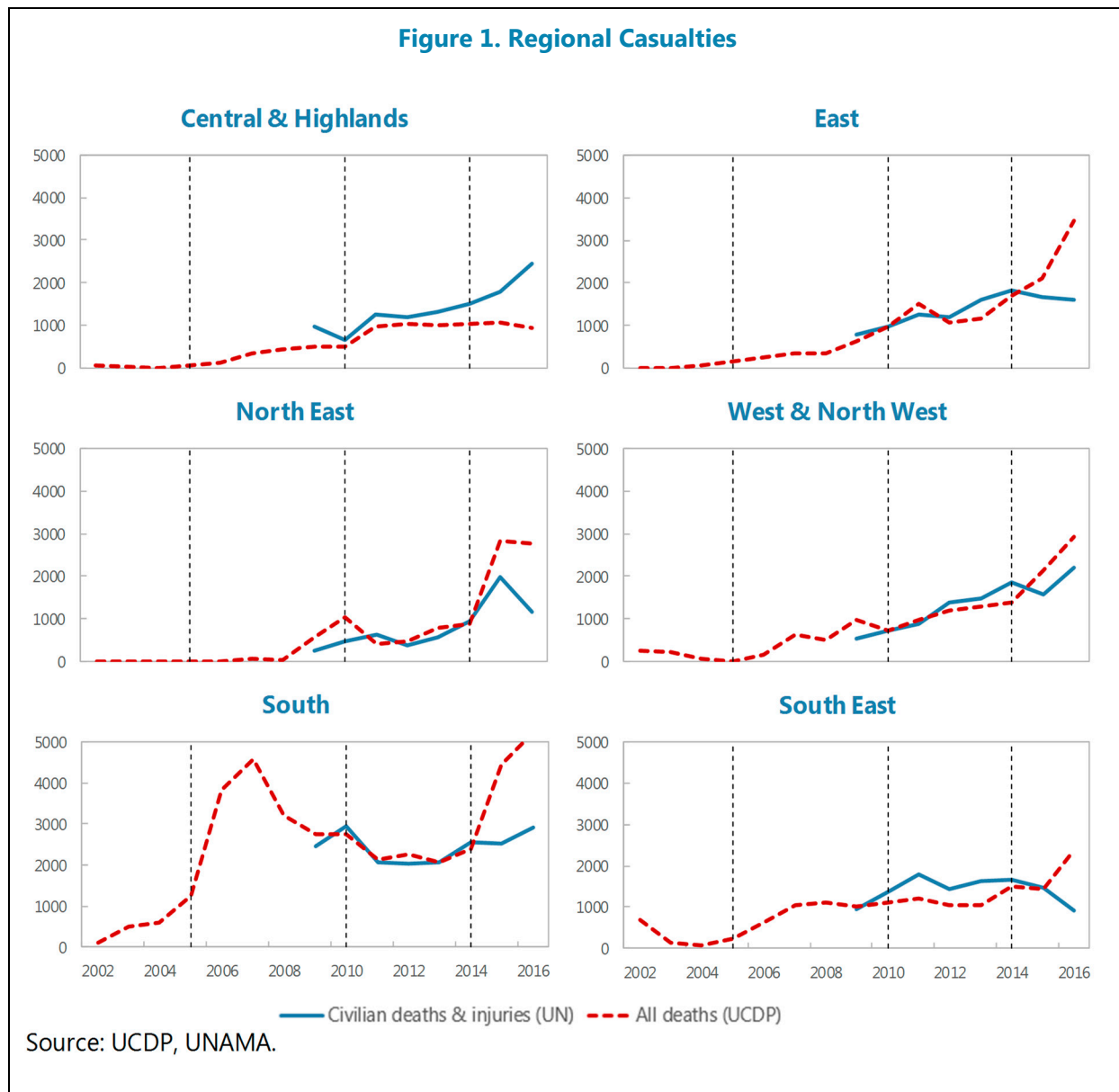
1. **In this paper, we present estimates of the fiscal revenue cost of conflict in Afghanistan, defined as the loss of government domestic revenue due to conflict.** The loss of government revenue is an important component of the humanitarian costs of conflict. When conflict disrupts the flow of revenues to the government, this reduces the amount that the government can spend providing health, education, security, and better infrastructure for its citizens and businesses. Thus, the lost revenue contributes to the massive human cost of conflict the people of Afghanistan have incurred over the past several decades.

2. **The fiscal revenue cost of conflict is also an approximate measure of the potential fiscal gains from peace.** Since it captures the cost of moving from peace to conflict, the fiscal revenue cost of conflict also represents the likely improvement in government resources of moving from conflict to peace, conditional on all else remaining unchanged. In Afghanistan, almost all security spending is funded by foreign grants, which will most likely be scaled back gradually in the event of peace. Hence, any fiscal peace dividend is likely to come principally from increased revenues, as reduced security spending will be mostly offset by reduced grants.

3. **This work contributes to the existing literature by providing a measure of the fiscal revenue cost that is country-specific, dynamic, and captures variation in conflict intensity.** Past studies have sought to measure the costs of conflict, either fiscal (as in Gupta et. al, 2004) or economic (as in IMF 2017; Mueller & Tobias 2016; Besley et al., 2015; Abadie & Gardeazabal 2003; Collier 1999; Knight et al., 1996). These contributions, while valuable, all suffer from at least one of two limitations. Those which classify periods as simply "conflict" or "non-conflict" ignore variation in the severity of conflict. And those which use cross-country data necessarily assume that the relationship between revenues and conflict is the same everywhere. By using within-country variation in deaths from conflict, we avoid these shortcomings. More recent studies attempt to address these issues. But they either measure the reverse relationship (how economic activity affects conflict, Dube & Vargas 2012), or lack the high-frequency data to disentangle the short- and long-run effects of conflict, as we do here (Mueller 2016, Mueller & Besley 2012).

¹ Prepared by Philip Barrett (FAD) with Mariusz Sumlinski (MCD) and research support from Tetyana Sydorenko.

4. **Our conclusion is that conflict-related violence reduced annual national revenues in 2016 by around 50 percent.** This is around Af 70 billion, or roughly \$1.0 billion, and relative to 2005 levels of violence. This matches well with the output loss estimates of Mueller & Tobias 2016. Using African data, they estimate that an increase in per capita conflict deaths on the scale of those seen in Afghanistan 2005–16 would reduce output growth by around 5 percentage points per year. The equivalent reduction in annual revenue growth implied by our estimates is around 6 percentage points.²



² As $0.94^{11} = 0.51$, 11 years of 6 percentage points lower growth is roughly a 50 percent loss.

B. Data on Conflict and Revenue in Afghanistan

5. **Data on conflict comes from the Uppsala Conflict Data Program (UCDP).** This is a commonly used dataset in the conflict literature. It records over 100,000 deaths from conflict in Afghanistan during 2005–16,³ in some 20,000 different incidents.⁴ These are aggregated to provide estimated deaths from conflict for each month during the sample period.

6. **The dynamics of conflict during 2001–16 can be divided into four main periods.** During 2001–05, conflict deaths in Afghanistan were in the thousands, with some 4,500 deaths nationwide in this period (see Figure 1).⁵ During 2006–10, as fighting intensified, deaths increased above 30,000, over half of which were in the Southern region⁶ Throughout 2011–14, conflict deaths declined as foreign troop numbers peaked (see Figure 2). In 2015–16 troops left; conflict intensified and deaths increased once again.

7. **Conflict violence in Afghanistan is high by international standards.** Figure 3 shows UCDP conflict deaths per 1000 of population for six countries in the region. Given the natural difficulties associated with collecting data in conflict-affected states, such comparisons should be considered only approximate. Nevertheless, these data suggest that the intensity of recent violence in Afghanistan is at least as severe as that experienced in Iraq in 2014

Figure 2. Development of ISAF Troop Strength

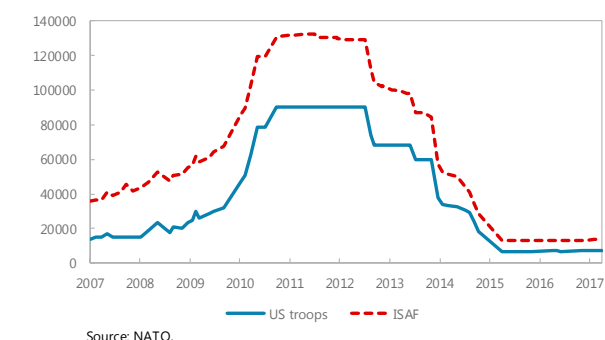
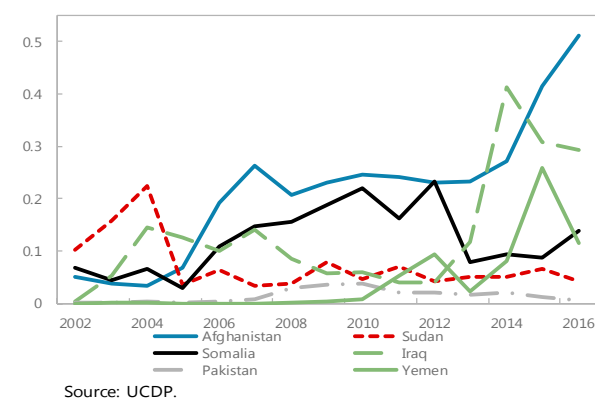


Figure 3. International Comparisons of Conflict Violence



³ The UCDP records for Afghanistan are available from 1989, but are restricted to post-2005 to match the available revenue data. Data for 2017 are not yet available.

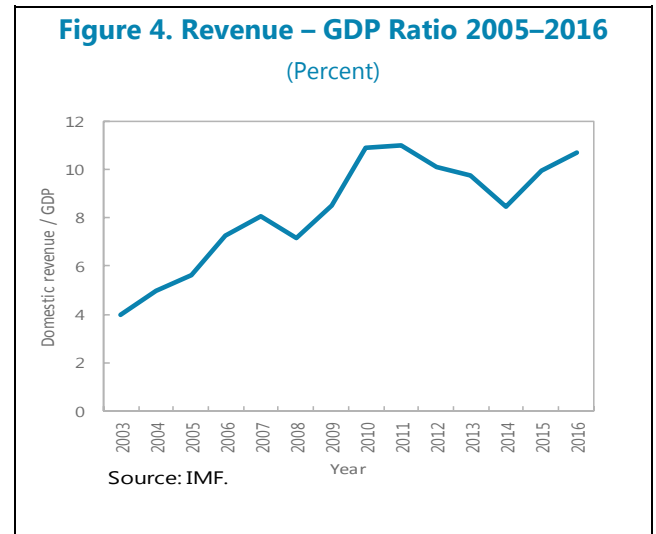
⁴ Recording deaths from conflict is inherently a very challenging task, and numbers of estimates likely subject to under-reporting. For the analysis in this paper, though, this is not central as the subsequent analysis is conducted in relative terms. So long as the omitted share of deaths from conflict is constant, relative movements are accurate. The broad agreement between the UCDP and UN data in Figure 1 (albeit for slightly different variables) suggests that the UCDP coverage is good.

⁵ Throughout, conflict and revenue data are not normalized by population, except where absolutely necessary (such as in Figure 3 for comparability with other sources). Afghanistan has not had a census since 1979, so even national population numbers are very rough estimates. The Central Statistics Organization does publish annual provincial population numbers, but these are purely judgement.

⁶ Bordering principally Pakistan, the Southern region comprises Helmand, Kandahar, Nimroz, Uruzgan, and Zabul provinces, and includes around 11 percent of the national population.

during the rise of Islamic State, at least on average nationwide. Syria is a notable omission from this chart. The intensity and scope of the Syrian conflict is much more severe, and arguably not comparable to the conflicts recorded in Figure 3; in 2016 UCDP per capita deaths from conflict in Syria were over five times those recorded in Afghanistan.

8. **Data on revenue are reported by the Ministry of Finance in their monthly financial statements.** We focus on domestic revenue, shown annually in Figure 4 as a share of GDP. Overall, revenues have risen considerably since 2005. The main drivers of this improvement have been efficiency improvements and policy changes (including the introduction of a tax on mobile phone top-ups). The decline in 2014 was a result of the economic slowdown following the drawdown of international forces.



9. **Contemporaneous increases in both conflict and revenue are consistent with a negative impact of conflict on revenues.** The claim that conflict reduces revenues may seem counterintuitive given that violence and revenues both rose during 2005–16. But a negative relationship between conflict and revenue does not mean that nationwide revenues will necessarily decline during periods of increasing violence. Rather, it means that provinces with relatively smaller increases in violence will exhibit relatively larger increases in revenues. This important point has a bearing on the estimation method discussed below. Furthermore, because conflict likely affects both the numerator and denominator of the series shown in Figure 4, we cannot make strong predictions about this ratio in the absence of further analysis.

C. Estimation Method

10. **To estimate the impact of conflict on revenue, we specify a dynamic relationship between revenue and deaths from conflict.** It is possible that third factors affect both revenues and deaths from conflict.⁷ To account for this, our model also includes four other variables: time fixed effects, to allow for the impact of factors correlated across provinces, such as national macro conditions and seasonality; province fixed effects, to account for permanent province-specific factors, such as the existence of a customs house; provincial average precipitation from the Centre for Environmental Data Analysis, as weather likely affects both conflict and fighting; and the regional opium price for similar reasons.⁸ It is also possible that when revenues decline, that decline may

⁷ In econometrics, this is referred to as the “omitted variables” problem.

⁸ Ideally, one would like to include more province-specific variables. But there are almost no other monthly, provincial data series available for Afghanistan

itself support insecurity and in turn lead to violence.⁹ To account for this, we include lagged revenue. This is valid if the impact of revenue on conflict is sufficiently slow-moving that it is well-predicted by its lags. Last, it is also possible that the impact of violence on revenue happens with a delay. For example, local business may decide to shut down or move away only after an extended period of violence. To allow for this we include lags of conflict deaths.¹⁰

11. **Formally, the model is a dynamic panel regression**, defined by:

$$y_{i,t} = \sum_{l=0}^L \beta_l s_{i,t-l} + \sum_{m=1}^M \rho_m y_{i,t-m} + \sum_{n=1}^N \alpha_l' z_{i,t-n} + \mu_i + \delta_t + u_{it}$$

where $y_{i,t}$ is the logarithm of revenues in province i in month t , $s_{i,t}$ is the logarithm of conflict deaths in province i in month t , $z_{i,t}$ is a vector of precipitation and regional opium price, and μ_i and δ_t are province and period fixed effects. The model is estimated via ordinary least squares.

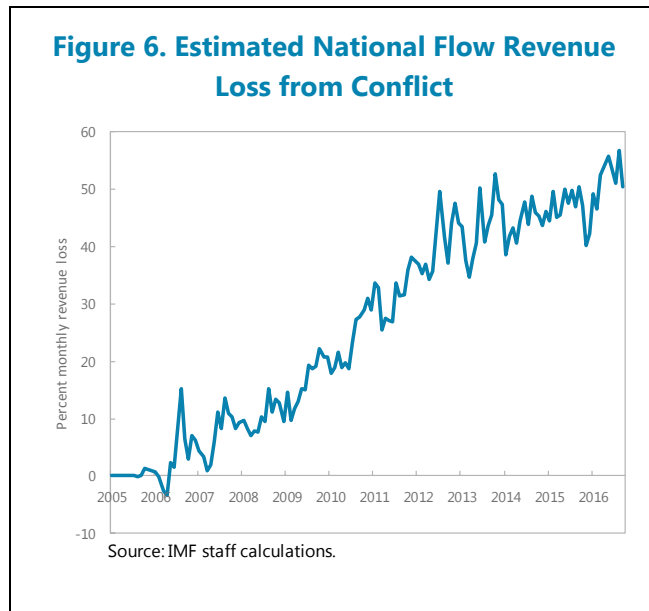
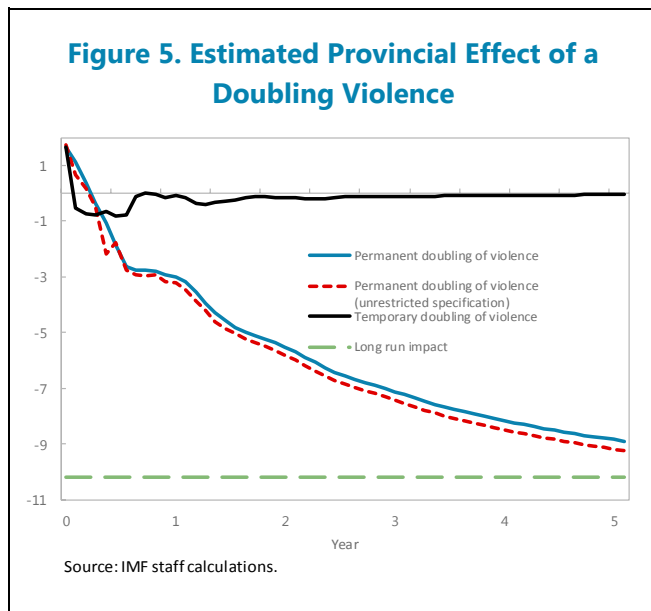
12. **Table 1 reports the results of estimation.** The coefficients can be interpreted as elasticities: a coefficient of -0.01 would mean that revenues decrease by 1 percent when conflict increases by 100 percent. Column (1) shows the estimated contemporaneous relationship between conflict and revenue for a specification which does not control for time or province effects. Unsurprisingly, since both revenue and conflict deaths have increased over time as shown in Figures 3 and 4 above, the coefficient on the measure of conflict is positive. In columns (2)–(6) we progressively enrich the estimation by controlling for time and geographic effects, controlling for rainfall and the regional opium price, adding lagged conflict measure to capture the effect of a delayed impact of conflict, and adding lagged revenues to control for a possible reverse causality. In all specifications, the impact of contemporaneous or lagged conflict is negative, reasonably stable, and statistically significant at the 5 percent level in the more sophisticated versions. In column (7) we show estimates of a specification with up to six months of past conflict. Almost all coefficients on the conflict variables are negative, and are jointly statistically significant at the 1 percent level. To illustrate this simply, in column (8) we show the estimates of a specification where the lagged conflict variables from column (7) are replaced by their average. The estimated coefficients include a large, negative effect on a lagged measure of conflict, significant at the 1 percent level. This is our preferred specification.

13. **The estimated impact of conflict on revenues is large and negative.** We used the model presented in column (8) of Table 1 to illustrate an impact of the increase in violence on revenue. In Figure 5 we illustrate the impact on revenue from a temporary increase in violence (black line) where

⁹ This effect is known as “reverse causality.”

¹⁰ Although with a shorter lag length than revenues, to retain the validity of the reverse-causality control.

conflict deaths double in the first period, before returning to their previous level and a permanent increase in violence (blue line) where conflict permanently doubles.¹¹ For the first case, the overall loss cumulates to a total of around 10 percent of one month's revenues. For the second case, the long-run impact is large and negative, with a revenue loss of over 10 percent per month.¹² The initial positive response is also interesting, and suggests that conflict may initially increase revenues. This might occur if fighters move into an area, boosting local demand, or because officials collect outstanding debts before businesses leave an area. In any case, the effect is only just significant at the 10 percent level, at least in specification (7), so we should not over-interpret it.



D. Estimated Impact of Conflict on National Revenue

14. **Aggregating the provincial effects gives a measure of the national revenue loss from conflict, which is around \$1 billion in 2016.** To compute a national revenue loss due to conflict, we feed into the estimated statistical model a counterfactual alternative sequence for deaths from conflict where in each province deaths remain at their 2005 level.¹³ We then aggregate the implied revenue loss across the provinces to produce an estimated national revenue loss. Figure 6 shows the

¹¹ The red line shows the model responses from specification (7) of Table 1. The results are very similar, verifying that using average lagged conflict is not restrictive.

¹² We can compute the long-run effect directly from the coefficients. It is $\sum_{l=0}^L \beta_l / (1 - \sum_{l=1}^L \rho_l)$ = $(0.017 - 0.042) / (1 - 0.735)$ = -0.102 . Or, an elasticity of 10.2 percent.

¹³ Because the national population has approximately doubled during this period, this experiment entails roughly a halving of the per capita fatality rate. One could approximately offset this change by halving the estimated impact. In the absence of reliable provincial population data, though, we cannot perform this exercise accurately.

result of this exercise, plotting the estimated monthly revenue loss due to conflict since 2005. As conflict has grown, so too has the associated revenue loss. In 2016, the estimated revenue loss was around 50 percent of revenues, some Af 70 billion, about 5 percent of GDP, or roughly \$1 billion.

15. **The distribution of increased conflict violence across provinces accounts for about half the estimated lost revenue.** Cross-provincial patterns play an important role in this national estimate. If all provinces had experienced the same relative increase in conflict, the national revenue loss would be about half the size.¹⁴ But because provinces which generate more revenue have tended to see the largest increases in violence, the larger losses there have an outsized impact on the national total.

	Log Revenues							
	(1)	(2)	(3)	(4)	(5)	(6)	(7)	(8)
Log conflict deaths	0.252*** (0.059)	-0.011 (0.013)	-0.006 (0.009)	0.0004 (0.008)	0.011 (0.010)	0.013 (0.010)	0.017* (0.010)	0.017 (0.010)
Log conflict deaths: 1 month lag				-0.018* (0.010)	-0.017** (0.008)	-0.018** (0.007)	-0.012 (0.008)	
Log conflict deaths: 2 month lag							-0.004 (0.007)	
Log conflict deaths: 3 month lag							-0.006 (0.009)	
Log conflict deaths: 4 month lag							-0.017** (0.007)	
Log conflict deaths: 5 month lag							0.007 (0.008)	
Log conflict deaths: 6 month lag							-0.010 (0.009)	
Log conflict deaths: 6 month lag ave.								-0.042*** (0.016)
Month-Province fixed effects	No	Yes	Yes	Yes	Yes	Yes	Yes	Yes
Revenue lags	0	0	1	1	12	12	12	12
Precipitation lags	0	0	0	0	0	12	12	12
Regional opium price lags	0	0	0	0	0	12	12	12
Observations	4,477	4,477	4,196	4,196	2,405	2,405	2,405	2,405
R ²	0.094	0.001	0.072	0.073	0.206	0.212	0.215	0.214
Adjusted R ²	0.094	-0.040	0.032	0.033	0.144	0.140	0.142	0.142
Note:	*p<0.1 **p<0.05 ***p<0.01 Heteroskedastic and autocorrelation consistent standard errors in parentheses							

¹⁴ Conflict deaths have increased tenfold, which the model predicts would have a long-run impact of around log (10)
* -0.102 = -0.24; a 24 percent loss.

E. Conclusion

16. **In this paper, we estimated the lost revenue from conflict in Afghanistan.** Lower revenues hamper the ability of the government to provide basic services to its citizens. Government revenue losses therefore contribute to the humanitarian costs of conflict. In Afghanistan, this loss appears very substantial, even when accounting for the considerable uncertainty about the exact size of the estimates. Nevertheless, size and the statistical significance of the results suggest that the order of magnitude of the estimate, around \$1 billion, is robust. By way of counterfactual, these results imply a sizeable potential fiscal dividend for Afghanistan should peace, or at least a significant reduction in violence, materialize.

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AFGHANISTAN'S INTEGRATION IN REGIONAL TRADE: A STOCKTAKING¹

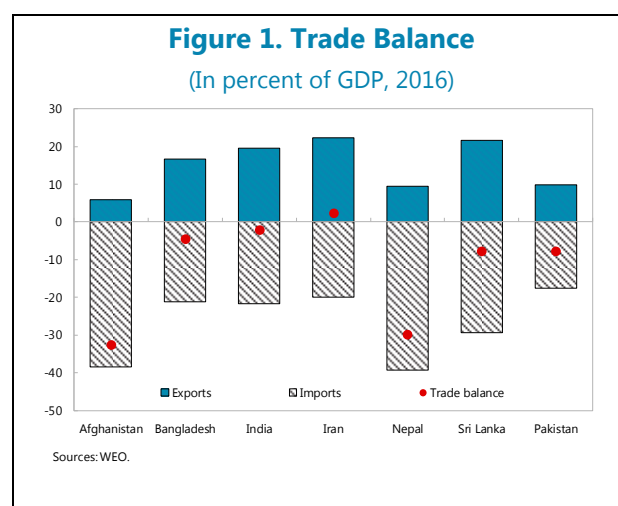
Several country-specific factors, including conflict and a landlocked geography, have held back an expansion in Afghanistan's trade which could increase the country's economic resilience. Improving its external connectivity is a key factor to unlocking its trade potential including leveraging its natural resources. Ongoing projects in transportation and energy transmission could boost trade and transit and make Afghanistan a hub for Central and South Asia. Policies aimed at unlocking supply side bottlenecks are necessary to achieve that. Closing infrastructure gaps can bring significant gains if coupled with strong institutions and implemented as part of a sound regional development agenda. Public Private Partnerships could be used as implementation mechanisms once legal and institutional frameworks are ready.

A. External Trade Performance

1. **Afghanistan's external trade contributes little to economic growth.** The country's share in global trade is insignificant. Its trade balance has been deeply negative for the last two decades. It compares poorly with its neighbors especially with respect to the low value of its official exports,² which have remained below 10 percent of GDP since 2012, while imports are dominated by foreign financed security spending and aid-related imports.

2. **Afghanistan's low degree of trade diversification makes it more vulnerable to external shocks.** Afghanistan's external trade is concentrated in agricultural products (nearly 45 percent of exports). This reflects the small manufacturing base and a recent decline in specialized products such as carpets and textiles owing to global competition. Furthermore, heavy export concentration (Pakistan and India) expose the country to demand shocks in those markets.

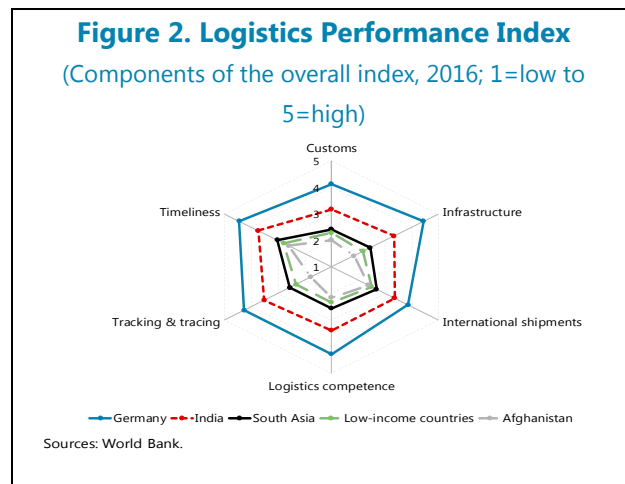
3. **Several country-specific factors have held back trade performance.** Constant conflict over the last 35 years, a landlocked geography, and infrastructure and institutional gaps have combined to thwart trade expansion. The costs of being landlocked are well-documented. The World Bank's Logistics Performance Index (LPI) shows that on average the delays and costs for both



¹ Prepared by Patrick Gitton (SPR) and Murtaza Muzaffari (local economist).

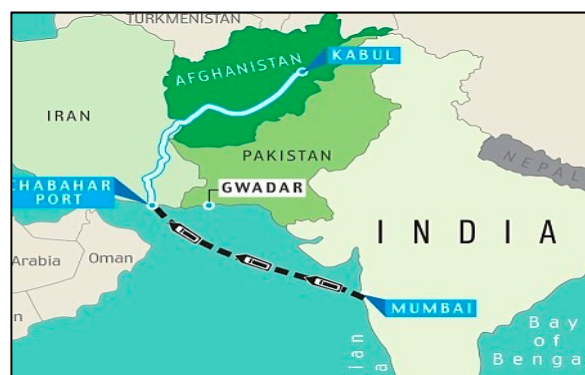
² The illicit opiate economy was estimated at US\$2.8 billion in 2014—equivalent to 13 percent of GDP (UNODC, 2016).

importing and exporting are far higher for landlocked countries than their coastal neighbors. In the case of Afghanistan, a range of domestic factors includes supply-side constraints (access to finance, land and electricity, energy costs), costs due to security challenges, and poor logistics and trade infrastructure. Given that Afghanistan depends on its coastal neighbors to access export markets, the future development of trade requires that it cooperates with its neighbors within bilateral and regional arrangements.



B. Bilateral, Regional and Multilateral Trade Cooperation

4. **Afghanistan has bilateral and regional trade cooperation agreements.** A trade-transit agreement signed in October 2010 superseded the first 1965 Afghanistan-Pakistan Transit Trade Agreement (APTTA), allowing both countries to use each other's transit corridor. Political tensions have limited its full implementation but, importantly, Afghanistan's participation in the new APTTA has helped the country meet its WTO accession requirements. In 2016, Iran and India signed an agreement to develop the Chabahar seaport, located on the Persian Gulf. India expanded it to a trilateral agreement to transit its products to Central Asian markets through Afghanistan. This also opens an opportunity for Afghanistan to use the transit corridors and the seaport for its trade activities. In addition, Afghanistan and India opened an air corridor in mid-2017 to ease access to the Indian market. Afghanistan also benefits from preferential regimes with the European Union and the United States and some other advanced economies.



5. **Afghanistan is a member of several regional cooperation organizations and, since 2016, the World Trade Organization (WTO).** On their path to WTO accession, the authorities have joined several regional organizations including the Asian Infrastructure Investment Bank. They also signed a Memorandum of Understanding with China's Belt and Road Initiative (BRI). At the technical level, the Afghan authorities have recently maintained

Table 1. Islamic Republic of Afghanistan: Afghanistan's Participation in Regional Economic Organizations

Organization	Accession
Asian Development Bank (ADB)	1966
Economic Cooperation Organization (ECO)	1992
Central Asia Regional Economic Cooperation (CAREC)	2005
Regional Economic Cooperation Conference on Afghanistan (RECCA)	2005
South Asian Association for Regional Cooperation (SAARC)	2007
Shanghai Cooperation Organization (SCO)	2012
Belt and Road Initiative (BRI)	(Observer) 2016
Asian Infrastructure Investment Bank (AIIB)	(MoU) 2017

an economic dialogue within the China-Pakistan Economic Corridor (CPEC) which, as part of China's Belt and Road initiative (BRI), envisages a US\$54 billion infrastructure project to connect China's Xinjiang region to Pakistan's Gwadar port. WTO membership should help develop external trade including through WTO trade policy technical assistance.

C. Transport Connectivity

6. **Many landlocked countries benefit from being part of a trade corridor.** Most existing trade corridor arrangements are in Africa: for example, the ones feeding Dar es Salaam, Mombasa, or Djibouti ports. In Latin America, Paraguay and Bolivia benefit from the International Land Transport Agreement (ATIT) adopted by the Mercosur in the 1990s. Transit trade is an opportunity to leverage Afghanistan's landlocked location into a comparative advantage.

7. **Afghanistan is part of the Lapis Lazuli transit and trade corridor.** The road project mainly financed by China and the Asian Development Bank connects Afghanistan, Azerbaijan, Georgia, Turkey, Turkmenistan, and links Central Asia, the Caucasus, the Balkans and Central Europe. Transit trade requires large foreign investment in infrastructure which would result in associated income and employment. The trade itself would have positive spillovers to service sectors, such as transportation and logistics, banking, insurance, health services, and hospitality industry. It is likely to foster reforms in customs systems and generate additional government revenue which could help finance domestic development needs. The World Bank estimates that gains from transit could grow to some 1 percent of GDP or nearly 10 percent of domestic revenues.

8. **New railway networks offer another opportunity for Afghanistan's regional integration.** One of CAREC's³ 35 projects in transport, energy transmission, and trade facilitation is the train line connecting Hairatan, the Afghan river port bordering with Uzbekistan, to Mazar-i-Sharif, the country's second largest commercial center. This is part of a broader plan to connect Tajikistan and Uzbekistan directly to Persian Gulf ports through Afghanistan. The Chinese "Belt and Road Initiative" (BRI) also established a commercial rail line in 2016, linking Western China to Hairatan through Kazakhstan and Uzbekistan. In addition, the "Five Nations Railway Corridor" connecting China to Iran through the Kyrgyz Republic, Tajikistan, and Afghanistan will bring considerable trade and transit opportunities to the country.

D. Energy Transmission Hub

9. **Energy transit trade can bring additional revenue and, very importantly, help the country meet its own electricity needs.** The World Bank estimates that exports could grow by more than 3 percent annually and transit trade contribute some US\$530 million to revenue by 2030 (about 1 percent of GDP).

³ The Central Asia Regional Economic Cooperation (CAREC) was initiated by the ADB in 2001. It brings together 10 member countries and international organizations including the World Bank. In addition to the five Central Asian republics, Afghanistan (since 2005), Azerbaijan, China, Mongolia, and Pakistan are members.

10. **Electricity transmission through Afghanistan could bring up to US\$45 million in transit fees per annum.** The World Bank, the U.S., and the European Investment Bank are financing a project to export electricity from Kyrgyz Republic and Tajikistan to Pakistan through Afghanistan (CASA-1000). Through this project, Afghanistan will also import 300 MW of electricity for its own needs to address chronic power shortage (with annual needs between 2,000 and 3,000 MW).



11. **Transit fees from the TAPI natural gas pipeline could considerably boost Afghanistan’s revenue.** The pipeline from Turkmenistan to Pakistan and India will position Afghanistan as an important transit route. The potential annual transit fees range from US\$300 million to US\$500 million.



12. **The currently negotiated electricity transmission Turkmenistan-Uzbekistan-Tajikistan-Afghanistan-Pakistan (TUTAP) project could further strengthen the country’s regional hub position.** TUTAP will interconnect Afghanistan’s currently isolated power grids and develop the infrastructure for transmission between Afghanistan, Pakistan, Tajikistan, Turkmenistan, and Uzbekistan. The project aims to increase energy security and efficiency in the whole region.

E. Challenges

13. **Reaping the full benefits of WTO membership and regional connectivity initiatives faces various challenges** from cross-border tensions including temporary closing, to insecurity, governance issues such as rent seeking and corruption, over-regulation, delays in customs clearance, and poor transportation infrastructures such as congested roads and limited railways. The country’s ongoing conflict hampers the unlocking of trade potential and investment prospects and weak governance lowers the contribution of trade to economic growth.

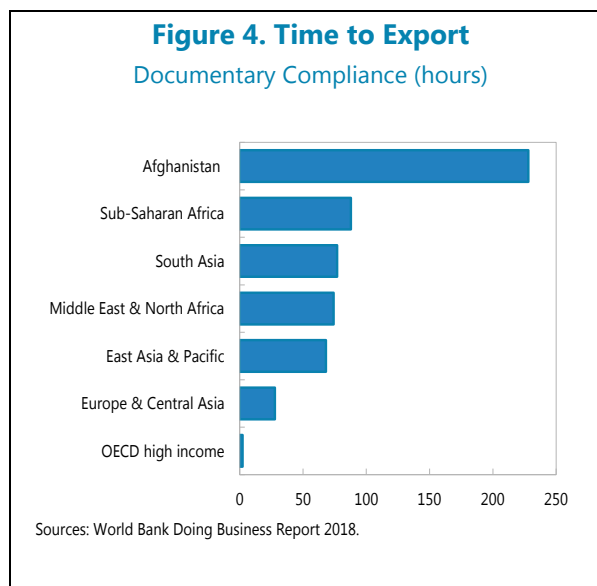
14. **Improving the business environment is central to Afghanistan’s long-term development strategy.** High costs of doing business in Afghanistan are reflective of the regulatory burden and perceived risks to investing and operating in the country. The inability of Afghanistan to attract FDI (less than 1 percent of GDP in recent years) has limited the country’s ability to take advantage of new sources of finance, knowledge and access to markets.



F. Policies

15. **Improving customs and border procedures can significantly boost trade.**

Delays related to customs and border procedures impede export potential. Procedures and documentary requirements could be streamlined and integrated into an automated national single system. All the necessary information for the export, import and transit operations could be centralized on a dedicated web portal. The authorities should work on enhancing cooperation and information sharing between various government agencies, and with the private sector. Government policies can positively affect domestic logistics performance through regulation and border management.



16. **Large infrastructure investments require careful macroeconomic management.** Large projects may exert additional pressure on the balance of payments due to their large import content, and on inflation given possible supply bottlenecks and wage pressures. Strong national frameworks for planning, allocating, implementing and monitoring public investment management are necessary to maximize the value of public spending. At this stage, debt sustainability considerations require to externally finance infrastructure only through grants and highly concessional loans.

17. **Private sector involvement in trade-related infrastructure also requires strong management capacity.** Gains from transit trade are conditional upon efficient logistics and quality trade-related infrastructure (transport, utilities). This requires large investments in transportation and border infrastructure which are competing with other physical infrastructure needs (agriculture, mining, energy). Private capital for public works and infrastructure investments is almost nonexistent, particularly for investments with high economic and social but low financial returns. While there is little scope for full private infrastructure building, the World Bank is supporting the creation of an enabling environment for Public-Private Partnerships (PPP). A strong PPP framework, including to manage associated fiscal risks, is a prerequisite for such contracts. Expertise also needs to be built for structuring projects to ensure an acceptable risk-return combination for private investors.

Table 2. Islamic Republic of Afghanistan: Afghanistan's Participation in Major Regional Connectivity Projects

Project	Purpose	Status	Participating Countries	Estimated Cost	Partnership
CASA 1000	Electricity transmission	Signed	AFG, KGZ, PAK, TJK	US\$ 1.2 billion	WB, US, IsDB, EIB
TAPI	Gas pipeline	Signed	AFG, IND, PAK, TKM	US\$ 10 billion	TAPI Pipeline Company Ltd (AFG, IND, PAK, TKM), JPN, ADB, consortium (CHN, JPN)
TUTAP	Electricity transmission	Under negotiation	AFG, PAK, TKM, UZB, TJK	US\$ 1.2 billion	ADB WB (ARTF)
Chabahar Port	Transit and trade	Signed	AGF, IND, IRN	US\$ 0.5 billion	IND
Lapis Lazuli Corridor	Transit and trade	Signed	AFG, TKM, AZE, GEO, TUR	N/A	CHN, ADB
Five Nations Railway Corridor	Transit and trade	Signed	AFG, CHN, IRN, TJK, KGZ	US\$ 2 billion	ADB, WB, US, CHN

Figure 5. Trade and Transit Corridors



Source: Afghan Ministry of Foreign Affairs.

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FINANCIAL INCLUSION AND ACCESS IN AFGHANISTAN¹

A. Introduction

- Afghanistan is seeking ways to increase inclusive growth in a security-constrained environment.** One possible source of inclusive growth and economic development is financial inclusion, by which we mean access to and ability to use formal financial services. As illustrated by many empirical studies, households' access to finance has a positive correlation with growth² At the macro level, financial deepening can reduce growth volatility by alleviating liquidity constraints on firms and households.
- This paper provides a snapshot of where Afghanistan stands on financial inclusion, including compared to similar countries, and identifies the key areas where inclusion can be raised.** The authorities, together with the World Bank, are working on a financial inclusion strategy that will set the medium-term agenda in this area.
- Financial inclusion and development are particularly important for fragile and conflict affected (FCA) countries which are struggling to ensure inclusive growth and generate jobs.** Financial inclusion may be an important means to stimulate self-employment and potentially reduce poverty. This is very relevant for Afghanistan considering its weak growth, high unemployment, and around 400,000 new labor market entrants every year. Financial inclusion can help achieve the Sustainable Development Goals. At the same time, boosting financial inclusion is also very challenging in the face of the on-going conflict.

B. Afghanistan's Financial Sector

- The financial sector in Afghanistan, though diversified, is dominated by banks.** Assets of commercial banks are equivalent to 21 percent of GDP and dwarf other financial institutions' assets. As of September 2017, there were 15 commercial banks with one specialized microfinance bank and six Islamic banking windows, four insurance companies, nine microfinance institutions, three electronic money institutions, 774 money service providers with 337 representative offices, and 2047 foreign exchange dealers (Box 1).

Box 1. Key Facts About Afghanistan's Financial Sector

Afghanistan is a cash economy with high level of dollarization:

Key financial indicators, December, 2016

- Credit to GDP: 4 percent
- Deposit dollarization: 66.2 percent
- Loan dollarization: 61.4 percent
- Currency to deposit ratio: 93.4 percent
- Loans to deposit ratio: 19.9 percent

Afghanistan's financial sector is dominated by commercial banks

DAB regulates and supervises all financial institutions except insurance companies (regulated by the MoF) Non-depository microfinance institutions which are not supervised by any institution.

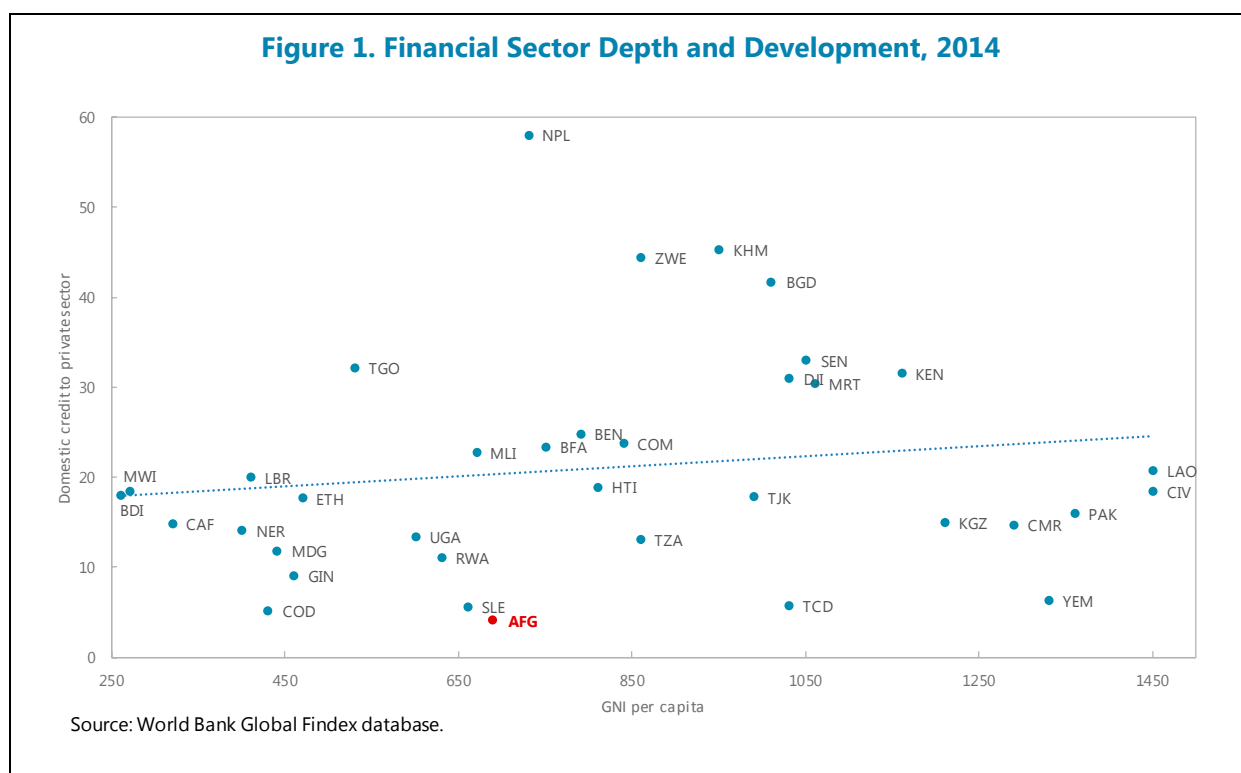
Year	# of commercial banks	# of specialized microfinance banks	# of Islamic banking windows	# of Insurance companies	# of Microfinance institutions	# of Electronic money institutions	# of Money service providers	# of MSPs' representative offices	# of Foreign exchange dealers
2014	16	1	6	3	5	3	462	309	1,772
2015	15	1	7	3	5	3	583	334	1,415
2016	15	1	7	4	5	3	669	348	2,192
2017	15	1	7	4	4	3	606	291	1,705

¹ Prepared by Farid Talishli, with research support from Tetyana Sydorenko.

² Sahay and others (2015 a), Demircuc-Kunt and others (2017).

5. **Microfinance is the second biggest component of Afghanistan's financial sector.** In the first quarter of 2017, the loan portfolio of the microfinance industry was Af 10.5 billion (0.8 percent of GDP) and savings deposits were Af 2.5 billion (0.2 percent). For comparison, loan portfolio of banking sector was Af 47.4 billion (3.6 percent) while total deposits were Af 234 billion (17.7 percent). The other financial service providers mostly handle the current transactions of their clients and do not take deposits.

6. **Afghanistan's financial sector is shallow even relative to other low income and fragile countries.** The domestic private credit to GDP ratio was only 4 percent in 2014 and likely around this level since, as overall domestic credit to GDP remains below 4 percent in 2017. This is extremely low even among the other fragile states at similar levels of development or versus regional comparators (Figure 1).

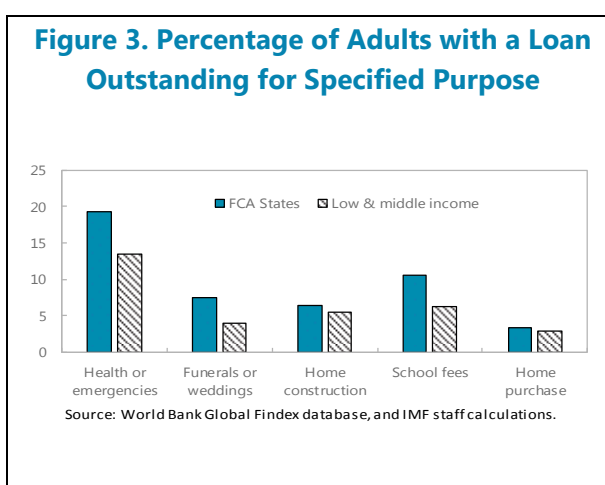
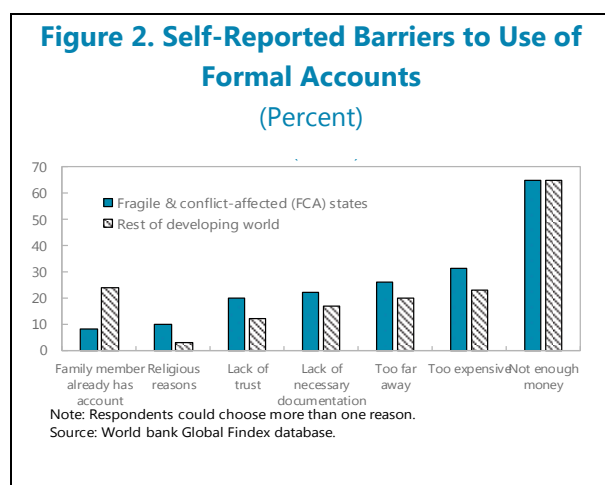


C. Financial Inclusion in FCA Countries

7. **Insecurity and uncertainty in FCA countries appear to hold back the development of the financial sector.** Weak institutions, poor or destroyed infrastructure, and challenging macroeconomic environment heavily affect access to basic financial services. According to the World Bank, 80 percent of adults in FCA countries remain outside of the formal financial system and only 15 percent of adults have an account at a formal financial institution compared to more than

40 percent in the rest of the developing world and 62 worldwide.³ Paradoxically, in FCAs countries there is high demand but low supply of financial services.

8. **A World Bank survey conducted in FCA countries identified barriers to the use of formal accounts** (Figure 2).⁴ Poverty (not having enough money) is by far the most common barrier, others are: religious reasons, lack of trust, documentation requirements, distance to the nearest financial institution and costs of financial account ownership. The survey also suggests that access to credit through formal channels is difficult: 48 percent of adults borrowed money but only six percent used a formal financial institution. The percentage of FCA countries' borrowers with loans outstanding exceeds those from other LICs (Figure 3). This is unsurprising since, all else equal, FCA borrowers would take longer to repay their loans and would like to roll them over more frequently than borrowers in non-FCA countries.



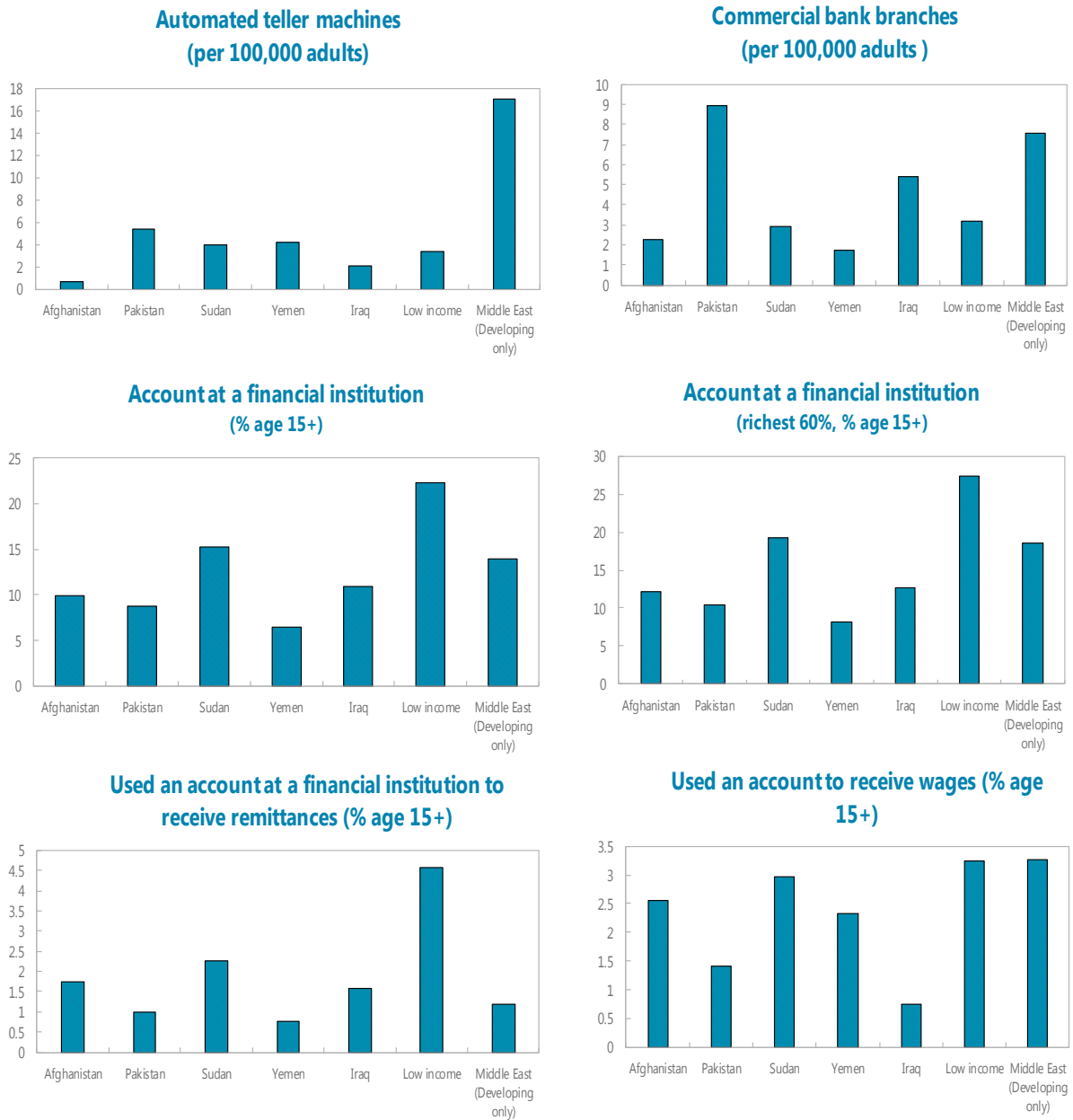
D. Financial Inclusion in Afghanistan

9. **Financial sector access indicators in Afghanistan are weak.** According to the World Bank's 2014 Global Findex Survey, the number of ATMs per 100,000 adults in Afghanistan lags other LICs, FCAs, and neighboring countries (Figure 4). The number of commercial bank branches per 100,000 adults is also small. Some regions of Afghanistan do not have access to even basic financial services (Figure 5), although that may be due to their exceptional remoteness, security challenges, or lack of the government's control over the territory in question. The number of accounts in financial institutions is less than average in other LICs even when controlled for income level. Anecdotal evidence suggests that households' banking accounts are mostly used as repositories for remittances or wages but not for transactions. Afghanistan lags the LICs average with respect to number of accounts used for business purposes (Figure 6). The reluctance to use accounts for business purposes may be motivated by tax evasion.

³ Asli Demircug-Kunt and others (2013).

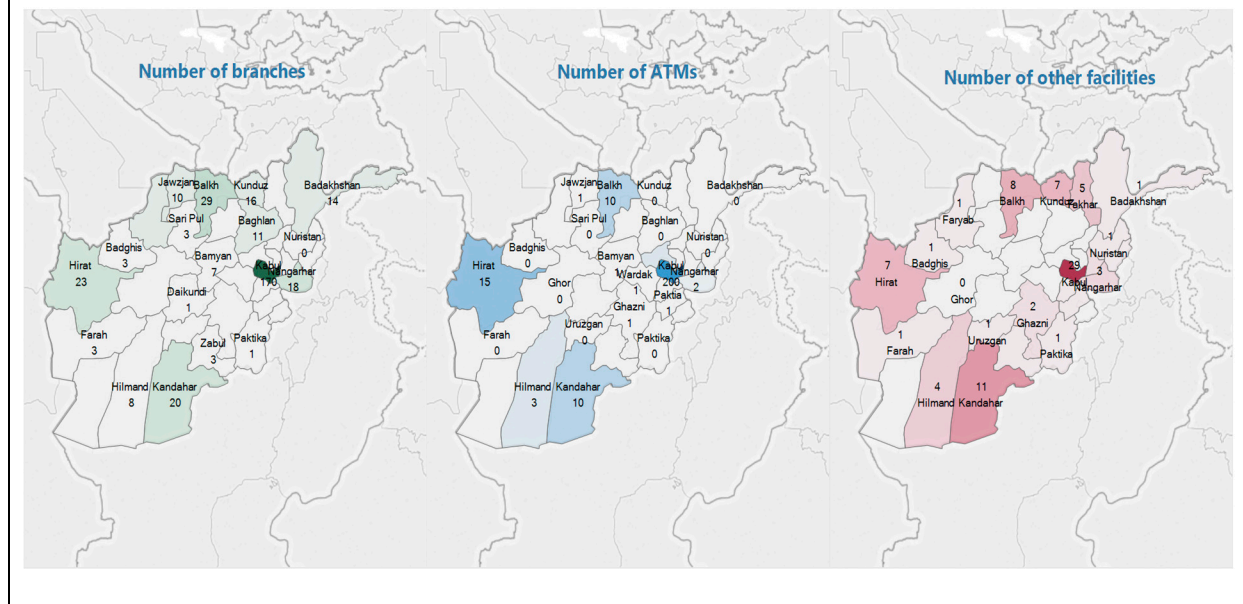
⁴ Asli Demircug-Kunt and Klapper (2012).

Figure 4. Indicators of Financial Access



Source: World Bank Global Findex database, and IMF staff calculations.

Figure 5. Branches, ATMs, and Other Facilities
(By province)



10. **In line with other LICs, poverty (not having enough money) is the most common barrier to the use of financial services in Afghanistan.** Other barriers also appear the same as in LICs more broadly. The Global Findex survey quoted above identified religious reasons, lack of trust, documentation requirements, distance to the nearest financial institution and costs of financial account ownership as hindering access to financial services in Afghanistan. Unique to Afghanistan, high illiteracy rate (60 percent) and low participation of woman in the economy also present formidable barriers to the expansion of financial access.⁵

11. **The cost of using financial services in Afghanistan may be higher than in other LICs.** This may have to do, among others, with the costs of compliance with the anti-corruption rules and procedures requiring the banks to "Know Your Customer," and the costs of enhanced diligence, both relatively new in Afghanistan. The benefits of compliance probably outweigh the costs and until conditions return to normal, these costs should be borne.

12. **Borrowing from formal financial institutions is also limited.** Afghans prefer borrowing from private lenders, relatives, and friends. The Global Findex reports that of the 41 percent of adults that borrowed money only 11 percent borrowed from a formal financial institution. The number of firms relying on bank loans to finance their investments is also exceptionally low as firms prefer their own financing. Only around three percent of firms relative to 18 percent in other fragile countries⁶ resort to bank financing in Afghanistan.

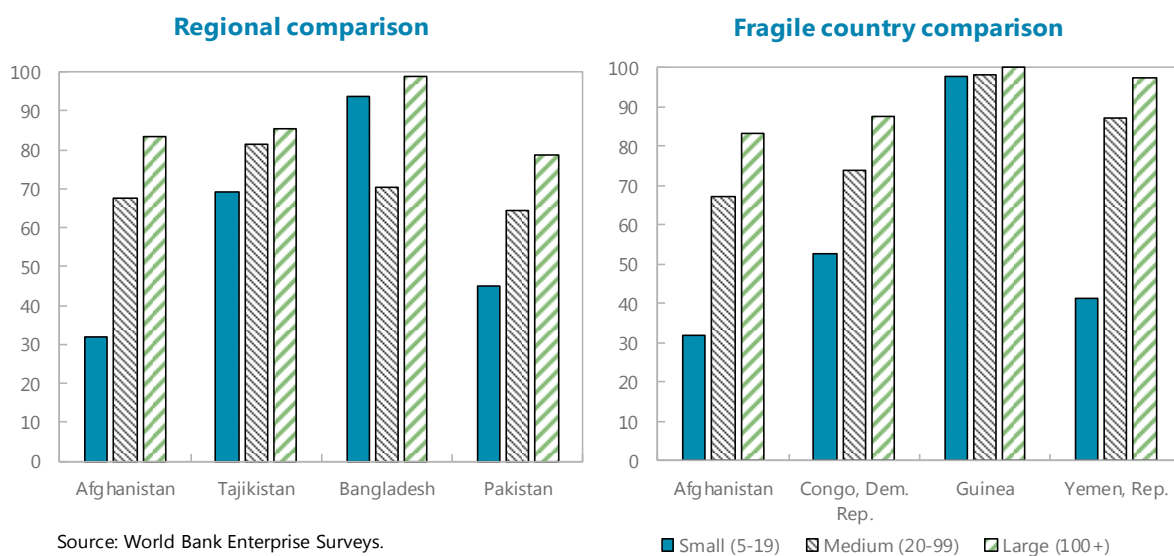
⁵ For legal and regulatory frameworks affecting women's access to financial services see the World Bank's "[Women, Business, and Law](#)".

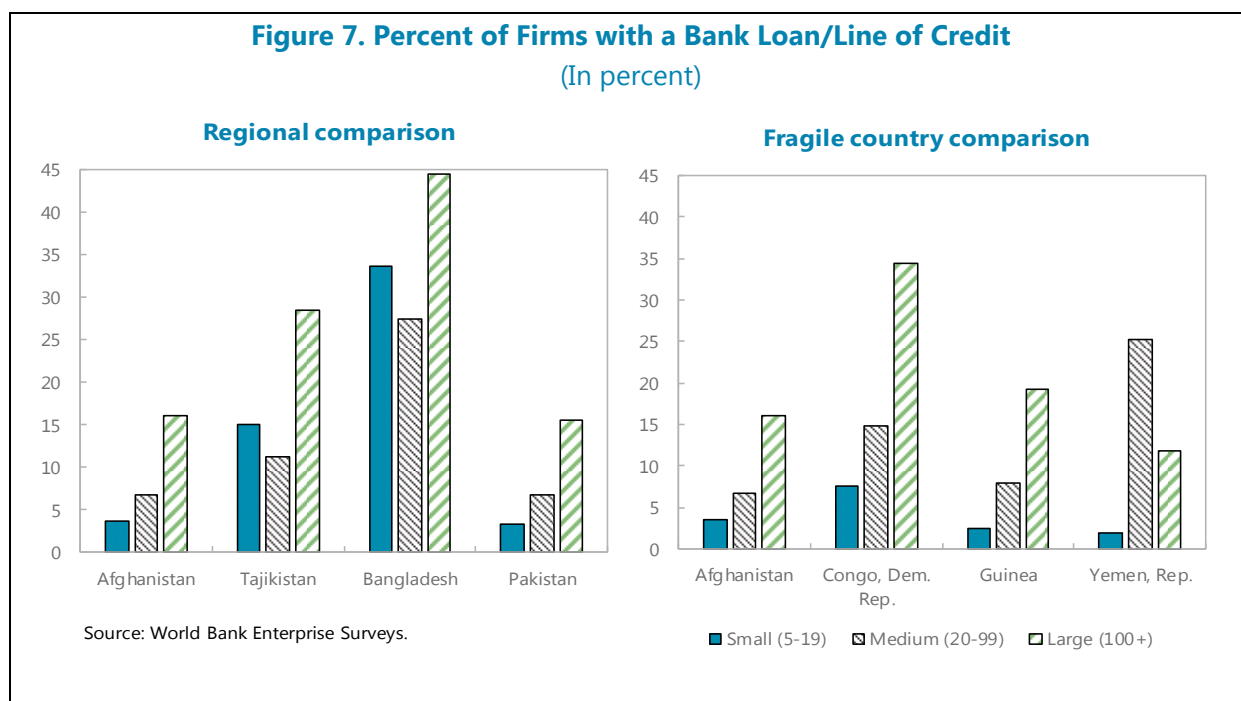
⁶ The World Bank Enterprises Survey 2008–15.

Table 1. Islamic Republic of Afghanistan: Financial Access for Firms

Indicator	Afghanistan	South Asia	All countries
Percent of firms with a checking or savings account	43.7	77.6	86.8
Percent of firms with a bank loan/line of credit	5.1	27.0	33.8
Proportion of loans requiring collateral (%)	70.7	81.1	79.4
Percent of firms whose recent loan application was rejected	35.3	14.4	12.2
Percent of firms using banks to finance investments	2.0	21.8	25.3
Proportion of investments financed internally (%)	84.5	73.9	71.2
Proportion of investments financed by banks (%)	1.5	14.4	14.3
Percent of firms using banks to finance working capital	3.9	25.0	30.4
Percent of firms identifying access to finance as a major constraint	47.6	26.5	26.5

13. **Requiring firms to open a bank account when registering their business could increase the use of the financial services.** As this is not required, relatively fewer firms, especially smaller firms, use bank accounts than in comparable countries (Figure 6 and Figure 7). It is understandable that in the current security environment making this a legal requirement could be difficult to enforce, and may even encourage shadow economic activity. However, if the security situation improves this may be considered as a measure to stimulate the use of financial services.

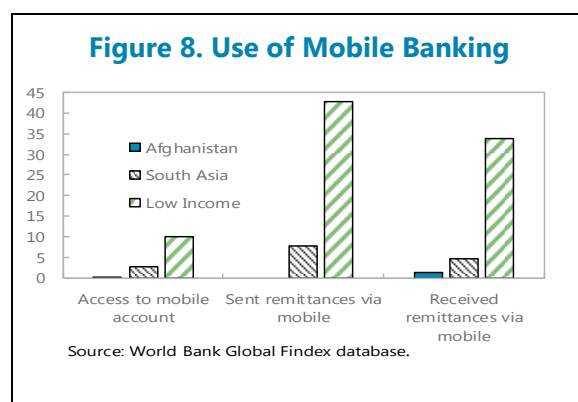
Figure 6. Percent of Firms with a Checking or Savings Account
(In percent)



E. Conclusions

14. **Financial sector development in Afghanistan faces formidable barriers owing to the security situation and a variety of other country-specific factors.** Deepening financial inclusion and promoting lending will require significant efforts to strengthen the legal framework and to remove barriers to financial development. Moreover, these measures need to be implemented without jeopardizing financial stability. Strengthening and extending the perimeter of financial supervision by including microfinance institutions is essential in achieving this task. Deepening financial inclusion may also strengthen the transmission mechanism of monetary policy to the real economy and will contribute to transparency and efficiency of tax collection. The following measures may help boost financial inclusion:

- *Developing mobile banking* to improve access in remote areas. Mobile banking is widely used for payments around the world (Figure 8) and Afghanistan could benefit from experience of other countries when developing the relevant regulations and policies.
- *Developing Sharia compliant instruments* to attract customers that do not use the existing financial institutions for religious reasons.
- *Reducing costs of operation of the financial services providers.* Measures aimed at resolving documentation problems by introducing unique biometric identification for all Afghanistan citizens would be helpful.⁷ Developing the insurance sector would help reduce risks for banks



⁷ Experience of India in developing Aadhar ID for each citizen might be considered.

and likely would reduce costs associated with lending.

- *Promoting financial literacy.* International experience with promotion of financial literacy is presented in Box 2.⁸

Box 2. Promoting Financial Literacy: Country Examples 1/

Indonesia has a National Strategy for Financial Literacy under the National Strategy for Financial Inclusion, launched in June 2012. This states that financial education to focus on increasing the level of knowledge among communities regarding financial products and services and financial management, and to provide information on consumer protection. The strategy for Financial Literacy comprises of three main pillars: i) *Education and campaign 2/*, ii) *Strengthening infrastructure for Financial literacy*, and iii) *development of financial products and services*.

The Netherlands: In 2006 the national strategy for financial education brought together some 40 partners from the financial sector, government, information and consumer organization, and academia to empower consumers on financial services. Chaired by the Ministry of Finance, the national strategy (the Money Wise Action Plan) concentrates on increasing the financial literacy of households through the education of consumers and the regulation of financial markets. The 2014–18 revised Action Plan focuses on managing money, engaging in financial planning, and making well-informed decisions on financial products.

Turkey has financial access, financial education, and financial consumer protection strategy launched in 2014. The Financial Education Action Plan has been designed to address the Strategy's goals of raising knowledge and awareness about financial products and services. While the Financial Education Action Plan covers the whole population, particular attention is being paid to target groups such as Family and Women, Primary and Secondary Education, and Universities and Academics. The main principles of financial education activities are as follows: i) *Inclusiveness:* All segments of society must be able to benefit from financial education opportunities, and financial education activities must be planned in such a way that they cover all financial products and services, ii) *Neutrality:* Financial education must be offered fairly, transparently and neutrally, without promoting any financial institution or product, iii) *Awareness Raising:* Financial education programs must raise awareness about the need for understanding financial subjects and risks, and must contain instruments for this purpose, iv) *Plain Language and Practical Explanation:* The language and content of financial education activities has to be understandable by the target audiences, and accordingly, legal, technical and foreign terminology must be used at a minimal level, and complicated financial topics must be presented through practical, daily language understandable by everyone.

The United States: consumer protection and financial literacy. The recently completed Financial Sector Assessment Program (FSAP) (IMF, 2015d) calls for financial inclusion to feature more prominently on the U.S. policy agenda. The Global Findex survey ranks the United States 27th out of 147 countries in terms of the percentage of adults with a bank account in a formal financial institution, and a 2013 Federal Deposit Insurance Corporation (FDIC) survey finds that 20 percent of U.S. households are “underbanked” and 8 percent are “unbanked.” More work is needed to identify barriers to inclusion, especially for households and small enterprises. The enhanced focus on consumer protection, including the setting up of the Consumer Financial Protection Bureau, is an important part of the crisis response, and is beneficial for both financial stability and financial inclusion. The activities of the Financial Literacy and Education Commission are welcome steps toward improvements in households' financial capability.

1/ Drawn from: “Financial Inclusion: can it meet multiple macroeconomic goals?”, Ratna Sahay and other, 2015; Financial Access, Financial Education, and Financial Consumer Protection Strategy and Action Plan, Central Bank of Turkey, 2014, Indonesian National Strategy for Financial Literacy, Financial Services Authority of the Republic of Indonesia, 2013, Promoting Financial Inclusion through Financial Education, Adele Atkinson, Flore-Anne Messy, OECD, 2013.

2/ Financial literacy, education, and campaign program is conducted to increase awareness on financial services for all level of formal education, general public, and different professions across the regions in Indonesia.

⁸ See the World Bank's “[Consumer Protection and Literacy Survey](#)”

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