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**INTERNATIONAL DEVELOPMENT ASSOCIATION  
AND  
INTERNATIONAL FINANCE CORPORATION**

**INTERIM STRATEGY NOTE  
(EXECUTIVE SUMMARY)**

**FOR**

**ISLAMIC REPUBLIC OF AFGHANISTAN**

**FOR THE PERIOD FY12-FY14**

## Executive Summary

Afghanistan is a country in conflict with improving, but still extremely fragile, state and civil society institutions. Despite the ongoing conflict and insecurity, there have been significant political achievements including 2 rounds of presidential and legislative elections (albeit with concerns about legitimacy) and the creation of an emerging media and NGO community. In terms of the economy and creation of institutions, there are visible gains including the development and roll-out of basic national programs in health, education and village level governance and service delivery, a functioning and credible public financial management system that has increased revenues from some \$130 million in 2002 to \$1.5 billion currently, a doubling of per capita GDP and significant improvements in human development indicators. These achievements, coming from an extraordinarily low base, are often overlooked in the face of more negative aspects -- insurgency and conflict, a constant opium trade, economic and political corruption, and inequity. The World Bank's 2011 World Development Report (WDR) on Conflict, Security and Development looks at a range of countries that were once unstable, violent and poor and are today doing better. What did they do right? What can others learn from them? How should governments and aid agencies support promising national initiatives? Many of the WDR's findings are relevant for Afghanistan:

- Overcoming a history of violence takes a long time, and usually involves setbacks along the way.
- Reliability and continuity of development activities and funding resources are critical.
- Reducing tensions, often stemming from injustice, is fundamental - development will not flourish in high tension environments.
- Institutions are, by definition, mediating structures; it follows that it is essential to build institutions that can address deeply-felt injustices and support inclusion and legitimacy.
- Creating capable, legitimate institutions can take a generation or more – not 5 or even 10 years.
- Creating jobs will be crucial to stability both in the short and long term.

In 2010, the Government and donors initiated a transition process whereby leadership in security and development choices would move from the international community to the Government of Afghanistan by the end of 2014. On the development side, the Government has set out 22 National Priority Programs (NPPs) and reached agreement with donors that at least 80% of assistance would be in line with these priorities even while accepting that not all the NPPs would be fully financed. Even so, the economic picture over these next three years contains significant uncertainties as Afghanistan will need both high levels of international assistance and to create new domestic sources of revenues and growth. How well GoA performs during this transition will determine the confidence that the Afghan people will have in their leaders and the country's ability to stand on its own. At the same time, the size and shape of international military and development assistance during this period, and commitments beyond, will strongly influence the political and economic outcomes over the next 10-15 years. Because of the ongoing conflict and uncertainty, the Bank's strategy is set out as an ISN rather than a CPS in order to maintain flexibility to adjust to events.

The Bank's work on Transition Economics paints a challenging picture of the issues that Afghanistan faces in 2014 and beyond. An economy that has been growing strongly at 9% per annum on the back of huge military and donor spending may slow by half to some 5-6% even under relatively optimistic scenarios. Even more worrying, a sizeable financing gap, which can only be filled by donor assistance, will need to be addressed throughout the coming 10 years, despite projections of healthy growth in domestic revenue collection. This gap (estimated at 25% of GDP in 2021) will need to drive the choices and strategy of the Government and donors in the coming years in terms of development, recurrent and security spending. At the same time, the prospects from the extractive sector hold the potential to begin to provide a fiscal cushion and the basis for sustainable growth in the medium term and beyond.

How then should the World Bank seek to support Afghanistan during this critical period? The importance of supporting the Government in implementing elements of the most important NPPs, the lessons of the WDR, and the work that the Bank has done on the economic impacts of the transition suggest a way forward. This strategy encompasses not only areas in which we will work in partnership with Government and other stakeholders, but sets out the principles of how this work should be approached recognizing the limitations and risks. It has further been informed by consultations with the Government, donors, civil society and the private sector. The Bank's program for FY12-14 will therefore be built around the following three interlocking themes:

- **Building the Legitimacy and Capacity of Institutions:** The Government recognizes the long-term importance of institution building in its priority programs, and to support it the Bank will continue and expand its work in supporting some key institutions that will, ultimately, provide legitimacy to the State at both central and local levels. This will be a long term endeavor with uneven progress -- some service delivery institutions such as education, health and NSP, have made huge strides while in other areas, for example in delivering justice and in creating an environment conducive for private sector growth, there is much farther to go. The Bank will focus on three institutional areas – (i) strengthening institutions and processes associated with transparent and competent financial and economic management, (ii) improving the sustainability and performance of line ministries in providing essential services country-wide and (iii) continuing to build the social capital and inclusive governance structures formed at the village level through a key NPP program—the National Solidarity Program (NSP)—which will be an essential element of rural stability. Within this, the Bank will support GoA's commitment to the EITI initiative and efforts to increase PFM transparency.
- **Equitable Service Delivery:** The key to sustained stability is the Government's effort to develop legitimate national institutions and programs which are nationally focused, particularly those that target injustice and concerns likely to provoke violence. Within Afghanistan, an enduring driver of conflict is a sense of inequity between and amongst regions, ethnic groups, cities and towns, and villages. The Bank's work on poverty across Afghanistan shows that over the past 10 years, aid flows have often predominated in the south and east, areas which have relatively less poverty than other parts of Afghanistan but which have borne the brunt of the violence. This suggests that a continuation and strengthening of the Bank's focus on institutions and national programs that can sustainably ensure equitable access to basic services across the country will be necessary. These efforts should be structured to help minimize corruption and exploitation and be as broad-based as possible. Sustaining and expanding as possible developed national programs supported by IDA and ARTF are the key to the Bank's engagement under this theme and include amongst them healthcare, education, rural connectivity, irrigation, micro and SME finance.
- **Inclusive Growth and Jobs:** Building domestic sources of growth and jobs to replace donor/military assistance is one of GoA's greatest priorities and it is expected that GoA's sequencing of NPPs will concentrate on foundational investments for growth. To help Afghanistan, the Bank will continue to support irrigation and agriculture, which provides a living to the majority of rural Afghans, rural infrastructure, and private sector development. However this will not be enough to sustain long term growth. Afghanistan's huge natural resources provide hope, but require development in a way that is transparent, inclusive and supports other sectors that will create jobs and help lift the nearly 50 percent of the population that is below or near the poverty line. This argues for focusing the Bank's engagement around the concept of "Resource Corridors" which link up mineral resources, infrastructure, communities and employment-creating sectors (agriculture, construction, enterprise development) in a way that provides growth and jobs beyond the borders of the mines, and potentially paves the way in the longer term for Afghanistan to become an important land bridge between international markets. It will also be important to give local communities a stake in natural resource

development which, in turn, promotes equity and security in an environmentally sustainable manner. It speaks to addressing the constraints to enterprise development including a weak financial sector, insufficient energy, and a regulatory environment that is uncertain and often corrupt. And we will support promising areas for regional cooperation, building on Afghanistan's traditional connection to its neighbors in trade and transit, energy, and water management.

Within this framework, “**conflict and transition**” will act as a cross-cutting filter through which our choices in both what we do and how we do it will be made. Recognizing that transition presents a particular risk for women and girls in Afghanistan not only if insecurity increases but if political solutions lead to a slowdown in progress, **gender** issues will continue to be mainstreamed in our portfolio. Within each activity we will assess how it can be designed to most effectively help in the transition, particularly along the dimensions of legitimacy, jobs, and gender. The decisions by GoA and the international community on the speed and depth of transition will impact the financing for development overall and the resources that flow through the ARTF. Even in an increasingly tight aid environment, there is a strong potential for significant additional flows into the ARTF as donors look to meet transition commitments and channel assistance through the budget. This will need to be balanced against maintaining rigorous standards and managing our security “footprint” and level of risk. This will require flexibility and good communications amongst the Bank, GoA and donors. The Bank Group will continue to deliver its program through a combination of instruments:

- Afghanistan is an **IDA-only grant** recipient with an allocation of about \$430 million over FY12- 14. This is a decline from past levels due to the gradual phase-out of the post-conflict premium. A portion of IDA may be provided as policy support, dependent on a continued satisfactory macroeconomic framework. The rest of IDA will be project grants and continue to be used in close coordination with much larger ARTF funding, allowing the Bank to leverage IDA to finance a considerably larger portfolio.
- The Bank-managed **Afghanistan Reconstruction Trust Fund (ARTF)**, under fairly optimistic scenarios for donor funding and Government capacity, could provide some \$800 million per year or more in grants during the period of the ISN, making it some four to six times larger than IDA. The ARTF funding would be used in accordance with the 3-year financing strategy (planned allocation) provisionally agreed by the GoA and ARTF donors. The ARTF has two windows – a recurrent cost window, and an investment window (project grant financing). A growing part of the recurrent cost window is structured as an Incentive Program, providing support on the basis of GoA fulfillment of reform indicators. All ARTF operations follow the same technical, fiduciary and supervisory requirements of IDA. In addition, through the ARTF, the Bank plays a preeminent role, with the Ministry of Finance, in coordinating and channeling donor funding through the budget to priority programs.
- In an environment where policy advice and assistance is essential, our **analytic work** provides support for Government and donor decision making. It is expected that the Bank will continue to play a leading role in terms of policy advice to Government through targeted, often crosssectoral, and analytic work. The Bank's work on Transition Economics and Resource Corridors, together with its poverty analysis, is expected to be instrumental in decisions of Government and the donor community. A hallmark of this work is the ability of the Country Team to work across sectors and produce outputs that are aimed at and appropriate for policy makers. Impact evaluations of core donor programs funded through IDA/ARTF, including NSP, EQUIP, SHARP (health), NRAP (rural access) will be used to continually refine and improve delivery of essential services and to give donors confidence in government implemented programs.

- To date, **IFC** has provided modest support through investments (totaling about \$90 million) and advisory assistance. Insecurity and the low level of investment and private sector activity within Afghanistan overall has limited the ability of IFC to expand its engagements. Nevertheless, IFC intends to continue its presence in country with an integrated approach in both investment and advisory and to look for opportunities, particularly in concert with the Bank's PSD program, to support improvements in the financial sector and the business climate. **MIGA** has offered a limited number of guarantees but there is interest by Government and the private sector to see additional guarantees going forward, particularly to support infrastructure investment.

Paying attention to **how the Bank operates** and the conditions under which we operate will continue to be essential. Heavy emphasis on financial management, supervision of projects, and supporting the build-up of Afghan capacity will continue to influence decisions on our program. The need to keep safe our relatively large presence in country will remain paramount with additional resources going towards secure office and housing and providing support for field visits within the prevailing **security environment**. In addition, the Bank will look for innovative ways to provide supervision and oversight including a program with an international NGO with dozens of Afghan engineers across Afghanistan that are visiting some 1500 sub-projects a year in even some of the most inaccessible parts of the country.

**Partnerships are critical** as The Bank Group is only one player in an environment where there are many extremely important bilateral, multilateral and civil society players. For many countries, including the US, UK and Australia; Afghanistan is one of their largest recipients of aid and is among their biggest diplomatic missions. ISAF plays an enormous role even outside the security sector. The UN keeps an extremely large and diverse presence in country covering political, humanitarian and development objectives. The Bank also coordinates closely with the IMF, which has an active and on-track Program with Afghanistan. CSOs, including the Aga Khan Development Network and a number of other international and national NGOs, play an absolutely essential role in delivering services on the ground (including for IDA/ARTF financing programs), often in extremely dangerous conditions.

The **high risks** associated with the Bank Group's engagement needs to be acknowledged and managed. Significant threats to security will continue as insurgents seek to position themselves for 2014 and beyond. The Bank program assumes no further deterioration in the security situation and that the ARTF remains well funded by donors. Should this not be the case, we would move to a considerably scaled down program that would aim to maintain depth in a few key areas of national priority, rather than breadth. Political risks during this period are likewise high as both the people of Afghanistan and the international community look to see how the Government will respond to the governance, fiscal, security and economic challenges ahead. Closely associated with this is the risk of corruption and fraud which will influence not only how the Afghan people judge the legitimacy of their Government, but also the size and shape of donor flows (including from the Bank).

Overall then, our approach is to support the Government in implementing elements of the most important NPPs in a way that is deeply embedded in building inclusive legitimate structures. Given the long term nature of development in a fragile environment, we must be realistic as to what can be achieved, and yet hopeful that we will contribute to the substantial benefits that a peaceful, stable and prosperous Afghanistan can deliver to its people.