

## Islamic Republic of Afghanistan: Joint Bank-Fund Debt Sustainability Analysis

1. **This document assesses Afghanistan’s external debt sustainability (DSA) using the joint World Bank–Fund’s DSA template for Low Income Countries.** Data limitations notwithstanding, a sound debt management strategy remains central to the overall growth dynamics of Afghanistan, which is currently heavily dependent on external financing.<sup>1</sup> Based on the current medium-term macroeconomic framework and outstanding stock of debt, this DSA examines Afghanistan’s annual borrowing capacity under two scenarios: one that assumes future borrowing under highly concessional terms, and another that assumes limited access to concessional borrowing. The analysis concludes that Afghanistan has relatively little scope for nonconcessional borrowing. Furthermore, Afghanistan is subject to an elevated risk of debt distress owing to the weakness of exports, the low revenue base and the country’s large reconstruction financing requirements.<sup>2</sup>

Table 1. Islamic Republic of Afghanistan: External Debt, 2004/05

(In millions of U.S. dollars)	
Total external debt	749
Multilateral debt	455
World Bank	233
Asian Development Bank	222
Bilateral debt 1/	294
Verified claims	137
United States	82
USAID	57
USDA	25
Former GDR	40
OPEC Fund	2
Kuwait Development Fund	13
Unverified claims	157
Bulgaria	47
Saudi Arabia	30
Iraq	6
Former Czechoslovakia	75
Memorandum item:	(In percent of GDP)
Total external debt	13
Total multilateral debt	8
Total verified bilateral debt	2
Total unverified bilateral debt	3

Sources: Afghan authorities; and Fund staff estimates.

1/ Excludes Russian claims. Staff estimate these claims to exceed \$10 billion.

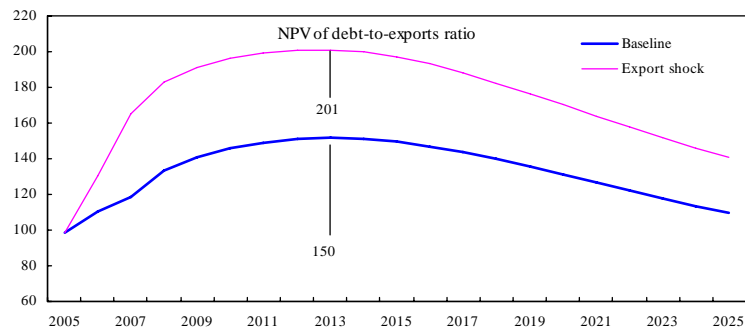
<sup>1</sup>While the DSA template uses 10-year averages of key macroeconomic variables to generate alternative scenarios for analytical purposes, this was not possible in the case of Afghanistan as reliable economic data exist only for the last three years. As a consequence, the present DSA does not employ the full set of stress tests typically presented in low-income country DSAs.

<sup>2</sup>A number of caveats must be noted. The World Bank has not yet assessed Afghanistan against its Country Policy and Institutional Assessment (CPIA) framework, which makes it impossible to identify a policy-dependent sustainability threshold as identified in “Operational Framework for Debt Sustainability Assessments in Low Income Countries—Further Considerations” (refer to [www.imf.org](http://www.imf.org)). For the purposes of this exercise, it is assumed that Afghanistan is evaluated as a medium performer in the CPIA. Thus, the sustainable ratio for the NPV of debt-to-exports is assumed to be 150 percent. It is possible that the indicative sustainability thresholds for Afghanistan may be revised following its evaluation under the CPIA. This would affect the results of the DSA. Owing to these caveats, this exercise cannot propose a definitive rating of debt distress for Afghanistan.

2. **The main economic assumptions are the same in both scenarios.** The scenarios are based on an end-2004/05 external debt stock of \$749 million (see Table 1), which includes all currently acknowledged, verified or unverified debts,<sup>3</sup> but excludes disputed Russian claims. If included, the Russian claims—preliminarily estimated at around \$10.8 billion—would dramatically increase the NPV of debt-to-export ratio and the need for debt relief (possibly in the context of the HIPC Initiative). Real economic activity is projected to expand rapidly over the next 10 years, as the reconstruction effort boosts all sectors of the economy. Real GDP growth is projected to be around 10 percent a year during this period of accelerated growth, before moderating to approximately 6 percent thereafter. Assuming annual export growth of about 15 percent a year in the medium term, the trade deficit diminishes but remains significant throughout the projection period. The current account (including grants) is nevertheless generally in surplus, as transfers are expected to remain substantial.

3. **The first scenario assumes that all future borrowing is contracted under highly concessional terms (i.e. with a grant element of at least 60 percent). On this basis, Afghanistan’s gross annual borrowing could reach \$380 million without breaching the indicative NPV of debt-to-exports threshold.**<sup>4</sup> While this level of borrowing represents a

significant increase over current levels, it may be useful to contrast it against the projected gap between total recurrent spending requirements and revenue excluding grants, estimated at around \$900 million per year over the medium term.<sup>5</sup> This highlights the need for



continued grant financing for several years. Debt sustainability is maintained only in the absence of shocks affecting the economy (e.g. lower export growth of about 9 percent would raise the NPV of debt-to-exports ratio to well above the indicative sustainability threshold).

4. **The second scenario assumes that Afghanistan has limited access (up to \$75 million annually) to concessional borrowing and borrows all additional funds on nonconcessional terms.**<sup>6</sup> In this case, additional nonconcessional borrowing could reach

<sup>3</sup>Unverified claims amount to roughly \$157 million, which the authorities are in the process of reconciling.

<sup>4</sup>This implies that most new borrowings would need to come from concessional creditors, such as IDA and/or the Asian Development Bank.

<sup>5</sup>See Box 1 of the staff report for a full explanation. The definition of “total recurrent spending” includes a number of items, such as recurrent military costs, currently in the external budget, which are funded directly by donors outside of the government-controlled operating budget.

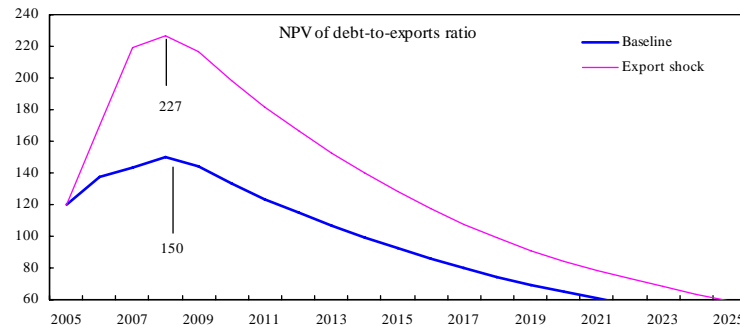
<sup>6</sup>This scenario is presented to underscore the importance of highly concessional resources in maintaining external sustainability. Afghanistan currently has no commercial market access, nor is it likely to have it in the

(continued...)

about \$250 million annually, without breaching the 150 percent indicative sustainability threshold. This scenario illustrates both the sensitivity of debt sustainability to export growth assumptions and the importance of continued access to highly concessional resources in meeting Afghanistan's

development needs. Although not shown in the tables and figures, the debt service-to-revenue ratio reaches nearly 24 percent under this scenario (compared to less than 3 percent in the first scenario), which is another indication of the sustainability problems that

would ensue if Afghanistan were to borrow on nonconcessional terms. Also, assuming export growth of only 9 percent a year, Afghanistan's sustainable borrowing capacity would be limited to about \$150 million annually. Given the geopolitical risks in the region, lower foreign direct investment could also hinder the country's capacity to service debt and thus would warrant a re-evaluation of the appropriate debt sustainability threshold.



## Policy Implications

5. **The availability of external borrowing to fund development spending will depend critically on the authorities meeting their fiscal targets.** Although revenue mobilization has increased rapidly in the last few years, it remains very low, amounting to 4.5 percent of GDP in 2004/05, equivalent to about 50 percent of operating expenditures and only 28 percent of total recurrent expenditures (see Box 1 of the staff report). The medium-term framework projects revenue to cover operating expenditures by 2010, when the revenue to GDP ratio is expected to reach 8 percent. Meeting the proposed fiscal target will require both a sustained increase in revenue and expenditure restraint. Any underperformance in these two areas, or any reduction in donor grants, will require additional borrowing to fund recurrent expenditures, thereby reducing by an equivalent amount the financing available for development spending.

6. **In view of the uncertainty surrounding the medium-term macroeconomic framework, the medium-term debt strategy should continue to rely primarily on grant financing and highly concessional borrowing.** The DSA indicates that, even under the conservative debt stock assumptions, external shocks may severely limit new borrowings,

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near future. Nevertheless, this scenario assumes that additional debt is contracted at terms similar to those obtained in commercial markets (8 percent coupon, 1-year grace period and 6 years of maturity; the principal is to be repaid in six equal installments).

corroborating the results of the previous DSA exercise (IMF Country Report No. 05/34). Afghanistan's reliance on grants and donor support may also be tested under an uncertain and changing political landscape.

7. **Also, the resolution of the Russian claims—not currently reconciled or acknowledged formally by Afghanistan—will have a significant impact on debt sustainability.** Preliminary calculations suggest that anything short of a full write-off of these claims could result in explosive debt dynamics, impeding any future borrowing. However, given the uncertainty regarding the resolution of this issue, it would be premature to evaluate specific debt relief options.

Table 2. Islamic Republic of Afghanistan: External Debt Sustainability Framework, Baseline Scenario, 2002–25 1/  
(In percent of GDP, unless otherwise indicated)

	Actual			Historical		Estimate		Projections						Average 2011–25
	2002	2003	2004	Average	Standard Deviation	2005	2006	2007	2008	2009	2010	Average 2005–10	2015	
<b>External debt (nominal) 1/</b>	13.1	12.3	11.8			10.7	10.0	9.9	9.8	9.7	9.5	9.5	7.8	4.1
<i>Of which: public and publicly guaranteed (PPG)</i>	13.1	12.3	11.8			10.7	10.0	9.9	9.8	9.7	9.5	9.5	7.8	4.1
<b>Change in external debt</b>	13.1	-0.8	-0.5			-1.1	-0.7	-0.1	-0.1	-0.1	-0.2	-0.2	-0.4	-0.3
<b>Identified net debt-creating flows</b>	...	-6.6	-7.4			-6.2	-4.1	-2.1	-1.8	-2.3	-2.7	-2.7	0.9	2.9
Noninterest current account deficit	3.4	-3.1	-2.1		2.9	-1.6	0.7	2.1	3.0	2.4	1.7	1.4	4.3	5.1
Deficit in balance of goods and services	54.6	67.8	53.5			48.4	43.3	34.0	30.5	29.0	27.6	21.5	13.6	4.6
Exports	6.8	7.5	7.4			7.1	7.1	7.2	6.7	6.5	6.3	6.3	5.6	4.7
Imports	61.4	75.3	60.9			55.5	50.4	41.1	37.1	35.5	34.0	27.1	27.1	18.3
Net current transfers (negative = inflow)	-29.9	-49.3	-43.9		-30.8	-35.1	-35.1	-28.2	-23.8	-23.8	-23.8	-29.1	-11.9	-2.5
Other current account flows (negative = net inflow)	-21.3	-21.7	-11.6			-10.4	-7.5	-3.7	-3.6	-2.9	-2.1	-3.7	-5.3	-6.0
Net FDI (negative = inflow)	-1.2	-1.1	-2.9		-1.3	-3.3	-3.8	-3.4	-4.1	-3.9	-3.7	-3.7	-3.0	-2.0
Endogenous debt dynamics 2/	...	-2.3	-2.4			-1.3	-1.0	-0.9	-0.8	-0.8	-0.8	-0.8	-0.5	-0.2
Contribution from nominal interest rate	...	0.2	0.2			0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0
Contribution from real GDP growth	0.0	-1.7	-0.8			-1.3	-1.0	-0.9	-0.8	-0.8	-0.8	-0.8	-0.6	-0.2
Contribution from price and exchange rate changes	0.0	-0.8	-1.8			...	...	...	...	...	...	...	...	...
<b>Residual 3/</b>	...	5.8	6.9			5.1	3.4	2.1	1.7	2.2	2.6	...	-1.3	-3.2
<i>Of which: exceptional financing</i>	...	-0.2	-0.2			-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<b>NPV of external debt 4/</b>	...	...	5.8			5.4	5.1	5.1	5.0	5.0	4.9	4.9	4.2	2.1
In percent of exports	...	...	78.6			75.4	71.2	71.0	75.3	77.1	77.9	77.9	74.4	44.4
<b>NPV of PPG external debt</b>	...	...	5.8			5.4	5.1	5.1	5.0	5.0	4.9	4.9	4.2	2.1
In percent of exports	...	...	78.6			75.4	71.2	71.0	75.3	77.1	77.9	77.9	74.4	44.4
Debt services-to-exports ratio (in percent)	2.6	3.8	3.4			1.2	1.1	0.9	0.9	1.0	1.1	1.1	2.1	2.7
PPG debt service-to-exports ratio (in percent)	2.6	3.8	3.4			1.2	1.1	0.9	0.9	1.0	1.1	1.1	2.1	2.7
Total gross financing need (in billions of U.S. dollars)	0.1	-0.2	-0.3			-0.4	-0.3	-0.1	-0.1	-0.2	-0.3	-0.3	0.5	2.9
Noninterest current account deficit that stabilizes debt ratio	-9.6	-2.4	-1.6			-0.5	1.4	2.2	3.1	2.4	1.9	1.9	4.7	5.4
<b>Key macroeconomic assumptions</b>														
Real GDP growth (in percent)	28.6	15.7	8.0	17.4	10.4	13.8	11.7	10.6	9.9	9.6	9.4	10.8	8.1	5.2
GDP deflator in U.S. dollar terms (percentage change)	4.0	6.4	17.0	9.2	6.9	9.9	8.0	5.0	5.0	4.6	4.6	6.2	4.6	3.8
Effective interest rate (in percent) 5/	...	1.6	1.6	1.6	0.0	0.5	0.5	0.4	0.4	0.5	0.6	0.5	1.0	0.8
Growth of exports of G&S (U.S. dollar terms, in percent)	...	36.1	25.0	30.6	7.9	20.1	20.6	17.0	7.4	11.3	11.4	14.6	10.5	7.5
Growth of imports of G&S (U.S. dollar terms, in percent)	...	50.9	2.1	26.5	34.5	14.0	9.6	-5.2	4.1	9.6	9.4	6.9	8.1	5.2

Source: Fund staff simulations.

1/ Includes both public and private sector external debt.

2/ Derived as  $[r - g - p(1+g)] / (1+g)^t$  times previous period debt ratio, with  $r$  = nominal interest rate,  $g$  = real GDP growth rate, and  $p$  = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that NPV of private sector debt is equivalent to its face value.

5/ Current year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.