

Islamic Republic of Afghanistan

Worsening security and the global downturn have made the socioeconomic situation even more difficult. Severe drought caused a sharp fall in agricultural output and a slump in GDP growth in the licit (non-opium) economy. Lower farm output and the escalation of global food and fuel prices pushed inflation to its highest level in 5 years, but it began to moderate toward the end of the year. The challenges are daunting, and, to name but a few, involve the need to strengthen security, rehabilitate basic infrastructure, combat narcotics production, improve the rule of law, strengthen public policy management, and foster private sector growth.

Economic performance

In FY2008 (ending 20 March 2009), drought hit agricultural production, which represents about a third of licit GDP. Although continued expansion in construction and services partly offset this decline, GDP growth is estimated to have slumped to 3.4% (Figure 3.14.1).

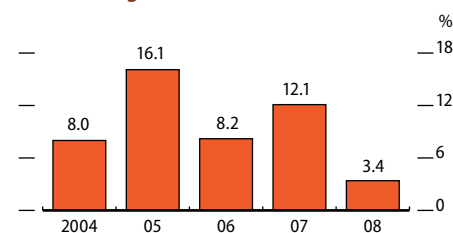
The country experienced a serious food crisis in FY2008 owing to a 40% lower wheat harvest than in FY2007 (partly because of poor rainfall that affected nonirrigated crops particularly); surging global prices of wheat and other foods (combined with a high dependence on food imports); and restrictions on wheat exports from Pakistan (the main source of supply).

As food accounts for three fifths of the consumer basket and as wheat is the staple, the consumer price index for Kabul, which began rising in late 2007, jumped by 43.2% year on year in May 2008 before falling to 22.7% in December. That month saw a 30.3% increase in food prices but an easing in nonfood prices in the basket of 10.7% (Figure 3.14.2). For FY2008, inflation averaged an estimated 28.3%, compared with 12.9% the prior year.

A combination of deteriorating security, the continued lack of basic infrastructure (mainly power), and what is seen to be rampant corruption has hampered government efforts to boost private sector investment. Nongovernment investment was essentially unchanged in FY2008 from a year earlier at 7.7% of GDP, and below the 9.6% and 8.1% shares recorded in FY2005 and FY2006. Overall investment as a share of GDP declined to about 32.0% from an estimated 36.7% in FY2007.

The opium economy, equivalent to about 20–30% of licit GDP, remains a grave challenge. Counter-narcotic efforts helped cut estimated opium production by about 6% in calendar 2008 from record production a year earlier, even as border prices fell to \$70 a kilogram (Figure 3.14.3). Afghanistan still produces around 90% of the world's opium, and the opium trade remains a major source of income for nearly 80% of the rural population. Potential earnings from poppy farming are much higher than from alternative crops, and financing for the crop from drug traffickers is readily available.

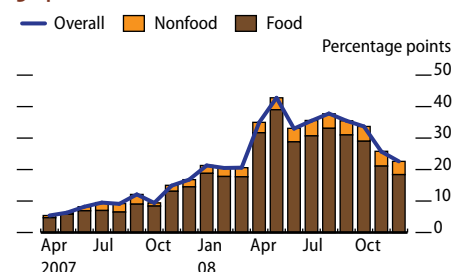
3.14.1 GDP growth



Source: International Monetary Fund, Country Report, February 2009 (unpublished).

[Click here for figure data](#)

3.14.2 Contributions to inflation



Note: Data refer to Kabul only.

Source: Central Statistics Office.

[Click here for figure data](#)

As a result of poor revenue performance and unanticipated expenditure (mainly related to increased security costs), the Government's Medium-term Fiscal Framework target of being able to fully finance its operating budget through domestic revenue will be delayed by 3 years, to FY2016. Due to a lower than expected volume of taxable imports and inadequate tax collection, domestic revenue is estimated to have declined to 6.6% of GDP in FY2008 (Figure 3.14.4), and is likely to have covered only about 55% of operating spending, or 11 percentage points lower than in FY2007.

Development budget execution, which had improved to about 55% of the budgeted target in FY2007, is estimated to have reached only about 42% in FY2008 because of the Government's limited absorption capacity. Lack of staff with skills in project implementation and management continued to have a negative impact on contracting and procurement, resulting in delays affecting physical progress as well as planned budget disbursement.

The external budget—the portion of the budget that donors implement directly—continued to account for more than half total public spending. That so much of total spending is outside the government budgeting process complicates the Government's development agenda in terms both of setting priorities and of monitoring progress against desired outcomes according to the Afghanistan National Development Strategy (ANDS), which was endorsed at the Paris International Conference in June. The Government would like to see more external funding channeled through the core budget.

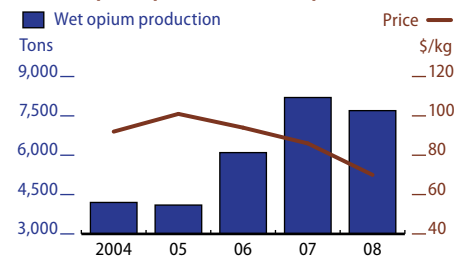
The Government has made progress in public financial management, including budgeting and accounting reforms. Some central ministries are now undertaking program budgeting, which is increasingly seen as a useful tool to align ministry strategies with the ANDS.

Monetary policy aims to support price and exchange rate stability. Inflation is expected to continue moderating from the high levels seen in early 2008 as a result both of declining global food and oil prices and of the Government's prudent monetary and fiscal policies. The nominal exchange rate remained stable at around AF50/\$1 (Figure 3.14.5).

The Government's monetary policy has been adjusted to accommodate balance-of-payments pressures resulting from emergency imports of large quantities of wheat. The net international reserves target has therefore been adjusted downward to about \$2.9 billion from the earlier \$3.0 billion monetary program target. Targets for reserve money and currency in circulation were correspondingly adjusted to ensure that monetary policy contributes to disinflation, capitalizing on the declining prices of imported food and fuel.

The current account deficit in FY2008, excluding grants, is estimated to have widened to \$7.1 billion, or about 58% of GDP, from \$6.4 billion a year earlier. The increase reflected a widening of the trade deficit stemming from greater imports associated with donor-financed activities, including security and development projects. Domestic official exports (that is, exports excluding transit trade and smuggling) are estimated to have risen by about 27% to \$610 million, or 5% of GDP. Including grants, the current account deficit is put at about 1.3% of GDP, financed by inflows of foreign direct investment (\$300 million) and concessional loans.

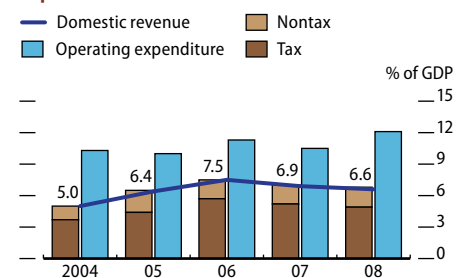
3.14.3 Opium production and prices



Source: International Monetary Fund, Country Report, February 2009 (unpublished).

[Click here for figure data](#)

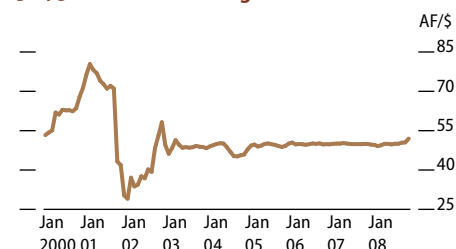
3.14.4 Domestic revenue and operating expenditure



Source: International Monetary Fund, Country Report, February 2009 (unpublished).

[Click here for figure data](#)

3.14.5 Nominal exchange rate



Source: International Monetary Fund, International Financial Statistics online database, downloaded 9 March 2009.

[Click here for figure data](#)

The International Monetary Fund's fourth review of the 3-year Poverty Reduction and Growth Facility (PRGF) ended in July 2008. The PRGF will enable Afghanistan to be eligible for debt relief under the Heavily Indebted Poor Countries (HIPC) initiative. The Government has continued to work toward reaching its HIPC "completion point" by the end of this year, and for this purpose it is pursuing agreements to settle its bilateral debts with the Czech Republic and the Kuwait Fund so as to regularize its relations with those external creditors not included in the Paris Club. Afghanistan's loans from the OPEC Fund were restructured in September 2008, and the Government intends to recognize its debts to the Islamic Republic of Iran and to request a waiver in light of its expected HIPC status.

For the ANDS, the Government has established a coordinating committee, consisting of key ministers and senior officials, to oversee the progress of implementation. Donors have input through the Joint Coordination Monitoring Board.

Parliament approved a new Civil Servants Law in July 2008, which includes provision for a new pay and grading structure for the whole civil service. The Government originally planned to start bringing into effect the new structure for 10% of civil servants during the second half of the current fiscal year. However, since a prerequisite under the new law is the regrading of positions, any significant fiscal impact is not expected before FY2009.

Although private sector-led economic growth is a major objective of the ANDS, progress in encouraging private development has been slow. To foster such development, an Afghanistan Investment Climate Facility was established in June last year. In addition, an enabling committee for the private sector and civil society has been established as a public-private forum to play a leadership and advocacy role.

Economic prospects

Externally financed development has buttressed growth in the licit economy. On the assumption of continued large inflows of donor funding and no drought or other factors that would affect agricultural production, GDP growth is forecast to rebound to 9.0% in FY2009 and then decline to 7.5%. Average inflation is expected to fall to 6.0% and then edge up to 6.8% in this period, reflecting the decline in global prices of food, fuel, and other commodities.

The external position is seen improving on the back of sustained large inflows of official transfers. Official development assistance and foreign direct investment, as well as debt relief through the HIPC initiative, will finance the small deficits in the current account (once official transfers are included).

Medium-term prospects depend heavily on the Government's success in combating corruption, overcoming infrastructure bottlenecks, and implementing further structural reforms, all of which are needed to stimulate private sector investment. Moderate to high growth targets will be attainable only if structural reforms are put through decisively and if public investment is targeted to key areas of infrastructure, notably transport and electricity.

3.14.1 Selected economic indicators (%)

	2009	2010
GDP growth	9.0	7.5
Inflation	6.0	6.8
Current account balance (share of GDP)	-3.5	-4.7

Source: Staff estimates.

3.14.1 Development challenges

Poor security, weak governance, and a poor environment for the private sector remain critical concerns. Additionally, lack of both physical and economic infrastructure (including stable power supply), land titling, and access to finance are hobbling the private sector.

A greater focus on development management and aid effectiveness, through better prioritization, would enable the Government to tackle these problems. However, until the presidential election scheduled for later this year is held, the Government may have difficulty in getting the National Assembly to approve crucial reform measures.