Islamic Republic of Afghanistan

The economy grew robustly on a recovery in agriculture in FY2009, and inflation declined sharply. More widely, the politico-economic environment was characterized by a significant worsening in security, as well as corruption and uncertainty. Steady economic growth and development in the medium term require continued moves toward the following: strengthening security, building critical infrastructure, substantially raising government institutional capacity while improving governance, creating a pro-growth business regulatory environment, fostering social inclusion and equity, and expanding access to social services.

Economic performance

In FY2009 (ending 20 March 2010), GDP growth is estimated to have rebounded to 15.1%, driven by a recovery in agriculture after severe drought a year earlier (Figure 3.14.1). The sector recorded the largest harvest in 32 years. The continued inflow of external assistance and increased security spending benefited other sectors.

The opium economy, which is equivalent to about 20%–25% of legal GDP, saw an estimated 10% decline in FY2009 owing to increased suppression efforts, lower prices, and expanded efforts to support legal crops. Nevertheless, it remains a major source of income for many farmers and especially rewards those involved in trafficking, which in turn boosts domestic demand in the legal economy.

Inflation (in Kabul) has been on a marked downward trend (Figure 3.14.2), reflecting lower global food prices and the recovery in domestic crop production (food has a 61% weight in the consumer price index). The 12-month rate in November 2009 was minus 13%, plummeting from a peak of 43% in May 2008, as the food index moved into negative territory. For FY2009, consumer prices are expected to be 10% lower on average than a year earlier.

The Da Afghanistan Bank, the central bank, continued to focus on controlling inflation while seeking to smooth exchange rate volatility. It responded to the fall in inflation and eased monetary policy, raising its target for growth in circulation of currency in FY2009 to 22% from the original 16%. This policy is consistent with the 12-month end-March 2010 inflation target of about 6%. To attain its monetary targets, the central bank is increasing the use of its 28-day capital notes as well as purchase and sale of foreign exchange with market dealers. It continues to promote a secondary market for these notes to develop a basis for controlling reserve money and monetary policy through open-market operations.

Afghanistan maintains a managed floating exchange rate system. The rate for the afghani strengthened slightly in FY2009 to around AF50/$1 (Figure 3.14.3), and close to its 5-year average in real effective terms. Large inflows of funds from external donors, remittances, and narcotics-related

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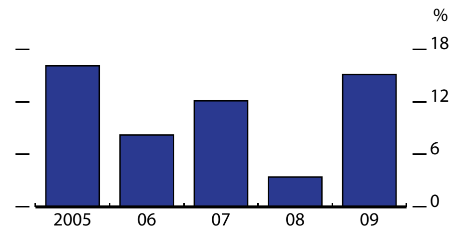
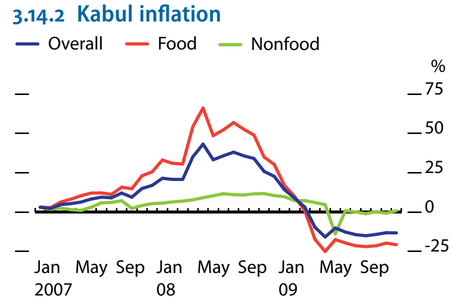
3.14.1 GDP growth



Source: International Monetary Fund. 2010. *Country Report* No. 10/22. January. http://www.imf.org

Click here for figure data

3.14.2 Kabul inflation



Source: Ministry of Agriculture, Irrigation & Livestock. *Agricultural Commodity Price Bulletin*. Various issues. http://mail.gov.af

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activities continue to create upward pressure on the real exchange rate, and this could deteriorate Afghanistan's external competitiveness.

The government made further progress in terms of revenue collection, by controlling expenditure, by adopting a programmatic and sustainable medium-term fiscal framework, and by aligning the budget with the objectives of the Afghanistan National Development Strategy (ANDS) to achieve macroeconomic stability and sustainable growth. It has focused on controlling non-security spending while incorporating increases in security spending financed with additional grants.

Over the past few years, even though the government has increased collection of domestic revenue, it is insufficient to meet operating budget spending; development expenditure in the government budget is almost fully donor funded. Moreover, a large part of donor activity is undertaken outside the government budget and accounts for more than half total public spending. This reduces the effectiveness of the government's development agenda in terms of priorities, resource allocation, fiscal policy, and in monitoring progress against desired outcomes according to the ANDS.

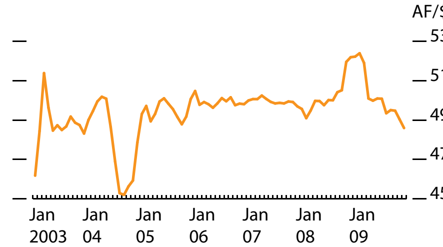
The fiscal position strengthened in FY2009 with domestic revenue estimated to have risen by almost 32%, bringing it to 8.1% of GDP after several years of little improvement (Figure 3.14.4). This increase was achieved by greater tax collection from large and medium taxpayers, stronger customs revenue via tighter controls on fuel imports, and legal amendments that subjected imports to a business tax.

With the decline in security, the government lifted operating budget spending to 14.4% of GDP in FY2009, with much of the rise due to an increase in the size of the police and army (of about 23% to 205,800). The operating budget (excluding grants) is expected to worsen by 1.6% of GDP, though including grants it will remain unchanged as nearly all the additional spending will be financed by grants (more than 80% of security expenditure is met from external sources). As the need for much higher levels of security spending has become evident, the government's target of being able to fully finance its operating budget through domestic revenue, originally slated for FY2015, will likely slip to FY2023, according to a January 2010 report from the International Monetary Fund (IMF).

The current account deficit (Figure 3.14.5), excluding grants, is estimated to have widened from $6.4 billion to $7.0 billion, or about 53.7% of GDP (but still lower as a share of GDP from 54.5% a year earlier). Including grants, the current account deficit was only $462 million (about 3.6% of GDP), and was more than fully financed by official loans ($392 million) and foreign direct investment ($185 million). Imports, the bulk of which are associated with donor-financed activities, increased by 3.5%. Domestic exports fell by 2.4%. Gross international reserves rose during the year and at an estimated $3.8 billion in March 2010 could finance about 13 months of domestic (non-donor) imports.

The IMF's sixth review of the Poverty Reduction and Growth Facility was completed in January 2010. It noted the successful implementation of the FY2009 economic program and the series of steps that qualified the country for $1.6 billion in debt relief from multilateral, bilateral, and private creditors (equivalent to a 96% reduction in the country's external debt), as it had reached the completion point under the heavily indebted

3.14.3 Nominal exchange rate



Source: International Monetary Fund. International Financial Statistics online database (accessed 16 March 2010).

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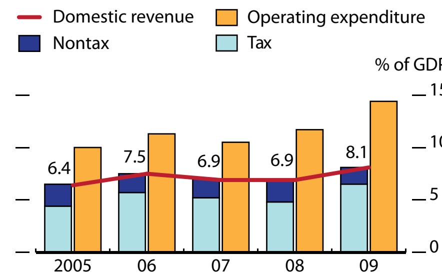
3.14.4 Domestic revenue and operating expenditure



Source: International Monetary Fund. 2010. *Country Report* No. 10/22. January. http://www.imf.org

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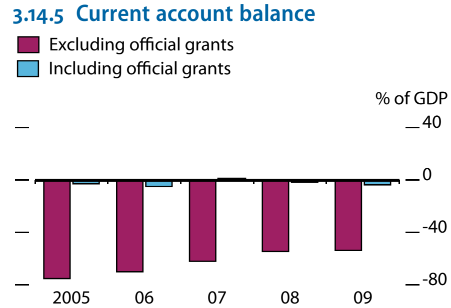
3.14.5 Current account balance



Source: International Monetary Fund. 2010. *Country Report* No. 10/22. January. http://www.imf.org

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poor country initiative. As part of this process, the Paris Club of 19 creditor countries met in March 2010 and canceled Afghanistan's debt owed to its members.

While the debt relief will reduce debt burden indicators to sustainable levels, the economy will remain at high risk. Given its reliance on foreign grants, it is vulnerable if grant support decreases. A sensitivity analysis carried out by the IMF in January emphasized that the external position is particularly exposed to slower growth and to greater reliance on debt rather than grant financing.

Economic prospects

GDP growth in FY2010 is forecast to moderate to 7.6% and to a little under 7.0% the following year. This forecast is based on a number of key assumptions: a gradual improvement in security, continuation of the large development partner funding for projects, sustained agricultural production, continued growth of business enterprises catering to growing consumer demand, improved revenue administration and public enterprise reform, financial sector development, and growing foreign direct investment, especially that aimed at development of the country's substantial mineral resources (such as copper and iron ore).

Monetary policy is expected to contain inflation to 8.4% and 4.5% in the forecast period, barring unexpected developments in global commodity prices or domestic crop failures. The current account deficit (including grants) is projected to improve slightly to about 2% of GDP, mainly owing to an improvement in export performance.

The medium-term growth forecast is subject to several key risks in terms of the domestic security situation; political stability; and the government's ability to combat corruption and to address the infrastructure constraints in power, transport, and irrigation. Inability to achieve steady implementation in structural reforms that will facilitate private sector investment is a further risk underscored in the World Bank's *Doing Business 2010* report.

3.14.1 Selected economic indicators (%)

	2010	2011
GDP growth	7.6	6.8
Inflation	8.4	4.5
Current account balance (share of GDP)	-1.8	-2.1

Source: ADB estimates.

Development challenges

It is important that the government continue with strengthening and developing its range of macroeconomic policy instruments, with advancing fiscal reform, and with increasing domestic revenue collection. It will also need to tightly manage and control budget expenditure, as well as improve the budget formulation process and capacity to execute projects among line ministries. Improved budget expenditure alignment with the ANDS priorities is also necessary.

Achieving greater aid effectiveness through stronger alignment of donor activities (done outside the government budget) with the national development priorities and the government budget is another priority. Associated with these measures are improvements in structural policies and the business and regulatory environment, the building of core government institutional capacity for efficient service delivery, and improvements in social inclusion, equity, and access to social services.