Islamic Republic of Afghanistan

In the licit economy, economic growth slowed as agriculture was hit by another drought, while reconstruction-linked construction and services continued to expand. The Government continued along its track of solid macroeconomic policy and structural reforms. Yet popular discontent with slow reconstruction, pervasive corruption, as well as sharply deteriorating security, institutional and human resource constraints, a heavy reliance on aid, and a very low domestic revenue base, all remain formidable challenges. As does the impact of opium production, which reached record levels. Since current, licit, drivers of growth cannot provide sustained growth, creating a private sector enabling environment and diversifying the economy remain crucial tasks.

Economic performance

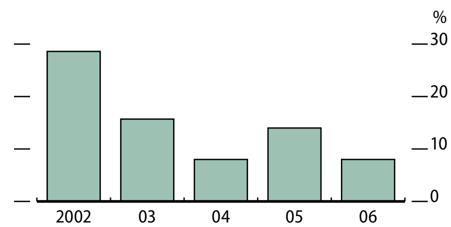
In FY2006 (ended 20 March 2007) the agricultural sector, representing about a third of licit GDP, was hit by another drought. (Box 2.13.1 on the next page discusses the non-licit economy—essentially opium.) While continued expansion in construction and services partly compensated for this decline, overall GDP growth for the year is now expected to reach only about 8% (Figure 2.13.1), or well below the 12% expected in the Poverty Reduction and Growth Facility program with the International Monetary Fund (IMF).

In December 2006, year-on-year inflation registered by the consumer price index for Kabul and five other cities declined to a little less than 4% (Figure 2.13.2), aided by a decline in energy prices and rents in the capital. Wheat imports lessened the impact of the drought on food prices.

Currency in circulation in the year to September 2006 grew less than expected with a gradual shift in money demand from cash toward deposits. Over the year, interest rates on the central bank's 30-day capital notes declined from about 8% to 5–6%. Growing competition in the banking sector is helping narrow the gap between bank deposit and lending rates. From a wider perspective though, the banking sector is still small relative to the economy, despite rapid growth in recent years, and bank assets still account for less than 9% of GDP. Commercial banks dominate the formal financial sector, with about 95% of its assets.

The Government continued to adhere to its "no overdraft" policy for bank financing of the national budget. By the end of FY2005 the execution rate of the development budget reached only 43%, reflecting low capacity, particularly in line ministries; poor prioritization of projects; unrealistic time, cost, and expenditure projections; and delays in project implementation due to a deteriorating security situation. In FY2006 the Government increased its efforts to address the poor implementation performance, such that development expenditures are likely to reach about 55–60% by the end of the fiscal year. To better reflect current spending capacities, the development budget was reduced by 5.1% at the midyear budget review.

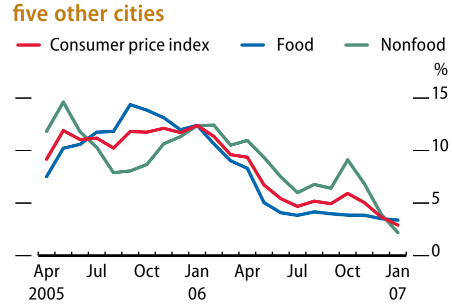
2.13.1 GDP growth



Source: International Monetary Fund, available: www.imf.org, downloaded 9 March 2007.

Click here for figure data

2.13.2 Monthly inflation, Kabul and five other cities



Source: Central Statistics Office, available: www.cso.gov.af, downloaded 19 February 2007.

Click here for figure data

As spending pressures are growing, the same review increased the operating budget by 6.3% to account for expenditures that had previously been funded by donors, such as the fuel subsidy to operate several power generation plants, costs of additional teachers required, and salary arrears (mainly to teachers). The deteriorating security situation is also adding to spending pressure, and these are likely to increase in the medium term.

On the income side, domestic revenues are expected to rise by 15–20%. Since FY2003, government revenues have seen an overall increase of about 500%, yet are still very low. Customs revenues dropped in the second half of last year, most likely due to new restrictions on imports of old and right-hand vehicles, delays in the introduction of a new tariff schedule, and concessions to traders. This drop was partly offset by higher revenues from taxes on income, profits, and business receipts.

With imports of consumer and capital goods outpacing only slowly rising licit exports, the trade deficit, at $2.6 billion in FY2005, is seen rising. But with grants, the current account should remain close to balance.

The exchange rate showed continued stability, fluctuating at AF49.73–50.65/$1 over calendar year 2006. The large foreign exchange inflows have made the currency relatively strong and, given the lack of productivity improvement in the economy, has harmed external competitiveness.

Since the Paris Club rescheduling agreement of July 2006, the Government has been finalizing outstanding bilateral issues and agreements. An agreement with the United States was signed in September 2006 and agreements with the Russian Federation, the largest creditor, and Germany are expected to be signed. Afghanistan will likely benefit from the Heavily Indebted Poor Countries initiative this year.

In January 2006, the Government approved the Interim Afghanistan National Development Strategy (I-ANDS). This sets 5-year benchmarks to enhance security, governance, rule of law, human rights, economic and social development, and stimulate private trade (Box 2.13.2). The Government initiated the implementation of the I-ANDS while preparing a full strategy. The Government continues to push for more aid to be channeled through the budget (currently about three quarters of aid is off-budget) as a further impetus to better align development projects with priorities identified in the I-ANDS. It would also enhance the Government's capacity and, by demonstrating its ability to deliver services to the people, help bolster its legitimacy.

In June 2006, IMF approved a 3-year arrangement worth SDR81.0 million (about $119 million) under the Poverty Reduction and Growth Facility, building on advances made under its Staff Monitored Program. Progress under the Program and the first review of the Facility has been good, with the authorities meeting most benchmarks.

Revenue administration continued to make progress: tax receipts, particularly from large businesses, increased almost 10-fold in FY2006; a road toll was introduced in June 2006 (though revenues fell far short of initial forecasts); a draft proposal to simplify the tax system and to abolish "nuisance taxes" is expected to be submitted for parliamentary approval by end-FY2006; and reform of the mustoufiats—provincial units of the Ministry of Finance—continued. Strengthening the capacity of these units—responsible for revenue collection, payment processing, and accounting functions at the provincial and district level—is vital.

2.13.1 Opium harvest at record in 2006

According to estimates of the United Nations Office on Drugs and Crime (UNODC), total opium cultivation in 2006 increased by 59% and production by 49%. Afghanistan now produces 6,100 tons, equivalent to 92% of total global supply. Most of the production increase was from volatile, conflict-ridden southern provinces.

With the expansion of the licit economy, the share of the total export value of opium to licit GDP is gradually decreasing: from 61.7% in FY2002 to 36.3% in FY2005.

The macroeconomic effects of opium are huge: it generates large aggregate demand, boosts the balance of payments and, through customs duties on drug-financed imports, supports government revenues. However, as much of the income from opium accrues to traffickers, is invested abroad, or is used on imported goods, the overall positive macroeconomic impact is limited.

In rural areas, opium production remains one of the leading sources of employment (it is more labor intensive and more profitable than the production of other crops). In 2006, the share of households involved in opium poppy cultivation rose by nearly half to about 13% of the population.

Responding to changes in economic and enforcement situations, the opium economy has proven to be extremely flexible. Reduction in cultivation in one province often results in production shifting elsewhere.

A study by UNODC and the World Bank has highlighted that eradication efforts tend to most affect poor farmers and rural wage laborers, those who lack political support, or those who cannot pay bribes. Considering the size of the opium economy, phasing out drug production will require significant and sustained effort.

Sources: UNODC. 2006. *Afghanistan Opium Survey 2006*. September; UNODC/World Bank. 2006. *Afghanistan's Drug Industry—Structure, Functioning, Dynamics, and Implications for Counter-Narcotics Policy*.

Reforms in customs focused on the introduction of the Automated System for Customs Data, attention to compliance, training, and expansion and upgrading of customs offices. The customs tariff structure was further rationalized, customs duties for all raw materials were reduced to 1% and customs duty for all imported machinery waived.

With only about 1.3% of the total population employed by the Government, the size of the Afghan civil service is low in both Asian and global terms. The public sector continues to suffer from lack of institutional and human capacity, impacting on the delivery of basic services, causing implementation delays of development projects, and fueling corruption, though in September 2006 a higher salary structure for many "nonuniformed" civil servants, including teachers, was brought in. In 2006 progress in reforming public administration remained slow.

Economic prospects

Assuming that the agriculture sector rebounds from the most recent drought, growth for FY2007 and FY2008 is expected to reach double digits again. Inflation is forecast to stay largely unchanged.

Growth prospects for the medium term hinge on the security situation. Overall physical security has deteriorated significantly over the past year, with antigovernment and anti-Coalition forces stepping up attacks, particularly in the south and east. Suicide attacks increased many-fold. Army and police forces, government employees, and aid workers have all been targeted. Less bloody, but still important for the long-term socioeconomic development of the country, are insecurity of contract, property, and land-tenure rights.

The substantial security costs, now largely paid for by other nations, will remain outside the Government's capacity for a long while. The authorities will also have to deal with uncertainties about nonmilitary donor commitments, including the funding of development projects' operating expenditures (currently covered by donors), and salary pressures.

Development challenges

Despite impressive growth and a solid track record of macroeconomic policy and structural reforms, the country still faces substantial challenges. The current reconstruction-related drivers of growth will neither sustain growth, create employment, nor reduce poverty over the medium term.

One of the Government's main priorities, emphasized in the I-ANDS, is to improve the enabling environment for the private sector and to encourage trade (Box 2.13.2 discusses why). An estimated 80–90% of economic activity is in the informal sector because of political uncertainty, the lack of the rule of law, inefficient business registration procedures, and the tax regime. Entrepreneurs in the informal sector typically remain small, avoiding investments in productive assets or technology that would enable them to achieve economies of scale or to move into higher value-added activities.

(A fuller discussion—still relevant—of the constraints and potential drivers of growth can be found in *ADO 2006*, pp. 145–146.)

2.13.1 Selected economic indicators

	2007	2008
GDP growth	10.0	10.0
Inflation	5.0	5.0
Current account balance (% of GDP)	-4.8	-5.7

Source: Staff estimates.

2.13.2 Private sector collapse

Prior to 1979, Afghanistan had a vibrant private sector with a long tradition of entrepreneurship, engaged in the production of agricultural products, small-scale industrial activities, and trade.

During the 1980s, most industries were nationalized, traditional manufacturing industries such as carpet weaving moved to neighboring countries, and many businesses were forced to close down due to lack of inputs.

Industrial production fell by 95% between 1979 and 2002, with private output hardest hit, falling from 60% of the total to 21% in this time, recovering to a modest 26% in 2005.

Private sector activity is concentrated in construction and services, both fueled largely by the influx of international donor assistance and opium-related funds. In services, trade and transport dominate. Private sector activity has increased in relatively new services sectors such as telecommunications and banking. Manufacturing is limited to traditional products and small-scale activities such as carpet weaving and dried fruit production.

The private sector cites a lack of adequate infrastructure (especially power), and poor access to land and finance as key impediments. A recent investment climate survey identified corruption as one of the main obstacles for doing business in the country—yet government efforts to combat corruption lack the strong political leadership required for focus and coordination.