Afghanistan

With a rebound in agricultural output, economic growth returned to double-digit levels in 2005. The Government continued its solid track record of macroeconomic policy and structural reforms, and elections were held without major disruptions. Substantial challenges remain: a heavy dependency on aid, institutional and staff capacity constraints, an extremely low domestic revenue base, and the threat posed by large (and illicit) opium activity. Transforming the economy will require ongoing strong commitment to the reform agenda, greater effort to promote the private sector, and the continued commitment of the international community. Though insecurity and the opium trade affect nation building, medium-term growth prospects are favorable.

Economic performance

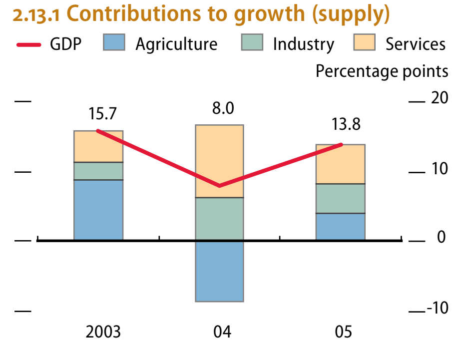
Growth of the licit economy was estimated at 13.8% in FY2005 (ended 20 March 2006). Agricultural output rebounded (Figure 2.13.1) on account of higher rainfall while the reconstruction effort continued to prop up growth in the construction, trade, and transport and telecommunications sectors. During the year, gross domestic product (GDP) expanded to the equivalent of $7.1 billion to bring per capita GDP to $294 (Figure 2.13.2).

For the first time since the ouster of the Taliban in 2001, opium poppy cultivation declined. According to estimates by the United Nations Office on Drugs and Crime, the area under drug crops fell by 21% in 2005. However, as a result of favorable weather conditions and higher yields, overall drug production dropped by only 2.4%. The value of opium exports in 2005 declined slightly to an estimated $2.7 billion, with total farmgate value put at $560 million and gross profits for Afghan traffickers at $2.1 billion, down from the previous year by around 7% and 3%, respectively. With the licit economy growing strongly, the share of the total export value of opium to licit GDP is estimated to have declined from about 47% to around 38%. The success of anti-narcotics efforts varies greatly across regions; however, opium production has been shifting and now extends to all provinces.

Year-on-year inflation recorded by the Kabul consumer price index is estimated to have declined to 10% in FY2005 (Figure 2.13.3), bringing the yearly average to 12%. The impact of higher oil prices on the index was largely offset by a marked deceleration in rent rises.

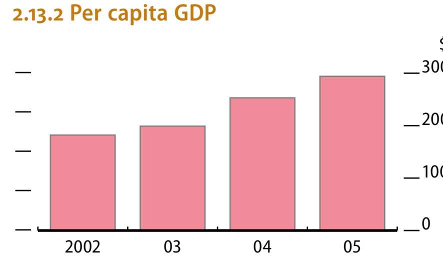
Monetary policy continued in line with the Staff Monitored Program (SMP) of the International Monetary Fund, allowing for flexibility to accommodate potential shifts in currency demand. Currency in circulation grew by 27.8% in the year to March 2006, reaching afghani (AF) 49,521 million. Interest rates on the central bank's overnight note were in the 1–2% range while its 30-day capital notes fluctuated between 4% and 6%. From a very low base of 0.6% of GDP, commercial bank lending operations expanded more than four times between March 2004

2.13.1 Contributions to growth (supply)



Source: International Monetary Fund, 2006, *Islamic Republic of Afghanistan: 2005 Article IV Consultation and Sixth Review Under the Staff Monitored Program*, March.

2.13.2 Per capita GDP



Source: International Monetary Fund, 2006, *Islamic Republic of Afghanistan: 2005 Article IV Consultation and Sixth Review Under the Staff Monitored Program*, March.

and November 2005, while deposits increased by more than two times in the same period. The banking system is being revived, and during the year three state-owned banks, four branches of foreign banks, and three foreign-owned private banks incorporated in Afghanistan were operating; the last group was responsible for about two thirds of the lending and the state-owned banks nearly all the rest. The exchange rate remained fairly stable, fluctuating just below AF50/$1 in FY2005 (Figure 2.13.4).

The Government maintained its commitment in FY2005 to its "no-overdraft" policy regarding bank financing of the national budget. Excluding grants, the operating budget balance in FY2005 is projected to show a deficit of $297 million, or about 4.2% of GDP; including grants, a surplus of $41 million, or about 0.6% of GDP. While the Government is encouraging donors to channel more assistance through the budget, nearly three quarters of total aid to the country is still spent outside the national budget.

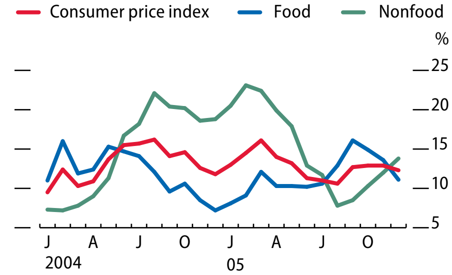
Domestic revenue is estimated to have increased by 40% (in dollar terms) to reach about $377 million for FY2005, excluding $80 million as a telecommunications license fee. Nevertheless, revenue still represents only about 5.3% of GDP, one of the lowest rates in the world. It covers about 56% of operating expenditure, but coverage is only 34% of total recurrent spending.

Collection of customs revenue for full-year FY2005 seems to have been higher than anticipated in the midyear review of the budget. Other tax receipts, mainly from income and profit taxes, were about half of the budgeted level despite revisions to tax laws. Nevertheless, total domestic revenue collection met the budgetary target for the year. Uncertainty created by delay in passing the amended income tax law, which was published in the *Official Gazette* in only November 2005, appears to have affected compliance during the year. It is likely to take time before the recent changes in the law generate the expected benefits. Customs revenue continued to account for the largest share—more than 70%—of total tax collection.

Following the pattern of previous years, development spending in the government budget fell short of planned levels on account of continuing capacity shortages, unrealistic expectations of implementation schedules, and security problems. Development spending for FY2005 is expected to have been less than half (at 6.3% of GDP) of the total of approximately $1 billion budgeted.

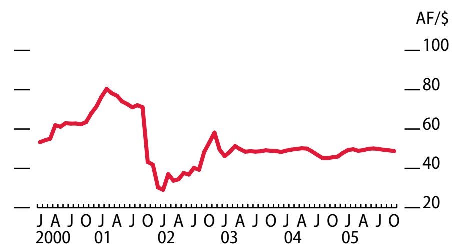
The trade deficit is estimated at $2.5 billion in FY2005 (Figure 2.13.5). Imports of goods increased to $4.4 billion and exports to $1.9 billion, although only $566 million came from domestic exports and the balance were reexports, mainly border trade with Pakistan. The current account deficit widened by about 13% to an estimated $3.0 billion (42.4% of GDP) excluding grants. Including grants, the current account recorded a surplus of $123 million (1.7% of GDP) (Figure 2.13.6). Foreign direct investment is estimated to have increased by 35% to $253 million, and net public loans inflows amounted to $82 million. The estimated overall balance of payments surplus ($458 million) brings international reserves to about $1.73 billion at end-FY2005. This would cover payments for 4.8 months of goods and services (excluding imports for reexport) (Figure 2.13.7).

2.13.3 Monthly inflation



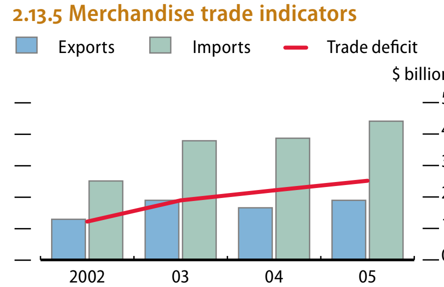
Source: International Monetary Fund, 2006, *Islamic Republic of Afghanistan: 2005 Article IV Consultation and Sixth Review Under the Staff Monitored Program*, March.

2.13.4 Nominal exchange rate



Source: International Monetary Fund, *International Financial Statistics* online database, available: http://ifs.apdi.net/imf/ifsbrowser.aspx?branch=ROOT, downloaded 18 March 2006.

2.13.5 Merchandise trade indicators



Source: International Monetary Fund, 2006, *Islamic Republic of Afghanistan: 2005 Article IV Consultation and Sixth Review Under the Staff Monitored Program*, March.

The Russian Federation has indicated its willingness to write off the estimated $10 billion Soviet-era debt within the framework of Paris Club discussions. Germany and the United States are similarly prepared to cancel debt obligations. Excluding the Russian debt, total external debt, benefiting from write-offs received to date, was estimated to be $749 million at end-FY2004, or 12.5% of GDP, including unverified claims of $157 million.

A World Bank-led public finance management review noted both the improvements made in budget management and execution and the many remaining challenges: capacity shortages, boosting domestic revenues to move toward fiscal sustainability, large differences in resource allocation between Kabul and the provinces, and concerns over transparency. The large concentration in government spending in Kabul is indeed causing political discontent, and upping resource allocation to the provinces is now a government priority.

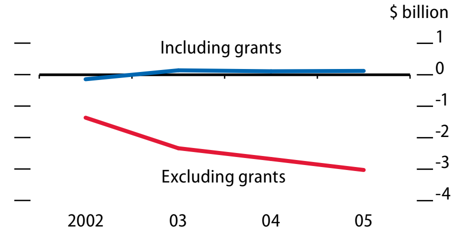
According to the Organisation for Economic Co-operation and Development (OECD), technical assistance since 2001 has amounted to an estimated $400 million annually for the whole of government, and has been instrumental in restoring essential administrative functions, as domestic capacity was often unavailable. The serious shortage of skilled staff affects not only the public but also the private sector, and is one of the main development challenges that the country faces.

Revenue collection is improving (Figure 2.13.8), but needs to be significantly strengthened if the Government's targets are to be reached: to increase domestic revenue to 8.6% of GDP by FY2009, to fund the wage bill by FY2010, and to cover the full cost of the recurrent budget by FY2014. To move in this direction, the Ministry of Finance is currently implementing a 5-year tax administration plan. Under the amended income tax law, tax is set at a two-tier structure of 10% for monthly incomes of up to AF100,000 and 20% for income above that, with a tax-free threshold of AF12,500 per month. A 10% services tax in telecommunications, restaurants, and hotels, and a rental service tax were introduced as well as an airport departure fee in FY2005. The Government has established a taxpayer register and is rolling out a tax identification number system. It is also focusing on strengthening the large taxpayer unit as well as improving tax and customs administration.

The Government established a fiscal policy unit and a fiscal coordination committee. In late 2005, it adopted a medium-term fiscal framework (MTFF) with a view to moving to a rolling 5-year plan. The MTFF is being aligned to the Government's new interim development strategy. In June 2005, a new public financial management law provided stricter guidelines for budget formulation and execution and a better framework for audit and external controls.

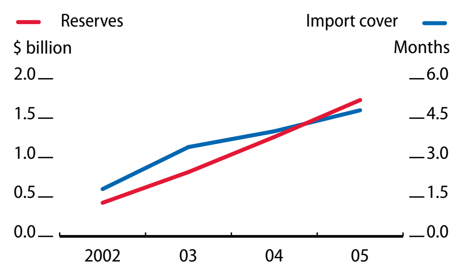
State enterprises have been classified according to the envisaged restructuring method: of the 66 directly owned by the Government, 58 are to be divested, liquidated, or privatized while eight will remain in government hands. Social safety provisions for redundancy payments, retraining, and job placement services were included in the FY2006 budget.

2.13.6 Current account balance



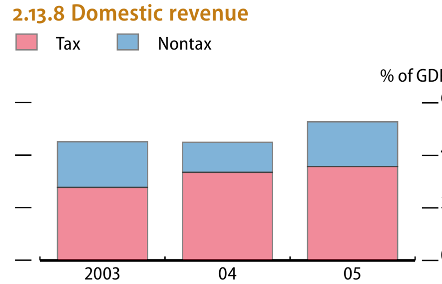
Source: International Monetary Fund, 2006, *Islamic Republic of Afghanistan: 2005 Article IV Consultation and Sixth Review Under the Staff Monitored Program*, March.

2.13.7 Gross international reserves



Source: International Monetary Fund, 2006, *Islamic Republic of Afghanistan: 2005 Article IV Consultation and Sixth Review Under the Staff Monitored Program*, March.

2.13.8 Domestic revenue



Source: International Monetary Fund, 2006, *Islamic Republic of Afghanistan: 2005 Article IV Consultation and Sixth Review Under the Staff Monitored Program*, March.

Economic outlook

With elections to the lower house of parliament and provincial councils in September 2005, Afghanistan completed the road map outlined in the Bonn Agreement. In January 2006, the international community renewed its commitment to the country within the framework of the Afghanistan Compact, pledging $10.5 billion (of which about 80% are new funds) at a high-level conference. The Compact outlines 5-year benchmarks to enhance security, governance, the rule of law, human rights, and economic and social development. The Government also presented its Interim Afghanistan National Development Strategy, which provides for monitoring mechanisms tied to the Compact and the Millennium Development Goals.

At the conference, the Government also launched its updated national drug control strategy, advocating a multipronged approach focusing on interdiction and law enforcement against opium traffickers and processors, while investing in alternative rural livelihoods. This approach will be supported by a counter-narcotics trust fund.

Prospects for 2006 and 2007

At the request of the Government, the SMP was extended until end-September 2006. Discussions between the International Monetary Fund and the Government are under way to move to a Poverty Reduction and Growth Facility that provides financial assistance and facilitates requests to the Paris Club for debt relief. Past performance under the SMP has been strong and its macroeconomic outlook established for FY2006 and FY2007 for growth, inflation, and the balance of payments should be achieved if the associated policies and structural reforms are carried out.

The Government estimates that sustained growth of 9% annually of licit GDP is required to provide citizens with a tangible sense of improvement in living conditions, and compensate for the contraction caused by the elimination of the narcotics sector. Projected growth in FY2006 at 11.7% and FY2007 at 10.6% (Figure 2.13.9) should exceed this minimum. This, though, assumes that agricultural production is not affected by drought, development assistance programs proceed as planned, and the private sector continues its recent expansionary trend. Inflation is projected to decline further (Figure 2.13.10) in line with monetary policy objectives. The current account deficit (excluding grants) is projected to improve gradually from 39.9% of GDP in 2006 to 33.8% in 2007 (Figure 2.13.11) as grant aid tapers down. The deficit (including grants) increases slightly, reflecting somewhat greater foreign direct investment and public loan inflows.

Medium-term prospects

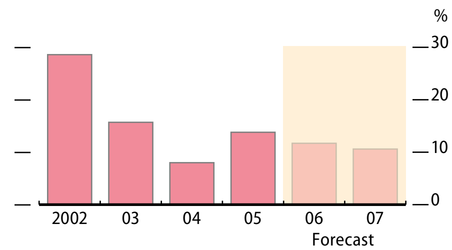
Current drivers of growth, linked to postconflict reconstruction, will not sustain growth or reduce poverty over the medium term. The large donor- and drug-related inflows and their impact on aggregate demand and the labor market have raised wages and growth to levels that cannot be sustained in normal circumstances. Moreover, the large foreign exchange inflows have made the currency quite strong (relative to the country's fundamentals) and, in the absence of productivity improvements, have had an adverse impact on external competitiveness, thereby narrowing

2.13.1 Selected economic indicators

	2006	2007
GDP growth	11.7	10.6
Inflation	8.0	5.0
Current account balance (% of GDP)	-0.9	-2.4

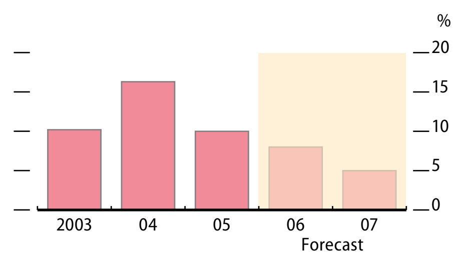
Sources: International Monetary Fund, 2006, *Islamic Republic of Afghanistan: 2005 Article IV Consultation and Sixth Review Under the Staff Monitored Program*, March; staff estimates.

2.13.9 GDP growth



Source: International Monetary Fund, 2006, *Islamic Republic of Afghanistan: 2005 Article IV Consultation and Sixth Review Under the Staff Monitored Program*, March.

2.13.10 Annual inflation



Source: International Monetary Fund, 2006, *Islamic Republic of Afghanistan: 2005 Article IV Consultation and Sixth Review Under the Staff Monitored Program*, March; staff estimates.

opportunities for export expansion and import substitution. These opportunities therefore need to be widened.

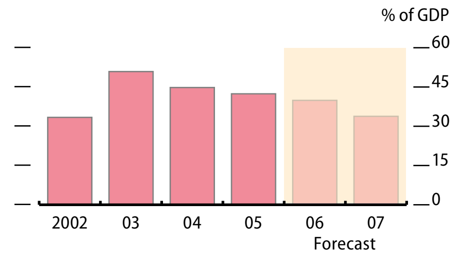
Much of the Government's effort will need to focus on creating an enabling environment for the private sector. Currently a large share, according to some estimates 80–90%, of private sector activity is concentrated in the informal sector. This has implications for longer-term investments, creates market distortions, and reduces the potential for increasing the domestic tax base. One key priority of the Government is therefore to encourage formalization of the economy through improving the investment climate. In the 2005 Doing Business report of the World Bank, Afghanistan ranked 122 out of 155 economies, largely reflecting high transaction costs. In addition, in an investment climate survey conducted by the World Bank, 64% of respondents cited lack of electricity, 60% access to land, 53% corruption, and 51% access to finance as major or severe obstacles to doing business. A series of pending laws should, though, promote private sector confidence when passed. However, effective enforcement mechanisms, particularly the commercial court system, are not yet in place or lack the resources to function properly. Similarly, lack of transparency and widespread corruption act as significant disincentives for investment.

The Government has identified four priority sources of growth in the Interim Afghanistan National Development Strategy and intends to target investments to foster growth in these areas. Agriculture, representing about 36% of GDP (excluding opium) and providing nearly two thirds of employment, is one source. Particular potential lies in high-value lines such as fruit, livestock development, agroprocessing, and rural industries. Investments in the rural economy will also be key to success of the counter-narcotics strategy and poverty reduction.

Mining and extractive industries are a second source, and are expected to attract significant foreign direct investment over the next few years. Afghanistan has largely untapped reserves of iron, copper, coal, hydrocarbons, quarry materials, and gemstones. Yet to fully benefit from these resources, regulatory and institutional deficiencies will have to be resolved and major infrastructure investments made. The third source is more productive use of state assets through the sale of public land for housing and privatization of state enterprises. The fourth is transit trade in goods and energy (Box 2.13.1).

Insecurity (and perceptions thereof) continue to affect long-term investments. The year 2005 witnessed more conflict-related deaths than any since 2001. Other forms of insecurity exist: they relate to contract, property, and land-tenure rights, exacerbated by weak enforcement mechanisms. Crucially, the penetration of the drug industry into the country's economic and political system has contributed to an escalation in criminal activities and corruption that inhibits state building and economic development. A survey conducted in early 2006 showed that poppy cultivation is likely to rise in 2006, although the Government (with foreign support) has stepped up efforts to eradicate poppy fields and provide alternative livelihoods. The large security costs, estimated at 17% of GDP in FY2005, and currently covered primarily by international funders, will remain beyond the Government's capacity for the medium term at least.

2.13.11 Current account deficit (excluding grants)



Source: International Monetary Fund, 2006, *Islamic Republic of Afghanistan: 2005 Article IV Consultation and Sixth Review Under the Staff Monitored Program*, March.

2.13.1 Transit trade

Trade has the potential to become an important driving force. However, formal trade flows with neighbors are relatively small (except for large-scale reexports to Pakistan and Iran and reconstruction-related imports). With an average tariff of 5.3%, Afghanistan has one of the most liberal trade regimes in the region. The country has initiated the World Trade Organization accession process and is seeking greater involvement in regional cooperation groups. The South Asian Association for Regional Cooperation admitted the country in November 2005.

Capitalizing on the country's position as a land bridge for trading within the region and promoting its wider integration in the formal global economy will require policy and institutional reforms as well as continued physical investment. At the moment, trade faces a series of obstacles including delays, cumbersome procedures, and lack of facilities at the borders, all of which undermine export competitiveness, increase the cost of imports, and discourage development of the country as a transit hub. Many existing transit agreements with key trading partners need to be modernized; some have not been fully enforced mainly due to inadequate monitoring mechanisms and a lack of high-level political commitment. Similarly, the lack of power-trading and water-sharing agreements stymie the development of regional power resources and of irrigation systems for agriculture.