Afghanistan

Despite deteriorating security, the economy grew steadily in 2010. Inflation increased (toward fiscal year-end), driven largely by import prices. The fiscal position continued to improve but a run on deposits at the leading private bank revealed a significant macroeconomic risk. The government presented an Afghan-led plan for development at the Kabul Conference of donors, but low implementation capacity, weak public sector governance, and perceptions of widespread corruption raise concerns over implementation. Sustainable, self-reliant growth requires significant improvements in security, progress in the Afghan-led reconciliation process, and a better private sector environment.

Economic performance

GDP continued to grow strongly, at 8.2% estimated for FY2010 (ending 20 March 2011), following high growth of 20.4% in FY2009 (Figure 3.14.1). Private consumption remained the economy's main driver, based on continued high external assistance inflows and security spending that fueled demand for production of goods and services, including construction. The wheat harvest was above average, but agricultural growth was below FY2009's record.

The size of the opium economy (not included in the official figures for economic activity) had been declining since 2007 because of crop-substitution policies, but in 2010 its farm gate price more than doubled, owing to plant disease–related lower production levels. This boosted farmers' opium-sourced income, likely complicating the already slow pace of poppy eradication.

In the early months of FY2010 the price deflation of the previous fiscal year continued. Prices began to rise from about May 2010, heavily influenced by food and then by fuel, reflecting rising import prices. Although inflation is projected to average 8.2% in FY2010, in February 2011 prices were 17.9% higher than a year earlier (20.9% food and 13.7% nonfood—Figure 3.14.2).

Afghanistan maintains a managed floating exchange rate regime. The afghani appreciated by around 10% against the US dollar over the period January 2010–February 2011, on high inflows of foreign exchange in the form of donor grants and remittances and on increased demand for domestic currency (Figure 3.14.3). This appreciation, alongside inflation now higher than among trade partners, is causing the real effective exchange rate to appreciate as well, potentially undermining exports.

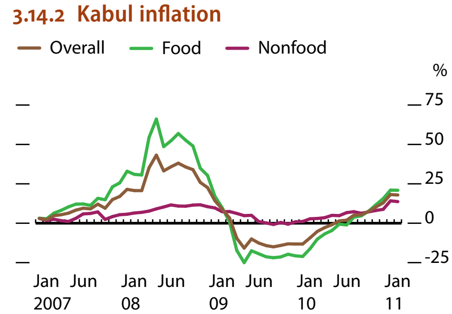
To achieve stability both in domestic prices and the exchange rate, Da Afghanistan Bank, the central bank, targets reserve money (bank reserves and currency in circulation) as its key monetary tool, relying on the issue of its capital notes and foreign currency auctions to control the

3.14.1 GDP growth

Source: Ministry of Finance.

Click here for figure data

3.14.2 Kabul inflation



Sources: Ministry of Agriculture, Irrigation & Livestock. *Agricultural Commodity Price Bulletin*. http://mail.gov.af; Central Statistical Office of Afghanistan; Da Afghanistan Bank.

Click here for figure data

This chapter was written by Rehman Rahmani and Tia Raappana of the Afghanistan Resident Mission, ADB, Kabul; and Nina Clare Fenton of the Central and West Asia Department, ADB, Manila.

money supply. The absence of price pressures at the start of the fiscal year allowed it to adopt a relatively expansionary monetary stance for FY2010, in order to accommodate an increase in demand for money stemming from expected economic growth. It targeted reserve money growth in FY2010 at 18.9%, 1.8 percentage points higher than in FY2009.

In view of inflation pressures, however, the central bank is expected to increase interventions in the market. Gross international reserves climbed to $5.0 billion at end-March 2011 (a rise of 19% from 12 months earlier), reflecting higher donor inflows. Reserves are sufficient to finance 14.3 months of imports and can facilitate market intervention to stabilize the economy and currency.

A run on deposits at Kabul Bank, the largest private bank, in the second half of 2010 raised concerns about financial stability, highlighting the need to strengthen central bank supervision (Box 3.14.1). Although the government took steps to stabilize the crisis, the bank's losses (stemming from serious weaknesses in its corporate governance and management) could constitute a heavy fiscal burden.

Following a surge in domestic revenue collection in FY2009, the government continued to improve in this area, and collection is expected to reach 9.8% of GDP in FY2010 (Figure 3.14.4). The good performance was driven by improved tax administration, including a levying of business receipts tax at borders and other structural reforms. Still, the fiscal position (excluding grants) remains among the world's weakest. Development expenditure is almost fully funded by external assistance while fiscal sustainability—domestic revenue as a share of recurrent spending—is expected to decline to around 65% in FY2010 from 72% a year earlier.

This decline is due to upward pressures on recurrent spending, mainly from the higher wage bill owing to the expansion of the Afghan security forces and the rollout of pay and grading reforms for civil servants. Steps toward fiscal sustainability are particularly important given plans to transit to Afghan-led security, since most International Security Assistance Force nations are setting dates for withdrawing their troops.

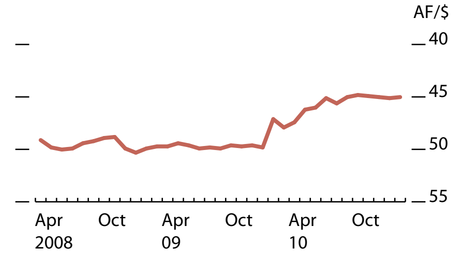
At conferences in London and Kabul in January and July 2010, the government presented refinements to its Afghan-led medium-term plan for development and announced results-based national priority programs to meet its objectives. It also set out public financial-management reforms.

Only an estimated 20% of donor funds are channeled, however, through the government budget, and to increase this share (as committed at the Kabul Conference), the government needs to greatly improve its implementation capacity. It also needs to address broader issues of transparency and accountability in the public sector, including strengthening audits on the use of domestic funds.

The current account deficit (excluding grants) is estimated to have narrowed from 43.6% to 37.6% of GDP in FY2010 (Figure 3.14.5). The narrowing trend reflects the fact that grant-related imports (and grant financing), though increasing in US dollars, are falling relative to nominal GDP. Including grants, the current account balance varies only slightly: it is expected to run a small surplus of 1.9% of GDP in FY2010, switching from a deficit of 1.4%.

During the fiscal year imports increased by 3.7%. The rise was

3.14.3 Nominal exchange rate



Source: Da Afghanistan Bank. http://www.centralbank.gov.af

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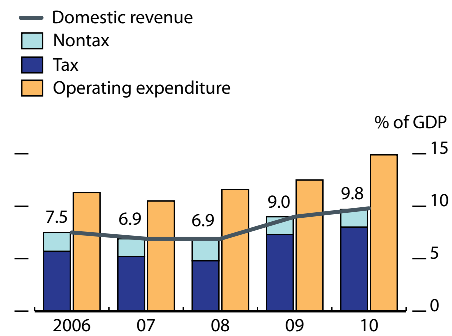
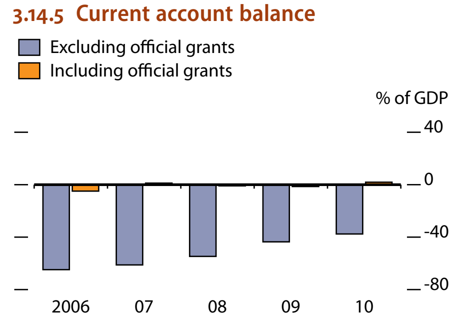
3.14.4 Domestic revenue and operating expenditure



Sources: International Monetary Fund. 2008. *Country Report No.* 08/72. February. http://www.imf.org; Da Afghanistan Bank. 2010. *Selected Economic Indicators*. November.

Click here for figure data

3.14.5 Current account balance



Sources: International Monetary Fund. 2008. *Country Report* No. 08/72. February. http://www.imf.org; Da Afghanistan Bank. 2010. *Selected Economic Indicators*. November.

Click here for figure data

attributed to continued high demand from donor-funded projects, particularly for fuel, capital equipment, and food, which together make up almost 80% of imports. Exports (much smaller than imports) rose by 6.9%; the main items remained dried fruits, carpets, and furs.

Economic prospects

GDP growth rates for FY2011 and FY2012 are projected at 8.0% and 8.5%, respectively. These estimates assume that substantial development-partner funding continues; agriculture and services perform well; the resolution of the Kabul Bank crisis is not disruptive; and industry improves, aided by mining-related construction.

If managed effectively, mining has the potential to grow robustly, although its contribution to the budget over the next few years is likely to be modest. The World Bank estimates that even in a low-impact scenario the first significant investment, the Aynak copper mine, could generate budget revenue of around $155 million a year in the construction phase (2011–2015), increasing to $365 million from royalties once the mine is operating. The Hajigak iron ore mine, too, may bring in revenue of $89 million a year after it starts construction in 2013. In the early years of development, combined receipts from these two mines could therefore be over 1% of GDP, but that amount is contingent on strong management.

The government expects in the next few years to make progress on revenue collection, particularly by the possible introduction of a value-added tax, and to increase its fiscal sustainability ratio to above 70%. The tax take should also benefit from increased mining activity, largely through indirect tax revenue in the construction phase. Meeting the 70% target will, though, be challenging under continued pressure on recurrent expenditure. Although external assistance is set to gradually decline, it is likely to be needed to cover at least part of such spending for several years.

Foreign aid will continue to plug the balance-of-payments gap. The current account surplus is expected to fall slightly in FY2011, to 1.4% of GDP (including official transfers), driven by increased imports as international commodity prices rise. Excluding official transfers, the balance should continue its gradual improvement to a deficit of 34.4% of GDP as development assistance falls relative to the size of the economy (though nominally it expands).

Inflation is projected to average 9.8% and 9.1% in FY2011 and FY2012, assuming that prudent monetary policy is adopted as planned and that it can mitigate the impact of rising international commodity prices.

The previous program of the International Monetary Fund ended in September 2010; the government has therefore requested a new Extended Credit Facility, though the Kabul Bank crisis has delayed a board decision.

The government's economic program is likely to set out key actions on resolving Kabul Bank's position and strengthening broader financial supervision measures, while keeping a focus on macroeconomic stability objectives and measures toward fiscal sustainability.

This outlook is subject to several risks, such as worsening security conditions, political instability, weak governance, loss of export

3.14.1 Kabul Bank crisis

Fraudulent loans came to light at Kabul Bank in September 2010, triggering a run on deposits. Despite this huge change to its financial position, the bank still has the largest deposits and branch network in the country, and performs crucial functions such as paying civil service salaries.

The central bank initially placed Kabul Bank under a conservatorship until the bank could be sold to a qualified buyer, or, in the worst case, liquidated.

The government has so far guaranteed $400 million of the bank's deposits but it will probably also need to finance any remaining unfunded liabilities at the time of a sale.

An alternative option, proposed by the International Monetary Fund, would be to place the bank in receivership, which could be expected to ensure more transparent, legally secure, and potentially faster resolution.

Importantly, any improper financial and legal interests would be unquestionably resolved and any further losses prevented. The government's financial exposure could also be limited to a predetermined level. In March 2011, the option of receivership was being considered by the Afghan authorities.

3.14.1 Selected economic indicators (%)

	2011	2012
GDP growth	8.0	8.5
Inflation	9.8	9.1
Current account balance (share of GDP)	1.4	-0.8

Source: ADB estimates.

competitiveness, and new barriers to trade with neighboring countries. The debt relief granted to Afghanistan under the extended heavily indebted poor countries initiative in 2010 has relieved the debt burden by $1.6 billion, taking it to a sustainable level (around 8% of GDP). Still, Afghanistan will stay at high risk of debt distress, particularly if foreign grants (expected to decrease gradually in the medium term) fall heavily.

Development challenges

It is important that the government continues to undertake a strong reform agenda and implement the commitments made at the Kabul Conference. A particular focus should be on strengthening governance, implementation capacity, and accountability of public institutions. The government's development plan should help to ensure that the budget is clearly focused on key policy objectives. Capacity should be strengthened to increase development budget implementation by at least 10%–20% annually, as committed to at the Kabul Conference. At the same time, the national budget process should build on existing systems to better monitor spending effectiveness.

If significant progress were made on all these fronts, development partners would channel more funds through the government budget, helping to align development priorities and increase aid effectiveness.

External assistance is expected to decline over the long term, hence the government needs to focus on the transition to fiscal sustainability. It is expected to continue improving its position by increasing domestic revenue and controlling public expenditure through a robust budget-formulation process.

The government will also want to improve the overall investment climate, so as to encourage private sector growth, promote exports, and reduce dependence on external assistance. The country still ranks the lowest in the region for ease of doing business, according to the World Bank's *Doing Business 2011* report, and this needs to change. Managing the potential mineral wealth well will also be critical.

3.14.2 South Asian rankings on the ease of doing business, 2011

Pakistan	83
Maldives	85
Sri Lanka	102
Bangladesh	107
Nepal	116
India	134
Bhutan	142
Afghanistan	167

Note: Out of 183 countries worldwide.
Source: World Bank. *Doing Business 2011*.