Afghanistan

Full responsibility for security is to be handed over to the government by end-2014 as international troops are withdrawn. Since economic development (as well as security) has depended heavily on aid and international military spending, the transition will require the country to find new sources of growth and ways to achieve fiscal sustainability, in an uncertain security environment. These challenges will require major domestic efforts and reforms alongside substantial external support by donors if development momentum is to be sustained.

Economic performance

GDP growth is estimated to have slowed to 5.7% in FY2011 (ending 20 March 2012)—following an 8.4% expansion the previous year—mainly because of a large fall in agricultural foodgrain production owing to unfavorable weather conditions for a second year (Figure 3.14.1).

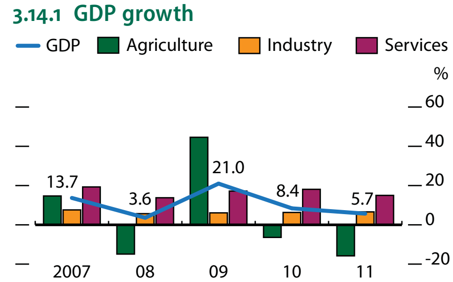
Private consumption remained the main source of economic growth, fueled by the large aid inflows that underpin most of the demand for goods and services. Growth in services activity, which accounted for 53% of GDP, moderated during the year, reflecting lower foreign inflows. Domestic investment is estimated at 22.6% of GDP, including private investment of just over a third of that.

Opium production increased by 61% in 2011, rebounding from a disease the year earlier that wiped out much of the crop, and farmers responded to high prices offered by traffickers. Farm income for opium in 2011 is estimated to exceed $1.4 billion, equivalent to nearly 8% of GDP; export value may be as much as $2.4 billion. Opium is not counted as part of GDP, but earnings generated by it and then retained and spent in the country boost domestic demand.

Consumer prices are highly volatile because of heavy import dependence, including food and fuel (Figure 3.14.2). Overall (year-on -year) inflation, which peaked at 18.2% in January 2011, receded to 9.2% in February 2012, mainly due to a fall in food inflation, which dropped from 21.0% to 7.1% mainly because of declining global food prices. Nonfood inflation was fairly stable in this period—varying around 14%—kept high by price adjustments for electricity and fuel, construction materials, transport, and housing rents. Average inflation in FY2011 is estimated at 10.5%.

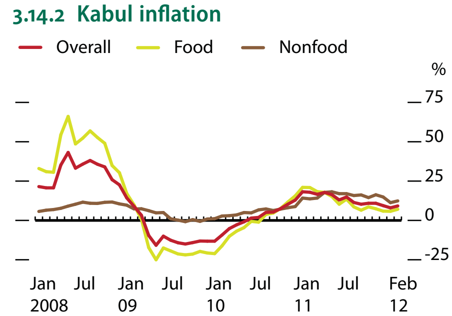
Revenue collection is estimated to have met the FY2011 budget target of AF98.8 billion (11.5% of GDP), reflecting tax administration reforms, improved tax compliance, and new tax measures such as a business receipts tax (Figure 3.14.3). Operating expenditure is estimated to have increased by 37.0% in FY2011, mainly because of growing security expenditure taken on to the budget and rapid implementation of pay and grading reforms for civil servants. Domestic revenue coverage of

3.14.1 GDP growth



Source: Ministry of Finance.

3.14.2 Kabul inflation



Sources: Central Statistical Office of Afghanistan; Da Afghanistan Bank.

This chapter was written by Rehman Rahmani of the Afghanistan Resident Mission, ADB, Kabul.

operating expenditure therefore fell, to about 65% from 73% a year earlier; the balance of operating expenditure was financed through donor grants.

The government tightened its policy on new project additions to the development budget in view of the low execution rate, which has been a major concern for the government and donors in recent years. The government has been struggling to meet its budgetary targets to achieve the Millennium Development Goals, for example.

The central bank adopted a relatively tight monetary policy during FY2011 to contain inflation pressures, although they largely stemmed from global price increases. Growth in currency in circulation was cut by nearly half to 17.8% from 34.2% in FY2010. The afghani remained broadly stable in real effective terms; it depreciated by about 8% against the dollar during FY2011 (Figure 3.14.4).

The current account deficit (excluding grants) is estimated to have narrowed by about 5.5% of GDP to a deficit of 34.3% of GDP in FY2011 (Figure 3.14.5). The narrowing trend reflects the fact that grant financing has remained broadly stable in dollar terms at about $6.3 billion in recent years but is falling in relation to a growing nominal GDP. Including grants, the current account is expected to run a surplus of 0.1% of GDP in FY2011, down from the 1.7% surplus in FY2011 due to a much smaller expansion in exports. The financial account improved slightly on increased foreign direct investment as a result of initial investment in mining industry. Gross international reserves are estimated to have increased to $6.1 billion, equivalent to cover 8.4 months of imports.

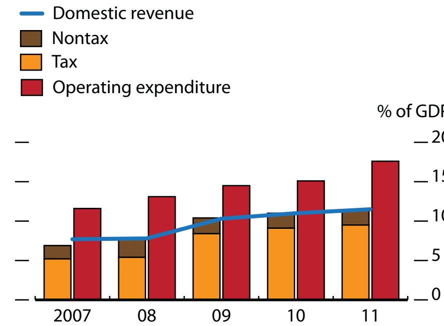
Economic prospects

Economic activity will continue to be driven mainly by consumption expenditure and is expected to pick up to 7.1% in FY2012 (assuming more favorable weather for agriculture). A slowdown to 5.8% is expected in FY2013, though, because of declining local spending from foreign security forces as they gradually withdraw and waning grant-financed development spending that is not channeled through the government budget. An economic program with the IMF under its Extended Credit Facility was agreed in November 2011 and it provides an overall macroeconomic adjustment framework for the next 3 years, as well as guidance to reform banking regulations after the failure of Kabul Bank (Box 3.14.1).

The government's operating budget deficit will come under pressure in the next 2 years because of increases in security spending, continuing pay and grading reforms in the civil service, absorption of the public servants paid by donors, and operation and maintenance cost of projects handed over by donors. Projections indicate that recurrent spending will rise to 18.6% of GDP, while domestic revenues will stay at about 11.5% of GDP over the next 2 years, thus domestic revenue will fall by another 3 percentage points to finance about 62% of recurrent expenditures. Increases in operating and development grants, however, are expected to keep total budget expenditure higher at over 25% of GDP in FY2012 and FY2013, or about 1.5–2 percentage points above that in FY2011.

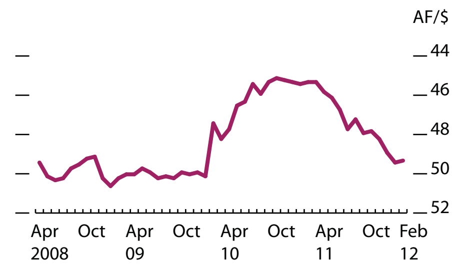
Monetary policy aims to bring down inflation to about 5% in the next 2 years. While the main drivers of prices are external and out of direct control, the *Asian Development Outlook 2012* baseline assumes broadly

3.14.3 Domestic revenue and operating expenditure



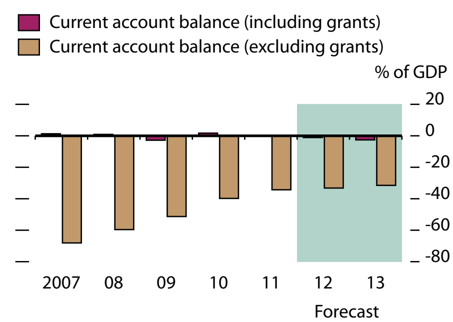
Source: International Monetary Fund. 2011. *Country Report* No. 11/330. November. http://www.imf.org

3.14.4 Nominal exchange rate



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

3.14.5 Current account balance



Source: International Monetary Fund. 2011. *Country Report* No. 11/330. November. http://www.imf.org

3.14.1 Selected economic indicators (%)

	2012	2013
GDP growth	7.1	5.8
Inflation	4.6	5.0
Current account balance (share of GDP)	-1.1	-2.5

Source: ADB estimates.

stable global commodity prices, indicating that this objective is attainable. The monetary authorities also intend, as in the past, to operate to smooth out volatility in the exchange rate and strengthen international reserves. Donors' projected substantial, though declining, aid inflows will facilitate meeting these objectives.

Foreign aid will continue to finance most of the balance-of-payments deficit, though pressures here will begin to emerge in the next 2 years. The current account deficit (excluding grants) as a share of GDP is projected to fall to 33.2% in FY2012 to 31.5% in FY2013 as responsibility for security is handed over to the government. Mainly because of reduced (export) sales to nonresidents and also some fall off in public grants, the current account balance (including grants) will turn to a deficit estimated at 1.1% of GDP in FY2012 and 2.5% of GDP in FY2013. Because domestic exports are so small, the country has very limited debt-carrying capacity and will be forced to rely on foreign direct investment and highly concessional loan assistance to cover these deficits.

Policy challenge—coping with the transition

The planned foreign troop pullout by end-2014 is seen lowering annual growth by at least 2–3 percentage points after that date, due to reduced local spending by these forces and by foreign civilian organizations with international and national staff. Unemployment will go up when local staff hired by foreign security and civilian organizations are laid off.

The fiscal impact of the transition will come mainly from increasing pressure on the government to take over externally financed operating expenditures (security and nonsecurity); declining grants to the government's development budget; and donors' continuously declining externally financed development budgets (some of their projects will be brought on budget). Over the next 10 years, fiscal policy will have to balance the takeover of externally financed security spending and other expenditures, while increasing propoor and development outlays within a very tight budget constraint. The transition will lead to limited fiscal space, thereby pushing back fiscal sustainability (defined as domestic revenue funding the government's recurrent expenditure). Without sustained, high grant assistance, the concept of fiscal sustainability is reduced to fiscal survival.

Afghanistan's debt burden could rise substantially in the near future. Current public sector debt is around 12.1% of GDP, but with a heavy reliance on external grants to finance its budget, a rapid reduction in grants could require the government to assume new loans to meet its financing needs. A worsening security environment could exacerbate these financing requirements and reduce the government's ability even to collect domestic revenue.

The external sector will be affected through pressures on the current account balance and the exchange rate due to declining aid inflows. But a weak policy, regulatory, and institutional framework seems to be more challenging for Afghanistan's competitiveness than the exchange rate, as shown by the World Bank's *Doing Business Report 2012*. Afghanistan stands at 160 out of 183 countries, showing further degradation from 154 the previous year.

3.14.1 Kabul Bank crisis update

Fraudulent loans came to light at Kabul Bank, the largest bank in the country, in September 2010, triggering a run on deposits. The central bank initially placed the bank under conservatorship, appointed new management and guaranteed all deposits. Subsequently, Kabul Bank was placed under receivership and its assets have been split into "good" and "bad" banks.

The bank's deposits and good assets are with a bridge bank called New Kabul Bank, which will likely be privatized in FY2012. The bad assets have been retained by the receiver, appointed and overseen by a newly created independent Financial Dispute Resolution Committee. Based on the latest estimates, around $935 million (principal and interest) are receivable, although this amount is likely to increase when an audit is completed. Formal charges have been brought against two shareholders who represent over 50% of the assets sought for recovery and seven bank officers, but the legal process is moving slowly.

This crisis exemplifies the risks of rapid banking sector growth with weak governance and rule of law, and a lack of capacity and experience in supervision at the central bank. In November 2011, the government and IMF agreed to a new three-year Extended Credit Facility that includes measures to address corruption and strengthen regulation and supervision over the banking system.