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Afghanistan

The next 2 years before the government assumes full responsibility for security in 2014 will be critical. Security and political uncertainties, including a presidential election, will weigh heavily on the direction the country takes. To ensure economic stability and a sound basis for transition, the government will have to fulfill commitments made under the Tokyo Mutual Accountability Framework and implement various policy and institutional reforms agreed under the current International Monetary Fund program.

Economic performance

GDP growth is estimated to have accelerated to 11.9% in 2012, following 7.2% expansion a year earlier, entirely due to the strong performance of agriculture, as weather improved from a drought in 2011 (Figure 3.14.1).

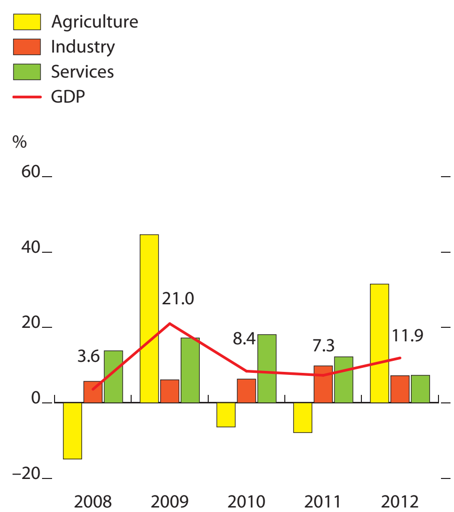
Private consumption buoyed by international aid flows, much of it related to security, remained the main source of growth. Aid fueled most of the demand for goods and services, especially in construction. Private investment increased slightly to 8.4% of GDP in 2012, as a 20% retrenchment by small and medium-sized enterprises was offset by a 26% increase in new investments in aviation, industry, agriculture, and real estate by large companies that began to shift their business focus from internationally funded security projects to enterprises catering to local demand.

Strong growth in agriculture, at 31.5%, reflected favorable weather, especially in the north. Wheat production, which accounts for three-fourths of cereal production, grew by 48%. Growth in industry slowed to 7.2% from 9.8% in 2011, mainly because of slower expansion in manufacturing and construction caused by protracted power shortages and spending cramped by the uncertain political and security situation. Growth in services, which accounts for about half of GDP, slowed to 7.3% from 12.7% in 2011, attributed to reduced spending by international security forces and by the local population because of uncertainty in the run-up to 2014.

Opium production fell from the equivalent of 7% of GDP in 2011 to 4% in 2012 as disease and unfavorable weather afflicted the main growing areas. The value of opium production is estimated to have halved from $1.4 billion in 2011 to $0.7 billion in 2012. Opium is not counted as part of GDP, but earnings generated by its sale that are retained and spent in Afghanistan boost domestic demand.

Average consumer price inflation almost halved to 6.2% in 2012 from 11.8% in 2011, mainly on account of a sharp drop in food prices, as the good harvest boosted domestic food supplies. Food inflation slowed to

3.14.1 Supply-side contributions to growth



Sources: Ministry of Finance; ADB estimates.

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2.4% in August before rising to 4.4% in December, owing to increases in prices for imported goods such as milk, cheese, eggs, meat, spices, and nonalcoholic beverages (Figure 3.14.2). Nonfood inflation also declined over the year to 7.4% in December 2012, mainly reflecting lower international fuel prices and domestic transportation costs.

Fiscal policy in 2012 focused on revenue mobilization and budget management. The government was unable to fully achieve the domestic revenue target set in the current International Monetary Fund (IMF) program. Domestic revenue fell to 10.3% of GDP, mainly from a shortfall in custom duties, which account for one-third of total revenue (Figure 3.14.3). This took the government further away from its fiscal sustainability target, as domestic revenues financed 56% of the government's recurrent operating expenditures in 2012, down from 68% in the previous year. A number of grants and projects previously administered separately by development partners were added to the national budget during 2012. This resulted in development partners financing 44% of the recurrent expenditure and 65% of development expenditure.

The Da Afghanistan Bank, the central bank, primarily targets price stability using foreign exchange auctions and short-term capital notes as monetary tools. The monetary authorities succeeded in keeping inflation low by pursuing a tighter monetary policy in 2012. The policy slowed growth in broad money to 9.3% from 21.3% a year earlier, which, with improved domestic food production, succeeded in moderating inflation. The afghani depreciated by about 5% to AF51.8 = $1 in the 12 months to January 2013, apparently owing to foreign exchange being in tighter supply and higher demand (Figure 3.14.4).

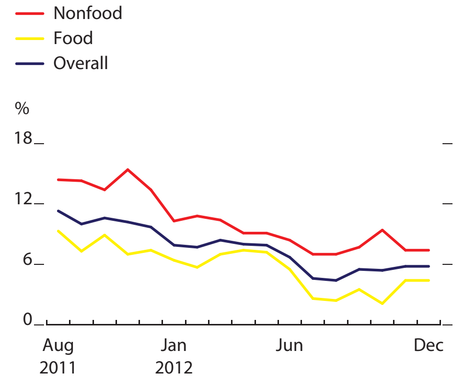
The current account deficit excluding grants is estimated to have widened slightly to 42.7% of GDP in 2012, mainly reflecting higher imports (Figure 3.14.5). Including grants, the current account surplus improved to 4.0% of GDP from 3.0%, mainly from increased public transfers. Foreign direct investment rose to $405 million, largely on investment to develop oil in the Amu Darya Basin. Gross international reserves increased by 10.6% to $6.9 billion in FY2012 (ending 20 March 2013), enough to cover 7.3 months of FY2013 projected imports, excluding imports for re-export.

Economic prospects

GDP growth is forecast at 3.3% in 2013 and 5.1% in 2014. Unusually slow growth in 2013 reflects the expectation that food crop production will be substantially lower than in 2012, when weather was unusually favorable, this base effect dragging down GDP growth overall. Afghanistan will go through a period of political and security uncertainty that is expected to weigh heavily on economic growth. Private consumption will slow but remain as the main source of growth. Industry and services are expected to grow more slowly as smaller international security forces may spend less.

The FY2013 national budget focuses on domestic revenue mobilization, sustainable growth, and poverty reduction. The development of the extractive industry, social sectors, and agriculture will be top priorities alongside security. Total spending will increase by 26.5%, with

3.14.2 Inflation



Note: March 2011 = 100.

Sources: Central Statistical Office. http://cso.gov.af/en (accessed 30 March 2013); ADB estimates.

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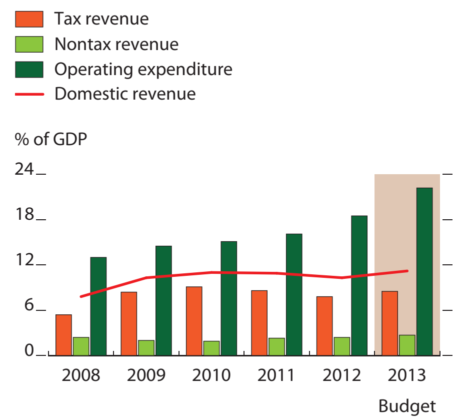
3.14.3 Fiscal indicators



Sources: International Monetary Fund. 2012. *Country Report* No. 12/245. August; Da Afghanistan Bank. http://www.centralbank.gov.af (accessed 4 March 2013).

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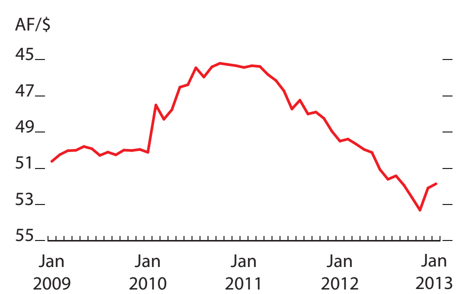
3.14.4 Nominal exchange rate



Source: Da Afghanistan Bank. http://www.centralbank.gov.af (accessed 4 March 2013).

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development partners to finance 60% of the $6.6 billion national budget, or 49% of the recurrent budget and 66% of the development budget. Domestic revenue will increase by 18.0% but slide to 50.1% of recurrent operating expenditure. The planned value-added tax will, if approved and implemented by 2014, help bridge the gap between recurrent budget and domestic revenues. On-budget grants will increase in 2013 and 2014, as the budget is extended to cover more external grants heretofore administered by development partners and new pledges made at conferences in Tokyo and Chicago are realized.

Inflation during 2013 and 2014 is forecasted to be around 6.0% on the assumption of good harvests, easing international commodity prices, and the maintenance of tight monetary and fiscal policies. Afghanistan will continue to manage a floating exchange rate.

The current account deficit excluding grants is projected to widen to 44.0% of GDP in 2013 as imports rise and exports slip slightly. In 2014, the deficit will fall to 42.2% of GDP as the growth in nominal GDP continues while the dollar value of imports, the trade deficit, and public transfers are broadly unchanged from a year earlier. Including grants, the current account surplus will dwindle to 0.3% of GDP in 2014.

Policy challenge—funding the transition

The withdrawal of international security forces by the end of 2014 and the transition to Afghans assuming full responsibility for security will put pressure on public expenditures and widen fiscal gaps. These pressures arise mainly from having to expand security and development expenditure that was previously provided by international forces, as well as covering the recurrent costs of public assets built by development partners. Consequently, IMF projections show public expenditures growing significantly to reach 39% of GDP by 2025. Domestic revenues, by contrast, are expected to reach only 17% of GDP by 2025, leaving a significant financing gap equal to 22% of GDP. To cover this gap initially, development partners at the 2012 conference in Tokyo pledged $16 billion for development through 2015, conditional on improved governance and transparency. They reconfirmed their commitment to channel half of aid through the budget and align 80% of their programs with national priority programs. In 2012, members of the North Atlantic Treaty Organization pledged $4.1 billion a year to fund security costs after 2014.

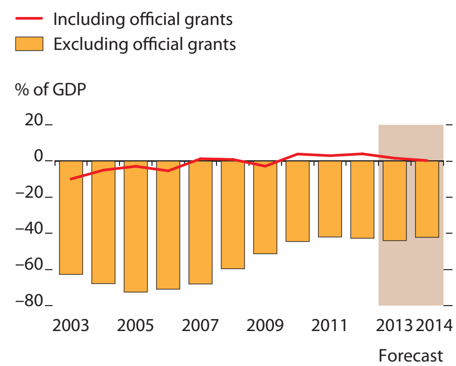
Afghanistan has large mineral resources potentially worth about $1 trillion, according to the US Geological Survey. If developed, these resources could provide a solid base for economic development. The government has agreed with international companies to establish large projects to mine copper and iron ore. However, implementing these projects will require a substantially improved security environment. Government revenue from an oil production project in the Amu Darya Basin is estimated to be $64 million in 2013 and $90 million in 2014, which is an encouraging start.

3.14.1 Selected economic indicators (%)

	2013	2014
GDP growth	3.3	5.1
Inflation	6.1	5.8
Current account balance (share of GDP)	1.6	0.3

Source: ADB estimates.

3.14.5 Current account balance



Sources: World Bank. 2011. Economic Update for Afghanistan. October; International Monetary Fund. 2011. *Country Report* No. 11/330. November; Da Afghanistan Bank. http://www.centralbank.gov.af (accessed 4 March 2013).

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