Growth decelerated to 3.3% following stellar agriculture and growth performances in 2012. Afghan forces have assumed responsibility for security, and the withdrawal of international troops will be complete by the end of 2014. The decision on retaining a small number of international troops, largely for mentoring and logistical support, has been delayed until after the April presidential election. The outlook is for modest growth until uncertainties are resolved.

Economic performance

Evolving political and security uncertainties substantially affected economic activity in 2013, except in agriculture. Growth in GDP excluding opium production is estimated to have declined to 3.3% in 2013, consistent with ADO 2013 projections, and was much lower than the 11.9% gain in 2012 (Figure 3.14.1). The weaker performance reflects slow expansion in agriculture, industry, and services on the supply side, and in private consumption and investment on the demand side.

On the supply side, agriculture production was slightly higher than the record output achieved in 2012, as the country enjoyed favorable weather for another excellent harvest. However, because 31.5% growth in 2012 established a high base, agriculture growth recorded in 2013 was only 1.6%. The retrenchment in spending by international security forces, the winding down of a large number of projects funded and implemented by development partners, and Afghans’ heightened caution greatly curtailed activity in industry and services. Growth in industry decelerated to 2.5% from 7.2% in 2012, while growth in services slipped to 4.3% from 7.3%.

On the demand side, private consumption continued to drive growth but at a slower pace, reflecting increased domestic savings but also the impact of slowing growth in incomes reflecting the drawdown of military and civilian personnel and declining aid since 2010. The deadlock over signing the Bilateral Security Agreement, which is necessary to retain a small number of international troops in Afghanistan for training and logistical support, added to uncertainties created by the exit of international forces by the end of 2014 and the prospect of further reductions in assistance. With consumer and investor confidence down, private investment is estimated to have dropped to 3.6% of GDP in 2013 from 4.9% in 2012.

Headline inflation accelerated to 7.3% in the year to December 2013 from 5.8% a year earlier, mainly because of food price hikes (Figure 3.14.2). Food inflation reached 9.7% in December on account of sharp rises in the prices of vegetables, fresh fruit, and dried nuts.
Nonfood inflation notably slowed to 4.8% in December from 7.4% in December 2012, reflecting a sharp drop in prices for real estate and rental houses and in restaurant and hotel services as demand softened from foreigners and Afghans alike. Inflation averaged 7.4% in 2013.

The budget came under enormous pressure in 2013 as revenues fell short of their targets and public expenditures rose, especially those related to security and the election in April 2014. Customs revenues notably disappointed because of the economic slowdown and the weak administration of customs and tax collections. The government managed to collect $2.0 billion toward its $2.1 billion target. This deepened the shortfall in domestic financing of the recurrent budget to a deficit of 7.7% of GDP from 6.8% in 2012 (Figure 3.14.3). In 2013, international development partners financed 60% of the national budget, 45% of recurrent expenditure, and 77% of the development budget. Including support from development partners, the budget surplus increased to 2.1% of GDP, from 1.1% in 2012.

Monetary policy aims for price stability and was relatively tight in 2013. Broad money (M2) growth edged up to 9.3% from 8.9% in 2012. However, it remained well below the 20%–30% rate of expansion in the fast-growth era before 2012. The slow growth in money supply since 2012 is attributed to significantly slowing demand for local currency in anticipation of the transition, as dollarization further increased. The value of the afghani has trended downward since 2011, and the currency depreciated by 9.1% against the dollar in 2013 to AF57.2 (Figure 3.14.4). The nascent financial sector has yet to shake negative spillover from the Kabul Bank crisis in 2010, and subsequent growth in banks’ net credit to the private sector has been slight.

The current account deficit excluding grants narrowed slightly to 41.6% of GDP in 2013 from 41.9% a year earlier (Figure 3.14.5). Import growth slowed in 2013, and deficits in the income and services accounts increased modestly. The current account surplus including grants declined to 2.5% of GDP from 3.9% in FY2012 on lower net foreign earnings.

Economic prospects

GDP is forecast to grow by 3.5% in 2014. This assumes subsiding political and security uncertainties, a smooth transfer of power to a new government following broadly accepted presidential and provincial council elections on 5 April 2014, and a signed Bilateral Security Agreement. Growth in agriculture is expected to be modest because current production is close to capacity. Expansion in industry and services should edge higher in the second half of the year as the policy direction of the new government becomes apparent and public confidence strengthens.

For 2015, GDP growth is estimated to accelerate to 4.5%, driven by higher consumer spending, private investment, and trend performance in agriculture. This post-transition outlook for growth rests on stable political and security conditions and high investor and consumer confidence.
A large 27.6% increase in national budget spending is planned for 2014, mostly for security—the item that will consume 65% of budgeted recurrent expenditures and 44% of the total budget. Rising security expenditure will create huge pressure to find new funding resources in 2014 and 2015. The new government will need to boost domestic revenues credibly to ensure strong support from development partners.

Inflation is projected at 7.0%, assuming good harvests, stable international commodity prices, and the pursuance of tight monetary policy. The government will keep the existing managed float regime for the exchange rate.

Including grants, the current account balance is forecast to ease to 1.7% of GDP in 2014 and 1.2% in 2015 as foreign aid inflows diminish. Excluding grants, the current account deficit is expected to narrow to 35.5% of GDP in 2015, reflecting reduced expenditures owing to the departure of international security forces in 2014.

### Policy challenge—domestic revenue mobilization

A major policy challenge for the government is to improve its domestic revenue performance. Domestic revenue as a share of GDP is lower in Afghanistan that almost anywhere else in the world. Moreover, it dropped to 9.6% of GDP in 2013 from 11.0% in 2010, falling short of an important reform benchmark in the current International Monetary Fund (IMF) economic program. The government has been struggling to improve revenue performance for the past 2 years. The revenue shortfalls partly reflect the slowdown in economic activity, in particular the shortfall in foreign trade that weakened customs revenues. However, the bulk of revenue is lost to leakage under weak tax administration that allows corruption. The gap between domestic revenues and the government’s recurrent expenditures has consequently widened, with revenue coverage down to 55.0% in 2013 from 72.8% in 2010.

In the forecast period, fiscal policy will be under huge pressure from rising security expenditures, the cost of operating and maintaining assets built by development partners, and the expense of expanding civil service reform, including reform to pensions. As a result, public expenditures will reach 34.5% of GDP in 2014 as domestic revenues are estimated to languish at 10.8%, leaving a financing gap of 23.7% that will need to be filled by development partners.

The weak revenue outlook necessitates concerted efforts on the part of the government to improve revenue collection through reform to tax policy, tax administration, and governance, as well as through other structural reforms in customs taxation under the program. The bills on tax administration and value-added tax pending in the parliament must be approved quickly to ensure that the value-added tax is implemented toward the end of 2014. Governance has to be strengthened and leakage significantly reduced through policy and structural reform to the revenue and customs departments. The approval of the mining bill now before the parliament has to be expedited to secure in the medium term new contributions to revenue from the development of mineral resources.