Afghanistan's Economic Prospects and Challenges[1]

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Afghanistan's GDP growth fell in the 2008/2009 fiscal year (March 21st-March 20th) but is expected to recover. The economy, dependent on agriculture for 30% of its output, grew less in the 2008/2009 fiscal year (from 12% the year before to 3%) due to a severe drought. Since the weather is expected to improve during 2009/2010, so is agricultural output. Agricultural gains are unlikely to be affected by the global downturn, since the sector isn't linked externally, but the global crisis is expected to make output in industry and services decrease by half in 2009/2010. Real GDP growth (excluding the opium sector[2]) is expected to reach 9% in 2008/2009, and is projected to average 8% between 2010/2011 and 2013/2014.

The current account deficit worsened in 2008/2009, and it is expected to remain at risk in 2009/2010. The global downturn will have negative repercussions on Afghan exports, donor funding, and remittances from the Afghan diaspora. In addition, imports[3] are expected to exceed exports in FY 2009/2010. The current account deficit excluding grants it is expected to reach 50.5% of GDP in 2009/2010. Fortunately, Afghanistan is expected to obtain near total debt cancellation, as its main creditors (the U.S., Russia, and Germany), have agreed to debt forgiveness independently of Afghanistan's HIPC completion status.

Conflict is an omnipresent factor. Economic measures, however well-designed, have been hampered by the deterioration of security since 2008. New coalition initiatives have recently been launched to regain control over parts of the country, and the new U.S. administration is weighing its strategic options. Conflict and instability can be expected to continue to negatively affect the economy at least in the short- to medium-term, as they put pressure on government finances (by reducing revenue collection and increasing expenditures on security), discourage investment, and disrupt economic activity.

The 2008/2009 fiscal deficit was higher than expected, due to increased spending and reduced revenue collection. Expenditures were higher due to emergency wheat purchases, the payment of arrears to the ministry of education, and salary increases for the military and police. Revenue collection fell short (although it picked up in January-March 2009) at regional tax collection offices and at customs (due in part to the undervaluation of oil imports), even though there were improvements at large tax collection offices. Although security was a factor,

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[2] Opium production fell by 6% in 2008, due to the drought and to international efforts to combat poppy cultivation. Because of poppy reduction efforts, and since wheat prices are expected to remain high (although decreasing) in 2009/2010, many farmers are expected to switch to wheat production in 2009/2010.

[3] The Aynak Copper Mine will require increasing imports of investment goods starting in 2010/2011.

governance was the main issue. The operating budget deficit (including grants) in 2008/2009 was an estimated 1.1% of GDP.

The fiscal deficit should narrow in the short-term, due to higher expected domestic revenues and grants, and lower spending. The government has taken measures to strengthen governance and collection at customs, has set up a Business Receipts Tax (BRT) on imports, and has begun regularizing the fiscal relations of state companies. These measures should yield increased revenues in FY 2009/2010 and beyond. Although additional spending will be needed in the areas of health, education, and defense, the government has committed to remain within the constraints of its budget. To this end, it has been improving its cash management and expenditure execution to ensure that no arrears are incurred. However, because of the mixed performance in FY 2008/2009, fiscal sustainability is estimated by the IMF to be achieved not earlier than FY 2014/2015.

The government expects domestic revenues and donor grants (as opposed to borrowing) to cover most of its future expenditures. However, donors are expected to scale back their funding in the coming years. In this context, it is all the more crucial that the government achieves a sustainable fiscal balance.

Grants from donors are a significant portion of the government's budget. Although in FY2008/2009 the operating deficit including grants was only 1.1% of GDP, the deficit excluding grants was 5.5% of GDP. In FY 2009/2010 the deficit including grants is anticipated to be balanced, but the budget excluding grants is projected to be in deficit by 4.7%.

External assistance includes substantial multi-sector, multi-donor grants and loans. For example, the $3 billion Afghanistan Reconstruction Trust Fund[4] is a grant estimated at 2.6% of GDP in 2008/2009.. It devotes 75% of its funding to agriculture and rural development, energy, and private sector development. Two large loans from the ADB are the Post-Conflict Multi-Sector Program (to improve governance in the financial, transportation, and energy sectors) and the Emergency Infrastructure Rehabilitation and Reconstruction loan, which focuses on improving infrastructure in Northern Afghanistan. USAID's economic growth spending in Afghanistan amounted to $253 million in 2002-2006 and $68 million in 2007, and aims at increasing investment and creating business opportunities. Finally, the IMF's Poverty Reduction Growth Facility (PRGF) arrangement is a $191.1 million loan from 2006 to March 2009 (extended through March 2010) that aims to support economic growth through fiscal and monetary policy.

Inflation rose in 2008/2009 but has begun to fall. The spike in the price of cereals (due to shortages caused by drought, as well as export restrictions abroad) and fuel prices generated higher inflation in FY 2008/2009, when it is estimated to have reached 27% on average. Due to lower world prices, inflation fell to 9% in February 2009. It is estimated that inflation will average 6% in FY 2009/2010, partly helped by anticipated favorable agricultural output.

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[4] Managed by the World Bank with participation from the Islamic Development Bank, the Asian Development Bank and the UN

The Central Bank intends to keep inflation low. Capital note auctions (a form of Central Bank debt) are and will continue to be the main tool of the central bank to maintain inflation between 5% and 5.5% between 2010/2011 and 2013/2014. Reserve money growth is expected to be halved compared to 2008/2009.

The Afghani appreciated in real terms. Although it depreciated slightly against the US Dollar, it appreciated against other important currencies such as the Pakistani and Indian Rupees. Although good for imports, appreciation of the Afghani poses a risk to the growth of a domestic industrial base that would provide employment and be conducive to long-term development efforts[5]. The Central Bank expects to maintain a floating exchange rate. International reserves have steadily increased, and in 2009/2010 they are expected to cover imports for 11 months.

The banking system has been growing, and vigorous supervision of the banking system will be vital. Assets in the banking system have risen by almost 20% a year, from 6% of GDP in 2004/05 to 20% in 2008/09. So far, the exposure of the financial system to risk and the number of its non-performing loans have been minimal. Recent interventions by the Central Bank, such as tightening reserve requirements, working to eliminate weaknesses in the legal framework, as well as taking steps to increase the supervision and monitoring of commercial banks, have been encouraging.

Public enterprises continue to pose fiscal risks. The inadequacy of financial data on large public enterprises and irregularities in terms of tax payments and other payables have prompted the authorities to initiate financial audits of public companies such as the state airline (Ariana), the state electricity company, Afghan Telecom, and the state fuel company. However, there have been several delays, and completion is not expected until January 2010. Subsequent steps, such as improving governance and regularizing state companies' relations with the government, and eventually restructuring, divesting, or privatizing them, will have to be taken as quickly as possible[6]. An example of the fiscal risks posed by public enterprises is the recent exhaustion mid-way through the year by the state electricity company of its yearly subsidy. This could have had a significant impact on the government's ability to remain on its fiscal program. Although donors stepped in to save the company until the end of the year, the rescue effort diverted much needed funds from development efforts.

Privatization efforts have not met expectations. So far, there has been little political will to move forward with preparing for and implementing the reforms.. Parliament recently amended the State-Owned Enterprise Law to control interventions connected to state-owned enterprises. However, Parliament subsequently rejected the liquidation of a small state-owned bank under the amended law.

[5] Currently, Afghan industries consist of small-scale production of textiles, soap, furniture, shoes, fertilizer, and cement; hand-woven carpets; natural gas, coal, and copper. In 2004, industry accounted for 10% of the labor force and in 2008 it accounted for 26% of GDP.

[6] In this respect, legal provisions on parliamentary approval for privatization need to be clarified to avoid even further delays.

Land registration and administration continue to be problematic. During Afghanistan's successive wars, land records and land administration offices were destroyed. As a result, delays in the registration process, inconsistent and unenforceable property rights, as well as competing or conflicting property claims pose serious problems to existing or aspiring businesses. As in the case of privatization, reforms in land administration are proceeding slowly, although donors have provided some assistance[7].

The government has expressed commitment to increasing trade but much remains to be done. In December 2004, Afghanistan's accession (to the WTO) working party was established, and a Memorandum on the Foreign Trade Regime was circulated in April 2009. However, the working party has not met yet. Much depends on the implementation of reforms by the government. Afghanistan has also had a Trade and Investment Framework Agreement[8] (TIFA) with the United States since 2004 and the establishment of Reconstruction Opportunity Zones (ROZ)[9] is also under consideration. However, problems remain due to the lack of information and understanding of the requirements and benefits of the various trade agreements on the part of the legislative and the government, hindering their implementation and effectiveness.

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[7] See, for example, USAID's Land Titling and Economic Restructuring in Afghanistan (LTERA) project at http://www.ltera.org/index.php

[8] TIFAs "provide strategic frameworks and principles for dialogue on trade and investment issues between the United States and the other parties to the TIFA".

[9] ROZs would allow certain goods from Afghanistan and parts of Pakistan to be imported into the U.S. duty free, and would add to the existing Generalized System of Preferences (GSP). However, ROZs appear to have limited potential for increasing exports from Afghanistan to the U.S.

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