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UPDATE

The Afghan Economy after the Election

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Post-Conflict Reconstruction: the Afghan Economy

The Afghan Economy after the Election[1]

1. Nation Rebuilding in the Aftermath of the Election

Afghanistan's nation rebuilding and reconstruction process has come a long way to the historic direct presidential election this month. An interim administration was installed following the Bonn Agreement in December 2001. The first recurrent (ordinary) budget was announced together with the National Development Framework in April 2002. The Emergency *Loya Jirga* was held in June 2002 followed by the installation of the transitional government led by President Karzai. The new constitution characterized by Islam as the national religion, a centralized power at the presidency, and gender equality in principle, was approved by the "constitutional *Loya Jirga*" and signed into law in January 2004. The first population census was carried out successfully under difficult political and security circumstances and paved the ground for voter registration toward the presidential election that took place on 9 October 2004.

2. Democratic Progress Boosts Economic Prospects

Prior to the election Mr. Karzai took bold steps to remove wartime leaders from government authority, first by dropping Defense Minister Fahim from the vice president candidacy, and then removing Ismail Khan as governor of Herat which triggered some local violence. While the parliamentary elections have had to be postponed till 2005, the first-ever democratic direct elections were met by high voter turnout, particularly among women, and without major disruptions by opposing leaders or the Taliban. While boxes of ballots are being transported (some by pack mules) to counting centers as of this writing, an early indication is that Mr. Karzai is expected to win a majority without the need for a run-off with the likely second-placed candidate, Mr. Qanooni.[2] The election is already seen as having reinforced the legitimacy of the Afghan government and should solidify continued support from the international donor community.

Despite the still uncertain security situation in many parts of the country, the Afghan transitional government has so far demonstrated a strong commitment to an economic system conducive to private-sector-driven growth. The present reconstruction effort is two-pronged: it is focused on rebuilding critical physical infrastructure on the one hand and on the other rebuilding public sector institutions from Soviet style central planning to market-led development. Macroeconomic planning and management at present is still hampered by poor information, weak systems of service delivery, and laws and regulations that need to be revised to fit a market economy. Nevertheless, the authorities, notably the Ministry of Finance and the central bank, have demonstrated a strong ownership in such effort with donor support.

3. Continued Economic Rebound

Starting from the devastated economic base during the conflict years, the Afghan economy has shown an estimated 28.6 percent real growth from FY2001/02 to FY2002/03.[3] Main contributors to the high growth rate included recovered agricultural production after drought years, a construction boom underway in urban areas and increased service establishments driven by the donor community's spending and emergency assistance efforts. The growth rate for FY2003/04 is estimated to be 16 percent.[4] While growth in construction and service sectors continued to be strong, the agricultural sector growth has slowed from the previous year's strong rebound. IMF puts growth projection for FY2004/05 also at 16 percent, implying per capita income of $246, which is still among the lowest in the world.

The state of poverty in Afghanistan is obviously serious but there are no systematic quantitative data based on a rigorously defined poverty line. Indications are that at least more than half of the population would be under the expenditure corresponding to the minimum required food and non-food consumption basket. The National Risk and Vulnerability Survey (NRVA) carried out in 2003 by the Ministry of Rural Rehabilitation and Development, covering 1,850 rural villages and over 11,000 households, estimated rural expenditures at $165 per year per capita.[5]

4. Demonstrated Commitment to Fiscal Discipline[6]

The Afghan government continues to adhere to the "no overdraft rule" (meaning that the government will not borrow from the banking system including commercial banks to finance its expenditure), ensuring that fiscal policy is designed to avoid inflationary financing. The operating budget deficit for FY2003/04 was estimated at $240 million, much lower than the budgeted $350 million, due to the lower-than-projected expenditures. While donor grant disbursements, estimated at $270 million, were also lower than the budgeted amount, they were more than sufficient to finance the budget deficit.

Expenditures in FY2003/04, at about $430 million, were substantially lower than the budgeted $550 million, because budget execution tended to focus on salary payments and was slow in non-salary expenses, notably in education, defense, and national security, reflecting delays in budget allotments and difficulties in procurement. Similar to the pattern in FY2003/04, the government's operating expenditures during the first quarter of FY2004/05 were well below what was expected given a budgeted amount (including external grants) for all of FY2004/05. There may be further payment delays in non-salary expenses. However, there should be a significant pick-up in spending during the remainder of the year as public expenditure management systems and capacity improve. The central bank (Da Afghanistan Bank, or DAB) is working toward improving the payments system, which is an essential element in extending the delivery of government services outside of Kabul.

Domestic revenues in FY2003/04 are expected to have reached $190 million (up from $132 million in 2002/03), meeting the budgetary target. This reflects not only a strong economic growth but also a progress in the transfer of domestic revenue from the provinces to the Treasury single account.[7] These transfers increased from Af0.9 billion in 2002/03 to over Af6.5 billion in 2003/04.

In June 2004, the government adopted a consolidated budget that combines operating and development expenditures that are financed by donors but reported through government systems.[8] This is expected to enhance fiscal coordination and consistency. Donor commitments for 2003/04 covered about 70 percent of the requirements expressed in the National Development Budget. As a result, the government was able to implement high-priority projects in infrastructure, education and other sectors.

5. Need for Continued Revenue Mobilization Effort

The FY2004/05 operating budget provides for a substantial increase in outlays to $609 million (equivalent to 11 percent of GDP). This reflects the substantive needs in education, social protection, security, and capacity building for public services, part of which was carried over from FY2003/04.

Domestic revenue is budgeted to reach $300 million,[9] a 50-percent increase from the previous year, leaving $309 million to be covered by foreign assistance and carry-over from funds in the government's bank balances. Meeting this ambitious target will require full implementation of planned customs and tax reforms, and considerable progress in tax collection, particularly in the provinces. In March 2004, the use of market exchange rates in customs valuation and a new streamlined tariff structure came into effect. A package of new revenue measures was also enacted by early 2004, including a final wage withholding tax on higher-income employees, a streamlined business establishment tax, and a limited range of consumption taxes on services such as telecommunications, air travel, hotels and restaurants. The most immediate concern is that tax holidays and concession arrangements have largely eroded the tax base. The Cabinet has passed a resolution to reexamine existing tax concessions and holidays and redraft legislation to preclude further erosion in the tax base. The government's medium-term objective is to achieve self-sufficiency in the operating budget by 2012.[10]

In the area of fiscal management, major achievements to date include: (a) introduction of a computerized financial management information system for expenditure recording, payment processing, and financial reporting; (b) assignment of fiscal advisors to provincial offices of the Ministry of Finance (MOF); (c) evolution of the budget process from a MOF-led top-down approach to one that is driven by the ministries; and (d) consolidation of government bank accounts to strengthen treasury control over cash flows.[11] However, progress in fiscal management in the provinces is still slow.

6. Monetary Developments under Reasonable Control

The introduction of the new currency in late 2002, which replaced 1000 old Afghani by 1 new Afghani with a superior quality and security feature, was a crucial step in the Afghan government's efforts to establish monetary control. This aimed at eliminating dubious currencies issued by regional leaders. After a dramatic three-month changeover operation ending in early January 2003, Af15.6 billion new Afghanis had been issued, leading to the amount of currency circulation at over Af20 billion. Since the introduction and float of the new currency, DAB has aimed to limit exchange rate volatility and to keep the rate within a range under what might be termed a "lightly managed float". The low degree of financial integration and market development allows DAB to pursue this approach.

After sharp depreciation of the Afghani from Af45-48/$ to Afg70$ in early November 2002, it strengthened and eventually stabilized at about Af46 per U.S. dollar by January 2003. With slight fluctuations, the exchange rate appears to have stabilized around Af48-9 per US$ in FY2003/04. The Afghani has remained strong at the same level through the first quarter of 2004/05, reflecting by now a widespread acceptance of the new currency.

Price data are currently limited to consumer price index (CPI) in Kabul. The index increased by double digits in October-November 2002 mainly due to the depreciation of the afghani after the introduction of the new notes. However, the prices stabilized since. The Kabul CPI has increased by 9 percent in FY2003/04, down from 52 percent in FY2002/03. Inflation has been somewhat higher than expected during the first quarter of FY2004/05, reflecting primarily increases in rents and the prices of other non-tradable goods.[12]

Monetary policy has continued to be prudent, with an increasingly regular regime of foreign exchange auctions to retain control over currency in circulation and ensure low inflation and a relatively stable exchange rate. Currency in circulation is estimated to have grown by 20 percent in 2002/03 and 35 percent in 2003/04, respectively. The rate of monetary expansion varied widely from quarter to quarter, reflecting the volatility of money demand, seasonal factors, and the level of interventions by the central bank. DAB's foreign exchange reserves reached an estimated $773 million at the end of FY2003/04, equivalent to three months of imports which is deemed broadly adequate given the government's commitment to a flexible exchange rate driven by market forces.[13]

7. Large Re-exports and Illicit Trade

Trade statistics have long been unavailable from the Afghan authorities since 1992-93. According to an external ad-hoc survey, Afghanistan's total trade in 2000 was $2.5 billion, comprising about $1.2 billion in imports and about $1.3 billion in exports. Pakistan has been the top trading partner, followed by Iran and other neighboring countries. According to a statement made by the Pakistani foreign minister in July 2004, the official trade between Afghanistan and Pakistan could reach $1 billion in 2004. However, about 90 percent of the estimated total exports could comprise re-exports, implying that indigenous exports falling significantly short of financing imports. Customs data are believed to cover only two-thirds of total imports and only a fraction of exports because of smuggling. The official figures do not include an estimate of opium exports, which was estimated to be in the order of $2.5 billion in 2002/03. When compared with Afghanistan's own non-opium exports, opium exports are the overwhelming source of export revenues generated with domestic resources. According to the statement made by UNODC in June 2004, Afghanistan was responsible for three-quarters of the world's illegal opium supply and for a 5 percent increase in the world supply and its production is expected to increase toward 2005.

Non-opium exports consist primarily of carpets, dried fruits, nuts, sheepskins and precious stones while its imports, excluding those for re-export, consist mainly of food items, fuel, transport and agricultural equipment. The re-exports consist of electronics, cosmetics, toiletries, crockery, auto parts, etc. Most of the re-exported goods find their way to Pakistan. It is likely that the opening up of the economy will cause imports to increase more rapidly in the short run.

8. Current Account Deficit Financed by Donor Money

The composition of the balance of payments and its changes under the current situation in Afghanistan reflect largely donor-financed reconstruction efforts and the revival of private sector activities. A presumably large current account deficit (before external grants) is currently funded mainly by official transfers. The bulk of service receipts and payments reflect activities by external actors. These include donor payments of local staff salaries as well as expatriate accommodation and restaurant expenses, and also visitor travel and the local staff cost of international forces present in Afghanistan and their local expenditures. Current transfers (inflow) in the balance of payments are mainly official donor grants to fund the budget and national development plan.

Reliable balance of payments data have not been available reflecting the poor condition of the statistical reporting system, although efforts to build statistical capacity in this area are underway with donor assistance. Best available information suggests that the formal balance of payments was in small surplus in 2002/03, and also in 2003/04. The current account appears to have deteriorated in 2003/04 due to increased imports associated with reconstruction activities. This deficit, equivalent to about 3.4 percent of GDP, was funded mainly by official transfers, some private capital flows, and modest levels of highly concessional borrowing from the Asian Development Bank and the World Bank.[14]

Excluding the uncertain amount of re-exports and smuggling, the government projects domestic exports and imports in 2004/05 at $190 million and $740 million, respectively, leading to a current account deficit of about 5 percent of GDP. This is again expected to be covered by donor assistance and some private capital flows.[15]

As loan assistance even on very concessional basis from multilateral lenders resumes and possibly followed by bilateral lenders later, external liabilities must be tracked carefully to maintain debt sustainability. The government established a debt management unit within the MOF, which is currently engaged in identifying and reconciling outstanding obligations to bilateral creditors. The outstanding debt to Russia appears to be by far the dominant but the most controversial in terms of future negotiation.

9. Need to Rebuild the Financial Sector

Many steps must be taken before a satisfactory financial infrastructure emerges and private sector led growth becomes sustainable. DAB's role must be properly redefined and its regulatory function strengthened. None of the existing banks has been operational. At least prior to the influx of new aid money beginning in 2002, much of the economy still depended on the traditional *hawala* system for money transfer, and the informal credit market met the demand for liquidity, The capital market is undeveloped and modern savings and investment instruments are almost nonexistent.

The new Central Bank Act ratified in September 2003 includes provisions that give DAB full autonomy in monetary and foreign exchange policy. The new Banking Law, also ratified in September 2003, includes the standard rules of a modern banking system. For the first time in the country's history, DAB is being disengaged from commercial banking and focusing on its central banking role. Reorganization of DAB will be accelerated in line with international practices for two-tier banking systems, including its own capacity building of supervising commercial banks. Five new commercial banks[16] have received operating licenses from DAB, among which the Afghanistan International Bank, a consortium of investors including ADB with technical assistance from ING Group, established its head office in Kabul in April 2004 and plans to open 7 branch offices in due time. Among the six state-owned banks, those that did not re-apply for a license by 15 March 2004 would cease operations and their resolution initiated. For those that reapplied for licenses, DAB would assess their applications and make a decision about approval. These developments set an important milestone for modernizing the financial sector. In addition, the government is committed to enact anti-money laundering legislation in 2004 with assistance from the IMF.[17]

10. Need to Rationalize and Reconstruct Public Administration

It is widely recognized both within the government and by the donor community that the current structure of public administration, including the large number of ministries relative to country size, and the quality of civil service leaves much to be reformed before they can start to function properly. An important step in the modernization of the civil service was the establishment of the Independent Administrative Reform and Civil Service Commission (IARCSC) in June 2002. The government presented in the 2003/04 National Development Budget a detailed short-term strategy for public administration and civil service reform.

The 2002/03-budget decree imposed headcount ceilings for each ministry's civil service staff, while the compensation due to SOE employees was removed from the budgeted wage appropriations. On the other hand, the government adopted in July 2003 a decree introducing an interim additional salary allowance for key civil service personnel. This was developed into a Priority Reform and Restructuring (PRR) program, which enables government departments to transfer/appoint key staff in reformed units to higher salary scales. By the end of FY2003/04, 36 departments had been granted PRR status and about 3,000 civil servants were transferred to the PRR scales. For FY2004/05, a more ambitious target of 30,000 civil servants has been set, of which 20 percent will be at the provincial level. This PRR scheme was followed in December 2003 by a proportional increase in the base salary of civil servants excluding military, police and teachers who had previously received a separate pay increase. This increase ranged from 13 percent for the lowest grade to 130 percent for the highest grade, with an overall average increase of about 25 percent.[18] On the other hand, efforts are being made to eliminate "ghost" workers from public payrolls.

11. Need to Create Market-Enabling Environment

Sound private sector environment is crucial to a market-led economy. In August 2002 the government replaced a 1987 law on private investment which had a negative impact on foreign direct investment. The new law provides 3-7 year tax holidays to eligible companies, according to the type of investments, as well as a 4-year exemption from export tariffs and duties. Under the law, a High Commission on Investment, chaired by the Minister of Commerce and comprising the ministers of finance, justice, foreign affairs, planning and reconstruction and two private sector representatives, is responsible for all policy decisions regarding domestic and foreign investment. The Office of Private Investment (OPI) established within the Ministry of Commerce determines which investments qualify for tax holidays.

However, most investments to date have been in the hotel, restaurant, and telecommunications businesses that are induced by donor activities. There is a plan by a consortium of Afghan-American and Turkish investors to build a Hyatt Regency hotel. Outside these areas, a US-based trading company is recently finding some success in marketing Afghan craftworks to a global market with the help of the Internet and has opened a warehouse in Kabul.[19]

Rationalization of SOEs is also a critical element of Afghanistan's transition to a market-led economy. Preliminary data suggest that, from the 174 public enterprises which operated under the communist regime, only 80 survived, accounting for a total of somewhat more than 35,000 employees. A Commission for the Evaluation of State-Owned Enterprises was established in June 2002 and started operating in January 2003. Its main activities include the assessment of SOE operations and assets, preparing recommendations for possible liquidation or privatization, and drafting of transparent procedures. However, the reform in this area has so far been limited to establishing a census of SOEs. Audits of the SOE assets are facing difficulties with finding proper records.

12. Need for Reintegration in the Short Run and Human Capital Building in the Long Run

The difficulty of prescribing human resource development in Afghanistan starts with the uncertain estimate of the population, which could range anywhere between 22 to 27 million, including returned refugees, nomads and internally displaced persons (IDPs). The difficulty is exacerbated by the high pace of refugees returning from neighboring countries. According to UNHCR, more than 2 million Afghan refugees have repatriated from Pakistan, about 900,000 from Iran, and furthermore, about 443,000 IDPs have returned home since early 2002 up to July 2004.

Social indicators for Afghanistan are among the worst in the world. According to the UNICEF's Multi-Indicator Cluster Survey in 2003, covering over 20,000 households, infant mortality and under-five mortality at 115 and 172, respectively, per thousand live births are among the world's highest. Nine out of ten births are not taking place in health facilities. Family planning is largely non-existent. Morbidity rates are extremely high at 30 percent. Illiteracy is also extremely high at 57 percent for men and 86 percent for women above 15 years of age. By all indications the current population growth rate is well above 2 percent per year.[20]

The economically active population in 2002 was about 11 million. While there are no official unemployment rate estimates,[21] it is evident that youth unemployment rates are high. The number of unemployed or underemployed should be rising with the recent inflow of young returning refugees. While there is an acute need to create immediate employment opportunities especially for young ex-combatants in order to avoid their re-militarization and to reintegrate them into productive activities, human resource potential of the whole population must be raised over the long run through investments in human capital.

13. Rising Concern for the Drug Economy

Afghanistan's official GDP figures do not include what is now widely recognized as a large illegal economy associated with opium production. According to the United Nations Office on Drugs and Crime (UNODC), Afghanistan's opium production is estimated to be equivalent to 40 percent of formal GDP.[22] Many Afghan farmers have been driven into poppy production due to poverty and lack of alternative livelihoods. As many as 1.5-2 million people may be involved in opium production. In some parts of the country with concentrated poppy cultivation, wage rates of as high as $11-12 per day have been reported, five times the market wage rate for rural unskilled labor. In addition to the overwhelming economic incentive for farmers, the phenomenal rise of the opium economy can also be attributed to comparative advantage in terms of easiness to transport and well-organized markets from farm gate to the border and beyond.[23]

The Afghan government considers poppy cultivation and heroin production to be one of the most serious obstacles to developing Afghanistan into a stable democracy. It established an Anti-Narcotics Directorate and adopted a National Drug Control Strategy that includes stronger law enforcement and development of alternative livelihoods, and aims to reduce opium production 70 percent by 2008, and eliminate it altogether within 10 years.[24] Resolution of this issue obviously requires intense international cooperation as well as the government's own efforts.

14. Medium-Term Economic Prospect after the Election

There has been strong economic growth in the short run after the end of the conflict years, induced mainly by economic activities associated with donor-supported relief and reconstruction activities. However, it is very difficult at this stage to predict with any degree of confidence how the economic picture looks in the medium run, especially given the uncertainties over many non-economic factors such as security, institutional capacity and overall governance of the central and local authorities. Particularly important would be the future prospect of security improvement throughout the country, which remains to unfold over the course of the national elections up to 2005.[25] Medium-term economic projection requires simulations under scenarios with varied assumptions on key parameters. While only indicative, assuming an improvement in security and continued sound economic management, a strong growth scenario would translate into the GDP growth rates of about 10 percent annually in 2006—2010. Exports would grow gradually toward 14 percent of GDP by 2010. Government revenue would grow gradually from 3.3 percent of GDP in 2002 and 4.1 percent in 2003 to about 11 percent by 2010. A moderate growth scenario would translate into the GDP growth rates of 6-7 percent annually in 2006-10. Exports would grow gradually toward 12 percent of GDP in 2010. Government revenue would grow gradually to about 7 percent of GDP by 2010.[26]

The government's own macroeconomic targets aim to achieve real GDP growth (excluding opium production, of course) of 15 percent in FY2004/05 and 11 percent annually during 2005/06-2007/08,[27] based on continued foreign assistance, improvement in business environment, and adequate security. Growth is expected to be driven mainly by diversification in agriculture, new initiatives in private sector manufacturing, and continued expansion of the services sector. To meet these objectives, the overall investment rate is envisaged to stabilize at about 22 percent of GDP during the same period. The average annual inflation rate is envisaged to be contained at 5 percent.[28]

Endnotes

[1] This is a brief update of the executive summary to the previous ADBI monograph entitled *Post-conflict Reconstruction: the Afghan Economy* (March 2004, ISBN 4-89974-003-4), mainly relying on publicly available information on latest developments. Views expressed are those of Manabu Fujimura, Associate Professor at Aoyama Gakuin University and sometime Visiting Fellow at ADBI, Tokyo and do not necessarily reflect those of ADB or ADBI.

[2] There were many challenges involved in the conduct of the elections. For example, the people had to cast votes among 16 presidential candidates (2 candidates withdrew two days before the elections) in some 25,000 polling stations across a country with geographical difficulty, uncertain security and inexperience with voting. In addition to about 10 million voters that are reportedly subject to multiple registering in some regions and under-registration in others, some 1.5 million refugees in Pakistan and 800,000 in Iran were expected to vote. Although the opposing candidates, including Mr. Qanooni, quickly announced a boycott based on concerns that the ink used to mark voters' thumbs to prevent multiple voting was easily washed off, they later dropped their opposition to the vote after discussions with UN representatives in Kabul. While political dealings with wartime and opposition leaders will recur to some extent in forming the new cabinet, the peak of the threat to the first democratic exercise seems over. International monitors have pronounced the election to be fairly democratic.

[3] The Afghan fiscal year starts in the last third of every March.

[4] IMF, August 2004, "Islamic State of Afghanistan: Concluding Statement of the First Quarterly Review under the Staff-Monitored Program".

[5] This survey was carried out without the benefit of a comprehensive population census at that time and therefore was subject to incomplete sampling.

[6] This section relies mainly on IMF (August 2004) and IMF (March 2004) "Islamic State of Afghanistan: Staff-Monitored Program".

[7] In August 2003 the Ministry of Finance (MOF) instructed DAB to close all the provinces' accounts and transfer their balances into two new accounts, one for expenditures and one for revenues so that provinces will no longer be authorized to draw on their revenue account to spend without explicit authorization from the MOF.

[8] Development projects funded through non-treasury channels are still difficult to consolidate due to multiple sources of funds and diverse transactions often dictated by donor procedures. Due to this problem, the Afghan government encourages donors to expand their assistance through the Afghan Reconstruction Trust Fund (ARFT), which has a unified management and approval process for spending.

[9] The target for domestic revenue for 2004/05 in the IMF-monitored program is more conservative at $256 million.

[10] IMF (March 2004).

[11] Islamic State of Afghanistan, March 2004, "Memorandum of Economic and Financial Policies," submitted to IMF.

[12] IMF (August 2004).

[13] IMF (March 2004).

[14] IMF (March 2004).

[15] Islamic State of Afghanistan (March 2004).

[16] Standard Chartered, National Bank of Pakistan, Afghanistan International Bank, First Microfinance Bank, and Habib Bank.

[17] Islamic State of Afghanistan (March 2004).

[18] Previously, civil servants' monthly salary was reportedly about $50 on average.

[19] BBC news, 13 July 2004.

[20] World Bank, September 2004, "Afghanistan: State Building, Sustaining Growth, and Reducing Poverty: A Country Economic Report", Poverty Reduction and Economic Management Sector Unit, South Asia Region.

[21] According to the NRVA (2003) mentioned earlier, the unemployment rate for household heads is estimated at 18%, implying that overall unemployment rate for the labor force could be a few times higher.

[22] UNODC, October 2003, "Afghanistan, Opium Survey 2003".

[23] World Bank (September 2004) analyzes the drug economy issue at some length.

[24] Islamic State of Afghanistan (March 2004).

[25] Despite the presence of some 26,000-strong US and NATO-led international forces, worrying symptoms include slow disarmament of local militias, continuing Taliban insurgency, and recurring attempts on President Karzai's life such as the ground assault in September 2002 and the rocket attack in September 2004.

[26] Due to the still tentative nature of many macroeconomic indicators, the figures and underlying assumptions used here remain the same as in the March ADBI monograph. The issue of statistical capacity in Afghanistan was discussed in detail in the previous ADBI monograph and also in World Bank (September 2004).

[27] These targets are in line with the March 2004 document entitled "Securing Afghanistan's Future", which is a revision of the reconstruction needs assessment of January 2002, prepared with assistance from the World Bank, the Asian Development Bank, and the United Nations.

[28] Islamic State of Afghanistan (March 2004).