Afghanistan

Growth slowed in 2018, weighed down by a devastating drought, continuing security challenges and political uncertainty, and negative spillover from neighboring economies. Inflation slowed despite currency depreciation throughout 2018. The outlook for growth is only modest improvement in light of continuing security concerns, upcoming elections, and declining foreign assistance. Infrastructure development promises to be the foundation of economic growth and job creation.

Economic performance

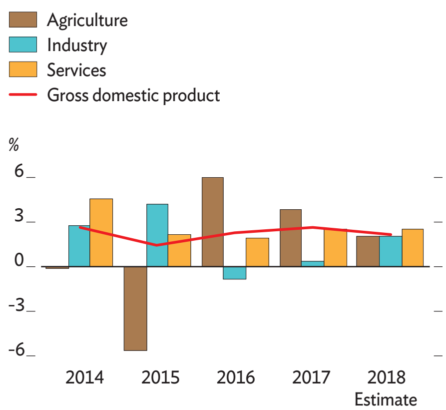
Growth is estimated to have slowed from 2.7% in 2017 to 2.2% in 2018, largely because of a severe drought (Figure 3.14.1). On the supply side, growth in agriculture shrank from 3.8% to 2.0% as drought affected more than half of the country, causing wheat production to fall by 71% in rainfed fields and by 6% in the much smaller irrigated area. Industry picked up to grow by 2.0%, and services expanded by 2.5%, unchanged from the previous year.

According to estimates by the United Nations Office on Drugs and Crime, opium production decreased by 29% to 6,400 tons in 2018 after record-high production the year before, reflecting decreasing yield because of prolonged drought and less area under poppy cultivation due to significantly lower market prices following the glut in 2017. The farm gate value of opium fell by more than half to $604 million in 2018, equal to 3% of Afghanistan's licit GDP.

Public consumption and investment both increased slightly on higher government budget expenditure in 2018. Private consumption is estimated to have contracted as continued drought squeezed rural incomes, while business uncertainty caused private investment to decelerate. Net exports continued to weigh on growth, probably aggravated by the reimposition of international sanctions on neighboring Iran, one of Afghanistan's main trade partners.

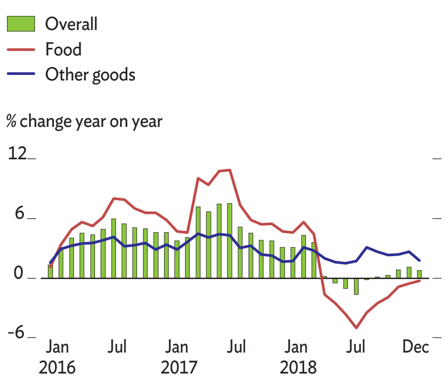
Inflation slowed considerably from 5.0% in 2017 to average 0.6% in 2018 as food inflation fell steeply in the course of the year to average 1.0%, and as food imports outweighed the shortfall in domestic food production (Figure 3.14.2). Nonfood inflation was quite moderate at 2.3%, especially considering large increase in global oil prices during the year and substantial currency depreciation.

3.14.1 GDP growth by sector



Sources: World Development Indicators, World Bank (accessed 22 February 2019); ADB estimates.

3.14.2 Inflation



Source: Central Statistical Office (accessed 12 March 2019).

This chapter was written by Abdul Hares Halimi of the Afghanistan Resident Mission, ADB, Kabul.

Amid regional currency pressures, informal outflows of US dollars to Iran, and global strengthening of the US currency, the afghani depreciated by 8.6% against the US dollar in 2018, reaching a record low in November (Figure 3.14.3). Sharp depreciation that started on 11 September was the result of speculation on the money market that led Da Afghanistan Bank, the central bank, to stabilize the currency by boosting sales of US dollars in the final months of the year by some 30% above sales a year earlier.

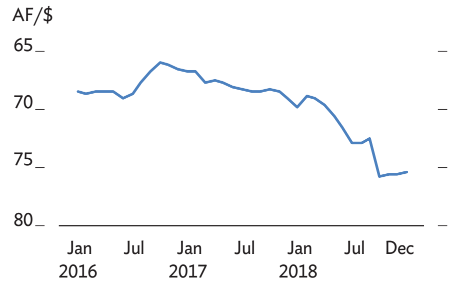
Domestic revenue is estimated to have reached 11.7% of GDP in 2018 thanks to enhanced tax administration and compliance, as well as measures against corruption in the customs department. Foreign aid comprised 56.3% of budget revenue, or 15.1% of GDP, to bring total revenue and grants to the equivalent of 26.4% of GDP. Government expenditure increased to equal 26.8% of GDP, with development expenditure at 7.8% of GDP. The operating budget deficit excluding grants increased to equal 6.1% of GDP because of higher security requirements and spending on pensions and civil service wages. The overall budget balance was estimated to be a deficit equal to 0.4% of GDP. Public debt was up slightly from 7.0% of GDP in 2017, estimated to equal 7.2% of GDP in 2018.

Growth in broad money supply (M2) accelerated from 4.1% in 2017 to 9.0% in 2018 (Figure 3.14.4). Credit to the private sector grew by 3.5% in 2018, but lending risks under the difficult security situation and poor macroeconomic conditions keep outstanding credit to the private sector very low at the equivalent of only 3.5% of GDP. Most transactions are in cash, with currency in circulation amounting to about 17% of GDP. Nonperforming loans declined slightly to 12% of total loans. Dollarization is high, with the share of foreign-denominated loans at about 60%.

The current account surplus including official grants rose from the equivalent of 5.0% of GDP in 2017 to an estimated 5.3% as official grants increased from 38.0% of GDP to an estimated 39.7% (Figure 3.14.5). Excluding grants, the current account deficit widened from 33.0% of GDP in 2017 to 34.5%. The merchandise trade deficit widened from 31.2% of GDP in 2017 to 32.4% as imports increased by 4.3%. Import growth more than offset 11.9% expansion in exports supported by currency depreciation and improved market access to India by air. Merchandise exports remained low at only 4.4% of GDP.

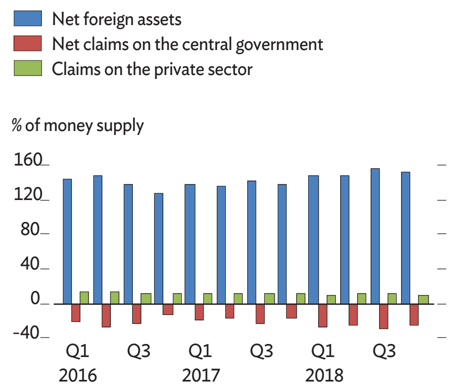
Gross international reserves rose from $8.1 billion in 2017 to $8.3 billion, or cover for 11.2 months of imports, as development partners financed large trade and current account deficits (Figure 3.14.6). The country's weak external position has necessitated government policy that strictly limited external borrowing, with external debt in 2018 estimated at only 6.7% of GDP.

3.14.3 Nominal exchange rate



Source: Da Afghanistan Bank (accessed 22 February 2019).

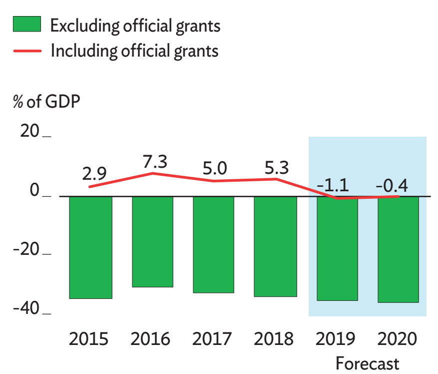
3.14.4 Monetary indicators



Q = quarter.

Source: Haver Analytics (accessed 12 March 2019).

3.14.5 Current account balance



Note: Years are fiscal years ending on 21 December of the same year.

Source: International Monetary Fund *Country Report 18/359*, December 2018.

Economic prospects

GDP growth is expected to recover to 2.5% in 2019 and 3.0% in 2020 (Figure 3.14.7). Political and security uncertainties cloud the outlook, however, as Afghanistan approaches elections in September 2019 for president, provincial councils, and district councils. At the Geneva Ministerial Conference on Afghanistan in November 2018, the international community reaffirmed its commitment to continued collaboration to further Afghanistan's socioeconomic development.

Agriculture is expected to pick up with better weather, fostering in turn expansion in industry and services. The International Monetary Fund agreed to renew its Extended Credit Facility for Afghanistan until 31 December 2019, and the consequent implementation of additional reform should support economic activity. Business confidence stands to improve if peace talks begun in late 2018 between the US and the Taliban prove to be productive. Public investment will become more challenging as inflows from development partners trend downward. New air corridors to the People's Republic China and India—and the Lapis Lazuli route to Europe inaugurated on 13 December 2018—promise to boost exports and improve the trade balance.

Inflation will accelerate to 3.0% in 2019 and 4.5% in 2020 with the lagged impact of 2018 currency depreciation and further depreciation expected in 2019 and 2020 as inflows of assistance slow. However, food prices are expected to remain low as agriculture recovers.

The 2019 budget presented a medium-term expenditure framework that foresees a less expansionary role for fiscal policy. Domestic revenue is budgeted to increase to the equivalent of 12.0% of GDP in 2019 and 12.3% in 2020. Grants are projected to fall to 51.4% of budget revenue in 2019 and 45.5% in 2020. Expenditure is budgeted to fall back to the equivalent of 25.5% of GDP in 2019 and 24.7% in 2020—considered necessary even though it will entail budget deficits equal to 0.6% of GDP in 2019 and 1.5% in 2020. In this scenario, the policy response to achieve fiscal sustainability requires an intense focus on reform to tax policy and administration and more efficient allocation of financial resources.

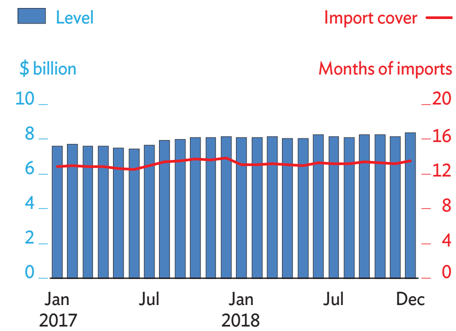
The current account balance including grants is expected to move into deficit equal to 1.1% of GDP in 2019 with an anticipated decline in grants. The deficit is forecast to narrow to 0.4% of GDP in 2020 as exports benefit from various trade connectivity initiatives.

3.14.1 Selected economic indicators (%)

	2019	2020
GDP growth	2.5	3.0
Inflation	3.0	4.5
Current account balance (share of GDP)	–1.1	–0.4

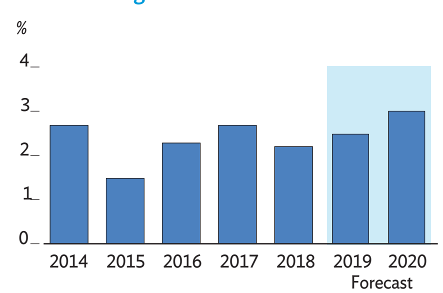
Source: ADB estimates.

3.14.6 International reserves



Sources: International Financial Statistics, IMF; Da Afghanistan Bank (both accessed 12 March 2019).

3.14.7 GDP growth



Sources: World Development Indicators, World Bank (accessed 22 February 2019); ADB estimates.

Policy challenge—accelerating infrastructure development

Afghanistan's growth prospects continue to be constrained by a number of factors beyond security, such as poor connectivity, poor access to limited energy supply, low agricultural productivity, and heavy reliance on overseas development partners. Better infrastructure can strengthen economic growth, enlist improved mobility to energize commerce and agriculture, and thereby boost government revenue available for development spending. Addressing infrastructure gaps can improve opportunities for trade as well and enhance regional economic cooperation and integration, the better to realize Afghanistan's potential as a transit hub connecting Central Asia with South Asia and beyond.

Despite some improvements to infrastructure, Afghanistan endures a severe infrastructure deficit, with disparity between urban and rural areas particularly high. According to the Afghanistan Living Conditions Survey, conducted in 2016 and 2017, only 36% of the population has access to safe drinking water nationally, including 75% of urban households but only 25% of rural households. Only 31% of the population is connected to the electric grid, the primary source of electrical power in urban areas with penetration at 92%, but reaching only 13% in rural areas. Only 63% of the rural population lives within 2 kilometers of an all-season road, and road density is estimated at a low 15 kilometers per 100 square kilometers of territory, below densities achieved by Afghanistan's neighbors. Further, the quality of infrastructure is generally poor. According to the World Bank's Logistics Performance Index, Afghanistan has consistently ranked in the bottom quintile for the quality of its infrastructure for trade and transport.

Regulatory and administrative reforms have attempted to provide a safer and more enabling environment for infrastructure investment. The government should accelerate its implementation of ongoing construction projects and upgrade its capacity to design, implement, and monitor investment projects. Moreover, the government should address skills shortages and stimulate private sector investment in infrastructure development.

Finally, the government should seek sustainable infrastructure financing and look at innovative approaches to increase access to funding. Financing needed for the National Infrastructure Plan, 2017–2021 of about $1 billion annually exceeds available resources from development partners, and domestic fiscal resources for new investment are limited. High security costs greatly add to project costs. Debt-financed infrastructure investment carries risks and would require adequate monitoring and macroeconomic management. Attracting private capital for infrastructure requires further efforts to create an enabling legal and institutional environment. Addressing fiscal risks is necessary to develop a strong public–private partnership framework. Finally, closing the infrastructure gap should be pursued in tandem with developing strong institutions and an agenda for regional cooperation.