
Country Report

Afghanistan

3rd Quarter 2013

Economist Intelligence Unit
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United Kingdom

The Economist Intelligence Unit

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ISSN 2047-4199

Symbols for tables

"0 or 0.0" means nil or negligible; "n/a" means not available; "-" means not applicable

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Summary

Editor: **Sujatha Santhanakrishnan**

Forecast Closing Date: **August 12, 2013**

Outlook for 2013-14

- Political stability in Afghanistan will remain poor, with an ongoing campaign of insurgency by various groups.
- The uncertainty engendered by the impending withdrawal of international forces in 2013-14 means that the likelihood of fragmentation of the state and continued conflict in Afghanistan remains high.
- The president, Hamid Karzai, will seek to strengthen his grip on power. His term of office is due to expire in 2014. The ability of the Afghan political system to manage a transfer of power has yet to be proved.
- Responsibility for security will start to be transferred to local forces in mid-2013 as international forces begin to withdraw from combat roles.
- Economic development will remain the focus of both policymaking and aid efforts. Donors will continue to emphasise the provision of basic services, such as electricity and education.
- Increasing fiscal revenue is an urgent priority, given that government spending is equivalent to slightly over 20% of GDP and that foreign donors are likely to wind down budgetary support in the coming years.

Review

- In late July Mr Karzai signed into law two key pieces of legislation governing Afghanistan's electoral processes, setting the stage for presidential and provincial council polls to take place in April 2014.
- In mid-June Mr Karzai announced the formal transfer of responsibility for security for all remaining Afghan districts around the country from international troops to local control.
- A twice-yearly progress report by the US Department of Defence, released in July, concluded that the transfer of responsibility for security was on track, but noted the need for continued international assistance beyond 2014.
- A UN study found that civilian deaths in the first six months of 2013 were 14% higher year on year, reversing a decline seen in 2012.
- In mid-July media reports in the US indicated that the American president, Barack Obama, was considering speeding up the withdrawal of combat troops from Afghanistan and leaving no soldiers on the ground after 2014.

Basic data

Land area

652,100 sq km (World Bank, World Development Indicators Database)

Population

29.8m (IMF 2012 estimate)

Main towns

Kabul: 2,536,300: (Central Statistics Organisation, 2006)

Kandahar: 450,300: (Central Statistics Organisation, 2006)

Herat: 349,000 : (Central Statistics Organisation, 2006)

Climate

Continental (wide extremes of temperature)

Weather in Kabul (altitude 1,815 metres)

Hottest month, July, 16-33°C (average daily minimum and maximum); coldest month, January, minus 8-2°C; driest month, September, 1 mm average monthly rainfall; wettest month, April, 102 mm average rainfall

Political structure

Official name

Islamic Republic of Afghanistan

Form of state

Islamic republic

The executive

The president is both head of state and leader of the government. The cabinet is appointed by the president and approved by the lower house of parliament

National legislature

The National Assembly, which comprises a 249-seat lower house, the Wolesi Jirga, and a 102-seat upper house, the Mushrano Jirga

National elections

Hamid Karzai began a second five-year term as president in November 2009 after a disputed election held in August of that year. Elections for the lower house were last held in September 2010. The next presidential and provincial council elections will be held in 2014 and the next legislative elections are due in 2015

National government

The president appoints the government, which reflects Afghanistan's ethnic mix

Main political organisations

A number of factions exist (some dating from the war against the Soviet Union in the 1980s), including the Taliban (Sunni Pashtun); the United National Front, primarily consisting of Jamiat-i-Islami (Tajik), Hezb-i-Wahdat (Shia Hazara), Junbish-i-Milli (Uzbek) and the National Islamic Front; Hizb-e-Haq wa Edalat (Right and Justice Party); Jabha-e Milli-e Afghanistan (National Front of Afghanistan); Hezb-i-Islami (Pashtun); and the National Coalition of Afghanistan

President: Hamid Karzai

First vice-president: Mohammad Qasim Fahim

Second vice-president: Mohammad Karim Khalili

Key ministers

Agriculture: Mohammad Asif Rahimi

Borders & tribal affairs: Azizullah Din Mohammad (acting)

Commerce & industry: Anwar ul-Haq Ahadi

Counter-narcotics: Zarar Ahmad Muqbel

Defence: Bismillah Khan Mohammadi (acting)

Economy & manpower: Abdul Hadi Arghandiwal

Education: Ghulam Farooq Wardag

Energy & water: Ismail Khan

Finance: Omar Zakhilwal

Foreign affairs: Zalmay Rasul

Information & culture: Sayed Makhdum Rahin

Interior: Mushtaba Patang (acting)

Justice: Habibullah Ghaleb

Mines: Wahidullah Sharani

Public health: Suraiya Dalil (acting)

Refugees & repatriation: Jamahir Anwari

Rural rehabilitation & development: Wais Ahmad Barmak

Telecommunications & information technology: Amirzai Sangin (acting)

Transport & aviation: Daoud Ali Najai

Urban development: Hassan Abdulhai

Central bank governor

Nurollah Delawari

Economic structure**Annual indicators**

| | 2008 ^a | 2009 ^a | 2010 ^a | 2011 ^a | 2012 ^a |
|--|-------------------|-------------------|-------------------|-------------------|-------------------|
| GDP at market prices (Af bn) | 711.7 | 784.2 | 984.8 | 1,102.4 | – |
| GDP (US\$ bn) | 14.2 | 15.6 | 21.2 | 23.6 | – |
| Real GDP growth (%) | 3.6 | 21.0 | 8.4 | 7.0 | – |
| Consumer price inflation (av; %) | 30.6 | -8.3 | 0.9 | 10.2 | 7.2 |
| Population (m) | 27.0 | 27.7 | 28.4 | 29.1 | 29.8 ^b |
| Exports of goods fob (US\$ m) | 2,465.0 | 2,517.0 | 2,836.0 | 2,908.0 | – |
| Imports of goods fob (US\$ m) | -8,945.0 | -8,872.0 | -9,139.0 | -9,174.0 | – |
| Current-account balance (US\$ m) | 92.0 | -347.0 | 267.0 | 18.0 | – |
| Foreign-exchange reserves excl gold (US\$ m) | 2,430.8 | 3,501.4 | 4,174.4 | 5,268.3 | 5,982.5 |
| Exchange rate (av) Af:US\$ | 50.25 | 50.33 | 46.45 | 46.75 | 50.92 |

^a Actual. ^b Economist Intelligence Unit estimates.

| Origins of gross domestic product 2011/12 ^a | % of total | Components of gross domestic product 2011/12 ^a | % of total |
|--|------------|---|------------|
| Agriculture | 24.3 | Private consumption | 70.8 |
| Industry | 23.3 | Government consumption | 12.6 |
| Services | 52.5 | Fixed investment | 13.0 |
| | | Exports of goods & services | 6.9 |
| | | Imports of goods & services | 28.5 |
| Principal exports 2011/12 ^a | US\$m | Principal imports 2011/12 ^a | US\$m |
| Carpets | 169 | Petrol & petroleum products | 2,103 |
| Dried fruit | 117 | Household items | 1,235 |
| Fresh fruit | 86 | Machinery & equipment | 961 |
| Medicinal plants | 45 | Food | 865 |
| Skins | 16 | Metals | 597 |
| | | | |
| Main destinations of exports 2012 | % of total | Main origins of imports 2012 | % of total |
| Pakistan | 32.1 | Pakistan | 24.3 |
| India | 26.6 | US | 18.0 |
| US | 6.2 | Russia | 8.7 |
| Tajikistan | 8.4 | India | 5.8 |

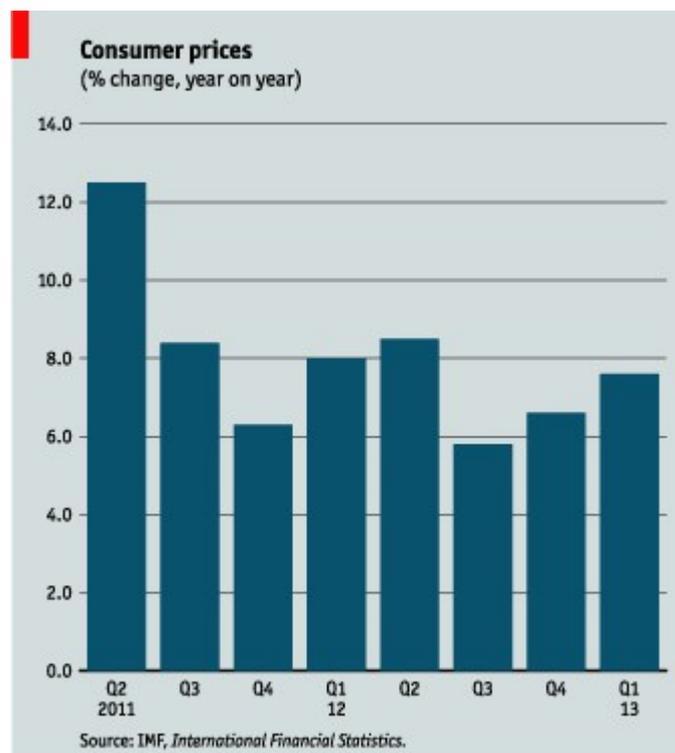
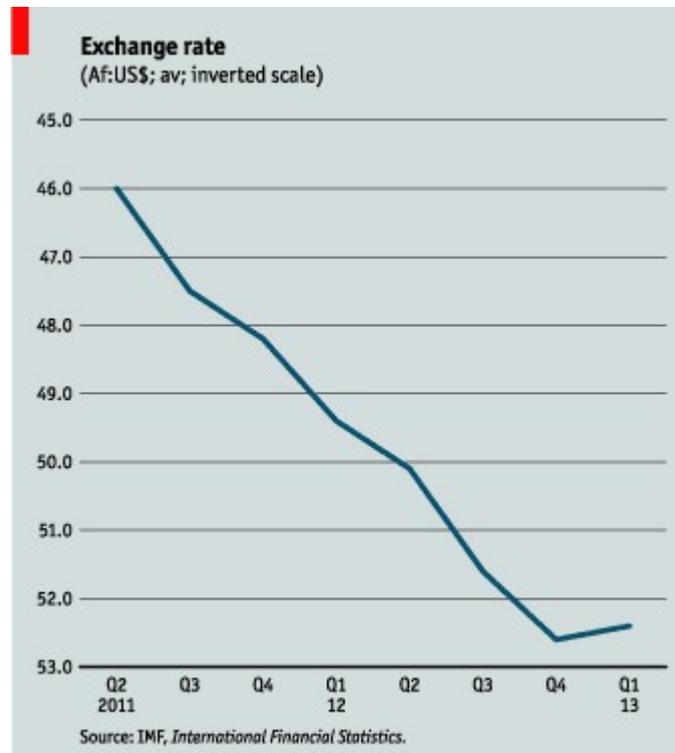
^a Fiscal years March 21st-March 20th.**Quarterly indicators**

| Prices | 2011 | | | 2012 | | | | 2013 |
|--------|-------|-------|-------|-------|-------|-------|-------|-------|
| | 2 Qtr | 3 Qtr | 4 Qtr | 1 Qtr | 2 Qtr | 3 Qtr | 4 Qtr | 1 Qtr |
| | | | | | | | | |

| | | | | | | | | |
|--|-------|-------|-------|-------|-------|-------|-------|-------|
| Consumer prices (av; 2005=100) | 144.0 | 147.2 | 152.2 | 153.9 | 156.2 | 155.8 | 162.3 | 165.6 |
| Consumer prices (% change, year on year) | 12.5 | 8.4 | 6.3 | 8.0 | 8.5 | 5.8 | 6.6 | 7.6 |
| Financial indicators | | | | | | | | |
| Exchange rate Af:US\$ (av) | 46.0 | 47.5 | 48.2 | 49.4 | 50.1 | 51.6 | 52.6 | 52.4 |
| Exchange rate Af:US\$ (end-period) | 46.8 | 48.3 | 49.0 | 49.4 | 51.8 | 52.1 | 52.1 | 53.5 |
| Lending rate (av; %) | 16.5 | 14.1 | 15.0 | 15.0 | 15.0 | n/a | n/a | n/a |
| Foreign reserves (US\$ m) | | | | | | | | |
| Reserves excl gold (end-period) | 4,990 | 5,039 | 5,268 | 5,290 | 5,533 | 5,786 | 5,983 | 5,782 |

Source: IMF, International Financial Statistics.

□



Outlook for 2013-14

Political stability

Political stability in Afghanistan remains poor, with an ongoing campaign of insurgency by various groups. Chief among these is the Taliban, the mainly Pashtun organisation that ruled most of Afghanistan on Islamic-fundamentalist principles between 1995 and 2001. The uncertainty created by the transition of responsibility for security to Afghan forces and the withdrawal of international troops in 2013-14 means that the likelihood of fragmentation of the state and continued internal conflict remains high, despite pledges of support for Afghanistan from foreign governments.

The president, Hamid Karzai, has been reluctant to offer political concessions that might reduce the threat posed to his administration by the Taliban insurgency. The Taliban in turn officially reject the Afghan government as a legitimate partner for negotiations. A US-led effort to negotiate with the Taliban ahead of the withdrawal of international troops has been prone to setbacks since it was mooted at the start of 2012. Both Afghan and US officials have sought the help of the Pakistani government in bringing the Taliban to the negotiating table (various participants in the Afghan insurgency are thought to be based in Pakistan, using that country to stage crossborder attacks against Afghan and international forces). So far these efforts have not yielded much progress. Any sustainable peace deal will require the co-operation of the Afghan administration, insurgent groups and regional governments, as well as international forces. All sides in the conflict are internally divided over the prospect of settlement talks, and are likely to continue to hold off from making concessions until the shock of the withdrawal of international forces compels new alignments of political power in the country.

Mr Karzai continues to seek to strengthen his grip on power. Afghanistan lacks an organised system of political parties, and politics is instead driven by patronage, with Mr Karzai making continuous attempts to balance and co-opt potential rivals and supporters. The president's term is due to expire in 2014, and the ability of the Afghan political system to manage a transfer of leadership is so far unproven. Efforts by Mr Karzai and others to consolidate their power ahead of the 2014 presidential election are likely to exacerbate tensions with groups on the political margins.

The struggle against the Taliban will remain the main priority during the forecast period. The International Security Assistance Force (ISAF), which comprises US and NATO troops, will wind down combat operations by end-2013, with the number of troops expected to halve, from around 100,000 as at mid-2013. In June Mr Karzai announced the formal transfer of responsibility for security to the domestic Afghan National Security Forces (ANSF). Most foreign troops are scheduled to leave the country by end-2014. The continued campaign of insurgency by the Taliban and other groups is indicative of the desire of militants to undermine the government's claims to be in control of the country, and illustrates their ability to do so.

In late 2012, at the request of Afghan officials, Pakistan's government began releasing mid-level Taliban prisoners held in Pakistani prisons. It is hoped that the release of these detainees, many of whom held senior positions in the erstwhile Taliban government in Afghanistan, may impart momentum to peace talks. However, Afghan officials have also raised concerns that those freed may instead join the insurgency. Meanwhile, the Taliban campaign of assaults continues unabated. According to UN investigators, the number of civilian deaths in Afghanistan rose by 14% year on year in January–June, to reach 1,319. The number of injuries in the same period grew by 28% to 2,533. Overall civilian casualties were up by 23% in the first six months of this year, a marked worsening of the situation in Afghanistan; in 2012 the number of civilian casualties in January–June had declined by 12%.

Election watch

The next presidential election is scheduled for April 2014. The final results (following the counting of votes and any run-off polls) will be announced by mid-May 2014. This timescale is designed to ensure that a new president is elected before the planned conclusion of the transfer of security responsibility from NATO forces to the ANSF by the end of that year. The next legislative and provincial council polls are due in 2015. The previous parliamentary election in September 2010 was accompanied by widespread allegations of fraud. The controversy surrounding the poll meant that the new parliament was not formed until January 2011; indeed, disagreements over the election results were only resolved in September 2011 through a deal in which nine members of parliament were replaced.

International relations

Afghanistan's most important international relationships are those with the US and other NATO states participating in ISAF. The US and other donors have repeatedly pledged that they will continue to support Afghanistan beyond 2014. In recent months, however, relations between foreign governments (the US in particular) and Mr Karzai have become increasingly strained. The Afghan president has balked at international diplomatic efforts to negotiate with the Taliban, concerned that his government was being marginalised in the process. Partly owing to these concerns, the Afghan president also recently halted negotiations on a bilateral US-Afghan status-of-forces protocol that would govern American military personnel remaining in the country after the transfer of responsibility for security to local forces. US media reports in July also indicated that the American president, Barack Obama, was mulling speeding up the withdrawal of combat troops and leaving behind no soldiers on the ground after 2014, a so-called "zero option". The Economist Intelligence Unit expects that the zero option is unlikely to become reality, but may induce the Afghan government to restart negotiations on the bilateral agreement.

Other global economic and geopolitical challenges now eclipse Afghanistan's importance for policymakers in the US and its allies, and this has accelerated the process of shifting responsibility for the country's future to its own leaders. International supporters have also expressed impatience with the Afghan government's efforts to curtail corruption and concerns over the pace of administrative preparation for the 2014 presidential election. The withdrawal of international security forces is likely to be accompanied by a reduction in financial assistance to the Afghan government, and, in leaving Afghan troops alone to deal with the Taliban insurgency, would worsen the security situation. Meanwhile, the Taliban are likely merely to wait until US forces have been drawn down and then try to reassert themselves more vigorously.

NATO allies have expressed a commitment to providing around US\$4bn annually to support Afghanistan's armed forces after 2014, in addition to around US\$4bn in non-military assistance annually in 2015-17. However, the details of this assistance remain under negotiation and subject to domestic pressures in many donor countries to reduce their support for the Afghan government. Agreements have yet to be finalised on the size of the Afghan army and police that will be supported over the long term or the number of international forces that will remain in the country after 2014, although recent NATO ministerial summits have suggested that around 8,000-12,000 international troops may remain, at least initially.

Afghanistan's relations with Pakistan will continue to be vital in a number of areas, including trade and security. However, the Pakistani government's capacity to enforce its rule in tribal areas bordering Afghanistan remains limited. Bilateral relations have soured in the past two years, as groups based in Pakistan or elements of its government have been blamed for several high-profile attacks in Afghanistan, including one on the US embassy and the NATO headquarters in Kabul in September 2011 and a series of large, coordinated attacks in the capital and three other eastern provinces in April 2012.

As one of the staunchest supporters of Mr Karzai's government and of the US's presence in Afghanistan, the Indian government is seeking both to advance its security interests (via the crackdown on terrorist safe havens) and to boost access to Central Asia's vast, largely untapped energy resources. Indian firms have been at the forefront in deals to develop Afghanistan's enormous potential mineral wealth—estimated to be worth US\$1trn, according to the US Geological Survey. Moreover, India has provided over US\$2bn towards building highways, hospitals, schools and rural electricity projects in Afghanistan over the past decade. However, the Pakistani administration, and especially that country's powerful military establishment, takes a dim view of the Indian government's ambitions. (Following the ouster of the Taliban in 2001, the Pakistani government—whose influence was closely tied to the group—found its role somewhat marginalised).

Policy trends

The Afghan government and the international donors and agencies that provide it with financial and security support will focus on economic development in 2013-14. Recent meetings between Afghanistan and its donors have emphasised the provision of basic services, such as electricity and education. There is likely to be growing emphasis on the need to move the public finances on to a more sustainable path. The government continues to make slow but measurable progress in economic reform. Land registration (a major impediment to business, owing to delays and competing claims) and privatisation efforts are also likely to see only gradual progress. In addition to these longer-term problems, the Afghan administration faces a formidable list of policy challenges in the next two years. According to the IMF, these include containing inflation, improving the efficiency of public spending, reducing corruption, addressing capacity constraints, strengthening the business environment and cutting unemployment.

The weakness of Afghanistan's banking sector was highlighted by the failure of Kabul Bank in 2010, when it was discovered that around US\$935m-worth of the institution's assets had been expropriated by shareholders. Only US\$128m of assets had been recovered by mid-2012, according to the IMF. In March 2013 the two main accused in the case received the relatively light sentences of five years in jail, raising concerns that the government is not doing enough to combat corruption. Addressing graft will remain a priority for donors in 2013-14.

Fiscal policy

In 2012 Afghanistan changed its fiscal year from the solar calendar (which typically ran from March 21st to March 20th) to a period that will end on December 20th in most years (the variation is due to the differences between months in the Gregorian and solar calendars). This will align the country's fiscal year more closely with the calendar year. Revenue collection has improved modestly in recent years. The IMF estimates domestic revenue collection as a proportion of GDP at 17.3% in 2011, up from 16.3% in 2010. The rise was aided by the improving ability of the Customs Department to charge tax on fuel imports, and also by amendments to the income tax law. The introduction of a business tax on imports in 2009 provided a further boost. The IMF expects tax revenue to increase as a result of the introduction of a value-added tax in 2014.

Despite the recent improvements, increasing revenue further remains an urgent priority, given that government spending is equivalent to around 18% of GDP and that foreign donors are likely to wind down budgetary support in the coming years. At the Tokyo conference in July 2012 international donors pledged around US\$16bn over the next four years for economic development under the Tokyo Framework of Mutual Accountability. This aid is separate from the annual amount of around US\$4bn that Afghanistan will receive for its armed forces.

Despite the pledges of aid, concerns persist over whether funds will actually be disbursed and whether the government will have the capacity to use the money effectively. According to a non-governmental organisation, Global Humanitarian Assistance, in 2002-09 around US\$26.7bn of aid was disbursed to Afghanistan, amounting to only 43% of the US\$62bn pledged by international donors for 2002-13.

Monetary policy

The Afghan authorities will have only limited influence over monetary policy in 2013-14, owing to the undeveloped nature of the country's financial system. Da Afghanistan Bank (the central bank) will continue to undergo reform in the next few years as it withdraws from commercial banking (its takeover of Kabul Bank in 2010 notwithstanding). During a visit in February 2013, IMF officials said that they had come to an agreement with Afghan officials that monetary policy would be tightened to maintain price stability and protect Afghanistan's foreign-exchange reserves.

International assumptions

International assumptions summary

(% unless otherwise indicated)

| | 2011 | 2012 | 2013 | 2014 |
|---|--------|--------|--------|--------|
| GDP growth | | | | |
| World | 3.8 | 2.9 | 3.0 | 3.6 |
| US | 1.8 | 2.2 | 2.0 | 2.5 |
| China | 9.3 | 7.8 | 7.5 | 7.4 |
| EU28 | 1.6 | -0.2 | -0.3 | 0.8 |
| Exchange rates | | | | |
| US\$ effective (2000=100) | 83.3 | 85.8 | 91.8 | 93.5 |
| ¥:US\$ | 79.8 | 79.8 | 98.1 | 102.0 |
| US\$:€ | 1.39 | 1.29 | 1.30 | 1.27 |
| Financial indicators | | | | |
| US\$ 3-month commercial paper rate | 0.20 | 0.20 | 0.10 | 0.20 |
| ¥ 3-month money market rate | 0.20 | 0.20 | 0.20 | 0.20 |
| Commodity prices | | | | |
| Oil (Brent; US\$/b) | 110.9 | 112.0 | 106.5 | 104.8 |
| Gold (US\$/troy oz) | 1570.6 | 1668.5 | 1399.1 | 1331.3 |
| Food, feedstuffs & beverages (% change in US\$ terms) | 30.1 | -3.4 | -6.6 | -4.1 |
| Industrial raw materials (% change in US\$ terms) | 21.7 | -20.3 | -3.2 | 6.0 |

Note. Regional GDP growth rates weighted using purchasing power parity exchange rates.

Economic growth

Real GDP growth in fiscal year 2011/12 (March 21st-March 20th) slowed to 6.9%, from 8.4% in 2010/11. The IMF estimates that growth rebounded sharply in 2012/13, to 10%, owing to a favourable agricultural harvest. The Fund forecasts that real GDP growth will average around 4% a year in 2013/14-2014/15. We believe that economic expansion will be supported by strong investment in construction (much of which will be linked to donor-led development projects) and by private consumption. Improved electricity supplies may also boost industrial growth during 2013-14. A power-transmission link to Uzbekistan has improved electricity supplies in Kabul and the rehabilitation of hydropower projects at Mahipar, near Kabul, and Kajaki, in Helmand province, will further expand generating capacity, provided that rainfall is adequate.

The weather will play the largest role in determining agricultural production. Cultivation of poppies for heroin and opium production is the largest industry in Afghanistan, although it remains illegal. Foreign agencies have led a campaign against poppy cultivation, but such efforts will play a less significant role than prices in determining the mix of crops.

The biggest risk facing the economy in the short term is that falling foreign military spending and aid as a result of the withdrawal of overseas security forces will trigger a rapid slowdown in GDP growth. Afghanistan's nominal GDP in 2011/12 is estimated at around US\$23.6bn, while the World Bank estimates that aid expenditure totalled US\$15.7bn in 2010, meaning that even small reductions in aid spending could have a substantial impact.

Inflation

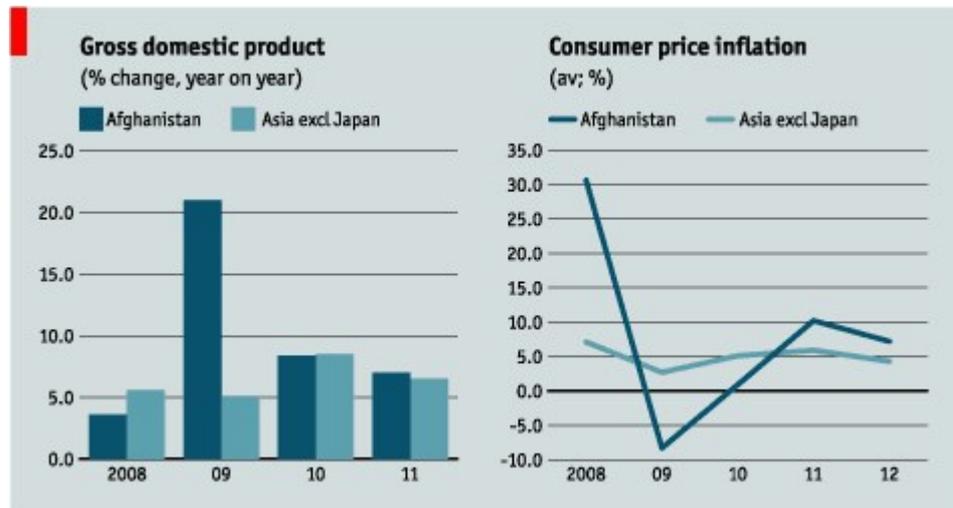
The rate of inflation peaked at 43% year on year in May 2008, according to IMF data, stoked by surging global food and fuel prices. Strong domestic harvests caused prices to drop rapidly in 2009. Prices began to rise again in June 2010, after 14 consecutive months of year-on-year falls. Consumer price inflation averaged 7.2% in 2012, up from 10.2% in the previous year. In 2013-14 falling global prices for commodities and food should reduce inflationary pressures, and so the IMF forecasts that inflation will average 6% in the two-year period.

Exchange rates

The local currency, the afghani, averaged Af50.9:US\$1 in 2012, down from Af46.7:US\$1 in 2011. Since 2001 the local currency has remained broadly stable, appreciating by an average of 0.7% a year against the US dollar.

External sector

Excluding grants, Afghanistan runs a wide current-account deficit, and we forecast that it will continue to do so. The composition of imports will increasingly be dominated by capital goods, many of which will be linked to the development of various extractive projects, including the Aynak copper deposit and the Hajigak iron ore mine, where operations are expected to start within the next decade. Substantially higher exports of minerals are therefore possible in the future but will take many years to be realised. Donor-funded infrastructure projects will also boost imports. The potential for an increase in Afghanistan's traditional exports, such as carpets and dried fruit, is limited, but greater transit trade from Central Asian countries and trade with Iran could provide a boost.



Recent analysis

Generated on October 8th 2013

The following articles were published on our website in the period between our previous forecast and this one, and serve here as a review of the developments that shaped our outlook.

Politics

Forecast updates

April 11, 2013: Political stability

Casualties surge in Afghan war

Event

The UN Assistance Mission in Afghanistan (UNAMA) said in early April that the number of civilian casualties in Afghanistan had increased dramatically in the first quarter of 2013, and called on all parties to refrain from attacking civilians.

Analysis

In a report released in February, UNAMA noted that the number of civilian deaths had fallen by 12% in 2012, to 2,754, from 3,131 in the previous year, marking the first annual decline since 2007. However, in a statement on April 8th the organisation warned that the trend could be reversed in 2013, amid mounting civilian casualties caused by growing violence attributed to both insurgents and foreign troops in Afghanistan.

The warning coincided with one of the bloodiest weeks in the 12-year Afghan conflict. On April 6th a suicide attack in Zabul province claimed six lives, including that of a US diplomat, following which a NATO airstrike on April 8th killed 11 children in eastern Afghanistan. The next day, in Wardak province, a roadside bomb hit a bus, leaving nine people dead and 22 injured.

Civilian casualties caused by NATO airstrikes have long been a major source of tension between the US and Afghan governments. However, according to the UNAMA report, insurgents were responsible for 81% of civilian casualties in 2012, with pro-government forces thought to be responsible for only 8% of deaths. The Taliban, which claimed responsibility for the suicide attack in Zabul, has repeatedly said that civilians working for the government are legitimate targets, despite a warning from the UN that such killings violate international law.

As the insurgents' annual spring offensive gets under way, hostilities are expected to surge in coming months even as foreign forces wind down their combat operations in preparation for the withdrawal of most combat troops by 2014.

Impact on the forecast

The recent surge in civilian casualties reinforces our forecast that achieving peace between the disparate groups in Afghanistan will remain a significant challenge. As a result, political stability will remain poor in the medium term.

April 22, 2013: Political stability

India-China meeting on Afghanistan is held

Event

Indian and Chinese officials met on April 18th in Beijing to discuss Afghanistan. The meeting, which was the first time Afghanistan had featured in Sino-Indian talks, is part of a wider set of ongoing dialogues between Afghanistan's neighbours, who are preparing for a period of heightened political and security uncertainty in 2013–14.

Analysis

The latest dialogue between China and India marks a departure from the past, when the two countries viewed Afghanistan through different prisms. India, along with Russia and Iran, has been a staunch supporter of the current Afghan government, headed by Hamid Karzai, and of the US presence in that country. By contrast, China remains wary of the presence of international troops in Afghanistan and seeks a greater role for regional organisations, including the Shanghai Co-operation Organisation (which comprises China, Kazakhstan, Kyrgyzstan, Russia, Tajikistan and Uzbekistan and deals with security in Eurasia), in addressing issues relating to the country. Despite these differences, both India and China are keen to gain access to Central Asia's vast untapped energy resources, which is predicated on stability in Afghanistan. Chinese and Indian firms have been at the forefront in deals to develop Afghanistan's enormous potential mineral wealth—which is estimated to be worth US\$1trn, according to the US Geological Survey.

With Afghanistan set to experience two crucial transitions in the next year—including the withdrawal of international forces and the transfer of security responsibility to Afghan forces, and the next presidential election—there is growing concern that Islamist militant groups may seek to destabilise the country. This fear is exacerbated by the possible fallout that instability in Afghanistan could have on the Chinese province of Xinjiang and Indian-administered Kashmir—both of which are Muslim-majority regions where separatist tendencies run high.

In recent months there have been a number of meetings between Afghanistan's neighbouring governments, as key regional players bid to enhance their leverage and secure political, economic and strategic concessions post-2014. Despite these regional discussions, we expect that long-standing geopolitical rivalries and the conflicting strategic concerns of individual countries will make reaching a consensus on Afghanistan challenging.

Impact on the forecast

Our forecast that political stability will remain poor—with disparate groups and countries jockeying for greater influence, often with conflicting goals—remains appropriate.

May 13, 2013: Election watch

Deadlock persists over electoral bodies

Event

In early May the president, Hamid Karzai, rejected a draft law governing Afghanistan's two principal electoral bodies, setting up a confrontation with parliament ahead of the 2014 elections.

Analysis

The next presidential election is currently scheduled to take place on April 5th 2014. Under the terms of the Afghan constitution, Mr Karzai is ineligible to seek a third term in office, meaning that the 2014 vote will mark the first transfer of executive power since the ouster of the Taliban regime in 2001.

Previous polls, including the presidential poll in 2009 and parliamentary elections in 2010, were marred by widespread allegations of fraud. Since the last elections, Afghanistan's parliament has taken some tentative steps towards challenging the power of the presidency. In particular, the legislature has sought to strengthen the power enjoyed by the electoral authorities, namely the Independent Election Commission (IEC) and the Electoral Complaints Commission (ECC). (While the IEC is tasked with conducting polls, the ECC has previously served as the arbiter of electoral disputes.)

After the 2010 election, Mr Karzai sought to eliminate the ECC and transfer its powers to the Supreme Court, whose composition he controls. However, in April 2013 both houses of parliament approved a draft law that retained the ECC and also proposed establishing a new committee to manage appointments to both the ECC and the IEC, thereby reducing presidential control over their composition. Mr Karzai objected to these provisions and has refused to sign the draft law as it currently stands.

Impact on the forecast

Mr Karzai's actions underscore our view that the upcoming transfer of leadership in 2014 is likely to prove contentious. Our forecast that political stability will remain poor in our current outlook period (2013–14) remains unchanged.

May 17, 2013: International relations

Border clashes raise tensions

Event

Crossborder clashes between Afghan and Pakistani military forces in early May led to bilateral ties worsening sharply. On May 12th, at least two children were injured and four houses damaged after shelling by Pakistani forces in Afghanistan's Kunar province, in the latest of such incidents.

Analysis

The shelling came days after one Afghan border police guard was killed and two Pakistani troops injured in border violence on May 2nd in the Goshta district of Nangarhar province. Thousands of Afghans participated in angry anti-Pakistan protests in the Afghan capital, Kabul, following the guard's death, highlighting the rise in nationalist sentiment and anti-Pakistan feeling in Afghanistan.

Both clashes occurred along the Durand Line, a de facto border between the two countries drawn by the British in 1893. The Afghan government contests the legality of the border, and has alleged that the Pakistani military, taking advantage of the impending withdrawal of international troops from Afghanistan, is setting up new border posts infringing on Afghan territory. For its part, the Pakistan government considers the Durand Line as a de jure border, and has argued that the checkpoints are essential along the porous Afghan-Pakistan border.

Afghanistan's relations with Pakistan will continue to be vital in a number of areas, including trade and security. However, bilateral relations have soured in the past two years, as groups based in Pakistan or elements of its government have been blamed for several high-profile attacks in Afghanistan, including one on the US embassy and the NATO headquarters in Kabul in September 2011 and a series of large, co-ordinated attacks in the capital and three other eastern provinces in April 2012.

Impact on the forecast

The recent crossborder clashes underscore our forecast that bilateral ties between Afghanistan and Pakistan will remain strained in the near term, clouded by Afghan scepticism of Pakistani intentions.

May 22, 2013: International relations

To arm or not to arm

Event

The latest round of Indo-Afghan talks on May 21st centred on an Afghan request for more Indian military assistance, ahead of a the planned withdrawal of the International Security Assistance Force (ISAF), which comprises US and other NATO troops, from Afghanistan in 2014.

Analysis

During his visit to India's capital, New Delhi, the Afghan president, Hamid Karzai, met his Indian counterpart, Pranab Mukherjee, as well as the Indian prime minister, Manmohan Singh, to press for more military aid. India and Afghanistan signed a strategic partnership agreement in 2011, and under its aegis the Indian government has provided training for some Afghan military officers. However, India has so far eschewed the provision of lethal weaponry, perhaps concerned that this would increase tensions with Pakistan, which has long been suspicious of India's growing involvement in Afghanistan.

Indian firms have been at the forefront in deals to develop Afghanistan's enormous potential mineral wealth—which is estimated to be worth US\$1trn, according to the US Geological Survey. Moreover, India has provided over US\$2bn towards building highways, hospitals, schools and rural electricity projects in Afghanistan over the past decade.

As one of the staunchest supporters of Mr Karzai's government and of the US's presence in Afghanistan, the Indian government is seeking both to advance its security interests (via the crackdown on terrorist safe havens) and to boost access to Central Asia's vast, largely untapped energy resources. However, the Pakistani administration, and especially that country's powerful military establishment, take a dim view of the Indian government's ambitions. (Following the ouster of the Taliban in 2001, the Pakistani government—whose influence was closely tied to the group—found its role somewhat marginalised.) A potential arms deal between the two countries ahead of a period of heightened political and security uncertainty in 2013–14 will further stoke regional tensions and intensify geopolitical rivalries over Afghanistan.

Impact on the forecast

Our forecast that political stability will remain poor—with disparate groups and countries jockeying for greater influence, often with conflicting goals—remains appropriate.

June 24, 2013: Political stability

More setbacks in peace process

Event

In mid-June the Taliban officially announced the opening of a political liaison office in Qatar, but initial indications that talks would be opened with both the US and Afghan governments were upended after Afghanistan's president, Hamid Karzai, said that he would not continue with the talks.

Analysis

Quiet efforts to establish a formal Taliban presence in Qatar that could allow for peace negotiations with the Afghan government and the international community began in 2011, but have proceeded fitfully since. The Taliban publicly broke off talks with the US in March 2012 over the issue of Taliban prisoners held in jails controlled by the US and its allies. American and NATO forces continue to battle the Taliban, and no immediate agreement on ceasefires or other confidence-building measures is expected.

The Afghan government is internally divided over the prospect of engagement with the insurgency, and the Taliban has previously ruled out recognition of Mr Karzai's government. Although the Taliban's statement announcing the new office primarily focused on intentions to establish relations with the international community, it did allow for "meetings with Afghans as times may demand".

A delegation led by a US special envoy, James Dobbins, was initially expected to travel to the Qatari capital, Doha, on June 20th for discussions with Taliban representatives, followed by a delegation from the Afghan government's High Peace Council. However, the Taliban's branding of its office in Qatar—complete with a flag and references to it as the office of the Islamic Emirate of Afghanistan, the name used by the group when they ruled the country prior to the international invasion—appear to have exacerbated Mr Karzai's concerns that his government would be marginalised in the negotiations. The Afghan president withdrew from the proposed talks, while also suspending separate talks with the US regarding the transition of security responsibility to Afghan forces.

The US subsequently cancelled Mr Dobbins' scheduled visit and discussions are under way to rebrand the Taliban office in Qatar. These moves appear to have mollified Mr Karzai somewhat, with the Afghan president thought to be now willing to at least resume talks over the security handover.

Impact on the forecast

The peace process thus far has been fitful and prone to setbacks. This is in line with our forecast that achieving peace between the disparate groups in Afghanistan will remain a significant challenge. As a result, political stability will remain poor in the medium term.

July 10, 2013: Political stability

US mulls speedy withdrawal of troops

Event

Media reports in the US have indicated that the American president, Barack Obama, is considering speeding up the withdrawal of combat troops from Afghanistan and leaving no soldiers on the ground after 2014.

Analysis

The International Security Assistance Force (ISAF), which comprises US and NATO troops, will wind down combat operations in Afghanistan in 2013, with most foreign troops scheduled to leave that country by end-2014. In February Mr Obama indicated that the number of US troops in Afghanistan would be halved over the next year, leaving around 34,000 troops by February 2014. Although no further announcements have been made, the US government is now reportedly considering removing the bulk of American armed forces by mid-2014 rather than waiting until the end of the year.

The US and other donors have repeatedly pledged that they will continue to support Afghanistan beyond 2014. In recent months, however, relations between foreign governments (the US in particular) and the Afghan president, Hamid Karzai, have become increasingly strained. Mr Karzai has balked at international diplomatic efforts to negotiate with the Taliban, concerned that his government was being marginalised in the process. Partly owing to these concerns, the Afghan president also recently halted negotiations on a bilateral US-Afghan status-of-forces protocol that would govern American military personnel remaining in the country after the completion of the security transition. Other international supporters have also expressed impatience with the Afghan government's efforts to curtail corruption and concerns over the pace of administrative preparation for the 2014 presidential election.

Amid rising tensions US officials are said to be increasingly considering a "zero option", whereby all troops are withdrawn after the 2014 deadline. (Mr Karzai has previously called for US troops to remain to provide training and support for the Afghan national security forces.) Such a withdrawal is likely to be accompanied by a reduction in financial assistance to the Afghan government, and, in leaving Afghan forces alone to deal with the Taliban insurgency, would worsen the security situation.

Impact on the forecast

The widening gaps between the priorities of the Afghan and US governments reinforces our forecast that political stability will remain poor in Afghanistan in 2013–14.

Analysis

June 24, 2013

Transition of security responsibility is announced

On June 18th Afghanistan's president, Hamid Karzai, announced the formal transfer of security responsibility for all remaining Afghan districts around the country from the International Security Assistance Force (ISAF), which comprises US and other NATO troops, to Afghan control. As part of a process first announced in November 2010, Afghan forces have gradually taken the lead in military operations against the Taliban insurgency, as international forces move to disengage from the 12-year conflict. But the government's ability to sustain itself independently over the long term will be seriously tested over the next 18 months and beyond.

Mr Karzai's announcement covers military operations in some 90 of Afghanistan's nearly 400 districts. Prior to this the domestic Afghan National Security Forces (ANSF) already officially led operations in more than three-quarters of the country. With this, international forces in Afghanistan, which currently number around 100,000, will officially shift to supporting roles; their numbers will halve by the end of 2013 and all combat troops are to be officially withdrawn by end-2014.

Afghanistan's army and police forces face high staff turnover, and have struggled to develop their own supporting air, artillery, logistics and intelligence services to replace those of the withdrawing international forces. High-profile attacks by the Taliban insurgency continue, including a roadside bombing in the capital, Kabul, targeting a prominent lawmaker from the Hazara community, Mohammad Mohaqiq, which took place on the same day as Mr Karzai's transition announcement. Besides the active Taliban insurgency, the government also faces a proliferation of smaller

independent militia forces, including some supported by the international community that are at best nominally loyal to the central Afghan government.

Uncertain commitments

NATO has pledged to continue its support for the Afghan military after 2014, although training will be limited to the upper levels of the command structure, rather than in the field. NATO allies have expressed a commitment to providing approximately US\$4bn annually to support Afghanistan's armed forces after 2014, in addition to around US\$4bn in non-military assistance annually in 2015–17. The details of this assistance remain under negotiation, however, and subject to domestic pressures in many donor countries to reduce their support for the Afghan government. Agreements have yet to be finalised on the size of the Afghan army and police that will be supported over the long term or the number of international forces that will remain in the country after 2014, although recent NATO ministerial summits have suggested that around 8,000–12,000 international troops may remain, at least initially.

In June the US, the largest source of military and non-military assistance in Afghanistan, was due to resume talks on a bilateral security agreement with the Afghan government that is intended to settle critical discussions over legal immunity and rules of engagement for American personnel serving in Afghanistan after 2014. However, in mid-June Mr Karzai suspended talks with the US in protest against a long-running US-backed initiative to engage in peace talks with the Taliban. (The Taliban officially announced the opening of a political liaison office in Qatar to open talks, but these were upended by Mr Karzai's announcement that his government would not continue with the talks unless the US was excluded.) Although US diplomats, including the secretary of state, John Kerry, have sought to assure Mr Karzai of the US government's support of his position, this fracas is likely to delay further the resolution of questions regarding NATO's post-2014 commitments to Afghanistan.

A number of transitions

The withdrawal of ISAF troops from Afghanistan will run parallel to presidential elections in that country, which are due to be held in April next year. Uncertainty over Afghanistan's future leadership is liable to complicate negotiations further with the international community, as well as stalling efforts to engage the Taliban in a credible peace process. Mr Karzai, who has led the executive branch in Afghanistan for more than a decade (as the head of the transitional government and subsequently over two terms as president), is constitutionally barred from seeking a third term and has yet to endorse a successor. Nevertheless, he has sought to retain an active role in shaping domestic politics ahead of the vote, rejecting draft legislation in April that would limit the presidency's control over appointments to the country's key electoral bodies. International donors have warned that a credible transfer of power to Mr Karzai's eventual successor through the electoral process will be a key condition for continued military and non-military assistance.

As the 2014 transition deadline looms, Mr Karzai faces the challenge of navigating peace talks with the Taliban, while seeking greater autonomy for his government (which the Taliban refuse to recognise as legitimate). Mr Karzai will also need to maintain the support of international donors in the face of war-weariness among the domestic populations of Western countries. Afghan security forces remain heavily dependent on external financing and cannot be sustained at current levels without international support. As international troops leave, and global focus on Afghanistan wanes, there is a growing likelihood that the Taliban could reassert themselves against the Afghan security forces. Political instability will thus remain the norm in the near term.

July 30, 2013

Electoral laws signed

In late July the president, Hamid Karzai, signed into law two key pieces of legislation governing Afghanistan's electoral processes. These include a law to govern the composition and remit of the Independent Election Commission (IEC) and the Electoral Complaints Commission (ECC), which are tasked with organising polls and adjudicating disputes respectively. Mr Karzai had rejected earlier drafts of the laws, raising concerns that the upcoming elections would be held under the auspices of a presidential ordinance rather than enacted legislation. Their passage clears the way for presidential and provincial council polls, which are currently scheduled to take place in April 2014.

Electoral legislation has been on the parliamentary agenda for much of this year, involving several rounds of discussions between the Wolesi Jirga (the lower house of parliament), the Meshrano Jirga (the upper house) and the presidential administration. The first piece of legislation, enacted on July 18th, governs the composition and authorities of the IEC and the ECC. Mr Karzai had previously pushed for the ECC to be dissolved while also rejecting proposals to create a new committee (which would include parliamentary representatives) to nominate IEC commissioners. However, in signing the new law, which retains both institutions, the president appears to have relented somewhat. Yet the ECC has been converted into a purely domestic organisation, unlike in previous elections—such as the 2004 and 2009 presidential and 2010 parliamentary polls—when the ECC included foreign commissioners. The new committee to nominate IEC members was formed shortly after the new law was ratified, but has yet to choose a new chairman for the IEC.

The second law, enacted on July 20th, covers general electoral processes. During earlier debate, proposals to introduce a mixed proportional representation system in parliament were rejected (the next round of legislative elections will be held in 2015). Reserved seats for women in the upcoming provincial council polls were removed without open debate in a version of the law passed by the lower house, drawing protests from female parliamentarians and women's rights groups. After conference with the upper house, the quota was reinstated, but reduced from 25% to 20% of provincial council seats. New education requirements for candidates were also introduced, including a master's degree for presidential candidates and a bachelor's for parliament—notable restrictions given the limited access to education for much of the country.

A year of transitions is ahead

The presidential and provincial council elections will take place amid the ongoing withdrawal of international troops from the country, a process that is expected to conclude by end-2014. The exact pace of the withdrawal and the nature of future international engagement with Afghanistan (in terms of military presence and aid) are yet to be finalised. However, the elections are expected to be run domestically; the commander of the International Security Assistance Force, General Joseph Dunford, reiterated this view in a recent media report where he said that responsibility for securing the voting process in April 2014 would be borne solely by Afghan forces, and that international forces would not be visible at all. Efforts to register approximately 4m new voters ahead of the 2014 polls began in May, with election officials at the time expressing concerns about security preparations at registration centres; new female voter registration has been notably low to date.

Although Mr Karzai has pledged to step down after his term ends, he has sought to retain a central position in controlling the election process in the run-up to the vote. Candidate registration will officially begin in September, and negotiations between political elites seeking consensus on presidential nominees have intensified in recent months. Observer groups and international donors have welcomed the passage of the electoral laws. However, uncertainty remains high about the state of preparations for the vote and the prospects for the first transfer of executive authority in Afghanistan since 2001.

Economy

Forecast updates

April 12, 2013: Economic growth

Crucial times

Event

In a report published on April 9th the Asian Development Bank (ADB) said that political and security uncertainty in Afghanistan over the next two years could adversely affect the country's economic prospects.

Analysis

In its annual *Asian Development Outlook*, published earlier this month, the ADB noted that real GDP growth had accelerated in 2012, to 11.9% from 7.2% in 2011. On a factor-cost basis, agricultural output grew by 31.5% in 2012 as unusually favourable weather boosted crop production. Industrial output slowed to 7.2% from 9.8% in the previous year, owing to the shortage of power, as well as uncertainty over the political and security situation. Output in the services sector, which accounts for one-half of GDP, slowed to 7.3% from 12.7% in 2011. The ADB attributes this slowdown to reduced spending by international security forces and by the local population owing to increased uncertainty in the run-up to the withdrawal of international troops in 2014.

Opium production is estimated to have fallen from the equivalent of 7% of GDP in 2011, to 4% in 2012. However, this fall is attributed to disease and unfavourable weather, rather than any particular success achieved by numerous campaigns undertaken by foreign agencies to curb poppy cultivation. (Opium production is not included in national accounts, but earnings from its sale support domestic demand.)

The ADB expects real GDP growth to slow sharply in 2013, to 3.3%, owing to the effect of a high base in the previous year. Crop production is expected to be substantially lower than the level seen in 2012. The ADB contends that private consumption and industrial growth—both key drivers of overall economic growth—will remain dependent on donor-led development projects and international aid flows, both of which are expected to fall as international troops wind down their operations in Afghanistan. With a presidential election also scheduled to take place in 2014, Afghanistan is entering a period of heightened political and security uncertainty, which will further constrain growth.

Impact on the forecast

The ADB's assessment of the Afghan economy is in line with our forecast that falling foreign military spending and aid as a result of the withdrawal of security forces will trigger a rapid slowdown in GDP growth.