AFGHANISTAN

Economic conditions continue to deteriorate following the political crisis of August 2021. Cessation of international grant support is driving a major collapse in aggregate demand, difficult macroeconomic adjustments, and disruptions to service delivery. Disruption to international financial relationships, the freezing of the central bank's overseas assets, and loss of confidence in the banking system is driving a financial sector crisis. Renewed international support for humanitarian activities and basic service delivery is now underway, but a broader program of action will be required for economic stabilization and eventual recovery.

Key conditions and challenges

Afghanistan is experiencing a worsening fiscal, macroeconomic, and financial sector crisis. The sudden cessation of international grants (previously equivalent to 45 percent of GDP and financing 75 percent of public expenditure) has caused a collapse in public spending and aggregate demand. Many frontline public service workers remain unpaid. Declines in aid and government spending have undermined private sector activity, especially in the aid-driven services sector which has accounted for a large proportion of output and growth since 2001. Loss of grant inflows has also left a shortage of hard currency with which to finance imports (Afghanistan was heavily dependent imports for critical items including food, fuel, and electricity, with a trade deficit equal to around 35 percent of GDP). Afghanistan's offshore central bank assets have been frozen, undermining the capacity of the central bank to smooth the required macroeconomic adjustment, while international banking relationships have been heavily disrupted due to international sanctions and associated Anti-Money Laundering (AML) concerns. These factors combined with a shortage of both USD and AFN cash notes have triggered a crisis of confidence in the banking sector, crippling cash shortages, and severe disruptions to domestic and international payments, with severe impacts on the private sector and humanitarian agencies. Disruptions to the banking sector are particularly impairing the operations of businesses that rely on formal financial flows to import necessary inputs, placing their ongoing viability at risk.

Rapidly deteriorating economic conditions in the context of severe drought are driving a humanitarian crisis. Afghans are suffering from rapidly increasing unemployment, deepening impoverishment, and worsening food insecurity. A largescale international humanitarian response is being mobilized, while efforts are underway to restore international development support to critical service delivery functions. Dysfunction of the financial sector, however, continues to both constrain the effective mobilization of aid support and limit prospects for economic stabilization and recovery.

Recent developments

Official GDP statistics are not being produced. Economic output is expected to decline by between 20-30 percent over the year from August 2021. According to a recent private sector survey, firms have laid off more than half of their staff on average. More than one third of small businesses have temporarily or permanently closed operations, while more than three-quarters of large companies report decreased demand for their outputs.

Despite reduced incomes and domestic demand, prices have increased rapidly. Headline y-o-y inflation reached 12.7 percent in December reflecting depreciation, increasing international prices, and import constraints arising from disruptions to international transactions. Food inflation reached 17.7 percent, reflecting heavy reliance on imported wheat. More recent data collected by the World Food Program shows y-o-y inflation for a basket of basic household goods reaching 42 percent in the first week of February.

According to official data, goods imports declined by around 47 percent over the second half of 2021 relative to the same period in 2020, in line with contracting domestic demand, disruptions to international payments, and the central bank's loss of access to overseas assets. Import contraction was broad-based, reflecting lower imports for all categories of goods. Recent data from the Pakistan authorities show imports from Pakistan in January 2022 were only around one-third of 2021 levels. Goods exports, on the other hand, declined only moderately over the second half of 2021 (4.7 percent lower than during the same period in 2020). Positive impacts of improved security and depreciation were offset by the closure of aid-subsidized air corridors for agricultural exports to India and China.

The Afghani has depreciated against most major trading currencies since August, reflecting the decline in aid inflows and heightened uncertainty. The Afghani fell by 14 percent against the USD, 10 percent against the Euro, and 4 percent against the Pakistani Rupee between the end-July 2021 and mid-February 2022. The market value of the AFN is being buoyed by a tightening of the domestic money supply driven by shortages of AFN banknotes and recent injections of USD cash through humanitarian cash shipments.

The abrupt cessation of aid inflows and difficult economic conditions are driving a significant fiscal contraction, with public spending expected to decline by around

75 percent. All development and security aid has ceased (previously equal to around US$8.5 billion per year), leaving only relatively limited humanitarian flows. The interim administration collected US$ 0.5 billion between September-December 2021 – around half of revenue collections over the same period in 2019. In its quarterly budget (December 21-March 21), the interim administration plans spending equal to around only 50 percent of 2019 levels, with the budget including ambitious revenue projections and a significant unfinanced deficit (equal to around US$60 million).[1]

Recent indicators of monetary poverty are not available, but a recent household survey shows that living conditions have deteriorated and food insecurity has worsened since August 2021. 70 percent of households report insufficient incomes to meet basic food and non-food needs (compared to about 35 percent reported for May 2021). A substantial decline in labor earnings and destruction of employment in the public and private sectors are driving increased unemployment and increased informal and casual work. The economic crisis is also weakening safety nets, with disruptions to international financial flows leading to a reduction from 10 to five percent in the share of households receiving remittances. Extreme poverty had led to the widespread adoption of harmful coping mechanisms such as reducing food consumption, borrowing at high interest rates and the sale or consumption of assets. This will have long-term consequences given Afghanistan's very young population.

1/ The quarterly budget includes large cuts to security and development project allocations, while maintaining allocations for recurrent health and education expenditures at close to previous levels. It remains unclear whether the budget will be effectively implemented.

Outlook

Afghanistan's economic outlook is stark. Under any scenario, Afghanistan will face a smaller economy, significantly higher rates of poverty, and more limited economic opportunities for the 600,000 Afghans reaching working age every year. Human development outcomes are likely to deteriorate in the context of substantial disruptions to basic services and increased poverty. The Russian invasion of Ukraine, war, and associated sanctions may have significant exacerbating impacts via increased prices for imported food and fuel.

Recent moves by the international community will mitigate human impacts. The United Nations is mobilizing a largescale humanitarian response to reach more than 24 million Afghans at a total cost over CY2022 of US$4.4 billion. The international community is also working towards renewed development assistance for basic services, including health, education, food security, and community development, to be delivered through off-budget channels. In the context of financial sector dysfunctions, USD cash shipments managed by the United Nations are providing a vital source of funding for humanitarian activities and an important source of USD liquidity.

All parties acknowledge, however, that current provision of humanitarian and basic services assistance is unsustainably expensive and cannot substitute for a functioning economy and private sector (current humanitarian needs exceed previous levels of civilian aid assistance). Economic stabilization or medium-term recovery would require: i) restoration of core financial sector functions, including effective operation of the central bank; ii) sound economic management; iii) restoration of confidence; and iv) maintenance of adequate security conditions. Such progress would likely require coordinated action between the international community and the interim administration, including in relation to the utilization of frozen assets, provision of technical assistance support for economic management, and measures to restore international banking relationships. Meanwhile, the world bank continues to provide analytical support to inform international community on engagement priorities.