

AFGHANISTAN

August 15, 2021, political transition led to a significant economic contraction, increasing food insecurity, and widespread deprivation. The resumption of off-budget aid during the year helped cushion some of the negative impacts of the widespread humanitarian crisis. There are signs that the economy has reached an inflection point and is likely plateauing around a low-level equilibrium. While inflation remains high, some indicators saw improvement, (i) exports have increased, (ii) exchange rate volatility has lessened, and (iii) domestic revenue collection is relatively healthy. Living conditions showed marginal improvements in the last few months, though deprivation remains very high across the country, and the persistent inflation might erode these welfare gains. Sustaining this outcome will require the continuation of off-budget international support, including the US\$ cash shipment by the UN.

Key conditions and challenges

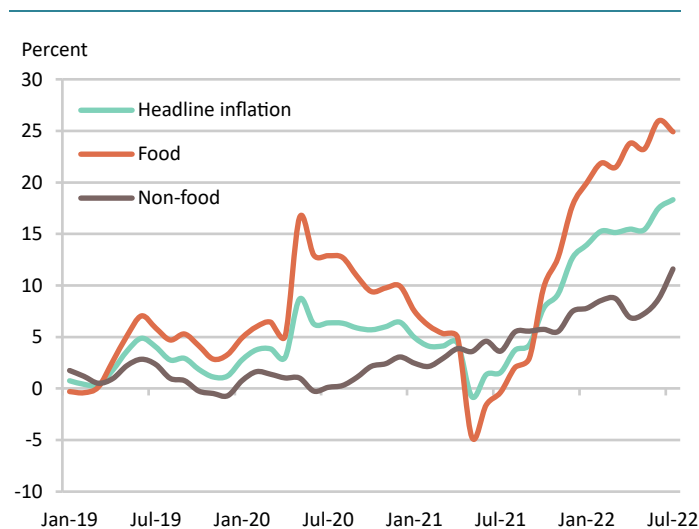
Immediately after Aug 15, 2021, the cessation of aid caused public spending and aggregate demand to contract severely. This, in turn, undermined private sector activity, especially in the aid-driven services sector, which significantly contributed to output and growth since 2001. Afghanistan's central bank lost its ability to manage the payment systems and conduct monetary policy due to the freeze of offshore assets and its inability to print new AFN notes. The resulting shortage of US\$ and AFN currency notes and the sanctions triggered a banking sector's confidence crisis. The US Government has issued licenses to ease the sanctions concerns and support humanitarian delivery. Still, international banks are reluctant to reestablish correspondent relations with the Afghan banks due to Anti-Money Laundering (AML)/Combating the Financing of Terrorism (CFT) concerns. Formal payments flowing into/from Afghanistan remain problematic for all actors, including the Interim Taliban Administration (ITA), for critical imports such as electricity and medicines, the private sector, and humanitarian agencies. Over the year, off-budget aid resumed (estimates ~US\$2 billion including ~US\$1.2 billion through direct cash shipments) primarily to support humanitarian delivery and basic services; yet this was significantly lower than in the past. This aid,

low corruption, and enhanced security helped the recovery of some economic activities and stabilization of the exchange rate.

Recent developments

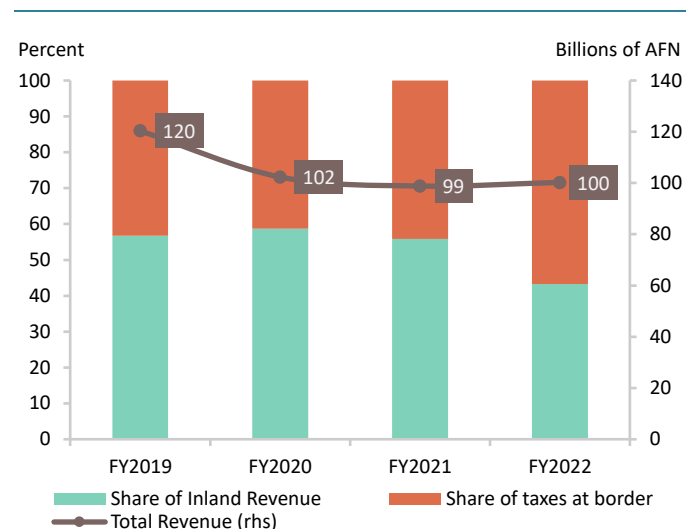
Despite reduced incomes and domestic demand, prices have rapidly increased, indicating a strong supply shock owing to supply disruptions and increased international prices. Official data for July 2022 shows headline consumer price index inflation at 18.3 percent, mainly driven by 25 percent Y-o-Y inflation in the food segment. Non-Food segment Y-o-Y inflation for July 2022 was recorded at 11.6 percent. The private sector businesses faced the brunt of the crisis and reacted by closing and reducing their operations as a coping strategy. A recent survey of firms shows that reduced demand is one of the critical constraints to business recovery. While no information on poverty is collected for the country, estimates for Q4-2021 showed that close to 70 percent of the country's population had difficulties covering their most basic expenses. Labor earnings plummeted across the country, and the contraction in salaried employment resulted in increased self-employment and other low-productivity jobs. However, more recent information collected this summer shows a slight improvement in living conditions, as the share of households reporting difficulties covering their most basic expenses has fallen to 64 percent compared to 70 percent at end-2021. Salaried employment has also recovered slightly in urban areas,

FIGURE 1 Afghanistan / Headline inflation



Source: National Statistic and Information Authority, Afghanistan.

FIGURE 2 Afghanistan / Revenue mobilization



Source: Ministry of Finance, Afghanistan.

Note: Data covering Dec 22nd through mid-August for all years.

though it remains below pre-COVID19 levels. On the downside, high inflation is eroding household earnings' real value, pushing food insecurity again and forcing households to adopt potentially harmful coping strategies.

The ITA has severely restricted access to public expenditure statistics. Recent revenue data shows good performance, with total revenue reaching AFN100 billion (US\$1.1 billion) for December 22, 2021, to mid-August 2022 (exceeding last year's collection during the same period) thanks to an increase in revenues collected at borders (import duties and Business Receipt Tax). The budgeted revenue for the fiscal year 2022 is AFN186.7 billion (US\$2.05 billion) against AFN203 billion (US\$2.2 billion) in recurrent expenditures and AFN27.9 billion (US\$0.3 billion) in development allocations. However, the ITA did not make the granular expenditure allocation public. A deficit of AFN44 billion (US\$500 million) remains explicitly unfinanced.

Economic contraction drove the reduction in imports: goods imports fell by 47 percent over the second half of 2021 relative to the same period in 2020. In the first quarter of 2022, while imports of fuel and petroleum products increased by 57 percent because of higher international prices, imports of other categories of goods declined significantly, resulting in an overall decline in total imports by 11.3 percent Y-o-Y. Exports have picked up since the fourth quarter of 2021, and the momentum continued into Q1-2022 (with US\$408.7 million in goods exports compared to US\$200.2 million in Q1-2021), reflecting a surge in the export of coal and fruits. Recent mirror trade data for July 2021

to June 2022 from Pakistan authorities shows that Afghanistan has a trade surplus of US\$79 million.

The AFN has depreciated against most major trading currencies after August 2021 and lost 40 percent of its value against the US\$ between mid-August 2021 and mid-December 2021. However, it has recovered since then, primarily due to the US\$ cash shipments by the UN and strengthened controls by ITA in the foreign exchange market, including by regulating the Money Service Providers and prohibiting the use of foreign currency for domestic transactions. The AFN value against the US\$ has hovered between 85 to 93 since mid-February 2022, and as of Sep 08, 2022, it is trading close to 88.19 AFN per US\$, 2.3 percent below its August 15, 2021 value.

Afghanistan's financial sector remains in crisis. Capacity gaps at the central bank (Da Afghanistan Bank – DAB) continue to limit its ability to undertake critical functions, including banking supervision, monitoring illicit financial flows, and performing AML/CFT monitoring. The bank run during the August 2021 crisis has eroded confidence in the banking sector. The mandatory transition to Islamic Banking for all financial institutions is also creating operational difficulties. All banks, but one, have reported significant losses for the first quarter of 2022. The losses are predominantly due to the inability to collect interest income and FX losses. NPLs remain underreported due to the central bank's forbearance measures. There are rapidly escalating stability risks in the banking sector, which are made more worrisome as DAB's Bank Resolution capacity is very limited.

Outlook

The economy is now re-adjusting from the "aid bubble," and the international community's ongoing humanitarian and off-budget basic service support is expected to mitigate some negative impacts of the contraction. Still, it will not be sufficient to bring the economy back on a sustainable recovery path. Under the baseline scenario where the country receives minimal international support for humanitarian activities and basic core services, the real GDP is projected to contract between 16 to 19 percent in 2022, with an accumulated contraction of close to 30 percent between 2021 and 2022. The economy is projected to move to a low growth path (2.0 to 2.4 percent) for the next two years—with no improvement in per capita incomes owing to high population growth and no significant changes in poverty or food insecurity. Inflation is expected to remain high immediately due to global commodity price increases and supply constraints, further eroding the real value of household incomes. At the same time, ITA's restrictive policies on women's education and work will lower Afghanistan's growth prospects. This outlook is subject to significant downside risks. These include (i) the potential discontinuation/reduction in aid from the current levels, (ii) a stoppage of US\$ cash shipments which could undermine exchange rate stability, and (iii) potential stability concerns in the banking sector.