OCTOBER

2023

AFGHANISTAN DEVELOPMENT UPDATE

UNCERTAINTY AFTER FLEETING STABILITY

THE WORLD BANK
IBRD • IDA | WORLD BANK GROUP

Afghanistan Futures
ASSESS, ANALYZE, ADVISE

AFGHANISTAN DEVELOPMENT UPDATE

Uncertainty After Fleeting Stability

October 2023

PREFACE:

The Afghanistan Development Update provides a comprehensive report on the state of the Afghan economy. It covers recent economic developments and the medium-term outlook for Afghanistan. Each edition includes Special Focus sections providing in-depth analysis of specific topics. The Afghanistan Development Update is intended for a wide audience, including policymakers, the donor community, the private sector, and the community of analysts and professionals engaged in Afghanistan's economy.

This report has been prepared by Muhammad Waheed (Senior Economist, ESAC1), Silvia Redaelli (Senior Economist, ESAPV), Wasim Shahid Malik (Consultant ESAC1), and Amna Sehar (Consultant, ESAC1). Valuable contributions were made by the following people: Namoos Zaheer, Senior Financial Sector Specialist in ESAF1; Mohammad Sulaiman Akbari, Senior Private Sector Specialist in EAEF1; Indira Iyer, Consultant in ESAC1; Oscar Barriga-Cabanillas, Economist in ESAPV, and Anais Dahmani-Scuitt, ET Consultant in ESAPV. Eduardo Olaberria, Program Leader and Senior Economist in ESAC1, and Kiran Afzal, Senior Private Sector Specialist in ESAF1, provided useful feedback. The report was created with the guidance of Melinda Good (Country Director for Afghanistan, SACKB), Saiyed Shabih Ali Mohib (Practice Manager, ESAC1), Ximena Del Carpio (Practice Manager, ESAPV), Gabi Afram (Practice Manager, ESAF1) and Mathew A. Verghis (Regional Director for Equitable Growth, Finance, and Institutions).

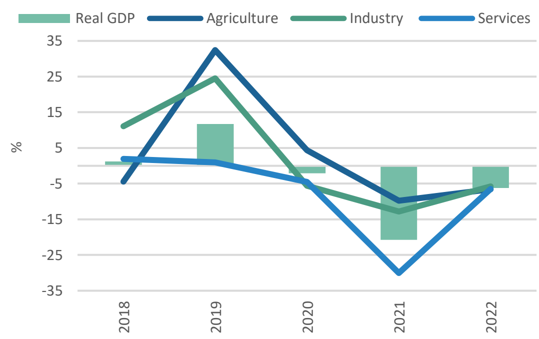
AFGHANISTAN DEVELOPMENT UPDATE OCTOBER 2023

KEY MESSAGES AT A GLANCE

The Afghan economy continues to contract and face uncertainty and fragility after the ITA takeover.

- The real sector has contracted for two consecutive years since ITA took over and is still facing uncertainty, making even fleeting stability fragile.
- Economic activity in all three sectors experienced a decline. The services sector, which contributes nearly 45 percent to the country's GDP, shrank by 6.5 percent, the agricultural sector, contributing about 36 percent to GDP, contracted 6.6 percent, and the industrial sector contracted 5.7 percent in 2022.

The Afghan Economy Contracted by 6.2% in 2022, Following a 20.7% Contraction in 2021.

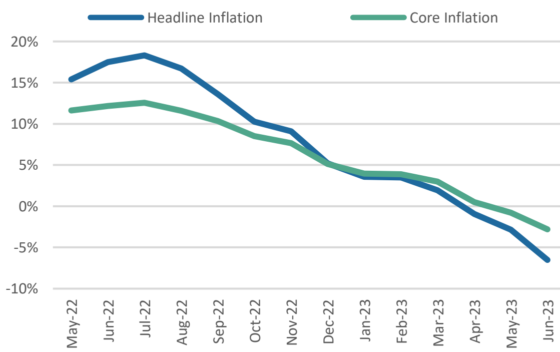


Inflation declined sharply and, since April 2023, turned into deflation. The economy adapts to structurally lower aggregate demand, improved supply conditions, and a stronger AFN. However, if deflation persists, the economy may face further deterioration.

- After hitting an 18.3 percent year-on-year peak in July 2022, inflation sharply declined, leading to deflation since April 2023. Although the supply of goods has improved and the AFN has appreciated, the sudden drop in inflation points towards continued economic weakness and depressed aggregate demand.
- Deflation may have short-term benefits; however, sustained lower aggregate demand can lead to further deterioration.

.

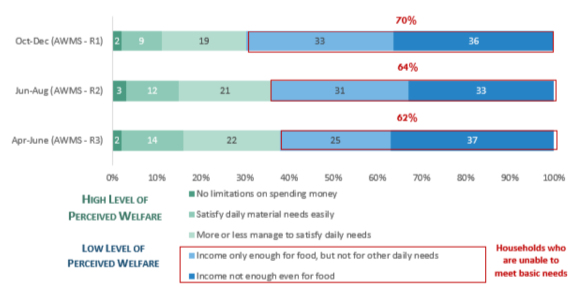
After Peaking in July 2022, Inflation Dropped Sharply, Resulting in Deflation Since April 2023



Falling food prices have helped Afghan households, but poverty rates are still high. The crisis caused high unemployment, especially among youth and women

- Food prices have fallen in Afghanistan, improving household well-being. However, monetary poverty still affects half of the country's population, and vulnerability remains high.
- The increase in labor supply has sizably outpaced a slacking demand, resulting in a doubling of unemployment and a one-quarter increase in underemployment

There is Improvement in Self-Reported Welfare; however, the Needs Level Remains High.



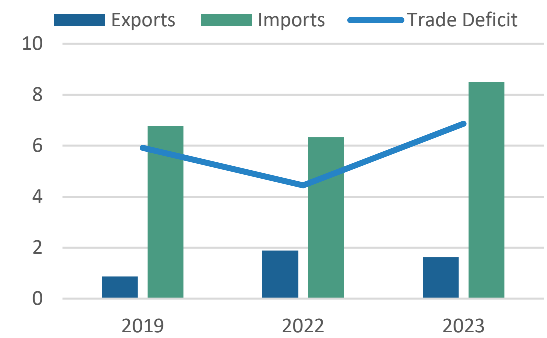
AFGHANISTAN DEVELOPMENT UPDATE OCTOBER 2023

KEY MESSAGES AT A GLANCE

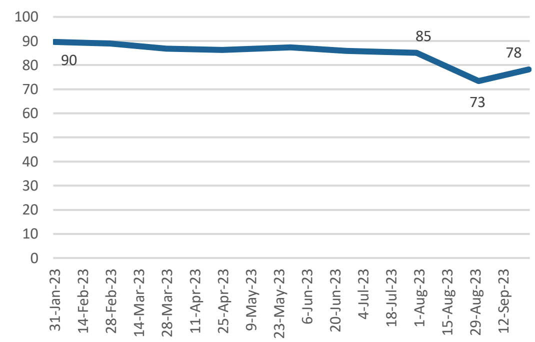
Afghanistan's currency appreciated despite a significant trade deficit caused by high imports in specific categories.

- Afghanistan's exports reached US$1.9 billion in 2022, driven by food, coal, and textiles. However, monthly export data indicates a decline in trend since February 2023 due to a decrease in coal exports.
- Imports in 2022 accounted for US$6.3 billion. For the first seven months of 2023, imports reached US$4.4 billion, marking a 32 percent increase from the same period in 2022.
- Between 2022 and 2023, the import of various goods, such as textiles, prepared food, vehicles and parts, tires, stone and glassware, and chemicals and allied industries, increased significantly despite the country's economic contraction.
- Anecdotal evidence suggests that many of these increased imports are not intended for Afghanistan. These are not paid from Afghanistan's forex market and explain the currency appreciation despite the widening trade deficit.

Exchange Rate is Appreciating Despite Widening Trade Deficit



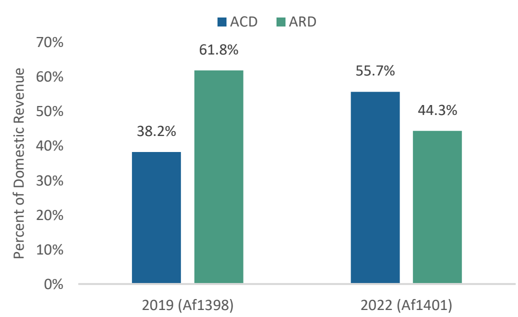
Exchange Rate (AFN/USD)



ITA heavily relies on border taxes due to underperforming inland revenue receipts, with operating expenditure replacing development expenditure.

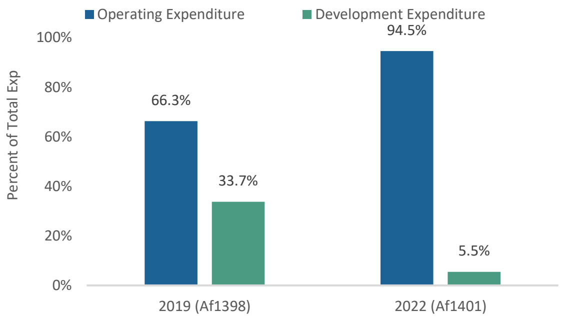
- In 2022, revenue collection reached AFN 193.9 billion (US$ 2.2 billion), with the majority coming from bordered trade. Revenue collection from inland sources remained low despite imposing more taxes, indicating a depressed economy.
- There have been significant compositional shifts in government expenditure in 2022 compared to 2019 in favor of the security sector. Moreover, operating expenditure takes a major chunk, leaving meager resources for the development budget.
- Based on the budget information gathered from various news sources, there seem to be credibility issues about the FY2023 budget.

Heavy Reliance on Revenue Collected at the Border



- Recent unconfirmed reports suggest that the ITA has reallocated part of its contingency budget allocations for tertiary hospitals, which were previously fully financed by international grants.

A Drastic Fall in Development Expenditure



The financial sector faces liquidity and stability risks.

- The payment system is dysfunctional, with most transactions using the informal Hawala channel. The banking sector faces instability and liquidity concerns, compounded by the unguided and mandatory shift to Islamic banking.

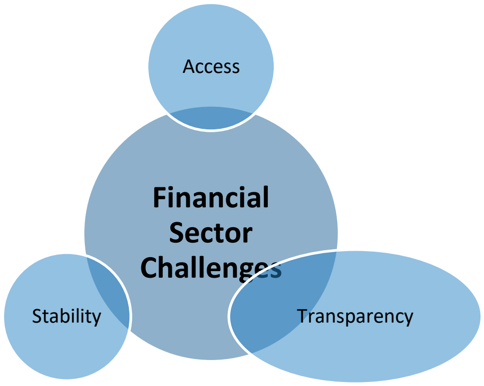


TABLE OF CONTENTS

LIST OF FIGURES

LIST OF BOXES

LIST OF ABBREVIATIONS

ACD	Afghanistan Customs Department
ACH	Automated Clearinghouse
AFMIS	Afghanistan Financial Management Information System
AFN	Afghan Afghani
AML	Anti-Money Laundering
APS	Afghanistan Payment System
ARD	Afghanistan Revenue Department
ASYCUDA	Automated System for Customs Data
AWMS	Afghanistan Welfare Monitoring Survey
CBR	Correspondent Banking Relationships
CFT	Combating the Financing of Terrorism
CP	Conversion Plan
CY	Calendar Year
DAB	Da Afghanistan Bank
FDI	Foreign Direct Investment
FMFB	First Micro-Finance Bank of Afghanistan
FY	Fiscal Year
GDP	Gross Domestic Product
H2	Second Half
IBCIRC	Islamic Banking & Contemporary Research Center
IELFS	Income, Expenditure, and Labor Force Survey
IPC	Integrated Food Security Phase Classification
IT	Information Technology
ITA	Interim Taliban Administration
LFP	Labor Force Participation
LTO	Large Taxpayer’s Office
MFI	Micro-finance Institution
MISFA	Micro-Finance Support Facility
MOD	Ministry of Defence
MOE	Ministry of Education
MOI	Ministry of Interior
MTO	Medium Taxpayer’s Office
NPLs	Non-Performing Loans
NSIA	National Statistics and Information Authority
NTR	Non-Tax Revenue
POS	Point-of-Sale
PSRS	Private-Sector Rapid Survey
Q3	Third Quarter
Q4	Fourth Quarter
R1	Round 1
R2	Round 2
R3	Round 3
RTGS	Real-Time Gross Settlement System
TPMA	Third-Party Monitoring Agent
UN	United Nations
US$	United States Dollar
WB	World Bank

EXECUTIVE SUMMARY

The Afghan economy continues to face uncertainty and fragility in the aftermath of the Interim Taliban Administration's (ITA) takeover. The economy contracted by 25 percent since the takeover, the ITA managed to collect $2.2 billion in revenue during Fiscal Year (FY) 2022, comparable to the amount collected in 2019. However, in FY 2023, revenue collection is falling short of the target, with most of the receipts coming from border taxes, as inland revenues struggle due to the weak economy and low non-tax receipts. Exports, which reached a record high of $1.9 billion in 2022, have been losing momentum since early 2023. The Afghani (AFN) appreciated in 2023 despite a substantial trade deficit, which cash shipments based on the budgetary requirements for humanitarian and basic service support and remittance inflows cannot fully explain. The informal Hawala system continues to play a crucial role in most financial transactions due to the limited formal financial sector.

Household welfare has improved, but the economy is adjusting to a structurally lower aggregate demand level with signs of potential further deterioration. The third round of the Afghanistan Welfare Monitoring Survey (AWMS-R3) indicates a slight improvement in household welfare since summer 2022, but half the population still faces poverty. Households' purchasing capacity has benefited from a decline in inflation, which declined sharply from its peak of 18.3 percent year-on-year in July 2022, turning into deflation since April 2023. These price shifts result from better supply conditions, a stronger AFN, and the economy adjusting to reduced aggregate demand. While deflation may temporarily boost real wages and household well-being, it could stifle business growth, leading to higher unemployment and underemployment, complicating economic recovery. Recent firm surveys already report a drop in demand as a most significant constraint.

There are substantial downside risks. "No-conflict" dividend is spent: the economy, which appeared to have stabilized at a low equilibrium level by the end of 2022, is now fragile. The economy still depends heavily on external support and lacks a self-sustaining indigenous growth engine for recovery. Consequently, the economy is expected to stagnate or shrink, with risks tilted towards the downside. This would lead to a decline in per-capita income, exacerbated by rapid population growth and persistent high poverty rates, vulnerable to weather-related shocks. Potential risks to this outlook include a steeper reduction in aid, including cash shipments for humanitarian and basic services associated with any adverse policy announcement by ITA, and prolonged deflation resulting from weakened aggregate demand. At the same time, the ITA's restrictive policies on women's education and work will further lower Afghanistan's growth prospects.

ECONOMIC DEVELOPMENTS

After the Taliban took control of Afghanistan, the economy contracted for two consecutive years, declining by 20.7 percent in 2021 and 6.2 percent in 2022. This downturn affected all sectors. Services, which comprise 45 percent of the GDP, shrank by 6.5 percent in 2022, following a staggering 30 percent in 2021. The agriculture sector, which accounts for 36 percent of the GDP, experienced a decline of 6.6 percent in 2022 due to unfavorable weather conditions. The industrial sector also saw a contraction of 5.7 percent in 2022, mainly attributed to manufacturing setbacks as businesses faced closures due to limited access to resources and financial challenges.

Since April 2023, the country has experienced deflation, likely due to improved supply, appreciating AFN, and the economy still adjusting to structurally lower aggregate demand. Following the August 2021 political upheaval, inflation surged due to supply disruptions and shocks in commodity prices, even amid reduced domestic demand. After peaking at 18.3 percent year-on-year in July 2022, inflation plummeted into deflation by April 2023. By July 2023, year-on-year inflation stands at -9.1 percent, driven by a 12.6 percent deflation in food and a 5.0 percent drop in non-food segments. Core inflation, excluding food and energy prices, registered a year-on-year negative 4.7 percent in July 2023. These price changes likely result from structurally decreased aggregate demand from depleted savings, reduced public spending, improved supply conditions, and a stronger Afghani currency.

Falling food prices have somewhat improved Afghan household well-being and food security, but monetary poverty remains high. According to recent estimates derived using AWMS-R3, the current level of poverty is similar in magnitude to what was observed before the regime change, when the intensity of conflict in Afghanistan was at its all-time high. The survey also reveals a marginal improvement in the share of households who report insufficient income to satisfy their basic needs. However, the status of households reporting insufficient income even for food remains unchanged compared to R1 and R2. Afghan households have coped with the crisis by increasing the labor supply, particularly youth and women. Female labor force participation saw a threefold increase compared to 2020, with women primarily engaged in home production (garment and food processing). Overall, the growth in labor supply has sizably outpaced a slacking demand, resulting in a doubling of unemployment and a one-quarter increase in underemployment, as proxied by the share of workers employed for less than 40 hours per week.

Many businesses are struggling to operate at full capacity. In the Private Sector Rapid Survey's third round in March-April 2023, just over half of the firms surveyed were fully operational, with another third operating below capacity. The top business constraint reported by surveyed firms was dampened demand, followed by uncertainty about the future and limited banking system functionality. Other difficulties surveyed firms face include a less efficient payment system, increased cost of doing business, poor availability of imported inputs, and difficulty securing loans. Nearly half of surveyed firms report an improvement in the security environment, but responses vary widely by firm size and gender of the firm owner. Female-owned firms are twice as likely to report a deterioration in security compared to male-owned firms. Many surveyed firms reported that their businesses "did not have to pay any unofficial payments or bribes" while paying taxes, clearing customs, participating in public procurement, or requesting government services.

Afghanistan's exports have surged in value, but the economy still runs a substantial trade deficit owing to a jump in imports in some categories. Imports in 2022 accounted for US$6.3 billion. For the first seven months of 2023, imports reached US$4.4 billion, marking a 32 percent increase from the same period in 2022. During 2022 and 2023, the import of certain goods, including textiles, prepared food, vehicles and parts, tires, stone and glassware, and chemicals and allied industries, nearly doubled compared to the average from 2016 to 2020. The increased import demand in these categories is not consistent with the depressed economic reality of the country. As explained later in Box 2, anecdotal evidence suggests that part of these imports (US$1.0 – 1.5 billion) were not intended for domestic consumption. Afghanistan's exports reached US$1.9 billion in 2022, driven by food, coal, and textiles, which accounted for 94 percent. While exports grew three percent in the first seven months of 2023 compared to the same period in 2022, monthly export data indicates a decline in trend since February 2023 due to a decrease in coal exports. Despite increased exports, unusually high imports in some categories led to a higher trade deficit.

Despite the widening trade deficit, Afghani has appreciated since the beginning of 2023. The cash shipments by the UN for humanitarian and basic services and remittance inflows do not fully explain the financing for the widened trade deficit. The foreign exchange market seems balanced, as there is no evidence of a parallel exchange market. This suggests the availability of unidentified external financing sources to bridge the forex market gap arising out of the widening trade deficit. As previously stated, it appears that a significant amount of imported goods is not intended for domestic consumption and is not paid from Afghanistan's forex market. This accounts for a significant portion of the trade deficit that cannot be explained by the inflow of remittances and US dollar shipments. Between January and August 24, 2023, Afghani (AFN) appreciated against the US dollar (7.3 percent), Chinese yuan (6.0 percent), and Pakistan rupee (29.3 percent). By August 24, 2023, the AFN-to-US$ rate was 83.1, marking a 3.7 percent increase since August 15, 2021. In addition to unidentified external flows, the AFN's gains partly stem from the ban on foreign currencies for domestic transactions, limited domestic money supply, higher remittances, and UN dollar shipments. In 2023, UN inflows were around US$1.12 billion, complementing the US$1.8 billion received in 2022.

The ITA relies solely on its revenue sources and cannot access on-budget grants. In 2022, revenue collection reached AFN 193.9 billion (US$ 2.2 billion), which accounted for almost 98 percent of the fiscal year's revised budget target of AFN 198.7 billion. Revenue collection for the first five months of the fiscal year 2023 reached AFN 76 billion, an 8 percent increase compared to the same period in the previous fiscal year but lower than the five-monthly target by 7.0 billion. Customs duty and Business receipt tax accounted for 60 percent of the collection. In contrast, revenue collection from inland sources saw a marginal 0.9 percent uptick compared to the prior year.

For FY 2022, public sector spending, recorded at AFN 195.2 billion, was limited to own-source revenue, resulting in a significant decrease from AFN 424.3 billion in 2019. The operating expenses decreased by 34 percent from AFN 281.2 billion in 2019 to AFN 184.5 billion in FY 2022. Similarly, development expenditures plunged significantly from AFN 143.1 billion to AFN 10.8 billion. The expenditure allocation also changed, with three ministries (the Ministry of Interior, the Ministry of Defense, and the Ministry of Education, including Higher Education) receiving an increased share of the operating budget from 39 percent in 2019 to 64 percent in FY 2022. Ninety-two percent of the development budget is allocated to three sectors: Governance and Public Services, Agriculture and Economic Affairs, and Transport and Communication. The budget deficit in FY 2022 was AFN 1.3 billion, equivalent to 0.1 percent of GDP and 0.7 percent of expenditure.

The financial sector is still constricted, and the informal Hawala system processes most payments. Although the banking system remains under stress, there are signs that the sharp decline in deposits has been halted. Publicly available data shows that deposits increased by five percent in the first quarter of 2023 after a nine percent decrease in the previous year. The banks are strategically shifting their asset base towards more liquid assets, a move prompted by diminishing prospects in interest income. Banks have intensified their focus on fee and commission-based revenues. Nevertheless, the sector is vulnerable. Without the prevailing forbearance measures, many banks would face undercapitalization. In addition, the international payment system is still not restored, as international banks are reluctant to reestablish correspondent relations.

OUTLOOK AND RISKS

The outlook is uncertain amid a mix of economic indicators and subject to significant downside risk. No conflict dividend have been spent. The economy, which seems to have stabilized at a low equilibrium level by the end of 2022, now appears vulnerable to some downside risks. Although international trade is ongoing and ITA continues to generate revenues, deflation points to persistent low aggregate demand coupled with some improvement in the supply of goods and services. It is also expected that humanitarian and basic service support will decline compared to 2022, and there will be no on-budget development assistance. Further, it is assumed that the ITA maintains internal cohesion and continues with the current conservative policy positions on gender and inclusivity. The financial sector remains constricted, and the central bank lacks the policy instrument to influence domestic demand.

Under the baseline scenario, the economy will hover around no-growth territory. Poor economic conditions resulting from deflation may cause private sector hesitation to invest, leading to layoffs in the short- to medium-term. As a result, there may be persistent unemployment and underemployment in the future. In addition, an appreciated and overvalued exchange rate may dampen exports and increase imports, weakening the struggling domestic industry. The economy requires significant external support to offset the negative impacts of the shock as it lacks an internal growth engine to support recovery. In a baseline scenario with limited humanitarian and basic service aid compared to 2022, the economy is projected to remain stagnant at best, with a wide confidence interval skewed towards the downside. Per capita income will decline due to an increasing population. Under this scenario, poverty is likely to remain high, and vulnerability to falling into poverty is a genuine concern until the economy can find new indigenous sources of growth that address unemployment and job quality challenges. Acknowledging the negative growth implications of ITA's restrictive policies on women's education and work is important.

This outlook is subject to significant downside risks. These include (i) a further decrease in demand for goods and services due to expected lower prices; (ii) the potential discontinuation of or reduction in aid due to fiscal pressures in donor economies and potential donor fatigue; (iii) a potential cessation of US$ cash shipments for humanitarian and basic service support which could cause problems with the exchange rate and undo some of the progress made; (iv) banking concerns related to payment resolution challenges, a forced transition to Islamic banking, and the inability of the central bank to manage domestic liquidity and undertake critical functions, including supervising the banking sector, monitoring illicit financial flows, and performing AML/CFT monitoring; and (v) potential climate events such as droughts which could hurt the agricultural sector. The country is also ill-prepared to face climate challenges, and large segments of people's livelihood, mainly in rural areas, remain vulnerable to weather shocks. If these risks materialize, the projected GDP path will shift downwards, potentially creating negative regional and global spillovers and pushing more people into deprivation and food insecurity.

1. RECENT ECONOMIC DEVELOPMENTS IN 2022—ADJUSTING TO THE NEW REALITIES

BACKGROUND & INTRODUCTION

In August 2021, a political crisis caused fear and uncertainty, eventually leading to an economic crisis. Skilled individuals left the country, businesses shut down, and government servants stopped receiving salaries. Essential public services were disrupted, development spending was abruptly ended, and the central bank's foreign asset freeze resulted in a loss of confidence in the banking sector. Depositors withdrew their deposits, correspondent banking relations were severed, and the supply chain was disrupted alongside a decline in demand.

After a sharp decline, some macroeconomic and social indicators in 2022 stabilized at a fragile new low-level equilibrium. Beginning in the summer of 2022, macroeconomic indicators stabilized at low levels due to improved law and order, eased supply constraints, and substantial international aid, including cash shipments of US dollars for humanitarian and basic service support. The ITA has begun paying public servants based on salary grades that have been revised downward, and the year 2022 witnessed a significant expansion in international trade, which even reached a historic high in exports. Although imports initially decreased due to the suspension of foreign aid, these increased later as US$ cash shipments for humanitarian and basic service support started arriving in the country. The AFN began to recover after a significant depreciation during Q4-2021. Initially, inflation rose due to supply chain disruptions, but it sharply declined after peaking in July 2022, as demand remained suppressed and supply constraints eased. Despite the crisis, the ITA managed to collect revenues at a level like the ones obtained before it. Although household welfare slightly improved by the summer of 2022 compared to the end of 2021, most of the population remained poor and deprived. Although some businesses began operating again by the summer of 2022, they were operating below their full potential. Banks began their operations, providing basic banking services, while the sharp decline in deposits has been halted. Nevertheless, the international payment system remained disrupted.

During 2023, some of the downside risks identified in last year's ADU materialized, impeding Afghanistan's economic recovery and heightened uncertainty for the future. The GDP during 2022 contracted further, and per-capita income deteriorated due to high population growth. The ITA's policies on women's education and employment remain restrictive, negatively impacting Afghanistan's growth prospects. The financial sector remains constricted, and AFN currency notes are in short supply, with most payments processed through the informal Hawala system. The general price level fell steeply, and since April 2023, the country has been facing deflation. These price dynamics likely stem from the economy adjusting to a structurally lower aggregate demand level, albeit recovering supply, leading to a bleak economic outlook. The AFN has appreciated significantly since the beginning of 2023, putting additional stress on the domestic tradeable sector. Despite conflict ceasing, one in two Afghans remain poor, and recent gains in welfare have come at the cost of possibly exhausting all coping strategies and household resources. With further challenges of weather-related shocks, the risk of poverty deteriorating remains a genuine concern.

REAL SECTOR DEVELOPMENTS

The real sector has contracted for two consecutive years, and the economy is still adjusting downward as proxied by recent deflation.

After a severe 20.7 percent GDP contraction in 2021, the Afghan economy contracted further by 6.2 percent in 2022. The latest available data indicates that economic activity further contracted by 6.2 percent in 2022 compared to 20.7 percent in 2021 (Figure 1). Economic activity in all three sectors experienced a decline. The services sector, which contributes nearly 45 percent to the country's GDP, shrank by 6.5 percent, although this rate was much lower than the 30 percent decline observed in 2021. The agriculture sector also recorded a contraction. The services sector suffered significant losses across all subsectors. The wholesale trade (-8.9 percent), health (-5.9 percent), finance and insurance (-6.6 percent), real estate (-5.2 percent), dining and lodging (-4.2 percent), and telecommunication (-4.7 percent) sectors suffered the most significant declines.

The agricultural sector, contributing about 36 percent to GDP, contracted 6.6 percent in 2022. Widespread drought conditions and below-average precipitation significantly reduced the wheat crop. Additionally, inadequate levels of rainfall in certain parts of the country have also affected pastoralists' livelihoods, which were already struggling due to the low availability of pasture during the last two years. An extremely cold wave during the winter of 2022 resulted in the deaths of many animals, mainly due to a lack of preparedness and the eroded resilience capacity of the farmers, who lacked the necessary financial resources to ensure proper winter preparation.

The industrial sector also contracted 5.7 percent in 2022 compared to 12.8 percent in 2021. This was mainly due to the contraction of 10 percent in manufacturing (including food & beverages and non-food manufacturing). In addition, the construction sector also marginally contracted by 0.8 percent compared to a 35 percent decline in 2021. The mining and quarrying sector grew by 4.1 percent against 1.7 percent growth in 2021 due to increased extraction of natural resources – particularly coal.

Figure 1: Real GDP Growth by Sector

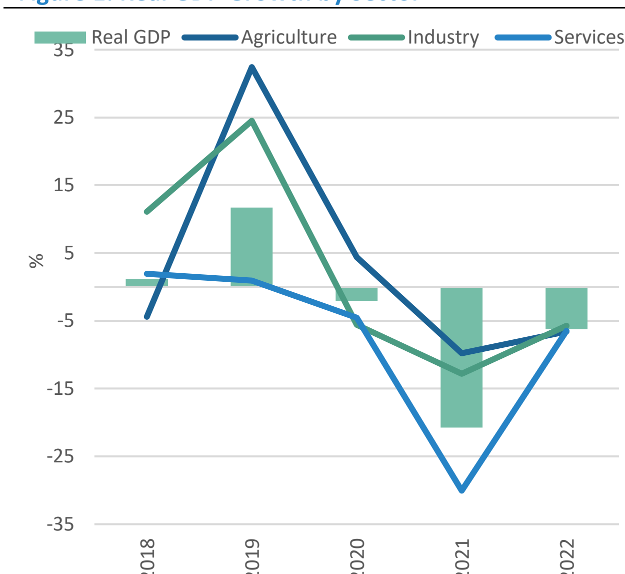
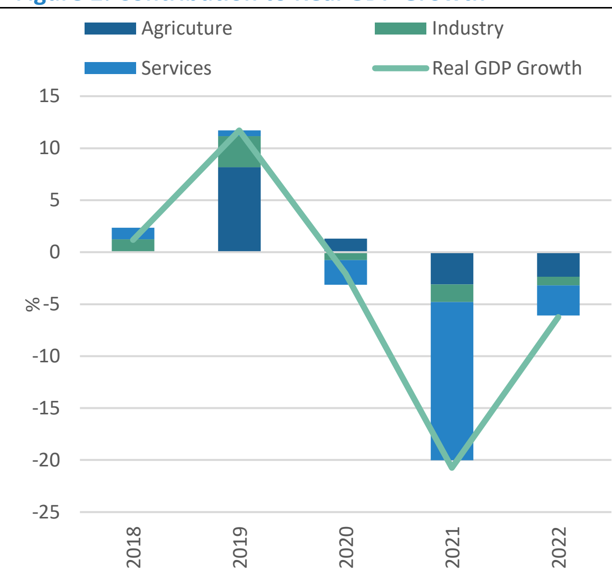


Figure 2: Contribution to Real GDP Growth



Source: National Statistics and Information Authority (NSIA)

PRICE TREND

After peaking at 18.3 percent year-on-year in July 2022, inflation sharply dropped, resulting in deflation since April 2023. This points towards continued economic weakness and depressed aggregate demand alongside better supply conditions.

The supply disruption caused a steep increase in general price levels despite a decrease in demand since August 15, 2021. The border closures after the crisis and the breakdown of the payment system caused a supply shock, which was exacerbated by elevated global commodity prices. The year-on-year headline inflation peaked at 18.3 percent in July 2022 (Figure 3, 4). Afterward, inflation decreased due to lower international commodity prices, stable exchange rates that reduced inflation pass-through, recovering supply, and structurally lower aggregate demand. After reaching 18.3 percent year-on-year in July 2022, inflation dropped sharply, resulting in deflation since April 2023. By July 2023, year-on-year inflation stands at -9.1 percent, driven by year-on-year deflation of 12.6 percent in food and 5.0 percent in non-food segments.

Both food and non-food groups contributed to the deceleration in inflation. Food inflation peaked at 26 percent year-on-year in June 2022 and fell to -12.7 percent by July 2023. Similarly, y-o-y non-food inflation declined to negative 5.1 percent in July 2023 compared to a peak of 11.6 percent in July 2022. This decline is broad-based, contributed by decreased prices of all basic food and non-food items, including bread and cereals, oil and fats, meat, spices, housing, transportation, etc. (Figure 5).

Figure 3: Headline Price Index

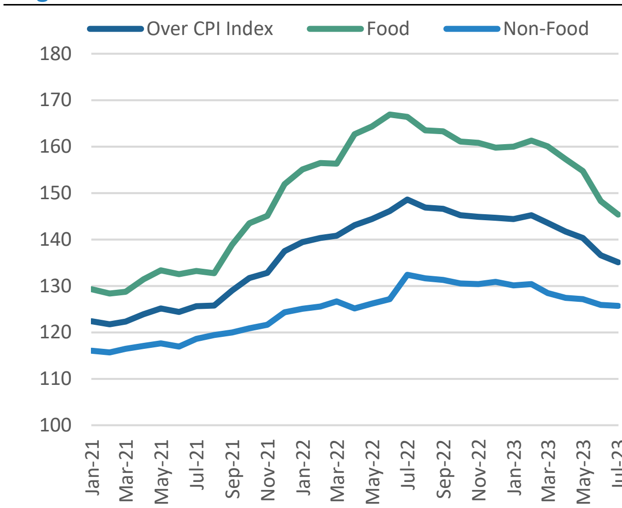
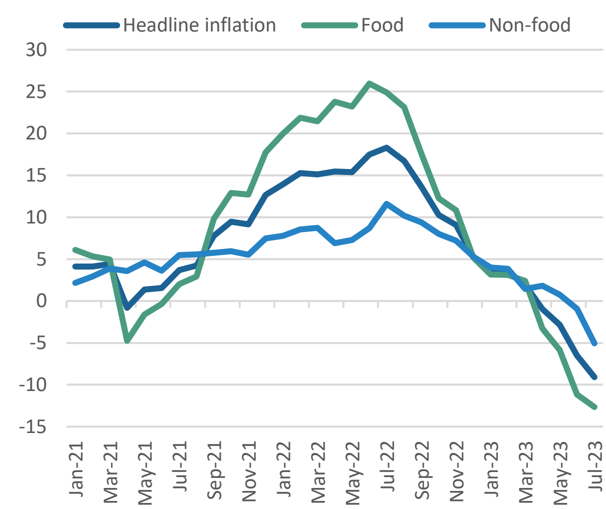


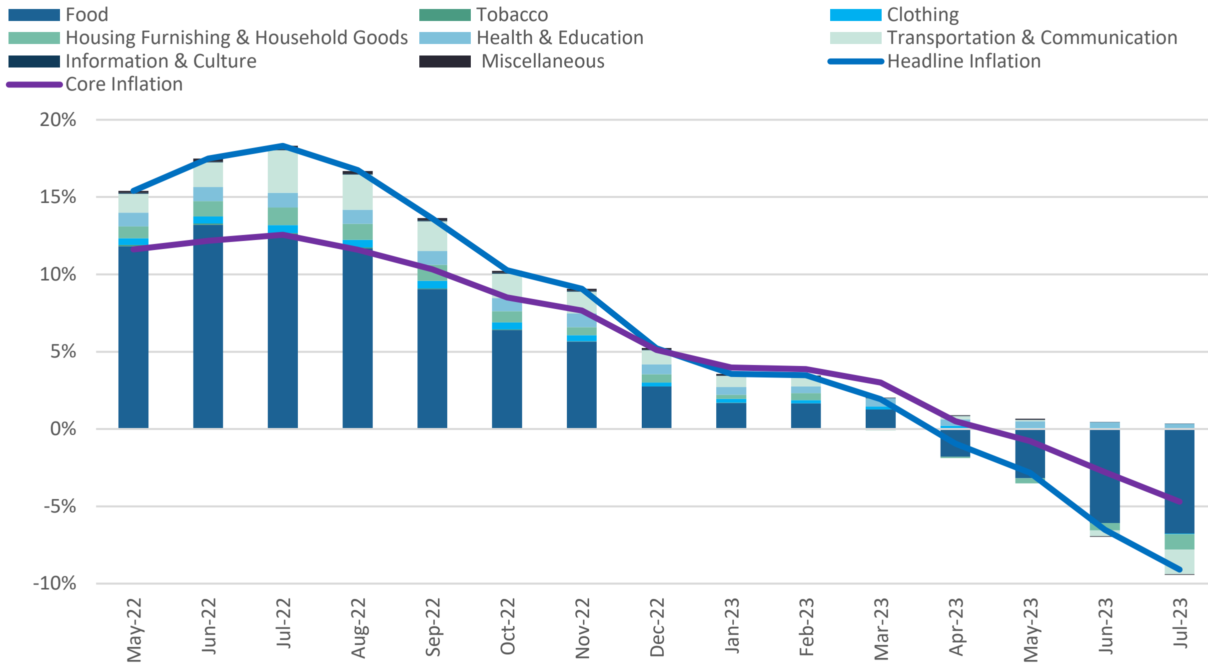
Figure 4: Headline Inflation (y-o-y)



Source: National Statistics and Information Authority (NSIA).

These price dynamics likely stem from the economy adjusting to a structurally lower aggregate demand level, improved supply conditions, and appreciating Afghani (AFN). The core inflation measure, which excludes food and energy prices, was negative at 4.7 percent in July 2023. This suggests that the overall demand for goods and services has weakened due to reduced consumer and investment spending. Anecdotes suggest that the reduction in aggregate demand could be attributed to depleted savings, reduced public spending, and shocks to farmer income from poppy cultivation bans. Moreover, the money supply is constant, so any increase in supply eventually translates into decreasing prices. The strong currency also contributes to low prices.

Figure 5: Factor Contributing to Headline Inflation

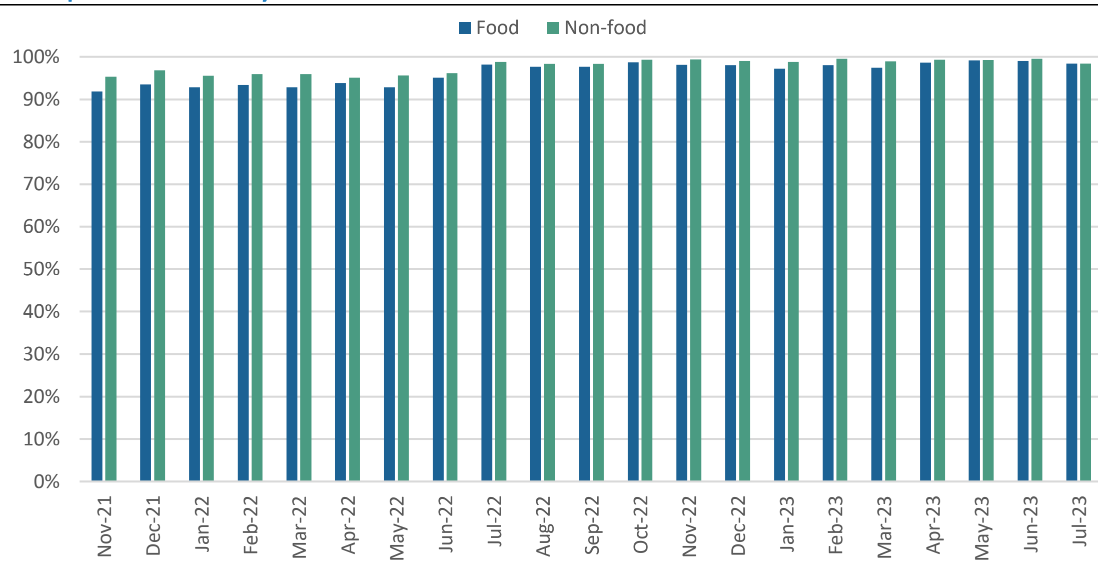


Source: National Statistics and Information Authority (NSIA) and WB staff calculations.

According to the World Bank's Third-Party Monitoring Agent (TPMA), essential food and non-food commodities remain accessible. Data gathered from 48 markets across 21 provinces affirms the widespread availability of these essential items. In July 2023, the average availability of crucial food and non-food products stood at 98 percent (

Figure 6). While improved supply conditions contributed to this availability, decreased overall demand has led to deflation, potentially hindering the country's growth and development efforts.

Figure 6: Reported Availability of Food & Non-Food Items



Source: Survey data collected by the World Bank's TPMA.

Box 1: Deflation: Good or Bad?

Since April 2023, the inflation rate in Afghanistan has turned negative, reaching -9.1 percent as of July 2023, driven by deflation of 12.7 percent in food and 5.1 percent in non-food items. Deflation refers to a decrease in the general price level, quite different from disinflation, which refers to a deceleration in price hikes. While disinflation is good for the economy despite short-term output loss, deflation may prove harmful.

Deflation can have both positive and negative effects on the economy, and its impact depends on various factors, including the severity and duration of the deflationary period, the underlying causes, and the overall economic conditions. For example, deflation may be caused by favorable aggregate supply conditions like technological advances – a recent phenomenon in Switzerland. Favorable supply conditions drove deflation in the Swiss economy, while demand didn't decrease as foreigners' demand for tourism services increased. However, the Afghan economy is experiencing deflation not because of technological expansion, and it has no such sector as tourism that attracts foreign demand. Therefore, the costs of deflation may outweigh the benefits in Afghanistan. The validity of this claim hinges on the duration of the ongoing deflation. While an initial decrease in overall prices may be attributed to improved supply, extended deflation indicates a sustained reduction in demand. Therefore, as long as deflation persists in Afghanistan's economy, there will continue to be potential for negative impacts.

Deflation has a first-round beneficial effect on the economy as purchasing power increases, led by a decrease in the prices of consumable items. Such an increase may help households increase their consumption, helping them improve their welfare. Moreover, households living below the poverty line can come out of poverty as they can afford high consumption with limited resources. However, such benefits never last longer, and a drag on economic activity led by deflation ultimately outweighs the first-round benefits. There are many reasons why this sequence happens.

First, deflation increases the real debt burden, with distributional consequences that unduly favor lenders at the expense of borrowers. When prices fall, the real value of debt rises, making it more difficult for individuals and businesses to repay their loans for their basic needs, operations, capital purchases, homes, and personal property. Deflation increases the actual worth of the debt that households, businesses, and governments must repay. This reduces their spending capacity, reducing the overall demand and contributing to deflationary pressures. Borrowers attempting to reduce their debt burden engage in distress selling to raise money for repaying debt. The debt-deflation cycle leads to depression in economic activity, as happened in the Great Depression of the 1930s and the Global Financial Crisis of 2006-09.

Second, deflation can lead to a self-perpetuating cycle where falling prices cause consumers and businesses to delay spending and investment in the hope of even lower prices in the future. This can lead to a further decline in demand, lower production, and higher unemployment. Japan faced deflation starting in the 1990s, followed by a severe contraction of economic activity. Falling prices can lead to shrinking profit margins, business failures, and resulting unemployment, further reducing purchasing power, so prices, output, and demand continue to spiral downward.

Third, the first-round beneficial impact on purchasing power dissipates as lower demand for consumption and investment results in a contraction of economic activity, leading to lower demand for labor. This stops nominal wages from increasing while making many lose their jobs. For instance, a 2021 KOF Swiss Economic Institute study finds that deflation and wage rigidities lead to lower incomes and higher unemployment. In such a situation, deflation deteriorates welfare. This may push many people below the poverty line, especially those living just above the poverty benchmark, and lose their jobs due to lower business activity.

Finally, deflation can harm fiscal accounts mainly due to increased spending. Tax revenues tend to decline during deflation, while some spending components are inflexible nominally. Reducing wages and social transfers when prices are falling is challenging, as freezing nominal expenditure often becomes the only viable option during deflation, resulting in a higher share of spending in GDP. In summary, historical trends suggest that we can expect a decline in the primary balance during the ongoing recessionary deflation in the economy.

References

Bordo, M. D., Landon-Lane, J., & Redish, A. (2004). Good versus bad deflation: lessons from the gold standard era. NBER Working Paper 10329.

Brooks, D. H., & Quising, P. F. (2002). Dangers of Deflation. ERD POLICY BRIEF SERIES: Economics and Research Department (Number 12).

KOF (2021). Do deflation and rigid wages harm the economy? The importance of wage rigidity for monetary policy. KOF Swiss Economic Institute.

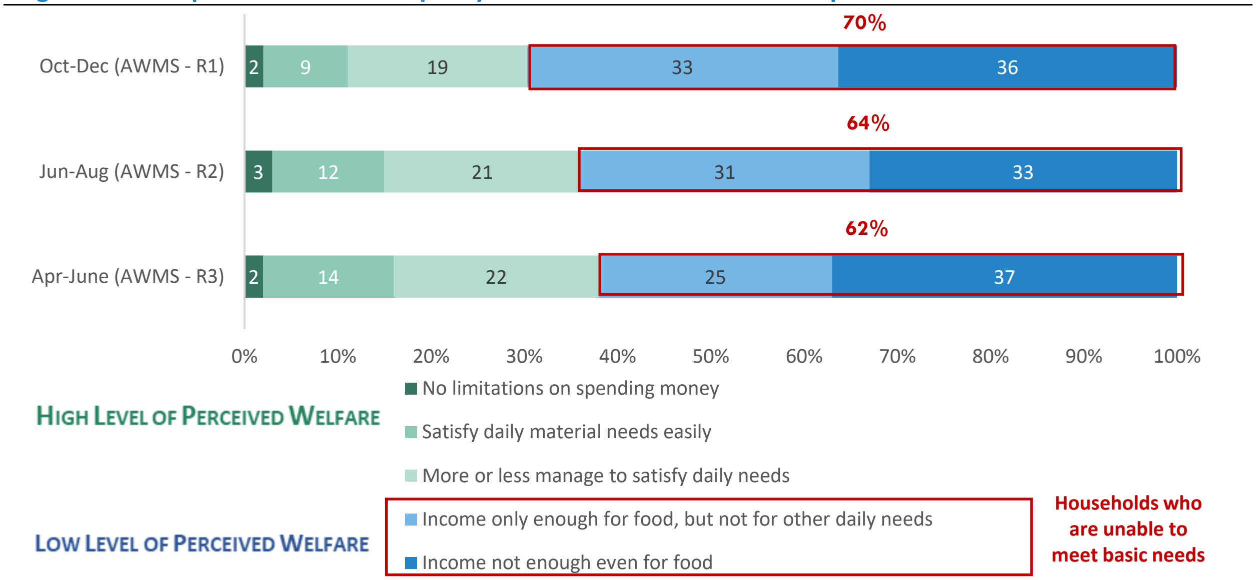
Mishkin, F. S. (2012). The Economics of Money, Banking, and Financial Markets: The Business School Edition. Pearson Higher Ed.

HOUSEHOLD WELFARE AND POVERTY:

Despite recent improvements in household welfare driven by favorable wage and price dynamics, poverty and vulnerability remain high. Afghan households have mobilized extra labor to cope with the economic contraction, but the increase in labor supply has sizably outpaced a slacking demand, resulting in higher unemployment and underemployment.

Afghan households report a progressive improvement in welfare, although the levels of deprivation and vulnerability remain high. Analysis based on the first three rounds of the Afghanistan Welfare Monitoring Survey (AWMS) shows evidence of a progressive, albeit small, improvement in the welfare of Afghan households compared to the months immediately following the Taliban takeover. While in the period between October to December of 2021, 70 percent of households reported lacking enough income to satisfy basic needs, this percentage reached 64 percent during the June to August 2022 follow-up and experienced an additional reduction to 62 percent in the latest measurement between April and June 2023 (Figure 7). Similarly, the share of households reporting crisis levels of acute food insecurity declined from 50 in the fall of 2021 to 44 percent in the summer of 2022 to 40 percent in the spring of 2023.

Figure 7: Self-reported household capacity to cover food and non-food expenses.



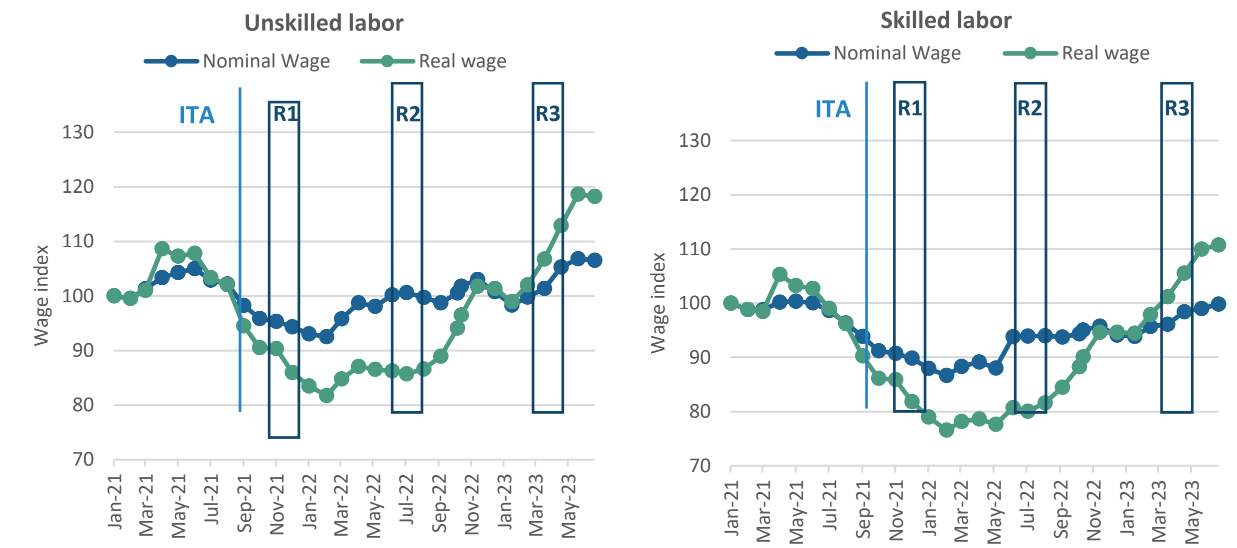
Source: Data from Afghanistan Welfare Monitoring Surveys: Round 1 (Oct-Dec 2021), Round 2 (Jun-Aug 2022), Round 3 results (April-June 2023).

Increasing wages and recent deflationary dynamics likely drive the observed improvement in Afghan households' capacity to satisfy basic needs. As shown in Figure 8, during the first six months immediately following the Taliban takeover, nominal wages of both unskilled and skilled workers contracted significantly, with negative consequences on household welfare further compounded by inflationary pressure eroding their purchasing capacity. After this initial crisis phase, captured in R1 of AWMS, nominal wages have started to recover to their pre-crisis levels, with progress in real wages further accentuated by a decline in headline inflation in the summer of 2022. Data from R2 of the AWMS conducted in the summer of 2022 indicate that the total annual dollar value of international remittances reaching Afghan households doubled compared to 2019.[1] In addition to remittances, the inflow of humanitarian aid, whose

[1] Unfortunately, no information on international remittances was included in R1 and R3 of the AWMS survey.

level in 2022 matched that of civilian development assistance recorded in 2019, is likely to have contributed to economic stabilization.[2] These developments are reflected in the improvement in Afghan households' welfare captured in R2 of the AWMS. The sustained negative inflation rate since April 2023 has further increased the value of real wages for both skilled and unskilled workers above pre-crisis levels, supporting the further advancement in household welfare captured in R3 of the AWMS.

Figure 8: Trends in nominal and real wages, unskilled and skilled labor



Source: WB staff calculation based on WFP food monitoring data

Despite conflict ceasing, one in two Afghans remain poor, and recent gains in welfare have come at the cost of possibly exhausting all coping strategies and household resources. The latest (fully completed) Income, Expenditure, and Labor Force Survey (IELFS) conducted by the National Statistics Information Authority (NSIA) in 2019–20 indicates that half of the Afghan population was already living in poverty before the Taliban takeover. Poverty projections on the latest AWMS survey indicate that the current level of monetary poverty is comparable in magnitude to the one observed in spring 2020, with 48.3 percent of the population being poor as of April-June 2023.[3] This means that half of all Afghans, or 20 million people, are currently poor (with consumption levels below the national poverty line) in a country where conflict has largely ceased, and households have already done their best to cope by mobilizing available resources.

Afghan households have coped with the crisis by increasing the labor supply, but labor demand is slacking, with unemployment and underemployment on the rise. Male labor force participation (LFP) increased from 69 percent in Apr-Jun 2020 to 86 percent in the same period in 2023, with the increase being particularly strong among young and older men. The expansion in economic activity was even more substantial among working-age women, with labor force participation increasing by a factor of three when compared to the corresponding period in 2020. The increase in economic activity among women is related to the expansion of home production, mainly small-scale and home-based manufacturing activities. Overall, the growth in labor supply has sizably outpaced a slacking demand, resulting in a

[2] In 2019, the total aid envelope included approximately US$ 4 billion in civilian development assistance, equally split between on and off-budget support. In addition, grants worth US$ 4.7 billion were spent for security. While the overall budget for civilian aid in 2022 is like what was recorded in 2019 (US$ 3.5-4 billion), all financial support is currently off-budget, and 70 percent is being spent on humanitarian support.

[3] See Box 5 for a description of the poverty estimation methodology.

doubling of unemployment and a one-quarter increase in underemployment, as proxied by the share of workers employed for less than 40 hours per week.

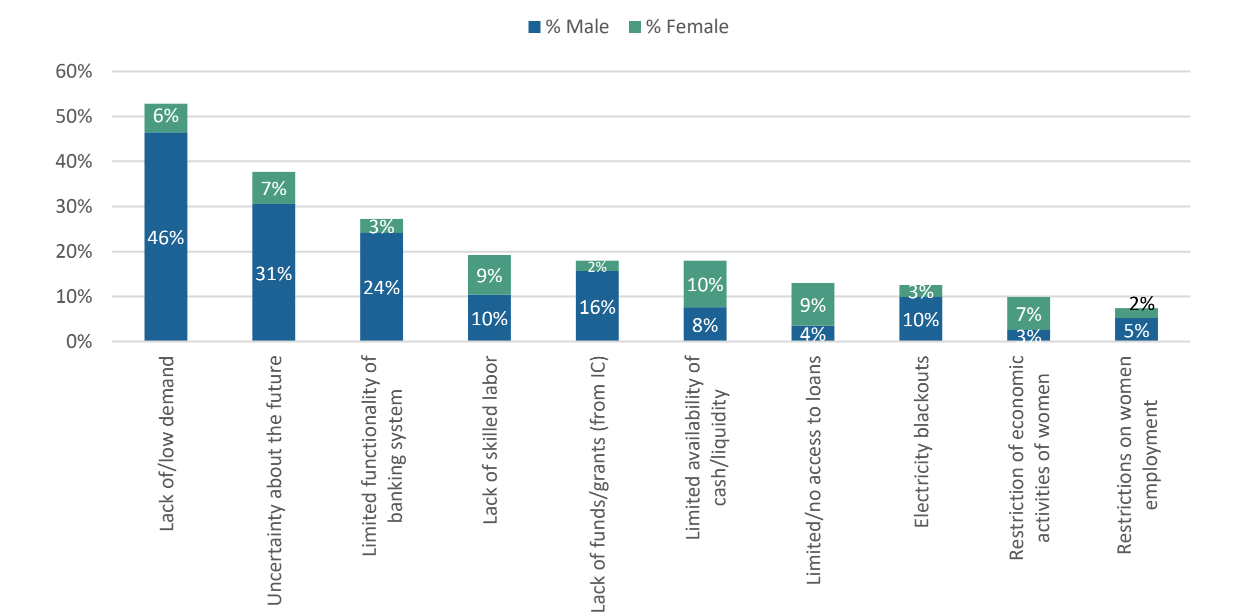
PRIVATE SECTOR DEVELOPMENTS

The private sector, especially women-owned businesses, has been struggling due to decreased demand, an uncertain future, limited banking services, and the high cost of doing business.

After the government transition in August 2021, international sanctions, talent outflow, financial sector disruptions, and global money transfers have significantly affected private sector activities. Many firms aren't operating at full capacity; just over half in the R3 of the Private Sector Rapid Survey (PSRS) report full operation, while one-third operate below capacity. Small and women-owned firms are disproportionately affected compared to larger and male-owned ones. In R3 of the PSRS, only around one-third of small and women-owned firms are fully operational, compared to 74 percent of large firms and 58 percent of male-owned firms.

Dampened demand remains the top business constraint, followed by uncertainty about the future and limited banking system functionality. The economic slowdown amid economic uncertainty and unavailability of monetary and fiscal stimulus have lowered purchasing power and dampened demand for goods and services. Uncertainty about the future and banking system challenges are also cited as top constraints. On the other hand, restrictions on women's economic activities and the limited availability of cash and liquidity remain among the main constraints for women-owned firms.

Figure 9: Top Constraints Faced by Businesses (Frequency of Responses)



Source: Private Sector Rapid Survey (PSRS).

The private businesses' confidence in the financial sector is low, and surveyed firms reported trying to avoid depositing funds into bank accounts. Although 75 percent of surveyed firms report having a corporate bank account, only 22 percent have deposited money to their accounts since August 2021. This demonstrates the limited trust placed in the formal banking sector. There is a wide variation by firm size in the use of formal banking services, with close to half of large firms (42 percent) indicating that they have made bank deposits since August 2021, compared to 17 percent of medium firms and 23 percent of small firms. In this context, firms prefer making payments in cash or through traditional *Hawala* transfers. Surveyed firms report a preference for either cash only or cash and *Hawala* in combination, citing a preference for holding cash and the lack of reliability and limitations of formal channels, including insufficient withdrawal limits. *Hawala* is the most often cited channel for international import- and export-related payments.

Nearly half (44 percent) of surveyed firms report an improvement in security, but responses vary widely by firm size and gender of the firm owner. Female-owned firms are twice as likely to report a deterioration in security compared to male-owned firms, and small firms were nearly three times more likely to report a worsening of security than large firms. Similarly, most respondents report not being required to make unofficial payments in the last year. Many surveyed firms reported that their businesses “did not have to pay any unofficial payments or bribes” while paying taxes, clearing customs, participating in public procurement, or requesting government services. Only 6 percent of firms report being required to make unofficial payments for imports and exports. An additional 11 percent of firms did not wish to answer the import question.

Firms have employed various coping strategies to mitigate the operational risks posed by the current business environment. Dialogue with the ITA to address potential issues was the tactic most employed by male-owned businesses to lessen potential revenue effects, whereas women-owned firms report having transitioned to allowing female staff to work from home. Other top survival strategies include laying off employees, shrinking investments, and increasing the use of *Hawala.* Approaching the ITA to discuss operational challenges did not typically help firms resolve those challenges. Among those who reported approaching the ITA, over half indicated their issues had not been resolved, and fewer than 10 percent reported a satisfactory resolution. Women-owned and small businesses had more difficulty engaging with the ITA and were less likely to use this as a coping strategy than male-owned and large businesses.

EXTERNAL SECTOR

Following record-high exports in 2022, monthly exports in 2023 are declining, while imports remain robust, resulting in a growing trade deficit. However, the increased imports of high-end consumption goods and industrial raw materials, including prepared food, vehicles, spare parts, stone, glassware, chemicals, and iron and steel, cannot be solely attributed to the weakened economy. Anecdotal evidence indicates that a significant portion of these increased imports is not destined for Afghanistan and is not financed through Afghanistan's forex market. This phenomenon explains the currency appreciation despite the apparent expansion of the trade deficit.

In H2-2021, political uncertainty, security issues, and financial sector disruptions caused a trade contraction. However, trade rebounded in 2022. Imports sharply declined in Q3-2021 due to reduced economic activity and financial sector problems. While exports also weakened, the larger import reduction narrowed the trade deficit. However, the situation began to improve by late 2021 and into 2022.

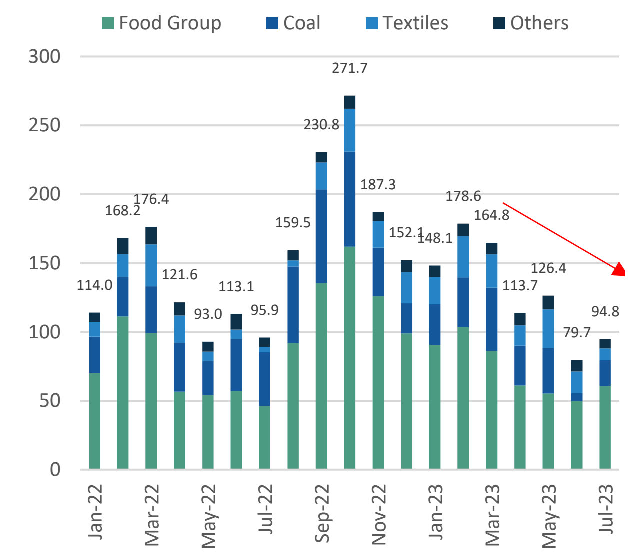
In early 2022, trade increased due to improved security and the use of informal payment channels. Unofficial customs data from Afghanistan indicates a substantial export surge in 2022, reaching US$1.9 billion, double the 2019 figure. Meanwhile, merchandise imports in 2022, at US$6.3 billion (excluding humanitarian imports), remained stable compared to 2019. Consequently, the trade deficit decreased to

US$4.4 billion in 2022, notably smaller than the US$5.9 billion in 2019. This data reflects a positive trend in Afghanistan's trade balance.

The trade deficit increased due to ongoing trade momentum in the first seven months of 2023, with a reversal of import and export trends. Merchandise exports grew moderately during Jan-July 2023, reaching US$0.91 billion, a 3 percent increase over the same period in 2022. Conversely, merchandise imports maintained strong growth during Jan-July 2023, hitting US$4.4 billion, a 32 percent increase compared to Jan-July 2022. From January to July 2023, the trade deficit was US$3.5 billion, up from US$2.4 billion during the same period in 2022.

Figure 10: Merchandise Trade Deficit (US$ Billion) – 2016-2023

Figure 11: Afghanistan Exports (US$ Million), 2022 – 2023



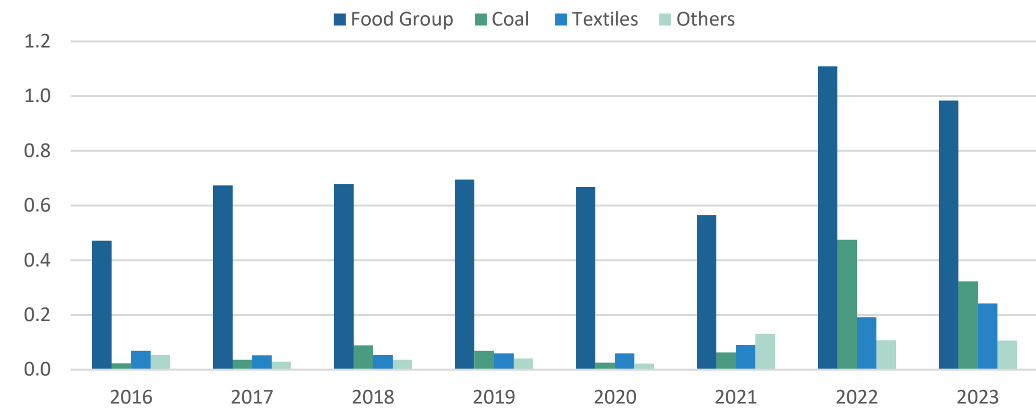
Source: NSIA for 2016 – 2021 data, ASYCUDA data for 2022 & 2023.

Merchandise Exports Performance:

Exports experienced a strong surge throughout 2022 but moderate growth in the first seven months of 2023. Merchandise exports, which averaged around US$ 0.8 billion in 2016–21 and stood at US$ 0.9 billion in 2019, increased sharply to US$ 1.9 billion in 2022. This significant increase in exports in 2022 was primarily due to the rise in food exports to Pakistan, which reached US$ 0.5 billion in 2022 (against US$ 0.16 billion in 2019), particularly in H2-2022, as the devastating floods in Pakistan created additional demand for food items. In addition, coal exports to Pakistan, which stood at US$ 476 million, represented a new source of export for Afghanistan as Pakistani importers switched to Afghan coal due to competitive pricing.

Exports in 2023 are losing momentum. The monthly export data indicates a decline in trend since February 2023. Unofficial customs data for Jan-Jul 2023 reveals exports reached US$ 0.91 billion, a three percent rise from the same period in 2022. Data from customs authorities show that exports of vegetable and fruit products (51 percent share in overall exports), coal (22 percent share), and textiles (16 percent share) remain the main drivers of overall exports – collectively contributing about 90 percent to total exports. During Jan – July 2023, textile exports (grew by 49 percent) mainly contributed to the moderate growth in overall exports, followed by food exports (2 percent growth). In contrast, coal exports declined by 12 percent during Jan-July 2023.

Figure 12: Exports - by Sectors (US$ Billion) 2016-2023



Source: NSIA for 2016 – 2021 data, ASYCUDA data for 2022 & 2023.

Food remains the major export group in Afghanistan's merchandise trade. The food group exports amounted to US$ 1.1 billion in 2022— double the average exports in 2016-21 (US$ 0.63 billion). During 2022, food group exports surged significantly by more than 60 percent after declining in 2020 and 2019. Out of the food group exports, vegetables and fruits contribute 68 percent– increasing from an average of US$ 0.42 billion during 2016-20 to US$ 0.76 billion in 2022. Other food items include resins and other vegetable extracts; coffee, tea, maté, and spices; and oil seeds and oleaginous fruits, which have significantly increased to US$ 0.3 billion in 2022 compared to the 2016–20 average of US$ 0.2 billion. Moreover, Afghanistan's exports of prepared foodstuffs have risen recently, with a value of US$ 42.2 million in 2022, up from an average of US$ 3.2 million for 2016–20. After a decline of 95 percent from 2016 to 2021, cereal exports increased substantially in 2022, particularly cereal exports to Pakistan (60 percent of total cereal exports). During Jan-July 2023, the food group exports reached 0.5 billion – a slight increase of 2 percent compared to the same period in 2022. The food exports remained moderate in recent months of 2023, mainly due to a decline in food exports to Pakistan.

Figure 13: Food Group Exports (US$ Million): 2016-2023

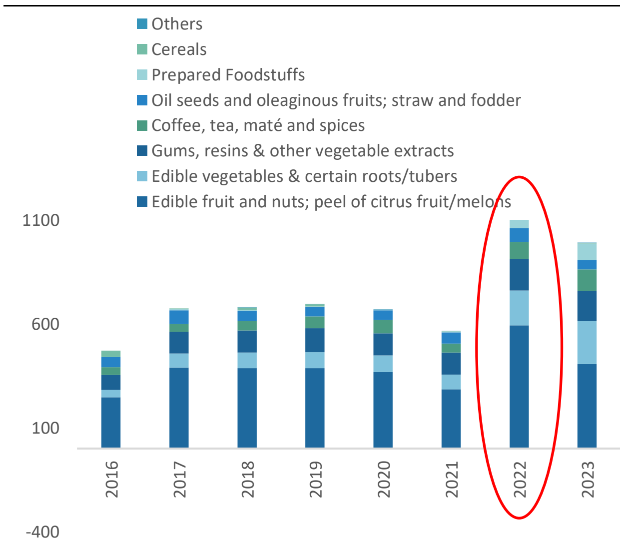
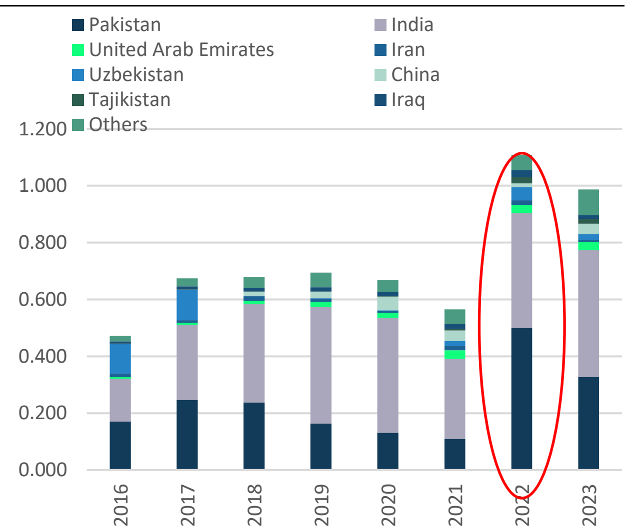


Figure 14: Food Exports by Destinations (US$ Million): 2016-2023



Source: NSIA for 2016 – 2021 data, ASYCUDA data for 2022 & 2023.

Coal exports from Afghanistan significantly increased in 2022 as Pakistani importers switched to cheaper Afghan coal but have since declined during 2023. Over the years, the coal exports remained moderate –average exports remained at US$ 49 million over 2016-20. However, coal exports have risen exponentially since Q4-2021 and reached US$ 476 million in 2022 (Figure 15), of which 99 percent of coal was exported to Pakistan. The favorable price differential of Afghan coal compared with international coal primarily contributed to this significant increase in demand. While coal remains one of the major export items in Jan-July 2023, reaching 198 million, it declined compared to US$ 226 million in Jan-July 2022. Anecdotal evidence suggests that Pakistani importers are reverting to their traditional suppliers due to the decreasing price difference between Afghan and international coal.

Cotton and cotton yarn exports also recorded an increase among textile exports. Cotton and cotton yarn (76 percent of total textile exports) increased substantially in 2022 and reached US$ 146 million, compared to US$ 49 million in 2021 and an annual average of US$ 19 million for 2016-20. The trend continued in recent months of 2023; cotton exports reached US$ 120 million during Jan-July 2023 compared to US$ 68 million during the same period in 2022 (Figure 16). This increase is mainly due to a significant rise in cotton exports to Pakistan (98 percent share in total cotton exports) due to low cotton production in Pakistan during the first half of 2023.

Pakistan and India have been Afghanistan's prime markets for food exports since 2016. Food exports to Pakistan reached US$ 0.5 billion in 2022 (against the 2016–21 average of US$ 0.17 billion). Anecdotal evidence suggests that the devastating floods in Pakistan caused a significant additional demand for Afghanistan's food exports – particularly for edible fruits and vegetables. After H2-2022, the food group exports to Pakistan sharply declined by 53 percent, reaching 0.18 billion from January to July 2023. Food exports to India reached US$ 0.4 billion in 2022 (against an average of 2016-20 exports of US$ 0.3 billion). It reached US$ 0.2 billion during Jan-July 2023, with India's share in total food export reaching 42 percent, becoming Afghanistan's most prominent food importer during Jan-July 2023. Furthermore, new (albeit small) markets are opening for Afghanistan's food exports, including the United Arab Emirates, Uzbekistan, Tajikistan, Iran, and Iraq.

Figure 15: Coal Exports (US$ Million): 2016-2023

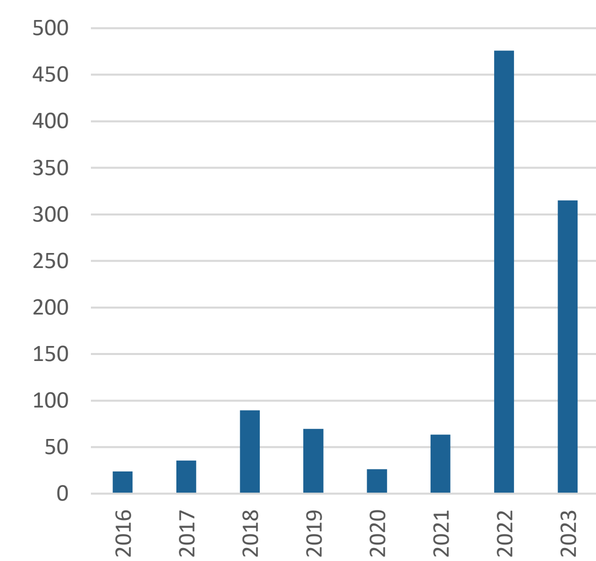
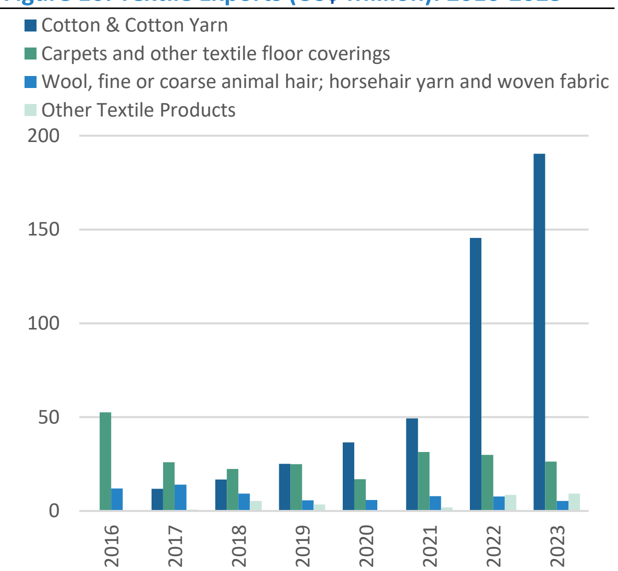


Figure 16: Textile Exports (US$ Million): 2016-2023

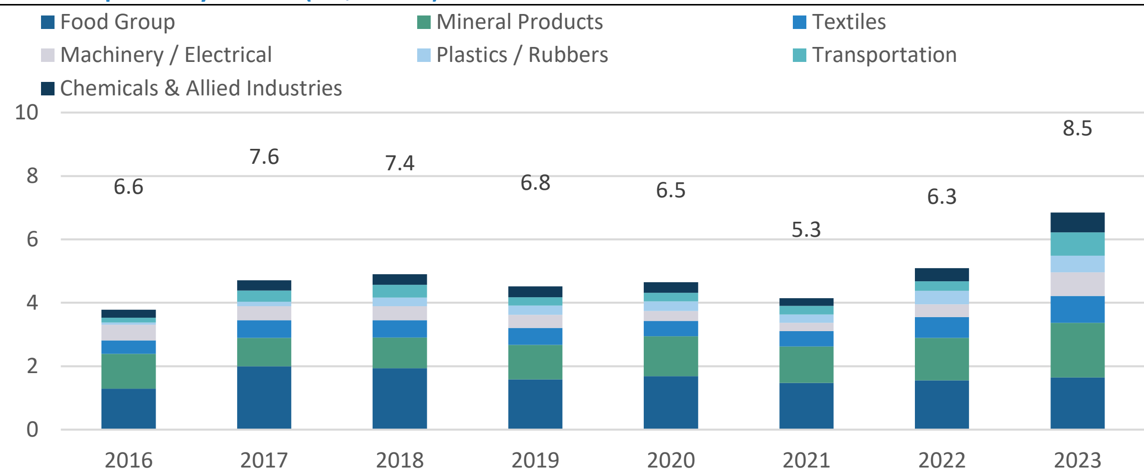


Source: NSIA for 2016 – 2021 data, ASYCUDA data for 2022 & 2023.

Merchandise Imports Performance:

Imports reached US$ 6.3 billion in 2022, a notable increase from the previous year's imports of US$ 5.3 billion but a decline from US$ 6.8 billion in 2019.[4] Merchandise imports remained strong in the first seven months of 2023 and reached US$ 4.4 billion, representing a 32 percent Y-o-Y growth over the same period in 2022. The import growth occurred despite the contraction in economic activity, as GDP was down by 6.2 percent in 2022. This negative correlation, coupled with the appreciation of Afghani, points to the inflow of foreign currency not shown in any official record.

Figure 17: Imports - By Sectors (US$ Billion) - 2016-2023



Source: NSIA for 2016 – 2021 data, ASYCUDA data for 2022 & 2023.

Imports have surged across nearly all categories. During 2022 and 2023, imports, including textiles, prepared food, vehicles and parts, tires, stone and glassware, and chemicals and allied industries, nearly doubled compared to the average from 2016 to 2020. This increase in imports is not consistent with the country's challenging economic situation (Box 2). Food imports, constituting 21 percent of total imports, amounted to US$ 1.6 billion in 2022 and reached US$ 0.93 billion in the first seven months of 2023. Vegetable imports, mainly onions and tomatoes, increased by 31 percent from January to July 2023 compared to the same period in 2022. Imports of minerals, mainly fuel & mineral oils, increased by 27 percent in 2022 from an average of US$ 1.06 billion during 2016-20, reaching US$ 1.35 billion in 2022 and US$ 0.91 billion during Jan-July 2023. Imports of salt, sulfur, cement, and plastering material have also increased since 2020. Textile imports grew by 29 percent in 2022, from an average of US$ 0.51 billion during 2016-20 to US$ 0.65 billion in 2022 and US$ 0.45 billion during Jan-July 2023.

[4] The combined impact of subdued domestic demand in the context of political uncertainty, reduced reliance on imported grains due to recovery in the agricultural sector, COVID-19-induced economic contraction, and cessation of international aid and trade disruptions following the Taliban takeover on August 15, 2021, has translated into a 30 percent drop in imports from 2017 to 2021.

Figure 18: Food Import (US$ Million): 2016-2023

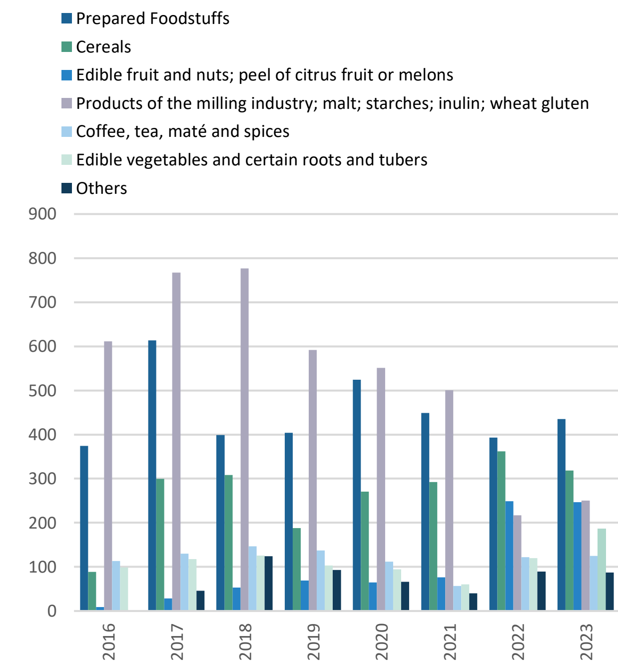
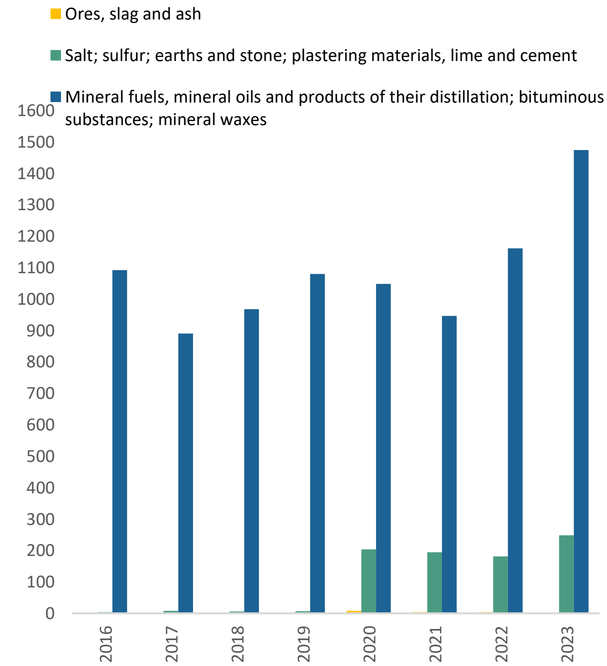


Figure 19: Mineral Import (US$ Million): 2016-2023



Source: NSIA for 2016 – 2021 data, ASYCUDA data for 2022 & 2023.

Iran has been the most significant import origin country. Over the years, the imports from Iran have steadily increased and reached US$ 1.4 billion in 2022 (accounting for 22 percent of total imports) from the 2016–21 average of US$ 1.1 billion (16 percent share). Mineral products, mainly fuel imports, accounted for 44 percent of Iran's total imports in 2016-22. Similarly, food imports reached US$ 0.22 billion (16 percent) in 2022—double the average imports in 2016–21 (US$ 0.09 billion). From January to July 2023, Iran accounted for a 21 percent share in imports. China and Pakistan also have consistently been among the most significant trading partners. On average, China and Pakistan accounted for 15 percent and 14 percent of total imports from 2016-2022. The total imports from China reached US$ 1.05 billion in 2022 – mainly comprising textiles, machinery/electrical, and plastics/rubber products. Imports from Pakistan reached US$ 1.06 billion in 2022 – primarily consisting of food and chemical products (particularly pharmaceutical products.

The UAE's share of Afghanistan's imports significantly increased from an average of 2 percent in 2016–21 to 13 percent in 2022. The import of transportation[5], prepared foodstuff[6], and machinery/electrical items[7] were the main contributors to the substantial increase in imports from the UAE. As explained in Box 2, it seems that most of these imports are not for domestic consumption, and explain the puzzling relationship between high imports and depressed economic situation. As On the other hand, Uzbekistan was one of the largest Afghan importing partners in 2016, accounting for 31 percent of Afghanistan's total imports. However, imports from Uzbekistan have been declining since 2016, reaching 4 percent of Afghanistan's total imports in 2022.

[5] Transportation imports increased from a 2016–21 average of US$ 7 million to US$ 191 million in 2022.
[6] Food imports increased from a 2016–21 average of US$ 29 million to US$ 110 million in 2022.
[7] Machinery/electrical items imports increased from an average of US$ 6 million to US$ 124 million in 2022.

Figure 20: Afghanistan Imports - By origin (US$ Billion): 2016-2022

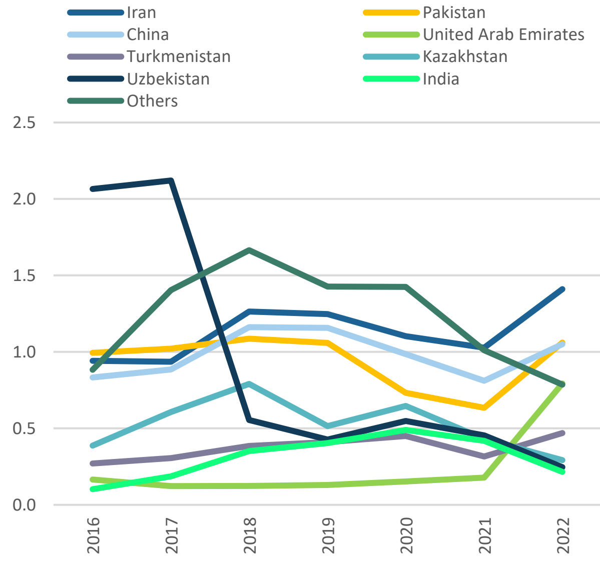
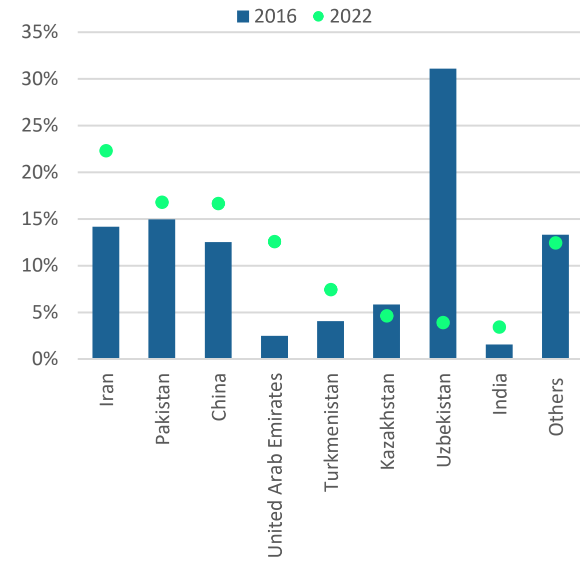


Figure 21: Share in Total Imports - By Origin: 2016-2022



'*Source:* NSIA for 2016 – 2021 data, ASYCUDA data for 2022 & 2023.

Box 2: The Import Puzzle

It's puzzling that the Afghani (AFN) has been appreciating against major currencies despite the country's widening trade deficit. In 2022, the trade deficit reached US$4.45 billion, which was partially covered by UN shipments of US$1.8 billion and an estimated US$1-1.2 billion in remittances from Afghanis working overseas. However, this still leaves a gap of US$ 1.5 billion for 2022 and an additional projected gap of US$1 billion between January and July 2023 that won't be covered by UN shipments and estimated remittances. Despite these financial challenges, the AFN has been steadily appreciating against major trading currencies since the start of 2023. By August 24, 2023, the AFN-to-US$ rate was 83.1, marking a 3.7 percent increase since August 15, 2021. It's unclear how the AFN can be appreciating while the external deficit widens, as official data and economic theory can't offer a clear explanation.

The unusual relationship between imports and the economic situation of Afghanistan may have a possible explanation for the currency puzzle. In 2022, imports of various products, such as textiles, prepared food, vehicles and parts, tires, stone and glassware, and chemicals, have nearly doubled compared to the average from 2016 to 2020. The value of these imports has also increased by 157 percent compared to a counterfactual value. However, the country's GDP and industrial output in US$ have declined by 26 percent since 2020, and the services sector output dropped by 46 percent. The substantial increase in imports of industrial inputs like base metals and chemicals is inconsistent with the decrease in industrial output. Furthermore, importing high-end consumption goods based on purchasing power does not match the current situation in Afghanistan, where two-thirds of households experience significant deprivation and businesses operate below capacity due to low demand.

There may be an explanation for this puzzling situation based on anecdotal evidence. In 2022, Pakistan implemented measures to reduce imports during its Balance of Payments crisis, including limiting letters of credit for importers. This caused shortages of imported goods. However, while imports decreased, the Pakistani Rupee depreciated in the open market, which is the opposite of what happened in Afghanistan, where the AFN appreciated. According to sources and market insiders, many goods imported into Afghanistan ended up in the Pakistani market instead of being consumed domestically.

The value of AFN did not depreciate despite the increased trade deficit, as it was partly financed through the Pakistani forex market. Interestingly, if Afghanistan's imports had dropped in line with the GDP contraction, items listed in Table 1 would have been approximately US$1 billion lower. This amount could increase to between US$1 to US$1.5 billion if additional imported items were included in the analysis. This explains a significant portion of the trade deficit that is not accounted for by remittances and UN shipments.

Table 1: Country's Imports that do not Align with Economic Situation

	2016-2020	2022			2023	
	Average	Actual	Counter-factual [a]	Increase over Counter-factual	Actual [b]	Increase over Counter-factual
Textile	268.8	611.1	202.9	408.1	601.4	398.5
Prepared Foodstuff	98.5	218.8	74.4	144.4	213.8	139.5
Vehicles and parts	153.7	246.3	116.1	130.2	354.5	238.5
Base Metal	20.6	135.6	15.6	120.0	161.4	145.9
Stone & Glass	2.7	42.1	2.0	40.0	32.0	30.0
Chemicals and Allied Industries	314.2	410.2	237.3	172.9	422.7	185.4
Sum	**858.5**	**1663.9**	**648.2**	**1015.7**	**1785.9**	**1137.7**
GDP	18905.8	14276.3			14276.3 [c]	

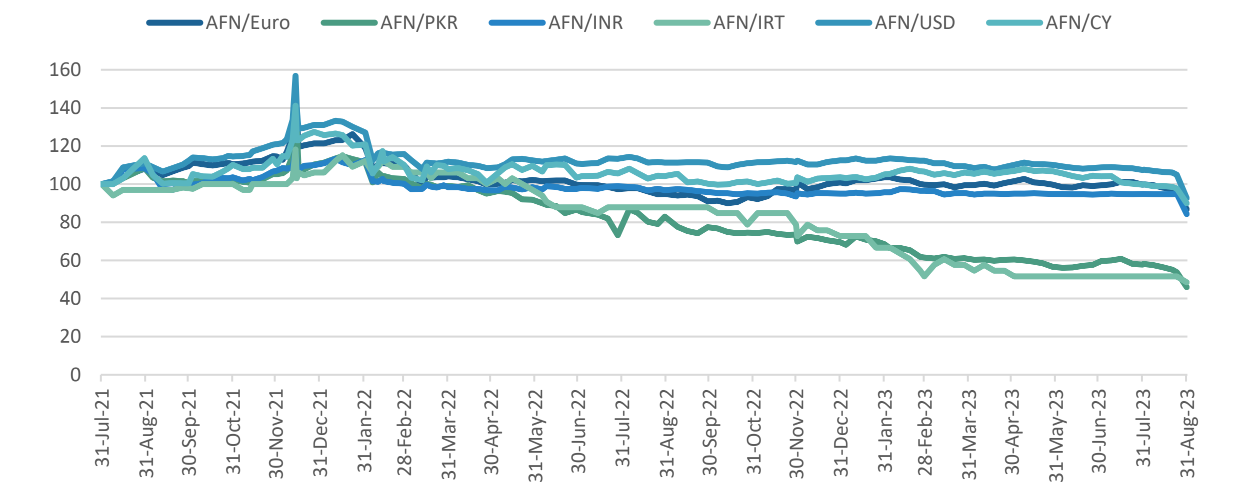
a Counterfactual scenario, where imports decline at the same rate as GDP contraction.
b All values for 2023 are extrapolated for the whole year based on available data for the first seven months.
c Consistent with the economic outlook.
Note: The detailed table is attached as Annexure-I.

Source: NSIA for 2016 – 2021 data, ASYCUDA data for 2022 & 2023. Bank staff calculations

Exchange Rate Dynamics:

Despite a higher trade deficit, AFN is appreciating. The foreign exchange market seems in balance, as there is no evidence of a parallel exchange market. This suggests the availability of unidentified external financing sources to bridge the forex market gap arising out of the widening trade deficit. As previously stated, it appears that a significant amount of imported goods is not intended for domestic consumption and not paid from Afghanistan's forex market and accounts for a significant portion of the trade deficit that cannot be explained by the inflow of remittances and US$ shipments. Between the start of CY2023 and August 24, 2023, the AFN appreciated against major trading currencies. It rose by 41.2 percent against the Iranian toman, 29.3 percent against the Pakistani rupee, 7.3 percent against the US dollar, 6.0 percent against the Chinese yuan, and 4.9 percent against the Euro. It remained stable against the Indian rupee. By August 24, 2023, the AFN-to-US$ rate was 83.1, marking a 3.7 percent increase since August 15, 2021. In addition to unidentified external flows, the AFN's gains partly stem from the ban on foreign currencies for domestic transactions, limited domestic money supply, higher remittances, and UN dollar shipments. In 2023, UN inflows were around US$1.12 billion, complementing the US$1.8 billion received in 2022.

Figure 22: AFN Movements against Major Currencies



Source: Da Afghanistan Bank (DAB).

FISCAL SECTOR

Inland revenue receipts are underperforming due to the weak economic situation, with the ITA heavily reliant on import-related revenues, which are vulnerable to import slowdowns. Expenditure patterns in 2022 have notably shifted towards security compared to 2019. Based on the budget information gathered from various news sources, there are credibility concerns regarding the FY2023 budget.

I. Broad Fiscal Aggregates

i. Revenue Trends

Total revenues in Afghanistan fell from AFN 396.2 billion in 2019 to AFN 193.9 in 2022 (Figure 23**).** In 2019, the grants at AFN188.9 billion accounted for close to half of the revenue budget. With on-budget grant revenues falling to nil in 2022 (Figure 24), domestic revenue accounted for 100 percent of total revenues at AFN 193.9 billion, leaving the fiscal envelope at 49 percent of 2019 levels. There has also been a shift in the revenue base from domestic sources collected by the Afghanistan Revenue Department (ARD) to revenues collected at the border by the Afghanistan Customs Department (ACD). In 2022, the share of the revenue from ACD at 55.7 percent was significantly higher than its share in 2019 at 38.2 percent (Figure 25). Revenue from customs is now 136 percent of 2019 levels, while revenue from ARD is 67 percent of 2019 levels (Figure 26). However, domestic revenue collections at 94 percent of the 2019 levels tend to stabilize in nominal terms.

Figure 23: Total Revenue Incl. Grants and Total Expenditure

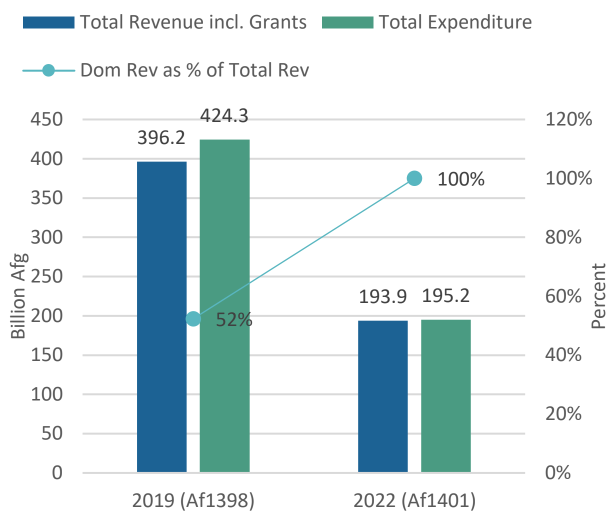
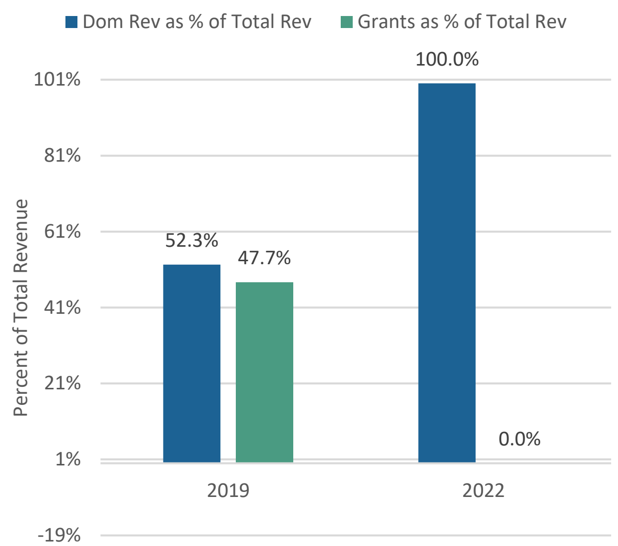


Figure 24: Composition of Total Revenue



Source: AFMIS, Ministry of Finance.

Figure 25: Composition of Domestic Revenue

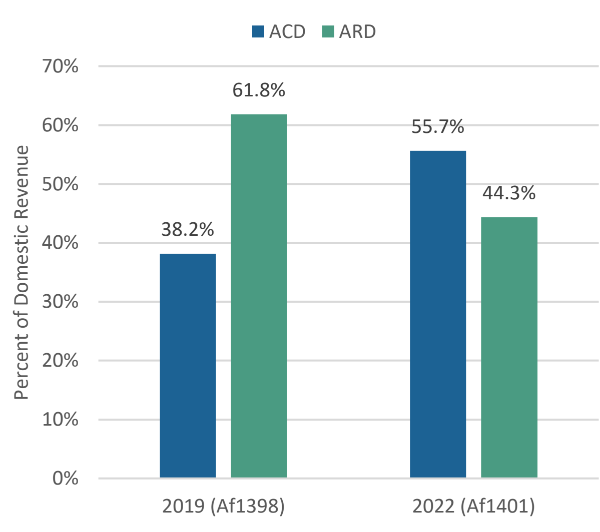
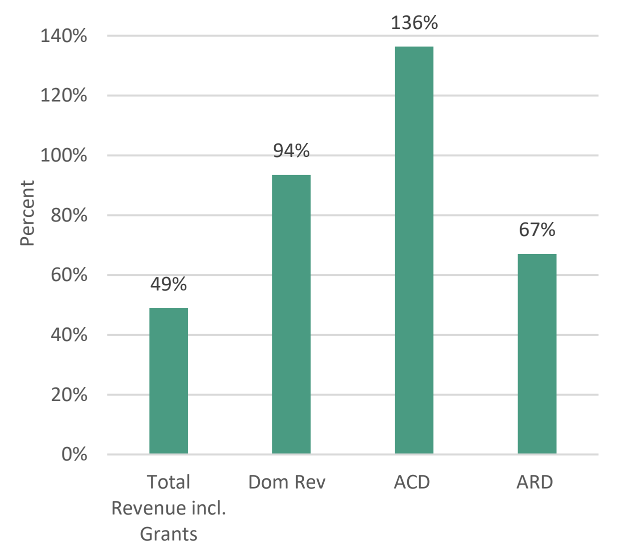


Figure 26: Revenue Ratios - FY 2022 as Compared to FY 2019



Source: AFMIS, Ministry of Finance.

During the first five months of fiscal year 2023, revenue is short compared to the targets due to the underperformance of the Inland Revenue collection. In the first five months of FY2023, revenue totaled AFN 76 billion, up 8 percent compared to the same period in 2022. However, it fell short by 7.0 billion from the target. Customs Duties and Business Receipt taxes drove this growth, rising 13 percent from FY2022's initial five months. Increased merchandise imports were key contributors. The Afghanistan Customs Department

(ACD) accounted for about 60 percent of total revenues, mainly from crossings with Iran and Pakistan. Conversely, Inland Revenue collection saw a mere 0.9 percent uptick year-on-year. The underperformance of non-tax revenues (NTR) was the primary reason, dropping 34 percent below the target, mainly due to weak collection by the Ministry of Mines and Petroleum, a significant NTR contributor.

ii. Expenditure Trends

Total expenditure in 2022 has fallen sharply from AFN 424.3 billion in 2019 to AFN 195.2 billion in 2022 and was at just over 46 percent of 2019 levels in nominal terms. In 2022, operating expenditure at AFN 184.5 billion was 66 percent of 2019. The most significant change was in the drastic fall in development expenditure, which in 2022 was at just 8 percent of 2019 levels (Figure 27). Development expenditure fell from 143.1 billion in 2019 to AFN 10.8 billion in 2022, sharply decreasing its share in total expenditure from 33.7 percent in 2019 to 5.5 percent in 2022 (Figure 28).

iii. Fiscal Deficit

In 2022, domestic revenue collections remained stable at 2019 levels in nominal terms, but expenditures decreased due to a significant decline in grants. However, expenditures have also dropped along with the sharp drop in grants. Total expenditures as a percent of total domestic revenue sharply fell from 205 percent in 2019 to 101 percent in 2022 (Figure 29). The twin effects of a fall in grants and an almost equivalent fall in public expenditure led to a nearly balanced budget in 2022. The total deficit as a percent of total revenues, including grants, fell sharply from 7.1 percent in 2019 to 0.7 percent in 2022 (Figure 30). Simultaneously, fiscal deficit as a percent of GDP, which stood at 1.9 percent in 2019, dropped to 0.1 percent in 2022. In 2022, the Ministry of Finance used its reserves of AFN 1.3 billion to meet this revenue shortfall.

Figure 27: Expenditure in FY 2022 as compared to FY 2019

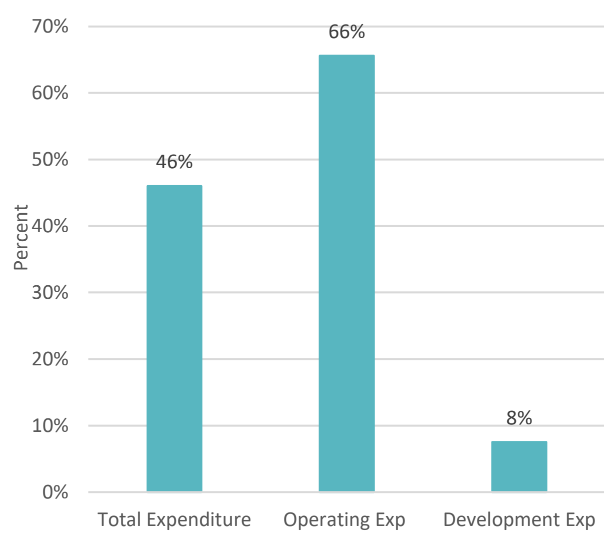
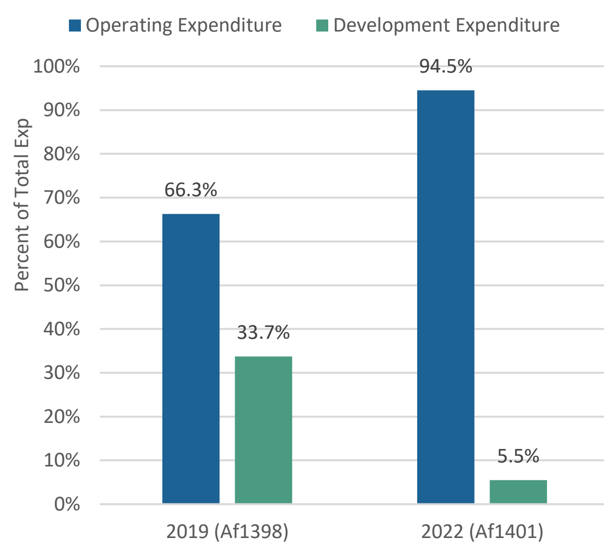


Figure 28: Composition of Total Expenditure



Source: AFMIS, Ministry of Finance.

Figure 29: Total Domestic Revenues and Total Expenditure

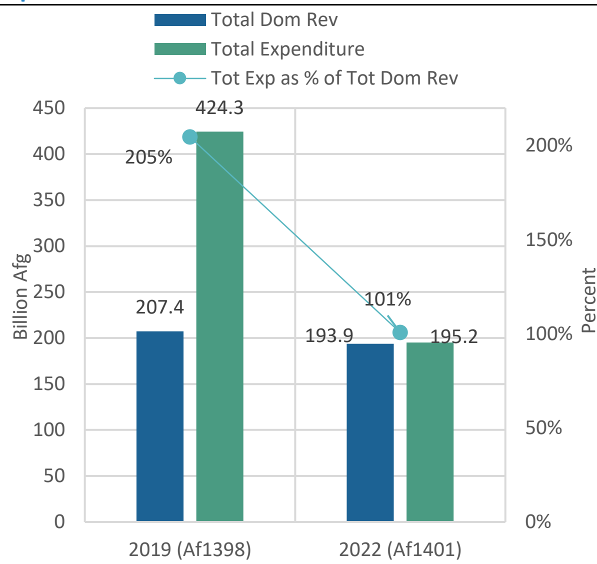
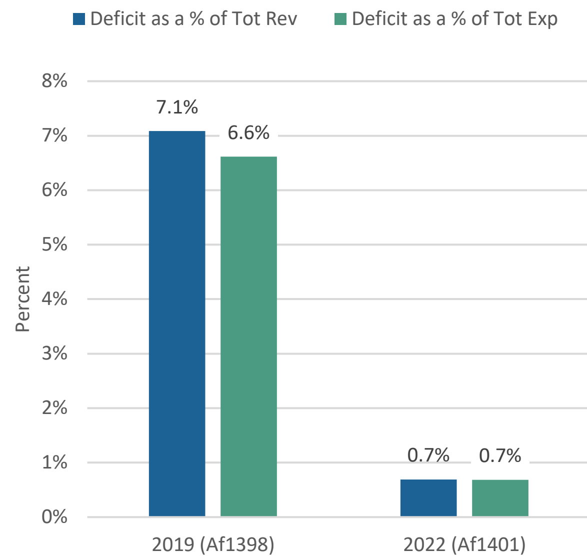


Figure 30: Fiscal Deficit as a percent of total revenues and total expenditure



Source: AFMIS, Ministry of Finance.

II. Expenditure Analysis[8]

i. Recurrent/Operating Expenditures

There have been significant compositional shifts in expenditure in 2022 compared to 2019. The total spending in 2022 at AFN 195.2 billion was less than half that in 2019 at AFN 424.3 billion. Of the 2022 recurrent expenditures, 72 percent were spent on wages and salaries and 21 percent on goods and services. While the spending in the Ministry of Interior decreased from AFN 51.5 billion to AFN 42.2 billion (Figure 31), its significance increased from 12 percent to 22 percent of total expenditure over this same period (Figure 32). The Ministry of Defense incurred the most spending at AFN 66.9 billion in 2019. Though the expenditure in the Ministry of Defense decreased to AFN 39.2 billion in 2022, it still accounted for 21 percent of the total spending in that year. Just three arms of the government - the Ministries of Interior, the Ministry of Defense, and the Department of Intelligence accounted for over 60 percent of the total operating expenditures in 2022.

[8] The expenditure analysis is done ministry-wise as sector-wise data for operating expenditures, which accounts for 95 percent of the spend in 2022, is not available. Sector-wise data is available for development expenditure, and this is discussed in the next section.

Figure 31: Operating Expenditures—Top Spending Ministries

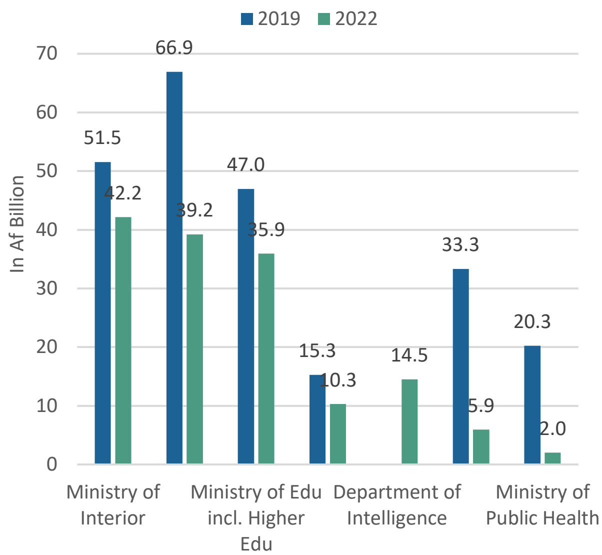
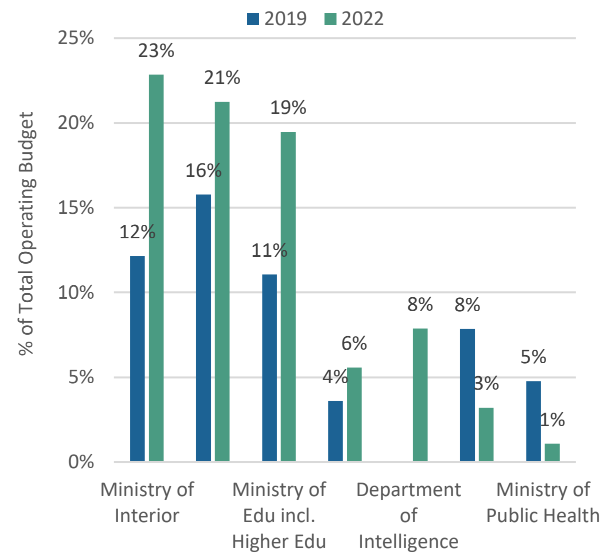


Figure 32: Top Spending Ministries – Percent of Operating Expenditures



Source: AFMIS, Ministry of Finance.

The expenditure on health was amongst the most significant casualties arising from the drastic reduction in overall expenditures. In 2019, the Department of Health spent AFN 20.3 billion, or 5 percent of the total expenditure. However, in 2022, this fell precipitously by 90 percent to AFN 2 billion, accounting for just 1 percent of the total public spending in 2022 (Figure 33). The operating expenditures in the infrastructure structure were also drastically reduced. For instance, the Ministry of Public Works' expenditure fell by 97 percent from AFN 21.3 billion in 2019 to AFN 0.7 billion in 2022. Providing water and electricity seemed to be one of the focus areas of the government before 2019, with the expenditure in the Ministry of Energy and Water more than doubling between 2016 and 2019 to AFN 10.4 billion before, falling to AFN 0.8 billion in 2022 (Figure 34). The expenditure by the Ministry of Interior experienced the lowest spending cuts at 18 percent compared to 2019, falling from AFN 51.5 billion in 2019 to AFN 42.2 in 2022 (Figure 35 & Figure 36).

Figure 33: Recurrent Expenditure on Human Development

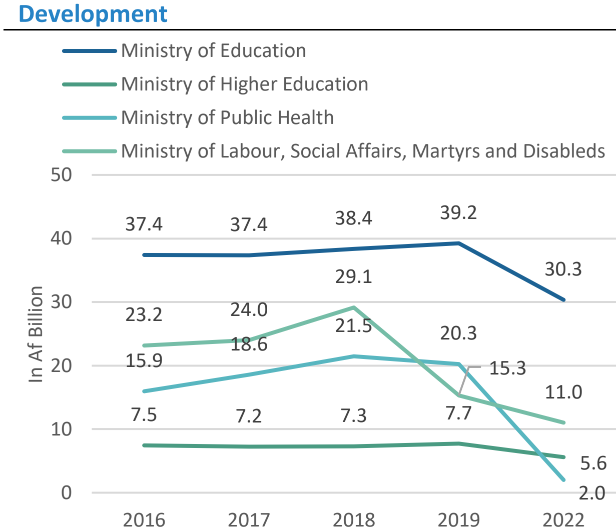
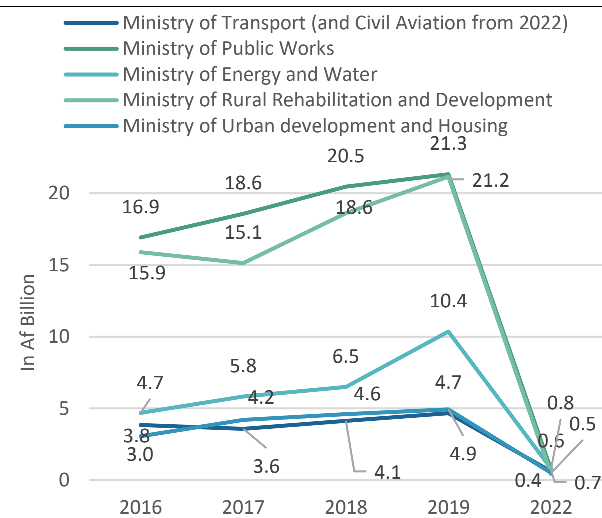


Figure 34: Recurrent Expenditure on Infrastructure



Source: AFMIS, Ministry of Finance.

Figure 35: Expenditure on Security and Finance

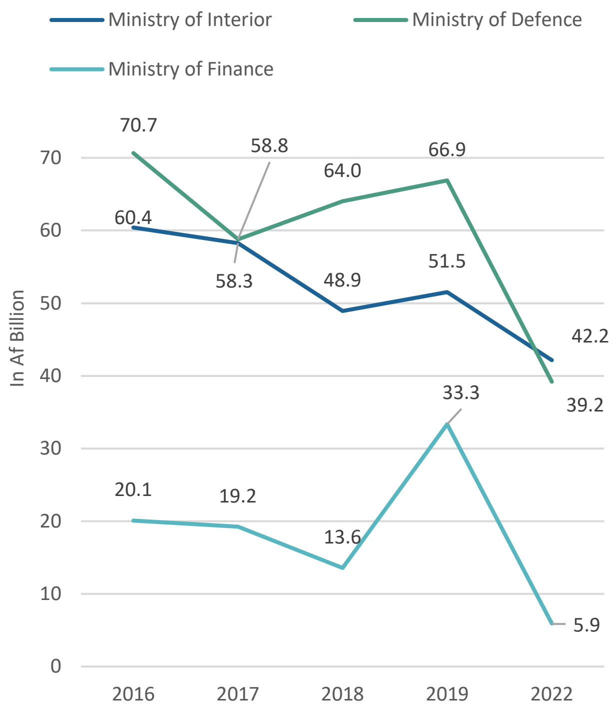
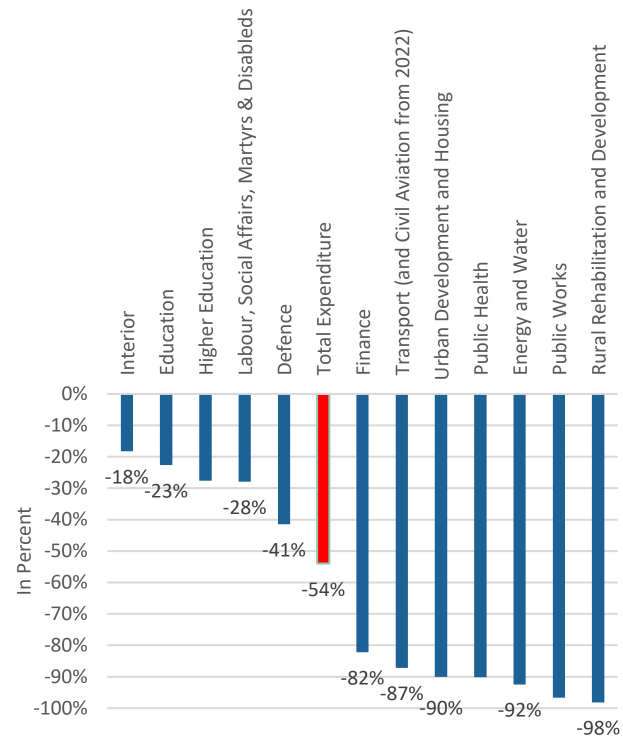


Figure 36: Percent fall in expenditure across Ministries between 2019 and 2022



Source: AFMIS, Ministry of Finance.

ii. Development expenditures

The development budget has taken the most significant cut in expenditure, falling from AFN 143.1 billion in 2019 to AFN 10.8 billion in 2022. At the start of 2022, the development budget comprised 66 projects, with 20 additional projects added during the year, including 14 projects from previous years and six new projects. The total cost for 20 newly added projects was AFN 1.39 billion, financed from the Contingency Funds. Of the 86 projects in the development budget in 2022, the expenditure on the Qoshtepe Irrigation Canal alone at AFN 5.46 billion accounted for 51 percent of the total development expenditure—indicating the ITA's preference for irrigation infrastructure. Overall, the ITA is utilizing available resources largely to pay for security, teachers' salaries, and core civil and administrative functions while leaving donors to finance healthcare, food security, broader education needs, and the agri-food system. Financing for long-term economic development needs, including infrastructure, from either source, is minimal.

For FY 2023, the final approved budget has not yet been published. However, based on unofficial information and news items, Box 3 highlights the key features of the budget:

Box 3: The FY2023 budget information collected from various news items indicates lack of credibility.

- The revenue target in budget FY 2023 is set at AFN 210 billion compared to the actual collection of AFN195 billion in FY2022. Expenditures are budgeted at AFN 295 billion in FY 2023, which is 51.2 percent higher than actual expenditure in FY 2022 and 23.5 percent higher than last year's budgeted expenditure. Such a steep jump seems hard to materialize. In the absence of on-budget foreign transfers and the domestic debt market, the ITA is bound to observe the limits of the domestic resource envelope.
- Operating expenditures are budgeted at AFN 255 billion, which is 38.2 percent higher than actual operating expenditure (AFN 185 billion) in FY 2022, while 21.1 percent higher than last year's budgeted operational expenditure (AFN 210 billion). On the other hand, development expenditures are budgeted at AFN 40.14 billion in FY 2023, 40.4 percent higher than the same in FY 2022 but 272 percent higher than last year's actual development expenditure. These budgeted development expenditures are 13.6 percent of the total budget, up from meager 5.5 percent of total spending in FY 2022.
- A significant portion of the budget is allocated to three areas: Defense, Public Order, and Education, Culture & Religion. These three items receive over 50 percent of the total budget allocation.
- About a quarter of the budget is allocated to the contingency codes. Allocations for these contingencies are one-fifth for operating and one-third for the development budget. Contingency allocations are concentrated in three ministries: The Ministry of Education (MoE), the Ministry of Interior (MoI), and the Ministry of Defense (MoD). Recent unconfirmed reports suggest that the ITA has reallocated part of its contingency budget allocations for tertiary hospitals, which were previously fully financed by international grants.

Source: Various news items

FINANCIAL SECTOR

The payment system is dysfunctional, with most transactions using the informal Hawala channel. The banking sector faces stability and liquidity risks, and the unplanned transition to Islamic banking poses an additional challenge.

Afghanistan's financial sector remains stressed. The stress in the banking sector started to escalate in the months leading up to August 2021 due to a significant loss of confidence. The crisis was worsened by several events in August, including the freezing of Da Afghanistan Bank's (DAB) offshore assets, the breakdown of international correspondent banking channels, difficulties in the domestic payment system, and a mandatory shift to Islamic banking. These factors greatly impacted the inflow and outflow of funds in Afghanistan.

Financial reporting from the banking sector is fragmented and incomplete; only 7 of the 12 banks operating in Afghanistan published their statements from 2022. According to publicly available information, Afghan banks can no longer perform their core banking functions, and various factors have impacted their profitability. The total revenue of the Afghan banking sector decreased by 51 percent from 2021 to 2022. Interest income in 2022 was only 27 percent of what it was in 2021, while income from fees and commissions increased by 112 percent during the same period. This shift has caused the bulk of all revenue to come from fees and commission-based business rather than the sector's core business, which includes interest from advances, trade finance, and investments. In 2022, 82 percent of banks' revenue came from non-interest income. Moreover, the asset quality of the sector has significantly declined. However, the full impact is still not reflected in the balance sheets due to the forbearance measures put in place by the DAB until April 2024. As a result, we do not have a complete picture of the state of the Afghan banking system since not all banks publish audited financial statements. A balance sheet review is necessary to restructure and resolve some banks that are likely in need. The mandatory transition of the banking sector to Islamic finance further complicates matters.

The UN cash shipments for humanitarian and basic service support have been the mainstay of the economy since December 2021. As of mid-August 2023, the UN has delivered approximately US$ 3.0 billion in cash based on the budgetary requirements for humanitarian and basic services. These cash shipments have been a mainstay for humanitarian and basic service support but have their emerging risks and rising costs. The risks of money laundering and financing terrorism are considerable. Using only one Afghan bank to transfer UN funds could create problems with fair competition in the banking sector, as one bank would receive most of the fee and commission revenue.

Critical Issues in the Banking Sector - Status Update

- **Liquidity & Local Currency Gaps**

Recent data shows that the banking sector deposits have steadied recently after falling significantly during 2021. Diminishing confidence in the banking sector meant an accelerated decrease in deposits even before the events of August 2021. This decrease was curbed by withdrawal limits imposed by the central bank (DAB) in the last week of August 2021. While withdrawal limits on all deposits predating August 15, 2021, remain in place, the aggregated deposit base has steadied.[9] Deposits decreased by over 20 percent in 2021 and decreased by an additional 9 percent in 2022 but now seem to be rising slowly. Due to DAB's expedient use of withdrawal limits, the initial depletion of deposits was steadied over 2022, and the first quarter of 2023 saw a 5.2 percent increase in aggregated deposit base (YoY).

The inability to print local currency is constricting the liquidity in the banking system. Many currency notes in circulation have deteriorated and are no longer usable. However, a slow inflow of fresh currency notes printed abroad is helping. With US State Department intermediation, the Crown Agent Bank, on an exceptional basis, has processed the payment from the DAB to the relevant international firms for printing the Afghani notes. The exact volume of the fresh currency order is unknown, and the new currency notes are unclear. However, a small shipment of 'sample' currency has reached Afghanistan and is being used by DAB to replace damaged notes (mainly through ATMs for now).

The availability of newly printed AFN banknotes should improve the operations of payment systems. With the currency notes, DAB should be able to ensure the convertibility of balances on commercial banks' reserve/settlement accounts with the central banks to physical cash, thus boosting trust in the system. The availability of cash is also likely to facilitate the resumption of suspended ATM services and enable ATM interoperability, in addition to a greater availability of point-of-sale cash-out services.

World Bank's Third-Party Monitoring Agency (TPMA), which conducts site visits of bank branches across Afghanistan, reports improved access to basic banking services. In 2023, TPMA visited 84 unique bank branches 441 times. Even though fewer branches are open compared to 2021, TPMA notes that the open ones provide better services. During the 441 visits, 99 percent of the branches were open, and all had operational ATMs. This is likely due to the fresh currency supply, as ATMs did not accept deteriorated currency notes. According to TPMA's bank manager and customer interviews, there has been a significant improvement in depositors' ability to withdraw funds. In 2022, many depositors could not withdraw even

[9] Withdrawals are restricted to AFN30,000 (US$400) per week for individuals (or a lump sum withdrawal of AFN100,000 (US$1,200) per month). DAB has issued a circular nominally allowing corporate clients to withdraw up to US$25,000 per month (including AFN equivalent) or 5 percent of deposited assets, whichever is lower. Banks still do not pay any US$ to individuals who have foreign currency accounts. International transfers are currently only allowed for corporate clients for selected purposes (e.g., food, medicines etc.).

the amounts within the withdrawal limits set by DAB due to insufficient funds. However, almost all individual depositors now report that they can withdraw funds more readily.

- **Breakdown of International Payments Channels (Correspondent Banking Relationships – CBR)**

Given the current political environment, most international banks do not have the risk appetite to transact with the Afghan financial system. Despite being granted the GL20 license in February 2022, correspondent banks have completely or significantly de-risked and limited transactions with Afghan banks. This has resulted in delays and high costs for the limited international payments still being made, which are only available to verified clients. Afghan banks have historically relied on cross-border business for revenue, but the restrictions have caused a significant decrease in earnings. Trade finance has also reached a standstill, significantly affecting the export sector. The banking and private sectors have found innovative solutions, such as establishing offshore holding companies in the region, but only more prominent players can benefit from these mechanisms.

The US and ITA have discussed the deployment of the US$ 3.5 billion (frozen assets). The proposal to the ITA is to release the funds to a trust fund, which will be managed by an international third-party Trustee on behalf of DAB **(The Afghan Fund).** This structure would facilitate critical international payments. However, it is pertinent to note that although releasing these funds will provide DAB with liquidity to inject into the banking sector, it will be a temporary relief. DAB still needs to reestablish correspondent banking relationships to replenish nostro accounts abroad and operationalize the payment system.

- **Disruptions in the Functioning of the Domestic Payments System**

While the payment system in Afghanistan has shown some signs of recovery, the pre-August 2021 situation has not yet been restored. The Afghanistan Payment System (APS), which handles domestic interbank ATM and POS card transactions, has resumed operations. It also manages the local AfPay card scheme and facilitates payments to the government, including utility payments and customs duties. However, not all banks are connected to the system, and one has been excluded due to technical insolvency. The APS still uses the SmartVista software provided by its main IT contractor, BPC, but there is a risk of losing some of the modules due to unpaid licensing and maintenance fees.

The Real-Time Gross Settlement System (RTGS) and the Automated Clearinghouse (ACH) managed by DAB have not resumed operation since the vendor was not paid and has not provided the necessary maintenance and support. Instead of modern systems, the central bank relies on an old in-house system for managing interbank wire transfers and cheque clearing. The process involves manual data entry through a web application, leading to clearing and settlement delays. As a result, the liquidity management in the system is not optimized.

- **Stability Risks**

The banking sector vulnerabilities will continue to deepen as the quality of assets deteriorates while the ability to generate revenue is severely undermined. Given that banks cannot engage in their core functions (lending, trade finance, etc.) in the current economic reality of Afghanistan, banks have seen a monumental decrease in revenue from core business. DAB allowed banks to revalue their real estate assets post-August 2021 to help bolster their balance sheets; this revaluation accounted for 26 percent of the revenue and 86 percent of the consolidated profits of banks in 2021. This, however, was a one-time balance sheet support; in the future, the banks' profits will continue to slide. Even though data is limited, and forbearance measures are still in place, many banks have eaten into their capital base. All this happens in a context where there is growing uncertainty around the capacity of the central bank to spearhead any banking resolution efforts.

Only a few of the banks published audited financial accounts for 2022. Seven Afghan banks, representing about 60 percent of the market in terms of assets, reported audited results for 2022. While the reported results looked better than expected (stable asset quality indicators, stabilizing deposits, etc.), this is likely since the results have been supported by significant forbearance measures put in place by DAB (including no NPL recognition, allowing a substantial revaluation of real estate assets to support balance sheets, no increase in generic provisions, no mark-to-market of investments, etc.). Banks now face problems generating revenue due to declining net interest income and sizeable foreign exchange losses. These losses are reported regardless of the significant forbearance measures by DAB. As such, if the forbearance measures are not currently in place, most of the banks would report being undercapitalized. The financial conditions of the microfinance sector have also significantly deteriorated, and the sector appears close to insolvency unless shareholders provide new equity.

- **Transition to Islamic Banking**

The mandatory transition to Islamic Banking for all financial institutions also creates operational difficulties. On the 22nd of March 2022, DAB published Guidelines for Conversion of a Conventional Bank to an Islamic Bank, where DAB underlined its commitment to promoting and developing Islamic banking in Afghanistan. Banks have been asked to prepare proposals for this transition. The Islamic Banking & Contemporary Research Center (IBCIRC) has been established to assist DAB in this process. The conversion process will involve the submission of a Conversion Plan (CP) to DAB by the banks, and after approval, DAB will issue Islamic Banking licenses. All financial institutions, including micro-finance institutions (MFIs), cannot engage in interest-based lending or recovery until Islamic products are approved. However, for now, DAB has not specified a timeline for the conversion to be completed, but the transition is critical to ensure the financial sector can recommence lending. MFIs have one Islamic product approved and have commenced lending. (Details below)

- **Micro-Finance**

The formal microfinance sector currently consists of 3 microfinance providers (MFPs). There are two microfinance institutions (MFIs) and one commercial bank that provides microcredit (FMFB) -all of which are partners of the Microfinance Investment Support Facility (MISFA). MISFA is a microfinance apex organization. Micro-finance has always had greater outreach than conventional banking since it has a rural outreach and a greater number of borrowers. However, even this sector has seen a rapid contraction (the sector has had 50 percent fewer active borrowers since August 2021).

In September 2022, one Islamic product was approved for use by MFIs (by DAB and the Islamic Banking & Contemporary Research Center). The Murabaha instrument is currently the only source of lending. In a Murabaha transaction, the MFI buys an asset identified by its client (borrower) from a third party and then sells that asset to the borrower for the original purchase price plus a profit element. Since September 2022, over 14000 loans (36 percent female borrowers) have been disbursed under the Murabaha structure.

However, MFIs are also facing solvency issues. MFIs have always had more borrowers than conventional banks (microfinance borrowers stand at ~60,000 whereas bank borrowers currently stand at ~35,500); as such, MFIs play a significant role in financial inclusion in Afghanistan. MISFA is in talks with the Board and sponsors of privately owned MFIs to seek early recapitalization of the remaining MFIs in Afghanistan.

2. OUTLOOK AND MEDIUM-TERM PROSPECTS

The outlook is uncertain amid a mix of economic indicators and subject to significant downside risk. The economy is experiencing some positive changes, such as marginally increased household welfare, expansion of international trade, and continued domestic resource mobilization. However, a decrease in domestic demand has led to a slowdown in economic activity, negative inflation, and ongoing issues with unemployment and underemployment. In addition, an appreciated and overvalued AFN will also dampen exports and increase imports, putting another dent in an already struggling and weak domestic industry. Unless domestic demand picks up, private sector sentiments improve, and the country attracts investment, humanitarian aid will not be sufficient to restore the economy to a sustainable recovery path.

Under the baseline scenario, the economy will hover around no-growth territory. Poor sentiments and uncertainty may lead to hesitancy on the part of the private sector to invest, and the ongoing deflation is expected to result in more layoffs in the short to medium term. At the same time, the ITA's restrictive policies on women's education and work will further lower Afghanistan's growth prospects. As a result, there may be persistent unemployment and underemployment in the future. In addition, an appreciated and overvalued exchange rate may dampen exports and increase imports, weakening the struggling domestic industry. The economy requires significant external support to offset the negative impacts of the shock as it lacks an internal growth engine to support recovery. In a baseline scenario with limited humanitarian and basic service aid compared to 2022, the economy is projected to remain stagnant at best, with a wide confidence interval skewed towards the downside. Per capita income will decline due to an increasing population. Under this scenario, poverty is likely to remain high, and vulnerability to falling into poverty is a genuine concern until the economy can find new indigenous sources of growth that address unemployment and job quality challenges.

Poverty is expected to remain widespread in the next few years. The projected minuscule pace of economic recovery will lead only to limited salaried employment creation and slight increases in labor earnings, insufficient to reduce the large share of the population that struggles to cover basic expenses. Favorable weather conditions may positively impact rural poverty, though the increased frequency of droughts in recent decades adds uncertainty to this possibility. Deflation may help households in the first round, but its second-round effects will start to materialize as employment opportunities further limit. In this context, households will enjoy decreasing food prices initially but may face economic hardship due to contracting business activity.

This outlook is subject to significant downside risks. These may include (i) further contraction in demand for durable and manufactured goods in anticipation of further price decline; (ii) the potential discontinuation of or reduction in aid due to fiscal pressures in donor economies and potential donor fatigue; (iii) the stoppage of US$ cash shipments, which could undermine exchange rate stability; (iv) potential stability concerns in the banking sector including the payment resolution challenges and an unmanaged transition to Islamic banking; (v) decline in imports with consequences for ITA's revenue receipts; and (vi) the impact of potential climate events, such as droughts. In addition, any deterioration in the security situation will exert downside pressures on the outlook. Similarly, the cessation of cash shipments will aggravate the liquidity condition of hard currency for needed imports. If these risks materialize, the already weak projected baseline GDP path will shift downwards. This may heighten the risk of negative regional and global spillovers, may stoke political unrest, increase deprivation, and increase food insecurity.

3. SPECIAL FOCUS – WELFARE AND LABOR MARKET DYNAMICS IN AFGHANISTAN AFTER THE TALIBAN TAKEOVER

SUMMARY

The third round of the Afghanistan Welfare Monitoring Survey (AWMS) indicates that Afghan households' welfare is better now compared to the months immediately following the dramatic events of August 15, 2021. However, it has not improved much since the previous survey round during the summer of 2022. Monetary poverty projections further indicate that the current poverty level is similar in magnitude to what was observed before the regime change when the intensity of conflict in Afghanistan was at its all-time high. This means that half of all Afghans, or 20 million people, are currently poor (with consumption levels below the national poverty line) in a country where conflict has largely ceased, and households have already done their best to cope.

Afghan households have coped with the crisis by increasing the labor supply, particularly youth and women. Female labor force participation saw a threefold increase compared to 2020, with women primarily engaged in home production (garment and food processing). Overall, the growth in labor supply has sizably outpaced a slacking demand, resulting in a doubling of unemployment and a one-quarter increase in underemployment, as proxied by the share of workers employed for less than 40 hours per week.

Afghan households report a marginal improvement in welfare, although the levels of deprivation and vulnerability remain high. Analysis based on the first three rounds of the Afghanistan Welfare Monitoring Survey (AWMS - Box 4) provides consistent evidence of a progressive, albeit small, improvement in the welfare of Afghan households compared to the months immediately following the Taliban takeover. Between April and June 2023, the share of households in need stood at 62 percent, compared to 64 percent in R2 and 70 percent in R1 (Figure 37). The welfare gains observed between the summer of 2022 (R2) and spring of 2023 (R3) come from a significant reduction in the share of households that can satisfy food needs but no other (non-food) daily needs. On the other hand, no significant change emerges in the share of households reporting lacking means to satisfy even food needs, the more extreme form of deprivation. Evidence corroborating an improvement in household welfare also emerges from the analysis of food insecurity, as captured through the reduced coping strategy index (RCSI). In particular, the share of households reporting crisis levels of acute food insecurity reduced from 50 to 40 percent between the fall of 2021 (R1) and the spring of 2023 (R3). Despite these positive signs, deprivation remains widespread, with only 16 percent of households unhindered in meeting their needs and more than 80 percent relying on at least one negative coping strategy to make ends meet.

Box 4: The Afghanistan Welfare Monitoring Survey (AWMS)

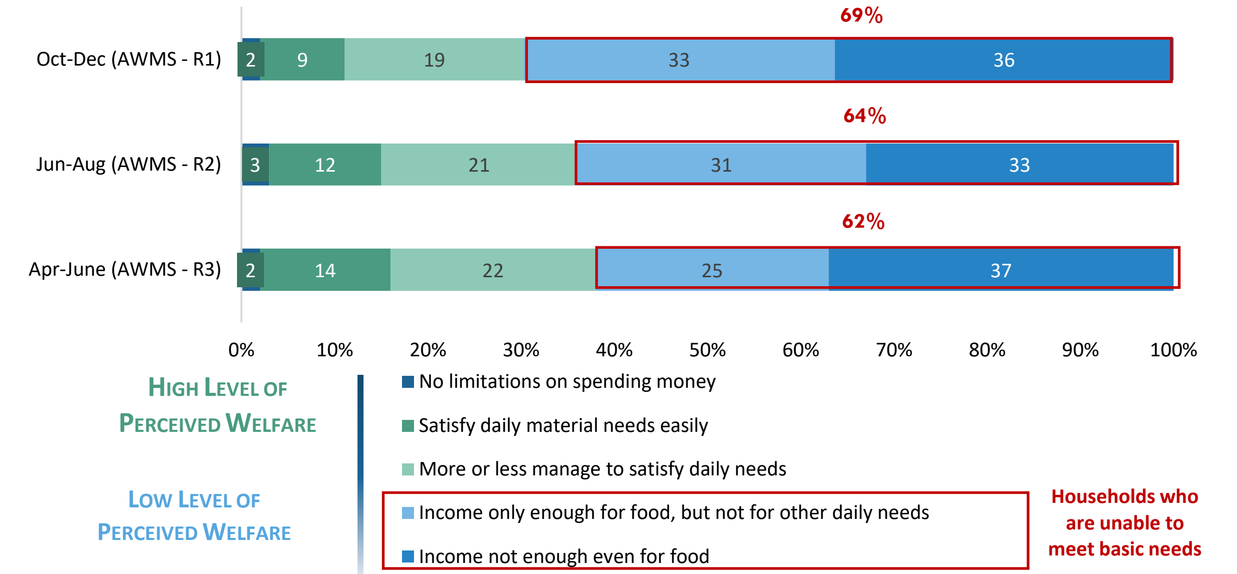
The Afghanistan Welfare Monitoring Survey (AWMS) is a key component of Afghanistan Futures, the World Bank's research, and monitoring program on the state of the Afghan economy and society. The AWMS is a nationally representative rapid-response phone survey that aims to fill knowledge gaps on the welfare status of Afghan households and their access to basic services under the new administration.

Conducted by telephone, the AWMS re-interviewed households previously surveyed through Afghanistan's primary multipurpose household survey: The Income, Expenditure, and Labor Force Survey (IELFS) conducted by the National Statistics Information Authority (NSIA) in 2019–20 and 2021. This design feature of the AWMS survey allows to assess the evolution of indicators of interest by tracking the same households over time and to achieve national representativeness through a reweighting process.

The first round of AWMS (R1) was conducted from November to December 2021; Round 2 (R2) of the survey was conducted from July to August 2022, whereas the third and most recent round of data collection was implemented between April and March 2022.

The findings in this special focus section summarize the results of all three AWMS survey rounds conducted so far. For a more detailed discussion of findings and methodology, see World Bank (2023) "Afghanistan Welfare Monitoring Survey, Round 3".

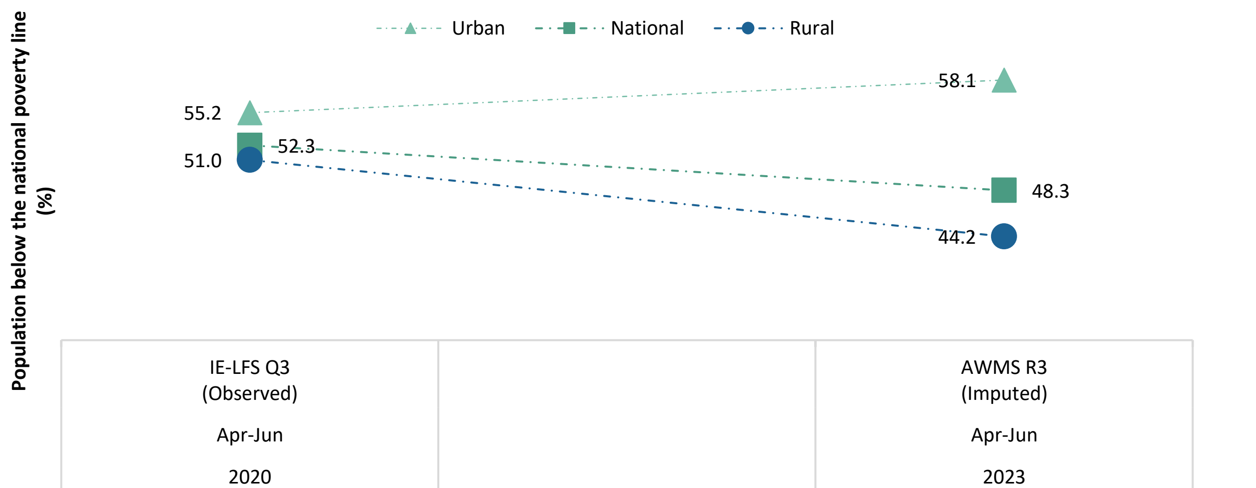
Figure 37: Self-Reported Household Capacity to Cover Food and Non-Food Expenses



Source: Data from Afghanistan Welfare Monitoring Surveys: Round 1 (Oct-Dec 2021), Round 2 (Jun-Aug 2022), Round 3 results (April-June 2023 – 90 percent target sample completed).

Estimates for the April to June period of 2023 further indicate that monetary poverty affects half of Afghanistan's population. Estimates based on the latest (fully completed) Income, Expenditure, and Labor Force Survey (IELFS) conducted by the National Statistics Information Authority (NSIA) in 2019–20 indicate that one in every other Afghan was already living in poverty before the Taliban takeover. Poverty projections based on R3 of the AWMS survey suggest that the current level of monetary poverty in Afghanistan is comparable in magnitude to the one observed in spring 2020 (Box 5). Overall, estimates suggest that 48.3 percent of the Afghan population was poor as of April-June 2023, a four-percentage point decline compared to poverty levels observed over the same months of 2020. As shown in Figure 38, monetary poverty is estimated to have declined from 51 to 44 percent in rural areas. In contrast, poverty has stagnated in urban areas, with the increase from 55 to 58 percent lacking statistical significance. Although no data were collected in R1 and R2 of AWMS to directly assess the evolution of monetary poverty during the first two years of the Taliban administration, it seems reasonable to expect that poverty first increased in the immediate aftermath of the Taliban takeover to progressively decline afterward, in line with emerging trends in self-reported welfare and food security.

Figure 38: Poverty Projections as of April-June 2023, by Urban-Rural Areas



Source: IE-LFS 2019-20 and AWMS 2023 (R3).
Note: The probability of differences in poverty between April-June 2023 and April-June 2020 being different from zero is 95.4 percent at the national level, 99.6 percent at the rural level, and less than 25 percent at the urban level.

Box 5: SWIFT-Plus Methodology for Poverty Estimation in AWMS R3

The lack of full-fledged household budget survey data during or after a crisis is a challenge not unique to Afghanistan. Not surprisingly, significant advances have been made in the research on survey-to-survey imputation techniques over the past decade**.**

The Survey of Well-Being via Instant and Frequent Tracking (SWIFT) methodology has been developed to make the estimation of poverty at the country level cheaper and faster. To train a model, SWIFT uses data from a past household survey that contains information on household expenditure and poverty correlates. It collects data on identified poverty correlates from a new survey (typically a short phone-based survey). It then uses the trained model to impute household expenditures for the recent survey from the poverty correlates.

The SWIFT methodology has been applied in over 75 countries and tested extensively. Building on this work, the SWIFT approach has been refined to address two significant methodological challenges: model stability over time and model capacity to capture shocks. In particular, the SWIFT-plus approach integrates Machine Learning (ML) and Cross-Validation (CV) steps to improve the stability of the estimated model and expand the list of variables for poverty modeling/data collection to include dummies on consumption of key items.

The SWIFT-plus model used to predict poverty in AWMS R3 was trained using the IELFS 2019-20 data. More specifically, to properly account for seasonal variation in poverty and welfare/livelihood differences between Afghanistan's urban and rural areas, separate urban and rural models were trained using the quarter-representative sample of the IELFS 2019-20 corresponding to the April to June months of 2020.

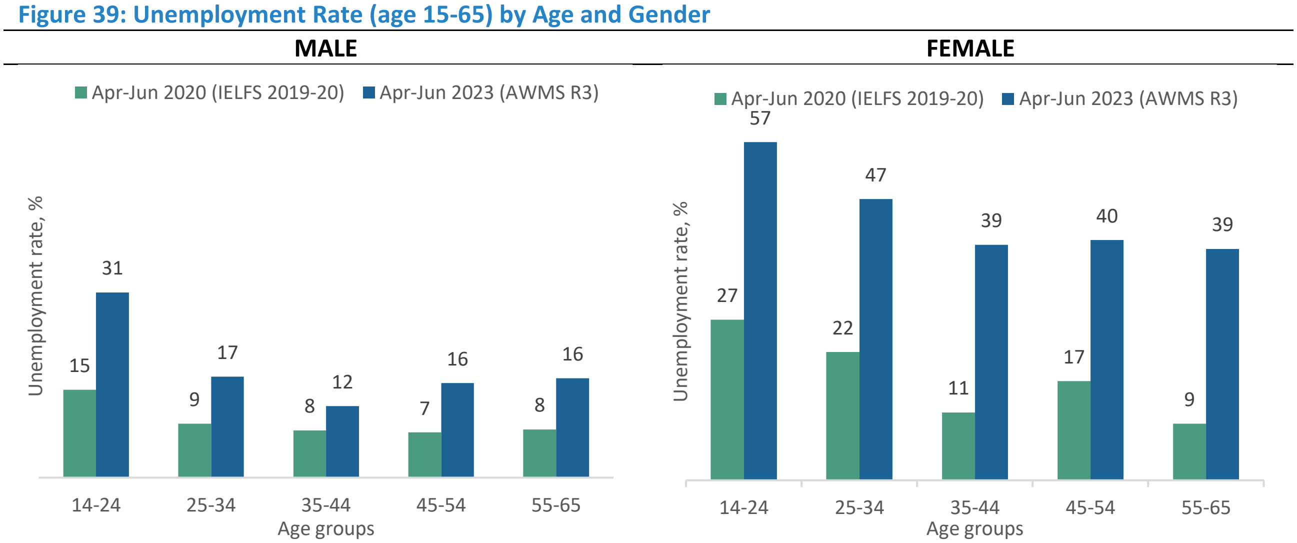
Source: Yoshida et al. (2022). The Concept and Empirical Evidence of SWIFT Methodology; World Bank (2023). Afghanistan Welfare Monitoring Survey, Round 3.

Analysis of round 2 and round 3 of the AWMS reveals that economic (or labor force) participation has structurally increased compared to before the Taliban takeover. Faced with worsening economic conditions, Afghan households have responded by leveraging the only asset abundantly at their disposal: labor. In particular, labor supply has increased for household members typically at the margin of the labor market, notably youth and women. In particular, the economic participation of Afghan women saw a threefold increase, with an increasing number of women engaged in economic activities – primarily in home-based manufacturing production (garment and food processing activities) - to support their households to make ends meet.

The Afghan economy and its labor market struggle to absorb the increased labor supply, and as a result, unemployment and underemployment have worsened compared to the period before the Taliban takeover. With a young and fast-growing population, volatile growth, and persistent conflict and insecurity, labor demand has traditionally lagged behind supply in Afghanistan. Estimates from the last decade indicate that approximately 400-500 thousand Afghans enter the labor market every year looking for jobs. The economic contraction ensuing from the political events of August 15 has further strained the absorption capacity of the Afghan labor market. Not surprisingly, the structural increase in labor force participation has gone hand in hand with an increase in joblessness, with unemployment doubling its rate compared to the period before the Taliban takeover and underemployment – as proxied by the share of workers employed for less than 40 hours per week - increasing by one quarter.

The level of unemployment is worryingly high among youth and women. As shown in Figure 39, among young men looking for a job in the 14 to 24 age group, nearly one in three is unemployed, while unemployment is almost twice as high among young women in the same age group. The gender gap in unemployment is more substantial among women in older age cohorts, reflecting the additional challenges women face in the Afghan labor market. In fact, not only are Afghan women hindered by the constraints on their physical mobility and the lack of familiarity with the labor market due to their traditional marginal economic role, but they are also disadvantaged by their lack of education and basic literacy. Among women aged 25 and above, the literacy level is abysmally low at 25 percent – meaning that only one in four women can read and write, against 61 percent among men in the same age group.[10]

Figure 39: Unemployment Rate (age 15-65) by Age and Gender



Source: IE-LFS 2019-20 and AWMS 2023 (R3).

Note: Due to strong seasonal patterns in employment, estimates from IE-LFS 2019-20 were computed over the months corresponding to AWMS R3 fieldwork.

The analysis of the three rounds of the AWMS gives back a worrisome picture of the current and future challenges facing Afghan households. Despite conflict ceasing, one in two Afghans – or 20 million people - remain poor. Afghan households have done their best to navigate the new economic context, possibly exhausting coping strategies and labor resources. Due to sustained population growth and a lack of economic growth drivers, gainful employment opportunities are scarce, with an average fertility rate close to five. Afghan households face high deprivation and vulnerability due to poverty being highest in urban areas and rural poverty being affected by weather variability and climate change challenges.

[10] Estimates based on AWMS R3.

ANNEXURE – I

Table: Country's Imports that do not Align with Economic Situation – Detailed Information

US$ Million	2016-2020 Avg.	2022	2023
Textile Imports			
Woven fabrics of flax. & synthetic filament yarn, including woven fabrics obtained from materials of heading 54.04.	240.12	501.65	285.25
Worn clothing and other worn articles.	6.11	37.76	15.99
Carpets and other textile floor coverings, knotted, whether or not made up.	4.99	23.90	16.18
Blankets and travelling rugs.	10.56	21.34	13.25
Textile fabrics impregnated, coated, covered or laminated with plastics, other than those of heading 59.02.	0.33	9.66	10.66
Cotton waste (including yarn waste and garnetted stock) and waste of man-made fibers	6.65	16.75	9.49
Prepared Foodstuff Imports			
Cigars, cheroots, cigarillos and cigarettes, of tobacco or of tobacco substitutes and other manufactured tobacco	73.41	111.60	58.13
Bread, pastry, cakes, biscuits and other bakers' wares, whether or not containing cocoa; communion wafers, empty cachets of a kind suitable for pharmaceutical use, sealing wafers, rice paper and similar products.	7.02	28.21	10.71
Sugar confectionery (including white chocolate), not containing cocoa.	6.76	25.91	17.97
Pasta, whether or not cooked or stuffed	6.23	21.64	13.77
Oil-cake and other solid residues, resulting from the extraction of soyabean oil	1.20	9.05	15.37
Jams, fruit jellies, marmalades, fruit or nut purée and fruit or nut pastes, obtained by cooking,	0.85	8.10	1.64
Yeasts (active or inactive); other single-cell micro-organisms, dead (but not including vaccines of heading 3	1.57	7.98	4.26
Other sugars, including chemically pure lactose, maltose, glucose and fructose,	1.46	6.26	2.89
Vehicle Imports			
Parts and accessories of the motor and other vehicles	120.1	207.4	169.5
Tractors (other than tractors of heading 87.09).	18.8	22.3	20.3
Motorcycles (including mopeds) and cycles fitted with an auxiliary motor, with or without side-cars; side-cars.	9.9	10.0	11.2
Trailers and semi-trailers; other vehicles, not mechanically propelled; parts thereof.	4.9	6.6	5.8
Base Metal			
Flat-rolled products of iron or non-alloy steel	1.87	82.73	53.53
Aluminium casks, drums, cans, boxes and similar containers	8.35	34.67	27.01
Wire of iron or non-alloy steel.	5.41	7.46	7.67
Wire, rods, tubes, plates, electrodes and similar products, of base metal or of metal carbides,	4.03	5.82	4.05
Razors and razor blades (including razor blade blanks in strips).	0.94	4.87	1.91
Stone & Glass			
Glassware of a kind used for table, kitchen, toilet, office, indoor decoration or similar purpose	2.71	42.09	18.69
Chemicals and Allied Industries	314.22	410.18	246.57