

AFGHANISTAN

Key conditions and challenges

The economic crisis continues, causing decreased activity and persistent poverty. A combination of better supply and depressed demand results in ongoing deflation. Off-budget transfers were reduced in 2023, shrinking the economy and raising concerns about pro-poor expenditure sustainability. The Interim Taliban Administration's (ITA) revenue collection remains slightly below target. The Afghani (AFN) depreciated against USD during Jan-Feb 2024 after strengthening throughout 2023. Poverty affects half of the population, with persistent high unemployment and underemployment amid contracting job and business opportunities.

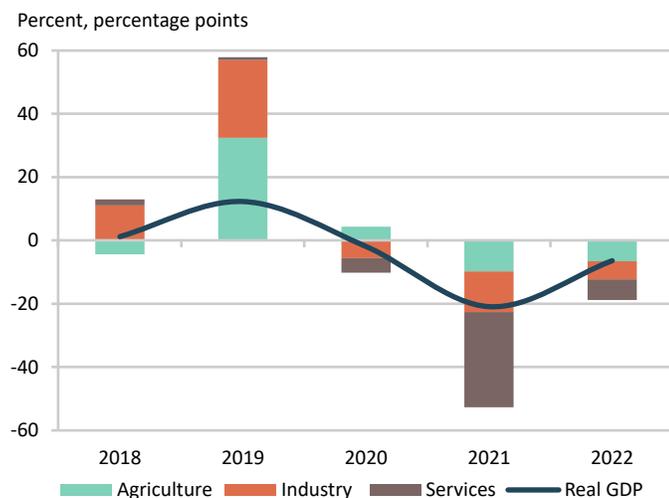
Afghanistan's economy remains weak, reflecting the lack of endogenous sources of growth compensating for the decline in international aid after the Taliban takeover. The deflationary process that started in April 2023 continued into January 2024, sustained by the appreciation of the local currency and the negative income shock brought about by the enforcement of the opium ban. This ongoing deflation reflects a troubling inability of both private and public sectors to stimulate sufficient demand. While falling prices may offer temporary financial relief to the most vulnerable households by reducing the cost of living, it can also harm the broader macroeconomy. Prolonged deflation can lead to a damaging cycle where consumers delay purchases, businesses reduce investment, and economic growth stalls, ultimately impeding more sustainable poverty alleviation and employment opportunities. The economic hardship has increased labor force participation, leading to a rise in unemployment as jobs are not available. About half of the country's population is living in poverty, and around 15 million people are facing food insecurity. Foreign aid is entirely off-budget, given the ITA's position on human rights, gender, and inclusion. While most off-budget spending is aimed at helping the poor, the global experience highlights sustainability challenges and increased service delivery

costs. In the medium term, the anticipated reduction in off-budget transfers (OBT) will negatively affect social sector service delivery for a vulnerable population. ITA is prioritizing non-productive security sector spending, and its insufficient policy response to the OBT cut will exacerbate the service delivery vacuum. The private sector remains burdened by the central bank's commitment to an overvalued currency and a fragile banking sector.

Recent developments

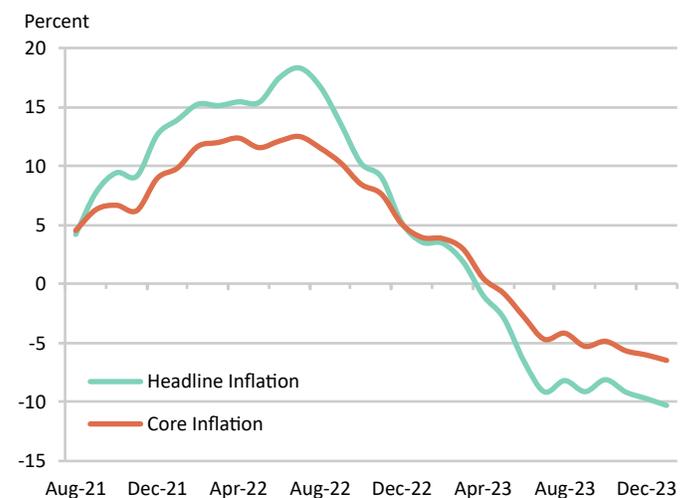
The real GDP shrank by a cumulative 26 percent during the last two fiscal years, with economic activity remaining stagnant during the ongoing fiscal year 2023-24. While supply conditions have eased, aggregate demand remains low, resulting in a sharp decline in the general price level. The headline inflation turned negative in April 2023, and in January 2024, it reached -10.2 percent YoY, primarily driven by negative inflation in the food group (-15.1 percent) and the non-food segment (-4.8 percent). Core inflation, excluding food and energy prices, also fell to -6.5 percent YoY. A significant appreciation of AFN against the USD during 2023 contributed to the falling price of imported commodities. The opium cultivation ban may be causing additional deflationary pressure due to a decrease in farmers' incomes, estimated to be around \$1.3 billion (about 8 percent of GDP) by the United Nations Office on Drugs and Crime, and a reduction in domestic food prices as approximately

FIGURE 1 Afghanistan / Real GDP growth and contributions to real GDP growth



Source: National Statistics and Information Authority.

FIGURE 2 Afghanistan / The country is facing deflation



Source: National Statistics and Inflation Authority.

200,000 hectares of land is estimated to be converted from illicit to licit crops. Moreover, since opium cultivation is more labor-intensive than other crops, the ban is likely to put additional upward pressure on unemployment. While declining prices might have contributed to improving the welfare of most vulnerable households, the overall weakness of the economy and the lack of employment opportunities are likely holding back more sustainable poverty reduction.

The country's total exports in CY2023 reached \$1.9 billion, almost the same as in CY2022. While coal exports fell by 46 percent, increased exports of food and textiles partially compensated for this. In CY2023, Afghanistan's imports surged 23 percent YoY to \$7.8 billion, resulting in a trade deficit of \$5.9 billion, 34 percent higher than the previous year. Analysis suggests that approximately a quarter of these imports were intended for the Pakistani market and financed by Pakistani importers as authorities implemented direct controls to lower imports. This explains a significant increase in imports in specific categories despite an overall decrease in real GDP and deflation. These imports subsequently enter Pakistan. Accounting for these, estimates suggest that imports for Afghanistan are approximately \$5.5 billion instead of \$7.8 billion, resulting in a de facto trade deficit of ~\$3.5 billion. The UN cash shipments of ~\$1.8 billion and estimated remittances at ~\$2 billion more than covered the de facto trade deficit of ~\$3.5 billion. The local forex market was in surplus, resulting in a 27 percent AFN appreciation in 2023. Recently, during Jan-Feb 2024, there has been some correction, with the AFN depreciating by 5.4 percent against the USD.

Revenue collection for the eleven months of FY2023-24 (from March 22, 2023, to February 21, 2024) totaled AFN 189 billion, narrowly missing the target by 2 percent

but marking a 5.6 percent increase from the same period of the previous fiscal year. The shortfall is mainly due to border taxes, which saw a mere one percent rise despite a 22 percent surge in imports. The AFN appreciation, reduced tariffs on some food items, and lower Business Receipt Tax on manufacturing inputs have contributed to this modest increase. Conversely, Inland revenues increased 11.8 percent YoY, driven by the Small Taxpayer Office and provincial collection. The growth was mainly due to improved compliance and collection of arrears. For the FY2023-24 budget, around AFN 295 billion is earmarked for expenses, representing a 43 percent YoY increase, mainly due to the planned new hiring and increased development projects. Non-productive security spending is prioritized over social sectors, significantly impacting health, agriculture, and social protection. However, attainment seems unlikely due to limited own-source collection.

The Afghan financial sector cannot support the private sector through financial intermediation. Banks face limitations in international payments. Due to the mandatory transition to Islamic Finance and legal uncertainties around loan recoveries, banks are not lending, and deposit withdrawal limits remain in place. Banks are reliant on commission-based business rather than core banking activities. The private sector is thus deprived of meaningful access to finance and standard banking services. In addition, the capacity of the Central Bank to monitor emerging risks, particularly around AML/CFT, remains unclear.

Outlook

The current ban enforced by the ITA on female education is endangering the economy's future. Continuing the ban

will cause a shortage of educated and skilled females in the country and may induce a further reduction in OBT. The economy is projected to remain stagnant, with no growth in the baseline. In 2025, GDP is projected to barely reach 2022's level with 2-3 percent annual growth after contracting 2-3 percent in 2023, resulting in a decrease in real per capita income. The baseline assumes a 15 percent decline in OBT in 2023 and 10 percent in the subsequent years, with domestic revenues only partially offsetting OBT decline amid contracting economic activity. Inflation will bounce back and will, on average, remain between 6-10 percent in 2024 and 2025 because of the base effect and correction in the exchange rate. Inflation and low growth will result in high poverty, while decreased pro-poor spending due to reduced off-budget transfers may cause a decline in service delivery for health and education and heighten vulnerability to falling into poverty. Unemployment and underemployment are expected to persist amid limited job and business prospects.

There are significant downside risks to the baseline scenario. A higher-than-projected decline in off-budget transfers will have substantial implications for pro-poor spending, having ripple effects on businesses and economic activities and thereby worsening the economic downturn. Insufficient investment in the country's human capital will have long-term consequences on the country's growth prospects and capacity to reduce poverty sustainably. Faster-than-expected depreciation of the Afghani will limit imports, taking a toll on economic growth, while a subsequent surge in inflation will intensify economic hardships. In addition, the lack of a country-wide strategy and necessary financial support to invest in climate adaptation will add additional downward risks to economic activity and poverty reduction.