AFGHANISTAN

Key conditions and challenges

Following the Interim Taliban Administration’s (ITA) takeover, the economy shrank by 20.7 percent and 6.2 percent in 2021 and 2022, respectively. The new low-level equilibrium, supported by international aid, is delicate and vulnerable to disruptions. The ITA has demonstrated its ability to collect revenues and increase international trade. Supply constraints have eased, reducing headline inflation steeply from its peak in July 2022, leading to deflation since April 2023. Despite a general improvement in household welfare over the last year, poverty still affects half of Afghanistan’s population, and high levels of unemployment and underemployment persist. The banking sector is struggling, and the payment system remains largely dysfunctional.

Recent developments

Following the August 2021 political upheaval, headline inflation surged due to supply disruptions and shocks to global commodity prices despite reduced domestic demand. After reaching 18.2 percent year-on-year in July 2022, prices 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. These price dynamics likely stem from the economy adjusting to a structurally lower aggregate demand level, improved supply conditions, and appreciating Afghani (AFN). Declining prices, notably in food, have supported a progressive improvement in Afghan households’ self-reported welfare and food security. According to recent (April-June 2023) estimates, monetary poverty is at 48.3 percent, a 4-percentage point decline compared to the same period in 2020, driven by the reduction in rural poverty. 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.

Afghanistan’s exports have surged in value, but the economy still runs a substantial trade deficit. Afghanistan’s exports reached US$19.9 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. 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. Food, minerals, and textiles composed more than half of imports. The trade deficit for Jan-July 2023 was US$3.5 billion, higher than the US$2.4 billion deficit in Jan-July 2022.

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). The AfN appreciated due to limited domestic money supply, higher remittances, and UN shipments of US dollars and other inflows. In 2023, the UN brought in approximately US$1.12 billion in addition to US$1.8 billion in 2022. Interestingly, the cash shipments and remittance inflows do not fully explain the financing for the trade deficit. The foreign exchange market seems balanced, with no evidence of a parallel exchange market, suggesting significant unidentified external inflows filling the gap.

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. Although the banking system remains under stress, there are signs that the sharp decline in deposits has been halted. Publicly available data shows that in the first quarter of 2023, deposits increased by five percent 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.

**Outlook**

The outlook is uncertain amid a mix of economic indicators and subject to significant downside risk. 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. 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. However, there are notable downside risks to this baseline scenario. The regime’s exclusionary nature and gender policies could trigger more external support cuts and hinder recovery. If deflation persists, a further downward adjustment of aggregate demand could cause the economy to contract significantly compared to the baseline. While the ban on growing Poppy can limit production, it can result in farmers losing income and lead to social unrest. Stability concerns in the banking sector are also a risk. 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.