

AFGHANISTAN DEVELOPMENT UPDATE

OCTOBER 2022



ADJUSTING TO THE NEW REALITIES

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PREFACE:

The Afghanistan Development Update provides a comprehensive report of 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 on 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.

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KEY MESSAGES AT A GLANCE

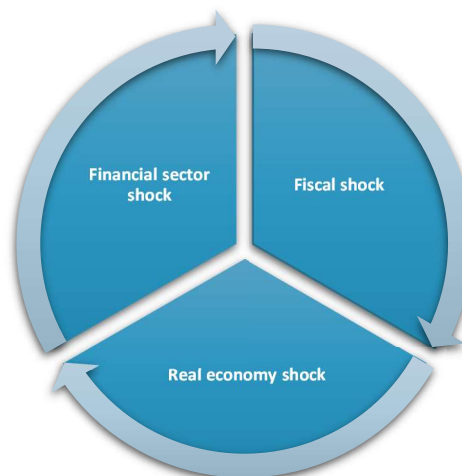
THE AUGUST 2021 TRANSITION RESULTED IN A PARADIGM SHIFT IN THE COUNTRY'S AID-DRIVEN ECONOMY.

The political uncertainty and fear resulted in a confidence crisis causing an exodus of highly skilled people and the closure of businesses and economic activities. The sudden stop of international aid and the confidence crisis culminated in three inter-related simultaneous shocks.

The economic output shrank significantly in the aftermath of the crisis due to interrelated shocks:

- Fiscal shock, as civil servants stopped receiving their salaries, development spending ended abruptly, and basic public services were disrupted.
- Second, the confidence crisis and central bank foreign asset freeze resulted in a bank run. Correspondent banking relations were severed due to foreign banks' concerns about the AML/CFT regime and due to the chilling effects of the sanctions.
- Third, a sharp fiscal contraction and financial sector challenges led to declining aggregate demand and disruptions in supply chains as import/export activities stopped and resulted in business closures and lay-offs. The overall output dropped sharply.

The economy faced multifaceted shocks.



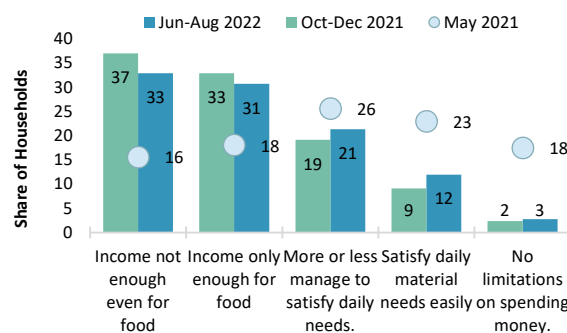
AFGHANISTAN'S ECONOMY IS ADJUSTING TO THE NEW REALITIES.

There are signs that the economy is adjusting to a low-level equilibrium. The resumption of off-budget aid (estimates USD2 billion, including USD1.2 billion through direct cash shipments), primarily to support humanitarian delivery and basic services, helped cushion some of the negative impacts of the widespread humanitarian crisis.

Inflation remains high, and financial sector constraints persist. However, some other indicators saw improvements:

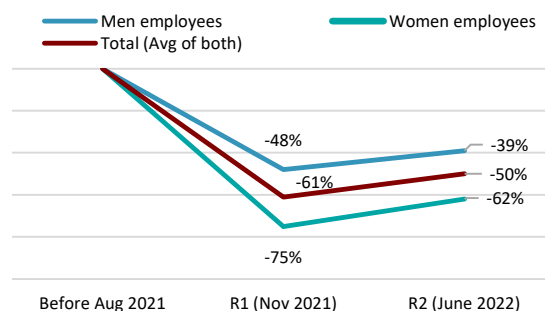
- Slight improvement in some business indicators (revenues, employment, and relatively better sentiments related to security and low corruption PSRS-2), as confirmed by an increase of days worked by skilled and unskilled workers (WB TPMA data)
- Share of households reporting difficulties covering their most basic expenses has fallen to 64 percent compared to 70 percent at the end of 2021 (AWMS-2 forthcoming)
- Exports have picked up since the fourth quarter of 2021, and the momentum continued into Q1-2022 (with USD409 million compared to USD200 million in Q1-2021).
- Relatively good revenue performance, with total revenue reaching AFN100 billion for December 22, 2021, to mid-August 2022 period, exceeding last year's collection during the same period
- Cash shipments of ~ USD1.2 billion (since November 2021) provided USD liquidity to the market (in the absence of regular USD auctions by DAB)
- Exchange rate volatility has lessened, and as of Sep 08, 2022, it was trading close to 88.19 AFN per USD, 2.3 percent below its August 15, 2021 value.

A slight improvement in household capacity to cover food and non-food expenses



Source: AWMS, Rounds 1 and 2

Employment has increased a tad since November 2021



Source: PSRS, Rounds 1 and 2

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KEY MESSAGES AT A GLANCE

THE BASELINE SCENARIO HINGES UPON DONOR OFF-BUDGET AID AND THE UN'S USD CASH SHIPMENTS.

Under the baseline scenario, the real GDP is projected to contract further in 2022, with an accumulated contraction of close to 30-35 percent between 2021 and 2022.

The economy is projected to move to a low growth path (2.0 to 2.4 percent) for the next two years—with no improvement in per capita incomes owing to high population growth and no significant changes in poverty or food insecurity. This outlook is subject to considerable downside risks. These include

- the potential discontinuation/reduction in aid from the current levels due to fiscal pressures in donor economies and potential fatigue
- a stoppage of USD cash shipments which could undermine exchange rate stability and reverse the anemic recovery in some indicators,
- potential stability concerns in the banking sector due to non-resolution of payment issues, an un-managed transition to Islamic banking, and
- climate disasters such as drought or shifts in precipitation patterns.

The new “economic normal” could remain “as is” or evolve into an upside and sustainable scenario under the following assumption:

- continued donor aid to essential services over the short to medium term.
- resolution of financial sector constraints,
- and a private sector-led future with an environment where the Afghan diaspora or residents takes the initiative and mobilize investments in the critical comparative advantage areas to create output and jobs.
- more use of ITA's resources and more transparency in public expenditure management related to the provision of basic services



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LIST OF ABBREVIATIONS

AFN	Afghan Afghani
AIB	Afghanistan International Bank
AML	Anti-Money Laundering
AWMS	Afghanistan Welfare Monitoring Survey
CFT	Combating the Financing of Terrorism
DAB	Da Afghanistan Bank
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IPC	Integrated Food Security Phase Classification
ITA	Interim Taliban Administration
LTO	Large Taxpayer's Office
MFI	Microfinance Institution
MTO	Medium Taxpayer's Office
MSP	Money Service Provider
NPLs	Non-Performing Loans
NSIA	National Statistics and Information Authority
PSRS	Private Sector Rapid Survey
Q1	Quarter 1
Q2	Quarter 1
Q3	Quarter 1
Q4	Quarter 1
R1	Round 1
R2	Round 2
STO	Small Taxpayer's Office
TPMA	Third-Party Monitoring Agent
UN	United Nations
USD	United States Dollar
WB	World Bank

EXECUTIVE SUMMARY

The political crisis in Afghanistan on August 15, 2021, brought about a significant economic contraction that increased food insecurity and led to widespread deprivation. The preliminary statistics on gross domestic product (GDP) show that the economy contracted by 20.7 percent in 2021. The cessation of aid in the wake of the transition shrank public spending and aggregate demand severely (through public sector salaries and contracted goods and services), which flowed into lower household incomes and reduced consumption. This, in turn, undermined private sector activity, especially in the aid-driven services sector, which has contributed significantly to output and growth since 2001. The loss of business confidence has dampened investment demand. The lack of consumer demand, payment system disruptions, and supply constraints have had a substantial impact on the private sector, forcing many businesses to close or scale down their operations.

ECONOMIC DEVELOPMENTS

Despite reduced incomes and domestic demand, prices have increased rapidly. This points to a strong supply shock caused by supply disruptions arising from disruptions to international transactions and increased global prices. Official data for July 2022 show headline consumer price index inflation at 18.3 percent, driven mainly by 25 percent year-on-year (y-o-y) inflation in the food segment. By comparison, y-o-y inflation in the non-food segment was recorded at 11.6 percent in July 2022. Estimates of basic household goods inflation, based on price information supplied by the World Food Programme, show that the price of typical household goods increased, on average, by 43 percent y-o-y in July 2022 before declining to a still-high 31.5 percent in August. These higher prices have severely impacted those who are less well-off and spend a larger share of their incomes on food.

Afghanistan's financial sector remains in crisis. The central bank, Da Afghanistan Bank (DAB), has lost its ability to manage payment systems and conduct monetary policy due to the freezing of offshore assets and its inability to print new afghani (AFN) notes. The resulting shortage of United States dollars (USD) and AFN currency notes, together with international sanctions, have triggered a crisis of confidence in the banking sector. All banks but one has reported significant losses for the first quarter (Q1) of 2022, due mainly to the inability to collect interest income and foreign exchange losses. Non-performing loans (NPLs) are underreported due to the central bank's forbearance measures. There are rapidly escalating stability risks in the banking sector, made more worrisome by DAB's limited bank resolution capacity.

The freeze on central bank assets and concerns related to anti-money laundering and combating the financing of terrorism (AML/CFT) is hindering the functioning of normal correspondent banking relations between Afghan and foreign banks. On September 14, 2022, the United States government announced the establishment of the Afghanistan Fund, using USD 3.5 billion of frozen assets. This fund will be housed at the Bank for International Settlements and managed by an independent board. Modalities are still unclear, however. In addition, the United States government has issued licenses to ease sanctions concerns and support humanitarian delivery. Still, international banks are reluctant to reestablish correspondent relations with Afghan banks due to AML/CFT concerns. Formal payments flowing into and out of Afghanistan remain problematic for all actors—including the Interim Taliban Administration (ITA), humanitarian agencies, and the private sector—for critical imports such as electricity, food, and medicines.

The resumption of off-budget aid during the year helped cushion some of the negative impacts of the widespread humanitarian crisis. Off-budget aid resumed shortly after the transition, primarily to support humanitarian assistance and basic services. Yet, at an estimated USD 2 billion, including USD 1.2 billion through direct cash shipments, this off-budget aid was significantly lower than in the past. There are signs

that the economy has reached an inflection point and is likely plateauing around a low-level equilibrium. While inflation remains high, some indicators have improved: (i) some improvement in living conditions has been observed amid large-scale deprivation and food insecurity; (ii) private businesses are adjusting to the new operating environment; (iii) exchange rate volatility has lessened; (iv) domestic revenue collection is relatively healthy; and (v) exports have increased. Nonetheless, sustaining these improvements will hinge upon the continuation of off-budget international support, including cash shipments of USD by the United Nations (UN).

While living conditions remain grim, more recent information collected this summer shows a slight improvement. Although no poverty data are collected for the country, estimates for Q4-2021 indicated that close to 70 percent of the country's population experienced difficulties covering their most basic expenses. This share saw marginal improvement this summer, as the share of households reporting difficulties in covering their most basic expenses has fallen to 64 percent. Labor earnings plummeted across the country, and recent data show that a contraction in salaried employment has resulted in increased self-employment and a shift to low-productivity jobs. Salaried employment has recovered slightly in urban areas but remains below the level in place before the onset of the COVID-19 pandemic. On the downside, high inflation is eroding the real value of household earnings, pushing more people into food insecurity, and forcing households to adopt potentially harmful coping strategies.

Businesses are adjusting to the new realities and are gradually starting to resume operations, albeit well below capacity. According to the second round of the Private Sector Rapid Survey, conducted in May-June 2022, more than three-fourths of surveyed firms were operational, compared to two-thirds after the first round in November 2021. Nevertheless, the majority are operating far below their capacity. While, by November 2021, employment in surveyed firms had dropped 61 percent below pre-crisis levels, round two results show that a marginal recovery to 50 percent below pre-crisis levels. Surveyed firms highlight the positive impacts of improved security and reduced corruption. Nonetheless, private sector firms continue to report high uncertainty, a dysfunctional banking system, and dampened consumer demand as the most significant constraints to their businesses.

After a significant initial depreciation, exchange rate volatility has lessened in recent months, thanks mainly to the UN's shipment of USD 1.2 billion in cash between November 2021 and August 2022. The AFN has exhibited mixed performance in recent months. DAB data show that between the end-June and mid-September 2022, the AFN depreciated by 0.5 percent against the USD and 1.9 percent against the Chinese yuan. However, the AFN gained 6.1 percent against Euro, 11.6 percent against the Pakistan rupee, and 0.2 percent against the Indian rupee. In the absence of central bank liquidity management, Afghanistan's money service providers (MSPs) continue to report some foreign exchange shortages in the open market as the ITA seeks to exert more robust controls in the foreign exchange market, including by regulating the MSP sector and prohibiting foreign currency-denominated domestic transactions.

Exports have picked up since Q4-2021, and the momentum continued into Q1-2022, reflecting a surge in exports of coal and food items. USD 408.7 million in goods were exported in Q1-2022, more than twice the USD 200.2 million exported the previous year in Q1-2021. Recent mirror trade data for July 2021 to June 2022 from Pakistan authorities indicate that Afghanistan has a trade surplus of USD 79 million. Economic contraction drove a 47 percent reduction in goods imports over the second half of 2021 relative to the same period in 2020. In Q1-2022, while imports of fuel and petroleum products increased by 57 percent because of higher international prices, imports of other categories of goods declined significantly, resulting in an overall decline of 11.3 percent y-o-y in total imports.

Domestic revenue collection is relatively healthy but insufficient compared to expenditure needs. Recent revenue data demonstrate good performance, with total revenue reaching AFN104 billion (USD 1.1 billion) for the period from December 22, 2021, to end-August 2022 (exceeding last year's collections

during the same period). This revenue boost results from increased revenues collected at borders (including import duties and the Business Receipt Tax). Budgeted revenue for the fiscal year covering March 21, 2022, to March 20, 2023 (FY1402) is AFN 186.7 billion (USD 2.05 billion), of which AFN 203 billion (USD 2.2 billion) are recurrent expenditures, and AFN 27.9 billion (USD 0.3 billion) are development allocations. The deficit of AFN 44 billion (USD 500 million) remains explicitly unfunded. The ITA has severely restricted access to public expenditure statistics, including granular information on expenditure allocations, and has stopped publishing data on planned and actual expenditures. ITA's spending will likely remain limited by the revenue collection, given the non-availability of on-budget external grants and debt disbursement.


OUTLOOK AND RISKS

The economy is now readjusting, and the international community's ongoing off-budget support for humanitarian needs and basic services is expected to mitigate some of the negative impacts of the contraction. Still, it will not be sufficient to bring the economy back onto a sustainable recovery path. Under the baseline scenario, in which the country receives minimal international support for humanitarian activities and basic core services, the real GDP is projected to contract further in 2022, with an accumulated contraction of close to 30-35 percent between 2021 and 2022. The economy is projected to move to a low growth path (2.0 to 2.4 percent) for the next two years, with no improvement in per-capita income owing to high population growth and no significant changes in poverty or food insecurity. Inflation is expected to remain high in the near term due to global commodity price increases and supply constraints, further eroding the real value of household incomes. At the same time, the ITA's restrictive policies on women's education and work will lower Afghanistan's growth prospects.

This outlook is subject to significant downside risks. These include: (i) the potential discontinuation of or reduction in aid due to fiscal pressures in donor economies and potential donor fatigue; (ii) the stoppage of USD cash shipments, which could undermine exchange rate stability and reverse the anemic recovery in some indicators; (iii) potential stability concerns in the banking sector due to payment resolution challenges and an unmanaged transition to Islamic banking; and (iv) the impact of potential climate events, such as droughts. The marginal improvements observed recently in sentiments, household welfare, and private sector business operations depend on the continuation of current levels of off-budget aid. Any disruption or decline in aid will risk an immediate reversal in sentiment and have broader welfare impacts.

The financial sector poses a significant downside risk to the baseline outlook. The central bank cannot manage domestic liquidity and undertake critical functions, including supervising the banking sector, monitoring illicit financial flows, and performing AML/CFT monitoring. The newly issued requirement that all financial institutions transition to Islamic banking will create additional operational difficulties if not handled carefully. Agriculture has strong forward and backward linkages with the economy and is subject to climate change risks. Drought or shifts in precipitation patterns pose significant downside risks to the baseline scenario.

A range of economic and political scenarios is possible for Afghanistan's future. In a more upside and sustainable scenario, one assumes that donor aid will remain limited to essential services over the short to medium term. It envisages the resolution of financial sector constraints and a private sector-led future with an environment where the Afghan diaspora or residents takes the initiative and mobilize investments in the critical comparative advantage areas to create output and jobs; more use of ITA's resources and more transparency in public expenditure management related to the provision of basic services. In addition, this investment could be complemented by regional partners in critical areas. Under this option, output growth is assumed to remain low. Although outcomes will be slow to materialize under these



conditions and output growth is projected to remain muted, this could create an environment under which donors can exit.

1. CONTEXT AND ECONOMIC DEVELOPMENTS—THE AFTERMATH OF THE AUGUST 2021 CRISIS¹

Afghanistan's growth was slow even before the political crisis last year. Reflecting decreased grant support and heightened political instability, real growth in the gross domestic product (GDP) declined from an average of close to 10 percent during 2005–14 to 2.3 percent during 2015–19. In 2020, the emergence of the COVID-19 pandemic further contracted the economy by 2.4 percent due to border closures, lockdowns, and reduced remittances. Poverty remained widespread, with 47 percent of the population living under the poverty line.

The August 2021 transition shifted the paradigm of the country's aid-driven economy. The climate of political uncertainty and fear brought about a crisis of confidence, causing an exodus of highly skilled people and the closure of businesses and economic activities. Together with the sudden cessation of international aid, this confidence crisis culminated in three interrelated, simultaneous shocks. First, there was a fiscal shock, as civil servants stopped receiving their salaries, development spending ended abruptly, and basic public services were disrupted. Second, a financial sector shock ensued, as the central bank's foreign asset freeze resulted in a loss of confidence in the banking sector, and depositors ran to withdraw their deposits. Correspondent banking relations were severed due to foreign banks' concerns about anti-money laundering and combating the financing of terrorism (AML/CFT) and the chilling effects of sanctions. Finally, a demand shock resulted from the sharp fiscal contraction and financial sector challenges, with declining aggregate demand and supply chain disruptions as import/export activities faltered and businesses were forced to close or lay off employees. Overall output dropped sharply in response.

The preliminary GDP estimates show that the economy contracted by 20.7 percent in 2021 (Figure 1), driven primarily by a sharp contraction in the non-agriculture sector (which accounts for two-third of GDP). The services sectors shrank by one-third compared to 2020. While almost all services sectors were hard-hit, the impact on health (-45 percent), dining and lodging (-38.7 percent), and education (-27 percent) sectors were particularly significant given their high dependence on aid. The effects were severe in urban areas, where economic activities rely largely on the aid-driven contracted services sector. The industrial sector was also negatively affected, due mainly to the contraction in construction (-48 percent) and non-food manufacturing (-18 percent), resulting in the closure of firms as these struggled for liquidity and inputs.

The agriculture sector is estimated to have contracted by at least 3 percent in 2021 (Figure 1) compared to 6 percent growth in 2020. Widespread drought conditions,² particularly during wheat harvesting, suggest a loss of two-fifths of the wheat crop. Afghanistan is among the world's most at-risk countries

¹ Scarce data and the ITA's restrictive policies on information sharing have made it extremely difficult to monitor and assess in a timely manner the actual state of the economy and humanitarian situation. Current *de facto* authorities have imposed heavy restrictions on publishing data and information. The Ministry of Finance has not published the annual budget documents for March 21, 2021–March 20, 2022, and national accounts data were produced with significant delays. No interim reports are published on the ITA's expenditure management and control. Almost all government websites remain either offline or outdated. In the absence of a complete set of official statistics, this report relies on the following sources:

1. Official Statistics, where available
2. Monthly data collected by the World Bank's Third-Party Monitoring Agent (TPMA)
3. [Afghanistan Private Sector Rapid Survey, Round 1](#) (October–November 2021), World Bank
4. [Afghanistan Welfare Monitoring Survey, Round 1](#) (October–December 2021), World Bank
5. [Afghanistan Private Sector Rapid Survey, Round 2](#) (May–June 2022)
6. Afghanistan Welfare Monitoring Survey, Round 2 (June–August 2022)

² World Bank Group and Asian Development Bank. 2021. *Climate Risk Country Profile: Afghanistan*. Washington, DC, and Manila: World Bank and Asian Development Bank.

with respect to climate change (Box 1). In addition, weak climate mitigation responses and heightened insecurity significantly affected crops and livestock in 2021. During last year's peak harvest seasons (June–August), increased clashes between the Taliban and the then-government, and the resulting loss of territory, further disrupted agriculture sector value chains, resulting in significant agribusinesses losses.

Figure 1: Real GDP growth by sector

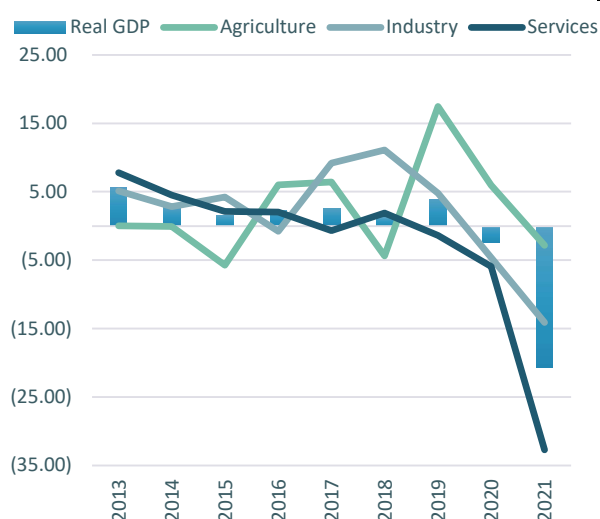
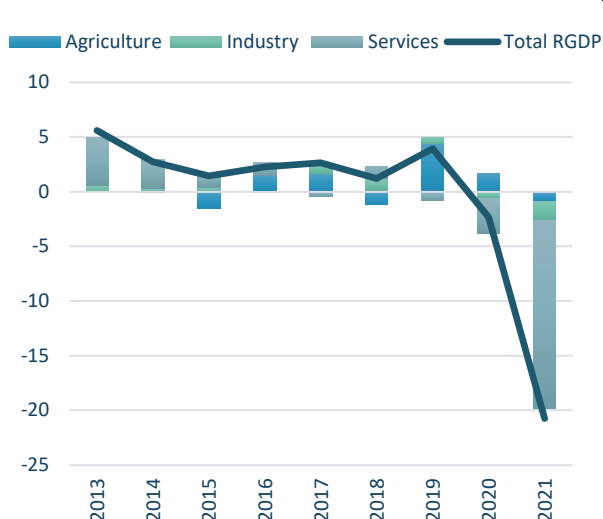


Figure 2: Contribution to real GDP



Source: National Statistics and Information Authority (NSIA).

Box 1: Climate Change—A Significant Threat to Afghanistan's Growth and Well-Being

The Climate Risk Country Profile, prepared jointly in 2021 by the World Bank and Asian Development Bank, finds that Afghanistan faces a higher warming rate than the global average; rising annual temperatures; greater variation and uncertainty in floods, rainfall, and drought; a loss of biodiversity; and an increase in heat-related sicknesses. With 80 percent of the country's water derived from rivers that are significant not only for Afghanistan but also for neighboring countries, improper water management in rivers can substantially exacerbate the environmental and economic consequences of climate change. Moreover, higher temperatures have resulted in an ecological transition that challenges cultivation and affects animal habitats.

Overall, Afghanistan is the fifth-most at-risk country in the world, with the highest level of natural hazards. The events of 2021 have further increased the population's vulnerability due to limited access to data and research and limited understating of the current situation.

Afghanistan depends heavily on agriculture for subsistence and livelihoods, as the sector employs half of the working population. Climate change and natural disasters threaten domestic production and the welfare of communities in the agricultural sector. Staple crops, such as wheat, are highly susceptible to water shortages; and agricultural production can drop by as much as 30 percent in years of drought. Afghanistan also remains one of the world's biggest net food importers, leaving the country vulnerable to external price shocks. In recent years, annual cereal imports have been equivalent to 29 percent of domestic production. Climate change impacts on agriculture result in increased malnutrition, inequality, and gender imbalances, increasing the economy's fragility.

Aggregate demand fell sharply. A sharp fiscal contraction impacted the large public sector and aid-driven economy (through public sector salaries and contracted goods and services). In addition, public sector civilian employees' salary payments stopped initially and resumed only partially afterward, with a lower salary scale. Payments to disband the Afghanistan National Army stopped completely. These factors resulted in lower household incomes, reduced consumption, and collapsing aggregate demand. In

addition, the loss of business confidence has dampened investment demand as the private sector reeled from declining consumer demand, payment system disruptions, and supply constraints.

The financial sector fell into crisis, and the core functions of the central bank and the banking sector remain unfulfilled. Even before the political crisis, depositors began withdrawing their savings from banks as a precaution. Confidence was undermined further by uncertainty about the political and economic environment, and after the Interim Taliban Administration's (ITA), this evolved into a full-blown bank run. To tackle the issue and preserve the banks' solvency, the central bank imposed a statutory withdrawal limit on all deposits made before August 15, 2021. The problem was compounded by the freezing of the central bank's assets (USD 9 billion), which compromised the central bank's ability to manage payment systems, conduct monetary policy, and print new AFN notes. The central bank's asset freeze and AML/CFT-related concerns are hindering the functioning of normal correspondent banking relations between Afghan and foreign banks. Formal payments flowing into and out of Afghanistan have been disrupted and remain problematic for all actors—including the ITA, humanitarian agencies, and the private sector—for critical imports such as electricity, food, and medicines.

Private sector activities came to an abrupt halt immediately after the political crisis. A Private Sector Rapid Survey (PSRS), conducted by the World Bank with a small sample of 100 firms in November 2021, suggested that businesses adopted a wide range of coping strategies across sectors and firm size. Large businesses were more resilient, increasing their use of cash and the informal *Hawala* system and scaling back operations. Medium and small businesses, on the other hand, were more likely to reduce operations significantly or to shut down altogether, whether temporarily or permanently. The PSRS showed that job losses and declining purchasing power had significantly dampened consumer demand (Figure 3). Firms in the agribusiness sector were relatively more resilient to shocks, reporting a lower-than-average drop in consumer demand. At the same time, firms in the services and manufacturing sectors bore the brunt of the adjustment. Surveyed businesses laid off 61 percent of full-time employees in response to these challenges (Figure 4), and the percentage of women workers who lost their jobs was even higher, at 75 percent.

Figure 3: Consumer demand by sector of activity (% of respondents)

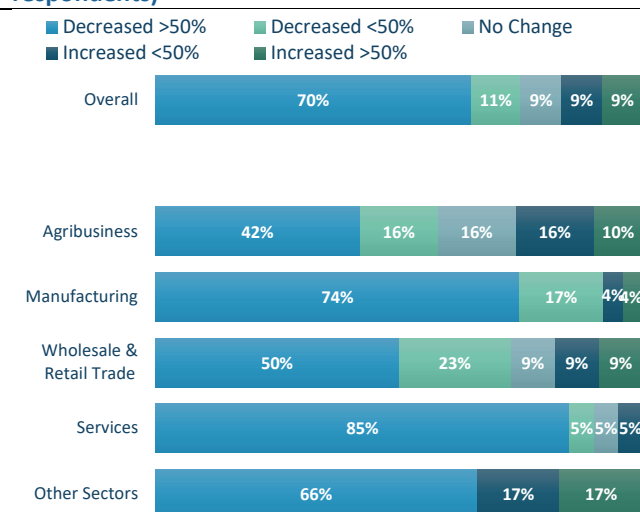
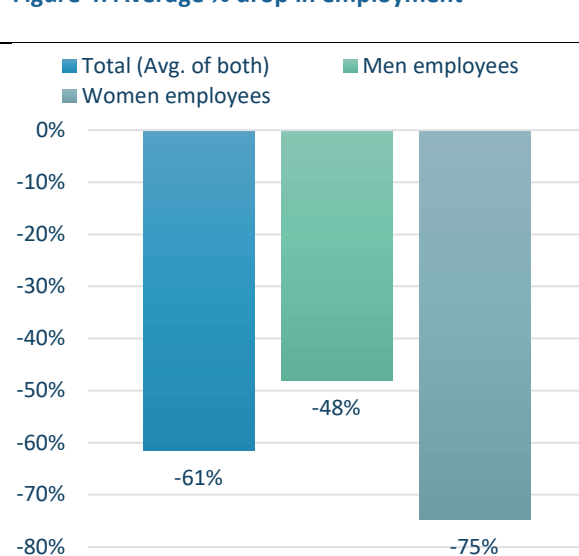


Figure 4: Average % drop in employment

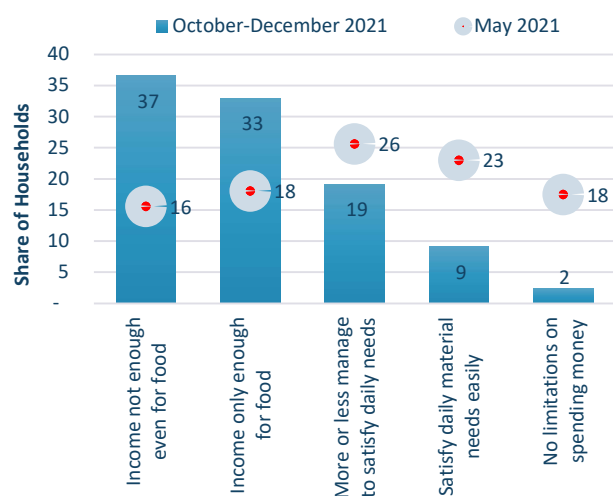


Source: Afghanistan PSRS, Round 1 (November–December 2021), World Bank.

The crisis resulted in a significant increase in prices, deteriorating economic conditions, a rise in food insecurity, widespread deprivation, and welfare losses. A sharp hike in inflation, combined with the fall in nominal incomes, caused a steep drop in purchasing power (Figure 5). Nearly 90 percent of employed

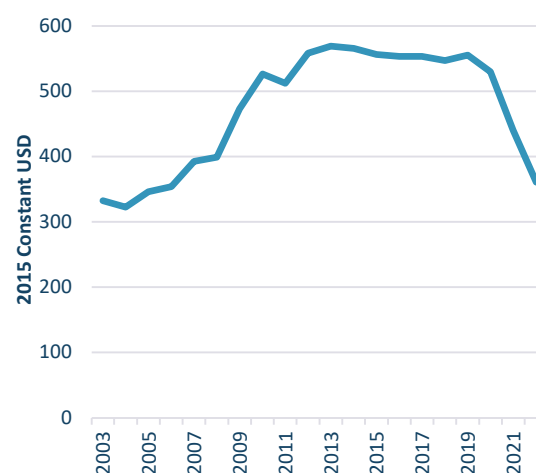
households interviewed for the World Bank's Afghanistan Welfare Monitoring Survey (AWMS) from October–December 2021 reported a decline in their labor earnings over the previous 30 days (Figure 6). Those who were self-employed or in casual work saw the most significant reduction, with 88 percent of respondents reporting a drop in earnings. Those employed in salaried jobs also experienced a decrease in income, with 80 percent of salaried workers in the public sector and 82 percent of salaried workers in the private sector reporting a drop in labor earnings. In rural areas, household earnings from agricultural sources were negatively affected by economic and climate conditions, with 85 percent of households reporting diminishing yields and lower revenue due to drought conditions.

Figure 5: Self-reported household capacity to cover food and non-food expenses



Source: AWMS, Round 1 (October–December 2021), World Bank.

Figure 6: Collapse in per-capita income to 2006–07 levels



Source: Official statistics, where available; World Bank staff projections.

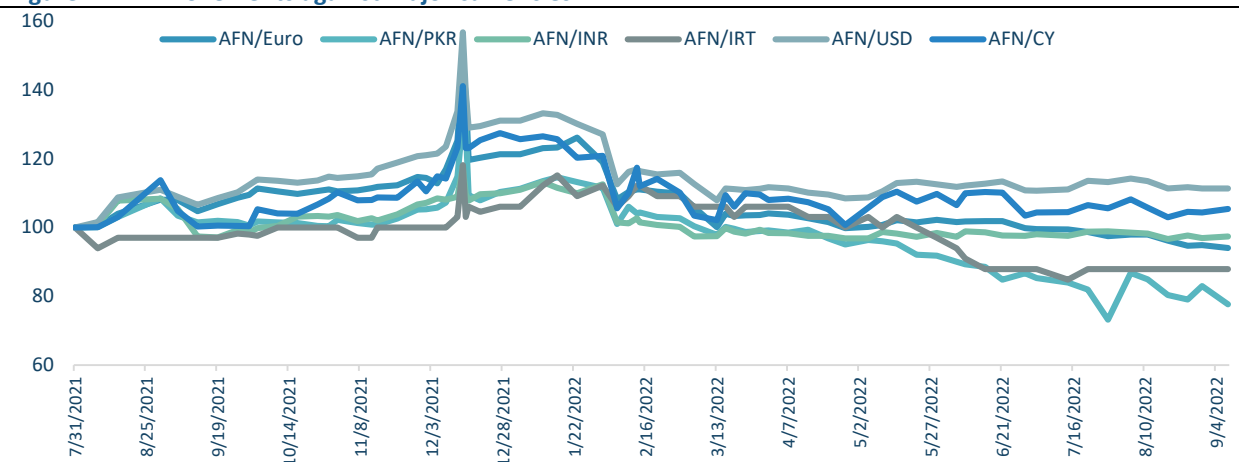
2. RECENT ECONOMIC DEVELOPMENTS IN 2022—ADJUSTING TO THE NEW REALITIES

While some key challenges stemming from the crisis persist, there are some positive signs that the economy is adjusting to a low-level equilibrium. The resumption of off-budget aid (estimated at USD 2 billion, including USD 1.2 billion in direct cash shipments), primarily to support humanitarian assistance and basic services, helped to cushion some of the negative impacts of the widespread humanitarian crisis. Owing largely to this aid and to improved security conditions, there are signs that the economy has reached an inflection point and is likely plateauing around a low-level equilibrium. While inflation remains high, some other indicators have improved: (i) exports have increased; (ii) exchange rate volatility has lessened; and (iii) domestic revenue collection is relatively healthy, (iv) some improvement in living conditions has been observed amid large-scale deprivation and food insecurity; and (v) private businesses are adjusting to the new operating environment. In addition, the United States government has issued general licenses to ease sanctions concerns and support humanitarian delivery. Still, international banks are reluctant to reestablish correspondent relations with Afghan banks due to AML/CFT concerns.

EXCHANGE RATE: The United Nations Cash Shipments Helped

While the afghani (AFN) depreciated significantly against the United States dollar (USD)—by 30 percent between August and December 2021—it appreciated gradually and stabilized at around AFN 88/USD by mid-September 2022, thanks mainly to cash shipments conducted by the United Nations (UN). Due to the country's dysfunctional payment system, the UN started bringing in shipments of cash in USD to support humanitarian operations from November–December 2021 (USD 1.2 billion in total, as of August 2022). Data issued by the central bank, Da Afghanistan Bank (DAB), show that, between end-June and mid-September 2022, the AFN depreciated by 0.5 percent against the USD and 1.9 percent against the Chinese yuan (Figure 7). However, the AFN gained by 6.1 percent against the Euro, 11.6 percent against the Pakistan rupee, and 0.2 percent against the Indian rupee. DAB's last USD auction was held on March 23, 2022. In the absence of central bank liquidity management, money service providers (MSPs) continue to report some foreign exchange shortages in the open market as the ITA seeks to exert more robust controls in the foreign exchange market, including by regulating the MSP sector and prohibiting foreign currency-denominated domestic transactions (such as buying or selling a house, apartment, or other commodities or conducting housing rental transactions).

Figure 7: AFN movements against major currencies



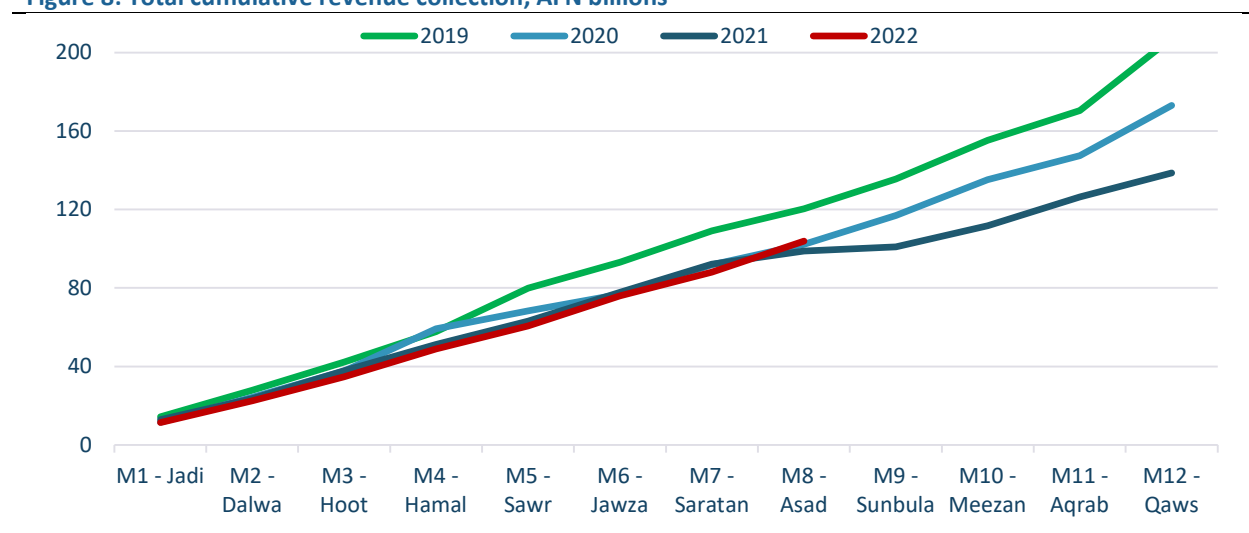
Source: Da Afghanistan Bank (DAB).

FISCAL SECTOR: Revenue Collection Exceeded Last Year's Performance

Domestic revenue collapsed in 2021 because of political events and unrest. Total domestic revenues amounted to AFN 140 billion in 2021 compared to AFN 173.2 billion in 2020, a nominal decline of 20 percent. Even prior to the events of August 15, 2021, domestic revenue collection dropped sharply starting in July 2021, as major border crossings were lost to the Taliban and overall confidence in the government began to sink. While the ITA moved quickly to restore centralized revenue collection starting in September 2021, this was insufficient to make up revenues for the year.

Preliminary data show that domestic revenue performance in the first eight months of 2022 reached AFN 104.0 billion, exceeding collections over the same period in 2020 and 2021 (Figure 8). Reliance on revenue collected at the border has increased significantly: 57 percent of revenue for the year up to August was collected by the Afghanistan Customs Department, compared to an average of 43 percent over the same period in the last three years (Figure 9). In the past, Afghanistan has relied relatively heavily on revenue collected at the border, as opposed to inland revenue collection, and this dependency has increased under the ITA. Customs department collections increased by 34 percent year-on-year (y-o-y) during the period from December 22, 2021, to end-August 2022. The overall revenue target for the new fiscal year (March 21, 2022–March 20, 2023) is ambitious at AFN 187 billion, or AFN 15.5 billion per month, on average—AFN 4 billion per month more than last year's average performance. In the first five months of the fiscal year (March–August 2022), average monthly overall collections remained below the target, at AFN 13.8 billion.

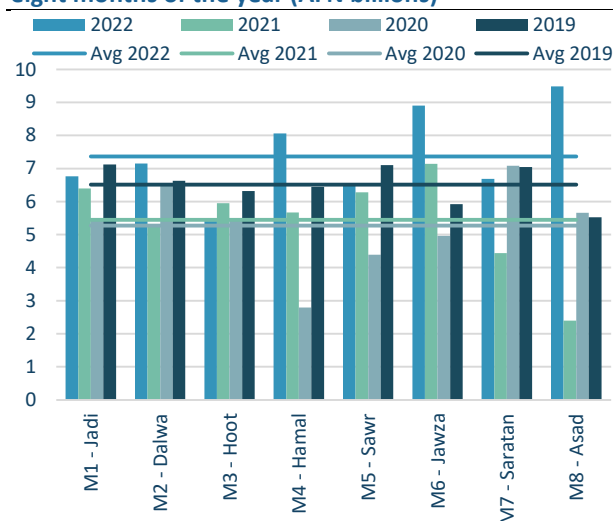
Figure 8: Total cumulative revenue collection, AFN billions



Source: Ministry of Finance, Afghanistan.

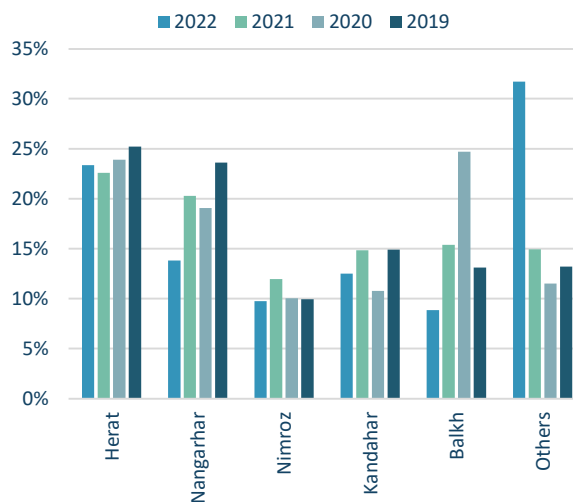
The Herat border crossing with Iran continues to collect the highest revenues (Figure 10). Customs department revenues from Herat reached AFN 14 billion, meeting the internal target. On the other hand, the share of customs collection from the Nangarhar border point has declined, from an average of 21 percent in the last three years to 14 percent in 2022. Similarly, customs points in Kandahar and Balkh contributed about 12 and 9 percent, respectively, between December 2021 to August 2022, compared to 15 percent over the same period last year.

Figure 9: Revenue collected at the border in the first eight months of the year (AFN billions)



Source: Ministry of Finance, Afghanistan

Figure 10: Share of collections at border crossings (%)

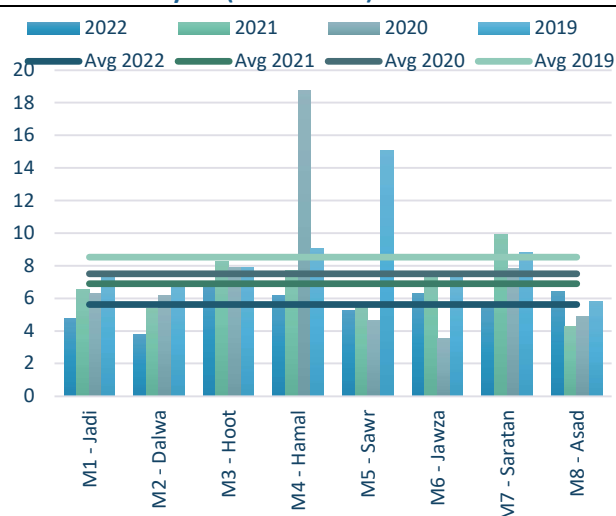


Inland tax revenues lagged significantly against internal targets and compared to previous performance.

Domestic tax revenues declined by about 18 percent y-o-y during the period from December 22, 2021, to end-August 2022, reflecting a compressed economy. Revenues from the Large Taxpayer Office (LTO), Medium Taxpayer Office (MTO), and Small Taxpayer Office (STO) during this period were a little over half of those in the same period of the previous year. Revenues from the LTO reached AFN 8.7 billion in the first eight months of 2022 (FY1401) compared to AFN 15.2 billion in 2021 (FY1400). Furthermore, the MTO and STO collected AFN 5.5 billion over the eight months, a 50 percent decline over the AFN 10.9 billion collected during the same period of the previous year.

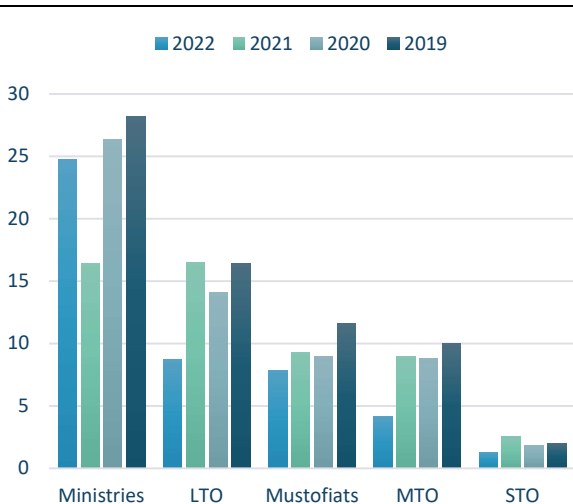
Non-tax revenues, on the other hand, performed relatively well (Figure 11). Ministries, which collect most of Afghanistan's non-tax revenues through administration fees and royalties, now contribute 54 percent of total inland revenues, compared to 30 percent in 2021 (Figure 12). The increase in ministries' revenue is likely driven by a rise in coal mining royalties and fees.

Figure 11: Inland revenue collection in the first eight months of the year (AFN billions)



Source: Ministry of Finance, Afghanistan.

Figure 12: Share of revenue collections by source (%)



The ITA has severely restricted access to public expenditure statistics. ITA spending will likely remain limited by revenue collection, owing to the lack of support for external grants and debt disbursement. Based on World Bank staff baseline estimates, total expenditures are likely to remain limited to AFN 164 billion during 2022, all of which would take the form of recurrent expenditures with no allocations for the development budget. Under the ITA, the Ministry of Finance has stopped publishing any data on planned or actual spending. The ITA recently moved the budget calendar from Dec 21–Dec 20 to Mar 21–Mar 20, aligning with the Afghan calendar.

The ITA's total expenditures are budgeted to reach AFN 231.4 billion, of which AFN 203.5 billion (88 percent) is allocated toward recurrent spending and the remaining AFN 27.9 billion (12 percent) i for development expenditure. Despite highly optimistic budgeted revenues, however, the budget estimates a high deficit of AFN 44.7 billion without any financing options. The development budget remains explicitly unfunded. Contingency expenditures are estimated at AFN 14.3 billion (or 7.6 percent of the total recurrent budget), doubling as a proportion of the total budget compared to previous years and over twice the allowed statutory limit of 3 percent.

EXTERNAL SECTOR: Imports Declined, but Exports Rebounded Strongly³

Afghanistan faced a sharp external adjustment in the second half of 2021 due to the cessation of international aid and trade disruptions following the Taliban takeover on August 15, 2021. With the cutoff of grant inflows, official transfers dropped to USD 0.6 billion in the second half of 2021, roughly one-third the amount received in the corresponding period of 2020. Imports recorded a sharp decline, especially in Q3-2021, due to a sudden reduction in economic activity and financial sector disruptions. Exports also weakened in the second half of 2021, but a much larger import contraction significantly narrowed the trade and current account deficits. The value of the AFN against major currencies decreased in the aftermath of political and financial instability and exhibited considerable volatility in the second half of 2021.

Facilitated by informal payment channels, trade is recovering gradually. The value of merchandise imports and exports in USD rebounded in Q4-2021 and continued to grow in Q1-2022, with the growth in imports outpacing the rise in exports (Figure 13). Nevertheless, while exports have quickly recovered to exceed pre-crisis levels, imports in Q1-2022 remain about 10 percent below the levels recorded in the same period in FY2021. As a result, the trade deficit in goods and services has widened since Q4-2021.

Imports have picked up steadily amid a recovery in economic activity and rising commodity prices. Following a collapse in Q3-2021, merchandise imports have been driven by a rebound in domestic demand and an uptick in international food and fuel prices, leading to solid growth in Q4-2021 (57.6 percent) and Q1-2022 (9.0 percent). The turnaround in imports since Q4-2021 has been broad-based (Figure 14), with the import of minerals and fuels rising by a compound sequential growth of 134 percent; foodstuffs by 59 percent; chemicals and plastics by 92 percent; textiles and footwear by 38 percent; and machinery by 44 percent. Services imports also recorded a robust sequential increase of 29.2 percent in Q1-2022. Recent data from the Pakistan authorities suggest that Afghanistan imports from Pakistan have continued to grow in Q2-2022.

³ The discussion in this section is limited by data availability constraints.

Figure 13: Exports and imports have rebounded (USD millions)

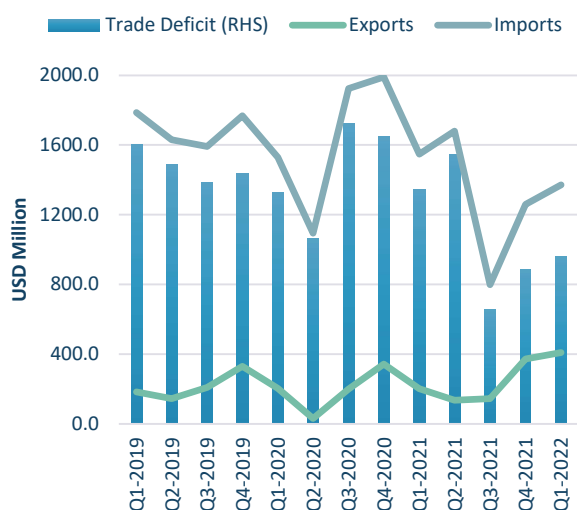
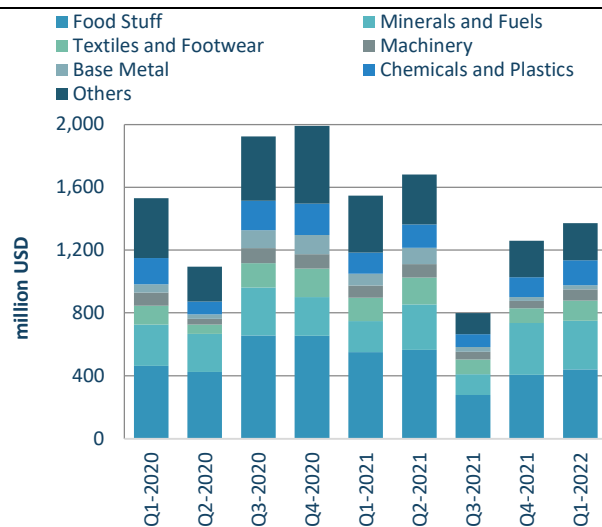


Figure 14: Broad-based increase in imports

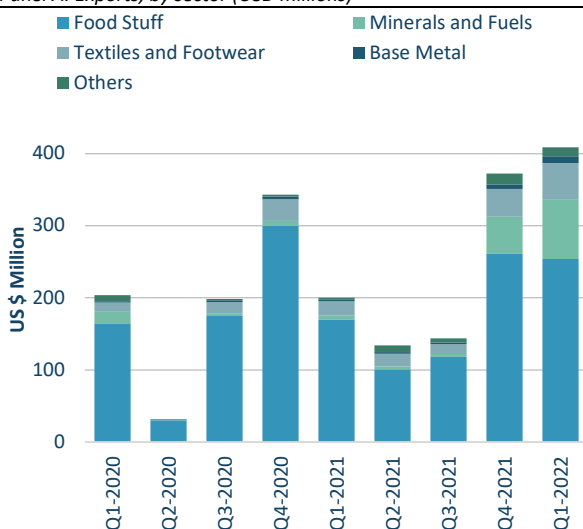


Source: National Statistics and Information Authority (NSIA).

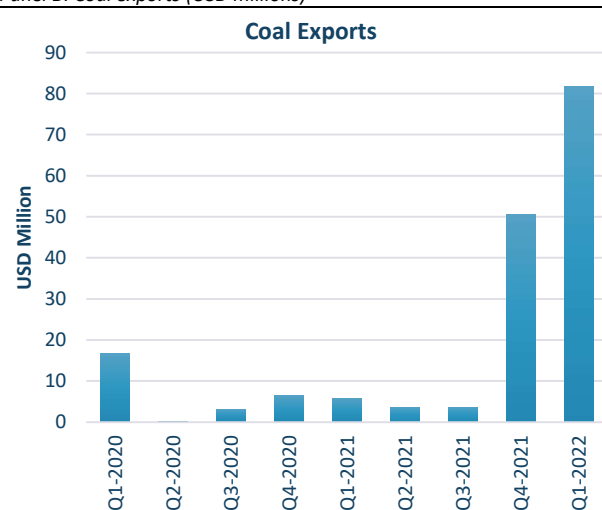
Exports have surged, helped by rising commodity prices due to disruptions in global supply chains. Exports have recovered strongly since Q4-2021, growing by 8.6 percent y-o-y in Q4-2021 and then recording a twofold increase in Q1-2022, compared to the same period in 2021. Both food and minerals contributed to solid export growth (Figure 15). Afghanistan's coal exports to Pakistan increased substantially due to the significant price differential between Afghanistan's coal price and that of other coal exporters. Coal exports amounted to USD 63.6 million in 2021 but have jumped to USD 81.8 million in just Q1-2022. Other commodities recording significant increases in exports include cotton and cotton yarn (from USD 9.5 million in Q1-2021 to USD 38.3 million in Q1-2022) and fresh and dried fruits (from USD 76.2 million in Q1-2021 to USD 104.2 million in Q1-2022).

Figure 15: Exports soared on the back of disruptions in global commodity markets

Panel A: Exports, by sector (USD millions)



Panel B: Coal exports (USD millions)



Source: National Statistics and Information Authority (NSIA).

PRIVATE SECTOR: A Marginal Recovery, As More Businesses Are Operational This Summer Compared to End-2021

According to the latest PSRS, conducted in May–June 2022, businesses are adjusting to new realities and are gradually starting to resume operations, albeit well below capacity. Half of the 265 businesses of all sizes surveyed in the second round of the PSRS reported a drop in demand since November 2021, while 37 percent indicated that demand for their products and services had increased in that period (Figure 16). More than three-fourths of surveyed firms were operational after the second round, compared to two-thirds in the first round. Nevertheless, the majority are operating far below capacity. Overall, panel firms—those that participated in both rounds of the survey—are better off now than in the first round: operating status improved for 43 percent, stayed the same for 40 percent, and deteriorated for 16 percent (Figure 17), indicating no “survival bias” in the selection of firms for the first-round survey. Of those firms that had closed temporarily in the first round, 75 percent are now either fully or partially open. One business is permanently closed. Of those firms that were fully open in R1, 38 percent are currently operating at lower capacity and thus considered only partially open.

Figure 16: Consumer demand, by firm size, November 2021 to June 2022 (% of respondents)

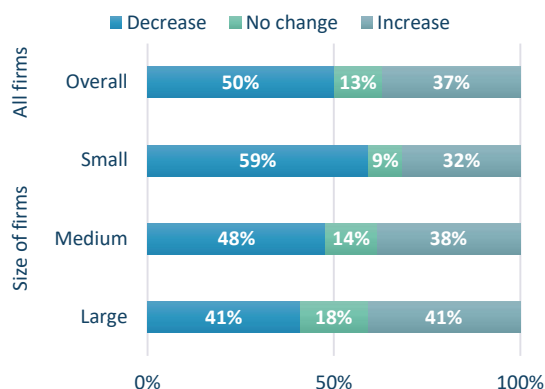


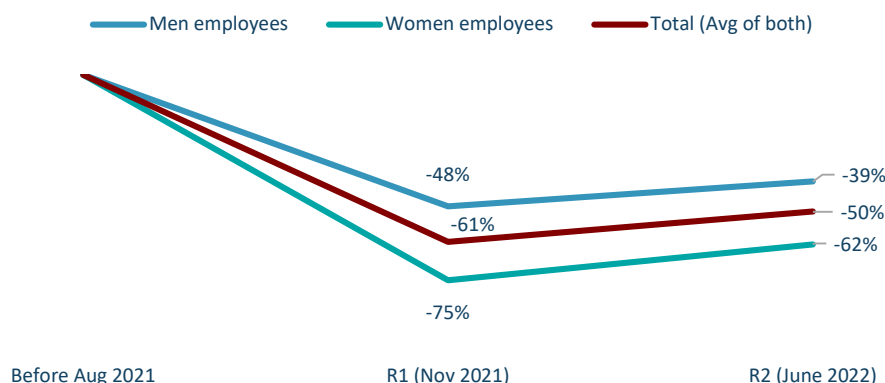
Figure 17: Operating status of panel firms (%) – R2 (2022) and R1 (2021)

		OPERATING STATUS OF PANEL FIRMS IN R1			
OPERATING STATUS OF FIRMS (R1 and R2)	OPERATING STATUS OF PANEL FIRMS IN R2	Fully open	Partially open	Temporarily closed	Permanently closed
		Overall	Overall	Overall	Overall
Fully open	Fully open	20%	25%	10%	55%
Partially open	Partially open	13%	12%	8%	33%
Temporarily closed	Temporarily closed	1%	1%	5%	7%
Permanently closed	Permanently closed			1%	3%
Overall		34%	39%	24%	4%

Source: Afghanistan PSRS, Round 2 (May–June 2022), World Bank. N=215.

Employment in surveyed firms has rebounded slightly (Figure 18). On average, employment in surveyed firms dropped to 61 percent below pre-crisis levels by November 2021. By June 2022, employment in firms that participated in the PSRS2 had recovered marginally but remained 50 percent below pre-crisis levels. In both survey periods, employment of women had dropped more significantly than that of men.

Figure 18: Employment has increased slightly compared to November 2021



Source: Afghanistan PSRS, Rounds 1 and 2, World Bank.

Nonetheless, private sector firms continue to report dampened demand, high uncertainty, and confidence-related banking challenges as their most significant business constraints (Figure 19). The PSRS2 results show that low consumer demand, due to a significant loss of income, is now the most considerable challenge to private sector activity, followed by the banking sector challenges. High levels of uncertainty about the future, including issues related to international sanctions, have tempered private sector investment sentiment since the first-round survey.⁴

Figure 19: Top constraints faced by businesses (% of respondents listing constraints among the top 3) – R2 (2022) & R1 (2021)

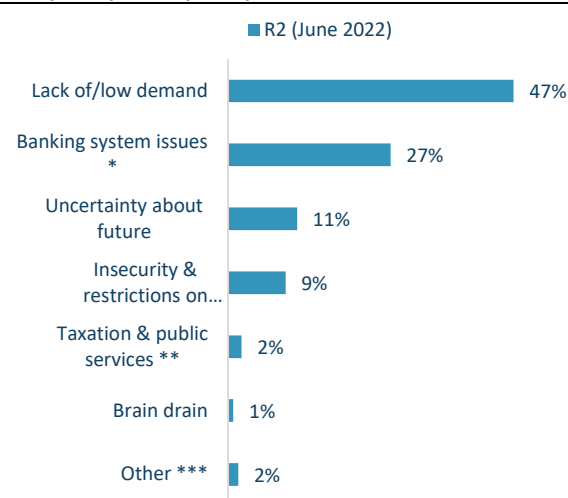
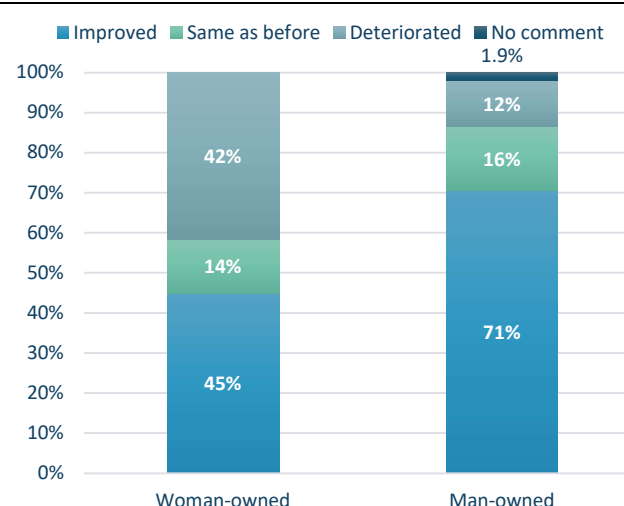


Figure 20: Security environment for businesses (% of respondents, 2022)



Source: Afghanistan PSRS, Rounds 1 and 2, World Bank.

Improved security and reduced corruption are two positives highlighted by surveyed firms. Most businesses reported that the security environment had improved since November 2021 (Figure 20). A higher proportion of men-owned firms cited improvements, as compared to women-owned firms. More than a quarter of women-owned firms reported experiencing a deterioration in the security environment for their businesses in recent months. On the other hand, firms reported significantly reduced corruption compared to pre-August 2021 (for details, see Section 4 below).

INFLATION: Supply Disruptions and a Global Surge in Food and Fuel Prices Have Kept Headline Inflation High

Prices of basic food and fuel items rose significantly over the year. Rising global prices for energy and food (which account for about half of the country's imports) and the impact of the drought on agricultural production have continued to drive inflation in Afghanistan (**Error! Reference source not found.**). Data collected by the World Food Programme show that the prices of basic food and fuel items significantly increased y-o-y, including: (i) diesel (55 percent); (ii) high-quality rice (33 percent); (iii) sugar (31 percent); (iv) wheat (42 percent); (v) pulses (16 percent); and (vi) bread (28 percent). These price increases resulted in 31.5 percent y-o-y inflation for basic household goods, slightly lower than the 43 percent increase recorded in July 2022. Price statistics for July 2022, published recently by the National Statistics and Information Authority (NSIA), show headline consumer price index inflation at 18.3 percent, driven mainly

⁴ Businesses were asked to identify the top three constraints. The results presented in Figure 19 are normalized to 100. The non-normalized results show that 96 percent of businesses listed low consumer demand as the top constraint, followed by banking sector issues (55 percent) and uncertainty about the future (23 percent).

by 25 percent y-o-y inflation in the food segment (**Error! Reference source not found.**). By contrast, y-o-y inflation in non-food was recorded at 11.6 percent in July 2022.

Figure 21: Inflation trend (index)

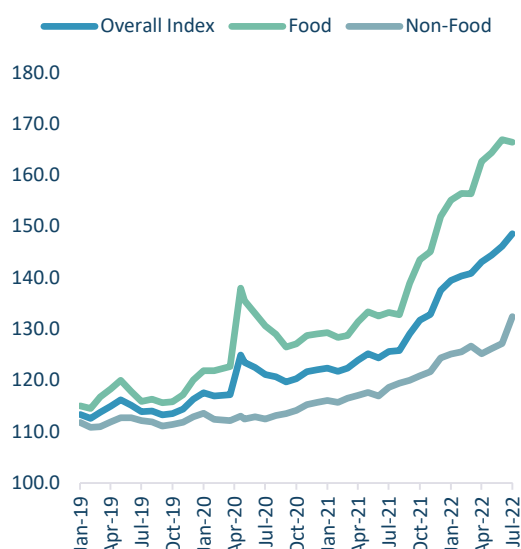
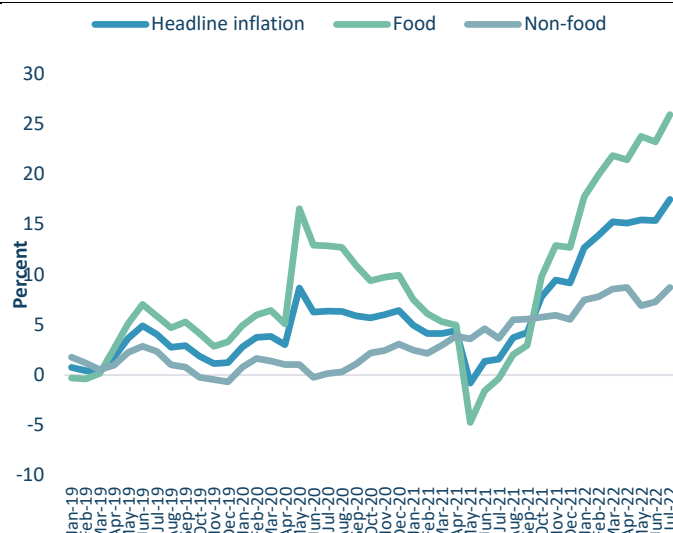


Figure 22: Price index, y-o-y change (%)



Source: National Statistics and Information Authority (NSIA).

Although prices remain high, basic food and non-food commodities remain available in the market. World Bank survey data collected from 48 markets in 21 provinces confirm the general availability of basic food and non-food items. Availability of several essential food items was, on average, 92 percent in November 2021 (Figure 23), with some food items as low as 76 percent. Similarly, availability of non-food items was at 95 percent (Figure 24), having almost wholly recovered as of July 2022. However, declining incomes and increasing prices have lowered the affordability of basic consumer goods for households.

Figure 23: Reported Availability of Food Items

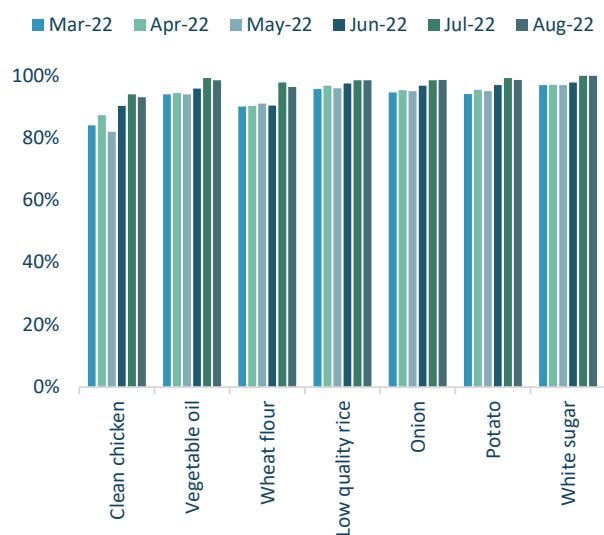
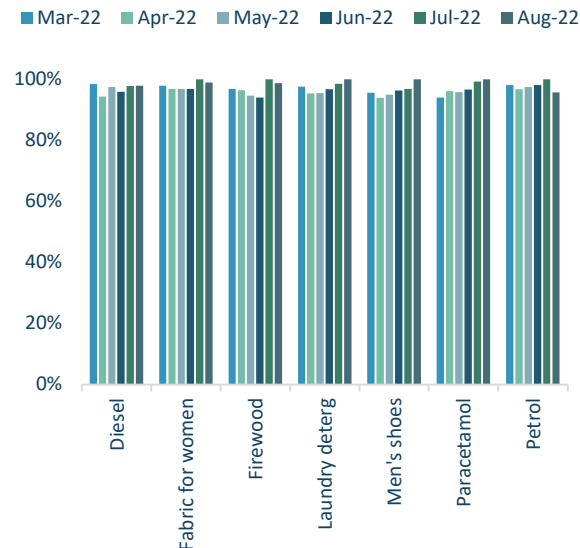


Figure 24: Reported Availability of Non-Food Items

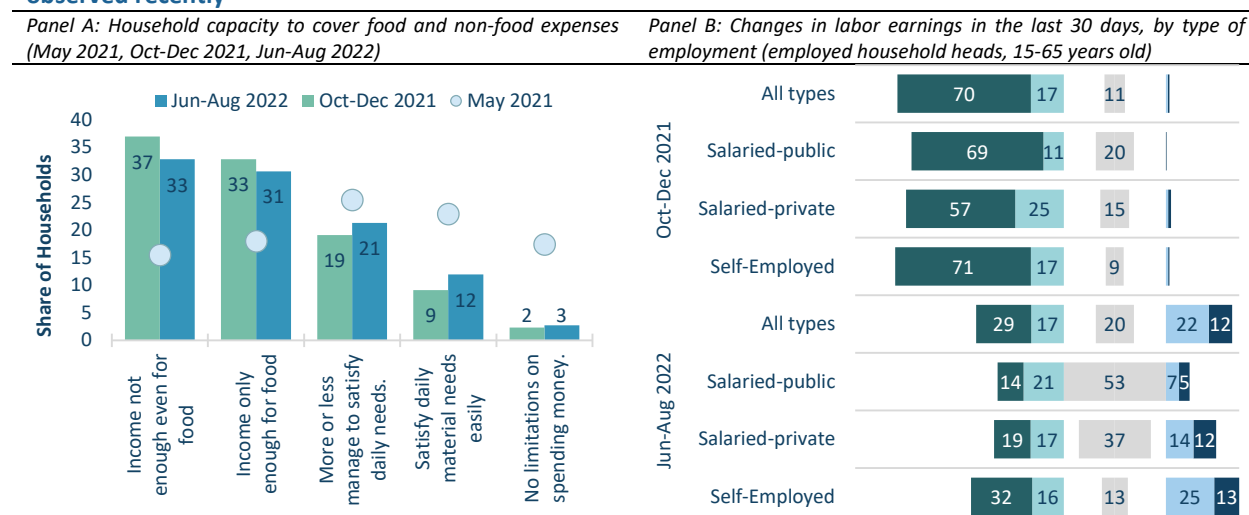


Source: Monthly data collected by World Bank's TPMA.

LIVING CONDITIONS AND WELFARE: Living Conditions Improved Slightly This Summer Compared to End-2021, but Deprivation Remains High

Living conditions continue to be dire, though some stabilization and marginal improvements have been observed in the last few months. While deprivation remains widespread in the country, the share of households that report struggling to cover their most basic expenses has receded slightly in recent months, dropping from 70 percent in October–December 2021 to 64 percent in June–August 2022 (Figure 25A). Among those who had trouble covering basic expenses, the share of households that could not afford food declined from 37 to 33 percent, a slight improvement but still a worrisome number. Reports from humanitarian agencies indicate that food insecurity remains substantial. Projections for June–November 2022 suggest that 45 percent of the population may be facing high levels of acute food insecurity,⁵ especially in the North and Northeast regions of the country, though no region is expected to reach imminent famine at this time.⁶

Figure 25: Living conditions continue to be dire, although some small labor market improvements have been observed recently



Source: AWMS Rounds 1 and 2, World Bank. In Panel B, for Decreased and Increased, a darker tone indicates workers reporting a large change, while the lighter tone indicates a small change.

Private employment in urban areas and labor earnings showed a slight recovery in recent months, consistent with the economy heading into a low-growth trajectory. Employment at the national level increased slightly between October–December 2021 and June–August 2022, from 79 percent to 82 percent. In urban areas, employment rose from 73 to 78 percent over the same period. Behind these improvements is expanding private employment, in line with other indicators suggesting that the economy may have started a slow recovery. In fact, among employed household heads, the share of those working in salaried jobs in the private sector increased from 8 percent to 11 percent, driven by an increase in private employment in urban areas. Meanwhile, the share of self-employment declined from 81 percent to 77 percent at the national level. Self-employment is still the most prevalent form of employment,

⁵ As defined by an Integrated Food Security Phase Classification (IPC) of Phase 3, indicating crisis, or above. See classification information at: <https://www.ipcinfo.org/ipcinfo-website/ipc-overview-and-classification-system/ipc-acute-food-insecurity-classification/en/>. See information on Afghanistan in IPC (2022) at: <https://www.ipcinfo.org/ipc-country-analysis/details-map/en/c/1155595/?iso3=AFG>.

⁶ IPC Phase 4: emergency.

composed mainly of vulnerable informal positions in the agriculture and services sectors. Labor earnings also show dynamics consistent with a slow recovery. While in October–December 2021, most workers reported declines in earnings over the previous 30 days (Figure 25B), in June–August 2022, close to a third of workers reported an increase in earnings over the previous 30 days, especially among the self-employed. Still, nearly half of workers reported a decline in earnings in the 30 days leading up to the June–August 2022 survey, indicating that the economic situation remains challenging for a sizeable share of workers in the country.

High inflation has further eroded the value of households’ already limited earnings, especially for the less well-off. Despite the collapse of aggregate demand in late 2021, prices continued to increase throughout late 2021 and 2022, reflecting depreciation, increasing international prices, and import constraints arising from disruptions to international transactions. Estimates from the World Bank’s economic monitoring, based on price information from the World Food Programme, show that the price of typical household goods increased, on average, by 43 percent y-o-y in July 2022 before declining to a still-high 31.5 percent in August. These higher prices have severely impacted those who are less well-off and spend a larger share of their incomes on food. Information from the 2019–20 Integrated Expenditure–Labor Force Survey showed that the bottom 40 percent of the population devoted as much as two-thirds of their monthly expenditures to food. On the upside, the increase in wheat prices represented an opportunity for rural households employed in agriculture, as wheat is the most important crop for a third of rural households (40 percent among households in the bottom decile), with at least three-quarters of their products sold in the market.⁷ It is uncertain, however, how these gains were distributed among agents along the wheat production and distribution chain (including wholesale traders, intermediaries, lenders, landowners, and retail traders). Moreover, it is expected that the below-average cumulative precipitation during the wet season resulted in a 7 to 13 percent reduction in the expected wheat harvest compared to the long-term average,⁸ making it highly unlikely that wheat producers will have seen considerable gains.

Access to services has remained at levels reported in late 2021, though the future of girls’ secondary education remains in question. After initial disruptions, access to health services recovered mainly due to the efforts of the international community to resume financing of health facilities. The improved security across much of the country also helped. Information from June–August 2022 shows that over 90 percent of people in need of medical attention were able to secure access at either a private or public provider, a similar share to that reported for October–December 2021. In addition, access to primary education has remained at levels like those observed in October–December 2021 for both girls and boys. In contrast, access to secondary education has declined for boys in urban areas (41 percent), and net attendance among teenage girls has plummeted (13 percent) overall. The only exceptions are the North and West-Central regions, where net attendance for teenage girls is still close to 40 and 50 percent, respectively. The future of girls’ access to education remains unclear, with potential negative impacts on human development and economic indicators in the coming years.

FINANCIAL SECTOR: Dysfunctional Payment System is a Binding Constraint to Recovery

Afghanistan’s financial sector remains in crisis. Capacity gaps at DAB continue to limit its ability to undertake critical functions, including supervising the banking sector, monitoring illicit financial flows, and performing AML/CFT monitoring. In addition, DAB has lost its ability to manage payment systems and conduct monetary policy due to the freezing of offshore assets and its inability to print new AFN notes.

⁷ Based on the 2016/2017 Afghanistan Living Conditions Survey (the latest survey with agricultural production and welfare information). Wheat sellers are households with 2+ *jeribs* of wheat and reported agricultural sales.

⁸ IPC (2022). Available at: <https://www.ipcinfo.org/ipc-country-analysis/details-map/en/c/1155595/?iso3=AFG>.

The run on the banks during the August 2021 crisis has eroded confidence in the banking sector, a situation exacerbated by the subsequent imposition of withdrawal limits. Anecdotal feedback suggests that the deposit base—albeit lower—is now somewhat stable.

DAB's foreign exchange reserves remain frozen, so it cannot provide the banking sector with currency exchange services. It should be noted that unless DAB can access a Nostro account, the impact of these measures will be muted. Correspondent banking relationships remain severely disrupted due to sanctions and AML/CFT concerns. Despite the issuance by the United States Office of Foreign Assets Control of General License 20, which authorizes transactions involving Afghanistan and its institutions under certain conditions, AML/CFT concerns remain elevated.

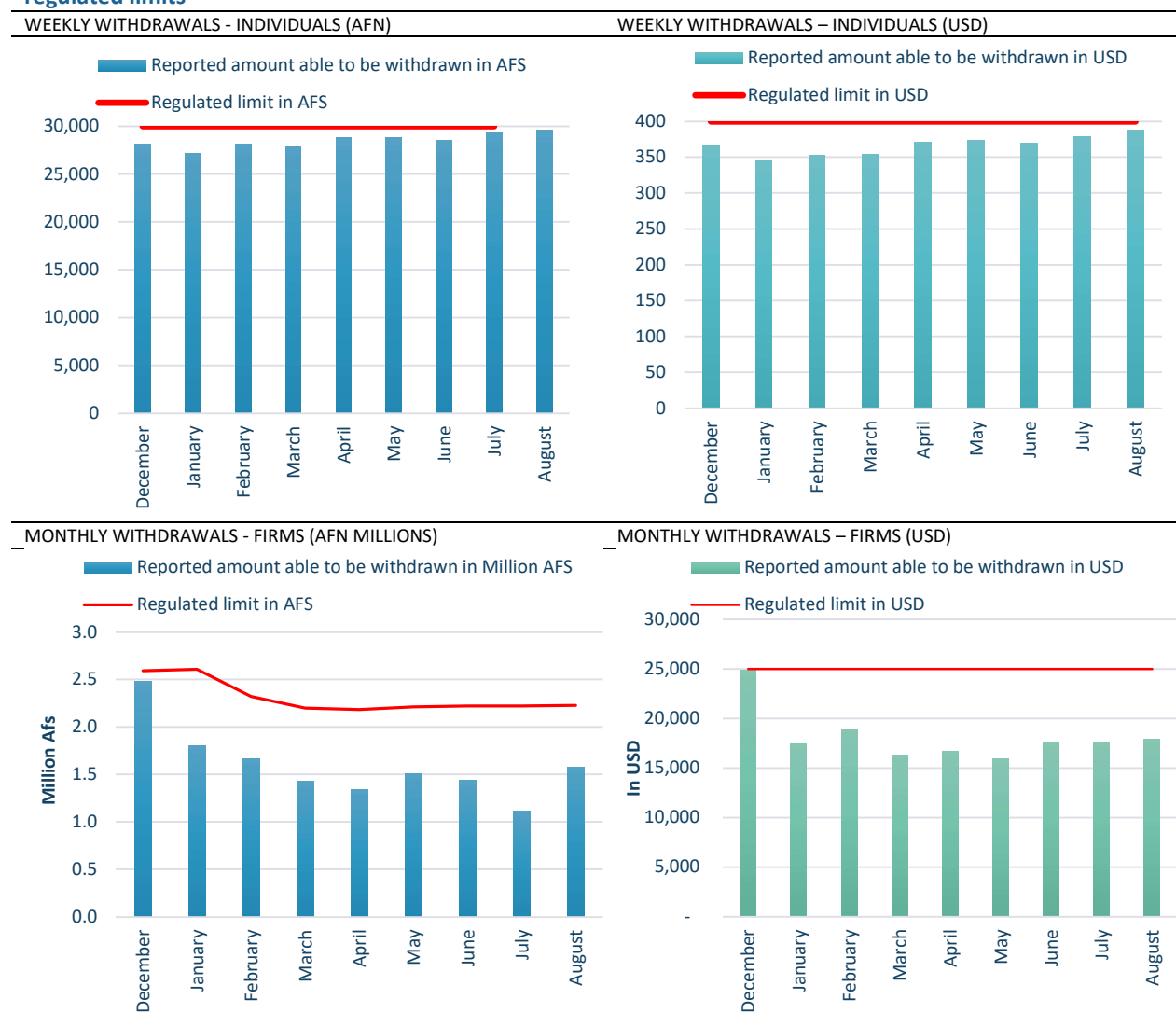
To tackle the issue of DAB's frozen assets, a new Afghan Fund has been established. The United States and ITA had discussed the deployment of frozen assets by releasing the funds to a trust fund managed by an independent board. Talks remained inconclusive, however. On September 14, 2022, the United States government, in coordination with international partners such as the government of Switzerland and Afghan economic experts, announced the establishment of a fund to benefit the people of Afghanistan. The Afghan Fund will protect and preserve USD 3.5 million in DAB reserves, making targeted disbursements to help stabilize the Afghan economy. The ITA is not a part of the Afghan Fund. Robust safeguards have been put in place to prevent the funds from being used for illicit activity. The Afghan Fund will maintain its account with the Bank for International Settlements, based in Switzerland. An external auditor will monitor and audit the Afghan Fund, as required by Swiss law.

Liquidity in the financial sector remains a critical issue. For individuals, domestic withdrawals on pre-August 2021 deposits are still restricted to AFN 30,000 (USD 400) per week. Data collected by the World Bank's TPMA in August show that individual withdrawals of both USD and AFN deposits and business withdrawals of USD remain below statutory limits (Figure 26). However, AFN withdrawals by firms are reported to have declined by 22 percent in July 2022 compared to the previous month. Firms continue to report that actual accessibility is much lower than allowed limits.

International transfers are only allowed for corporate clients for selected purposes, such as food and medicines. DAB has issued a circular nominally allowing corporate clients to withdraw up to USD 25,000 per month (including AFN equivalent) or 5 percent of deposited assets, whichever is lower.

The liquidity crisis in the banking sector has been exacerbated because a significant portion of the AFN notes in circulation have deteriorated and are no longer usable. DAB had ordered the printing of new banknotes before the Taliban takeover. Following the takeover, however, the two international printing contracts signed by DAB for that purpose could no longer be honored. Recently, through the intermediation of the United States State Department, the Crown Agent bank (AIB's correspondent bank) agreed, on an exceptional basis, to process the payment from the ITA to the relevant firm for the printing of AFN notes. Before that transaction can occur, DAB must present a plan to distribute new banknotes and collect old banknotes and a timeline for issuing these new banknotes. DAB cannot control the domestic money supply with limited access to Afghani notes.

Figure 26: Firms still report an inability to withdraw AFN and USD funds from bank accounts, even up to regulated limits



Source: Monthly data collected by World Bank's TPMA.

Note: Regulated limit as stipulated by DAB. Reported amount able to be withdrawn as reported by individual respondents to the TPMA survey.

Both domestic and international payments remain severely disrupted. The National e-Payment Switch of Afghanistan (the Afghan payment system) remains out of service due to the DAB's inability to maintain the external maintenance contract. Clearing and settlement are impaired (including for interbank transactions).⁹ Given these banking sector difficulties, firms are increasingly relying on cash and *Hawala* payment systems for domestic transactions (Figure 27). The loss of correspondent banking relationships has had a significantly impact on international payments. Given the current political environment, most international banks do not have the risk appetite to transact with the Afghan financial system. As a result, correspondent banks have de-risked completely or significantly and have restricted transactions with Afghan banks. The breakdown of international payment channels affects larger formal firms more than small businesses, as they rely more on global markets and cannot use *Hawala* because their clients seek

⁹ Interbank clearing is now reliant on an old, insecure system that was replaced in 2019.

transparent payment channels. Restrictions on the banking sector have forced businesses to use cash for domestic transactions, while increasing reliance on *Hawala* for international transactions (Figure 28).

Figure 27: Preferred channels for domestic payments (% of respondents)

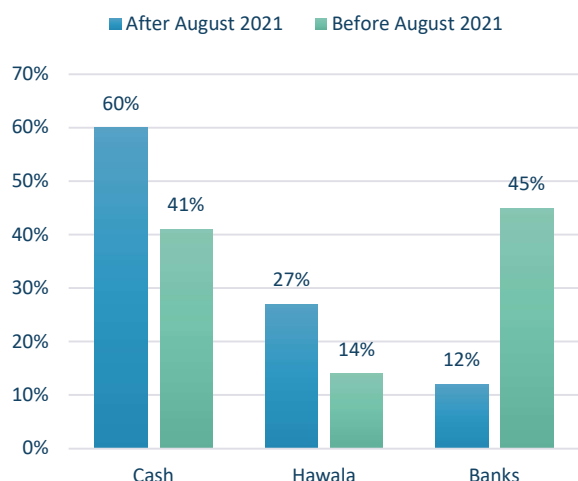
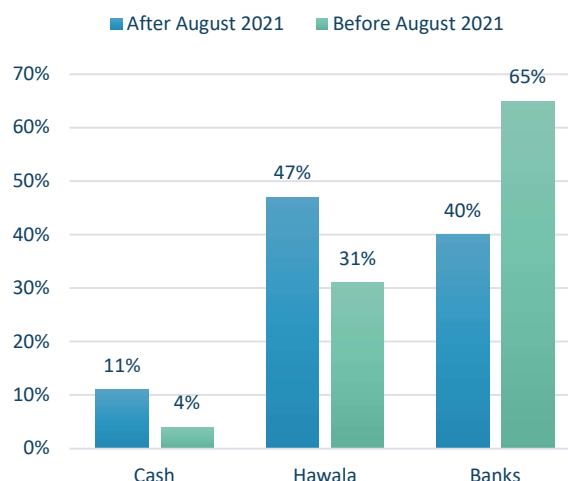


Figure 28: Preferred channels for international payments (% of respondents)



Source: Afghanistan PSRS, Round 2 (May–June 2022), World Bank. N2 = 257.

Note: Multiple responses allowed; results normalized to 100 percent.

The mandatory transition to Islamic banking for all financial institutions creates operational difficulties.


In March 2022, DAB published Guidelines for Conversion of a Conventional Bank to an Islamic Bank, in which it underlined its commitment to promoting and developing Islamic banking in Afghanistan. Banks have been asked to prepare proposals for this transition. The Islamic Banking and Contemporary Research Center has been established to assist DAB in this process. The conversion process will involve bank submitting a Conversion Plan to DAB; if approved, DAB will issue an Islamic banking license. All financial institutions, including microfinance institutions (MFIs), will be prohibited from engaging in interest-based lending or recovery until Islamic products have been approved. DAB has not yet specified a timeline for the conversion to be completed, but the transition is critical to ensure that the financial sector can recommence lending.

There are rapidly escalating stability risks in the banking sector, which are made more worrisome by the major limitations on DAB's bank resolution capacity. The most recent publicly available financial information¹⁰ on the banking sector paints a bleak picture of its stability and soundness. All banks, except one, have reported significant losses for the quarter ending in March 2022. These losses are predominantly due to the inability to collect interest income and to foreign exchange losses. These losses are reported despite significant forbearance measures put in place by DAB (and because banks are still not fully reporting credit losses, actual losses may be much higher than currently published). All but one bank¹¹ have seen their share of deposits from customers drop significantly since September 2021. This drop reconfirms those customers have lost trust in the banking sector's ability to safeguard their deposits. Anecdotal reports suggest that deposits have stabilized, but this assessment is not reflected in the most recently available data (March 2022). Currently, non-performing loans (NPLs) range between 6 and 40 percent among all eight banks operating in Afghanistan.

On December 22, 2021, DAB issued a circular to provide relief to the banks to maintain asset classification and loan loss provisions as of June 30, 2021. That circular was to expire on June 30, 2022,

¹⁰ Eight out of the 12 banks have published unaudited interim financial statements as of March 31, 2022.

¹¹ New Kabul Bank has reported a slight increase in customer deposits.



but DAB extended the relief period for another two months until end-August 2022. The latest financial statements do not, therefore, capture any deterioration in loan losses and asset classification that may have taken place since June 2021. Considering the overall macro situation, it is safe to assume that NPLs have increased.

MFIs remain on the precipice, as the sector has not been able to collect interest on the outstanding loan portfolio since August 2022. MFIs have collected only around 60 percent of the principal amount. As such, there has been a substantial deterioration across all sector key indicators. The portfolio-at-risk has increased to 31 percent (well above the sustainable level of 5 percent). In the absence of other sources of income, and given plummeting repayment rates, MFIs have reported substantial liquidity and solvency issues (much like the banking sector). The Islamic Banking and Contemporary Research Center has recently approved an Islamic lending product for MFIs (Murabaha), but liquidity and solvency issues limit their ability to recommence lending.


3. OUTLOOK AND MEDIUM-TERM PROSPECTS

The international community's ongoing off-budget support for humanitarian needs and basic services is expected to mitigate some of the negative impacts of the contraction. Still, it will not be sufficient to bring the economy back onto a sustainable recovery path. Under the baseline scenario, where the country receives minimal international support for humanitarian activities and basic core services, real GDP is projected to contract in 2022, with an accumulated contraction of close to 30-35 percent between 2021 and 2022. The economy is projected to move to a low growth path (2.0 to 2.4 percent) for the next two years, with no improvement in per-capita income owing to high population growth and no improvement in poverty or food insecurity. Inflation is expected to remain high in the near term due to global commodity price increases and supply constraints, further eroding the real value of household incomes. At the same time, the ITA's restrictive policies on women's education and work will lower Afghanistan's growth prospects.

Poverty is expected to remain widespread in the next few years, with only minimal reductions driven by the slow economic recovery. The expected low pace of economic growth 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 impact rural poverty, though the increased frequency of droughts in recent decades adds uncertainty to this possibility. Inflation is expected to remain high in the near term due to global commodity price increases and supply constraints, further eroding the real value of household incomes. In this context, households will be forced to either reduce food consumption or switch to lower-quality alternatives, thereby increasing food insecurity. The ITA's restrictive policies on women's education and work will lower Afghanistan's growth prospects and the chances of breaking the cycle of intergenerational transmission of poverty.

This outlook is subject to significant downside risks. These include: (i) the potential discontinuation of or reduction in aid due to fiscal pressures in donor economies and potential donor fatigue; (ii) the stoppage of USD cash shipments, which could undermine exchange rate stability and reverse the anemic recovery in some indicators; (iii) potential stability concerns in the banking sector due to payment resolution challenges and an unmanaged transition to Islamic banking; and (iv) the impact of potential climate events, such as droughts. As described above, the country received substantial off-budget aid for humanitarian assistance and basic service delivery (estimated at USD 2 billion, including USD 1.2 billion through direct cash shipments). The marginal improvements observed recently in business sentiment, household welfare, and private sector business operations depend on the continuation of current levels of off-budget aid. Any disruption or decline in aid will risk an immediate reversal in sentiment. Any deterioration in the security situation will exert downside pressures on the outlook. Similarly, the cessation of UN cash shipments will aggravate the liquidity condition of hard currency for needed imports. It may cause a sharp depreciation in the AFN, posing potential downsides in an environment already marked by high inflation.

The “new economic normal” baseline scenario could remain as is or evolve into a range of economic and political scenarios possible for Afghanistan's future. In a more upside and sustainable scenario, one assumes that donor aid will remain limited to essential services over the short to medium term. It envisages the resolution of financial sector constraints and a private sector-led future with an environment where the Afghan diaspora or residents takes the initiative and mobilize investments in the critical comparative advantage areas to create output and jobs; more use of ITA's resources and more transparency in public expenditure management related to the provision of basic services. In addition, this investment could be complemented by regional partners in critical areas. Under this option, output growth is assumed to remain low. Although outcomes will be slow to materialize under these conditions



and output growth is projected to remain low, this could create an environment under which donors can exit.

4. SPECIAL FOCUS—PRIVATE SECTOR SHOWS SIGNS OF RESILIENCE

Afghanistan's private sector was hit hard by the political crisis. The events of August 2021 brought about rapid and momentous changes to the country's social and economic situation. The private sector was already suffering from weakened business confidence, endemic corruption, and political instability when the COVID-19 pandemic emerged in 2020. Since then, the political crisis has amplified the risks to the private sector, exacerbating the slowdown in economic activity through business closures, declining sales, and employment reductions and giving rise to new constraints such as sanctions and their impacts on banking sector functionality and liquidity shortages. Within this continually evolving context, the World Bank implemented a Private Sector Rapid Survey (PSRS) series¹² to gather information on the status and concerns of the country's private sector firms. This section highlights some of the key findings. For the sample design, methodology, and detailed report, please visit:

<https://www.worldbank.org/en/country/afghanistan>

Box 2: Afghanistan's Private Sector

Afghanistan's private sector contributes significantly to the economy but is largely informal. Overall, the private sector is estimated to contribute to over half the country's GDP.¹ There is currently no single, consolidated, and accessible master database on enterprises. The Afghanistan Central Business Registry reports a total of 118,116 companies registered with the Ministry of Industry and Commerce as of December 2019; however, the actual number of active firms is less than the total number of registered firms owing to cumbersome business closure procedures. The Business Establishment Survey (2015) estimates the total number of establishments across 30 provinces (out of 34) to be approximately 700,000, most of which hold some form of registration or license with either the ministry or municipalities.² The Afghanistan Chamber of Craftsmen and Shopkeepers has over 500,000 members, most of whom are registered with municipalities.

Most small and medium enterprises in rural areas are in traditional sectors, such as agribusiness, carpets, and textiles, while those in major urban centers are involved mostly in trade, small-scale manufacturing, and retail activities.

Information on domestic investments is piecemeal and largely anecdotal, given the lack of documentation and the informal nature of the private sector. Domestic investment is limited in scale and concentrated in the construction, trade, transport, agribusiness, and services sectors. Net flows of foreign direct investment (FDI) were estimated at around 0.4 percent of GDP (annual average) between 2015 and 2020 (USD 80 million cumulative).³ FDI stock, at USD 1.6 billion (2019), represented 8.0 percent of the country's GDP.⁴ FDI inflows have been low and erratic, with spikes every few years due to one-off investments, and are generally linked to the telecommunications, construction, and transportation sectors.

¹ Afghanistan Central Statistics Organization (2018). Private sector companies represent two-thirds of total manufacturing value-added (21.7% of GDP) and are key players in retail trade (8%), transport (18.6%), telecommunications (6%), and agriculture (20.8%).

² Municipalities maintain paper records of firms registered or licensed with them. The lack of digital records makes it challenging to agglomerate databases at a centralized, nationwide level.

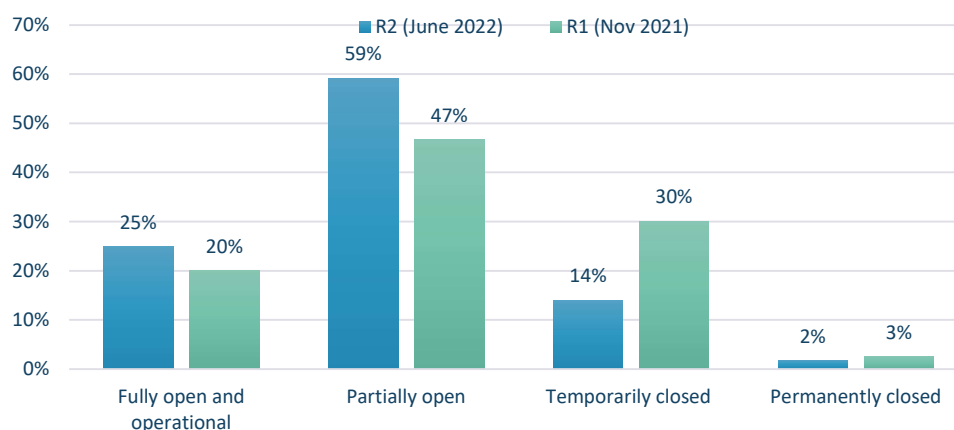
³ World Bank Group. 2020. *Macro Poverty Outlook*. Washington, DC: World Bank.

Firms in Afghanistan are adjusting to the new reality in the country and are gradually starting to resume operations, albeit well below capacity. More than three-fourths of firms participating in the second round of the PSRS were operational, compared to two-thirds in the first round (Figure 29). However, the majority are operating at far less than full capacity and are thus considered only partially open. The overall

¹² The first round of the PSRS was conducted in October-November 2021. The survey report published in March 2022 concluded that the country's firms were mired in challenges and uncertainties. The PSRS Round 2 was conducted in May-June 2022.

improvement in firms' operating status is confirmed by an analysis of panel firms, or those that participated in both rounds of the survey.

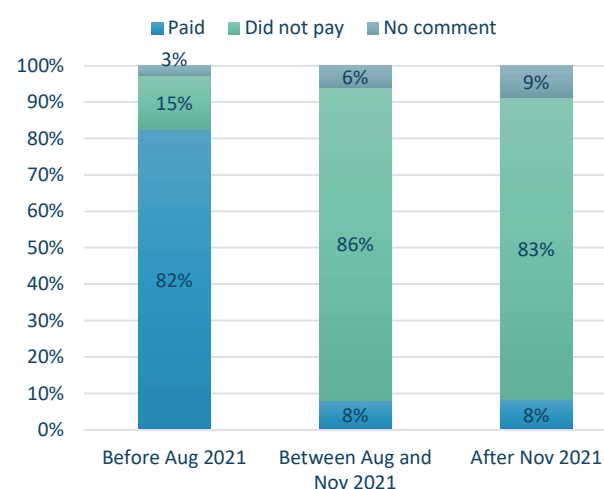
Figure 29: Operating status of firms (% of respondents) – R2 (2022) and R1 (2021)



Source: Afghanistan PSRS, Rounds 1 and 2, World Bank.

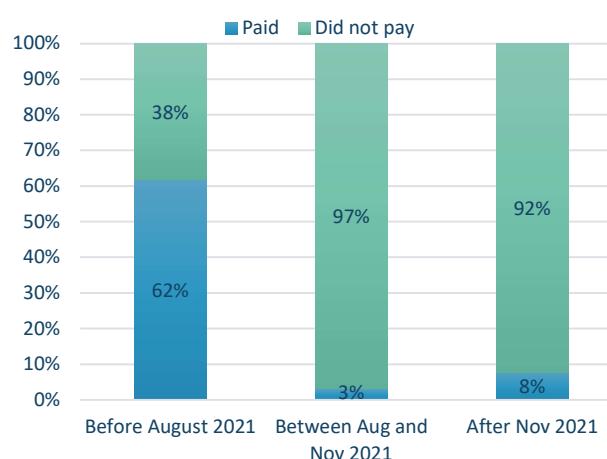
The majority of firms reported improvements in the security environment after the events of August 2021, and perception of corruption have improved significantly. Over two-thirds of men-owned firms cited improvements in the security situation since November 2021, compared to 11 percent who felt the situation had deteriorated. Among women-owned firms, a similar share reported that the security environment had improved for their business in recent months (45 percent) as those who cited a deterioration over the same period (41 percent). Similarly, the incidence of unofficial payments and bribes dropped significantly after August 2021, as reported by survey respondents, although a slight uptick was observed in the revenue department in recent months. Fewer than 10 percent of surveyed firms reported having made unofficial payments since August 2021, compared to 82 percent before that (Figure 29 Figure 301).

Figure 290: Unofficial payments, customs department (% of respondents) – R2 (2022)



Source: Afghanistan PSRS, Round 2 (May–June 2022), World Bank. N = 76.

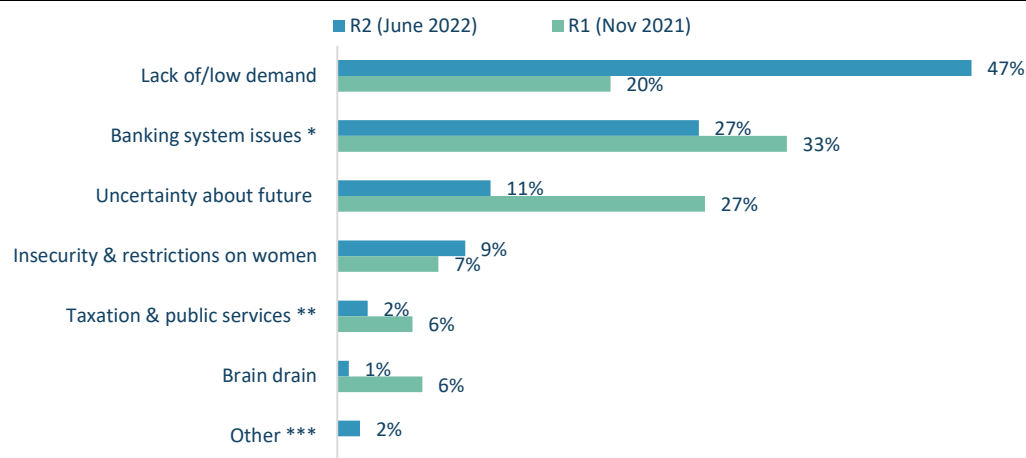
Figure 301: Unofficial payments, revenue department (% of respondents) – R2 (2022)



Source: Afghanistan PSRS, Round 2 (May–June 2022), World Bank. N = 175.

The high level of uncertainty experienced by firms immediately after the events of August 2021 appears to have subsided, but firms continue to face daunting operational challenges. The overall economic challenges confronting Afghanistan, including employment losses, salary payment delays, and high inflation, have resulted in low purchasing power which has dampened consumer demand. Surveyed firms also cited banking system challenges and uncertainty about the future as top constraints, though at a lower rate in the second round of the survey than in the first (Figure 32). Insecurity and restrictions on women’s economic activity remained among the main constraints for women-owned firms.

Figure 32: Top constraints faced by businesses (% of respondents listing constraints among the top 3) – R2 (2022) & R1 (2021)



Source: Afghanistan PSRS, Rounds 1 and 2, World Bank. N2 = 257, N1= 100.

Note: Multiple responses allowed; results normalized to 100 percent.

A significant decline in demand for goods and services in the economy is taking a toll on firms. Consumer demand appears to have improved slightly between November 2021 and June 2022, although it remains considerably lower than before August 2021. While 82 percent of Round 1 participants reported a decline in demand since the onset of the crisis, half of Round 2 participants experienced a drop in demand between November 2021 and June 2022. The share of firms experiencing an uptick in demand doubled between survey rounds, from 17 percent in Round 1 to 37 percent in Round 2.

Restrictions on the banking sector have forced businesses to use cash for domestic transactions and to rely increasingly on *Hawala* for international transactions. Issues with banking sector functionality have undermined business confidence in formal banking. Firms continue to face difficulties in completing business transactions locally and internationally, and trade activities have been disrupted, particularly about accessing export markets. More than one-third of surveyed firms engaged in trade indicated that demand for exports and imports had declined since November 2021.

Access to domestically produced and imported inputs remains difficult. Surveyed firms reported that domestically produced inputs have become more expensive and difficult to obtain due to price inflation and the closure of businesses that supplied inputs. Access to imported inputs has been constrained by abrupt border closures, high prices, and difficulties in making payments to vendors abroad.

Firms have adopted various coping strategies to keep the lights on. Surviving firms have been forced to lay off employees, scale back operations, rely more heavily on informal financial institutions, shrink investments, shut down temporarily, hire women to work from home, and/or shift investments overseas.

Though some firms have increased hiring in recent months, laying off employees is still among the main coping strategies that businesses adopt to mitigate the risk of revenue losses.

Approaching the ITA to discuss the challenges they faced did not help firms resolve those challenges. A staggering 54 percent of surveyed firms reported having reached out to the ITA to discuss issues related to trade, taxation, and restrictions on women’s economic activities. Among those firms, 60 percent indicated that their issues had not been resolved. The reasons cited included a lack of knowledge and expertise regarding administrative work and a lack of response to the matters raised.

The outlook remains challenging for most surveyed firms. Although the level of uncertainty that businesses face has subsided in recent months, this has not prompted a significant shift in their investment decisions, as the private sector is still adjusting to this new reality. Of those firms surveyed in Round 2 that had decided on an investment strategy for the next six months, the majority (81 percent) plan to maintain their current level of investment. Over two-fifths indicated that they would shrink investments, which suggests that businesses do not plan to make significant changes in investment (Figure 313, Figure 324).

Figure 313: Perceptions of future investment prospects in the next six months (% of respondents) – R2 (2022)

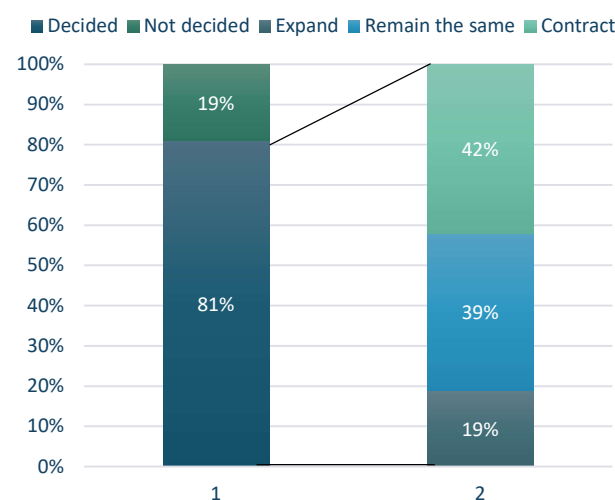
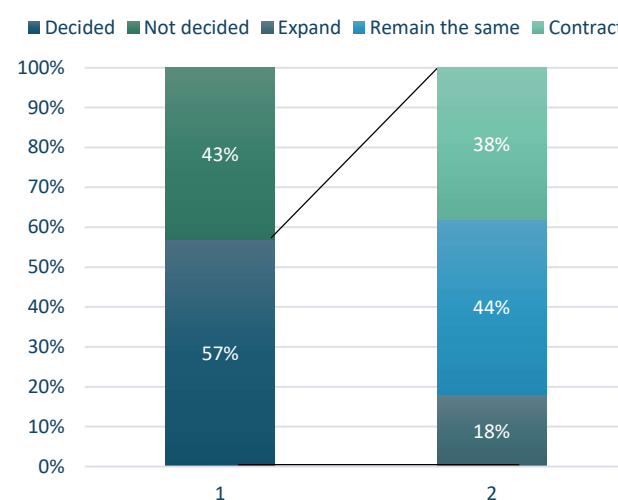


Figure 324: Perceptions of future investment prospects in the next six months (% of respondents) – R1 (2021)



Source: Afghanistan PSRS, Rounds 1 and 2, World Bank. N1= 100, N2= 257.

Note: Multiple responses allowed; results normalized to 100%.

