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AFGHANISTAN DEVELOPMENT UPDATE

Navigating Challenges: Confronting Economic Recession and Deflation

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Confronting Economic Recession and Deflation

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PREFACE

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

This report has been prepared by Muhammad Waheed (Senior Economist, ESAC1 and Task Team Leader), Eduardo Olaberria (Program Leader and Senior Economist in ESAC1), Abdul Rahman Rahimi (Economist, ESAC1), Wasim Shahid Malik (Consultant, ESAC1), Namoos Zaheer (Senior Financial Sector Specialist, ESAF), Silvia Redaelli (Senior Economist, ESAPV), Arvind Nair (Senior Economist, ESAC1) and Amna Sehar (Consultant, ESAC1). The report was produced under the guidance of Melinda Good (Country Director for Afghanistan, SACKB), Mathew A. Verghis (Regional Director for Equitable Growth, Finance, and Institutions), and Saiyed Shabih Ali Mohib (Practice Manager, ESAC1).

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LIST OF ABBREVIATIONS

ABA	Afghanistan Banks Association
ACD	Afghanistan Customs Department
AFMIS	Afghanistan Financial Management Information System
AFN	Afghan Afghani
AML	Anti-Money Laundering
ARD	Afghanistan Revenue Department
ASYCUDA	Automated System for Customs Data
ATM	Automated Teller Machine
BRT	Business Receipt Taxes
CBR	Correspondent Banking Relationships
CFT	Combating the Financing of Terrorism
CY	Calendar Year
DAB	Da Afghanistan Bank
FX	Foreign Exchange
FY	Fiscal Year
GDP	Gross Domestic Product
IT	Information Technology
ITA	Interim Taliban Administration
NPLs	Non-Performing Loans
NSIA	National Statistics and Information Authority
NTR	Non-Tax Revenue
OBT	Off-budget Transfers
POS	Point-of-Sale
PSRS	Private-Sector Rapid Survey
R2	Round 2
R3	Round 3
STO	Small Taxpayer Office
TSD	Tax Services Directorate
Q3	Quarter 3
UAE	United Arab Emirates
UN	United Nations
USD	United States Dollar
UNODC	United Nations Office on Drugs and Crime
WB	World Bank
YoY	Year-on-Year

EXECUTIVE SUMMARY

The Afghan economy is struggling to confront deflationary winds.

Over the past two years, Afghanistan's economy has been characterized by a tumultuous downturn, underlined by a staggering 26 percent contraction in real GDP. The aftermath of the Taliban takeover has seen a stark decline in international aid, leaving the nation without any internal engines of growth, and the recent return of Afghan migrants and an earthquake in Herat have intensified these challenges. The October 2023 earthquake damaged critical infrastructure, reducing GDP growth by estimated 0.5-0.8 percent. With no policy levers to stimulate aggregate demand, the economy remains stagnant, with low demand driving a noticeable deflation.

By February 2024, headline inflation plummeted to -9.7 percent year-over-year, propelled primarily by substantial reductions in food (-14.4 percent) and non-food (-4.4 percent) prices. Core inflation, excluding food and energy, mirrored this downward trajectory, registering at negative 3 percent. While the food sector has benefited from better supply, weakened demand due to low purchasing power is a major driver of the deflationary process that started in April 2023 and is persisting through February 2024. This protracted deflationary process stems from a confluence of factors, including the adverse ramifications of the opium ban, the shrinking of the money supply, and the appreciation of the Afghani.

The ban on opium cultivation precipitated a staggering $1.3 billion loss in farmers' incomes, equivalent to approximately 8 percent of GDP. According to United Nation's Office on Drugs and Crime (UNODC), the opiate economy's value has contracted by 90 percent, the area under cultivation declined by 95 percent and has cost Afghan 450,000 jobs at the farm level alone and doesn't include the high economic losses downstream. Furthermore, repurposing around 200,000 hectares of land previously dedicated to illicit crops towards food production has led to downward pressure on domestic food prices, albeit at the expense of heightened unemployment.

Constraints to monetary policy also contributed to the deflationary process. Da Afghanistan Bank (DAB) has reported a significant decrease in money supply, with M2 contracting by nearly 11 percent from the fourth quarter of 2020 to the second quarter of 2023. This decline is due to sanctions, frozen assets, banking disruptions, domestic payment system issues, and a shift to Islamic banking, leading to a cash-dominant economy. The country's inability to mint new currency, compounded by sanctions that prevent replacing old banknotes, has further tightened the money supply. Lower currency in circulation has limited access to credit for consumers and deterred spending, while businesses encounter obstacles in securing investment loans. Consequently, this is dampening demand for goods and services, prompting businesses to lower prices to attract customers, exacerbating deflationary trends.

A reduced money supply has also led to an exchange rate appreciation, exacerbating the deflationary cycle. Since August 2021, the Afghani has appreciated 22.8 percent against the US dollar. This has been instrumental in mitigating the costs of imported goods, amplifying the deflationary pressures affecting the economy. It has also rendered Afghanistan's exports pricier on the international market, diminishing their demand and undercutting Afghanistan's export sector's potential to catalyze economic growth in the post-conflict landscape. It is also adding to the widening trade deficit.

The widening trade deficit poses yet another challenge to Afghanistan's economic situation. Notwithstanding a 46 percent decrease in coal exports, food and textile export gains have provided a semblance of equilibrium. Despite a shrinking economy, Afghanistan's imports surged by 23 percent to $7.8 billion in 2023. The trend continued into 2024, with January seeing a 37 percent increase in imports year-

over-year. The rise in imports, particularly in secondary commodities like machinery and chemicals, is partially due to an overvalued exchange rate and complex factors such as purchases by Pakistani buyers in the United Arab Emirates. While food, minerals, and textiles still make up a significant portion of imports, their relative share has decreased as Afghanistan's import patterns shift.

Prolonged deflation threatens to engender a negative cycle where consumers defer spending, businesses curtail investment, and economic growth languishes, impeding sustainable poverty alleviation and job creation. While the price decline may alleviate financial burdens for vulnerable households by reducing living costs, it also portends risks for the broader economy. Consumer reluctance to purchase in anticipation of further price declines can deepen economic downturns, reducing production, job losses, and heightened unemployment, thus contributing to recessionary pressures. The economic strain has triggered a surge in labor force participation, exacerbating unemployment amidst limited job opportunities. Approximately half of the population is trapped in poverty, and 15 million individuals are facing food insecurity.

Amidst these economic changes, the fiscal landscape remains a focal point of scrutiny. The fiscal year 2023 conveyed a 9 percent uptick in total revenue; buoyed by heightened imports and non-tax revenues, it surpassed Interim Taliban Administration’s (ITA) target. However, the FY2023-24 budget, augmented by 43 percent from the preceding year, accentuates ITA’s preference for security spending over essential social sectors, such as health and agriculture, thereby potentially compromising social protection mechanisms.

Compounding these challenges is the financial sector's sluggishness in facilitating financial intermediation, hampering private sector dynamism. Banks, entangled by international payment restrictions and compelled shifts towards Islamic Finance, have scaled back lending activities, exacerbating economic headwinds. The efficacy of the Central Bank in monitoring risks, particularly in anti-money laundering and counter-financing of terrorism (AML/CFT), also warrants scrutiny. The declining assets and deposits, challenges in international payments, and the transition to Islamic Finance have precipitated a heightened reliance on cash and non-traditional payment methods. This has further constricted the money supply, exacerbating the economic downturn and deflationary pressures discussed above.

Outlook: Navigating Turbulent Waters in Search of New Engines of Growth

Afghanistan's economic outlook remains uncertain, with the threat of stagnation looming large until at least 2025. The absence of GDP growth coupled with declining external financing avenues for off-budget expenditures paints a bleak picture of the nation's economic prospects. Structural deficiencies in the private sector and waning international support for essential services are anticipated to impede any semblance of economic progress. The trajectory for 2023-2025 envisages a persistently stagnant economy, with real GDP growth projected to flatline, leaving economic activity by 2025 at par with 2022 levels as per capita income shrinks due to population growth.

This economic stagnation is poised to deepen poverty and unemployment, with job opportunities expected to fall, exacerbating food insecurity and widening social fissures. The decline in off-budget transfers will continue suppressing overall demand and slash spending on poverty alleviation as funds are diverted to security. The ban on female education above the primary level exacerbates these challenges, limiting the pool of educated women in the workforce and potentially triggering a further reduction in international aid.

Revenue and expenditure are expected to remain stable, with a decrease in off-budget transfers. Domestic revenue is projected to consistently account for 15 percent of GDP, with on-budget spending estimated to be between AFN 200-220 billion annually. However, the real value of these figures will be

less than in 2022. Off-budget transfers are projected to fall to AFN 269 billion by 2025, from AFN 327 billion in 2022, leading to reduced demand and diminished spending on poverty alleviation as security takes precedence. The expected decrease in off-budget transfers will likely dampen economic activity, with the economy projected to reach 2022 levels by 2025.

The baseline scenario is subject to risks, including the ITA exclusionary and gender policies. Further cuts beyond the current projections will result in an even more pronounced decline in economic activity. The ITA may partially offset the loss in off-budget transfers through improved domestic revenue collection, but this will not fully compensate for the shortfall. If the ITA reallocates its spending priorities, it could reduce the negative impact on social sector expenditures and service delivery. Without such reallocation, any additional domestic revenue will likely be directed toward security, significantly reducing funding for social services. The deflation trend that started in April 2023 may further contract the economy. Banking sector instability and climate issues also pose threats to the GDP trajectory. These risks could exacerbate poverty and food insecurity regionally and globally.

Amidst the gloom, glimmers of hope emerge as the potential for growth and change exists. Afghanistan's long-term growth prospects are contingent upon a significant shift from the previous 15 years of reliance on international aid and consumption-driven growth to a more resilient, private-sector led economy that capitalizes on the nation's inherent strengths. Afghanistan must focus on its comparative advantages for a sustainable future, particularly in the agricultural and extractive sectors. Agriculture is poised to be a key driver of growth and poverty reduction, potentially creating jobs and positively impacting income distribution. Strategic investments in irrigation infrastructure, land tenure security, research, and market access are essential to enhance agricultural productivity and resilience. These efforts should be supported by strengthening human capital and institutional frameworks to create a conducive business environment.

INTRODUCTION

Economic activity remains sluggish, marked by persistent deflation. Over the past two fiscal years, the real GDP contracted by 26 percent, with economic activity stagnating in fiscal year 2023. The economic downturn is characterized by poverty, food insecurity, high unemployment, and underemployment. The private sector struggles with low demand for goods and services and a frail banking sector. Despite better supply conditions, reduced off-budget transfers, the opium cultivation ban, and insufficient fiscal and monetary stimuli have led to an economy adapting to diminished demand, driving deflation. While this offers temporary respite to vulnerable households, it presents considerable risks to the overall economy. Natural disasters such as the Herat earthquake and the involuntary return of Afghans from neighboring countries have added to the stress.

The private sector in Afghanistan continues to struggle with low demand and a weak banking sector that is hindering recovery. The latest private sector survey indicates an increase in operational companies from the previous year, yet over a third are not fully utilized, and 8 percent—predominantly women-owned—have temporarily or permanently ceased operations. Demand has waned, hitting small and medium enterprises hard. Besides low demand, banking sector issues remained among the most critical constraints in private sector recovery.

The banking sector has been under stress. The banking sector is experiencing considerable strain from dwindling assets and deposits, compounded by difficulties with international payments and the shift to Islamic Finance. These issues have spurred a greater dependence on cash and non-traditional payment methods, further tightening the money supply and aggravating economic downturn and deflation.

Despite the struggling economy, the import level in 2023 paradoxically remained strong. Anecdotes and data analysis show that about a quarter of the imports are for the Pakistani market, financed by Pakistani importers. Considering these additional imports and $2 billion in remittances, the forex market in 2023 was in surplus—explaining the 26 percent appreciation of Afghani. The strong imports allowed the ITA to hit its revenue targets, thanks to increased border taxes and non-tax revenue. However, actual spending was substantially below the budget due to the inability to obtain on-budget foreign grants or loans. Despite stagnant exports, the surge in imports widened the trade deficit. Nonetheless, the Afghani appreciated by 26 percent in 2023.

Pro-poor expenditures have diminished as international grants have waned. The ITA has favored security over social and economic services, with off-budget transfers (OBT) in 2023 falling short of the previous year's levels, adversely affecting humanitarian efforts and basic services. The ITA's continued controversial stance on human rights, gender, and inclusion suggests a further decrease in international OBT. This trend raises concerns for the sustainability of pro-poor spending and economic recovery.

This Afghanistan Economic Update is divided into three parts. The first section discusses recent economic developments, including the real sector, inflation, revenue and expenditures, international trade, and the financial sector. The report then provides a medium-term economic and social service delivery outlook, highlighting potential risks. Lastly, it offers a scenario analysis to explore the effects of varying levels of declining off-budget transfers on sectoral spending and service provision.

1. THE ECONOMIC DEVELOPMENTS

REAL SECTOR DEVELOPMENTS

The real GDP contracted by 26 percent over the past two fiscal years, with economic activity stagnating in fiscal year 2023. Despite improved supply conditions, weak aggregate demand has significantly dropped the general price level.

Afghanistan's GDP dropped by 20.7 percent in 2021 and a further 6.2 percent in 2022 (Figure 1 & Figure 2). The services sector, 45 percent of GDP, contracted by 6.5 percent in 2022, less than the 30 percent decline in 2021. Agriculture, 36 percent of GDP, fell by 6.6 percent due to drought, affecting wheat yields and pastoralists, with harsh winters compounding the impact. The industrial sector shrank by 5.7 percent, with manufacturing down by 10 percent, though less than in 2021, when there was a 12.8 percent drop. Construction declined by 0.8 percent, compared to a 35 percent fall in 2021. Conversely, mining and quarrying grew by 4.1 percent, thanks to increased coal extraction.

Figure 1: Real GDP Growth by Sector

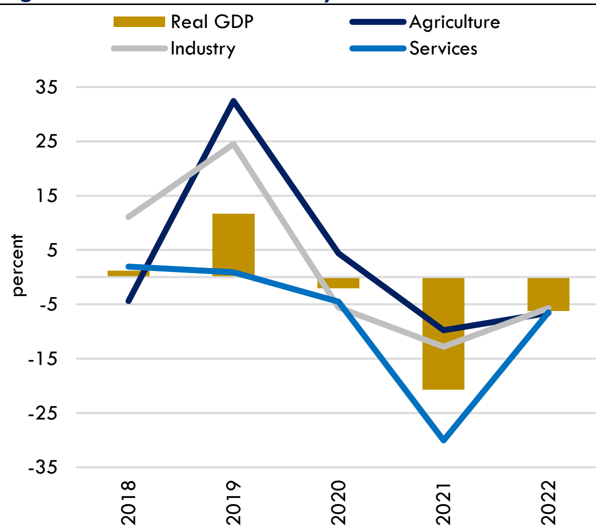
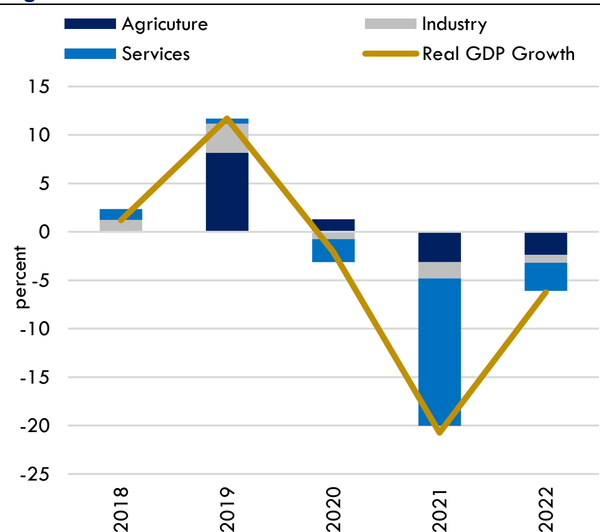


Figure 2: Contribution to Real GDP Growth

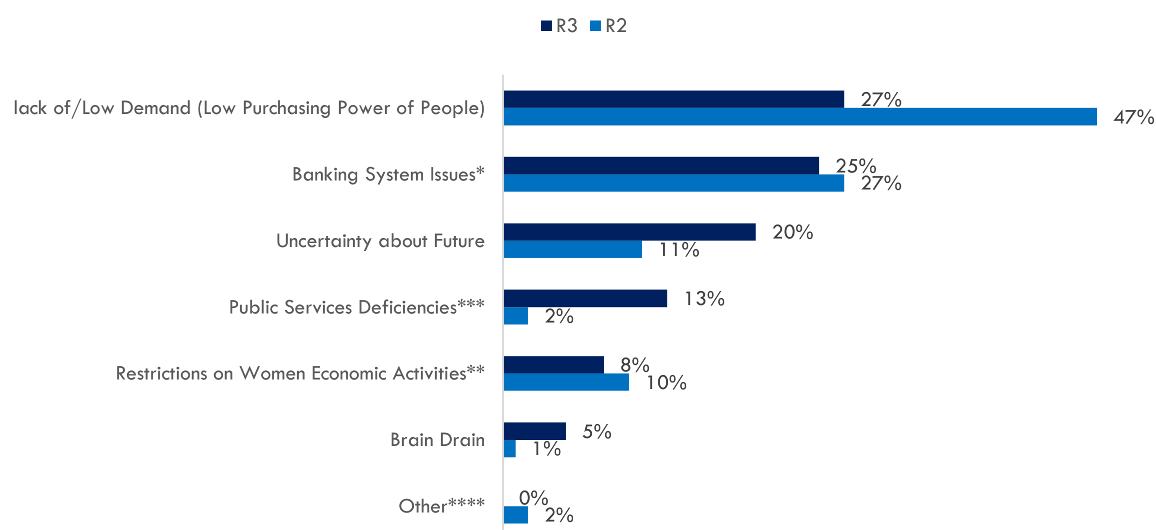


Source: National Statistics and Information Authority (NSIA).

The private sector in Afghanistan continues to struggle with low demand and a weak banking sector hindering recovery (Figure 3). The latest private sector survey indicates an increase in operational companies from the previous year, yet over a third are not fully operational, and 8 percent—predominantly women-owned—have temporarily or permanently ceased operations.[1] Demand has waned, hitting small and medium enterprises hard. Employment remains substantially below pre-August 2021 levels, with a 58 percent employment gap. Economic hardship and heightened poverty, aggravated by political shifts, have caused a rise in job seekers and informal employment, exacerbating unemployment. Moreover, the number of firms without female employees has climbed to 50 percent.

[1] https://www.worldbank.org/en/news/press-release/2024/03/19/afghanistans-private-sector-still-facing-significant-challenges

Figure 3: Top Constraints Faced by Businesses (percent respondents listing top 3 constraints) - R2 and R3



Source: Afghanistan Private Sector Rapid Survey—Round 3, The World Bank

Overall, the private sector in Afghanistan continues to grapple with significant obstacles. While there has been some improvement, many businesses still operate under capacity, and closures, particularly among women-owned firms, are evident. Smaller enterprises suffer more from reduced demand, leading to lower employment. Economic difficulties have intensified post-August 2021 change, exacerbating the employment gap from before the crisis and increasing informal work. Additionally, gender disparities in employment persist, as seen in the growing number of firms without female employees.

While household welfare in Afghanistan has seen some gains due to lower prices, poverty, and vulnerability are still widespread due to limited job opportunities. Households have added more labor to counter the economic downturn, yet this has led to an oversupply of labor compared to the weak demand, causing higher unemployment and underemployment. Initial deflation may have seemed beneficial for households, but its persistence signals a deep economic slump. Food security is also precarious; acute food insecurity dropped from 40 percent in April 2023 to 29 percent in October 2023 but is expected to deteriorate to 36 percent by March 2024.[2]

The economy has been impacted by several factors, including the ban on opium cultivation, the forced repatriation of Afghans from neighboring countries, and the earthquake in the Herat region. The UNODC estimates the opium ban could cut farmers' incomes by $1.3 billion, or 8 percent of GDP, and lower food prices as land shifts from illicit to licit crops. This ban may also tighten the labor market, as opium farming requires more labor than other crops. While lower prices might aid the most vulnerable, the weak economy and scarce jobs hinder sustainable poverty reduction. The country also contends with challenges from returning migrants, mainly from Pakistan, and the October 2023 Herat earthquake, which damaged infrastructure and livelihoods, potentially reducing GDP growth by 0.5-0.8 percentage points (see Box 1).

[2] Integrated Food Security Phase Classification— https://www.ipcinfo.org/ipc-country-analysis/details-map/en/c/1156351/?iso3=AFG

PRICE TREND

Supply conditions have improved, but with persistently low demand, prices have fallen significantly. Inflation peaked at 18.3 percent year-on-year (YoY) in July 2022 but has since turned into deflation from April 2023, indicating ongoing economic frailty and subdued demand despite better supply.

Deflation persists amid anemic economic activity. Since April 2023, headline inflation has plummeted to -9.7 percent year-on-year by February 2024, driven by steep declines in both food (-14.4 percent YoY) and non-food (-4.4 percent YoY) prices (Figure 4 & Figure 5). Core inflation, excluding volatile food and energy, also fell to -3.0 percent YoY. The food sector, benefiting from better supply but weakened demand due to low purchasing power, led the deflationary trend (Figure 6). Additionally, the Afghani's significant appreciation against the dollar in 2023 helped lower the cost of imported goods.

Figure 4: Headline Price Index

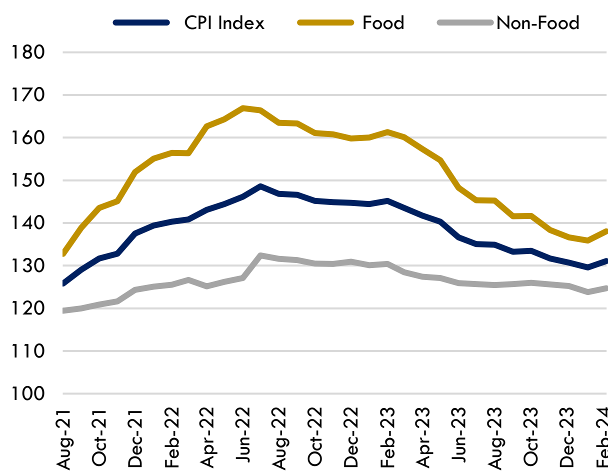
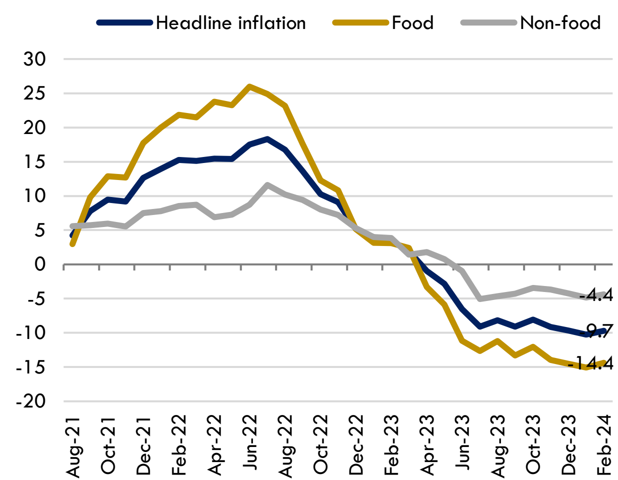
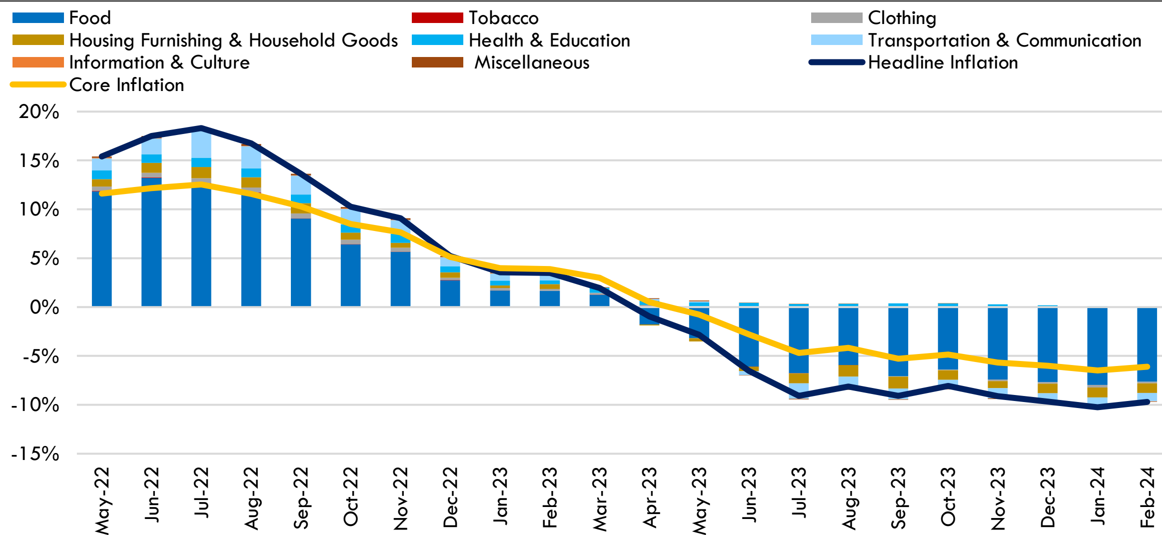


Figure 5: Headline Inflation (YoY)



Source: National Statistics and Information Authority (NSIA).

Figure 6: Factors Contributing to Headline Inflation



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

The extended period of deflation indicates that the economy is grappling with persistently low aggregate demand. This sustained price decrease signals a concerning lack of demand stimulation by private and public entities. Although deflation might temporarily ease financial burdens for vulnerable households by lowering living costs, it can harm the overall economy. If consumers postpone spending in anticipation of further price drops, businesses may cut back on investments, hindering economic expansion and job creation, which are crucial for long-term poverty reduction.

Box 1: The Macroeconomic Impact of the Earthquakes in Afghanistan's Herat Province

In October 2023, four magnitude (Mw) 6.3 earthquakes struck Herat Province, Afghanistan, causing significant devastation. Over 1,500 fatalities and 2,600 injuries were reported. Subsequently, the United Nations (UN), along with the United Nations Development Programme (UNDP), the World Bank (WB), the European Union (EU), and the Asian Development Bank (ADB), initiated the Herat Earthquakes Post-Disaster Needs Assessment (PDNA). This Box summarizes the results from the analysis of the macroeconomic implications of the earthquakes, particularly focusing on the economic outlook.

The earthquakes primarily impacted rural areas, resulting in extensive damage to assets, especially in the services sector. Disruptions in supply chains and increased production costs affected industries, while the agriculture sector faced challenges, threatening household vulnerability and food security. Although there was a decline in sectoral production and economic activities, fiscal and balance of payments were minimally impacted due to continuous international trade and support. However, the economic outlook remains pessimistic, with risks such as reduced demand, potential aid cuts, banking sector instability, and climate events hindering recovery. Despite the negative effects on production levels and economic growth projections for 2024, recovery efforts, including international aid, are expected to alleviate some adverse effects, particularly through service sector growth and reconstruction.

The service sector, encompassing health, education, and transport, suffered significant damage, accounting for about 64 percent of total damage, equivalent to 0.9 percent of GDP. This resulted in a sectoral production loss of 1 percent and an overall production loss of 0.5 percent. The industrial sector suffered around 28 percent of the total damage. This indicates a considerable percentage of the overall damage, amounting to 0.4 percent of GDP. Our estimates show that the damages to the industrial sector will result in a decline in sectoral production by 1 percent and the country's overall output or income level by 0.1 percent from the baseline. The agriculture sector, including farming and livestock production, accounted for about 7.3 percent of the total damage, which is 0.1 percent of GDP. It experienced a sectoral decline in production of 0.2 percent, which impacted overall economic activities by 0.1 percent (Table B).

Table A: Sectoral Damages

	Sectoral Damages - in million USD	Percent Share of Total Damages	Percent Share of FY23 GDP
Agriculture	14.6	7.3	0.1
Industry	56.2	28.0	0.4
Services	128.6	64.0	0.9
Total Damages	199.4	99.8	1.4

Table B: Productivity Losses

	Real GDP Losses - in million USD	Percent Decline Sectoral Production	Percent Decline in FY23 GDP
Agriculture	10.7	0.2	0.1
Industry	17.7	1.0	0.1
Services	58.3	1.0	0.5
Real GDP Losses	86.7	0.7	0.7

In sum, the earthquakes have contributed to a downturn in economic activity, further dampening the already pessimistic growth outlook for 2024. Projections suggest a 0.7 percent reduction in national production for 2023 and a 0.2 percent drop in 2024 due to the earthquakes. These events are likely to impede economic expansion and production. Nonetheless, recovery initiatives are expected to mitigate some of the adverse effects, particularly through the expansion of service delivery and reconstruction efforts. Moreover, thanks to international aid, the earthquakes had a minimal effect on fiscal stability and the balance of payments, with international trade remaining unaffected.

FISCAL DEVELOPMENTS

In FY 2023, the ITA met its revenue goal of AFN 210 billion, driven by robust import growth and non-tax revenues. Despite this, revenues fell short of budgeted expenditures, necessitating cuts in critical service and development spending due to funding shortfalls.

REVENUES:

The ITA achieved its FY 2023 revenue target mainly due to increased import taxes and non-tax revenues. Total revenue for the fiscal year reached AFN 210.7 billion, a 9 percent increase from the previous year, including AFN 108.1 billion from customs and AFN 102.6 billion from inland revenue. This marks the first time the ITA has slightly exceeded its target of AFN 210 billion. Revenue in 2023 surpassed that of 2022, with border tax and non-tax revenues growing year-on-year despite a decline in customs duty (Figure 7). Non-tax revenues had positive YoY growth, while customs duty had negative growth in 2023 (Figure 8). The ITA aims to enhance domestic revenue by improving compliance and enforcement. However, the reliance on higher imports and non-tax revenues to meet targets may threaten future revenue stability.

Figure 7:Cumulative Monthly Revenue Collection and its Comparison (AFN Billions)

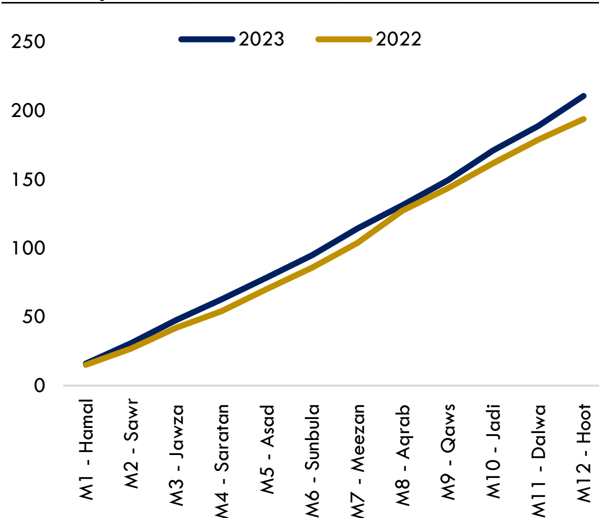
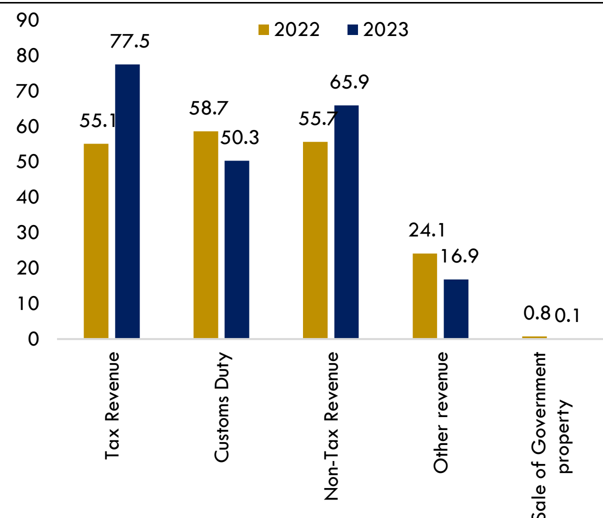


Figure 8: Revenue Collection by Object (AFN Billions)



Source: Ministry of Finance.
Note: The Afghan fiscal calendar month, Hamal, runs from March 22–April 21.

Despite tariff reductions and valuation adjustments, border tax revenue increased due to increased imports, though its sustainability remains questioned. Customs receipts grew by 5 percent in 2023 compared to 2022, propelled by greater trade volume and enhanced collection efficiency. Trade taxes constituted 75 percent of total customs revenue, with the remainder coming from road transport fees, vehicle income, transit services, and other sources. Of the trade tax revenue, customs duties represented 54.3 percent, business receipt taxes 20 percent, and fixed taxes about 10 percent. The customs revenue hike was primarily attributed to a 26 percent year-on-year trade increase in 2023. Nonetheless, customs revenue growth has been slower than in merchandise imports due to lowered duties and valuations in response to trader demands. Heavy reliance on customs revenue may be precarious as trade policies and consumer patterns shift, and changes in trading partners' preferences, like the coal trade with Pakistan, could also influence border tax earnings.

Figure 9: Composition of Total Revenues (FY2023-24)

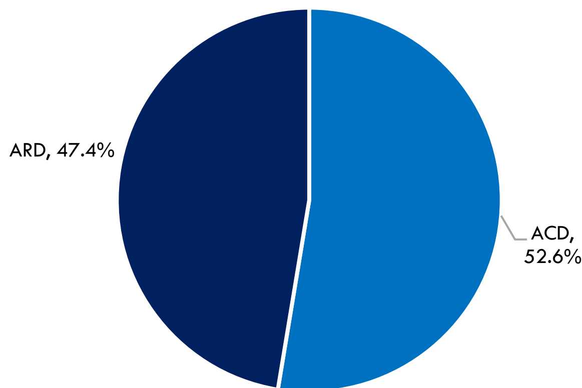
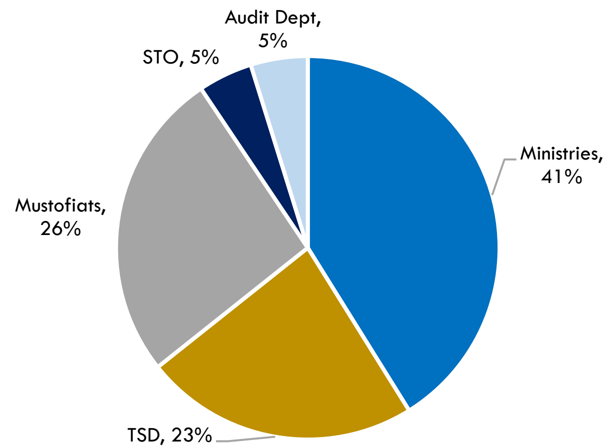


Figure 10: Composition of Inland Revenues by Source



Source: Ministry of Finance.

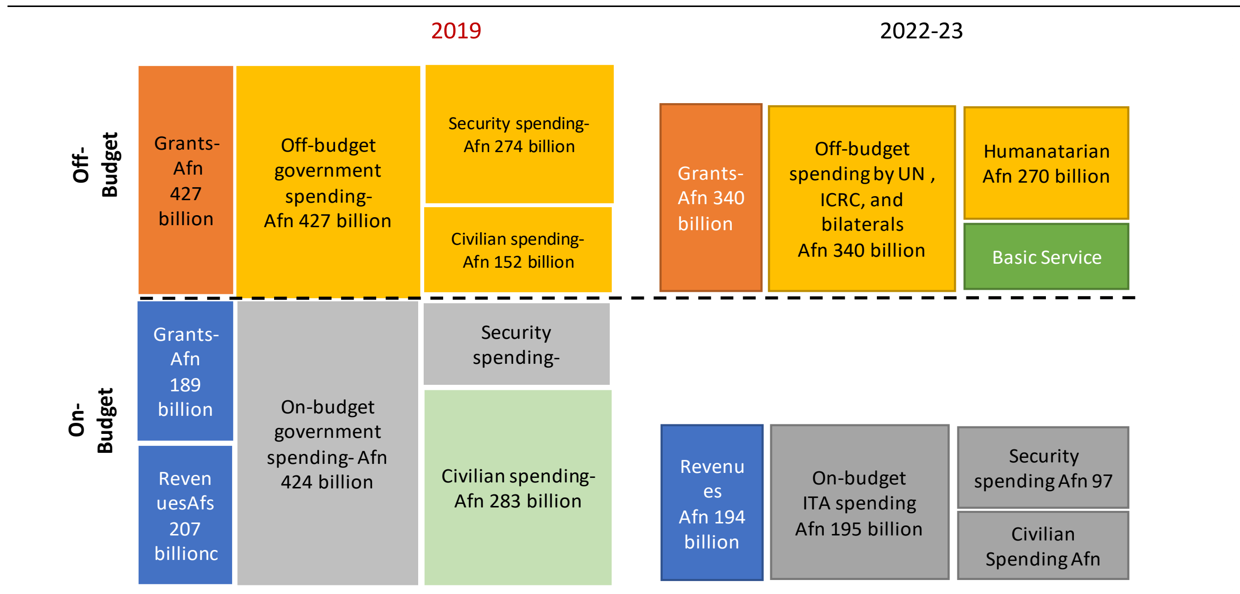
In FY2023, inland revenue growth eclipsed border taxes thanks to expanded compliance and a broader tax base. Inland revenues climbed by 13 percent to AFN 102.6 billion, making up 49 percent of total revenues, up from 45 percent the prior year (Figure 9). This boost resulted from tax rate cuts, stricter compliance, and tax base expansion. To aid the private sector, the Business Receipt Tax (BRT) rate for industries was halved to 2 percent, small business tax rates were trimmed from 1.5 percent to 0.5 percent, pre-2016 arrears were forgiven, and scaled exemptions were introduced post-2016. Moreover, penalties for overdue driving permits and vehicle registrations were abolished.

Non-tax revenues significantly contributed to meeting the FY2023 revenue target. Ministries were the most prominent inland revenue collectors at 41 percent, followed by Mustofiats at 26 percent, the Tax Services Directorate at 23 percent, and both the Small Taxpayer Office and Audit Department at 5 percent each (Figure 10). While Ministries and Mustofiats largely collected non-tax revenues, the Tax Service Directorate (TSD), Small Taxpayer Office (STO), and Audit departments focused on tax revenues. Non-tax sources accounted for approximately 60 percent of inland revenue, with tax revenues comprising the remaining 40 percent. Notable non-tax contributions included fees from newly registered right-hand vehicles, increased passport issuances, royalties, and tolls on major roads. A spectrum auction also generated about AFN 1 billion in FY2023, with further payments due over the next two years. Sustainable economic growth is essential for the long-term viability of inland revenue, as dependence on border taxes and one-time non-tax revenues can challenge financial stability.

EXPENDITURES:

The ITA's spending power is constrained by the absence of on-budget grants and borrowing options. Post-takeover, on-budget grants ceased, confining ITA's expenditures to its own revenue, which was AFN 210.7 billion in 2023 (Figure 11). While 2023 expenditure data is missing, it's likely that ITA's spending mirrored its revenue. Based on FY 2022's spending preferences, the ITA might have allocated more to security, with limited funds for social and economic sectors, depending on international support for basic services.

Figure 11: Without On-Budget Grants, the Amount of Revenue Collected Constraints the ITA's Public Expenditures.



Source: AFMIS, Ministry of Finance, and UN.

The ITA's fiscal strategy for 2023 was misaligned with its resource mobilization, undermining the credibility of its budget and leading to unsustainable spending accumulation. Initially, the ITA expanded its Tashkeel by nearly 30 percent over 2022, launched various development projects, and made provisions for pensions and arrears without adequate financing plans. This led to a projected budget shortfall of AFN 85 billion at the beginning of 2023. Line ministries exacerbated spending pressures by hiring additional staff, leaving many without compensation. The ITA also postponed pension payments for the third year, contributing to arrears accumulation, including unpaid amounts to past development project contractors. Anecdotal evidence suggests arrears from the previous administration amount to approximately AFN 180 billion, with AFN 37 billion in pension arrears and a backlog of contractor payments, indicating that the government's arrears are nearing its annual revenue collection.

Foreign aid is entirely off-budget due to the ITA's stance on human rights, gender, and inclusion. Most off-budget aid targets poverty alleviation, but reductions necessitate ITA's enhanced revenue mobilization and altered spending priorities. Both on-budget and off-budget expenditures declined under the ITA, with off-budget still exceeding on-budget. In 2022, total spending was 61 percent of the 2019 figure, with on-budget at 46 percent (Figure 12). Off-budget spending focused on humanitarian aid and basic service support, especially in healthcare, education, and water management, targeting pro-poor outcomes. Conversely, on-budget funds were largely allocated to security (Figure 13). Going forward, ITA will grapple with fiscal limitations in providing essential services and incorporating them into the National Budget, compounded by expected decreases in donor funding.

Figure 12: On and Off-Budget - Revenues and Expenditures (AFN Billion)

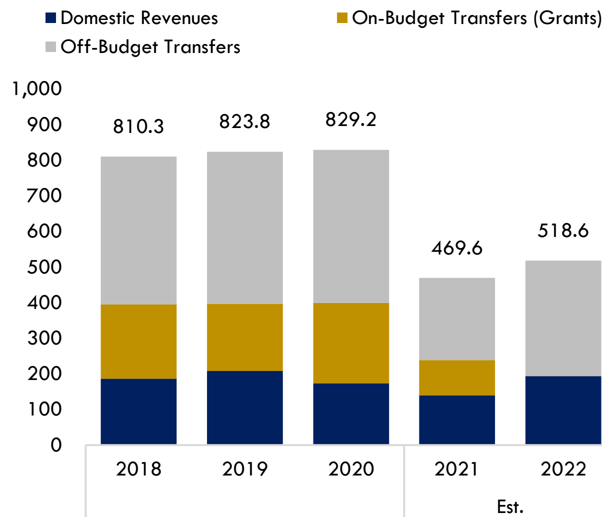
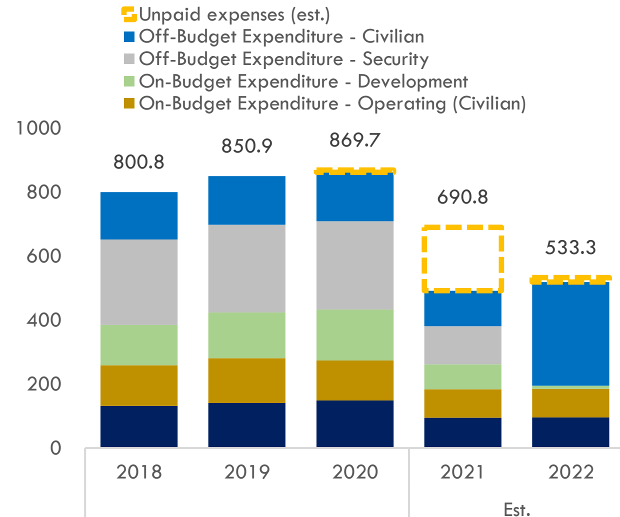


Figure 13: Sectoral Allocation of Expenditure (AFN Billion)



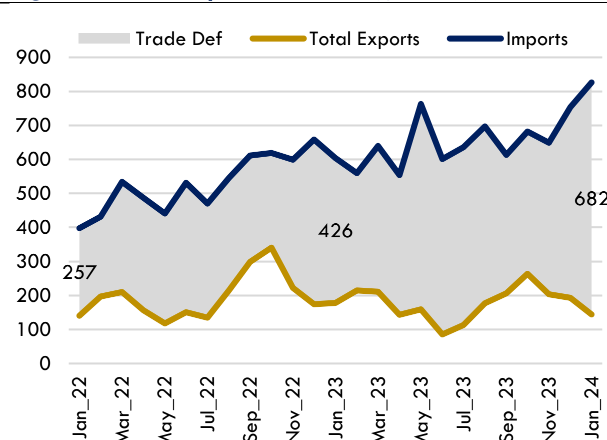
(*) *Source*: AFMIS, Ministry of Finance, and UN
(**) Unpaid expenditure refers to estimated arrears that will have to be paid sometime in the following years.

EXTERNAL SECTOR

In 2023, exports remained steady while imports soared, resulting in a larger trade deficit than the previous year. The influx of imports, largely destined for Pakistan, does not align with the Afghan economy's condition or the currency's appreciation.

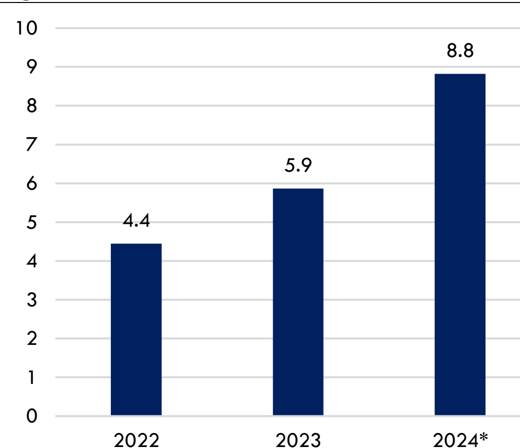
Persistent import growth with stagnant exports has led to a substantial trade deficit in 2023, continuing into 2024. The deficit increased by 66 percent year-on-year from $256 million in January 2022 to $426 million in January 2023, and by 60 percent year-on-year to $682 million in January 2024 (Figure 14). The annual trade deficit rose from $4.4 billion in 2022 to $5.9 billion in 2023, with a projected $8.8 billion in 2024 (Figure 15). Despite Afghanistan's foreign exchange shortage, the trade deficit has widened. This paradox is resolved by Pakistan financing a significant portion of the deficit, explaining the coexistence of a high trade deficit with currency appreciation and economic stagnation.

Figure 14: Monthly Trade Deficit ($Million)



Source: Automated System for Customs Data (ASYCUDA).

Figure 15: Annual Trade Deficit ($Billion)



* The 2024 value is simulated based on the January 2024 value of the trade deficit and the 2023 seasonal pattern.

EXPORTS:

Exports in Afghanistan remained relatively stable from 2022 to 2023, with the rise in food and textile exports offsetting the decline in coal exports. The total exports for 2023 were $1.9 billion, a slight increase of 0.39 percent from the previous year. Export fluctuations were notable, with significant increases in January, May, and December of 2023, but otherwise stagnant or declining exports in other months. January 2023 saw a 30 percent year-on-year growth, while January 2024 experienced a 5 percent year-on-year decrease (Figure 17). This reduction in exports is likely due to subdued economic activity and an overvalued exchange rate.

Coal exports from Afghanistan have sharply declined as Pakistani buyers revert to their usual sources. Coal was a key export, but from 2023 to January 2024, its performance plummeted. In 2023, coal exports fell by 46 percent, dropping from $476 million in 2022 to $257 million. The downward trend persisted into 2024, with January figures showing a mere $3.9 million compared to $29.6 million in January 2023 and $26.6 million in January 2022 (Figure 16). This marks an 87 percent decrease from January 2023 and an 85 percent drop from January 2022. The 2022 boost in coal exports was largely driven by Pakistani demand, as Afghan coal was priced more competitively than international options. However, reports indicate that Pakistani importers are shifting back to their traditional suppliers as the price gap between Afghan and international coal narrows.

Growth in food and textile exports has compensated for the decline in coal exports. Food exports increased by 13 percent to $1.25 billion in 2023 from $1.11 billion in 2022, with a notable 29 percent year-on-year surge in January 2023, followed by an additional 7 percent rise in January 2024. Textile exports also experienced a significant boost, climbing 46 percent to $281 million in 2023 from $192 million in 2022. January 2023 saw textile exports at $19.7 million, a substantial 91 percent increase from January 2022, and by January 2024, they further rose to $29.9 million, marking a 52 percent year-on-year growth. Favorable weather conditions contributed to the increase in food exports, while the growth in textile exports was supported by unrestricted imports. The two sectors' resilience is partly due to the low purchasing power in a depressed economy, as primary commodities are less influenced by exchange rates and more by consumer purchasing power.

Figure 16: Exports Trend ($billion)

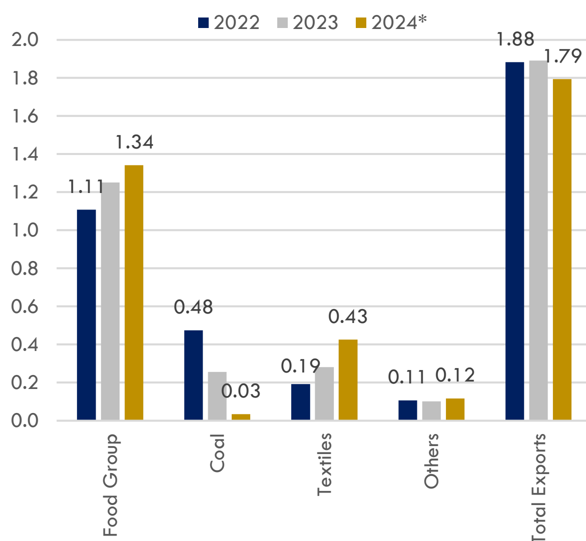
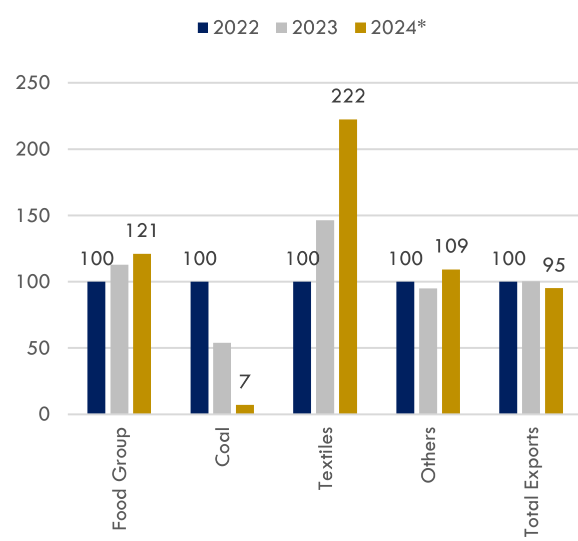


Figure 17: Exports Growth (2022=100)



Source: WB Staff calculations based on Automated System for Customs Data (ASYCUDA)

* The 2024 value is simulated based on the January 2024 value of exports and the 2023 seasonal pattern.

Afghanistan's export dynamics shifted, with Pakistan's share decreasing and India's increasing, particularly in food. In 2023, Pakistan and India were the main export destinations, with 54 percent and 31 percent shares, respectively. By January 2024, these figures shifted to 45 percent for Pakistan and 34 percent for India. Exports to Pakistan fell by 15 percent, from $1.2 billion in 2022 to $1.0 billion in 2023. Food and coal, which comprised 70 percent of exports to Pakistan, saw significant contraction. Coal exports drop by 46 percent in 2023 and by 87 percent year-on-year in January 2024. Food exports to Pakistan also decreased by 10 percent to $450 million in 2023, which was 36 percent of Afghanistan's total food exports, and declined by 18 percent year-on-year in January 2024. In contrast, food exports to India rose by 43 percent to $578 million in 2023, accounting for 46 percent of Afghanistan's total food exports, and increased by 22 percent year-on-year in January 2024. This growth in exports to India helped mitigate the decline in exports to Pakistan.

IMPORTS:

Imports to Afghanistan surged in 2023, a 23 percent increase to $7.8 billion from $6.3 billion the previous year, despite a contracting economy and reduced foreign exchange from declining off-budget transfers. Each month of 2023 experienced year-on-year import growth, with May and January showing the highest rates at 73 percent and 52 percent, respectively. This trend continued into 2024, with January imports up 37 percent year-on-year to $826.3 million from $603.6 million. In January 2022, imports stood at $398 million. The rise in imports amid economic downturns is perplexing. While an overvalued exchange rate may partly explain the increase, as it makes imports cheaper and domestic production less competitive, this is not the full picture. Reports and data suggest that some imports attributed to Afghanistan are actually financed by Pakistani buyers in the UAE (See Box 2 below for a detailed analysis).

In 2023, Afghanistan saw a shift in import patterns, with secondary commodities like machinery, transportation, and chemicals growing faster than primary commodities such as food, textiles, and minerals. Food imports made up 22 percent of total imports at $1.7 billion, a 9 percent increase from the previous year, and continued to rise by 14 percent year-on-year in January 2024 to $167 million (Figure 18). Mineral products, accounting for 20 percent of imports, grew by 15 percent to $1.6 billion in 2023, with a 27 percent year-on-year increase in January 2024 to $158 million. Textile imports rose by 11 percent to $720 million in 2023, with a modest 1.9 percent year-on-year growth in January 2024 to $59.9 million. These three categories represented 51 percent of total imports in 2023, but their share decreased to 47 percent in January 2024. Conversely, imports of machinery, transportation, and chemicals saw remarkable year-on-year growth of 63 percent, 85 percent, and 37 percent in 2023, respectively, and even higher rates of 111 percent, 106 percent, and 59 percent in January 2024 (Figure 19). Their combined share in total imports rose from 23 percent in 2023 to 32 percent in January 2024. This trend, favoring secondary over primary commodities, is at odds with the Afghan economy's condition. Iran was the largest import source in 2023 (23 percent) and January 2024 (32 percent), followed by Pakistan (19 percent and 14 percent), China (15 percent and 5 percent), and the UAE (15 percent and 27 percent).

Figure 18: Imports Trend ($billion)

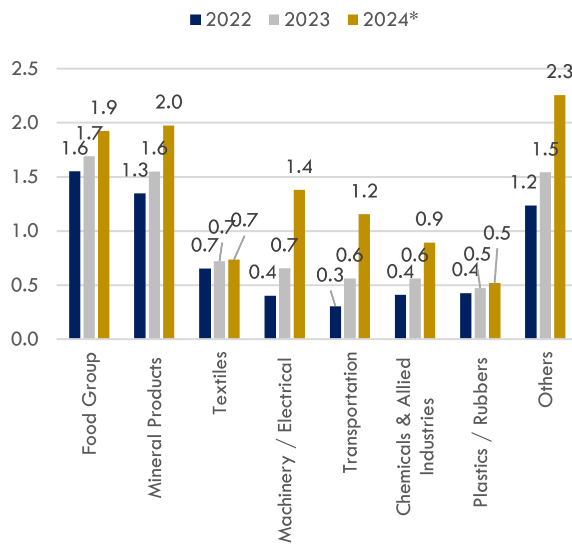
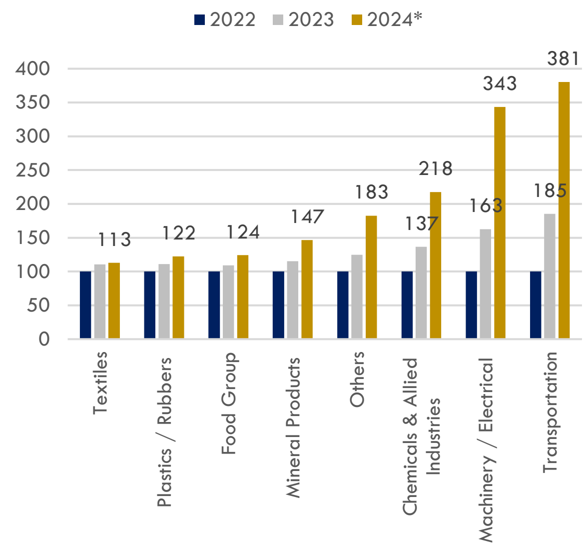


Figure 19: Imports Growth (2022=100)



Source: WB Staff calculations based on Automated System for Customs Data (ASYCUDA)

* The 2024 value is simulated based on the January 2024 value of exports and the 2023 seasonal pattern.

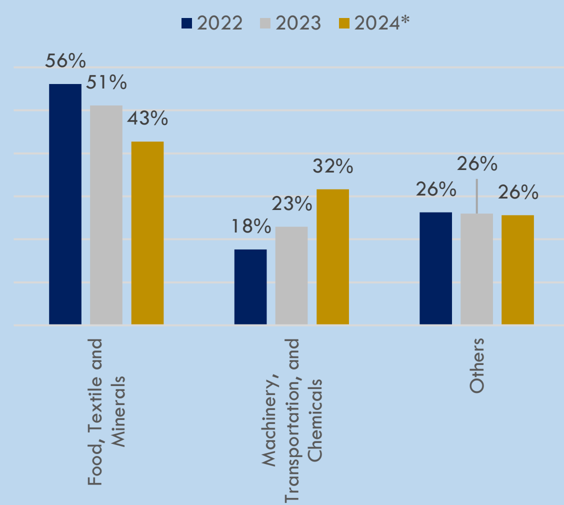
Box 2: Import Puzzle and Possible Explanation for Exchange Rate Appreciation

To explain the current international trade trend, we must consider Afghanistan's economic slowdown, marked by two years of contraction in 2022 and 2023. Despite a growing trade deficit, the Afghan exchange rate appreciated throughout 2023. A plausible explanation for this is that approximately one-fourth of Afghanistan's imports were actually destined for Pakistan, paid for by Pakistani importers. Starting in mid-2022, Pakistani authorities implemented controls to reduce imports. Trade data between 2022 and 2024 reveals a shift in the import composition of various commodities. In 2023, imports of primary goods such as food, textiles, and minerals rose by 11.6 percent from the previous year, with a further increase to 16.8 percent in January 2024. Secondary goods, including machinery, transportation, and chemicals, saw a remarkable 59.3 percent growth in 2023 over the previous year, and an even more extraordinary 94.3 percent year-over-year growth in January 2024. These varying growth rates have significantly altered the composition of imports, with the share of primary goods falling from 56 percent in 2022 to 43 percent in 2024, and secondary goods rising from 18 percent to 32 percent over the same period (Figure A). The proportion of all other goods has remained stable. Notably, the shift in import patterns does not align with the contraction in Afghanistan's industrial sector, indicating that the bulk of the imported secondary goods were likely consumed in Pakistan, not Afghanistan.

To account for Pakistan's import ban, we adjusted Afghanistan's import data. This adjustment helped us determine the volume of imports that Pakistan originally intended to receive. Pakistan imposed the ban in September 2022, and it remained in effect for most of 2023. We assessed the ban's impact by comparing imports from January to August 2022 with the same period in 2023. We also compared imports from September to December for both years. The difference in imports for the first eight months of the two years reflects the effect of Pakistan's import ban and economic factors like exchange rate overvaluation. However, the difference for the last four months of the two years only reflects changes due to economic fundamentals. We calculated the ratio of these two differences to determine the impact of Pakistan's import ban on Afghanistan's imports. We then adjusted Afghanistan's imports using this ratio-of-differences and made another adjustment for the economic contraction rate, assuming an import elasticity with economic activity of one.

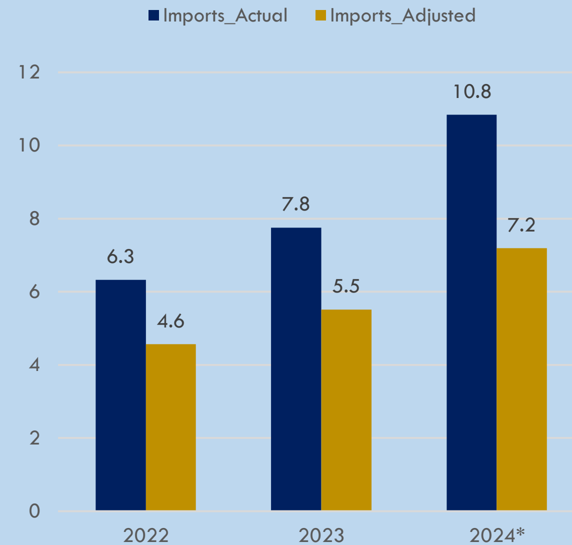
The adjustments indicate that Afghanistan's imports might be closer to $5.5 billion, not the $7.8 billion recorded in the actual accounts (Figure B). Therefore, the actual trade deficit for 2023 is likely around $3.6 billion instead of the reported $5.9 billion. The UN's cash injections of approximately $1.8 billion, along with estimated remittances of around $2 billion, were more than sufficient to offset the actual trade deficit of about $3.6 billion. This supports the 27 percent appreciation of the Afghan currency in 2023, in spite of a seemingly large trade deficit that was not counterbalanced by remittances and UN cash transfers.

Figure 20A: Changing Imports Shares



Source: WB Staff calculations based on Automated System for Customs Data (ASYCUDA)

Figure B: Actual and Adjusted Imports ($billion)



* The 2024 value is simulated based on the January 2024 val of exports and the 2023 seasonal pattern.

EXCHANGE RATE:

Throughout 2023, the Afghani (AFN) gained value against major currencies, marking a reversal of the trend observed since January 2024.

In 2023, Afghani appreciated notably against key currencies buoyed by foreign exchange inflows that comfortably covered the trade deficit. Specifically, the Afghani strengthened due to around $1.8 billion in UN cash shipments and an estimated $2 billion in remittances, outpacing the near $3.6 billion trade deficit. This led to a foreign exchange market surplus and significant appreciation of the Afghani, including a 27.1 percent rise against the US dollar and substantial gains against the Euro, Yuan, Rupee, and Toman (Figure 21).

However, targeting the exchange rate led to deflation and dampened economic activity. By December 26, 2023, the Afghani was up 22.8 percent from August 15, 2021, at 70.13 to the US dollar, making imports cheaper and reducing demand for local goods. The central bank's frequent forex auctions indicated a policy focus on bolstering the Afghani's value throughout 2023.

In early 2024, the Afghani's overvaluation began to correct with dwindling foreign exchange inflows, leading to depreciation. By the end of March 2024, the Afghani had fallen to 71.6 against the US dollar (Figure 22), losing ground against all major currencies, including a 2.0 percent drop against the US dollar.

Despite this, the exchange rate on March 28, 2024, still represented a 20.4 percent appreciation since August 15, 2021.

Figure 21: Exchange Rate – Index

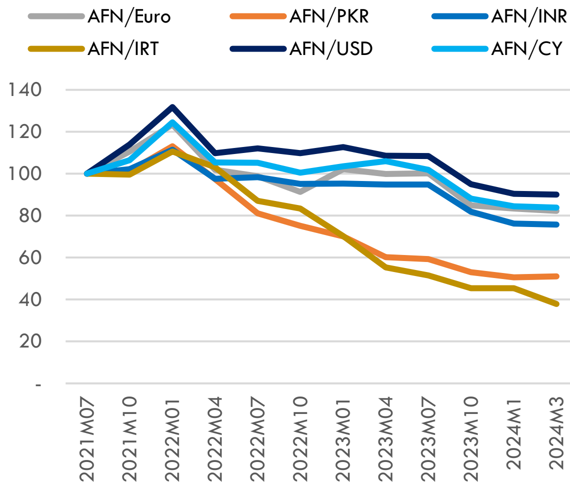
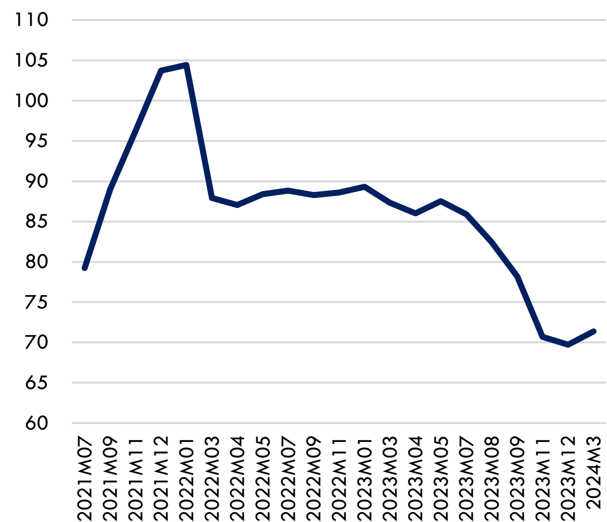


Figure 22: Average Monthly AFN/$Exchange Rate



Source: Da Bank of Afghanistan (DAB).

FINANCIAL SECTOR:

The banking sector is experiencing considerable strain from dwindling assets and deposits, compounded by difficulties with international payments and the shift to Islamic Finance. These issues have spurred a greater dependence on cash and non-traditional payment methods, further tightening the money supply and aggravating economic downturn and deflation.

The banking sector is under stress. The full scope of the crisis is not entirely clear due to limited data availability. Since the events of August 2021, only seven out of the twelve commercial banks in Afghanistan have disclosed their financial statements. The quality of the sector's assets is also uncertain, partly because of the forbearance measures implemented since 2021. The Afghanistan Banks Association (ABA), which appears to collect quarterly data from all twelve banks, has indicated that the sector's total asset base shrank by 10.54 percent year-on-year in December 2023. This suggests a reduction of roughly 25 percent in the total asset base of the banking sector since 2020, signaling a concerning trend for an already small industry (with total assets accounting for less than 20 percent of GDP in 2020).

The contraction in the banking sector's assets is due to various factors that continue to hinder the sector's core operations. The takeover by the ITA led to multiple challenges for the banking sector, including a sharp decline in the overall deposit base, which resulted in the central bank imposing withdrawal limits. These limits apply to deposits made before August 2021, and their levels were revised upwards in 2023. After an initial steep drop, deposits appeared to stabilize throughout 2022 and into early 2023. Nevertheless, the last six months of 2023 have seen a renewed decrease in the deposit base. The ABA reports a 9 percent year-onr-year reduction in aggregate deposits as of December 2023. This decline may be partly due to the ABA's method of calculating cumulative deposits in AFN; with the AFN's appreciation over the year, foreign exchange deposits are now worth less in AFN terms. ABA data indicates that by the end of 2023, 59 percent of all banking sector deposits were in foreign exchange, a decrease from 70 percent at the end of 2022. Meanwhile, median broad liquidity figures show a year-on-year increase of 7.35 percent, suggesting that

the liquidity crunch of 2022 might be alleviating, especially as new currency notes are circulated in the system.

Table 1: Banking Quarterly Financial/ Non-Financial Statistics with Comparison for 12 Banks (Consolidated)

S.no	Description	Q4 End 2022	Q4 End 2023	Absolute	YoY Growth
1	Total Deposits (Amount)	198536.0	180,507	-18029.2	-9.1
2	Total Assets	245394.0	219,534	-25860.0	-10.5
3	Broad Liquidity (Median)	67.2	74.6	7.4	10.9
4	NPL Percentage	18.3	24.3	6.0	32.6
5	Total Gross Loans	27596.0	22763.0	-4832.8	-17.5
6	Total Financial Capital	36677.0	33,487	-3190.0	-8.7
7	Total Branches (operational)	369	390	21	5.7
8	Total Foreign Exchange Deposits	139349.0	106,724	-32624.9	-23.4
9	Borrowing by Banking Sector	1948.0	821.0	-1127.0	-57.9
10	Amount of NPA in AFN (Doubtful and loss- Non Accrual Status)	4298.0	5399.0	1101.4	25.6
11	Number of ATM Machines (Operational)	141	226	85	60.3
12	Number of POS Machines (Operational)	347	369	22	6.3
13	Number of Borrowers	32,535	26,869	-5666.0	-17.4
14	Interest Income	1590.0	1,827	237.19	14.9
15	Interest Expense	238.0	146.7	-91.3	-38.4
16	Non-Interest Expense	8083.0	8,257	173.7	2.2
17	Non-Interest Income	8968.0	8,502	-466.3	-5.2
18	Net Profit/Loss	-806.0	(4,035)	-3229.1	400.6
19	ROA	0.0	0.0	0.0	459.6
20	ROE	0.0	-0.1	-0.1	448.3
21	CAR	30.9	31.3	0.4	1.3
22	Total Number of Depositors	4,420,482	3,839,628	-580854.0	-13.1
23	Total Number of Deposit accounts	4,611,787	4,089,906	-521881.0	-11.3
24	Total Number of Employees (Male & Female)	7,756	8,073	317.0	4.1

Source: Commercial Banks' Balance Sheets

The banking sector has seen a significant decrease in aggregate deposits, largely due to fluctuations in currency values. The Afghanistan Banks Association (ABA) reported an 11 percent decrease in the total number of deposit accounts from December 2022 to December 2023. This aligns with the World Bank's Private Sector Rapid Survey (PSRS) findings from its third round, published early in 2024, which was based on data collected in the first half of 2023. The survey included 422 formally registered Afghan firms, including 117 owned by women, and revealed that while 75 percent of the firms had bank accounts, only 27 percent had made deposits since August 2021. This trend was more pronounced among small and medium-sized enterprises, which have increasingly operated on a cash basis compared to larger firms. These findings highlight the persistent confidence issues within the sector since early 2021. The PSRS also indicated a growing reliance on cash transactions, with 89 percent of firms using cash for domestic payments, 32 percent utilizing hawala networks, and only 13 percent relying on banking channels for such payments.

The banking sector's role as a financial intermediary is significantly hampered by the mandatory transition to Islamic Finance. This prohibits earning income through interest on investments, loans, or deposits with the central bank. As a result, publicly available data from 7 banks shows that cash and cash equivalents made up 63 percent of total assets as of Q3 2023, up from 37 percent at the end of 2020. Although interest income in 2022 was significantly lower than in 2021, at only 27 percent of the previous year's income, there was a slight recovery in 2023. According to ABA data, interest income increased by 15 percent from December 2022 to December 2023. This increase may be partially due to new banking relationships with foreign banks, especially in Bahrain and Central Asia, which could provide opportunities for income generation through deposits and investments. The sector's total gross loans decreased by 17.5 percent between December 2022 and December 2023, while non-performing loans (NPLs) increased by 32.6 percent during the same period. Despite ongoing forbearance measures, these losses have not been fully recognized or provisioned for in the banks' accounts. Proper accounting would likely reveal a significant erosion of most banks' capital positions, presenting serious stability risks to the sector. The absence of an interbank money market further compounds the crisis.

The banking sector continues to face challenges with international payments, particularly through U.S. banking channels. The de-risking stance of USD settlement banks has left Afghanistan largely excluded from international payment systems. While some Afghan banks have established new correspondent banking relationships (CBRs) with regional banks, the extent and impact of these relationships are not fully transparent. The reliance on UN cash shipments persists as the primary method for international payments, pending a significant breakthrough. Concerns about the central bank's capacity to monitor and manage anti-money laundering and combating the financing of terrorism (AML/CFT) risks add to the hesitancy in engaging with Afghan banks. The increasing use of the hawala system for international payments further heightens the perception of AML/CFT risks. According to the World Bank's Private Sector Rapid Survey (PSRS), hawala is becoming more entrenched in cross-border business transactions, with 43 percent of surveyed firms using it for such payments. Declining assets and deposits, compounded by difficulties with international payments and the shift to Islamic Finance, has spurred a greater dependence on cash and non-traditional payment methods, further tightening the money supply and aggravating economic downturn and deflation (Box 3).

On a more positive note, the financial sector's infrastructure is expanding. The number of operational bank branches grew from 369 in December 2022 to 390 in December 2023. There has been a 60 percent increase in operational ATMs since December 2022, and the number of Point of Sale (POS) machines has also seen a modest 6 percent year-on-year increase as of December 2023. The Murabaha lending product, approved by the central bank in September 2022, is now being utilized by microfinance institutions and some banks. Murabaha is a sales contract where the lender buys goods and sells them to the client at a marked-up price, with repayment typically in installments. It is currently the sole Islamic lending instrument in use in Afghanistan. The sector has proposed four additional Islamic financial products, which are awaiting approval from the ITA. At present, Murabaha is primarily offered through microfinance, but commercial banks are also starting to provide limited, small-scale lending using this instrument. As of December 2023, microfinance providers have issued 31,317 Murabaha contracts, with 42 percent to women borrowers. These contracts support four main sectors: trade and services, handicrafts and manufacturing, agriculture, and livestock. There has been a 100 percent repayment rate for Murabaha loans thus far.

Box 3: Macroeconomic Consequences of the Contraction in Money Supply

Da Afghanistan Bank (DAB) has reported a notable decrease in Afghanistan's money supply, with M2 shrinking by nearly 11 percent from the fourth quarter of 2020 to the second quarter of 2023. This decline is due to a combination of factors, including sanctions, the freezing of DAB's offshore assets, disruptions in international banking channels, challenges within the domestic payment system, and a mandatory transition to Islamic banking. These elements have collectively pushed Afghanistan towards a predominantly cash-based economy. Additionally, the introduction of new currency into circulation has been significantly hindered. Traditionally, DAB would annually retire and replace 3 to 4 billion Afghanis of old and worn banknotes with new ones printed overseas, given Afghanistan's lack of domestic minting facilities. However, the imposition of international sanctions has obstructed the Taliban's ability to secure new currency, exacerbating the money supply contraction.

Macroeconomic theory highlights the profound impact that a reduction in money supply can have on economic activity, price levels, and exchange rates, as currently witnessed in Afghanistan. A diminished money supply can lead to decreased consumer and business spending. With a scarcity of money, consumers may struggle to obtain credit and reduce their spending, while businesses may find it difficult to secure investment loans. This can lead to a reduced demand for goods and services, prompting businesses to lower prices to attract customers, potentially resulting in deflation. This is reflected in the steep drop in headline inflation in Afghanistan, which plummeted to -9.7 percent year-on-year by February 2024.

Deflation can paradoxically damage the economy despite increasing the currency's purchasing power. It can cause consumers to delay purchases in anticipation of further price drops, which can exacerbate an economic downturn. This can lead to reduced production, job losses, and higher unemployment, contributing to a recession. Afghanistan's economy has contracted by 27 percent since 2021, reflecting these conditions.

The exchange rate is also affected by the supply and demand for a country's monetary assets. A constricted money supply can lead to currency appreciation if its purchasing power increases. Since August 2021, the Afghani has appreciated by 22.8 percent against the US dollar. This appreciation has rendered Afghanistan's exports more expensive on the international market, reducing their demand and negatively impacting the export sector's potential to drive economic growth in the post-conflict era.

Understanding these economic principles is essential for Afghanistan's policymakers as they navigate through periods of economic recession. Historical examples, such as the Great Depression in the United States and Japan's "Lost Decade," underscore the significance of these dynamics. During the Great Depression, the U.S. dollar appreciated due to deflation, but as the crisis deepened, the U.S. devalued the dollar to boost exports.

Given these considerations, it is crucial for Da Afghanistan Bank to re-evaluate and adjust its monetary policy to effectively address the current economic challenges. A thoughtful recalibration of monetary policy could help alleviate the adverse effects of deflation and promote a more balanced economic recovery. The bank's proactive approach to monetary policy could be instrumental in reversing the economic downturn and setting Afghanistan on a path to recovery and prosperity.

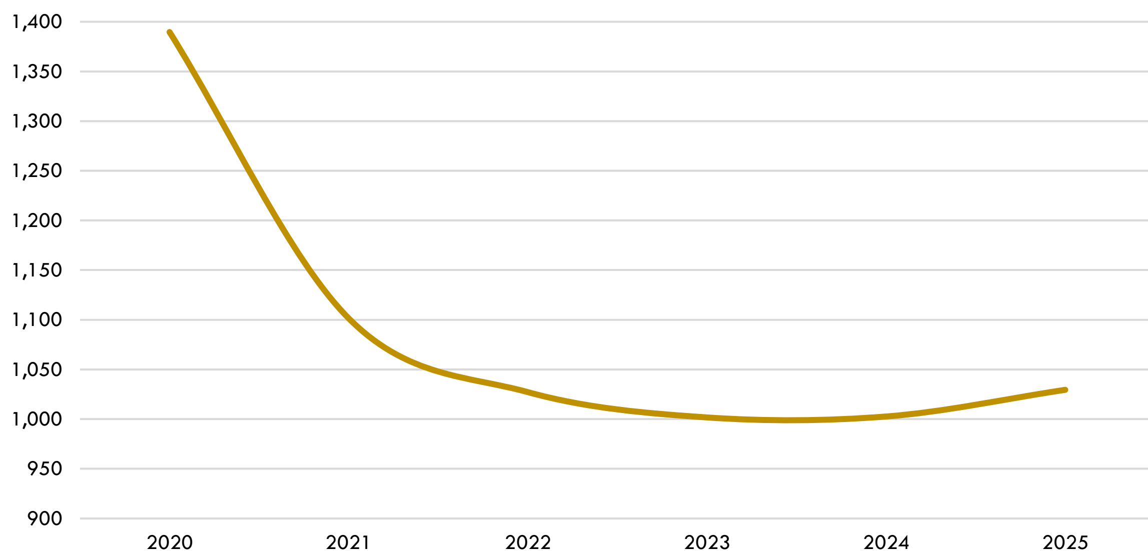
The micro-finance sector is also a significant source of credit in the Afghan economy. The microfinance sector accounted for 17 percent of the total formal credit in 2020. However, it has been severely affected by the economic downturn since late 2021, with borrowers struggling to repay loans, leading to a sharp decline in asset quality. The transition to Islamic finance, which prohibits interest collection, has further weakened the sector's capital. To recover, microfinance institutions must rectify their balance sheets, which currently do not reflect the reality that 68 percent of the AFN 4.01 billion in gross loans were issued before August 2021, and nearly 90 percent of these are over 180 days overdue, technically making them non-performing loans.

2. OUTLOOK AND MEDIUM-TERM PROSPECTS

The Afghan economy is expected to remain stagnant through 2025 with no GDP growth, declining per capita income due to population growth. The ITA's policies, deflation, banking instability, and climate issues pose risks that could exacerbate poverty and food insecurity, while a shift to a private sector-led economy focusing on agriculture and extractives is necessary for sustainable growth.

The private sector's weaknesses, structural challenges, and diminished international support for humanitarian and basic services are expected to hinder economic progress. The baseline scenario for 2023-2025 envisages persistent economic stagnation with a decrease in external funding for off-budget expenses. Real GDP growth is projected to stagnate, averaging zero growth over the next three years, leaving economic activity in 2025 at the same level as in 2022, while per capita income falls due to population growth. The projection includes a 15 percent reduction in Off-Budget Transfers (OBT) in 2023, followed by a 10 percent yearly decline thereafter. Lower OBT means that the foreign exchange market will likely face pressure, leading to the depreciation of the exchange rate over the same period. Inflation is set to recover due to base effect and via import channel from the current deflationary period, averaging around 6 percent between 2023-2025. As a result, merchandise exports are expected to increase by an average of 4 percent, while imports may decrease by 9 percent annually from 2023 to 2025.

Figure 23: Real GDP| Constant Prices (AFN billion)



Source: WB staff estimates.

Economic stagnation is expected to perpetuate poverty and unemployment in the medium term. With little growth in economic activity, job opportunities will be limited, making it difficult for many to earn a living. Rural poverty might decline as farmers switch to alternative crops following the opium cultivation ban. High unemployment and falling incomes will likely lead households to cut back on food or opt for cheaper, lower-quality options, exacerbating food insecurity. The ban on female education above the primary level poses a long-term economic threat by depleting the pool of educated women and potentially reducing Off-Budget Transfers (OBT). Additionally, the lack of climate change mitigation plans could negatively impact the agricultural sector and overall economic activity.

Revenue collection and on-budget spending are projected to stagnate, with a forecasted decline in off-budget transfers. The ITA is expected to maintain its 2022 revenue mobilization levels, with domestic revenue averaging 15 percent of GDP over the next three years. On-budget expenditure is anticipated to be AFN 200 billion annually, funded entirely by domestic revenues, but with a lower real value (AFN 147 billion) compared to 2022. The ITA, lacking alternative financing and unable to borrow, is not expected to settle floating debts to suppliers and pensioners due to financial constraints. Off-budget transfers are projected to be cut significantly, dropping to AFN 269 billion (AFN 190 billion in constant prices) by 2025 from AFN 327 billion in 2022 under the baseline scenario. This reduction in OBT will further suppress overall demand and sharply curtail spending on poverty alleviation as the ITA reallocates more funds to security.

Figure 24: Domestic Revenues | Constant AFN billion

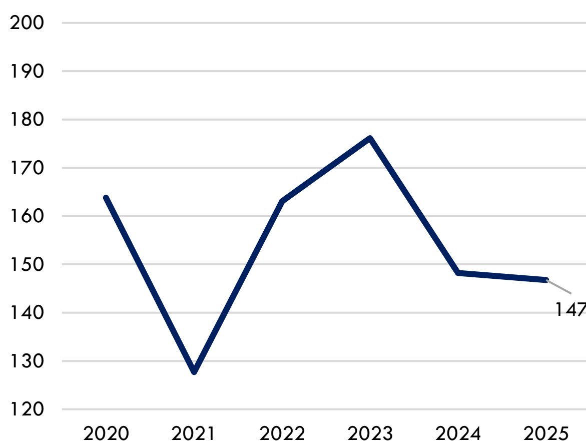
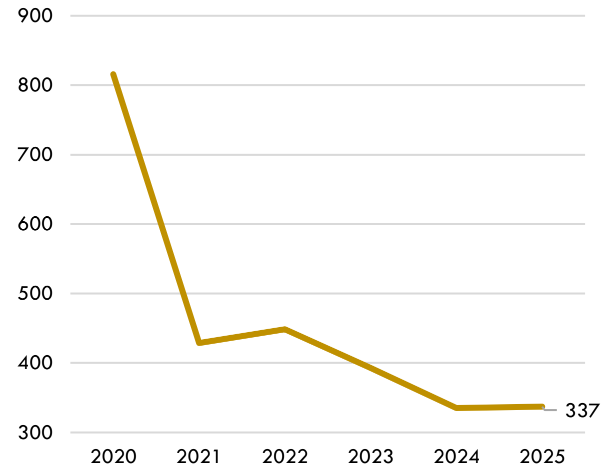


Figure 25: Overall Spending | Constant AFN billion



Source: WB staff estimates.

The baseline economic scenario is subject to significant risks. The ITA's discriminatory policies, particularly regarding gender, may lead to further reductions in external support. A larger-than-anticipated cut in Off-Budget Transfers (OBT) could diminish economic activity and cut critical spending aimed at poverty reduction, which is currently not included in the budget. Persistent deflation, which began in April 2023, has the potential to contract the economy over the medium term rather than just stagnate it. The stability of the banking sector and environmental challenges also pose risks. Should these risks materialize, the GDP could fall below current projections, with negative consequences that could extend regionally and globally, driving more individuals into poverty and exacerbating food insecurity.

3. SPECIAL FOCUS – POSSIBLE SCENARIOS FOR SECTORAL ALLOCATION AND SERVICE DELIVERY IN RESPONSE TO REDUCTION IN OFF-BUDGET TRANSFERS BY THE INTERNATIONAL COMMUNITY.

BACKGROUND

Since August 2021, the delivery and financing of public goods and services in Afghanistan have been in a state of crisis, marked by a drastic reduction in foreign aid and a shift of all aid to off-budget channels. Prior to the political upheaval, the total on and off-budget foreign aid averaged USD 8.4 billion annually from 2018-2020, accounting for approximately 45 percent of GDP. This starkly contrasts with the current situation, where off-budget foreign transfers amount to a mere USD 3.7 billion in 2022, or about 26 percent of GDP. The total expenditure on public goods and services, both on and off-budget, has plummeted by 35 percent in 2022 compared to the pre-crisis period (2018-2020) average. Notably, the expenditure managed by the ITA in 2022 was a mere half of the average annual spending under the previous Administration in 2018-2020.

In the context of high social vulnerability and declining resources, improving the efficiency and sustainability of service delivery and financing of public goods becomes critical. Arguably, the use of off-budget expenditure programs by international organizations for delivering public goods and services is inherently inefficient. Besides, as donors and agencies seem likely to continue reducing the external grants that still fund the off-budget expenditures, a financing gap is expected to emerge in the foreseeable future; hence, two intertwined risks are building up: (i) the financing of public goods and services may not be sustainable, and (ii) the fragile macroeconomic stability may be undermined by a renewed contractive impact that would result if expenditure programs run by international organizations continue shrinking as foreign aid tightens further.

Given the current economic and societal challenges in Afghanistan, it is unfeasible for the ITA to boost its revenue collection to match the funding levels of the previous government. The former administration's average annual expenditure was AFN 410 billion from 2018 to 2020. To reach this level of on-budget spending using only domestic revenue, without foreign aid, would require doubling the AFN 194 billion collected in 2022, which was 15 percent of GDP. Raising domestic revenue to approximately AFN 410 billion, or 32 percent of GDP, in a short timeframe is not only economically and socially impractical but could also lead to a contraction in economic activity and increased public unrest.

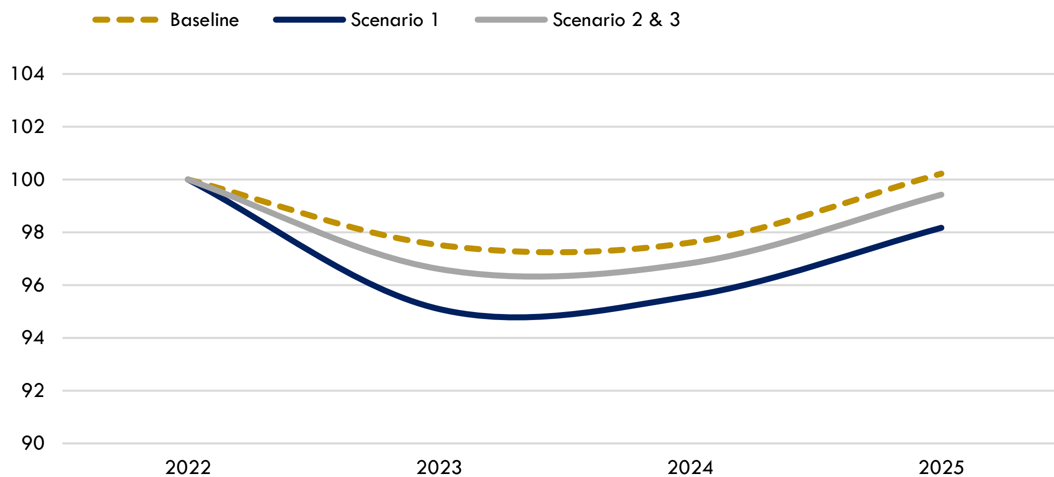
POLICY SCENARIOS:

Three alternative scenarios have been assumed for policy simulations compared to the baseline discussed in the outlook section. In all three scenarios, there is an assumed 10 percent annual decrease in OBT from 2023 onwards, over and above the baseline. In Scenario 1, the ITA remains indifferent to a decline in OBT. It does not improve its revenue mobilization and expenditures, resulting in lower medium-term overall spending compared to the baseline. Scenario 2 assumes that the ITA decides to raise 50 cents to a USD loss in OBT. Estimates suggest that on-budget expenditures are twice as efficient as off-budget spending. However, under this scenario, the increased own-source revenues will be allocated according to ITA's revealed preference, as shown in actual FY 2022 expenditures, meaning that it will continue to pour more money into the security sector. Similarly, Scenario 3 also assumes that the reduction in OBT will be 50 percent offset by increased domestic revenue mobilization. However, contrary to Scenario 2, ITA will use increased own-source revenues to proportionally compensate for the loss in off-budget expenditures in concerned sectors.

SIMULATIONS OVER THE MEDIUM-TERM

A reduction in off-budget transfers will hurt economic activity. As discussed in the outlook section, under the baseline scenario, economic activity in 2025 will barely reach 2022 levels. In the event of an additional reduction in OBT under alternate scenarios, economic activity will further decline. The decline is estimated to be two percentage points under scenario one and one percentage point under scenarios 2 and 3. All the alternative scenarios are worse than the baseline, but scenario 1 is the worst. In scenario 1, the loss in OBT is not compensated by ITA. However, in scenarios 2 and 3, the increase in revenue mobilization partially offsets the reduction in OBT, allowing ITA to spend more. This helps bridge the gap between real GDP in the baseline and that under scenario 1.

Figure 26: Real GDP | Index 2022=100



Source: WB staff projection.

In real terms (at 2018 prices), the overall spending (on and off-budget) is projected to decline. The amount of off-budget spending is expected to decrease in real terms from AFN 285 billion in 2022 to AFN 190 billion in 2025. Similarly, there will also be a decrease in real domestic revenue from AFN 163 billion to constant AFN 147 billion due to lower economic activity caused by lower off-budget spending. In the alternate scenario 1, a further 10 percent reduction in off-budget spending would lead to a decreased real domestic revenue of constant AFN 144 billion. However, as ITA is assumed to collects additional revenues in scenarios 2 and 3 to compensate for the loss in off-budget spending, increasing real domestic revenue to AFN 156 billion in 2025. Even though ITA partially offsets the loss in off-budget spending, the overall real spending, both on-budget and off-budget, decreases in all three scenarios compared to the baseline. While scenario 1 shows an obvious spending decline, scenarios 2 and 3 indicate the same due to partial offsetting by ITA and low economic activity.

Figure 27: Domestic Revenue | Constant AFN billion

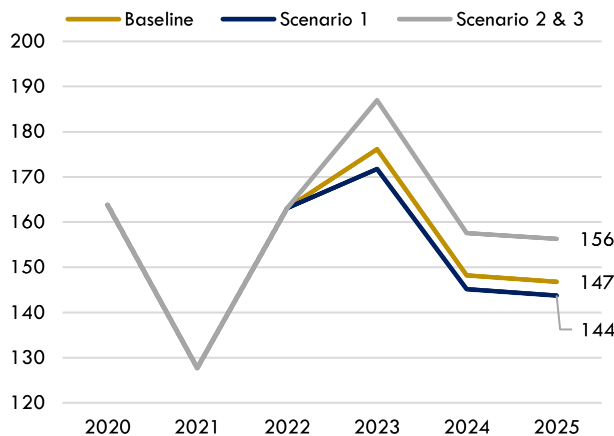
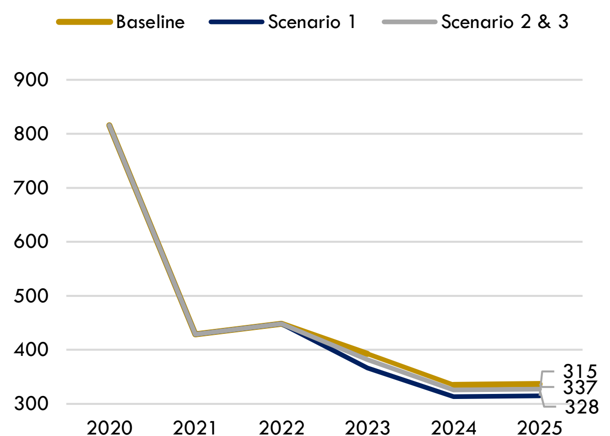


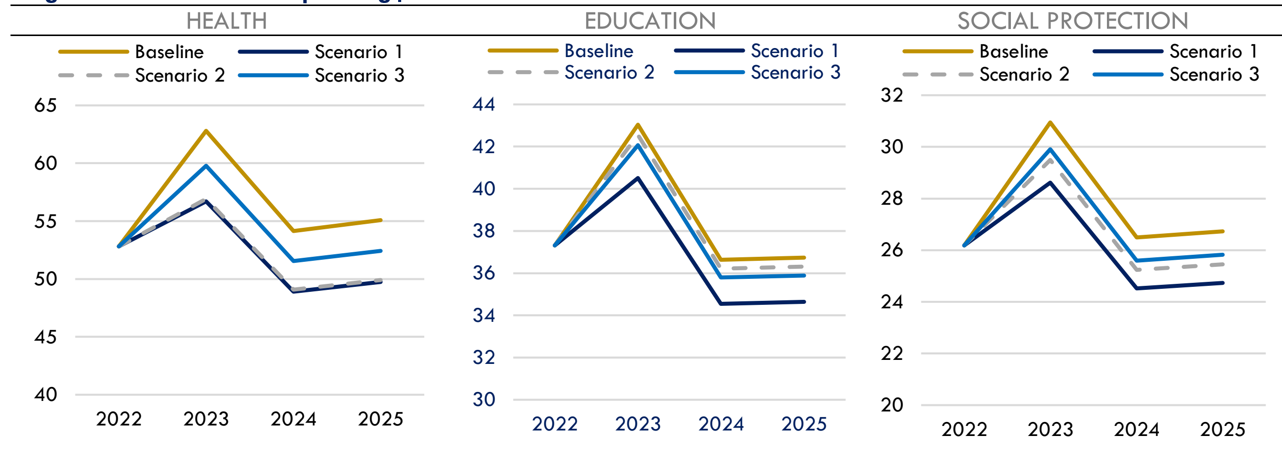
Figure 28: Overall Spending | Constant AFN billion



Source: WB staff estimates.

A combination of increased revenue mobilization and preference change by ITA for sectoral allocation can help partially mitigate the impact on social sector spending. To offset the effect of the decline in OBT on social sectors, ITA can raise revenues and change the expenditure allocation pattern observed in the 2022 budget away from security to social sectors. In FY 2022, on-budget spending accounted for 38.8 percent of the total expenditure (on-budget and off-budget combined). However, on-budget spending on health, education, and social protection was only 1.4 percent, 13.4 percent, and 5.8 percent of the total, respectively. To compensate for these minuscule on-budget allocations, 95.3 percent, 37.4 percent, and 61.6 percent of the total spending on health, education, and social protection came from donors and was off-budget. Therefore, under all scenarios of higher OBT reduction than the baseline, social sector spending decreases compared to the baseline. Scenario 1 is the worst for the social sector, as OBT - the primary funding source for social spending - decreases with no response from ITA to compensate for OBT reduction. However, the negative effect on health and social protection can be minimized under scenario 3, where ITA allocates increased domestic revenue to offset the off-budget spending cut proportionately. Conversely, education attracts more resources under scenario 2, as ITA spends relatively more on education compared to other social sectors.

Figure 29: Social Sector Spending | Constant AFN billion

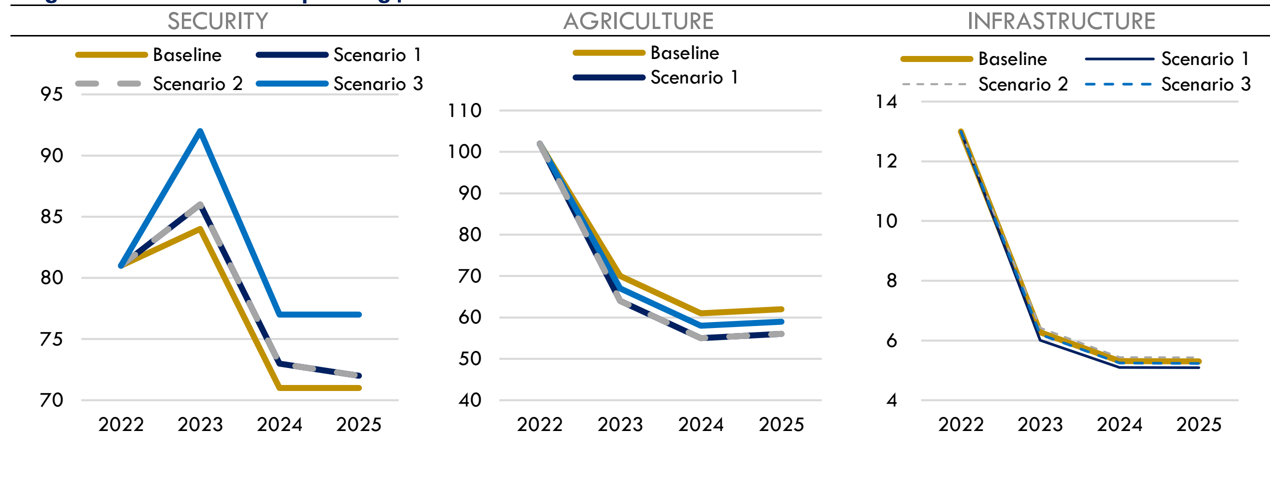


Source: WB staff estimates.

No adjustments in ITA's priorities for sectoral allocation would result in increased funding for the security sector from the additional domestic revenues. If ITA enhances its capability to generate domestic

revenue but continues to spend according to the expenditure pattern of FY 2022, then the security sector will benefit the most. In FY 2022, the government allocated 53.2 percent of the on-budget envelope to the security sector, while agriculture and infrastructure received only 0.7 percent and 2.7 percent, respectively. On the other hand, 98.8 percent of the total agriculture and 63.4 percent of infrastructure expenditures were financed by the international community outside the budget. Scenario 1 shows that every sector, including security, will be affected if ITA does not compensate for OBT reduction. Scenario 3 shows that the loss in OBT is balanced by higher revenue mobilization (50 cents for a USD loss in OBT), resulting in minimal loss to the spending in the security, agriculture, and infrastructure sectors. However, suppose ITA maintains its spending pattern and aligns it with the 2022 expenditure. In that case, only the security sector will benefit from higher revenue mobilization at the expense of all other sectors.

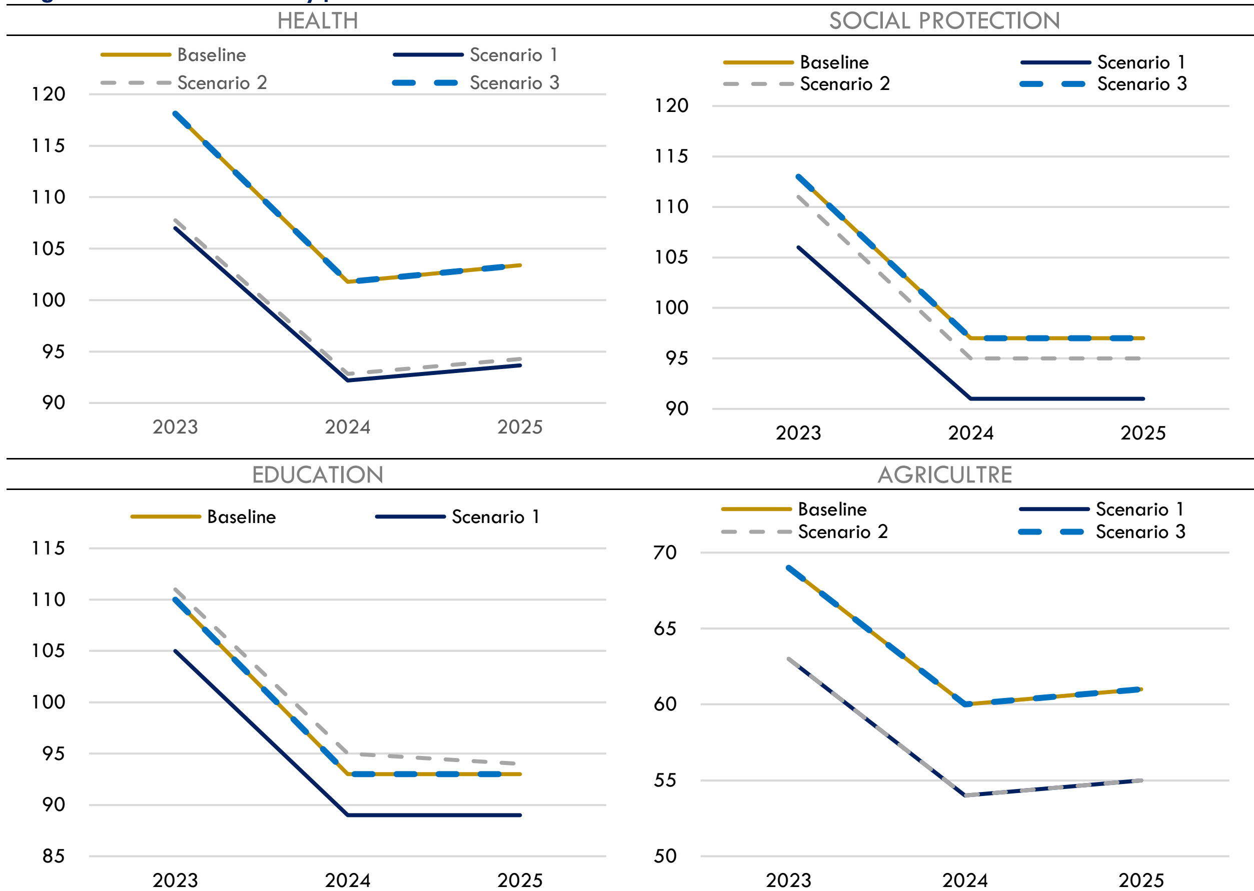
Figure 30: Social Sector Spending | Constant AFN billion



Source: WB staff estimates.

Increasing domestic revenue mobilization and prioritizing social sectors can maintain the value of service delivery outputs (Figure 31). Scenario 3 is the only alternative scenario where service delivery in social sectors like health and social protection and agriculture's primary income sector remains equivalent to the baseline. This is because social sectors will not be under-financed due to declining OBT, but rather, on-budget spending will compensate for the off-budget decline. However, service delivery in the education sector will improve if the ITA improves domestic revenue mobilization and spending according to the FY 2022 expenditure. This is because education is the only social sector where ITA spent 63 percent, while off-budget spending was just 37 percent in FY 2022. Therefore, the education sector will be more protected if ITA does not alter its spending pattern.

Figure 31: Service Delivery | Index 2022=100



Source: WB staff estimates.

KEY FINDINGS

Here's a summary of the key findings from the special section on reducing OBT, ITA's response, and sectoral allocation.

- A decline in off-budget transfers will negatively impact economic activity. In 2025, economic activity will barely reach 2022 levels. A further cut in transfers over the baseline will result in an additional decline in economic activity.
- ITA can only partially compensate for the loss in OBT with increased domestic revenue mobilization.
- A combination of increased revenue mobilization and preference change of ITA for sectoral allocation can help mitigate the impact on social sector spending and service delivery.

No adjustments in ITA's priorities for sectoral allocation would result in increased funding for the security sector from additional domestic revenues, leading to a significant reduction in overall social sector spending and service delivery