AFGHANISTAN

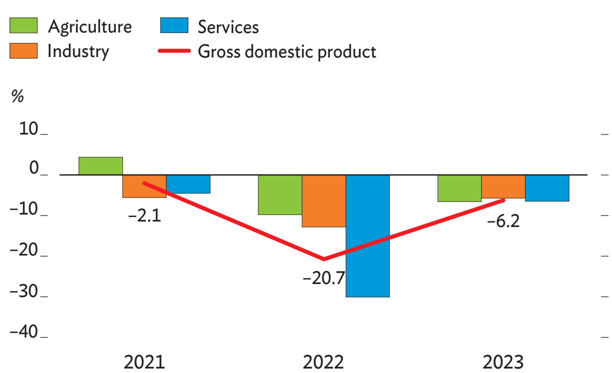
Drought, cold, disasters, and a weak investment climate brought a third consecutive year of economic contraction. In the medium term, modest economic growth could resume with better security, domestic revenue mobilization, expanding trade, and improved agriculture as El Niño boosts precipitation. Deflation that occurred due to a strong local currency and falling global commodity prices will give way to inflation as pressure for currency appreciation recedes. Inclusive growth requires improved access to finance.

Economic Performance

Drought, cold weather, disasters, and a weak investment climate led to a third consecutive year of contraction. However, with continued international humanitarian assistance and support for basic needs, the decline in real GDP diminished from 20.7% in 2022 (years designating, unless otherwise specified, the fiscal year ending on 20 March of that year) to 6.2% in 2023. Data from the de facto National Statistics and Information Authority showed activity declining in agriculture, industry, and services, with each contracting by 5%–7% (Figure 2.14.1). Accompanying the declines was a substantial change in the sector composition of GDP. From 2021 to 2023, the share of services declined by 14.3% to 45.0% of GDP, while the share of agriculture grew by 12.4% to 33.7% of GDP and that of industry by 23.9% to 16.1%, despite declining output in each sector.

Figure 2.14.1 Supply-Side Growth

The economy shrank for 3 consecutive years with declines in all three major sectors.



Note: Years are fiscal years ending 20 March of that year.
Source: National Statistics and Information Authority.

Services, the largest sector of the economy, accounted for nearly half of the GDP decline. They contracted a further 6.5% in 2023, following a 30.1% decline in 2022, reflecting significant decreases in all leading service industries. Wholesale and retail trade each contracted by 8.6%, finance and insurance by 6.6%, health and social services by 5.9%, real estate by 5.2%, restaurants and hotels by 4.9%, and post and telecommunication by 4.7%. Only education expanded, by a modest 0.7%.

Another 35% of the decline in GDP came from agriculture, which contracted by 6.6%. Significant crop losses were caused by the current multiyear drought, the most severe in the past 3 decades; an extreme cold wave during December 2022 and January 2023; and earthquakes and flooding. In addition, scarcity of seeds and other agricultural inputs, restricted market access, and supply chain disruption reduced the area under cultivation. Livestock

ADB placed on hold its regular assistance in Afghanistan effective 15 August 2021.

production suffered from high feed prices, disease, adverse weather, poor-quality forage, and limited access to veterinary services and water.

A sharp worsening of the investment climate and collapsing business confidence contributed to the decline in industry. Industry contracted by 5.6% as the sector shifted toward resource-intensive primary activities such as mining and quarrying, which expanded by 4.1%. The move away from more diversified and skill-intensive activities reflected brain drain and commercial pessimism from weak governance and policy uncertainty, macroeconomic instability, chronic illiquidity, and elevated risk premiums required for formal finance.

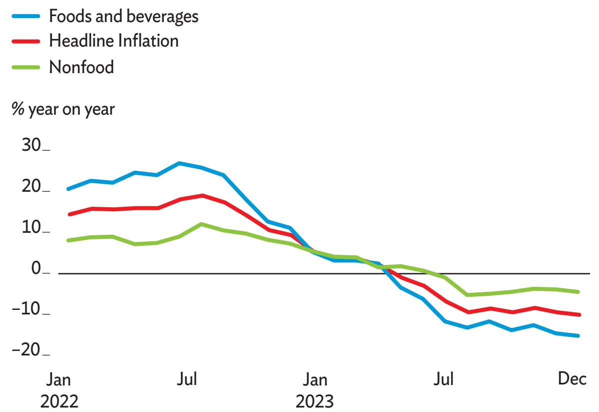
Rising global prices for food and petroleum, drought, and supply chain difficulties brought double-digit inflation. Inflation averaged 10.8% in 2023, with food prices rising by 14.6% and prices of other goods rising by 7.0% (Figure 2.14.2). Year-on-year inflation peaked in July 2022 at 18.3%, reflecting increases of 25.0% for food and 11.6% for other items. Inflation slowed to 3.1% in the fourth quarter of 2023 with an easing of international supply chain bottlenecks and stabilization of the afghani, the local currency.

The formal finance sector performed well below its potential to support economic recovery, constrained by real and perceived illiquidity risks. International humanitarian assistance, especially the attendant inflow of US dollar banknotes for humanitarian purposes, and robust revenue collection have moderately improved liquidity. Bank deposits rose by 2.4% in 2023 (Figure 2.14.3). However, total loan volume fell by 18.3%, with a perceived substantial increase in nonperforming loans. This reflects the adverse effect of 3 years of economic contraction on the capacity of borrowers to service debt, which has weakened bank balance sheets.

The trade deficit widened sharply as rising global prices for oil and food caused imports to grow much more than exports. The trade deficit ballooned from $4.4 billion in 2022 to $6.2 billion in 2023 as merchandise imports rose by 44.6% to $7.1 billion (Figure 2.14.4). Food accounted for 22.2% of imports, petroleum and oil 19.0%, and machinery and spare parts 8.3%. Merchandise exports rose by 116.1% from

Figure 2.14.2 Monthly Inflation

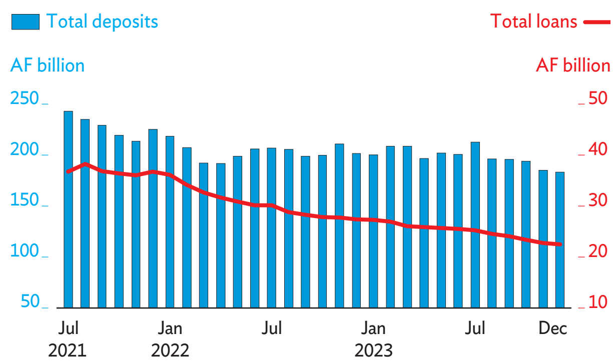
Inflation peaked in July 2022 and has declined since then.



Source: Data collected from official sources.

Figure 2.14.3 Bank Deposits and Credit

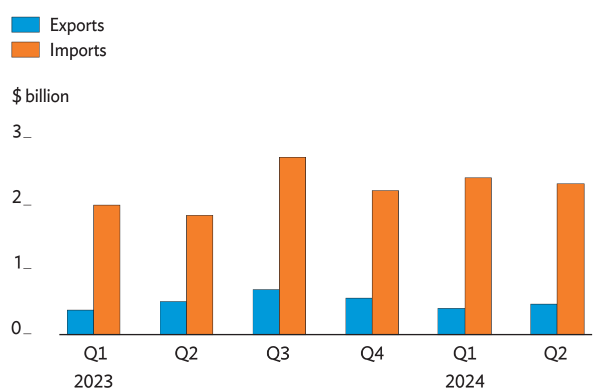
Credit from banks declined under economic contraction.



Source: Data collected from official sources.

Figure 2.14.4 Merchandise Exports and Imports

Imports have remained far larger than exports.

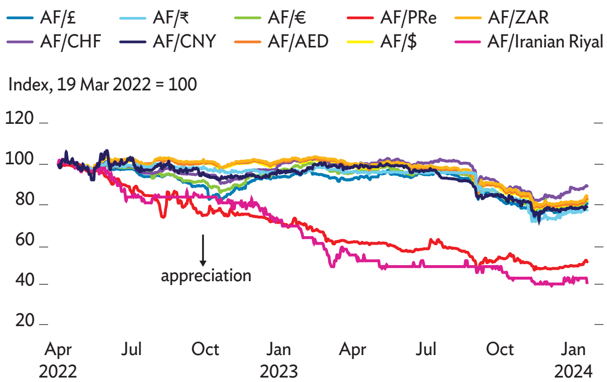


Q = quarter.

Note: Years are fiscal years ending 20 March of that year. Source: Data collected from official sources.

Figure 2.14.5 Afghani Exchange Rates

The afghani showed little change against major world currencies but appreciated against the Pakistan rupee and the Iranian riyal.



Notes: Afghanis per unit of foreign currency, so a downward slope indicates afghani appreciation. Readings were on the 19th day of each month.

Source: Data collected from official sources.

$0.85 billion to $1.83 billion in 2023, with a 500% rise in coal and an 80% jump in food registering the main increases.

Afghani exchange rates with the currencies of major advanced economies remained relatively stable. However, the afghani appreciated against the Pakistani rupee and the Iranian riyal, the currencies of the country's main import suppliers (Figure 2.14.5).

Economic Prospects

Modest economic growth is possible in 2024 and 2025. This assumes sustained international humanitarian assistance and support for basic needs. Growth would depend on improved security, higher domestic revenue mobilization, expanded trade, and better performance in agriculture. Inflows of US dollars for humanitarian purposes help stabilize the economy, providing needed liquidity to banks, supporting purchasing power, and reaching needy households.

Output in agriculture is likely to increase somewhat, with above-average precipitation from the current El Niño weather cycle. According to the Famine Early Warning Systems Network, moderate to heavy precipitation in the winter of 2024 may ease groundwater shortfalls in Afghanistan's central region. Supported by irrigation in the country's center and south, production is likely to increase, though past water deficits may continue to inhibit rainfed crops. Meanwhile, a drug ban imposed in April 2022 is projected to slash opium cultivation by 95% and eliminate more than $1 billion in rural income annually.

Likely deflation in 2024 reflects a strong afghani and falling global commodity prices, but inflation could return in 2025. Deflation began in April 2023 and continued for the first 3 quarters of the fiscal year, with year-on-year decreases in prices for both food and other items. In calendar 2023, a year-on-year decline in food prices averaged 7.4%, while deflation for other items was 1.2%. Given high pass-through of exchange rate changes into inflation, appreciation of the afghani against the Pakistani rupee and Iranian riyal likely maintained deflation for the whole of fiscal 2024. Inflation could rise to middle single digits in 2025 with no further appreciation of the afghani.

Fiscal space to support development projects will likely remain tight. With Afghanistan receiving only humanitarian aid and no assistance for development projects, the budget for development spending is reduced. Future ability to support investment, directly or through public–private partnerships, remains uncertain, particularly given weak capitalization in domestic banks.

Higher imports are likely to spell a wider trade deficit in 2024. In the first half of the fiscal year, merchandise imports surged by 23.8% over the same period in 2023, reaching $3.8 billion. Merchandise exports in the same period were 7.4% below those in the first half of 2023 to $720 million. The rise in imports reflected higher demand for essential goods financed by humanitarian support and real appreciation of the afghani against the currencies of Afghanistan's major trade partners. An informal system of money transfer called hawala has proved resilient in financing imports but exposes the country to greater economic vulnerability.

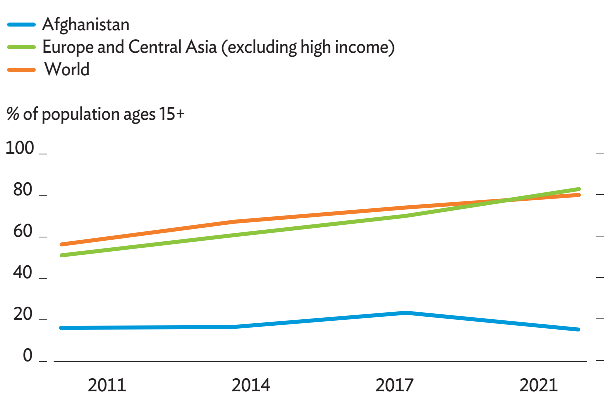
This outlook faces significant downside risks. Besides institutional uncertainties and economic vulnerabilities, risks include a potential reduction in international humanitarian assistance and support for basic needs; possible further restrictions on education and employment for women; and continued drought, flooding, and landslides. If these risks materialize, the economy will contract further, and unemployment, poverty, and food insecurity will worsen.

Policy Challenge—Improving Access to Financial Services

Access to finance services is essential to support inclusive and sustainable growth. A well-functioning formal financial system provides intermediation that boosts access to financing and investment. It also helps firms and households manage risk, financial volatility, and economic vulnerability. Financial inclusion enables households to invest in education and health and obtain access to savings, credit, and insurance, and firms to access capital for investment and growth. Despite 2 decades of significant advances in the country's formal financial system from calendar years 2002 to 2021, around 90% of adult Afghans lack access to financial services (Figure 2.14.6), with a large and expanding gender gap in account ownership (Figure 2.14.7). From 2017 to 2021, women's already small share of financial account ownership fell by a third, from 7% to 5%, far below peer and regional economies. Furthermore, the share of financing for micro-, small, and medium-sized enterprises (MSMEs) and agriculture lags that in other conflict-affected low-income countries. Loans for MSMEs equaled only 0.17% of GDP in 2018, while lending for agriculture including livestock was only 4.2% of GDP, despite agriculture then providing 22% of GDP.

Figure 2.14.6 Bank Account Ownership

Account ownership in Afghanistan lags the rest of the world, including the average for transitional countries in Europe and Central Asia.

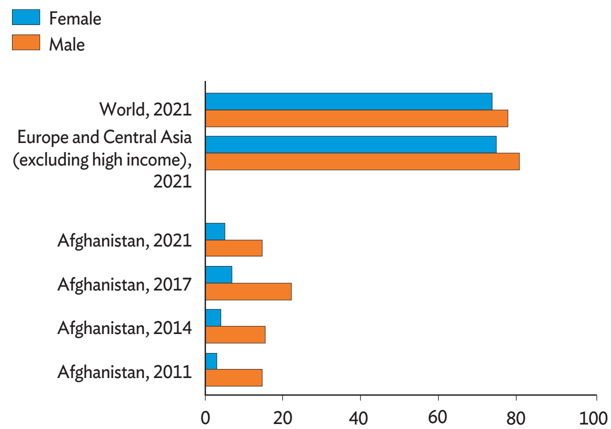


Note: Years are calendar years.

Source: World Bank, World Development Indicators.

Figure 2.14.7 Gender Gap in Account Ownership

A far smaller percentage of women in Afghanistan have bank accounts than the average for transitional countries in Europe and Central Asia.



Note: Years are calendar years.

Source: World Bank. World Development Indicators database.

Both demand- and supply-side barriers limit the access of individuals and firms to financial services. Demand-side obstacles include low financial literacy, limited and asymmetric information, high interest rates, heavy documentation requirements, and lack of trust. In addition, most households lack the funds needed to open a bank account. On the supply side, commercial and state-owned banks do not understand the needs and business models of MSMEs. Weak property rights severely limit collateralization and opportunities for contracting, while high trade and transport margins shorten the horizon of profitable market access and increase risk. Other issues include the lack of a transparent and credible legal and regulatory framework, poor infrastructure, substandard accounting and auditing standards, weak formal credit services, and high costs attributable to locally monopolistic money lending, high security expenses, and corruption. These barriers disproportionally affect the poor, youth, women, and the internally displaced.

Innovative business models and financial services could alleviate these constraints. This would require tailoring them to the needs of MSMEs, particularly those owned by women. Accompanying these changes should be legal and regulatory reforms ensuring contract transparency and enforcement, secured transactions, data privacy, and compliance with credit reporting regulations. Improving financial literacy could mitigate information failures and asymmetries, reduce monitoring costs, and greatly improve risk perceptions for small entrepreneurs, individuals, and households. International experience suggests that financial literacy is strongly linked with the business performance of young entrepreneurs, since it enables individuals and firms, particularly MSMEs, to use debt, credit, and strategic investment more creatively and allow more proactive and complex financial decisions.

Digitizing payment systems, particularly through mobile phones, could prompt millions of unbanked Afghans to use formal financial services. According to the New York Times, in 2023 around 70% of the Afghan population had access to mobile phones, and an even higher percentage of adults. Mobile payment systems can achieve much greater geographical coverage for financial services, are far more competitive than local informal lending, and can deliver benefits to those whose limited mobility and cash assets currently prevent them from opening bank accounts. Developing and expanding interoperable payment infrastructure to facilitate transactions and financial transfers among mobile money providers, banks and other lenders, and public agencies can promote broader, lower-cost access to a wider range of financial services.