

AFGHANISTAN

A forward-looking snapshot of the Afghan economy



Anticipatory analysis
05 January 2023

While economic recovery is a critical question for donors, humanitarian responders, and the Taliban government, restoring the livelihoods of the Afghan people is also an essential topic. The performance of the Afghan economy will determine how humanitarian needs may change – for better or for worse. This forward-looking snapshot aims to provide humanitarians with an understanding of the key economic constraints that Afghanistan is facing. This brief identifies a number of factors constraining the Afghan economy and three scenarios considering how changes to these constraints could affect the recovery of the economy over the coming one to two years and over the long term.

Constraints on economic recovery are grouped into the following five areas:

- political uncertainty and sanctions
- the lingering effects of aid dependency
- the decline in public employment and fiscal spending
- the liquidity and banking crisis
- climate change and natural disasters.

Based on the analysis, three scenarios for the economy have been developed:

- **High-growth scenario (low likelihood of realisation):** high economic growth driven by the resumption of development grants, strong recovery in private sector activity and employment, significant and sustained decrease in humanitarian needs
- **Medium-growth scenario (high likelihood of realisation):** medium and stagnant economic growth driven mainly by gradual economic stabilisation efforts, small recovery in private sector activity and employment, slow and sustained decrease in humanitarian needs
- **Low/stagnant-growth scenario (high likelihood of realisation):** low economic growth or even a further contraction because of the continuation of the status quo, no recovery in private sector activity and employment, humanitarian needs remain high or increase

Methodology

This brief draws from a rapid review of recently published reports by leading organisations on the Afghan economy, including the World Bank, UNDP, and the Afghanistan National Statistics and Information Authority. Eight experts on the Afghan economy were interviewed, with a focus on economic outlook scenarios and key economic constraints. Experts were identified through their involvement in key economic institutions, such as the Afghan Fund, or for their active work on the Afghan economy either inside or outside Afghanistan. This brief was written as a collaboration between ACAPS and an economist specialising on Afghanistan.

Limitations

There is insufficient up-to-date and robust data on key economic indicators in Afghanistan. This brief uses evidence from private sector and household surveys and rapid assessments carried out by UN agencies and the World Bank. Evidence was triangulated between multiple sources to ensure accuracy and reliability.

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BACKGROUND AND CONTEXT

Afghanistan is among the largest and most complex and challenging humanitarian crises globally (OCHA accessed 13/12/2022). The REACH Whole of Afghanistan Assessment found that most household income is spent on food, and only 20% of the country's population has an acceptable food consumption score (REACH 03/11/2022). WFP notes that 90% of Afghans face insufficient food consumption (WFP 09/12/2022). The proportion of households with insufficient income to cover basic food needs increased from 16% in May 2021 to 33% in August 2022. A similar increase was recorded in the proportion of households whose income is only enough to cover food, rising from 18% in May 2021 to 31% in August 2022 (WB 10/2022).

Following the Taliban's return to power in August 2021, the Afghan economy contracted by 20.7% in 2021 and is predicted to contract a further 15% in 2022 (WB 10/2022; UNDP 05/10/2022). This sharp economic decline has worsened an already dire humanitarian situation, almost doubling the number of people in need of food assistance: from 11 million in May 2021 to 20 million in May 2022 (IPC 22/04/2021 and 09/05/2022). Total employment is estimated to have declined by 8%, which translates to 700,000 jobs lost. Employment losses for women have been higher (16%) than for men (6%) (ILO 19/01/2022). Household incomes have also been shrinking from month to month (WFP 09/12/2022).

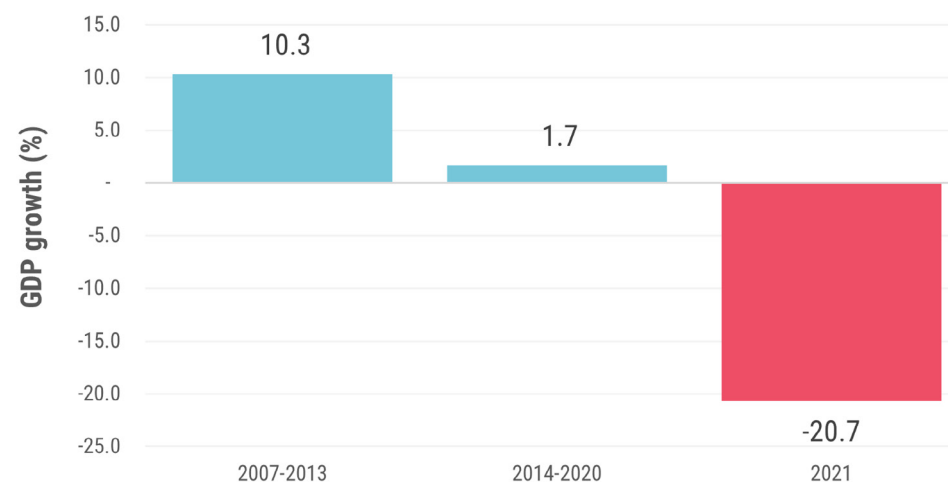
Even prior to the Taliban's return to power, Afghanistan was experiencing an economic slowdown. This slowdown had been occurring since 2014, when international troops started withdrawing from the country, aid flows decreased, and conflict intensified. Drought and COVID-19 in 2020–2021 also caused the economy to contract. The current economic contraction since August 2021 has been a result of sanctions, the decrease in foreign aid inflows (while humanitarian aid has increased, all other forms of aid have stopped), a reduction in government spending, disruptions in the financial and banking sector, a crisis of confidence in the private sector, and the isolation of the Taliban government. Afghanistan has also experienced an exodus of skilled people and private wealth in the last 18 months.

The decrease in household income and the reduction in government and development expenditure, which have adversely affected the private sector activity and employment. A recent World Bank rapid assessment of the private sector found that 50% of businesses reported a decline in demand for their goods and services from August to November 2021. The closure rate of women-run businesses (42%) was almost double that of men (26%) (WB 10/2022). The private sector is facing serious challenges, including an uncertain economic outlook, a liquidity crisis, and a lack of access to international markets.

The Afghani (Afghanistan's currency) has maintained its stability after an initial depreciation, supported by foreign currency inflows that are part of humanitarian aid. While these inflows have helped stabilise the price volatility of essential food and non-food items, the global

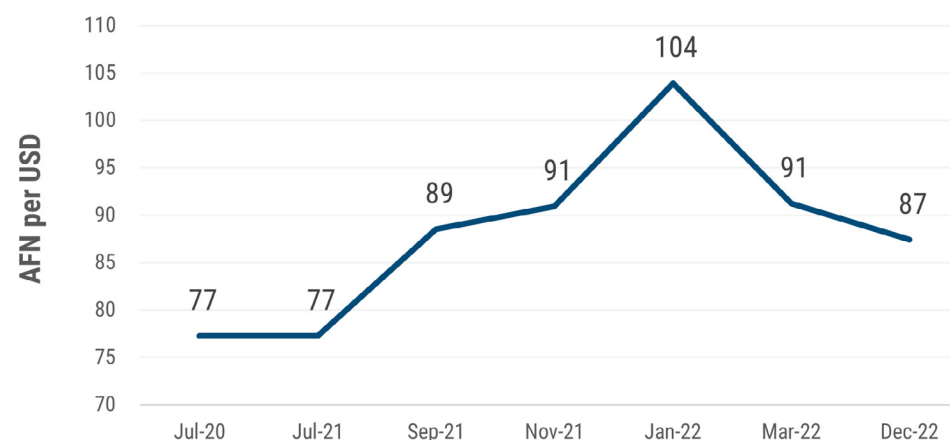
increase in food and energy prices resulting from the war in Ukraine (along with sanctions and the banking crisis) is seeping into the domestic economy, resulting in high inflation despite a stable exchange rate. The effect of rising inflation on purchasing power has directly contributed to the increase in poverty, hunger, and the cost of delivering humanitarian aid.

Figure 1. Three periods of changes in GDP



Sources: NISA (02/12/2022), UNDP (05/10/2022)

Figure 2. AFN vs USD exchange rate, 2020–2022



Sources: DAB (23/12/2022); Xe.com (23/12/2022)

Women's participation in the economy

Women's economic participation has been severely reduced since the Taliban's return to power in August 2021. Women are actively discouraged from public participation, and mobility restrictions directly affect their involvement in income generation. This situation is reflected in the high rates of job loss and closures of women-led businesses. Women in leadership positions have either left their jobs or been replaced, and the ban on girls' secondary school education in government-run schools in most of the country and banning women from university education will have long-term adverse impacts on women's economic participation (ACAPS 13/12/2022).

Women in public service are facing uncertainty, with some being asked to identify a male relative as their professional replacement. Women do continue to be allowed to work in essential sectors, such as the health, education, security (police), humanitarian, and private sectors (ACAPS 13/12/2022).

Supporting economic recovery is probably the most effective way to improve the livelihoods of Afghans and reduce their humanitarian needs. Afghanistan is facing political, economic, social, and ecological challenges, all with significant adverse impacts on the economic outlook. The most recent UNDP economic report showed that the Afghan economy has lost up to USD 5 billion in since August 2021, equivalent to ten years of economic growth (UNDP 05/10/2022).

The Afghan fund

A major impact of the August 2021 Taliban return to power was the imposition of sanctions, including on the Afghan Central Bank – Da Afghanistan Bank (DAB). Up to USD 9 billion in Afghan assets were frozen, leaving DAB unable to ensure currency stability. The sanctions have had a chilling effect on the rest of the banking and financial sector. Both private and public banks are experiencing challenges providing banking services, and all banks but one, Afghanistan International Bank (AIB), are unable to establish foreign correspondent banks for international transactions and banking, leading to higher transaction costs given the lack of competition and increased compliance requirements. Most humanitarian funds flow through AIB.

In September 2022, the US Government announced the creation of the Afghan Fund, hosted by the Bank of International Settlement in Switzerland (US Department of State 14/09/2022). Through this fund, USD 3.5 billion of DAB assets will become available to support the Afghan economy. A four-member board of trustees, including two Afghan experts, a representative from the United States, and a representative from Switzerland will run the Afghan Fund. The fund will not include members from the Taliban government and will facilitate the use of the frozen Afghan assets to help ensure macroeconomic stability, in particular exchange rate and price stability.

ACAPS spoke with a member of the board of trustees of the Afghan Fund, who identified the following key functions for the fund:

- **Price and exchange rate stability**, previously maintained through the sale of USD by DAB. The Afghan Fund can intervene when needed to sell USD and stabilise the exchange rate.
- **Payment of World Bank arrears** to unlock Afghanistan's eligibility for International Development Association funding, which could amount to billions of dollars over the coming years.
- **Representing DAB in court** to secure the release of the other USD 3.5 billion in frozen assets currently subject to litigation by the families of the victims of the 9/11 terrorist attacks in the United States.
- **Payment for some critical imports**, which will be determined by the board of trustees – for example, the printing of Afghani notes and passports.
- **Assessment of the capacity of DAB** and potentially providing technical support.
- **Support to the third-party monitoring of DAB's anti-money laundering and counterterrorism financing systems**, already agreed upon by the Taliban and the US, to provide assurance and potentially pave the way for DAB recapitalisation.

The mandate of the Afghan Fund does not include support for humanitarian assistance. Neither are the funds intended to support government expenditure, as fiscal policy falls outside DAB's mandate.

CONSTRAINTS ON ECONOMIC RECOVERY

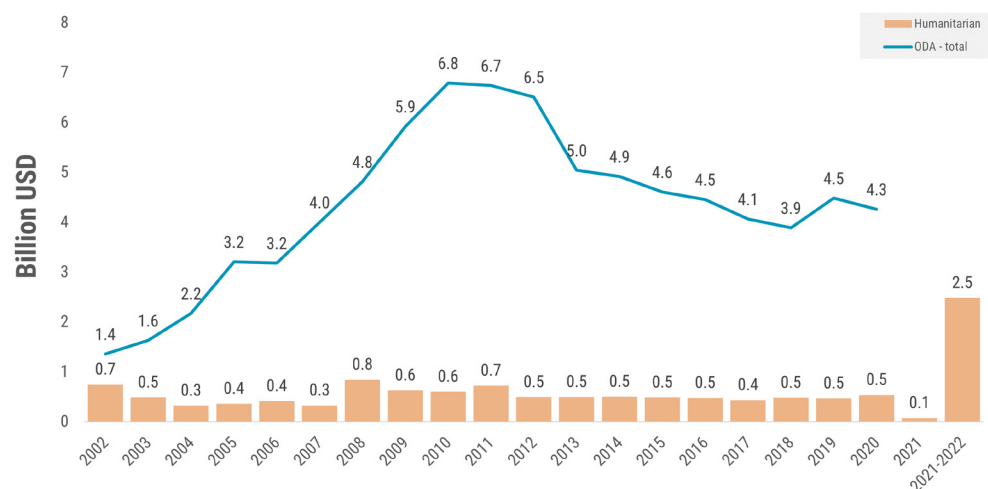
Political uncertainty and sanctions

Afghanistan's uncertain political outlook is among its most consequential constraints. Afghanistan remains globally isolated, facing some of the world's toughest sanctions. While levels of violence have decreased compared to the last few years, the threat of escalation remains high considering the activities of various anti-Taliban resistance groups (ICG 12/08/2022). Sanctions and the absence of formal diplomatic relations result in limited opportunities for trade, capital inflows, and investment, blocking Afghanistan from important sources of growth. During the second half of 2021, formal trade declined by one-third compared to the same time in the previous year (WB 10/2022). The most significant negative impact of international isolation and sanctions is the withdrawal of foreign aid, previously the largest funding source for development activities and the national budget.

Lingering effects of aid dependency

Figure 3. Official development assistance to Afghanistan, 2002–2020

Source: OECD/DAC (accessed 09/12/2022); OCHA (22/12/2022)



Foreign aid and government spending in Afghanistan (including high spending in the security sector) were the two key drivers of economic growth in the last two decades. Between

2002–2020, Afghanistan received USD 4.3 billion annually in official development assistance (Figure 3) and an estimated additional USD 81.6 billion in military assistance between 2001 and 2020 to fund salaries, equipment, supplies, and the construction and repair of facilities (SIPRI 22/09/2021). This funding created jobs, funded development projects, improved living conditions, and financed a rentier state¹ and an economy riddled with corruption and mismanagement. Afghanistan has no substitute for foreign aid to achieve any short-term economic growth.

The initial halt in humanitarian funding after the Taliban return to power was short-lived as donors tried to address the catastrophic increase in humanitarian needs. Humanitarian aid had reached USD 2.5 billion since August 2021 (OCHA accessed 22/12/2022). Regardless, development aid remains paused, and long-term projects are absent. In the meantime, Afghans and Afghanistan remain dependent on foreign assistance to meet basic needs and keep services running.

Decline in public employment and fiscal spending

Public sector employment, development activities, and the public procurement of goods and services (all mostly funded through aid) kept the Afghan economy afloat for two decades. In 2020 (the last full year budget for the Islamic Republic of Afghanistan), the proposed budget amounted to AFN 428.4 billion (USD 5.53 billion), most of which was for development activities (USD 3.73 billion) (Integrity Watch 01/2020). The most recent budget of the Taliban government was AFN 231 billion (USD 2.6 billion), with 88% allocated to operational costs (VOA 14/05/2022). This amount contrasts with the Islamic Republic's last budget, where operational costs comprised less than one-third (32%), with the remaining two-thirds spent on development activities. Unlike the previous government, however, the Taliban have funded the entire budget through domestic revenue and increased operating spending. The USD 3 billion budget shortfall compared to the previous government is mostly in development, resulting in a decline in demand for private sector goods and services and a rise in unemployment.

The Taliban government has stopped publishing regular budget and expenditure reports, raising transparency and accountability concerns in relation to budget allocation and spending. Some of the experts interviewed noted that there is low but rising corruption in public institutions – an area to watch as battling corruption has long been a selling point for the Taliban and an area of contention between the Afghan people and the previous government. An increase in corruption (or allegations of corruption) may undermine the Taliban's legitimacy.

¹ A rentier state is a state where most or all of its national revenue comes from foreign sources (individuals or governments).

Liquidity and banking crisis

The current liquidity and banking crisis is a serious constraint on economic activity. Withdrawal limits on pre-August 2021 deposits are still in place for businesses and individuals, and much of the currency in circulation is not suitable for further use because of physical deterioration (WB 10/2022). The Taliban have taken some steps to resolve this issue by printing new banknotes in Poland, but the freezing of central bank assets has left the Taliban government unable to inject liquidity into the economy, especially for banks to return customer deposits. Anti-money laundering and counterterrorism financing concerns mean that even if the sanctions on DAB are lifted, foreign correspondent banking will be difficult to re-establish, meaning international banking transactions will remain challenging. The establishment of the Afghan Fund may address some critical issues, including the liquidity and banking crisis underway, but this remains to be seen.

Climate change and natural disasters

Afghanistan is one of the most vulnerable countries to climate change and its negative impacts (UNEP 14/05/2019). The country has experienced significant warming, changes in precipitation, and an increase in the prevalence of natural disasters (VOX 15/09/2021). The EM-DAT database of natural disasters shows that Afghanistan experienced six years of drought in the last two decades (EM-DAT 2021). Afghanistan has also seen catastrophic flooding in recent years, causing damage to property and displacing tens of thousands of people.

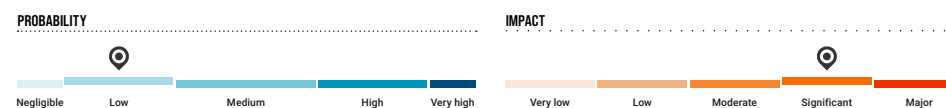
Climate change-driven events affect millions of Afghans, especially those dependent on livestock and agriculture, contributing to the increase in humanitarian needs. Rain, drought, and other disasters reduce opportunities for exports, as most of Afghanistan's exports are agricultural products or mining commodities.

SCENARIOS

The economic shock that followed the events of August 2021 was more severe than the coping capacities of the Afghan people and the Taliban government. The political transition, abrupt aid cuts, and sanctions left both fiscal and monetary institutions in Afghanistan with limited ability to intervene and support the economy. Some early indications suggest that the worst part of the economic collapse might be coming to an end as the rate of economic decline slows, driven by recovery in humanitarian aid and government expenditure (WB 10/2022). Private sector activity and employment have showed a small recovery from its worst decline in 2021. That said, the economic prospect remains grim, as the many economic constraints on Afghanistan continue to stifle recovery. This section presents three potential scenarios for the Afghan economy, ranging from the best case (rapid and widespread recovery) to the worst case (stagnation or further economic decline). The purpose of these scenarios is to highlight how humanitarian needs and the wellbeing of the Afghan people could change with economic shifts.

High-growth scenario

(low probability of realisation)



Triggers/assumptions

This scenario envisions increased engagement with the international community, the return of a significant level of development aid, a boost in government spending, and the revitalisation of small and medium businesses. Under this scenario, government revenue increases as increased trade volume and mining exports generate more tax and tax collection is improved. The establishment of the Afghan Fund has a positive impact on the banking sector, with the potential recapitalisation and establishment of international correspondent banking.

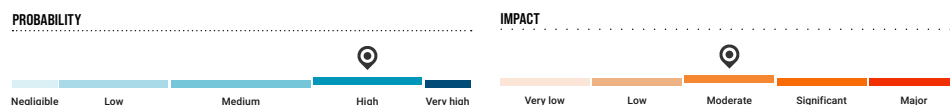
Unlike other constraints, the immediate effects of climate change (droughts and floods) cannot be mitigated through policy. In this high recovery scenario, however, humanitarians have more resources available and more time for planning and preparedness to respond to rapid-onset disasters, while development aid and private sector investment enable communities to rebuild and become more resilient.

Impacts

This scenario presents the most optimistic outlook for the Afghan economy, with significant positive developments towards reducing economic constraints. The Afghan economy returns to high economic growth in the immediate recovery period (the next one to two years) and maintains a moderate level of growth over the next few years. Unemployment rates decline as business activity and consumer demand recover, leading to a gradual and sustained decrease in humanitarian needs. Instead of the humanitarian response supporting most of the Afghan population and maintaining basic services (including healthcare), humanitarian response focuses on the people most in need and responding to sudden-onset disasters and the displaced population, while development aid supports the recovery of basic service provision.

Medium-growth scenario

(high probability of realisation)



Triggers/assumptions

This scenario presents the most likely outlook for the Afghan economy if some changes are made, especially on the part of the international community. Economic growth remains medium to low initially and stagnates in the medium to long term, while humanitarian needs slowly decrease from their current level. Commodity exports and prices remain stable or experience an improvement, increasing domestic revenue. The political environment does not deteriorate, and the level of sporadic violence remains low.

This scenario requires that current levels of engagement between the Taliban government and the international community and humanitarian aid are sustained. There are also slight improvements in enabling conditions, such as the resumption of donor interventions in the livelihoods sector, the easing of sanctions, and the restoration of normal banking operations.

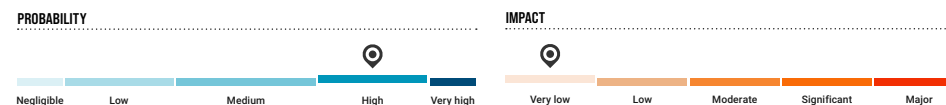
Impact

Even a small recovery in off-budget development aid would have a positive multiplier effect, improving the demand for labour, increasing household income, and reducing the dependency on humanitarian support. That said, in this scenario, the humanitarian community would

continue to provide humanitarian assistance to more than half the population and support the provision of basic services, such as healthcare. The dependency on humanitarian aid hinders the development of resilience to climate disasters in the medium to long term.

Low- or stagnant-growth scenario

(high likelihood of realisation)



Triggers/assumptions

This scenario presents the most probable outlook if no significant changes occur. Economic growth remains stagnant or declines. Despite the creation of the Afghan Fund, the financial and banking sector remains in crisis, and government revenue and expenditure fall because of a decrease in export revenue (such as from the sale of coal as global energy prices decrease). This outcome further reduces the government's ability to sustain an already limited level of basic services. Government revenue declines as trade volume falls because of the weak domestic demand and the continuation of sanctions. A lack of jobs and high unemployment remain endemic.

International legitimacy remains elusive, with little progress on deeper engagement with regional countries and the international community. Current levels of humanitarian aid are sustained without the resumption of development aid.

Impact

Humanitarian assistance remains the primary response mechanism to the needs of more than half of the Afghan population. The scale of the humanitarian response becomes unsustainable, and even a small decrease in assistance funding could mean a further contraction of the economy (ACAPS 26/09/2022). The decrease in humanitarian funding and the collapse in the economy drive an increase in unmet humanitarian needs.

TABLE 1. CHANGES IN THE CONSTRAINTS UNDER EACH SCENARIO

		STAGNATION OR LOW GROWTH	MEDIUM GROWTH	HIGH GROWTH
Political uncertainty and sanctions	International relations	Continued isolation, with a lack of process on the engagement between the Taliban government and the international community Sanctions remain	Basic engagement with the international community Sanctions remain, with relief only on humanitarian aid and remittances	Improved engagement Sanctions eased specifically around banking and private sector development
	Development funding	Continued block on development funding	Continued block on development funding	Significant resumption in development funding
	Domestic legitimacy	A lack of domestic legitimacy	Progress on domestic legitimacy	Progress on domestic legitimacy
Decline in public employment and fiscal spending	Domestic revenue	A gradual reduction in domestic revenue	Current level of domestic revenue is sustained	Domestic revenue increases
	International trade	Global commodity prices drive down export prices and volumes	Trade volume increases proportional to economic growth	Trade volume increases proportional to economic growth
	Domestic spending	Decline in public employment and fiscal spending	Continuation of the current level of domestic revenue and public expenditure	Public expenditure increases
Aid dependency effects	Humanitarian aid	Slow decline in humanitarian funding	Humanitarian assistance continues at similar levels	Humanitarian assistance continues at similar levels
Liquidity and banking crisis	Functioning of the banking sector	Formal financial system collapses despite the establishment of the Afghan Fund	The banking crisis continues, although the Afghan Fund functions	Relaxation of the banking crisis and improvement in the private sector A functioning Afghan Fund






















Source: ACAPS






not functioning/none	very limited/minimal	some	substantial	substantial
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TRIGGERS/ASSUMPTIONS

	STAGNATION OR LOW GROWTH	MEDIUM GROWTH	HIGH GROWTH
International relations			
Development funding			
International trade			
Functioning of the banking sector			
Domestic legitimacy			
Humanitarian aid			
Domestic revenue			

IMPACT

	LOW GROWTH	MEDIUM GROWTH	HIGH GROWTH
Employment			
Currency stability			
Investment in the private sector			
International trade			
Humanitarian needs			
Functioning of public services			
Safety and security			

				
major improvement	slight improvement	continuation of current status	slight deterioration	major deterioration

Source: ACAPS