Da Afghanistan Bank

The Monetary Policy Committee (MPC) Meeting

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(1) International Economic Environment

According to the International Monetary Fund (IMF), uncertainty remains high in case of the world economy after a year of coronavirus pandemic. Despite the continuation of world-wide vaccination process, new variants of the coronavirus have added to concerns. Economic recoveries differ from one country to another due to the variation in COVID-19 and measures taken for controlling the pandemic as well as policy support. After an estimated negative global economic growth of (-3.3) percent in 2020, a 6.0 percent economic growth is forecasted for the world economy in 2021. The economic growth of advanced economies is forecasted at 5.1 percent in 2021 while the emerging markets and developing economies will experience 6.7 percent economic growth in the mentioned year.

Global manufacturing declined sharply in the first quarter of 2020, but the decline was for a shorter period of time compared to the global financial crisis. In the second half the year 2020, synchronized V-shaped recoveries were noticed across both advanced and emerging market economies. The rebound in manufacturing was partly due to production resumption after shutdown while other demand-related factors also played a role. These factors included the release of pent-up demand after the ease in lockdowns and higher demand for goods to facilitate work from home as well as protective equipment. Recently, global merchandise trade volumes have reached the pre-pandemic level while cross-border trade in services has remained subdued. Due to the unprecedented policy response, the damaging effects of the COVID-19 pandemic to the world economy is lesser compared to the global financial crisis in 2008 while the emerging market economies and less income developing countries have been hit harder and are expected to suffer more significant losses in the medium term.

Despite the COVID-19 interrupted the worldwide economic activities, the global agricultural trade and global markets for food items indicated resilience to the COVID-19 shock. The agricultural trade, particularly for food items, continued almost normally. The global food markets are well supplied and it is expected that activities of the global agricultural markets and trade will pick up in 2021. As the demand for goods and services increases worldwide, the prices of finished goods and services are moving upwards. According to the IMF projections, the consumer prices in advanced economies are projected to increase by 1.6 percent in 2021 indicating a 0.1 percentage points increase compared to the previous year. The consumer prices in emerging markets and developing economies are forecasted to increase by 4.9 percent in 2021 lower than 5.1 percent increase in 2020.

In 2021, the path to recovery is anticipated to be different among emerging markets and developing countries in Asia. The prospects vary significantly across countries, depending on the pandemic's path, vaccine distributions, re-opening of borders, and policy responses. It is expected that the economic activities will move back towards normal and as a result, employment condition will indicate improvement and the economic growth of the regional economies will gain momentum. According to the IMF projections, the economic growth of emerging and developing Asia will reach 8.6 percent in 2021. The Chinese economy will grow by 8.4 percent while India will experience an economic growth of 12.5 percent. In addition, the IMF projects a 6.0 percent growth for Turkey in 2021.

(2) Domestic Economic Environment

The outbreak of the COVID-19 and the subsequent restrictive measures severely damaged the economy of Afghanistan last year. However, activities moved toward normalization faster than anticipated. The economic recovery process is gaining continuous momentum as all four sectors of the economy are moving steadily toward pre-pandemic levels. Although recent vaccination program has raised hopes of a turnaround in the pandemic this year, renewed waves and new variants of the virus pose concerns for the economic outlook to some extent.

The economy of Afghanistan experienced a negative growth of (-1.93) percent last year due to the COVID-19 pandemic and imposed quarantine. The most affected sector from COVID-19 and measures taken to control the pandemic was the services sector indicating a negative growth of (-4.8) percent while the second most affected sector was the industrial sector with a negative growth of (-4.2) percent. The agricultural sector indicated a positive growth of 5.3 percent last year compared to 17.5 percent growth in 2019.

The consumer and business sentiments have shown improvement in 2021. Therefore, in the current fiscal year, it is forecasted that the economy of Afghanistan will grow by 3.0 percent. According to the prediction, the agricultural and industrial sectors of the economy will contribute the most to the GDP growth of the country. The growth of agricultural sector is forecasted at 6.3 percent for 2021 while the growth of industrial sector is forecasted at 3.0 percent. Besides, it is expected that the services sector will indicate a positive growth of 1.5 percent in 2021.

The agricultural sector is considered to be the most important sector for the economy of Afghanistan. This component accounts for 27.0 percent of the GDP. In 2020, positive growth reflected favorable weather conditions and limited negative impact of COVID-19 related disruptions on the harvesting of cereals and fruits, and livestock. The agricultural sector is expected to experience a weaker growth in 2021compared to the pre-pandemic growth level due to lack of sufficient rain and snow falls. While both rain-fed farming and livestock are likely to contract, irrigated farming is expected to experience moderate growth. Building dams across the country is expected to mitigate the effects of drought to some extent. Besides, increasing number of cold storages will also be beneficial in conserving fresh produce. Furthermore, investments in irrigation rehabilitation could support continued recent growth of agricultural production, driven by fruit and vegetables, and facilitate further expansion in food processing sector.

The industrial sector, which contributes 12.5 percent to the GDP of Afghanistan, witnessed a considerable decline in 2020 as the sector had been terribly affected by measures taken for controlling the COVID-19 pandemic such as lockdowns and border closures. Even before the pandemic, the growth of industrial sector was sluggish due to very weak confidence because of lack of security and political stability as well as uncertainty regarding the future international support to the government of Afghanistan. Therefore, the industrial sector is expected to grow at a slower pace in 2021.

The services sector accounts for 56.1 percent of the GDP of the country. The operations of services sector resumed in the third quarter of 2020. Recovery in the services sector is expected to be sluggish due to continued weak investment confidence. The urban services sector was hit hard by lockdown measures and trade disruptions as the restaurants and hotels were closed and reopened back in the third quarter of 2020. Declining grants also led to contraction of the services sector which associated a decline in income and employment. In 2021, it is expected that the services sector would indicate a positive growth.

The economic recovery of Afghanistan is expected to be accompanied by healthy trade. Merchandise exports are expected to bounce back indicating a 9.0 percent increase in 2021 reaching USD 900.0 million from a value of USD 776.7 million in 2020. Both merchandise exports as well as the exports of services are likely to reach at a value of USD 1,600.0 million in 2021 from the value of USD 1,476.3 million in 2020. Besides, the inauguration of air corridors has also facilitated Afghan exports. In 2019, around 5,300 MT of goods through over 855 flights valued nearly USD 130.0 million has been exported while in the next year, 3,800 MT of goods valued nearly USD 83 million has been exported. With the normalization of trade and transit via land between Afghanistan and the rest of the world, it is expected that the exports of Afghanistan through the air corridors would indicate a slight increase in 2021 compared to the same period of last year.

(3) Inflation Dynamics

Inflation dynamics have been positive despite the COVID-19 shock and heightened political risk. During the month of May 2021, the headline inflation rate (year-on-year) was recorded at 1.4 percent. The food inflation rate (year-on-year) stood at (-1.6) percent in the mentioned period while the non-food inflation rate was 4.6 percent.

In May 2021, the housing inflation rate was recorded at 4.8 percent as the demand for the construction materials increased while the bread and cereals inflation rate declined to (-3.7) percent due to an increase in supply of domestic products. In the meanwhile, the year-on-year core inflation rate (excluding food, beverages and transportation) increased to 4.6 percent in the month of May 2021 compared to 4.1 percent in previous month.

However, the recent out-turns are encouraging which suggest strengthening of supply-side price pressure. While current reforms as well as increase in tax may cause an up-take in inflation, this is likely to be transient given excess capacity in the economy and well-anchored inflation expectations. As a result, inflation is still expected to fall within the previously announced range of 5 ∓2 percent for 2021 and trend towards the 5 ∓2 percent target range over a medium term.

(4) Financial Conditions

Overall, the banking sector performed well during 2020 despite the COVID-19 pandemic, rendering necessary services to the public. No liquidity short falls were noticed in any of the banks and their capital positions remained within the regulatory threshold. Main financial indicators such as total assets including cash in vault and claims on DAB, investments in bonds, deposits and financial capital increased while loans and interbank claims had a decreasing trend. Given the spread of the pandemic, in the coming months, the banking sector may experience more Non-Performing Loans (NPLs), high provisions which will lead to lower profitability, capital, and financial ratios.

(5) Risk Conditions

On balance, DAB observes risks as having increased. It is worth mentioning that the U.S. government has made the decision to withdraw its troops completely from Afghanistan by September 11, 2021. The decision has added to concerns about the future of Afghanistan. Since the economic condition is highly influenced by the security condition in the country, concerns about the future security condition of the country have created uncertainty among main economic players as well as among the general public. This situation could positively affect the demand for foreign currencies, particularly the U.S. dollars. Hence, DAB expects potentially higher demand for the U.S. dollars could add depreciation pressure on the domestic currency and could pave the way for an increase in the inflation rate, as the exchange rate has high pass-through effect on inflation in Afghanistan.

(6) The MPC Decisions

In light of global and domestic economic conditions, the MPC has taken the following decisions:

- DAB will continue to use the managed floating exchange rate regime and the monetary policy framework to target monetary aggregates.
- To better promote the domestic currency and encourage the commercial banks to increase afghani deposits, the MPC has also decided to increase the interest rate on overnight deposits (deposit rate) from 3.0 percent to 6.0 percent.
- In order to maintain the price stability and strengthening the banking system in accordance with the second section of article 64 of the DAB's law, the MPC decided to maintain its policy of paying 0.25 percent interest per annum on USD required reserves and 1.0 percent interest per annum on AFN required reserves.
- To increase afghani and FX liquidity among banks, the MPC has also decided to reduce required reserves on afghani and FX deposits by 2.0 percent.
- To support the development of the Islamic Banking Department, the MPC supports the continuing provision of Wadiah products.
- To further increase afghani liquidity for lending, DAB has developed short duration USD-for-afghani swap lines with local banks. However, DAB will limit the use of such swaps as DAB monitors the use and risks of this new policy.
- To increase international reserves and increase afghani liquidity, DAB has approved a transparent process for the purchase of gold from the commercial banks.
- To increase financial inclusion, DAB has developed regulations to support the provision of credit across a number of sectors.

DAB strives to take advantage of the available monetary policy instruments for achieving its ultimate objective which is the domestic price stability. The MPC continues to make transparent as well as appropriate decisions based on data and after considering the economic condition of the country.