Navigating Afghanistan's Financial Landscape: Informal Financial Markets, Monetary Policy Challenges, and Exchange Rate Dynamics

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Abstract

The Afghani have shown remarkable stability since the Taliban takeover in August 2021, despite some very harsh economic and political adversities. Contributory factors to this result include enormous UN cash transfers, high remittances, and harsh Taliban rules that involve the banning of foreign currency from daily transactions. Steps taken by DAB to control the money supply and to stop the illicit smuggling of US dollars have further stabilized the currency. Under the Taliban Interim Administration, the interplay of the informal financial market with the dynamics of the exchange rate and currency stability was of importance.

The main policy recommendations involve improvements in managing macroeconomics, restoration of autonomy to the central bank, increased supply of private banking services, regulation of money markets at informal levels, promotion of digital financial inclusion, and adherence to standards of human and democratic rights on an international level. All these steps are necessary to secure global support, ensure financial stability, and facilitate economic recovery in Afghanistan.

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1. Introduction

1.1. Background

More than four decades of persistent armed conflict resulted in Afghanistan's formal financial system collapse and the total breakdown of both local and international payment systems. Nearly all lending activities in the country were shut down and considerably reduced and most of the banks were disconnected from the international banking system. Afghanistan's formal financial system particularly the central bank referred to as Da Afghanistan Bank (DAB) suffered serious disruption as a result of international sanctions during the first Taliban regime from 1996 to 2001. These institutions grappled with outdated banking regulations, operational constraints, a lack of skilled personnel, and insufficient banking infrastructure. As a result, the formal financial sector was unable to provide financial services efficiently, principally in domestic and international payment systems. Furthermore, specialized financial institutions such as development and investment banks either operated at minimal capacity or entirely shut their operations.

The absence of a functional formal banking system fueled the development of an enormous informal financial system larger than formal banking. This was mainly facilitated by "Sarafi", or money exchange dealers who offer efficient, cost-effective, and fast financial services. This system has been deeply rooted in Afghan culture for generations and has become the preferred means for secure, reliable, and economical fund transfer methods.

Money exchange dealers (Sarafies) have been an integral part of Afghanistan's economy for more than two centuries. Since the 1950s, their main hub of activity has been Sarai Shahzada, the central money market in Kabul. These Sarafies offer a diverse array of services, including currency exchange, money transfers, savings and investment opportunities, and the provision of short to medium-term loans. Additionally, some Sarafies engage in a range of diversified business ventures. They have traditionally been governed by their own community's legal norms. This system showed great resilience during the civil war from 1992 to 1996 when they stood as the sole operational financial entities in Afghanistan, following the collapse of formal bankings.

Since the 1950s, money exchange dealers, known as Sarafies, have been an integral part of Afghanistan's economy. The central money market of the country located in Sarai Shahzada, Kabul is a financial hub. The Sarafies provide a number of services: currency exchange, money transfer, saving and investment opportunities, and they also provide short to medium-term loans. Traditionally, they were regulated by their own community's legal norms. During the civil war of 1992 to 1996 they were the only operative financial organization in Afghanistan, given the collapse of the formal banking system.

1.2. Currency Complexities

By the end of 2001, the financial system of Afghanistan had essentially collapsed, and cash transactions were the order of the day all over the country. In the late 90s, under Taliban rule, the formal banking sector took a severe hit on account of long-drawn conflict and civil strife. What remained was the informal financial system, which became one of the main means of transactions, currency exchange, and money transfer. The national currency, the Afghani, had lost much of its value on account due to persistent inflation leading to a low level of confidence in it. Additionally, DAB had little say in issuing the currency. In the country, at least three varieties of the national currency were in circulation along with other regional currencies.

During the Taliban's first regime, the central bank relied on remaining inventories of Afghani banknotes. The exiled government printed duplicates of real banknotes and re-released old series, distributing them in the northern areas using the same serial numbers. The two main local warlords also issued a counterfeit currency and though much more similar to the real banknotes than previous iterations, was treated as a lower denomination currency in Kabul's markets due to a lack of trust in the national currency. Bigger transactions and savings used foreign currencies such as the U.S. dollar and the currencies of the surrounding countries.

Given the circumstances, the new government in late 2001 faced some tough and critical monetary policy decisions. To pave the way for recovery and economic expansion, it was imperative to establish a certain level of financial stability but the fundamental issue was how to accomplish this expeditiously. The most immediate and relevant issues for this were the choice of whether to accept a foreign currency as legal tender or to introduce a new national currency. Having chosen the latter, which would mean a long period of preparation, a plan would have to be prepared during the transition period to achieve complete implementation.

The choice of introducing a new currency in Afghanistan was a critical issue as it played a pivotal role in achieving financial stability and ensuring donor support. The new government aimed to introduce a new national currency swiftly, but the Internat Monetary Fund (IMF) staff had advised considering this at a later date because of technical difficulties and the necessity of a credible financial framework. For the interim period, several options were considered including full dollarization and the use of a foreign currency in government transactions. In the end, the Afghan government opted to stay with the existing Afghani and to introduce the new currency as soon as possible, which they viewed as the symbol of sovereignty and unity. The new currency was introduced publically in September of the year 2002, and the process of change began in October of the same year and was completed on January 2, 2003. The exchange rate remained stable, showing the positive and healthy functioning of the financial policies and public confidence in the new currency.

1.3. Economic Overview of Afghanistan

Since 2001, the Afghan economy exhibited substantial economic growth predominantly driven by foreign aid money and the existence of foreign forces. This growth came to an instant complete standstill after the post-2014 withdrawal of these forces coupled with the COVID-19 pandemic. In August 2021, after the Taliban took over Kabul, the economy was severely shattered and unemployment became excessively high followed by inadequate investment and trade. The existing political and economic instability added more to these challenges, with the decline in foreign aid resulting in volatile economic growth.

Figure 1: Real GDP Growth Rate (in percent)

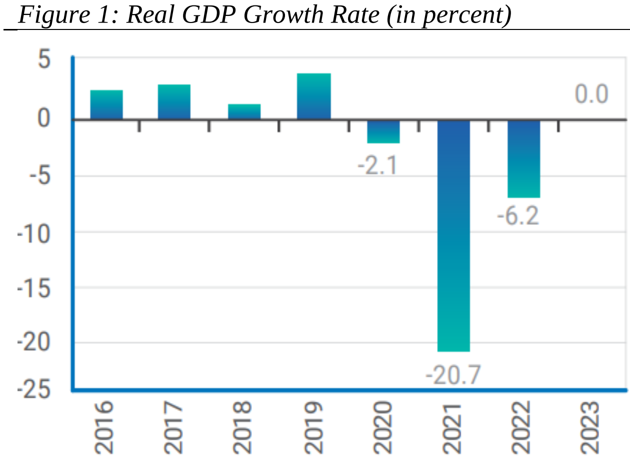
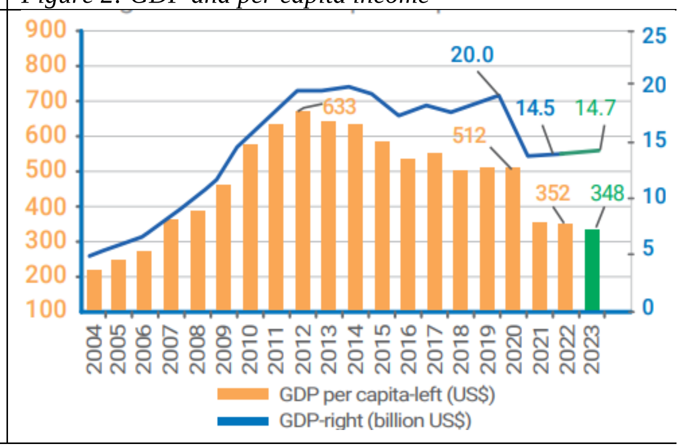


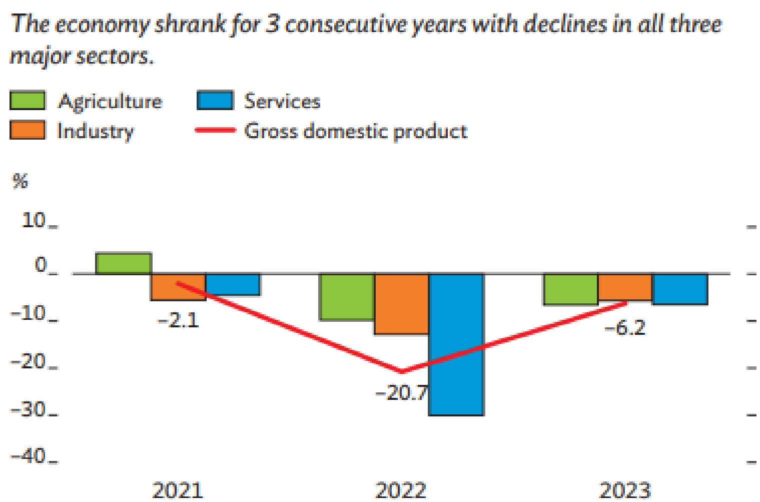
Figure 2: GDP and per capita income



Sources: NSIA data and UNDP

In the aftermath of the regime change in August 2021, the Afghan economy witnessed substantial economic shocks as a result of reduced development assistance, freezing of the official reserves, sanctions, and a paralyzed banking system. The regime's restrictive policies against women's education and activities have further blurred the economic prospects of the country leading to a contraction in economic activity and declining per capita incomes. According to the World Bank's 2024 development report, in the last two and half years under the Taliban rule, Afghanistan's economy faced severe deflationary pressures, and the real GDP contracted by 26%, headline inflation dropped to -9.7% in February 2024, mainly due to ban on opium cultivation, reduced money supply and appreciation of Afghani which resulted in declining food and non-food price since April 2023 which is contrasting with the inflation following the August 2021 political upheaval.

Figure 3: Supply-Side Growth



Source: National Statistics and Information Authority.

While this opium economy is equivalent to 1.3 billion US dollars and almost 8% of total GDP, a complete ban is a huge blow to the farmers and the economy. Whereas lower food prices have improved household well-being and food security, the incidence of monetary poverty remains high. Businesses grapple with difficulties arising from low demand, increased uncertainty, and restricted access to banking services.

However, the Taliban government, largely self-funded, met 98% of its 2022 budget target. In the fiscal year 2023, revenue increased but failed to meet the target with customs duties and business taxes contributing 60% of it. The public sector operated with reduced spending, leading to a small budget deficit of 0.1% of GDP and 0.7% of expenditure. Operating expenses decreased by 34%, while development expenditures sharply fell. In the meantime, the World Bank, Afghanistan Development Update Report (April 2024), observed that Afghani's strength was largely due to the external funding covering the trade deficit.

1.4. Current Status of Financial System

Following the Taliban takeover in August 2021, several countries immediately imposed sanctions on their government, the United States of America, in particular, has frozen more than USD 9 billion of the Da Afghanistan Bank's reserve funds held in the Federal Reserve Bank of New York, which constitutes a significant portion of the total reserves. The EU also put at least $ 1.4 billion of long-term and emergency assistance at stake, pending the current government is bound by democratic institutions. The IMF and World Bank did withhold USD 1 billion and $ 800 million, respectively, which had been allocated for projects of the country. The UN has listed some of the top members of the Taliban administration under its sanctions, which hesitates international organizations from providing funds not only to the Taliban government itself but also to non-governmental organizations, including money exchangers such as Sarafi agents and financial institutions. This has a direct impact on the ability of humanitarian actors to conduct their activities, perhaps international organizations directly provide humanitarian assistance to end-users without involving the government.

The UNDP (2023) SEO report highlights that sanctions have severely limited the inflow of foreign funds into Afghanistan as opposed to the previous republic regime, where foreign support was used to pay the salaries of about 60% of public officials. The new administration struggles to maintain a functional banking sector due to the freezing of the central bank's assets and a recent decline in international aid. Withdrawal restrictions have been imposed for individual and corporate customers, initially allowing only a limited amount to be withdrawn per week in a month. Measures to prevent the immediate drain of foreign currency reserves and bank runs include forcing banks to limit withdrawals only in the local currency and prohibition conducting any transactions in foreign currency in the market. The recent easing of withdrawal and foreign currency restrictions, especially for corporate entities, continued to restrict trading and required all transactions to be only in Afghanis.

Although formal banking infrastructure in Afghanistan has been on a decline for the last couple of years, the informal financial market has exploded to fill the gap left by formal banking services. The money exchange dealers act as important facilitators for humanitarian aid, development aid, and commercial transactions. Nevertheless, the rapid, unregulated expansion of the Sarafi market has been challenging to control the monetary policy of the Central Bank, and that, in turn, contributes to destabilizing conditions. According to the DAB directory, as of December 2020, there were 12 banks in Afghanistan, of which three are public banks, seven are private banks, and two are foreign bank branches. Private banks, with private shareholders, dominate the industry holding 67.36% of the assets, while public banks, totally owned by the Afghan government, are at 26.87%, and foreign banks are at 5.77%.

1.5. Formal Financial Services

Access to cost-effective, transparent, and reliable financial services is a significant challenge for many people in Afghanistan. According to the World Bank by 2024 only 27 percent of adults had official bank accounts, including mobile money accounts which is far below the global average of 70 percent in South Asia. Between August 2021 and when the Taliban's interim administration came into power, the banking sector was structurally fragile and highly limited in international connectivity and disconnected from SWIFT. Global de-risking practices led to limited international payments via banking channels, resulting in a reliance on physical cash shipments into Afghanistan, exceeding $2 billion since August 2021. Domestic banking channels had additional liquidity constraints and withdrawal limits that affected the public's confidence in the banking system.

Following the Taliban takeover, banks were shut down for about two weeks, causing shock and panic among the Afghans trying to withdraw their savings. ATMs ran out of money, thereby leaving many branches unable to meet the cash demands of their customers. Some main branches in Kabul had relatively more cash than others. In precaution against the possible collapse, banks transferred cash to Kabul, following the 2015 Kunduz incident where some banks were loathed when the Taliban captured the city.

DAB imposed a withdrawal limitation on each customer which capped at USD 200 per week, then increased to $400 per week on November 3, 2021. Businesses are allowed to withdraw up to 5% of their total funds or $25,000 per month. The banks were experiencing an extensive outflow of funds, and many branches were closed. As of May 2023, the central bank increased the weekly withdrawal limit for individuals with pre-August 2021 deposits from AFN 30,000 to AFN 50,000, but actual withdrawals are still below the legal limit. Meanwhile, companies have been allowed to withdraw as much as AFN 4.0M per month, which increased from AFN 2.5M since May 2023.

Despite international efforts to create humanitarian exceptions to sanctions, Afghanistan is still considered a high-risk jurisdiction, limiting access to formal international payment channels. Nearly three years later, there is no clear strategy for ending Afghanistan's isolation. The increasing reliance on informal service providers domestically has marginalized the formal financial system. Establishing a sustainable framework is crucial for facilitating both international and domestic transactions and supporting humanitarian endeavors and private sector activities.

1.6. Informal Financial System

Informal financial markets refer to systems of financial exchange that exist independently of formal banking institutions and regulatory structures. As such, these markets, typical of what happens in the practice of Hawala, are said to be flexible, accessible, and based on the principle of trust and personalized connections in making transactions (Razavy & Haggert, 2009). In the informal financial markets, there are fewer strict conditions, which means easier transactions and better accessibility, hence it fosters economic activities that might otherwise be constrained by formal financial institutions. The other important related dimension concerning an informal financial market is that of financial inclusion—access to banking, digital payments, and financial literacy (Singh, 2017). This presents the importance of knowing about financial concepts and information for their meaningful participation in the financial market.

The development and spread of informal financial systems like Sarafi or Hawala in the Middle East and South Asia, in particular in Afghanistan, have been influenced by a combination of cultural practices, economic conditions, and regulatory regimes. In Afghanistan, Hawala has been recognized for its contribution to financial stability and the smooth functioning of markets (Rahimi, 2020). Although the application of regulations is necessary to prevent misuse, regulators must comprehend how these systems provide a way to facilitate legitimate businesses and access to credit. Such cultural financial practices as Hawala have come into focus in the universal ethical context (Redin et al., 2012). The example of Hawala shows that global regulations are needed not only in the formal sector of finance but also in the informal one, or in what is called the shadow banking sector. It means that the informal systems of finance need to be within the broader framework of regulation to grant transparency and accountability.

The Afghanistan informal financial system is mostly controlled by Sarafi or money exchange, a term also used as "Hawala". The Sarafs are doing Hawala to transfer funds, lend and borrow, save, and much more than these. Entrenched within Islamic ethical practices, this represents a centuries-old banking system focused on trust. It is an informal banking system in which inter-individual transactions are effected without transaction through a bank or similar money transfer entities; thus such transactions are referred to as "informal". The two major developments of this century, globalization and the mobility of people and goods, have led to the significant expansion of hawala all around the world, especially in many non-Western countries, however accurate estimates of its size and scope are lacking.

The Informal Financial System, a traditional remittance system has shown significant resilience and still play a key role in many developing countries including the Middle East and South Asia, and remains a significant means of money transfer. The term "Informal Hawala" is used to refer to the practice, by acknowledging the fact that, in some countries within these areas, "Hawala" can also refer to money transfers within the formal financial institutions. In some literature, other terms, such as "Informal Fund Transfer" and "underground banking" are used interchangeably with the Informal Hawala System (Qorchi et al., 2003). This system is openly practiced in Afghanistan; some are with valid licenses while others are without licenses but are in the public domain, hence contradicting the nature of the system as strictly "underground."

The transfer process via Hawala involves two exchangers, Broker A and Broker B, who maintain a pre-existing business relationship and operate offices in different locations, possibly in different countries like Europe and Afghanistan. A customer, such as Ahmad, approaches Broker A in Europe to send money to Afghanistan. Broker A levies a fee of the agreed amount usually between 0-5% of the total amount, furnishes Ahmad with a password or Hawala number, and provides instructions to Broker B on how to disperse the funds locally. The recipient, for example, Khan, approaches Broker B, shares the password, and receives the funds either in the local currency or the same currency, with both brokers profiting from currency exchange fees. The transfer is swift, within minutes or over a day or two, especially for transfers to remote areas. Debts between Brokers A and B are settled once the funds are disbursed.

The Sarafi or Hawala system relies on social networks and trust—it is really difficult to track or document transactions. Sarafs are well-connected across Afghan society, mostly and conduct their transactions through verbal agreements, thereby facilitating speed, anonymity, and the near impossibility of tracing money flows. The system also serves as a channel for funds derived from Afghanistan's narcotics trade due to these characteristics.

Some brokers or Sarafs manage diversified portfolios of businesses in different countries. In certain instances, upon collection of funds from foreign senders, the Saraf may decide to purchase products in that country and send goods instead of money benefiting both from transfer fee and doing business with that money. Sometimes, upon collecting funds from individuals or businesses in one country, they enter into a currency swap with another businessman or Saraf in a particular country, transferring funds with little or no charges, and even for free when business opportunities or the use of the money is limited. Therefore, it’s preferred by many businesses which is fast with little or no paperwork, cost-effective, and fast.

This thesis discusses the evolving landscape of informal financial institutions in Afghanistan and how they have functioned to bring changes in the dynamics of the exchange rate, monetary policy, and currency value. The questions to be answered: 1) What are the primary drivers of the Afghani currency stability in the last three years during the Taliban regime? 2) How do informal money exchange markets impact currency stability? 3) What role do government regulations play in controlling informal money exchange markets and Aghani stability? The regulations will be discussed in how they have shaped activities around Sarafies or money exchange dealers and how they intersect with the government monetary policies. This research will be of major importance to policymakers and regulators in the sphere of currency stability and monetary policy in the context of Afghanistan. This study attempts to fill existing research gaps and provide insights into which factors are driving currency stability and monetary policies in Afghanistan.

The thesis contains a number of key sections. The introduction gives a brief overview of the country's financial environment, specifying the rise of informal financial systems and emphasizing the need for study on currency stability and monetary policy. The second part is the literature review, followed by a theoretical framework, describing the conceptual base that guides this research, referring to theories and models appropriate for this case. The methodology part defines the approach for the study, which includes methods of data collection. Further chapters analyze currency and exchange rate dynamics, and the role of government policy and interventions. The last part is the conclusion, recommendations, and policy implications which provide actionable insights for policy interventions in Afghanistan.

2. Literature review

The literature review presented herein attempts to provide a comprehensive view of the complex interaction between the informal financial market, monetary policy, and exchange rate dynamics in the context of Afghanistan and similar financial ecosystems. This review, therefore, delves into available research and scholarly literature to bring clarity to the working mechanism of informal financial landscape dynamics and to identify important areas for further research.

The literature on the informal financial system and money market is categorized into four main discussions. Firstly, scrutiny arises regarding its potential misuse by terrorist groups and organized crime syndicates, utilizing it for illicit activities such as financing terrorism and money laundering (Passas, 2003; Thompson, 2006). Second, attention has focused on the use of irregular money transfers or Hawala for remittance by families and immigrant workers abroad (Viles, 2008; Ballard, 2003). Third, researchers have delved into the informal institutional setups that enable the system to function without formal legal safeguards, underscoring the importance of trust (Ismail, 2007). Finally, discussions revolve around appropriate regulatory responses to address the challenges associated with irregular money transfers or Hawala (Passas, 2003). Furthermore, there has been insufficient focus on the positive function of Hawala as a crucial remittance avenue for low-income migrants. (Malit et al., 2017).

This literature will review the discussion of regulating the informal financial system and look further into what has already been done and what gaps exist in this area of research. It will be of great significance academically and in policymaking by offering a well-rounded understanding of the multifaceted dynamics of the financial system of Afghanistan. Through the identification of gaps and weaknesses in previous literature, it gives critical insights into guiding further research.

The literature on informal money exchange markets and currency value provides crucial insights into the complex dynamics that impact exchange rates and monetary systems in developing countries. Operating outside formal regulatory frameworks, these markets play an important role in facilitating currency exchange, remittances, and trade, with a big impact on the subjective preferences and cultural norms of people within the societies where they take place (Kaminsky & Reinhart, 1996). Such markets have long been key channels through which individuals and small businesses access funds in environments characterized by highly regulated financial markets with little credit availability. Several studies in the currency value literature have discussed various factors that may have influenced the exchange rate movements, such as those emanating from the differentials in the interest rates, carry trades, and deviations from covered interest rate parity (Brunnermeier et al., 2008).

The size of the shadow economy, determined by the development of the financial sector, is very important in the economic literature. (Berdiev & Saunoris, 2016). As financial markets improve, efficient intermediaries emerge in the formal economy and decrease credit costs, which in turn spur economic agents to move from the informal to formal sectors (Capasso & Jappelli, 2013).

Institutional quality significantly influences the degree of informality within economies. According to Canh et al., (2021), a strong institutional framework would promote transparency, efficiency in contract enforcement, low transaction costs, and guaranteed property rights. That, in turn, provides the right environment and platform for formal economic activities within the economy. Conversely, weak institutional environments are characterized by overregulation, poor contract enforcement, high and uncertain transaction costs, and bureaucratic inefficiency, which discourages formalization and prompts economic agents to engage in informal practices (Friedman et al., 2000). Contrary to the common beliefs, Friedman et al. (2000) imply that higher tax rates are not the reasons for increasing informality. Rather, a high level of discretion and lack of integrity in the institutional framework are more responsible for the expansion of the informal economy.

Additionally, monetary policy effectiveness is influenced by uncertainties in future policy rates and transmission mechanisms from monetary policy to financial markets. Bauer et al. (2021) point out that these uncertainties can complicate the ability of central banks to predict and control the effects of their monetary policies, especially in the context of informal financial markets. Furthermore, the reaction of financial market participants to central bank communications and policy signals, as shown by Petrova & Trunin (2021), may introduce volatility and distortion into the system, making the control of monetary policy effectiveness difficult.

In the presence of a large informal financial market, central banks may need to adopt non-conventional monetary policy arrangements and accumulate international reserves to enhance the effectiveness of their monetary policy (Brandao-Marques et al., 2020). The presence of informal financial systems can weaken the implementation and effectiveness of traditional monetary policy tools and strategies. As Rey (2016) points out, the interaction of informal financial systems and traditional monetary policy tools can lead to complexities in the implementation and outcomes of monetary policy.

Within the informal financial system, the exchange rate dynamics have attracted much academic research for its implication to the macroeconomic policy. This was studied by Aghion et al., (2006), that the volatility of real exchange rates has been proven to matter to the dynamics of long-term productivity growth, and this effect varies in the level of a country's financial development. This debate on exchange rate regimes has continued to emphasize evaluating the factors related to financial development, stability of the economy, and effects on macroeconomic variables as per different regimes (Frankel, 1999). The financial development-exchange rate volatility was analyzed, highlighting the significance of macroeconomic variables in the development of financial depth for any country (Hajilee & Nasser, 2016).

Informal currency exchange markets play an important role in currency stability. For example, such markets exist independently from formal systems and are stable due to reputation instead of legal mechanisms (Ibrahim, et al. 2021). In countries with political uncertainty and capital flight, there will be the development of dual foreign exchange markets with different rates, influencing stability. The black market, trading at a higher rate, will overshoot the equilibrium rate corresponding to the level of reserves available (Ibrahim, et al. 2021 and Yugank et al. 2018). Kubo (2018) also stated that such overshooting will depend on the level of official reserves. If the level of official reserves is low, there will be a larger premium in the black market. Moreover, Lascaux in his (2015) study cited that strict exchange restrictions will lead to further segmentation in the forex market, resulting in multiple rates and encouraging activities such as smuggling in the informal economy, which is facilitated by informal money transfer systems.

The informal financial market in Afghanistan has a key position and a profound influence on the foreign exchange rate of the country. A study by Kubo (2017) extensively examines the relationship between informal financial markets and exchange rate dynamics, illustrating how informal trading tends to have a huge impact on the stability of the foreign exchange market. Further study by Azizi and Daqiq (2019), analyzes the effectiveness of Afghanistan's central bank policies in managing the informal financial market and their impacts on the foreign exchange rate. Hence, the relationship between the choices of monetary policy and the informal financial sector becomes somewhat intricate, especially in matters of handling exchange market pressure; therefore, strategic approaches towards handling these dynamics are required, as highlighted by Xiangsheng (2017).

The role of money exchangers and hawala networks in influencing the dynamics of the exchange rate is pretty unique in Afghanistan. Zagaris (2007) explains that the far-reaching influence of these informal money transfer systems is deeply ingrained in social, cultural, and ethnic values, therefore affecting the country's macroeconomy. Being part of the informal financial market, they play a crucial role in facilitating cross-border transactions while greatly influencing the exchange rate through their prevalent operations. Moreover, Levine (2004) underlines that the informal value transfer networks, including the hawala, affect financial transactions, exchange rates, and currency values in vast measures. Moreover, it integrates the social, cultural, religious, and ethnic dimensions.

In light of these dynamics, it can be said that the dominance of the informal financial market is a central force in shaping Afghanistan's foreign exchange rate. The interaction between informal financial markets, monetary policy decisions, liquidity, and exchange market pressure creates a complex web of dynamics that shape the stability and fluctuations of foreign exchange rates, as explained by Nafeh et al. (2022).

The literature on governmental intervention and regulation seeks to provide monetary authorities with a mechanism to impact exchange rates autonomously from monetary policy. Humpage (2003) evaluates theoretical channels and empirical results are evaluated from this perspective, providing insights into how such interventions can be effectively employed. Also, studies by Ho and Yuen (2003) dig into the relationship between exchange rate regimes and macroeconomic stability which offers valuable insights into exchange rate management dynamics. Additionally, Chiou and Willems (2013) and Siklos (2009) highlight the distortions in exchange rates caused by government interventions in the foreign exchange market and underline the influence of such interferences in constraining currency appreciations and mitigating exchange rates.

3. Theoretical Framework

The financial landscape of Afghanistan reflects a quite complex interaction between informal financial markets and formal economic policies. This complexity stems from the dominance of informal financial systems—such as Sarafi (money exchange dealers) and Hawala networks in the economy. These informal networks operate alongside formal financial institutions and are deeply intertwined in the socio-economic fabric of Afghan society. Their persistence is attributed to the accessibility, trust, and efficiency of services provided by the informal systems, where formal institutions often fail or are absent.

This theoretical framework tries to bring together some economic theories to understand how such informal financial practices, institutional structures, monetary policies, and exchange rate mechanisms influence the stability of Afghanistan's financial system and economy. It is trying to answer critical questions regarding the drivers of currency stability, the impact of informal money exchange markets, and the role of government regulations. The framework integrates theories from financial dualism, institutional economics, monetary theory, and exchange rate theory to provide a comprehensive understanding of the interactions between these elements.

3.1. Key Theories and Models

3.1.1. Financial Dualism Theory

Financial dualism is described as the coexistence of formal and informal financial sectors in the financial systems of most developing countries (Germidis, 1990). This dualism arises mostly as a result of financial repression, in the form of government regulation that extends to the control of interest rates and exchange rates and credit rationing, thereby restricting access to formal financial institutions for a large portion of the population. Consequently, an informal financial sector emerges to fill this gap. Supporting arguments are that financial liberalization, through the reduction of these regulatory constraints, would reduce reliance on the informal sector by expanding access to formal financial services. This dual structure identifies the core mechanics of financial development and how informal financial practices can linger in developing economies.

This phenomenon is usually observed in developing countries where modern financial institution serves a relatively small proportion of the population, while a great majority rely on the informal financial system. In such systems, the traditional sector remains much as it was in pre-industrialized economies, while modern finance serves export-oriented firms (Graff & Karmann, 2001). This would mean that financial dualism is not a transitory phenomenon but a structural attribute of underdeveloped economies.

The financial landscape in Afghanistan is characterized by financial dualism, where along with formal banking, informal financial systems like Sarafies or Hawala networks are also in operation. Dualism is also evident in that more money flows through the informal system than through the formal banking system, a situation further exacerbated by the collapse of Kabul Bank in 2010[1], which eroded confidence in the formal financial sector (Teichmann & Boticiu, 2022; Callen et al., 2024). Financial dualism describes the survival and coexistence of informal financial practice with formal banking practice as a response to the failures and inefficiencies in the formal sector (Chiteji, 2002). Hence, informal financial practices like Hawala play a crucial role in stabilizing financing and markets in the country (Rahimi, 2020). Moreover, in Afghanistan, these shortcomings are even deeper, hence informal financial practices such as Sarafies and hawala were critical in doing

[1] The financial scandal that broke Afghanistan's Kabul Bank. (2011, June 16). The Guardian. https://www.theguardian.com/world/2011/jun/16/kabul-bank-afghanistan-financial-scandal
“Nearly $1bn has disappeared from Kabul Bank in mysterious insider loans. The scandal has pushed Afghanistan's tiny economy to the brink of ruin – and yet no one has been charged. Jon Boone follows the cash trail”

monetary transactions (Zagaris, 2007). This is a perfect reflection of financial dualism, where informal finance thrives, while the formal sector is either inefficient or not trusted.

The role of informal finance in Afghanistan is further supported by limitations for integrating such systems into formal banking—recommended by regulatory bodies such as FATF—since integrations in many developing countries with underdeveloped financial infrastructures are not effective (Trautsolt & Johnson, 2012). The informal financial sector provides key services in international and domestic remittances, notably for humanitarian and relief operations in regions, where the formal financial system is not fully operational (Zagaris, 2007). In line with this notion, financial inclusion is a predecessor of economic growth, wealth generation, and sustainable development. Therefore, recognizing and incorporating the informal financial sector into the financial policies and strategies becomes key and crucial in leading to financial stability and economic development in Afghanistan by the theory of financial dualism.

3.1.2. Institutional Economics

Institutional economics studies how institutions, such as financial markets and intermediaries, affect economic growth and development, and they are vital for long-run growth in that they provide indispensable services (Levine, 1999). According to Levine, the emergence of financial markets and institutions is a result of information and transaction costs. In developing economies, both formal institutions and informal norms or culture could be essential in effecting economic exchange (Bongomin et al., 2018). According to Aryeetey et al. (1997), for regions like Africa, the integration of informal and formal financial markets is vital for financial liberalization and bank restructuring. Financial development is a requirement of modern economic growth, while this remains an issue in rural areas and formal financial institutions often fail to adequately serve such areas (Zeng, 2019).

In Afghanistan, the informal financial market such as Sarafi or money exchangers and Hawala operates under community-based norms and trust. Sarafi is the key money exchange bazaar in Kabul, which has adopted the influence of state regulation to its internal formalization of rules and management structures but remains independent, thus signifying the interaction between state and private legal systems (Keith & Johnson, 2022). More particularly, Hawala, a very old remittance system, continues to perform financial transactions via a large network of Hawaladars or Sarafs and therefore keeps emphasizing the role of informal credit practices in sustaining supply chains. The implications are such that the formalization of these practices under regulatory approaches can help in enhancing financial inclusion and in ensuring compliance with anti-money laundering regulations (Choudhury, 2021). These examples underscore the importance of community-based norms and trust as determining the shape that the informal financial market can take within the framework of institutional economics.

In conclusion, institutional economics puts great emphasis on the role of financial institutions and markets in economic development. However, the interaction between formal and informal financial systems, the effects of institutional investors, and the need for strong financial infrastructure to play together will remain one of the major concerns of achieving sustainable economic growth. The philosophy of financial inclusion should thus incorporate both the formal and informal financial systems to increase opportunities for economic growth, wealth generation, and sustainable development in countries like Afghanistan.

3.1.3. Monetary Theory

Monetary theory is essential in analyzing the dynamics of money supply, inflation, and the role of central banking, especially in informal financial markets. An important aspect regarding money supply and inflation is dealt with in monetary theory. Studies have found that besides the effective control of inflation through money supply growth, central banks also change interest rates to stabilize the supply of money (Yan & Guo, 2015). Also, the endogenous concept of money points out that it is not just central banks that control the money supply but rather it also emerges in the financial markets through credit availability (Özdemir, 2019).

Monetary theory also delves into its influence on the efficiency of financial markets and speculative bubbles. Monetary policy has been examined regarding financial market efficiency, especially in the presence of speculative bubbles, by entropy-based approaches (Alonso-Rivera et al., 2019). In addition, the dynamics of monetary policy regarding the liquidity premium—the market value of the liquidity services provided by financial assets—are also explored in understanding the impact of monetary policy on the financial markets (Lee, 2019).

The prevalence of informal financial markets in Afghanistan makes the question of the interaction of informal financial systems with traditional monetary policy mechanisms of great significance to currency stability. The use of Hawala in Afghanistan not only sustains the business climate but also helps in stabilizing financing and markets (Rahimi, 2020). Despite efforts to develop a formal financial system, informal financing plays a critically important role in rural areas, hence the persistence and importance of such informal financial practices (Hemat, 2023).

Money supply dynamics in addition to informal credit markets, such as Sarafies and Hawala in Afghanistan, are other determinants that could have an effect on the stability of currency within informal financial markets. Various studies have shown that the informal economy could affect the official money multiplier in currency supply, therefore highlighting how informal economic activities influence the broader monetary environment (Mughal et al., 2021). For countries like Afghanistan, the presence of an informal financial system is important for providing financial services for individuals and businesses and stabilizing the financial market.

Monetary theory offers valuable insights on money supply, inflation, and central banking, and their effects on the informal financial markets. Regarding Afghanistan, it is imperative order to see how the informal financial systems interact with traditional monetary mechanisms in maintaining currency stability and financial resilience. This relationship is complex and multi-dimensional between currency stability, informal financial markets, and monetary policy; hence, it has to be understood and regulated for financial stability to propel economic development.

3.1.4. Exchange Rate Theory

Exchange rate theory plays a critical role in influencing currency stability, particularly in informal financial markets like Afghanistan. According to Gabaix and Maggiori (2015), the determination of exchange rates in imperfect financial markets generally suggests that there is often a dislocation in the connection between exchange rates and traditional macroeconomic fundamentals. For instance, this dislocation can increase the volatility of currency values, a feature that notably plays a major role in the stability of currencies in informal financial markets. In addition, factors influencing reserve stocks, like financial openness, access to foreign currency, and exchange rate policies, act as significant predictors, which, in turn, affect currency stability (Obstfeld et al., 2010).

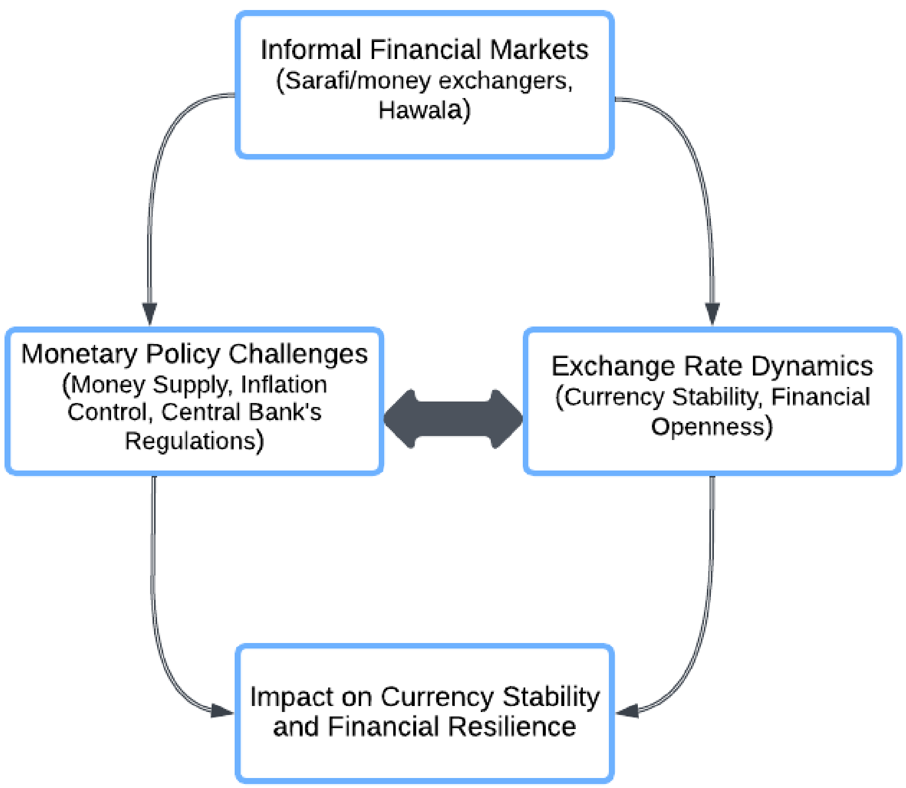
In Afghanistan's informal financial markets, where access to foreign currency is limited and volatility is high, the theories by Gabaix and Maggiori (2015) go further to explain changes in the value of currencies. The presence of market frictions, as discussed above deteriorates the challenges of maintaining currency stability. The COVID-19 pandemic has had huge ripples on currency stability within the informal financial markets of Afghanistan. Moreover, the application of synthetic local currency debt is bound to lead to issues with currency stability, especially in financial crises (Allayannis et al., 2003). Debt in domestic denominations tends to enjoy certain advantages but exposes currencies to volatility from external factors. Understanding the interdependence of exchange rates is, therefore, a key step for Afghanistan's policymakers and investors to understand how to manage the challenges presented by the volatility of currency (Liu & Sriboonchitta, 2019).

Historically, Afghanistan exchange rates are determined freely, with little intervention by the central bank through selling foreign currency and capital notes influencing the movement of exchange rates (Onour & Sergi, 2021). Capital flows, changes in the balance sheet of financiers, and risks towards an imbalance of international demands for financial assets determine exchange rate dynamics in Afghanistan (Azizi & Daqiq, 2019). According to Fry (1976), the exchange rate system of Afghanistan remains stable based on the real rate of return on investment being greater than the rate of depreciation of the local currency in the formal market.

In conclusion, exchange rate theory influences, through financial openness, access to foreign currencies, and market frictions, the stability of currency in the informal financial markets of Afghanistan. Drawing on the insights from studies on the dynamics of the exchange rate and financial stability, policymakers and market participants would be in a better position to address the challenges of maintaining stable currencies in such environments.

3.2. Conceptual Framework

It conceptualizes the interplays between informal financial markets, challenges in monetary policy, dynamics of exchange rates, and their aggregated effects on currency stability and financial resilience in Afghanistan. Informal financial systems, like Sarafi and Hawala, are essential to provide the most basic financial services which have been highly deficient and underserved by the formal system. However, dominance by these makes it challenging for the central bank to control money supply and inflation, since these transactions are usually out of control of formal regulatory systems. It is always cumbersome for the central bank to implement appropriate monetary policies, leading to inconsistencies in economic instability.



This, in turn, creates problems in the implementation of monetary policy, which may propagate to the exchange rate dynamics; exchange rate volatility can be partly explained by informal financial activities. Stable exchange rates are very important in currency stability; however, volatility has the potential to dilute investor confidence and economic stability. In the final analysis, the interactions between these variables determine the fate of the stability of the Afghan Afghani and the financial system at large. Proper management and regulation of the informal financial markets, coupled with strong monetary policies, are necessary to maintain currency stability and to achieve economic resilience in Afghanistan.

4. Methodology

This chapter describes the methodology through which Afghanistan's financial landscape, particularly the interplay between informal financial markets, challenges in monetary policy, and exchange rate dynamics, was analyzed. Since access to primary qualitative data is limited, this study relies mostly on secondary sources of data. It shall include reports by Da Afghanistan Bank, the Central Statistics Department, international organizations like the International Monetary Fund and the World Bank, academic journals, and financial databases. In this way, methodology ensures that the analysis takes on as much as possible from the existing financial environment and its implications.

4.1. Research Design

This research has a descriptive and analytical design. It will use secondary data to formulate the theoretical framework and the current financial situation in Afghanistan. The study attempts to explain the dynamics of informal financial markets and their interaction with formal monetary policy and exchange rates.

4.2. Study Limitations

Availability of Data: The study is constrained by the availability and quality of secondary data. Some data may be too old or non-existent, hence limiting the scope of coverage.

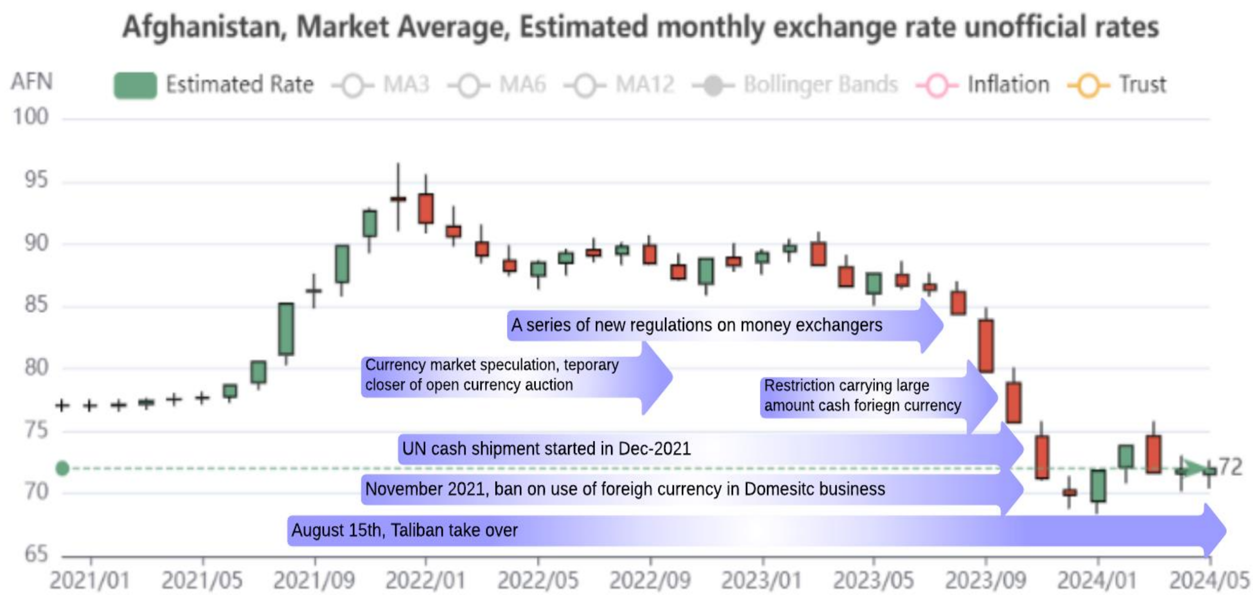
Lack of Primary Data**:** This ensures that the availability of primary qualitative data restricts the potential for nuanced dimensions of local stakeholder perceptions engaged in informal financial markets.

Reliance on Existing Reports**:** This study greatly relies on the accuracy and objectivity of reports from various organizations, which may contain inherent biases.

5. Analysis of Afghani Appreciation

This part will look at the time series of events since the takeover by the Taliban in August 2021 and their bearing on the stability and resilience of the Afghani currency. It aims at a proper evaluation of the key monetary policy actions, exchange rate fluctuations, and other relevant indicators of how these events have affected the ability of the currency to maintain stability and resilience in a volatile environment.

Figure 3: Major events time series and their impact on Afghani



Source: World Bank, development data group, self-edited

5.1. Taliban Takeover and Currency Control

During the political upheaval in 2021, the Afghani (AFN) witnessed turbulent fluctuations, soaring to a peak of 130 AFN per USD in the black market, while the official rate hovered around 100 AFN per dollar. Money exchangers' speculation and open market auctions of foreign currencies fueled this chaos, eroding public confidence in Afghani. One significant factor contributing to the spike in foreign currency demand was the rush among politicians, high-level government officials, and warlords to convert their assets into foreign currencies, particularly US dollars, fearing instability and seeking to safeguard their wealth amidst the changing political landscape. This widespread demand for foreign currency created a shortage of dollars in the market while flooding it with an excessive supply of Afghani, exacerbating the depreciation of the currency.

5.2. Market Speculation

Immediately after these speculations, the Taliban thereafter, suspended open market foreign currency auctions and closed the forex market temporarily to cool speculation, stabilize the market, and instill some form of confidence in Afghani. Slowly, the Afghani started recovering and over time stabilized at about 85 AFN per USD in the domestic market. However, in August 2023, Afghani started gaining massively, with it sliding from 85 AFN to 73 AFN per USD, reflecting a gain of about 15%. This appreciation happened just after the Taliban identified money exchangers and speculative activities as some of the main reasons behind the currency's slide.

The strict policy of the Taliban over the withdrawal of foreign currency, mainly the USD, from the banks is a very important move toward keeping the currency stable in economic turmoil and protecting the banking system from collapse. Such policy restricts the availability of US dollars in Afghanistan, reduces massive Afghani sell-offs, and prevents capital flight via unofficial channels. Together with the positive effects of strengthening currency stability, these measures have negative ones. They do not encourage the free flow of capital and increase transaction costs of trade, especially for the hawala network, which depends on cross-border currency transfers.

5.3. Regulations on the Currency Market

In November 2021, the Taliban government enforced a sweeping ban on the use of foreign currencies across Afghanistan, mandating the utilization of the national currency for all transactions. A stern warning accompanied the decree, threatening legal repercussions for any violations. This prohibition extended to various aspects of daily life, including property transactions, NGO cash distributions, and government procurement, emphasizing the exclusive use of Afghani over foreign currencies like the US dollar, Pakistani rupee, or Iranian riyals. Provinces accustomed to using foreign currencies for everyday transactions received strict directives to adhere to the new regulation or face legal consequences.

Amid recent changes in Afghanistan's financial landscape, in February 2022, money exchangers and currency exchange markets ceased operations in response to new regulations imposed by the Taliban administration. The regulations require that every exchanger set up a five million Afghani guarantee in the central bank and for applicants of financial service licenses to have approximately 50 million in the capital. Also, license renewal fees were fixed at 200,000 Afghanis, with licenses needing renewal every three years. The Taliban's Central Bank has introduced tough conditions, including minimum resources and guarantees deposited in the central bank, for obtaining licenses for money service providers and exchange offices.

Subsequently, Taliban officials imposed more restrictions on February 7, 2023, which would confine the use of and export of certain currencies from Afghanistan. The directives limited the sum of US currency a person could take out of the country to at most USD 500 when using land border crossings and USD 5,000 if using airports. Violations of these directives would come with penalties ranging from imprisonment to fines, depending on the amount of money. It is not certain if these restrictions and corresponding penalties apply to non-citizens of Afghanistan, and questions linger concerning their broader implications and enforcement.

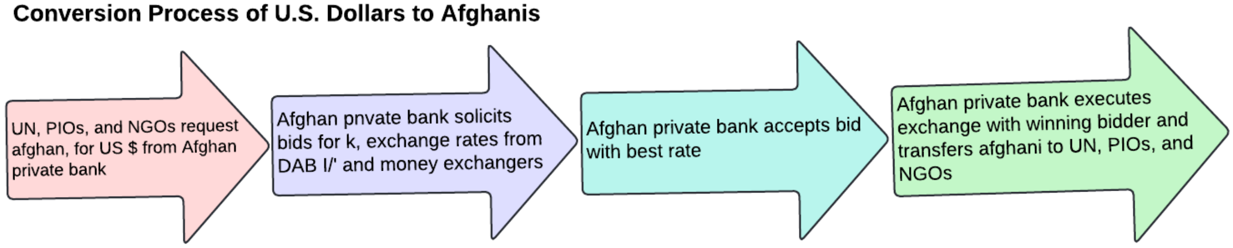
Online exchanges have been declared banned from April 2024 and legal action has been threatened against individuals and firms involved in such operations. It is all part of bringing transparency and oversight in line with international standards, trying to address the concerns against it for money laundering and terrorist funding. This is also a step towards addressing some of the Taliban's needs for foreign currency amid uncertain prospects for the release of Afghanistan's currency reserves by the US.

5.4. UN Cash Shipment of US Dollars

In December 2021, the UN began delivering cash to Afghanistan to support humanitarian operations for various UN entities and NGOs, including the World Bank and the Asian Development Bank. The Special Inspector General for Afghanistan Reconstruction (SIGAR) report (2024) indicates that the Taliban benefits significantly from UN supplies of US dollars. When working in Afghanistan, UN entities and NGOs, their partners often need to convert these dollars into Afghanis for funding their operations. Because private banks and money exchangers typically do not hold a large stock of Afghanis, they use the UN-provided dollars to buy local currency from Da Afghanistan Bank in currency auctions. The process leaves DAB, under Taliban rule, with a good stock of US dollars, hence strengthening their financial position.

According to the report, DAB auctions occur one to three times a week, with the participation of private Afghan banks and local money exchangers. From 20 to 50 bidders take part in the auctions, and the auction size and the winning bids are public. Converting US dollars into Afghanis through these auctions, the Taliban-controlled central bank ensures a steady inflow of foreign currency. The accumulation of dollars helps the Taliban manage the local currency supply and sustain a modicum of economic stability despite international isolation and sanctions.

Conversion Process of U.S. Dollars to Afghanis



The cash transfers by the UN have played a crucial role in the stabilization of the Afghani through the injection of much-needed dollars into the market. The funds are critical sources of liquidity, which guarantee the payment of imports and the purchase of local goods and services, including salaries. That has helped to close the huge gap that exists between imports and exports in Afghanistan, thus maintaining a stable exchange rate for the Afghani and keeping inflation at bay. All this has gone a long way to avoid hyperinflation similar to that experienced in the 1990s and kept the economy relatively stable.

5.5. Unseen Currency Inflows and the Afghan Transit Trade

The Afghani has maintained a progressive trend against major trading currencies since early 2023, despite huge economic challenges facing Afghanistan. The Central Bank says such a trend cannot be fully accounted for by any conventional data and economic theory. The bank has been monitoring the foreign exchange market without finding a parallel market. Assuming an unrecorded inflow of foreign currency, equivalent to an informal income stream balancing out the trade balance and supporting the currency, can best explain the unexpected strength of Afghani amidst a falling GDP and growing import base.

The influx of revenue is particularly noticeable when analyzing the types of imports, which consist of consumer luxury and essential inputs in industries, including prepared foodstuffs, vehicles and spare parts, stone, glassware, chemicals, and iron and steel. Although industrial production decreased by 26% compared with 2020, the imports of such products increased to almost double in 2022-23 against the average of 2016-2020. The Central Bank questions the reason why an economy with such decreased industrial output would need a massive surge in imports of industrial inputs, noticing the importation of high-end consumption goods contradicts the reality of Afghanistan now, as two-thirds of all Afghan households suffer from acute deprivation, and local businesses produce at a fraction of capacity due to demand deficiency.

The Bank estimates that $1 to $1.5 billion of goods imported into Afghanistan found their way to the Pakistani market, rather than being consumed in Afghanistan. This was paid for out of the foreign currency reserves of neither the Bank nor Afghanistan. The appreciation of the Afghani, along with a depreciation of the Pakistani currency, the Pakistani rupee, further showed that goods were being imported into Afghanistan and then smuggled into Pakistan. Later, following the measures taken by Pakistan in 2022 to cut imports to balance the payments crisis, such as limiting letters of credit for importers, the demand for illegal imports via Afghanistan surged.

This process is incentivized by the exemption Afghanistan enjoys from paying Pakistani customs on goods bound for domestic consumption, a privilege extended to landlocked countries. Historically, Afghanistan engaged in the Afghan Transit Trade, importing and then re-exporting goods that were banned in Pakistan. This has significantly increased since import restrictions in Pakistan were tightened. The calls to ease these restrictions came in efforts to reduce smuggling from Afghanistan. Success in such efforts could impact the revenue of the Afghan government and the value of the Afghani, which in turn affects the prices of basic imported goods, such as food, fuel, and medicine.

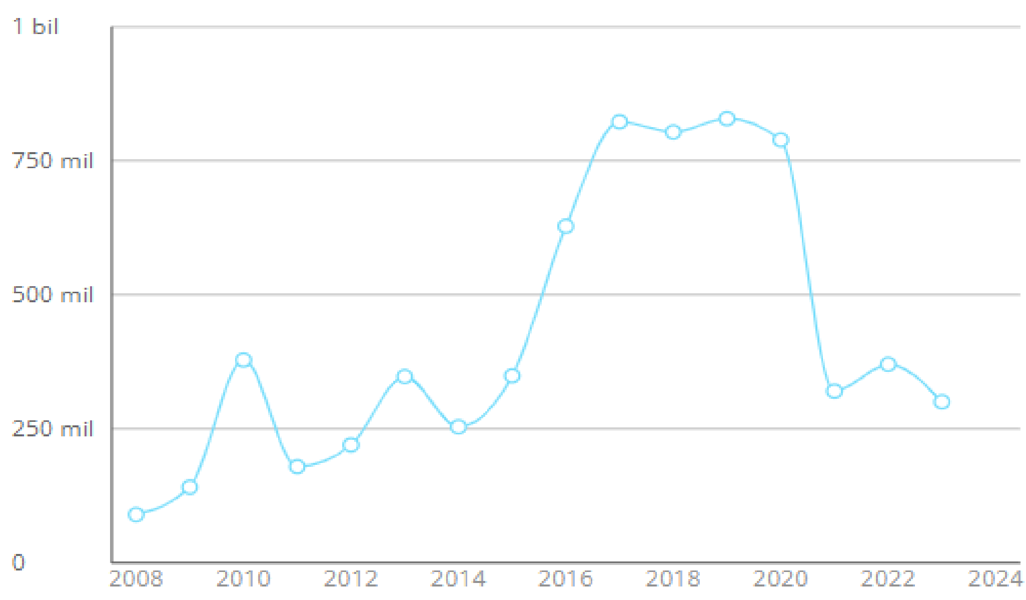
6. Discussion

6.1. Examination of Current Informal Financial Practices

6.1.1. Use of Sarafi and Hawala Systems for Remittance

Sarafi and Hawala systems are crucial constituents of the Afghan economy, considering the constraints of the formal financial sector. The services offered by Sarafi operators include currency exchange and fund transfers, which are vital for daily transactions and business operations. Hawala provides fast and secure transfer of money both at the domestic and international levels through a trust-based relationship network. Such an informal form of financial practice is essential to the areas where formal banking services are scarce, enabling financial inclusion and local economic development.

Figure 4: Trend of Remittance Inflows to Afghanistan



Source: World Bank - KNOMAD, 2023

The graph above shows the trend of remittance inflows to Afghanistan from 2008 to 2024. The data are for remittances measured through formal financial channels—that is, excluding informal networks, such as the Hawala system. From 2008 to 2016, an upward trend in remittance inflows is depicted, reaching around 2018 at approximately 1 billion USD. This period can be interpreted as a growing tendency to use formal financial systems for making remittance transfers.

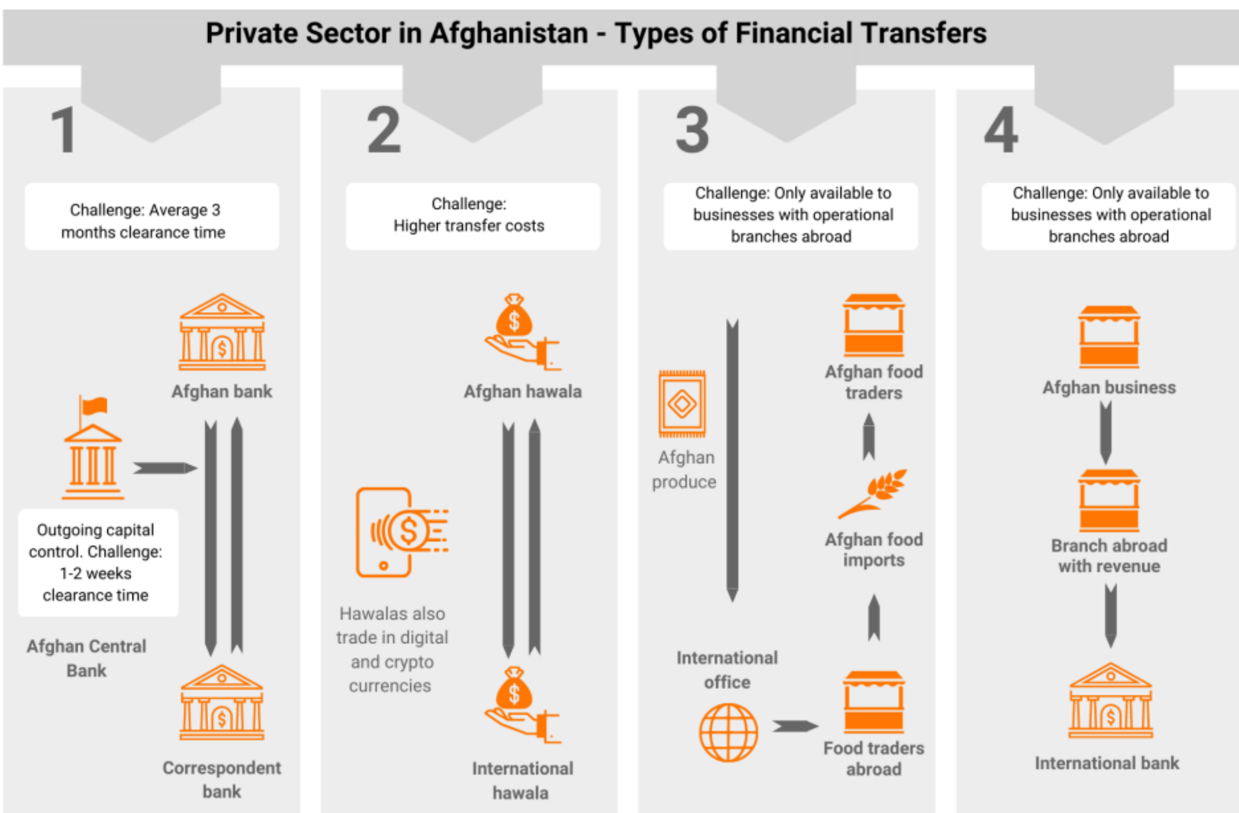
However, a sudden decline is seen starting from 2019, with a deterioration of the security situation in the country which deepens dramatically from August 2021 onwards. This decline corresponds with the cutoff and disconnection of Afghanistan's banking system from international financial transfers and the sanctions imposed on the Taliban government after their takeover. Here, remittance inflows went down to about 250 million USD in 2022, which reflects the heavy impacts of these geopolitical situations on formal financial channels.

Despite this decrease in official remittance inflow, it is the case that the gap has been substituted by informal financial channels, especially the Hawala system. Although the formal remittance figures had fallen, probably the actual inflows of money were higher since many families had turned to the informal system given the collapse of the formal financial system and high unemployment rates. Besides, over 200,000 people left Afghanistan to mainly the US, Canada, and European countries, and they started sending more money back home in support of their families and on account of charitable causes via the Hawala system. According to the World Bank Development update report in May 2024, remittance to Afghanistan was estimated at about $2 billion.

This shift shows the strength and flexibility of informal financial networks in stabilizing the economy if the formal systems are at a halt. Such an increase in reliance on informal modes of financial transactions, through the Sarafi and Hawala systems, means that their importance in the financial ecosystem of Afghanistan continues to go up. Not only did these systems allow financial transactions to continue in the face of the collapsing formal sector, but they also proved to be of paramount importance in maintaining currency stability and economic resilience. The data suggests a greater need to understand and monitor these informal channels to gain a proper idea of their impact on the wider economy and to put in place strategies to integrate these with formal financial systems in a better manner.

6.1.2. Financial Transfer Methods Used by Businesses in Afghanistan

The following diagram highlights the four main methods Afghan businesses use for international transfer amidst the challenges of a collapsing formal banking system. Each carries specific challenges and limitations that modify how businesses approach financial transactions in this complex environment.



Source: Norwegian Refugee Council. (2023). Barriers to Afghanistan's critical private sector recovery.

6.1.3. Overseas Bank Accounts Avoiding Afghanistan

Many Afghan businesses turn to foreign bank accounts as a means of getting around Afghanistan's banking restrictions. They maintain accounts in foreign countries, for instance, Dubai, where money goes through. However, businesses face challenges, such as having difficulty opening new accounts and their transactions being blocked if they mention Afghanistan. It is mainly accessible to big businesses with the capacity to establish and maintain foreign accounts, whereas small businesses have to rely on less formal systems of money transfers.

6.1.4. Hawala System

Hawala is one of the most practiced informal systems of money transfer, both within Afghanistan and internationally. Given the constraints and costly dealings of formal banking channels, Afghan businesses are increasingly switching over to Hawala. On one side, it deals with comparatively fast and flexible transfers of money, which generally includes digital and crypto deals. On the other side, it comes with relatively high transfer fees and usually is not accepted by international suppliers outside of the Middle East and Asia. These constraints notwithstanding, Hawala remains a critical mechanism through which Afghan businesses could maintain liquidity and continue their operations under such restricted financial conditions.

6.1.5. Currency Swaps

Currency swaps have been the way Afghan firms have been able to access physical cash when formal banking channels are closed to them. These swaps are similar to those the NGOs and UN bodies use but are different and rarer in their availability. They require strong networks and access to foreign bank accounts, which make them practical for only a few businesses. In this respect, currency swaps are helpful but do not provide a practical or long-term solution for most Afghan businesses, particularly those that do not have a preexisting international relationship.

6.1.6. Digital Payment Platforms

Digital payment platforms represent a growing but still limited option for financial transactions within Afghanistan. Since 2021, mobile money and digital platforms have begun to increase in use, but slowly, because of limited digital infrastructure and cultural resistance. Platforms like HesabPay are starting to take importance, though most of the current functionality is domestic. It is still very difficult to make international transactions through such platforms. Therefore, further international support is required to develop and enhance digital banking and payment solutions. In this way, the private sector of Afghanistan would become more inclusive, resilient, and transparent.

6.2. Monetary Policy and Government Intervention

Monetary policy generally involves the instruments and policies that a central bank uses to regulate the supply of money and interest rates for maintaining broad monetary policy goals, such as controlling inflation, managing employment, and stabilizing the currency. Conventional monetary instruments usually include open market operations, interest rate manipulation, adjusting the reserve requirements, and quantitative easing. However, after the Taliban takeover all interest-based transactions were banned, and shifted the banking system to Islamic banking, the conventional tools at the capacity of the central bank were drastically reduced.

Da Afghanistan Bank uses several monetary policy instruments to regulate the country's financial stability. The tools mainly used include foreign exchange auctions and reserve requirements. Foreign exchange auctions are held twice during the week and involve licensed foreign exchange dealers and commercial banks under an open and transparent process.

Besides foreign exchange, DAB uses the reserve requirements, both for precautionary and monetary policy goals. The Afghani and foreign currency deposit required reserve rates are differentiated based on the CAMEL[2] ratings. Still, the incumbent government has severe constraints since more than 9 billion dollars were frozen abroad from the Central Bank reserves, whose access it does not have as a monetary tool. That again raises limitations for DAB to work properly to stabilize the country's finances.

[2] The CAMEL rating system is a supervisory tool used to evaluate the health and stability of financial institutions by assessing their Capital adequacy, Asset quality, Management quality, Earnings, and Liquidity.

6.3. Exchange Rate Mechanism and Currency Fluctuations in Afghanistan

Afghanistan has a 'managed float' exchange rate regime whereby the Afghani is determined largely by market forces with some interventions by Da Afghanistan Bank. The exchange rate, therefore, changes according to the forces of demand and supply, and this has a substantial effect on the financial market. An appreciating exchange rate means that Afghani becomes more valuable in terms of foreign currency; the effect is that households can buy more, and profitability is higher for firms that rely on imported inputs. Alternatively, if the exchange rate is depreciating—that is, the Afghani becomes less valuable in terms of foreign currency—household purchasing power falls, and the domestic producers who rely on imported inputs also suffer because their costs rise, and this reduces their profitability. Fast depreciation also means that the cost of importable pushes households into poverty and increases economic challenges.

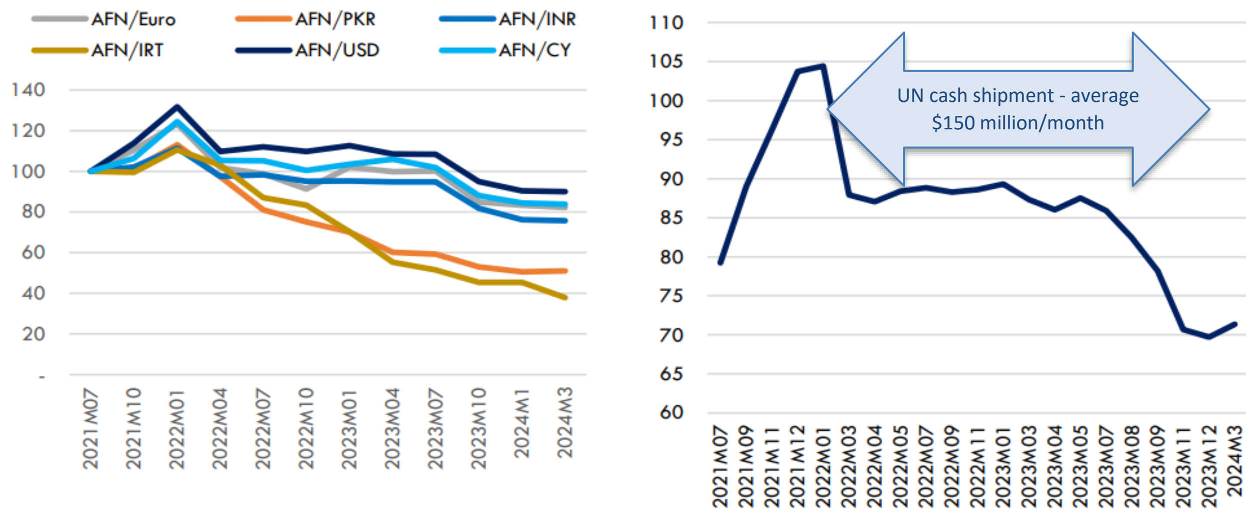
The value of a national currency depends on various factors, wherein an important role is played by the performance of the supply and demand mechanism in capital and financial markets. Very remarkably, amidst serious economic and financial crises, Afghanistan has been able to maintain the stability of the currency and inflation rates. The latest situation as reported by Da Afghanistan Bank reflects the rate of 68 Afghanis for one US Dollar (USD), reflecting a surge of approximately 20% in the value of the Afghan currency against the US dollar and the Euro since the start of the year 2023.

In reaction to financial sanctions, Afghanistan has moved to decentralized currency exchanges through local money exchangers or 'Saraafs', pivotal as it is for the country to keep up with the isolation it is facing globally in the financial system. There have been controls enforced on currency speculation and corruption at customs. Furthermore, there are reports of an uncontrolled outflow of foreign currencies, mostly USD, to neighboring countries through unrecorded channels, which had created a shortage of USD within Afghanistan itself and was beyond the entirely wholesome control of the Central Bank of Afghanistan. The Taliban regime has taken certain measures to manage the Afghani, such as not allowing the use of foreign currencies in local transactions and declaring the carrying of large amounts of cash currency across the border illegal.

Afghanistan's economic flexibility can be evident from the fact that amidst a large trade deficit, Afghani has been able to bear shocks and stands as the best regional currency performer against the US dollar in the last two and half years, while other regional currencies continue to struggle. But the question here is how Afghanistan can fund this deficit despite such currency appreciation. Undisclosed mechanisms of external financing are supposed to be major players.

Though Afghanistan is dependent on over 90% of its trade from imports, there is a high outflow of US dollars, resulting in a persistent annual trade deficit, which has averaged close to $6 billion in the last two decades. According to the World Bank, the trade deficit has increased from $4.4 billion in 2022 to $5.9 billion in 2023, with an estimated $8.8 billion in 2024. Notwithstanding such a big trade imbalance, there has been an appreciation of the Afghani. It indicates that there are undisclosed mechanisms for external financing. The paradox of currency appreciation amidst a growing trade deficit is explained by Pakistan financing a huge part of the deficit.

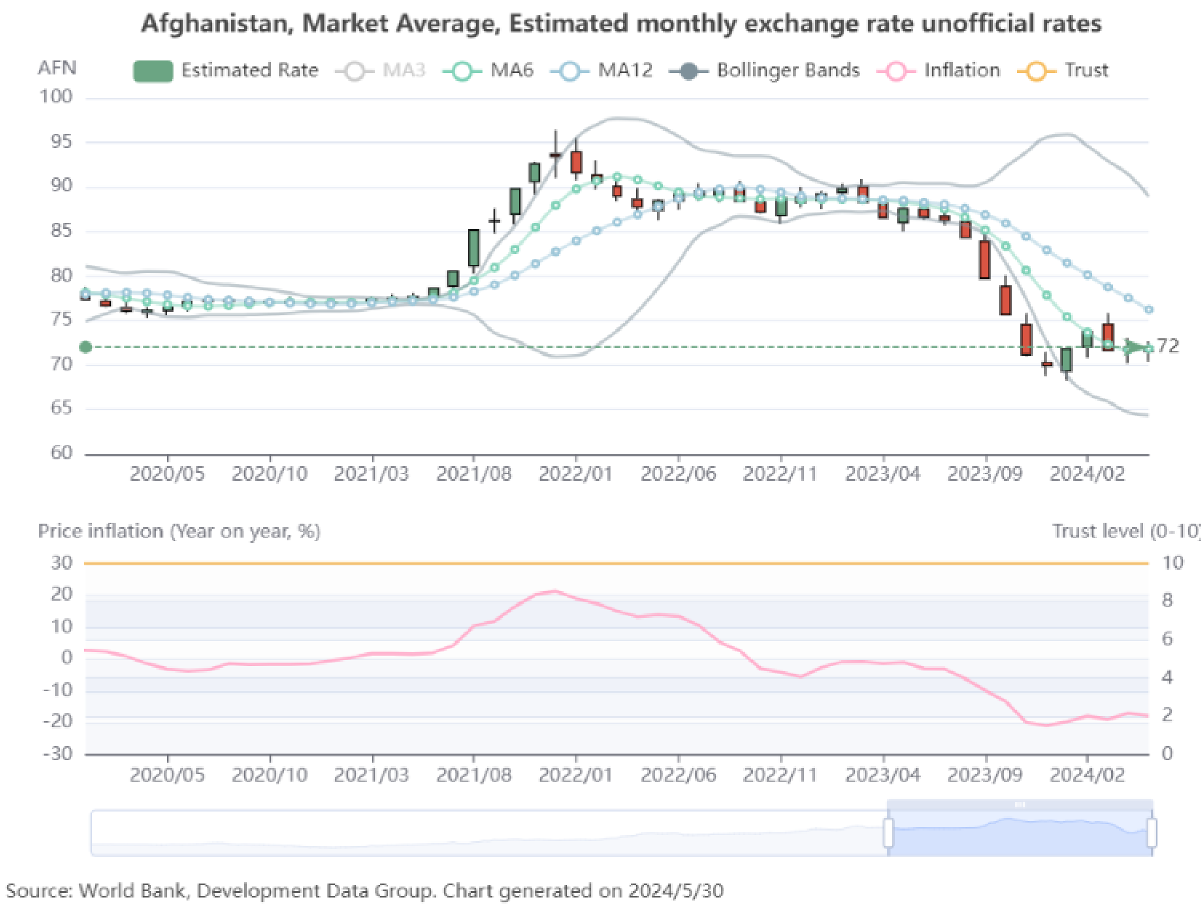
Figure 5: Fluctuations of Afghani (AFN) against Key Currencies since the Taliban took over



Source: World Bank and Da Afghanistan Bank

Following the Taliban's takeover, the Afghani quickly lost its value, once briefly falling to 130 against the US dollar in the unofficial money exchange market, and 107 as the official rate. Due to speculation against the currency, the Taliban banned USD auctions for short time in the open market, which eroded people's trust and sent a scramble to convert Afghani into more stable currencies. However, various factors, such as unidentified external flows, the ban on foreign currencies for domestic transactions, controls on domestic money supply, increased remittances, and monthly shipments of $150 million by the United Nations, had helped prop up the Afghani.

Figure 6: Afghani (AFN) exchange rate trend against the US dollar



As per the World Bank's report in 2024, Afghani experienced a remarkable surge against major currencies in 2023, thanks to foreign exchange inflows that comfortably exceeded the trade deficit. This surge was primarily fueled by $ 2.9 billion in UN cash shipments and an estimated $2 billion in remittances, creating a surplus in the foreign exchange market. Consequently, the Afghani strengthened by 27.1 percent against the US dollar and made substantial gains against other currencies. However, this deliberate targeting of the exchange rate led to deflation and a dampening effect on economic activity. By December 26, 2023, the Afghani had appreciated by 22.8 percent from August 15, 2021, reaching 70.13 to the US dollar.

Volatility in the exchange rate is depicted over time by the Bollinger Bands in the top graph. During the period of mid-2021 to early 2022, the bands begin to diverge sharply, showing great volatility and price movements at this period. This coincides with the peak level of the exchange rate. Subsequently, when the rate of exchange gradually declined, the Bollinger Bands began to contract, showing lower volatility with more stable prices. Narrowing and widening of the bands thus reflect periods of higher and lower volatility in exchange rate trends.

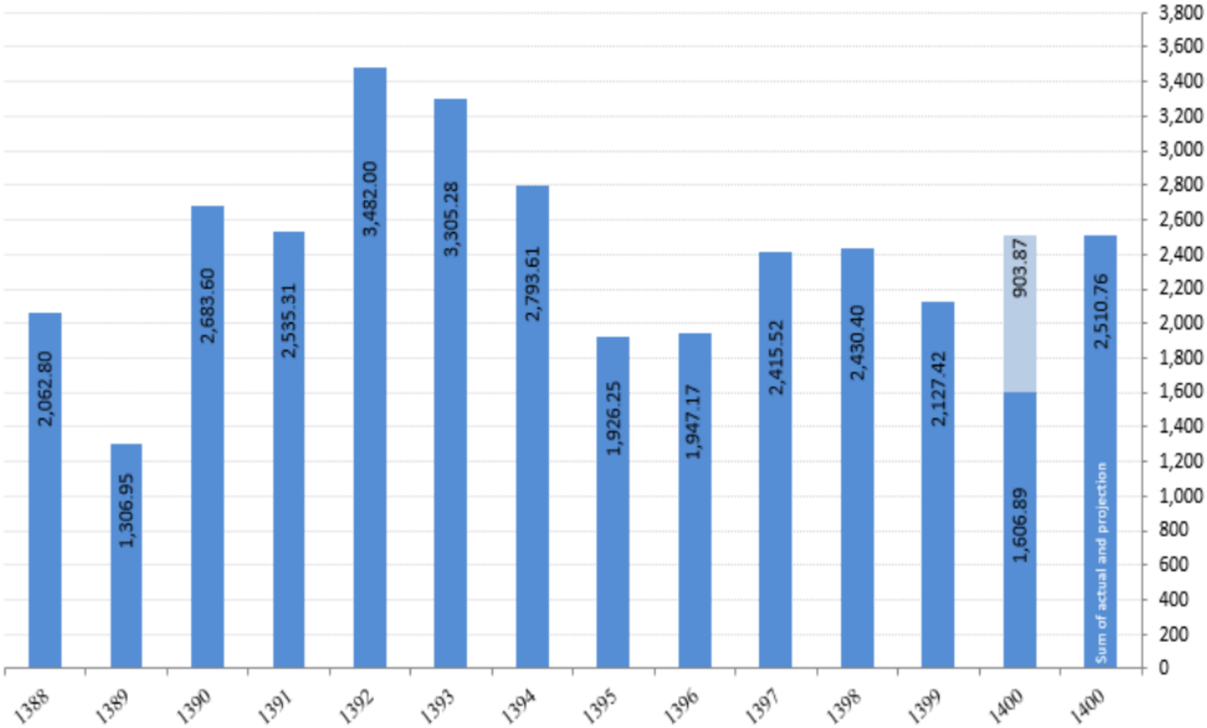
However, during early 2024, the Afghani started falling again with weakening foreign exchange inflows to 71.6 against the US dollar by the end of March 2024. This decline underlines the fragile balance held with external financial support and the continuing challenge the economy of Afghanistan is put through.

6.4. Currency Auction

Da Afghanistan Bank carries out foreign exchange auctions two to three times a week auction to manage the supply of money and keep prices stable. These FX auctions essentially mop up excess liquidity and mitigate the exchange rate volatility of Afghani with the main sales of US dollars. In line with the guidelines of the IMF, DAB's Board of Directors, and the Auction Committee, these auctions manage the supply of Afghani in the market. An Auction Committee sits weekly to decide on the auction volume, with information publicized through media such as Afghanistan Radio and Television to ensure full and adequate information of the participants and full readiness of the participants.

The central bank or DAB relied mainly on foreign currency auctions as the means of regulating market liquidity. Throughout the last twelve years, DAB has sold on average $ 2.4 billion per annum, peaking at $3.5 billion at the time of the military surge. Throughout the last five years, average annual sales were $2.2 billion.

Figure 7: Annual US dollar auctions by DAB.



Source: Source: DAB data (as of August 15, 2021), cited in [3]

[3] Ahmady (2023).

7. Conclusion

In a state of severe economic and political crises following the Taliban's takeover in August 2021, Afghani has shown great stability and resilience, which characterize a complex interplay of a variety of factors. Despite Afghanistan's high dollarization ratio and the freezing of its foreign reserves by the Federal Reserve, cash transfers from abroad, mainly from the United Nations, have been instrumental in stabilizing the currency and injecting much-needed liquidity into the Afghan economy. Other key factors have been remittances to the Afghani. Afghanistan has received an average of approximately 1.6 billion USD annually in remittances since 2020. Remittances not only increase the supply of Afghani in the market but also contribute to its appreciation, exerting upward pressure on its value.

The Taliban's strict rules, particularly the ban on using foreign currencies in everyday transactions, especially in border cities, have helped to boost the demand for Afghani tremendously, hence strengthening the value and maintaining currency stability. In conjunction with these, strict monitoring of foreign currency withdrawals by the government and efforts of that government to reduce illicit dollar smuggling have helped in stabilizing the Afghani. Extensive measures taken by the Da Afghanistan Bank to control the money supply, thereby protecting the local financial market from international turbulence, have also reinforced the prospect of currency stability. Hence, in the wake of lowering demand for foreign currency and a higher supply of USD in the domestic market, the rising affinity for Afghani has led to its significant appreciation vis-à-vis major foreign currencies and helped the cause of economic recovery.

Other contributing factors that have helped Afghani stability are: The monetary policy of DAB—Central Bank of Afghanistan—currency auctions and tight regulations, combined with the government's initiatives, such as the ban on the use of foreign currencies, have gone a long way in stabilizing the Afghani. Though the Afghan economy has faced problems, the Afghani has gained value against major currencies since early 2023 and has the stability till now. One important reason for this has to do with the receipt of an unrecorded inflow of foreign currency in support of the trade deficit, which has fueled imports with a notable portion going to the Pakistani market. This fuels imports with a notable portion going to the Pakistani market and partly impacts the depreciation of the Pakistani rupee.

7. Policy Recommendations

Our analysis points to some measures that will ensure stability in Afghanistan's informal financial system and currency stability under Taliban rule. To be able to put in place an enabling economic environment, strengthening macroeconomic management by the Taliban Interim Administration should be the initial basic step. This would involve designing a comprehensive macroeconomic adjustment plan covering monetary, exchange rate, and fiscal management policies.

Long-term financial stability requires trust in the formal financial system and improvements in the central bank. First, the central bank needs to gain back its autonomy without any political interference. In addition, it is crucial to offer technical assistance to domestic payment systems. Moreover, expanding private banking services to more locations will incentivize greater citizen participation in the formal financial market. Assisting financial service providers and easing the requirements for activities that are formal and legal will serve to build credibility and functionality, thereby leading to stability and growth.

Regulation of informal money exchange markets is key to controlling speculation and thus stabilizing the currency. Putting a licensing and regulatory system in place will make such markets subject to official supervision, thus reducing the impact of speculation on the Afghani. Tough rules and enforcement are required to check unlawful currency transfers and smuggling. The present government is seen to be active in these regards but needs to further work on the regulations for the benefits to reach the money exchangers and the government.

Encouraging digital financial inclusion via investments in mobile money and digital payment systems enhances currency stability by reducing cash dependence and enhancing transaction efficiency. Pilot programs and capacity-building initiatives on digital financial technologies expedite adoption, broadening access to financial services and decreasing reliance on informal financial systems.

International engagement and economic support depend on the Taliban Interim Administration's respect for basic human and democratic rights standards. A commitment to equitable treatment, especially toward women and girls, and human rights will be key to international assistance and investment. Elaborating laws that protect private property rights will further stimulate private investments and lead to a much more dynamic economic environment supportive of stability and recovery.

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