Afghanistan Banks Association

Economic Trends and Their Impact on Banking Sector in Afghanistan

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The views reflected in this report are those of its author, and do not necessarily represent the views of Afghanistan Banks Association

1. Introduction

In Least Developed Countries (known as "LDCs"), the Banking sector plays a dynamic role in intermediating funds between depositors with surplus, on the one hand, to the borrowers with profitable investment opportunities. In Afghanistan, 16 banks are operating: three state-owned banks, four branches of foreign banks, and nine privately-owned commercial banks. In Afghanistan, the banking sector is a major part of the financial system, largely because of the absence of formal capital markets. Banks provide financing to various sectors of the economy to uplift the economic situation of the country through real sectors of the economy. The contribution of the banking sector in economic growth of both developing and developed countries is substantial in size. Beck and Levine (2004) conducted research in 40 developing and developed countries. The research shows that stock market and bank financing engender positive impact on economic growth and development in the surveyed countries. In the last decade, Afghanistan witnessed strong economic growth and development. Growth in the financial sector, and specifically within the banking sector, was vital and considerable in size. National income increased manifold with improvements in most of the macroeconomic indicators, including exchange rate, inflation, balance of payments, government revenues, investment, international trade, industrial production, employment level, and the size of growth in real sectors of the economy. This paper analyzes relevant economic trends and their linkages with banking sector in the country. The first part of this paper highlights macroeconomic environment, while the second part discusses banking sector trends and their causes.

2. Macroeconomic Background

Afghanistan's economy has grown significantly in the past few years (WEO, 2014). Aggregate output increased in the agriculture, manufacturing, and service sectors of the economy. The average growth rate of the economy stood at 18 percent during 2003-2013. According to the IMF World Economic Outlook, the growth in nominal GDP jumped by 23 percent in 2012. However, IMF estimate shows drastic decline in gross domestic product to 11.08 percent in year 2013 and 8.76 percent in 2014. There is a widespread consensus among Afghan analysts that the decline in economic growth mainly results from deteriorating confidence in the Afghan economy due to the uncertain political outlook. Further details are depicted in figure 1.1. Afghanistan is an import-based economy wherein most of the domestic demand in various sectors of the economy is satisfied by imports. Bjornland (August, 1997) found that imported inflation plays a vital role in determining core inflation in Norway. Therefore, in Afghanistan, domestic inflationary pressures will not only depend on Afghanistan's own monetary policy, but also upon the level of inflation in its trading partners' own economies. During 2003-2008, Afghanistan's economy faced an average inflation of 13 percent. However, in 2009, deflationary pressures declined to ten percent. The decline in prices was mainly attributed to the decline in prices of commodities imported from trading partners, as well as a good agricultural harvest in Afghanistan. In 2012 and 2013, the price level remained at 5.8 and 7.2 percent respectively. The decline in prices is mainly attributed to declining aggregate demand due to political uncertainty in the country. Leduc and Liu (February, 2014) highlighted in their paper that uncertainty shocks are aggregate demand shocks. The paper highlighted that uncertainty shocks lead to macroeconomic shocks resulting in increase in unemployment, decline in inflation and nominal interest rate.

Figure 1.1: Gross Domestic Product (Current Prices, Percentage Change)

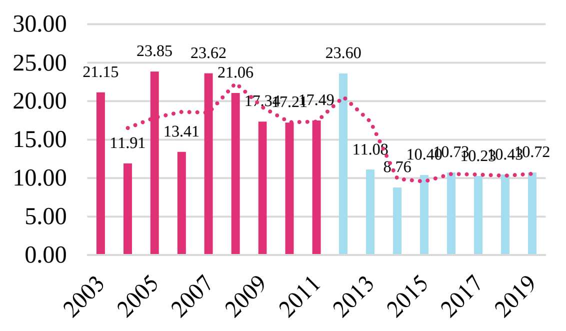
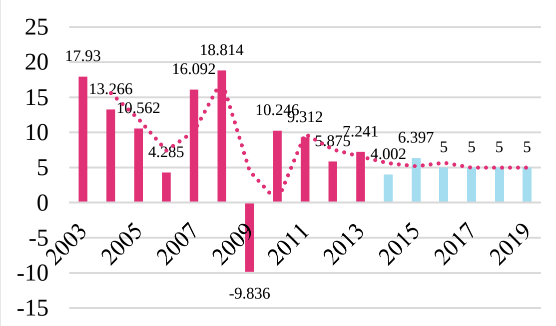


Figure 1.2: Inflation (End of Period, Percentage Change)



Source: World Economic Outlook (April, 2014), IMF

After significant reforms in various fronts intended to facilitate privatization and investment, the investment increase during 2002-2011 was phenomenal. The reforms in taxation, investment procedures, growing income and size of the market, a relatively better security environment, market for inputs, linkage with regional markets, availability of improved infrastructure, and improved communication inside the country are among the major reasons for the growth. The IMF estimates shows that investment declined to 18.6 and 18 percent in 2012 and 2013 respectively. The growth in investment was hampered due to upcoming elections and the pull-out of US combat forces from Afghanistan by the end of 2014.Enoma and Mustapha (2010) conducted research on factors impacting investment decisions in Nigeria. The paper’s findings included that political, economic, social, environmental and religious factors have significant impact on investment decisions.

On the other hand, in Afghanistan, gross national savings experienced a rapid increase during 2003-2011.However, after 2011, IMF estimates shows that there has been, and continues to be, a significant decline in gross national savings. Graphically, both investment and gross national savings show strong positive correlations. Further details are shown in figure 1.4.

Figure 1.3: Total Investment (Percentage Change)

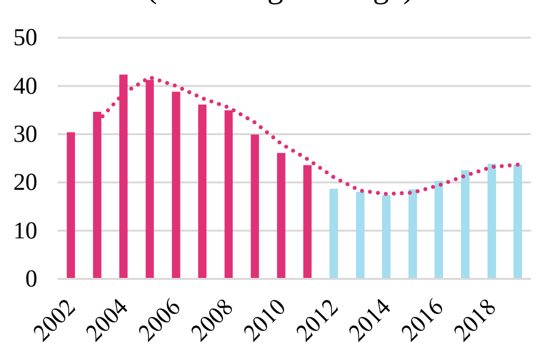
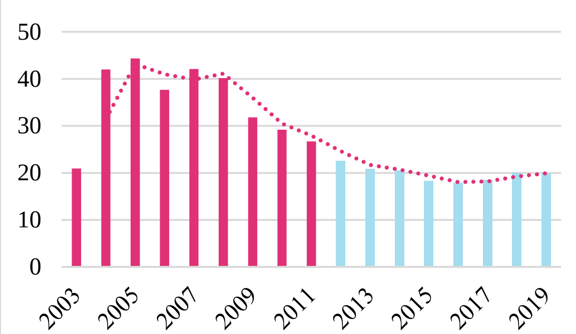


Figure 1.4: Gross National Saving (Percentage Change)



Source: World Economic Outlook (April, 2014), IMF

To cover domestic aggregate demand, Afghanistan mainly relies on imports of goods and services from its neighboring countries, and from other regional and international trading partners. Imports significantly increased in volume due to growing aggregate demand in the country. The level of growth in real sectors of the economy is significant but not sufficient, real sectors of the economy do not fulfill domestic demand. The Afghan economy primarily depends upon donor contributions/assistance from the international community. Similarly, Afghanistan has huge potential, and import substitutions, along with further industrialization, will be key factors for economic sustainability and for creating a broad-based and sustainable export base.

Imports, parenthetically, experienced sizeable declines in 2013, and are estimated to further decrease in 2014, largely due to declining consumer confidence, political uncertainty, and an overall unsustainable economy. Similarly, exports in volume remained below USD 1 billion and it showed insignificant increase as compared to 2012 and 2013, due to declining levels of trade in carpet, and dry and fresh fruit..

Figure 1.5: Volume of Imports of Good and Services (Percentage Change)

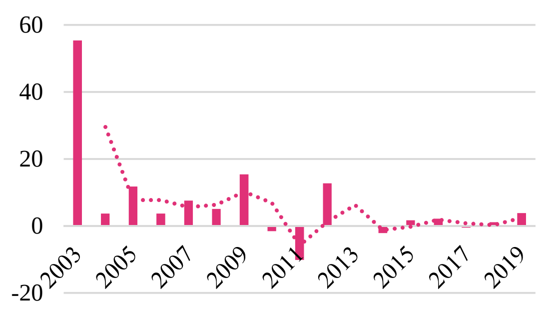
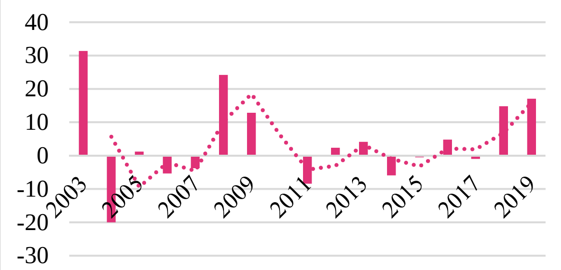


Figure 1.6: Volume of Exports of Goods and Services (Percentage Changes)



Source: World Economic Outlook (April, 2014), IMF

3. The Status of the Banking Sector and its Causes

The Afghanistan banking sector experienced phenomenal growth over the past ten years. It increased from few state-owned banks to 16 banks in the country. The growth in deposits and the size of the banking sector are two of the great outcomes of market economy reforms undertaken in the country. Over the recent years, growth in the size of the banking sector increase remained constrained due to growing economic and political uncertainty. Total long-term deposits held by the banking sector in the 4th quarter of 2013 decreased to AFN 207,799 million from AFN 208,881 million. The decline in total long-term deposits was mainly due to saving and time deposits. In countries where long- term deposits are declining (or remain low), political and economic uncertainty generally are to blame. Similarly, there was a significant decline in number of depositors in the last three quarters of 2013. Total depositors decreased from 3,402,417 to 2,695,139. Again, the decline in depositors can only be attributed to the declining aggregate economic activity, and the uncertain economic and political outlook.

Afghanistan Banks Association (ABA), through the support of USAID's "Financial Access for Investing in the Development of Afghanistan" (FAIDA), has been arranging regular access-to-finance and business-to-bank roundtables and exhibitions to expand financial inclusion in the country. These events provide a good platform for banks and businesses to discuss financing needs of businesses, and to understand different financial products available from the banking sector.

Total deposits and number of depositors are depicted in the following figure 1.7 and 1.8 respectively.

Figure 1.7: Total and Current Account Deposits (Million, AFN)

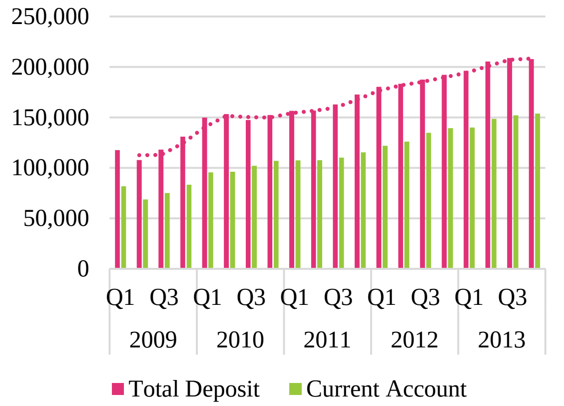
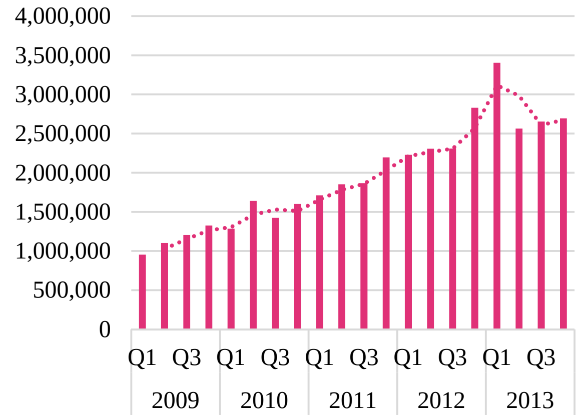


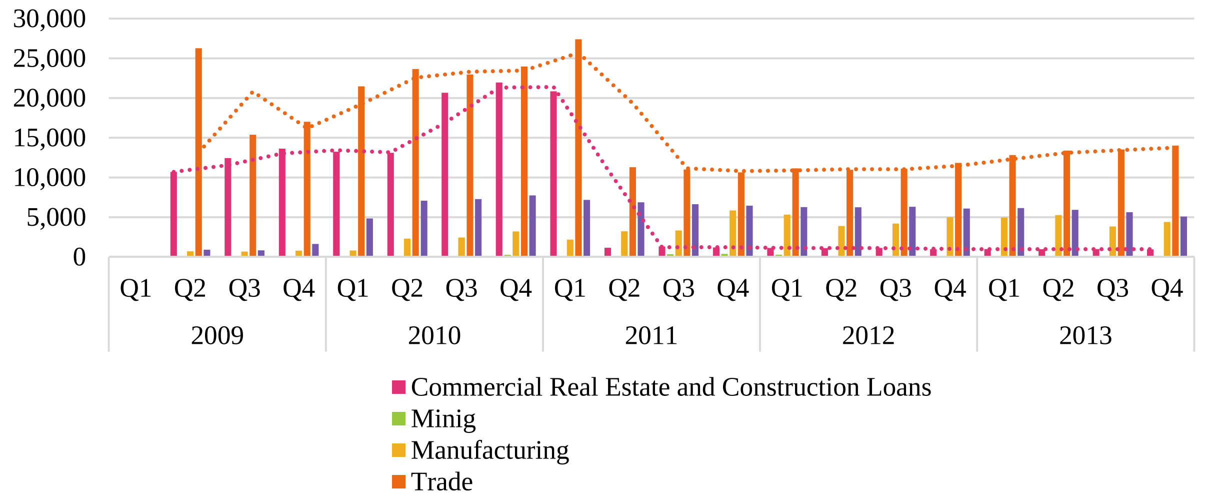
Figure 1.8: Total Banking Sector Depositors



Source: Da Afghanistan Bank (Central Bank of Afghanistan)

ABA member banks provide loans to various sectors of the economy, specifically in trading, real estate and construction, manufacturing, residential mortgage loans, communication, and agriculture sector. Bank financing plays a vital role in the Afghan economy. Gondwe, in her paper on *the Role of Financial Institutions in the Economic Development of Malawi: Commercial Banks Perspective* discussed the role of financial intermediation in economic development. The major findings included that improvements in the Malawi economy will not only depend on the development of financial intermediaries, but also on government commitment to maintaining a stable and encouraging economic environment. Before the announcement of US pull-out in 2012, loans in real estate and construction were large, due to high profitability. Afterwards, the decline in loans to the construction sector was mainly due to the declining real estate prices. Similarly, loans in the area of international trade declined due to declining activities and low aggregate demand in the country. The trend of commercial loans extended by banks the various sectors of the economy is shown in figure 1.9.

Figure 1.9: Commercial Loans Extended by Banks (Millions, AFN)



Source: Da Afghanistan Bank (Central Bank of Afghanistan)

Similarly, the number of bank borrowers reduced from 67,742 in the 3rd quarter of 2013, to 64,544 in the 4th quarter of 2013. The decline in the number of borrowers is mainly attributed to the declining willingness by banks to extend commercial loans, engendered by a more cautious and conservative approach by ABA member banks due to the 2014 presidential elections, and the withdrawal of combat troops of the US and its allies. The number of borrowers during 2009-2013 is depicted in the following figure 2.0. In response to the decline in economic activities, banks in Afghanistan increased their capital to strengthen their financial position. Total banking sector capital had significant increase from AFN 18,366 million to AFN 28,473 million (figure 2.1).

Figure 2.0: Total Bankign Sector Borrwers

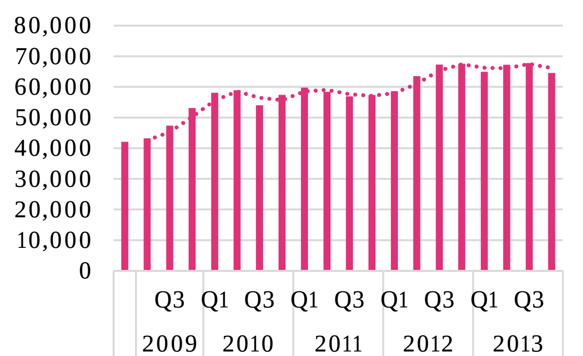


Figure 2.1: Total Banking Sector Capital (Millions, AFN)

Source: Da Afghanistan Bank (Central Bank of Afghanistan)

In any country, liquidity risk is one of the major risks in the banking sector. Banks are characterized as cash-flow insolvent if they are not able to make their payments when they fall due. In such an event, in any country, cash flow insolvent banks face regulatory intervention, including liquidation. Here in Afghanistan, however, in order to protect the interests of their depositors, the Afghanistan banks have remained liquid. The liquidity position of ABA member banks increased by68 percent in the last quarter of 2013. In the first quarter of 2014, liquidity position of the banks declined as compared to the same quarter a year ago. However, on average, liquidity position of the banking sector remained high in 2012 and 2013 as compared to 2010 and 2011. On the other hand, quality of assets improved, given that banking sector non-performing assets declined to 5 percent in the last quarter of 2013, as compared to 8 percent in 3rd quarter of 2013.

Figure 2.2: Banking Sector Liquidity (Percentage)

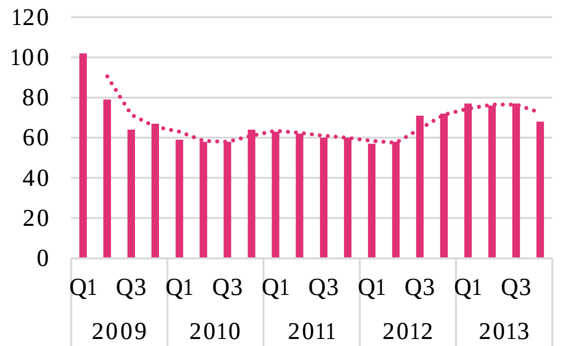
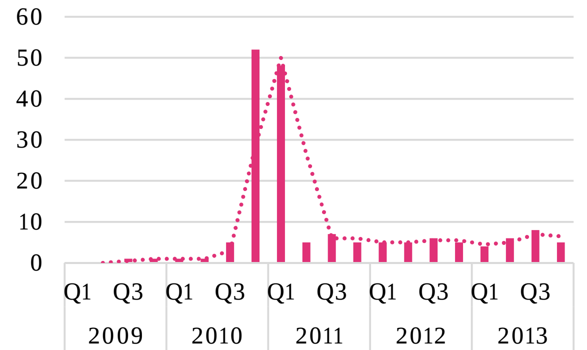


Figure 2.3: Banking Sector Non Performing Assets (NPA)



Source: Da Afghanistan Bank (Central Bank of Afghanistan)

In summary, the Afghanistan banking sector remained responsive to the economic and political situation in the country. However, the banking sector adopted a more cautious and conservative approach toward lending, and banks significantly increased their capital to ensure their stability. Due to strong credit and risk management mechanisms employed by the banks, their non-performing assets declined. Similarly, the liquidity position of Afghan banks was stronger in 2012 and 2013 than in previous years. The banking sector remained largely immune from the slowdown in economic activities in the country. Appropriate responses to the economic slowdown have been undertaken by banks to ensure their stability in the medium-to-long-term.

Acknowledgements

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