Is Afghani/US dollar depreciation a problem for Afghanistan?

AFGHANISTAN DEVELOPMENT BRIEF

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January 2019

Topic: Exchange rate

Afghanistan uses a ‘managed floating’ exchange rate regime, in which the value of the afghani is determined largely by market forces with moderate interventions by Da Afghanistan Bank. The currency’s value fluctuates in response to changes in supply and demand. Recent depreciation of the afghani against the United States dollar (US dollar) has spurred public and policy discussion regarding state of the economy and the appropriateness of current monetary policies.

In this note we discuss whether and to what extent recent currency depreciation is a problem for Afghanistan. We show that: i) depreciation against the US dollar has been modest and driven mostly by external factors; and ii) depreciation against the US dollar is not significantly driving inflation. Taking account of these realities, recent developments provide little justification for additional intervention aimed at stabilizing the afghani/US dollar exchange rate or any revisions to the overall monetary policy framework.

Why is the exchange rate important?

Changes in exchange rates can have significant distributional, welfare, and economic development impacts in any economy.

An appreciating exchange rate means that the afghani is worth more in foreign currency terms. An appreciation of the afghani increases the purchasing power of households that have income denominated in Afghans: they can purchase more imported goods with the same income in Afghans. Similarly, firms that rely on imported inputs and sell to the domestic market can purchase inputs at lower prices in domestic currency terms from abroad, increasing profitability.

In contrast, a depreciating exchange rate means that one afghani is worth less in foreign currency terms. If the afghani depreciates against its major trading partners, households will not be able to buy as much from abroad. A common concern associated with rapid depreciation is that households are driven into poverty or hardship through rapidly increasing prices for vital imported goods, including food. Rapid depreciation also make inputs costlier for Afghan producers that service domestic markets. It is more expensive for them to buy imported inputs, reducing their profitability.

Not everyone wins from an appreciation and loses from a depreciation, however. Industries engaged in exporting goods and services will often prefer a weaker
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When a currency depreciates, exports become cheaper in foreign-currency terms, allowing firms to reduce foreign-currency denominated prices and increase sales in foreign markets.

**How and why has the afghani/US dollar exchange rate been changing?**

The afghani has been depreciating gradually against the US dollar for several years. In 2018, the rate of depreciation against the US dollar accelerated, reaching a little under 9 percent. This depreciation has been caused by several factors.

Outflows of US dollars to neighboring economies may have played some role in recent depreciation. US dollar outflows have likely been partly driven by the increased purchasing power of US dollar in Iran in the context of recent sanctions, incentivizing informal cross-border outflows. Outflows may also have been driven by efforts of investors and citizens to move savings overseas in the context of current political uncertainty. With Afghans selling Afghanis to buy dollars, the price of dollars has increased, and the price of Afghanis has declined.

A much more significant factor, however, has been the global strengthening of the US dollar. As the US Federal Reserve moves to tighten monetary policy, investors around the world are moving their savings into US dollar to take advantage of higher US interest rates. As demand for US dollars increases, the US dollar has appreciated against most currencies around the world.

General appreciation of the US dollar against global currencies is shown in Figure 1, which presents changes in the value of the afghani and several other regional and international currencies against the US dollar since January 2018. The chart shows that recent depreciation of the afghani against the US dollar is not out of line with depreciation experienced by other countries. While the afghani depreciated by around 8.5 percent against the US dollar since January, the Sri Lankan rupee depreciated by around 15 percent while the Indian rupee depreciated by around 14 percent (before recovering recently). Reflecting broader macroeconomic imbalances and uncertainty, the Pakistani rupee depreciated at a much faster rate than any currency in the region, with a 22 percent depreciation against the US dollar since January 2018. The Euro depreciated by around 7 percent against the US dollar over the same period.

Finally, the chart also shows movements in the US dollar index which values US dollars against a basket of currencies comprised of the US major trading partners. Movement in the US dollar Index are roughly equivalent to changes in the afghani/US dollar exchange rate, providing further evidence that the strengthening US dollars is the main driver of recent afghani/US dollar depreciation.
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**Figure 1: Depreciation against US dollar – afghani and comparators**

*(Percent change)*

Is recent depreciation against the US dollar a problem?

Depreciation of the afghani might be considered beneficial to economic development if it was leading to competitiveness of exports. However, depreciation of the afghani might also be considered problematic if it was leading to rapid increases in prices for Afghan households and firms. These positive and negative impacts are not being realized for two main reasons.

The average exchange rate against all trade partners has appreciated during 2018

Firstly, not all of Afghanistan’s imports and exports are denominated in US dollars. As shown in Figure 2, Afghanistan’s largest markets for both imports and exports are Pakistan, India, China, and Iran, none of which use the US dollar as their currency (although some trade through these counties is denominated in United States dollars). The afghani/US dollar exchange rate therefore only has any impact on a limited proportion of Afghanistan’s total exports and imports. While the afghani is depreciating against U.S. dollars it has appreciated against most of its major trading partners.

Figure 3 shows the Nominal Effective Exchange Rate (NEER), which represents an aggregate measure of the strength of the afghani against its major trading partner and the Real Effective Exchange Rate (REER) which is the same measure adjusted for the effects of inflation.

These measures show that, in aggregate, taking account of the impacts of movements of the afghani against all relevant currencies, there has been very little movement in the overall value of the afghani over recent months relative to historical variations.

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**Figure 2: Afghanistan’s major import and export markets**  
(Percent of total by value)

**Figure 3: afghani Nominal and Real Effective Exchange Rate**  
(Index 2010 = 100)

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**Inflation remains modest**

Secondly, there is no evidence of rapid economy-wide inflation. Period average inflation has remained moderate at around 1.2 percent as of mid-September despite the extreme drought the country is facing. The cost of food items actually decreased by 1.9 percent. The cost of non-food items increased by only 2.3 percent, mostly driven by increasing international energy prices.
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Recent Afghani/US dollar depreciation is not a major problem for Afghanistan.

Figure 4: Consumer Price Index – food and non-food
(12 month percentage change)

What are the implications for policy?

Changes in a currency's value create different winners and losers, and depreciation can benefit the overall economy even if it leads to price increases. There can be valid concerns that rapid depreciation leads to inflation and therefore hardship for households and a decline in profitability for firms that rely on imported inputs to service the domestic market. All these effects depend on the extent to which local firms and households depend on imported items and how international prices are changing relative to local prices.

In Afghanistan’s case, most concerns around depreciation are not currently relevant. The depreciation of the afghani against the US dollar is in line with international trends and mostly driven by the overall strengthening of the US dollar. Further, Afghanistan's currency has been appreciating, on average, against trading currencies despite the depreciation against the US dollar. Accordingly, inflation remains moderate with food prices declining over the past year.

Overall, there is little reason to believe that the depreciation of the afghani against the US dollar is causing major hardship or difficulty for firms and households. Recent experience of depreciation against the US dollar does not, in itself, provide strong justification for further exchange rate intervention or any broader revision to the existing monetary policy framework.