

## The Effect of Dollarization on the National Economy of Afghanistan

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| ARTICLE INFO  | ABSTRACT  |
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| <p><b>Article History:</b><br/> Received: October 17, 2025<br/> Revised: November 28, 2025<br/> Accepted: December 12, 2025<br/> Available Online: December 19, 2025</p> <p><b>Keywords:</b><br/> GDP, Investment, Employment, Inflation and National Economy</p> <p><b>Corresponding Author:</b><br/> Hayat Ullah<br/> Email: <a href="mailto:hayatkhan477@gmail.com">hayatkhan477@gmail.com</a></p> | <p><i>Dollarization has been consistently high in Afghanistan despite relatively low inflation and developments towards central bank independence in last few years. This paper begins with providing definition of different strands of dollarization then goes on to present stylized facts and trends of dollarization in Afghanistan. The main content of this paper focuses on pros and cons of dollarization in Afghanistan especially emphasizing on loss of seigniorage, currency mismatch and loss of central bank's role as a lender of last resort. In this paper we have also tried to shed some light on the dollarization phenomenon in Afghanistan and to address the posed questions regarding the short-term and long term effects of dollarization on the economic stability of the country. At the end, we will conclude our findings in the form of some policy recommendations for the monetary authorities Afghanistan for the purpose of dealing the issue of dollarization in the country. It should be noted that we have conducted our study mostly based on literature review and study of similar cases around the world.</i></p> |



### Introduction

Gross Domestic Product is one of the mainly broadly used measured for measuring the dimension and performance of economy. It represent the total financial worth of all ending supplies and services created within a country's limits during a particular period, typically quarterly or yearly (World Bank, 2023). As a inclusive compute of national output, GDP provide strategy makers, researchers, and global organizations with a key standard for compare economic show crosswise countries and in excess of time.GDP expansion, in exacting, reflects the speed of boost in a nation's creative ability and generally economic action. A positive development rate generally indicate extension, growing incomes, and enhanced standards of livelihood, while negative development signals reduction and possible economic suffering (OECD, 2022). Measuring GDP growth is therefore central to macroeconomic study, as it allows governments to charge the efficiency of their policies, observe inflationary pressures, and appraises long-term growth

strategies (Mankiw, 2020). However, GDP development as meter also has its limits. It does not fully imprison issues such as income dissimilarity, ecological sustainability, or the casual economy, which are predominantly relevant in mounting countries (Stiglitz, Sen, & Fitoussi, 2009). Despite these short comings, GDP development remains an essential tool for considerate macroeconomic dynamics and guide evidence-based financial policy. This study paper focuses on the thought of GDP development, its dimension, determinants, and implications for public economies. By investigative hypothetical foundations and experiential evidence, the learning aims to emphasize both the strengths and boundaries of GDP growth as a calculate of economic development.

Employment is a vital pillar of economic growth and social strength. It refers to the appointment of individuals in industrious activities that produce income, add to national output, and improve overall welfare (ILO, 2022). The level and excellence of employment in a country are broadly regarded as key indicators of financial health, as they straight sway poverty decrease, income sharing, and living principles. In macroeconomic study, employment is directly linked to development, inflation, and efficiency. According to classical economic hypothesis, higher employment levels drive collective demand and rouse production, while being without a job reflects underutilization of human resources and imposes communal and economic expenses (Mankiw, 2020). Employment is not only a basis of income but also an instrument for social addition, human capital growth, and political constancy. Despite its consequence, employment leftovers a main test in both residential and developing economies. Issues such as, underemployment, casual labor, and ability mismatches carry on to limit the ability of effort markets to take up an increasing workforce (World Bank, 2023). The International Labor association estimates that worldwide unemployment has remain tirelessly high in many regions, exacerbated by structural factors and financial crises (ILO, 2022). In rising countries, employment challenges are often intensify by weak institutions, dependence on casual sectors, and limited manufacturing diversification. For example, much of the labor force leftovers trapped in low-productivity jobs, contribution incomplete security and income constancy (Todaro & Smith, 2020). Addressing these challenges requires not only financial growth but also embattled labor marketplace policies, career training, and speculation in education to get better employability. This study paper seeks to investigate the dynamics of employment, its determinants, and its implications for sustainable financial growth. By exploring both hypothetical perspectives and experiential evidence, the revise aims to show up the role of employment in influential economic wealth and social comfort

Inflation is one of the most important macroeconomic indicators, reflecting the general increase in the prices of goods and services over time. It directly affects purchasing power, cost of living, investment decisions, and economic stability. Economists define inflation as the sustained rise in the overall price level within an economy, usually measured by indices such as the Consumer Price Index (CPI) or the GDP deflator (Mankiw, 2020). The study of inflation is central to macroeconomics because of its close relationship with development, employment, and monetary policy. Moderate inflation is often seen as a natural outcome of economic growth, while high or hyperinflation undermines currency constancy, reduces real wages, and erodes savings (Blanchard, 2017). constant inflation may also deject investment and decline international competitiveness, creating long-term challenges for sustainable growth. Globally, policymakers and central banks use a mixture of monetary policy tools (such as interest rates and money supply management) and fiscal policy measures to control inflation. The International Monetary Fund (IMF) emphasizes that price stability is essential for maintaining investor confidence and protecting vulnerable groups in society (IMF, 2023). However, controlling inflation is complex, as it can be driven by multiple factors including demand-pull pressures, cost-push shocks (e.g., rising energy prices), and structural weaknesses in production and distribution. In developing countries, inflation often poses

a more severe challenge due to weak institutions, currency depreciation, reliance on imports, and exposure to external shocks. Studies show that inflation disproportionately affects low-income households by reducing their purchasing power and worsening poverty levels (Todaro & Smith, 2020). Given its far-reaching consequences, understanding the causes, trends, and impacts of inflation remains critical for both economic policymakers and researchers. This research paper aims to explore the concept of inflation, its determinants, and its implications for overall economic stability and development.

Investment is a fundamental driver of economic growth and development. In economics, investment refers to the allocation of resources, particularly capital, into productive assets such as machinery, infrastructure, technology, and human capital, with the expectation of generating future returns (Samuelson & Nordhaus, 2010). It is a key component of Gross Domestic Product (GDP) and plays a central role in stimulating innovation, enhancing productivity, and expanding the overall capacity of an economy. Investment can be broadly categorized into domestic investment and foreign direct investment (FDI). Domestic investment reflects the confidence of local businesses and households in the economy, while FDI brings in not only financial capital but also technology transfer, managerial expertise, and access to international markets (Todaro & Smith, 2020). Both forms of investment are essential for long-term development and poverty reduction. The significance of investment is highlighted in growth theories, such as the Solow growth model, which emphasizes capital accumulation as a determinant of output expansion (Mankiw, 2020). Empirical studies further show that higher investment rates are strongly associated with sustained economic growth, employment generation, and structural transformation in developing economies (World Bank, 2023). However, the flow of investment is influenced by multiple factors, including political stability, macroeconomic policies, infrastructure quality, financial market development, and the legal environment. In countries with weak institutions, high corruption, or political uncertainty, investment levels remain low despite the presence of abundant natural or human resources (UNCTAD, 2022). Given its importance, investment is a critical area of study for policymakers and researchers. This research paper examines the role of investment in fostering economic growth, explores its determinants, and analyzes the challenges that hinder capital accumulation in developing economies. In recent years, Afghanistan has experienced **deflation** rather than inflation: for example, the year-on-year consumer price index (CPI) rate turned negative for much of 2024, reaching around  $-9.7\%$  in February 2024. This deflationary period was mainly driven by sharply declining food prices and weak aggregate demand. By early 2025, inflation began to edge back into positive territory: for example, year-on-year inflation was reported at about  $0.1\%$  in April 2025, up from  $-7.5\%$  a year before World Bank (2025). Employment is a central pillar of economic and social well-being. Broadly defined, employment refers to the state in which individuals engage in productive work—in return for wages or as self-employed—and thereby contribute to the production of goods and services in an economy (Piana, 2001). From a conceptual standpoint, the GDP metric plays several key roles in economic research and policy-making. First, as a measure of output it helps to track economic growth (or contraction) over time: rising GDP implies expansion, while declining GDP may signal recession or stagnation. Second, the composition of GDP (such as consumption, investment, government spending, net exports) helps analysts understand the underlying drivers of economic activity (Badejo & Adekeye, 2010). Measurement and classification of investment matter for research. Economists typically distinguish between gross investment and net investment (after depreciation), between real investment (in productive capital) and financial investment (purchase of securities) and between domestic and foreign investment (Pettinger, Tejvan, 2020).

### **Problem statement**

Afghanistan's economy has long faced structural weaknesses, including political instability, weak institutions, and a fragile banking system. In recent years, the widespread use of the U.S. dollar alongside the Afghan Afghani (AFN) has led to increasing levels of partial dollarization. While dollarization is often seen as a tool to stabilize economies by reducing inflation and enhancing foreign trade, in Afghanistan it has also created significant challenges. On one hand, dollarization in Afghanistan reflects low public trust in the national currency due to persistent inflation, exchange rate volatility, and limited monetary policy credibility. On the other hand, it limits the ability of the Afghan government and central bank to exercise effective monetary policy, weakens the role of the AFN in domestic transactions, and reduces government revenue through the loss of seignior age. Moreover, heavy reliance on the U.S. dollar makes Afghanistan's economy more vulnerable to external shocks, global financial fluctuations, and restrictions on U.S. currency flows—especially under the current political and economic conditions. This dependency raises concerns about the sustainability of economic sovereignty, trade competitiveness, and financial sector stability. Therefore, understanding the effects of dollarization on Afghanistan's national economy is crucial. It is important to investigate whether dollarization contributes to macroeconomic stability or whether it deepens the structural problems of the Afghan economy, thereby limiting future economic growth and development.

### **Research objective**

- 1- To analyze the impact of dollarization on inflation and monetary stability in Afghanistan.
- 2- To assess how dollarization (GDP) affects the national economy of Afghanistan.
- 3-To investigate the relationship between dollarization (investment)and the national economy of Afghanistan
- 4-To evaluate the impact of dollarization (employment) on the national economy of Afghanistan.
- 5- To determine how dollarization (inflation) influences the national economy of Afghanistan.

### **Research question**

- 1- What is the overall effect of dollarization on Afghanistan's national economy?
- 2- How does dollarization (GDP) affects the national economy of Afghanistan?
- 3- To what extent does dollarization (investment) and the national economy of Afghanistan?
- 4- What role does dollarization (employment) on the national economy of Afghanistan)?
- 5- How does dollarization (inflation) influences the national economy of Afghanistan?

### **Significant of the study**

The study on the effect of dollarization on the national economy of Afghanistan is of great importance as it provides a deeper understanding of how the widespread use of foreign currency influences the country's economic performance and financial stability. Afghanistan's economy has long been characterized by a high degree of dollarization, where the U.S. dollar is commonly used in trade, savings, and even daily transactions. This situation has direct implications for monetary sovereignty, exchange rate stability, inflation control, and the effectiveness of national fiscal policies. The findings of this study can assist policymakers, particularly those in Da Afghanistan Bank and the Ministry of Finance, in developing appropriate strategies to strengthen the Afghani, improve monetary control, and promote economic resilience. Moreover, the research is significant

for investors and the private sector, as it provides valuable insights into the risks and opportunities associated with operating in a dollarized economy. By understanding how dollarization affects inflation, exchange rate movements, and financial market confidence, investors can make more informed decisions, thereby contributing to a more stable business environment. Academically, this study fills a gap in the limited literature on dollarization in post-conflict and developing economies, especially in the unique context of Afghanistan, where economic instability, dependence on foreign aid, and weak financial systems have encouraged the use of foreign currency. The study also holds social importance by increasing public awareness of the broader economic consequences of dollarization and the benefits of supporting the national currency. Encouraging greater confidence in the Afghani can strengthen national identity, enhance financial inclusion, and contribute to long-term economic independence. Overall, this research provides valuable contributions to economic policymakers, financial institutions, investors, and scholars, while serving as a foundation for future studies on currency substitution and its impact on developing economies like Afghanistan.

## **Literature Review**

**Gross Domestic Product (GDP)** is widely recognized as the most important measure of a nation's overall economic performance. It represents the total market value of all final goods and services produced within a country over a specified period, typically quarterly or annually (World Bank, 2023). Since its introduction by Simon Kuznets in the 1930s, GDP has become the standard indicator used by governments, international organizations, and researchers to assess the size and growth of economies (Kuznets, 1934). Classical and neoclassical economists argue that GDP growth is primarily driven by capital accumulation, labor input, and technological progress. According to the Solow Growth Model, long-term increases in GDP depend more on technological innovation than on mere increases in capital and labor (Solow, 1956). Keynesian theory, however, emphasizes the role of aggregate demand and government spending in influencing short-run GDP fluctuations (Mankiw, 2020). Empirical studies highlight multiple factors that influence GDP growth, including investment, trade openness, human capital, infrastructure, and institutional quality. For instance, Barro (1991) found that education and political stability strongly contribute to higher GDP growth in developing economies. Similarly, international trade and foreign direct investment (FDI) are seen as key channels for enhancing productivity and expanding output (Todaro & Smith, 2020). Despite its widespread use, scholars have criticized GDP as an incomplete measure of welfare. Stiglitz, Sen, and Fitoussi (2009) argue that GDP does not account for environmental sustainability, income inequality, or non-market activities such as unpaid household work. Similarly, Daly and Cobb (1989) emphasized that GDP growth can coexist with declining social well-being if issues like resource depletion, pollution, and inequitable wealth distribution are ignored. Global trends show that sustained GDP growth is associated with higher living standards and poverty reduction, particularly in East Asian economies such as China and South Korea (World Bank, 2020). In contrast, many low-income and fragile states experience stagnant or volatile GDP growth due to political instability, weak institutions, and reliance on external aid. Overall, the literature suggests that while GDP growth remains a vital indicator of economic performance, it should be analyzed alongside other social and environmental factors to gain a holistic understanding of development. Its determinants vary across contexts, but investment, education, trade, and governance consistently emerge as key drivers of long-term economic growth.

**Employment** is a critical component of economic development, as it reflects the degree to which a nation utilizes its human capital in productive activities. Economists widely agree that employment contributes not only to income generation but also to social inclusion, poverty reduction, and political stability (ILO, 2022). Classical economists, such as Adam Smith and David Ricardo,

considered labor as a fundamental factor of production and argued that free markets naturally adjust to achieve full employment in the long run. Keynes (1936), however, challenged this view by highlighting that economies could remain in prolonged periods of unemployment without government intervention. According to Keynesian theory, aggregate demand plays a central role in determining employment levels, and public policies such as fiscal stimulus are necessary to correct labor market imbalances (Keynes, 1936). The literature identifies multiple factors affecting employment, including economic growth, technological change, education, and institutional quality. Okun's Law, for example, demonstrates a strong relationship between GDP growth and employment creation, where higher economic output tends to reduce unemployment (Mankiw, 2020). Additionally, investment in human capital—through education and training—has been shown to enhance employability and labor productivity (Todaro & Smith, 2020). Despite its importance, employment faces persistent challenges worldwide. The International Labour Organization (ILO) highlights global issues such as high youth unemployment, underemployment, informal labor, and gender disparities in labor markets (ILO, 2022). In many developing countries, a significant share of the workforce is employed in low-productivity informal sectors, limiting income stability and social protection. Structural unemployment, caused by mismatches between labor skills and market demands, is also a recurring problem in both advanced and developing economies. Employment is not only an economic variable but also a social development indicator. According to the United Nations Development Programme (UNDP, 2021), quality employment contributes to human development by providing individuals with dignity, empowerment, and improved living standards. Furthermore, inclusive employment policies are essential for reducing inequality and promoting sustainable development.

Inflation is one of the most closely monitored macroeconomic indicators, reflecting a sustained rise in the general price level of goods and services within an economy over time. Economists broadly agree that moderate inflation is a natural outcome of economic growth, whereas high or hyperinflation can destabilize economies, reduce purchasing power, and erode savings. Economic theories classify inflation into different types, primarily demand-pull inflation and cost-push inflation. Demand-pull inflation occurs when aggregate demand exceeds aggregate supply, often during periods of rapid economic growth (Keynes, 1936). Cost-push inflation arises from rising production costs, such as wages or raw materials, which are passed on to consumers (Blanchard, 2017). Modern monetary theory emphasizes the role of money supply in influencing inflation. Milton Friedman famously argued that “inflation is always and everywhere a monetary phenomenon,” highlighting the need for careful management of the money supply to maintain price stability (Friedman, 1963). Central banks across the world use interest rates, reserve requirements, and other monetary tools to control inflation and anchor expectations. Empirical studies indicate that inflation is influenced by both internal and external factors. Internal determinants include monetary expansion, fiscal deficits, and structural rigidities in the economy. External determinants involve global commodity price fluctuations, exchange rate movements, and imported inflation (IMF, 2023). In developing countries, inflation often results from a combination of weak institutions, reliance on imports, and currency depreciation. Inflation affects various aspects of the economy. Moderate inflation can encourage investment and spending, as holding money loses value over time. However, high inflation leads to uncertainty, discourages savings, reduces real incomes, and disproportionately impacts low-income households (Todaro & Smith, 2020). Hyperinflation can destabilize entire economies, as seen historically in countries like Zimbabwe and Venezuela. Inflation is measured using price indices, most commonly the Consumer Price Index (CPI) and the GDP deflator. The CPI tracks changes in the cost of a typical basket of goods and services consumed by households, while the GDP deflator captures price changes for all goods and services produced domestically (World Bank, 2023). Accurate

measurement is critical for designing monetary policies and assessing the real growth of the economy.

Investment is a crucial driver of economic growth and development. Economists define investment as the allocation of resources, especially capital, into productive assets, with the expectation of generating future returns. Investment contributes not only to the accumulation of physical and human capital but also to technological advancement, productivity growth, and overall economic expansion (Samuelson & Nordhaus, 2010). Investment is broadly categorized into domestic investment and foreign direct investment (FDI). Domestic investment reflects confidence of local businesses and households in the economy, whereas FDI brings capital inflows, advanced technology, managerial expertise, and access to international markets (Todaro & Smith, 2020). Both types of investment are vital for achieving sustained economic growth, reducing unemployment, and promoting structural transformation. Investment is broadly categorized into domestic investment and foreign direct investment (FDI). Domestic investment reflects confidence of local businesses and households in the economy, whereas FDI brings capital inflows, advanced technology, managerial expertise, and access to international markets (Todaro & Smith, 2020). Both types of investment are vital for achieving sustained economic growth, reducing unemployment, and promoting structural transformation. Classical growth theories, such as the Solow-Swan model, emphasize the role of capital accumulation in increasing output and GDP growth (Solow, 1956). Endogenous growth theories further highlight the importance of human capital, innovation, and knowledge spillovers in enhancing investment efficiency and productivity (Romer, 1990). Investment is thus seen not only as a monetary activity but also as a critical mechanism for technological progress and long-term development. Empirical studies show that investment levels depend on multiple factors, including:

**Macroeconomic stability:** Inflation, interest rates, and exchange rate stability influence investment decisions (IMF, 2023).

**Institutional quality:** Political stability, property rights, and ease of doing business are key for attracting both domestic and foreign investment (World Bank, 2023).

**Infrastructure and human capital:** Adequate infrastructure and skilled labor enhance investment productivity (Todaro & Smith, 2020). Investment has a significant impact on economic growth, employment, and technological development. Higher investment levels are associated with increased production capacity, job creation, and improvements in living standards. FDI also has additional benefits by introducing new technologies, management practices, and market linkages that domestic firms can adopt (OECD, 2022). Despite its importance, investment in developing countries faces challenges such as political instability, corruption, weak financial systems, and lack of infrastructure. These constraints often result in low investment levels, hindering economic growth and job creation (UNCTAD, 2022).

## **Methods and Material**

### **Descriptive Analysis**

This type of analysis provides an overview of the current and historical situation of dollarization in Afghanistan.

It includes:

- Describing trends in the use of the U.S. dollar versus the Afghani (AFN).
- Examining changes in key economic indicators such as inflation, GDP growth, employment, and investment.

- Summarizing data in tables, graphs, and percentages.
- To understand the general pattern and extent of dollarization and its basic economic implications.

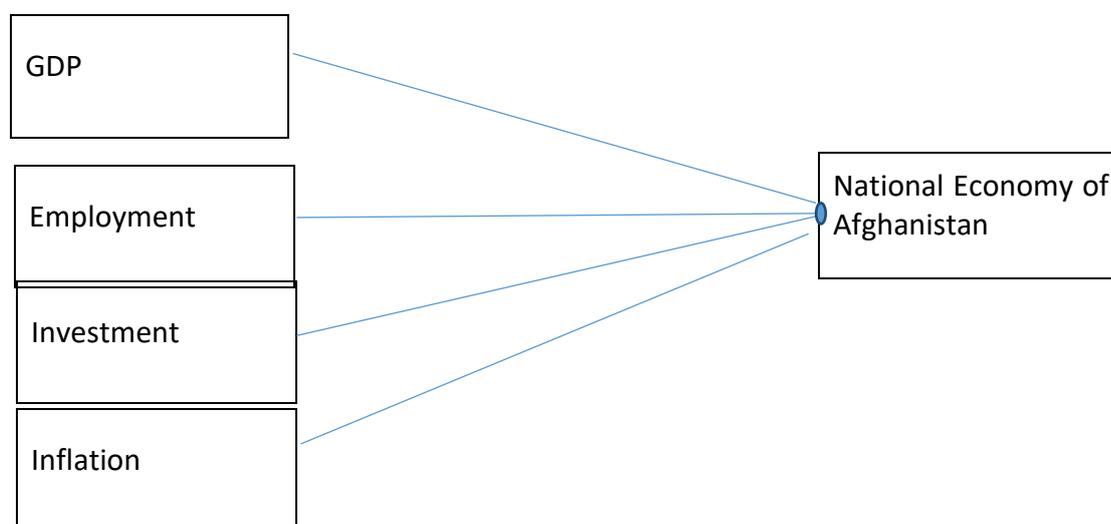
### **Time-Series Analysis**

Historical economic data are available, time-series analysis can be conducted to:

- Track the trend of dollarization over time.

Examine how economic variables behaved before and after major events. To assess long-term patterns and causality between dollarization and economic performance.

### **Conceptual framework**



## **Analysis**

### **Trends and Measures of Unofficial Dollarization in Afghanistan:**

#### **Measures of unofficial dollarization:**

The total stock of foreign currency being held by residents of a country determines the degree of dollarization in that country. The total stock of foreign currency is comprised of foreign currency deposits (FCD) in the domestic banking system and foreign currency in circulation (FCC). To measure the degree of dollarization various ratios including the ratio of foreign currency deposits to local currency deposits (FCD/LCD), the ratio of foreign currency deposits to total domestic deposits and the ratio of foreign currency deposits to money supply (FCD/M2) are commonly used. Besides the foreign currency deposits, businesses and households maintain a big portion of their wealth in foreign denominated currencies, mainly in the US dollar. In contrast to foreign currency deposits which are easy to measure, it is very difficult to measure the amount of foreign currency being held by people in the form of cash. Despite the difficulties in measurement, there are some indirect methods to estimate the FCC in the country. To estimate the stock of foreign currency in circulation (FCC) in Afghanistan, we have used a method proposed by Erasmus, Leichter and Menkulasi in their joint work on Dollarization in Liberia. To get to an estimation of the foreign currency in circulation, they used the money supply process and assumed an identical money multiplier for both domestic and foreign currencies. Since the assumption of identical

money multiplier for both domestic and foreign currencies plays a central role in estimation of the stock of foreign currency in circulation in this method, therefore, the robustness of the outcome is highly dependent on plausibility of this assumption.

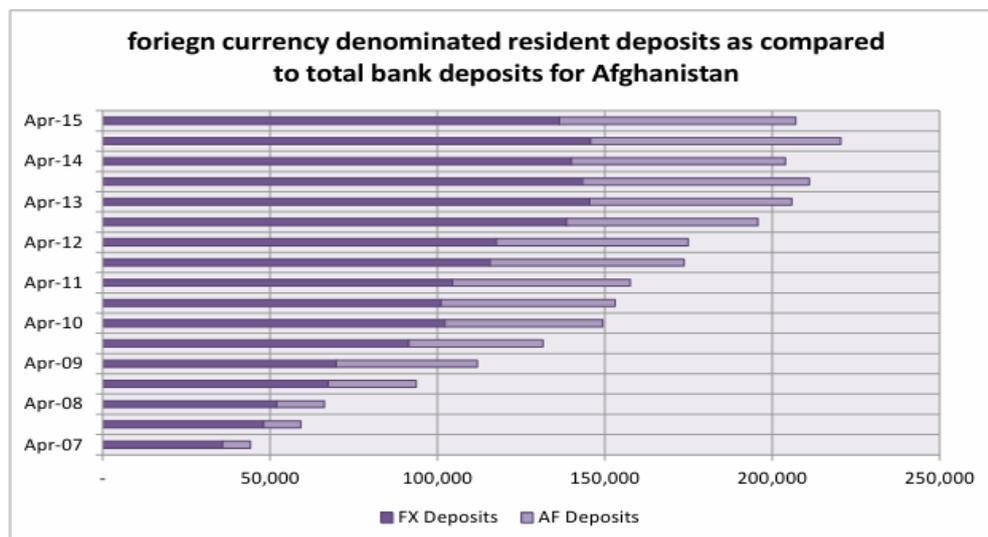
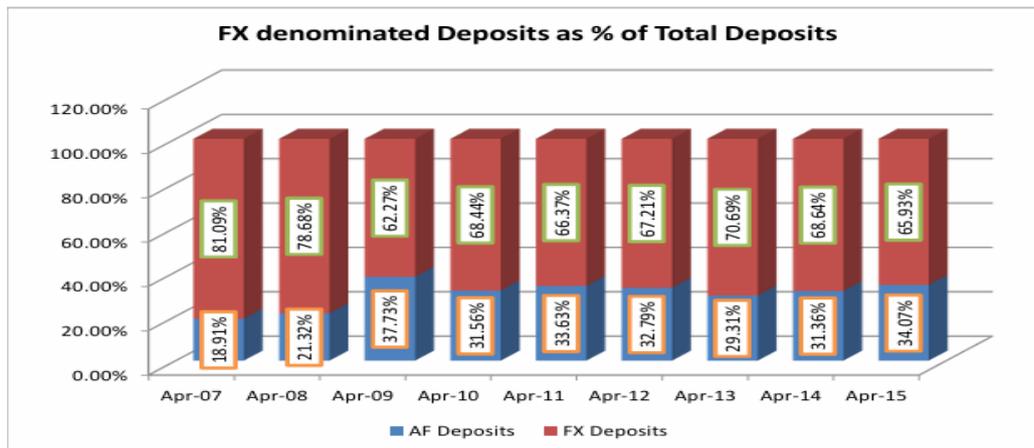
### **Estimation of Foreign Currency in Circulation in Afghanistan:**

Since Afghanistan is a cash-based economy, there is a substantial foreign currency in circulation and in order to get a reliable estimation of dollarization in Afghanistan we must take this measure into account. In this paper we have used the same method used by Erasmus et al. in estimation of foreign currency in circulation for Liberia. The assumption of same money multiplier for both domestic and foreign currencies, which is the backbone of this method, is a plausible assumption in case of Afghanistan. We provide two reasons for this claim: first, a less developed banking system and second, same required reserve ratio for both domestic and foreign currency deposits. Using the available data on total value of deposits available in our banking system and with a money multiplier of 1.25, we estimated the total value of foreign currency in circulation from December 2002 up to April 2010 to be equivalent to 476 billion Afghanis. This method generates a high estimate for foreign currency in circulation. It would therefore be reasonable to assume that this figure could rather be regarded as an upper bound of the stock of foreign currency in circulation in the country.

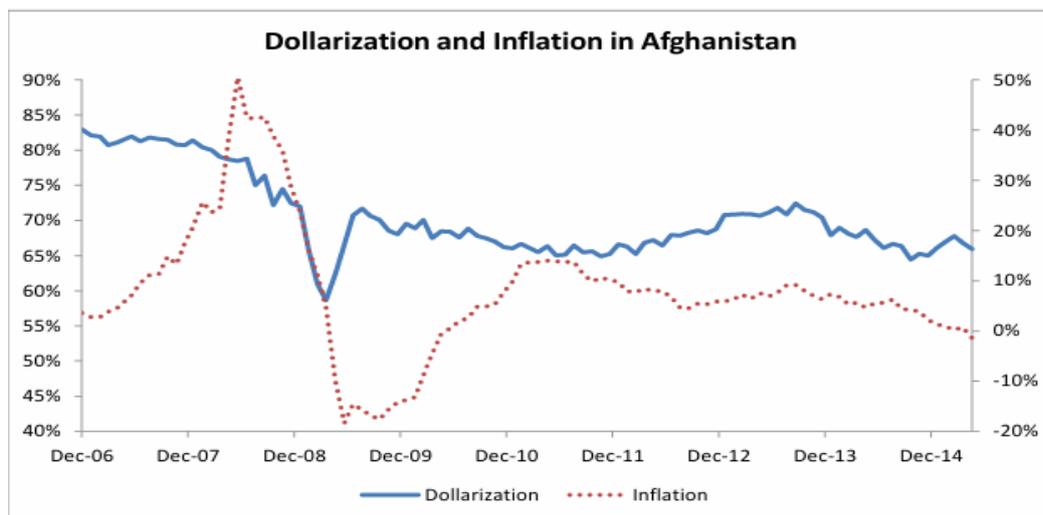
### **Dollarization in Afghanistan**

Afghanistan is a small open economy which is heavily reliant on imports. Although the country has experienced developments over the last decade but it has not yet found sustainable sources of growth. The GDP of the country is around \$20 billion and the country is confronting with severe fiscal and trade deficit. Among all the economic challenges Afghanistan is facing dollarization poses most dominant hurdle in way of achieving macroeconomic stability. The phenomenon of dollarization took tremendous momentum in Afghanistan during civil war. In the late 90s political parties were printing their own Afghani banknotes to finance their expenses; excessive supply of Afghani currency in the market surged the inflation to astronomical levels. Consequently various foreign currencies including Pakistani Rupees and Iranian Toman were extensively used as a medium of exchange alongside Afghani. The lack of confidence on demand side coupled with large inflows of aids to different political parties provided impetus for speedy dollarization. It is worth mentioning that the lack of financial and banking system in the country during civil war also played its part in expediting dollarization in Afghanistan. However, the end of civil war saw a further increase in dollarization in Afghanistan, tremendous amount of inflows of international donations for reconstruction process coupled with repatriation of Afghan resident's deposits abroad catapulted foreign currency deposits to an unprecedented level. Despite the introduction of New Afghani currency in 2002, Afghan monetary authorities couldn't reverse dollarization hysteresis in the country, albeit the introduction of New Afghani currency was effective in restoring some degree of confidence in domestic currency. The dollarization in Afghanistan reached to its all-time high level of 81.09% in April 2006, measured in terms of percentage of foreign currency denominated residents deposits as compared to total bank deposits for Afghanistan. Following a series of fluctuations dollarization was recorded lowest in 2009, 62.27%. Unstable inflation, devaluation, bank failures and most important of all economic uncertainty augmented dollarization in the years following 2009, as of April 2010 the dollarization ratio in Afghanistan stood at 65.93%. Consequently, U.S. dollar has become a de facto currency along with the national currency, Afghani. As a result, Afghanistan has been confronting with free circulation of multiple currencies within its territory, to the extent that the dollar has become the dominant currency and weakening the role of Afghani currencies as legal tender. The foreign currency deposits are dominant, while the usage of Afghani currency is very limited; Government

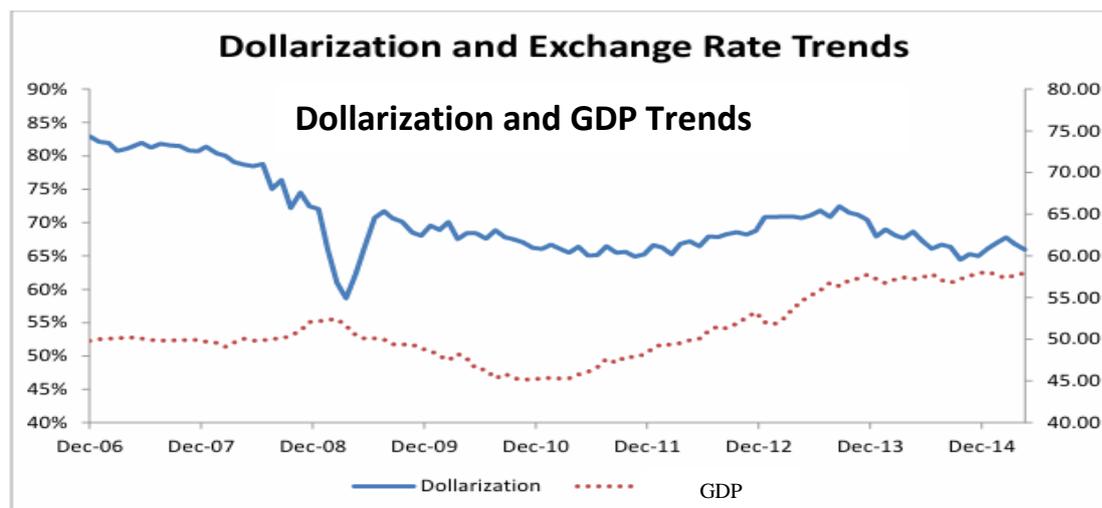
authorities often use Afghani for execution of budget, including the payment of taxes and salaries of civil servants.



Baliño et. al. (1999) defines highly dollarized countries as those whose foreign currency denominated deposits ratio exceed 30% of total deposits. According to this definition, Afghanistan having foreign currency deposit ratio of 65.93% can be characterized as a "highly" dollarized economy. The main drivers of dollarization in Afghanistan has been economic and political instability, inflation differential between Afghani and foreign currency (US dollar), and relatively low transaction costs for acquiring foreign currency; dollarization has become widespread as the residents restrain from holding domestic currency due to its high holding cost. However, inflation has been relatively low in the last few years but it couldn't reduce dollarization level in the country. A thorough analysis of the relation between inflation and dollarization in Afghanistan depicts a weak relationship between the two variables as shown in the figure below. As shown in the figure below, in April 2006 inflation stood at 3.59% and dollarization hit record high, peaked at 82.93%. However, in following year inflation gained momentum while dollarization kept decreasing, in the early 2009 both inflation and dollarization plunged to record low levels albeit inflation took a much deeper dip than dollarization. From 2009 onward both inflation and dollarization have had relatively similar trend. The available data suggests that the correlation between dollarization and inflation in the country is 0.361, which is very weak.



Some economist such as Ize and Levy (1998 and 2003) argue that risk averse borrowers and lenders prefers to denominate contracts in foreign currency when its purchasing power is relatively stable than domestic currency, hence exchange rate volatility becomes the bigger driver of dollarization. However, our findings paint a different picture, exchange rate volatility does not seem to be one of the major contributors to dollarization in Afghanistan. As per our calculations, the correlation between dollarization and exchange rate, as expected, is negative but very insignificant (-0.09).



### Pros and Cons of Unofficial Dollarization

In this part of the paper we discuss the disadvantages of increased dollarization and the challenges associated with this phenomenon in the context of Afghanistan by generalizing our finding from literature review. The potential economic costs associated with dollarization are as follow.

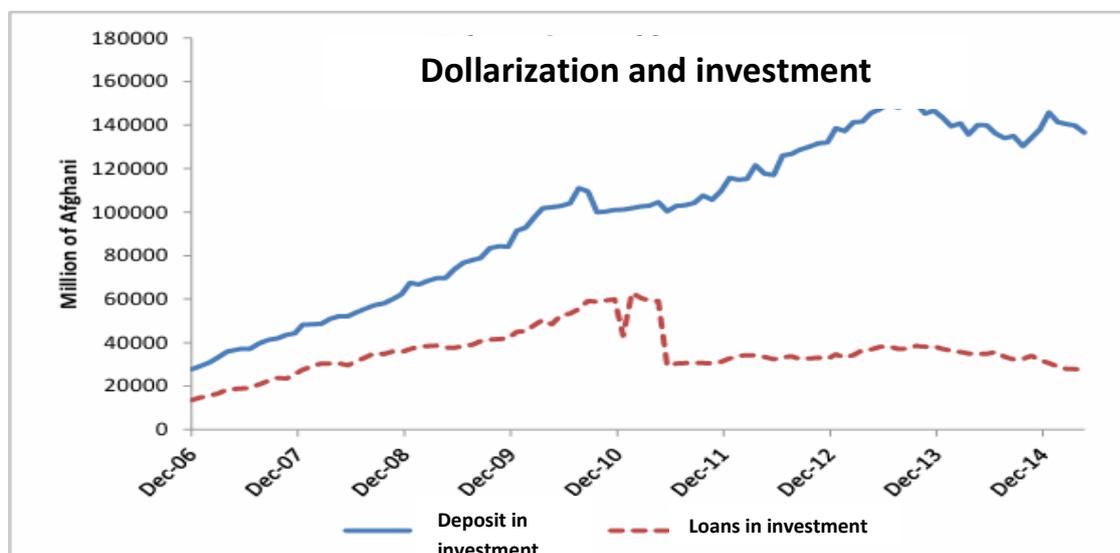
#### Costs Associated with Dollarization:

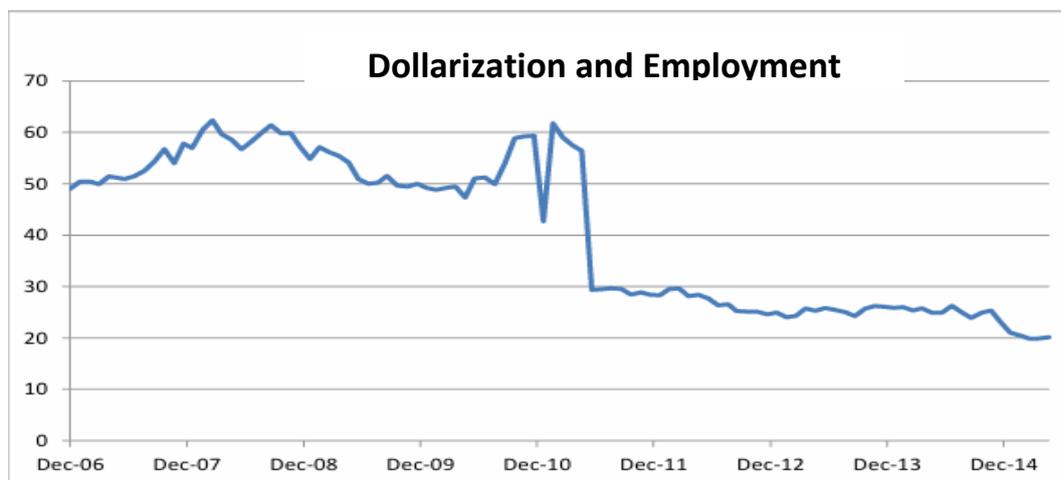
**Currency mismatch:** Highly dollarized economies are prone to solvency and liquidity risks stemming from exchange rate fluctuations which increase the vulnerability of financial system. When a highly dollarized economy faces some level of instability that raise concerns about the risks associated with the banking sector forces the demand for assets denominated in local currency to fall, causing the local currency to depreciate.

**Liquidity risk:** In a dollarized economy a large portion of the deposits with the banking system would be in foreign exchanges. The more foreign denominated loans issued by banks to domestic households and businesses the more vulnerable the banking sector would be to liquidity risk, which stems from exchange rate fluctuations. A substantial level of depreciation of local currency would impose pressure on the financial position of the households and businesses whose incomes are in local currency while their debts are in denominated in foreign currency. This increases the chances of default on their foreign currency denominated debts which in turn weakens the financial position of the banking sector.

**Solvency risk:** Similar to liquidity risk, currency mismatch is the main factor causing solvency risk in a dollarized financial system. In case of substantial local currency depreciation, balance sheet of the banks would be affected in two ways: first, by negatively affecting the value of local currency denominated assets that banks hold on their balance sheet and second, by weakening the financial position of the borrowers whose income are in domestic currency increasing the probability of default on their foreign exchange denominated debts.

Financial statements of local banks depict a highly liquid banking system in Afghanistan. Foreign currencies denominated loans constitute 20 percent of the total foreign currency deposits hold by the banking system in the country. Such high levels of liquidity create a reliable buffer against any unpredictable shock that may lead to bank run on foreign currency deposits. Moreover, considering the foreign exchange reserves of the central bank and comparing it with the total value of foreign exchange denominated liabilities of the banking system, in case of any possible bank run central bank can act as the lender of last resort to domestic banking system and eliminate liquidity risk. Despite the low liquidity risk that banking system is exposed to at the moment, knowing that Afghanistan is prone to many types of shocks which can change the current favorable stable condition to unfavorable, prudent policies are vital to control the liquidity risks involved with foreign currency denominated deposits. Unlike liquidity risk, solvency risk is a more serious risk for the domestic banking system. The borrowers whose revenue is in domestic currency but having foreign currency denominated loans are vulnerable to any unfavorable exchange rate fluctuation. Given that only 20% of the total foreign currency deposits is loaned out, the solvency risk is not a major source of concerns for domestic banking system. But still the given unfavorable fluctuations in exchange rate coupled with other attributes of banking system in the country such as lack of reliable measures to check the credit history of the costumers and lack of standard criteria to value the collaterals provided by the costumers, increase the potential solvency risk to domestic banking system which requires a close supervision by the central bank of country.





**Loss of seignior age revenue:** seignior age refers to the difference between the nominal value and the printing cost of a currency. Under unofficial dollarization (partial dollarization) government's revenue from printing units of domestic currency falls due to usage of foreign exchange as medium of exchange by the domestic residents. Depending on the level of growth in demand for money the loss of seignior age revenue in dollarized economies may be substantial. In short, loss of seignior age is considered one of the most important costs of dollarization. We estimated the stock of foreign currency in circulation in Afghanistan using the method proposed by the Erasmus, Leichter and Menkulasi. Assuming an identical money multiplier of 1.25 for both the domestic and foreign currencies, we got an estimated number of 476 billion Afghanis (it should be noted that this figure is mere an estimation of the upper bound for foreign currency in circulation) for foreign currency in circulation from 2002 to 2010. Given the estimated stock of FCC, our estimation of seignior age loss is equivalent to 460 billion Afghanis (for the detailed procedure of estimating seignior age loss).

**Loss of role of Lender of Last Resort:** As a lender of last resort, central banks try to assist illiquid banks to overcome bank runs on deposits. With a partial dollarization since domestic central bank is not the legal authority to print foreign currency, it would definitely lose part of its capacity to act as a lender of last resort to the domestic banking system in times of financial crisis. Foreign currency denominated deposits constitutes 65.93 percent of the total deposits available in the domestic banking system which is equivalent to 136.521 billion Afghanis (or \$2.275 billion). The ability of DAB (central bank of Afghanistan) to help illiquid domestic banks (with bank run on foreign denominated deposits) would be confined by its stock of foreign exchange reserves of \$6.7 billion which limits DAB's ability to perform its role as the Lender of last resort.

**Ineffectiveness of monetary policy:** Almost all available literature on dollarization have consensus on the negative effects of dollarization on conduction of effective monetary policy. According to the literature, dollarization negatively affects the effectiveness of monetary policy through its effects on monetary transmission mechanism. Afghanistan is following a monetary targeting regime; in such regime having precise figures of currency in circulation and other monetary aggregates is very crucial for conducting a sound monetary policy. However, having a dollarized economy makes it very difficult for monetary authorities to calculate FCiC as well as to control foreign currency component of broad money. Thus the role of monetary authorities in determining money supply would decrease which in turn would adversely affect the effectiveness of monetary policy.

Another key issue regarding challenges to conduct monetary policy in a partial dollarized economy is the extent to that currency substitution amplifies the pass-through effect from exchange rate to

domestic prices. The higher the pass through the harder it becomes for the monetary authority to control inflation through monetary targeting. Based on this, one can argue that exchange rate in a highly dollarized economy where non-tradable goods and services are priced in foreign currency will be passed to domestic prices through a broader set of goods; hence, exchange rate volatility will be more painful in a dollarized economy.

**Downward pressure on Domestic Currency:** Widespread transaction dollarization (currency substitution) will likely increase demand for foreign exchange in the economy which will in turn exert pressure on exchange rate, weakening the domestic currency. Furthermore, the literature and empirical evidence demonstrate that high level of currency substitution aggravates the exchange rate volatility. In other words, the higher the currency substitution the more would be the exchange rate volatility (Akçay et al. 1997). As it is known, exchange rate volatility would adversely affect the domestic economy by increasing volatility in inflation rate, increasing exchange rate risk and destabilizing inflation expectations.

### **Benefits Associated with Dollarization:**

International experience shows that partial dollarization is primarily driven by the quest of individuals to protect the real value of their income, and the biggest threat to the real value of individuals' income is high inflation. In a highly dollarized economy such as Afghanistan the openness of foreign currency deposits helps controlling capital flight. In countries where resident are restricted from opening foreign currency accounts, residents tend to keep their foreign currencies "under the mattress" or send it abroad. Based on this argument one can say that de facto dollarization is helpful in deepening financial market through encouraging business and households to keep their foreign currency denominated income and wealth in local bank, enhancing the level of activities and operations of the domestic banking sector. In a highly dollarized economy central bank loses its ability to serve as lender of last resort to a great extent. Consequently, government seek to introduce crucial reforms in attempt to encourage competition, strengthen supervision and regulation and to pave the way for the entry of international banks. In Afghanistan Da Afghanistan Bank, central bank, and IMF strictly monitors the regulation and supervision of private banking sector, and because of macroeconomic volatility Da Afghanistan bank has imposed even stricter regulation on capital requirement. Scholars believe that the presence of international banks will provide residence with an extra confidence, currently, 6 out of 16 banks are foreign owned. Another major advantage of high dollarization is that it provides Afghan resident an opportunity to protect the value of their wealth against inflation and currency depreciation. Although inflation has been relative stable in the past few years but Afghani, local currency has experienced drastic depreciation. More so allowing foreign currency deposits eliminate the exchange rate risk which implicitly encourages foreign direct investment and provides an opportunity for further economic growth.

## **Conclusion and recommendations**

### **Conclusion**

Dollarization is not a new phenomenon in Afghanistan. The prevalent usage of foreign currencies as medium of exchange and store of value by domestic residents can be traced to the start of civil war in the country. Lack of confidence in domestic currency is the main driver of dollarization in Afghanistan which can be attributed to some major factors including prolonged political and security turbulences, lack of a strategic macroeconomic management, a history of high inflation in the past plus high levels of exchange rate volatility. Despite a considerable decline in the level of dollarization, foreign denominated deposits constitute around 66% of the total deposits in domestic banking sector making Afghanistan one of the highly dollarized economies of the world. Based on

a rough estimation, the upper bound for stock of foreign currency in circulation is around 474 billion Afghanis which is approximately three times the current stock of domestic currency in circulation in the country. After studying different aspects of dollarization and evaluating its costs and benefits to a relatively small and open economy like Afghanistan, we have come to the conclusion that dollarization has cost our economy dear. As it is explained in this paper, the costs associated with dollarization such as currency mismatch, seignior age loss and less effective monetary policy are significantly high and they outweigh its benefit by a great margin. Therefore, we propose that a set of policy framework which covers economic, regulatory and administrative aspects of de-dollarization shall be formulated in order to achieve a sustained de-dollarization in Afghanistan. International experience indicates that there is no short-term and easy path to a sustained de dollarization. In general those countries that have pursuit market-driven approach to de-dollarization have been more successful at achieving sustained de-dollarization in comparison with the countries that resorted to administrative force to achieve de-dollarization. We should realize that de-dollarization is a lengthy process with macro-economic stability being a necessary condition for it. Unless we do not solve the existing profound structural weaknesses in our economy, we will not be able to get any favorable outcome in this regard. Hence, we are of the opinion that macro-economic and legal reforms are necessary in order to achieve sustained de-dollarization in the country.

### **Recommendations**

This paper made it evident that dollarization in Afghanistan has been consistently high and that monetary authorities of the country have been unable to reduce the level of dollarization. As stated above the cost of dollarization is significantly high and it outweighs its benefit by a great margin. Hence, we propose that a set of policy framework which covers economic, regulatory and administrative aspects of de-dollarization shall be formulated in order to achieve a sustained de-dollarization in Afghanistan. International experience demonstrates that dollarization is hard to reverse and an effective de dollarization is a lengthy process which takes decades to produce desirable outcome. Literature on de dollarization also shows that countries haven't had good experience with forced de-dollarization, in most of the cases forced de-dollarization has backfired and stimulated capital flight and reduced financial sector intermediation ultimately leading to slower economic growth (IMF). After a deep study of different countries case studies that have successfully reduced dollarization we came to the conclusion that effective de-dollarization policy entails a combination of prudential regulations and development of local currency market. By prudent regulation we mean conducting a monetary policy specifically focusing on bi-currency environment and the strengthening of prudential norms to cope with associated risk, meanwhile, development of currency market is more proactive that aims at limiting the incentives that favor dollarization in the first place and foster development of local currency instruments. Prudential regulation includes standard prudential best practices as well as regulation implemented in dollarized economies aiming to address bank level currency imbalances (such as an active management of reserve requirement differential, measure to create incentive to internalize the risk of dollarization for instance higher reserve requirement for foreign currency deposits, strict quantitative limits and proportional tax measures). These prudential approaches tend to diminish the incentive for dollar intermediation while at the same time incentives local currency intermediation. Successful implementation of prudential regulations is one of the key aspects of macroeconomic stabilization policies in highly dollarized economies. According to Escribano and Saso (2010) macroeconomic stabilization policies result in low inflation, anchored inflation expectations and gradual appreciation of domestic currencies. Highly dollarized Latin American Countries such as Bolivia, Paraguay, Peru and Uruguay saw significant decline in dollarization in 2000s, the decline in dollarization during this period was accompanied by contained inflation and a

domestic currency appreciation trend. It is worth mentioning that the latter was the bigger driver of de-dollarization. Development of local currency market becomes necessary in order to minimize the costs in terms of financial disintermediation in foreign currencies. It is necessary that prudential regulations should couple with expanding menu of domestic currency instruments in order to achieve sustained de-dollarization. In such scenario development and deepening of local currency market does the job of menu expansion of domestic currency instrument as well as it enhances the attractiveness of local currency against the USD. International experiences shows that credit de-dollarization have been facilitated by the development capital market in local currency, especially issuance of long term public bonds have been very instrumental. Countries such as Bolivia, Peru and Uruguay introduced local currency denominated public bonds with maturities exceeding 10 years which lead to considerable extension of the domestic yield curve expediting bank funding and pricing of long-term loan in domestic currency. An empirical analysis conducted by Escribano (2010) on determinants of de-dollarization in Latin America revealed that issuance of long term public bonds had been incredibly successful in diminishing credit dollarization level albeit issuance of long term public bond had very little or no effect on deposit dollarization. IMF report on de-dollarization published in 2012 suggests that countries that successfully de-dollarized had better macroeconomic stability, higher economic growth, a better external and fiscal balance and persistently lower debt than countries which remain unsuccessful in their attempts to de-dollarize their economies. The report further argues that inflation in successful countries was contained below 14 percent on average and exchange rate remained stable. However, unsuccessful countries have had persistently high inflation as well as exchange rate depreciation. Based on this report one can argue that macroeconomic stability is perhaps the most significant driver of de-dollarization. Without persistent macroeconomic stability de-dollarization efforts often backfires and produce undesirable outcomes that can have negative implications on the economy as a whole.

### **Recommendations for Future Research**

- The future research will be recommended as a qualitative based.
- The other variable will be add such as (interest rate and foreign trade).
- The one sector can be selected for the GDP indication.
- Further the dollarization can indicated with economy growth.
- The regime change data can be evaluated for the GDP effect.

### **Limitations of the Study**

This study focuses on examining the effect of dollarization on the national economy of Afghanistan, particularly its impact on major economic indicators such as inflation, exchange rate stability, monetary policy effectiveness, and overall economic growth. The research primarily covers the period from the early 2000s to 2010, a time during which dollarization became increasingly visible in Afghanistan's economy due to foreign aid inflows, international trade transactions, and the lack of confidence in the local currency, the Afghani. The study is limited to analyzing secondary economic data obtained from national and international sources such as Da Afghanistan Bank, the World Bank, and the International Monetary Fund. It also considers relevant academic studies and reports related to dollarization and its macroeconomic effects. The scope of this research is confined to the macroeconomic level, meaning it does not deeply explore microeconomic aspects such as household behavior or individual business practices regarding currency preference. Likewise, the revision does not intend to measure the mental or social attitude of the population en route for the use of the U.S. dollar. The psychiatry is limited by the accessibility and reliability of economic information in Afghanistan, as official data may be incomplete or conflicting due to political unsteadiness and limited institutional ability.

Furthermore, the learn focuses mainly on the economic extent of dollarization and does not fully cover political or security-related factors that may not directly influence currency replacement.

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