AFGHANISTAN RESEARCH NETWORK

Da Afghanistan Bank's Foreign Exchange Reserves

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Afghanistan Research Network

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Key Takeaways

- The collapse of the Islamic Republic of Afghanistan and the subsequent suspension of foreign aid resulted in financial instability, including depreciation of the local currency and inflation, leading to a run on the banks and the economy being on the brink of collapse.
- The provision of humanitarian assistance by donors has played a crucial role in stabilizing the Afghan currency against major currencies and alleviating economic burdens.
- Recommendations for the best use of the assets include establishing a transparent mechanism that ensures AML/CFT compliance, allowing commercial banks to access their money to pay off their depositors, and channeling humanitarian assistance funds in ways that help Afghanistan maintain its current reserves position.
- There is an exaggerated amount of expectation surrounding the Afghan assets. While it may contribute to a solution, it is not a cure-all for the country's economic woes.

Background

Da Afghanistan Bank (DAB) is Afghanistan's central bank, charged with the primary objectives of maintaining domestic price stability; fostering liquidity, solvency and effective functioning of a stable market-based financial system; and promoting a safe, sound, and efficient national payment system. To achieve these objectives, DAB supervises and licenses financial institutions, formulates and executes monetary policy, adopts foreign exchange policy, holds and manages the foreign reserves of Afghanistan, and provides clearing and settlement systems both inside and outside the country.

Afghanistan has been an aid-dependent country with economic instability in both fiscal and monetary policies. For fiscal policy, the national budget was mostly funded by international aid, while for monetary policy, DAB manages a floating exchange rate regime that is determined by market forces. DAB intervenes to support stability through foreign currency auctions.[1] On August 15, 2021, when the Taliban seized power and the Islamic Republic of Afghanistan collapsed, international financial institutions, aid agencies, and the United Nations (UN) suspended their assistance, including central bank foreign reserves, commercial banks' correspondent accounts, and development aid. Billions of dollars of financial assistance were frozen, hindering DAB's ability to conduct open market operations (foreign currency auctions), thus affecting market liquidity, depreciating the local currency, and creating higher inflation. To address the panic and stabilize the market, the Taliban interim government intervened by adopting certain temporary policy measures. Meanwhile, DAB conducted a limited auction of $10 million in mid-November 2021 to restore confidence and stabilize the exchange rate.

Despite these limited temporary measures, the currency continued to depreciate, inflation was at a peak, and a run had started on banks, bringing the economy to the brink of collapse. The international community, Afghans abroad, civil society and human rights activists, and other humanitarian organizations called for preventive measures to avoid a human catastrophe and total economic collapse. The major demands for preventive measures were the release of DAB foreign reserves to control inflation, stabilize the exchange rate, and provide liquidity to the market and banks to satisfy customer demands for their deposits. In addition to this, they demanded the immediate release of emergency financial assistance for basic needs such as health, food, and shelter. The release of DAB foreign exchange assets was also demanded by major global powers, such as Russia, China, and Afghanistan's neighbor Pakistan.

Responding to humanitarian appeals, the United States issued General License 14 and 15 on September 23, 2021, and GL 20 in February 2022, allowing the US government and international aid organizations to support humanitarian assistance. Following issuance of these licenses, the World Bank approved more than $1 billion of aid money placed in the Afghanistan Reconstruction Trust Fund (ARTF) and introduced a system in collaboration with the UN to swap millions of dollars of aid for Afghan currency in a plan to stem the humanitarian and economic crisis and bypass blacklisted Taliban leaders: "The plan, which will bypass sanctioned Taliban authorities by disbursing the money through U.N. agencies and international aid groups, will provide a major boost to efforts to ease the country's worsening humanitarian and economic crises".[2] This injection of foreign currency through/by the UN helped stabilize the market and appreciated the Afghani against the dollar exchange rate. This also helped DAB access foreign currency to conduct open market operations, as the UN sends these funds to a local bank (Afghanistan International bank) and that bank then exchanges it with Da Afghanistan Bank for AFN (Afghani) using the bank's daily exchange rate.

What is a Foreign Exchange Reserve?

Foreign exchange reserves are assets that central banks hold to stabilize exchange rates, clear trade payments, provide liquidity to the market, and act as a lender of last resort during economic shocks. Such reserves are held with financial institutions abroad, such as the World Bank/IMF or other central banks, such as the Federal Reserve Bank. According to the IMF's guidelines for international reserves and foreign currency liquidity, ". . . external assets that are readily available to and controlled by monetary authorities for meeting balance of payments financing needs, for intervention in exchange markets to affect the currency exchange rate, and for other related purposes (such as maintaining confidence in the currency and the economy, and serving as a basis for foreign borrowing)".[3]

Foreign exchange reserves include cash, gold, and other reserve assets held by a central bank or other monetary authority, primarily available to balance payments, influence the currency exchange rate, and maintain confidence in the financial market. Forex reserves are foreign currency assets held by the central banks of countries.

The Da Afghanistan Bank law under Article 72 defines foreign exchange reserves or international reserve assets as "consisting of gold, other precious metals and stones, banknotes and coins in freely convertible foreign currency, credit balances in freely convertible foreign currency held in accounts of the central bank, special drawing rights of the International Monetary Fund, bills of exchange, promissory notes, certificates of deposit, bonds and other debt securities payable in convertible foreign currency, and forward purchase or repurchase agreements and any currency swap agreements".[4]

Objectives of Foreign Exchange Reserve

The objectives of foreign exchange reserves are exchange rate stability, inflation control, management of market liquidity, management of economic and financial shocks, and payments, clearing, and settlement of accounts, particularly to facilitate trade. Reserve assets include monetary instruments such as cash, bonds, treasury bills, securities, gold, special drawing rights (SDRs), reserve positions in the IMF, and other reserve assets of the central bank.

Sources of Afghanistan's Foreign Exchange Reserves

Afghanistan's foreign exchange reserves come from international grants, issuance of new currency, exports, foreign direct investment (FDI), and correspondent accounts of financial institutions for clearing. After the fall of the Taliban regime in 2001, the new interim government of Afghanistan was financially supported by the international community. This aid was deposited into DAB correspondent accounts, resulting in the DAB's accumulation of foreign exchange reserves. DAB issues new currency in accordance with its monetary policy, considering economic growth, inflation, market demand, and government expenditure. The issuance of new currency for circulation also causes an accumulation in foreign exchange reserves. Exports are a major source of accumulating foreign exchange reserves for a country. Afghanistan has limited exports and is mainly dependent on imports. However, the World Bank's latest report on the Afghanistan Economic Monitor indicates an increase in exports from Afghanistan. FDI and correspondent accounts of financial institutions for clearing are also sources of foreign exchange reserves.

Foreign Exchange Reserves Policy of Da Afghanistan Bank

Da Afghanistan Bank (DAB) manages its foreign exchange reserves by investing primarily in foreign central banks and government-guaranteed bonds. The bank's policy prioritizes the safety and accessibility of funds over profit. DAB invests in short-term, low-income assets with secure institutions, including some commercial banks that are rated AAA or AAB by reputable international companies such as Fitch or Moody. Most of these reserves are held in foreign currencies, with the US dollar being the most traded currency in the world.

As of August 14, 2021, DAB's total foreign exchange reserves were $9.1 billion, consisting of various currencies such as the British Pound, Euro, and Dirham. Of this amount, $1.2 billion was held in gold reserves located in New York.

Given Afghanistan's trade deficit of around 35% of GDP, which makes the country heavily dependent on imports, DAB has adopted a managed floating exchange rate regime to manage the money supply. The bank intervenes in the market through open market operations and sells central bank bonds (Capital Notes) to financial institutions to control excessive liquidity and maintain acceptable inflation levels.

To stabilize exchange rates, DAB regularly auctions cash dollars in the open market. This auction is funded by DAB's account with the Federal Reserve Bank in New York. However, when the US froze DAB's foreign assets, the foreign currency auction was halted, leading to higher depreciation and inflation.

In March 2003, DAB's foreign exchange reserves were USD 426 million, while the currency in circulation was AFN 20 billion. Over time, as the economy grew, the circulation of Afghanis increased, and foreign reserve accumulation paralleled the increase in circulation.

Bank-wise Asset Allocation on eve of the Republic's collapse

No	Bank's Name	Location	Funds (US$ billion)	Percent
1.	FED RAMP	New York	2,440.30	26.5%
2.	The Gold Value	New York	1,245.44	13.5%
3.	FED 1-3Y Index	New York	1,064.65	11.6%
4.	FED UST Bills	New York	949.71	10.3%
5.	FED 3-5Y Index	New York	925.36	10.1%
6.	Commerz Bank	Frankfurt	434.31	4.7%
7.	The Vault	Kabul	75.59	0.8%
8.	BIS IPA	Basle	394.30	4.3%
9.	State Bank of India	London	374.17	4.1%
10.	BIS	Basle	274.68	3.0%
11.	Citibank (MMTD/ADGM)	Abu Dhabi GM	246.07	2.7%
12.	FED 5-10Y Index	New York	164.53	1.8%
13.	First Abu Dhabi Bank	Abu Dhabi	101.05	1.1%
14.	Deutsche Bundes Bank	Frankfurt	94.69	1.0%
15.	Citibank	New York	93.01	1.0%
16.	Bank Alfalah Limited	Peshawar	10.99	0.1%
17.	Citibank	Dublin	14.56	0.2%
18.	The Provinces	Kabul	0.52	0.0%
19.	Federal Reserve Bank	New York	288.90	3.1%
20.	Bank of Italy	Rome	0.30	0.0%
21.	Central Bank of UAE	Abu Dhabi	0.01	0.0%
22.	Bank of England	London	0.01	0.0%
Grant Total (US$ billion)			**9,193.16**	**100%**

Source: Da Afghanistan Bank and author's personal records

US President Executive Order and Split of Afghanistan Foreign Reserves into Two Parts

Following the tragic terrorist attacks on September 11, 2001, the United States blacklisted the Taliban for providing shelter to Al-Qaeda and supporting the leaders of the Al-Qaeda network. The assets and bank accounts of the Taliban were frozen and seized globally, and banks were instructed to avoid dealing with them.

In 2012, a New York federal court ruled that the Taliban, along with Al-Qaeda, Osama bin Laden, and Iran, owed $7 billion in compensation to the families of the 9/11 victims. However, the US government requested a series of delays to give its position on the matter: "Following the takeover, a group of 9/11 victim families claimed that they were owed $7 billion in frozen assets held by the Federal Reserve of New York".[5]

In response, on February 11, 2022, US President Joseph R. Biden Jr. issued an executive order splitting DAB's $7 billion foreign exchange reserves maintained with US banks into two parts. Half of the $7 billion was placed in reserve in case the court decided in favor of the families of the 9/11 victims, while the other half was reserved for the national emergency and welfare of the people of Afghanistan, as announced in a statement issued by the White House: "The Administration will seek to facilitate access to $3.5 billion of those assets for the benefit of the Afghan people and for Afghanistan's future pending a judicial decision".[6]

The Da Afghanistan Bank (DAB) issued a statement condemning the executive order as an "injustice to the people of Afghanistan".[7] The US Treasury's Office of Foreign Assets Control (OFAC) subsequently issued License No. DABRESERVES-EO-2022-886895-1, allowing for $3.5 billion allocated for the welfare of the people of Afghanistan to be transferred to a newly established account in Switzerland called the "Afghan Fund".[8] This fund includes former Minister of Finance Dr. Anwarul Haq Ahady and DAB's board member and audit committee chairman Prof. Shah Mohammad Mehrabi as Afghan experts, along with two non-Afghan representatives from the US and Swiss governments. The Taliban were not included in the Afghan Fund.

The Taliban acting government and DAB rejected the establishment of the Afghan Fund and warned that they would impose penalties on entities facilitating it, as described in a statement issued by the Taliban Foreign Ministry: "The Islamic Emirate will be forced to impose fines against, and ban activities of, all individuals, institutions and companies that facilitate this illegal scheme and seek to misuse the central bank reserves for humanitarian and other purposes".[9]

On February 21, 2023, a US district court judge decided that DAB assets could not be used to compensate the victims of 9/11. The judge said that these assets belonged to the people of Afghanistan and to the "Islamic Republic of Afghanistan." He further explained that the US Constitution did not authorize the court to seize DAB's assets, as the Taliban government was not recognized by the US government. The judge warned that letting victims seize those assets would amount to a ruling that the Taliban are Afghanistan's legitimate government, which is not acceptable. This decision also complicated the Afghan Fund's dealings with the Taliban-controlled central bank.

Conclusion and Recommendations

The decision to divide the assets of the Afghan Central Bank through an executive order may not be the optimal solution. Alternatively, it would have been preferable to maintain the freeze on the assets held by these central banks, as the international community did in 1996 when the Taliban previously governed Afghanistan, and only release them once the government is acknowledged by the global community as having the backing of the Afghan people.

Despite this situation, there are recommendations for the use of these assets through the newly established assets management board for the "Afghan Fund." The following are suggestions for the best use of the assets:

1. Reserves should only be used for monetary policy, as they have been set aside for this objective.

2. The Afghan Fund should collaborate with the DAB to establish a transparent mechanism that ensures AML/CFT compliance, including an auction of foreign currency, procedures for dollar disbursement, and the recall of excessive Afghani in circulation.

3. The Fund should enable the accumulation of export money into the DAB account, clearing of trade, and settlement for commercial banks' correspondent accounts, which is crucial for managing the exchange rate and controlling inflation.

4. The Afghan Fund board does not need to be expanded as the current structure is sufficient for reserve management decision-making.

5. The Afghan Fund should be temporary, and a mechanism should be developed to ensure all fund data is transferable. The data should ultimately be transferred back to Da Afghanistan Bank.

6. The commercial banks should access their money, which is also included in the $3.5 billion reserves, so that they pay off their depositors.

7. Countries should allow remittances to Afghanistan and establish correspondence relationships with Afghan banks to prevent a human catastrophe, as was arranged in 2003/2004.

8. Humanitarian assistance funds should be channeled in ways that help Afghanistan maintain its current reserves position. If these funds are not channeled through the correspondent accounts of reserves, Afghanistan will suffer huge trade payment deficits in the near future.

9. The investment/placement of reserves should be allowed as there is a high demand for liquidity in almost every currency globally. Interest rates have gone up while Afghanistan's reserves remain idle.

10. Afghanistan is claiming $7 billion on US banks, not $3.5 billion. Therefore, either the Afghan Fund or another organization in the US should hire reputable law firms to defend the case.

In the end, there is an exaggerated amount of expectation surrounding the Afghan assets. Many believe that releasing or returning these assets to Afghanistan will solve all of the country's economic problems and bring prosperity to its people. Unfortunately, this is not the case, and it is important to manage these expectations. Addressing fundamental economic issues in the country is crucial for improving the economic situation. Assuming that unfreezing the assets will be a panacea for all economic problems is misguided. While it may contribute to a solution, it is not a cure-all for the country's economic woes.

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Endnotes

[1] As per Supreme Council approved regulation, auctions should have been conducted twice a week. In 2016 when the currency badly depreciated, the DAB governor increased auctions to three times per week. This should have been approved by the board but was never reported to the board for approval. The increase was done to save reputational damage from being unqualified to stabilize currency.

[2] Reuters News, March 2, 2022- World Bank board backs using $1 billion in frozen Afghan funds for aid.

[3] International Reserves and Foreign Currency Liquidity ; published October 01, 2013

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[5] Al Jazeera (Joseph Stepansky), January 27, 2022 - How will US respond to 9/11 victims seeking frozen Afghan funds?

[6] FACT SHEET: Executive Order to Preserve Certain Afghanistan Central Bank Assets for the People of Afghanistan - February 11, 2022

[7] Da Afghanistan Bank statement on Decision of United States of America to split foreign exchange reserves of Afghanistan; issued Feb 12, 2022

[8] License issued by the US Treasury Department authorizing the release of $3.5 billion belonging to Da Afghanistan Bank for the benefit of the Afghan people (later used to endow the Fund for the Afghan People in Switzerland) - September 14, 2022

[9] Statement by MoFA on DAB reserves; issued Oct 13, 2022

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