

THE ROLE OF ECONOMIC INSTABILITY IN BANK CREDIT RISK IN AFGHANISTAN.

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Abstract. Economic instability can create significant challenges for the banking sector, particularly in countries experiencing financial and institutional difficulties. This study explores the role of economic instability in bank credit risk in Afghanistan, focusing on inflation, unemployment, exchange rate fluctuations, and economic growth. It adopts a qualitative analytical approach based on academic literature and reports from international institutions. The study discusses how changes in macroeconomic conditions can affect borrowers' repayment capacity, loan portfolio quality, and banks' financial stability. Recent evidence indicates that Afghanistan's banking sector continues to face rising non-performing loans, regulatory uncertainty, and limited lending activity (World Bank, 2025). The paper argues that effective credit risk management requires stronger monitoring systems, improved financial transparency, and the integration of macroeconomic indicators into banks' risk assessment processes. The study provides policy recommendations for strengthening banking resilience under conditions of economic uncertainty.

Keywords: *economic instability, credit risk, banking sector, Afghanistan, non-performing loans, financial stability.*

1. Introduction

Economic stability is essential for a well-functioning banking system. Banks provide financial resources to businesses and households, supporting investment, consumption, and economic development. However, when economic conditions deteriorate, borrowers may experience declining incomes, rising costs, and difficulties in repaying their loans. These developments can increase credit risk and weaken banks' financial performance.

Afghanistan presents an important case for examining this relationship. The country has experienced substantial economic disruptions, declining external assistance, limited access to international financial services, and persistent employment challenges. Although economic activity has shown signs of recovery, the banking sector continues to face regulatory uncertainty, liquidity constraints, and concerns about non-performing loans (World Bank, 2025).

The objective of this study is to examine how economic instability may contribute to credit risk in Afghanistan's banking sector. It also identifies potential measures that banks and policymakers can adopt to improve financial resilience.

2. Literature Review and Analytical Framework

Previous research suggests that macroeconomic conditions are closely associated with the quality of bank loan portfolios. Economic growth generally supports borrowers' repayment capacity, whereas economic downturns may increase the probability of loan defaults (Klein, 2013; Louzis et al., 2012).

Inflation can increase household expenditure and business operating costs, leaving borrowers with fewer resources to service debt. Unemployment may reduce household income and weaken repayment capacity. Exchange rate fluctuations can also affect businesses that depend on imported goods or have foreign-currency liabilities. However, the effects of inflation and exchange rate movements depend on the structure of the economy and the financial position of individual borrowers.

Table 1 summarises the main channels through which economic instability may influence credit risk.

Table 1.

Economic instability and potential credit risk channels

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Economic factor	Potential effect on borrowers	Possible consequence	banking
Inflation	Higher living and production costs	Increased difficulties	repayment
Unemployment	Lower household income	Higher probability of loan default	
Exchange rate fluctuations	Uncertainty in import costs and foreign-currency obligations	Deterioration in loan quality for exposed borrowers	
Weak economic growth	Lower business revenues and investment	Higher credit risk	
Regulatory uncertainty	Reduced confidence and weaker lending conditions	Restricted credit activity and financial instability	

Source: Author's synthesis based on Klein (2013), Louzis et al. (2012), and World Bank (2025).

These relationships are potential mechanisms rather than proof that a particular factor directly caused changes in Afghanistan's non-performing loans.

3. Economic Instability and Afghanistan's Banking Sector

The World Bank's April 2025 Afghanistan Development Update estimated that the economy grew by 2.5% in 2024. Nevertheless, the report highlighted persistent poverty, employment challenges, external vulnerabilities, and a fragile banking environment. It also reported that credit to the private sector had declined by 12.4% year-on-year, indicating continued constraints on financial intermediation (World Bank, 2025).

Table 2.

Selected indicators of Afghanistan's economic and banking conditions

Indicator	Reported evidence	Relevance to credit risk
Real GDP growth	Estimated at 2.5% in 2024	Economic recovery may support borrowers, but growth remains insufficient to resolve structural challenges
Private-sector credit	Declined by 12.4% year-on-year in the period reported by the World Bank in April 2025	Indicates constrained lending activity
Banking-sector conditions	Rising non-performing loans and regulatory uncertainty were identified as concerns	Suggests continuing pressure on asset quality and confidence

Source: World Bank (2025), *Afghanistan Development Update*, April 2025.

The evidence suggests that economic recovery alone does not necessarily guarantee a stronger banking sector. Weak household purchasing power, limited employment opportunities, and uncertainty affecting businesses can continue to place pressure on borrowers. At the same time, reduced lending may restrict access to finance for productive businesses, potentially slowing economic recovery.

The relationship between economic instability and credit risk can be summarised as follows:

Economic instability → Pressure on household and business finances → Greater difficulty repaying loans → Potential increase in non-performing loans → Weaker bank asset quality.

This framework illustrates a plausible transmission mechanism. Establishing the magnitude of these effects in Afghanistan would require consistent banking and macroeconomic data.

4. Discussion and Recommendations

The analysis highlights the importance of considering economic conditions when assessing credit risk. Banks should evaluate not only individual borrowers' financial circumstances but also broader risks related to employment, inflation, currency movements, and economic growth.

First, banks should strengthen early-warning systems by monitoring changes in borrowers' repayment behaviour and relevant macroeconomic indicators. Second, regular stress testing could help assess how adverse economic scenarios might affect loan portfolios. Third, regulators should promote transparent reporting of non-performing loans and other financial soundness indicators. Finally, improving access to reliable financial information could support more effective lending decisions and strengthen public confidence in the banking sector.

These measures should complement, rather than replace, borrower-level credit assessments and sound banking supervision.

5. Conclusion

Economic instability can contribute to credit risk by weakening household repayment capacity, increasing business costs, and creating uncertainty in financial markets. In Afghanistan, these challenges are compounded by structural economic difficulties and continuing constraints on banking activity. Although the economy has shown signs of recovery, concerns about non-performing loans and restricted lending demonstrate the need for stronger risk management.

The study recommends improved macroeconomic monitoring, regular stress testing, transparent financial reporting, and stronger supervisory practices. Since this paper is based on secondary sources and qualitative analysis, it does not establish causal relationships between individual economic indicators and credit risk. Further research using consistent time-series or bank-level data would help quantify these relationships.

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