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DOLLARIZATION IN AFGHANISTAN: CHALLENGES AND PROSPECTS FOR DE-DOLLARIZATION

Abstract. Dollarization is one of the most important monetary challenges facing many developing economies. Afghanistan is a classic example of US dollar importance for financial transactions, trade and pricing. The widespread use of foreign currencies is the result of long-term political instability, weak financial institutions, inflationary pressures and a lack of confidence in the national currency. The paper examines the major determinants of dollarization in Afghanistan, its economic consequences and the perspectives of gradual de-dollarization. The conditions for reducing dependence on foreign currencies are macroeconomic stability, increased confidence in the national currency and development of domestic financial institutions, the study says.

Keywords: Dollarization, de-dollarization, Afghanistan, monetary sovereignty, financial stability, national currency.

Introduction

The U.S. dollar remains the world's dominant currency in the international monetary and financial system. The dollar is the world's reserve currency. It is a valuable medium of exchange for international transactions, and a valuable store of value. But de-dollarization has received more attention in the wake of recent geopolitical tensions, financial sanctions and attempts by several countries to increase their monetary sovereignty. One can hear talk of global de-dollarisation everywhere. But the question of domestic dollarisation is no less important for many developing economies. Afghanistan is a particularly interesting case of deep entrenchment of foreign currencies in economic activity. Understanding the causes and consequences of dollarization in Afghanistan provides useful lessons for the broader relationship between monetary stability, institutional development and economic sovereignty.

Afghanistan dollarisation

Dollarization is the use of a foreign currency, parallel to or instead of one's national currency. Domestic dollarization is defined as the use of foreign currency for transactions, savings and contracts of the residents within the borders of the country. Afghanistan has been deeply dollarized for decades. The history of armed conflict, political instability, economic uncertainty and dependency on large amounts of international aid has led to the greater use of the U.S. dollar. In many places, big business deals, real-estate purchases and international trade have been traditionally done in dollars, not Afghan Afghans.

Besides there is no confidence in the monetary institutions and this has made the residents to keep their savings in foreign currency. Inflation and currency depreciation or instability are expected. So they prefer dollar-denominated assets. That kind of behaviour erodes faith in the local currency and speeds up the process of dollarization even more.

Economic Consequences of Dollarization

Dollarization Economic Effects Dollarization may have some short term benefits. A stable foreign currency may reduce transaction costs, protect savings from inflation and increase



international trade. For countries with severe macro instability a foreign currency may give short term monetary stability. But excessive dollarization has serious downsides. One of the most important consequences is the loss of effectiveness of monetary policy. In a foreign currency economy, the central bank has less control over the money supply and interest rates. This restricts its ability to respond to economic shocks. Also, dollarization means the loss of monetary sovereignty. Monetary policy limits the ability of national authorities to influence the domestic economic environment. Dependence on the dollar also leads vulnerability to international currency fluctuations and external financial shocks. Therefore, vulnerability of the financial sector is a cause for concern. If a bank has significant foreign currency liabilities but its revenues are generated in local currency, it is exposed to the financial risks linked with exchange rate fluctuations. Such discrepancies can lead to financial instability during periods of economic stress.

Challenges of De-Dollarization in Afghanistan

De-dollarization is often seen as a desirable policy objective, but it is hard to achieve. Afghanistan is awash with structural constraints. The first is institutional weakness. For de-dollarisation you need a credible central bank, good financial regulation and stable public institutions. The genesis of such institutions is a long-term process, which depends on the stability of the political and economic systems.

Another task: to shake confidence in the national currency. The currency is usually based on historic experience. The dollar has fallen, but for many Afghans it is still a safer place to park value than the afghani. But changing those expectations is a matter of years of solid macroeconomic stability. The third problem is the underdevelopment of domestic financial markets. There are good reasons for holding assets in local currency. Financial institutions are sound domestically. Otherwise they tend to seek foreign currency assets. Then there is the question of international economic dependency. Historically, Afghanistan's trade, foreign aid inflows and cross-border financial flows have been linked to the dollar-based international financial system. This structure makes it hard to reduce the dollar.

Prospects for De-Dollarization

Slow de-dollarization is still possible if the economic conditions are right.

Macroeconomic stability: Confidence in the national currency is built on stable inflation, predictable exchange rates and responsible fiscal policy. International experience also shows that successful de-dollarization tends to go hand in hand with improvements in economic fundamentals.

The financial sector's development is also important: "Residents are able to better manage finances, broaden banking services and provide attractive financial products in local currency to stimulate the use of the afghani.

Digital financial technologies can also help to reduce dollarization: Modern payment systems, mobile banking platforms and central bank digital currency initiatives can improve the efficiency and appeal of domestic currency transactions.

The key is public confidence." Trust in institutions and credibility of monetary policy strongly affect preferences for the currency as shown by Yalçın (2025) for Turkey. Also, Afghanistan can learn about strengthening institutions and continuity of policies. More discussion on alternative payment systems, reserve diversification, and regional financial cooperation around the world could slowly change the monetary landscape of the world. But the evidence so far suggests that de-dollarisation is a slow rather than a rapid process and that the US dollar will remain the dominant international currency in the long run.

Conclusion

Dollarization has become a characteristic of Afghanistan's economic system after many decades of instability, weak institutions and little confidence in the national currency. Dollarization can generate benefits in terms of short-term stability but also entail long-term challenges for monetary



policy, financial stability and economic sovereignty. De-dollarization in Afghanistan is propelled by macroeconomic stability, institutional credibility and development of financial sector. "Policymakers should not be rushing into quick policy changes but should be working to create the conditions for more confidence in the afghani to develop organically. A gradual market based approach is the wise approach to reduce dependence on foreign currencies and enhance national monetary sovereignty.

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