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Reviving Afghanistan's Economy

Summary

- Expectations about reviving Afghanistan's economy need to be modest and must start with a more effective Afghan government, acting in a unified manner as if the country faced a national emergency.
- Business-as-usual approaches by the government or the international community will not succeed in reviving the Afghan economy.
- This brief puts forward some outside-the-box ideas, which, combined with greater government effectiveness and, hopefully, reductions in violent conflict, may help turn the economy around.
- Key proposals include creating fiscal space through modest government borrowing, regularizing informal urban settlements, starting a few sizable infrastructure projects, selected urban jobs and income support programs, imposing moderate import duties on agricultural cash crops (not wheat), and promoting exports of high-value cash crops through export promotion grants.

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Need for Modest Expectations

Reviving the Afghan economy in this time of intensifying violent conflict and declining external financial inflows will be extremely challenging—some might say impossible. But measures to address the deteriorating economy cannot wait until the conflict abates and deep-seated political issues are fully resolved. Given the nature of Afghanistan's conflict and its economy, conventional business-as-usual economic approaches won't work. There is a need to think creatively while recognizing the limits to what can be accomplished in a time of war. This brief tries to think outside the box on how to help stimulate some degree of economic revival. (A longer report explaining these and other ideas in greater detail will be forthcoming.)

Afghanistan can be characterized as a demand-driven, supply constrained, and very open economy that faces an enormous structural fiscal gap and extremely high dependency on international aid. Over the past several years, the sharp decline in international military expenditures caused a major negative demand shock. The slowdown in economic growth from over 9 percent per year during the previous decade to as low as 1.3 percent in 2014 also reflects loss of business and consumer confidence, lack of private investment, very low public investment, and deepening uncertainty over the political transition and security outlook. The slow start and continuing weaknesses of the national unity government (NUG) have further contributed to uncertainty and anemic demand and investment. Capital flight and human flight, already significant, have worsened in the past year.

Economic growth can be expected to remain low—perhaps in the 2–4 percent per year range, meaning little or no rise in average per capita incomes given high population growth. Even this modest growth scenario is vulnerable to political, security, and climatic shocks. Avoiding negative growth, and reducing the volatility of growth, would constitute a genuine accomplishment in this situation. In the short run, even worse than economic weakness is the fiscal crisis.[1] Expectations about turning around both the economy and the fiscal crisis need to be modest—and the overall fiscal gap, well into the double digits as a ratio to gross domestic product (GDP), can only be bridged by aid for the foreseeable future.

What Can Be Done?

Measures to promote a modest economic revival must start with political leadership. Around the world, "unity governments" cobbled together due to domestic political problems that could not be handled through the normal political process typically have short time horizons, struggle to function effectively, are unstable, and frequently fail (leading to new elections in parliamentary systems). There is, however, a different, more promising model: national unity governments formed by the coalescence of different political groups in response to what, by consensus, is perceived as a "national emergency."[2] Rather than engaging in political infighting and short-run positioning, Afghanistan's NUG instead should begin to act more like the unified government of a country facing a national crisis—which it clearly does—and focus on addressing the very serious challenges in the current situation. While this may seem naïve and unrealistic, it represents a first outside-the-box idea.

Turning to the economy per se, macroeconomic measures can be divided into three categories: those which build confidence and stimulate overall demand, or at least mitigate the drop in demand; those which shift demand toward domestic supply and away from imports, or stimulate exports to exploit foreign demand; and those which ameliorate the fiscal crisis.

Measures to Increase Confidence and Stimulate Demand

Offsetting the negative demand shock of declining international military spending and aid will be impossible. Significant amounts of Afghan private capital are being held outside the country—probably tens of billions of dollars—which could be repatriated and invested productively in Afghanistan, but this cannot be expected to happen unless there is greater confidence in the future, a more effective NUG, and prospects for reduction of violence and progress of reconciliation. Within a broader context where improvements are taking place in at least some of these areas, a few specific measures are put forward below.

Starting sizable infrastructure projects. While large infrastructure projects have long gestation periods and enhance the supply capabilities of an economy only over time, starting a few projects now would have concrete short-run benefits. They would begin to increase demand for labor, goods, and services. More important, credible infrastructure project starts would send a strong signal of both government and donors' commitment to the medium-term development agenda, in turn increasing confidence among the population and the private sector. It would be necessary to focus on only a small number of key projects, not spread limited resources across numerous separate, underfunded public investments.

Regularizing informal urban settlements.[3] Rapid urbanization in Afghanistan has occurred mostly through informal settlements (often on public land), where residents lack legal claim to the land they are occupying. Surveying these settlements and providing official documentation and legal security of tenure for resident households would boost confidence, lengthen time horizons, and provide stronger incentives for such households to make improvements to their properties. The Afghan government is already pursuing such an initiative, which needs to be supported and could be accompanied by modest, publicly funded improvement programs (streets and pathways, basic services, etc.). This is a low-cost way to enhance confidence and the sense of security for large numbers of relatively poor urban residents, while at the same time generating a moderate increase in demand in the economy.

Implementing selected urban income support and jobs programs. Resources for development programs are woefully inadequate, especially for new initiatives of any size. In the short run, therefore, drastic prioritization is called for, and only programs that achieve multiple objectives in building confidence, increasing demand at least modestly, and alleviating poverty can be considered. This rules out massive rural programs, which would spread resources thin and would not have a visible impact in the short run. Selected urban public works and income support programs, well designed and effectively implemented with good governance and focused on a few large cities, would have better prospects to further short-run goals and, in conjunction with other measures, to help break out of the current economic impasse.

Shifting Demand from Imports to Domestic Supply and Stimulating Exports

In Afghanistan's ultra-open economy, measures to increase demand will not necessarily translate into higher national production and incomes because a large part of higher demand will be met by imports. A promising but little considered option is to nudge the composition of demand away from imports and toward domestic production, provided this is done in sectors where a domestic supply response is possible. Increasing exports likewise would stimulate domestic production and incomes.

Spending programs that target the poor would increase domestic demand since the poor tend to spend a larger part of their budgets on domestic goods and services. These types of programs would have both macroeconomic and poverty reduction benefits and could be funded by increased public resources (including through aid) and/or by shifting resources from lower-priority activities.

Increasing local procurement through greater preference for Afghan companies in government tenders, as well as domestic content requirements incorporated in contracts, is another option that is already being pursued but perhaps can be taken further. Such measures need to be supported over the medium-term by efforts to enhance the supply capabilities of the Afghan economy, such as infrastructure investments, building human capital in a demand-responsive manner, improving the business climate for the private sector, and developing business support services.

Imposing moderate import duties on agricultural cash crops is a more radical option for demand switching. This sector comprises one of the country's only areas of comparative advantage, but its potential has not been realized and is threatened by low-cost competing imports of many agricultural products that flood the Afghan market. A modest, broad-based, and undifferentiated import tariff would help contain imports of vegetables and fruits that can be and are grown in Afghanistan, stimulating domestic production of these goods. Food-grain (primarily wheat) should not be subject to such a tariff since it is disproportionately consumed by the poor and is not the crop of Afghanistan's future.[4]

Export promotion grants. A plethora of value-chain weaknesses and obstacles prevents good potential for exports of high-value agricultural cash crops from being realized. One approach, not yet tried in Afghanistan, takes as its inspiration the "contract farming" model, where businesses in developed countries (grocery chains and the like) contract with farmers in developing countries to grow agricultural products, working closely with them to meet importing countries' standards. Rather than trying very imperfectly to substitute for the private sector through fragmented public investments and programs, a better option would be to make it worthwhile for businesses at the demand end to engage in something like contract farming in Afghanistan. While such businesses are deterred because of insecurity, poor governance, difficult logistics, and associated high costs, the Afghan government could, with donor funding, provide competitively tendered export promotion grants that offset the extra costs of doing business in Afghanistan and make it attractive, or at least feasible, for foreign businesses to engage in this way.[5] These grants would have to be performance-related (contingent on actual exports and sales) and time-bound (e.g., for a period of 2–3 years, after which they could be competitively rebid). Where a value chain blockage is due to government-related problems (e.g., delays at the border/airport), it would be brought to the attention of the Afghan government and donors for resolution.

Creating Fiscal Space

More fiscal space, as well as providing greater resources for development programs, will help address the fiscal crisis. Increasing revenues, lowering and restructuring expenditures in favor of higher-priority spending, and government borrowing can create fiscal space. The first two approaches are being actively pursued, but there has been virtually no consideration of borrowing.

In a stagnant economy with low inflation and no near-term balance of payment problems, tight fiscal policy is a harmful contractionary force. In the current situation, modest government borrowing and associated fiscal deficits would moderately stimulate the economy, and at least would not make the situation worse. The government ran monetized fiscal deficits on the order of 1–2 percent of GDP in 2013 and 2014 by running down its deposits at the central bank, but this is no longer possible since such deposits have been largely exhausted. The government therefore should borrow directly from the central bank and could also issue bonds (e.g., Islamic bonds, *sukuk*) for sale to the Afghan public. Indeed, if the government starts acting like the unified government of a country facing a national emergency, "patriotic bonds" potentially could mop up a part of the enormous wealth accrued by some Afghans over the past dozen years.

Any government borrowing would need to be limited and responsible. Borrowing from the central bank should be limited to no more than around 2 percent of GDP, and inflation and exchange rate trends would need to be monitored. Borrowing in domestic currency from the Afghan public is feasible but requires debt sustainability analysis. The riskiest form of government borrowing—on foreign markets and denominated in foreign currency—may not be appropriate for Afghanistan at this point in time.

Critical Mass and Donor Support

A modest economic revival in Afghanistan will come about not as a result of any individual measure but through a combination of actions that, taken together, achieve a critical mass that may be able to break through the severe headwinds the economy faces. Restoring confidence will be critical to raising demand and, over time, unlocking the large amounts of Afghan money potentially available for private investment. If the Afghan government does take serious action to revive the economy—including not least through greater political effectiveness—donors should respond proactively, not with business as usual. The international community will need to be supportive of responsible government borrowing, provide advisory and technical support for macroeconomic management and to help design and implement the programs described in this brief as well as others, and be willing to reallocate and front-load aid to support promising initiatives as they are developed. Working closely with the Afghan government, donors should review and restructure their aid portfolios to shift funding toward activities that disburse more quickly and achieve faster economic and development results.

Notes

1. See William A. Byrd, "Afghanistan's Continuting Fiscal Crisis: No End in Sight," Peace Brief no. 185, Washington, DC, U.S. Institute of Peace, May 2015, www.usip.org/sites/default/files/PB185-Afghanistans-Continuing-Fiscal-Crisis-No-End-In-Sight.pdf.
2. For a discussion on experience with unity governments in other countries, see Thomas Ruttig, "Elections 2014 (50): Experience with 'Governments of National Unity' Elsewhere," Afghanistan Analysts Network, September 16, 2014, https://www.afghanistan-analysts.org/elections-50-experience-with-governments-of-national-unity-elsewhere/.
3. This idea has been inspired by Hernando de Soto, among others. See de Soto's books, *The Other Path: The Invisible Revolution in the Third World* (New York: Harper and Row Publishers, 1989) and *The Mystery of Capital: Why Capitalism Triumphs in the West and Fails Everywhere Else* (New York: Basic Books, 2000).
4. The real potential for agricultural development lies in high-value, labor-intensive cash crops, which are more appropriate for Afghanistan's resource endowment and constraints.
5. Many larger companies in developed countries have corporate responsibility objectives and programs, and some of them may be interested in participating in this kind of scheme from that perspective.

About This Brief

This brief, while calling for modest expectations, puts forward some outside-the-box ideas, which, combined with greater government effectiveness and, hopefully, reductions in violent conflict, may help turn the Afghan economy around. William A. Byrd is a senior expert at the U.S. Institute of Peace. He has been following the Afghan economy closely since 2001. Extensive comments and inputs from Scott Smith, and comments from Andrew Wilder and Colin Cookman, are gratefully acknowledged. The views expressed are the author's and do not necessarily reflect the views of the U.S. Institute of Peace, which does not take policy positions.

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