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The Afghan Economy: A Brief History

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This document provides an overview of the history of economic development in Afghanistan since the 1970s. Further information on economic development is available at www.cimicweb.org.[1] **Sources can be accessed by following the hyperlinks embedded in the text.**

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1. Introduction

While there is a limited amount of reliable data on Afghanistan's economy over the course of the past century, the country's economic history has often been closely related to its political history.[2] Landlocked yet situated at the crossroads of Asia, Afghanistan could serve as a trade crossroads and a major supplier of natural resources for the global economy. However, in recent decades, the nation's vast economic potential has failed to take root. Afghanistan relies on external financial flows from the international community as well as from international terrorist and narcotics-trafficking networks, which, as the UK Department for International Development (DFID) noted in a 2008 report, 'are critical for both state building and for opposition/insurgency' respectively. Local economic developments have fed into national and regional economic processes which, conversely, have influenced Afghan politics and economics at even the lowest levels. The rapidly-changing nature of these processes has led to a profoundly unstable and volatile "political economy" (that is, the two-way interaction between politics and economics).

This report looks closely at developments within the Afghan economy, beginning with an examination of the early Cold War years and then portraying economic trends during the Soviet period and amidst the subsequent internal strife of the 1990s. It concludes with remarks concerning the current state of the Afghan economy.

2. The Economy of Pre-Soviet Afghanistan

The British invasion of Afghanistan in 1838 marked the first of three Anglo-Afghan wars that would frame Afghanistan's role as buffer state in the 19th century and later as protectorate of the United Kingdom (UK) in the 20th century. When Afghanistan achieved independence from the British in 1919, Afghan leaders attempted to modernise the country's society and economy at a rapid though uneven pace. The post-independence government of King Amanullah pursued economic centralisation for much of the 1920's before Amanullah was deposed in 1929. More gradual attempts

[1] A CMO user account may be required to access some of the links in this document.
[2] Jonathan Goodhand, 'From Holy War to Opium War? A Case Study of the Opium Economy in North-eastern Afghanistan', *Central Asian Survey* 19: 2 (June 2000), p. 265.

at modernisation continued until the mid-1950s when they were hastened by King Zahir Shah, who utilised the national bank and state cartels in pursuit of a "tightly controlled" economic modernisation which included industrialisation and the spread of education and other social measures.

Afghanistan's economy from the 1950s onward became closely intertwined with the Cold War. From 1953 to 1963 Afghanistan's Prime Minister Mohammed Daoud Khan had solicited military and economic assistance from both the United States (US) and the Union of Soviet Socialist Republics (USSR), believing that, without rapid growth, Afghanistan would become severely politically fragmented. Often dubbed the "economic Korea", the country received 50% of its foreign aid from the Soviet Union between 1950 and 1970 and 30% from the United States during that same time span.[3] In the early 1960s Soviet investment targeted immense infrastructure projects including the 1964 completion of the Salang tunnel which greatly reduced travel time between northern Afghanistan and Kabul. By 1967 the country had 1,200 miles of paved roads and a 25% increase in power output.[4]

In the early 1970s, however, the economic situation markedly declined. Criticisms by socialist, Maoist and liberal factions against the government's financial policy increased, while famine set in due to drought. During the drought years, the value of the currency, the Afghani (AFN), declined rapidly as exports decreased and imports increased; food, in particular, moved across borders, often illegally, to compensate for the food shortage. US Department of State officials, according to historian Nick Cullather, found it difficult to assess the crisis; noting that "student strikes and the suspension of parliament pointed to a 'creeping crisis' in mid-1972." Combined with the failure to create new jobs for the educated, some experts argue that this contributed to increased frustration and radicalisation which fed into both leftist and Islamist movements. Amidst this mounting political and economic crisis, former Prime Minister Daoud Khan assumed the presidency in 1973 after a bloodless coup. He soon initiated new modernisation programmes including state regulation of the economy, social welfare reform and the expansion of education.

The government, under Daoud, gained tighter control of imports as well as of export industries and, in 1977, intervened to lower the exchange rate as intense currency appreciation had threatened to make many traditional exports unprofitable. The fiscal system in the 1970s was small and centralised, leaving provinces with neither tax authority nor budgets.[5] Tax revenues amounted to around 7% of GNP in 1978. Two-thirds of all taxes were on foreign trade, thus illustrating, in Rubin's words, "the extent to which the government relied on its links to the international system as a counterweight to its inability to [govern] or transform the society as a whole".[6] Though improved harvests in 1972-1976 allowed for the increased adoption of higher-value cash crops, exports accounted for 15% of GNP in 1978, suggesting only modest improvement in the country's terms of trade.[7] By 1978 approximately 80% of the Afghan population was dependant on the rural economy and agriculture accounted for 60% of GDP (figures which remain largely consistent to the present).

[3] In the 1960s foreign aid accounted for over 40% of the budget. DFID reports the same figure for 2003-2008.
[4] A World Bank delegation which visited Afghanistan in 1971, however, claimed that the country's financial management had faced many challenges during these years in part because returns on capital investments were low.
[5] In 1926 taxes on agriculture amounted to 62.5% of domestic revenue, which over the years steadily declined to 18.1% in 1952-3, 7% in 1958 and to less than 2% in the 1970s as landowners began to dominate parliament.
[6] Barnett R. Rubin, "Lineages of the State in Afghanistan", *Asian Survey* 28:11 (Nov. 1988): 1201.
[7] Agricultural goods accounted for 60%, natural gas for 12% and handicrafts for 12% of that amount.

In order to promote industrial development, banks were nationalised and the government gained control of the most important private firms (*sherkats*), thus causing a crisis of confidence in the private sector in 1978. During this period the World Bank recommended "a considerable decentralisation of administration, institutions and investment in physical and human infrastructure since growth would be regionally spread rather than concentrated in the Kabul area". Yet, as the 1970s progressed and reforms failed to materialise, the World Bank and other donor institutions became dissatisfied. Foreign aid declined as donors became increasingly disillusioned, thus increasing the country's instability and its dependence upon the Soviet Union. In 1978 the People's Democratic Party of Afghanistan (PDPA) violently overthrew Daoud's government and seized power.

Box 1. Social and Economic Infrastructure
With only six miles of railroads in 1933, Afghanistan's government has continually sought international assistance in building the necessary infrastructure. A 1973 USD 200 million assistance agreement[8] between the USSR and Afghanistan brought oil development, trade, transport, irrigation, factories and highway construction. According to the Institute of Strategic Studies (ISS) in Islamabad, however, investment in infrastructure did not necessarily translate into increased production or income as there were problems of project identification, preparation, and management. Also, expenditures were "less dependent on domestic project implementation capacity" than on the type of assistance donors were willing to give. The World Bank also recorded only 5% of Afghanistan's population having intermittent electricity access while water and communication installations were limited to cities. Indeed, much of Afghanistan's development and infrastructure was focused around urban areas, thus exacerbating the country's political and economic centre-periphery divide. The public sector also took on the task of exploiting natural gas, most of which was piped to the USSR and grossed about USD 50 million a year. Though discovery of mineral deposits led to new production, industry in general provided few Afghans with employment (locals made up 0.5% of the labour force) and contributed only 3.5% to the GDP.

3. Damage to the Traditional Economic Basis, 1978 – 1989

In 1978 the World Bank recommended that Afghanistan, with its comparative advantage vested in small-scale agricultural production, should focus its economy on horticulture and livestock. Subsequent Soviet involvement would inhibit this economic strategy as the already bleak economy deteriorated further in the face of mounting conflict. After the Soviet entry into Afghanistan in 1979, new official aid commitments from the West ceased, thus making Afghanistan almost exclusively reliant upon the USSR for funding. Soviet funding increased, however, with annual disbursements reaching around USD 200 million. While some of the "evidence [from the World Bank] suggests a decline" in GNP during the Soviet period in Afghanistan, infrastructure improved dramatically. One author notes that, by at least 1987, "roads became more secure, and trade and humanitarian assistance that had previously travelled by pack animal […] could now go by truck".

Despite such improvements, the Soviet period in Afghanistan experienced a significant "brain drain" as skilled workers and the educated, among others, fled to neighbouring countries and beyond. In addition, an estimated 3.5 million Afghan people were lost over the course of the Soviet period as a result of the deadly conflict and violence-induced displacement.[9] Population displacement

[8] US Department of State, 'The Transitional Islamic State of Afghanistan', in *Background Notes on Countries of the World 2003* (US Department of State, Washington, DC, 2003), pp. 1-16.
[9] Estimates vary: Schetter reports 2 million fatalities and 6 million refugees while the World Bank estimates 3.5 million people affected.

contributed to a decline in agricultural productivity in the 1980s as conflict and a poor harvest in 1982 created severe food insecurity. Shortages of key foodstuffs led to widespread hoarding, an active black market and a 95% increase in the prices of basic commodities between 1981 and 1982. In addition, Soviet attempts to "disrupt production in resistance-dominated areas also contributed to [agricultural] decline as did the disruption to transportation resulting from ongoing conflict".[10]

After the Soviet invasion, flights between Afghanistan and Western Europe were suspended. This, combined with the inability to sell surplus goods and an increasing reliance on Soviet staple commodities, exacerbated trade relations with the West and caused an almost 50% decline in total imports and exports. During this period the Soviets supplied Afghanistan with industrial equipment, transportation infrastructure, oil, meat and grain; in return, Afghanistan supplied the USSR with gas and agricultural products. Soviet period shortages of critical energy supplies led to Afghan industry coming to a virtual standstill and a marked reduction in processed goods. At the same time, the burgeoning war economy gave remote areas new infrastructure including roads, hotels and bazaars (primarily due to the fact that they were on a secure supply route for the mujahedeen). The economy became divided, as it partly remains to this day, comprised of licit and illicit components, each of which was marked by a high degree of informality.

The Afghan government's military and civilian spending, funded by the USSR, increased enormously during the late 1980s, making fiscal sustainability close to unachievable in the event external support was lost. Consider, for instance, that external aid made up to 70% of Afghanistan's gross national income (GNI) during this period. Defence expenditures jumped from 18% of the state budget in the mid-1980s to 60% in 1988-1989. Afghans relied on the Soviets for fuel, consumer goods and a significant proportion of their food, which was imported from the USSR on credit.

4. Rise of the War Economy, 1989 – 2001

The Soviet withdrawal and ensuing civil conflict between the government and various Afghan factions led to a rapid increase in money supply (as competing governments printed their own currencies), the depreciation of the Afghan currency and a resulting rise in food prices. Mujahideen forces captured Kabul in 1992, renaming the country the Islamic State of Afghanistan, and began violently competing for control of the state. As military entrepreneurs could no longer rely on external support, they were forced to increasingly rely on domestic revenues. The sale of natural gas from Afghanistan accounted for about 56% of total export revenues in the 1980s[11]; however, as the Soviets retreated the gas fields "were capped to prevent sabotage by the mujahedin" thereby limiting the potential income from natural resources. With licit income sources on the decline, the war economy that developed during the Soviet period not only continued but also expanded. DfID reports that the supply routes established during the anti-Soviet resistance, which were used by segments of the international community to provide weapons as well as humanitarian supplies, "laid the foundations for the regionalised war economy that was to emerge in the 1990s". Profits accumulated by commanders and traders were invested in illicit activities such as narcotics-trafficking and cross-border smuggling.[12] Revenue collection by the warring factions and commanders was achieved through predation and banditry, road blocks, asset stripping, appropriation of state land, taxation and the illegal regulation of trade.

[10] See note 8.
[11] See note 8.
[12] See note 2, p. 268.

The war economy was overwhelmingly informal and highly decentralised. With no central economic authority, provincial capitals and major cities within Afghanistan became integrated into the economies of neighbouring countries, turning the borderlands – from Herat in the West, Kandahar in the South or Mazar-e Sharif in the North – into self-regulating economic centres.

Further changes were on the horizon with the emergence of the Taliban in 1994 and their subsequent takeover of Kabul in 1996. Fighting continued between the predominantly Pashtun Taliban and the United Front. Though the Taliban technically controlled most of Afghanistan, they did not have the means to administer and run public services in a centralised fashion; each region was administered by local authorities who acted quite autonomously. There were significant regional and economic linkages between Central and South Asia and the Middle East, which allowed for the circulation of cars, weapons and drugs. The prevalence of predatory economic activities, which included extraction of payments by local commanders[13], "reflected the fragmentation of social power". Cross border trade acted as "a centrifugal influence", relocating economic activity from Kabul toward the provincial cities.[14] At the same time transnational trade was increasing, state borders were becoming increasingly permeable as the Taliban employed a multinational network.

While Afghanistan experienced a decline in licit revenues from natural gas and other sources throughout the 1990s, the Taliban continued to generate income through their control of the main roads, cities, airports and border crossings (where customs are collected). Conrad Schetter of the University of Bonn reports that by charging 6% on each item imported into Afghanistan "the Taliban earned USD 2.1 billion from trade in 1997" alone. As Taliban influence grew, "they implemented a transition from localized predatory warlordism" to state power based on extraction of natural resources and a criminalised open economy. Put more simply, the Taliban began moving from a form of decentralised rule by local "strongmen" to a more hierarchical system of government funded through the proceeds of what one could label "criminal" activities such as narcotics production and trafficking. Opium, however, was essentially a licit commodity as the Taliban used funds accrued from its cultivation to provide a system of national security. Warring parties gained from the drug trade by collecting a 20% tax on harvested opium. The greater security provided by the Taliban also improved conditions for the trade in opium, and, in 1998, opium production rose by 9%.[15] Estimates suggest, however, that revenues earned from transit trade – that is, the movement of products through Afghanistan – actually exceeded that of the opium trade as border crossings into Pakistan became more accessible. By the year 2000, Afghanistan's economy still consisted of the transit trade, the drug trade and the gem trade, with service industries stimulated by their growth.

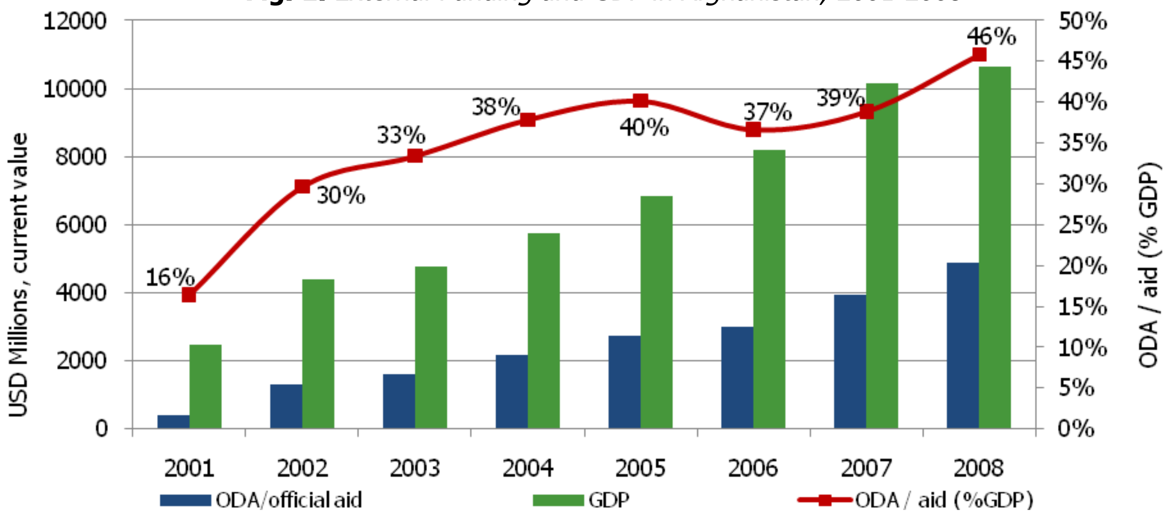
5. Selected Economic Developments Since 2001

Many remnants of Afghanistan's earlier economies, including the warlord economy and reliance upon external assistance (see Fig. 1, next page), have continued into the post-Taliban era. Formal measurements of licit economic growth estimate quite rapid development in recent years (e.g. real GDP growth of 13.5% in 2007/08 and a doubling of per capita GNI in the half-decade since 2002). DFID, however, claims that obstacles remain, as output has been driven "especially by construction projects linked to donor activities and by private consumption, rather than by a sustained expansion in sectors likely to support long-run growth". With the recent discovery of new minerals, many

[13] See note 2, p.276
[14] See note 2, p. 267.
[15] *Ibid.*

countries and private actors have already shown interest in helping Afghanistan utilise these natural resources, including the Chinese Metallurgical Group Corporation (MCC), which is investing USD 3 billion in the Aynak copper mine south of Kabul. Russia has also become eager to cooperate as it has expressed interest in reviving USD 1 billion worth of Soviet-era public works. Furthermore, domestic revenues have risen dramatically since 2001, from USD 131 million in 2002-2003 to USD 831 million in 2008-2009.[16] Current security concerns, however, may impede development, according to recent reports in the *New York Times*. Furthermore, the fiscal sustainability of Afghanistan's security sector remains a key challenge should external financial support decrease in the future.

Fig. 1. *External Funding and GDP in Afghanistan, 2001-2008*



Source: *The World Bank, World Development Indicators 2002-2009.*

The Afghan war economy has, based on historical analysis, generated what Rubin has described as a "pattern of regional economic activity and associated social and political networks that compete with and undermine legal economies and states." As such, the question remains, how the war economy can be replaced with a licit economy which allows the entire country to benefit more from peace and stability than from maintained insecurity. As the next chapter of the Afghan economy opens, time will tell whether the patterns which have hindered the economic progress of Afghanistan thus far will persist or whether they can be tempered and even overcome.

[16] Although total revenue excluding grants (% of GDP) and tax revenue (% of GDP) both experienced a 1% dip in 2007, they recovered to 2006 levels at 7.6% and 5.8% respectively by the end of 2008.