

# Afghanistans transition towards a market driven economy economics essay

[Economics](#)



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## Introduction

Afghanistan is one of the several countries where the reliable data availability is very limited. When talking about Afghanistan's economy, one can't separate it from its politics. Whenever one speaks of Afghanistan's economic history, he has to relate it with the political history otherwise it remains incomplete. Transition has been one of the topics widely discussed nowadays. Scholars are largely in favor of moving forward towards a new economic system in favor of the nation's wellbeing. Market Economy is what everyone is eyeing for. This study is designed to provide a brief history of Afghanistan during the political and economic transitions and in short, show its economy is intertwined with its politics. This study will try to understand the prerequisites of a successful transition to a Market Economy and what challenges lay ahead for Afghanistan to overcome for a successful change. SMEs are widely renowned as the engine for a country's economy. In addition to identifying the requirements for the transition, this paper will try to understand the growth of SMEs in Afghanistan. To what extent SMEs have been successful in their respective fields and what the government in SME development? This research will be based on established theories, scholarly articles, individual interviews, focus groups, annual reports, case studies and interpretive analysis. Before proceeding any further, let us understand what is meant by Market Economy. Investopedia defines Market Economy as "an economic system where the wellbeing of a nation should be decided by the best determinants which are the market forces, such as supply and demand and where the government intervention is to the least, limited to government playing a role as of a regulator." [1] This shouldn't be mistaken

by Capitalism. Even though Capitalism and Market Economy are entwined when it comes to basic concepts but it's very important to understand the distinction between the two doctrines. While capitalism refers more to the creation of wealth, market economy refers to the exchange of wealth in different forms. Capital is an essential base of both markets. However, open competition is not an essential element of capital but of market economy. This is because in capitalism, the capital owners have much more dominance and influence in the means of production whereas market economy is strictly run by the demand and supply principle without or with very little external influences. In economy, be it any, SME plays an important role in its development. SMEs are known to be the fuel of the economic growth. SMEs are more innovative and mostly regarded as the seeds of future large corporations[2]and are characterized to be fast and flexible adapters to external and internal environmental changes. Governments are required to improve the SME sector in order to witness a sustainable growth. Studying SMEs can enhance our understanding of their needs with respect to development of an economy. SMEs are the backbone of the private sector which constitute over 90 percent of enterprises in the world and constitute 50-60 percent of employment.[3]SME, due to its ambiguity in relation to its size and categorization, many authors have expressed it in many different ways (Ganguly 1985,[4]Cross 1983,[5]et al). In this paper, I used the definition given by the European Commission (EC). EC defines SMEs based on the total turnovers and the number of employees. EC considers any enterprise as an SME when " the total numbers of the active employees are no more than 250 persons, their annual turnover are not exceeding the EUR

50 million and/or their annual balance sheet total is limited to EUR 43 million." [6] One of the other criteria for an enterprise to be considered as an SME requires the enterprise to be autonomous. EC defines autonomous to be when " you are totally independent, i. e. you have no participation in other enterprises and no enterprise has a participation if yours. Or you have a holding or less than 25% of the capital or voting rights in one or more other enterprises and outsider not have a stake of 25% or more of the capital or voting rights in your enterprise." [7] SMEs can be broken down to three categories based on its size: Micro Enterprise Small Enterprise Medium Enterprise The figure 1 shows a clear distinction of the aforementioned categories. C: UsersAmanullah NuristaniDesktopUntitled-1. jpg Figure 1: Source: European Commission " The new SME Definition"

### **Afghanistan's historical background:**

The past three decades of war and atrocities have had a devastating impact on lives of the Afghans. Tens of thousands have been killed and millions of more have been forced to flee their homes and seek refuge in foreign countries. The basic infrastructure has been torn apart and the country destroyed. But the post-Taliban government under Karzai administration has seen a significant amount of development in the last decade. Afghanistan is landlocked yet strategically positioned in Asia where it could serve as a crossroad across Asia, which grabbed the interest of many, but in the past few decades the country's economic potential hasn't taken its root.

Afghanistan has been on the receiving end of equation for the past 4 decades. Afghanistan relies heavily on the external financial flows from the international communities. The rapidly changing nature and the correlation

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of politics and economics have led to an unstable and volatile political economy. It's not just the past three decades, Afghanistan's demise started in the mid-18th century when it became the buffer state between the two giants, Russia and great British Empire. The great rivalry of who is going to control Afghanistan continued for decades. "The Great Game" finally came to an end with the Anglo-Russian Convention in 1907. This declared Afghanistan as protectorate of the United Kingdom in the 20th century. When Afghanistan achieved independence from the British rule in 1919, Afghan leaders started modernizing Afghanistan in a very rapid and uneven pace. During the cold war between United States and Russia, Afghanistan remained neutral thanks to Zahir Shah but Afghanistan's economy was very much entangled with the cold war. Zahir Shah imposed a controlled economy, modernizing internal industrialization, providing equal education and social measures for all. Amid the cold war, Afghanistan's prime minister Mohammad Daud Khan plead for financial assistance from both the United States (US) and Union of Soviet Socialist Republics (USSR) believing that without brisk economic growth, the country will be segregated into sever political fragments which will completely destroy the hopes of reviving an already broken country.[8]Russia began aiding Afghanistan in 1950s. They provided financial support to build up the economic infrastructure of Afghanistan as well as substantial military assistance. The aid lasted for many years and gained the trust of the Afghan people. Looking at Russia influencing Afghanistan, US started allocating their part of the budget for Afghanistan which was later estimated to be 30% of the foreign aid Afghanistan received. 50% of the foreign aid was provided by the USSR.[9]In

late 1970s, Afghanistan faced creeping crisis. Due to drought years, the value of the currency significantly depreciated. Exports decreased and imports increased by great margins. Shortages of food items resulted in illicit smuggling. When Daud Khan took over the presidency, he carried on modernizing the society and establishing a more government regulated economy. He reformed the social welfare and expanded education. Being an Islamic state, I wouldn't say it was a great reform but abolition of Purdah was one of the reforms Daud Khan brought in Afghanistan. The government, under Daud Khan, gained tighter control of imports as well as of export industries. In 1977, the government had to intervene to lower the exchange rate as the currency appreciation had threatened to make many exports unprofitable. The fiscal system in the 1970s was small and centralized, leaving provinces with neither tax authority nor budgets. 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".[10] 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. By 1978 approximately 80% of the Afghan population was dependent on the rural economy and agriculture accounted for 60% of GDP (figures which remain largely consistent to the present).[11] 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[12]between the USSR and Afghanistan brought oil development, trade, transport, irrigation, factories and highway construction.

### **Afghanistan's Economic downfall:**

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) that resulted in the depreciation of the Afghan currency, thus increasing the 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 \$300 million a year in export revenues, about 56% of total export revenues in the 1980s[13]but around 90% of the revenues generated by the exports of the country went back to Soviet Union for the debt they incurred by abundance of imports; however, when the Russians retreated, the gas fields " were capped to prevent sabotage by the mujahedin" thereby limiting the potential income from natural resources.

[14]With licit income sources on the decline, the war economy that developed during the Soviet period not only continued but also expanded. Gas production after the withdrawal of the Soviet Union dropped from a high of 290 million cubic feet (Mmcf) per day in the 1980s to current low of about 22 Mmcf in 2001.[15]DfID reports that the supply routes established during the anti-Soviet resistances, which were used by segments of the international community to provide weapons as well as humanitarian supplies, " laid the foundations for the regionalized war economy that was to

emerge in the 1990s". Profits accumulated by commanders and traders were invested in illicit activities such as drug trafficking and cross-border smuggling.[16]Revenue collection by the warring parties and commanders was achieved through predation and banditry, appropriation of state land, taxation and the illegal regulation of trade. The war economy was devastatingly informal and highly decentralized. With no central economic authority, provincial capitals and major cities within Afghanistan became integrated into the economies of neighboring countries. Significant changes occurred on emergence of the Taliban in 1994 and their subsequent takeover of Kabul in 1996. Fighting continued between the predominantly Pashtun Taliban and the revolutionaries. Though the Taliban technically controlled most of Afghanistan, they did not have the means to administer and run public services in a centralized fashion; each region was administered by local authorities who acted quite independently. The significant economic relations between the central Asian countries allowed the warlords cross-border trafficking of cars, drugs and weapons. 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. Taliban began to form a more stabilized and hierarchical system moving from " Rule of the



strong" to a system funded by illicit activities such as narcotic production and trafficking. Opium production and revenue generated by it was the main source of maintaining the rule not considering foreign funds. The greater security provided by the Taliban also improved conditions for the trade in opium, and, in 1998, opium production rose by 9%.[17] Estimates suggest, however, that revenues earned from transit trade 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.

## **Economic Development and Recovery:**

### **Primary Sector:**

After the fall of Taliban and an interim Karzai government, Afghanistan heavily depended on foreign aid to stay afloat. Between 2001 and 2006, half of its operating costs were covered by the foreign support. According to the World Bank, Afghanistan's operating budget for 2005 was \$600 million, half of which came from taxes and the other half from foreign donors.

Afghanistan's economy picked up pace and started growing in a convincing manner. The past few years have shown significant growth in different sectors of Afghanistan. The real GDP growth has seen its share of tumbles but currently remains at a solid 8.4% at the end of FY2010/11, according to the annual reports of the World Bank. It has been a known fact that Afghanistan's agricultural sector plays a major role in the country's economy. It has been reported by the World Bank that 70% of the labor force works in this sector and about 30% of the country's GDP comes from

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agriculture. Afghanistan is enriched with wheat, dry and fresh fruits, wool, mutton, opium and different kinds of nuts. Afghanistan witnessed a great increase in their GDP in FY2009/10 but it was volatile and unstable thus falling down to an average 8. 4% for the year 2010/11 (Figure A).

### **Service Sector:**

For the past five years, the service sector has led the way. The sector accounted for almost half of the GDP growth of Afghanistan (Figure B). The subsectors actively participating in the GDP growth have been the Telecommunication sector, transportation, finance and insurance and minimum contribution has been done by retail trade which grew at 5. 7%. [18]Overall, industry grew by 6. 3 percent from last year. This was largely due to the expanding mining sector which grew sharply by 43 percent. On the other hand, subsectors such as construction and manufacturing which have larger contribution to GDP growth, showed modest annual growth of 7. 7 percent and 3. 8 percent respectively.[19]

### **Inflation and Price control:**

Afghanistan's inflation has always been fluctuating since being an importing country, it seems normal. According to the World Bank report, Afghanistan witnessed a steep inflation in year 2010 till the early months of 2011. Based on the consumer price index (CPI), inflation rose to 13. 3% in the said period of time (Figure 1). This can be explained by the super dependence of Afghanistan on foreign imports. As the prices in the external markets fluctuated, the prices in Afghanistan changed likewise but a strong deflation was seen in the in the late months of 2011 which can be explained by the

declining international prices of commodities and by a high degree of food imports substitution made possible by a good domestic harvest.

### **Why I choose to research on this topic:**

Every sector has seen good development if not great since the reestablishment of a new government but the critics have not yet been satisfied. In the past few years, Afghanistan has been able to lay the foundation of a more stable and productive economy. But the question still lingers, is Afghan government able to place itself as a regulator, not a producer, of goods with proper segregation of public and private sectors, enabling it to come out of the government controlled economy of the past? An independently operating central bank, a more liberalized system and regulations allowing private owners to fully own factors of production characterizes an era of a new economic landscape but will external factors effecting Afghanistan let this country move into a new direction? Will the psychic of Afghans understand such a system or even if they do, will they be able to adapt it? Substantial challenges remain, many of the problems this economy faces are typical for those rebuilding after war. High prices from an immature system that lacks sufficient private sector competitiveness; resistance to change from a state-controlled system; the shortage of human capital; increased corruption; insecurity to the utmost; and inequalities created by the market system itself are the challenges Afghan government needs to overcome first and later think of alterations in the economic systems. Most of the critics believe that even though billions of dollars are poured in Afghanistan, the equivalent development as not been made. One of the major reasons for choosing this topic is because transition has been

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one of the hot talks discussed all around Afghanistan but their eyes are stuck to only one side of the picture. No one has ever tried to understand what the Afghans want. One of the five prerequisites and most probably the most important one of a successful transition is the public support based on Anatoly A. Sobchak's theory.[20]I want to understand whether the public will support such a phenomenon or do they still linger in "government do everything" concept. Anatoly Sobchak considers five elements very basic elements which are necessary for a successful transition to a market economy.[21]There have been a lot of speculations on this regard for the past 5 years now. Afghanistan's former Finance Minister, Anwar-ul-Haq 'Ahadi' has been highly optimistic about Afghanistan being ready to take a step forward in building a more liberal market. This research will evaluate the current situation of Afghanistan and determine whether the prerequisites for the market economy are met and to what extent the optimism is likely to be put into practice.

## **Literature Review:**

In economic, the most challenging part is to understand the causes and nature of an economic change, what results in transition from a relatively sound system to a potentially terminal economic system, what will be consequences of the change and will the outcome be as expected. In the field of economics historical data is important but present reliable data is far more important in future decision making. Change over time has historically been proven to benefit the overall economy of a country but there are some prerequisites to the change. A transition wouldn't be necessary if there wasn't a need for it and when there is need, there are terms, conditions,

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requirement and status which can be in any form. Adam Smith (1776) in his work claims that " in order to maximize the universal prosperity, everyone should be given the freedom to produce and exchange goods and services (free trade) not only domestically but also internationally and no restrictions should be made by the government and governments should practice Laissez Faire. Adam Smith further strengthens his theory by proposing three every critical factors for achieving success to a market economy. He believed that in order to bring universal opulence, a nation has to practice three elements: Enlighten Self-Interest: Adam Smith claimed that thrift and hard work is something which comes naturally to human beings and working for one's interest is something natural. Smith saw the savings as an important virtue as long as they are to be invested in some stage of life. Through investments, the industry would have more capital to buy factors of productions and individuals would get high returns on their investments thus improving their standards of livingsGovernment Intervention: Adam Smith limited, his theory, the government intervention to basic infrastructure which is road building, constitution, universal education and full say in crime and fraud but opposed the idea of government disrupting the economic factors or enforcing bureaucratic laws of market transactions. Solid Currency: The third element that Adam Smith believed in economic success was having large reserves of gold or equivalently precious metals." [22]Chris Seabury (2009) expresses a contrary view when it comes to its application. He has argued that " market economy at its purest form is when the allocation of resources is determined by the market forces, supply and demand, without any sort of government intervention. This sort of system creates a competitive

environment forming an atmosphere of survival of the fittest. This will cause businesses to disregard the safety of the general public to increase the bottom line. Furthermore, he discusses that wealth is not distributed equally as a small percentage of the society keeps generating wealth while the rest of the society lives in poverty, meaning the rich get richer and the poor die without tasting what's it like to be being rich. The author also believes that by practicing market economy; there raise the question of economic stability. He claims that greed overproduction causes the economy to have wild swings ranging from times of robust growth to cataclysmic recessions."

[23]Looking at the arguments of both authors, it raises the question whether Market Economy has been completely understood by its nature or everyone can have a difference of opinions. Not only this, but to what extent is Market Economy applicable before it takes a shape of "Survival of the Fittest" economy. Afghanistan has been a country prone to transitions which not always have assisted the economy conditions. Anatoly A. Sobchak (1991) suggests that there are five necessary elements in order to have a successful transition to a market economy."

**Economic Stabilization:** First, a market economy must be preceded by a period of economic stabilization. He suggests that in period of crisis, when the economy is weakening radically, it is impossible to switch at once to a market economy without securing a period of stabilization.

**Market Infrastructure:** Second parallel to economic Stabilization is market infrastructure. Just like Soviet Union's economy back in 1990s, Afghanistan's economy is very primitive. Afghanistan's economy doesn't have the infrastructure to support the market economy as yet.

**Property Ownership:**

Third most important element of a successful transition to market economy is the freedom of property ownership in different stratum forms. The government should de-monopolize and take itself out of the main sectors.

**Change of Mentality:** The next condition for the transition to a market economy means a profound, fundamental transformation in more than just the industrial and economic conditions of the society but what is necessary is a change in the psyche of the people, the way of life, in people's understanding and the way they see their position in the society.

**Public Support:** The author believes that any change is not possible unless the public stands beside the decision and support the ideology of any fundamental change. The confidence of people is what drives the government to carry out operations on a nation-wide level." [24] A high percentage of my thesis will be based on rectifying the aforementioned elements in the context of Afghanistan. Many of the Afghan government officials believe that Afghanistan has reached a stage where a transition to such an economy is possible. A large portion of my thesis will try to identify to what extent the transition is possible and if the transition, given the circumstances, is not likely, what can be done in order to get to a point where the social welfare of the people are met. Anthony H. Cordesman (2012) writes in his report that the chances of a successful transition are very less as Economy of Afghanistan is not the only aspect people should think about. He believes that the ultimately it will be the Afghan government determining the success of the transition where the internal politics and regional states will play a vital role. [25] Cordesman further emphasizes that the government or international donors should stop claims of progress based

on "uncertain methodologies, uncertain databases or analytic structures that are not related to any other aspect of data collection and analysis".[26]"

There is only limited time for the US and its allies to deal with the economic problems in Transition. Moreover, if they are to have any chance of success, they need to address these economic problems as honestly and objectively as possible, admit how serious they are and admit how limited the progress has been to date. They also need to stop treating the economics of Afghanistan as if there are reliable data on the challenges involved, or even reliable data on basic economic measures like population and GDP. This means planning must concentrate on the art of the possible in terms of defining what military and civil aid can realistically do to achieve stability and securing Afghanistan between 2012 and 2020 in spite of the lack of adequate data for planning. It means looking far enough beyond 2014 to see what may be needed to ensure some form of stability, and to create an integrated civil-military approach that deals as honestly with the challenges involved as possible.

### **There are No Reliable Macroeconomic Data on Afghanistan**

The first step is to admit just how bad and conflicting many of the data now being used really are. If effective planning is to take place, organizations like the World Bank, IMF, UNAMA, USAID, the State Department, and other countries and donors need to adopt basic standards of professionalism in approaching their efforts to plan Transition. They need to stop using point estimates with no clear source, definition, or effort to estimate uncertainty. Figure One compares the most basic macroeconomic data on Afghanistan using some of the primary sources now being used in Transition planning.

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The data on GDP differ so radically that it is clear there is no meaningful baseline for economic planning. The population data appear to agree only because different sources borrow from the same guesstimate in the absence of any meaningful census, and even so, the Afghan data differ significantly from the data used by outside sources.

## **No Useful or Reliable GDP Data**

The lack of a meaningful census, the inability to assess the domestic GDP accurately in either market or PPP terms, and on all other key measures result in real world uncertainty levels that can easily reach 20-30%. It is time that honesty and integrity – as well as clear explanations and definitions of the source of the data and exact methodology used in key estimates – were made part of official efforts

## **Figure One: Baseline Economic Statistics: Will the Real Afghanistan**

### **Please Stand Up?**

Estimate Population (M) GDP (\$USB) GDP perMarket/RealPPP/NominalCapita (\$US)Afghan Central StatisticsOrganization 24. 485\*\* 18. 410/11 \* \*to 26.

OCIA World Factbook 30. 412 17. 911 29. 9911 1, 00011US State

DepartmentBackground Note 29. 39609 - 27. 36 10 900 09World Bank

EconomicUpdate 10/11 30. 1810/11 7. 4510/11 15. 92810/11 489 10/11IMF

WEO Database9/11 32. 0712 19. 3812 32. 01712 1, 015. 64712UN Country

Profile 28. 1509 12. 85309 - 456. 609US Census Bureau IDB 30. 42012 - - -

\*Did not function when access was attempted.\*\*Settled population in yearbook for 2010-2011. Note: Superscript shows year for estimate.

Assumes 1 \$USD = 49.5 Afghanis unless conversion done by source There is a 4:1 difference in the various GDP estimates shown in Figure One.

Ironically, the primary outlier is the World Bank, which US and Afghan government planners have used in much of their Transition planning – although the US and Afghan estimates of GDP growth are anywhere from more than two times higher to four times – depending on which measure of GDP is used. Unfortunately, there is no way to put these differences in perspective. None of the sources fully explain where the data for their estimates of the Afghan GDP come from, or how it is calculated in any meaningful detail. No source describes the key uncertainties in the estimate, or attempts to indicate the uncertainty in percent. Normally, market or currency transaction-driven estimates are more accurate than estimates that include efforts to compensate for the larger part of developing economics that either do not use currency, do not take place at market prices, or are not recorded. In Afghanistan's case, however, there do not seem to be meaningful base points for market estimates of the GNP during the Taliban years, or any reliable basis for estimating how much the massive flow of US, other International Security Assistance Force (ISAF) country, and donor spending that built up after 2002 was actually spent in country versus spent on the war and aid outside it".[27] SMEs in developing countries face a financing gap that undermines economic prosperity" SMEs are a fundamental part of the economic fabric in developing countries, and they play a crucial role in furthering growth, innovation and prosperity. Unfortunately, they are strongly restricted in accessing the capital that they require to grow and expand, with nearly half of SMEs in developing countries

rating access to finance as a major constraint. They might not be able to access finance from local banks at all, or face strongly unfavorable lending conditions, even more so following the recent financial crisis. Banks in developing countries are in turn hampered by the lack of lender information and regulatory support to engage in SME lending. The overall result is absence of a well-functioning SME lending market, and SMEs are impeded in their growth, with negative consequences for innovation, economic growth and macro-economic resilience in developing countries." [28]

## **THE IMPACT OF ACCESS TO FINANCE ON SMEs**

Access to finance is necessary to create an economic environment that enables firms to grow and prosper. SMEs in developing countries, however, face significant barriers to finance. Financial constraints are higher in developing countries in general, but SMEs are particularly constrained by gaps in the financial system such as high administrative costs, high collateral requirements and lack of experience within financial intermediaries. Increased access to finance for SMEs can improve economic conditions in developing countries by fostering innovation, macro-economic resilience, and GDP growth. [29] Small firms are disproportionately handicapped by a lack of finance, but they receive a stronger boost in growth than large firms if financing is provided. Financing obstacles affect small firms more than large firms. Small firms not only report higher financing obstacles, but they are also more adversely affected by these obstacles. [30]