Economic Transition in Afghanistan: How to Soften a Hard Landing

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The clock is ticking. Between now and 2014, upwards of 150,000 foreign troops and 30,000 contractors will start leaving Afghanistan. Donor aid is also declining. In the past year, the U.S. Agency for International Development (USAID) budget has been cut in half. In other words, the war economy is unraveling.

While most of the $118 billion in foreign spending for this war economy is done outside the Afghan economy, the foreign spending inside the Afghanistan economy has created a large "bubble economy." As this bubble economy starts to dry up, there will almost certainly be a large reduction in aggregate demand.

Given both the expected cuts in foreign spending in Afghanistan and the pace of the military drawdown between now and 2014, U.S. Treasury officials have come up with a range for the expected contraction of the Afghan economy.

- The best case scenario has the Afghan gross domestic product (GDP) falling by 13 percent, or about the same as occurred in the United States during the Great Depression.
- The worst case scenario has the GDP falling by 41 percent.

Anything inside this broad range of possibilities means unemployment in Afghanistan is likely to soar unless something is done to stem the tide.

The specter of an Afghan economic train wreck does not faze the optimists. They point to the military drawdown in Iraq which has gone relatively smoothly under the able direction of General Lloyd Austin. But the promising macroeconomic picture in Iraq is totally different than in embattled Afghanistan. In Iraq, the international oil companies are boosting oil production, which boosts GDP and counters downward economic pressure. Unfortunately, international oil companies are not rushing into Afghanistan anytime soon to fill the gap.

While no two situations are exactly alike, a better macroeconomic analogy for Afghanistan is East Timor. When peacekeepers left the country, there was no effort made to boost private or public investment. There was also no attempt to create rural banks. So money literally had to be carted around. A proposal to execute a public works program to rebuild the shattered infrastructure was rejected. United Nations (UN) peacekeepers opted to cut and run, which left rising unemployment and violence in their wake. A similar failure cannot be an option in Afghanistan.

How do we soften the blow in Afghanistan and avoid this violent East Timor-like scenario? Unfortunately, in Afghanistan there is no “shake and bake” solution. That said, there is reason for hope. The good news is that Afghanistan has lots of potential wealth. The bad news is that Afghanistan is struggling to turn potential wealth into actual wealth.

Afghanistan lacks what MIT Economist Walt Rostow used to call the preconditions for economic “take off.” Afghanistan is a landlocked country with inadequate infrastructure. Only 7 percent of its roads are paved, and there is no railway nearby to carry heavy minerals to regional or global markets. In other words, Afghanistan's fatal flaw is poor market access. If products somehow get to the borders, bottlenecks cause them to get stuck there. As a result, farmers and miners have little incentive to increase productivity or boost output.

To achieve Rostow's economic takeoff in Afghanistan, we need: a) a strategic vision; b) concrete projects to reach that vision; and, c) the political will and perseverance to make it all happen. A good historical example of the strategic vision that we need in Afghanistan appeared after World War II when Jean Monnet called for a European Coal and Steel Community. The Realists ridiculed Monnet for being hopelessly naïve and idealistic. Didn’t Monnet know that France and Germany hated each other and had fought each other for centuries?

But Monnet correctly argued that an alternative future was possible. If given a chance, French and German businessmen would bond. What was needed was a strategic vision and unwavering moral courage to execute a viable economic strategy and concrete economic plans for regional economic integration. Shared prosperity would outweigh security concerns. Before long, French and German businessmen would reduce the demand for violence. They would turn swords into ploughshares. As France and Germany began to see mutual economic benefit, enemies turned into friends.

Like Jean Monnet, Sham Bathija, President Karzai’s top economic advisor, understands that Afghanistan needs shared prosperity with other trade partners rather than economic nationalism. Therefore, Bathija proposed a new *Silk Road Initiative* (or regional transport, trade, and transit network) in a speech he gave at the RECCA (Regional Economic Cooperation Conference on Afghanistan) conference in Istanbul in November 2010. U.S. Secretary of State Hillary Clinton embraced a similar new Silk Road vision in a speech she gave in Chennai, India, on July 20, 2011, calling for a new Silk Road Initiative.

In addition, we need concrete development projects to reach the vision. Toward these ends, the U.S. Government has identified a number of economic development projects in the areas of transportation, mining, energy, and trade facilitation, which need to be completed as soon as possible in order to create critical preconditions for economic takeoff to occur in Afghanistan. By building more roads and railways and fostering trade facilitation, these development projects will help Afghan goods not only flow through Afghanistan, but from Afghanistan. Additionally, Afghanistan’s abundant mineral wealth and agricultural products would have access to regional and global markets.

In essence, these additional roads and railway system become strategic enablers (or a catalyst) that will jump start other U.S. policy pillars in Afghanistan. For instance, improving Afghanistan's infrastructure creates jobs in the construction industry. Better roads also have a multiplier effect, stimulating job creation in the private sector as gas stations, restaurants, and motels spring up along these routes.

At the same time, the cost of completing the economic development projects is not just limited to the technical costs. If these projects are going to be sustainable, they need buy-in from the local stakeholders. The real costs of mining require a 360-degree approach that includes community outreach and education and training of the future workforce on the front end.

If local stakeholders see the benefits of the projects for themselves, they will encourage this shared prosperity. Just as French and German businessmen buried the hatchet when they saw mutual benefit, local stakeholders who previously saw violence as the only option, will now see a viable alternative. As peace breaks out around the projects, it will be possible to reduce the size of the Afghan police and military forces, thereby reducing the large budget deficit that the central government would otherwise have to shoulder. This net assessment shows how local and provincial progress can make things more affordable for the Afghan Government.

That said, getting buy-in from local stakeholders is not easy. For instance, mining projects require vast quantities of water. However, farmers also need water for irrigation, as well as energy officials who want to use water for hydropower. In other words, there are tradeoffs among the competing uses for water. Here is where the international community can help. In the United States, for instance, the states that compete for water benefit from the work of economists who can demonstrate their tradeoff analysis. They can show Afghan economists the diminishing returns when farmers go beyond trickle irrigation.

Finally, we need political will and perseverance to fend off the criticism from the skeptics who argue that the United States and Europe are virtually "broke" and cannot afford these new Silk Road projects. Why is it that President Abraham Lincoln could visualize a transcontinental railroad in the United States 150 years ago, but skeptics cannot imagine the same thing in Afghanistan today? Why is it that President Eisenhower could envision an interstate highway system in the 1950s, but skeptics cannot imagine the same thing in Afghanistan today?

Asking whether or not the U.S. Government and its allies can afford to fund these economic development projects is the wrong question. For starters, the reason the projects are incomplete often has nothing to do with money. Case in point is the Ring Road inside Afghanistan. The Asian Development Bank (ADB) has the money to finish the road. The showstopper has been an indemnity issue. The ADB wanted to be able to sue the U.S. Army Corps of Engineers if something went wrong.

Admittedly, much more money is needed to complete other Afghan projects. While the U.S. Government would like to see other governments boost their economic support to the Afghan Government, the lion's share of the money needed to complete the larger projects needs to come from foreign investors. Foreign investors have trillions of dollars sitting idle on Wall Street and in Dubai. They all agree that Afghanistan is the last frontier in mineral wealth. Curiously enough, physical security is not the showstopper.

Then why have foreign investors stayed on the sidelines? To begin with, foreign investment is a voluntary act among consenting adults. Foreign investors will put money into Afghanistan if they see an attractive enabling environment. At a minimum, the Afghan political economy needs to be what the World Bank calls market friendly.

- A market friendly economy is not laissez-faire. Markets require a robust legal and regulatory framework that only the Afghan Government can provide. In addition, the Afghan Government must do more to improve education, health care, and the environment.
- However, the Afghan Government needs to do less on the shop floor in the production of goods. Competitive markets are the best way yet found for efficiently organizing the production and distribution of goods. Domestic and external competition provides incentives that unleash local entrepreneurship.

In other words, foreign investors want to see the Afghan Government and the market strike the right balance that will complement each other. The Afghan Government must support rather than supplant competitive markets. Kabul should only intervene in the marketplace where and when markets prove inadequate or fail.

The Way Ahead.

As we approach the regional conference on Afghanistan in Istanbul in early November 2011 and the global conference on Afghanistan in Bonn in early December 2011, foreign investors want to see clear signs that the international community is steadfast in its economic and political commitment to Afghanistan. They want concrete signs that the United States and the rest of the international community will not abandon the country, as happened after the Soviets left Afghanistan. Most of all, foreign investors want no replay of the East Timor scenario when UN peacekeepers cut and ran, leaving rising unemployment and violence in their wake. A similar failure cannot be an option in Afghanistan.

Thankfully, Assistant Secretary of State Marc Grossman has internalized Jean Monnet's vision of shared prosperity that can outweigh the demand for violence. Foreign investors are delighted to see that Ambassador Grossman is now leading the U.S. interagency charge for a viable U.S. economic strategy for Afghanistan. To counter the economic contraction from the fall in foreign military spending and donor aid, the U.S. Government is orchestrating a new Silk Road strategy, which in turn will get Afghanistan a lot closer to market access and the other preconditions for its economic takeoff.

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