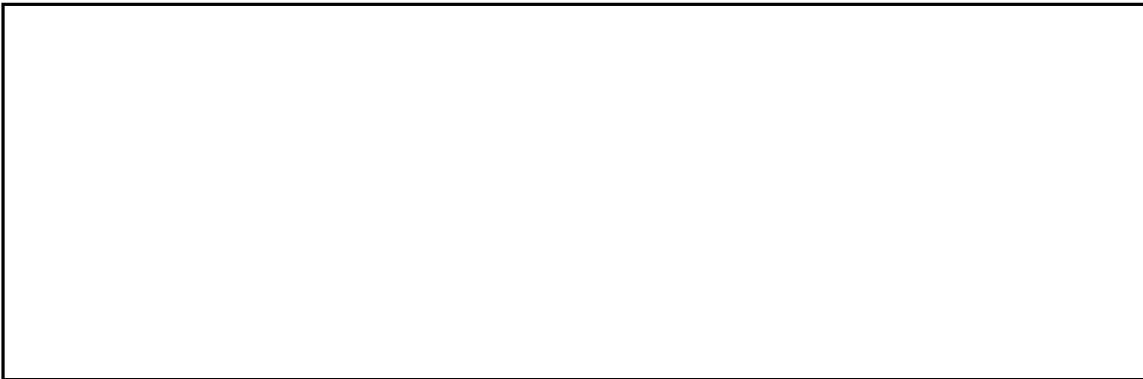


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5 April 1965

MEMORANDUM

**SUBJECT: Political Dangers Inherent in Afghanistan's
Economic Crisis**



The Political Stakes

1. Some time during the next year, one of two factions in the Afghan cabinet will probably win a quiet, often dull debate on economic policy. The issue, sometimes unrecognized, is whether to accept near-integration of the Afghan economy with that of the Communist world. While the outcome of the debate will profoundly affect Afghanistan's ability to maintain its independence, the decision may be difficult to recognize since it may emerge gradually as an accumulation of individually unremarkable policy actions regarding trade and development.

2. Afghanistan is in deep financial trouble, symptomized by a budgetary deficit about double the maximum figure deemed tolerable by the International Monetary Fund. In recent months the Kabul regime has been so short of funds that it has been unable to pay the salaries of many of its employees. The

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question is whether the government will finally decide to take the "easy" way out and rely more heavily on Soviet support, or whether it will undertake reforms that would be economically more sophisticated and politically more difficult.

Obstacles to Action

3. The longer Afghanistan indulges in "charge account living" without establishing any sound way of paying its bills as they fall due, the worse its financial predicament becomes. Although speedy remedial action is needed, procrastination is the rule of the day. A year ago decisions were being postponed until after the new constitution was passed. Now the excuse is the "need" to wait for the election of a new National Assembly, which is to convene in October.

4. These excuses are used to hide the real obstacle to getting on with the job--the impasse between two cabinet factions. No decisive action is likely until the King intervenes. The cabinet is more or less evenly divided between those who think in terms of solving economic problems by government intervention, control, and planning, and those who think in terms of encouraging private enterprise and working through the market mechanism. As is often the case, the planners are instinctively inclined to turn to the USSR for outside help, while the free marketers tend to look to the Free World.

5. The King likes to maintain a rough balance between the two factions as he makes new appointments in order to facilitate his own control of the government. Neither side is likely to be able to break the impasse without the King's support. The King, however, is unlikely to support either side until the economic pressures become politically unbearable. He is not accustomed to think about economic problems and has apparently not developed any convictions of his own.

6. The chances are probably better than even that the King, unless he acquires some convictions of his own about the fundamentals of economic policy, will eventually come down on the side of the planners, who are led by Prime Minister Yusuf. If some way should be found to educate the King on certain fundamentals, however, he might well elect to throw his support to those who look to the Free World.

Trade and Development - Inseparable Problems

7. Afghanistan's present financial problems are the price it is paying for its ambitious program of foreign-aided development projects. Roughly two-thirds of these are being built with Communist assistance, the balance with Free World aid.

8. So far, Afghanistan's economic development program has concentrated heavily on "infrastructure" projects, that is, projects such as roads, tunnels, dams for power and irrigation, and airports. These facilities will make it more possible to build new factories, to get raw materials, and to ship products to market. They do not in themselves, however, increase the amount of goods on the market. As local materials and labor have to be paid for in the construction of these projects, they add greatly to the money supply and therefore to demand for more goods.

9. The Afghan Government has secured money to pay for local costs of projects, mainly by "borrowing" from the central bank, that is, by printing it. As the money supply has expanded faster than domestic production, there have been two adverse effects. The first is inflation. The second is a chronic trade imbalance as domestic production has failed to satisfy the increased demand for goods and as the demand for imports has increased.

10. Since imports have risen faster than exports, foreign exchange has become scarcer. Approximately a fourth of Afghanistan's imports come from Japan, which

imports practically nothing from Afghanistan. Consequently, there is mounting pressure to reduce imports to a level closer to Afghanistan's ability to pay for them, especially from Japan. But, if the Afghan Government restricts imports to achieve something closer to an even balance in its overall foreign trade accounts, the resulting reduction in goods available on the Afghan market would increase domestic inflationary pressures.

11. A reduction in imports, then, would increase the need to reduce the money supply by stopping work on some development projects. Thus, one politically unpalatable retrenchment measure would increase pressure for a second action equally unpalatable. It seems highly unlikely that the Afghan Government will choose this course of action.

12. Afghanistan needs to increase domestic production fast enough to absorb the expanding money supply, and it needs to expand export earnings to a level that will pay for existing levels of imports. These "solutions" have the necessary combined virtues of being both economically and politically feasible.

13. There are good prospects for increasing domestic production and export earnings. All that has been accomplished in developing Afghanistan's economic infrastructure can now support new producing factories. Interest among potential Afghan and foreign investors in building such factories is increasing. The main problem is to break out idle capital, which is there to be invested, by establishing a favorable political climate. This will require a decision by the King to support those officials who favor working through the market mechanism.

14. Export earnings can be increased by improving the quality of Afghanistan's present exports through better grading, cleaning, and packing of such items as cotton, wool, and fresh and dried fruits. Some such projects are already underway, but others are being delayed by the impasse in the cabinet.

15. Such favorable long-term prospects for increasing production and export quality are not adequate in themselves, however. If a dangerous inflation is to be avoided, it will be necessary to maintain present import levels for the next few years before Afghanistan achieves the capacity to pay for them. This may be possible.

16. In considering Afghanistan's foreign trade problems it is necessary to distinguish between three separate but interacting markets. These are the barter account with Communist countries, the Free World account, and the blocked rupee account with India. It would be possible for Afghanistan to manipulate these accounts and markets by policy actions, in order to get time to increase domestic production and improve the quality of exports.

17. The deficit which has been accrued on the barter account is now being slowly reduced, since exports to Communist countries exceed imports by a small amount. There is, moreover, pressure from the planner faction in the Afghan Government to increase the rate at which this deficit is reduced by channeling a larger percentage of Afghanistan's total exports into the barter accounts.

18. The planners are also inclined to turn to the Communist countries, such as the USSR, Czechoslovakia, and Poland, for help in launching new projects to improve the quality of exports. If this happens, marketing standards in vogue in the Communist World will be employed and it will be easier to export the improved exports to Communist markets than to the Free World.

19. Furthermore, if additional production and better foreign exchange earners are channelled into the barter account, they will not help the free market account. This is the important account for purposes of improving Afghanistan's trade position. The annual deficit in this account now runs about \$5,000,000 out of a trade which totals about \$25-30,000,000 per year with the Free World, excepting India.

20. It would be preferable to direct any improved earning capacity into the free market accounts and merely continue to reduce the barter account deficit at the present modest rate. To accomplish this, a government decision is needed which will encourage private Afghan investment and Free World investment in new production facilities and in projects for improving quality standards set to meet Free World market requirements.

21. If Afghan trade with the Free World is not to be diverted into the barter account, a method must be found to handle the substantial Afghan deficit in the free market account until Afghanistan raises its export earnings.

22. This deficit arises mainly in Afghan trade with Japan, which sends a wide variety of goods to Afghanistan but finds nothing there to buy. The Afghans have indirectly sounded out the Japanese about the possibility of a long-term consumer goods loan, to be backed by funds earned in Japan by the sale of PL-480 surplus food shipments from the U.S. There are precedents for such cooperative actions by USAID in other countries. The Japanese Foreign Ministry and Ministry of Trade, which are concerned about the possibility of losing the Afghan export market, have seemed receptive. The Japanese Ministry of Finance, however, does not like the idea of long-term consumer goods loans and is offering strong opposition. The outlook for such a scheme is now poor.

23. The third Afghan foreign trade account is in Indian blocked rupees. Until about five years ago, Afghanistan exported fresh and dried fruit to India and used the foreign exchange earned there to buy consumer goods from Japan. The Indians, however, somewhat arbitrarily assigned this fruit to the "luxury" category, and since luxury imports are discouraged, would pay for them only in blocked rupees. A ceiling

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of about \$1,000,000 has been set on the amount of rupees Afghans are allowed to accumulate in Indian banks at any one time. These rupees may be spent only for a restricted list of items which are not desired in Afghanistan.

24. If the list of Indian goods available for such rupees could be expanded to include some of the goods presently imported from Japan, this action alone could reduce Afghanistan's deficit with Free World trading partners by as much as 20 percent. Since India now produces such goods in quantity, such a move would be of little moment to the Indian economy. Prime Minister Shastri apparently showed considerable sympathy for this view when he met with Prime Minister Yusuf some months ago in Cairo, but on returning to New Delhi ran into considerable opposition from Indian officials.

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