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CIA/RR CB 65-45
August 1965

Copy No. 192

INTELLIGENCE BRIEF

FINANCIAL PROBLEMS IN AFGHANISTAN

DIRECTORATE OF INTELLIGENCE

Office of Research and Reports

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FINANCIAL PROBLEMS IN AFGHANISTAN

Increased foreign assistance has, for the present at least, enabled Afghanistan to overcome an emerging financial crisis. During the past fiscal year (21 March 1964 - 20 March 1965),* convertible foreign exchange reserves declined about 15 percent to \$9.5 million, the annual budgetary deficit was 100 percent higher than expected, prices of several key domestic commodities increased rapidly, and the value of the afghani depreciated steadily. In response to this developing crisis, the International Monetary Fund (IMF) extended a standby credit of \$6.75 million; the USSR deferred for 27 years repayments on \$16.5 million of a 1956 credit; the US extended additional commodity aid of \$5 million; and West Germany probably will expand its commodity aid program by \$2.5 million.

The generosity of aid donors assures the government of Afghanistan temporary relief from the recent large budgetary deficit and the resultant inflation. It is estimated that the increase in government revenue resulting from foreign aid during Fiscal Year (FY) 1966 will almost cover the budgetary deficit. In the latest agreement with the IMF, Afghanistan reluctantly accepted a number of stringent financial reform measures designed to promote greater monetary stability. Based on Afghanistan's past record in this respect, however, it is doubtful that these measures will be effectively implemented and enforced. The easing of financial pressure resulting from increased aid, along with the government's desire to avoid the adverse domestic political reactions that normally accompany tax increases and reduced government expenditures, will tend to deter the implementation of needed reform measures.

1. Background

Afghanistan's latest financial problems stem from excessive deficit spending over a 6-year period by the central government. The FY 1965 deficit, originally projected at 500 million afghanis, totaled about 1,000 million afghanis, nearly equaling the 1,056 million peak of FY 1963 (see Table 1). The FY 1965 deficit was the product of a continuation of a more rapid increase in expenditures than in revenues. Military expenditures during FY 1965 increased by nearly 25 percent, and government expenditures increased significantly as employees received a substantial pay raise. In addition, there was no

* Until 1961 the Afghan fiscal year was 1 October - 30 September. In 1961 a fiscal half-year (1 October 1961 - 20 March 1962) was introduced. Since 1962 the current fiscal year has been in effect.

perceptible decline in expenditures on economic development. At the same time, failure to implement minimal tax reforms continued to retard growth in revenues.

Large-scale deficits of recent years, financed by governmental borrowing from the central bank, have led to excessive monetary expansion. Between March 1961 and March 1965 the supply of money more than doubled, increasing at an average annual rate of about 20 percent, while the rate of growth in production was negligible. ^{1/} As a result, prices have risen rapidly. During the last 2 years, the prices of two major food staples, wheat flour and rice, each increased by more than 60 percent. ^{2/} In spite of the inflationary trends, there has been a continued hoarding of local currency. The hoarding and the substantial increases in imports paid for in hard currency served to hold prices down somewhat. Current inflationary pressures undoubtedly would be accelerated in the event of a loss of confidence in the afghani or a cutback in imports.

There has been a steady increase in the free-market foreign exchange rate as compared to the official rate, reflecting an increased demand for convertible foreign exchange. * Since the afghani was devalued in March 1963, the government has unsuccessfully attempted to maintain the free rate close to the official rate through open market sales of foreign exchange. ** Such sales amounted to \$9 million during FY 1964 and \$4 million during the first half of FY 1965

Nevertheless, the free rate has continued to rise, and by June 1965 it was about 64 percent above the official rate (see Table 2).

* The free market rate, commonly known as the bazaar rate, is the rate at which foreign currency is exchanged freely in the open market and reflects primarily the demand for dollars and pounds sterling, since Bloc trade is carried out in nonconvertible clearing account dollars. The other foreign exchange rate maintained in Afghanistan is the official rate, which is used for government imports and certain exports -- including the major hard currency exports, karakul and wool. Since the foreign exchange earnings from official exports of karakul and wool have to be exchanged at the official rate, the existence of a free rate that is considerably higher than the official rate tends to promote illegal exports.

** In these open market transactions the government sells foreign exchange through the central bank at a rate that is higher than the official rate and lower than the free market rate.

Foreign exchange difficulties during FY 1965 have been further aggravated by a drop in official exports paid for in hard currency as a result of bad weather and weak prices in the international market. Simultaneously, imports paid for in hard currency have increased. During the first 11 months of FY 1965, Afghanistan's receipts of hard currency were only \$8.3 million, compared with about \$17.5 million in each of the 2 previous years, whereas hard currency payments for imports rose from \$38 million in FY 1964 to \$45 million in FY 1965. 4/ Since March 1963, despite drawings of \$11.3 million in foreign exchange from the IMF (excluding the most recent credit), Afghan convertible foreign exchange reserves have declined from about \$10.2 million to \$9.5 million in March 1965, with the net gold and foreign exchange position declining from \$45.2 million to \$40.3 million. 5/

The combination of excessive deficit financing, domestic inflation, and dwindling foreign exchange reserves has generated considerable anxiety in the Afghan government. A similar financial crisis contributed to the resignation of Prime Minister Daud in March 1963, when the present Yusuf government assumed office. At that time the present government gained temporary respite by the reopening of the Pakistan-Afghanistan border and the devaluing of the afghani, but it did not make any significant effort to eliminate budgetary deficits, the fundamental cause of monetary instability.

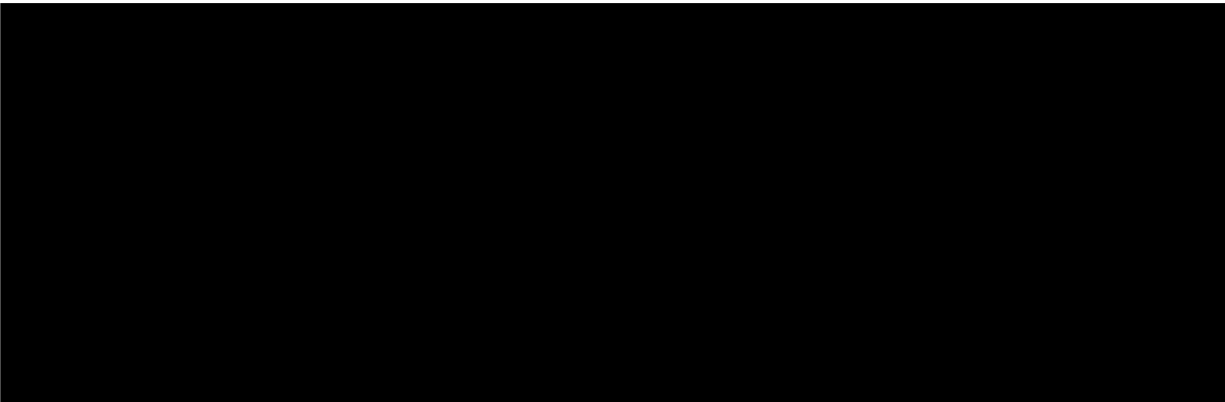
2. Foreign Aid

To overcome the developing financial crisis, Afghanistan had either to obtain an increase in foreign aid or to draw down its foreign exchange reserves still further. The USSR responded to Afghan appeals for increased aid by tentatively agreeing to defer for 27 years repayments on \$16.5 million of a 1956 credit, but the US and West Germany withheld additional assistance until Afghanistan agreed to adopt the financial reforms demanded by the IMF in their proposed standby credit agreement. After the \$6.75 million IMF standby agreement was signed in May, the US agreed to provide additional PL 480 commodity aid of 150,000 tons of wheat valued at \$5 million, and West Germany probably will extend additional commodity aid valued at \$2.5 million. 6/ This additional assistance, together with increased utilization of aid under existing programs, will provide the equivalent of nearly 900 million afghanis (more than 20 percent of total domestic revenue projected for FY 1966) and will almost cover the budgetary deficit.



3. Prospects

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Afghanistan's prospects of attaining long-run internal monetary stability are not bright. It is doubtful that revenues can be increased significantly because the fundamental task is the attainment of more efficient and less corrupt tax administration along with tax increases. It will be almost impossible to hold expenditures constant, given the extreme reluctance to cut development spending and the tendency for ordinary expenditures to increase as more and more development projects are completed. In addition to the limit on expenditures, it will be necessary to carry out further financial reforms and to redirect investment to projects with more rapid payoffs. Necessary reforms would include a reduction in development expenditures and a greater willingness to restrain general governmental expenditures.

Although it is probable that during FY 1966 revenues will be lower and expenditures higher than projected, the limit on governmental borrowing from the central bank probably will not be exceeded, and

as a result inflationary pressures will be somewhat eased. This, however, will not necessarily be an indication that significant improvement has been made in balancing domestic revenues and expenditures but rather will be a reflection of the generosity of aid donors. During FY 1966 the increase in revenue from foreign aid is estimated at nearly 900 million afghanis, * compared with a deficit of 1.0 billion during FY 1965. As a result, the Afghans could keep domestic revenues at the FY 1965 level, increase expenditures by 200 million afghanis, and still adhere to the IMF limit on borrowing from the central bank. This is similar to the situation in March 1963 and July 1964, when the Afghan government, faced with serious monetary problems, agreed to implement IMF fiscal reforms designed to reduce expenditures and increase revenues, and in return to receive additional foreign aid. In each instance, once the pressure was off, the Afghan government failed to implement completely the reform measures which would have been accompanied by adverse domestic reactions. Thus it appears that current foreign aid will have the effect of alleviating financial problems during FY 1966 but, by again reducing the pressure on the Afghan government, may retard the implementation of measures necessary for long-run monetary equilibrium.

* Excluding the Soviet deferral of loan repayments, which will allow the Afghans to reduce debt service payments during FY 1966 by 220 million afghanis.

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Table 1

Afghanistan: Estimated Government Budget
Fiscal Years, 1960-65 a/

| | Million Afghanis | | | | |
|---|------------------|--------------|--------------|--------------|--------------|
| | <u>1960</u> | <u>1961</u> | <u>1963</u> | <u>1964</u> | <u>1965</u> |
| Total expenditures | <u>2,099</u> | <u>3,108</u> | <u>3,291</u> | <u>3,876</u> | <u>4,300</u> |
| Ordinary | 1,394 | 1,558 | 1,849 | 2,272 | N.A. |
| Development | 705 | 1,550 | 1,442 | 1,604 | N.A. |
| Total revenues | <u>1,714</u> | <u>2,303</u> | <u>2,235</u> | <u>3,320</u> | <u>3,300</u> |
| of which: | | | | | |
| Afghanis generated by commodity aid b/ | 347 | 390 | 205 | 625 | 390 |
| Deficit | -385 | -804 | -1,056 | -556 | -1,000 |

a. 7/. Until 1961 the Afghan fiscal year was 1 October - 30 September. In 1961 a fiscal half-year (1 October - 20 March) was introduced. Since 1962 the fiscal year has been 21 March - 20 March. The fiscal half-year is omitted in this table.

b. Excluding all other foreign aid because it cannot be expressed realistically in afghanis.

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Table 2

Afghanistan: Official and Bazaar Exchange Rate a/
Fiscal Years, 1962-66

| Fiscal Year | Afghanis Per US \$ | |
|----------------|--------------------|---------------|
| | <u>Official</u> | <u>Bazaar</u> |
| 1962 <u>b/</u> | 20 | 45 |
| 1963 <u>b/</u> | 20 | 56 |
| 1964 <u>b/</u> | 45 | 51 |
| 1965 | | |
| June | 45 | 59 |
| September | 45 | 62 |
| December | 45 | 66 |
| 1966 | | |
| March | 45 | 75 |
| June | 45 | 74 |

a. 8/

b. As of 20 March.

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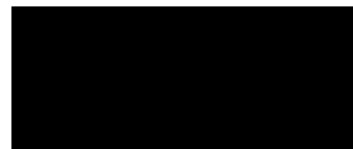
17 August 1965

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BY: *WOB*

Date: *8 Aug 65*

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