Growth Sputter

By Saad Mohseni

KABUL—The Afghan economy has grown substantially, albeit from a very low base, since 2002. However, that economy is now in danger of stalling. The opportunities, which seemed boundless just a few years ago, now seem lost and frustration and cynicism are mounting.All is not lost yet, but swift action is needed to preserve the gains of the past few years and ensure that development continues.

The Afghan economy could use a jumpstart.

At first, policymakers did much to create an environment conducive to investment. Within the first two years after its liberation from the Taliban, Afghanistan had a Singapore-style High Commission for Investment to encourage private capital inflows from abroad; an Investment Support Agency to help foreign businessmen navigate the Afghan regulatory system; a stable new currency backed by reserves that have increased to $2 billion today from nothing in 2002; the country's first fully serviced industrial parks; and a new tax and tariff regime that started to roll back the dross of 20 years of communist-inspired economic policy.

The economic boom that ensued has pushed our per capita gross domestic product to a projected $400 by 2008, up from $354 this year, $300 in 2005 and just $182 in 2002. The average annual real GDP growth from 2002 to 2005 comes in at 16.6%.

Yet these gains are in serious jeopardy, for several reasons.

First and foremost, the reform vision so prevalent in the early days is no longer there. Ashraf Ghani, who engineered Afghanistan's taxation and currency reforms and secured billions from the international community, was dismissed as Minister of Finance in 2004 in a cabinet reshuffle. Sayed Mustafa Kazemi, a former mujahedeen leader who worked as Commerce Minister and Chairman of the High Commission for Investment to bring his former brothers in arms on board with economic reform, is currently a member of parliament, opposition spokesman and chairman of the parliamentary economic committee.

Other capable technocrats were either pushed out of office as a result of bureaucratic turf-warring within the ministries or left of their own accord in frustration over low pay or lack of progress. With the leadership gone, many second-tier bureaucrats also left. Suddenly there was a huge leadership vacuum. The system stalled and began reverting to its old ways.

One result is that some institutions launched by reformers to jumpstart development are now getting in the way. The Afghan Investment Support Agency or AISA—our much flaunted one-stop shop for registering a business in Afghanistan—now takes 10 days to register a new business. It used to take four. Even worse, registration fees for small business have risen to $1,000 from $100. A small business operator willing to invest $10,000 is required to spend 10% of his capital in registration fees. In return for this quality service, AISA's annual budget has ballooned to almost $2 million from $400,000 in 2002.

Government indecision is also taking its toll, especially in the natural resources sector. Afghanistan sits atop one of the largest copper reserves in the world, and the government is currently soliciting bids for a mining concession. But the process doesn't appear to be going anywhere. One reason is that the government has dithered in launching smaller-scale mining operations for precious stones, oil and gas, coal, gold and other smaller natural-resource deposits. Absent such small preliminary steps, international mining investors have no way of judging how hospitable a business climate Afghanistan will offer them, or even to make an educated guess about whether one could truly make money from mining in the country.

And then there's the security problem, which is not confined to the war against the remnants of the Taliban. Robberies and kidnappings carried out by garden-variety thugs are doing a lot to dissuade even the most ardent investors from committing to Afghanistan. Standard Chartered Bank was recently the victim of a $3 million armored truck heist carried out in broad daylight across from the Turkish embassy in Kabul. At least three prominent Afghan businessmen (or their siblings) have been nabbed by professional kidnappers. Some foreign residents believe that the robbers and kidnappers are colluding with key members of the Afghan police force. Although such theories are difficult to confirm, the government certainly has done little to investigate or punish the culprits.

All of these problems are only compounded by another major problem facing the country: poorly allocated foreign aid. Money continues to be wasted in disturbing ways on white elephant projects that win political kudos in donor countries but don't do much for the Afghan people.

AFP

Open for business in the bazaar, but times could be better.

Consider the Afghan Womens' Business Federation (AWBF), a project funded by the U.S. Agency for International Development. It is supposed to "better coordinate" the activities of all Afghan business women. One of the main goals of the AWBF was to create an "Afghan Women's Design Centre" intended to "empower" Afghan women in the commercial handicrafts sector, a cottage industry where natural talent is abundant but there is a dramatic absence of good raw materials and professional guidance for entering the business-to-business or foreign markets.

A year later, not a single textile weaving or printing project has been initiated, and no professional strategy for competing with neighboring countries has been developed. In fact, the project has become politicized, burdened by infighting and allegations of graft. The American taxpayers' $6 million spent on AWBF has achieved absolutely nothing.

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Afghanistan boasts some of the region's most entrepreneurial business minds. Afghan businessmen have achieved success in Central and South Asia as well as the Middle East and the former Soviet states. Afghans are desperate to do business in Afghanistan again.

But the government needs to act to create a conducive climate. A reduction in the number of ministries and some fresh, more capable, blood at the helms of remaining departments would help. Some of the savings must be directed to enhanced policing and the acceleration of major infrastructure projects as basic as electricity and water. The tax system is ripe for an overhaul. Attempts to slash indirect taxes such as value added taxes, highway fees (in Kandahar and Jalalabad) and "special telecommunications" taxes have already been partially successful, and the corporate and individual income tax rates could do with reduction.

The government is due to host an investment conference in Kabul in early June where such concerns will be addressed. The Afghan business community sincerely hopes this forum will lead to substantive changes in the way Afghanistan does business. Afghanistan's long suffering private sector and the Afghan nation deserve as much, if not better.

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Cracking Open India's Capital Account

By Eswar S. Prasad

Capital account liberalization is back on the table in India. In 1996, with spectacularly bad timing, the government-appointed Tarapore committee recommended rapid opening of the capital account. The Asian crisis that erupted in 1997 halted that policy dead in its tracks. In 2006, with the Asian crisis a distant memory, the Reserve Bank of India revived the Tarapore committee. This time, the group's report was more cautious, endorsing a gradual move towards a more open capital account. Another government committee's work, dubbed the "Mistry Committee" report, has ratcheted up the debate this year by arguing that to give Mumbai a fighting chance of becoming an international financial center, the capital account must be fully opened by the end of 2008.

Would India be putting the cart before the horse by plunging headlong into capital account liberalization? The financial system is still underdeveloped, the fiscal deficit remains high (around 7% of GDP) and the exchange rate is still managed (although in recent weeks the rupee has been allowed to appreciate significantly). Under such circumstances, when the economy is not equipped to handle a gusher of capital flowing in or out, unbridled capital account opening in some emerging market economies has ended in tears.

Despite the risks, capital account liberalization could indeed prove to be a boon for India, but for a completely different set of reasons than the traditional ones associated with pulling in capital inflows. And, notwithstanding the recent complications with managing inflows, it is important to keep the big picture in mind, and reforms moving forward.

The traditional view is that opening up to inflows allows capital-poor developing countries to import capital, increase domestic investment and grow faster. The problem for proponents of this view is that economists analyzing macroeconomic data have found it difficult to detect the direct growth-enhancing benefits of foreign capital.

More than just money would flow in.

But a new paradigm has recently emerged in the academic literature on this issue. The real benefits of financial globalization to an emerging market economy have less to do with the raw financing provided by foreign capital. Instead, the indirect "collateral" benefits associated with such capital are far more important. These indirect benefits may be crucial for India's development.

One of the key benefits is that openness to foreign capital catalyzes financial market development. Foreign investment in the financial sector tends to enhance competition, raise efficiency, improve corporate governance standards and stimulate the development of new financial products. For instance, in India, even the limited entry of foreign banks has already given domestic banks a much-needed kick in the rearside and forced them to improve their efficiency in order to compete and stay viable.

Liberalizing outflows has the salutary effect of giving domestic investors an opportunity to diversify their portfolios internationally. This means greater competition for domestic financial institutions but also an opportunity for them to cultivate the financial savvy to offer products that would help their customers invest abroad.

Other indirect benefits associated with foreign capital include transfers of expertise—technological and managerial—from more advanced economies. When supported by liberal trade policies, foreign investment can help boost export growth. Foreign-invested firms also tend to have spillover effects in generating efficiency gains among domestic firms.

Notwithstanding these potential benefits, there is strident opposition in India to capital account opening. Some of it is based just on ideological opposition to foreign involvement in the economy. Dig deeper, though, and it turns out that much of the opposition comes from entrenched interests that view foreign-financed competition as an unwelcome intrusion that erodes the protection and privileges they have enjoyed for many years. Indeed, a "shock" like capital account opening is just the tonic to shake up the system and thwart coalitions that try to block reforms in this and other dimensions.

So why the rush towards a fully open capital account? What is so special about the end-of-2008 date or, for that matter, any specific date? In short, nothing.

But deadlines do have a way of focusing the mind. A policy commitment to fully open the capital account in a couple of years would give domestic firms time to adjust to the new landscape but force them to get to work immediately on restructuring themselves. It would give less room for reactionary forces to coalesce and block the reforms. It would also force policy makers to push forward with reforms such as deficit reduction and increased currency flexibility. Moreover, the historically high level of foreign exchange reserves (about $200 billion) and the benign international environment provide a window of opportunity to undertake capital account liberalization with fewer risks.

For an emerging market economy, the process of opening the capital account comes down to a delicate balance between the benefits it affords and the risks of disruptions to growth if things go wrong. For the Indian economy, which has made great strides in recent years, the balance has shifted—the risks are now smaller and well worth taking to embrace financial globalization and push growth higher.

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