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Effects of the Taliban Returning to Afghanistan and its Effects on the Monetary and Fiscal Policies of the Country

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ABSTRACT

This paper speaks about the effects of the Taliban returning to Afghanistan and its effects on the monetary and fiscal policies of the country. This paper provides adequate background information and context by talking about the historical overview of Afghanistan which includes the social, cultural, and geographical history. Consequently, it also exhibits the reasons that caused the Taliban to take over the country with reference to the U.S.A, 9/11 attacks and finally the return of U.S.A troops from Afghanistan in 2021. This paper then explains the meaning of monetary and fiscal policy while enumerating the roles and tools of the policies and the functioning. It then compares the monetary and fiscal policy of Afghanistan before and after Taliban's takeover due to the lack of official data and literature, this paper also proposes to first estimate a Taylor rule for the central bank of Afghanistan prior to the Taliban's takeover and then predict the central bank's reaction function to current output and inflation. A comparison between interest rates and current interest rates sheds more light on the impact of the Taliban over monetary policy. Finally, the paper presents a macro snapshot, acting as a comparative study between the inflation of Afghanistan and its neighbours.

Introduction

The main objective of this paper is to find out whether the Taliban's takeover has had a positive or negative impact on the monetary and fiscal policies. We also aim to find out the economic aims of the terrorist outfit. Georges St-Pierre said "When you pay attention to detail, the big picture will take care of itself." Inspired by this saying I have aimed to look into Afghanistan from the historical, economic, social and political aspects so that we have more context to the studies provided in this paper.

This paper speaks about the historical overview of Afghanistan, a brief introduction to monetary and fiscal policies, monetary and fiscal policy with reference to Afghanistan, an introduction to the Taylor rule and its methodology and finally a macro snapshot which compares the inflation of Afghanistan from its neighbours.

In Section 1 I review the available literature, Section 2 handles the data and methodology and Section 3 gives the summary and concluding remarks.

Literature Review

Historical Overview of Afghanistan

Afghanistan is endowed with rich religious and ethnic history. Around 2004 Afghanistan had a population of 28,513,677 (July 2004 est.). More than 3.5 million Afghans lived outside the country, mainly in Pakistan and Iran, although over two and a half million returned since the removal of the Taliban. The predominant religion that is followed by 99% of the population in Afghanistan is Islam. The population is split into the Sunni and Shia Muslims. The Sunni Muslims consists of 85% whereas the Shia Muslims 14% of the Afghan Muslim population. (Merril, 2006) Afghanistan's rich religious and ethnic history as well as its strategic location is one of its biggest assets.

Afghanistan's location is extremely tactical as well as home to many trade routes. Afghanistan is located in the southwestern corner of Central Asia. Lying on the north subtropical zone it extends from 29°21' N to 38°30' N latitude and from 60°31' N to 75° East longitude. It is bound on the north by Uzbekistan, Turkmenistan, and Tajikistan; on the West by Iran; on the South and East by Pakistan; and in the extreme Northeast by the People's Republic of China. (Gopalakrishnan, 1982) Afghanistan has thrived both in culture as well as economics due to its geographical location along the Silk Road, which acted as an early source of revenue for merchants. Even without access to seaports the country is perfectly nestled along the crucial trade routes between East Asia, South Asia, and the Middle East. (Runion, 2017) For these exact reasons, other countries wanted to gain control of these lucrative trade routes and strategic location to benefit their homeland.

What Caused the Taliban to Take Over, And How Was Afghanistan Before?

Afghanistan has been plagued with wars, terrorism and military exercises. In 2001, the US responded to the 9/11 attacks on New York and Washington, in which nearly 3,000 people were killed. Officials identified Islamist militant group al-Qaeda, and its leader Osama Bin Laden, as responsible. Bin Laden was in Afghanistan, under the protection of the Taliban, the Islamists who had been in power since 1996. When they refused to hand him over, the U.S. used military intervention to quickly remove the Taliban and vowed to support Democracy and eliminate the terrorist threat. (Anon., 2021) After the U.S. intervention, which caused a great deal of loss of life, the U.S. was tasked with setting up a new government.

The next decade was full of uncertainty and conflict between the Taliban and the US installed Afghan government. NATO allies had joined the U.S. and a new Afghan government took over in 2004, but deadly Taliban attacks continued. In 2014, at the end of what was the bloodiest year since 2001, NATO's international forces ended their combat mission, leaving responsibility for security to the Afghan army. That gave the Taliban momentum and they seized more territory. (Anon., 2021) After all the conflict and violence the U.S. government and the Taliban finally resorted to diplomacy to discuss a peace treaty in 2020.

In 2020 the U.S. government and the Taliban signed a peace deal called the Doha agreement. This set a timeline for the withdrawal of U.S. troops from Afghanistan. In return, the Taliban pledged to prevent territory under its control from being used by terrorist groups and to enter into negotiations with the Afghan government. After a brief reduction in violence, the Taliban quickly resumed attacks on Afghan security forces and civilians. (Center for Preventive Action, 2022) After the failure of the agreement the U.S. troops began mobilising and prepared to return to the United States by 2021.

In April 2021, U.S. President Joe Biden announced that U.S. military forces would leave Afghanistan by September 2021. The Taliban, which had continued to capture and contest territory across the country despite ongoing peace talks with the Afghan government, ramped up attacks on ANDSF bases and outposts and began to rapidly seize more territory. In May 2021, the U.S. military accelerated the pace of its troop withdrawal. By the end of July 2021, the United States had completed nearly 95 percent of its withdrawal, leaving just 650 troops to protect the U.S. embassy in Kabul. On August 15, 2021, over two weeks *before* the official U.S. withdrawal deadline, Taliban fighters entered the capital. Afghan President Ashraf Ghani subsequently fled the country and the Afghan government collapsed. (Center for Preventive Action, 2022)

Before exploring the deeper policy implications of the Taliban takeover, a detailed exposition of monetary and fiscal policies and the theories underpinning them is warranted. I first detail the monetary side and then continue with fiscal policy aspects.

Monetary Policy

Monetary policy is one of the two principal means (the other being fiscal policy) by which government authorities in a market economy regularly influence the pace and direction of overall economic activity. Central banks carry out monetary policy, by exploiting their control over the supply of certain kinds of claims against the central bank hence the label "monetary"- that enable a country's businesses, banks and individuals to carry out their day-to-day economic affairs. Therefore, the role of the central bank to use monetary policy to regulate the nature of the market is very important. (Friedman, 2000)

The central bank has to take up many roles and tools to consider while conducting monetary policy. The central bank's first role is as a monopolist. The central bank's power to conduct monetary policy stems from its role as the sole source of reserves (or, again, monetary base) to meet this demand. In short, the central bank is a monopolist over the supply of its own liabilities. Its second role is conducting open market operations whether they are expansionary or contractionary. Thirdly, reserve requirements. Here the central bank uses this tool to adjust the number of reserves that a bank is supposed to hold in relation to their outstanding deposits. (Friedman, 2000) Working hand in hand with monetary policy is another peremptory policy called the Fiscal policy.

Fiscal Policy

Fiscal policy is the use of government spending and taxation to influence the economy. Governments typically use fiscal policy to promote strong and sustainable growth and reduce poverty. As compared to the role of the central bank in monetary policy, the government has a role to play in fiscal policy.

The government helps in the functioning of the policy by influencing the economy through changing the level and types of taxes, the extent and composition of spending, and the degree and form of borrowing. Governments directly and indirectly influence the way resources are used in the economy. A basic equation of national income accounting that measures the output of an economy—or gross domestic product (GDP)—according to expenditures helps show how this happens:

$$GDP = C + I + G + NX.$$

On the left side is GDP—the value of all final goods and services produced in the economy. On the right side are the sources of aggregate spending or demand—private consumption (C), private investment (I), purchases of goods and services by the government (G), and exports minus imports (net exports, NX). This equation makes it evident that governments affect economic activity (GDP), controlling G directly and influencing C, I, and NX indirectly, through changes in taxes, transfers, and spending. (Horton, n.d.)

Fiscal policy itself plays an indispensable role in the economy. The objectives of fiscal and monetary policy are to control the expansion and contraction of the economy. During a recession, the government works to keep money in the accounts of businesses and consumers. (Horton, n.d.) In a boom, they do the opposite. To execute this role, they make use of few economic tools.

The government has two tools it uses when implementing fiscal policy. The first tool is collecting taxes on business and personal income, capital gains, property, and sales. Taxes provide the revenue that funds the government. The second tool is government spending—funds are directed into subsidies, welfare programs, public works, infrastructure projects, and government jobs. Government spending puts more money back into the economy, which increases demand for products and services. (Horton, n.d.)

Fiscal and Monetary Policy in Afghanistan

Afghanistan's policy until 2021 experienced an expansionary fiscal policy for more than a decade, which was largely held together through donor grants to the economy. However, multiple transitions in 2014 brought a substantial change in the course of the Afghan economy. Since then, the focus is on sustainability of domestic revenue and managing the expenditures once financed by foreign aid/grants. To work toward its long-term economic development goal, the Afghan government, through tax administration and tax regime reforms, successfully increased the share of domestic revenue significantly. This is all achieved against the headwinds of political uncertainty and subpar economic growth. (Ministry of Finance, Afghanistan., 2021)

The implementation of new taxes such as VAT, issuance of Sukuk which are Islamic bonds that help finance public expenditure and bring idle cash into circulation, and limited concessional loans in the coming years will augment fiscal resources and partially offset the impact of declining aid. (Ministry of Finance, Afghanistan., 2021) This would help in excessive revenue collection which would in turn help in reviving the failing economy. Afghanistan's

To understand monetary policy in Afghanistan one must delve into the structure and functions of the central bank of Afghanistan, which is called the Da Afghanistan bank. Post-Taliban takeover, Mr. Abdul Qahir is the acting governor of the bank. The bank is wholly controlled by the government which now includes members of the Taliban. Before the Taliban takeover the bank operated under two councils; the Supreme Council and the executive board. The Supreme Council of DAB is known as the highest decision-making and policy-making body of Da Afghanistan Bank. The Executive Board of DAB is composed of three members, each of whom are: Governor, First and Second Deputy Governors. The Executive Board is responsible for all matters concerning the administration and operations of DAB. But after the Taliban takeover there is very little clarity on the future goals, aims and structure of the bank.

Before Taliban's takeover, the Da Afghanistan bank believed that, low and stable inflation provides favourable conditions for sustainable growth and employment generation over time. It reduces uncertainties about future prices of goods and services and helps households and businesses to make economically important decisions such as consumption, savings and investments with more confidence. This, in turn, facilitates higher growth and creates employment opportunities over the medium term leading to overall economic well-being in the country. (DAB bank, n.d.) The central bank used various method to ensure it achieves its goals.

Previously, DAB signalled its monetary policy stance through adjustments in money supply in the market. Changes in money supply would impact demand in the economy. To maintain its primary objective of domestic price stability, Da Afghanistan Bank adopted a framework which is known as the Monetary Aggregate Targeting Framework. Controlling liquidity conditions is highly important in the economy. Liquidity is a type of financial rate used to determine a country's ability to pay its short-term debt obligations through the method of liquidating its assets; hence, any changes in the rate of liquidity will have a direct impact on the overall economic activities in the country. Therefore, changes in liquidity rate should be consistent with the rate of economic growth as well as the demand for the national currency in the economy. (DAB bank, n.d.) Unfortunately as of 2022 very less is known of the working of the monetary policy, rather only the effects and consequences of the takeover are known.

The takeover had severe consequences on the economic sector of Afghanistan, and crippled the entire economic system. The preliminary official GDP statistics show that the economy contracted by 20.7 percent in 2021. Even though the Taliban takeover was a major factor, it wasn't the only one. Covid-19 played a huge role in crippling and contracting the economy. The sudden cessation of aid led to dramatic drop in public spending and aggregate demand, shrinking household incomes and reducing consumption. Afghanistan's financial sector remains in crisis. The Central Bank (Da Afghanistan Bank – DAB) has lost its ability to manage the payment systems and conduct monetary policy due to the freeze of offshore assets and its inability to print new afghani currency notes. The resulting shortage of US dollars and afghani and the sanctions triggered a confidence crisis in the banking sector. (World bank, 2022) There is no clarity on the working of monetary policy, and data is inaccessible and almost impossible to get.

After the takeover, the working of the monetary policy is extremely ambiguous, not much is known about the prevailing interest rates and lending rates. It is known that few of the negative impacts of the takeover on the fiscal structure of the country are extremely high inflation, and exchange rate volatility. The lending interest rates in Afghanistan since 2008 have always been around 15%, and the real interest rates have been 17.5% (2009), -1.2% (2011), 14.4% (2014) and finally 17.6% in 2016. (Data World Bank, n.d.) This type of data is not available to the general public after the Taliban takeover and monetary clarity is extremely less.

To combat this gap in data, a Taylor rule can be used to find out the behaviour of the Taliban controlled government regarding the prevailing interest rates.

Firstly, what is a Taylor rule? The Taylor Rule is an equation linking the Federal Reserve's benchmark interest rate to levels of inflation and economic growth. John Taylor originally proposed it as a guideline for monetary policy. The Taylor rules formula ties a key instrument which is the funds rate to two factors, the actual inflation rate and the Targeted inflation rate. The Taylor Rule adjusts the equilibrium rate based on divergence in inflation and real GDP growth from the central bank's targets. (Hayes, 2022)

A Taylor Rule can be established by using the interest rates before the Taliban takeover to estimate the interest rates that would have prevailed in the current situation if the Taliban didn't takeover Afghanistan and then compare the predicted interest rates with the actual Interest rates that prevail under the Taliban. (Data that is hard to access, and even if it exists it is poorly placed.) Therefore, telling us the behaviour of the Central bank under Taliban Rule.

Methodology

To estimate a Taylor rule for Afghanistan, assumes the following equation:

$$i_t = r_t^- + a(\pi_t - \pi^*) + b(y_t - y_t^-) \text{ ----- (1)}$$

In equation (1) which is the classical representation of the Taylor rule, the interest rate is equal to the Neutral plus the reaction to deviations from inflation target and potential output. Coefficients a and b are summarising the central bank's attitude towards inflation and output gaps.

$$i_t^* = \rho i_{t-1}^* + (1-\rho) i_t \text{ ----- (2)}$$

Furthermore, the observed interest rate is set as a linear combination or a weighted average between the previously observed interest rate and current Taylor rule prescription. This equation (2) represents the actual rate settings.

Now Plugging 1 into 2: (substituting i_t into equation 2)

$$i_t^* = \rho i_{t-1}^* + (1-\rho) r_t^- + \varphi_\pi (\pi_t - \pi^*) + b(y_t - y_t^-) \text{ ----- (3)}$$

Rearranging the equation, we get:

$$i_t^* = (1-\rho) r_t + \rho i_{t-1}^* + (1-\rho) a (\pi_t - \pi^*) + b(y_t - y_t^-) \text{ ----- (4)}$$

Introducing Constant terms α, φ.

$$i_t^* = \alpha + \rho i_{t-1}^* + \varphi_\pi (\pi_t - \pi^*) + \varphi_y (y_t - y_t^-) \text{ ----- (5)}$$

Inflation target or π^* can be assumed as 2%, (1- ρ) r_t becomes the constant α, ρ is interest rate inertia. i_{t-1}* is the previous interest rate and can be observed from data. i_t^* is todays interest rate and can be observed from the data. $(\pi_t - \pi^*)$ or inflation deviation can be calculated. The coefficient φ_y shows the responsiveness to the output gap and can be estimated. After estimating all the unknowns which are α, rate inertia, $\varphi_{\pi,}$ and φ_y, it eventually helps in finding in equation (1)

$$a = \frac{\varphi_y}{(1-\rho)}$$

We can similarly obtain b.

Therefore, we can always calculate i_t, and if we can do that, we can always calculate i_t^*. This would give us the counterfactual interest rate and finally help us estimate a Taylor rule for Afghanistan.

Generally, estimation of a central bank's reaction function poses some challenges, however. Ordinary Least Squares (OLS) estimation of monetary policy rules produces potentially inconsistent estimates of policy parameters. This is so because central banks react to variables that are endogenous to monetary policy shocks. Endogeneity implies a correlation between regressors and the error term – hence, an asymptotic bias. In principle, estimation by Instrumental Variables (IV) or Generalized Method of Moments (GMM) can solve this endogeneity problem. Therefore, these methods are more widely encouraged to be used. (Carvalho, 2021)

A Comparative Study of Inflation Between Neighboring Countries

India

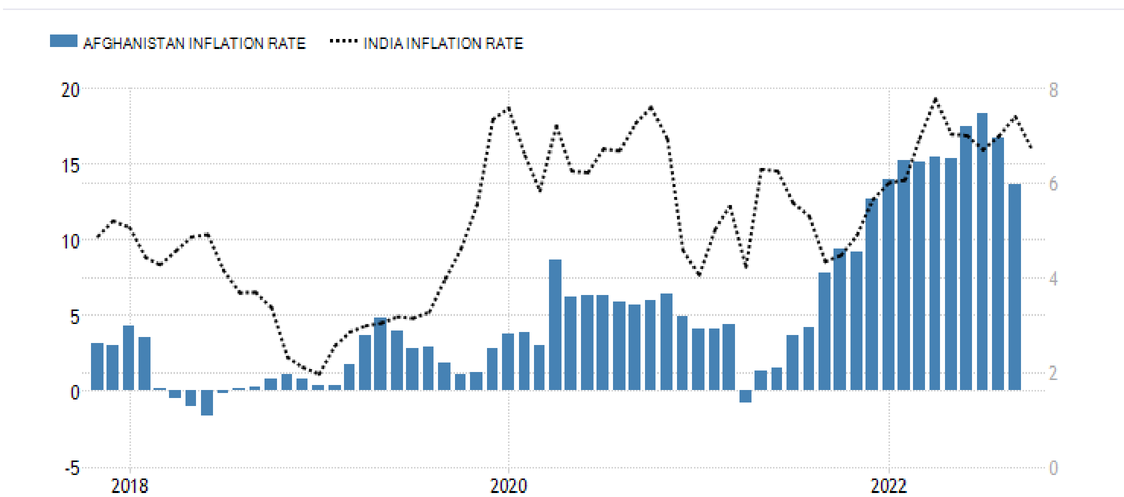

Figure 1. Afghanistan vs India inflation rate (2018-2022) (Trading Economics, 2022)

As we can see in Figure 1, Afghanistan's inflation rate was historically lower than that of India's. As of the beginning of 2021 the inflation rate of Afghanistan was around 3-4% and after the Taliban takeover the inflation rate soared up to equal India's high inflation rate ranging about 16-19%. This shows us that inflation increased tremendously during the past two years and now equals India's inflation rate.

Iran

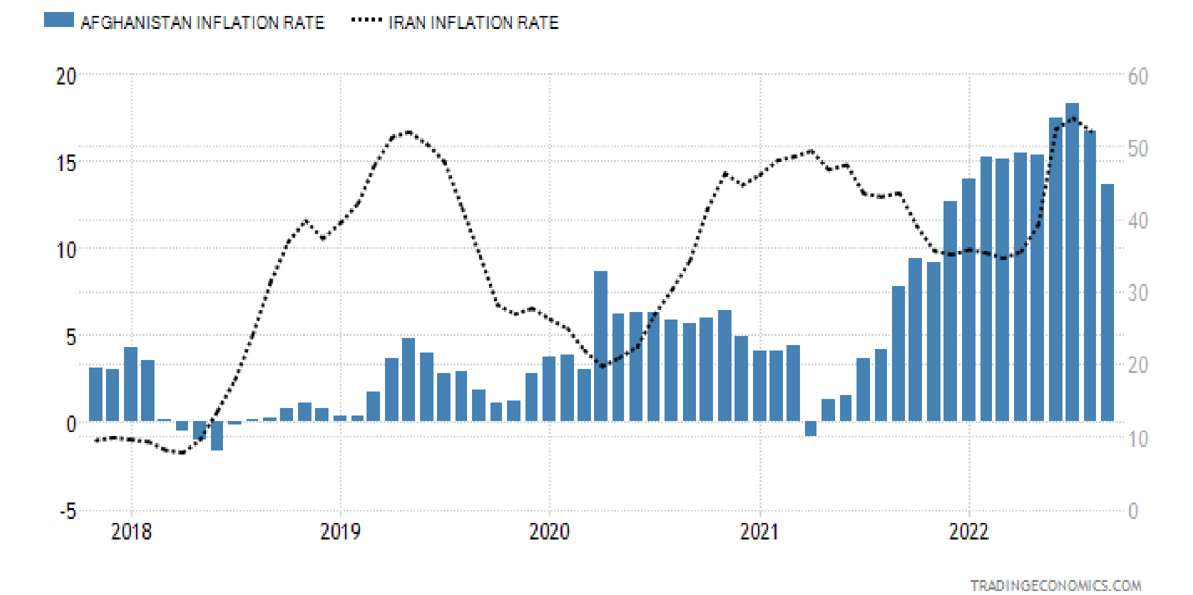

Figure 2. Afghanistan vs Iran inflation rate (2018-2022) (NSIA, 2022)

Iran's inflation rate has always been through massive phases of high inflation and consequent deflation. Iran's inflation rate was considerably higher than that of Afghanistan during 2019 by about a 9% margin. After the Taliban takeover and the increase in inflation, Iran has less inflation than Afghanistan in the third quarter of 2021 by 3%.

Tajikistan

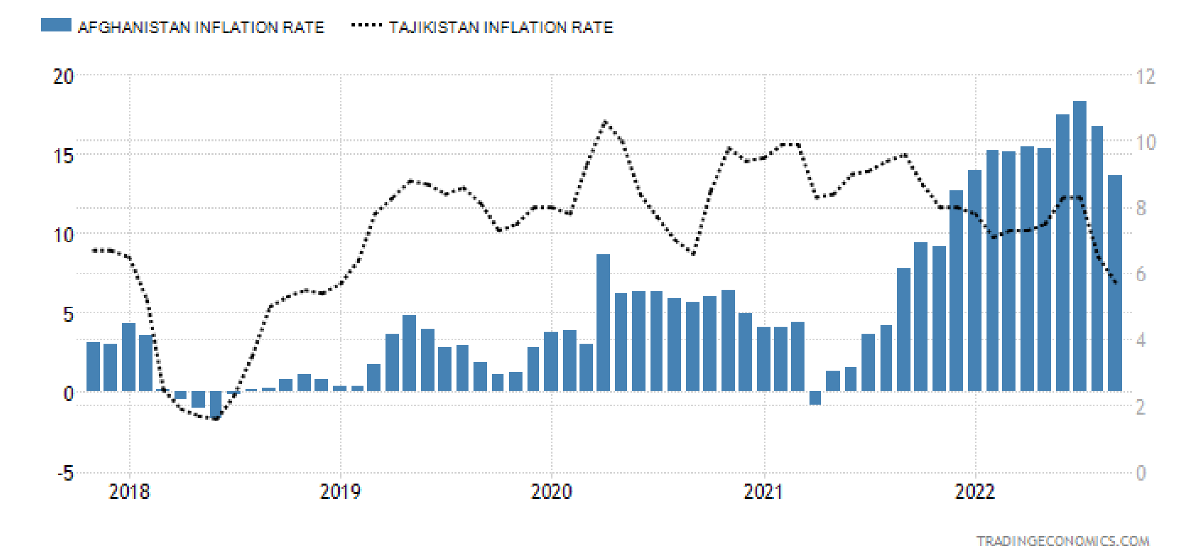

Figure 3. Afghanistan vs Tajikistan inflation rate (2018-2022) (National Statistics and Information Authority, 2022)

Tajikistan is a very interesting case. With a history of comparatively high inflation than Afghanistan, Tajikistan has been successful in turning things around. Over the past decade, Tajikistan has made steady progress reducing poverty and growing its economy. Between 2000 and 2021, the poverty rate, measured by national poverty line, fell from 83% of the population to an estimated 26.5% while the economy grew at an average rate of 7% per year. (World Bank, 2021)

Since August 2022, Tajikistan has started a deflationary process in the consumer sector to reduce the prices of goods and tariffs and stimulate the national economy. According to the Tajik Statistics Agency, prices for goods and tariffs for paid services decreased by 0.3% in September 2022. (Boltuc, 2022)

Conclusion

In this paper, I propose a way of assessing whether the Taliban are interfering with the working of the monetary policy in Afghanistan. To do so, I propose the estimation of a Taylor rule for the period before Afghanistan was under control of the Taliban and then using the reaction function to predict the interest rate that would have prevailed in the present time if Taliban hadn't taken over the country. Any wedge between this implied interest rate and the actual interest rate is possibly due to the Taliban's interference.

The paper also spoke about the rich history of Afghanistan, and its international relations mostly with the U.S.A. It also served as a comparative study for the working of the fiscal and monetary policy before and after the Taliban's takeover. This paper also provides the readers with a Macro snapshot about the countries' inflation trends.

This paper provides a holistic overview on this issue and also gives a few valid solutions to find the involvement of the Taliban even after the lack of data to analyse.

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