

# REPLACING NARCO-USURERS WITH MICRO-LENDERS

THE AGRICULTURAL FINANCE COMPONENT OF OPIUM  
SUBSTITUTION PROGRAMS IN AFGHANISTAN

Master of Arts in Law and Diplomacy Thesis

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**List of Abbreviations**

IMF - International Monetary Fund

UNODC - United Nations office for Drugs and Crime (Formerly UNDCP -United Nations office for Drugs and Crime Prevention)

ITSA - Islamic Transitional State of Afghanistan

ATA - Afghanistan Transitional Authority / Interim Administration

ADB - Asian Development Bank

FAO - Food and Agriculture Organization

WFP - World Food Program

UNAMA - United Nations Assistance Mission to Afghanistan

UNDP - United Nations Development Program

**Glossary of terms**

Poor - loans in Pashto

Karz-e-asaan - easy credit, credit without interest

Riba - interest

Salaam - Advance sale of future crop at discounted rates

Anawat - short-selling, speculation with goods

Soothkhor - literally one who eats interest; moneylender

## TABLE OF CONTENTS

	Executive Summary .....	(1)
I.	The Thesis.....	(2)
II.	The Opium Problem.....	(9)
	a. The Politics of opium	
	b. Prices don't tell the whole story	
	c. Opium credit relationship	
	▪ Credit as a coping strategy	
	▪ Narco-usurers	
III.	Opium Substitution Strategies.....	(31)
	a. Opium Substitution strategies	
	i. Forced eradication	
	ii. Contractual eradication	
	iii. Alternative development	
	b. Alternative Development Program components	
IV.	Role of agricultural finance in opium substitution.....	(38)
	a. Agricultural finance component of Alternative development programs	
	i. Bridge funding	
	ii. Constraints	
	▪ Post-conflict situation and fragmented society	
	▪ Risk and uncertainty	
	▪ Islamic principles	
	b. Recommendations	
	i. Design choices	
	ii. Product choices	
	▪ Credit instruments	
	▪ Savings instruments	
V.	Concluding comments.....	(56)
VI.	Sources and Bibliography.....	(57)

## EXECUTIVE SUMMARY

Most of the focus in the opium substitution and eradication effort in Afghanistan since the fall of the Taliban has been on the development of alternative crops and enforcement of the ban issued by the interim administration. Program managers and researchers are focusing on the price dynamic influencing farmers decisions to cultivate opium, while underemphasizing the credit arrangements developed by narco-traders to incentivize opium cultivation. In the absence of access to other credit sources, small farmers find it especially difficult to resist the possibility of obtaining advances from narco-usurers for the opium crop before planting season. This paper argues that in the absence of effective control on factors influencing demand and prices for opium, the interim administration, NGOs, and donors should focus their attention on factors that influence farmers' decisions to cultivate poppy. Primary among these factors is the availability of credit, since is integral to coping strategies especially for smaller households. Providing alternative agricultural financing mechanisms and programs can be one of the strategies employed by international organizations and NGO's to divert production away from opium, especially in newer opium-growing regions. Designing these programs involves understanding of best practices in agricultural financing, Islamic financing, and administrative constraints in the Afghan environment. This paper analyses the opium credit- relationship that narco-usurers and traders have developed by exploiting the asset insecurity of Afghan households in sustaining the cultivation of opium. In response this paper recommends that agricultural micro-financing programs can play an important role in providing incentives to farmers to switch to crops other than opium, especially in the newer opium growing provinces. It finally makes recommendations about design choices, products, and administrative concerns that organizations can use while outlining their strategy.

## CHAPTER I: THE THESIS

Much of the recent Berlin conference where donors pledged \$8.2 billion over the next 10 years for the reconstruction effort in Afghanistan was clouded by discussions of the deteriorating security situation, and the administration's inadequate fight against the narcotics industry. Since the fall of the Taliban, the interim administration has made establishment of food security and opium eradication important priorities in addition to rebuilding physical infrastructure and restoration of security and stability.

Opium has emerged as a problem crop for Afghanistan only in the last 20 years. It has financed the fight of the Mujahideen against the Soviet Union, and today it helps several warlords maintain their independence, undermining the authority of the Central government. In the last two years, the number of provinces coming under the sway of opium cultivation has been increasing, leaving lesser room for the planting of food crops like wheat, in what is called the "ballooning effect." Horticultural crops traditionally accounted for the largest share of Afghan exports. But with 23 years of conflict, the amount of Afghan exports fell by more than 83%, with total imports being more than three times higher than legal exports.<sup>1</sup> The situation was only exacerbated by a four-year drought, most heavily felt in 2000 and 2001. Today the country's main agricultural products are opium, wheat, fruits, nuts, wool, mutton, sheepskins, and lambskins, with wheat as its staple food and opium its largest export.<sup>2</sup>

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<sup>1</sup> "The Opium Economy in Afghanistan: An International Problem," UN Office on Drugs and Crime, New York, (2003).

<sup>2</sup> The World Factbook, Central Intelligence Agency, USA, (November 2003).  
<http://www.cia.gov/cia/publications/factbook/geos/af.html>

More than 70% of the world's illicit opium supply comes from Afghanistan.<sup>3</sup> Up to 90% of the heroin consumed in Europe and Central Asia is made from Afghan poppy<sup>4</sup>. Across the northern border, opium and heroin trafficking have presented an unwieldy problem especially for Central Asian republics and Eastern Europe, affecting rule of law, and encouraging a rise in crime rates. Internationally the drug-terrorism nexus has become a major focal point, with the US stressing that the war on terror includes the war against drugs. Echoing these international concerns, the United Nations Security Council passed a resolution in November 2001, noting that the ITSA, as well as the new government to be instituted after elections later this year "should respect international obligations including cooperating fully in international efforts to combat terrorism and illicit drug trafficking within and from Afghanistan."<sup>5</sup>

Within Afghanistan, the question of opium eradication has become inextricably linked to that of food security. On the one hand, with more provinces succumbing to opium production in the last 2 years, choosing it over wheat cultivation, the pressure of providing food to the population has increased. The food insecurity only rises as the country grapples with the rehabilitation of returning refugees.<sup>6</sup> On the other hand, people choose to cultivate opium as one of the only strategies remaining to ensure food security for their families. With lack of non-farm opportunities, the Afghan population is naturally drawn to opium, as a cash crop and a coping mechanism. Policy makers and aid agencies argue on both sides of the food-security–opium linkage; some contest that if the concern is for food security, then in an environment with limited

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<sup>3</sup> UNODC and UNAMA, "Fact sheet on Drugs and Crime: Drug cultivation, production, trafficking and abuse" (March 30, 2004). [http://www.unodc.org/afg/en/fact\\_sheet.html](http://www.unodc.org/afg/en/fact_sheet.html)

<sup>4</sup> Ibid.

<sup>5</sup> UNSC resolution Number 1378

<sup>6</sup> The FAO estimates that "large number of people remain highly vulnerable to food insecurity and dependent on relief assistance due to several years of conflict and drought. About 6 million people, including 3.3 million persons affected by natural disaster and conflict, 1.2 million returnees, 400,000 internally displaced persons (IDPs) and nearly 350,000 urban poor will require food aid during 2002/03."

opportunities the government should allow people their crop of last resort. Others like the UNODC will argue that as the ballooning effect takes more space, food security is invariably threatened. Keeping that debate aside, opium eradication is important for several other reasons, most important among them being establishment of rule of law, controlling the power of warlords, and preventing the spread of the HIV/AIDS pandemic through the use of infected needles.

Recognizing the domestic importance of the problem as well as international concerns, the interim administration issued three decrees banning the cultivation, production, and trafficking of opium, and drug abuse, and outlining an eradication plan for the government, soon after assuming office.<sup>7</sup> The Counter-Narcotics Directorate (CND) was established in 2002 under the National Security Council to coordinate efforts among the various agencies involved in the monitoring and control of illicit crop production and distribution, with liberal support from the UK, U.S, Iran, and the EC. The National Drug Control Strategy<sup>8</sup> identifies key elements in the strategy for the long term elimination of the problem. The strategy has shifted from one of eradication only, to recognition of the importance of alternative development, and includes implementation of drug law enforcement measures, and provision of alternative livelihoods to farmers cultivating opium as key elements. In addition UN agencies like UNAMA, FAO and UNODC are providing crucial research and field support for the government to implement its

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<sup>7</sup> "Drug Control in the Afghan Context," Report prepared jointly by Counter Narcotics Directorate (CND) of the National Security Council (NSC) and Ministry of Rural Rehabilitation and Development (MRRD) on behalf of the Afghanistan Transitional Authority (ATA), Kabul, Afghanistan (2002).

<sup>8</sup> The strategy, developed after extensive dialogue between Afghan government officials, international stakeholders, UN agencies and NGOs, is to be jointly administered by the Ministry for Rural Rehabilitation and Development, the Counter-Narcotics Directorate, and National Security Council. It was approved by Chairman Hamid Karzai in May 2003, and talks are on to include it in the National Budget.

strategy.<sup>9</sup> Alongside, several NGOs are involved in the market research and development of alternative crops like scented-oil, saffron, olives, dry-fruits, organic herbs, and cotton. NGOs are also setting up microcredit programs for income generation, seed distribution programs, and rehabilitation of waterworks to support the bid for alternative livelihoods in rural areas. In an economy that is largely agricultural,<sup>10</sup> a discussion of opium substitution and eradication will involve a regeneration of ailing agriculture, and provision of services in a bid to provide reasonable alternatives to opium, while ensuring livelihoods security.

While the government recognizes the importance of alternative livelihoods programs in influencing farmers' crop choices, it has, along with the UNODC, focused on causal factors individually, instead of taking an integrated view. Their approach is called the "income-output approach" of alternative development, focusing on the irresistible prices of opium, and underemphasizing other causal factors that make poppy a coping mechanism rather than just an attractive cash crop. Analysis of farm-gate prices from the early nineties shows that except in recent years there has not been very substantial difference in prices between opium and other crops, making price trends a necessary but insufficient foundation for crop substitution programs.<sup>11</sup> The income approach is both insufficient for the task at hand and can be counter-productive if it encourages aid dependence and reverse conditionality among program recipients.<sup>12</sup>

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<sup>9</sup> Source is the ISTA's Counter-Narcotics Consultative Group  
<http://www.afghanistangov.org/ag/narcotics/index.html>

<sup>10</sup> "Rebuilding Afghanistan," Central Asia Development Group, Singapore. <http://www.central-asia.net/Agriculture.htm> 'More than half of the Afghanistan's GDP traditionally is estimated to come from the agriculture, with about 70% of the population involved either directly or indirectly in the sector.'

<sup>11</sup> "Islamic State of Afghanistan: Rebuilding a Macroeconomic Framework for Reconstruction and Growth," IMF Country Report No. 03/299, International Monetary Fund, Washington, DC (September, 2003).  
<http://www.imf.org/external/pubs/ft/scr/2003/cr03299.pdf>

<sup>12</sup> This was the approach used in programs commissioned by the UNODC, where farmers had to agree to reducing area under poppy cultivation in return for economic assistance. The danger was that farmers could use the threat of increasing cultivation as a bargaining chip to secure additional assistance. This is known as reverse conditionality.

An IMF preliminary needs assessment report for the ITSA shows that it is not just the price that opium fetches against other crops that is attractive for farmers, but the possibility of obtaining credit at the beginning of the planting season that draws several of them into the opium trade.<sup>13</sup> Narco-traffickers have used the general credit paucity in Afghanistan to their advantage, by modifying age-old credit arrangements to fit the opium crop. Traffickers incentivize opium cultivation by providing advance credit to farmers before planting season at usurious rates. Without resort to other sources besides kinship groups, Afghans resort to narco-lenders. In a recent UNODC survey on farmers' intentions to cultivate opium in 2004, about a fifth of the farmers in the sample said they would opt for opium because it enabled them to obtain advance cash during the lean season.<sup>14</sup> The opium industry has set up credit systems, and a marketing network that cannot be easily uprooted. A sophisticated analysis must include discussions of resource and credit access that opium brings, and adopt an integrated livelihoods approach, understanding the resilience of populations in conflict, and vulnerability of rural households in coping within such situations.<sup>15</sup>

Credit is integral to coping strategies, especially for smaller households. This paper argues that the opium-credit relationship has been not stressed enough in the research on alternative development, and must be incorporated strongly into new programs. By manipulating the opium-credit relationship, concerned parties including both the government and NGOs, can increase

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<sup>13</sup> IMF Country Report No. 03/299

<sup>14</sup> "Afghanistan: Farmers' Intentions Survey 2003/2004," UNODC and Government of Afghanistan Counter Narcotics Directorate, (February 2004). [http://www.unodc.org/pdf/afg/afg\\_fis\\_report\\_2003-2004.pdf](http://www.unodc.org/pdf/afg/afg_fis_report_2003-2004.pdf)

<sup>15</sup> Adam Pain points out that "The dynamics of the chronic conflict in Afghanistan has been poorly understood, not least in terms of its effects on livelihoods... the recognition of embedded knowledge of nongovernmental organisations (NGOs) that have worked long-term in specific locations and the need to build learning explicitly into their programming; the poor understanding of the resilience of livelihoods; the need to recognise the legitimacy of 'illicit' activities; the dynamic nature of conflict and power relations and the poor conceptualisation of vulnerability within the livelihoods framework." Adam Pain, "Understanding and Monitoring Livelihoods under Conditions of Chronic Conflict: Lessons from Afghanistan," *Working Paper 187*, Overseas Development Institute, UK, (December 2002).

their influence over farmers' decisions. Thus, agricultural finance programs are an important tool in the alternative development framework to eliminate opium cultivation in Afghanistan.

Designing these programs involves an understanding of the different socio-economic groups involved in opium production, best practices in agricultural financing, Islamic financing, and administrative constraints in the Afghan environment.

The discussion on agricultural finance worldwide has slowed down considerably, after the large scale failure of subsidized government-run agricultural credit programs in the 1970's and 1980's. Moreover the application of decentralized microfinance programs to the agricultural sector has not received as much attention as perhaps its application to urban income-generation and women's betterment programs. This paper asks the question, "How can agricultural microfinance programs be included in the alternative development approach to incentivize opium substitution?" In answering that question, the paper first provides evidence of why prices are a necessary but insufficient point of focus in substitution programs. Second, it gives evidence of credit availability as an important factor to consider when confronting the opium problem. Third, it analyses the components of an effective opium substitution strategy. Finally, it analyses the opportunities and constraints in applying agricultural finance programs in manipulating the opium-credit relationship, and makes recommendations regarding parameters and design choices for instituting such programs.

## CHAPTER II: THE OPIUM PROBLEM

### The Politics of Opium

Afghanistan was not a drug-led economy traditionally. It is only in the last 25 years that illicit opium production has emerged as a problem for the country as a whole. The Soviet intervention in Afghanistan in 1979 was a turning point; since then the country has seen a steady rise in production, reversed only in 2001 under the Taliban enforced ban. Since the fall of the Taliban production levels recorded dramatic increases once again.

Afghanistan emerged as the leading supplier for the global heroin industry in the period beginning 1979, following a failure of monsoons in the golden triangle, i.e. Burma, Laos and Thailand. This was accompanied by stricter enforcements against trade in illicit substances in Turkey, Iran and Pakistan.<sup>16</sup> The geopolitics of the Cold War turned Afghanistan into a buffer state once again, prompting guerrilla warfare within the country. Armed resistance to the Soviet occupation required heavy funding, part of which came from the U.S, and part came from the rebel groups' control of trade in and around their base region. For the 23 years of the civil war, and the period following the fall of the communist party, various Mujahideen groups like the Hizb Islami led by Gulbuddin Hekmatayar used the returns from the opium crop to fund and run their resistance.<sup>17</sup> Since the central government had virtually no control in the remote areas outside of Kabul, the warlords flourished in the trade of opiates. The Mujahideen fought two wars, first against the Soviets and the Communist faction in Afghanistan, and then with the Taliban who had unseated the Mujahid government led by President Burhanuddin Rabbani and Hekmatayar in

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<sup>16</sup> IMF Country Report No. 03/299

<sup>17</sup> Jonathan Goodhand, "Frontiers and Wars: a study of the opium economy in Afghanistan (DRAFT)," SOAS, University of London, London, UK (January, 2003).

1994.<sup>18</sup> Hekmatayar, General Rashid Dostum—an Uzbek warlord in the north, and smaller warlords in southern provinces emerged as the protectors of the highland drug trade, similar to the pattern emerging in Burma around the same time.<sup>19</sup> From an annual production of 100 metric tons (MT) in 1971, production jumped three times to 300 MT in 1982 and to 575 MT in the following year.<sup>20</sup> Jonathan Goodhand describes the historical context surrounding the crop as a two-way relationship. “The opium economy is partly an outcome and partly a cause of war-making, state building, and state collapse—the war created the conditions in which opium production could thrive, but opium has also helped create a self sustaining war economy in which there may be limited incentives for putting the state back together.”<sup>21</sup> By 1989, the seven major Mujahideen factions were responsible for more than 800 MT of the country’s illicit opium production.<sup>22</sup>

This trend however did not stop with the fall of the Mujahideen governments. When the Taliban came into power, they initially used the opium crop to finance their operations. Their approach was generally guided by “religious principles, ambiguity and expediency”.<sup>23</sup> Finally, in July 2000, they succumbed to intense international pressure, and introduced a ban on the production of opium poppy. The real reasons behind the Taliban’s edict however are debated. Several researchers contend that the Taliban issued the ban to bring up international prices for

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<sup>18</sup> Stephen Tanner, “Afghanistan: A Military History from Alexander the Great to the Fall of the Taliban,” DaCapo Press, (July, 2002).

<sup>19</sup> In the 1980’s warlords such as Khun Sa in Burma took control of the highland drug trade. During the same period there was a dramatic rise in opium cultivation and heroin exports from the region. More information is available from Alfred McCoy’s book “The Politics of Heroin in Southeast Asia,” HarperCollins, (August 1972).

<sup>20</sup> Alfred W. McCoy, “Opium History, 1979 To 1994,” Recreational Drug Information, (1999).  
[www.a1b2c3.com/drugs](http://www.a1b2c3.com/drugs)

<sup>21</sup> Goodhand (2003).

<sup>22</sup> John Cooley, “Unholy Wars: Afghanistan, America and International Terrorism,” Pluto Press, Sterling, Virginia, USA, (2000).

<sup>23</sup> Cited in Goodhand (2003).

opium which had declined in the prior years.<sup>24</sup> Besides the edict applied only to production and cultivation, and trade in opium was still legal. Ultimately, though production fell, Afghanistan continued to grow in its share of the global supply of opium from 50% in 1995, to 79% in 1999. By the year 2000, Afghanistan's production had increased more than 15-fold since 1979. Today about three-quarters of the world's supply of illicit opium comes from Afghanistan.<sup>25</sup>

The ban enforced by the Taliban started the upward pressure on prices, and hence suppliers were waiting in the ranks to take advantage of the price rise. Following the US bombings of Afghanistan in the later part of 2001, farmers decided to reinvest in poppy production, anticipating that lack of stability would ensue after the fall of the Taliban, and the interim administration would have no enforcement capacity. In addition to the attractive price hike, farmers also needed to repay old debts, especially those taken from opium traders before the ban enforced by the Taliban. During the ban, several traders had allowed farmers to monetize their debts, but after the fall of the Taliban they were once again using opium as a bargaining chip. Farmers who could not repay the current cash value of their debts were looking to reap rich dividends from the windfall of high prices, and those who had been negotiating with their lenders agreed to harvest a crop as a means to reduce the total their total repayments. Their instincts were well reciprocated as prices surged to the ceiling,<sup>26</sup> and farmers were able to compensate losses from previous years. The harvest of 2002 also saw the first reasonable rainfall in four years, all

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<sup>24</sup> Following an increase of 2000 metric tons in production from 1999 to 2000, bazaar prices fell from \$55 per kg to \$39 per kg. One theory suggests that the Taliban in fact wanted to create a temporary shortage of opium supply and thereby push up prices. Price information obtained from the UNODC Opium Survey of 2003.

<sup>25</sup> The World Factbook, Central Intelligence Agency (CIA), USA (November 2003).  
<http://www.cia.gov/cia/publications/factbook/geos/af.html>

<sup>26</sup> See Table 1 for the trends in indicators of the opium crop. Source UNODC, Annual Opium Survey 2002.

contributing to a bumper harvest.<sup>27</sup> Bazaar prices shot up from \$39 to \$301 per kg, and for the first time there was no significant difference between farmgate prices and the prices in bazaars, indicating that farmers would get a reasonable share of the windfall gains immediately post-harvest.

*Table 1. Afghanistan: Indicators of Opium Cultivation, 1994–2002*

Source: UNODC Opium Survey 2002

Indicators	Years								
	1994	1995	1996	1997	1998	1999	2000	2001	2002
Production (in metric tons)	3,416	2,335	2,248	2,804	2,693	4,565	3,276	185	3,422
Cultivated area (in ha after eradication)	71,470	53,759	56,824	58,416	63,674	90,983	82,171	7,606	74,045
Yield per ha (in kg)	47.8	43.4	39.6	48	42.3	50.2	39.9	24.3	46.2
Average farm gate price at harvest time (\$ per kg)	30	23	24	33.7	32.8	40.1	27.8	301	350.7
Main bazaar prices (in \$ per kg)	69	65	50	71	65	55	39	301	350.7
Gross income per ha (in \$)	3,297.90	2,823.20	1,978.00	3,408.00	2,749.10	2,759.60	1,554.90	7,321.20	16,207.60
Direct farm employment (in person year)	77,205	58,073	61,384	63,104	68,784	98,284	88,765	8,216	79,987
Persons needed at harvest time (in persons)	794,111	597,322	631,378	649,067	707,489	1,010,922	913,011	84,511	822,722

Upon assuming office, one of the first acts of the ATA was to issue a decree forbidding all poppy cultivation and trading on January 17, 2002. The decree however was too late to affect outcomes for 2002, given that harvest was at hand. But for the following years, the government undertook an ambitious poppy eradication plan along with UNODC, in an attempt to win control of areas outside of Kabul as well as assuage international clamour. Despite this decree, even in the following year, production rose to the highest levels since 1999. Lack of authority over most provinces, rendered the governments' alternative development efforts ineffective and the harvest saw prices rise further to \$350 per kg for newly harvested opium. This price trend now presents a

<sup>27</sup> Opium is a water-intensive crop, and even though it doesn't require as much nurturing as wheat, it requires more water per hectare than substitutable crops. It is therefore typically grown in areas that have reliable access to water sources or irrigation facilities.

serious problem for those advocating crop substitution and alternative development strategies. Providing a crop that can compare in value to opium is virtually impossible, given the severe resource constraints farmers face. For 2004, UNDCP estimates that poppy production will rise further, with 2 out of 3 interviewed farmers stating that they will increase the area devoted to the crop. The farmers' intentions survey revealed that despite a clear awareness of the ban, farmers intended to increase their production significantly.<sup>28</sup> This poses a threat on several levels: security, stability, resurgence of Taliban, drug addiction and spread of HIV AIDS. Programs for alternative development must take into account price trends as well as other factors that make opium an attractive cash crop.

### *Opium as a cash crop*

The opium survey of 2003 estimated that between 1.5 and 1.7 million people were involved in opium production, representing about 7% of Afghan population.<sup>29</sup> Any decision affecting the crop therefore has important implications. Studies point to several reasons influencing farmers' decisions, most prominent among these are grinding poverty, high income potential of opium, and access to credit. The survey on farmers' intentions asked farmers whether they were aware of the ban imposed by the ATA, and most replied in the affirmative, yet they asserted their intentions to increase the acreage devoted to opium, highlighting that the short term returns from the crop outweigh the risks of interdiction.<sup>30</sup> The breakdown of the Afghan state, lack of rule of law, decline of agriculture, lack of resources for both farm and non-farm activities, absence of alternative economic and commercial opportunities, and widespread destruction of

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<sup>28</sup> UNODC Farmers' Intentions Survey 2003/2004

<sup>29</sup> UNODC Opium Survey 2003

<sup>30</sup> UNODC Farmers' Intentions Survey 2003/2004

infrastructure made poppy cultivation one of the few remaining viable economic activities. Erosion of asset bases, including land and livestock led to a decline in the average income levels of households.<sup>31</sup> Opium cultivation presents the only attractive opportunity in their depleted lifestyle.

Besides, opium has several technical advantages over other crops. Despite being water-intensive it does not require as much monitoring as wheat for example. As a labour intensive crop, it allows poor farmers to earn high income with cheap labour, and gain access to resources that they might otherwise not have, like land, credit, and off-farm income. It is a low-weight high value product,<sup>32</sup> weather resistant, non-perishable with a long shelf life and a relatively short harvest period,<sup>33</sup> provides more security than other crops, yields by-products that are important sources of fuel, and is suited to the damaged infrastructure conditions of Afghanistan.<sup>34</sup> Thus, especially in the last 5 years, it has become more difficult for farmers to resist the un-Islamic nature of opium cultivation.

### *Prices don't tell the whole story*

The most common reason cited for the undisputed rivalry of opium as a winter crop in Afghanistan is that crop prices, and by extension farmers' profitability and incomes are irresistibly

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<sup>31</sup> Sue Lautze, et al., "Qaht-e-Pool: A cash famine – Food Insecurity in Afghanistan 1999-2002," Feinstein International Famine Centre (FIFC), Tufts University, Boston USA. (May 2002).

<sup>32</sup> David Mansfield, "Alternative development in Afghanistan: the failure of the quid pro quo," Paper for the International Conference on Alternative Development in Drug Control and Cooperation, Feldafing, Germany, August, 2001. (Mansfield 2001a)

<sup>33</sup> This is an important technical factor, especially for those farmers with small landholdings, and even those who work as sharecroppers on rented land. Cumin for example takes 3 years to bear significant results. With a short harvest period, farmers can plant a second winter crop like maize, at least for purposes of household consumption, after the harvest of opium.

<sup>34</sup> David Mansfield, "Economic Superiority of illicit Drug Production: Myth and Reality – Opium Poppy Cultivation in Afghanistan," Paper for the International Conference on Alternative Development in Drug Control and Cooperation, Feldafing, Germany, August, (2001) (Mansfield 2001b); and UNODC (2003a).

high when compared to other crops like wheat. Also known as the “income-output” approach, this has served as the focal point for the programs run by UNODC and its predecessor UNDCP.

Several opium eradication programs like the Afghanistan Drug Control and Rural Rehabilitation Programme (1989-1996) and the Poppy Crop Reduction Programme (1997-2000), both initiated by the UNDCP as supply-side initiatives, based their program design on this theory. The emphasis on the development of alternative livelihoods also relies heavily on this approach for guidance.

The caveat is that prices don’t reveal the entire story. A reliance on this approach ignores the role of opium as a coping strategy for poor households. Also, the price theory has several gaps in explaining the attractiveness of opium as a cash crop.<sup>35</sup>

Between 1994 and 2000, UNODC estimates that 200,000 farmers were engaged in the opium trade on average, raising revenues of approximately \$95 million.<sup>36</sup> This represented an average income of \$475 per opium cultivating farmer.<sup>37</sup> The drastic shift came after the Taliban imposed ban in 2000. In the next two years, between 2000 and 2002, bazaar prices went up almost 6 times, from an average of \$60 over the previous period, to \$350, and annual poppy income rose to \$1.2 billion.<sup>38</sup> Spread over 200,000 farmers, this represented an annual income of \$6000 per poppy cultivating farmer, approximately 12 times the income of unskilled farm labour. This amount however does not capture the differences in opium income across regions and socio-economic groups; the distribution is highly skewed. For example in 2001, most of the income was

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<sup>35</sup> See David Mansfield, “Alternative Development: The Modern Thrust of Supply Side Policy,” *United Nations Bulletin on Narcotics*, Vol. LI, Nos. 1 and 2, 1999, for a further critique of alternative development programs. ((Mansfield 1999)

<sup>36</sup> UNODC Opium Survey 2001, and UNODC (2003a)

<sup>37</sup> UNODC (2003a)

<sup>38</sup> Refer to Table 1

concentrated in the Northern provinces which were under the control of the Northern Alliance.<sup>39</sup>

Understanding the distribution of poppy incomes is important to introduce effective programs that provide different socio-economic groups with different incentives to encourage a shift away from the crop.

While survey data shows that in the last 10 years opium has become a much more attractive alternative than wheat, it has not always been the more profitable crop.<sup>40</sup> The IMF strategic assessment for Afghanistan points out that till the recent price spikes in opium, farmgate prices and returns per hectare on opium were not that different from other crops like grapes, black cumin and other fruits.<sup>41</sup> Moreover, a comparison with other crops in terms of input intensity also reduces the profitability differences. Farmers typically account for inputs such as fertilizers, seeds, and water in calculating profits, but leave out household labour. Opium is much more labour intensive compared to other crops, and therefore since the cost of labour is not accounted for the profitability seems exaggerated.<sup>42</sup> Different regions within the country also have different degrees of competition between opium and other crops over different time periods. For example “in 1994,

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<sup>39</sup> UNODC Opium Survey 2001, Map – Opium growing districts 2001. The highest opium growing region in 2001 was Badakshan in the north, followed by Nangarhar in the East.

<sup>40</sup> UNDCP, Afghanistan: Assessment Strategy and Programming Mission to Afghanistan, May-July 1995; and UNDCP, Afghanistan Annual Opium Poppy Survey 1997, (Islamabad, UNDCP, p. 11).

<sup>41</sup> IMF Country Report No. 03/299, “A UNODC study shows that, for example, for the 1998/99 season opium was by far the most profitable crop because of a combination of high prices, a bumper harvest, and poor yields and prices for competing crops. But this situation reversed in the next season of 1999/2000, when the return per hectare on several alternative crops, including, grapes, onion, black cumin, and other fruits comfortably exceeded that of opium.”

<sup>42</sup> UNODC (2003a). Estimates suggest that approximately 350 person days are required to cultivate one hectare of opium poppy compared to 135 person days per hectare for black cumin and 41 person days per hectare for wheat. Opium harvesting alone requires some 200 person days per hectare. Farm data from field surveys shows that while a fourth of the labour on opium farms is hired labour, the remaining three-fourths is family labour, which goes unaccounted for.

1997 and 1999, wheat generated higher returns than opium poppy in a number of districts in the southern region of Afghanistan.”<sup>43</sup>

Moreover, opium’s role as “a medium of exchange between the resource rich and the resource poor” has skewed the spread of benefits across different groups,<sup>44</sup> and for the smallest farmers, choice of crop may be influenced more by access to resources than by prices alone. If opium were as irresistible, given the favourable agro-climactic conditions in the country, more proportion of land would be devoted to it, rather than the average 2.6% of the arable land in the country.<sup>45</sup> Different groups dependent on opium for their income have diverse livelihood strategies, and programs aimed at opium substitution should pay attention to the multi-functional role of opium in the in lives of different socio-economic groups. “For the resource poor, the income that households accrue for their work on opium poppy is only one motivation for its cultivation.”<sup>46</sup>

Estimates of annual income are calculated using farmgate prices, and these mark conservative estimates of income, ignoring the stockpiling and delayed sale of opium at bazaar prices (which are substantially higher<sup>47</sup>) by farmers. Research shows that farmers typically sell only part of their produce immediately after harvest and sell the remaining during later times in the year when prices are higher. In this sense, the upper ceiling to estimates of farmers’ incomes may be derived from calculating revenues based on average bazaar prices.

But both farmgate prices as well as annual average bazaar prices may raise the ceiling too high in depicting farmers’ incomes. Farmers typically tend to sell their produce to traders in

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<sup>43</sup> Mansfield 2001b, and UNDCP, Afghanistan: Assessment Strategy and Programming Mission to Afghanistan, May-July 1995

<sup>44</sup> Mansfield 2001b

<sup>45</sup> Von der Schulenburg, 2001, Cited in Goodhand (2003).

<sup>46</sup> Mansfield (2001b).

<sup>47</sup> This is due to qualitative differences between wet and dry opium. Dry opium is more valued in the market.

advance at half the price of the planting season. This is one of the credit arrangements at work in the opium chain also called the salaam system. Thus their returns are significantly lower, irrespective of the potential income that can be earned. Most farmers in Afghanistan have below average landholdings, thus the returns to most opium growing farmers are also below the average figure of \$6000. Moreover most of the gains are seen in Nangarhar and Helmand provinces, which grow more than half of the country's opium. Thus focusing on the irresistible prices argument does not explain the compulsion of smaller farmers especially in newer opium growing districts. From field studies conducted by the UNODC, about 5% of opium revenues seem to be salaam arrangements,<sup>48</sup> this figure seems suspiciously small. Most other crops traditionally have used these arrangements, and in the absence of other credit sources it is not clear where farmers would find the resources to cultivate opium unless they too collected advances on their crop.

The gains from poppy cultivation are unevenly spread across different socio-economic groups, with landowners and traders making a bulk of the gains, and smaller farmers left without options. Unequal land tenure arrangements like sharecropping unfairly skew the advantages in favour of landowners. Sharecropping arrangements usually arrange returns in proportion to the division of inputs between the sharecropper and the landowner.<sup>49</sup> Inputs are not accounted for with their price value but by the number of inputs, i.e. land, water, fertilizer, seed, labour. The sharecropper usually provides one to three of these inputs and his return varies from a third of the output to one half. These arrangements are standard in the case of wheat, and fruit cultivation, and have been applied to opium as well. In the case of opium however, they do not reflect true

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<sup>48</sup> UNODC Opium Survey 2003.

<sup>49</sup> Farmers in Afghanistan usually fall under three categories: zamindar (landowner), kishtagar (sharecropper), bazgar (laborer, small sharecropper). Kishtagars are sharecroppers who usually provide 2 out of 5 inputs and their share is usually 1/3<sup>rd</sup> of output. Bazgars are also sharecroppers, but more akin to land laborers who provide 1 out of 5 inputs and take 1/5<sup>th</sup> of the total produce. All of these arrangements vary depending on the crop, planting season, indebtedness to the landlord, and whether the farmer is from the village or is a migrant worker.

contributions of the sharecroppers who provide all the labour and get one-third of output in return. Opium is the most labour intensive of crops in Afghanistan and requires skilled labour especially for extraction of the resin from the flower. Households that cultivate opium also typically tend to have more family members engaged in the production process. And since they do not put a price value on household labour, their share is significantly lesser than accounted for by average figures. While it is true that in certain regions, sharecropping arrangements for opium take into account the labour intensiveness of the production process, sharecroppers and itinerant labourers choose opium fields primarily because it provides them access to land and credit. The former helps the sharecroppers also cultivate a small part of the field with food crops especially cereal for household needs. The latter enables him to obtain credit for both inputs such as fertilizer (if the sharecropper is providing for it), as well as wheat and medicines from shopkeepers during the lean winter months. Large landowners are able to reap benefits of this labour intensity by hiring sharecroppers who provide all the labour, and also by giving out crop advances to other farmers. Similarly, traders and shopkeepers in the opium bazaars are able to minimise their contribution, and reap rich dividend.

In evaluating the “irresistible-prices argument,” the nuances of actual returns especially to the smallest farmers (after discounting debt and delayed sale profits), and differences among different socio-economic groups engaged in cultivation must be taken into account. Both these factors will have important implications for the way policy is framed, and for successful intervention by NGOs. This paper argues that in the absence of effective control over prices of opium, UNODC as well as the government could better invest their efforts in manipulating other factors affecting cultivation decisions, such as the availability of credit. Such targeted intervention

takes into account the credit dynamics of opium, and incorporates agricultural finance programs as a key element of strategies aiming at creating licit livelihoods. If the calculation of annual income of opium farmers does not reflect these nuances, opium substitution efforts may be misplaced. For instance since prices of illicit crops cannot be directly manipulated, substitution efforts may focus their energies on finding crops that are as valuable, instead of manipulating other factors that influence farmers' decisions. Michael Alexander sums up the insufficiency of the prices argument in his paper on the opium farmers search for other options. He observes, "This is not to say that opium poppy is not a profitable endeavour; it can be. It does, however, suggest that opium poppy is not necessarily a profitable crop in all circumstances. In the current environment in Afghanistan opium poppy cultivation is clearly an appealing option. As a non-perishable, low weight - high value product, it is ideally suited to the war-damaged physical infrastructure. Moreover, as an annual crop, with a relatively guaranteed market, opium has provided a degree of security that many crops, such as fruit and vegetables, cannot offer."<sup>50</sup> From prices therefore we should turn our attention to other factors such as credit which farmers cite as important determinants of their crop choices.

### *Opium-credit relationship*

Four kinds of agricultural credit arrangements are prevalent in Afghanistan: *salaam*, *anawat*, credit from shopkeepers, and credit from informal sources like the extended family and kinship group, allowing farmers to "spread their liabilities across a range of lenders including

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<sup>50</sup> Michael Alexander, "The Afghan opium poppy farmer: far from wealthy and keen on legal options," *Entwicklung + Laendlicher Raum*, 2002/3, Frankfurt, Germany.

family, landlords and commercial traders.”<sup>51</sup> But with 23 years of civil war and intense fragmentation of Afghan society, the trust necessary to maintain financial intermediation operations was eroded and informal lending arrangements relying on *qawm* or kinship ties, or intra-village relationships became more popular.<sup>52</sup> In the urban areas where some informal lenders existed, there was demand for high collateral or lending was conditional on the willingness to cultivate opium. Credit arrangements within the *qawm* are on the basis of *karz-e-asaan*, meaning easy credit, or credit without any interest or mark-up.<sup>53</sup> However, with six years of drought following the civil war, *qawm* networks have been stressed and recourse to community insurance is becoming more difficult. Afghans are thus resorting to traders, shopkeepers, and narco-usurers for their credit needs, including seeds and fertilizers for on-season farm needs as well as wheat, tea, sugar, medicines etc for household needs.<sup>54</sup> While credit from these sources does not involve explicit rates of interest, they are usually marked up depending on the specific arrangements. Such arrangements are especially important to rural farming households due to the seasonal nature of the income flows. In lean winter months obtaining credit becomes additionally important given the household food shortages.<sup>55</sup> Rural credit finances agriculture and acts as insurance facility for poor farmers and their families. Credit also acts as a coping mechanism for subsistence, and allows

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<sup>51</sup> UNODC Strategic Study on the Role of Opium as a Source of Informal Credit (1999).

<sup>52</sup> FIFC Cash Famine paper (2002).

<sup>53</sup> UNODC (2003a)

<sup>54</sup> UNODC Strategic Study on the Role of Opium as a Source of Informal Credit (1999), and FIFC Cash Famine paper (2001) “In the focus group interviews, debts that threatened food security were incurred in order to purchase food, to finance migration, to pay for medical and funeral costs, and to support the cost of drug addiction. In addition, households, farmers and businessmen incurred productive debts, including debts to finance the purchase of seed and fertilizer for the year’s winter wheat crop (especially in the north where spring rains were promising).”

<sup>55</sup> UNODC Strategic Study on the Role of Opium as a Source of Informal Credit (1999). Respondents for the UNODC Baseline Survey on the role of opium as a source of credit (1998), revealed that credit is often seasonal, with 72% of respondents obtaining loans between mid September and mid March. The first two months in the period are the months for marriages and planting of the winter crop. The later part of the period is when households experience food shortages.

for consumption smoothing during times of hardship.<sup>56</sup> Any aggravation of the debt situation increases the vulnerability of rural households significantly.<sup>57</sup> Without access to credit there is a lack of ability to mechanize, diversify, or invest on land, making intensive cultivation difficult. Availability of credit will allow farmers to increase productivity and to diversify from opium production.

Since the beginning of the Taliban regime, studies have recorded a fall in the level of economic security among the population, in terms indebtedness, diet, asset bases, and water and resource availability.<sup>58</sup> Their policy of ambiguity with regard to opium cultivation has severely distorted credit arrangements in the region, especially in opium growing provinces. On coming to power they also appreciated the currency, which brought down price levels, but was disastrous to those in debt. Moreover, the strict interpretation of Shari'a law under the Taliban made lending activities dangerous, and formal institutions shut down, closing avenues for on-season capital lending, and off-season consumption smoothing. This led to a credit gap; lending activities became socially unacceptable and borrowing impossible for poor families, pushing them further into destitution.<sup>59</sup> Thus Afghans faced credit paucity both in terms of access to sources as well as depletion of assets to back up their credit needs. Informal surveys and spot conversations point out that for most Afghans it is access to credit that is the main problem not the cost of it,<sup>60</sup> and it is this credit paucity that drug lords, narco-traders, and shopkeepers have taken advantage of.

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<sup>56</sup> UN Habitat Agency in Helmand province conducted a study in April 2000 which found that of all loans taken by households, only a third were used for productive activities and the rest were for basic needs like food, household expenses, medicines, marriage expenses etc.

<sup>57</sup> Bhuvana Anand and Mariela Martinez, "Food Security Strategy for the Transitional Islamic state of Afghanistan: Focus on Water and Credit Paucity," (Unpublished), Fletcher School of Law and Diplomacy, 2003.

<sup>58</sup> FIFC Cash Famine paper (2002). This is in part due to the weight of drought in the latter years of the regime.

<sup>59</sup> Bhuvana Anand, "Agricultural Micro-lending programs in Afghanistan: Parameters and Design Choices", (Unpublished), Fletcher School of Law and Diplomacy, 2003.

<sup>60</sup> FIFC Cash Famine paper (2002), "Drought, war and political changes have increased risks over time, with predictable but damaging implications for both the availability and cost of credit."

Field reports show that most rural households hold significant amounts of debt, mostly from extended family, shopkeepers and traders.<sup>61</sup> The extent and depth of the problem of indebtedness however is difficult to verify due to lack of data. Different studies estimate that at least half the farmers took on some new debt in 2002, and about 60% were in debt from the previous years.<sup>62</sup> The failure of crops due to the drought for consecutive years before 2002 only increased the extent of indebtedness in the population, leading some families to go so far as marrying young daughters to their lenders for no *mehr*, in return for debt forgiveness.<sup>63</sup> Indebtedness is also closely correlated with agricultural self-sufficiency and food security.<sup>64</sup> Surveys conducted by the WFP, FAO, ICARDA, USAID, and Future Harvest consortium all point to lack of access to credit, as one of the most important reasons for low agricultural productivity and food insecurity of rural households.<sup>65</sup> Farmers, especially small landholders and the landless, are caught in the vicious circle of default, delinquency, and delayed payments which, in the absence of other productive avenues, can only be broken by cultivating opium, given its enormous profitability.<sup>66</sup>

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<sup>61</sup> Adam Pain, Sue Lautze, "Addressing Livelihoods in Afghanistan," *Final Draft Issues Paper*, Afghanistan Research and Evaluation Unit, Kabul, (2002).

<sup>62</sup> Some studies have postulated that the debt problem is exaggerated. Even if the extent of indebtedness is less acute than claimed by aid agencies, from my fieldwork past summer farmers still lack access to less more reliable and less burdensome credit sources. Reinstating credit facilities is thus an important investment in any alternative development strategy.

<sup>63</sup> Bride price or *mehr* is the amount that men pay during engagement as a promissory to the bride's father in Islam. In Afghanistan, mehr has become an important factor motivating farmers towards opium, as the only recourse to marriage is obtaining loans on future crops in order to officiate the marriage. Most people today do not have access to credit, and the Agriculture Bank exists only in name. In addition, drought-related losses of income have put kinship credit under strain, forcing men to seek out moneylenders. Many families have mortgaged their lands, harvests, or water rights - and even sold their (very young) daughters into marriage.

<sup>64</sup> "Agriculture in Afghanistan: Restoring alternatives to poppy," Future Harvest Consortium to Rebuild Agriculture in Afghanistan, UK, (February 2003). [http://www.futureharvest.org/pdf/Final\\_afghanistan\\_poppy.pdf](http://www.futureharvest.org/pdf/Final_afghanistan_poppy.pdf)

<sup>65</sup> According to the Winter Survey conducted by the FAO, households with a cereal deficit tend to incur higher debt. USAID in a recent statement cited lack of credit as the major barriers to farmers' productivity, and has outlined programs to help "small and medium scale businesses with credit for production, input trade, processing, and marketing enterprises."<sup>65</sup> USAID in Afghanistan - [http://www.usaid.gov/locations/asia\\_near\\_east/countries/afghanistan/afghanistan\\_brief.html](http://www.usaid.gov/locations/asia_near_east/countries/afghanistan/afghanistan_brief.html)

<sup>66</sup> "Afghanistan: Focus on Food Security," Integrated Region Information Networks, UN Office for Coordination of Humanitarian Affairs, ISLAMABAD, (August 21, 2002).

The recourse to opium finances multiple needs: inputs for cultivation, marriage expenses, payment of old debts (incurred on opium as well as other crops),<sup>67</sup> and purchase of food during winter. With the absence of formal lending institutions,<sup>68</sup> and the impoverishment of *qawm* networks, farmers resort to opium arrangements with narco-traders and shopkeepers in local bazaars. Opium also becomes a source of credit, savings and investment, because through the year the value of opium appreciates as it becomes dryer, and farmers can earn profits during the year by stockpiling some of their harvest.<sup>69</sup> Through opium landless farmers could get access to land since they could afford to enter into sharecropping arrangements based on inputs purchased on credit, or advance sale of opium. In the last five years, large landowners, shopkeepers, and narco-traders have adapted agricultural credit arrangements to fit the production patterns of opium and also to offer smaller farmers an incentive for cultivation. Since “*poor* (loans and credit in Pashto) is an integral part of household livelihood strategies,”<sup>70</sup> it is difficult for farmers to refuse the only credit recourse available to them. In several opium-growing regions it is near impossible to get credit, especially bazaar credit for everyday needs, unless farmers show a willingness to cultivate opium, and willingness then becomes a measure of creditworthiness. Farmers in water-abundant areas naturally chose opium over wheat or fruit. Narco-usurers were back in business, and this time,

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[http://www.irinnews.org/report.asp?ReportID=29430&SelectRegion=Central\\_Asia&SelectCountry=AFGHANISTAN](http://www.irinnews.org/report.asp?ReportID=29430&SelectRegion=Central_Asia&SelectCountry=AFGHANISTAN)

<sup>67</sup> UNODC Strategic Study on the Role of Opium as a Source of Informal Credit (1999). “Poor opium yields in 1998 would appear to have had a considerable impact on respondents’ ability to repay the debts they had incurred during the winter period. Almost one third of those respondents without land claimed that their debts had increased because of the poor harvest and the need to reschedule their repayments.”

<sup>68</sup> UNODC (2003a). “Reliable institutions to deposit funds in Afghanistan have been in short supply over the last decade, notably since the Taliban came to power and prohibited the charging of interest. No formal banks existed for people to deposit their savings (Prior to the Taliban take-over, more than half of the country’s private deposits were held by Da Afghanistan Bank, the country’s central bank. (Source: IPC, *Afghanistan, The Scope for Promoting Micro, Small and Medium Sized Enterprises in the Private Sector by Establishing a Microfinance Bank*, March 2002, p. 33 and p. 47.) Savings were thus either invested in businesses of relatives and/or handed over to money traders/lenders who would invest the savings and then share the profit or loss with the investors.”

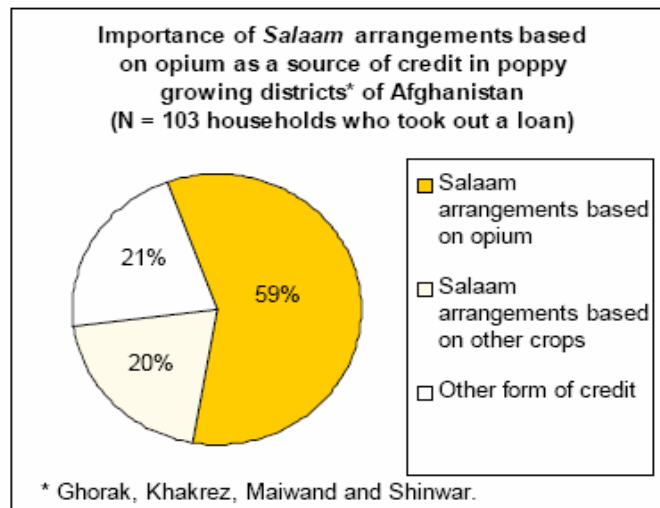
<sup>69</sup> Difference between dry opium and wet opium prices, and stockpiling tendencies.

<sup>70</sup> UNODC Strategic Study on the Role of Opium as a Source of Informal Credit (1999).

were giving farmers advances on opium under a system called the “salaam,” charging them usurious annual rates, where farmers’ lose 58% of the value of their produce for an advance of 42%.<sup>71</sup>

### Salaam

Salaam is the advance sale of produce before planting season at negotiated rates. Salaam arrangement was traditionally used in the case of cereals such as wheat, and now has adapted to opium production. Opium traders approach farmers with advance cash for their future produce, and for cash-strapped farmers this is an easy source of credit. Repayment is in terms of the produce itself, and usually is significantly higher than the advance amount.



**Figure 5**  
Source: UNDCP, Afghanistan Strategic Study #3, The Role of Opium as a Source of Informal Credit, 1999, p. 9.

The terms of the salaam arrangement tend to improve closer to harvest, and also depending on the financial situation of the farmer. Typically the terms of salaam tend to offer between 50% and 80% of market prices at the time to farmers as a cash advance. Moreover since

<sup>71</sup> Bhuvana Anand and Mariela Martinez, (2003).

repayment is in output itself, farmers have no way of insuring against low opium prices and loss of potential profit. On the other hand, salaam terms are not very favourable to traders themselves because the salaam-giver bears a significant brunt of risk. Salaam arrangements also expect prompt repayment, but in case of a failed crop farmers typically have to pay back more output the following harvest. Narco-traders are not the only source of salaam, more often it is shopkeepers within the local bazaars who offer salaam in terms of fertilizers or pesticides in certain cases. In the last ten years, opium has emerged as the preferred crop of salaam agreements.<sup>72</sup> In fact in certain opium growing districts especially in Kandahar and Helmand provinces, opium is the only crop that you can obtain advances on today.<sup>73</sup> More over the terms of the contract seem to be more unfavourable for opium than wheat, with farmers losing a greater proportion of post-harvest returns. The figure shown below from the UNODC strategic study shows that farmers pay up to 517% as annual rate of interest on salaam arrangements on opium.<sup>74</sup>

<b>Table 1. Cost of salaam for opium in four districts* of Afghanistan</b>		
Average price at harvest time per kg	\$ 42.60	100%
Average advance price received per kg	\$ 17.90	42%
Cost per kg of opium	\$ 24.70	58%
Cost in % of advance price	138%	
Average length of loan	3.2 months	
<b>Interest rate on an annual basis</b>	<b>517%</b>	
Ghorak, Khakrez, Maiwand (Kandahar) and Shinwar (Nanqarhar).		
Source: UNDCP, Afghanistan, Strategic Study #4, The Role of Opium as a Source of Informal Credit, January 1999, p. 10.		

Salaam arrangements secure supply to traders, and drive the ‘ballooning effect,’ i.e. the spread of opium newer districts. Typically farmers’ with smaller landholdings are more likely to

<sup>72</sup> UNODC Farmers’ Intentions Survey 2003/2004 and UNODC Strategic Study on the Role of Opium as a Source of Informal Credit (1999).

<sup>73</sup> Based on interviews I carried out over 2 months with farmers in 6 villages of 2 districts (Daman, and Arghandab) in Kandahar as part of a pilot study on rural indebtedness for Afghans for Civil Society, Kandahar, Afghanistan, (June-August 2003).

<sup>74</sup> UNODC Strategic Study on the Role of Opium as a Source of Informal Credit (1999).

cultivate opium<sup>75</sup> and these are also farmers most likely to take salaam on future crops. Due to lack of sufficient assets, these farmers cannot obtain credit from other sources unless they cultivate opium.

Table 15: *Area of land under poppy cultivation in 2003 and intended change in poppy cultivation in 2004 (in jeribs)*

Poppy cultivation per farmer	Average poppy area per farmer in 2003	Average poppy area per farmer in 2004	Change
more than 10 jeribs	17	26	52%
> 5 to 10 jeribs	8	13	63%
5 jeribs or less	2	4	108%

#### *Anawat*

Another system used for agricultural arrangements is anawat, less popular than other arrangements, but a last recourse in dire situations. Anawat is the short-selling of commodities for cash loans. Under anawat, farmers buy commodities on from shopkeepers and traders at a significantly marked up price, and sell it immediately back to them at regular market prices. The difference is available to them as a cash loan. Opium as a fairly stable crop is a useful speculative commodity, but typically this arrangement is frowned upon due to the Shari'a rules against *gharar*.<sup>76</sup> Anawat is the middle ground for farmers can obtain cash advances without paying explicit interest, or *riba*. Anawat is especially useful when farmers speculate across regions with opium making use of regional price differences.

#### *Commodity credit*

The next most important credit arrangement is the delayed payment on commodities purchased at the local bazaar obtained from shopkeepers and traders. Since *riba* is forbidden

<sup>75</sup> This is also substantiated by the farmers' intentions survey where the largest intended changes were expressed by farmers with 10 jeribs of land or less.

<sup>76</sup> *Gharar* is speculation under Islamic law, and is forbidden. Transactions based on risk-less gain such as interest bearing loans, and those based on full risk such as short selling are completely forbidden under Islam.

under Islam, unlike the rest of South Asia there are relatively few “moneylenders” in Afghanistan. The frequency of taking cash loans directly from richer non-kinship sources at mark-up costs therefore is rarer. Instead farmers buy commodities from traders at higher prices, sometimes marked up to a 100% or on the promise of repayment in opium terms. In the commodity credit arrangement repayment is usually in cash terms, but based on the credit worthiness on the farmer often linked to his choice of crop.

Farmers’ usually purchase wheat, tea, sugar, and fertilisers during crop season. Rate of return on each of these commodities differs, based on the past relationships of farmers with the shopkeepers, existing debt,<sup>77</sup> tribal affiliations, and the amount of assets that farmer had. However, since collateral-based lending is also prohibited under Islam, farmers prefer to borrow against the promise of opium and shopkeepers trade inputs accordingly. The implicit mark-ups on inputs are higher than tea, sugar or wheat, and terms get better closer to harvest. The mark-up on fertilisers is perhaps the highest. Distinguished as white and black fertilisers, urea and DAP are purchased at between 40% and 60% of the current market price.<sup>78</sup> In Afghanistan, a common way of denoting payment rates is to calculate it as a “third part of value,” essentially meaning an additional 50% of purchase price.

Besides local shopkeepers, opium traders are an important source of rural credit in poppy provinces.

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<sup>77</sup> In Afghanistan, most people typically are part of close knit communities, where reputation has great importance. Information about individual community members is usually well-known among the rest of the community. Knowledge of existing debt levels of families therefore was fairly well-known especially in the bazaar and the council of the village. My interviews with village headmen for example incorporated this knowledge base in asking them the number of poppy versus non-poppy growing farmers in the village, and the extent of indebtedness in families.

<sup>78</sup> UNODC Strategic Study on the Role of Opium as a Source of Informal Credit (1999).

On average opium growing farmers were more likely to take loans, had a higher level of outstanding debt than non-opium growing farmers, and the standard repayment strategy was consideration to opium for the following season. UNODC studies point to an interesting trapping in opium cultivation, “cultivation of poppy facilitates access to credit, but cultivation of poppy also increases the likelihood of indebtedness.” This can be related with the ballooning effect that Afghanistan has been experiencing in the last two years, as opium spreads to newer provinces, for example the annual survey last year point out that the fifth largest opium growing province was Ghor, displacing Kandahar.<sup>79</sup> UNODC has also found that in village surveys, about 75% of loans in opium growing districts come from shopkeepers and traders in the bazaar, and a large part of the remaining from external sources and kinship groups. Typically the percentage of people not obtaining credit from external sources is smaller in opium-growing districts than in non-opium growing ones.<sup>80</sup> In urban areas, the survey pointed out, people had to rely more on family sources than in rural opium growing districts, all confirming the link between credit-worth and opium, and ultimately the choice farmers make.<sup>81</sup>

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<sup>79</sup> UNODC Opium Survey 2003.

<sup>80</sup> UNODC Opium Survey 2003.

<sup>81</sup> UNODC Strategic Study on the Role of Opium as a Source of Informal Credit (1999).

### CHAPTER III: OPIUM SUBSTITUTION STRATEGIES

#### *Overview*

The ITSA has outlined a target of eliminating 70% of illicit opium cultivation by the Islamic year 1386 (2007 in the Gregorian calendar), and complete elimination by 1391 (2012).<sup>82</sup> Both targets are unrealistically ambitious, given the central government's lack of control over the hinterland, and lack of experience in executing a detailed drug elimination strategy. In countries like Thailand where the government has managed to almost eliminate illicit cultivation, it took up to 40 years of programs to see viable results. Moreover, in Thailand, the government was able to execute law enforcement measures, and the economy had the absorptive capacity to include the workforce exiting illicit cultivation. In Afghanistan, non-farm opportunities are scarce, and stability and law enforcement capability are suspect. The crop elimination strategy of the government has included a broad array of strategies to combat poppy cultivation. The National Drug Control Strategy has designed twelve national public investment programs, three of which focus on law enforcement.<sup>83</sup> The strategy is executed mostly by the Counter-narcotics directorate, UNODC and allied NGOs. The UNODC has executed two big programs since the 1980's to eradicate poppy cultivation – the Afghanistan Drug Control and Rural Rehabilitation Program (ADCRRP, 1989-1996) and the Opium Poppy Reduction Project (OPRP 1997-2000). Both programs had very limited success and led to questions about the assumptions that poppy-reduction strategies were based on. Most strategies focused on the high prices opium fetched relative to other crops. Opium producers were viewed as a homogenous group and programs adopted a standard “carrot-stick” approach. There is however a theoretical shift from this approach and attempts are being made to

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<sup>82</sup> National Drug Control Strategy

<sup>83</sup> National security, justice and public administration.

devise integrated programs based on extensive research on the multi-functional role opium plays in the lives of the rural community.<sup>84</sup>

Substitution strategies have three major components:

(i) *Forced eradication*

In Afghanistan, the ATA declared opium as a banned crop soon after coming into office. Along with the UNODC, and foreign military assistance, it undertook an ambitious elimination program. The eradication program included aerial fumigation, and manual eradication. However, these programs force the government to risk internal stability and loyalty to the Karzai government against local commanders.<sup>85</sup> In the season of 2002-2003, Afghan authorities reported forced eradication of 21,430 hectares of opium fields, about 20% of cultivated poppy land.<sup>86</sup> The initial efforts were met with armed resistance in certain provinces, and farmers have not been assuaged by the meagre compensation amounts of \$500 per eradicated acre.<sup>87</sup> Forced eradication of illicit crops has sparked enormous resistance among cultivators in other illicit drug producing countries. Experience in Bolivia, Peru, and Thailand have linked forced crop eradication to human rights abuses, and migration of cultivating groups to other areas.<sup>88</sup> Forbidding production and forceful eradication add a premium on prices and push incentives in a direction opposite to what is desired. Besides, the worst affected are small farmers and landless cultivators. As opium harvests

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<sup>84</sup> The UNODC has commissioned several strategic studies like the role of opium in obtaining credit, the coping strategies of traders, and the role of women in the poppy extraction process. These studies are based on pilot surveys, and provide a detailed understanding of different socio-economic groups involved in opium trade.

<sup>85</sup> Since the Karzai government is straddling the fine balance between assuaging provincial warlords and asserting central government authority, it is both difficult as well as undesirable for Afghan central government authorities to upset the bases of the regional commanders (for example in Helmand, Kandahar, Nangarhar, Badakhshan etc.) by undertaking extensive eradication programs.

<sup>86</sup> UNODC Opium Survey 2003.

<sup>87</sup> "Afghan Eradication Program Sparks Armed Resistance, Protests—Farmers Blame America," *Drug War Chronicle*, the Drug Reform Coordination Network (DRCNet), Washington DC, (December 4, 2002). <http://stopthedrugwar.org/chronicle/232/afghanfarmers.shtml>

<sup>88</sup> Sara Weinstein, "Alternatives to Coca in Bolivia: Making it work," MALD thesis, Fletcher School of Law and Diplomacy, (April 2002).

are fumigated, farmers find themselves saddled with debts from the previous years, and with no alternative source of income. For the next harvest, they return to opium, because the debt collectors are at their door, and taking the short term risk is their only option. In certain areas, farmers also use this as a strategy to get compensated, by planting opium poppy in areas close to the road in sight of monitoring authorities. For some farming communities this is the only way to get included in aid programs, especially integrated rural development projects. However, in the long term, the forced eradication effort is not sustainable, and if pursued more intensively, it could raise a serious legitimacy crisis for the Afghan central government.

(ii) *Contractual eradication*

The first instance of voluntary contractual eradication was pursued under the ADCRRP. Inserted as the poppy clause, this program required communities to voluntarily cease opium cultivation, in return for development assistance. The OPRP, shifted its stance only slightly, introducing “conditional development,” whereby the community undertook a targeted reduction of opium acreage in return for assistance.<sup>89</sup> The programs failed on two counts: first, they were not able to offer long term incentives to shift away from poppy, and second, they encouraged reverse conditionality, whereby the community started demanding more aid as a condition to reducing opium production. The latter has become an especially difficult problem given the resource constraints facing the Afghan government and the donor community. It also encourages aid dependence, and like the previous approach is not sustainable in the long run.

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<sup>89</sup> David Mansfield, 1999.

(iii) *Alternative development*

Voluntary reduction is usually undertaken in conjunction with an alternative development strategy, most of which focus on developing generic rural development projects. In the case of illicit crops, an important component of this approach is developing substitute crops which farmers could switch cultivation to with relative ease, and less loss of income. Alternative development programs developed in response to agitations against the forced eradication programs, especially in Latin America.<sup>90</sup> Today, with the realisation that elimination of the crop and introducing alternatives is necessary but not sufficient to reduce drug supply, international agencies like the UNODC have made alternative crop development an integral part of their strategies. “Alternative development supports communities to adopt alternative and legal livelihoods that are long lasting.”<sup>91</sup> However, much of the strategy remains mired in rhetoric, without a clear micro-level understanding of household decision making processes relating to opium poppy. Programs put forward a one-size-fits-all package which inevitably benefits larger farmers, not those who remain dependent on opium for food security, land and credit access.<sup>92</sup> Moreover, programs focus attention on areas cultivating the crop, sidelining the movement of labour into other areas for purpose of poppy cultivation. Thus any reductions in target districts are off-set by increases in outside areas prompted by population movements.

Timing, targeting, and structuring have all been weak in the case of alternative development programs aimed at illicit crop substitution in Afghanistan. A broader framework,

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<sup>90</sup> Arganaras

<sup>91</sup> “Poverty, crime and development: Can alternative development bridge the gap?” Issues paper for ECOSOC Ministerial Roundtable, hosted by UNODC, (July 2003).

<sup>92</sup> David Mansfield, 1999. ‘This has had an impact on the achievement of both drug control objectives, due to the relocation of more marginal drug crop producers to neighbouring areas, and the broader development goals, such as equity.’

with attention to the impacts of different program components taken as a whole not just individually is required. Program components such as off-farm income generation, credit facilities, and extension services must be evaluated for their impact on each other, as well as on the broader problem. Most importantly, it is important that an institutional framework be created including the opium problem under the broader mandate of governance.

### *Program components*

A comprehensive alternative development strategy must take into account different factors influencing cultivation preferences, and develop components to target each of these sections. In the case of opium substitution in Afghanistan, primary factors influencing farmers' choices include access to land and credit, labour availability within the households, and technical advantages of opium over other crops. A well-integrated strategy will include:

1. Alternative crop development
2. Generation of credit facilities
3. Household labour absorption
4. Extension services, transport, and training

The alternative crop development component must be able to provide crops that can match the weight-volume-value advantage and the long shelf-life of opium. In addition to devising an alternative crop, arrangements for processing, marketing, and transport must be taken into account. The crop must also be adaptable to the institutional structure surround agriculture, with respect to land tenure and credit arrangements. Moreover, it must not make villains of people

engaged in the opium trade, considering the difficult context of survival in Afghanistan.<sup>93</sup>

Afghanistan has experience in exporting dried fruits, and has an extensive tradition in floriculture, especially cultivation of rose flowers. However, crop development must be closely linked to infrastructure development like building of roads for market access.

In a recent study on drug control through rural development, the UNODC outlined preconditions for the success of alternative development projects. Accordingly, effective central government presence, “enabling sustainable economic environment,” and “disincentives through law enforcement and eradication” are cited as prerequisites,<sup>94</sup> reiterating the focus on law enforcement over other program components. The UNODC admits that the government and aid agencies are focussing on the elimination component without developing the capability to support rural poppy-households with alternative sources of income, financing and livelihoods.<sup>95</sup> Even internationally, the percentage of area under alternative development programs in source countries is a very small part of total investment.<sup>96</sup> In recent programs outlined for Afghanistan, UNODC has found it difficult to find committed funding from donors for key program components such as a pilot project in Kandahar and Badakshan provinces to support farmers who formerly grew opium

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<sup>93</sup> UNODC typically views opium traders as enemies of the cause. This is a problematic perception, since not all traders are mega-traffickers. Some of them are even small farmers engaged in speculative gains from opium. The UNODC overview of the opium problem outlines its approach: “Finally, there is also a need to change the image of opium traders. They cannot be perceived any longer as local heroes who supply their villages with income, but as criminals who cause misery to many people across the world and prevent the village from securing rehabilitation and development assistance.” From my conversation with farmers in Kandahar province as well as other NGOs, opium traders are a broad group of people from the regional commanders to share-croppers. This is the fundamental gap in the UNODC thinking, clouding its strategic approach with its normative perspective on the drug issue.

<sup>94</sup> “Alternative Development –Drug Control through Rural Development,” UNODC article prepared for the ACC Network on Rural Development and Food Security, (September 1998). (UNODC 1998a)

<sup>95</sup> Progress report on the implementation of the strategy on drugs and crime in Afghanistan, UNODCCP, (October 2002). “While first eradication measures have been taken by the Afghan Administration in 2002, aid agencies have not yet developed a full range of suitable interventions to sustain the non-cultivation of opium poppy in future.”

<sup>96</sup> *Ibid.*

poppy with alternative sources of cash income, and a “quick impact project” to provide alternative income to opium growing communities in Nangarhar province.<sup>97</sup>

The success of alternative development strategy depends on its ability to develop a sustainable rural economy. In Afghanistan, this is integrally related to agricultural development, infrastructure development, and provision of off-farm income opportunities.<sup>98</sup> Community participation through the creation of rural cooperatives can be an important component of such an integrated program. Cooperatives can be responsible for credit disbursement, voluntary reduction of poppy acreage, identification of community specific needs, disbursement of block grants outlined by the national drug control strategy, land tenure arrangements, execution of infrastructure projects to absorb household labour, and establishment of marketing and extension services with technical assistance from aid agencies.

The next section of the paper focuses on the provision of alternative credit facilities to small farmers as one of the most important components in the overall program. As discussed earlier, farmers’ choices are influenced to a large degree by the ability to procure credit using opium as a tool of increasing their credit-worth. Similar in depth understanding of each of the other factors especially the issue of household labour must be addressed through component schemes.

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<sup>97</sup> Progress report on the implementation of the strategy on drugs and crime in Afghanistan, UNODCCP, (October 2002), “For example in Peru, the country with the largest coca growing areas, approximately 10% of the area under cultivation is covered by UNDCP supported Alternative Development projects.”

<sup>98</sup> (UNODC 1998a)

## CHAPTER IV: ROLE OF AGRICULTURAL FINANCE IN OPIUM SUBSTITUTION

The previous two sections attempt to outline the problem that opium substitution poses for Afghanistan especially on its long-term stability and economic growth. The opium credit section also explains the importance of linking opium as a crop choice with credit availability as a key component of the decision matrix. This section provides program choices that are available to the aid community to pursue as part of the opium substitution strategy as linked with agricultural development. Agricultural financing is crucial to recovering commercial agriculture and to diverting production to licit alternatives. Rural demand for credit in Afghanistan can be spilt into three components:

- (i) on season credit;
- (ii) emergency non-productive credit during the off season; and
- (iii) enterprise development facilities for non-farm households.

Bringing about a rejuvenation of agriculture involves increase income and productivity in the sector itself, and financial services are a major component of such efforts. The ADB needs assessment report cites lack of agricultural credit as a key issue, and has one of its short term programs a review of the financial sector and development of a framework for community and asset based lending. The long term component of the ADB's approach is to develop "functioning commercial bank and non-bank financial institutions lending to agriculture."<sup>99</sup>

The failure of directed credit schemes in most developing countries also has reduced the enthusiasm among the aid community to experiment with agri-fin programs. However, it might be well-worthwhile to experiment in rural microfinance in the Afghan context, using a mixed model,

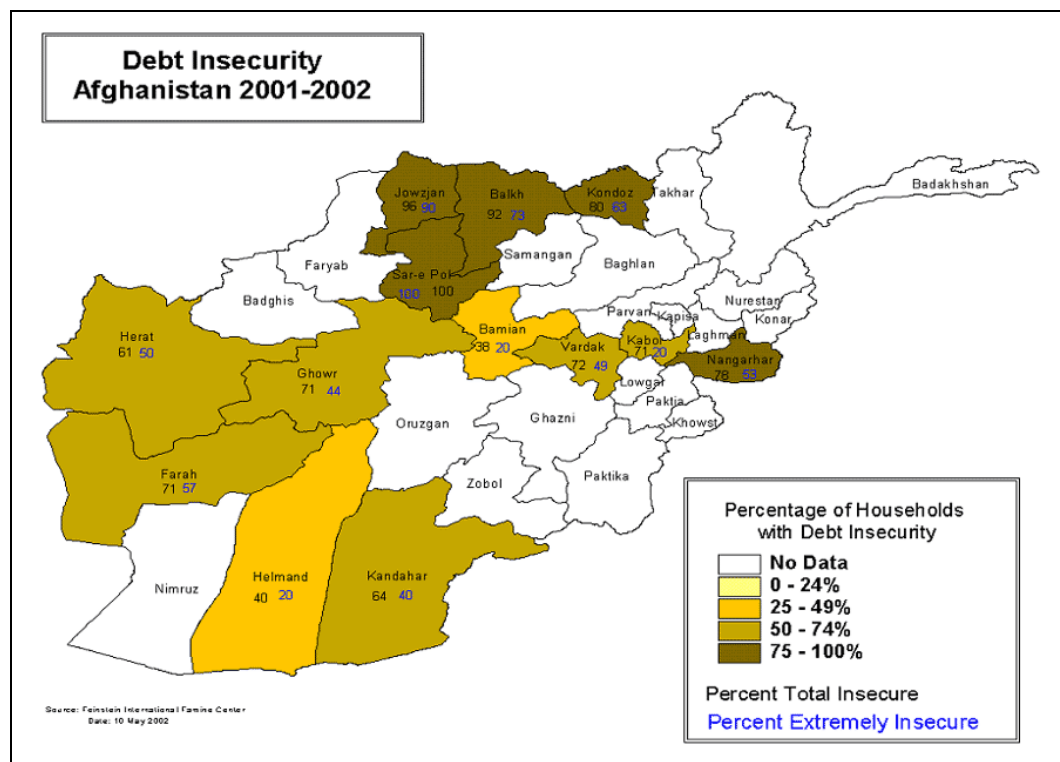
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<sup>99</sup> "Afghanistan: Natural Resources and Agriculture Sector Comprehensive Needs Assessment Final Draft report," Mission led by the Asian Development Bank, (July 2002).

one that works on the principle of sustainable banking and treats the rural poor as clients not just for credit facilities but for a host of other services, especially savings deposits.

Much of the need for agricultural financing can be explained by pointing to the distortion in credit markets caused by the opium trade. In areas conducive to opium production, cultivation of other crops is very difficult unless you are a large landowner with significant resources at your disposal. FIFC mapped the debt insecurity of the country as a whole; a glance at the map underlines the need for rural financing.

Source: Feinstein Famine Centre, Tufts University, May 10, 2002



One of the priority areas for the government and international agencies is therefore is to establish a financial infrastructure that will encourage savings, and fill the credit gap. As CGAP observes, “While increased earnings are by no means automatic, clients have overwhelmingly

demonstrated that reliable sources of credit provide a fundamental basis for planning and expanding business activities.”<sup>100</sup>

Given the lack of a financial superstructure, decentralized programs following micro-lending setups are likely to work better in the Afghan setting. With microfinance, an array of choice is available, from the subsidized credit of the Grameen model, to the sustainable banking approach. MFI's can provide loans at competitive rates of interest, and can also mobilize savings and provide insurance in areas where there may be demand. Among the donor community there is enormous interest in the microfinance investment potential of Afghanistan. Donors are now developing a willingness to apply market-based methods to disbursing aid to post-conflict societies using minimum government involvement through independent micro-lending programs administered by field-based non-governmental organizations and financial service providers. A carefully tailored program, initially undertaken as a pilot in select regions could serve as an important learning step in setting up full-scale rural financial services.

While there is interest in the microfinance investment potential of Afghanistan, donors are reluctant to invest resources into the risky arena of rural finance. Before the Soviet incursion, the Agriculture Development Bank provided rural finance, but given the geographical distance and the inaccessibility of areas outside of Kabul, such programs did not have a wide reach.<sup>101</sup> The focus even then was provision of in-kind assistance for both farm and non-farm needs of the rural community. In addition the Bank attempted to provide technical assistance and training to farmers in conjunction with NGOs and cooperatives. The key feature though was that the Bank's lending was based on collateral or asset backing, which is considered fundamentally unIslamic.

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<sup>100</sup> Consultative Group to Assist the Poorest (CGAP): <http://www.cgap.org>

<sup>101</sup> Technical Annex 3 for “Prospects for Afghan Agriculture,” Prepared by Mohiuddin Alamgir, Asian Development Bank, 2001.

Traditionally the finance sector in Afghanistan has used innovative methods to circumvent the Shari'a prohibition of riba, or usury.

Financial intermediation through microfinance providers will serve two purposes: increasing agricultural productivity and allowing incentives for diversification from opium production. The first step is perhaps financial deepening, i.e. establishing services that cater to all sections of the rural population including farm and non-farm households. Financial deepening will have to be followed by financial widening, or increasing the range of services from credit and savings opportunities to possibilities like crop insurance.

#### *Agricultural Finance Component of Alternative development programs*

The agricultural financing and credit component has not been given enough space in the action plan of the ATA as well as the UNODC. UNODC in general has paid limited attention to providing alternative sources of financing to Afghans. In the past in programs implemented in other source countries, credit facilities were included in the broad plans, but not executed either due to lack of sufficient funding or insufficient research. For example in the Dir District Development Project (DDDP) in Pakistan, the credit component was completely ignored, and no provisions made to provide off-farm opportunities to absorb idle household labour.<sup>102</sup> Similarly, in the case of the OPRP, a major component of which was the Opium Crop Substitution Project, no credit facilities to provide bridge funds were made available to farmers, pushing them back to borrowing from shopkeepers and opium traders on the basis of promises to cultivate opium.

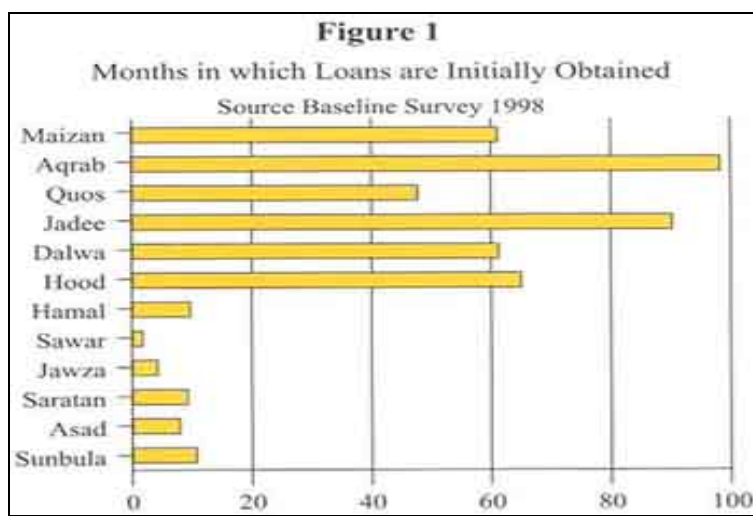
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<sup>102</sup> Mansfield 2001b footnotes: "DFID, Aide Memoire: Fact Finding Mission- Sustainable Livelihoods Programme, Dir District, NWFP Pakistan, November 2000. Unpublished Paper. Also see Rita Gebert, An Assessment of Social Impact and Community Development, October 2000, p. 5; and Peter Sloane, Project Impact Socio-Economic Survey Report - Impact Assessment of Project C28- Alternative Development Pilot Project, November 2000, p.17"

Providing agricultural microfinance in the Afghan context for opium substitution poses two challenges: the inherent unstable nature of a post-conflict environment, as well as the risk associated with the agricultural sector. With lending to poppy-farmers, an additional set of factors needs to be included in the decision-making process like availability of income generation schemes, the ability to introduce alternative crops and livelihood strategies, as well as the socio-economic mix of target areas.

### Bridge funding

The most important element of providing agricultural microfinance to opium producers is the concept of bridge funding, and the importance of timing interventions correctly. The section on credit outlined the times of most credit paucity during the year. Traditionally the winter months are a time of food scarcity, and household resources are severely constrained since preparations must be made for the next planting season. The main draw of opium-based credit arrangements is that they allow farmers to draw the possibility of bridge funds from lenders, either in the form of cash through salaam, or in kind from shopkeepers. The figure below outlines the months in which most loans are taken in a year.



Source: UNODC baseline Survey for the Study on Role of Opium as a Source of Informal Credit, 1998.

The period beginning Maizan (mid-September) upto Hood (mid- February are a period of credit paucity, the maximum intensity of which is felt mid-November and mid-January. Any credit facility being established must take into account the credit-needs calendar in establishing the structure and execution of its credit program.

Bridge funding also involves assimilating an understanding of livelihoods adopted by different socio-economic groups. This relates closely to the credit needs of individual farming families. The lack of such understanding will lead to program failures, as in the case of OPRP and previous programs.

### **Constraints**

First and foremost, the most severe constraint in developing viable micro-lending programs to cater to Afghan farmers is the lack of rule of law, infrastructure and security. However, this threat can be overcome by co-opting regional and district level governance structures such as the shuras. Eliminating this risk involves selecting the appropriate institutional structure and level of operations. Moreover, in the short term, only pilot projects can be undertaken in order to build a careful catalogue of practices that can then in the medium term be duplicated more extensively. The absence of rule of law in Afghanistan, and its peculiar fragmented culture may prove very challenging to administer financial services effectively. However, as the handbook points out, “strong and innovative microfinance providers are able to operate even in extremely challenging circumstances. These providers uphold two prerequisites of successful microcredit: discipline—both

for clients (timely repayment) and institutions (business practices that lead to sustainability); and no subsidization of interest rates.”<sup>103</sup>

Secondly, rural microfinance is fraught with risk and high transaction costs due to the dispersed nature of the rural population. MFI's operating in the area of rural and agricultural microfinance have to take into account several factors like seasonality, diverse and spread out needs, longer borrowing periods, lack of assets to offer as collateral etc. Lending instruments and design choices have to be modified to fit the needs of individual farmers, as well as minimizing costs to FSP's.

Third, but perhaps the easiest to deal with, is the marrying of conventional understanding of microfinance instruments with the strictures of Islamic law. In designing and delivering credit assistance, three key Islamic principles must be followed:

- a. No *riba* – Islam is fundamentally opposed to the idea of riskless gain. Earning income through money is considered haram, and is strictly prohibited. Therefore whatever instruments are designed must adapt the principles of earning interest through contractual fees, or mark-ups.
- b. No *gharar* – Islam is also opposed to the idea of speculative gain, or gain from full risk. Therefore any investments that the MFI undertakes to sustain its operations other than the activities within the target group must refrain from speculative investment.
- c. Equity, fairness, and justice – Islam law seeks to create an equitable society, and its financial instruments are designed to avoid usury. Instead they rely on equity participation and profit sharing.

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<sup>103</sup> Joanna Ledgerwood, "Sustainable Banking with the Poor" in Microfinance handbook: An institutional and financial perspective. IBRD/The World Bank, Washington D.C. (1998).

Keeping in mind these constraints, MFI's can proceed to choose appropriate models and designs to reach out to opium farmers.

### ***Recommendations***

Microfinance experts distinguish design choices based on financing tools, client groups, and specific markets being reached. Poverty levels of client groups play a significant role in directing the scope of the program initiated, as do gender, geographic location and occupation of clients, level of infrastructure in region of operation, competing programs by other groups in the region, economic and political stability, and legislations regarding provision of financial services.

### ***Model and institutional set-up***

In the case of Afghanistan emphasis must be placed on the history, and Islamic traditions as well as cultural fragmentation of society while designing programs. A clear assessment of community and asset based lending, sources of financing and methods to attract commercial funds are essential. In designing the financing component of alternative development programs, FSP's can create rural cooperatives as the key unit of administering the program. The cooperative can be instrumental in all aspects of the development program including research, training, and execution. Cooperatives also have a significant benefit in incorporating different segments of the society including women, and other vulnerable groups. Cooperatives that work in conjunction with the shura administration can overlook self-help groups, revolving chit-fund schemes, individual banking projects, as well as group lending mechanisms. In the Afghan scenario, NGOs and aid agencies are the vital link to starting up such cooperatives and involving both district

administration as well as other specialised groups. NGOs enhance the participatory process, and have a key role to play in monitoring and training programs.<sup>104</sup>

#### *Unit of operations*

The district is the ideal unit of functioning in rural Afghanistan. District shura representatives are generally enthused by new investment, and are willing to provide logistical assistance and mobilize support of the villagers. The district shura can also be tapped into for information regarding specific mix of village, extent and depth of poverty, occupational structure, and lending-borrowing information. Shura members are also typically elders of their villages and are able to provide information about the credit worth of most villagers, dispute-settling practices, and specific needs of the village in question. The shura can also be used as a forum to train villagers on banking practices and stress on the importance of savings. The shura is also an important forum for application and screening procedures. While trained staff from the organization itself is necessary, local residents can also be co-opted as staff over a period of time.

Several other factors must be simultaneously worked on:

- a. Credit culture and discipline can be fostered through client education<sup>105</sup>
- b. Lending risk must be analyzed on an individual basis so that the organization can better evaluate its portfolio and increase its chances on getting returns.
- c. Computerized operations
- d. Detailed asset and risk management tools must be developed over a period of time

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<sup>104</sup> ADB needs assessment paper, 2002.

<sup>105</sup> GTZ - <http://www.gtz.de/fsd/Business-Fields/RaAF.htm>

Given the fragmented and dispersed nature of households and the difficult terrain, infrastructure investment in building rural branches of operation will significantly increase program costs. Instead the approach might be to have a central branch at the district shura with mobile units, which visit villages between fixed intervals. The district shura is an ideal venue for the bank branch because it tends to be secure, as well as already has a building and compound. The visiting intervals also can be scheduled around farming seasons, especially in the couple of months before planting the winter crop, and the planting season for lending operations, and just after the harvest for scheduling repayment collections. Visits can also be scheduled during village shura meetings, which typically take place once in two weeks.

#### *Interest, and repayment structures*

The most complicated program factor for MFI's in Afghanistan however is determining an appropriate rate of interest on the products it will offer. Since there are no formal lenders in the Afghan financial markets, basing program fees on market interest will involve an analysis of rates charged by informal lenders. Product design will also involve a significant understanding of Islamic financial principles and acceptable instruments. Informal surveys indicate that depending on crop mix, and location, the rates of interest vary between 25% and 200%. Therefore cost of credit is not likely to be a constraint on demand. Detailed determination of the ROI will involve risk analysis of individual borrowers, agro-climatic information, and willingness to pay.

Best practices in micro-finance point to innovation as crucial to successful operations. One such innovation has been in the field of collateral. Collateral acts as a useful guarantee against default, and in the case of group liability, joint collateral is an effective tool to ensure prompt

repayment. Field workers however, point to lack of assets as a major constraint in obtaining credit. Afghan farmers share this trait, often having to mortgage land under the *garvi* (mortgage) system at adverse rates from usurious *sootkhors*. The FSP therefore must develop loan collateral substitutes, like inventory credit, and leasing contracts. Given the lack of access to external markets, Afghan farmers typically have inventory from past harvests, especially opium. If supervised efficiently, this could be used to drain household savings of opium and drain them into pharmaceutical companies in India or Pakistan. This is a very controversial recommendation, since the aid community does not want to be seen as a marketing network for illicit opium. However, if supervised through the co-operatives and the shura this could become an interesting short term strategy.

In the Afghan context, given the high level of distrust and fragmentation, assigning loans to groups collectively could significantly increase the risk associated with such loans. Group lending has several advantages like peer borrower screening, and availability of insider information.<sup>106</sup> However, individual lending allows us to circumvent the shortcomings of group lending where marginalized sections in the village, especially landless labourers and opium sharecroppers that may not be able to partake in group action. Lending to individual farmers allows us much more flexibility and is more likely to reduce our portfolio risk. It is also easier to evaluate risks for individual borrowers than that for groups of borrowers. However, it is possible that the poorest and the smallest farmers will still not be able to be part of the program. Individual banking does not give smallest farmers to pool their resources together and avail of loans. This must be considered an inevitable drawback of the program. Training exercises and providing

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<sup>106</sup> Brigitte Klien, et al, *Better Practices in Agricultural Lending*. Food and Agriculture Organization of the United Nations (FAO), (December 1999).

technical assistance to groups of severely marginalized farmers to form savings and self-help groups can be a useful way to inculcate a banking culture while minimizing risk.

Lending to the group as a whole is likely to be successful if the groups' composition and interests are homogenous. In the case of poppy growing districts this will involve dividing target villages into groups based on land ownership, occupation, as well as availability of household labour. Past debt levels are also an important component of the decision matrix. That being said, as sustainability of operations is established, the FSP can extend its loan products to include group lending. This can be an appropriate choice for lending for capital investment like farm equipment like tractors and threshels, or micro-enterprise like a marketing agency.

Organizing groups on the basis of liability rather than loans, gives us a cost and efficiency advantage, while retaining the benefits of individual lending. Groups act as loan monitors as well as enforcement officers increasing the efficiency of the program without comparable costs. Joint liability from the borrowers' perspective ensures greater discipline since the borrowers' risks are increased to include both individual repayment risk, as well as the risk assumed on behalf of the group as a whole. Since all borrowers are expected to repay at the same time, and instalments are regularized, it also makes administration easier. In the initial period of operations this is a desirable feature to cut costs. Studies have pointed to the emergence of "negative solidarity" in the case of group liability where the group<sup>107</sup> However the validity of that concern would depend on the cohesion level and homogeneity of the group, as well as the ability of the shura to extend a reasonable amount of control on village residents.

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<sup>107</sup> Brigitte Klien, et al. (December 1999).

On the administrative side, field staff must periodically monitor repayment progress especially as due dates draw closer. If a possibility of default is evident, the reasons must be examined, and repayments can be rescheduled based on the validity of the claims. Based on the repayment performance of clients, the FSP could allow them to graduate onto larger loan sizes, and individual liability schemes.

#### *Product choices*

FSP's operating in non-constrained environments have developed a wide range of financial services for rural clients ranging from the standard savings deposits, and credit, to crop insurance, technical assistance, evaluating of business practices etc. Since our operations are targeted to an environment with minimal banking experience and to a select group of clients primarily with the aim of providing bridge funding, it is advisable to approach clients with a few standardized products that are Shari'a compliant, and then diversify as sustainability is established.

#### Credit Instruments:

The choice of credit instruments depends heavily on the cash flow information of households.<sup>108</sup> The figure of the monthly distribution of loans in poppy growing districts provides a fair substitutable indication of the cash flow of households, indicating that their demand for credit is likely to be highest in the latter part of the year. Demand for agricultural credit centers around demand for on-season working capital, and demand to purchase fixed assets like tractors, the constraint however is that farmers do not have sufficient assets to offer as collateral.<sup>109</sup>

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<sup>108</sup> Brigitte Klien, et al. (December 1999)

<sup>109</sup> Joanna Ledgerwood, (1998).

Providing working capital for the agriculture is fraught with irregularity and risk. Given that Afghanistan is prone to drought, the risk factor gets compounded. The extent of risk however gets reduced in an environment where farmers are well trained and have better management skills. Hence, it is important that the financial service provider pay adequate attention to liaising with NGO's working in the area that might be willing to oversee training programs. This must be considered a long-term investment, following which the FSP is more likely to achieve sustainability. Providing working capital while minimizing risk is more achievable when the FSP has a deeper reach into the community. Working with the shura gives the FSP this reach, and allows them to have closer contact with borrowers. Lending periods will typically be between three and six months for farmers, and shorter time frames for non-farm borrowers.

For the long-term capital needs of opium farmers, two instruments could be considered. One is the use of lease-based financial agreements. Currently, Afghan farmers tend to buy equipment from traders and informal lenders on credit at interest rates varying between 33% and 50% with strict forfeiture clauses. This is one of the acceptable instruments in Islamic financial practices worldwide. Also called *ijaara*, under this instrument, the FSP could purchase equipment and offer them on lease, with the option that farmers who are able to put up costs over a period can buy the equipment, at an interest rate that is profitable to the bank, and reasonable to farmers. Secondly, the FSP could limit loans for fixed assets only to groups, especially those that over previous dealings have been prompt in repayment and have exhibited a fair degree of cohesion. For capital lending, the FSP must also limit its contribution to part of the costs to be incurred, and encourage equity participation by the farmer. All these instruments serve to reduce the risk of long-term lending. Ijaara instruments can also be modified to include a purchase clause, similar to a

mortgage, called Ijaara wa-qtina. The repayment of original loan amounts goes to into buying the leased product, such as a tractor or a threshel. FSP's can also try to copy the commodity credit instrument used by traders in local bazaars, also called as *Bay' Mu'ajjal* (credit sale), with allowance for a delayed payment with a certain percentage of mark-up. *Bay' Mu'ajjal* can be offered on commodities such as petrol required in running the tractors, and threshels, fertilisers, and seeds.

In the short term, the most appropriate credit instruments are perhaps cash loans. As the cooperative and the shura together adjust to provision of financial services, they can also include provision of salaam on alternative crops developed. This however will remain a medium term enterprise, contingent on the development of an adequate substitute product.

#### Savings instruments:

While it is possible to finance working capital as well as long term capital requirements through the FSP, in the interest of sustainability, it is important to augment savings capacity, so that farmers can finance their future needs from their own reserves. Augmenting savings before starting credit facilities might also be one way of convincing farmers that unless they save, credit cannot be financed. An important constraint in designing savings deposits schemes is that these cannot be interest bearing deposits. Therefore, revolving savings into credit instruments such as leases could earn a mark-up for depositors. These are not meant to be sophisticated instruments but elementary products to provide a start-up facility. As the rule of law and safeguard of contracts is enhanced, more nuanced products marrying an understanding of Shari'a principles with western banking instruments can be introduced into the Afghan environment.

Savings could be augmented through self-help groups, which are useful as a training exercise. Villagers would be sceptical about handing their savings to unfamiliar organizations. Therefore it is essential that the FSP again operate along with a known NGO, preferably a UN agency. Mandatory savings have been pushed for by most MFI's; however, few give as much importance to voluntary savings. Since there are no restrictions on deposit taking services in the Afghan context, it would be easier to mobilize voluntary savings and set up savings deposits. The most important vehicle for mobilising savings and lending together is the revolving funds method, where the community pools in resources and the funds are circulated for short periods among different members of the group.

Over the long term, savings deposits can be an important tool of bridge funding, keeping in tact the traditional manner of borrowing and lending within the qawm. Since the project should have other components such as providing for off-farm income, in the off-season, household labour can be used in rural projects commissioned with help from the cooperative and the shura, and use the earnings from this period can be invested safely with the FSP.

The FSP could arrange money-collectors to make rounds every so often and have the money deposited with a trusted village elder. The money collector would have to be a trusted village elder, someone who is respected by all factions within the village. Shura representatives could act as loan officials, since they tend to be established village elders, who have significant investments in the village. They also have to maintain a degree of respect in the eyes of other members. Such peer group pressure ensures that fraud is minimized. However, one must be careful that shura representatives do not coerce villagers to co-opt into the scheme. This could damage the image of the FSP in the eyes of the village residents, and reduce the level of trust.

## Conclusion

Administratively, the FSP must ensure sufficient decentralization in its decision making procedures, so that field officers can take discretionary actions in the case of emergencies. At the same time a system of computerized reporting, and management information systems must be installed to ensure checks and balances. It is also essential to recognize that independent operations will multiply the risks. Instead FSP's will have to work in cooperation with NGO's and district administration in implementing its program.

Extensive use of micro-credit can harm the nascent microfinance sector, and an overemphasis on this one service against others must be avoided where possible. There is also a general tendency to use microcredit programs to generate social change by attaching social obligations to programs. This may not be such a good idea in the Afghan context, serving to alienate potential clients. In the short term it might be better to limit objectives and focus on provision of financial services in poppy growing regions primarily for agricultural development and opium substitution.

MFI's and FSP's must ensure that they build up a network with other similar institutions to create a financial structure that can take advantage of economies of scale and ensure spread of best practices. The Agriculture Bank of Afghanistan was a pioneer institution During the Daoud Khan regime, providing a host of financial and technical services to Afghan farmers. Efforts to link the network of FSP's to the Bank will ensure continuity as well as opportunities for expansion. Over the long term, this network also brings in a wide variety of funding sources that can be tapped into for widening the portfolio of services offered as well as expanding scale of operations. Institutions must recognize that while most rural residents are farm employed, there is potential

for non-farm enterprise as well. Lending to support such activities could be one way of reducing the risk of agricultural lending by diversifying client base.

## CONCLUSION

To conclude, opium presents a very unwieldy challenge to the Afghan government as well as international organisations. The long term stability of the country and the ability to build a sustainable economy is dependent on the development of a coherent strategy that incorporates the various nuances of the opium problem, including the politics and the micro-economic motivations of households.

The tendency has been to focus on the role of the government and UNODC as law enforcement agencies attempting to control both demand for opium and opium based products as well as supply. However, UNODC and the government must attempt to integrate other players into the framework of alternative development, especially those who are involved in creating a coherent integrated agricultural development strategy.

The most significant point of focus in approaching the opium problem is understanding and responding to the multi-functional role that opium plays in reducing vulnerability of rural households. A role in this respect is the access to credit that opium promises. Crucial to the success of an alternative development strategy is to include a well-designed microfinance provision facility. This includes an understanding of Islamic products and principles, as well as the individual components of the program and their impact on various socio-economic groups. This paper has attempted to provide a cursory understanding of what it will take to replace narco-usurers with micro-lenders, and the benefits that such programs can bring.

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