AFGHANISTAN AND CENTRAL ASIA: Strengthening Trade and Economic Ties
# TABLE OF CONTENTS

1. **EXECUTIVE SUMMARY** ......................................................................................................................................................... 3

2. **INTRODUCTION: TRADE AND REGIONAL INTEGRATION AS DRIVERS OF AFGHANISTAN’S DEVELOPMENT** ................................................................................................................. 18

3. **AFGHANISTAN: ECONOMIC OVERVIEW AND CHALLENGES** ........................................................................................................... Error! Bookmark not defined.
   - Afghanistan’s economic outlook ........................................................................................................................................... Error! Bookmark not defined.
   - Afghanistan’s trade performance ........................................................................................................................................... Error! Bookmark not defined.
   - Foreign Direct Investment .................................................................................................................................................... Error! Bookmark not defined.

4. **TRADE AND INVESTMENT FLOWS BETWEEN AFGHANISTAN AND CENTRAL ASIA** ............................................................................................................................... Error! Bookmark not defined.
   - Afghanistan’s trade with Central Asian partners ............................................................................................................. Error! Bookmark not defined.
   - ‘Non-standard’ border trade between Afghanistan and Central Asia .................................................................................... Error! Bookmark not defined.
   - Energy trade and linkages .................................................................................................................................................... Error! Bookmark not defined.

5. **AFGHANISTAN’S EXPORT POTENTIAL** ............................................................................................................................... Error! Bookmark not defined.
   - Production concentration and export diversification ........................................................................................................... Error! Bookmark not defined.
   - Identifying products with export potential for Afghanistan .............................................................................................. Error! Bookmark not defined.
   - Products with export potential to Central Asia and the Russian Federation ...................................................................... Error! Bookmark not defined.

6. **BARRIERS TO TRADE** ......................................................................................................................................................... Error! Bookmark not defined.
   - Tariff barriers ....................................................................................................................................................................... Error! Bookmark not defined.
   - Non-tariff measures .............................................................................................................................................................. Error! Bookmark not defined.
   - Beyond the border barriers and trade costs ......................................................................................................................... Error! Bookmark not defined.

7. **INFRASTRUCTURE CONNECTIVITY AND TRADE FACILITATION** ..................................................................................... Error! Bookmark not defined.
   - Road ..................................................................................................................................................................................... Error! Bookmark not defined.
   - Rail ....................................................................................................................................................................................... Error! Bookmark not defined.
   - Trade facilitation at border crossing points with Central Asia .......................................................................................... Error! Bookmark not defined.

8. **BUSINESS SECTOR CAPACITY** ........................................................................................................................................ Error! Bookmark not defined.
   - Business environment .......................................................................................................................................................... Error! Bookmark not defined.
   - Female Entrepreneurs ........................................................................................................................................................ Error! Bookmark not defined.

9. **RECOMMENDATIONS AND PRIORITIES FOR REFORM** ...................................................................................................... Error! Bookmark not defined.
   - Improving trade policies ................................................................................................................................................... Error! Bookmark not defined.
   - Facilitating trade and transit ............................................................................................................................................... Error! Bookmark not defined.
   - Investing in infrastructure and connectivity ...................................................................................................................... Error! Bookmark not defined.
   - Creating the right regional business environment .......................................................................................................... Error! Bookmark not defined.
   - Strengthening regional economic institutions ................................................................................................................ Error! Bookmark not defined.

10. **PLANNED ESCAP CAPACITY BUILDING PROGRAMMES FOR AFGHANISTAN IN THE CONTEXT OF DEVELOPING REGIONAL COOPERATION** ................................................................ error! Bookmark not defined.

11. **ANNEX A: AFGHANISTAN: IDENTIFIED PRODUCTS WITH EXPORT POTENTIAL AND ABOVE AVERAGE COMPLEXITY** Error! Bookmark not defined.

12. **ANNEX B: AFGHANISTAN: IDENTIFIED PRODUCTS WITH EXPORT POTENTIAL AND ABOVE AVERAGE COMPLEXITY FOR CENTRAL ASIA** Error! Bookmark not defined.

13. **REFERENCES** ..................................................................................................................................................................... 21
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1. EXECUTIVE SUMMARY

A. AFGHANISTAN’S ECONOMIC PROSPECTS AND THE NEED FOR REGIONAL INTEGRATION

Afghanistan is facing a difficult period of economic and political transition; further regional integration, including with the countries of Central Asia, will be an essential element of any future development strategy.

- Afghanistan has made significant developmental gains over the past decade. For instance, per capita income increased more than threefold between 2003 and 2013, rising from $198 to $678 (World Bank Development Indicators, 2014).
- However, Afghanistan remains among the poorest countries in the Asia-Pacific region with wide ranging social and economic challenges. Further, the country is now facing a difficult period of economic and political transition. The withdrawal of foreign security forces, alongside reductions in the volume of donor assistance, is already having direct impacts on economic growth.
- Economic growth in 2013 was estimated at 3.3% having fallen from 11.9% in 2012. For 2014 and 2015 GDP growth is expected to be 3.5% and 4.5%, respectively (figure 1.1) (ADB, 2014). The recent formation of a new government should remove some of the political uncertainties and support further expansion in industrial and services outputs.
- However, the World Bank estimates that growth—after the transition towards Afghan control of security—will be around 5% a year under the baseline scenario in the period 2015-2018. This is a significant drop from the 9.4% average growth seen from, 2003-2012 which was supported by donor assistance and security spending (World Bank Global Economic Prospects, 2014).

Figure 1.1: Afghanistan’s GDP growth, 2000-2015

To succeed in the coming years, Afghanistan should take advantage of its unique geographical position as a ‘land bridge’ linking Central and South Asia, as well as making use of its substantial natural resources. Considerable long-term benefits to employment, revenues and economic
growth are available, both to Afghanistan and its Central Asian neighbours, if a successful regional framework can deliver on the region’s trade, transport, and transit potentials.

- Regional co-operation can bring specific benefits in terms of: economies of scale to increase local supply capacity and improve access to markets; integrated or harmonized treatment of trans-boundary issues such as trade, regulatory frameworks and policies, and regional infrastructure; and management of shared natural resources.

- For Afghanistan and Central Asia, particular opportunities exist in energy trade, transit trade, and border trade among populations close to crossing-points. Regional integration is thus a vital component in managing a successful transition in Afghanistan. The Russian Federation and South Asian countries are also integral to successful integration efforts.

- Indeed, for landlocked countries such as Afghanistan and the Central Asian Republics, regional integration is especially imperative: increasing regional integration not only encourages increased trade and connectivity within the region, but also, by creating links across the region to external markets, enables broader integration with large regional markets and the global economy more broadly.

Afghanistan continues to run large trade deficits as exports are limited and trade remains highly concentrated by both partners and products. Levels of foreign direct investment are low despite considerable opportunities in the natural resources sector.

- Afghanistan runs large and longstanding trade deficits. Afghanistan’s total merchandise exports were $515 million in 2013, whereas imports were $8,724 million. Afghanistan depends heavily on imports of fuels, food staples, processed materials, and manufactured goods, largely due to a lack of domestic infrastructure for production and processing. Total imports have been generally rising since 2008 when they stood at $3,019 million.

- Exports, though low in overall volume, have grown in recent years. Indeed, merchandise exports grew 20% in 2013 whereas imports contracted by 4%. This indicates weak links between imports and exports which is symptomatic of a lack of capacity to engage in many value-adding activities. The largest exported categories of goods included vegetable products; textiles; mineral products; briquettes; metals (10%) consisting almost exclusively of scrap iron. However, due to weaknesses in Afghanistan’s border security and customs, an estimated 40% of total trade goes unrecorded (World Bank, 2013).

- In terms of partners, Afghanistan’s trade in merchandise goods is heavily concentrated (table 1.1). Pakistan is by far the largest trading partner for Afghanistan, accounting for 47% of exports and 14% of imports in 2013 according to WTO figures. However, Pakistan’s likely true share of both is higher as much trade is not adequately recorded. As Afghanistan’s major transit route to the sea, it is natural for Pakistan to play an important role in the country’s trade but it also makes transit issues through Pakistan of critical importance.

- While not currently among Afghanistan’s top 5 trading partners, the Russian Federation is also a potentially important partner. In 2013, the Russian Federation imported only $14 million from Afghanistan. Over $13 million of which were fruits and vegetables. In contrast, Afghanistan imported $418 million from the Russia Federation. Over $300 million of imports were for mineral fuels, other categories of significance were wood articles ($55 million) and animal and vegetable fats ($20 million).
• Afghanistan at present receives relatively small amounts of foreign direct investment (FDI). Total greenfield FDI inflows for the period 2009-2013 were recorded at around $4.4 billion (FDi Markets, 2014). By comparison, Myanmar received over $9 billion over that period.
• China was the largest source of inward FDI accounting for over three quarters of this total inflow. Chinese investment was primarily concentrated in natural resources, such as copper and gold. However, uncertainties over the legal regime governing resource extraction, as well as security concerns, appear to be delaying planned investments.

Table 1.1: Afghanistan’s exports and imports by major partner, 2013

<table>
<thead>
<tr>
<th>Exports</th>
<th>Imports</th>
</tr>
</thead>
<tbody>
<tr>
<td>WTO data</td>
<td>Government of Afghanistan data</td>
</tr>
<tr>
<td>Country</td>
<td>Share in %</td>
</tr>
<tr>
<td>Pakistan</td>
<td>47</td>
</tr>
<tr>
<td>India</td>
<td>16.3</td>
</tr>
<tr>
<td>Iran, I. R.</td>
<td>6.2</td>
</tr>
<tr>
<td>China</td>
<td>1.1</td>
</tr>
<tr>
<td>Saudi Arabia</td>
<td>0.4</td>
</tr>
<tr>
<td>Unspecified</td>
<td>28.7</td>
</tr>
</tbody>
</table>

Source: WTO Trade Profiles, 2014; Government of Afghanistan, 2014

B. ECONOMIC LINKAGES BETWEEN AFGHANISTAN AND CENTRAL ASIA AND REGIONAL COOPERATION

Existing trade linkages between Afghanistan and Central Asian countries are weak, but potential exists for further development in a number of sectors, notably: energy trade, transit trade and informal border trade.

• Afghanistan and the Central Asian countries all face common challenges related to their landlocked geographic position and need for greater economic diversification. The region is far from major economic centres, and has relatively small populations and market sizes, underdeveloped infrastructure and political and security challenges that pose risks for human development (Mogilevskii, 2012).
• Despite the long common border linking Afghanistan and three of the five Central Asian states (Turkmenistan, Uzbekistan and Tajikistan) trade linkages remain extremely limited. Likewise, in terms of cross-border investment projects, current international data does not record any flows between Central Asia and Afghanistan.
• Overall, Afghanistan imports considerably more from Central Asia than it exports in return. In 2011, the last year for which comprehensive bilateral data is available, less than 3% of Afghanistan’s exports (worth $13.2 million) went to Central Asia with Tajikistan and Turkmenistan being the only economies to see imports of notable size. In contrast, roughly a
quarter of Afghanistan’s imports came from Central Asia, principally Uzbekistan (worth $1.67 billion).

<table>
<thead>
<tr>
<th>Table 1.2: Afghanistan’s exports to Central Asia (2011)</th>
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</thead>
<tbody>
<tr>
<td>Kazakhstan</td>
</tr>
<tr>
<td>$ millions</td>
</tr>
<tr>
<td>% total</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Table 1.3: Afghanistan’s imports from Central Asia (2011)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Kazakhstan</td>
</tr>
<tr>
<td>$ millions</td>
</tr>
<tr>
<td>% total</td>
</tr>
</tbody>
</table>

Source: UN COMTRADE

- In terms of imported products, energy tends to dominate. Afghanistan’s largest import from four of the five Central Asian economies is refined petroleum. Petroleum gas is another major import category from Central Asia. Uzbekistan is the largest source of imports among the Central Asian countries, with total imports worth ($732 million) in 2011. Next is Turkmenistan ($353 million), followed by Kazakhstan ($333 million), and Tajikistan ($226 million). Imports from the Kyrgyz Republic were valued at $24 million.

- As noted, Afghanistan’s exports to Central Asia are highly limited in terms of value and composition in comparison with imports. Official trade data is also not widely available. However, WTO figures suggest that agricultural products such as potatoes, grapes, and citrus fruits account for the bulk of exports, alongside other products such as curbstones. Tajikistan has the highest recorded imports from Afghanistan in 2011, followed by Kazakhstan and Kyrgyzstan.

- In addition to ‘standard’ trade—in which data on the type of good, its origin, quantity, and price are recorded by border authorities—‘non-standard’ border trade, in which small merchants and traders cross borders to buy or sell generally small volumes of products, is also common in Central Asia and between Afghanistan and its neighbours. Such trade can have major positive effects on the livelihood of communities living near the border areas. Because of its nature, however, data is scarce. Some estimates are that around 40% of Afghanistan’s total trade by value is unrecorded (World Bank, 2012).

- A study of Afghanistan’s non-standard border trade with its Central Asian neighbours found that the bulk of trade with Uzbekistan and Tajikistan passes through only two crossing points: at Hairatan and Sher Khan Bandar respectively. In general, border trading was found to be underdeveloped on account of several obstacles to the free flow of people and goods.

- Regional energy trade also has considerable potential and can help both: (i) provide Afghanistan with electricity to meet acute domestic shortages and (ii) deliver benefits from Afghanistan’s role as a ‘bridge’ linking the energy reserves of Central Asia with the growing demand of South Asia. Major energy projects like the Turkmenistan, Afghanistan, Pakistan and India Natural Gas Pipeline (TAPI) and the Central Asia – South Asia Electricity Transmission and Trade Project (CASA-1000) will help build regional connectivity in this area.
A number of major regional frameworks currently support regional cooperation between Afghanistan and Central Asia. These include: SPECA (the UN Special Program for Economies of Central Asia); RECCA (Regional Economic Cooperation Conference on Afghanistan); and CAREC (Central Asia Regional Economic Cooperation Program).

- SPECA was launched in 1998 in order to strengthen subregional cooperation amongst countries in Central Asia and to integrate the subregion into the world economy. Current members of SPECA are: Afghanistan, Azerbaijan, Kazakhstan, Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan. SPECA is supported by both UNECE and ESCAP, in recognition of the sub-region’s importance as a transport and connectivity hub between Europe and Asia. SPECA strengths have been especially marked in the improvement of border-crossing procedures and transport data harmonization in the region. In December 2014, the SPECA Economic Forum took place in Ashgabat under the chairmanship of the Representative of Afghanistan. The theme of the conference was “Improving Connectivity: a key contribution of SPECA to the success of the Transformation Decade of Afghanistan.”

- RECCA serves as the coordination body for economic activities related to Afghanistan. The first RECCA took place in Kabul in 2005 and since then has been followed by four further conferences. The aim of RECCA is to achieve regional cooperation in the promotion of shared economic interests as well as better coordination of political and security initiatives in the region. Within the framework of RECCA, Afghanistan completed a range of joint development projects with the governments of countries of Central Asia. In its objectives, RECCA acts as an extension of Afghanistan National Development Strategy and has channelled capital to facilitate the expansion of railroad networks, economic corridors and electricity transmission lines, connecting Afghanistan with Kyrgyzstan, Tajikistan, Turkmenistan and Uzbekistan. RECCA V, the latest conference that took place in 2012, laid down foundations for the “transformation decade” (2015-2024).

- CAREC was established in 1997, with China, Kazakhstan, Kyrgyzstan and Uzbekistan being the founding members, and since then has expanded its membership to 10 countries to also include Afghanistan, Azerbaijan, Mongolia, Pakistan, Tajikistan and Turkmenistan. CAREC is additionally supported by six multilateral development institutions (ADB, EBRD, IMF, IDB, UNDP, and WB). The purpose of the initiative is to promote cooperation in economic activities in Central Asia. 146 CAREC-related projects have been implemented so far in the areas of transport, trade facilitation, trade policy and energy, within the total budget of $22.4 billion. Since Afghanistan joined CAREC in 2005, it has received $2.6 billion in investment into 25 projects in the areas of trade, transport and energy, with 17 CAREC projects still ongoing.

C. IDENTIFYING AFGHANISTAN’S EXPORT POTENTIAL

Afghanistan and Central Asian economies are highly dependent on the export of a few commodities. Export diversification into a wider—and more complex—number of products can help deliver more balanced growth. Diversification is, however, path dependent and will be influenced by existing capabilities as well as external circumstances.

- The exports Afghanistan and the economies of Central Asia are highly dependent on a few key commodities, generally with low domestic value added. The commodity concentration index, which reflects how both exports and imports are concentrated on a few products, is
considerably higher in Afghanistan and the Central Asian economies than the global developing country average (figure 1.2).

**Figure 1.2: Diversification indices of merchandise exports and imports (2013)**

Countries dependent on earnings from primary commodities can suffer particular disadvantages. For instance, the low income elasticity of world demand for primary commodities can lead to falling export revenues which can be exacerbated by historically downward trends in primary commodities’ prices relative to manufactures. Further, primary commodity production for export often has weak backward and forward linkages to other sectors leading to little in the way of technological spillovers or learning.

Diversification does not occur at random. Instead, countries are encouraged to diversify into sectors that are related with their existing production base and product mix. In other words, diversification is ‘path dependent.’ In general, private firms are best placed to spot export opportunities and make decisions on whether to expand into new products. However, analysis of a country’s competitiveness can help understand the blockages that may be preventing exports and prompt public intervention where there are public, market or information failures.

ESCAP analysis can help identify sectors where there may be opportunities based on patterns of production observed elsewhere; key sectors with the largest number of potential products for Afghanistan appear to be in textiles, and base metals, and plastic and rubber.

ESCAP research has produced a global ‘product space’ which can help countries identify products that may be suitable for production given their existing capabilities (ESCAP, 2014). In other words, given an existing set of products it is possible to estimate which new products could emerge through diversification with a high degree of probability (given the relationships observed in other countries).

Afghanistan’s product space shows that production is limited to a few products and that these are generally to the periphery of the global product space (figure 1.3). This means that there are fewer ‘nearby’ products than in the dense centre of the product space; future diversification is thus harder. For contrast, the product space of China shows—as would be expected—a much
wider range of product types and more production of products which are closely linked with numerous other products.

Figure 1.3: The ‘product space’ of Afghanistan and China compared (2012)

- While diversification is important per se, countries should also seek to diversify into products which have greater complexity than existing production. ‘Complex’ products are defined as those produced by more diversified (generally higher income) economies; it can thus be assumed that they embody a more sophisticated set of production capabilities. Because learning to produce these products entails the acquisition of new capabilities it opens the possibility of further new product production and diversification.
- Applying this analysis to Afghanistan reveals those products of above average complexity (compared to existing production in Afghanistan) in which Afghanistan has production and export potential. This is based on a mapping of Afghanistan’s current export profile and then comparing it with similar countries’ export profiles and a mapping of global import demand.
- Opportunities across 220 products at the HS code six-digit level have been identified with the full list given at Annex A. The top five sectors in which Afghanistan has opportunities in and their shares among the total are identified in table 1.2, with similar results for the Central Asian economies included for comparison.
- Textiles, Base Metals, and Plastic and Rubber are the two sectors with the largest number of potential products. Examples of specific products with identified export potential include various garments and apparel items like coats and gloves; certain items of plastics; cereals based processed foods like waffles; and paper-based items like paperboards.
The agriculture sector does not feature among the top five sectors identified, however, given its importance for employment in the region, it is essential to also consider opportunities for export diversification in that sector. Table 1.3 shows the share of agricultural export opportunities across different commodities. For Afghanistan, the most products with export potential were in the categories of cereal, flour, starch milk preparations and products.

By linking the identified promising products of Afghanistan with the production and import structure of Central Asia, one can get better insights of potential Afghan exports to the subregion.

Refining the analysis to consider only Central Asian markets, it is possible to derive a shortened list of potential products that Afghanistan could produce where import demand is also growing in Central Asia. The size of the growth in import demand in the previous year (in this case 2012-13) is then understood as the size of the export potential for that product in that market.

Given the small size of the Central Asian economies, it is unsurprising that the total export potential for identified products is considerably less than in the top 5 markets globally. Of the Central Asian economies Uzbekistan is deemed to have the highest total potential for new Afghan products with an export potential value of $71 million. Although the total size of the
Central Asian markets is small, Afghanistan may be better placed to gain market share in these markets if the right policies are put in place so that it can benefit from its proximity.

- In terms of the specific products identified with export potential for Central Asia, the most promising by value are shown in table 1.4 (the full list is included in Annex B). Products identified include iron and steel based items such as flat rolled metals and wires; wood or paper based items like fibreboard and sacks; and some apparel items like gloves.

**Table 1.6: Top 10 products of above average complexity for export to Central Asia by size of export opportunity ($ USD million)**

<table>
<thead>
<tr>
<th>Partner</th>
<th>HS Code</th>
<th>Category</th>
<th>Sub-Category</th>
<th>Export opportunity ($USD million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Uzbekistan</td>
<td>721070</td>
<td>Iron and steel</td>
<td>Flat-rolled prod. Of iron/non-alloy steel, of a width of 600mm/more</td>
<td>25.6</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>841790</td>
<td>Nuclear reactors, boilers, machinery and mechanical appliances</td>
<td>Parts of the industrial/labouratory furnaces &amp; ovens of 8417.10-8417.80</td>
<td>12.9</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>721710</td>
<td>Iron and steel</td>
<td>Wire of iron/non-alloy steel, not plated/coated, whether or not polished</td>
<td>9.2</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>441119</td>
<td>Wood and articles of wood</td>
<td>Fibreboard of wood/oth. Ligneous mats., whether or not bonded with resins</td>
<td>6.9</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>721240</td>
<td>Iron and steel</td>
<td>Flat-rolled prod. Of iron/non-alloy steel, of a width of &lt;600mm</td>
<td>6.7</td>
</tr>
<tr>
<td>Tajikistan</td>
<td>611692</td>
<td>Articles of apparel and clothing accessories</td>
<td>Gloves, mittens &amp; mitts, knitted or crocheted, other than those impregnated</td>
<td>5.6</td>
</tr>
<tr>
<td>Turkmenistan</td>
<td>680790</td>
<td>Articles of stone, plaster, cement, asbestos, mice or similar materials</td>
<td>Articles of asphalt/sim. Mat. (e.g., petroleum bitumen/coal tar pitch)</td>
<td>4.2</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>390330</td>
<td>Plastics and articles thereof</td>
<td>Acrylonitrile-butadiene-styrene (ABS) copolymers, in primary forms</td>
<td>4.0</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>481930</td>
<td>Paper and paperboard; articles of paper pulp</td>
<td>Sacks &amp; bags, having a base of a width of 40cm/more</td>
<td>3.9</td>
</tr>
<tr>
<td>Uzbekistan</td>
<td>600634</td>
<td>Knitted or crocheted fabrics</td>
<td>Knitted/crocheted fabrics, n.e.s. in Ch.60, of synth. Fibres, printed</td>
<td>2.9</td>
</tr>
</tbody>
</table>

*Source: ESCAP analysis 2014 (mimeograph)*

- The analysis also considers Afghanistan’s trade potential with the Russian Federation. The overall export opportunity for the identified products was $345 million. Top potential products included acrylics, iron and gloves.
- The analytical techniques described above can provide a useful starting point for countries that are seeking to pursue strategic policies of economic diversification. Implementing a strategy of this nature requires “the selective promotion of new economic activities over traditional ones.
through the use of targeted industrial, infrastructure, trade, investment and private sector development policies” (ESCAP, 2014, p37).

- A few caveats should be noted. Firstly, this analysis relies on export data as a proxy for production data. As Afghanistan’s trade data is not comprehensive there may be gaps: in the case of countries with low overall trade volumes like Afghanistan, exports may not be a good proxy for total productive capacities. In relation to this, areas where there is large potential but virtually no production at present—such as many minerals in the case of Afghanistan—will not be captured by the methodology.
- Second, the results identified—in terms of specific products—by these analytical methods should be considered as a starting point for further detailed sectoral analysis and identification of directions for diversification. In this sense, this type of information has the qualities of a public good in that it “reduces the cost of discovery of potential successful new economic activities by informing entrepreneurs of the new products that require productive capacities similar to those already available in the country” (Ibid).

D. TARIFF AND NON-TARIFF BARRIERS TO TRADE

Average applied tariffs are fairly low across Afghanistan and Central Asia; however, in Central Asia high tariffs are applied on some key Afghan export items with potential deterrent effects on trade. As an LDC, Afghanistan can benefit from preferential tariffs in developed and some developing country markets.

- Average applied tariff rates are generally low in most Central Asian economies. Only Uzbekistan has an average applied tariff rate above 10%. However, some of Afghanistan’s top export products do face higher than average tariffs in some Central Asian economies (figure 1.4). Notably, cotton; fruit; vegetables; and carpets all face tariffs between 20% and 80% in Turkmenistan and Uzbekistan. Preferential access for Afghan traders to these markets might help encourage trade in these product sectors which are of considerable potential.
- Afghanistan could benefit from the preferential market access that the Russia Federation offers to LDCs through its Generalized System of Preferences, launched in 2012. This offers Duty-Free Quota-Free access to a range of products from LDCs. At present the scheme covers 38.1% of tariff lines and excludes some products of interest to Afghanistan, including petroleum products, copper, iron ores, articles of leather, articles of apparel and clothing. There is scope for thus considering expanding the scheme to cover an even wider range of relevant products.
Non-tariff measures are also an obstacle to intra-regional trade; in particular Sanitary and Phytosanitary Standards are problematic because of inefficient or inadequate inspection regimes and facilities at borders

- Non-tariff measures (NTMs) include a wide range of policies, regulations and standards impacting trade. Data on the existence and impact of non-tariff measures on trade is harder to obtain than in the case of tariffs but their consequences can often be greater.
- ‘Technical’ non-tariff measures such as Technical Barriers to Trade (TBTs) and Sanitary and Phytosanitary (SPS) Standards can be particularly disadvantageous for developing economies in general, and least developed countries like Afghanistan in particular.
- NTMs are also frequently applied to those products which are of particular importance for developing economies like Afghanistan. For instance, food and agricultural goods—often sectors where developing countries have a comparative advantage—are some of the areas where NTMs, especially SPS measures—are the most prevalent.
- There is evidence that Afghan agricultural exports have been struggling to meet SPS standards abroad, including those of the Central Asia countries, or are suffering delays at the border caused by inefficient or inadequate inspection regimes and facilities. This undermines the ability of export-oriented agriculture industries to supply their produce to the region. Indeed, trade across the region as a whole suffers from a number of impediments resulting from inefficient, out-dated or uncoordinated SPS systems.

E. INFRASTRUCTURE AND TRADE FACILITATION

Infrastructure constraints, in particular the lack of road and rail connections linking Afghanistan with neighbouring countries continue to be a major obstacle to trade and contribute to existing high trade costs.
As a landlocked country, Afghanistan is being prevented from reaching its trade potential by the lack of infrastructure, in particular road and rail links with neighbouring countries which are also its transit routes in reaching other export markets. The mountainous nature of the country makes rail connectivity costly and difficult; and road connectivity between large business centres and consumers and producers of raw materials at the towns and villages yet to establish, remains a major challenge to doing business in Afghanistan. Around 30% of firms in Afghanistan consider transportation as a major constraint (World Bank, 2014).

As a result, trade costs between Afghanistan and Central Asia, are extremely high: costs are estimated as tariff ('ad valorem') equivalents are over 150% for all Central Asian partners for which data is available (figure 1.5).

**Figure 1.5: Trade Costs between Afghanistan and Central Asia in comparison with regional partners (Ad Valorem Equivalents)**

![Figure 1.5: Trade Costs between Afghanistan and Central Asia](image)

Source: ESCAP-World Bank Trade Costs Database. (Note: No data available for Turkmenistan)

Afghanistan currently has a road network of approximately 135,000 km (AIMS, 2014). Data suggests that around 70% of the interprovincial and interdistrict roads remain in a poor state (ADB, 2014). Given the country’s topography, a circular road network close to the borders is a priority for linking the country internally – this has been improved in recent years. Radial branches from this highway then link to neighbouring countries. With the completion of the stretch between Herat and Qaiser (300 km), the road circle will be fully in place. The recently completed road radial from Zaranj-Delaram links the circular road with Iran and its port at Chabahar.

Given that the biggest share of Afghan trade is with Pakistan, transit links are crucial both for port access and to provide access to the Indian market. Afghanistan and Pakistan have concluded a transit agreement (APTTA). However, a major Afghan concern remains that
implementation is lagging; cargo is often delayed at Karachi; and access to India is not permitted.

- Land transit for trucks from India seeking to reach Afghanistan is a topic of discussion between Pakistan and India, at present though Indian trucks are not able to reach Afghanistan via Pakistan. Afghanistan also has trade and transit with Uzbekistan and Turkmenistan. A transit and motor vehicle agreement, CBTA, was signed in early 2013, between Afghanistan, Tajikistan and Kyrgyzstan, in the same period a motor vehicle and tanker movement agreement was signed with Iran.

- Historically, Afghanistan never developed a railway network of any scale. Prior to 1990, two railway lines from Central Asia (one from Turkmenistan and one from Uzbekistan) reached the Afghan border but did not extend beyond. Afghanistan was not one of the countries that negotiated and adopted the Intergovernmental Agreement on the Trans-Asian Railway Network. Currently, several initiatives are gradually changing the situation; future rail development could play a significant role in linking Afghanistan with other landlocked countries in Central Asia. One link has already been completed: in 2010 a 75-km single-track rail link was completed from Khairaton at the border with Uzbekistan to Mazar-i-Sharif. The Islamic Republic of Iran is also now constructing a 205-km link between Sangan in Eastern Iran to Herat.

**Trade facilitation, including more efficient border processes, is also needed**

- Facilitating trade at border crossing points is as important as the physical infrastructure that connects border crossings with cities and hinterlands. At present Afghanistan has relatively few sizeable border crossing points with Central Asian neighbours.

- One of the most important crossings is Hairatan located at the Uzbek border as it is the only border crossing with efficient transport links with much of Central Asia and modern customs facilities. Before completion of the bridge at Sher Khan Bandar, Tajikistan, in 2007, Hairatan was the only major route to Central Asia. The Uzbek city of Termez, located a few kilometres from Hairatan, has railroad connections with both Dushanbe, the capital of Tajikistan, and Tashkent, the capital of Uzbekistan. Goods moving through the Hairatan BCP are mainly industrial raw materials (for example, fuels, glass, and iron bars), shipped to Afghanistan, and limited quantities of raisins shipped to Uzbekistan.

**F. BUSINESS SECTOR ENVIRONMENT AND CAPACITY**

The overall business environment needs substantial improvement

- World Bank placed Afghanistan as the 183rd out of 189 countries for 2015 in its Ease of Doing Business rankings, which is the lowest position in Asia-Pacific region. The business environment in Afghanistan thus requires significant development and introduction of suitable legislation, particularly aiming at promotion of SMEs. Despite, employing 75% of Afghanistan’s workforce and contributing around 50% to the country’s GDP (Asia Foundation, 2013), SMEs in Afghanistan are facing various challenges.

- While starting an enterprise in Afghanistan is very easy (it is the 24th easiest country to start a business out of 189) and access to credit (at least for larger enterprises) is much better than in
other countries at the similar stage of development (89th out of 189), in many other aspects, sustaining and operating a firm in Afghanistan is challenging. The most onerous issues for Afghanistan’s business environment are: poor enforcement of contracts, no protection of minority investors, lack of functioning property registration system at a national level and difficulties in obtaining construction permits. Access to finance for SMES is also a major constraint; not least as many SMEs lack access to require collateral.

- Women-owned businesses can play a role, not only in empowering women but also in raising productivity more broadly. Gender-based asset inequality affects resource allocation within the household and labour productivity. Women’s entrepreneurship can make a particularly strong contribution to the economic well-being of the family and communities, poverty reduction and women’s empowerment, thus contributing to the resources of the household, the pattern of consumption tends to be more child-focused and oriented to meeting basic needs.

- The One Village One Product movement, which promotes rural production of products embodying traditional knowledge—for instance, handicrafts—for national and international sale could potentially be applied to Afghanistan. The movement has had considerable success in other countries including Thailand, where it is better known as OTOP.

G. RECOMMENDATIONS AND PRIORITIES FOR REFORM

Realizing the potential for regional trade and integration requires action on: improving trade policies; facilitating trade and transit; investing in infrastructure and connectivity; creating the right regional business environment; and strengthening regional economic institutions.

- This report has documented the limited scale of existing trade, investment and infrastructure linkages between Afghanistan and Central Asia. However, there is also considerable potential for greater trade in certain sectors, identified by ESCAP analysis. Expanded intra-regional exports can thus play a role in Afghanistan’s wider strategy of economic development and diversification. Realizing this potential will require action across a number of areas and requires political commitment across the region. Our recommendations, based on the analysis in the report, and summarized in the table below, suggest five priority themes: improving trade policies; facilitating trade and transit; investing in infrastructure and connectivity; creating the right regional business environment; strengthening regional economic cooperation.

<table>
<thead>
<tr>
<th>Theme</th>
<th>Areas for focus</th>
<th>Priorities for Afghanistan</th>
<th>Priorities for Regional Partners</th>
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</thead>
<tbody>
<tr>
<td>IMPROVING TRADE POLICIES</td>
<td>Tackling tariff barriers to current trade and export diversification</td>
<td>- Identify tariff barriers on existing products and products with export potential as identified by ESCAP analysis &lt;br&gt; - Open discussions with regional partners on mechanisms for reducing tariff barriers</td>
<td>- Enter discussions on means of improving Afghanistan’s market access, including tariff liberalization on key products of interest &lt;br&gt; - Russian Federation to consider expanding GSP scheme on products on interest to Afghanistan</td>
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<td></td>
<td>Streamline non-tariff barriers, especially SPS</td>
<td>- Survey business to uncover critical NTM measures in partner countries which are impeding trade, in particular for agricultural products</td>
<td>- Improve NTM systems with risk-based approaches and modernize processes in line with WTO guidelines &lt;br&gt; - Work with Afghanistan on improving laboratory infrastructure for product</td>
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<tr>
<td><strong>FACILITATING TRADE AND TRANSIT</strong></td>
<td><strong>INVESTING IN INFRASTRUCTURE AND CONNECTIVITY</strong></td>
<td><strong>CREATING THE RIGHT REGIONAL BUSINESS ENVIRONMENT</strong></td>
<td><strong>STRENGTHENING REGIONAL ECONOMIC COOPERATION</strong></td>
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<td><strong>Deepen and expand existing regional trade agreements</strong></td>
<td>- Identify priority products that would benefit from preferential access</td>
<td>- Prioritize investment in rail and road links to key centers</td>
<td>- Accelerate existing areas of cooperation and jointly develop a single regional economic strategy</td>
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<td>Improve and expand APTTA</td>
<td>- Work with Pakistan to improve APTTA including thorough addressing issues such as illegal smuggling</td>
<td>- Complete existing proposals on TAPI and CASA-1000 and build momentum towards further projects</td>
<td>- Give higher priority to regional integration efforts on promoting trade and identify areas that can most effectively be tackled through regional cooperation</td>
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<td>Improve efficiency of border processes</td>
<td>- Invest in training and facilities, including single window systems</td>
<td>- Continue to engage in regional efforts, e.g. CAREC, to bring links to the Afghan border</td>
<td>- Launch OVOP-style programme to develop rural productive capacity based on traditional skills</td>
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<td>Encourage border trade</td>
<td>- Establish joint task-forces with partners focused on easing problems related to non-standard border trade</td>
<td>- Review impediments to further energy linkages with Afghanistan and South Asia</td>
<td>- Share experiences of rural development and production capacity building</td>
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<td><strong>Road and Rail</strong></td>
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<td>- Organize regional ‘matchmaking’ services for Central Asian and Afghan businesses</td>
<td>- Work on a joint regional economic strategy for Afghanistan and Central Asia targeted at improving trade flows, informed by the views of the private sector and other stakeholders</td>
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<td><strong>Energy</strong></td>
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<td>- Consider regional approaches to capacity building for the private sector, for example on how to meet standards and regulations</td>
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<td><strong>Improving the business and investment climate and access to finance</strong></td>
<td>- Prioritize reforms to the business and investment climate, especially clarifying rules governing resource investments</td>
<td>- Consider changes to capacity building for the private sector, for example on how to meet standards and regulations</td>
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<tr>
<td><strong>Building regional business linkages</strong></td>
<td>- Boost access to finance, particularly for SMEs</td>
<td>- Establish regional private sector forum to feed in business perspectives to regional gatherings i.e. RECCA and SPECA</td>
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<td><strong>Support Women-owned businesses</strong></td>
<td>- Remove legal and financial restrictions on female entrepreneurs and women owned business</td>
<td>- Create regional women’s business network to share contacts and provide mutual support</td>
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<td><strong>Develop local production capacity utilizing traditional knowledge</strong></td>
<td>- Use online platforms to help women-owned businesses connect with each other</td>
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<td></td>
<td>- Launch OVOP-style programme to develop rural productive capacity based on traditional skills</td>
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2. INTRODUCTION: TRADE AND REGIONAL INTEGRATION AS DRIVERS OF AFGHANISTAN’S DEVELOPMENT

Afghanistan is now facing a critical period that will determine the success of its future development efforts. The new Afghan administration needs to maintain and enhance the social and economic gains of the past decade, while facing financial and political challenges resulting from the withdrawal of foreign troops and a projected decline in total donor assistance.

Increasing trade and regional integration will be vital components in managing a successful transition in Afghanistan. Regional integration encompasses action across a broad range of policies but normally includes efforts to facilitate the movements of goods, services, capital and people. In general terms, the benefits from pursuing regional integration are numerous and include:

- Reaping economies of scale or other efficiencies to increase local supply capacity and improve access to markets
- Integrated or harmonized treatment of trans-boundary issues such as: trade; regulatory frameworks and policies; and regional infrastructure
- Management of shared natural resources.

Thus, substantial long-term benefits to employment, revenues and economic growth are available, both to Afghanistan and its Central Asian neighbours, if a successful regional framework can deliver on the region’s trade, transport, and transit potentials. This must take advantage of Afghanistan’s unique geographical position as a ‘land bridge’ linking Central and South Asia and its substantial natural resources. Particular opportunities exist in energy trade, transit trade and border trade among populations close to crossing-points.

Indeed, for landlocked countries such as Afghanistan and the Central Asian Republics, regional integration is especially imperative: increasing regional integration not only encourages increased trade and connectivity within the region, but also, by creating links across the region to external markets, enables broader integration with large regional markets and the global economy more broadly. Further regional integration between Afghanistan and Central Asia is thus not a substitute for integration with the rest of the world. Rather, it must be buttressed with broader economic integration that makes the most of the region’s comparative advantages.

Although the size of the markets in Afghanistan and Central Asia are very small when considered individually, pooling markets through regional economic integration can generate economies of scale and the potential for regional production sharing. As smaller markets can be vulnerable to monopoly capture, market widening can increase competition and offer higher productivity gains (ITCSD, 2011).

Further, in the context where a large share of trade is informal and unrecorded, substantial economic activity is not captured by official statistics and may thus suffer from poorly designed policies based on the incorrect assumption that the informal economy is unproductive. Regional trade facilitation measures can raise the level of formality and the volume of trade.

Moreover, regional provision of public goods, for instance in the areas of policy and provision of connectivity infrastructure (e.g. energy, finance, telecommunications, transport) can make an
important contribution to addressing development challenges. This is especially the case when connectivity improvements are made within an agreed regional trade facilitation strategy.

The role of regional co-operation is thus explicitly recognized in Afghanistan’s National Development Strategy (ANDS, 2008) which notes that: “The central goal of the Regional Cooperation issue is to contribute to regional stability and prosperity, and to enhance the conditions for Afghanistan to resume its central role as a land bridge between Central Asia and South Asia, and the Middle East and the Far East, as the best way of benefiting from increased trade and export opportunities.” The ANDS anticipates that regional integration will yield significant strategic benefits including to economic growth, social wellbeing and security (figure 2.1).

**Figure 2.1: Strategic outcomes from regional integration: Afghanistan’s National Development Strategy**

- Link energy rich Central Asia with South Asia
- Revenue benefits from transit role
- Lower trade barriers to create freer markets
- Harmonization facilitates cross border initiatives on energy and infrastructure
- Better border management helps fight crime
- Improved access for women to economic and political opportunities
- Improved economic conditions facilitate refugee return

*Source: Afghanistan National Development Strategy, 2008*

However, despite widespread recognition of the their importance for regional security and prosperity, trade and economic exchanges between Afghanistan and Central Asia remain below their potential. At present, Afghanistan and Central Asia countries trade mainly with other partners: Pakistan in the case of Afghanistan or the Russian Federation, the European Union, and China in the case of Central Asia. The bulk of extra-regional exports are commodities, and as such are generally not incorporated in regional supply-chains, not least because of the serious underdevelopment of a regional manufacturing base. Therefore, combined with the regions difficult geography and weak transport links, it is not surprising that total levels of intra-regional trade are amongst the lowest in the world.

A number of initiatives, including substantial investment projects, are helping improve this situation. Forums like SPECA and CAREC, as well as SAARC and others, are all actively engaged in fostering trade and transport throughout the Greater Central Asia region. Major projects like the TAPI pipeline and the CASA-1000 energy link have the potential to transform the regional dynamics and can also serve as building blocks for further efforts. But accelerating and going beyond existing initiatives will be essential if regional integration and trade are to fulfill their potential as sustainers of Afghanistan’s successful transition.
This paper reviews the current state of Afghanistan’s trade and economic linkages with the Central Asian Republics. It is structured as follows: Section 3 reviews Afghanistan’s broader economic and development context; Section 4 describes the current scale and scope of linkages between Afghanistan and Central Asia; Section 5 examines the sectors with the most export potential; Section 6 covers the major trade policy barriers impeding further trade flows in the region\(^1\); Section 7 considers the need for trade facilitation and infrastructure; Section 8 considers problems in the business environment; Section 9 makes suggestions for reform to tackle the identified impediments. Finally, Section 10 outlines the role that ESCAP can play in facilitating further regional integration.

\(^{1}\) This paper does not address intra-regional investment. At present no data could be found on investment in Afghanistan from Central Asia. While addressing barriers to FDI is crucial for Afghanistan, the obstacles are general in nature and do not specifically relate to Central Asia. They are thus already addressed through, for instance, the work of the World Bank on the business environment in Afghanistan (see World Bank, 2014).
REFERENCES


