



UNIVERSITY  
OF CENTRAL ASIA

GRADUATE SCHOOL OF DEVELOPMENT

Institute of Public Policy and Administration



# Small and Medium Enterprises Development and Regional Trade in Afghanistan

Mujib Mashal



WORKING PAPER №24, 2014





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## **Abstract**

This paper analyses the role of Small and Medium Enterprises (SMEs) in the Afghan economy; the challenges of developing SMEs in an infant market economy; how SMEs are coping with the military transition and declining aid. The paper also looks at the role of SMEs in Afghanistan's trade with Central Asia and the hurdles impeding growth of that trade. The paper provides recommendations for strengthening SMEs and better - facilitating their role in trade.

## **Keywords**

Afghanistan, Central Asia, Small and Medium Enterprises, Trade and economic relations, trade facilitation.

JEL Codes: P33, P45, N75, L53, O10

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## Executive Summary

Over the past decade, massive spending tied to the international military presence has been at the heart of Afghanistan's steady economic growth. As the military withdrawal nears, attention has shifted to the sustainability of developments in the private sector, which is now seen as the primary driver of growth of the Afghan economy. Growth is already slowing, with those sectors directly tied to military aid - construction and services - reporting a decline in the past year. This transition comes when the fundamentals of the new market economy, which Afghanistan adopted after 2001, are still fragile in the country. The tremendous flow of money over the past decade has quelled people's expectations of the government - which has largely remained according to the systems of socialist regimes of the past. Without a clear campaign about the government's role in the new economic system, it will continue to be blamed for failures to support businesses and create jobs as aid and economic activities related to the military presence decline.

Due to Afghanistan's unpredictable economic climate after decades of conflict, large investments remain limited. The World Bank ranked Afghanistan's business climate 164 out of 189 economies. Small and Medium Enterprises (SMEs) are more adaptive to current conditions. They make up 85 percent of Afghan businesses, half of the country's GDP and employ more than one third of the country's labour force. Most SMEs operate in urban areas and between 70 and 80 percent remain informal, unregistered with the government. For small and medium business owners, the incentives to formalise their business are minimal compared to the burden of corruption and bureaucracy. This leaves some SMEs, particularly those with export ambitions, vulnerable to exploitation of "commission workers",<sup>1</sup> who work as middlemen. Some of them have recently been formally integrated into the Afghan trade system, which has distanced the traders from the market.

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<sup>1</sup> Official 2 at the Afghan Ministry of Commerce, interviewed on December 3, 2013 described the commission workers a rank of middlemen who position themselves as the facilitators clearing traders' goods at customs. A second variety of commission workers acquire trade licenses to export or import on behalf of smaller, unregistered businesses and then tear up their licenses at the end of the year to avoid paying taxes.

## 1. Introduction

In Afghanistan's turn to market economy after the US invasion in 2001, the private sector, 85 percent of it made up of Small and Medium Enterprises (SMEs), was defined as the engine for growth. But the flow of tremendous aid and money tied to the military presence distracted the government from focusing on the development of SMEs and facilitating their access to market, which would ensure the sustainability of the economy in the long run. The Afghan government's current SME strategy, which was not finalized until 2009, has sought to focus on target sectors that could develop alternatives to imports. Meanwhile, large challenges facing SMEs raise questions about their competitiveness, ingenuity, and their ability to survive the transition. The uncertainty and unpredictability of the business environment, dependence on donor organizations, lack of industrial - level energy, access to market, and a lack of clear link between the market - needs and what the education system offers are the main issues impeding SME growth. In the case of women - led businesses, the challenges are exacerbated by social limitations, as the support for women to work outside home seems to be declining.

Afghanistan's trade, though still limited to traditional items, has seen sound growth in the past decade, but the trade deficit remains large. In 2002, Afghanistan exports were estimated at about \$100 million. In 2012, registered exports rose to \$470 million.

For Afghan traders, challenges related to transportation and border transit and corruption at customs and taxation offices impede growth. Because the majority of Afghan SMEs remain informal, Afghan exports are carried out by a mix of registered SMEs and commission workers who collect from small producers. Afghan officials also describe a "mafia", with far - reaching ties within government, which exports to Pakistan and beyond, bypassing official quality control channels. This impacts Afghanistan's revenues as well as the perception of the quality of Afghan products. The eastern border with Pakistan is unreliable, closing frequently due to protests over drone strikes. Corruption is also a major issue at ports of crossing from Pakistan, which affects market competition for traders importing from ports in the north. On the northern front, freight capacity is limited.

In recent years, Afghanistan has been touted as the pivot for inter - regional trade between south, east and central Asia and from there to Europe. But despite improved in - country infrastructure, deemed necessary for increasing the volume of trade, Central Asian nations remain largely sceptical of the benefits to trade with Afghanistan based on the risks that come with sharing about 2,000 kilometres (km) of borders. Amid uncertainty about US commitment in the region, the volume of trade between Afghanistan and Central Asia is unlikely to change dramatically, both due to Central Asian fears and unresolved "soft issues" such as border clearing and customs technology.

Based on the study of existing literature and extensive interviews with sectorial officials, this paper hopes to highlight the current state of SMEs in Afghanistan, the role of women in SMEs, the state of Afghanistan's trade with Central Asia, and the role that SMEs play in that trade.

## 2. Methodology

This report relies on two sources of information and analysis: a thorough study of existing literature, and extensive interviews with experienced sectorial representatives.

The literature review included reports on the Afghan economy, trade, private sector development and diplomatic relations with Central Asian nations. Reports from aid organisations working on enterprise development (such as ASMED) provided insight into the challenges of developing SMEs in Afghanistan. World Bank reports about the state of the Afghan economy and the business climate were also reviewed. Conference presentations by government officials and independent experts on export, regional trade, transport expansion and customs reform were also reviewed.

Primary data collection was done through extensive key informant interviews with officials from the Afghan Ministry of Commerce and Industry, the Ministry of Finance, business association members, SME owners and business consultants.

## 3. The Afghan Economy

Afghanistan has seen steady economic growth over the past decade, with real gross domestic product (GDP) growth averaging 10.5 percent between 2005 and 2012.<sup>2</sup> Fuelling the growth has been the international presence, particularly the military presence, which has brought about massive spending. A large portion of the service sector, particularly construction and logistics, remain heavily dependent on military and development aid.

As the international troops begin to withdraw, growth is expected to slow down because of a reduction in aid and political uncertainty which creates a perception of risk for investors. Construction and services sectors have already slowed down in major cities.<sup>3</sup> The transition comes at a time when the market economy, the system Afghanistan adopted after the US invasion, has not completely taken root despite policy and legislation frameworks in place.<sup>4</sup> After decades of Soviet - style socialism followed by a decade of statelessness, there were expectations that the government would assert influence on the market again and subsidise prices. The opening of the market and privatisation of industries have been met with scepticism, fuelling the perception that the government is neither creating jobs nor regulating prices. Until now, some of that gap has been filled by the tremendous flow of aid money and military - related spending. As the currency devalues in the face of uncertainty and prices fluctuate, further questions will be raised about the fragile market economy.

<sup>2</sup> The World Bank, *GDP growth (annual %), Afghanistan*, <http://data.worldbank.org/indicator/NY.GDP.MKTP.KD.ZG/countries/AF?display=graph> (accessed January 15, 2014)

<sup>3</sup> Wadsam, *Services and Construction Sector Declining in Kabul, Mazar and Kandahar, ACCI Report*, November 30, 2013, <http://www.wadsam.com/services-and-construction-sector-declining-in-kabul-mazar-and-kandahar-acci-report-989/> (accessed January 12, 2014)

<sup>4</sup> Interview with Ministry of Commerce and Industries Official 3. Kabul; December 6, 2013 .



The World Bank predicts several scenarios for Afghanistan's economy during the decade of transition after the foreign force withdraw. The most optimistic scenario predicts the economy will continue to grow at an average rate of 7 to 8 percent. This scenario assumes that the military transition would not affect the business climate. It further assumes that the extractive industries, notably mining which is also dependent on security, will contribute noticeably to the economy. Other scenarios predict growth at about 6 percent. This is, the most likely scenario, if growth in agriculture and businesses are sustained and international aid decreases gradually. However, if there is an extreme deterioration of security, growth is likely to be less than one percent.

In 2012, the first year of the transition as security was gradually handed over to Afghan forces ahead of the foreign withdrawal, the World Bank reported that economic growth was largely unaffected. It remained at an estimated 11.8 percent, a 4.5 percent increase from 2011. The growth is attributed to "an exceptional harvest," in which wheat production met 93 percent of domestic consumption, approaching self - sufficiency. Oil production in Amu-Daryain creased the extractive industries share to 1.8 percent of GDP, a 1.2 percent rise from 2010. Oil production is currently at 1,950 barrels per day. This is expected to rise to 4,000 barrels per day by the end of 2014.

However, in 2013, economic growth fell significantly. The security and political uncertainty, combined with a decreased harvest due to moderate rainfall, slowed growth to about 3.1 percent of GDP. Business confidence had already suffered, as evidenced by an 8 percent decline in new business registration in 2012.<sup>5</sup> The Afghanistan afghani (AFN) depreciated from AFN 48 to AFN 57 to the US dollar in 2011. Exports, estimated at US\$2.6 billion (factoring in unrecorded trade), fell by 5 percent in 2012, while imports increased by as many percentage points to reach about US\$ 11.2 billion. The trade deficit stands at US\$8.5 billion.<sup>6</sup> Domestic revenues fell short of expectations due to customs performance, which saw a 9.6 percent decline despite the increase in imports.

Domestic revenues can only finance 65 percent of the operating budget which keeps growing every year. The rest has to be funded by donors. Military and civilian aid pledged by international community at recent conferences is expected to be about US\$8 billion annually, and will help finance the gap. The reduction in aid is expected to impact urban centres more than rural areas, where aid essentially did not trickle down over the past decade.

The mining sector, despite its US\$3 trillion value in copper, gold and iron ore , requires significant investments before it will generate jobs and revenue. These investments have not yet been made. Rushing to extraction without the perquisite human resource could lead to outsourcing to international firms, which would undermine the desired economic impact.

<sup>5</sup> The World Bank, "Afghanistan: From Transition to Transformation II", *Senior Officials Meeting*, July 2, 2013, <http://www.worldbank.org/content/dam/Worldbank/document/SAR/afghanistan/SOM-WorldBank-July2013.pdf> (accessed December 2, 2013)

<sup>6</sup> Ibid.

## 4. Small and Medium Enterprises

With Afghanistan's turn to the market economy, the private sector is considered the engine for growth. At the heart of the private sector are small and medium enterprises (SMEs).<sup>7</sup> SMEs make up about 80 percent of Afghan businesses, half the country's GDP, and employ more than 1/3 of the labour force.<sup>8</sup> Despite having such an important role in the economy, the development of SMEs has not been prioritised until recently, and the sector faces significant challenges.

### 4.1 The SME Strategy

Afghanistan did not have a clear SME strategy during the first eight years after the US invasion. A strategy was finalised in 2009,<sup>9</sup> but its implementation and oversight did not begin until 2011, when the SME Directorate was formed within the Ministry of Commerce and Industry.<sup>10</sup> The Directorate began with a staff of 12, which doubled a year later. However it remains understaffed for the complexity of the work it oversees.

In the short and medium terms, due to a massive trade deficit, the strategy targeted sectors developing import. Specifically, it provided capacity building and market information, and called for donor and government support for target industries, such as food, vegetable oil, dairy and poultry production. Export promotion, in the short term at least, was not considered a key element of the strategy because exports remain limited to traditional items.<sup>11</sup> In the current, medium to long term phase, the strategy maintains a focus on import alternatives, while also concentrating on mineral exports.

Officials working on SME development lament that a clear awareness campaign about the new economic system was never launched and that not enough attention was given to value chain development and coordination of economic policy at a higher level. SME development happened on an ad - hoc, donor - driven basis. Business owners "rapidly adapted to the perceived priorities of international dollars," turning to "short - term trading at the expense of long - term productive enterprises".<sup>12</sup>

As a result, the subsidising role that the socialist government had played in the past was taken on by donor organisations. In the process, the role of the government and its new

<sup>7</sup> According to Ministry of Commerce official 3, in their definition "Small" enterprises employ between 5 and 20 people and "medium" enterprises employ between 20 to 100 individuals.

<sup>8</sup> *Afghanistan Country Report-Enhancing the Competitiveness of Small and Medium Enterprises in Member States*. Presentation by Afghan Ministry of Commerce and Industries at Organization of Islamic Cooperation Meeting in Istanbul. October 8-11, 2012

<sup>9</sup> Ibid.

<sup>10</sup> Interview with Ministry of Commerce and Industries, Official 3. Kabul; December 6, 2013.

<sup>11</sup> Ministry of Economy, Islamic Republic of Afghanistan, "Enhancing the Competitiveness of Small and Medium Enterprises in Member States," *Presentation at Organization of Islamic Cooperation*, Istanbul, Turkey (October, 2012).

<sup>12</sup> Jake Cusack and Erik Malmstrom, "Challenges and Hope for Private Sector Development in Afghanistan," *Transcript, Council on Foreign Relations*, November 1, 2010, <http://www.cfr.org/afghanistan/bactrian-gold-challenges-hope-private-sector-development-afghanistan/p23583> (accessed November 1, 2013)

economic system was undermined; a problem exacerbated by rampant corruption. The directorate reports that a majority of SMEs, between 70 and 80 percent, developed informally and did not register with the authorities.<sup>13</sup> From the perspective of SME owners, formal registration simply meant a tax officer raiding their offices. However, as the subsidising role of international aid organisations shrinks, they are increasingly turning to the government to invest in their businesses.

Despite 10 years of a market economy, corruption notwithstanding, the perceived role of government remains grounded in the beliefs of three decades ago. If a clear strategy for SMEs had been put into action earlier, value chains would have been tested by now and the role of the government in facilitating business would have become clear to business owners. What has happened instead is growth based on the construction boom and the service sector tied to the foreign presence. The competitiveness and ingenuity of SMEs to survive after the transition is in question.

Despite a limited government strategy, major donor projects have been completed to support SMEs. These include USAID's five and a half year, \$114 million ASMED programme. ASMED supported value chain development, which helped Afghan businesses maximise their profit and resulted in job creation. The programme also provided in-kind grants and technical assistance to a range of enterprises include gem cutting, carpet cut and wash facilities and cardboard production for packing fruit. ASMED supported both existing business associations and the formation of new ones.

ASMED studied specific industries to assess value gaps. For example, the marble industry needed to enhance finishing techniques and improving links to international markets. This meant direct grant investments in finishing techniques, combined with work with associations and the government to identify business opportunities in foreign markets. The Dried Fruit Exporters Association of Kandahar (DFEAK) and the Fresh Fruit Exporters Union of Kandahar (FFEU) buy from 20,000 farmers in the southern region of the country, exporting about 90 percent of the fruit from the south. With ASMED's support, a box factory was installed in Kandahar, reducing the cost of packaging from \$2 to \$1 per 20 kilogrammes.

To assess its success, ASMED used the number of SMEs (1,300) and jobs (100,000) created under the programme. The challenge is sustainability; a problem which ASMED acknowledges, saying that even in the US, as many as 30 percent of new businesses fail within two years.

## **4.2 Challenges Facing SMEs**

SMEs in Afghanistan are in a fragile state. This is largely due to a lack of attention in the first few years immediately after the US invasion. The government did not have an SME strategy until 2009 and implementation did not begin until 2011. In its initial phase, due to a massive trade deficit, the strategy sought to focus on target sectors that could develop alternatives to imports. Export promotion was not a priority. Despite a lack of clear strategy, projects led by

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<sup>13</sup> Interview with Ministry of Commerce and Industries Official 3. Kabul; December 6, 2013.

donor organisations, such as the United States Agency for International Development (US-AID) funded Afghanistan Small and Medium Enterprise Development (ASMED) project, have tried to fill the gaps in SME value chains and improve technical capacities.

Daunting challenges facing SMEs raise questions about their competitiveness, ingenuity and ability to survive the transition. Among the issues they face are the uncertainty of the business environment and decreasing market confidence; dependence on donor organisations for start-up support; limited access to credit; lack of industrial-level energy, quality control and creativity; limited product diversity and access to markets. Lack of awareness of the workings of the new economic and trade system remain significant impediments to the growth of SMEs. Insufficient human and technological capacity exists, which is exacerbated by a disconnect between market-needs and the education system.

The majority of SMEs operate in urban areas, outside government formal structures. Between 70 and 80 percent remain informal and unregistered, largely pushed to the margins out of fear of entanglement in bureaucracy and corruption<sup>14</sup>. For small and medium business owners, the incentives to formalise their business are minimal compared to the burden of corruption and bureaucracy. This leaves some SMEs, particularly those with export ambitions, vulnerable to exploitation by a mafia of export “commission workers,” which in return undermines the quality of Afghan products as well as affects government revenues.<sup>15</sup>

A 2009 survey by Afghanistan Rural Enterprise Development Programme (AREDP) showed that, besides the obvious problems of security and access to credit, SMEs lacked capacity in business planning and marketing. About 60 percent of the surveyed SMEs expressed a need “for knowledge-based business development”.<sup>16</sup> This was confirmed in ASMED’s assessment of their biggest challenges. Gathering market information and helping SMEs interpret that information is difficult. A 2013 survey by the Afghan Chamber of Commerce and Industries, found that 80 percent of surveyed business owners listed lack of electricity, 78 percent listed corruption, and 32 percent identified land acquisition as their main challenges.<sup>17</sup>

With regard to security, the main concern is “uncertainty and unpredictability” rather than physical security. The majority of SMEs operate out of urban centres, such as Kabul, Mazar-e-Sharif, Herat, Kandahar, Jalalabad, Kunduz, Maimamna, Taluqan and Jawzjan, where physical insecurity is not a crippling problem. Most urban centres have been largely secured in recent years, though potential attacks are not ruled out. The unpredictability stems from the foreign drawdown and the imminent political transition. While Afghan businesses, born in relative insecurity, are adaptive to occasional attacks, the fear of a return to the insecurity that the country faced in the 1990s when business was impossible, has created a hesitation to expand. If the elections get messy this time around, the results could be widespread chaos, which is not good for business.

<sup>14</sup> Interview with Ministry of Commerce Official 3. Kabul; December 6, 2013

<sup>15</sup> Interview with Ministry of Commerce and Industries Official 2. Kabul; December 3, 2013.

<sup>16</sup> *Afghanistan Country Report-Enhancing the Competitiveness of Small and Medium Enterprises in Member States*. Presentation by Afghan Ministry of Commerce and Industries.

<sup>17</sup> ACCI Survey Reveals More Than 50% of Afghan Private Firms are Optimistic about Future. *Wadsam* (June 6, 2013), <http://www.wadsam.com/acci-survey-reveals-more-than-50-of-afghan-private-firms-are-optimistic-about-future-344/> (accessed December 1, 2013)

Access to markets is impacted by the capacity of the business. In the export market, particularly the dried fruit sector, there are some business with decades of export experience.<sup>18</sup> These have simply revived and expanded those connections. However, new SMEs have little capacity in accessing to markets. When exhibitions are held abroad, for example, business owners see it as a one - time sales opportunity rather than an opportunity to network for longer term and larger trade opportunities.

### **4.3 Women and SMEs:**

For women - led businesses, existing challenges are exacerbated by social limitations. Their gender makes access to markets and credit, where property documents are often required for loan insurance, more complicated. Illiteracy and lack of capacity are also key issues. Economic policy - making remains dominated by men and women are not represented in decision - making trade institutions, such as the Chamber of Commerce and Industry and the Afghanistan Investment Support Agency.

While women's participation in the value chain of the Afghan economy is comparable to men's, their role in leading businesses remains marginal. According to figures from the Afghanistan Investment Support Agency (AISA), about 1,600 women - owned businesses have been registered in Afghanistan since 2003. The majority of these are SMEs in the handicraft and business services sectors,<sup>19</sup> which are currently subsidised by donors, calling into question their long - term sustainability.

Without donor subsidies, the sustainability of women's role in the Afghan economy is in question. Social restrictions seem to be increasing in the environment of uncertainty. A recent survey found that support for women to work outside the home fell from 71 percent in 2006 to 63 percent in 2013.<sup>20</sup> The Ministry of Women's Affairs, which is responsible for facilitating women - friendly economic policy, has been heavily criticised for incompetence. Additionally, the Ministry has failed to establish a tangible presence in rural areas. About 77 percent of survey were unaware of the Ministry's activities in their area. There are over 125 women's associations throughout the country, most of which are in Kabul, highlighting the uneven regional growth.<sup>21</sup>

Without an enabling and appropriate environment for work that is rooted in a policy framework, capable women will not realise their full potential because companies are hesitant to give them opportunities.

Access to finance for women - led businesses is more complicated than for male - led businesses. While 17 commercial banks and microfinance institutions offer loans, the insurance for those loans largely relies on property or land ownership, which is limited for Afghan women. Historically, properties are registered by male household members.

<sup>18</sup> Interview with Ministry of Commerce and Industries Official 2. Kabul, December 3, 2013

<sup>19</sup> Anne Simmons-Benton, Jessica Heinzelman, and Jill Sackett, *Economic Empowerment Strategies for Afghan Women*, (USAID Afghanistan, March 2012), [http://pdf.usaid.gov/pdf\\_docs/pnady804.pdf](http://pdf.usaid.gov/pdf_docs/pnady804.pdf)

<sup>20</sup> The Asia Foundation, *Afghanistan in 2013: A Survey of the Afghan People*. December, 2013 <http://asiafoundation.org/resources/pdfs/English2013ExecutiveSummary.pdf>, (accessed January 1, 2014)

<sup>21</sup> Ibid.

Women's businesses also suffer from management capacity. Run with an "NGO - like mentality," they struggle in the face of competition. Some ASMED projects reported problems with budget spending, declining revenue generation and book - keeping within women's businesses. Business capacity building for women needs to move beyond training in specific sectors, such as handicrafts. Capacity building needs to address the rest of the value chain and the need for the existing products to have sustainable access to markets.

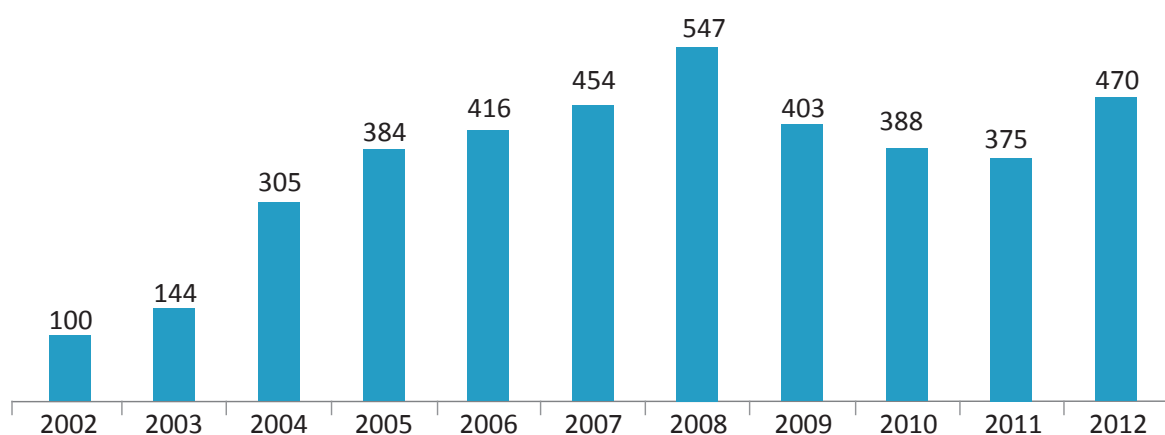
## 5. Afghanistan's Trade

Afghanistan's trade has seen tremendous growth in the past decade, but the deficit has remained massive. While Afghanistan depends heavily on foreign products for its domestic consumption, its exports remain limited, both in volume and variety. The World Bank ranked Afghan business 184th out of 189 economies for cross - border trade. Exports, peaking in 2008, have seen a steep drop since 2011; some items dropping as much as a 50 percent drop.

Officials say the reason for the drop is more complex than just fears linked to the security transition. Corruption and mafia - like networks exporting outside official channels of quality control impact the perception of Afghan produce in foreign products. Transportation, especially cross - border transport, remains a hurdle. At the policy level, the Afghan government has failed to assuage the reticence of Central Asian nations, who remain sceptical of expanding trade with the country, due to the political and security uncertainties. The volume of trade with Pakistan has expanded, but so has informal trade, costing the Afghan government tremendously in customs revenues.

In 2002, Afghanistan exports were estimated at about \$100 million. In 2012, the country's registered exports rose to \$470 million. If unrecorded smuggled goods are considered, the number rises to \$2.6 billion. Exports peaked in 2008 to US\$547 million, largely due to investment confidence as well as the injection of grant money into SMEs.

**Figure 1. Afghanistan's Export Statistics (million US dollars)**

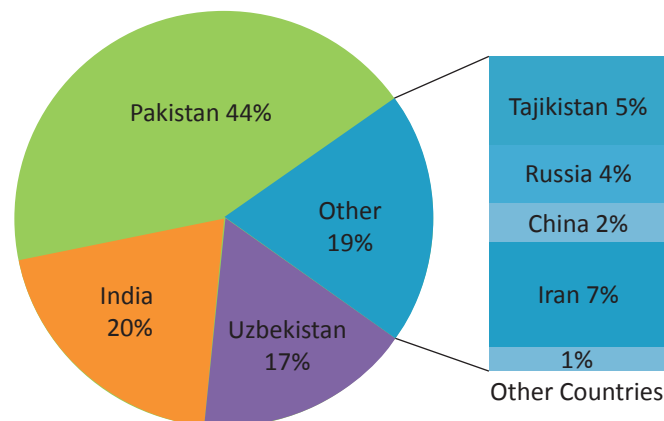


Source: Afghanistan Export Promotion Agency

Improvements in exports may seem substantial because of a low starting point. The Asian Development Bank estimated Afghan exports would reach \$1.019 billion by 2010 without significant improvements in regional trade agreements, and even further to \$1.612 billion if road conditions improve and regional trade was better facilitated. In fact, total Afghan exports only reached \$ 492 million in 2010.

Afghanistan's main trading partners are Uzbekistan,<sup>22</sup> Pakistan and China. In 2012, Afghanistan's total trade with Central Asian countries stood at \$1.5 billion in imports and \$17 million in exports. With Pakistan, Afghanistan's imports were valued at \$597 million and exports were at \$151 million. With China, imports were at \$703 million compared to \$11.6 million in exports.<sup>23</sup>

**Figure 2. Afghanistan's Export Partners**



Sources: Afghanistan Export Promotion Agency and Afghanistan Central Statistics Office

Afghanistan's exports remain limited to traditional items: carpets make up about 40 percent of exports, dried fruit 20 percent, natural herbs 14 percent, and fresh fruit 13 percent. Remaining exports include cotton, hides, animal skins and wool.<sup>24</sup> About 80 percent of Afghanistan's dried fruit goes to or through Central Asia. In 2012, Afghan Raisin Export Promotion Agency reported that the country exported about 20,000 tons of raisins alone to Central Asia.<sup>25</sup> Fresh fruit largely goes to Pakistan, most of it via unofficial channels because trafficking and corruption are more prevalent on the country's eastern border.

### 5.1 Trade with Central Asia:

Central Asian countries remain largely sceptical of the benefits of trade with Afghanistan, particularly in comparison to risks that come from sharing about 2000 kilometres of bor-

<sup>22</sup> Trade with Uzbekistan is largely shaped by electricity imports.

<sup>23</sup> Najla Habibyar, *Recommendation for Central Asian Countries*. A Presentation by CEO of Afghanistan Export Promotion Agency (EPAA), November 12, 2012

<sup>24</sup> Najla Habibyar, *A Presentation by CEO of Afghanistan Export Promotion Agency (EPAA) to USAID's FAIDA programme*, June 2013

<sup>25</sup> Interview with Ministry of Commerce and Industries Official 2. Kabul; December 3, 2013

ders. Much of that fear can be explained by history. Despite the fact that the former - Soviet republics were integral to more than two decades of commercial relations between Kabul and Moscow, the subsequent falling out of Kabul and Moscow during the anti - Soviet *jihad* had great ramifications for the Central Asian nations, particularly during the civil war in Tajikistan. Their insurgents often found refuge in Afghanistan. During the 1990s, official economic relations were close to nonexistent between Afghanistan and Central Asian countries, which were going through a decade of recession associated with transitions.

Between 2001 and 2010, all the Central Asian countries bounced back from the recession and demonstrated economic growth; Turkmenistan reported a double - digit growth in its GDP.<sup>26</sup> The growth in trade for most of Central Asian countries is dominated by primary products such as hydrocarbons and metals. The share of manufactured goods in exports remains low. In 2010, all Central Asia countries only exported 5.9 percent share of their exports to each other. Their exports to the European Union, Russia and China combined made up about 69 percent of their total exports.<sup>27</sup>

In the past decade, Central Asia's trade with Afghanistan has also grown considerably, given its low start. However, the volume remains abysmal compared to Central Asia's trade with other countries. Trade with Tajikistan, for example, has grown from \$3.2 million in 2001 to \$92.1 million in 2010. However, Afghanistan's share in Tajikistan's foreign trade remains below one percent and is largely dominated by electricity and re - exports.<sup>28</sup>

As the uncertainty around the US troop withdrawal increases, the volume of trade between Afghanistan and Central Asia is unlikely to change dramatically in the short term. This is due to Central Asian fears, and because of unresolved "soft issues" such as border clearing and customs technology.<sup>29</sup> Afghan officials complain that Central Asian authorities remain slow in communication. While roads have improved on both sides of the borders, Central Asian governments have made little progress in installing new customs technologies. Reports suggest that Tajikistan, Turkmenistan and Uzbekistan, already suspicious of incoming goods from Afghanistan, plan to reinforce security at their borders as withdrawal begins.

## 5.2 Trade and Transit Facilitation: Infrastructure Development

A key hurdle for Afghanistan in expanding trade with Central Asia, besides security and the uncertain political climate, is infrastructure and trade facilitation. The Logistics Performance Index, developed by the World Bank, paints a bleak but improving picture of where Central Asian countries stand in terms of trade logistics "friendliness". In 2007, out of the 155 countries Afghanistan ranked 150, Tajikistan 146, Uzbekistan 129, and Kazakhstan 129. By 2012, the ranking was improved. Afghanistan moved up 15 places, Tajikistan 10 places, Uzbekistan 12 places and Kazakhstan 47 places.

<sup>26</sup> Roman Mogilevskii, "Trends and Patterns in Foreign Trade of Central Asia Countries", *Institute of Public Policy and Administration Working Paper Series No. 1* (Bishkek: University of Central Asia. 2012)

<sup>27</sup> Ibid.

<sup>28</sup> Khodjamahmad Umarov, "Trade and Economic Relations between the Republic of Tajikistan and the Islamic Republic of Afghanistan," *Institute of Public Policy and Administration Working Paper Series No. 13* (Bishkek: University of Central Asia, 2013).

<sup>29</sup> Interview with Ministry of Finance official, Kabul; November 28, 2013.



**Table 1. Logistics Performance Index**

Country	2007	2010	2012
Afghanistan	150	143	135
Tajikistan	146	131	136
Uzbekistan	129	68	117
Kazakhstan	133	62	86

Source: World Bank Logistics Performance Index<sup>30</sup>

In the past decade, considerable work has been done in Central Asia to improve transport facilitation through infrastructure development, particularly in-country roads and railways. Led by the Asian Development Bank, the Central Asia Regional Economic Cooperation (CAREC) is one body that is coordinating in-country infrastructure projects with the larger vision for trade facilitation<sup>31</sup>. At the heart of the CAREC vision is the development of land transport corridors “that link Central, East, and South East Asia with the Middle East and Europe”. With the goal of creating a fully functioning transport network by 2017, CAREC countries have already implemented 120 transport projects worth \$19 billion. These include building or repairing 4,000 kilometres of roads and 3,200 kilometres of railways. An additional set of infrastructure projects planned over seven years and valued at \$38.8 billion was recently agreed on.<sup>32</sup>

Within Afghanistan, progress in connecting the country through highways has been lauded as a major achievement of the past decade. In 2002, it was estimated that Afghanistan only had 50 kilometres of paved road. Afghanistan now has a 3,200 kilometre long ring road.

A 75 kilometre railroad with a transit capacity of 30,000 to 40,000 tons per month has been built between Uzbekistan and the northern Afghan city of Mazar-e-Sharif. The railroad is considered crucial to NATO's supply route, particularly since the route through Pakistan is increasingly unreliable due to protests and closures. NATO will exit some of its goods from Afghanistan through this northern route. A feasibility study for another 300 kilometres of an east-west railway in northern Afghanistan has been commissioned.

### 5.3 Trade and Transit Facilitation: Soft Projects

Unlike infrastructure development, the “softer” components needed to increase the capacity and volume of trade between Central Asia and Afghanistan have lagged behind and proving a greater challenge to implement.

<sup>30</sup> The World Bank, *Logistics Performance Index* [http://siteresources.worldbank.org/TRADE/Resources/239070-1336654966193/LPI\\_2012\\_final.pdf#page=15](http://siteresources.worldbank.org/TRADE/Resources/239070-1336654966193/LPI_2012_final.pdf#page=15) (accessed December 1, 2013)

<sup>31</sup> CAREC is a partnership of 10 countries receiving technical and financial support from six multilateral institutions: The Asian Development Bank, the European Bank for Reconstruction and Development, the International Monetary Fund, the Islamic Development Bank, the United Nations Development Programme, and the World Bank. <http://www.adb.org/countries/subregional-programs/carec>

<sup>32</sup> Asian Development Bank, “CAREC Ministers Agree on \$23 Billion Action Plan to Boost Central Asia Links,” October 30, 2012, <http://www.adb.org/news/carec-ministers-agree-23-billion-action-plan-boost-central-asia-links?ref=countries/subregional-programs/carec> (accessed December 1, 2013)

Central Asian nations continue to mistrust goods coming from Afghanistan, “because of a perception of drugs and guns”<sup>33</sup>. Physical inspections at borders remain a major hurdle, slowing the flow of goods. Central Asian countries have not yet adopted the technology to integrate trade and transit at their custom points and open standardised lines of communication about goods, particularly transit goods. This has limited trade and increased the cost for traders.<sup>34</sup>

In contrast, Afghanistan has installed the Automated System for Customs Data (ASYCUDA), providing communication and information follows across countries and borders. Afghan custom houses, manned by ASYCUDA trained operators, easily share information across the country. When a truck arrives from Pakistan, transiting Afghanistan to Uzbekistan, it enters the system in Torkham and gets sealed. It exits the system when it leaves Afghanistan in Hairatan. Still, complaints about harassment and corruption at checkpoints remain prevalent. Truck drivers in the east recently threatened to boycott work if the Afghan government does not address the issue of corruption along truck routes.

Afghan officials complain that the technology they have in place does not help them if their trade partners do not have the same technology. Of their key partners, only Iran has an older version of ASYCUDA. The technology is costly and Central Asian nations do not have the same level of international aid as Afghanistan. Afghan officials partially attributes the lack of progress towards the technology to a larger symptom of Central Asian countries lacking “faith in increasing the level of trade” with Afghanistan<sup>35</sup>.

#### **5.4 Policy Framework and Potential for Growth:**

Due to weak infrastructure, the cost of land transport and the lack of confidence in partnerships, interregional trade - flow between the Central and South Asia remains low at about 15 percent of total trade. Afghanistan’s potential in this is massive; not just because it connects Central and South Asia, but also because of its potential to serve as a pivot for India to access European market through Central Asia. Central Asian countries can also become more reliable trade partners for Afghanistan as Pakistan, one of Afghanistan’s main trade partners, continues to struggle with militancy and has proved unreliable in following through with its Afghanistan - Pakistan Transit Trade Agreement (APTTA) commitments. Experts warn that Afghanistan’s trade potential is limited if the focus, particularly of the New Silk Road Initiative,<sup>36</sup> remains on “traffic between Afghanistan and its neighbours”. Rather, the vision should be one of “continued corridors of transport”.<sup>37</sup>

At the policy level, Central Asian countries are not convinced of the US commitment to helping Afghanistan become the transit hub envisioned in the New Silk Road Initiative. Without a specific budget and a clear team leading the project, the initiative has remained “a way of

<sup>33</sup> Interview with Ministry of Finance official. Kabul; November 28, 2013.

<sup>34</sup> Ibid.

<sup>35</sup> Ibid.

<sup>36</sup> Launched former US secretary of State Hillary Clinton in October 2011,

<sup>37</sup> Frederick Starr, “Central Asia, Afghanistan and the New Silk Road.” Presentation at Jamestown Foundation, November 2011.

thinking" to date, and not a concrete strategy. Doubts have been furthered by the US's simultaneous pivot to East Asia.

However, a number of major projects have created some optimism about realizing regional trade potential. The Central Asia - South Asia Electricity Transmission and Trade Project (CASA - 1000), aims to provide hydro - electricity during summer from Tajikistan and Kyrgyzstan to Pakistan via Afghanistan, and is expected to boost economic relations in Central Asia. Afghanistan would benefit from the project as a consumer of about 300 mega watts of electricity, and as a transit nation receiving transit fees, as 1000 mega watts of electricity transit through Afghanistan to Pakistan's national grid. Technical implementation of the project is expected to begin in 2014 and be completed by 2017.<sup>38 39</sup>

The Turkmenistan - Afghanistan - Pakistan - India Natural Gas Pipeline (TAPI) is 1,735 kilometre, \$7.6 billion pipeline. While progress has been slow, steps have been taken recently to ensure the project is operational by the expected deadline of 2017.<sup>40</sup> The pipeline is expected to bring about 3.2 billion cubic feet of natural gas per day to Afghanistan, Pakistan and India from the Dault-abad fields, 200 kilometres within Turkmenistan.<sup>41</sup> The gas will be transported to India through 735 kilometres of Afghan territory (Kandahar and Herat), and 800 kilometres in Pakistan (Quetta and Multan). Recently, the partners signed a Transaction Advisory Agreement to find a reputable international firm to lead the consortium implementing the project. The Asian Development Bank is serving as the transaction advisor.

## 5.5 Trade Challenges and SMEs

For Afghan traders, transportation and transit at the borders, and corruption at customs and taxation offices are the main issues impeding growth. On the eastern front, the Pakistani border is unreliable, gate closing down frequently due to protests over drone strikes. On the northern front, the freight capacity to carry goods is limited, with only up to four trains operating weekly.<sup>42</sup> The railway is only used for imports. The trains bringing goods into Afghanistan return empty because Uzbekistan only allows Afghan goods to arrive via ship. This leaves room for corruption. Additionally, because of corruption, transit goods coming from Pakistan are sometimes prioritised over local produce.

Afghan officials also describe a mafia, with far - reaching ties inside the government. This mafia controls exports to Pakistan and beyond, bypassing the official quality control channels.

<sup>38</sup> Aziz, Afghan Minister Discuss CASA-100 Project. The Daily Times; September 19,2013 <http://archives.dailytimes.com.pk/business/19-Sep-2013/aziz-afghan-minister-discuss-casa-1000-project> (accessed January 15, 2013)

<sup>39</sup> The 1,222 kilometer transmission project is expected to cost about \$820 million. However, funding remains uncertain; the Asian Development Bank has withdrawn, while the World Bank is yet to make a commitment, as the project needs to be presented to its board of directors for a final decision. The US recently promised \$15 million for the project.

<sup>40</sup> "India for Big Push to get TAPI pipeline," *The Hindu*, November 23, 2013 <http://www.thehindu.com/business/Industry/india-for-big-push-to-get-tapi-pipeline/article5383455.ece>

<sup>41</sup> "Another Agreement on TAPI Gas Pipeline Project Signed in Ashqabat." *Turkmenistan.Ru* <http://www.turkmenistan.ru/en/articles/17490.html>

<sup>42</sup> BBC Persian, *Hairtan, Afghanistan's Gateway to Central Asia* [http://www.bbc.co.uk/persian/afghanistan/2012/10/121004\\_album\\_hairatan\\_port\\_afghanistan.shtml](http://www.bbc.co.uk/persian/afghanistan/2012/10/121004_album_hairatan_port_afghanistan.shtml), (accessed December 1, 2013)

This impacts Afghanistan's revenues as well as brings down exports. In some cases, onions for example, the product exported by the mafia reenter Afghan market at a price three - to - four times higher than the original price. The mafia is also known to import low - quality foreign dried fruit, such as Iranian and Brazilian almonds, mix it with Afghan dried fruit, and re - exporting it, again bypassing quality control. This affects the perception of the quality of Afghan products and, in this case, decreases demand for Afghan dried fruits.<sup>43</sup>

## **5.6 SME Case Studies**

### **5.6.1 Tabasum Raisin Processing, Kabul**

The Kabul-based Tabasum Raisin Processing company was launched in 2007. The owner had 17 years of experience exporting raisins to Central Asia prior to establishing Tabasum. With about 110 workers, the company processes and exports between 3,000 and 4,000 tons of raisins a year to Central Asia, and from there to Europe and North America. About 60 percent of the company's workers are male and 40 percent are female. Tabasum gathers its raisins primarily from small - scale farmers, but also from other companies.

Last year, over 3,000 tons of dried fruits, largely raisins, was stranded at the border in Hairatan for three month, waiting for a ship to transfer it to Uzbekistan. According to officials, cement and oranges coming from Pakistan were given priority over the Afghan raisins. About 1,700 tons of the stranded dried fruit came from Tabasum. This incident affected Tabasum's relationship throughout the value chain, but especially with the clients in Central Asia and Europe. When the raisins finally made it through months later, the product life span had been shortened.

Tabasum reports a 30 percent decline in exports over the past two years. This is partially due to problems at the borders and partially due to tough competition from neighbouring countries, particularly Iran.<sup>44</sup> With the Iranian currency depreciating rapidly in recent years, the price of Iranian raisins has dropped, making it difficult for Afghan exporters to market their product. Tabasum has since diversified its export routes, using Pakistan, as well as the Afghan border town of Aqina, from where the raisins are transported to Turkmenistan and Iran and then Turkey.

The construction of the Uzbekistan - Hairatan railway line raised the hopes of Afghan traders, but it remains in use only for imports. Almost all imports, excluding oil and wood, come by rail. Oil and wood transit by ship from the river port of Termez to Hairatan. This began in 2011, when the demand for imports was high and the capacity of Afghan terminals to unload from rail cargos was limited. Despite increased terminal capacity and excess capacity on the railway, wood and oil continues to be brought by ship.

Afghan exporters have repeatedly called on the government to address the issue of transport bringing goods into Afghanistan do not return empty. However, Uzbekistan remains sceptical about the security of goods coming from Afghanistan by rail. In addition to this being an inefficient use of railway resources, the ships operating between Termez and Hairatan are few and

<sup>43</sup> Interview with Ministry of Commerce and Industries Official 2.

<sup>44</sup> Interview with Owner of Tabasum Raisin Processing, Kabul, December 1, 2013

old and goods have been drowned.<sup>45</sup> Additionally, using only ships for exports means that goods are loaded and unloaded more than the usual. Tabasum's boxed raisins, for example, are loaded at the warehouse in Kabul, driven to Hairatan and unloaded, loaded onto the ship, unloaded again in Tarmez across the river, loaded onto a train, unloaded onto a truck before they reach their destination. By the time the boxes reach the customer, the packaging is in bad shape.

Another challenge Tabasum reports is having to clear its balance with the government annually, which requires bribes. Tabasum has to clear two accounts, one for processing, one for export. The license for each of the operation falls under a different government entity, requiring Tabasum to clear its balance twice at the end of each year.

### 5.6.2 Ariana Trading, Balkh

Ariana Trading imports flour and oil and other cooking materials from Central Asia, and exports raisins and herbs to Central Asia and Europe. The company employs 26 people in its export and import business. In the last half of 2013, Ariana exported 500 tons of semi - processed raisins through Hairatan and Aqina.

For Ariana Trading, corruption at border crossing points, particularly at eastern and southern borders with Pakistan, makes market competition difficult. A recent survey of traders showed that with the exception of Kabul, corruption was a major issue at all entry points into Afghanistan, with Aqina, Spin Boldak, Hairatan, Miran Shah and Torghandi reported as corrupt by over 75 percent<sup>46</sup> of respondents.<sup>47</sup> Ariana and several other Balkh traders used to import Malaysian vegetable oil through Hairatan and sell it throughout the country. Cooking oil from Malaysia is considered high quality in Afghanistan. However, the largely impoverished nation also demands low prices.<sup>48</sup> In the past two years, Kandahari businessmen have imported the same Malaysian oil through Pakistan. With corruption prevalent at the Pakistani border crossings, southern traders end up paying less custom duty when they import through Spin Boldak. Kandahari traders end up providing the same Malaysian vegetable oil for much cheaper than what Ariana Trading and other Balkh business offer. As a result, Balkh businesses have completely stopped importing vegetable oil.

<sup>45</sup> Interview with Balkh Chamber of Commerce and Industry official. Mazar-e-Sharif, December 9, 2013

<sup>46</sup> Saeed Parto, Jos Winters, Ehsan Saadat, Mohsin Usyan, and Anastasiya Hozyainova. "Afghanistan and Regional Trade: More, or Less Imports from Central Asia?", Institute of Public Policy and Administration Working Paper Series No. 3 (Bishkek: University of Central Asia, 2012)

<sup>47</sup> Owners of Ariana Trading say corruption is less of an issue for them at the northern borders, which contradicts the survey finding. The discrepancy could be explained by the fact that Ariana has outsourced clearing its goods at customs to commission workers who charge a service fee of about \$40 per cargo of about 60 tons. If there is corruption, Ariana Trading does not experience it first-hand.

<sup>48</sup> Saeed Parto, Jos Winters, Ehsan Saadat, Mohsin Usyan, and Anastasiya Hozyainova, "Afghanistan and Regional Trade."

## 6. Conclusions and Policy Recommendations

With the imminent decline in aid following the foreign withdrawal from Afghanistan, attention is bound to shift to the deficiencies of the country's economic structure. The heavy reliance on aid and spending tied to the military presence has meant that the private sector, the engine of growth for the country's economy, has not received timely attention. As the uncertain political and security climate will continue to limit large investments, SMEs will remain at the core of the Afghan private sector. However, SMEs lacked a government strategy until as late as 2009, and even then, implementation did not begin until 2011. With adequate attention, SMEs could have developed more capacity and self-sufficiency. However, corruption, real and perceived, and a lack of clear benefits have kept a majority of SMEs informal and unregistered. Those that are involved in trade remain prey to corruption.

Trade and transit with Central Asia has long been touted as having a potential major economic boost for Afghanistan. However, it remains at a modest level and the volume is unlikely to grow dramatically in the near future as major hurdles remain. Central Asian countries are hesitant about expanding the volume of investment in trade in Afghanistan at a time of uncertainty. Their hesitance is evident in their slow policy shifts and lack of investment in "softer projects", such as customs technology, that would pave the way for increased cross-border trade. The US has not quelled Central Asia's justified fears; despite much hype, the New Silk Road Initiative has not turned into an actual strategy as the US has begun a pivot to Asia.

On the Afghan side, most trade is conducted by SMEs, with the exception of energy-import projects that are either run by the government or larger companies. SMEs involved in trade face multiple problems that hamper their expansion. The most serious of these are political and security uncertainty and problems transiting the border. Their desire to expand transactions, particularly exports which Afghanistan aims to increase as the trade deficit is massive, are met by limited transport and customs capacity at ports of entry.

Afghanistan's implementation of new customs technology, remains useless to a large extent because its neighbours have not installed the same technology. Corruption at the borders means goods transiting from Pakistan get priority over Afghan exports. Corruption also makes market competition for importers difficult. Those traders importing goods through more porous borders with Pakistan, where customs revenue collection is less rigid due to corruption, can sell their goods at a cheaper price than traders importing the same product via northern borders with Central Asia.

### Recommendations

- **Raise awareness of the role of government in business development:** With the decline in aid and military spending, the Afghan government will increasingly become the focal point for businesses. Many business owners remain uncertain about the role of government in business facilitation under the new economic policy. A well-orchestrated campaign is needed to inform business-owners about when they can seek help from the government and when demands go beyond the government's limited role in the market economy.

- **Include women:** Female business leaders are completely missing from policy - making bodies such as the Afghanistan Investment Support Agency and the Afghanistan Chamber of Commerce and Industry. Female - owned SMEs are struggling and public acceptance of women working outside home is declining. The presence of women in the decision - making bodies could result in formulation of policies that create more enabling environments for women in business.
- **Coordinate the Implementation of the SME Strategy:** With a clear SME strategy finally in place, the SME Directorate at the Ministry of Commerce and Industry coordinating implementation remains understaffed. The government needs to increase human resource capacity within the directorate to meet the demand.
- **Build SME Capacity to Find and Engage New Markets:** Afghan traders still struggle in finding markets abroad. The culture of exhibitions, largely subsidised by international organisations over the past decade, needs to be better rooted in the trade community. The government needs to help SMEs in marketing and networking strategies to engage long - term clients, not just immediate sales at exhibitions.
- **Link Business Needs and the Education System:** The SME Directorate should work with public and private educational institutions to ensure that educational curricula reflect local economic and business needs.
- **Facilitate SME Formalisation:** Inefficient bureaucracy and corruption, combined with no clear incentives for SMEs, has kept a majority of SMEs outside the government's sphere of influence. The process of registering businesses has been simplified, but licensing remains complicated. The Afghan government needs to simplify the licensing for SMEs if it wants to bring more of the sector under its formal supervision.
- **Improve Communication with Central Asia:** Afghanistan has struggled with communications with Central Asian countries. Officials describe interactions as infrequent and difficult to arrange. The result is low level of coordination at the border crossing point. Streamlined channels of communication are needed to facilitate hearing about problems from traders and the removal of barriers. Improved communication could help address transit issues, such as the frequency and condition of ships at Hairatan port, or working out an agreement for Afghan goods to be transported in train wagons that return empty.
- **Gain Clarity on the New Silk Road Initiative:** The United States needs to clarify the exact framework for its New Silk Road Initiative. This clarity could help Central Asian nations assess the benefits of investing in customs technology and trade facilitation to pave the way increased trade with Afghanistan.

## Resources

Roman Mogilevskii. "Trends and Patterns in Foreign Trade of Central Asia Countries." *Institute of Public Policy and Administration Working Paper Series No. 1*. Bishkek: University of Central Asia, 2012.

Saeed Parto, Jos Winters, Ehsan Saadat, Mohsin Usyan, and Anastasiya Hozyainova. "Afghanistan and Regional Trade: More, or Less Imports from Central Asia?" *Institute of Public Policy and Administration Working Paper Series No. 3*. Bishkek: University of Central Asia, 2012.

Khodjamahmad Umarov. "Trade and Economic Relations between the Republic of Tajikistan and the Islamic Republic of Afghanistan." *Institute of Public Policy and Administration Working Paper Series No. 13*. Bishkek: University of Central Asia, 2013.





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