

POLICY SOLUTIONS FOR ECONOMIC GROWTH IN A DEVELOPING COUNTRY

Perspectives on Afghanistan's
Trade and Development

NASSIR UL HAQ WANI



Policy Solutions for Economic Growth in a Developing Country

First of its kind, comprehensive and illuminating insight into Afghanistan with concrete recommendations on how the country can thrive and help itself reform its trade and trade relations with the world.

—*Dr Ahmad Khalid Hatam,*
**Chancellor, Kardan University,
Kabul, Afghanistan**

Immersing myself in the pages of this book, I journeyed through the world of Afghanistan's global trade, concluding with enriched insights essential for academics and policymakers.

—*Dr Behnaz Saboori,*
**Assistant Professor,
College of Agricultural and Marine Sciences,
Sultan Qaboos University, Muscat, Oman**

I highly recommend this book for its in-depth exploration of Afghanistan's international trade journey, especially post-2001. It provides valuable insights for policymakers and scholars, offering innovative trade proposals and insights into Afghanistan's global trade role. Essential for understanding Afghanistan's trade potential.

—*Dr Lyla Abdul Latif,*
**Chair and Research Lead, Committee on Fiscal Studies,
University of Nairobi**

This book provides a timely and profoundly insightful exploration into a fundamental question that has bedevilled economic policy planning for decades – how should developing countries achieve economic growth? Straddling the topics of international trade, globalisation, economic development, state policy planning and private sector development, Wani diagnoses the impediments to export-oriented growth and proposes ambitious recommendations that may serve as correctives. His focus on Afghanistan provides a rich site for exploring these challenges. Using extensive quantitative analysis alongside well-established theoretical models, Wani positions Afghanistan vis-à-vis its regional neighbours as well as concerning ASEAN and SAARC nations and the European Union, thereby evincing opportunities for enhanced international trade. While optimistic, he also raises the trade-offs of different policy choices. The book draws on Wani's decade of scholarly engagement with Afghanistan's economy, ultimately succeeding in providing lessons on economic growth that may be applied to much of the developing world.

—*Dr Nafay Choudhury,*
London School of Economics and Political Science

Policy Solutions for Economic Growth in a Developing Country: Perspectives on Afghanistan's Trade and Development

BY

NASSIR UL HAQ WANI

Kardan University, Afghanistan



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INVESTOR IN PEOPLE

Dedicated to ...

The Humble People of Afghanistan

&

My Beloved Parents (Gh. Mohi Ud Din Wani and Sara Parveen)

My Wife (Amina Hamid)

Our Daughter (Ummat-Un- Nafiyah) and Son (Ahmad Ehaan Wani).

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List of Abbreviations

ADF	Augmented Dickey–Fuller
AFTA	ASEAN Free Trade Area
APPTA	Afghanistan Pakistan Preferential Trade Agreement
APTTA	Afghanistan–Pakistan Transit and Trade Agreement
ARDL	Auto Regressive Distributed Lag
ASEAN	Association of South East Asian Nations
ATP	Afghanistan Trade Policy
BFTAs	Bilateral Free Trade Agreements
BIMSTEC	Bengal Initiative for Multi-Sectoral Technical and Economic Cooperation
BOP	Balance of Payments
BTA	Bilateral Trade Agreement
BSA	Bilateral Security Agreement
CAB	Current Account Balance
CAD	Current Account Deficit
CAR	Central Asia Region
CES	Constant Elasticity of Substitution
CCE	Commodity Composition Effect
CIF	Cost Insurance and Freight
CL	Civil Liberties
CMS	Constant-Market-Share
COR	Changes in Official Reserves
CSE	Commodity Structure Effect
DAB	Da Afghanistan Bank
ECA	Europe and Central Asia
ED	Export Survival
ES	Export Sophistication
ESCAP	Economic and Social Commission for Asia and the Pacific

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EU	European Union
FMOLS	Fully Modified Ordinary Least Square
FOB	Free on Board
GATT	General Agreement on Trade and Tariffs
GDP	Gross Domestic Product
GFI	Global Financial Integrity
HHI	Herfindahl–Hirschman Product Concentration Index
HOS	Heckscher–Ohlin–Samuelson
HS	Harmonised Standards
IARTII	Intra-Regional Trade Intensity Index
IERTII	Inter-Regional Trade Intensity Index
IMF	International Monetary Fund
IRTS	Intra-Regional Trade Share
LF	Lafay Index
MDE	Market Distribution Effect
MENA	Middle East Nations
MFN	Most Favoured Nation
MNNA	Major Non-NATO Ally
NAC	Net Acquisition of Non-Bank Private Short-Term Capital
NAFA	Net Acquisition of Foreign Assets
NAFTA	North America Free Trade Agreement
NFDI	Net Foreign Direct Investment
NTBs	Non-Tariff Barriers
NTMs	Non-Tariff Measures
ODA	Official Development Assistance
PTA	Preferential Trade Arrangement
RCA	Revealed Comparative Advantage
RCF	Reverse Capital Flow
RDE	Residual Competitiveness Effect
REER	Real Effective Exchange Rate
RTA	Regional Trading Agreements
SA	South Asia
SAARC	South Asian Association for Regional Cooperation

SAE	Structural Adaptation Effect
SAFTA	South Asian Free Trade Agreement
SAPTA	South Asia Preferential Trade Agreement
SBC	Schwarz Bayesian Criterion
SIGAR	Special Inspector General for Afghanistan Reconstruction
SITC	Standard International Trading Classification
SPS	Sanitary and Phytosanitary
TBT	Technical Barriers to Trade
TC	Trade Costs
TCI	Trade Complementarity Index
TO	Trade Openness
TP	Tariff Preferential
TR	Tariff Rate
UN	United Nations
UNCLOS	United Nations Conventions of Law of Sea
UNCTAD	United Nations Conference on Trade and Development
WEF	World Economic Forum
WITS	World Integrated Trade Solution
WTO	World Trade Organization

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About the Author

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Preface

This book combines my writings on international trade and development at Kardan University (KU) since joining KU in 2017. All the papers aim to develop concepts and ideas concerning trade and development in Afghanistan. This book provides a longitudinal study of Afghanistan's involvement in multilateral trade negotiations, highlights the policy propositions for enhancing and expediting trade ties with the region and other trading partners and presents policy discourse on key elements akin to trade escalation and growth.

This book offers a detailed analysis and explores the possibility that economic globalisation may finally deliver to developing countries what they had failed to achieve in five decades of multilateral negotiations – an opportunity to climb the industrialisation ladder and achieve development. The book offers a proposal for revising the format of trade negotiations in a way that helps overcome stalemates and deadlocks. Perspectives on trade and development will interest students and scholars of international trade, trade and development, negotiation, global governance, political economy, international relations and economics.

The volume thus addresses several issues and challenges fairly novel to the Afghanistan economy in general and the trade sector in particular. This book will be most suitable for applied courses on international trade and development for graduate and undergraduate students and for policy and decision-makers in the government.

I benefitted from a personal association with Dr Ahmad Khalid Hatam (Chancellor and Professor) at KU. It is hoped his influence on my work will have prevented detection. I benefited greatly from other faculty members at many presentations, conferences and workshops at KU and abroad. A special thanks to Dr Jasdeep Kaur Dhami (Professor and Dean R&D, CT University, Punjab, India), Dr Nafay Choudhary (British Academy Postdoctoral Research Fellow at the Centre for Socio-Legal Studies [CSLS], University of Oxford), Dr Amruta Deshpande (Assistant Professor, Indira School of Business Studies PGDM, Maharashtra, India) and Dr Suhailah Akbari (Postdoctoral Researcher at Humboldt Universität zu Berlin), for motivating and helping me with the research materials and offering conducive feedbacks whenever needed.

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Dr Nassir Ul Haq Wani

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I BLAME ALL OF YOU. Writing this book has been an exercise in sustained suffering along with great learning, and finally, that learning outweighs the suffering. The casual reader may perhaps exempt himself from excessive guilt, but for those of you who have played the larger role in prolonging my agonies with your encouragement and support as well. . .you know who you are, and you owe me but anyway. . .

All praises and thanks to Almighty Allah who bestowed me with the potential, ability and opportunity to work on this book. It is a matter of great pleasure to express my cordial gratitude to KU's top leadership including Mr Roen Rahmani and Ms. Meena Rahmani for the support and encouragement that they have given throughout this research work. The support extended by them throughout the course of writing this book is beyond words.

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Finally, I respectfully offer thanks to my beloved parents (Gh. Mohi Ud Din Wani and Sarah Parveen), for their love, mellifluous affection and sincerity which hearten me to achieve success in every sphere of my life. I am highly indebted to my wife Aamina Hamid for her frequent help, care and encouragement during the course of writing this book. A big thank you to my daughter (Ummatun Nafiyah) and son (Ahamd Ehaan Wani) for making my work easier, by having a cute smile always on their faces. That cute smile is like an energy booster always.

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Part I

Introduction

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Introduction to the Book

1. Background

This book examines Afghanistan's participation in international trade and evaluates its involvement in global trade. The post-World War II trading framework did not accommodate, and in some circumstances excluded, the developmental goals of newly independent nations, and the emergence of this book provides a thorough examination of the following topics. This book does not discuss the economic fragility that doomed Afghanistan before 2001; however, a sincere effort to discuss the trading mechanism and other phenomena is vigorously discussed post-2001. This book further examines the prospect that economic globalisation would finally provide underdeveloped nations with what they have been unable to accomplish during five decades of international negotiations: a chance to climb the industrialisation ladder and attain development. The book proposes altering the framework of trade talks to avoid stalemates and deadlocks. The collection of papers offers Afghanistan numerous policy options and options for positioning itself to obtain entrance into international markets to position itself as a reliable and appealing trading partner on a global scale.

Gauging the present situation of the export industry reflects fundamental constraints that need to be addressed via policy dialogue. The export sector faces serious impediments, as identified in the preceding chapters, such as a dearth of the exceptional workforce for managing endeavours in a rapidly evolving global marketplace, a deficiency of creative operations that impede export firms' capacity for acquisition in implementing advancements in technology in both manufacturing and service procedures, a scarcity of financing for export firms, and inefficient affordable infrastructures.

Afghanistan's export performance is additionally constrained by the government's anti-export prejudice, which prohibits resources from being reallocated from the import-competing economy to the country's export sector. Excessive domestic market protection, especially for exporting-oriented businesses, results in inefficiencies, waste and reduced product and service quality; consequently, the export sector bears the burden of protection. The prevalence of allowances and exceptions for non-traded manufacturing has shifted native producers' interest from quality products as well as the export market; the incentive and incidence of

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fleeing the capital and bypassing import taxes contributed to trade mis-invoicing, undermining trade policy's goal; and an unsupportive credit policy for trade and other economic reforms was never implemented.

The export revenues have varied drastically because of a shortage of significant exportable commodities and a relatively limited production and export base. Export concentration has increased the danger of fluctuating export revenues. Afghanistan's principal export items suffer trade restrictions in overseas markets, limiting export capability. The export base is undiversified and focused on relatively low-value-added items; exports concentrate in marketplaces in which growth in imports is slow, generating limited possibilities for export growth; trade costs are high because of the absence of global links and trade facilitation; and export tactics has always concentrated on merchandised exports while ignoring exports of services that might substitute for them.

Given the poor pace of the export sector and economy, Afghanistan must brace itself for a significant policy commitment to begin on a growth path to re-energise its economy and exports. By adopting trade policy decisions, the nation may assure long-term growth, expand possibilities for residents and methodically obtain a larger share of the expanding global wealth. The chapters in this book evaluate the national, international, and regional trading platforms to launch a consistent and long-term set of policies to encourage exports. These studies emphasise that besides macroeconomic stability, governance and private sector development, technical advancement, socio-economic balance, trade liberalisation and export revitalisation may all play an important role in Afghanistan's wealth generation. These chapters discuss the worldwide trade and economic consequences of Afghanistan. The study is carried out utilising cutting-edge models and estimate approaches.

2. The Perspective

The primary goal of this introductory chapter is to synthesise the findings of all of the investigations in this collection. The chapters are succinct, energetic, and profound. The book has eight chapters covering critical aspects of Afghanistan's foreign trade and economic growth. The book is further divided into four parts, with part two focusing on the nexus between Trade and Development, part three hinges on determinants of trade costs, export supply, diversification and growth and part four discusses the policy discourse analysis by offering policy insights with an international perspective and offering a gateway for the stage of development.

The paper included in Chapter 1 discusses *Afghanistan's Regional Integration with Central Asia: Identifying Trade Linkages, Economic Recital, and Future Latency*. Using different trade indices spanning 2018–2021, this paper investigates Afghanistan's current patterns, prospects and barriers for intra- and inter-regional trade perspectives, emphasising the various pathways by which Afghanistan trades with Central Asian economies. The empirical findings reflect that the potential value of trade between Afghanistan and Central Asia is about twice as

high as the actual level. Furthermore, the analysis categorises industries that range from sector diversification across resource-intensive, labour-intensive and technology-intensive industries. The study further augmented Afghanistan's trade potential with Central Asia and vice versa by highlighting the comparative advantage, diversification, complementarity and similarity in trade. The findings suggest that larger economies are rated higher than smaller ones as size and development level are essential factors in regional trade development. The most effective channels of regional trade development are price competitiveness measures, intra-industry trade and trade complementarities. These results significantly impact the crafting of various trade policy initiatives to promote trade within and between the two regions. These policy initiatives could be implemented to encourage investment and trade in and between the two regions.

Chapter 2 evaluates the trade potential of Afghanistan with SAARC and the European Union by employing the Gravity Model Approach. The impact of trade on economic growth has been phenomenal. Thus countries reaping the trade dividends diversify their trade destinations. Against this backdrop, this study investigates the trade potential of Afghanistan with the SAARC and European Union by employing an augmented Gravity Model approach. The model used the latest Economic and Social Commission for Asia and the Pacific (ESCAP) dataset with the base year 2016. The study used panel data for seven years, from 2015 to 2021. The results of the study satiate that out of the chosen 15 countries of the European Union, the magnitude of Afghanistan's trade potential is high with three EU countries (Germany, France and Spain), whereas in the case of SAARC, Afghanistan's trade potential is highest with Pakistan, followed by India and Bangladesh. Results show that simple average tariff imposition and partner countries' GDP positively impact Afghanistan's trade value.

Chapter 3 highlights the determinants/drivers of export supply in selected South Asian economies, primarily focusing on Afghanistan. Given the significance of international trade and export performance in economic development, this research investigates the drivers of exports in SAARC countries from 2008 to 2021, utilising pooled time series and cross-section data. This research aims to determine if classic trade model elements, developing trading realities or macro-economic variables influence export supply choices. The approach used is the export demand model and the augmented-exports supply model, which are provided with relevant variables. The model with fixed effects (country-specific intercepts) examines the connection between exports and their possible drivers. Traditional export supply models show that production capacity, variable cost and relative price significantly impact South Asian export supply performance. Changes in trade, for example, have a substantial impact on export supply, demonstrating that the trade reform process promotes export growth, import compression and technological innovation. The deterioration of the energy sector and rising levels of corruption have proven to be significant impediments to export supply selections. According to the research, FDI has a favourable but modest influence on export growth. GDP, GDP growth, official development aid, development expenditures, indirect taxes, labour force and real exchange rate benefit exports. Furthermore, the findings demonstrate that an increase in savings

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considerably impacts exports. The report recommends that concerned governments reassess their export policies and develop new approaches that align with changing realities to grow and improve export performance.

Chapter 4 explains export diversification in ASEAN and SAARC regions by empirically investigating the trends and factors. Emerging countries have experienced export product concentration primarily due to manufacturing and exporting raw materials and semi-manufactured goods. While these products do not often have market access issues, they have inelastic demand in foreign markets, and close replacements are easily accessible. In developed markets, finished manufactured goods exported by underdeveloped nations face substantial trade obstacles. As a result, these nations' exports are heavily centred on raw materials and semi-manufactured goods. Countries having export concentration are more sensitive to external shocks. Aware of the negative consequences, ASEAN and SAARC nations have prioritised export product diversification to increase exports and per capita income to globalise their economies. This study examines the trends and factors affecting export diversification in ASEAN and SAARC regions by employing the normalised Hirschman index covering the data from 2018 to 2021. The findings suggest that structural transformation was aimed at shifting the production line from basic and intermediate goods to exporting finished products. Except for the fuel-intensity variable, which demonstrates the dependence on natural resource exports minimises motives for broadening exports, the statistical results exhibit that all variables, such as competitiveness, industrial sector growth rate, institutional endurance, domestic capital growth, financial growth and macroeconomic situation efficiency, are positively and significantly associated with export diversification. The study's main finding is that institutional strength enables countries to diversify their exports.

Chapter 5 discusses Afghanistan's trade costs, primarily focusing on determinants and measurement. The trading expenses encountered domestically and across borders have a detrimental influence on global trade. Higher trade costs hamper trade and limit the benefits of trade liberalisation. The present study employs Novy's (2013) micro-founded trade cost measure to estimate the relative bilateral trade costs of Afghanistan's (agricultural and non-agricultural) trade with its significant trading partners. The advantage of employing this model is that trade costs may be determined purely from observable trade data. The data show that agricultural trade costs are much higher than in the non-agricultural industry.

Consequently, focusing on agricultural trade facilitation would be advantageous. The research also investigates the elements that determine trade costs. It reveals that two sectors, trade infrastructure and free trade zones with trading partners, are ideal for governmental intervention to mitigate trade costs. Better shipment communication with trade partners increases transportation routes efficiently, cutting time and other expenses. Similarly, free trade agreements reduce trade costs by lowering non-tariff and behind-the-border regulatory measures. The study suggests successfully executing the WTO's trade facilitation agreement, decreasing red tape at border crossings, simplifying and harmonising

non-tariff barriers (NTBs) and establishing soft infrastructures using current technologies.

Chapter 6 highlights the occurrence of the reverse capital flight to Afghanistan by analysing the incidence of evidence. Afghanistan has seen capital flight, which has long perplexed policymakers and planners, and concerns have been expressed about the 'paradoxical' nature of capital outflows (capital), which jeopardises national welfare. A craving for foreign exchange due to portfolio reasons, excessive taxation, the expectation of a significant exchange rate realignment, macroeconomic (large fiscal deficit and current account deficit), political instability and other external pull factors are the driving forces behind capital flight from a country. The illegal outflow of money is often supported by remittances routed via the Hawala (correspondence) system, under-invoicing of exports, over-invoicing of imports and capital transfer through smuggled precious metals, antiquities and other items. This study aims to investigate the nature and prevalence of reverse capital flight in Afghanistan. The results state four critical reasons for reverse capital. It aids in whitening black money (money laundering), which was previously unlawfully flown out of the nation; secondly, it allows import tax evasion and the realisation of unnecessary export rebates and refunds; thirdly, it facilitates the avoidance of non-tariff measures (NTMs) on imports; and lastly, it provides for the concealment of investment in the underground economy. The analysis recommends maintaining a detailed record of illegal cash flows in Afghanistan since the nature of trade in Afghanistan is arduous due to the simultaneous flow of illicit capital. Adjusting unrecorded private capital flows (from short-term capital movements or payment flows that do not show up immediately in recorded statistics) with illicit flows of capital arising from trade mis-invoicing becomes crucial.

Chapter 7 depicts the debate on trade creation vs trade diversion and general equilibrium effects in Afghanistan's regional and bilateral free trade agreements. This article emphasises welfare as a severe concern produced by free-trade zones and corresponding preferential tariff reductions as economies increasingly participate in regional and bilateral free-trade agreements. The impact of regional and bilateral free-trade agreements on Afghan imports is ascertained. As such, the technique isolates the effects of tariff changes due to free-trade agreements from the general equilibrium effects due to unobserved factors impacting the country's imports (historical ties, common language and culture, landlocked). This method evaluates whether preferential tariff reductions favouring partner countries would benefit or harm member countries. The findings show that the impact of trade creation is much more significant in scale than the impact of trade diversion. Surprisingly, trade creation produced by general equilibrium effects outperforms trade creation caused by tariff preferences offered to member countries. Afghanistan's free trade agreements are not harmful but enhance living conditions. The report recognises South Asian Free Trade Area (SAFTA's) trade growth potential. Of course, SAFTA requires members to demonstrate a solid commitment to regional integration and increased liberalisation via a more readily improved tariff structure and procedures, a trade facilitation system and simplified financial services. The findings are significant since WTO members are often wary of

Regional Trade Agreements (RTAs) or Bilateral Free Trade Agreements (BFTAs) because trade diversification harms welfare. However, trade diversion is only sometimes damaging since the consumer advantage from trade outweighs the trade losses implied by moving imports to the higher cost partner country. Consumption advantages accrue in trade because consumers may now consume imports at a lower price, closer to the true (distortion-free) global price determined by the least-cost non-member countries.

In contrast, simple average tariff imposition bilaterally harms the trade volume of the reporting country. Statistically, a 1% tariff rate change will decrease by 0.3% in Afghanistan's total trade. Moreover, a 1% increase in the GDP of the partner countries will increase Afghanistan's total trade by 0.5%. Furthermore, common language, landlocked and distance significantly impact Afghanistan's total trade. The results suggest that Afghanistan needs to explore the ways and means to improve its trade relations with the countries further and improve its market share. The study proposed that Afghanistan should use trade as an economic development tool to flourish in the region and capture the markets to realise its maximum trade potential. This research recommends that South Asian and EU countries revise the tariff rates and other non-tariff barriers to boost trade and connectivity for a better trade future.

Chapter 8 offers a conducive understanding of the impact of NTMs on trade within the SAARC region, primarily targeting Afghanistan. The benefits of global trade are attributed principally to reducing trade distortions between trading partners. The anticipated promise of a progressive diminution in tariffs throughout the globe was, regrettably, steadily superseded by NTMs. However, the impact of these NTMs is only sometimes evident since it occurs in various disguises. NTMs significantly influence trade in the SAARC, mandating prompt attention. The question is how much internal trade will expand if NTMs are repealed. Based on statistics from 2015 to 2020, the study endeavours to quantify the impact of NTMs on Afghanistan's trade volume within the SAARC region, primarily targeting four export destinations (Bangladesh, India, Pakistan and Sri Lanka). Using trade freedom scores as a proxy for trade distortions, it has been determined that Afghanistan's magnitude of export earnings is significantly lower due to NTMs imposed by its importing trading partners. According to the findings, a 1% rise in tariffs and NTMs applied by importing countries diminishes Afghanistan's exports by 1.23%. In contrast, the impact of tariffs alone lowers Afghanistan's exports by 1.13%. The incidence of NTMs also devoid actual Afghanistan exports by US\$ 5.70 million, equal to a 0.029% loss of Afghanistan's GDP. The calculations also reveal that lowering or eliminating non-tariff barriers has diverse trade-growth effects in different trade groupings. The study recommends a serious NTM-oriented trade policy dialogue that is liberal and guarantees regional integration, thereby promoting and ensuring the future of Afghanistan's economic laurels and stability.

Hence, this book delivers an extensive and eclectic compilation of articles aimed at designing policies to reinvigorate exports from Afghanistan thoughtfully. The book encompasses insights based on current advances in international trade theory. The book argues to focus on the issues and challenges highlighted in