Ministry of Economy

Islamic Republic of Afghanistan

DRAFT
PRODUCTIVE AFGHANISTAN STRATEGY
2019 - 2025

Afghanization I Commercialization I Industrialization

NOVEMBER 2018

GENEVA CONFERENCE ON AFGHANISTAN

Acronyms & Abbreviations

ACCI	Afghan Chamber of Commerce and Industries
ACD	Afghan Customs Department
ACDR	Afghanistan Commercial Dispute Resolution Centre
ACEPA	Afghanistan Centre for Economic Policy Analysis
AIB	Afghanistan International Bank
AISA	Afghanistan Investment Support Agency
ANPDF	Afghanistan National Peace and Development Framework
ANTP	Afghanistan National Trade Policy
APTTA	Afghanistan Pakistan Trade and Transit Agreement
ARAZI	Afghanistan Independent Land Authority
ARDS	Afghan Development and Reconstruction Services
ASYCUDA	Automated System for Customs Data
AWCI	Afghanistan Women Chamber of Commerce & Industries
CLDP	Commercial Legal Development Program
CPA	Central PPP Authority
CPCPD	Consumer Protection and Competition Policy Department of MoIC
CSO	Central Statistics Organisation
DABS	Da Afghanistan Breshna Sherkat
DBI	Doing Business Indicators
DPEPF	Domestic Production and Export Promotion Fund
EPAA	Export Promotion Authority of Afghanistan
FACT	Federation of Afghan Craftsmen and Traders
GDP	Gross Domestic Product
GoIRA	Government of the Islamic Republic of Afghanistan
HEC	High Economic Council
IAB	Investment Advisory Board
IMF	International Monetary Fund
IPA	Industrial Parks Authority
ISI	Import Substation Industrialization
MAIL	Ministry of Agriculture, Irrigation and Livestock
MEC	Monitoring and Evaluation Committee
MoE	Ministry of Education
MoEc	Ministry of Economy
MoF	Ministry of Finance
MoFA	Ministry of Foreign Affairs
MoIC	Ministry of Industry and Commerce
MoJ	Ministry of Justice
MoLSAMD	Ministry of Labour, Social Affairs, Martyrs and Disabled
MoPH	Ministry of Public Health
MRRD	Ministry of Rural Rehabilitation and Development
NES	National Export Strategy
NGOs	Non-governmental Organisations
NPA	National Procurement Agency
NPP	National Priority Program
NUG	National Unity Government
OECD	Organisation for Economic Co-operation and Development
PPP	Public Private Partnership
PPU	MOF's Procurement Policy Unit
PRISEC	Executive Committee on Private Sector Development
PSD	Private Sector Development
R&D	Research and Development
RADP-E	Regional Agriculture Development Program-EAST
RCA	Revealed Comparative Advantage

RECCA	Regional Economic Cooperation Conference on Afghanistan
SCIS	Steering Committee on Import Substitution
SDG	Sustainable Development Goals
SDGs	Sustainable Development Goals
SEZ	Special Economic Zones
SMEs	Small to Medium Sized Enterprises
SWOT	Strengths, Weakness, Opportunities, Threats
T1	Transit Document
TVET	Teaching and Vocational Education and Training
WB	World Bank
WTO	World Trade Organization

FOREWORD

H.E. DR. MOHAMMAD ASHRAF GHANI
PRESIDENT
ISLAMIC REPUBLIC OF AFGHANISTAN

I have been a strong advocate of putting domestic producers first, and am delighted to see a strong Afghanization Strategy finally being established to support the ANPDF.

It has been clear to me for many years that unless we adopt an Afghanistan First policy, our industrial clusters will underperform, our competitiveness will worsen, and unemployment and poverty rates will increase.

This strategy builds on the many business friendly reforms that I have already introduced, and its commercial focus will be critical to unleashing private capital to upscale production and to substitute for the many foreign goods that we continue to import. Our trade deficit remains a major concern, not just because it is unsustainable, but also because of what it tells us about the state of our own economy and the preferences that we have as consumers.

The incentive framework outlined here will help households, small to medium enterprise and large corporates to increase their profitability, to better manage risks, to access improved financial services and also to benefit from agri-business parks and special economic zones where the business environment and investment climate will provide a competitive advantage. In terms of upscaling agriculture, cement and pharmaceutical production, I remain encouraged by the rising tide of investment in these clusters, and know that the doing business reforms I have overseen will see a more productive Afghanistan in the near future.

FOREWORD

H.E. DR. ABDULLAH ABDULLAH
CHIEF EXECUTIVE
ISLAMIC REPUBLIC OF AFGHANISTAN

I have long dreamed of a day when Afghanistan would live up to its full potential.

This strategy, which compliments the National Exports Strategy, provides some hope that the next generation of development tools is better geared to meeting the priority and needs of my fellow Afghans. With international development assistance inevitably set to decline further, this strategy helps us to stand on our own, and to minimizing the risk that external shocks will dictate a future of volatility and uncertainty.

As a trading nation, it is the strength of our private sector that will eventually determine our success as an economy. Government is an important stakeholder in this process, but we must be judged on how we help and not hinder business expansion. While we strive to accelerate exports and to close the trade deficit, we know that this will only happen once the private sector is given the support it deserves. We have come to realize – after tens of billions of dollars invested – that money alone does not make development and that we need to put in place a new set of policy measures to lower the risks for private expansion; albeit small holders or large-scale corporations.

Closing the trade deficit and current account deficit is best achieved by pursuing a joint policy of promoting exports and substituting imports. We must be able to pay our own way, and to determine our own destiny. For this to happen, we need to shift the incentive framework towards durable investments that can be scaled and multiplied. Unless we generate jobs internally, the refugee problem in Europe will continue and each successive generation born will seek opportunities outside, not here at home.

Development economists agree that successful development involves compounding. Compounding means increasing value of an asset due to the interest earned on both a principal and accumulated interest. In essence, this means that future income flows will be determined by current investments. The biggest opportunity costs for us is time, and time is the one thing we will never get back.

I stand squarely behind the investment program developed here, and as the Chief Executive Office, declare my full support to get these reforms adopted at the High-Level Economic Council. Following which, I will work with cabinet colleagues, civil society and the private sector to make sure that these commitments are implemented in full.

FOREWORD

DR. MUSTAFA MASTOOR
MINISTER OF ECONOMY
ISLAMIC REPUBBLIC OF AFGHANISTAN

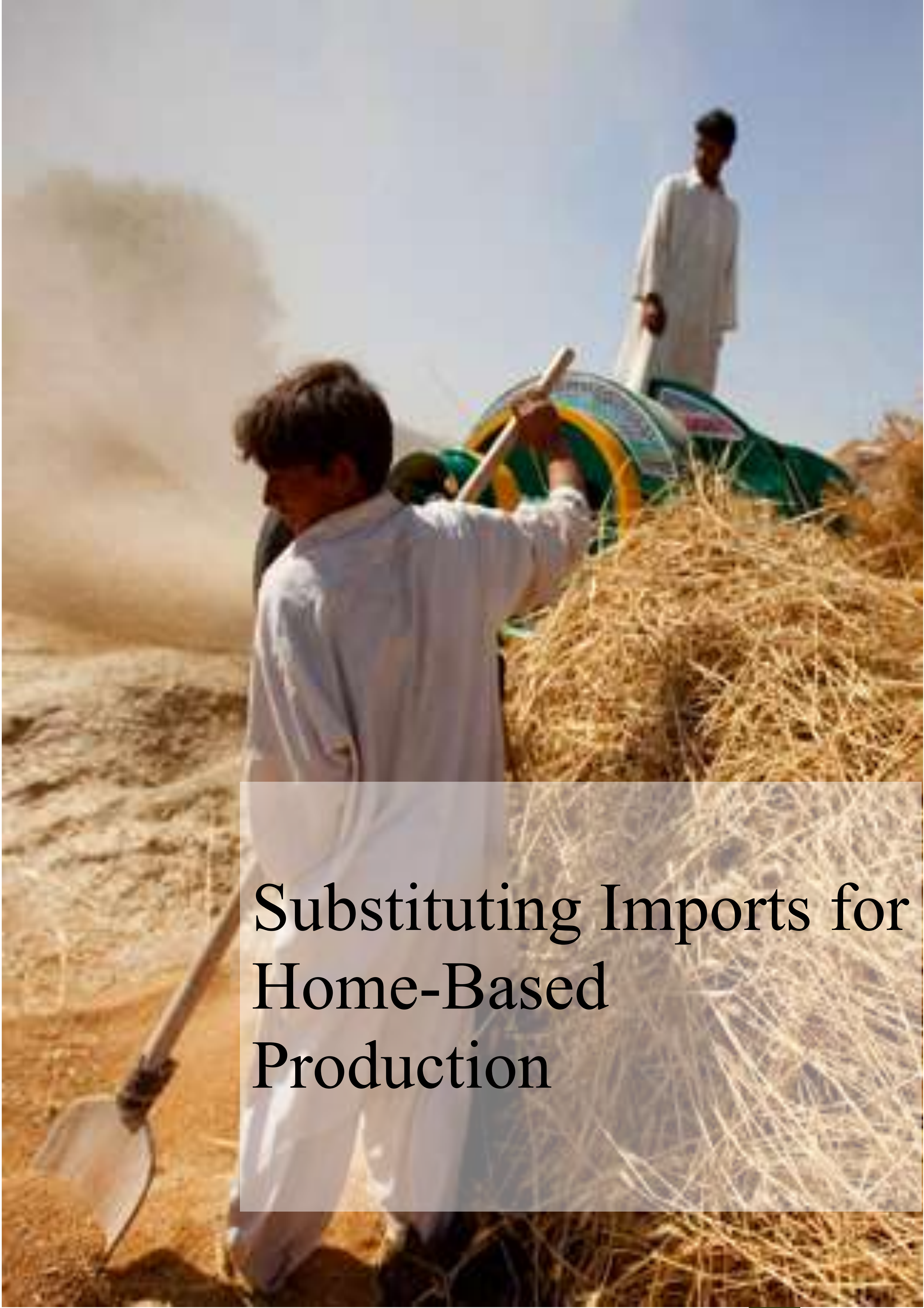
On behalf of the National Unity Government of the Islamic Republic of Afghanistan, I am delighted to present '*Productive Afghanistan - An Import Substitution Strategy (2019-2025)*' focused on Afghanization, industrialization and commercialization. This strategy compliments the National Export Strategy (NES) and is fully aligned to the Afghanistan National Peace and Development Framework (ANPDF) and Growth Strategy, which foresees GDP growth of 8%+ by 2025.

Government remains deeply concerned about the trade and current account deficits and the over-reliance on imported over home produced goods and services. Given rising unemployment and poverty rates, accelerating domestic production (including lowering the costs of production) must remain a policy priority; importation costs increase as the currency depreciates. In a challenging business environment, we have learned that investors prefer to hedge than invest, they extract rather than give back, and they prioritize short term gains rather than laying the foundation for long term growth. All of these investment characteristics are entirely rational; in the context of conflict and instability.

Currently, our national purchasing power is generating jobs abroad while we are in dire need to generate jobs at home. While the largest percentage of imports cannot be substituted, this strategy identified a select group of products that show considerable potential for substitution. We have learned that consumption preferences are not always determined by price, and as a result we must improve both product marketing and branding efforts, as part of an investment process that must foster small-scale industrial expansion.

I am therefore delighted to put forward this strategy focused on Afghanization, industrialization and commercialization. ***Afghanization*** means investing in domestic production over foreign goods and services. ***Industrialization*** means improving product-space development and economic complexity to support value addition and capturing of domestic markets. ***Commercialization*** means putting in place new modalities that strengthen the competitive advantage of the private sector, to include a gear shift towards larger scale commercial activities. We have land, excess liquidity in the banking sector, a generation of knowledge and skill thirsty workers and a willing and supportive international community.

What excites me most about this strategy, is the many innovations that are proposed. We must strengthen our economic policy, and I propose to put that in place. Our international partners procure from abroad, when as is the case with wheat and other commodities, we are sufficiently well endowed to fill that market. We must put in place blended finance models that reduced the risk for private equity expansion, and we must promote financial inclusion. We must support a policy of progressive industrialization, know that hiked in import tariffs alone will have no impact on substitution. We must also shift from top-down supply side driven processes to investing in more effective demand, and internal market integration. Most importantly, we must dare to dream that a self-reliant Afghanistan is finally within reach.



Substituting Imports for Home-Based Production

Contents

Tables

Charts

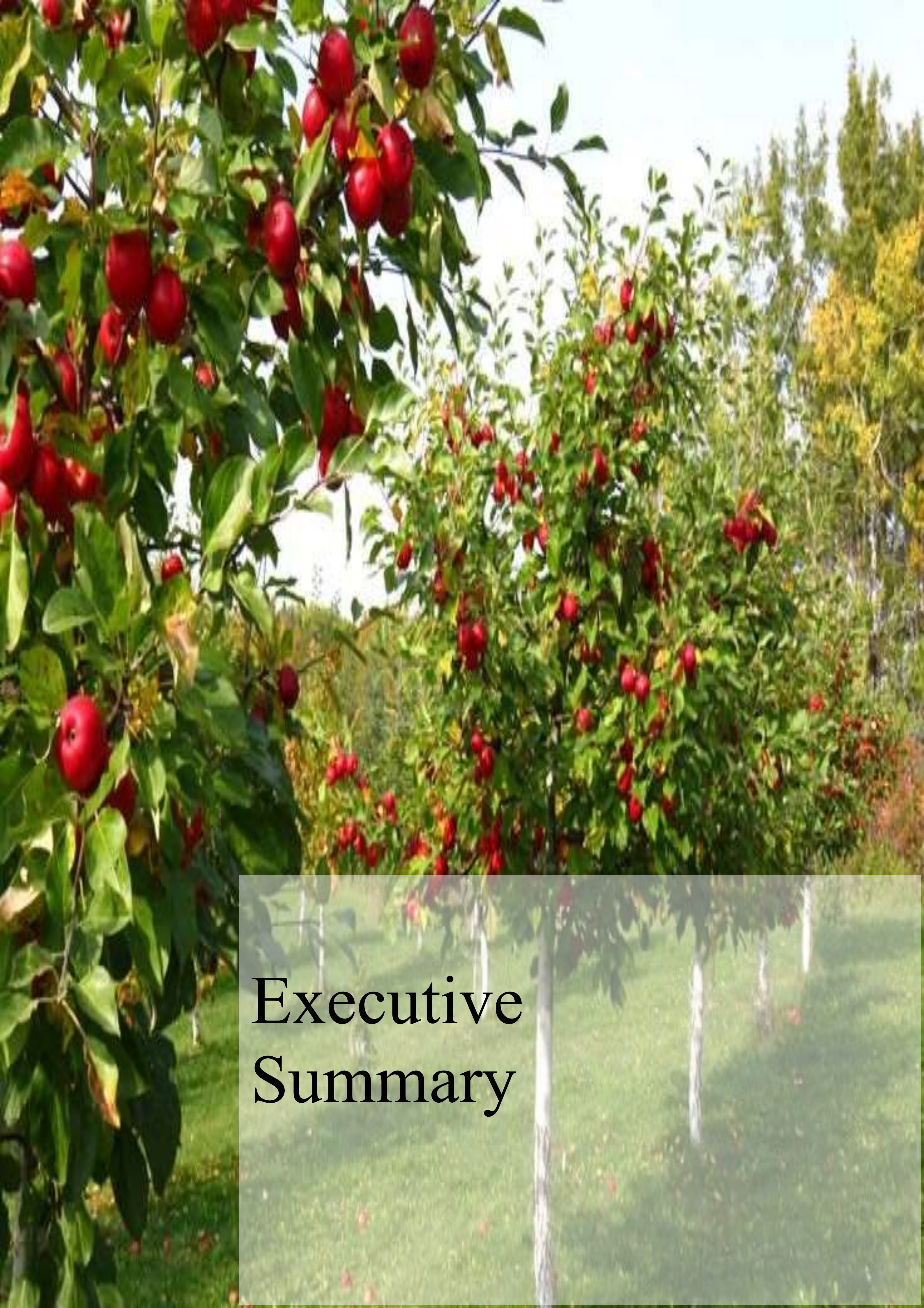
Figures

Acknowledgment

The Ministry of Economy is grateful for the financial support of the European Union in Afghanistan, for the provision of technical assistance. The Ministry is also grateful to the Ministry of Agriculture, Irrigation and Livestock (MAIL) CARD-F program for providing photos for this strategy. Ministry of Economy expresses its gratitude to Central Bank of Afghanistan, Ministry of Finance (Fiscal Policy Directorate), World Bank Afghanistan Country Office, IMF, ITC, Office of Advisor to President on Agriculture and Irrigation, Office of the advisor to President on Banking and Finance, Ministry of Commerce, and Industry, Ministry of Mines and Petroleum, USAID, Chambers of Commerce, Chambers of Industry, Women Chambers of Commerce, academicians, private sector and various other entities and individuals for their support in the development of Productive Afghanistan Strategy and for providing valuable inputs that enriched the contents of the document and helped convey its message.

Key Terms Used

Key Terms	
Afghanization	A policy prioritizing building durable Afghan capacities first, to include a preference for home-based production over foreign goods, improved alignment and harmonization with the ANPDF, and support for a basket of new measures more likely to work in the Afghan context.
Import Substitution Industrialization	An Afghan trade and economic policy which advocates replacing foreign imports with domestic production, to close the trade and capital account deficits, and to boost jobs and self-reliance where comparative advantages exist. The Afghan policy is based on a pragmatic industrialization approach.
Revealed Comparative Advantage	Measures of revealed comparative advantage (RCA) have been used to help assess a country's export potential. The RCA indicates whether a country is in the process of extending the products in which it has a trade potential, as opposed to situations in which the number of products that can be competitively exported is static. It can also provide useful information about potential trade prospects with new partners. Countries with similar RCA profiles are unlikely to have high bilateral trade intensities unless intra-industry trade is involved. RCA measures, if estimated at high levels of product disaggregation, can focus attention on other non-traditional products that might be successfully exported. The RCA index of country I for product j is often measured by the product's share in the country's exports in relation to its share in world trade.
Product Space	The product space is a network connecting products that are likely to be co-exported and can be used to predict the evolution of a country's export structure. So, if Afghanistan already exports pomegranate it has a better chance of exporting pomegranate juice than it does manufacturing armoured vehicles. Afghanistan exports 63 products with revealed comparative advantage (meaning that its share of global exports is larger than what would be expected from the size of its export economy and from the size of a product's global market).
Product Proximity	The Product Space is a network that formalizes the idea of relatedness between products traded in the global economy. The Product Space network has considerable implications for economic policy, as its structure helps elucidate why some countries undergo steady economic growth while others become stagnant and are unable to develop. The concept has been further developed and extended by The Observatory of Economic Complexity, through visualizations such as the Product Exports Treemaps and new indexes such as the Economic Complexity Index (ECI), which have been condensed into the Atlas of Economic Complexity.
Forward and Backward Linkages	A forward linkage is created when investment in a particular project encourages investment in subsequent stages of production. A backward linkage is created when a project encourages investment in facilities that enable the project to succeed. Normally, projects create both forward and backward linkages.
Anchor, Ancillary and Spinoff Investments	An anchor project is a major investment supported by an anchor investment, such as roads, special economic zones, hydro power station or port. Ancillary investments are those investments that are made possible by the anchor investment, to include market feeder roads, electricity or finance. Spin off projects are investments that are made possible by supplying works, services or supplies as a result of the anchor and ancillary investments. For example, if a special economic zone is established as an anchor investment, and financial services, regulatory regimes and other business enabling services put in place, a large number of spin-off projects can emerge in the wider market to include SMEs for example, that maintain buildings, provide transport, supply food or business management services.



Executive Summary

Executive Summary

In many ways Afghanistan remains a pre-industrial society, and as a result it remains heavily dependent on a basket of imports that we can only afford as a result of considerable external support. Given the desire for Afghanistan to become self-sufficient by 2024, substituting imported goods for home produced goods – where feasible – is eminently desirable. As a result, this strategy promotes a system of industrial incentives, not a system of industrial protection and focuses on measures to improve the terms of trade while generating growth and jobs at home. This strategy provides a core contribution to the Afghan National Peace and Development Framework and its Growth Strategy, including the following Self-Sufficiency goals:

- Nine (9) percent growth rate by 2024 (within 6 years);
- Substantially improving the trade balance;
- Increased mobilization of private capital for development;
- Expansion of exports to US$2 billion by 2024 (within 6 years);
- Expansion of revenues to US$8 billion by 2024 (within 6 years); and,
- Reduction in poverty, including in lagging areas (long term).

While import substitution is generally viewed as a lesser alternative to increasing exports, in Afghanistan the range of products amenable to export is essentially limited once minerals are excluded. When factoring for economic complexity and the constrained business and investment climate, it is likely to be easier to offset imports for candidate clusters and products than to compete in open international markets where quality infrastructure is more advanced. As a result, a dual policy that coordinates import substitution with export promotion reduces the risks of being overly dependent on an expensive global market; whose terms of trade have often been prohibitive for Afghanistan.

CORRECTING A HISTORY OF DISTORTED GROWTH

More than US$ 900 billion in external support has been spent on Afghanistan since 2001, with the cost of war in 2018 alone at US$ 45 billion. In 2018, 66% of the Afghan national budget is still funded by external partners. Official Development Assistance has gone from a high of US$ 13 billion in 2011 to US$ 5 billion in 2016. These huge flows effectively constitute a massive subsidy to the economy, distorting investment incentives and artificially inflating the purchasing power of the population.

Despite the above reality, Afghanistan's trade deficit was just short of US$ 7 billion or around 40% of GDP in 2016. Growing purchasing power has not been translated into greater production and demand for home grown goods and services. Instead, Afghanistan remains firmly a trading nation, even though in the long-term purchasing power is likely to fall; as aid further deleverages. Given the ongoing demographic transition and the very real opportunity of adopting an 'Afghan First' policy to drive growth and jobs, this strategy provides an investment program to substitute for imported products wherever Afghanistan has the comparative advantage to do so.

Perhaps one of the most important findings of this strategy is that it is not pricing but market failures that are inhibiting improved growth, import substitution and export potential. The Afghani has repeatedly depreciated against a basket of other currencies but such depreciation has not spurred exports or created a pricing advantage for home production. In addition, and for example, the imposition of an increased import tariff on eggs from 8% to 20% did not lead to an increase in domestic production, instead it led to inflation. As a result, Government is committed not to put in place protectionist policies, but rather to work hard to boost incentives and draw down on risk, while deploying new modalities such as a rapid expansion in large-scale commercial agriculture.

A review of the structure of imports however highlights that the vast majority of imported goods and services, currently cannot be made at home. Product space development, value chain development and improving competitiveness is key to steadily shifting the advantage towards home based industrial expansion. Only when incentives for increasing the complexity of Afghan production have been put in place, can growth be less volatile, with stronger returns to revenues and jobs creation. Finally, the many businesses that have thrived on overseas assistance will be forced to transact at home, which will lay a strong fabric for a more resilient and less distorted growth path.

WHY ADOPT A POLICY OF IMPORT SUBSTITUTION?

While import substitution has been marginalised from development policy discourse since the 1970s, the truth is that most economies in the regions surrounding Afghanistan pursue an investment policy based on Import Substitution Industrialization (ISS); to varying degrees. While the history of ISS implementation has often had mixed results, it is widely acknowledged that most advanced economies have used ISS as a growth and economic complexity springboard. Moreover, surrounding economies have similar production profiles and are closer to global markets, making it easier to offset imports than to export bulk commodities to new markets.

Cyclical droughts decimate agricultural product 1 year in 4, insecurity and periods of political unrest undermine private investment and the long-term future of overseas development assistance cannot be taken for granted. If the currency depreciates further, the costs of imports will spike, potentially leading to inflation in products many of which are consumed by the poorest sections of society. Yet, under the right macro-economic and policy framework, and indeed trading regime, both agricultural and non-agricultural growth sectors can assist in solving problems that are now universally shared. The flood of refugees from Afghanistan in recent years highlight the long-term risks of economic underperformance at home.

A STRATEGY BASED ON EVIDENCE

The Ministry of Economy (MoEc) understands that diversified production systems experience more stable and sustained levels of economic growth, and are better at resisting economic and climatic shocks; both of which Afghanistan suffers. Therefore, this strategy compliments the Private Sector Development (PSD) National Priority Program (NPP), and National Export Strategy (NES), and is central to the Afghanistan National Peace and Development Framework (ANPDF).

The core of the strategy reflects a focus on '***Afghanization***', '***Commercialization*** and '***Industrialization***. This strategy is underpinned by evidence for an innovative approach, reviewing primary constraints, and developing an incentives-based support program focused on a number of candidate industrial clusters. The strategy answers the following key questions:

- Which product, materials and equipment could be produced or manufactured locally and what services rendered could be localised in Afghanistan?
- Which methods of import substitution would be the most effective in the Afghan context, and what would Afghanization policies entail?
- How can farmers and companies best be supported in building the required competencies and competitive advantage?
- Given excess liquidity in the banking sector, an overly dollarized economy, weak monetary controls and lack of quality infrastructure, what new modalities can be introduced to create durable solutions?
- How can government ensure that enterprises supported by the government would evolve to be self-sufficient?

An integrated approach has been adopted, with key elements (evidence-based policy and coordination) provided by MoEc, but with the bulk of the reforms either aggregated from existing strategies or introducing new priorities, to provide a whole-of-government approach.

AFGHANIZATION – PUTTING AFGHANISTAN FIRST

At its core, Afghanization is an initiative by the government to maximize growth and employment benefits for Afghan firms and citizens, to both produce and be employed in a meaningful and efficient manner in the public and private sectors at home. There has been an over-dependence on external support and imports, leading to trade, current account, investment and skills deficits. The incentive package to boost Afghanization has a number of measures designed to strengthen domestic production capacities, visa a vis internal and external markets. Primary measures are as follows:

- Adopting an 'Afghanistan First' policy at every stage of the development process;
- Contracting Afghan firms wherever possible and desirable;
- Developing local content directives and regulations;
- Ramping up efforts to de-dollarize the economy;
- Developing the secondary market including Sukuks;
- Overcoming weaknesses in domestic output expansion;
- Lowering the costs of production and lowering risk; and,
- Generate growth and employment at home.

INDUSTRIALIZATION – A QUANTUM LEAP IN VALUE ADDITION

Insufficient attention has been paid to accelerating industrialization in Afghanistan. Industrial cluster analysis is not routinely undertaken, import co-efficiency is not measured, and no employment multipliers have been established either. Incentive packages have not been properly developed, and a decline in manufacturing and industry has been the result; negatively affecting employment rates. As a result, establishing an import substitution strategy must first of all deal with the lack of data and analysis upon which an optimal policy can be established. The primary approach has therefore is to provide more direct support to foster industry and manufacturing, not just through product space and value chain development, but also by working with the private sector to improve the balance of risks to rewards.

- Three-year tax holiday for new manufacturing firms to encourage investment;
- Identify and support value chains that represent the most competitive prospects for value addition in selected industrial clusters;
- Provide both fiscal and non-fiscal incentives;
- Improve access to finance and availability of banking products to support industry and SMEs;
- Strengthen the industrial incentives package available to domestic producers to promote internal trade and investment;
- Target investments that overcome market failures such as lower priced energy, improved product aggregation, cold storage, packaging, certification, transportation and market information;
- Enhance financial inclusion;
- Accelerate development of special economic and ago-industrial zones; and,
- Further deploy public private partnerships including concessions.

COMMERCIALIZATION – EXPANDING PRIVATE CAPITAL

There has been very little emphasis in recent years in large-scale commercial expansion either for agriculture, or pharmaceuticals. While large scale mining concessions were granted, large scale extraction is for export commodities. The potential for using state land for large-scale commercial agriculture will not only boost production and offset import dependency, it will also go a long way to promoting technological transfers and in generating employment, and forward and backward linkages. For example, according to MAIL Afghanistan has more than 7.5 million hectares of arable land, but only 2.5 million hectares of land was cultivated in 2017. A sea change in scale requires considerable investment in irrigation and a reduction in insecurity.

CANDIDATE INDSUTRIAL CLUSTERS

The selected industrial clusters are those likely to have the largest impact on the trade deficit, but also those with a revealed comparative advantage for scaling up, and for generating value addition and employment. The candidate industrial clusters cover agriculture, cement, electricity, steel, pharmaceuticals, as outlined below. The goal is to substitute 50% of imports with home production by 2025.

Industrial Cluster Candidates

Industrial Cluster	Import Value (US$)	Tariff Rate	Import RCA [1]	% of Imports	Potential for Industrialization
Wheat & Wheat Flour	906,000,000	2.5-5	208	12.2 %	Yes
Pharmaceuticals & Medical Services	744,300,000	2.5	Various	1.2 %	Yes
Cement	303,000,000	10	12.2	4.1%	Yes
Edible Oil	395,100,000	2.5	26	5.3%	Yes
Sugar &Confectionary	212,500,000	5-16	99.4	2.9%	Yes
Poultry Meat	46,400,000	5-20	2.89	0.51%	N/A
Vegetables	79,000,000	5-40	Various	1.1%	N/A
Cereals	57,000,000	5-10		0.8%	N/A
Dairy Products	76,000,000	5-2		1.0%	Yes
Steel	363,000,000	5-16		4.9%	Yes
Electricity	289,000,000	2.5		3.9%	Yes
Totals	3,471,300,000			%	N/A

OUTCOMES & IMPACT GOALS

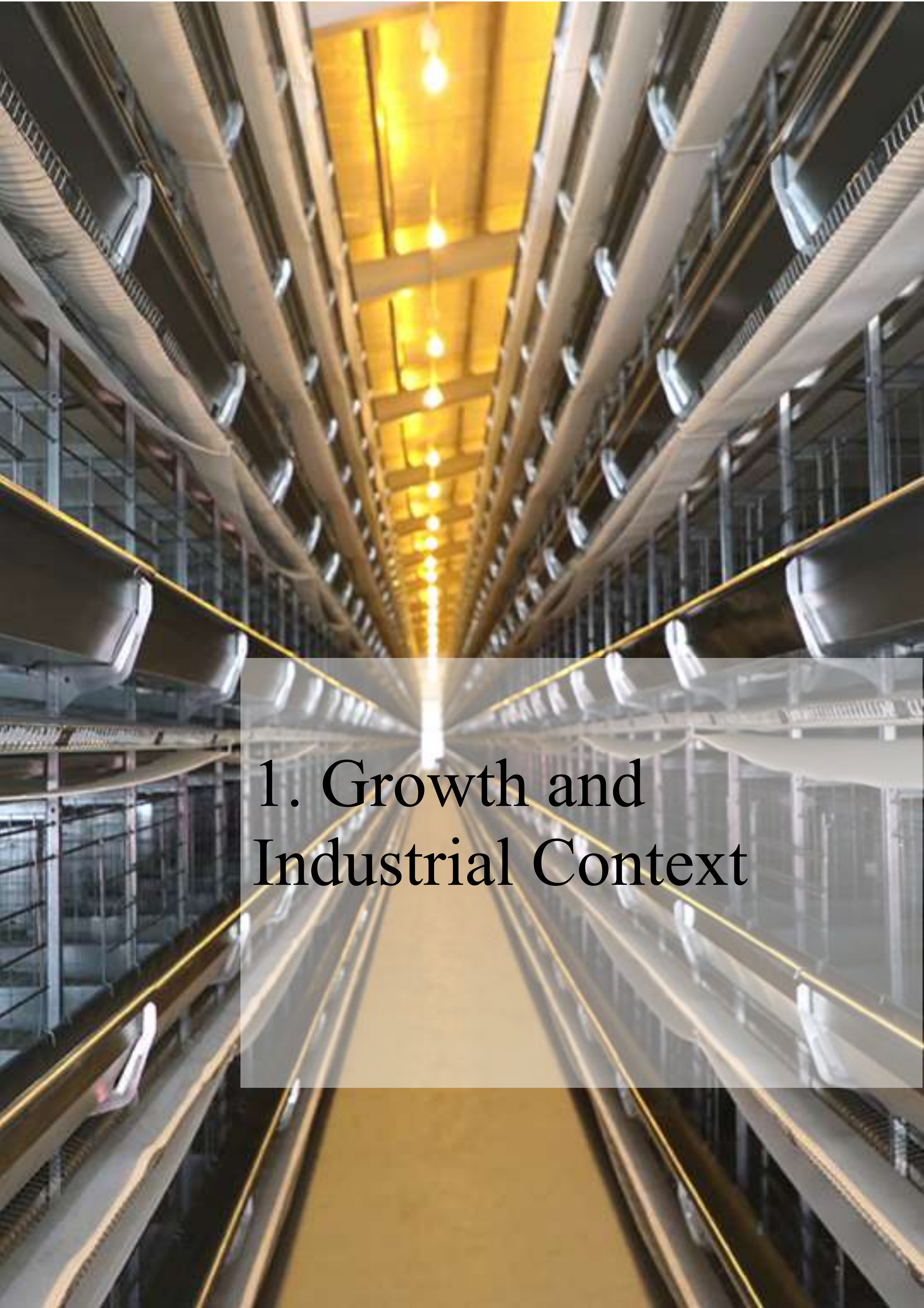
The following high-level outcome and impact level goals are expected to be achieved in support of the overall ANPDF Growth Strategy:

- A 50% reduction in import dependency for selected products by 2025;
- Reduced current account deficit from -22% in 2016 to -10% by 2025;
- Reduced imports of goods and services from 40.02 % of GDP in 2016 to 35% by 2025;
- Improved trade balance from US$ -6.97 billion in 2016 to US -5.5 billion by 2025;
- Reverses decline in the share of manufacturing from 11.31 % of GDP in 2016 to 16% by 2025;
- Reverse decline in the share of industry from 21.7% in 2016 to 25% by 2025;
- Increase SME contribution to GDP from 50% of GDP to 60% of GDP by 2025;
- One hundred percent employment growth in the industrial sector by 2025;
- Fifty percent reduction in importation of cement offset by domestic supply; and,
- Four (4) agri-industrial parks / special economic zones established by 2025.
- Increase capital investment as a percent of GDP from 17.71 % in 2016 to 22% by 2025;
- Expanded irrigation by 300,000 hectares by 2025 and non-irrigable land by 200,000 hectares by 2025;
- Improve financial inclusion with percent of population having bank accounts increasing from 15% to 25%; and,
- To raise Afghanistan's global ranking in the Logistics Performance Index from 160 to 140 by 2025.

REPORT STRUCTURE

Section 1 looks at Growth and Import Substitution Constraints leading to the Import Substitution Strategy in ***Section 2***. ***Section 3*** presents the proposed import substitution measures and actions, central to the proposed investment framework. ***Section 4*** outlines the approach and goals of Afghanization, Industrialization and Commercialization leading the expected impact which is provided in **Section 5**. Support functions are outlined in ***Section 6***, the implementation plan outlined in ***Section*** *7*, and monitoring and evaluation plan outlined in ***Section 8***.

[1] RCAs were calculated for four different years (depending on data availability) reflecting four different points of time – 1996, 2000, 2010 and 2016; allowing trends to be observed. Larger RCA values indicate relatively higher export competitiveness, and when assessed alongside production and export volumes, a clearer picture of preferred products for value chain support is realized. An ideal product for this strategy would be a product that has both high RCA value and also relatively high and increasing values of exports amongst those considered; assuming that export potential remains a critical priority.



1. Growth and Industrial Context

1. Growth and Import Substitution Constraint Context

This section presents the macro-economic context within which import substitution will take place. In a highly volatile growth and investment environment, where investment levels are impeded by high costs of production (land and electricity) weak financial inclusion and limited access to risk minimization support, a new incentive framework is required. As noted in the subsequent sections, imports for many of the candidate industrial clusters have been in decline in real terms, though based on 2016 figures, potential for substation exists.

1.1. Introduction

The Ministry of Economy (MoEc), working closely with other relevant government agencies, aims to support creation of a favourable business climate in Afghanistan, to promote domestic production, economic growth, expand employment opportunities, and reduce the trade imbalance. In doing so, it will work to accelerate commercialization of agriculture linked to small scale industrial expansion, in order to increase import substitution industrialization. Such an approach could also reduce both income and consumption inequality, and assist the Government in meeting the Government's targets for Self-Sufficiency by 2024, which is underpinned by the following targets:

- 9 percent growth rate by 2024 (within 6 years);
- Substantially improving the trade balance;
- Increased mobilization of private capital for development;
- Expansion of exports to US$2 billion by 2024 (within 6 years);
- Expansion of revenues to US$8 billion by 2024 (within 6 years); and,
- Reduction in poverty, including in lagging areas (long term).

To fulfil this mandate, the Ministry of Economy puts forward: "***Productive Afghanistan: An Import Substitution Strategy (2019-2025) – Afghanization – Industrialization- Commercialization***" *(hereafter referred to as the Strategy).* The Strategy focuses on accelerating the promotion of domestic production based on potential areas of Afghanistan's Revealed Comparative Advantages. This strategy supports the newly endorsed Afghan National Export Strategy (NES): 'Peace Through Prosperity – Prosperity Through Trade. [2]

Current economic challenges include: (i) slow economic growth (Central statistic organization (CSO) data indicate GDP grew by only 2.9% in 2017 compared to the previous year), (ii) a high unemployment rate of 24 percent,[3] and, (iii) a highly skewed trade imbalance (Afghanistan only exported USUS$1.2B but imported USUS$9B, resulting in a negative trade balance of US$7.81B in 2016). Afghanistan has an unfavourable climate for doing business and for investment, ranking 167th in the Doing Business Indicators (DBI) 2019, which is far lower than the average of 159 for fragile and conflict-affected states. Other challenges include the ongoing violent conflict (which undermines production, value chain addition and market access), political uncertainty as elections approach (stability), dependence on donor assistance (which also distorts markets), and overreliance on the agriculture sector for employment (agriculture accounts for almost 40% of total employment).[4] Afghanistan also suffers from a major savings-investment gap (the mirror of the trade imbalance), and there is low foreign direct investment (FDI), and capital flight to countries such as Turkey and the UAE further reduced domestic liquidity for investment.

In 2017 (actual) and 2018 (projected) GDP growth rates are estimate by the IMF to be 2.5%, though with inflation running at 5% and with the population growth rate at 2.7%, the impact of growth is insufficient to drive progress and reduce poverty. Expanding domestic production must therefore remain

[2] The NES identifies six priority sectors with high potential for export growth, employment generation and innovation: dried fruits and nuts; fresh fruits and vegetables; saffron; marble and granite; carpets; and precious stones and Jewelry. For each of the six, it sets out policy reforms and institutional investments to tackle bottlenecks that are currently preventing Afghan MSMEs from realizing their full export potential.
[3] Afghanistan Living Conditions Survey (ALCS) 2016-17, CSO.
[4] Same as above

central to Government policy. The poverty rate stands at 5% according to ALCS 2016/17 [5] Given that primary commodities being exported from Afghanistan have no formal certification, the commodity export price is low and many products are then re-exported at higher prices to third economies. A critical area of future development, if import substitution is to be possible and the trade balance reigned in, is a greater focus on value chain and product space development; where the Revealed Comparative Advantage (RCA) of a product has been shown to be positive, and ideally on an upwards trend. In other words, though boosting domestic production is critical to growth, the economy must now diversify rapidly, to take advantage of the weak Afghani. Moreover, as this strategy makes clear, rather than focusing on broad institutional capacity and other enabling reforms, it is better to focus on removing critical constraints on the production and market expansion side.

The aforementioned challenges are complex and multifaceted in nature, and will not be overcome unless a whole of government – in fact whole-of-market effort - is embraced. Therefore, a strategy that attempts to tackle those challenges must be multi-dimensional. The Strategy will directly support economic growth, development and promotion of domestic production, and a decrease in imports (which is already occurring), while increasing exports (and thereby improving the trade balance). Capturing Afghan markets through domestic production will create permanent jobs in the process, thereby potentially lowering poverty rates. More permanent jobs and higher economic growth would over time lower dependence on donor assistance and bring about greater long-term self-reliance. This is in line with the vision in Afghanistan National Peace and Development Framework (ANPDF) promulgated by the leadership of the National Unity Government (NUG). A targeted and proactive domestic production strategy would also be a step toward addressing the issue of sectoral imbalance over the long run. Thus overall, this strategy seeks to bring greater stability, better standards of living, reduced illegal activities, and progress toward long-run self-reliance for the Afghan economy.

In line with this growth-oriented vision, complementing the revenue-maximization emphasized in ANPDF, the Strategy focuses on domestic producing firms (both SMEs and larger enterprises) and considers them as the engine for growth: these firms employ people and contribute to net exports, ultimately contribute to GDP growth. The Ministry of Economy has the mandate to develop and coordinate the implementation of such a strategy.

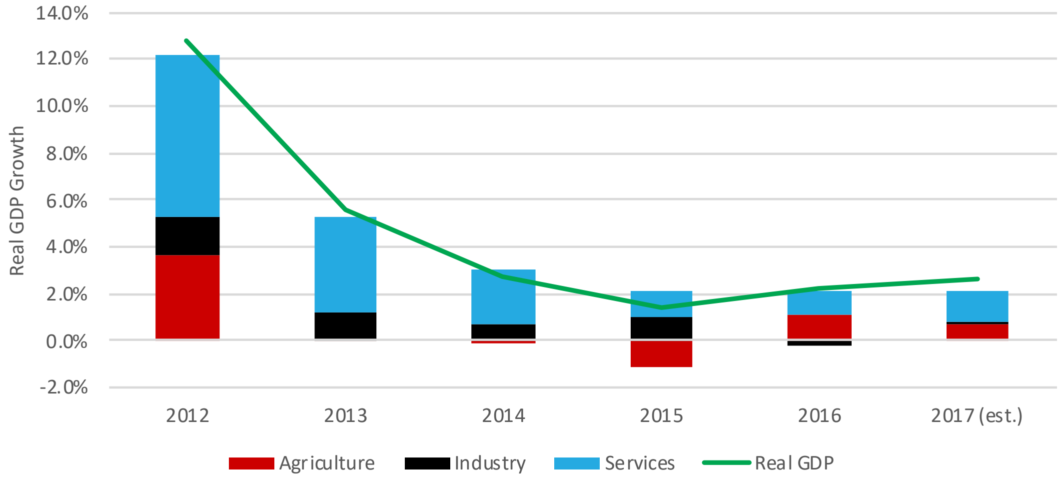
There are several reasons behind proposing a strategy focused on increasing domestic production. Afghanistan as noted earlier has an enormous trade deficit, driven by large imports of goods that already are or relatively easily can be produced in Afghanistan. This represents a major opportunity to capture the markets for imported goods by means of import substitution. On the export side, there are also opportunities to increase production and exports of goods where the country has a comparative advantage and demonstrated potential in the form of growing exports already. There is a need for supply-side interventions to support greater efficiency and productivity, and also for demand-side interventions to encourage the shift from imports to domestic production.

1.2. Volatile and Agriculturally Dependent Growth

Gross Domestic Product (GDP) has historically been volatile in Afghanistan. Some of that volatility results from insecurity, though the majority results from periodic drought and limited investments in integrated watershed management to drought proof the economy. Increase domestic production is essential, as is drought proofing the economy to mitigate risks of cyclical drought. As a result, real GDP per capita in Afghanistan was US$676 and real GDP grew by 2.1 percent in 2016.[6] The IMF estimate GDP per capita at US$561 for 2016. New estimates from central statistics organization indicate that per capita growth rose to 2.6 percent in 2017. The real rate of GDP growth fluctuated greatly between 2003 and 2016; peaking at 20.6 percent in 2009, reached a low in 2015 before improving modestly in 2016 and 2017 (Chart1).

[5] The poverty line represents the national norm for the cost of covering basic needs including a set of food items that deliver 2,100 kilocalories per person per day as well as necessary non-food expenditures on housing, clothing, education and transportation. In 2016–17, the poverty line was 2,064 Afghanis per person per month, around US$1 a day in current exchange rate terms. Between 2011–12 and 2016–17, the national poverty rate increased from 38.3 to 54.5 percent.
[6] Central Statistics Organization (CSO), 2016

Chart 1. GDP Growth (2012-2017) and Sector Contributions

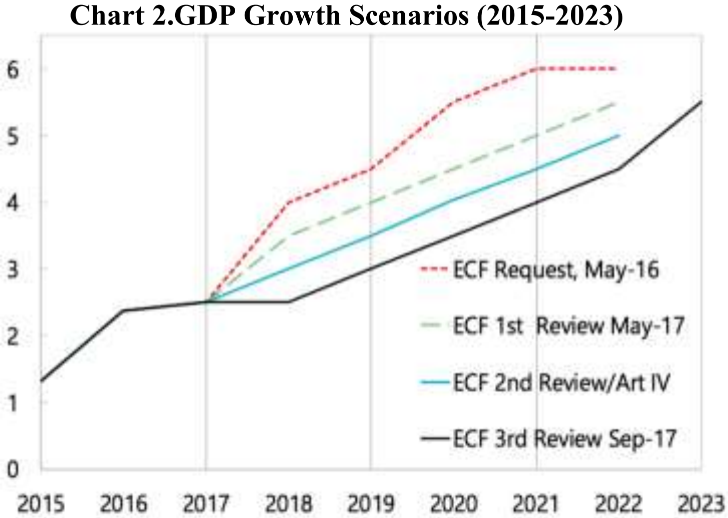


Source: World Bank (2018)

A major reason for the fluctuations in Afghanistan's GDP growths rate in the past 15 years is its strong dependency on the agricultural sector – a part of the economy that is highly dependent on the level of rainfall and water management (e.g. in the year 2009 there was adequate rainfall, contributing to the peak growth rate of 20.6%). The rate of GDP growth is directly correlated to the growth or contraction in both agriculture and non-agricultural sectors and vice versa. Agriculture relies heavily on rainfall and effective water management, and mining relies on concession and active mining operators. GDP growth improves in the years during which agriculture growth is high. This is shown in Chart 2 below.

Relative to world average growth rates, Afghanistan had been performing at rates comparable to the highest among other developing countries. [7]However, from 2012 onward, Afghanistan's low growth rates have lagged behind these developing partners. This reflects deterioration in growth reflects, in particular, the sharp decline in international military expenditures in Afghanistan as a result of the drawdown of foreign troops, as well as political uncertainty around the 2014 Presidential election and its aftermath. Projections for the next five years show an average of 2-3 percent increase, a figure not sufficient to secure improvement in living standards and in tackling poverty. IMF staff estimates (See Chart 3 below) provide growth scenarios up until 2023, highlighting Extended Credit Facility (ECF) forecasts, with growth outturns assumed to be in the low 2.5% to 5% by 2023, assuming no significant deterioration in security, continued reforms, and no adverse shocks to aid flows.

Chart 2.GDP Growth Scenarios (2015-2023)



S

[7] IMF's Economic Outlook, 2016

As agribusiness is a potential area that can help increase GDP growth rates, interventions in the target sectors proposed in this strategy – such as in irrigation systems and, storage and distribution networks, there is the potential of sharply improve poverty rates particularly in rural areas where agribusiness is most prominent. Agriculture's contribution to economy of Afghanistan is important but dominated by small-scale farmers; and therefore, the need to expand commercial agriculture in all areas, linked to small scale industrialization. Agriculture is the second largest pillar of the economy of Afghanistan after the services sector, contributing around 25 percent to its GDP; the percentage becomes even higher if processing of agricultural products is included.

The agriculture sector employs around 40 percent of the country's working force and provides support to approximately 80 percent of its population. Afghanistan long time back was the main supplier of the horticulture products to the international markets. Horticulture has always been a strong asset of the Afghan economy, because of its climate diversity which allows for a large spectrum of crops, long and staged harvest periods beneficial for export, relatively good soils, and availability of groundwater. In the 1970s, Afghanistan supplied over 30 percent of all dried apricots, 18 percent of raisins, 12 percent of pistachios, and roughly 6 percent of grapes and fresh apricots traded in international markets. In terms or mining (which has been hampered by ongoing security problems, inadequate infrastructure, and declining international commodity prices), the mining law is being revised as the Extractive Industries Transparency Initiative (EITI) is being further developed.

1.3. Trade Balance, Import Composition and Country of Origin

While exports have increased substantially from a low base during this period (partially as a result of depreciation), they have failed to keep pace with imports, leading to a large trade deficit. According to the World Bank, over the period 2012-16 Afghanistan's exports of goods and services rose from US$1.13 billion to US$1.34 billion, an increase of only 18.5 percent. Imports grew at a similar rate (18.7 percent) from US$8.04 billion to US$9.54 billion. The structural trade deficit in goods and services has remained around 40 percent of GDP in recent years, reaching 42.1 percent in 2016, and exports amounted to only 6.9 percent of GDP in 2016. Thankfully foreign exchange reserves stand at more than US$8.2 billion; greater than one years of merchandise import cover. Large external flows (including US Government flows that are still not tracked in the economy) into the country have bolstered national purchasing power, leading to such an imbalance. The perverse effect of this situation is that despite Government and donors being desperate to increase employment at home, instead, Afghanistan has been creating jobs abroad. The composition of Afghan imports for 2016 is provided below, indicating product import dependencies, some of which cannot be produced locally (i.e. armoured vehicles), with others that can (i.e. wheat flour).

Figure 1. AFGHANISTAN – COMPOSITION OF IMPORTS (2016)

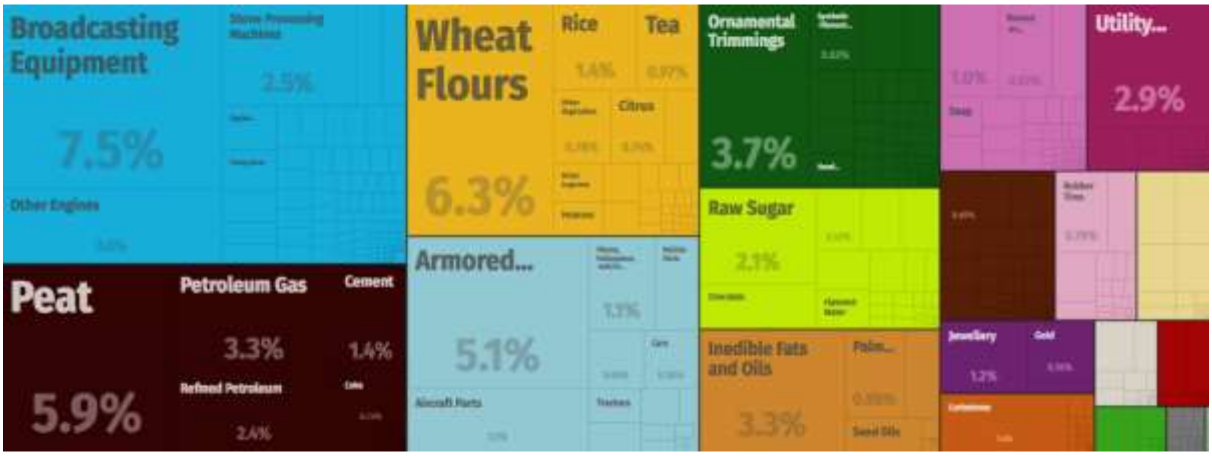
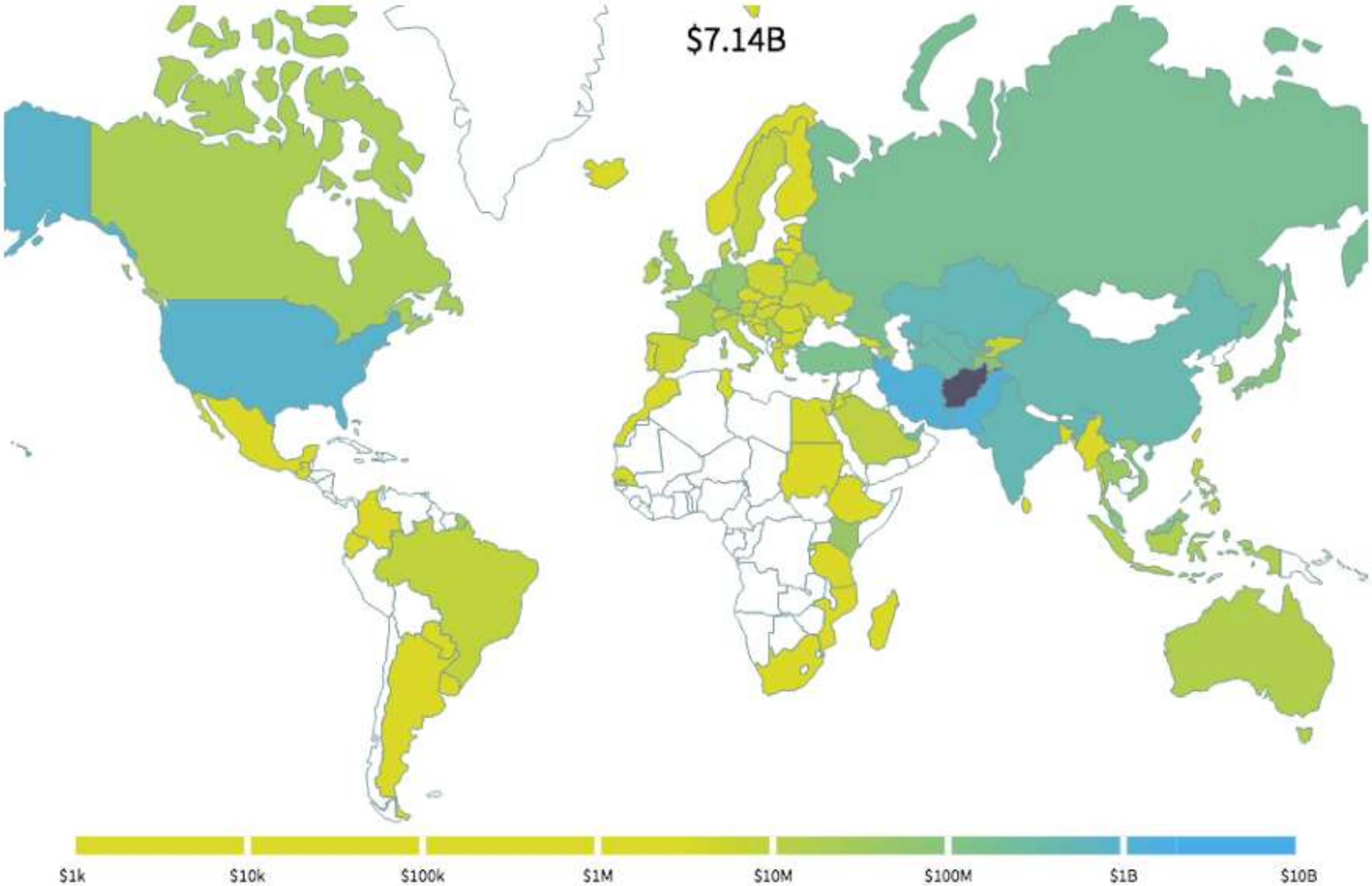


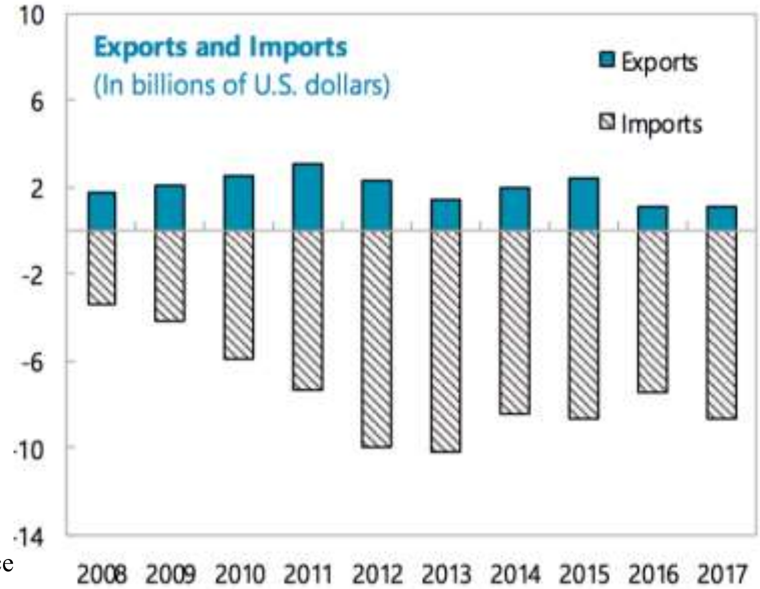
Figure 2 below shows the import origins for Afghanistan, highlighting the importance of trade within the wider sub-region. Most goods derived from the USA are high value addition goods.

Figure 2. AFGHANISTAN IMPORT ORIGINS (2016)



As shown in Chart 3 below, both imports and exports of goods and services remains highly volatile, and as a result a pathway toward substituting imports and promoting exports has never been more important. Though opium is not an official export, with a value at US$ 2 billion, its transaction adds considerably to national purchasing power. Displacing the opium economy can only happen once formal export markets open up, with tradable commodities that are certified and WTO compliant.

Chart 3.Exports and Imports (2008 – 2017)

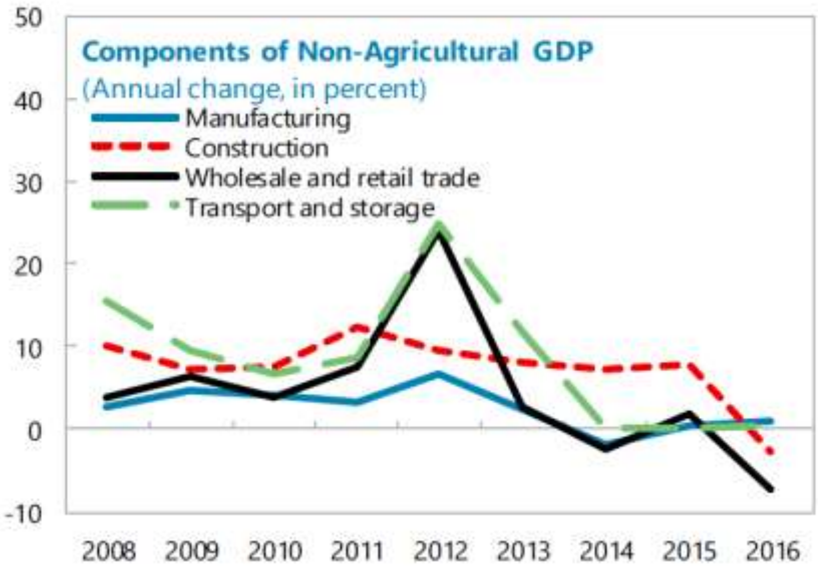


Source

1.4. Manufacturing & Industrial Sector Contribution to GDP

Manufacturing increased rapidly between 2002 and 2005, and then nearly doubled between 2005 and 2011, however, since 2012 manufacturing has been steadily contracting as a share of GDP, as highlighted in Chart 4 below. The value for Manufacturing, value added (annual % growth) in Afghanistan was 1.02 as of 2016. As Chart 4 shows, in recent years manufacturing reached a maximum value of 7.32 per cent in 2012 and a minimum value of -2.49 in 2014. The contraction as a percentage of GDP has been mirrored across all sectors, reflecting a reduction in overseas development assistance support a worsening business environment. Reversing these trends will require greater political stability and security, greater control over the effective exchange rate and a huge push towards overcoming micro-economic constraints that limit domestic investment.

Chart 4. Components of Non-Agricultural Growth



1.5. Business Environment Reforms

Government has put in place significant improvements in the business enabling environment, including a new Electricity Law, an Open Access Fiber Optics Policy, a Public Private Partnership (PPP) Law and the development of a National Trade Policy. In addition to securing membership of WTO, government has opened up air corridors and is looking to expand access to industrial land through various modalities: industrial parks, special economic zones, free economic zones, free trade zones, export processing zones and agro-parks. So far, 26 land plots in 18 provinces have been set aside for such development. Having secured membership of WTO and approved the National Export Strategy, increased business activity is anticipated. In addition to the NES, Government has put in place the Afghanistan National Trade Policy (ANTP), Comprehensive Agriculture Development NPP (CAD NPP) and Agribusiness Charter (ABC); all of which aim to support product space and value chain development.

Despite the above, firms complain of constraints at many levels. According to the Afghanistan Enterprise Survey (2014) access to critical production inputs impedes business growth; though access to land, finance and cheap electricity were outlined as significant inhibiting factors. The PSD program notes that access to serviced industrial land undermines investment, and the new Industrial Parks Policy, linked to the PPP law, allows for large-scale concessions to be let. To make this work, the costs of doing business must be reduced, to lower the hurdle rate for investment, and to bring financial rates of return to a level where rewards outweigh risks.

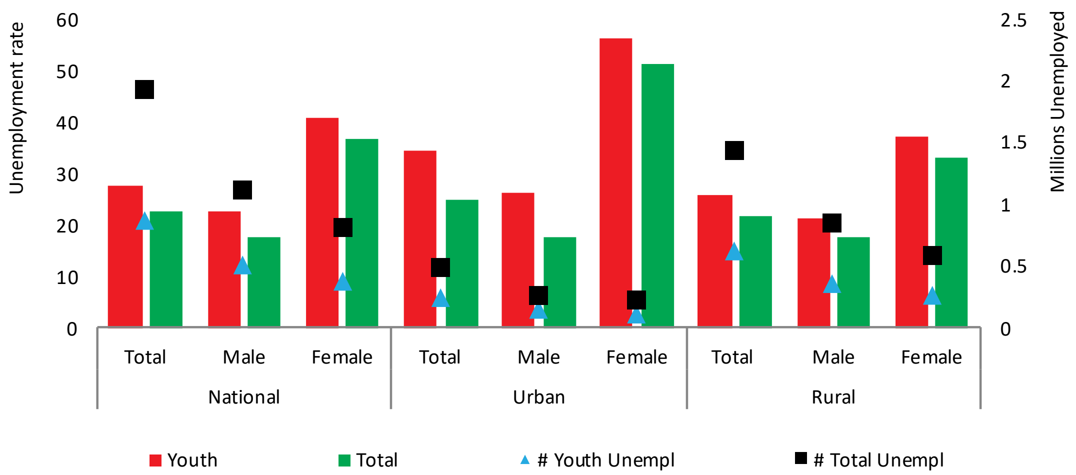
1.6. Employment

The Afghanistan Living Conditions Survey (ALCS) 2016-17 results show that in total 24 percent of the labour force is unemployed, and the percentage of unemployed women stands at a very high rate of 41 percent. Furthermore, over 400,000 Afghans enter the job market every year, adding to the already substantial oversupply of available labour. The share of youth not in employment, education or training (NEET) is another measure that reveals high levels of joblessness and idleness among the youth in Afghanistan. NEET rate stands at 42 percent for both sexes but for women it is 68 percent. The problems associated with the job market are even more serious than what is suggested by these indicators. These measures don't include the quality of jobs, the adequacy of pay, and working conditions in Afghanistan. For example, 20 percent of the employed labour force are classified as underemployed.[8] That means 1.3 million people who have jobs which are less than full-time and probably vulnerable and insecure.

Primarily, the majority of rural Afghans are dependent on agriculture for livelihood.[9] Agriculture represents around 40% of national GDP, giving it an important centrality in the Afghan national economy. The natural climate of the country is not conducive to the welfare of rural Afghan nationals that depend on agriculture for sustenance. There is little arable land per capita, precipitation is scarce and climatic conditions are difficult in many parts of the country. Poverty in Afghanistan is also related to the low quality of infrastructure and poor pace of infrastructural development. As a result, according to the World Bank, 75.6% of poor Afghans are illiterate, and poor people are also less likely to have access to electricity (63.8 %), safe drinking water (40.3%), and sanitation (2.8%). (World Bank, 2015) The World Bank has found that "*the higher the human capital endowment of the household head, the lower the risk for the household to be poor*." (World Bank, 2015) Thus, those who live in rural areas in Afghanistan and have less access to education have a higher risk of living in poverty" (World Bank, 2015).

[8] People who work less than 40 hours a week, but are available and willing to work additional hours.
[9] Average farm sizes range from 2-5 jeribs (0.4-1.0 hectare) for small-scale producers to 5-10 jeribs (1.0-2.0 hectares) for larger-scale producers. Most poor farmers grow cereals for household food security. Wheat is grown on 80 percent of the cereal area (about 45 percent of total wheat area is irrigated) and accounts for about 70 percent of total national cereal consumption. Wheat is both a major crop in terms of agricultural production and the main staple of the Afghan diet. (World Bank, Pathways to Inclusive Growth, 2014)

Chart 5. Unemployment by Gender and Urban and Rural Areas



Unemployment / underemployment is a multifaceted phenomenon; some of the factors behind it include: low quantity and quality of jobs, low skills and skills mismatch, as well as a lack of certified technical and general education. Aligned with the Afghanistan National Peace and Development Framework (ANPDF), sectors must be identified that can boost employment and create more stable, longer-term jobs. Therefore, the vision behind designing development projects should be sustainable growth and the creation of more permanent jobs.

1.7. Population Growth

The Afghan population has one of the youngest age profiles in the world; approximately 46.2 percent (14.32 millions) of the population (31 millions) is under the age of 15. The population growth rate is estimated at 2.14 percent per year. [10]At this rate, over the next 25 years Afghanistan's population will almost double. Rapid population growth raises two concerns: 1) slow GDP growth would be unsustainable and would mean declining incomes for many people, as well as increasing poverty as has occurred in recent years; and 2) according to the Central Statistics Organisation (CSO), Afghanistan has a very high dependency ratio level of 99, this means for every 100 persons between the ages of 15 to 64, there are another 99 persons in the dependent groups below the age of 15 and over 65. In contrast, the average figure for the world in 2016 was 54. The very high dependency ratio means that the percentage of the population not in the labour force is very high. Having a very young population tends to be a drag on the economy, though it can have positive aspects if it is harnessed with intelligent and proactive strategy and policy designs that emphasize investing in human capital and research and development. Large pockets of youth unemployment is both regressive and destabilizing.

1.8. Competition and Fair Trading

Unfair trade and business practices undermine investment and often crowd out sectors where a large number of firms could be competing. Surrounding market dump inferior products in Afghanistan, which as a result of weak regulatory enforcement, undermine the potential for domestic firm expansion. The biggest risks relate to state capture, particularly in the PPP and industrial facility context, where unfair preferences may benefit one firm over another. Moreover, given the existence of State-Owned Enterprises (SOEs), large parts of the economy are in effect regulated to allow state provision, reducing the competitive advantage of the market-based producers and suppliers. Moreover, as noted in the NES, an effective national measurement system is essential to ensure fair trade and quality assurance. At present, there is '*no establishment in the country to maintain national measurement standards and ensure traceability of measurements in the country*.' (NES, Pg. 40)

[1] Central Statistics Organization (CSO), 2016

1.9. High Costs of Production

One of the many effects of large inflows into the economy, particularly through overseas development assistance, is its inflationary impact on wages and prices; a result of demand being artificially skewed. Moreover, the size of Afghanistan's import dependency and depreciating currency means that Afghanistan is also importing inflation. The IMF forecasts inflation at 5 percent on average in 2018, the same as in 2017, eroding gains in real GDP. Moreover, given the lack of value chain infrastructure, high friction in doing business and other impediments such as insecurity, the costs of doing business in Afghanistan remain far too high, undermining output expansion and a strong export base. Opium production also undermines the expansion of other less profitable sectors, crowding out diversification opportunities. Lowering the costs of production – to include a reduction in import tariffs for critical inputs – as well as lower transaction costs between markets through improved infrastructure are important.

1.10. Currency Depreciation

In 2011 the Afghani traded at Afs 43 to the US dollar, but as of October 2018 the Afghani had depreciated around 60% to Afs 75, largely as a result of a strong dollar. In recent years the Iranian Rial (as a result of sanctions) and Pakistan Rupee have also depreciated against the Afghani, making exports to primary trading partners more expensive. Real Effective Exchange Rate (REEF) appear to be correlated with aid flows, and excessive dollarization have made investment planning for importers and exporters challenging. Export levels have remained largely unaffected by the recent depreciation in REER due to domestic supply-side constraints (access to finance, electricity and land, etc.), higher fixed costs (due to security challenges) and limited access to international markets. International aid has also had a considerable inflationary impact on goods and services, undermining competitiveness with external markets. Aid-induced appreciation combined with investment climate constraints have negatively impacted incentive to substitute imports and expand exports. Moreover, the Afghani still has convertibility issues.

1.11. Financial Inclusion

Using the Hausmann, R., Rodrik, D. & Velasco, A., (2005) Growth Diagnostics framework, access to finance and the costs of finance are critical indicators that enable (or disable) the expansion of private sector activity. [11]Afghanistan has made considerable progress in developing financial markets and excess liquidity is in many ways, a good problem to have. Currently however, financial soundness indicators for the banking sector continue to under-perform with non-performing loans at 12 percent of total loans as of March 2018, according to the Central Bank. Banking sector profitability has also been negatively affected as a result of low levels of lending, as reflected in high liquidity ratios. The reasons for low lending rates – despite the Central Bank reducing interest rates – reflects lack of appetite by private sector borrowers and the high costs of production. The "*rebound in growth of credit to the economy, since mid-2017, is encouraging, but credit remains below 4 percent of GDP*" given the dearth of bankable projects in a high-risk environment. (IMF, May 2018). [12]

[1] See https://growthlab.cid.harvard.edu/publications/growth-diagnostics-0

[1] IMF, Third Review Under the Extended Credit Facility Arrangement and Request for Modification Of Performance Criteria—Press Release; And Staff Report (May 2018)

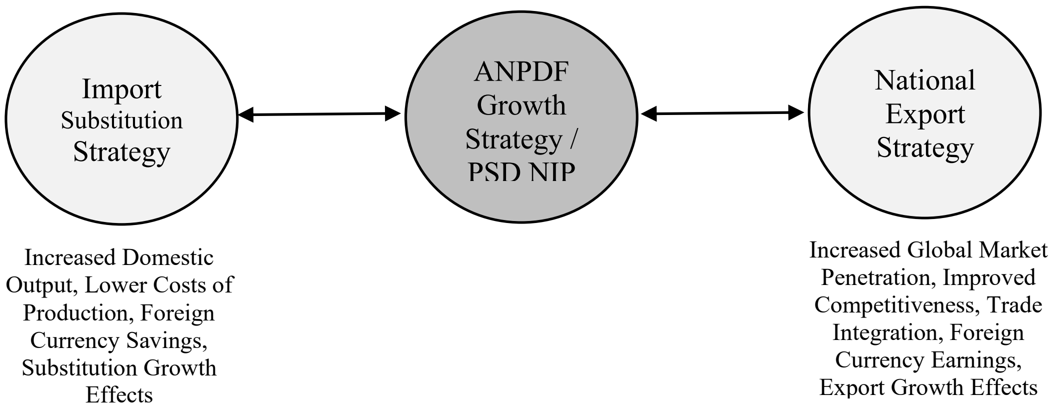
2. Import Substitution Strategy

2. Import Substitution Strategy

In adopting an Import Substitution Industrialization (ISS) strategy, the Government of Afghanistan has reviewed the impacts of both incentive and protective policies adopted by various countries, in order to deduce a basket of measures most likely to stimulate growth at home. This strategy is based on available evidence, including a review of the impacts on domestic production of currency depreciation and increased in tariff rates between 2011 and 2018; neither of which have had a considerable impact on increasing exports or reducing imports.

This strategy supports and is fully aligned to the ANPDF Growth Strategy, which foresees GDP growth of 8% + by 2025. A core part of this strategy involves lowering the costs of production but also improving the incentives for producers. The strategy is also fully linked to the National Export Strategy (NES), contributing to the incentives to increased domestic productivity; which has direct spinoffs and catalytic effects on export potential too. Critical to achieving the growth strategy is maximizing the impact of public and private spending on growth, revenues and jobs. The import substitution strategy targets both growth and jobs creation, with strong income effects within the chosen industrial clusters and product value chains. Moreover, and in view of the evidence available, government has decided not to impose tariff measures, but rather to focus on accelerating incentives. The Import Substitution Strategy and NES contribute directly to the goals of the ANPDF Growth Strategy (See Figure 1 below).

Figure 3. ANPDF, NES AND IMPORT SUBSTITUTION STRATEGY CONTRIBUTIONS



2.1 What Does the Evidence Suggest?

Import substitution as a growth strategy has been adopted by many countries to varying degrees, and is essentially an inward-looking policy that emphasizes home grown development initiatives. The primary focus of IS strategy is to provide local substitutes for simple consumer foreign imports and to produce local substitutes for more sophisticated high-technology imports. Positive impacts on the trade and current account deficits and on employment creation would be outcomes. As a result, this strategy is directly linked to our policy of Afghanization (home production first), Industrialization (product space and value chain development) and Commercialization (upscaling productivity). Government believes that import substitution is best achieved through incentivizing local producers and small-scale industries. As outlined in Table 1, of the two systems for industrial expansion Government favours the system of industrial incentives.

TABLE 1: **SYSTEMS OF INDUSTRIAL INCENTIVES WITH PROTECTION**

A. The System of Industrial Incentives	**B. The System of Protection**
▪ Measures that can be adopted:	▪ Measures that can be adopted:
▪ Tax Holidays	▪ Tariffs
▪ Incentives for a specified period of time	▪ Non-Tariff Measures such as Import Quotas, Licensing and Foreign Exchange Rate Control
▪ Grant of Accelerated Depreciation	
▪ Subsidies	
▪ Favourable Credit Policies	
▪ Establishment of Local Industries for Local Production	

Perhaps the most critical element in formulation of this strategy is to make sure that proposed interventions are evidence based. Critical here, given both Government, World Bank and US Government work on modelling the growth effects using different investment assumptions, is to develop an approach that (i) learns lessons from Afghanistan's tariff and non-tariff history and (ii) international experience. In addition, it is essential for the government to integrate an evidence-based learning capacity within the strategy, to measure effects and to provide evidence for suggesting policy adjustments. In terms of lessons learned between 2001 and 2018, but particularly since 2011 when the development and use of Computable General Equilibrium (CGE) models in Afghanistan started to emerge, the following lessons have been learned:

- ***Despite Rising Import Costs Substitution Effects have been Limited***: Since 2011 the Afghani has depreciated from Afs 45 to Afs 75 to the US dollar, which should have been a boon for exports, and import substitution, though supply and demand has not changed considerable implying inelasticity (demand and supply appear to be at least partly insensitive to changes in price or income).

- ***Tariff Impositions have increased inflation but not Stimulate Growth***: Numerus examples of hikes in import tariffs highlight that increasing the relative costs of imports has not led to a surge in domestic supply, despite the pricing advantage gained. As a result, non-pricing factors appear to remain the primary constraints to industrial expansion at home. Price signals do not significantly affect supply and demand.

- ***Market Failures (public goods, market control, externalities and imperfect information) must be addressed in order to improve competitiveness and connectivity***: Evidence suggests that market failures largely explain the growing trade and current account imbalance, moreover the pass-through effect of the exchange rate is quite significant for imports, which make it difficult for infant industries in Afghanistan to compete with cheap foreign products in domestic market. The Real Effective Exchange Rate (REER) appear to be correlated with aid flows, and excessive dollarization have made investment planning for importers and exporters challenging.

- ***Supply-Side Constraints Are Important***: Factors such as domestic supply-side constraints (access to finance, electricity and land, etc.), higher fixed costs (due to security challenges) and limited access to international markets significantly impedes the expansion of industries in Afghanistan. The inflation is primarily imported, with the pass-through effect of REER being significant while international aid has also had a limited inflationary impact on goods and services, undermining competitiveness with external markets. Aid-induced appreciation combined with investment climate constraints have negatively impacted incentive to substitute imports and expand exports. Moreover, the economy is overly dollarized and the Afghani still has convertibility issues.

- ***Lack of small-scale industrial capacity and commercial scale production undermine product space development***: The industrial clusters and products identified can only be more competitive once costs of production are reduced, new technologies deployed, large-scale commercial development expedited and value chain consolidation achieved.

- ***Production Costs and Risks Remain High***: Lowering production costs (which might include lowering of tariffs on critical imports) and drawing-down on producer risks is critical to wider output expansion, though lowering costs alone will have limited effects due to price inelasticity.

In practice countries adopt a mixed approach utilizing more than one of the measures outlined in Table 1, rather than focusing on any one specific measure. The end goal of import substitution is building enough productive competitiveness to be a more open export-oriented economy. The policy of Import Substitution has been deployed as a policy to accelerate industrialization; Brazil, South Africa and East Asian Countries have followed this path. East Asian countries, often adopted protective import substitution measures in order to ramp up production to prime the export pump. That said, if protection policies are too overbearing, and implemented over a long period, they can undermine competitiveness within global markets, implying the need for a short but multi-year investment focus. Table 2 below (adapted from Zobov et al (2017) outlines strategies that have worked and not worked for other countries, around which this strategy has been carefully developed.

TABLE 2: CLASSIFICATION OF THE MAIN MEASURES OF IMPORT SUBSTITUTION			
Classification	**Countries**	**Measures Adopted**	**Growth Gains**
		Time of Initiation of Import Substitution Policies	
1950s	Latin American Countries	Protectionist import duties, various exchange rates for imports of different categories of goods, cheap state loans for industrial enterprises, direct state participation in certain sectors	Insignificant
1960s-70s	The countries of South-East Asia (the Republic of Korea, Taiwan, Singapore)	Establishment of a realistic exchange rate, incitement of the exports: subsidizing and lending on favourable terms for the enterprises exporting products with high added value of at least a certain volume, reduction or exemption from import duties on intermediate resources	Significant
1980s- 1990s	European Economies	Lending rates, compensation, tariff policy	Average
		The Initiator of Import Substitution Policies	
Domestic initiative of the states	Latin American Countries, the countries of South- East Asia (the Republic of Korea, Taiwan, Singapore), European countries		Significant in some states
Foreign initiative	Kenya, the colonial states		Insignificant
		The Nature of the Target Market	
Domestic	Latin American Countries	Focused on the domestic market only with no combination of the import substitution policy with the policy for goods promotion to the foreign market	Led to a decrease in national industry competitiveness
Foreign	The countries of South-East Asia	Improvement of the export potential of the state	Led to a significant increase in the economies of the states
		Policy Variations	
Administrative and tariff barriers	Brazil, Argentina, Mexico, Chile, the USSR	The maximum amount of own products are produced by the state. Only goods with no analogues, or if the cost of analogues is much higher are imported.	Insignificant
Gradual reduction and the subsequent termination of state support of new industries	The countries of East Asia	The state is focused on supporting the new promising market segments. When the enterprises enter these markets, the state provides them with preferences in order to support the competitiveness of national producers at the initial stage.	Significant
Based on the "flying geese" paradigm	USA, Japan, Taiwan, India, China, South Korea, Thailand, Malaysia, Philippines	The state supports only the competitive industries with the enterprises, engaged in active export activities.	Significant

Research conducted to support this strategy assessed the Macroeconomic effects of promoting domestic production. Conclusion from this research are summarised below:

A paper developed by Omar Joya assessed the macro-economic effects of promoting domestic production using the MODAF Model (A small macroecon(ometr)ic model for the Afghan economy). The paper states that a proactive government policy to reduce imports and promote exports could well increase GDP by 2 percent, and will help reduce the merchandise trade deficit to 17 percent of GDP. However, the research shows that this policy comes at a cost. The implementation of such a policy could lead to a budget deficit of about 3 percent of GDP by 2025, unless considerable private capital is raised. This means a cumulative US$3.5 billion of additional financing through 2025, or around US$ 600 million on average annually, on top of expected donor grants. While in normal circumstances, the welfare effects of a 2 percent increase in economic growth may likely exceed the estimated fiscal cost, risks of weak revenue mobilization or an aid shock could affect the policy; (Joya, O, (2018).

A critical takeaway from this work is the importance of increasing private flows to the chosen industrial clusters. Adopting an approach where private investments in commercial production catalyse expansion in small scale industrial outputs, to include increased borrowing, provides for considerable multipliers and backwards and forwards linkages; which have still to be quantified. As a result, and in order to remove fiscal risks, a move towards blended finance modalities and commercialization in production would allow new capital flows. A modest change in investment flows would improve the competitiveness of the economy, both in terms leading to import substitution and exports.

2.2 Vision

To be a more competitive market with a more diversified, innovative and global industrial base, contributing to sustainable growth, jobs creation, and improved trade and current account deficits by 2026.

2.3 Overall Objectives

The accelerate output production through the application of incentive measures, in order to offset import dependencies and improve product space development and generate jobs at home; not abroad.

2.4 Selection Criteria for Industrial Cluster Development

No other country has been studied in as much detail as Afghanistan, and few other countries have been supported by such a volume of external support. Despite this, the status quo has not served Afghanistan well and critical areas of analysis such as (i) industrial cluster analysis (ii) research on employment multipliers and (iii) import substitution dependency for example, have never been studied. Each project employs a different set of assumptions and baselines, and as a result the selection of cluster for development is established up a rather simplified method; at this stage.

Given that historically import substitution polices are either informed by economic base case theory or industrial cluster analysis, the approach outlined combines both approaches.

On the output side, very little investment has been made in high-input large-scale commercial agriculture, and yet it is only such an approach that allows product quality, aggregation, packaging and marketing to make economic sense. Very little investment has been made to foster domestic pharmaceutical or cement industries, and the country pays a high price importing from abroad. As a result, adopting a policy of Afghanization makes a great deal of sense, in order to put in place policies and investment modalities that lower import dependency in the Afghan context, based on installed comparative and competitive advantages.

In terms of import substitution industrialization, the aim is not to impose higher import tariffs in order to increase incentives for domestic production, but rather to consider tariffs as one measure in a basket of tools. Creation of an internal market has become critical. All countries that have industrialized have followed such a policy, and closing the trade and current account deficits – which will lead to a sustainable exchange rate – must now become policy central. The current account includes transactions in goods, services, investment income and current transfers.

Criticisms for import substitution are mostly twofold: (i) Import substitution measures are protectionist and are against the ethos of the multilateral trading system particularly the WTO and (ii) Import substitution even when it has been done successfully has led to a redistribution of wealth and there are winners and losers. How do we address these concerns? Firstly in the case of the WTO and protectionist measures, Afghanistan would not be the first country to adopt import substitution under this regime. Many countries both developing and developed are currently in the process of adopting this to varying degrees. The 'make in India' strategy adopted by the Indian government for instance focuses on localisation and building domestic production and trade capacity. Even within developed countries box shifting under agricultural subsidies is a contentious issue. Further even within the WTO system it might be possible to increase the extent of local production and exports without violating international agreements. This would be a focus of this strategy. Secondly on the redistribution of wealth and creation of winners and losers, being a late entrant into adopting the trade policy of import substitution the benefit Afghanistan can learn from the experiences of other countries and this learning will be incorporated into this strategy document.

Import substitution measures are traditionally divided under two heads (i) the system of industrial incentive (ii) system of protection. The measures under the industrial incentive policies include provision of tax holidays or incentives for a specified period of time, grants of accelerated depreciation allowances, pioneer status, subsidies, favourable credit policies and the establishment of local industries for the production of local goods. The measures under the system of protection include tariff measures and non-tariff measures such as quantitative restrictions in the form of quotas, extension of credit lines to industries through donor contributions, import licencing and foreign exchange rate control. This strategy will identify under these heads the right policies for Afghanistan.

Product shortlisting criteria for this strategy have been established as follows:

- Products that are imported in large quantities that can be produced domestically whose substitution would have a considerable impact on trade and current account deficits;
- Products amenable to accelerated output increases;
- Products amenable to production efficiencies to further improve competitiveness;
- Products showing a positive Import Revealed Comparative Advantage (RCA);
- Products that can be produced on a large commercial scale and are amenable to industrialization.

Obviously, products such as broadcasting equipment (US$ 680 million in 2016), armoured vehicles (US$ 460 million in 2016), engines (US$ 275 million in 2016) cannot be substituted any time soon, but products such as wheat flour (US$ 566 million in 2016), cement (US$ 123 million in 2016) and poultry (US$ 46.4 million in 2016) can; with the correct inducements.

The potential growth in non-agricultural sectors remains considerable. In mining for example, Afghanistan has over 1,400 mineral fields, and through large scale mining in Aynak, Hajigak and Bamiyan stalled due to insecurity, certain sectors such as the expansion in gold mining highlights the promise of the wider sector. Moreover, in September 2018, Afghanistan-registered Silk Road Mining signed a large-scale mineral development contract with the Ministry of Mines and Petroleum covering the exploration and subsequent exploitation of a large copper deposit in Shaida, located in Herat Province. This is the first large scale mining contract signed by the Government of Afghanistan in the last 10 years, and reflect renewed optimism. Growth in the construction industry has stalled in recent years, though new major investments in mining, roads and energy indicate greater potential for expansion. The potential for expansion of private sector health care provision remains considerable, and companies such as Afghan Pharma demonstrate the possibility for import substitution, and partnering with established international pharmaceutical companies. Other local pharmaceutical companies are increasing the domestic share of the lucrative pharmaceutical market which has been traditionally dominated by imported pharmaceutical products. Many locally produced products are cost competitive.

2.5 Industrial Cluster and Product Group Selection

The implementation of the Afghan Import Substitution Strategy is expected to stimulate and encourage value addition activities on a range of candidate commodities as a means of increasing domestic consumption, creating employment opportunities and transforming the Afghan economy into one that is diversified and competitive, with strong internal market integration linked to export markets. What is good for import substitution is also good for export promotion. As a result, this industrial cluster focuses on ten (10) sub-sectors as priority drivers of import substitution industrialization. These have been established on the basis of the application of stated criteria, and are outlined in Table 3 below.

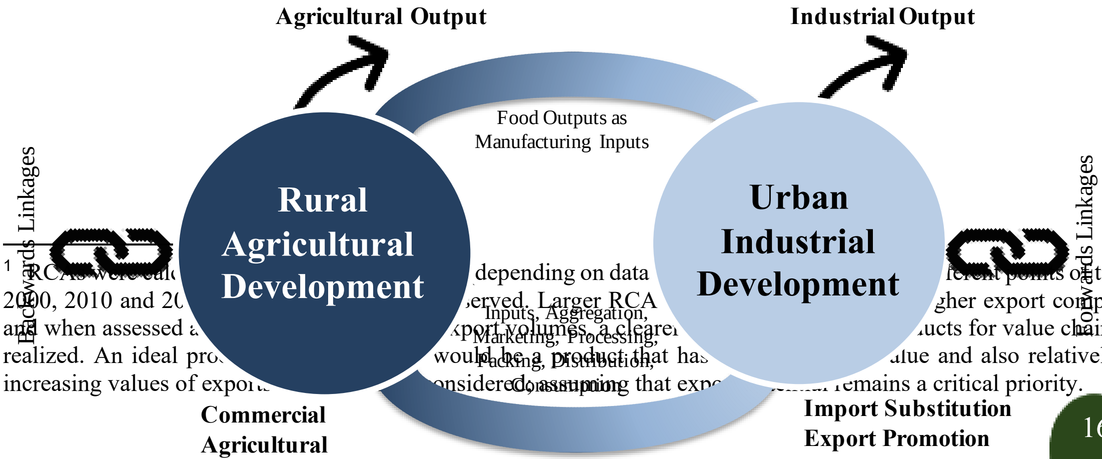
Industrial Cluster Candidates					
Industrial Cluster	Import Value (US$)	Tariff Rate	Import RCA [1]	% of Imports	Potential for Industrialization
Wheat & Wheat Flour	906,000,000	2.5-5	208	12.2 %	Yes
Pharmaceuticals & Medical Services	744,300,000	2.5	Various	1.2 %	Yes
Cement	303,000,000	10	12.2	4.1%	Yes
Edible Oil	395,100,000	2.5	26	5.3%	Yes
Sugar &Confectionary	212,500,000	5-16	99.4	2.9%	Yes
Poultry Meat	46,400,000	5-20	2.89	0.51%	N/A
Vegetables	79,000,000	5-40	Various	1.1%	N/A
Cereals	57,000,000	5-10		0.8%	N/A
Dairy Products	76,000,000	5-2		1.0%	Yes
Steel	363,000,000	5-16		4.9%	Yes
Electricity	289,000,000	2.5		3.9%	Yes
Totals	3,471,300,000			%	N/A

* For vegetable products, the average tariff is 10 since many lines have this tariff, the peak tariff is 16 for some lines and many lines have 2.5.

2.6 Overall Import Substitution Approach

The largest percentage of imports that can be substituted is derived from the agricultural and horticultural sector, and this sector is also the largest employer. As a result, and given the need to create an internal market that links supply and demand, any approach must seek to strengthen market linkages and dependencies between rural and urban areas. It would be insufficient to focus on product-space and value chain development outside of the demand for products and services, and therefore the overall approach adopted might be understood as '*Agricultural Led Industrialization*'. This approach strengthens both backwards and forwards linkages between clusters and markets, and better supports value chain integration. Figure 4 outlines the overall approach, aimed at increasing output, profitability, re-investment, expansion and increased demand.

Figure 4. AN 'AGRICULTURAL LED INDUSTRIALIZATION' APPROACH



[1] RCAs were calc... depending on data ... ferent points of time – 1996, 2000, 2010 and 20... served. Larger RCA ... gher export competitiveness, and when assessed a... xport volumes, a clearer ... ucts for value chain support is realized. An ideal pro... would be a product that has ... alue and also relatively high and increasing values of expor... onsidered, assuming that exp... remains a critical priority.

2.7 Overcoming Supply Side Constraints

As noted in the ANPDF and PSD programs, supply side constraints must be overcome. The strategy proposed is to identify the primary supply-side constraints for each industrial cluster and candidate product, based on outreach with the private sector and value chain actors. Primary constraints to be addressed on the supply side are as follows:

- ***Agricultural Land*** (increased access to land for commercial purposes, large scale concessions etc.);
- ***Industrial Land / Parks*** (access to improved business environments including land, buildings, electricity, water, finance, processing and communications)
- ***Electricity*** (improved pricing, network expansion, power outages, voltage fluctuations);
- ***Roads*** and ***transport*** (improved market to market infrastructure);
- ***Agricultural*** and ***pharmaceutical inputs***, lower costs and improved quality;
- ***Finance*** (improved inclusion, lower interest rates, better products);
- ***Credit Guarantees*** (risk sharing facilities to scale up lending to under-performing sectors and to extend the time horizon for lending). [14]; and,
- ***Human Resources*** (closing the skills gap, hands-on training, technical and vocational skills)

Again, the strategy does not focus country and market wide, but instead bears down on candidate value chains, removing constraints for a specific product for a known set of market actors. As a result, strong public private dialogue is critical to prioritizing constraints and identifying durable solutions. Packages of industrial incentives will be developed, targeting specific product and markets.

2.8 Overcoming Demand Side Constraints

Even though on paper Afghanistan has been a story of worsening demand since 2011, the reality is that 2016 saw continued demand for the import of products and services. Import dependency reflects a failure to capitalize on internal demand for home produced goods and services and it reflects the fact that it is not market pricing but supply that is shaping consumer preferences. In the long term strengthening require a shift in productivity, but in the short-term incomes must increase relative to spending. This can only happen when business activities are more profitable, when risks are better mitigated, and when capital flows into the parts of the economy most amenable to growth.

Government looks to put in place a system of demand-driven services, where market actors can benefit from incentives that boost rewards against risks. For example, a demand-driven credit guarantee program will be launched, risk-management products made available, increased lending for production and consumption smoothing delivered, and import tariffs removed on critical products that are essential for output expansion. DAB will work to achieve domestic price stability and to mitigate severe fluctuations in exchange via intervention in the domestic market – given the significant pass-through effect of exchange rate into inflation. These and other actions are critical to attaining the goals of the Productive Afghanistan Strategy.

Another critical area of support must be on improved branding and marketing of products, to allow often inferior local products to be scale, and improved. Increasing market share for home produced products

---

[1] A number of risk-sharing facilities[4] already exist in Afghanistan, such as the Afghanistan Credit Guarantee Facility and USAID Development Credit Authority, though they are not market wide and expansion is necessary.

could be encouraged with a 'Made in Afghanistan' branding, with government communication channels supporting greater awareness amongst consumers.

2.9 A Product Space Development Approach

This strategy depends heavily on the critical concept of 'product-space-development'. [15] The Product Space is understood as a network that formalizes the idea of relatedness between products traded in the global economy. In Afghanistan, the product space network has considerable implications for economic policy as it explains how steady economic growth can be achieved and how an Agricultural Led Industrialization (ALI) policy will assist in accelerating productivity growth, while also supporting import substitution and export promotion.

A Product Space Development approach link would encourage investments around products already being developed, with similar productive environment and complexity profiles. So, for example, as Afghanistan currently exports fresh pomegranate to neighbouring countries, it has a greater chance of developing pomegranate drink processing capabilities than building armoured vehicles. As a result, the Revealed Comparative Advantage (RCA) of each product, when seen from a product space point of view, allows Government to use data to target investments that expand product space development for products that have demonstrated advantages. Linking product space development with and AALI approach leads to broad scale developments in Small to Medium Enterprises (SME). This strategy therefore combines a number of critical elements together, to allow AALI to have a demonstrable effect on growth, import substitution and exports. These elements imply investing around the following approach:

- ***Revealed Comparative Advantage***: Investing in products with a positive Revealed Comparative Advantage. If the RCA value exceeds one, the share of exports of a country in a given product is deemed to be larger than the share of that product in all global trade;

- ***Product Space Network***: Developing the product space network for Afghanistan as the basis for understanding the evolution of Afghanistan's productive structure;

- ***Product Proximity***: Adopting an approach where the proximity between one product and another allows the identification of next generation products, which have similar production profiles and requirements;

- ***Forward and Backward Linkages***: Not just looking at products as isolated production outcomes, but rather looking at the forward linkages (outcome, impact and potential of investments made) and backwards linkages (when a project encourages investment in facilities that enable the project to succeed); and,

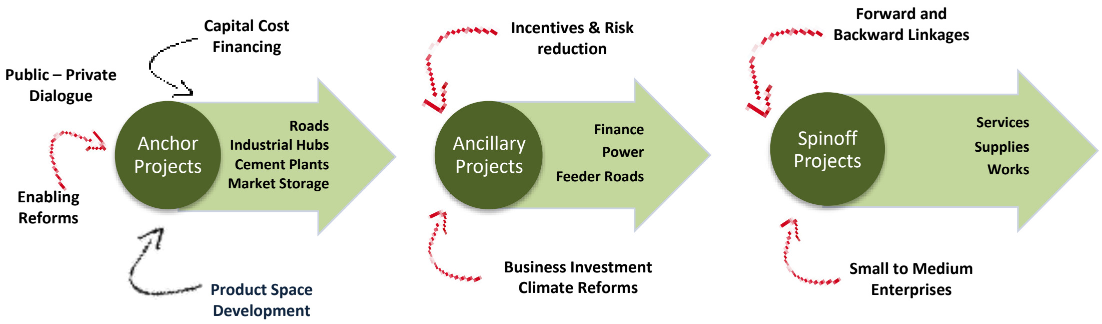
- ***Anchor, Ancillary and Spinoff Investments***: A critical approach to building investments that exhibit positive rates of return, have strong multiplier effects and lead to spinoff investments is to develop a public investment program – with strong private equity engaged – combining large, medium and small investments into an integrated approach. Anchor financier can be both public and private, and include PPP and SPV modalities.

The first step toward sustainable and stable economic growth is to rebalance Afghanistan's terms of trade, by boosting production and national competitiveness, lowering market transaction costs and lowering exposure to market risks. For this to happen, investments must be more than the sum of the projects, and an integrated approach must be developed that improves both policy and investment coordination. This import substitution strategy therefore forwards an anchor, ancillary and spin off investment approach (See Figure 5 below), in order to maximize direct, indirect, induced and catalytic effects.

[1] The network first appeared in the July 2007 issue of Science in the article "The Product Space Conditions the Development of Nations,"[1] written by Cesar A. Hidalgo, Bailey Klinger, Ricardo Hausmann, and Albert-László Barabási.

For example, not only do industrial parks provide anchor infrastructure, they are specifically designed to bring value chain stakeholders together under one roof. Supply side constraints can be overcome, and product aggregation, processing, packaging, marketing and distribution cane be improved. Power and finance can be provided as a quality service, and the direct and indirect spinoffs of such a structure foster improved linkages between SME's and larger supply side companies. Inputs can be purchased in bulk at lower prices. Ancillary investment from trade hubs include roads, cold storage systems, quality infrastructure. MoEc intends to support a more integrated economic approach for the import substation strategy, working across Government to bring added value in strengthening the business case for the candidate clusters.

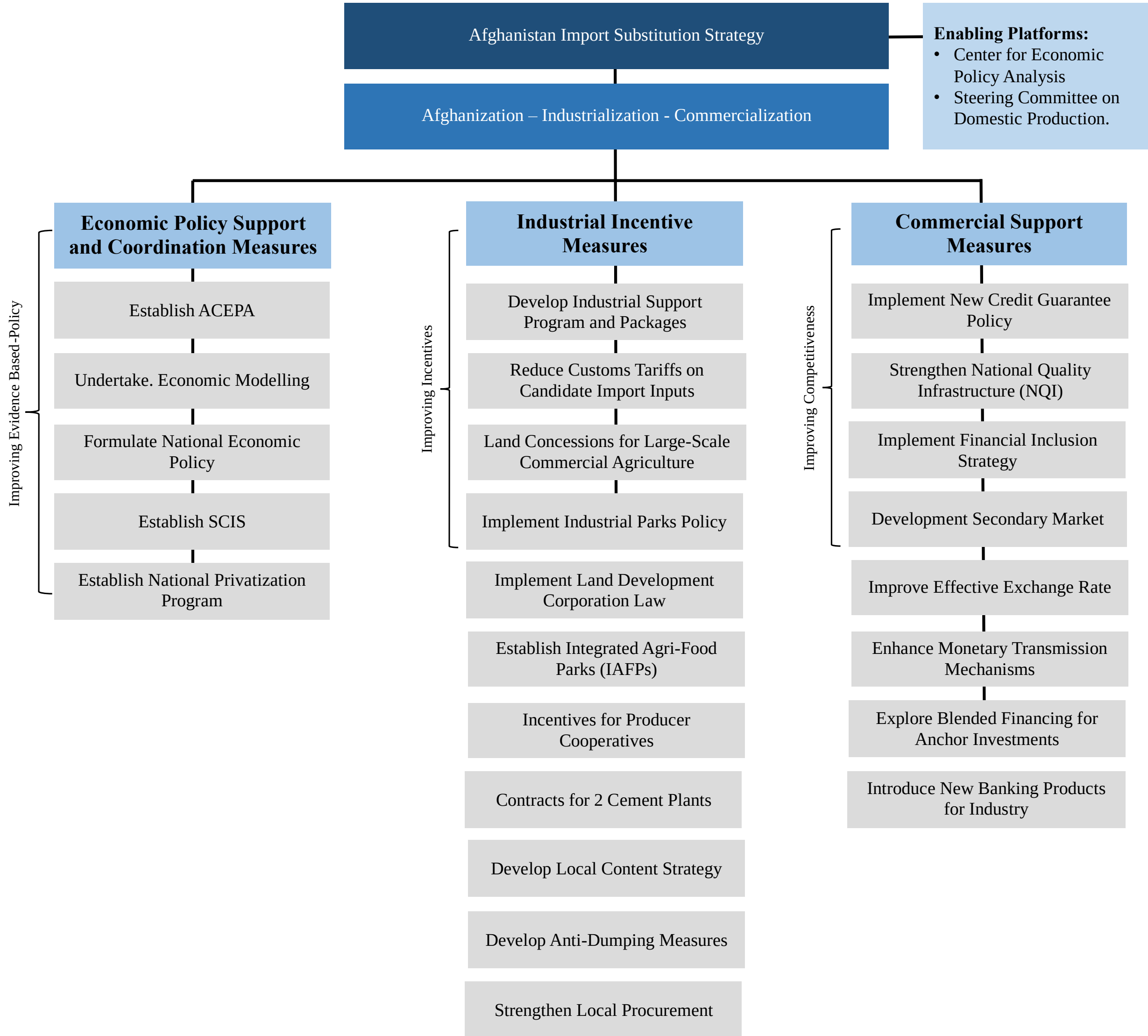
Figure 5. ANCHOR, ANCILLARY AND SPIN OFF INVESTMENT MODALITY

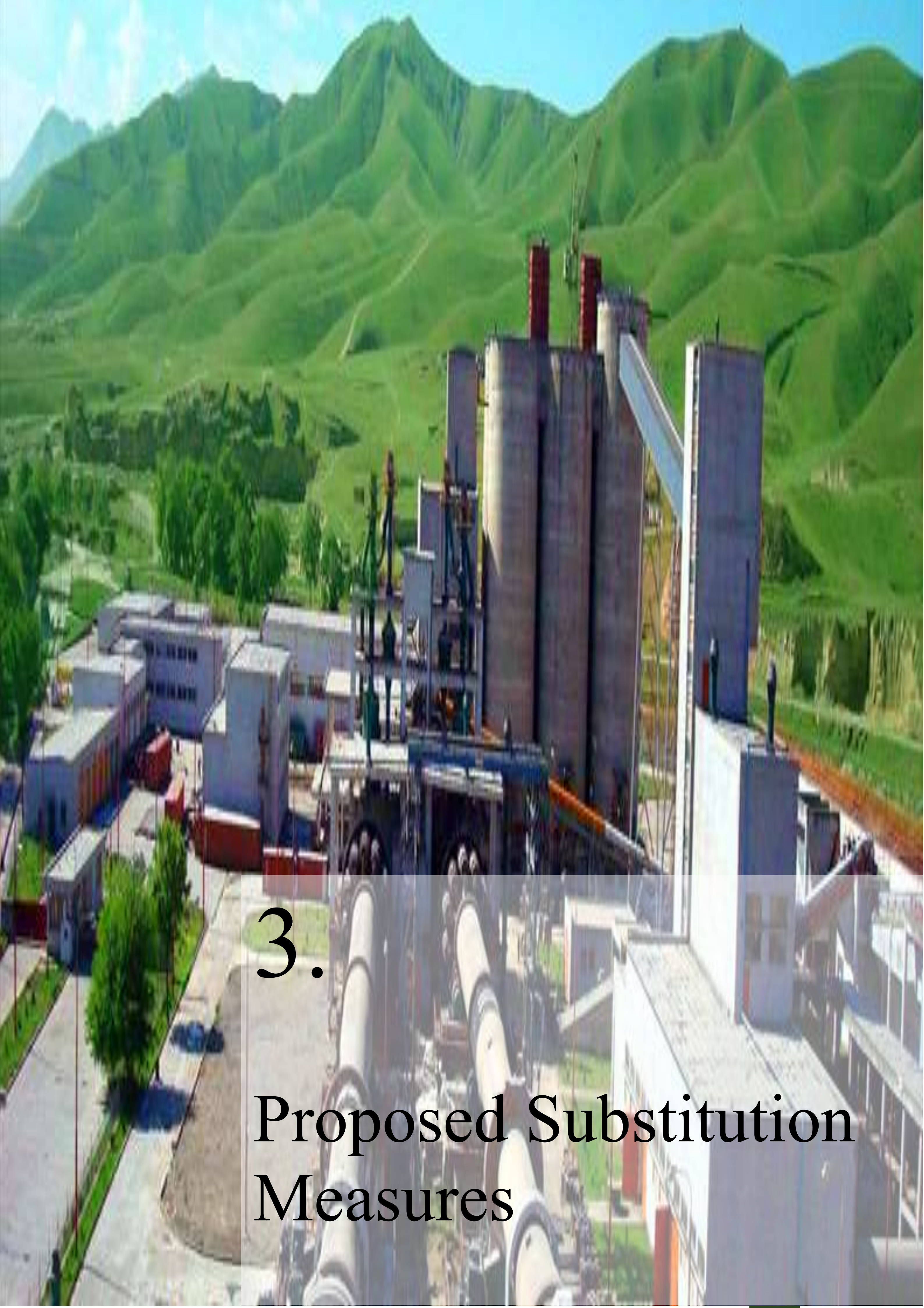


2.10 Overview of the Import Substitution Strategy

Figure 6 below provides an overview of the core elements of the strategy, built around three core areas of support, and bringing together a set of measures to meet the goals laid out in the following sections. The strategy (see implementation chapter) will be implemented as a whole-of-government program, building on existing programs, with new elements aimed at improving evidence and impact.

Figure 6. OVERVIEW OF THE IMPORT SUBSTITUTION STRATEGY





3.

Proposed Substitution Measures

3 Import Substitution (Incentive) Measures

For import substitution to be accelerated the incentive framework must be strengthened. For the industrial cluster candidates identified for development, a basket of direct and indirect support options must be developed, to encourage expansion, lower costs of production, draw down on risks and overcome market failures. As a result, the import substitution strategy outlines the following set of measures to substitute imports for domestic production:

- Economic Policy Support and Coordination Measures;
- Industrial incentive measures; and,
- Passive Support measures for financial and credit markets.

The ANPDF Growth Strategy forecasts agro-processing value addition to increase by around US$330 million through the establishment of agri-business parks and other measures. As outlined in the industrial cluster candidate selection section, this strategy focused on ***agriculture***, ***mineral*** and ***pharmaceuticals*** only.

3.1 Candidate Industrial Clusters

The World Bank issued a report entitled "*Agriculture Sector Review: Revitalizing Agriculture for Economic Growth, Job Creation and Food Security*" in June 2014. The overall objective of the report was to highlight the significance of agriculture towards overall poverty reduction in rural areas, inclusive economic growth, food security and job creation Afghanistan. The report recommends to the Government of Afghanistan to play a lead role in (i) driving and coordinating the strategy within each of the selected value chains to encourage this growth, and (ii) in overcoming cross-cutting constraints including irrigation water and finance.

Given the country's high population growth rate, simulations with an economy-wide model show that agriculture will need to grow by at least six percent per year if rural incomes are to increase. Therefore, rather than trying to drive the entire agricultural sector, it may be more realistic to focus attention initially on a few "first movers" commodities that are imported, and traditional export crops. These "first movers" are:

- Irrigated Wheat;
- Intensive Livestock (Milk, Eggs, and Poultry Meat); and,
- Horticulture Crops (Fruits, Nuts, Vegetables).

The promotion of the "first-mover" strategy responds both to the adjustment of the anticipated decline in foreign aid and agricultural transformation that is necessary for Afghanistan's inclusive economic growth, job creation and food security. It also assists in closing the trade and current account gaps. The first movers – industrial clusters – were selected

- They have the best catch-up potential in the short term for raising productivity;
- Cost analysis shows that irrigated wheat and horticultural and livestock products can be produced on a competitive basis with imports;
- These commodities face strong and growing demand at home or abroad;
- They can leverage significant value addition and employment along value chains, and increase the incomes and employment of large numbers of people;
- The industrial clusters are spatially concentrated in relatively small intensive irrigated and peri-urban areas that are somewhat secure and have good access to markets; and,
- At a time of fiscal tightening, they offer a way to concentrate available public resources so as to achieve the best possible gains

Irrigation Wheat

Irrigated wheat accounts for one quarter of agricultural GDP and 6.3 percent of national GDP (70 percent of its value comes from irrigated areas) and it generates between 1.1 and 1.3 million full time jobs (on farm and off-farm i.e agro-industries, including milling and baking). It is also realistic to expect that production could be increased to displace most imports within five to ten years, at least in non-drought years. Moreover, it would be unrealistic to substitute Irrigated Wheat for alternative crops within the medium to short term, for the following reasons:

- The development of high-value horticultural production and markets will take time, and is likely to be concentrated in areas that have ready access to markets and/or cold storage facilities. This means that irrigated wheat will remain competitive in many areas for a long time;
- Farmers decide what crops to grow, and given the uncertain environment in which they live, most choose to grow wheat for their own food security; and,
- The Government needs to balance the need for economic efficiency in the use of the country's agricultural resources against the need to prevent a national food crisis (such as that occurred in 2008), and this requires maintaining an acceptable ratio of domestic production to national consumption.

If irrigated wheat area can be expanded by 10 percent over ten years through rehabilitation and the yield can be raised to 4.5 MT/ha, then total irrigated wheat production would increase by 2.25 million MT over the decade, giving an additional annual GDP contribution of US$1.58 billion. This would create up to 173,800 new FTE jobs in wheat production and 54,700 in agroindustry, including wheat milling and baking.

Livestock

Analysis of import dependency and revealed comparative advantage shows a considerable potential for upscaling livestock and milk production. Livestock contributes about 15 percent of agricultural GDP, or US$ 680 million in 2014, creating about 1.1 million full time jobs, 15 percent of which are off the farm. The livestock subsector also has good catch-up potential and it could contribute much to growth and employment, substitute for imports, and exploit more export opportunities. The cluster can also leverage more agro-processing activity at small and medium scales. Low productivity breeds, diseases, poor feeding, drought, and the difficulties of marketing perishable commodities are the main constraints on the livestock cluster. Without additional support, intensive livestock production will increase only modestly over the next ten years. But with support there is reasonable potential to double the output of intensive dairy and poultry production within this period, adding US$270 million annually to GDP and creating 715,300 full time jobs over the decade. Poultry and egg production has massive potential for expansion.

Horticulture

Currently the horticulture subsector extends to about 360,000 ha, covering almost 14 percent of the country's irrigated land area and involving more than 2 million people. Horticulture currently contributes US$1.4 billion to national GDP and 34 percent of agricultural GDP, and provides some 350,000 full time jobs, of which some 90,000 are in the non-farm economy. It is reasonable to expect that the irrigated area devoted to horticulture could be increased (through rehabilitation) by 25,000 ha each year, thus adding another 250,000 ha by 2024. Together these changes could lead to an annual GDP contribution of about US$3.23 billion per year by 2024. They would add 361,900 FTE jobs by 2024

The potential for industrial and agri-park development, product space enhancement and value chain integration remain considerable. The three clusters alone could more than double Afghanistan's agricultural GDP over the next ten years, driving an average annual agricultural growth rate of about eight percent. An addition of 1.3 million full time jobs within the next decade (1.05 million in agriculture and 0.26 million in the non-farm economy), a number equivalent to about 30 percent of the estimated net addition to the labour force over the period.

Cement

Afghanistan imports over 90% of its cement from Pakistan and the balance from Iran. Some 4 million tonnes are imported annually, down from 8.3 million tonnes in 2013. [1] The expansion of the Chinese Pakistan Economic Corridor (CPEC) in Pakistan has however saturated supply, and exports to Afghanistan have been falling. Afghanistan currently has four cement plants though in 2017 a Czech company announced a US$ 70 million investment in a new cement facility in the South West. The cost of cement in Herat are set to fall substantially. The four main cement plants are as follows:

- Ghori I & Ghori II cement plants Pul-e Khumri;
- Jabal-e Saraj cement;
- Herat cement; and,
- Samangan Cement.

Ghori I & Ghori II plants are designed as a two kiln which has production capacity of 400 Tonnes per day, and 1,000 tonnes per day of clinker. The Herat cement plant was originally designed to be a tow-line, wet process plant with a rated design capacity of 700 tonnes per day of clinker. Jabel-e – Seraj cement plan has a rated design capacity of 100 tonnes per year. Ghori cement has been privatized since 2006 and Government plans to corporatize both Herat Cement and Samangan Cement. Government has announced plans to attract foreign direct investors in the sector. Some 40,000 tonnes of cement are need in Afghanistan on a daily basis, and importing cement from abroad remains expensive. The Afghanistan Customs Department reportedly banned imports of cement at the Farah border crossing from Iran's South Khorasan Province.

Afghanistan has the potential to substitute large current cement imports through domestic production, including through mobilizing private investment in existing cement plants. Domestic cement production could displace imports of around US$700 million. The cement is not a big employer, though the benefits of lower costs and improved supply affects all industries.

Pharmaceuticals

Afghanistan remains highly import dependent on the import of pharmaceutical drugs, though domestic production of basic drugs is slowly increasing (8% of demand). Afghanistan continues to imports from the US, Japan, Switzerland, Turkey, India, Pakistan and Iran and even where domestic production is increasing, raw materials are imported from China and India. Reports of dumping of low-quality medicines on the Afghan market have persisted for years, with illegal imports likely to be considerable. The 2007 Afghan Pharmaceuticals law and 2008 Law on Licensed National Pharmaceutical Products List (2008) need to be upgraded, with greater regulatory oversight of import quality and domestic production. Closing the import gap for basic drugs can be achieved on a commercial basis within ten years.

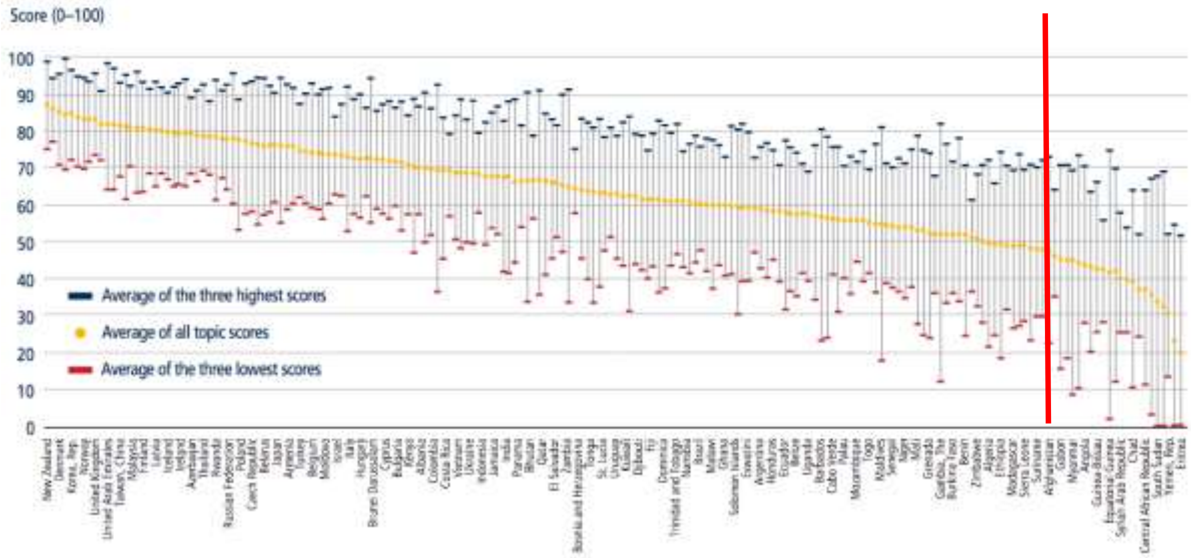
3.2 Doing Business

Chart 5 below provides a summary of Afghanistan's Doing Business indicators compared to other fragile and conflict affected states. The survey does not measure all aspects of the business environment that matter to firms or investors — such as macroeconomic stability, the size of the market, the state of the financial system or the quality of human capital. That said, in 2018 Afghanistan jumped up the Doing Business rankings by 10 points, with major changes in the area of areas of Starting a Business, Getting Credit, Protecting Minority Investors, Paying Taxes, and Resolving Insolvency.

Afghanistan - the top improver in Doing Business 2019 - focused on enhancing the legal framework for businesses. Minority investor protections were strengthened substantially, making Afghanistan one of the economies advancing most in this area. A new law on limited liability companies made noteworthy progress toward mitigating the risks of prejudicial conflicts of interest in companies and strengthening corporate governance structures. In addition, the Commercial Procedure Code was amended to grant greater powers to shareholders to challenge related-party transactions. Afghanistan also adopted a new insolvency legal framework in 2018.

[1] http://www.globalcement.com/news/itemlist/tag/Afghanistan

Chart 6. Afghanistan's Improving Regulatory Environment



Source: World Bank Doing Business (2018)

While many measures are not caught by the doing business reports, the emergence of sub-national doing business reports allow Government and external partners to target primary constraints at the provincial and district levels, potentially impacting domestic production and business capacity.

3.3 Import Substitution Matrix of Measures

The proposed is to adopt an integrated approach to import substation, providing a whole-of-government solution. A basket of measures is proposed covering (i) economic policy support and coordination measures (ii) industrial incentive measures; and (iii) passive support measures for financial and credit markets. The corrective measures proposed below are practical and actionable, and have been selected because they bring together priority reforms from various parts of government, into a coherent whole.

A critical focus on the proposed measures is Afghanization, Industrialization and Commercialization. The measures outlined in Table 4 below improve investment incentives and lower risks, in order to improve domestic supply and demand. The primary aim is to increase private capitals share of investment in all the industrial clusters selected in order to improve value addition, and jobs creation. Of note, reforms outlined in 1 below focus on improving the economic policy making environment, given the scarcity of critical analysis on key areas of economic performance and industrial expansion.

TABLE 3: PRODUCTIVE AFGHANISTAN SUBSTITUTION MATRIX OF MEASURES

Activities		Priority (1 = High) (2 = Medium) (3 = Low)	Implementation Period 2019	2020	2021	2022	2023	2024	Activities	Implementers
1. Economic Policy Support and Coordination Measures										
1.1	**Establish Afghanistan Centre for Economic Policy Analysis (ACEPA)**	**1**							- Quarterly Economic Updates	MoEC ACEPA
									- Publish Economic Indicators	
									- One Off Research Publications	
1.2	**Close Economic Modelling Gaps**	**1**							- Confirm Candidate Products	OoP, HLEC, MoEc, MoIC, Sector Ministries
									- Macro-Economic Dashboard	
									- Establish National CGE Model	
									- Industrial Cluster Analysis	
									- Develop import co-efficient	
									- Establish employment multipliers	
									- Model Tariff and Quota Option	
									- Model Market Elasticities	
									- Import Quota Modelling	
1.3	**Formulate National Economic Policy**	**2**							- Establish Drafting Committee	OoP, CEO Office, HLEC, MoEc
									- Macro-economic Stabilization	
									- Fiscal and Expenditure Stance	
									- Review Tax and Interest Rate Policy	
									- Trade Support Measures	
									- Employment Measures	
1.4	**Establish Steering Committee on Import Substitution (SCIS)**	**1**							- Cross-Ministerial Coordination	MoEc, MAIL,
									- Implementation	
									- Impact Monitoring	
1.5	**Establish National Privatization / Corporatization Program**	**1**							- Develop Legislative Frameworks of Targeted Sectors for Privatization	OoP, HLEC, MoF, MoEc, MoIC
									- Establish Privatization Supervisory Committees	
									- Define strategy, metrics and incentives	
									- Unlock state-owned assets for the Private Sector	

TABLE 3: **PRODUCTIVE AFGHANISTAN SUBSTITUTION MATRIX OF MEASURES**

Activities		Priority (1 = High) (2 = Medium) (3 = Low)	Implementation Period 2019	2020	2021	2022	2023	2024	Activities	Implementers
2. Industrial Incentive Measures										
2.1	**Develop Industrial Support Program and Packages**	1							- Fiscal and Non-Fiscal Incentives	HLEC, MoIC, MoEc
									- Accelerated Depreciation Allowances	
									- Tax Breaks	
									- Pioneer Status and Subsidies	
									- Credit Policies	
									- Implement Agricultural Charter	
2.2	**Reduce Customs Tariffs on Candidate Import Inputs**	1							- Undertake economic Analysis	MoF, ACEPA, WB, IMF
									- Periodic Cost Benefit Studies	
2.3	**Land Concessions for Large-Scale Commercial Agriculture**	1							- Feasibility Studies	ARAZI, MoF PPP, MAIL
									- PPP Procurement	
									- Assess Off-take Potential	
2.4	**Implement Industrial Parks Policy**	2							- Site Selection	MoIC, MoF, ARAZI, AAEDC, MoF
									- Business Plan and procurement	
									- Concession Award and Management	
2.5	**Implement Land Development Corporation Law**	2							- Establish Government-Owned Entity on Joint ventures (SPV)	ARAZI, MoF, MoIC, MoEc
									- Identify projects on state-owned land.	
2.6	**Establish Integrated Agri-Food Parks (IAFPs)**	2							- Feasibility Studies	AIPRA
									- Investment Promotion Strategy	
									- Procure Operators & Tenant Companies	
2.7	**Incentives for Producer Cooperatives**	2							- Establish Guidelines & Incentives	MAIL, MRRD, MoF, MoIC
									- Establishment and Support	
2.8	**Finalize contract for private investments in 2 existing cement plants**	2							- Conduct Feasibility Studies	MoF, MoIC
									- PPP Transaction Advisory	
2.9	**Develop Local Content Strategy**	1							- Establish Local Content Task Force	OoP, MoF
									- Foster Afghanization (% local product)	
2.10	**Develop anti-dumping measures**	1							- Identify Product Injuring Effects	MoEc, MoIC
									- Consider Anti-Dumping Duties	
		1							- Increase Local Firm Participation	MoF

TABLE 3: **PRODUCTIVE AFGHANISTAN SUBSTITUTION MATRIX OF MEASURES**

Activities		Priority (1 = High) (2 = Medium) (3 = Low)	Implementation Period						Activities	Implementers
			2019	2020	2021	2022	2023	2024		
2.11	**Strengthen Local Procurement**								- Maximize In-Country Spending	
3. First Level and Passive Support Measures For Financial and Credit Markets										
3.1	**Implement Credit Guarantee Scheme**	**1**							- Terms and Pricing - Eligibility - Establish Eligible Sectors	DAB, MoF, Sectors
3.2	**Strengthen National Quality Infrastructure (NQI)**	**2**							- Strengthen Institutional Capacity - Enhance Private Sector Engagement - Private Sector NQI Service Providers	ANSA, Chamber of Commerce
3.3	**Implement Financial Inclusion Strategy**	**1**							- Formulate the National Financial Inclusion Strategy (NFIS) - Formulate the National Strategy for Financial Literacy & Capability - Formulate Consumer Protection Laws	DAB, WB, IMF
3.4	**Development Secondary Market**	**2**							- Finalize legal and regulatory frameworks for Sukuk market - Issue Domestic Debt Instrument	DAB, MoF
3.5	**Improve Effective Exchange Rate**	**1**							- Effectiveness of the interest channel - National Currency Trust Measures	DAB
3.6	**Enhance Monetary Transmission Mechanisms**	**2**							- Improve Aggregate Demand - Prudent Interest Rate Regime - Credit Market Development	DAB
3.7	**Explore Blended Financing for Anchor Investments**	**3**							- Identify Anchor Projects for PPP/SPV - Identify Anchor Financiers - Pilot Sector Blended Finance Models	MoF, MoEc, IFIs, Donors
3.8	**Introduce New Banking Products for Industry**	**2**							- Dialogue with Industry and SMEs - Engage Commercial Banks	DAB, MISFA, Commercial Banks, SOEs

4. Afghanization, Industrialization & Commercialization Key Performance Indicators

4 Afghanization, Industrialization & Commercialization KPIs

This Strategy is supported by a new policy approach, based on the concept of Afghanization. Afghanization is supported by a strong focus on building up small to medium sized industries and a huge push for increased commercialization.

The strategy links internal sector growth with forward and backward linkages between Agricultural production and industrial development; which links to external sector growth; i.e. exports. Afghan agriculture will provide the commodity base for both import substitution and exports, including domestic food supply and industrial output; in order to enlarge the market for domestic manufacturing expansion. While the Afghan mineral deposit sector has long term potential, the commodity super cycle having ended, and with low global commodity prices and high costs for extraction and transport, links between AALI and the mineral sector will take time to evolve. AALI therefore can be characterized as an investment strategy that:

- Increases agricultural output and productivity;
- Increase industrial output and productivity;
- Focuses on labour intensive industries;
- Closes input-output linkage between the two sectors; and,
- Blended finance; public and private investment.

Afghanistan GDP is US$ 20.8 Billion and the structure of GDP contribution is 21% to agriculture, 22% to industry, 11% to manufacturing and 53% to services. Within this context, the approach and goals for these elements are outlined below:

4.1 Afghanization – Boosting Domestic Production Capabilities

The Government of Afghanistan wishes to put in place a new policy called ‘Afghanization’. At its core, Afghanization is an initiative by the government to maximize growth and employment benefits for Afghan firms and citizens, to both produce and be employed in a meaningful and efficient manner in the public and private sectors. There has been an over-dependence on external support and imports, leading to trade, current account, investment and skills deficits.

4.1.1 Approach:

The incentive package to boost Afghanization has a number of measures designed to strengthen domestic production capacities, visa a vis internal and external markets. Primary measures are as follows:

- Adopting an ‘Afghanistan First’ policy at every stage of the development process;
- Contracting Afghan firms wherever possible and desirable;
- Developing local content directives and regulations;
- Ramping up efforts to de-dollarize the economy;
- Developing the secondary market including Sukuks;
- Overcoming weaknesses in domestic output expansion;
- Lowering the costs of production and lowering risk;
- Generate growth and employment at home;
- Lowering risk and boosting rewards.

4.1.1 Key Performance Indicators:

The primary goal of Afghanization is to put Afghanistan First. This implies improving the incentives package for producers, and putting policies and regulations in place to support Afghan production over imports where there appears to be justification for doing so. For example, Afghanistan can be self-sufficient in wheat and what flour, and produce poultry and eggs at home, and also develop both cement and pharmaceutical industries which will also catalase other industries, given backwards and forwards linkages. The policy goal implies generating jobs at home not abroad, and putting in place investments that increase Afghanistan’s competitiveness vis a vis the external market. Key goals are provided in the Box below:

Afghanization Goals:

- A national economic policy supported by evidence, and routine availability of economic analysis to guide industrial and commercial development;
- A 50% reduction in import dependency for selected products by 2025;
- To reduce the current account deficit from -22% in 2016 to -10% by 2025;
- To reduce imports of goods and services from 40.02 % of GDP in 2016 to 35% by 2025; and,
- To improve the trade balance from US$ -6.97 billion in 2016 to US -5.5 billion by 2025.

4.2 Industrialization – Enhancing Value Addition [1] 7

The Ministry of Economy believes that insufficient attention has been paid to accelerating industrialization in Afghanistan. Industrial cluster analysis is not routinely undertaken, import co-efficiency is not measured, and no employment multipliers have been established either. Incentive packages have not been properly developed, and a decline in manufacturing and industry has been the result; negatively affecting employment rates. As a result, establishing an import substitution strategy must first of all deal with the lack of data and analysis upon which an optimal policy can be established.

4.2.1 Approach:

The primary approach is to provide more direct support to foster industry and manufacturing, not just through product space and value chain development, but also by working with the private sector to improve the balance of risks to rewards.

- Three-year tax holiday for new manufacturing firms to encourage investment;
- Identify and support value chains that represent the most competitive prospects for value addition in selected industrial clusters;
- Provide both fiscal and non-fiscal incentives;
- Improve access to finance and availability of banking products to support industry and SMEs;
- Strengthen the industrial incentives package available to domestic producers to promote internal trade and investment;
- Target investments that overcome market failures such as lower priced energy, improved product aggregation, cold storage, packaging, certification, transportation and market information;
- Enhance financial inclusion;
- Accelerate development of special economic / agri-industrial zones and public private partnerships including concessions; and

4.2.1 Key Performance Indicators:

The primary goal is to expand manufacturing and industry output as a percentage of GDP, based on growth in the industrial clusters identified. Existing value chain development investments focus heavily on horticultural and livestock development, with an increasing focus on building up firm output capacities, for products with both value and volume potential.

---

[1] Industry corresponds to ISIC divisions 10-45 and includes manufacturing (ISIC divisions 15-37). It comprises value added in mining, manufacturing (also reported as a separate subgroup), construction, electricity, water, and gas. Value added is the net output of a sector after adding up all outputs and subtracting intermediate inputs. It is calculated without making deductions for depreciation of fabricated assets or depletion and degradation of natural resources. The origin of value added is determined by the International Standard Industrial Classification (ISIC), revision 3 or 4. Manufacturing refers to industries belonging to ISIC divisions 15-37. Value added is the net output of a sector after adding up all outputs and subtracting intermediate inputs. It is calculated without making deductions for depreciation of fabricated assets or depletion and degradation of natural resources. The origin of value added is determined by the International Standard Industrial Classification (ISIC), revision 3. Note: For VAB countries, gross value added at factor cost is used as the denominator.

Industrialization Goals:

- Reverse the decline in the share of manufacturing from 11.31 % of GDP in 2016 to 16% by 2025;
- To reverse the decline in the share of industry from 21.7% in 2016 to 25% by 2025;
- To increase SME contribution to GDP from 50% of GDP to 60% of GDP by 2025;
- Import tariffs removed on a basket of imported items in order to lower production costs and improve competitiveness;
- To attain 100 % employment growth in the industrial sector by 2025;
- A 50% reduction in importation of cement offset by domestic supply; and,
- Four (4) agri-industrial parks / special economic zones established by 2025.

4.3 Commercialization – Expanding Private Capital

There has been very little emphasis in recent years in large-scale commercial expansion either for agriculture, or pharmaceuticals. While large scale mining concessions were granted, large scale extraction is for export commodities. The potential for using state land for large-scale commercial agriculture will not only boost production and offset import dependency, it will also go a long way to promoting technological transfers and in generating employment, and forward and backward linkages. For example, according to MAIL Afghanistan has more than 7.5 million hectares of arable land, but only 2.5 million hectares of land was cultivated in 2017. A sea change in scale requires considerable investment in irrigation and a reduction in insecurity.

4.3.1 Approach:

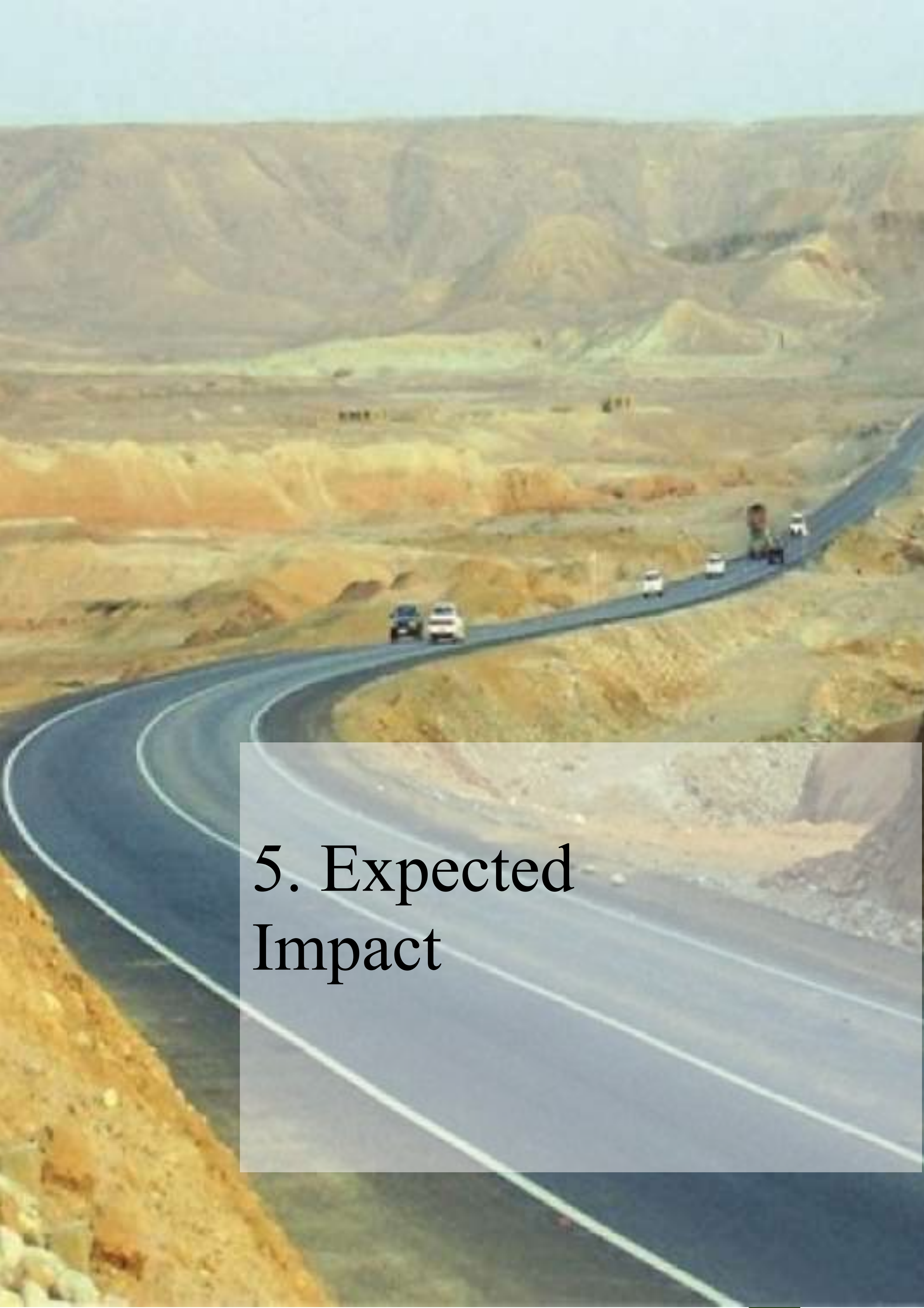
Working with DAB, MoIC, MoF, ARAZI, Sector Ministries and Chambers of Commerce, work to improve quality infrastructure, with a particular focus on improving financial markets and producer access to credit, credit guarantees, risk insurance and the introduction of sharia compliant debt instruments.

4.3.1 Key Performance Indicators:

The following goals are proposed in order to radically shift to commercial scale operations in the country. In the case of expanding commercial agriculture (irrigable and arable) major investment is needed to expand area under production, potentially using blended finance modalities that draws down on the risk for commercial operators. Tax breaks, concessionary loans, joint-ventures with international firms and ring-fenced agri-industrial processing arrangements will improve the business environment.

Commercialization Goals:

- To increase capital investment as a percent of GDP from 17.71 % in 2016 to 22% by 2025;
- Expand irrigation by 500,000 hectares by 2025 and non-irrigable land by 400,000 hectares by 2025;
- National Political Risk and Credit Guarantee system established;
- Improve financial inclusion with percent of population having bank accounts increasing from 15% to 25%;
- Establish legal and regulatory framework for development of the secondary market; and,
- To raise Afghanistan's global ranking in the Logistics Performance Index from 160 to 140 by 2025.



5. Expected Impact

5 Expected Impact

This Strategy proposes interventions to incentivize import substitution, in line with the Ministry of Finance Growth Strategy. Three scenarios are discussed in this section. The first scenario assumes a virtuous investment cycle supported by peace and improved security dividends, including execution of the measures proposed here. The second scenario assumes all the reforms introduced in scenario 1 but assumes that there is no progress towards a substantive peace settlement however, and conflict, insecurity, and violence continue at current or close to current levels. The third scenario implies a business as usual growth story which is the baseline for the other two scenarios, with no peace dividends and extremely limited growth. Given the strategic goals established in Section 4 above, we forecast positive impacts of the various measures outlined, in relation to the following outturns:

- Trade Deficit;
- Current Account Balance;
- Reversal of declines in industrial and manufacturing;
- Reduction in import dependency for candidate clusters;
- SME activity;
- Employment growth in agriculture, cement and pharmaceuticals;
- Agri-business plants and special economic zone to support formalization;
- Increases in capital investment and fixed capital formation;
- Commercial agriculture;
- Financial inclusion;
- Secondary market development; and,
- Improvements in Logistical Performance Rankings.

4.2 Investment Scenarios

Transformation of the Afghan economy from a largely subsistence one to an urbanized, integrated, enterprise-dominated one is the essence of economic development, and also what sustains improvements in economic welfare. The strategy proposed here links acceleration in production with import substitution, not just to improve the terms of trade but also to also lay the foundation for small scale industrialization and value addition. Such an approach is now necessary, as external support begins to decline and Afghan markets are expected to improve social and economic welfare through (increasingly un-subsidized) market mechanisms.

As the Government looks to incentivize domestic production, reforms must be accompanied by (i) increasing state capacity for macroeconomic management, public expenditure management, and guiding economic transformation; (ii) creating a business-friendly environment that also fosters private sector participation; (iii) developing people's skills for a modern economy; (iv) boosting domestic private savings and investments; (v) attracting private foreign investment; (vi) building and maintaining physical infrastructure; (vii) identifying and supporting particular sectors, products, and economic activities in each country's potential comparative advantage.

Manufacturing in Afghanistan has been contracting since 2002, though the service sector has increased substantially. Given that import substitution often involves economic diversification, diversification also requires strong support and extensive investments to address coordination and market failures, while also reducing the risk for private investments. Given the fiscal costs associated with structural adjustment programs, private equity must be deployed to fill the resource gap. For that to happen, new financing models must be considered.

Three investment scenarios are developed below, one focused on a virtuous investment cycle implementing the ANDPF and reforms outlined in the Import Substitution Strategy (Growth Scenario 1) and a scenario where these reforms are implemented but without peace thereby muting the effect of the reforms to a large extent (Scenario 2). Finally, a baseline scenario (business as usual) is developed without a process of reform leading to under investment and instability (Scenario 3).

TABLE 4: **THREE SCENARIO SUMMARY – IMPACT BY 2025 (US$ BILLIONS)**																
SCENARIOS	GDP growth (%)		GDP (US$)		General Revenues		Flagship Revenues		Total Revenues		Current Account Balance		Imports (GDP)		Balance of Trade	
	2025	Average to 2030	US$	Per capita	US$	% of GDP	US$	% of GDP	US$	% of GDP	US$	% of GDP	US$	% of GDP	US$	% of GDP
Baseline (BAU)	3.5	3.4	24.9	579	3.1	12.3	0.21	0.9%	3.3	13.15	4.48	-18%	7.05	28.34	-12.4	-49.88
Reforms amidst continuing conflict	5.5	4.9	26.7	621	3.8	14.3	0.57	2.2%	4.4	16.42	2.67	-10%	5.83	21.88	-6.8	-25.51
Reforms and peace	7.8	6.9	30.7	716	4.4	14.3	1.12	3.7%	5.5	17.93	2.46	-8%	5.35	17.40	-5.50	-17.91

4.3 Growth Scenario 1: Peace, Import Substitution and Export Growth

Government maintains steady progress with implementation of ANPDF reforms as outlined in NPPs and sector plans as presented in the Implementation Plan matrices. Elections are completed and peace discussions prove successful by 2020. The peace deal holds and leads to a substantial, durable reduction in insecurity and violence, boosting business and investment. The impact on the economy are as follows:

<u>Growth Scenario Narrative</u>:

- To support and consolidate peace, development partners increase grants by 5 percent of GDP over the baseline amount for the first six years of the projection period following the peace deal (this is consistent with international experience of a short boost in aid following the cessation of violence).
- Government revenues improve with higher economic growth, strengthening institutional quality, via improvements in enforcement and compliance.
- Government expenditure demands increase for stabilization and demobilization programs.
- There is an overall short-term surge in demand, stimulating growth initially in the urban services sectors, but eventually reaching throughout the economy.

4.4 Investment Costs:

<u>In this scenario private sector investment increases via the following three channels;</u>

- Direct reductions in violence and insecurity encourage investment confidence (political instability is currently cited as the main constraint to investment in surveys, and empirical evidence from several sources show that investment is negatively correlated with insecurity and violence);
- Returning skilled migrants support an improvement in overall government capacity and therefore institutional quality. This effect dominates the likely effect of additional political bargaining in policy processes under a peace government; and,
- Repatriation of overseas capital (10 percent of GDP) increases the stock of private capital available for investment (this is consistent with estimates from other conflict countries where overseas private capital holdings are estimated at up to 30 percent of GDP)

There would be an initial exogenous shock to investment to the tune of around 10% of GDP over the first two years reflecting repatriation of overseas capital and mobilization of bank liquidity in the context of improving confidence and then with an enhanced security environment and an added boost to improve the productive capacity and industrial and manufacturing capabilities there would be investment increases to 22% in 2025 and ultimately to 31% in 2030. This investment would be in tune with the rate of growth that has been projected. The increased investment would be utilised for improving the share of manufacturing and industry and would also in turn help reduce the import dependence from the current levels.

Other developments supporting increase in investment would be- By 2024, nominal growth in security sector expenditure slows to the pace of inflation, freeing up additional fiscal space for civilian investment. TAPI, TAP, and CASA proceed as planned. Public investment in agriculture – 400,000 hectares of additional irrigation achieved over five years. Agricultural productivity improvements reflecting agribusiness park development and expansion of priority subsectors, including pine nuts, horticulture, grapes. Agri-business parks and training services rolled out within five years. Human capital investment increases as a share of budget, reaching 50 of total recurrent expenditures by 2020, and driving increased literacy, and reductions in population growth rate and labour force growth rate by the end of the period. All energy sector investments would continue in line with the DABS investment plan; Further Peace would reduce demands on the security sector, but benefits would be slow to materialize. In line with international experience, there would be no rapid reduction in either security sector size or total security sector expenditures, although resources would be redistributed towards demobilization programs within the sector.

4.5 Impact on GDP

Growth rate increases quickly to around 9 percent by 2025 before gradually declining to around 6 percent. Growth rate is higher than the baseline scenario and scenario 2 (reforms + continuing conflict). The growth rate declines from the peak of 9% to 6% because of the normalization of the demand boom.

4.6 Impact on Trade Balance

Currently the trade balance is -6.9 Billion which is approximately 34% of GDP. With the reforms as envisioned by this import substitution/export growth strategy along with the ANDPF reforms total imports decline by 10% by 2025 with the imports of selected product basket reducing by 50%. This would lead to a reduced trade deficit of -5.5 Billion.

The products identified in the product list constitute imports worth US$ 1.3 million (3 Billion$)for the year 2017. This has been a significant increase from the value of imports in these products from US$50 Mn in the year 2000. Over this 17-year period there has been a tremendous increase in imports though with significant ups and downs. While some of the increase can be attributed to the values of overall global trade having increased, most of the increase can be attributed to the increase in imports of vegetables, wheat flour, raw sugar, cement and pharmaceutical products. Over this period, the annual increase in imports on these products on an average is more than 150% indicating a strong import dependency. The identified product list currently constitutes around 27% of overall imports.

A 50% reduction of the value of the product basket considered would lead to a decline in imports to the tune of US$ 0.72 billion assuming product shares remain constant. This can be considered as a revenue generation minus the tariff values. But import substitution and Afghanization requires the reduction in imports to be replaced by domestic production. Other than pharmaceuticals and Cement, most of the products do not require major skill intensive training to support production and if the right industry incentives are provided can be built immediately leading to a production increase and revenue generation which can eventually lead to an increase in exports in these products.

4.7 Impact on the Current Account

On the current account balance, International grants increase by 5 percent of GDP, allocated to civilian projects above the baseline for six years. After six years, aid immediately returns to its baseline trajectory. The proportion of on-budget grants increases from around 30 percent to around 60 percent by 2030 in both the security and civilian sectors. A reduction of imports and trade balance as estimated above would reduce the current account deficit and the estimated value of reduction in imports would lead to reducing the current account deficit from -22% to -10% by 2025.

4.8 Impact on Employment

The impact on employment would only be able to be estimated in detail once the specific project list and detailed breakup of investment sectors would be determined. But the following multiplier table provides a sense of how the investment would be translated into employment generation. Table 6 below provides sector specific type 1 multipliers. The multipliers have been derived from similar South Asian countries. For each sector the multiplier tells us the number of jobs created for an increase in output by 100,000 Afghanis.

TABLE 5: **INDUSTRIAL CLUSTER EMPLOYMENT MULTIPLIERS**

	Formal Worker	Informal Worker
Agriculture and Allied Activities	0.039	2.291
Mining	0.038	0.158
Furniture	0.063	2.689
Petroleum products	0.037	0.149
Cement	0.125	0.197
Non-Metallic Mineral Products	0.096	0.361
Other Manufacturing	0.093	0.0673
Construction	0.072	0.0784

Electricity	0.077	0.217
Transport Services	0.15	0.56

4.9 Growth Scenario 2: Continued conflict, Import Substitution and Export Growth

<u>Growth Scenario Narrative</u>:
Government maintains steady progress with implementation of ANPDF reforms as outlined in NPPs, sector plans as presented in the Implementation Plan matrices and the import substitution and export growth reform measures as outlined in the previous chapter. Elections are completed without major disruption to policy processes or any increase in violence, i.e. at most some temporary disruptions during the elections themselves but no lasting damage (unlike in the case of the 2014 election). But there is no progress towards a substantive peace settlement with the Taliban, however, and conflict, insecurity, and violence continue at current or close to current levels. Accordingly, private sector confidence remains muted (although strengthening slightly on the completion of elections). Extractives development is gradual, but some progress is made. Investment is mobilized, but revenue and production occur mostly towards the end of the projection period. Agricultural production also increases, with gradual expansion of irrigation and improved farmer training.

4.10 Investment Costs

In this scenario there is no exogenous shock to investment and therefore no increase in investment in the first two years as in the scenario 1. There is increased investment though gradually picking up pace over the period 2018-2025. To maintain the growth rate in this scenario there would be an investment cost initially of 17% gradually increasing to 25% by 2030.

With continued conflict, increased government expenditure on security as international support declines. On-budget security sector expenditures increase at 9 percent per annum. Civilian recurrent expenditures remain constant in real per-capita terms. O&M spending increases at a steady rate to reach the estimated sustainable level of 7.2 percent of GDP (estimated requirement from survey evidence).

<u>On public investment,</u> TAPI, TAP, and CASA would proceed as planned. Public investment in agriculture up to 500,000 hectares of additional irrigation would take place, but pace of expansion would be constrained by limited fiscal space. Agri-business parks and training services would be rolled out gradually. Human capital investment would increase as a share of budget to reach 50 percent of recurrent expenditures by 2024.

4.11 Impact on GDP

Slightly lower growth rate than under the ANPDF scenario, reflecting limited progress with mobilization of extractives and a more negative security environment. Growth rate increases gradually to around 4 percent over first five years, increasing to 5.5 percent until 2030. The growth under this scenario is more than the baseline but more muted when compared to Scenario 1 due to continued conflict and security issues

4.12 Impact on Trade Balance

In this scenario total imports would increase by 20% by 2025 and the trade balance deficit would be -6.8. While the deficit would not significantly increase from the current period, it would not reduce as much as in scenario 1 as well since in a scenario of security and conflict issues continuing, import substitution incentive measures would not have the required impact.

4.13 Impact on the Current Account

International support remains strong, but aid flows do not keep pace with economic growth. Nominal grants decrease from around US$8 billion to around US$5.5 billion. This is a decline from around 40 percent of GDP today to around 20 percent of GDP by 2030. The proportion of on-budget grants increases from around 30 percent to around 60 percent by 2030 in both the security and civilian sectors.

The overall impact on current account deficit in this scenario would be to have the deficit reduced to -14% in contrast to the current -22%.

4.14 Growth Scenario 3: Business as Usual

This scenario is business as usual but with neither the ANPDF reforms nor the import substitution and export growth reforms implemented. Conflict continues and no lasting peace deal is reached leading to conflict, insecurity, and violence to continue at current levels. In the continuing presence of conflict and the absence of reforms private sector confidence remains muted (although strengthening slightly on the completion of elections). All the assumptions for the scenario 2 continue but without the implementation of reforms. In such a scenario most of the variables deteriorate from the current scenario with only a few positive signs.

4.15 Investment Costs

In an continued security concern situation investment levels would eventually decline, transaction costs would remain high and growth, revenue and job impacts would be sub-optimal.

4.16 Impact on GDP

The GDP growth rate in this scenario would be much more muted than both the previous scenarios since there is an absence of reforms. The growth rate would increase to 3.5% but would then remain at this rate until 2025.

4.17 Impact on Trade Balance

In this scenario total imports would increase to 45% by 2025 in the absence of any import substitution or export orientation and the trade balance deficit would significantly increase to -12%.

4.18 Impact on the Current Account

With continued support from the international community the current account balance would reduce from the current -22% but only to around -20% by 2025. This would be because of the increasingly worsening trade balance.

4.19 Impact on Employment

The official unemployment rate in Afghanistan is 8.8%, though this appears to be under-reported, and does not include under-employment. Given the ongoing demographic transition, the creation of job bearing investments is critical to solving poverty.

TABLE 6: BASELINE, REFORM AND CONFLICT AND REFORM AND PEACE SCENARIOS												
SCENARIO: BASELINE												
YEAR	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**	**2027**	**2028**	**2029**	**2030**
GDP (USD billions)	20.5	21.1	21.8	22.5	23.3	24.1	24.9	25.7	26.5	27.4	28.3	29.3
GDP growth (%)	2.8	3.2	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5	3.5
GDP per-capita (USD)	550	555	560	565	569	574	579	585	591	597	604	611
GOVERNMENT FINANCES (% of GDP unless otherwise indicated)												
Government revenues (including grants)	27.0	27.5	29.7	28.4	27.3	22.1	22.2	22.1	22.2	22.2	22.2	22.2
Government revenues (own source)	12.3	12.8	12.9	12.9	13.0	13.1	13.2	13.1	13.2	13.2	13.2	13.2
in USD (millions)	2,523	2,704	2,822	2,915	3,035	3,155	3,270	3,372	3,492	3,611	3,742	3,880
...of which extractives and transit	6	110	141	146	173	197	214	214	229	239	258	280
Grants	39.6	42.9	39.6	36.5	33.8	10.0	10.0	10.0	10.0	10.0	10.0	10.0
On-budget	14.6	14.7	16.8	15.5	14.3	9.0	9.0	9.0	9.0	9.0	9.0	9.0
in USD (millions)	3,000	3,100	3,665	3,490	3,328	1,925	1,989	2,055	2,124	2,195	2,268	2,343
Off-budget	24.9	28.3	22.8	21.1	19.5	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Government expenditures	27.0	27.5	29.7	28.4	27.3	22.1	22.2	22.1	22.2	22.2	22.2	22.2
Security Expenditures	10.7	10.8	10.8	10.9	10.9	11.0	11.0	11.1	11.1	11.2	11.2	11.3
Civilian Recurrent Expenditures	8.4	8.4	8.4	8.5	8.5	8.5	8.5	8.5	8.5	8.5	8.6	8.6
Civilian Development Expenditures	7.9	8.3	10.5	9.1	8.0	2.7	2.6	2.6	2.5	2.5	2.4	2.4
SCENARIO: REFORMS AMIDST CONTINUING CONFLICT												
YEAR	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**	**2027**	**2028**	**2029**	**2030**
GDP (USD billions)	20.5	21.2	22.0	23.0	24.1	25.3	26.7	28.0	29.5	31.1	32.7	34.4
GDP growth (%)	2.8	3.5	4.2	4.5	5.1	5.5	5.5	5.5	5.5	5.5	5.5	5.5
GDP per-capita (USD)	550	556	566	575	588	604	621	639	657	677	697	718
GOVERNMENT FINANCES (% of GDP unless otherwise indicated)												

Government revenues (including grants)	27.0	27.5	29.7	28.7	28.0	24.9	25.4	25.3	25.5	25.5	25.4	25.4
Government revenues (own source)	12.3	12.8	13.0	13.4	13.9	15.9	16.4	16.3	16.5	16.5	16.4	16.4
in USD (millions)	2,526	2,714	2,856	3,067	3,349	4,035	4,377	4,584	4,859	5,120	5,373	5,650
...of which extractives and transit	9	113	151	246	275	547	573	580	646	686	707	739
Grants	39.6	42.9	39.4	36.2	33.2	10.0	10.0	10.0	10.0	10.0	10.0	10.0
On-budget	14.6	14.6	16.7	15.4	14.1	9.0	9.0	9.0	9.0	9.0	9.0	9.0
in USD (millions)	3,000	3,100	3,685	3,528	3,393	2,026	2,132	2,244	2,361	2,485	2,615	2,752
Off-budget	24.9	28.2	22.6	20.8	19.1	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Government expenditures	27.0	27.5	29.7	28.7	28.0	24.9	25.4	25.3	25.5	25.5	25.4	25.4
Security Expenditures	10.7	10.7	10.7	10.7	10.6	10.4	10.3	10.1	10.0	9.9	9.7	9.6
Civilian Recurrent Expenditures	8.4	8.4	8.4	8.3	8.3	8.2	8.1	8.0	7.9	7.9	7.8	7.7
Civilian Development Expenditures	7.9	8.3	10.6	9.7	9.2	6.3	7.1	7.2	7.5	7.8	7.9	8.1
SCENARIO: REFORMS AND PEACE												
YEAR	**2019**	**2020**	**2021**	**2022**	**2023**	**2024**	**2025**	**2026**	**2027**	**2028**	**2029**	**2030**
GDP (USD billions)	20.7	21.6	22.9	24.6	26.6	28.6	30.7	32.9	35.2	37.6	40.2	42.7
GDP growth (%)	4.2	4.6	6.2	7.9	8.2	8.0	7.8	7.6	7.2	7.2	7.2	6.6
GDP per-capita (USD)	557	569	589	617	649	682	716	750	784	819	857	892
GOVERNMENT FINANCES (% of GDP unless otherwise indicated)												
Government revenues (including grants)	26.8	27.6	30.5	30.6	30.4	26.8	26.9	26.7	26.7	26.6	26.5	26.4
Government revenues (own source)	12.4	13.3	14.0	15.7	16.9	17.8	17.9	17.7	17.7	17.6	17.5	17.4
in USD (millions)	2,565	2,871	3,218	3,868	4,481	5,078	5,508	5,838	6,219	6,626	7,036	7,442
...of which extractives and transit	16	210	401	839	954	997	1,124	1,138	1,195	1,258	1,297	1,344
Grants	39.0	42.4	38.6	35.0	31.6	10.0	10.0	10.0	10.0	10.0	10.0	10.0

On-budget	14.5	14.3	16.5	14.9	13.5	9.0	9.0	9.0	9.0	9.0	9.0	9.0
in USD (millions)	3,000	3,100	3,775	3,680	3,598	2,287	2,457	2,634	2,816	3,009	3,216	3,418
Off-budget	24.6	28.1	22.1	20.0	18.1	1.0	1.0	1.0	1.0	1.0	1.0	1.0
Government expenditures	26.8	27.6	30.5	30.6	30.4	26.8	26.9	26.7	26.7	26.6	26.5	26.4
Security Expenditures	10.5	10.5	10.3	9.9	9.6	9.2	8.9	8.6	8.4	8.1	7.9	7.7
Civilian Recurrent Expenditures	8.3	8.2	8.0	7.8	7.6	7.3	7.1	7.0	6.8	6.7	6.5	6.4
Civilian Development Expenditures	8.0	8.9	12.2	12.9	13.3	10.2	10.9	11.1	11.5	11.8	12.1	12.3

Source: World Bank, MoF and MoEc Projections

6. Support Functions

6 Support Functions

.

6.1 Industrial Policy Adoption

The primary aim of the proposed policy framework, is to exploit the unmet potential of the agricultural, mining, pharmaceutical and energy sectors in the first instance as an accelerator for small to medium scale commercialisation. As a result, the strategy embraces what wold be called a soft industrial policy to better navigate between economy-wide and sector-specific measures. Sector specific measures will be applied, as outlined above, but will avoid stifling competition or investing resources in to low rate of return activities. In essence therefore, AALI provides a springboard approach for improved competition, using primary indirect reforms, supported where justified, with more direct measures.

6.2 Cabinet and National Economic Council Coordination

MoEc is mandated with overseeing and stimulating the Afghan economy at the macro level. In addition to tracking and reporting on national economy and budget outcomes and impact, it is also responsible for guiding the executive in putting in place an economic policy and investment framework that maximizes investment returns to growth. As a result, this strategy is a cross-ministerial strategy to be executed by Government, at the national and sub-national levels. The strategy will be presented to H.E. the President, the Cabinet, and members of the National Economic Council for strengthening, deliberation and validation.

6.3 Policy and Strategy Coherence

This strategy is not an economic policy, though it does outline a new set of economic policy options that must be carefully considered by Government, and its development partners. The strategy is inline with – and fully supports – the Afghanistan National Peace and Development Framework (ANPDF), which is a five-year strategic plan for achieving self-reliance. The framework aims to help Afghanistan meet its many challenges, bring an end to poverty, and ensure security and stability, and to chart a course to self-governance and improved macro-fiscal sustainability.

This strategy does not replace or compete with other strategies. Rather, it seeks to compliment existing policy, and will be fully integrated with the Private Sector Development National Priority Program, Extractive National Priority Program, Agricultural Development Framework and National Export Strategy. The aim is not to create parallel or competing structures, but rather to add value through improved diagnostic, analysis and research, and to propose alternative options based on evidence.

6.4 Development of a New National Economic Model

The strategy will be supported by the establishment of a new economic model for Afghanistan, adapted from the World Bank developed MAMA model and the MODAF model; which provides a small macro-econometric model for the Afghan economy. The aim is to make this model available publicly, and to allow multiple inputs to strengthen its veracity, in order to strengthen the impact of its deployment on public policy and investment decisions. [18]

The final model will be an economy-wide simulation model focused on analysing medium and long-run development strategies and investment trade-offs. The model integrates a relatively standard dynamic recursive computable general equilibrium (CGE) model with an additional feature that makes it useful for policy analysis. When compared to standard CGE models, the final model will allow Government to model the impact of different direct and indirect policy measures on growth, revenues and jobs creation. The model will also allow the endogenization of factor productivity (which depends on government capital stocks and economic openness) and the tracking of assets (or liabilities) of the different institutions (factor endowments, domestic government debts, and foreign debts). It will also be used to model the impacts of proposed import substitution options.

[1] MODAF is principally a demand-side model, which also incorporates the agriculture supply. The model includes 8 stochastic equations, with 18 identities, and has 41 variables, out of which 13 are exogenous user-supplied variables.

6.5 Enabling Domestic Production Environment

The investment approach includes measures proposed to promote domestic production in the target sectors specified earlier as well as to improve the general business environment. The overarching objective is to increase private investment (domestic and foreign), reduce costs of production, transaction costs between markets, and increase production while improving the trade balance.

6.6 Access to Credit

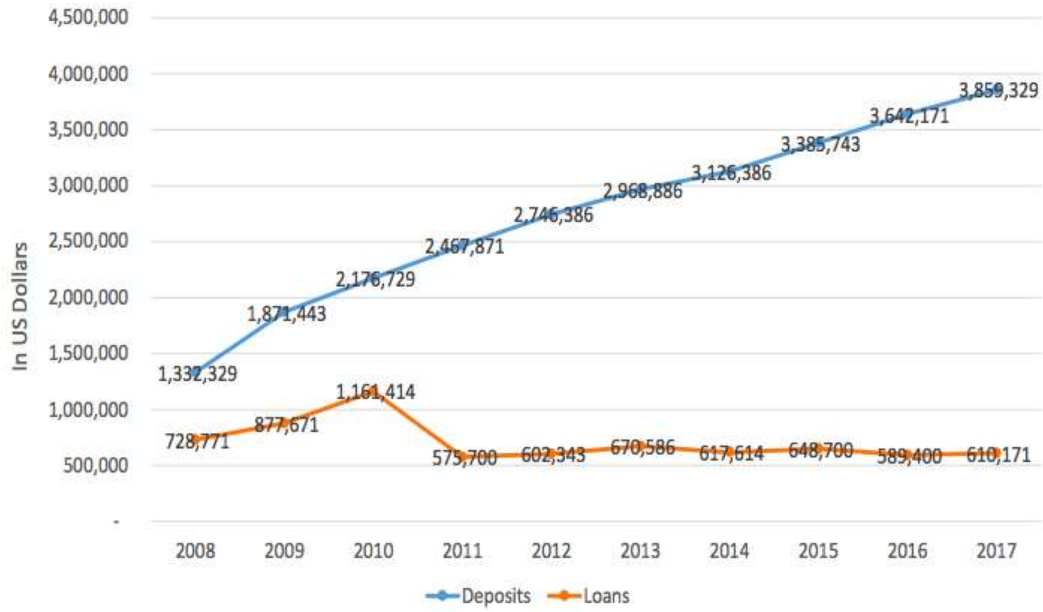
The Strategy recognises that access to credit (including export credit) through the banking system, is important for creating more favourable business climate and promoting domestic production. In part due to the legacy of the Kabul Bank disaster, Afghanistan is facing a peculiar situation where the banks have huge deposits but those deposits are not being converted into credit for industrial and economic development. Afghanistan has been ranked 101/190 countries for accessing credit.[19] In addition to credit supply constraints due to strict regulations, complex collateral requirements, and risk-avoidance by banks, demand for credit is low, mainly because of weak demand in the economy:

- Access to finance is often important in funding investments and starting new projects that will produce domestically. Figure 7 shows that deposits in the financial system have increased whereas lending/borrowing activity has witnessed a sharp decline;
- The Strategy proposes the launch of a dialogue between the Central Bank, state owned banks and the private banks to ease access to credit for domestic firms. Parts of discussion include the creation of viable insurance mechanisms to protect both the banks and allow the firms access affordable credit;
- The Ministry of Economy will encourage NGOs with the experience to redirect their efforts to work closely with SMEs and support domestic production. NGOs have an already established network throughout the country and have the institutional capacity as well as the manpower to make a difference.

The Strategy recognises the difference in the days of the weekend between Afghanistan and the rest of the world as another barrier to financial connectivity. This complicates and extends the gap between Afghan exporting firms and the rest of the world in doing business. Especially, there is a huge gap in financial transaction to take place and a delay in exports is equal to one-day reduction in trade.[20]

[19] Doing Business Indicators (DBI) report, World Bank, 2016.
[20] Djankov, Freund and Pham, 2010

Chart 7. Trends in Deposits and Loan Ratio



The Government proposes to work with state and commercial banks to review the entire financing arrangements and products for exports, with a view to putting in place a National Export Financing Scheme (to include export credits) and Export Finance Guarantees.

6.7 Local Content Requirement in Government Procurements

The Government of Afghanistan is one of the biggest buyers in the domestic market. The Strategy considers this an opportunity and advocates that government contracts be procured with local content and local production requirements. This way the government, as a major buyer, helps promote local competition and create demand for local production.

The Strategy requests that the Cabinet endorse the local content requirement approach and provide for further preferential treatment toward local products. The National Procurement Authority (NPA) already has implemented this to a certain degree. A review of this has revealed that the procedures are adequate for the purpose of this strategy. We therefore advocate a full review of the requirements and conditions to qualify for NPA bidding to positively discriminate in favour of domestic firms, to ensure diversity, wherever possible.

Investment levels and the private sector capacities are too low. In line with donors aligning their development assistance according to the priorities of the Afghan government, the Private Sector Development National Priority Program provides an opportunity to stress encouraging domestic production as a priority for the country.

6.8 Land Management Improvements to Expand Commercial Farming

The Strategy considers improving land management to help domestic production to be of critical importance for moving toward a production-based economy. The mix of traditional and modern land regulations has resulted in antagonistic and confusing land management systems in Afghanistan. Since 2004, through USAID, several projects have attempted to bring about improvements to the land and tenure systems in Afghanistan. Much has been achieved, such as the Arazi Land Records Management Information System (ALRMIS), Cadastral and Survey Department part of Arazi, and Handbook of Informal Settlement Upgrading. More can be done to further improve land management in Afghanistan.

According to the US institute of Peace, around 70 percent of urban residents in Afghanistan live in informal settlements. Informal settlements according to OECD comprise areas where housing units are built on land that the occupants have no legal claim to. The Joint Monitoring and Evaluation Committee

(MEC) maintains that paper records and archives are poor, incomplete, susceptible to damage and prone to forgery. [21]

The Strategy focuses on the aspects of land management reform that directly affect producing firms; therefore having a more direct impact on private sector development and economic growth. While upgrading industrial parks and establishing free economic zones would reduce cost of doing businesses in Afghanistan, the Strategy also proposes long term leasing of government lands to firms that engage in domestic production based on a model of medium teo large scale commercial farming (i.e. farms from 50 to 500 hectares. This gives them the assurance to invest inside the country and turn the unused land into capital. MoEc will coordinate between government entities such Arazi, line ministries and the chamber of commerce and trade and chamber of industries and mines, in order to facilitate the process of improving land management.

6.9 Improving DBI Using Subnational Analysis

Afghanistan is ranked 183rd out of 190 countries in the World Bank's Doing Business Indicators (DBI) in 2018. As shown in Chart 8, there are two areas where Afghanistan is relatively doing better, starting a business (ranked 107) and getting credit (ranked 105). Chart 9 shows the performance of selected countries as a percentage of the best performer (100). Afghanistan, with a percentage of 36.19, falls 63.81 percentage points short of the frontier. Compared with regional countries Afghanistan is lagging behind. Therefore, there is much work to be done to enhance the country's competitiveness vis-à-vis neighbours, as has been stressed throughout this strategy.

Chart 8. Afghanistan's Doing Business Components for (2018)

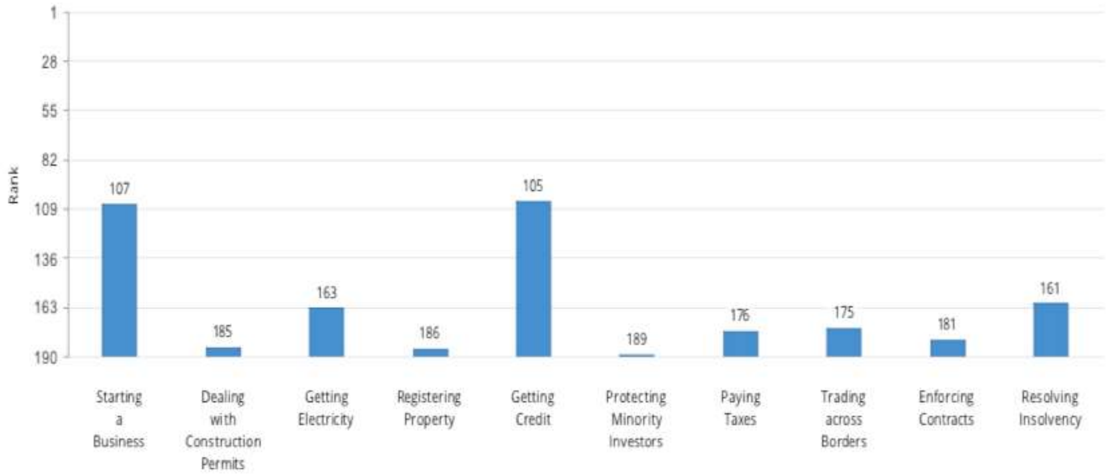
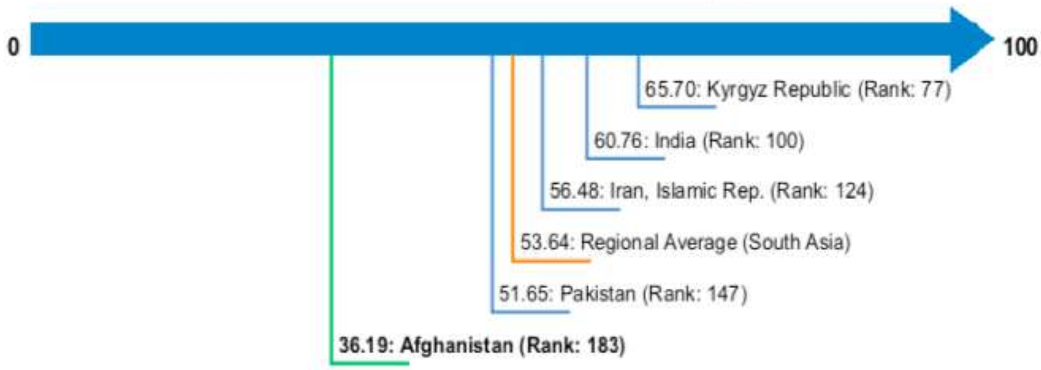


Chart 9. Afghanistan's Distance to Frontier Compared to the Region (2018)



The World Bank has also studied regulations relating to four important stages in establishing a small to mid-sized firm, namely setting up a business, dealing with construction permits, getting electricity, and

[2] See OECD Glossary of Statistical Terms.

registering property, in Kabul, Balkh, Herat, Kandahar and Nangarhar provinces on a subnational level. The main findings were as follows:

- Afghan entrepreneurs face different regulatory hurdles depending on where they establish their businesses. Regulatory quality and efficiency vary across locations in the four areas studied, because of differences in local interpretations of the law and in the efficiency of local agencies responsible for administering regulations;

- Afghan provinces can improve the ease of doing business by learning from each other. Reform-minded policymakers can make tangible improvements by replicating measures already successfully implemented elsewhere in the country;

- By adopting all the good practices found at the subnational level, Afghanistan would jump 11 places in the global ranking of 190 economies on the ease of doing business, moving up from 183 to 172.

- Kabul leads in starting a business and getting electricity, as a result of reforms that were implemented only in the capital. Rolling these reforms out across Afghanistan would benefit entrepreneurs in other provinces and urban centres. Kandahar ranks first in dealing with construction permits and registering property, while Balkh comes in a steady second in all four areas measured by the report.

The Strategy fully supports the positive contribution of stronger local governance and replication of best practices from local experiences across the country. Furthermore, the Strategy considers enhancing efficiency in the provinces and freeing up resources in Kabul, where many bureaucratic processes are centralized, to be a key element of future progress. The subnational analysis has further revealed that:

- Afghanistan has made important strides since 2008 in simplifying the start-up process. If Kabul represented the country, Afghanistan would rank among the top 50 economies worldwide in terms of the ease of starting a business;
- On average in the five provinces, completing the construction permitting process takes five weeks less than the regional average for South Asia, but it costs more than twice as much;
- To improve safety in the construction industry, Kabul municipality recently adopted a regulation specifying the rules and requirements for getting final approval for a newly constructed building. Local initiatives like this one could converge into a national construction law;
- On average in the five provinces, getting an electricity connection takes three weeks less than the regional average for South Asia, but it costs almost 70% more;
- Faced with the challenge of having less than 30% of urban land formally registered, Afghanistan remains one of the most difficult places globally to transfer land.

Procedural complexity, low levels of transparency, and lack of adequate record-keeping infrastructure are some of the major obstacles to improving the reliability of the land administration system. The subnational analysis has revealed both strengths and areas for intervention; we can replicate the success stories and learn from the weaknesses and intervene with better policy design.

6.10 Reforming Access to Industrial Electricity

In Afghanistan, it costs 70 percent more for businesses to access electricity compared to other South Asian economies.[2] The Strategy considers reducing the cost of access to electricity as a priority. Electricity costs contribute a high percentage to the cost of per unit of production in Afghanistan. Furthermore, specific polices to reduce the cost of electricity for SMEs, export firms, and in general for the domestic productive sector could boost the level of domestic production. There is a huge potential for investing in alternatives to generate electricity. The following options exists and are possible in Afghanistan: extracting coal and natural gas and using them to generate electricity, expanding solar panels, building more hydro Power Plants to reduce dependency on imported electricity.

[2] Doing Business Indicators Report, World Bank, 2016.

Currently, Da Afghanistan Breshna Sherkat (DABS) is a state-owned company, of which all the shareholders are government agencies, including the Ministry of Economy. This gives the ministry the power to directly advocate and convince other shareholders to reform and put forward specific policy proposals to enhance growth, promote businesses. As a first step, the Strategy advocates the introduction of a flat rate electricity tariff for domestically producing firms as a crucial enabling factor for the private sector. Doing this will lower the cost of getting electricity for domestic production, remove energy constraint on enterprises, and make them more competitive both nationally and internationally.

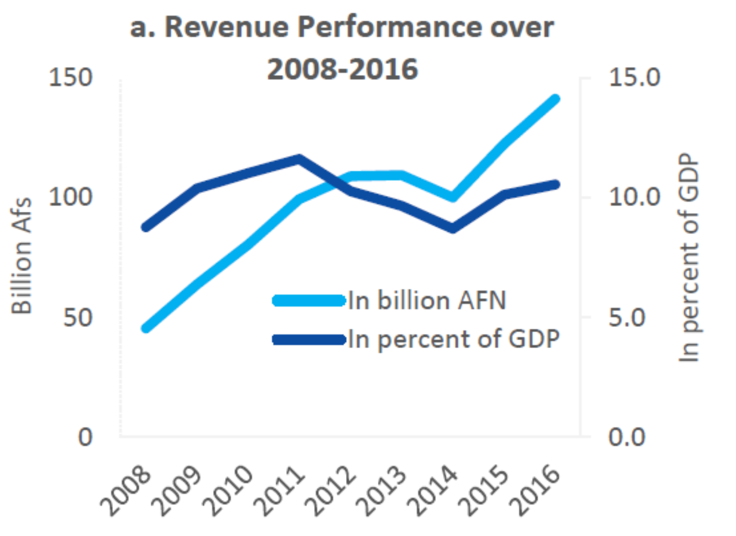
6.11 Reforming the Tax System

Afghanistan's tax regime was reformed from 2003 to 2005. This was a huge endeavour in terms of formalising taxpaying entities, and in bringing a formal (and simplified) structure to collect revenues. At the time, Afghanistan's economic context and priorities were different. Over 10 years on, both the economic context and priorities have evolved. Tax policies can have two objectives:

- Increasing revenue by broadening the tax base and improving compliance to finance state functions; and,
- As an economic policy to support growth and investments by maintaining relatively low rates and efficient collection procedures.

The government is already working on the first objective. Revenues have been increasing for the last two years; see Chart 10. This has been achieved mainly due to the introduction of fresh taxes and possibly better tax compliance. The focus of tax policy has been primarily on increasing revenues and less attention has been given to the negative impact of taxation and tax administration on investments and economic growth.

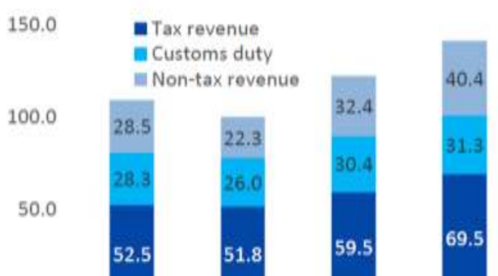
Chart 10.Afghan Government Revenue (2008-2016)



Source: Ministry of Finance

Chart 11 shows that comparatively the highest share of governed revenue comes from domestic taxes. From 2013 to 2016, the share of revenue from domestic taxes has increased by almost 20 percent. This is not uncommon phenomenon however it is a consensus among economists that direct taxes distort investments and ultimately slows the GDP growth.

Chart 11.Tax Revenue Composition



The Strategy, with its vision to focus on sustainable growth and associated revenue generation, rather than maximising revenue in the short run, proposes the initiation of the next phase of tax reform in coordination with High Economic Council (HEC), Ministry of Finance (MoF) and other relevant government agencies. Improving tax compliance, ensuring transparency, predictability, honesty and efficiency in tax administration will be key elements of reform. The Strategy puts forward the following principles in order initiate the next phase of reforms:

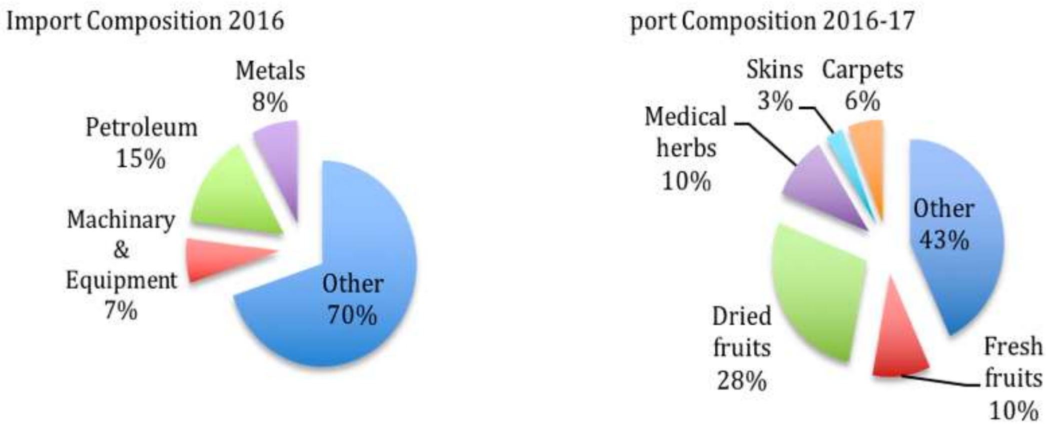
- Rationalizing tax regime so that businesses are encouraged to invest more and expand their operations;
- Provide sector specific and targeted tax incentives to allow new investments and further expansions. Also, to provide incentives for new entrants to the market. Especially on domestically producing and potentially exporting SMEs; and,
- Formalization of business entities – currently 70 to 80 percent of the economy operates informally. This will increase the potential for more tax collection.

6.12 Standardising, Marketing and Promotion

The overall Balance of Payments in Afghanistan is in surplus because of direct transfers (donor assistance). However, looking at the trade deficit or net exports (exports minus imports) provides a better picture of the economic structure. Afghanistan's trade deficit in 2007 was US$2,475 million, and this increased to US$5,938 million in 2016. The total level of external trade in Afghanistan in 2016 was US$7,131 million, of which 91.6 percent was Current Account every year.

Imports in 2016 fell by 15.4 percent in Afghanistan and exports increased by 4.4 percent compared to 2015, suggesting that there may well be scope for both import substitution and export growth. See Chart 12 for the current profile of Afghanistan's imports and exports. [23]

Chart 12.Afghanistan – Composition of Imports (2016-2017)



Many factories that opened or re-opened post-2001 have closed due to cheaper-imported goods due to the openness of Afghanistan's borders to both legal and smuggled imports. The farmers and smaller producers who used to provide raw or intermediate products to these factories have ceased to do businesses and consequently lost their livelihoods as a result. For example, a report in Afghanistan Outlook explained reasons for closure of more than half of original 300 factories in the Herat Industrial Park. "The reason of course is the influx of foreign-made products most of which comes from the

[2] [3] Figures taken from Central Statistics Organisation, 2016

neighbouring Iran. The industrial units that have closed down have been unable to compete with the barrage of cheap, mostly low-quality Iranian goods that have flooded markets in Kabul and elsewhere throughout the country."[24] Similarly, many commodities such as marble, wheat flour, dairy products are coming from neighbouring countries, which dampens domestic production.

The Strategy proposes an immediate opportunity for intervention to support domestic infant productive forces so they can continue to their production and sell in local markets. In the post-WTO accession, Afghanistan has been negotiating a schedule of concessions on more than 2,400 items, which provides an opportunity to be exploited in line with the objectives of this strategy. Coupled with **moderate protection against imports**, the Strategy considers the following areas where the government can intervene to help promote exports:

- Attracting/creating certified companies to lower barriers to exports, such as labelling, packaging, and certification in general which inhibit exports. Better labelling and packaging also increases domestic attractiveness of products;
- It is extremely important to have trade representatives based in export destination countries to market Afghan products. A network of local representatives in export markets can help find clients and link foreign businesses to domestic firms. They can identify sector-specific markets for export through private-public dialogue; and,
- Establishing or hiring marketing agencies abroad to help domestic producers to find clients and promote domestic products is another option to consider.

[24] Afghan Industries Struggling in the Face of Cheaper Imports by Mehdi Rezaie (20 June 2011). The Daily Outlook, Afghanistan.

7. Implementation Plan

7 Implementation Plan

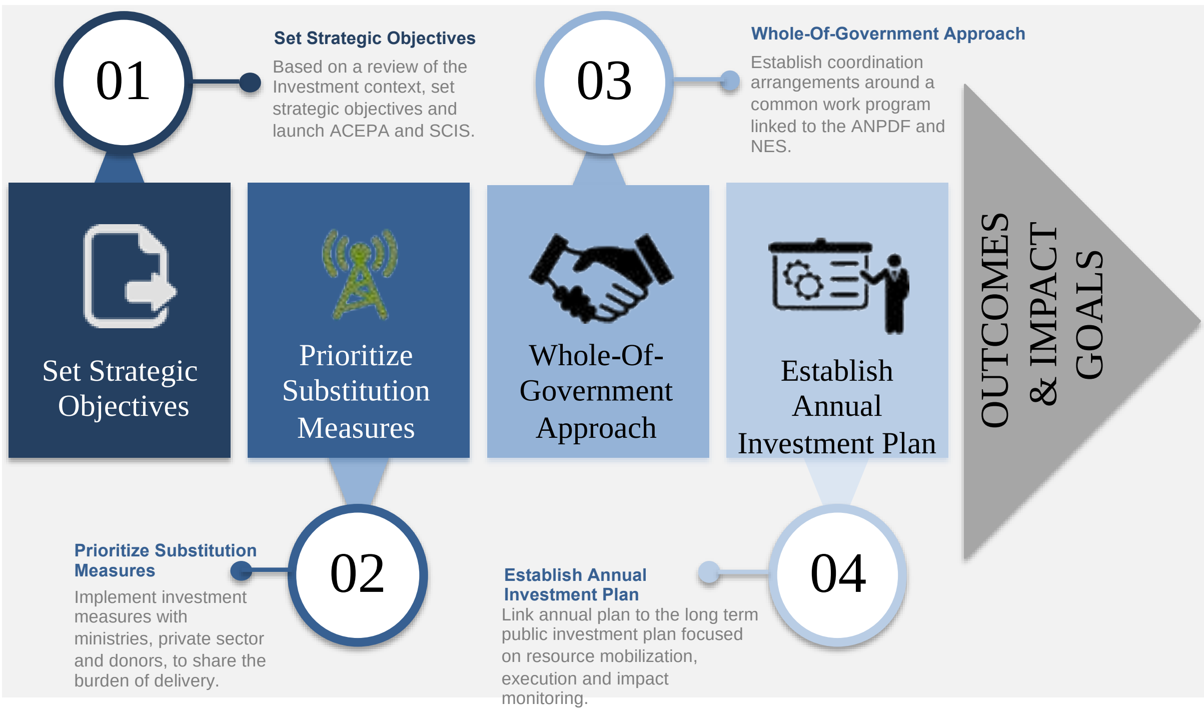
The program will be overseen by the High Economic Council, High Council on Reforms, MoEc, MoIC with economic policy research support provided by the Afghanistan Centre for Economic Policy Analysis (ACEPA). The Steering Committee on Import Substitution (SCIS) will be responsible for issuing directives based on guidance provided. The overall long-term implementation plan will be split up into annual work plans, with key performance indicators supported by base, mid and end lines.

7.1 Implementation Approach

This strategy has been established through an evidenced based approach, allowing strategic decisions to focus on investments that have a positive rate of return on substitution goals. Critical to success will be putting in place a joined-up-government approach, where the Ministry of Economy works through ACEPA to strengthen evidence-based government, adding value to the work of sector stakeholders. If research is not undertaken to inform substitution directives, mistakes will be made and policy implementation will be negatively impacted.

Once the strategy is adopted, and ACEPA and SCIS established, this long-term strategy will be developed into annual work plans linked to the Government fiscal and budget years. The annual work plan will be coordinated by MoEc and members of SCIS will formally approve each annual work plan, and related task order. Figure 6 below provides an overview of the proposed approach, highlighting establishment, prioritization, whole-of-government coordination and annual investment plan processes. Outcomes and impact will be monitored by ACEPA working with the Central Statistics Office and sector ministries. The outcome and impact key performance indicators are outlined in Section 4 above.

Figure 7. OVERALL IMPLEMENTATION PLAN APPROACH



7.2 An Annual Planning Cycle within a Long-Term Plan

The overall strategy will be broken down into an annual planning cycle. In the first year, the aim will be to establish the coordination and clarify the delivery arrangements, and to set baselines and targets for the entire program. In Year 1 (Y1), an annual work plan will be developed and approved by the SCIC, and presented to the High Economic Council for approval. The annual planning cycle will be in line with the national budget formulation process, with costs integrated into the wider Private Sector Development (PSD) program, and coordinated with the National Export Strategy. Each annual plan will be supported by an results matrix, outlining baselines, targets, means of verification and assumptions.

7.3 New Policy Research and Coordination Structures

In order to implement this strategy two new bodies will be established. Their establishment will be approved by the Council of Ministers, with one being statutory (ACEPA) and one being temporary (SCIC). ACEPA will be approved by the office of administrative affairs and will be accompanied by an establishment law. SCIC will be a temporary body, acting as an inter-ministerial committee, but with members representatives of private sector bodies such as the Chamber of Commerce. The overall role and functional assignments for ACEPA and SCIC are provided below.

7.3.1 Afghanistan Centre for Economic Policy Analysis (ACEPA)

The strategy proposes the establishment of an economic analysis centre to focus on research to guide economic policies and serve as an extended research arm for the MoEc. The centre will be staffed with national and international experts, including economists, trade and sector experts. Furthermore, it will have a small administrative team to execute decisions and perform admin related work. The following role and functional assignments will be applied:

- Advise on economic growth and import substitution policies;
- Lead the implementation of '*Economic Policy Support and Coordination Measures*' outlined in Section 3;
- Undertake ex ante and ex post policy impact evaluation of national development programs both within and outside the scope of this strategy.
- Provide policy recommendations on economic growth, macro-fiscal issues, employment, poverty analysis, social welfare, infrastructure, pensions, education, health;
- Establish international partnerships with international research institutions including skills and technical transfers;
- Establish and maintain the national growth CGE Model, feeding research findings into the model and adjusting assumptions to make projections and forecasts;
- Maintain outreach and public policy dialogue with the private sector;
- Host national conferences and seminars; and,
- The centre will hold annual economic summits to provide an update on the economic outlook of Afghanistan, assess future trends and organise trainings and workshops to build capacity.

7.3.2 Steering Committee on Import Substitution (SCIS)

The creation of the SCIS as a cross-government platform chaired by the Ministry of Economy that specifically focuses on implementing, coordinating and oversight of the import substitution strategy. The SCDP members will be drawn from all sectoral directorates and departments currently operating within relevant parts of Government, to avoid the creation of parallel structures. The SCDP will be divided into working units depending on the chosen sectors for intervention, specified earlier to provide assessments, situation analysis and value chains as well as technical assistance to target sector enterprises The SCIC will review research results, deliberate over policies, gain agreement from cabinet and the High Economic Council, and issue directives for execution. The budget for the SCIS will be drawn from the internal budgets of the Ministries, and supported by the international community as required. Functional assignments are proposed as follows:

- Deliberate over research findings and draw relevant policy conclusions;
- Lead on the prioritization and implementation of the overall and annual work plans;
- Issue directives for approval of the High Economic Council;
- Foster linkages with similar international bodies and agencies; and,
- Provide outreach to the private sector to include working with start-ups and entrepreneurship support schemes for SMEs, as start-up ventures result in economic intelligence assistance, capacity building, university graduate scheme and partnerships, start-up capital support.

The SCIS will support the implementation of the strategy and benefit from the evidence base provided ACEPA.

7.4 Timeframe for Implementation

This strategy is to be executed over a period of seven (7) years. This means that the strategy will continue across electoral cycles to guarantee continuity, with each year will be underpinned by an annual work plan. Given that changes in industrial capacity takes many years to come to effect, such a time frame allows the careful sequencing of support measures, supported by new research, learning and impact assessment. The strategy will be aligned to the Medium-Term Fiscal Framework (MTFF) and Medium-Term Expenditure Framework (MTEF).

7.5 Institutional Arrangements

Implementing this strategy must become a government wide priority, to include the executive, legislative and judicial branches. Critically, it must also be executed at the provincial and district levels, where much of the productive capacity exists. The primary roles and responsibilities are outlined below.

7.5.1 Role of Ministries and Government Agencies

The success of this strategy will be a result of joint implementation efforts of other public institutions including Ministries, regulators and statutory bodies. The specific roles are as follows:

- ***High Economic Council and High Reform Council***: Approve strategy and overall and annual work plans, sanction suggested policy and regulatory reforms and review outcome and impact level progress.

- ***Ministry of Economy***: Overall coordination, research and development and day-to-day impact monitoring. Provision of high-quality research on economic policy and import substitution by ACEPA, and chairing of the SCIS. Evidential research on industrial cluster development, tariff and non-tariff reforms and on employment multipliers; for example. Issuance of quarterly economic updates and annual impact reporting.

- ***Ministry of Commerce and Industry***: The main executor of industrial and manufacturing policy in order to encourage growth through the development of appropriate policies and regulations, and the facilitation of private sector production and trade. MoIC will support the following strategic objectives to support his strategy: (i) improve the enabling and regulatory environment for business and Afghanistan's Doing Business Index ranking (ii) improve international competitiveness and trade (iii) industrialize Afghanistan through increased exports and import substitution (iv) ensure the private sector operates fairly and equitably (v) ensure pro-poor growth and (vi) promote the market economy and increase understanding of how it operates.

- ***Ministry of Finance***: The primary role of the Ministry of Finance is support macro-fiscal stability, improve public finance management and set standards and have oversight of budget formulation and execution processes. Given the focus on public private partnerships, including long term concessions, MoF will support the procurement of PPP investments, to include large-scale commercial agriculture and special economic zones; for example.

- ***Da Afghanistan Bank***: The role of Da Afghanistan Bank in supporting the Productive Afghanistan strategy is to provide indirect but important policy level support to foster Afghanization, import substitution and accelerate commercialization. The primary goal of the Monetary Policy Department is to achieve domestic price stability and to mitigate severe fluctuations in exchange via intervention in the domestic market – given the significant pass-through effect of exchange rate into inflation. Both actions are critical to attaining the goals of the Productive Afghanistan Strategy.

- ***Ministry of Agriculture, Irrigation and Livestock***: MAIL is leading on the implementation of Comprehensive Agriculture Program and provides support for plant and animal health, extension services and food safety, and is implementing the Agriculture Charter; elements of which are key to this import substitution strategy.

- ***Ministry of Public Health***: With a strong focus on supporting import substitution for the pharmaceutical industry, in order for all citizens reach their full potential in health. The primary strategic support areas are as follow: (i) increase equitable access to quality health services (ii) strengthen the stewardship role of MoPH and governance in the health sector (iii) support regulation and standardization of the private sector to provide quality health services and (iv) create an enabling environment for the production and availability of quality pharmaceuticals.

- ***Afghan National Standards Authority***: ANSA is primarily responsible for adopting and setting national standards and supporting the development of national quality infrastructure. ANSA is supported by the Supreme Council on Standards. ANSA will provide the following main functions to support this strategy: (i) standardization (ii) metrology (weights and measures) (iii) conformity assessment services; and (iv) regulatory function.

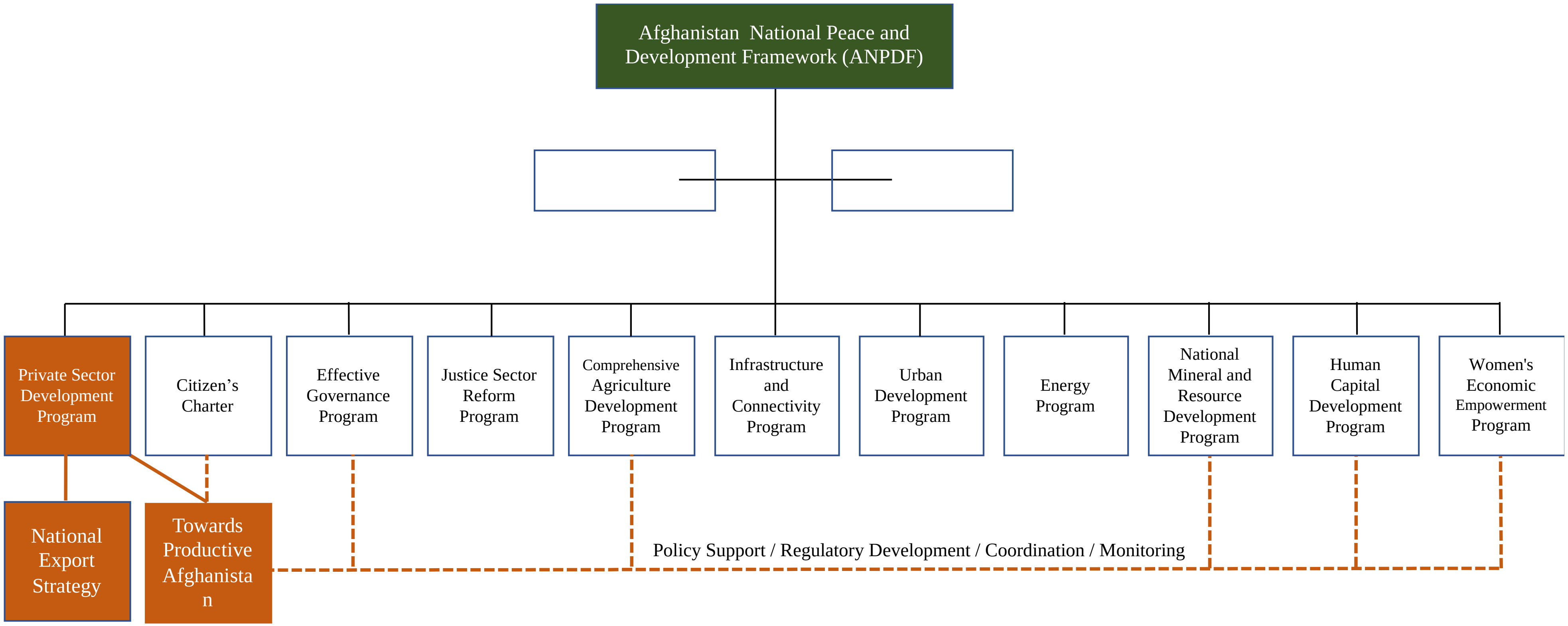
- ***Other Line Ministries***: All other line Ministries have one or more of the following responsibilities to support this strategy, as outlined below:

  - Facilitate the identification and review of legislation which impacts on industrial development to ensure they facilitate the growth of industrial clusters in the country for wealth and job creation;
  - Support efforts in improving Research and Development (R&D) in cooperation with ACEPA, as well as technology transfer and skills development;
  - Ensure provision of land and the mainstreaming of environmental safety and protection issues in the national import substitution strategy and NES;
  - Make necessary budgetary and human resources available for execution of this strategy;
  - Engage the MoEc and MoIC in executing the annual work plan, including reporting back on results;
  - Facilitate the development of industrial and transport infrastructure and the provision of energy and water requirements to support industrial activity across the nation;
  - Support the development of large-scale commercial production, including the establishment and deployment of agroindustry and special economic zones;
  - Support the private sector, small to medium enterprises and participation of women, youth and vulnerable groups in the development of industry;
  - Strengthen forwards and backwards linkages between manufacturing, industry, agriculture, extractives and pharmaceutical clusters;
  - Work to improve the business and investment climate; and,
  - Support performance, outcome and impact monitoring.

7.6 Cost

The cost of implementing this strategy will be calculated on an annual basis, and agreed through the national budget process. Given that the overall projections are in line with a support the MoF Growth Strategy, the costing assumptions also reflect the medium term fiscal and expenditure frameworks. Additional fiscal costs (for example by lowering tariffs) will be calculated in due course, and incorporated into each fiscal projection.

Figure 8. OVERALL COORDINATION FRAMEWORK FOR THE PRODUCTIVE AFGHANISTAN STRATEGY



8. Monitoring & Evaluation

8 Monitoring & Evaluation

The Ministry of Economy, working with other national and sectoral Ministries, statistical and commercial agencies and international partners will establish a policy baseline (2019) around which intermediate and end-term indicators and targets will be established. The strategy will be operationalized through the Import Substitution Strategy Implementation Plan provided in section 6 below.

The Afghanistan Centre for Economic Policy Analysis (ACEPA) will lead the monitoring and evaluation work, linked to research on industrial cluster analysis, employment multipliers and other indicators, linked to the national budget process, around which fiscal, expenditure, GDP and employment impacts will be reported. Moreover, given risks of delay in putting policy measures in place, and in undertaking market testing to gauge private sector interest, baseline, mid-line and end-line indicators must reflect a pragmatic approach to investment potential. The strategy is aligned to the ANPDF Growth Strategy and to the Macro-Fiscal Framework, and as a result outcome and impact resulting from this strategy will be reflected there.

The M&E Department of the MoEc will lead the outcome and impact level monitoring, and it is proposed that the mid-term and end-term evaluations will be jointly conducted with other Ministries and the international community.

Bibliography

Central Statistics Organisation. (2017). “Afghanistan Statistical Yearbook 2016-2017.”

Central Statistics Organisation. (2016/17). “Afghanistan Living Conditions Survey. Labour Chapter”

Djankov, S, Caroline F, & Cong S. P. (2010). "Trading on time." *The Review of Economics and Statistics* 92.1 (2010): 166-173.

International Monetary Fund. (2017). “The World Economic Outlook; Afghanistan.”

Balma., L (2018) Economic Impacts of Structural Transformation and Import Substitution Strategies in Afghanistan: Simulations using MAMS commissioned by the Government of Afghanistan, Ministry of Economy

Joya., O, (2018) Macroeconomic effects of promoting domestic production in Afghanistan, commissioned by the Government of Afghanistan, Ministry of Economy

Lin, J. (2012). New Structural Economics. “A Framework for Rethinking Development and Policy”. The World Bank. Retrived from: http://siteresources.worldbank.org/DEC/Resources/84797-1104785060319/598886-1104951889260/NSE-Book.pdf

Mehdi, R. (2011). “Afghan Industries Struggling in the Face of Cheaper Imports.” *The Daily Outlook,* Afghanistan.

Ministry of Finance. (2016). “Fiscal Strategy Paper; Medium Term Fiscal Framework.”

USAID. (2017). “Regional Agriculture Development Program-EAST.”

The World Bank Group. (2018). “Doing Business Indicators 2018 Country Profile: Afghanistan”.

Appendix

ANNEX 1: ELEVEN PRIVATE SECTOR PRIORITIES

Developed by HARAKAT and ACCI put forward by the GoIRA in London and Brussels Conference:

i. Improve traditional irrigation systems and promote sustainable modern systems.
ii. Advance the development of a national railway system for Afghanistan (review and address the key decisions and recommendations of the Afghanistan National Railway Plan and seek international support for its implementation).
iii. Develop ancillary infrastructure (road and electricity) around resource corridors to facilitate development and reliable transport of extracted minerals.
iv. Establish 'one stop shops' for public services with integrated electronic systems providing streamlined business administration services (registration, licensing, licensing renewal, tax, custom duty payments and other essential business administration requirements in Kabul and 7 commercial hubs).
v. Lower the cost and increase the availability of financing by expanding existing credit guaranty and microfinance schemes and by making the contract enforcement and debt collection environment more attractive to lenders.
vi. Develop a strategy for industrial parks which reflects comments and ideas from the private sector (including establishment of an independent office for industrial park with special authority).
vii. Urgently approve an electricity law, relevant sub-laws and guidelines that facilitate the immediate establishment of an independent electricity regulatory authority to implement policies that support private sector investment in the electricity sector.
viii. Establish a program to upgrade the infrastructure and equipment of TVET institutions for 200,000 students based on market needs.
ix. Protect investors and promote investment (improve contract enforcement, dispute resolution, solving insolvency).
x. Develop a national policy and a legal and regulatory framework for public private partnerships.
xi. Establish an alternative transit route through Central Asia that would be implemented along with the proposed Central Asian Gas Pipeline project.

ANNEX 2: TOP IMPORT ITEMS FROM AFGHAN CUSTOMS DEPARTMENT (2016)

List of top 22 imported items in Afghanistan that constitutes the highest share in our imports as well as more than 80 percent of our customs revenue in 2016.

List of top 22 imported items that constitutes +80% of customs revenue in 2016 (in million Afghanis)					
No	**Items**	**Customs (revenue)**	**Trade value**	**Percentage (%)**	
				Revenue	**Trade**
1	Petroleum (Gas and Fuel), Petroleum products	13,142	54,413	**20.12%**	**12.64%**
2	Wheat flour	4,898	40,126	**7.50%**	**9.32%**
3	Iron	4,755	27,055	**7.28%**	**6.29%**
4	Machinery, mechanical, mechanical telecommunication and parts	3,440	26,586	**5.27%**	**6.18%**
5	Vehicles and vehicle parts	3,237	18,900	**4.96%**	**4.39%**
6	Cement	2,977	16,974	**4.56%**	**3.94%**
7	Edible oil	2,898	30,219	**4.44%**	**7.02%**
8	Lumbering	2,879	30,012	**4.41%**	**6.97%**
9	Sugar and Sweets	1,895	18,724	**2.90%**	**4.35%**
10	Vegetables and Beans	1,257	6,827	**1.92%**	**1.59%**
11	Wheat	1,238	10,117	**1.90%**	**2.35%**
12	Wood and Wooden objects	1,210	7,799	**1.85%**	**1.81%**
13	Tobacco (cigarettes, Paan, etc…)	1,131	4,362	**1.73%**	**1.01%**
14	Dairy	999	6,830	**1.53%**	**1.59%**
15	Plastic material and appliance	994	8,671	**1.52%**	**2.01%**
16	Paper and paper made objects	977	6,466	**1.50%**	**1.50%**
17	Black and Green tea	941	8,813	**1.44%**	**2.05%**
18	Fertilisers	838	8,744	**1.28%**	**2.03%**
19	Tools made of normal metals (stainless steel, aluminium etc..)	717	5,484	**1.10%**	**1.27%**
20	Rubber and objects made of rubber	694	6,857	**1.06%**	**1.59%**
21	Meat (edible)	690	4,585	**1.06%**	**1.07%**
22	Medicinal products	466	4,863	**0.71%**	**1.13%**
Other imports		13,043	76,91	**20.00%**	**17.90**
Total		**65,31**	**430,34**	**100.00%**	**100.00**

ANNEX 3: TOP 10 IMPORT ITEMS FROM AFGHAN CUSTOMS DEPARTMENT (2017)

List of top 22 imported items in Afghanistan that constitutes the highest share in our imports as well as more than 80 percent of our customs revenue in 2017.

Top 10 Import items (million Afs)			
		2017	
No	**Items**	**Customs Value**	**Customs Revenue**
1	Wheat Flour	49,169	5,533
2	Petroleum (Gas and Fuel), Petroleum products	35,970	6,923
3	Lumbering	32,716	2,829
4	Edible Oil	32,457	2,808
5	Machinery, mechanical, mechanical telecommunication and parts	24,547	3,936
6	Sugar	22,237	1,923
7	Cement	21,363	3,478
8	Liquid Gas	17,027	1,461
9	Rice	10,463	901
10	Vehicles and vehicle parts	10,245	1,158
Top 10 Import Countries (million Afs)			
		2017	
No	**Countries**	**Customs Value**	**Customs Revenue**
1	Pakistan	83,456	10,077
2	Iran	79,101	12,432
3	China	77,672	8,219
4	Kazakhstan	58,485	6,408
5	Turkmenistan	25,300	3,270
6	Japan	24,574	3,950
7	Uzbekistan	24,293	3,771
8	Malaysia	23,949	2,125
9	India	16,167	1,924
10	Russia	13,466	1,571

ANNEX 4: THE ROLE OF THE DA AFGHANISTAN BANK (DAB)

Context

The Primary objective of Da Afghanistan Bank is to maintain price stability in Afghanistan through formulating and implementing a prudent monetary policy. Over the past decade Da Afghanistan Bank has been consistently successful in containing inflation with in the target level. To achieve the goal of general level of prices and avoiding prolonged inflation and deflation the monetary authorities target reserve money under the PRGF-extended credit facility of IMF. The role of International Monetary Fund is that of a supervisor in formulating and execution a prudent and sound monetary policy. In economic terms the monetary policy regime of Afghanistan can be categorized as monetary targeting. Monetary targeting is referred to a monetary policy that targets growth rate of a specific monetary aggregate. The foundation of this type monetary policy regime is based on the relationship of money growth and price stability. There is ubiquitous consensus among economic scholar that monetary targeting is ideal for countries with sever information gaps and data limitations.

Macro-economic and monetary stability are pre-conditions for growth and investment, though political turmoil, conflict, capital flight and drought in Afghanistan have created a volatile environment for both domestic and foreign investors. Economic growth is recovering but remains sluggish (projected at 2.4% for 2018) and poverty rates have increased from 38 % in 2011/12 to 55 % in 2016/17, according to the Afghanistan Living Conditions Survey (ALCS). Despite improvements in the financial sector – including high levels of liquidity and lowering of the interest rate paid on DAB's capital notes – according to the IMF the financial sector remains vulnerable to adverse shocks.

Da Afghanistan Bank maintains managed floating Exchange rate regime and intervenes in foreign exchange market to mitigate severe fluctuation in exchange rate. In 2011 the Afghani traded at Afs 43 to the US dollar, but as of October 2018 the Afghani had depreciated around 60% to Afs 75, largely as a result of a strong dollar. In recent years the Iranian Rial (as a result of sanctions) and Pakistan Rupee have also depreciated against the Afghani. The items included in Afghanistan exports basket are limited, seasonal and peculiar to Afghanistan. In addition, exports are price inelastic to a greater extent. The pass-through effect of exchange rate is quite significant for imports, which make it difficult for infant industries in Afghanistan to compete with cheap foreign products in domestic market.

Real Effective Exchange Rate (REER) appear to be correlated with aid flows, and excessive dollarization have made investment planning for importers and exporters challenging. Export levels have been affected by the recent depreciation in REER, meanwhile factors such as domestic supply-side constraints (access to finance, electricity and land, etc.), higher fixed costs (due to security challenges) and limited access to international markets significantly impedes the expansion of industries in Afghanistan. The inflation is primarily imported from trading partners, with the pass-through effect of REER being significant while international aid has also had a limited inflationary impact on goods and services, undermining competitiveness with external markets. Aid-induced appreciation combined with investment climate constraints have negatively impacted incentive to substitute imports and expand exports.

While exports have increased substantially from a low base during this period, they have failed to keep pace with imports, leading to a large trade deficit. According to the World Bank, over the period 2012-16 Afghanistan's exports of goods and services rose from US$1.13 billion to US$1.34 billion, an increase of only 18.5 percent. Imports grew at a similar rate (18.7 percent) from US$8.04 billion to US$9.54 billion. The structural trade deficit in goods and services has remained around 40 percent of GDP in recent years, reaching 42.1 percent in 2016, and exports amounted to only 6.9 percent of GDP in 2016. Thankfully foreign exchange reserves stand at more than US$8.2 billion; greater than one years of import cover. Large external flows (including US Government flows that are still not tracked in the economy) into the country have bolstered national purchasing power, leading to such an imbalance. The perverse effect of this situation is that despite Government and donors being desperate to increase employment at home, instead, Afghanistan has been creating jobs abroad.

The fiscal situation is also worsening, undermining rates of public investment. The overall fiscal balance including grants moved from zero in 2016 to a deficit of 0.6 percent GDP in 2017; with trade and current account deficits largely financed by donor grants. As a small, open and land-locked economy with a long-lasting trade deficit, exchange rate volatility continues to impact domestic price stability. Excessive dollarization of the economy has also not helped either, with the dollar trading at near record highs.

On the commercial and economic formalization side, low rates of business formalization have undermined fiscal sustainability, and they also limit the effectiveness of Central Bank operations in the market place. Given that large inflows appear to have catalyzed increased demand for foreign and not home-made goods, generating growth abroad and not at home, polices must now look to overcome such market and price signal failures. Total credit to the private sector remains well below 2014 levels. Combined with a focus on small-scale agricultural production (much of which is unsustainable) and not large-scale commercial farming, output production gains have remained modest. Indian and Pakistani exporters have access to export credits, Afghani exporters do not. No Afghan product is also quality assured, limiting export market penetration.

Role of Da Afghanistan Bank in the Productive Afghanistan Strategy

The role of Da Afghanistan Bank in supporting the Productive Afghanistan strategy is to provide indirect but important policy level support to foster Afghanization, import substitution. The primary goal of the Monetary Policy Department is to achieve domestic price stability and to mitigate severe fluctuations in exchange via intervention in the domestic market – given the significant pass-through effect of exchange rate into inflation. Both actions are critical to attaining the goals of the Productive Afghanistan Strategy as price and exchange rate stability play a significant in maintaining macroeconomic stability.

Strategy Supporting Actions

The status quo has not served Afghanistan well, largely because the Afghan government does not have full access to the full basket of economic tools necessary to accelerate growth, industrialization and employment. The following set of supportive measures have therefore been identified as being central to this strategy, to better foster Afghanization, Import Substitution Industrialization and Commercialization. Productive Afghanistan priorities are outlined below.

- Ramp up efforts in collaboration with other major government economic and financial institutions to ***reduce dollarization and improve the effective exchange rate***, increasing transactions and financial products denominated in Afghanis, to restore the effectiveness of monetary policy;
- Enhance the ***monetary transmission mechanism*** where general economic conditions are more directly affected by monetary policy decisions;
- Ramp up ***financial inclusion,*** expanding access to low interest rate loans for small, medium and large producers and traders;
- Development of banking products in Islamic finance, leasing, and other instruments which would help agricultural commercialization;
- Diagnostics to better understand the low level of private sector borrowing from commercial banks. Despite efforts to make loan cheaper and more accessible, private sector has in general hesitation to take loans from banks.
- Further development of Microfinance and Non-Bank Financial institutions in advancing the Afghanization agenda;
- Encourage commercial banks in developing new ***financial products*** for large scale commercial operators and small-scale industrialists linked to donor supported blended finance (lower discount rate), reducing investment risk and lowering the investment hurdle rate;

- Da Afghanistan Bank will have a dynamic role in the secondary market in co-ordination with the Ministry of Finance and an array of other government legal and executive authorities.

- Support the development of a National Economic Policy to accelerate Afghanization.