



PRIVATE SECTOR DEVELOPMENT IN AFGHANISTAN AND PAKISTAN²

A regional development agenda

Two major developments will be extremely important for the future of Afghanistan. The first is the 2014 presidential election that took place on April 5 and was an important step toward consolidating a transition to democracy. The second one is the withdrawal of NATO forces from the country until the end of 2014. The election is over, but the results have yet to be determined. The new president will need to decide on the Bilateral Security Agreement between the US and Afghanistan immediately after assuming his new role. As the NATO forces will hand over security to Afghanistan's nascent national forces, it is highly likely that the country will spend a significant part of its energy on ensuring security in the near future. In such an environment, there is the risk that Afghanistan's economic woes are being overlooked.

¹ <http://www.tepav.org.tr/tr/ekibimiz/s/1213/Ozan+Acar>

² This note was originally published in the EastWest Institute report titled "Afghanistan Reconnected Regional Economic Security Beyond 2014" <http://www.ewi.info/sites/default/files/adp%20%282%29.pdf>

Afghanistan has had rapid economic growth throughout the last decade. In 2001, it had the 2nd lowest per capita income in the world. With the windfall of revenues mostly from development aid, the Afghan economy grew by approximately 10 percent on a yearly basis between 2003 and 2012. As a result of this significant economic progress, Afghanistan's per capita income ranked the 20th lowest in the world in 2011. Even though, Afghanistan outstripped 18 countries in per capita income level in the last decade, it is still a fragile and low income country that is dependent on international aid flows. Any effort towards decreasing Afghanistan's dependence on foreign aid flows and expand opportunities for its population should be pursued by the new administration and supported by the international community and all of Afghanistan's friends. Otherwise the country could easily spiral down into a new era of instability.

A proposal for the establishment of an Integrated Production Zone (IPZ)

At the Third Istanbul Forum Meeting, the Economic Policy Research Foundation of Turkey (TEPAV), a think-tank based in Ankara, presented a proposal for the development of an Integrated Production Zone (IPZ) on the border of Afghanistan and Pakistan. The IPZ is comprised of multiple zones to harness cross border complementarities between the two countries. The proposed IPZ model gets its inspiration from Turkish Chamber Federation's (TOBB) effort to develop Jenin Industrial Zone on the border of Israel and Palestine. Despite all the roadblocks the land acquisition for Jenin Industrial Zone is completed at the end of 2013 and the construction work is expected to start in the first half of 2014. IPZ is a cross border project with two fundamental targets. The first one is to enhance the economic integration between Afghanistan and Pakistan, whereas the second target is to bring economic development to the regions that IPZ will be established. In this short study, TEPAV's IPZ proposal is going to be discussed briefly.

Conceptual framework

In order to bring stability to Afghanistan and Pakistan there is a need to focus on cross border regional development projects based on private sector development (PSD). The private sector is the most important agent that has the tools and capabilities to bring prosperity to the people of the two countries. PSD programs in this respect have to be based upon a set of carefully selected sectors, the ones that add value to both sides of the border should be given priority. Policy intervention should aim to focus on missing or weak links in the value chain in the two countries. Such PSD policies could be successful even under political constraints as they have the potential to create win-win situations.

PSD in a politically unstable environment with security problems is a delicate business. Incremental designs rather than grand projects have a higher chance of success in such environments. Independent of the size of the project, PSD in fragile states requires effective coordination among all parties. Maintaining dialogue among public and private sectors and the international community is a key factor throughout the process.

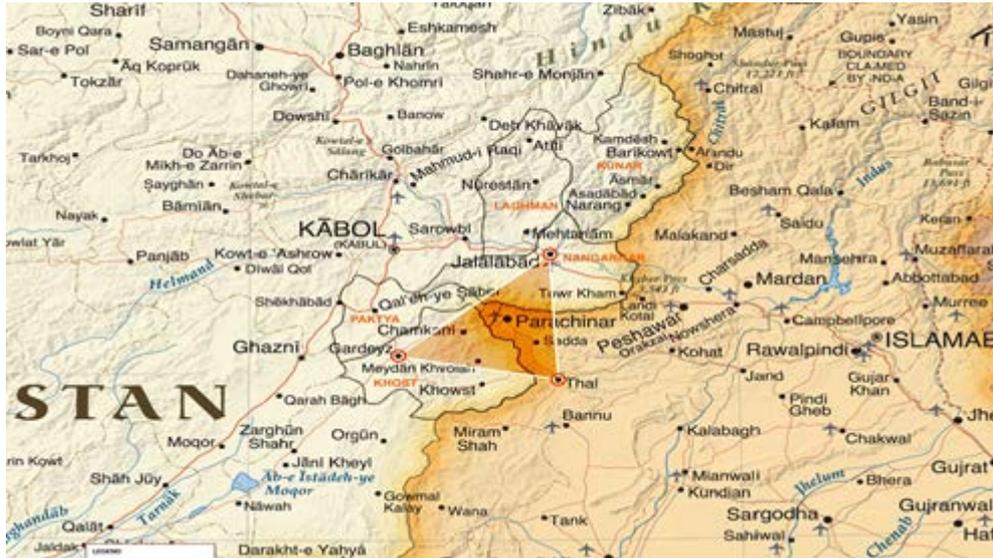
In order to make the projects sustainable, they must produce profits for the involved private sectors.

Tackling all investment climate constraints at once is not feasible. Economic uncertainty, infrastructure problems, the lack of a skilled workforce and vulnerability to finance problems are significant challenges behind underdeveloped private sectors in such environments. However, creating a favorable investment climate at the local level can be possible. Three issues should be tackled in creating a conducive business environment. The first one is to initiate capacity building programs with a focus on institutional building that are necessary for production and commercial transactions. The second one is to provide a superior infrastructure at the local level. The final one is to decrease the effective cost of investment of the private sector through insurance mechanisms and subsidized credits.

PSD in the framework of an Integrated Production Zone (IPZ) requires a cross-border cluster development perspective. The success of the project is strongly tied to the sector selection. In making this decision, backward and forward linkages of the sectors and available capabilities in the region should be carefully analyzed. Following this conceptual framework, the Economic Policy Research Foundation of Turkey (TEPAV) conducted an initial feasibility study for an IPZ that is proposed to be established on the border of Afghanistan and Pakistan. Site and sector selection criteria together with an evaluation of critical project components are summarized below.

Proposed site for IPZ

The proposed site for IPZ is on the northern border of Afghanistan and Pakistan. It will expand to the area that encompasses Khost and Gardeyz of Afghanistan, Parachinar and Thal of Pakistan. On this triangle, there will be multiple production zones that will leverage the existing capabilities available in the region and cross border complementarities between Afghanistan and Pakistan. The proposed region partially includes Federally Administered Tribal Areas and is not the most secure among the alternatives. In addition to the internal security problems of Afghanistan, one can see that the tensions between Afghanistan and Pakistan escalating in this region. Despite all the downsides, the proposed IPZ site was selected on the basis of technical and economic feasibility.



Map: Proposed site for IPZ

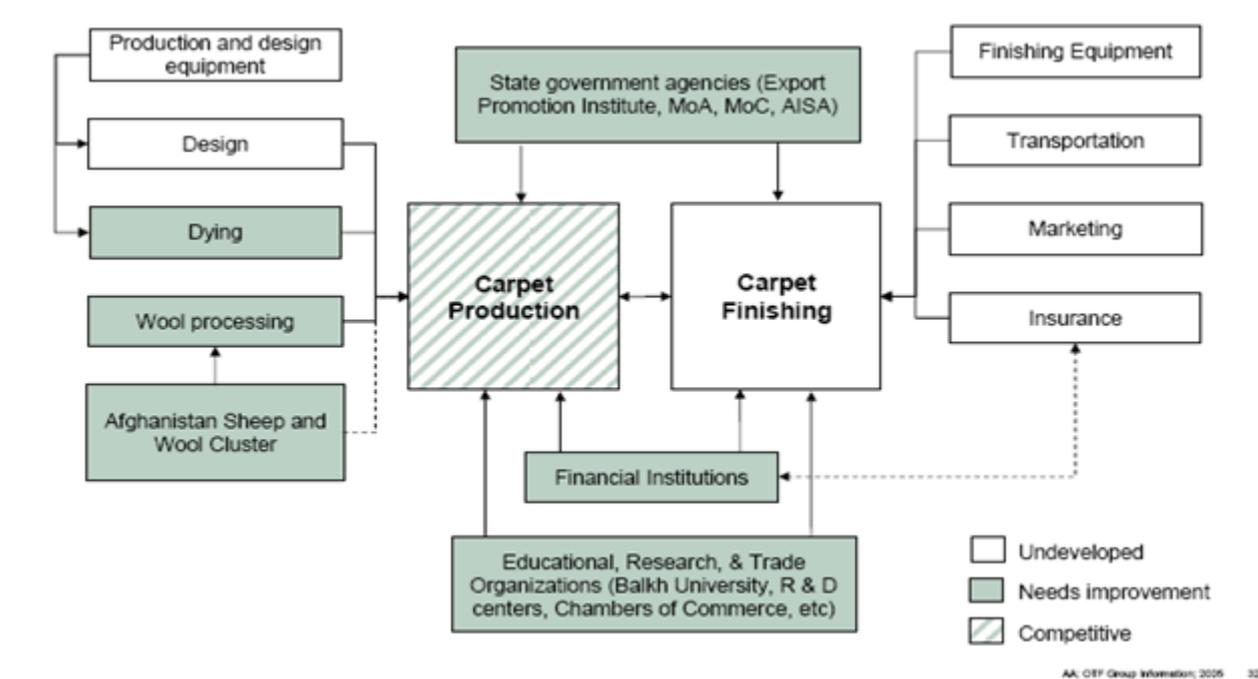
Considering the terrain characteristics, border crossing availability, transport conditions and electricity production potential, the proposed region is suitable for an IPZ. First, Thal is an open valley with a perfectly suitable terrain, convenient for the construction of a joint production zone. Furthermore, in the vicinity of Thal, there are gas and coal reserves available for electricity generation, which is crucial for growing private sector activity. Products of an IPZ in the proposed region can cross the border from the Gulam Khan Border crossing, which is one of the most important border crossings between Afghanistan and Pakistan. It is not ready for public use right now, but there is an airport under construction in the Khost province as well. In terms of availability of road transportation opportunities, the Khost to Gardeyz road is currently under construction and will shorten the route between Kabul and Karachi by approximately 400 km when it is complete. This road project is extremely important as it will ensure easier access of products that are produced in IPZ to the Karachi Port.

Selection of Priority Sectors: The Carpet Example

Increasing the level of economic integration between Afghanistan and Pakistan is one of the building blocks of the IPZ idea. We therefore need to analyze cross border entities. Priority sectors should be identified by taking into account the backward and forward linkages between the two countries. Another factor that shouldn't be overlooked in the selection of priority sectors is the availability of natural resources, skills and physical infrastructure. Carpet production is identified as one of the priority sectors that could benefit from cross border exchange. The food and furniture sectors, which are not covered in this short note due to space constraints, are the other priority sectors that are identified by TEPAV.

The Carpet sector is one of the two high-potential sectors, after the initial feasibility studies, to be targeted in IPZ. Afghanistan has achieved some competitiveness in the carpet production segment. The total amount of Afghanistan’s carpet exports exceeds 200 million USD, which is approximately 45 percent of the country’s total exports. The main source of Afghanistan’s competitiveness in carpet production is the country’s abundant supply of high-quality wool. The combined lack of adaptation capacity to frequent changes in global trends, working capital and finishing equipment for washing and cutting, as well as problems in access to export markets are the main impediments to increasing the country’s global market share in the carpet trade. Strengths and weaknesses of Afghanistan’s carpet value chain are summarized in the chart below.

Figure: Carpet value chain in Afghanistan



Establishment of carpet washing and cutting facilities in the Gardeyz-Khost region to strengthen the value chain has the potential to create significant economic gains for Afghans and Pakistanis. Afghanistan could contribute to the carpet value chain through its existing capacity of drying facilities in Khost region, whereas Pakistan could provide chemical inputs for the washing stage and electricity to the value chain. As a third party, Turkish carpet producers could take part in the value chain through know-how transfer to Afghan producers namely by following trends in the world market and the creation of new designs and colors. Carpets that are produced in Afghanistan with the necessary inputs from Pakistan could be marketed and transported to export markets by Pakistani retailers and logistics operators.

Potential benefits of strengthening the weak parts of the carpet value chain in Afghanistan with the involvement of Pakistan and Turkey are huge for all the parties involved. From the point of view of Afghanistan, the country would increase its

competitiveness and production of carpets. Afghan carpet producer's access to world markets and value added of carpet production would increase. Know-how transfer from Turkish industrialists in terms of adaptation to changing tastes and preferences in world markets would help Afghan producers to sustain competitiveness in the global carpet trade. Potential benefits of such an engagement to Pakistan are significant as well. First, in Pakistan, new employment in input industries for cutting and washing would be created. New business opportunities for Pakistani fleet operators and retail service providers would increase.

Integrating the project components

An IPZ that is going to be developed on the border of Afghanistan and Pakistan can be successful only if off-site infrastructure is adequately provided for private sector companies to operate in an effective manner. Electricity, transportation, border crossings, waste management, and security are all prerequisites that would make the IPZ an attractive investment location. TEPAV has completed a needs assessment for off-site infrastructure components.

Power shortages are a key problem for industrial development in both of these countries. However, there are deposits of high quality coal in Kohat and Kurram. Exploration techniques have to be improved in order to make better use of these reserves. One or more coal-fired thermal power plants should be constructed to leverage the availability of coal reserves in electricity production. The private sector would be interested in investing in coal-fired power plants under a public-private partnership arrangement (PPP). This framework is a must to enable the private sector to share the risk of such an investment. In addition to strengthening the electricity production capacity, there is the need to improve the existing transmission lines and building new cross border transmission lines between Afghanistan and Pakistan.

An efficient logistics and road infrastructure is required for companies, which are going to be based in IPZ, to transport their raw materials and intermediate inputs from outside and final goods to their customers. Under the current situation the lack of reliable roads and railways makes logistics difficult in the region. In terms of transport infrastructure, priority should be given to the improvement of Thal-Kohat railway that is going to be used for the transport of coal to coal-fired thermal plants. Cross border road infrastructure should be carefully inspected and any problem that increases travel times should be fixed. In this respect, another priority project should be the improvement of Parachinar-Thal road.

Customs administration and border gates are also important project components that affect the likelihood of the IPZ's success. Ongoing initiatives to improve border gates and customs administration in Afghanistan and Pakistan should be completed as soon as possible. Aside from the ongoing initiatives, establishment of a new border crossing where goods trade between Afghanistan and Pakistan can be quickly processed and should be supported by the governments. The Turkish Chamber Federation (TOBB)

border gates modernization projects in Turkey could be taken as a model in increasing the effectiveness of the crossing on Afghanistan’s Pakistan border. Currently, there are six border gates in Turkey, which have achieved significant performance improvement after TOBB started to operate them. The goal of these initiatives is to improve trade facilitation through a PPP scheme. TOBB could undertake a similar task in Afghanistan and Pakistan with the partnership of Afghan and Pakistani Business Chambers.

Cilvegozu Border Gate (on Turkey’s Syria border)	
Before TOBB	After TOBB
	

Without capacity building programs, the proposed IPZ cannot become operational in an efficient manner. In this respect, vocational training centers should be planned as part of the production zones in the IPZ. Vocational training programs should target skills building and skills conversion. In addition to vocational training centers, there is the need for a business development center specialized in SME development with a micro-credit focus. Chamber federations that should be actively involved in administration of the production zones should improve their capacity for income resources, estate and border management.

The Turkish Chamber Federation (TOBB), which has been actively involved in the Istanbul Process from the outset, would be willing to get involved in the dialogue process for the establishment of IPZ, revitalization of border crossings and designing capacity building programs. TEPAV, which is supported by TOBB, could undertake detailed feasibility studies that would assist policy makers in deciding on the best location and sector alternatives.

What to do next?

- 1) Building consensus: the IPZ is a multi-stakeholder initiative. In addition to governments of Afghanistan and Pakistan, there is the need to get the endorsement of business communities led by the chamber federations of these countries. But that will not be enough. The support of the U.S., Turkey, and other donor countries to provide financial, technical and security assistance would be highly useful in the realization of this project.

- 2) Land issues: The IPZ's success depends greatly on its location. A delegation of experts should contact governments and identify the best location for an IPZ.
- 3) Legislative process: Analyze the local legislations to identify the parts that negatively affect the establishment of an IPZ. A concession agreement should be drafted at this stage and free trade agreements between Afghanistan and Pakistan should be modified if necessary. In addition to a Free Trade Agreement between Afghanistan and Pakistan, developed countries should give zero tariff access to the products produced in IPZ to their domestic markets.
- 4) Identifying donors: international financial institutions and development agencies of major donor countries should be contacted to discuss provisions of financing and technical advisory to the IPZ. The World Bank, Asian Development Bank, Islamic Development Bank, USAID, the Department for International Development (DFID), and the Turkish Cooperation and Coordination Agency (TIKA) should be on the list of contacts.

It should be noted that "the journey of a thousand miles begins with one step." There is the need to start thinking about establishing IPZ on the border of Afghanistan and Pakistan to bring prosperity to the region and enhance regional integration between these two countries. Despite all the political problems between Afghanistan and Pakistan, this IPZ is a workable project that could provide significant economic gains to all the parties involved. TOBB and TEPAV are ready to provide technical assistance to Afghan and Pakistani governments as well as business organizations in their efforts to realize the IPZ mission.