April 2005
IMF Country Report No. 05/128

Islamic Republic of Afghanistan: Third Review Under the Staff-Monitored Program and Request for an Extension

This paper on the third review under the staff-monitored program for the Islamic Republic of Afghanistan was prepared by a staff team of the International Monetary Fund in connection with the periodic consultation with the member country. It is based on the information available at the time it was completed on March 31, 2005. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the Islamic Republic of Afghanistan or the Executive Board of the IMF.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of the Islamic Republic of Afghanistan*
Update to the Memorandum of Economic and Financial Policies by the authorities of the Islamic Republic of Afghanistan*
Amendment to the Technical Memorandum of Understanding*

*May also be included in the Staff Report

The policy of publication of staff reports and other documents by the IMF allows for the deletion of market-sensitive information.

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

Copies of this report are available to the public from

International Monetary Fund ● Publication Services
700 19th Street, N.W. ● Washington, D.C. 20431
Telephone: (202) 623 7430 ● Telefax: (202) 623 7201
E-mail: publications@imf.org ● Internet: http://www.imf.org

Price: $15.00 a copy

International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF AFGHANISTAN

Third Review Under the Staff-Monitored Program and Request for an Extension

Prepared by the Middle East and Central Asia
and Policy Development and Review Departments

(In consultation with other departments)

Approved by Saleh M. Nsouli and Matthew Fisher

March 31, 2005

- Discussions for the third review (October–December 2004) and extension of the Staff-Monitored Program (SMP) were held in Kabul from January 23–February 3, 2005. The mission met with Vice-President Masood, Minister of Finance Ahady, Minister of Economy Farhang, Minister of Commerce Arsala, Da Afghanistan Bank Governor Delawari, other senior officials, as well as representatives of the diplomatic community, nongovernmental organizations, business community, international press, and international organizations.

- The 12-month SMP covers the fiscal year 2004/05 (March 20, 2004–March 20, 2005). Its objectives are to maintain financial stability, build a statistical base, and establish institutional capacity. If implemented successfully, it may pave the way for an arrangement under the Poverty Reduction and Growth Facility (PRGF).

- The mission members consisted of Messrs. Symansky (head), Bessaha, Martin, Ms. Mwase (EP) (all MCD), Mr. Schneider (PDR), and Mr. Thomas (FAD). The mission was assisted by the resident representative, Mr. de Schaetzen.

- The new economic team, which was appointed in December 2004 as part of a new Cabinet, encountered some initial difficulties associated with the departure of some senior officials from key government institutions. However, it quickly assumed control over daily operations and the implementation of fiscal and monetary policies.

- After several months without any major security incidents, there have been some incidents in early March. The United Nations continues to rate Afghanistan at Security Phase III. Security is expected, however, to remain volatile until after the legislative elections, which have been postponed to September 18, 2005. Security conditions permitting, the mission for the fourth review under the SMP is scheduled for early May 2005.

- Consistent with their transparency policy, the Afghan authorities have already agreed to the publication of the updates to the Memorandum of Economic and Financial Policies (MEFP) and to the Letter of Intent (LOI) after their distribution to the Executive Board.

Contents Page

List of Acronyms

AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
ANA	Afghan National Army
ARTF	Afghanistan Reconstruction Trust Fund
CSO	Central Statistics Office
DAB	Da Afghanistan Bank
IMC	Inter-Ministerial Committee
I-PRSP	Interim Poverty Reduction Strategy Paper
LOI	Letter of Intent
LOTFA	Law and Order Trust Fund for Afghanistan
MEFP	Memorandum of Economic and Financial Policies
PRGF	Poverty Reduction and Growth Facility
PRR	Priority Reform and Restructuring
RER	Real exchange rates
SAF	Securing Afghanistan's Future
SMP	Staff-Monitored Program
TA	Technical Assistance
TCC	Technical Coordination Committee

EXECUTIVE SUMMARY

- Performance during the third quarter of the SMP was strong, particularly considering that the October 2004 presidential elections and the ensuing formation of a new government diverted important human resources. All end-December 2004 indicative quantitative indicators and structural benchmarks were met, except for the benchmark related to the publication in the official gazette of the central bank law and the commercial banking law, as the publication of the latter was delayed for technical reasons.

- Output continued to grow steadily despite the lingering drought that affected agricultural performance. Inflation declined while the exchange rate depreciated slightly. Money growth and fiscal revenue were in line with program projections. International reserves continued to increase.

- To address the rising problem of the drug economy, the government developed a multi-pronged strategy, combining eradication, interdiction, and alternative livelihoods. There is anecdotal information that planting is down this year.

- Further mobilization of fiscal revenue is predicated on a steadfast implementation of the tax and customs reform programs. In the face of pressures to increase spending, there is also a need to control the wage increases to those stemming from ongoing civil service reform initiatives. At the same time, the budget process is complicated by uncertainty regarding donor support.

- The 2005/06 monetary program is consistent with a slowdown in the pace of monetization of the economy, reflecting the high degree of monetization already achieved, the expected development of the banking sector, and the envisaged decline in drug-related activities. The authorities need to intensify their efforts aimed at restructuring the relicensed state-owned banks and resolving those that were not relicensed.

- The structural reform agenda focuses on improving the regulatory environment for private investment and maintaining the external competitiveness of the Afghan economy. Work on an Interim Poverty Reduction Strategy Paper (I-PRSP) has been initiated, and is expected to be completed by October 2005.

- The authorities requested an extension of the SMP through end-September 2005.

- Notwithstanding these achievements, there are several major risks to program implementation, including (a) the continued volatile security and the political uncertainty in the run-up to the legislative elections scheduled for September; (b) the economic impact of the programs to deal with the drug economy, successful or not; (c) the focus of donor's attention on other regions of the world; and (d) the improving, but still low, implementation capacity of the authorities.

I. Introduction

1. On January 19, 2005, the Executive Board concluded the 2004 Article IV consultation with the Islamic Republic of Afghanistan. On that occasion, Executive Directors noted that prudent fiscal and monetary policies had helped to contain inflation and facilitate relatively high levels of growth. However, they emphasized that daunting economic and social challenges persist and that poverty remains widespread, calling for the pursuit of skillful economic management and strong implementation of structural reforms, with continued donor support. Directors encouraged the new government to pursue economic reforms, capacity building, and rehabilitation of physical infrastructure. They supported recent efforts by the government and its international partners to develop a multi-pronged strategy to fight the rise in illicit drug activities, while calling for safeguards to alleviate any significant adverse economic impact on the most vulnerable segments of the population. Directors supported the continued implementation of the SMP to build a solid foundation for transition to an arrangement supported by the PRGF. They welcomed the authorities' decision to initiate work on an I-PRSP to frame their policy agenda.

2. **The authorities requested an extension of the SMP through end-September 2005, and prefer to wait until after the forthcoming legislative elections, scheduled for September 18, 2005, to consider a PRGF-supported program.** The extension will be used to further strengthen the policy framework and administrative capacity. In the meantime, steps are being taken to initiate work on an I-PRSP.

II. Performance Under the Staff-Monitored Program

3. **All end-December 2004 indicative quantitative targets were met. All structural benchmarks were also completed on time,** except the benchmark related to the publication in the official gazette of the central bank law and the commercial banking law.[1] Understandings were reached on an update to the MEFP. To avoid bunching and accommodate capacity constraints related to the change in government, some of the structural benchmarks initially set for end-March 2005 have been either moved to end-June 2005 or end-September 2005; those not viewed as important from a macroeconomic perspective were retained as policy actions in the update to the MEFP.

4. **Staff view the authorities' performance during the third quarter of the SMP as strong, particularly against the background of the formation of a new government.** While there were indications that the government intends to reassess its policies to better meet pressing social demands, the new economic team reiterated its commitment to continue with the current SMP and to achieve the program objectives.

[1] While the central bank law was published in December, the publication of the commercial banking law (referred to as "the banking law" in the MEFP, in line with its official name) has encountered technical delays stemming from low capacity to translate into Dari and Pashto. It is expected to be published soon.

III. Recent Developments

5. **Recent real sector developments were broadly in line with the SMP projections (Tables 1 and 2).** Reflecting adverse weather conditions, agricultural output is estimated to have fallen by 15–20 percent during the first nine months of 2004/05. At the same time, activity continued to be buoyant in construction, transportation, and other services. Despite the drought, which lowered yields, poppy production increased substantially as cultivation spread to new areas of the country and requires less water than most other crops. This increase in production led to a subsequent drop in farm gate prices.

6. **Reflecting primarily a seasonal increase in food prices, consumer prices in Kabul increased by 4.0 percent between September and December 2004**.[2] Excluding food items, consumer prices rose by 0.9 percent, due in part to a decline in rent and petroleum prices, which had increased sharply over the first half of 2004/05 (Figure 1). Year-on-year inflation reached 11.9 percent at end-December 2004 (6.6 percent excluding rents and petroleum products), compared with 14.1 percent at end-September 2004.

7. **Domestic revenue for the first nine months of 2004/05 is estimated at Af 8.9 billion, exceeding the SMP indicative target of Af 8.6 billion (Tables 3a and 3b)**. Following a subdued start in the third quarter, receipts rebounded sharply in December. The rise in customs revenue in December likely reflected delays in posting transactions during the October presidential elections and Ramadan. **At the same time, the rate of spending, particularly for development programs, remained below budget projections.** The slow rate of development spending was attributed to the lack of implementation capacity, delays in mobilizing donor funding, and the level of insecurity (see paragraph 5 of MEFP). Underspending in operating expenditure resulted from delays in recruiting teachers and implementing the main civil service restructuring program.[3]

8. **Monetary growth was lower than programmed during the third quarter of 2004/05** (Table 4 and Figure 2). The slowdown in currency growth appears to have resulted from the financing of the Hajj and from lower-than-projected donor spending in the period leading up to the formation of the new government.[4] Reflecting the high level of liquidity in the state-owned banks, interest rates on the short-term capital notes remained low (at 1–2 percent overnight; and 3–4 percent for 30-day notes (Figure 3)). Foreign exchange reserves continued to increase, while the nominal exchange rate depreciated somewhat, to

[2] The consumer price index that includes five other major cities increased by 3.4 percent during the third quarter of 2004/05 and 8.4 percent over the first nine months of 2004/05 (compared with 12.6 percent in Kabul).

[3] Total government employment was around 375,000 at end-December, including 134,000 for the police and defense force, compared to a budget estimate of 406,000. The shortfall was mainly in the education sector.

[4] Most Hajj pilgrims financed their journey by depositing Afghanis in Da Afghanistan Bank.

about Af 48 per U.S. dollar at end-December 2004—roughly the same level as at the beginning of the year.

9. **While further progress was made in modernizing Da Afghanistan Bank (DAB) and strengthening the commercial banking regulatory framework, the restructuring of the state-owned banks continue to be slow and uncertain**. The external audit of DAB's 2003/04 financial accounts was initiated and the findings are expected to be presented to DAB management shortly. Progress was made toward finalizing the transfer of DAB's commercial accounts to other entities, and new banking data reporting requirements have been implemented. The publication of the central bank law in the official gazette is another positive development. At the same time, there were delays in the restructuring of the state-owned banks, partly because of weak supervision and management capacities and uncertainty regarding their ownership. Furthermore, a decision had yet to be taken regarding the resolution process of the three state-owned banks that were not relicensed.[5]

10. **Preliminary data indicate that the current account deficit (excluding grants) narrowed to 32 percent of GDP in the first three quarters of 2004/05,** down from 39 percent a year before, and was primarily financed by donor grants (Table 5). Including grants, the current account recorded a surplus equivalent to 2.9 percent of GDP, compared with 0.3 percent of GDP a year before. The improvement in the current account appears to have reflected a further recovery in domestic exports (from a very low base), due in part to improved infrastructure. External borrowing, which was on highly concessional terms, remained limited, with disbursements estimated at $172 million. The authorities continue to make progress in verifying external obligations to bilateral creditors.

IV. Macroeconomic Outlook and Policy Framework

11. **The prospect of legislative elections is putting pressure on the new government to reassess policies and redefine priorities to improve more quickly the delivery of public services and to provide badly needed infrastructure.** At the same time, the government recognizes that the reform agenda embodied in its long-term strategy, called Securing Afghanistan's Future (SAF), and that the prudent policies pursued thus far have served the country well and are critical to address medium-term challenges.[6] These challenges include: generating sufficient growth to address poverty and unemployment; eliminating the drug economy; improving security; and maintaining a sound and sustainable fiscal policy at a time of rising uncertainty regarding donor commitments in light of other pressing international needs. Staff cautioned against the short- and medium-term fiscal implications of some recently envisaged initiatives. Discussions with the authorities centered

[5] These entities have ceased their commercial banking operations. They continue to pay employee salaries using the substantial rental revenue they earn.

[6] "Securing Afghanistan's Future," Transitional Islamic Government of Afghanistan, 2004. Available at http://www.af/recosting/index.html.

on maintaining macroeconomic sustainability, transparency, and a long-term, pro-growth structural agenda.

12. **Understandings were reached on an updated macroeconomic framework for 2004/05 and 2005/06 and on a set of quantitative indicators and structural benchmarks for end-June 2005 and end-September 2005.** If met, these objectives should help ensure continued macroeconomic stability and contribute to further strengthening administrative capacity. While ambitious, these policies are within the government's ability to implement. A renewed commitment to intra-governmental cooperation and coordination will be critical in this regard.

A. Macroeconomic Objectives

13. **Real GDP growth projections for 2004/05 and 2005/06 were kept broadly unchanged at 8 percent and 10 percent, respectively**. While recovering, the agricultural output would experience moderate growth in 2005/06, due in part to lingering drought conditions. The other sectors would continue to grow steadily, albeit at lower paces than in 2004/05. Inflation is expected to pick up slightly during the fourth quarter of 2004/05, to 13 percent year-on-year at end-2004/05, due to a further increase in food prices. In 2005/06, inflation is projected to decline to 10 percent, reflecting a tightening in monetary policy and an expected slowdown in rent prices. Prudent macroeconomic policies and financial sector reforms are also expected to contribute to an improvement in domestic savings from -15.7 percent of GDP in 2004/05 to -8.6 percent of GDP in 2005/06. Investment would decline slightly relative to GDP (from 26.5 percent of GDP to 24.6 percent of GDP). The savings-investment gap will continue to require highly concessional aid flows. The current account balance including grants is currently projected to swing from a surplus of 1.8 percent of GDP in 2004/05 to a deficit of 1.7 percent in 2005/06, reflecting conservative assumptions regarding donor inflows.

14. **The authorities, in collaboration with the donor community, intend to step up their efforts to deal with the drug economy through the implementation of a multi-pronged strategy that combines eradication, an active interdiction campaign, and the development of meaningful and permanent alternative livelihoods**. They are encouraged by the current environment, characterized by the voluntary switch by some poppy farmers to other crops, due to the recent decline in farm gate poppy prices, increased dangers associated with the government's anti-narcotic campaign, and favorable precipitation.

B. Fiscal Policy

15. **The authorities are likely to meet the SMP revenue target for 2004/05 of Af 12.8 billion (4.8 percent of GDP).** Domestic revenue is expected, however, to fall short of the budget target of Af 15.4 billion (see paragraph 15 of MEFP). This shortfall stems largely from a slower-than-anticipated implementation of the tax reform program, which reflected capacity constraints in passing legislation and the restructuring of the Ministry of

Finance.[7] The shortfall in domestic revenue relative to the budget is expected to be offset by a combination of lower operating expenditures and additional donor funding. As observed in previous years, while projected to rise sharply during the fourth quarter, recurrent expenditures are expected to remain well below the budget for 2004/05. At the same time, improved compliance with the financial management procedures should continue to raise reimbursement rates from the two multi-donor trust funds.[8]

16. **The 2005/06 budget will aim at a further increase in domestic revenue, of about 26 percent, and continue to rely on the "no-overdraft rule."** Staff emphasized the need to follow the tax and customs reform agendas, and cautioned strongly against quick fixes to generate temporary revenue gains, as they could prove detrimental in the long run. Staff welcomed the government's commitment to stop granting exemptions and to adopt amendments to the revenue code to ensure that investment incentives are given only through the relevant tax legislation (end-March 2005 structural benchmark). Staff also welcomed the government's intention to further consolidate the current and capital budgets and to improve fiduciary standards (see paragraph 20 of the MEFP).[9] Similar to the previous two fiscal years, there is, however, a concern that fiscal operations may again be disrupted as a result of a late adoption of the budget.[10] To avoid this problem in 2005/06, staff urged the authorities to establish appropriate arrangements.

17. **In order to preserve fiscal sustainability, the increase in wage costs should be limited to those stemming from ongoing reforms that are fully financed, such as the priority reform and restructuring (PRR) programs** (see paragraph 19 of the MEFP).[11] The wage bill, which represents about 75 percent of the operating budget, is envisioned to rise under the donor-supported civil service reforms, including the recruitment of around 37,000 new teachers, and to widen the operating budget deficit in 2005/06 and over the

---

[7] The tax reform program includes the wage withholding tax, a fixed tax on selected services, a reduction in the corporate tax rate to 20 percent, and a rent tax.

[8] Afghanistan Reconstruction Trust Fund (ARTF) and Law and Order Trust Fund for Afghanistan (LOTFA).

[9] The planned introduction of a single chart of accounts is expected to help unify the operating and development components of the core budget.

[10] Payment delays occurred at the start of the previous two fiscal years, particularly for salaries, due to the lack of coordination between the budget allotment process and the employee register. While the 2005/06 operating budget is expected to be adopted by end-2004/05, the core budget, which includes some development expenditures, is likely to be adopted shortly after the start of the fiscal year, due to delays in organizing the donors forum, resulting partly from the change in Cabinet.

[11] These PRR programs are funded by donors to restructure ministries and attract appropriately skilled and experienced Afghan officials to core managerial and technical positions.

medium term, thus requiring additional donor financing.[12] The authorities, faced with strong pressures for additional generalized or sector-specific wage increases, recognized that such increases would put medium-term fiscal sustainability at risk and could undermine the implementation of a comprehensive civil service reform. To counter such pressures, staff argued for a wage cap, but the authorities, while concurring, took the view that they needed first to (a) assess the impact and benefits of such a policy; and (b) gain the support of the Cabinet for this policy. In addition, several donors raised concerns that a wage cap would hinder the administrative reform program agreed to in Berlin. Staff explained that the wage cap would take into account the implications of this reform program and pointed out that the increasing financial support required over the next few years to implement the Berlin agenda has yet to materialize. A strategy for containing the wage bill will be discussed further during the next review. In addition, there are concerns about other donor-financed programs with large recurrent costs and substantial medium-term fiscal implications, notably in the security sector and in relation to the counter-narcotics effort.[13]

18. **The development budget, which is totally donor-funded, is also expected to expand in 2005/06, although less than initially envisaged, partly because of weak implementation capacity**. The government is placing emphasis on infrastructure partly in response to the frustration expressed by the public about the lack of visible effect of donor money. Staff stressed the need to manage the public's expectations and called for the preparation of a medium-term budget based on realistic assumptions about revenue growth, donor funding, and implementation capacity to preserve medium-term fiscal sustainability within the context of the upcoming I-PRSP.

C. Monetary Policy and Reforms

19. **Monetary policy will continue to aim at lowering inflation within the framework of a floating exchange rate**. It will continue to be guided primarily by indicative targets for currency in circulation, as set out in the SMP. When consistent with the monetary program, the authorities may intervene to avoid unwarranted short-term exchange rate fluctuations. However, given the potential for large structural changes and Afghanistan's vulnerability to external shocks, they would not resist persistent pressures on the exchange rate, should such pressures emerge. Through its impact on the competitiveness of the export sector, such flexibility might prove essential to ensure the sustainability of the balance of payments in the event of a substantial decline in opium- and donor-related inflows. Moreover, in view of the

---

[12] The civil service restructuring strategy presented in SAF envisages the civilian wage bill to rise from 6.5 percent of GDP in 2003/04 to about 10.5 percent of GDP in 2008/09 (while employee numbers remain relatively stable). Domestic revenue is expected to cover the wage bill in about five years.

[13] The Afghan National Army (ANA) is currently funded by external grants, outside of the budget. The incorporation of the ANA into the budget, proposed for 2005/06, would significantly increase the reported operating costs. The police are also funded by donors through LOTFA and large pay increases have been proposed. The public expenditure review currently being conducted should quantify spending in the security sector.

high uncertainty surrounding money demand, the monetary program will remain flexible, and the authorities should stand ready to tighten monetary policy, if warranted by price and exchange rate developments.

20. **In view of the slowdown in consumer prices during the third quarter and the monetary tightening already implied in the program for the remainder of the year, understandings were reached to keep the monetary targets for 2004/05 unchanged.** For 2005/06, the monetary program is consistent with a slowdown in the pace of monetization of the economy, reflecting the level of monetization of the Afghan economy already achieved (see Box 2, IMF Country Report No. 05/33), the expected development of the banking sector, and the envisaged decline in drug-related activities (see paragraph 21 of the MEFP). Foreign exchange reserves are projected to increase further in 2005/06, to the equivalent to 5.5 months of prospective imports of goods and services.[14]

21. **The authorities intend to further modernize the central bank.** They reiterated their commitment to implement several key measures aimed at allowing DAB to focus on its core functions, including the transfer of its commercial activities and noncore assets (see paragraph 22 of the MEFP). Staff encouraged DAB to move toward the development of interbank money and foreign exchange markets. Of particular importance is the development of the money market (Box 1), which will facilitate the transfer of excess liquidity from the state-owned banks to private banks seeking to develop their lending operations in Afghani and contribute to establishing a market-driven benchmark interest rate, thus improving the efficacy of the capital note as an instrument of monetary policy.

22. **Staff stressed the need to further strengthen the commercial banking regulatory framework and to proceed with the resolution of the unlicensed state-owned banks.** Staff encouraged the authorities to promptly publish in the official gazette the commercial banking law, as well as the various regulations adopted by DAB's Supreme Council over the last year. Staff urged the authorities to ensure a strict implementation of the conditions attached to the relicensing of the three state-owned banks. In addition, staff cautioned the authorities against reviving the three state-owned banks that have not been relicensed, and stressed that a decision regarding their resolution process should be taken and implemented promptly. The authorities are committed to take such a decision by end-June 2005 (see paragraph 23 of the MEFP).

---

[14] The indicative floors for DAB's gross international reserves for end-June 2005 and end-September 2005 were set consistent with a five-month coverage of imports of goods and services, a cushion believed to be sufficient to deal with most exogenous shocks.

Box 1. Monetary Instruments

The implementation of monetary policy currently relies essentially on the foreign currency auctions. These auctions, organized on a weekly basis, allow the central bank to control the currency in circulation. While they are open only to the money changers, the commercial banks are given access after each auction to a fixed allocation of foreign currency at the exchange rate determined by the auction. The central bank is considering giving a more prominent role to the commercial banks, through the introduction of an automated auction system open to the commercial banks and the gradual phasing out of the current system (the money changers would then have to open banking accounts to conduct their foreign currency operations). These plans have so far been put off due to (a) the lack of foreign currency demand by the banks, illustrated by the fact that these banks have almost never used the foreign currency allocation; and (b) the commercial banks' reluctance to offer banking accounts to the money changers, due in part to difficulties in complying with the requirements of the recently enacted banking and AML/CFT legislation.

The current structure of the interest rates essentially reflects the liquidity surplus, and the lack of market experience, of the state-owned banks. While these banks are currently the only buyers of capital notes, their high level of liquidity relative to the amounts offered has pushed downward overnight rates, to 1–2 percent. At the same time, their limited interest for longer maturities, whose auctions are consistently underbid, have resulted in higher 30-day interest rates (3–4 percent). Private commercial banks have stopped participating in these auctions, because they lack Afghani liquidity and consider the current interest rates too low.

Private commercial banks currently conduct most of their operations in foreign currency, but have seen an increase in the demand for lending in Afghani, which reflects the increasing use of the domestic currency by their clients (see Box 2 on Deepening of the Domestic Currency Market or "Afghanization" in IMF Country Report No. 05/33). While these banks, which are foreign-owned, have access to foreign currency funding, their access to funding in local currency remains limited. It partly reflects: their reluctance to diversify their deposit base toward retail clients, due in part to concern regarding the banking and AML/CFT requirements; their willingness to avoid foreign exchange exposure; and the lack of other sources of funding in Afghani.

The central bank, in its role as the institution to support the development of financial markets, needs to work toward the development of a money market, which will facilitate the transfer of excess liquidity of the state-owned banks to the private banks. To that purpose, a few issues need to be addressed (a) the lack of instruments that could serve as collateral to back the lending operations; (b) the poor management of the state-owned banks. These banks should seek better-remunerated investments for their liquidity, including lending to the other banks. They should also review the interest rates they pay on the deposits, which currently are relatively high and thus contribute to the low deposits base of the other banks; and (c) the need to strengthen the legal framework for market operations.

The development of a money market would also contribute to improve DAB control of broad money and hence the efficiency of the monetary policy. Relying essentially on the foreign currency auctions, which basically consist in the exchange of two assets of similar liquidity, monetary policy has a limited impact on overall liquidity. The development of a money market would allow the central bank to conduct money market operations, and thereby to affect the overall level of liquidity of the banking sector.

D. External Sector and Debt Management

23. **Data weaknesses complicate the balance of payments projections**. Over the medium term, the current account is expected to widen somewhat on the back of continued strong demand for imported industrial inputs and consumer goods, along with a gradual decline in external grants.[15] Over the longer term, however, it is envisaged that a revival of exports and the replacement of some imports with domestically-produced goods will contribute to a gradual improvement in the current account.

24. **Consistent with the authorities' prudent debt management approach, external borrowing is expected to remain relatively modest over the medium term, with a high degree of concessionality (see paragraph 26 of the MEFP)**. Staff encouraged the authorities to finalize the identification of debts incurred by previous governments, reconcile their amounts with external creditors, and complete the survey of external debt by end-March 2005. While there is no immediate pressure on the balance of payments, staff underscored the need for caution and vigilance. Staff advised the authorities to maintain a careful watch for emerging pressures in the balance of payments in view of large structural changes taking place in the economy, notably in the opium sector, weaknesses in external sector data, and the occasional lumpiness in donor disbursements.

E. Structural Reforms

25. **The structural reform agenda aims at fostering private sector development which currently faces administrative barriers, legal constraints, poorly developed infrastructure, and high input costs.** In addition to the fiscal and financial structural benchmarks already in the program, the mission urged the authorities to implement several other key reforms. These include (a) publishing the investment law in the official gazette, which will help to simplify and clarify investment procedures for enterprises; (b) putting in place the enabling environment for private sector activity, including by adopting laws governing mortgages, land ownership, and bankruptcy; and (c) restructuring the state-owned enterprises, which should contribute to improving external competitiveness (see Box 2).

F. Other Issues

26. **The authorities are working on an overall assessment of the technical assistance (TA) provided so far.** The findings of this assessment are expected by end-2005 and will serve as a basis for a plan to utilize TA more efficiently. In the statistics area, the authorities decided in January to place the Central Statistics Office (CSO) under the authority of the Ministry of Economy. This change may have its merits, but raises concerns regarding CSO's possible loss of independence. Staff cautioned against such a move, which could negatively impact on the implementation of reforms in the statistics area and possibly diminish badly needed donor support.

---

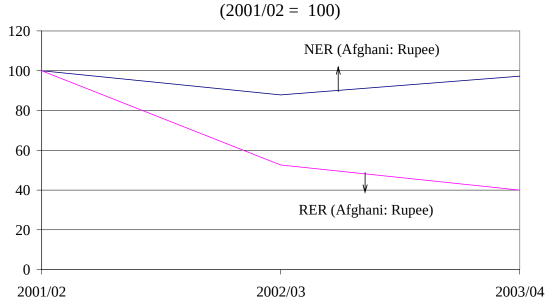
[15] Projections of grant financing are inherently difficult to make given constraints that many donors face within their own budgetary processes regarding multi-year commitments.

Box 2. External Competitiveness

The current weaknesses of Afghanistan's statistical system limit the set of indicators available to assess the competitiveness of the Afghan economy. In the absence of reliable data on unit labor costs and value-added deflators in manufacturing, on wholesale prices and on the geographical structure of trade, this assessment has to rely on bilateral wage-based and CPI-based real exchange rates (RER) with Afghanistan's main trading partner countries. Due to data limitations in some of these countries, the wage-based RER was only estimated against Pakistan (Figure 1), while the CPI-based RER index was constructed against Pakistan and Iran (Figure 2).

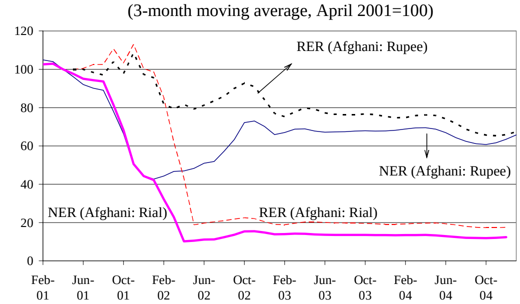
There is some evidence that Afghanistan is experiencing a loss in external competitiveness. Since 2001, the Afghani has steadily appreciated in real terms against the Pakistani and Iranian currencies. While in 2001–02, this appreciation primarily reflected the nominal appreciation of the Afghani against these two currencies, it has since been primarily driven by the relatively higher inflation, measured using either prices or wages, in Afghanistan.

Figure 1. Afghanistan: Nominal Exchange Rate and Wage-based Real Exchange Rate Index, 2001/02–2003/04 1/
(2001/02 = 100)



1/ Increase in index indicates depreciation.

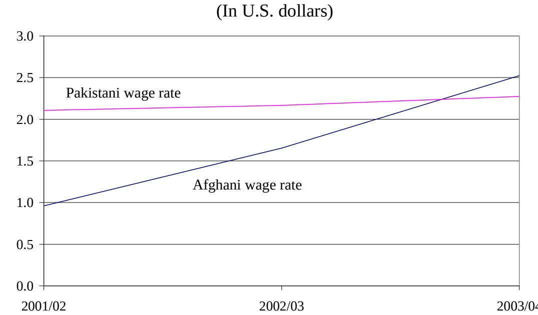
Figure 2. Afghanistan: Nominal Exchange Rate and CPI-based Real Exchange Rate Index, February 2001–January 2005 1/
(3-month moving average, April 2001=100)



1/ Increase in index indicates depreciation.

This real appreciation appears greater when using wages. This appears to reflect the significant upward pressure (similar to the "Dutch disease" experienced by oil-producing countries) donor- and opium-related activities are putting on wages. The high wages offered in these sectors are fueling wage increases in the other sectors. Wage increases exceed those in neighboring countries eroding the competitiveness of the tradable sector. Hence, in 2003/04, nominal wage growth in Afghanistan amounted to 52 percent in dollar terms, compared with 5 percent in Pakistan (Figure 3).

Figure 3. Average Daily Wages of Unskilled Labor in Afghanistan and Pakistan, 2001/02–2003/04
(In U.S. dollars)



The overall lack of infrastructure also affects negatively, through higher input costs, the competitiveness of the Afghan economy. This is particularly true for energy costs, which exceed those in most neighboring countries, as electricity production remains well below demand. Though Afghanistan imports electricity to address this shortfall, electricity supply bottlenecks impede the development of local industries.

27. With assistance from donors, the authorities have initiated work on an I-PRSP, which is expected to be completed by end-October 2005. To that effect, the authorities are taking steps to put in place an adequate institutional framework, including an Inter-Ministerial Committee (IMC) (see paragraph 28 of MEFP).

G. Program Monitoring

28. Understandings were reached on a set of quantitative indicators and structural benchmarks for end-June 2005 and end-September 2005 (LOI; paragraph 31 of MEFP; Appendix I, Tables l–2). The fourth, fifth, and sixth reviews under the SMP are tentatively scheduled for end-July 2005, end-October 2005, and end-January 2006, respectively.

V. Staff Appraisal

29. **Afghanistan's overall economic performance remained strong during the third quarter**. Output continued to grow despite the lingering drought that affected agricultural performance. Inflation declined. Fiscal revenue and monetary growth were in line with the program targets. Finally, the structural benchmarks under the SMP were largely met, which contributed to an improvement in administrative capacity within the government. **Nevertheless, major challenges are still looming,** including lingering insecurity, the continued prevalence of drug-related activities, and pervasive poverty.

30. **In addressing the fundamental issue of the drug economy, the government is well advised to combine eradication of poppy crops with stronger interdiction of opium trade and decisive efforts to ensure the transition to alternative livelihoods**. Without such complementary efforts, the apparent shift to legitimate agriculture now emerging in rural communities may prove to be nothing more than a cyclical response to the recent decline in farm gate prices for poppy.

31. **Afghanistan needs to make further progress in mobilizing domestic revenue.** Quick fixes are not a substitute for comprehensive tax and customs reforms and may be detrimental in the long run. Ultimately, the response to the revenue needs of Afghanistan rests in the full implementation of the tax and customs reform programs. To that end, close collaboration between various ministries, including finance, justice, and interior, is critical.

32. **Delays in the adoption of the 2005/06 budget should not translate into an unwelcome disruption of fiscal operations**. Staff called upon the authorities to establish arrangements to ensure that payments—particularly for salaries—are not disrupted. In a more general setting, this raises the issue of a disciplining framework, which the new budget law (now slated to be adopted by June 2005 because of a backlog of pending legislation in the Ministry of Justice) is expected to provide.

33. **Fundamental weaknesses in delivering basic government services and infrastructure remain to be addressed**. Despite pressures to act quickly, policy changes should be pondered carefully, and guided by realistic assumptions regarding domestic revenue growth and available donor financing over the medium term. **Another problem is**

the current limited capacity to execute spending plans, particularly for major reconstruction projects. Experience of other post-conflict countries shows that it takes time to improve planning, financial management, procurement, and audit capacity. Therefore, staff encouraged the government to manage public expectations and pass realistic budgets that reflect its limited absorptive capacity.

34. **Afghanistan needs an effective and affordable public administration.** Staff urged the authorities to rule out generalized or sector-specific wage increases as they would erode the government's ability to carry out comprehensive civil service reform and could crowd out priority spending in other social sectors. The authorities will be well advised to explore all admissible means to contain risks of fiscal laxity over the medium term. Staff and the authorities agreed to the need to initially limit increases in the wage bill to those stemming from ongoing PRR reform initiatives, but there are continuing pressures from donor-supported programs for sector-specific increases. While it was agreed that a wage ceiling would be premature at this stage without the broad support for the Cabinet, this issue will be explored further during the next review of the SMP with the authorities and the donors.

35. **While the current monetary framework has been effective in moderating inflation, there is scope for extending the set of monetary instruments and indicators**. Monetary policy continues to be implemented almost exclusively through foreign exchange auctions, limiting DAB's capacity to effect changes in overall liquidity (including U.S. dollars). As a result, monetary policy affects consumer prices primarily through the exchange rate. The implementation of the recently adopted reserve requirements will contribute to broaden DAB's monetary instruments. Nonetheless, staff encouraged the authorities to also define a broad strategy, including development of a money market, aimed at strengthening DAB's control over liquidity. Equally important, staff emphasized the need to expand the set of monetary indicators and develop monthly monetary survey. Finally, staff urged the authorities to intensify efforts to restructure the relicensed state-owned banks and to resolve the former state-owned banks that were not relicensed.

36. **Staff welcomed the authorities' prudent approach to external borrowing, particularly given the potential fragility of the balance of payments over the medium term and Afghanistan's limited foreign exchange and fiscal resources**. Staff stressed the need to complete the reconciliation of pre-existing debts with bilateral creditors by the end-March 2005 deadline as a necessary precursor to seeking debt relief. Staff underscored the importance of a comprehensive strategy with regard to external debt management—a structural benchmark for end-September 2005.

37. **Poverty reduction is rightly becoming a key priority of the government's development platform**. Staff welcomed the authorities' efforts to initiate work on a poverty reduction strategy and complete the I-PRSP by end-October 2005. The challenge now is how to coordinate all the work involved, and avoid duplication of activities without further stretching available capacity. The IMC, formed of ministers and deputy ministers from a cross-section of government to coordinate work on the I-PRSP, is a welcome first step.

38. **Achieving strong and sustained economic growth will require a clear and aggressive approach to eliminating structural impediments.** First and foremost should be an effort to tackle rigidities in the regulatory framework and ensure that there is a well-defined legal framework to facilitate investment and private sector development. Staff strongly support the current agenda, including the rationalization of the state-owned enterprises. Taken together, these reforms should improve the external competitiveness of the Afghan economy.

39. **Staff viewed the continuing performance of the Technical Coordination Committee (TCC) as a positive development**. It is now important that the TCC develops its analytical capacity, reaches out to other government agencies to enhance ownership of the reform program, and lays the ground for a close coordination with working groups expected to be put in place as part of the I-PRSP process.

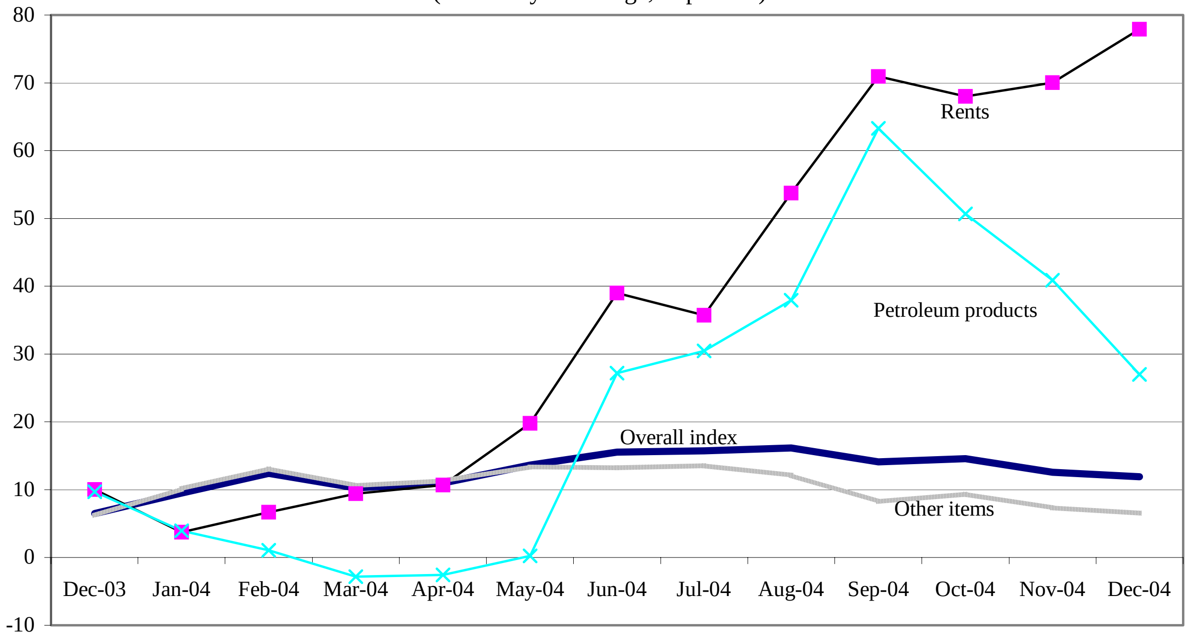
40. **The improvement of the statistical database is a pillar of the SMP**. This requires, inter alia, an independent CSO. The benefits of a strong statistical apparatus are unquestionable. Staff urged the authorities to safeguard the independence of the CSO, and encourage them to put in place a work program to implement the statistical master plan with active donor support.

41. **Staff welcomed the authorities' request to extend the SMP through end-September 2005.** While the reform agenda for the upcoming nine months is ambitious, the staff remains confident about Afghanistan's capacity to deliver. Over the past few years, the Afghan authorities have demonstrated their willingness and ability to take decisive measures to maintain macroeconomic stability, improve transparency, and build capacity. Afghanistan is encouraged to take advantage of this extension to further strengthen capacity and improve policy formulation. A successful implementation of the SMP could pave the way for an arrangement under the PRGF.

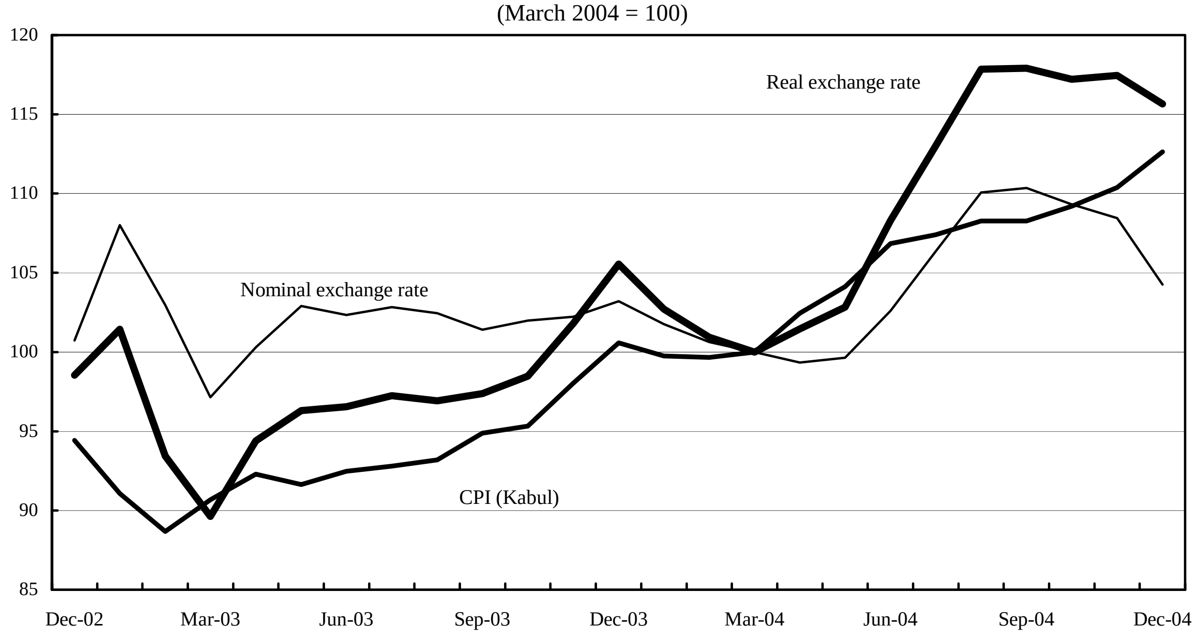
42. **There are a number of risks to the program.** Insufficient progress in improving security and in strengthening government's control over the provinces could slow down the reform process. Political pressures in the run-up to, and following, the legislative elections could also delay the implementation of reforms, notably in the fiscal sector, and limit the authorities' capacity to meet the program's objectives. The 2005 campaign to reduce opium-related activities, successful or not, could prove disruptive to security and to the economy. Lastly, donor fatigue and/or increased attention to the pressing needs of other countries could affect their long-term support to Afghanistan.

Figure 1. Islamic Republic of Afghanistan: Price and Exchange Rate Developments, 2002–04 1/

Consumer Price Index
(Year-on-year change; in percent)



Price and Exchange Rate Indices 2/
(March 2004 = 100)

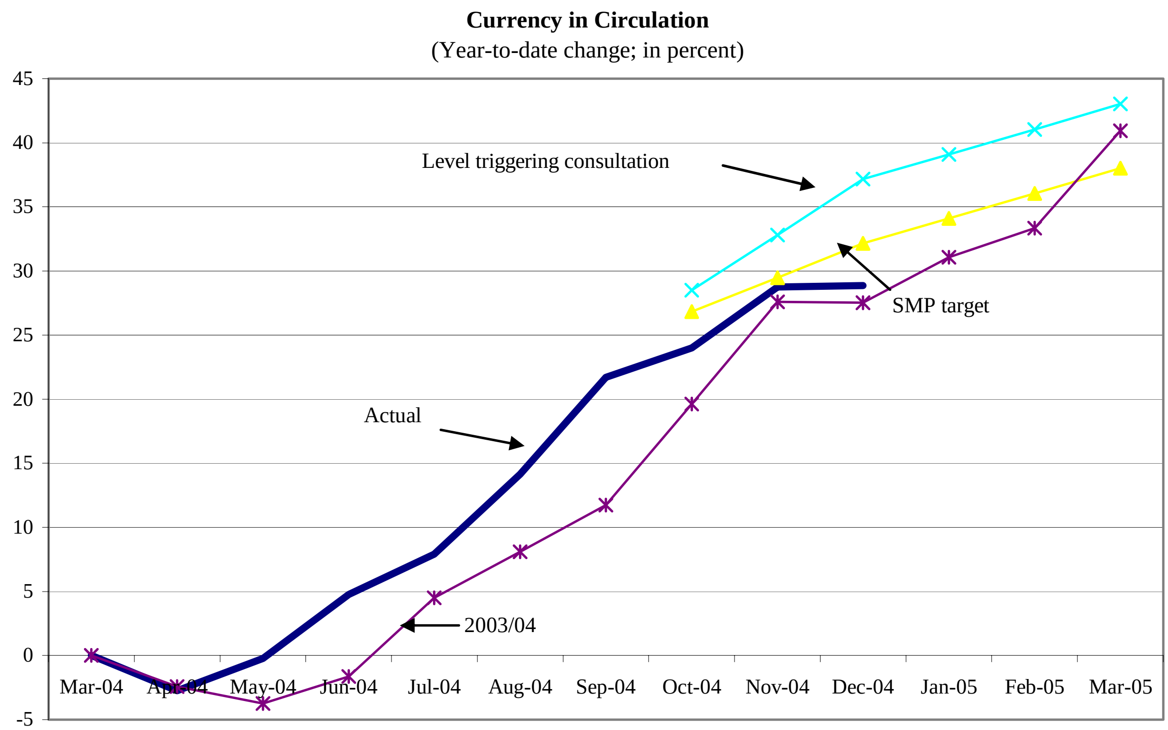


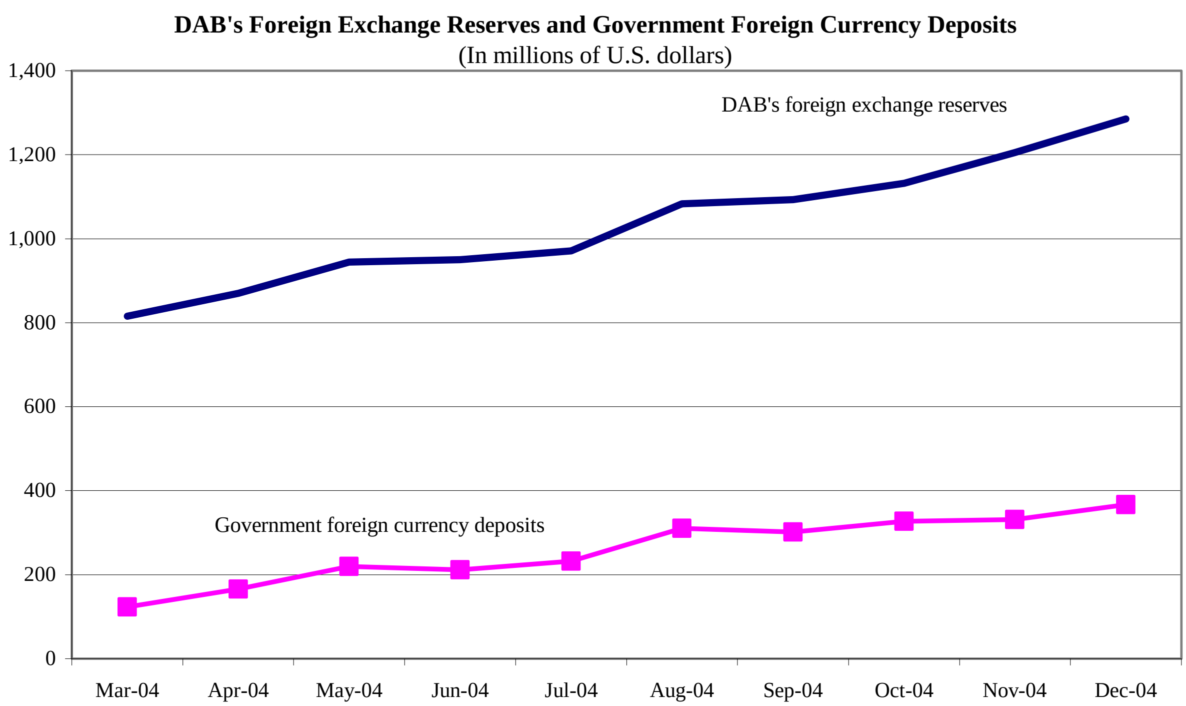
Sources: Central Statistics Office; Da Afghanistan Bank; and Fund staff estimates.

1/ Last observation: December 2004.

2/ An increase in the exchange rate indices corresponds to an appreciation. The real exchange rate is estimated using the U.S. and Afghan CPIs.

Figure 2. Islamic Republic of Afghanistan: Monetary Developments, 2003–05 1/



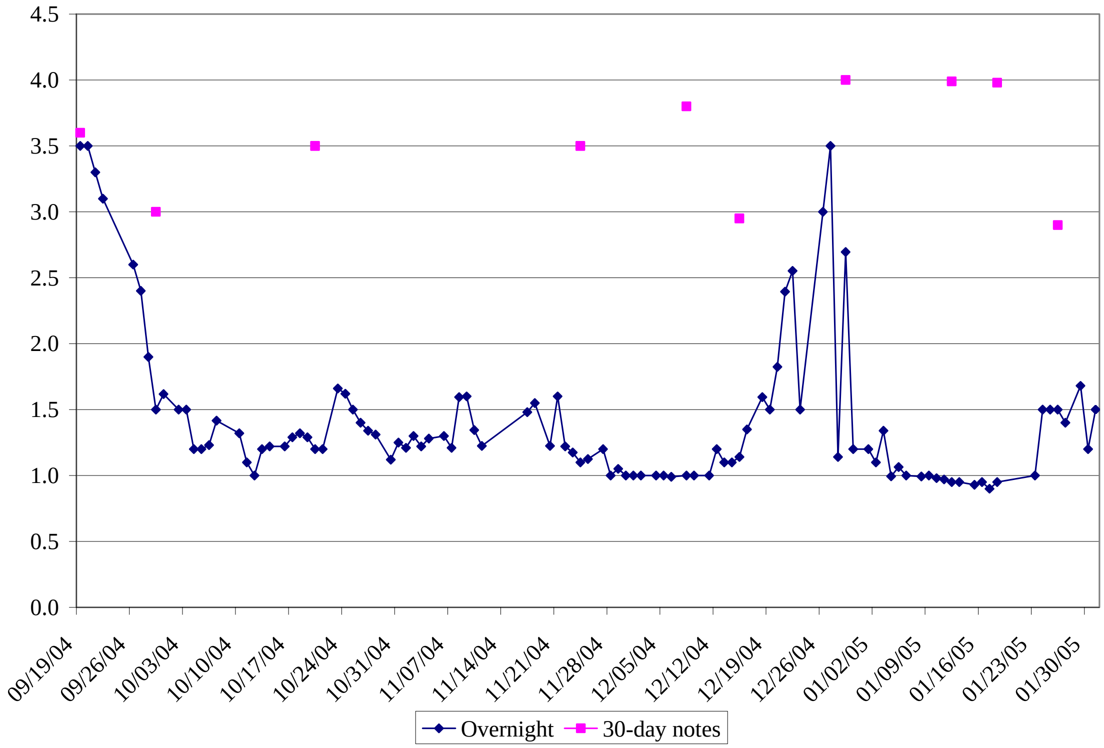


Sources: Central Statistics Office; Da Afghanistan Bank; and Fund staff estimates.

1/ Last observation: December 2004.

Figure 3. Islamic Republic of Afghanistan: Capital Note Auctions,
September 2004–January 2005 1/

(Interest rate; in percent)



Source: Da Afghanistan Bank.

1/ Last observation: January 30, 2005.

Table 1. Islamic Republic of Afghanistan: Basic Data, 2001/02–2005/06 1/

	2001/02 Est.	2002/03 Est.	2003/04 Est.	2004/05 Proj.	2005/06 Proj.
I. Economic and Financial Indicators					
Production					
GDP (in millions of U.S. dollars, excluding opium production)	2,463	4,084	4,585	5,526	6,687
GDP (in millions of Afghanis)	133,987	182,862	225,108	275,397	333,258
Real GDP growth rate (in percent)	...	28.6	15.7	7.5	10.1
GDP per capita (in U.S. dollars)	123	182	199	234	275
Opium production (in metric tons)	200	3,400	3,600	4,200	...
Opium value (in millions of U.S. dollars)	...	2,540	2,300	2,800	...
Consumer prices					
CPI (Kabul, year-on-year change; in percent)	-43.4	52.3	10.3	13.0	10.0
CPI (Kabul, average change; in percent)	...	5.2	24.2	13.7	10.0
	(In millions of U.S. dollars, unless specified otherwise)				
General government recurrent budget					
Revenues	...	132	207	263	332
Expenditures	...	349	451	579	695
Donor grants and loans	...	209	205	316	363
Revenues (in percent of non-opium GDP)	...	3.2	4.5	4.8	5.0
Expenditures (in percent of non-opium GDP)	...	8.5	9.8	10.2	10.5
Monetary indicators					
Domestic currency in circulation (annual change; in percent)	...	20.1	40.9	38.0	27.1
Gross foreign exchange reserves	...	426.1	815.5	1,246.3	1,413.0
	(In millions of U.S. dollars, unless specified otherwise)				
External sector					
Exports of goods (including reexports)	708.9	1,290.6	1,893.9	1,953.0	1,856.9
Exports of goods (annual change; in percent)	...	82.1	46.7	3.1	-4.9
Imports of goods	1,645.0	2,508.2	3,785.9	3,835.0	3,815.4
Imports of goods (annual change; in percent)	...	52.5	50.9	1.3	-0.5
Imports of oil	...	...	...	...	...
Current account deficit (excluding grants)	...	-1,363.7	-2,334.7	-2,333.7	-2,223.0
Current account deficit (including grants; in percent of GDP)	...	-3.5	1.7	1.8	-1.7
Afghani/U.S. dollar (average)	54.4	44.8	49.0	...	...
Afghani/U.S. dollar (end-year)	31.0	52.6	50.3	...	...
	(In percent of GDP)				
Investment and savings					
Gross investment	...	28.3	32.7	26.5	24.6
Domestic savings	...	-5.1	-18.2	-15.7	-8.6
II. Social and Demographic Indicators					
Area	652,000 square kilometers				
Population (2002/03)	21.8 million				
Life expectancy at birth (2001)	42.8 years				
Infant mortality per 1,000 live births (2003)	115				
Under-five mortality per 1,000 live births (2003)	172				

Sources: Afghan authorities; and Fund staff estimates and projections.

1/ The fiscal year 2004/05 runs from March 20, 2004 until March 20, 2005.

Table 2. Islamic Republic of Afghanistan: Savings-Investment Balances, 2002/03–2007/08

	2002/03 Est.	2003/04 Est.	2004/05 Proj.	2005/06 Proj.	2006/07 Proj.	2007/08 Proj.
	(In millions of U.S. dollars)					
Domestic expenditures	5,447	6,919	7,859	8,910	10,004	11,086
Consumption	4,293	5,421	6,395	7,262	8,154	9,187
Public 1/	318	407	538	613	723	844
Private 2/	3,975	5,014	5,857	6,649	7,432	8,343
Gross fixed capital formation	1,154	1,499	1,464	1,647	1,849	1,899
Public	1,104	1,441	1,314	1,187	1,278	1,225
Private 3/	50	58	150	460	571	674
Net exports of goods and services	-1,364	-2,335	-2,334	-2,223	-2,299	-2,222
Exports of goods and services (excluding reexports)	328	482	538	658	783	830
Imports of goods and services (excluding reexports)	-1,691	-2,817	-2,871	-2,881	-3,082	-3,052
Domestic savings	-210	-836	-869	-576	-450	-323
Public savings	-187	-200	-282	-288	-325	-367
Private savings	-23	-636	-588	-287	-124	44
GDP at market prices	4,084	4,585	5,526	6,687	7,705	8,864
	(In percent of GDP)					
Domestic expenditures	133.4	150.9	142.2	133.2	129.8	125.1
Consumption	105.1	118.2	115.7	108.6	105.8	103.6
Public	7.8	8.9	9.7	9.2	9.4	9.5
Private	97.3	109.4	106.0	99.4	96.5	94.1
Gross fixed capital formation	28.3	32.7	26.5	24.6	24.0	21.4
Public	27.0	31.4	23.8	17.8	16.6	13.8
Private	1.2	1.3	2.7	6.9	7.4	7.6
Net exports of goods and services	-33.4	-50.9	-42.2	-33.2	-29.8	-25.1
Exports of goods and services (excluding reexports)	8.0	10.5	9.7	9.8	10.2	9.4
Imports of goods and services (excluding reexports)	-41.4	-61.4	-52.0	-43.1	-40.0	-34.4
Domestic savings	-5.1	-18.2	-15.7	-8.6	-5.8	-3.6
Public savings	-4.6	-4.4	-5.1	-4.3	-4.2	-4.1
Private savings	-0.6	-13.9	-10.6	-4.3	-1.6	0.5
Memorandum items:						
Real GDP growth (annual change; in percent)	28.6	15.7	7.5	10.1	9.7	9.6
Nominal GDP growth (annual change; in percent)	33.8	23.1	22.3	21.0	15.2	15.0
Sectoral shares of GDP (in percent)						
Agriculture	49.8	48.5	38.4	35.6	34.0	32.6
Industry	20.1	21.3	23.5	24.5	25.5	22.5
Services	30.1	30.2	38.0	39.8	40.5	44.9
GDP per capita (in U.S. dollars)	182	199	234	275	308	344
Domestic government revenue (in percent of GDP)	3.2	4.5	4.8	5.0	5.2	5.4

Sources: Afghan authorities; and Fund staff estimates and projections.

1/ Data originating from the fiscal accounts.

2/ Determined as a residual.

3/ Equivalent to foreign direct investment reported in the balance of payments and some new private investment.

Table 3a. Islamic Republic of Afghanistan: Core Budget, 2002/03–2005/06

	2002/03 Est.	2003/04 Prelim.	2004/05 Core Budget 1/	2004/05 Q1-Q3 Prelim.	2004/05 Proj. 2/	2005/06 Proj. 2/
			(In millions of Afghanis)			
Domestic revenue	5,864	10,168	15,380	8,880	13,121	16,524
Tax revenues	...	6,262	8,817	6,687	9,112	11,286
Taxes on income, profits, and capital gains	...	363	750	749	1,128	1,734
Taxes on international trade and transactions	...	5,369	7,167	4,959	6,677	7,511
Other taxes	...	531	900	978	1,306	2,041
Nontax revenues	...	3,906	3,967	2,193	4,009	5,237
Donor assistance grants (to operating budget)	9,430	10,074	14,952	9,287	15,782	18,113
ARTF	...	8,182	12,575	7,515	12,709	13,955
LOTFA and Army Trust Fund	...	1,892	2,377	1,690	2,990	3,240
Other grants	...	0	0	83	83	918
Donor assistance grants (core development budget)	...	4,569	36,882	8,360	10,439	62,938
Operating expenditure	15,514	22,151	30,332	18,197	28,138	34,637
Wages and salaries	...	14,660	20,813	13,019	21,390	25,827
Purchase of goods and services	...	4,653	4,862	2,760	3,671	4,405
Transfers and subsidies	...	652	1,471	547	846	1,149
Pensions	...	177	724	695	925	1,017
Capital expenditure	...	2,009	2,461	1,176	1,306	2,238
Core budget development spending 3/	...	8,082	36,882	8,360	10,439	62,938
National Programs	...	3,339	11,817	7,851	9,814	21,546
1.4 Livelihoods and Social Protection	...	159	967	367	458	668
2.1 Transport	...	75	75	1,404	1,756	0
2.2 Energy, Mining, and Telecommunications	...	852	4,560	590	738	8,498
2.3 Natural Resources Management	...	449	1,027	3,279	4,099	2,243
2.4 Urban Management	...	394	1,146	0	0	827
3.1 Trade and Investment	...	95	1,241	0	0	1,824
3.2 Public Administration Reform and Economic Management	...	598	1,605	53	67	7,391
3.3 Justice	...	0	0	1,581	1,976	0
3.4 National Police, Law Enforcement, and Stabilisation	...	319	1,196	576	720	20
3.5 Afghan National Army	...	399	0	0	0	75
National Priority Programs	...	6,115	25,065	510	625	41,392
Education and Vocational Training	...	289	1,186	109	136	877
Health and Nutrition	...	508	1,111	391	489	6,728
National Emergency Employment Program	...	2,622	2,103	0	0	3,554
National Solidarity Program	...	927	6,998	0	0	12,231
Afghanistan Stabilization Program	...	10	3,758	0	0	6,340
National Transportation Program	...	1,410	8,637	0	0	4,934
National Irrigation Program	...	349	1,271	0	0	5,233
National Feasibility studies program	...	0	0	0	0	1,495
Unclassified	...	0	0	10	0	0
Operating budget balance (excluding grants)	-9,650	-11,983	14,952	-9,317	-15,017	-18,113
Operating budget balance (including grants)	-219	-1,910	0	-30	765	0
Core budget balance	-219	-5,423	0	-30	765	0
Float and adjustment 4/	-657	1,693	0	480	-298	0
Financing	876	3,730	0	-450	-467	0
External Loans (net)	0	3,513	0	5,008	5,008	3,987
Domestic (net)	876	217	0	-5,458	-5,476	-3,987
Of which:						
Net transfers from foreign currency deposits 5/	0	396	0	-6,640	-6,640	-3,987
Domestic banking financing 6/	-502	-179	0	1,182	1,164	0
Other financing 7/	1,379	0	0	0	0	0

Sources: Ministry of Finance; Da Afghanistan Bank; and Fund staff estimates and projections.

1/ Budget estimates. Staff projected domestic revenue of Af 12.8 billion for 2004/05.

2/ Staff projections. Government budget projections for core development spending in 2005/06. These projections represent commitments, while historical data are actual expenditures.

3/ Government program classification. The authorities have not been able to fully reconcile the program classification with government accounting data. This is due to classification problems. A new chart of accounts has been prepared for 2005/06 to overcome these problems.

4/ Variation between the fiscal position recorded at Ministry of Finance and DAB. This discrepancy is due to the difference ("float") between checks issued and checks cashed.

5/ Net transfers from foreign currency deposits. This includes temporary financing to bridge intra-year cash shortfalls for the operating budget, due to delays in the disbursement of grant funds. A positive sign corresponds to a decline in balances and a negative sign to an increase in balances.

6/ Banking financing refers to changes in the domestic government accounts with DAB. A positive sign corresponds to a decline in balances, and a negative sign to an increase in balances.

7/ In 2002/03, includes one-off transfers of overflight revenue and customs valuation fees accumulated over several years and the sale of telecommunication licenses.

Table 3b. Islamic Republic of Afghanistan: Core Budget, 2002/03–2005/06

	2002/03 Est.	2003/04 Prelim.	2004/05 Core Budget 1/	2004/05 Q1-Q3 Prelim.	2004/05 Proj. 2/	2005/06 Proj. 2/
	(In percent of GDP)					
Domestic revenue	3.2	4.5	5.6	3.2	4.8	5.0
Tax revenues	...	2.8	3.2	2.4	3.3	3.4
Taxes on income, profits, and capital gains	...	0.2	0.3	0.3	0.4	0.5
Taxes on international trade and transactions	...	2.4	2.6	1.8	2.4	2.3
Other taxes	...	0.2	0.3	0.4	0.5	0.6
Nontax Revenues	...	1.7	1.4	0.8	1.5	1.6
Donor assistance grants (to operating budget)	5.2	4.5	5.4	3.4	5.7	5.4
ARTF	...	3.6	4.6	2.7	4.6	4.2
LOTFA and Army Trust Fund	...	0.8	0.9	0.6	1.1	1.0
Other grants	...	0.0	0.0	0.0	0.0	0.3
Donor assistance grants (core development budget)	...	2.0	13.4	3.0	3.8	18.9
Operating expenditure	8.5	9.8	11.0	6.6	10.2	10.5
Wages and salaries	...	6.5	7.6	4.7	7.8	7.9
Purchase of goods and services	...	2.1	1.8	1.0	1.3	1.3
Transfers and subsidies	...	0.3	0.5	0.2	0.3	0.3
Pensions	...	0.1	0.3	0.3	0.3	0.3
Capital expenditure	...	0.9	0.9	0.4	0.5	0.7
Core budget development spending 3/	...	3.6	13.4	3.0	3.8	18.9
National Programs	...	1.5	4.3	2.9	3.6	6.5
1.4 Livelihoods and Social Protection	...	0.1	0.4	0.1	0.2	0.2
2.1 Transport	...	0.0	0.0	0.5	0.6	0.0
2.2 Energy, Mining, and Telecommunications	...	0.4	1.7	0.2	0.3	2.5
2.3 Natural Resources Management	...	0.2	0.4	1.2	1.5	0.7
2.4 Urban Management	...	0.2	0.4	0.0	0.0	0.2
3.1 Trade and Investment	...	0.0	0.5	0.0	0.0	0.5
3.2 Public Administration Reform and Economic Management	...	0.3	0.6	0.0	0.0	2.2
3.3 Justice	...	0.0	0.0	0.6	0.7	0.0
3.4 National Police, Law Enforcement, and Stabilisation	...	0.1	0.4	0.2	0.3	0.0
3.5 Afghan National Army	...	0.2	0.0	0.0	0.0	0.0
National Priority Programs	...	2.7	9.1	0.2	0.2	12.4
Education and Vocational Training	...	0.1	0.4	0.0	0.0	0.3
Health and Nutrition	...	0.2	0.4	0.1	0.2	2.0
National Emergency Employment Program	...	1.2	0.8	0.0	0.0	1.1
National Solidarity Program	...	0.4	2.5	0.0	0.0	3.7
Afghanistan Stabilization Program	...	0.0	1.4	0.0	0.0	1.9
National Transportation Program	...	0.6	3.1	0.0	0.0	1.5
National Irrigation Program	...	0.2	0.5	0.0	0.0	1.6
National Feasibility studies program	...	0.0	0.0	0.0	0.0	0.4
Unclassified	...	0.0	0.0	0.0	0.0	0.0
Operating budget balance (excluding grants)	-5.3	-5.3	5.4	-3.4	-5.5	-5.4
Operating budget balance (including grants)	-0.1	-0.8	0.0	0.0	0.3	0.0
Core budget balance	-0.1	-2.4	0.0	0.0	0.3	0.0
Float and adjustment 4/	-0.4	0.8	0.0	0.2	-0.1	0.0
Financing	0.0	1.7	0.0	-0.2	-0.2	0.0
External Loans (net)		1.6	0.0	1.8	1.8	1.2
Domestic (net)	0.0	0.1	0.0	-2.0	-2.0	-1.2
Of which:						
Net transfers from foreign currency deposits 5/	...	0.2	0.0	-2.4	-2.4	-1.2
Domestic banking financing 6/	-0.3	-0.1	0.0	0.4	0.4	0.0
Other financing 7/	0.8	0.0	0.0	0.0	0.0	0.0
Memorandum items:						
Real GDP growth (in percent)	28.6	15.7	...	...	7.5	10.1
Inflation (year-on-year)	52.3	1.0	...	...	13.0	10.0
Current account (percent of GDP)	-3.5	1.7	...	...	1.8	-1.7

Sources: Ministry of Finance; Da Afghanistan Bank; and Fund staff estimates and projections.

1/ Budget estimates. Staff projected domestic revenue of Af 12.8 billion for 2004/05.

2/ Staff projections. Government budget projections for core development spending in 2005/06. These projections represent commitments, while historical data are actual expenditures.

3/ Government program classification. The authorities have not been able to fully reconcile the program classification with government accounting data. This is due to classification problems. A new chart of accounts has been prepared for 2005/06 to overcome these problems.

4/ Variation between the fiscal position recorded at Ministry of Finance and DAB. This discrepancy is due to the difference ("float") between checks issued and checks cashed.

5/ Net transfers from foreign currency deposits. This includes temporary financing to bridge intra-year cash shortfalls for the operating budget, due to delays in the dismbursement of grant funds. A positive sign corresponds to a decline in balances and a negative sign to an increase in balances.

6/ Banking financing refers to changes in the domestic government accounts with DAB. A positive sign corresponds to a decline in balances, and a negative sign to an increase in balances.

7/ In 2002/03, includes one-off transfers of overflight revenue and customs valuation fees accumulated over several years and the sale of telecommunication licenses.

Table 4. Islamic Republic of Afghanistan: Monetary Program (Da Afghanistan Bank), 2002/03–2005/06

	2002/03	2003/04	2004/05					2005/06			
	Est. Mar. 20	Est. Mar. 19	Est. Jun. 20	Est. Sep. 21	Proj. Dec. 20	Est. Dec. 20	Proj. Mar. 20	Proj. Jun. 20	Proj. Sep. 21	Proj. Dec. 20	Proj. Mar. 20
	(In millions of Afghanis)										
Net foreign assets 1/	19,602	41,147	47,876	55,267	56,245	64,805	62,917	64,932	67,098	69,175	71,422
Foreign assets	19,602	41,147	47,876	55,267	56,245	64,805	62,917	64,932	67,098	69,175	71,422
Foreign exchange reserves	19,602	40,644	47,343	54,483	55,445	64,044	62,117	64,082	66,198	68,225	70,422
Gold	9,030	14,015	14,015	14,015	14,015	14,015	14,015	0	14,015	14,015	14,015
Other	10,572	26,628	33,328	40,468	41,430	50,029	48,102	64,082	52,183	54,210	56,407
Other foreign assets	0	503	533	784	800	761	800	850	900	950	1,000
Foreign liabilities	0	0	0	0	0	0	0	0	0	0	0
Net domestic assets	1,074	-10,023	-16,117	-19,252	-17,179	-25,853	-21,361	-20,811	-20,260	-19,460	-18,659
Domestic assets	14,361	6,796	3,308	-598	1,676	-4,868	-1,049	-799	-549	-49	451
Net claims on general government	14,361	6,796	3,308	-598	1,676	-4,868	-1,049	-799	-549	-49	451
Net claims on government before 2002/03	14,951	14,951	14,951	14,951	14,951	14,951	14,951	14,951	14,951	14,951	14,951
Net claims on government in 2002/3–2004/05	-590	-8,155	-11,643	-15,549	-13,274	-19,819	-16,000	-15,750	-15,500	-15,000	-14,500
Domestic currency deposits 2/	-344	-1,984	-1,069	-466	-733	-1,488	-1,500	-1,500	-1,500	-1,500	-1,500
Foreign currency deposits 2/	-245	-6,171	-10,574	-15,083	-12,541	-18,331	-14,500	-14,250	-14,000	-13,500	-13,000
Other claims	0	0	0	0	0	0	0	0	0	0	0
Other items net	-13,287	-16,818	-19,425	-18,653	-18,856	-20,984	-20,312	-20,011	-19,711	-19,410	-19,110
Reserve money	20,676	31,124	31,759	36,015	39,066	38,953	41,555	44,121	46,837	49,715	52,763
Currency in circulation 4/	20,676	28,801	30,172	35,054	38,066 3/	37,116	39,755 3/	42,208 3/	44,812	47,578	50,513
Banknotes and coins issued	21,302	29,726	31,226	36,226	39,316	39,426	41,555	44,058	46,712	49,528	52,513
less cash holdings 4/	626	925	1,054	1,172	1,250	2,310	1,800	1,850	1,900	1,950	2,000
Bank deposits with DAB and capital note holdings	0	2,323	1,587	962	1,000	1,836	1,800	1,913	2,025	2,138	2,250
Memorandum items:	(In percent, unless otherwise indicated)										
Currency in circulation (level triggering discussions; revised levels; in millions of Afghanis)	...	...	...	...	39,503	...	...	43,263	47,053	...	...
Currency in circulation (year-to-date change)	...	40.9	4.8	21.7	32.2	28.9	38.0	6.2	12.7	19.7	27.1
Currency in circulation (year-on-year change)	20.1	40.9	...	...	...	...	38.0	39.9	27.8	28.2	27.1
Gross international reserves (end-of-period level; in millions of U.S. dollars)	426.1	815.5	949.9	1,093.2	1,112.5	1,285.0	1,246.3	1,285.7	1,328.2	1,368.9	1,413.0
Consumer prices in Kabul (quarterly change)	-4.0	-0.6	6.8	1.3	...	4.0	...	...	...	...	...
Consumer prices in Kabul (annual change)	52.3	10.3	15.5	14.1	...	11.9	13.0	...	...	...	10.0

Sources: Da Afghanistan Bank; Central Statistics Office; and Fund staff estimates and projections.

1/ Foreign currency amounts converted into Afghani at the program exchange rate (Af 49.84 per U.S. dollar in 2004/05–2005/06); gold valued at $400 per ounce in 2004/05–2005/06.
2/ In 2002/03, includes only Ministry of Finance deposits.
3/ The projections are consistent with the quarterly indicative ceilings on the cumulative changes in currency in circulation .
4/ In 2002/03, cash holdings only include cash in DAB treasury vaults. Starting in 2003/04, they also include cash in DAB's six major branches.

Table 5. Islamic Republic of Afghanistan: Balance of Payments, 2002/03–2007/08

	2002/03 Est.	2003/04 Est.	2004/05 Proj.	2005/06 Proj.	2006/07 Proj.	2007/08 Proj.
	(In millions of U.S. dollars)					
Trade balance	-1,217.6	-1,892.0	-1,882.0	-1,958.5	-1,999.4	-2,000.0
Exports of goods 1/	1,290.6	1,893.9	1,953.0	1,856.9	1,644.8	1,461.2
Domestic exports	276.8	376.8	418.2	575.3	669.5	723.4
Reexports	1,013.9	1,517.1	1,534.8	1,281.6	975.3	737.8
Imports of goods	2,508.2	3,785.9	3,835.0	3,815.4	3,644.1	3,461.2
Recorded imports	1,142.3	1,688.5	1,937.2	1,974.4	1,877.8	1,883.4
Commodity food aid	94.0	40.9	23.6	0.0	0.0	0.0
Unrecorded	1,271.9	2,056.5	1,874.2	1,841.0	1,766.3	1,577.9
Services	-145.1	-439.3	-455.8	-277.7	-318.6	-244.9
Receipts	50.8	105.5	119.6	83.1	113.6	106.8
Donor-related	45.9	94.2	100.1	56.9	70.9	54.5
Other	4.9	11.3	19.5	26.2	42.7	52.3
Payments	195.9	544.8	575.4	360.8	432.2	351.8
Donor-related	195.9	544.8	575.4	360.8	432.2	351.8
Wages of expatriates	131.3	470.9	500.5	284.6	354.6	272.7
Other	64.6	73.9	74.8	76.2	77.6	79.1
Income (net)	-1.1	-3.4	4.1	13.2	19.2	23.1
Receipts	0.0	4.9	13.8	25.3	32.8	38.3
Payments (interest) 2/	1.1	8.3	9.7	12.1	13.7	15.3
Current transfers 3/	1,221.7	2,413.7	2,435.9	2,110.1	2,058.0	1,978.4
Public	1,170.1	2,358.7	2,354.1	2,016.0	2,006.0	1,926.4
Commodity food aid	94.0	40.9	23.6	0.0	0.0	0.0
Other	1,076.2	2,317.8	2,330.5	2,016.0	2,006.0	1,926.4
Private	51.6	55.0	81.7	94.1	52.0	52.0
Other	0.0	0.0	0.0	0.0	0.0	0.0
Current account balance (including grants)	-142.0	79.0	102.2	-112.9	-240.8	-243.5
Current account balance (before grants)	-1,363.7	-2,334.7	-2,333.7	-2,223.0	-2,298.8	-2,221.9
Capital financial account	144.0	147.7	265.5	269.2	289.9	292.4
Public loans	94.0	89.9	165.2	158.8	168.8	168.8
Disbursements	100.2	96.1	171.5	165.0	175.0	175.0
Amortization paid 2/	6.2	6.2	6.2	6.2	6.2	6.2
Direct investment	50.0	57.8	100.3	110.4	121.1	123.6
Net errors and ommisions	153.3	152.3	52.2	0.0	0.0	0.0
Overall balance	155.3	379.0	419.9	156.3	49.1	49.0
Financing	-155.3	-379.0	-419.9	-156.3	-49.1	-49.0
Change in net foreign assets of DAB	-101.0	-389.4	-430.5	-167.0	-60.0	-60.0
Fund credit (net)	0.0	0.0	0.0	0.0	0.0	0.0
Purchases	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	0.0	0.0	0.0	0.0	0.0	0.0
Exceptional Financing	-54.3	10.4	10.6	10.7	10.9	11.0
Arrears 2/	-54.3	10.4	10.6	10.7	10.9	11.0
Debt rescheduling	0.0	0.0	0.0	0.0	0.0	0.0
Debt forgiveness	0.0	0.0	0.0	0.0	0.0	0.0
Financing gap	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items:						
Official foreign exchange reserves						
In millions of U.S. dollars	426	816	1,246	1,413	1,473	1,533
In months of prospective imports 4/	1.8	3.4	5.2	5.5	5.7	6.1
Current account balance (In percent of GDP)						
Including grants	-3.5	1.7	1.8	-1.7	-3.1	-2.7
Excluding grants	-33.4	-50.9	-42.2	-33.2	-29.8	-25.1
GDP (In millions of U.S. dollars)	4,084	4,585	5,526	6,687	7,705	8,864

Source: Fund staff estimates and projections.

1/ Excludes opium exports and, because information is unavailable, flows associated with U.S. Army and most ISAF activities.
2/ Debt service projections are based on recognized obligations, reconciled with creditors. Arrears shown here represent an estimate by Fund staff, on the basis of loans which have been verified with creditors, but are not being serviced.
3/ Includes all grants. The core budget tables (3a and 3b) reflect only grants to the core budget and not those financing projects implemented directly by donors.
4/ In months of prospective imports of goods and services, excluding imports for reexport.

Islamic Republic of Afghanistan: Relations with the Fund
(As of January 31, 2005)

I. **Membership Status**: Joined July 14, 1955; Article XIV.

II. **General Resources Account**	SDR Million	% Quota
Quota	161.90	100.00
Fund holdings of currency	161.92	100.01
Reserve position in Fund	0.00	0.00
Holdings Exchange Rate		

III. **SDR Department**	SDR Million	% Allocation
Net cumulative allocation	26.70	100.00
Holdings	0.04	0.14

IV. **Outstanding Purchases and Loans** None

V. **Financial Arrangements** None

VI. **Projected Obligations to Fund**
(SDR million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2005	2006	2007	2008	2009
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.61	0.62	0.62	0.62	0.62
Total	0.61	0.62	0.62	0.62	0.62

VII. **Implementation of HIPC Initiative** Not Applicable

Nonfinancial Relations

VIII. **Exchange Arrangement**

Afghanistan is an Article XIV member country. The authorities are implementing a liberal exchange system. Based on information currently available to the staff, no exchange restrictions and multiple currency practices are currently in place. The authorities intend to formalize the current liberal regime through the adoption of new laws and regulations, for which they have asked for technical assistance (TA) from the Fund. At least since end-2001, the Afghani has been floating, and more recently the authorities have been implementing a managed float with no predetermined path for the exchange rate. As of March 20, 2005, the average exchange rate on the Kabul money exchange market was Af 48.65 per $1.

To conduct monetary policy, the authorities rely on foreign exchange auctions since May 2002. Auctions are open to all licensed money changers. To ensure transparency, DAB has progressively introduced measures, including public announcements of the auctions in advance in local media outlets, and clear instructions on how the auctions are conducted. Over the years, DAB has also improved the mechanics of the auctions to ensure that settlements are made after successful bids. Auctions are linked to the overall monetary program and are held on a fairly regular basis at 1–2 week intervals.

IX. **Article IV Consultation**

The last Article IV consultation with Afghanistan was discussed by the Executive Board on January 19, 2005. Consultations with Afghanistan are on the standard 12-month cycle.

X. **Technical Assistance, 2002–05**

Department	**Date**	**Purpose**
Interdepartmental	January 27–31, 2002	Initial assessment of TA needs
FAD	February 10–21, 2002	Fiscal management
	May 13–26, 2002	Tax policy and administration
	January 5–18, 2003	Fiscal management
	October 22–November 4, 2003	Expenditure management
	March 2004 (ongoing)	Resident Treasury Expert
	March 22–April 3, 2004	Tax policy and administration
	April 18–May 2, 2004	Customs administration
MFD	February 27–March 7, 2002	Financial sector reform
	May 19–June 2, July 10–27, 2002	Financial sector reform
	December 11–16, 2002	Financial sector legislation workshop
	September 7–16, 2003	DAB restructuring program and creation of a central bank short-term debt instrument.
	February 2–6, 2004	Anti-money laundering legislation
	March 21–30, 2004	DAB capital adequacy and balance sheet structure
	December 2005 (ongoing)	Training coordinator
	February 2–15, 2005	Implementation of DAB balance sheet reconstruction and capital adequacy recommendations
LEG	February 27–March 7, 2002	Financial sector legislation
	December 11–16, 2002	Financial sector legislation workshop
	February 2–6, 2004	Anti-money laundering legislation
	March 3–21, 2004	Fiscal revenue legislation
	January 29–February 12, 2005	Income Tax Law
STA	April 15–21, 2002	Multisector statistics
	November 18–30, 2002	Consumer Price Index
	January 26–February 8, 2003	Government finance statistics

	March 1–11, 2003	Monetary and financial statistics
	June 9–20, 2003	Consumer Price Index
	January 29–March 15, 2004	Multisector statistics
	April 19–May 3, 2004	Balance of Payments statistics
	May 13–June 30, 2004	Multisector statistics
	May 17–29, 2004	Consumer Price Index
	January 15–February 15, 2005	Multisector statistics

A resident treasury expert for the Ministry of Finance, Mr. Platais, was appointed in March 2004.

Afghanistan is now a participant in the Middle East Technical Assistance Center (METAC).

A resident multisector statistical advisor, Mr. Soulatha, was stationed in Kabul on July 17, 2002. STA has provided TA through a series of missions under a peripatetic multisector statistics assignment which began in January 2004. These missions were suspended in July 2004 due to the security situation. A new series of peripatetic missions commenced in January/February 2005. Four missions, accounting for a total of nine months of TA, are scheduled to be delivered over a 12-month period, the first mission covered the period January 15–February 15, 2005.

A resident MFD expert was posted during July–October 2002 at DAB as an accounting adviser. In addition, from April 2002 to February 2003, several experts visited Kabul to provide advice on payment systems, restructuring of DAB, and bank supervision. A mission to provide advice on foreign exchange and short-term capital note auctions is scheduled for the first half of 2005.

During 2004, with the financial support provided by the Sweden Technical Assistance SubAccount, the Fund has sponsored a number of training activities aimed at DAB officials and is now engaged in preparing a full-scale training program for DAB. A long-term advisor has been appointed in Kabul since mid-October, 2004. The training coordinator is responsible for all practical matters related to the delivery of formal training to DAB staff in Kabul, as well as the coordination of training for DAB staff outside Afghanistan. He has already carried out a training needs assessment and finalized a training plan for 2005, which has been approved by both DAB and Sweden. Finally, Sweden has agreed to finance during the period December 2004 to December 2005 a monetary policy peripatetic advisor to assist DAB in developing the strategy and the instruments for the implementation of the next stage of monetary policy—setting and advising on options to replace the existing exchange rate auctions.

XI. **Resident Representatives**

During the first half of 2002, the Fund's resident representative in Pakistan, Mr. Ghesquière, assisted in maintaining relations with the Afghan authorities. A resident representative, Mr. de Schaetzen, took up his post in Kabul on August 24, 2002.

Islamic Republic of Afghanistan: Relations with the World Bank
(As of January 31, 2005)

1. A second **Transitional Support Strategy** (TSS) was presented to the World Bank Board of Executive Directors in March 2003. The TSS outlines a strategy for World Bank operations over the subsequent 18 months to 2 years until the establishment of a stable, representative government. The strategy focuses on four strategic areas: improving livelihoods, fiscal strategy, institutions and management, governance and public administration reform, and enabling private sector development. In collaboration with the new government and other stakeholders, the World Bank intends to update its country strategy for Afghanistan in 2005. Based on the preparatory work toward the I-PRSP, a country assistance strategy, covering a three-year period, could be finalized in FY 2006.

2. In FY 2002, World Bank staff prepared and negotiated four projects to utilize IDA grant funds to a total of $100 million. Following the clearance of Afghanistan's arrears to the World Bank and Fund, through donor contributions, the first IDA credit for $108 million for the **Emergency Transport Project** was approved by the Board in March 2003. By the end of FY 2003, an additional three projects—**Emergency Health Sector Rehabilitation** ($59.6 million), **Emergency Public Administration II** ($8.4 million), and **National Emergency Employment II** ($39.2 million) were approved bringing to $215 million the total allocation for the year.

3. Five IDA credits/grants were negotiated for FY 2004, for a total of $293 million. These programs include the **Emergency Communications Project** ($22 million), the **Emergency Customs Modernization and Trade Facilitation** ($31 million), the **National Solidarity Program II** ($95 million), the **Emergency Irrigation Rehabilitation** ($40 million), and the **Emergency Power Rehabilitation** ($105 million).

4. For FY 2005, four projects were approved in July 2004, for a total of $145 million: the first budget-support operation, **Programmatic Support for Institution Building** ($80 million), the **Kabul Urban Reconstruction Project** ($25 million), the **Investment Guarantee Facility** ($5 million), together with MIGA, and the **Education Quality Improvement Program** ($35 million). An additional project, Public Administration Capacity Building ($27 million) was approved in January 2005. Three other projects are planned, for an additional commitment of $113 million, a supplemental financing for the Emergency Transport, the Strengthening Higher Education project, and the National Solidarity Program.

5. The World Bank also administers the **Afghanistan Reconstruction Trust Fund (ARTF)**, which became effective in May 2002 and plays a critical role in funding the recurrent costs of government. In its first year of operation (SY 1381—March 21, 2002 to March 20, 2003), the ARTF mobilized $185 million and disbursed $65 million. Paid-in contributions for SY 1382 (March 21, 2003 to March 20, 2004) amounted to $286 million, while disbursements reached $254 million. Pledges for SY 1383 (March 20, 2004 to

March 20, 2005) amount to $426 million. ARTF is increasing its financing of investments and has the potential to support tighter donor coordination, simplified processes, and fast results.

6. The World Bank is also actively engaged in advisory services to government and continues to respond quickly to a range of requests. In September 2004, the World Bank has released a country economic report “State Building, Sustaining Growth, and Reducing Poverty.” Current analytical work includes work on the civil service reform, urban development and land management, education policy reform, labor market and pensions, a gender assessment and oil/gas infrastructure development, as well as broader regional trade work encompassing issues with Afghanistan’s neighbors. The World Bank has notably initiated a major Public Finance Management (PFM) Review, which incorporates a review of public expenditures and fiduciary aspects, including procurement and financial management. Fund staff are contributing to the PFM review, including through providing an analysis of domestic revenue prospects. The World Bank has also actively utilized **Post Conflict Fund** and continues to use the **Japan Social Development Fund** resources to provide on-the-ground support to the government and communities.

7. The World Bank’s program is growing quickly and has an active IDA portfolio of 15 investments and one budget support operation as of February 2005. One project has closed. Total commitments add up to $753 million, of which 40 percent has been disbursed as of January 2005. The World Bank’s office in Kabul is fully functional and growing rapidly to take on increasing demands. A country manager, as well as several other international staff, and a growing number of national staff are now in place.

Kabul, February 3, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, DC 20431
U.S.A.

Dear Mr. de Rato,

The Government of Afghanistan held discussions with Fund staff in the context of the third review of the staff-monitored program (SMP), that was put in place in March 2004. We remain pleased with the progress under the program, and with the framework it provides for enacting key reforms. The attached Memorandum of Economic and Financial Policies (MEFP) reviews macroeconomic developments and the implementation of structural reform measures during the first three quarters of 2004/05, and describes the objectives and policies the government intends to pursue for the remainder of the year and the first half of 2005/06. Given the benefits the SMP has brought in terms of macroeconomic policy formulation and the design and implementation of key structural reforms, we have also reached understandings with IMF staff on an extension of the current SMP for six months—through end-September 2005. The indicative targets and structural benchmarks set out for this period are also described in the MEFP.

We are pleased to inform you that we have met all the end-December 2004 quantitative indicators and structural benchmarks, with the exception of the benchmark on publishing the central bank and banking laws in the official gazette. The central bank law has already been published, but some technical delays have slowed gazetting of the commercial banking law—although we expect this law to be published in the immediate future. A number of benchmarks that had been established for end-March 2005 have been moved to end-June 2005 or end-September 2005, in an effort to avoid bunching and to accommodate capacity constraints partly associated with newly appointed cabinet and senior officials familiarizing themselves with their respective portfolios. We feel it is important to emphasize that this does not represent a lack of political will on behalf of the government to enact difficult reforms. Indeed, we have found the benchmarks to be very useful guideposts in the midst of a massive reform effort. Rather, it is a recognition of real capacity constraints in selected line ministries—a risk highlighted by IMF staff when the SMP was first put in place in March 2004.

The government believes that the policies and measures set forth in the attached MEFP are adequate to achieve the objectives of the program. However, we also stand ready to take any additional steps as may be needed or appropriate to meet both the letter and the spirit of the reforms outlined in the program. The Government of Afghanistan will continue to work closely with IMF staff in this regard, and will provide any information required to assess the implementation of the SMP, as updated. The Government of Afghanistan authorizes the publication and distribution of this letter, the attached MEFP and the technical memorandum of understanding, and all reports prepared by IMF staff regarding the SMP.

Sincerely,

/s/	/s/
Anwar Ul-Haq Ahady	Noorullah Delawari
Minister of Finance	Governor
Ministry of Finance	Da Afghanistan Bank

Attachments:
Update to the Memorandum of Economic and Financial Policies
Amendment to the Technical Memorandum of Understanding

Update to the Memorandum of Economic and Financial Policies of the Government of Afghanistan

Third Review Under the Staff-Monitored Program, 2004/05

I. INTRODUCTION

1. Following the successful presidential elections of October 2004, President Karzai formed a new Cabinet in December. The new team, which comprises a number of senior officials from the interim government, has a strong reform orientation, and remains fully committed to the macroeconomic objectives and agenda of structural measures outlined in the staff-monitored program (SMP), put in place in March 2004. In this context, the government's policies for the last quarter of 2004/05 will remain guided by the targets and objectives described in the Memorandum of Economic and Financial Policies (MEFP) of March 24, 2004, and as modified on September 6, 2004, and December 29, 2004. In addition, and in light of the useful framework the SMP has provided for the formulation of macroeconomic and structural policies, the government has reached understandings with IMF staff on an extension of the current program for an additional six months—through end-September 2005.

2. This update to the MEFP reviews performance during the third quarter of 2004/05, updates the government's macroeconomic objectives for the medium term, and describes the policies and targets for the remainder of 2004/05 and the first half of 2005/06. To avoid bunching and to accommodate capacity constraints, a number of structural benchmarks initially set for end-March 2005 under the MEFP have been moved to end-June 2005 and end-September 2005. We feel it is important to emphasize that this does not represent a lack of political will on behalf of the government to enact difficult reforms. Indeed, we have found the benchmarks to be very useful guideposts in the midst of a massive reform effort. Table 2 includes the structural benchmarks that are critical to deliver the macroeconomic performance consistent with this update to the MEFP and to strengthen the government's administrative capacity. In addition, several reforms, to which we remain committed, are not included in Table 2, but are described in this document.

II. DEVELOPMENTS UNDER THE SMP

3. Agricultural output is expected to fall by 17 percent in 2004/05, due to adverse weather conditions. This decrease would be largely offset by buoyant activity in transportation and other services. **Overall, real GDP growth would amount to about 8 percent in 2004/05. Consumer prices in Kabul increased by 4.0 percent during the third quarter of 2004/05, reflecting a seasonal increase in food prices, and rose by**

12.6 percent through the first nine months.[1] Excluding food items, whose prices increased by 6.9 percent, the consumer price index is estimated to have risen by only 0.9 percent, due in part to a decline in rents and petroleum prices, which had increased sharply over the first half of 2004/05. Overall, year-on-year inflation amounted to 11.9 percent at end-December (6.6 percent excluding rents and petroleum products), compared to 14.1 percent at end-September.

4. Domestic revenue for the first nine months of 2004/05 is estimated at Af 8.9 billion, exceeding the SMP indicative target of Af 8.6 billion. Following a subdued start to the quarter, receipts rebounded sharply during the last month, largely due to an increase in customs revenue.

5. **The rate of government spending, particularly for development programs, continued to lag behind budget expectations.** Operating budget expenditures amounted to Af 18.2 billion during the first nine months of 2004/05, compared with the annual budgeted amount of Af 30.3 billion. This underspending is due mainly to the slower-than-expected pace of public administration reform—particularly delays in the recruitment of additional teachers, and in the main civil service restructuring program.[2] Over the same period, core budget development spending was Af 8.4 billion while direct donor spending was reported at $1.5 billion, compared to the budget estimates of Af 38.4 billion and $3.5 billion, respectively, for the year as a whole. The slow rate of development spending was due to: (i) the lack of capacity in line ministries and implementing agencies to develop and implement projects; (ii) delays in mobilizing donor funding; and (iii) concerns over the level of insecurity. Nonetheless, the total level of development spending is significantly higher than that seen in the same period in 2003/04. We also recognize that development spending varied substantially across national programs, with infrastructure relatively low, especially compared with the rate of delivery in the security sector.

6. **We continue to observe the no-overdraft policy with respect to government financing.** The rate of reimbursement from the two multi-donor grant funds—the Afghanistan Reconstruction Trust Fund (ARTF) and the Law and Order Trust Fund for Afghanistan (LOTFA)—rose significantly during the third quarter, mainly due to improvements in compliance with new financial management procedures. As a consequence, we were able to rebuild government deposits in the central bank, and fully replenish funds that had been drawn from an Asian Development Bank concessional loan to fund the operating budget. This is consistent with our commitment to utilize solely concessional loans to fund development programs and projects, and only where they demonstrate the clear

---

[1] The consumer price index that includes five other major cities increased by 3.4 percent during the third quarter of 2004/05 and 8.4 percent over the first nine months of 2004/05.

[2] Total government employment was around 375,000, including 134,000 for the police and defense force, compared to a budget estimate of 406,000.

ability to deliver economic growth, increase domestic revenues, accelerate international co-operation, and promote trade and inward investment.

7. **Currency in circulation amounted to Af 37.1 billion at the end of the third quarter of 2004/05, slightly below the SMP indicative ceiling (Af 38.1 billion)**. The stronger-than-expected slowdown in monetary growth in the third quarter reflected the financing of the Hajj[3] and a slowdown in donor-related spending in the period leading up to the formation of the new government. Reflecting the persistent high level of liquidity of some banks, the interest rates on the overnight capital notes remained low (at 1–2 percent). Due in part to a further accumulation of government deposits, foreign exchange reserves continued to increase steadily during the third quarter, to $1.2 billion at end-December (equivalent to 5.3 months of 2005/06 imports). The nominal exchange rate depreciated slightly during the last two months of 2004, to about Af 48 per dollar at end-December—roughly the same level as at the beginning of the year.

8. **Further progress was made in modernizing Da Afghanistan Bank (DAB) and creating a sound financial system.** External auditors initiated an audit of DAB's 2003/04 financial statements and will present their findings to DAB's supreme council in early February. Significant progress was made toward finalizing the transfer of DAB's commercial accounts to other entities. The central bank law was published and progress was made toward the publication of the banking law. Some progress was also made in restructuring the relicensed state-owned banks. Finally, new reporting requirements for banking data have been implemented.

9. **Data for the external accounts are limited, but DAB remains committed to improving statistical capacity in this area and will actively seek donor assistance in this regard**. Based on preliminary data, the external current account (before grants) during the first three quarters narrowed to a deficit equivalent to 32 percent of GDP, down from a deficit of about 39 percent during the same period in 2003/04. This decline in the deficit appears to have stemmed from an improvement in the trade balance, including a continued increase in domestic exports. Donor inflows, predominantly in the form of grants, continued to finance the deficit, along with some private inflows in the form of foreign direct investment. Disbursements of external loans were limited, and on highly concessional terms. The positive errors and omissions entry in the balance of payments suggests the continued presence of unrecorded inflows (perhaps from opium exports, unrecorded foreign investments, or remittances).

[3] The pilgrims were required to deposit with DAB, by end-December, an amount equivalent to the cost of the pilgrimage, which are then administered by the Ministry of Hajj. The deposits, which had to be denominated in Afghani, totaled Af 2.5 billion.

10. **All quantitative indicators and structural benchmarks for end-December 2004 were met,** with the exception of the benchmark related to the publication in the official gazette of the central bank and banking laws, due to some technical delays in publishing the banking law. We expect to resolve these difficulties and publish the banking law shortly.

III. The Program for the Remainder of 2004/05 and for 2005/06

A. Macroeconomic Objectives

11. **Recent economic developments are consistent with a projected real GDP growth rate of 8 percent for 2004/05—in line with estimates agreed with IMF staff at the time of the second review**. We expect inflation to pick up slightly during the fourth quarter, reflecting higher food prices. Inflation is expected to reach about 13 percent year-on-year at end-2004/05.

12. **Going forward, real GDP is projected to grow by 10 percent in 2005/06 and over the medium term.** If achieved, this sustained increase in economic activity should create a dent in poverty. We expect growth to come primarily from non-traditional sectors, including services and industry. Agriculture is projected to maintain an average growth rate of 4.5 percent. Reflecting a tightening in monetary policy and an expected slowdown in rents, inflation is projected to decline to 10 percent in 2005/06 before tapering off to 5 percent in the ensuing years.

13. **While the medium-term outlook appears favorable, we are fully aware of the many serious challenges facing Afghanistan, including the rising share of drug-related activities in the economy and the heavy reliance on external support**. These challenges highlight the need to focus our efforts to encourage sustained and equitable economic growth. To achieve the levels of growth necessary to reduce poverty and diminish the need for external resources, investment will need to average about 24 percent of GDP over the medium term, reflecting continued donor support, and increased foreign direct and private domestic investment. As a result, private savings are projected to rise to 0.5 percent of GDP in 2007/08, up from dissavings of 10.6 percent of GDP in 2004/05. Conversely, private consumption is expected to decline from 106 percent of GDP to 94.1 percent over the same period.

14. **In responding to the challenge of the illegal opium economy, we intend to implement our multi-pronged strategy, supported by the donor community**. We expect this strategy will be particularly efficient this year, as it will be implemented at a time when many poppy farmers, faced with the current low farm gate prices and the increased risk associated with government intervention, plan to turn voluntarily to other crops. To ensure the sustainability of our efforts, this will be supported by an interdiction campaign. To limit the potentially adverse economic impact of this campaign on the most vulnerable segments of the population, we will devote our full attention to providing alternative livelihoods.

B. Fiscal Policy

15. **The shortfall in domestic revenues relative to the operating budget, is expected to be offset by a combination of lower operating expenditures and additional donor funding.** Domestic revenues are expected to total around Af 13.1 billion for 2004/05, exceeding the SMP target of Af 12.8 billion, but below the budget target of Af 15.4 billion. The shortfall in revenue is mainly the result of slower-than-anticipated implementation of the tax reform program, particularly regarding the passage of new legislation and the organizational restructuring. Consistent with the trend observed in previous years, and with the reallocation of resources to faster-spending ministries recommended during the mid-year review (MYR), recurrent expenditures are expected to rise during the last quarter of the year. Overall, the MYR adjustments will reduce the operating budget allocations by at least Af 1.9 billion. Improving compliance with the financial management procedures should continue to raise reimbursement rates from the two multi-donor trust funds, so that recurrent expenditures can be wholly funded by grants and domestic revenues.

16. **The MYR adjustments should increase the rate of development spending**. [4] The MYR introduced new projects, totaling Af 3.9 billion ($78.4 million), into the core development budget, which is wholly donor-funded. [5] These changes will affect: (i) projects that received government discretionary funds by Presidential Decree after completion of the 2004/05 budget, amounting to Af 1.3 billion ($25.8 million); (ii) a number of new projects not included in the 2004/05 budget, totaling Af 2.6 billion ($52.6 million); and (iii) the reallocation of discretionary funds within the existing budget toward faster-spending projects, reflecting our desire to increase the rate of spending on physical infrastructure. No changes were made to the external development budget, which is directly implemented by donor agencies. The MYR was approved by Presidential Decree.

17. **An acceleration of customs and tax reforms is required to boost domestic revenues**. To reinvigorate the reform effort, we will prioritize the following reforms: publication of the amendments to the revenue laws, including the new Customs code (both are structural benchmarks); introduction of the updated import valuation schedule for customs and the continued strengthening of border facilities; full implementation of the measures in last July’s tax reform package—including the services tax in Kabul (where compliance has been poor)—and the airport departure tax. We will also accelerate the implementation of the Priority Reform and Restructuring (PRR) of the revenue headquarters

[4] The review covered the operating and development components of the core budget as well as a review of implementation of direct donor-funded programs within the National Development Budget. It was delayed due to the presidential elections; the proposed adjustments will impact on operations during the last quarter of the year.

[5] The funding will be provided from ARTF for an amount of Af 1 billion ($20 million), from the ADB Post-Conflict Program Loan for an amount of Af 2.8 billion ($56.4 million), and from the WB Programmatic Support for Institutional Building (PSIB) for an amount of Af 99.7 million ($2 million). The amount represents committed funds that will most likely be spent over a number of years and not in the remainder of 2004/05.

and the Kabul provincial revenue office. In addition, we will give high priority to measures aimed at improving tax administration law and corporate law, which will give the MoF enforcement and collection powers, and hope to have these published in the official gazette by end-September.

18. **Looking forward, we anticipate a slight delay in adopting the Development budget for 2005/06 and some slippage in the structural reforms, attributable to the change in government.** We intend to approve the operating budget before the start of the fiscal year (March 21) but the Core budget (which includes development spending that passes through the Treasury) will be presented shortly after. The slight delay to early April in organizing the donors forum, which is required to confirm the sources of development funding, is partially the result of the change in cabinet. We remain committed to a timely budget process and will ensure that arrangements are in place to avoid a repeat of the payment delays that occurred at the start of previous years. [6] The new budget law, which will improve the legal framework for fiscal policy, has been drafted and should be submitted to cabinet shortly. However, its publication in the Official Gazette is likely to take place in June 2005, essentially on account of the backlog of legislation with the Ministry of Justice.

19. **For FY 2005/06, we intend to maintain the no-overdraft financing rule and therefore to fund the operating budget only from domestic revenue and external grant resources**. Consistent with this approach, we are committed to enhance revenue reforms, strengthen expenditure management and to ensure that demands for expanding the public sector are sustainable. Salary costs (representing about 75 percent of operating expenditures) are expected to increase significantly over the medium term due to the ongoing public administration reforms. We are cognizant of the need to contain the growth in the wage bill—to that stemming from the ongoing reform initiatives supported by donors—in order to achieve a sustainable fiscal position. Formal arrangements aimed at containing the wage bill will be discussed with the IMF during the next review of the SMP. We will also continue to limit borrowing to highly concessional external loans to fund development expenditures.

20. **We will continue to consolidate government operations and improve fiduciary standards.** During 2004/05, the introduction of the treasury single account, the initiation of cash planning, and the piloting of new payment and payroll systems have improved control over revenue collection and expenditures. For 2005/06, a single chart of accounts has been agreed to help unify the operating and development components of the core budget.[7] The above measures will continue to be strengthened and particular attention will be given to the

[6] The past two years have witnessed severe payment delays at the start of the year, particularly for salaries, due to the lack of coordination between the budget allotment process and the official establishment register (*Tashkeel*).

[7] The Afghan National Army (ANA) is currently being funded by external grants outside of the core budget. The incorporation of the ANA into the core budget has been proposed and would further strengthen the consolidation of the fiscal operations within the budget.

provinces. In addition, we will continue our efforts to enhance the quality of budget reporting and internal and external audit functions.

C. Monetary and Exchange Rate Policies

21. **DAB will maintain the current stance on monetary policy, aimed at maintaining low inflation while also guarding against currency instability**. For the rest of 2004/05, in view of the slowdown in consumer prices over the last few months and the monetary tightening already implied in the program for the remainder of the year, monetary policy will continue to be guided by the target for currency in circulation agreed with IMF staff at the time of the second review. In 2005/06, we expect the pace of monetization of the economy to slow somewhat, reflecting the now relatively high level of monetization and an expected increase in bank intermediation as the financial sector develops. Accordingly, and in view of the objective to reduce inflation from 13 percent in 2004/05 to 10 percent in 2005/06, the indicative targets for currency in circulation for the first half of 2005/06 are consistent with a 5 percent increase in monetization in 2005/06, compared with a projected 13 percent increase in 2004/05. The program will remain flexible, allowing us to accommodate, up to an additional 5 percent, perceived shifts in demand for Afghani, as well as to modify the target in consultation with Fund staff when warranted by exchange rate and price developments. We also stand ready to tighten the monetary stance, should inflation pressures emerge.

22. **We will actively pursue further reforms to modernize the central bank.** By end-March 2005, we will implement several measures aimed at allowing DAB to focus on its core activities, including: (i) the transfer of DAB's commercial accounts to other entities; (ii) the transfer of its commercial holdings and potential liabilities to the MoF; and (iii) the transfer to DAB of the ownership of the monetary gold and silver held in the palace vaults. These measures, together with the results of the DAB's external audit (the financial statements of which will be published by end-June 2005) will allow us to assess whether DAB is adequately capitalized. Should DAB prove undercapitalized, we will take a decision by end-June 2005 regarding its recapitalization. Finally, we will introduce an automated foreign auction system, allowing access to the commercial banks in a more market-based way.

23. **We will make further progress toward reforming the banking sector.** By end-March 2005, we will publish the banking law in the official gazette. We will further strengthen our supervision framework through the enforcement of the various regulations recently adopted by DAB. As the shareholders, we will continue to modernize the relicensed state-owned banks, partly through technical assistance. By end-June 2005, we will take a decision on, and start the implementation of, the specific resolution process for each of the three former state-owned banks that were not relicensed.

D. External Policy and Debt Management

24. **The government remains committed to an open trade and exchange system**. The introduction of a new tariff system and the use of market exchange rates for import valuation were significant steps forward in this regard. Afghanistan is now one of the most open economies in the region, with a simple average applied tariff of only 4 percent, and very few nontariff barriers. To enhance the prospects for regional trade, the government will also continue to pursue or improve upon trade and transit agreements with neighboring countries. Consideration is also being given to membership in the World Trade Organization.

25. **The outlook regarding the external accounts appears largely positive**. Caution is warranted, however, given the lack of clear and reliable data, and uncertainties regarding the level of donor support, the impact of the opium eradication campaign, and the potential level of foreign direct investment and other inflows. On current trends, the external current account (including grants) is projected at a surplus of 1.8 percent of GDP for 2004/05—roughly the same level observed in 2003/04. Foreign exchange reserves would amount to about $1.2 billion at end-2004/05, equivalent to over 5 months of prospective goods and services imports—a cushion sufficient to deal with most exogenous shocks. In 2005/06, we expect some improvement in the merchandise trade account (in terms of GDP) as the initial surge in imports associated with the post-war period begins to level off, and as our relatively small domestic export base continues to expand. Under relatively conservative assumptions regarding donor and private investment inflows, we expect the external current account balance to deteriorate to a deficit of about 2–3 percent for the next two years, before gradually improving over the medium term. However, we should still be able to maintain or even add to our substantial cushion of foreign exchange reserves—which we view as prudent given Afghanistan's vulnerability to external shocks. Key to this outlook, however, will be to ensure higher levels of domestic and foreign investment to enable an expansion of our export base and to take advantage of transit trade.

26. **We remain committed to prudent management of external debt**. Regarding the stock of debt, we have made further progress in identifying debts undertaken by previous governments, and reconciling their amounts with external creditors. It is our intention to complete a survey of these debts and a reconciliation with bilateral creditors by the end of March 2005. Simultaneously, and to ensure Afghanistan's medium- and long-term external and fiscal sustainability, we will also continue to seek generous debt relief from bilateral creditors. During the first three quarters of 2004/05, and consistent with the SMP, we have contracted external loans only on highly concessional terms. Disbursements have also been limited. To ensure that this prudent strategy remains a central pillar of Afghanistan's reconstruction and stabilization, we will seek to design and implement a comprehensive external debt management strategy by end-September 2005. In the interim, we will continue to be guided by the indicative target on the minimum level of concessionality required for new external loans established under the original SMP in March 2004.

E. Structural Reforms

27. **We remain convinced that the development of a vibrant private sector is key to attaining our medium-term objectives, particularly in light of the inherent institutional, technical, and financial limits on government action**. Consistent with this view, we will continue our efforts to eliminate constraints weighing on private sector activity, including (i) reform of the legal and judicial framework for business, with assistance from various donors; (ii) tax reforms to modernize and simplify procedures for enterprises; (iii) financial sector modernization; and (iv) gazetting of the investment law by end-September 2005. At the same time, we will work towards improving the competitiveness of the Afghan economy through reforms and accelerating some vital projects in some key sectors, including energy, transportation, and telecommunications—and will look for continued support from donors in this regard. We also are working actively to restructure state-owned enterprises, and expect to adopt a classification plan for these firms (by restructuring method) by end-September 2005.

F. Poverty Reduction Strategy

28. **We are determined to place poverty reduction at the center of our development platform**.[8] To that end, we have decided to develop a poverty reduction strategy for Afghanistan—called the National Development Strategy. An interim poverty reduction strategy paper (I-PRSP) is expected to be completed by end-October 2005, based on a preliminary consultative process in Kabul and at the provincial level. To coordinate and conduct work on the I-PRSP, we envisage putting in place an Inter-Ministerial Committee (IMC), formed of ministers and deputies from a cross-section of government, including the Ministry of Finance, the Ministry of Economy, the Ministry of Foreign Affairs, and social line ministries. Under the direction of the IMC, there will be a working group of predominantly Afghan experts who will conduct the technical work. To facilitate exchanges with partners outside the government and civil society, an External Advisory Group (EAG), formed of representatives from United Nations agencies, international financial institutions, key donors, and NGOs will be established. The EAG will provide advice on the preparation and feedback to the working group and IMC on draft documents.

G. Statistical Issues

29. **We will continue our efforts to improve the statistical database**. Consistent with the recent reorganization of the government, and with a view to help the Cabinet in its decision-making process, the Central Statistical Office (CSO) will now report to the newly created Ministry of Economy. In addition, we are working, in coordination with some key

[8] This platform is reflected in successive National Development Budgets (2002/03; 2003/04; 2004/05), based on the National Development Framework; Securing Afghanistan's Future, which outlined the development needs of the country for the period 2004-2015; the Berlin working plan; the 12 National Priority Programs; the 16 Public Investment Programs; and strategic initiatives by key donors and multilateral institutions.

donors, on a program to help implement the statistical master plan.[9] This work program is expected to be completed by end-March 2005. At the same time, we are also seeking external support to fund the work program. We had hoped to improve our monetary and balance of payments reporting, but security concerns delayed provision of the required technical assistance.

H. Technical Assistance

30. **An evaluation of technical assistance (TA), initiated by the previous Cabinet, is now underway.** This evaluation aims at ensuring that the work remaining in various government agencies is adequately covered, and implemented in a coordinated and cost-efficient manner. We expect to complete this assessment exercise and adopt a TA plan by end-December 2005.

I. Program Monitoring

31. **The program will continue to be monitored** using the definitions, data sources, and frequency of monitoring set out in the attached Technical Memorandum of Understanding (TMU). The quantitative indicators for end-March, 2005, end-June 2005, and end-September 2005 are included in Table 1. The structural benchmarks are detailed in Table 2. The government will continue to make available to Fund staff all core data, appropriately reconciled and on a timely basis, as specified in the TMU.

32. **The Technical Committee of Coordination (TCC) has been instrumental in implementing the SMP and in providing core data to the Fund**. It will continue to do so in the months ahead, while simultaneously deepening its analytical function, and reaching out to other government agencies. It will also coordinate closely with the working group involved with the I-PRSP.

33. **The fourth review of the program is scheduled to take place in early May 2005**, based on indicative targets and benchmarks for end-March. At the time of that review, the quantitative indicators and structural benchmarks for end-June and end-September 2005 may be revised in light of developments.

J. Relations with the Fund

34. **The government of Afghanistan values highly the ongoing policy dialogue and support from the IMF under the SMP**. The close consultations with IMF staff on key macroeconomic policy choices and structural reforms have proven instrumental in building capacity and maintaining macroeconomic stability. Given the magnitude of the unfinished agenda, and the daunting economic challenges still facing Afghanistan, the government is eager to continue the close working relationship developed with the IMF. Given the strong

---

[9] Funding of the statistical master plan is projected at $6.5 million.

financial support provided by donors and the consequent absence of an immediate balance of payments need, a six-month extension of the current SMP (to end-September 2005) is the most logical policy choice. Extension of the current framework would allow for more time to build the administrative and statistical capacity required under a formal IMF arrangement. Further, given the need to ensure broad ownership of the reform strategy until after the legislative elections, an extension of the current framework to end-September would allow time for due consideration of a follow-on program.

Table 1. Islamic Republic of Afghanistan: Quantitative Indicators, 2004/05–2005/06

(In millions of Afghanis, unless otherwise indicated; cumulative changes from beginning of fiscal year)

	2004/05					2005/06	
	Sep. 21 Initial Indicative Target	Sep. 21 Preliminary Estimate	Dec. 20 Indicative Target	Dec. 20 Preliminary Estimate	Mar. 20 Indicative Target	Jun. 20 Indicative Target	Sep. 20 Indicative Target
Currency in circulation (ceiling) 1/	3,774	6,253	9,265	8,315	10,954	2,453	5,057
Claims of the banking system on the central government (ceiling)	0	0	0	0	0	0	0
Gross international reserves of the central bank (floor) (in millions of U.S. dollars)	29.1	277.7	115.0	469.5	115.0	0	0
Fiscal revenue of the central government (floor)	5,506	5,886	8,649	8,880	12,784	3,526	7,182
External debt							
a) New medium- and long-term nonconcessional external debt (with original maturities of one year or more) contracted or guaranteed by the government (ceiling) 2/ 3/	0	0	0	0	0	0	0
b) New nonconcessional debt with an original maturity of less than one year (ceiling) 3/ 4/ 5/	0	0	0	0	0	0	0
Memorandum item:							
Currency in circulation (level triggering consultation)	4,475	...	10,702	...	12,392	3,508	7,298

Sources: Data provided by the Afghan authorities; and Fund estimates and projections.

1/ At end-2003/04, currency in circulation amounted to Afs 28.8 billion.
2/ Excluding rescheduling arrangements, but including debt with maturities of more than one year.
3/ This benchmark will be evaluated on a continuous basis.
4/ Concessional debt is defined as debt with a grant element of at least 60 percent calculated on the basis of currency-specific discount rates, based on the OECD commercial interest reference rates (CIRRs).
5/ On a contracting or guaranteed basis. Excluding debt related to normal import transactions.

Table 2. Islamic Republic of Afghanistan: Structural Benchmarks, December 2004–September 2005

Policy Actions	**Target Date**	**Status**
Adopt new chart of accounts compatible with IMF GFS 2001 (cash basis) requirements for classifying revenue and expenditure transactions.	End-December 2004	Implemented
Prepare (by MoF) monthly cash flow projections to improve cash management and for coordination with DAB.	End-December 2004	Implemented
Publish in the official gazette the central bank and commercial banks laws.	End-December 2004	Not implemented [1/]
Introduce the auction process for a short-term DAB capital note.	End-December 2004	Implemented
Initiate an external audit of the DAB based on internationally recognized accounting standards.	End-December 2004	Implemented
Publish in the Official Gazette the amendments to the revenue laws: (i) enacting the income tax reform package; and (ii) ensuring that the revenue laws supersede all other legislation in revenue-related matters.	End-March 2005	
Consolidate all recent revenue measures into the existing revenue code and publish as a single document.	End-March 2005	
Complete the survey of external debt, including reconciliation with creditors.	End-March 2005	
Transfer of DAB's commercial holdings to the MoF, and transfer of ownership of marketable gold and silver in the palace vaults to the DAB.	End-March 2005	
Improve government payments by initiating (i) a system of non-cash payments to vendors; and (ii) a pilot for direct salary payments for the employees of two ministries. [2/]	End-March 2005	
Approve (by the Cabinet) the Customs Code.	End-March 2005	
Ensure that budget allotments and authorized staff positions are established for all budget users (center and provinces) to allow timely salary payments every month.	End-March 2005	
Publish an official estimate of the annual revenue forgone as a result of tax holidays, exemptions or concessions and a time-bound plan, approved by the MoF, to address all existing tax exemptions or concessions.	End-March 2005	
Publish in the Official Gazette the banking law.	End-March 2005	

Table 2. Islamic Republic of Afghanistan: Structural Benchmarks, December 2004–September 2005 (concluded)

Policy Actions	Target Date	Status
Adopt (by the cabinet) and publish in the official gazette the financial management law.	End-June 2005	
Publish the financial statements of the 2003/04 external audit of DAB.	End-June 2005	
Reconcile the government accounting records with the government's bank accounts. [3/]	End-September 2005	
Submit to Parliament the 2004/05 financial accounts (core budget) with audit opinion.	End-September 2005	
Adopt (by Cabinet) a comprehensive external debt management strategy.	End-September 2005	

1/ Only the central bank law was published in the Official Gazette.
2/ The method of direct salary payment may be specified as either direct transfers from the MoF into the bank accounts of employees or a "pay-from-the-list" system.
3/ See relevant bullet point inserted in paragraph 14 of the TMU.

Amendment to the Technical Memorandum of Understanding

1. The following bullet points will be inserted at the end of paragraph 14:

- **Reconcile government fiscal and banking records.** The reconciliation will cover all core budget operations (recorded with AFMIS) and associated banking data from the beginning of 2005/06. It will be undertaken at least monthly. A reconciliation that leaves unexplained differences up to 5 percent of total core expenditures between the banking and accounting records will not meet the benchmark.