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Islamic Republic of Afghanistan: Fourth Review Under the Staff-Monitored Program

This paper on the fourth review under the staff-monitored program for the Islamic Republic of Afghanistan was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on July 8, 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

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ISLAMIC REPUBLIC OF AFGHANISTAN

Fourth Review Under the Staff-Monitored Program

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

(In consultation with other departments)

Approved by Julian Berengaut and Matthew Fisher

July 8, 2005

- Discussions for the fourth review (January–March 2005) under the Staff-Monitored Program (SMP) were held in Kabul from May 8–19, 2005. The mission met with Minister of Finance Ahady, Minister of Economy Farhang, Minister of Commerce Arsala, Da Afghanistan Bank Governor Delawari, other senior government officials, and representatives of nongovernmental organizations and of the donor and business communities.

- The 12-month SMP, which started on March 20, 2004, was extended through end-September 2005 at the request of the authorities. Its objectives are to maintain financial stability, establish institutional capacity, and build a statistical database.

- The mission members consisted of Messrs. Symansky (head), Bessaha, Martin, Ms. Mwase (EP) (all MCD), and Mr. Thomas (FAD). The mission was assisted by the outgoing resident representative, Mr. de Schaetzen, and by Mr. Charap, his successor, and coordinated with a STA mission on balance of payments statistics, and a MFD mission on monetary policy and financial markets.

- Since its formation in December 2004, the government has faced strong pressures for salary increases, which have intensified recently. The authorities, who adopted a prudent budget for 2005/06, have committed to resist such pressures until the midyear budget review, giving themselves sufficient time to consult with partners and assess the scope for adjustment within a sustainable medium-term fiscal framework.

- The security situation has recently deteriorated due to the intensification of the anti-narcotics campaign, political power struggles, and maneuvering in the run-up to the upcoming September legislative elections, rising criminality, but also resurgence of Taliban activity. The situation is not expected to improve before these elections.

- Discussions for the fifth review under the SMP are expected to take place in August 2005, security conditions permitting.

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List of Acronyms

ARTF	Afghanistan Reconstruction Trust Fund
CSO	Central Statistics Office
DAB	Da Afghanistan Bank
FDI	Foreign Direct Investment
I-PRSP	Interim Poverty Reduction Strategy Paper
LOTFA	Law and Order Trust Fund for Afghanistan
MEFP	Memorandum of Economic and Financial Policies
MTFF	Medium-Term Fiscal Framework
MYR	Midyear Review
NDS	National Development Strategy
PAR	Public Administration Reform
PRR	Priority Restructuring and Reform
SMP	Staff-Monitored Program
TA	Technical Assistance
TCC	Technical Coordination Committee
TMU	Technical Memorandum of Understanding

EXECUTIVE SUMMARY

- Under the SMP, Afghanistan continued to make progress in improving macroeconomic management, strengthening its capacity to formulate policy, and creating conditions for sustainable economic growth. All indicative quantitative indicators and structural benchmarks for the fourth review were observed, except for the external debt survey, due to the lack of cooperation of some creditors.
- Despite unfavorable weather, real GDP continued to increase at a steady pace, estimated at 7.5 percent in 2004/05. Inflation increased to 16.3 percent year-on-year, largely due to the acceleration of rents, education fees, and petroleum product prices. Excluding these items, year-on-year inflation declined slightly in 2004/05, to 10.3 percent. The exchange rate was broadly stable during the fourth quarter, and fiscal and monetary developments conformed with program objectives. Structural reforms advanced on several fronts.
- The authorities began implementing their anti-narcotics strategy. The reported decline in poppy cultivation is partly attributable to a decline in farm gate prices, which could reverse quickly, and does not guarantee in itself a decline in production, as yields are expected to rise significantly.
- The government is facing pressures for higher salaries, infrastructure spending, and support to agriculture. The authorities committed to wait until the midyear budget review before considering any easing of the fiscal stance. This will give them time to evaluate various options, within a medium-term fiscal framework. At the same time, higher revenue mobilization is needed over the medium term and requires an acceleration of the implementation of the revenue reforms.
- Consistent with the objective of reducing inflation, the monetary program for 2005/06 provides for a substantial tightening of the monetary stance while allowing a further monetization of the economy. The exchange rate will remain flexible. The authorities will pursue the modernization of the banking sector, including through restructuring the state-owned banks that were relicensed and resolving the former state-owned banks that were not relicensed.
- In the structural area, several initiatives are being pursued to create an adequate regulatory framework and reduce the share of the public sector in the economy.
- A further extension of the SMP, probably through end-March 2006, is being considered by the authorities. It would allow them to prepare their national development strategy, which will form the basis for the Interim Poverty Reduction Strategy Paper (I-PRSP).
- The approaching legislative elections, a poor security environment, low administrative capacity, red tape, and the drug economy are some of the factors that may slow down the pace of reforms and program implementation in the coming months.

I. Introduction

1. **One year into the SMP, Afghanistan has made marked progress in improving macroeconomic management, strengthening its capacity to formulate policy, and creating conditions for sustainable economic growth**. Macroeconomic stability is largely achieved, as evidenced by moderate core inflation, monetary growth and fiscal revenue consistent with program objectives, a stable exchange rate, and increasing international reserves. At the same time, further progress was made in reestablishing political stability, in particular through the organization of the October 2004 presidential election and the formation of a new Cabinet in December 2004. Progress on the macroeconomic and political fronts contributed to the observance of all indicative quantitative indicators and almost all structural benchmarks over the last 12 months.

2. **Notwithstanding these achievements, administrative capacity continues to be limited, private sector activity is constrained by complex procedures and rigidities, the security situation and the drug economy remain major concerns, infrastructure needs are substantial, and delivery of government services is still poor**. The authorities' main challenge is to achieve high and sustainable growth while preserving fiscal and external sustainability. Over the next few years, the Afghan economy will have to grow by an average rate of at least 10 percent so that significant inroads can be made in reducing poverty and advancing toward the Millennium Development Goals.[1] To meet these objectives, the country needs to strengthen its structural reform agenda to encourage private investment, prioritize spending in favor of poverty reduction and investment, and increase domestic revenue. To support these reforms, given Afghanistan's low domestic savings and limited scope for external borrowing, the country will require continued predictable and sizeable assistance from the donor community in the form of grant financing and concessional lending. In the short term, Afghanistan must focus its efforts on (a) diversifying the sources of growth; (b) implementing appropriate policies to maintain donor inflows and preserve external competitiveness; and (c) strengthening administrative capacity.

II. Recent Developments and Program Performance

3. **All quantitative indicators and structural benchmarks for the fourth review were met,** except for the survey of external debt, which was not completed owing to the lack of cooperation of some creditors.

4. **The 2004/05 macroeconomic performance was in line with program projections**. Economic activity continued to increase at a steady pace, with real GDP growth estimated at 7.5 percent in 2004/05, as the fall in agricultural output caused by weather conditions was offset by strong growth in construction, transportation, and trade (Tables 1 and 2). **Poppy**

[1] The determinants of Afghanistan's medium- and long-term growth potential are described in "Securing Afghanistan Future," Transitional Islamic Government of Afghanistan (http://www.af./recosting/index.html).

cultivation appears to have declined significantly in early 2005, due in part to the authorities' anti-narcotics campaign and the fall in farm gate prices triggered by the 2004 bumper harvest. It was uncertain, however, whether the reduction in planted areas would bring a significant reduction in opium production, as yields were expected to rise as a result of improved rainfall.

5. **Inflation was higher than projected in 2004/05** (paragraph 3 of MEFP and Figure 1). Year-on-year consumer prices increased by 16.3 percent in Kabul, compared with a SMP projection of 13 percent.[2] The increase in inflation in 2004/05, up from 10.2 percent at end-2003/04, essentially reflected the acceleration of rents, education fees, and petroleum product prices.

6. **Provisional data indicate that fiscal revenue reached Af 12,800 million in 2004/05, slightly above the SMP indicative target (Af 12,784 million) but well below the budget forecast** (Af 15,380 million; paragraphs 4–6 of the MEFP and Tables 3a and 3b). The SMP target was met as buoyant customs duties compensated for a shortfall in tax and nontax revenues stemming partly from delays in collecting about Af 800 million in overflight charges due to limited administrative capacity. As the shortfall in revenue relative to the budget target was more than offset by lower-than-expected operating expenditures, the operating budget recorded a surplus of Af 1.1 billion for the year. Despite a substantial rise during the fourth quarter, operating spending was also below the midyear review (MYR) projection, mainly due to continued delays in recruiting teachers and in implementing civil service reform. More timely grant disbursements from the multi-donor trust funds were facilitated by better expenditure controls and compliance. Development spending was again substantially below budget expectations, essentially due to the lack of security and the low capacity of line ministries and implementing agencies to develop and implement projects.

7. **The authorities adhered strictly to the monetary program for 2004/05** (paragraph 8 of MEFP). Currency in circulation amounted to Af 39.6 billion at year-end, compared with the SMP indicative target of Af 39.8 billion (Figure 2 and Table 4). During the fourth quarter, Da Afghanistan Bank (DAB) stepped up its foreign currency auctions to partly offset the monetary expansion caused by increased government spending and maintain money in circulation in line with the SMP indicative ceiling. Together with the government's drawdown of its foreign currency deposits with DAB, this led to a slight decline in DAB's foreign exchange reserves, to $1.3 billion at end-2004/05 (Figure 3). The interest rate on the overnight capital note remained low, at 1–2 percent, while the one-month auctions continued to be undersubscribed. The nominal exchange rate was broadly stable during the fourth quarter. The Afghani appreciated in nominal terms by 3.4 percent against the U.S. dollar in 2004/05, to Af 48.65 per dollar at year-end, and by 15.1 percent in real terms.

[2] The "national" consumer price index, covering five major cities in addition to Kabul, increased by 10.9 percent year-on-year at end-2004/05.

8. **Preliminary data indicate that the current account deficit, excluding grants, reached 43.7 percent of GDP in 2004/05, down from 50.9 percent in 2003/04**, reflecting essentially an increase in imports not associated with reexports (Table 5).[3] While foreign direct investment and concessional borrowing increased, the deficit continued to be mainly financed by grants. Including grants, the current account was broadly balanced in 2004/05, compared with a 3.1 percent of GDP surplus in 2003/04. External borrowing remained limited and on highly concessional terms.

9. **Structural reforms have advanced on several fronts. In the fiscal area,** the authorities published in March 2005 in the Official Gazette (a) the amendments to the revenue laws enacting an income tax reform package and ensuring that the revenue laws supersede all other legislation in revenue-related matters; and (b) the new customs code, which provides the enabling legislation for implementing the revised tariff structure introduced in 2004 (see Box 1, IMF Country Report No. 05/33, January 4, 2005).[4] The publication of these two pieces of legislation marked the enactment of a more effective tax regime, relying now on accelerated depreciation and loss-carry forward to encourage private investment rather than on tax holidays and exemptions. In a move for greater fiscal transparency, the authorities published an estimate of revenue forgone (about $14.6 million in 2005/06, equivalent to 4.4 percent of budgeted revenue, and over $30.2 million since 2003/04) through past investment-related tax exemptions and concessions, as well as a time-bound plan to address all exemptions and concessions.[5] They also indicated that the previous tax regime favored particular sectors, such as construction, which were not intended to be the primary beneficiaries of such incentives. All tax concessions not included in the income tax law ceased to have any effect on June 21, 2004. Most, if not all, of the concessions granted before this date will no longer be in force, as most of the companies that could have benefited from them are not in full compliance with the requirements attached to these concessions. **In the banking area,** the central bank continued to restructure its balance sheet and strengthen the banking regulatory framework. The authorities published the commercial banking law in the Official Gazette and DAB gained ownership of the silver and gold held in the palace vaults (both structural benchmarks).[6] Other positive developments include the cessation by DAB of its headquarters-based commercial activities, the completion of the

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[3] Some of the data related to imports and reexports were adjusted to reflect the findings of the May 2005 Fund technical assistance mission on balance of payments statistics.

[4] The tax reform package 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.

[5] "Report on Revenues Forgone Due to Tax Holidays and Time-Bound Plan to Address such Holidays," available at http://www.mof.gov.af/pdf/Tax_holidays_summary_of_estimate_and_plan.doc. This estimate does not include the exemptions granted on aid-related inflows.

[6] The ownership of the gold and silver found in the palace vaults at the end of the Taliban regime was the subject of a dispute between the DAB and the Ministry of Finance.

audit of DAB's end-2003/04 financial accounts, and the adoption by DAB's supreme council of a set of new banking regulations. Lastly, DAB started enforcing the reserve requirements.

10. **The private banking sector is developing steadily, but little progress has been made in restructuring the state-owned banks**. While still limited, the private commercial banks' lending operations, essentially denominated in U.S. dollars, have increased significantly. Some of the banks are now considering expanding their operations in the provinces, in particular to participate to the financing of the alternative livelihoods programs. The licensed state-owned banks developed more modern internal procedures, but made little progress in hiring qualified staff and toward divesting real estate investments, as required under the conditionality attached to their relicensing. This reflected in part insufficient government involvement as the shareholder. The authorities had yet to take a decision regarding the specific resolution process of the three former state-owned banks that were not relicensed.

III. Policy Discussions

11. **While macroeconomic conditions are expected to remain favorable, the authorities face major macroeconomic policy challenges, including pressures for wage increases, providing possible budgetary support to stabilize farmers' income, and higher infrastructure spending, while maintaining the country on the path of fiscal sustainability**. As the authorities are sizing up these challenges and are trying to articulate a medium-term National Development Strategy (NDS), the policy discussions focused on (a) the scope for higher operating and infrastructure spending; (b) fiscal policy and administration measures aimed at increasing revenue over the medium term; and (c) the legal and financial structural reforms in support of private investment.

12. **Staff revised upward their real GDP growth projections for 2005/06, to 13.6 percent, essentially to reflect an expected rebound in agricultural output due to better precipitation**. While slowing down, activity in construction, transport, and telecommunications would continue to grow steadily. In the medium term, growth should remain around its estimated potential of 10 percent, sustained by continued expansion in agriculture, construction, and trade, and the development of new manufacturing activities. Reflecting the tightening of the monetary stance, as well as an anticipated slowdown in food prices and rents, year-on-year inflation is projected to decline to 10 percent by end-2005/06.

A. Fiscal Policy and Reforms

13. **The approval of the budget prior to the start of the fiscal year helped avoid a repeat of the payment delays witnessed in previous years**. Despite significant pressures for additional spending, particularly for higher wages, operating expenditures are budgeted to grow broadly in line with nominal GDP.[7] The authorities maintained the 'no-overdraft'

[7] The operating budget provided for a 15 percent increase in spending over the MYR projections for 2004/05, and for a 23 percent increase compared with the 2004/05 actual outturn.

financing rule and will rely on domestic revenue and grants to fund the operating budget. Grants from the main donor trust funds, which cover more than half of operating expenditures, are expected to increase in absolute terms in 2005/06. With work on the NDS underway, the authorities concurred with staff on the need to use the 2005/06 operating budget as a base to develop a medium-term fiscal framework (MTFF) to rationalize spending, encourage a robust response from private investment, and help sustain medium-term growth.

14. **Domestic revenues for 2005/06 are expected to be higher than budgeted**. With the prospective receipts of two overflight payments and a higher baseline, the authorities agreed to revise the indicative SMP revenue target for 2005/06, to the equivalent of 5.2 percent of GDP, compared with the 2004/05 outturn of 4.5 percent of GDP.[8] The target is now above the budget projection, unlike the 2004/05 SMP target, which was below the revenue level projected in the 2004/05 budget.

15. **The authorities reiterated that they consider increasing revenue as their top priority**. They noted the need to accelerate the implementation of their revenue reforms and requested technical assistance from the Fund to help review and reprioritize the reform programs on customs and tax administration and tax policy. They considered that customs reforms should quickly yield significant additional revenues, assuming (a) planned improvements in infrastructure; (b) introduction of the Automated System for Customs Data; (c) enactment of regulations to support the new customs code; and (d) the establishment of the new customs police. In tax administration, they intend to give priority to (a) the large taxpayer office; (b) restructuring the revenue headquarters and provincial tax offices; (c) introducing enforcement powers and additional corporate tax reform measures in the income tax law (a new end-September 2005 benchmark); and (d) removing the plethora of illicit or nuisance taxes (a large constraint on the business sector). Consistent with their commitment for higher revenue, the authorities have resisted pressures for lower taxes from the business community, arguing that the tax rates are relatively low and that the expansion of private investment would be better served through other relevant measures, including the recently-enacted accelerated depreciation and loss-carry forward, as well as an adequate regulatory framework. The authorities also intend to strengthen the monitoring of the large volume of aid-related exemptions, particularly to ensure the validity of the reported end-use of exempt goods.

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[8] The administrative weaknesses responsible for the delays in collecting the overflight charges are expected to be addressed in 2005/06.

16. **The authorities are of the view that any easing of the fiscal stance should wait until the MYR**. Since the beginning of the year, the authorities are under strong pressures to adjust salaries, shift more resources to large infrastructure projects, and consider policies to help stabilize farmers' incomes, partly to provide an alternative livelihood to poppy farmers. They argued that the current salaries are not competitive with those offered by the donor community, thereby impeding the hiring of trained and competent staff. Staff acknowledged the merit for salary adjustment but suggested that the issue be addressed at the time of the MYR and consistent with the World Bank-supported public administration reform (PAR) program, expected to be completed before end-2005. While agreeing with this suggestion, the Minister of Finance indicated that, given the relatively low level of wages and since no wage increase was included in the 2005/06 budget, a salary adjustment appeared unavoidable at some point this year. The authorities concurred with staff that, to avoid a possible fall in agricultural prices, it would be more effective to address, in collaboration with various partners, the bottlenecks hindering farming activity, notably transportation and stocking facilities, than to introduce agricultural price supports.

17. **The 'interim' development budget will be amended by a supplementary budget in June and at the time of the MYR, scheduled for October**.[9] Core development and external budget spending are currently projected to increase from 4.5 percent and 35.4 percent of GDP in 2004/05, to 13.2 percent and 44.5 percent of GDP in 2005/06, respectively. The amendment of the development budget, which is entirely funded by donors, will help incorporate additional commitments anticipated during the course of the year from some of the main donors and for the new Counter Narcotics Trust Fund.

18. **The authorities are committed to move toward a more standard and consistent cash-based presentation of the budget, within a MTFF, and publish more timely quarterly core budget reports**. The authorities acknowledged the need to develop a realistic MTFF and improve the consistency of the budget presentations, so as to create more realistic expectations.[10] To further enhance the transparency and realism of the budget, the authorities also intend to base their projections on available financing and the real absorption capacity of the country over the medium term. However, projecting available financing may prove difficult, as only a few donors can provide multiyear commitments, and since the budgetary processes of some of the larger donors limit them to one-year commitments.

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[9] The relatively large unclassified development spending will be allocated to specific projects within the scope of the existing National Priority Programs, some of which will likely be for opium eradication. This will take place either at the time the supplementary budget is finalized or during the MYR.

[10] The current presentation of the core budget, which combines cash and commitment concepts, significantly overstates the actual amount of spending within the year and creates undue expectations.

19. **To strengthen medium-term fiscal viability, the program envisages an acceleration of fiscal reforms**. Given the importance of an appropriate legal framework for public finance, the authorities recognized the importance of publishing the public financial management law in the Official Gazette and of developing thereafter the accompanying financial regulations, but noted that insufficient translation capacity at the Ministry of Justice was largely responsible for the delays in implementing these measures. The authorities eventually reiterated their commitment to have the law published by end-June. To enhance expenditure control and transparency, the authorities will put in place, by end-September 2005, a system linking the Ministry of Finance with DAB to facilitate the reconciliation of the main government bank accounts with expenditure data. Finally, the authorities intend to submit the audited 2004/05 financial statements to parliament by end-September 2005.

B. Monetary and Exchange Rate Policy and Reforms

20. **The authorities stated that monetary policy would continue to be guided by the monetary program developed at the time of the third review**. This program provides for a substantial tightening of the monetary stance, while allowing a further monetization of the economy. The authorities intend to maintain a flexible exchange rate. DAB will therefore not resist persistent pressures on the exchange rate, especially when such resistance may conflict with DAB's primary objective of reducing inflation. In particular, the authorities will allow nominal exchange rate appreciation so that a real appreciation of the Afghani resulting from donor- and drug-related inflows, if sustained, is not realized only through higher prices, as was broadly the case in 2004/05. DAB may, however, intervene to smooth short-term exchange rate fluctuations when consistent with its primary objective. The monetary program will remain flexible, allowing a revision of the monetary stance, in consultation with the Fund, if warranted by exchange rate and price developments, and will be reviewed at the time of the next mission. Moreover, to allow for a possible further tightening of the monetary stance at a point in the budget cycle where the government is drawing down its deposits with DAB, the end-June 2005 floor for gross international reserves was revised downward. The end-September 2005 floor was kept unchanged and is consistent with a coverage of four months of prospective imports at end-2005/06.[11]

21. **The authorities reiterated their commitment to pursue the modernization of the banking sector.** By end-June, DAB will publish its audited 2003/04 financial accounts. The authorities are taking steps to obtain a preliminary estimate of the gold and silver held in the palace vaults; which will allow them to determine whether DAB is adequately capitalized. In the unlikely event of an undercapitalization, the authorities stand ready to take remedial action. By end-September, DAB's commercial activities in its city branches in Kabul, and in its branches located in provinces where at least one commercial bank operates, will be

[11] The end-2004/05 reserve coverage of prospective imports has been revised downward compared with the third review estimates, from 5.2 months to 3.9 months.

transferred to other entities. To strengthen its control over liquidity, DAB will work toward broadening the set of monetary instruments, based on the findings of the May 2005 Fund technical assistance mission on monetary policy and financial markets. The authorities will continue their efforts to tackle some of the administrative impediments to the development of the banking sector, including the absence of bankruptcy and corporate laws and high fees (e.g., property registration). The authorities are also taking steps to work closely with the commercial banks to improve the timeliness and reliability of monetary reporting.

22. **The authorities will intensify their efforts to restructure the state-owned banks.** While the three licensed state-owned banks, which are highly capitalized, do not currently represent a systemic risk, the authorities noted that there is significant room for improving their operational performance. The Minister of Finance, as the main shareholder, is committed to prepare, by end-September 2005, a long-term strategic plan for the restructuring of these banks. The authorities also concurred with staff that the Agricultural Development Bank, one of the three former state-owned banks that were not relicensed, should not be revived, as the rural financing needs of the country would be best served through other means. DAB indicated that the relicensing of any of these banks would be conditional upon strict compliance with licensing requirements. On the resolution of the three former state-owned banks that were not relicensed, the authorities acknowledged that any further delay could be counterproductive and reiterated their commitment to take a decision on this issue, and to start implementing it by end-June.

C. External Sector and Debt Management

23. **Continued reconstruction and relatively strong economic recovery suggest a 2005/06 external position similar to 2004/05, with a current account deficit, excluding grants, of about 44.8 percent of GDP.** Over the medium term, the current account deficit excluding grants is expected to decline somewhat, reflecting a revival of exports, a decline in imports related to donor-financed activities, and the substitution of some imports with domestically-produced goods. The current account, including grants, would deteriorate however, before recovering in the long term. With the economy undergoing significant structural changes, the government will remain vigilant to emerging pressures on the balance of payments and take a moderate stance on the growth outlook. The authorities will pursue their macroeconomic and structural reform efforts to improve the external competitiveness and create a level playing field for private sector activity. In particular, the authorities intend to ensure that donor-related inflows, which, along with drug-related inflows, have contributed to a significant real appreciation of the Afghani over the last two years, are spent efficiently and help improve the productivity of the Afghan economy.

24. **There are significant pressures within the government—and even from some donors—to increase borrowing to finance infrastructure projects.** While recognizing the sizeable infrastructure needs of the country, the authorities underscored the need for new external project financing to be consistent with their cautious external debt management policy, and based on a comprehensive assessment of the investment projects. They indicated that they will continue to seek grant financing and highly concessional borrowing. In line

with this approach, external borrowing is expected to remain relatively modest over the medium term. The authorities are committed to continue their good faith efforts to reconcile their existing external liabilities with foreign creditors and complete the survey of external debt. Staff welcomed the government's intention to contact the Paris Club Secretariat to ensure that there are no obligations outstanding vis-à-vis Paris Club creditors and indicated their willingness to facilitate exchanges between the government and officials of the non-Paris Club creditors, would it be deemed necessary by the authorities.

D. Structural Reforms

25. **The authorities are committed to establish an environment conducive to private sector investment and activity**. Several initiatives are under consideration, including a modern and simplified tax system, an appropriate legal framework for business activity, and simplified procedures to create and operate enterprises. A new investment law is expected to be published in the Official Gazette by end-September 2005. As part of their plan to reduce the role of the public sector in the economy, the authorities are working on an overall economic restructuring plan and a classification of state-owned enterprises by envisaged restructuring method, expected to be adopted by Cabinet by end-September 2005.

E. Poverty Reduction

26. **The authorities intend to prepare by end-October 2005 an I-PRSP, which will be based on their NDS**. They concurred with staff on the need to promptly put in place an appropriate institutional framework that would help coordinate the NDS/I-PRSP process, including the inter-ministerial committee, the working group of predominantly Afghan experts that will conduct the technical work, and the external advisory group to draw on the expertise and feedback of the United Nations agencies, the international financial institutions, key donors, and civil society.

F. Data Issues and Technical Assistance

27. **Despite recent progress, data provision and quality remain weak**. The government is taking steps to build an adequate statistical base, and a set of measures are under way to help implement the statistical master plan adopted in September 2004. Key among these measures is restructuring the Central Statistical Office (CSO). This should be accompanied by the adoption by end-September 2005 of a statistical law providing the adequate legal framework for data collection, processing, and publication and by the launching in June–July 2005 of key surveys (paragraph 31 of MEFP). Those surveys will also feed into the aforementioned work on poverty reduction.

28. **Technical assistance (TA) will remain crucial in the years ahead to build capacity and carry out the ambitious reform agenda**. The authorities noted that, while generally satisfactory, some aspects of TA delivery were weak, including its allocation among government agencies, the coordination within the government and between the government and donors, and the overlapping among various providers. The authorities, in collaboration with the donor community, are conducting a full review of TA, which will provide the basis for a much-needed redeployment. They intend to play a more active role in the future in managing TA. The authorities expressed their appreciation for Fund support, including the training delivered in Kabul in April 2005 by the Middle East and Central Asia and Monetary and Financial Systems Departments. Staff reiterated the Fund's willingness to continue to provide further TA in support of the authorities' economic reforms.

G. Program Conditionality and Monitoring

29. **Conditionality includes quantitative indicators and structural benchmarks through end-September 2005, which are set out in Tables 1 and 2 of the MEFP**. Three new end-September 2005 structural benchmarks related to the preparation of the external debt survey, the publication in the Official Gazette of additional amendments to the income tax law that provide enforcement powers, and the implementation of recently approved tax measures, have been added. The fifth and sixth reviews under the SMP, tentatively scheduled for August and November 2005 will assess quantitative performance and structural conditionality through end-June 2005 and end-September 2005, respectively. A technical memorandum of understanding (TMU) provides the details of the program design and terminology. The government will continue to make available to Fund staff all data as specified in the TMU. Looking ahead, the authorities indicated that they would like Fund monitoring to continue beyond the current SMP timeframe, possibly through an additional six-month extension of the SMP. It was agreed to discuss this issue further at the time of the fifth review.

IV. Staff Appraisal

30. **The Afghani economy continued to perform strongly over the last year but is still facing significant challenges in terms of medium-term fiscal and external sustainability**. GDP growth has been strong, even in the face of bad weather conditions and volatile security. Inflation remained under control, while gross international reserves increased further. The implementation of fiscal and monetary policies conformed to program objectives. Notwithstanding these achievements, since the formation of the new government and ahead of the upcoming legislative elections, the government is facing intensifying pressures for higher wages, infrastructure spending, and external borrowing. In addition, the growing share of the drug economy, the lingering insecurity, and cumbersome procedures hindering private investment continue to pose major risks for program implementation.

31. **The recent deterioration of the security situation appears to be related to various factors**, including the anti-narcotics campaign, political power struggles and maneuvering in the run-up to the upcoming September legislative elections, rising criminality, and the resurgence of Taliban activity. There is no hard evidence, however, that security conditions will worsen further, particularly after the elections, in view of the increasing support by the donor community to improve security and reduce the drug economy. Against this background, and while insecurity contributes to uncertainty regarding the long-term prospects of the Afghan economy, staff consider that the short- and medium-term objectives set by the authorities are attainable.

32. **Staff encouraged the authorities to pursue vigorously the implementation of their multi-pronged anti-narcotics strategy.** Staff considered that only protracted efforts by all partners can lead to tangible and lasting results in the fight against the drug economy. The recently reported decline in poppy cultivation is very welcome, but it is partly attributable to a decline in farm gate prices triggered by the 2004 bumper harvest, which could reverse quickly. Another issue is the macroeconomic impact of a successful anti-narcotics strategy. Staff indicated their availability to assist in capturing the possible effects and designing corrective policies.

33. **Staff emphasized that a medium-term PAR program should be the basis for moving toward a sustainable fiscal position.** Salary costs will continue to be a major component of the operating budget over the medium term. To address this issue, the World Bank-supported pay and grading review, which forms the basis for a PAR program, needs to be pursued more vigorously. In the interim, while understanding the rationale for some salary adjustment, staff reiterated the need to contain pressures for generalized or sector-specific pay increases, some of which are driven by donors in support of their own projects (Afghan National Army, police), as these might undermine a comprehensive reform effort. Staff welcomed the authorities' intention to postpone any decision regarding increases in salaries and infrastructures spending until the MYR. Staff also welcomed the authorities' commitment not to introduce agricultural price supports.

34. **Staff welcomed the projected rise in core development and external budget spending in 2005/06.** However, the ability to sustain higher development spending in the future requires improvements in implementation capacity and security, which are likely to be gradual.[12] Staff noted that, short of such improvements, attempts to increase the share of development spending implemented by the government, rather than by the international community, could further slow spending. Staff also welcomed the authorities' reiterated

[12] Accordingly, the staff projection for core budget development spending in 2005/06 is at 5.4 percent of GDP, substantially lower-than-budgeted (13.2 percent of GDP).

commitment to publishing the financial management law in the Official Gazette by end-June, as they consider that any further delay would raise questions about the authorities' commitment to reform.

35. **The authorities also need to reprioritize tax and customs reforms.** Only an intensive and sustained effort to improve revenue collection will lead to a viable fiscal position. The government will be well-advised to focus on medium-term administrative reforms rather than on quick fixes and eliminate nuisance taxes. Staff welcomed the authorities' renewed commitment to the reform programs and the request for Fund TA to help review and prioritize their customs and administration reform programs and their tax policy. Regarding tax policy, staff considered that the new tax regime is not burdensome and that lower tax rates would jeopardize fiscal sustainability while doing little to encourage investment. Staff was encouraged by the authorities' resistance to pressures from the business community for lower taxes, but stressed the need to maintain a regular dialogue with the business community to address related issues.

36. **Even with strong revenue mobilization efforts and expenditure restraint, significant external assistance will be required over the medium term**. Staff encouraged the government to develop a realistic MTFF with "stretch targets" for accelerated revenue mobilization, the maintenance of expenditure discipline, and to improve the realism of the budget. This will help manage growing expectations and offer a sound basis for donors to provide predictable resources, consistent with the priorities included in the NDS.

37. **The authorities need to broaden the set of monetary instruments and indicators and strengthen the banking sector.** Staff encouraged the authorities to develop a work program along the lines of the recommendations of the Fund TA mission on monetary policy and financial markets to improve the effectiveness of the existing monetary instruments and help introduce new ones. Staff welcomed the authorities' intention to address the rigidities impeding the development of the commercial banking sector and encouraged the DAB to introduce bankruptcy and corporate laws to facilitate the development of financial markets. Staff also welcomed DAB's commitment to improve monetary reporting. Staff expressed some concern regarding the slow pace of restructuring of the licensed state-owned banks and the absence of progress in resolving those banks that were not relicensed, which appear to have reflected the limited capacity of the ministry, but also a lack of political will. Staff urged the Ministry of Finance, in its role of shareholder, to take a more active role in addressing these issues and DAB to enforce strictly the conditionality attached to the relicensing of the licensed state-owned banks.

38. **A comprehensive survey of external debt is necessary to design an external debt management strategy.** Staff is confident that the authorities, through renewed efforts, will be able to finalize this survey by end-September 2005. Seeking the assistance of the Paris Club Secretariat will contribute to a comprehensive account for all outstanding debt obligations, while bilateral contacts should help determine the remaining obligations vis-à-vis the non-Paris Club creditors.

39. **Accelerating the overhaul of the regulatory environment is critical for sustaining and enhancing private sector development**. The reforms being pursued are commendable. The authorities should continue putting in place decisive measures in the areas of taxes, business laws, and regarding transparency. The authorities are also rightly giving priority to reducing government involvement in market mechanisms and economic activities.

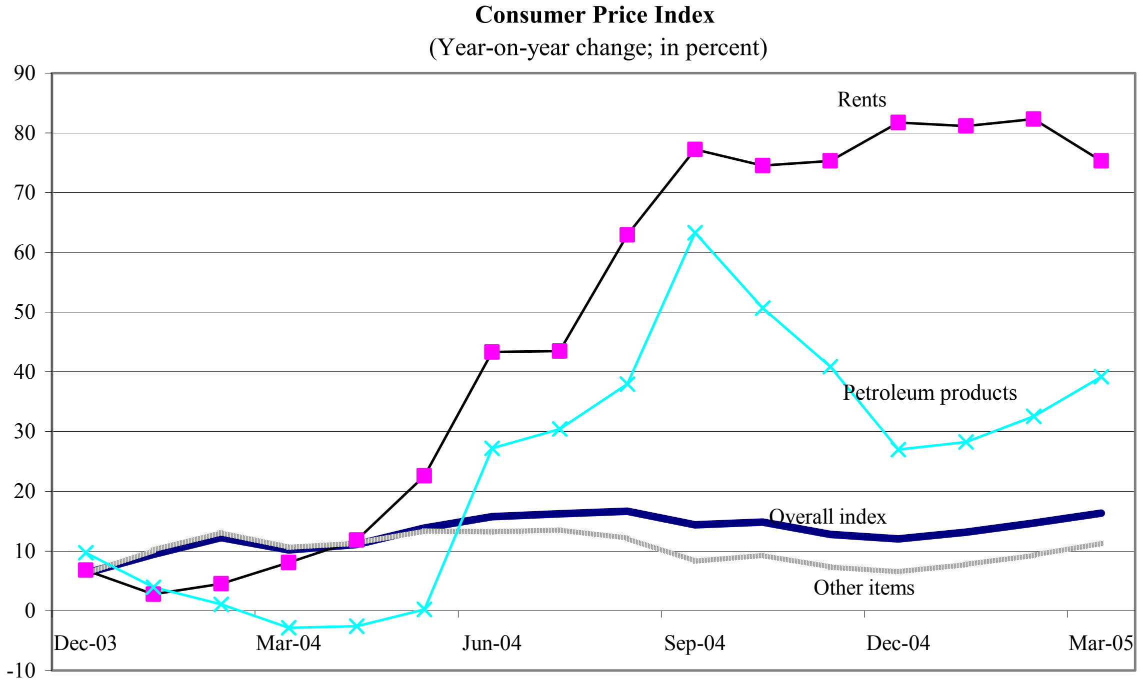
40. **There are serious concerns regarding the timely passage of economic legislation.** Staff recognize that the reconstruction process is generating a significant flow of new legislation and is stretching thin the already limited capacity of the Ministry of Justice. Until a new parliament is elected, staff urged the government to establish clear priorities in the legislative agenda, monitor carefully the whole law generation process, and actively seek additional resources from the donor community to bolster the Ministry of Justice's capacity to deal with this issue.

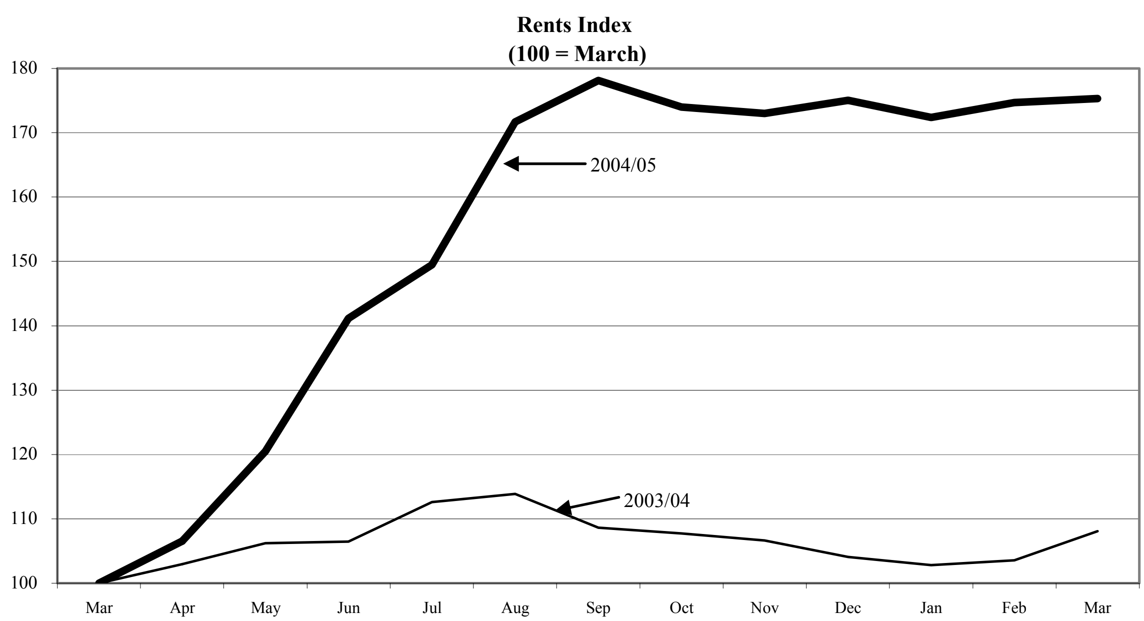
41. **The authorities should press ahead with pending reforms in the statistical area**. Those reforms need to be reinvigorated in order to establish an adequate legal and institutional framework and produce data of international standards. Closer coordination among government agencies and with international donor community is necessary to bring the changes and implement promptly the methodological improvements contained in the statistical master plan. Staff considered also that there is no alternative to an independent CSO and urged the government to take all necessary steps in that direction.

42. **While the institutional mechanism to monitor macroeconomic developments and report core data and information on the implementation of the SMP is in place and working well, there is room for improvemen**t. The technical coordination committee (TCC) needs now to develop an analytical role in the macroeconomic area, and reach out to other government agencies. This will help strengthen the ownership of the reforms and improve domestic capacity.

43. The economic program for 2005/06 represents a strong and credible effort to address the vulnerabilities facing Afghanistan. On this basis, staff supported the authorities' request to complete the fourth review under the SMP.

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

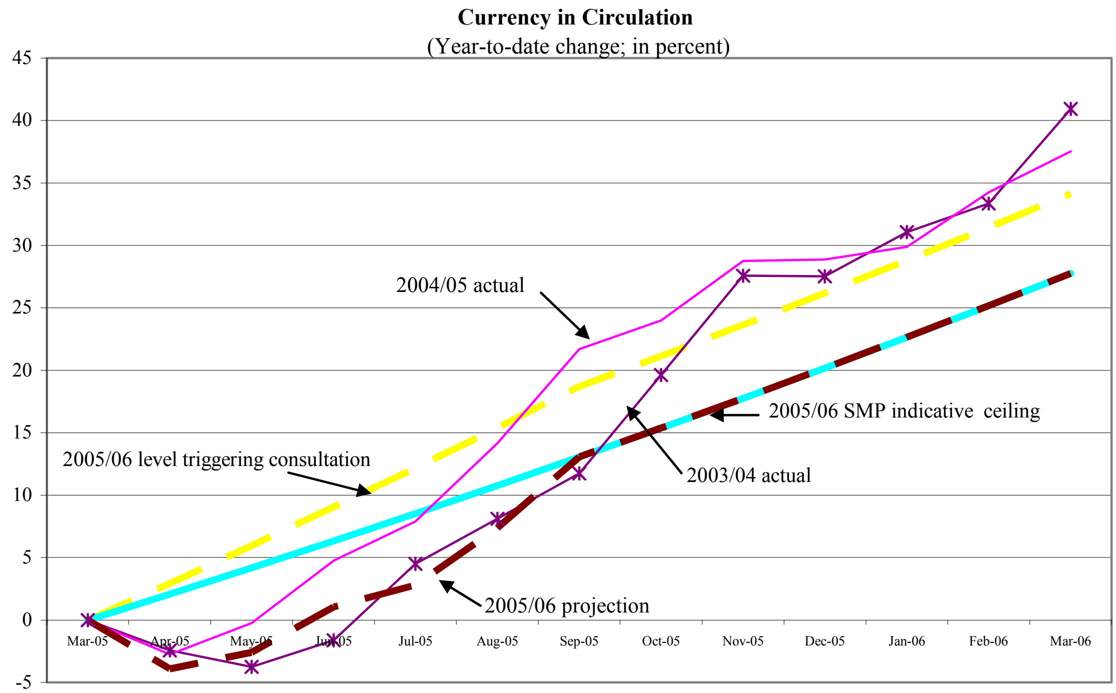


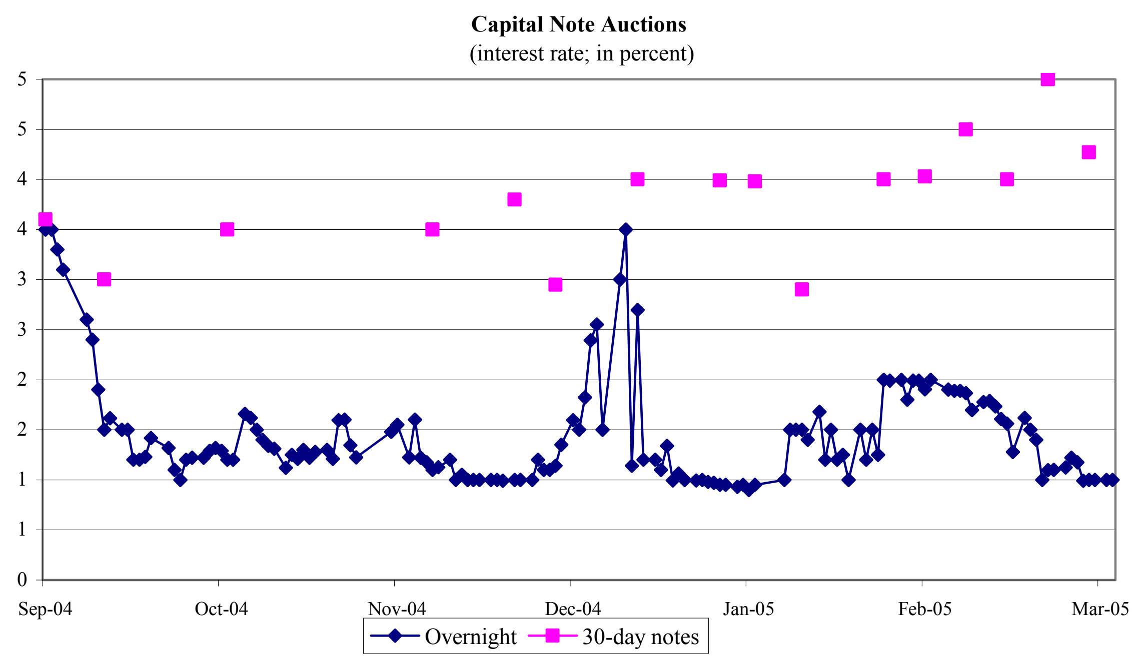


Sources: Central Statistics Office of Afghanistan; and Fund staff estimates.

1/ Last observation: March 2005.

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



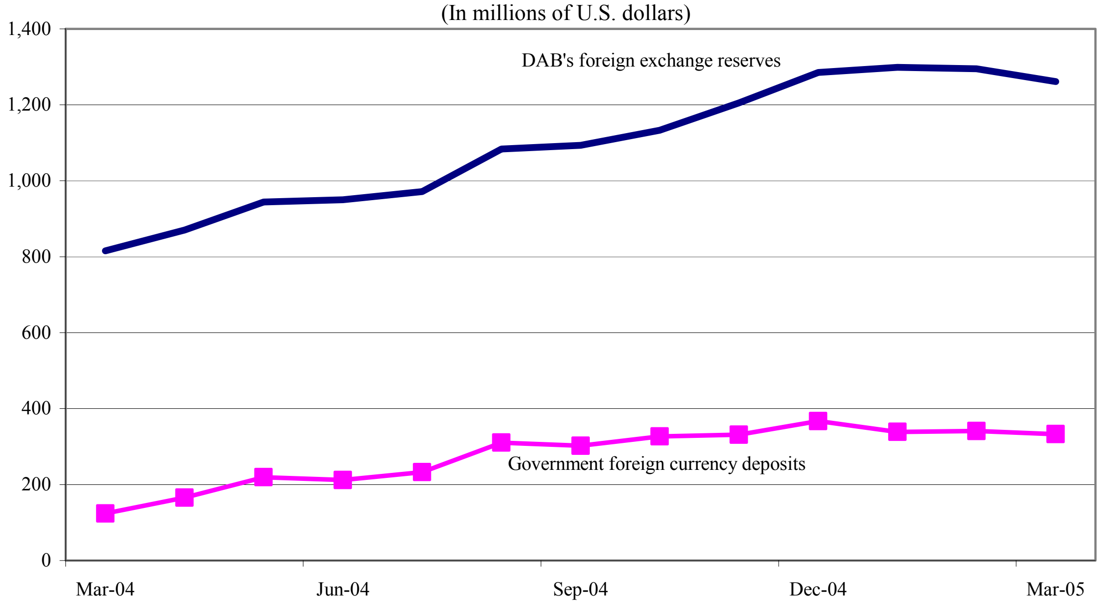


Sources: Da Afghanistan Bank; and Fund staff estimates and projections.

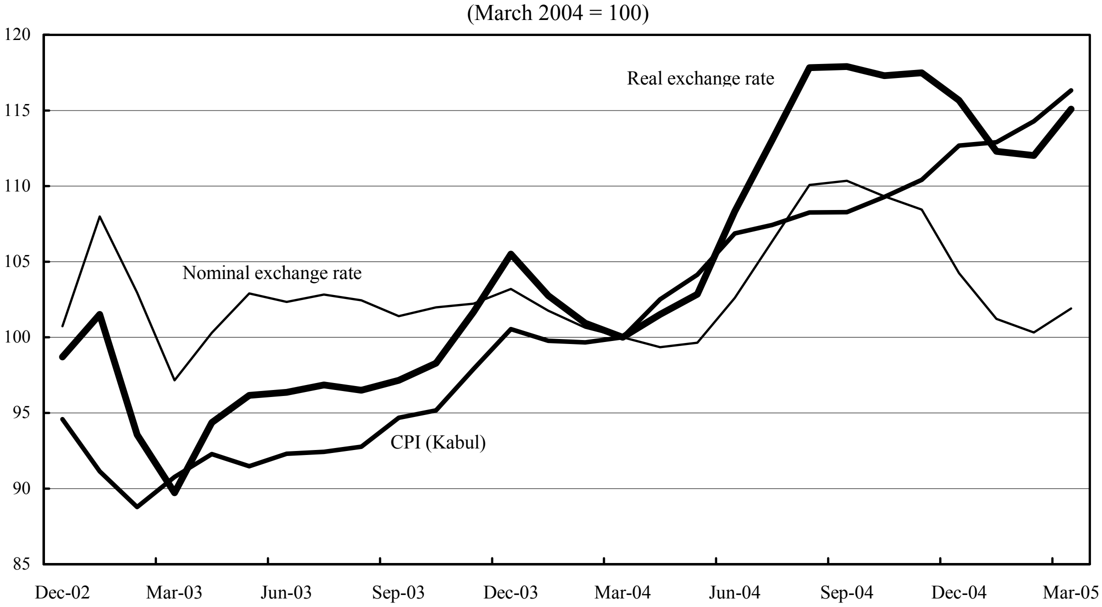
1/ Last observation: March 20, 2005.

Figure 3. Islamic Republic of Afghanistan: Foreign Exchange Reserves and Real Exchange Rate, 2003–05 1/

DAB's Foreign Exchange Reserves and Government Foreign Currency Deposits
(In millions of U.S. dollars)



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



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

1/ Last observation: March 2005.

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.

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

	2001/02 Est.	2002/03 Est.	2003/04 Est.	2004/05 Est.	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	5,941	7,095
GDP (in millions of Afghanis)	133,987	182,862	225,108	283,089	353,627
Real GDP growth rate (in percent)	...	28.6	15.7	7.5	13.6
GDP per capita (in U.S. dollars)	123	182	199	252	292
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	10.2	16.3	10.0
CPI (Kabul, average change; in percent)	...	5.2	24.2	14.3	12.0
	(In millions of U.S. dollars; unless specified otherwise)				
General government recurrent budget					
Revenues	...	132	207	269	368
Expenditures	...	349	451	561	660
Donor grants and loans	...	209	205	314	354
Revenues (in percent of non-opium GDP)	...	3.2	4.5	4.5	5.2
Operating expenditures (in percent of non-opium GDP)	...	8.5	9.8	9.4	9.3
Monetary indicators					
Domestic currency in circulation (annual change; in percent)	...	20.1	40.9	37.5	27.8
Gross foreign exchange reserves	...	426.1	815.9	1,261.3	1,619.5
	(In millions of U.S. dollars; unless specified otherwise)				
External sector					
Exports of goods (including reexports)	708.9	1,290.6	1,893.9	1,750.0	1,916.7
Exports of goods (annual change; in percent)	...	82.1	46.7	-7.6	9.5
Imports of goods	1,645.0	2,508.2	3,785.9	3,863.9	4,534.6
Imports of goods (annual change; in percent)	...	52.5	50.9	2.1	17.4
Imports of oil	...	...	...	...	...
Current account deficit (excluding grants)	...	-1,363.7	-2,334.7	-2,596.5	-3,178.6
Current account deficit (including grants; in percent of GDP)	...	-3.5	3.1	0.0	-0.5
Afghani/U.S. dollar (average)	54.4	44.8	49.0	47.7	...
Afghani/U.S. dollar (end-year)	31.0	52.6	50.3	48.7	...
	(In percent of GDP)				
Investment and savings					
Gross investment	...	28.3	35.2	39.0	39.3
Domestic savings	...	-5.1	-15.7	-4.7	-5.5
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 2005/06 runs from March 21, 2005 until March 20, 2006.

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

	2002/03 Est.	2003/04 Est.	2004/05 Est.	2005/06 Proj.	2006/07 Proj.	2007/08 Proj.
	(In millions of U.S. dollars)					
Domestic expenditures	5,447	6,919	8,538	10,274	11,674	12,642
Consumption	4,293	5,305	6,219	7,485	8,584	9,846
Public 1/	318	429	571	623	669	764
Private 2/	3,975	4,875	5,648	6,863	7,916	9,082
Gross fixed capital formation	1,154	1,615	2,319	2,788	3,089	2,796
Public	1,104	1,557	2,082	2,226	2,404	1,985
Private 3/	50	58	237	562	685	811
Net exports of goods and services	-1,364	-2,335	-2,596	-3,179	-3,409	-3,027
Exports of goods and services (excluding reexports)	328	482	535	677	797	921
Imports of goods and services (excluding reexports)	-1,691	-2,817	-3,131	-3,855	-4,205	-3,947
Domestic savings	-210	-720	-278	-390	-319	-231
Public savings	-187	-203	-275	-205	-207	-222
Private savings	-23	-517	-2	-186	-112	-9
GDP at market prices	4,084	4,585	5,941	7,095	8,265	9,615
	(In percent of GDP)					
Domestic expenditures	133.4	150.9	143.7	144.8	141.2	131.5
Consumption	105.1	115.7	104.7	105.5	103.9	102.4
Public	7.8	9.4	9.6	8.8	8.1	7.9
Private	97.3	106.3	95.1	96.7	95.8	94.5
Gross fixed capital formation	28.3	35.2	39.0	39.3	37.4	29.1
Public	27.0	34.0	35.0	31.4	29.1	20.6
Private	1.2	1.3	4.0	7.9	8.3	8.4
Net exports of goods and services	-33.4	-50.9	-43.7	-44.8	-41.2	-31.5
Exports of goods and services (excluding reexports)	8.0	10.5	9.0	9.5	9.6	9.6
Imports of goods and services (excluding reexports)	-41.4	-61.4	-52.7	-54.3	-50.9	-41.1
Domestic savings	-5.1	-15.7	-4.7	-5.5	-3.9	-2.4
Public savings	-4.6	-4.4	-4.6	-2.9	-2.5	-2.3
Private savings	-0.6	-11.3	0.0	-2.6	-1.4	-0.1
Memorandum items:						
Real GDP growth (annual change; in percent)	28.6	15.7	7.5	13.6	10.9	10.8
Nominal GDP growth (annual change; in percent)	33.8	23.1	25.8	24.9	16.5	16.3
Sectoral shares of GDP (in percent)						
Agriculture	49.8	48.5	37.4	36.2	35.4	34.6
Industry	20.1	21.3	24.1	24.4	25.1	25.1
Services	30.1	30.2	38.5	39.4	39.6	40.3
GDP per capita (in U.S. dollars)	182	199	252	292	330	373
Domestic government revenue (in percent of GDP)	3.2	4.5	4.5	5.2	5.0	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, 2002/03–2006/07

	2002/03 Est.	2003/04 Est.	2004/05 Core Budget 1/	2004/05 Q1 Est.	2004/05 Q2 Est.	2004/05 Q3 Est.	2004/05 Q4 Est.	2004/05 Est.	2005/06 Core Budget	2005/06 Proj. 2/	2006/07 Proj.
					(In millions of Afghanis)						
Domestic revenue	5,864	10,168	15,380	2,689	3,258	2,980	3,873	12,800	16,150	18,328	20,652
Tax revenues	---	6,262	8,886	1,993	2,495	2,201	2,857	9,546	---	12,250	15,636
Taxes on income, profits and capital gains	---	363	1,276	184	360	205	246	995	---	1,923	3,574
Taxes on international trade and transactions	---	5,369	6,039	1,600	1,654	1,708	2,285	7,247	---	8,206	9,322
Other taxes	---	531	1,571	209	482	287	326	1,304	---	2,122	2,741
Nontax revenues	---	3,906	6,341	696	763	779	1,016	3,254	---	6,078	5,016
Donor Assistance Grants (to operating budget)	9,430	10,074	14,952	2,137	1,721	5,429	5,697	14,984	17,195	17,643	19,467
ARTF	---	8,182	12,575	2,137	1,234	4,143	4,804	12,319	13,955	13,955	16,228
LOTFA and Army Trust Fund	---	1,892	2,377	0	404	1,286	893	2,583	3,240	3,240	3,240
Other grants	---	0	0	0	83	0	0	83	0	449	0
Donor Assistance Grants (core development budget)	---	4,569	36,882	856	1,976	1,894	3,525	8,250	25,395	12,908	11,795
Total core budget expenditure	15,514	31,606	67,214	6,073	9,426	11,066	12,984	39,550	79,488	51,951	60,637
Operating expenditure	15,514	22,151	30,332	5,225	6,794	6,186	8,511	26,716	32,883	32,883	40,119
Wages and salaries	---	14,660	20,813	3,411	4,834	4,801	5,855	18,902	20,239	22,263	23,628
Purchase of goods and services	---	4,653	4,862	1,052	1,012	672	1,447	4,182	6,908	4,884	5,373
Transfers and subsidies	---	652	1,471	141	172	238	212	764	1,975	1,975	2,272
Pensions	---	177	724	223	246	227	193	889	1,459	1,459	1,678
Capital expenditure	---	2,009	2,461	399	529	248	803	1,979	2,301	2,301	7,169
Core budget development spending 3/	---	9,455	36,882	849	2,632	4,880	4,474	12,834	46,605	19,068	20,517
National programs	---	3,339	11,817	706	2,519	4,626	4,219	12,070	39,294	15,718	16,466
Livelihoods and Social Protection	---	159	967	105	74	188	194	560	8,667	3,467	635
Culture, Media, and Sport	---	0	0	0	0	0	0	0	468	187	0
Transport	---	75	75	404	254	746	768	2,173	12,465	4,986	4,891
Energy, Mining, and Telecommunications	---	852	4,560	107	151	332	342	932	7,501	3,000	7,140
Natural Resources Management	---	449	1,027	0	1,987	1,292	1,330	4,609	2,572	1,029	1,651
Urban Management	---	394	1,146	0	0	0	0	0	2,028	811	1,128
Trade and Investment	---	95	1,241	0	0	0	0	0	1,585	634	255
Public Administration Reform and Economic Management	---	598	1,605	88	-42	8	8	61	2,821	1,128	766
Justice	---	0	0	0	80	1,501	1,000	2,581	155	62	0
National Police, Law Enforcement, and Stabilisation	---	319	1,196	2	14	560	577	1,153	837	335	0
Afghan National Army	---	399	0	0	0	0	0	0	0	0	0
Mine Action	---	0	0	0	0	0	0	0	194	78	0
National Priority Programs	---	6,115	25,065	142	113	254	255	765	7,312	3,351	4,051
Education and Vocational Training	---	289	1,186	0	47	62	64	172	1,570	628	760
Health and Nutrition	---	508	1,111	142	67	183	188	579	1,480	592	1,919
National Emergency Employment Program	---	2,622	2,103	0	0	0	0	0	0	0	0
National Solidarity Program	---	927	6,998	0	0	0	0	0	0	0	0
Afghanistan Stabilization Program	---	10	3,758	0	0	0	0	0	0	0	0
National Transportation Program	---	1,410	8,637	0	0	0	0	0	0	0	0
National Irrigation Program	---	349	1,271	0	0	0	0	0	0	0	0
National Feasibility Studies Program	---	0	0	0	0	0	0	0	1,211	606	0
Unclassified	---	---	---	---	---	10	3	13	3,050	1,525	1,373
Operating budget balance (excluding grants)	-9,650	-11,983	14,952	-2,536	-3,536	-3,206	-4,638	-13,916	-16,733	-14,555	-19,467
Operating budget balance (including grants)	-219	-1,910	0	-399	-1,815	2,222	1,060	1,068	462	3,089	0
Core budget balance	-219	-6,795	0	-392	-2,471	-764	111	-3,516	-20,749	-3,072	-8,722
Float and adjustment 4/	-657	1,693	0	1,530	-609	3,140	-3,704	357	0	0	0
Financing	876	5,102	0	-1,138	3,080	-2,376	3,593	3,158	20,749	3,072	8,722
External Loans (net)		4,886	0	2,351	6,985	1,894	3,525	14,754	20,559	8,219	8,722
Domestic (net)	876	217	0	-3,489	-3,905	-4,270	68	-11,596	190	-5,147	0
Of which:											
Change in foreign currency deposits 5/	---	396	0	-4,404	-4,508	-3,248	1,703	-10,457	0	-4770	0
Change on domestic currency deposits 5/	-502	-179	0	915	603	-1,022	-1,635	-1,139	190	-377	0
Other financing 6/	1,379	0	0	0	0	0	0	0	0	0	0
Memorandum item:											
External budget expenditure 7/	---	74,528	178,512	---	---	---	---	100,225	156,423	101,675	104,679

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

1/ Budget estimates. Staff projected domestic revenue of Af 12.784 billion for 2004/05.
2/ Staff estimates.
3/ Government program classification.
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 government deposits with Da Afghanistan Bank. A positive sign corresponds to a decline in balances and a negative sign to an increase in balances.
6/ In 2002/03, includes one-off transfers of overflight revenue and customs valuation fees accumulated over several years and the sale of telecommunication licenses.
7/ Development spending outside Treasury accounts.

Table 3b. Islamic Republic of Afghanistan: Core Budget, 2002/03–2006/07

	2002/03 Est.	2003/04 Est.	2004/05 Core Budget 1/	2004/05 Q1 Est.	2004/05 Q2 Est.	2004/05 Q3 Est.	2004/05 Q4 Est.	2004/05 Est.	2005/06 Core Budget	2005/06 Proj. 2/	2006/07 Proj.
	(In percent of GDP)										
Domestic revenue	3.2	4.5	5.4	0.9	1.2	1.1	1.4	4.5	4.6	5.2	5.0
Tax revenues	---	2.8	3.1	0.7	0.9	0.8	1.0	3.4	---	3.5	3.8
Taxes on income, profits and capital gains	---	0.2	0.5	0.1	0.1	0.1	0.1	0.4	---	0.5	0.9
Taxes on international trade and transactions	---	2.4	2.1	0.6	0.6	0.6	0.8	2.6	---	2.3	2.3
Other taxes	---	0.2	0.6	0.1	0.2	0.1	0.1	0.5	---	0.6	0.7
Nontax revenues	---	1.7	2.2	0.2	0.3	0.3	0.4	1.1	---	1.7	1.2
Donor Assistance Grants (to operating budget)	5.2	4.5	5.3	0.8	0.6	1.9	2.0	5.3	4.9	5.0	4.8
ARTF	---	3.6	4.4	0.8	0.4	1.5	1.7	4.3	4.0	4.0	4.0
LOTFA and Army Trust Fund	---	0.8	0.8	0.0	0.1	0.5	0.3	0.9	0.9	0.9	0.8
Other grants	---	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0
Donor Assistance Grants (core development budget)	---	2.0	13.0	0.3	0.7	0.7	1.2	2.9	7.2	3.7	2.9
Total core budget expenditure	8.5	14.0	23.7	2.1	3.3	3.9	4.6	14.0	22.6	14.8	14.8
Operating expenditure	8.5	9.8	10.7	1.8	2.4	2.2	3.0	9.4	9.3	9.3	9.8
Wages and salaries	---	6.5	7.3	1.2	1.7	1.7	2.1	6.7	5.8	6.3	5.8
Purchase of goods and services	---	2.1	1.7	0.4	0.4	0.2	0.5	1.5	2.0	1.4	1.3
Transfers and subsidies	---	0.3	0.5	0.0	0.1	0.1	0.1	0.3	0.6	0.6	0.6
Pensions	---	0.1	0.3	0.1	0.1	0.1	0.1	0.3	0.4	0.4	0.4
Capital expenditure	---	0.9	0.9	0.1	0.2	0.1	0.3	0.7	0.7	0.7	1.7
Core budget development spending 3/	---	4.2	13.0	0.3	0.9	1.7	1.6	4.5	13.2	5.4	5.0
National programs	---	1.5	4.2	0.2	0.9	1.6	1.5	4.3	11.2	4.5	4.0
Livelihoods and Social Protection	---	0.1	0.3	0.0	0.0	0.1	0.1	0.2	2.5	1.0	0.2
Culture, Media, and Sport	---	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.0
Transport	---	0.0	0.0	0.1	0.1	0.3	0.3	0.8	3.5	1.4	1.2
Energy, Mining, and Telecommunications	---	0.4	1.6	0.0	0.1	0.1	0.1	0.3	2.1	0.9	1.7
Natural Resources Management	---	0.2	0.4	0.0	0.7	0.5	0.5	1.6	0.7	0.3	0.4
Urban Management	---	0.2	0.4	0.0	0.0	0.0	0.0	0.0	0.6	0.2	0.3
Trade and Investment	---	0.0	0.4	0.0	0.0	0.0	0.0	0.0	0.5	0.2	0.1
Public Administration Reform and Economic Management	---	0.3	0.6	0.0	0.0	0.0	0.0	0.0	0.8	0.3	0.2
Justice	---	0.0	0.0	0.0	0.0	0.5	0.4	0.9	0.0	0.0	0.0
National Police, Law Enforcement, and Stabilisation	---	0.1	0.4	0.0	0.0	0.2	0.2	0.4	0.2	0.1	0.0
Afghan National Army	---	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Mine Action	---	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.0	0.0
National Priority Programs	---	2.7	8.8	0.1	0.0	0.1	0.1	0.3	2.1	1.0	1.0
Education and Vocational Training	---	0.1	0.4	0.0	0.0	0.0	0.0	0.1	0.4	0.2	0.2
Health and Nutrition	---	0.2	0.4	0.1	0.0	0.1	0.1	0.2	0.4	0.2	0.5
National Emergency Employment Program	---	1.2	0.7	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
National Solidarity Program	---	0.4	2.5	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Afghanistan Stabilization Program	---	0.0	1.3	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
National Transportation Program	---	0.6	3.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
National Irrigation Program	---	0.2	0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
National Feasibility Studies Program	---	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.3	0.2	0.0
Unclassified	---	---	---	---	---	0.0	0.0	0.0	0.9	0.4	0.3
Operating budget balance (excluding grants)	-5.3	-5.3	5.3	-0.9	-1.2	-1.1	-1.6	-4.9	-4.8	-4.1	-4.8
Operating budget balance (including grants)	-0.1	-0.8	0.0	-0.1	-0.6	0.8	0.4	0.4	0.1	0.9	0.0
Core budget balance	-0.1	-3.0	0.0	-0.1	-0.9	-0.3	0.0	-1.2	-5.9	-0.9	-2.1
Float and adjustment 4/	-0.4	0.8	0.0	0.5	-0.2	1.1	-1.3	0.1	0.0	0.0	0.0
Financing	0.5	2.3	0.0	-0.4	1.1	-0.8	1.3	1.1	5.9	0.9	2.1
External Loans (net)	0.0	2.2	0.0	0.8	2.5	0.7	1.2	5.2	5.8	2.3	2.1
Domestic (net)	0.5	0.1	0.0	-1.2	-1.4	-1.5	0.0	-4.1	0.1	-1.5	0.0
Of which:											
Change in foreign currency deposits 5/	---	0.2	0.0	0.3	0.2	-0.4	-0.6	-0.4	0.0	-0.1	0.0
Domestic banking financing 5/	-0.3	-0.1	0.0	-1.6	-1.6	-1.1	0.6	-3.7	0.1	-0.1	0.0
Other financing 6/	0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum item:											
External budget expenditure 7/	---	33.1	63.0	---	---	---	---	35.4	44.5	28.9	25.5

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

1/ Budget estimates. Staff projected domestic revenue of Af 12.784 billion for 2004/05.
2/ Staff estimates.
3/ Government program classification.
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 government deposits with Da Afghanistan Bank. A positive sign corresponds to a decline in balances and a negative sign to an increase in balances.
6/ In 2002/03, includes one-off transfers of overflight revenue and customs valuation fees accumulated over several years and the sale of telecommunication licenses.
7/ Development spending outside treasury accounts.

Table 4. Islamic Republic of Afghanistan: Monetary Program (Da Afghanistan Bank), 2003/04–2005/06

	2003/04	2004/05					2004/05	2005/06			
	Est. Mar. 19	Est. Jun. 20	Est. Sep. 21	Est. Dec. 20	Proj. Mar. 20	Est. 1/ Mar. 20	Est. 1/ Mar. 20	Proj. Jun. 20	Proj. Sep. 21	Proj. Dec. 20	Proj. Mar. 20
	(In millions of Afghanis)										
Net foreign assets 2/	39,199	45,920	53,302	62,838	60,946	61,612	61,612	61,420	66,106	75,199	79,748
Foreign assets	41,169	47,890	55,272	64,808	62,916	63,582	63,582	63,390	68,076	77,169	81,718
Foreign exchange reserves	40,665	47,357	54,488	64,047	62,116	62,861	62,861	62,600	67,215	76,239	80,718
Gold 2/	14,015	14,015	14,015	14,015	14,015	14,015	14,015	14,015	14,015	14,015	14,015
Other	26,650	33,341	40,473	50,032	48,101	48,846	48,846	48,585	53,200	62,223	66,703
Other foreign assets	503	533	784	761	800	721	721	791	860	930	1,000
Foreign liabilities	-1,970	-1,970	-1,970	-1,970	-1,970	-1,970	-1,970	-1,970	-1,970	-1,970	-1,970
Net domestic assets	-8,075	-14,161	-17,287	-23,886	-19,391	-19,702	-20,549	-19,720	-19,511	-25,601	-26,977
Domestic assets	6,795	3,307	-599	-4,869	-1,049	-4,800	-19,751	-18,628	-18,128	-23,898	-24,898
Net claims on general government	6,795	3,307	-599	-4,869	-1,049	-4,800	-19,751	-18,628	-18,128	-23,898	-24,898
Net claims on government before 2002/03	14,951	14,951	14,951	14,951	14,951	14,951	0	0	0	0	0
Net claims on government in 2002/03–2004/05	-8,155	-11,643	-15,549	-19,819	-16,000	-19,751	-19,751	-18,628	-18,128	-23,898	-24,898
Domestic currency deposits	-1,984	-1,069	-466	-1,488	-1,500	-3,123	-3,123	-2,000	-1,500	-2,500	-3,500
Foreign currency deposits	-6,171	-10,575	-15,083	-18,331	-14,500	-16,628	-16,628	-16,628	-16,628	-21,398	-21,398
Other claims	0	0	0	0	0	0	0	0	0	0	0
Other items net	-14,870	-17,468	-16,688	-19,017	-18,342	-14,902	-799	-1,092	-1,383	-1,703	-2,080
Reserve money	31,124	31,759	36,015	38,953	41,555	41,911	41,063	41,701	46,595	49,598	52,771
Currency in circulation 3/	28,801	30,172	35,054	37,116	39,755	39,611	38,763	39,163	43,820	46,585	49,521
Banknotes and coins issued	29,726	31,226	36,226	39,426	41,555	41,228	41,228	41,762	46,553	49,452	52,521
less cash holdings 3/	925	1,054	1,172	2,310	1,800	1,617	2,465	2,599	2,732	2,866	3,000
Bank deposits with DAB and capital note holdings	2,323	1,587	962	1,836	1,800	2,300	2,300	2,537	2,775	3,012	3,250
	(In percent, unless otherwise indicated)										
Memorandum items:											
Currency in circulation (SMP indicative ceiling; in millions of Afghanis)	...	...	...	...	39,755	...	...	41,216	43,820	...	...
Currency in circulation (level triggering discussions; in millions of Afghanis)	...	...	...	...	41,532	...	...	42,271	46,061	...	...
Currency in circulation (year-to-date change)	40.9	4.8	21.7	28.9	38.0	37.5	...	1.0	13.0	20.2	27.8
Currency in circulation (year-on-year change)	40.9	...	...	...	38.0	37.5	...	32.6	27.7	28.3	27.8
Gross international reserves (end-of-period level; in millions of U.S. dollars)	815.9	950.2	1,093.3	1,285.1	1,246.3	1,261.3	1,261.3	1,256.0	1,348.6	1,529.7	1,619.5
Consumer prices in Kabul (quarterly change)	-0.6	6.8	1.3	4.0	...	3.2	3.2	...	...	...	...
Consumer prices in Kabul (annual change)	10.2	15.5	14.1	11.9	13.0	16.3	16.3	...	...	...	10.0

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

1/ The second March 20 column takes into account the writing-off of DAB's claims on the government anterior to 2002/03, as per the TMU signed by DAB and the Ministry of Finance. The difference in currency in circulation corresponds to a change in definition (see footnote 3).

2/ Foreign currency amounts converted into Afghani at the program exchange rate (Af 49.84 per U.S. dollar in 2004/05–2005/06). The gold is valued at $400 per ounce in 2004/05–2005/06 and does not include the gold held in the palace vaults.

3/ In 2003/04–2004/05, cash holdings only include cash in DAB's treasury vaults and in DAB's six major provincial branches. In 2005/06, they include cash in DAB's Treasury vaults and in all DAB's provincial branches.

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

	2002/03 Est.	2003/04 Est.	2004/05 Est.	2005/06 Proj.	2006/07 Proj.	2007/08 Proj.
	(In millions of U.S. dollars)					
Trade balance	-1,217.6	-1,892.0	-2,113.8	-2,617.9	-2,925.3	-2,673.7
Exports of goods 1/	1,290.6	1,893.9	1,750.0	1,916.7	1,917.7	1,697.8
Domestic exports	276.8	376.8	457.2	571.0	664.7	773.0
Reexports	1,013.9	1,517.1	1,292.8	1,345.6	1,253.0	924.7
Imports of goods	2,508.2	3,785.9	3,863.9	4,534.6	4,843.0	4,371.4
Recorded imports	1,142.3	1,688.5	1,993.1	2,481.3	2,850.6	2,800.4
Duty free	840.0	1,000.0	1,203.3	1,326.3	1,335.6	1,075.1
Of which: commodity food aid	94.0	40.9	107.8	0.0	0.0	0.0
Other	525.9	1,097.4	667.5	727.0	656.8	495.9
Services	-145.1	-439.3	-486.8	-573.9	-502.4	-375.9
Receipts	50.8	105.5	77.5	105.5	131.9	147.6
Payments	195.9	544.8	564.3	679.4	634.3	523.5
Income (net)	-1.1	-3.4	4.1	13.2	19.1	23.0
Interest receipts	0.0	4.9	13.8	25.3	32.8	38.3
Interest payments 2/	1.1	8.3	9.7	12.1	13.7	15.3
Current transfers 3/	1,221.7	2,476.7	2,593.8	3,144.9	3,310.1	2,337.2
Public	1,170.1	2,421.7	2,518.7	3,048.3	3,233.5	2,275.6
Commodity food aid	94.0	40.9	107.8	0.0	0.0	0.0
Other	1,076.2	2,380.8	2,410.9	3,048.3	3,233.5	2,275.6
Other	51.6	55.0	75.1	96.6	76.6	61.6
Current account (including grants)	-142.0	142.0	-2.7	-33.7	-98.5	-689.4
Current account (excluding grants)	-1,363.7	-2,334.7	-2,596.5	-3,178.6	-3,408.6	-3,026.6
Capital and financial account	144.0	147.7	345.6	381.2	404.2	429.7
Foreign direct investment	50.0	57.8	186.9	212.4	235.4	260.9
Public loans	94.0	89.9	158.7	168.8	168.8	168.8
Disbursement	100.2	96.1	164.9	175.0	175.0	175.0
Amortization paid 2/	6.2	6.2	6.2	6.2	6.2	6.2
Net errors and omissions	-153.3	-89.3	-145.7	0.0	0.0	0.0
Overall balance	155.3	379.0	488.5	347.5	305.7	-259.8
Financing	-155.3	-379.0	-488.5	-347.5	-305.7	259.8
Changes in reserve assets						
Foreign exchange of the DAB	-101.0	-389.4	-499.1	-358.2	-316.6	248.8
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	-54.3	10.4	10.6	10.7	10.9	11.0
Memorandum items:						
Official foreign exchange reserves						
In millions of U.S. dollars	426	816	1,261	1,620	1,936	1,687
In months of prospective imports 4/	1.8	3.1	3.9	4.6	5.5	5.1
Current account balance (in percent of GDP)						
Including grants	-3.5	3.1	0.0	-0.5	-1.2	-7.2
Excluding grants	-33.4	-50.9	-43.7	-44.8	-41.2	-31.5
GDP (millions of U.S. dollars)	4,084	4,585	5,941	7,095	8,265	9,615

Sources: Afghan authorities; and 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. Tables 3a and 3b reflect only grants to the core budget and not those financing projects implemented directly by donors.

4/ In months of imports of goods and services, excluding imports for reexport.

Islamic Republic of Afghanistan: Relations with the Fund

(As of May 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	0.02	0.07

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	0.33	0.67	0.67	0.67	0.67
Total	0.33	0.67	0.67	0.67	0.67

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

Nonfinancial Relations

IX. **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 from the Fund. A joint LEG/MFD mission is envisaged to take place over the next few weeks. 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 June 30, 2005, the average exchange rate on the Kabul money exchange market was Af 50.15 per $1.

To conduct monetary policy, the authorities rely on foreign exchange auctions since May 2002 and on short-term capital note auctions since September 2004. The foreign exchange auctions are open to all licensed money changers, while the capital note auctions are open to commercial banks. Auctions are linked to the overall monetary program and are held on a regular basis (weekly for foreign exchange auctions, daily for capital note auctions). Reserve requirements have started to be implemented in May 2005.

X. 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.

XI. Technical Assistance, 2004–05

Department	Date	Purpose
FAD	March 2004 (ongoing)	Resident Treasury Expert
	March 22–April 3, 2004	Tax policy and administration
	April 18–May 2, 2004	Customs administration
	May 19–25, 2005	Seminar of reorganization of the MoF.
MFD	February 2–6, 2004	Anti-money laundering legislation
	March 21–30, 2004	DAB capital adequacy and balance sheet structure
	December 2004 (ongoing)	Training coordinator
	February 2–15, 2005	Implementation of DAB balance sheet reconstruction and capital adequacy recommendations
	May 16-25, 2005	Monetary Policy and Financial Markets
LEG	February 2–6, 2004	Anti-money laundering legislation
	March 3–21, 2004	Fiscal revenue legislation
	January 29–February 12, 2005	Income Tax Law
STA	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
	March 23–June 11, 2005	Multisector Statistics
MCD	April 16–20, 2005	Basic Macroeconomic Accounting Relationships and Introduction to Financial Programming

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

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

A resident multisector statistical advisor, Mr. Soulatha, was stationed in Kabul on July 17, 2002. STA has provided technical assistance 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 technical assistance, are scheduled to be delivered over a 12-month period. The first two missions took place from January 15–February 15, 2005 and from March 23–June 11, 2005, respectively.

During 2004, with financial support from the Sweden Technical Assistance SubAccount, the Fund has sponsored a number of training activities aimed at DAB officials and conducted a full-scale training program for DAB. A long-term training advisor, Mr. Khan, was appointed in October 2004. He 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 and is being implemented. Finally, Sweden has agreed to finance during the period December 2004–December 2005 a monetary policy peripatetic advisor, Mr. Coats, 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.

X. **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. Mr. Charap succeeded him on June 13, 2005.

Islamic Republic of Afghanistan: Relations with the World Bank

(As of June 23, 2005)

1. A second Transitional **Support Strategy** (TSS) was presented to the World Bank Board of Executive Directors in March 2003. This was due to be updated by March 2005 following the culmination of the political process outlined in the Bonn process. Despite a successful presidential election in October 2004, legislative elections in Afghanistan have been postponed until September 2005. This delay in the political process, coupled with the government's intentions to develop a National Development Strategy (I-PRSP) in 2005, have delayed the World Bank's efforts to develop a new Interim Strategy Note. The government has just started working on the National Development Strategy. The World Bank will continue to assist the government in operating under the existing TSS and will quickly prepare an Interim Strategy Note, or Country Assistance Strategy, in line with the government's plans for the National Development Strategy.

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). Two new projects, **Public Administration Capacity Building** ($27 million), and **Strengthening Higher Education** ($40 million), and a supplemental financing for the **Emergency Transport Project** ($45 million) have been approved in 2005. An additional project (**National Solidarity Program**) is planned for end of June 2005, for an additional commitment of $28 million. This will bring FY 2005 commitments to $285 million.

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 (2002/03), the ARTF mobilized \$185 million and disbursed \$65 million. Paid-in contributions for 2003/04 amounted to \$286 million, while disbursements reached \$254 million. Paid-in contributions for 2004/05 amounted to \$380 million, while disbursements reached \$292 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 17 investments as of June 2005 (one project has closed). In addition, a budget support operation was approved in July 2004. Total commitments since 2001 add up to \$865 million, of which \$429 million in grants.

Kabul, May 18, 2005

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

Dear Mr. de Rato,

1. We have carried out discussions with Fund staff on the fourth review under the staff-monitored program (SMP) agreed to in March 2004 and updated on September 6, 2004, December 29, 2004, and February 3, 2005, respectively. We have reached understandings on the policies for 2005/06 and on the priorities for the medium term. The focus of our strategy continues to be on achieving high rates of economic growth in a non-inflationary environment and reducing poverty through sustainable fiscal and monetary policies and structural reforms aimed at increasing revenue mobilization, rationalizing public spending, facilitating the development of the private sector, and at improving governance.

2. The attached update to the Memorandum of Economic and Financial Policies (MEFP) reviews macroeconomic developments and the implementation of structural reform measures during 2004/05, and describes the objectives and policies the government intends to pursue during the first half of 2005/06.

3. We are pleased to inform you that our program remains on track. We have met all the end-March 2005 indicative quantitative indicators and structural benchmarks, with the exception of the benchmark related to the completion of a survey of external debt. This benchmark was not met on account of the limited response from external creditors, which prevented a full reconciliation of this debt. Recognizing the importance of this survey in the design of an external debt management policy, we have reached understandings with Fund staff on a new end-September 2005 structural benchmark related to the completion of this survey. The Government of Afghanistan would appreciate assistance from the IMF in contacting our creditors and ensuring observance of this structural benchmark.

4. 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. 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 directly related to the SMP.

Sincerely yours,

/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

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

Fourth Review Under the Staff-Monitored Program, 2004/05–2005/06

May 18, 2005

I. Introduction

1. This update to the Memorandum of Economic and Financial Policies (MEFP) reviews performance during the fourth quarter (January–March 2005) of the Staff-Monitored Program (SMP) and describes policies and targets for the first half of 2005/06. The program will continue to be guided by the macroeconomic and structural reform policies described in the MEFP of March 24, 2004, and in the updates of September 6, 2004, December 29, 2004, and February 3, 2005. The next review under the SMP, scheduled for August 2005, will assess performance during the first quarter of 2005/06. Key issues will include: assessing progress toward implementing tax and customs reforms; fiscal and external sustainability; and modernization of the banking system. Table 1 contains the updated quantitative targets while Table 2 sets out the structural benchmarks for end-June 2005 and end-September 2005. This update to the MEFP includes several additional reform measures.

2. Despite unfavorable security conditions, we continue, in the context of SMP, to maintain macroeconomic stability, build capacity, and improve our statistical base. We observed all end-March 2005 indicative quantitative targets and structural benchmarks, with the exception of the benchmark related to the completion of the survey of external debt, due to some creditors not responding to our requests for reconciliation of liabilities. We will take advantage of the extension of the SMP through end-September 2005 to pursue our capacity-building efforts, broaden ownership of the reform strategy, and improve policy formulation and implementation.

II. Developments Under the SMP

3. **Real GDP growth for 2004/5 is estimated to have been in line with the SMP projection (7.5 percent), with a fall in agricultural output being more than offset by buoyant activity in telecommunications and construction**. Consumer prices in Kabul increased by 3.2 percent during the fourth quarter, reflecting a further increase in food prices (5.8 percent) stemming from the poor agricultural crop. Year-on-year inflation reached 16.3 percent at end-2004/05, compared with 10.2 percent a year earlier.[1] The increase in

[1] Inflation was lower in the provinces than in Kabul: the “national” consumer price index, which covers five major cities in addition to Kabul, increased by 2.7 percent during the fourth quarter and by 10.9 year-on-year at end-2004/05.

inflation was largely attributable to the acceleration of rents, education fees, and petroleum product prices. Excluding these items, which account for less than 10 percent of the consumer basket, year-on-year inflation declined slightly in 2004/05, to 10.3 percent, from 10.8 percent at end-2003/04.

4. **Provisional data indicate that domestic revenue for 2004/05 reached Af 12,800 million, slightly above the SMP indicative target (Af 12,784 million), but below the budget forecast of Af 15,380 million (Table 3)**. The SMP target was met despite the fact that administrative difficulties resulted in the delayed (May 2005) collection of Af 797 million in overflight charges, although they accrued in 2004/05. Customs duties exceeded their target by approximately 20 percent and constituted about 50 percent of revenue, compensating for a shortfall in tax and nontax revenues.

5. **The shortfall in revenue relative to the budget was more than offset by lower operating expenditures.** Although operating budget expenditure increased substantially during the fourth quarter, the annual amount of Af 26.7 billion fell short of the midyear review projection of Af 29.1 billion for 2004/05 (the original budget was Af 30.3 billion). This resulted mainly from continued delays in recruiting teachers and in implementing the main civil service restructuring program. Enhanced expenditure controls and compliance have improved fiduciary standards significantly over the year and facilitated more timely grant disbursements from the multidonor trust funds. Overall, the operating budget, including grants, recorded a modest surplus of Af 1.1 billion for the year.

6. **The rate of development spending has improved but remains well below budget expectations.** In 2004/05, core budget development spending amounted to Af 12.9 billion and external budget spending, which is implemented directly by donors, was reported at $2 billion, compared with budget estimates of Af 38.4 billion and $3.5 billion, respectively. Development spending continues to be hampered by: (i) the lack of capacity in line ministries and implementing agencies to develop and implement projects; (ii) the lead time required to design and initiate projects; and (iii) security concerns.

7. **Amendments to the income tax law and the new customs code were published in the Official Gazette in March 2005, introducing a more efficient regime for providing tax incentives to private investors**. In support of our policy of fiscal transparency, we also published an estimate of revenue forgone as a result of the previous regime of tax exemptions and concessions—estimated conservatively at $14.6 million for 2005/06, equivalent to 4.4 percent of budgeted revenue, and over $30.2 million since 2003/04. The report also highlighted the extent to which the previous tax regime favored particular sectors, such as construction, which should not have been the primary beneficiaries of such incentives.

8. **Currency in circulation increased by 38 percent in 2004/05 reaching Af 39.6 billion at end-year, slightly below the SMP indicative target (Af 39.8 billion)**. To meet this target, Da Afghanistan Bank (DAB) stepped up its foreign currency auctions to $105 million (Af 5.1 billion) during the fourth quarter, so as to offset partly the monetary expansion resulting from the increase in government spending. Since increased spending was

partly financed through a drawdown of government's deposits with DAB, foreign exchange reserves declined slightly during the fourth quarter to $1.3 billion (equivalent to 3.9 months of projected 2005/06 imports). The interest rate on the overnight capital note remained low, at 1–2 percent, while the rate on the one-month note, whose auctions remain undersubscribed, increased modestly to 5 percent at end-March. The nominal exchange rate appreciated by 3.4 percent in 2004/05 to Af 48.7 per U.S. dollar at end-year, although the rate was stable during the final quarter.

9. **Further progress was made in restructuring DAB's balance sheet and in strengthening the banking sector regulatory framework.** The cessation of DAB's headquarters-based commercial activities was completed by end-March: about 30 percent of the relevant current accounts and 20 percent of the savings accounts were closed, while the remainder, whose owner was not identified or that were not claimed, were transferred to a **control account**.[2] The ownership of the silver and gold held in the palace vaults was transferred to DAB and an independent local expert has started working on their valuation. DAB's commercial holdings, which comprised state-owned banks and enterprises, were transferred to the government. The audit of DAB's end-2003/04 financial statements was finalized. The commercial banking law was published in the Official Gazette and a set of new banking regulations, related to corporate governance, foreign exchange positions, and enforcement activities, was adopted by DAB's Supreme Council. And DAB has started to enforce reserve requirements, currently set at 8 percent.

10. **The current account deficit, excluding grants, reached 43.7 percent of GDP in 2004/05, down from 50.9 percent in 2003/04.** While foreign direct investment (FDI) and concessional borrowing increased, this deficit continued to be mainly financed by grants (Table 5). Including grants, the current account was broadly balanced in 2004/05, down from a 3.1 percent of GDP surplus in 2003/04. This mostly reflected a rise in imports not associated with reexports. External borrowing remained limited and on highly concessional terms. Net errors and omissions remained high.

A. Macroeconomic Objectives

11. **We recognize that there are significant challenges ahead and that security conditions, weak capacity, and bureaucratic impediments pose risks to program implementation.** Nonetheless, we will continue to implement prudent economic policies in 2005/06 with the aim of maintaining macroeconomic stability and sustaining economic growth while fighting pervasive poverty.

[2] As agreed under the SMP, foreign delegations, international agencies, government agencies, and public enterprises were permitted to keep accounts with DAB. A control account does not allow for any transaction, with the exception of a final cash withdrawal.

12. **Economic policies for 2005/06 are consistent with our medium-term objectives of spurring private sector-led growth while enhancing external and fiscal sustainability**. The success of this strategy is predicated on a substantial increase in revenue, notably through better tax and customs administration, as well as improved efficiency of expenditure. Expenditures will be consistent with the priorities identified in the National Development Strategy, which we have begun to define, and should help to move towards the Millennium Development Goals.

13. **In 2005/06, real GDP growth is expected to increase to 13.6 percent, reflecting largely a rebound in agricultural output due to better precipitation.** While slowing down, activity in construction, transport, and telecommunications is expected to continue to grow steadily. Reflecting some tightening of the monetary stance, as well as an expected slowdown in food price and rent increases, inflation is projected to decline to 10 percent year-on-year by end-2005/06.

14. **There has been a reduction in poppy cultivation due to the anti-narcotics campaign and to a decline in farm gate prices triggered by the bumper harvest in 2004.** It is uncertain, however, whether this will translate into a significant reduction in opium production as yields are expected to rise due to better weather conditions. We are vigorously pursuing the anti-narcotics strategy developed with our external partners, which is built upon eradication, interdiction, alternative livelihoods, and education.

B. Fiscal Policy

15. **The operating budget for 2005/06 is prudent and should provide a solid base for developing a medium-term budgetary framework**. Despite an uncertain level of external funding, the operating budget was approved before the start of the fiscal year (March 21), which enabled us to avoid a repeat of the payment delays that occurred at the beginning of previous fiscal years. Although some uncertainty about the level of donor financing remains, we have maintained the no-overdraft policy and are funding the operating budget only from revenue and external grants.[3] Despite demands for additional spending, recurrent expenditures are budgeted to grow broadly in line with nominal GDP.[4]

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[3] Grants from the Afghanistan Reconstruction Trust Fund (ARTF) and the Law and Order Trust Fund for Afghanistan (LOTFA) are expected to increase to cover over half of operating budget expenditures in 2005/06. Indications of donor commitments suggest that the ARTF and LOTFA will have sufficient funds to cover operating budget requirements.

[4] The operating budget provides for a 15 percent increase in recurrent spending over the mid-year review projections for 2004/05, while the lower-than-expected outturn for 2004/05 implies an increase of around 23 percent.

16. **In anticipation of further donor commitments, an 'interim' development budget was approved at the start of the fiscal year.** This interim budget presented the main priorities of the government for the year, but was not fully funded as some donors had not confirmed their commitments.[5] We will continue to request that donors channel funds through the budget, or alternatively via the multidonor trust funds. Any additional donor funding committed for 2005/06 will be allocated to development spending, unless it finances recurrent expenditures previously funded directly by donors. In the latter case, it will be absorbed within the operating budget. Any such changes would be presented in a supplementary budget. Core development spending financed through the treasury is currently budgeted to increase from 4.5 percent of GDP in 2004/05 to 13.2 percent of GDP in 2005/06. This increase reflects the growing capacity of line ministries to implement projects, the readiness of donors to implement projects through the budget, and the completion of the design stage for some large projects.

17. **Improving the consistency of the budget presentation and developing a realistic medium-term fiscal framework will help to manage expectations**. The current presentation of the budget combines cash and commitment concepts, and therefore significantly overstates the actual amount of spending expected within the year. To better manage expectations among the population regarding development spending, as well as to reflect the possibility of a limited absorptive capacity over the medium term, we will continue to improve the transparency and realism of the development budget formulation and reporting. We will adopt a more standard and consistent cash-based presentation of the budget within a medium-term framework and provide regular quarterly reports on the core budget.

18. **Developing an affordable and efficient public administration is an essential element to attain a sustainable fiscal position**. Salary costs represent about 75 percent of operating expenditures and are expected to increase over the medium term due to ongoing public administration reforms and the need to absorb additional security spending, notably the Afghan National Army. While we appreciate the need to contain pressures for generalized or sector specific pay increases, quantitative limits on the wage bill might be best introduced in the context of a comprehensive medium-term public administration reform. Until such a program is in place, hopefully for the next fiscal year, we will continue to contain the wage bill consistent with the implementation of the Priority Restructuring and Reform (PRR) program. We will also continue to limit borrowing to highly concessional external loans.

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[5] The interim budget was approved prior to the Afghanistan Development Forum (ADF) donor meeting in early April 2005.

19. **Domestic revenue for 2005/06 should be higher than budgeted**. The SMP target for 2004/05 was achieved despite the delay in receipt of the overflight charges, which suggests that domestic revenue should be higher than budgeted in 2005/06.[6] The SMP revenue target was revised accordingly.[7]Prior to the midyear review, any additional domestic revenue above the budget forecast will be used to either: (i) offset shortfalls in budgeted grant resources for the operating or development budgets; or (ii) build the government's prudential cash reserves. The midyear review will give us the opportunity to assess, in collaboration with the donor community and in light of the National Development Strategy (NDS), the scope for budgetary adjustments.

20. **We are committed to accelerating the customs and tax administration reform programs**. Our strategy will continue to focus on the medium-term reforms for improving compliance, on taxpayer education, and on identifying areas where the potential revenue yield appears highest, rather than on quick actions that may not necessarily lead to sustainable improvements. At the same time, we will rationalize the 'nuisance' taxes (notably the fixed taxes) and remove illicit charges. Priority will also be given to ensure that the large taxpayer office (LTO) identifies and starts to work with its main clients, rather than diverting scarce human resources to collect revenues from smaller taxpayers. We will accelerate the restructuring of the revenue headquarters and the new provincial revenue offices. New tax revenue enforcement powers to support the revenue administration should be in place by end-September 2005. We are also developing new regulations to support the new customs code and we will continue to improve customs infrastructure, to roll out a computerized management information system, and to introduce the new customs police service. We have requested IMF technical assistance to help review and prioritize our customs and tax reform programs.

21. **We will continue to address the structural impediments to better fiscal management.** We are committed to promulgating the new public financial management law by end-June 2005 and expect to develop the accompanying financial regulations shortly thereafter. The new system that links the Ministry of Finance with DAB enables us to more promptly reconcile the main government bank accounts with the expenditure data and we are confident of meeting this end-September 2005 structural benchmark. Finally, we have approved a timetable for the submission of the audited financial statements to parliament before end-September 2005.

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[6] The updated forecast for 2005/06 accounts for the payment of two overflight charges (one paid in May 2005 but accrued in 2004/05 and one accrued and paid before the end of 2005/06), and is based on the higher-than-expected 2004/05 outturn of other domestic revenue.

[7] The budget forecast will not be amended at this time.

C. Monetary and Exchange Rate Policies

22. **Monetary policy will continue to be guided by the monetary program developed with Fund staff at the time of the third review**. While the upward revision of growth projections for 2005/06 might have justified an upward revision of the growth of currency in circulation, we consider that, in view of the increase in prices in the fourth quarter of last year, a conservative approach is warranted at this stage. So as to allow for a possible tightening of the monetary stance at a point in the budget cycle where the government is drawing down its deposits with DAB, the end-June indicative target for gross international reserves was revised downward. The revised target is consistent with a coverage of four months of prospective imports at end-2005/06 The exchange rate will remain flexible: while DAB may intervene to smooth short-term exchange rate fluctuations, it will not resist persistent pressures on the exchange rate, especially when such resistance is not consistent with the objective of reducing inflation. Given the uncertainty surrounding both money demand and the efficiency of monetary policy, the monetary program will remain flexible, allowing for a revision of the monetary stance in consultation with the Fund when warranted by exchange rate and price developments.

23. **We will continue to restructure DAB's balance sheet and improve monetary reporting.** The transfer of DAB's commercial activities remains a priority. By end-September, we will finalize the transfer of these activities in Kabul's 14 city branches and in the 10 provincial branches located where at least one commercial bank operates. By end-June, we will publish DAB's audited 2003/04 financial statements. In light of the preliminary estimate of the gold and silver held in the palace vault, we will also determine whether DAB is adequately capitalized. While we anticipate DAB to be adequately capitalized, we stand ready to take action regarding its recapitalization. In collaboration with the commercial banks, we will work toward improving the timeliness and reliability of monetary reporting.

24. **We will continue to modernize the banking sector.** Based on the findings of the IMF technical assistance mission on monetary policy, we will explore broadening DAB's monetary instruments, so as to strengthen its control over liquidity. In particular, we intend to develop an interbank market and to modernize our foreign exchange and capital note auctions. We also intend to tackle some of the administrative impediments to the development of the banking sector, including the absence of laws supporting financial market development (e.g., bankruptcy and corporate laws) and high fees (e.g., property registration). We will play a more active role in restructuring the state-owned banks with technical assistance from our partners. By end-June 2005, we will take a decision regarding the specific resolution process for each of the former state-owned banks that were not relicensed and begin implementation of that decision. Finally, by end-September 2005, in accordance with our shareholder responsibilities, we will prepare a long-term strategic plan for the restructuring of the three state-owned banks.

D. External Policy and Debt Management

25. **The outlook for the external accounts remains favorable.** Under relatively conservative assumptions on donor inflows, private investment flows, and ongoing structural changes in the economy, we expect the current account balance to deteriorate slightly in 2005/06, to a deficit of 0.5 percent of GDP. Over the medium term, we expect imports to remain high and to continue to be financed through donor inflows. Higher levels of domestic and foreign investment should help to expand of our export base.

26. **Building upon IMF technical assistance, we have improved the framework for compiling the balance of payments in line with international standards.** Trade data have been reconciled with the national accounts, while key components of the balance of payments have been compiled using surveys. Over the next few months, we will begin to compile balance of payments data on a quarterly basis and implement other key recommendations of the IMF technical assistance mission. To this end, we are requesting further external support so that our statistical agencies can implement the proposed surveys.

27. **We remain committed to pursuing a cautious external debt management strategy, relying on grant financing and highly concessional borrowing.** While grant financing remains high, there is significant pressure from some donors to increase borrowing to fund our large investment needs, especially in infrastructure. Given the still fragile post-conflict environment, we strongly believe that uninterrupted multilateral and bilateral support is fundamental to maintain medium-term fiscal and external sustainability and ensure the success of our financing strategy. Consistent with the SMP, we will continue to adopt a prudent debt strategy, and seek generous debt relief from existing bilateral creditors.

28. **The end-March 2005 benchmark related to the completion of a full reconciliation of the survey of external debt was not met on account of the limited response from creditors.** We are committed to continue our good faith efforts to reconcile fully our external liabilities and complete the survey of external debt by end-September 2005 (a new structural benchmark). As a first step, we intend to seek the assistance of the Paris Club Secretariat to help contact Paris Club creditors regarding outstanding obligations. We also welcome the assistance of Fund staff in facilitating contacts between the government of Afghanistan and officials of non-Paris Club creditors.

E. Structural Reforms

29. **More generally, we remain committed to creating an environment friendly to private investment**. Structural reforms to that effect are underway and include work to introduce a modern and simplified tax system, establish an adequate legal framework for business, simplify procedures for enterprises, and publication in the Official Gazette of an investment law. We are also focusing our efforts on restructuring state-owned enterprises (SOEs). Classification of the SOEs by envisaged restructuring method and an economic restructuring plan should be adopted by the Cabinet by end-September 2005.

F. Poverty Reduction Strategy

30. **We have started working with the donor community to prepare a National Development Strategy, which will form the basis for an Interim Poverty Reduction Strategy Paper (I-PRSP) by end-October 2005**. Accordingly, we are taking steps to establish an institutional framework to coordinate and conduct work on the I-PRSP. The working group of predominantly Afghan experts is now in place and will be working under an Inter-Ministerial Committee that should be established shortly.

G. Statistical Issues

31. **The improvement of the statistical database remains a central concern of the government of Afghanistan**. In that context, and consistent with the current work program to implement the statistical master plan, we will adopt a statistical law by end-September 2005. In addition, with support from the donor community, the Central Statistical Office will be restructured. Finally, we intend to launch in June–July 2005 three key surveys, including the national risk vulnerability assessment survey on rural households, the integrated living standard survey on household income and expenditure, and the integrated business enterprise survey (expected to cover a sample of about 1000 medium and large enterprises). These surveys will help strengthen the statistical database and feed into the work on poverty reduction conducted in the context of the National Development Strategy,

H. Technical Assistance

32. **We are continuing an assessment of the technical assistance we have received from various donors to rationalize technical assistance throughout the government**. We anticipate that this assessment will lead to some redeployment of resources to broaden ownership of the reform program. We greatly appreciated the recent technical assistance program put in place by the IMF to address technical assistance needs in the fiscal, monetary, consumer price inflation, balance of payments, and legal areas.

I. Program Monitoring

33. **The SMP 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-June, 2005, and end-September 2005 are included in Table 1. The structural benchmarks are set out 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, and will notify Fund staff prior to taking any policy actions and developments that might impact upon the program.

34. **The Technical Coordination Committee (TCC) is gradually developing ownership of the program.** It will continue in the months ahead to monitor implementation of the SMP and provide core data to the Fund. At the same time, we see the need for the TCC to broaden its role and develop an analytical capacity, while reaching out to other government agencies. We will also engage the TCC with the work on the macroeconomic issues that need to be covered in the context of the work involved with the NDS and I-PRSP.

35. **Discussions on the fifth review of the program are scheduled to take place in early August 2005**, based on indicative targets and benchmarks for end-June 2005. At the time of those discussions, the quantitative indicators and structural benchmarks for end-September 2005 may be revised in light of developments.

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	
	Dec. 20	Dec. 20	Mar. 20	Mar. 20	Jun. 20	Sep. 20
	Indicative Target	Preliminary Estimate	Indicative Target	Preliminary Estimate	Indicative Target	Indicative Target
Currency in circulation (ceiling) 1/	9,265	8,315	10,954	10,847	2,453	5,057
Claims of the banking system on the central government (ceiling)	0	0	0	0	0	0
Gross international reserves of the central bank (floor) (in millions of dollars)	115.0	469.5	115.0	445.4	-50	0
Fiscal revenue of the central government (floor)	8,649	8,880	12,784	12,800	4,629	8,306
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
b) New nonconcessional debt with an original maturity of less than one year (ceiling) 3/ 4/ 5/	0	0	0	0	0	0
Memorandum item:						
Currency in circulation (level triggering consultation)	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, March 2005–September 2005

Structural Benchmarks	**Target Date**	**Status**
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	Implemented
Consolidate all recent revenue measures into the existing revenue code and publish as a single document.	End-March 2005	Implemented
Complete the survey of external debt, including reconciliation with creditors.	End-March 2005	Not Implemented [1/]
Transfer of DAB's commercial holdings to the Ministry of Finance, and transfer of ownership of marketable gold and silver in the palace vaults to the DAB.	End-March 2005	Implemented
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.	End-March 2005	Implemented
Approve (by the Cabinet) the Customs Code.	End-March 2005	Implemented
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	Implemented
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 Ministry of Finance, to address all existing tax exemptions or concessions.	End-March 2005	Implemented
Publish in the Official Gazette the banking law.	End-March 2005	Implemented
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 account.	End-September 2005	
Publish the 2004/05 audited financial statements (core budget).	End-September 2005	
Adopt (by Cabinet) a comprehensive external debt management strategy.	End-September 2005	

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

Structural Benchmarks	Target Date	Status
Contact the Secretariat of the Paris Club to assist with the comprehensive review of, and reconciliation of, debt owed to Paris Club creditors; and continue to contact the non-Paris Club creditors for a full reconciliation of external obligations, including those that did not respond to earlier requests for debt reconciliation.	End-September 2005	
Publish in the Official Gazette: the proposed amendments to the income tax law to provide for administrative powers and for additional corporate tax reform measures.	End-September 2005	
Commence implementation of recently approved tax measures, notably the business receipt tax on hotels, restaurants, telecommunications, and airlines and the wage withholding tax, accompanied by a taxpayer education program.	End-September 2005	

1/ Some donors did not respond to the authorities' request for debt reconciliation.

Amendment to the Technical Memorandum of Understanding

1. Paragraph 5 will be replaced with: "Currency in circulation is defined as total currency (new Afghani) issued by DAB. It excludes currency held in the presidential palace vault, in DAB main vault, and in the vaults of DAB's provincial branches, but includes currency in the vaults of DAB's district branches."