

**Islamic State of Afghanistan: 2004 Article IV Consultation and Second Review Under the Staff-Monitored Program—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Islamic State of Afghanistan**

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2004 Article IV consultation with the Islamic State of Afghanistan and second review under the staff-monitored program, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation and second review under the staff-monitored program, prepared by a staff team of the IMF, following discussions that ended on November 3, 2004, with the officials of the Islamic State of Afghanistan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 4, 2005. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff statement of January 19, 2005 updating information on recent developments.
- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its January, 19, 2005 discussion of the staff report that concluded the Article IV consultation.
- a statement by the Executive Director for the Islamic State of Afghanistan.

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

Letter of Intent sent to the IMF by the authorities of the Islamic State of Afghanistan\*  
Memorandum of Economic and Financial Policies—Update\*  
Technical Memorandum of Understanding—Update\*  
Selected Issues Paper and Statistical Appendix  
\* May also be included in Staff Report

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

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INTERNATIONAL MONETARY FUND

ISLAMIC STATE OF AFGHANISTAN

**Staff Report for the 2004 Article IV Consultation  
and Second 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 Saleh M. Nsouli and Matthew Fisher

January 4, 2005

- Discussions for the 2004 Article IV consultation and the second review under the Staff-Monitored Program (SMP) were held in Kabul from October 20–November 3, 2004. The mission met with Vice-President Arsala, Minister of Finance Ghani, Minister of Foreign Affairs Abdullah, Da Afghanistan Bank Governor Ahady, and other senior officials, as well as representatives of the diplomatic community, nongovernmental organizations, the business community, and international organizations. The Afghan authorities published the concluding statement and have agreed to publish the staff report, the updated Memorandum of Economic and Financial Policies (MEFP), and the Letter of Intent after their distribution to the Executive Board.
- The 12-month SMP covers the fiscal year 2004/05 (March 20, 2004–March 20, 2005). It aims at maintaining financial stability and building institutional capacity. If implemented successfully, and assuming a balance of payments need, it may pave the way for an arrangement under the Poverty Reduction and Growth Facility (PRGF).
- In concluding the 2003 Article IV consultation (the first such consultation since 1991), Executive Directors noted that prudent macroeconomic management had, together with sizable aid and the end of the drought, provided an environment conducive to the resumption of economic growth. They underscored the need for donors to continue to provide substantial assistance, and noted that revenue-raising measures would be needed to ensure the independence of the operating budget in due course. They saw merit in a “lightly managed” float for a country that remains vulnerable to shocks and is undergoing structural change and reconstruction. They were concerned about the risks posed by the opium economy and urged the authorities to intensify eradication, while offering alternative livelihoods.
- The mission members consisted of Messrs. Symansky (head), Bessaha, Martin (all MCD), Schneider (PDR), and Thomas (FAD). The mission was assisted by the resident representative, Mr. de Schaetzen. Mr. Farhadi (Advisor to Mr. Mirakhor) participated in some of the policy discussions.
- The security situation, while stable in the run-up to the presidential election, could deteriorate in the period preceding the parliamentary elections currently scheduled for April 2005. The United Nations (UN) continues to rate Afghanistan at Security Phase III.
- Looking beyond March 2005, the authorities indicated that they would like to continue with the SMP and, in the absence of any immediate balance of payments need, wait until after the forthcoming elections before considering a Fund-supported arrangement. In the interim, they have initiated consultations on the PRSP process.

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### **List of Acronyms**

AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
ARTF	Afghanistan Reconstruction Trust Fund
CIRRs	Commercial Interest Reference Rates
CPI	Consumer Price Index
DAB	Da Afghanistan Bank
ISAF	International Security Assistance Forces
MDGs	Millennium Development Goals
MEFP	Memorandum of Economic and Financial Policies
MoF	Ministry of Finance
OECD	Organization for Economic Cooperation and Development
PRGF	Poverty Reduction and Growth Facility
SMP	Staff-Monitored Program
SOEs	State-Owned Enterprises
TCC	Technical Committee of Coordination
TA	Technical Assistance
TSA	Treasury Single Account
UN	United Nations
UNODC	United Nations Office on Drugs and Crimes
WTO	World Trade Organization

## Executive Summary

- **Economic performance under the SMP has been broadly in line with program commitments.** The quantitative indicators and structural benchmarks in the SMP have largely been met, despite weak administrative capacity, security concerns, and political considerations. GDP continues to grow steadily, although slower than expected largely because of a prolonged drought, while inflation has been moderate. Domestic revenue has been slightly higher than programmed, while both current and development expenditures have been below budget. However, further progress could have been made in implementation of some structural measures.
- **The drug economy continues to increase.** The government and the international community are tackling this issue, but this could lead to social, economic, and political instability over the near term. Success in this area will depend upon a multi-faceted approach, including developing alternative livelihoods, while continuing with macroeconomic and structural reforms conducive to sustained growth.
- **The authorities would like to continue with an SMP, at least until after a Parliament is elected, to sustain the reform momentum and build capacity.** Although the SMP has been on target, the country faces major economic and social risks.
- **The authorities' medium-term strategy is articulated around:** increased security; private sector-led growth; strengthened revenue efforts; prudent monetary policy; eliminating the drug economy; and institution-building. Successful implementation of structural reforms will be critical.
- In the context of a managed float, the authorities agreed to continue implementing a monetary policy anchored by a target for currency in circulation.
- The authorities are committed to introduce an ambitious structural fiscal reform agenda to achieve fiscal sustainability over the medium term.

## I. BACKGROUND AND OVERVIEW

1. **Afghanistan's first direct presidential election, which took place on October 9, 2004, represents an important milestone in rebuilding the nation's institutional framework.** President Hamid Karzai was elected with 55 percent of the vote. Following his inauguration on December 7, and after a lengthy consultative process, President Karzai appointed a new cabinet on December 23, 2004, giving more prominence to technicians to the detriment of regional factions. The new economic team, who signed the attached Letter of Intent, is expected to pursue the current agenda of economic reforms.<sup>1</sup> Parliamentary elections are currently scheduled for April 2005.
2. **While economic policies have been essentially in line with Fund staff recommendations and the SMP (Section III), further progress could have been made in implementation.** In many instances, the authorities complied with the program benchmarks, but follow-through has been weaker than envisaged—often due to weak administrative capacity, security concerns, or political considerations.
3. **The security situation remains unpredictable but generally calm.** The longer-term implications of the kidnapping (and release) of UN staff members remain a matter of concern among security experts. Although the situation is expected to remain volatile until the general elections, the international community remains actively involved in the country.
4. **The foremost challenge facing the authorities is the drug economy.** Drug activities have continued to increase, and there is a substantial risk that Afghanistan will (or already has) become a narco-state. The latest United Nations Office on Drugs and Crimes (UNODC) report indicates that poppy production continued to rise in 2004, with cultivation spreading to new areas of the country and involving an increasing share of the population. Drug revenue is estimated to have risen to \$2.8 billion, equivalent to about 60 percent of nondrug GDP.<sup>2</sup> Despite a higher export value, a steep drop in the average farm gate price cut farmers' gross drug income by 40 percent to about \$600 million, while proceeds to traders and laboratories rose sharply (more than 70 percent) to \$2.2 billion. The government and the international community are developing a common strategy to abate the drug economy. The manner in which this strategy is implemented will be critical in maintaining social, economic, and political stability.

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<sup>1</sup> Mr. Ahady, formerly Governor of Da Afghanistan Bank (DAB), was appointed Minister of Finance. Mr. Delawari, formerly president of the Afghanistan Investment Support Agency, was named Governor of DAB.

<sup>2</sup> While poppy cultivation expanded by 64 percent to a record level (2.9 percent of agricultural land), total production rose by only 17 percent, still below the record level in 1999. The decline in the average yield resulted from adverse weather, disease, parasites, and the inexperience of new farmers.



5. **The return of peace and the ensuing resumption of economic growth have led to some improvement in Afghanistan's social indicators**, which are among the lowest in the world. Refugees have returned to their lands; school enrollment has increased; vaccination campaigns against some deadly diseases were conducted; and food security has improved. Nonetheless, the challenges remain daunting as infant and maternity mortality are still among the highest in the world. Illiteracy still affects 57 percent of men and 87 percent of women, and only 40 percent of the population are reported to have access to drinking water. Electricity is provided to only 17 percent of the rural households. Poverty remains widespread, especially in rural areas.

6. **While still relatively strong, real GDP growth has slowed over the past 18 months, and was lower than expected (Tables 1 and 2)**. This slowdown reflects primarily the negative impact of adverse weather conditions on agricultural production, which notably led to the 25 percent fall in cereal production during the first half of 2004/05. This fall was only partially offset by expansion in other sectors. Increased opium activity, together with the heavy reliance on external support, highlights the fragility of Afghanistan's economic recovery. Increases in rent and fuel prices led to a rise in inflation over the last 12 months, but moderated somewhat during the second quarter of 2004/05 (Figure 1). Year-on-year inflation amounted to 14.1 percent at end-September. Excluding rents and petroleum products, it amounted to 8.3 percent. Reflecting a strong balance of payments, the nominal and real exchange rates vis-à-vis the U.S. dollar have appreciated.

7. **The authorities have maintained their commitment to fiscal discipline and have continued to improve fiscal management**. The government continues to observe the "no-overdraft" financing rule prohibiting borrowing from Da Afghanistan Bank (DAB), as the operating budget continues to be financed by donor grants and concessional disbursements (Table 3). Central government control of provincial revenue and expenditure has sharply improved. Further, the authorities adopted, for the first time in 2004/05, a 'core budget,' to improve coordination and control over donor flows.<sup>3</sup> Over the last 18 months, domestic revenues have exceeded program projections, while expenditures were constrained by delays in recruitment and general procurement. All line ministry accounts have been consolidated into the Treasury Single Account (TSA) and revenue from provincial accounts are now regularly deposited into the TSA. These measures bolstered the central government's ability to monitor and collect revenue, of which 70 percent is collected in the provinces.

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<sup>3</sup> See paragraph 7 of MEFP, IMF Country Report No. 04/364, November 9, 2004 and Box 1 of the Selected Issues Paper, ([www.imf.org](http://www.imf.org)), for a detailed explanation of the various budget concepts. The operating budget covers essentially current expenditures; the core budget consolidates the operating budget with development expenditures channeled through the treasury's accounts; and the external budget refers to fiscal operations implemented directly by donors.

8. **Despite a paucity of monetary instruments, DAB's flexible approach to monetary policy, in the context of a "managed float," has been largely successful in limiting both inflation and exchange rate volatility.** Monetary policy continues to be implemented almost entirely through foreign currency auctions, the only market-based instrument until the recent introduction of short-term capital notes. Monetary policy is guided primarily by indicative targets for currency in circulation (as set out in the SMP). However, in view of the substantial uncertainties surrounding relationships between key macroeconomic variables, DAB uses all available indicators to assess changes in the demand for domestic currency. As illustrated by the recent revision of the monetary program (paragraph 22), DAB stands ready to adjust its monetary stance when necessary to preserve macroeconomic stability.

9. **The government introduced a number of important structural reforms.** Following the adoption of commercial banking legislation, the regulatory framework has been strengthened further through DAB's adoption of banking regulations. Three state-owned commercial banks were granted conditional licenses, while eight private banks—all foreign-owned—were licensed and are now operating. However, only limited progress has been made in restructuring the relicensed state-owned banks, and in resolving the three that were not relicensed. Considerable trade regime reforms have been implemented. As a result, Afghanistan is now one of the most open economies in the region (Box 1). Other important structural reforms include: the introduction of a computerized system for expenditure and revenue operations; the simplification of customs clearance procedures; and the adoption of five-year plans to improve customs and tax administrations.

## II. PERFORMANCE UNDER THE STAFF-MONITORED PROGRAM

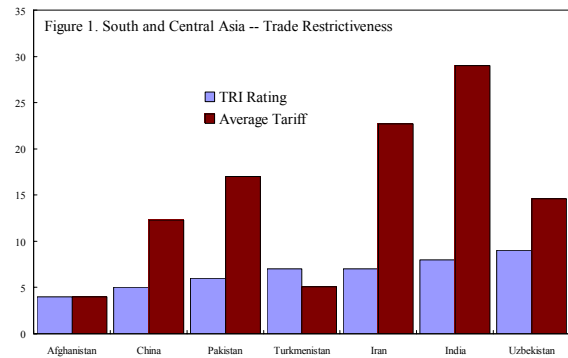
10. **All end-September 2004 quantitative and structural benchmarks under the SMP were observed,** with the exception of the benchmark related to the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) legislation, which was enacted with a short delay. This strong performance was achieved despite a volatile security situation and the mobilization of considerable resources for the presidential election.

11. **After consultation with Fund staff, DAB allowed money growth to exceed its second quarter SMP indicative target** (Table 4). Currency in circulation increased by 22 percent during the first half of 2004/05, compared with an objective of 13 percent (Figure 2). This increase was justified by the sharp appreciation of the Afghani, which, along with the slowdown in inflation, pointed to an increase in money demand (Box 2). DAB's decision to accommodate this increase was instrumental in stabilizing the exchange rate. After appreciating by 20 percent in the first five months of 2004/05, reaching Af 42 per dollar in the third week of August, the exchange rate stabilized in the Af 45–46 per dollar range. Reflecting its foreign exchange activity and a further increase in government foreign currency deposits, DAB's accumulation of international reserves exceeded its indicative floor for the first half of 2004. At end-September, the international reserves were equivalent to over four months of imports (Figure 3).

### Box 1. Afghanistan's Trade Regime

Establishment of an open and transparent trade regime has been a consistent priority of the Afghan authorities—moving in tandem with sweeping reforms to the tariff regime and customs administration. The result has been a significant improvement in transparency and simplicity, leaving Afghanistan as one of the most open economies in the region, although significant work remains to eliminate informal barriers and address governance issues.

Under the trade regime inherited by the transitional government, there were 25 tariff bands, with rates ranging from 7 to 150 percent—with a simple average of about 43 percent (although the effective tariff was much lower, due to the use of a lower exchange rate in import valuation). An overhaul of the tariff system brought the number of rates to six (2.5, 4, 5, 8, 10, and 16 percent), with a relatively low level of dispersion. By virtue of this rationalization, the average tariff also declined to 4 percent. Even with the addition of a range of “fees” (both legitimate and illegitimate), the estimated average applied tariff is only 5.3 percent—the lowest in the region. The effective tariff rose considerably, however, given the authorities’ decision to use market exchange rates in import valuation. Afghanistan maintains bans on only a few products (largely for religious purposes), and imposes no seasonal restrictions, quotas, or other nontariff barriers. Further, licensing requirements—reformed effective April 2004—have been drastically simplified. The import license application process, which previously involved 42 steps, 58 signatures, and several weeks of processing, now involves only three steps, six signatures, and 48 hours to process.



A number of problems remain, however. Some provincial governments reportedly prohibit the use of foreign trucks. There are also other *ad hoc* fees imposed by local governments, warlords, and commanders, but these appear to be evenly applied to all transport, and not just on imported goods. Customs clearance in some areas (for example, in some of the more problematic areas on the border with Pakistan) can also be cumbersome. From a government policy perspective, however, substantial progress is being made to simplify customs administration—including computerization and the introduction of a customs single administrative document.

With regard to international trade policy, the emphasis thus far has been regional—reflecting the large potential for immediate gains from facilitating transit trade with such countries as India, Pakistan, and Iran. This process is expected to continue, with the Afghan authorities seeking to codify relationships with other neighboring economies. On the multilateral level, Afghanistan has recently requested observer status from the World Trade Organization (WTO). Accession to the WTO is a future goal, although the authorities have indicated that a significant number of legal reforms will be required to meet WTO requirements.

### **Box 2. The Deepening of the Domestic Currency Market or “Afghanization”**

**Since the introduction of the new Afghani in late 2002, currency in circulation has increased substantially faster than nominal GDP.** Afghanis in circulation rose by 41 percent during 2003/04 and by 22 percent during the first six months of 2004/05, while nominal GDP growth amounted to 23 percent in 2003/04 and is projected at 19 percent in 2004/05. Overall, the velocity of currency in circulation is estimated to have declined by 13 percent in 2003/04 and by an additional 10 percent during the first six months of 2004/05 (Figure 2).

**This decline in velocity, at a time of moderate inflation and an appreciating currency, points to an increase in demand for the Afghani.** While year-on-year inflation has increased during the first part of 2004/05, from 7 percent at end-December 2003 to 14 percent at end-September 2004, this largely reflects non-monetary factors. Excluding petroleum products, rents, and education, inflation has remained moderate, at 7 percent at end-September 2004 (compared with 6 percent at end-2003). At the same time, the Afghani has steadily appreciated since end-2003, gaining 7 percent vis-à-vis the dollar during the first nine months of 2004.

**This higher demand for the Afghani seems to result from both a monetization and a dedollarization of the economy.**<sup>1/</sup> The use of the local currency as a means of exchange has benefited from: (i) administrative measures aimed at encouraging its use (DAB has insisted that all goods and services be priced in Afghani); (ii) its increasing use by the donor community, such as the U.S. Army for the payment of contractors and Afghan National Army salaries, which has contributed to its diffusion, notably in the rural areas; and (iii) an increased confidence resulting from its stability over the recent period. There is anecdotal evidence that the Afghani is now the preponderant currency for transactions. However, the U.S. dollar remains widely used in a few sectors, such as the telecommunication sector, the trade sector, and the opium economy.<sup>2/</sup> Hence, preliminary data for end-August 2004 indicate that 91 percent of deposits at private commercial banks were in U.S. dollars, reflecting the preferences of their depositors, mostly traders and large companies.

**With a level of monetization similar to that of other least-developed economies, the financial deepening of the Afghan economy is expected to come from the development of the banking sector** (Figure 4). The ratio of reserve money to GDP, at 13 percent at end-September, is slightly higher than that observed in other least-developed countries. This is partly explained by the low level of development of the banking sector, which until recently provided few investment opportunities. Deposits with commercial banks and lending activities represented 1.8 percent and 0.4 percent of GDP, respectively at end-August (these numbers include foreign currency deposits and dormant accounts). As a result, Afghanistan’s broad money to GDP ratio was significantly lower than in similar developing countries. As the banking sector develops, this ratio should increase substantially, while the ratio of currency on circulation to GDP may decline somewhat.

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1/ Due to the lack of reliable data on cash holdings in U.S. dollars, it is not possible to estimate the respective contribution of financial deepening (i.e. increase in the *broad* currency in circulation, including foreign currency holdings) and dedollarization (i.e. decline in currency substitution).

2/ The use of the Pakistani rupee and the Iranian rial, which was sizeable in some of the provinces, now appears marginal.

12. **Domestic fiscal revenue for the first half of 2004/05 reached Af 5.9 billion, exceeding the program target of Af 5.5 billion.** The sharp increase in revenue over the same period last year was attributed to more timely sweepings of provincial revenue into the TSA and to the gradual implementation of customs and domestic tax reforms. Operating budget spending reached Af 12 billion during the first half of 2004/05, compared with the annual budgeted amount of Af 30.3 billion. The rate of security-related spending, representing 51 percent of total operating expenditures, was in line with the budget, while spending on education and social services remained significantly under budget, mainly due to problems in recruiting qualified staff. Core budget development spending reached Af 3.5 billion during the first half of 2004/05, compared with the budgeted Af 38.4 billion, reflecting the late approval of the core budget, the poor security environment, and the limited implementation capacity of line ministries and other agencies.<sup>4</sup> For similar reasons, external budget spending was also quite low, as donors reported disbursements of \$103 million during the first half of 2004/05, compared with annual commitments of \$2.6 billion.

13. **The authorities maintained their “no-overdraft” financing rule but drew down a significant amount of government deposits to finance the operating budget deficit.** As reimbursement from the multi-donor trust funds were lower than expected during the first half of 2004/05, the operating budget deficit was partly financed by a draw-down of domestic deposits, of Af 1.6 billion, and funds from a highly concessional loan, amounting to \$12 million.

14. **Balance of payments data remain of very poor quality.** Nevertheless, preliminary data indicate that the current account deficit narrowed to 12 percent of GDP in the first half of 2004/05, down from 22 percent a year before, and was primarily financed by external grants (Table 5).<sup>5</sup> The decline in the deficit appears to reflect an improvement in the trade balance, including an increase in domestic exports but also a slowdown in imports, likely attributable to delays in project implementation. External borrowing, which is on highly concessional terms, remained limited, reaching an estimated \$104 million during the first semester. The authorities continue to make progress in verifying external obligations to bilateral creditors, and a survey of external debt and reconciliation with creditors is expected to be completed by end-March 2005.

15. **Progress was made in implementing structural reforms under the SMP.** Efforts have focused on implementing tax reforms, extending the consumer price index (CPI) coverage, ensuring a more timely transfer of provincial revenue to the central government accounts, restructuring the state-owned enterprises (SOEs), drafting a private investment law, and establishing a legal framework for extractive industries. In the financial sector, bank

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<sup>4</sup> The 2004/05 core development budget was not approved until end-June, after the start of the fiscal year (March 20) and the Berlin donors' conference.

<sup>5</sup> The balance of payments trends reported here do not incorporate developments in the opium economy or flows associated with U.S. military or activities of the International Security Assistance Forces (ISAF).

regulation was strengthened through enactment of AML/CFT legislation and the adoption of bank reserves requirements. DAB also successfully introduced a short-term capital note (end-December benchmark), a significant step toward establishing a benchmark interest rate. Progress in other areas, however, remained slow. The restructuring of the three relicensed state-owned banks (a requirement under their relicensing) and the resolution of the other state-owned banks appear stalled. Moreover, the recent opening of the foreign exchange auctions to the commercial banks has not been satisfactory as the banks only have access to a fixed allocation, sold on a noncompetitive basis after each auction.<sup>6</sup>

16. The overall process of drafting, adopting, and giving force of law to key reform legislation has encountered a number of bottlenecks in the intergovernmental process, including the limited capacity of the Ministry of Justice. As a result, publication in the official gazette has been delayed for key economic legislation. While a dialogue is underway to remove these obstacles, the process is far from complete.

### **III. MACROECONOMIC OUTLOOK AND POLICY FRAMEWORK FOR THE REMAINDER OF 2004/05**

17. Discussions with the authorities on the program for the remainder of 2004/05 focused on: (i) maintaining macroeconomic stability in a period of political transition and persistent insecurity; (ii) strengthening capacity; and (iii) stepping up structural reforms to spur private investment and improve delivery of government services. The macro-framework was updated and understandings were reached to step up revenue collection, strengthen expenditure management, and improve the business regulatory framework.

18. **Modifications were made to the structural benchmarks for the rest of the year.** Several end-December 2004 benchmarks were moved to end-March 2005: the benchmark related to the transfer to other entities of all DAB commercial activities, because of difficulties in identifying and contacting the owners of commercial accounts opened at DAB; the benchmark related to the piloting of a system to pay salaries and vendors directly, mainly resulting from the limited coverage of the banking system; and the benchmarks related to the publication in the official gazette of the financial management law, to the consolidation of all recent revenue measures into the revenue code, and to the adoption of a list classifying the SOEs according to proposed economic restructuring method, due to administrative delays linked to the lengthy political transition period between the presidential election and the appointment of a new Cabinet. In addition, the end-March 2005 benchmark for asset transfers between the DAB and the Ministry of Finance (MoF) now covers only DAB's commercial holdings, which will be transferred to MoF, and the gold and silver in the

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<sup>6</sup> While not affecting significantly the monetary policy implementation, as the size of these transactions are relatively limited, this fixed allocation creates potential arbitrage opportunities for the commercial banks, as it is available for up to one week (on a first come first serve basis) at the auction exchange rate.

Presidential palace vaults, which will be transferred to DAB.<sup>7</sup> The two institutions will work together to resolve issues related to remaining liabilities, mostly related to Russian claims, currently housed at DAB. Finally, an end-March 2005 benchmark related to the publication of tax amendments in the official gazette was added. The delay in the publication of the revenue laws should not affect significantly the SMP revenue target.<sup>8</sup>

#### **A. Macroeconomic Framework**

19. **The authorities and staff agreed on a revised short-term outlook, with substantially lower growth, and unchanged inflation.** The downward revision of growth, from 16 percent to 8 percent, reflected the sharp reduction in agricultural output during the first half of the year and lingering drought in the southern provinces. At the same time, growth in other sectors was revised upward, as their better-than-anticipated performance during the first half is expected to continue.

#### **B. Fiscal Policy**

20. **Staff concurred with the authorities that the budget revenue target for the year remains ambitious but achievable.** Meeting the budget target for domestic revenue, which, at Af 15 billion (5.6 percent of GDP), is higher than the program target (Af 12.8 billion), will require a significant improvement in revenue collection, including from the provinces, during the second half of the year and is contingent on the implementation of customs and tax reforms and the collection of sizeable over flight charges near the end of the fiscal year (paragraph 16 of MEFP).

21. **Donor funding should be sufficient to finance the core budget in 2004/05.** Budgeted revenue, grants, and program loans for the approved core budget exceed projected expenditures by \$305 million. The government initially planned to allocate this 'surplus' funding to specific development projects at the time of the mid-year review. However, due to the postponement of this review on account of the elections, and given the slow pace of core budget development spending, this additional funding will likely be carried over to subsequent years.

#### **C. Monetary and Exchange Rate Policies**

22. **In view of Afghanistan's vulnerability to external and domestic shocks, it was agreed that a flexible exchange rate remained appropriate and that monetary policy should continue to be anchored on targets for currency in circulation.** Flexibility remains key, however, and, given the stronger-than-expected money demand, the monetary targets for

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<sup>7</sup> The minister of finance has no specific plan (at this juncture) on how to eventually privatize the best assets transferred from DAB. Recent technical assistance from the U.S. Treasury is intended to help address this issue.

<sup>8</sup> While they still have to be published, the revisions to the income tax laws have started to be implemented by the authorities, in accordance with the Ministry of Justice view that they have currently status of law.

the remainder of the year were revised upward. The revised targets still imply a significant tightening of monetary policy in the coming months, as year-on-year money growth is expected to decline from more than 50 percent at end-September 2004 to a maximum of 38 percent at end-March 2005. The revised program should allow DAB to accommodate the anticipated further increase in demand for Afghanis without feeding inflation. As money demand is highly uncertain, the program will remain flexible and will be carefully monitored. In particular, the authorities reiterated their commitment to closely follow price and exchange rate developments and to tighten the monetary stance, should prices accelerate. Finally, in light of the foreign exchange accumulation during the first six months, the authorities agreed to revise upward the indicative floors for international reserve growth for the remainder of the year, to levels consistent with import coverage of 3.5 months at end-2004/05.<sup>9</sup>

#### **D. External Sector**

23. **While limited data render projections for the balance of payments difficult, continued reconstruction and relatively strong economic recovery would suggest a 2004/05 outcome similar to that estimated in 2003/04.** The current account deficit including grants (currently projected at 3.4 percent of GDP) would be more than adequately financed by inward flows, allowing for a continued accumulation of reserves—keeping coverage in terms of imports constant at about four months. Given the large structural changes taking place in the economy, however, staff stressed the need to remain vigilant to emerging pressures on the balance of payments. External borrowing is expected to remain relatively light, given the authorities' cautious approach to new obligations and the current availability of grant financing.

#### **E. Structural reforms**

24. **The authorities recognize the continued presence of structural impediments to private sector activities and investment, and are pursuing reforms to eliminate these obstacles.** In addition to ongoing fiscal and financial reforms, they are pressing ahead with measures to reform public enterprises, and improve governance and transparency, and the legal and institutional environment for private sector investment.<sup>10</sup>

25. **Developing a more robust legal framework is an important component of the strategy to reestablish the rule of law and promote a market-based economy.** A significant amount of economic legislation is at various stages of preparation, including a public financial management law and a customs code (both of which should be approved within the current fiscal year), revisions to the income tax law, and laws to regulate the mining, oil, and gas sectors.

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<sup>9</sup> See IMF Country Report No. 04/110, March 26, 2004, paragraph 19 for an explanation why the floor on international reserves is set at a level lower than the one implied by the monetary projections.

<sup>10</sup> The nonfinancial public enterprise sector in Afghanistan is small, thus limiting the fiscal impact of its restructuring.



26. **Key public expenditure management reforms are being implemented with donor support.** They include: (a) automating the payments system, with electronic funds transfer and a verified payroll (initially for Kabul-based ministries only); (b) improving general compliance with financial management procedures; (c) combining operating and development spending in line with a single new chart of accounts; and (d) reestablishing internal and external audit functions.

27. **Donors are also funding a number of programs to restructure ministries and attract appropriately skilled and experienced Afghan professionals to core managerial and technical positions (see paragraph 27 of MEFP).** Recognizing that these programs are likely to increase the already high share of the operating budget devoted to salaries over the medium term, the authorities intend to undertake a comprehensive pay and grading review which should be linked to the goal of achieving sustainable fiscal position within a few years (see Selected Issues Paper, “Medium-Term Structural Fiscal Reforms,” ([www.imf.org](http://www.imf.org))).

28. **The authorities continue to modernize and reform the banking sector.** The transfer of DAB’s commercial activities and noncore assets to the MoF will allow the central bank to focus on its primary functions. Taken together with an external audit, this will help clarify DAB’s financial situation and facilitate an assessment of whether it is adequately capitalized. Also, the commercial banking regulatory framework will be further strengthened. The authorities are also committed to allowing private banks to play a more prominent role in the foreign exchange market, and to deepen interest in DAB’s short-term capital notes.

#### F. Technical Assistance

29. **Afghanistan’s track record of implementing Fund technical assistance (TA) recommendations is satisfactory.** The Fund’s priority has been to provide policy advice and TA to help Afghanistan establish a sound foundation for economic management and macroeconomic stability. In many areas, where institution building requires extensive resources, the Fund approach has been to set the overall framework, leaving other partners to deliver detailed TA (paragraph 6 of IMF Country Report No. 03/299; September 10, 2003). Recent TA from the Fund under the SMP helped the authorities pass AML/CFT legislation, extend CPI coverage, prepare a balance sheet for DAB, and provide training for DAB officials. However, progress in implementing Fund TA recommendations in customs has thus far been slow. While the authorities praised Fund’s assistance and reiterated their interest in continuing to receive TA, they also expressed disappointment that the Fund has not always been able to deliver, because of security concerns, on TA that was promised in key areas—delaying implementation of structural reforms.

#### G. Data Issues

30. **Afghanistan’s statistical framework is improving but substantial weaknesses remain.** The mission welcomed the progress made in compiling basic real sector data, extending CPI coverage, and improving the reliability and timeliness of fiscal and monetary data. Although broadly adequate for surveillance and program monitoring, the current

provision of data falls short of international standards in terms of quality, frequency, and dissemination. Staff welcome the recent adoption of a statistical master plan and encourage the authorities to establish a clear work program and mobilize the needed resources.

#### **H. Program Monitoring**

31. The Technical Committee of Coordination (TCC) is playing an important role by improving collaboration between the MoF, DAB, and the Central Statistics Office, which has enabled close monitoring of the targets and benchmarks. The program will be monitored through the quantitative indicators and structural benchmarks specified in Tables 1 and 2 of Attachment II.

#### **IV. MEDIUM-TERM OUTLOOK AND REFORM STRATEGY**

32. **Afghanistan's current economic and institutional environment present a number of positive features.** The institutional and political frameworks are broadly in place and economic reforms are progressing. Important tax policy measures combined with ambitious tax and customs administration reforms are helping the central government to regain control over revenue. A financial management law, soon to be adopted, will provide an adequate legal framework for fiscal policy. Modernization of the central bank and reform of the financial system are progressing, although the sector is still in its infancy. The regulatory framework for private investment is expected to receive a boost from the new private investment law and the establishment of a legal framework for extractive industries—an area of potential for new investment and growth. Private investment should also benefit from the privatization of SOEs.

33. **These achievements notwithstanding, Afghanistan still faces major challenges,** including a volatile security situation, a fragmented political environment, a growing drug economy, the continued strength of warlords, an ineffective legal system, poor governance, and widespread poverty. Against this background, staff welcome the government's formulation of a broad-based strategy. This strategy is articulated around: (a) increased security; (b) private sector-led growth; (c) strong revenue efforts to allow funding of recurrent costs within a medium-term horizon; (d) eliminating the drug economy (Box 3); and (e) institution-building. If appropriately followed, this strategy should contribute toward the accomplishment of the 2015 Millennium Development Goals (MDGs).

34. Against this background, staff engaged the authorities in discussions on their medium-term policies only in broad terms as their limited capacity currently precludes a more in-depth discussion. Generally, however, the authorities concurred that Fund staff policy advice was consistent with their long-term strategy as envisioned in the *Securing Afghanistan's Future*.

### **Box 3: Key Elements and Macroeconomic Impact of a Strategy to Fight the Drug Economy**

#### **The 2005 campaign**

The authorities adopted in early 2003 a multiyear anti-narcotics strategy, which aims at completely eliminating opium production by 2012. Although current efforts, including the 2004 eradication campaign, have not been very successful, the expansion of the drug economy would have likely been even more vigorous without them. With the support from donors, the government intends to focus on five key areas during the 2005 campaign:

- An information campaign that will reemphasize the illegal nature of these activities.
- A broad alternative livelihood strategy, focusing especially on rural rehabilitation and development (see Box 4).
- Centralization and intensification of eradication under the responsibility of a newly created department in the Ministry of the Interior.
- Intensification of interdiction actions aimed at traffickers and laboratories.
- Strengthening of the laws, courts, and penal systems to work against production and trading.

In addition, counter-narcotics efforts are being mainstreamed in the government's overall development and reconstruction program. This takes into account the complexity of the drug issue and aims at limiting the social and economic disruptions caused by eradication (physical elimination of the poppy fields) and/or interdiction (legal action against the producers, processors, and traffickers).

#### **Macroeconomic impact**

**The drug economy, which is excluded from GDP, adds to the demand for domestic products and improves the balance of payments.** It impacts the nondrug economy primarily through the income it generates, and the use of this income varies according to the economic actor. **Farmers**, who accounted for less than 25 percent of the estimated \$2.8 billion of drug income in 2004, consume a large part of their earnings, mostly on domestic goods. **Processors and traffickers**, while consuming some domestic and imported goods, probably save, or spend, much of their income outside the country. This group imports raw materials and drug-related capital goods (for transport, processing, and security), and also invests part of its savings domestically (the current construction boom appears to be partly financed through drug revenue). As opium is exported, and as long as some income is spent domestically, the drug economy contributes positively to the balance of payments. However, the drug economy negatively affects the competitiveness of other domestically produced goods through high wage rates and a higher real exchange rate (similar to "Dutch disease"). The macroeconomic effect of a counter-narcotic campaign will depend on the method used. Eradication tends to raise farm gate prices due to lower production, while interdiction tends to lower farm gate prices due to lower demand by traffickers. Thus, these policies create different incentives and rates of return for farmers and traffickers.

**A successful campaign could adversely affect GDP growth, the balance of payments and government revenue.** Due to a highly inelastic demand, an eradication campaign could result, at least temporarily, in higher incomes for farmers, but also for the traffickers, which would be able to sell their stocks at higher prices.<sup>1/</sup> A multi-pronged strategy, if successful, should however result in a lower drug income, leading to a slowdown in real growth in the nondrug economy and a deterioration of the balance of payments, putting downward pressure on the exchange rate. The relative magnitude of this shock to GDP would be less to the extent that the burden falls on traffickers. On the external side, the high foreign savings and import content associated with drug revenue suggest that the impact on the balance of payments would be substantially less than the total decline in drug revenue. However, this impact could be temporarily accentuated by capital flight, as some traders and traffickers may want to protect their assets from increased scrutiny. The slowdown in growth and the decline in imports will in turn affect negatively government revenue.

**Overtime, the reallocation of resources to the nondrug sector will allow higher recorded growth.** *Ceteris paribus*, the real depreciation of the exchange rate resulting from lower demand and the deterioration of the balance of payments, will contribute to the reallocation of resources to the export sector. Depending on monetary policy, this depreciation will come from a nominal depreciation and/or a relative decline in domestic prices. The current level of international reserves will allow the central bank, through a tightening of its monetary stance, to avoid unwarranted exchange rate depreciation.

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<sup>1/</sup> While the overall impact on farmers revenue would be positive, the social impact could be substantial, as the farmers directly touched by the eradication campaign would lose their main source of revenue.

### A. Macroeconomic Framework

35. While recognizing that recent growth rates will be difficult to maintain, the authorities expect an average annual growth rate of 9 percent over the medium term will be needed to address poverty and unemployment and meet the MDGs (Box 4). In support of this target, investment is expected to average about 25 percent of GDP over the next five years, reflecting: (a) continued donor support averaging about 29 percent of GDP; (b) a gradual rise in foreign private sector investment (mostly in the form of foreign direct investment); and (c) higher levels of productivity from accelerated structural reforms. Fiscal policy targets a level of current spending averaging about 12 percent of GDP, while capital spending would decline to 17 percent of GDP by 2007/08, facilitating an expansion of private sector investment. Consumption, reflecting structural changes underway, is projected to fall to 100 percent of GDP over the same period, down from 110 percent of GDP in 2004/05. As structural reforms take hold, the gray economy shrinks, the banking system develops, and security improves, income is expected to rise and alter the household's expenditure and savings patterns. As a result, private savings are projected to rise to 4.1 percent of GDP in 2007/08, up from -5.3 percent of GDP in 2004/05.

36. **This outcome is predicated on:** (a) efficient public spending that supports development and creates an enabling environment for private investment while maintaining fiscal stability; (b) public enterprise reform; and (c) accelerating market reform and promoting the rule of law and greater transparency. But even more important, the government must overcome deeply rooted problems impeding reform (paragraph 33). Furthermore, although official statistics are not available, there is evidence that wage rates have become relatively high for the region, largely driven by the aid and drug economies.

### B. Medium-Term Fiscal Policy

37. The authorities are committed to promote fiscal sustainability over the medium term. Their fiscal policy is designed to ensure that the government achieves its policy objectives within the resources available, deliver basic government services efficiently, and facilitate budget execution and monitoring. The authorities intend to continue implementing a broad structural fiscal reform agenda centered around (a) continuing to consolidate fiscal management; (b) rebuilding and broadening the domestic tax base; and (c) developing an effective public administration and public expenditure management system (see Selected Issues Paper, "Medium-Term Structural Fiscal Reforms" ([www.imf.org](http://www.imf.org))).

### C. Monetary and Exchange Rate Policies

38. **Monetary policy will be implemented under a managed float.** It will continue to be anchored by a target for currency in circulation but will avoid large and unwarranted changes in the exchange rate, as long as such policy is consistent with maintaining low inflation. The central bank will develop its arsenal of market-based instruments to strengthen its capacity to implement monetary policy. As the banking sector develops and more reliable

#### **Box 4. The Sources of Growth in Afghanistan**

**Following two years of crisis management, the government adopted in early 2004 a broad-based strategy called “Securing Afghanistan’s Future”.** The strategy aims at building a financially self-sustaining state, with the capacity to meet basic social needs and address poverty reduction. Central to this strategy is the need to sustain an annual growth rate in the nondrug economy of at least 9 percent to raise per capita income from \$135 by end-2001 to \$350 by 2015 and to reduce unemployment.

**Over the past three years, growth has rebounded—reflecting sound macroeconomic policies, sizable aid flows, favorable weather conditions, reconstruction efforts, and essential structural reforms.** Non-opium GDP growth reached 29 percent in 2002/03, and almost 16 percent in 2003/04. Agriculture, which represents 48 percent of GDP, was the main engine of this growth. The strong performance in this sector was due largely to the return of some 3 million refugees to farmlands, the timely availability of fertilizers and other inputs, and a temporary end to drought conditions. Other sectors that fueled growth, albeit to a lesser extent, included construction and services, which represent respectively 5 percent and 30 percent of GDP.

**Growth is now expected to slow as various factors that supported the economy in the immediate post-conflict period gradually diminish.** Agricultural growth will be limited by the lingering drought, which is expected to continue as a result of a long-term pattern, and the low potential for a further rise in yields under current techniques (yields are now similar to those in neighboring countries). Value-added in livestock will also suffer from the drought. The boom in construction and services is expected to continue, but will not be sufficient to support the economy. Afghanistan will therefore need to exploit the full potential of existing sectors and identify other leading sources of economic growth.

**Assuming the country addresses the structural impediments constraining private sector investment, including insufficient power and a difficult regulatory environment, economic expansion could be secured not only from some existing sectors but also from new sectors:**

- In the agricultural sector, expansion could come from: (a) extension of the irrigated areas (presently only 40 percent of the cultivated area is under irrigation) to break the total dependence on erratic winter snows and spring rains for water; (b) use of machines, chemical fertilizers, and pesticides to improve the yields and the quality of the grain and other staples; (c) strengthening transportation networks to ensure distribution of food and other goods; and (d) growing staples with more value added, including cotton and sugar beet on an industrialized scale.
- Other sectors with significant scope for growth are trade, construction, and transportation. Trade links are expected to grow over time with neighbors as the country slowly builds its transportation network. The highway system requires total reconstruction, and regional road are in total disrepair.
- New sectors that can contribute to sustained growth include extractive industries. The country is endowed with natural resources, including extensive deposits of natural gas, petroleum, copper, coal, chromites, talk, barites, sulfur, lead, zinc, iron, salt, and precious and semiprecious stones.

monetary data become available, DAB will base its monetary policy decisions on a broader set of indicators, including reserve money and broad money. The authorities will work to strengthen the financial sector legal framework — which currently hinders bank financing of the private sector.

#### **D. External Policy and Debt Sustainability Analysis**

**39. The external accounts will likely be driven by the pace of reconstruction, the availability of new trade opportunities and the impact of recent changes to trade policy.**

Over the medium term, as the external impact of donor projects lessens and the domestic supply of goods and services gradually supplants imports, the current account is projected to improve, reaching a deficit of 2.6 percent of GDP by 2008/09. This should facilitate a similarly gradual accumulation of foreign exchange reserves—to about five months of imports. While conservative, these projections are subject to downside risks, stemming notably from the high share of exports linked to agriculture and animal husbandry products, and from the positive impact of unrecorded capital inflows.

**40. The current cautious approach to external borrowing will remain a key component of economic policy for the near term.** This reflects Afghanistan’s fragile economic position, its relatively scarce foreign exchange earnings (excluding donor flows and drug-related trade), extremely low level of domestic revenue, and lack of clarity regarding the status of some pre-existing bilateral claims. Staff emphasized the need to adopt an explicit strategy to guide external debt management over the medium term. A debt sustainability analysis (see Selected Issues Paper, “Debt Sustainability Analysis,” ([www.imf.org](http://www.imf.org))), conducted as part of the current Article IV consultation, highlighted the potential risks and vulnerabilities associated with external borrowing under different scenarios. The results indicate that, assuming a “clean slate” with regard to old bilateral claims, and reasonably strong economic and revenue performance, there is a comfortable margin with regard to key sustainability thresholds. Through successive macroeconomic and other shocks outlined in the various scenarios, however, this margin quickly diminishes, leading to situations where Afghanistan’s debt and debt service burden would be deemed unsustainable.

**41. The authorities recognized the need to provide the legal framework that conforms to their liberal trade and exchange rate regime to pave the way for accepting the obligations under Article VIII of the Fund’s Articles of Agreement.** This would send a positive signal to investors. Staff reiterated the Fund’s willingness to provide TA in this area.

#### **V. FUND RELATIONS**

**42. The authorities view a formal arrangement with the Fund as one possible pillar in the strategy to fight poverty and unemployment.** However, until a new parliament is in place, and in the absence of any immediate balance of payments needs, they favor continuing

with an SMP to sustain the reform momentum, improve policy formulation, and strengthen administrative capacity. Staff were encouraged by the decision to initiate, in cooperation with the donor community, work on an Interim Poverty Reduction Strategy Paper.

## VI. STAFF APPRAISAL

43. **Under the current SMP, Afghanistan is making headway in macroeconomic management and structural reform.** Prudent fiscal and monetary policies have helped to contain inflation and facilitate relatively high levels of growth. Afghanistan's performance during the first semester of the SMP is encouraging. Notwithstanding an array of challenges and demands, the authorities implemented a demanding program, more heavily focused on structural reforms than on quantitative targets, and have largely met every benchmark.

44. **At the same time, there is a need for a forceful response to the rise in opium production, which threatens the very fabric of Afghan society.** Staff support recent efforts by the government and its international partners to develop a multi-pronged strategy to deal with the opium economy. However, staff recognize that eradication cannot be accomplished in isolation, and could have a significant economic impact—particularly on some of the most vulnerable segments of the population.

45. **In addition, Afghanistan is still faced with significant challenges in policy implementation due to serious capacity constraints and weak institutions.** The widespread shortages of skilled civil servants and weaknesses in the public administration hinder the absorptive capacity. In many cases, these capacity constraints have meant that the effectiveness of reforms was less than envisaged under the program, particularly with regard to revenue administration, and restructuring of the banking system. Failure to address these issues will hinder efforts to attract private investment which is the backbone of Afghanistan's future growth prospects. Staff welcome the authorities intention to press ahead with planned reforms, and urge them to strengthen these efforts. Staff look forward to further progress in the reform program with the new government. The forthcoming general elections constitute another step toward broadening ownership of economic reforms.

46. **The thrust of the macroeconomic policies in the current SMP strikes an appropriate balance between the requirement to support growth during this period of transition and the crucial need to remain vigilant with regard to potential risks.** As the fiscal program will be a key component, staff urge the authorities to develop a comprehensive medium-term budget framework that maintains fiscal discipline. The authorities should continue in their efforts to enhance revenue and strengthen expenditure management. The high share of wages and security-related outlays might have been appropriate until now. A gradual shift away from security and reconstruction is the most desirable avenue for expenditure policy to support more broad-based sustainable development in the medium term.

47. **Continued donor support is key to ensuring success of the government's reform strategy.** To enhance ownership and coordination of the reform program, donor funding should be integrated into one consolidated medium-term budget framework (moving away from a collection of donor-implemented programs). More direct donor grant support to the budget would simplify fiscal management and help coordinate donor funds. This will require continued improvement in fiduciary standards and the mechanisms for promoting accountability.

48. **The current framework for monetary policy, based on a monetary anchor and aimed at ensuring low inflation and currency stability, appears appropriate.** The flexibility imbedded in the monetary program has allowed DAB to react promptly to shifts in money demand, ensuring moderate inflation and limiting exchange rate volatility. DAB needs to remain vigilant with respect to inflation and exchange rate developments. Looking beyond 2004/05, staff encourage the monetary authorities to extend their set of market-based instruments and improve monetary statistics. As the banking sector expands and more reliable monetary data become available, DAB should base its monetary policy decisions on a broader set of monetary indicators.

49. **Sustained economic growth, employment opportunities, and export prospects will require further structural reforms to improve the business climate.** The new investment law is a valuable step forward. Staff advised the authorities to now focus on introducing property rights, bankruptcy laws, contract enforcement, and a transparent and effective judicial system. Staff also view the cooperation of all government ministries and agencies, along with a political commitment at the highest levels in creating a clear and level playing field for business, as the cornerstone of the government's strategy of creating private sector-led growth.

50. **The mission encouraged the authorities to intensify efforts to rationalize the public enterprise sector.** While the state-owned banks may not represent a systemic risk, staff urge the authorities to take measures to restore the profitability of those which were relicensed and to resolve those which were not relicensed.

51. **Failure to strengthen the legal system could undermine Afghanistan's economic reform program and medium-term outlook.** Key economic legislation remains in limbo due to low capacity at the Ministry of Justice. Staff have urged the government to elicit donor aid and technical support to the benefit of the Ministry of Justice.

52. **Building on the achievement of the TCC, staff encouraged the authorities to consolidate program ownership** further and enable the TCC in making inroads into policy and analytical roles.

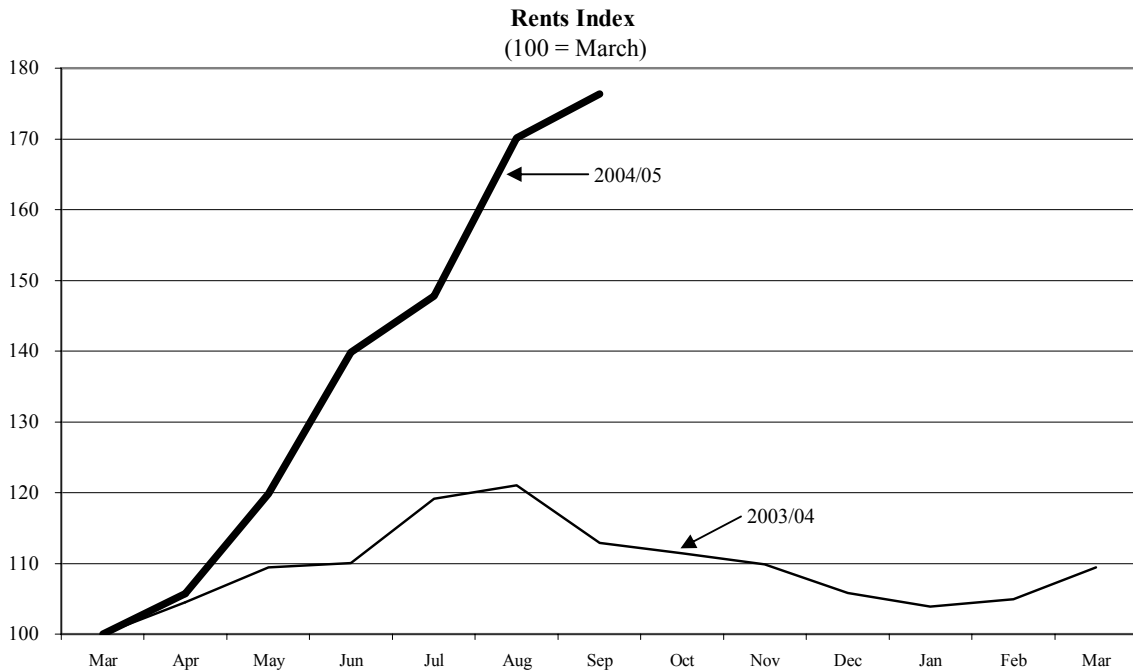
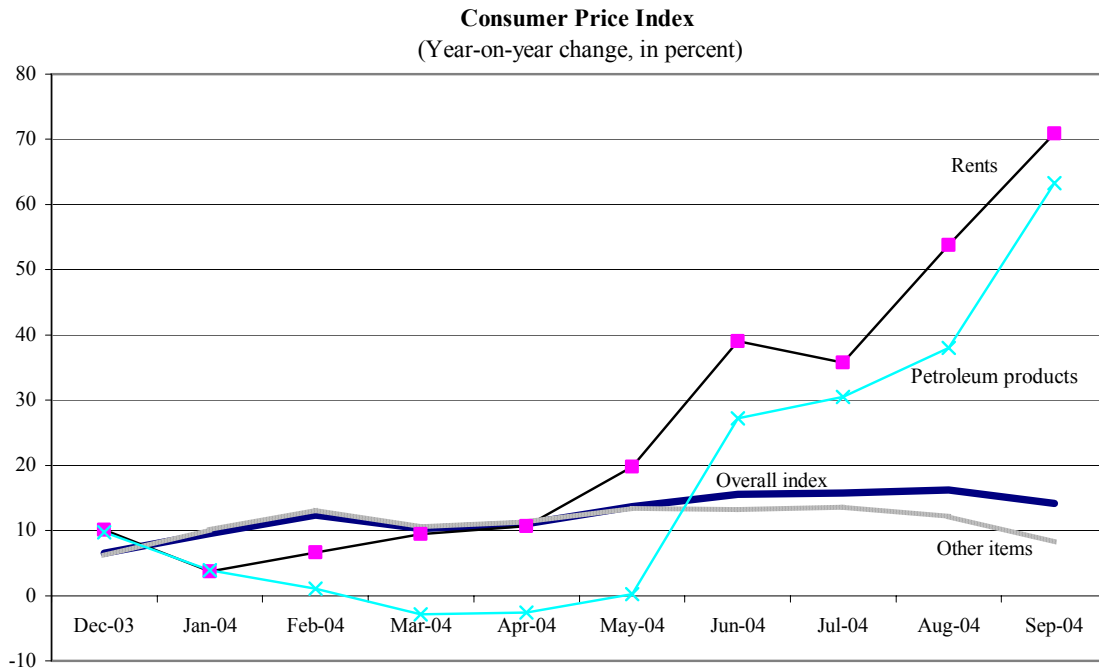
53. **Notwithstanding progress so far, particularly in the fiscal area, much remains to be done in the governance area.** The perception of widespread corruption, the rise in drug activities, and the lack of transparency in many areas have undermined the business environment. Staff welcome the authorities' determination to address these issues forcefully.



54. **There are a number of risks to the program.** The security situation and the limited control of the government over the provinces constrain reconstruction. Political risks remain substantial and, especially in the run-up to the parliamentary elections, could complicate program implementation. The eradication of drug activities, if not handled properly, could cause major macroeconomic and social disruptions, especially in rural areas already affected by the lingering drought. All these factors could cloud Afghanistan's future. However, the government's track record so far is testimony of its resolve to move forward in its reform agenda. The authorities' program for 2004/05, aimed at strengthening macroeconomic stability and Afghanistan's long-term prospects, therefore deserves continued support from the Fund. Staff recommend completion of the second review and concur with the authorities strategy to continue within an SMP.

55. It is proposed that the next Article IV consultation with Afghanistan be held on the standard 12-month cycle.

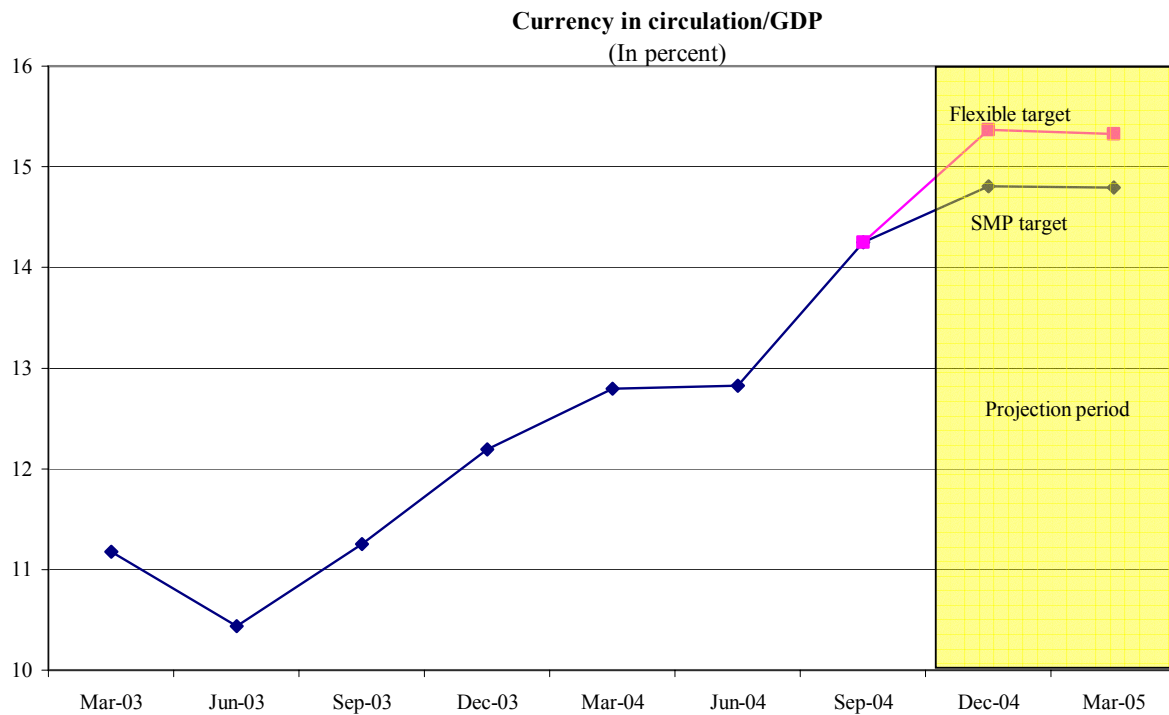
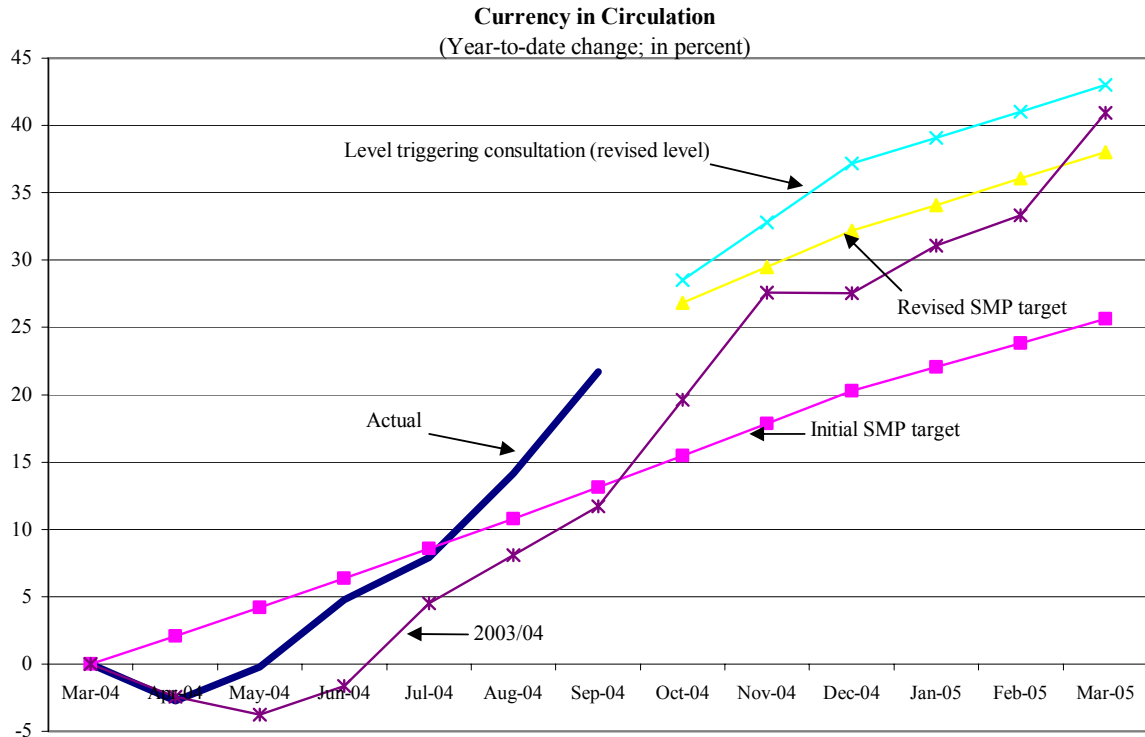
Figure 1. Islamic State of Afghanistan: Price Developments, 2003–04 1/



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

1/ Last observation: September 2004.

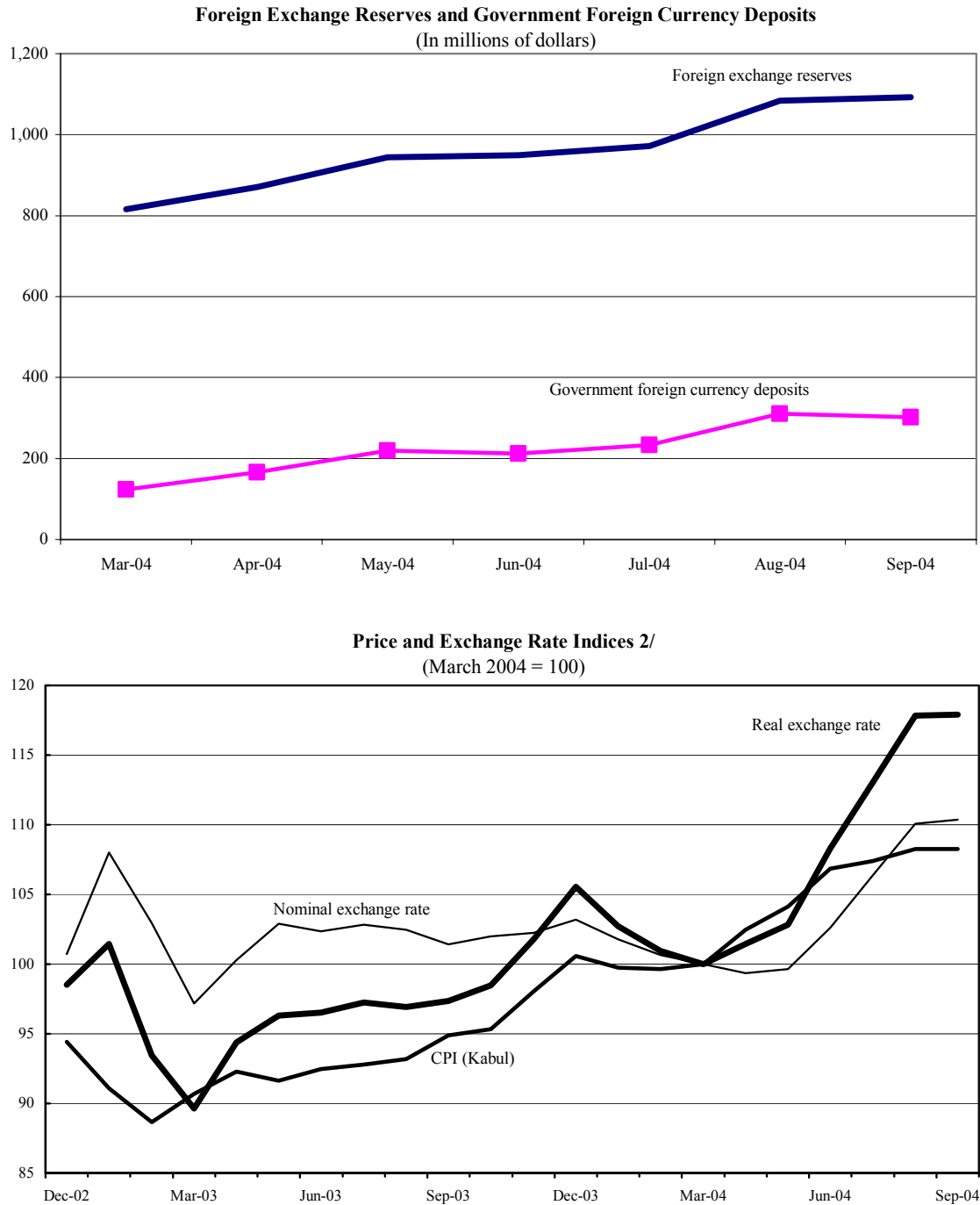
Figure 2. Islamic State of Afghanistan: Monetary Developments, 2003–05 1/



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

1/ Last observation: September 2004.

Figure 3. Islamic State of Afghanistan: Foreign Exchange Reserves and Real Exchange Rate, 2003–04 1/

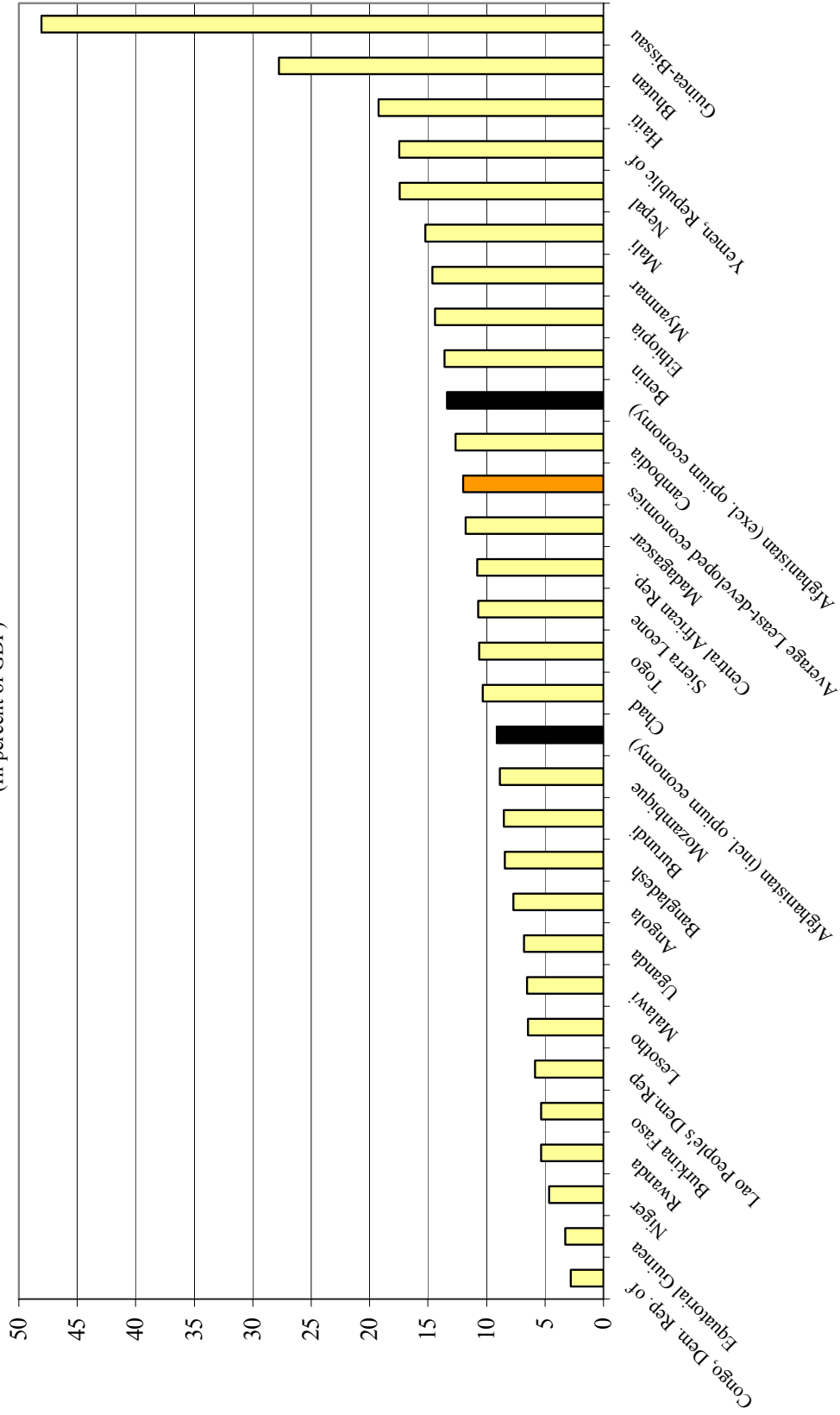


Sources: Central Statistics Office of Afghanistan, Da Afghanistan Bank; and Fund staff estimates.

1/ Last observation: September 2004.

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

Figure 4. Islamic State of Afghanistan. Reserve Money to GDP Ratio 2003-04 1/  
(In percent of GDP)



Sources: WEO; Da Afghanistan Bank; Central Statistics Office of Afghanistan; and Fund staff estimates.  
1/ Latest data: 2003 or latest available; end-September 2004 for Afghanistan.

Table 1. Islamic State of Afghanistan: Basic Data, 2001/02–2004/05 1/

	2001/02	2002/03	2003/04		2004/05	
	Est.	Est.	Prel. Est. 2/	Revised Est.	Init. Proj. 2/	Revised Proj.
<b>I. Economic and Financial Indicators</b>						
<b>Production</b>						
GDP (in millions of U.S. dollars, excluding opium production)	2,463	4,084	4,585	4,585	5,802	5,392
GDP (in millions of new Afghani)	133,987	182,862	225,108	225,108	289,180	268,738
Real GDP growth rate (in percent)	...	28.6	15.7	15.7	16.0	7.5
GDP per capita (in U.S. dollars)	123	182	199	199	246	228
Opium production (metric tons)	200	3,400	...	3,600	...	4,200
Opium value (in millions of U.S. dollars)	...	2,540	...	2,300	...	2,800
<b>Consumer prices</b>						
CPI (Kabul, year-on-year change; in percent)	-43.4	52.3	10.3	10.3	10.2	10.2
CPI (Kabul, average change; in percent)	...	5.2	24.2	24.2	12.3	12.3
(In millions of U.S. dollars, unless specified otherwise)						
<b>General government recurrent budget</b>						
Revenues	...	132	207	207	256	256
Expenditures	...	349	451	451	609	609
Donor grants and loans	...	209	205	205	352	300
Revenues (in percent of non-opium GDP)	...	3.2	4.5	4.5	4.4	4.8
Expenditures (in percent of non-opium GDP)	...	8.6	9.8	9.8	10.5	11.3
<b>Monetary indicators</b>						
Domestic currency in circulation (annual change; in percent)	...	20.1	40.9	40.9	25.7	38.0
Gross foreign exchange reserves	...	426.1	815.5	815.5	977.0	1,105.3
(In millions of U.S. dollars, unless specified otherwise)						
<b>External sector</b>						
Exports of goods (including reexports)	708.9	1,248.3	1,700.8	1,820.0	1,822.5	2,030.9
Exports of goods (annual change; in percent)	...	76.1	36.2	45.8	7.2	11.6
Imports of goods	1,645.0	2,407.6	3,758.9	3,414.5	4,134.1	3,425.9
Imports of goods (annual change; in percent)	...	46.4	56.1	41.8	10.0	0.3
Imports of oil	...	...	...	...	...	...
Current account deficit (excluding grants)	...	-1,305.5	-2,578.2	-1,944.8	-2,838.7	-1,721.3
Current account deficit (including grants; in percent of GDP)	...	-2.1	-0.9	-1.8	-1.6	-3.4
Afghani/U.S. dollar (average during fiscal year)	54.4	44.8	49.0	49.0	...	...
Afghani/U.S. dollar (end-fiscal year)	31.0	52.6	50.3	50.3	...	...
(In percent of GDP)						
<b>Investment and savings</b>						
Gross investment	...	28.3	37.6	27.2	43.2	21.9
Domestic savings	...	-3.7	-18.6	-15.2	-5.7	-10.1
<b>II. Social and Demographic Indicators</b>						
Area	652,000 square kilometers					
Population (2002/03)	21.8 million					
Life expectancy at birth (2001)	42.8 years					
Infant mortality per 1,000 live births (2003)	115					
Under-five mortality per 1,000 live births (2003)	172					

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

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

2/ First review under the staff-monitored program (IMF Country Report No. 04/364; November 9, 2004).

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

	2002/03		2003/04		2004/05		2005/06		2006/07		2007/08	
	Est.	Est.	Est.	Est.	Init. Proj.	Rev. Proj.	Init. Proj.	Rev. Proj.	Init. Proj.	Rev. Proj.	Init. Proj.	Rev. Proj.
(In millions of U.S. dollars)												
Domestic expenditures	5,389	6,529	8,641	7,113	9,881	8,792	9,757	10,808	8,677	9,757	10,808	8,677
Consumption	4,235	5,282	6,134	5,934	7,517	6,940	7,658	8,677	7,658	7,658	8,677	7,658
Public 1/	318	407	545	512	699	670	791	930	791	791	930	791
Private 2/	3,917	4,875	5,589	5,423	6,818	6,270	6,866	7,746	6,866	6,866	7,746	6,866
Gross fixed capital formation	1,154	1,248	2,507	1,179	2,364	1,852	2,099	2,131	2,099	2,099	2,131	2,099
Public	1,104	1,190	2,175	1,029	1,916	1,390	1,527	1,456	1,527	1,527	1,456	1,527
Private 3/	50	58	332	150	448	462	573	676	573	573	676	573
Net exports of goods and services	-1,305	-1,945	-2,839	-1,721	-2,865	-2,314	-2,272	-2,193	-2,272	-2,272	-2,193	-2,272
Exports of goods and services (excluding reexports)	328	459	774	624	1,011	862	1,006	1,087	1,006	1,006	1,087	1,006
Imports of goods and services (excluding reexports)	-1,633	-2,404	-3,613	-2,345	-3,876	-3,176	-3,278	-3,279	-3,278	-3,278	-3,279	-3,278
Domestic savings	-151	-697	-332	-542	-501	-462	-173	-62	-173	-173	-62	-173
Public savings	-187	-200	-288	-255	-357	-329	-365	-413	-365	-365	-413	-365
Private savings	36	-498	-44	-287	-144	-133	192	352	192	192	352	192
GDP at market prices	4,084	4,585	5,802	5,392	7,016	6,478	7,485	8,615	7,485	7,485	8,615	7,485
(In percent of GDP)												
Domestic expenditures	132.0	142.4	148.9	131.9	140.8	135.7	130.4	125.5	130.4	130.4	125.5	130.4
Consumption	103.7	115.2	105.7	110.1	107.1	107.1	102.3	100.7	102.3	102.3	100.7	102.3
Public	7.8	8.9	9.4	9.5	10.0	10.3	10.6	10.8	10.6	10.6	10.8	10.6
Private	95.9	106.3	96.3	100.6	97.2	96.8	91.7	89.9	91.7	91.7	89.9	91.7
Gross fixed capital formation	28.3	27.2	43.2	21.9	33.7	28.6	28.0	24.7	28.0	28.0	24.7	28.0
Public	27.0	25.9	37.5	19.1	27.3	21.5	20.4	16.9	20.4	20.4	16.9	20.4
Private	1.2	1.3	5.7	2.8	6.4	7.1	7.7	7.8	7.7	7.7	7.8	7.7
Net exports of goods and services	-32.0	-42.4	-48.9	-31.9	-40.8	-35.7	-30.4	-25.5	-30.4	-30.4	-25.5	-30.4
Exports of goods and services (excluding reexports)	8.0	10.0	13.3	11.6	14.4	13.3	13.4	12.6	13.4	13.4	12.6	13.4
Imports of goods and services (excluding reexports)	-40.0	-52.4	-62.3	-43.5	-55.2	-49.0	-43.8	-38.1	-43.8	-43.8	-38.1	-43.8
Domestic savings	-3.7	-15.2	-5.7	-10.1	-7.1	-7.1	-2.3	-0.7	-2.3	-2.3	-0.7	-2.3
Public savings	-4.6	-4.4	-5.0	-4.7	-5.1	-5.1	-4.9	-4.8	-4.9	-4.9	-4.8	-4.9
Private savings	0.9	-10.9	-0.8	-5.3	-2.0	-2.1	2.6	4.1	2.6	2.6	4.1	2.6
Memorandum items:												
Real GDP growth (annual change; in percent)	28.6	15.7	16.0	7.5	12.0	11.3	10.0	9.6	10.0	10.0	9.6	10.0
Nominal GDP growth (annual change; in percent)	33.8	23.1	28.5	19.4	20.9	20.1	15.5	15.1	15.5	15.5	15.1	15.5
Sectoral shares of GDP (in percent)												
Agriculture	49.8	48.5	47.0	39.7	46.9	37.2	35.5	34.0	35.5	35.5	34.0	35.5
Industry	20.1	21.3	20.7	24.3	20.8	25.6	26.5	22.5	25.6	25.6	22.5	25.6
Services	30.1	30.2	29.4	36.0	29.5	37.2	37.9	43.5	37.2	37.9	43.5	37.9
GDP per capita (in U.S. dollars)	182	199	246	228	288	266	299	334	266	299	334	266
Domestic government revenue (in percent of GDP)	3.2	4.5	4.4	4.8	4.9	6.1	6.5	6.7	6.5	6.5	6.7	6.5

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 3. Islamic State of Afghanistan: Operating Budget (in millions of Afghanis), 2002/03–2007/08

	2002/03	2003/04	2003/04	2003/04	2003/04	2004/05	2004/05	2004/05	2005/06	2006/07	2007/08	
	Est.	Budget	Q1	Q2	Q3	Q4	Prel.	Prog. 1/	Q1	Q2	YTD est.	Proj.
<b>Domestic revenue 2/</b>	<b>5,864.5</b>	<b>9,000</b>	<b>2,148.5</b>	<b>2,289.5</b>	<b>2,076.8</b>	<b>3,653.1</b>	<b>10,167.9</b>	<b>12,783.9</b>	<b>2,670.1</b>	<b>3,235.5</b>	<b>5,905.6</b>	<b>18,667</b>
Center	1,036.7	---	159.8	334.7	603.2	1,861.6 3/	2,959.3	---	550.1	615.0	1,165.1	---
Provinces	4,827.8	---	1,988.6	1,954.8	1,473.6	1,791.5	7,208.6	---	2,120.0	2,620.5	4,740.5	---
<b>Expenditure</b>	<b>15,514.0</b>	<b>24,750</b>	<b>3,916.7</b>	<b>4,440.8</b>	<b>5,600.3</b>	<b>8,193.6</b>	<b>22,151.4</b>	<b>30,332.4</b>	<b>5,223.0</b>	<b>6,776.5</b>	<b>11,999.5</b>	<b>37,128</b>
<b>Center-Provinces</b>	<b>---</b>	<b>---</b>	<b>3,916.7</b>	<b>4,440.8</b>	<b>5,600.3</b>	<b>8,193.6</b>	<b>22,151.4</b>	<b>30,332.0</b>	<b>5,223.0</b>	<b>6,776.5</b>	<b>11,999.5</b>	<b>---</b>
Central government	---	---	1,732.3	2,843.7	2,984.5	4,373.3	11,933.9	17,222.3	3,405.4	3,979.4	7,384.8	---
Of which: wages	---	---	1,098.9	1,689.0	1,908.6	2,763.9	7,460.3	11,154.4	1,334.6	1,740.9	3,075.4	---
Others	---	---	633.5	1,154.8	1,075.9	1,609.4	4,473.5	6,067.9	2,070.8	2,238.5	4,309.4	---
Provinces 5/	---	---	2,184.4	1,597.1	2,615.8	3,820.4	10,217.5	13,109.7	1,817.6	2,797.1	4,614.7	---
Of which: wages	---	---	505.4	1,409.5	2,148.5	3,136.2	7,199.7	9,658.9	1,292.7	1,988.1	3,280.8	---
Others	---	---	1,678.9	187.5	467.2	684.1	3,017.9	3,450.7	524.9	809.0	1,334.0	---
<b>Economic classification</b>	<b>---</b>	<b>---</b>	<b>3,916.7</b>	<b>4,440.8</b>	<b>5,600.3</b>	<b>8,193.6</b>	<b>22,151.4</b>	<b>30,332.0</b>	<b>5,223.0</b>	<b>6,776.5</b>	<b>11,999.5</b>	<b>---</b>
Wages and Salaries	---	---	1,604.3	3,098.5	4,057.2	5,900.1	14,660.0	20,813.3	3,409.0	4,827.1	8,236.1	---
Purchase of goods and services	---	---	1,923.3	785.5	807.9	1,136.7	4,653.4	4,862.4	1,051.7	1,019.8	2,071.6	---
Transfers and subsidies	---	---	141.5	182.3	169.6	158.9	652.3	1,471.3	141.1	154.9	296.0	---
Pensions	---	---	0.0	132.5	0.0	44.5	177.1	724.0	222.7	245.9	468.6	---
Capital expenditure	---	---	247.7	242.0	565.6	953.3	2,008.5	2,460.9	398.6	528.7	927.3	---
<b>Functional classification</b>	<b>---</b>	<b>---</b>	<b>3,916.7</b>	<b>4,440.8</b>	<b>5,600.3</b>	<b>8,193.6</b>	<b>22,151.4</b>	<b>30,332.0</b>	<b>5,223.0</b>	<b>6,776.5</b>	<b>11,999.5</b>	<b>---</b>
General public services	---	---	333.7	498.5	429.7	770.9	2,032.9	3,298.8	471.0	585.8	1,056.7	---
Defense	---	---	903.3	984.4	1,533.4	2,583.1	6,004.3	5,934.6	1,288.5	1,520.3	2,808.8	---
Public order and safety	---	---	640.9	1,121.6	1,492.8	1,893.0	5,148.3	6,721.0	1,493.1	1,849.7	3,342.8	---
Education	---	---	266.8	880.8	1,130.3	1,511.6	3,789.4	6,342.3	874.6	1,435.4	2,310.0	---
Health	---	---	140.5	258.0	326.2	342.2	1,067.4	1,262.9	287.5	265.5	552.9	---
Social protection	---	---	17.6	153.7	56.6	188.1	416.0	1,687.7	112.2	180.9	293.1	---
Housing and communal services 5/	---	---	1,290.3	8.0	12.4	16.8	1,327.6	62.6	10.6	16.6	27.2	---
Recreation and culture	---	---	40.9	111.5	132.4	197.8	482.6	621.0	99.8	150.6	250.4	---
Economic affairs	---	---	282.7	424.2	486.0	690.1	1,882.9	4,401.1	585.8	771.7	1,357.5	---
<b>Balance MOF</b>	<b>-9,649.5</b>	<b>-15,750</b>	<b>-1,768.2</b>	<b>-2,151.3</b>	<b>-3,523.5</b>	<b>-4,540.5</b>	<b>-11,983.5</b>	<b>-17,548.1</b>	<b>-2,552.9</b>	<b>-3,541.0</b>	<b>-6,094.0</b>	<b>-18,462</b>
<b>Floater and adjustment 6/</b>	<b>-657.3</b>	<b>0</b>	<b>869.5</b>	<b>-1,204.7</b>	<b>692.3</b>	<b>1,335.7</b>	<b>1,692.8</b>	<b>0.0</b>	<b>223.8</b>	<b>-1.0</b>	<b>222.9</b>	<b>---</b>
<b>Donor assistance grants and loans</b>	<b>9,430.4</b>	<b>15,750</b>	<b>2,469.2</b>	<b>1,326.0</b>	<b>2,934.3</b>	<b>3,740.2</b>	<b>10,469.7</b>	<b>14,952.0</b>	<b>2,137.4</b>	<b>1,638.5</b>	<b>3,775.9</b>	<b>18,462</b>
ARIF	---	---	11,250	2,275.5	528.4	2,452.9	8,182.3	12,574.6	2,137.4	1,234.4	3,571.8	---
LOTFA and Army Trust Fund	---	---	4,500	193.8	797.6	418.3	1,891.6	2,377.4	0.0	404.1	404.1	---
Net transfers from foreign currency deposits 7/	---	0	0.0	0.0	0.0	395.8	395.8	---	-798.2	1,240.6	442.3	---
Domestic banking financing 8/	-502.2	0	-1,570.5	2,029.9	-103.0	-535.4	-179.0	0.0	990.0	662.9	1,652.9	0
<b>Other financing 9/</b>	<b>1,378.5</b>	<b>0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>2,596.1</b>	<b>0.0</b>	<b>0.0</b>	<b>0.0</b>	<b>0</b>

Sources: Ministry of Finance and Da Afghanistan Bank (DAB), and Fund staff estimates.

1/ Staff estimates. The budget adopted by the government projects revenue of about Af15 billion.

2/ The first half of 2003/04 includes a \$18 million lump-sum transfer from Herat province. Revenue in the fourth quarter of 2003/04 were affected by the disruptions in collection that accompanied the aborted introduction of the customs reform in January 2004.

3/ The sharp increase in revenue from the center reflects transfers of overflight revenue from IATA (Af 800 million) and of passport fees from the Ministry of Foreign Affairs (Af 300 million).

4/ The functional, economic and center/provinces classifications of expenditures reported in 2004/05 reflects IMF staff projections and do not reflect Government Finance Statistics (GFS). These projections are based on assumptions regarding unallocated expenditures amounting to Af15.3 billion.

5/ The first quarter of 2003/04 includes \$25.2 million paid by the Ministry of Reconstruction in Herat province for the purchase of services.

6/ Variation between the fiscal position recorded at MOF and DAB. This discrepancy is due to the difference ("float") between checks issued and checks cashed and the fact that the provinces' accounts in DAB branches are not consolidated into the government's central accounts.

7/ This financing is assumed to be temporary and bridges temporary shortfalls in financing due to delays in securing the reimbursement of submitted expenditures from the ARIF. A positive sign corresponds to a decline in balances and a negative sign to an increase in balances.

8/ Refers to changes in the domestic government accounts with DAB.

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



Table 4. Islamic State of Afghanistan: Monetary Program (Da Afghanistan Bank), 2002/03-2004/05

	2002/03			2003/04			2003/04			2004/05		
	Est.	Est.	Est. 1/	Est.	Est.	Est. 1/	Est.	Est.	Est.	Rev. Proj.	Rev. Proj.	
	Mar. 20	Jun. 21	Sep. 22	Dec. 21	Mar. 19	Jun. 20	Mar. 19	Jun. 20	Sep. 21	Dec. 20	Mar. 20	
(In millions of Afghani)												
Net foreign assets 2/	19,602	24,031	26,158	32,659	33,607	41,147	47,876	55,267	56,245	55,888	55,888	
Foreign assets	19,602	24,031	26,158	32,659	33,607	41,147	47,876	55,267	56,245	55,888	55,888	
Foreign exchange reserves	19,602	24,031	26,158	32,659	33,607	40,644	47,343	54,483	55,445	55,088	55,088	
Gold	9,030	9,030	9,030	9,030	9,030	14,015	14,015	14,015	14,015	14,015	14,015	
Other	10,572	15,001	17,128	23,629	24,577	26,628	33,328	40,468	41,430	41,073	41,073	
Other foreign assets	0	0	0	0	0	503	533	784	800	800	800	
Foreign liabilities	0	0	0	0	0	0	0	0	0	0	0	
Net domestic assets	1,074	-3,691	-3,056	-6,292	-4,466	-10,023	-16,117	-19,252	-17,179	-15,133	-15,133	
Domestic assets	14,361	10,433	11,344	8,300	7,138	6,796	3,308	-598	1,676	3,951	3,951	
Net claims on general government	14,361	10,433	11,344	8,300	7,138	6,796	3,308	-598	1,676	3,951	3,951	
Net claims on government before 2002/03	14,951	14,951	14,951	14,951	14,951	14,951	14,951	14,951	14,951	14,951	14,951	
Net claims on government in 2002/3-2004/05	-590	-4,518	-3,606	-6,650	-7,813	-8,155	-11,643	-15,549	-13,274	-11,000	-11,000	
Domestic currency deposits 3/	-344	-975	-1,364	-1,140	-1,924	-1,984	-1,069	-466	-733	-1,000	-1,000	
Foreign currency deposits 3/	-245	-3,543	-2,243	-5,510	-5,889	-6,171	-10,574	-15,083	-12,541	-10,000	-10,000	
Other claims	0	0	0	0	0	0	0	0	0	0	0	
Other items net	-13,287	-14,124	-14,401	-14,592	-11,604	-16,818	-19,425	-18,653	-18,856	-19,084	-19,084	
Reserve money	20,676	20,340	23,102	26,367	29,140	31,124	31,759	36,015	39,066	40,755	40,755	
Currency in circulation 4/ 5/	20,676	20,340	23,102	26,367	29,140	28,801	30,172	35,054	38,066 4/	39,755 4/	39,755 4/	
Banknotes and coins issued	21,302	21,302	23,302	27,392	29,726	29,726	31,226	36,226	39,316	41,105	41,105	
less cash holdings 5/	626	962	200	1,025	586	925	1,054	1,172	1,250	1,350	1,350	
Bank deposits with DAB and capital note holdings 6/	0	0	0	0	0	2,323	1,587	962	1,000	1,000	1,000	
(In percent, unless otherwise indicated)												
Memorandum items:												
Currency in circulation (SMP first review targets; in millions of Afghani)	...	...	...	...	...	...	30,628	32,575	34,649	36,185	36,185	
Currency in circulation (level triggering discussions; revised levels; in millions of Afghani)	...	...	...	...	...	...	...	...	39,503	41,193	41,193	
Currency in circulation (year-to-date change)	...	-1.6	11.7	27.5	40.9	40.9	4.8	21.7	32.2	38.0	38.0	
Currency in circulation (year-on-year change)	20.1	...	...	37.7	40.9	40.9	...	...	...	...	38.0	
Gross international reserves (end-of-period level; in millions of U.S. dollars)	426.1	522.4	568.7	710.0	730.6	815.5	949.9	1,093.2	1,112.5	1,105.3	1,105.3	
Consumer prices in Kabul (quarterly change)	-4.0	2.0	2.6	6.0	-0.6	-0.6	6.8	1.3	...	...	...	
Consumer prices in Kabul (annual change)	52.3	52.9	32.6	6.5	10.3	10.3	15.5	14.1	...	...	10.2	

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

1/ The first column reports the March 19 outcome using the 2003/04 program exchange rate for estimating foreign assets and liabilities; the second reports the same outcome using the 2004/05 program exchange rate. The difference in currency in circulation, government deposits and banks' claims on DAB correspond to changes in definitions (see footnotes 3, 5, 6), as new data have become available. The difference in Other items net between the two columns reflects the capital gains implied by using a higher value of the dollar vis-a-vis the Afghani in 2004/05 than in 2003/04 and these changes in definitions.

2/ Foreign currency amounts converted into Afghani at the program exchange rate (Af 46 per dollar in 2003/04 and Af 49.84 per dollar in 2004/05); gold valued at \$279 per ounce in 2003/04 and \$400 per ounce in 2004/05.

3/ In 2003/04, includes only Ministry of Finance deposits.

4/ The revised projections are consistent with the revised indicative ceilings on the changes in currency in circulation (Table 1 of the MEFP).

5/ In 2002/03-03/04, cash holdings only include cash in DAB Treasury vaults. In 2004/05, they also include cash in DAB's six major branches.

6/ The differences as compared to the first review (IMF Country Report No. 04/364; November 9, 2004) corresponds to the fact that reliable data on bank deposits and capital note holdings have become available and are now reported.

Table 5. Islamic State of Afghanistan: Balance of Payments, 2001/02–2007/08 1/

	2001/02	Est. 2002/03	Est. 2003/04	Proj. 2004/05	Proj. 2005/06	Proj. 2006/07	Proj. 2007/08
(In millions of U.S. dollars)							
Trade balance	-936.1	-1,159.3	-1,594.5	-1,395.0	-1,940.5	-1,935.6	-1,930.0
Exports of goods 1/	708.9	1,248.3	1,820.0	2,030.9	2,005.5	1,844.1	1,705.5
Domestic exports	85.2	276.8	376.8	541.8	758.3	891.5	981.2
Re-exports	623.7	971.5	1,443.2	1,489.1	1,247.2	952.6	724.3
Imports of goods	1,645.0	2,407.6	3,414.5	3,425.9	3,946.0	3,779.7	3,635.5
Recorded imports	1,696.0	1,089.4	1,596.2	1,871.9	1,914.6	1,837.7	1,871.2
Commodity food aid	71.1	94.0	40.9	23.6	0.0	0.0	0.0
Unrecorded	764.0	1,224.2	1,777.4	1,530.4	2,031.4	1,942.0	1,764.2
Services	...	-145.1	-346.9	-329.3	-391.9	-362.3	-288.8
Receipts	...	50.8	82.4	81.8	103.6	114.4	105.4
Donor-related	...	45.9	71.1	67.3	83.9	79.8	63.0
Other	...	4.9	11.3	14.6	19.7	34.6	42.4
Payments	...	195.9	429.3	411.1	495.5	476.7	394.1
Donor related	...	195.9	429.3	411.1	495.5	476.7	394.1
Wages of expatriates	...	131.3	355.4	336.3	419.3	399.1	315.0
Other	...	64.6	73.9	74.8	76.2	77.6	79.1
Income (Net)	...	-1.1	-3.4	2.9	18.6	25.6	26.0
Receipts	...	0.0	4.9	12.6	30.5	39.1	41.1
Payments (Interest) 2/	...	1.1	8.3	9.7	11.9	13.5	15.1
Current transfers	...	1,221.7	1,863.8	1,536.5	2,082.7	2,029.8	1,947.5
Public	...	1,170.1	1,808.8	1,434.0	2,016.0	2,006.0	1,911.1
Commodity food aid	71.1	94.0	40.9	23.6	0.0	0.0	0.0
Other	...	1,076.2	1,767.9	1,410.4	2,016.0	2,006.0	1,911.1
Private	...	51.6	55.0	102.5	66.7	23.8	36.4
Other	...	0.0	0.0	0.0	0.0	0.0	0.0
Current account balance (including grants)	...	-83.8	-81.0	-184.8	-231.1	-242.5	-245.3
(before grants)	...	-1,305.5	-1,944.8	-1,721.3	-2,313.8	-2,272.3	-2,192.8
Capital financial account	...	144.0	147.7	241.7	270.4	291.6	294.3
Public loans	...	94.0	89.9	141.4	158.8	168.8	168.8
Disbursements	...	100.2	96.1	147.6	165.0	175.0	175.0
Amortization paid 2/	...	6.2	6.2	6.2	6.2	6.2	6.2
Direct investment	...	50.0	57.8	100.3	111.6	122.8	125.5
Other capital flows	...	0.0	0.0	0.0	0.0	0.0	0.0
Net errors and omissions	...	95.1	312.2	222.3	0.0	0.0	0.0
Overall balance	...	155.3	379.0	279.2	39.3	49.1	49.0
Financing	...	-155.3	-379.0	-279.2	-39.3	-49.1	-49.0
Change in net foreign assets of DAB	...	-101.0	-389.4	-289.8	-50.0	-60.0	-60.0
Fund credit (net)	...	0.0	0.0	0.0	0.0	0.0	0.0
Purchases	...	0.0	0.0	0.0	0.0	0.0	0.0
Repurchases	...	0.0	0.0	0.0	0.0	0.0	0.0
Exceptional Financing	...	-54.3	10.4	10.6	10.7	10.9	11.0
Arrears	...	-54.3	10.4	10.6	10.7	10.9	11.0
Debt Rescheduling	...	0.0	0.0	0.0	0.0	0.0	0.0
Debt Forgiveness	...	0.0	0.0	0.0	0.0	0.0	0.0
Financing gap	...	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum items							
Official foreign exchange reserves							
In millions of U. S. dollars		426	816	1,105	1,155	1,215	1,275
In months of prospective imports 3/		2.1	4.2	4.2	4.2	4.4	4.8
Current account balance (In percent of GDP)							
Including grants		-2.1	-1.8	-3.4	-3.6	-3.2	-2.8
Excluding grants		-32.0	-42.4	-31.9	-35.7	-30.4	-25.5
GDP (In millions of U. S. dollars)		4,084	4,585	5,392	6,478	7,485	8,615

Source: Fund staff estimates and projections.

1/ Excludes opium exports and, because information is unavailable, flows associated with U.S. Army and most ISAF activities.

2/ Debt service projections are based on recognized obligations, reconciled with creditors. Arrears shown here represent an estimate by IMF staff, on the basis of loans which have been verified with creditors, but are not being serviced.

3/ In months of prospective imports of goods and services, excluding imports for re-export.

**Islamic State of Afghanistan: Relations with the Fund**  
(As of November 30, 2004)

I.	<b>Membership Status:</b> Joined July 14, 1955; Article XIV.		
II.	<b>General Resources Account</b>	<u>SDR Million</u>	<u>% Quota</u>
	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.	<b>SDR Department</b>	<u>SDR Million</u>	<u>% Allocation</u>
	Net cumulative allocation	26.70	100.00
	Holdings	0.04	0.14
IV.	<b>Outstanding Purchases and Loans</b>	None	
V.	<b>Financial Arrangements</b>	None	
VI.	<b>Projected Obligations to Fund</b> (SDR Million; based on existing use of resources and present holdings of SDRs)		

	<u>Forthcoming</u>			
	<u>2005</u>	<u>2006</u>	<u>2007</u>	<u>2008</u>
Principal	0.00	0.00	0.00	0.00
Charges/Interest	0.59	0.59	0.59	0.59
Total	0.59	0.59	0.59	0.59

**Nonfinancial Relations**

**VII. 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. 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 December 1, 2004, the average exchange rate on the Kabul money exchange market was Af 47.26 per \$1.

To conduct monetary policy, the authorities rely on foreign exchange auctions since May 2002. Auctions are open to all licensed money changers. To ensure transparency, DAB has progressively introduced measures, including public announcements of the auctions in

advance in local media outlets, and clear instructions on how the auctions are conducted. Over the years, DAB has also improved the mechanics of the auctions to ensure that settlements are made after successful bids. Auctions are linked to the overall monetary program and are held on a fairly regular basis at 1–2 week intervals.

### VIII. Article IV Consultation

The last Article IV consultation with Afghanistan was discussed by the Executive Board on November 21, 2003. Consultations with Afghanistan are on the standard 12-month cycle.

### IX. Technical Assistance, 2002–04

<b>Department</b>	<b>Date</b>	<b>Purpose</b>
Interdepartmental	January 27–31, 2002	Initial assessment of TA needs
FAD	February 10–21, 2002	Fiscal management
	May 13–26, 2002	Tax policy and administration
	January 5–18, 2003	Fiscal management
	October 22–November 4, 2003	Expenditure management
	March 2004 until today	Resident Treasury Expert
	March 22–April 3, 2004	Tax policy and administration
	April 18–May 2, 2004	Customs administration
MFD	February 27–March 7, 2002	Financial sector reform
	May 19–June 2, July 10–27, 2002	Financial sector reform
	December 11–16, 2002	Financial sector legislation workshop
	September 7–16, 2003	DAB restructuring program and creation of a central bank short-term debt instrument.
	February 2–6, 2004	Anti-money laundering legislation
	March 21–30, 2004	DAB capital adequacy and balance sheet structure
LEG	February 27–March 7, 2002	Financial sector legislation
	December 11–16, 2002	Financial sector legislation workshop
	February 2–6, 2004	Anti-money laundering legislation
	March 3–21, 2004	Fiscal revenue legislation
STA	April 15–21, 2002	Multisector statistics
	November 18–30, 2002	Consumer Price Index
	January 26–February 8, 2003	Government finance statistics
	March 1–11, 2003	Monetary and financial statistics
	June 9–20, 2003	Consumer Price Index
	January 29–March 15, 2004	Multisector statistics
	April 19–May 3, 2004	Balance of Payments Statistics
	May 13–June 30, 2004	Multisector statistics
May 17–29, 2004	Consumer Price Index	

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 will commence during January/February 2005. They are expected to resume in late-2004/early-2005.

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

During 2004, with the financial support provided by the Sweden Technical Assistance SubAccount, the Fund has sponsored a number of training activities aimed at DAB officials and is now engaged in preparing a full-scale training program for DAB. A long-term advisor has been appointed in Kabul since mid-October, 2004. The training coordinator will be 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. Finally, Sweden has agreed to finance during the period December 2004 to December 2005 a monetary policy peripatetic advisor to assist DAB in developing the strategy and the instruments for the implementation of the next stage of monetary policy—setting and advising on options to replace the existing exchange rate auctions.

#### **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.

**Islamic State of Afghanistan: Relations with the World Bank**  
(As of November 30, 2004)

1. A second **Transitional Support Strategy (TSS)** was presented to the World Bank Board of Executive Directors in March 2003. The TSS outlines a strategy for World Bank operations over the subsequent 18 months to 2 years until the establishment of a stable, representative government. The strategy focuses on four strategic areas: improving livelihoods, fiscal strategy, institutions and management, governance and public administration reform, and enabling private sector development. In collaboration with the new government and other stakeholders, the World Bank intends to update its country strategy for Afghanistan in 2005. Based on the preparatory work toward the I-PRSP, a country assistance strategy, covering a three-year period, could be finalized in FY 2006.
2. In FY 2002, World Bank staff prepared and negotiated four projects to utilize IDA grant funds to a total of \$100 million. Following the clearance of Afghanistan's arrears to the World Bank and Fund, through donor contributions, the first IDA credit for \$108 million for the **Emergency Transport Project** was approved by the Board in March 2003. By the end of FY 2003 an additional three projects—**Emergency Health Sector Rehabilitation** (\$59.6 million), **Emergency Public Administration II** (\$8.4 million), and **National Emergency Employment II** (\$39.2 million) were approved bringing to \$215 million the total allocation for the year.
3. Five IDA credits/grants have been 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 have been 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). Four other projects are planned, for an additional commitment of \$140 million, including the Emergency Public Administration III, a supplemental financing for the Emergency Transport, the Programmatic Support for Institution Building II, and the Strengthening Higher Education project.
5. The World Bank also administers the **Afghanistan Reconstruction Trust Fund (ARTF)**, which became effective in May 2002 and plays a critical role in funding the recurrent costs of government. In its first year of operation (SY 1381—March 21, 2002 to March 20, 2003) the ARTF mobilized \$185 million and disbursed \$65 million. Paid-in contributions for SY 1382 (March 21, 2003 to March 20, 2004) amounted to \$286 million, while disbursements reached \$254 million. Pledges for SY 1383 (March 20, 2004 to

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

6. The World Bank is also actively engaged in advisory services to government and continues to respond quickly to a range of requests. In September 2004, the World Bank has released a country economic report “State Building, Sustaining Growth, and Reducing Poverty.” Current analytical work includes work on the civil service reform, urban development and land management, education policy reform, labor market and pensions, a gender assessment and oil/gas infrastructure development, as well as broader regional trade work encompassing issues with Afghanistan’s neighbors. The World Bank has notably initiated a major Public Expenditure Review (PER), which incorporates fiduciary aspects, including procurement and financial management. Fund staff are contributing to the PER, 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 IDA portfolio of 17 projects as of December 2004. Total commitments add up to \$753 million, of which 44 percent has been disbursed. The World Bank’s office in Kabul is fully functional and growing rapidly to take on increasing demands. A country manager, as well as several other international staff, and a growing number of national staff are now in place.

Islamic State of Afghanistan: Survey of Reporting of Main Statistical Indicators

(As of November 30, 2004)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP
Date of latest observation	Nov. 30, 2004	Nov. 30, 2004	Nov. 30, 2004	Nov. 2004	...	...	Nov. 2004	...	...	Oct. 2004	2003/04
Date received	Nov. 30, 2004	Nov. 30, 2004	Dec. 5, 2004	Dec. 5, 2004	...	...	Dec. 5, 2004	...	...	Nov. 2004	Jul. 2004
Frequency of data 1/	D	M	M	M	...	...	M	...	...	M	Mission
Frequency of reporting 1/	D	M	M	M	...	...	M	...	...	M	Mission
Source of data	DAB	DAB	DAB	DAB	DAB	DAB	CSO	CSO	DAB	MoF	CSO
Mode of reporting	E-mail	Mission/ e-mail	E-mail	E-mail	...	...	E-mail	...	...	Mission	Mission
Confidentiality	Unrestricted	Confidential	Unrestricted	Unrestricted	...	...	Unrestricted	...	...	Unrestricted	Unrestricted
Frequency of publication 1/	D	M	Q	...	...	...	M	...	...	M	...

1/ Q=quarterly; M=monthly; and D=daily.



Kabul, December 29, 2004

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

Dear Mr. de Rato,

The government of Afghanistan has held discussions with Fund staff in the context of the second review of the staff-monitored program (SMP) agreed to in March 2004 and is very pleased with the progress under the program. Based on these discussions, the attached memorandum of economic and financial policies (MEFP) reviews macroeconomic developments and implementation of structural policies during the first two quarters of fiscal year 2004/05 and describes the objectives and policies that the government intends to pursue during the remainder of the fiscal year 2004/05. The government's program will continue to be guided by the macroeconomic and structural reform policies described in the MEFP of March 24, 2004, and modified by the updated MEFP of September 6, 2004. The attached technical memorandum of understanding (TMU) was also updated to reflect the adjustments introduced to some terms and conditions of the program.

With the support of your staff, we have met all of the end-September 2004 quantitative indicators and structural benchmarks, except the benchmark on the adoption of anti-money laundering/combating the financing of terrorism legislation, due to a slight delay in issuing the presidential decree. The government of Afghanistan appreciates the technical support provided by the Fund and intends to continue its reform efforts as envisaged under the SMP. Reacting to the changing circumstances, the government reached an understanding with the mission on a revised macroeconomic framework for 2004/05, and on the deferment to end-March 2005 of several of the structural benchmarks because of technical difficulties and capacity issues related to the long political transition that followed the Presidential election. We have also strengthened our program by including an additional structural benchmark for end-March 2005 on the publication in the Official Gazette of the amendments related to (i) the tax reform package; and (ii) ensuring that the revenue laws supersede all other legislation in revenue-related matters.

The government believes that the policies and measures set forth in the attached MEFP are adequate to achieve the objectives of its program, but we stand ready to take any further measures that may become appropriate for this purpose. Afghanistan will consult with the Fund on the adoption of any measure that may be deemed necessary and will provide information that Fund staff request to assess the implementation of the SMP, as updated. The government of Afghanistan authorizes the publication and distribution of this letter, the attached MEFP and TMU, and all reports prepared by Fund staff regarding the SMP.

Very truly yours,

/s/

Anwar Ul-Haq Ahady  
Minister of Finance  
Ministry of Finance

/s/

Noorullah Delawari  
Governor  
Da Afghanistan Bank

Attachments:

Update to the Memorandum of Economic and Financial Policies  
Amendments to the Technical Memorandum of Understanding

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

### **Second Review Under the Staff-Monitored Program, 2004/05**

#### **I. INTRODUCTION**

1. The positive outcome of Afghanistan's first direct presidential election was an important step in rebuilding the nation's institutional framework and broadening ownership of the government's reform agenda. In this context, we will continue to pursue prudent macroeconomic policies and structural reforms, while simultaneously rebuilding administrative capacity. The government's program for the rest of 2004/05 will continue to be guided by the policies described in the Memorandum of Economic and Financial Policies (MEFP) of March 24, 2004, and modified by the updated Memorandum of September 6, 2004.

2. This MEFP reviews performance during the second quarter of 2004/05, updates the government's macroeconomic objectives in the context of a medium-term framework, and describes the policies and targets for FY 2004/05. Two of the quantitative indicators have been changed in accordance with an earlier agreement with Fund staff and management and consistent with the flexibility clause in the program. In addition, some minor changes to the end-December 2004 and end-March 2005 structural benchmarks are incorporated in the program to reflect circumstances that were not fully known at the time that they were originally developed, including the long political transition that followed the Presidential election.

#### **II. DEVELOPMENTS UNDER THE SMP**

3. **Overall economic performance during the first semester of 2004/05 was broadly satisfactory** despite some adverse shocks, including a more fragile security situation in the run-up to the election. The resurgence of drought conditions in some southern provinces led to lower-than-projected growth in the agricultural sector, with both cereal and livestock output declining during the main harvest season (April–July). However, output was sustained by stronger than expected growth in construction and services. After a rise of 6.9 percent in the first quarter, **consumer price inflation declined to 1.3 percent during the second quarter.**<sup>1</sup> Inflation continued to be led by rents and petroleum product prices, which increased by 26 percent and 17 percent, respectively. Rental prices increases were attributable to the imposition of the rental tax, and increased demand from donors and returning refugees. Excluding rents and petroleum products, consumer prices declined by

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<sup>1</sup> The Consumer Price Index (CPI) has recently been extended to include five additional large cities (end-September benchmark) and that CPI indicates that inflation amounted to 3.1 percent in the first quarter and 2.3 percent in the second quarter.

1.7 percent during the second quarter, reflecting a decline in bread and cereal prices. Overall, year-on-year inflation amounted to 14.1 percent at end-September (8.3 percent excluding rents and petroleum products), compared to 15.5 percent at end-June.

4. **The United Nations Office on Drugs and Crimes (UNODC) has just released its official findings for the 2004 harvest.** The report indicates that opium cultivation has covered 206,700 hectares during the 2004 crop season as poppy farming continued to spread to new areas of the country. However, opium production does not appear to have increased significantly, due mainly to crop diseases and adverse climatic conditions. Indications are also that farm gate prices have declined markedly and are expected to average below \$100 per kilogram (compared to \$283 in 2003). The market appears to be segmented as the price decline is reportedly much larger in the southern part of the country, due to intensified interdiction. As the decline in farm gate price was not reflected in export prices, it is likely that the aggregate share of opium revenues taken by traders and laboratories has again markedly risen. Overall, total export revenues from opium are tentatively estimated at \$2.2 billion, of which only about \$600 million went to farmers. Consistent with the increase in cultivation, it is also estimated that the number of people deriving income directly from opium has also risen to 2.3 billion.

5. **Fiscal revenue for the first half of 2004/05 was Af 5,886 million, exceeding the SMP indicative target of Af 5,506 million.** Revenue mobilization over the first half of the year represents a significant increase (about 33 percent) over the same period last year. This positive outcome was attributed to administrative reforms, which have yielded sharp increases in administrative fees, and taxes on goods and services (including rent), and on companies. The more timely sweeping of provincial accounts into the central government account (end-December 2004 benchmark) has also helped in regularizing revenue collection. Following some initial delays, the rate of spending for operating expenditures increased, reaching Af 12 billion by the end of the first half of the year, compared with an annual budgeted amount of Af 30.3 billion (11.3 percent of GDP). In light of the election and continuing security concerns, 51 percent of operating expenditures were directed towards security-related spending.

6. **We continue to respect the no-overdraft policy and operating expenditures continued to be financed through revenue, foreign assistance and the draw down of government deposits.** However, the level of reimbursements from the two multi-donor grant funds—the Afghanistan Reconstruction Trust Fund (ARTF) and the Law and Order Trust Fund for Afghanistan (LOTFA)— was less than expected and the domestic deficit during the first half of the year was covered by a draw down of both domestic deposits of Af 1.6 billion from a highly concessional loan from the Asian Development Bank (ASDB) amounting to \$12 million. The resources from the ASDB loan are expected to provide only temporary financing during the year as the rate of reimbursement from the ARTF gradually picks up, compliance with financial management rules improves, and as LOTFA receives and disburses additional funds. Direct payments to vendors' bank accounts were recently introduced and should help reduce corruption and speed up payments.

7. **Core budget development spending reached Af 3.5 billion during the first half of 2004/05, compared to the annual budget estimate of Af 38.4 billion for FY 2004/05 (equivalent to 14.3 percent of GDP).**<sup>2</sup> The low rate of development spending was attributed to several factors, including (i) the late approval of the core development budget;<sup>3</sup> (ii) the poor security environment, which has hampered implementation; and (iii) the limited capacity of line ministries and other agencies to implement programs. During the first half of the year, development spending was concentrated in just a few of the National Priority Programs.

8. **In consultation with Fund staff, and to accommodate the perceived increase in money demand, Da Afghanistan Bank (DAB) allowed the growth of money in circulation to exceed the second-quarter SMP indicative target.** Money in circulation increased by 21.7 percent during the first half of 2004/05, exceeding by 7.6 percent the SMP indicative target. This higher-than-targeted money increase was justified by the strong appreciation of the Afghani, which along with the recent slowdown in inflation, pointed to an increase in money demand. DAB's decision to accommodate this increase in money demand was successful in stabilizing the exchange rate. After appreciating by 20 percent in the first five months of 2004/05, including by 9 percent in the third week of August (when it reached Af 42 per dollar), the exchange rate has stabilized in the Af 45–46 per dollar range.

9. **We continued to modernize the DAB and create a sound financial system.** The banking regulatory framework was strengthened through enactment of the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) legislation, and the adoption of bank reserves requirements. The Export Promotion Bank, whose licensing had been delayed due to the cancellation of its merger with 3 other state-owned banks, was granted a conditional banking license. DAB also granted a preliminary license to Arian Bank, raising to eight the number of private commercial banks operating in Afghanistan. DAB introduced short-term capital note auctions. Reflecting the high level of liquidity in the banking system, overnight auctions were overbid and the interest rates on these notes declined steadily to less than 2 percent. At this early stage, demand for longer maturities remains limited. Finally, DAB started implementing the transfer of its commercial activities and the Supreme Council agreed to develop a modern payments system (electronic funds transfer).

10. **Data for the external accounts are limited, but steadily improving.** Based on preliminary data, the external current account balance (before grants) narrowed to a deficit equivalent to 12 percent of GDP, down from a deficit of about 22 percent during the first half of 2003/04. This decline in the deficit appears to have stemmed largely from an improvement

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<sup>2</sup> The core budget concept was introduced for this financial year. It incorporates operating and development spending that passes through the Treasury's accounts. A considerable amount of development spending, which is fully financed by external assistance, is undertaken directly by donors and is not included in the core budget.

<sup>3</sup> The FY 2004/05 core development budget was approved at the end of June, after the start of the fiscal year (March 20) and the Berlin Donors' Conference that took place in March 2004. The core development budget is organized around a number of "National Programs" (NP) and "National Priority Programs" (NPP).

in the trade balance, including a substantial increase in domestic exports. Donor inflows, predominantly in the form of grants, continued to finance the deficit, along with some private inflows in the form of foreign direct investment. Disbursements of external loans remained limited, and on highly concessional terms. The large and positive errors and omissions in the balance of payments suggest the continued presence of unrecorded inflows (perhaps from opium exports, unrecorded foreign investments and capital flows, or remittances).

11. **In terms of the SMP, all quantitative indicators for end-September were observed**, with the exception of the ceiling on currency on circulation. However the failure to observe this target was in accordance with the flexibility established in the program.

12. **On the structural front, progress has been made, and all the structural benchmarks were met**, except for the benchmark related to the issuance of a presidential decree enacting the AML/CFT legislation.<sup>4</sup>

### III. THE PROGRAM FOR THE REMAINDER OF 2004/05

#### A. Macroeconomic Objectives

13. With climatic conditions adversely affecting the short-term potential for further gains in agriculture, overall economic growth now depends more heavily on such activities as construction, transport, and other services, led by the private sector. Notwithstanding weaker prospects for agricultural production, which is likely to fall by 20 percent for the year as a whole, we expect growth to continue in 2004/05 and beyond. While somewhat slower than the brisk pace of the two previous years, real GDP growth is projected to reach about 7.5 percent for 2004/05. Downside risks include the lingering drought, volatile oil prices, and security. Inflation is expected to remain moderate during the remainder of the year as the rent prices appear to be stabilizing. Some pickup in import demand is expected to materialize in the second half of the year, associated with a post-election resumption of donor activities. Nevertheless, we expect an improvement in the overall external current account relative to 2003/04.

14. **Against this backdrop, we will continue to adhere to sound fiscal and monetary policies.** Strengthening our administrative capacity, accelerating structural reforms, and providing an enabling environment for private sector activity, while being mindful of poverty and social concerns, are also key priorities. At the same time, we are working very closely with our international partners to develop a five-pronged strategy to deal with the issue of opium, focused on education, alternative livelihoods, interdiction, eradication, and legal reform. We are also keenly aware that eradication of opium production cannot be accomplished in isolation, and that the economic consequences of any program will have to be carefully managed.

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<sup>4</sup> The decree was not issued until early October due to several issues raised by ministers during the initial Cabinet discussion of the law.

## B. Fiscal Policy

15. **The increase in revenue over the first half of the year is encouraging and we are confident that we will achieve the SMP target.** However, we recognize that the budgetary revenue target for the whole year (Af 15 billion) is ambitious but achievable.<sup>5</sup> Meeting this objective will require a significant improvement in revenue collection during the second half of the year—by about 55 percent over the first half of 2004/05.

16. **Achievement of the core budget target will require a redoubling of our collection efforts.** Customs and tax administration both have a comprehensive five-year reform plan to rebuild capacity in the Afghanistan Customs Department (ACD) and Revenue Presidency, within the Ministry of Finance. The central office of both organizations have recently been restructured under the Priority Reform and Restructuring (PRR) process. Key measures in the customs area include stronger management and coordination of domestic and donor-financed projects, and the construction of modern customs houses at key border posts. On the revenue side, the Large Taxpayer Office (LTO) is now operational and reform of the Kabul provincial revenue office (Model Office) is now underway. Parts of the tax reform package have also been implemented in Kabul, including: (i) the rental services tax; (ii) a 10 percent business receipts tax on service providers in restaurants, telecommunications, and hotels; and (iii) corporate tax rates have been harmonized at a rate of 20 percent. A simplified fixed tax on money changers and a withholding tax on wages will be gradually introduced, while legislation is pending to increase the airport departure tax. Finally, before the end of March 2005, we will publish in the Official Gazette the amendments to: (i) the income tax law relating to the tax reform package; and (ii) ensure that the revenue laws supersede all other legislation in revenue-related matters. By that time, we also intend to consolidate all recent revenue measures into the existing revenue code and to publish it as a single document.<sup>6</sup> In addition, we will receive some large non-tax revenue in the fourth quarter.

17. **Operating expenditures are expected to pick up significantly during the remainder of the year.** Additional training is being provided to line ministries and *moustoufiats* in financial and procurement procedures. This should improve compliance with current expenditure controls, which should translate into better rates of non-salary spending and the associated financing from the ARTF. The government is considering paying a bonus of Af 1,000 after Ramadan to most civilian employees, at a total cost of around Af 300 million, which can be accommodated within the current budget appropriations.

18. **We will continue to consolidate government operations and upgrade our public expenditure management systems.** While it had, for administrative reasons related to the political transition process, to be postponed from end-December 2004 to end-March 2005,

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<sup>5</sup> The annual revenue indicative target (floor) for the SMP is Af 12.8 billion (\$256 million).

<sup>6</sup> Due to administrative reasons related to the political transition process, the benchmark covering this measure had to be moved from end-December 2004 to end-March 2005.

the Cabinet approval and publication in the Official Gazette of the Financial Management Law will provide the legal framework for fiscal policy. Significant progress has been made with the development of the core budget and the consolidation of government accounts into the Treasury Single Account (TSA). **These reforms need to be deepened with additional efforts to:** (i) further harmonize the operating and development budgets, initially by agreeing to a single Chart of Accounts; (ii) improve the payment and payroll systems and expenditure controls; (iii) strengthen macro-fiscal analysis and cash management capabilities; (iv) enhance quarterly budget reporting and budget classification; and (v) reintroduce internal and external audit functions.

19. **Expenditure policy will gradually shift from security and reconstruction toward more broad-based sustainable development as improvements in the security situation allow.** The budget is currently dominated by the wage bill (58 percent of the operating budget) with spending on security comprising more than 40 percent of the total. Given the limited scope for increasing domestic revenue, we envisage the medium-term role of the public service as restricted to providing only the most essential services in the most cost-efficient manner. We are just beginning more fundamental sector-based planning in the form of a Public Expenditure Review (PER), which will initially assist with the preparation of the 2005/06 budget but is also expected to become a key component in developing government priorities and monitoring performance.

### C. Monetary and Exchange Rate Policies

20. **The revised monetary framework will continue to be geared toward maintaining low inflation and currency stability.** The revision of the monetary program was warranted given the emergence of stronger-than-anticipated money demand, the sharp appreciation of the Afghani, and the slowdown in inflation. The increase in money demand may partly reflect seasonal factors, such as the impact of the poppy harvest and the return of expatriate Afghans. However, we believe that the root cause of the increase, which coincided with weaker economic growth, is a greater acceptance of the local currency. This faster-than-expected “Afghanization” of the economy appears to have been spurred by efforts to promote the use of the Afghani by the public in daily transactions, the relative stability of the exchange rate, and the greater use of the Afghani by the donor community. We expect this process to continue, albeit at a slower rate. We therefore believe that the new monetary indicative targets, which imply a monetary tightening as compared to the current stance, will ensure a further decline in inflation.<sup>7</sup> In any case, DAB will continue to closely monitor exchange rate and price developments, and stands ready to tighten its monetary policy would inflation not abate.

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<sup>7</sup> The revised monetary program implies a decline in money growth from more than 50 percent at end-September 2004 to a maximum of 38 percent in March 2005.



21. **We will continue our reform of the financial system.** Difficulties in identifying the owners of current and savings accounts will prevent DAB from finalizing the transfer of its commercial activities by the target date of end-December 2004. We are committed to finalize the transfer of all commercial activities from the DAB's main office, and to start implementing the transfer in the provincial branches, by end-March 2005. As first steps, by end-December we intend to (i) complete a campaign asking customers to transfer their accounts; (ii) classify all accounts into three categories (voluntary transfer; involuntary transfer; and incapables of transfer); and (iii) initiate transfers. This, together with the transfer of DAB's non-core assets to the Ministry of Finance, will help lay the foundations of a modern central bank. Reflecting difficulties in assigning some potential liabilities currently housed at DAB, this transfer will be initially limited to the transfer of DAB's commercial holdings (end-March 2005 benchmark). At the same time, the findings of DAB's external audit will provide a comprehensive assessment of its financial situation and set, if needed, a framework for its recapitalization. DAB will also work toward a more market-oriented foreign exchange market, with a view to giving a more prominent role to the commercial banks and will try to deepen interest in the short-term capital note. Finally, we will decide the time frame and restructuring strategy for the three licensed state-owned banks, and the specific resolution methods of the three unlicensed ones.

#### **D. External Policy and Debt Management**

22. **The government remains committed to an open trade and exchange system.** The introduction of a new tariff system and the use of market exchange rates for import valuation were significant steps forward in this regard. Afghanistan is now one of the most open economies in the region, with a simple average applied tariff of only 4 percent, and very few nontariff barriers. To enhance the prospects for regional trade, the government will also continue to pursue or improve upon trade and transit agreements with neighboring countries. Consideration is also being given to membership in the World Trade Organization. On current trends, the current account balance (excluding grants) is projected to narrow to 32 percent of GDP, a 10 percentage points decline compared with the 2003/04 estimate. Such an outcome would enable us to further increase our foreign exchange reserves to about \$1.1 billion, equivalent to roughly 4 months of prospective goods and services imports. In any event, we are raising our floor for international reserves to 3.5 months of imports, a sufficient level of reserves to help us face a possible external shock.

23. **We remain committed to prudent management of external debt.** Regarding the stock of debt, we have made further progress in identifying debts undertaken by previous administrations, and reconciling their amounts with external creditors. More remains to be done in this area, however, as there are still a number of outstanding claims which have yet to be verified. In seeking international cooperation in this area, we will also continue to look for generous debt relief from bilateral creditors. We see such relief as essential to external and fiscal sustainability over the medium- and long-term. During the first two quarters of 2004/05, and consistent with the SMP, we have contracted external loans only on highly concessional terms. Disbursements have also been limited. To ensure that this prudent

strategy remains a central pillar of Afghanistan's reconstruction and stabilization, we will seek to design and implement a comprehensive external debt management strategy in the near future.

### E. Structural Reforms

24. We recognize the need to undertake reforms to unlock the potential of new growth-generating economic activities. One avenue is to press ahead with our structural reform agenda, with a particular focus on making improvements to the business and regulatory environment, as well as the public sector.

25. **Notwithstanding the limited availability of detailed financial data, we have recently completed a survey of state-owned enterprises (SOEs), including a preliminary assessment of their financial situation.** On the basis of this survey, we have established a preliminary classification of SOEs according to how they might be best restructured. Accordingly, we intend to maintain 10 SOEs in public ownership and at least 20 for liquidation. Currently, as many as 41 are slated for privatization, and the larger firms will be subject to an international tendering process. Further work on the financial state of these SOEs is ongoing, which will likely lead to some adjustment of the current classification. Due to delays related to the formation of new government, however, we do not expect this classification, and the related restructuring plan, to be adopted by the Cabinet by end-December 2004, as initially envisaged under the SMP. We are fully committed though to have the classification adopted by end-March 2005. In the meantime, we have already initiated the privatization process of a limited number of small SOEs, including the sale of a cotton company and a sugar beet company. In undertaking this process of privatization and reform, we remain keenly aware of the need to alleviate the social impact of the restructuring and efficiently manage the implications for current employees. Toward this end, we have compiled a comprehensive list of all employees of SOEs, which will help the government retrain or reassign workers displaced by the restructuring process.

26. **With a view toward boosting nonagricultural private sector investment, we are finalizing a new private investment law and anticipate its publication in the Official Gazette before end-December.** We are also making headway in putting in place a legal framework for the extractive industries—an area where we see considerable scope for new investment and growth.

27. **Reform of public administration must balance the need to improve productivity with the availability of resources.** To enhance control over the payroll and reduce a source of corruption, we are developing a “verified payroll plan” for ministries to normalize the payroll process and improve employee verification.<sup>8</sup> Over the medium-term,

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<sup>8</sup> The structural benchmark to initiate: (i) direct electronic payments to vendor bank accounts; and (ii) a pilot for direct salary deposits to bank accounts for the employees of three ministries has been deferred from December 2004 to March 2005 due to technical difficulties.

this will enable us to develop a more comprehensive personnel database and computerized payroll. Over the next few years, we will aim at maintaining the size of the civil service while enhancing its productivity with major investments in capacity building and salary increases to retain and recruit professional staff. The PRR process has been the essential component in civil service reform and it has gained wide acceptance within the government.

28. **We remain concerned about poverty. We have begun a dialogue with our various social counterparts** both within government, including the provinces, as well as civil society and our international partners to develop a poverty reduction strategy. We expect that an interim strategy should be finalized before end-March 2006.

#### **F. Safeguard Assessment and Statistical Issues**

29. DAB has hired an international consulting firm to conduct an external audit based on internationally recognized standards. This audit will serve as a basis for the introduction, in consultation with the Fund, of a safeguard assessment—which should begin after the external audit is completed.

30. **Notwithstanding the progress made so far, the statistical database remains weak.** We remain committed to improving the quality, coverage, and timeliness of our macroeconomic statistics. In this context, we have adopted a statistical master plan, aimed at establishing clear work program priorities, including the introduction of institutional and legal reforms to underpin statistical capacity, promote interagency coordination, and enable the resources and technical assistance needed for the development of a comprehensive statistical database.

#### **G. Technical Assistance**

31. **Technical assistance (TA) received from various donors has been instrumental in reconstructing an institutional infrastructure and achieving significant improvements in various areas.** While TA needs will remain significant in some areas, they are expected to diminish in others. Consequently, TA needs must be redefined, focused, coordinated and efficiently delivered. For that purpose, we intend to conduct a comprehensive review of technical assistance, and establish a comprehensive TA action plan.

#### **H. Program Monitoring**

32. **The program will continue to be monitored** using the definitions, data sources, and frequency of monitoring set out in the attached Technical Memorandum of Understanding (TMU). The quantitative indicators for the third and fourth quarters of 2004/05 are included in Table 1. The structural benchmarks are detailed in Table 2. The government will make available to Fund staff all core data, appropriately reconciled and on a timely basis, as specified in the TMU.

33. **The Technical Committee of Coordination (TCC) is gradually emerging as the key unit in monitoring the implementation of the SMP and in providing core data to the Fund.** It is now the main body through which coordination of technical work is conducted. Notwithstanding this progress, there is still room for improvement. In particular, the government will encourage the TCC to step up its capacity-building efforts, develop a much needed analytical function, and reach out to other government agencies.

34. **The third review of the program is scheduled to take place around mid-January 2005,** based on performance at end-2004. At the time of that review, the quantitative indicators and structural benchmarks for end-March 2005 may be revised in light of developments.

35. **The presidential election has just been completed and the composition and form of both the Cabinet and economic policy oversight is expected soon.** We believe it would be premature to discuss any future Fund program until the new government is in place. However, given the need to further build administrative capacity, and given the absence of an immediate balance of payments need, we believe a follow-on SMP (either a new program or an extension of the current SMP) might be an appropriate step.

Table 1. Afghanistan: Quantitative Indicators, 2004/05

(In millions of Afghani, unless otherwise indicated; cumulative changes from March 19, 2004)

	2004/05					
	Sep. 21 Initial Target	Sep. 21 Preliminary Estimate	Dec. 20 Initial Indicative Target	Dec. 20 Revised Indicative Target	Mar. 20 Initial Indicative Target	Mar. 20 Revised Indicative Target
Currency in circulation (ceiling) 1/	3,774	6,253	5,848	9,265	7,384	10,954
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)	29.1	277.7	47.6	115.0	55.4	115.0
Fiscal revenue of the central government (floor)	5,506	5,886	8,649	8,649	12,784	12,784
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/ 5/	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)	4,475	...	6,899	10,702	8,785	12,392

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

1/ At end-2003/04, currency in circulation amounted to Afis 28.8 billion.

2/ Excluding rescheduling arrangements, but including debt with maturities of more than one year.

3/ 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).

4/ On a contracting or guaranteed basis. Excluding debt related to normal import transactions.

5/ This benchmark will be evaluated on a continuous basis.

Table 2. Islamic State of Afghanistan: Prior Actions and Structural Benchmarks  
Under the Staff-Monitored Program

Policy Actions	Target Date	Status
<b>I. Prior Actions for Management Approval of the SMP</b>		
Adopt the 2004/05 operating budget (by the Cabinet).		Implemented on March 18, 2004
Establish procedures and a timetable for regular sweeping provincial balances into TSA at DAB headquarters and a plan to transfer all 2002/03 year-end balances in the provincial accounts and ministerial accounts to the treasury account at DAB.		Implemented on March 13, 2004
Initiate the closure and resolution process for all banks that have not applied for licenses.		Implemented by DAB on March 16, 2004
Set up a Technical Committee to coordinate the implementation of the SMP.		Implemented on March 15, 2004
Sign a presidential decree enacting the tax policy package (see paragraph 11 of MEFP).		Implemented on March 18, 2004
Adopt a ministerial order to implement the customs policy package (see paragraph 11 of MEFP).		Implemented on March 18, 2004
Adopt a Cabinet resolution to draft legislation that eliminates tax exemptions and concessions except those contained in revenue legislation.		Implemented on March 18, 2004
<b>II. Structural Benchmarks</b>		
Consolidate all line ministry accounts into TSA.	End-June 2004	Implemented
Transfer regularly provincial <i>moustoufiat</i> balances into TSA at DAB headquarters, from at least 70 percent of provinces.	End-June 2004	Implemented
Adopt the 2004/05 development budget (by the Cabinet).	End-June 2004	Implemented
Establish a timetable for (a) a verified payroll of government employees; (b) a wage decompression compatible with medium-term fiscal sustainability; and (c) the closure or corporatization of public enterprises.	End-June 2004	Implemented
Transfer all 2002/03 year-end balances in the provincial accounts and ministerial accounts to the treasury account at DAB.	End-June 2004	Implemented

Table 2. Islamic State of Afghanistan: Prior Actions and Structural Benchmarks  
Under the Staff-Monitored Program (continued)

Policy Actions	Target Date	Status
Develop a balance sheet for DAB.	End-June 2004	Implemented
Develop a monetary survey, including balance sheets of commercial banks.	End-June 2004	Implemented
Complete (by DAB) the relicensing operation of the commercial banks and begin the resolution proceedings for those whose licenses applications have been rejected.	End-June 2004	Largely implemented 1/
Develop consolidated fiscal accounts including provinces and operating and development budgets (see paragraph 14 of the TMU).	End-June 2004	Implemented
Adopt a presidential decree enacting amendments to the tax and customs laws to preclude the use of tax exemptions or concessions, except those contained in revenue legislation and the existing statutory exemptions, grandfathered until March 20, 2005 (see paragraph 14 of the TMU).	End-June 2004	Adopted
Issue (a) presidential decree enacting Anti-Money Laundering/Combating Financial Terrorism (AML/CFT) legislation; and (b) a decision by the Supreme Council of DAB for a modern payment system.	End-September 2004	Largely implemented 2/
Extend the consumer price index survey to main cities beyond Kabul.	End-September 2004	Implemented
Adopt (by the Cabinet) the 2003/04 final accounts (operating budget).	End-September 2004	Implemented
Transfer regularly within 30 days all provincial <i>moustoufiat</i> balances into TSA at DAB headquarters.	End-September 2004	Implemented
Complete the relicensing operation of, or begin the resolution proceeding for Export Promotion Bank of Afghanistan.	End-September 2004	Implemented
Adopt new chart of accounts compatible with IMF GFS 2001 (cash basis) requirements for classifying revenue and expenditure transactions.	End-December 2004	
Prepare (by MoF) monthly cash flow projections to improve cash management and for coordination with DAB.	End-December 2004	

Table 2. Islamic State of Afghanistan: Prior Actions and Structural Benchmarks  
Under the Staff-Monitored Program (continued)

Policy Actions	Target Date	Status
Publish in the official gazette the central bank and commercial banks laws.	End-December 2004	
Introduce the auction process for a short-term DAB capital note.	End-December 2004	Implemented
Initiate an external audit of the DAB based on internationally recognized accounting standards.	End-December 2004	
Adopt (by the Cabinet) and publish in the official gazette the financial management law.	End-March 2005	
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	
Complete an assessment of the financial position of the SOEs. Adopt (by Cabinet) (a) the list classifying SOEs according to proposed economic restructuring method; and (b) the Economic Restructuring Plan.	End-March 2005	
Consolidate all recent revenue measures into the existing revenue code and publish as a single document.	End-March 2005	
Complete the survey of external debt, including reconciliation with creditors.	End-March 2005	
Transfer of DAB's commercial holdings to the MoF, and transfer marketable gold and silver in the palace vaults to the DAB.	End-March 2005	
Transfer to other entities all DAB commercial activities that are inconsistent with the central bank and commercial banking laws.	End-March 2005	
Implement a program to monitor and record duty exempt imports.	End-March 2005	
Adopt the consolidated budget for FY 2005/06 according to the structure of the new chart of accounts before the start of the fiscal year.	End-March 2005	



Table 2. Islamic State of Afghanistan: Prior Actions and Structural Benchmarks  
Under the Staff-Monitored Program (concluded)

Policy Actions	Target Date	Status
Improve government payments by initiating (i) direct electronic payments to vendor bank accounts; and (ii) a pilot for direct salary deposits to bank accounts for the employees of three ministries.	End-March 2005	
Approve (by the cabinet) the Customs Code.	End-March 2005	
Implement verified payroll plan by: (a) establishing through decree or regulation that provide legal basis for a single general employee database; and (b) ensuring that budget allotments and authorized staff positions are entered into AFMIS for all line ministries and their subordinated units in the center and provinces before the start of the fiscal year.	End-March 2005	
Publish (by the MoF) on a quarterly basis fiscal data.	End-March 2005	
Publication of an official estimate of the annual revenue forgone as a result of tax holidays, exemptions or concessions and a time-bound plan, approved by the MoF, to address all existing tax exemptions or concessions.	End-March 2005	

1/ Due to shareholder opposition to its merger with three other state-owned commercial banks, the Export Promotion Bank of Afghanistan had to resubmit an application for relicensing. It was granted a new license in September.

2/ At end-September, the decree had been approved by Cabinet. It was signed by the President in early October.

### **Amendments to the Technical Memorandum of Understanding**

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

- **Complete an assessment of the financial position of the SOE. Adopt (by Cabinet) (i) the list classifying SOEs according to proposed economic restructuring method; and (ii) the Economic Restructuring Plan.** For those nonfinancial SOEs with poor record keeping and scarce financial information, instead of an assessment of the financial position, the experts will make, at a minimum, an informed judgment of the state of the enterprise through in-site visits and thorough discussions with management and staff. If sufficient financial information becomes available, then a full-fledged assessment of the financial position of the SOE will be conducted prior to its restructuring. The Economic Restructuring Plan will reflect the various steps and tasks entailed by the restructuring process, and will be adopted by the Ministries in charge of the SOEs and presented to the Cabinet.
- **Transfer to other entities all DAB commercial activities that are inconsistent with the central bank and commercial banking laws.** At a minimum, this will include all commercial activities performed by DAB's main office. Notwithstanding the transfer of other commercial activities, the transfer of commercial accounts will, at least, comprise all accounts which are not: frozen; non-cash; or requiring audit or/and legal determination.

2. The following bullet point will be inserted at the end of paragraph 15:

- **Core development budget operations and their financing should be reported on a quarterly basis no more than six weeks after the end of the quarter.** The data should be at least quarterly, but whenever possible, should include monthly expenditures covered under the core budget, as well as financing. The structure of the financing (grants and loans) and expenditure data should be on the same classification as the operating budget in addition to the program classification used by the budget. The data should also compare outturns against the budget.

**Statement by the Staff Representative  
January 19, 2005**

1. This statement summarizes information that has become available since the staff report for the 2004 Article IV consultation and second review under Afghanistan's staff-monitored program was circulated to the Board on January 4, 2005. It does not change the thrust of the staff appraisal.
2. Consumer prices in Kabul increased by 4.0 percent during the third quarter of 2004/05, reflecting a seasonal increase in food prices. Rents and petroleum prices, which had increased sharply over the first half of 2004, declined somewhat. Year-on-year inflation declined to 12.0 percent in December (6.6 percent excluding rents and petroleum).
3. Preliminary data indicate that revenues dropped to less than Af 0.9 billion in each of the seventh and eighth months of the fiscal year, compared with an average of around Af 1.0 billion per month in the preceding months. This decline appears to have resulted from a slowdown in the implementation of customs and tax administration reforms, largely due to capacity constraints and disruptions from the presidential election. It could also be attributed in part to seasonal factors as a similar pattern was observed in 2003/04. Meeting the third quarter cumulative SMP target for domestic revenue (Af 8.6 billion) will require a rebound in revenue during the last month of the quarter, to around Af 1.0 billion.
4. Operating budget spending amounted to Af 16 billion during the first eight months of 2004/05, compared with the annual budgeted amount of Af 30 billion. This underspending is mainly due to the slower-than-expected pace of public administration reform, particularly delays in the recruitment of additional teachers and in the main civil service restructuring program. The government also introduced measures to improve expenditure controls during the year, which may have slowed the pace of non-salary spending, particularly in the provinces.
5. Preliminary data indicate that currency in circulation amounted to Af 37 billion at the end of the third quarter of 2004/05, slightly below the SMP indicative ceiling (Af 38 billion). After increasing by a total of 6 percent in October–November, currency in circulation remained broadly unchanged in December. The slowdown in monetary expansion appears linked to the conversion of Afghanis into dollars for the Hajj, and to a slowdown in donor-related spending in the period leading up to the formation of the new government. Foreign exchange reserves continued to increase during the third quarter, to \$1.3 billion at end-November (equivalent to 4.8 months of 2005/06 imports). The nominal exchange rate depreciated during the last three months of 2004, to about Af 50 per dollar at mid-January—roughly the same level as at the beginning of the fiscal year.
6. All end-December 2004 benchmarks appear to have been met, with the exception of the benchmark related to the publication in the official gazette of the central bank and commercial banking laws. While the central bank law was published, the publication of the commercial banking law was delayed, essentially as a result of the limited translation capacity of the ministry of justice.



INTERNATIONAL MONETARY FUND

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January 27, 2005

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

## **IMF Executive Board Concludes 2004 Article IV Consultation with the Islamic State of Afghanistan**

On January 19, 2005, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Islamic State of Afghanistan.<sup>1</sup>

### **Background**

During 2001–03, after more than 20 years of conflict, interspersed with earthquakes and drought, the authorities of Afghanistan focused on crisis management by establishing or rebuilding fundamental institutions, providing basic government services, and restoring economic stability. In 2004, with most of these tasks largely achieved, the authorities articulated, and started implementing, a long-term strategy aimed at building a financially self-sustaining state with the capacity to meet basic social needs and address poverty through: increasing security; promoting private sector-led growth; increasing revenue efforts to allow funding of recurrent costs within a medium-term horizon; eliminating the drug economy; and strengthening further the institutions. This strategy, entitled “Securing Afghanistan’s Future”, was endorsed by the donor community at the Berlin conference in March 2004. A one-year staff-monitored program (SMP) was adopted in March 2004 that focuses on capacity building and establishing a track record, providing the basic economic underpinnings for many of the government reforms. Overall, the authorities have successfully implemented this program.

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<sup>1</sup> Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

The authorities have made further progress in rebuilding institutions and implementing sound economic policies. They have maintained their commitment to fiscal discipline, evidenced by their observance of a “no-overdraft” financing rule prohibiting government borrowing from Da Afghanistan Bank (DAB), and have continued to improve fiscal management. Important tax policy measures, combined with ambitious tax and customs administration reforms, are helping the central government to regain control over revenue collection. Further, for the first time, the authorities adopted in 2004/05 a ‘core budget,’ to improve coordination and control over donor flows. Expenditure management has improved, although, as in many post-crisis countries, the level of expenditures have significantly lagged behind budget projections because of weak implementation capacity.

Despite a paucity of monetary instruments, DAB’s flexible approach to monetary policy, in the context of a “managed float,” has been largely successful in limiting both inflation and exchange rate volatility. While monetary policy is guided primarily by indicative targets for currency in circulation, DAB, uses all available indicators to assess changes in the demand for domestic currency given the substantial uncertainties surrounding relationships between key macroeconomic variables, and stands ready to adjust its monetary stance when necessary to preserve macroeconomic stability. Modernization of the central bank and reform of the financial system are progressing, although the banking sector is still in its infancy.

Real GDP growth has been relatively strong, albeit from a very low base, and has slowed over the past 18 months, due primarily to the negative impact of adverse weather conditions on agricultural production. Growth remained strong in the other sectors, especially in construction and services, which continued to benefit from a buoyant aid-related, and possibly opium-related, demand. Real GDP growth is now projected at 8 percent in 2004/05, compared with 16 percent in 2003/04 and 29 percent in 2002/03. While there was some improvement in social indicators, including in school enrollment and food security, the social challenges remain daunting. After increasing during the first half of 2004 as a result of sharp increases in rents and petroleum products prices, inflation has moderated somewhat. Reflecting a strong balance of payments, the nominal and real exchange rates vis-à-vis the U.S. dollar appreciated through September 2004, but have recently depreciated.

Current efforts by the authorities and the donor community in addressing the opium economy have not been very successful so far. The latest report of the United Nations Office on Drugs and Crimes indicates that poppy production continued to rise in 2004, with cultivation spreading to new areas of the country and involving an increasing share of the population. Illicit drug revenue is estimated to have risen to US\$2.8 billion, equivalent to about 60 percent of nondrug GDP. The government and the international community are developing a common medium-term strategy to abate the drug economy. The manner in which this strategy is implemented will be critical in maintaining social, economic, and political stability.

## **Executive Board Assessment**

Directors commended the Afghan authorities for their continued pursuit of sound macroeconomic and structural reforms despite a challenging security environment. Directors noted that prudent fiscal and monetary policies have helped to contain inflation and facilitate relatively high levels of growth, and were encouraged by the continued successful implementation of the staff-monitored program. Although budget execution has not met expectations, a core budget has been introduced that consolidates all the government operations channeled through the Treasury, revenue collection has continued to improve, and significant progress has been made in the implementation of structural reforms. Directors noted, however, that notwithstanding these achievements, daunting economic and social challenges remain, and poverty is widespread, calling for continued skilful economic management and strong implementation of further structural reforms, with continued donor support.

Directors commended the authorities for the successful conduct of Afghanistan's first direct presidential election, and viewed the forthcoming legislative elections as an opportunity to broaden the ownership of economic reforms. Directors encouraged the new government to continue to pursue the economic reforms, capacity building, and rehabilitation of physical infrastructure. Directors stressed the importance of improving security conditions, including through a vigorous disarmament, demobilization, and reintegration process.

Directors expressed concern about the continuing rise in opium-related activities, which they saw as jeopardizing security as well as macroeconomic stability. Agreeing that eradication by itself will be insufficient to address the issue, Directors supported recent efforts by the government and its international partners to develop a multi-pronged strategy to deal with the opium economy. Directors advised establishing safeguards to alleviate any significant adverse economic impact of opium eradication, particularly for the most vulnerable segments of the population. In this connection, they stressed the need to create broader economic opportunities and alternative livelihoods for farmers, expand the formal economy, and promote pro-poor growth.

Looking ahead, Directors supported the continued implementation of the SMP, which they saw as providing a framework for maintaining the reform momentum and building a solid foundation for a possible transition to a Fund program that could be supported by the Poverty Reduction and Growth Facility. In this regard, Directors were encouraged by the authorities' decision to initiate work on an Interim Poverty Reduction Strategy Paper to frame their policy agenda.

Directors observed that widespread shortages of skilled civil servants and very low administrative capacity continue to pose significant challenges for policy implementation. They considered that, in many instances, these capacity constraints have lessened the effectiveness of reforms envisaged under the program. They called on the authorities to tackle these issues, so as to support macroeconomic stability and promote private investment. Directors welcomed the intention to press ahead with planned public administration reforms.

Directors considered that the thrust of macroeconomic policies in the current staff-monitored program strikes an appropriate balance between supporting growth during this period of

transition and the need to remain vigilant with regard to potential risks. Looking ahead, they encouraged the authorities to continue to develop a comprehensive medium-term budget framework that lays the ground for fiscal sustainability. This will require redoubled efforts to enhance revenue and strengthen expenditure management. Directors attached particular importance to stepping up the implementation of the planned reform of tax and customs administration, including at the level of the provinces. Directors expressed some concern about under spending on social programs, and encouraged the implementation of an expenditure framework that would increasingly support more broad-based and sustainable development, especially as progress is made in meeting the immediate security and reconstruction needs. They also cautioned the authorities to undertake only those public investments that generate an adequate rate of return.

Directors agreed that the success of the government's reform strategy is predicated on continued donor support and well coordinated technical assistance, and urged the donor community to do its part in fulfilling their financial commitments and pledges. They urged the authorities to work with donors to integrate progressively their spending into the government's medium-term budget framework, which would in turn enhance ownership and coordination of the reform program. In this context, Directors noted that direct donor support to the budget would simplify fiscal management and help coordinate donor funds. This will require continued improvement in fiduciary standards and the mechanisms for promoting accountability.

Directors noted the results of the debt sustainability analysis and the need for the authorities to maintain a cautious approach toward new external obligations. In this context, Directors supported the authorities' efforts to obtain external financing on only the most concessional terms, but also emphasized the need for the authorities as well as creditors to resolve the issues of outstanding bilateral claims. It was recognized that mobilization of grant financing has helped meet pressing social and development needs. Directors also recommended that the authorities adopt an explicit strategy to guide external debt management over the medium term.

Directors viewed the current framework for monetary policy, based on a monetary anchor, as adequate to ensure low inflation while avoiding unwarranted exchange rate fluctuations. They agreed that the flexibility embedded in the monetary program has allowed DAB to react promptly to shifts in money demand, while keeping inflation in check and limiting exchange rate volatility. Directors encouraged the authorities to remain vigilant to price developments and to stand ready to tighten monetary policy if warranted. They encouraged the authorities to work toward improving their monetary and banking data so as to better inform their monetary policy decisions, and gradually expanding the range of instruments for liquidity management.

Directors considered that further structural reforms will be crucial in improving the business climate, and in helping to sustain economic growth, employment opportunities, and export prospects. In this regard, they welcomed the new investment law. Directors also highlighted several other key elements of the reform agenda that should be pursued, including property rights, bankruptcy laws, contract enforcement, and a transparent and effective judicial system. Directors emphasized that the cooperation of all government ministries and agencies, along

with political commitment at the highest levels, will also be required to create a clear and level playing field for business, and spur private sector-led growth.

Directors supported the authorities' efforts to rationalize the public enterprise sector. While agreeing that the state-owned banks may not represent a systemic risk, Directors urged the authorities to take measures to restore the profitability of those which were relicensed, and to resolve those which were not relicensed.

Directors emphasized the need for a strengthened legal system as key to the success of Afghanistan's economic reform program and medium-term outlook. They observed that the status of key economic legislation remains uncertain owing to low capacity at the Ministry of Justice. Directors urged the authorities to seek external support to address this issue. They welcomed the enactment of a legislative framework for anti-money laundering and combating the financing of terrorism actions, while underscoring the critical importance of effective implementation.

Directors noted that the creation of a technical committee of coordination for the Staff Monitored Program has facilitated program implementation and ownership. They advised the authorities to take steps to enable the committee to develop and strengthen much needed analytical and policy capacities.

Directors emphasized that, notwithstanding progress made so far, much remains to be done with respect to improving governance. They regretted indications that widespread corruption, the rise in drug activities, and the lack of transparency in many areas may have undermined the business environment.

Directors welcomed the steady progress in trade liberalization, and the authorities' commitment to a liberal foreign exchange regime. They looked forward to further advances, including through development of a supporting legal framework that will pave the way for accepting the obligations under Article VIII of the Fund's Articles of Agreement.

Directors welcomed the authorities' continuing efforts to improve the statistical framework. At the same time, they noted that the current provision of data falls short of international standards in terms of quality, frequency, and dissemination. They were encouraged by the recent adoption of a statistical master plan and urged the authorities to put in place a realistic work program and mobilize the resources needed for implementation.

**Public Information Notices (PINs)** are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board.



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Islamic State of Afghanistan: Selected Economic Indicators, 2001–05

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	2001/02 Estimate	2002/03 Estimate	2003/04 Estimate	2004/05 Projection
<b>Output</b>				
Real GDP growth (percent, excluding opium)	...	29	16	8
GDP (billions of Afghani)	134	183	225	269
GDP (millions of U.S. dollars, excluding opium)	2,463	4,084	4,585	5,392
GDP per capita (U.S. dollars, excluding opium)	123	182	199	228
<b>Prices</b>				
CPI (Kabul, year-on-year change, in percent)	-43.4	52.3	10.3	10.2
CPI (Kabul, average change, in percent)	...	5.2	24.2	12.3
<b>Exchange rates</b>				
Afghani/US\$ (annual average)	54.4	44.8	49.0	...
Afghani/US\$ (end of period)	31.0	52.6	50.3	...
<b>General government operating budget</b>				
Revenues (millions of U.S. dollars)	...	132	207	256
Expenditures (millions of U.S. dollars)	...	349	451	609
Grants (millions of U.S. dollars)	...	209	205	300
<b>Monetary indicators</b>				
Domestic currency in circulation (percent change)	...	20.1	40.9	38.0
Gross international reserves (millions of U.S. dollars)	...	426	815	1,105
<b>External indicators</b>				
Current account (excluding grants; in million of dollars)	...	-1,305	-1,945	-1,721
Current account (including grants; in percentage of GDP)	...	-2.1	-1.8	-3.4

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

**Statement by Abbas Mirakhor, Executive Director for Islamic State of Afghanistan  
January 19, 2005**

1. My authorities highly appreciate the continuous dialogue with staff that has been instrumental in the successful implementation of their Staff-Monitored Program (SMP). They are also grateful for the assistance from the donor community in support of Afghanistan's security and reconstruction needs. Against the background of a difficult security and political environment, the authorities have persevered with prudent financial policies and structural reforms. All quantitative and structural benchmarks of the SMP for end-September were observed on time, with the exception of the benchmark relating to the AML/CFT legislation, which was implemented with a slight delay.
2. The recent direct presidential election—with large voter participation and a strong mandate to President Karzai—was a milestone in rebuilding the institutional framework and broadening policy ownership. The new cabinet is dominated by technocrats and the economic team is expected to continue the current successful policies. The authorities recognize the challenges ahead, including maintaining security, stemming the growing drug economy, sustaining non-inflationary growth, and reducing poverty. In addressing these challenges, they count on continued strong financial and technical support from the international community as they strive toward mobilizing domestic resources and building institutional capacity.
3. Despite the adverse effect of the persistent drought on the agricultural sector, real GDP growth remained strong, bolstered by robust activity in construction and services. Inflation, which had been fueled by sharp increases in rents and petroleum products prices, has slowed recently. Reflecting an improved trade balance, driven by a marked increase in domestic exports, the current account deficit is expected to narrow significantly and to be financed mainly from grants, highly concessional loans, and foreign direct investment.
4. The authorities have demonstrated strong commitment to fiscal discipline and to improving budget management. In the first half of FY 2004/05, revenue exceeded the SMP indicative target and registered a significant increase over the same period last year, reflecting administrative reforms and improved transfer of provincial collections into the central government account. The rate of current spending, most of it security-related, increased after initial delays, while core development budget spending fell substantially short of expectations due to combination of late budget approval, the security situation, and capacity constraints. The no-overdraft policy, a strong signal of fiscal discipline, was maintained, with operating expenditures financed through revenue, foreign assistance, and the temporary draw down of government deposits in the face of lower-than-expected reimbursements from the two multi-donor grant funds. A system of direct payment to vendors' bank accounts has been recently initiated and is expected to accelerate payments and to improve fiscal discipline.
5. While remaining anchored on targets for currency in circulation and carried out through foreign currency auctions, monetary policy continued to be implemented flexibly.

Hence, the higher-than-expected increase in money demand, reflected in the strong appreciation of the *Afghani* and the growing "*Afghanization*," a testimony to rising confidence in the economy, has been accommodated. Monetary policy flexibility, buttressed by the managed float, has contributed to the containment of inflation, reduction of exchange rate volatility, and building of reserves. The Da Afghanistan Bank (DAB) successfully introduced a short-term note and will work toward developing additional monetary policy instruments.

6. Despite capacity constraints, significant progress has been made in structural reforms, including introduction of major initiatives in the banking and fiscal areas. Bank legislation and regulatory framework have been reinforced along with the licensing of several state- and foreign-owned banks. Further reform of the state banks will be undertaken in the period ahead to bolster competition and efficiency. Computerization of expenditure and revenue operations, and the adoption of five-year plans to improve customs and tax administrations, are expected to significantly improve budget management.

7. For the second half of 2004/05 and over the medium term, the program will focus on maintaining fiscal and monetary discipline, accelerating structural reforms, improving the environment for private sector activity, strengthening administrative capacity, and addressing poverty and social concerns. The goal is to foster broad-based growth as well as a more efficient and resilient economy.

8. The short-term outlook is overshadowed by a weaker prospect for the agricultural production due to persisting adverse weather conditions that threaten food security for up to 3.5 million people (15 percent of the population). Growth in other sectors is expected to continue, perhaps at a slower pace, spearheaded by private sector-led activities in construction, transport, and other services. Downside risks to this outlook, aside from the effects of prolonged drought, include volatile oil prices, the spread of opium activities, and the uncertain security situation. Inflation is expected to remain moderate as rents stabilize. The external current account is also expected to improve, notwithstanding a projected pickup in import demand, reflecting post-election resumption of donor activities and, as the staff suggest in BUFF/05/3, reserves increased to about US\$1.3 billion, equivalent to 4.8 months of imports at end-November.

9. In the fiscal area, the strong revenue collection for the first half of 2004/05 bodes well for performance over the year. While the pace of revenue collection slowed down somewhat in October and November, this reflected a reasonable pattern, and possibly the effect of the elections, and revenue performance is expected to strengthen thereafter. The tax system is being simplified, and its base broadened, along with efforts to consolidate revenue laws into a single code. On the expenditure side, government operations are to be consolidated and expenditure management systems upgraded. Operating expenditures are projected to pick up significantly, and compliance with expenditure regulations is expected to improve as additional training of personnel is provided in financial and procurement procedures. Reforms aimed at developing the core budget and consolidating the government accounts into the Single Treasury Account will be strengthened. As improvements in the security situation allow, the expenditure policy will shift gradually from security and reconstruction

to more broad-based development objectives. The outcome of a public expenditure review, currently being undertaken by the World Bank and other donors, should help in establishing priorities for next year's budget.

10. Low inflation and currency stability remain the primary goals of monetary policy. The DAB will closely monitor price and exchange rate developments and will take prompt action in adjusting policy as necessary, in close consultation with Fund staff. A more market-determined exchange rate policy will be fostered, with an increased role for commercial banks, which should bolster the nascent export sector. Financial sector reform will continue to be geared to restructuring the state-owned banks and DAB operations. The restructuring strategy for the three licensed state-owned banks will be finalized, as will the resolution plan for the three unlicensed banks. The process of transferring DAB's commercial activities and its non-core assets, a challenging task, will continue, as it is aimed at laying the foundations for a modern central bank. DAB's recapitalization needs are expected to be determined by its external audit, which will also form the basis for a safeguards assessment.

11. In the structural area, reforms will be accelerated to unlock the potential of new growth-generating activities and to expand employment opportunities. A recently undertaken survey of state-owned enterprises (SOEs) will form the basis for their privatization, restructuring, or liquidation. The SOEs classification and reform plan is expected to be adopted by Cabinet by end-March 2005. In the meantime, privatization of a number of small SOEs, including a cotton company and a sugar beet company, has already been initiated. The adverse employment impact of SOEs reform will be alleviated through retraining and reassignment of displaced workers. Public administration reform will seek to balance the need to improve service delivery with resource availability. In this connection, an employee and payroll verification system is being developed to ensure effective expenditure control and will be transformed into a more comprehensive personnel database and computerized payroll over the medium term. Civil service capacity will be strengthened and remuneration improved to assist recruitment and retention of skilled staff. The government attaches high importance to private sector investment and is finalizing the requisite legal and regulatory framework. In this regard, the importance of clarifying property rights, contract enforcement, and bankruptcy laws is duly recognized. Moreover, governance concerns, including those relating to perception of corruption, are to be forcefully addressed to enhance business confidence.

12. The authorities recognize, and are committed to, the benefits of an open and transparent trade and exchange system. The introduction of a new tariff system with just a few rates and estimated average tariff of 4 percent as well as the use of market exchange rates for import valuation are important steps in this regard. Due emphasis is being placed on promoting regional trade, where the potential is significant, including through agreements on trade and transit with neighboring countries. At the multilateral level, WTO membership is a future goal once the requisite legal reforms are introduced. Long-term debt sustainability is a priority for the authorities who are committed to prudent debt management and intend to design and implement a comprehensive strategy to that end. Furthermore, steps are being taken to reconcile and verify existing debts, while limiting borrowing to highly concessional terms. The staff report duly emphasizes the need for very generous treatment of pre-war

claims to ensure long-term fiscal and debt sustainability. Consequently, the authorities will continue to seek generous debt relief from bilateral creditors.

13. The growing drug-related activities pose a daunting challenge. The authorities recognize that relying solely on eradication without considering potential economic consequences, especially for the poor, will not be successful. While the government is determined to reduce opium production markedly in the years ahead, sustained donor financial and technical assistance is needed to create, in particular, alternative livelihoods for rural population. The authorities are working with international partners to develop a five-pronged strategy involving education, alternative livelihoods, interdiction, eradication, and legal reform. The “*Securing Afghanistan’s Future*” strategy seeks, *inter alia*, to sustain high growth in the nondrug economy, exploiting alternative sources of growth, including in agriculture, extractive industries, construction, and transportation. Alleviating poverty exacerbated by the war and meeting basic social needs are central to the strategy. In furtherance of this goal, a dialogue with social and development partners is underway to develop an interim poverty reduction strategy that is expected to be finalized by end-March 2006.

14. Considerable scope exists for improving the quality, coverage, and timeliness of the statistical database. In this regard, a statistical master plan to prioritize a work program and coordinate resources and TA for the development of a comprehensive database has been adopted. To maximize the benefits of TA, redefinition, focus, and coordination are critical, and, for that purpose, a comprehensive review and the establishment of an action plan are contemplated.

15. The authorities are resolved to forge ahead with their reform agenda. They recognize the risks associated with the security and the political situation, which should to be handled cautiously to maintain the necessary social stability and cohesion. Afghanistan will need significant donor assistance, including substantial debt relief, to support its reconstruction and development efforts. Until a new national assembly is in place, and given the need for more time to build a solid administrative capacity and for the new government to become fully functional, the authorities have expressed their preference for a follow-on SMP before embarking on a formal program relationship with the Fund. The SMP should continue to focus on maintaining macroeconomic stability and building a track record of policy implementation while supporting the authorities’ capacity building efforts. They are grateful to staff, management, and the Board for their advice and support.