

Islamic Republic of Afghanistan: Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criterion—Staff Report; Staff Supplement and Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Islamic Republic of Afghanistan

In the context of the fourth review under the three-year arrangement under the Poverty Reduction and Growth Facility and request for a waiver of a performance criterion, the following documents have been released and are included in this package:

- The staff report for the Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criterion, prepared by a staff team of the IMF, following discussions that ended on May 1, 2008, with the officials of the Islamic Republic of Afghanistan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 23, 2008. 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 supplement on the joint IMF/World Bank debt sustainability analysis.
- A staff statement of July 7, 2008 updating information on recent developments.
- A Press Release summarizing the views of the Executive Board as expressed during its July 7, 2008 discussion of the staff report that completed the request and review.
- A statement by the Executive Director for the Islamic Republic 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 Republic of Afghanistan*
Memorandum of Economic and Financial Policies by the authorities of the
Islamic Republic of Afghanistan*
Technical Memorandum of Understanding*
*Also 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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ISLAMIC REPUBLIC OF AFGHANISTAN

**Fourth Review Under the Three-Year Arrangement Under
the Poverty Reduction and Growth Facility and Request for Waiver of Performance
Criterion**

Prepared by the Middle East and Central Asia Department
in consultation with other departments

Approved by Juan Carlos Di Tata and Matthew Fisher

June 23, 2008

- Discussions on the fourth review under the Poverty Reduction and Growth Facility (PRGF) arrangement were held in Kabul during April 19–May 1, 2008. The staff team comprised Messrs. Elhage (head) and Wieczorek, Ms. Farahbaksh (all MCD), Mr. Tyson (FAD), and Mr. Saxegaard (PDR). Mr. Charap (IMF resident representative in Kabul) assisted the mission. The mission met with Senior Minister Arsala; Minister of Finance Ahady; Governor of Da Afghanistan Bank (DAB) Fitrat; Minister of Commerce and Industry Farhang; other government officials; and representatives of the diplomatic and donor communities and of the private sector.
- Afghanistan's three-year PRGF arrangement amounting to SDR 81.0 million (50 percent of quota) was approved by the Executive Board on June 26, 2006. The arrangement supports the authorities' economic program through March 2009 and Afghanistan's participation in the Heavily Indebted Poor Countries (HIPC) Initiative. Completion of the fourth review would allow the fifth disbursement (SDR 11.3 million) under the arrangement.

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LIST OF ACRONYMS

AML	Anti-Money Laundering
ANDS	Afghanistan National Development Strategy
CFT	Combating Financing of Terrorism
CiC	Currency in Circulation
CN	Capital Note
CPI	Consumer Price Index
BRT	Business Receipts Tax
DAB	Da Afghanistan Bank
DABM	Da Afghanistan Breshna Moassesa
DABS	Da Afghanistan Breshna Sherkat
DSA	Debt Sustainability Analysis
FDI	Foreign Direct Investment
FLGE	Fuel and Liquid Gas Enterprise
GDP	Gross Domestic Product
GST	General Sales Tax
HIPC	Heavily Indebted Poor Countries
I-ANDS	Interim Afghanistan National Development Strategy
MCD	Middle East and Central Asia Department
MDRI	Multilateral Debt Restructuring Initiative
MEFP	Memorandum of Economic and Financial Policies
MOF	Ministry of Finance
MOCI	Ministry of Commerce and Industry
MTFF	Medium-Term Fiscal Framework
NCBF	Net Central Bank Financing
NIR	Net International Reserves
OFID	OPEC Fund for International Development
PFM	Public Financial Management
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
SOEs	State-Owned Enterprises
SMEFP	Supplementary Memorandum of Economic and Financial Policies
TMU	Technical Memorandum of Understanding

EXECUTIVE SUMMARY

Economic developments in the second half of 2007/08 were broadly favorable, but inflation picked up significantly. Real gross domestic product (GDP) growth is estimated at 11.5 percent in 2007/08, and consumer price index (CPI) inflation reached 20.7 percent, reflecting higher prices of imported fuel and foodstuffs. The external position strengthened and the Afghani remained stable relative to the U.S. dollar.

Program performance during the second half of 2007/08 (the fiscal year ended on March 19, 2008) fell short of expectations. The performance criterion on fiscal revenue was missed and the authorities fell behind on several program commitments.

For 2008/09, real GDP growth is projected to moderate to 7.5 percent and inflation to decelerate to 15½ percent by year's end. However, food prices have exerted considerable upward pressure on the CPI in the early months of 2008/09 and the near-term inflation outlook is subject to a significant upside risk. The external position is projected to strengthen further due to strong export growth and aid inflows in excess of 50 percent of GDP.

Three prior actions were incorporated into the program to bring government revenues back on track. The prior actions call for: (i) introducing a system for timely updates of reference prices for petroleum products; (ii) enforcing tax and non-tax collections from airlines; and (iii) ensuring that customs has the authority to verify independently the amount and quality of fuel imports stored at the depots of the state-owned fuel company. The program also includes additional measures to ensure a sustained improvement in revenue performance.

To enhance the conduct of monetary policy, the authorities intend to implement measures to develop the secondary market for conducting open market operations using capital notes.

To address the slippage in the structural agenda (mainly in public financial management), the program includes a revised timetable for earlier commitments—whose implementation has been delayed—and additional commitments to strengthen program performance.

The Afghanistan National Development Strategy (ANDS—Afghanistan's PRSP) and the Joint Staff Advisory Note (JSAN) were discussed by the IMF Executive Board on June 2, 2008. The strategy provides a comprehensive framework for growth and poverty reduction over the medium term; however, the economy's absorptive capacity will be challenged by the steep increase in spending envisaged under the ANDS. There is a need for prioritizing the sectoral strategies, and domestic revenue must increase to prevent long-term aid dependence.

The security and political situation remains fragile and governance problems hamper the implementation of the reform agenda. The government's inability to deliver on structural reforms is a growing risk, and it is encouraging interest groups opposed to reform.

I. INTRODUCTION

1. **On February 13, 2008, the Executive Board approved the third review of Afghanistan's three-year PRGF arrangement and concluded the 2007 Article IV consultation.** On that occasion, Executive Directors urged the authorities to accelerate structural reforms, enhance governance, overcome infrastructure bottlenecks, and promote private sector activities while reducing the government's involvement in the economy. They also emphasized the importance of revenue enhancing measures to move Afghanistan toward fiscal sustainability.
2. **The ANDS—Afghanistan's PRSP—and the JSAN were discussed by the Executive Board of the IMF on June 2, 2008.** Directors stressed the need for further prioritization of sectoral programs in the ANDS and strengthened mobilization of domestic revenue to prevent long-term aid dependence. During the Paris Conference held on June 12, 2008, donors pledged about \$20 billion for the implementation of the ANDS. The horizon of donor pledges varied from two to five years; some donors are expected to make additional pledges in the period ahead.¹
3. **Security remains a major challenge and the political environment surrounding the program has become increasingly complex.** The government continues to experience difficulties in assuming control over large parts of the country affected by the war and the illegal drug economy. Presidential elections are scheduled for 2009, to be followed by parliamentary elections in 2010.

II. RECENT ECONOMIC DEVELOPMENTS

4. **Economic developments in the second half of 2007/08 were broadly favorable, but inflation increased significantly.** Real GDP is estimated to have increased by 11.5 percent (Table 1). Higher prices of imported fuel and foodstuffs raised 12-month (end-of-period) inflation to 20.7 in March 2008—the end of 2007/08 (Figures 1a–1b). The price level jumped by 20 percent in the first two months of 2008/09, reflecting the sharp increase in food prices following the imposition of export restrictions on wheat by Afghanistan's regional trading partners (Figure 1c). Opium production reached a record level in 2007/08 and farm-gate prices of opium declined significantly reflecting the increase in supply.
5. **The domestic revenue target was undershot by 6 percent.** As a percent of GDP, domestic revenue declined from 7.5 percent in 2006/07 to 7.0 percent in 2007/08 (Tables 2a and 2b). Although partly related to lower than projected imports, the revenue shortfall was mainly due to inadequate enforcement efforts and undervaluation of petroleum imports by customs. Nevertheless, the operating budget deficit excluding grants is estimated to have narrowed to 3.6 percent in 2007/08 (slightly lower than programmed), as the security spending envelope (which was significantly increased in mid-2007/08) was not fully used.

¹ The medium-term macroeconomic framework under the PRGF-supported program assumes that Afghanistan will receive about \$28.5 billion in grants during 2008/09–12/13, of which \$10.3 billion for security-related expenses.

Development expenditures are estimated to have been broadly in line with program projections, at Af 45 billion or 9.4 percent of GDP.

6. **Structural reforms in public finance have been uneven.** The authorities expanded the program budget pilots to help align public spending priorities with the ANDS, and initiated Treasury reforms to strengthen tracking of poverty related spending through reporting on government budget execution. Progress in these areas form part of the HIPC completion point triggers. Nevertheless, the linkage between budget formulation and subsequent execution and monitoring remains weak, and progress in integrating the operating and development budgets—a key objective of the program pilots—has been slow.

7. **Da Afghanistan Bank (DAB) observed the end-year currency in circulation (CiC) ceiling.** CiC growth was kept at 17.0 percent in 2007/08, significantly below the growth of nominal GDP (24 percent), which helped mitigate inflationary pressures in the latter part of 2007/08 (Table 3, Figure 2). DAB increased significantly the issuance of capital notes (CNs) during the second half of 2007/08. As a result, interest rates on 28-day CNs increased to 14.6 percent at end-2007/08, compared with 7.6 percent at end-2006/07. The Afghani strengthened by 1.1 percent vis-à-vis the U.S. dollar during 2007/08, and is estimated to have appreciated by 3.0 percent in real effective terms over the same period (Figure 3).

8. **DAB continued modernizing its operations.** The new accounting system at the DAB became fully operational, and now covers six regional branches. The authorities are also in the process of implementing the recommendations of the safeguards assessment and technical assistance in the areas of accounting and internal control. The ongoing modernization of DAB has been accompanied by a training program and restructuring of its workforce.

9. **The external position continued to strengthen in 2007/08 due to improvements in the trade balance and higher than expected aid inflows.** The current account balance (including grants) registered a surplus of 0.9 percent of GDP in 2007/08 (compared to a deficit of 4.9 percent in 2006/07). Gross international reserves increased to about US\$2.8 billion (11 months of imports).

10. **The authorities continued their efforts to regularize relations with external creditors, as required under the Enhanced HIPC Initiative.** In January 2008, Saudi Arabia agreed to write off most of the eligible outstanding claims on Afghanistan (approximately \$25.5 million; all in arrears) and restructure the remaining balance on terms comparable to those granted by Paris Club creditors. In May 2008, Iraq agreed to forgive Afghanistan's debts (about \$9.6 million in arrears). Negotiations on debt relief agreements are underway with the Kuwait Development Fund and the OPEC Fund for International Development. The authorities are also undertaking a review of DAB's records regarding an unverified (pre-cutoff) claim by Iran, with a view to confirming its validity by mid-2008/09. In addition, the authorities continue to make good faith efforts to enter into debt relief negotiations with the remaining non-Paris Club creditors.

III. PERFORMANCE UNDER THE PROGRAM

11. Performance under the PRGF program in the second half of 2007/08 was mixed:

- The authorities met all the quantitative performance criteria and indicative targets for end-2007/08, with the exception of the floor on domestic revenue (Supplementary Memorandum of Economic and Financial Policies (SMEFP); Attachment II, Table 1).
- Four out of seven structural benchmarks were met (SMEFP Table 2). The benchmark on adopting a comprehensive restructuring/divestment plan for state-owned enterprises (SOEs) and government agencies engaged in commercial activities was not observed. DAB also missed the benchmark on monetary data reconciliation; however, this reconciliation has now been completed and the data for monitoring the 2008/09 program will be sourced directly from DAB's accounting records. While the electricity company (DABM) was corporatized, enabling it to continue operating as a public entity but on strictly commercial basis, the authorities missed the structural benchmark on the conclusion of an agreement between the Ministry of Finance (MOF) and DABM on quarterly reform benchmarks in exchange for subsidy disbursements.
- Many other commitments specified in the Memorandum of Economic and Financial Policies (MEFP) of January 28, 2008 were not fulfilled. These included, among others, a review of fiscal relations between the government and key SOEs, and the submission to Parliament of laws that are critical for private sector development.

IV. THE 2008/09 PROGRAM

12. **Discussions with the authorities on their policies for 2008/09 focused on** (a) maintaining macroeconomic stability and other reform priorities; (b) prior actions to address the revenue shortfall in 2007/08 and other measures to strengthen revenue performance; (c) the monetary policy framework and bank supervision; (d) mechanisms to address the effects of rising wheat prices; and (e) structural reforms. Program discussions were guided by the MEFP of January 28, 2008. The changes to the program are reflected in the attached supplementary memorandum of understanding for 2008/09. In addition to three prior actions (¶14), the proposed program includes six new structural benchmarks for the fifth review and two more for the sixth review (Box 1). The new conditionality consists of actions that are deemed critical for improving the revenue performance, further developing the monetary policy framework, and strengthening public financial management (PFM) and bank supervision.

Box 1. Rationale for Added Structural Conditionality		
Structural Benchmarks	Target Dates	Rationale
<u>Fifth Review Under the PRGF Arrangement</u>		
Notify traders of the expiration of exemption from the general income tax regime and inform them that they will be expected to file and pay their tax liabilities for 2008/09 according to the general provisions applying to corporate income tax payers.	July 31, 2008	Critical for ensuring compliance with the revised general income tax regime for traders and for the overall success of the new regime, to be introduced in 2009/10
Develop an action plan to address the gaps in DAB's legal framework based on the weaknesses identified in DAB's self-assessment against the Basle Principles.	September 30, 2008	Critical for mapping the next steps toward strengthening bank supervision
Create an electronic registry of CNs at DAB.	September 30, 2008	Critical for developing secondary market operations in CNs and strengthening the role of CNs as a monetary policy instrument
Roll out the Large Taxpayer Office (LTO) to Herat, Jalalabad, and Mazar-e-Sharif.	September 30, 2008	Critical for broadening the revenue base to provinces and moving away from presumptive taxation
Amend income tax legislation, including by introducing BRT on imports.	November 30, 2008	Critical for the success of tax policy reforms and increasing tax revenue in 2009/10
MOF will review the fiscal relations between the government and Afghan Telecom, Ariana, DABS, and FLGE.	December 31, 2008	Critical for PFM and governance, and for bringing under control fiscal and quasi-fiscal liabilities of key SOEs
<u>Sixth Review Under the PRGF Arrangement</u>		
MOF will collect at least Af 79 million on airlines' tax and nontax liabilities due by airlines and outstanding at end-2007/08 and maintain regular collection of BRT and landing right fees throughout 2008/09.	March 31, 2009	Critical for governance and enforcement of tax laws with respect to large and politically connected enterprises
Implement the ASYCUDA Transit and Declaration Processing Module in Nangarhar and Herat, and at Kabul Airport inland clearing depots.	March 31, 2009	Critical for sustainable improvements in customs administration and for strengthening revenue collection

A. Macroeconomic Outlook

13. **Growth and inflation are both expected to moderate in 2008/09, and the external position is projected to improve.** Real GDP growth is projected to decelerate to 7.5 percent as drought will affect negatively agricultural output. Average 12-month CPI inflation is projected at 24 percent, with end-period inflation declining to 15.6 percent by year's end. This is an optimistic scenario that assumes a significant downward correction in food prices in the wake of government and donor efforts to bring adequate supplies of wheat into the country. Maintenance of this low inflation assumption is designed to keep the overall program targets (fiscal and monetary) tight. The inflation outlook is, however, subject to a significant upside risk (especially if food prices do not decline as envisaged), and the program may need to be revised if inflation through mid-year turns out to be significantly higher than projected. The external position is projected to improve further due to strong export growth, mining-related FDI, and aid inflows in excess of 50 percent of GDP.

B. Fiscal Policy

14. **Three prior actions were incorporated into the program to bring government revenues back on track (SMEFP ¶8).** The prior actions call for (i) introducing a system for timely updates of reference prices for petroleum products; (ii) collecting at least Af 79 million on the business receipt tax (BRT) and non-tax (landing/parking right fees) liabilities due by airlines and outstanding at end-2007/08²; and (iii) ensuring that customs has the authority to verify independently the amount and quality of fuel imports stored at the depots of the state-owned fuel company. The prior actions address directly the key sources of revenue leakages and noncompliance in 2007/08, and are critical for ensuring the viability of the revenue objectives for 2008/09.

15. **The operating budget deficit (excluding grants) is projected at 3.2 percent of GDP in 2008/09.** Revenues are targeted to increase to Af 44.5 billion (7.0 percent of GDP, of which 0.4 percent of GDP is on account of prior actions and additional program measures—SMEFP ¶8). The operating expenditure envelope of Af 65.0 billion (10.2 percent of GDP) is slightly lower, relative to GDP, than the outturn for 2007/08. The program also provides for an additional Af 1.9 billion (0.3 percent of GDP), if needed, to enable acceleration of Afghanistan National Army (ANA) recruitment. The core budget deficit (including grants) would be Af 2.5 billion higher than originally envisaged, but the prospects of significant receipts from the recently announced privatization of Afghan Telecom, planned for mid-2008, have significantly reduced the need for domestic financing in 2008/09.

² This amount represents an estimated 25 percent of the business receipt tax (BRT) and non-tax (landing/parking right fees) liabilities due by airlines and outstanding at end-2007/08. Another 25 percent of these liabilities is to be collected by March 31, 2009.

16. **Despite the revenue measures incorporated in the program, the revenue-to-GDP ratio is not expected to rise in 2008/09.** Higher food prices increase nominal GDP, but do not affect revenues because food is not taxed. The revised fiscal program, therefore, now aims only to stabilize the revenue-to-GDP ratio for 2008/09 (Figure 4); however, in nominal terms, revenue is projected to be 33 percent higher than in 2007/08.

17. **Continued structural fiscal reforms are necessary to strengthen the fiscal outlook** (SMEFP ¶¶11–13). The authorities plan to: (i) modernize the civil service by implementing the Pay and Grade reform; (ii) strengthen the financial management system in view of scaled-up aid in the context of ANDS by implementing the budget and treasury reforms; and (iii) regularize the relations between the budget and public enterprises. To this end, the authorities reconfirmed their commitment to initiate the review of fiscal relations between the government and key state-owned enterprises (SOEs).

18. **The authorities intend to work with donors on mechanisms to help the poor cope with the impact of increased wheat prices.** The authorities have thus far resisted the idea of providing aid via cash transfers to the needy, pointing to the lack of appropriate identification and distribution mechanisms, and have already imported about \$50 million of wheat from neighboring countries at a price below the market price in Afghanistan with the intention of selling the imported wheat at a cost-recovery level (SMEFP ¶7).

C. Monetary Policy, Financial Sector Reforms, and External Sector

19. **Monetary policy will aim to contain inflationary pressures; however, widespread dollarization will continue to limit its effectiveness.** Foreign exchange auctions will remain a primary instrument of monetary policy, with the objective of maintaining CiC growth at or below the growth of nominal GDP (33.1 percent) and limiting exchange rate volatility without resisting the underlying trend in the Af/US\$ exchange rate. Given the increasing importance of noncash transactions and the need to broaden the monetary policy framework, DAB intends to use an indicative ceiling on reserve money (RM) in addition to the quantitative performance criterion on CiC, and to strengthen its liquidity forecasting and monitoring (SMEFP ¶¶16–18). The introduction of the reserve money target will provide guidance for operations in CNs and help lower interest rate volatility. DAB also plans to take measures to develop the secondary market for conducting open market operations using CNs (SMEFP ¶17).

20. **DAB will also continue to build its capacity and modernize its operations.** The completion of the 2007/08 external audit (expected by end-June 2008) will form the basis for an action plan to strengthen further DAB's capacity, including in accounting, reporting, and internal control.

21. **DAB aims to strengthen the legal and regulatory framework of the banking sector, which has grown rapidly in recent years.** To that end, DAB intends to develop an action plan to address the gaps in the legal framework based on the weaknesses identified in the self-assessment exercise against the Basle Principles. Also, regulations on risk management (credit, market, liquidity, country, and operational) are under preparation. In addition, DAB will continue to maintain restrictions on the growth of credit and branches of weak banks (SMEFP ¶¶20-21).

22. **Foreign exchange reserves are expected to rise further to US\$3 billion** (about 11½ months of projected imports) by the end of 2008/09. Despite significant copper mine related imports (Box 2), the current account deficit (excluding grants) is projected to improve over the medium term, in line with the decline in donor-related imports and full delivery of debt relief under the HIPC initiative.

Box 2. Afghanistan's Mining Potential

Afghanistan has significant mineral resources, including copper, iron, gold, coal, and semi-precious stones. Despite considerable exploration and deposit identification, large-scale mining has had limited development, and represents less than one percent of GDP.

In November 2007, Afghanistan tendered the right for exploration of its first large-scale copper mine, Aynak. The mine is considered to be the world's second largest untapped copper deposit, with estimated reserves of up to 13 million tons. Total FDI inflows associated with the project are projected at about \$2.8 billion over the next six years, enabling annual production of up to 200,000 tons (1.3 percent of current world production), which will amount to about 2 percent of GDP in about ten years, when Aynak reaches its expected peak. Fiscal revenues in terms of royalties and taxes are projected at about \$200 million a year. An ambitious program is also being planned to build the necessary infrastructure, which will boost activity in construction, water and electricity, coal, and transport.

Other mining projects are in the planning stages, including development of a large iron ore mine (with estimated reserves of about 1.8 billion tons), natural gas, and oil.

23. **The updated debt sustainability analysis (DSA) suggests that Afghanistan continues to have a high risk of debt distress, absent debt relief.**³ The DSA highlights the risk to Afghanistan's debt sustainability of lower-than-expected official transfers and a

³ The updated DSA illustrates that Afghanistan's NPV of external debt-to-exports remains until 2010/11 above the sustainability threshold (100 percent) under the baseline scenario, which assumes continued HIPC interim relief during the PRGF arrangement but no HIPC completion point debt relief.

slower-than-expected expansion of its narrow export base. However, full delivery of debt relief under the HIPC initiative and the Multilateral Debt Relief Initiative (MDRI) would be sufficient to reduce Afghanistan's debt to sustainable levels.

D. Structural Policies, Poverty Reduction, and Statistical Issues

24. **The authorities recognize the need to reinvigorate the structural agenda** (SMEFP ¶¶22–25). In line with understandings reached in January 2008, they plan to: (i) strengthen fiscal control over the financial operations of DABS (former DABM); (ii) place key SOEs on a sound financial footing, with a view to creating conditions for their restructuring or privatization; (iii) prepare the petroleum company for privatization by completing its external audit by November 2008; and (iv) strengthen the legal framework for private sector development.

25. **In the period ahead, the authorities will focus on the implementation of the ANDS.** This is an ambitious program, which should bring important benefits to the Afghan people. However, the envisaged scaling-up of expenditure may overstretch the absorptive capacity of the economy. Prioritization and full costing of programs will be essential to ensure their maximum benefit without compromising fiscal sustainability.

26. **The ANDS also presents an opportunity to address serious weaknesses in the statistical base.** The current state of the statistical base is inadequate for monitoring development progress under the ANDS and poses difficulties for the monitoring of the PRGF-supported program. In this regard, there is a need to develop a strategy for strengthening the Central Statistical Office (CSO), while progressively broadening the coverage and reliability of the statistical base.

E. Staff Appraisal

27. **Afghanistan's performance in the second half of 2007/08 under the PRGF-supported program fell short of expectations.** Looking ahead, continued macroeconomic discipline, progress in key structural reforms, improved conditions to facilitate private sector development (including state disengagement from economic activity), and political resolve to tackle difficult issues will be critical to the success of the program.

28. **The overall fiscal strategy for 2008/09 strikes a reasonable short-term compromise.** Nevertheless, achieving policy autonomy and financial independence from long-term aid will require a significant increase in domestic revenue, which remains one of the lowest in the world in proportion to GDP. The target date for covering operating expenditures with domestic revenue has slipped by one year to 2013/14, and the revenue shortfall in 2007/08 underscores the importance of high-level political support for revenue reforms. The authorities need to adopt a strategic approach to developing a modern tax and customs administration to meet their longer-term fiscal policy objectives.

29. **Further progress is required in PFM reforms.** In particular, there is a need for progress in improving the budgetary process, project preparation, procurement, expenditure

execution, and tracking. The government must also overcome the inertia in the civil service (Pay and Grade) reform, strengthen the public sector's human capital, and allocate efficiently the available human resources. Decisive steps to link the compensation system in the public sector to skills and performance are also needed. Meanwhile, the resurgence of inflation and the pressure for broad-based salary increases pose a major risk to the future of the civil service reform.

30. Monetary policy needs to remain focused on containing inflationary pressures.

To that end, DAB needs to strengthen its cooperation with the MOF in preparing liquidity forecasts and design a framework for the timely monitoring of commercial banks' liquidity. Staff welcomes DAB's intention to increase the role of CNs auctions and develop the secondary market for these instruments. However, the volumes of CNs auctions should be commensurate with market conditions to avoid unnecessary interest rate volatility and further widening of the spreads between dollar- and Afghani-denominated instruments. As regards foreign exchange auctions, the staff urges DAB to ensure strict observance of the program ceilings for CiC and do not resist possible pressures toward an appreciation of the currency against the U.S. dollar should the demand for Afghani turn out stronger than expected.

31. The rapid growth of commercial bank activities calls for further strengthening the regulatory framework and enforcement procedures. In particular, there is a need for strict and prompt corrective measures when warranted by bank examinations.

32. Structural reforms need to be accelerated to enhance the prospects for private sector development, foreign direct investment, and growth. This includes following up on commitments to improve transparency in the domestic petroleum sector and preparing for the privatization of the government-owned petroleum enterprise. There is also an urgent need to clarify the relationship between the budget and key public enterprises.

33. Regarding the government's involvement in the wheat market, the additional efforts by the government should be complementary to those by the World Food Program and other donor agencies, with emphasis to be placed mainly on targeted cash transfers to vulnerable households instead of direct wheat imports. This approach would help avoid distorting the market and would ensure that support can be made available promptly.

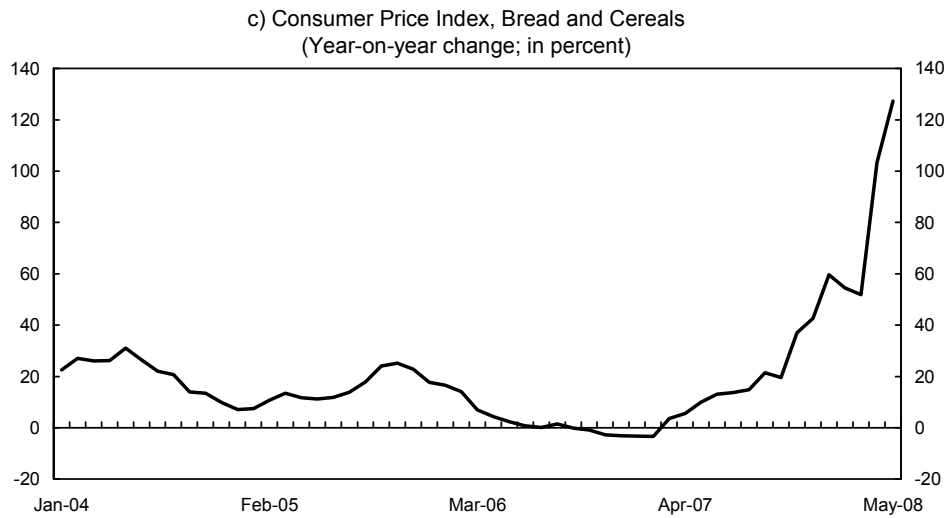
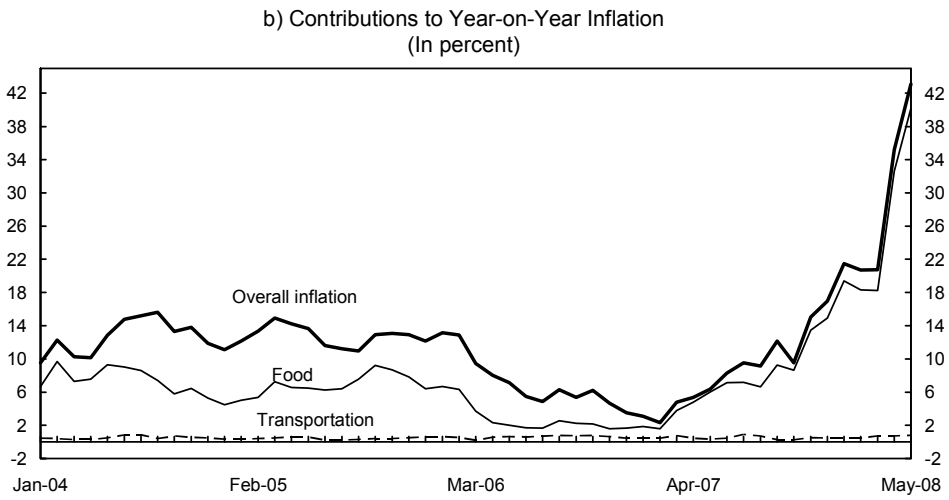
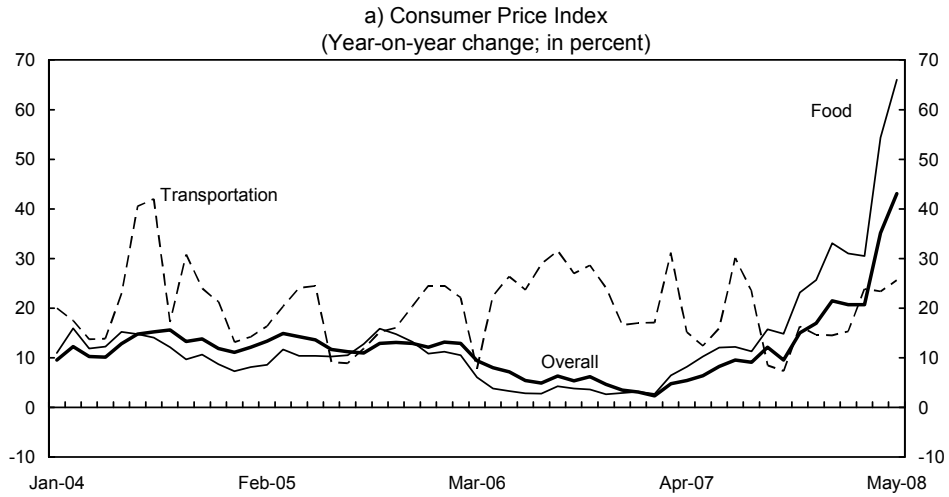
34. The quality of statistics has improved in areas critical for program monitoring (e.g., fiscal and monetary statistics). However, progress in improving statistics in other areas (e.g., the real sector and the balance of payments) has been slow. The staff urges the authorities to take advantage of Fund technical assistance currently being provided in these areas.

35. The biggest risk to the program concerns the inflation assumption. If the jump in food prices is not partially reversed, inflation in 2008/09 will turn out higher. The program has assumed an ambitious inflation objective in order to keep the monetary targets tight and resist pressures for additional spending in the budget. If inflation turns out higher, the government revenue-to-GDP ratio is likely to fall, even if the program's revenue targets are met.

36. **The program remains vulnerable to the ongoing security problems and capacity constraints.** In addition, the government's inability to deliver on structural reforms is emerging as another major risk. Given that 2009 will be an election year, political support for the reform agenda may weaken in the period ahead.

37. **Notwithstanding these risks, based on the authorities continued efforts and commitments, including the strengthened structural conditionality in reform areas of critical importance, the staff recommends the completion of the fourth review under the PRGF-supported arrangement.** In view of the prior actions which will address the primary causes of the revenue slippage in 2007/08 and the additional measures aimed at ensuring that the improvement in the revenue performance will be sustained in 2008/09, **staff supports the waiver of nonobservance of the quantitative performance criterion** on the floor on fiscal revenue.

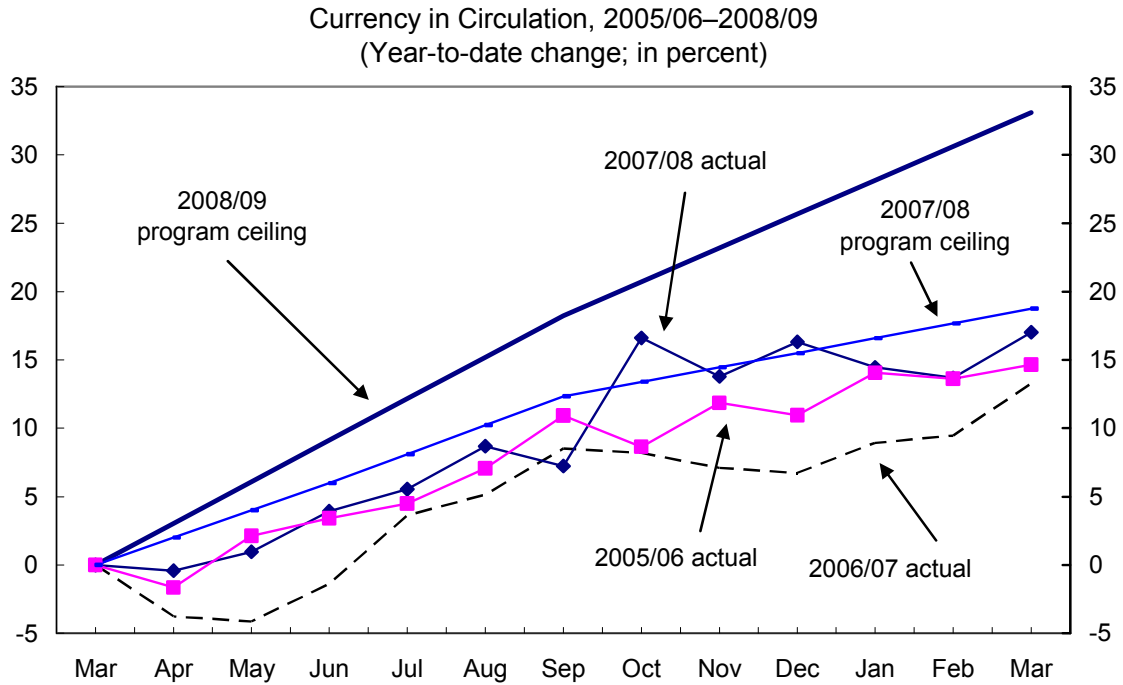
**Figure 1. Islamic Republic of Afghanistan: Price Developments
January 2004–May 2008 1/**



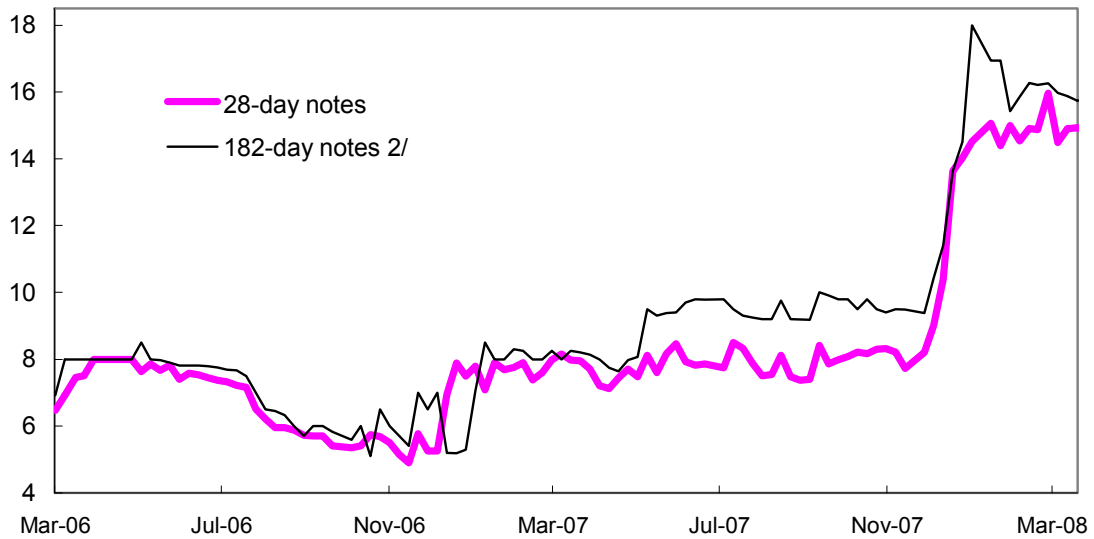
Sources: Central Statistics Office of Afghanistan; and Fund staff estimates.

1/ CPI data for Kabul only.

Figure 2. Islamic Republic of Afghanistan: Monetary Developments



Capital Note Auctions, March 2006–April 2008 1/
(Interest rate; in percent)

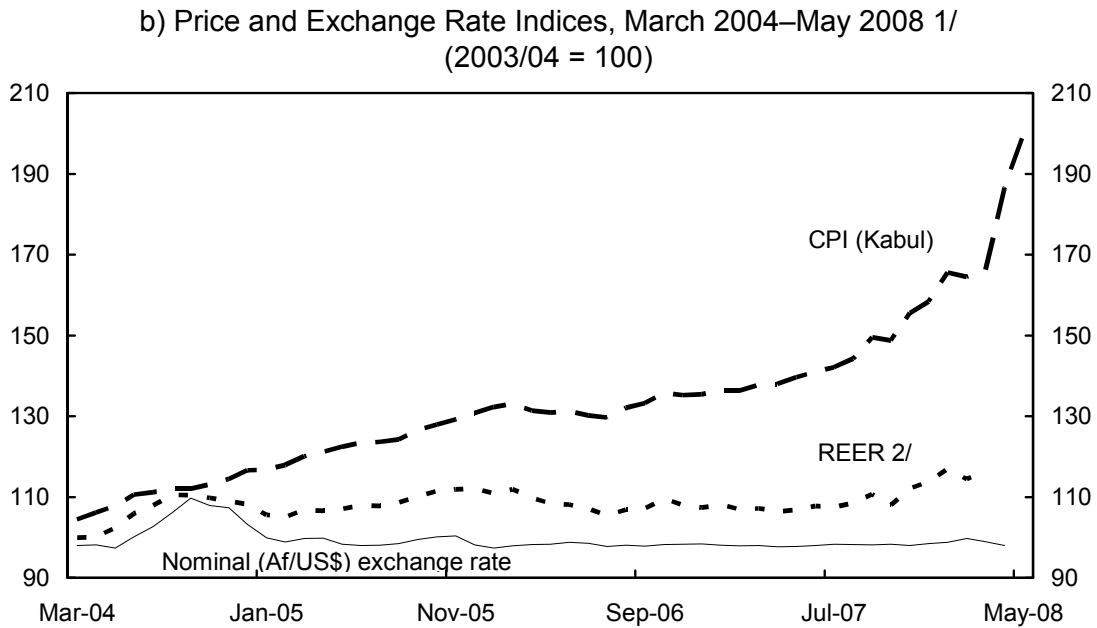
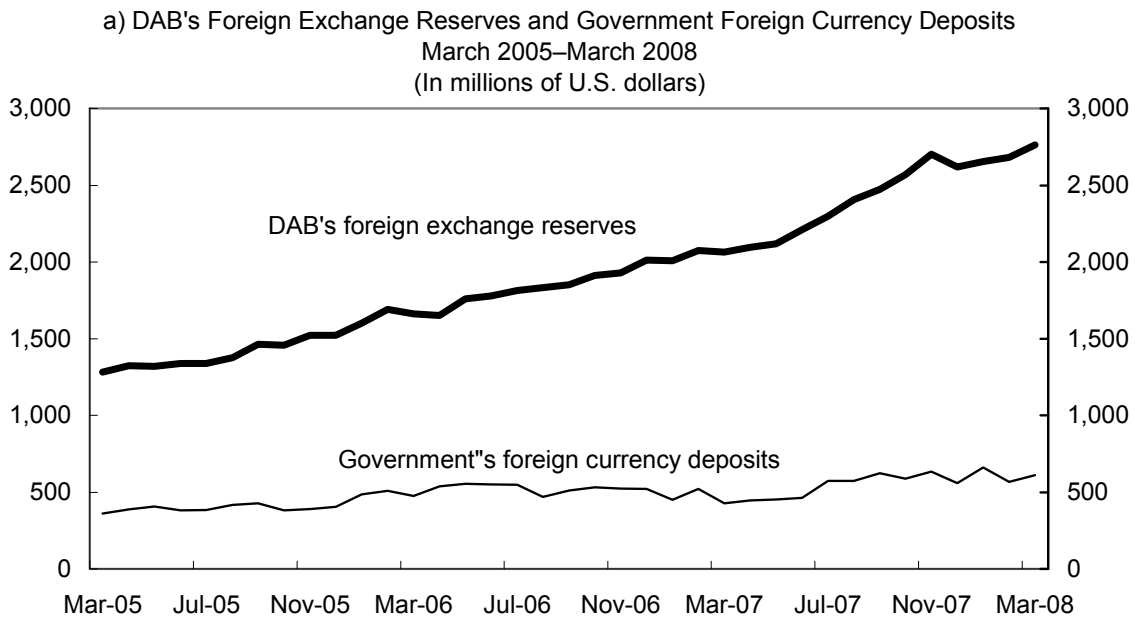


Sources: Da Afghanistan Bank; and Fund staff estimates and projections.

1/ Last observation: April 15, 2008.

2/ 56-day notes until February 27, 2007.

Figure 3. Islamic Republic of Afghanistan: Foreign Exchange Reserves and Price and Exchange Rate Indices

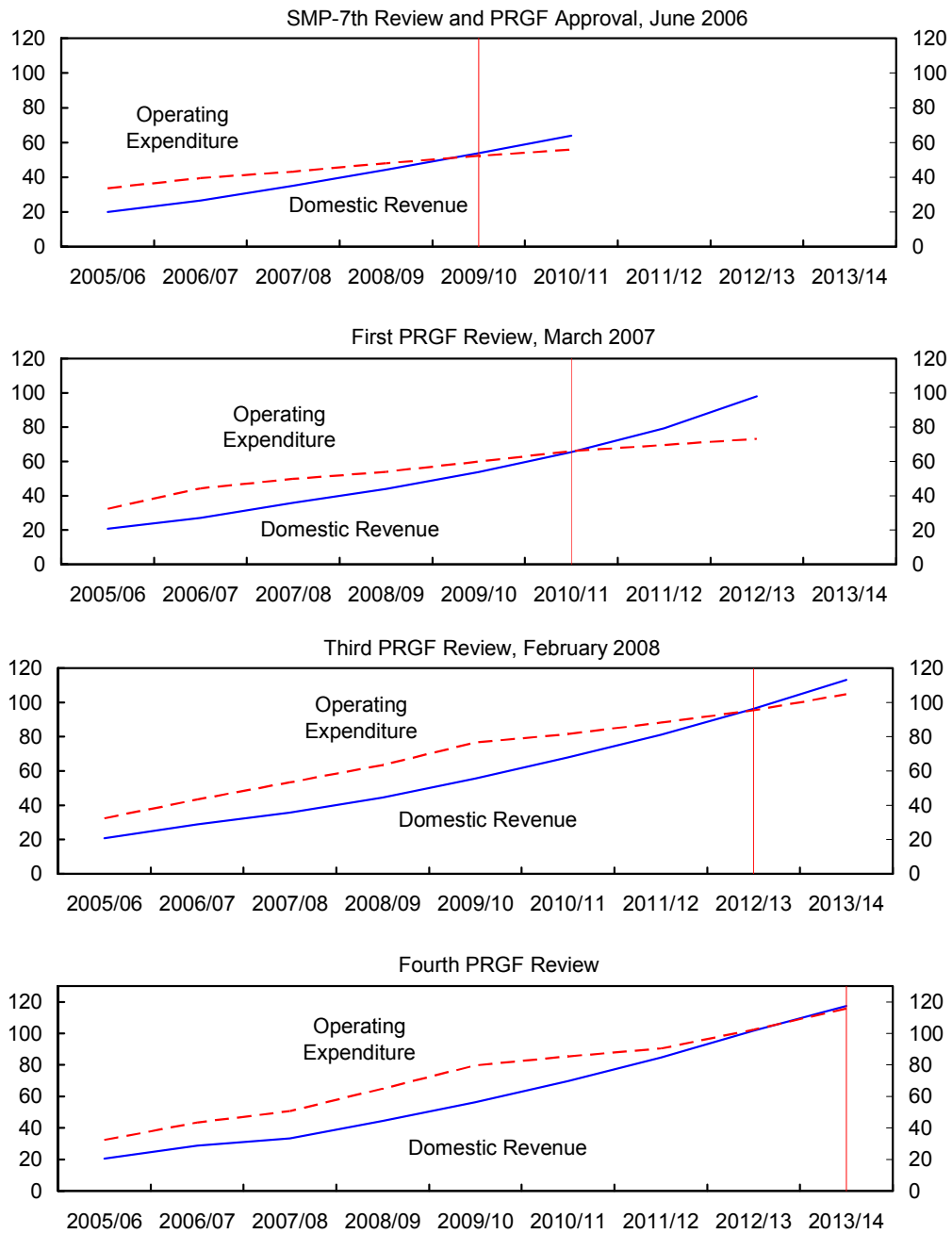


Sources: Central Statistics Office of Afghanistan; Da Afghanistan Bank; and Fund staff estimates.

1/ An increase in the exchange rate indices corresponds to an appreciation.

2/ CPI based; last observation: March 2008.

Figure 4. Fiscal Sustainability: Changing Target Dates for Zero Operating Budget Balance Under the PRGF Supported Program, 2005/06–2013/14 (In billions of Aghanis)



Source: MOF and Fund staff estimates.

Table 1. Islamic Republic of Afghanistan: Selected Economic Indicators, 2005/06–2012/13

(Quota: SDR 161.9 million)
 (Population: 26.7 million; 2006/07)
 (Per capita GDP: US\$290; 2006/07)
 (Poverty rate: n.a.)
 (Main export: carpets, US\$186 million; 2006/07)

	Est. 2005/06	Est. 2006/07	Est. 2007/08	Projections				
	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
(Annual percentage change; unless otherwise indicated)								
Output and prices 1/								
Real GDP	16.1	8.2	11.5	7.5	8.3	8.2	7.6	7.4
Nominal GDP (in millions of Afghanis)	322,231	385,489	478,058	636,249	750,767	859,093	975,198	1,100,335
Nominal GDP (in millions of U.S. dollars)	6,489	7,723	9,596	12,850	15,162	17,350	19,695	22,222
Consumer prices (period average) 2/	12.3	5.1	13.0	24.0	9.5	6.0	5.4	5.0
Consumer prices (end of period) 2/	9.4	4.8	20.7	15.6	6.0	6.0	5.0	5.0
(In percent of GDP)								
Investment and saving								
Gross domestic investment	44.6	40.5	37.0	31.2	31.1	29.2	28.1	27.8
Of which: nongovernment	9.6	8.1	7.8	7.7	11.9	12.3	13.2	14.4
Gross domestic savings	41.8	35.6	37.8	31.9	27.9	25.0	23.7	22.9
Of which: nongovernment	45.4	39.4	41.4	35.1	31.0	26.8	24.3	23.0
Public finances								
Operating revenue (excluding grants)	6.4	7.5	7.0	7.0	7.5	8.1	8.7	9.3
Operating revenue (including grants)	11.6	12.5	11.8	10.7	10.3	9.9	9.9	10.1
Operating expenditure 3/	10.0	11.3	10.6	10.2	10.6	9.9	9.3	9.3
Operating budget balance (excluding grants) 3/	-3.6	-3.8	-3.6	-3.2	-3.1	-1.8	-0.6	-0.1
Operating budget balance (including grants) 3/	1.6	1.2	1.2	0.5	-0.4	-0.1	0.7	0.7
Primary operating balance (including grants) 3/	1.6	1.2	1.3	0.5	-0.3	0.0	0.7	0.8
Core budget balance (including grants)	1.0	-2.9	-1.8	-2.5	-3.0	-2.4	-1.7	-1.6
Total government debt 4/	184.0	155.0	21.0	17.8	9.3	9.4	9.4	9.3
(Annual percentage change; unless otherwise indicated)								
Monetary sector								
Reserve money	12.1	22.3	14.4	33.5	...	...	...	...
Currency in circulation (year-to-date change)	14.6	13.3	17.0	33.1	...	...	...	...
Velocity of broad money	...	...	...	...	...	...	...	...
One-month capital note interest rate (end-period, in percent) 5/	6.5	7.6	14.9	14.9	...	...	...	...
(In percent of GDP; unless otherwise indicated)								
External sector 6/								
Exports of goods (in U.S. dollars, percentage change) 7/	22.2	2.9	11.0	34.8	21.9	18.9	18.5	18.2
Imports of goods (in U.S. dollars, percentage change) 8/	25.5	12.5	20.6	9.3	1.5	5.6	4.1	5.2
Imports excluding security related expenditure (in U.S. dollars, percentage change)	10.8	16.8	11.9	12.4	10.3	6.1	4.1	5.4
Merchandise trade balance	-66.8	-63.9	-62.5	-49.8	-41.6	-37.6	-33.6	-30.4
Current account balance, excluding official transfers	-75.2	-70.0	-66.9	-53.1	-44.1	-39.8	-35.6	-32.3
Current account balance, including official transfers	-2.8	-4.9	0.9	0.6	-3.1	-4.2	-4.4	-4.8
Foreign direct investment	4.2	3.1	2.5	2.6	6.5	6.4	6.4	6.5
Total external debt 4/	184.0	155.0	21.0	17.8	9.3	9.4	9.4	9.3
Gross reserves (in millions of U.S. dollars)	1,662	2,064	2,763	3,228	3,150	3,010	3,150	3,350
In months of next year imports of goods and services 9/	7.7	9.7	11.1	11.7	10.0	8.6	8.1	7.8
Relative to external debt service due	44.3	80.0	42.6	49.5	81.7	184.5	169.1	108.0
Memorandum items:								
Poppy production (wet opium, in tons)	4,100	6,100	8,200	...	...	...	...	...
Price (\$ per kg of wet opium)	101	94	86	...	...	...	...	...
External budget grants (in percent of GDP)	56.0	50.6	52.3	40.0	27.8	23.2	19.8	17.0
Unemployment rate (in percent)	...	...	...	...	...	...	...	...
Afghanis per U.S. dollar (period average)	49.7	49.9	49.8	...	...	...	...	...
Real effective exchange rate (annual average, percentage change) 10/	2.7	-2.0	2.6	...	...	...	...	...

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

1/ National accounts numbers were revised to reflect the authorities' data, excluding the drug economy.

2/ For Kabul.

3/ Does not include core budget development spending and externally-financed development expenditures, which amounted to 8.4 percent of GDP and 50.6 percent of GDP, respectively, in 2006/07.

4/ After HIPC and MDRI relief as well as debt relief beyond HIPC relief from Paris Club creditors. Debt also includes obligations to the IMF. The debt stock includes the capitalization of interest to Paris Club creditors until completion point under the Enhanced HIPC Initiative.

5/ The 2008/09 number is for April 15, 2008.

6/ Numbers have been revised as a result of more reliable data on public grants.

7/ Includes official recorded exports plus staff estimates of smuggling; excludes reexports.

8/ Excludes reexports.

9/ In months of imports of goods and services, excluding imports for reexports and duty free imports by donors.

10/ An increase in the exchange rate indices corresponds to an appreciation. For 2007/08, REER is for the period April to December.

Table 2a. Islamic Republic of Afghanistan: Core Budget, 2005/06–2012/13 1/
(In millions Afghanis)

	Est. 2005/06	Est. 2006/07	Prelim. 2007/08	Program 2007/08	Budget 2008/09	Program 2008/09	Proj. 2008/09	Proj. 2009/10	Proj. 2010/11	Proj. 2011/12	Proj. 2012/13
Domestic revenue	20,660	28,789	33,438	35,721	44,375	44,539	44,501	56,486	69,753	84,534	101,821
Tax revenues	14,035	21,893	24,994	27,629	34,592	34,753	34,670	44,662	55,565	67,580	81,673
Taxes on income, profits, and capital gains	2,621	6,713	7,633	4,933	6,400	6,402	9,752	11,789	14,038	16,520	19,418
Taxes on international trade and transactions	9,446	11,980	12,948	15,074	18,418	18,575	17,818	22,200	27,584	33,531	40,659
Domestic taxes on goods and services	1,771	2,083	3,451	6,338	---	8,225	5,845	9,169	12,192	15,500	19,259
Other taxes	197	1,117	962	1,284	9774	1,550	1,255	1,504	1,750	2,030	2,337
Nontax revenues	6,624	6,896	8,445	8,092	9,783	9,786	9,830	11,823	14,188	16,953	20,148
Donor assistance grants (to operating budget) 2/	16,732	19,214	23,131	23,617	23,722	24,593	23,520	20,484	15,171	12,254	8,776
ARTF (recurrent window)	12,572	14,947	14,461	14,523	13,822	13,522	13,716	11,884	10,398	8,913	6,437
LOTFA	4,068	3,722	6,949	7,493	7,650	9,247	7,576	6,818	4,773	3,341	2,339
Other grants	92	544	1,721	1,601	2,250	1,824	2,228	1,783	0	0	0
Donor assistance grants (core development budget)	19,251	16,625	30,305	26,793	63,175	37,523	37,160	50,331	60,793	66,622	72,373
Total core budget expenditure	53,437	75,702	95,710	98,812	134,767	120,293	121,344	150,175	166,702	180,065	201,063
Operating expenditure	32,348	43,448	50,667	53,329	65,359	63,439	65,040	79,796	85,397	90,397	102,428
Wages and salaries	20,430	26,454	33,567	33,728	45,578	39,641	44,846	52,150	58,329	61,625	69,533
Purchase of goods and services	6,679	10,200	11,001	10,308	11,611	13,341	11,747	17,766	16,881	19,831	23,064
Transfers, subsidies, and other	495	2,176	1,746	4,765	3,713	4,787	3,925	4,863	4,691	2,951	3,329
Pensions	1,540	2,461	2,829	2,773	2,940	3,557	3,240	3,547	3,759	3,964	4,162
Capital expenditure	3,054	1,987	1,417	1,437	1,018	1,723	994	1,173	1,342	1,524	1,719
Interest 3/	150	169	107	318	500	390	288	297	394	503	620
Core budget development spending 4/	21,089	32,254	45,043	45,483	69,408	56,853	56,304	70,380	81,305	89,668	98,635
Interim Afghanistan National Development Strategy programs											
Security	1,122	1,408	1,460	1,891	675	2,364	1,825	2,281	2,281	1,984	2,183
Governance, rule of law, and human rights	551	802	746	1,783	1,119	2,228	932	1,165	1,165	1,014	1,115
Infrastructure and natural resources	6,235	13,001	19,331	17,850	28,240	22,312	24,164	30,205	36,246	39,870	43,858
Education	1,035	1,786	3,187	3,953	5,012	4,941	3,983	4,979	5,975	7,170	7,887
Health	991	2,061	2,191	2,834	2,866	3,542	2,739	3,424	4,109	4,930	5,423
Agriculture and rural development	10,170	12,031	15,753	14,262	19,556	17,828	19,691	24,614	27,075	29,783	32,761
Social protection	30	33	91	107	500	134	113	142	170	204	225
Economic governance and private sector development	956	1,133	2,285	2,803	11,440	3,503	2,856	3,570	4,284	4,713	5,184
Operating budget balance (excluding grants)	-11,688	-14,658	-17,229	-17,608	-20,984	-18,900	-20,539	-23,310	-15,643	-5,863	-606
Operating budget balance (including grants)	5,044	4,555	5,902	6,009	2,738	5,692	2,980	-2,826	-473	6,391	8,169
Core budget balance (including grants)	3,206	-11,075	-8,836	-12,680	-3,495	-13,638	-16,163	-22,875	-20,984	-16,656	-18,093
Float and adjustment 5/	-1,989	1,235	8,952	0	-1	0	0	0	0	0	0
Sale of nonfinancial assets 6/	1,986	2,317	74	100	0	1,502	9,903	1,485	495	0	0
Financing	-3,203	7,523	-190	12,580	3,496	12,135	6,260	21,389	20,489	16,656	18,093
External loans (net)	5,318	6,132	6,062	6,379	3,496	6,057	5,989	7,542	11,224	10,374	11,345
Domestic (net) 7/	-8,521	1,391	-6,252	6,201	---	6,078	271	13,847	9,265	6,281	6,748
Memorandum items:											
Before HIPC											
Amortization due (excluding IMF, including stock relief, excluding arrears)	173,951	190	194	196	---	201	199	183	167	175	266
Interest due (including IMF, including stock relief, excluding arrears)	284,1149	542	2,612	2,756	---	2,834	2,747	1,568	482	589	740
Flow relief (HIPC, MDRI and beyond)											
Amortization due (cash, excluding IMF)	---	0	102	102	---	148	147	149	152	152	222
Interest due (cash)	---	182	2,425	2,438	---	2,492	2,459	1,271	88	86	120
HIPC and MDRI stock relief											
---	---	1,474	508,521	520,009	---	0	2,790	52,541	0	0	0
Fuel Subsidy to DABM											
---	---	2,176	1,694	3,141	2,000	2,841	2,000	2,591	2,091	---	---
Noncash transaction (fuel in kind)											
---	---	---	1,500	1,500	1,500	---	1,500	---	---	---	---
External budget (direct donor expenditure) 8/	180,583	195,035	250,190	237,942	251,802	270,393	254,196	208,475	199,462	192,662	187,017
Security Adjuster (ANA force size of 86,000) 9/											
---	---	---	---	---	---	---	1,920	---	---	---	---
Adjuster for wheat purchases 10/											
---	---	---	---	---	---	---	2,500	---	---	---	---

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

1/ Core budget includes domestic revenues, grants, operating and development expenditure, and financing that are accounted for by the central government.

2/ Funding for operating budget from the multi-donor trust funds: The Afghanistan Reconstruction Trust Fund (recurrent window) and the Law and Order Trust Fund (LOTFA).

3/ Interest due (cash only) reflects rescheduling under enhanced HIPC Initiative.

4/ Government's current program classification based on a simple aggregation of administrative units.

5/ Variation between the fiscal position recorded at MOF and DAB. This discrepancy is partially due to the difference ("float") between checks issued and checks cashed.

6/ In 2005/06 and 2006/07 includes \$40 million receipt from sale of telecommunications spectrum bandwidth and late overflight payment. From 2007/08 includes sale of land and buildings and privatization receipts.

7/ Net change in government deposits with DAB (excluding provincial branch balances). A positive sign corresponds to a decline in balances.

8/ Estimates from MOF and donors.

9/ Security adjuster should ANA force strength increase to 86,000.

10/ Possible purchase of \$50 m worth of wheat for resale.

Table 2b. Islamic Republic of Afghanistan Core Budget 2005/06–2012/13 1/
(In percent of

	138Est. 2005/06	138Est. 2006/07	138Est. 2007/08	138Est. 2007/08	138Est. 2008/09	138Est. 2008/09	138Proj. 2008/09	138Proj. 2009/10	138Proj. 2010/11	138Proj. 2011/12	138Proj. 2012/13
Domestic revenue	6.4	7.5	7.0	8.2	7.0	8.5	7.0	7.5	8.1	8.7	9.3
Tax revenues	4.4	5.7	5.2	6.3	5.4	6.6	5.4	5.9	6.5	6.9	7.4
Taxes on income, profits, and capital gains	0.8	1.7	1.6	1.1	1.0	1.2	1.5	1.6	1.6	1.7	1.8
Taxes on international trade and transactions	2.9	3.1	2.7	3.5	2.9	3.5	2.8	3.0	3.2	3.4	3.7
Domestic taxes on goods and services	0.5	0.5	0.7	1.5	...	1.6	0.9	1.2	1.4	1.6	1.8
Other taxes	0.1	0.3	0.2	0.3	1.5	0.3	0.2	0.2	0.2	0.2	0.2
Nontax revenues	2.1	1.8	1.8	1.9	1.5	1.9	1.5	1.6	1.7	1.7	1.8
Donor assistance grants (to operating budget) 2/	5.2	5.0	4.8	5.4	3.7	4.7	3.7	2.7	1.8	1.3	0.8
ARTF (recurrent window)	3.9	3.9	3.0	3.3	2.2	2.6	2.2	1.6	1.2	0.9	0.6
LOTFA	1.3	1.0	1.5	1.7	1.2	1.8	1.2	0.9	0.6	0.3	0.2
Other grants	0.0	0.1	0.4	0.4	0.4	0.3	0.4	0.2	...	...	...
Donor assistance grants (core development budget)	6.0	4.3	6.3	6.1	9.9	7.2	5.8	6.7	7.1	6.8	6.6
Total core budget expenditure	16.6	19.6	20.0	22.6	21.2	23.0	19.1	20.0	19.4	18.5	18.3
Operating expenditure	10.0	11.3	10.6	12.2	10.3	12.1	10.2	10.6	9.9	9.3	9.3
Wages and salaries	6.3	6.9	7.0	7.7	7.2	7.6	7.0	6.9	6.8	6.3	6.3
Purchase of goods and services	2.1	2.6	2.3	2.4	1.8	2.5	1.8	2.4	2.0	2.0	2.1
Transfers, subsidies, and other	0.2	0.6	0.4	1.1	0.6	0.9	0.6	0.6	0.5	0.3	0.3
Pensions	0.5	0.6	0.6	0.6	0.5	0.7	0.5	0.5	0.4	0.4	0.4
Capital expenditure	0.9	0.5	0.3	0.3	0.2	0.3	0.2	0.2	0.2	0.2	0.2
Interest 3/	0.0	0.0	0.0	0.1	0.1	0.1	0.0	0.0	0.0	0.1	0.1
Core budget development spending 4/	6.5	8.4	9.4	10.4	10.9	10.9	8.8	9.4	9.5	9.2	9.0
Interim Afghanistan National Development Strategy programs											
Security	0.3	0.4	0.3	0.4	0.1	0.5	0.3	0.3	0.3	0.2	0.2
Governance, rule of law, and human rights	0.2	0.2	0.2	0.4	0.2	0.4	0.1	0.2	0.1	0.1	0.1
Infrastructure and natural resources	1.9	3.4	4.0	4.1	4.4	4.3	3.8	4.0	4.2	4.1	4.0
Education	0.3	0.5	0.7	0.9	0.8	0.9	0.6	0.7	0.7	0.7	0.7
Health	0.3	0.5	0.5	0.6	0.5	0.7	0.4	0.5	0.5	0.5	0.5
Agriculture and rural development	3.2	3.1	3.3	3.3	3.1	3.4	3.1	3.3	3.2	3.1	3.0
Social protection	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0	0.0
Economic governance and private sector development	0.3	0.3	0.5	0.6	1.8	0.7	0.4	0.5	0.5	0.5	0.5
Operating budget balance (excluding grants)	-3.6	-3.8	-3.6	-4.0	-3.3	-3.6	-3.2	-3.1	-1.8	-0.6	-0.1
Operating budget balance (including grants)	1.6	1.2	1.2	1.4	0.4	1.1	0.5	-0.4	-0.1	0.7	0.7
Core budget balance (including grants)	1.0	-2.9	-1.8	-2.9	-0.5	-2.6	-2.5	-3.0	-2.4	-1.7	-1.6
Float and adjustment 5/	-0.6	0.3	1.9	...	0.0	...	...	...	...	...	...
Sale of nonfinancial assets 6/	0.6	0.6	0.0	0.0	...	0.3	1.6	0.2	0.1	...	...
Financing	-1.0	2.0	0.0	2.9	0.5	2.3	1.0	2.8	2.4	1.7	1.6
External loans (net)	1.7	1.6	1.3	1.5	0.5	1.2	0.9	1.0	1.3	1.1	1.0
Domestic (net) 7/	-2.6	0.4	-1.3	1.4	...	1.2	0.0	1.8	1.1	0.6	0.6
Memorandum items:											
Before HIPC											
Amortization due (excluding IMF, including stock relief, excluding arrears)	0.1	0.0	0.0	0.0	...	0.0	0.0	0.0	0.0	0.0	0.0
Interest due (including IMF, including stock relief, excluding arrears)	0.1	0.1	0.5	0.6	...	0.5	0.4	0.2	0.1	0.1	0.1
Flow relief (HIPC, MDRI, and beyond)											
Amortization due (cash, excluding IMF)	...	...	0.0	0.0	...	0.0	0.0	0.0	0.0	0.0	0.0
Interest due (cash)	...	0.0	0.5	0.6	...	0.5	0.4	0.2	0.0	0.0	0.0
HIPC and MDRI stock relief	...	0.4	106.4	119.1	...	...	0.4	7.0	...	...	...
Fuel Subsidy to DABM	...	0.6	0.4	0.7	0.3	0.5	0.3	0.3	0.2	...	...
Noncash transaction (fuel in kind)	...	...	0.3	0.3	0.2	...	0.2	...	...	...	...
External budget (direct donor expenditure) 8/	56.0	50.6	52.3	54.5	39.6	51.7	40.0	27.8	23.2	19.8	17.0
Security Adjuster (ANA force size of 86,000) 9/	...	...	...	...	...	...	0.3	...	...	...	...
Adjuster for wheat purchases 10/	...	...	...	...	...	...	0.4	...	...	...	...
Nominal GDP	322,231	385,489	478,058	436,646	636,249	523,466	636,249	750,767	859,093	975,198	1,100,335

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

1/ Core budget includes domestic revenues, grants, operating and development expenditure, and financing that are accounted for by the central government.

2/ Funding for operating budget from the multi-donor trust funds: The Afghanistan Reconstruction Trust Fund (recurrent window) and the Law and Order Trust Fund (LOTFA).

3/ Interest due (cash only) reflects rescheduling under enhanced HIPC Initiative.

4/ Government's current program classification based on a simple aggregation of administrative units.

5/ Variation between the fiscal position recorded at MOF and DAB. This discrepancy is partially due to the difference ("float") between checks issued and checks cashed.

6/ In 2005/06 and 2006/07 includes \$40 million receipt from sale of telecommunications spectrum bandwidth and late overflight payment. From 2007/08 includes sale of land and buildings and privatization receipts.

7/ Net change in government deposits with DAB (excluding provincial branch balances). A positive sign corresponds to a decline in balances.

8/ Estimates from MOF and donors.

9/ Security adjuster should ANA force strength increase to 86,000

10/ Possible purchase of \$50 million worth of wheat for resale.

Table 3. Islamic Republic of Afghanistan: Monetary Program (Da Afghanistan Bank), 2005/06–2008/09

	Act. 1/		Prog.		Act. 2/		Prog.		Act. 1/		Prog.	
	Mar. 20	Mar. 20	Dec. 21	Dec. 21	Mar. 19	Mar. 19	Jun. 20	Jun. 20	Sep. 21	Sep. 21	Dec. 20	Mar. 20
	2005/06		2007/08		2007/08		2008/09		2008/09			
Net foreign assets	85,122	105,826	120,430	127,300	116,578	129,717	141,663	146,763	149,055	162,106	163,800	163,800
Foreign assets	86,300	108,503	125,032	131,063	122,034	134,476	146,705	151,806	155,009	168,061	170,666	170,666
Foreign exchange reserves	82,995	103,376	118,035	123,613	116,936	124,600	136,807	141,673	144,642	157,459	159,830	159,830
Gold 3/	19,230	23,006	23,006	23,006	23,006	23,006	32,848	32,848	32,848	32,848	32,848	32,848
Other	63,765	80,370	95,028	100,606	93,930	101,594	103,960	108,825	111,794	124,611	126,982	126,982
Other foreign assets	3,304	5,129	6,997	7,450	5,098	9,876	9,898	10,133	10,367	10,602	10,837	10,837
Foreign liabilities	-1,177	-2,680	-4,601	-3,763	-4,759	-5,042	-5,042	-5,042	-5,954	-6,866	-6,866	-6,866
Net domestic assets	-39,069	-49,524	-57,633	-64,083	-51,887	-65,291	-77,237	-76,022	-72,400	-80,538	-77,817	-77,817
Domestic assets	-33,620	-34,011	-35,179	-39,896	-28,310	-43,967	-43,613	-42,398	-38,775	-46,913	-44,192	-44,192
Net claims on general government	-29,574	-28,343	-28,263	-30,909	-22,142	-34,670	-34,311	-32,883	-29,048	-36,973	-34,040	-34,040
Gross claims on the government	0	998	2,706	2,706	3,560	3,560	3,845	3,845	4,757	4,757	5,669	5,669
Domestic currency deposits	-5,755	-8,010	-6,439	-5,656	-8,010	-7,873	-7,863	-7,649	-7,986	-9,174	-9,646	-9,646
Foreign currency deposits	-23,819	-21,331	-24,530	-27,959	-17,692	-30,357	-30,293	-29,079	-25,819	-32,556	-30,062	-30,062
Other claims (including capital notes) 4/	-4,046	-5,668	-6,917	-9,987	-6,168	-9,297	-9,302	-9,514	-9,727	-9,940	-10,152	-10,152
Of which: capital notes 4/	-330	-1,145	-2,280	-1,790	-2,480	-4,664	-4,664	-5,239	-5,814	-6,389	-6,964	-6,964
Other items net	-5,449	-15,513	-22,454	-24,187	-23,576	-21,324	-33,625	-33,625	-33,625	-33,625	-33,625	-33,625
Reserve money 5/	46,054	56,301	62,797	63,218	64,691	64,426	64,426	70,741	76,655	81,569	85,983	85,983
Currency in circulation 6/	44,433	50,329	58,127	58,547	59,764	58,899	58,899	64,272	69,644	74,017	78,389	78,389
Banknotes and coins issued	48,460	57,584	66,204	65,306	67,928	66,689	66,689	73,139	79,214	84,289	89,364	89,364
Less cash holdings	4,026	7,254	8,077	6,759	8,165	7,789	7,789	8,867	9,570	10,272	10,975	10,975
Bank deposits with DAB	1,620	5,972	4,670	4,671	4,928	5,526	5,526	5,969	6,511	7,052	7,594	7,594
Memorandum items:												
Currency in circulation (year-to-date change) 6/	14.6	13.3	15.5	16.3	18.7	17.0	17.0	9.1	18.2	25.7	33.1	33.1
Currency in circulation (year-on-year change) 6/	14.6	13.3	22.6	23.5	18.7	17.0	17.0	22.9	29.0	26.4	33.1	33.1
Currency in circulation (ceilings under the PRGF; in millions of Afghani)	...	...	58,127	58,547	59,764	58,899	58,899	64,272	69,644	74,017	78,389	78,389
Gross international reserves (at market rates; in millions of U.S. dollars)	1,661.8	2,064.2	...	2,618.8	...	2,763.0	2,763.0	...	...	...	...	...
Gross international reserves (at program rates; in millions of U.S. dollars)	...	2,064.2	2,356.9	2,468.3	2,335.0	2,488.0	2,763.0	2,861.2	2,921.2	3,180.0	3,227.9	3,227.9
Consumer prices in Kabul (quarterly change)	0.4	1.7	...	5.9	...	5.0	5.0	...	...	...	...	...
Consumer prices in Kabul (annual change)	9.4	4.8	...	9.5	12.0	20.7	20.7	...	...	...	15.6	15.6
Interest rates on 28-day capital notes 7/	6.5	7.6	...	7.7	...	14.9	14.9	...	...	...	...	...
Af/US\$ (e.o.p.) exchange rate	49.9	50.1	50.1	49.7	50.1	49.5	49.5	49.5	49.5	49.5	49.5	49.5

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

1/ Foreign currency-denominated components evaluated using the actual exchange rates at dates indicated.

2/ Foreign currency-denominated components evaluated using applicable program exchange rates.

3/ The gold does not include the gold held in the palace vaults.

4/ Until March 2006, capital notes and foreign currency deposits of commercial banks with DAB were included in Reserve money (as banks could use capital notes to meet their reserve requirements; this possibility was removed in March 2006, at which time banks were also instructed to meet the reserve requirements in Afghani only, against both Afghani and foreign currency deposits).

5/ National currency only.

6/ Program projections for Dec. 21, 2008 and Mar. 19, 2008 have been realigned with the revised base for March 20, 2007.

7/ Weighted average of bid rates; 30-day notes until March 2006; last observation: March 17, 2008.

Table 4. Islamic Republic of Afghanistan: Balance of Payments, 2005/06–2012/13
(In millions of U.S. dollars; unless otherwise indicated)

	Est.	Est.	Prel. Est.	Projections				
	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
Current account (including grants)	-182.2	-379.2	82.1	83.0	-476.7	-735.5	-874.3	-1075.0
Current account (excluding grants)	-4880.3	-5405.7	-6424.4	-6827.9	-6685.5	-6902.8	-7006.0	-7174.4
Trade balance	-4335.3	-4933.0	-6001.9	-6397.5	-6315.1	-6527.4	-6616.4	-6766.5
Exports of goods (f.o.b.) 1/	1794.8	1810.6	1834.5	2138.4	2382.3	2624.8	2905.2	3222.5
Official exports	385.9	416.5	482.5	675.0	850.5	1041.3	1265.3	1528.9
Unofficial exports	1408.9	1394.2	1352.0	1463.4	1531.8	1583.6	1639.9	1693.6
Smuggling	173.7	159.3	156.9	186.5	199.8	207.9	214.7	220.6
Transit trade	1235.2	1234.9	1195.2	1276.8	1332.0	1375.7	1425.2	1473.0
Imports of goods (f.o.b.)	-6130.1	-6743.6	-7836.4	-8535.9	-8697.5	-9152.3	-9521.6	-9989.0
Official imports	-5481.7	-6049.2	-7246.2	-7968.0	-8171.2	-8663.4	-9074.7	-9576.9
Of which: Duty free	-3258.3	-3579.4	-4685.1	-4943.9	-4745.9	-4794.3	-4799.2	-4842.2
Smuggling	-648.4	-694.5	-590.2	-567.9	-526.3	-488.9	-446.8	-412.1
Services and income, net	-545.0	-472.7	-422.5	-430.5	-370.3	-375.3	-389.7	-407.9
Of which: Interest due 2/ 3/	-21.2	-17.0	-60.9	-61.2	-34.9	-12.9	-15.1	-18.1
Current transfers	4698.2	5026.6	6506.5	6911.0	6208.8	6167.3	6131.8	6099.4
Public	4361.1	4625.4	6068.4	6359.2	5640.5	5562.5	5493.6	5430.4
Private 4/	337.1	401.2	438.1	551.8	568.3	604.8	638.2	669.0
Capital and financial account	356.8	194.1	24.0	80.2	-912.5	396.5	825.0	1100.4
Capital transfers	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt forgiveness 3/	0.0	0.0	0.0	0.0	-1061.1	0.0	0.0	0.0
Foreign direct investment	271.4	237.6	241.8	332.5	986.6	1106.7	1257.8	1448.7
Official loans (net)	85.4	154.9	129.5	121.2	152.5	226.8	206.5	224.6
Disbursement	101.7	163.8	133.4	125.2	156.2	230.2	210.0	230.0
Amortization due 2/ 3/	-16.3	-8.8	-3.9	-4.0	-3.7	-3.4	-3.5	-5.4
Commercial banks, net	...	-198.4	-347.3	-373.5	-990.4	-937.0	-639.3	-572.9
Errors and omissions (including short-term capital)	175.6	552.9	501.4	215.1	204.4	194.1	184.4	175.2
Of which: Valuation Change	0.0	147.6	274.9	...	...	...	...	...
Overall balance	350.3	367.8	607.5	378.3	-1184.8	-144.8	135.2	200.6
Financing	-350.3	-367.8	-607.5	-412.4	1167.7	144.8	-135.2	-200.6
Changes in reserve assets of the DAB	-378.5	-402.4	-698.7	-465.0	77.9	140.0	-140.0	-200.0
Use of Fund resources (net)	0.0	19.8	51.4	0.0	0.0	0.0	0.0	-7.5
Exceptional financing	28.3	14.8	39.8	52.6	1089.8	4.8	4.8	6.9
Arrears 5/	-1.1	-132.0	-11006.9	-84.1	0.0	0.0	0.0	0.0
Debt rescheduling, of which: 6/	0.0	117.2	776.7	80.4	28.7	4.8	4.8	6.9
Capitalization of interest	0.0	3.6	47.4	47.9	23.9	0.0	0.0	0.0
Multilateral HIPC assistance	0.0	0.0	3.3	4.7	4.8	4.8	4.8	6.9
Debt forgiveness, of which: 3/	29.4	29.5	10270.0	56.3	1061.1	0.0	0.0	0.0
HIPC	0.0	0.0	0.0	0.0	442.3	0.0	0.0	0.0
MDRI	0.0	0.0	0.0	0.0	34.7	0.0	0.0	0.0
Financing gap	0.0	0.0	0.0	-34.0	-17.1	0.0	0.0	0.0
Identified financing (provisional)	0.0	0.0	0.0	34.0	17.1	0.0	0.0	0.0
Of which: IMF PRGF	0.0	0.0	0.0	34.0	17.1	0.0	0.0	0.0
Remaining gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Memorandum Items:								
Gross international reserves	1,661.8	2,064.2	2,763.0	3,227.9	3,150.0	3,010.0	3,150.0	3,350.0
(In months of imports) 7/	7.7	9.7	11.1	11.7	10.0	8.6	8.1	7.8
(Relative to external debt service due)	44.3	80.0	42.6	49.5	81.7	184.5	169.1	108.0
(Relative to commercial bank foreign currency liabilities)	2.6	2.1	2.1	1.9	1.2	0.8	0.7	0.7
Trade balance (percent of GDP)	-66.8	-63.9	-62.5	-49.8	-41.6	-37.6	-33.6	-30.4
Current account balance (percent of GDP)								
Including grants	-2.8	-4.9	0.9	0.6	-3.1	-4.2	-4.4	-4.8
Excluding grants	-75.2	-70.0	-66.9	-53.1	-44.1	-39.8	-35.6	-32.3
Private sector current account balance (percent of GDP)								
Including grants	-19.8	-18.5	-13.6	-10.4	-9.0	-8.7	-8.0	-7.5
Excluding grants	-25.0	-23.6	-18.1	-14.7	-15.7	-14.7	-13.5	-12.5
Total debt service (percent of exports) 8/ 9/	5.7	1.6	1.1	1.2	0.8	0.7	1.0	1.1
Total debt stock (percent of GDP) 8/	184.0	155.0	21.0	17.8	9.3	9.4	9.4	9.3

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

1/ Excludes opium exports and, due to limited data availability, flows associated with U.S. Army and most ISAF activities.

2/ Debt service projections are based on the total stock of external debt (including estimates of unverified arrears). Given lack of data on the rate of penalty interest and ongoing bilateral negotiations, interest on overdue obligations represent an estimate by Fund staff.

3/ Assumes that Afghanistan will reach the completion point under the enhanced HIPC initiative and receive MDRI relief from IDA in 2009/10. Paris Club creditors are assumed to go beyond HIPC and provide 100 percent stock reduction on eligible debts and capitalized interest at completion point.

4/ Includes foreign transactions recently reported by licensed money changers.

5/ Arrears shown represent Fund staff estimates of debt service due, but not paid, on estimated overdue obligations. The 2006/07 and 2007/08 reduction in arrears corresponds principally to the July 2006 rescheduling of Paris Club debt on Naples terms, including the upfront cancellation of the majority of Russian claims consistent with Paris Club practice.

6/ Debt rescheduling includes the capitalization of interest falling due to Paris Club creditors until the completion point of the enhanced HIPC Initiative, interim assistance from multilateral creditors, and HIPC debt relief from multilateral creditors after the completion point.

7/ In months of imports of goods and services, excluding imports for reexports and duty free imports by donors. The definition of imports used for the calculation of reserve coverage has been changed to exclude duty free imports by donors that are fully financed.

8/ After HIPC and MDRI relief as well as debt relief beyond HIPC from Paris Club creditors. Debt includes obligations to the IMF. The debt stock includes the capitalization of interest to Paris Club creditors until completion point of the enhanced HIPC initiative.

9/ Exports exclude reexports.

Table 5. Islamic Republic of Afghanistan: External Financing Requirement and Sources, 2005/06–2012/13
(In millions of U.S. dollars)

	Est.	Prel. Est.	Projections					
	2005/06	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13
I. Total financing requirement	5,276.2	5,948.9	18,133.9	7,381.0	7,672.4	6,766.2	7,149.6	7,387.3
Current account (excluding grants)	4,880.3	5,405.7	6,424.4	6,827.9	6,685.5	6,902.8	7,006.0	7,174.4
Amortization	16.3	8.8	3.9	4.0	3.7	3.4	3.5	12.9
Of which: IMF	0.0	0.0	0.0	0.0	0.0	0.0	0.0	7.5
Prepayment of debt	0.0	0.0	0.0	0.0	1,061.1	0.0	0.0	0.0
Change in reserves (increase = +)	378.5	402.4	698.7	465.0	-77.9	-140.0	140.0	200.0
Reduction in arrears	1.1	132.0	11,006.9	84.1	0.0	0.0	0.0	0.0
II. Available financing	5,276.2	5,948.9	18,133.9	7,347.0	7,655.3	6,766.2	7,149.6	7,387.3
Current transfers	4,698.2	5,026.6	6,506.5	6,911.0	6,208.8	6,167.3	6,131.8	6,099.4
Foreign direct investment	271.4	237.6	241.8	332.5	986.6	1,106.7	1,257.8	1,448.7
Short-term private financing flows	...	-198.4	-347.3	-373.5	-990.4	-937.0	-639.3	-572.9
Official medium- and long-term loans	101.7	163.8	133.4	125.2	156.2	230.2	210.0	230.0
IMF disbursements	0.0	19.8	51.4	0.0	0.0	0.0	0.0	0.0
Debt forgiveness	29.4	29.5	10,270.0	56.3	1,061.1	0.0	0.0	0.0
Debt rescheduling	0.0	117.2	776.7	80.4	28.7	4.8	4.8	6.9
Other	175.6	552.9	501.4	215.1	204.4	194.1	184.4	175.2
Required financing = I-II	0.0	0.0	0.0	34.0	17.1	0.0	0.0	0.0
Financing gap	0.0	0.0	0.0	34.0	17.1	0.0	0.0	0.0
Identified financing (provisional)	0.0	0.0	0.0	34.0	17.1	0.0	0.0	0.0
Of which: IMF PRGF	0.0	0.0	0.0	34.0	17.1	0.0	0.0	0.0
Remaining gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

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

Table 6. Islamic Republic of Afghanistan: Projected Payments to the Fund as of April 30, 2008
(In millions of SDRs)

	2008 1/	2009	2010	2011	2012	2013	2014	2015	Beyond	Total
Obligations from existing drawings										
1. Principal										
GRA repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
PRGF repayments	0.0	0.0	0.0	0.0	2.5	8.3	9.4	9.4	17.5	47.1
2. Charges and interest 2/										
PRGF interest	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.1	0.0	1.7
SDR assessments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SDR charges	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7	2.9	8.5
Total obligations	0.8	1.0	1.0	1.0	3.4	9.2	10.3	10.3	20.4	57.3
(percent of quota)	0.5	0.6	0.6	0.6	2.1	5.7	6.4	6.3	12.6	35.4
Obligations from prospective drawings 3/										
1. Principal										
PRGF repayments	0.0	0.0	0.0	0.0	0.0	1.1	4.5	6.8	21.5	33.9
2. Charges and interest 2/										
PRGF interest	0.0	0.1	0.2	0.2	0.2	0.2	0.2	0.1	0.2	1.3
Total obligations	0.0	0.1	0.2	0.2	0.2	1.3	4.7	6.9	21.6	35.2
(percent of quota)	0.0	0.1	0.1	0.1	0.1	0.8	2.9	4.3	13.4	21.7
Cumulative obligations (existing and prospective)										
1. Principal										
GRA repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
PRGF repayments	0.0	0.0	0.0	0.0	2.5	9.4	13.9	16.2	39.0	81.0
2. Charges and interest 2/										
PRGF interest	0.3	0.4	0.4	0.4	0.4	0.4	0.3	0.2	0.1	3.0
SDR net charges	0.6	0.7	0.7	0.7	0.7	0.7	0.7	0.7	3.0	8.5
Total obligations	0.8	1.1	1.1	1.1	3.6	10.5	15.0	17.2	42.1	92.5
Outstanding Fund credit	58.4	81.0	81.0	81.0	78.6	69.1	55.2	39.0	...	...
Memorandum items:										
Outstanding Fund credit										
In percent of:										
Exports of goods and services 4/	5	5	4	3	3	2	1	1	...	...
External public debt	2	4	3	3	2	2	1	1	...	...
Gross official reserves	1	2	2	2	2	1	1	1	...	...
GDP	0	0	0	0	0	0	0	0	...	...
Quota	36	50	50	50	49	43	34	24	...	...
Total Obligations										
In percent of:										
Exports of goods and services 4/	0.1	0.1	0.1	0.0	0.1	0.3	0.3	0.3	...	...
External public debt	0.0	0.1	0.0	0.0	0.1	0.3	0.4	0.4	...	...
Gross official reserves	0.0	0.0	0.0	0.0	0.1	0.2	0.2	0.3	...	...
GDP	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...	...
Quota	1	1	1	1	2	6	9	11	26	57

Source: Fund staff estimates and projections.

1/ May 8, 2008 to December 31, 2008.

2/ Projections are based on current interest rates for PRGF. The current SDR interest rate is assumed for net use of SDRs.

3/ Based on the proposed level and phasing of access, and subject to Executive Board approval.

4/ Excludes reexports.

Table 7. Islamic Republic of Afghanistan: Proposed Schedule of Reviews and Disbursements

Date	Amount of Disbursement		Conditions
	Millions of SDRs	Percent of Quota 1/	
June 2006	13.2	8.2	Approval of arrangement 2/
March 2007	11.3	7.0	First review and September 2006 performance criteria 3/
July 2007	11.3	7.0	Second review and March 2007 performance criteria 4/
February 2008	11.3	7.0	Third review and September 2007 performance criteria 5/
July 2008	11.3	7.0	Fourth review and March 2008 performance criteria
January 2009	11.3	7.0	Fifth review and September 2008 performance criteria
May 2009	11.3	7.0	Sixth review and March 2009 performance criteria
Total	81.0	50.0	

Source: Fund staff estimates.

1/ Does not sum due to rounding.

2/ Due to domestic legal obstacles, the first disbursement was drawn with a delay, on January 19, 2007.

3/ The first review was concluded on March 7, 2007 and the second disbursement was drawn on March 29, 2007.

4/ The second review was concluded on July 9, 2007 and the third disbursement was drawn on July 23, 2007.

5/ The third review was concluded on February 13, 2008 and the fourth disbursement was drawn on February 28, 2008.

ATTACHMENT I. ISLAMIC REPUBLIC OF AFGHANISTAN: LETTER OF INTENT

Kabul, June 23, 2008

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Strauss-Kahn,

The attached memorandum supplements and updates the commitments contained in our Memorandum of Economic and Financial Policies (MEFP) of January 28, 2008. It reports on quantitative performance through March 2008 and on implementation of structural reforms under the Poverty Reduction and Growth Facility (PRGF)-supported program. It proposes quantitative targets through March 2009, including quantitative performance criteria for September 2008 and March 2009, and supplements understandings with regard to the government's policies for the remainder of the program, including prior actions for completing the fourth review, and structural conditionality for future disbursements.

We met all the March 2008 quantitative performance criteria, with the exception of the floor for fiscal revenue, which we missed mainly due to a significant slippage in the collection of customs duties. Despite the revenue shortfall, we maintained fiscal discipline and met the end-2007/08 indicative target for the operating budget deficit. We believe that the measures committed to in the attached memorandum ensure that, moving forward, our revenue performance will be in line with program targets. On this basis, we request a waiver of nonobservance with respect to the March 2008 performance criterion on fiscal revenue of the government. In the face of unexpectedly high inflation, we tightened our monetary policy stance and, despite the surge in money demand in the last quarter of 2007/08, met the original end-year currency in circulation target. We also observed the continuous zero ceilings on contracting or guaranteeing of new medium- and long-term nonconcessional external debt, on short-term external debt, and on new lending from state owned banks to, or government-guaranteed borrowing by, enterprises in need of restructuring. In addition, we met the continuous performance criterion prohibiting accumulation of new external payments arrears.

Structural conditionality for the fourth review proved challenging, and we fell behind in the implementation of several program commitments. We met the structural benchmarks on the submission of the core budget to parliament and publication of the schedule of fees charged by the state-owned petroleum trading enterprise (FLGE). We also ensured automatic monitoring of the operations of the central bank's six regional branches from the central bank's headquarters and repealed the requirement for commercial banks to invest 80 percent of their deposits in domestic economy. Nonetheless, we missed the structural benchmark on the preparation of a restructuring/privatization plan for the public enterprises that are not covered by the law on state-owned enterprises and are currently excluded from the privatization process. While we made significant progress toward restructuring of our state-

owned electricity provider (DABM), we missed the structural benchmark on concluding an agreement between the Ministry of Finance and the DABM on quarterly reform benchmarks in exchange for subsidy disbursements. We believe that the remedial measures that we committed to in the attached memorandum will enable us to regain reform momentum in these critical areas. We also incurred a minor delay in reconciling the central bank's accounting records with the monthly data reported by the central bank for program monitoring purposes. This reconciliation has now been completed and the 2008/09 program will be monitored based on the data sourced directly from central bank's accounting records.

The government and Da Afghanistan Bank (DAB) believe that the economic and financial policies set forth in the attached memorandum provide an adequate basis for achieving the objectives and targets of the program. During the period of the arrangement, we will consult with the Fund on the adoption of any further measures that may be appropriate, at the initiative of the government or DAB, or whenever the Managing Director of the IMF requests such a consultation. In addition, we will provide the Fund in a timely manner with all information necessary to monitor implementation of the program. The fifth review under the PRGF arrangement will be completed on or after January 15, 2009.

On the basis of this performance, and on the strength of the policies set forth in the attached memorandum, we request that the IMF complete the fourth review under the PRGF arrangement and approve the fifth disbursement (in the amount of SDR 11.3 million). After the period of this arrangement and while Afghanistan has outstanding financial obligations to the IMF, we will periodically consult with the IMF, at the initiative of the government or DAB, or whenever the Managing Director of the IMF requests consultation on Afghanistan's economic and financial policies.

We remain committed to transparent policy-making and are keen on making the contents of this letter and those of the attached supplementary MEFP and technical memorandum of understanding, as well as the staff report for the fourth review under the PRGF arrangement, available to the public and hereby authorize their posting on the Fund's website subsequent to Executive Board consideration of this request.

Sincerely yours,

Anwar Ul-Haq Ahady
Minister of Finance
Ministry of Finance
/s/

Abdul Qadeer Fitrat
Governor
Da Afghanistan Bank
/s/

**ATTACHMENT II. SUPPLEMENTARY MEMORANDUM OF ECONOMIC AND FINANCIAL
POLICIES FOR 2008/09**

June 23, 2008

1. **This memorandum supplements our Memorandum of Economic and Financial Policies (MEFP) of January 28, 2008 with regard to the policies to be undertaken by the Government of the Islamic Republic of Afghanistan and Da Afghanistan Bank (DAB) in the context of the economic program for 2008/09**, the last year of the three-year arrangement under the Poverty Reduction and Growth Facility. The supplement covers: (i) the quantitative program for 2008/09, including the proposed quantitative performance criteria for the sixth and seventh disbursement under the PRGF arrangement (Table 1); and (ii) a revised timetable for commitments—whose implementation have been delayed—and additional commitments identified to strengthen program performance, including prior actions for the completion of the fourth review, and additional structural conditionality for 2008/09 (Table 2).

A. Recent Economic Developments and Performance Under the Program

2. **The revised estimates for the 2006/07–07/08 national accounts and latest economic activity and price indicators imply significant changes to the assessment of macroeconomic performance in 2007/08 and our projections for 2008/09.** The final GDP figure for 2006/07 shows a significant upward revision on the grounds that the decline in agriculture was not as dramatic as previously estimated. Consequently, the ensuing rebound in 2007/08—albeit from a higher base—was less pronounced than previously estimated. Moreover, given the negative impact of the harsh winter on livestock and relatively low private sector merchandise imports (reported to have grown by only 3.7 percent in nominal terms in 2007/08, although this is likely to be significantly understated due in part to the undervaluation of fuel imports by customs), the overall growth in economic activity in 2007/08 appears to have been weaker than expected. As a result, real GDP growth in 2007/08 is now estimated at 11.5 percent (rather than 13.5 percent). Due to a sharp increase in prices of imported food and fuel in the second half of the year, CPI growth in 2007/08 exceeded expectations, with end-period inflation reaching 20.7 percent and average inflation 13 percent. For 2008/09, the GDP growth forecast has been revised downward to 7.5 percent on account of rainfall shortage during the germination period. The surge in food price inflation—fueled by the imposition of export restrictions on wheat by key regional trade partners—continued in the first two months of 2008/09, during which the CPI increased by a further 20 percent. Assuming that the disruption of wheat imports will be temporary and that the upward pressure from the world-wide increase in commodity prices will subside in the latter part of the year, inflation in 2008/09 may moderate to about 15½ percent by year's end. Nevertheless, average CPI inflation in 2008/09 is expected to be at least 24 percent (program

assumption). Moreover, the inflation outlook is subject to a considerable upside risk and the program may need to be revisited if the inflation trend through mid-year departs significantly from the program path.

3. **Program implementation in the second half of 2007/08 presented us with a difficult challenge.** We met all quantitative performance criteria and indicative targets for end-2007/08, with the notable exception of the criterion on the domestic revenue, which was missed by Af 2.3 billion or 6 percent of the annual target due to a significant decline in customs duties collection. We also experienced important setbacks in the implementation of structural conditionality (only four out of seven structural benchmarks were implemented) for the fourth review, and we fell behind on most of the commitments in our MEFP of January 28, 2008.

B. Fiscal Performance in 2007/08 and Program for 2008/09

4. **Despite a revenue shortfall of 0.5 percent of (revised) GDP, the fiscal position was slightly better than envisaged due to under-expenditure of the operating budget.** Revenue is estimated to have reached Af 33.4 billion in 2007/08. As a result, the revenue-to-GDP ratio declined from 7.5 percent in 2006/07 to 7.0 percent in 2007/08. While part of the revenue shortfall could be attributed to a lower than expected volume of taxable imports, policy inertia, inadequate enforcement efforts, and our customs valuation policy were the main contributing factors. Operating expenditures are estimated to have been lower than programmed at Af 50.7 billion or 10.6 percent of GDP. Consequently, the operating budget deficit (excluding grants) is estimated to have been slightly lower than envisaged under the program, at 3.6 percent of GDP. At the same time, development expenditures are estimated to have been broadly in line with program projections at Af 45 billion or 9.4 percent of GDP.

5. **In the face of significantly higher than expected inflation, the revised fiscal program for 2008/09 aims to stabilize the revenue-to-GDP ratio.** Many components of our tax base will not respond immediately to the recent increase in the inflation rate, which is mainly driven by growing food prices (these have doubled during the 12-months ending in May 2008). Taxation of food imports was reduced last year to alleviate the impact of price increases and the bulk of domestic food production is not captured by current tax collections. Consequently, our 2008/09 domestic revenue target (program floor) of Af 44.5 billion (7.0 percent of GDP) reflects a baseline revenue projection of 6.6 percent of GDP plus revenue measures geared at yielding additional revenue equivalent to 0.4 percent of GDP (¶8–10). Our operating expenditure envelope for 2008/09 is Af 65.0 billion (10.2 percent of GDP); this is Af 1.6 billion higher, and is weighted more towards salaries than its variant discussed with the IMF staff in November 2007. The program also allows, as a contingency, for additional security spending (¶6). Regarding development outlays, we aim at a significant

improvement in project preparation and implementation, and at executing at least 80 percent of the core development budget envelope of Af 69.4 billion (10.9 percent of GDP) approved by parliament.

6. **We have reconciled our operating budget envelope with the cash projection for expenditure under the fiscal program for 2008/09 consistent with the understandings reached with IMF staff in November 2007.** The operating budget envelope approved by parliament was Af 65.4 billion or Af 1.9 billion higher than reflected in the understandings reached with the IMF staff in November 2007. This additional allocation is a contingency that allows us to accelerate recruitment of the Afghan National Army and will be added to the program (via an adjuster) should the Afghan National Army (ANA) headcount exceed the 70,000 troops budgeted for 2008/09. However, the operating budget envelope approved by parliament does not yet reflect the Af 1.6 billion that was added to the program in consultation with Fund staff (¶5); this will be submitted to Parliament for approval as part of midyear budget review. Following the receipt of in-kind fuel donations for the Ministry of Interior, we took the opportunity to reallocate the cash set aside (Af 1.5 billion) for that purpose to increase the food allowances for the army and police, as a response to the food price increases, and also to mitigate the impact of the National Directorate of Security coming on to the core budget.

7. **The Government intends to mitigate the impact of increased wheat prices on the poor by working with donors to elaborate mechanisms to provide assistance to the needy.** Separately, the Government purchased \$50 million of wheat from neighboring countries at a price lower than the current market price in Afghanistan. This imported wheat would be sold domestically, and the government intends to recover fully the costs of its procurement. The Government will sell this wheat in a manner that would not create major price distortions in the domestic market. While the Government recognizes the limited impact this operation will have on poverty alleviation and on addressing social concerns related to the increase in world market prices for wheat, we believe that the additional supply from this operation might lead to lower domestic prices.

C. Policies to Strengthen Domestic Revenue

8. **We recognize the risks to the program caused by the nonobservance of the domestic revenue target for 2007/08.** We also share the concerns of the IMF staff and the international community regarding the prospects for fiscal sustainability, and the slow progress in broadening the tax base and addressing governance issues. To ensure successful implementation of our economic program for 2008/09, we are prepared to take additional measures to strengthen our revenue performance. To this effect, we commit to implementing the following measures as **prior actions** before the IMF Executive Board discussion of the fourth review of the program:

- Ministry of Finance (MOF) will issue an instruction for Afghan Customs Department (ACD) to ensure timely updates of reference prices for petroleum products, which will be applied in assessing the amount of applicable duties and taxes collected at the border (TMU ¶2).
- MOF will collect at least Af 79 million on the business receipt tax (BRT) and nontax (landing/parking right fees) liabilities due by airlines and outstanding at end-2007/08. (TMU ¶2).
- MOF and the Ministry of Commerce and Industry (MOCI) will sign a memorandum of understanding to clarify working arrangements of both ministries and the Fuel and Liquid Gas Enterprise (FLGE) with a view to granting customs officials full access to depot and storage areas and the authority to verify independently the amount and the quality of fuel being imported by FLGE and private importers before it is taken into FLGE's custody (TMU ¶2).

In addition, we will implement the following actions which we deem critical to ensuring continued improvement in the revenue performance:

- Notify traders of the expiration of exemption from the general income tax regime and inform them that they will be expected to file and pay their tax liabilities for 2008/09 according to the general provisions applying to corporate income tax payers (structural benchmark for end-July 2008).
- Expand operations of the Large Taxpayer Office (LTO) to Herat, Jalalabad, and Mazar-e-Sharif (structural benchmark for end-September 2008).
- Pass amendments to the income tax legislation (including the introduction of BRT on imports) (structural benchmark for end-November 2008).
- Implement the ASYCUDA transit and Declaration Processing Module (DPS) in Nangarhar and Herat, and Kabul Airport inland clearing depots (ICD) (structural benchmark for end-March 2009).
- Collect the remainder of airlines' tax and nontax liabilities outstanding at end-2007/08 that have been agreed with IMF staff to be collected in 2008/09 (altogether at least Af 158 million) and maintain regular collection of BRT and landing right fees throughout 2008/09 (structural benchmark for end-March 2009).

9. **To strengthen our efforts to broaden the revenue base**, we will establish an inter-ministerial Revenue Board, which would include key ministers that will be responsible to Cabinet and the President for revenue collection and modernization.

10. **In addition to policy actions listed in ¶25 of our MEFP of January 28, 2008, we will take measures to strengthen control mechanisms at customs.** To this effect, we will properly staff and resource the Internal Control/Audit unit at ACD, improve internal data processing, and conduct regular internal audits of customs duty exemptions. We are also committed to implementing vigorously the measures envisaged under ACD's 5-year strategy.

D. Public Financial Management Reforms

11. **We remain committed to the Pay and Grade reform to modernize the civil service.** To ensure the timely implementation of this reform we will: (i) allocate the workforce of the ten largest ministries according to the new grade structure by end-June 2008 (Civil Service Commission); (ii) cost the new structure according to the agreed pay scale for the ten ministries by end-September 2008 (MOF); and (iii) negotiate the transition in the ten ministries, subject to the budget envelope established by the MOF, and begin implementation by end-November 2008.

12. **We are cognizant of the need to ensure that our financial management systems are robust enough to cope with the challenge of scaled-up aid in the context of the ANDS.** We have undertaken simple program budget pilots to help align public spending priorities with the ANDS and have initiated Treasury reforms to strengthen tracking of poverty related spending through reporting on government budget execution. Nonetheless, both the MOF and line ministries have run into difficulties with implementing these measures. We plan to use a METAC technical assistance mission to review progress jointly with budget, Treasury, and the pilot ministries to identify practical ways forward that will allow us to plan and report on expenditure in a way that facilitates a focus on, and discussion of, service delivery to the most vulnerable.

13. **We will follow up on our commitments regarding the regularization of the relations between the budget and public enterprises.** To this effect, we will promptly initiate the review of the fiscal relations between the government and key state-owned enterprises (SOEs), as committed in ¶23 of the January MEFP. The results of the review will be reported to the IMF staff (structural benchmark for end-December 2008).

E. External Sector Developments and Policies

14. Our external position continued to strengthen in 2007/08 as a result of an improving trade balance and stronger than expected aid inflows. The current account deficit (excluding grants) receded from 70 percent of GDP in 2006/07 to 66.9 percent in 2007/08, mainly because of weaker than expected private sector merchandise imports and strong growth of exports, albeit from a low basis. The net international reserves target for end-2007/08 was met with a significant margin. As a result, DAB's international reserves coverage of imports

improved from just under 10 months at end-2006/07 to more than 11 months at end-2007/08 and the coverage of commercial bank foreign currency liabilities remains comfortable (above 200 percent)

15. **Looking forward, we project a further improvement in our external current account, on the expectation that export growth continues apace and FDI increases on the back of large-scale investment projects in the mining sector.** The largest FDI to date, Aynak Copper project, was competitively bid, and another bid for Hajigak Iron Ore is under preparation. We are confident that these projects will contribute to future growth and are committed to ensuring that a transparent fiscal regime is applied to mineral extraction operations and to the resources transferred to the core national budget.

F. Monetary Policy and Strengthening of DAB's Reporting Framework

16. **Despite upward pressure on money demand exerted by higher than expected inflation, we have increased confidence in the Afghani and strengthened our monetary policy framework.** Despite the surge in money demand in the last quarter of 2007/08, we met the end-year currency in circulation (CiC) ceiling. In the event, CiC grew at 17 percent in 2007/08, significantly below the growth of nominal GDP, which helped mitigate the inflationary pressure brought about by higher import prices. Strengthening of the Afghani via increased foreign exchange interventions in the last quarter of 2007/08 and a significant increase in the issuance of capital notes were instrumental in this regard. We intend to increase further our reliance on capital notes (CNs) as a policy instrument, the use of which will be guided by the indicative ceiling on reserve money (in addition to the quantitative performance criterion on currency in circulation). DAB's operations in CNs will also be carried out with due consideration for interest rate developments.

17. **To enhance the conduct of monetary policy,** we intend to start open market operations in CNs and promote the development of a secondary market. To this effect, we will create an electronic registry of CNs at DAB (structural benchmark for end-September 2008). To assist in integrating CNs in the monetary policy framework, we will strengthen our liquidity forecasting and monitoring. We will also increase the frequency of the government's liquidity forecast from monthly to biweekly and broaden it to include a forecast of core development budget expenditure. At the same time, we will develop a framework for monitoring commercial bank liquidity on a weekly basis (ahead of announcing the volumes of the primary CN auctions).

18. **The parameters of the quantitative monetary program for 2008/09** have been aligned with the projection of nominal GDP and an assessment of growth prospects in commercial bank activity. Consequently, we commit that the growth of CiC in 2008/09 will not exceed the projected growth of nominal GDP (33.1 percent), and will attempt to keep

the CiC at 2–3 percentage points below the linear monthly growth path consistent with that projection to ensure that CiC growth contributes to disinflation. The quarterly indicative targets for reserve money will be set in line with the annual growth projection for reserve money (33.5 percent), which reflects an assumption of growth in commercial bank deposits of 50 percent and a tightening of control over banks' excess liquidity. Should growth of reserve money exceed the targeted quarterly path, we will consult with the IMF staff to clarify whether increased issuance of CNs is in order. Likewise, we will refrain from adjusting the reserve requirement without prior consultation with IMF staff.

19. **We will ensure that the 2008/09 program will be monitored using reliable monetary data that will be reconciled with DAB's accounting records.** We have incurred a delay in monetary data reconciliation and missed the April 20, 2008, structural benchmark, but the extension of the accounting system to six regional branches and timely commencement of the end-2007/08 external audit provide good basis for a durable improvement in the areas of accounting, reporting, and internal control. The reconciliation of the data used for monetary program monitoring with DAB's accounting records has now been completed. We will strengthen further our data reporting and accounting framework, drawing, among others, on the results of the external audit (expected to be published by end-June 2008). We are also committed to implementing the recommendations of the November 2007 safeguards recommendation update, and follow through on the recommendations of technical assistance from METAC in the areas of accounting and control.

G. Financial Sector Supervision

20. **We have monitored closely the rapid growth of banking sector activity and have continued to improve banking supervision, but we are yet to strengthen our enforcement procedures.** To address emerging risks in the banking sector, we continued with examinations of weak banks and restricted their credit growth to 5 percent per quarter as long as their CAMEL ratings continued to be assessed by DAB as 4 or 5. We also suspended the issuance of licenses for new branches of these banks. We established a risk management department at the DAB, drafted a number of guidelines on risk management, and began training of staff. We also created a Non-banking Supervisory Section in the Financial Supervision Department.

21. **DAB will develop an action plan to address the gaps in the legal framework based on the weaknesses identified in the self-assessment against the Basle Principles (structural benchmark for end-September 2008).** Also by end-September 2008, we will (i) issue guidelines on operational risk management, corporate governance risk management, liquidity risk management, and market risk management. By end-June 2008, we will (i) prepare, on the basis of the third round of on-site supervision reports, a second summary report on banks' compliance with prudential regulations; and (ii) develop an off-site

supervision form detailing sectoral loan concentration. We will enforce strictly and promptly corrective measures warranted by on-site examinations and increase our targeted examinations in order to ensure that banks are in compliance with DAB's enforcement actions.

H. Structural Reforms in Public Enterprises

22. **We have made significant progress toward restructuring our electricity provider (DABM) but we acknowledge the need for an immediate strengthening of fiscal control over its financial operations.** On March 17, 2008, the Cabinet adopted the articles of incorporation (transforming DABM into DABS, with the MOF taking the largest, 45 percent, stake in the company and playing a dominant role at the Board of Directors) enabling it to continue operating as a public entity but on a strictly commercial basis. We will promptly publish DABS' articles of incorporation in the Official Gazette and will sever financial links between DABS and the Ministry of Energy and Water by end-June 2008. We are committed to appointing a competent management for DABS, with a strong mandate to reform the company and a responsibility for fulfilling conditions that the MOF will insist upon in exchange for the disbursement of subsidy toward fuel purchases by DABM/DABS (in line with the understandings listed in ¶26 of the January MEFP). In addition, the submission of DABS' audited financial statements for 2006/07–2007/08 will be a structural performance criterion for end-September 2008.

23. **Regarding the preparation of the strategic plan for the non-Tassady enterprises,** given the capacity shortfall and the lack of consensus among the key stakeholders on the future of these enterprises, we are not in a position to commit to a timeline for the preparation of the comprehensive plan. Instead, we will focus on the actions needed to put the most important enterprises in that group on a sound financial footing with a view to creating conditions for their restructuring or privatization. Building on the successful restructuring of Afghan Telecom (AT), we plan to launch its privatization in June 2008. Regarding the national airline Ariana, in the absence of audited financial statements and a restructuring plan, we will continue to refrain from directing or guaranteeing lending to Ariana and will not use the state-owned banks to recapitalize it. Given the deteriorating financial and technical condition of the company, the Cabinet will take steps to find a durable resolution for Ariana, and will take immediate measures to preserve the assets of the company, while safeguarding the budget from potential fiscal drains.

24. **We have undertaken steps to improve the transparency in the domestic petroleum sector and are preparing for the privatization of the FLGE.** We posted a schedule of fees charged by FLGE, as committed in our MEFP of January 28, 2008. The external audit of FLGE is currently underway and we intend to post its report by end-November 2008, as envisaged. We also started the preparations for the privatization of the FLGE. To that end, we have invited Expressions of Interest (EoI) from companies

interested in managing the process and we intend to privatize FLGE by March 2009, in accordance with our commitment under the Afghanistan Compact.

25. **We have made significant progress toward strengthening the legal framework for financial transactions and private sector development but uncertainty continues to surround the application of the new commercial laws.** We submitted to Parliament the Secured Transaction Laws of Moveable and Immoveable Property 2008, sponsored by DAB, and plan to submit the Negotiable Instruments Law (also sponsored by DAB) by September 2008. The Parliament continues to review the four laws sponsored by MOCI (Commercial Arbitration Law, Commercial Mediation Law, Business Partnerships Law, and Law on Business Corporations and Limited Liability Companies), which were published in the Official Gazette in January 2007 following their approval by President Karzai, but had not been discussed by Parliament prior to their presidential approval.

I. ANDS and HIPC-related Issues

26. **We have finalized our ANDS and submitted it to the IMF and World Bank Boards for consideration.** We are mindful that successful implementation of our ambitious strategy will require the costing of additional sector strategies, and improvements in the statistical base necessary for monitoring of results. We remain mindful of the potential adverse effects that the dramatic scaling-up of aid in the context of the ANDS may have on macroeconomic stability, and are committed to improving the coordination of monetary and fiscal policies to avoid overheating, and to pursue the structural reforms necessary to safeguard competitiveness.

27. **We continued our efforts to regularize relations with our external creditors as required under the Enhanced HIPC Initiative.** Saudi-Arabia agreed in January 2008 to write off most of our debts eligible for relief under the Enhanced HIPC Initiative (approximately \$25.5 million) and restructure on soft terms the remainder. Iraq agreed in May 2008 to forgive all its claims on Afghanistan (totaling approximately \$9.6 million). Negotiations on a debt relief agreement are underway with the Kuwait Development Fund. Discussions with the OPEC Fund for International Development continued during the Spring Meetings of the IMF and the World Bank in April 2008. We are also working to validate unverified claims—originally to the Czech Republic, but now held by a private company in Germany—by undertaking a legal review of the loan including, if needed, using an outside legal firm. In addition, we will undertake a review of DAB's records regarding an unverified claim by Iran (pre-cutoff debt) and we aim to confirm the validity of this claim by the end of the second quarter of 2008/09. If the validity of the claim is confirmed, we will promptly approach the Iranian authorities to negotiate a debt rescheduling agreement. In our negotiations with our creditors we remain mindful of our commitment not to accord any category of creditors a treatment more favorable than that accorded to the Paris Group of Countries. We will continue to rely primarily on grants and highly concessional loans to meet our financing needs. To that end, the government and DAB will not contract or guarantee any nonconcessional external debt (continuous performance criterion).

J. Measures to Strengthen Statistical Capacity

28. **We commit to redoubling our efforts to support the Central Statistical Office (CSO).** We recognize the urgency of improving data collection and dissemination, particularly in the areas of national accounts and poverty indicators. The implementation of ANDS and its monitoring underscore the need to strengthen our statistical capacity and ensure that the economic policies under the ANDS are properly designed, executed, and monitored. We are making progress toward improving our balance of payments (BoP) statistics. A FDI survey was launched in April 2008 and we will work with the companies involved with an aim to complete the survey by end-June 2008. The compilation of BoP has also been complicated by inadequate merchandise trade data collected by CSO and by inconsistencies between CSO data and those recorded by customs. As committed in the last MEFP (¶50), we intend to strengthen CSO's ability to compile accurate and timely merchandise trade data, including data on duty-free imports. We will seek donor support for CSO; however, in its absence, we are prepared to use the needed funding from our discretionary development expenditure to revamp and properly equip the CSO and strengthen its professional capacity, based on an action plan with a specific timetable to be agreed with IMF's STA department.

Table 1. Islamic Republic of Afghanistan: Performance Criteria and Indicative Targets for 2007/08–2008/09 1/
(For 2007/08, cumulative changes from March 20, 2007 and for 2008/09, cumulative changes from March 19, 2008; unless otherwise indicated)

	Mar. 20, 2007		Dec. 21, 2007		Mar. 19, 2008		Jun. 20, 2008		Sep. 21, 2008		Dec. 20, 2008		Mar. 20, 2009	
	Stocks	MEFP	Indicative Targets	Adjusted	Actual	MEFP	Performance Criteria	Actual	Indicative Targets 2/	Revised Targets	Indicative Targets 2/	Performance Criteria	Indicative Targets	Performance Criteria
Quantitative performance criteria and benchmarks														
Floor on fiscal revenue of the government	...	24,600	...	...	23,562	35,721	...	33,438	10,207	8,521	20,983	18,354	30,045	44,501
Ceiling on currency in circulation 3/	50,329	7,798	...	...	8,218	9,435	...	8,570	2,899	5,373	5,798	10,745	15,118	19,490
Ceiling on net central bank financing of the government	-28,343	81	-191	...	-2,565	6,201	3,518	-6,326	-1,154	1,428	724	5,263	-2,862	271
Indicative target (ceiling) on the operating budget deficit of the government, excluding grants	...	12,032	...	...	10,924	17,608	...	17,229	2,481	4,487	7,565	10,914	15,483	20,539
Indicative target (ceiling) on reserve money	...	...	...	...	...	...	...	64,426 4/	...	6,315	...	12,229	17,143	21,557
Floor on net international reserves of DAB	1,991.1	230.3	234.2	382.9	166.3	218.4	388.2	110.3	72.4	127.2	93.0	329.6	338.1	338.1
Zero ceiling on contracting or guaranteeing new medium- and long-term nonconcessional external debt by the government and DAB 5/	0	0	...	...	0	0	...	0	0	0	0	0	0	0
Zero ceiling on short-term external debt owed or guaranteed by the government or DAB 5/	0	0	...	...	0	0	...	0	0	0	0	0	0	0
Nonaccumulation of new external payments arrears, excluding interest on preexisting arrears 5/	0	0	...	...	0	0	...	0	0	0	0	0	0	0
Zero ceiling on lending from State-Owned Banks to SOEs in need of restructuring or government guaranteeing borrowing by these SOEs 5/	...	0	...	...	0	0	...	0	0	0	0	0	0	0
Memorandum items:														
Operating budget deficit of the government, including grants	...	-2,728	...	...	-720	-6,009	...	-5,902	-2,438	-217	-3,502	330	-981	-2,980
Reference Projections for the Adjustors														
Core budget development spending		Program	Actual	Deviation	Program	Actual	Deviation	Program	Revised	Program	Revised	Program	Revised	Program
External financing of the core budget and sale or transfers of nonfinancial assets		27,063	26,370	-694	45,483	45,043	-440	7,107	7,038	21,320	21,114	35,190	35,190	56,304
Expenditure currently financed outside the budget moved onto the operating budget		38,980	39,252	272	56,889	59,572	2,683	10,742	10,098	28,161	26,765	53,335	53,335	76,572
	

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

1/ The performance criteria and indicative targets envisaged under the program, and their adjustors, are defined in the Technical Memorandum of Understanding.

2/ As projected at the time of the third review.

3/ March 20, 2007 data revised as a result of reconciliation of DAB's Monetary Policy Department data with its Accounting Department data; the concomitant revisions of data for Sep. 20, 2007 do not affect performance assessment.

4/ Stock.

5/ These performance criteria apply on a continuous basis.

Table 2. Islamic Republic of Afghanistan: Structural Performance Criteria and Structural Benchmarks, July 2007–March 2009

<u>Fourth Review Under the PRGF Arrangement</u>		
Prior Actions (TMU ¶2 Section A).	Target Dates	Status
MOF will issue an instruction for Afghan Customs Department (ACD) to ensure timely updates of reference prices for petroleum products, which will be applied in assessing the amount of applicable duties and taxes collected at the border.	Five business days before Board meeting	Implemented
MOF will collect at least Af 79 million on the business receipt tax (BRT) and nontax (landing/parking right fees) liabilities due by airlines and outstanding at end-2007/08.	Five business days before Board meeting	Pending
MOF and MoCI will sign a memorandum of understanding to clarify working arrangements of both ministries and the Fuel and Liquid Gas Enterprise (FLGE) with a view to granting customs officials full access to depot and storage areas and the authority to verify independently the amount and the quality of fuel imported by FLGE and private importers before it is taken into FLGE's custody.	Five days before Board meeting	Implemented
Structural Benchmarks (TMU of January 28, 2008 ¶2 Section B).	Target Dates	Status
Submit core budget to parliament according to the PFEM Law and accompanied by a MTFF.	February 3, 2008	Implemented
Publish a schedule of the fees charged by the FLGE for its services.	February 29, 2008	Implemented
MOF will conclude an agreement with the DABM on quarterly reform benchmarks to be met by DABM throughout 2008/09 in exchange for the subsidy disbursements.	March 21, 2008	Not implemented
Adopt a comprehensive restructuring/divestment plan for the public entities and government agencies engaged in commercial activities but not covered by the SOEs law.	March 31, 2008	Not implemented
DAB will issue a circular informing banks that the requirement to invest 80 percent of bank deposits in domestic economy has been repealed.	March 31, 2008	Implemented
Ensure that the accounting system at DAB's six regional hubs is automatically monitorable from DAB's headquarters.	March 31, 2008	Implemented
Reconcile DAB's accounting records and the monthly reports on DAB's operations for 2007/08 prepared by DAB's Monetary Policy Department.	April 20, 2008	Implemented in May 2008
<u>Fifth Review Under the PRGF Arrangement</u> (TMU ¶2 Section B)		
Structural Performance Criteria	Target Dates	Status
Submit to parliament the core budget's audited financial statement for 2007/08. 1/	September 21, 2008	
Submission of DABM's audited financial statements for 2006/07–2007/08.	September 30, 2008	

Table 2. Islamic Republic of Afghanistan: Structural Performance Criteria and Structural Benchmarks, July 2007–March 2009 (concluded)

Structural Benchmarks	Target Dates	
DAB will produce the Monetary Survey for 2007/08 using a consistent time frame (Solar or Gregorian) for the entire banking system.	June 30, 2008	
Notify traders of the expiration of exemption from the general income tax regime and inform them that they will be expected to file and pay their tax liabilities for 2008/09 according to the general provisions applying to corporate income tax payers.	July 31, 2008	
Develop an action plan to address the gaps in the DAB's framework based on the weaknesses identified in DAB's self-assessment against the Basle Principles.	September 30, 2008	
Create an electronic registry of CNs at DAB.	September 30, 2008	
Roll out the Large Taxpayer Office (LTO) to Herat, Jalalabad, and Mazar-e-Sharif.	September 30, 2008	
Amend income tax legislation, including, by introducing BRT on imports.	November 30, 2008	
Publish external audit report of FLGE.	November 30, 2008	
MOF will review the fiscal relations between the government and Afghan Telecom, Ariana, DABM/DABS, and FLGE.	December 31, 2008	
MOF will conclude a comprehensive agreement with the DABM on a medium-term plan to reduce subsidies.	December 31, 2008	
<u>Sixth Review Under the PRGF Arrangement (TMU ¶2 Section C)</u>		
Structural Performance Criterion	Target Dates	Status
Reduce to 20 percent the 40 percent tariff rate on soft drinks established by Presidential Decree Nr. 96. 2/	March 31, 2009	
Structural Benchmarks	Target Dates	Status
Withdraw trader concessions on filing and paying taxes.	March 21, 2009	
Start collecting BRT on imports.	March 21, 2009	
MOF will collect at least Af 79 million on airlines' tax and nontax liabilities due by airlines and outstanding at end-2007/08 and maintain regular collection of BRT and landing right fees throughout 2008/09.	March 31, 2009	
Implement the ASYCUDA Transit and Declaration Processing Module in Nangarhar and Herat, and at Kabul Airport inland clearing depots.	March 31, 2009	

1/ In the Memorandum of Economic and Financial Policies (MEFP) of January 28, 2008, Fund staff and the authorities reached an understanding that this measure would be made a structural performance criterion for the sixth disbursement.

2/ In the Memorandum of Economic and Financial Policies (MEFP) of January 28, 2008, Fund staff and the authorities reached an understanding that this measure would be made a structural performance criterion for the seventh disbursement.

ATTACHMENT III: TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This memorandum sets out the understandings between the Afghan authorities and Fund staff relating to the monitoring of the Poverty Reduction and Growth Facility (PRGF)-supported program approved by the IMF Executive Board on June 26, 2006. It defines the structural performance criteria and benchmarks (Section I), valuation for purposes of monitoring the quantitative targets under the program (Section II), quantitative performance criteria and indicative targets (Section III); and adjustors (Section IV). It also sets out data reporting requirements (Section V).

I. STRUCTURAL PERFORMANCE CRITERIA AND BENCHMARKS

2. Prior actions for the fourth review and structural performance criteria and benchmarks for the fifth and sixth reviews are specified in Table 2 of the Supplementary Memorandum of Economic and Financial Policies (SMEFP) and defined as follows:

A. Fourth Review Under the PRGF Arrangement

Prior actions

- Ministry of Finance (MOF) will issue an instruction for Afghan Customs Department (ACD) to ensure timely updates of reference prices for petroleum products, which will be applied in assessing the amount of applicable duties and taxes collected at the border. The instruction shall provide for the: (i) method to be used in the determination of the reference prices based on a weighted average of CIF prices paid by the importers of the petroleum products over preceding three months; (ii) periodicity of updating the reference prices not to exceed three months; and (iii) the maximum percentage deviation between the reference prices and the relevant import prices not to exceed 10 percent. The formula shall be applied to calculate the reference price for aviation fuel, diesel, petrol, and kerosene. All other petroleum product imports shall be valued at the invoice price.
- Ministry of Finance (MOF) will collect at least Af 79 million on the business receipt tax (BRT) and nontax (landing/parking right fees) liabilities due by airlines and outstanding at end-2007/08. To fulfill the prior action the authorities are required to submit the relevant official revenue forms showing: a) taxpayer; b) amount collected; and c) the period in which the liability accrued (amounts to be collected as a prior action should not include BRT liabilities accrued in the fourth quarter of 2007/08, which are due in the first quarter of 2008/09).
- MOF and the Ministry of Commerce and Industry (MoCI) will sign a memorandum of understanding to clarify customs procedures for fuel products stored at Fuel and Liquid Gas Enterprise (FLGE) depot and storage areas. The memorandum shall state that: (i) customs officials have full and immediate access to any imported

consignments of fuel for the purpose of verifying the quantity and quality of fuel; (ii) documentation regarding the imported consignments of fuel must be reported to customs immediately; (iii) imported consignments of fuel stored by FLGE can only be released by the written consent of a customs official once applicable duties and taxes have been paid.

B. Fifth Review Under the PRGF Arrangement

Structural performance criteria

- MOF will submit to parliament the core budget's audited financial statements for 2007/08. An audit report of the core budget financial statements to parliament will be prepared by the Control and Audit Office in accordance with international accounting practices.
- Afghanistan Electricity Company (DABS, former DABM) will submit to MOF DABM's financial statements for 2006/07–2007/08 audited by a reputable international audit firm.

Structural benchmarks

- DAB will produce and publish the Monetary Survey for 2007/08 using a consistent time frame (Solar or Gregorian calendar) for the entire banking system.
- MOF will publicly notify traders of the expiration of exemption from the general income tax regime and inform them that they will be expected to file and pay their tax liabilities for 2008/09 according to the general provisions for corporate income tax payers.
- DAB will develop an action plan to address the gaps in DAB's legal framework based on the weaknesses identified in DAB's self-assessment against the Basle Principles.
- DAB will create an electronic registry of capital notes (CNs). The registry will keep track of secondary market transactions and changes in the ownership of the claim, its residual maturity, and discounted value on a weekly basis.
- MOF will roll out the operations of the Large Taxpayer Office (LTO) to Herat, Jalalabad, and Mazar-e-Sharif.
- Parliament will pass amendments to the income tax legislation that have already been submitted (including the introduction of BRT on imports).
- Ministry of Commerce and Industry (MoCI) will publish an external audit report of FLGE. The audit shall cover FLGE's financial statements for 2007/08

and shall be conducted in accordance with international accounting principles. In addition, the audit shall cover FLGE's headcount and wage bill, and will include a review of FLGE's commercial dealings with the government and other state-owned enterprises. The audit report shall be published on MOCI's external website.

- MOF will conduct a review the fiscal relations between the government and the following state-owned enterprises (SOEs): Afghan Telecom, Ariana, DABS, and FLGE. The review will cover the period from 2005/06 onward and will focus on: (i) payment of bills and service charges by the line ministries; (ii) payment of taxes by these SOEs; (iii) transfers of these SOEs' profits to the Treasury account; and (iv) closure of unauthorized bank accounts. The results of the review showing the status of relations between each SOE and the budget and an action plan for their regularization will be summarized in a report, which shall be submitted to the IMF staff before December 31, 2008.

- MOF will conclude a comprehensive agreement with the DABS (former DABM) on a medium-term plan to reduce subsidies. The plan will be finalized by December 2008 for implementation in March 2009 and shall include steps to reduce and gradually eliminate the fuel subsidy. Key components of the plan would include: (i) operational and financial independence for DABS from the MoEW; (ii) measurable benchmarks on DABM's restructuring process; (iii) an agreement on the optimal use of existing and new generation capacity; (iv) tariff increases for premium power users as the electricity supply improves; (v) targets for improved collection from government ministries and agencies (could include centralized debits from ministry and agency budget allocations if arrears are built up); (vi) a schedule of tax payments to the Ministry of Finance; and (vii) a plan for scheduled load shedding for residential customers.

C. Sixth Review Under the PRGF Arrangement

Structural Performance Criterion

- Presidential Decree No. 96 will be amended to reduce to 20 percent the 40 percent tariff rate on soft drinks.

Structural benchmarks

- MOF will withdraw trader concessions on filing and paying taxes. Clarification: By March 21, 2009, the current agreement, whereby traders do not have to file any tax returns if they have paid the 2 percent fixed tax on imports in lieu of income tax, will cease. Registration with the tax authorities for BRT and income tax will be determined by the relevant thresholds as set out in legislation.

- MOF (Customs Department) will start collecting BRT on imports by March 21, 2009. Clarification: The BRT collected on imports (2 percent) shall be in addition to the existing 2 percent advance payment of income tax.
- MOF (Revenue Department) will collect Af 79 million on airlines' outstanding tax and nontax 2007/08 liabilities to be collected in 2008/09 (in addition to Af 79 million to be collected as a prior action for the fourth review; altogether no less than Af 158 million) and be current with all airline tax and nontax payments by the end of the fiscal year 2008/09.
- MOF (Customs Department) will implement the ASYCUDA Transit and Declaration Processing Module in Nangarhar, Herat, and at Kabul Airport inland clearing depots.

II. PROGRAM EXCHANGE RATES AND GOLD VALUATION

3. Program exchange rates will be used for purposes of monitoring the quantitative targets under the program. All foreign assets and liabilities denominated in U.S. dollars will be converted into Afghanis using a program exchange rate of 49.52 Afghanis per U.S. dollar, which corresponds to the average of the Af/US\$ buy and sell cash rates, as reported by DAB as of March 19, 2008. For assets and liabilities denominated in SDRs and in foreign currencies other than the U.S. dollar, they will be converted into U.S. dollars at their respective exchange rates prevailing as of March 19, 2008, as reported in the following table. Gold holdings will be valued at US\$943.65 per ounce, the price as of March 19, 2008.

Exchange Rate	Program Rate
U.S. dollar/Canadian dollar	0.988240
U.S. dollar/U.A.E. dirham	0.272290
U.S. dollar/Egyptian pound	0.182000
U.S. dollar/Euro	1.564250
U.S. dollar/Hong Kong dollar	0.128614
U.S. dollar/Indian rupee	0.024780
U.S. dollar/Pakistani rupee	0.015907
U.S. dollar/Polish zloty	0.441794
U.S. dollar/Iranian rial	0.000111
U.S. dollar/Saudi rial	0.266840
U.S. dollar/Russian ruble	0.042340
U.S. dollar/Swiss franc	1.002810
U.S. dollar/United Kingdom pound	1.985350
U.S. dollar/SDR	1.630000

III. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

4. The quantitative performance criteria (for September 21, 2008 and March 20, 2009) and indicative targets specified in Table 1 of the SMEFP are: a floor on fiscal revenue of the central government;

- a ceiling on currency in circulation (CiC);
- a ceiling on the net central bank financing (NCBF) of the central government;
- a floor on net international reserves (NIR);
- a zero ceiling on contracting and/or guaranteeing new medium- and long-term nonconcessional external debt by the government and DAB (continuous);
- a zero ceiling on short-term external debt owed or guaranteed by the government or DAB (continuous);
- a zero ceiling on the accumulation of external payment arrears, excluding interest on preexisting arrears (continuous);
- a zero ceiling on lending from state-owned banks to, or government guaranteed borrowing by, state-owned enterprises in need of restructuring (continuous);
- a ceiling for the operating budget deficit of the central government, excluding grants (indicative target); and
- a ceiling on reserve money (indicative target).

A. Currency in Circulation

5. **Currency in circulation** is defined as total currency issued by DAB. It excludes currency held in the presidential palace vault, in DAB main vault, and in the vaults of all DAB's provincial and district branches.

B. Net Central Bank Financing of the Government

6. **NCBF of the government** is defined as the difference between the central bank's claims on the government and the deposits of the government with DAB. These deposits include the deposits held at DAB headquarters, but exclude the deposits held at DAB's branches.¹

¹ This definition differs slightly from international standards owing to the unavailability of reliable and timely government deposit data from DAB's branches.

C. Net International Reserves

7. **Net international reserves (NIR)** are defined as reserve assets minus reserve liabilities of DAB.

8. **Reserve assets of DAB**, as defined in the fifth edition of the balance of payments manual (BPM5), are claims on nonresidents denominated in foreign convertible currencies, that are controlled by DAB, and are readily and unconditionally available for DAB to meet balance of payments financing needs, intervention in exchange markets, and other purposes. They include DAB holdings of monetary gold, SDRs, Afghanistan's reserve position in the IMF, foreign currency cash (including foreign exchange banknotes in the vaults of DAB, but excluding cash held in DAB's branches), and deposits abroad (including balances on accounts maintained with overseas correspondent banks). Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered;² claims on residents; precious metals other than monetary gold; assets in nonconvertible currencies; illiquid assets; and claims on foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options).

9. **Reserve liabilities** are defined as short-term (original maturity) foreign exchange liabilities of DAB to nonresidents (held at DAB headquarters); all credit outstanding from the IMF; foreign currency reserves of commercial banks held at DAB headquarters; commitments to sell foreign exchange arising from derivatives (such as futures, forwards, swaps, and options); and all arrears on principal or interest payments to commercial banks, suppliers, or official export credit agencies.

10. Reserve assets and reserve liabilities will both be expressed in U.S. dollars.

D. Revenues of the Central Government

11. **Revenues of the central government** are defined in line with the Government Financial Statistics Manual (GFSM 2001) on a cash accounting basis, excluding foreign grants. Revenue is an increase in net worth of the central government (including its units in the provinces and agencies) resulting from a transaction. Revenues of the central government include taxes and other compulsory transfers imposed by central government units, property income derived from the ownership of assets, sales of goods and services, social contributions, interest, fines, penalties and forfeits and voluntary transfers received from nongovernment other than grants. The definition for program monitoring excludes grants and

² In particular, assets that are counterpart of the government's foreign currency deposits that back letters of credit are excluded from the reserve assets. However, assets that are counterpart of other government deposits are included in the reserve assets.

other noncompulsory contributions received from foreign governments and international organizations; such transfers between central government units would be eliminated in the consolidation of the fiscal reports and not recorded as revenue. Receipts collected by central government on behalf of noncentral government units should not be counted as revenue (e.g., Red Crescent fees). Receipts from the sale of nonfinancial assets, such as privatization, and transactions in financial assets and liabilities, such as borrowing but excepting interest payments, are also excluded from the definition of revenue.

12. Revenues should be recognized on a cash basis and flows should be recorded when cash is received. The official AFMIS reports will be used as the basis for program monitoring. Exceptional advanced payments will be treated as if received on the normal due date. All revenue must be supported by the relevant documentation and revenue receivables, where a cash sum has been recorded but the revenue item has not yet been accounted for, and revenues payable, where the revenue has been reported but the cash has yet to be recorded should be separately reported on a gross basis.

E. External Debt and Arrears

13. As set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt (Decision No. 12274-00/85; August 24, 2000), the term “debt” will be understood to mean a current (i.e., not contingent) liability, created under a contractual arrangement through the provision of value in the form of assets (including currency) or services, and which requires the obligor to make one or more payments in the form of assets (including currency) or services, at some future point(s) in time; these payments will discharge the principal and/or interest liabilities incurred under the contract.

- Debts can take a number of forms, the primary ones being: (a) loans, (i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future—including deposits, bonds, debentures, commercial loans and buyers’ credits—and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (b) suppliers’ credits (i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided); and (c) leases (i.e., arrangements under which property is provided that the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property). Excluded from this limit are leases of real property by Afghan embassies or other foreign representations of the government.

- For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property. Arrears, penalties, and judicially-awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.

14. **The ceiling on medium- and long-term external debt applies on a continuous basis to the contracting or guaranteeing by the government or DAB of new nonconcessional external debt with an original maturity of more than one year.** For program purposes, “government” includes the central government (including government departments), as well as official agencies that do not seek profit and whose budgets are issued independent of the annual operational or development budgets. Consistent with the PFEM law, the Ministry of Finance (MOF) should have sole responsibility for the contracting and guaranteeing of external debt on behalf of the government.

- **It applies to** both debt as defined in paragraph 13 of this memorandum, and also to commitments contracted or guaranteed for which value has not been received. For the purposes of the program:
 - external debt will be considered to have been contracted at the point the loan agreement or guarantee is signed by the MOF (on behalf of the government) or DAB Governor; and
 - the guarantee of a debt arises from any explicit legal obligation of the government or DAB, or any other agency acting on behalf of the government, to service such a debt in the event of nonpayment by the recipient (involving payments in cash or in kind), or indirectly through any other obligation of the government or DAB to cover a shortfall incurred by the loan recipient.
- **Excluded** from the limits are refinancing credits and rescheduling operations, credits extended by the IMF, and credits on concessional terms defined as those with a grant element of at least 60 percent. The grant element is to be calculated using currency-specific discount rates based on the Organization for Economic Cooperation and Development’s Commercial Interest Reference Rates (CIRRs): for maturities of less than 15 years, the grant element will be calculated based on six-month averages of CIRRs; and for maturities longer than 15 years, the grant element will be calculated based on 10 year averages.
- Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract or guarantee becomes effective.

15. **The zero ceiling on short-term external debt** applies on a continuous basis to the stock of short-term external debt owed or guaranteed by the government (as defined in paragraph 14 of this memorandum) or DAB, with an original maturity of up to and including one year.

- **It applies to** debt as defined in paragraph 13 of this memorandum.
- **Excluded** from the limit are rescheduling operations (including the deferral of interest on commercial debt) and normal import-related credits.
- Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract or guarantee becomes effective.

16. A continuous performance criterion applies to the **nonaccumulation of new external payments arrears** on external debt contracted or guaranteed by the central government or DAB. External payment arrears consist of external debt service obligations (principal and interest) falling due after March 20, 2006 and that have not been paid at the time they are due, as specified in the contractual agreements. **Excluded** from the prohibition on the accumulation of new arrears are: (a) arrears arising from interest on the stock of arrears outstanding as of March 20, 2006; and (b) external arrears that are subject to debt rescheduling agreements or negotiations.

F. Lending to, or Guaranteeing Borrowing by, State-Owned Enterprises

17. **The zero ceiling on new lending from state-owned banks to, or government guaranteed borrowing by, enterprises in need of restructuring applies on a continuous basis.**

- For the purposes of this performance criterion:
 - “state-owned banks” refers to those banks that are wholly or majority owned by the government (as defined in paragraph 14 of this memorandum); including Bank Millie, Bank Pashtany, and Export Promotion Bank;
 - “enterprises in need of restructuring” refers to enterprises that meet any one of the following: (a) enterprises (public or private) that have not had an audited balance sheet in fiscal years 1384 and 1385; (b) public enterprises that have been identified by the MOF for liquidation; (c) public enterprises that do not have Cabinet-approved restructuring plans;

- “public enterprises” refers to enterprises wholly or majority owned by the government, including those covered by the State-Owned Enterprise (Tassady) Law, and 13 state-owned corporations³ and any other public entities and government agencies engaged in commercial activities but not covered by Tassady Law.

- **It applies to** any new loans (or financial contributions) extended directly from state-owned banks to enterprises in need of restructuring, and also to any new government guarantees (as defined in paragraph 14 of this memorandum) of borrowing undertaken by these enterprises. It applies to loan agreements and guarantees for which value has not been received.

G. Operating Budget Deficit of the Central Government, Excluding Grants (Indicative Target)

Revenues of the Central Government as defined above (¶11) minus operating budget expenditure recorded in AFMIS.

H. Reserve Money (Indicative Target)

Reserve money is defined to include CiC and Afghani-denominated commercial bank deposits with DAB, including balances maintained by the commercial banks in DAB’s overnight facility.

IV. ADJUSTORS

18. The floor on NIR and the ceiling on the NCBF of the government are defined consistent with the assumption that core budget development spending in 2008/09 will amount, on a cumulative basis from March 19, 2008, to:

June 20, 2008	Af 7,038 million
September 21, 2008	Af 21,114 million
December 20, 2008	Af 35,190 million
March 20, 2009	Af 56,304 million

Should core budget development spending exceed these projections, the NIR floor will be adjusted downward and the NCBF ceiling will be adjusted upward by the difference between

³ Afsotar, Afghan Teor, Aftento, Af-Turk, Afghan Cart, Afghan Naichi, Astrass, Afghan Telecom, Afghan Wireless, Afghan National Insurance Company, Afghan Textile, Ariana Afghan Airlines, and Hotel Intercontinental (Baghi Bala/Kabul).

the actual level (up to the appropriated amount) and the projected level of development spending.

19. The NIR floor and NCBF ceiling are defined consistent with the assumption that the external financing of the core budget and the receipts from the sale or transfer of nonfinancial assets will amount, on a cumulative basis from March 19, 2008, to:

June 20, 2008	Af 10,098 million
September 21, 2008	Af 26,765 million
December 20, 2008	Af 53,335 million
March 20, 2009	Af 76,572 million

Should external financing of the core budget (including that associated with off-budgetary spending coming on budget) and the receipts from the sale or transfer of nonfinancial assets collectively exceed (fall short of) these projections, the NIR floor will be adjusted upward (downward) and the NCBF ceiling will be adjusted downward (upward) by the difference between their actual level and the projected level.

20. Should some expenditure currently financed directly by donors outside the budget be moved on to the operating budget, the NIR floor will be adjusted downward, and the NCBF ceiling and the indicative targets (ceilings) for the operating budget deficits of the central government, excluding grants, will be adjusted upward, by the actual amount of these expenditures on the conditions that (a) the moving on budget of these expenditures is justified by a statement from donors indicating their decision to stop financing them outside the budget and (b) they are subject to a supplementary appropriation approved by parliament. The overall downward adjustment to the NIR floors will be capped at US\$300 million.

21. Should the Ministry of Defense core operating budget exceed Af 12,137 million, the NIR floor will be adjusted downward, and the NCBF ceiling and the indicative target (ceiling) for the operating budget deficit of the central government, excluding grants, will be adjusted upward, conditional on the Afghan National Army (ANA) headcount exceeding the 70,000 troops budgeted for 2008/09. The extent of the adjustment will be contingent on the final 2008/09 ANA force size, with zero adjustment for a force size of 70,000 and Af 1,919 million adjustment for a final force size of 86,000. The adjustment for any force size between 70,000 and 86,000 will be calculated on a prorated basis. The cumulative downward adjustment to the NIR floors at each test date will be capped at US\$ 38.4 million. The cumulative upward adjustment to the NCBF ceilings and the indicative targets (ceilings) for the operating budget deficits of the central government, excluding grants, at each test date, will be capped at Afs 1.9 billion.

V. PROVISION OF INFORMATION TO FUND STAFF

22. To facilitate the monitoring of program implementation, the government of Afghanistan and DAB will provide to Division A of the Middle East and Central Asia Department (MCD), through the office of the Resident Representative of the IMF in Afghanistan, the information specified below and summarized in the list of reporting tables provided by Fund staff to the Technical Committee.

23. In order to facilitate regular monitoring of the PRGF-supported program, actual outcomes should be provided with the frequencies and lags indicated below.

- **DAB net international reserves** should be reported weekly, no later than two weeks after the end of the week.
- **Monetary statistics, including exchange rates, government accounts with DAB, currency in circulation, reserve money, and a monetary survey** should be reported monthly and no later than three weeks after the end of the month. The monetary survey will include the balance sheet of DAB and a consolidated balance sheet of the commercial banking sector.
- **Core budget operations and their financing** should be reported monthly and no later than four weeks after the end of the month. The official reports for the purpose of program monitoring will be the monthly financial statements from the Afghanistan Financial Management Information System. The structure of financing (grants and loans should be separately identified) and expenditure data should be on a consistent cash basis. Core operating expenditures should be reported on a monthly basis using the budget appropriation economic (object) and administrative classification in addition to the program and functional classification as reported in the budget documents. Core development expenditures should also be reported separately on a monthly basis using the budget program classification in addition to the economic (object), administrative and functional classification consistent with the operating budget. All the data should also compare outturns against the approved budget (or figures reported in the budget documents). Core operating and development revenues and expenditures should also be reported by province, separately on the same monthly basis.
- **External budget operations and their financing** (i.e., donor funded spending outside the core budget treasury systems) should be reported at least semi-annually (more frequently if possible) and no later than eight weeks after the end of the period. External development expenditures should be reported on a disbursement basis (as currently defined in budget documents) using the budget program

classification (and an administrative, functional and provincial classification where possible).

- **External debt data** should be reported quarterly and no later than six weeks after the end of the quarter. They will include: (a) details of new loans contracted or guaranteed during the quarter, including the terms of each new loan; (b) the stock of debt at the end the quarter, including short-term debt, and medium- and long-term debt; (c) loan disbursements and debt service payments (interest and amortization) during the quarter; (d) debt relief received during the quarter; (e) information on all overdue payments on short-term debt, and on medium- and long-term debt, including new external arrears (if any); and (f) total outstanding amount of arrears.
- **National accounts data**, with the exception of merchandise trade data, should be reported annually and no later than eight weeks after the end of the year. Merchandise trade data should be reported quarterly and no later than eight weeks after the end of the quarter.
- **Consumer price indexes (CPIs)** for the city of Kabul and for Kabul and five other major cities (“national” CPI) should be reported monthly and no later than four weeks after the end of the month.

24. The government of Afghanistan and DAB will prepare and send to the IMF reports explaining progress made in implementing structural reforms, in particular regarding those included as structural performance criteria and benchmarks in the program. These reports will include appropriate documentation to substantiate progress achieved, and will explain any deviations relative to the initial reform plans or timetable, specifying expected revised completion date.

25. Other details on major economic and social measures taken by the government that are expected to have an impact on program sequencing (such as changes in legislation, regulations, or any other pertinent document) will be sent in a timely manner to IMF staff, for consultation or information.

26. The Technical Committee of Coordination (TCC) will provide Division A of MCD with any other information that may be required by the staff of the IMF for the effective monitoring of the program. For program monitoring purposes, working meetings are planned, at least biweekly, with the participation of representatives of the designated members of the TCC, including any party that could facilitate monitoring implementation of the program.

INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF AFGHANISTAN

**Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction
and Growth Facility, and a Request for a Waiver of Performance Criterion**

Informational Annex

Prepared by Middle East and Central Asia Department
(In consultation with other Departments)

June 23, 2008

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ANNEX I. ISLAMIC REPUBLIC OF AFGHANISTAN—RELATIONS WITH THE FUND

(As of April 30, 2008)

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

II. General Resources Account	<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. SDR Department	<u>SDR Million</u>	<u>% Allocation</u>
Net cumulative allocation	26.70	100.00
Holdings	0.26	0.98
IV. Outstanding Purchases and Loans	<u>SDR Million</u>	<u>% Quota</u>
PRGF Arrangements	47.10	29.09

V. **Latest Financial Arrangements:**

<u>Type</u>	<u>Date of Arrangement</u>	<u>Expiration Date</u>	<u>Amount Approved (SDR Million)</u>	<u>Amount Drawn (SDR Million)</u>
PRGF	June 26, 2006	June 25, 2009	81.00	47.10

VI. **Projected Payments to Fund**

(SDR million; based on existing use of resources and present holdings of SDRs)

	<u>Forthcoming</u>				
	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>
Principal					2.45
Charges/Interest	0.77	0.96	0.96	0.96	0.96
Total	0.77	0.96	0.96	0.96	3.41

VII. **Implementation of HIPC Initiative:**

	<u>Enhanced Framework</u>
I. Commitment of HIPC assistance	
Decision point date	July 2007
Assistance committed (NPV terms) ¹	
by all creditors (US\$ million)	571.40
<i>Of which:</i> Fund assistance (US\$ million)	--
(SDR equivalent in million)	--

¹ Net Present Value (NPV) at the decision point under the enhanced framework.

Completion point date	Floating
-----------------------	----------

II. Disbursement of IMF assistance (SDR Million)	
Assistance disbursed to the member	--
Interim assistance	--
Completion point balance	--
Additional disbursement of interest income ²	--
Total disbursements	--

VIII. **Implementation of MDRI Assistance:** Not Applicable

Non-financial Relations

IX. **Exchange Arrangement**

Afghanistan is an Article XIV member country. The authorities are implementing a liberal exchange system. Based on information currently available to the staff, no exchange restrictions and multiple currency practices are currently in place. The authorities have provided documents to IMF staff related to laws and regulations on the exchange regime and have requested technical assistance from the Fund to formalize the current liberal regime. They have been implementing a managed float system with no predetermined path for the exchange rate. On April 30, 2008, the average of the buying and selling exchange rates in cash transactions on the Kabul money exchange market was Af 50.04 per \$1.

To conduct monetary policy, the authorities rely on foreign exchange auctions since May 2002, and on short-term capital note auctions since September 2004. The foreign exchange auctions were initially open only to licensed money changers, but since June 2005 they are also open to commercial banks. The capital note auctions are open to commercial banks. Auctions are linked to the overall monetary program and are held on a regular basis (biweekly for foreign exchange auctions, daily for capital note auctions).

X. **Article IV Consultation**

The last Article IV consultation with Afghanistan was discussed by the Executive Board on February 13, 2008. Consultations with Afghanistan are on the standard 12-month cycle.

² Under the enhanced framework, an additional disbursement is made at the completion point corresponding to interest income earned on the amount committed at the decision point, but not disbursed during the interim period.

XI. Safeguards Assessment

Under the Fund's safeguards assessment policy, Da Afghanistan Bank (DAB) is subject to a safeguards assessment with respect to PRGF arrangement approved on June 26, 2006. A safeguards assessment of DAB was completed on June 12, 2006. It revealed serious vulnerabilities in DAB's external and internal audit mechanisms, as well as in its financial reporting framework and system of internal controls. Capacity constraints, however, hampered the effective implementation of measures recommended by the assessment, and a follow-up staff visit conducted in November 2007 found that while external audit arrangements had been strengthened, financial reporting and controls were insufficient to ensure the accuracy of monetary data and the accounting system remained unreliable. Depending on the outcome of KPMG's ongoing external audit of financial year 1386 (ended March 19, 2008), staff will assess the need to continue special audits to verify reserve assets at test dates (a special audit was completed in January 2008 as a prior action for completion of the third review of the PRGF arrangement). DAB is continuing its implementation of outstanding safeguards recommendations. These efforts are being monitored by staff in the context of the program.

XII. Technical Assistance, 2005–08

Department	Date	Purpose
FAD	March 2004–July 2006	Resident treasury expert
	May 19–25, 2005	Seminar on reorganization of the MOF
	October 18–25, 2005	Tax policy
	February 21–March 04, 2006	Public financial management
	April 30–May 09, 2006	Tax policy
	November 15–23, 2006	Tax and customs administration
	August 18–30, 2007	Program budgeting
	August 28–September 12, 2007	GFS
	October 2007–September 2008	Resident Treasury Advisor
FIN	April 2–11, 2006	Safeguards assessment
	November 9–12, 2007	Safeguards assessment
LEG	January 29–February 12, 2005	Income tax law
LEG/MCM	May 2–10, 2006	Legal framework of DAB's monetary and payment system policies
	January 13–21, 2008	Monetary policy and payment system
MCM	September 2004–April, 2006	Training coordinator
	April 2006–June 2007	Training coordinator (peripatetic)
	February 2–15, 2005	Implementation of DAB balance sheet reconstruction and capital adequacy recommendations
	May 16–25, 2005	Monetary policy and financial markets

Department	Date	Purpose
MCM	October 11–20, 2005	Monetary policy
	November 20–29, 2005	Financial markets
	January 22–February 5, 2006	Monetary policy
	January 22–February 5, 2006	Monetary policy
	May 2–10, 2006	Monetary policy, foreign reserve management, money markets and insurance
	November 28–December 10, 2006	Monetary policy formulation and implementation
	March 19–April 16, 2007	Central bank capacity building
	March 24–29, 2007	Banking supervision
	April 17–30, 2007	Monetary policy formulation and implementation
	November 7–14, 2007	Banking Supervision
STA	January 15–February 15, 2005	Multisector statistics
	March 23–June 11, 2005	Multisector statistics
	July 20–August 31, 2005	Multisector statistics
	October 31, 2005–January 12, 2006	Multisector statistics
	March 6–15, 2006	Balance of payments statistics
	March 8–May 2, 2006	Multisector statistics
	March 13–April 1, 2006	Monetary and financial statistics
	May 24–July 18, 2006	Multisector Statistics
	August 2–16, 2006	Balance of payments statistics
	August 8–October 3, 2006	Multisector statistics
	September 22–October 4, 2006	Government finance statistics
	November 1–December 26, 2006	Multisector statistics
	November 5–19, 2006	Monetary and financial statistics
	April 22–May 4, 2007	Monetary and financial statistics
	July 7–30, 2007	National accounts
	August 29–September 25, 2007	National accounts
	March 30–April 2, 2008	TA evaluation
	April 20–30, 2008	Monetary and financial statistics
MCD	April 16–20, 2005	Basic macroeconomic accounting and financial programming
METAC	November 15–20, 2005	Tax policy and administration
	June 2006	Budget integration
	November–December 2006	Budget integration
	December 2006	Cash management
	March 2007	Cash management
	May 19–25, 2007	Balance of payments statistics
	June 6–19, 2007	Accounting
	July 1–10, 2007	Banking supervision
	August 2007	Cash management and program budgeting

Department	Date	Purpose
METAC	September 2–17, 2007	Central bank accounting
	November 13–December 4, 2007	Central bank accounting
	November 4–8, 2007	Banking supervision
	November 6–15, 2007	Banking supervision

Afghanistan is a participant in the Middle East Technical Assistance Center.

With financial support from the Sweden Technical Assistance Subaccount, the Fund sponsored a number of training activities aimed at DAB officials. A long-term resident training advisor, Mr. Khan, was posted at DAB from September 2004-April 2006 and is now conducting peripatetic technical assistance missions. Finally, Sweden has financed a monetary policy peripatetic advisor (a position currently shared by Mr. Coats and Mr. Gray) to assist DAB in developing the strategy and instruments for improving the implementation of monetary policy.

XIII. Resident Representatives

During the first half of 2002, the Fund's resident representative in Pakistan, Mr. Ghesquière, assisted in maintaining relations with the Afghan authorities. A resident representative, Mr. de Schaetzen, took up his post in Kabul on August 24, 2002. Mr. Charap succeeded him on June 13, 2005, and will be replaced by Mr. Khanjar Wabel Abdallah as of June 2008.

Appendix II. Islamic Republic of Afghanistan—Relations with the World Bank

(As of May 20, 2008)

1. Since April 2002, the World Bank has committed over US\$1.65 billion for 41 development and emergency reconstruction projects and three budget support operations in Afghanistan. This support comprises over US\$1.2 billion in grants and US\$436.4 million in no-interest loans—known as ‘credits.’ Currently, the Bank has 23 active projects in Afghanistan with net commitments of over \$950 million. Three budget support operations and emergency public works, infrastructure reconstruction, education rehabilitation projects, and the first phase of a rural development and public administration projects have so far been completed.
2. This FY (July 07-June 08), the Board has approved eight new projects for a commitment amount of \$255 million. Areas of intervention included irrigation, health, microfinance, and capacity building in public administration. In terms of sectoral composition of the overall investment portfolio, rural and transport sectors continue to represent the two largest shares, with respect to both commitments and disbursements. This is largely due to the successful implementation of the two nation-wide programs: National Solidarity Program (NSP) that supports development of community demand-driven rural infrastructure and community level governance, and the National Emergency Employment Program (NEEP) that provides short-term employment opportunities to the vulnerable segments of rural population through rural roads rehabilitation and reconstruction. A new Country Assistance Strategy is planned for early CY2009. It will support the recently released Afghanistan National Development Strategy.
3. The Afghanistan Reconstruction Trust Fund (ARTF) is administered by the World Bank on behalf of 27 donors and managed in conjunction with the Asian Development Bank, Islamic Development Bank, United Nations Assistance Mission for Afghanistan, and the United Nations Development Program. It is the main mechanism for providing coordinated funding support to Afghanistan’s recurrent budget and investments, in line with the agreed budget priorities of the government. As of April, 2008, 28 donors had pledged US\$2.45 billion to ARTF, of which US\$2.4 billion has been received. More than US\$1.35 billion has been disbursed to the Government of Afghanistan to help cover recurrent costs, and US\$600 million had been made available for investment projects.
4. The Japan Social Development Fund (JSDF), administered by the World Bank, has provided a special window for Afghanistan which operates in a harmonized manner to support the national programs of the government. As of April 2008, Japanese contributions to JSDF for Afghanistan reached US\$23 million.

5. The World Bank has provided advice to help the government manage donor funds effectively and in a transparent way. The World Bank also supports the government by providing analytical work on the economy, public administration, gender, poverty, the opium economy, and an ongoing public finance management (PFM) review. The Bank has actively supported key reforms, particularly in the fiscal and public administration spheres, and through its budget support operation. It has advocated building capacity and legitimacy of the State and channeling donor resources through the government to ensure investments are aligned with national priorities. To this end, the World Bank works closely with other multilateral and bilateral agencies across a number of sectors where aid coordination and government ownership are most critical.

INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF AFGHANISTAN

Joint IMF/World Bank Debt Sustainability Analysis

Prepared by the staffs of the International Monetary Fund and
The International Development Association

Approved by Juan Carlos Di Tata and Matthew Fisher (IMF)
and Carlos Braga (IDA)

June 23, 2008

The external low-income country debt sustainability analysis (LIC DSA) reveals that Afghanistan has a high risk of debt distress, underlining the need for debt relief under the HIPC Initiative and the Multilateral Debt Relief Initiative (MDRI).^{1, 2} Under the alternative scenario which assumes full delivery of HIPC, MDRI, and beyond-HIPC debt relief at the completion point of the HIPC Initiative, debt burden indicators fall below the country-specific indicative thresholds. The public debt LIC DSA suggests that Afghanistan's overall public sector debt dynamics will remain manageable, despite rapid increase in domestic borrowing toward the end of the projection period. Further fiscal consolidation (or more external grants) should be considered in order to stabilize the debt burden indicators.

A. Introduction

1. The external and public debt sustainability analyses presented here are based on the common standard LIC DSA framework, with a modification to the stress tests to

¹ These DSAs have been produced jointly by Bank and Fund staffs.

² Usually, the country-specific indicative thresholds for the LIC DSA are determined using a three-year average of the country's rating under the World Bank's Country Policy and Institutional Assessment (CPIA). However, the CPIA for Afghanistan is available only for 2006 and 2007. In both years, Afghanistan was rated a weak performer. Accordingly, the thresholds for the LIC DSA are 30 percent for the NPV of debt-to-GDP ratio, 100 percent for the NPV of debt-to-exports ratio, and 15 percent for the debt service-to-exports ratio.

address the volatility of aid inflows.^{3,4} The DSA presents the projected path of Afghanistan’s external and public sector debt burden indicators, and draws some conclusions on the forward-looking sustainability of debt. The baseline scenario assumes continued delivery of HIPC interim debt relief during the life of the PRGF arrangement (no irrevocable debt relief at completion point), while an alternative scenario assumes the delivery of debt relief, including MDRI and beyond-HIPC debt relief, at the HIPC completion point, which is assumed to occur in mid-2009.

2. **Two key changes to the baseline scenario explain the differences between the current analysis and the previous DSA included in the HIPC decision point:** (i) aid inflows are significantly higher (about seven percentage points of GDP higher in the long-term), reflecting the upward revision to the size of the donor-funded external budget; (ii) real GDP growth is projected to average about one percentage point more in the long-run than at the time of the decision point, reflecting the higher aid flows and public investment coupled with the direct and indirect effects of the Aynak copper mine.

B. Baseline Scenario

3. **Average annual real GDP growth is expected to moderate over the projection period,** from 7.8 percent in 2008/09–2012/13 to the long-run average of 6.1 percent in 2013/14–2030/31. This pattern reflects the projected decrease in the investment-to-GDP ratio from short-to medium-term exceptional levels of around 30 percent, to a still high, yet markedly lower, long-term level (around 17½ percent). The latter is necessary to sustain an acceptable pace of growth in per capita consumption. Continued donor support for reconstruction and public investment is likely to be the main driving factor during the earlier years. The contribution of donor-led investment is expected to decline over the medium-term, with private investment gaining in prominence and eventually playing the lead role. Inflation is projected to ease over time from about 20.7 percent in 2007/08 to 5 percent starting in 2012/13 and during the remainder of the projection period. The nominal exchange rate is

³ See “Debt Sustainability in Low-Income Countries: Proposal for an Operational Framework and Policy Implications” (<http://www.imf.org/external/np/pdr/sustain/2004/020304.htm> and IDA/SECM2004/0035, 2/3/04) and “Debt Sustainability in Low-Income Countries: Further Considerations on an Operational Framework and Policy Implications” (<http://www.imf.org/external/np/pdr/sustain/2004/091004.htm> and IDA/SECM2004/0629, 9/10/04).

⁴ The volatility of aid flows over the past five years makes a shock to non-debt creating flows based on historical data difficult to interpret. Hence, we follow the approach in the 2007 LIC DSA of assuming grant financing 25 percent below the baseline projection (or 12.5 percent in the combined test) for 2009/10-10/11. (See “The Decision Point Document on Assistance to the Islamic Republic of Afghanistan under the Enhanced Initiative for Heavily Indebted Poor Countries,” IDA Report No. 39922-AF and [IMF Country Report No. 07/253](#)).

assumed to remain stable over the projection period, leading to a continued real exchange rate appreciation.

4. **Continued macroeconomic stability is predicated on sustained fiscal discipline**, with the government's overall deficit (including grants) improving from a peak of 3.0 percent of GDP in 2009–10 to about 1.2 percent of GDP by the end of the projection period.

Underlying this, revenues are assumed to increase gradually from 7 percent of GDP in 2007/08 to 11.6 percent of GDP in 2028/29, while expenditures (channeled through the national budget) are expected to decline in the short term before rising gradually to just over 19 percent of GDP with the mounting costs of maintaining new investments.

5. **The external position is expected to remain comfortable with continued donor support and increasing mining-related FDI over the medium-term.** Over the long-term, the current account deficit (excluding grants) is projected to decrease gradually from 66.9 percent of GDP in 2007/08 to just under 9 percent in 2028/29, in line with an improvement in the trade balance relative to GDP as imports relating to post-war reconstruction decline and the export sector, in particular mining, rebounds. The negative effects of the continued real exchange rate appreciation on exports and real economic activity are expected to be offset by continued productivity gains. External grants are expected to remain the predominant form of financing, but would decline relative to GDP from 63.2 percent in 2006/07 to 6.9 percent in 2028/29.⁵

C. Debt Sustainability Analyses

External Debt Sustainability

6. **The baseline scenario indicates that Afghanistan has a high risk of debt distress** (Table 1 and Figure 1). Although the NPV of external debt-to-GDP ratio remains well below the threshold (30 percent), the NPV of external debt-to-exports ratio remains above the 100 percent threshold until 2010/11, reflecting Afghanistan's very narrow export base. As exports are expected to grow in US\$ terms at 15 percent on average over the projection period, the NPV of external debt-to-exports ratio declines rapidly and is expected to approach 20 percent toward the end of the projection period. The relatively comfortable debt service ratios (to export and revenue) reflect in part the very high degree of concessionality on the outstanding stock of debt from multilaterals (mainly on IDA or IDA-like terms).

7. **The alternative scenarios and stress tests indicate that the evolution of Afghanistan's external debt position is subject to considerable vulnerabilities** (Table 2, Figure 1). Most debt indicators deteriorate significantly under the bound tests (temporary

⁵ Official borrowing is assumed to continue to be on concessional terms.

shocks) and in the face of a permanent worsening in the terms of new borrowing. The debt ratios also deteriorate significantly under the historical scenario, where the main macroeconomic variables are kept at their historical averages over the projection period.⁶ This reflects mainly a projected improvement in the current account excluding grants—which is not captured in the historical scenario—from higher export growth, higher mining-related FDI, and a slow-down in imports related to post-war reconstruction.

8. **The bound tests and the alternative scenarios underscore the vulnerability posed by Afghanistan’s heavy reliance on official transfers.** If official transfers in 2009/10–2010/11 were 25 percent lower than in the baseline, the NPV of external debt-to-exports would rise to 276 percent by 2010/11 and would not fall below the threshold until 2019/20.

9. **The bounds tests also demonstrate that an improvement in Afghanistan’s external debt indicators depends heavily on an expansion of its very narrow export base.** If export growth during 2009/10 and 2010/11 were to fall to a level one standard deviation below the historical average, the NPV of external debt-to-exports would rise to 184 percent in 2010/11 and would not fall below the 100 percent threshold until 2015/16.

10. **Debt relief under the HIPC and Multilateral Debt Relief Initiatives (MDRI) is expected to significantly improve Afghanistan’s debt situation.** Assuming the full delivery of HIPC and MDRI assistance at completion point, all three debt-burden indicators (NPV of debt-to-GDP ratio, NPV of debt-to-exports ratio, and debt service-to-exports ratio) would fall significantly below the indicative thresholds.

Public Sector Debt Sustainability

11. **Under the baseline scenario, Afghanistan’s public debt (including domestic debt) is expected to decline steadily relative to GDP until 2012/13, before increasing thereafter** (Table 3 and Figure 2). In the short term, the government is expected to draw down its significant deposits at Da Afghanistan Bank (the central bank) which, together with generous grant financing, explains the initial decline in the public debt ratios. However, the availability of external grants (channeled through the national budget) is expected to decline as a share of GDP over the projection period, from a high of around 9.5 percent of GDP in 2008/09 to about 6.2 percent in 2028/29.

12. **The medium- to longer-term decline in external grant financing is expected to be offset by a combination of increased revenue and domestic borrowing.** By 2028/29, the domestic debt is projected to reach 11.3 percent of GDP from a zero base in 2008/09, under the expectation of a gradual development of the domestic debt market. While the level

⁶ Due to lack of data, five-year averages are used rather than the standard ten-year averages.

of public debt over the projection period will not endanger fiscal sustainability, the average long-run primary deficit, at 1.1 percent of GDP, would be above the level that stabilizes the debt to GDP ratio.

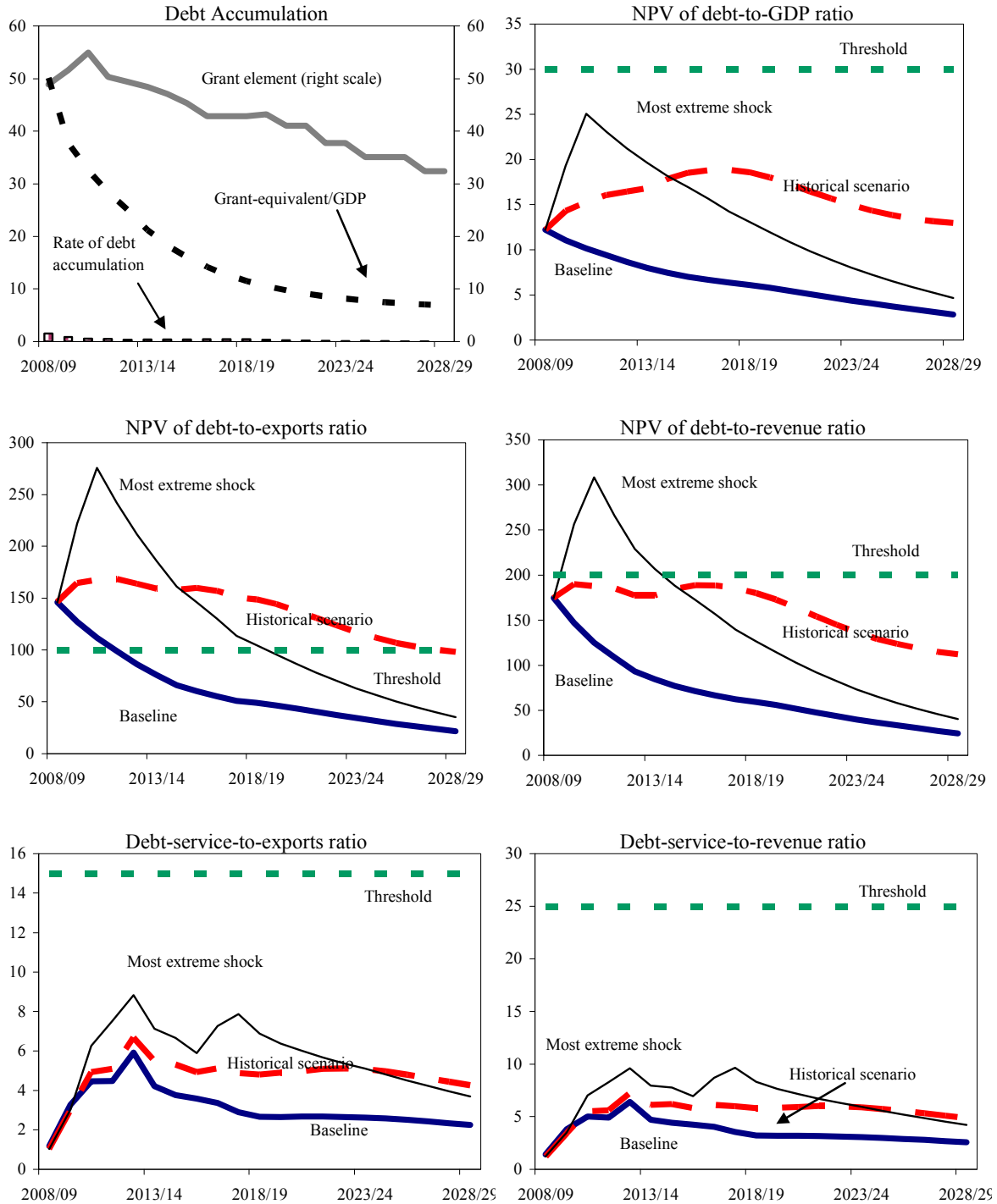
13. **Debt dynamics remain manageable under the various stress tests, but nonetheless vulnerable to a reduction in foreign grants.** (Table 4 and Figure 2). The most extreme stress test (scenario that produces the largest deterioration in a debt burden indicators after 10 years) is linked to a 10 percent of GDP shock in debt creating flows. The above scenario could be interpreted as a negative shock to foreign grants, which confirms the vulnerability posed by the heavy reliance on official transfers that is seen in the external DSA. The no reform scenario (no improvement in the primary balance) also produces significant deterioration in all debt burden indicators, which highlights the need for adherence to the medium-term fiscal framework.

14. **As in the external DSA, debt relief under the HIPC and Multilateral Debt Relief Initiatives (MDRI) is expected to significantly improve Afghanistan's public debt situation.**

D. Conclusion

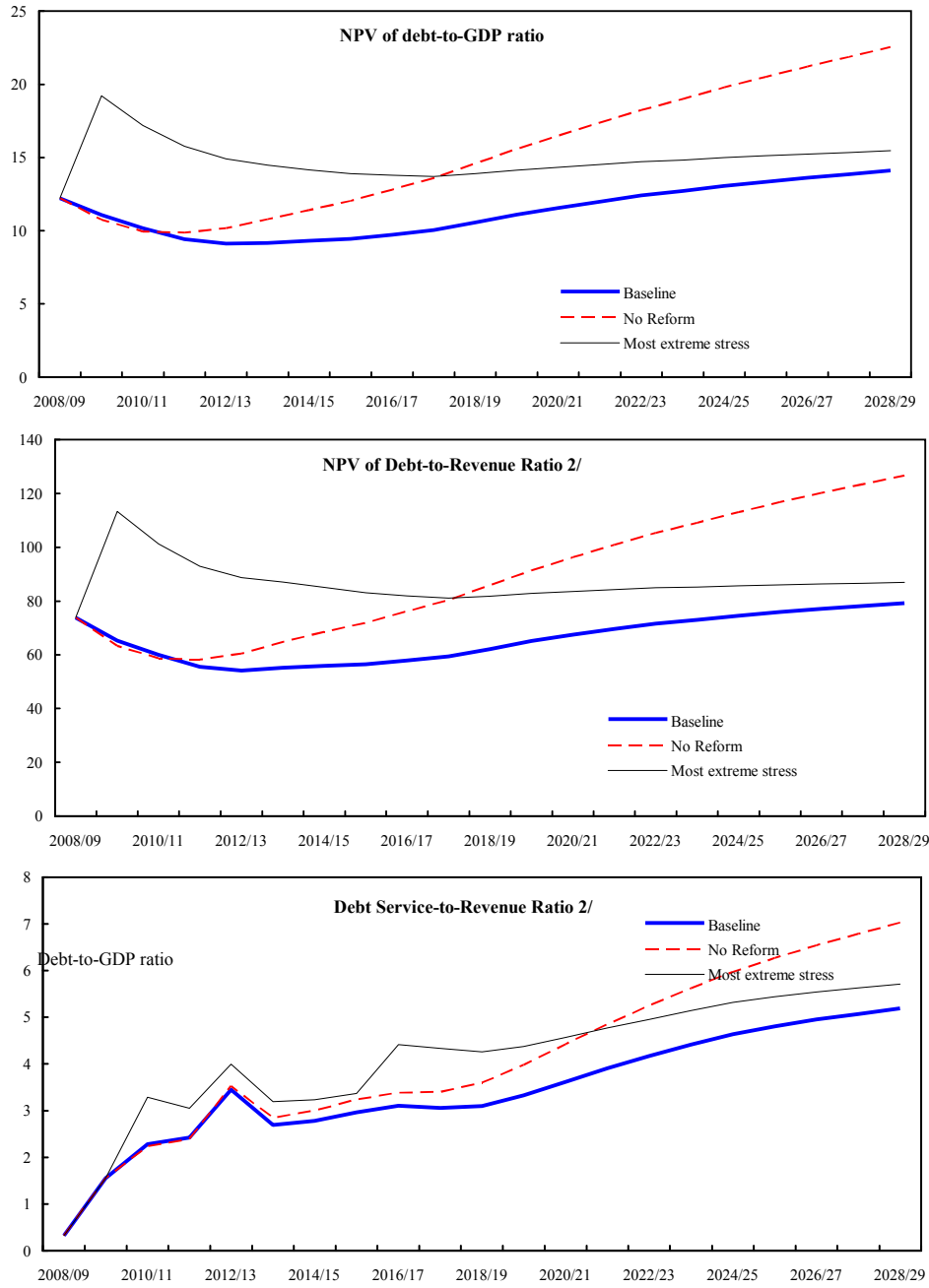
15. **The LIC DSA reveals that Afghanistan continues to face a high risk of debt distress.** The baseline path of the NPV of external debt-to-exports remains above the LIC DSA threshold (100 percent) until 2012/13, while the sensitivity analysis indicates that Afghanistan's external debt sustainability is heavily dependant on the continued availability of official grant financing supplemented by highly concessional loans. The emerging role of domestic debt financing over the longer term does not pose an immediate risk to the debt outlook, but it does underscore the need for a cautious approach to fiscal policy as the government builds the domestic revenue base, and given the uncertainties about the pace at which donor expenditures would be brought on budget. While the level of public debt remains manageable over the projection period, the government will need additional grant financing and/or fiscal consolidation to contain the debt dynamics beyond that horizon.

Figure 1. Afghanistan: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2008/9-2028/29



Source: Staff projections and simulations.

Figure 2. Afghanistan: Indicators of Public Debt Under Alternative Scenarios, 2008/09-2028/29 1/



Source: Staff projections and simulations.
 1/ Most extreme stress test is test that yields highest ratio in
 2/ Revenue including grants.

Table 1. Country: External Debt Sustainability Framework, Baseline Scenario, 2005/06-2028/29 1/
(In percent of GDP, unless otherwise indicated)

	Actual		Projections										2018/19-28/ Average	
	2005/06	2006/07-2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2008/09-13/14 Average		2018/19	2028/29	Average	
External debt (nominal) 1/	184.0	155.0	21.0	17.8	16.3	16.2	15.2	14.3	13.6	10.5	10.5	4.6	4.6	
o/w public and publicly guaranteed (PPG)	184.0	155.0	21.0	17.8	16.3	16.2	15.2	14.3	13.6	10.5	10.5	4.6	4.6	
Change in external debt	169.8	-29.0	-134.0	-3.2	-1.5	-0.1	-1.0	-0.9	-0.7	-0.6	-0.6	-0.5	-0.5	
Identified net debt-creating flows	-3.8	-27.6	-33.6	-4.4	-4.4	-3.0	-2.9	-2.5	-2.4	-1.6	-1.6	-1.0	-1.0	
Non-interest current account deficit	2.5	4.7	-1.0	-0.7	3.1	4.2	4.2	4.7	4.5	1.4	1.4	0.8	1.4	
Deficit in balance of goods and services	75.4	70.6	67.3	53.3	44.5	40.4	36.1	32.8	28.6	14.8	14.8	8.9	8.9	
Exports	10.2	9.1	8.2	8.4	8.7	9.1	9.5	10.0	10.6	12.5	12.5	13.2	13.2	
Imports	85.6	79.7	75.5	61.6	53.2	49.5	45.6	42.8	39.1	27.3	27.3	22.1	22.1	
Net current transfers (negative = inflow)	-72.4	-65.1	-67.8	-53.8	-40.9	-35.5	-31.3	-27.6	-23.5	-12.9	-12.9	-7.8	-7.8	
o/w official	-67.2	-59.9	-63.2	-49.5	-37.2	-32.1	-28.0	-24.6	-20.7	-11.2	-11.2	-6.8	-6.8	
Other current account flows (negative = net inflow)	-0.5	-0.7	-0.5	-0.2	-0.5	-0.6	-0.6	-0.5	-0.5	-0.5	-0.5	-0.3	-0.3	
Net FDI (negative = inflow)	-4.2	-3.1	-2.5	-2.6	-6.5	-6.4	-6.4	-6.5	-6.3	-2.6	-2.6	-1.6	-1.6	
Endogenous debt dynamics 2/	-2.1	-29.2	-30.1	-1.1	-1.0	-0.8	-0.8	-0.7	-0.6	-0.4	-0.4	-0.2	-0.2	
Contribution from nominal interest rate	0.3	0.2	0.1	0.1	0.2	0.4	0.3	0.3	0.3	0.2	0.2	0.1	0.1	
Contribution from real GDP growth	-1.9	-12.6	-14.3	-1.2	-1.3	-1.2	-1.1	-1.0	-0.9	-0.6	-0.6	-0.2	-0.2	
Contribution from price and exchange rate changes	173.6	-1.4	-100.4	1.2	3.0	2.9	1.9	1.7	1.7	1.0	1.0	0.5	0.5	
Residual (3-4) 3/	-0.4	-0.2	-0.4	-0.4	-0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
o/w exceptional financing	...	...	...	...	...	...	...	...	...	...	...	...	...
NPV of external debt 4/	...	...	14.8	12.2	11.1	10.2	9.4	8.6	8.0	6.1	6.1	2.8	2.8
In percent of exports	...	...	180.1	146.2	127.3	111.9	98.9	86.0	75.7	49.0	49.0	21.5	21.5
NPV of PPG external debt	...	...	14.8	12.2	11.1	10.2	9.4	8.6	8.0	6.1	6.1	2.8	2.8
In percent of exports	...	...	180.1	146.2	127.3	111.9	98.9	86.0	75.7	49.0	49.0	21.5	21.5
In percent of government revenues	...	...	212.2	174.6	147.1	125.2	108.7	93.3	84.5	59.3	59.3	24.5	24.5
Debt service-to-exports ratio (in percent)	3.7	2.4	1.8	1.2	3.3	4.5	4.5	5.9	4.2	2.7	2.7	2.2	2.2	
PPG debt service-to-exports ratio (in percent)	3.7	2.4	1.8	1.2	3.3	4.5	4.5	5.9	4.2	2.7	2.7	2.2	2.2	
PPG debt service-to-revenue ratio (in percent)	5.9	3.0	2.1	1.4	3.8	5.0	4.9	6.4	4.7	3.2	3.2	2.6	2.6	
Total gross financing need (billions of U.S. dollars)	-0.1	0.1	-0.3	-0.4	-0.5	-0.3	-0.3	-0.3	-0.3	-0.4	-0.4	-0.6	-0.6	
Non-interest current account deficit that stabilizes debt ratio	-167.4	33.7	133.1	2.5	4.6	4.3	5.2	5.6	5.2	2.0	2.0	1.3	1.3	
Key macroeconomic assumptions														
Real GDP growth (in percent)	16.1	8.2	11.5	7.5	8.3	8.2	7.6	7.4	7.2	7.7	6.2	5.4	6.1	
GDP deflator in US dollar terms (change in percent)	3.6	10.0	11.5	24.6	8.9	5.8	5.5	5.1	5.0	9.1	5.0	5.0	5.0	
Effective interest rate (percent) 5/	2.8	0.1	0.1	1.3	0.6	1.5	2.5	2.3	2.2	1.9	2.0	1.6	1.9	
Growth of exports of G&S (US dollar terms, in percent)	23.5	6.8	11.9	16.3	35.7	22.7	19.6	19.1	18.8	22.5	11.3	11.5	13.0	
Growth of imports of G&S (US dollar terms, in percent)	25.1	10.9	17.7	36.8	9.3	1.8	6.4	4.7	5.8	5.2	7.6	9.0	7.3	
Grant element of new public sector borrowing (in percent)	...	...	...	...	48.9	51.6	55.0	50.3	49.4	50.6	42.9	32.4	39.5
Aid flows (in billions of US dollars) 7/	4.5	4.8	6.2	6.5	5.8	5.8	5.7	5.7	5.5	5.3	8.8	8.8	8.8	
o/w Grants	4.4	4.6	6.1	6.4	5.6	5.6	5.5	5.5	5.2	5.0	5.0	8.5	8.5	
o/w Concessional loans	0.1	0.2	0.2	0.2	0.2	0.2	0.2	0.2	0.3	0.3	0.3	0.3	0.3	
Grant-equivalent financing (in percent of GDP) 8/	...	...	...	50.1	37.7	32.6	28.5	25.0	21.2	11.5	11.5	6.8	10.3
Grant-equivalent financing (in percent of external financing) 8/	...	...	...	98.7	98.8	98.7	98.5	98.1	97.8	96.2	96.2	97.7	97.1
<i>Memorandum items:</i>														
Nominal GDP (billions of US dollars)	6.5	7.7	9.6	12.8	15.2	17.4	19.7	22.2	25.0	44.6	44.6	125.7	125.7	
(NPV _t -NPV _{t-1})/GDP _{t-1} (in percent)	1.5	0.8	0.6	0.6	0.6	0.5	0.3	0.3	0.4	0.7	0.5	0.0	0.2	

Source: Staff simulations.

1/ Includes both public and private sector external debt. Debt service figures are presented on a cash basis and do not take into account debt relief to be delivered at the HIPC completion point (currently projected for March 2009) and therefore may differ from those in Table 4 of the accompanying Staff Report.

2/ Derived as $[r - g - p(1+g)]/(1+g-p+r-g)$ times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and p = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that NPV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the NPV of new debt).

Table 2. Country: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2008/09-28/29
(In percent)

	Projections							
	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2018/19	2028/29
NPV of debt-to-GDP ratio								
Baseline	12	11	10	9	9	8	6	3
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2009-28 1/	12	14	15	16	16	17	19	13
A2. New public sector loans on less favorable terms in 2009-28 2/	12	11	11	10	9	9	8	4
A3. Full delivery of HIPC Initiative, MDRI, and beyond-HIPC assistance	12	3	3	3	4	4	4	3
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2009-10	12	11	10	9	9	8	6	3
B2. Export value growth at historical average minus one standard deviation in 2009-10 3/	12	12	12	11	10	10	7	3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2009-10	12	12	12	11	10	9	7	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2009-10 4/	12	19	25	23	21	20	13	5
B5. Combination of B1-B4 using one-half standard deviation shocks	12	16	19	17	16	15	10	4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	12	15	14	13	12	11	8	4
NPV of debt-to-exports ratio								
Baseline	146	127	112	99	86	76	49	22
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2009-28 1/	146	165	168	168	164	159	149	98
A2. New public sector loans on less favorable terms in 2009-28 2/	146	130	117	106	94	85	62	33
A3. Full delivery of HIPC Initiative, MDRI, and beyond-HIPC assistance	146	36	35	35	35	34	32	20
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2009-10	146	127	112	99	86	76	49	22
B2. Export value growth at historical average minus one standard deviation in 2009-10 3/	146	161	184	163	142	124	78	32
B3. US dollar GDP deflator at historical average minus one standard deviation in 2009-10	146	127	112	99	86	76	49	22
B4. Net non-debt creating flows at historical average minus one standard deviation in 2009-10 4/	146	222	276	242	211	185	105	35
B5. Combination of B1-B4 using one-half standard deviation shocks	146	192	233	205	179	157	92	34
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	146	127	112	99	86	76	49	22
Debt service-to-exports ratio								
Baseline	1	3	4	4	6	4	3	2
A. Alternative Scenarios								
A1. Key variables at their historical averages in 2009-28 1/	1	3	5	5	7	5	5	4
A2. New public sector loans on less favorable terms in 2009-28 2/	1	3	5	5	7	5	3	3
A3. Full delivery of HIPC Initiative, MDRI, and beyond-HIPC assistance	1	3	1	1	1	1	2	2
B. Bound Tests								
B1. Real GDP growth at historical average minus one standard deviation in 2009-10	1	3	4	4	6	5	2	2
B2. Export value growth at historical average minus one standard deviation in 2009-10 3/	1	4	6	7	9	7	4	3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2009-10	1	3	4	4	6	5	2	2
B4. Net non-debt creating flows at historical average minus one standard deviation in 2009-10 4/	1	3	6	8	9	7	7	4
B5. Combination of B1-B4 using one-half standard deviation shocks	1	3	6	7	9	7	6	3
B6. One-time 30 percent nominal depreciation relative to the baseline in 2009 5/	1	3	4	4	6	5	2	2

Source: Staff projections and simulations.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.

2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline, while grace and maturity periods are the same as in the baseline.

3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).

4/ Includes official and private transfers and FDI.

5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent.

6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 3. Afghanistan: Public Sector Debt Sustainability Framework, Baseline Scenario, 2005/06-2028/29
(in percent of GDP, unless otherwise indicated)

	Actual					Estimate					Projections																	
	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09 - Average 5/	Standard Deviation 5/	2008/09 - Average 5/	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15 - Average 5/	2015/16 - Average 5/	2016/17 - Average 5/	2017/18 - Average 5/	2018/19 - Average 5/	2019/20 - Average 5/	2020/21 - Average 5/	2021/22 - Average 5/	2022/23 - Average 5/	2023/24 - Average 5/	2024/25 - Average 5/	2025/26 - Average 5/	2026/27 - Average 5/	2027/28 - Average 5/	2028/29 - Average 5/
Public sector debt 1/	14.4	14.2	184.0	155.0	21.0	17.8	16.3	16.2	15.2	14.8	14.8	14.7	14.8	14.8	14.8	14.8	15.0	15.1	15.2	15.3	15.4	15.5	15.6	15.7	15.7	15.8	15.8	15.8
<i>low foreign-currency, denominated</i>	14.4	14.2	184.0	155.0	21.0	17.8	16.3	16.2	15.2	14.3	13.6	12.9	12.3	11.7	11.1	10.5	9.8	9.1	8.4	7.8	7.2	6.6	6.1	5.6	5.1	4.6	4.6	4.6
Change in public sector debt	1.0	-0.3	169.8	-29.0	-134.0	-3.2	-1.5	-0.1	-0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Identified debt-creating flows	0.2	3.2	-1.5	-28.0	-134.8	-4.4	-1.6	-0.8	-1.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Primary deficit	3.1	1.4	-1.0	2.8	1.8	2.5	3.0	2.4	1.5	1.4	1.4	1.4	1.4	1.4	1.3	2.0	1.3	1.2	1.2	1.1	1.1	1.1	1.1	1.0	1.0	0.9	0.9	0.9
Revenue and grants	11.4	14.0	17.6	16.8	18.2	16.5	17.0	17.0	17.0	16.8	16.6	16.6	16.7	16.8	16.9	17.0	17.1	17.1	17.2	17.3	17.4	17.5	17.6	17.6	17.7	17.7	17.8	1.1
<i>of which: grants</i>	6.7	9.0	11.2	9.3	11.2	9.5	9.4	8.8	8.3	7.6	7.2	7.0	6.9	6.8	6.7	6.7	6.6	6.6	6.6	6.6	6.6	6.5	6.5	6.4	6.4	6.3	6.3	6.2
Primary (noninterest) expenditure	14.5	15.3	16.5	19.6	20.0	19.0	20.0	19.4	18.4	18.2	18.0	18.1	18.1	18.2	18.2	18.2	18.2	18.3	18.3	18.4	18.4	18.4	18.5	18.5	18.6	18.6	18.6	18.6
Automatic debt dynamics	-2.8	-2.7	-2.5	-29.7	-31.4	-1.8	-1.4	-1.2	-1.1	-1.0	-1.0	-1.0	-0.9	-0.9	-0.9	-0.9	-0.9	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
Contribution from interest rate/growth differential	-2.0	-1.5	-2.3	-19.1	-19.6	-1.8	-1.4	-1.2	-1.1	-1.0	-1.0	-1.0	-0.9	-0.9	-0.9	-0.9	-0.9	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8	-0.8
<i>of which: contribution from average real interest rate</i>	-0.2	-0.4	-0.3	-5.2	-3.6	-0.3	-0.1	0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
<i>of which: contribution from real GDP growth</i>	-1.8	-1.2	-2.0	-13.9	-16.0	-1.5	-1.4	-1.2	-1.1	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-1.0	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9	-0.9
Contribution from real exchange rate depreciation	-0.8	-1.1	-0.2	-10.6	-11.8	-3.4	-1.0	-0.6	-0.5	-0.4	-0.4	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
Other identified debt-creating flows	-0.1	4.5	2.0	-1.1	-105.2	-1.8	-2.1	-1.5	-0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Privatization receipts (negative)	0.0	0.0	-0.6	-0.6	0.0	-1.6	-0.2	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Recognition of implicit or contingent liabilities	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt relief (HIPC and other)	0.0	0.0	0.0	0.0	-107.0	-0.4	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other (specify, e.g. bank recapitalization)	-0.1	4.5	2.6	-0.1	11.8	0.2	-2.0	-1.4	-0.8	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Residual, including asset changes	0.8	-3.5	171.3	-1.0	0.7	1.2	0.2	0.7	0.0	-0.4	0.0	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
NPV of public sector debt	0.0	0.0	20.4	17.8	14.8	12.2	11.1	10.2	9.4	9.1	9.2	9.3	9.4	9.7	10.0	10.6	11.1	11.6	12.0	12.4	12.7	13.0	13.3	13.6	13.8	14.1	14.1	14.1
<i>low foreign-currency, denominated</i>	0.0	0.0	20.4	17.8	14.8	12.2	11.1	10.2	9.4	8.6	8.0	7.4	7.0	6.7	6.4	6.1	5.8	5.5	5.1	4.7	4.4	4.0	3.7	3.4	3.1	2.8	2.8	2.8
<i>ow external</i>	...	...	...	...	...	12.2	11.1	10.2	9.4	8.6	8.0	7.4	7.0	6.7	6.4	6.1	5.8	5.5	5.1	4.7	4.4	4.0	3.7	3.4	3.1	2.8	2.8	2.8
NPV of contingent liabilities (not included in public sector debt)	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Gross financing need 2/	3.2	1.4	-0.9	2.9	1.9	2.5	3.3	2.8	1.9	2.0	2.3	2.9	3.6	4.1	4.6	5.1	5.8	6.6	7.3	8.0	8.7	9.4	9.9	10.5	11.0	11.5	11.5	11.5
NPV of public sector debt-to-revenue and grants ratio (in percent)	0.0	0.0	115.8	106.0	81.2	73.9	65.3	59.9	55.6	54.2	55.1	55.9	56.4	57.9	59.4	62.2	65.1	67.5	69.6	71.7	73.1	74.6	75.9	77.1	78.2	79.3	79.3	79.3
NPV of public sector debt-to-revenue ratio (in percent)	0.0	0.0	317.5	238.1	211.0	174.6	147.1	125.2	108.7	98.5	96.7	106.5	101.1	97.6	94.6	102.2	106.4	109.7	112.5	114.9	116.1	117.4	118.9	120.1	120.9	121.8	121.8	121.8
<i>ow external 3/</i>	...	...	...	...	...	174.6	147.1	125.2	108.7	93.3	84.5	44.7	41.8	39.6	37.6	37.6	37.6	37.6	37.6	37.6	37.6	37.6	37.6	37.6	37.6	37.6	37.6	37.6
Debt service-to-revenue and grants ratio (in percent) 4/	0.7	0.4	0.6	0.6	0.2	0.3	1.6	2.3	2.4	3.4	2.7	2.8	3.0	3.1	3.1	3.1	3.3	3.6	3.9	4.2	4.4	4.6	4.8	5.0	5.1	5.2	5.2	5.2
Debt service-to-revenue ratio (in percent) 4/	1.7	1.3	1.6	1.2	0.6	0.8	3.5	4.8	4.7	6.3	4.7	4.8	5.1	5.2	5.1	5.1	5.4	5.9	6.3	6.7	7.0	7.3	7.5	7.7	7.9	8.0	8.0	
Primary deficit that stabilizes the debt-to-GDP ratio	...	...	-170.9	31.8	135.9	5.7	4.5	2.5	2.4	1.8	1.4	1.5	1.4	1.3	1.3	1.1	1.1	1.1	1.1	1.0	1.0	1.0	1.0	0.9	0.9	0.8	0.8	0.8
Key macroeconomic and fiscal assumptions	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Real GDP growth (in percent)	15.1	8.8	16.1	8.2	11.5	7.5	8.3	8.2	7.6	7.4	7.2	7.6	7.0	7.0	7.1	7.7	6.2	6.1	6.0	5.8	5.7	5.6	5.5	5.5	5.5	5.4	5.4	6.1
Average nominal interest rate on forex debt (in percent)	0.0	0.0	0.4	0.0	0.0	0.2	0.3	1.4	2.4	2.2	2.1	2.1	2.1	2.0	2.0	1.7	1.9	1.9	1.8	1.8	1.8	1.8	1.7	1.7	1.7	1.6	1.6	1.8
Average real interest rate on domestic currency debt (in percent)	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Real exchange rate depreciation (in percent)	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Real exchange rate depreciation (in percent) -7.1	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	5.2	9.1	7.6	10.6	11.2	8.7	2.4	23.8	8.9	5.8	5.1	5.0	4.9	4.9	4.9	9.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
Growth of real primary spending (deflated by GDP deflator, in percent) ...	...	...	...	...	...	7.3	2.3	13.6	4.9	2.4	6.2	6.2	7.8	7.3	7.3	5.9	6.5	6.3	6.2	6.1	5.9	5.8	5.7	5.7	5.7	5.7	5.6	6.3
Grant element of new external borrowing (in percent) ...	0.0	0.0	0.0	0.0	0.0	0.0	48.9	51.6	55.0	50.3	49.4	48.4	47.1	45.4	42.9	50.6	42.9	43.2	41.0	41.0	37.8	37.8	35.1	35.1	35.1	32.4	32.4	

Sources: Country authorities and World Staff estimates and projections.

1/ Indicate coverage of public sector, e.g. general government or nonfinancial public sector. Also whether net or gross debt is used.

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

5/ Historical averages and standard deviations are derived over the past 5 years.

Table 4. Afghanistan: Sensitivity Analysis for Key Indicators of Public Debt 2008/09-2028/29

	Projections							
	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14	2018/19	2028/29
NPV of Debt-to-GDP Ratio								
Baselin	12	11	10	9	9	9	11	14
A. Alternative								
A1. Real GDP growth and primary balance are at historical averages	12	10	8	8	7	8	8	10
A2. Primary balance is unchanged from 2008/09	12	11	10	10	10	11	15	23
A3. Permanently lower GDP growth 1/	12	11	10	10	10	10	13	24
A4. Full Delivery of HIPC Initiative, MDRI, and beyond HIPC assistance	12	3	3	3	4	4	7	13
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2009/10-2010/11	12	11	10	9	9	9	10	14
B2. Primary balance is at historical average minus one standard deviations in 2009/10-2010/11	12	11	11	10	10	10	11	14
B3. Combination of B1-B2 using one half standard deviation shocks	12	11	10	9	9	9	11	15
B4. One-time 30 percent real depreciation in 2009/10	12	15	13	12	11	11	11	15
B5. 10 percent of GDP increase in other debt-creating flows in 2009/10	12	19	17	16	15	14	14	15
NPV of Debt-to-Revenue Ratio 2/								
Baselin	74	65	60	56	54	55	62	79
A. Alternative								
A1. Real GDP growth and primary balance are at historical averages	74	60	52	48	47	49	58	70
A2. Primary balance is unchanged from 2008/09	74	63	59	58	61	65	86	127
A3. Permanently lower GDP growth 1/	74	66	61	57	57	60	77	128
A4. Full Delivery of HIPC Initiative, MDRI, and beyond HIPC assistance	74	18	19	20	21	23	44	73
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2009/10-2010/11	74	65	60	55	54	55	62	78
B2. Primary balance is at historical average minus one standard deviations in 2009/10-2010/11	74	66	64	59	57	58	64	80
B3. Combination of B1-B2 using one half standard deviation shocks	74	63	58	55	54	56	67	86
B4. One-time 30 percent real depreciation in 2009/10	74	91	79	72	68	66	67	82
B5. 10 percent of GDP increase in other debt-creating flows in 2009/10	74	113	101	93	89	87	82	87
Debt Service-to-Revenue Ratio 2/								
Baselin	0	2	2	2	3	3	3	5
A. Alternative								
A1. Real GDP growth and primary balance are at historical averages	0	2	2	2	3	2	2	3
A2. Primary balance is unchanged from 2008/09	0	2	2	2	4	3	4	7
A3. Permanently lower GDP growth 1/	0	2	2	2	4	3	3	7
A4. Full Delivery of HIPC Initiative, MDRI, and beyond HIPC assistance	0	0	0	0	0	0	2	4
B. Bound tests								
B1. Real GDP growth is at historical average minus one standard deviations in 2009/10-2010/11	0	2	2	2	3	3	3	5
B2. Primary balance is at historical average minus one standard deviations in 2009/10-2010/11	0	2	2	3	4	3	3	5
B3. Combination of B1-B2 using one half standard deviation shocks	0	2	2	2	3	3	3	5
B4. One-time 30 percent real depreciation in 2009/10	0	2	3	3	4	3	4	5
B5. 10 percent of GDP increase in other debt-creating flows in 2009/10	0	2	3	3	4	3	4	6

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

1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of 20 (i.e., the length of the projection period).

2/ Revenues are defined inclusive of grants.

Statement by the IMF Staff Representative
July 7, 2008

1. This statement summarizes information that became available since the issuance of the staff report on June 23, 2008, concerning the implementation of the three prior actions. It also provides an update on the Kabul CPI in June 2008.
2. Two of the three prior actions have already been met. These include: (i) the prior action calling for the issuance by the Ministry of Finance (MOF) of an instruction to the Afghan Customs Department to ensure timely updates of reference prices for petroleum products; and (ii) the prior action consisting of the signing by MOF and the Ministry of Commerce and Industry of a memorandum of understanding to clarify customs procedures for fuel products stored at the Fuel and Liquid Gas Enterprise.
3. The third prior action calling for the collection by the MOF of at least Af 79 million corresponding to on the business receipt tax (BRT) and nontax receipts (landing/parking right fees) from airlines has not yet been met. As of July 2, 2008, the authorities reported having collected Af 69.3 million and provided staff with documents confirming this amount. The documentation provided by the authorities, although not fully complete, confirms that the payments were made by the airlines or on their behalf.¹ Moreover, the MOF's Revenue Department informed the staff that the amounts collected correspond to the tax and nontax liabilities accrued by the eligible entities during the period prior to the end of the third quarter of 2007/08. The authorities have arranged for an additional Af 10.5 million (about US\$200,000) to be collected from two airlines before the July 7, 2008 Board meeting.
4. Inflation in June receded significantly, mainly on account of a fall in prices of bread and cereal (14 percent), following two months of unprecedented growth. The CPI for Kabul showed a 6 percent decline relative to May 2008. As a result, year-on-year inflation subsided from 43 percent in May 2008 to 33 percent in June 2008. Food prices declined by 9 percent, while nonfood prices rose by 1.4 percent, owing mainly to an increase in prices of transportation services.

¹ A large portion of the eligible liabilities was netted out against the transfers made by the Ministry of Hajj, totaling Af 30.4 million, to cover the overdue payments for services provided by one of the airlines.



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July 7, 2008

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Fourth Review Under PRGF Arrangement with The Islamic Republic of Afghanistan and Approves US\$18.5 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) today completed the fourth review of The Islamic Republic of Afghanistan's performance under the economic program supported by the three-year Poverty Reduction and Growth Facility (PRGF) arrangement. The completion of the review allows for an immediate disbursement of SDR 11.3 million (about US\$18.5 million), which would bring total disbursements under the arrangement to SDR 58.4 million (about US\$95.6 million).

In completing the review, the Board also granted a waiver of non-observance of a quantitative performance criterion related to the collection of fiscal revenue. The Afghan authorities have implemented measures to address the primary causes of the revenue slippage in 2007/08 (fiscal year ending on March 19, 2008) and committed to take additional measures to ensure that the improvement will be sustained in 2008/09.

The PRGF arrangement for the Islamic Republic of Afghanistan was approved in June 2006 for an amount equivalent to SDR 81.0 million (about US\$132.5 million) (see [Press Release No. 06/144](#)).

Following the Executive Board's discussion, Mr. Murilo Portugal, Deputy Managing Director and Acting Chair, said:

“The Afghan economy experienced strong growth in FY 2007/08, while inflation surged reflecting higher food and fuel import prices, and the security situation remained precarious. These are daunting challenges for the authorities to implement their PRGF-supported program. The success of the program hinges on a sustained implementation of the revenue-enhancing measures needed to prevent long-term aid dependence, and achieve fiscal sustainability over the long term. The expeditious implementation of tax policy and administration reforms is a priority in this regard. There is also a need to accelerate structural reforms in order to improve the country's growth and poverty alleviation prospects. Strong commitment by the Afghan authorities to the objectives of the program along with further improvements in governance will help ensure continued support from the international community.

“The fiscal reform agenda focuses on strengthening public financial management, particularly on project preparation, procurement, expenditure execution, and tracking. Steps

will need to be taken to modernize the civil service, including by linking the compensation system to skills and performance in the context of pay and grade reform. Clarifying the relationship between the budget and key state-owned enterprises will be key to preventing the emergence of fiscal drains and foster good corporate governance, particularly with respect to the national airline and the state-owned electricity company. There is also a need to improve transparency in the domestic petroleum sector and to prepare for the privatization of the government-owned Fuel and Liquid Gas Enterprise.

“The resurgence of inflation, caused by the sharp increase in food prices, requires a carefully designed policy response. This will involve prudent financial policies to help contain second-order inflationary effects, and targeted policy actions to alleviate the impact of higher food prices on vulnerable groups.

“Lowering inflation will be helped by ensuring observance of the currency in circulation ceiling. It will also be important to proceed cautiously with the planned increases in the volume of capital notes in order to avoid excessive interest rate fluctuations. A further strengthening of the regulatory framework and enforcement procedures will help stem risks in the banking sector.

“The authorities need to work closely with the World Food Program and other donor agencies to help the poor cope with the impact of increased wheat prices. Putting in place appropriate mechanisms to deliver assistance through targeted cash transfers to vulnerable households seems preferable to relying exclusively on direct wheat imports,” Mr. Portugal said.

The PRGF is the IMF's concessional facility for low-income countries. PRGF loans carry an annual interest rate of 0.5 percent and are repayable over 10 years with a 5½-year grace period on principal payments.

**Statement by Mr. Jafar Mojarrad, Executive Director for the Islamic Republic of Afghanistan
July 7, 2008**

On behalf of our authorities, we thank management and staff for their continued support for Afghanistan's reforms under the PRGF. The authorities are also grateful to the international community for the strong support expressed during the Paris Conference in June and the generous pledges made by donors. They hope that this spirit of cooperation will continue to prevail and they look forward to the timely disbursements of donors' commitments.

Performance under the PRGF program in 2007/08

During the second half of FY 2007/08, Afghanistan faced an increasingly difficult environment. The security situation continued to deteriorate, prices of imported fuel and foodstuffs increased substantially, and the harsh winter adversely affected livestock and private sector imports. Notwithstanding these developments, the economy is estimated to have grown by a comfortable 11 ½ percent in 2007/08 as a whole. The sharp rise in fuel and food import prices was compounded by disruptions in exports of wheat in regional markets. Consequently, inflation increased at a higher rate than expected.

The fiscal outcome in 2007/08 was better than programmed despite a revenue shortfall. The operating budget deficit (excluding grants) was lower due to under-spending, while development expenditure was in line with the program. The external position strengthened, with the current account position, including grants, shifting from a deficit of 4.9 percent of GDP in 2006/07 to a surplus of 0.9 percent of GDP. Gross international reserves increased to the equivalent of about 11 months of imports, reflecting mainly the improvement in the current account. The Afghani appreciated slightly against the U.S. dollar.

Despite the many constraints faced by Afghanistan, the authorities continued to implement their reform program. While the preparation of the Afghanistan National Development Strategy (ANDS) and the Paris Conference absorbed considerable time and resources, the authorities continued to focus their attention on the various policy actions and structural reforms agreed under the PRGF program. As highlighted in the Supplementary Memorandum of Economic and Financial Policies (SMEFP), all quantitative performance criteria and indicative targets for end-2007/08 were met, with the exception of the March 2008 criterion on domestic revenue, for which the authorities are seeking a waiver. In the structural area, a number of structural benchmarks were met, while more complex reforms, such as the restructuring and privatization plan for the public enterprises not covered by the law on state-owned enterprises, proved to be more challenging and would require more preparatory time. Nonetheless, the authorities are committed to taking remedial measures to accelerate the reform progress in this area in the context of the 2008/09 program. They have also implemented two of the three prior actions for the completion of the fourth review under the PRGF program and are in the process of confirming implementation of the third one.

Outlook and reform program for 2008/09

The authorities intend to take full advantage of the momentum created by the political and social consensus that was built around the ANDS and by the Paris Conference to forge ahead with their reform program in 2008/09 to achieve their medium-term objectives of sustained growth and poverty reduction. They are determined to preserve macroeconomic stability in spite of the rise in energy and food prices, make up for past delays and shortcomings in completing key structural reforms, and lay the foundations for sustained private sector development and growth.

The outlook for 2008/09 is clouded by the drought, which is expected to lower real GDP growth to about 7 ½ percent, while average 12-month CPI inflation is projected to increase as a result of the world-wide increase in fuel and food prices. However, efforts underway by the government and donors to improve the supply of wheat from regional sources could help contain inflationary pressures and soften the impact on the poor. To ease price pressure in the market, the authorities are in the process of importing 50,000 tons of wheat flour from Pakistan. The outlook for exports, FDI, and aid inflows is favorable, which would help further improve the external position.

Fiscal policy

The revised fiscal program aims at stabilizing the revenue-to-GDP ratio, which is a challenging task, given the run-up in food inflation and the fact that food is not taxed. On-going revenue collection measures, together with the additional measures outlined in the SMEFP, will increase revenue by 33 percent over the 2007/08 outcome, which will be a considerable improvement by any standard. On the expenditure side, while operating expenditure will be contained, the program provides for additional outlays that may be needed to accelerate recruitment in the military. Overall, the core budget deficit will be slightly higher than envisaged, but its financing will be available from the privatization of Afghan Telecom.

The authorities are also determined to carry out a number of structural reforms in the fiscal area. These include modernization of the civil service, strengthening the financial management system to enhance absorptive capacity, and regularization of relations between the budget and public enterprises. Finally, the authorities will give priority to mitigating the impact of increased food prices on the poor and intend to work closely with the donors to develop appropriate mechanisms to this effect.

Monetary and financial sector policies

Monetary policy will be geared toward containing inflation in a challenging environment of uncertainty regarding energy and food prices, while continuing to enhance confidence in the Afghani. To achieve these objectives, the central bank (DAB) will maintain the growth in currency in circulation below that of nominal GDP, while also monitoring the growth of reserve money through indicative targets. To further enhance the monetary policy framework, DAB intends to launch open-market operations in CNs and take measures to develop a secondary market for this instrument. It also plans to strengthen liquidity forecasting and develop a mechanism for the monitoring of commercial banks' liquidity on a weekly basis. In the financial sector, DAB's efforts will continue to focus on building its capacity in several areas, including

accounting, reporting, and internal control. It will also strengthen the legal and regulatory framework of the banking sector, including regulations on risk management and bank supervision.

Structural reforms

The authorities intend to accelerate implementation of their structural reform agenda, as outlined in the ANDS, and look forward to cooperating closely with development partners. As highlighted in the SMEFP, these wide-ranging reforms will cover the electricity sector, a number of state owned enterprises that will be restructured or privatized, and further improvements in the regulatory environment.

Debt sustainability analysis

The debt sustainability analysis carried out by the staffs of the World Bank and the IMF confirms that Afghanistan continues to face a high risk of debt distress and that external debt sustainability hinges on continued availability of grants and highly concessional loans. Nonetheless, some positive elements have emerged, which could improve the outlook. These include higher GDP growth rates based on sustained inflows of grants and FDI, as well as the promising prospects of the mining sector in Afghanistan. The analysis also underscores the importance of debt relief under the enhanced HIPC-Initiative and MDRI, which would reduce Afghanistan' debt to sustainable levels. In this regard, the authorities will be working toward reaching the HIPC completion point in mid-2009 and will maintain a prudent fiscal policy to avoid a rapid domestic debt build-up.