**International Monetary Fund**

Islamic Republic of Afghanistan and the IMF

**Press Release**:
IMF Executive Board Completes Fifth Review under the PRGF Arrangement with the Islamic Republic of Afghanistan
April 22, 2009

Country's Policy Intentions Documents

**E-Mail Notification**
Subscribe or Modify your subscription

# **Islamic Republic of Afghanistan:** Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

March 4, 2009

**ISLAMIC REPUBLIC OF AFGHANISTAN: LETTER OF INTENT**

Kabul, March 4, 2009

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

Dear Mr. Strauss-Kahn,

The purpose of this letter and the attached Supplementary Memorandum of Economic and Financial Policies is to inform you about the implementation of our economic program supported by the Poverty Reduction and Growth Facility, set out policies for the period ahead, and request waivers of nonobservance of two performance criteria. We also request the sixth disbursement following the completion of the Fifth Review under the arrangement, an extension of the arrangement until March 2010, and a rephasing of disbursements, with the Sixth Review tied to end-June performance criteria and an additional Seventh Review tied to end-December performance criteria. The extension will allow us to implement pending reforms, boost revenue performance, demonstrate our commitment to economic stability, and reach the completion point under the Enhanced HIPC Initiative.

We met all but one of the September 2008 quantitative performance criteria. The floor on fiscal revenues was missed by a small amount. Owing to a technical delay, the structural performance criterion on the submission of audited financial statements of the state-owned electricity company DABM was not met on time. The submission will be a prior action for completion of the Fifth Review.

We experienced serious difficulties in revenue administration and expenditure overruns in recent months, which will make it impossible to meet two quantitative performance criteria corresponding to the Sixth Review due in March 2009: the floor on fiscal revenues and the ceiling on net central bank financing to the government. A new test date for the Sixth Review (June 2009) and ambitious quarterly revenue targets are proposed for the remainder of the extended arrangement.

The revenue problems were caused mainly by governance problems at customs and at the state-owned fuel company. We are implementing corrective measures, including personnel changes, and are pleased to report a turnaround in collection since January 2009. We intend to amend income tax legislation and produce by March 21, 2009 the first report on the

implementation of a memorandum of understanding between the Ministry of Finance and the Ministry of Commerce and Industry. We have reached understandings with Fund staff that the last two measures will also be prior actions for completion of the Fifth Review.
For 2009/10, we are committed to a strong recovery in revenues. In case of a revenue shortfall, we will reduce expenditures accordingly. We are also committed to reinvigorating the economic reform agenda and advancing the implementation of the Afghanistan National Development Strategy.

We believe that the policies and measures set in this memorandum are adequate to achieve the objectives of the program and we stand ready to take additional measures if needed. We will consult with the Fund on the adoption of further measures or any revision of policies in accordance with Fund procedures. In addition, we will provide the Fund the information required to assess progress in implementing the program. Lastly, we consent to the publication of the staff report for the Fifth Review under the PRGF arrangement, the Supplementary Memorandum of Economic and Financial Policies, and the Technical Memorandum of Understanding, including on the IMF's website.

Sincerely yours,

| | |
|---|---|
| /s/ | /s/ |
| Omar Zakhilwal | Abdul Qadeer Fitrat |
| Minister of Finance | Governor, Da Afghanistan Bank |

## Supplementary Memorandum of Economic and Financial Policies for 2009/10

March 4, 2009

1. The Government of Afghanistan's economic policies for 2009/10 are designed to consolidate the gains achieved under the PRGF arrangement; redress recent slippages; and set the basis for low inflation, strong growth, and fiscal sustainability. This memorandum describes the quantitative framework for the remainder of the extended program, including the proposed quantitative targets and structural conditionality for the Sixth and Seventh Reviews (Tables 1 and 2). The Sixth and Seventh Reviews will be completed on or after September 21, 2009 and March 19, 2010, respectively.

### A. Recent Developments and Outlook

2. **Growth and inflation**. The economic and security situation has been challenging in 2008/09 owing to high food and fuel prices and increased violence in some provinces. A severe drought hit the agriculture sector, which accounts for about 30 percent of the economy, requiring emergency imports of wheat. Consequently, we estimate real GDP growth in 2008/09 to decline to about 3 percent and inflation to be about 27 percent on average.

3. **Fiscal outturn**. Due to weak revenues and higher than expected spending, we estimate that the operating budget deficit excluding grants will be Af 33 billion, instead of Af 20.5 billion as targeted. We also estimate that discretionary cash balances will amount to no less than Af 1.4 billion after cancellation of some wheat contracts compared to Af 4 billion in 2007/08. We were unable to observe the end-September 2008 quantitative performance criterion on domestic revenues (by a small margin), for which we are requesting a waiver. We expect not to observe the end-March 2009 quantitative performance criteria set at the time of the Fourth Review on domestic revenues and on net central bank financing of the government. We are setting new quarterly targets through March 2010, with performance criteria for June 2009 and December 2009 (Sixth and Seventh Reviews under the PRGF-supported program).

4. **Revenues**. We expect to collect total revenues in 2008/09 of Af 40 billion compared with Af 44.5 billion target. Performance has been good at the large and medium taxpayer offices in Kabul. We have extended these offices to Herat, Jalalabad, and Mazar-e-Sharif (end-September 2008 structural benchmark). In addition, traders have been notified that their exemption from the general income tax regime has expired (end-July 2008 structural benchmark). However, customs collection has been disappointing due to governance problems that led to poor enforcement and undervaluation of customs duties. Collection of duties on fuel

entering through Hairatan (about 80 percent of total fuel imports) has been hampered by customs officers' lack of access to storage depots of the Fuel and Liquid Gas Enterprise (FLGE). In response to these problems, we have implemented personnel changes; set up audit units in Kabul, Kandahar, and Herat; strengthened the head office's control over the mobile verification teams; increased the head office's audit capacity; and introduced a daily reporting regime for identification of underperformance. We are already seeing a turnaround in collection, and we expect these and other measures (see below) to further improve collection in 2009/10. Lastly, legislation approving the introduction of the business receipts tax (BRT) on imports was delayed (end-November 2008 structural benchmark). We now expect legislative approval by mid-March 2009, which will enable collection of the BRT on imports later that month.

5. **Expenditures**. Spending pressures rose in the middle of 2008/09 due to worsening security, higher food and fuel prices, drought-related food shortages, and increases in teachers' salaries. Accordingly, the midyear budget review provided for: (i) Af 4.8 billion of wheat purchases; (ii) Af 1.3 billion for clearance of arrears by the Ministry of Education; (iii) Af 1 billion for salary increases for the military and police; and (iv) Af 2.2 billion in salary increases for teachers. The salary increase for teachers was financed by donors and accelerates the pay and grade reforms of the civil service.

6. **Public enterprises**. Reforming public enterprises continues to face serious challenges. Privatization suffered setbacks when Parliament stopped the auction of property of the Agricultural Development Bank in December. The attempt to privatize Afghan Telecom has also been unsuccessful. We will move forward to privatize FLGE and, despite delays, we will conclude and publish its financial audit, covering about 80 percent of operations by end-June 2009.

7. **Electricity subsidies**. We were unable to prevent Da Afghanistan Breshna Moasisa/Sherkat (DABM/S), the state electricity company, from spending the annual fuel subsidy about halfway through the 2008/09 fiscal year. Furthermore, the expenditure occurred without sufficient assurances as to its efficient use and accountability. The end-September 2008 structural performance criterion on the submission of DABM/S audited financial statements for 2006/07–2007/08 was not observed and will be a prior action for the completion of the Fifth Review. With some delay, we concluded a plan to reduce subsidies from the Ministry of Finance to DABM/S on February 22, 2009 (end-December 2008 structural benchmark).

8. **Fiscal relations with public enterprises**. We have prepared a preliminary review of fiscal relations between the government and key public enterprises, but due to data limitations and capacity constraints, the review could not include an action plan for three of the four enterprises (end-December 2008 structural benchmark). We note that although Ariana continues to delay tax payments and has problems with debts on fuel and airport fees, it has not benefited from loans by state-owned banks or government guarantees.

9. **Monetary policy**. We have consistently observed the ceilings on currency in circulation. We have continued to foster the growth of the capital notes (central bank bills) market in order to strengthen control over monetary aggregates and encourage banks to use notes to manage liquidity. As first steps in launching the secondary market for notes, the central bank, Da Afghanistan Bank (DAB), has created an electronic registry of notes (end-September 2008 structural benchmark) and allowed banks to use them as collateral for short-term interbank lending. DAB will install an upgraded electronic registry by May 2009. In June 2008, to encourage banks to use notes to manage liquidity, we widened the interest corridor on standing facilities from +/-150 bps to +/-350 bps above/below the rate 28-day notes.

10. **Financial sector**. Following the intervention in November 2008 of DAB in a small private bank, reserve requirements were tightened by excluding banks' cash in vault and current account deposits in DAB from eligible instruments and requiring banks to hold reserves in a "lock box" and to maintain required reserves daily. The central bank has also increased staffing at the financial supervision department, introduced an incentive-based salary scheme, separated onsite and offsite functions, and increased the frequency of onsite examinations to twice per year. We will soon introduce a credit bureau, a collateral registry, and possibly a limited deposit insurance scheme geared toward small depositors and funded by premiums from depository institutions. In August 2008, we prepared an action plan to address weaknesses identified in our self-assessment against Basel Principles (end-September 2008 structural benchmark) and are now implementing the plan.

11. **DAB internal structural reforms**. The external audit of DAB for end-2007/08 has been completed and posted on DAB's website. Among other things, the report provides assurance on the existence and availability of DAB's foreign reserves. As recommended by the safeguards assessment, we are actively recruiting an independent accounting expert to be appointed to the internal audit committee and a qualified deputy director and an advisor for the internal audit department. After consulting with commercial banks, we concluded that it was impractical to produce a monetary survey using a unified timeframe (end-June 2008 structural benchmark). We have instead produced a monetary survey based on a hybrid (Solar/Gregorian) timeframe, while ensuring concordance between key items reported simultaneously by the banks. Lastly, since October 2008, monetary data produced by DAB have been sourced directly from DAB's new accounting system. We are now working on ensuring consistency of the DAB's and Ministry of Finance's data on government deposits.

12. **HIPC Completion Point**. We intend to work toward reaching the HIPC completion point. To regularize relations with external creditors not covered under the Paris Club, we are pursuing agreements to settle our bilateral debts. We will honor our obligations under the

Paris Club agreement and accelerate work toward meeting the completion point triggers including advancing the implementation of the Afghanistan National Development Strategy and preparing a debt sustainability analysis. We will further improve data on service exports and we expect to have survey-based service export estimates for the last two years by end-June 2009 for use in calculating debt relief.

13. **Macroeconomic outlook**. We project real GDP growth of 9 percent in 2009/10. Although the global downturn implies weaker export growth and a deceleration of industry and services activities, a recovery in agricultural output will be sufficient to sustain high growth. Lower commodity prices and a disinflationary monetary program will lock in the downward inflation trend and enable us to reduce annual inflation to 6 percent at the end of 2009/10. We expect a current account deficit of about 3.7 percent of GDP, or 51 percent of GDP, if grants are excluded.

## B. Fiscal Policies for 2009/10

14. **Fiscal balance**. The budget for 2009/10 attempts to balance the need to increase spending, mainly in security and education, with limited resources. We are targeting total domestic revenues of Af 51 billion and total operational expenditures of Af 84 billion. To help ensure that we achieve the revenue target, we will provide adequate funding for the logistics and operations of the tax and customs departments. Consequently, the operating deficit excluding grants will be Af 33 billion. We are targeting a balanced budget including grants. We also have a contingency for an additional Af 10.4 billion related to security spending, to be financed by external assistance.

15. **Expenditures**. Compared to 2008/09, we have not budgeted for any additional wheat imports. We will contain the growth of domestically financed nonsecurity spending, including through slowing the implementation of pay and grade reforms. Should revenues fall short of the targets, we will cut expenditures accordingly to meet our fiscal deficit targets. We will not incur arrears. Through expenditure restraint and close monitoring of expenditure commitments and payments (see ¶20), we will ensure that commitments for wage expenditure are paid within one month of their due date; and commitments for goods, services, and capital expenditures, within three months of their due date.

16. **Customs collections**. Beyond the changes described in paragraph 4**,** we began implementing the memorandum of understanding between the Ministry of Finance and the Ministry of Commerce and Industry, granting customs officials full access to and control of fuel import consignments in Hairatan for weighing and valuation before these consignments are taken into custody by FLGE officials or stored in FLGE tanks. Starting March 21, 2009,

customs will begin issuing monthly reports verifying that the memorandum of understanding has been implemented and documenting its effect on revenues, including a detailed assessment of the volume and value of all categories of fuel imported and the amount of taxes and customs duties levied and collected (prior action for the Fifth Review). We will also ensure that customs officials have continuous access to private fuel depots in Hairatan.

17. **Other customs reforms**. We will implement other measures to bolster customs enforcement. By end-April 2009, we will implement the Automated System for Customs Data (ASYCUDA) transit and declaration processing module in Nangarhar, Herat, and Kabul airport, and will extend the module to Nimroz by January 2010. We will implement the transit module along the Zaranj-Nimroz axis in the same period. By end-May 2009, we will set up post-clearance audit units in Jalalabad and Mazar-e-Sharif, to reinforce customs enforcement. Finally, to ensure better customs control at the border we will adopt and implement by end-January 2010 the business model of border controls clarifying the role of each ministry at the border in line with international best practice and in consultation with other stakeholders (Ministry of Commerce and Industry, and Ministry of the Interior).

18. **Revenue administration**. Building on recent progress, we will introduce the collection of BRT on imports at the point of entry effective March 21, 2009 (prior action). We will extend the large and medium taxpayers offices to more provinces, withdraw remaining trader concessions on filing and paying taxes, collect at least Af 79 million on airlines' liabilities, and step up our public campaign to increase taxpayers' awareness, including about the collection of BRT on imports at the point of entry. Starting July 2009, we will prepare monthly reports documenting collection of the BRT based on dutiable imports. The first report will be a structural benchmark for the Sixth Review. We remain committed to simplifying the trade regime by reducing the tariff on soft drinks from 40 percent to 20 percent, which was originally a performance criterion for the Sixth Review. This measure will be enacted through a presidential decree to be signed in September 2009 and implemented from March 2010 onwards.

19. **Tax and customs departments**. In consultation with Fund staff, the Ministry of Finance will prepare by end-December 2009 an action plan to improve the efficiency and effectiveness of the tax and customs department, particularly by enhancing their responsibility for human and financial resources under the authority of the Minister of Finance and by increasing the efficiency of their organizational structure.

20. **Expenditure management**. We will ensure that no arrears are incurred. Toward this end, we will improve cash management and expenditure execution and enhance our capacity to identify and prevent arrears. We have already improved the accuracy of the budget preparation process to improve calculations of expenditure commitments. We will also

improve cash planning and management through credible spending ceilings and improved accounting and recording. Given our cash-based recording and reporting, we will need to establish auxiliary records to track and manage noncash transactions from commitments to payment authorizations. Accordingly, we will: (i) track monthly commitments by the Ministry of Finance and line ministries and ensure that these are within the approved spending ceilings/cash releases; (ii) regularly compile a consolidated statement of outstanding commitments and unpaid bills of all ministries and spending units as an input into cash planning and management by using appropriate thresholds; (iii) produce quarterly statements of the stock and flow of arrears starting from fiscal year 1387 (2008/09); and (iv) once these arrears are audited by Ministry of Finance internal audit office, we will establish a plan for their clearance in cash and not through mutual offset/netting.

21. **Public enterprises**. We will finalize, by end-January 2010, a comprehensive review of the financial situation of Ariana, Afghan Telecom, DABM/S, and FLGE and their fiscal relations with the government in terms of tax owed, subsidies (if applicable), and other payables of receivables. The review will include regularization of tax payments and other cross debts and reduction of subsidies (if applicable); closure of unauthorized bank accounts; review of corporate governance procedures; business plans; and plans for divestiture, restructuring, or privatization for these enterprises. Separately, starting end-November 2009, DABM/S will publish quarterly financial flows and other key variables for Kabul and other jurisdictions for the preceding year and with a forecast for the coming year. The Ministry of Finance, as sole owner of the two state-owned banks, will take actions to improve their CAMEL[1] ratings to comply with the central bank financial supervision department's recommendations by December 2009. Effective immediately, and in compliance with Decision No. 3 of April 17, 2007 of the Economic Committee of the Council of Ministers, we will replace FLGE's in-kind collection of the 2 percent service fee on fuel imports with the intended pecuniary service charge.

## C. Monetary and Financial Policies

22. **Monetary program**. The 2009/10 monetary program will focus on reducing inflation to single digits by June 2009 and to 6 percent by end-March 2010. In addition, the program provides for a healthy level of international reserves and encourages the growth of the secondary market for capital notes. Currency in circulation is targeted to grow by no more than 16 percent and net international reserves are targeted to increase by about US$200 million. We also expect the stock of capital notes to increase from Af 14 billion in February 2009 to about Af 19 billion in March 2010. Inflation trends will be monitored

[1] Capital adequacy, Asset quality, Management, Earnings, and Liquidity.

closely. Should inflation remain high, we will promptly act to tighten monetary policy and adjust the program in consultation with the Fund. We will also maintain a managed floating exchange rate policy to benefit from the role of the exchange rate as a shock absorber and to ensure the effectiveness of our monetary targeting.

23. **Financial sector policies**. We will strengthen DAB's supervisory capacity and push weaker banks to improve their CAMEL ratings. We will build up bank examiners' capacity, especially for auditing IT systems in commercial banks. With assistance from the World Bank, we will initiate the automation of offsite examination and supplement the full-scope examination cycle for banks with CAMEL ratings of 4 or worse with 2-3 targeted examinations focusing on implementation of actions stipulated in warning letters. Finally, we will work on measures to improve the two operating state banks' CAMEL ratings, especially with regard to the quality of their management.

Table 1. Islamic Republic of Afghanistan: Quantitative Performance Criteria and Indicative Targets Under the PRGF Arrangement, 2009/10 1/
(Cumulative changes from March 20, 2009; unless otherwise indicated)

| | Jun. 21, 2009 Performance Criteria | Sept. 22, 2009 Indicative Target | Dec. 21, 2009 Performance Criteria | Mar. 20, 2010 Indicative Target |
|---|---|---|---|---|
| | (In billions of Afghanis) | | | |
| Floor on fiscal revenues of the government | 12.3 | 25.1 | 37.3 | 51.0 |
| Ceiling on currency in circulation | 2.9 | 7.1 | 9.6 | 12.0 |
| Ceiling on net central bank financing of the government | 0.1 | 0.0 | 3.0 | 8.4 |
| Indicative target (ceiling) on the operating budget deficit of the government, excluding grants | 4.5 | 12.6 | 21.3 | 32.8 |
| Indicative target (ceiling) on reserve money | 3.2 | 7.8 | 11.3 | 14.8 |
| | (In millions of US dollars) | | | |
| Floor on net international reserves of DAB | 58.7 | 127.6 | 166.9 | 197.5 |
| Ceiling on contracting or guaranteeing new medium- and long-term nonconcessional external debt by the government and DAB 2/ | 0.0 | 0.0 | 0.0 | 0.0 |
| Ceiling on short-term external debt owed or guaranteed by the government or DAB 2/ | 0.0 | 0.0 | 0.0 | 0.0 |
| New external payments arrears, excluding interest on preexisting arrears 2/ | 0.0 | 0.0 | 0.0 | 0.0 |
| Ceiling on lending from state-owned banks to public enterprises in need of restructuring or government guaranteeing borrowing by these public enterprises 2/ | 0.0 | 0.0 | 0.0 | 0.0 |
| | (In billions of Afghanis) | | | |
| Memorandum items: | | | | |
| Operating budget deficit of the government, including grants | -1.1 | -2.2 | -1.7 | -0.1 |
| Reference projections for the adjustors | | | | |
| Core budget development spending | 6.6 | 19.8 | 33.0 | 52.8 |
| External financing of the core budget and sale or transfers of nonfinancial assets | 10.9 | 32.4 | 51.4 | 77.3 |
| Externally financed expenditures transferred to the core operating budget | 0.0 | 0.0 | 0.0 | 0.0 |

Source: Fund staff estimates.

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

2/ These performance criteria apply on a continuous basis.

Table 2. Islamic Republic of Afghanistan: Structural Conditionality Under the PRGF Arrangement
March 2009–January 2010

| Fifth Review | Target Dates |
|---|---|
| **Prior Actions** | |
| Submission of DABM/S audited financial statements for 2006/07–07/08. | |
| Amendment of income tax legislation to introduce business receipts tax on imports. | |
| Customs will prepare first monthly report verifying that the memorandum of understanding between the Ministry of Finance and the Ministry of Commerce and Industry has been implemented and its effect on revenue, including a detailed assessment of the volume and value of all categories of fuel imported and amount of taxes and customs duties levied and collected. The report will also document the access received by customs and any areas that need improvement. | |
| Sixth Review | |
| **Benchmarks** | |
| Implementation of the ASYCUDA transit and Declaration Processing Module in Nangarhar, Herat, and Kabul Airport inland clearing depots. | April 30, 2009 |
| Setting up of post clearance audit units in the Customs Directorates of Jalalabad and Mazar-e-Sharif. | May 31, 2009 |
| Publication of the external audit report of FLGE for the period 2002/03–2007/08. | June 30, 2009 |
| Issuance of first monthly report by the revenue department verifying the collection of BRT on imports. | June 30, 2009 |
| Seventh Review 1/ | |
| **Benchmarks** | |
| DABM/S will publish bimonthly report on financial flows and other key variables. | November 30, 2009 |
| Finalize a comprehensive review of the financial situation of Afghan Telecom, Ariana, DABM, and FLGE and their fiscal relations with the government in terms of tax owed, subsidies (if applicable), and other payables or receivables. The review will include regularization of tax payments and other cross debts and reduction of subsidies (if applicable); closure of unauthorized bank accounts; review of corporate governance procedures; business plans; and plans for divestiture, restructuring, or privatization for these enterprises. | January 31, 2010 |
| Adopt and implement the business model of border controls clarifying the role of each ministry at the border consistent with internationally accepted best practices in consultation with other stakeholders (Ministry of Commerce and Industry and Ministry of the Interior) for better customs controls at the border. | January 31, 2010 |
| Implement the ASYCUDA transit module along Zaranj-Nimroz axis and Declaration Processing Module at Nimroz. | January 31, 2010 |

1/ Structural benchmarks for the Seventh Review will be revisited at the time of the Sixth Review.

## TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This memorandum updates the understanding between the Afghan authorities and Fund staff in relation to the monitoring of the PRGF-supported program until March 2010. It defines selected structural performance criteria and benchmarks (Section I), valuation for monitoring quantitative targets under the program (Section II), quantitative performance criteria and indicative targets (Section III); and adjustors (Section IV). It also specifies the agreed data reporting (Section V).

## I. STRUCTURAL PERFORMANCE CRITERIA AND BENCHMARKS

2. Prior actions for the Fifth Review, and structural performance criteria and benchmarks for the Sixth and Seventh Reviews are specified in Table 2 of the Supplementary Memorandum of Economic and Financial Policies (SMEFP). The following section elaborates only on those measures that require specification.

### A. Fifth Review

Specification of selected prior actions for completion of the Fifth Review:

- Amend income tax legislation to introduce business receipts tax (BRT) on imports. This includes passage by the Upper House of Parliament (as it has already been approved by the Lower House), and presidential ratification of the law allowing for its implementation from March 21, 2009.

- Customs will prepare the first monthly report verifying that the memorandum of understanding (MOU) between the Ministry of Finance and the Ministry of Commerce and Industry has been implemented. The report will gauge its effect on revenue, including a detailed assessment of the volume and value of all categories of fuel imported and amount of taxes and customs duties levied and collected. The report will also document the access received by customs, and any areas that need improvement.

### B. Sixth Review

Specification of structural benchmarks for the Sixth Review:

- Prepare first monthly report by the revenue department verifying the collection of BRT on imports. The BRT is expected to be collected starting at the beginning of 1388 (2009/10), and as such, the collection will be verified as part of the regular report on revenues on an ongoing basis.

- Ministry of Finance (Customs Department) will implement the Automated System for Customs Data (ASYCUDA) transit and Declaration Processing Module in Nangarhar, Herat, and Kabul Airport inland clearing depots by April 30, 2009. Impact of ASYCUDA implementation on collection of customs duties and other taxes collected on imports shall be regularly reviewed and analyzed through data generated from the ASYCUDA databases.

- Ministry of Finance (Customs Department) will set up Post Clearance Audit (PCA) units in the Customs Directorates of Jalalabad and Mazar-e-Sharif by May 31, 2009. This shall complete the first phase of implementation extending the scope of the post clearance audits to the five major customs directorates in the country. Ministry of Finance shall monitor the results of the audits to be conducted on a monthly basis. A report analyzing the full impact of the PCA units on increasing compliance with customs laws and improving customs clearance procedures shall be submitted to the Ministry of Finance by the Customs Department at the end of the year. The report shall also give details of the amount of unpaid government revenue detected, the amount recovered and the amount outstanding.

- Ministry of Finance (Customs Department) will establish continuous and effective customs controls at the private sector fuel storage facilities at Hairatan by June 30, 2009. This would be in addition to providing access to Customs staff at the FLGE owned premises as a result of the MOU signed between the Ministry of Finance and Ministry of Commerce and Industry in early-1387 (2008/09) and will strengthen government's efforts for closing potential loopholes in the collection of customs duty and other taxes on imported fuel. The controls shall be developed with the support of the TA provided to the customs department by donors in accordance with internationally accepted best practices suitably adapted to local conditions. Ministry of Finance will eventually authorize collection of customs duty at Hairatan to minimize risks of nonduty-paid fuel being diverted away from the Mazar-e-Sharif internal customs depot. The implementation status report of the agreed measure shall be submitted to the IMF by June 30, 2009.

### C. Seventh Review

Specification of structural benchmarks:

- Da Afghanistan Breshna Moasisa/Sherkat (DABM/S) will start publishing quarterly financial flows and other key variables for Kabul and other jurisdictions, both for the preceding year and with a forecast for the coming year, with the first report published by November 30, 2009. The variables displayed will include sources of revenues and other receivables, power generation, expenditures, subsidies received, overall and primary balances, technical and nontechnical (theft) losses including own use, collection rates, revenues at 100 percent collection rates, and financing and other payables. Revenues and subsidies will distinguish among cash, credits, other government obligations, and payment of bills on behalf of DABM/S. The reporting will take place with a two month lag on a quarterly basis beginning with the period June–September 2009. The corresponding templates for reporting will be developed by the IMF with inputs from the authorities and international technical experts as needed.

- With support from qualified external experts, finalize by January 31, 2010 a comprehensive review of the financial situation of Afghan Telecom, Ariana, DABM/S, and FLGE and their fiscal relations with the government in terms of tax owed, subsidies (if applicable), and other payables or receivables. The review will include regularization of tax payments and other cross debts and reduction of subsidies (if applicable). Specifically, the review would include (i) payment of bills and service charges by the line ministries; (ii) payment of taxes by these public enterprises; (iii) transfers of these public enterprises' profits to the single Treasury account; (iv) closure of unauthorized bank accounts; (v) review of corporate governance procedures detailing how decisions are made, approved, and reviewed and definition of the roles of external and internal auditors and directors, as well as the status of management information systems; (vi) business plans for these enterprises; and (vii) plans for divestiture, restructuring, or privatization.

- Ministry of Finance (Customs Department) will adopt and implement the business model of border controls clarifying the role of each ministry at the border in consultation with other stakeholders (Ministry of Commerce and Industry and Ministry of Interior) for better customs controls at the border .The basic framework for this business model will be developed in accordance with internationally accepted best practices with TA support already at the disposal of the Ministry of Finance. Ministry of Finance shall coordinate with the Ministry of Commerce and Industry, Ministry of Interior, Ministry of Transport and other ministries who have representation at the borders to arrive at an agreement. The Ministry of Finance will give a full implementation report focusing specifically on the changes impacting customs controls and physical placements, if any, by January 31, 2010.

- Ministry of Finance (Customs Department) will implement the ASYCUDA transit module along Zaranj-Nimroz axis and Declaration Processing Module at Nimroz by January 31, 2010. Ministry of Finance will provide the necessary resources to the ASYCUDA program to ensure its timely implementation.

## II. Program Exchange Rates and Gold Valuation

3. Program exchange rates are used for formulating and monitoring quantitative targets. All foreign assets and liabilities denominated in U.S. dollars will be converted into Afghanis at a program exchange rate of 52.1375 Afghanis per U.S. dollar, which corresponds to the cash rate of December 19, 2008. Gold holdings will be valued at US$838.28 per ounce, the price as of December 19, 2008. Assets and liabilities denominated in SDRs and in foreign currencies other than the U.S. dollar will be converted into U.S. dollars at their respective exchange rates of December 19, 2008, as reported in the following table. Gold holdings will be valued at US$838.28 per ounce, the price as of December 19, 2008.

| Exchange Rate | Program Rate |
|---|---|
| U.S. dollar/Canadian dollar | 0.820200 |
| U.S. dollar/U.A.E. dirham | 0.272300 |
| U.S. dollar/Egyptian pound | 0.181800 |
| U.S. dollar/Euro | 1.391200 |
| U.S. dollar/Hong Kong dollar | 0.129020 |
| U.S. dollar/Indian rupee | 0.021150 |
| U.S. dollar/Pakistani rupee | 0.012598 |
| U.S. dollar/Polish zloty | 0.336300 |
| U.S. dollar/Iranian rial | 0.000101 |
| U.S. dollar/Saudi rial | 0.266600 |
| U.S. dollar/Russian ruble | 0.035490 |
| U.S. dollar/Swiss franc | 0.906000 |
| U.S. dollar/United Kingdom pound | 1.492000 |
| U.S. dollar/SDR | 1.545010 |

## III. Quantitative Performance Criteria and Indicative Targets

4. The quantitative performance criteria for June and December 2009 specified in Table 1 of the SMEFP are:

- Floors on fiscal revenue of the central government and net international reserves (NIR); and

- Ceilings on currency in circulation (CiC); net central bank financing (NCBF) of the central government; contracting and/or guaranteeing new medium- and long-term nonconcessional external debt by the government or the Da Afghanistan Bank (DAB), the central bank, (continuous); short-term external debt owed or guaranteed by the government or the DAB (continuous); accumulation of external payment arrears, excluding interest on preexisting arrears (continuous); lending from state-owned banks to, or government guaranteed borrowing by, public enterprises in need of restructuring (continuous).

The above variables constitute indicative targets for September 2009 and March 2010. In addition, the program includes the following indicative targets for the next four quarters:

- Ceilings on the operating budget deficit of the central government excluding grants and on reserve money.

### A. Currency in Circulation

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

### B. Net Central Bank Financing of the Government

6. **Net central bank financing of the government** is defined as the difference between the central bank's claims on the government and government deposits at the DAB. These deposits exclude deposits held at the DAB's branches because of the unavailability of reliable and timely data from the DAB's branches.

### C. Net International Reserves

7. **NIR** are defined as reserve assets minus reserve liabilities of the DAB, both of which are expressed in U.S. dollars.

8. **Reserve assets of the 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 the DAB, and are readily and unconditionally available for the 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 the DAB, but exclude cash held in the 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;[1] 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 the 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.

### D. Revenues of the Central Government

10. **Revenues of the central government** are defined in line with the Government Financial Statistics Manual (GFSM 2001) but on a cash accounting basis, excluding 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

[1] 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.

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 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.

11. Revenues should be recognized on a cash basis and flows should be recorded when cash is received. The official Afghanistan Government Financial Management Information System (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

12. 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: (i) 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); (ii) 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 (iii) 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.

13. The ceiling on medium- and long-term external debt applies on a continuous basis to the contracting or guaranteeing by the government or the 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 Public Finance and Expenditure Management (PFEM) Law, the Ministry of Finance 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 12 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 Ministry of Finance (on behalf of the government) or the DAB Governor; and

    - the guarantee of a debt arises from any explicit legal obligation of the government or the 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 the 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.

14. **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 the DAB, with an original maturity of up to and including one year.

- It applies to debt as defined in paragraph 12 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.

15. A continuous performance criterion applies to the **nonaccumulation of new external payments arrears** on external debt contracted or guaranteed by the central government or the 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: (i) arrears arising from interest on the stock of arrears outstanding as of March 20, 2006; and (ii) external arrears that are subject to debt rescheduling agreements or negotiations.

### F. Lending to, or Guaranteeing Borrowing by, Public Enterprises

16. The zero ceiling on new lending from state-owned banks to, or government guaranteed borrowing by public 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: (i) enterprises (public or private) that have not had an audited balance sheet in fiscal years 1384 and 1385; (ii) public enterprises that have been identified by the Ministry of Finance 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 corporations[2] 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 public enterprises in need of restructuring, and also to any new government guarantees (as defined in paragraph 13 of this memorandum) of borrowing undertaken by these public 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

17. Revenues of the central government as defined above minus operating budget expenditure recorded in AFMIS.

### H. Reserve Money

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

## IV. Adjustors

19. The floor on NIR and the ceiling on the NCBF of the government are consistent with the assumption that core budget **development spending** in 2009/10 will amount, on a cumulative basis from March 21, 2009, to:

| | |
|---|---|
| June 20, 2009 | Af 6.6 billion |
| September 21, 2009 | Af 19.8 billion |
| December 20, 2009 | Af 33.0 billion |
| March 20, 2010 | Af 52.8 billion |

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

20. The NIR floor and NCBF ceiling are defined consistent with the assumption that the **external financing of the core budget and receipts from the sale or transfer of nonfinancial assets** will amount, on a cumulative basis from March 21, 2009, to:

[2] 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).

| | |
|---|---|
| June 20, 2009 | Af 10.9 billion |
| September 21, 2009 | Af 32.4 billion |
| December 20, 2009 | Af 51.4 billion |
| March 20, 2010 | Af 77.3 billion |

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.

21. 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 (i) 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 (ii) 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.

22. Should the central government undertake **security-related operating expenditures** based on spending plans agreed between the central government and donors, the indicative target (ceiling) for the operating budget deficit of the central government, excluding grants, will be adjusted upward and, should there be quarterly discrepancies between disbursements and executions, the NIR floor will be adjusted downward, and the NCBF ceiling upward by the sum of: (i) Af 1.8 billion, contingent on the final 2009/10 Afghan National Army (ANA) headcount exceeding 86,000, with the adjustment for any force size between 86,000 and 109,000 calculated on a prorated basis; (ii) Af 4.5 billion for augmentations ("top-ups") to the salaries of the 109,000 ANA force size with the adjustment for any force size between 86,000 and 109,000 calculated on a prorated basis; (iii) Af 2.2 billion for the salaries of the 16,000 soldiers recruited in 2008/09; (d) Af 900 million for equipment purchases by the Ministry of Defense; (iv) Af 400 million for equipment purchases by the Ministry of the Interior; and (v) Af 599 million for increasing the food allowances of the Afghan National Police. The cumulative downward adjustment to the NIR floors at each test date will be capped at US$199.5 million. The cumulative upward adjustment to the NCBF ceilings and the indicative targets (ceilings) for the operating budget deficit of the central government, excluding grants, at each test date, will be capped at Af 10.4 billion.

## V. Provision of Information to the Fund

23. To facilitate monitoring program implementation, the government of Afghanistan and the DAB will provide Division A of the Middle East and Central Asia Department 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 to the Technical Coordination Committee (see paragraph 25 below).

24. Actual outcomes will be provided with the frequencies and lags indicated below.

- **DAB net international reserves**: weekly, no later than two weeks after the end of the week.

- Monetary statistics, including exchange rates, government accounts with the DAB, currency in circulation, reserve money, and a monetary survey: monthly and no later than three weeks after the end of the month. The monetary survey will include the balance sheet of the DAB and a consolidated balance sheet of the commercial banking sector.

- **Core budget operations and their financing**: 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. 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): 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:** quarterly and no later than six weeks after the end of the quarter. These will include: (i) details of new loans contracted or guaranteed during the quarter, including the terms of each new loan; (ii) the stock of debt at the end the quarter, including short-term debt, and medium- and long-term debt; (iii) loan disbursements and debt service payments (interest and amortization) during the quarter, beginning with the first quarter of fiscal year 1388 (2009/10); (iv) debt relief received during the quarter; (v) information on all overdue payments on short-term debt, and on medium- and long-term debt, including new external arrears (if any); and (vi) total outstanding amount of arrears.

- **National accounts data**: 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): monthly and no later than four weeks after the end of the month.

25. The Technical Coordination Committee (TCC) will prepare and send to the IMF reports by the end of each quarter explaining progress in implementing structural performance criteria and benchmarks under the program. These reports will include appropriate documentation to substantiate progress achieved, and explain any deviations relative to the initial reform plans or timetable, specifying expected revised completion date. 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.