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

June 21, 2007

The following item is a Letter of Intent of the government of Islamic Republic of Afghanistan, which describes the policies that Islamic Republic of Afghanistan intends to implement in the context of its request for financial support from the IMF. The document, which is the property of Islamic Republic of Afghanistan, is being made available on the IMF website by agreement with the member as a service to users of the [IMF](#) website.

Kabul, June 21, 2007

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

Dear Mr. de Rato,

1. The attached Memorandum of Economic and Financial Policies (MEFP) supplements and updates the understandings with IMF staff on our economic program under the Poverty Reduction and Growth Facility (PRGF) arrangement and in the context of the first review of the program. The new MEFP reports on progress in implementing the program since the completion of the first review in March 2007, describes the policy agenda and understandings on structural conditionality for 2007/08, and sets the quarterly targets through March 2008, including the quantitative performance criteria for September 2007.
2. We are pleased to inform you that we met all the March 2007 quantitative performance criteria. The achievement of our ambitious revenue targets for 2006/07 strengthened considerably the public finances and the prospects for achieving fiscal sustainability over the medium term. We also observed the continuous performance criteria on the contracting or guaranteeing of new medium- and long-term nonconcessional external debt, on the stock of short-term external debt, and on the nonaccumulation of new external payments arrears. Our program has contributed to the consolidation of macroeconomic stability, strengthened our balance of payments, and increased confidence in the domestic currency.
3. We have also made important progress toward implementing our structural reform agenda. We obtained parliamentary approval of our 2007/08 budget, which conforms with understandings reached in the context of the first review and met the structural benchmarks pertaining to the second review, with the exception of the adoption of a restructuring/divestment plan for public entities not covered by a law applying to a subset of state-owned enterprises. Regarding the latter, a preliminary plan has been developed and is being reviewed by our consultants with a view to adopting it expeditiously. Looking ahead, we plan to submit the core budget's audited financial statement for 2006/07 in time to observe the structural performance criterion for the third review. We also wish to confirm our commitment to meeting the structural benchmarks for the third review, with the understanding that more time will be needed to complete the restructuring plan for Bank Pashtany in light of its merger with the Export Promotion Bank and the time required to finalize the audits of both banks. Meanwhile, there will be no lending from state-owned banks (notably Bank Millie and Bank Pashtany) to enterprises in need of restructuring. The government will also refrain from guaranteeing lending to these enterprises.

4. The government and Da Afghanistan Bank (DAB) believe that the economic and financial policies set forth in the attached updated memorandum provide a sound basis for achieving the objectives and targets of the program. During the period of the arrangement, Afghanistan 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 all information necessary to monitor the implementation of the program in a timely manner. The government and DAB will conduct with the Fund the third review under the arrangement before end-January 2008.

5. Based on our performance, and the strength of the policies set forth in the attached memorandum, we request that the IMF complete the second review under the PRGF arrangement and approve the third disbursement in the amount of SDR 11.3 million.

6. After the period of this arrangement and while Afghanistan has outstanding financial obligations to the IMF arising from disbursements under this arrangement, 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.

7. We remain committed to transparent policy-making and are keen on rendering the contents of this letter and those of the attached MEFP and technical memorandum of understanding, as well as the staff report on the second review under the three-year PRGF arrangement, available to the public. Therefore, we hereby authorize the posting of these documents on the Fund's website subsequent to Executive Board consideration of this request.

Sincerely yours,

/s/

Anwar Ul-Haq Ahady
Minister of Finance
Ministry of Finance

/s/

Noorullah Delawari
Governor
Da Afghanistan Bank

Attachment:

Memorandum of Economic and Financial Policies for 2007/08
Technical Memorandum of Understanding

**MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES
FOR 2007/08**

June 21, 2007

I. INTRODUCTION

1. **The Government of Afghanistan and Da Afghanistan Bank (DAB) have continued to implement the reform strategy to reduce poverty and move Afghanistan to a sustainable growth path.** This memorandum reviews performance through March 2007 under the program supported by Poverty Reduction and Growth Facility (PRGF) arrangement, sets out the revised economic and financial policies for 2007/08, and updates the government's medium-term objectives and policy framework. Based on these policies, we request completion of the second review and approval of the third disbursement under the PRGF arrangement.

II. PERFORMANCE UNDER THE PROGRAM

2. **Economic developments in 2006/07 have been broadly satisfactory.** Available information suggests that the impact of the drought on agricultural production was somewhat stronger than previously anticipated, with real gross domestic product (GDP) growth decelerating to about 7.5 percent in 2006/07, from 14 percent in 2005/06. Annual end-period inflation, as measured by the consumer price index for Kabul, subsided to 4.8 percent in March 2007 because a decline in rent prices mitigated the impact of rising food prices and an increase in administered energy prices in the latter part of 2006/07. Annual end-period "national" inflation, covering Kabul and five other cities, was 3.9 percent in March 2007.

3. **All the March 2007 quantitative targets under the program were observed,** including the performance criteria on fiscal revenue, currency in circulation, net central bank financing of the government, and net international reserves. We also met the continuous performance criteria on the contracting or guaranteeing of nonconcessional external debt, and on the nonaccumulation of short-term external debt and external arrears (Table 1).

4. **Progress in implementing the structural reform agenda has been mixed owing mainly to capacity constraints and an increasingly difficult political environment.** While four of the five structural benchmarks for the second review were met, we were unable to implement a number of other program commitments. In particular, we were unable to adopt a comprehensive restructuring/divestment plan for public entities engaged in commercial activities that are not covered by the SOE law (end-March 2007 structural benchmark). The World Bank document *Afghanistan: Privatization Strategy Note*—submitted to us in May 2007—should facilitate the development of such a plan. Also, no specific agreement to reduce the net cost of the energy subsidy has been reached with the Ministry of Energy and

Water and DABM (the electricity utility). Moreover, submission to parliament of a secure transaction law, a business organization law and a negotiable instruments law was further delayed, as the Ministry of Justice continues to review these laws.

5. **The overall fiscal position in 2006/07 was slightly stronger than envisaged under the program.** Preliminary data show that the operating budget deficit (excluding grants) was 3.6 percent of GDP, compared to a program target of 4.1 percent, owing primarily to a pick-up in revenue collection in the fourth quarter and slightly lower-than-programmed expenditures. The overall core budget deficit (including grants) reached only 2.7 percent of GDP in 2006/07, compared to a program projection of 3.8 percent, leading to a significantly lower-than-envisaged drawdown of government deposits. Slightly higher-than-expected sales of nonfinancial assets offset in part a lower-than-expected level of external financing.

6. **Strong domestic revenue collection in the last quarter of 2006/07 allowed the government to meet the related March 2007 performance criterion with a comfortable margin.** Revenue collection is estimated to have reached 7 percent of GDP in 2006/07, or about 6.6 percent above the annual target.¹ Notwithstanding a loss of staff in the Large Taxpayer Office (LTO) in the fourth quarter, intensified administration efforts led to an increase in the collection of the Business Receipts Tax on services and the withholding tax on wages. Also, customs revenues picked up in the last month of 2006/07, partially due to the transfer of funds previously accumulated in provincial accounts to DAB's central accounts. Fixed taxes on importers with business licenses, however, did not increase as expected.²

7. **Operating expenditures reached 10.5 percent of GDP in 2006/07, in line with the program.** A pick up in spending during the last two months brought operating budget execution to about 98 percent. Reflecting the current security situation, over 40 percent of the operating budget was spent on defense, public order, and safety. The next largest sector was education, accounting for 20 percent of operating expenditures. Development expenditures reached 7.8 percent of GDP in 2006/07—approximately half of the annual development budget (as approved by parliament)—representing an increase of over 50 percent relative to 2005/06. Following a review of allotment, contracting, and cash management procedures, progress was made in addressing the difficulties in executing development spending encountered earlier in 2006/07. As a result, development budget execution picked up in the latter part of the year. Investment in infrastructure, natural resources, and rural development accounted for over 75 percent of core development spending in 2006/07.

¹ The indicative revenue target for the third quarter of 2006/07 was missed by a small margin.

² In part, this is due to errors in classification by some provincial tax offices, which attributed the collection to the Business Receipts Tax (BRT)—nonetheless, the authorities believe that the analysis above about the pick up in BRT collections is correct.

8. **Progress on fiscal reforms has largely been on track, but some difficulties are still being confronted in a number of areas.** Although we requested that the Control and Audit Office verify the 2006/07 tashkeel reviews at the Ministry of Education and Interior (end-January 2007 structural benchmark), progress in furthering payroll control by making the certified payroll system fully operational has been slow. Legislation to eliminate nuisance taxes and simplify the income tax was submitted to parliament at end-March 2007; but, however, its parliamentary approval is still pending. In mid-April 2007, parliament approved the 2007/08 budget, consistent with our program commitments. This was accompanied by Cabinet endorsement of our medium-term fiscal framework (MTFF) that identifies fiscal policy objectives and likely challenges for the period 2007/08–2009/10. The structural presentation of the budget has been improved, including presentation of the Ministry of Education budget (on a pilot basis) according to a simple program structure. In January 2007, we also established a steering committee, chaired by the Minister of Finance, to monitor the tax and customs modernization plans. We faced difficulties in clarifying and documenting the roles of various agencies operating at the borders, as some entities were not fully cooperative. To address this issue, an understanding has been reached and a draft document has been prepared to clarify the roles of these agencies. We intend to publish this document and make it operational by end-September 2007.

9. **We introduced some changes to our external tariff structure,** including a new 40 percent tariff rate on soft drinks and bottled water (the previous maximum tariff was 25 percent). This was intended to offset high production costs for domestic producers and unfair competition from subsidized imports from regional trading partners. The President also issued a decree, whereby producers can apply for a 1 percent tariff rate (lower than the regular rate) on imports of selected raw materials and intermediate goods. The 1 percent rate, however, is applicable only to those producers whose imports are regarded by the Afghanistan Investment Support Agency (AISA)—with agreement of customs—to be used exclusively for industrial production.

10. **We achieved our monetary policy objectives, and confidence in the Afghani has strengthened.** We continued to anchor monetary policy on monthly currency in circulation targets. Foreign exchange auctions remained the primary vehicle for implementing monetary policy, facilitated by the regular provision of monthly Treasury liquidity forecasts since January 2007. The March 2007 performance criteria for currency in circulation and net international reserves were met with comfortable margins. In 2006/07, currency in circulation increased by 12.4 percent (in line with nominal GDP growth) and DAB's net international reserves rose by nearly US\$220 million. At the same time, the Afs/US\$ exchange rate remained broadly stable.

11. **We have strengthened the role of capital notes in absorbing liquidity and broadened the scope of capital notes transactions.** In the last quarter of 2006/07, the volume of 28-day capital notes auctions was increased to Afs 200 million per week, and as of February 2007 DAB launched capital notes with a 182-day maturity at a rate of

Afs 50 million per week. Meanwhile, 56-day capital notes have been phased out. The increase in the volume of CNs auctions was accompanied by an increase in interest rates from 5–6 percent during most of the second half of 2006/07 to 7–8 percent in March 2007, which in turn allowed banks to better manage their excess liquidity. Standard settlement procedures for secondary market trading and the recording of trades have been drafted but not yet been issued. Preliminary discussions with banks will be held following the finalization of the draft by DAB. We have also adjusted the procedures guiding the conduct of foreign exchange auctions. The monetary policy committee decided that the cut-off rate should not exceed ± 5 basis points from the previous auction cut-off rate.

12. **We have monitored closely the growth in banking sector activity and continued to strengthen banking supervision.** Bank activity increased rapidly in 2006/07, and commercial bank deposits and lending more than doubled. At the same time, bank operations continued to be heavily dollarized. In response to the rapid growth of bank intermediation, several steps were taken to strengthen bank supervision. Also, the penalty rates for banks' noncompliance with reserve requirements were raised to 300 basis points above the overnight credit facility rate. We have also strengthened the application of prudential regulations, enforced remedial actions to address some cases of noncompliance with capital adequacy requirements, and curtailed the use of lotteries to attract deposits. A full round of on-site inspections was completed during 2006/07, and a report summarizing the main findings is scheduled to be issued by end-July 2007.

13. **Central bank operations are being modernized.** A new accounting system has been introduced at DAB headquarters. The test phase is expected to be completed during the summer of 2007, and the system will be fully operational at DAB's headquarters and six regional hubs by September 2007 (structural benchmark). In collaboration with the IMF's statistics department, a monetary survey has been developed that will be used once the reliability of the new accounting system is fully tested. We also strengthened management of our branch network, including by reducing reporting delays by installing real time communication channels between headquarters and the regional branches. An external audit of DAB's end-2006/07 accounts by an internationally reputable firm is scheduled to be completed by June 15, 2007. In line with safeguards assessment recommendations, this included a special audit of DAB's foreign reserves as of March 20, 2007.

14. **Some progress was made toward restructuring Bank Millie and Bank Pashtany.** A restructuring plan for Bank Millie was sent to Cabinet (end-March 2007 structural benchmark) and was subsequently approved, and an external audit of the bank was completed in May 2007. A board of supervisors has been put in place, and the regional branches have been linked with headquarters to allow for the compilation of a consolidated balance sheet on a daily basis. While a new CEO of Bank Millie has been appointed, a full management board is not yet in place. Regarding Bank Pashtany, an external audit began in June 2007 and is expected to be completed by end-July 2007. We expect that the

restructuring plan for Bank Pashtany will be submitted to Cabinet by August 31, 2007 (instead of July 31, 2007 as previously intended).

15. **The external current account deficit (excluding grants and after rescheduling) widened** to 44 percent of GDP in 2006/07, from just below 42 percent in 2005/06. The trade deficit increased on account of higher-than-anticipated imports associated with donor activities outside the core budget, including additional security measures, as well as ongoing reconstruction and development projects. Higher interest receipts on foreign reserves and the capitalization of moratorium interest under the July 2006 Paris Club agreement helped contain the deterioration in the current account balance. The current account balance including grants shifted from a small surplus in 2005/06 to a small deficit (about ½ percent of GDP) in 2006/07. This deficit was financed largely by an increase in concessional loan disbursements, which, together with Fund support and debt relief, led to a further strengthening of gross international reserves to over US\$2 billion.

16. **Efforts to regularize relations with creditors have intensified**, following the Fund and World Bank Boards' consideration of the preliminary assessment of Afghanistan's eligibility for assistance under the Heavily Indebted Poor Countries (HIPC) Initiative. In late May 2007, an understanding in principle to regularize arrears to the OPEC Fund for International Development was reached, with the details of the agreement to be finalized after the decision point. Bilateral agreements have also been signed with two Paris Club creditors—the United States (September 2006) and Germany (April 2007)—and the government is working on finalizing an agreement with Russia. After contacting all our non-Paris Club creditors in April 2007, we are discussing a restructuring proposal with one creditor and expect to enter discussions with the remaining creditors in the coming months.

17. **Despite the difficult security situation and capacity constraints, we have continued with our efforts to collect balance of payments data.** During 2006/07, we collected quarterly foreign direct investment data from AISA. We also continued work to improve data sharing arrangements between DAB and the Ministry of Finance (MoF), and to develop the international transactions reporting system. In consultation with Fund staff, the decision was taken not to proceed with the border trade survey, and to examine alternative means of estimating informal trade flows.

18. **Progress in divesting state-owned enterprises (SOEs) has been slow.** We have auctioned only one SOE (in the first quarter of 2007/08), but another nine are scheduled to be auctioned by July 2007. We have appointed liquidation committees for the nine SOEs approved for liquidation. Moreover, a total of 35 SOEs have been identified for privatization. In the absence of restructuring plan, we have resisted pressures to provide budgetary support to Ariana, which recently defaulted on its plane leases.³

³ In 2006/07 US\$2 million in budget support for spare parts was granted to Ariana.

III. THE PROGRAM FOR 2007/08

A. Macroeconomic Objectives

19. **Our strategy for 2007/08 seeks to consolidate progress to date on macroeconomic stabilization, including by deepening financial and structural reforms.** Real GDP growth is projected to rebound to 13 percent in 2007/08 owing mainly to a significant pick up in agricultural production following a good rainfall. End-of-period Kabul-CPI inflation is projected to increase to 6 percent in 2007/08, as transportation costs would continue to rise and generalized pass-through of higher energy prices to other consumption items (notably food) is anticipated.

B. Fiscal Policy

20. **We expect the good revenue performance to continue in 2007/08.** Revenue is projected to reach Afs 35.7 billion (7.3 percent of GDP), 24 percent higher than last year's outcome. This is consistent with our Compact objective of collecting revenue equivalent to 8 percent of GDP by FY1389 (2010/11).

21. **The budget ratified by parliament is consistent with the program for 2007/08, and includes an adjuster for additional security expenditure.** Operating expenditure is projected at Afs 53.6 billion (11 percent of GDP) in 2007/08. Although this is about 0.8 percent of GDP above the program, it is consistent with the program adjuster and reflects the expectation that the additional security-related spending (up to Afs 3.8 billion) will be covered by external grants. Parliament approved development expenditures of Afs 77.0 billion (15.8 percent of GDP), but considering the systematic underspending in previous years, we are targeting an amount of Afs 44.1 billion (9.1 percent of GDP) under the program.⁴ Accordingly, the operating deficit (excluding grants) would be 3.7 percent of GDP in 2007/08, or around 0.8 percent of GDP higher than envisaged at the time of the first review. Higher-than-expected funding from the Afghanistan Reconstruction Trust Fund will free domestic resources for key priorities in the development budget. However, in light of the increase in operating expenditures, we expect that our overall fiscal sustainability target of covering the operating budget with domestic revenue will be attained by 2012/13 (two years later than projected at the time of the first review). This assumes that donor funding for the recurrent budget will be available for at least another five years.

22. **Pressures emerged in the budget negotiations that may need to be considered during the midyear budget review and in the context of the third review under the PRGF arrangement.** In particular:

⁴ The PCs adjust automatically should development expenditure be higher than programmed, up to the budgeted amount.

- Previously identified education expenditures of 0.2 percent of GDP might need to be added to the budget in the midyear review, subject to meeting the quarterly revenue targets through September 2007.
- Recent understandings reached with our security partners to: (a) increase the number of police from 73,000 to 82,000 by 2008/09; and (b) potentially achieve parity between police and army remuneration may require increasing the security adjuster further by Afs 1.3 billion (0.3 percent of GDP).
- A “Governors’ Outreach Fund” estimated at about \$5.4 million for 2007/08 may be needed to enable provincial governors to enhance outreach activities. All expenditure from this fund would be subject to Budget and Treasury Department guidelines and conform to fiduciary standards.

23. Continued progress is needed on tax and customs policy and administration to meet the medium-term fiscal objectives. To that end, we will:

- Strive to resist political pressures in both revenue policy and administration, and to build government-wide support for reforms in these areas;
- Strengthen support for the customs and tax reform by ensuring that the relevant departments have adequate staffing and resources;
- Provide appropriate support to the LTO collection enforcement and audit programs, and give higher priority to reforming the regional customs directorates. The steering committee for tax and customs modernization, chaired by the Minister of Finance, will play a key role in this regard;
- Continue consulting with the IMF on the draft of a new tax policy framework (end-July 2007 structural benchmark), and ensure that any modifications will be at least revenue-neutral. The framework will clearly set out the government’s revenue base, the supporting legislation, and the reform agenda;
- Continue work on transferring, on a pilot basis, accountability for all large- and medium-size taxpayers in Kabul directly to the revenue department (end-September 2007); and
- Move toward a broad-based consumption tax by submitting to parliament the goods and services tax (GST)/business receipts tax (BRT) legislation by end-March 2008, either as a stand-alone piece of legislation or as part of a wider reform of the tax code.

24. We will use the MTFE as a tool for engaging donors to discuss the level of external support needed for the recurrent budget. With a view to achieving our HIPC completion point triggers, we will strengthen the MTFE in time for the 2008/09 budget to:

- Set out a plan to reduce the operating deficit (excluding grants), extend the MTFF horizon to show the target date for covering the operating budget from domestic revenue (currently 2012/13), and specify the government's policy on non-grant financing. We will use this to anchor our fiscal policy over the medium term;
- Begin incorporating basic tax policy analysis and future policy options, reflecting inputs from both the Fiscal Policy Unit and the Revenue Department;
- Establish medium-term envelopes (for both the operating and development budgets) for key cross-cutting fiscal issues (e.g., Pay and Grading reform, pensions, external budget operation and maintenance expenditures); and
- Include concise descriptions of policy actions to support the projections.

25. The MoF will take the lead in aligning public expenditure with the Interim Afghanistan National Development Strategy (I-ANDS)/Afghanistan National Development Strategy (ANDS) priorities and tracking core budget and external budget spending. To this end, in parallel with ANDS preparation, we will:

- Continue to refine the harmonized donor reporting format in order to expand donor reporting and inform the annual core budget process, beginning with the preparation of the 2008/09 budget;
- Present our annual budget according to sectoral priorities using the program budgeting pilots where possible; and,
- Undertake the necessary Treasury reforms to improve expenditure tracking, including by adjusting the Chart of Accounts to reflect simple program classification in the relevant ministries and, where possible, improving the functional classification of expenditures.

26. A disciplined approach to fiscal policy will be needed to achieve the objectives set out in the budget and the MTFF. In particular:

- While the budget currently shows a declining profile for the energy subsidy, we are committed to establishing a more comprehensive agreement among DABM, the MoF, and the Ministry of Energy and Water to develop a medium-term plan to gradually eliminate subsidies. To that end, the MoF will aim to receive and analyze DABM's financial statements, and to conclude the agreement by end-March 2008 (delayed from January 2007). The agreement will stipulate relative contributions to fuel purchases by DABM, taking into account DABM's revenue performance and projections, and restructuring plans;

- Avoid extending government guarantees, or directing state-owned banks to lend, to Ariana and other enterprises in need of restructuring (continuous performance criterion). Various options on how best to address Ariana's problems will be considered, including the possibility of divesting the company. In the interim, any possible budget support for Ariana will be met within the existing operating expenditure envelope, contingent on a viable restructuring plan for the company; and,
- Following formal political approval, which is expected in the coming weeks, begin to implement Pay and Grading reforms this year, and ensure that any civil service pay increases outside the new scale do not exceed inflation in the 2008/09 budget.

C. Monetary and Exchange Rate Policy and Financial Sector Reforms

27. **We will continue to target currency in circulation and to smooth out exchange rate volatility.** Demand for currency is projected to grow at double-digit rates in 2007/08. Given the observed shift from cash to deposits, however, the growth in currency in circulation may fall short of nominal GDP growth. Nonetheless, seasonal factors are expected to stimulate the demand for currency in the first half of the year. With the improved reporting by branches, we have begun to target a tighter definition of currency in circulation which excludes cash balances in all central bank branches (rather than only in the regional branches). We also plan to foster the development of a secondary market for capital notes by putting in place a depository mechanism. Secondary market trading is expected to increase the attractiveness of capital notes for commercial banks.

28. **The rapid increase in banks' intermediation role in the economy calls for further strengthening of our regulatory and supervisory framework.** By end-November 2007, we will issue: (a) regulations on credit risk management, and the required policies and processes to be followed by banks in order to identify, measure, monitor, and control credit and counterparty risks (structural benchmark); and (b) regulations setting limits on loan concentration in one single sector of the economy (structural benchmark). To enhance transparency and disclosure, we will require banks to publish their audited annual financial statements as soon as they become available. Before considering options for establishing a deposit insurance scheme, we will ensure that: (a) DAB is materially in compliance with Basel Core Principles; (b) the banking system is fully sound; and (c) the state-owned banks' restructuring process is completed.

29. **We will intensify our efforts to restructure the state-owned banks.** To preserve the value of these banks, there will be no direct or "roundtrip" lending from state-owned banks to those state-owned enterprises making a loss or that have not had an audited balance sheet for the last two years (continuous structural performance criterion). This criterion will apply also to enterprises not covered by the Tassady Law, such as Ariana. With support from external advisors and based on the external audit as of end-March 2007, we will prepare and submit for Cabinet approval a restructuring plan for Bank Pashtany by end-August 2007

(structural benchmark). We will also prepare, on the basis of on-site supervision reports, a summary report on banks' compliance with prudential regulations by end-July 2007. Based on the audited reports of their balance sheets, DAB will enforce licensing requirements for Bank Pashtany and Bank Millie by end-September 2007. The liquidation process for non-licensed state-owned banks will continue, and the transfer of deposits in the Export Promotion Bank to Bank Pashtany will be finalized by end-September 2007. In addition, we will follow up with the Justice Department on the set of core enabling laws for commercial banking—including laws on secure transactions, negotiable instruments, and mortgages—with the aim of submitting them to parliament by end-July 2007.

D. External Sector Policies

30. **The current account deficit (excluding grants and after rescheduling) is expected to decline to just over 40 percent of GDP in 2007/08**, owing to an improvement in the trade balance, continued growth in interest earned on reserves, and the favorable treatment of moratorium interest by Paris Club creditors. However, projection of the trade balance is hindered by uncertainties surrounding the level of donor activities. If official transfers (relative to GDP) moderate as expected, the current account deficit (including grants) would widen to around 2 percent of GDP in 2007/08. Foreign exchange reserves are expected to rise further to nearly US\$2.3 billion (around 5.1 months of imports) by year's end.

31. **With continued donor support, our balance of payments position should remain manageable over the medium term.** The current account (excluding grants) is expected to improve, but would still average around 37½ percent of GDP over the next few years due to the need to contain insecurity, and Afghanistan's investment and reconstruction needs. As official transfers relative to GDP taper off, the current account deficit (including grants) could widen to over 6 percent by 2010/11. This underscores the importance of sustained support from the international community. Reserve coverage is envisaged to average just above five months of imports of goods and services over the medium term, which is prudent given Afghanistan's dependence on official donor financing and uncertainties surrounding the FDI and export capacity.

32. **In addition to the assistance we hope to receive under the HIPC Initiative, we will try to restore Afghanistan's external sustainability by maintaining a prudent debt management strategy.** First, we will continue to rely primarily on grants, supplemented by highly concessional loans, to meet our financing needs. The government and DAB will not contract or guarantee any nonconcessional external debt (continuous performance criterion). Second, having regularized relations with multilateral and Paris Club bilateral creditors, we are now working actively to reach agreements with our non-Paris Club bilateral creditors on terms at least comparable with Paris Club creditors. Finally, we are working toward strengthening the tracking and reporting of our external debt data as envisaged under the relevant HIPC completion point trigger. In this regard, we hope to commence producing quarterly debt reports later this year.

33. **Recent changes to the customs tariff regime are temporary, and we remain committed to a trade regime that minimizes distortions.** Recent changes seek to offset high production costs for domestic producers and unfair competition from subsidized imports from regional trading partners. As such, and consistent with supporting some “infant industries”, these tariffs are not permanent. In this regard, in consultation with Fund staff, the government intends to develop a proposal to eliminate the discretionary application of the 1 percent tariff rate on imports of raw materials and intermediate goods before the completion of the third review under the PRGF arrangement. Also, in the context of the third review under the PRGF arrangement, the government will specify a time-bound plan to eliminate the new 40 percent tariff rate. Moreover, we will refrain from granting further concessions and reclassifying more goods into the three highest tariff bands. We also remain mindful of our intention to unwind earlier tariff increases as the revenue situation permits. **We are also committed to maintaining a foreign exchange system free of restrictions** and are working toward accepting our obligations under Article VIII, Sections 2, 3, and 4 of the Fund’s Articles of Agreement. To this end, we would welcome IMF technical support to help us assess the adequacy of the legal framework and formalize a restrictions-free exchange rate system.

E. Other Structural Reforms

34. **We plan to intensify our efforts to improve the private sector investment climate.** In particular, we will send to parliament: (a) laws on partnership and corporations by end-June 2007; and (b) a comprehensive restructuring/divestment plan for public entities and government agencies engaged in commercial activities but not covered by the SOEs (Tassady) law (end-September 2007 structural benchmark). We will move expeditiously to divest entities covered by the SOE law through liquidation and privatization.

F. Poverty Reduction Strategy

35. **Preparation of the PRSP—the ANDS—is progressing well,** as was reported to our development partners at the Afghanistan Development Forum that took place in Kabul in April 2007. Consultations have been intensified by conducting public awareness campaigns in 27 provinces in 2006 and pilot discussions at the provincial level in April 2007. We plan to complete all 34 provincial consultations by September 2007. Given the limited seasonal sampling (summer only) in the 2005 National Risk and Vulnerability Assessment (NRVA), we plan to complete an update of the 2005 NRVA by mid-2007, which would allow us to improve our poverty data. To help prioritize ANDS sectoral strategies, we intend to use the budget and MTF as tools to balance the need for affordability with fiscal prudence. We hope that increased reporting by development partners about their activities under the external budget would, over time, allow us to strengthen the alignment of core budget expenditures. The ANDS is expected to be completed by early-mid 2008.

G. Technical Assistance and Statistical Issues

36. **We are committed to improving economic statistics, notably the national accounts, the balance of payments, and social/poverty indicators.** In consultation with international donors, we have streamlined our surveys. We plan to launch the 2007 NRVA by June 2007, which will extend the consumption module of the 2005 NRVA to a larger number of non-food items. Furthermore, we will launch the Integrated Business Enterprise Survey by end-December 2007. The findings of these surveys will help upgrade the social database and serve as a basis for building the national accounts. In addition, with the support of peripatetic Fund technical assistance on balance of payments statistics, we hope to strengthen data collection and coverage over the coming year, with a view to compiling a preliminary balance of payments statement for 2007/08.

IV. PROGRAM MONITORING

37. **The program will be monitored through quantitative performance criteria for September 2007 and indicative targets for June 2007, December 2007, and March 2008.** The third review under the arrangement is scheduled to be completed by January 2008 and will be conditional upon compliance with the end-September 2007 quantitative performance criteria and specified structural conditionality (Tables 1 and 2). Structural benchmarks and performance criteria will continue to focus on improving the financial and fiscal areas, strengthening statistical capacity, and implementing public enterprise reform. The updated Technical Memorandum of Understanding (attached) specifies the details of program monitoring, including definitions of performance criteria and adjusters and data provision requirements.

38. During the program period, Afghanistan will not impose or intensify restrictions on the making of payments and transfers for current international transactions, or introduce or modify multiple currency practices, or conclude bilateral payments agreements inconsistent with Article VIII, or impose or intensify import restrictions for balance of payments purposes.

Table 1. Islamic Republic of Afghanistan: Performance Criteria and Indicative Targets for 2006/07–2007/08 1/
(Cumulative changes from March 20, 2006, unless otherwise indicated)

	Sep. 21, 06		Dec. 20, 2006		Mar. 20, 2007		Jun. 21, 2007		Sep. 21, 2007		Dec. 20, 2007		Mar. 20, 2008		
	Actual Performance	Indicative Targets	Actual Performance	Adjust. Targets	Performance Criteria	Actual Performance	Actual Performance	Indicative Targets 2/	Performance Criteria 2/	Performance Criteria 2/	Indicative Targets 2/	Indicative Targets 2/	Indicative Targets 2/	Indicative Targets 2/ 3/	
Quantitative performance criteria and benchmarks															
Floor on fiscal revenue of the government	11,990	18,668	...	...	17,925	27,015	...	28,788	7,037	14,996	24,310	35,721		
Ceiling on currency in circulation	3,063	4,672	...	...	2,622	7,395	...	5,548	3,012	6,207	7,798	9,435		
Ceiling on net central bank financing of the government	-501	3,252	982	...	-465	4,223	6,399	1,391	-982	2,385	4,148	4,703			
Indicative target (ceiling) on the operating budget deficit of the government, excluding grants	5,234	11,805	...	...	9,534	17,185	...	14,659	5,412	9,902	13,037	14,074		
						(In millions of U.S. dollars)									
Floor on net international reserves of DAB	98.9	69.4	114.9	...	222.0	94.0	50.4	214.0	55.6	45.5	44.9	72.1			
Zero ceiling on contracting or guaranteeing new medium- and long-term nonconcessional external debt by the government and DAB 4/	0	0	...	...	0	0	...	0	0	0	0	0		
Zero ceiling on short-term external debt owed or guaranteed by the government or DAB 4/	0	0	...	...	0	0	...	0	0	0	0	0		
Nonaccumulation of new external payments arrears, excluding interest on preexisting arrears 4/	0	0	...	...	0	0	...	0	0	0	0	0		
Zero ceiling on lending from state-owned banks to enterprises in need of restructuring or government guaranteeing borrowing by these enterprises	...	...	...	...	...	...	...	...	0	0	0	0		
														15	
Memorandum items:															
Operating budget deficit of the government, including grants	2,038	909	...	...	-4,263	-1,410	...	-4,554	1,019	630	-1,114	-5,442		
Reference Projections for the Adjustors															
Core budget development spending	-5,755	20,372	17,280	...	-3,092	35,276	32,243	-3,033	5,512	16,536	27,560	44,096			
External financing of the core budget and sale or transfer of nonfinancial assets	-92	27,972	28,620	...	648	46,464	44,288	-2,176	11,906	24,052	36,449	53,467			
Expenditure currently financed outside the budget moved onto the operating budget	0	0	0	...	0	0	0	0	0	0	0	0			
Additional donor-funded security expenditures 5/	...	...	...	...	...	...	...	...	0	0	0	0		

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

- 1/ The performance criteria and indicative targets and their adjustors, are defined in the Technical Memorandum of Understanding.
- 2/ Cumulative changes from March 20, 2007.
- 3/ Will be converted into performance criteria at the time of the third PRGF review.
- 4/ These performance criteria apply on a continuous basis.
- 5/ The program provides for Af\$ 3,800 million in 2007/08 to be spent at any time, conditional on the availability of donor support.

Table 2. Islamic Republic of Afghanistan: Structural Performance Criteria and Structural Benchmarks, January–November 2007

<u>Second Review Under the PRGF Arrangement</u>		
Structural Benchmarks	Target Dates	Status
Request verification by the Control and Audit Office of the 2006 reviews of the Tashkeel at the Ministry of Interior and Ministry of Education and the related arrears from 2005/06.	January 31, 2007	Implemented
Make a public statement announcing the liquidation of the Export Promotion Bank or its merger with another licensed commercial bank.	January 31, 2007	Implemented
Submit to Cabinet a restructuring plan for Bank Millie.	March 31, 2007	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, 2007	Delayed
Implement an integrated accounting system at DAB's headquarters.	March 31, 2007	In progress 1/
<u>Third Review Under the PRGF Arrangement</u>		
Structural Performance Criteria	Target Dates	Status
Submit to parliament the core budget's audited financial statement for 2006/07.	September 21, 2007 2/	
Structural Benchmarks	Target Dates	Status
Develop a monthly monetary survey in line with international standards.	July 31, 2007	Underway
Clarify the tax policy framework and system, including the difference between the BRT and income taxes.	July 31, 2007	Underway
Prepare (and submit to Cabinet) a restructuring plan for Bank Pashtany, based on the bank's audited financial statement.	August 31, 2007 3/	Underway
Adopt a comprehensive restructuring/divestment plan for the public entities and government agencies engaged in commercial activities but not covered by the SOEs law.	End-September 2007	
Expand the automated integrated accounting system to DAB's six regional hubs.	September 30, 2007	Underway
Issue regulations on credit-granting standards and credit monitoring processes.	November 30, 2007	
Issue regulations setting limits on sectoral loan concentration.	November 30, 2007	

1/ A new accounting system has been introduced at DAB's headquarters, but is not yet operational. The test phase is expected to be completed during the summer of 2007, and the system will be fully operational at DAB's headquarters and the six regional hubs by September 2007.

2/ This deadline is consistent with the requirement stated in the Public Finance and Expenditure Management Law that the core budget financial statements be submitted to parliament at least six months before the end of the fiscal year.

3/ This deadline has been postponed by one month to allow for the completion of the external audit.

TECHNICAL MEMORANDUM OF UNDERSTANDING

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 criterion and benchmarks (Section I), as well as the principal concepts and financial variables, including the quantitative performance criteria and indicators (Section II). It also sets out data reporting requirements (Section III).

I. STRUCTURAL PERFORMANCE CRITERION AND BENCHMARKS

1. The structural performance criterion and benchmarks for the third review specified in Table 2 of the Memorandum of Economic and Financial Policies (MEFP) are defined as follows:

Performance criterion

- **Submit to parliament the core budget's audited financial statements for 2006/07 by September 21, 2007.** The Public Finance and Expenditure Management (PFEM) law requires the government to submit an independent audit report of the core budget financial statements to parliament at least six months before the end of the fiscal year. The report will be prepared by the Control and Audit Office in accordance with international accounting principles.

Structural benchmarks

- **Develop a monthly monetary survey in line with international standards.** The monetary survey should be the consolidation of the accounts of Da Afghanistan Bank (DAB) and of the commercial banks. The data should be presented in the format recommended by the Fund's Monetary and Financial Statistics missions of March 2006, November 2006, and April–May 2007. DAB accounts will include the accounts of its headquarters, as well as those of its branches.
- **Clarify the tax policy framework and system, including the difference between the business receipts tax (BRT) and income taxes.** The framework should describe the nature, role, supporting legislation, and expected contribution to fiscal objectives of the various taxes either currently in effect (e.g., income tax) or planned for the future (e.g., the amendments to the BRT). It should include a plan to clearly distinguish the legal framework that applies to different taxes, either by separating the current framework into different laws or by issuing one tax code with different chapters for different tax types.
- **Prepare (and submit to Cabinet) restructuring plans for Bank Pashtany.** The plan will present the restructuring of the bank with a view to its remaining in the

public domain. The plan should specify and cost the measures that will be put in place to ensure the long-term financial sustainability of the bank, including measures aimed at strengthening management and supervision, enhancing productivity, and modernizing lending policies and procedures.

- **Adopt a comprehensive restructuring/divestment plan for public entities and government agencies engaged in commercial activities but not covered by the state-owned enterprises law.** This restructuring/divestment plan will reflect the necessary steps and tasks entailed by the restructuring/divestment process and a schedule for their implementation. The plan will be adopted by the Cabinet.
- **Expand the automated integrated accounting system to DAB's six regional hubs.**
- **Issue regulations on credit risk management.** The regulations should address credit-granting standards and credit monitoring process. They should also address assessment of asset quality and adequacy of loan loss provisions and reserves. These regulations will be in accordance with Principles 7 and 8 of the Basle Core Principle for Effective Banking Supervision.
- **Issue regulations on setting limits on loan concentration.** This regulation will require bank management to identify concentrations of risk and set prudential limit to restrict bank exposures to a single sector of the economy. This regulation will be in accordance with Principle 9 of the Basle Core Principles for Effective Banking Supervision.

II. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

2. The quantitative performance criteria and indicative targets specified in Table 1 of the MEFP are:

- a floor on fiscal revenue of the central government;
- a ceiling on currency in circulation;
- 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); and
- a ceiling for the operating budget deficit of the central government, excluding grants (indicative target).

A. 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 50.08 Afghanis per U.S. dollar, which corresponds to the average of the US\$/Afs buy and sell cash rates, as reported by DAB as of March 19, 2007. 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, 2007, as reported in the following table. Gold holdings will be valued at US\$653.47 per ounce, the price as of March 19, 2007.

Exchange rate	Program rate
U.S. dollar/Canadian dollar	0.850770
U.S. dollar/U.A.E. dirham	0.272330
U.S. dollar/Egyptian pound	0.175290
U.S. dollar/Euro	1.330750
U.S. dollar/Hong Kong dollar	0.128005
U.S. dollar/Indian rupee	0.022721
U.S. dollar/Pakistani rupee	0.016468
U.S. dollar/Polish zloty	0.343796
U.S. dollar/Iranian rial	0.000108
U.S. dollar/Saudi rial	0.266670
U.S. dollar/Russian ruble	0.038400
U.S. dollar/Swiss franc	0.825490
U.S. dollar/United Kingdom pound	1.944950
U.S. dollar/SDR	1.509310

B. Currency in Circulation

4. **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.¹

C. Net Central Bank Financing of the Government

5. **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.²

D. Net International Reserves

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

7. **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;³ 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).

8. **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,

¹ This definition has been revised to exclude currency from DAB's district branches as reliable and timely currency data from DAB's district branches is now available.

² This definition differs slightly from international standards owing to the unavailability of reliable and timely government deposit data from DAB's branches.

³ 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.

swaps, and options); and all arrears on principal or interest payments to commercial banks, suppliers, or official export credit agencies.

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

E. Revenues of the Central Government

10. **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 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. 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.

F. 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: (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.

13. 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.

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 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.

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 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.

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

16. **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 corporations⁴ 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.

H. Adjustors

17. The floor on NIR and the ceiling on the NCBF of the government are defined consistent with the assumption that core budget development spending will amount, on a cumulative basis from March 20, 2007, to:

June 21, 2007	Afs 5,512 million
September 21, 2007	Afs 16,536 million
December 20, 2007	Afs 27,560 million
March 20, 2008	Afs 44,096 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 the actual level (up to the appropriated amount) and the projected level of development spending.

⁴ 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).

18. 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 20, 2007, to:

June 21, 2007	Afs 11,906 million
September 21, 2007	Afs 24,052 million
December 20, 2007	Afs 36,449 million
March 20, 2008	Afs 53,467 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.

19. 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.

20. Should the central government undertake urgent, security-related, operating expenditures in excess of the fiscal program ceilings, 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 to the extent that these expenditures are executed with the use of additional grants provided by donors, based on spending plans agreed between the central government and the donors. These adjustments will apply starting with the fiscal year 2007/08. The cumulative downward adjustment to the NIR floors at each test date will be capped at US\$76 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 3.8 billion.

21. The overall downward adjustment to the NIR floors will be capped at US\$300 million.

III. 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, and currency in circulation** should be reported monthly and no later than three weeks after the end of the month. Monetary statistics will also include a monetary survey (quarterly, and then monthly starting in March 2007), including balance sheets 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 (AFMIS). 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) information on all

overdue payments on short-term debt, and on medium- and long-term debt, including new external arrears (if any); and (e) total outstanding amount of arrears.

- **National accounts data** should be reported annually 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.