April 2004
IMF Country Report No. 04/110

Islamic State of Afghanistan: Staff-Monitored Program

This paper on the staff-monitored program for the **Islamic State of Afghanistan** was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **March 25, 2004.** The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the **Islamic State of Afghanistan** or the Executive Board of the IMF.

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International Monetary Fund
Washington, D.C.

INTERNATIONAL MONETARY FUND

ISLAMIC STATE OF AFGHANISTAN

Staff-Monitored Program

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

(In consultation with other departments)

Approved by Saleh M. Nsouli and Matthew Fisher

March 25, 2004

- Discussions on a staff-monitored program (SMP) with Afghanistan were held in Kabul during January 25–February 10, 2004 and March 3–13, 2004. The mission met with Vice Presidents Khalili and Arsala, Minister of Finance Ghani, Minister of Foreign Affairs Abdullah, Da Afghanistan Bank Governor Ahady, other senior officials, and representatives of the diplomatic community and international organizations.

- The staff members included Messrs. Bennett (former head), Symansky (current head), Bessaha, Martin (all MCD), and Schneider (PDR). Mr. Farhadi (Advisor to Mr. Mirakhor) participated in some of the policy discussions. The mission was assisted by the resident representative, Mr. de Schaetzen.

- **Last Article IV consultation**. In concluding the 2003 Article IV consultation on November 21, 2003, Executive Directors noted that prudent macroeconomic management had, together with sizable aid and the end of the drought, provided an environment conducive to the resumption of economic growth. They also underscored the need for the international community to remain engaged and for the donors to continue to provide substantial assistance. Directors noted that fiscal discipline required further donor support and revenue-raising measures to ensure the independence of the operating budget in due course. They saw merit in a "lightly managed" float for a country, which remains vulnerable to shocks and is undergoing structural changes and reconstruction. Directors urged the authorities to undertake, with technical assistance from the Fund and other donors, improvements in the statistical database. They were concerned about the risks posed by the opium economy and urged the authorities to intensify eradication, while offering alternative livelihoods and improving security.

- **SMP**. In the Memorandum of Economic and Financial Policies (MEFP) attached to the Letter of Intent (LOI), the authorities have indicated their intention to implement a 12–month SMP covering the Afghan fiscal year starting March 20, 2004, with prior actions, structural benchmarks, and quarterly indicative targets.

- **Program objectives**. The program aims at maintaining financial stability while laying the groundwork for a more comprehensive Fund-supported arrangement under the Poverty Reduction and Growth Facility (PRGF) in due course. The SMP would also seek to strengthen the economic and financial database, reinforce the government's capacity to monitor economic developments, and undertake key structural reforms.

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List of Acronyms

AFMIS	Afghanistan's Financial Management Information System
AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
ARTF	Afghanistan Reconstruction Trust Fund
ASYCUDA	Automated Systems for Customs Data
CIRR	Commercial Interest Reference Rates
CPI	Consumer Price Index
DAB	Da Afghanistan Bank
EPCA	Emergency Post Conflict Assistance
GoA	Government of Afghanistan
IARCSC	Independent Administrative Reform and Civil Service Commission
IC	Inter-ministerial Committee
I-PRSP	Interim-Poverty Reduction Strategy Paper
ISAF	International Security Assistance Force
LOFTA	Law and Order Trust Fund for Afghanistan
LOI	Letter of Intent
MEFP	Memorandum of Economic and Financial Policies
MoF	Ministry of Finance
OECD	Organization for Economic Cooperation and Development
PRGF	Poverty Reduction and Growth Facility
PRR	Priority Reform and Restructuring
PRSP	Poverty Reduction Strategy Paper
SMP	Staff-monitored program
SOE	State-Owned Enterprises
TSA	Treasury Single Account
UNODC	United Nations Office on Drugs and Crime

I. Background

1. **Since end-2001, the Government of Afghanistan (GoA) has focused on crisis management, establishing or rebuilding fundamental institutions and basic government services, and maintaining economic stability with the help of the international community**. With most of these tasks largely achieved, the GoA is now directing its attention to improving macroeconomic management, strengthening its capacity to formulate policy, and creating conditions for sustainable long-term growth as a way to address widespread poverty (Box 1).

2. **In this context, the GoA has requested closer involvement from the Fund**. Its objective is to launch an ambitious program, eventually supported by an arrangement under the Poverty Reduction and Growth Facility (PRGF). The staff supports the authorities' intention to eventually undertake a formal Fund arrangement. The framework that a PRGF would provide for policy reform will be critical in achieving durable structural adjustment and growth. At this juncture, however, weaknesses in institutional and administrative capacity suggest strongly that a staff-monitored program (SMP) is the appropriate first step. Current problems with regard to security, the limited range of central government control, and transparency in policy formulation highlight the need for enhanced technical assistance and capacity building within the framework of a SMP prior to undertaking the obligations associated with a PRGF. Should balance of payments pressures emerge in the interim, however, use of Emergency Post Conflict Assistance (EPCA) could be considered.

3. **The authorities have made significant strides in fiscal and monetary policies**. Together with improvements in budgetary management, important tax policy measures were enacted, an ambitious set of customs reforms introduced, and fiscal policy continued to be guided by the "no-overdraft rule" (no monetary financing of the budget). In the monetary area, the Afghani gained acceptance, and new central bank and commercial banks laws were approved.

4. **The new constitution, adopted by the Loya Jirga and signed into law in January 2004, is a critical step to re-establish a unified state, and strengthen the institutional framework**. This new constitution establishes a strong presidency and a bicameral legislative body. It also opens the way for national elections in 2004.

II. Recent Economic Developments

5. **Real GDP (excluding opium) is estimated to have grown by 23 percent in 2003/04, following 29 percent in 2002/03** (albeit from a very low base—Tables 1 and 2). Growth was particularly high in the construction and service sectors, which benefited from donor assistance, while agricultural production recovered due to increased rainfall, the return of refugees to their lands, and an expansion of cultivated acreage.

Box 1. 2003 Article IV Recommendations and Follow-up

In November 2003, Afghanistan concluded its first Article IV consultation with the Fund in 12 years. Executive Directors welcomed the opportunity to review Afghanistan's economic performance and prospects after such a long hiatus. Directors were particularly encouraged by the authorities' strong commitment to prudent macroeconomic policies and management. On fiscal policy, Directors supported efforts to put in place revenue-raising measures to reduce the dependence of the operating budget on donor assistance. They supported measures to broaden the source of revenue through tax policy and customs reform and improved collection. They regarded prudent monetary policy supported by strong fiscal discipline, including the "no-overdraft rule" for budget financing, as instrumental in ensuring the stability of the exchange rate. They supported the staff's view that a "lightly managed" float was appropriate for a country undergoing structural changes and reconstruction, but cautioned against using a narrow or rigid target range for the exchange rate.

On structural reforms, Directors encouraged a process of meaningful civil service reform, including the civil service wage system. They supported the authorities' commitment to a liberal trade and exchange regime, welcomed progress toward the integration of donor projects into the development budget, and commended the authorities' progress in financial sector development and supervision. Directors remained concerned, however, about the serious risks posed by the rise in poppy cultivation and the production of opium in Afghanistan, and urged the authorities to intensify eradication programs and to provide farmers with alternative livelihoods.

In the short period since the Article IV report, the authorities have continued to move forward with their reform agenda, making progress in many areas recommended by Directors. **The "no-overdraft rule"** has again been adopted as a pillar of the 2004/05 budget. The use of **market exchange rates in customs valuation and a new streamlined tariff structure** were adopted in early February 2004 and came into effect on March 20, 2004. A package of **new revenue measures** was enacted, including a final wage withholding tax on higher-income employees, an improved income tax regime, a streamlined business establishment tax, a tax on a limited range of services consumed by high-income earners (e.g., telecomunications, air travel, hotels, and restaurants), and other revenue measures (rent tax, land tax, and an airport departure fee). Collection of provincial revenue, while improving, is still a difficult issue, however. **Monetary policy has continued to be prudent**, with an increasingly regular regime of foreign exchange auctions to retain control over currency in circulation and ensure low inflation and a relatively stable exchange rate. **Progress is ongoing in civil service reform**, and the authorities have set a target of 30,000 employees to be transferred to new pay scales by the end of 2004/05. **Five new banks** have received operating licenses from the Da Afghanistan Bank (DAB), adding considerable depth to the financial sector. With regard to opium activity, the government has **established an Anti-Narcotics Directorate and adopted a National Drug Control Strategy** that aims to reduce opium production by 70 percent by 2008, and eliminate it altogether within 10 years.

Building on the progress made, the authorities now intend to broaden their reform effort under the SMP. In line with the recommendations of the Fund, the authorities are determined to continue the progress on macroeconomic management, including an ambitious revenue target, important measures to enhance fiscal transparency and management, and maintenance of price stability while allowing for sufficient money growth. Further reform and modernization of the financial system will also be key benchmarks, as well as a range of other structural reforms. The authorities' goal is to establish, through successful implementation of the SMP, an adequate track record toward a possible PRGF arrangement, with full donor support.

6. **This strong performance was accompanied by an equally strong resumption of opium production, which is estimated to be equivalent to 40 percent of formal GDP**.[1] The GoA has passed broad anti-narcotics legislation, banning all opium production and trading. It has established an Anti-Narcotics Directorate and adopted a National Drug Control Strategy that aims to reduce opium production by 70 percent by 2008, and eliminate it altogether within 10 years.

7. Consumer prices rose **by 3 percent in both November and December 2003**, mainly driven by increases in food prices, which were associated with Ramadan and colder than usual weather at year-end. Prices in January and February 2004 fell modestly, with year-on-year inflation for 2003/04 projected at 9 percent, down from 52 percent in 2002/03.

8. **Currency in circulation is estimated to have grown by 35 percent in 2003/04, slightly more than envisaged under the indicative monetary program agreed with Fund staff** (Table 3). The rate of monetary expansion varied widely from quarter to quarter, reflecting volatility of money demand, seasonal factors, and the level of DAB interventions. In the absence of more sophisticated instruments, DAB continued to control the money supply (currency in circulation) through the auction of foreign currency to money market dealers.[2] DAB's foreign exchange reserves reached an estimated $773 million at end-2003/04, equivalent to three months of imports.

9. **Due to lower-than-projected expenditures, the 2003/04 operating budget deficit was estimated at $240 million, much lower than the budgeted $350 million** (Table 4). Domestic revenues are expected to have reached the Af 9 billion budgetary target, reflecting strong economic growth and a significant improvement in tax collection.[3] Although the target was achieved, some of the revenue reflects one-off transfers of bank balances from provincial accounts.[4] However, this points to the progress achieved in ensuring the transfer of domestic revenue from the provinces to the Treasury Single Account (TSA). These transfers increased from Af 0.9 billion in 2002/03 to over Af 6.5 billion in 2003/04. Expenditures, at about

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[1] This estimate is based on "*Afghanistan, Opium Survey 2003*," UNODC, October 2003.

[2] Domestic currency is pumped into the economy as the GoA draws down its domestic bank balances, which are built up from conversion of foreign assistance.

[3] In US dollar terms, however, and due to the depreciation of the Afghani vis-à-vis the US dollar, domestic revenues were slightly lower than budgeted.

[4] During the first quarter of 2003/04, the Herat provincial branch of the ministry of reconstruction purchased directly services rather than use the government's expenditure system. The authorities in Herat reported that most of these purchases (amounting to $25 million) were funded with revenues collected locally during the first quarter; however, in all likelihood, much of these revenues accrued during previous years.

$430 million, were substantially lower than envisaged by the budget ($550 million), notably in education, defense, and national security. Low levels of spending were prevalent in the first part of the year, reflecting delays in budget allotments and difficulties in procurement. While donor grant disbursements, which amounted to an estimated $270 million, were lower than envisaged in the budget, they were more than sufficient to finance the budget deficit, allowing some carry-over of available financing for the 2004/05 budget. Donor commitments for 2003/04 covered about 70 percent of the requirements expressed in the National Development Budget. As a result, the GoA was able to implement high-priority projects in infrastructure, education, and other critical areas.

10. Data on **external sector developments** are extremely limited, reflecting the poor condition of the statistical reporting system after two decades of neglect.[5] However, available information suggests that the formal balance of payments was in surplus in 2003/04, resulting in a sizable increase in reserves (Table 5). A current account deficit, equivalent to about 3.4 percent of GDP, was funded mainly by official transfers, some private capital flows, and modest levels of highly concessional borrowing from the World Bank and the Asian Development Bank.

III. Policy Discussions

11. Notwithstanding the significant achievements already made, the GoA is faced with several challenges, including security, the opium economy, limited capacity, a fledgling private sector, low domestic revenue, and unpredictable aid flows. The GoA intends to address these issues by pursuing and intensifying macroeconomic and structural reforms.

12. **The SMP will aim at maintaining financial stability while laying the groundwork for a more comprehensive Fund-supported arrangement under the PRGF**. The SMP would also seek to strengthen the economic and financial database, reinforce the government's capacity to monitor economic developments, and undertake key structural reforms. Performance under the program will be monitored using quarterly indicative targets, structural benchmarks, and reviews (paragraph 41, Tables 1 and 2 of the MEFP).

A. Fiscal Policy

13. **The 2004/05 operating budget adopted by Cabinet on March 18 provides for a substantial increase in outlays** to $609 million (equivalent to 11 percent of GDP). This increase reflects the enormous needs in education, social protection, and security, as well as the GoA's increasing capacity to deliver public services. Part of the increase in expenditures reflects $15 million (0.3 percent of GDP) for a recently adopted increase in pension payments to retired civil employees. The pension increase is viewed as a temporary measure, pending

[5] Improving data collection and analysis for the balance of payments will be a priority, and a peripatetic advisor has been identified to assist the authorities in this area.

the implementation of long-term reform, aimed at helping one of the poorest and most vulnerable parts of the population. The authorities are working with the World Bank on the design of a sustainable solution. Domestic revenue is budgeted to reach $300 million, a 50 percent increase over 2003/04, leaving $309 million to be covered by foreign assistance and carry-over from funds in the government's bank balances. The increase in revenue would result from a range of tax policy, tax administration, and customs reforms. A list of high-priority development projects will be submitted to the donors at the Berlin conference. The development budget, which is expected to be adopted before the Afghanistan Development Forum scheduled in mid-April, will only include those projects for which assured financing has been identified.

14. **The authorities recognize that the domestic revenue target included in the 2004/05 operating budget is very ambitious**, and will require the full implementation of envisaged customs and tax reforms, and considerable progress in tax collection, particularly in the provinces. The most immediate concern regarding revenues, however, is that tax holidays and concession agreements have largely eroded the tax base.[6] The authorities recognize that this problem must be addressed if the government is to achieve the 2004/05 revenue target. The Cabinet has passed a resolution to reexamine existing tax concessions and holidays and redraft legislation to preclude further erosion and enhance the tax base. Staff considers that the government revenue target is still achievable but constitutes more of a high case than a baseline scenario. Accordingly, the domestic revenue targets were set in line with staff projections ($256 million, see Box 2). The authorities also recognized that the 2004/05 budget depends on funding that will not be known until after the Berlin donors conference. However, the authorities argued that lower domestic or grant revenue will not result in bank financing as the budget will again be governed by the "no-overdraft rule."[7] The ministry of finance (MoF) has also indicated to ministries that expenditure adjustments will be made as part of a mid-year budget review if revenues fall short. A quarterly review process is also being implemented to help guide ministries and prepare the ground for corrective actions.

15. **The authorities argued that, in a first phase, consolidation of the operating and development budgets would be limited to development projects channeled through the treasury**. Staff agreed with the authorities that the current lack of timely and reliable

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[6] No quantitative estimates are available about the budgetary costs of these tax holidays and concessions, but the revenue authorities indicate that most taxpayers have been granted these holidays.

[7] The authorities are committed not to borrow from the banking system, including the commercial banks, in 2004/05. The SMP includes a quantitative indicator related to claims of the banking system on the central government, which is meant to prevent borrowing by government from state-owned banks.

Box 2. Sources of Domestic Revenue

Projecting domestic revenues in post-conflict countries is frequently a difficult exercise, clouded in the uncertainty of a rapidly changing environment. Particularly for Afghanistan, where such issues as security, control over provincial transfers, and significant tax policy reforms cloud the outlook, the precision of a revenue forecast will always be in question. Furthermore, the lack of reliable information also affects the quality of the staff's estimates. There was little information regarding the structure of dutiable imports or domestic taxpayers. Staff's projection for domestic revenues of $256 million during 2004/05 is set against this backdrop, but is made on the best information available, and follows the same assumptions as the authorities' estimate (differing only on the expected effectiveness of implementation). A breakdown of expected revenues is shown below.

Afghanistan: Sources of Domestic Revenue in 2004/05

(In millions of U.S. dollars)

Revenue base, 2003/04	177
Impact of economic growth	19
Tax administration reform	21
Tax policy reform	14
Customs reform	26
Total domestic revenue, 2004/05	256

Revenue base: The revenue base differs from the $190 million noted in the MEFP and the staff report, and reflects a downward adjustment to account for one-off revenues. From the $190 million figure, $18 million is subtracted to reflect collections from Herat province in the first quarter, and $5 million in customs duty is added to adjust for disruptions linked to the temporary implementation of tariff reforms during the fourth quarter.

Tax administration reform*:* Measures to improve tax administration focus mainly on enforcement and compliance. Also important, however, are such developments as the establishment of a Large Taxpayer Unit (LTU) within the MoF and improved provincial transfers.

Tax policy reform*:* Key changes to the tax structure include a final wage withholding tax on higher-income employees, an improved income tax regime, a streamlined business establishment tax, a tax on a limited range of services consumed by high income earners, a rent tax, land tax, and airport departure fee.

Customs reform*:* The government has enacted a sweeping reform of trade taxes, including the use of market exchange rates for import valuation, a streamlined tariff structure (moving from 25 tariff rates to six), a reduction in tariff dispersion (the old system had rates ranging from 0–150 percent, while the new system ranges from 2.5–16 percent), and establishing new, more effective broker processes.

information from donors on other development projects was an impediment to budget consolidation. Staff encouraged the authorities to work with the donors on improving reporting, in particular regarding actual expenditures. Staff agreed with the authorities that the channeling of more donor money through the Afghanistan Reconstruction Trust Fund (ARTF) would substantially contribute to the improvement of budget monitoring, and reduce the uncertainty related to donor financing.

16. **Based on previous staff recommendations, the GoA is committed to establishing a TSA**. Consolidating all of the government's operating budget accounts will significantly enhance cash management, expenditure control, and fiscal reporting. The authorities explained that they encountered some unexpected implementation problems and that the initial timetable discussed with the Fund staff was not achievable. Subsequently, the MoF and DAB collaborated on an action plan aimed at resolving complicated ownership issues, and instituting procedures to regularly transfer all revenue balances to the main government account at DAB.

B. Monetary and Exchange Rate Policy

17. The authorities agreed with staff's assessment that macroeconomic conditions and special factors (such as the low degree of monetization in a highly dollarized economy, as well as a very large unmeasured drug economy) affecting monetary variables are extremely difficult to predict, and that a flexible approach should be taken toward monetary policy, rather than adherence to a strict set of policy rules. As the Afghan economy moves through reconstruction and sizable structural adjustments, it will be critical for both staff and the authorities to continually review relationships between money demand, inflation, and the exchange rate, with a view to developing a more effective monetary policy. Therefore, while monetary targets are set under the SMP, an additional degree of flexibility is provided for currency growth, underpinned by a mechanism for close consultation with Fund staff to guard against excessive inflationary pressures.

18. **The authorities' monetary program for 2004/05 is geared toward maintaining price stability**, while allowing for sufficient growth of currency to accommodate the increase in money demand stemming from growth in nominal income (20 percent) and continued monetization (an additional 5 percent, Table 3). DAB will also seek to avoid large fluctuations in the exchange rate, but will not adhere to a rigid target for the Afghani vis-à-vis the U.S. dollar. To provide for flexibility, the program will allow for currency growth of up to 31 percent—5 percent above the program target. However, if currency growth appears to jeopardize the quarterly target consistent with the 26 percent growth rate, the government will discuss developments with the staff, with a view to assessing the implications for price and exchange rate stability, and potentially an adjustment to the remaining quarterly indicative targets. Currency outturns consistent with rates of growth over 31 percent, however, will trigger a formal consultation with staff.

C. External Sector Policy

19. **DAB's reserves, equivalent to three months of prospective imports and roughly 136 percent of currency in circulation, are deemed broadly adequate given the government's commitment to a flexible exchange rate driven by market forces**. As the DAB has no monetary policy instruments other than foreign exchange auctions, however, the indicative targets for growth of currency in circulation imply a path for international reserves. Assuming program targets are met, international reserves could grow by as much as $111 million during 2004/05, to a level consistent with 3.5 months of import cover. To ensure flexibility (i.e., a tighter monetary policy), however, indicative targets for international reserves under the SMP are set along a somewhat lower path, implying a total buildup of $55 million over the program period, to a level equivalent to 3.3 months of imports.

20. **Indicative targets and conditions related to external borrowing have also been established under the SMP**. Given the potential fragility of Afghanistan's economic recovery and extremely limited foreign exchange resources, a careful watch on accumulation of external liabilities must be maintained to ensure medium-term sustainability.[8] The authorities indicated that they are even concerned about the build-up of concessional borrowing. Therefore, they are committed to avoid nonconcessional borrowing of any kind, and ensure that loans that are contracted have a sufficiently high level of concessionality (a grant element of at least 60 percent) so as to maintain medium-term fiscal and debt sustainability. The authorities established a debt management unit within the MoF, which is currently engaged in identifying and reconciling outstanding obligations to bilateral creditors. Moving forward, this unit will be critical in formulating a medium-term government debt management strategy.

D. Structural Reforms

21. **The authorities are engaged in an ambitious structural reform agenda to diversify economic activity, promote private sector development, enhance good governance, and address widespread poverty and weak social indicators**. Structural reform is of critical importance in the restoration of macroeconomic stability in post-crises countries. Key areas include civil service reform (particularly decompression of civil service wages), privatization, the establishment of a sound investment climate, and improvements in basic education and primary health care. The World Bank and other multilateral development banks will have the lead in these areas (the World Bank's Emergency Post-Conflict Facility contains a number of benchmarks to ensure progress in the social sector and civil service employment). Financial sector reforms, and in particular the relicensing process for the six state-owned banks, will be

[8] See "Islamic State of Afghanistan – Debt Sustainability Analysis."

a critical test of the government's ability to deliver on politically difficult measures, and will be monitored under the SMP.[9]

E. Program Risks and Monitoring

22. **The Afghan authorities have already demonstrated a solid track record**. Nevertheless, there are several risks to successful implementation of the SMP. Perhaps the first and foremost relates to administrative capacity. The Afghan authorities have made tremendous progress in setting up a framework for macroeconomic and financial management in the past two years. The desire to enter into a Fund program highlights the GoA's continued ambition in this area. Nevertheless, administrative resources in the government remain shallow at this juncture, and there is a high degree of dependence on international advisors. Statistical capacity necessary for program reporting is insufficient in some areas, and one objective of the SMP is to address the most serious deficiencies.

23. **Afghanistan has established the legal framework for a strong central government authority, but central government control outside of Kabul remains limited**. The SMP has benchmarks dependent on cooperation of the provinces, and the quantitative indicators also build on this control. This will severely test the Afghan government.

24. **Transparency in policy formulation is another potential pitfall.** The authorities have demonstrated a laudable degree of commitment to transparency and have provided a remarkable amount of information in light of current circumstances. However the government is new, and few of the key policy officials have any previous government experience. Communication between government agencies is thus sometimes less than smooth, and information on policy changes does not always reach all points. Further, given the highly politicized nature of the policy making process, there is a danger that the authorities may fail to make staff aware of developments that impinge on the SMP. The onus will be on both the authorities and staff to ensure a clear and consistent dialogue.

25. **There is substantial uncertainty regarding the revenue impact of tax and customs reforms**, especially in light of the erosion of the tax base resulting from tax holidays and concessions agreements. If not addressed in a full and timely manner, this could lead to revenue shortfalls and ad hoc and potentially counterproductive expenditure cuts and possibly arrears.

26. **Other potential program risks relate to areas largely outside the authorities' control**. Political difficulties and reform fatigue have the potential to undermine the needed consensus for key measures—particularly as Afghanistan approaches its first elections. There

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[9] The relicensing process is in line with the 2003 *Law of Banking in Afghanistan*. Under this law, all banks, including the six state-owned banks, which were already in possession of a valid banking license issued by DAB, had to file applications for relicensing before March 16, 2004.

is no assurance that the post-election government will have the same degree of commitment to reform as the current leadership. The security situation is another genuine concern, as the GoA and International Security Assistance Force (ISAF) grapple to bring order to many parts of the country. Uncertainty regarding donor support is also a risk. With donors providing large amounts of technical and financial assistance, a significant decline in donor support could jeopardize the GoA's ability to meet program benchmarks and targets. Finally, and as repeatedly highlighted by the authorities, the destructive influence of poppy cultivation and opium production could undermine the progress made thus far and severely diminish prospects for future reform. Conversely, elimination of poppy, without successful introduction of alternatives to replace this large component of income, could have significant negative consequences.

27. **Because of these risks, the staff will closely monitor program execution, using quarterly indicative targets, structural benchmarks, and quarterly reviews** (Tables 1 and 2 of the MEFP). Looking forward, the staff will discuss with the authorities an appropriately ambitious set of structural benchmarks for end-December 2004 and end-March 2005 at the time of the first review.[10]

28. **The staff had extensive discussions with the donor community about the objectives of the SMP**, the prior actions, the quantitative targets, the structural benchmarks, and the quarterly monitoring of the program. The donors responded favorably to the adoption of a SMP, particularly as an adequate framework for government policy coordination and much needed capacity building. **The donors established their own benchmarks for the Berlin conference and with the government's consent**, incorporated some aspects of the SMP as part of their conditionality for future support.[11] During the discussions, none of the donors indicated that they were expecting financial support from the Fund at this juncture. The staff will remain in close touch with the donor community and other groups with a critical stake in the reconstruction process.

29. **In the context of the SMP, additional technical assistance will be provided by the Fund,** focused on improving the country's capacity to implement policies and monitor macroeconomic developments. In addition to the recent posting of a resident treasury adviser at the MoF and peripatetic visits by a multisector Statistics Department expert, a resident expert to DAB on monetary policy is expected to be assigned soon. Technical assistance missions are planned on tax policy, tax administration, customs administration, balance of

[10] The first review under the SMP is expected to take place in the second half of July 2004 and will assess performance during March 21–June 21.

[11] Donors' conditionality mainly focuses on areas outside the purview of Fund activity, including, inter alia, free and fair elections, security, and the rule of law. However, revenue benchmarks were designed to be consistent with the SMP.

payments statistics, Anti-Money Laundering and Combating the Financing of Terrorism (AML/CFT) and foreign exchange legislation, and a Monetary and Financial Systems Department expert will assist DAB with asset valuation.

IV. Staff Appraisal

30. **Afghanistan has made excellent progress in a short period and under difficult circumstances**. The accomplishments of the GoA in restoring basic services and setting up the framework for effective macroeconomic and financial management have been impressive. Much remains to be done, however, and the authorities' desire to enter into a closer working relationship with the Fund—despite limited administrative capacity—is indicative of their commitment to moving the reform and reconstruction process forward.

31. **Staff welcomes the authorities' intention to continue and broaden its adjustment and reform effort under a one-year SMP**. The goal is to consolidate the initial stabilization gains, broaden the government's capacity in macroeconomic and financial management, and establish a strong track record toward a possible PRGF arrangement. In this regard, the staff indicated to the authorities the need to initiate work on an interim-PRSP (I-PRSP) as a first step toward a PRGF. Together with the World Bank, the staff will follow-up on this during its next mission. The staff welcomes the government's intention and fully supports the authorities' request for a SMP, as well as their intention to make the MEFP and supporting documents publicly available. Further, the establishment of the Inter-ministerial Committee should help address some of the shortcomings in the current policy-making environment.

32. **Structural adjustment, geared toward building the government's budgetary and expenditure management capacity, increasing domestic revenue, enabling a strong and effective financial system, and building statistical capacity in key areas is at the heart of the SMP**. The GoA has worked closely with the staff in developing this program, and has already demonstrated its ability to make politically difficult but crucial structural reforms. This capacity will again be put to the test in the coming months.

33. **Raising the provision of government services is a key objective, and a worthwhile goal given the extremely low level of social sector indicators**. The budgeted increase in government expenditure in 2004/05 is thus appropriate. Accomplishing this task in the context of a sustainable medium-term fiscal program, however, will require close adherence to the range of tax policy and administrative measures outlined in the SMP and MEFP.

34. **The authorities deserve credit for achieving their revenue target for 2003/04 — which staff had viewed with skepticism—and for improvements to the budgetary process**. Staff supports the GoA's ambitious target for domestic revenue in 2004/05, and believes this is an achievable goal provided that the extensive tax holidays and tax concessions are eliminated. This will require overcoming entrenched and powerful financial interest and legal hurdles. The lower indicative revenue target established in the SMP—which is ambitious in its own right—simply reflects staff's experience with implementation

issues, and should not be considered as questioning the government's commitment. Critically, the MoF has set up expenditure implementation procedures that allow for changes in spending authority as conditions warrant, and protect against monetary financing of the budget.[12]

35. **The monetary program is the product of considerable discussion on the uncertainties facing the economy**. The flexibility contained in the 2004/05 monetary program reflects the genuine difficulty in predicting the behavior of fundamental variables—inflation and money demand in particular—in a post-conflict environment. The staff believes that the structure of the program, and especially the triggers for consultations on economic and monetary developments, is entirely appropriate in the current context.

36. **Development of a sound financial system will be key to reconstruction, and the staff attaches considerable weight to measures contained in the SMP in this area**. Staff views as essential that the GoA adheres to the timeline and procedures outlined in the central bank and commercial banking laws regarding the licensing process for the six state-owned banks, including the provisions for closure and resolution, if applications are rejected.

37. **The staff supports the authorities' cautious approach to external debt**. Given the uncertainties surrounding the balance of payments—most particularly the effect of the opium economy—the government's commitment to refrain from borrowing on all but the most concessional terms is welcome. The provisions contained in the SMP represent the first step toward developing a more formal, medium-term debt management framework.

38. **The authorities have established an Inter-ministerial Committee** to coordinate government action and promote macroeconomic and structural reforms in the context of the SMP. The establishment of this institution, assisted by a technical committee in charge of coordinating the implementation of the SMP, is a positive step in improving macroeconomic management and bodes well for ownership of the reform program.

39. **Overall, the authorities' program represents an ambitious, but critical and achievable set of reforms and policies**. The authorities have already demonstrated a strong commitment to adjustment, even under difficult circumstances. Further strong performance under the indicative targets and benchmarks of the SMP will be essential in establishing the track record and capacity to move to a program supported under the PRGF.

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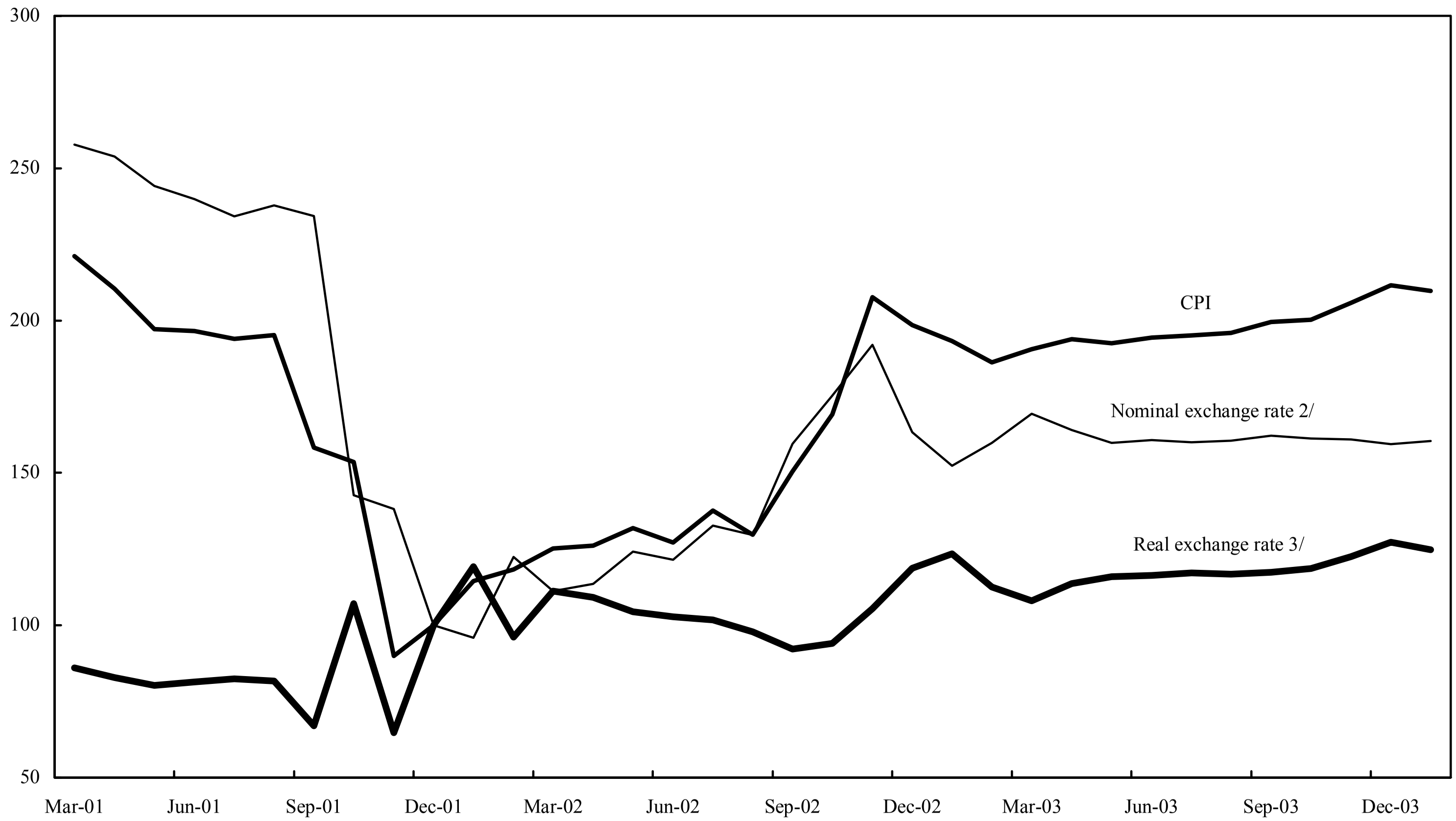
[12] The budget department will conduct regular reviews of the budget outturn. The results of these budgetary reviews, combined with an update of available financing, will help determine if a reallocation of resources is warranted during the mid-year budget review.

Figure 1. Islamic State of Afghanistan: Price and Exchange Rate Indices, 2001–03 1/
(December 2001 = 100)



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

1/ Last observation: January 2004.
2/ The nominal exchange rate represents Afghanis per U.S. dollar. An increase in the index corresponds to a nominal depreciation of the Afghani.
3/ The real exchange rate is evaluated in U.S. dollar per Afghani. An increase in the index corresponds to a real appreciation of the Afghani.

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

	2001/02 Est.	2002/03 Est.	2003/04 Init. 2/ Proj.	2003/04 Rev. Proj.	2004/05 Proj. SMP
I. Economic and Financial Indicators					
Production					
GDP (in millions of U.S. dollars, excluding opium production)	2,463	4,048	...	4,704	5,577
GDP (in millions of new Afghani)	133,987	181,350	271,373	230,962	277,950
Real GDP growth (in percent)	...	29	20	23	15
GDP per capita (in U.S. dollars)	123	186	...	207	236
Opium production (metric tons)	185	3,400	3,600	3,600	3,600
Opium value (in millions of U.S. dollars)	...	2,540	2,320	2,320	2,320
Consumer prices					
CPI (Kabul, percentage change year-on-year)	-43.4	52.3	14.9	9.0	5.0
CPI (Kabul, percentage change on average)	...	5.2	24.7	24.0	5.0
	(In millions of U.S. dollars, unless specified otherwise)				
General government recurrent budget					
Revenues	...	132	200	190	256
Expenditures	...	349	550	430	609
Donor grants and loans	...	209	350	247	300
Revenues (in percent of non-opium GDP)	...	3.3	...	4.0	4.6
Expenditures (in percent of non-opium GDP)	...	8.6	...	9.1	10.9
Monetary indicators					
Domestic currency in circulation (annual percentage change)	...	20.1	30.0	35.5	26.4
Gross foreign exchange reserves (in millions of U.S. dollars)	...	426.0	564.6	772.6	883.6
	(In millions of U. S. dollars, unless specified otherwise)				
External sector					
Exports of goods (including reexports)	1,657.4	2,241.2	...	2,778.6	2,362.2
Imports of goods	2,531.1	3,550.7	...	4,388.0	4,682.8
Current account deficit	...	-1,413.7	...	-1,818.2	-2,770.6
Current account deficit (including grants, in percent of GDP)	...	-4.7	...	-3.4	-4.8
Afghani/U.S. dollar (average during solar year)	54.4	44.8	...	49.0	...
Afghani/U.S. dollar (end-solar year)	31.0	52.6	...	50.3	...
	(In percent of GDP)				
Investment and savings					
Gross investment	...	19.8	...	34.0	43.3
Domestic savings	...	-15.2	...	-4.6	-6.4
II. Social and Demographic Indicators					
Area	652,000 square kilometers				
Population (2002/03)	21.8 million				
Life expectancy at birth (2001)	42.8 years				
Infant mortality per 1,000 live births (2001)	165				
Under-five mortality per 1,000 live births (2001)	257				

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

1/ The Afghan solar year 1383 runs from March 20, 2004 until March 20, 2005.

2/ IMF Country Report No. 03/391; December 22, 2003.

Table 2. Islamic State of Afghanistan: Gross Domestic Product at Current Prices, 2002/03–2007/08

	2002/03 Est.	2003/04 Proj.	2004/05 Proj.	2005/06 Proj.	2006/07 Proj.	2007/08 Proj.
	(In millions of U.S. dollars)					
Consumption	4,662	4,922	5,934	6,974	8,134	9,465
Public	318	394	558	716	879	1049
Private	4344	4528	5376	6258	7255	8416
Gross fixed capital formation	800	1,600	2,413	2,185	2,009	1,922
Public	750	1500	2286	2051	1870	1767
Private 1/	50	100	127	134	139	155
Domestic expenditures	5,462	6,522	8,347	9,159	10,143	11,387
Net exports of goods and services 2/	-1,414	-1,818	-2,771	-2,603	-2,522	-2,527
Exports of goods and services 3/	129	180	301	387	517	680
Imports of goods and services	-1,542	-1,998	-3,072	-2,990	-3,039	-3,207
Domestic savings 4/	-614	-218	-357	-418	-514	-605
Public savings 5/	-187	-205	-302	-383	-464	-547
Private savings	-427	-13	-56	-35	-50	-58
GDP at market prices	4,048	4,704	5,577	6,556	7,621	8,860
	(In percent of GDP)					
Consumption	115.2	104.6	106.4	106.4	106.7	106.8
Public	7.9	8.4	10.0	10.9	11.5	11.8
Private	107.3	96.3	96.4	95.5	95.2	95.0
Gross fixed capital formation	19.8	34.0	43.3	33.3	26.4	21.7
Public	18.5	31.9	41.0	31.3	24.5	19.9
Private	1.2	2.1	2.3	2.0	1.8	1.8
Domestic expenditures	134.9	138.7	149.7	139.7	133.1	128.5
Net exports of goods and services	-34.9	-38.7	-49.7	-39.7	-33.1	-28.5
Exports of goods and services	3.2	3.8	5.4	5.9	6.8	7.7
Imports of goods and services	-38.1	-42.5	-55.1	-45.6	-39.9	-36.2
Domestic savings	-15.2	-4.6	-6.4	-6.4	-6.7	-6.8
Public savings	-4.6	-4.4	-5.4	-5.8	-6.1	-6.2
Private savings	-10.5	-0.3	-1.0	-0.5	-0.7	-0.7
Memorandum items:						
Real GDP growth	28.6	23.2	14.6	12.0	10.9	10.9
Nominal GDP growth	33.8	27.4	20.3	17.6	16.3	16.3
Sectoral shares of GDP						
Agriculture	52.0	51.9	51.6	51.6	50.6	50.7
Industry	24.0	23.6	25.9	25.9	24.8	25.2
Services	21.8	22.0	22.0	22.0	24.0	24.0
GDP per capita (in U.S. dollars)	180.8	204.6	236.2	269.5	304.2	343.4
Consumption per capita	208.2	214.1	251.3	286.7	324.7	366.8

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

1/ Equivalent to foreign direct investment reported in the balance of payments.
2/ Equivalent to the current account deficit, excluding grants.
3/ Domestic exports of goods and services. Excludes reexports.
4/ Defined as GDP minus consumption.
5/ Defined as taxes minus public consumption.

Table 3. Islamic State of Afghanistan: Monetary Program (Da Afghanistan Bank), 2002/03–2004/05

	2002/03	2003/04						2004/05				
	Est.	Est.				Init. Proj 1/	Proj.	Prog.				
	Mar. 20	Jun. 21	Sep. 22	Dec. 21	Feb.19	Mar. 20	Mar. 20	Mar. 20	Jun. 20	Sep. 21	Dec. 20	Mar. 20
	(In millions of Afghanis)											
Net foreign assets 2/	19,602	24,031	26,158	32,653	33,253	25,971	32,407	38,506	39,863	41,344	42,958	44,039
Foreign assets	19,602	24,031	26,158	32,653	33,253	25,971	32,407	38,506	39,863	41,344	42,958	44,039
Foreign exchange reserves	19,602	24,031	26,158	32,653	33,253	25,971	32,407	38,506	39,863	41,344	42,958	44,039
Gold	9,030	9,030	9,030	9,030	9,030	9,030	9,030	13,177	13,177	13,177	13,177	13,177
Other	10,572	15,001	17,128	23,624	24,223	16,942	23,378	25,329	26,686	28,168	29,781	30,863
Other foreign assets	0	0	0	0	0	0	0	0	0	0	0	0
Foreign liabilities	0	0	0	0	0	0	0	0	0	0	0	0
Net domestic assets	1,074	-3,691	-1,056	-6,286	-5,768	912	-4,397	-10,495	-10,025	-9,560	-9,099	-8,645
Domestic assets	14,361	10,433	11,344	8,300	7,950	14,951	9,321	8,917	9,476	10,034	10,592	11,151
Net claims on general government	14,361	10,433	11,344	8,300	7,950	14,951	9,321	8,917	9,476	10,034	10,592	11,151
Net claims on government before 2002/03 (SY 1381)	14,951	14,951	14,951	14,951	14,951	14,951	14,951	14,951	14,951	14,951	14,951	14,951
Net claims on government in 2002/03-2004/05 (SY 1381-83)	-590	-4,518	-3,606	-6,650	-7,001	0	-5,630	-6,033	-5,475	-4,917	-4,358	-3,800
Domestic currency deposits	-344	-975	-1,364	-1,140	-1,874	0	-800	-800	-800	-800	-800	-800
Foreign currency deposits	-245	-3,543	-2,243	-5,510	-5,126	0	-4,830	-5,233	-4,675	-4,117	-3,558	-3,000
Claims on nonbank public institutions	0	0	0	0	0	0	0	0	0	0	0	0
Claims on deposit money banks	0	0	0	0	0	0	0	0	0	0	0	0
Other items net	-13,287	-14,124	-12,401	-14,587	-13,718	-14,039	-13,718	-19,413	-19,501	-19,594	-19,692	-19,796
Reserve money	20,676	20,340	25,102	26,367	27,485	26,883	28,011	28,011	29,838	31,785	33,858	35,395
Afghanis in circulation	20,676	20,340	25,102	26,367	27,485	26,883	28,011	28,011	29,838	31,785	33,858	35,395
Banknotes and coins issued	21,302	21,302	25,302	27,392	28,642	27,683	28,811	28,811	30,638	32,585	34,658	36,195
Less cash holdings	626	962	200	1,025	1,157	800	800	800	800	800	800	800
Bank reserves	0	0	0	0	0	0	0	0	0	0	0	0
	(In percent, unless indicated otherwise)											
Memorandum items:												
Reserve money growth (quarterly)	8.0	-1.6	23.4	5.0	4.2	6.8	6.2	6.2	6.5	6.5	6.5	4.5
Reserve money growth (YTD)	...	-1.6	21.4	27.5	32.9	30.0	35.5		6.5	13.5	20.9	26.4
Reserve money growth (annual)	20.1	…	...	37.7	37.6	30.0	35.5	35.5	46.7	26.6	28.4	26.4
Gross international reserves (millions of U.S. dollars)	426.1	522.4	568.7	709.9	722.9	564.6	704.5	772.6	799.8	829.5	861.9	883.6
Inflation (quarterly; Kabul)	-4.0	2.0	2.6	6.0	1.8	5.3	-1.8	...	1.2	1.2	1.2	1.2
Inflation (twelve-month; Kabul)	52.3	52.9	32.6	6.6	12.5	14.9	9.0	...	...	...	...	5.0

Sources: All figures are Fund staff estimates based on available data in Da Afghanistan Bank and the Central Statistics Office.

1/ Monetary program devised by the monetary authorities and discussed with Fund staff in early 2003.

2/ Foreign currency amounts converted into Afghani at the program exchange rate (Af 46/$1 in 2003/04 and Af 49.84/$1 in 2004/05); gold valued at $279 per ounce in 2003/04 and $400 per ounce in 2004/05.

Table 4. Islamic State of Afghanistan: Operating Budget, FY 2002/03–2006/07

	2002/03	2003/04					2004/05	2005/06	2006/07
	Est.	Budget	Q1	Q2	Q3	Proj.	Proj. 1/	Proj.	Proj.
	(In million of Afghanis)								
Domestic revenue 2/	5,864.5	9,000.0	2,148.5	2,289.5	2,075.7	9,310.7	12,783.9	16,609.0	20,691.8
Center	1,036.7	---	159.8	334.7	602.1	2,379.9	---	---	---
Provinces	4,827.8	---	1,988.6	1,954.8	1,473.6	6,930.9	---	---	---
Expenditure	15,514.0	24,750.0	3,916.7	4,436.3	5,585.0	21,100.3	30332.0 3/	38,922.8	47,780.3
Center-provinces	---	---	3,916.7	4,436.3	5,585.0	21,100.3	30,332.0	---	---
Central government	---	---	1,732.3	2,843.8	2,984.5	11,980.6	17,222.3	---	---
Of which: wages	---	---	1,098.9	1,689.0	1,908.6	7,554.5	11,118.7	---	---
Others	---	---	633.5	1,154.8	1,075.9	4,426.1	6,103.6	---	---
Provinces	---	---	2,184.4	1,592.5	2,600.5	9,119.7	13,109.7	---	---
Of which: wages	---	---	505.4	1,409.5	2,141.3	6,541.7	9,628.0	---	---
Others	---	---	1,678.9	183.0	459.2	2,578.0	3,481.6	---	---
Economic classification	---	---	3,916.7	4,436.3	5,585.0	21,100.3	30,332.0		
Wages and salaries	---	---	1,604.3	3,098.5	4,049.8	14,096.1	20,746.7	---	---
Purrchase of goods and services	---	---	1,923.3	785.6	801.6	4,617.0	4,929.0	---	---
Transfers and subsidies	---	---	141.5	177.7	168.5	572.1	1,471.3	---	---
Pensions	---	---	0.0	132.5	0.0	153.1	724.0	---	---
Capital expenditure	---	---	247.7	241.9	565.0	1,662.0	2,460.9	---	---
Functional classification	---	---	3,916.7	4,436.3	5,585.0	21,100.3	30,332.0	---	---
General public services	---	---	333.7	498.6	429.7	1,891.0	3,298.8	---	---
Defense	---	---	903.3	984.4	1,533.3	5,636.3	5,934.6	---	---
Public order and safety	---	---	640.9	1,121.6	1,487.5	4,799.4	6,721.0	---	---
Education	---	---	266.8	880.8	1,128.0	3,744.4	6,342.3	---	---
Health	---	---	140.5	258.0	326.2	1,069.0	1,262.9	---	---
Social protection	---	---	17.6	153.7	55.8	320.9	1,687.7	---	---
Housing and communal services 4/	---	---	1,290.3	8.0	12.4	1,379.0	62.6	---	---
Recreation and culture	---	---	40.9	111.5	131.8	474.0	621.0	---	---
Economic affairs	---	---	282.7	419.6	480.2	1,786.3	4,401.1	---	---
Balance MOF	-9,649.5	-15,750.0	-1,768.2	-2,146.8	-3,509.3	-11,789.6	-17,548.1	-22,313.8	-27,088.5
Float and adjustment 5/	-657.3	0.0	869.5	-1,209.2	678.1	338.4	0.0		
Balance DAB	-10,306.8	-15,750.0	-898.7	-3,356.0	-2,831.2	-11,451.2	-17,548.1		
Donor assistance grants and loans	9,430.4	15,750.0	2,469.2	1,326.0	2,934.3	12,120.4	14,952.0		
ARTF	---	11,250.0	2,275.5	528.4	2,452.9	11,286.2	---		
LOTFA and Army Trust Fund	---	4,500.0	193.8	797.6	481.3	2,061.0	---		
Other	---	0.0	0.0	0.0	0.0	-1,226.8	---		
Banking financing 6/	-502.2	0.0	-1,570.5	2,029.9	-103.0	-669.2	2,596.1		
Other financing 7/	1,378.5	0.0	0.0	0.0	0.0	0.0	0.0		
Memorandum item:									
Year-end balance on government accounts	2,084.9					2,754.1	158.0		

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

1/ Staff estimates. The budget adopted by the government projects revenue of about Af 15 billion.
2/ The first quarter of 2003/04 includes a $18 million lump-sum transfer from Herat province.
3/ The functional, economic, and center/provinces classifications of expenditures reported in 2004/05 reflects Fund staff projections and do not reflect GFS. These projections are based on assumptions regarding unallocated expenditures amounting to Af 5.3 billion.
4/ The first quarter of 2003/04 includes $25.2 million paid by the Ministry of Reconstruction in Herat province for the purchase of services.
5/ Variation between the fiscal position recorded at MOF and DAB. This discrepancy is due to the difference ("float") between checks issued and checks cashed and the fact that the provinces' accounts in DAB branches are not consolidated into the government central accounts.
6/ Changes in the government accounts with DAB. A positive sign corresponds to a decline of balances and a negative sign to an increase in balances. Government accounts are not allowed to go into overdraft.
7/ In 2002/03, includes one-off transfers of overflight revenue and customs valuation fees accumulated over several years and the sale of telecommunication licenses.

Table 5. Islamic State of Afghanistan: Balance of Payments, 2001/02–2006/07 1/

	2001/02	2002/03 Est.	2003/04 Proj.	2004/05 Proj.	2005/06 Proj.	2006/07 Proj.
	(In millions of U.S. dollars)					
Trade balance	-873.7	-1,309.5	-1,609.5	-2,320.7	-2,184.4	-2,121.4
Exports of goods 1/	1,657.4	2,241.2	2,778.6	2,362.2	1,883.4	1,487.6
Domestic exports	68.0	100.0	133.4	191.2	282.2	407.0
Re-exports	1,589.4	2,141.2	2,645.2	2,170.9	1,601.3	1,080.6
Imports of goods	2,531.1	3,550.7	4,388.0	4,682.8	4,067.9	3,609.0
Services	...	-104.2	-208.7	-450.0	-418.7	-401.0
Receipts	...	28.6	46.8	109.8	104.5	109.8
Donor-related	...	23.9	35.5	96.0	88.0	84.9
Other	...	4.8	11.3	13.8	16.6	24.8
Payments	...	132.8	255.5	559.8	523.2	510.8
Donor-related	...	132.8	251.3	553.9	514.5	500.1
Wages of expatriates	...	68.3	177.4	480.0	439.8	424.7
Other	...	64.6	73.9	73.9	74.6	75.4
Interest paid 2/	...	0.0	4.2	5.9	8.7	10.7
Current transfers	...	1,221.7	1,656.9	2,504.2	2,279.1	2,183.4
Public	...	1,170.1	1,606.9	2,395.8	2,212.6	2,093.0
Commodity food aid	71.1	94.0	21.0	0.0	0.0	0.0
Other	...	1,076.2	1,585.9	2,395.8	2,212.6	2,093.0
Private	...	51.6	50.0	108.4	66.5	90.4
Other	...	0.0	0.0	0.0	0.0	0.0
Current account balance	...	-192.0	-161.2	-266.4	-324.0	-339.0
(before grants)	...	-1,413.7	-1,818.2	-2,770.6	-2,603.1	-2,522.4
Capital financial account	...	100.0	236.0	377.4	384.1	388.9
Public loans	...	50.0	136.0	250.0	250.0	250.0
Disbursements	...	50.0	136.0	250.0	250.0	250.0
Amortization paid 2/	...	0.0	0.0	0.0	0.0	0.0
Direct investment	...	50.0	100.0	127.4	134.1	138.9
Other capital flows		0.0	0.0	0.0	0.0	0.0
Net errors and ommisions	...	247.3	271.8	0.0	0.0	0.0
Overall balance	...	155.3	346.5	111.0	60.0	50.0
Financing	...	-155.3	-346.5	-111.0	-60.0	-50.0
Change in net foreign assets of DAB	...	-101.0	-346.5	-111.0	-60.0	-50.0
Arrears	...	-54.3	0.0	0.0	0.0	0.0
Fund credit (net)		0.0	0.0	0.0	0.0	0.0
Purchases		0.0	0.0	0.0	0.0	0.0
Repurchases		0.0	0.0	0.0	0.0	0.0
Financing gap		0.0	0.0	0.0	0.0	0.0
Memorandum items:						
Official foreign exchange reserves						
In millions of U.S. dollars		426.1	772.6	883.6	943.6	993.6
In months of prospective imports 3/		2.6	3.0	3.5	3.7	3.7
Current account balance as share of GDP						
Including grants		-4.7	-3.4	-4.8	-4.9	-4.4
Excluding grants		-34.9	-38.7	-49.7	-39.7	-33.1
GDP (millions of U.S. dollars)		4,048	4,704	5,577	6,556	7,621

Source: Fund staff estimates.

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

2/ Debt service projections are based on recognized obligations, reconciled with creditors, and do not include debt service or arrears on claims which have yet to be fully identified or agreed with creditors.

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

Islamic State of Afghanistan: Relations with the Fund
(As of January 31, 2004)

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

II. **General Resources Account**	SDR Million	% Quota
Quota	161.90	100.00
Fund holdings of currency	161.92	100.01
Reserve position in Fund	0.00	0.00
Holdings Exchange Rate		

III. **SDR Department**	SDR Million	% Allocation
Net cumulative allocation	26.70	100.00
Holdings	0.40	1.49

IV. **Outstanding Purchases and Loans** None

V. **Financial Arrangements** None

VI. **Projected Obligations to Fund**
(SDR Million; based on existing use of resources and present holdings of SDRs)

	Overdue	Forthcoming				
	Jan. 31, 2004	2004	2005	2006	2007	2008
Principal	0.00	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.00	0.42	0.41	0.41	0.41	0.42
Total	0.00	0.42	0.41	0.41	0.41	0.42

Nonfinancial Relations

VII. **Exchange Arrangement**

Afghanistan is an Article XIV country. The authorities are implementing a liberal exchange system. Based on information currently available to the staff, no exchange restrictions and multiple currency practices are currently in place. The authorities intend to formalize the current liberal regime through the adoption of new laws and regulations, for which they have asked for technical assistance from the Fund. At least since end-2001, the Afghani has been floating, and more recently the authorities have been implementing a managed float with no predetermined path for the exchange rate. As of February 29, 2004, the average exchange rate on the Kabul money exchange market was Afs 49.84 per $1.

VIII. **Article IV Consultation**

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

IX. Technical Assistance, 2002–04

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

FAD technical assistance missions on customs reform and tax policy are scheduled for March and April, respectively. A resident treasury expert for the Ministry of Finance, Mr. Platais, was appointed in February 2004.

A MFD technical assistance mission on the valuation of the central bank's assets and liabilities is scheduled for late March. Joint MFD and LEG technical assistance missions on anti-money laundering and foreign exchange law are scheduled for the second quarter of 2004.

A resident multisector statistical advisor, Mr. Soulatha, was stationed in Kabul on July 17, 2002. STA is currently providing technical assistance through a series of missions under a peripatetic multisector statistics assignment which began in January 2004. A STA technical assistance mission on balance of payments issues is scheduled for late April.

X. Resident Representatives

During the first half of 2002, the Fund's resident representative in Pakistan, Mr. Ghesquiere, assisted in maintaining relations with the Afghan authorities. A new resident representative, Mr. de Schaetzen, took up his post in Kabul on August 24, 2002.

Kabul, March 24, 2004

Ms. Anne Krueger
Acting Managing Director
International Monetary Fund
Washington, D.C. 20431
U.S.A.

Dear Ms. Krueger:

More than 20 years of conflict and natural disasters have devastated the political, economic, and social fabric of Afghanistan, leaving our country among the world's most destitute. The establishment of a legitimate and effective government has been a formidable challenge. During its brief two-year tenure, the government has made significant strides in terms of crisis management and restoring basic government services and operations. Notable achievements include: (a) the legal formation of a transitional administration; (b) provision of peace and security over much of the country; (c) agreement on the national development framework and national budgets; (d) facilitating the return of over 2 million Afghans from refuge, which helped boost agricultural production and reach self-sufficiency in 2002/03; (e) renewal of the country's administration through a public administration reform program; (f) the signature of trade agreements with a number of neighboring countries; (g) the creation of millions of days of employment for poor and vulnerable groups; (h) creation of an environment in which the private sector has begun to be active; and (i) the renewal of the infrastructure.

We are now determined to move beyond the basic building blocks, and work toward a more comprehensive medium-term strategy. Toward this end, we will build on our recent success and continue to pursue an ambitious reform program, with a view to strengthening administrative capacity, diversifying the economy, facilitating private sector activity, accelerating economic growth, and reducing poverty.

The central pillar of the government's reform agenda has been close adherence to sound macroeconomic policies. The government has made significant efforts to improve revenue collection, strengthen budgetary management, re-establish commercial banking, and ensure stable monetary conditions—including the introduction of a new currency. A comprehensive program for 2004/05 was prepared in consultation with Fund staff, which includes quantitative targets and structural reforms to support our ongoing efforts.

The attached Memorandum of Economic and Financial Policies (MEFP) presents our medium-term objectives and policies for 2004/05 and includes: (a) the budget for 2004/05 and the supporting measures; and (b) key financial sector objectives that will aim at monetary stability and strengthen the development of the banking system. The detailed objectives and policies focus on the period March 2004–March 2005, and include quantitative targets and structural reforms, which together constitute a Staff-Monitored Program (SMP). In light of the uncertainties surrounding monetary conditions, the SMP has been designed to provide some flexibility. We hope that the successful implementation of the SMP will lead to a successor program for 2005/06 that can be supported by the use of Fund resources.

The government believes that the policies set forth in the attached MEFP are adequate to achieve the objectives of its program, but it will take any further measures that may become appropriate for this purpose. The government of Afghanistan will consult with the Fund on the adoption of these measures and in advance of any revision to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation.

Very truly yours,

/s/
Ashraf Ghani
Minister of Finance
Ministry of Finance

/s/
Anwar Ul-Haq Ahady
Governor
Da Afghanistan Bank

Attachments:
Memorandum of Economic and Financial Policies
Technical Memorandum of Understanding

Memorandum of Economic and Financial Policies

I. Introduction

1. The Afghan Transitional Authority began its task of reconstruction in an environment that was virtually unparalleled. Two decades of conflict had reduced physical and social infrastructure to skeletal proportions. Coherent government and administration were nonexistent. Social indicators were among the world's lowest, and simply maintaining security was an immense challenge. During the first two years of administration, the government's central focus has been on crisis management, and working to establish or rebuild the fundamental institutions and services necessary for any state. Now that many of these building blocks are in place, the government's goals are increasingly focused on establishing a greater sense of economic and political 'normalcy,' while ensuring a high degree of government transparency and accountability.

2. Establishing the institutions and processes necessary for a peaceful political transition have been at the forefront of our agenda, and in line with commitments made at the Bonn Conference. The constitution approved by the Loya Jirga in early January 2004 was signed into law by President Karzai on January 26, and is a critical first step in re-establishing a unified state. The new constitution establishes a strong presidency with wide ranging powers and a bicameral legislative body. Although Dari and Pashto are identified as the national official languages, other regional languages were given official status in the regions where they are spoken. The adoption of the new constitution provides for national elections in 2004, and fulfills the timetable agreed upon at the Bonn Conference. Voter registration is proceeding, although slower than hoped, partly reflecting the security conditions.

3. Rebuilding economic and financial institutions and implementing sound macroeconomic policies have been clear priorities. Important economic and institutional reforms have been undertaken. In the fiscal sector, the Government of Afghanistan (GoA) has focused on improving budgetary management, enacting some important tax policy measures, introducing an ambitious program of customs reform, and gaining control over national revenue. The budget has been guided by the "no-overdraft rule," which will remain a pillar of fiscal policy for 2004/05. A draft public financial management law will be presented to the Cabinet early in the new fiscal year. A new currency was successfully launched and is gaining increased acceptance by the public. Monetary policy has been conducted with a view to guarding against inflation, providing a stable exchange rate, and building an adequate level of international reserves. New financial sector legislation has established autonomy for the central bank and paves the way for the creation of a modern banking sector. The economy is growing again, benefiting from external support and the end of the drought.

4. After reviewing recent economic developments, this memorandum sets out our main economic and social objectives for 2004/05.[1] The memorandum also presents in detail the quantitative targets and structural reforms for the period March 2004–March 2005, which together will constitute a staff-monitored program (SMP) with the IMF. The quantitative benchmarks for end-June 2004, end-September 2004, end-December 2004, and end-March 2005, along with the prior actions and structural benchmarks for this period, are presented in the attached Tables 1 and 2.

II. Recent Economic Developments

5. **During 2003/04, real GDP (excluding opium) is estimated to have grown by 23 percent, following 29 percent in 2002/03, although these high figures represent growth from a very low base.** Construction and service sectors benefited from donor assistance, while agricultural production recovered as a result of increased rainfall, the return of refugees to their lands, and an expansion of cultivated acreage. However, the government is deeply concerned about a similarly strong recovery in opium production, which represents an estimated 40 percent of formal GDP.[2]

6. Consumer prices rose by 52 percent in 2002/03. While prices remained relatively flat during March–October 2003, **prices rose by 3 percent in both November and December**, mainly driven by food prices which were associated with Ramadan and colder than usual weather at year-end. Prices in January and February fell modestly, with year-on-year inflation expected to be 9 percent by the end of 2003/04.

7. These encouraging developments reflected a monetary policy focused on maintaining price stability, in the context of a relatively stable exchange rate. Monetary policy was executed through control over the growth of currency in circulation.[3] Despite the lack of sophisticated monetary policy instruments, the government has had considerable success in meeting its monetary objectives. Increases in money demand brought about by increases in

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[1] The Afghan solar year (which coincides with the Afghan fiscal year) begins on March 20. The solar year 1383 covers 2004/05.

[2] Temporarily banned in 2001, opium production has returned to the level of the late 1990s and prices are relatively high. The United Nations Office on Drugs and Crime estimates opium earnings in 2002 and 2003 at $2.5 billion and $2.3 billion, respectively. The street value of Afghan opiates in Europe and elsewhere is reported to be ten times these amounts. Afghanistan is believed to supply three quarters of the world's opium. The growing importance of opium in the economy is further straining the country's internal security and political stability.

[3] Foreign exchange accumulates at DAB mostly through the conversion of donor funds into Afghani. Because of the magnitude of these inflows, DAB has held periodic auctions to limit the growth of currency in circulation. As DAB holds no marketable domestic assets, currency growth is controlled entirely through periodic foreign exchange auctions (the exchange rate has been used as a leading indicator of monetary conditions).

real growth and increased use of the Afghani have been accommodated while simultaneously avoiding excessive inflationary pressure. Currency in circulation increased by 38 percent through February and is estimated to have grown by 35 percent in the 12 months to March 2004, somewhat more than envisaged in the indicative monetary program for 2003/04 agreed with IMF staff (30 percent by year-end).[4] This growth was also reflected in higher-than-envisaged accumulation of foreign exchange reserves. International reserves increased by $346 million through March 2004, to a level equivalent to three months of imports.

8. **The enactment of the new central bank and commercial banking laws paves the way for modernization of Da Afghanistan Bank (DAB) and the entry of new commercial banks.** The new laws provide a framework for an independent and accountable central bank and the creation of a sound financial system. Progress has already been achieved in reorganizing and modernizing DAB, including building an information technology (IT) system, designing a national payment network, and re-establishing communications between DAB's headquarters and some of its territorial branches. The monitoring of monetary developments has also improved substantially. Further, consistent with the Central Bank Law, a new corporate structure has been established, including the appointment of a Supreme Council to oversee DAB's operations and to ensure accountability. In addition, five new commercial banks were licensed in 2003/04.[5]

9. **Fiscal policy in 2003/04 facilitated monetary control through continued adherence to the "no-overdraft rule," which forbids monetary financing of the budget.** Domestic revenue for the operating budget is expected to have reached the Af 9 billion budgetary target.[6] Spending was slow early in the year, due to delays in budget allotments, procurement constraints, and weak financial management capacity. However, ministries steadily accelerated their pace of spending through the course of the year, and expenditures should reach an estimated Af 21.1 billion ($430 million) by the end of the financial year, compared with a budgeted amount of Af 24.8 billion ($550 million). The lower level of spending compared to the budget principally reflects lower outlays by the education, health, defense, interior, and foreign affairs ministries. Donor disbursements are expected to have amounted to about $272 million in 2003/04 (compared to a budgeted level of $350 million), allowing for the financing of the budget and some carry-over of available financing into the upcoming year. Donor commitments for 2003/04 covered about 70 percent of the

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[4] Currency in circulation includes currency held in DAB branch vaults, the size of which is not precisely known, but which has most likely risen substantially since the beginning of the year. Excluding these sums would suggest somewhat lower growth for currency in circulation.

[5] Standard Chartered, National Bank of Pakistan, Afghan International Bank, First Microfinance Bank, and Habib Bank.

[6] In dollar terms, IMF staff expects domestic revenue to amount to about $190 million, compared to a budget target of $200 million. The shortfall in dollar terms vis à vis Afghani is due to the depreciation of the currency.

requirements expressed in the National Development Budget adopted in March 2003. As a result, we were able to implement high-priority projects in infrastructure, education, and other critical areas.

10. **Significant progress has also been made in fiscal management, where the immediate task has been to identify and eliminate waste and to reassert transparent control over public finances.** The major achievements include: (a) the introduction of Afghanistan's Financial Management Information System (AFMIS), a computerized system for expenditure recording, payment processing, and financial reporting; (b) the assignment of fiscal advisors to provincial offices of the Ministry of Finance (MoF) (*Moustoufiats*) as well as to a number of line ministries to assist with financial management and reporting; (c) a budget process for 2004/05 which evolved from a top-down approach controlled by the MoF to one that was driven by the ministries; (d) the progressive consolidation of government bank accounts to strengthen treasury control over cash flows; (e) initial steps toward a modern payroll system; (f) the increased integration of the operational and development budgets;[7] and (g) considerably more comprehensive tracking of external resources by MoF and other ministries through the Donor Assistance Database and integration with the budget preparation process. The comparatively slow progress in the provinces highlights the need for continued focus and support to bring responsible fiscal management to the country as a whole.

11. **On the revenue side, a landmark customs reform package was enacted,** which will in effect make Afghanistan one of the most open economies in the region. The package includes using the market exchange rate for import valuation, streamlining the tariff structure, putting in place new broker processes, and lowering tariff rates from the current range of 0 to 150 percent to six rates ranging from 2.5 to 16 percent. In addition, an important set of new revenue measures was enacted, including a final wage withholding tax on higher-income employees, an improved income tax regime, a tax on a limited range of services consumed by high income earners (e.g., telecommunications, air travel, hotels, and restaurants), and other revenue measures (rent tax, land tax, and an airport departure fee). While progress has been made in securing the transfer of provincial revenues to the center in 2003/04, a few provinces continue to retain some revenue, and a reliable mechanism to verify the total amount of provincial revenues and expenditures has yet to be established.[8]

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[7] Much of the coordination of the development budget between donors, ministries, and implementing partners is being carried out through the Consultative Groups that were established to take responsibility in different program areas.

[8] Afghanistan is structured as a unitary state and the provinces are in effect the local agents of the central government, responsible for the collection of revenues and payment of expenditures on behalf of the center. All revenues must be remitted to the center, which in turn provides the provinces with the necessary resources for the payment of wages and other local expenses. In the early part of the year, many of the provinces have been acting as semi-independent states, remitting only a part of their revenues to the center and undertaking substantial local expenditures (including public investment) with the withheld resources.

Furthermore, we recognize the need to address the loss of revenue resulting from multi-year tax holidays and concession agreements. The Cabinet signed a declaration recognizing that the loss of prospective tax revenue arising from multi-year tax exemptions granted under the current investment law, and from concessions granted outside the legal framework, is unacceptable and created an Inter-ministerial Committee (IC) to draft legislation.

12. Notably, the government has already begun to establish a strong track record with regard to meeting adjustment targets set by international development banks and other donors. Over the past two years, Afghanistan has benefited from concessional lending provided by the Asian Development Bank and the World Bank, and the government has fulfilled all of the benchmarks and other conditions required under those loans.

13. **Reforms in other areas have only recently been initiated. Regarding civil service reform,** the government designed a program to decompress the civil service salary structure to help the government attract and retain qualified staff in key positions.[9] In July 2003, the government adopted a decree allowing for interim additional salary payments for key civil service personnel. This measure was followed by the government's approval in December 2003 of a large proportional increase in the base salary of civil servants, excluding the military, police, and teachers who had previously received a separate pay increase. This increase ranged from 13 percent for the lowest grade to 130 percent for the highest grade, with an overall average increase of about 25 percent. Efforts have also been made by the government to eliminate "ghost" workers from public payrolls. **Public enterprise reform** so far has been limited to establishing a census of state-owned enterprises (SOEs). Audits of the assets of SOEs are underway, but have been hampered by lack of records and absence of foreign assistance in this area. Although the government remains committed to the private sector as the engine of future economic growth, little progress on **privatization** is expected in the immediate future. A Priority Reform and Restructuring (PRR) program was launched by decree in July 2003 and provides the primary mechanism for promoting administrative reforms across government departments and agencies. Managed by the Independent Administrative Reform and Civil Service Commission (IARCSC) under the oversight of the Ministerial Advisory Committee on public administration reforms, the PRR framework enables departments to transfer/appoint key staff in reformed units to higher salary scales. By the end of 2003/04, 36 departments had been granted PRR status and approximately 3,000 civil servants were transferred to the PRR scales in these departments. For 2004/05, a more ambitious target of 30,000 civil servants has been established, of which 20 percent will be at the provincial level.

[9] The pay differential between the most junior and most senior officials was in the range of $10 per month. Because base salaries are so low, the budgetary impact of this measure is expected to be manageable (about $22 million in a full year). The government intends to seek offsetting budget cuts elsewhere, as well as ministerial commitments to abjure all other "ad hoc" wage increases.

14. **The GoA considers poppy cultivation and heroin production to be one of the most serious obstacles to developing Afghanistan** into a secure, stable democracy with a prosperous economy. Many Afghan farmers have been driven into poppy production by decades of deep poverty and lack of alternative livelihoods. But the drug economy has benefited mostly international narcotics and terrorist networks. We are deeply committed to root out this grave threat to Afghanistan's future, and have therefore passed broad anti-narcotics legislation, banning all opium production and trading. We have also established an Anti-Narcotics Directorate and adopted a National Drug Control Strategy that aims to reduce opium production by 70 percent by 2008, and eliminate it altogether within 10 years. An ambitious eradication program was launched that led to the destruction of more than one quarter of the poppy fields during the 2002–03 season.

III. Government Program for 2004/05

A. Main Challenges

15. Notable economic and structural reforms have been accomplished in a short period and under extremely difficult circumstances. Nevertheless, Afghanistan's prospects remain clouded by a number of daunting challenges, namely (a) security issues; (b) the rise in illegal economic activities linked to opium production; (c) limited administrative capacity; (d) unpredictable aid flows and low domestic revenue; and (e) limited private sector development. Further, social indicators are among the lowest in the world: life expectancy at birth is estimated at 42.8 years; and access to water and other basic social services remains very limited for a large segment of the population.

16. We are determined to confront these challenges by pursuing and intensifying our macroeconomic program and undertaking structural reforms, including actions to help diversify the economy, achieve sustainable economic growth, and reduce poverty on a lasting basis. The country has growth potential in agriculture, manufacturing and services, including commerce, transit trade, and telecommunications. This potential could be realized by a significant pick-up in private investment, but will require reforms to restructure the public sector, develop a sound banking system, modernize the central bank, establish a market-oriented legal framework conducive to private sector development, strengthen good governance and transparency, and continued efforts to increase domestic revenue and strengthen expenditure management. In support of these adjustment efforts, Afghanistan is seeking increased assistance from the international community, particularly in the form of grants and external debt relief.

B. Macroeconomic Objectives

17. In line with the recently revised reconstruction needs assessment,[10] **the government aims to achieve real GDP growth (excluding opium) of 15 percent in 2004/05** and 11 percent per annum on average during 2005/06–2007/08, sustained by foreign assistance, an improvement in the business environment, and adequate security. Growth is expected to be driven mainly by diversification in agriculture, new initiatives in private manufacturing, and continued expansion of the services sector. To meet these objectives, the overall investment rate is envisaged to stabilize at about 22 percent of GDP during the same period. The average annual inflation rate is expected to be contained to 5 percent, reflecting the pursuit of prudent fiscal and monetary policies.

C. Macroeconomic Policies

18. **For 2004/05, our macroeconomic policy stance will remain broadly unchanged.** Fiscal policy will continue to be guided by the "no-overdraft rule." Monetary policy will be geared toward ensuring price stability, while simultaneously meeting money demand and limiting exchange rate fluctuations.

Fiscal policy

19. **Raising the level and quality of government services while ensuring fiscal sustainability is a key objective over the medium term**. Revenue mobilization will be crucial in this regard. We are keenly aware that donor support for the operating budget cannot continue indefinitely and that much of the upcoming external assistance will fund projects rather than support recurrent expenditures under the budget. Further, to preserve fiscal sustainability and given limited foreign exchange resources, the government will refrain from nonconcessional external borrowing, and will even minimize concessional borrowing to levels consistent with priority economic development requirements. The government's medium-term objective is to increase domestic revenue such that the operating budget will be fully financed with domestic resources by 2012. Meeting this goal will require new policy initiatives, strengthening the capacity of the revenue and customs departments, and improvement of tax operations in the provincial offices.

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[10] The document, "Securing Afghanistan's Future," was prepared with the help of the World Bank, the Asian Development Bank, and the United Nations, and was circulated to donors as background for the upcoming conference. The last such exercise was conducted for the Tokyo Conference in early 2002. The conference will take place March 31–April 1 in Berlin and update the financing needs of the country to address the issues of security, illegal economy, role of the private sector, and stabilization and productivity of aid flows.

20. **For the GoA to realize its revenue goal, provincial revenues must be regularly and fully transferred to the recently established Treasury Single Account (TSA).** Further, the ministries that collect revenues must also allow these revenues to be regularly "swept" into the TSA. Both of these actions represent important governance issues and are included as structural benchmarks under the SMP.

21. Consistent with these medium-term objectives, the budget law for 2004/05 aims to achieve total **domestic revenues of Af 15 billion**, compared with an estimated Af 9 billion in 2003/04. The revenue target is based on the full effect of the customs and tax measures adopted last year and further administrative measures, including increased enforcement and compliance, to improve tax collection. As importantly, a new investment law will be enacted by end-June that ensures that investment incentives will be granted through accelerated depreciation rather than tax holidays. Given the erosion of the revenue base related to extensive tax holidays granted over the last two years, existing exemptions will be grandfathered and phased out in line with the new law. The tax concessions that have been granted by various ministers are a serious case of concern and the government will take action to address this issue. Furthermore, the new financial management law that will be adopted this year provides the appropriate degree of control over new concession agreements.

22. **The government is committed to pursuing the reforms needed to improve current revenue systems.** The IMF staff supports the government's efforts to achieve a suitably ambitious revenue target, as attaining self-sufficiency for the operating budget will be a pillar of future economic success. However, given potential difficulties in implementation and uncertainty surrounding the net revenue impact of reforms, the SMP will target a lower, but still ambitious domestic revenue target of Af 12.8 billion ($256 million), representing a 35 percent increase over 2003/04.

23. In **customs administration**, the GoA is guided by a comprehensive five-year customs reform plan, supported by substantial technical and other assistance from donors.[11] Streamlining administrative procedures remains a priority, and simplified customs clearance procedures in the provinces were adopted last year.[12] For 2004/05, we intend to implement the following customs measures: (a) a progressive implementation of a system of licensed customs brokers; (b) an exemptions monitoring system; (c) a centralized customs data

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[11] The government adopted a five-year customs administration plan (2003–07) aimed at (a) revamping the customs department and its regional offices; (b) training of customs officials; (c) reforming customs procedures; (d) centralizing customs revenues collected by the provinces; and (e) rehabilitating progressively customs infrastructure, equipment, and communications.

[12] In addition to adopting a single administrative document for customs clearance, the government's focus is on improved monitoring of exemptions, progressive introduction of the harmonized tariff classification system for commercial goods, and development of a comprehensive database for customs valuation.

reporting system; (d) establishment of regional customs valuation units; (e) initiation of Automated Systems for Customs Data (ASYCUDA); and (f) introduction of the Afghan Harmonized System Tariff reflecting the new import tariff policy and using the official rate as published by DAB. A new Customs Code is being drafted and will be enacted this year. Reform of domestic tax administration is to be guided by a five-year plan, and will include establishment of a large taxpayer unit and reorganization of *moustoufiat* revenue operations in a few provinces.

24. **Total current expenditures are projected to increase significantly this year and the budget is expected to reach Af 30.3 billion ($609 million).** Much of the increase reflects spending that could not take place last year because of limited capacity; financial management capacity was weak outside the MoF and in several ministries—most notably education—staff needed to be hired. In addition, the evolution of the budget process away from the top-down approach is expected to continue and enhance broader ownership of the budget. Lastly, there has been a large increase in the budget allocated to internal security; newly hired recruits are now paid as regular staff and the Ministry of Interior has taken on expenditures that were previously paid by donors. The budget also provides for a temporary increase in pension payments for retired civil employees, aimed at helping one of the poorest and most vulnerable part of the population. Recognizing that this action provides only a temporary solution, the GoA will work toward designing a long-term, financially sustainable, pension reform program. Given the expected level of domestic revenue, the budget will need additional financing of about $310 million.[13] The GoA anticipates at least $300 million from donors at the Berlin Conference and expects the residual to be financed from the carry-over of bank balances. However, even if revenue falls short of planned expenditures, the annual appropriation and newly drafted financial management laws prohibit bank financing "no-overdraft rule." Finalization of the development budget is contingent upon the outcome of the upcoming donors' conference. However, unlike 2003/04, where the development budget reflected a list of projects, only some of which were funded, the 2004/05 development budget will contain only those development expenditures with assured funding.

25. **The government is continuing reforms to enhance the effectiveness and transparency of budgetary management.**[14] These reforms include (a) passing a budget systems law; (b) restructuring the MoF; (c) mid-year budget reviews to adjust appropriations as well as quarterly reviews to help both ministries and the MoF in budget

[13] Based on IMF domestic revenue projections, the additional financing needed would be $352 million.

[14] These reforms are in line with the recommendations of the November 2003 FAD technical assistance mission on public expenditure management.

implementation and control; (d) reporting of consolidated fiscal accounts;[15] (e) streamlining the budget allotment process, especially for the provinces; (f) reforming the salary disbursement process; and (g) strengthening the AFMIS by enforcing expenditure control, improving revenue information, introducing automated reconciliation of treasury and bank accounts, linking payroll disbursement to pay period, and extending the AFMIS system to provinces.[16] In addition, we will also work to ensure Cabinet approval of year-end government accounts for 2003/04.[17]

Monetary and exchange rate policy

26. **Monetary policy will aim at maintaining low inflation and the exchange rate will continue to be flexibly determined by market forces.** DAB's weekly auctions will primarily focus on achieving the monetary growth targets, but will try to prevent large and undesirable exchange rate movements. The DAB will continue to use the domestic money supply (currency in circulation) as an intermediate target. The monetary program for 2004/05 is based on demand for money (currency in circulation) growing in line with nominal income (20 percent, including 5 percent inflation), with an additional 5 percent for continued remonetization, equivalent to what was observed in 2003/04. The indicative 26 percent monetary growth rate target for 2004/05 compares with an estimated 2003/04 outturn of 35 percent.

27. **Significant uncertainties surround money demand**, including real income growth, the pace of remonetization, and the role of recently licensed private banks. The **monetary target will thus need to be flexible**, while also guarding against inflation and currency instability. Therefore, while the program target is set at 26 percent, the program will allow for growth of currency up to 31 percent. However, if currency growth appears to jeopardize the quarterly target consistent with the 26 percent growth rate, the government will discuss developments with the IMF, with a view to assessing the implications for price and exchange rate stability. **Currency outturns consistent with rates of growth over 31 percent, however, will trigger a formal consultation with the IMF.** The DAB will provide the IMF with monthly reports to ensure effective surveillance in this regard, and regular quarterly reviews will naturally include a thorough discussion of monetary developments.

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[15] The government will report on all expenditures and revenues in the operating budget. For development expenditures, it will report expenditures that pass through the treasury system. It will also report on commitments, disbursements, and expenditures reported to the government by donors. In 2003/04, the data from donors was often not provided or provided with long lags.

[16] The GoA envisages organizing a donor's workshop to discuss how their fiduciary requirements could be met within the budgetary and treasury system.

[17] Although the 2002/03 accounts were a mixture of paper and computerized records, the accounts for that year were finalized, although it is unlikely that they will be externally audited.

28. Given the "no-overdraft rule" policy and pending the introduction of alternative market-based monetary instruments,[18] the monetary projection implies a path for net international reserves, as there is little scope for changes in net domestic assets (which include government deposits) and none for domestic credit. **But to allow the DAB room for maneuver, the indicative floor for international reserves will be below the programmed path** with a minimum objective of $828 million or 3.3 months of imports by end-2004/05 (from $773 million or 3 months at end-2003/04).

29. **The government believes that a floating exchange rate regime remains the appropriate choice for Afghanistan,** given the potential for large structural changes in the near future and the associated difficulties in projecting demand for the Afghani. Potential vulnerability to external shocks and uncertainty regarding the future of the balance of payments also argues for a regime that will allow flexibility and adjustment. While stability of the Afghani is desirable, the **DAB will not resist persistent pressures on the exchange rate**, should these emerge.

30. **We will take further steps toward modernization of the central bank and the creation of a sound financial system.** The reorganization of DAB will be accelerated in line with best international practices in two-tier banking systems. DAB will transfer by September 2004 to other entities (commercial banks, government agencies) all activities which are inconsistent with the new central bank and commercial banking laws.[19] Considerable emphasis will be placed on improving DAB's operations, including the resolution of issues pertaining to DAB assets, and the development of a central bank balance sheet and a monetary survey (including a balance sheet for the commercial banking system).[20] DAB will also focus on further increasing its capacity to license and supervise commercial banks. In this regard, DAB will address the future of the six state-owned banks in line with banking laws enacted in 2003. Among these six banks, those that did not reapply for a license by March 15, 2004 will immediately cease operations and their resolution will be initiated by a conservator. For those that do reapply for licenses, DAB will assess their applications and make a decision by June 15, 2004. For those banks whose licenses are rejected, the procedures will be the same as for those banks who did not apply for a license. In addition, the government is committed to enact Anti-Money Laundering and Controlling Financial Terrorism (AML/CFT) legislation this year. DAB has already received assistance from the IMF in this area and follow-up is expected in June.

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[18] DAB, in line with technical assistance recommendations from the IMF, will consider introducing a short-term debt instrument that could be used as an investment instrument by financial institutions and would contribute to developing a financial market.

[19] Currently, DAB engages in some commercial banking operations. Under the law, DAB may continue these operations as long as it is not competing with private banking operations (i.e., one private bank operating in the same geographic area).

[20] DAB will be assisted in this effort by experts from the IMF.

External sector policies

31. **Data and information on the balance of payments is extremely limited, and a priority for the government will be to improve data collection so as to better evaluate external sector developments**. Initial estimates indicate a small balance of payments surplus in 2002/03, which resulted in an increase in international reserves of DAB. Preliminary estimates for 2003/04 suggest another surplus, largely resulting from donor inflows as well as unrecorded exports. The outlook for 2004/05 for the balance of payments is uncertain, however, as a substantial amount of foreign exchange receipts depend on, as yet unknown, donor assistance and unofficial trade flows. Against this background, domestic exports are projected to reach $190 million; recorded domestic imports (i.e., excluding those related to the re-export trade, smuggling, and donor imports) are expected to total $740 million, largely reflecting economic recovery and reconstruction. The projected current account deficit, equivalent to about 5 percent of GDP, is expected to be covered by donor assistance and some private capital flows.

32. **The government remains committed to an open trade and exchange system.** Following passage by the Cabinet of a new customs decree, work is underway to identify and eliminate trade and payments restrictions that remain on the books (but are not enforced). A joint IMF mission from the Legal and Monetary and Financial Systems Departments is expected to visit Kabul to review the exchange and payments system and identify priority reforms in this area. Looking forward, the government will seek to avoid imposing restrictions on payments and transfers for international transactions, to introduce new or intensify trade restrictions for balance of payments purposes, or resort to multiple currency practices. The government will also continue to discuss with IMF staff the possibility of accepting the obligations of Article VIII, Sections 2, 3, and 4 of the IMF's Articles of Agreement.

33. **One of our priorities is to strengthen external debt management and normalize its relations with all creditors**. The government's intention is to enhance debt monitoring, analytical capacity, and debt reporting systems in the(MoF). To that end, the recently created Debt Unit in the (MoF) is expected to complete a detailed inventory of the status, terms, source, and size of Afghanistan's stock of external debt within six months. Subsequently, the Debt Unit will submit quarterly reports to the government on the external debt situation, including debt service obligations and accumulated arrears. The government intends to normalize its relations with key creditors. To ensure that the external debt burden remains manageable, the government will refrain from any nonconcessional external borrowing. The GoA will also seek to develop a medium-term debt strategy, the central pillar of which will be to minimize external borrowing to levels consistent with the country's debt servicing capacity and its economic development needs, and to ensure that loans are associated with investments with a positive net return. Support from the international community will be critical to ensure that foreign borrowing can be accomplished at highly concessional terms, with equal treatment from all creditors in this regard. The GoA will also continue to seek generous debt relief from bilateral creditors.

D. Structural Reforms, Poverty Reduction, and Good Governance

34. We are committed to implement an ambitious structural reform agenda to diversify economic activity, promote the development of the private sector, enhance good governance, and sustain economic growth to reduce widespread poverty.

Civil service reform

35. **The GoA will establish by end-June 2004 a timetable for key reforms** aimed at establishing a verified payroll of government employees, and further decompression of civil service wages consistent with medium-term fiscal sustainability and other reforms in the civil service.

Private sector development

36. The government recognizes that improving the business environment, fostering competition, and providing adequate infrastructure are crucial to stimulate private investment. With the advice of partners, the authorities will prepare an action plan by **end-September 2004.** The strategy/action plan would be aimed at prioritizing and sequencing the policy, as well as the legal and institutional reforms required to create an investment climate that helps accelerate private investment in Afghanistan. The action plan will also cover privatization, support to small-and-medium enterprises, and the institutional framework for enabling policy-making for private sector development, including mechanisms for systematic consultation with the private sector.

Public enterprise reforms

37. **By end-June 2004, we will prepare an action plan to regularize the operations of state-owned enterprises and continue to subject them to hard budget constraints**. The GoA intends to complete an assessment of the financial position of these enterprises by **end-September 2004**, in particular through finalizing the audit of their assets. On this basis, a timetable will be developed for rationalizing the state-owned enterprise sector, including, when appropriate, closure or divesture to the private sector through an open and transparent process.

Poverty reduction and social policy

38. **In light of Afghanistan's weak social indicators, the government places the fight against poverty high on its agenda. The government will initiate work to prepare a strategy to alleviate poverty.** In this context, we will define a work program by **end-September 2004** and take measures toward developing a participatory framework to produce a Poverty Reduction Strategy Paper (PRSP). In the interim, the government will initiate work on an Interim-PRSP (I-PRSP).

Opium eradication

39. **The GoA intends to further intensify its action to combat opium cultivation and narcotics trafficking.** We see this as critical to thwart the possible emergence of a narco state. We will continue to closely work with donors to achieve the objectives of the National Drug Control Strategy, and will develop action plans that will focus on five main areas: (a) strengthening law enforcement, including stepped up eradication interdictions; (b) accelerating judicial reform; (c) developing alternative livelihoods; (d) raising public awareness; and (e) reducing domestic demand.

Statistical issues

40. Considerable progress has already been made in improving the timeliness and quality of Afghanistan's economic and social statistics, due in large part to support and technical assistance from the international community. These improvements were reflected in the recent publication of the *Afghanistan Statistical Yearbook*—the first in many years, and a major achievement given the low level of statistical and administrative capacity. **The government remains firmly committed to expanding and improving the statistical database as a key measure supporting macroeconomic management and policy formulation.** Toward this end, we will seek the continued support of the international community to achieve further improvements in data for prices, national accounts, balance of payments, and other key sectors. A concrete step in this regard will be the extension of the consumer price index (CPI) survey outside of Kabul to include five other major cities in 2004/05.

IV. PROGRAM MONITORING AND TECHNICAL ASSISTANCE

Program monitoring

41. The period covered by the SMP will be March 20, 2004–March 20, 2005. **Performance under the program will be monitored using quarterly indicative targets, structural benchmarks, and quarterly reviews**. Indicative targets for end-June 2004, end-September 2004, end-December 2004, and end-March 2005, as specified in Table 1, relate to currency in circulation, net claims of the banking system on the central government, gross international reserves of the central bank, fiscal revenue of the central government, and contracting of new external debt. These targets are further elaborated in the Technical Memorandum of Understanding (TMU) attached to this document. The SMP also includes a number of structural benchmarks, as specified in Table 2. Approval by the management of the IMF of the Letter of Intent (LOI) and the MEFP and their transmission to the Executive Board are subject to the implementation of the prior actions listed also in Table 2.

42. **To coordinate and monitor implementation of the SMP, the GoA has put in place an IC.** The IC coordinates government action, defines broad economic and social guidelines, and promotes macroeconomic and structural reforms related to the SMP. The IC is assisted by a technical committee in charge of implementing the SMP.

Technical assistance needs

43. To improve Afghanistan's capacity to design and implement policies and monitor macroeconomic developments, **a broad technical assistance program is envisaged by the IMF.** This will be coordinated with the substantial assistance already provided by other donors. In particular, and in response to the recommendations of a previous IMF technical assistance mission, an IMF Fiscal Affairs Department resident treasury expert for the Ministry of Finance has recently been appointed. In the area of statistics, the IMF Statistics Department is providing technical assistance through periodic visits by technical experts. The monetary authorities have requested technical assistance in the form of a resident expert at DAB to advise on monetary policy and oversee the provision of data for program monitoring. Furthermore, various technical assistance missions are expected to be fielded during the year by FAD, MFD, LEG, and STA to strengthen the government's capacity in the fiscal, monetary, and statistical areas.

44. The government believes that the policies described herein will further strengthen our macroeconomic stabilization and structural reform efforts, and that they are adequate to achieve the objectives of our economic program for 2004/05. We intend to remain in close consultation with the IMF, in accordance with IMF policies on such consultation, and will provide the IMF with information it requests for monitoring economic developments and implementation of policies under the program. The government stands ready to take further measures, in consultation with the IMF staff, which might be necessary to ensure that the overall objectives of the program can be achieved.

45. To promote transparency, we hereby request that the LOI and the MEFP be published on the IMF website.

Table 1. Islamic State of Afghanistan: Quantitative Indicators, 2004/05

(In millions of Afghanis, unless otherwise indicated; cumulative changes from March 20, 2004)

	2004/05			
	Jun. 20 Ind.	Sep. 21 Ind.	Dec. 20 Ind.	Mar. 20 Ind.
Currency in circulation (ceiling)	1,827	3,774	5,848	7,384
Claims of the banking system on the central government (ceiling)	0	0	0	0
Gross international reserves of the central bank (floor) (in millions of U.S. dollars)	13.3	29.1	47.6	55.4
Fiscal revenue of the central government (floor)	2,585	5,506	8,649	12,784
External debt				
a) New medium- and long-term nonconcessional external debt (with original maturities of one year or more) contracted or guaranteed by the government (ceiling) 1/ 4/	0	0	0	0
b) New nonconcessional debt, contracted or guaranteed by the government, with an original maturity of less than on year (ceiling) 2/ 3/ 4/	0	0	0	0
Memorandum item:				
Currency in circulation (level triggering consultation)	1,977	4,093	6,359	8,785

Source: Fund staff estimates and projections.

1/ Excluding rescheduling arrangements, but including debt with maturities of more than one year.
2/ Concessional debt is defined as debt with a grant element of at least 60 percent calculated on the basis of currency-specific discount rates, based on the OECD commercial interest reference rates (CIRRs).
3/ On a contracting or guaranteed basis. Excluding debt related to normal import transactions.
4/ This benchmark will be evaluated on a continuous basis.

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

Policy Actions	Target Date	Status
I. Prior Actions for Management Approval of the SMP		
Adopt the 2004/05 operating budget (by the Cabinet).		Adopted on March 18, 2004
Establish procedures and a timetable for regular sweeping provincial balances into TSA at DAB headquarters and a plan to transfer all 2002/03 year-end balances in the provincial accounts and ministerial accounts to the treasury account at DAB.		Adopted on March 13, 2004
Initiate the closure and resolution process for all banks that have not applied for licenses.		Measures adopted by DAB on March 16, 2004
Set up an Inter-ministerial Technical Committee to coordinate the implementation of the SMP.		Implemented on March 15, 2004
Sign a presidential decree enacting the tax policy package (see paragraph 11 of MEFP).		Implemented on March 18, 2004
Adopt a ministerial order to implement the customs policy package (see paragraph 11 of MEFP).		Implemented on March 18, 2004
Adopt a Cabinet resolution to draft legislation that eliminates tax exemptions and concessions except those contained in revenue legislation.		Adopted on March 18, 2004
II. Structural Benchmarks[1/]		
Consolidate all line ministry accounts into the Treasury Single Account (TSA).	End-June 2004	
Transfer regularly provincial *moustoufiat* balances into TSA at DAB headquarters, from at least 70 percent of provinces.	End-June 2004	
Adopt the 2004/05 development budget (by the Cabinet).	End-June 2004	
Establish a timetable for (a) a verified payroll of government employees; (b) a wage decompression compatible with medium-term fiscal sustainability; and (c) the closure or corporatization of public enterprises.	End-June 2004	
Transfer all 2002/03 year-end balances in the provincial accounts and ministerial accounts to the treasury account at DAB.	End-June 2004	
Develop a balance sheet for DAB.	End-June 2004	

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

Policy Actions	**Target Date**	**Status**
Develop a monetary survey, including balance sheets of commercial banks.	End-June 2004	
Complete (by DAB) the relicensing operation of the commercial banks and begin the resolution proceedings for those whose licenses applications have been rejected.	End-June 2004	
Develop consolidated fiscal accounts including provinces and operating and development budgets (see paragraph 14 of the TMU).	End-June 2004	
Adopt a presidential decree enacting amendments to the tax and customs laws to preclude the use of tax exemptions or concessions, except those contained in revenue legislation and the existing statutory exemptions, grandfathered until March 20, 2005 (see paragraph 14 of the TMU).	End-June 2004	
Issue (a) presidential decree enacting Anti-Money Laundering/Combating Financial Terrorism (AML/CFT) legislation; and (b) a decision by the Supreme Council of DAB for a modern payment system	End-September 2004	
Extend the consumer price index survey to main cities beyond Kabul.	End-September 2004	
Adopt (by the Cabinet) the 2003/04 final accounts (operating budget).	End-September 2004	
Transfer regularly all provincial *moustoufiat* balances into TSA at DAB headquarters.	End-September 2004	

1/ End-December 2004 and end-March 2005 benchmarks will be established at the time of the first quarterly review under the SMP.

INTERNATIONAL MONETARY FUND

ISLAMIC STATE OF AFGHANISTAN

Technical Memorandum of Understanding

1. This memorandum sets out the understandings between the Afghan authorities and the IMF staff relating to the monitoring of the staff-monitored program (SMP). It is organized as follows: Section I specifies the quantitative indicative targets; Section II provides definitions of the principal concepts and financial variables; and Section III relates to the reporting requirements.

I. QUANTITATIVE INDICATIVE TARGETS

2. Monitoring of the implementation of the program will be conducted on the basis of an assessment of the observance by the Government of Afghanistan (GoA) of the quantitative indicators and structural benchmarks at specified dates.

3. The quantitative indicators are specified in Table 1 of the MEFP attached to the letter of March 24, 2004. They are as follows:

- a ceiling on currency in circulation of Da Afghanistan Bank (DAB);
- a ceiling on net claims of the banking system on the central government;
- a floor for the build-up of gross international reserves of the DAB;
- a floor on fiscal revenue of the central government;
- a ceiling on new medium and long-term nonconcessional external loans contracted or guaranteed by the government; and
- a ceiling on new nonconcessional debt contracted or guaranteed by the government with an original maturity of less than one year.

II. DEFINITIONS

A. Program Exchange Rate

4. For purposes of monitoring under the program, a program exchange rate will be used. This program exchange rate will be the average of the U.S. dollar/Afghani buy and sell cash rates, as reported by the DAB as of February 29, 2004 (Af 49.84 per U.S. dollar). The program exchange rate will be used to convert into Afghanis the U.S. dollar value of all foreign assets and liabilities denominated in U.S. dollars. For assets and liabilities denominated in SDRs and in foreign currencies other than the U.S. dollar, they will be

converted in U.S. dollars at their respective exchange rates prevailing as of February 29, 2004, as published in the *International Financial Statistics (IFS)*.

B. Currency in Circulation

5. Currency in circulation is defined as total currency (new Afghani) issued by DAB, and includes currency held in DAB branch vaults, but excludes currency held in the DAB main vault and in the presidential palace vault.

C. Net Claims of the Banking System on the Government

6. Net claims of the banking system on the government are defined as the difference between the banking system's claims on the government and the deposits of the government with the banking system.

D. Gross International Reserves

7. Gross usable reserves of the DAB are reserve assets, as defined in the balance of payments (BOP) manual, that are controlled by the DAB, are immediately and unconditionally available to the DAB for meeting balance of payments needs, and are not earmarked by the DAB for meeting specific payments. They consist of balances on accounts maintained with overseas correspondent banks, foreign exchange banknotes in the vaults of the DAB, monetary gold, SDRs, and Afghanistan's reserve position in the IMF.

E. Nonconcessional Public Sector or Publicly Guaranteed External Debt

8. Table 1 of the MEFP specifies limits to the contracting or guaranteeing of new external debt by the government. For program purposes, "government" includes the central government and government departments and official agencies which do not seek profit and whose budgets are issued independent of the annual operational or development budgets. Government and government-guaranteed external debt covers all external debts incurred or guaranteed by the government.

9. The limits specified in Table 1 of the MEFP apply to the contracting or guaranteeing by the government of new, nonconcessional external debt with an original maturity of more than one year. This limit applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt in Fund Arrangements (Decision No. 6230-(79/140), August 3, 1979, as amended by Decision Nos. 11096-(95/100), October 25, 1995, and 12274-(00/85), August 24, 2000), but also to commitments contracted or guaranteed for which value has not been received. Excluded from this limit are leases of real property by Afghan embassies or other foreign representations. External debts will be expressed in U.S. dollar terms, with debts in currencies other than the U.S. dollar converted into U.S. dollars at the market rates of the respective currencies prevailing on February 29, 2004, as published in *IFS*.

10. The limits specified in Table 1 of the MEFP also apply to the contracting and guaranteeing by the government of new, noncessional external debt with an original maturity of one year or less. The term "debt" has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt in Fund Arrangements (adopted by the Executive Board of the IMF on August 24, 2000). Excluded from this limit are normal import-related credits. External debts will be expressed in U.S. dollar terms, with debts in currencies other than the U.S. dollar converted into U.S. dollars at the market rates of the respective currencies prevailing on February 29, 2004, as published in *IFS*.

11. For purposes of the program, 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.

12. Concessionality will be based on currency-specific discount rates based on the Organization for Economic Co-operation Development (OECD) commercial interest reference rates (CIRRs). For loans of an original maturity of at least 15 years, the average of CIRRs over the last 10 years will be used as the discount rate for assessing the concessionality of these loans, while the average of CIRRs of the preceding six-month period will be used to assess the concessionality of loans with original maturities of less than 15 years. To the ten-year and six-month averages of CIRRs, the following margins will be added: 0.75 percent for repayment periods of less than 15 years; 1 percent for 15–19 years; 1.15 percent for 20–30 years; and 1.25 percent for over 29 years. Under this definition of concessionality, only loans with grant element equivalent to 60 percent or more will be excluded from the debt limits. The debt limits will not apply to loans contracted for debt rescheduling or refinancing.

F. Fiscal Revenues of the Central Government

13. Fiscal revenues of the government include revenues collected in Kabul as well as revenues collected by the provincial offices of the government and transferred to the government account at DAB. They include revenues from corporate income tax, personal income tax, business receipts tax, fixed withholding taxes on imports and exports (and creditable against the income tax), presumptive taxes in lieu of the income tax, import duties and other charges and fees (the Chamber of Commerce import/export valuation charge, the Red Crescent fee, permit fees from the Ministry of Commerce, fees and charges from the Ministry of Communication, and over flight fees collected by the Ministry of Civil Aviation). It excludes revenue from privatizations or other sale of state assets, grants, and other direct transfers. It excludes provincial revenues accrued between March 20, 2004 and March 20, 2005 but where funds are not transferred to government's DAB accounts by April 20, 2005. It also excludes revenue accrued before February 21, 2004, even if funds are transferred to government accounts between March 20, 2004 and March 20, 2005. All revenue must be supported by the relevant documentation.

G. Structural Benchmarks

14. The structural performance benchmarks are specified in Table 2 of the MEFP attached to the letter of March 24, 2004. They are elaborated further as follows:

- **Consolidation of all line ministry accounts into the Treasury Single Account (TSA).** All revenue collected by ministries must be deposited into the main government account (including sub-accounts), and no ministry may have its own bank account without the explicit written consent of the Minister of Finance.

- **Regular transfer of provincial *moustoufiat* balances into the TSA at DAB headquarters.** Transfers will take place, where possible, on a weekly basis, but at a minimum on a monthly basis. Also the provinces may not make expenditures from their revenue accounts. This will be verified by the records of DAB.

- **Development of consolidated fiscal accounts including provinces and operating and development budgets.** This should be prepared on a monthly basis, with a six-week lag, for the operating budget, using a functional, ministerial, and economic classification. For the development budget, which would include those transactions that pass through the Treasury, these accounts must be prepared on a quarterly basis, with a six-week lag, using the classification structure under the National Development Framework. Development expenditures implemented directly by donors will be included if data are available.

- **Extension of the consumer price index survey to main cities beyond Kabul.** This must include at least five other cities.

- **Development of a monetary survey, including the balance sheets of commercial banks.** The survey is to include only those banks licensed under the new banking law.

- **Adoption of presidential decree precluding tax exemptions and concession.** Appropriate legal enactment to ensure statutory tax rules prevail over nonstatutory concessions in agreements.

III. Provision of Information to the Fund Staff

A. Data

15. To permit the monitoring of developments under the program, the government will provide to Division A of the Middle Eastern 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 IMF staff to the Technical Committee. The program is designed with quarterly quantitative targets and the actual outcome should be provided within six weeks following the end of the quarter. However, in order to facilitate regular monitoring, many of the indicators should be provided with the frequencies indicated below.

- DAB gross foreign exchange reserves (weekly) from **March 20, 2004**. This should be reported no longer than 2 weeks after the end of the week.

- Monetary statistics, including exchange rate data (daily), government accounts with the DAB and currency in circulation (monthly) from **March 20, 2004**. This should be reported no longer than 3 weeks after the end of the month.

- Foreign trade statistics (imports, exports, re-exports) (quarterly) from **March 20, 2004**. This should be reported no longer than 8 weeks after the end of the quarter.

- Operational budget operations and their financing should be reported on a monthly basis no more than 4 weeks after the end of the month.

- Detailed data on foreign grants and loans disbursed, contracted, or guaranteed by the central government; foreign debt amortization and interest payments, including new external arrears (if any); and total outstanding amount of arrears (quarterly) from **March 20, 2004**.

- List of short, medium, and long-term government or government-guaranteed external loans contracted during each quarter; identifying for each loan: the creditor, the borrower, the amount and currency, the maturity and grace period, and interest rate arrangements (quarterly) from **March 20, 2004**.

- National accounts data (quarterly) from **March 20, 2004**. This should be reported no longer than 8 weeks after the end of the quarter.

- Consumer price index (CPI) for the city of Kabul (monthly) from **March 20, 2004**; then starting in October 2004, CPI covering 5 major cities (monthly). These should be reported no longer than 4 weeks after the end of the month.

B. Structural Reforms

16. **Review of the structural reforms**. The GoA will prepare and send to the IMF reports, with appropriate documentation, indicating progress achieved, explaining any deviations relative to the initial planning, and specifying expected revised completion date.

C. State-Owned Banks

17. The authorities will provide staff with relevant documents and information dealing with the proceedings associated with the relicensing and/or closure and resolution of commercial banks.

D. Other Information

18. 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.

19. The Inter-ministerial Committee will provide Division A of the Middle East and Central Asia Department with any other information that may be required by the staff of the IMF for the effective monitoring of the program.

E. Program Monitoring

20. For the purposes of program monitoring, working meetings are planned, at least bi-weekly, with the participation of representatives of the Ministry of Finance, the DAB, the committee in charge of overseeing implementation of the program, and the IMF resident representative.

/s/
His Excellency
Dr. Ashraf Ghani
Minister of Finance
Islamic State of Afghanistan

Date: March 24, 2004

/s/
The Honorable
Anwar-Ul-Haq Ahady
Governor
Da Afghanistan Bank

Date: March 24, 2004