

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

In the context of the seventh review under the Staff-Monitored Program and request for a three-year arrangement under the Poverty Reduction and Growth Facility, the following documents have been released and are included in this package:

- the staff report for the Seventh Review Under the Staff-Monitored Program and Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility, prepared by a staff team of the IMF, following discussions that ended on March 26, 2006, with the officials of the Islamic Republic of Afghanistan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on May 15, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- a staff supplement of June 13, 2006 updating information on recent developments.
- a staff statement of June 21, 2006 updating information on recent developments.
- a Press Release summarizing the views of the Executive Board as expressed during its June 26, 2006 discussion of the staff report that completed the request.
- a statement by the Executive Director for the Islamic Republic of Afghanistan.

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

Interim Poverty Reduction Strategy Paper
Interim Poverty Reduction Strategy Paper—Summary Report
Joint Staff Advisory Note on the Interim Poverty Reduction Strategy Paper
Letter of Intent sent to the IMF by the authorities of the Islamic Republic of Afghanistan*
Memorandum of Economic and Financial Policies by the authorities of the Islamic Republic of Afghanistan*
Technical Memorandum of Understanding*
* Also included in Staff Report

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

To assist the IMF in evaluating the publication policy, reader comments are invited and may be sent by e-mail to publicationpolicy@imf.org.

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INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF AFGHANISTAN

**Seventh Review Under the Staff-Monitored Program
and Request for a Three-Year Arrangement Under the Poverty Reduction
and Growth Facility**

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

Approved by Juan Carlos Di Tata and Matthew Fisher

May 15, 2006

- Discussions for the seventh review under the staff-monitored program (SMP) and on a successor program to be supported by an arrangement under the Poverty Reduction and Growth Facility (PRGF) were held in Kabul from March 12–26, 2006. The mission met with the Minister of Finance, the Governor of Da Afghanistan Bank (DAB), other senior government officials, some ranking members of parliament, and representatives of the diplomatic and donor community, NGOs, and the private sector.
- The SMP currently in place aims to maintain macroeconomic stability, build institutional capacity, and strengthen the statistical framework. The authorities are requesting a three-year PRGF arrangement for SDR 81 million (50 percent of quota) in support of a successor program covering the period April 2006–March 2009. The authorities regard the new PRGF-supported program as a useful vehicle to help them implement their structural reform agenda and resolve outstanding debt issues with Paris Club creditors in the context of the Heavily Indebted Poor Countries (HIPC) Initiative.
- The authorities' Interim Afghanistan National Development Strategy (I-ANDS), which was presented to the donor community in January 2006, has been sent to Fund management as their Interim Poverty Reduction Strategy Paper (I-PRSP). Paris Club creditors have provided appropriate financing assurances in support of the PRGF-supported program.
- The mission comprised Messrs. Symansky (head), Bessaha, Martin (all MCD), Ms. Ongley (PDR), and Mr. Thomas (FAD). It was assisted by the Fund resident representative in Kabul, Mr. Charap. Messrs. Di Tata (MCD) and Zaidi (OED) participated in some of the policy discussions.

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LIST OF ACRONYMS

ANDS	Afghanistan National Development Strategy
ARTF	Afghanistan Reconstruction Trust Fund
CAO	Control and Audit Office
CIRRs	Commercial Interest Reference Rates
CPI	Consumer Price Index
DAB	Da Afghanistan Bank
DSA	Debt Sustainability Analysis
FDI	Foreign Direct Investment
HIPC	Heavily Indebted Poor Countries
I-ANDS	Interim Afghanistan National Development Strategy
I-PRSP	Interim Poverty Reduction Strategy Paper
ISN	Interim Strategy Note
MCD	Middle East and Central Asia Department
MEFP	Memorandum of Economic and Financial Policies
MoF	Ministry of Finance
MTFF	Medium-Term Fiscal Framework
MYR	Midyear Budget Review
NCBF	Net Central Bank Financing
NIR	Net International Reserves
PFEM	Public Finance and Expenditure Management
PFM	Public Finance Management
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
SMP	Staff-Monitored Program
SOEs	State-Owned Enterprises
TCC	Technical Committee of Coordination
TMU	Technical Memorandum of Understanding
WTO	World Trade Organization

EXECUTIVE SUMMARY

- **Afghanistan's performance under the SMP during the third quarter of 2005/06 continued to be satisfactory.** All the end-December 2005 quantitative targets and structural benchmarks under the program were observed, except for the publication of the audited 2004/05 core budget financial statements, which took place in March 2006. Economic activity remained strong, inflation declined, and international reserves increased. Fiscal and monetary developments were broadly in line with program projections, with domestic revenue exceeding the program targets. Further progress was made in the structural area.
- **Looking forward, Afghanistan faces the challenges of sustaining rapid growth, reducing poverty, and achieving the goals set out in the I-PRSP.** At the same time, the medium-term outlook remains clouded owing to lingering insecurity, weak institutional capacity, and a still fragile social consensus. The successor program to be supported by the PRGF arrangement seeks to address these challenges and to help resolve outstanding debt issues, possibly in the context of the HIPC Initiative.
- **The PRGF-supported program will build on the progress made under the SMP.** Over the next three years, the program will aim at sustaining real GDP growth of about 10 percent a year, reducing inflation to about 5 percent, further strengthening the external position, and accelerating institutional and structural reforms. The fiscal program will seek to increase revenue to above 8 percent of GDP by 2010/11, while improving the provision of health and education services.
- **The program for 2006/07 assumes real GDP growth of 12 percent and a decline in year-on-year inflation to 9 percent.** The operating budget deficit is targeted to decline to 2.9 percent of GDP, from 3.7 percent in 2005/06, through a combination of revenue measures and expenditure restraint. The fiscal program provides sufficient flexibility to accommodate higher development spending if implementation capacity improves, and to incorporate in the budget, operating expenditures currently financed by donors outside the budget. In view of weaknesses in the banking statistics and the shallowness of financial markets, the monetary program will continue to target currency in circulation, in the context of a managed float system. The structural reform agenda focuses on fiscal and central bank reforms, enhancing the statistical framework, and improving the business environment.
- **Risks to the program remain considerable.** In addition to those related to the security situation and the government's weak control over the provinces, the authorities will have to deal with persistent opium-related activities, expenditure pressures, and medium-term uncertainties about donor assistance.

I. OVERVIEW

1. **Over the past few years, the Afghan authorities have made significant progress toward rebuilding the foundations for macroeconomic stability and economic development.** On the political front, the institutional framework envisaged under the 2001 Bonn Agreement was brought to fruition with the September parliamentary elections and the recent confirmation by parliament of the new cabinet formed in late March by President Karzai. On the economic front, Afghanistan has delivered a strong performance under the SMP initiated in March 2004. Macroeconomic stabilization has been largely achieved, and significant reforms have been introduced in the fiscal and banking areas.
2. **Looking ahead, the authorities continue to face formidable challenges.** Afghanistan remains one of the poorest countries in the world, with a GDP per capita (excluding opium) estimated at \$300 in 2005/06 and very weak social indicators. Persistently high levels of insecurity and drug-related activities represent direct threats to stability and social harmony, while adding to the already significant fiscal burden. Also of concern are developments that could compromise the reform momentum, including a still fragile social consensus and unrealistic expectations regarding improvements in economic and living conditions following several years of war and conflict.
3. **The authorities view a successor PRGF-supported program as the appropriate tool to address these challenges in the context of the policies and objectives outlined in the I-ANDS.** They believe that such a program will provide an adequate framework for: (a) making further progress toward fiscal and external sustainability; (b) establishing a stable monetary policy framework and a resilient banking system; (c) creating an environment conducive to sustained private sector-led growth; and (d) increasing the efficiency of the economy through competition and higher productivity. Continued technical assistance and highly concessional financial support by the donor community will be essential to implement the authorities' strategy.
4. In the attached Letter of Intent (Attachment I), the government of Afghanistan requests a three-year PRGF arrangement in the amount of SDR 81 million (50 percent of quota). The accompanying memorandum of economic and financial policies (MEFP) reviews Afghanistan's performance under the SMP and presents the macroeconomic and structural policies to be implemented from April 2006–March 2009.
5. **Afghanistan's security situation remains volatile.** The number of security incidents has increased in the southern provinces, owing in part to resurgent Taliban activities and resistance to counternarcotics efforts. Incidents in the other provinces, including in Kabul, remain sporadic.

II. BACKGROUND AND PERFORMANCE UNDER THE STAFF-MONITORED PROGRAM

6. **Performance under the SMP continued to be satisfactory during the third quarter of 2005/06.** All end-December 2005 quantitative targets and structural benchmarks

under the program were observed, except for the publication of the audited 2004/05 core budget financial statements, which did not take place until March 2006.

7. **Economic activity accelerated in 2005/06 (Tables 1 and 2).** Real GDP is estimated to have grown by 14 percent, in line with SMP projections, owing mainly to a strong performance of the agricultural sector in response to better precipitation. **Year-on-year inflation in Kabul declined markedly to 9.5 percent in March 2006, from 12.9 percent in September (Figure 1).** The decline in inflation was particularly pronounced during the fourth quarter of 2005/06 and essentially reflected a slowdown in food prices (see paragraph 5 of MEFP).

8. **Preliminary estimates point to a possible rebound of opium cultivation in 2006.** A United Nations Office on Drugs and Crime rapid assessment survey reported potential increases in planting in a large number of provinces (see paragraph 6 of the MEFP). Unless eradication efforts are intensified, cultivated areas could increase in 2006, after declining by 21 percent in 2005. Dry opium prices in early 2006 were broadly unchanged compared with those observed a year earlier.

9. **Reflecting higher revenue, the operating budget deficit excluding grants is estimated at 3.7 percent of GDP in 2005/06, compared with a program projection of 4.2 percent of GDP (Tables 3a and 3b).** Owing mostly to higher-than-anticipated customs receipts, revenues amounted to Af 13.3 billion during the first nine months of 2005/06, compared with a program target of Af 12.7 billion. Tax collection and fees are estimated to have picked up significantly during the fourth quarter as a result of: the sweeping in of receipts from the 2 percent income withholding tax on importers; collection of overflight fees for 2005/06; and an increase in the coverage of taxes introduced in October 2005.¹ As a result, revenue collection is now estimated at 5.5 percent of GDP for 2005/06 as a whole, compared with a program target of 5.0 percent of GDP (see paragraph 7 of the MEFP).

10. **Operating expenditures were maintained within budget ceilings, notwithstanding increasing pressures.** Larger outlays on security and on the Afghan National Army (previously financed directly by donors), and higher-than-planned teacher recruitment, are estimated to have been met within the existing operating expenditure budget by restraining other spending. Nonetheless, some salary payments were delayed as the Ministry of Education breached its manpower ceilings. The authorities have indicated that these delays have been addressed.

¹ The 2-percent income withholding tax on importers was introduced in mid-2005/06 and is collected by customs. An investigation by the MoF found that these funds were deposited with central bank branches, but not reported or swept into the Treasury single account. This procedural oversight has now been corrected and around 0.5 percent of GDP is estimated to have been swept from these accounts during the fourth quarter. The main tax measures introduced in October 2005 include a higher turnover tax rate for specific services, a wage withholding tax, and an airport departure fee.

11. **Core development spending is estimated to have amounted to 5.2 percent of GDP in 2005/06, less than 40 percent of the midyear budget review (MYR) projection,** owing to continued implementation problems, security concerns, and weaknesses in budget formulation.² External grants to the core budget reached 8.0 percent of GDP in 2005/06, and the core budget deficit including grants is estimated at 0.9 percent of GDP, compared with 0.1 percent projected in the program. Foreign borrowing and the sale of a telecommunication bandwidth led to a further significant build-up of government deposits with DAB. No information is yet available on donor-funded spending implemented outside the core budget.

12. **Further steps have been taken to enhance fiscal transparency.** The Ministry of Finance (MoF) has been posting comprehensive fiscal reports on its website on a monthly basis. Moreover, to avoid a repeat of the procedural problems that delayed the publication of the audited 2004/05 core budget financial statements, an audit plan has been agreed between the MoF and the Control and Audit Office for the submission to parliament of the 2005/06 financial statements by end-September 2006. As part of a progressive move by the large taxpayer office to enhance voluntary tax compliance through self-assessment, a revised tax manual was published in March 2006, along with new income tax forms.

13. **Starting in the fourth quarter of 2005/06, the monetary stance was tightened in response to persistent inflation and incipient pressures toward a depreciation of the currency (Table 4 and Figures 2 and 3).**³ As a result, currency in circulation grew by only 3.8 percent during the second half of 2005/06, remaining well below the program target for the year. International reserves rose further, to \$1.7 billion at end-March 2006 (4.7 months of prospective imports of goods and services), owing mainly to the increase in government deposits with DAB. Interest rates on overnight and 30-day capital notes remained between 1–2 percent and 4–6 percent, respectively, while the exchange rate continued to fluctuate within the 48.5–50.5 Afghanis per U.S. dollar range. Reflecting higher inflation than in the United States, the Afghani appreciated by 2 percent in real terms against the U.S. dollar during the second half of 2005/06.

14. **The authorities continued to modernize DAB's operations and to strengthen the monetary policy framework.** Participants in the foreign exchange auctions were allowed to both sell and buy dollars, and to enter multiple bids. DAB also started to publish the interest rates on capital note auctions, and to enforce reserve requirements while remunerating required reserves.

15. **Limited progress was made in restructuring the state-owned banks.** The MoF appointed a new Board of Directors at Bank Millie and a team to oversee the liquidation of

² A planned reorganization of the Budget Department along sector lines, together with additional technical assistance, should help line ministries to gradually improve project management.

³ The aforementioned drop in inflation was concentrated in the last two months of the fiscal year.

the three former state-owned banks. In addition, DAB accepted the appointment of a new CEO for Bank Millie on the condition that he will be assisted by advisors with strong banking backgrounds. However, the appointment of a new Board of Directors at Bank Pashtany, initially envisaged for end-March 2006, had to be postponed due to the lack of qualified candidates. Lastly, the remaining deposits with the Agricultural Development Bank, the only former state-owned bank that had retained a deposit base, were reimbursed or transferred to DAB.

16. **Notwithstanding underlying weaknesses, Afghanistan's balance of payments position has continued to improve (Table 5).** After widening to 51 percent of GDP in 2003/04 on account of the reconstruction effort, the external current account deficit excluding grants narrowed to an estimated 42½ percent of GDP in 2005/06. This improvement largely paralleled developments in the trade deficit, but also reflected higher interest receipts associated with the build-up of reserves. The current account deficit is estimated to have been more than covered by official grants and loans in 2005/06.

17. **The authorities have maintained contacts with Afghanistan's Paris Club creditors (Germany, Russia, and the United States), who have indicated their intention to provide 100 percent debt relief in the context of the enhanced HIPC Initiative.** Including the current estimates of Russian claims, Afghanistan's external debt is estimated at nearly 150 percent of GDP.

III. THE MEDIUM-TERM PROGRAM FOR 2006–09

18. **The PRGF-supported program will aim at sustaining high growth by fostering a sound and stable macroeconomic environment and improving economic efficiency through structural reforms.** Guided by the I-PRSP, the program will build on the gains already made in stabilizing the economy and strengthening public institutions and infrastructure. Over the next three years, the government's main economic objectives will be to: (a) achieve economic growth of about 10 percent a year; (b) reduce inflation to around 5 percent; (c) further consolidate the fiscal position by raising revenue to above 8 percent of GDP by 2010/11 while improving the provision of health and education services; and (d) strengthen the international reserve cover to about 5 months of imports. Agricultural growth is expected to return to trend, while telecommunications, transport, and trade would provide further impetus to economy activity. The construction sector is expected to increase steadily, albeit at a slower pace than in recent years. This would contribute to raising per capita income to more than \$450 by 2008/09.

19. **Progress toward fiscal sustainability is predicated on implementing durable reforms supported by sound debt management.** The authorities' fiscal program focuses on (a) mobilizing additional revenue; (b) prudently managing expenditures as fiscal operations are gradually consolidated within the core budget; and (c) implementing an affordable public administration reform. In the context of their Medium-Term Fiscal Framework (MTFF) and the I-ANDS, the authorities reiterated their commitment to fiscal responsibility and emphasized the need for donors' aid to be channeled through the core budget, contingent on

continued improvements in financial management and implementation capacity. Given Afghanistan's large development financing needs, the government will continue to rely predominantly on grant financing and highly concessional borrowing.

20. **The fiscal program envisages a number of reforms to increase tax revenue. In particular, the authorities intend to:** (a) strengthen the large taxpayers' office; (b) further improve transparency and simplify procedures to enhance voluntary compliance; (c) upgrade physical and human administrative capacity, especially in the provinces; and (d) introduce an excise tax on selected goods. Moreover, the authorities are considering transforming the current cascading business receipts tax into a more efficient consumption based tax.

21. **On the expenditure side, the medium-term fiscal strategy faces considerable challenges and uncertainties, and the MTFE will need to be refined over time to ensure consistency with both the I-ANDS and the annual budget process.** Specifically, the underlying strategy needs to be flexible enough to cope with: (a) the uncertainty related to the pace of consolidation into the core budget of expenditures currently funded directly by donors; (b) improved execution of development spending; (c) implementation of a public administration reform program to raise productivity; and (d) the need to improve public financial management to increase transparency, reduce corruption, and enhance spending capacity.

22. **The program incorporates several steps to improve the conduct of monetary policy.** To that end, the authorities intend to: (a) strengthen DAB's implementation capacity through new monetary instruments and the deepening of financial markets; (b) increase DAB's policy formulation capacity by developing its analytical tools and improving the monetary statistics; and (c) better manage public expectations through greater transparency in monetary management. In the near future, the authorities will continue targeting currency in circulation, but once the necessary building blocks are in place, they intend to focus on a broader monetary aggregate. The authorities are also committed to creating an enabling environment for bank operations and to accelerating the restructuring of the state-owned banks by improving their operational efficiency.

23. **While Afghanistan's external position is expected to remain broadly stable over the medium term, there are considerable uncertainties.** The current account deficit excluding grants is expected to narrow to around 24½ percent in 2009/10, reflecting mainly a further improvement in the trade balance. This deficit will continue to be financed primarily by official transfers, which are projected to average \$2.4 billion a year over the medium term. However, as these transfers would decline relative to GDP, the current account deficit including grants would increase to over 6 percent of GDP by 2009/10. The envisaged strengthening of international reserves will provide a comfortable buffer against potential vulnerabilities. External debt sustainability is predicated on a comprehensive debt restructuring in the context of the enhanced HIPC Initiative.

24. **The medium-term structural reform agenda will focus on increasing efficiency and transparency in the public sector and improving the business environment.**

Particular emphasis will be placed on enhancing effectiveness in the use of donor funds in order to raise productivity and improve external competitiveness. Moreover, further steps will be taken to simplify the trade system, improve the supply of energy and telecommunications, enhance human capital, and build an adequate road network in support of the authorities' objective to diversify the sources of growth. Other reforms to facilitate private sector-led growth will cover land tenure and business regulations.

IV. THE PROGRAM FOR 2006/07

25. **The macroeconomic program for 2006/07 assumes real GDP growth of 12 percent, with agricultural growth returning to its historical trend; a decline in end-year inflation to 9 percent; and an increase in international reserves to 4.9 months of imports by year-end.** Structural reforms include measures aimed at enhancing tax and customs administration and public expenditure management, improving central bank operations, and accelerating the restructuring of the state-owned banks.

A. Fiscal Policy

26. **The operating budget deficit excluding grants is programmed to decline from 3.7 percent of GDP in 2005/06 to 2.9 percent in 2006/07 (a level somewhat lower than envisaged in the budget but higher than agreed upon in the SMP), owing to a combination of revenue and expenditure measures.**⁴ Domestic revenue is targeted to rise by 0.5 percentage point of GDP in 2006/07, to 6 percent of GDP, on account of: (a) the rationalization of the import tariff structure;⁵ (b) the introduction of road tolls and excise taxes on a selected group of items; and (c) the full year effect of tax measures introduced in the third quarter of 2005/06. The program's revenue target exceeds that included in the budget by 0.3 percentage points of GDP, owing mainly to a better outturn in 2005/06 than envisaged at the time the budget for 2006/07 was prepared.

27. **Operating expenditures are programmed to decline from 9.3 percent of GDP in 2005/06 to 8.9 percent in 2006/07, notwithstanding the absorption of significant costs previously funded directly by donors.**⁶ The program envisages the initiation of a pay and

⁴ The difference between the budgeted operating deficit and the SMP projection, which was broadly consistent with the MTFP on the spending side, mostly reflects the consolidation of fiscal operations previously funded directly by donors within the core budget.

⁵ The proposed rationalization would move some items from the lowest 2.5 percent rate, where around 50 percent of items are currently rated, to higher rates within the existing band structure. It aims primarily at removing anomalies in this structure, as some inputs are currently taxed at higher rates than finished products. An upcoming FAD tax policy mission has been asked to review the proposed tariff changes and will caution against measures that may increase effective protection.

⁶ These costs include the absorption of the Afghan National Army, the National Security Council and presidential protective services, the Election Commission, and the Ministry of Counter Narcotics.

grading reform for the civil service in deference to any general pay increase. Relative to the budget, the authorities are committed to making cost savings of around 0.3 percent of GDP stemming from: (a) strict enforcement of approved manpower and appropriation ceilings for employee compensation through the introduction of a certified monthly payroll system; (b) slower-than-budgeted implementation of the pay and grading reforms in view of capacity constraints; and (c) strict enforcement of the rules on the use of contingency funds—for unforeseen policy initiatives and natural emergencies. The indicative target on the operating budget deficit will support the authorities' intention to contain current spending to more sustainable levels and safeguard resources intended for development spending.

Further amendments to the fiscal program could be considered at the time of the MYR, following consultations with Fund staff and donors, if needed to cope with security uncertainties and the implementation of priority reforms. The program also provides room for the operating budget to incorporate expenditures currently financed directly by donors outside the budget, dependent on available financing.⁷ The need for this flexibility highlights a vulnerability for effective budget implementation in an environment where the government is heavily dependent on donor resources and a large part of fiscal activities are conducted outside the core budget.

28. In light of capacity constraints, the program assumes that, while increasing, core development spending will remain, at 6.8 percent of GDP, well below the budgeted amount (14.2 percent of GDP). However, program adjusters to allow for a larger use of government deposits with DAB are included in order to ensure that, contingent on the need to maintain a prudent level of international reserves, core development spending is not constrained in case of faster execution.⁸ Conscious that underspending could undermine the credibility of the budget, the authorities will introduce several reforms, including: (a) publishing a new budget calendar and reorganizing the budget department and provincial treasuries with a view to producing more realistic budgets and enhancing financial management; (b) targeting capacity building in line ministries to assist in project management; and (c) introducing computerized grant management and contract/commitment monitoring capabilities. Externally-financed off-budget spending is expected to remain substantial at around 24 percent of GDP.

B. Monetary and Exchange Rate Policies and Financial Sector Reforms

29. In view of current weaknesses in the banking statistics and the shallowness of financial markets, the monetary program will continue to target currency in circulation

⁷ The indicative target (ceiling) for the operating budget deficit excluding grants will be adjusted upward by the actual amount of expenditures moved on the operating budget, on the conditions that (a) this move is justified by a statement from the donor(s) indicating their decision to stop financing these expenditures outside the budget and (b) the expenditures are subject to a supplementary appropriation approved by parliament.

⁸ The overall downward adjustment to the floor on net international reserves has been capped to ensure a minimum coverage of three months of imports.

in the context of a managed float system. Circulation is projected to increase at a slower pace than nominal GDP in 2006/07, owing largely to the expected shift to bank deposits as the banking system develops. The corresponding increase in the velocity of currency in circulation is, however, expected to be smaller than in 2005/06, as the latter reflected in part some deceleration after two years of rapid monetary growth. In view of the uncertainties surrounding money demand, the authorities will stand ready to tighten the monetary stance as needed, should inflationary pressures emerge.⁹

30. **Further steps will be taken to modernize DAB's operations and strengthen the monetary policy framework.** In particular, the authorities will adopt measures to deepen the capital notes market and introduce credit and deposit standing facilities, and the financial relations between the government and DAB will be clarified through a service level agreement. In addition, DAB's capital position will be strengthened by processing the gold held in the palace vaults into a form that qualifies as a reserve asset, and DAB's external audits for 2004/05 and 2005/06 will be finalized and submitted to parliament. Program monitoring will be facilitated by developing a monthly balance sheet of DAB, as well as a monthly monetary survey in line with international standards by end-2006/07.

31. **The program incorporates additional measures aimed at accelerating the restructuring of the state-owned banks.** The Export Promotion Bank will be liquidated or merged with Bank Pashtany and Bank Millie. In addition, the authorities will appoint a new Board for Bank Pashtany by end-June 2006 and will adopt long-term restructuring plans for Bank Millie and Bank Pashtany by end-September.

32. **The authorities are committed to addressing the administrative and legal impediments to the development of the banking sector.** In this regard, they will work closely with the banking community toward the establishment of an interbank money market, the adoption of a group of enabling laws, and the clarification of land ownership rights. Moreover, the authorities intend to reduce the rate of remuneration of private savings accounts held with DAB in provinces where no commercial banks operate, so as to encourage the commercial banks to expand their activities in these provinces.

C. External Sector Policies

33. **The external current account deficit excluding grants is projected to narrow to 39½ percent of GDP in 2006/07, reflecting an improvement in the trade balance.** Official transfers are expected to decline relative to GDP, resulting in a deficit including grants of 1¾ percent of GDP. This, combined with a decline in foreign direct investment following a large one-off telecommunications operation in 2005/06, will result in a lower reserve accumulation than in previous years.

⁹ The floor on net international reserves provides sufficient room for an eventual tightening of the monetary stance, given that foreign exchange auctions are the main monetary instrument.

34. **The PRGF arrangement is expected to facilitate comprehensive debt relief, which is critical to addressing Afghanistan's unsustainable debt burden (Box 1).** Paris Club creditors have provided appropriate financing assurances in support of the PRGF-supported program. The expected Paris Club treatment, along with the comparable treatment the authorities are committed to seeking from non-Paris Club bilateral creditors, will be an important step toward normalizing relations with creditors and addressing sustainability problems. However, ensuring debt sustainability will require additional steps. Once Afghanistan has settled its bilateral disputes and verified its debts, Fund and World Bank staff should be in a position to reassess its eligibility under the enhanced HIPC Initiative. HIPC eligibility and satisfactory performance under a PRGF-supported program would pave the way for a comprehensive treatment of external debt under the HIPC and Multilateral Debt Relief Initiatives.

35. **The program relies on continued prudent debt management to ensure debt sustainability.** Development expenditures are expected to be covered predominantly with grants, and the authorities intend to review project soundness carefully, and to increase their capacity to spend resources productively. The effectiveness of the public debt management strategy depends on ensuring that the MoF has sole responsibility for all borrowing and loan guarantees on behalf of the government, in line with the Public Expenditure and Financial Management Law.

36. **Maintaining a transparent and liberal trade regime will be critical in establishing an enabling environment for private sector development.** Correcting the anomalies in the classification of goods by tariff rate should contribute to developing a level playing field for investment and growth. Staff noted the authorities' concerns about reported trade practices, such as subsidies to exporters, in trading partner countries, but emphasized the need to resist protectionist sentiment or revenue-motivated pressures to backtrack on liberal tariff reforms.

D. Structural Policies and Poverty Reduction

37. **In addition to the fiscal and banking reforms outlined above, the authorities' reform program for 2006/07 includes measures aimed at:** (a) harmonizing and simplifying legislation, procedures, and regulations related to investment; (b) preparing and implementing a strategy for the divestment of state-owned enterprises (SOEs) and other government agencies engaged in commercial activities but not covered by the SOEs law; and (c) enabling registration of land titles (Box 2 describes structural conditionality under the program).

38. **Afghanistan's I-ANDS was submitted to the IMF and World Bank managements in mid-March 2006 as their I-PRSP, and is discussed in the Joint Staff Advisory Note (refer to www.imf.org).** The I-ANDS lays out the government's anti-poverty strategies for the medium term. In addition to the commitment to pursue sound economic and financial policies and achieve the Millennium Development Goals (Table 9), it places emphasis on improving incomes in rural areas; developing infrastructure, including transport, power and

Box 1. Debt Sustainability Analysis

Afghanistan has extensive external arrears, mainly to Paris Club creditors. The present external debt sustainability analysis (DSA) demonstrates that comprehensive debt relief from creditors is required to restore external viability (Tables 11a and 11b, and Figure 4).

Afghanistan's Debt Stock

At end-2004/05, Afghanistan's verified external debt stock amounted to \$762 million (13 percent of GDP, Table 10), of which more than 40 percent constituted arrears, with the remainder being highly concessional multilateral debt. Even with this somewhat benign picture, the DSA conducted for the 2005 Article IV consultation (IMF Country Report No. 06/113) underlined the limitations to undertaking further borrowing, particularly on nonconcessional terms, given Afghanistan's narrow export base and uncertain nonofficial sources of foreign exchange inflows.

In addition, this debt stock does not include substantial Russian claims, preliminarily estimated at around \$10 billion. Including these claims, the external debt amounted to 150 percent of GDP at end-2005/06. Even under the most conservative assumptions on penalty interest, including the full stock of Russian claims would imply additional interest obligations equivalent to nearly 80 percent of domestic exports, or more than a third of core budget expenditures, an enormous burden in view of the country's sizeable development needs.

Analysis of the Baseline and Alternative Scenario

The analysis of Afghanistan's debt dynamics is based on the standardized external debt template, with some modifications to the stress tests to address data limitations. The macroeconomic assumptions underlying the analysis are consistent with program projections. However, given the very limited information available on debt service schedules and the uncertainty surrounding longer-term macroeconomic variables, this analysis (including the reliability of NPV calculations) should be treated with caution.

The **baseline scenario** is consistent with three central assumptions regarding the treatment of external debt. First, there will be a significant upfront reduction of Russian claims consistent with procedures for Russia participation in the Paris Club. Second, the remaining Russian and other Paris Club claims are rescheduled on highly favorable terms to avert a further accumulation of arrears pending an assessment of HIPC eligibility. Third, grants will continue to represent the vast majority (over 95 percent) of donor financing and all borrowing will be from multilaterals on highly concessional terms. Under these assumptions, the external debt ratios would decline steadily over the medium term. However, even with this comprehensive debt relief, the NPV of external debt-to-exports would remain close to 200 percent in 2006/07.

Given that Afghanistan only has reliable data since 2001, the **historical average scenario** was based on 10-year averages for nontransition low-income members receiving emergency post-conflict assistance from the Fund since 1995. Under this scenario, rather than falling, ratios—debt to GDP, debt to exports, and debt service to exports—would increase, with the NPV of debt-to-exports exceeding 300 percent by 2011.

The **less concessional financing scenario** is not particularly illustrative, given that: (a) the vast majority of financing is still in the form of grants; and (b) the base level of concessionality is extremely high. However, the estimated impact of a **shock to nondebt creating flows** illustrates the importance of continued grant financing. In the extreme case where official transfers are only half their programmed levels in 2007 and 2008 (and replaced by concessional debt financing), the NPV of debt-to-GDP ratio would double over the projection period. Moreover, the NPV of debt-to-exports would peak at 370 percent in 2008. If the additional debt financing were to be on less concessional terms, the impact would be considerably worse. The **export growth shock** also demonstrates the extreme sensitivity of Afghanistan debt servicing capacity to any setbacks in the desired expansion of the export industry from its very low base.

Box 2. Structural Conditionality

Coverage of Structural Conditionality in the PRGF-Supported Program

The structural performance criterion (PC) and benchmarks (SB) (attachment II, Table 4) concentrate on areas that are critical for achieving the program's macroeconomic objectives.

- **Fiscal transparency:** submission to parliament of the core budget's audited financial statements for 2005/06 (PC).
- **Fiscal policy and management:** establishment of a certified monthly payroll system (SB), and submission to parliament of legislation to eliminate nuisance taxes and introduce an excise tax on selected goods (SB).
- **Banking restructuring:** appointment of a new Board of Directors at Bank Pashtany (SB); adoption by shareholders of long-term restructuring plans for Bank Millie and Bank Pashtany (SB); publication of a public statement announcing the liquidation of the Export Promotion Bank or its merger with another licensed commercial bank, and completion of the transfer of its deposits (SB).
- **Modernization of DAB:** development of a monthly monetary survey in line with international standards (SB); processing of gold held in the palace vaults into a form that qualifies as a reserve asset (SB); and submission to parliament of the 2004/05 and 2005/06 external audits of DAB (SB).
- **Public enterprise reform:** adoption of a comprehensive restructuring/divestment plan for the public entities and government agencies engaged in commercial activities but not covered by the state-owned enterprises law (SB).

Status of Structural Benchmarks Under the SMP

All structural benchmarks under the SMP were observed, albeit with delays in a few cases. This contributed to a marked improvement in revenue collection and expenditure management, and to central bank modernization. The reconciliation of external debt has proven more difficult than anticipated as some creditors have not provided the requested documentation.

water facilities; enhancing natural resource management; building institutional and human capacity; and improving social protection. In view of the serious shortcomings affecting social data, the government is conducting a national vulnerability assessment. It would be important to complement this work with the Asian Development Bank-financed household income and expenditures survey in order to help prepare the poverty diagnostics and profile for the PRSP.

E. Data Issues, Technical Assistance, and Capacity Building

39. **The data available for program monitoring purposes are broadly adequate.** The quality and timeliness of the fiscal and monetary data used to evaluate Afghanistan's quantitative performance have improved over the course of the SMP. Some progress has also been made in disseminating these data and enhancing consumer price information. However, substantial shortcomings continue to affect the national accounts, balance of payments, monetary, and social sector data. In addition to the aforementioned development of a

monetary survey, the authorities will take significant steps to enhance the quality and reliability of balance of payments data (see paragraph 36 of the MEFP).

40. **The authorities are committed to strengthening technical capacity within the government and DAB.** To that end, they will receive technical assistance from the Fund in several areas, including statistics, tax and customs administration and policy, public expenditure management, liquidity and reserves management and banking supervision, and financial markets legislation and operations.

V. OTHER PROGRAM ISSUES

A. Access and Capacity to Repay the Fund

41. **Proposed access over the three-year period covered by the new PRGF arrangement amounts to SDR 81 million (50 percent of quota), to be disbursed in seven broadly equal tranches.** This access is below the norm for first- and second-time users of PRGF resources in view of Afghanistan's relatively strong reserve position and the availability of donor financing on grant terms. Nevertheless, a further build-up of reserves is desirable in view of the considerable political and economic uncertainty Afghanistan faces.¹⁰ Reserves could also be drawn down if the government uses its deposits with DAB to finance higher-than-envisaged core development expenditures or to cover operating outlays previously outside the budget if donors withdraw their funding.

42. **Most of the \$10.4 billion financing gap over the program period is attributable to the assumed settlement of external arrears, mainly to Paris Club creditors, and is expected to be closed through rescheduling (Table 6).** The remainder of the gap would be covered by PRGF disbursements. The program assumes that Afghanistan will not accumulate new external arrears.

43. **Afghanistan should be able to service its obligations to the Fund and other creditors on a timely basis.** Based on the projected schedule of repayments and disbursements, Afghanistan's total outstanding Fund credit is expected to peak at 50 percent of quota in 2009/10, and its debt service obligations (after rescheduling) would average around 1¼ percent of domestic exports over the program period (Table 8). On this basis, and considering that the medium-term prospects for continued grant and concessional assistance remain favorable, Afghanistan should have no difficulty in meeting its remaining external obligations.

¹⁰ In the event of large additional balance of payments needs arising from exogenous shocks, staff may consider the possibility of augmenting access under the arrangement.

B. Program Monitoring and Conditionality

44. **The program will be monitored through semiannual quantitative performance criteria, structural performance criteria, and quarterly indicative targets and structural benchmarks.** Program reviews will take place every six months. Disbursements would be semiannual, with the first taking place upon Board approval, and the second upon observance of the September 2006 performance criteria and completion of the first review (Table 7 and paragraph 43 of the MEFP). The quantitative performance criteria and indicative targets are shown in Table 3 of the MEFP, and the structural performance criteria and benchmarks in Table 4. Quantitative and structural conditionality, including the adjustors to the quantitative performance criteria and indicative targets, is specified in the technical memorandum of understanding.

45. **A full safeguards assessment of DAB is being completed.** A safeguards mission to Kabul revealed a number of vulnerabilities in the external and internal audit mechanisms, the financial reporting framework, and the system of internal controls, and made recommendations to address them. While the authorities indicated that several recommendations are already being implemented and that DAB is working on addressing the remaining concerns, capacity constraints may hamper effective and timely implementation. A follow-up mission is envisaged in one year.

VI. STAFF APPRAISAL

46. **Afghanistan's performance under the SMP continued to be commendable in 2005/06.** Real GDP growth remained strong, inflation declined, the external position was strengthened, and further advances were made in the structural area. Notwithstanding these achievements, the country still faces formidable challenges in order to sustain rapid growth, reduce poverty, and attain the goals set out in the I-ANDS.

47. **To address these challenges, the authorities have developed a successor program for which they have requested Fund support under a three-year PRGF arrangement.** The authorities regard the PRGF arrangement as a valuable tool to help them implement the structural reform agenda outlined in the I-ANDS and to resolve outstanding debt issues in the context of the HIPC Initiative. The new program will build on the gains made under the SMP in stabilizing the economy and developing economic institutions. It will seek to maintain strong growth, further reduce inflation, strengthen the international reserves position, and accelerate institutional and structural reforms, all of which are needed to facilitate poverty reduction.

48. **Consistent with the objective of achieving fiscal sustainability, the fiscal program for 2006/07 envisages a reduction in the operating deficit excluding grants through a significant increase in revenues and expenditure restraint.** Achievement of the revenue target will require continued efforts to strengthen the large taxpayers' office and administrative capacity in the provinces, as well as the timely introduction of excises on selected goods. On the expenditure side, it will be essential to avoid general wage increases

while adhering to the envisaged implementation of the pay and grading reforms, and to strictly enforce the approved manpower and appropriation ceilings for employee compensation. Operating spending will be reassessed at the time of the first review and revised, if necessary, in order to cope with justified security requirements or faster implementation of priority public administration reforms. The program provides sufficient flexibility to accommodate an increase in development expenditures in case of improvements in implementation capacity or in operating expenditures should additional responsibilities be transferred to the budget by donors. Staff support the authorities' view that amendments should be incorporated in the budget as part of an orderly and transparent process.

49. **The consolidation into the core budget of fiscal operations financed externally by donors is a positive development but, if accompanied by a reduction in external assistance, could reduce fiscal space over the medium term.** In this connection, a well implemented public administration reform program is critical to raise public sector productivity while containing budgetary costs. Moreover, the MTFE needs to be strengthened as a more effective guide for budget formulation by linking more closely multi-year projections with policies. In this regard, staff welcome the proposed measures to improve budget formulation, such as the publication of a less compressed budget calendar and the reorganization of the Budget Department. There is also a strong need to increase the authorities' capacity to spend resources productively, as well as to improve the financial management capacity of line ministries and provinces.

50. **The authorities must persevere with their efforts to reduce inflation.** The tightening of the monetary stance during the third quarter of 2005/06 was an appropriate step in view of the persistence of high inflation, and helped DAB meet its inflation objective for the year. Looking forward, the authorities should strengthen the monetary policy framework, including through the development of DAB's analytical capacity, the modernization of its instruments, and the improvement of the monetary statistics. Moreover, in light of the uncertainties surrounding money demand, DAB should stand ready to tighten the monetary stance as needed in the context of the present managed float system, in order to achieve the program's inflation target.

51. **Reforms aimed at building a resilient banking system should be intensified.** While significant progress has been made in modernizing DAB's operations and its balance sheet, efforts should be intensified to accelerate the restructuring of the state-owned banks and the creation of an enabling environment for commercial banking operations. At the same time, the authorities should work closely with the banking community toward the prompt adoption of an appropriate legal and administrative framework for the development of financial institutions, the establishment of an interbank money market, and the clarification of land ownership rights.

52. **The authorities should move ahead decisively with their plans to improve the investment climate and enhance the competitiveness of the economy.** Specifically, there is a need to address corruption and improve security, lower the cost of doing business by harmonizing and simplifying investment regulations, and develop and implement an

appropriate strategy for the divestiture of SOEs and other government agencies involved in commercial activities. In addition, maintaining a transparent and liberal trade regime will be critical in promoting private sector development. In this regard, the authorities should focus on the envisaged rationalization of the tariff structure and avoid protectionist measures, as these would increase distortions and run counter to the objective of establishing a level playing field for investment and growth.

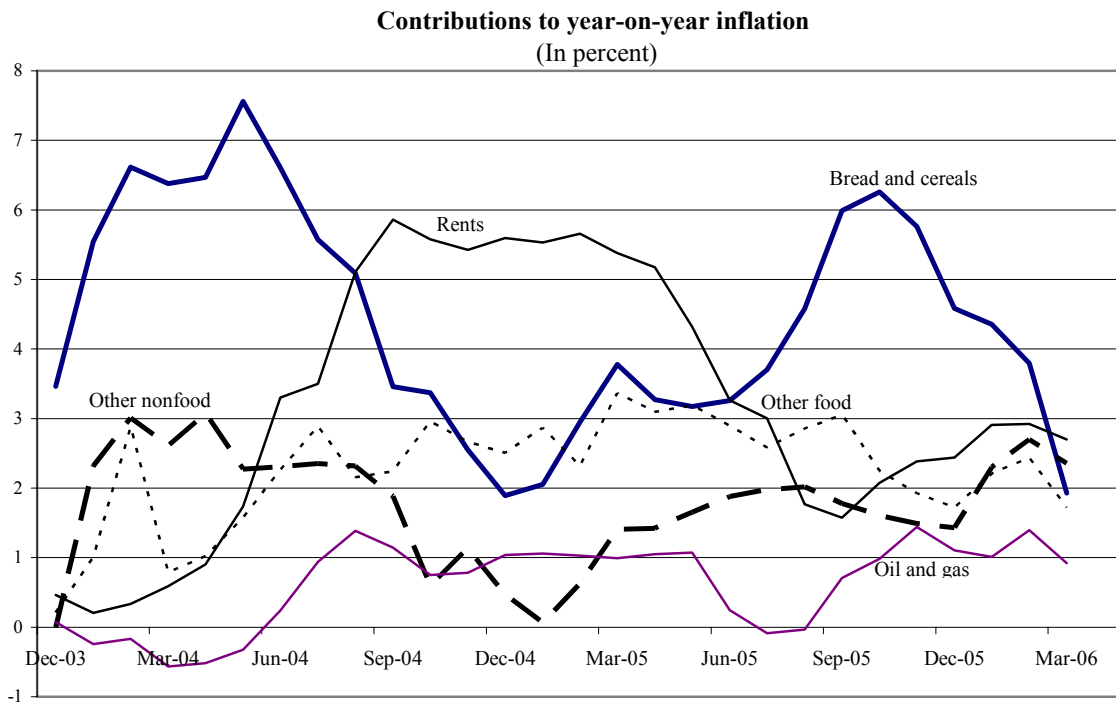
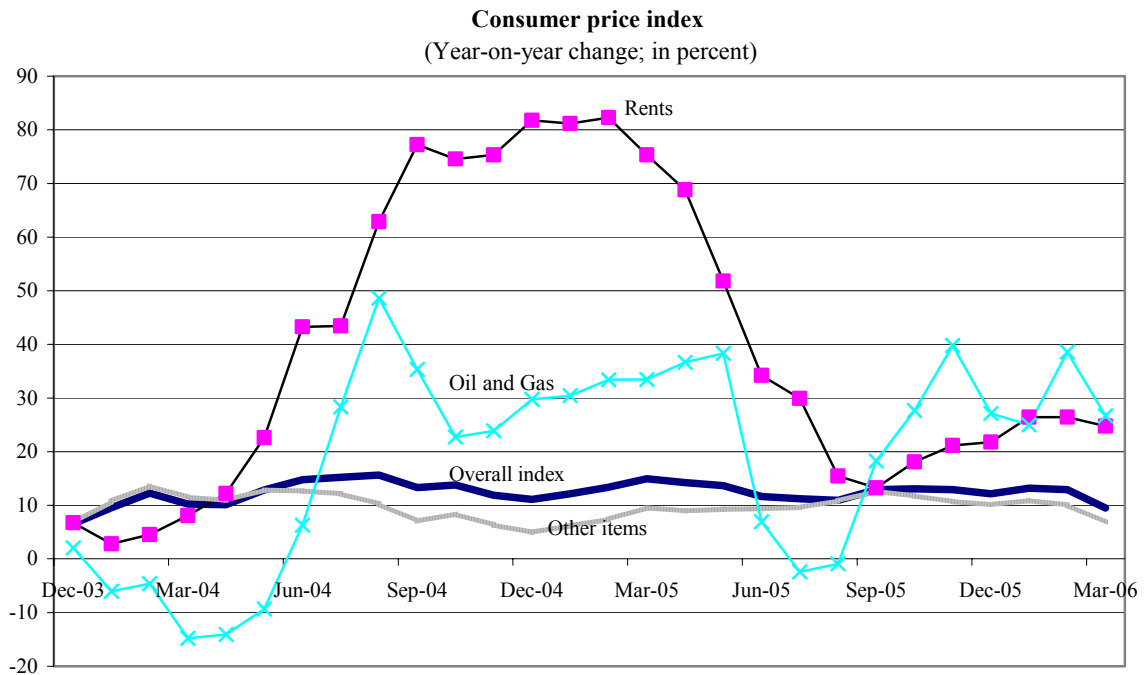
53. **Comprehensive debt relief—along with prudent debt management and enhanced grant management—will be essential to restore and maintain Afghanistan’s external sustainability.** The expected upfront cancellation of most Russian claims and Paris Club flow rescheduling will provide a significant amount of relief. However, Afghanistan’s large development needs and limited repayment capacity require action to address the remaining debt burden. To this end, continued progress under the PRGF arrangement will be critical to establish a track record toward eligibility for debt relief under the enhanced HIPC Initiative, paving the way for significant additional debt reduction from bilateral and multilateral creditors. The fact that the MoF has been given sole responsibility for all borrowing and loan guarantees on behalf of the government will enhance debt management.

54. **Further efforts are required to address a number of statistical shortcomings.** In this regard, staff welcomes the authorities’ commitment to improve the monetary and balance of payments statistics, which will help to better inform the design and implementation of monetary policy. The enhancement of social data, including through the conduct of household surveys, will also be crucial in preparing the poverty diagnostics and profile in the context of the PRSP.

55. **Risks to the program remain considerable.** Insufficient progress in improving security, developing the new political institutions, and strengthening government control over the provinces could slow the reform process. Political pressures could delay reforms and limit the authorities’ ability to meet the program’s objectives. The program is also subject to implementation risks related to ongoing capacity constraints, the programmed containment of spending somewhat below the budget, the pace at which expenditures directly funded by donors will be consolidated into the core budget, and, more generally, the uncertainty about continued donor assistance. Lastly, efforts to eradicate opium-related activities could have disruptive effects on security.

56. **In light of Afghanistan’s commendable performance under the SMP and the authorities’ continued commitment to macroeconomic stability and structural reform, staff recommend granting approval to the authorities’ request for Fund support under a three-year PRGF arrangement.**

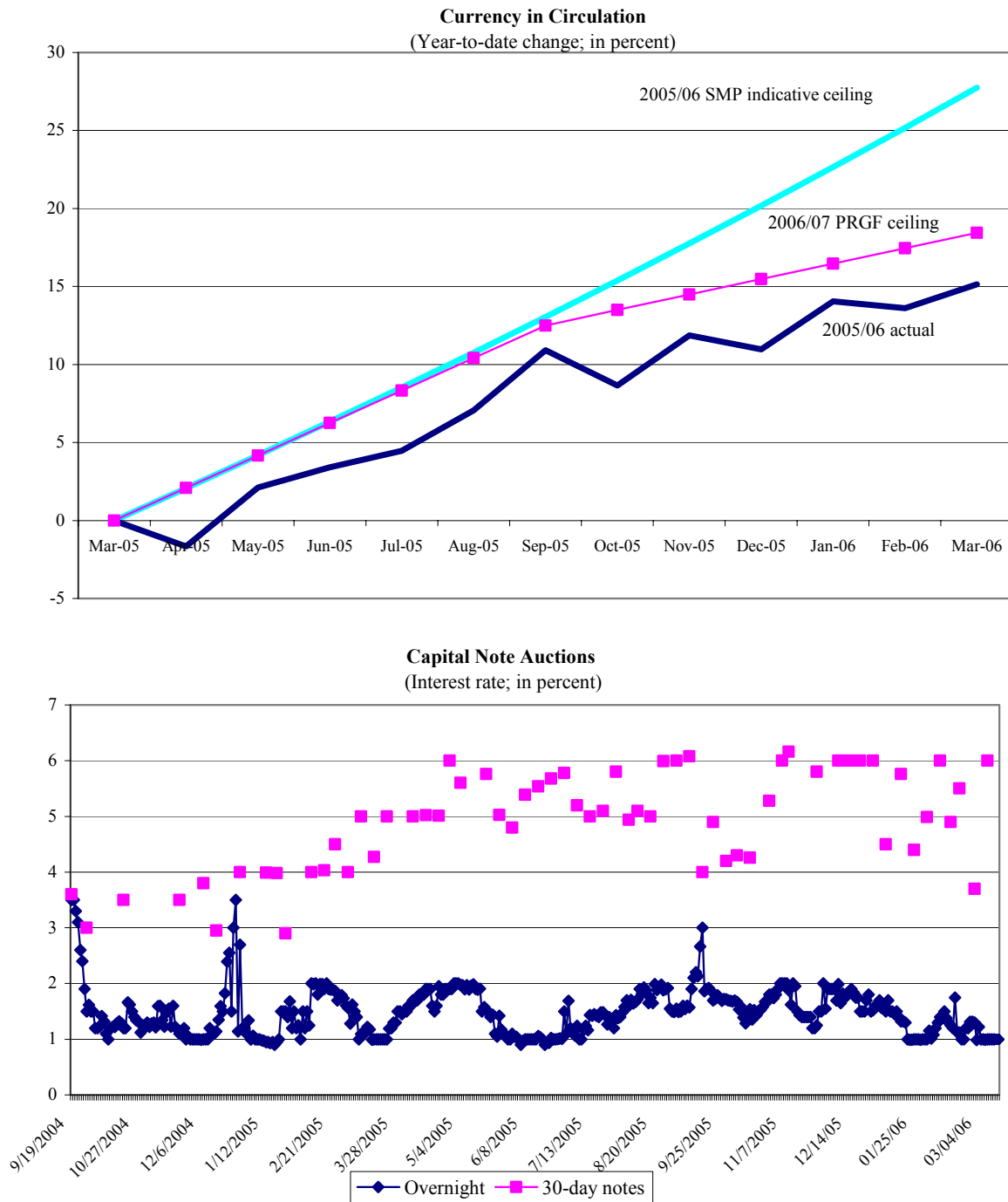
Figure 1. Islamic Republic of Afghanistan: Price developments, 2003–06 1/



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

1/ Last observation: March 2006.

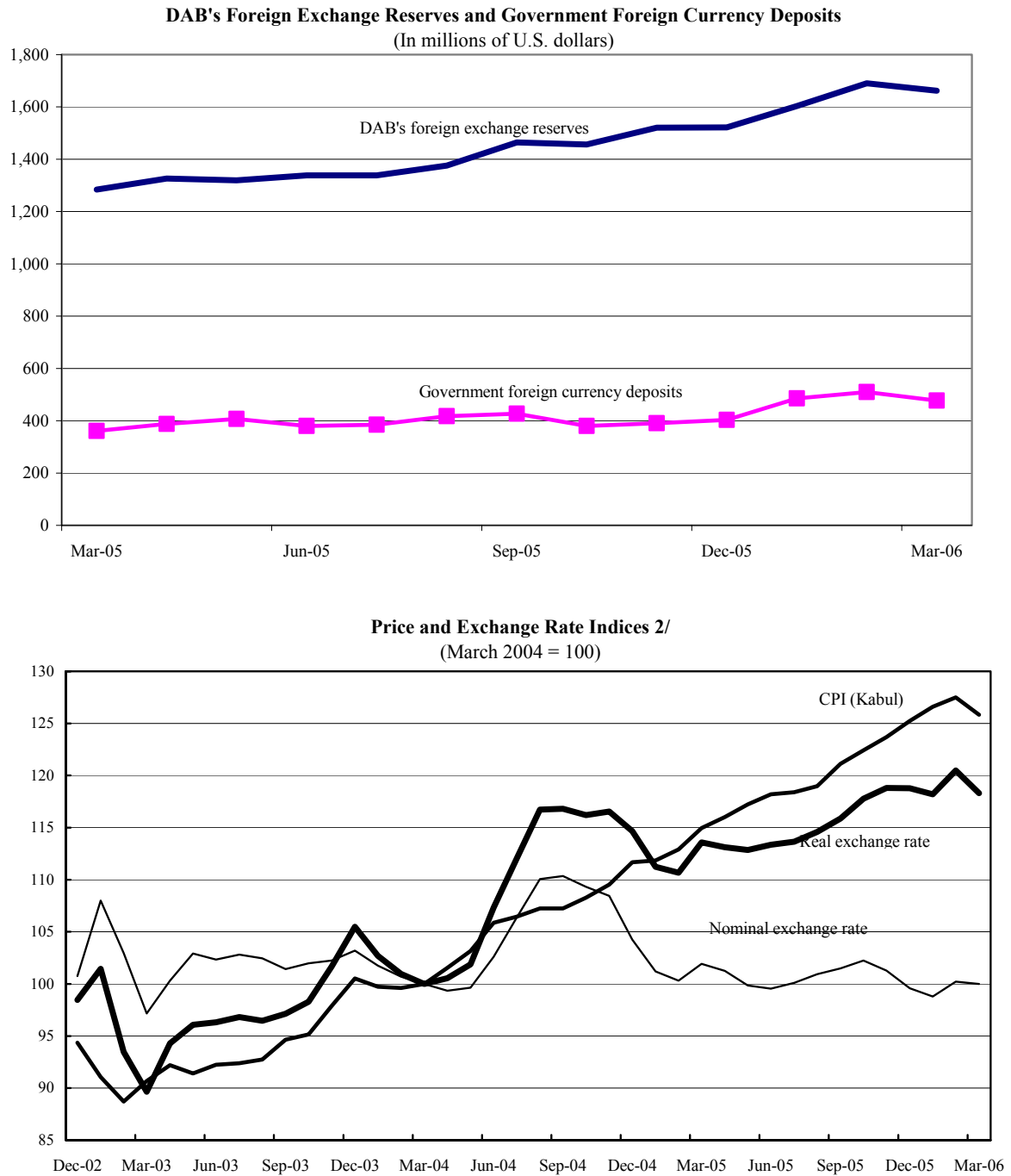
Figure 2. Islamic Republic of Afghanistan: Monetary Developments, 2004–06 1/



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

1/ Last observation: March 20, 2006.

Figure 3. Islamic Republic of Afghanistan: Foreign Exchange Reserves and Real Exchange Rate, 2003–06 1/

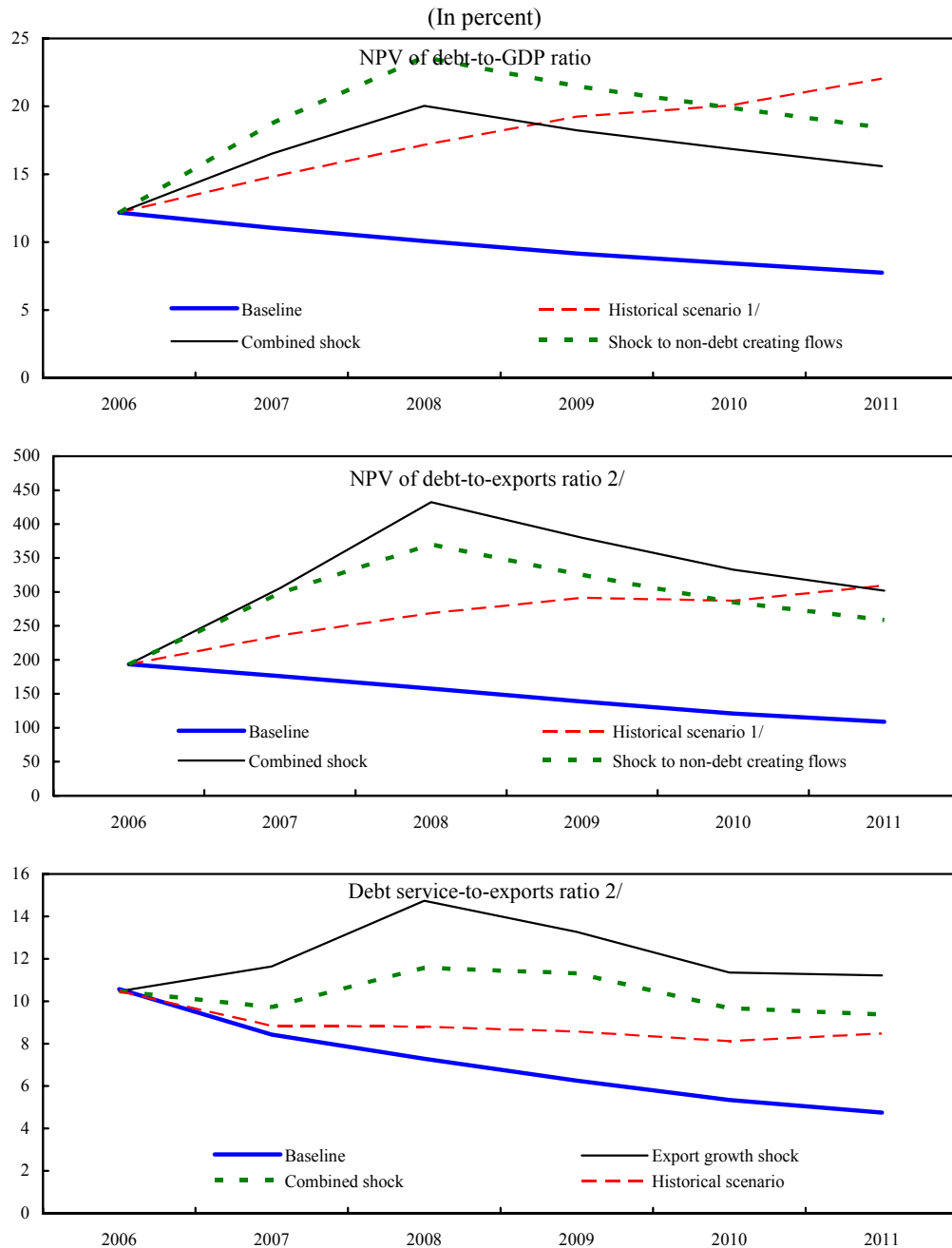


Sources: Central Statistics Office of Afghanistan; Da Afghanistan Bank; and Fund staff estimates.

1/ Last observation: March 2006.

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

Figure 4. Islamic Republic of Afghanistan: Indicators of Public and Publicly Guaranteed External Debt Under Alternative Scenarios, 2006–11



Source: Fund staff projections and simulations.

1/ Variables include real GDP growth, GDP deflator (in U.S. dollar terms), noninterest current account in percent of GDP, and nondebt creating flows. Given that Afghanistan only has reliable data since 2001, the historical average scenario was based on 10-year averages (WEO) for nontransition low-income members receiving emergency post-conflict assistance from the Fund since 1995.

2/ Ratio to exports of goods and services, excluding reexports (transit trade) and Fund staff estimates of smuggling.

Table 1. Islamic Republic of Afghanistan: Selected Economic Indicators, 2001/02–2006/07

(Quota: SDR 161.9 million)

(Population: 21.8 million; 2002/03)

(Per capita GDP: US\$300; 2005/06)

(Poverty rate: n.a)

(Main export: carpets, US\$156 million; 2003/04)

	Est. 2001/02	Est. 2002/03	Est. 2003/04	Est. 2004/05	Prel. Est. 2005/06	Proj. 2006/07
	(Annual percentage change)					
Output and prices						
Real GDP (at market prices)	...	28.6	15.7	8.0	14.0	12.0
Consumer prices (end of period)	-43.4	52.4	10.3	14.9	9.5	9.0
Consumer prices (period average)	...	5.1	24.1	13.2	12.3	9.2
	(In percent of GDP)					
Investment and saving						
Gross domestic formation	...	34.5	42.0	43.4	40.3	37.8
Of which: nongovernment	...	7.5	8.1	8.5	9.6	9.8
Gross national savings	...	1.0	-8.9	-1.9	-2.3	-1.3
Of which: nongovernment	...	5.6	-4.5	2.3	1.1	1.2
Public finances 1/						
Revenue (including grants)	...	8.4	9.0	9.8	10.2	9.9
Operating expenditure	...	8.5	9.8	9.4	9.3	8.9
Operating budget balance (including grants)	...	-0.1	-0.8	0.4	0.9	1.0
Primary balance (including grants)	...	-0.1	-0.8	0.4	0.9	1.0
Total government debt 2/	...	13.2	14.6	12.8	11.6	...
	(Annual percentage change; unless otherwise indicated)					
Monetary sector						
Credit to the private sector	...	...	...	...	...	...
Base money	...	20.1	40.9	37.5	15.1	18.4
Broad money	...	20.1	40.9	37.5	15.1	18.4
Velocity of broad money	...	...	-12.7	-8.1	9.8	3.0
One-month capital note interest rate (end-period, in percent)	...	...	...	4.27	6.00	...
	(In percent of GDP; unless otherwise indicated)					
External sector						
Exports of goods (in U.S. dollars, percentage change) 3/	...	...	36.2	21.3	6.8	20.1
Imports of goods (in U.S. dollars, percentage change) 3/	...	...	51.8	18.5	15.7	12.8
Merchandise trade balance	...	-29.8	-41.3	-37.4	-35.9	-33.0
Current account balance, excluding official transfers 4/	...	-33.5	-51.0	-45.2	-42.6	-39.1
Current account balance, including official transfers 4/	...	-3.6	3.1	1.4	-0.9	-1.5
Foreign direct investment	...	1.2	1.3	3.1	5.2	2.5
Total external debt 2/	...	13.2	14.6	12.8	11.6	...
Gross reserves (in millions of U.S. dollars)	...	425	820	1,283	1,662	1,804
In months of next year imports of goods and services 3/	...	1.8	3.0	4.1	4.7	4.9
In percent of short-term external debt (on remaining maturity basis)	...	...	...	...	...	...
Memorandum items:						
Nominal GDP (excluding opium production; in millions of U.S. dollars)	2,463	4,084	4,585	5,971	7,309	8,869
Opium production (in millions of U.S. dollars)	...	2,540	2,300	2,800	2,700	...
Unemployment rate (in percent)	...	...	...	...	...	...
Net imports of petroleum products (in millions of U.S. dollars)	...	13	24	77	...	...
Afghanis per U.S. dollar (period average)	54.4	44.8	49.0	47.7	49.7	...
Real exchange rate (annual average, percentage change) 5/	...	21.0	12.4	13.8	5.4	...
Stock market index	...	...	...	...	...	...

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

1/ Operating budget. Does not include core budget development spending and externally-financed development expenditures, which amounted to 4.5 percent of GDP and 35.2 percent of GDP, respectively, in 2004/05.

2/ Includes unreconciled debts. Excludes Russian claims.

3/ Excluding reexports.

4/ After rescheduling (i.e., excludes estimated penalty interest obligations programmed to be rescheduled beginning in 2006/07).

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

Table 2. Islamic Republic of Afghanistan: Savings-Investment Balances, 2002/03-2009/10

	2002/03		2003/04		2004/05		2005/06		2006/07		2007/08		2008/09		2009/10		
	Est.	Est.	Est.	Proj. Sixth Rev.	Est. Sixth Rev.	Proj. Sixth Rev.	Est. Sixth Rev.	Proj. Sixth Rev.	Est. Sixth Rev.	Proj. Sixth Rev.	Est. Sixth Rev.	Proj. Sixth Rev.	Est. Sixth Rev.	Proj. Sixth Rev.	Est. Sixth Rev.	Proj. Sixth Rev.	
	(In millions of U.S. dollars)																
Domestic expenditures	5,452	6,921	8,672	10,245	10,424	12,084	12,337	13,380	13,910	15,581	17,030	13,380	13,910	15,581	17,030	13,380	13,910
Consumption	4,043	4,993	6,083	7,163	7,476	8,580	8,980	9,978	10,479	12,136	13,608	9,978	10,479	12,136	13,608	9,978	10,479
Public 1/	318	429	546	640	664	778	813	903	901	1,011	1,113	903	901	1,011	1,113	903	901
Private 2/	3,725	4,563	5,537	6,522	6,813	7,802	8,167	9,075	9,578	11,125	12,495	9,075	9,578	11,125	12,495	9,075	9,578
Gross fixed capital formation	1,409	1,928	2,589	3,082	2,947	3,504	3,357	3,402	3,431	3,445	3,422	3,402	3,431	3,445	3,422	3,402	3,431
Public	1,104	1,557	2,082	2,298	2,249	2,526	2,486	2,307	2,365	2,138	1,678	2,307	2,365	2,138	1,678	2,307	2,365
Private 3/	305	371	507	784	698	978	871	1,095	1,066	1,307	1,744	1,095	1,066	1,307	1,744	1,095	1,066
Net exports of goods and services	-1,368	-2,336	-2,701	-3,106	-3,115	-3,476	-3,468	-3,381	-3,566	-3,600	-3,319	-3,381	-3,566	-3,600	-3,319	-3,381	-3,566
Exports of goods and services (excluding reexports)	328	482	550	686	609	829	734	960	848	991	1,164	960	848	991	1,164	960	848
Imports of goods and services (excluding reexports)	-1,696	-2,818	-3,251	-3,792	-3,724	-4,305	-4,202	-4,341	-4,414	-4,591	-4,483	-4,341	-4,414	-4,591	-4,483	-4,341	-4,414
Domestic savings	41	-408	-112	-23	-168	28	-111	21	-135	-155	103	21	-135	-155	103	21	-135
Public savings	-187	-203	-251	-266	-248	-275	-221	-279	-122	-31	81	-279	-122	-31	81	-279	-122
Private savings	228	-205	139	243	80	303	109	300	-12	-124	22	300	-12	-124	22	300	-12
GDP at market prices	4,084	4,585	5,971	7,139	7,309	8,608	8,869	9,999	10,344	11,981	13,711	9,999	10,344	11,981	13,711	9,999	10,344
	(In percent of GDP)																
Domestic expenditures	133.5	151.0	145.2	143.5	142.6	140.4	139.1	133.8	134.5	130.0	124.2	133.8	134.5	130.0	124.2	133.8	134.5
Consumption	99.0	108.9	101.9	100.3	102.3	99.7	101.3	99.8	101.3	101.3	99.3	99.8	101.3	101.3	99.3	99.8	101.3
Public	7.8	9.4	9.1	9.0	9.1	9.0	9.2	9.0	8.7	8.4	8.1	9.0	8.7	8.4	8.1	9.0	8.7
Private	91.2	99.5	92.7	91.4	93.2	90.6	92.1	90.8	92.6	92.9	91.1	90.8	92.6	92.9	91.1	90.8	92.6
Gross fixed capital formation	34.5	42.0	43.4	43.2	40.3	40.7	37.8	34.0	33.2	28.8	25.0	34.0	33.2	28.8	25.0	34.0	33.2
Public	27.0	34.0	34.9	32.2	30.8	29.3	28.0	23.1	22.9	17.8	12.2	23.1	22.9	17.8	12.2	23.1	22.9
Private	7.5	8.1	8.5	11.0	9.6	11.4	9.8	11.0	10.3	10.9	12.7	11.0	10.3	10.9	12.7	11.0	10.3
Net exports of goods and services	-33.5	-51.0	-45.2	-43.5	-42.6	-40.4	-39.1	-33.8	-34.5	-30.0	-24.2	-33.8	-34.5	-30.0	-24.2	-33.8	-34.5
Exports of goods and services (excluding reexports)	8.0	10.5	9.2	9.6	8.3	9.6	8.3	9.6	8.2	8.3	8.5	9.6	8.2	8.3	8.5	9.6	8.2
Imports of goods and services (excluding reexports)	-41.5	-61.5	-54.4	-53.1	-51.0	-50.0	-47.4	-43.4	-42.7	-38.3	-32.7	-43.4	-42.7	-38.3	-32.7	-43.4	-42.7
Domestic savings	1.0	-8.9	-1.9	-0.3	-2.3	0.3	-1.3	0.2	-1.3	-1.3	0.7	0.2	-1.3	-1.3	0.7	0.2	-1.3
Public savings	-4.6	-4.4	-4.2	-3.7	-3.4	-3.2	-2.5	-2.8	-1.2	-0.3	0.6	-2.8	-1.2	-0.3	0.6	-2.8	-1.2
Private savings	5.6	-4.5	2.3	3.4	1.1	3.5	1.2	3.0	-0.1	-1.0	0.2	3.0	-0.1	-1.0	0.2	3.0	-0.1
Memorandum items:																	
Real GDP growth (annual change; in percent)	28.6	15.7	8.0	13.8	14.0	11.7	12.0	10.6	11.1	10.3	10.0	10.6	11.1	10.3	10.0	10.6	11.1
Nominal GDP (in millions of Afghamis)	182,862	225,108	284,504	355,829	362,940	429,014	442,898	498,353	516,586	598,328	684,710	498,353	516,586	598,328	684,710	498,353	516,586
Nominal GDP growth (annual change; in percent)	33.8	23.1	26.4	25.1	27.6	20.6	22.0	16.2	16.6	15.8	14.4	16.2	16.6	15.8	14.4	16.2	16.6
Kabul Consumer Price Index (year-on-year change; in percent)	52.4	10.3	14.9	10.0	9.5	8.0	9.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0	5.0
National Consumer Price Index (year-on-year change; in percent)	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Sectoral shares of GDP (in percent)	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...	...
Agriculture	49.8	48.5	37.2	36.1	35.9	34.3	32.9	33.5	32.9	32.8	33.1	33.5	32.9	32.8	33.1	33.5	32.9
Industry	20.1	21.3	24.4	24.8	24.4	24.7	24.5	25.1	25.1	23.5	24.1	25.1	25.1	23.5	24.1	25.1	25.1
Services	30.1	30.2	38.3	39.2	39.7	41.0	42.6	41.4	42.0	43.7	42.9	41.4	42.0	43.7	42.9	41.4	42.0
GDP per capita (in U.S. dollars)	182	199	253	294	300	344	354	388	401	451	501	388	401	451	501	388	401
Domestic government revenue (in percent of GDP)	3.2	4.5	4.5	5.3	5.5	6.0	6.0	6.4	6.8	7.4	7.9	6.4	6.8	7.4	7.9	6.4	6.8

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

1/ Data originating from the fiscal accounts.

2/ Determined as a residual.

3/ Equivalent to foreign direct investment reported in the balance of payments, and some new private investment.

Table 3a. Islamic Republic of Afghanistan: Core Budget, 2002/03-2009/10

	Est.		Est.		Revised MYR		YTD		Core Budget					Proj. 2/ 2009/10
	2002/03	2003/04	2004/05	Est.	2005/06	Core Budget 1/	11 months	2005/06	2006/07	2007/08	2008/09	2009/10		
Domestic revenue	5,864	10,168	12,800	18,735	16,668	20,071	20,071	20,071	26,595	35,149	44,255	53,777		
Tax revenues	...	6,262	9,546	13,128	10,718	13,351	13,351	18,867	20,008	26,877	33,990	41,122		
Taxes on income, profits, and capital gains	...	363	995	3,789	1,060	2,310	2,310	4,559	3,580	5,048	6,325	7,841		
Taxes on international trade and transactions	...	5,369	7,247	8,917	8,425	9,554	13,774	14,339	17,772	21,755	25,115	31,155		
Other taxes	...	531	1,304	422	1,233	1,487	534	2,089	4,057	5,909	8,166	10,266		
Nontax revenues	...	3,906	3,254	5,607	5,950	6,720	6,354	6,588	8,273	10,266	12,655	15,255		
Donor assistance grants (to operating budget) 3/	9,430	10,074	14,984	16,878	16,889	16,889	16,889	17,218	17,218	12,233	8,990	6,248		
ARTF (recurrent window)	...	8,182	12,319	13,580	14,571	14,571	13,580	13,580	13,580	8,595	5,353	2,610		
LOTPA	...	1,892	2,583	3,298	2,218	2,218	3,638	3,638	3,638	3,638	3,638	3,638		
Other grants	...	83	83	0	100	100	0	0	0	0	0	0		
Donor assistance grants (core development budget)	...	4,569	8,250	29,013	9,415	12,327	36,086	18,843	22,584	34,741	42,456	50,756		
Total core budget expenditure	15,514	31,606	39,550	83,666	43,628	52,529	103,541	69,436	80,591	94,810	110,756	130,756		
Operating expenditure	15,514	22,151	26,716	33,601	27,615	33,606	40,643	39,511	43,184	48,051	52,307	60,611		
Wages and salaries	...	14,660	18,902	20,788	17,861	17,861	21,695	25,870	24,938	27,770	31,463	34,611		
Purchase of goods and services	...	4,653	4,182	6,609	6,082	7,464	9,349	9,349	9,349	9,816	10,307	10,719		
Transfers and subsidies	...	652	764	2,293	2,26	2,26	1,876	1,676	1,676	1,955	2,264	2,590		
Pensions	...	177	889	1,659	1,536	1,885	1,850	1,850	1,850	1,943	2,040	2,121		
Capital expenditure	...	2,009	1,979	1,847	2,019	2,386	1,227	1,227	1,227	1,431	1,657	1,896		
Interest	...	...	...	404	150	150	471	471	471	270	321	370
Core budget development spending 4/	...	9,455	12,834	50,066	16,012	18,924	62,898	29,926	37,407	46,759	58,449	69,759		
Security	...	...	...	3,496	898	1,062	2,322	1,161	1,451	1,814	2,268	2,668
Governance, rule of law, and human rights	...	...	...	1,644	262	310	2,299	1,149	1,437	1,796	2,245	2,784
Infrastructure and natural resources	...	...	...	22,772	5,335	6,305	33,330	11,665	14,582	18,227	22,784	27,784
Education	...	...	...	3,536	556	657	4,179	2,090	2,612	3,265	4,081	4,981
Health	...	...	...	1,582	791	935	3,261	1,631	2,038	2,548	3,185	3,885
Agriculture and rural development	...	...	...	14,264	7,248	8,566	13,906	10,429	13,037	16,296	20,370	24,370
Social protection	...	...	...	65	22	26	115	92	144	180	226	276
Economic governance and private sector development	...	...	...	2,706	901	1,065	3,416	1,708	2,135	2,669	3,336	4,006
Operating budget balance (excluding grants)	-9,650	-11,983	-13,916	-14,866	-10,947	-13,535	-15,423	-12,915	-8,034	-3,796	1,469	5,194		
Operating budget balance (including grants)	-219	-1,910	1,068	2,012	5,942	3,354	1,794	4,302	4,198	5,194	7,717	10,266		
Core budget balance	-219	-6,795	-3,516	-19,040	-655	-3,243	-25,017	-6,780	-10,626	-6,824	-8,276	-10,266		
Float and adjustment 5/	-657	1,693	359	0	2,428	2,443	0	0	0	0	0	0		
Sale of nonfinancial assets 6/	876	5,102	3,157	3,987	1,994	1,994	0	0	0	5,732	10,965	12,460		
Financing	0	4,886	14,753	23,946	3,397	7,286	10,846	5,538	5,289	4,940	4,342	4,342		
External loans (net)	876	217	-11,596	-8,892	-7,164	-8,480	14,172	1,242	-395	-9,081	-8,526	-8,526		
Domestic (net) 7/	...	...	...	...	...	...	...	...	...	...	...	...
Memorandum item:	...	74,528	100,225	na	102,958	na	106,361	91,956	69,840	32,398	32,398	32,398		
External budget expenditure 8/	...	...	...	...	...	...	...	...	...	...	...	...

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

1/ November 2005 midyear review supplementary budget. The core budget includes domestic revenues, grants, operating and development expenditure, and financing that are accounted for by the central government.

2/ Staff estimates and projections.

3/ Funding for the operating budget provided through the multi-donor trust funds: The Afghanistan Reconstruction Trust Fund (ARTF) (recurrent window) and the Law and Order Trust Fund (LOOTFA).

4/ Interim Afghanistan National Development Strategy programs. Government program classification based on a simple aggregation of administrative units. Expenditure is not delineated by a standard classification of purpose or function.

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

6/ In 2005/06, includes \$40 million receipt from the sale of telecommunications spectrum bandwidth. From 2006/07, also includes proceeds from planned privatizations.

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

8/ In 2002/03, includes one-off transfers of cover flight revenue and customs valuation fees accumulated over several years and the sale of telecommunication licenses. From 2006/07 includes PRGF inflows.

Table 3b. Islamic Republic of Afghanistan: Core Budget, 2002/03–2009/10

	Est.		Est.		Revised MYR		YTD		Core Budget				
	2002/03	2003/04	2004/05	2005/06	Core Budget 1/	11 months	2005/06	2006/07	2006/07	2007/08	2008/09	2009/10	
Domestic revenue	3.2	4.5	4.5	4.6	5.2	4.6	5.5	5.7	6.0	6.8	7.4	7.9	
Tax revenues	...	2.8	3.4	3.0	3.6	3.0	3.7	4.3	4.5	5.2	5.7	6.0	
Taxes on income, profits, and capital gains	...	0.2	0.3	0.3	1.0	0.3	0.6	1.0	0.8	1.0	1.1	1.1	
Taxes on international trade and transactions	...	0.2	2.5	2.3	2.5	3.1	2.6	3.1	3.2	3.4	3.6	3.7	
Other taxes	...	0.2	0.5	0.1	0.1	0.3	0.4	0.1	0.5	0.8	1.0	1.2	
Nontax revenues	...	1.7	1.1	1.6	1.5	1.6	1.9	1.4	1.5	1.6	1.7	1.8	
Donor assistance grants (to operating budget) 3/	5.2	4.5	5.3	4.7	4.6	4.7	4.7	3.9	2.4	1.5	0.9	0.4	
ARTF (recurrent window)	...	3.6	4.3	3.7	3.7	4.0	4.0	3.1	3.1	1.7	0.9	0.4	
LOTFA	...	0.8	0.9	0.9	0.6	0.6	0.6	0.8	0.8	0.7	0.6	0.5	
Other grants	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	
Donor assistance grants (core development budget)	...	2.0	2.9	2.6	8.0	2.6	3.4	8.1	4.3	4.4	5.8	6.2	
Total core budget expenditure	8.5	14.0	13.9	12.0	23.0	12.0	14.5	23.4	15.7	15.6	15.8	16.2	
Operating expenditure	8.5	9.8	9.4	7.6	9.3	7.6	9.3	9.2	8.9	8.4	8.0	7.6	
Wages and salaries	...	6.5	6.6	5.7	5.7	4.9	6.0	5.8	5.6	5.4	5.3	5.1	
Purchase of goods and services	...	2.1	1.5	1.8	1.7	2.1	2.1	2.1	2.1	1.9	1.7	1.6	
Transfers and subsidies	...	0.3	0.3	0.6	0.0	0.4	0.4	0.4	0.4	0.4	0.4	0.4	
Pensions	...	0.1	0.3	0.5	0.4	0.5	0.4	0.4	0.4	0.4	0.3	0.3	
Capital expenditure	...	0.9	0.7	0.5	0.6	0.7	0.3	0.3	0.3	0.3	0.3	0.3	
Interest	...	0.0	0.0	0.1	0.1	0.0	0.0	0.1	0.1	0.1	0.1	0.1	
Core budget development spending 4/	...	4.2	4.5	4.4	13.8	4.4	5.2	14.2	6.8	7.2	7.8	8.5	
Security	...	...	...	...	1.0	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Government, rule of law, and human rights	...	...	...	...	0.5	0.1	0.1	0.5	0.3	0.3	0.3	0.3
Infrastructure and natural resources	...	...	...	...	6.3	1.5	1.7	7.5	2.6	2.8	3.0	3.3
Education	...	...	...	...	1.0	0.2	0.2	0.9	0.5	0.5	0.5	0.6
Health	...	...	...	...	0.4	0.2	0.3	0.7	0.4	0.4	0.4	0.5
Agriculture and rural development	...	...	...	...	3.9	2.0	2.4	3.1	2.4	2.5	2.7	3.0
Social protection	...	...	...	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Economic governance and private sector development	...	...	...	...	0.7	0.2	0.3	0.8	0.4	0.4	0.4	0.5
Operating budget balance (excluding grants)	-5.3	-5.3	-4.9	-3.0	-4.1	-3.0	-3.7	-3.5	-2.9	-1.6	-0.6	0.2	
Operating budget balance (including grants)	-0.1	-0.8	0.4	1.6	0.6	1.6	0.9	0.4	1.0	0.8	0.9	1.1	
Core budget balance	-0.1	-3.0	-1.2	-0.2	-5.2	-0.2	-0.9	-5.6	-1.5	-2.1	-1.1	-1.2	
Float and adjustment 5/	0.0	0.8	0.1	0.7	0.0	0.7	0.7	0.0	0.0	0.0	0.0	0.0	
Sale of nonfinancial assets 6/	0.0	0.0	0.0	0.5	1.1	0.5	0.5	0.0	0.0	1.1	1.8	1.8	
Financing	0.5	2.3	1.1	-1.0	4.1	-1.0	-0.3	5.6	1.5	0.9	-0.7	-0.6	
External loans (net)	0.0	2.2	5.2	0.9	6.6	0.9	2.0	2.4	1.3	1.0	0.8	0.6	
Domestic (net) 7/	0.5	0.1	-4.1	-2.0	-2.4	-2.0	-2.3	3.2	0.3	-0.1	-1.5	-1.2	
Memorandum item:	...	...	33.1	na	0.0	na	28.4	na	24.0	17.8	11.7	4.7
External budget expenditure 8/	...	...	33.1	na	0.0	na	28.4	na	24.0	17.8	11.7	4.7

Memorandum item:

External budget expenditure 8/

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

1/ November 2005 midyear review supplementary budget. The core budget includes domestic revenues, grants, operating and development expenditure and financing that are accounted for by the central government.

2/ Staff estimates and projections.

3/ Funding for the operating budget provided through the multi-donor trust funds: The Afghanistan Reconstruction Trust Fund (ARTF) (recurrent window) and the Law and Order Trust Fund (LOTFA) by Interim Afghanistan National Development Strategy programs. Government program classification based on a simple aggregation of administrative units. Expenditure is not delineated by a standard classification of purpose or function.

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

5/ In 2005/06, includes \$40 million receipt from the sale of telecommunications spectrum bandwidth. From 2006/07, also includes proceeds from planned privatizations.

6/ Net change in government deposits with DAB (excluding provincial branch balances). A positive sign corresponds to a decline in balances and a negative sign to an increase in balances.

7/ In 2002/03, includes one-off transfers of over flight revenue and customs valuation fees accumulated over several years and the sale of telecommunication licenses. From 2006/07 includes PRGF inflows.

8/ In 2002/03, includes one-off transfers of over flight revenue and customs valuation fees accumulated over several years and the sale of telecommunication licenses. From 2006/07 includes PRGF inflows.

Table 4. Islamic Republic of Afghanistan: Monetary Program (Da Afghanistan Bank), 2004/05–2006/07 1/

	Est.			Est.			Proj.		
	2004/05			2005/06			2006/07		
	Mar. 20	Jun. 21	Sep. 22	Dec. 21	Mar. 20	Jun. 21	Sep. 21	Dec. 20	Mar. 20
Net foreign assets	63,934	68,379	73,029	78,432	85,790	82,178	81,004	82,649	92,379
Foreign assets	64,375	69,069	74,507	79,610	86,967	84,310	83,135	84,781	95,328
Foreign exchange reserves	62,438	67,115	72,101	76,112	82,992	80,013	78,513	79,834	90,082
Gold 2/	14,989	15,405	16,150	17,371	19,230	19,230	19,230	19,230	19,230
Other	47,449	51,710	55,951	58,741	63,762	60,782	59,283	60,604	70,851
Other foreign assets	1,937	1,954	2,407	3,499	3,975	4,297	4,622	4,946	5,246
Foreign liabilities	-440	-690	-1,479	-1,178	-1,177	-2,131	-2,131	-2,131	-2,948
Net domestic assets	-19,809	-23,076	-25,750	-30,510	-35,444	-29,948	-24,827	-25,888	-33,135
Domestic assets	-20,678	-20,996	-23,657	-22,998	-29,574	-25,987	-20,532	-21,320	-28,331
Net claims on general government	-20,678	-20,996	-23,657	-22,998	-29,574	-25,987	-20,532	-21,320	-28,331
Gross claims on the government	0	0	0	0	0	954	954	954	1,771
Domestic currency deposits	-3,123	-1,959	-2,622	-2,854	-5,755	-5,755	-5,755	-5,755	-5,755
Foreign currency deposits	-17,554	-19,036	-21,035	-20,143	-23,819	-21,187	-15,731	-16,519	-24,348
Other claims	0	0	0	0	0	0	0	0	0
Other items net	869	-2,081	-2,093	-7,512	-5,871	-3,961	-4,295	-4,569	-4,803
Reserve money	44,126	45,303	47,279	47,923	50,346	52,230	56,176	56,761	59,245
Currency in circulation	38,763	40,084	42,997	43,012	44,629	46,482	50,217	50,590	52,862
Banknotes and coins issued	41,228	42,758	45,823	47,325	48,648	50,621	54,476	54,969	57,362
less cash holdings	2,465	2,674	2,825	4,314	4,018	4,139	4,259	4,380	4,500
Nongovernment resident deposits with DAB and capital note holdings	5,363	5,219	4,281	4,911	5,717	5,748	5,960	6,171	6,383
Memorandum items:									
Currency in circulation (year-to-date change)	...	3.4	10.9	11.0	15.1	4.2	12.5	13.4	18.4
Currency in circulation (year-on-year change)	37.5	35.8	25.3	18.4	15.1	16.0	16.8	17.6	18.4
Currency in circulation (ceilings under the PRGF; in millions of Afghamis)	...	...	...	...	...	47,423	50,217	51,539	52,862
Gross international reserves (at market rates; in millions of U.S. dollars)	1,283.4	1,338.6	1,464.6	1,521.9	1,661.8	...	...	...	...
Gross international reserves (at program rates; in millions of U.S. dollars)	1,235.9	1,319.2	1,431.9	1,484.0	1,587.1	1,602.2	1,572.2	1,598.6	1,803.8
Consumer prices in Kabul (quarterly change)	2.9	2.8	2.5	3.4	0.5	...	...	...	...
Consumer prices in Kabul (annual change)	14.9	11.6	12.9	12.1	9.5	...	...	...	9.0

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

1/ Historical data are estimated using market exchange rates. Projections are made on the basis of the program exchange rate.

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

Table 5. Islamic Republic of Afghanistan: Balance of Payments, 2002/03–2009/10

	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
	Est.	Est.	Est.	Est.		Projections		
(In millions of U.S. dollars)								
Current account (including grants)	-146.5	139.8	86.1	-67.5	-174.8	-501.2	-682.9	-920.8
Trade balance	-1,217.6	-1,892.0	-2,231.1	-2,622.5	-2,923.8	-3,008.8	-3,057.0	-2,784.2
Exports of goods 1/	1,290.6	1,893.9	1,642.3	1,599.6	1,725.7	1,827.1	1,921.6	2,196.1
Domestic exports	276.8	376.8	457.2	488.4	586.8	685.7	809.8	961.7
Reexports	1,013.9	1,517.1	1,185.1	1,111.2	1,138.9	1,141.3	1,111.8	1,234.4
Imports of goods	2,508.2	3,785.9	3,873.4	4,222.1	4,649.5	4,835.8	4,978.6	4,980.3
Recorded imports	1,142.3	1,688.5	1,999.6	2,062.3	2,348.7	2,647.9	2,947.8	3,272.9
Duty Free	840.8	1,001.0	1,203.3	1,462.3	1,620.4	1,530.0	1,367.2	1,039.4
<i>Of which:</i> Commodity food aid	94.0	40.9	107.8	70.1	60.4	56.9	55.2	0.0
Other	525.1	1,096.4	670.5	697.4	680.4	657.9	663.6	668.0
Services and income (net)	-150.8	-444.1	-470.1	-492.6	-591.3	-599.1	-584.9	-576.4
<i>Of which:</i> Interest due 2/	5.7	9.7	10.3	11.1	54.0	49.6	50.6	51.6
Current transfers	1,221.8	2,475.9	2,787.2	3,047.5	3,340.3	3,106.6	2,959.0	2,439.8
Public	1,170.2	2,420.9	2,477.1	2,652.0	2,857.6	2,543.6	2,278.7	1,627.2
<i>Of which:</i> Commodity food aid	94.0	40.9	107.8	70.1	60.4	56.9	55.2	0.0
Private 3/	51.6	55.0	310.1	395.6	482.7	563.1	680.3	812.5
Capital and financial account	144.0	149.6	475.2	467.5	328.7	432.3	558.1	749.5
Foreign direct investment	50.0	57.8	186.9	378.1	218.7	327.4	460.2	663.7
Official loans (net)	94.0	91.8	288.3	89.4	110.0	104.9	97.9	85.9
Disbursement	100.2	101.6	299.3	101.7	115.0	110.0	103.0	91.0
Amortization due 2/	6.2	9.8	11.0	12.3	5.0	5.1	5.1	5.1
Other capital (incl. errors & omissions)	157.8	93.3	-111.1	-35.7	-90.4	98.2	153.7	165.1
Overall balance	155.3	382.7	450.2	364.2	63.5	29.2	28.9	-6.2
Financing	-155.3	-382.7	-450.2	-364.2	-10,297.4	-100.0	-100.0	-50.0
Changes in reserve assets of DAB	-101.0	-394.7	-463.8	-378.4	-142.0	-100.0	-100.0	-50.0
Use of fund resources (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exceptional financing	-54.3	12.0	13.6	14.2	-10,155.4	0.0	0.0	0.0
Arrears 4/	-54.3	12.0	-4.0	-15.2	-10,155.4	0.0	0.0	0.0
Debt rescheduling	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Debt forgiveness	0.0	0.0	17.6	29.3	0.0	0.0	0.0	0.0
Financing gap	0.0	0.0	0.0	0.0	10,233.8	70.8	71.1	56.2
Identified financing (provisional)	0.0	0.0	0.0	0.0	35.1	32.4	32.4	16.2
<i>Of which:</i> IMF PRGF	0.0	0.0	0.0	0.0	35.1	32.4	32.4	16.2
Remaining gap 4/ 5/	0.0	0.0	0.0	0.0	10,198.7	38.4	38.7	39.9
Memorandum items:								
Gross international reserves								
In millions of U.S. dollars	425	820	1,283	1,662	1,804	1,904	2,004	2,054
In months of imports 6/	1.8	3.0	4.1	4.7	4.9	4.9	5.3	5.1
Relative to external debt service due	35.8	42.1	60.2	71.0	30.6	34.8	35.9	36.2
Trade balance (in percent of GDP)	-29.8	-41.3	-37.4	-35.9	-33.0	-29.1	-25.5	-20.3
Current account balance (in percent of GDP) 7/								
Including grants	-3.6	3.1	1.4	-0.9	-1.5	-4.5	-5.4	-6.4
Excluding grants	-33.5	-51.0	-45.2	-42.6	-39.1	-34.5	-30.1	-24.2
Total debt service (in percent of exports) 8/	3.6	4.0	3.9	3.8	1.5	1.5	1.4	1.2

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

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

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

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

4/ Arrears shown here represent an estimate by Fund staff of debt service due, but not being paid, on overdue obligations. The 2006/07 reduction in arrears (and financing gap) corresponds principally to preliminary staff estimates of the rescheduling of Paris Club debt on favorable terms (including the upfront cancellation of the majority of Soviet claims consistent with Paris Club practice).

5/ The financing gap corresponds to preliminary staff estimates of debt service arising from bilateral arrears. As bilateral negotiations progress and these calculations are refined, adjustments in projected interest and amortization due will correspond to changes in the remaining financing gap that is expected to be met through bilateral debt rescheduling agreements.

6/ In months of imports of goods and services, excluding imports for reexports.

7/ After rescheduling (i.e., excludes estimated penalty interest obligations programmed to be rescheduled beginning in 2006/07).

8/ Debt service includes obligations to the IMF and excludes estimated moratorium interest. Exports exclude reexports.

Table 6. Islamic Republic of Afghanistan: External Financing Requirement and Sources, 2002/03–2009/10
(In millions of U.S. dollars)

	Est.	Est.	Est.	Prelim.	Projections			
	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
I. Total financing requirement	1,529.8	2,728.6	3,179.9	3,521.0	13,817.4	3,713.0	3,747.1	3,415.7
Current account (excluding grants)	1,368.3	2,336.1	2,701.2	3,115.1	3,515.1	3,607.9	3,641.9	3,360.6
Amortization	6.2	9.8	11.0	12.3	5.0	5.1	5.1	5.1
<i>Of which: IMF</i>	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (increase = +)	101.0	394.7	463.8	378.4	142.0	100.0	100.0	50.0
Reduction in arrears	54.3	-12.0	4.0	15.2	10,155.4	0.0	0.0	0.0
II. Available financing	1,529.8	2,728.6	3,162.3	3,491.6	3,583.6	3,642.3	3,675.9	3,359.5
Current transfers	1,221.8	2,475.9	2,787.2	3,047.5	3,340.3	3,106.6	2,959.0	2,439.8
Foreign direct investment	50.0	57.8	186.9	378.1	218.7	327.4	460.2	663.7
Short-term private financing flows	...	...	...	...	...	...	...	...
Official medium- and long-term loans	100.2	101.6	299.3	101.7	115.0	110.0	103.0	91.0
IMF disbursements	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other	157.8	93.3	-111.1	-35.7	-90.4	98.2	153.7	165.1
Financing gap = I-II	0.0	0.0	17.6	29.3	10,233.8	70.8	71.1	56.2
Exceptional financing								
Debt relief	0.0	0.0	17.6	29.3	0.0	0.0	0.0	0.0
Balance of payments support	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Remaining gap	0.0	0.0	0.0	0.0	10,233.8	70.8	71.1	56.2
Identified financing (provisional)	0.0	0.0	0.0	0.0	35.1	32.4	32.4	16.2
<i>Of which: IMF PRGF</i>	0.0	0.0	0.0	0.0	35.1	32.4	32.4	16.2
Unfinanced gap	0.0	0.0	0.0	0.0	10,198.7	38.4	38.7	39.9

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

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

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

Source: Fund staff estimates.

1/ Does not add up due to rounding.

Table 8. Islamic Republic of Afghanistan: Projected Payments to the Fund as of March 31, 2006
(In millions of SDRs, unless otherwise indicated)

	2006 1/	2007	2008	2009	2010	2011	2012	2013	Beyond	Total
Obligations from existing drawings										
1. Principal										
GRA repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
PRGF repayments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
2. Charges and interest 2/										
PRGF interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SDR assessments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SDR charges	0.7	0.9	0.9	0.9	0.9	0.9	0.9	0.9	6.9	14.1
Total obligations	0.7	0.9	0.9	0.9	0.9	0.9	0.9	0.9	6.9	14.1
Percent of quota	0.4	0.6	0.6	0.6	0.6	0.6	0.6	0.6	4.3	8.7
Obligations from prospective drawings 3/										
1. Principal										
PRGF repayments	0.0	0.0	0.0	0.0	0.0	1.3	4.9	9.4	65.4	81.0
2. Charges and interest 2/										
PRGF interest	0.0	0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.7	3.1
Total obligations	0.0	0.2	0.3	0.4	0.4	1.7	5.3	9.8	66.1	84.1
Percent of quota	0.0	0.1	0.2	0.2	0.3	1.1	3.3	6.0	40.8	52.0
Cumulative obligations (existing and prospective)										
1. Principal										
GRA repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
PRGF repayments	0.0	0.0	0.0	0.0	0.0	1.3	4.9	9.4	65.4	81.0
2. Charges and interest 2/										
PRGF interest	0.0	0.2	0.3	0.4	0.4	0.4	0.4	0.4	0.7	3.1
SDR net charges	0.7	0.9	0.9	0.9	0.9	0.9	0.9	0.9	6.9	14.1
Total obligations	0.7	1.1	1.2	1.3	1.3	2.6	6.2	10.7	73.0	98.2
Percent of quota	0.5	0.7	0.7	0.8	0.8	1.6	3.8	6.6	45.1	60.7
Outstanding Fund credit	13.2	35.8	58.4	81.0	81.0	79.7	74.8	65.4	...	...
Memorandum items:										
Outstanding Fund credit										
In percent of:										
Exports of goods and services 4/	1.3	2.9	4.1	4.8	4.1	3.6	4.8	3.6	...	...
External public debt	0.6	1.5	2.2	2.9	2.8	2.6	2.4	2.0	...	...
Gross official reserves	0.5	1.3	2.0	2.7	3.2	3.0	2.6	2.2	...	...
GDP	0.1	0.2	0.3	0.4	0.4	0.3	0.3	0.2	...	...
Quota	8.2	22.1	36.1	50.0	50.0	49.2	46.2	40.4	...	...
Total obligations										
In percent of:										
Exports of goods and services 4/	0.1	0.1	0.1	0.1	0.1	0.1	0.4	0.6	...	...
External public debt	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.3	...	...
Gross official reserves	0.0	0.0	0.0	0.0	0.1	0.1	0.2	0.4	...	...
GDP	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	...	...
Quota	0.5	0.7	0.7	0.8	0.8	1.6	3.8	6.6	45.1	60.7

Source: Fund staff estimates.

1/ March 31, 2006 to December 31, 2006.

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

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

4/ Excludes reexports.

Table 9. Islamic Republic of Afghanistan: Millennium Development Goals, 1990–2003

	1990	1994	1997	2000	2003
Goal 1: Eradicate extreme poverty and hunger					
Percentage share of income or consumption held by poorest 20 percent	...	...	...	...	...
Population below US\$1 a day (in percent)	...	...	...	...	...
Population below minimum level of dietary energy consumption (in percent)	...	...	...	...	...
Poverty gap ratio at US\$1 a day (incidence x depth of poverty)	...	...	...	...	...
Poverty headcount, national (in percent of population)	...	...	...	...	...
Prevalence of underweight in children (under five years of age)	...	...	49.3	...	...
Goal 2: Achieve universal primary education					
Net primary enrollment ratio (in percent of relevant age group)	26.5	...	...	...	...
Primary completion rate, total (in percent of relevant age group)	...	23.0	...	...	...
Proportion of pupils starting grade 1 who reach grade 5	...	...	...	...	...
Youth literacy rate (in percent ages 15–24)	...	...	...	...	...
Goal 3: Promote gender equality and empower women					
Proportion of seats held by women in national parliament (in percent)	4.0	...	...	...	...
Ratio of girls to boys in primary and secondary education (in percent)	...	...	...	...	...
Ratio of young literate females to males (in percent ages 15–24)	...	...	...	...	...
Share of women employed in the nonagricultural sector (in percent)	17.8	...	...	...	...
Goal 4: Reduce child mortality					
Immunization, measles (in percent of children ages 12–23 months)	20.0	40.0	48.0	35.0	50.0
Infant mortality rate (per 1,000 live births)	168	...	...	...	...
Under 5 mortality rate (per 1,000)	260	...	...	...	...
Goal 5: Improve maternal health					
Births attended by skilled health staff (in percent of total)	...	...	...	12.4	14.0
Maternal mortality ratio (modeled estimate, per 100,000 live births)	...	...	...	1,900	..
Goal 6: Combat HIV/AIDS, malaria, and other diseases					
Contraceptive prevalence rate (in percent of women ages 15–49)	...	...	...	...	10.0
Number of children orphaned by HIV/AIDS	...	...	...	...	...
Prevalence of HIV, total (in percent of population aged 15–49)	...	...	...	...	...
Tuberculosis cases detected under DOTS (in percent)	...	...	2.0	9.0	18.2
Goal 7: Ensure environmental sustainability					
Access to an improved water source (in percent of population)	...	...	...	...	13.0
Access to improved sanitation (in percent of population)	...	...	...	...	8.0
Access to secure tenure (in percent of population)	...	...	...	...	...
CO2 emissions (in metric tons per capita)	0.1	0.1	...	...	...
Forest area (in percent of total land area)	2.1	...	...	2.1	...
GDP per unit of energy use (2000 PPP, U.S. dollars per kg oil equivalent)	...	...	...	...	...
Nationally protected areas (in percent of total land area)	...	...	...	...	0.3
Goal 8: Develop a global partnership for development					
Aid per capita (in U.S. dollars)	7.4	11.1	...	...	...
Debt service (in percent of exports)	...	...	...	...	...
Fixed line and mobile phone subscribers (per 1,000 people)	2.2	1.6	1.3	1.3	11.8
Internet users (per 1,000 people)	...	...	...	...	1.0
Personal computers (per 1,000 people)	...	...	...	...	...
Unemployment, youth female (in percent of female labor force ages 15–24)	...	...	...	...	...
Unemployment, youth male (in percent of male labor force ages 15–24)	...	...	...	...	...
Unemployment, youth total (in percent of total labor force ages 15–24)	...	...	...	...	...
Other					
Fertility rate, total (births per woman)	6.9	...	...	...	...
GNI per capita, Atlas method (in U.S. dollars)	...	...	...	...	197.2
GNI, Atlas method (in billions of U.S. dollars)	...	...	...	...	4.3
Gross capital formation (in percent of GDP)	...	...	...	...	...
Life expectancy at birth, total (years)	41.5	...	...	...	...
Literacy rate, adult total (in percent of people ages 15 and above)	...	...	...	...	...
Population, total (in millions)	17.7	20.7	...	...	...
Trade (in percent of GDP)	...	...	...	...	145.6

Source: World Development Indicators database, April 2005.

Table 10. Islamic Republic of Afghanistan: Government and Government Guaranteed External Debt, 2002/03–2006/07

	Est. 2002/03	Est. 2003/04	Est. 2004/05	Est. 2005/06	Est. 1/ 2005/06	Proj. 2/ 2006/07
(In millions of U.S. dollars)						
Total government external debt	539	669	762	847	10,847	1,549
Bilateral creditors	314	347	330	301	10,301	857
<i>Of which: Paris Club creditors 3/</i>	122	151	151	155	10,155	711
Multilateral creditors	226	322	432	546	546	692
<i>Of which: use of Fund resources</i>	0	0	0	0	0	35
Service on government external debt 4/	1.1	7.5	7.7	9.2	...	11.3
<i>Of which: to the Fund</i>	1.1	0.3	0.6	0.6	...	1.2
Amortization paid 4/	0.0	3.6	3.3	3.5	...	3.9
<i>Of which: to the Fund</i>	0.0	0.0	0.0	0.0	...	0.0
Interest paid 4/	1.1	3.9	4.3	5.7	...	7.4
<i>Of which: to the Fund</i>	1.1	0.3	0.6	0.6	...	1.2
(In percent of GDP)						
Total government external debt	13.2	14.6	12.8	11.6	148.4	17.5
Bilateral creditors	7.7	7.6	5.5	4.1	140.9	9.7
<i>Of which: Paris Club creditors 3/</i>	3.0	3.3	2.5	2.1	139.0	8.0
Multilateral creditors	5.5	7.0	7.2	7.5	7.5	7.8
<i>Of which: use of Fund resources</i>	0.0	0.0	0.0	0.0	0.0	0.4
Service on government debt 4/	0.0	0.2	0.1	0.1	...	0.1
Amortization	0.0	0.1	0.1	0.0	...	0.0
Interest	0.0	0.0	0.0	0.0	...	0.0
(In percent of exports of goods and nonfactor services) 5/						
Total government external debt	164.6	138.6	138.6	139.0	1781.2	182.6
Bilateral creditors	95.8	72.0	60.0	49.4	1691.5	101.0
<i>Of which: Paris Club creditors 3/</i>	37.4	31.4	27.5	25.5	1,667.6	83.8
Multilateral creditors	68.8	66.7	78.6	89.6	89.6	81.6
<i>Of which: use of Fund resources</i>	0.0	0.0	0.0	0.0	0.0	4.1
Service on government debt 4/	0.3	1.6	1.4	1.5	...	1.3
Amortization	0.0	0.7	0.6	0.6	...	0.5
Interest	0.3	0.8	0.8	0.9	...	0.9
Memorandum items:						
Stock of arrears						
In millions of U.S. dollars	313.7	347.1	329.6	300.9	10,300.9	145.6
In percent of GDP 6/	7.7	7.6	5.5	4.1	140.9	1.6

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

1/ End-2005/06 external debt stock assuming included of preliminary estimates of Russian claims.

2/ The sizeable increase in the debt stock in 2006/07 reflects the inclusion of the Russian claims, net of the assumed the upfront cancellation of the majority of Soviet claims consistent with Paris Club practice and subsequent rescheduling of all Paris Club claims on favorable terms.

3/ Excludes Russian claims prior to their expected regularization via a Paris Club rescheduling.

4/ Cash basis through 2005/06; thereafter on an estimated commitment basis.

5/ Excludes reexports.

6/ Assumes rescheduling of Paris Club arrears in 2006/07, but authorities will also seek comparable treatment on remaining non-Paris Club arrears.

Table 11a. Islamic Republic of Afghanistan: External Debt Sustainability Framework, Baseline Scenario, 2002–11 1/
(In percent of GDP, unless otherwise indicated)

	Actual				Historical Average 8/ Standard Deviation 8/	Projections					Average 2006-11
	2002	2003	2004	2005		2006	2007	2008	2009	2010		2011
External debt (nominal) 1/	13.2	14.6	12.8	11.6	17.5	16.3	15.2	14.0	13.1	12.2	12.2
<i>Of which:</i> Public and publicly guaranteed (PPG)	13.2	14.6	12.8	11.6	17.5	16.3	15.2	14.0	13.1	12.2	12.2
Change in external debt	...	1.4	-1.8	-1.2	-1.9	-1.2	-1.1	-1.2	-0.9	-0.9	-0.9
Identified net debt-creating flows	...	-5.8	-8.0	-6.6	-1.9	0.0	0.4	0.5	3.2	0.6	0.6
Noninterest current account deficit	3.4	-3.3	-1.6	0.8	-0.2	2.9	5.3	6.3	8.8	5.9	5.3
Deficit in balance of goods and services	53.4	72.1	58.2	51.5	46.1	40.5	35.2	29.7	26.1	22.6	22.6
Exports (excludes reexports)	8.0	10.5	6.7	6.3	6.3	6.3	6.4	6.6	7.0	7.1	7.1
Imports	61.4	82.6	64.9	57.8	52.4	46.7	41.6	36.3	33.1	29.8	29.8
Net current transfers (negative = inflow)	-29.9	-54.0	-46.7	-41.7	-43.1	-30.0	-24.7	-17.8	-13.1	-12.3	-12.3
Other current account flows (negative = net inflow)	-20.0	-21.3	-13.2	-9.0	-7.1	-6.1	-5.2	-5.6	-4.1	-4.5	-4.5
Net FDI (negative = inflow)	-1.2	-1.3	-3.1	-5.2	-2.7	-2.5	-3.8	-4.8	-5.0	-4.7	-4.0
Endogenous debt dynamics 2/	...	-1.2	-3.2	-2.2	-1.9	-0.8	-1.2	-1.0	-0.7	-0.6	-0.6
Contribution from nominal interest rate	...	0.2	0.2	0.2	0.2	0.3	0.5	0.4	0.4	0.3	0.3
Contribution from real GDP growth	...	-1.8	-0.9	-1.5	-1.1	-1.1	-1.7	-1.5	-1.0	-0.9	-0.9
Contribution from price and exchange rate changes	...	0.4	-2.5	-0.9	...	...	...	...	...	...	...
Residual (3-4) 3/ 4/	...	7.1	6.1	5.4	7.8	-1.2	-1.5	-1.7	-4.1	-1.5	-1.5
<i>Of which:</i> Exceptional financing	...	-0.3	-0.2	-0.2	-0.5	-0.4	-0.3	-0.3	-0.3	-0.3	-0.3
NPV of external debt 5/	...	...	...	16.1	12.2	11.1	10.1	9.2	8.4	7.8	7.8
In percent of exports (excluding reexports)	...	...	...	256.5	193.4	175.9	157.8	138.7	120.8	108.9	108.9
NPV of PPG external debt	...	...	...	16.1	12.2	11.1	10.1	9.2	8.4	7.8	7.8
In percent of exports (excluding reexports)	...	...	...	256.5	193.4	175.9	157.8	138.7	120.8	108.9	108.9
Debt service-to-exports ratio (in percent; excluding reexports)	3.6	4.0	5.4	5.1	10.6	8.4	7.3	6.3	5.3	4.7	4.7
PPG debt service-to-exports ratio (in percent)	3.6	4.0	5.4	5.1	10.6	8.4	7.3	6.3	5.3	4.7	4.7
Total gross financing need (in billions of U.S. dollars)	0.1	-0.2	-0.3	-0.3	0.0	0.2	0.2	0.2	0.3	0.7	0.3
Noninterest current account deficit that stabilizes debt ratio 4/	...	-4.6	0.2	1.9	-4.5	5.5	6.4	7.5	9.8	6.8	6.8
Key macroeconomic assumptions											
Real GDP growth (in percent)	28.6	15.7	8.0	14.0	12.0	11.1	10.3	10.0	8.0	8.0	9.9
GDP deflator in U.S. dollar terms (change in percent)	...	-2.9	20.6	7.4	8.3	11.8	5.0	4.0	3.7	3.7	5.0
Effective interest rate (in percent) 6/	...	1.8	1.5	1.5	1.6	0.2	3.0	2.8	2.7	2.6	3.0
Growth of exports of goods and services (U.S. dollar terms, in percent)	...	47.2	-17.6	15.1	14.9	32.4	17.7	18.4	18.4	14.1	17.9
Growth of imports of goods and services (U.S. dollar terms, in percent)	...	50.9	2.3	9.0	20.8	26.4	10.1	4.0	1.9	0.9	3.3
Grant element of new public sector borrowing (in percent) 7/	...	...	...	...	49.7	49.9	49.5	52.2	56.9	56.9	52.5
Memorandum item:											
Nominal GDP (in billions of U.S. dollars)	4.1	4.6	6.0	7.3	8.9	10.3	12.0	13.7	15.4	17.2	17.2

Source: Fund staff simulations.

1/ Includes both public and private sector external debt.

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

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

4/ The large residual in 2006 corresponds to the effect of incorporating the Russian debt (net of the programmed Paris Club treatment).

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

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

7/ The calculation of the grant element for this DSA differs from that used for program purposes. While the former uses a more current discount rate, the latter uses a discount rate based on 10 year average interest rates, plus an additional premium reflecting the loan's maturity.

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

Table 11b. Islamic Republic of Afghanistan: Sensitivity Analyses for Key Indicators of Public and Publicly Guaranteed External Debt, 2006–11
(In percent)

	Projections					
	2006	2007	2008	2009	2010	2011
NPV of debt-to-GDP ratio						
Baseline	12	11	10	9	8	8
A. Alternative Scenarios						
A1. Key variables in line with historical averages for selected post-conflict countries in 2007–26 1/	12	15	17	19	20	22
A2. New public sector loans on less favorable terms in 2007–26 2/	12	12	11	11	10	10
B. Bound Tests						
B1. Real GDP growth at historical average minus one standard deviation in 2007–08	12	11	11	10	9	8
B2. Export value growth at historical average minus one standard deviation in 2007–08 3/	12	12	12	11	10	10
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2007–08	12	12	12	11	10	9
B4. Net non-debt creating flows halved relative to baseline in 2007–08 4/	12	19	24	21	20	18
B5. Combination of B1-B3 using one-half standard deviation shocks plus one-third decline in non-debt flows	12	17	20	18	17	16
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	12	15	14	13	12	11
NPV of debt-to-exports ratio 6/						
Baseline	193	176	158	139	121	109
A. Alternative Scenarios						
A1. Key variables in line with historical averages for selected post-conflict countries in 2007–26 1/	193	236	269	291	287	310
A2. New public sector loans on less favorable terms in 2007–26 2/	193	186	175	160	144	135
B. Bound Tests						
B1. Real GDP growth at historical average minus one standard deviation in 2007–08	193	176	158	139	121	109
B2. Export value growth at historical average minus one standard deviation in 2007–08 3/	193	268	389	342	299	270
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2007–08	193	176	158	139	121	109
B4. Net non-debt creating flows halved relative to baseline in 2007–08 4/	193	298	370	325	285	259
B5. Combination of B1-B3 using one-half standard deviation shocks plus one-third decline in non-debt flows	193	306	432	380	333	302
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	193	176	158	139	121	109
Debt service ratio 6/						
Baseline	11	8	7	6	5	5
A. Alternative Scenarios						
A1. Key variables in line with historical averages for selected post-conflict countries in 2007–26 1/	10	9	9	9	8	8
A2. New public sector loans on less favorable terms in 2007–26 2/	10	8	8	7	7	6
B. Bound Tests						
B1. Real GDP growth at historical average minus one standard deviation in 2007–08	10	8	7	6	5	5
B2. Export value growth at historical average minus one standard deviation in 2007–08 3/	10	12	15	13	11	11
B3. U.S. dollar GDP deflator at historical average minus one standard deviation in 2007–08	10	8	7	6	5	5
B4. Net non-debt creating flows halved relative to baseline in 2007–08 4/	10	8	9	9	8	7
B5. Combination of B1-B3 using one-half standard deviation shocks plus one-third decline in non-debt flows	10	10	12	11	10	9
B6. One-time 30 percent nominal depreciation relative to the baseline in 2007 5/	10	8	7	6	5	5
Memorandum item:						
Grant element assumed on residual financing (i.e., financing required above baseline) 7/ 8/	54	54	54	54	54	54

Source: Fund staff projections and simulations.

1/ Variables include real GDP growth, GDP deflator (in U.S. dollar terms), noninterest current account in percent of GDP, and nondebt creating flows. Given that Afghanistan only has reliable data since 2001, the historical average scenario was based on 10-year averages (WEO) for non-transition low-income members receiving emergency post-conflict assistance from the Fund since 1995.

2/ Assumes that the interest rate on new borrowing is by 4 percentage points higher than in the baseline, while grace and maturity periods are the same as in the baseline.

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

4/ Includes official and private transfers and FDI. Given the high level of transfers since 2001 and absence of a longer data series, the standard bound test of one standard deviation below the average would have produced higher than programmed transfers in 2007–08. To better reflect Afghanistan's sensitivity to official support, an alternative shock of halving nondebt creating flows was applied.

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

6/ Excludes reexports and staff estimates of smuggling.

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

8/ The calculation of the grant element for this DSA differs from that used for program purposes. While the former uses a more current discount rate, the latter uses a discount rate based on 10-year average interest rates plus an additional premium reflecting the loan's maturity.

Islamic Republic of Afghanistan: Relations with the Fund

(As of March 31, 2006)

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

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

III. SDR Department	<u>SDR Million</u>	<u>% Allocation</u>
Net cumulative allocation	26.70	100.00
Holdings	0.02	0.09

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)

	<u>Forthcoming</u>				
	<u>2006</u>	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	<u>0.69</u>	<u>0.92</u>	<u>0.93</u>	<u>0.92</u>	<u>0.92</u>
Total	0.69	0.92	0.93	0.92	0.92

VII. **Implementation of HIPC Initiative** Not Applicable

Nonfinancial Relations

VIII. Exchange Arrangement

Afghanistan is an Article XIV member country. The authorities are implementing a liberal exchange system. Based on information currently available to the staff, no exchange restrictions and multiple currency practices are currently in place. The authorities have provided documents to IMF staff related to laws and regulations on the exchange regime and have requested technical assistance from the Fund to formalize the current liberal regime. They have been implementing a managed float system with no predetermined path for the exchange rate. As of May 2, 2006, the average exchange rate on the Kabul money exchange market was Af 49.62 per \$1.

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

IX. Article IV Consultation

The last Article IV consultation with Afghanistan was discussed by the Executive Board on March 6, 2006. Consultations with Afghanistan are on the standard 12-month cycle.

X. Safeguards Assessment

A safeguards assessment of Da Afghanistan Bank (DAB) is being completed. A safeguards mission to Kabul took place from April 2–11 and revealed serious vulnerabilities in four of the five safeguards areas, specifically in the external and internal audit mechanisms, the financial reporting framework, and the system of internal controls. Staff made recommendations, which, together with the ongoing modernization program, should help address these vulnerabilities. However, capacity constraints in many areas within the DAB may hamper effective and timely implementation. It is envisaged that staff will take stock of improvements in the DAB’s safeguards framework through a follow-up visit in approximately one year.

XI. Technical Assistance, 2005–06

Department	Date	Purpose
FAD	March 2004 (ongoing)	Resident Treasury expert
	May 19–25, 2005	Seminar on reorganization of the MoF
	October 18–25, 2005	Tax policy
	February 21–March 04, 2006	Public financial management
	April 30–May 09, 2006	Tax policy
FIN	April 2–11, 2006	Safeguards assessment
LEG	January 29–February 12, 2005	Income tax law
LEG/MFD	May 2–10, 2006	Legal framework of DAB’s monetary and payment system policies
MFD	September 2004–March, 2006	Training coordinator
	February 2–15, 2005	Implementation of DAB balance sheet reconstruction and capital adequacy recommendations
	May 16–25, 2005	Monetary policy and financial markets
	October 11–20, 2005	Monetary policy
	November 20–29, 2005	Financial markets

Department	Date	Purpose
MFD	January 22–February 5, 2006	Monetary policy
	May 2–10, 2006	Monetary policy, foreign reserve management, money markets and insurance
STA	January 15–February 15, 2005	Multisector statistics
	March 23–June 11, 2005	Multisector statistics
	July 20–August 31, 2005	Multisector statistics
	October 31, 2005–January 12, 2006	Multisector statistics
	March 8–May 2, 2006	Multisector statistics
	March 6–15, 2006	Balance of payments statistics
MCD	March 13–April 1, 2006	Monetary and financial statistics
	April 16–20, 2005	Basic macroeconomic accounting and financial programming
METAC	November 15–20, 2005	Tax policy and administration

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

A resident treasury expert for the Ministry of Finance, Mr. Platais, was appointed in March 2004. Two FAD missions covering tax administration and tax policy issues are scheduled in 2006.

A resident multisector statistical advisor, Mr. Soulatha, was stationed in Kabul on July 17, 2002. STA has also provided technical assistance through a series of peripatetic multisector missions which began in January 2004. These missions were suspended in July 2004 due to the security situation. A new series of peripatetic missions commenced in January/February 2005.

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

XII. Resident Representatives

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

Islamic Republic of Afghanistan: Relations with the World Bank

(As of April 20, 2006)

1. A second Transitional Support Strategy was presented to the World Bank Board of Executive Directors in March 2003. This was due to be updated by March 2005, following the culmination of the political process outlined in Bonn. Despite a successful Presidential election in October 2004, parliamentary elections in Afghanistan were not held until September 2005. This delay in the political process, coupled with the government's preparation of a National Development Strategy, delayed the preparation of a new Interim Strategy Note (ISN), which has now been prepared and is anticipated for Board discussion on May 25, 2006. The new ISN reflects only a minor shift in strategy, notably to provide a greater focus on rural development.
2. In FY 2002, World Bank staff prepared and negotiated four projects to utilize IDA grant funds for a total of \$100 million. Following the clearance of Afghanistan's arrears to the World Bank and the Fund through donor contributions, the first IDA credit for \$108 million for an Emergency Transport Project was approved by the Board in March 2003. By the end of FY 2003, three additional projects—Emergency Health Sector Rehabilitation (\$59.6 million), Emergency Public Administration II (\$8.4 million), and National Emergency Employment II (\$39.2 million)—were approved, bringing to \$215 million the total allocation for the year.
3. Five IDA credits/grants were negotiated for FY 2004, for a total of \$293 million. These programs include the Emergency Communications Project (\$22 million), the Emergency Customs Modernization and Trade Facilitation Project (\$31 million), the National Solidarity Program II (\$95 million), the Emergency Irrigation Rehabilitation Program (\$40 million), and the Emergency Power Rehabilitation Program (\$105 million).
4. For FY 2005, six projects and two supplementals were approved, for a total of \$285 million: the first budget-support operation, Programmatic Support for Institution Building (\$80 million); the Kabul Urban Reconstruction Project (\$25 million); the Investment Guarantee Facility (\$5 million), together with MIGA; the Education Quality Improvement Program (\$35 million); Public Administration Capacity Building (\$27 million); Strengthening Higher Education (\$40 million); and supplemental financing for the Emergency Transport Project (\$45 million) and the National Solidarity Program (\$28 million).
5. For FY 2006, six projects are planned for a total IDA grant commitment of \$230 million. To date, three programs have been approved by the Board—the second budget support operation: Programmatic Support for Institution Building II (\$80 million), which was approved in December 2005, and two additional grants for Health Sector Emergency Rehabilitation (\$30 million) and National Solidarity Program (\$40 million).

6. The World Bank also administers the Afghanistan Reconstruction Trust Fund (ARTF), which became effective in May 2002 and plays a critical role in funding the recurrent costs of government. In its first year of operation (2002/03), the ARTF mobilized \$185 million and disbursed \$65 million. Paid-in contributions for 2003/04 amounted to \$286 million, while disbursements reached \$254 million. Paid-in contributions for 2004/05 amounted to \$380 million, while disbursements reached \$292 million. Paid in contributions for 2005/06 reached \$470 million, with \$405 million paid in (as of March 20, 2006). ARTF is increasing its financing of investments and has the potential to support better donor coordination, simplified processes, and fast results. Discussions are under way with donors to the ARTF to increase the focus on policy reform.

7. The World Bank is also actively engaged in providing advisory services to the government and continues to respond quickly to a range of requests. Current analytical work focuses on civil service reform, urban development and land management, education policy reform, labor market and pensions, and oil/gas infrastructure development, as well as broader regional trade work encompassing issues with Afghanistan's neighbors. A Gender Assessment was released in January 2006. The World Bank completed a major Public Finance Management (PFM) review, which incorporates an assessment of public expenditures and fiduciary aspects, including procurement and financial management. Fund staff contributed to the PFM review, including by providing an analysis of domestic revenue prospects. The World Bank has also actively utilized the Post Conflict Fund and continues to use resources from the Japan Social Development Fund to provide on-the-ground support to the government and communities. Future analytical work being planned will focus on anti-corruption efforts and public administration reform.

8. The World Bank's program is growing quickly and, as of April 2006, has an IDA portfolio of 20 investments and four supplementals (one project has closed). Commitments since 2001 total \$1043.2 million, of which \$606.8 million are in grants. Disbursements are at 62 percent. Total commitments for FY 2006 are expected to reach \$230 million, entirely in grants.

Kabul, May 15, 2006

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

Dear Mr. de Rato,

During the past four years, Afghanistan has made substantial progress in reconstructing its economy and restoring macroeconomic stability. In particular, we have benefited from close cooperation with the Fund in the context of the 2004–06 staff-monitored program (SMP). In the context of the seventh review, we are pleased to report that we have met all the end-December 2005 quantitative indicators and structural benchmarks, except for the one related to the publication of the 2004/05 audited core budget financial statements, which was met with some delay.

The challenges in the period ahead are daunting and a sustained effort will be needed to diversify the economy and remove the impediments to growth, as well as to restore medium-term external and fiscal sustainability. To address these challenges, consolidate macroeconomic stability, and enhance our efforts to reduce poverty, we have developed our Interim Afghanistan National Development Strategy (I-ANDS).

The economic policies and program for 2006–09—as described in the attached memorandum of economic and financial policies (MEFP)—are drawn largely from the I-ANDS, which was submitted to the IMF and World Bank in March 2006. Based on the track record of good performance under the SMP and in support of our medium-term program, we are requesting a three-year arrangement under the Poverty Reduction and Growth Facility (PRGF) in the amount of SDR 81 million (50 percent of quota).

The government and Da Afghanistan Bank (DAB) believe that the policies set forth in the attached MEFP are adequate to achieve the objectives of their program, but they will take any further measures that may become appropriate, for this purpose. Afghanistan will consult with the Fund on the adoption of these measures, and in advance of revisions to the policies contained in the MEFP, in accordance with the Fund’s policies on such consultations. In addition, we will provide the Fund with all information necessary to monitor implementation of the PRGF-supported program in a timely manner. The government and DAB will conduct with the Fund two reviews during the first year of the PRGF arrangement, the first scheduled no later than end-January 2007 and the second scheduled before end-June 2007.

Moreover, after the period covered by this arrangement, and while Afghanistan has outstanding financial obligations to the IMF arising from loan disbursements under the

arrangement, we will consult with the IMF from time to time, at the initiative of the government or DAB, or whenever the Managing Director of the IMF requests consultation on Afghanistan's economic and financial policies.

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

Sincerely yours,

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

/s/
Noorullah Delawari
Governor
Da Afghanistan Bank

Attachments:

Memorandum of Economic and Financial Policies for 2006/07–2008/09

Technical Memorandum of Understanding

Islamic Republic of Afghanistan
Memorandum of Economic and Financial Policies for 2006/07–2008/09

I. INTRODUCTION

1. This memorandum describes our economic program for the fiscal year 2006/07 (March 22, 2006–March 21, 2007), in the context of our medium-term strategy for the period through March 21, 2009, for which support is being requested under a three-year arrangement under the IMF’s Poverty Reduction and Growth Facility (PRGF). It also reviews performance during the third quarter of 2005/06 (October–December 2005) under the current staff-monitored program (SMP).
2. Over the last two years, the SMP has been instrumental in consolidating macroeconomic stability, and building momentum for institutional and structural reforms. Looking ahead, we remain committed to promoting sustainable and inclusive economic growth to reduce the widespread incidence of poverty. To this end, our medium-term strategy—outlined in the Interim Afghan National Development Strategy (I-ANDS)¹—aims at supporting development and poverty reduction while ensuring macroeconomic stability and fiscal sustainability. We view a formal PRGF arrangement as the most appropriate vehicle to support the policies and objectives outlined in the I-ANDS, which will be developed in a full ANDS.
3. The government also considers that a PRGF-supported program will provide an appropriate framework that would allow Afghanistan to settle its outstanding claims with creditors and restore external sustainability. In this regard, the government hopes that Afghanistan’s eligibility for the enhanced Heavily Indebted Poor Country (HIPC) Initiative would be considered around the time of the first review under the PRGF arrangement. With continued satisfactory performance under the first year of the program, this would allow Afghanistan to reach the decision point under the enhanced HIPC Initiative.

II. RECENT ECONOMIC DEVELOPMENTS AND PERFORMANCE UNDER THE SMP

4. **After a significant slowdown in 2004/05, economic activity accelerated in 2005/06.** Real GDP is estimated to have grown by 14 percent, in line with SMP projections and well above the 2004/05 outcome (8 percent). Owing to better precipitation, agricultural output rebounded, while growth in the other sectors continued to be driven by the sustained momentum in the reconstruction effort.
5. **Year-on-year inflation in Kabul continued to decline steadily.** The decline from 12.9 percent in September 2005 to 9.5 percent in March 2006 was underpinned by a

¹ The I-ANDS, which is Afghanistan’s Interim Poverty Reduction Strategy, was submitted to the IMF and World Bank in March 2006.

slowdown in food prices (which increased by 2.6 percent over that period, compared with 12 percent over the same period of 2004/05) that was partly offset by accelerating rents and petroleum product prices. Rents and petroleum product prices increased by 24.8 and 26.6 percent, respectively, during 2005/06. Excluding these two items, year-on-year inflation declined to 6.8 percent in March, from 12.6 percent in September 2005.²

6. Opium cultivation is expected to increase in 2006, after declining by 21 percent in 2005. A rapid assessment survey conducted by the United Nations Office on Drugs and Crime in cooperation with the Ministry of Counter Narcotics pointed to potential sharp increases in 7 provinces (which contributed to 43 percent of cultivation in 2005) and moderate increases in 6 other provinces (representing 9 percent of 2005 cultivation). Cultivation was expected to remain broadly unchanged or decline in the remaining 19 provinces. To avoid an overall increase in cultivation from translating into a rise in production, the government, in cooperation with the donor community, has intensified its eradication efforts.

7. Continued strong fiscal performance in 2005/06 was underpinned by robust revenue collection and expenditure discipline. Consequently, the 2005/06 operating budget deficit excluding grants is expected to be lower than projected, at 3.7 percent of GDP, compared with a midyear budget review (MYR) estimate of 4.1 percent. External grants to the operating budget are projected to reach 4.7 percent of GDP in 2005/06, contributing to a surplus after grants of 0.9 percent of GDP, compared with a MYR estimate of 0.6 percent.

- **Revenues, excluding grants, continued to grow strongly in 2005/06.** They exceeded budget projections, amounting to Af 13.3 billion during the first 9 months of 2005/06, compared with a program target of Af 12.7 billion. Customs revenue performed strongly throughout the year, and domestic tax collection picked up significantly during the fourth quarter as receipts from a 2-percent income withholding tax on importers were swept into the central government accounts and overflight charges (Af 880 million for 2006/07) were received.³ Annual revenue collection is expected to be around 5.5 percent of GDP, significantly above the MYR projection (5.2 percent of GDP), the SMP program target (5.0 percent of GDP), and the 2004/05 outcome (4.5 percent of GDP). Administrative reforms have played an important part in this strong performance.
- **Despite mounting pressures, operating expenditures during the first 9 months of 2005/06 were kept broadly in line with budget projections.** Considerable costs that

² The national CPI, which covers five major cities in addition to Kabul, increased by 8.5 percent in 2005/06.

³ The 2-percent income withholding tax on importers was introduced in 2005/06 and is collected by customs. An investigation by the Ministry of Finance found that these funds were deposited with central bank branches, but not reported or swept to the central government. This procedural oversight has now been corrected and around Af 1.7 billion is expected to be swept from these accounts during the fourth quarter.

had not been anticipated at the time of the MYR had to be funded within the operating budget. These costs include increased spending associated with insecurity, outlays for the Afghan National Army previously financed directly by donors, and higher-than-expected recruitment in the education sector. While we expect to meet these additional costs within the existing operating budget ceiling (9.3 percent of GDP), there have been some delays in paying salaries in a limited number of provinces, an apparent breach of the manpower ceiling by the Ministry of Education, and recent demands by other ministries for additional appropriations to meet wage costs. To address these pressures and inform the 2006/07 MYR, we plan to limit the recruitment and strictly enforce both financial and manpower controls pending a review of civil service recruitment, remuneration, and human resource management in key sectors.

8. **Core budget development spending for 2005/06 is expected to reach less than 40 percent of MYR estimates.** Continued implementation problems reflect capacity constraints, security concerns, and weaknesses in budget formulation. A planned reorganization of the Budget Department along sector lines and additional technical assistance should help to support line ministries in developing detailed costing and disbursement schedules for projects in the future. Although donors have still to provide us with detailed information, donor-funded spending implemented outside the core budget is estimated to have amounted to about 28 percent of GDP in 2005/06.
9. **The 2004/05 core budget audited financial statements were published in March 2006 (initially an end-September 2005 benchmark), after procedural delays in meeting the requirements of the Control and Audit Office (CAO).** We have constituted a working group comprising representatives of the Ministry of Finance (MoF) and CAO, which has developed an audit plan to ensure that the 2005/06 financial statements are submitted to parliament by the legal deadline of end-September 2006.
10. **Faced with higher-than-projected inflation and a depreciating exchange rate, we tightened our monetary stance during the second half of 2005/06.** Currency in circulation increased by only 3.8 percent during this period, amounting to Af 44.6 billion at end-March (compared with an indicative ceiling of Af 49.5 billion). International reserves rose further, to \$1.7 billion at end-March 2006 (equivalent to 4.7 months of 2006/07 imports of goods and services). Interest rates on overnight and 30-day capital notes continued to move in the 1–2 percent and 4–6 percent ranges, respectively.
11. **The exchange rate has continued to fluctuate within the 48.5–50.5 Afghanis per U.S. dollar range.** Reflecting substantially higher inflation than in the United States, the Afghani appreciated by 2 percent in real terms against the U.S. dollar during the second half of 2005/06.
12. **We pursued the modernization of central bank operations and made progress toward restructuring the state-owned banks.** Participants in the foreign exchange auctions are now allowed to both sell and buy dollars, and to enter multiple bids. We have started

publishing the interest rates on capital note auctions. We have also strengthened the enforcement of reserve requirements and initiated the remuneration of required reserves, while excluding capital notes from the eligible assets. Regarding the state-owned banks, we appointed a new Board of Directors at Bank Millie, which will be in charge of its restructuring, and another team to oversee the liquidation of the three former state-owned banks that had not been relicensed. Lastly, we completed the transfer of the remaining deposits with the Agricultural Development Bank, the only of these former banks that had retained a deposit base.

13. **Preliminary estimates suggest that the current account deficit, excluding grants, moderated to 42½ percent of GDP in 2005/06, from just over 45 percent of GDP in 2004/05.** However, owing to a decline in public transfers as a share of GDP, the current account including grants shifted from a surplus of just under 1½ percent of GDP in 2004/05 to a deficit nearing 1 percent of GDP in 2005/06. Total donor disbursements remained largely unchanged in dollar terms, as a tapering off in concessional loan disbursements was offset by higher official transfers. The current account deficit, including grants, was more than covered by a doubling of foreign direct investment (FDI), to more than 5 percent of GDP, on account of one-off telecommunication investments.

14. **We continued our efforts to improve balance of payments statistics and compilation.** In line with the recommendations of the May 2005 IMF technical assistance mission, we have undertaken surveys of non-recorded trade and travel. The recommendations of the March 2006 technical assistance follow-up mission will support our ongoing efforts to compile and analyze these surveys, and also improve data reporting and collection from commercial banks, major FDI enterprises, money changers, foreign embassies, and international organizations.

15. **Progress in verifying external debt owed to Paris Club and non-Paris Club creditors continued, albeit at a slower-than-desired pace.** During the fourth quarter of 2005/06, the Slovak Republic agreed to forgive our arrears. However, progress with other non-Paris Club creditors has been constrained by delays in obtaining the documentation needed to validate and reconcile related claims. We welcome the announcement by our Paris Club creditors—Germany, Russia, and the United States—of their intention to provide 100 percent debt relief in the context of the enhanced HIPC Initiative.

16. **Following the adoption of the statistical law, we established a National Statistical Council, which will supervise implementation of our statistical policy and reform plan.**⁴ At the same time, we are reorganizing the Central Statistics Office. On macroeconomic statistics, in addition to the aforementioned efforts aimed at enhancing balance of payments

⁴ The National Statistical Council is expected to include representatives from the Vice President Office, Ministry of Finance, Ministry of Economy, Ministry of Education, Ministry of Health, Da Afghanistan Bank, Central Statistics Office, the Oversight Committee of ANDS, women from academia, and the private sector.

data, we continue to make progress in drafting the metadata necessary to participate in the General Data Dissemination System.

III. POLICIES UNDER THE PRGF PROGRAM

A. Medium-Term Strategy

17. **Sustained broad-based growth and poverty reduction are the primary objectives of our medium-term reform agenda.** Building on progress under the SMP, the comprehensive I-ANDS reform agenda aims at consolidating macroeconomic stability, diversifying the sources of growth, setting policies to establish a path for achieving fiscal and external sustainability, removing institutional and structural impediments to private sector development, and gradually eliminating opium-related activities.

18. **The I-ANDS represents an unprecedented plan to address poverty in Afghanistan.** The establishment of the Oversight Committee, which directed the strategic orientations of the I-ANDS, together with the consultative process underlying the preparation of the I-ANDS—upon which we intend to build in preparing the ANDS—make the I-ANDS an invaluable tool for promoting social stability and economic development. To this end, the poverty reducing elements of the I-ANDS center on: (a) increasing employment and enterprise creation; (b) developing human capital through better education and health, and adequate social protection; (c) rural development; and (d) establishing a solid infrastructure base to take full advantage of our natural resources.

19. **The PRGF-supported program provides a medium-term macroeconomic framework to support this reform agenda** that is consistent with average annual real GDP growth of about 10 percent a year over the next five years, and a further decline in annual inflation to less than 5 percent by 2009. The policies needed to produce such an outcome will be based on a sustainable medium-term fiscal strategy that supports development; a gradual strengthening of the current account excluding grants; a further increase in international reserves; and an improvement in the external debt outlook with the resolution of arrears to external creditors.

20. **Sustained robust growth is predicated on improved security and a reduction in drug-related activities, together with the establishment of an environment conducive to private investment.** The I-ANDS identifies several sources of growth in the short and medium term that will be vital to the poverty reduction strategy. In the broader context of developing the rural economy, a key objective will be productivity gains in the agricultural sector, which currently accounts for about one third of GDP. Considerable potential also exists in the telecommunications and manufacturing sectors, including food processing. In the long run, modernizing and diversifying exports as well as developing mining activities are important potential sources of growth.

21. **We will continue to refine the medium-term fiscal framework (MTFF) to enhance budget credibility, restore fiscal sustainability, and support the I-ANDS**

objectives. In addition to projecting budget resources, the MTFP provides a framework for assessing and determining priorities and strategies to tackle future policy challenges. While adjustments will be necessary, principally to reflect changes in donor funding—the gradual absorption of some critical expenditures currently funded off-budget—and to reflect other inherent uncertainties, these changes will be clearly identified and justified in the annual budget and MYR. Consistent with the move toward fiscal sustainability, our medium-term fiscal strategy is based upon: (a) funding the operating budget exclusively through own revenue and trust fund grants; (b) maintaining the “no-overdraft rule”, which implies that central bank financing of the government will be limited to the drawdown of its deposits with Da Afghanistan Bank (DAB); (c) refraining from borrowing at any commercial bank; (d) continued strengthening of revenues from around 5.5 percent of GDP in 2005/06 to over 8 percent by 2010/11; (e) public administration reform to improve performance and contain costs to sustainable levels; and (f) improving the implementation of the development budget.

22. **Given Afghanistan’s dependence on official donor financing and the uncertainties attached to the expected acceleration of FDI and exports, we intend to bring the international reserve coverage at a comfortable level of no less than five months of imports of goods and services over the medium term.** While the current account deficit, including grants, is expected to increase as donor resources moderate over the medium term, the current account deficit, excluding grants, should decline to about 24 percent of GDP by 2009/10. This reflects a narrowing of the trade balance deficit stemming from declining donor-related imports, as well as improved net remittances as the macroeconomic situation continues to stabilize. Nevertheless, additional donor resources—by way of debt rescheduling—will be required to alleviate the debt service requirements arising from our stock of outstanding claims, until a permanent settlement of these arrears is reached in the context of the enhanced HIPC Initiative.

B. The 2006/07 Program

23. **Our strategy for 2006/07 builds on our achievements under the SMP.** The immediate challenge is to ensure that the conditions for continued economic growth are met. Consistent with a return to trend growth in the agricultural sector and sustained expansion in construction, manufacturing, and telecommunications, real economic growth is projected at 12 percent in 2006/07. Per capita income would increase to \$354, up from \$300 in 2005/06. Monetary policy will be geared toward limiting year-on-year inflation to 9 percent by end 2006/07.

24. **The current account deficit excluding grants is expected to decline from 42½ percent of GDP in 2005/06 to 39 percent of GDP in 2006/07,** owing to an improvement in the trade balance and higher interest receipts associated with the build-up in international reserves. Following large one-off telecommunication investments in 2005/06, FDI is expected to decline in 2006/07. However, donor disbursements are expected to accelerate, bolstered by pledges at the recent International Donors’ Conference.

Fiscal Policy

25. **The budgeted operating deficit excluding grants of 3.5 percent of GDP for 2006/07 is higher than the 2.1 percent of GDP envisaged under the MTFF.** The increase relative to the MTFF reflects the following factors:

- Operating expenditures are budgeted at 9.2 percent of GDP, compared to 9.3 percent in 2005/06 and an MTFF projection of 8.9 percent of GDP. Higher-than-expected spending is accounted for by: (a) the absorption of significant costs that had previously been funded directly by donors;⁵ (b) a significant increase in the number of teachers in 2005/06;⁶ and (c) the introduction of the pay and grading reform for the civil service.
- While the 0.2 percent of GDP budgeted increase in domestic revenue—to 5.7 percent of GDP in 2006/07—is significantly less than the 1.3 percent of GDP increase envisioned under the MTFF, it reflects in part the higher-than-expected outturn for 2005/06. The revised estimates are based on more realistic assumptions regarding the pace of key tax policy and administration reforms, including: (a) rationalizing the import tariff structure;⁷ (b) introducing excise taxes and road tolls; and (c) the full year implementation of tax measures introduced in the third quarter of 2005/06.⁸

26. **However, we will ensure, through additional expenditure measures and higher than budgeted revenue, that the actual operating deficit excluding grants will not exceed 3.0 percent of GDP in 2006/07.** Preliminary analysis indicates that the budgeted contingency for an additional 17,000 staff will not be required, resulting in fiscal savings equivalent to 0.1 percent of GDP. Moreover, the slower-than-anticipated implementation of the pay and grading reforms, stemming from capacity constraints, is likely to further reduce expenditure by 0.1 percent of GDP. We will also strictly enforce the guidelines governing the use of contingency funds, which should limit their use and generate further savings. An additional 0.3 percent of GDP in savings is attributable to higher-than-budgeted revenue. With expected grant funding of 3.9 percent of GDP from the two multi-donor trust funds

⁵ These costs include the Afghan National Army, the National Security Council and presidential protective services, the Election Commission, and the Ministry of Counter Narcotics.

⁶ During 2005/06 the Ministry of Education appears to have increased the number of its staff, in order to meet community demands for teachers, significantly in excess of its manpower ceiling (Tashkeel).

⁷ The rationalization, which is being developed in consultation with the business community, would likely result in moving some items from the lowest 2.5 percent rate, where around 50 percent of items are currently rated, to higher rates within the existing band structure, with the top rate remaining unchanged at 16 percent. The rationalization is designed to remove anomalies in the current system, in which some intermediate goods may be taxed at lower rates than basic inputs.

⁸ The main tax measures adopted in the third quarter of 2006/07 include: (a) a higher turnover tax rate for specific services; (b) a wage withholding tax; and (c) an airport departure fee.

exceeding the operating deficit, the excess resources would be allocated to boost development budget spending. Any further amendments to increase spending would be agreed with our development partners, including the IMF, during the MYR process and would depend upon factors such as a demonstrated need for additional spending, revenue performance, and donor assistance.

27. **Expenditure discipline will be reinforced by the strict management of public sector staffing levels, salary and wage costs.** The wage bill accounted for almost 65 percent of the operating budget in 2005/06, and careful management and controls are critical to ensure improved performance and fiscal sustainability. We will, therefore, step up efforts to monitor and enforce the manpower ceiling (Tashkeel) and appropriation ceilings for employee compensation, including the use of benefits and allowances. To this end, we will accelerate the roll-out of the verified payroll system—a revised plan will be published by end-June 2006. A joint investigation by the civil service commission, the largest line ministries, and the MoF will verify: the number and location of public servants; recent recruitment practices (particularly for those ministries, such as education, that recruited in excess of their Tashkeel in 2005/06); and trends in remuneration and payroll management. Based on the findings of this investigation, we will make recommendations aimed at improving payroll management, strengthening recruitment controls (particularly in the provinces), and improving the monitoring and evaluation of the wage bill. These findings will also inform discussions on the 2006/07 MYR. No across-the-board wage increase is envisaged in 2006/07, and future increases will be linked to pay and grading reform and improvements in performance, subject to what the government can afford from its own revenues.

28. **To boost revenues over the medium term consistent with our revenue targets (a performance criteria), we will accelerate the pace of structural reform.** Priority reforms for 2006/07 include:

- Strengthening the audit capacity of the large taxpayers' office and promoting voluntary compliance by large taxpayers, including through self assessment;
- Publishing by tax and customs authorities the taxpayer manuals and procedures to improve transparency and accountability;
- Upgrading physical and human capacity, particularly in the provinces, where a professional tax administration needs to be put in place;
- Establishing a transparent appeals process for the customs and tax administrations by end-September 2006;
- Submitting to parliament by end-December 2006 new legislation introducing an excise tax on selected goods, and removing the plethora of “nuisance” taxes and illicit charges that are hindering private sector development; and

- Producing a strategy document, in consultation with the major stakeholders, aimed at promoting the phased extension of a broad-based consumption tax to replace the current cascading business receipts tax.

29. **The core development budget of 14.2 percent of GDP is ambitious and will require a considerable effort to overcome constraints hindering spending capacity.** Development budget execution has continued to fall short of expectations and available financing. If not addressed, protracted underspending could undermine the credibility of the budget process. Therefore, we will adopt a number of measures to raise the implementation rate of the core development budget, to around 50 percent of the budget. These measures will include: (a) publishing a strategic plan for the MoF as well as plans for reorganizing the budget department and reforming provincial treasuries (Mustofiats), with a view to producing more realistic budgets and enhancing financial management; (b) targeting capacity building for line ministries to assist in project identification, appraisal, planning and budgeting; and (c) introducing computerized grant management and contract/commitment monitoring capabilities, so as to enhance the monitoring and control of development programs. The external budget is expected to remain significant at around 24 percent of GDP. The timetable for preparation of the 2007/08 budget will be published by end-April to ensure that, in contrast to previous years, the MoF has sufficient time to conduct a thorough analysis of project proposals and consult more broadly with donors.

Monetary and Exchange Rate Policies and Financial Sector Reforms

30. **The monetary program for 2006/07 will continue to target currency in circulation, in the context of a flexible exchange rate and consistent with a further decline in inflation to 9 percent by end-2006/07.** Currency in circulation is expected to increase by 18.4 percent in 2006/07, compared with a 22.0 percent increase in nominal GDP. The corresponding increase in the velocity of currency—adding to that observed in 2005/06—is expected to result largely from the expansion of the commercial banking sector, which is expected to be accompanied by a shift from currency in circulation to deposits. In view of continued money demand uncertainty, we will monitor price and exchange rate developments closely, and stand ready to tighten the monetary stance as needed should inflationary pressures emerge. International reserves are expected to increase further to more than \$1.8 billion at end-2006/07 (equivalent to 4.9 months of 2007/08 imports of goods and services).⁹

31. **In an effort to modernize DAB's operations and strengthen the monetary policy framework, we plan to:**

⁹ To provide room for an eventual tightening of the monetary stance, the floor on net international reserves is set lower than projected under the program. The floor is consistent with a threshold of 4.2 months of imports at end-2006/07.

- Implement regulations related to commercial banks' foreign exchange open positions (end-August 2006);
- Adopt measures aimed at deepening the capital notes market, such as opening the auctions to the licensed money changers, authorizing the banks to bid on behalf of their clients, and introducing notes with longer maturities;
- Introduce a standing deposit facility and an overnight collateralized credit facility, with capital notes eligible as collateral;
- Submit to parliament the external audits of DAB for 2004/05 and 2005/06 (end-September 2006);¹⁰
- Complete a review of the financial relations of the government and DAB by end-September 2006, with a view to clarifying their respective roles and responsibilities and developing a service level agreement setting out the appropriate charges for financial services provided by DAB and the remuneration of government deposits;
- Process the gold held in the palace vaults into a form that qualifies as a reserve asset (end-September 2006); and
- Develop a monthly balance sheet of DAB, covering all its provincial branches (end-September 2006), and a comprehensive monetary survey (end-March 2007).¹¹

32. We will make further progress in restructuring state-owned banks and reforming the banking sector. By end-June 2006, we will appoint a new Board of Directors at Bank Pashtany. Concerning the Export Promotion Bank, we will publish a decision to liquidate it or merge it with Bank Pashtany and Bank Millie, and complete the transfer of its deposits by end-September. By this date, we will also adopt long-term restructuring plans for Bank Millie and Bank Pashtany. In addition, we will work with the banking community to establish an interbank money market, which will contribute to a more efficient allocation of the banking system's resources in Afghanistan.¹² We will also intensify our efforts aimed at tackling the administrative and legal impediments to the development of the banking sector. In particular, by end-2006/07, we will adopt a core group of enabling laws, including

¹⁰ Due to security-related reasons, the 2004/05 audit had to be postponed. It is now expected to start, along with the 2005/06 audit, during the first quarter of 2006/07.

¹¹ The accounting department of DAB currently compiles their balance sheet on an annual basis. This balance sheet is found to be incomplete and insufficiently detailed for compiling monetary statistics.

¹² While most of the private banks' holdings of Afghani-denominated assets are insufficient for them to comply with the foreign currency open position requirements, the state-owned banks appear overly liquid in Afghanistan.

legislation on secure transactions, business organization, and negotiable instruments; and the clarification of land ownership rights. Lastly, as part of our efforts to encourage the development of the commercial banking system in the provinces where no commercial banks are operating, DAB will reduce significantly the interest rate it pays on savings accounts in the provincial branches by end-September.

External Policies

33. **With the envisaged foreign support, we expect the balance of payments position to remain manageable.** Nonetheless, Afghanistan's sizeable investment and reconstruction needs will put pressure on the current account. While narrowing, the current account deficit excluding grants is likely to amount to 39 percent of GDP in 2006/07. This underscores the importance of continued financial assistance from the international community—including IMF support under the PRGF—predominantly in the form of grant financing. The current account, including grants, is expected to record a deficit of nearly 1½ percent of GDP in 2006/07, widening somewhat over the medium term as donor financing tapers off.

34. **Our debt management strategy will continue to center on a cautious approach to external borrowing and the regularization of relations with external creditors as the basis for restoring external sustainability.** Reflecting the pledges made at the International Donors' Conference, we will continue to rely primarily on grants and highly concessional loans to meet our financing needs. In this regard, we intend to ensure our external sustainability by observing the ceiling on short-term external debt owed or guaranteed by the government or DAB and the ceiling on the contracting or guaranteeing of medium- and long-term nonconcessional external debt by the government or DAB (performance criteria) set under the PRGF. We anticipate that the projected large financing gap in 2006/07 will be covered principally through the rescheduling of bilateral debt. Having verified our debts and arrears to bilateral creditors, we intend to request debt relief from the Paris Club on favorable terms, and comparable relief from other creditors, as a step toward settling our bilateral arrears. We are committed to remaining current on our other external financial obligations.

35. **We are committed to maintaining a liberal and transparent trade regime as a foundation for enhancing our growth prospects.** With a view to minimizing investment distortions, the envisaged rationalization of the tariff structure will focus on correcting anomalies and resist demands for a more protectionist tariff structure. In support of these reforms, in 2007/08, we will begin to compile merchandise trade statistics according to the Standard International Trade Classification. We will also pursue our preparatory work for discussions toward membership to the World Trade Organization (WTO); this would provide us with access to the WTO's dispute settlement mechanism and technical assistance. We are also committed to maintaining a foreign exchange system free of restrictions and to making further progress toward establishing an adequate legal framework for the exchange system. In this regard, we would welcome further technical support from the IMF to allow us to formalize our liberal exchange rate system, and to accept the obligations under Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement.

36. **We are committed to further enhancing the quality and reliability of balance of payments data.** The compilation and analysis of the recently completed surveys of non-recorded trade and travel will help us to refine our estimates of goods and services trade. We will also continue to meet regularly with the primary providers of data on other financial flows and private remittances. Consistent with our debt management strategy, the MoF—in close collaboration with DAB—will continue to strengthen the tracking of external debt data and will reconcile its obligations on a regular basis with all outside parties.

Structural Reforms

37. **Our structural reforms will be guided by the I-ANDS, which aims at fostering an enabling environment for private sector activity.** The fiscal and banking reforms discussed earlier will form the core of the structural agenda under the PRGF-supported program, but achieving the objectives of growth and poverty reduction will also require implementation of structural reforms in other areas, often with the support of the international community. In this regard, the PRGF-supported program will focus on measures aimed at: (a) harmonizing and simplifying legislation, procedures, and regulations related to investment; (b) establishing and implementing a strategy for the divestment of state-owned enterprises and government agencies engaged in commercial activities but not covered by the Tassady law (end-September 2006 structural benchmark); and (c) enabling registration of land titles in rural and all major urban areas.

38. **Strengthening the information on social indicators will be a particularly important step in monitoring progress under our poverty reduction strategy** and, therefore, will be a crucial step in moving from the I-ANDS to the full ANDS. In this regard, together with the international community, we established a Joint Monitoring and Coordination Board for implementation of the Compact and progress against the I-ANDS (and eventually ANDS) objectives.

39. **Recognizing the critical importance of good governance and transparency in promoting growth and effective social and economic policies,** we will submit to parliament the audited financial statement of the 2005/06 core budget (end-September 2006 structural performance criterion) and plan to introduce new accounting standards for the public sector by end 2006/07. In addition, as indicated in the Afghanistan Compact, we will ratify the UN Convention on Corruption and introduce complementary modifications to national legislation to fight corruption and strengthen economic governance.

Safeguards, Statistical Issues, and Technical Assistance

40. **We are committed to maintaining DAB's financial soundness by adhering to the principles of good governance and best practices encapsulated in the IMF's safeguards guidelines.** Pending completion of the requested safeguards assessment, we will strengthen our internal auditing capacity, and make the best use of our existing financial supervision apparatus and legislation, including that related to money laundering and the financing of international terrorist organizations.

41. **In view of Afghanistan's significant technical assistance needs, the government will continue to work closely with its multilateral and bilateral partners to strengthen administrative capacity in priority areas.** These include tax and customs administration and policy, public expenditure management, civil service reform, liquidity management and banking supervision, and financial markets legislation and its operation. Assistance will also continue to be needed to improve economic statistics, notably the national accounts, balance of payments, monetary statistics, and poverty and social indicators.

IV. PROGRAM MONITORING AND CONTINGENCIES

42. The first year of the three-year PRGF-supported program will be monitored on the basis of quantitative performance criteria for September 21, 2006 and March 21, 2007, and quantitative indicators for June 21 and December 21, 2006 (Table 3). The quantitative targets are set on a cumulative basis from March 21, 2006. Structural performance criteria and benchmarks under the 2006/07 program are presented in Table 4. These quantitative and structural conditions are defined in the attached Technical Memorandum of Understanding (TMU).

43. The first review under the PRGF arrangement, scheduled to be completed by end-January 2007, would be conditional upon observing the September 2006 performance criteria. At that time, the quantitative indicative targets for March 2007 will be converted to performance criteria and additional structural conditionality may be set for the second review, scheduled to be completed by end-June 2007.

44. To provide for contingencies, the monitoring framework includes adjustors (described in detail in the TMU) relating to potential deviations from program projections in development spending and/or in external financing and receipts from the transfer of nonfinancial assets. The program also provides room for moving on budget of expenditures currently financed directly by donors. The government also stands ready to adopt additional measures, in consultation with IMF staff, should they prove necessary to meet the program objectives.

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

46. As with the SMP, we will continue to monitor execution of the PRGF-supported program internally through our Technical Coordination Committee.

Table 1. Islamic Republic of Afghanistan: Quantitative Indicators under the SMP, 2005/06
(In millions of Afghanis, unless otherwise indicated; cumulative changes from beginning of fiscal year)

	Indicative Target		Estimate Dec. 20 2005/06	Indicative Target	
	Dec. 20	Mar. 20		Dec. 20	Mar. 20
Currency in circulation (ceiling) 1/	7,822	10,758	4,249	10,758	
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)	100	158	248	158	
Fiscal revenue of the central government (floor)	12,676	18,328	13,346	18,328	
External debt					
a) New medium- and long-term nonconcessional external debt (with original maturities of one year or more) contracted or guaranteed by the government (ceiling) 2/ 3/	0	0	0	0	0
b) New nonconcessional debt with an original maturity of less than one year (ceiling) 3/ 4/ 5/	0	0	0	0	0
Memorandum item:					
Currency in circulation (level triggering consultation)	10,151	13,234	...	13,234	

Sources: Data provided by the Afghan authorities; and Fund staff estimates.

1/ At end-2004/05, currency in circulation amounted to Af 38.8 billion.

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

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

4/ 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).

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

Table 2. Islamic Republic of Afghanistan: Structural Benchmarks Under the SMP, June 2005–March 2006

Structural Benchmarks	Target Date	Status
Adopt (by the Cabinet) and publish in the Official Gazette the financial management law.	End-June 2005	Implemented
Publish the financial statements of the 2003/04 external audit of DAB.	End-June 2005	Implemented
Reconcile the government accounting records with the government's bank accounts.	End-September 2005	Implemented 1/
Publish the 2004/05 audited financial statements (core budget).	End-September 2005	Not implemented
Adopt (by Cabinet) a comprehensive external debt management strategy.	End-September 2005	Implemented 1/
Contact the Secretariat of the Paris Club to assist with the comprehensive review of, and reconciliation of, debt owed to Paris Club creditors; and continue to contact the non-Paris Club creditors for a full reconciliation of external obligations, including those that did not respond to earlier requests for debt reconciliation.	End-September 2005	Implemented
Publish in the Official Gazette: the proposed amendments to the income tax law to provide for administrative powers and for additional corporate tax reform measures.	End-September 2005	Implemented 1/
Commence implementation of recently approved tax measures, notably the business receipt tax on hotels, restaurants, telecommunications, and airlines and the wage withholding tax, accompanied by a taxpayer education program.	End-September 2005	Implemented 1/
Issue a statement indicating the Ministry of Finance decision, as the main shareholder, to liquidate the three former state-owned banks.	End-September 2005	Implemented 1/
Appoint liquidators for the three former state-owned banks and start implementing their liquidation.	End-December 2005	Implemented
Replace the management board of Bank Millie.	End-December 2005	Implemented
Adopt (by Cabinet) a Medium-Term Fiscal Framework that includes (a) a fiscal table with 3-year projections of revenues, expenditures, fiscal deficit and sources of financing, and (b) a description of the policy actions which sustain the projections.	End-December 2005	Implemented
Eliminate, or reduce substantially, registration fees for deeds.	End-December 2005	Implemented
Publish the 2004/05 audited financial statements (core budget).	End-December 2005	Not Implemented 2/
Remunerate required reserves.	End-March 2006	
Identify largest taxpayers to be administered by the Large Taxpayer Unit according to agreed transparent criteria, and prepare detailed compliance profile for each taxpayer.	End-March 2006	
Publish estimate of revenues forgone as a result of customs exemptions, including due to international assistance, and income tax law exemptions.	End-March 2006	

1/ Implemented with some delay.

2/ The 2004/05 audited financial statements (core budget) were published in March 2006.

Table 3. Islamic Republic of Afghanistan: Performance Criteria and Indicative Targets for 2006/07 1/
(Cumulative changes from end-March 2006)

	Program			
	Jun. 21 2006 Ind. Target	Sept. 21 2006 Perf. Criteria	Dec. 20 2006 Ind. Target	Mar. 20 2007 Ind. Target 2/
	(In millions of Afghanis)			
Floor on fiscal revenue of the government	5,317	10,636	17,201	26,595
Ceiling on currency in circulation	2,794	5,587	6,910	8,233
Ceiling on net central bank financing of the government	3,587	9,042	8,254	1,242
Indicative target (ceiling) on the operating budget deficit excluding grants of the government	4,561	9,120	12,432	12,915
	(In millions of U.S. dollars)			
Floor on net international reserves of DAB	-124.3	-198.6	-217.2	-68.5
Zero ceiling on contracting or guaranteeing new medium- and long-term nonconcessional external debt by the government and DAB 3/	0	0	0	0
Zero ceiling on short-term external debt owed or guaranteed by the government or DAB 3/	0	0	0	0
Nonaccumulation of new external payments arrears, excluding interest on preexisting arrears 3/	0	0	0	0

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

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

2/ Indicative targets to be converted to performance criteria at the time of the first review.

3/ These performance criteria apply on a continuous basis.

Table 4. Islamic Republic of Afghanistan: Structural Performance Criterion and Structural Benchmarks, June 2006–March 2007

Structural Performance criterion	Target Dates
Submit to parliament the core budget's audited financial statements for 2005/06.	End-September 2006

Structural Benchmarks	Target Dates
Appoint a new Board of Directors at Bank Pashtany.	End-June 2006
Adopt long-term restructuring plans for Bank Millie and Bank Pashtany.	End-September 2006
Publish a public statement announcing the liquidation of Export Promotion or its merger with another licensed commercial bank, and finalize the transfer of its deposits.	End-September 2006
Establish appeals process for customs and tax administrations.	End-September 2006
Submit to parliament the 2004/05 and 2005/06 external audits of DAB.	End-September 2006
Process gold held in the palace vaults into a form that qualifies as a reserve asset.	End-September 2006
Establish a certified monthly payroll system.	End-December 2006
Submit to parliament legislation to eliminate nuisance taxes and introduce an excise tax on selected goods from the start of 2007/08.	End-December 2006
Adopt a comprehensive restructuring/divestment plan for the public entities and government agencies engaged in commercial activities but not covered by the SOEs law.	End-March 2007
Develop a monthly monetary survey in line with international standards.	End-March 2007

INTERNATIONAL MONETARY FUND
ISLAMIC REPUBLIC OF AFGHANISTAN

Technical Memorandum of Understanding

1. This memorandum sets out the understandings between the Afghan authorities and Fund staff relating to the monitoring of the Poverty Reduction and Growth Facility (PRGF)-supported program. In particular, it defines the benchmarks and performance criteria established in the Memorandum of Economic and Financial Policies (MEFP) for March 21, 2006–March 20, 2007, the first year of the program. It is organized as follows: Section I defines the structural performance criteria and benchmarks; Section II provides definitions of the principal concepts and financial variables, including the quantitative performance criteria and indicators; Section III relates to the reporting requirements.

I. STRUCTURAL PERFORMANCE CRITERIA AND BENCHMARKS

2. The structural performance criterion and benchmarks specified in Table 4 of the MEFP are defined as follows:

Performance criterion

- **Submit to parliament the core budget's audited financial statements for 2005/06.** Consistent with the Public Finance and Expenditure Management (PFEM) law, the government will submit to the National Assembly an independent audit report of the core budget financial statements within six months from the end of the fiscal year. The report will be prepared by the Control and Audit Office in accordance with international accounting principles.

Structural benchmarks

- **Appoint a new Board of Directors at Bank Pashtany.** The new appointees will meet the qualification requirements set by out by Da Afghanistan Bank (DAB) in its role as banking supervisor.
- **Adopt long-term restructuring plans for Bank Millie and Bank Pashtany.** The plans will present and justify the chosen restructuring method (liquidation, merger with another bank, separate restructuring) for each bank. Should a plan find that a bank should remain in the public domain and continue its operations, it should also specify and cost the measures that will be put in place to ensure their long-term financial sustainability, including measures aimed at strengthening management and supervision, enhancing productivity, and modernizing lending policies and procedures. These time bound restructuring plans will be prepared by the Ministry of Finance (MoF), adopted by Cabinet, and published.

- **Publish a public statement announcing the liquidation of Export Promotion Bank or its merger with another licensed commercial bank, and finalize the transfer of its deposits.** The public statement will be made by the shareholders.
- **Establish appeals processes for the custom and tax administrations.** The appeals processes will be adopted by the MoF and published.
- **Submit to parliament the 2004/05 and 2005/06 external audits of DAB.** The external audits should be conducted in accordance with International Standards on Auditing, as required under the DAB law.
- **Adopt a comprehensive restructuring/divestment plan for public entities and government agencies engaged in commercial activities but not covered by the state-owned enterprises law.** This restructuring/divestment plan will reflect the necessary steps and tasks entailed by the restructuring/divestment process and a schedule for their implementation. The plan will be adopted by the Cabinet.
- **Process gold held in the palace vaults into a form that qualifies as a reserve asset.** To qualify as a reserve asset, the processed gold will have to be in London Good Delivery form and purity. Should the authorities use part of the gold held in the palace vaults to mint gold coins, the structural benchmark would be considered to be observed as long as the rest is processed into a form that qualifies as a reserve asset. However, the gold coins would not be included as part of DAB's gross official reserves.
- **Establish a certified monthly payroll system.** The responsibilities and procedures for calculating salaries and wages will be formalized and standardized. In each budget entity, the authorizing official will be clearly identified and required to certify that the monthly payroll submitted to the MoF: (a) is consistent with the Tashkeel (manpower ceiling) and takes account of the designation of all employees; (b) identifies new recruitments (ensuring that these have been made in accordance with established procedures) during the period; and (c) have up-to-date employment and attendance records. The MoF will issue a procedural circular to all budget entities indicating: (a) the procedures for certifying the monthly payroll (clarifying respective roles and responsibilities and with the timing of effective implementation); (b) the penalties the authorized officials would face in case of miscertification or hiring above authorized Tashkeel and budget allotment; and (c) the procedures and implementation strategy for verification and ex post audit of the certified payrolls. A program of regular audits of budget entities will be initiated upon issuance of the procedures and on a risk management basis, particularly in those units where payroll disbursement violations have been suspected, and sanctions imposed for violations.
- **Submit to parliament legislation to eliminate nuisance taxes and introduce an excise tax on selected goods from the start of 2007/08.**

- **Develop a monthly monetary survey in line with international standards.** The monetary survey should be the consolidation of the accounts of DAB and of the commercial banks. The data should be presented in the format recommended by the Fund's Monetary and Financial Statistics mission of March 2006. DAB accounts will include the accounts of its headquarters, as well as those of its branches.

II. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

3. The quantitative performance criteria and indicative targets specified in Table 3 of the MEFP are:

- a floor on fiscal revenue of the central government;
- a ceiling on currency in circulation;
- a ceiling on the net central bank financing (NCBF) of the central government;
- a floor on net international reserves (NIR);
- a zero ceiling on contracting and/or guaranteeing new medium- and long-term nonconcessional external debt by the government and DAB;
- a zero ceiling on short-term external debt owed or guaranteed by the government or DAB;
- a zero ceiling on the accumulation of external payment arrears, excluding interest on preexisting arrears; and
- an indicative target (ceiling) for the operating budget deficit excluding grants of the central government.

A. Program Exchange Rate

4. Program exchange rates will be used for purposes of monitoring the quantitative targets under the program. All foreign assets and liabilities denominated in U.S. dollars will be converted into Afghanis using a program exchange rate of 49.94 Afghanis per U.S. dollar, which corresponds to the average of the U.S. dollar/Afghani buy and sell cash rates, as reported by the DAB as of March 20, 2006. For assets and liabilities denominated in SDRs and in foreign currencies other than the U.S. dollar, they will be converted into U.S. dollars at their respective exchange rates prevailing as of February 28, 2006, as reported in the following table. Gold holdings will be valued at 552.85 dollars by ounce, the price as of March 20, 2006.

Exchange rate	Program rate
Dollar/Canadian Dollar	0.861700
Dollar/UAE Dirham	0.272280
Dollar/Egyptian Pound	0.174370
Dollar/Euro	1.190650
Dollar/Hong Kong Dollar	0.128841
Dollar/Indian Rupee	0.022532
Dollar/Pakistani Rupee	0.016633
Dollar/Polish Zloty	0.306876
Dollar/Iranian Ryal	0.000109
Dollar/Saudi Ryal	0.266640
Dollar/Russian Ruble	0.035660
Dollar/Swiss Franc exchange rate	0.760980
Dollar/UK Pound exchange rate	1.736050
Dollar/SDR	1.447570

B. Currency in Circulation

5. **Currency in circulation** is defined as total currency issued by DAB. It excludes currency held in the presidential palace vault, in DAB main vault, and in the vaults of DAB's provincial branches, but includes currency in the vaults of DAB's district branches.¹

C. Net Central Bank Financing of the Government

6. **NCBF of the government** is defined as the difference between the central bank's claims on the government and the deposits of the government with DAB. These deposits include the deposits held at DAB headquarters, but exclude the deposits held at DAB's branches.²

D. Net International Reserves

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

8. **Reserve assets of DAB**, as defined in the fifth edition of the balance of payments manual (BPM5), are claims on nonresidents denominated in foreign convertible currencies, that are controlled by DAB, and are readily and unconditionally available for DAB to meet balance of payments financing needs, intervention in exchange markets, and other purposes. They include DAB holdings of monetary gold, SDRs, Afghanistan's reserve position in the

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

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

IMF, foreign currency cash (including foreign exchange banknotes in the vaults of DAB, but excluding cash held in DAB's branches), and deposits abroad (including balances on accounts maintained with overseas correspondent banks). Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered;³ claims on residents; precious metals other than monetary gold; assets in nonconvertible currencies; illiquid assets; and claims on foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options).

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

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

E. Revenues of the Central Government

11. **Revenues of the central government** are defined in line with the Government Financial Statistics manual (GFSM 2001) on a cash accounting basis, excluding foreign grants. Revenue is an increase in net worth of the central government (including its units in the provinces and agencies) resulting from a transaction. Revenues of the central government include taxes and other compulsory transfers imposed by central government units, property income derived from the ownership of assets, sales of goods and services, social contributions, interest, fines, penalties and forfeits and voluntary transfers received from nongovernment other than grants. A non-exhaustive list of revenues include: corporate income tax, personal income tax, business receipts tax, taxes on properties, fixed withholding taxes on imports and exports, excise taxes, presumptive taxes in lieu of the income tax, import duties, and other charges and fees. The definition for program monitoring excludes grants and other non-compulsory contributions received from international organizations and such transfers between central government units would be eliminated in the consolidation of the fiscal reports and not recorded as revenue. Receipts collected by central government on behalf of non-central government units should not be counted as revenue (e.g., Red Crescent fees). Receipts from the sale of nonfinancial assets, such as privatization, and transactions in financial assets and liabilities, such as borrowing but excepting interest payments, are also excluded from the definition of revenue.

³ In particular, assets that are counterpart of the government's foreign currency deposits that back letters of credit are excluded from reserve assets. However, assets that are counterpart of other government deposits are included in the reserve assets.

12. Revenues should be recognized on a cash basis and flows should be recorded when cash is received. It excludes any revenues received prior to March 21, 2006 but where funds are not transferred to government's accounts at DAB by this date. Exceptional advanced payments will be treated as if received on the normal due date. All revenue must be supported by the relevant documentation and revenue receivables, where a cash sum has been recorded but the revenue item has not yet been accounted for, and revenues payable, where the revenue has been reported but the cash has yet to be recorded should be separately reported on a gross basis.

F. External Debt and Arrears

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

- Debts can take a number of forms, the primary ones being: (a) loans, (i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future—including deposits, bonds, debentures, commercial loans and buyers' credits—and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (b) suppliers' credits (i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided); and (c) leases (i.e., arrangements under which property is provided that the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property). Excluded from this limit are leases of real property by Afghan embassies or other foreign representations of the government.
- For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property. Arrears, penalties, and judicially-awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.

14. **The ceiling on medium- and long-term external debt applies on a continuous basis to the contracting or guaranteeing by the government or DAB of new nonconcessional external debt with an original maturity of more than one year. For**

program purposes, “government” includes the central government (including government departments), as well as official agencies that do not seek profit and whose budgets are issued independent of the annual operational or development budgets. Consistent with the PFEM law, the MoF should have sole responsibility for the contracting and guaranteeing of external debt on behalf of the government.

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

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

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

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

G. Adjusters for Net International Reserves and Net Central Bank Financing

17. The floor on NIR and the ceiling on the NCBF of the government are defined consistent with the assumption that core budget development spending will amount, on a cumulative basis from March 20, 2006, to:

June 21, 2006	Af 3,741 million
September 21, 2006	Af 11,222 million
December 20, 2006	Af 18,704 million
March 20, 2007	Af 29,926 million

Should core budget development spending exceed these projections, the NIR floor will be adjusted downward and the NCBF ceiling will be adjusted upward by the difference between the actual level (up to the appropriated amount) and the projected level of development spending.

18. The NIR floor and NCBF ceiling are defined consistent with the assumption that the external financing of the core budget and the receipts from the sale or transfer of nonfinancial assets will amount, on a cumulative basis from March 20, 2006, to:

June 21, 2006	Af 4,715 million
September 21, 2006	Af 11,300 million
December 20, 2006	Af 22,882 million
March 20, 2007	Af 41,599 million

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

19. Should some expenditure currently financed directly by donors outside the budget be moved on to the operating budget, the NIR floor will be adjusted downward, and the NCBF ceiling and the indicative target (ceiling) for the operating budget deficit excluding grants of the central government will be adjusted upward, by the actual amount of these expenditures on the conditions that (a) the moving on budget of these expenditures is justified by a

statement from donors indicating their decision to stop financing them outside the budget and (b) they are subject to a supplementary appropriation approved by parliament.

20. The overall downward adjustment to the NIR floors will be capped at \$375 million.

III. PROVISION OF INFORMATION TO FUND STAFF

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

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

- **DAB net international reserves** should be reported weekly, no later than two weeks after the end of the week.
- **Monetary statistics, including exchange rates, government accounts with DAB, and currency in circulation** should be reported monthly and no later than three weeks after the end of the month. Monetary statistics will also include a monetary survey (quarterly, and then monthly starting in March 2007), including balance sheets of DAB and a consolidated balance sheet of the commercial banking sector.
- **Operational budget operations and their financing** should be reported monthly and no later than four weeks after the end of the month. **Core development budget operations and their financing** should also be reported monthly and no later than four weeks after the end of the month. The structure of financing (grants and loans should be separately identified) and expenditure data should be on a consistent cash basis. Core operating expenditures should be reported on a monthly basis using the budget appropriation economic (Object) and administrative classification in addition to the program and functional classification as reported in the budget documents. Core development expenditures should also be reported separately on a monthly basis using the budget program classification in addition to the economic (Object), administrative and functional classification consistent with the operating budget. All the data should also compare outturns against the approved budget (or figures reported in the budget documents). Core operating and development revenues and expenditures should also be reported by province, separately on the same monthly basis.
- **External budget operations and their financing** (i.e., donor funded spending outside the core budget treasury systems) should be reported at least semi-annually (more frequently if possible) and no later than eight weeks after the end of the period. External development expenditures should be reported on a disbursement basis (as currently defined

in budget documents) using the budget program classification (and an administrative, functional and provincial classification where possible).

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

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

24. 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.

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

INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF AFGHANISTAN

**Seventh Review Under the Staff-Monitored Program and Request for a Three-Year Arrangement Under the Poverty Reduction and Growth Facility
Supplementary Information**

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

Approved by Juan Carlos Di Tata and Carlo Cottarelli

June 13, 2006

1. This supplement provides information on key program developments since the staff report (refer to www.imf.org) was issued. The thrust of the staff appraisal remains unchanged.
2. **On June 3, 2006, Afghanistan's recently elected parliament approved a revised budget for 2006/07.** On May 21, the parliament had rejected the original budget submitted by the government in early April on the grounds that it did not include a general increase in wages for civil servants and pensions for retirees, the disabled, and martyrs. To break the budgetary deadlock, the government consulted actively with key members of parliament and the donor community, which was concerned about a significant general wage increase at the current juncture. As a result of these discussions, the government submitted to parliament a revised budget that incorporates increases in wage and pensions equivalent to about half of those originally requested by parliamentarians.
3. **The revised budget passed by parliament provides for an average increase of about 10 percent in the basic salaries of civil servants (excluding the police and the military) and a moderate adjustment in pensions for martyrs and the disabled, while keeping total programmed expenditures unchanged.**¹ The increase in the basic salaries of civil servants will become effective at midyear (September 21) and is broadly in line with the expected rise in consumer prices (end-year inflation is targeted at 9 percent in 2006/07), while the increase in pensions applies as of March 21, 2006. The fiscal impact of these measures, which amounts to Af 713 million (0.16 percent of GDP) in 2006/07, will be fully offset by reductions in the appropriations for other programmed expenditures, and by using in part the contingency reserves envisaged in the original budget. Overall, total operating

¹ Owing to the small share of basic salaries in civil servants' total remuneration, the total wage bill is projected to increase by only 2 percent relative to the original budget.

expenditures (and the operating budget deficit) remain as originally programmed.² The changes in the composition of expenditures are reflected in the attached revised fiscal tables (Tables 1a and 1b). These modifications do not affect the performance criteria or indicative targets already set under the requested PRGF arrangement.

4. **The authorities have issued a supplement to the Memorandum of Economic and Financial Policies (MEFP) that describes the modifications incorporated in the revised budget (Attachment I).** This supplement to the MEFP includes a firm commitment by the authorities to avoid any additional across-the-board wage increases during the remainder of 2006/07, particularly given the need to implement the envisaged pay and grading reform. The recent discussions between the government, the donor community, and parliamentarians have paved the way for a closer dialogue in the future, and have raised parliament's awareness of the government's financing constraints and its dependence on external donor support.

5. **While the increase in basic salaries reduces somewhat the fiscal space for civil service reform, and the use of a portion of the contingency reserves (which declined from 3.5 percent of operating expenditures to 2.8 percent) leaves the budget more vulnerable, staff consider that the implications for medium-term sustainability are not significant.** In particular, the impact of the salary increase on the medium-term fiscal position is still expected to leave sufficient room for implementing the pay and grading system. Staff welcome the government's commitment to avoid further across-the-board wage increases, which should be strictly adhered to in order to contain medium-term fiscal risks (Attachment I). At the same time, looking ahead, staff would like to emphasize the need to avoid ad hoc decisions that could undermine the quality of non-wage recurrent expenditure and to intensify efforts aimed at strengthening the budget formulation process. Staff support the government's intention to consider, at the time of the midyear budget review, increasing the expenditure appropriations that have been reduced in the event of higher-than-expected revenue collection or savings in other areas.

6. **Based on the above, staff continue to support the completion of the seventh review under the staff-monitored program and the authorities' request for a PRGF arrangement.**

² The increases in basic salaries and pensions, amounting to Af 498 million and Af 215 million, respectively, would be fully offset by reductions in the appropriations for goods and services (Af 348 million), contingency reserves (Af 289 million), capital expenditures (Af 7 million), and specific cuts in the wage bill (Af 69 million).

Table 1a. Islamic Republic of Afghanistan: Core Budget, 2002/03-2009/10

	Est.		Est.		Est.		Revised		Revised		Revised		Revised	
	2002/03	2003/04	2004/05	2005/06	2005/06	11 months	Proj. 3/ 2005/06	Revised Core Budget 2006/07	Initial Fiscal Program 2006/07	Revised Fiscal Program 2006/07	Revised Proj. 3/ 2007/08	Revised Proj. 3/ 2008/09	Revised Proj. 3/ 2009/10	
Domestic revenue	5,864	10,168	12,800	18,735	16,668	16,668	20,071	25,220	26,595	26,595	35,149	44,255	53,777	
Tax revenues	...	6,262	9,546	13,128	10,718	10,718	13,351	18,867	20,008	20,008	26,877	33,990	41,122	
Taxes on income, profits, and capital gains	...	363	995	3,789	1,060	1,060	2,310	4,559	3,580	3,580	5,048	6,325	7,841	
Taxes on international trade and transactions	...	5,369	7,247	8,917	8,425	8,425	9,554	13,774	14,339	14,339	17,772	21,755	25,115	
Other taxes	...	531	1,304	422	1,233	1,233	1,487	534	2,089	2,089	4,057	5,909	8,166	
Nontax revenues	...	3,906	3,254	5,607	5,950	5,950	6,720	6,354	6,588	6,588	8,273	10,266	12,655	
Donor assistance grants (to operating budget) 4/	9,430	10,074	14,984	16,889	16,889	16,889	16,889	17,218	17,218	17,218	12,233	8,990	6,248	
ARTF (recurrent window)	...	8,182	12,319	13,580	14,571	14,571	14,571	13,580	13,580	13,580	8,595	5,353	2,610	
LOTFA	...	1,892	2,583	3,298	2,218	2,218	2,218	3,638	3,638	3,638	3,638	3,638	3,638	
Other grants	...	0	83	0	100	100	100	0	0	0	0	0	0	
Donor assistance grants (core development budget)	...	4,569	8,250	29,013	9,415	9,415	12,327	36,086	18,843	18,843	22,584	34,741	42,456	
Total core budget expenditure	15,514	31,606	39,550	83,666	43,628	43,628	52,529	103,244	69,436	69,437	81,454	95,873	112,042	
Operating expenditure	15,514	22,151	26,716	33,601	27,615	27,615	33,606	40,346	39,511	39,511	44,047	49,114	53,594	
Wages and salaries	...	14,660	18,902	20,788	17,861	17,861	21,695	25,378	24,938	25,378	28,770	32,463	35,611	
Purchase of goods and services	...	4,653	4,182	6,609	6,082	6,082	7,464	8,999	9,349	9,809	9,809	10,544	11,230	
Transfers and subsidies	...	652	764	2,293	22	22	26	2,213	1,676	1,378	1,608	1,862	2,130	
Pensions	...	177	889	1,659	1,536	1,536	1,885	2,065	1,850	2,065	2,168	2,277	2,368	
Capital expenditure	...	2,009	1,979	1,847	1,847	1,847	2,386	1,220	1,423	1,220	1,423	1,648	1,885	
Interest	...	...	...	404	150	150	150	471	471	471	270	321	370
Core budget development spending 5/	...	9,455	12,834	50,066	16,012	16,012	18,924	62,898	29,926	29,926	37,407	46,759	58,449	
Security	...	...	...	3,496	898	898	1,062	2,322	1,161	1,161	1,451	1,814	2,268
Governance, Rule of Law and Human Rights	...	...	...	1,644	262	262	310	2,299	1,149	1,149	1,437	1,796	2,245
Infrastructure and Natural Resources	...	...	...	22,772	5,335	5,335	6,305	33,330	11,665	11,665	14,582	18,227	22,784
Education	...	...	...	3,536	556	556	657	4,179	2,090	2,090	2,612	3,265	4,081
Health	...	...	...	1,582	791	791	935	3,261	1,631	1,631	2,038	2,548	3,185
Agriculture and Rural Development	...	...	...	14,264	7,248	7,248	8,566	13,906	10,429	10,429	13,037	16,296	20,370
Social Protection	...	...	...	65	22	22	26	184	92	92	115	144	180
Economic Governance and Private Sector Development	...	...	...	2,706	901	901	1,065	3,416	1,708	1,708	2,135	2,669	3,336
Operating budget balance (excluding grants)	-9,650	-11,983	-13,916	-14,866	-10,947	-10,947	-13,535	-15,126	-12,915	-12,916	-8,897	-4,859	183	
Operating budget balance (including grants)	-219	-1,910	1,068	2,012	5,942	5,942	3,354	2,092	4,302	4,302	3,335	4,131	6,431	
Core budget balance (including grants)	-219	-6,795	-3,516	-19,040	-655	-655	-3,243	-24,720	-6,780	-6,781	-11,489	-7,887	-9,562	
Float and adjustment 6/	-657	1,693	359	0	2,428	2,428	2,443	-297	0	0	0	0	0	
Sale of Nonfinancial assets 7/	0	0	0	3,987	1,994	1,994	1,994	0	0	0	5,732	10,965	12,460	
Financing	876	5,102	3,157	15,054	-3,767	-3,767	-1,194	25,017	6,780	6,781	5,757	-3,078	-2,898	
External loans (net)	0	4,886	14,753	23,946	3,397	3,397	7,286	10,846	5,538	5,538	5,289	4,940	4,342	
Domestic (net) 8/	876	217	-11,596	-8,892	-7,164	-7,164	-8,480	14,172	1,242	1,243	468	-8,018	-7,240	

Memorandum item:

External budget expenditure 9/

na 102,958 na 106,361 106,361 91,956 69,840 32,398

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

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

2/ November 2005 midyear review supplementary budget.

3/ Staff estimates and projections.

4/ Funding for the operating budget provided through the multi-donor trust funds: The Afghanistan Reconstruction Trust Fund (ARTF; recurrent window) and the Law and Order Trust Fund (LOTFA).

5/ Interim Afghanistan National Development Strategy programs. Government program classification based on a simple aggregation of administrative units. Expenditure is not delineated by a standard classification of purpose or function.

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

7/ In 2005/06, includes \$40 million receipt from the sale of telecommunications spectrum bandwidth. From 2006/07, also includes proceeds from planned privatizations.

8/ Net change in government deposits with DAB (excluding provincial branch balances). A positive sign corresponds to a decline in balances and a negative sign to an increase in balances.

9/ In 2002/03, includes one-off transfers of over flight revenue and customs valuation fees accumulated over several years and the sale of telecommunication licenses. From 2006/07 includes PRGF inflows.

Table 1b. Islamic Republic of Afghanistan: Core Budget¹, 2002/03–2009/10

	Est.		Est.		Revised		Year-To-Date		Revised		Initial		Revised		
	2002/03	2003/04	2004/05	2004/05	Core Budget 2/	Midyear Review	11 months	2005/06	2005/06	2006/07	2006/07	Fiscal Program 3/	2007/08	2008/09	2009/10
Domestic revenue	3.2	4.5	4.5	4.5	5.2	4.6	4.6	5.5	5.7	6.0	6.0	6.8	7.4	7.9	7.9
Tax revenues	...	2.8	3.4	3.6	3.6	3.0	3.0	3.7	4.3	4.5	4.5	5.2	5.7	6.0	6.0
Taxes on income, profits, and capital gains	...	0.2	0.3	1.0	1.0	0.3	0.6	1.0	1.0	0.8	0.8	1.0	1.1	1.1	1.1
Taxes on international trade and transactions	...	2.4	2.5	2.5	2.5	2.3	2.6	3.1	3.2	3.2	3.4	3.6	3.7	3.7	3.7
Other taxes	...	0.2	0.5	0.1	0.1	0.3	0.4	0.4	0.1	0.5	0.5	0.8	1.0	1.2	1.2
Nontax revenues	...	1.7	1.1	1.5	1.5	1.6	1.9	1.4	1.4	1.5	1.5	1.6	1.7	1.8	1.8
Donor assistance grants (to operating budget) 4/	5.2	4.5	5.3	4.6	4.6	4.7	4.7	3.9	3.9	3.9	3.9	2.4	1.5	0.9	0.9
ARTF (recurrent window)	...	3.6	4.3	3.7	3.7	4.0	4.0	3.1	3.1	3.1	3.1	1.7	0.9	0.4	0.4
LOTFA	...	0.8	0.9	0.9	0.9	0.6	0.6	0.8	0.8	0.8	0.7	0.7	0.6	0.5	0.5
Other grants	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Donor assistance grants (core development budget)	...	2.0	2.9	8.0	8.0	2.6	3.4	8.1	8.1	4.3	4.3	4.4	5.8	6.2	6.2
Total core budget expenditure	8.5	14.0	13.9	23.0	23.0	12.0	14.5	23.3	23.3	15.7	15.7	15.8	16.0	16.4	16.4
Operating expenditure	8.5	9.8	9.4	9.3	9.3	7.6	9.3	9.1	9.1	8.9	8.9	8.5	8.2	7.8	7.8
Wages and salaries	...	6.5	6.6	5.7	5.7	4.9	6.0	5.7	5.7	5.6	5.7	5.6	5.4	5.2	5.2
Purchase of goods and services	...	2.1	1.5	1.8	1.8	1.7	2.1	2.0	2.0	2.1	2.0	1.9	1.8	1.6	1.6
Transfers and subsidies	...	0.3	0.3	0.6	0.6	0.0	0.0	0.5	0.5	0.4	0.3	0.3	0.3	0.3	0.3
Pensions	...	0.1	0.3	0.5	0.5	0.4	0.5	0.5	0.5	0.4	0.5	0.4	0.4	0.3	0.3
Capital expenditure	...	0.9	0.7	0.5	0.5	0.6	0.7	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Interest	...	...	...	...	...	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Core budget development spending 5/	...	4.2	4.5	13.8	13.8	4.4	5.2	14.2	14.2	6.8	6.8	7.2	7.8	8.5	8.5
Security	...	1.0	1.0	1.0	1.0	0.2	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.3
Governance, Rule of Law and Human Rights	...	...	...	0.5	0.5	0.1	0.1	0.5	0.5	0.3	0.3	0.3	0.3	0.3	0.3
Infrastructure and Natural Resources	...	...	...	6.3	6.3	1.5	1.7	7.5	7.5	2.6	2.6	2.8	3.0	3.3	3.3
Education	...	...	...	1.0	1.0	0.2	0.2	0.9	0.9	0.5	0.5	0.5	0.5	0.6	0.6
Health	...	...	...	0.4	0.4	0.2	0.3	0.7	0.7	0.4	0.4	0.4	0.4	0.5	0.5
Agriculture and Rural Development	...	...	...	3.9	3.9	2.0	2.4	3.1	3.1	2.4	2.4	2.5	2.7	3.0	3.0
Social Protection	...	...	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Economic Governance and Private Sector Development	...	...	...	0.7	0.7	0.2	0.3	0.8	0.8	0.4	0.4	0.4	0.4	0.5	0.5
Operating budget balance (excluding grants)	-5.3	-5.3	-4.9	-4.1	-4.1	-3.0	-3.7	-3.4	-3.4	-2.9	-2.9	-1.7	-0.8	0.0	0.0
Operating budget balance (including grants)	-0.1	-0.8	0.4	0.6	0.6	1.6	0.9	0.5	0.5	1.0	1.0	0.6	0.7	0.9	0.9
Core budget balance (including grants)	-0.1	-3.0	-1.2	-5.2	-5.2	-0.2	-0.9	-5.6	-5.6	-1.5	-1.5	-2.2	-1.3	-1.4	-1.4
Float and adjustment 6/	-0.4	0.8	0.1	0.0	0.0	0.7	0.7	-0.1	-0.1	0.0	0.0	0.0	0.0	0.0	0.0
Sale of Nonfinancial assets 7/	0.0	0.0	0.0	1.1	1.1	0.5	0.5	0.0	0.0	0.0	0.0	1.1	1.8	1.8	1.8
Financing	0.5	2.3	1.1	4.1	4.1	-1.0	-0.3	5.6	5.6	1.5	1.5	1.1	-0.5	-0.4	-0.4
External loans (net)	0.0	2.2	5.2	6.6	6.6	0.9	2.0	2.4	2.4	1.3	1.3	1.0	0.8	0.6	0.6
Domestic (net) 8/	0.5	0.1	-4.1	-2.4	-2.4	-2.0	-2.3	3.2	3.2	0.3	0.3	0.1	-1.3	-1.1	-1.1

Memorandum item:

External budget expenditure 9/

na

na

24.0

17.8

11.7

4.7

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

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

2/ November 2005 midyear review supplementary budget.

3/ Staff estimates and projections.

4/ Funding for the operating budget provided through the multi-donor trust funds: The Afghanistan Reconstruction Trust Fund (ARTF; recurrent window) and the Law and Order Trust Fund (LOTFA).

5/ Interim Afghanistan National Development Strategy programs. Government program classification based on a simple aggregation of administrative units. Expenditure is not delineated by a standard classification of purpose or function.

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

7/ In 2005/06, includes \$40 million receipt from the sale of telecommunications spectrum bandwidth. From 2006/07, also includes proceeds from planned privatizations.

8/ Net change in government deposits with Da Afghanistan Bank (excluding provincial branch balances). A positive sign corresponds to a decline in balances and a negative sign to an increase in balances.

9/ In 2002/03, includes one-off transfers of over flight revenue and customs valuation fees accumulated over several years and the sale of telecommunication licenses. From 2006/07 includes PRGF inflows.

Kabul, June 10, 2006

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
700 19th Street N.W.
Washington, D.C. 20431

Dear Mr. de Rato,

1. This letter supplements our Letter of Intent (LOI) and Memorandum of Economic and Financial Policies (MEFP) of May 15, 2006, which set out our medium-term economic program for which we requested the support of the IMF through an arrangement under the Poverty Reduction and Growth Facility (PRGF).
2. Following parliament's rejection of our initial budget proposal on May 21, 2006, we have conducted discussions with members of parliament and the donor community in an effort to address, to the extent possible, some of the concerns raised by the parliamentarians while preserving our overriding objective of maintaining fiscal discipline. As a result of this dialogue, the government submitted to parliament a revised budget that was approved on June 3.
3. Reflecting the government's commitment to medium-term fiscal sustainability, the revised budget is consistent with the same operating budget deficit for 2006/07 envisaged in the MEFP. The modifications introduced in the revised budget are as follows:
 - The 2006/07 fiscal program now includes a Af 300 increase (effective from September 21, 2006) in the monthly basic salaries of civil servants (excluding the police and the military), and a Af 100 increase in monthly pensions for the disabled and martyrs (from March 21, 2006), with a total cost estimated at Af 713 million (0.16 percent of GDP) in 2006/07.
 - To keep the programmed operating deficit (excluding grants) unchanged at 2.9 percent of GDP (MEFP; ¶26), these increases are fully offset by reducing other programmed expenditures, principally for goods and services (0.08 percent of GDP), and by using a portion of the contingency reserves envisaged in the original budget (0.07 percent of GDP).

4. These amendments ensure that the 2006/07 program remains in line with the quantitative targets and performance criteria set out in our May 15 MEFP (Table 3; Staff Report: 5/15/06).

5. In keeping with the broader objectives of our medium-term fiscal strategy, we remain conscious of the need to establish an expenditure framework that does not unduly impinge on day-to-day budgetary flexibility and ensures medium-term fiscal sustainability. To this end, the revised budget seeks to minimize the use of the contingency reserves, preserving over 80 percent of the previously programmed level (nearly 0.3 percent of GDP). We are also committed to refraining from additional across-the-board wage increases during the remainder of fiscal year 2006/07, and to linking future selective increases to the pay and grading reforms envisaged under the program (MEFP; ¶27). Finally, any consideration of additional expenditures at the time of the midyear budget review (MEFP; ¶26), will: (i) depend on revenue collection exceeding the September 2006 performance criterion and being expected to do so for the remainder of the fiscal year; and (ii) give priority to unwinding the expenditure offsets identified above (¶3).

6. The Government of Afghanistan continues to stand by all the other commitments included in the LOI and MEFP of May 15, 2006.

Sincerely yours,

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

/s/
Noorullah Delawari
Governor
Da Afghanistan Bank

Statement by the IMF Staff Representative
June 26, 2006

1. This statement contains information on recent economic developments in the Islamic Republic of Afghanistan that has become available since the supplement to the staff report was circulated to Executive Directors on June 13, 2006. This information does not alter the thrust of the staff appraisal.
2. Inflation (year-on-year) declined further, from 9.5 percent in March 2006 to 7.5 percent in May. The slowdown was broad-based; and the only noticeable exception was a faster increase in transportation costs resulting, in part, from rising oil prices.
3. Preliminary data indicate that the operating budget deficit, excluding grants, amounted to 3.7 percent of GDP in 2005/06, in line with program projections. While higher than the staff-monitored program floor, revenue in terms of GDP, at 5.2 percent, was slightly lower-than-projected. This outcome reflected a continued underperformance of domestic taxes and fees, which was offset by better-than-anticipated customs receipts. Operating budget spending turned out slightly lower-than-programmed, owing largely to lower-than-envisaged transfers, salaries, and interest payments. Budget development spending exceeded expectations during the fourth quarter; but for 2005/06 as a whole, it amounted to only 5.8 percent of GDP, compared with a midyear review projection of 13.8 percent, due to continued weaknesses in implementation capacity.
4. Liquidity remained tight as Da Afghanistan Bank (DAB) continued to sell foreign exchange through its regular auctions during the first two months of 2006/07. As a result, the exchange rate remained broadly stable, fluctuating within a narrow range (Af/\$49.5–50.0), while currency in circulation declined by 3 percent during the same period. Owing to a further accumulation of government deposits at the central bank, the decline in currency in circulation did not translate into a drop of international reserves, which remained largely unchanged, at more than \$1.6 billion.
5. On the external debt, significant progress has been made in reconciling the Russian claims, but some issues are still outstanding. Discussions are ongoing.
6. The Finance Department has conducted a safeguards assessment of DAB. The assessment identified several vulnerabilities and made recommendations to remedy them. DAB has agreed to implement the proposed recommendations.



Press Release No. 06/144
FOR IMMEDIATE RELEASE
June 26, 2006

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves US\$119.1 Million PRGF Arrangement for the Islamic Republic of Afghanistan

The Executive Board of the International Monetary Fund (IMF) today approved a three year, SDR 81.0 million (about US\$119.1 million) arrangement under the Poverty Reduction and Growth Facility (PRGF) for Afghanistan, which is designed to support the nation's economic program through March 2009 and build upon progress made under the IMF's Staff-Monitored Program (SMP).

As a result of the approval, Afghanistan will receive an initial disbursement under the PRGF arrangement amounting to SDR 13.2 million (about US\$19.4 million).

Following the Executive Board's discussion of Afghanistan, Mr. Agustín Carstens, Deputy Managing Director and Acting Chair, said:

“Afghanistan's economy continued to perform strongly under the staff-monitored program, resulting in rapid economic growth, inflation declining to single digit levels, and the international reserves position strengthening further. At the same time, the authorities implemented key structural reforms in the fiscal and monetary areas, while bringing to fruition the political framework envisaged under the 2001 Bonn agreement. These achievements, carried out in an extremely challenging environment characterized by lingering insecurity, poor infrastructure, and weak institutions, have paved the way for a comprehensive three-year reform program to be supported by a Poverty Reduction and Growth Facility arrangement from the Fund.

“The authorities' economic program draws on the government's Interim Afghanistan National Development Strategy (I-ANDS) paper and focuses on furthering capacity building, consolidating macroeconomic stability through sound fiscal and monetary policies, reducing poverty, and creating an investment climate conducive to private sector investment and sustained growth.

“Nonetheless, risks remain considerable. In addition to those related to the security situation, the government faces the challenges of dealing with persistent opium-related activities, weak implementation capacity, and uncertainties about donor assistance.

“In the fiscal area, the authorities seek to enhance revenue mobilization, including by strengthening the large taxpayers’ office, improving transparency and simplifying procedures, and upgrading administrative capacity. On the spending side, the authorities will strengthen the enforcement of the manpower and appropriation ceilings, while moving gradually to a new pay and grading system. These efforts will be complemented by further improvements in implementation capacity to increase much-needed development spending.

“The authorities’ continued tight monetary policy in the context of a managed float exchange system is warranted. The authorities intend to strengthen the monetary policy framework by developing the central bank’s analytical capacity, modernizing the monetary policy instruments, and improving the monetary statistics. Financial sector reforms will seek to enhance private savings and investment.

“The authorities place a welcome emphasis on structural measures aimed at promoting good governance and strengthening the institutional framework, simplifying business regulations, and divesting public sector activities. This will facilitate a more efficient use of resources, improvements in the investment climate, and continued mobilization of much-needed external assistance.

“A prudent external financing strategy, comprehensive debt relief, and continued donor support on highly concessional terms are necessary in light of Afghanistan’s large development needs and limited repayment capacity,” Mr. Carstens said.

The PRGF is the IMF's concessional facility for low-income countries. PRGF-supported programs are based on country-owned poverty reduction strategies adopted in a participatory process involving civil society and development partners and articulated in the [Poverty Reduction Strategy Paper \(PRSP\)](#). This is intended to ensure that PRGF-supported programs are consistent with a comprehensive framework for macroeconomic, structural, and social policies to foster growth and reduce poverty.

PRGF loans carry an annual interest rate of 0.5 percent and are repayable over 10 years with a 5½-year grace period on principal payments

ANNEX

Background

Economic activity in Afghanistan remained strong, inflation declined, and international reserves increased into the period ended December 2005. Fiscal and monetary developments were also broadly in line with projections under the SMP, although domestic revenue exceeded program targets. All but one of the structural benchmarks set under the SMP were observed and progress was made more generally in the area of structural reform.

Looking forward, Afghanistan still faces challenges in sustaining rapid growth and achieving the goals set out in the I-ANDS Paper. The medium-term outlook remains clouded by lingering

insecurity, weak institutional capacity, and a still fragile social consensus. Afghanistan's economic program supported by the PRGF arrangement seeks to address these challenges and to help resolve outstanding debt issues, possibly in the context of the Heavily Indebted Poor Countries Initiative. Over the next three years, the IMF-supported program will aim to sustain real GDP growth of about 10 percent a year, reduce inflation to about 5 percent, and further strengthen the country's external position. The program seeks to increase budgetary revenue to more than 8 percent of GDP by 2010/11, while improving the provision of health and education services.

For 2006/07, the program assumes real GDP growth of 12 percent and a decline in year-on-year inflation to 9 percent. The operating budget deficit is targeted to decline to 2.9 percent of GDP, from 3.7 percent in 2005/06, through a combination of revenue measures and expenditure restraint. The fiscal program provides some flexibility to accommodate higher development spending if Afghanistan's implementation capacity improves, and to incorporate operating expenditures in the budget that are currently financed off-budget by donors. Monetary policy will continue to target currency in circulation in the context of a managed float system. Structural measures will focus on fiscal and banking reforms, steps to enhance the statistical framework and to improve Afghanistan's business environment.

The principal risks to Afghanistan's economic program are related to the security situation, the government's weak control over the provinces, and significant capacity constraints. The authorities will have to also deal with persistent opium-related activities, expenditure pressures and medium-term uncertainties about donor assistance.

Islamic Republic of Afghanistan: Selected Economic Indicators, 2001/02–2006/07

	Est. 2001/02	Est. 2002/03	Est. 2003/04	Est. 2004/05	Prel. 2005/06	Proj. 2006/07
Output and prices						
Real GDP (in percent, excluding opium)	...	28.6	15.7	8.0	14.0	12.0
GDP (in billions of Afghanis)	134	183	225	285	363	443
GDP (in millions of U.S. dollars, excluding opium)	2,463	4,084	4,585	5,971	7,309	8,869
GDP per capita (in U.S. dollars, excluding opium)	123	182	199	253	300	354
Prices						
CPI (Kabul, year-on-year change; in percent)	-43.4	52.4	10.3	14.9	9.5	9.0
CPI (Kabul, average change; in percent)	...	5.1	24.1	13.2	12.3	9.2
Exchange rates						
Afghanis per U.S. dollar (annual average)	54.4	44.8	49.0	47.7	49.7	...
Afghanis per U.S. dollar (end of period)	31.0	52.6	49.8	48.7	49.9	...
General government operating budget						
Revenue excluding grants (in percent of GDP)	...	3.2	4.5	4.5	5.5	6.0
Expenditures (in percent of GDP)	...	8.5	9.8	9.4	9.3	8.9
Grants (in percent of GDP)	...	5.2	4.5	5.3	4.7	3.9
Monetary indicators						
Broad money (percent change)	...	20.1	40.9	37.5	15.1	18.4
Gross international reserves (in millions of U.S. dollars)	...	425	820	1,283	1,662	1,804
(In percent of GDP; unless otherwise indicated)						
External sector						
Current account (excluding grants; in millions of U.S. dollars)	...	-1,368	-2,336	-2,701	-3,115	-3,515
Current account (including grants; in percent of GDP)	...	-3.6	3.1	1.4	-0.9	-1.5

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

**Statement by Abbas Mirakhor, Executive Director
for the Islamic Republic of Afghanistan
June 26, 2006**

Key Points

- *Afghanistan's performance during the third quarter of 2005/06 under the SMP continued to be satisfactory, with all of the end-December 2005 quantitative targets and structural benchmarks observed, except for the publication of the audited 2004/05 core budget financial statements, which took place in March 2006.*
- *The budget deficit was lower than envisaged in 2005/06. Revenue exceeded the program target, while spending remained lower than budgeted because of capacity constraints.*
- *Monetary policy was tightened significantly, starting in the fourth quarter of 2005/06 in response to inflation and incipient pressures toward a depreciation of the currency, and the inflation objective was achieved.*
- *The overall business climate and governance in key macroeconomic institutions have improved, and the authorities intend to pursue their structural reform agenda even more forcefully to improve external competitiveness and establish an adequate environment for private investment. They also recognize that an open and transparent trade regime is vital for growth prospects.*
- *I-ANDS lays a solid foundation for developing a full ANDS/PRSP, and staff have commended the authorities for their efforts aimed at defining a number of medium- to long-term goals for their poverty reduction strategies and establishing clear benchmarks to measure progress.*
- *The authorities are requesting a PRGF-supported arrangement to address these challenges in line with the policies and objectives outlined in the I-ANDS. Proposed access under the PRGF arrangement will be 50 percent of quota, which is substantially lower than the norm of 90 percent and close to the historical minimum for first-time users of PRGF resources.*

My Afghan authorities thank the Board, management and staff for their continuous support and assistance under the Staff-Monitored Program (SMP). Even though they have developed full ownership of policy design, bear the responsibility for the day-to-day implementation of the ambitious program, and are rightly proud of their track record since the inception of the SMP in March 2004, they are cognizant that their successful policy decisions owe a great deal to the productive dialogue and constructive collaboration with the Fund. They recognize the key role played by the Fund in pulling them out of the deep crisis that afflicted the country before they came into office. They are aware that there is a long road ahead towards

sustainable growth and implementation of the ambitious program of reforms required to conclude the tasks of economic reconstruction, eliminate opium production and providing alternative income opportunities, strengthen productive efficiency, and reduce poverty. The considerable progress made under the SMP in promoting macroeconomic stability and structural reform in an exceptionally challenging environment dominated by security issues and external shocks has been indeed recognized by the international community. The policy implementation record assures that a successor program under the PRGF would help the authorities to consolidate these gains and reinforce the implementation of the policies necessary for significantly improving social conditions.

As discussed in the lucid staff report, Afghanistan's performance under the SMP during the third quarter of 2005/06 continued to be satisfactory, with all of the end-December 2005 quantitative targets and structural benchmarks observed, except for the publication of the audited 2004/05 core budget financial statements, which took place in March 2006. Economic activity remained buoyant; real GDP grew by 14 percent in 2005/06. Notwithstanding underlying weaknesses, such as a narrow export base, massive reconstruction needs, and weak physical infrastructure, the balance of payments position has continued to improve, with a narrowing of the external current account deficit and increasing international reserves. Year-on-year inflation declined markedly to 9.5 percent in March 2006 from 12.9 percent in September 2005.

Fiscal policy

Tax collection and fees picked up significantly during the fourth quarter, and revenue collection is now estimated at 5.5 percent of GDP for 2005/06 in total, compared to a program target of 5.0 percent of GDP. Reflecting higher revenue, the operating budget deficit, excluding grants, is estimated at 3.7 percent of GDP in 2005/06, compared to a program projection of 4.2 percent of GDP. Notwithstanding these positive developments, the authorities remain concerned that domestic revenues account for only a small share of total budgetary expenditures and will focus on efforts aimed at broadening the tax base and strengthening administrative capacity of the revenue directorate. Operating expenditures were maintained within budget ceilings despite pressures for larger outlays on security and higher-than-planned teacher recruitment. The revised budget passed by the parliament ensures that the salary increase for civil servants, which is broadly in line with the expected inflation, will keep total programmed expenditures unchanged. In particular, the fiscal impact of the wage and pension measures will be fully offset by reductions in the appropriations for other programmed expenditures and by using, in part, the contingency reserves envisaged in the original budget. The wage adjustment allows sufficient room for implementing the pay and grading system, which is a top priority in the policy agenda. Core development spending was significantly lower than the midyear budget review projection, attributed mainly to implementation problems and security concerns.

A major source of concern is that the bulk of external assistance resources is channeled outside of the government's financial management systems, weakening government appropriation procedures. In this connection, the staff rightly point out that absorbing into the core budget those fiscal operations that were previously financed externally by donors, is a

positive development, but, if accompanied by a reduction in external assistance, would reduce fiscal space over the medium term. The authorities plan to work closely with the donor community to strengthen government's capacity to implement its program, including measures to improve budget formulation, such as publication of a less compressed calendar and the reorganization of the Budget Department. The recent discussions on fiscal management among the government, the donor community, and parliamentarians have forged an even closer bond, including a better understanding by the parliament of the government's financing constraints and increased awareness among the donors about how foreign financial assistance, largely channeled outside of the budget, adversely affects the government's capacity for project prioritization.

Monetary and exchange rate policies

The overriding objective in the conduct of monetary policy is to contain inflation. The authorities have tightened monetary policy significantly in response to inflation and incipient pressures toward a depreciation of the currency, starting in the fourth quarter of 2005/06. As a result, currency in circulation grew at a rate well below the program target, which was sufficient to achieve the inflation target. Nevertheless, DAB stands ready to tighten monetary policy further, if necessary, in the context of the present managed float system to achieve the inflation target for the coming period.

Considerable progress has been made in modernizing DAB's operations and its balance sheet. The efforts aimed at strengthening the monetary policy framework have focused on the development of DAB's analytical capacity, the modernization of its instruments, and the improvement of the monetary statistics. DAB has started to publish the interest rates on capital note auctions and to enforce reserve requirements while remunerating required reserves. Participants in the foreign exchange auctions are now allowed to both sell and buy dollars and to enter multiple bids. The authorities are committed to further progress in restructuring the state-owned banks and have appointed a new Board of Directors at Bank Millie and a team to oversee the liquidation of the three former state-owned banks.

Structural reform

The authorities intend to pursue their structural reform agenda forcefully. The overall business climate and governance in key macroeconomic institutions have improved. Notwithstanding this progress, the authorities have stressed that improving governance in all public institutions is of high priority; they are determined to create an environment conducive to investment. Their plan to further improve the investment climate and enhance competitiveness of the economy include measures to address corruption and improve security, lower the cost of doing business by harmonizing and simplifying investment regulations, implement an appropriate strategy for the divestiture of SOEs and other government agencies involved in commercial activities, and regulate and reform the judicial system, such as preparatory work for laws aimed at enhancing governance, property rights, and competition. They are committed to maintaining a transparent and liberal trade regime, which they consider to be an essential condition for promoting private sector development. The authorities are focusing on the envisaged rationalization of the tariff structure and will

avoid protectionist measures, which run counter to the objective of promoting investment and growth.

External debt

Staff have rightly stressed that comprehensive debt relief—along with prudent debt management and enhanced grant management—will be essential to restore and maintain external sustainability. Including the current estimates of Russian claims, Afghanistan’s external debt is estimated at nearly 150 percent of GDP. The expected upfront cancellation of Russian claims and Paris Club flow rescheduling will provide a significant amount of relief, but the large development needs and limited repayment capacity require additional action to address the remaining debt burden. The authorities are fully aware that continued progress under the PRGF arrangement will be a key element in establishing a track record toward eligibility for debt relief under the enhanced-HIPC Initiative, and are determined to pursue policies that would pave the way for significant additional debt reduction from bilateral and multilateral creditors. In this regard, the medium-term fiscal framework (MTFF) will serve as a key anchor for sound macroeconomic policies, with focus on fiscal and external sustainability, including an ambitious program to increase domestic revenue. Lastly, the fact that the Ministry of Finance has been given sole responsibility for all borrowing and loan guarantees on behalf of the government is a right step towards enhancing debt management.

Interim Afghanistan National Development Strategy (I-ANDS)

The Joint Staff Advisory Note rightly points out that the I-ANDS lays a solid foundation for developing the full ANDS/PRSP, and has commended the authorities for their efforts aimed at defining a number of medium- and long-term goals for their poverty reduction strategies and establishing clear indicators of progress. In addition to the commitment to pursue sound economic and financial policies and to achieve the Millennium Development Goals, I-ANDS emphasizes improving incomes in rural areas; developing infrastructure, including transport, power and water facilities; enhancing natural resource management; building institutional and human capacity; and strengthening social protection. The authorities recognize the need for adequate capacity development and meaningful participation to enhance the quality and ownership of the national strategy, and, accordingly, have done their utmost to continuously strengthen the participatory process. The preparation of the I-ANDS included a significant consultative process, with more than 400 consultative meetings with stakeholders, including sectoral ministries, provincial governors, the private sector, members of local communities, civil society organizations, a number of parliamentarians, donors, foreign office officials, and ambassadors. It is noteworthy that all meetings were public, with minutes (where available) posted on the ANDS website. Moreover, the I-ANDS recognizes that further efforts are required to strengthen the consultation process toward a complete ANDS and outlines the proposed participatory process, including how to deepen and broaden discussion and analytical work through consultative groups (CGs) and other formal and informal structures.

To mitigate the risk that the interim strategy may not be fully integrated into budget formulation and execution processes, the authorities have embarked on a detailed program to strengthen basic monitoring capacities, focusing in particular on the necessity to avoid any

duplication of functions, which may hamper capacity development, including in the Central Statistics Office (with regard to household and expenditure surveys), the Ministry of Economy and DAB (macroeconomic reporting), and the Ministry of Finance (public finance monitoring and project tracking systems). They will spare no effort to institutionalize processes that would strengthen policy formulation and monitoring mechanisms, including the flow of information into government decision-making and annual budget preparation. They are committed to the comprehensive compilation and dissemination of macroeconomic and socio-demographic statistics, realizing that it is essential for formulating sound macroeconomic policies. In September 2004, with the assistance of international agencies, the authorities launched a statistics master plan to produce official statistics in line with international standards. Their efforts have borne fruits, and it is heartening to note that STA has indicated (since the publication of the staff report) that Afghanistan will imminently become a participant in the General Data Dissemination Standards (GDDS).

Poverty Reduction and Growth Facility

As noted in the staff report, Afghanistan has delivered a strong performance under the SMP, with macroeconomic stabilization largely achieved, and significant reforms introduced in the fiscal and banking areas. The authorities are requesting a successor PRGF-supported program as an appropriate tool to address the challenges in the context of the policies and objectives outlined in the I-ANDS. The PRGF-supported program will build on the gains made under the SMP in stabilizing the economy and developing economic institutions. It will seek to maintain strong growth, further reduce inflation, strengthen the international reserves position, and accelerate institutional and structural reforms, all of which are needed to facilitate poverty reduction. Over the next three years, the program will aim at sustaining real GDP growth of about 10 percent a year, reducing inflation to about 5 percent, narrowing the current account deficit and building up reserves, and accelerating institutional and structural reforms. The fiscal program will seek to increase revenue progressively, while improving the provision of health and education services.

Proposed access over the three-year period covered by the new PRGF arrangement amounts to SDR 81 million (50 percent of quota), which is significantly lower than the norm of 90 percent and close to the historical minimum for first-time users of PRGF resources. The low access reflects Afghanistan's relatively strong reserve position and the availability of donor financing on grant terms. However, the need to build up reserves should be stressed in view of the political, economic, and other myriad uncertainties typical of a post-conflict environment. Most of the \$10.4 billion financing gap over the program period is attributable to the assumed settlement of external arrears, mainly to Paris Club creditors, and is expected to be closed through rescheduling and debt relief. The remainder of the gap would be covered by PRGF disbursements. The staff have rightly noted that Afghanistan should be able to service its obligations to the Fund and other creditors on a timely basis. A full safeguards assessment of DAB is being completed: the recommendations made during the mission with regard to the vulnerabilities in the external and internal audit mechanisms, the financial reporting framework, and the system of internal controls are already being implemented, or DAB is diligently working on addressing them in an expeditious manner within the capacity constraints.