

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

In the context of the second review under the 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 Second Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, prepared by a staff team of the IMF, following discussions that ended on May 10, 2007, with the officials of the Islamic Republic of Afghanistan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on June 21, 2007. 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 Press Release summarizing the views of the Executive Board as expressed during its July 9, 2007 discussion of the staff report that completed the review.
- A statement by the Executive Director for the Islamic Republic of Afghanistan.

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

HIPC Initiative 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 by the authorities of the Islamic Republic of Afghanistan*

*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

**Second Review Under the Three-Year Arrangement Under
the Poverty Reduction and Growth Facility**

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

Approved by Juan Carlos Di Tata and Matthew Fisher

June 21, 2007

- Discussions on the second review under the Poverty Reduction and Growth Facility (PRGF) arrangement were held in Kabul from April 25–May 10, 2007. The staff team comprised Messrs. Elhage (head) and Wieczorek, Ms. Farahbaksh (all MCD), Mr. Tyson (FAD), and Ms. Ongley (PDR). Mr. Charap, Fund resident representative in Kabul, assisted the mission.
- Afghanistan’s three-year PRGF arrangement amounting to SDR 81.0 million (50 percent of quota) was approved by the Executive Board on June 26, 2006. The arrangement supports the authorities’ economic program through March 2009 and Afghanistan’s participation in the Heavily Indebted Poor Countries (HIPC) Initiative. Completion of the second review would allow the third disbursement (SDR 11.3 million).

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LIST OF ACRONYMS

AISA	Afghanistan Investment Support Agency
AFMIS	Afghanistan's Financial Management Information System
ANDS	Afghanistan National Development Strategy
ARTF	Afghanistan Reconstruction Trust Fund
BRT	Business Receipts Tax
CIC	Currency in Circulation
CIRRs	Commercial Interest Reference Rates
CNs	Capital Notes
CPI	Consumer Price Index
DAB	Da Afghanistan Bank
DABM	Da Afghanistan Breshna Moassese (Afghanistan electricity authority)
GDP	Gross Domestic Product
GST	Goods and Services Tax
HIPC	Heavily Indebted Poor Countries
I-ANDS	Interim Afghanistan National Development Strategy
LOTFA	Law and Order Trust Fund for Afghanistan
LTO	Large Taxpayer Office
MCD	Middle East and Central Asia Department
MEFP	Memorandum of Economic and Financial Policies
MoF	Ministry of Finance
MTFF	Medium-Term Fiscal Framework
NCBF	Net Central Bank Financing
NIR	Net International Reserves
NRVA	National Risk Vulnerability Assessment
OFID	OPEC Fund for International Development
PFEM	Public Finance and Expenditure Management
PRGF	Poverty Reduction and Growth Facility
SOEs	State-Owned Enterprises
TCC	Technical Committee of Coordination
TMU	Technical Memorandum of Understanding

EXECUTIVE SUMMARY

Despite a difficult security environment, Afghanistan's performance during 2006/07 conformed broadly with the objectives of the program supported by the PRGF arrangement. All the quantitative performance criteria and indicative targets through March 2007, and the structural benchmarks for the second review were observed, except for the benchmark related to the preparation of a divestment plan for state-owned enterprises and government agencies engaged in commercial activities.

Real gross domestic product (GDP) growth is estimated at 7.5 percent in 2006/07 and (year-on-year) consumer price index (CPI) inflation declined to 4.8 percent by year's end. The exchange rate remained stable, and official reserves increased further. Commercial bank deposits and lending more than doubled in 2006/07.

The fiscal performance was better than programmed, and the revenue target for 2006/07 was met with a comfortable margin. However, political pressures on tax administration and the granting of concessions to some manufacturers through increased protection on final goods and lower duty rates on raw materials pose risks to achieving the revenue targets, and are distorting the customs regime.

Real GDP growth is projected to increase by 13 percent in 2007/08, primarily owing to a rebound in agriculture. With continued appropriate monetary and fiscal policies, CPI inflation is expected to be contained at 6 percent. The external current account is projected to improve, and official reserves would remain at around five months of prospective imports.

Looking ahead, the success of the program hinges on maintaining macroeconomic discipline and deepening structural reforms, in particular revenue mobilization. Also, fiscal policy needs to pay increasing attention to medium-term sustainability considerations, and to rely on the medium-term fiscal framework (MTFF) as a tool for fiscal policy design. In addition, the authorities should refrain from supporting the ailing national airline without credible assurances of its viability.

During the discussions, staff reached preliminary understandings with the authorities on the need to reverse recent trade policy measures. It also urged the authorities to muster government-wide support for reforms in the areas of tax policy and administration.

The rapid growth in commercial banks' activities underscores the need for strengthening bank supervision. Priorities include putting in place regulations on credit risk management, including credit-granting standards and monitoring processes, and introducing regulations setting limits on sectoral loan concentration.

Preparations for the HIPC decision point have been completed. Discussions on the HIPC completion point triggers have been finalized, and progress has been made in preparing the Afghanistan National Development Strategy (ANDS). However, further efforts will be required to cost, prioritize, and integrate the development strategy into the budget by the time the ANDS is expected to be completed in early- to mid-2008.

I. INTRODUCTION

1. **On March 7, 2007, the Executive Board approved the first review of Afghanistan's three-year PRGF arrangement** in support of a program aimed at: (a) maintaining fiscal discipline and achieving medium-term fiscal sustainability while ensuring adequate pro-poor spending; (b) implementing structural reforms to boost economic growth; and (c) addressing the large external debt through the HIPC Initiative.
2. **Security remains a challenge and the political environment surrounding the program has become increasingly complex.** Lingering insecurity in many provinces is complicating budget management, and political pressures could pose a risk to achieving the program's objectives, in particular the revenue targets. Looking ahead, continued macroeconomic discipline, progress on structural reforms, and political resolve to tackle some difficult issues are critical to continued success.

II. RECENT ECONOMIC AND POLICY DEVELOPMENTS

3. **Economic developments in 2006/07 have been generally favorable.**¹ Available information suggests that the impact of drought on agricultural production was somewhat larger than previously anticipated, with real GDP growth decelerating to about 7.5 percent, from 14 percent in 2005/06 (Table 1). Year-on-year inflation, as measured by the CPI for Kabul, subsided to 4.8 percent in March 2007, with declining rent prices mitigating the impact of rising food prices and an increase in administered energy prices in the second half of the fiscal year (Figure 1). Despite intensified counter-narcotics efforts, opium production is estimated to have risen substantially in 2006/07.
4. **The fiscal performance in 2006/07 was better than programmed** (Table 2a). Preliminary data indicate that the operating budget deficit (excluding grants) was 3.6 percent of GDP, compared to 4.1 percent envisaged in the program, on account of a stronger-than-expected revenue collection and expenditure discipline (Table 2b). The execution of development expenditures improved significantly in 2006/07 (50 percent higher than in 2005/06), reaching over 90 percent of the program's target. The overall core budget deficit (including grants) narrowed to 2.7 percent of GDP in 2006/07, compared to 3.8 percent targeted in the program (Memorandum of Economic and Financial Policies (MEFP), ¶¶5–7).²
5. **There were, however, a number of adverse developments in tax administration and trade policy.** Tax administration has suffered from: (a) frequent investigations, perceived as interference, from the Attorney-General's office and Anti-corruption Police; and (b) political pressures to reverse tax enforcement decisions. As a result, staff morale has weakened, and the Large Taxpayer Office (LTO) has experienced numerous departures. Regarding trade policy, the authorities: (a) introduced a new 40 percent tariff on soft drinks

¹ Fiscal year begins March 21.

² The core budget excludes donor-financed development expenditures implemented outside the Treasury.

and bottled water; and (b) issued a new presidential decree allowing some producers to apply for a lower import tariff (of 1 percent) on raw materials and intermediate inputs (MEFP, ¶9).

6. **The financial situation of Ariana has deteriorated further, and the airline recently lost two planes after failing to honor the leases.** Thus far, the authorities have resisted pressures to bail out Ariana but are exploring measures to keep it afloat (MEFP, ¶18).³ There is currently no restructuring plan for the company.

7. **Monetary developments point to increased confidence in the Afghani.** International reserves have increased further, and the exchange rate remains broadly stable (about Afs 50 per U.S. dollar), while money demand has grown steadily. Currency in circulation (CIC) increased by 12.4 percent in 2006/07, while commercial banks' deposits and lending more than doubled (Table 3). Although bank operations continue to be heavily dollarized, there appears to be no currency mismatch between banks' assets and liabilities.

8. **Da Afghanistan Bank (DAB) has continued improving its monetary policy instruments and modernizing its operations.** In line with staff's recommendations, the volume of 28-day capital notes (CNs) weekly auctions has increased, and 182-day CNs were launched in the last quarter of 2006/07. The increase in CNs auctions resulted in an increase in interest rates from 5–6 percent to 7–8 percent (Figure 2; MEFP, ¶11). A new accounting system has been introduced at DAB's headquarters, but is not yet operational. The external audit of DAB's end-2006/07 accounts is scheduled to be completed on June 15, 2007, including a special audit of foreign reserves in line with recommendations made in the context of the safeguards assessment (MEFP, ¶13). However, results of the 2005/06 audit (year ending March 20, 2006) indicate that significant control weaknesses and accounting issues persist.

9. **The current account deficit, excluding grants, widened slightly to 44 percent of GDP in 2006/07** (MEFP, ¶15; Table 4), reflecting a larger trade deficit on account of higher-than-anticipated imports associated with donor activities outside the core budget. The current account balance, including grants, registered a deficit of about ½ percent of GDP. This deficit was largely financed by an increase in concessional loan disbursements, which, together with Fund support and debt relief, allowed for a further strengthening of gross international reserves to over US\$2 billion (five months of imports).

10. **The authorities continued their discussions with creditors in preparation for the HIPC decision point** (MEFP, ¶16). Consistent with the July 2006 Paris Club agreement, the authorities have signed two bilateral agreements, and they are working to finalize the remaining agreement. They also wrote to all non-Paris Club creditors, with a view to opening debt restructuring discussions. In late May, the authorities reached an understanding in principle with the OPEC Fund for International Development (OFID) to regularize

³ While the mission was informed that there are no formal outstanding government guarantees, Ariana received US\$2 million in budgetary support in 2006/07. Ariana's tax liabilities (about US\$40 million) are likely to exceed the company's value.

Afghanistan's arrears, with the details of the agreement to be finalized after the decision point. Staff also reached understandings with the authorities on the completion point triggers.

III. PERFORMANCE UNDER THE PROGRAM

11. **Program performance in 2006/07 was broadly satisfactory.**

- The authorities met all the March 2007 quantitative performance criteria and indicative targets (MEFP, Table 1). While the December 2006 indicative target on revenue was missed, the March performance criterion was observed with a comfortable margin.
- Four of the five structural benchmarks for the second review were implemented (MEFP, Table 2). The benchmark on adopting a comprehensive restructuring/divestment plan for state-owned enterprises (SOEs) and government agencies engaged in commercial activities was not observed.

12. **Progress continued on structural reforms in the public finances.** The authorities have fulfilled many of their commitments from the first review, such as Cabinet endorsement of the MTFP, and program budgeting, on a pilot basis, in the Ministry of Education (MEFP, ¶8). The Control and Audit Office verified the headcount at the Ministry of Education and Interior (end-January 2007 structural benchmark), but progress in furthering payroll control, by making the certified payroll system fully operational, has been slow. The authorities also submitted legislation to eliminate nuisance taxes and simplify the income tax by end-March 2007, but parliamentary approval is still pending.

13. **Some progress has been made regarding the restructuring of Bank Millie and Bank Pashtany.** A restructuring plan for Bank Millie was approved by Cabinet and an external audit of the bank was completed in May 2007. Also, a board of supervisors has been put in place, and efforts continue to fill the vacant management positions. A new Chief Executive Officer has been appointed at Bank Pashtany, and an external audit has been commissioned to provide the basis for a restructuring plan.

14. **Several other commitments under the program, however, have not been met.** While the authorities have taken steps to clarify and document the role of various agencies currently operating at the borders, these measures have not yet been made operational.⁴ Also, no agreement has yet been reached between the Ministry of Finance, the Ministry of Energy and Water, and the state electricity company (DABM) on reducing energy subsidies over time. Moreover, the submission of a secured transactions law, a business organization law, and a negotiable instruments law to parliament has been further delayed (MEFP, ¶4 and ¶8).

⁴ Traders and other importers have complained about bureaucracy and rent-seeking behavior from non-customs entities operating at the border, which weakens the impact of customs reforms.

IV. THE 2007/08 PROGRAM

15. **Discussions with the authorities on their policies for 2007/08 focused on** (a) tax policy and revenue mobilization; (b) monetary management and bank supervision; (c) structural reforms and policies to enhance private sector development; (d) HIPC-related issues; and (e) technical assistance needs and statistical issues.

A. Macroeconomic Outlook

16. **The macroeconomic outlook for 2007/08 is expected to remain favorable.** Real GDP growth is projected at 13 percent owing to a rebound in agriculture and sustained growth in the construction and services sectors. Average annual CPI inflation would increase slightly to 6 percent, due to rising transportation costs and the pass-through of higher energy prices. Given their high import content, the additional security expenditures (relative to the first review) are not expected to have a significant inflationary impact.

B. Fiscal Policy

17. **The operating budget deficit, excluding grants, is projected at 3.7 percent of GDP in 2007/08.** Revenues are targeted to increase to 7.3 percent of GDP, while both operating and development expenditures are expected to rise. The latter would be about 37 percent higher than the 2006/07 outturn, reflecting new procedures prioritizing projects that have undergone the preparatory stages, rather than an expenditure “wish-list.”⁵ Spending pressures that are expected to emerge later in the year will be addressed during the third review under the PRGF arrangement.⁶ The scope for increasing non-security expenditures will be contingent on meeting the September 2007 revenue target. In this regard, overcoming political pressures and renewed momentum to implement FAD’s recommendations on tax and customs policy and administration will be crucial (MEFP, ¶¶21–23). In the event of a revenue shortfall, the authorities will need to accelerate reforms to bring revenue performance back on track if longer-term expenditure corrections are to be avoided. Nevertheless, the authorities may need to exercise expenditure restraint in nonpriority areas until the revenue performance is in line with the program.

18. **The authorities’ objective of covering operating budget expenditures with domestic revenue would be achieved by 2012/13** (two years later than envisaged at the time of the first review), which implies a need for continued donor support to cover the recurrent budget for at least another five years. The staff encouraged the authorities to use the MTF as a tool for fiscal policy design and for engaging donors on the external support needed for the recurrent budget.

⁵ Based on past performance, development expenditures are projected at Afs 44.1 billion (9.1 percent of GDP), compared to a budgeted amount of Afs 77.0 billion (15.8 percent of GDP). Related performance criteria adjust automatically in case of higher development expenditures, up to the budgeted amount.

⁶ Possible additional spending needs on education and provincial governors’ outreach (0.3 percent of GDP) and on security (0.3 percent of GDP) have already been identified by the authorities (MEFP, ¶22).

19. **Continued structural fiscal reforms are necessary to meet the medium-term fiscal objectives** (MEFP, ¶¶23–26). The authorities plan to: (a) renew their efforts to strengthen revenue mobilization and move ahead with key tax reforms; (b) implement improvements to the MTF; (c) broaden budget and treasury reforms; and (d) take steps to control costs. Given Ariana’s acute financial difficulties, staff strongly recommended that the authorities develop a restructuring plan and avoid using government resources to support the company (MEFP, ¶26).

C. Monetary and Exchange Rate Policies and Financial Sector Reforms

20. **Currency in circulation is projected to grow broadly in line with nominal GDP in 2007/08.** Based on the anticipated trend in the demand for currency, foreign exchange and CNs sales will target an increase in CIC not to exceed 19 percent during the year. While the weekly foreign exchange auctions will continue to be the main instrument for monetary management, DAB intends to increase the use of capital notes to absorb banks’ excess liquidity. Moreover, the development of a secondary market in capital notes is expected to facilitate the use of capital notes of longer (182-day) maturities. The current range of interest rates on CNs (7–8 percent) is appropriate relative to domestic inflation.

21. **In response to the rapid growth of banks’ activities, DAB also plans to take steps to strengthen the regulatory and supervisory framework for the banking system.** The authorities intend to issue: (a) regulations on credit risk management, and the required policies and processes to be followed by banks in order to identify, measure, monitor, and control credit and counterparty risks; and (b) regulations to set limits on sectoral loan concentration. To enhance transparency and disclosure, DAB will require banks to publish their audited annual financial statements (MEFP, ¶28).

22. **The authorities plan to move forward with the restructuring of the remaining state-owned banks and finalize the liquidation of non-licensed state-owned banks.** To that end, they plan to submit for Cabinet approval a restructuring plan for Bank Pashtany by end-August 2007, and will prepare, on the basis of on-site supervision reports, a summary report on banks’ compliance with prudential regulations by end-July 2007. DAB will enforce licensing requirements for Bank Pashtany and Bank Millie by end-September 2007. To preserve the value of these banks, no direct lending will be provided by state-owned banks to state-owned enterprises that have not developed comprehensive restructuring plans, or that have not had an audited balance sheet for the last two years.

D. External Sector Outlook and Policies

23. **The external sector outlook is expected to remain broadly unchanged relative to 2006/07** (MEFP, ¶¶30–31). In the near term, continued robust export performance and higher interest income on international reserves should allow for an improvement in the overall external current account balance. However, the external current account deficit, excluding grants, is projected to average 37.5 percent of GDP over the medium term, underscoring the need for continued donor support. For 2007/08, foreign exchange reserves are expected to rise further to nearly US\$2.3 billion (about five months of projected imports).

24. **The 2007/08 program is fully financed.** In addition to continued considerable official transfers, the financing gap is expected to be closed through debt relief under the HIPC Initiative (Table 5). The program assumes that—in line with the July 2006 Paris Club agreement—Afghanistan will seek comparable treatment from other bilateral creditors, with the authorities making good faith efforts to reach understandings with these creditors (MEFP, ¶16). The program also allows for the prospective regularization of arrears to OFID. Regarding possible claims by commercial creditors uncovered during the HIPC debt reconciliation process,⁷ the authorities informed staff that they remain in dispute. Accordingly, these claims are not treated as arrears for program purposes. While staff encourages the authorities to continue efforts to clarify Afghanistan’s obligations vis-à-vis all possible creditors, the program financing assumptions remain unchanged.

25. **The authorities plan to unwind recent changes to the tariff schedule.** They intend to: (a) put forward, in consultation with staff, a proposal to eliminate the discretionary application of the 1 percent tariff rate on raw materials and intermediate inputs before the completion of the third review; and, also in the context of the third review, (b) adopt a time-bound plan to eliminate the new 40 percent tariff rate (MEFP, ¶33).

E. Structural Policies, Poverty Reduction, and Statistical Issues

26. **The authorities intend to deepen structural reforms to foster private sector development.** Accordingly, they will (a) submit to parliament laws on partnership and corporations by end-June 2007; (b) prepare a comprehensive restructuring/divestment plan for public entities and government agencies engaged in commercial activities but not covered by the SOEs law; and (c) divest entities covered by the SOEs law through liquidation and privatization.

27. **Preparation of the ANDS (Afghanistan’s Poverty Reduction Strategy) is well-advanced** (MEFP, ¶35). Notwithstanding intensified consultations and significant progress in drafting sector strategies and improving the poverty baseline, further efforts will be required to cost, prioritize, and integrate the development strategy into the budget by the time the ANDS is expected to be completed in early- to mid-2008.

28. **The authorities are to be commended for their commitment to improve economic statistics, notably the national accounts, the balance of payments, and social/poverty indicators.** In this regard, they plan to launch the 2007 National Risk and Vulnerability Assessment (NRVA) by end-June 2007 to improve the coverage of the 2005 NRVA and correct its seasonal bias. The authorities also intend to initiate an Integrated Business Enterprise Survey by end-December 2007. This work will help upgrade the social database and serve as a basis for building the national accounts.

⁷ The amounts in question are estimated to be very small (around ½ percent of Afghanistan’s end-2005/06 total external debt stock).

V. PROGRAM MONITORING AND RISKS

29. **The third review under the PRGF arrangement is expected to be completed by end-January 2008**, with the fourth disbursement being subject to the observance of the September 2007 quantitative performance criteria and relevant structural conditionality (MEFP, Tables 1 and 2). Structural conditionality for the third review is based on the Board-approved agenda, with the exception of the two new structural benchmarks that were introduced to address the most urgent regulatory shortcomings in bank supervision.

30. **In addition to security concerns and capacity constraints, policy-induced distortions and backsliding are emerging as major sources of risk.** Unabated security pressures could, over time, crowd out other priority expenditures or threaten fiscal sustainability. Recent trade policy measures have also highlighted the significance of political pressures and the risks to revenue mobilization efforts.

VI. STAFF APPRAISAL

31. **Afghanistan's performance under the PRGF-supported program continued to be broadly satisfactory in 2006/07.** Looking ahead, the success of the program hinges on maintaining macroeconomic discipline and deepening structural reforms, in particular, revenue mobilization.

32. **Staff commends the authorities for meeting the ambitious March 2007 revenue target;** however, failure to resist political pressures and muster government-wide support in the areas of tax policy and administration could jeopardize future revenue performance. Strong efforts are needed to support customs and tax reforms as well as the LTO for collection enforcement and audit. Also, further work is needed to achieve a consensus for reforming the Business Receipts Tax, which has been delayed owing to political pressures.

33. **Fiscal policy should pay increasing attention to medium-term sustainability.** The authorities should strengthen the MTFE in line with the HIPC completion point triggers. The MTFE will provide an instrument for engaging donors on the level of external support needed for the operating budget and aligning core and external budget expenditures with the ANDS priorities. It should also take into account the timing and impact of transferring donor-funded expenditure to the core budget. Further treasury reforms and improved donor reporting are also necessary to enhance expenditure tracking (MEFP, ¶¶24–25).

34. **Monetary policy remains appropriate, but the rapid growth in commercial banks' activities calls for a strengthening of the regulatory and prudential framework.** In particular, the authorities need to improve banking supervision, put in place regulations on credit risk management, and set limits on sectoral loan concentration. In addition, the central bank needs to improve the accounting and reporting systems to enhance its operations, including monetary policy formulation and execution.

35. **Structural reforms should be deepened in order to encourage private sector development.** In particular, there is need to move forward with legislative and regulatory reforms and restructuring/divestment plans for state-owned banks, SOEs, and government entities engaged in commercial activities.

36. **Any budget support to Ariana should be funded from within the existing operating expenditure envelope and be contingent on a robust restructuring plan.**

Moreover, the authorities should refrain from supporting indirectly Ariana or other enterprises in need of restructuring and should not encourage state-owned banks to extend loans or guarantees to these enterprises.⁸

37. **The recent trade policy measures consisting of the introduction of a new tariff on soft drinks and bottled water and discretionary application of a new 1 percent tariff rate on some raw materials and intermediate inputs should be promptly reversed.** These measures undermine the government's stated objective of putting in place a streamlined and transparent trade regime. It is also important to refrain from granting further concessions and reclassifying additional goods into the three top tariff bands.

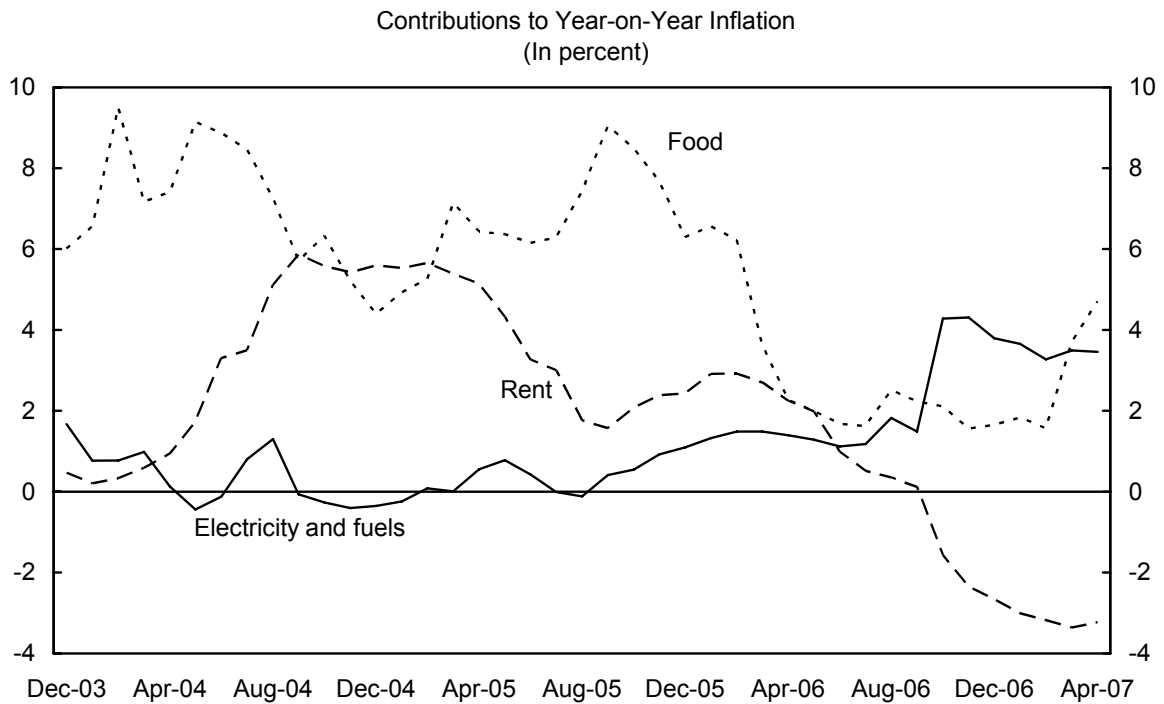
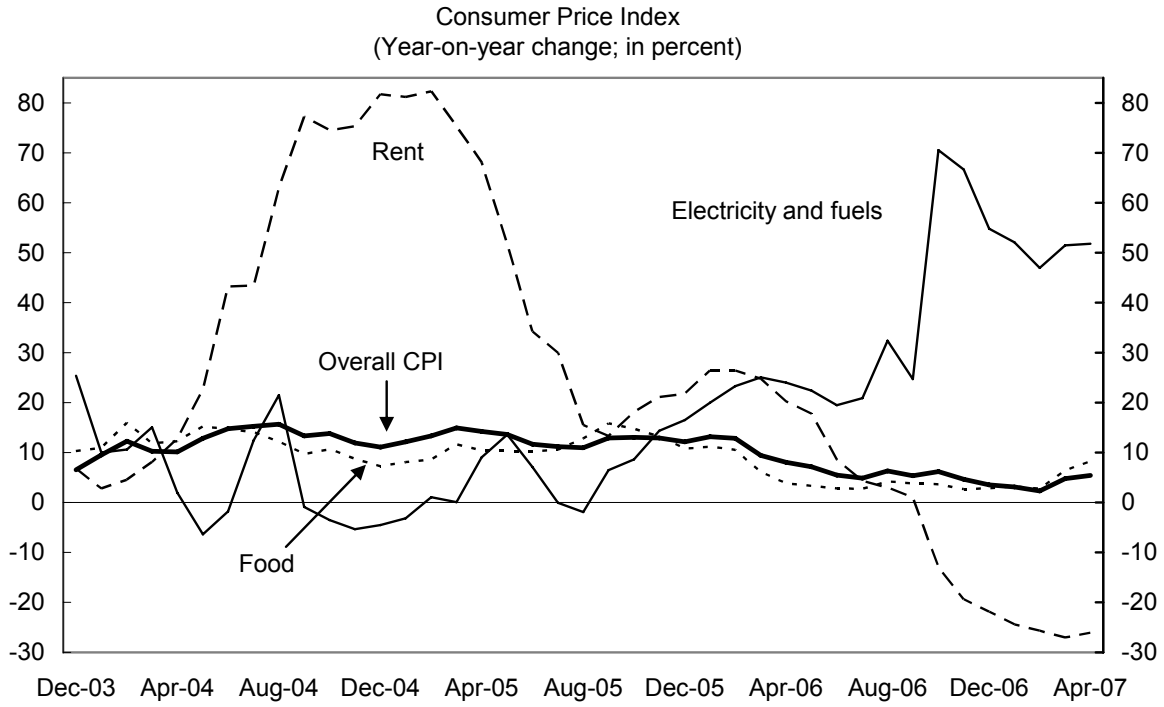
38. **The authorities' discussions with creditors in the context of the HIPC Initiative are welcome.** It will be important to continue these efforts following the decision point. Staff also urges the authorities to formalize an agreement regularizing arrears to OFID and to seek from remaining creditors treatment comparable with the 2006 Paris Club agreement.

39. **The progress made toward preparing the ANDS is encouraging.** Looking ahead, the authorities face the difficult challenge of costing and aligning the ANDS with the budget, in line with the government's fiscal objectives. The MTFE should play a crucial role in this regard.

40. Based on Afghanistan's satisfactory performance during 2006/07 and the authorities' commitment to the 2007/08 program, the staff recommends completion of the second review under the PRGF arrangement.

⁸ The program includes a continuous performance criterion on not extending directed lending or government guarantees to enterprises in need of restructuring, including Ariana.

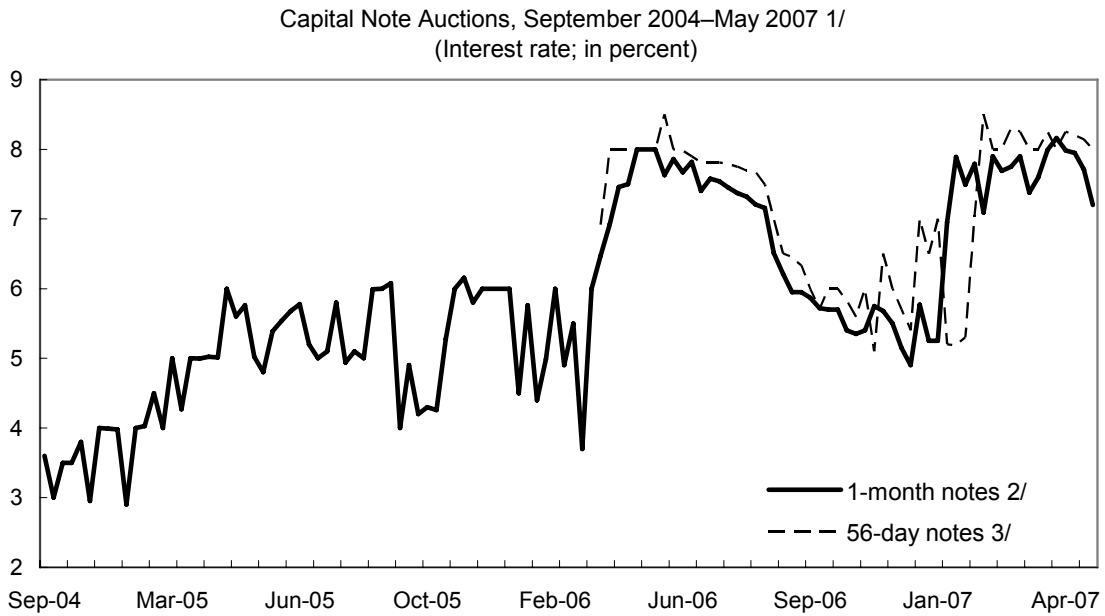
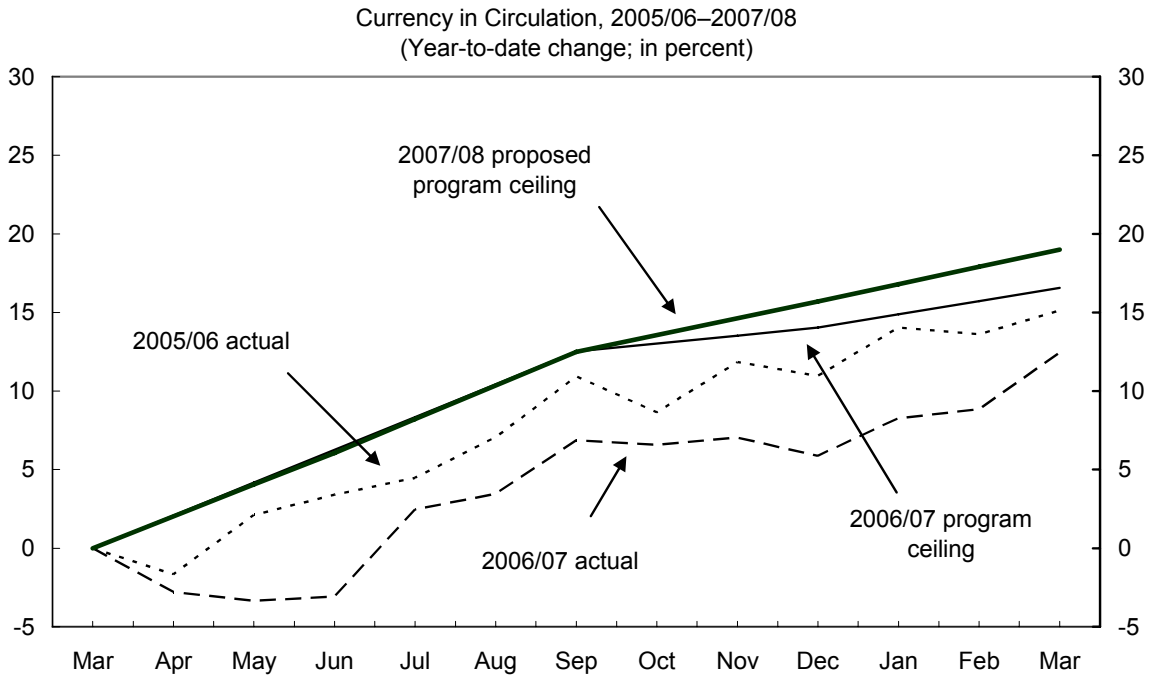
Figure 1. Islamic Republic of Afghanistan: Price Developments, December 2003–April 2007 1/



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

1/ CPI data for Kabul only. Last observation: April 2007.

Figure 2. Islamic Republic of Afghanistan: Monetary Developments



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

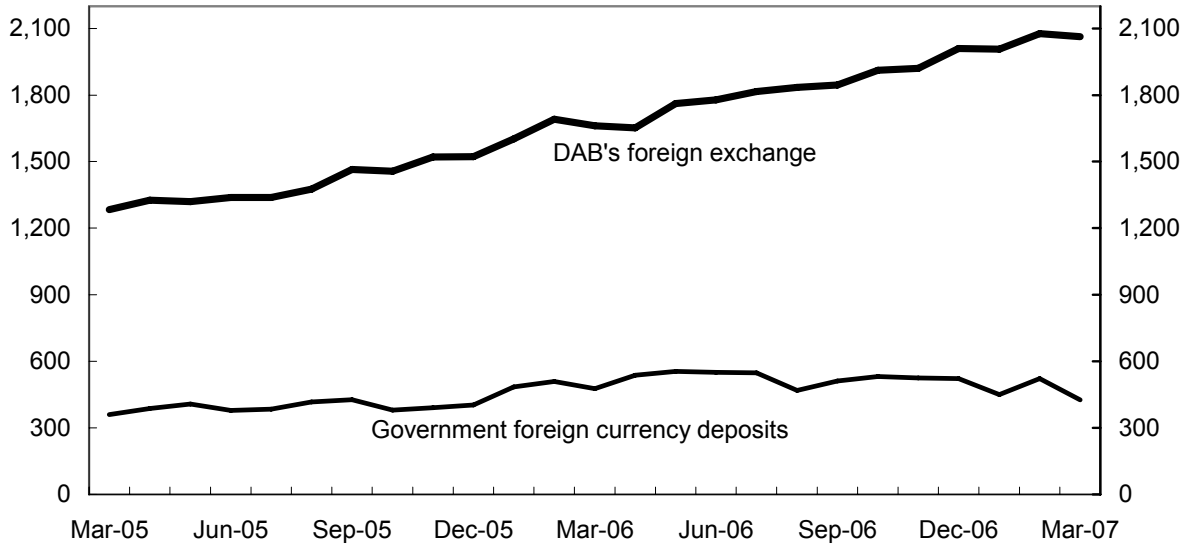
1/ Last observation: May 1, 2007.

2/ 30-day notes from September 2004–March 3, 2006. 28-day notes from March 28, 2006.

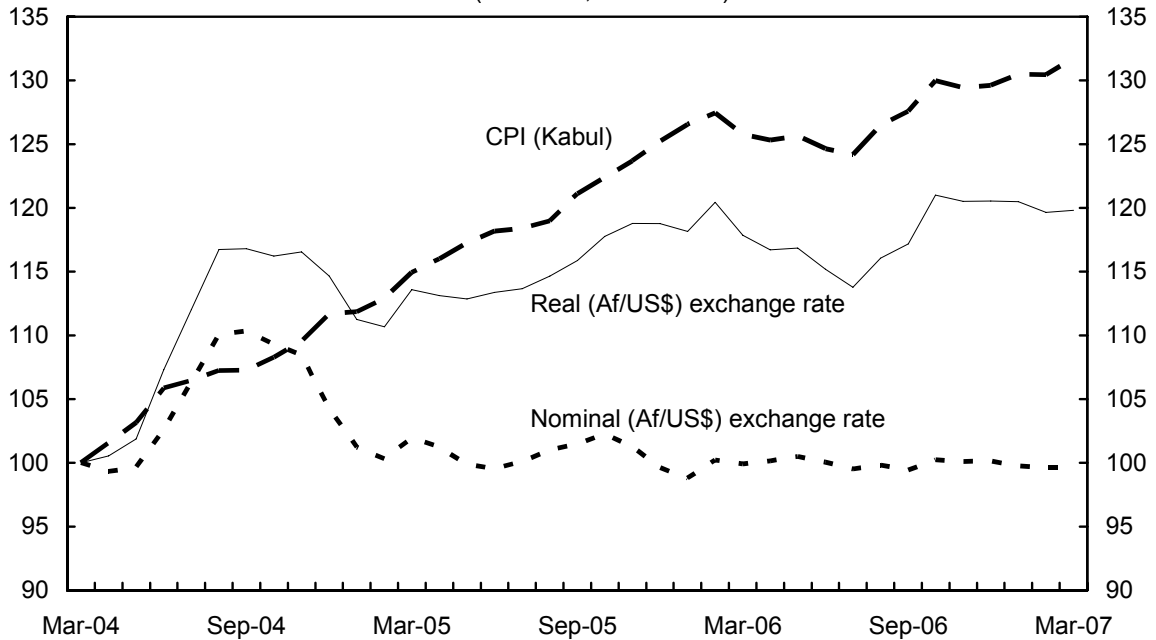
3/ 182-day notes since February 27, 2007.

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

DAB's Foreign Exchange Reserves and Government Foreign Currency Deposits,
 March 2005–March 2007
 (In millions of U.S. dollars)



Price and Exchange Rate Indices, March 2004–March 2007 2/
 (March 20, 2004 = 100)



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

1/ Last observation: March 2007.

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

Table 1. Islamic Republic of Afghanistan: Selected Economic Indicators, 2002/03–2007/08

(Quota: SDR 161.9 million)
 (Population: 25.7 million; 2005/06)
 (Per capita GDP: US\$300; 2005/06)
 (Poverty rate: n.a.)
 (Main export: carpets, US\$156 million; 2003/04)

	Est. 2002/03	Est. 2003/04	Est. 2004/05	Est. 2005/06	CR 07/130 2006/07	Est. 2006/07	Proj. 2007/08
(Annual percentage change; unless otherwise indicated)							
Output and prices							
Real GDP	28.6	15.7	8.0	14.0	8.0	7.5	13.0
Nominal GDP (in millions of Afghanis)	182,862	225,108	284,504	362,940	419,448	412,074	486,907
Nominal GDP (in millions of U.S. dollars)	4,084	4,585	5,971	7,309	8,399	8,256	9,723
Consumer prices (period average) 1/	5.1	24.1	13.2	12.3	6.4	5.1	5.9
Consumer prices (end of period) 1/	52.4	10.3	14.9	9.4	7.0	4.8	6.0
(In percent of GDP)							
Investment and saving							
Gross domestic investment	28.3	35.7	45.0	38.9	41.3	44.1	39.8
Of which: nongovernment	1.2	1.3	8.5	8.1	9.9	10.1	10.7
Gross domestic savings 2/	24.6	38.7	46.7	39.5	...	43.5	37.8
Of which: nongovernment	19.3	33.4	41.8	36.3	...	40.0	34.1
Public finances 3/							
Operating revenue (including grants)	8.4	9.0	9.8	10.3	10.9	11.6	12.1
Operating expenditure	8.5	9.8	9.4	8.9	10.5	10.5	11.0
Operating budget balance (excluding grants)	-5.3	-5.3	-4.9	-3.2	-4.1	-3.6	-3.7
Operating budget balance (including grants)	-0.1	-0.8	0.4	1.4	0.3	1.1	1.1
Primary operating balance (including grants)	-0.1	-0.8	0.4	1.4	0.3	1.1	1.2
Total government debt 4/	13.2	14.0	10.9	162.2	19.7	20.0	19.4
(Annual percentage change; unless otherwise indicated)							
Monetary sector							
Credit to the private sector	...	...	...	...	...	...	...
Reserve money	50.2	50.6	31.9	12.7	19.8	23.2	15.4
Broad money	...	...	...	...	...	...	...
Currency in circulation (year-to-date change)	...	...	34.6	15.1	18.4	12.4	19.0
Velocity of broad money	...	...	...	...	...	...	...
One-month capital note interest rate (end-period, in percent) 5/	...	...	5.0	6.5	...	7.6	...
(In percent of GDP; unless otherwise indicated)							
External sector							
Exports of goods (in U.S. dollars, percentage change) 6/	...	36.1	21.6	22.2	13.3	15.7	18.3
Imports of goods (in U.S. dollars, percentage change) 7/	...	51.8	18.5	14.6	18.8	23.9	11.9
Merchandise trade balance	-29.8	-41.3	-37.4	-34.5	-36.1	-38.4	-36.1
Current account balance, excluding official transfers 8/	-33.6	-51.0	-44.9	-41.9	-41.8	-44.0	-40.1
Current account balance, including official transfers 8/	-3.7	3.0	1.8	0.6	-1.7	-0.6	-2.0
Foreign direct investment	1.2	1.3	3.1	3.7	2.8	2.8	3.1
Total external debt 4/	13.2	14.0	10.9	162.2	19.7	20.0	19.4
Gross reserves (in millions of U.S. dollars)	425	820	1,283	1,662	1,838	2,063	2,295
In months of next year imports of goods and services 7/	1.8	3.1	4.1	4.5	4.8	5.0	5.1
Relative to external debt service due	28.1	37.6	54.7	62.1	30.2	34.6	37.8
Memorandum items:							
Unemployment rate (in percent)	...	...	...	...	...	...	...
Afghanis per U.S. dollar (period average)	44.8	49.1	47.7	49.7	...	...	...
Real exchange rate (annual average, percentage change) 9/	21.0	12.4	-11.2	-4.9	...	...	...
Stock market index	...	...	...	...	...	...	...

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

1/ For Kabul.

2/ Current account includes official transfers and Paris Club rescheduling.

3/ Operating budget. Does not include core budget development spending and externally-financed development expenditures, which amounted to 5.8 percent of GDP and 27.5 percent of GDP, respectively, in 2005/06.

4/ Up to 2004/05, includes estimates of unreconciled debt, with the exception of Russian claims. In 2005/06, the large increase in the debt reflects principally the recognition of Russian claims (that were subsequently restructured in the July 2006 Paris Club rescheduling agreement), as well as the reconciliation of all March 2006 debt stocks for HIPC Initiative.

5/ The 2006/07 figures is for January 23, 2007.

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

7/ Excludes reexports.

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

9/ 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 indexes.

Table 2a. Islamic Republic of Afghanistan: Core Budget, 2004/05–2009/10 1/

(In millions of Afghani)

	CR 07/130		CR 07/130		Approved		Revised 2/	Projection	Projection
	Est. 2004/05	Est. 2005/06	Fiscal Program 2006/07	Prelim. 2006/07	Fiscal Program 2007/08	Core Budget 2007/08			
Domestic revenue	12,800	20,652	27,015	28,788	35,773	35,773	35,721	43,232	52,062
Tax revenues	9,546	14,035	22,462	21,892	29,482	30,735	27,629	33,745	41,138
Taxes on income, profits, and capital gains	995	2,621	4,178	3,850	5,788	11,363	4,933	6,161	7,491
Taxes on international trade and transactions	7,247	9,446	12,750	11,980	16,535	16,106	15,074	18,173	21,270
Other taxes	1,304	1,968	5,534	6,062	7,159	3,266	7,622	9,412	12,378
Nontax revenues	3,254	6,617	4,553	6,896	6,290	5,038	8,092	9,487	10,924
Donor assistance grants (to operating budget) 3/	14,984	16,732	18,595	19,214	18,819	22,850	23,316	20,686	19,326
ARTF (recurrent window)	12,319	12,572	13,095	14,947	13,580	13,500	14,022	12,520	11,018
LOTFA	2,583	4,068	4,800	3,722	3,638	6,150	6,193	6,342	6,442
Other grants	83	92	700	544	1,601	3,200	3,101	1,824	1,866
Donor assistance grants (core development budget)	8,250	19,251	18,064	16,625	25,928	60,068	25,928	40,259	49,354
Total core budget expenditure	39,550	53,437	79,476	75,691	93,891	130,630	97,691	115,213	134,282
Operating expenditure	26,716	32,348	44,200	43,448	49,795	53,600	53,595	60,093	65,383
Wages and salaries	18,902	20,430	27,276	26,454	29,667	32,674	32,428	37,680	41,722
Purchase of goods and services	4,182	6,679	9,352	10,200	10,769	11,997	11,808	12,777	13,658
Transfers, subsidies, and other expenditure	764	495	3,816	2,176	4,765	5,066	4,765	4,684	4,651
Pensions	889	1,540	2,065	2,461	2,773	2,465	2,773	2,912	3,057
Capital expenditure	1,979	3,054	1,220	1,987	1,437	996	1,437	1,631	1,824
Interest	...	150	471	169	384	403	384	410	471
Core budget development spending 4/	12,834	21,089	35,276	32,243	44,096	77,030	44,096	55,119	68,899
Interim Afghanistan National Development Strategy programs									
Security	...	1,122	1,513	1,408	1,891	1,980	1,891	2,364	2,955
Governance, rule of law, and human rights	...	551	1,426	802	1,783	1,957	1,783	2,228	2,785
Infrastructure and natural resources	...	6,235	13,731	13,001	17,163	33,401	17,163	21,454	26,818
Education	...	1,035	3,041	1,786	3,801	6,877	3,801	4,751	5,939
Health	...	991	2,267	2,061	2,834	3,892	2,834	3,542	4,428
Agriculture and rural development	...	10,170	10,971	12,031	13,714	19,090	13,714	17,142	21,428
Social protection	...	30	86	33	107	543	107	134	167
Economic governance and private sector development	...	956	2,242	1,122	2,803	9,290	2,803	3,503	4,379
Operating budget balance (excluding grants)	-13,916	-11,695	-17,185	-14,659	-14,023	-17,827	-17,874	-16,862	-13,321
Operating budget balance (including grants)	1,068	5,036	1,410	4,554	4,796	5,023	5,442	3,825	6,005
Core budget balance (including grants)	-3,516	3,199	-15,802	-11,064	-13,372	-11,939	-12,726	-11,036	-13,541
Float and adjustment 5/	359	-1,989	0	1,223	0	0	0	0	0
Sale of nonfinancial assets 6/	0	1,994	1,994	2,318	5,732	1,002	1,002	5,008	10,016
Financing	3,157	-3,203	13,808	7,524	7,640	10,937	11,724	6,028	3,525
External loans (net)	14,753	5,318	7,811	6,132	7,306	...	7,021	7,071	7,071
Domestic (net) 7/	-11,596	-8,521	5,998	1,391	334	...	4,703	-1,043	-3,547
Memorandum items:									
External budget expenditure 8/	100,225	99,780	109,518	114,599	91,956	113,451	113,451	107,779	102,390
Fuel subsidy	...	...	2,438	2,176	3,141	1,700	3,141	2,841	2,591
Security spending pressures (adjusters) 9/	...	...	...	...	...	...	3,800	6,232	5,588
Program operating deficit excluding grants 9/	...	...	...	...	...	...	-14,074	-10,630	-7,733

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/ Staff estimates and projections.

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

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

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

6/ In 2005/06 includes \$40 million receipt from sale of telecommunications spectrum bandwidth and delayed overflight payment from 2004/05. 2006/07 includes another sale of spectrum bandwidth and non-produced assets (does not include Afs 77 million from land and building sales). Beyond 2006/07 it 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.

8/ Estimates from MoF and donors.

9/ Fiscal tables assume security adjuster is fully utilized (i.e., operating expenditure and revenue Afs 3.8 billion higher). Program deficit before adjusters shown separately as memorandum item.

Table 2b. Islamic Republic of Afghanistan: Core Budget, 2004/05–2009/10

(In percent of GDP)

	Est. 2004/05	Est. 2005/06	CR 07/130 Fiscal Program 2006/07	Prelim. 2006/07	CR 07/130 Fiscal Program 2007/08	Approved Core Budget 2007/08	Revised Projections 2/ 2007/08	Projection 2008/09	Projection 2009/10
Domestic revenue	4.5	5.7	6.4	7.0	7.2	7.3	7.3	7.8	8.4
Tax revenues	3.4	3.9	5.4	5.3	6.0	6.3	5.7	6.1	6.7
Taxes on income, profits, and capital gains	0.3	0.7	1.0	0.9	1.2	2.3	1.0	1.1	1.2
Taxes on international trade and transactions	2.5	2.6	3.0	2.9	3.3	3.3	3.1	3.3	3.4
Other taxes	0.5	0.5	1.3	1.5	1.4	0.7	1.6	1.7	2.0
Nontax revenues	1.1	1.8	1.1	1.7	1.3	1.0	1.7	1.7	1.8
Donor assistance grants (to operating budget) 3/	5.3	4.6	4.4	4.7	3.8	4.7	4.8	3.7	3.1
ARTF (recurrent window)	4.3	3.5	3.1	3.6	2.7	2.8	2.9	2.3	1.8
LOTFA	0.9	1.1	1.1	0.9	0.7	1.3	1.3	1.1	1.0
Other grants	0.0	0.0	0.2	0.1	0.3	0.7	0.6	0.3	0.3
Donor assistance grants (core development budget)	2.9	5.3	4.3	4.0	5.2	12.3	5.3	7.3	8.0
Total core budget expenditure	13.9	14.7	18.9	18.4	19.0	26.8	20.1	20.8	21.7
Operating expenditure	9.4	8.9	10.5	10.5	10.1	11.0	11.0	10.9	10.6
Wages and salaries	6.6	5.6	6.5	6.4	6.0	6.7	6.7	6.8	6.8
Purchase of goods and services	1.5	1.8	2.2	2.5	2.2	2.5	2.4	2.3	2.2
Transfers, subsidies, and other expenditure	0.3	0.1	0.9	0.5	1.0	1.0	1.0	0.8	0.8
Pensions	0.3	0.4	0.5	0.6	0.6	0.5	0.6	0.5	0.5
Capital expenditure	0.7	0.8	0.3	0.5	0.3	0.2	0.3	0.3	0.3
Interest	...	0.0	0.1	0.0	0.1	0.1	0.1	0.1	0.1
Core budget development spending 4/	4.5	5.8	8.4	7.8	8.9	15.8	9.1	10.0	11.2
Interim Afghanistan National Development Strategy programs	0.0								
Security	...	0.3	0.4	0.3	0.4	0.4	0.4	0.4	0.5
Governance, rule of law, and human rights	...	0.2	0.3	0.2	0.4	0.4	0.4	0.4	0.5
Infrastructure and natural resources	...	1.7	3.3	3.2	3.5	6.9	3.5	3.9	4.3
Education	...	0.3	0.7	0.4	0.8	1.4	0.8	0.9	1.0
Health	...	0.3	0.5	0.5	0.6	0.8	0.6	0.6	0.7
Agriculture and rural development	...	2.8	2.6	2.9	2.8	3.9	2.8	3.1	3.5
Social protection	...	0.0	0.0	0.0	0.0	0.1	0.0	0.0	0.0
Economic governance and private sector development	...	0.3	0.5	0.3	0.6	1.9	0.6	0.6	0.7
Operating budget balance (excluding grants)	-4.9	-3.2	-4.1	-3.6	-2.8	-3.7	-3.7	-3.1	-2.2
Operating budget balance (including grants)	0.4	1.4	0.3	1.1	1.0	1.0	1.1	0.7	1.0
Core budget balance (including grants)	-1.2	0.9	-3.8	-2.7	-2.7	-2.5	-2.6	-2.0	-2.2
Float and adjustment 5/	0.1	-0.5	0.0	0.3	0.0	0.0	0.0	0.0	0.0
Sale of nonfinancial assets 6/	0.0	0.5	0.5	0.6	1.2	0.2	0.2	0.9	1.6
Financing	1.1	-0.9	3.3	1.8	1.5	2.2	2.4	1.1	0.6
External loans (net)	5.2	1.5	1.9	1.5	1.5	...	1.4	1.3	1.1
Domestic (net) 7/	-4.1	-2.3	1.4	0.3	0.1	...	1.0	-0.2	-0.6
Memorandum items:									
External budget expenditure 8/	35.2	27.5	26.1	27.8	18.6	23.3	23.3	19.5	16.6
Fuel subsidy	...	...	0.6	0.5	0.6	0.3	0.6	0.5	0.4
Security spending pressures (adjusters) 9/	...	...	...	...	...	...	1.3	1.0	0.0
Program operating deficit excluding grants 9/	...	...	...	...	...	...	-2.9	-1.9	-1.3
Nominal GDP (in millions Afghani)	284,504	362,940	419,448	412,074	494,001	486,907	486,907	552,634	617,885

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/ Staff estimates and projections as percent of updated GDP.

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

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

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

6/ In 2005/06 includes \$40 million receipt from sale of telecommunications spectrum bandwidth and delayed overflight payment from 2004/05. 2006/07 includes another sale of spectrum bandwidth and non-produced assets (does not include Afs 77 million from land and building sales). Beyond 2006/07 it 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.

8/ Estimates from MoF and donors.

9/ Fiscal tables assume security adjuster is fully utilized (i.e., operating expenditure and revenue Afs 3.8 billion higher). Program deficit before adjusters shown separately as memorandum item.

Table 3. Islamic Republic of Afghanistan: Monetary Program (Da Afghanistan Bank), 2004/05–2007/08 1/

	Act.		Act. 5/		Prog.		Act. 5/		Prog.		Act. 5/		Proj. 6/		
	Mar. 20	Mar. 20	Jun. 21	Sep. 21	Dec. 21	Mar. 20	Jun. 21	Sep. 21	Dec. 20	Mar. 20	Jun. 21	Sep. 21	Dec. 20	Mar. 20	
	2004/05	2005/06			2006/07									2007/08	
Net foreign assets	63,934	85,790	89,562	93,504	91,898	96,387	94,005	98,616	106,326	111,594	112,284	113,341	115,797		
Foreign assets	64,375	86,967	90,566	94,621	93,991	97,463	96,936	101,252	109,006	115,128	116,672	117,729	121,039		
Foreign exchange reserves	62,438	82,995	86,209	88,373	88,494	94,176	91,789	95,643	103,300	109,240	110,645	111,663	114,933		
Gold 2/	14,989	19,230	19,230	19,230	19,230	19,230	19,230	19,230	23,006	23,006	23,006	23,006	23,006		
Other	47,449	63,765	66,979	69,143	69,264	74,945	72,559	76,412	80,294	86,234	87,638	88,656	91,927		
Other foreign assets	1,937	3,972	4,357	6,248	5,497	3,287	5,147	5,609	5,705	5,888	6,027	6,067	6,106		
Foreign liabilities	-440	-1,177	-1,004	-1,117	-2,094	-1,076	-2,931	-2,635	-2,680	-3,534	-4,388	-4,388	-5,242		
Net domestic assets	-22,867	-39,491	-44,194	-42,020	-37,031	-45,270	-36,861	-41,047	-49,278	-51,748	-49,572	-49,105	-49,989		
Domestic assets	-23,736	-33,620	-38,609	-35,050	-29,721	-34,365	-29,195	-33,802	-34,011	-35,594	-32,426	-30,919	-30,713		
Net claims on general government	-20,678	-29,574	-34,374	-30,074	-26,321	-30,039	-25,350	-28,182	-28,343	-29,326	-25,958	-24,196	-23,641		
Gross claims on the government	0	0	0	0	977	0	1,814	954	998	1,852	2,706	2,706	3,560		
Domestic currency deposits	-3,123	-5,755	-6,940	-4,592	-4,592	-3,997	-4,592	-8,010	-8,010	-8,010	-8,010	-8,010	-8,010		
Foreign currency deposits	-17,554	-23,819	-27,434	-25,482	-22,706	-26,042	-22,572	-21,127	-21,331	-23,168	-20,654	-18,892	-19,191		
Other claims (including capital notes) 3/	-3,058	-4,046	-4,235	-4,976	-3,400	-4,326	-3,845	-5,620	-5,668	-6,268	-6,468	-6,723	-7,073		
Of which : capital notes 3/	...	-330	-625	-800	-1,000	-800	-1,445	-1,145	-1,145	-1,945	-2,345	-2,800	-3,350		
Other items net	869	-5,871	-5,585	-6,969	-7,310	-10,905	-7,666	-7,244	-15,266	-16,155	-17,146	-18,187	-19,276		
Reserve money	41,068	46,300	45,368	51,484	54,866	51,116	57,144	57,569	57,048	59,846	62,712	64,236	65,808		
Currency in circulation	38,763	44,629	43,256	47,692	49,301	47,251	52,024	50,177	49,656	52,668	55,863	57,454	59,090		
Banknotes and coins issued	41,228	48,648	48,651	53,687	54,724	54,754	57,747	57,258	57,258	60,568	63,963	65,641	67,363		
Less cash holdings	2,465	4,018	5,395	5,994	5,423	7,502	5,723	7,081	7,602	7,900	8,100	8,187	8,273		
Bank deposits with DAB	2,304	1,670	2,111	3,792	5,565	3,865	5,120	7,392	7,392	7,178	6,849	6,782	6,718		
Memorandum items:															
Currency in circulation (year-to-date change)	...	15.1	-3.1	6.9	10.5	5.9	16.6	12.4	11.3	6.1	12.5	15.7	19.0		
Currency in circulation (year-on-year change)	34.6	15.1	7.9	10.9	14.6	9.9	16.6	12.4	11.3	22.2	17.4	23.4	19.0		
Currency in circulation (ceilings under the PRGF; in millions of Afghani)	...	...	...	...	49,301	...	52,024	...	...	52,668	55,863	57,454	59,090		
Gross international reserves (at market rates; in millions of U.S. dollars)	1,283.4	1,661.8	1,778.2	1,845.5	...	2,010.3	...	...	...	...	...	...	0.0		
Gross international reserves (at program rates; in millions of U.S. dollars)	...	1,661.8	1,726.3	1,769.6	1,772.0	1,885.8	1,838.0	1,915.2	2,062.7	2,181.3	2,209.4	2,229.7	2,295.0		
Consumer prices in Kabul (quarterly change)	2.9	0.4	-0.9	2.4	...	1.6	...	...	...	...	...	...	...
Consumer prices in Kabul (annual change)	14.9	9.4	5.5	5.3	...	3.5	7.0	4.8	4.8	...	...	...	6.0		
Interest rates on 28-day capital notes 4/	5.0	6.5	7.8	5.9	...	5.8	...	7.6	7.6	...	...	...	...

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

1/ 2004/05 and 2005/06 data are estimated using market exchange rates. 2006/07 and 2007/08 estimates and projections are made on the basis of the program exchange rate.

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

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

4/ Weighted average of bid rates; 30-day notes until March 2006.

5/ Assets and liabilities denominated in foreign exchange are evaluated using March 20, 2006 exchange rates and monetary gold is evaluated at March 20, 2006 prices.

6/ Assets and liabilities denominated in foreign exchange are evaluated using March 19, 2007 exchange rates and monetary gold is evaluated at March 19, 2007 prices.

Table 4. Islamic Republic of Afghanistan: Balance of Payments, 2002/03–2010/11

(In millions of U.S. dollars)

	Est.	Est.	Est.	Est.	CR 07/130	Prel. Est.	Projections			
	2002/03	2003/04	2004/05	2005/06	2006/07	2006/07	2007/08	2008/09	2009/10	2010/11
Current account (including grants)	-149.7	137.2	106.1	43.1	-193.3	-97.0	-244.6	-398.0	-610.3	-822.7
Trade balance	-1,217.6	-1,892.3	-2,230.4	-2,522.2	-3,031.4	-3,171.7	-3,509.2	-3,847.5	-4,183.1	-4,318.2
Exports of goods 1/	1,290.6	1,893.6	1,643.0	1,794.8	1,883.1	1,923.8	2,074.8	2,124.8	2,135.2	2,305.8
Recorded exports	100.1	143.7	305.3	385.9	448.7	460.9	561.2	659.5	763.7	865.2
Unrecorded exports (including transit)	1,190.5	1,749.9	1,337.7	1,408.9	1,434.5	1,462.9	1,513.5	1,465.4	1,371.5	1,440.7
Smuggling	176.6	232.8	152.7	173.7	181.7	186.7	204.6	216.3	225.5	249.1
Transit trade	1,013.9	1,517.1	1,185.1	1,235.2	1,252.8	1,276.2	1,308.9	1,249.0	1,146.0	1,191.6
Imports of goods	2,508.2	3,785.9	3,873.4	4,317.0	4,914.6	5,095.5	5,584.0	5,972.4	6,318.3	6,624.0
Recorded imports	1,142.3	1,688.5	1,999.6	2,223.4	2,505.5	2,552.5	2,945.1	3,211.8	3,438.1	3,666.5
Duty Free	840.8	1,001.0	1,203.3	1,445.2	1,713.2	1,827.5	1,832.9	1,902.5	1,983.5	2,023.9
Of which: Commodity food aid	94.0	40.9	107.8	78.2	110.8	110.8	96.5	93.5	0.0	0.0
Other	525.1	1,096.4	670.5	648.4	695.8	715.5	806.0	858.1	896.7	933.6
Services and income (net)	-154.0	-446.4	-450.7	-538.3	-525.1	-505.9	-438.4	-426.7	-399.3	-419.6
Of which: Interest due 2/	8.9	12.0	13.0	14.4	57.3	55.8	56.9	58.1	59.4	60.5
Current transfers	1,221.8	2,475.9	2,787.2	3,103.6	3,363.3	3,580.5	3,703.0	3,876.2	3,972.1	3,915.1
Public	1,170.2	2,420.9	2,477.1	2,724.0	2,927.1	3,151.8	3,215.2	3,337.2	3,385.6	3,280.0
Of which: Commodity food aid	94.0	40.9	107.8	78.2	110.8	110.8	96.5	93.5	0.0	0.0
Private 3/	51.6	55.0	310.1	379.6	436.2	428.8	487.8	539.0	586.5	635.1
Capital and financial account	144.0	149.6	475.7	360.8	388.5	391.2	443.2	597.8	776.5	865.2
Foreign direct investment	50.0	57.8	186.9	271.4	232.1	231.2	303.0	456.6	635.3	664.0
Official loans (net)	94.0	91.8	288.9	89.4	156.4	160.0	140.2	141.2	141.2	201.2
Disbursement	100.2	101.6	299.3	101.7	160.0	163.8	144.0	145.0	145.0	205.0
Amortization due 2/	6.2	9.8	10.5	12.3	3.6	3.8	3.8	3.8	3.8	3.8
Other capital (including errors and omissions)	161.0	93.6	-133.9	-42.9	-210.8	46.4	-64.0	-50.7	-31.4	-26.4
Overall balance	155.3	380.4	447.9	360.9	-15.6	340.5	134.6	149.2	134.9	16.2
Financing	-155.3	-380.4	-447.9	-360.9	-1.2	-381.1	-212.4	-228.5	-190.0	-40.0
Changes in reserve assets of the DAB	-101.0	-394.7	-463.7	-378.4	-176.2	-400.9	-232.3	-230.0	-190.0	-40.0
Use of Fund resources (net)	0.0	0.0	0.0	0.0	19.6	19.9	17.0	0.0	0.0	0.0
Exceptional financing	-54.3	14.3	15.8	17.5	155.5	0.0	2.9	1.5	0.0	0.0
Arrears 4/	-54.3	14.3	-1.8	-11.8	-11,135	-11,415	0.0	0.0	0.0	0.0
Debt rescheduling	0.0	0.0	0.0	0.0	760.2	817.8	2.9	1.5	0.0	0.0
Debt forgiveness	0.0	0.0	17.6	29.4	10,530	10,598	0.0	0.0	0.0	0.0
Financing gap	0.0	0.0	0.0	0.0	16.8	40.5	77.8	79.4	55.1	23.8
Identified financing (provisional)	0.0	0.0	0.0	0.0	16.8	0.0	34.0	34.1	17.1	0.0
Of which: IMF PRGF	0.0	0.0	0.0	0.0	16.8	0.0	34.0	34.1	17.1	0.0
Remaining gap 4/	0.0	0.0	0.0	0.0	0.0	40.5	43.8	45.2	38.0	23.8
Memorandum Items:										
Gross international reserves										
(In millions of U.S. dollars)	425	820	1,283	1,662	1,838	2,063	2,295	2,525	2,715	2,755
(In months of imports) 5/	1.8	3.1	4.1	4.5	4.8	5.0	5.1	5.2	5.3	5.1
(Relative to external debt service due)	28.1	37.6	54.7	62.1	30.2	34.6	37.8	40.8	42.9	42.8
Total exports (goods and services)	1,341	1,999	1,721	1,897	2,002	2,069	2,251	2,332	2,375	2,578
Imports (goods and nonfactor services)	2,704	4,331	4,410	4,975	5,564	5,751	6,229	6,648	7,009	7,373
Trade balance (percent of GDP)	-29.8	-41.3	-37.4	-34.5	-36.1	-38.4	-36.1	-34.9	-33.9	-31.4
Current account balance (percent of GDP) 6/										
Including grants	-3.7	3.0	1.8	0.6	-1.7	-0.6	-2.0	-3.2	-4.9	-6.0
Excluding grants	-33.6	-51.0	-44.9	-41.9	-41.8	-44.0	-40.1	-38.3	-37.1	-34.5
Total debt service (percent of exports) 6/ 7/	10.0	8.7	6.1	5.5	1.5	1.8	1.6	1.5	1.4	5.7

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

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

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

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

4/ Arrears shown for 2002/03 to 2005/06 represent Fund staff estimates of debt service due, but not paid, on estimated overdue obligations. The 2006/07 reduction in arrears corresponds principally to the July 2006 rescheduling of Paris Club debt on Naples terms, including the upfront cancellation of the majority of Soviet claims consistent with Paris Club practice.

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

6/ After July 2006 Paris Club rescheduling agreement (including capitalization of moratorium interest) and assuming comparable treatment from non-Paris Club bilateral creditors.

7/ Debt service includes obligations to the IMF. Exports exclude reexports.

Table 5. Islamic Republic of Afghanistan: External Financing Requirement and Sources, 2002/03–2009/10
(In millions of U.S. dollars)

	Est.	Est.	Est.	Est.	Prel. Est.	Projections		
	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
I. Total financing requirement	1,533.0	2,728.9	3,157.1	3,463.1	15,497.6	4,183.7	4,508.0	4,776.2
Current account (excluding grants)	1,371.5	2,338.7	2,681.1	3,060.5	3,677.6	3,947.6	4,274.2	4,582.4
Amortization	6.2	9.8	10.5	12.3	3.8	3.8	3.8	3.8
Of which: IMF	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (increase = +)	101.0	394.7	463.7	378.4	400.9	232.3	230.0	190.0
Reduction in arrears	54.3	-14.3	1.8	11.8	11,415.3	0.0	0.0	0.0
II. Available financing	1,533.0	2,728.9	3,139.5	3,433.7	4,041.8	4,103.0	4,427.2	4,721.1
Current transfers	1,221.8	2,475.9	2,787.2	3,103.6	3,580.5	3,703.0	3,876.2	3,972.1
Foreign direct investment	50.0	57.8	186.9	271.4	231.2	303.0	456.6	635.3
Short-term private financing flows	...	...	...	...	...	...	...	...
Official medium- and long-term loans	100.2	101.6	299.3	101.7	163.8	144.0	145.0	145.0
IMF disbursements	0.0	0.0	0.0	0.0	19.9	17.0	0.0	0.0
Other	161.0	93.6	-133.9	-42.9	46.4	-64.0	-50.7	-31.4
Required financing = I-II	0.0	0.0	17.6	29.3	11,455.8	80.7	80.8	55.1
Exceptional financing								
Debt relief	0.0	0.0	17.6	29.4	10,597.5	0.0	0.0	0.0
Debt rescheduling	0.0	0.0	0.0	0.0	817.8	2.9	1.5	0.0
Balance of payments support	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Financing gap	0.0	0.0	0.0	0.0	40.5	77.8	79.4	55.1
Identified financing (provisional)	0.0	0.0	0.0	0.0	0.0	34.0	34.1	17.1
Of which: IMF PRGF	0.0	0.0	0.0	0.0	0.0	34.0	34.1	17.1
Remaining gap	0.0	0.0	0.0	0.0	40.5	43.8	45.2	38.0

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

Table 6. Islamic Republic of Afghanistan: Projected Payments to the Fund as of June 7, 2007

(In millions of SDRs)

	2007	1/	2008	2009	2010	2011	2012	2013	2014	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	2.5	4.9	4.9	12.3	24.5
2. Charges and interest 2/											
PRGF interest	0.1		0.1	0.1	0.1	0.1	0.1	0.1	0.1	0.1	1.0
SDR assessments	0.0		0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SDR charges	0.6		1.1	1.1	1.1	1.1	1.1	1.1	1.1	5.5	13.7
Total obligations	0.7		1.2	1.2	1.2	1.2	3.7	6.1	6.1	17.8	39.1
(percent of quota)	0		1	1	1	1	2	4	4	11	24
Obligations from prospective drawings 3/											
1. Principal											
PRGF repayments	0.0		0.0	0.0	0.0	0.0	0.0	4.5	9.0	42.9	56.5
2. Charges and interest 2/											
PRGF interest	0.0		0.1	0.3	0.3	0.3	0.3	0.3	0.2	0.4	2.2
Total obligations	0.0		0.1	0.3	0.3	0.3	0.3	4.8	9.3	43.4	58.7
(percent of quota)	0		0	0	0	0	0	3	6	27	36
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	2.5	9.4	13.9	55.2	81.0
2. Charges and interest 2/											
PRGF interest	0.1		0.3	0.4	0.4	0.4	0.4	0.4	0.3	0.5	3.1
SDR net charges	0.6		1.1	1.1	1.1	1.1	1.1	1.1	1.1	5.5	13.7
Total obligations	0.7		1.4	1.5	1.5	1.5	3.9	10.9	15.3	61.2	97.8
(percent of quota)	0		1	1	1	1	2	7	9	38	60
Outstanding Fund credit	35.8		58.4	81.0	81.0	81.0	78.6	69.1	55.2	...	...
Memorandum items:											
Outstanding Fund credit											
In percent of:											
Exports of goods and services 4/	3		4	5	5	4	4	3	2	...	...
External public debt	1		2	2	2	2	2	2	1	...	...
Gross official reserves	1		2	2	2	2	2	2	2	...	...
GDP	0		0	0	0	0	0	0	0	...	...
Quota	22		36	50	50	50	49	43	34	...	...
Total Obligations											
In percent of:											
Exports of goods and services 4/	0.1		0.1	0.1	0.1	0.1	0.2	0.4	0.5	...	...
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	0.0	0.1	0.3	0.4	...	...
GDP	0.0		0.0	0.0	0.0	0.0	0.0	0.0	0.0	...	...
Quota	0		1	1	1	1	2	7	9	38	60

Source: Fund staff estimates and projections.

1/ June 8, 2007 to December 31, 2007.

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

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

4/ Excludes reexports.

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

Date	Amount of Disbursement		Conditions
	Millions of SDRs	Percent of Quota 1/	
June 2006	13.2	8.2	Approval of arrangement 2/
March 2007	11.3	7.0	First review and September 2006 performance criteria 3/
July 2007	11.3	7.0	Second review and March 2007 performance criteria
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 due to rounding.

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

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

ATTACHMENT I

Kabul, June 21, 2007

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

Dear Mr. de Rato,

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

banks (notably Bank Millie and Bank Pashtany) to enterprises in need of restructuring. The government will also refrain from guaranteeing lending to these enterprises.

4. The government and Da Afghanistan Bank (DAB) believe that the economic and financial policies set forth in the attached updated memorandum provide a sound basis for achieving the objectives and targets of the program. During the period of the arrangement, Afghanistan will consult with the Fund on the adoption of any further measures that may be appropriate, at the initiative of the government or DAB, or whenever the Managing Director of the IMF requests such a consultation. In addition, we will provide the Fund all information necessary to monitor the implementation of the program in a timely manner. The government and DAB will conduct with the Fund the third review under the arrangement before end-January 2008.

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

6. After the period of this arrangement and while Afghanistan has outstanding financial obligations to the IMF arising from disbursements under this arrangement, we will periodically consult with the IMF, at the initiative of the government or DAB, or whenever the Managing Director of the IMF requests consultation on Afghanistan's economic and financial policies.

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

Sincerely yours,

/s/

Anwar Ul-Haq Ahady
Minister of Finance
Ministry of Finance

/s/

Noorullah Delawari
Governor
Da Afghanistan Bank

Attachment:

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

**ATTACHMENT II: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES
FOR 2007/08**

June 21, 2007

I. INTRODUCTION

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

II. PERFORMANCE UNDER THE PROGRAM

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

III. THE PROGRAM FOR 2007/08

A. Macroeconomic Objectives

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

B. Fiscal Policy

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

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

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

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

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

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

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

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

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

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

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

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

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

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

C. Monetary and Exchange Rate Policy and Financial Sector Reforms

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

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

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

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

D. External Sector Policies

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

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

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

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

E. Other Structural Reforms

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

F. Poverty Reduction Strategy

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

G. Technical Assistance and Statistical Issues

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

IV. PROGRAM MONITORING

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

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

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

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

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

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

2/ Cumulative changes from March 20, 2007.

3/ Will be converted into performance criteria at the time of the third PRGF review.

4/ These performance criteria apply on a continuous basis.

5/ The program provides for Af\$ 3,800 million in 2007/08 to be spent at any time, conditional on the availability of donor support.

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

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

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

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

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

ATTACHMENT III: TECHNICAL MEMORANDUM OF UNDERSTANDING

This memorandum sets out the understandings between the Afghan authorities and Fund staff relating to the monitoring of the Poverty Reduction and Growth Facility (PRGF)-supported program approved by the IMF Executive Board on June 26, 2006. It defines the structural performance criterion and benchmarks (Section I), as well as the principal concepts and financial variables, including the quantitative performance criteria and indicators (Section II). It also sets out data reporting requirements (Section III).

I. STRUCTURAL PERFORMANCE CRITERION AND BENCHMARKS

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

Performance criterion

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

Structural benchmarks

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

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

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

II. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

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

- a floor on fiscal revenue of the central government;
- a ceiling on currency in circulation;
- a ceiling on the net central bank financing (NCBF) of the central government;
- a floor on net international reserves (NIR);
- a zero ceiling on contracting and/or guaranteeing new medium- and long-term nonconcessional external debt by the government and DAB (continuous);
- a zero ceiling on short-term external debt owed or guaranteed by the government or DAB (continuous);

- a zero ceiling on the accumulation of external payment arrears, excluding interest on preexisting arrears (continuous);
- a zero ceiling on lending from state-owned banks to, or government guaranteed borrowing by, state-owned enterprises in need of restructuring (continuous); and
- a ceiling for the operating budget deficit of the central government, excluding grants (indicative target).

A. Program Exchange Rates and Gold Valuation

3. Program exchange rates will be used for purposes of monitoring the quantitative targets under the program. All foreign assets and liabilities denominated in U.S. dollars will be converted into Afghanis using a program exchange rate of 50.08 Afghanis per U.S. dollar, which corresponds to the average of the US\$/Afs buy and sell cash rates, as reported by DAB as of March 19, 2007. For assets and liabilities denominated in SDRs and in foreign currencies other than the U.S. dollar, they will be converted into U.S. dollars at their respective exchange rates prevailing as of March 19, 2007, as reported in the following table. Gold holdings will be valued at US\$653.47 per ounce, the price as of March 19, 2007.

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

B. Currency in Circulation

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

C. Net Central Bank Financing of the Government

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

D. Net International Reserves

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

7. **Reserve assets of DAB**, as defined in the fifth edition of the balance of payments manual (BPM5), are claims on nonresidents denominated in foreign convertible currencies, that are controlled by DAB, and are readily and unconditionally available for DAB to meet balance of payments financing needs, intervention in exchange markets, and other purposes. They include DAB holdings of monetary gold, SDRs, Afghanistan's reserve position in the IMF, foreign currency cash (including foreign exchange banknotes in the vaults of DAB, but excluding cash held in DAB's branches), and deposits abroad (including balances on accounts maintained with overseas correspondent banks). Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered;³ claims on residents; precious metals other than monetary gold; assets in nonconvertible currencies; illiquid assets; and claims on foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options).

8. **Reserve liabilities** are defined as short-term (original maturity) foreign exchange liabilities of DAB to nonresidents (held at DAB headquarters); all credit outstanding from the IMF; foreign currency reserves of commercial banks held at DAB headquarters; commitments to sell foreign exchange arising from derivatives (such as futures, forwards,

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

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

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

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

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

E. Revenues of the Central Government

10. **Revenues of the central government** are defined in line with the Government Financial Statistics Manual (GFSM 2001) on a cash accounting basis, excluding foreign grants. Revenue is an increase in net worth of the central government (including its units in the provinces and agencies) resulting from a transaction. Revenues of the central government include taxes and other compulsory transfers imposed by central government units, property income derived from the ownership of assets, sales of goods and services, social contributions, interest, fines, penalties and forfeits and voluntary transfers received from nongovernment other than grants. The definition for program monitoring excludes grants and other noncompulsory contributions received from foreign governments and international organizations; such transfers between central government units would be eliminated in the consolidation of the fiscal reports and not recorded as revenue. Receipts collected by central government on behalf of noncentral government units should not be counted as revenue (e.g., Red Crescent fees). Receipts from the sale of nonfinancial assets, such as privatization, and transactions in financial assets and liabilities, such as borrowing but excepting interest payments, are also excluded from the definition of revenue.

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

F. External Debt and Arrears

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

- Debts can take a number of forms, the primary ones being: (a) loans, (i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future—including deposits, bonds, debentures, commercial loans and buyers’ credits—and temporary exchanges of assets that are equivalent to

fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (b) suppliers' credits (i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided); and (c) leases (i.e., arrangements under which property is provided that the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property). Excluded from this limit are leases of real property by Afghan embassies or other foreign representations of the government.

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

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

- **It applies to** both debt as defined in paragraph 13 of this memorandum, and also to commitments contracted or guaranteed for which value has not been received. For the purposes of the program:
 - external debt will be considered to have been contracted at the point the loan agreement or guarantee is signed by the MoF (on behalf of the government) or DAB Governor; and
 - the guarantee of a debt arises from any explicit legal obligation of the government or DAB, or any other agency acting on behalf of the government, to service such a debt in the event of nonpayment by the recipient (involving payments in cash or in kind), or indirectly through any other obligation of the government or DAB to cover a shortfall incurred by the loan recipient.

- **Excluded** from the limits are refinancing credits and rescheduling operations, credits extended by the IMF, and credits on concessional terms defined as those with a grant element of at least 60 percent. The grant element is to be calculated using currency-specific discount rates based on the Organization for Economic Cooperation and Development's Commercial Interest Reference Rates (CIRRs): for maturities of less than 15 years, the grant element will be calculated based on six-month averages of CIRRs; and for maturities longer than 15 years, the grant element will be calculated based on 10 year averages.
- Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract or guarantee becomes effective.

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

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

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

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

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

- For the purposes of this performance criterion:

- “state-owned banks” refers to those banks that are wholly or majority owned by the government (as defined in paragraph 14 of this memorandum); including Bank Millie, Bank Pashtany, and Export Promotion Bank;
 - “enterprises in need of restructuring” refers to enterprises that meet any one of the following: (a) enterprises (public or private) that have not had an audited balance sheet in fiscal years 1384 and 1385; (b) public enterprises that have been identified by the MoF for liquidation; (c) public enterprises that do not have Cabinet-approved restructuring plans;
 - “public enterprises” refers to enterprises wholly or majority owned by the government, including those covered by the State-Owned Enterprise (Tassady) Law, and 13 state-owned corporations⁴ and any other public entities and government agencies engaged in commercial activities but not covered by Tassady Law.
- **It applies to** any new loans (or financial contributions) extended directly from state-owned banks to enterprises in need of restructuring, and also to any new government guarantees (as defined in paragraph 14 of this memorandum) of borrowing undertaken by these enterprises. It applies to loan agreements and guarantees for which value has not been received.

H. Adjustors

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

June 21, 2007	Afs 5,512 million
September 21, 2007	Afs 16,536 million
December 20, 2007	Afs 27,560 million
March 20, 2008	Afs 44,096 million

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

⁴ Afsotar, Afghan Teor, Aftento, Af-Turk, Afghan Cart, Afghan Naichi, Astrass, Afghan Telecom, Afghan Wireless, Afghan National Insurance Company, Afghan Textile, Ariana Afghan Airlines, and Hotel Intercontinental (Baghi Bala/Kabul).

18. The NIR floor and NCBF ceiling are defined consistent with the assumption that the external financing of the core budget and the receipts from the sale or transfer of nonfinancial assets will amount, on a cumulative basis from March 20, 2007, to:

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

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

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

20. Should the central government undertake urgent, security-related, operating expenditures in excess of the fiscal program ceilings, the NIR floor will be adjusted downward, and the NCBF ceiling and the indicative target (ceiling) for the operating budget deficit of the central government, excluding grants, will be adjusted upward to the extent that these expenditures are executed with the use of additional grants provided by donors, based on spending plans agreed between the central government and the donors. These adjustments will apply starting with the fiscal year 2007/08. The cumulative downward adjustment to the NIR floors at each test date will be capped at US\$76 million. The cumulative upward adjustment to the NCBF ceilings and the indicative targets (ceilings) for the operating budget deficits of the central government, excluding grants, at each test date will be capped at Afs 3.8 billion.

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

III. PROVISION OF INFORMATION TO FUND STAFF

22. To facilitate the monitoring of program implementation, the government of Afghanistan and DAB will provide to Division A of the Middle East and Central Asia Department (MCD), through the office of the Resident Representative of the IMF in

Afghanistan, the information specified below and summarized in the list of reporting tables provided by Fund staff to the Technical Committee.

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

- **DAB net international reserves** should be reported weekly, no later than two weeks after the end of the week.
- **Monetary statistics, including exchange rates, government accounts with DAB, and currency in circulation** should be reported monthly and no later than three weeks after the end of the month. Monetary statistics will also include a monetary survey (quarterly, and then monthly starting in March 2007), including balance sheets of DAB and a consolidated balance sheet of the commercial banking sector.
- **Core budget operations and their financing** should be reported monthly and no later than four weeks after the end of the month. The official reports for the purpose of program monitoring will be the monthly financial statements from the Afghanistan Financial Management Information System (AFMIS). The structure of financing (grants and loans should be separately identified) and expenditure data should be on a consistent cash basis. Core operating expenditures should be reported on a monthly basis using the budget appropriation economic (object) and administrative classification in addition to the program and functional classification as reported in the budget documents. Core development expenditures should also be reported separately on a monthly basis using the budget program classification in addition to the economic (object), administrative and functional classification consistent with the operating budget. All the data should also compare outturns against the approved budget (or figures reported in the budget documents). Core operating and development revenues and expenditures should also be reported by province, separately on the same monthly basis.
- **External budget operations and their financing** (i.e., donor funded spending outside the core budget treasury systems) should be reported at least semi-annually (more frequently if possible) and no later than eight weeks after the end of the period. External development expenditures should be reported on a disbursement basis (as currently defined in budget documents) using the budget program classification (and an administrative, functional and provincial classification where possible).
- **External debt data** should be reported quarterly and no later than six weeks after the end of the quarter. They will include: (a) details of new loans contracted or guaranteed during the quarter, including the terms of each new loan; (b) the stock of debt at the end the quarter, including short-term debt, and medium- and long-term debt; (c) loan disbursements and debt service payments (interest and amortization) during the quarter; (d) information on all

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

- **National accounts data** should be reported annually and no later than eight weeks after the end of the quarter.
- **Consumer price indexes (CPIs)** for the city of Kabul and for Kabul and five other major cities (“national” CPI) should be reported monthly and no later than four weeks after the end of the month.

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

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

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

INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF AFGHANISTAN

**Second Review Under the Three-Year Arrangement Under
the Poverty Reduction and Growth Facility**

Informational Annex

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

June 21, 2007

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Annex I: Islamic Republic of Afghanistan—Relations with the Fund
(As of May 31, 2007)

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	0.79	2.96

IV. Outstanding Purchases and Loans	<u>SDR Million</u>	<u>% Quota</u>
PRGF Arrangements	24.50	15.13

V. **Latest Financial Arrangements:**

	<u>Date of</u>	<u>Expiration</u>	<u>Amount Approved</u>	<u>Amount Drawn</u>
<u>Type</u>	<u>Arrangement</u>	<u>Date</u>	<u>(SDR Million)</u>	<u>(SDR Million)</u>
PRGF	June 26, 2006	June 25, 2009	81.00	24.50

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

	<u>Forthcoming</u>				
	<u>2007</u>	<u>2008</u>	<u>2009</u>	<u>2010</u>	<u>2011</u>
Principal					
Charges/Interest	<u>0.66</u>	<u>1.23</u>	<u>1.23</u>	<u>1.23</u>	<u>1.23</u>
Total	<u>0.66</u>	<u>1.23</u>	<u>1.23</u>	<u>1.23</u>	<u>1.23</u>

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

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

Nonfinancial Relations

IX. **Exchange Arrangement**

Afghanistan is an Article XIV member country. The authorities are implementing a liberal exchange system. Based on information currently available to the staff, no exchange

restrictions and multiple currency practices are currently in place. The authorities have provided documents to IMF staff related to laws and regulations on the exchange regime and have requested technical assistance from the Fund to formalize the current liberal regime. They have been implementing a managed float system with no predetermined path for the exchange rate. As of May 10, 2007, the average exchange rate on the Kabul money exchange market was Af 50.17 per \$1.

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

X. Article IV Consultation

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

XI. Safeguards Assessment

A safeguards assessment of the DAB has been completed. A safeguards mission to Kabul took place from April 2–11, 2006 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. A staff visit to take stock of improvements in the DAB's safeguards framework is yet to be scheduled.

XII. Technical Assistance, 2005–07

Department	Date	Purpose
FAD	March 2004–July 2006	Resident treasury expert
	May 19–25, 2005	Seminar on reorganization of the MoF
	October 18–25, 2005	Tax policy
	February 21–March 04, 2006	Public financial management
	April 30–May 09, 2006	Tax policy
	November 15–23, 2006	Tax and customs administration
FIN	April 2–11, 2006	Safeguards assessment
LEG	January 29–February 12, 2005	Income tax law

Department	Date	Purpose
LEG/MCM	May 2–10, 2006	Legal framework of DAB’s monetary and payment system policies
MCM	September 2004–April, 2006	Training coordinator
	April 2006–June 2007	Training coordinator (peripatetic)
	February 2–15, 2005	Implementation of DAB balance sheet reconstruction and capital adequacy recommendations
	May 16–25, 2005	Monetary policy and financial markets
	October 11–20, 2005	Monetary policy
	November 20–29, 2005	Financial markets
	January 22–February 5, 2006	Monetary policy
	January 22–February 5, 2006	Monetary policy
	May 2–10, 2006	Monetary policy, foreign reserve management, money markets and insurance
	November 28–December 10, 2006	Monetary policy formulation and implementation
	April 17–30, 2007	Monetary policy formulation and implementation
STA	January 15–February 15, 2005	Multisector statistics
	March 23–June 11, 2005	Multisector statistics
	July 20–August 31, 2005	Multisector statistics
	October 31, 2005–January 12, 2006	Multisector statistics
	March 6–15, 2006	Balance of payments statistics
	March 8–May 2, 2006	Multisector statistics
	March 13–April 1, 2006	Monetary and financial statistics
	May 24–July 18, 2006	Multisector Statistics
	August 2–16, 2006	Balance of payments statistics
	August 8–October 3, 2006	Multisector statistics
	September 22–October 4, 2006	Government finance statistics
	November 1–December 26, 2006	Multisector statistics
	November 5–19, 2006	Monetary and financial statistics
	April 22–May 4, 2007	Monetary and financial statistics
MCD	April 16–20, 2005	Basic macroeconomic accounting and financial programming
METAC	November 15–20, 2005	Tax policy and administration
	May 19–25, 2007	Balance of payments statistics

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

With financial support from the Sweden Technical Assistance SubAccount, the Fund sponsored a number of training activities aimed at DAB officials. A long-term resident training advisor, Mr. Khan, was posted at DAB from September 2004–April 2006 and is now

conducting peripatetic technical assistance missions. Finally, Sweden has financed a monetary policy peripatetic advisor (a position currently shared by Mr. Coats and Mr. Gray) to assist DAB in developing the strategy and instruments for improving the implementation of monetary policy.

XIII. Resident Representatives

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

Annex II: Islamic Republic of Afghanistan—Relations with the World Bank
(As of May 09, 2007)

Hugh Riddell, Acting Country Officer, Telephone: (202) 473-5601

1. The Interim Strategy Note (ISN) discussed by the IDA Board of Executive Directors on May 25, 2006 follows the two Transitional Support Strategies (TSS) that covered the 2002–06 period. It is guiding IDA’s engagement in Afghanistan over the period of 2006–08 and is expected to be followed by a full Country Assistance Strategy (CAS) once the government has finalized its full PRSP—Afghanistan National Development Strategy expected to be completed in March 2008. The government promulgated its Interim Afghanistan National Development Strategy (I-ANDS) in January 2006. As the government had submitted the I-ANDS to the IMF and the World Bank as its Interim Poverty Reduction Strategy (I-PRSP), Bank and Fund staff prepared a Joint Staff Advisory Note (JSAN) which was also discussed by the Bank Board on May 25, 2006. The ISN focus shifts slightly from the previous TSS, notably to provide greater emphasis on the development of the rural economy. Its pillars are: (i) build the capacity of the state and its accountability to its citizens to ensure the provision of services that are accountable, accessible, and of adequate quality; (ii) promote growth of the rural economy and improve rural livelihoods; and (iii) support growth of a formal, modern, and competitive private sector.

2. As of May 2007 the World Bank has committed an aggregated of US\$1.3 billion in IDA assistance to Afghanistan, financing more than 30 projects covering public administration, infrastructure, education, health, customs, transport and rural development. Three IDA projects closed in FY 2007 (i.e., July 2006–June 2007) and four in FY 2006. Four grants, for an Emergency National Solidarity Program II, an Emergency Irrigation Rehabilitation Project, an Avian Influenza Control and Human Preparedness Project, a Private Sector Development Project, were approved in December 2006–April 2007. Three more operations are expected to go to the Board by the end of FY 2007, a Civil Service Reform Project, a Public Financial Management Reform Project and a Programmatic Support for Institution Building III.

3. As of April 2007 IDA’s active portfolio comprised 18 investment projects which support the government’s development strategy in areas such as health, education, public administration, capacity building and private sector support. Cumulative disbursements of active portfolio totaled US\$549.9 million (53 percent of commitments). Excluding the three new operations that have not yet achieved effectiveness, the disbursement ratio stands at 61 percent. Five new projects are expected to be added to IDA portfolio by the end of FY07: Programmatic Support for Institution Building (PSIB) III (a budget support operation), Public Financial Management Project, Civil Service Reform Project, HIV/AIDS project and additional financing for the Emergency Irrigation Rehabilitation project, for a total of US\$173 million.

4. The World Bank also administers the Afghanistan Reconstruction Trust Fund (ARTF), on behalf of 26 donors, which became effective in May 2002. The ARTF is the main mechanism for providing coordinated funding support to Afghanistan's recurrent budget, as well as investments through the Core Development Budget in line with agreed budget priorities of the government. In the previous year of operation (2005/06), the ARTF mobilized over US\$450 million, while cumulative disbursements reaching US\$350 million.

5. As of March 21, 2007 (end of Afghan solar year), paid-in donor contributions to the ARTF reached US\$1.8 billion. In addition to a US\$1.2 billion commitment to the Recurrent Cost Financing Trust Fund, there are 10 active grants funded by the investment window with combined commitments of US\$405 million, of which US\$311 million (77 percent) has been disbursed. The National Solidarity Program (NSP) and Microfinance are the two largest and fastest-disbursing programs, accounting for 85 percent of total disbursements from the ARTF investment window. The new Management Capacity Program will be added to the ARTF active portfolio in FY 2007. The Bank also administers a special window for Afghanistan for the Japanese Social Development Fund of US\$50 million. ARTF is increasing its financing of investments and has the potential to support better donor coordination, simplified processes, and fast results.

6. The World Bank is also actively engaged in providing analytical and advisory services to the government. Current and recent analytical work has focused on civil service reform, urban development and land management, education policy reform, labor market and pensions, oil/gas infrastructure development, and the drug economy, 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 in 2006, which incorporates an assessment of civilian public expenditures and fiduciary aspects, including procurement and financial management, as well as revenue and security sector expenditures. Fund staff contributed to the PFM review, including by providing an analysis of domestic revenue prospects. Technical assistance on pensions and three major analytical tasks, on *Public Administration Reform*, on *Fighting Corruption*, and on *Sub-National Administration* have been initiated in FY07 in response to government requests.



Press Release No. 07/154
FOR IMMEDIATE RELEASE
July 9, 2007

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Second Review Under the PRGF Arrangement with the Islamic Republic of Afghanistan, Approves US\$17.2 Million Disbursement, and Agrees on Afghanistan Reaching the Decision Point Under the Enhanced HIPC Initiative

The Executive Board of the International Monetary Fund (IMF) completed today the second review of the Islamic Republic of Afghanistan's performance under the economic program supported by a three-year, SDR 81.0 million (about US\$123.4 million) Poverty Reduction and Growth Facility (PRGF) arrangement (see [Press Release No. 06/144](#)). Completion of the review enables the release of an amount equivalent to SDR 11.3 million (about US\$17.2 million), which would bring total disbursements under the arrangement to SDR 35.8 million (about US\$54.5 million).

Executive Directors also agreed that the Islamic Republic of Afghanistan has taken the steps necessary to reach the decision point under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative. The IMF Executive Board decision follows consideration of the decision point document by the World Bank Executive Board on July 3. A separate press release regarding these deliberations will be issued jointly with the World Bank.

At the conclusion of the Board's discussion of Afghanistan's performance under its IMF-supported economic program, Mr. Murilo Portugal, Deputy Managing Director and Acting Chairman, issued the following statement:

“Despite a difficult security environment and persistent expenditure pressures, Afghanistan continues to maintain macroeconomic stability and move forward with its structural reform agenda. Performance during 2006/07 conformed broadly with the objectives of the PRGF-supported program.

“Real GDP growth is projected to increase strongly in 2007/08, owing primarily to a rebound in agriculture. Inflation is expected to remain contained at 6 percent. The program’s fiscal objectives are to increase both revenues and development expenditures. In the event of revenue shortfalls, the authorities are prepared to accelerate reforms to ensure that longer-term expenditure corrections can be avoided. Continued strong donor support and a comfortable official reserves position should provide an adequate buffer for external shocks.

“The continued success of the program will hinge on maintaining macroeconomic discipline and deepening structural reforms. Fiscal policy should pay increasing attention to medium-term sustainability, and the medium-term fiscal framework should serve to underpin fiscal policy design and donor engagement. Reinvigorating government-wide support for the revenue reform agenda and avoiding ad hoc policies that erode the revenue base will be crucial to strengthen revenue mobilization and attain the program’s fiscal objectives. The authorities are also encouraged to accelerate the restructuring and, where appropriate, the divestment of state-owned banks and enterprises.

“The current monetary stance remains appropriate, with growing confidence in the Afghani. The deepening of the capital notes market should enhance the effectiveness of monetary policy. Looking ahead, the authorities intend to strengthen bank supervision and introduce regulations on managing credit risk,” Mr. Portugal said.

**Statement by Abbas Mirakhor, Executive Director for the
Islamic Republic of Afghanistan
July 9, 2007**

My Afghan authorities and I wish to express our appreciation and gratitude to staff for their hard work and dedication, as well as for their balanced assessment and conclusions, which we broadly share. During the first review of the PRGF-supported program and the subsequent review of the preliminary assessment of Afghanistan's eligibility under the enhanced-HIPC Initiative, Executive Directors endorsed the completion of the first review and Afghanistan's eligibility for HIPC debt relief. Their welcome support was predicated on two main factors: The first factor is the magnitude of the efforts required on all fronts to resurrect Afghanistan from the protracted war and conflicts, which could not be achieved without the generous and continuing support from donors and international institutions, including the IMF. The second factor is the authorities' demonstrated dedication to achieving macroeconomic stability and reconstruction through a comprehensive reform process, notwithstanding a difficult security and political situation and severe capacity limitations. These factors continue to prevail and will remain relevant in the future. Qualification to debt relief under the HIPC Initiative and, hopefully soon thereafter, under the MDRI, is a steppingstone for freeing the country of unsustainable debt burden and enabling it to direct its resources to investment in infrastructure and human capital in order to accelerate growth and poverty reduction. In that spirit, the authorities are grateful to the international community for its generous financial and technical support to Afghanistan's reconstruction.

Performance under the PRGF is encouraging. All quantitative performance criteria and indicative targets for the second review have been met, and all structural benchmarks, except one, have been observed. The breadth and complexity of the ongoing structural reform process, the imperative of building social and political consensus, especially in view of security concerns, as well as the severe capacity constraints have resulted in some delay in reform implementation. Nevertheless, despite the difficult political situation, the authorities have demonstrated remarkable tenacity in implementing their reform agenda, including the structural benchmarks that were difficult to attain under the first review. Concerning the remaining commitments under the second review, as noted by the authorities in their LOI and MEFP, they are at advanced stages of preparation toward implementation (restructuring/divestment plan for public entities and submission to Parliament of some commercial laws). Moreover, Afghanistan continues to maintain satisfactory macroeconomic performance. Growth remains high, though volatile, reflecting heavy dependency on the agricultural sector and its vulnerabilities; inflation has declined and the exchange rate remains stable, reflecting greater confidence in the afghani and more effective use of monetary policy instruments; fiscal performance has been better than programmed, with improved tax collection and lower-than-programmed expenditure and notwithstanding faster execution of development spending reflecting improved procedures; the banking sector is expanding rapidly, with bank deposits and lending more than doubled in a context of strengthened bank regulation and supervision; and foreign reserves are at a comfortable level. Although the medium-term outlook remains vulnerable to a deterioration in the security situation and volatility in donor support, it is broadly encouraging with high growth, low inflation, and a sustainable external position, provided that the debt overhang is appropriately

addressed. Under reasonable baseline assumptions, debt sustainability analysis confirms a significant improvement in the country's debt burden following HIPC and MDRI debt relief, and post-relief sustainability analysis points to manageable medium- to long-term debt position. Despite the risks highlighted in the Decision Point document—lower export and GDP growth; less favorable loan concessionality; greater reliance on debt financing—the medium-term outlook is positive due to the authorities' strong track record of macro-economic discipline and reform implementation. Importantly, for maintaining debt sustainability following HIPC debt relief, they are aware of the need to continue to upgrade debt management capacity—and are grateful to donors for their support in this key area—and the imperative of continued reliance on grants and highly concessional loans for future financing needs.

As reported in the Decision Point document, the authorities have made further progress in their dialogue with creditors since the preliminary HIPC assessment. The reconciliation of 100 percent of multilateral and bilateral official debt has been completed; bilateral agreements with the United States and Germany have been signed; and the bilateral agreement with Russia, the main debt holder, is expected to be concluded shortly. The authorities and the OPEC Fund (OPIC) have agreed to address the arrears issue shortly after the decision point. The remaining debt in dispute has been excluded from the HIPC analysis (in line with the standard practice) and, although it is a minimal percentage of the total, the authorities are seeking to clarify those claims. The updated HIPC assessment shows no significant change in the magnitude of debt and debt forgiveness.

The outlook for satisfactory performance under the third review is also positive. While the increasing complexity of some “second-generation” reforms has impacted timing of their implementation, the authorities are committed to pursuing their reform agenda. Also, with so much at stake, not only for large debt relief but also for stable and sustained growth and poverty reduction, they are fully cognizant that sound macroeconomic management and fiscal discipline will underpin program success. In this regard and to safeguard the fiscal position, accommodation of additional non-security expenditure pressures is contingent on meeting revenue targets for the third review. In line with staff recommendations, the authorities are also committed to correcting the recently granted tariff concessions; restructuring/divestment of the national airline is under consideration; and regulatory framework and supervision of the expanding financial sector are being strengthened, along with introduction of longer-term monetary instruments and restructuring of state-owned banks, which has gained considerable momentum. The authorities are striving to improve budget preparation and execution, rationalization and prioritization of expenditure, and tax collection capacity (including the revamping of the large Taxpayers Unit; administrative enhancements; and implementation of FAD recommendations). They are strengthening the MTF as an operational guide to enable longer-term fiscal planning in line with the ANDS, to engage donors on a more systematic basis, and to gradually incorporate donor-financed expenditure into the core budget. Toward these ends, as staff note, the authorities have made commendable progress in improving economic statistics and preparing the ANDS (which is at an advanced stage and will be the blueprint for a coordinated poverty-reduction strategy). They are cognizant of the importance of costing sectoral strategies and aligning the budget with the ANDS—calling for improved donor reporting and coordination in support of

appropriate alignment of priorities—and of further improving economic statistics. Continued technical assistance by the IMF and other institutions and donors will play a crucial role in these areas.

The authorities thank the Executive Board, management, and staff for their invaluable support and advice, and look forward to the completion of the second review under the PRGF-supported program as well as Board approval of Afghanistan's qualification for debt relief and the decision point under the enhanced-HIPC Initiative. As this Chair highlighted in the previous HIPC discussion, the completion point triggers are well within the authorities' reform agenda. They are confident that perseverance with sound policy implementation and continued support from the international community will enable them to reach the completion point and qualify for the MDRI at an early stage.