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Islamic Republic of Afghanistan: 2005 Article IV Consultation and Sixth Review Under the Staff Monitored Program—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Islamic Republic of Afghanistan.

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2005 Article IV consultation with the Islamic Republic of Afghanistan and the sixth review under the staff-monitored program, the following documents have been released and are included in this package:

- the staff report for the 2005 Article IV consultation and sixth review under the staff-monitored program, prepared by a staff team of the IMF, following discussions that ended on November 22, 2005, 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 February 15, 2006. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a staff statement of March 6, 2006 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its March 6, 2006 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for the Islamic Republic of Afghanistan.

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

Letter of Intent sent to the IMF by the authorities of the Islamic Republic of Afghanistan*
Memorandum of Economic and Financial Policies—Update*
Selected Issues and Statistical Appendix
* May also be 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

Staff Report for the 2005 Article IV Consultation and Sixth Review Under the Staff-Monitored Program

Prepared by the Staff Representatives for the 2005 Consultation with the Islamic Republic of Afghanistan

Approved by Juan Carlos Di Tata and Matthew Fisher

February 15, 2006

- Discussions for the 2005 Article IV consultation and the sixth review under the staff-monitored program (SMP) were held in Kabul from November 8–22, 2005. The mission met with Vice-President Masood, Minister of Finance Ahady, Minister of Commerce Arsala, Minister of Foreign Affairs Abdullah, Da Afghanistan Bank Acting Governor Ibrahimi, and other senior officials. The mission also held discussions with representatives of the diplomatic community, nongovernmental organizations, international institutions, the business and banking communities, and parliamentarians.

- At the request of the authorities, the SMP, which initially covered the period March 2004–March 2005, was extended through end-September 2006 at the time of the fifth review. The SMP aims at maintaining financial stability and building institutional capacity. Progress made so far under the SMP has paved the way for discussions on a program that could be supported by the Poverty Reduction and Growth Facility (PRGF), which could be presented for consideration by the Executive Board in the second quarter of 2006.

- The mission consisted of Messrs. Symansky (head), Bessaha, Martin, Singh (all MCD), and Thomas (FAD). It was assisted by the Fund resident representative in Kabul, Mr. Charap. Messrs. Di Tata (MCD) and Zaidi (OED) participated in some of the policy discussions.

- At the International Donors' Conference held in London from January 31–February 1, 2006, the authorities submitted their Interim Afghanistan National Development Strategy (I-ANDS), which will form the basis for the Interim Poverty Reduction Strategy Paper (I-PRSP).

- The last Article IV consultation was concluded on January 19, 2005.

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List of Acronyms

CPI	Consumer Price Index
DAB	Da Afghanistan Bank
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
HIPC	Heavily Indebted Poor Countries
I-ANDS	Interim Afghanistan National Development Strategy
I-PRSP	Interim Poverty Reduction Strategy Paper
MoF	Ministry of Finance
MTFF	Medium-Term Fiscal Framework
MYR	Midyear Budget Review
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
SMP	Staff-Monitored Program
SOEs	State-Owned Enterprises
TA	Technical Assistance
TMU	Technical Memorandum of Understanding
WTO	World Trade Organization

EXECUTIVE SUMMARY

- Afghanistan's performance under the SMP continues to be commendable. In a challenging environment, the authorities have continued to pursue prudent fiscal and monetary policies and have made further advances on the structural front. While preparing for the September legislative elections, they observed all the end-September 2005 quantitative indicators and, albeit with some delays, all the structural benchmarks, except for the publication of the audited 2004/05 core budget financial statements.

- A rebound of economic activity during the last 12 months was accompanied by a decline in inflation, and a relatively stable exchange rate. Revenue slightly exceeded the program target, while government spending remained lower than budgeted. At the same time, monetary growth was lower than envisaged under the program. The authorities approved a medium-term fiscal framework that outlines a path for fiscal sustainability, made significant progress in modernizing Da Afghanistan Bank's (DAB) operations, and took further steps to restructure the public sector.

- Opium production declined by 2 percent in 2005, as a sharp drop in cultivation in anticipation of intensified anti-narcotics efforts was largely offset by higher yields owing to favorable weather conditions.

- The near-term economic outlook is favorable. The real GDP growth target of 14 percent for 2005/06 is within reach as better rainfall is expected to boost agricultural output, and the construction and service sectors remain buoyant. As price and exchange rate developments remain broadly in line with expectations, the monetary program was kept unchanged. The budget deficit is expected to be lower than previously envisaged in 2005/06, which should contribute to a further build up of government deposits with DAB.

- Sustained rapid growth and poverty alleviation require a major improvement in the investment climate. In the context of the Interim Afghanistan National Development Strategy (I-ANDS) presented during the International Donors' Conference that took place in London in late January, the authorities submitted a broad program of growth-boosting reforms, focused on reducing the role of the government in the economy and improving the business environment. Continued reforms of the banking system are also needed to ensure a sustainable flow of credit to the private sector.

- Risks to the program remain considerable. Insufficient progress in improving security and strengthening government control over the provinces could slow down the reform process. Political pressures could also delay the implementation of reforms and limit the authorities' capacity to meet the program's objectives. Lastly, efforts to eradicate opium-related activities could have disruptive effects on security.

- Against this background, and on the basis of the SMP implementation to date, the authorities intend to request a Poverty Reduction and Growth Facility (PRGF) arrangement to support the implementation of their ambitious reform agenda. In this connection, the I-ANDS should form the basis of an Interim Poverty Reduction Strategy Paper (I-PRSP).

I. Overview

1. **Since the inception of the staff-monitored program (SMP) in March 2004, the Afghan authorities have pursued prudent fiscal and monetary policies and have implemented a number of important institutional and structural reforms, which have contributed to the stabilization of the economy and the resumption of growth.** Commendable efforts have been made to improve revenue collection, establish a transparent expenditure system with fiduciary standards, and modernize central bank operations while strengthening the banking sector regulatory framework. These efforts took place within a difficult environment, dominated by continued insecurity and a heavy political agenda. Looking ahead, the authorities face the challenges of diversifying the sources of growth; achieving external and fiscal sustainability; enhancing the competitiveness of the economy; removing institutional and structural obstacles to private sector development; and gradually eliminating opium-related activities.

2. **Afghanistan's first legislative and provincial elections took place on September 18, 2005**. About 50 percent of the 12.4 million eligible Afghans voted in elections for the 249-seat parliament and 34 provincial councils. Although some leading parliamentarians are not supportive of President Karzai's government, they indicated their intention to work in a constructive fashion with the present administration. The parliament held its first meeting on December 19, 2005.

3. **The security situation remains volatile**. The number of incidents increased in the period leading to, and in the aftermath of the legislative elections, likely due to a resurgence of Taliban activity and the government's counternarcotics efforts.

4. **Performance under the SMP during the second quarter of 2005/06 (the period covered by the sixth review) continued to be favorable, notwithstanding minor slippages in the implementation of structural reforms.** While these slippages do not reflect a change in policy priorities, they illustrate the need for the authorities to remain focused on the reform program and strengthen ownership.

II. Background and Performance Under the Staff-Monitored Program

5. **The government met all the end-September 2005 quantitative indicators and observed, albeit with some delays, all structural benchmarks, except for the publication of the audited 2004/05 core budget financial statements.**[1] This performance was achieved in the context of the preparations for the elections.

6. **After slowing down sharply in early 2004/05, economic activity has rebounded over the last 12 months, in line with program projections (Tables 1 and 2).** These swings in economic activity reflected primarily the impact of weather conditions on agricultural

[1] The fiscal year 2005/06 runs from March 21, 2005 to March 20, 2006.

output: cereal production fell by 17 percent in 2004/05, before recovering in 2005/06. At the same time, the reconstruction effort continued to drive growth in construction, trade, transportation, and telecommunications. Although it is slowing, real growth remained strong at 30 percent in the industrial sector and 31 percent in services.[2]

7. **The drug economy remains a major challenge for the government**. Opium production declined by 2 percent in 2005, as a 21 percent reduction in cultivated areas was offset by an increase in yields due to favorable weather conditions. The sharp decline in cultivated areas was due primarily to many farmers not planting in anticipation of intensified government-led anti-narcotics activities. Increased drug seizures and eradication efforts continued to have a modest direct impact relative to the size of the problem. Opium prices fell slightly, which contributed to declines in export and farm gate values of 4 percent and 7 percent, respectively, to $2.7 billion and $560 million.

8. **After rising sharply in 2004/05 on account of an acceleration of rents and petroleum product prices, inflation subsided over the first half of 2005/06, reflecting primarily a slowdown in rents (Figure 1).** Year-on-year inflation declined to 12.9 percent in September 2005, from 16.3 percent in March, as envisaged in the program.[3] However, excluding rents and petroleum product prices, inflation rose slightly to 12.7 percent in September, from 11.1 percent in March, owing mainly to sharp increases in bread and cereal prices. After appreciating during the first half of 2004/05, the Afghani was broadly stable in real effective terms during the 12 months ending in September 2005, the nominal depreciation of the currency being offset by a positive inflation differential.

9. **The fiscal program is on track as the authorities remain committed to fiscal discipline and continue to improve fiscal management.** The operating budget deficit, excluding grants, reached 4.9 percent of GDP in 2004/05 and 1.7 percent of annual GDP during the first half of 2005/06 (Tables 3a and 3b). This deficit was slightly lower than envisaged; combined with higher-than-expected grants, it contributed to a further build up of government deposits with Da Afghanistan Bank (DAB).

10. **During 2004/05 and the first half of 2005/06, revenue was broadly in line with program projections.** Although customs reforms and larger transfers from the provinces led to a higher-than-expected increase in customs revenue, tax administration and tax policy reforms have yet to translate into higher domestic revenues. Domestic tax revenue declined by 9 percent in the first half of 2005/06 owing to reduced compliance stemming from uncertainty over the delay in passing the amended income tax laws, which were finally approved and published in the Official Gazette in November 2005. A number of recently

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[2]Although it is improving, the quality of the statistical data, particularly for the national accounts and the balance of payments, remains poor as the compilation process is hampered by the general lack of reporting from primary sources (see appendix on statistical issues).

[3]The “national” CPI, which covers five major cities in addition to Kabul, increased by 10.8 percent during the 12 months ended in September 2005.

adopted tax measures, including a higher turnover tax rate for specific services, a wage withholding tax, and an airport departure fee, took effect in October 2005. Lastly, in response to pressure from the private sector, the government recently: (a) eliminated the withholding tax on exports, which had been implemented in July 2005; (b) removed import duties on dye and yarn to assist domestic carpet makers, while raising the import tariff on finished carpets; and (c) exempted some basic commodities and livestock from customs duty and withholding tax, with a view to encouraging imports and reducing domestic prices.

11. **Government spending, especially for development purposes, remained lower than budgeted because of capacity constraints**. Core development expenditure reached 2.5 percent of annual GDP during the first half of 2005/06, compared with a revised budget target of 14.1 percent of GDP for the fiscal year as a whole. Despite well structured coordination mechanisms that seek to align donor activities with the government's priority programs, limited information is available on external budget spending (projected at 29 percent of GDP in 2005/06), which is directly implemented by donors.[4]

12. **The midyear budget review (MYR) was concluded in October 2005.** The authorities capped the increase in operating expenditure to 2.1 percent over the budget, as a 3 percent increase in compensation for civil servants—agreed under the program—and unanticipated spending for parliamentarians and pensions were partially offset by savings in other expenditures. A medium-term fiscal framework (MTFF) was approved by Cabinet at the time of the MYR, including a set of integrated macroeconomic projections and fiscal targets that outline a path towards fiscal sustainability.

13. **The authorities have continued to focus on improving fiscal management and transparency.** The budgetary process and transparency have been strengthened through the adoption of a new public finance and expenditure management law, the routine reconciliation of the government's fiscal and banking records, and the publication of monthly core budget reports. A World Bank study is helping to design the computerized financial management system that will eventually be rolled out to line ministries and provinces. However, the reconciliation of fiscal and banking data remains largely manual and constrained by existing procedures and information systems, and weak capacity. The external audit of the 2004/05 core budget financial statements was delayed by uncertainty over the appropriate procedures following the introduction of the new budget law.[5] To avoid a repetition of these delays, the Ministry of Finance (MoF) and the Control and Audit Office will agree on an audit plan for 2005/06 before the end of the current fiscal year. A multi-year public administration reform program is expected to be adopted during the remainder of 2005/06.

14. **Monetary developments during 2004/05 and through September 2005 remained**

[4]Security spending continues to dominate the budget. It is projected at 26 percent of total core and external development spending in 2005/06 (implementation rates in this sector tend to be highest).

[5]Audits of the main multi-donor trust fund (Afghanistan Reconstruction Trust Fund) and World Bank funds, which cover a large part of the budget, were finalized by end-December.

broadly in line with SMP projections (Table 4). Monetary policy continued to be guided primarily by indicative targets for currency in circulation, and implemented almost entirely through foreign currency auctions.[6] As expected, there was a marked slowdown in currency growth, due in part to the development of the banking sector. Currency in circulation rose by 11 percent during the first half of 2005/06, below the SMP indicative ceiling (13 percent). As the seasonal increase in money demand during the second quarter was less marked than last year, DAB was able to contain money growth within program limits without triggering an appreciation of the Afghani, such as the one observed in August 2004. International reserves reached $1.5 billion at end-September 2005 (equivalent to 4.1 months of 2006/07 imports of goods and nonfactor services), owing partly to the accumulation of deposits by the government. Interest rates on overnight and 30-day capital notes continued to move in the 1–2 percent and 4–6 percent ranges, respectively. Commercial bank lending operations increased at a brisk pace, albeit from a low base, with the banks' deposit base rising by 9 percent during the first half of 2005/06.

15. **The authorities made significant progress in modernizing DAB's operations and strengthening the banking sector regulatory framework.** In line with Fund recommendations, DAB modernized its foreign exchange and capital note auctions, made progress toward introducing new instruments and increasing transparency, restructured its balance sheet, and improved monetary statistics. The authorities also adopted a set of regulations and administrative measures to strengthen DAB's supervision of the banking sector and improve the environment for lending operations, including by reducing the registration fee for deeds from 6 percent to 0.5 percent.

16. **The external current account deficit, excluding grants, narrowed to 45 percent of GDP in 2004/05, from 51 percent in 2003/04 (Table 5).**[7] This improvement essentially reflected a slowdown in imports attributable to a stabilization of foreign aid and one-off factors (i.e. purchase of airplane parts by Ariana Airlines in 2003/04). Including grants, the current account recorded a surplus close to 2 percent of GDP in 2004/05, compared with 3 percent in 2003/04.

17. **Further progress was made in reconciling the external debt (an end-September 2005 structural benchmark).** The reconciliation process has been completed with many of Afghanistan's creditors. However, debt reconciliation with the former Czechoslovakia and Yugoslavia is hampered by uncertainty over the claimant, while two other small creditors have yet to provide adequate documentation to validate their claims. Also, a few outstanding issues still need to be resolved to reconcile Russian claims. The Cabinet has adopted a comprehensive debt management strategy—a structural benchmark—which defines the

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[6] Afghanistan's exchange rate system consists of a managed float with no predetermined path for the exchange rate. Foreign exchange auctions are conducted on a weekly basis.

[7] Current account figures exclude drug exports but include rough estimates of re-exports and unrecorded imports.

institutional and operational guidelines for public borrowing, consistent with both fiscal and external debt sustainability.

18. **Further steps have been taken to restructure public financial institutions.** The authorities have made public their intention to liquidate three former state-owned banks that had not been relicensed, of which only one, the Agricultural Development Bank, keeps a deposit base. As a first step toward the transfer/reimbursement of the remaining deposits of this bank, initially expected to be completed by end-September 2005, DAB froze its correspondent accounts in November. In addition, the MoF (the main shareholder) will restructure two of the relicensed state-owned banks, Bank Millie and Bank Pashtany, and is considering the transfer of the assets of the Export Promotion Bank to one of these two institutions. Other positive developments in the banking sector included the divestiture of DAB's commercial activities in those provinces where at least one commercial bank is active.

19. **In the public enterprise area, the government adopted, with donor assistance, a classification of state-owned enterprises (SOEs) by the envisaged restructuring method.**[8] Out of 66 enterprises directly owned by the government, 8 are expected to remain state-owned, while 58 will be liquidated or privatized. In addition, the government amended the SOEs law to provide the MoF full authority and responsibility to privatize these enterprises. However, the detailed modalities of the privatization have yet to be developed.

20. **Statistical deficiencies are being addressed.** To improve balance of payments data, the authorities are putting in place a new reporting system covering trade flows, private grants, interest receipts and payments, and the international investment position. Also, a new statistical law has been adopted which provides for an independent statistical agency and defines the legal framework for collecting, processing, and disseminating economic data.

III. Policy Discussions

21. **Afghanistan continues to establish a solid track record of macroeconomic policy and structural reforms**. As noted above, despite concerns that low capacity would hinder the delivery of the program's commitments, the authorities have been able to meet all the quantitative indicators and almost all the structural benchmarks set under the SMP.

22. **Notwithstanding this commendable performance, Afghanistan's outlook remains clouded by lingering insecurity, drug industry activities, weak institutions, and serious capacity constraints.** Furthermore, the government remains under pressure to quickly improve public services, increase wages, and borrow at lower concessional terms to fund major infrastructure projects. Some constituencies, frustrated by the slow rise in the standards of living, dispute the government's policies and advocate lowering or temporarily eliminating taxes to encourage investment; raising import tariffs to protect domestic

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[8] A number of public entities and government agencies engaged in commercial activities are not covered by the SOEs law and were, therefore, excluded from this classification.

industries; and increasing government interference in the economy, including through government ownership and price controls, notably in the agricultural sector. Staff advised the authorities to keep the focus on the long-term benefits of market-oriented policies, and to press ahead with medium-term policies and a reform agenda that is financially sustainable and in line with their development objectives.

23. **While the SMP has served the country well, the authorities are ready to move to a more ambitious reform program.** At their request, the mission initiated discussions on a successor program that could be supported by a Poverty Reduction and Growth Facility (PRGF) arrangement. The authorities view such a program as an appropriate vehicle for implementing their structural reform agenda, which is described in detail in the Interim Afghanistan National Development Strategy (I-ANDS) and has been prepared in consultation with the civil society and the donor community. Specifically, the authorities are of the view that a PRGF-supported program would help them consolidate macroeconomic stability, develop the institutions and conditions necessary for private sector development, and significantly improve social conditions. In addition, a PRGF arrangement would contribute to the resolution of outstanding debt issues with Paris Club creditors (possibly in the context of the heavily indebted poor countries (HIPC) Initiative). Further discussions on a successor program are expected to take place in early March 2006, with the view of submitting to the Executive Board a request for a PRGF arrangement in the second quarter of 2006.

24. **Against this background, the discussions with the authorities focused on: (a) the policy framework for the remainder of the period covered by the SMP; and (b) the medium-term economic outlook and the reform strategy.** The authorities were in broad agreement with the staff on most of the issues that were discussed, except on tariff policy, as they raised the possibility of an increase in import tariffs with a view to increasing revenue and protecting the domestic industries.

A. Macroeconomic Outlook and Policy Framework for the Remainder of the Program Period

25. **The macroeconomic outlook for 2005/06 remains favorable**. Real GDP growth is still projected at 14 percent, as originally envisaged, on account of a continued recovery of the agriculture sector—due to better rainfall—and sustained activity in construction and services. While there are some upside risks from second round effects of the increase in oil prices, year-on-year inflation is targeted to decline to about 10 percent by end-2005/06. The current account deficit, excluding grants, is projected to narrow further in 2005/06, while international reserves would continue to rise.

Fiscal Policy

26. **In the context of the MYR, the government reaffirmed its commitment to fiscal sustainability.** The operating budget deficit, excluding grants, is now projected to narrow to 4.2 percent of GDP in 2005/06, from 4.9 percent in 2004/05, owing essentially to rising revenues, while the overall deficit would be significantly lower than expected because of continued capacity constraints in executing development spending. Overall, including anticipated grants and loans, the government is expected to build up further cash reserves in 2005/06. Revenues are projected to increase to 5.3 percent of GDP in 2005/06, from 4.5 percent in 2004/05, reflecting the better-than-expected performance of customs revenue, but also the implementation of the recently adopted tax measures.[9] The ratio of operating expenditures to GDP is expected to remain unchanged at its 2004/05 level of 9.4 percent.

27. **For 2006/07, under the MTFF, the operating budget deficit, excluding grants, is projected to decline further to 2.8 percent of GDP.** Revenues are projected to reach 6 percent of GDP (a 38 percent rise over 2005/2006), largely owing to the full impact of the recent measures and structural reforms. The authorities are committed to limiting the nominal increase in operating expenditures to 13 percent in 2006/07, thus reducing their ratio to GDP to 8.9 percent.

28. **Possible budgetary pressures arising from the pension system are of a growing concern.** In the MYR, the authorities increased the allocation for pensions to about 5 percent of total operating expenditures. However, a recent Supreme Court decision links military pensions directly to sizeable salary increases granted to the Afghan National Army. This decision, if implemented, would add a further 7 percent to the budget (0.6 percent of GDP) for past payments, and about half that amount annually to future budgets. The authorities have indicated that they are not in a position to fund this unexpected increase in expenditure and have appealed the Supreme Court's decision on the grounds that (a) it would set a costly precedent given the imminent retirement of a large number of civil servants and proposed pay reforms; and (b) any payment would be outside the recently adopted budget law. The authorities and staff concurred on the need to address pension issues in a comprehensive manner in the context of their ongoing public administration reform program.

Monetary and Exchange Rate Policies and Financial Sector Reforms

29. **In view of the decline in inflation, the monetary program, which caps the increase in currency in circulation to 28 percent in 2005/06, was kept unchanged**. In 2006/07, pending a deepening of the financial markets (interbank market, capital notes), the authorities will continue to target currency in circulation within the context of a market-determined exchange rate. However, with upward risks to inflation from second-

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[9] These projections exclude $80 million (equivalent to 21 percent of total revenue) stemming from the sale of the telecoms spectrum band width (transfer of nonfinancial assets).

round effects of the increase in oil prices, DAB will stand ready to tighten the monetary stance as needed to achieve the program's inflation target.

30. **DAB is committed to pursuing the modernization of its operations and strengthening its monetary policy framework**. In line with Fund recommendations, DAB will amend regulations to remunerate reserve requirements, while excluding capital notes from eligible assets. These new regulations, as well as those related to open foreign currency positions, will be enforced by end-March 2006. In addition, the authorities committed to allowing participants in the foreign exchange auctions to sell, as well as buy foreign exchange, and to establishing an overnight collaterized credit facility with capital notes eligible as collateral. DAB also intends to introduce capital notes of longer maturities. Lastly, DAB will strengthen monetary management through more reliable liquidity forecasts, publication of the capital note interest rates, and stronger oversight.

31. **The authorities are committed to accelerating the restructuring of the public banking sector.** They will appoint officials to oversee the liquidation of the former state-owned banks, and, by end-March 2006, they will complete the transfer/reimbursement of Agricultural Development Bank deposits. In addition, the management boards of Bank Millie and Bank Pashtany will be replaced and experts will be appointed to help restructure these banks' operations. By end-June 2006, the new managements of both banks, in coordination with the MoF, will adopt long-term restructuring plans. In its capacity as banking supervisory authority, DAB will monitor these developments closely.

32. **The authorities agreed to address several administrative and legal impediments facing the banking sector**. While factors such as poor judicial enforcement hinder the expansion of bank lending operations, there appears to be a consensus between the government and the business and donor communities on the need to give priority to the enactment of a core group of enabling laws, including on secure transactions, business organization, and negotiable instruments, as well as to clarify land ownership rights. Together with several donors, the authorities are working toward the adoption of this legislation.

External Sector Policies

33. **The current account deficit, excluding grants, would decline to 42 percent of GDP in 2005/06.** Although foreign direct investment (FDI) is expected to increase, this deficit will continue to be primarily covered by grant financing, which is projected at $3.1 billion. Including grants, the current account is projected to record a surplus of 2 percent of GDP in 2005/06.

34. **An open and transparent trade regime will help improve Afghanistan's growth prospects.** The authorities intend to pursue technical work in support of discussions on Afghanistan's accession to the World Trade Organization (WTO), with the longer-term aim of reaping the benefits of a liberal trade regime as well as of the WTO's dispute settlement mechanisms and technical assistance. As part of its trade strategy, Afghanistan recently

joined several regional organizations, including the Central Asian Regional Economic Council and the South Asian Association for Regional Cooperation.

35. **The authorities also recognized the need to establish an adequate legal framework for the exchange system,** in order to pave the way for accepting the obligations under Article VIII of the Fund's Articles of Agreement. They requested Fund assistance in this area.

Structural Reforms

36. **In addition to the fiscal and financial structural reforms described above, the authorities intend to make further progress in restructuring the public sector and creating an enabling environment for private investment.** In particular, they committed to: (a) publish in the Official Gazette, by end-December 2005, the amendments to the SOEs law; (b) initiate an open and transparent divestiture process for the SOEs slated for liquidation or privatization; and (c) complete by end-December 2005, an inventory of the various public entities and government agencies engaged in commercial activities but not covered by the SOEs law, with a view to preparing an appropriate divestment strategy.

Poverty Reduction

37. **The I-ANDS prepared in consultation with donors and the civil society places priority on: (a) security; (b) governance, rule of law, and human rights; and (c) economic and social development**. It also identifies the elimination of the narcotics industry as a vital and cross-cutting priority, includes sectoral strategies that outline objectives and constraints, and provides rough estimates of resource needs. The government and the donor community have developed a "Compact" that establishes commitments, benchmarks, and a monitoring mechanism to support the delivery of the development strategy.

Statistical Issues and Technical Assistance

38. **Notwithstanding recent progress, a number of statistical weaknesses remain**. The authorities are seeking assistance to improve the quality and coverage of the national accounts and CPI estimates, as well as the reliability of monetary and balance of payments data. An ongoing survey on recorded trade, which should be completed by March 2006, will improve the estimates of overall trade flows. Efforts are also being made to develop social statistics and conduct a population census in support of work on the PRSP. Lastly, DAB will coordinate closely with the MoF to improve the quality of external debt data.

39. **The authorities decided to delay the completion of their assessment of technical assistance (TA) until after the International Donors' Conference.** This assessment will help identify the country's main human capacity constraints and TA needs. It should also contribute to improving disbursement rates and the cost-efficiency of available resources, in line with the priorities set in the I-ANDS. Key areas of possible future Fund TA include tax and customs administration and policy, public expenditure management, legal assistance in

the fiscal area (including provisions for extractive industries), banking supervision and liquidity management, financial markets legislation, and statistics.

Program Monitoring

40. **Program implementation will continue to be guided by the definitions, data sources, and frequency set out in the Technical Memorandum of Understanding (TMU)**. The tables attached to the Memorandum of Economic and Financial Policies establish quantitative indicators (Table 1) and structural benchmarks (Table 2) through end-September 2006. Fund staff will be notified prior to the introduction of any policy actions and developments that might affect the program. The SMP will continue to be in effect unless a successor program is approved by the Executive Board before end-September 2006.

B. Medium-Term Outlook and Reform Strategy

41. **Afghanistan's medium-term prospects are broadly favorable.** Based on preliminary projections, growth is expected to be around 10 percent a year over the medium-term. Agricultural growth is expected to return to its historical trend, while telecommunications, transport, and trade would continue to expand at a strong pace. Construction activity would increase steadily, albeit more slowly than in recent years. Further growth prospects are predicated on the emergence of new economic activities, assuming increased efficiency in the public sector, the design of an appropriate regulatory framework for private sector activity, and improvements in human capital and infrastructure. In the context of the I-ANDS, the authorities have identified four sectors that could enhance the country's growth and exports prospects: (a) agriculture and rural industry; (b) leasing of state assets (land and buildings); (c) mining and extractive industries; and (d) regional trade and transit. Assuming continued sound monetary and fiscal polices, inflation is expected to decline further, to about 8 percent by end-2006/07, and to 5 percent a year thereafter.

42. **These projections are based on the assumption of a gradual fall in opium production.** A sharper decline in opium production could, at least temporarily, affect adversely the real sector (GDP growth would fall due to an income-induced decline in the demand for licit goods), and the balance of payments. However, the impact on the real sector might not be pronounced because the larger decline in income would fall on traffickers, who have a lower propensity to consume. Similarly, both the high level of drug-related capital outflows and the large import content associated with drug-related consumption could moderate the effect on the balance of payments.

43. **Fiscal consolidation and continued substantial donor support are required over the medium term.** The MTFF provides a good basis for medium-term fiscal consolidation and sustainability. However, it needs to be strengthened in order to ensure (a) a significant increase in revenue from its low level; (b) the implementation of a civil service reform program to contain the wage bill and pensions to affordable levels; and (c) a gradual consolidation of fiscal operations within the core budget. Based on the current reform programs, it should be possible for revenues (excluding grants) to cover the rising nominal

wage bill by 2006/07, and the entire operating budget, as currently defined, within four years. Nonetheless, reliance on external funding will remain significant, even for basic activities such as the Afghan National Army and health expenditures (see Box 1).

44. **The MTFF includes an ambitious program to increase tax revenue.**[10] Revenue is projected to rise from 4.5 percent of GDP in 2004/05 to 8.6 percent by 2009/10, through: (a) rationalization of the current tariff structure and introduction of road tolls and excises in 2006/2007; (b) implementation of the taxes introduced in 2005/06; and (c) strengthened compliance facilitated by administrative reforms, including through the operations of the large taxpayer unit. Tax simplification to remove the plethora of small nuisance taxes and procedures will continue over the medium-term, and the authorities intend to gradually transform the turnover tax into a more efficient consumption-based tax. As noted earlier, during the discussions, the authorities also raised the possibility of an increase in import tariffs, with a view to increasing revenue while protecting the domestic industries. Staff cautioned strongly against such an approach, emphasizing that protectionist measures would send a wrong signal to potential investors while raising the prices of domestic goods often needed by the poor. Instead, staff recommended giving consideration to introducing excise taxes on a group of items.

45. **The primary medium-term objective of monetary policy will continue to be the reduction of inflation to single-digit levels.** Accordingly, with Fund assistance, the authorities intend to: (a) strengthen DAB's implementation capacity through new monetary instruments and the deepening of financial markets; (b) increase DAB's policy formulation capacity by developing its analytical tools and improving monetary statistics; and (c) better manage public expectations through greater transparency. Once these building blocks are in place, the authorities intend to begin targeting a broader monetary aggregate. The authorities will also proceed with the planned restructuring of the public banks to improve their operational efficiency and maximize shareholder value. More generally, they will aim at creating an enabling environment for bank lending.

46. **The pace of reconstruction and structural changes will continue to influence the balance of payments**. A decline in imports relative to GDP, stemming from a progressive reduction in aid and gradual import substitution, would contribute to a steady decline in the current account deficit, excluding grants, to around 29 percent of GDP by 2008/09. While largely offset by a reduction in grant financing, this improvement in the current account, together with an increase in FDI, would contribute to maintaining a strong reserve position.

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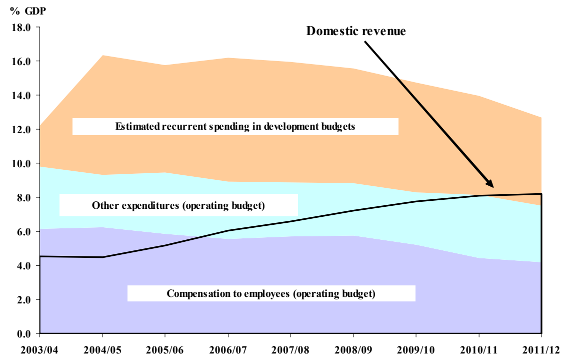
[10] In late October 2005, the MoF organized a revenue conference with the private sector and the international community to discuss both policy and administrative issues. Several working groups were established to address the issues raised during the conference.

Box 1. Achieving Fiscal Sustainability [1/]

Government operating expenditure and revenue projections to 2011/12
(in percent of GDP)



Sources: Government of Afghanistan;World Bank; and Fund staff projections.

Substantial external assistance will be required to fund Afghanistan's operating expenditures for many years. The overall fiscal deficit (excluding grants) is large and predominantly funded by external grants (Tables 3a and 3b). A large part of spending, including recurrent spending, in key areas such as security, counternarcotics, elections, and infrastructure, is undertaken directly by donors through the external budget. Eventually, the recurrent costs of these activities, including military salaries and infrastructure maintenance, will have to be included in the government's core budget. The attached chart presents a conservative projection of total recurrent expenditures in the operating and development/external budgets and domestic revenue mobilization. [2/]

A strong increase in revenue is needed to move towards fiscal sustainability. Although revenue mobilization has increased rapidly in the last few years, meeting the government's revenue target of 8.6 percent of GDP by 2009/10 will require a sustained effort to rebuild administrative capacity, with a focus on the new large taxpayer unit and customs, and a gradual move toward a coherent policy framework placing lesser reliance on trade taxes.

A first step toward fiscal sustainability would be the ability to fund recurrent expenditures from tax revenue. So far, the government has demonstrated its commitment to pursuing a prudent fiscal policy based on the funding of operating expenditures from tax revenue and grants. Expenditure restraint will have to remain a priority if the government is to achieve its medium-term objectives of using only revenue to fully fund the wage bill by 2006/07 and all other expenditures currently included in the operating budget by 2010/11. This leaves little room for a substantial pay restructuring and a significant increase in staff numbers. Also, given the expected borrowing constraints, other recurrent expenditures currently outside the operating budget will need to be funded by foreign grants (around $900 million per year).

Expenditure should be consolidated within a realistic MTFF. The MTFF should be used to articulate the path towards fiscal sustainability by elaborating strategies for domestic revenue mobilization and public service reform, and developing detailed sectoral policies consistent with the I-ANDS and future operating and maintenance costs. To assist the planning process and improve transparency, donors are being encouraged to channel their resources through the budget, with greater multi-year predictability.

1/ This box draws on discussions and information supplied by the authorities and World Bank staff during the development of the I-ANDS.

2/ Significant recurrent costs are currently funded by donors in the core development and external budgets, such as: the Afghan National Army; health costs; non-salary education costs; transfers under the National Solidarity Program; and costs related to the elections. The projections do not include possible increases in pensions following the recent Supreme Court ruling.

47. **Afghanistan's currency appreciated by about 20 percent in real effective terms over the 30 months ended in September 2005.** To a large extent, this real appreciation results from "Dutch disease" stemming from drug- and aid-related inflows. In addition, relatively high production costs reflect the difficult security situation, cumbersome business practices, and poor infrastructure. The authorities concurred with the staff that in Afghanistan's present context, there is little that financial policies can do to improve external competitiveness. Rather, strengthening competitiveness will require strong efforts to increase efficiency in utilizing external aid, as well as the determined implementation of structural reforms to increase productivity, including by lowering the cost of doing business. Of course, better security conditions would help improve the business climate and unlock investment opportunities.

48. **The authorities concurred with the main findings of the debt sustainability analysis conducted by the staff (Appendix V).** While emphasizing that Afghanistan's medium-term program cannot be financed solely by grants, they indicated that highly concessional borrowing was key to achieving external sustainability. In addition, the government will continue to seek generous debt relief from official bilateral creditors and to pursue good faith efforts to complete the debt reconciliation process with all creditors. In this connection, the authorities have recently intensified their contacts with Russia, Afghanistan's largest creditor, and remain confident that substantial progress can be achieved over the coming months toward the resolution of outstanding claims.[11]

IV. Staff Appraisal

49. **Economic developments in Afghanistan have remained generally favorable, and the SMP has contributed to improving macroeconomic management and making headway in the structural area**. At the same time, the country has made significant strides in its political stabilization efforts, as evidenced by the recent legislative and provincial elections. Still, Afghanistan faces formidable challenges, and its medium-term outlook is subject to the risks and uncertainties typical of a post-conflict environment. In particular, there is a need to consolidate macroeconomic stability, diversify the sources of growth, achieve fiscal and external sustainability, address institutional and structural obstacles to private sector development, and gradually eliminate opium-related activities. Addressing these challenges will require formidable coordinated efforts on the part of the government, the private sector, and the donor community for several years.

50. **Fiscal policy should remain cautious over the medium term to ensure macroeconomic stability and maintain external imbalances at sustainable levels.** New revenue measures and decisive efforts to strengthen the limited administrative capacity of the revenue directorate, including by targeting large taxpayers, are needed to achieve the

[11]The governments of Russia, Germany, and the United States have indicated their intention to cancel all of the debt owed by Afghanistan through the Paris Club under the HIPC Initiative. Further details will be included in the staff statement to the Executive Board.

objectives of the MTFF. In particular, the introduction of excises on certain consumption items and continued implementation of the current reform plan for the customs and tax administrations are of critical importance. The staff would caution strongly against raising import tariffs, introducing ad-hoc duty exceptions, or reducing tax rates.

51. **Affordable public administration reform is a major challenge.** Government policy to date has been to maintain the size of the civil service, except for the recruitment of more teachers, while enhancing its productivity through capacity building and higher salaries to recruit and retain qualified professional staff. In the medium term, a more systematic reform program is required to strike a better balance between the need for higher salaries and budgetary considerations. Furthermore, linking pensions to salary increases would constitute a costly and counterproductive policy shift that could jeopardize medium-term fiscal sustainability.

52. **The MTFF needs to be progressively refined to closely link multi-year projections with policies, notably those aimed at wage reform, while ensuring proper maintenance of development budget investments.** Also, critical fiscal activities presently funded off-budget by donors, such as the military, should be progressively incorporated in the MTFF in order to increase transparency and better estimate the government's significant long-term financing needs.

53. **Monetary developments should be monitored closely, and the authorities should stand ready to tighten monetary conditions as needed to achieve the targeted reduction in inflation.** The modernization of the current monetary framework will contribute to strengthening DAB's control on overall liquidity in the context of a developing financial sector. In this connection, the authorities' intention to remunerate required reserves and introduce a collaterized credit facility and capital notes of longer maturities are steps in the right direction. Looking forward, further efforts are necessary to develop DAB's analytical capacity and enhance the transparency of monetary management.

54. **The present managed float system has been working well and should be maintained.** The real appreciation experienced by the Afghani in recent years reflects, to a large extent, the impact of opium- and aid-related inflows. In this context, strengthening competitiveness requires enhancing efficiency in the utilization of foreign aid as well as a deepening of structural reforms to increase productivity, including by lowering the cost of doing business.

55. **The authorities must persevere in their efforts to build a resilient banking system.** In this regard, it is essential to adhere strictly to the work programs for the restructuring of state-owned banks and to speed up the adoption of an appropriate legal and administrative framework for the development of private financial institutions.

56. **A vigorous implementation of structural reforms is critical to promote private sector-led growth**. The authorities must continue to strengthen the legal and regulatory environment for private sector activities, focusing on financial and business regulations and increased transparency. Also, priority should be given to further reducing government

involvement in the economy, including by pressing ahead decisively with the divesture of SOEs and reducing interference by public entities and government agencies not covered by the current SOEs law. Direct intervention in the agricultural sector through price controls should be avoided. More generally, the business environment could be improved by enhancing the consistency and predictability of government policies.

57. **The I-ANDS is an important step forward in defining the government's medium-term development strategy.** The authorities are encouraged to broaden the participatory process as they move toward a PRSP. The main challenge will be to turn the large number of proposals in the I-ANDS into a coherent and fully sustainable set of medium-term programs and policies.

58. **Continued efforts are needed to eliminate the opium economy.** With the cooperation of the donor community, the government should implement vigorously the programs aimed at reducing the cultivated area and putting in place sustainable income generation activities in support of the eradication, interdiction and prevention campaigns. This would pave the way for a decline in drug activities and would create the conditions for improved security and governance.

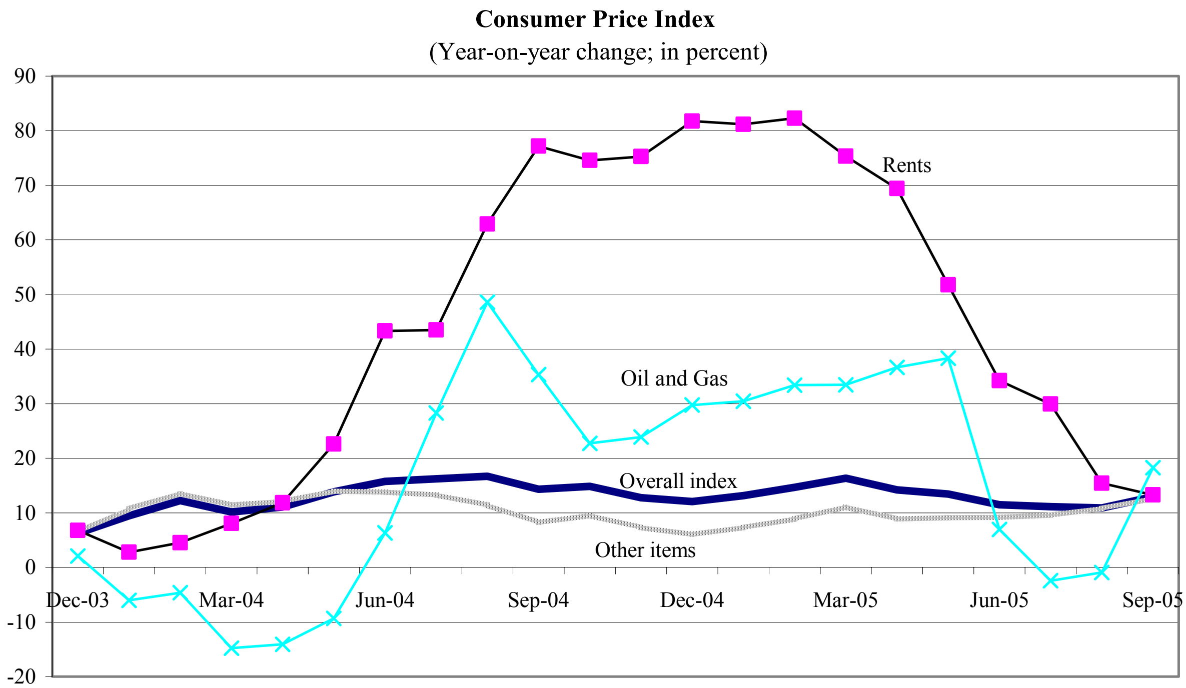
59. **Further determined efforts are required to address a number of statistical deficiencies.** Particular attention should be given to improving the quality and coverage of the national accounts and CPI estimates, as well as the reliability of the monetary and balance of payments data, with donor assistance. The recent approval of a new statistical law is a welcome step that should contribute to a successful implementation of the statistical master plan.

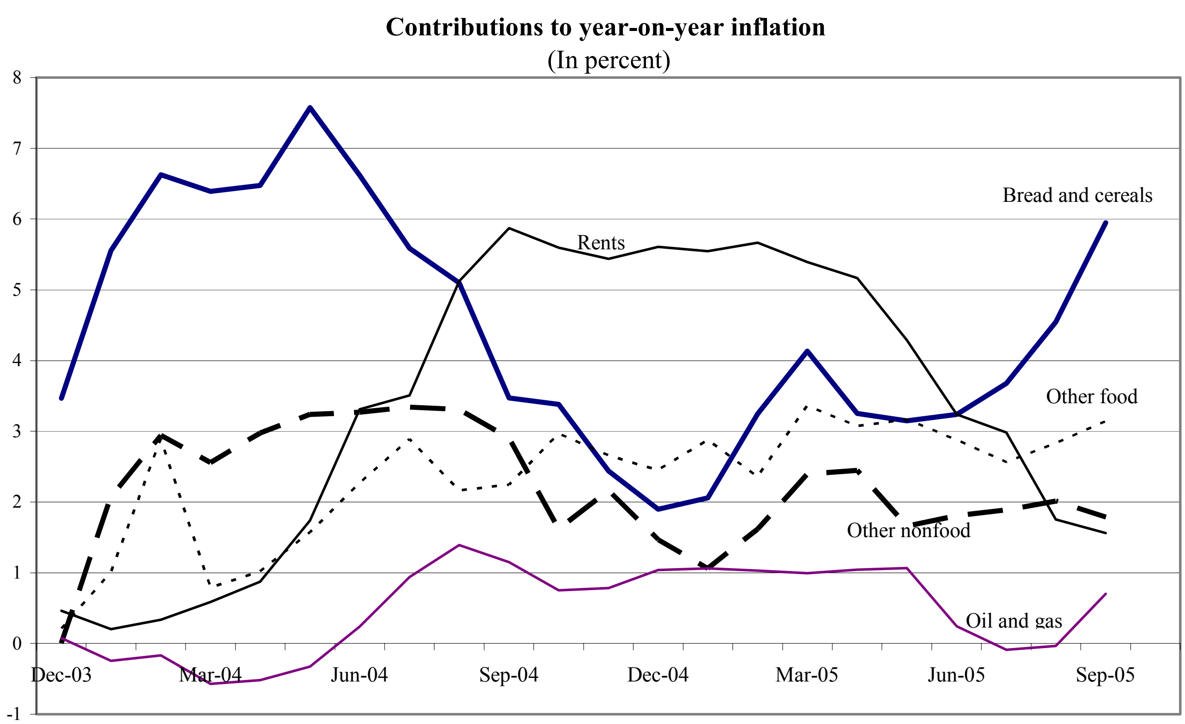
60. **The program is subject to a number of risks.** In particular, insufficient progress in improving security and strengthening government control over the provinces could slow down the reform process. Political pressures could also delay the implementation of reforms, notably in the fiscal area, and limit the authorities' capacity to meet the program's objectives. Lastly, the fight against opium-related activities could have disruptive effects on the security situation.

61. **The current SMP has been instrumental in maintaining macroeconomic stability and building a momentum for structural reform, and the authorities have continued to implement it satisfactorily.** Accordingly, staff support the authorities' request for completion of the sixth review. Staff is of the view that a successor program that could be supported by a PRGF arrangement would help the authorities consolidate the gains that have been made under the SMP, and would provide a suitable framework for the continued implementation of their ambitious reform agenda.

62. It is proposed that the next Article IV consultation with Afghanistan take place on the standard 12-month cycle.

Figure 1. Islamic Republic of Afghanistan: Price Developments, 2003–2005 1/

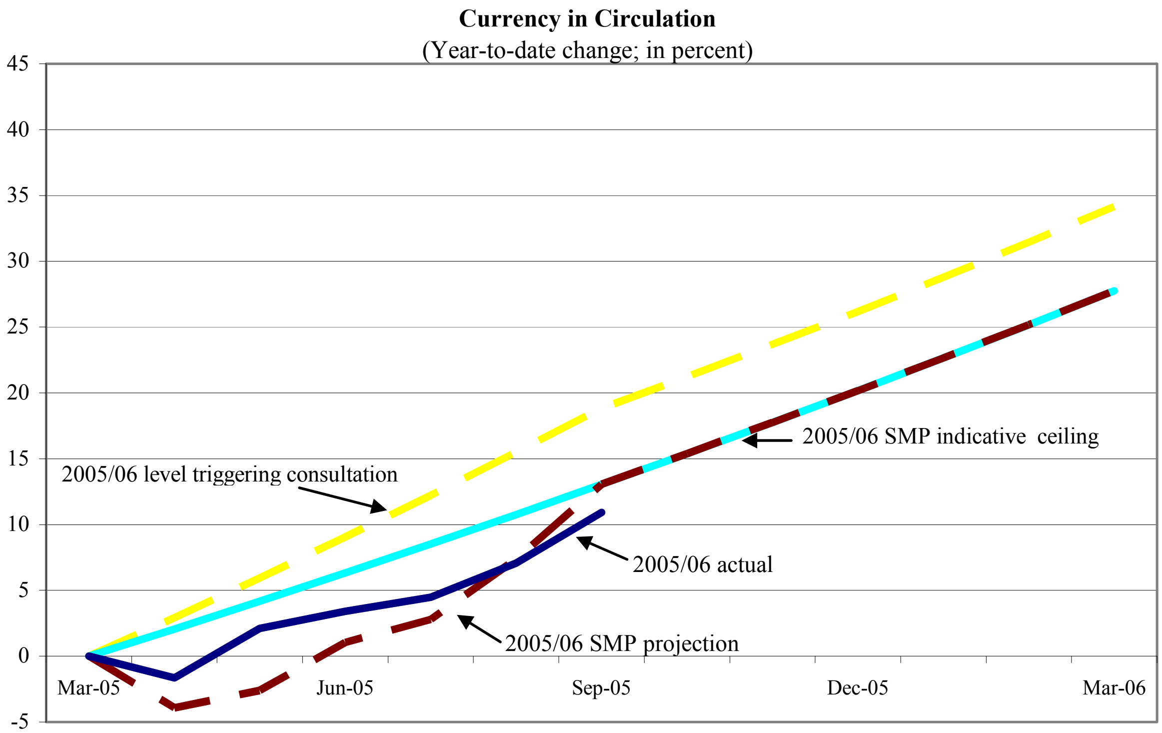


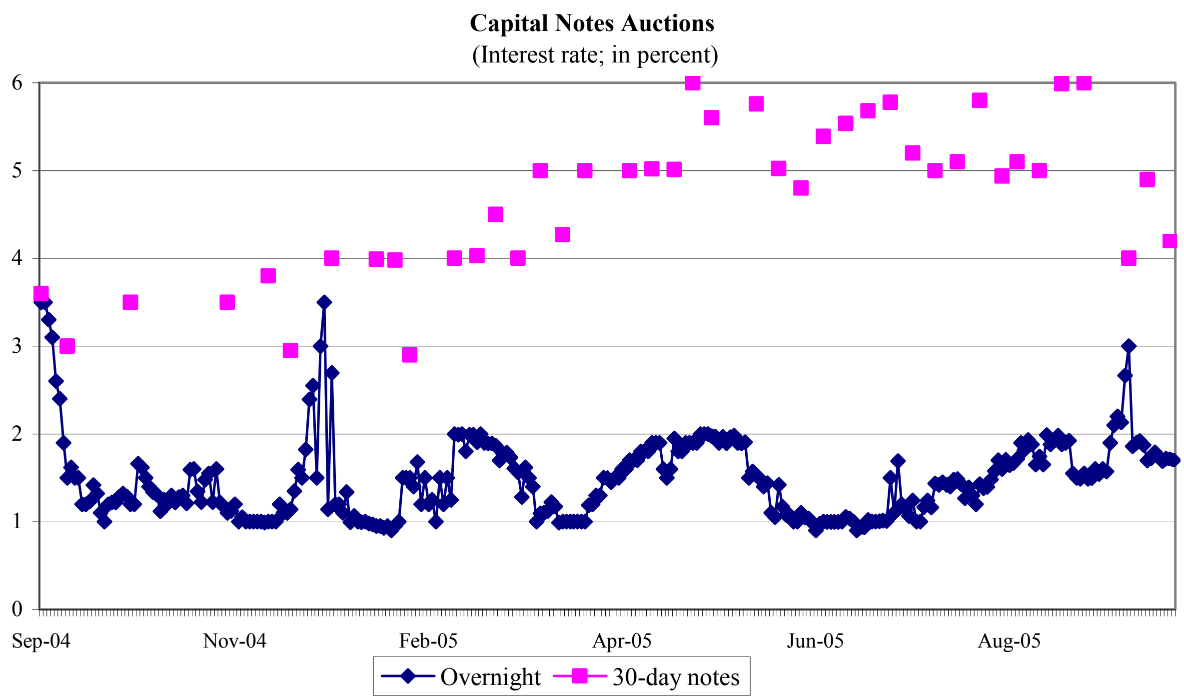


Sources: Central Statistics Office of Afghanistan; and Fund staff estimates.

1/ Last observation: September 2005.

Figure 2. Islamic Republic of Afghanistan: Monetary Developments, 2003–05 1/



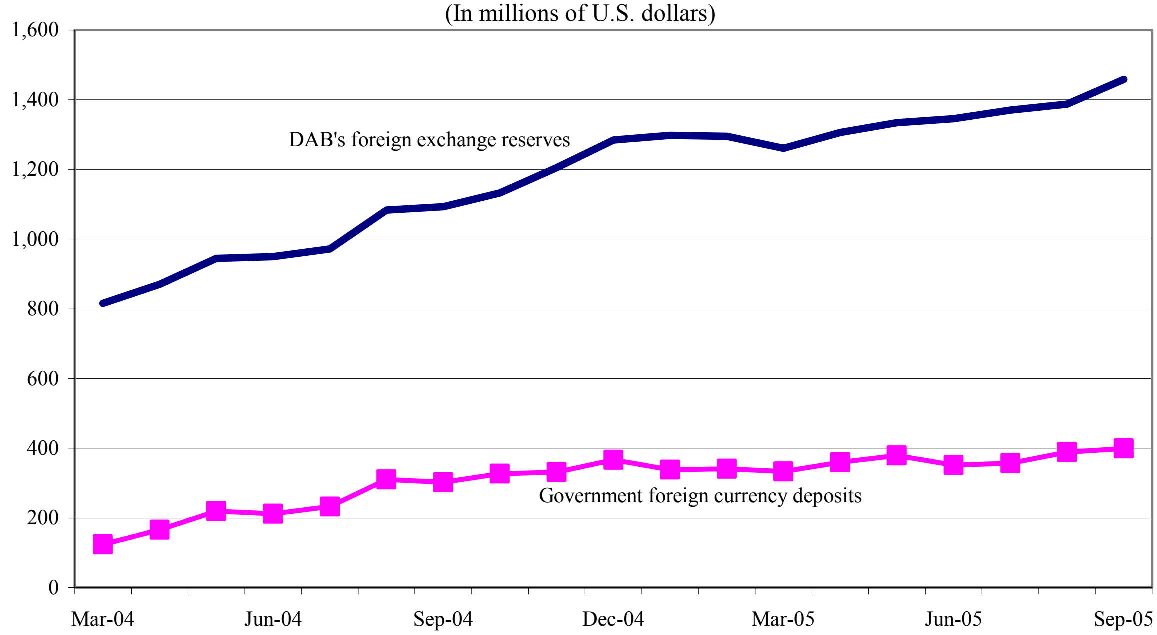


Sources: Da Afghanistan Bank; and Fund staff estimates and projections.

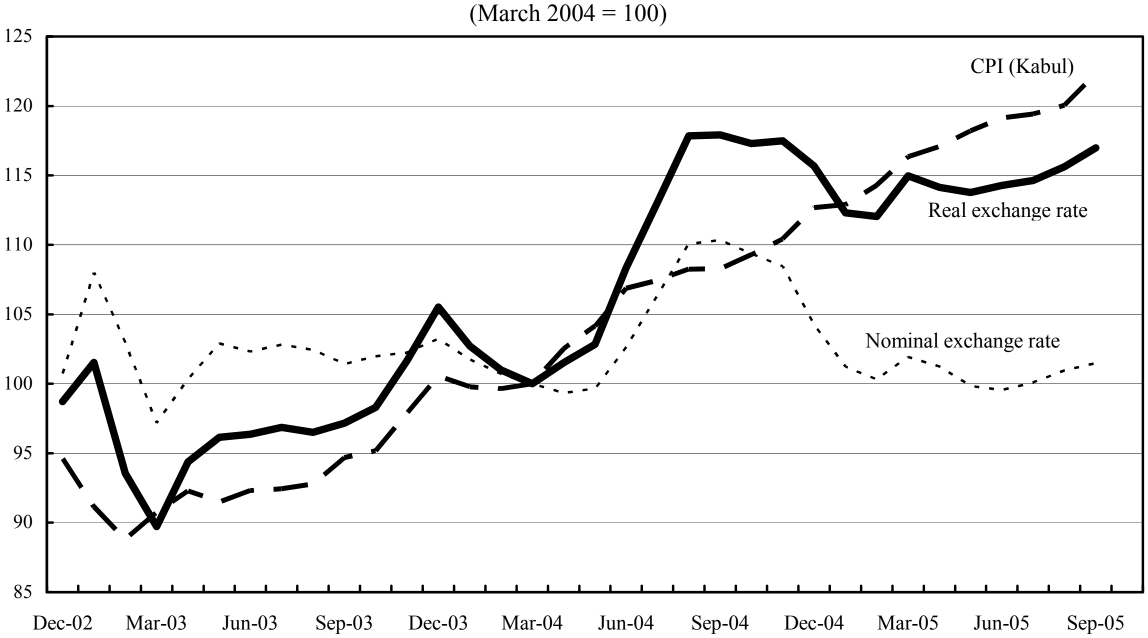
1/ Last observation: September 30, 2005.

Figure 3. Islamic Republic of Afghanistan: Foreign Exchange Reserves and Real Exchange Rate, 2003–05 1/

DAB's Foreign Exchange Reserves and Government Foreign Currency Deposits
(In millions of U.S. dollars)



Price and Exchange Rate Indices 2/
(March 2004 = 100)



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

1/ Last observation: September 2005.
2/ An increase in the exchange rate indices corresponds to an appreciation. The real exchange rate is estimated using the U.S. and Afghan CPIs.

Table 1. Islamic Republic of Afghanistan: Selected Economic Indicators, 2001/02–2006/07
(Quota: SDR 161.9 million)
(Population: 21.8 million; 2002/03)
(Per capita GDP: US$253; 2004/05)
(Poverty rate: n.a)
(Main export: carpets, US$156 million; 2003/04)

	Est. 2001/02	Est. 2002/03	Est. 2003/04	Est. 2004/05	Proj. 2005/06	Proj. 2006/07
	(Annual percentage change)					
Output and prices						
Real GDP (at market prices)	...	28.6	15.7	8.0	13.8	11.7
Consumer prices (end of period)	-43.4	52.1	10.2	16.3	10.0	8.0
Consumer prices (period average)	...	5.0	23.9	14.3	12.0	8.9
	(In percent of GDP)					
Investment and saving						
Gross domestic formation	...	34.5	42.0	45.2	43.1	40.8
Of which: nongovernment	...	7.5	8.1	10.3	10.9	11.4
Gross national savings	...	1.1	-8.9	0.3	0.7	0.9
Of which: nongovernment	...	5.7	-4.4	4.9	4.5	4.1
	(In percent of GDP)					
Public finances 1/						
Revenue (including grants)	...	8.4	9.0	9.8	10.0	9.2
Expenditure	...	8.5	9.8	9.4	9.4	8.9
Budget balance (including grants)	...	-0.1	-0.8	0.4	0.6	0.4
Primary balance (including grants)	...	-0.1	-0.8	0.4	0.6	0.4
Total government debt 2/	...	13.1	13.5	12.5	...	...
	(Annual percentage change; unless otherwise indicated)					
Monetary sector						
Credit to the private sector	...	...	...	...	...	...
Base money	...	20.1	40.9	37.5	27.8	22.5
Broad money	...	20.1	40.9	37.5	27.8	22.5
Velocity of broad money	...	8.8	7.8	7.3	7.2	7.1
One-month capital note interest rate (end-period, in percent)	...	...	...	4.27	...	...
	(In percent of GDP; unless otherwise indicated)					
External sector						
Exports of goods (in U.S. dollars, percentage change) 3/	...	...	36.1	25.0	20.1	20.6
Imports of goods (in U.S. dollars, percentage change) 3/	...	...	51.8	18.2	14.9	15.1
Merchandise trade balance	...	-29.8	-41.3	-37.0	-35.2	-33.3
Current account balance, excluding official transfers	...	-33.4	-50.9	-44.8	-42.4	-39.9
Current account balance, including official transfers	...	-3.5	3.1	1.9	1.7	-0.9
Foreign direct investment	...	1.2	1.3	3.1	3.5	4.2
Total external debt 2/	...	13.1	13.5	12.5	...	...
Gross reserves (in millions of U.S. dollars)	...	426	816	1,261	1,730	2,119
In months of next year imports of goods and services 3/	...	1.8	3.4	4.0	4.8	5.8
In percent of short-term external debt (on remaining maturity basis)	...	...	...	...	...	...
Memorandum items:						
Nominal GDP (excluding opium production; in millions of U.S. dollars)	2,463	4,084	4,585	5,971	7,139	8,608
Opium production (in millions of U.S. dollars)	...	2,540	2,300	2,800	2,700	...
Unemployment rate (in percent)	...	...	...	...	...	...
Net imports of petroleum products (in millions of U.S. dollars)	...	13	24	77	...	...
Afghanis per U.S. dollar (period average)	54.4	44.8	49.0	47.7	...	...
Real exchange rate (annual average, percentage change) 4/	...	21.0	12.2	14.9	...	...
Stock market index	...	...	...	...	...	...

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

1/ Operating budget. Does not include externally-financed development expenditures, which amounted to 40 percent of GDP in 2004/05.
2/ Includes unreconciled debts. Excludes Russian claims.
3/ Excluding reexports.
4/ An increase in the exchange rate indices corresponds to an appreciation. The real exchange rate is estimated using the U.S. and Afghan CPIs.

Table 2. Islamic Republic of Aghanistan: Savings-Investment Balances, 2002/03–2007/08

	2002/03		2003/04		2004/05		2005/06		2006/07		2007/08	
	Est.	Rev. Est.	Est.	Rev. Est.	Est. Fifth Rev.	Est. Sixth Rev.	Est. Fifth Rev.	Est. Sixth Rev.	Est. Fifth Rev.	Est. Sixth Rev.	Est. Fifth Rev.	Est. Sixth Rev.
	(In millions of U.S. dollars)											
Domestic expenditures	5,447	5,447	6,919	6,919	8,658	8,647	10,326	10,165	11,976	12,045	13,036	13,380
Consumption	4,293	4,038	5,305	4,992	6,339	5,951	7,432	7,087	8,857	8,534	10,294	9,950
Public 1/	318	318	429	429	546	546	661	640	729	778	826	903
Private 2/	3,975	3,720	4,875	4,562	5,793	5,405	6,771	6,447	8,128	7,756	9,468	9,047
Gross fixed capital formation	1,154	1,409	1,615	1,928	2,319	2,696	2,893	3,078	3,119	3,511	2,742	3,429
Public	1,104	1,104	1,557	1,557	2,082	2,082	2,331	2,298	2,433	2,526	1,931	2,307
Private 3/	50	305	58	371	237	614	562	780	686	985	811	1,122
Net exports of goods and services	-1,364	-1,364	-2,335	-2,335	-2,688	-2,676	-3,196	-3,026	-3,415	-3,437	-3,086	-3,381
Exports of goods and services (excluding reexports)	328	328	482	482	564	564	685	686	825	829	956	960
Imports of goods and services (excluding reexports)	-1,691	-1,691	-2,817	-2,817	-3,251	-3,239	-3,881	-3,712	-4,240	-4,266	-4,042	-4,341
Domestic savings	-210	45	-720	-407	-369	20	-303	53	-296	74	-343	49
Public savings	-187	-187	-203	-203	-251	-273	-246	-266	-234	-275	-249	-279
Private savings	-23	232	-517	-204	-118	293	-57	319	-61	349	-94	328
GDP at market prices	4,084	4,084	4,585	4,585	5,971	5,971	7,130	7,139	8,562	8,608	9,951	9,999
	(In percent of GDP)											
Domestic expenditures	133.4	133.4	150.9	150.9	145.0	144.8	144.8	142.4	139.9	139.9	131.0	133.8
Consumption	105.1	98.9	115.7	108.9	106.2	99.7	104.2	99.3	103.5	99.1	103.4	99.5
Public	7.8	7.8	9.4	9.4	9.1	9.1	9.3	9.0	8.5	9.0	8.3	9.0
Private	97.3	91.1	106.3	99.5	97.0	90.5	95.0	90.3	94.9	90.1	95.2	90.5
Gross fixed capital formation	28.3	34.5	35.2	42.0	38.8	45.2	40.6	43.1	36.4	40.8	27.6	34.3
Public	27.0	27.0	34.0	34.0	34.9	34.9	32.7	32.2	28.4	29.3	19.4	23.1
Private	1.2	7.5	1.3	8.1	4.0	10.3	7.9	10.9	8.0	11.4	8.2	11.2
Net exports of goods and services	-33.4	-33.4	-50.9	-50.9	-45.0	-44.8	-44.8	-42.4	-39.9	-39.9	-31.0	-33.8
Exports of goods and services (excluding reexports)	8.0	8.0	10.5	10.5	9.4	9.4	9.6	9.6	9.6	9.6	9.6	9.6
Imports of goods and services (excluding reexports)	-41.4	-41.4	-61.4	-61.4	-54.4	-54.3	-54.4	-52.0	-49.5	-49.6	-40.6	-43.4
Domestic savings	-5.1	1.1	-15.7	-8.9	-6.2	0.3	-4.2	0.7	-3.5	0.9	-3.4	0.5
Public savings	-4.6	-4.6	-4.4	-4.4	-4.2	-4.6	-3.4	-3.7	-2.7	-3.2	-2.5	-2.8
Private savings	-0.6	5.7	-11.3	-4.4	-2.0	4.9	-0.8	4.5	-0.7	4.1	-0.9	3.3
Memorandum items:												
Real GDP growth (annual percentage change)	28.6	28.6	15.7	15.7	8.0	8.0	13.6	13.8	11.2	11.7	10.7	10.6
Nominal GDP growth (annual percentage change)	33.8	33.8	23.1	23.1	26.4	26.4	24.9	25.1	20.1	20.6	16.2	16.2
Sectoral shares of GDP (in percent)												
Agriculture	49.8	49.8	48.5	48.5	37.2	37.2	36.1	36.1	34.3	34.3	33.5	33.5
Industry	20.1	20.1	21.3	21.3	24.4	24.4	24.8	24.8	24.7	24.7	25.1	25.1
Services	30.1	30.1	30.2	30.2	38.3	38.3	39.2	39.2	41.0	41.0	41.4	41.4
GDP per capita (in U.S. dollars)	182	182	199	199	253	253	294	294	344	344	388	388
Domestic government revenue (in percent of GDP)	3.2	3.2	4.5	4.5	4.5	4.5	5.2	5.3	5.2	6.0	5.5	6.4

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

1/ Data originating from the fiscal accounts.
2/ Determined as a residual.
3/ Equivalent to foreign direct investment reported in the balance of payments, and some new private investment.

Table 3a. Islamic Republic of Afghanistan: Core Budget, 2003/04–2008/09

	Est. 2003/04	H1 Est. 2004/05	Est. 2004/05	Revised MYR 1/ 2005/06	YTD Prov. 2005/06	Proj. 2/ 2005/06	Proj. 2/ 2006/07	Proj. 2/ 2007/08	Proj. 2/ 2008/09
				(In millions of Afghanis)					
Domestic revenue	**10,168**	**5,947**	**12,800**	**18,735**	**8,752**	**18,776**	**25,864**	**31,970**	**39,835**
Tax revenues	6,262	4,488	9,546	13,128	5,670	12,705	19,717	24,212	30,257
Taxes on income, profits and capital gains	363	544	995	3,789	428	1,738	3,345	5,654	7,059
Taxes on international trade and transactions	5,369	3,254	7,247	8,917	4,573	9,323	14,347	15,635	19,155
Other taxes	531	691	1,304	422	669	1,643	2,025	2,923	4,043
Non tax revenues	3,906	1,458	3,254	5,607	3,082	6,072	6,147	7,759	9,578
Donor assistance grants (to operating budget)	**10,074**	**3,858**	**14,984**	**16,878**	**8,588**	**16,878**	**13,733**	**12,122**	**10,248**
ARTF (recurrent window)	8,182	3,372	12,319	13,580	7,257	13,580	10,580	10,062	9,080
LOTFA	1,892	404	2,583	3,298	1,331	3,298	3,153	2,060	1,168
Other grants		83	83	0	0	0	0	0	0
Donor assistance grants (core development budget)	**4,569**	**2,831**	**8,250**	**29,013**	**8,008**	**20,019**	**32,506**	**36,044**	**39,145**
Total core budget expenditure	**31,606**	**15,499**	**39,550**	**83,666**	**23,586**	**55,865**	**70,860**	**81,692**	**95,575**
Operating expenditure	**22,151**	**12,019**	**26,716**	**33,601**	**14,680**	**33,601**	**38,043**	**44,092**	**50,643**
Wages and salaries	14,660	8,245	18,902	20,788	9,347	20,972	23,918	28,364	33,117
Purchase of goods and services	4,653	2,064	4,182	6,609	3,233	6,609	7,357	8,245	9,244
Transfers and Subsidies	652	314	764	2,293	0	2,109	2,478	2,813	3,186
Pensions	177	469	889	1,659	782	1,659	1,742	1,829	1,920
Capital expenditure	2,009	927	1,979	1,847	1,222	1,847	2,132	2,421	2,750
Interest				404	96	404	415	420	425
Core budget development spending 3/	**9,455**	**3,481**	**12,834**	**50,066**	**8,906**	**22,265**	**32,818**	**37,600**	**44,933**
National programs	**3,339**	**3,225**	**12,070**	**44,351**	**8,228**	**20,571**	**29,120**	**33,488**	**40,186**
1.4 Livelihoods and Social Protection	159	179	560	13,585	3,997	9,992	16,533	19,013	22,816
1.5 Culture, Media, Sport	0	0	0	284	3	7	106	122	147
2.1 Transport	75	659	2,173	9,893	1,982	4,954	4,508	5,184	6,221
2.2 Energy, Mining, and Telecommunications	852	258	932	7,992	931	2,329	2,113	2,430	2,916
2.3 Natural Resources Management	449	1,987	4,609	2,775	21	53	54	62	75
2.4 Urban Management	394	0	0	2,253	274	684	1,161	1,336	1,603
3.1 Trade and Investment	95	0	0	386	3	7	12	14	17
3.2 Public Administration and Economic Management	598	46	61	4,629	758	1,896	3,490	4,014	4,817
3.3 Justice	0	80	2,581	41	2	4	30	34	41
3.4 National Police, Law Enforcement and Stabilization	319	16	1,153	2,512	258	644	1,112	1,279	1,535
3.5 Afghan National Army	399	**0**	0	0	0	0	0	0	0
National priority programs	**6,115**	**256**	**765**	**5,715**	**678**	**1,694**	**3,697**	**4,111**	**4,746**
Education and Vocational Training	289	47	172	3,147	243	608	1,003	1,154	1,385
Health and Nutrition	508	209	579	1,583	421	1,052	1,747	2,009	2,411
Other programs	5,318	0	13	985	14	34	947	949	951
Operating budget balance (excluding grants)	**-11,983**	**-6,072**	**-13,916**	**-14,866**	**-5,929**	**-14,824**	**-12,179**	**-12,122**	**-10,808**
Operating budget balance (including grants)	**-1,910**	**-2,213**	**1,068**	**2,012**	**2,660**	**2,054**	**1,554**	**0**	**-560**
Core budget balance	**-6,795**	**-2,863**	**-3,516**	**-19,040**	**1,761**	**-192**	**1,242**	**-1,556**	**-6,348**
Float and adjustment 4/	**1,693**	**921**	**357**	**0**	**-1,630**	**0**	**0**	**0**	**0**
Sale of nonfinancial assets 5/	**0**	**0**	**0**	**3,987**	**0**	**3,987**	**0**	**0**	**0**
Financing	**5,102**	**1,942**	**3,158**	**15,054**	**-131**	**-3,795**	**-1,242**	**1,556**	**6,348**
External loans (net)	4,886	9,336	14,754	23,946	2,701	4,236	3,880	7,351	7,750
Domestic (net), *of which:*	217	-7,394	-11,596	-8,892	-2,832	-8,031	-5,122	-5,795	-1,402
Change in foreign currency deposits 6/	396	-8,912	-10,457	na	-3,313	-5,718	-3,647	na	na
Change on domestic currency deposits 6/	-179	1,518	-1,139	na	481	-2,313	-1,475	na	na
Memorandum item:									
Domestic revenue (government medium-term targets) 7/	...	...	...	...	...	18,842	28,873	34,539	43,260
External budget expenditure 8/	74,528	...	100,225	105,394	na	102,958	104,679	87,449	83,077
GDP	225,108	...	284,504	...	...	355,829	429,014	498,353	574,883
Real GDP growth rate (in percent)	15.7	...	8.0	...	...	13.8	11.7	10.6	9.9

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

1/ November 2005 supplementary budget relased following the midyear budget review (MYR).
2/ Staff projections. Operating budget expenditure is consistent with the authorities medium-term fiscal framework (MTFF) but domestic revenue, development spending and funding/financing are lower.
3/ Government program classification.
4/ Variation between the fiscal position recorded at MoF and DAB. This discrepancy is partially due to the difference ("float") between checks issued and checks cashed.
5/ For 2005/06 this includes US$80 million in revenue from the sale of telecommunications licenses.
6/ Net transfers from government deposits with DAB. A positive sign corresponds to a decline in balances and a negative sign to an increase in balances.
7/ Government revenue projections from the MTFF, which assume considerable policy changes and new measures.
8/ For 2005/06 the budget estimate includes only the funded portion of expected expenditure.

Table 3b. Islamic Republic of Afghanistan: Core Budget, 2003/04–2008/09

	Est. 2003/04	H1 Est. 2004/05	Est. 2004/05	Revised MYR 1/ 2005/06	H1 Prov. 2005/06	Proj. 2/ 2005/06	Proj. 2/ 2006/07	Proj. 2/ 2007/08	Proj. 2/ 2008/09
				(In percent of GDP)					
Domestic revenue	**4.5**	**2.1**	**4.5**	**5.3**	**2.5**	**5.3**	**6.0**	**6.4**	**6.9**
Tax revenues	2.8	1.6	3.4	3.7	1.6	3.6	4.6	4.9	5.3
Taxes on income, profits, and capital gains	0.2	0.2	0.3	1.1	0.1	0.5	0.8	1.1	1.2
Taxes on international trade and transactions	2.4	1.1	2.5	2.5	1.3	2.6	3.3	3.1	3.3
Other taxes	0.2	0.2	0.5	0.1	0.2	0.5	0.5	0.6	0.7
Non tax revenues	1.7	0.5	1.1	1.6	0.9	1.7	1.4	1.6	1.7
Donor assistance grants (to operating budget)	**4.5**	**1.4**	**5.3**	**4.7**	**2.4**	**4.7**	**3.2**	**2.4**	**1.8**
ARTF (recurrent window)	3.6	1.2	4.3	3.8	2.0	3.8	2.5	2.0	1.6
LOTFA	0.8	0.1	0.9	0.9	0.4	0.9	0.7	0.4	0.2
Other grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Donor assistance grants (core development budget)	**2.0**	**1.0**	**2.9**	**8.2**	**2.3**	**5.6**	**7.6**	**7.2**	**6.8**
Total core budget expenditure	**14.0**	**5.4**	**13.9**	**23.5**	**6.6**	**15.7**	**16.5**	**16.4**	**16.6**
Operating expenditure	**9.8**	**4.2**	**9.4**	**9.4**	**4.1**	**9.4**	**8.9**	**8.8**	**8.8**
Wages and salaries	6.5	2.9	6.6	5.8	2.6	5.9	5.6	5.7	5.8
Purchase of goods and services	2.1	0.7	1.5	1.9	0.9	1.9	1.7	1.7	1.6
Transfers and subsidies	0.3	0.1	0.3	0.6	0.0	0.6	0.6	0.6	0.6
Pensions	0.1	0.2	0.3	0.5	0.2	0.5	0.4	0.4	0.3
Capital expenditure	0.9	0.3	0.7	0.5	0.3	0.5	0.5	0.5	0.5
Interest	0.0	0.0	0.0	0.1	0.0	0.1	0.1	0.1	0.1
Core budget development spending 3/	**4.2**	**1.2**	**4.5**	**14.1**	**2.5**	**6.3**	**7.6**	**7.5**	**7.8**
National programs	**1.5**	**1.1**	**4.2**	**12.5**	**2.3**	**5.8**	**6.8**	**6.7**	**7.0**
1.4 Livelihoods and Social Protection	0.1	0.1	0.2	3.8	1.1	2.8	3.9	3.8	4.0
1.5 Culture, Media, Sport	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
2.1 Transport	0.0	0.2	0.8	2.8	0.6	1.4	1.1	1.0	1.1
2.2 Energy, Mining, and Telecommunications	0.4	0.1	0.3	2.2	0.3	0.7	0.5	0.5	0.5
2.3 Natural Resources Management	0.2	0.7	1.6	0.8	0.0	0.0	0.0	0.0	0.0
2.4 Urban Management	0.2	0.0	0.0	0.6	0.1	0.2	0.3	0.3	0.3
3.1 Trade and Investment	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.0	0.0
3.2 Public Administration and Economic Management	0.3	0.0	0.0	1.3	0.2	0.5	0.8	0.8	0.8
3.3 Justice	0.0	0.0	0.9	0.0	0.0	0.0	0.0	0.0	0.0
3.4 National Police, Law Enforcement and Stabilization	0.1	0.0	0.4	0.7	0.1	0.2	0.3	0.3	0.3
3.5 Afghan National Army	0.2	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
National priority programs	**2.7**	**0.1**	**0.3**	**1.6**	**0.2**	**0.5**	**0.9**	**0.8**	**0.8**
Education and Vocational Training	0.1	0.0	0.1	0.9	0.1	0.2	0.2	0.2	0.2
Health and Nutrition	0.2	0.1	0.2	0.4	0.1	0.3	0.4	0.4	0.4
Other programs	2.4	0.0	0.0	0.3	0.0	0.0	0.2	0.2	0.2
Operating budget balance (excluding grants)	**-5.3**	**-2.1**	**-4.9**	**-4.2**	**-1.7**	**-4.2**	**-2.8**	**-2.4**	**-1.9**
Operating budget balance (including grants)	**-0.8**	**-0.8**	**0.4**	**0.6**	**0.7**	**0.6**	**0.4**	**0.0**	**-0.1**
Core budget balance	**-3.0**	**-1.0**	**-1.2**	**-5.4**	**0.5**	**-0.1**	**0.3**	**-0.3**	**-1.1**
Float and adjustment 4/	**0.8**	**0.3**	**0.1**	**0.0**	**-0.5**	**0.0**	**0.0**	**0.0**	**0.0**
Sale of nonfinancial assets 5/	**0.0**	**0.0**	**0.0**	**1.1**	**0.0**	**1.1**	**0.0**	**0.0**	**0.0**
Financing	**2.3**	**0.7**	**1.1**	**4.2**	**0.0**	**-1.1**	**-0.3**	**0.3**	**1.1**
External loans (net)	2.2	3.3	5.2	6.7	0.8	1.2	0.9	1.5	1.3
Domestic (net), *of which:*	0.1	-2.6	-4.1	-2.5	-0.8	-2.3	-1.2	-1.2	-0.2
Change in foreign currency deposits 6/	0.2	-3.1	-3.7	na	-0.9	-1.6	-0.9	na	na
Change on domestic currency deposits 6/	-0.1	0.5	-0.4	na	0.1	-0.7	-0.3	na	na
Memorandum item:									
Domestic revenue (government medium-term targets) 7/	...	...	...	...	...	5.3	6.7	6.9	7.5
External budget expenditure 8/	33.1	0.0	35.2	29.6	na	28.9	24.4	17.5	14.5

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

1/ November 2005 supplementary budget relased following the midyear budget review (MYR).
2/ Staff projections. Operating budget expenditure is consistent with the authorities medium-term fiscal framework (MTFF) but domestic revenue, development spending and funding/financing are lower.
3/ Government program classification.
4/ Variation between the fiscal position recorded at MoF and DAB. This discrepancy is partially due to the difference ("float") between checks issued and checks cashed.
5/ For 2005/06 this includes $80 million in revenue from the sale of telecommunications licenses.
6/ Net transfers from government deposits with DAB. A positive sign corresponds to a decline in balances and a negative sign to an increase in balances.
7/ Government revenue projections from the MTFF, which assume considerable policy changes and new measures.
8/ For 2005/06 the budget estimate includes only the funded portion of expected expenditure.

Table 4. Islamic Republic of Afghanistan: Monetary Program (Da Afghanistan Bank), 2003/04–2006/07

	Est.	Est.	Est	Proj.	Est	Proj.		Proj.			
	Mar. 19	Mar. 20	Jun. 21	Sep. 22	Sep. 22	Dec. 20	Mar. 20	Jun. 21	Sep. 21	Dec. 20	Mar. 20
	2003/04	2004/05	2005/06					2006/07			
	(In millions of Afghanis)										
Net foreign assets 1/	39,199	61,612	65,724	69,640	71,834	79,650	85,445	85,438	89,440	96,173	105,124
Foreign assets	41,169	63,582	67,693	71,610	73,803	81,619	87,414	87,408	91,410	98,143	107,094
Foreign exchange reserves	40,665	62,861	67,073	70,653	72,703	80,469	86,214	86,133	90,060	96,718	105,594
Gold 1/	14,015	14,015	14,015	14,015	14,015	14,015	14,015	14,015	14,015	14,015	14,015
Other	26,650	48,846	53,058	56,638	58,687	66,454	72,199	72,118	76,045	82,703	91,579
Other foreign assets	503	721	621	957	1,101	1,150	1,200	1,275	1,350	1,425	1,500
Foreign liabilities	-1,970	-1,970	-1,970	-1,970	-1,970	-1,970	-1,970	-1,970	-1,970	-1,970	-1,970
Net domestic assets	-8,075	-20,549	-23,477	-23,796	-27,295	-30,894	-33,324	-31,894	-31,508	-35,156	-40,985
Domestic assets	6,795	-19,751	-19,576	-19,576	-22,627	-25,836	-27,782	-25,782	-24,782	-27,782	-32,904
Net claims on general government	6,795	-19,751	-19,576	-19,576	-22,627	-25,836	-27,782	-25,782	-24,782	-27,782	-32,904
Net claims on government before 2002/03	14,951	0	0	0	0	0	0	0	0	0	0
Net claims on government in 2002/3–2004/05	-8,155	-19,751	-19,576	-19,576	-22,627	-25,836	-27,782	-25,782	-24,782	-27,782	-32,904
Domestic currency deposits	-1,984	-3,123	-2,000	-2,000	-2,686	-4,188	-5,436	-4,436	-3,436	-4,936	-6,911
Foreign currency deposits	-6,171	-16,628	-17,576	-17,576	-19,941	-21,648	-22,346	-21,346	-21,346	-22,846	-25,993
Other claims	0	0	0	0	0	0	0	0	0	0	0
Other items net	-14,870	-799	-3,901	-4,220	-4,668	-5,058	-5,542	-6,113	-6,726	-7,374	-8,081
Reserve money	31,124	41,063	42,247	45,845	44,538	48,755	52,121	53,544	57,933	61,017	64,140
Currency in circulation 2/	28,801	38,763	40,084	43,820	42,997	46,585	49,521	50,678	54,799	57,617	60,640
Banknotes and coins issued	29,726	41,228	42,758	46,591	45,823	49,398	52,321	53,578	57,799	60,717	63,840
less cash holdings 2/	925	2,465	2,674	2,771	2,825	2,813	2,800	2,900	3,000	3,100	3,200
Bank deposits with DAB and capital note holdings	2,323	2,300	2,163	2,025	1,541	2,170	2,600	2,867	3,133	3,400	3,500
Memorandum items:	(In percent; unless otherwise indicated)										
Currency in circulation (year-to-date change)	...	...	3.4	13.0	10.9	20.2	27.8	2.3	10.7	16.3	22.5
Currency in circulation (year-on-year change)	40.9	37.5	35.8	27.7	25.3	28.3	27.8	26.4	25.1	23.7	22.5
Currency in circulation (SMP indicative ceiling; in millions of Afghanis)	...	...	...	43,820	...	46,585	49,521	52,093	54,799	...	...
Currency in circulation (level triggering discussions; in millions of Afghanis)	...	...	...	46,061	...	48,914	51,997	53,396	57,539	...	...
Gross international reserves (end-of-period level; in millions of U.S. dollars)	815.9	1,261.3	1,345.8	1,417.6	1,458.7	1,614.5	1,729.8	1,728.2	1,807.0	1,940.6	2,118.7
Consumer prices in Kabul (quarterly change)	-0.5	3.2	2.4	...	2.6	...	...	...	...	...	...
Consumer prices in Kabul (annual change)	10.2	16.3	11.5	...	12.9	...	10.0	...	...	...	8.0

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

1/ Foreign currency amounts converted into Afghani at the program exchange rate (49.84 per dollar in 2004/05-05/06). Gold figures do not include the gold held in the palace vaults and is valued at US$400 per ounce in 2004/05-05/06.

2/ In 2003/04–04/05, cash holdings only include cash in DAB's Treasury vaults and in DAB's six major provincial branches. In 2005/06–2006/07, they include cash in DAB's Treasury vaults and in all DAB's provincial branches.

Table 5. Islamic Republic of Afghanistan: Balance of Payments, 2002/03–2008/09

	Est. 2002/03	Est. 2003/04	Est. 2004/05	Proj. 2005/06	Proj. 2006/07	Proj. 2007/08	Proj. 2008/09
	(In millions of U.S. dollars)						
Trade balance	-1,217.6	-1,892.0	-2,210.8	-2,515.1	-2,863.2	-2,824.1	-2,904.6
Exports of goods 1/	1,290.6	1,893.9	1,656.1	1,893.3	1,968.6	1,755.3	1,861.4
Domestic exports	276.8	376.8	471.0	565.5	681.8	797.5	856.6
Reexports	1,013.9	1,517.1	1,185.1	1,327.8	1,286.8	957.8	1,004.8
Imports of goods	2,508.2	3,785.9	3,866.9	4,408.5	4,831.9	4,579.4	4,766.0
Recorded imports	1,142.3	1,688.5	1,993.1	2,328.7	2,829.7	2,900.4	3,183.5
Duty Free	840.8	1,001.0	1,203.3	1,348.0	1,323.6	1,061.7	1,088.0
Of which: Commodity food aid	94.0	40.9	107.8	0.0	0.0	0.0	0.0
Other	525.1	1,096.4	670.5	731.8	678.5	617.2	494.5
Services	-145.1	-439.3	-480.8	-542.3	-621.6	-613.5	-614.8
Receipts	50.8	105.5	92.5	120.5	146.9	162.6	180.8
Payments	195.9	544.8	573.3	662.8	768.5	776.1	795.7
Income (net)	-1.1	-3.4	15.7	31.6	47.7	56.8	64.8
Interest receipts	0.0	4.9	25.4	35.1	51.6	60.8	68.8
Interest payments 2/	1.1	8.3	9.7	3.5	3.9	4.0	4.0
Current transfers	1,221.8	2,475.9	2,787.1	3,148.5	3,361.7	3,138.4	3,057.4
Public	1,170.2	2,420.9	2,477.0	2,806.0	3,018.0	2,708.0	2,648.0
Commodity food aid	94.0	40.9	107.8	0.0	0.0	0.0	0.0
Other	1,076.2	2,380.0	2,369.2	2,806.0	3,018.0	2,708.0	2,648.0
Private 3/	51.6	55.0	310.1	342.5	343.7	430.4	409.4
Current account (including grants)	-141.9	141.2	111.1	122.7	-75.5	-242.4	-397.2
Current account (excluding grants)	-1,363.7	-2,334.7	-2,676.0	-3,025.8	-3,437.2	-3,380.8	-3,454.6
Capital and financial account	144.0	147.7	476.7	334.8	453.7	530.9	685.7
Capital account	0.0	0.0	17.6	0.0	0.0	0.0	0.0
Debt forgiveness	0.0	0.0	17.6	0.0	0.0	0.0	0.0
Financial account	144.0	147.7	459.1	334.8	453.7	530.9	685.7
Foreign direct investment	50.0	57.8	186.9	253.3	351.2	383.4	530.2
Public loans	94.0	89.9	289.8	81.5	102.5	147.5	155.5
Disbursement	100.2	96.1	296.0	85.0	106.0	151.0	159.0
Amortization paid 2/	6.2	6.2	6.2	3.5	3.5	3.5	3.5
Net errors and omissions	153.2	90.1	-99.3	0	0	0	0
Overall balance	155.3	379.0	488.5	457.8	378.0	289.0	288.8
Financing	-155.3	-379.0	-488.5	-457.8	-378.0	-289.0	-288.8
Changes in reserve assets							
Foreign exchange of the DAB	-101.0	-389.4	-499.1	-468.5	-388.9	-300.0	-300.0
Fund credit (net)	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Exceptional financing	-54.3	10.4	10.6	10.7	10.9	11.0	11.2
Arrears	-54.3	10.4	10.6	10.7	10.9	11.0	11.2
Memorandum Items:							
Official foreign exchange reserves							
In millions of U.S. dollars	426	816	1,261	1,730	2,119	2,419	2,719
In months of imports 4/	1.8	3.4	4.0	4.8	5.8	6.4	7.3
Exports of goods and nonfactor services	1,341	1,999	1,749	2,014	2,116	1,918	2,042
Imports of goods and nonfactor services	2,704	4,331	4,440	5,071	5,600	5,355	5,562
Trade balance (in percent of GDP)	-29.8	-41.3	-37.0	-35.2	-33.3	-28.2	-24.5
Current account balance (in percent of GDP)							
Including grants	-3.5	3.1	1.9	1.7	-0.9	-2.4	-3.4
Excluding grants	-33.4	-50.9	-44.8	-42.4	-39.9	-33.8	-29.1
GDP (in millions of U.S. dollars)	4,084	4,585	5,971	7,139	8,608	9,999	11,853

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

1/ Excludes opium exports, and because information is unavailable, flows associated with U.S. Army and most ISAF activities.
2/ Debt service projections are based on recognized obligations, reconciled with creditors. Arrears shown here represent an estimate by Fund staff, on the basis of loans which have been verified with creditors, but are not being serviced.
3/ Includes foreign transactions recently reported by licensed money changers.
4/ In months of imports of goods and services, excluding imports for reexports.

Table 6. Islamic Republic of Afghanistan: Millennium Development Goals, 1990–2003

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

Source: World Development Indicators database, April 2005.

Islamic Republic of Afghanistan: Relations with the Fund

(As of December 31, 2005)

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

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

III. **SDR Department**	SDR Million	% Allocation
Net cumulative allocation	26.70	100.00
Holdings	0.03	0.11

IV. **Outstanding Purchases and Loans** None

V. **Financial Arrangements** None

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

	Forthcoming				
	2006	2007	2008	2009	2010
Principal	0.00	0.00	0.00	0.00	0.00
Charges/Interest	0.81	0.81	0.81	0.81	0.81
Total	0.81	0.81	0.81	0.81	0.81

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

Nonfinancial Relations

VIII. **Exchange Arrangement**

Afghanistan is an Article XIV member country. The authorities are implementing a liberal exchange system. Based on information currently available to the staff, no exchange restrictions and multiple currency practices are currently in place. The authorities intend to formalize the current liberal regime through the adoption of new laws and regulations, for which they have asked for technical assistance from the Fund. A joint LEG/MFD mission is envisaged to take place over the next few weeks. The authorities have been implementing a managed float system with no predetermined path for the exchange rate. As of February 2, 2006, the average exchange rate on the Kabul money exchange market was Af50.36 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 (weekly for foreign exchange auctions, daily for capital note auctions).

IX. Article IV Consultation

The last Article IV consultation with Afghanistan was discussed by the Executive Board on January 19, 2005. Consultations with Afghanistan are on the standard 12-month cycle.

X. Technical Assistance, 2004–05

Department	Date	Purpose
FAD	March 2004 (ongoing)	Resident Treasury Expert
	March 22–April 3, 2004	Tax policy and administration
	April 18–May 2, 2004	Customs administration
	May 19–25, 2005	Seminar of reorganization of the MoF
	October 18–25, 2005	Tax policy
MFD	February 2–6, 2004	Anti-money laundering legislation
	March 21–30, 2004	DAB capital adequacy and balance sheet structure
	September 2004 (ongoing)	Training coordinator
	February 2–15, 2005	Implementation of DAB balance sheet reconstruction and capital adequacy recommendations
	May 16–25, 2005	Monetary Policy and Financial Markets
	October 11–20, 2005	Monetary Policy
	November 20–29, 2005	Financial Markets
LEG	February 2–6, 2004	Anti-money laundering legislation
	March 3–21, 2004	Fiscal revenue legislation
	January 29–February 12, 2005	Income Tax Law
STA	January 29–March 15, 2004	Multisector statistics
	April 19–May 3, 2004	Balance of Payments Statistics
	May 13–June 30, 2004	Multisector statistics
	May 17–29, 2004	Consumer Price Index
	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
MCD	April 16–20, 2005	Basic Macroeconomic Accounting Relationships and Introduction to Financial Programming
METAC	November 15–20, 2005	Tax policy and administration

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

A resident treasury expert for the Ministry of Finance, Mr. Platais, was appointed in March 2004.

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

During 2004, with financial support from the Sweden Technical Assistance SubAccount, the Fund sponsored a number of training activities aimed at DAB officials. A long-term training advisor, Mr. Khan, was appointed in September 2004. He is responsible for all practical matters related to the delivery of formal training to DAB staff in Kabul, as well as the coordination of training for DAB staff outside Afghanistan. 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.

XI. **Resident Representatives**

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

Islamic Republic of Afghanistan: Relations with the World Bank

(As of January 17, 2006)

1. A second **Transitional Support Strategy (TSS)** was presented to the World Bank Board of Executive Directors in March 2003. This was due to be updated by March 2005, following the culmination of the political process outlined in Bonn. Despite a successful Presidential election in October 2004, parliamentary elections in Afghanistan were not held until September 2005. This delay in the political process, coupled with the government's preparation of a National Development Strategy, slowed down the World Bank's efforts to develop a new Interim Strategy Note. The World Bank continues to assist the government under the existing TSS and is now in the process of preparing an Interim Strategy Note, in line with the government's plans for the National Development Strategy.

2. In FY 2002, World Bank staff prepared and negotiated four projects to utilize IDA grant funds for a total of $100 million. Following the clearance of Afghanistan's arrears to the World Bank and the Fund through donor contributions, the first IDA credit for $108 million for an **Emergency Transport Project** was approved by the Board in March 2003. By the end of FY 2003, three additional projects—**Emergency Health Sector Rehabilitation** ($59.6 million), **Emergency Public Administration II** ($8.4 million), and **National Emergency Employment II** ($39.2 million) were approved, bringing to $215 million the total allocation for the year.

3. Five IDA credits/grants were negotiated for FY 2004, for a total of $293 million. These programs include the **Emergency Communications Project** ($22 million), the **Emergency Customs Modernization and Trade Facilitation Project** ($31 million), the **National Solidarity Program II** ($95 million), the **Emergency Irrigation Rehabilitation Program** ($40 million), and the **Emergency Power Rehabilitation Program** ($105 million).

4. For FY 2005, six projects and two supplementals were approved, for a total of $285 million: the first budget-support operation, **Programmatic Support for Institution Building** ($80 million); the **Kabul Urban Reconstruction Project** ($25 million); the **Investment Guarantee Facility** ($5 million), together with MIGA; the **Education Quality Improvement Program** ($35 million); **Public Administration Capacity Building** ($27 million); **Strengthening Higher Education** ($40 million); and supplemental financing for the **Emergency Transport Project** ($45 million) and the **National Solidarity Program** ($28 million).

5. For FY2006, six projects are planned for a total IDA grant commitment of $267 million. To date, one program has been approved by the Board–the second budget support operation: Programmatic Support for Institution Building II ($80 million), which was approved in December 2005.

6. The World Bank also administers the **Afghanistan Reconstruction Trust Fund (ARTF)**, which became effective in May 2002 and plays a critical role in funding the recurrent costs of government. In its first year of operation (2002/03), the ARTF mobilized $185 million and disbursed $65 million. Paid-in contributions for 2003/04 amounted to $286 million, while disbursements reached $254 million. Paid-in contributions for 2004/05 amounted to $380 million, while disbursements reached $292 million. Pledges for 2005/06 have reached $470 million, with $288 million having been paid in (as of December 21, 2005). ARTF is increasing its financing of investments and has the potential to support better donor coordination, simplified processes, and fast results. Discussions are under way with donors to the ARTF to increase the focus on policy reform.

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

8. The World Bank's program is growing quickly and, as of December 2005, has an active IDA portfolio of 18 investments and two supplementals (one project has closed). Total commitments since 2001 add up to $973 million, of which $537 million are in grants. Disbursements amount to $636.5 million. A number of projects are under preparation for the remainder of the fiscal year and total commitments for FY 2005 are expected to reach $267 million, entirely in grants.

Islamic Republic of Afghanistan: Statistical Issues

General

1. The statistical system has improved since 2002; nonetheless, organizational weaknesses, poor staffing, and lack of equipment continue to hamper the compilation process. Due to security reasons and limited central government influence outside Kabul, setting up nationwide statistics has been a difficult undertaking. While the Central Statistics Office (CSO) has regional offices, staffing and communication are poor. Staffing in most agencies is inadequate both in number and expertise, and salaries remain low. Strengthening the statistical capacity is an ongoing process; greater efforts and significant institutional support will be required if further substantial improvements are to be made. STA continues to provide technical assistance through a peripatetic multisector statistics advisor as well as short-term topical missions.

2. The authorities have restructured the CSO but many key donors involved in preparing the statistical master plan (SMP) have expressed concern over the independence of the CSO, which now reports to the Ministry of National Economy; and the integrity of the statistical system. Progress on the implementation of the SMP has been delayed as the authorities have been slow in undertaking the required institutional changes and strengthening the management structure of the CSO.

3. The authorities have expressed interest in participating in the General Data Dissemination System (GDDS) and have appointed a national GDDS coordinator. The statistical agencies have started drafting the GDDS metadata with the support of STA.

Real Sector

4. The national accounts compilation process is hampered by the general lack of source data. The Asian Development Bank is providing funding for two major surveys that could supply critical source data for the national accounts; however, the survey fieldwork has been delayed until 2006. Thus, the survey data may not be available before 2007.

5. The CSO now compiles a nationwide CPI covering Kabul and the five major cities. Nonetheless, the inexperience of the price collectors has posed some early challenges to the compilation process. There is also the need to update the index weights. The CPI basket was derived from a 1987 household income and expenditure survey. In 2003, the CSO conducted a limited exercise to update the weights based on household expenditure in Kabul; however, a comprehensive exercise to obtain representative weights is required, and is predicated on the completion of the delayed integrated living standard survey.

6. Customs coverage of overland foreign trade—which is most of foreign trade—is limited at best. The CSO currently records trade at only seven of the 14 customs posts. Monthly trade data are updated manually, thereby causing delays in dissemination. Accordingly, there is an urgent need for improved computer hardware.

Government Finance Statistics

7. An Advisor from FAD has been assisting the Ministry of Finance in compiling GFS data; however, there is an acute shortage of staff to work on compilation. The *FreeBalance* software, which is used in many countries for budget execution and tracking and could generate some data, does not work very well in Afghanistan. The authorities have reported data on budgetary central government for publication in the *2005 Government Finance Statistics Yearbook*.

Money and Banking Statistics

8. The banking sector has developed steadily over the last several years. In addition to three relicensed state-owned banks, four foreign-owned commercial banks and four foreign banks are now in operation. While there was some improvement in the scope and quality of data reporting by the central bank, there are still weaknesses in many areas. Da Afghanistan Bank (DAB) is now in the process of installing new accounting software, which is expected to be ready for use by May 2006. This new accounting software will allow DAB to produce its balance sheet at least on a monthly basis. The very limited accounting capacity of DAB, especially outside Kabul has hindered efforts to produce a complete and reliable balance sheet. Regarding the commercial banks, DAB has developed new reporting formats to provide data for bank supervision and monetary statistics, and the banks have started reporting data to DAB regularly according to these formats. STA reviewed the new report forms and found that they lacked sectorization and classification of financial assets by type of financial instrument, which are basic requirements for compiling monetary statistics in accordance with international standards. In this regard, STA provided guidance on how to incorporate these required breakdowns into the new report forms. STA plans to send a mission on monetary and financial statistics to Kabul during March 2006 to help develop source data and a data reporting system, and train staff on the methodology.

Balance of Payments

9. Like the national accounts, balance of payments compilation suffers from the paucity of source data. There are no estimates of unrecorded border trade, which constitutes a significant proportion of foreign trade. No reliable source data exist to estimate services, income, transfers, and foreign direct investment. A balance of payments statistics mission that visited Kabul during April 11–May 7, 2005 reported that while some of the recommendations from the previous mission in April 2004 had been introduced, most of the efforts regarding data generation had not materialized, as the response and cooperation from respondents was poor. The 2005 mission provided the authorities with a list of important actions that need to be implemented before a follow-up mission:

- Estimate exports and imports based on CSO data with adjustment for illegal trade and duty free imports. The CSO should start including duty free imports according to international classifications.

- Adjust freight and insurance at 12 and 3 percent, respectively, of c.i.f. imports from overseas to calculate imports f.o.b.

- Introduce questionnaire to hotels and guesthouses to collect data on expenses of nonresidents to estimate travel receipts.

- Conduct sample surveys of residents returning from travel abroad and use the immigration data to estimate travel expenses.

- Introduce the questionnaire for collecting data from foreign embassies and other foreign organizations to estimate government receipts, compensation of employees, etc.

- Introduce the questionnaire on foreign direct investment (FDI) to collect data from major FDI enterprises.

- Introduce reporting forms to commercial banks (on foreign exchange transactions between residents and nonresidents) following discussions with them and with the Banking Supervision Department of the DAB.

- Introduce questionnaire to money changers and money service providers.

- Collect quarterly data from the Ministry of Economy on NGOs' receipts of donations and grants.

- Compile preliminary balance of payments on the basis of various estimation procedures discussed with and documented by the Balance of Payments Section.

10. A follow-up mission is tentatively scheduled for early 2006.

External debt

11. Many records were destroyed during the war and the authorities are slowly rebuilding their database through a reconciliation process in cooperation with the Secretariat of the Paris Club and all non Paris Club creditors. The same reconciliation process is taking place regarding Russian claims.

Islamic Republic of Afghanistan: Table of Common Indicators Required for Surveillance
(As of January 10, 2006)

	Date of latest observation	Date received	Frequency of Data[6]	Frequency of Reporting[6]	Frequency of Publication[6]
Exchange Rates	01/08/06	1/08/06	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	12/21/05	12/28/05	W	W	W
Reserve/Base Money	12/21/05	01/08/06	M	M	M
Broad Money	09/30/05	10/30/05	Q	Q	Q
Central Bank Balance Sheet	12/21/05	01/08/06	M	M	M
Consolidated Balance Sheet of the Banking System	9/31/05	11/15/05	Q	Q	Q
Interest Rates[2]	01/08/06	01/08/06	W	W	W
Consumer Price Index	12/05	12/31/05	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3]—General Government[4]	-	-	-	-	-
Revenue, Expenditure, Balance and Composition of Financing[3]—Central Government	11/05	12/05	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	-	-	-	-	-
External Current Account Balance	2004/05	8/15/05	A	A	A
Exports and Imports of Goods and Services	2004/05	08/15/05	A	A	A
GDP/GNP	2004/05	8/15/05	A	A	A
Gross External Debt	2004/05	8/15/05	A	A	A

1/ Includes reserve assets pledged or otherwise encumbered as well as net derivative positions.
2 / Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.
3/ Foreign, domestic bank, and domestic nonbank financing.
4 / The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.
5 / Including currency and maturity composition.
6 / Daily (D); weekly (W); monthly (M); quarterly (Q); annually (A); irregular (I); and not available (NA).

Debt Sustainability Analysis

1. **This annex assesses Afghanistan's external debt sustainability (DSA) using the joint World Bank–Fund's DSA template for Low Income Countries**. Data limitations notwithstanding, a sound debt management strategy remains central to the overall growth dynamics of Afghanistan, which is currently heavily dependent on external financing.[1] Based on the current medium-term macroeconomic framework and outstanding stock of debt, this DSA examines Afghanistan's annual borrowing capacity under two scenarios: one that assumes future borrowing under highly concessional terms, and another that assumes limited access to concessional borrowing. The analysis concludes that Afghanistan has relatively little scope for nonconcessional borrowing. Furthermore, Afghanistan is subject to an elevated risk of debt distress owing to the weakness of exports, the low revenue base and the country's large reconstruction financing requirements.[2]

Table 1. Islamic Republic of Afghanistan: External Debt, 2004/05

	(In millions of U.S. dollars)
Total external debt	749
Multilateral debt	455
World Bank	233
Asian Development Bank	222
Bilateral debt 1/	294
Verified claims	137
United States	82
USAID	57
USDA	25
Former GDR	40
OPEC Fund	2
Kuwait Development Fund	13
Unverified claims	157
Bulgaria	47
Saudi Arabia	30
Iraq	6
Former Czechoslovakia	75
Memorandum item:	
	(In percent of GDP)
Total external debt	13
Total multilateral debt	8
Total verified bilateral debt	2
Total unverified bilateral debt	3

Sources: Afghan authorities; and Fund staff estimates.

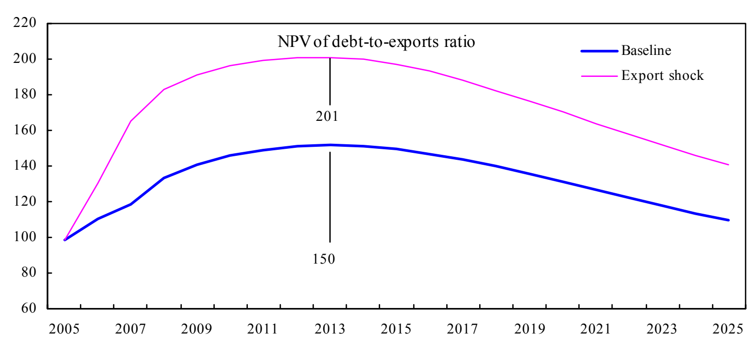
1/ Excludes Russian claims. Staff estimate these claims to exceed $10 billion.

[1]While the DSA template uses 10-year averages of key macroeconomic variables to generate alternative scenarios for analytical purposes, this was not possible in the case of Afghanistan as reliable economic data exist only for the last three years. As a consequence, the present DSA does not employ the full set of stress tests typically presented in low-income country DSAs.

[2]A number of caveats must be noted. The World Bank has not yet assessed Afghanistan against its Country Policy and Institutional Assessment (CPIA) framework, which makes it impossible to identify a policy-dependent sustainability threshold as identified in "Operational Framework for Debt Sustainability Assessments in Low Income Countries—Further Considerations" (refer to www.imf.org). For the purposes of this exercise, it is assumed that Afghanistan is evaluated as a medium performer in the CPIA. Thus, the sustainable ratio for the NPV of debt-to-exports is assumed to be 150 percent. It is possible that the indicative sustainability thresholds for Afghanistan may be revised following its evaluation under the CPIA. This would affect the results of the DSA. Owing to these caveats, this exercise cannot propose a definitive rating of debt distress for Afghanistan.

2. **The main economic assumptions are the same in both scenarios**. The scenarios are based on an end-2004/05 external debt stock of $749 million (see Table 1), which includes all currently acknowledged, verified or unverified debts,[3] but excludes disputed Russian claims. If included, the Russian claims—preliminarily estimated at around $10.8 billion—would dramatically increase the NPV of debt-to-export ratio and the need for debt relief (possibly in the context of the HIPC Initiative). Real economic activity is projected to expand rapidly over the next 10 years, as the reconstruction effort boosts all sectors of the economy. Real GDP growth is projected to be around 10 percent a year during this period of accelerated growth, before moderating to approximately 6 percent thereafter. Assuming annual export growth of about 15 percent a year in the medium term, the trade deficit diminishes but remains significant throughout the projection period. The current account (including grants) is nevertheless generally in surplus, as transfers are expected to remain substantial.

3. **The first scenario assumes that all future borrowing is contracted under highly concessional terms (i.e. with a grant element of at least 60 percent). On this basis, Afghanistan's gross annual borrowing could reach $380 million without breaching the indicative NPV of debt-to-exports threshold.[4]** While this level of borrowing represents a significant increase over current levels, it may be useful to contrast it against the projected gap between total recurrent spending requirements and revenue excluding grants, estimated at around $900 million per year over the medium term.[5] This highlights the need for continued grant financing for several years. Debt sustainability is maintained only in the absence of shocks affecting the economy (e.g. lower export growth of about 9 percent would raise the NPV of debt-to-exports ratio to well above the indicative sustainability threshold).



4. **The second scenario assumes that Afghanistan has limited access (up to $75 million annually) to concessional borrowing and borrows all additional funds on nonconcessional terms.[6]** In this case, additional nonconcessional borrowing could reach

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[3]Unverified claims amount to roughly $157 million, which the authorities are in the process of reconciling.

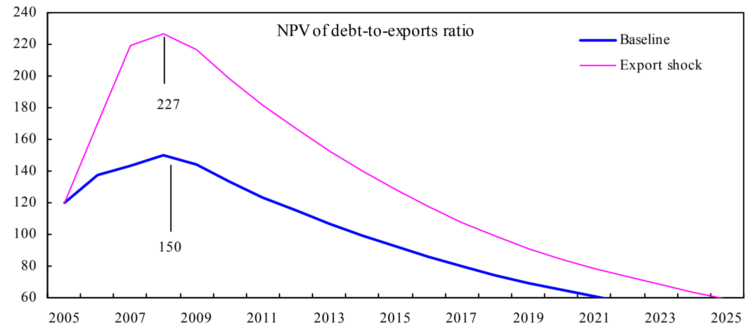
[4]This implies that most new borrowings would need to come from concessional creditors, such as IDA and/or the Asian Development Bank.

[5]See Box 1 of the staff report for a full explanation. The definition of "total recurrent spending" includes a number of items, such as recurrent military costs, currently in the external budget, which are funded directly by donors outside of the government-controlled operating budget.

[6]This scenario is presented to underscore the importance of highly concessional resources in maintaining external sustainability. Afghanistan currently has no commercial market access, nor is it likely to have it in the

(continued…)

about $250 million annually, without breaching the 150 percent indicative sustainability threshold. This scenario illustrates both the sensitivity of debt sustainability to export growth assumptions and the importance of continued access to highly concessional resources in meeting Afghanistan's development needs. Although not shown in the tables and figures, the debt service-to-revenue ratio reaches nearly 24 percent under this scenario (compared to less than 3 percent in the first scenario), which is another indication of the sustainability problems that would ensue if Afghanistan were to borrow on nonconcessional terms. Also, assuming export growth of only 9 percent a year, Afghanistan's sustainable borrowing capacity would be limited to about $150 million annually. Given the geopolitical risks in the region, lower foreign direct investment could also hinder the country's capacity to service debt and thus would warrant a re-evaluation of the appropriate debt sustainability threshold.



Policy Implications

5. **The availability of external borrowing to fund development spending will depend critically on the authorities meeting their fiscal targets**. Although revenue mobilization has increased rapidly in the last few years, it remains very low, amounting to 4.5 percent of GDP in 2004/05, equivalent to about 50 percent of operating expenditures and only 28 percent of total recurrent expenditures (see Box 1 of the staff report). The medium-term framework projects revenue to cover operating expenditures by 2010, when the revenue to GDP ratio is expected to reach 8 percent. Meeting the proposed fiscal target will require both a sustained increase in revenue and expenditure restraint. Any underperformance in these two areas, or any reduction in donor grants, will require additional borrowing to fund recurrent expenditures, thereby reducing by an equivalent amount the financing available for development spending.

6. **In view of the uncertainty surrounding the medium-term macroeconomic framework, the medium-term debt strategy should continue to rely primarily on grant financing and highly concessional borrowing**. The DSA indicates that, even under the conservative debt stock assumptions, external shocks may severely limit new borrowings,

near future. Nevertheless, this scenario assumes that additional debt is contracted at terms similar to those obtained in commercial markets (8 percent coupon, 1-year grace period and 6 years of maturity; the principal is to be repaid in six equal installments).

corroborating the results of the previous DSA exercise (IMF Country Report No. 05/34). Afghanistan's reliance on grants and donor support may also be tested under an uncertain and changing political landscape.

7. **Also, the resolution of the Russian claims—not currently reconciled or acknowledged formally by Afghanistan—will have a significant impact on debt sustainability**. Preliminary calculations suggest that anything short of a full write-off of these claims could result in explosive debt dynamics, impeding any future borrowing. However, given the uncertainty regarding the resolution of this issue, it would be premature to evaluate specific debt relief options.

Table 2. Islamic Republic of Afghanistan: External Debt Sustainability Framework, Baseline Scenario, 2002–25 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 6/	Standard Deviation 6/	Estimate	Projections								
	2002	2003	2004			2005	2006	2007	2008	2009	2010	Average 2005–10	2015	2025	Average 2011–25
External debt (nominal) 1/	**13.1**	**12.3**	**11.8**			**10.7**	**10.0**	**9.9**	**9.8**	**9.7**	**9.5**		**7.8**	**4.1**	
Of which: public and publicly guaranteed (PPG)	13.1	12.3	11.8			10.7	10.0	9.9	9.8	9.7	9.5		7.8	4.1	
Change in external debt	**13.1**	**-0.8**	**-0.5**			**-1.1**	**-0.7**	**-0.1**	**-0.1**	**-0.1**	**-0.2**		**-0.4**	**-0.3**	
Identified net debt-creating flows	**...**	**-6.6**	**-7.4**			**-6.2**	**-4.1**	**-2.1**	**-1.8**	**-2.3**	**-2.7**		**0.9**	**2.9**	
Noninterest current account deficit	3.4	-3.1	-2.1	-0.4	2.9	-1.6	0.7	2.1	3.0	2.4	1.7	1.4	4.3	5.1	4.6
Deficit in balance of goods and services	54.6	67.8	53.5			48.4	43.3	34.0	30.5	29.0	27.6		21.5	13.6	
Exports	6.8	7.5	7.4			7.1	7.1	7.2	6.7	6.5	6.3		5.6	4.7	
Imports	61.4	75.3	60.9			55.5	50.4	41.1	37.1	35.5	34.0		27.1	18.3	
Net current transfers (negative = inflow)	-29.9	-49.3	-43.9	-30.8	22.1	-39.6	-35.1	-28.2	-23.8	-23.8	-23.8	-29.1	-11.9	-2.5	-9.1
Other current account flows (negative = net inflow)	-21.3	-21.7	-11.6			-10.4	-7.5	-3.7	-3.6	-2.9	-2.1		-5.3	-6.0	
Net FDI (negative = inflow)	-1.2	-1.1	-2.9	-1.3	1.2	-3.3	-3.8	-3.4	-4.1	-3.9	-3.7	-3.7	-3.0	-2.0	-2.7
Endogenous debt dynamics 2/	...	-2.3	-2.4			-1.3	-1.0	-0.9	-0.8	-0.8	-0.8		-0.5	-0.2	
Contribution from nominal interest rate	...	0.2	0.2			0.0	0.0	0.0	0.0	0.0	0.0		0.1	0.0	
Contribution from real GDP growth	0.0	-1.7	-0.8			-1.3	-1.0	-0.9	-0.8	-0.8	-0.8		-0.6	-0.2	
Contribution from price and exchange rate changes	0.0	-0.8	-1.8			…	…	…	…	…	…		…	…	
Residual 3/	**...**	**5.8**	**6.9**			**5.1**	**3.4**	**2.1**	**1.7**	**2.2**	**2.6**		**-1.3**	**-3.2**	
Of which: exceptional financing	...	-0.2	-0.2			-0.1	-0.1	-0.1	0.0	0.0	0.0		0.0	0.0	
NPV of external debt 4/	**...**	**...**	**5.8**			**5.4**	**5.1**	**5.1**	**5.0**	**5.0**	**4.9**		**4.2**	**2.1**	
In percent of exports	...	...	78.6			75.4	71.2	71.0	75.3	77.1	77.9		74.4	44.4	
NPV of PPG external debt	**...**	**...**	**5.8**			**5.4**	**5.1**	**5.1**	**5.0**	**5.0**	**4.9**		**4.2**	**2.1**	
In percent of exports	...	...	78.6			75.4	71.2	71.0	75.3	77.1	77.9		74.4	44.4	
Debt service-to-exports ratio (in percent)	2.6	3.8	3.4			1.2	1.1	0.9	0.9	1.0	1.1		2.1	2.7	
PPG debt service-to-exports ratio (in percent)	2.6	3.8	3.4			1.2	1.1	0.9	0.9	1.0	1.1		2.1	2.7	
Total gross financing need (in billions of U.S. dollars)	0.1	-0.2	-0.3			-0.4	-0.3	-0.1	-0.1	-0.2	-0.3		0.5	2.9	
Noninterest current account deficit that stabilizes debt ratio	-9.6	-2.4	-1.6			-0.5	1.4	2.2	3.1	2.4	1.9		4.7	5.4	
Key macroeconomic assumptions															
Real GDP growth (in percent)	28.6	15.7	8.0	17.4	10.4	13.8	11.7	10.6	9.9	9.6	9.4	10.8	8.1	5.2	7.2
GDP deflator in U.S. dollar terms (percentage change)	4.0	6.4	17.0	9.2	6.9	9.9	8.0	5.0	5.0	4.6	4.6	6.2	4.6	3.8	4.2
Effective interest rate (in percent) 5/	...	1.6	1.6	1.6	0.0	0.5	0.5	0.4	0.4	0.5	0.6	0.5	1.0	0.8	1.0
Growth of exports of G&S (U.S. dollar terms, in percent)	...	36.1	25.0	30.6	7.9	20.1	20.6	17.0	7.4	11.3	11.4	14.6	10.5	7.5	9.6
Growth of imports of G&S (U.S. dollar terms, in percent)	...	50.9	2.1	26.5	34.5	14.0	9.6	-5.2	4.1	9.6	9.4	6.9	8.1	5.2	7.2

Source: Fund staff simulations.

1/ Includes both public and private sector external debt.

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

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

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

5/ Current year interest payments devided by previous period debt stock.

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

Kabul, February 11, 2006

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, DC 20431
U.S.A.

Dear Mr. de Rato,

1. In November 2005, we carried out with IMF staff the discussions for the 2005 Article IV consultation and the sixth review under the staff-monitored program (SMP) agreed in March 2004.

2. Since the completion of the fifth review under the SMP, we have continued to maintain economic stability while holding, for the first time in recent history, legislative and provincial elections. During the recent discussions, we reached understandings on a revised macroeconomic framework and an updated memorandum of economic and financial policies (MEFP) covering the period through September 2006. As detailed in the MEFP, we have observed all the end-September 2005 quantitative indicators and, albeit with some delays caused by technical factors, all but one of the end-September structural benchmarks under the SMP program (Tables 1 and 2).

3. We believe that the policies and measures set forth in the attached MEFP are adequate to achieve the objectives of the program, but we will take any further measures that may become appropriate for this purpose. In accordance with IMF's policies on such consultations, the Government of Afghanistan will consult with staff prior to adopting any such measures or revising any of the policies contained in the MEFP. We will also provide any information required to assess the implementation of the SMP.

4. Looking forward, and in view of the significant challenges facing the country, including the prevalence of drug-related activities and pervasive poverty, we intend to intensify our adjustment and structural reform efforts. To that end, we are preparing an interim national development strategy consistent with the Millennium Development Goals, which will focus on creating adequate conditions for sustainable economic growth and reducing poverty in the context of fiscal and external sustainability. In support of this strategy, we have initiated discussions with IMF staff on a formal program that could be supported by the Poverty Reduction and Growth Facility (PRGF). We expect to continue these discussions in early March 2006, with the view of requesting a PRGF arrangement in the second quarter of 2006.

5. In continuing with our policy of transparency, we consent to the publication of this letter, the attached MEFP, the technical memorandum of understanding, and the accompanying Executive Board documents on the IMF's website.

Sincerely yours,

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

/s/
Noorullah Delawari
Governor
Da Afghanistan Bank

Attachment:
Update to the Memorandum of Economic and Financial Policies

Update to the Memorandum of Economic and Financial Policies of the Government of Afghanistan

Sixth Review Under the Staff-Monitored Program

November 22, 2005

I. Introduction

1. The government of Afghanistan held discussions with IMF staff in the context of the sixth quarterly review under the staff-monitored program (SMP). These discussions, which coincided with the 2005 Article IV consultation, covered: (a) developments under the SMP during the second quarter of 2005/06, as specified in our Memorandum of Economic and Financial Policies (MEFP) of September 26, 2005; (b) the macroeconomic outlook for the remainder of 2005/06 and the first half of 2006/07; (c) the structural reform agenda; and (d) the medium-term outlook.

2. This update to the MEFP reviews performance during July–September 2005 and describes policies and objectives for the remainder of 2005/06 and the first half of 2006/07. The program will continue to be guided by the macroeconomic and structural reform policies described in the MEFP of March 2004, and in the supplements of September 6, 2004; December 29, 2004; February 3, 2005; May 18, 2005; and September 26, 2005. The seventh review under the SMP is scheduled for early March 2006 and will coincide with discussions to reach understandings on a program supported by the Poverty Reduction and Growth Facility (PRGF). That review, combined with the interim Afghanistan National Development Strategy (I-ANDS), which we will present at the January 2006 Donors' Conference in London, will provide the basis for policy discussions related to the PRGF program.

3. **The government continues to attach paramount importance to the SMP**. We have adhered fully to the agreed macroeconomic policies, having observed all the end-September quantitative indicators. We have also met, albeit with some delays caused by various factors, all end-September structural benchmarks, except for the benchmark related to the publication of the audited 2004/05 core budget financial statements, which we now intend to meet by end-December. Lastly, as described below, we have also taken important policy actions in the fiscal, financial, and statistical areas.

4. **While much has been achieved under the SMP in terms of macroeconomic stabilization and structural reforms, we still face significant challenges, including the prevalence of drug activities and pervasive poverty**. To further strengthen our reform efforts, we intend to develop a comprehensive economic program for 2006/07–2008/09 consistent with our I-ANDS and the Millennium Development Goals (MDGs). In support of these policies, the government of Afghanistan has initiated discussions with IMF staff on a three-year PRGF-supported program, with the view of requesting a PRGF arrangement in the second quarter of 2006.

A. Developments Under the SMP

5. **Macroeconomic developments during the first half of 2005/06 were in line with program projections.** Reflecting a rebound in agriculture output—resulting from favorable weather conditions—and sustained activity in construction, transportation, and telecommunications, economic growth remained strong during the first half of the year.

6. **Consumer prices in Kabul have continued to increase at a moderate pace during the second quarter of 2005/06**. They increased by 2.6 percent, up from 2.4 percent in the first quarter. Reflecting the pass-through of international prices to consumer prices, petroleum product prices increased by 26.3 percent during the second quarter. While slowing markedly, rents increased by 6.5 percent. Excluding these two items, prices increased by 1.6 percent during the first quarter, and by 3.3 percent during the first half of 2005/06. After declining sharply during the first quarter, from 16.3 percent at end-March to 11.5 percent at end-June, year-on-year inflation rebounded somewhat, to 12.9 percent at end-September.[1]

7. **According to preliminary estimates provided by the UN Office of Drugs and Crime, opium production declined by 2 percent in 2005, as a sharp fall in area cultivated was largely offset by a rebound in yields due to favorable weather conditions**. Opium cultivation declined by 21 percent, primarily due to the decision by many farmers not to plant in anticipation of intensified government-led anti-narcotics efforts but also in response to relatively low farm gate prices. The intensification of the government's interdiction efforts led to a significant increase in seizures of opium, while eradication contributed to a reduction in the cultivation area. Due to a slight decline in prices, the production export value and farm gate value fell by 4 percent and 7 percent, respectively, to $2.7 billion and $560 million.

8. **The core operating budget deficit, excluding grants, was lower than expected, reaching 1.7 percent of GDP during the first half of 2005/06**. The government continued to abide by its "no-overdraft" commitment and the core operating deficit was more than covered by foreign grants, resulting in a surplus of 0.7 percent of GDP (including grants). Core budget operating and development spending during the first half of the year totaled Af 14.6 billion and Af 8.9 billion, respectively, compared with revised annual budget estimates of Af 33.6 billion and Af 50.1 billion. Compensation of employees accounted for about 64 percent of operating expenditures, while spending on livelihoods and social protection and on transport amounted to 67 percent of the core development budget.

9. **Revenue, excluding grants, was estimated at Af 8.8 billion in the first half of 2005/06, exceeding the SMP indicative target (Af 8.3 billion)**. Revenue comprised Af 4.6 billion in customs duties, Af 1.1 billion in domestic taxes, and Af 3.1 billion in nontax revenues. While customs performed better than anticipated, increasing by 40 percent over the

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[1]The national CPI, which covers five major cities in addition to Kabul, increased by 10.6 percent in the twelve months ending in September 2005.

same period of 2004/05, tax collections declined by 9 percent. While a number of new tax polices and administrative reforms were introduced over this period, covering: the lowering of corporate tax rates (from 25 to 20 percent); the increase in turnover tax rates for specific services; the introduction of a rental tax; the removal of tax holidays; and the creation of a large taxpayer office; the expected revenue benefits from these changes, with the exception of the rental tax, are yet to be achieved. Factors which affected the revenue collections, and which have now been resolved, involved: delays in the approval of the new enforcement provisions, so over the period compliance remained voluntary; and uncertainty associated with the administration and application of the amended income tax law, as the new one was already drafted and was being discussed.

10. **We have started to implement a range of recently-adopted tax measures.** These measures, which have been the subject of a taxpayer education program, include: (a) an increase in turnover tax rates for specific services (hotels, restaurants, telecommunications, and airlines); (b) a wage withholding tax; and (c) an airline departure fee. As our administrative capabilities are still limited and several technical issues related to implementation and coverage need to be resolved, we are initially focusing on the larger taxpayers.

11. **The new income tax law was approved after a short delay**. The new law, which incorporates amendments to provide for administrative powers and additional corporate tax reform measures, was approved by the Cabinet and signed into law by the President in November 2005. The short delay was largely due to an unanticipated legal ruling that required the re-submission of the complete law, rather than only the amendments, as was originally intended.

12. **The midyear review (MYR), was adopted by Cabinet in October 2005.** An increase in the wages of non-uniformed public servants was required, as the last general increase was in November 2003. Importantly, the aggregate rise in the wage bill for 2005/06 was restricted to less than 3 percent over the original budget (Af 549 million). Overall, the increase in operating budget stemming from the MYR was limited to 2.1 percent, with additional unanticipated spending for parliamentarians and pensions partially offset by savings in other current and capital expenditures. This increase in operating spending should be more than offset by additional domestic revenues, projected to increase by around 14 percent over the initial budget.[2]

13. **We have adjusted the core development budget to make it more realistic, reflecting the government's limited spending capacity.** For the remainder of 2005/06, core development spending was reduced by 14 percent to Af 50.1 billion (15 percent of GDP) as projects unlikely to be started in the current year were carried forward to 2006/07. Over the medium term, core development spending is expected to average around 8 percent of GDP

[2]The increase in revenue excludes $80 million (equivalent to 21 percent of domestic revenue) from the sale of telecoms spectrum band width that we expect will be received in the third quarter of the year.

and be predominantly funded by external grants. Donor-funded spending currently implemented outside the core budget is estimated at Af 105.4 billion (31 percent of GDP) in 2005/06.[3] To enhance transparency, accountability, and the role of the budget as a key policy instrument, we continue to encourage donors to bring this expenditure on-budget.

14. **Currency in circulation increased by 12.1 percent during the first half of 2005/06, to Af 43.5 billion, slightly below the SMP second quarter indicative ceiling (Af 43.8 billion)**. As expected, demand for money accelerated somewhat during the second quarter due to seasonal factors. This acceleration was, however, less pronounced than last year, allowing Da Afghanistan Bank (DAB) to contain money growth within program limits without triggering a sharp appreciation of the Afghani. Reflecting the central bank's foreign exchange activity and the accumulation of deposits by the government, international reserves increased further, reaching $1.5 billion at end-September, equivalent to 4.1 months of prospective imports. Interest rates on the overnight and 30-day capital notes continued to move in the 1–2 percent and 4–6 percent ranges, respectively. After depreciating by 3 percent during the first quarter, the Afghani appreciated by 2 percent against the U.S. dollar during the second quarter. During the 12 months leading to end-September, the Afghani has depreciated modestly against the dollar but remained broadly stable in real terms.

15. **Progress was made in restructuring the state-owned banks.** The Ministry of Finance, formally notified by DAB, and made public our decision to restructure the licensed banks, and to liquidate the three former state-owned banks that had not been relicensed. As a first step toward the transfer of its remaining deposits, DAB froze the correspondent accounts of Agricultural Development Bank, the only institution among the three former banks that had kept a deposit base. Regarding the licensed state-owned banks, we have decided to restructure Bank Millie and Bank Pashtany and to finalize the restructuration plan of Export Promotion Bank. The Ministry has initiated steps to restructure the management and operation of the Bank Mille, with recruitment of a new chief executive and a management team, all with the appropriate skills and experience, which will be in charge of implementing the restructuring. At the same time, DAB has conducted a review of the performance of these banks regarding observance of the conditions attached to their licenses. Based on the findings of this review, DAB has adopted enforcement measures to improve the operational performance and governance of these banks, starting with the replacement of the top management of Bank Mille. Accordingly, consultants are being recruited to advise and assist management of the Bank. A similar approach will be taken with Bank Pashtany. Other positive developments in the financial sector include the completion of the transfer of DAB's commercial activities, and the reduction of the registration fees for deeds from 6 percent to 0.5 percent.

[3]This figure reflects the funded portion of the external budget, while an additional Af 77 billion is planned but not funded in 2005/06.

16. **The current account deficit, excluding grants, reached 45 percent of GDP, compared with 51 percent in 2003/04.**[4] Including grants, the current account recorded a surplus, which narrowed to 1.9 percent of GDP in 2004/05, down from 3.1 percent of GDP in 2003/04. In addition, there was increasing foreign direct investments, concessional loans, as well as other unrecorded flows.

17. **We stepped up our efforts to improve compilation of balance of payments statistics.** In line with the recommendations of the May 2005 IMF technical assistance mission on balance of payments statistics, we have started implementing a reporting system that covers trade flows, private grants, interest receipts and payments, and the international investment position. In this context, we are working closely with the banking community, money changers, nongovernmental organizations, and firms engaged in international trade.

18. **We have made progress in verifying external debt owed to Paris Club creditors and to non Paris Club creditors (an end-September 2005 structural benchmark)**. However, despite protracted efforts, we are still to receive from some creditors a reply to our requests, or provision of adequate documentation to validate claims.

19. **We have adopted a classification of state-owned enterprises (SOEs) by the envisaged restructuring method.** This list comprises the 66 enterprises directly owned by the government. Eight will remain state-owned, while 58 will be divested (liquidated or privatized). We expect about two thirds of the latter to be privatized, including about seven through international tenders. To facilitate the privatization of these enterprises, many of which are no longer in operation but hold large real estate assets, we adopted amendments to the Tassidy law giving the Ministry of Finance full authority and responsibility to privatize these enterprises.

20. **We have adopted a statistical law, which provides for an independent statistical agency.** This law establishes the legal framework for collecting, processing, and disseminating economic data, with the Central Statistical Office (CSO) being an independent institution with a separate budget. In addition, we adopted a program of restructuring and reform to ensure that the CSO has the human capital needed to implement the statistical master plan.

II. Policies for the Remainder of 2005/06 and 2006/07

21. To ensure a continued strong economic performance, we intend to pursue prudent macroeconomic policies, consistent with the SMP objectives, and create the conditions for sustained growth and poverty alleviation.

[4] As it is now currently constructed, the current account does not include drug exports.

A. Macroeconomic Objectives

22. **The macroeconomic outlook for 2005/06 remains favorable**. Real GDP is expected to grow by 14 percent in 2005/06, driven by the continued recovery of the agriculture sector due to better rainfall during the planting season, and sustained activity in construction and services. Year-on-year inflation is expected to decline further, to about 10 percent at end-2005/06, notwithstanding upside risks related to possible second round effects of oil prices. The current account deficit, including grants, is projected to decline to 1.7 percent of GDP in 2005/06, while international reserves are expected to increase further.

B. Fiscal Policy

23. **In October, the Cabinet adopted a medium-term fiscal framework (MTFF), that will form the basis for the 2006/07 budget, which also contains projections of the main fiscal aggregates over the next four years.** This MTFF, the government's first, includes a set of integrated medium-term macroeconomic and fiscal targets and projections that set out a path towards fiscal sustainability. The MTFF will be gradually refined to strengthen the linkages between these aggregate projections and our policy priorities. Although it will take time to develop more detailed sector strategies, the I-ANDS process, combined with work in a few priority sectors, should help improve the linkages between policies and operating and development spending and contribute to a more sustainable fiscal position and improved outcomes.

24. **The MTFF highlights the country's main fiscal challenges.** Fiscal sustainability is predicated on: (a) rebuilding domestic tax collection from its extremely low level; (b) implementing an civil service reform program to both contain the wage bill and pensions to affordable levels, in the face of significant cost pressures, and improve performance; and (c) gradually consolidating fiscal operations within the core budget, consistent with our limited ability to sustain such activities. In particular, incorporating the ongoing costs arising from the current reconstruction and capital investments (i.e. for maintenance) into the budget, remains a significant challenge. Over the medium-term, we will continue to rely on significant external funding, even for some core current spending (such as the Afghan National Army), while planning to enhance its predictability and effectiveness by bringing such spending into the budget, consistent with the MTFF and I-ANDS.

25. **Revenue is expected to increase significantly over the medium-term.** The MTFF includes an ambitious program to increase domestic revenue from 4.5 percent of GDP in 2004/05 to 8.6 percent by 2009/10. In order to achieve these ambitious revenue targets, we plan to rationalize the current tariff structure for 2006/07, expand the coverage of the taxes introduced earlier in the year, and continue to strengthen compliance through the large taxpayer office. We will also consider introducing an excise tax. In addition, following the October 2005 tax policy conference with the private sector, we are jointly reviewing the priority reforms, including the turnover tax, revenue administration, and the abolition of nuisance taxes. Before major changes are made, we will consult widely and consider the impact on the whole economy. By maintaining our competitive income tax and customs duty rates and improving administration by simplifying procedures, streamlining the number of

taxes, and reducing the burden of illicit taxation and corruption, we seek to increase revenue and reinforce a positive business environment.

26. **Continuing to improve fiscal transparency, accountability and the integrity of fiscal information is a priority.** Fiscal reporting improved markedly over the last year, with monthly core budget data now published on our website. However, the reconciliation of fiscal and banking data (an end-September benchmark) is constrained by existing procedures, information systems and weak capacity. The audit of the financial statements for the 2004/05 core budget (an end-September 2005 benchmark), which has been delayed by uncertainty over the appropriate procedures, recent changes in the new budget law, and limited administrative capacity will now be submitted to cabinet before end-December 2005. To avoid a repeat of such delays, the Ministry of Finance and the Control and Audit Office will agree on an audit plan for the 2005/06 core budget by end-February 2006.

C. Monetary and Exchange Rate Policies and Financial Sector Reforms

27. **As price, exchange rate and financial developments during the first half of 2005/06 were largely in line with SMP projections, monetary policy will continue to be guided by the program agreed during the third review**. In view of the upward risks on inflation, stemming in particular from possible second-round effects of the increase in oil prices, we will closely monitor price and exchange rate developments in the coming months and stand ready to tighten the monetary stance, should inflationary pressures emerge. International reserves are expected to increase further, to about $1.7 billion at end-2005/06. In 2006/07, pending the deepening of the financial markets (interbank market, capital notes) and the development of a monetary survey in line with international standards, monetary policy will continue to target currency in circulation, and the exchange rate to be market-determined.

28. **We will continue to modernize DAB's operations and strengthen the monetary policy framework**. We will adopt amendments to remunerate reserve requirements, while excluding capital notes from the eligible assets. By end-March 2006, we will enforce these new regulations, as well as those related to the foreign currency open positions, and penalize non-compliance. By end-December 2005, we will allow participants to the DAB's foreign exchange auctions to sell, as well as to buy, dollars. By year end, with technical assistance from the IMF, we will also introduce an overnight collaterized credit facility, with capital notes eligible as collateral. We also intend to introduce capital notes of longer maturities. Lastly, we will strengthen the monetary framework, through the development of more reliable liquidity forecasts, publication of the capital note interest rates, and strengthened oversight by DAB's Supreme Council.

29. **We will pursue the restructuring of the public banking sector.** By end-December 2005, we will appoint people in charge of overseeing the liquidation of the state-owned banks, and by end-March 2006, we will start implementing this liquidation and complete the transfer/reimbursement of the Agricultural Development Bank deposits. We will replace the management boards of Bank Millie and Bank Pashtany by end-December 2005 and end-March 2006, respectively. By end-June 2006, the new management teams, in

coordination with the Ministry of Finance, will adopt long-term restructuring plans for these two banks.

30. **We intend to tackle the administrative and legal impediments to the development of the banking sector**. We will continue working with the banking and donor communities to identify the main impediments to the development of banking operations, prioritize a legal, administrative and legislative reform agenda to address impediments, and ensure better coordination between donors. One of our priorities is the adoption of essential enabling laws for lending operations, including the secure transactions law, the business organization law, and the negotiable instrument law.

D. External Policies and Debt Management

31. **The overall external sector outlook remains favorable**. The revised current account deficit, excluding grants, is projected to reach 42 percent of GDP in 2005/06, compared with 45 percent in 2004/05. Although foreign direct investment and concessional loans are expected to increase in the near future, the deficit will continue to be primarily supported by grant financing, as well as other flows. Including grants, the current account is expected to record a surplus of 1.7 percent of GDP.

32. **We are committed to further enhance the quality and reliability of balance of payments data.** The survey of non recorded trade is expected to be completed by end-March 2006. Its findings will help refine trade flow estimates. In addition to the various surveys under way on other components of the balance of payments, we will hold regular meetings with the primary providers of data on remittances, financial flows, and the international investment position. On external debt data, DAB will coordinate closely with the Ministry of Finance.

33. **Our external borrowing strategy will remain cautious, relying primarily on grants and highly concessional loans to meet our financing needs**. We envisage continued lending from multilaterals such as the Asian Development Bank and additional highly concessional lending from bilaterals, if need be, to fund specific projects that directly benefit the population and reduce poverty. We will continue to seek generous debt relief from existing bilateral creditors and examine the various debt-reduction options. We will pursue good faith efforts to conclude the debt reconciliation process with all our creditors.

34. **We recognize that an open and transparent trade regime is critical to enhancing Afghanistan's growth prospects.** We intend to consolidate the gains made thus far through reforms of the trade regime and customs administration. We have begun discussions with the world trade organization (WTO) as a first step toward membership. Such membership will provide us with more predictability in our trade relations with other countries, and give us access to the WTO dispute settlement apparatus and to technical assistance. In addition, to

enhance our role in the region, we recently became a member of the Central Asian Regional Economic Council, and are being considered for membership in several other regional organizations.

E. Structural Reforms

35. **In addition to reforms in the fiscal and monetary areas, we intend to focus on further liberalizing the economy and strengthening competition**. Key measures will include: (a) the publication in the Official Gazette, by end-December 2005, of the amendments to the Tassady Law; (b) the initiation of an open and transparent divestiture process of the 58 SOEs slated for liquidation or privatization; and (c) the completion by end-December 2005 of an inventory of the various public entities and government agencies engaged in commercial activities.[5] The divesture will be accompanied by an equitable and affordable retrenchment plan. To enhance competition and ensure an adequate regulatory environment for investment, we will also promote land ownership rights and an insurance law.

F. Poverty Reduction Strategy

36. **As part of the first step in formulating our development strategy, a draft document, the I-NDS, is being developed with broad intra-government consultation and participation of civil society and the donor community.** This draft will define our strategic vision and sectoral priorities, consistent with the Millennium Development Goals, and will include broad estimates of our medium-term development needs. This draft will subsequently be discussed with our development partners, and civil society to build broader ownership before it is presented at the January 2006 International Donors' Conference. We will continue to work closely with World Bank and IMF staffs to ensure that the I-ANDS meets the requirements of an interim poverty reduction strategy paper (I-PRSP) that could support our upcoming request for a PRGF-supported program. A final version of the I-ANDS in a format consistent with an I-PRSP, is expected to be adopted before end-March 2006.

G. Statistical Issues

37. **We are committed to building our statistical capacity with support from the international community**. We intend to complete the institutional statistical framework by putting in place, by March 2006, the National Statistical Council provided for by the new statistical law. At the same time, we will actively seek donor support to fully fund the action plan for rebuilding our statistical capacities. We recently notified the IMF of our commitment to join the General Data Dissemination System (GDDS), and have appointed a GDDS

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[5] This inventory will include (a) enterprises which are not fully-owned by the government (e.g. Ariana Afghan Airlines); and (b) departments—within ministries—which are engaged in commercial activities.

coordinator and started work on the metadata. Lastly, owing to some technical difficulties, the three surveys designed to measure development progress were delayed and are now expected to start in March 2006.[6]

H. Technical Assistance

38. **An overall review of technical assistance (TA) will be completed after the Donors' Conference**. As we intend to request a PRGF-supported program, this review will be instrumental in helping us, as well as our partners, to enhance the quality of TA, ensure a better distribution of TA across government agencies, and redeploy resources in line with the priorities defined in the I-ANDS. The government of Afghanistan remains grateful for the assistance provided so far by the IMF and looks forward for its support in the months ahead to implement its reform program.

III. Program Monitoring

39. **We will continue to monitor, through the Technical Coordination Committee, the implementation of the SMP.** In doing so, we will refer to the definitions, data sources, and frequency set out in the technical memorandum of understanding (TMU). Table 1 includes the quantitative indicators through end-September 2006. Table 2 sets out the structural benchmarks. For reporting purposes, the government will continue to provide IMF staff all core data, appropriately reconciled and on a timely basis, as specified in the TMU. IMF staff will be notified prior to introducing any policy actions and developments that might affect the program.

40. **Discussions on a PRGF-supported program are expected to be completed by March 2006, and the request for a program presented for consideration by the Executive Board in the second quarter of 2006.** Performance under the seventh review will serve as a basis for policy discussions under the PRGF.

[6] These surveys are: (a) the national risk vulnerability assessment survey on rural households; (b) the integrated business enterprise survey; and (c) the integrated living standard survey or household income expenditure survey.

Table 1. Islamic Republic of Afghanistan: Quantitative Indicators, 2005/06–2006/07

(In millions of Afghanis, unless otherwise indicated; cumulative changes from beginning of fiscal year)

	2005/06						2006/07	
	Jun. 21	Jun. 21	Sep. 22	Sep. 22	Dec. 20	Mar. 20	Jun. 20	Sep. 20
	Indicative Target	Estimate	Indicative Target	Estimate	Indicative Target	Indicative Target	Indicative Target	Indicative Target
Currency in circulation (ceiling) 1/	2,453	1,321	5,057	4,693	7,822	10,758	2,572	5,278
Claims of the banking system on the central government (ceiling)	0	0	0	0	0	0	0	0
Gross international reserves of the central bank (floor) (in millions of dollars)	-50	85	0	198	100	158	0	0
Fiscal revenue of the central government (floor)	4,629	4,757	8,306	8,752	12,676	18,328	5,567	11,371
External debt								
a) New medium- and long-term nonconcessional external debt (with original maturities of one year or more) contracted or guaranteed by the government (ceiling) 2/ 3/	0	0	0	0	0	0	0	0
b) New nonconcessional debt with an original maturity of less than one year (ceiling) 3/ 4/ 5/	0	0	0	0	0	0	0	0
Memorandum item:								
Currency in circulation (level triggering consultation)	3,508	...	7,298	...	10,151	13,234	3,875	8,018

Sources: Afghan authorities; and Fund estimates and projections.

1/ At end-2004/05, currency in circulation amounted to Af 38.8 billion.
3/ Excluding rescheduling arrangements, but including debt with maturities of more than one year.
3/ This benchmark will be evaluated on a continuous basis.
4/ Concessional debt is defined as debt with a grant element of at least 60 percent calculated on the basis of currency-specific discount rates, based on the OECD commercial interest reference rates (CIRRs).
5/ On a contracting or guaranteed basis. Excluding debt related to normal import transactions.

Table 2. Islamic Republic of Afghanistan: Structural Benchmarks, June 2005–September 2006

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

1/ This structural benchmark was inplemented with some delay.

Table 2. Islamic Republic of Afghanistan: Structural Benchmarks, June 2005–September 2006 (concluded)

Structural Benchmarks	Target Date	Status
Publish estimate of revenues forgone as a result of customs exemptions, including due to international assistance, and income tax law exemptions.	End-March 2006	
Establish appeals process for customs and tax administrations.	End-June 2006	
Process gold held in the palace vaults into a form that qualifies as a reserve asset and transfer any monetary gold held in Afghanistan to an international gold center.	End-September 2006	
Submit to parliament the core budget's audited financial statements for 2005/06.	End-September 2006	

Statement by the IMF Staff Representative
March 6, 2006

1. This statement contains information on recent economic developments in Afghanistan that has become available since the staff report was circulated to Executive Directors on February 16, 2006. This information does not alter the thrust of the staff appraisal.

2. Preliminary data indicate that all end-December 2005 quantitative indicators and all but one of the structural benchmarks under the SMP have been observed. The authorities appear to have failed again to meet the benchmark on the publication of the 2004/05 core budget's audited financial statements, which had initially been set for end-September. The statements have been submitted to the Auditor-General, who still has to certify them.

3. Inflation (year-on-year) declined further to 12.2 percent in December, reflecting a slower increase in food prices that was partly offset by an acceleration in rents and petroleum product prices.

4. The operating budget deficit, excluding grants, reached 1.9 percent of annual GDP during the first nine months of 2005/06, a level lower than envisaged in the program, owing to a better-than-expected performance of customs revenue. Domestic tax collection remained somewhat below last year's outcome, as weaker compliance appears to have offset the gains from new tax measures. Operating budget spending was broadly in line with the program, but core budget development spending was only 25 percent of the estimate for the whole fiscal year, owing to weak implementation capacity and security concerns. The operating budget surplus, including grants, was equivalent to 1.2 percent of annual GDP.

5. The government has not yet finalized the budget for 2006/07, as the authorities are still discussing changes in budget coverage with the staff and the donor community. Staff expect the budget to be consistent with a reduction in the operating deficit to 3.5 percent of GDP in 2006/07, from 4.2 percent now projected for 2005/06, owing mainly to an increase in revenue. Operating expenditure is expected to remain broadly unchanged relative to GDP, after the inclusion of security and other outlays previously financed outside the budget. Staff are working closely with the authorities to ensure that the budget is consistent with medium-term fiscal sustainability.

6. Faced with some pressure on the exchange rate, Da Afghanistan Bank tightened its monetary stance by keeping currency in circulation virtually unchanged during the third quarter of 2005/06. International reserves increased further, to more than $1.5 billion at end-December 2005 (4.2 months of prospective imports of goods and services). The Afghani gradually rescinded the 3-percent gain against the U.S. dollar it had made during the second quarter, before stabilizing in January. Reflecting the inflation differential with the United States, this resulted in a real appreciation of about 2 percent against the U.S. currency during the third quarter.

7. At the International Donors' Conference held in London from January 31–February 1, 2006, the authorities presented their Interim Afghanistan National Development Strategy. By mid-March 2006, they intend to send the final version of this strategy to the Fund and the World Bank as well as their Interim Poverty Reduction Strategy Paper. The authorities and the donor community have also agreed on a "Compact" that includes time-bound benchmarks on security, governance, rule of law, and economic development, and encourages donors to deliver aid more effectively by pledging multiyear support and channeling it through the budget.

8. At the London Conference, donors made pledges of financial assistance amounting to about $10.5 billion over the next five years. In addition, Germany, Russia, and the United States (Afghanistan's three Paris Club creditors) indicated their intention to provide 100 percent debt relief.

INTERNATIONAL MONETARY FUND
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International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2005 Article IV Consultation with the Islamic Republic of Afghanistan

On March 6, 2006, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Islamic Republic of Afghanistan.[1]

Background

Since its inception in March 2004, the Staff Monitored Program (SMP) has been instrumental in maintaining macroeconomic stability and contributing to the implementation of the government's reform agenda.

Over the last 12 months, the Afghan authorities have made further progress in rebuilding institutions and stabilizing the economy. In a challenging environment, dominated by the difficult security situation and parliamentary elections, the authorities have continued to pursue prudent fiscal and monetary policies and have implemented a number of important institutional and structural reforms that have contributed to strong growth, moderate inflation, a stable exchange rate, and fiscal consolidation. The government met all the end-September 2005 quantitative indicators under the SMP and observed, albeit with some delays, all structural benchmarks, except for the publication of the audited 2004/05 core budget financial statements.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities.

After slowing down to 8 percent in 2004/05, economic activity has rebounded over the last 12 months, owing primarily to a weather-related recovery of agricultural output. Opium production declined by 2 percent in 2005, as a sharp reduction in the cultivated area was largely offset by an increase in yields due to good rainfalls. After rising sharply in 2004/05 on account of an acceleration of rents and petroleum product prices, year-on-year inflation declined to 12.9 percent in September 2005, owing to a slowdown in rents. At the same time, the external current account deficit, excluding grants, narrowed to 45 percent of GDP in 2004/05, from 51 percent in 2003/04.

The operating budget deficit is expected to decline significantly in 2005/06, mainly because of an increase in revenue. During 2004/05 and the first half of 2005/06, revenue was broadly in line with program projections, as higher-than-programmed customs receipts offset a lower-than-envisaged domestic tax collection. Government spending, especially for development purposes, remained lower-than-budgeted because of capacity constraints.

Monetary developments during 2004/05 and through September 2005 remained broadly in line with SMP projections. Monetary policy continued to be guided by indicative targets for currency in circulation, within the context of a managed float exchange rate system, and was implemented through mainly foreign currency auctions. International reserves continued to increase steadily.

On the structural side, the Afghan authorities have carried out major reforms to improve revenue collection, and have started to establish a transparent public expenditure system with fiduciary standards. The authorities have also modernized central bank operations and reinforced its supervision capacity, while strengthening the banking sector regulatory framework. Moreover, the authorities have adopted a debt management strategy and a medium-term fiscal framework consistent with their continued commitment to fiscal and external sustainability. Further steps have also been taken to restructure the public sector.

Building upon the progress made so far under the SMP, and with a view to addressing vigorously the country's important challenges, the government has initiated discussions on a successor program that could be supported by the IMF's Poverty Reduction and Growth Facility (PRGF). The Interim-Afghanistan National Development Strategy that the authorities presented at the London International Donors' Conference in late January will form the basis of an interim poverty strategy paper, in support of such a program.

Executive Board Assessment

Executive Directors commended the authorities for the continued implementation of sound macroeconomic policies, which have contributed to Afghanistan's strong economic performance over the last year. Directors noted Afghanistan's record of sustained growth and moderate inflation and viewed the short-term economic outlook as favorable, notwithstanding some downside risks. They were also encouraged by the fact that the recent legislative and provincial elections took place without any major disruption.

Directors observed that Afghanistan faces formidable medium-term challenges, which are compounded by lingering insecurity. The most pressing tasks are to consolidate macroeconomic stability while pursuing vigorously the government's reform agenda in support of sustained growth and poverty alleviation. Directors were encouraged by the authorities' commitment to address these challenges, as articulated in the Interim Afghanistan Development Strategy (I-ANDS). This strategy focuses on diversifying the sources of growth, ensuring fiscal and external sustainability, addressing institutional and structural obstacles to private sector development, and gradually eliminating opium-related activities.

Directors welcomed the authorities' fiscal consolidation efforts and their adoption of a medium-term fiscal framework (MTFF). Adherence to this framework will be critical to achieving fiscal sustainability, especially as significant expenditure pressures for both existing and new programs are likely to develop. Directors encouraged the authorities to refine the MTFF over time to link closely multi-year projections with policies. Also, fiscal activities presently funded off-budget by donors need to be progressively incorporated into the core budget in order to increase transparency and estimate better the government's long-term financing needs.

Directors welcomed the continued growth in revenue, which consistently exceeded the targets set under the Staff Monitored Program. New revenue measures and decisive efforts to strengthen tax administration, including by targeting large taxpayers, will be crucial to achieving the MTFF's objectives. Directors called for the introduction of excises on certain consumption items and the continued implementation of the reform plans for the customs and tax administrations, in order to enhance long-term fiscal sustainability. They cautioned against raising import tariffs for protectionist purposes, introducing ad-hoc duty exemptions, or reducing domestic tax rates.

Directors noted that, while recurrent spending has been broadly in line with budget estimates, development expenditures have remained significantly lower than budgeted. They encouraged the authorities to prepare more realistic development budgets, taking into account capacity constraints. Directors recognized, however, that this task is complicated by the large amount of spending implemented directly by donors. In this regard, they hoped that the Compact recently adopted by the government and the donor community—as well as the I-ANDS—will help to improve aid delivery and the process of economic reconstruction.

Directors supported the authorities' efforts to enhance the productivity of the civil service through capacity building. They emphasized the need to implement, in due course, a reform of the public administration that will provide adequate compensation to government employees while ensuring fiscal sustainability and broad social harmony. Directors cautioned the authorities against linking pensions to salary increases, as this would have serious budgetary implications.

Directors regarded the current monetary program as broadly consistent with the program's objectives, and welcomed the authorities' commitment to tighten monetary conditions further, if necessary to reduce inflation. They supported the central bank's efforts to strengthen the monetary policy framework, including through the introduction of new monetary instruments, the development of its analytical capacity, and increased transparency in monetary management.

Directors were of the view that the present managed float exchange rate system has worked well and should be maintained. They noted that the real appreciation of the Afghani in recent years stemmed, to a large extent, from the impact of opium- and aid-related inflows, and that monetary policy could do little in this context to enhance competitiveness. Directors emphasized that future efforts to strengthen competitiveness should focus primarily on enhancing the effectiveness of foreign assistance and deepening structural reforms in order to increase productivity.

Directors emphasized the importance of moving forward with reforms aimed at building a resilient banking system. In particular, they stressed the need for decisive action to address the situation of the state-owned banks, and encouraged the authorities to adopt an appropriate legal and administrative framework for the development of the commercial banking system.

Directors called for the establishment of an enabling environment for private sector activities. They urged the further liberalization of the economy through a careful and well-sequenced divestiture of the state-owned enterprises and of commercial activities currently performed by public agencies. They emphasized that enhancing the consistency and predictability of government policies would contribute to improving the business climate.

Directors considered that the I-ANDS meets most of the requirements for an Interim Poverty Reduction Strategy Paper. However, much needs to be done to turn the large number of proposals in the I-ANDS into a coherent and sustainable set of medium-term programs and policies. Directors encouraged the authorities to strengthen the participatory process and broaden the involvement of stakeholders as they work on their poverty reduction strategy.

Directors called on the authorities to continue implementing vigorously, with donor support, the programs aimed at eliminating the drug economy. In particular, they underscored the importance of developing sustainable income generation activities in support of the eradication, interdiction, and prevention campaigns. Success in this area would also help improve security and governance.

Directors noted that, notwithstanding recent progress, further efforts are necessary to address a number of statistical weaknesses. Looking ahead, they encouraged the authorities to implement, with donor assistance, the statistical master plan, which aims at tackling data deficiencies. Directors welcomed the recent adoption of a new statistical law.

Taking into account Afghanistan's solid track record of policy implementation under the SMP, Directors supported the authorities' intention to open discussions on a successor program that could be supported by a three-year arrangement under the Poverty Reduction and Growth Facility. Such a program would help the authorities consolidate macroeconomic stability, provide a suitable framework for the continued implementation of their ambitious reform agenda, and contribute to resolving outstanding debt issues. Directors were encouraged by the announcement by Paris Club creditors that they would offer 100 percent debt relief to Afghanistan if it meets the eligibility criteria for the enhanced HIPC Initiative.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

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

	Est. 2001/02	Est. 2002/03	Est. 2003/04	Est. 2004/05	Est. 2005/06	Proj. 2006/07
Output and prices						
Real GDP (in percent, excluding opium)	...	28.6	15.7	8.0	13.8	11.7
GDP (in billions of Afghanis)	134	183	225	285	356	429
GDP(in millions of U.S. dollars, excluding opium)	2,463	4,084	4,585	5,971	7,139	8,608
GDP per capita (in U.S. dollars, excluding opium)	123	182	199	253	294	344
Prices						
CPI (Kabul, year-on-year change; in percent)	-43.4	52.1	10.2	16.3	10.0	8.0
CPI (Kabul, average change; in percent)	...	5.0	23.9	14.3	12.0	8.9
Exchange rates						
Afghanis per U.S. dollar (annual average)	54.4	44.8	49.0	47.7	...	...
Afghanis per U.S. dollar (end of period)	31.0	52.6	50.3	48.7	...	...
General government operating budget						
Revenue (in percent of GDP)	...	3.2	4.5	4.5	5.3	6.0
Expenditures (in percent of GDP)	...	8.5	9.8	9.4	9.4	8.9
Grants (in percent of GDP)	...	5.2	4.5	5.3	4.7	3.2
Monetary indicators						
Broad money (percent change)	...	20.1	40.9	37.5	27.8	22.5
Gross international reserves (in millions of U.S. dollars)	...	426	816	1,261	1,730	2,119
	(In percent of GDP; unless otherwise indicated)					
External sector						
Current account (excluding grants; in millions of U.S. dollars)	...	-1,364	-2,335	-2,676	-3,026	-3,437
Current account (including grants; in percent of GDP)	...	-3.5	3.1	1.9	1.7	-0.9

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

Statement by Abbas Mirakhor, Executive Director for Islamic Republic of Afghanistan
March 6, 2006

Key Points

- *In an exceptionally challenging environment, the Afghan authorities have persevered with the implementation of prudent financial policies and bold structural reforms, and have observed all of the quantitative indicators and the structural benchmarks for end-September under the SMP, except for the publication of the audited 2004/05 core budget financial statements.*

- *The budget deficit is expected to be lower than envisaged in 2005/06. Revenue exceeded the program target during the first half of 2005/06, while spending remained lower than budgeted because of capacity constraints.*

- *Monetary policy remained focused on inflation control, and inflation subsided over the first half of 2005/06.*

- *Important regulatory and judicial reforms are underway, including preparatory work for laws aimed at enhancing governance, property rights, and competition.*

- *The authorities recognize that an open and transparent trade regime is vital for growth prospects, and they intend to pursue discussions on Afghanistan's accession to the WTO.*

- *The authorities have expressed strong interest in continued Fund involvement, and the progress made so far under the SMP has paved the way for discussions on a program that could be supported by the PRGF.*

The Afghan authorities would like to thank management and staff for the constructive policy dialogue and support, particularly over the last two years of the Staff Monitored Program (SMP). They value highly their collaborative relationship with the Fund and recognize the important role of this engagement in support of their efforts to stabilize and transform the economy. The staff report reflects in a comprehensive and balanced way the progress made under the SMP, while highlighting the remaining challenges. The topics selected for analysis in the Selected Issues paper are relevant, and the discussion is informative, providing the analytical underpinnings for policy formulation.

In an exceptionally challenging environment dominated by security issues and adverse shocks—but with significant support from the international community—the authorities have persevered with the implementation of prudent financial policies and bold structural reforms. Although the security situation in some parts of the country remains difficult, with the number of incidents increasing in the period surrounding the legislative elections and despite concerns that low capacity would hinder the delivery of the program's commitments, the authorities observed all of the quantitative indicators and the structural benchmarks for end-September in the SMP, except for the publication of the audited 2004/05 core budget financial statements. The budget statements have been submitted to the Auditor-General, but administrative capacity constraints have led to delays in their certification. The progress so far achieved in the adjustment of the economy finds strong expression in the high rate of economic growth and reduced inflation. Economic growth moderated in 2004/05, attributed primarily to the impact of adverse weather conditions on agricultural output, but real GDP rebounded in 2005/06, with the reconstruction effort continuing to drive growth in construction, trade, transportation, and telecommunications. After rising sharply in 2004/05 on account of petroleum prices, inflation subsided over the first half of 2005/06: year-on-year inflation declined to 12.9 percent in September 2005, from 16.3 percent in March, as envisaged in the program. Opium production declined by 2 percent in 2005: the decline could have been significantly larger, as many farmers did not plant in anticipation of intensified government-led anti-narcotics activities, but the sharp drop in cultivation was largely offset by higher yields owing to favorable weather conditions.

Fiscal policy

The authorities have continued to focus on improving the budgetary process and transparency, which were strengthened through the adoption of a new public finance and expenditure management law. The authorities recognize that fiscal policy should remain cautious over the medium term to ensure macroeconomic stability, and have demonstrated their commitment to fiscal discipline in the steadfast implementation of the SMP. The budget deficit is expected to be lower than previously envisaged in 2005/06, which should contribute to a further build-up of government deposits with Da Afghanistan Bank (DAB). The operating budget deficit, excluding grants, was 4.9 percent of GDP in 2004/05 and 1.7 percent of annual GDP during the first half of 2005/06. Revenue has increased rapidly in the last few years and exceeded the program target during the first half of 2005/06. Nonetheless, the authorities plan to take new measures because they are well aware that a broad tax base and a reduced reliance on trade taxes, as well as a strengthened administrative capacity of the revenue directorate, are a sine qua non to achieve fiscal sustainability. They have initiated a reform plan for the customs and tax administrations, with immediate focus on the new large taxpayer unit for improving compliance. They are also contemplating the introduction of excises on certain consumption items.

Current government spending remained close to budgeted but capital expenditure was lower because of capacity constraints. Core development expenditure reached 2.5 percent of annual GDP during the first half of 2005/06, compared to a revised budget target of 14.1 percent of GDP for the fiscal year as a whole. In the midyear budget review (MYR) in October 2005, the authorities capped the increase in operating expenditure to 2.1 percent over the budget, as a 3 percent increase in compensation for civil servants—agreed under the program—and unanticipated spending for parliamentarians and pensions were partially offset by savings in other expenditures. As for rationalizing the civil service, given the relatively large public employment level, the authorities believe that reform in this area should be gradual and in line with employment developments in the private sector to avoid social disruptions. To this end, the modest wage increase in 2005 was undertaken to reduce the large gap between public and private sector wages. They have chosen to keep wage increases low so as to leave room for a more fundamental reform. Recognizing that a systematic reform program is required to strike a better balance between the need for higher salaries and budgetary considerations in the medium term, a medium-term fiscal framework (MTFF) was approved by Cabinet at the time of the MYR, which includes integrated macroeconomic projections and fiscal targets.

Monetary and exchange rate policies

Monetary policy remained focused on inflation control, guided primarily by indicative targets for currency in circulation. The growth of monetary indicators during 2004/05 and through September 2005 was in line with, or lower than SMP projections, which included a marked slowdown in currency growth. DAB made significant progress in modernizing its foreign exchange and capital note auctions, as well as in strengthening the banking sector regulatory framework. Other positive developments in the banking sector included the divestiture of DAB's commercial activities in those provinces where at least one commercial bank is active, and the reduction, from 6 percent to 0.5 percent, of the registration fee for deeds, whose high level had constituted a major deterrent to lending operations. The authorities consider that the new regulations and administrative measures to strengthen DAB’s supervision of the banking sector will result in higher public confidence in banks, thereby encouraging depositors to invest in longer-maturity instruments, which in turn should improve the environment for lending operations.

The managed float system has served the country well. The real appreciation experienced by the Afghani in recent years reflects, to a large extent, the impact of drug- and aid-related inflows. The authorities agree with the staff that, in this context, strengthening external competitiveness requires enhancing efficiency in the utilization of foreign aid and deepening structural reforms to increase productivity, and they view the maintenance of competitiveness through these measures as a constant challenge. They are anxious about the upward risks to inflation, stemming in particular from possible second-round effects of the increase in oil prices. They have been following closely price and exchange rate developments, with a view to tighten the monetary stance if there were to be any intensification of inflationary pressures.

Structural reforms

In recent years, the foundation of the economy has been strengthened significantly due to the structural reforms that have been undertaken. In addition to modernizing DAB’s monetary operations and strengthening bank supervision, the authorities took further steps to advance the reform agenda, including removing distortions and addressing structural weaknesses in the economy, which should encourage private investment and diversify the growth and export bases. Important regulatory and judicial reforms are underway, including preparatory work for laws aimed at enhancing governance, property rights, and competition. In particular, the authorities, with donor support, are working toward the adoption of a core group of enabling laws—including on secured transactions, business organization, and negotiable instruments—that would strengthen judicial enforcement. Regarding state-owned enterprises (SOE), the government adopted a classification for the envisaged restructuring in which only a few will remain in the public sector: out of 66 SOEs, eight are expected to remain state-owned, while 58 will be liquidated or privatized. In the restructuring of public financial institutions, the authorities have made public their intention to liquidate three former state-owned banks that had not been relicensed. The authorities recognize that an open and transparent trade regime is vital for growth prospects, and they intend to pursue technical work in support of Afghanistan's accession to the World Trade Organization (WTO).

Poverty reduction

In the Interim Afghanistan National Development Strategy (I-ANDS), which was presented during the international donors' conference in London in January, the authorities have articulated a medium-term development strategy, which will be underpinned by growth-boosting reforms, focused on reducing the role of the government in the economy and improving the investment climate. The I-ANDS process has been conducted through broad-based consultations with key stakeholders and civil society, which has enabled the authorities to develop a broad and credible agenda of reforms and establish their priorities, taking into account the competing demands on the limited resources. The I-ANDS places priority on: (a) security; (b) governance, rule of law, and human rights; and (c) economic and social development. The elimination of the narcotics industry is identified as a top priority in the quest for sustained rapid growth and poverty alleviation. They will exercise expenditure restraints as dictated by the MTFF, especially in nonpriority areas that have been identified. The government and the donor community have developed a "Compact" that establishes commitments, benchmarks, and a monitoring mechanism. There will be improvement in monitoring and evaluation, which will help to identify capacity constraints in the public sector. While moving toward a full ANDS, the authorities will broaden the already extensive participatory process of the I-ANDS, and will clearly define the goals and link them to specific policy actions.

Medium-term outlook

The authorities recognize that the medium-term outlook is subject to various risks, but with the support of the population in the new environment shaped by the first legislative and provincial elections in 35 years, they stand ready to face the formidable challenges and make further progress in reducing poverty. Under the assumptions of continued reform, donor support, and the gradual improvement of infrastructure, the medium-term framework envisages growth of about 10 percent on average for the next three years. This scenario is consistent with a return to trend of agricultural growth, and sustained, albeit decelerating, activity in construction and services. The MTFF will serve as a key anchor for sound macroeconomic policies; it outlines a clear path toward fiscal and external sustainability, including an ambitious program to increase domestic revenue from 4.5 percent of GDP in 2004/05 to 8.6 percent of GDP by 2009/10, through, inter alia, the rationalization of the current tariff structure and the introduction of road tolls and excise taxes in 2006/07. Considerable progress has been made in reconciling the external debt, which was an end-September 2005 structural benchmark, including the completion of the reconciliation process with many of the creditors. A major milestone was reached in the aftermath of the recent donor's conference when the governments of Russia, Germany, and the United States indicated their intention to cancel the entire debt owed by Afghanistan through the Paris Club under the HIPC Initiative. It was heartening to read in the public statements of the donors on 100% debt cancellation that this achievement reflected the hard work of the government and the people of Afghanistan to build a stable economy, despite many challenges, and that the solution of the debt problem will strongly contribute to the further development of Afghanistan's trade, investment and other economic ties with its major creditors and with the rest of the world.

Poverty reduction and growth facility

The authorities have taken appropriate measures to ensure achievement of macroeconomic objectives under the SMP. These successes can hardly be overestimated in light of the difficult and severely constrained circumstances under which they were achieved and the variety of adverse shocks that have complicated program implementation. At the same time, the authorities are very much aware that there is a long way to go towards self-sustained growth and completing the ambitious program of reforms required to finish the tasks of economic reconstruction, eliminating opium production and providing alternative income opportunities, strengthening productive efficiency, and reducing poverty. As indicated in the staff report, the authorities have expressed strong interest in continued Fund involvement, and the progress made so far under the SMP has paved the way for discussions on a program that could be supported by the PRGF. The current SMP has been instrumental in maintaining macroeconomic stability and building a momentum for structural reform, and a successor program would help the authorities to consolidate these gains, reinforce the implementation of the ambitious policy agenda, including the critical task of developing the institutions and conditions necessary for private sector development, and significantly improving social conditions. In addition, a PRGF arrangement would contribute to the resolution of outstanding debt issues with Paris Club creditors in the context of the HIPC Initiative.

The authorities plan to continue the laborious process of restructuring the economy, improving governance and transparency, and enhancing efficiency through greater reliance on market forces with reduced government intervention in the economy. Their adjustment record since the inception of the SMP in March 2004 should give confidence in their ability to pursue such a strategy in a pragmatic way within the existing economic and political constraints. The record is all the more commendable because of a difficult environment, which has been dominated by lingering insecurity, poor state of infrastructure, weak institutions, and other myriad uncertainties typical of a post-conflict environment.