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

In the context of the first review under the three-year arrangement under the Poverty Reduction and Growth Facility, the following documents have been released and are included in this package:

- the staff report for the First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, prepared by a staff team of the IMF, following discussions that ended on November 26, 2006, with the officials of the Islamic Republic of Afghanistan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 22, 2007. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF;

- a staff supplement of February 27, 2007, updating information on recent developments;

- a Press Release summarizing the views of the Executive Board as expressed during its March 7, 2007 discussion of the staff report that completed the review; and

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

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

Letter of Intent sent to the IMF by the authorities of Islamic Republic of Afghanistan*
Memorandum of Economic and Financial Policies by the authorities of the Islamic Republic of Afghanistan*
Technical Memorandum of Understanding*
*Also included in Staff Report

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

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ISLAMIC REPUBLIC OF AFGHANISTAN

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

Prepared by the Middle East and Central Asia Department in collaboration with other departments

Approved by Juan Carlos Di Tata and Matthew Fisher

January 22, 2007

- Discussions were held in Kabul from November 12–26, 2006. The staff team comprised Messrs. Symansky (head), Bessaha, Wieczorek (all MCD), and Mr. Tyson (FAD). Ms. Ongley (PDR) supported the team from headquarters. Mr. Charap, Fund resident representative in Kabul, assisted the mission. Mr. Erbas (OED) participated in the policy discussions.

- Afghanistan's three-year PRGF arrangement amounting to SDR 81.0 million (50 percent of quota) was approved by the Executive Board in June 2006. The arrangement supports the authorities' economic program through March 2009, which builds upon a previous staff-monitored program, and seeks to address outstanding debt issues in the context of the Heavily Indebted Poor Countries (HIPC) Initiative.

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LIST OF ACRONYMS

ANP	Afghan National Police
ANA	Afghan National Army
ANDS	Afghanistan National Development Strategy
ARTF	Afghanistan Reconstruction Trust Fund
CAO	Control and Audit Office
CIRRs	Commercial Interest Reference Rates
CPI	Consumer Price Index
BRT	Business Receipts Tax
DAB	Da Afghanistan Bank
DGT	Directorate General of Treasury
DSA	Debt Sustainability Analysis
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
GST	General Sales Tax
HIPC	Heavily Indebted Poor Countries
I-ANDS	Interim Afghanistan National Development Strategy
I-PRSP	Interim Poverty Reduction Strategy Paper
MCD	Middle East and Central Asia Department
MEFP	Memorandum of Economic and Financial Policies
MoF	Ministry of Finance
MoE	Ministry of Education
MTFF	Medium-Term Fiscal Framework
MYR	Midyear Budget Review
NCBF	Net Central Bank Financing
NIR	Net International Reserves
NRVA	National Risk Vulnerability Assessment
PFEM	Public Finance and Expenditure Management
PFM	Public Finance Management
PRGF	Poverty Reduction and Growth Facility
PRSP	Poverty Reduction Strategy Paper
SMP	Staff-Monitored Program
SOEs	State-Owned Enterprises
TCC	Technical Committee of Coordination
TMU	Technical Memorandum of Understanding

EXECUTIVE SUMMARY

- Despite a difficult security environment and persistent expenditure pressures, Afghanistan's performance during the first six months of 2006/07 (fiscal year starts on March 21) was in line with the program. The authorities met all the end-September 2006 quantitative performance criteria and indicative targets, the structural performance criterion, and most structural benchmarks, except those related to the state-owned banks.

- Real GDP growth is expected to reach 8 percent in 2006/07. CPI inflation declined to 5.4 percent (year-on-year) in September 2006, and the exchange rate has been relatively stable. Opium production is estimated to have increased substantially.

- Real GDP growth is projected at 12 percent in 2007/08 and 10 percent from 2008/09 onwards. With continued appropriate monetary and fiscal policies, CPI inflation is targeted at 6 percent by year's end, and at 5 percent in 2007/08 and beyond. The external current account has continued to improve, and official reserves would remain at around five months of prospective imports over the medium term.

- The overall fiscal strategy for the remainder of 2006/07 and for 2007/08 strikes a balance between addressing critical spending pressures and fiscal sustainability. Over the medium term, a strategic approach is needed for revenue mobilization, including administrative reforms and a move toward a broad-based consumption tax.

- Monetary developments point to strengthened confidence in the Afghani. The current monetary stance remains appropriate, but Da Afghanistan Bank (DAB) must stand ready to absorb banks' growing excess liquidity and forestall undue pressures in the foreign exchange market, partly by increasing placements of capital notes.

- Decisive action is required to deal with the state-owned banks. The authorities must (a) accelerate their restructuring to fulfill the licensing requirements by end-September 2007; or (b) liquidate/privatize these banks.

- There has been progress in the negotiations of the bilateral Paris Club rescheduling agreements, but data are still needed from some non-Paris Club creditors to complete the external debt database and perform the eligibility assessment under the Heavily Indebted Poor Countries (HIPC) Initiative**.**

- The authorities intend to complete the PRSP by mid-2008. Efforts are under way to ensure stakeholders' participation and to align the medium-term fiscal framework (MTFF) with sectoral strategies based on the country's PRSP objectives. The recently completed national risk vulnerability assessment (NRVA) should provide sufficient inputs to assess poverty for PRSP purposes.

I. INTRODUCTION

1. **On June 26, 2006, the Executive Board approved a three-year PRGF arrangement with Afghanistan** in support of a program aimed at (a) maintaining fiscal discipline to achieve medium-term fiscal sustainability, while ensuring an adequate level of pro-poor spending; (b) implementing structural reforms to boost economic growth; and (c) addressing the large external debt, possibly through the HIPC initiative.[1]

2. **Security remains a challenge, although it has not hindered program implementation**. After deteriorating in the summer and through mid-October 2006, the security situation in Kabul—which still remains fragile—appears to have improved somewhat recently, as it did in the past two winters.

II. RECENT ECONOMIC DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM

3. **Economic developments in the first half of 2006/07 were generally favorable** (Table 1). Real GDP growth is on track to reach 8 percent in 2006/07, notwithstanding lingering drought and a slow start in public investment. Year-on-year CPI inflation declined to 5.4 percent in September 2006, owing largely to a deceleration in rent prices. The international reserves position has strengthened, and the exchange rate has remained stable. Despite intensified counternarcotics efforts, opium production is estimated to have risen substantially.

4. **Performance under the PRGF-supported program has been broadly satisfactory**. The authorities met all the end-September quantitative performance criteria and indicative targets, the structural performance criterion, and the structural benchmarks, except those related to the state-owned banks (MEFP, Tables 1–2) because they were considering alternative reform strategies (MEFP, ¶16).

5. **The overall fiscal performance during the first half of 2006/07 was better than programmed** (Tables 3a–3b). Domestic revenues exceeded the program's target because a stronger-than-expected performance of the income, profits, and business receipts taxes (BRT) more than offset lower-than-expected customs receipts.[2] Operating expenditures were lower than originally projected owing largely to the delayed adoption of the budget. As a result, the operating budget deficit, excluding grants, was 1.2 percent of GDP, compared with

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[1] The first PRGF disbursement, drawn on January 19, 2007, was delayed due to domestic legal obstacles.

[2] This outcome reflected delays in introducing a new tariff schedule and concessions made to traders.

2.1 percent envisaged in the program.[3] The slower-than-expected execution of the development budget led to a core budget deficit,[4] including grants, of 1.2 percent of GDP in the first half of 2006/07 (2.4 percent in the program) (MEFP, ¶¶4–6).

6. **Structural conditions in the fiscal area have been observed** (MEFP, ¶7), including the submission to parliament of the core budget audited financial statements for 2005/06 (end-September 2006 structural performance criterion). Progress has also been made on reforms that were not covered by program conditionality, including public financial management, tax policy and administration, and the launching of program-budgeting in selected ministries.

7. **Monetary developments point to increased confidence in the Afghani and the banking system** (Table 4). Currency in circulation increased by nearly 7 percent—somewhat less rapidly than expected—while bank deposits rose by more than 40 percent, albeit from a low level. Interest rates on capital notes dropped from about 8 percent in early 2006/07 to 5–6 percent in recent months, reflecting the banks' rising liquidity in Afghanis. Other interest rates also declined, and the spreads between bank deposit and lending rates narrowed.

8. **The external current account position was stronger than expected in 2005/06, reflecting higher official transfers and a surge in exports** (Table 5). The external current account (including grants) remained in surplus in 2005/06 (MEFP, ¶12), and foreign direct investment grew modestly. Official reserves rose to US$1.8 billion (4.6 months of imports) at end-September 2006, exceeding the program projections mainly because of a slower-than-expected drawdown of the government's foreign exchange deposits at DAB.

9. **The new tariff schedule—adopted in August 2006—addressed several cases of negative effective protection** (MEFP, ¶5), but increased tariff dispersion. Two new rates (20 and 25 percent) above the previous maximum (16 percent) were introduced, mainly in lieu of excises.

III. The Program for the Remainder of 2006/07 and 2007/08

10. **The discussions with the authorities focused on their policies for the remainder of 2006/07 and 2007/08**. A key issue was to strike a balance between addressing expenditure pressures and ensuring security and adequate pro-poor spending, without compromising fiscal sustainability.

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[3] The operating budget deficit, including grants, was 0.5 percent of GDP, compared with 1.1 percent envisaged in the program.

[4] The core budget excludes donor-financed development expenditures implemented outside the Treasury.

A. Macroeconomic Outlook

11. **Real GDP growth is expected to reach 12 percent in 2007/08 and 10 percent from 2008/09 onwards, assuming a rebound of agriculture and sustained activity in construction and services. Inflation is targeted at 7 percent by end-March 2007, notwithstanding an expected seasonal upturn**. Food prices are envisaged to rise less than in previous years as timely imports of wheat have prevented cereal shortages, while rents and energy prices are expected to rise moderately. Continued appropriate monetary and fiscal policies will help limit the increase in the CPI to 5 percent in 2007/08 and beyond.

B. Fiscal Policy

12. **The good revenue performance is expected to continue in the second half of 2006/07, but new spending authorized in the midyear budget review (MYR) will lead to a higher budget deficit, excluding grants**. Domestic revenue is projected at 6.4 percent of GDP in 2006/07, slightly above the original target. Nonetheless, the operating budget deficit, excluding grants, is projected at 4.1 percent of GDP (2.9 percent in the program). This reflects: (a) additional security and education outlays—the program foresaw their possible expansion in the context of the MYR (IMF Country Report No. 06/251; ¶27); (b) the clearing of arrears that have been identified after the fiscal year began; and (c) the transfer onto the budget of expenditures previously covered by donors, primarily the energy subsidy (MEFP, ¶19).

13. **In 2007/08, the operating budget deficit, excluding grants, is expected to decline to 2.8 percent of GDP, slightly higher than previously projected (MEFP, ¶21)**.[5] The main causes include: (a) the cost of the energy subsidy that moved on budget (expected to diminish over the medium term (MEFP, ¶19); (b) higher maintenance costs of the development budget; (c) higher provisions for pensions; and (d) security-related expenditures, for which funding has been identified.[6]

14. **Achieving medium-term fiscal sustainability requires durable reforms, expenditure discipline, and improvements in public financial management (MEFP, ¶¶23–25)**. The authorities will focus on: (a) mobilizing additional revenue—the reform of the BRT will replace ad hoc measures envisaged for the short-term; (b) prudently managing donor-funded expenditures that are transferred to the core budget; (c) consolidating the operating and development budgets; (d) implementing an affordable

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[5] The operating budget surplus including grants rises to 1.0 percent of GDP, from 0.6 percent in the original program as additional donor support is expected to exceed the increase in operating expenditures.

[6] The program will accommodate additional security-related expenditures (up to an agreed ceiling; Table 3a (memorandum item) and TMU, ¶20) as long as they are fully-funded by donors (MEFP, ¶22).

public administration reform; and (e) seeking government-wide commitment to the MTFF. The authorities continued to emphasize the need to channel all foreign assistance flows through the core budget in order to optimize the use of aid and enhance the efficiency of the budget as a policy tool in implementing the ANDS.

C. Monetary and Exchange Rate Policies and Financial Sector Reforms

15. **Currency in circulation is projected to grow broadly in line with nominal GDP, with bank deposits increasing at a faster pace**. With the strengthening of DAB's analytical and operational capacity, monetary policy will increasingly focus on liquidity management through capital notes (MEFP, ¶28). To this effect, DAB will increase the auction volumes, issue longer maturity notes, and create a framework for the development of the secondary market. DAB will also continue to supply foreign exchange through twice weekly auctions. DAB's Supervision Department will complete the on-site inspections of all banks by end-March 2007, and will subject the ailing state-owned banks to standard licensing requirements.

16. **The authorities will put in motion a new plan to restructure or liquidate the remaining state-owned banks (MEFP, ¶29)**. The restructured banks will be expected to meet all licensing requirements by end-September 2007; in particular the appointment of a qualified management and a board of directors. In case of noncompliance, DAB will withdraw the conditional licenses under which these banks are currently operating (MEFP, ¶29). The authorities acknowledge the difficulties involved in this process, and the challenges it poses to the MoF's and DAB's credibility.

D. External Sector

17. **External sustainability is predicated on reforms to strengthen export growth and foreign investment, as well as a favorable resolution of Afghanistan's external arrears**. While the current account deficit (excluding grants) is expected to narrow over the medium term, the current account balance (including grants) is likely to move into deficit as official transfers moderate after 2006/07 (MEFP, ¶¶31–32). Import demand should remain strong, reflecting ongoing reconstruction and development needs. In any event, imports will be largely determined by absorptive and implementation capacity.

18. **Progress has been made in regularizing Afghanistan's relations with external creditors, although debt management capacity remains limited**. The authorities intend to finalize the bilateral agreements with Paris Club creditors by end-February 2007.[7] Debt service (after relief) will average around 1½ percent of exports over the medium term. Nearly

[7] The bilateral agreement with the United States was signed in September 2006 (MEFP, ¶14).

all the debt data needed for a HIPC debt sustainability analysis are already available (MEFP, ¶14). Staff are working to overcome deficiencies in the official export data to enable an assessment of HIPC eligibility in early 2007.

19. **The 2006/07 program is fully financed, reflecting the July 2006 Paris Club rescheduling agreement and robust donor support**. Assuming continued aid inflows during the program period, Fund support and the capitalization of moratorium interest under the Paris Club agreement would fill the residual financing gap. In the medium term, as grants taper off, the accumulated official reserves would provide an adequate balance of payments buffer. On this basis, Afghanistan should have no problem in servicing its obligations to the Fund and other multilateral creditors.

E. Structural Policies, Poverty Reduction, and Statistical Issues

20. **The authorities are committed to accelerating structural reforms in order to foster private sector development and mobilize the growth potential of the economy**. Accordingly, they intend to implement measures to enhance transparency and improve the country's business climate, and will press ahead with public enterprise reform.

21. **The authorities intend to complete the PRSP by mid-2008**. Efforts are under way to create the institutional framework for the participation of stakeholders in the PRSP discussions and the development of key sectoral strategies. The recently completed 2005 NRVA will provide sufficient inputs to define the poverty profile.

22. **The authorities are implementing the statistical master plan** to address data weaknesses in the national accounts and the monetary and balance of payments statistics, with support from the Fund and donors.

IV. Program Monitoring, Risks, and Safeguards Assessment

23. **The second review under the PRGF arrangement is expected to be completed by end-July 2007**, and will make available the third disbursement subject to the observance of the end-March 2007 quantitative performance criteria (Attachment II).

24. **The program is subject to a number of risks**. Revenue mobilization will play a critical role as continued external support in some key areas is not assured, and the possible transfer to the budget of unfunded spending currently undertaken off-budget by donors could jeopardize the fiscal program. Although continued insecurity has been reflected in program design, it could have further detrimental effects on project implementation and investment. Moreover, growing public dissatisfaction with the pace of reforms and limited progress in addressing governance concerns pose additional risks.

25. **DAB continues to implement the recommendations of the Fund's safeguards assessment conducted in mid-2006**. The integrated accounting system will be operational shortly. To provide assurances on the level of DAB's foreign reserves, external auditors will reconcile the net foreign reserves data reported to the Fund with the underlying bank/creditor statements. DAB will also commission special audits of reserves at program test dates.

V. STAFF APPRAISAL

26. **Despite a difficult security environment and persistent expenditure pressures from domestic constituents and donors, Afghanistan's performance under the program has been broadly satisfactory**. Growth has been sustained, inflation has subsided, and fiscal and monetary developments have remained favorable. All the quantitative and structural performance criteria for end-September 2006 were observed. Looking forward, the success of the program will depend on continued macroeconomic discipline, a vigorous implementation of structural reforms, and political resolve to tackle some difficult issues, such as revenue mobilization and the restructuring of state-owned banks.

27. **Fiscal policy and reforms should focus on sustainability, with increased reliance on an articulated MTFF**. While ad hoc revenue measures envisaged by the authorities appear sufficient to meet the revenue target for 2007/08, the government needs to develop a modern tax and customs administration to achieve its longer term fiscal policy objectives. In this regard, renewed efforts are needed to achieve a consensus for the BRT reform, which has been delayed owing to political pressures. Furthermore, the macro-fiscal framework should become sufficiently flexible to accelerate development spending, respond to the country's security challenges, and facilitate the inclusion of donor-funded expenditures into the budget.

28. **The current monetary stance remains appropriate, but DAB must stand ready to absorb banks' growing excess liquidity and forestall undue pressures in the foreign exchange market**. To that effect, the volumes of capital notes auctions should be raised. Looking forward, DAB should be ready to engage in secondary market operations in capital notes to gain flexibility in achieving its policy objectives.

29. **Decisive actions are required regarding the state-owned banks**. As the role of these banks diminish—in light of the larger participation of private banks in the system—the government needs to accelerate the restructuring of those banks that are deemed potentially viable. The banks that cannot be restructured should be liquidated or privatized to avoid a further dissipation of public capital.

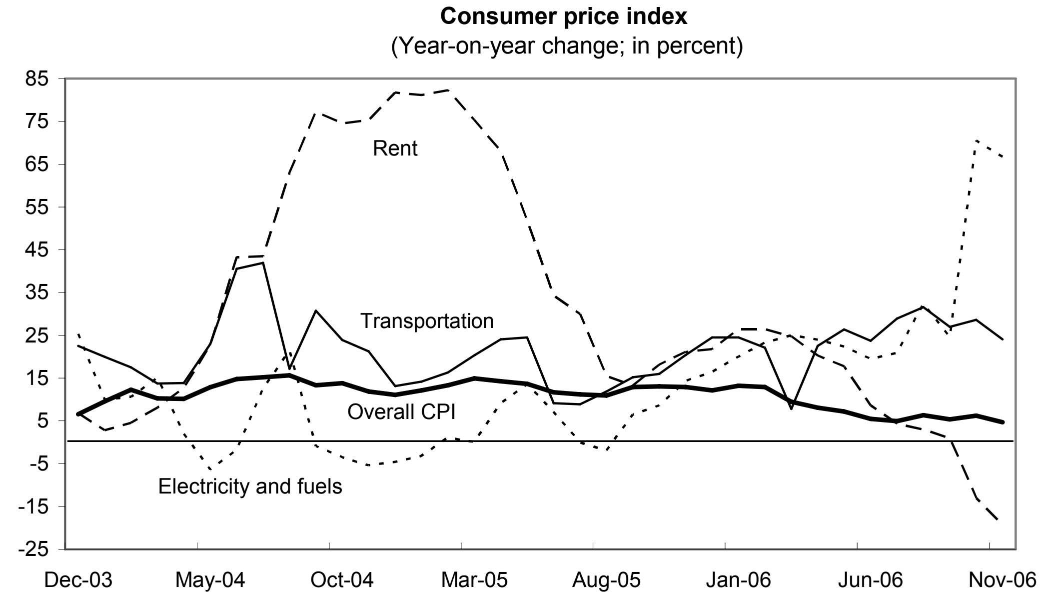
30. **While the Paris Club agreement contributed to a substantial debt reduction, the remaining external debt represents a significant burden**. Restoring longer-term sustainability will require further assistance, possibly in the context of the HIPC Initiative. In parallel, the authorities need to strengthen their debt management capacity.

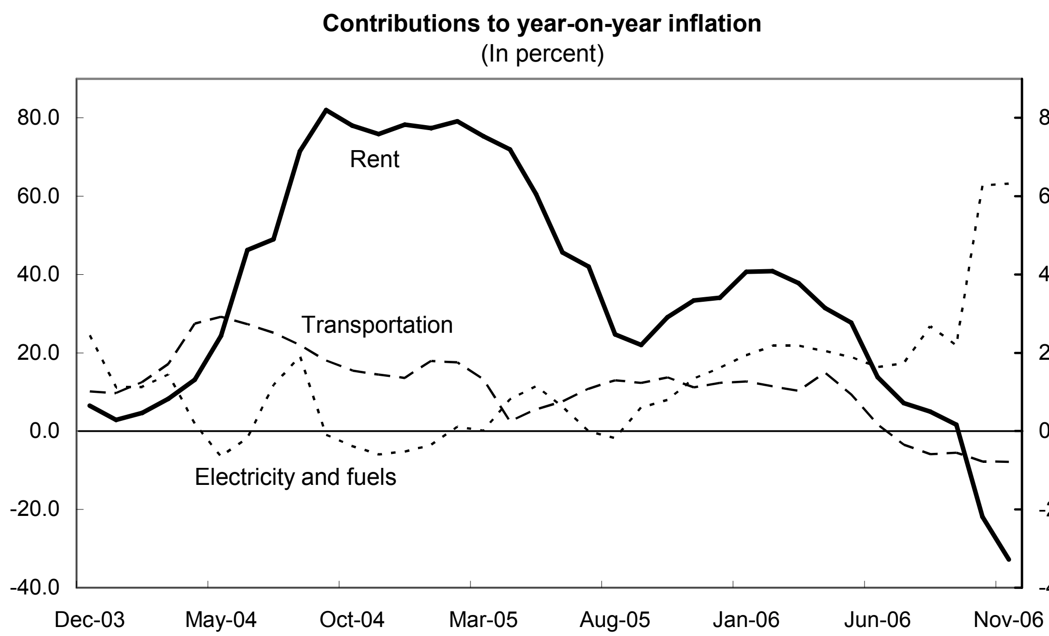
31. **Looking forward, the authorities should replace the new higher tariff rates with excise taxes**. In the interim, they should refrain from moving more items to the top tariff bands and introducing ad hoc concessions that could erode the revenue base and distort the trading system.

32. To facilitate the completion of the PRSP by mid-2008, the authorities should focus on costing key strategies and integrating them in the MTFF.

33. Based on Afghanistan's satisfactory performance, the staff recommends completion of the first review under the PRGF arrangement.

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

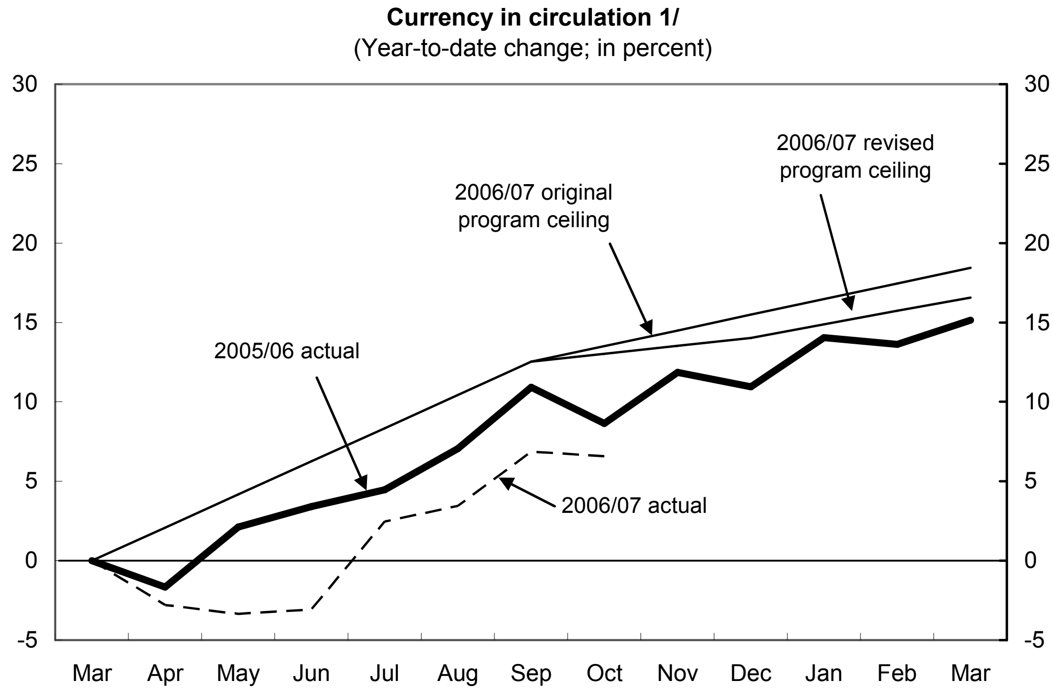


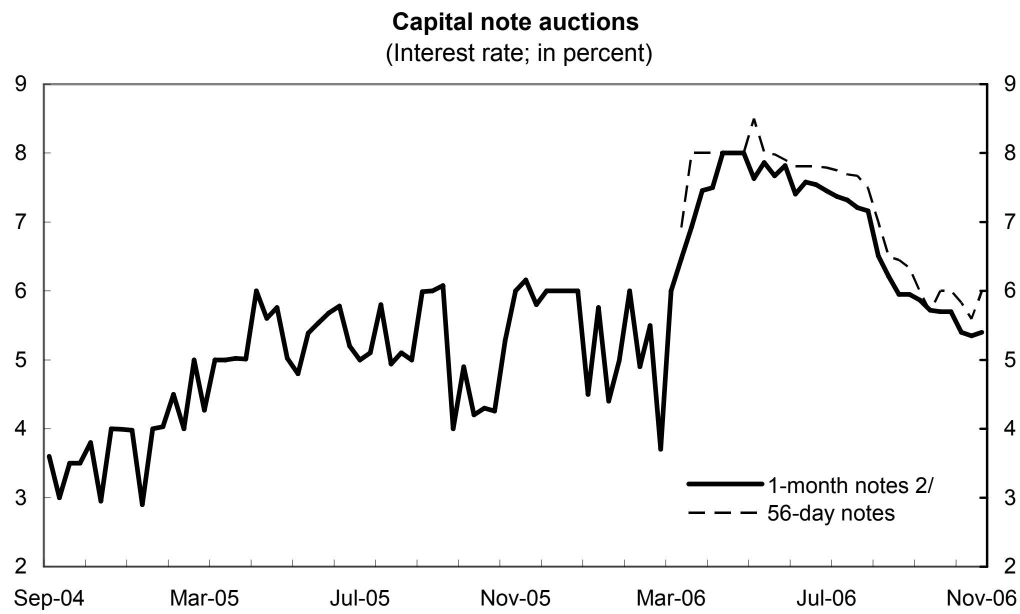


Sources: Central Statistics Office of Afghanistan; and Fund staff estimates.

1/ Last observation: November 2006.

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



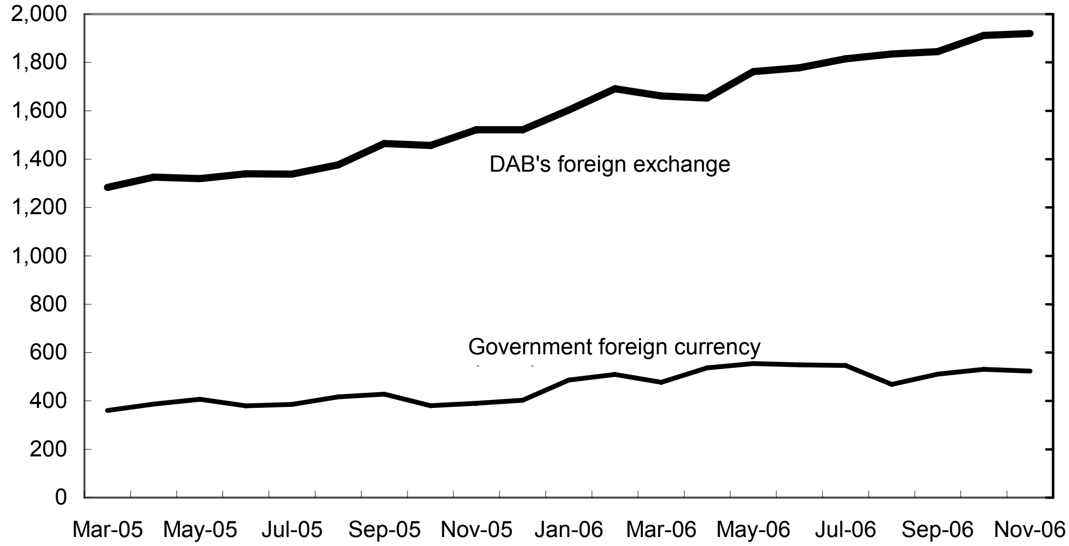


Sources: Da Afghanistan Bank; and Fund staff estimates and projections.

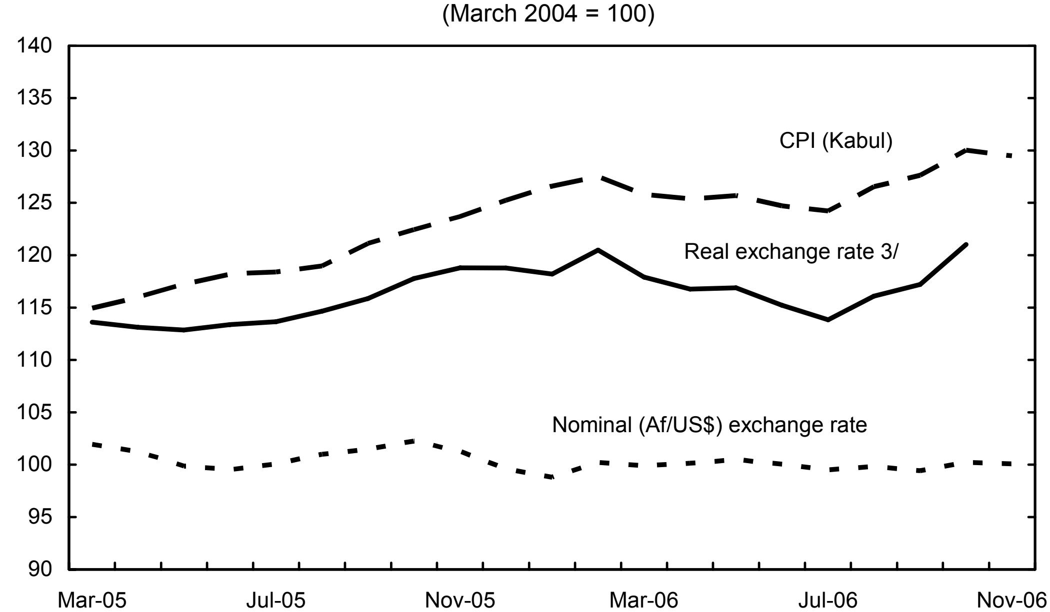
1/ Last observation: October 22, 2006.
2/ 30-day notes from September 19, 2004. 28-day notes from March 28, 2006.

Figure 3. Islamic Republic of Afghanistan: Foreign Exchange Reserves and Real Exchange Rate, 2005–06 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: November 2006.
2/ An increase in the exchange rate indices corresponds to an appreciation. The real exchange rate is estimated using the U.S. and Afghan CPIs.
3/ Last observation for real exchange rate is October 2006.

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

(Quota: SDR 161.9 million)
(Population: 21.8 million; 2002/03)
(Per capita GDP: US$300; 2005/06)
(Poverty rate: n.a.)
(Main export: carpets, US$156 million; 2003/04)

	Est. 2002/03	Est. 2003/04	Est. 2004/05	Rev. Est. 2005/06	CR 06/251 2006/07	Rev. Proj. 2006/07	Rev. Proj. 2007/08
			(Annual percentage change)				
Output and prices							
Real GDP (at market prices)	28.6	15.7	8.0	14.0	12.0	8.0	12.2
Consumer prices (end of period)	52.4	10.3	14.9	9.5	9.0	7.0	5.0
Consumer prices (period average)	5.1	24.1	13.2	12.3	9.2	6.4	5.9
			(In percent of GDP)				
Investment and saving							
Gross domestic capital formation	34.5	42.0	43.3	38.7	37.8	41.3	36.1
Of which: nongovernment	7.5	8.1	8.5	8.1	9.8	9.9	11.0
Gross domestic savings	0.9	-9.0	-1.6	-3.2	-1.3	-0.5	-0.6
Of which: nongovernment	5.5	-4.6	2.6	-0.8	1.2	3.2	1.8
Public finances 1/							
Revenue (including grants)	8.4	9.0	9.8	10.3	9.9	10.9	11.1
Operating expenditure	8.5	9.8	9.4	8.9	8.9	10.5	10.1
Operating budget balance (including grants)	-0.1	-0.8	0.4	1.4	1.0	0.3	1.0
Primary balance (including grants)	-0.1	-0.8	0.4	1.4	1.1	0.4	1.0
Total government debt 2/	13.2	14.0	12.3	11.6	…	19.7	19.0
			(Annual percentage change; unless otherwise indicated)				
Monetary sector							
Credit to the private sector	...	...	...	...	...	...	...
Base money	50.2	40.9	34.6	17.0	13.7	19.8	14.1
Broad money	…	…	…	…	…	…	…
Velocity of broad money	...	...	...	...	...	...	...
One-month capital note interest rate (end-period, in percent)	...	...	5.0	6.5	...	...	...
			(In percent of GDP; unless otherwise indicated)				
External sector							
Exports of goods (in U.S. dollars, percentage change) 3/	...	36.2	21.3	21.7	20.1	13.3	18.3
Imports of goods (in U.S. dollars, percentage change) 3/	...	51.8	18.5	14.6	12.8	18.8	7.8
Merchandise trade balance	-29.8	-41.3	-37.4	-34.6	-33.0	-36.1	-32.4
Current account balance, excluding official transfers 4/	-33.6	-51.0	-44.9	-41.9	-39.1	-41.8	-36.7
Current account balance, including official transfers 4/	-3.7	3.0	1.8	0.6	-1.5	-1.7	-3.8
Foreign direct investment	1.2	1.3	3.1	3.7	2.5	2.8	3.5
Total external debt 2/	13.2	14.0	12.3	11.6	…	19.7	19.0
Gross reserves (in millions of U.S. dollars)	425	820	1,283	1,662	1,804	1,838	2,097
In months of following year's imports of goods and services 3/	1.8	3.1	4.1	4.6	4.9	4.8	5.2
In percent of short-term external debt (on remaining maturity basis)	...	...	...	...		...	...
Memorandum items:							
Nominal GDP (excluding opium production; in millions of U.S. dollars)	4,084	4,585	5,971	7,309	8,869	8,399	9,892
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)	12.8	23.6	76.6	...		...	...
Afghanis per U.S. dollar (period average)	44.8	49.0	47.7	49.7	...	...	...
Real exchange rate (annual average, percentage change) 5/	21.0	12.4	13.8	5.4	...	...	...
Stock market index	...	...	...	...	...	...	...

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

1/ Operating budget. Does not include core budget development spending and externally-financed development expenditures, which amounted to 5.8 percent of GDP and 27.5 percent of GDP, respectively, in 2005/06.
2/ Includes unreconciled debts. Up to 2005/06, excludes estimates of Russia's claims. Thereafter, includes Russian claims as restructured in the July 2006 Paris Club rescheduling agreement.
3/ Excluding reexports.
4/ After rescheduling (i.e., excludes estimated penalty interest obligations programmed to be rescheduled beginning in 2006/07).
5/ An increase in the exchange rate indices corresponds to an appreciation. The real exchange rate is estimated using the U.S. and Afghan consumer price indices.

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

	2002/03	2003/04	2004/05	2005/06	2006/07		2007/08		2008/09		2009/10	
	Rev. Est.	Rev. Est.	Rev. Est.	Est. Mar. 06	Proj. Mar. 06	Rev. Proj. Nov. 06	Proj. Mar. 06	Rev. Proj. Nov. 06	Proj. Mar. 06	Rev. Proj. Nov. 06	Proj. Mar. 06	Rev. Proj. Nov. 06
	(In millions of U.S. dollars)											
Domestic expenditures	5,455	6,923	8,653	10,371	12,337	11,907	13,910	13,523	15,581	15,259	17,030	16,898
Consumption	4,046	4,999	6,069	7,540	8,980	8,441	10,479	9,956	12,136	11,626	13,608	13,246
Public 1/	318	429	546	629	813	922	901	1,049	1011	1,149	1,113	1,289
Private 2/	3,728	4,570	5,523	6,911	8,167	7,519	9,578	8,907	11125	10,477	12,495	11,958
Gross fixed capital formation	1,409	1,924	2,584	2,830	3,357	3,466	3,431	3,567	3,445	3,633	3,422	3,652
Public	1,104	1,553	2,077	2,239	2,486	2,634	2,365	2,481	2138	2,285	1,678	1,864
Private 3/	305	371	507	591	871	832	1,066	1,086	1307	1,348	1,744	1,788
Net exports of goods and services	-1,372	-2,338	-2,682	-3,062	-3,468	-3,508	-3,566	-3,631	-3,600	-3,746	-3,319	-3,715
Exports of goods and services (excluding reexports)	328	487	556	698	734	802	848	948	991	1,116	1,164	1,317
Imports of goods and services (excluding reexports)	-1,699	-2,826	-3,238	-3,760	-4,202	-4,310	-4,414	-4,579	-4,591	-4,862	-4,483	-5,032
Domestic savings	37	-415	-98	-232	-111	-42	-135	-64	-155	-113	103	-63
Public savings	-187	-203	-251	-171	-221	-310	-122	-244	-31	-159	81	-73
Private savings	224	-211	153	-61	109	268	-12	180	-124	46	22	10
GDP at market prices	4,084	4,585	5,971	7,309	8,869	8,399	10,344	9,892	11,981	11,513	13,711	13,183
	(In percent of GDP)											
Domestic expenditures	133.6	151.0	144.9	141.9	139.1	141.8	134.5	136.7	130.0	132.5	124.2	128.2
Consumption	99.1	109.0	101.6	103.2	101.3	100.5	101.3	100.6	101.3	101.0	99.3	100.5
Public	7.8	9.4	9.1	8.6	9.2	11.0	8.7	10.6	8.4	10.0	8.1	9.8
Private	91.3	99.7	92.5	94.6	92.1	89.5	92.6	90.0	92.9	91.0	91.1	90.7
Gross fixed capital formation	34.5	42.0	43.3	38.7	37.8	41.3	33.2	36.1	28.8	31.6	25.0	27.7
Public	27.0	33.9	34.8	30.6	28.0	31.4	22.9	25.1	17.8	19.8	12.2	14.1
Private	7.5	8.1	8.5	8.1	9.8	9.9	10.3	11.0	10.9	11.7	12.7	13.6
Net exports of goods and services	-33.6	-51.0	-44.9	-41.9	-39.1	-41.8	-34.5	-36.7	-30.0	-32.5	-24.2	-28.2
Exports of goods and services (excluding reexports)	8.0	10.6	9.3	9.6	8.3	9.5	8.2	9.6	8.3	9.7	8.5	10.0
Imports of goods and services (excluding reexports)	-41.6	-61.6	-54.2	-51.4	-47.4	-51.3	-42.7	-46.3	-38.3	-42.2	-32.7	-38.2
Domestic savings	0.9	-9.0	-1.6	-3.2	-1.3	-0.5	-1.3	-0.6	-1.3	-1.0	0.7	-0.5
Public savings	-4.6	-4.4	-4.2	-2.3	-2.5	-3.7	-1.2	-2.5	-0.3	-1.4	0.6	-0.6
Private savings	5.5	-4.6	2.6	-0.8	1.2	3.2	-0.1	1.8	-1.0	0.4	0.2	0.1
Memorandum items:												
Real GDP growth (annual change; in percent)	28.6	15.7	8.0	14.0	12.0	8.0	11.1	12.2	10.3	10.8	10.0	10.1
Nominal GDP growth (annual change; in percent)	33.8	23.1	26.4	27.6	22.0	15.6	16.6	17.8	15.8	16.4	14.4	14.5
Sectoral shares of GDP (in percent)												
Agriculture	49.8	48.5	37.2	35.9	32.9	30.9	32.9	31.4	32.8	31.5	33.1	31.8
Industry	20.1	21.3	24.4	24.4	24.5	26.2	25.1	25.1	23.5	24.5	24.1	25.1
Services	30.1	30.2	38.3	39.7	42.6	42.9	42.0	43.5	43.7	44.0	42.9	43.1
GDP per capita (in U.S. dollars)	182	199	253	300	354	335	401	383	450.8	433	501	482
Domestic government revenue (in percent of GDP)	3.2	4.5	4.5	5.7	6.0	6.4	6.8	7.2	7.4	7.6	7.9	8.2

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, 2003/04–2009/10 1/
(In millions of Afghanis)

	Est. 2003/04	Est. 2004/05	Prelim. 2005/06	Approved Core Budget 2/ 2006/07	CR 06/251 Mid-year Proj. 2006/07	YTD 6 months Prelim. 2006/07	CR 06/251 Fiscal Program 2006/07	Revised Proj. 3/ 2006/07	CR 06/251 Fiscal Program 2007/08	Revised Proj. 3/ 2007/08	Proj. 2008/09	Proj. 2009/10
Domestic revenue	10,168	12,800	20,652	25,220	10,636	11,990	26,595	27,015	35,149	35,773	43,943	53,831
Tax revenues	6,262	9,546	14,035	18,867	8,188	9,862	20,008	22,462	26,877	29,482	35,899	43,712
Taxes on income, profits, and capital gains	363	995	2,621	4,559	1,683	1,911	3,580	4,178	5,048	5,788	7,284	9,037
Taxes on international trade and transactions	5,369	7,247	9,446	13,774	5,745	5,127	14,339	12,750	17,772	16,535	20,284	23,428
Other taxes	531	1,304	1,968	534	761	2,825	2,089	5,534	4,057	7,159	8,331	11,248
Nontax revenues	3,906	3,254	6,617	6,354	2,447	2,127	6,588	4,553	8,273	6,290	8,044	10,118
Donor assistance grants (to operating budget) 4/	10,074	14,984	16,732	17,218	4,304	3,196	17,218	18,595	12,233	18,819	19,041	19,083
ARTF (recurrent window)	8,182	12,319	12,572	13,580	3,395	2,614	13,580	13,095	8,595	13,580	13,580	13,580
LOTFA	1,892	2,583	4,068	3,638	909	579	3,638	4,800	3,638	3,638	3,638	3,638
Other grants		83	92	0	0	3	0	700	0	1,601	1,824	1,866
Donor assistance grants (core development budget)	4,569	8,250	19,251	37,362	5,611	2,504	18,843	18,064	22,584	25,928	40,259	49,354
Total core budget expenditure	31,606	39,550	53,437	106,925	30,977	22,690	69,436	79,476	81,454	93,891	109,106	128,780
Operating expenditure	22,151	26,716	32,348	40,346	19,755	17,224	39,511	44,200	44,047	49,795	53,986	59,881
Wages and salaries	14,660	18,902	20,430	25,378	12,469	11,683	25,378	27,276	28,770	29,667	32,487	37,173
Purchase of goods and services	4,653	4,182	6,679	8,999	4,674	4,023	8,999	9,352	9,809	10,769	11,738	12,501
Transfers and subsidies	652	764	495	2,213	838	0	1,378	3,816	1,608	4,765	4,731	4,755
Pensions	177	889	1,540	2,065	925	1,108	2,065	2,065	2,168	2,773	2,912	3,028
Capital expenditure	2,009	1,979	3,054	1,220	614	327	1,220	1,220	1,423	1,437	1,672	1,915
Interest	...	...	150	471	236	83	471	471	270	384	446	508
Core budget development spending 5/	9,455	12,834	21,089	66,579	11,222	5,467	29,926	35,276	37,407	44,096	55,119	68,899
Interim Afghanistan National Development Strategy programs												
Security	...	...	1,122	2,522	435	296	1,161	1,513	1,451	1,891	2,364	2,955
Governance, Rule of Law, and Human Rights	...	...	551	2,377	431	218	1,149	1,426	1,437	1,783	2,228	2,785
Infrastructure and Natural Resources	...	...	6,235	34,327	4,375	1,195	11,665	13,731	14,582	17,163	21,454	26,818
Education	...	...	1,035	5,068	784	617	2,090	3,041	2,612	3,801	4,751	5,939
Health	...	...	991	3,779	612	759	1,631	2,267	2,038	2,834	3,542	4,428
Agriculture and Rural Development	...	...	10,170	14,628	3,911	2,336	10,429	10,971	13,037	13,714	17,142	21,428
Social Protection	...	...	30	143	35	0	92	86	115	107	134	167
Economic Governance and Private Sector Development	...	...	956	3,737	641	46	1,708	2,242	2,135	2,803	3,503	4,379
Operating budget balance (excluding grants)	-11,983	-13,916	-11,695	-15,126	-9,120	-5,234	-12,915	-17,185	-8,897	-14,023	-10,044	-6,050
Operating budget balance (including grants)	-1,910	1,068	5,036	2,092	-4,815	-2,038	4,302	1,410	3,335	4,796	8,998	13,033
Core budget balance (including grants)	-6,795	-3,516	3,199	-27,126	-10,426	-5,001	-6,780	-15,802	-11,489	-13,372	-5,863	-6,513
Float and adjustment 6/	1,693	359	-1,989	0	0	-7	0	0	0	0	0	0
Sale of Nonfinancial assets 7/	0	0	1,994	0	0	1,994	0	1,994	5,732	5,732	10,965	12,460
Financing	5,102	3,157	-3,203	27,126	10,426	3,014	6,780	13,808	5,757	7,640	-5,102	-5,947
External loans (net)	4,886	14,753	5,318	10,846	1,385	3,515	5,538	7,811	5,289	7,306	7,057	6,557
Domestic (net) 8/	217	-11,596	-8,521	16,280	9,039	-501	1,242	5,998	468	334	-12,159	-12,504
Memorandum items:												
External budget expenditure 9/	74,528	100,225	99,780	106,361	...	...	106,361	109,518	91,956	91,956	69,840	32,398
Operating budget deficit excluding grants (minus mid-year additions from external budget and security)	...	...	...	-15,126	...	...	-12,915	-13,929	-8,897	-10,776	-7,093	-3,346
Known pressures in the security sector with no firm donor commitments	...	...	...	...	...	...	...	...	...	1,295	2,870	1,830

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

1/ Core budget includes domestic revenues, grants, operating and development expenditure and financing that are accounted for by the central government.
2/ June 2006 budget approved by parliament
3/ Staff estimates and projections.
4/ Funding for the operating budget provided through the multi-donor trust funds: The Afghanistan Reconstruction Trust Fund (ARTF) (recurrent window) and the Law and Order Trust Fund (LOTFA).
5/ Government program classification based on a simple aggregation of administrative units. Expenditure is not delineated by a standard classification of purpose or function.
6/ Variation between the fiscal position recorded at MoF and DAB. This discrepancy is partially due to the difference ("float") between checks issued and checks cashed.
7/ In 2005/06 includes $40 million receipt from sale of telecommunications spectrum bandwidth and delayed overflight payment from 2004/05. 2006/07 includes another sale of spectrum bandwidth and beyond includes proceeds from planned privatizations.
8/ Net change in government deposits with DAB (excluding provincial branch balances). A positive sign corresponds to a decline in balances and a negative sign to an increase in balances.
9/ Estimates from MoF.

Table 3b. Islamic Republic of Afghanistan: Core Budget, 2003/04–2009/10 1/

(In percent of GDP)

	Est. 2003/04	Est. 2004/05	Prelim. 2005/06	Approved Core Budget 2/ 2006/07	CR 06/251 Mid-year Proj. 2006/07	YTD 6 months Prelim. 2006/07	CR 06/251 Fiscal Prog. 3/ 2006/07	Revised Projections Prog. 3/ 2006/07	CR 06/251 Fiscal Prog. 2007/08	Revised Projections Prog. 3/ 2007/08	Proj. 2008/09	Proj. 2009/10
Domestic revenue	4.5	4.5	5.7	5.7	2.4	2.9	6.0	6.4	6.8	7.2	7.6	8.2
Tax revenues	2.8	3.4	3.9	4.3	1.8	2.4	4.5	5.4	5.2	6.0	6.2	6.6
Taxes on income, profits, and capital gains	0.2	0.3	0.7	1.0	0.4	0.5	0.8	1.0	1.0	1.2	1.3	1.4
Taxes on international trade and transactions	2.4	2.5	2.6	3.1	1.3	1.2	3.2	3.0	3.4	3.3	3.5	3.6
Other taxes	0.2	0.5	0.5	0.1	0.2	0.7	0.5	1.3	0.8	1.4	1.4	1.7
Nontax revenues	1.7	1.1	1.8	1.4	0.6	0.5	1.5	1.1	1.6	1.3	1.4	1.5
Donor assistance grants (to operating budget) 4/	4.5	5.3	4.6	3.9	1.0	0.8	3.9	4.4	2.4	3.8	3.3	2.9
ARTF (recurrent window)	3.6	4.3	3.5	3.1	0.8	0.6	3.1	3.1	1.7	2.7	2.4	2.1
LOTFA	0.8	0.9	1.1	0.8	0.2	0.1	0.8	1.1	0.7	0.7	0.6	0.6
Other grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.0	0.3	0.3	0.3
Donor assistance grants (core development budget)	2.0	2.9	5.3	8.4	1.3	0.6	4.3	4.3	4.4	5.2	7.0	7.5
Total core budget expenditure	14.0	13.9	14.7	24.1	7.0	5.4	15.7	18.9	15.8	19.0	19.0	19.6
Operating expenditure	9.8	9.4	8.9	9.1	4.5	4.1	8.9	10.5	8.5	10.1	9.4	9.1
Wages and salaries	6.5	6.6	5.6	5.7	2.8	2.8	5.7	6.5	5.6	6.0	5.7	5.6
Purchase of goods and services	2.1	1.5	1.8	2.0	1.1	1.0	2.0	2.2	1.9	2.2	2.0	1.9
Transfers and subsidies	0.3	0.3	0.1	0.5	0.2	0.0	0.3	0.9	0.3	1.0	0.8	0.7
Pensions	0.1	0.3	0.4	0.5	0.2	0.3	0.5	0.5	0.4	0.6	0.5	0.5
Capital expenditure	0.9	0.7	0.8	0.3	0.1	0.1	0.3	0.3	0.3	0.3	0.3	0.3
Interest	...	...	0.0	0.1	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Core budget development spending 5/	4.2	4.5	5.8	15.0	2.5	1.3	6.8	8.4	7.2	8.9	9.6	10.5
Interim Afghanistan National Development Strategy programs	0.0	0.0										
Security	...	...	0.3	0.6	0.1	0.1	0.3	0.4	0.3	0.4	0.4	0.4
Governance, Rule of Law, and Human Rights	...	...	0.2	0.5	0.1	0.1	0.3	0.3	0.3	0.4	0.4	0.4
Infrastructure and Natural Resources	...	...	1.7	7.7	1.0	0.3	2.6	3.3	2.8	3.5	3.7	4.1
Education	...	...	0.3	1.1	0.2	0.1	0.5	0.7	0.5	0.8	0.8	0.9
Health	...	...	0.3	0.9	0.1	0.2	0.4	0.5	0.4	0.6	0.6	0.7
Agriculture and Rural Development	...	...	2.8	3.3	0.9	0.6	2.4	2.6	2.5	2.8	3.0	3.3
Social Protection	...	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Economic Governance and Private Sector Development	...	...	0.3	0.8	0.1	0.0	0.4	0.5	0.4	0.6	0.6	0.7
Operating budget balance (excluding grants)	-5.3	-4.9	-3.2	-3.4	-2.1	-1.2	-2.9	-4.1	-1.7	-2.8	-1.7	-0.9
Operating budget balance (including grants)	-0.8	0.4	1.4	0.5	-1.1	-0.5	1.0	0.3	0.6	1.0	1.6	2.0
Core budget balance (including grants)	-3.0	-1.2	0.9	-6.1	-2.4	-1.2	-1.5	-3.8	-2.2	-2.7	-1.0	-1.0
Float and adjustment 6/	0.8	0.1	-0.5	0.0	...	0.0	0.0	0.0		0.0	0.0	0.0
Sale of Nonfinancial assets 7/	0.0	0.0	0.5	0.0	...	0.5	0.0	0.5	1.1	1.2	1.9	1.9
Financing	2.3	1.1	-0.9	6.1	2.4	0.7	1.5	3.3	1.1	1.5	-0.9	-0.9
External loans (net)	2.2	5.2	1.5	2.4	0.3	0.8	1.3	1.9	1.0	1.5	1.2	1.0
Domestic (net) 8/	0.1	-4.1	-2.3	3.7	2.0	-0.1	0.3	1.4	0.1	0.1	-2.1	-1.9
Memorandum items:												
External budget expenditure 9/	33.1	35.2	27.5	24.0	...	...	24.0	26.1	17.8	18.6	12.1	4.9
Operational budget deficit excluding grants (minus mid-year additions from external budget and security)	...	...	...	-3.4	...	...	-2.9	-3.3	-1.7	-2.2	-1.2	-0.5
Known pressures in the security sector with no firm donor commitments	...	...	...	...	...	...	...	...	...	0.3	0.5	0.3
Nominal GDP (in millions of Afghanis)	225,108	284,504	362,998	442,995	442,995	419,448	442,995	419,448	516,586	494,001	574,960	658,367

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

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

2/ June 2006 budget approved by parliament.

3/ Staff estimates and projections as percent of updated GDP.

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

5/ Government program classification based on a simple aggregation of administrative units. Expenditure is not delineated by a standard classification of purpose or function.

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

7/ In 2005/06 includes $40 million receipt from sale of telecommunications spectrum bandwidth and delayed overflight payment from 2004/05. 2006/07 includes another sale of spectrum bandwidth and beyond includes proceeds from planned privatizations.

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

9/ Estimates from MoF.

Table 4. Islamic Republic of Afghanistan: Monetary Program (Da Afghanistan Bank), 2004/05–2007/08 1/

(In millions of Afghanis; unless otherwise indicated)

	Est.	Est.	Est	Init. Proj.	Est	Rev. Proj.		Rev. Proj.			
	Mar. 20	Mar. 20	Jun. 21	Sep. 21	Sep. 21	Dec. 20	Mar. 20	Jun. 21	Sep. 21	Dec. 20	Mar. 20
	2004/05	2005/06	2006/07					2007/08			
Net foreign assets	63,934	85,790	89,562	81,958	93,504	91,898	94,005	96,066	96,365	97,036	106,109
Foreign assets	64,375	86,967	90,566	83,135	94,621	93,991	96,936	98,997	100,134	100,805	110,719
Foreign exchange reserves	62,438	82,995	86,209	81,260	88,373	88,494	91,789	93,767	94,668	95,050	104,722
Gold 2/	14,989	19,230	19,230	19,230	19,230	19,230	19,230	19,230	19,230	19,230	19,230
Other	47,449	63,765	66,979	62,030	69,143	69,264	72,559	74,536	75,438	75,820	85,492
Other foreign assets	1,937	3,972	4,357	1,875	6,248	5,497	5,147	5,230	5,466	5,755	5,996
Foreign liabilities	-440	-1,177	-1,004	-1,177	-1,117	-2,094	-2,931	-2,931	-3,769	-3,769	-4,609
Net domestic assets	-22,867	-38,085	-43,029	-27,937	-40,242	-37,031	-36,861	-37,016	-35,344	-33,966	-40,919
Domestic assets	-23,736	-32,214	-37,444	-23,641	-33,273	-29,721	-29,195	-28,936	-26,801	-24,922	-31,340
Net claims on general government	-20,678	-29,574	-34,374	-21,486	-30,074	-26,321	-25,350	-24,896	-22,556	-20,472	-26,675
Gross claims on the government	0	0	0	0	0	977	1,814	1,814	2,652	2,652	3,492
Domestic currency deposits	-3,123	-5,755	-6,940	-5,755	-4,592	-4,592	-4,592	-4,592	-4,592	-4,592	-4,592
Foreign currency deposits	-17,554	-23,819	-27,434	-15,731	-25,482	-22,706	-22,572	-22,117	-20,616	-18,532	-25,575
Other claims (including capital notes) 3/	-3,058	-2,640	-3,070	-2,155	-3,199	-3,400	-3,845	-4,040	-4,245	-4,450	-4,665
Of which: capital notes 3/	…	-330	-625	…	-800	-1,000	-1,445	-1,640	-1,845	-2,050	-2,265
Other items net	869	-5,871	-5,585	-4,295	-6,969	-7,310	-7,666	-8,081	-8,543	-9,044	-9,579
Reserve money	41,068	47,706	46,533	54,021	53,261	54,866	57,144	59,050	61,021	63,070	65,190
Currency in circulation	38,763	44,629	43,256	50,217	47,692	49,301	52,024	53,928	55,902	57,949	60,070
Banknotes and coins issued	41,228	48,648	48,651	54,476	53,687	54,724	57,747	59,725	61,771	63,888	66,077
Less cash holdings	2,465	4,018	5,395	4,259	5,994	5,423	5,723	5,797	5,869	5,939	6,007
Bank deposits with DAB	2,304	3,076	3,276	3,804	5,569	5,565	5,120	5,121	5,118	5,121	5,121
Memorandum items:											
Currency in circulation (year-to-date change)	...	15.1	-3.1	12.5	6.9	10.5	16.6	3.7	7.5	11.4	15.5
Currency in circulation (year-on-year change)	37.5	15.1	7.9	16.8	10.9	14.6	16.6	24.7	17.2	17.5	15.5
Currency in circulation (ceilings under the PRGF; in millions of Afghanis)	...	...	...	50,217	...	49,301	52,024	53,928	55,902	57,949	60,070
Gross international reserves (at market rates; in millions of U.S. dollars)	1,283.4	1,661.8	1,724.2	...	1,754.1	...	...	...	...	...	...
Gross international reserves (at program rates; in millions of U.S. dollars)	...	1,661.8	1,726.3	1,627.2	1,769.6	1,772.0	1,838.0	1,877.6	1,895.6	1,903.3	2,097.0
Consumer prices in Kabul (quarterly change)	2.9	0.5	-0.9	...	2.4	...	...	...	...	...	...
Consumer prices in Kabul (annual change)	14.9	9.4	5.5	...	5.4	...	7.0	...	...	...	5.0
Interest rates on 28-day capital notes 4/	5.0	6.5	7.8	...	5.9	...	...	...	...	...	...

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

1/ 2004/05 and 2005/06 data are estimated using market exchange rates. 2006/07 and 2007/08 estimates and projections are made on the basis of the program exchange rate.
2/ The gold does not include the gold held in the palace vaults.
3/ Until March 2006, capital notes were included in Reserve money (as banks could use capital notes to meet their reserve requirements; this possibility was removed in March 2006).
4/ Weighted average of bid rates; 30-day notes until March 2006.

Table 5. Islamic Republic of Afghanistan: Balance of Payments, 2002/03–2009/10
(In millions of U.S. dollars; unless otherwise specified)

	Est.	Est.	Est.	CR 06/251	Rev. Est.	CR 06/251	Projections			
	2002/03	2003/04	2004/05	2005/06	2005/06	2006/07	2006/07	2007/08	2008/09	2009/10
Current account (including grants)	-149.7	137.5	105.4	-67.5	41.1	-174.8	-193.3	-427.6	-584.4	-998.3
Current account (excluding grants)	-1,371.5	-2,338.4	-2,681.8	-3,115.1	-3,062.5	-3,515.1	-3,556.6	-3,678.7	-3,794.0	-3,762.7
Trade balance	-1,217.6	-1,892.0	-2,231.1	-2,622.5	-2,525.3	-2,923.8	-3,031.4	-3,203.2	-3,318.2	-3,284.6
Exports of goods 1/	1,290.6	1,893.9	1,642.3	1,599.6	1,791.7	1,725.7	1,883.1	2,020.5	2,132.2	2,239.9
Domestic exports	276.8	376.8	457.2	488.4	556.4	586.8	630.4	745.5	888.1	1,061.1
Reexports	1,013.9	1,517.1	1,185.1	1,111.2	1,235.2	1,138.9	1,252.8	1,275.0	1,244.2	1,178.8
Imports of goods	2,508.2	3,785.9	3,873.4	4,222.1	4,317.0	4,649.5	4,914.6	5,223.8	5,450.4	5,524.5
Recorded imports	1,142.3	1,688.5	1,999.6	2,062.3	2,223.4	2,348.7	2,505.5	2,868.8	3,199.3	3,536.4
Duty free	840.8	1,001.0	1,203.3	1,462.3	1,445.2	1,620.4	1,713.2	1,596.1	1,445.0	1,139.0
Of which: Commodity food aid	94.0	40.9	107.8	70.1	78.2	60.4	110.8	96.5	93.5	0.0
Other	525.1	1,096.4	670.5	697.4	648.4	680.4	695.8	758.9	806.2	849.0
Services and income (net)	-154.0	-446.4	-450.7	-492.6	-537.1	-591.3	-525.1	-475.5	-475.8	-478.0
Of which: Interest due 2/	8.9	12.0	13.0	11.1	13.3	54.0	57.3	58.5	59.8	61.0
Current transfers	1,221.8	2,475.9	2,787.2	3,047.5	3,103.6	3,340.3	3,363.3	3,251.1	3,209.5	2,764.4
Public	1,170.2	2,420.9	2,477.1	2,652.0	2,724.0	2,857.6	2,927.1	2,737.3	2,585.9	2,019.1
Of which: Commodity food aid	94.0	40.9	107.8	70.1	78.2	60.4	110.8	96.5	93.5	0.0
Private 3/	51.6	55.0	310.1	395.6	379.6	482.7	436.2	513.8	623.6	745.3
Capital and financial account	144.0	149.6	476.7	467.5	360.8	328.7	388.5	493.6	642.6	839.8
Foreign direct investment	50.0	57.8	186.9	378.1	271.4	218.7	232.1	347.3	501.3	708.5
Official loans (net)	94.0	91.8	289.8	89.4	89.4	110.0	156.4	146.3	141.3	131.3
Disbursement	100.2	101.6	299.3	101.7	101.7	115.0	160.0	150.0	145.0	135.0
Amortization due 2/	6.2	9.8	9.6	12.3	12.4	5.0	3.6	3.7	3.7	3.7
Other capital (incl. errors and omissions)	161.0	93.3	-133.2	-35.7	-39.8	-90.4	-210.8	104.1	25.5	41.6
Overall balance	155.3	380.4	448.9	364.2	362.0	63.5	-15.6	170.1	83.7	-116.9
Financing	-155.3	-380.4	-448.9	-364.2	-362.0	-10,297	-1.2	-203.7	-117.4	100.0
Changes in reserve assets of DAB	-101.0	-394.7	-463.7	-378.4	-378.4	-142.0	-176.2	-259.0	-180.0	100.0
Use of fund resources (net)	0.0	0.0	0.0	0.0	0.0	0.0	19.6	0.0	0.0	0.0
Exceptional financing	-54.3	14.3	14.8	14.2	16.4	-10,155	155.5	55.2	62.6	0.0
Arrears 4/	-54.3	14.3	-2.8	-15.2	-12.9	-10,155	-11,135	0.0	0.0	0.0
Debt rescheduling	0.0	0.0	0.0	0.0	0.0	0.0	760.2	55.2	62.6	0.0
Debt forgiveness	0.0	0.0	17.6	29.3	29.3	0.0	10,530	0.0	0.0	0.0
Financing gap	0.0	0.0	0.0	0.0	0.0	10,233.8	16.8	33.6	33.7	16.9
Identified financing (provisional)	0.0	0.0	0.0	0.0	0.0	35.1	16.8	33.6	33.7	16.9
Of which: IMF PRGF	0.0	0.0	0.0	0.0	0.0	35.1	16.8	33.6	33.7	16.9
Remaining gap 4/	0.0	0.0	0.0	0.0	0.0	10,198.7	0.0	0.0	0.0	0.0
Memorandum Items:										
Gross international reserves										
(In US$ millions)	425	820	1,283	1,662	1,662	1,804	1,838	2,097	2,277	2,177
(In months of imports) 5/	1.8	3.1	4.1	4.7	4.6	4.9	4.8	5.2	5.4	5.1
(Relative to external debt service due)	28.1	37.6	57.0	71.0	64.8	30.6	30.2	33.7	35.9	33.6
Exports (goods and nonfactor services)	1,341	1,999	1,720	1,720	1,893	1,873	2,002	2,158	2,291	2,423
Imports (goods and nonfactor services)	2,704	4,331	4,410	4,864	4,975	5,381	5,564	5,855	6,115	6,218
Trade balance (in percent of GDP)	-29.8	-41.3	-37.4	-35.9	-34.6	-33.0	-36.1	-32.4	-28.8	-24.9
Current account balance (in percent of GDP) 6/										
Including grants	-3.7	3.0	1.8	-0.9	0.6	-1.5	-1.7	-3.8	-4.7	-7.2
Excluding grants	-33.6	-51.0	-44.9	-42.6	-41.9	-39.1	-41.8	-36.7	-32.5	-28.2
Total debt service (in percent of exports) 6/ 7/	4.6	4.5	4.2	3.8	3.9	1.5	1.5	1.4	1.3	1.2

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

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

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

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

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

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

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

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

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

	Est.	Est.	Est.	Prelim.	Projections			
	2002/03	2003/04	2004/05	2005/06	2006/07	2007/08	2008/09	2009/10
I. Total financing requirement	1,533.0	2,728.6	3,157.9	3,466.2	14,871.3	3,941.4	3,977.7	3,666.4
Current account (excluding grants)	1,371.5	2,338.4	2,681.8	3,062.5	3,556.6	3,678.7	3,794.0	3,762.7
Amortization	6.2	9.8	9.6	12.4	3.6	3.7	3.7	3.7
Of which: IMF	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Change in reserves (increase = +)	101.0	394.7	463.7	378.4	176.2	259.0	180.0	-100.0
Reduction in arrears	54.3	-14.3	2.8	12.9	11,134.9	0.0	0.0	0.0
II. Available financing	1,533.0	2,728.6	3,140.3	3,436.9	3,564.1	3,852.5	3,881.4	3,649.5
Current transfers	1,221.8	2,475.9	2,787.2	3,103.6	3,363.3	3,251.1	3,209.5	2,764.4
Foreign direct investment	50.0	57.8	186.9	271.4	232.1	347.3	501.3	708.5
Short-term private financing flows	...	...	...	...	...	...	...	...
Official medium- and long-term loans	100.2	101.6	299.3	101.7	160.0	150.0	145.0	135.0
IMF disbursements	0.0	0.0	0.0	0.0	19.6	0.0	0.0	0.0
Other	161.0	93.3	-133.2	-39.8	-210.8	104.1	25.5	41.6
Financing gap = I-II	0.0	0.0	17.6	29.3	11,307.2	88.8	96.3	16.9
Exceptional financing								
Debt relief	0.0	0.0	17.6	29.3	10,530.2	0.0	0.0	0.0
Debt rescheduling	0.0	0.0	0.0	0.0	760.2	55.2	62.6	0.0
Balance of payments support	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Remaining gap	0.0	0.0	0.0	0.0	16.8	33.6	33.7	16.9
Identified financing (provisional)	0.0	0.0	0.0	0.0	16.8	33.6	33.7	16.9
Of which: IMF PRGF	0.0	0.0	0.0	0.0	16.8	33.6	33.7	16.9
Unfinanced gap	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

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

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

Date	Amount of Disbursement		Conditions
	Millions of SDRs	Percent of Quota 1/	
June 2006	13.2	8.2	Approval of arrangement 2/
February 2007	11.3	7.0	First review and September 2006 performance criteria
June 2007	11.3	7.0	Second review and March 2007 performance criteria
January 2008	11.3	7.0	Third review and September 2007 performance criteria
May 2008	11.3	7.0	Fourth review and March 2008 performance criteria
January 2009	11.3	7.0	Fifth review and September 2008 performance criteria
May 2009	11.3	7.0	Sixth review and March 2009 performance criteria
Total	**81.0**	**50.0**	

Source: Fund staff estimates.

1/ Does not sum due to rounding.
2/ Due to domestic legal obstacles, the first disbursement was drawn with a delay in January 2007.

ATTACHMENT I

Kabul, January 17, 2007

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

Dear Mr. de Rato,

1. Building on the achievements of the 2004–06 staff-monitored program, Afghanistan entered into a program supported by a three-year arrangement with the International Monetary Fund (IMF) under its Poverty Reduction and Growth Facility (PRGF). The arrangement, for an amount of SDR 81 million (50 percent of quota), was approved by the IMF Executive Board on June 26, 2006 and runs through June 2009. In the context of the first review of the program, we are pleased to report to you that the government of Afghanistan and Da Afghanistan Bank (DAB) have successfully implemented the key measures required for the completion of this review.

2. The attached memorandum of economic and financial policies (MEFP) supplements the one attached to our letter to you dated May 15, 2006. The new MEFP reports on the progress in implementing the program and sets the policy agenda for the remainder of 2006/07 and for 2007/08, including the quantitative and structural targets through September 2007.

3. All quantitative performance criteria for end-September 2006 were met. We also observed the continuous performance criteria on contracting or guaranteeing of new medium- and long-term nonconcessional external debt, on the short-term external debt, and on nonaccumulation of new external payments arrears. We have submitted to parliament the core budget's audited financial statements and thereby complied with the end-September 2006 structural performance criterion. We also met end-June 2006 and end-September 2006 structural benchmarks, except those related to the state-owned banks. We missed the end-June 2006 benchmark related to the appointment of a new Board of Directors at Bank Pashtany and the end-September 2006 benchmarks on the adoption of long-term restructuring plans for Bank Pashtany, and on the publication of a statement announcing the liquidation of the Export Promotion Bank or its merger with another commercial bank and finalizing the transfer of its deposits. The nonobservance of these three benchmarks resulted from a shift in our banking reform strategy, which was prompted by the banks' limited operational capacity and the dearth of qualified managers. In order to improve

the operations of our state-owned banks and implement their restructuring plans, we are in discussion with several donors to obtain significant technical assistance. We also postponed the processing of gold held in the palace vaults into a form that qualifies as a reserve asset (structural benchmark for end-September 2006). Implementing this measure requires the transfer of the gold abroad, which could trigger a negative public reaction in the current volatile security context.

4. The government and DAB believe that the economic and financial policies set forth in the attached updated memorandum provide a sound basis for achieving the objectives and targets of the program. During the period of the arrangement, Afghanistan will consult with the Fund on the adoption of any further measures that may be appropriate, at the initiative of the government or DAB, or whenever the Managing Director of the IMF requests such consultation. In addition, we will provide the Fund in a timely manner with all information necessary to monitor the implementation of the program. The government and DAB will conduct with the Fund the second review before end-July 2007.

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

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

7. We remain committed to transparent policy-making and wish to make available to the public the contents of this letter and those of the attached MEFP and technical memorandum of understanding (TMU), as well as the staff report on the first review under the three-year PRGF arrangement. We hereby authorize their posting on the Fund's website subsequent to Executive Board consideration of this request.

Sincerely yours,

/s/	/s/
Anwar Ul-Haq Ahady	Noorullah Delawari
Minister of Finance	Governor
Ministry of Finance	Da Afghanistan Bank

Attachments:
Memorandum of Economic and Financial Policies for 2006/07–2007/08
Technical Memorandum of Understanding

ATTACHMENT II: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES FOR 2006/07–2007/08

January 17, 2007

I. INTRODUCTION

1. **The government and DAB have started implementing their reform strategy to reduce poverty and move Afghanistan to a sustainable growth path**. The strategy, as articulated in our Interim Afghan National Development Strategy (I-ANDS), was discussed with development partners at the London International Donors Conference in early 2006. Our program—consistent with the I-ANDS and supported by an IMF Poverty Reduction and Growth Facility (PRGF) arrangement—is designed to maintain macroeconomic stability and implement structural reforms to foster private sector development while addressing our acute poverty situation. This memorandum reviews progress in 2006/07 under the PRGF, updates the government's medium-term objectives and policy framework, and sets out our revised economic and financial policies for the remainder of 2006/07 and 2007/08. On the basis of these policies, we request completion of the first review under the PRGF arrangement and approval of the second disbursement.

II. PERFORMANCE UNDER THE PROGRAM

2. **Afghanistan's economy continues to grow, albeit at a slower pace**. After reaching 14 percent in 2005/06, available information suggests that GDP growth will ease to about 8 percent in 2006/07 due to a drought-induced decline in agricultural production. Inflation, as measured by the consumer price index for Kabul, subsided to about 5.4 percent (year-on-year) by September 2006, as a slower increase in rent prices largely offset a faster rise in food and energy prices. "National" year-on-year inflation, which covers Kabul and five other cities, was 5.2 percent in September.

3. **Opium production rose by almost 50 percent in 2006, reflecting a 60-percent increase in cultivated areas and a 6 percent decline in yields**. The sharp increase in production led to a substantial decline of the farm gate prices over the last 12 months.

4. **Overall fiscal performance during the first half of 2006/07 was in line with the program**. At 1.2 percent of GDP over the first two quarters, the operating budget deficit, excluding grants, was lower than projected. The operating deficit, including grants, at 0.5 percent of GDP, was also below program projections, as lower external grants (amounting to around 0.8 percent of GDP) were offset by lower spending. Together with the

unanticipated sale of a telecommunication spectrum bandwidth (about 0.5 percent of GDP), this led to a slightly higher increase in government deposits relative to the program.

5. **Revenues, excluding grants, performed strongly during the first two quarters of 2006/07**, amounting to Af 12.0 billion (2.9 percent of GDP), exceeding the program target of Af 10.6 billion. Lower-than-expected customs receipts, resulting from delays in introducing a new tariff schedule and concessions made to traders,[1] were offset by a higher collection of taxes on income and profits and the business receipts tax (BRT). A draft law to eliminate nuisance taxes and introduce collection of BRT on imports was submitted to parliament (end-December 2006 benchmark) but was returned to the government, partly because of procedural issues. The government is currently reviewing ways to proceed.

6. **Operating expenditures over the first six months reached 4.1 percent of GDP, compared with 4.5 percent of GDP in the program**. While core operating spending in the first two months of the year was well below average due to delays in parliament's approval of the annual budget, it gradually recovered and reached 43 percent of the approved operating budget by September. Core development budget expenditures over the first six months, as recorded in Afghanistan's Financial Management System (AFMIS), reached only 1.3 percent of GDP.[2] However, due to technical difficulties, some development expenditures that were incurred have not yet been entered into AFMIS; accordingly, actual expenditures may have reached double the recorded figure. Furthermore, more than 40 percent of budgeted development expenditures were allotted. Development expenditures are forecast to reach about 55 percent of the approved core development budget by the end of the fiscal year. This represents a 67 percent increase over 2005/06, although it is still substantially lower than planned, due to delays in budget approval and continuing implementation difficulties, which are being addressed vigorously.

7. **The 2005/06 core budget audited financial statements were submitted to parliament in September (end-September 2006 structural performance criterion)**. In addition, a working group has been established between the ministry of finance (MoF) and the control and audit office (CAO) to follow up on the auditor's recommendations. The appeals process for customs and revenue has been established (end-September benchmark) and the training of officials is underway. Draft procedures for implementing a certified monthly payroll system (end-December benchmark) have been circulated for comments.

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[1] A new tariff schedule was introduced in late August (several months later than originally planned). The reclassification of various items addressed cases of negative effective protection. There are three new tariff bands, of which two are above the previous maximum. The revenue impact of the delay in the adoption of the new tariff schedule was mitigated by reclassifying some items in the new highest tariff bands that were introduced in lieu of excises.

[2] This is equivalent to 8 percent of the approved core development budget.

Progress has been made on other priority reforms, which include: reorganization of the budget department and the initiation of simple program budgeting pilots in selected ministries; publication of a less compressed budget calendar for 2007/08; strengthening of the large taxpayer office; and upgrading of administrative capacity in the provinces.

8. **The monetary objectives for the first six months have been attained**. Currency in circulation increased by nearly 7 percent (markedly less than the program projection of 12.5 percent) and the accumulation of net international reserves (NIR) exceeded the end-September floor by nearly US$300 million. The overperformance margins reflected the relatively slow pace of government development spending, and in the case of currency in circulation, a gradual decline in velocity. The latter possibly reflected a slowdown in the demand for Afghani cash and a gradual shift toward increased holding of Afghani deposits. Reflecting DAB's efforts to ensure compliance with prudential ratios, notably reserve requirements (to be met in Afghani) and limits on the foreign exchange open position (strictly enforced from end-August 2006), there has been marked progress in the "afghanization" of financial transactions. For their part—encouraged by sustained exchange rate stability and declining inflation—banks have begun to recognize the opportunities of dealing in local currency and have started to offer favorable conditions on deposits and transactions in Afghani, reflecting their lower costs relative to transactions in foreign exchange (especially cash).

9. **The Afghani exchange rate has remained stable due to foreign currency interventions (both selling and buying foreign exchange), while capital notes auctions have begun to play a more active role in liquidity managemen**t. Since March 2006, the Afghani-U.S. dollar exchange rate has fluctuated within a 49.5–50.5 range, except on two occasions in May when the Afghani briefly appreciated below 49.5. The interest rates on 28-day and 56-day capital notes declined from 7–8 percent in June to 5–6 percent in late September, reflecting increased demand by the banks, whose Afghani liquidity has been growing steadily (with some excess liquidity accumulating in the standing deposit facility).

10. **We continued modernizing central bank operations**. In order to foster the use of capital notes, we opened the auctions to licensed money changers, authorized the banks to bid on behalf of their clients, and introduced an overnight credit facility with capital notes as eligible collateral. We have also made progress in DAB's accounting and reporting practices. In September 2006, we began producing monthly balance sheets covering all DAB's branches. Preparations for producing the monetary survey are on track. We also completed a review of financial relations between the government and DAB and signed a service level agreement that—pending further review—preserves the status quo, which both parties found mutually agreeable.

11. **In line with the recommendations of the IMF safeguards assessment mission, the external audits of DAB's 1383 and 1384 financial statements have been completed**. The financial statements have been published on DAB's website together with the related audit opinions. The external auditors submitted to DAB a report on the reconciliation with the audited financial statements of end-1384 (March 20, 2006) NIR data reported to the IMF. Efforts are underway to address weaknesses identified by the safeguards assessment in the areas of accounting and financial reporting, internal audit, and control.

12. **Due to stronger-than-expected export performance, the trade deficit narrowed more than envisaged in 2005/06, to 34½ percent of GDP from 37½ percent in 2004/05**. There was a similar improvement in the current account deficit (excluding grants) to 42 percent of GDP and, with continued strong donor support, the current account (including grants) recorded a small surplus (around ½ percent of GDP).

13. **We redoubled our efforts to develop balance of payments statistics**. With support from an August 2006 IMF technical assistance mission, DAB compiled the results of surveys undertaken earlier in the year. The resulting draft balance of payments has been discussed with Fund staff, with a view to refining the presentation and identifying priority areas to strengthen data reporting, collection, and compilation.

14. **We have intensified our dialogue with our external bilateral creditors**. Following the July 2006 Paris Club rescheduling agreement, we have made progress toward finalizing bilateral agreements with the United States (signed in September) and Germany (draft is currently under review). We are also working on a bilateral agreement with Russia. With a view to seeking the IMF and World Bank's assessment of Afghanistan's eligibility for the Heavily Indebted Poor Countries (HIPC) Initiative, we have requested external debt data from all our bilateral creditors.[3] Most have provided the necessary data and we are following up with the remaining creditors.

15. **We have approved seven state-owned enterprises (SOE) for liquidation and appointed liquidation committees**. For three SOEs, severance packages have been granted to former employees who received job counseling and training in the context of the national skills development program. Liquidation plans are now underway, of which two are expected to be completed shortly. Lastly, we prepared corporatization procedures that are being assessed by the SOE evaluation commission.

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[3] The bilateral external debt data requested for end-2004 and end-2006 are needed to assess HIPC eligibility and estimate the possible amount of debt relief at the decision point, respectively. World Bank staff have taken the lead in compiling the necessary multilateral debt data.

16. **All September 2006 quantitative performance criteria were met and we have made progress on the key structural conditions**. We also observed the continuous external debt and arrears performance criteria. While we observed the end-September 2006 structural performance criteria, we failed to meet a few structural benchmarks that reflected conscious efforts to pursue alternative approaches. We did not appoint a new Board of Directors at Bank Pashtany by end-June 2006 (benchmark) or adopt a long-term restructuring plan for Bank Pashtany by end-September (benchmark). This was due to a shift in our banking reform strategy in favor of merging Bank Pashtany with Bank Millie and the Export Promotion Bank, which was prompted by the banks' limited operational capacity and the dearth of qualified managers. The proposed merger did not however gain political support. For Bank Millie, the Board of Directors agreed on a restructuring plan in early 2006. We also postponed the processing of gold held in the palace vaults into a form that qualifies as a reserve asset (end-September 2006 structural benchmark). Implementing this measure would require transferring the gold abroad, which we felt could trigger a negative public reaction in the current volatile security context.

III. The Updated Program for 2006/07 and 2007/08

A. Macroeconomic Objectives

17. **The strategy for the remainder of 2006/07 and 2007/08 seeks to consolidate the progress achieved so far on macroeconomic stabilization, address slippages, and deepen needed financial and structural reforms**. The quantitative targets for the remainder of this fiscal year and 2007/08 have been set accordingly (Table 1). The updated program projects growth rising from 8 percent in 2006/07 to 12 percent in 2007/08, with inflation declining from 7–8 percent in 2006/07 to 5 percent in 2007/08. The original growth objective of 12 percent this year is out of reach, as agricultural production declined significantly due to insufficient rainfalls in the spring. The original inflation projection of 9 percent has been revised downward in view of the inflation outcome through midyear and the expected moderate rise in food, rent, and petroleum prices over the remainder of the year.

B. Fiscal Policy

18. **The good revenue performance is expected to continue during the second half of 2006/07**. Revenue for the year as a whole is envisaged to be around Af 27.0 billion (6.4 percent of GDP), slightly above the original program target of Af 26.6 billion and significantly exceeding the 2005/06 outcome of Af 20.7 billion (5.7 percent of GDP). In the event of a revenue shortfall, we stand ready to introduce offsetting expenditure measures.

19. **Operating expenditures are expected to reach Af 44.2 billion (10.5 percent of GDP), as some unanticipated spending pressures that emerged in the mid-year budget review (MYR) are being accommodated in an amended budget for 2006/07**. These unanticipated outlays include:

- **Expenditures previously funded by donors, namely the cost of fuel to power several electric plants (0.6 percent of GDP)**. The scope for reducing the net cost of the fuel subsidy this fiscal year is limited, except for an increase in electricity tariffs—a measure already taken—and the envisaged improvement in collection. The expected increase in electricity revenue will help bring down the net subsidy by at least Af 150 million this year. Looking ahead, we envisage offsetting measures to reduce it further (a study is currently being prepared in collaboration with donor partners), including through importation of electricity from neighboring countries.

- **Additional spending associated with the deteriorating security situation in the south** necessitated the recruitment of auxiliary police. Their employment will be temporary (based on one-year contracts). Additional donor support is expected to cover these increased security costs (about 0.2 percent of GDP).

- **Additional teachers** identified by a joint investigation of the civil service commission, the MoF, and the ministry of education (MoE) (outlined in our May 2006 MEFP) regarding the number and location of all civil servants in the MoE. This investigation revealed that about 10,000 additional teachers must be recognized in the government payroll. The corresponding cost (0.1 percent of GDP) will be covered by the contingency included in the approved budget, which, however, was not part of the fiscal program for the first half of the year but the May 2006 MEFP foresaw the possibility of accommodating this expenditure in the context of the MYR. These supplementary expenditures have been discussed and agreed with our donor partners. A similar investigation at the Ministry of Interior is under way, but since it is not complete, no adjustment will be made in this year's budget.

- **Clearing of domestic arrears**. Once the delays in paying salaries in a limited number of provinces have been confirmed by the CAO (MoF's request for verifying the Tashkeel and arrears is an end-January 2007 structural benchmark), we will make provisions to settle these obligations as soon as possible. We have also taken stock of outstanding government obligations to the telephone and electricity utilities. The total cost of all arrears is equivalent to 0.2 percent of GDP.

- **Other expenditure pressures** representing an estimated 0.2 percent of GDP were met through savings and reprioritization and will not affect our overall fiscal balance.

20. **Reflecting the above developments, the operating budget deficit, excluding grants, will be contained at 4.1 percent of GDP in 2006/07, compared with 2.9 percent originally envisaged under the program**. We expect to cover the deficit through a

combination of increased grants, receipts from the sale of the GSM license, and a drawdown of government deposits at DAB. After grants, our operating budget balance is now expected to show a surplus of 0.3 percent of GDP, compared with a programmed surplus of 1 percent of GDP.

21. **In 2007/08, the operating budget deficit excluding grants would decline to 2.8 percent of GDP; nonetheless, it will still be above the 1.7 percent projected in the original program**.[4] The higher deficit mainly reflects an increase in operating expenditures to Af 49.8 billion (10.1 percent of GDP against a program target of 8.5 percent). Higher spending is attributable to (a) the recurrent cost of the fuel subsidy;[5] (b) security-related pressures; (c) the inclusion of higher operating costs of the development budget; and (d) higher provisions for pensions. However, since donors have agreed to finance many of these additional pressures, the operating budget surplus including grants is projected to increase from 0.6 percent of GDP in the original program to 1.0 percent of GDP. In particular, our international partners have agreed to maintain the same level of funding for the multi-donor Afghanistan Reconstruction Trust Fund over the next few years and indicated their intention to increase their support to the Law and Order Trust Fund.

22. **Due to uncertainty over funding, not all the security-related expenditure pressures have been addressed in our program**. Any additional security expenditures will only be undertaken on the condition that they are fully funded by donors, thus leaving our operating budget deficit, including grants, unchanged.[6] Total additional expenditures could be as much as 0.5 percent of GDP. In order to ensure appropriate parliamentary engagement in the budget process, we will send the 2007/08 draft budget to parliament at least 45 days before the start of next fiscal year, as required by law (February 4, 2007 structural performance criterion).

23. **We remain committed to our stated objective of medium-term fiscal sustainability**. Cognizant of developments in the country, we reaffirm the objectives agreed with international partners:

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[4] The September 2007 targets on revenue and the fiscal deficit are set out in Table 1.

[5] Should any of the additions to the budget for the fuel subsidy not be needed for this purpose, we will discuss with our donor partners their reallocation.

[6] Additional security expenditures are those above what was identified in our MTFF and include: the cost of the auxiliary police; accelerated recruitment in the Afghan National Army (ANA) and Afghan National Police (ANP) to reach full staffing and more generous pay and rank reform in the ANA and ANP to encourage recruitment and retention

- An overall objective of covering all core operating expenditures from domestic revenues. Assuming no new unfunded transfers from the external budget to the core budget, this objective would be achieved in 2010/11, one year later than originally envisaged.

- The ratio of revenue to estimated total recurrent expenditures (including estimated recurrent expenditures in the core and external development budgets), is projected to rise from 28 percent in 1383 (2004/05) to 58 percent in 1389 (2010/11).

- Afghanistan's total domestic budgetary revenue—equivalent to 4.5 percent of estimated non-opium GDP in 2004/05—will steadily increase, reaching 8 percent of GDP by 2010/11. Barring unforeseen developments, we currently expect to meet this objective one year ahead of schedule.

- We recognize that the deficit, excluding grants, may exceed the targeted level due to an unexpected increase in grant-financed expenditures. However, we will attempt to achieve the deficit target excluding grants, since we are mindful that donor support may not be permanent. Nonetheless, adjustors have been added to our NIR and NCBF targets for additional security expenditures discussed in ¶22.

24. **These targets are ambitious and we recognize the need for sustained efforts to boost revenue**. Notwithstanding progress to date in a very difficult environment, we will continue to modernize tax and customs administration. In this vein, we will:

- Clarify the tax policy framework, and system including the difference between the BRT and income taxes (end-July 2007 structural benchmark).

- Resubmit to parliament legislation to eliminate nuisance taxes (end-March 2007).

- Move towards a broad-based consumption tax by submitting to parliament the GST/BRT legislation by March 2008 and begin implementation within 6 months of passage of the bill by parliament.

- Implement by end-September 2007, on a pilot basis, the transfer of accountability for administration of all Kabul large and medium-size taxpayers directly to the revenue department.

- Clarify and document the roles of the various agencies currently operating at the borders (end-March 2007).

- Establish a steering committee chaired by the Minister of Finance to monitor implementation of the tax and customs administration modernization plans (end-January 2007).

- Study options to reverse, over the medium term, customs tariff increases as excise taxes are introduced on selected goods.

25. **We will continue to exercise expenditure discipline in the operating budget and improve overall public financial management**. In this regard, and building upon the recent progress made in restructuring our budget department along sectoral lines, we are piloting a simple program approach for the 2007/08 budget in selected ministries. These changes are expected to further consolidate the recurrent and core development budgets and improve the relationship between the MoF and line ministries. We will adopt additional measures to enhance the credibility and effectiveness of our core budget, including:

- Presenting the 1384 budget performance report to parliament as required under the PFEM Law, article 55–59 (end-January 2007).

- Promptly eliminating the backlog of development budget payments unrecorded in AFMIS (end-January 2007).

- Reviewing allotment, contracting, commitment and cash management procedures for the development budget in order to remove bottlenecks and increase their effectiveness (end-March 2007).

- Building on pilots to prepare the 2008/09 consolidated core budget according to a simple program and economic classification structure, and developing financial management capacity in the line ministries.

- Continuing to strengthen our medium-term fiscal framework as an instrument to define macro-fiscal constraints. We aim to have cabinet agreement on the medium-term fiscal strategy, consistent with our agreed program with the IMF in January 2007, and then publish this alongside our aggregate macroeconomic figures (end-March 2007).

- Strengthening the tracking of commitments and expenditures from the external development budget, including through the use of common reporting formats that we will agree to with our large donors. We will also coordinate reporting between the Aid Coordination Unit and the Treasury.

C. Monetary and Exchange Rate Policy and Financial Sector Reforms

26. **We have revised the monetary program for the remainder of 2006/07 to lower the growth in currency in circulation, consistent with the lower-than-originally expected inflation in the first half of the fiscal year**. In support of the monetary (currency in circulation) targets, we will continue to manage flexibly the exchange rate to preserve confidence in the Afghani. Our goal is to achieve the currency in circulation targets with minimum exchange rate volatility. Although the expected acceleration in government

spending is likely to cause a significant upward shift in the demand for currency during the coming months, the increase in currency in circulation should not exceed 16.6 percent (one percentage point above the projected nominal GDP growth) by end-2006/07, compared with 18.4 percent in the original program.

27. **Looking forward to 2007/08, we expect that growth in currency in circulation will be about two percentage points less than nominal GDP growth (18½ percent)**. This target reflects technological improvements in banking services—including banks' management of government payroll and other government expenditure previously paid for in cash—and increased financial deepening expected to result in a shift in the transactions demand for money away from cash toward deposits. International reserves are expected to rise prudently from slightly below $1.8 billion in September 2006 to just above $1.9 billion in September 2007, ensuring a reserve cover of about 5 months of the following year's imports of goods and services.

28. **We remain committed to modernizing the central bank as envisaged in the original program (paragraph 31 of our May 15 MEFP)**. To further the objectives of the program, we will also undertake the following actions in the monetary area.

- DAB will develop a monthly monetary survey in line with international standards (end-July 2007 structural benchmark).

- In order to further improve DAB liquidity management and develop the Afghani financial market, DAB will expand the volume and use of capital notes and will launch (starting end-January 2007) auctions of 182-day capital notes. The volumes of capital notes auctions will be determined by the Monetary Policy Committee in coordination with DAB's Monetary Policy Department and the Market Operations Department, taking into account the monetary policy objectives and the market's liquidity needs.

- DAB will take the necessary steps to facilitate (end-February 2007) secondary trading of capital notes. To this effect, DAB will issue procedures for clearing and settling secondary trades of CN, strengthen the legal and regulatory foundations for such trading (with technical assistance from the Fund), and discuss the process with banks.

- By end-January 2007, DAB will amend the reserve requirement regulations to set the penalty rate for bank's shortfalls in complying with the requirements at a rate 300 basis points above that of the overnight collateralized credit facility for the second consecutive offense.

- On the basis of on-site inspections, DAB's Banking Supervision Department will prepare a summary report on banks' compliance with prudential regulations, which will assess threats to the stability of the banking system (e.g., stemming from risk concentration and connected lending) (end-July 2007).

- The Directorate General of Treasury (DGT) of the MoF will prepare and submit to DAB its monthly liquidity forecast for three months ahead, and will update this forecast on a monthly basis, starting end-January 2007.

29. **We will make further efforts to restructure the state-owned banks and reform the banking sector**. With support from external advisors, the MoF will prepare a restructuring plan for Bank Pashtany. For that purpose, we have requested technical assistance with a view to having advisers in place by end-March 2007 and a restructuring plan for Cabinet submission by end-July 2007 (structural benchmark). We are also seeking Cabinet approval of our restructuring plan for Bank Millie (end-March 2007 structural benchmark) and are in the process of recruiting advisors to help in its implementation. The restructuring of the two banks will enable them to meet by end-September 2007 the licensing conditions set by DAB's Banking Supervision Department. We will continue the liquidation process for the non-licensed state-owned banks (four out of six are in various stages of liquidation). In this context, we will publish a statement announcing the liquidation of the Export Promotion Bank or its merger with another licensed commercial bank (end-January 2007 structural benchmark), and finalize the transfers of its deposits in about six months. An adviser will be working at the MoF to oversee the bank restructuring. We will also take steps to be able to adopt by end-March 2007 the set of core enabling laws for commercial banking, including laws on secure transactions, negotiable instruments, and mortgages.

30. **We are committed to improving DAB's operations consistent with the principles of good governance included in the IMF's safeguards assessment report**. To provide assurances with regard to the level of DAB's foreign reserves, we will request the external auditors to reconcile the net foreign reserves data reported to the Fund with the underlying bank/creditor statements, and we will commission special audits of reserves for each of the test dates under the program (end-July 2007). We will also proceed with the implementation of the new integrated accounting system at DAB (end-March 2007 and end-September 2007 structural benchmarks).

D. External Sector Policies

31. **The current account deficit (excluding grants) is expected to stay largely unchanged at just under 42 percent of GDP in 2006/07**. An expected pick-up in development spending in the second half of the year, as well as some increase in other

budgetary expenditures (e.g., security-related), will contribute to higher-than-originally anticipated imports. Additional external resources will ensure that reserve accumulation remains in line with the program.

32. **We expect the medium-term balance of payments position to remain manageable**. While the current account (excluding grants) should improve, it could still average around 35 percent of GDP over the next few years on account of our sizeable investment and reconstruction needs. Even with a moderate tapering off of official transfers, the current account deficit (including grants) could widen to over 7 percent by 2009/10. This underscores the importance of sustained support from the international community.

33. **We also remain committed to a prudent debt management strategy**. First, and foremost, we will rely primarily on grant financing, supplemented by highly concessional borrowing. We intend not to contract or guarantee any nonconcessional debt (continuous performance criterion) and will also work expeditiously to regularize our relations with bilateral creditors. We intend to finalize the bilateral agreements with Paris Club creditors and intensify our efforts to obtain the outstanding bilateral debt data. We aim to complete the debt database to allow for an assessment of HIPC eligibility in early 2007.

34. **We are committed to maintaining a liberal and transparent trade regime**. To this end, we will refrain from reclassifying more goods into the two new top tariff bands, and will work to unwind the tariff increases as the revenue situation allows. We are also committed to maintaining a foreign exchange system free of restrictions and to making further progress toward establishing its legal framework. In this regard, we would welcome further IMF technical support to allow us to formalize our restriction-free exchange rate system, and to accept the obligations under Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement.

E. Other Structural Reforms

35. **In addition to fiscal and banking reforms outlined above, and with the support of the international community, we will press ahead with measures** aimed at:
(a) updating, modernizing, harmonizing and simplifying legislation, regulations and procedures related to private investment. In this context, we aim at (a) adopting by end-March 2007 laws on partnerships and corporations; (b) further disengaging the state from economic activities by liquidating or corporatizing 11 additional SOEs; and (c) adopting a comprehensive restructuring/divestment plan for public entities and government agencies engaged in commercial activities but not covered by the SOEs law (end-March 2007 structural benchmark).

F. PRSP

36. **With support from donors and building on the I-ANDS, we are actively preparing the PRSP**. We intend to use the findings of the 2005 National Risk Vulnerability Assessment (NRVA) survey—which uses a sample of 31,000 households nationwide—to build a poverty profile that will underpin our poverty analysis, and provide input for the sectoral strategies. We will continue our efforts to develop an institutional framework for ANDS consultations, organize the thematic and regional workshops, and define a set of major issues to be raised during consultations. Lastly, we are continuing preparations to ensure that the medium-term fiscal framework will be aligning expenditures with our ANDS objectives. We intend to complete the ANDS by mid-2008.

G. Statistical Issues and Technical Assistance

37. **Afghanistan has extensive technical assistance needs. We will continue to work closely with our development partners to build administrative capacity in priority areas**. These include tax and customs administration, civil service reform, monetary and exchange rate policy, and banking reform. Assistance will also be needed to improve economic statistics, notably for national accounts, the balance of payments, and social/poverty indicators. We are committed to improving the national statistical base and implementing the statistical master plan. We plan to:

- Launch the Integrated Business Enterprise Survey and the Integrated Living Standards Survey (or Household Income Expenditure Survey) by end-March 2007, the findings of which will help upgrade the social database and serve as a basis for improving the national accounts and modernizing the consumer price index;

- Strengthen mandatory reporting to DAB of balance of payments data by the nonbank sector by adopting new legal provisions (end-March 2008) specifying: (a) power and authority of DAB to request data on all resident sectors; (b) confidentiality of reported data; and (c) penalties for noncompliance, misreporting, and breach of confidentiality;

- Conduct quarterly foreign direct investment surveys using updated information from the Afghanistan Investment Support Agency records, beginning end-March 2007;

- Organize data sharing arrangements between DAB and the MoF on current transfers, capital transfers, and duty-free imports;

- Launch a second border trade survey by end-March 2007.

IV. Program Monitoring

38. **With regard to program monitoring, we are proposing quantitative performance criteria for end-March 2007 and indicative targets for end-December 2006 and end-June 2007**. The second review under the arrangement is scheduled to be completed by July 2007 and will be conditional upon compliance with the end-March 2007 quantitative performance criteria and specified structural conditionality (Tables 1 and 2). Key structural benchmarks and structural performance criteria for the second review will continue to focus on improvements in the financial and fiscal areas, strengthening our statistical capacity, and public enterprise reform.

Table 1. Islamic Republic of Afghanistan: Performance Criteria and Indicative Targets for 2006/07–2007/08 1/

(Cumulative changes from March 20, 2006; unless otherwise indicated)

	Program											
	Jun. 21, 2006			Sep. 21, 2006			Dec. 20, 2006		Mar. 20, 2007		Jun. 21, 2007	Sep. 21, 2007
	Indicative Targets	Adjustment Targets	Actual Performance	Performance Criteria	Adjust. Targets	Actual Performance	Original Targets 2/	Revised Targets	Original Targets 2/	Performance Criteria	Indicative Targets 3/	Indicative Targets 3/
Quantitative performance criteria and benchmarks												
	(In millions of Afghanis)											
Floor on fiscal revenue of the government	5,317	5,317	5,375	10,636	10,636	11,990	17,201	18,668	26,595	27,015	7,405	15,665
Ceiling on currency in circulation	2,794	2,794	-1,373	5,587	5,587	3,063	6,910	4,672	8,233	7,395	1,904	3,878
Ceiling on net central bank financing of the government	3,587	1,326	-4,801	9,042	9,134	-501	8,254	3,252	1,242	4,223	454	2,794
Indicative target (ceiling) on the operating budget deficit of the government, excluding grants	4,561	4,561	370	9,120	9,120	5,234	12,432	11,805	12,915	17,185	5,044	9,233
	(In millions of U.S. dollars)											
Floor on net international reserves of DAB	-124.3	-79.0	69.1	-198.6	-200.4	98.9	-217.2	69.4	-68.5	94.0	14.6	-8.7
Zero ceiling on contracting or guaranteeing new medium- and long-term nonconcessional external debt by the government and DAB 4/	0	0	0	0	0	0	0	0	0	0	0	0
Zero ceiling on short-term external debt owed or guaranteed by the government or DAB 4/	0	0	0	0	0	0	0	0	0	0	0	0
Nonaccumulation of new external payments arrears, excluding interest on preexisting arrears 4/	0	0	0	0	0	0	0	0	0	0	0	0
Memorandum item:												
	(In millions of Afghanis)											
The operating budget deficit of the government, including grants	…	…	-2,246	…	…	2,038	…	909	…	-1,410	2,492	1,976
Reference Projections for the Adjustors												
	Program	Actual	Deviation	Program	Actual	Deviation	Program	Revised	Program	Revised	Program	Program
Core budget development spending	3,741	167	-3,574	11,222	5,467	-5,755	18,704	20,372	29,926	35,276	5,512	16,536
External financing of the core budget and sale or transfers of nonfinancial assets	4,715	6,976	2,261	11,300	11,208	-92	22,882	27,972	41,599	46,464	10,102	22,145
Expenditure currently financed outside the budget moved onto the operating budget	0	0	0	0	0	0	0	0	0	0	0	0

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

1/ The performance criteria and indicative targets envisaged under the program, and their adjustors, are defined in the Technical Memorandum of Understanding.
2/ Former indicative targets that were tentatively set at the time of the PRGF approval.
3/ Cumulative changes from March 20, 2007.
4/ These performance criteria apply on a continuous basis.

Table 2. Islamic Republic of Afghanistan: Structural Performance Criteria and Structural Benchmarks, September 2006–September 2007

First Review Under the PRGF Arrangement

Structural Performance Criteria	**Target Dates**	**Status**
Submit to parliament the core budget's audited financial statements for 2005/06.	September 30. 2006	Implemented
Structural Benchmarks	**Target Dates**	**Status**
Appoint a new Board of Directors at Bank Pashtany.	June 30, 2006	Not Implemented 1/
Adopt by shareholders long-term restructuring plans for Bank Millie and Bank Pashtany.	September 30, 2006	Not Implemented 1/
Publish a public statement announcing the liquidation of Export Promotion Bank or its merger with another licensed commercial bank, and finalize the transfer of its deposits.	September 30, 2006	Not Implemented 1/
Establish by MoF appeals process for customs and tax administrations.	September 30, 2006	Implemented
Submit to parliament the 2004/05 and 2005/06 external audits of DAB.	September 30, 2006	Implemented 2/
Process gold held in the palace vaults into a form that qualifies as a reserve asset.	September 30, 2006	Not Implemented
Establish a certified monthly payroll system.	December 31, 2006	Implemented
Submit to parliament legislation to eliminate nuisance taxes and introduce an excise tax on selected goods from the start of 2007/08.	December 31, 2006	Not Implemented

Second Review Under the PRGF Arrangement

Structural Performance Criteria	**Target Dates**	**Status**
Submit core 2007/08 budget to parliament.	February 4, 2007 3/	
Structural Benchmarks	**Target Dates**	**Status**
Request verification by the Control and Audit Office of the 2006 reviews of the Tashkeel at the Ministry of Interior and Ministry of Education and the related arrears from 2005/06.	January 31, 2007	
Make a public statement announcing the liquidation of the Export Promotion Bank or its merger with another licensed commercial bank.	January 31, 2007	
Submit to Cabinet a restructuring plan for Bank Millie.	March 31, 2007	
Adopt a comprehensive restructuring/divestment plan for the public entities and government agencies engaged in commercial activities but not covered by the SOEs law.	March 31, 2007	
Implement an integrated accounting system at DAB headquarters.	March 31, 2007	

Third Review Under the PRGF Arrangement

Structural Performance Criteria	Target Dates	Status
Submit to parliament the core budget's audited financial statement for 2006/07.	September 21, 2007 4/	
Structural Benchmarks	**Target Dates**	**Status**
Develop a monthly monetary survey in line with international standards.	July 31, 2007	
Clarify the tax policy framework and system, including separating the legislation of the BRT and income taxes.	July 31, 2007	
Prepare (and submit to Cabinet) a restructuring plan for Bank Pashtany.	July 31, 2007	
Expand the automated integrated accounting system to DAB branches.	September 30, 2007	

1/ These benchmarks were not met owing to the authorities' decision in August 2006 to merge the three state-owned banks. However, the decision to merge these banks was subsequently reversed.
2/ The audits were submitted to parliament in October 2006.
3/ This deadline is consistent with the requirement stated in the Constitution and in the Public Finance and Expenditure Management (PFEM) Law that the budget be submitted to parliament at least 45 calendar days before the start of the fiscal year.
4/ This deadline is consistent with the requirement stated in the PFEM Law that the core budget financial statements be submitted to parliament at least six months before the end of the fiscal year.

ATTACHMENT III: TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This memorandum sets out the understandings between the Afghan authorities and Fund staff relating to the monitoring of the Poverty Reduction and Growth Facility (PRGF)-supported program approved by the IMF Executive Board on June 26, 2006. In particular, it defines the benchmarks and performance criteria for the second and the third review of the program. Section I defines the structural performance criteria and benchmarks; Section II defines the principal concepts and financial variables, including the quantitative performance criteria and indicators; and Section III relates to the reporting requirements.

I. STRUCTURAL PERFORMANCE CRITERIA AND BENCHMARKS

2. The structural performance criteria and benchmarks for the second and the third review specified in Table 2 of the MEFP are defined as follows:

Performance criteria

- **Submit core budget to parliament by February 4, 2007**. The Public Finance and Expenditure Management (PFEM) law requires the government to submit the budget to parliament for consideration at least 45 days before start of the fiscal year.

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

Structural benchmarks

- **Request verification by the CAO of the 2006 reviews of the Tashkeel and Ministry of Interior and Ministry of Education, and the related arrears for 2005/06**. The CAO should be informed of the Tashkeel investigations and asked to verify the procedures for arriving at the new Tashkeel levels.

- **Make a public statement announcing the liquidation of Export Promotion Bank or its merger with another licensed commercial bank, and finalize the transfer of its deposits**. The public statement will be made by the shareholders.

- **Adopt a comprehensive restructuring/divestment plan for public entities and government agencies engaged in commercial activities but not covered by the state-owned enterprises law**. This restructuring/divestment plan will reflect the necessary steps and tasks entailed by the restructuring/divestment process and a schedule for their implementation. The plan will be adopted by the Cabinet.

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

- **Clarify the tax policy framework and system, including the difference between the BRT and income taxes**. The framework should set out the nature, role, supporting legislation, and expected contribution to fiscal objectives of the various taxes either currently in effect (e.g. income tax) or planned for the future (e.g. the amendments to the BRT), including separating pieces of legislation or one tax code with different chapters for different tax types.

- **Submit to Cabinet a restructuring plan for Bank Millie**. The plan will present and justify the restructuring of the bank with a view to its remaining in the public domain. The plan should specify and cost the measures that will be put in place to ensure the long-term financial sustainability of the bank, including measures aimed at strengthening management and supervision, enhancing productivity, and modernizing lending policies and procedures.

- **Implement an integrated accounting system at DAB**. The Core Banking System should address the shortcomings of the present system and allow timely completion of the DAB's financial statements for FY 1385. The system shall be capable of producing data needed for DAB's financial reporting including monthly balance sheet, monthly central bank operations table, and monetary survey.

- **Prepare (and submit to Cabinet) restructuring plans for Bank Pashtany**. The plan will present and justify the restructuring of the bank with a view to its remaining in the public domain The plan should specify and cost the measures that will be put in place to ensure the long-term financial sustainability of the bank, including measures aimed at strengthening management and supervision, enhancing productivity, and modernizing lending policies and procedures.

- **Expand the integrated accounting system to DAB branches**.

II. Quantitative Performance Criteria and Indicative Targets

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

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

A. Program Exchange Rate

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

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

B. Currency in Circulation

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

C. Net Central Bank Financing of the Government

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

D. Net International Reserves

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

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

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

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

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

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

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

E. Revenues of the Central Government

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

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

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

F. External Debt and Arrears

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

- Debts can take a number of forms, the primary ones being: (a) loans, (i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future—including deposits, bonds, debentures, commercial loans and buyers' credits—and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (b) suppliers' credits (i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided); and (c) leases (i.e., arrangements under which property is provided that the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property). Excluded from this limit are leases of real property by Afghan embassies or other foreign representations of the government.

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

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

- **It applies to** both debt as defined in paragraph 13 of this memorandum, and also to commitments contracted or guaranteed for which value has not been received. For the purposes of the program:

    - external debt will be considered to have been contracted at the point the loan agreement or guarantee is signed by the MoF (on behalf of the government) or DAB Governor; and

    - the guarantee of a debt arises from any explicit legal obligation of the government or DAB or any other agency acting on behalf of the government to service such a debt in the event of nonpayment by the recipient (involving payments in cash or in kind), or indirectly through any other obligation of the government or DAB to cover a shortfall incurred by the loan recipient.

- **Excluded** from the limits are refinancing credits and rescheduling operations, credits extended by the IMF, and credits on concessional terms defined as those with a grant element of at least 60 percent. The grant element is to be calculated using currency-specific discount rates based on the Organization for Economic Co-operation and Development Commercial Interest Reference Rates (CIRRs): for maturities of less than 15 years, the grant element will be calculated based on six-month averages of CIRRs; and for maturities longer than 15 years, the grant element will be calculated based on 10 year averages.

- Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract or guarantee becomes effective.

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

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

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

G. Adjustors

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

December 20, 2006	Af 20,372 million
March 20, 2007	Af 35,276 million

and from March 20, 2007, to:

June 21, 2007	Af 5,512 million
September 21, 2007	Af 16,536 million

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

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

December 20, 2006	Af 27,972 million
March 20, 2007	Af 46,464 million

and from March 20, 2007, to:

June 21, 2007	Af 10,102 million
September 21, 2007	Af 22,145 million

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

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

20. Should the central government undertake urgent security-related expenditures in excess of fiscal program (MEFP, ¶22), the NIR floor will be adjusted downward, and the NCBF ceiling and the indicative target (ceiling) for the operating budget deficit of the central government, excluding grants, will be adjusted upward to the extent that these expenditures are executed with the use of additional grants provided by donors, based on spending plans agreed between the central government and the donors. These adjustments will apply starting with the fiscal year 2007/08. The cumulative downward adjustment to the NIR floors at June 21, 2007 and September 21, 2007 will be capped at US$25.9 million. The cumulative upward adjustment to the NCBF ceilings and the indicative targets (ceilings) for the operating budget deficits of the central government, excluding grants, at June 21, 2007 and September 21, 2007 will be capped at Af 1,295 million.

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

III. Provision of Information to Fund Staff

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

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

- **DAB net international reserves** should be reported weekly, no later than two weeks after the end of the week.

- **Monetary statistics, including exchange rates, government accounts with DAB, and currency in circulation** should be reported monthly and no later than three weeks after the end of the month. Monetary statistics will also include a monetary survey (quarterly, and then monthly starting in March 2007), including balance sheets of DAB and a consolidated balance sheet of the commercial banking sector.

- **Operational budget operations and their financing** should be reported monthly and no later than four weeks after the end of the month. **Core development budget operations and their financing** should also be reported monthly and no later than four weeks after the end of the month. The structure of financing (grants and loans should be separately identified) and expenditure data should be on a consistent cash basis. Core operating expenditures should be reported on a monthly basis using the budget appropriation economic (Object) and administrative classification in addition to the program and functional classification as reported in the budget documents. Core development expenditures should also be reported separately on a monthly basis using the budget program classification in addition to the economic (Object), administrative and functional classification consistent with the operating budget. All the data should also compare outturns as recorded in AFMIS against the approved budget (or figures reported in the budget documents). Core operating and development revenues and expenditures should also be reported by province, separately on the same monthly basis.

- **External budget operations and their financing** (i.e., donor funded spending outside the core budget treasury systems) should be reported at least semi-annually (more frequently if possible) and no later than eight weeks after the end of the period. External development expenditures should be reported on a disbursement basis (as currently defined in budget documents) using the budget program classification (and an administrative, functional and provincial classification where possible).

- **External debt data** should be reported quarterly and no later than six weeks after the end of the quarter. They will include: (a) details of new loans contracted or guaranteed during the quarter, including the terms of each new loan; (b) the stock of debt at the end the quarter, including short-term, and medium- and long-term debt; (c) loan disbursements and debt service payments (interest and amortization) during the quarter; (d) information on all overdue payments on short-term debt and on medium- and long-term debt, including new external arrears (if any); and (e) total outstanding amount of arrears.

- **National accounts data** should be reported annually and no later than eight weeks after the end of the quarter.

- **Consumer price indices (CPIs)** for the city of Kabul and for Kabul and five other major cities ("national" CPI) should be reported monthly and no later than four weeks after the end of the month.

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

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

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

INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF AFGHANISTAN

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

Informational Annex

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Annexes

Appendix I: Islamic Republic of Afghanistan—Relations with the Fund
(As of November 30, 2006)

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	0.12

IV. **Outstanding Purchases and Loans**: None

V. **Financial Arrangements:**

Type	Date of Arrangement	Expiration Date	Amount Approved (SDR Million)	Amount Drawn (SDR Million)
PRGF	June 26, 2006	June 25, 2009	81.00	0.00

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

	Forthcoming				
	2006	2007	2008	2009	2010
Principal					
Charges/Interest		1.08	1.08	1.08	1.08
Total		1.08	1.08	1.08	1.08

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

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

Nonfinancial Relations

IX. **Exchange Arrangement**

Afghanistan is an Article XIV member country. The authorities are implementing a liberal exchange system. Based on information currently available to the staff, no exchange restrictions and multiple currency practices are currently in place. The authorities have provided documents to IMF staff related to laws and regulations on the exchange regime and have requested technical assistance from the Fund to formalize the current liberal regime. They have been implementing a managed float system with no predetermined path for the exchange rate. As of October 19, 2006, the average exchange rate on the Kabul money exchange market was Af 49.70 per $1.

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

X. Article IV Consultation

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

XI. Safeguards Assessment

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

XII. Technical Assistance, 2005–06

Department	**Date**	**Purpose**
FAD	March 2004–July 2006	Resident treasury expert
	May 19–25, 2005	Seminar on reorganization of the MoF
	October 18–25, 2005	Tax policy
	February 21–March 04, 2006	Public financial management
	April 30–May 09, 2006	Tax policy
	November 15–23, 2006	Tax and customs administration
FIN	April 2–11, 2006	Safeguards assessment
LEG	January 29–February 12, 2005	Income tax law
LEG/MCM	May 2–10, 2006	Legal framework of DAB's monetary and payment system policies

Department	Date	Purpose
MCM	September 2004–December, 2006	Training coordinator (peripatetic)
	February 2–15, 2005	Implementation of DAB balance sheet reconstruction and capital adequacy recommendations
	May 16–25, 2005	Monetary policy and financial markets
	October 11–20, 2005	Monetary policy
	November 20–29, 2005	Financial markets
MCM	January 22–February 5, 2006	Monetary policy
	May 2–10, 2006	Monetary policy, foreign reserve management, money markets and insurance
	November 28–December 10, 2006	Monetary policy formulation and implementation
STA	January 15–February 15, 2005	Multisector statistics
	March 23–June 11, 2005	Multisector statistics
	July 20–August 31, 2005	Multisector statistics
	October 31, 2005–January 12, 2006	Multisector statistics
	March 6–15, 2006	Balance of payments statistics
	March 8–May 2, 2006	Multisector statistics
	March13–April 1, 2006	Monetary and financial statistics
	May 24–July 18, 2006	Multisector Statistics
	August 2–16, 2006	Balance of payments statistics
	August 8–October 3, 2006	Multisector Statistics
	September 22–October 4, 2006	Government finance statitistics
	November 1–December 26, 2006	Multisector Statistics
	November 5–19, 2006	Monetary and financial statistics
MCD	April 16–20, 2005	Basic macroeconomic accounting and financial programming
METAC	November 15–20, 2005	Tax policy and administration

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

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

XIII. **Resident Representatives**

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

Appendix II: Islamic Republic of Afghanistan—Relations with the World Bank
(As of October 20, 2006)

Enrique Pantoja, Acting Country Officer, Telephone: (202) 473-2516

1. A second Transitional Support Strategy (TSS) was presented to the World Bank Board of Executive Directors in March 2003. Following the government's promulgation of its Interim Afghanistan National Development Strategy (I-ANDS) in January 2006, the World Bank prepared a new Interim Strategy Note (ISN) which was discussed by the World Bank Executive Board of Directors on May 25, 2006. As the government had submitted the I-ANDS to the IMF and the World Bank as its Interim Poverty Reduction Strategy (I-PRSP), Bank and Fund staff prepared a Joint Staff Advisory Note (JSAN) which was also discussed by the Bank Board on May 25, 2006. It is anticipated that a full Country Assistance Strategy (CAS) would be prepared by the Bank when the government's full ANDS/PRSP is completed.

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 included 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. In 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. In FY 2006, four projects and two additional grants were approved, for a total of $240 million. Projects include the second budget support operation, Programmatic Support for Institution Building II ($80 million); Horticulture and Livestock Productivity

($20 million); Urban Water Supply and Sanitation ($40 million); and Natural Resources and Industrial Development ($30 million). Two additional grants were approved for Health Sector Emergency Rehabilitation ($30 million) and the National Solidarity Program ($40 million).

6. For FY 2007, new commitments may reach $300–400 million. Potential projects include: Programmatic Support for Institutional Building III, Private Sector Development, National Solidarity Program II, Public Administration Capacity Building II, HIV/AIDS Prevention, Avian Flu Preparedness, and National Emergency Employment Program for Rural Access.

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

8. The World Bank is also actively engaged in providing analytical and advisory services to the government. Major work on public administration reform and on fighting corruption is being initiated in response to government requests. Current and recent analytical work has focused on civil service reform, urban development and land management, education policy reform, labor market and pensions, oil/gas infrastructure development, and the drug economy, as well as broader regional trade work encompassing issues with Afghanistan's neighbors. A Gender Assessment was released in January 2006. The World Bank completed a major Public Finance Management (PFM) review in FY 2006, which incorporates an assessment of civilian public expenditures and fiduciary aspects, including procurement and financial management, as well as revenue and security sector expenditures. Fund staff contributed to the PFM review, including by providing an analysis of domestic revenue prospects. 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.

9. The World Bank's program is growing quickly and, as of September 2006, has an IDA portfolio of 16 active projects, totaling $865 million in net commitments, and an undisbursed amount of $436 million. Aggregate commitments since 2001 total $1.3 billion, of which $696.8 million are in grants. Total commitments for FY 2007 may reach $300–$400 million, entirely in the form of grants.

INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF AFGHANISTAN

First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility Supplement and Financing Assurances Review

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

Approved by Juan Carlos Di Tata and Matthew Fisher

February 27, 2007

1. This supplement provides information on key program developments since issuing the staff report for the first review under the Poverty Reduction and Growth Facility (PRGF) arrangement. It also reflects additional understandings reached with the authorities during a mission that visited Kabul from January 21–February 1, 2007. In coordination with an overlapping World Bank mission, Fund staff also assisted the authorities in their preparations for an assessment of Afghanistan's eligibility for the Heavily Indebted Poor Countries (HIPC) Initiative.[1] The thrust of the staff appraisal remains broadly unchanged.

A. Recent Developments and Program Performance

2. **Economic performance under the program during the third quarter of 2006/07 was broadly satisfactory**. The authorities met all the December 2006 quantitative indicative targets, except for that on fiscal revenue, and made progress on structural reforms, including establishing the certified monthly payroll system (end-December structural benchmark), announcing the merger of the Export Promotion Bank with Bank Pashtany, and requesting the verification by the Control and Audit Office of the 2006 reviews of the Tashkeel at the Ministry of Interior and Ministry of Education and the related arrears from 2005/06 (the two structural benchmarks proposed for end-January 2007). Year-on-year inflation fell to less than 4 percent at end-2006, with the Afghani-U.S. dollar rate remaining within a narrow band around Afs 50. Preliminary indications are that the poppy crop will be substantially above last year's record harvest.

3. **The security situation in Kabul improved recently**, as it did during the last two winters. However, most experts expect security to deteriorate in the spring, as the Taliban appears to be organizing for a major offensive.

[1] The mission comprised Messrs. Symansky, Elhage, and Wieczorek (MCD), Mr. Tyson (FAD), and Mmes. Ongley and Hakobyan (PDR), and was assisted by Mr. Charap, resident representative. Mr. Mirakhor (OED) participated in many of the meetings.

B. Fiscal Policy Issues

4. **Despite the third quarter revenue shortfall, the operating budget deficit excluding grants was below program projections**. Domestic revenue at the end of the third quarter was about Afs 0.8 billion (less than 0.2 percent of GDP) below the December 2006 indicative target. The reasons for this shortfall, which can be traced to a downturn in corporate income and sales taxes and to slower than expected growth in customs revenue, remain to be clarified.[2] There is not enough information to determine if the shortfall represents a temporary or permanent decline in revenue. Operating expenditures were equivalent to only 62 percent of the operating budget, reflecting slow execution in the first quarter. Recorded development expenditures have picked up significantly, reaching 26 percent of the approved budget due to more effective implementation and elimination of the backlog of unrecorded expenditures.[3]

5. **Programmed expenditures for the remainder of 2006/07 appear broadly on track, but meeting the March 2007 revenue target would require stepped up efforts**. In this regard, the authorities are concentrating on improving compliance on a few large revenue items in the last quarter of the fiscal year.[4] In the context of the next review, staff will assess the success of these measures and the implications for the program. Looking beyond the immediate future, the authorities have completed the first draft of a tax policy strategy to clarify the revenue framework (as called for under the end-July 2007 structural benchmark); an important step toward a durable improvement in revenue performance.

6. **Although the baseline fiscal parameters for 2007/08 established in November 2006 remain unchanged, the government's consultations with security partners revealed that further outlays would be required in this area**. The authorities also raised the need for additional nonsecurity expenditures in social sectors (amounting to about 0.2 percent of GDP, mainly in the education sector). The fiscal program for 2007/08 initially provided (through an adjustor) for additional security expenditures above the budgeted amount, to be financed by additional donor resources. This adjustor has now been relaxed.[5] The additional nonsecurity spending pressures identified by the authorities would be taken up in the context of the next review. However, staff expressed their concern that any

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[2] A recent Ministry of Finance report suggests that extension of filing deadlines, launching the recruiting campaign in the provinces, a loss of staff in the large taxpayers office, and the deteriorating security situation in the south may have all played a part.

[3] Due to technical difficulties, almost 600 transactions from the development budget went unrecorded in the financial management system in the first half of 2006/07. This did not affect observance of program targets.

[4] One-off over-flight payments are due in the fourth quarter. The authorities have also renewed efforts to collect taxes due from the airlines and to follow up on 2005/06 income tax returns by large taxpayers that were not filed.

[5] To this effect, the cap on the relevant adjustors has been raised from US$25.9 million (or Afs 1.295 billion) to US$76 million (or Afs 3.8 billion). Paragraph 20 of the attached Technical Memorandum of Understanding has been amended accordingly.

additional spending in the absence of adequate revenue measures could delay achieving the authorities stated fiscal sustainability objective (First Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility, Attachment II, ¶23 (www.imf.org)). In this regard, staff urged the authorities to place additional spending needs within a revised framework for attaining fiscal sustainability in the medium term—this framework, demonstrated need, and the availability of resources, would be the primary criteria for evaluating possible changes to the fiscal program in the next review.

7. **Consultations with donors on security spending, including at a recent meeting of the Joint Compact Monitoring Board in Berlin, delayed briefly the finalization of the 2007/08 budget**. Since many Cabinet ministers attended the Berlin meeting, the budget was submitted to parliament on February 8, 2007, four days after the deadline specified in the Public Finance and Expenditure Management Law. With the delay in the Board's consideration of the first review, the proposed performance criterion for the second review on budget submission became moot and is no longer included in the authorities' program.

C. Monetary Sector Issues

8. **Monetary policy remains appropriate and conditions are improving for expanding the use of Da Afghanistan Bank's (DAB) policy instruments**. Preparations are under way for opening a secondary market for capital notes and introducing capital notes of longer maturities. Combined with increased volumes of capital notes auctions, these steps will facilitate the development of financial markets and enhance banks' ability to manage liquidity efficiently. While several banks have increased significantly their lending in the domestic market, other banks (mostly foreign-owned) continued to shy away from lending domestically. The authorities welcomed the staff's recommendation to receive a Fund mission in order to assess progress in the area of banking supervision.

9. **Staff expressed concern about a new regulation that will force commercial banks to invest 80 percent of their deposits in the domestic market within two years**. Efforts to develop the domestic financial sector and encourage domestic lending should focus on establishing the appropriate legal, regulatory, and enforcement frameworks, rather than on dictating investment strategies. The authorities concurred with staff's assessment and indicated that efforts would be made to rescind the new regulation before it becomes binding.

10. **Weaknesses remain in the central bank's financial reporting**. Staff urged DAB to improve the coordination of financial data among its various departments and to implement without delay the automated accounting system at DAB's headquarters (end-March 2007 structural benchmark).

D. External Sector and HIPC-Related Issues

11. Following the introduction of the new custom tariff schedule in August 2006, **additional items appear to have been moved into the top tariff bands, further exemptions and concessions have been introduced, and a 1 percent tariff rate for (as yet unspecified) raw materials has been added**. These measures appear to run counter to staff's advice and further details—to be examined in the context of the second review—are needed to assess their impact.

12. **The authorities have continued their dialogue with external bilateral creditors and, in particular, have commenced good faith efforts to reach understandings with them**. In reconciling their external debt data to facilitate an assessment of Afghanistan's eligibility for the HIPC Initiative, the authorities contacted all bilateral external creditors. This revealed possible, and previously unidentified, claims by commercial creditors.[6] Given that the authorities have been unable to confirm their validity, these claims remain in dispute and are not considered arrears for purposes of the PRGF arrangement (or the prospective preliminary HIPC document). As the program had assumed that—in line with the July 2006 Paris Club agreement—Afghanistan would seek comparable treatment from other bilateral creditors (initially thought to be all official), no payments on these claims had been projected during the program period. Therefore, **staff considers that this does not alter the financing assumptions for the PRGF-supported program**, but will nevertheless monitor developments in the resolution of these claims. Staff encouraged the authorities to continue their efforts to finalize bilateral agreements with the remaining Paris Club creditors[7] and to open negotiations with all non-Paris Club official creditors.

13. **The authorities have made good progress in preparing for an assessment of HIPC eligibility**, but the lack of official data for the export of services has complicated the debt sustainability analysis. However, progress was made in discussing options for addressing these data constraints, which could allow Fund and World Bank staff to prepare a HIPC debt sustainability analysis. The authorities also reached broad understandings with Fund and Bank staff on possible triggers for the floating completion point.

14. **The mission to conduct discussions for the second review under the PRGF-supported program is scheduled for late-April 2007**.

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

[7] The agreement with the United States was signed in September 2006 and the agreement with Germany is expected to be signed shortly. Discussions with Russia are ongoing.

Table 3a. Islamic Republic of Afghanistan: Core Budget, 2003/04–2009/10 1/
(In millions of Afghanis)

	Est. 2003/04	Est. 2004/05	Prelim. 2005/06	Approved Core Budget 2/ 2006/07	CR 06/251 Mid-year Proj. 2006/07	YTD 6 months Prelim. 2006/07	CR 06/251 Fiscal Program 2006/07	Revised Fiscal Program 3/ 2006/07	CR 06/251 Fiscal Program 2007/08	Revised Proj. 3/ 2007/08	Proj. 2008/09	Proj. 2009/10
Domestic revenue	10,168	12,800	20,652	25,220	10,636	11,990	26,595	27,015	35,149	35,773	43,943	53,831
Tax revenues	6,262	9,546	14,035	18,867	8,188	9,862	20,008	22,462	26,877	29,482	35,899	43,712
Taxes on income, profits, and capital gains	363	995	2,621	4,559	1,683	1,911	3,580	4,178	5,048	5,788	7,284	9,037
Taxes on international trade and transactions	5,369	7,247	9,446	13,774	5,745	5,127	14,339	12,750	17,772	16,535	20,284	23,428
Other taxes	531	1,304	1,968	534	761	2,825	2,089	5,534	4,057	7,159	8,331	11,248
Nontax revenues	3,906	3,254	6,617	6,354	2,447	2,127	6,588	4,553	8,273	6,290	8,044	10,118
Donor assistance grants (to operating budget) 4/	10,074	14,984	16,732	17,218	4,304	3,196	17,218	18,595	12,233	18,819	19,041	19,083
ARTF (recurrent window)	8,182	12,319	12,572	13,580	3,395	2,614	13,580	13,095	8,595	13,580	13,580	13,580
LOTFA	1,892	2,583	4,068	3,638	909	579	3,638	4,800	3,638	3,638	3,638	3,638
Other grants		83	92	0	0	3	0	700	0	1,601	1,824	1,866
Donor assistance grants (core development budget)	4,569	8,250	19,251	37,362	5,611	2,504	18,843	18,064	22,584	25,928	40,259	49,354
Total core budget expenditure	31,606	39,550	53,437	106,925	30,977	22,690	69,436	79,476	81,454	93,891	109,106	128,780
Operating expenditure	22,151	26,716	32,348	40,346	19,755	17,224	39,511	44,200	44,047	49,795	53,986	59,881
Wages and salaries	14,660	18,902	20,430	25,378	12,469	11,683	25,378	27,276	28,770	29,667	32,487	37,173
Purchase of goods and services	4,653	4,182	6,679	8,999	4,674	4,023	8,999	9,352	9,809	10,769	11,738	12,501
Transfers and subsidies	652	764	495	2,213	838	0	1,378	3,816	1,608	4,765	4,731	4,755
Pensions	177	889	1,540	2,065	925	1,108	2,065	2,065	2,168	2,773	2,912	3,028
Capital expenditure	2,009	1,979	3,054	1,220	614	327	1,220	1,220	1,423	1,437	1,672	1,915
Interest	...	...	150	471	236	83	471	471	270	384	446	508
Core budget development spending 5/	9,455	12,834	21,089	66,579	11,222	5,467	29,926	35,276	37,407	44,096	55,119	68,899
Interim Afghanistan National Development Strategy programs												
Security	...	...	1,122	2,522	435	296	1,161	1,513	1,451	1,891	2,364	2,955
Governance, Rule of Law, and Human Rights	...	...	551	2,377	431	218	1,149	1,426	1,437	1,783	2,228	2,785
Infrastructure and Natural Resources	...	...	6,235	34,327	4,375	1,195	11,665	13,731	14,582	17,163	21,454	26,818
Education	...	...	1,035	5,068	784	617	2,090	3,041	2,612	3,801	4,751	5,939
Health	...	...	991	3,779	612	759	1,631	2,267	2,038	2,834	3,542	4,428
Agriculture and Rural Development	...	...	10,170	14,628	3,911	2,336	10,429	10,971	13,037	13,714	17,142	21,428
Social Protection	...	...	30	143	35	0	92	86	115	107	134	167
Economic Governance and Private Sector Development	...	...	956	3,737	641	46	1,708	2,242	2,135	2,803	3,503	4,379
Operating budget balance (excluding grants)	-11,983	-13,916	-11,695	-15,126	-9,120	-5,234	-12,915	-17,185	-8,897	-14,023	-10,044	-6,050
Operating budget balance (including grants)	-1,910	1,068	5,036	2,092	-4,815	-2,038	4,302	1,410	3,335	4,796	8,998	13,033
Core budget balance (including grants)	-6,795	-3,516	3,199	-27,126	-10,426	-5,001	-6,780	-15,802	-11,489	-13,372	-5,863	-6,513
Float and adjustment 6/	1,693	359	-1,989	0	0	-7	0	0	0	0	0	0
Sale of Nonfinancial assets 7/	0	0	1,994	0	0	1,994	0	1,994	5,732	5,732	10,965	12,460
Financing	5,102	3,157	-3,203	27,126	10,426	3,014	6,780	13,808	5,757	7,640	-5,102	-5,947
External loans (net)	4,886	14,753	5,318	10,846	1,385	3,515	5,538	7,811	5,289	7,306	7,057	6,557
Domestic (net) 8/	217	-11,596	-8,521	16,280	9,039	-501	1,242	5,998	468	334	-12,159	-12,504
Memorandum items:												
External budget expenditure 9/	74,528	100,225	99,780	106,361	...	...	106,361	109,518	91,956	91,956	69,840	32,398
Operating budget deficit excluding grants (minus mid-year additions from external budget and security)	...	...	...	-15,126	...	...	-12,915	-13,929	-8,897	-10,776	-7,093	-3,346
Known pressures in the security sector with no firm donor commitments	...	...	...	...	...	...	...	...	...	3,800	6,232	5,588

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

1/ Core budget includes domestic revenues, grants, operating and development expenditure and financing that are accounted for by the central government.
2/ June 2006 budget approved by parliament
3/ Staff estimates and projections.
4/ Funding for the operating budget provided through the multi-donor trust funds: The Afghanistan Reconstruction Trust Fund (ARTF) (recurrent window) and the Law and Order Trust Fund (LOTFA).
5/ Government program classification based on a simple aggregation of administrative units. Expenditure is not delineated by a standard classification of purpose or function.
6/ Variation between the fiscal position recorded at MoF and DAB. This discrepancy is partially due to the difference ("float") between checks issued and checks cashed.
7/ In 2005/06 includes $40 million receipt from sale of telecommunications spectrum bandwidth and delayed overflight payment from 2004/05. 2006/07 includes another sale of spectrum bandwidth and beyond includes proceeds from planned privatizations.
8/ Net change in government deposits with DAB (excluding provincial branch balances). A positive sign corresponds to a decline in balances and a negative sign to an increase in balances.
9/ Estimates from MoF.

Table 3b. Islamic Republic of Afghanistan: Core Budget, 2003/04–2009/10 1/
(In percent of GDP)

	Est. 2003/04	Est. 2004/05	Prelim. 2005/06	Approved Core Budget 2/ 2006/07	CR 06/251 Mid-year Proj. 2006/07	YTD 6 months Prelim. 2006/07	CR 06/251 Fiscal Prog. 3/ 2006/07	Revised Fiscal Program 3/ 2006/07	CR 06/251 Fiscal Prog. 2007/08	Revised Projections Prog. 3/ 2007/08	Proj. 2008/09	Proj. 2009/10
Domestic revenue	4.5	4.5	5.7	5.7	2.4	2.9	6.0	6.4	6.8	7.2	7.6	8.2
Tax revenues	2.8	3.4	3.9	4.3	1.8	2.4	4.5	5.4	5.2	6.0	6.2	6.6
Taxes on income, profits, and capital gains	0.2	0.3	0.7	1.0	0.4	0.5	0.8	1.0	1.0	1.2	1.3	1.4
Taxes on international trade and transactions	2.4	2.5	2.6	3.1	1.3	1.2	3.2	3.0	3.4	3.3	3.5	3.6
Other taxes	0.2	0.5	0.5	0.1	0.2	0.7	0.5	1.3	0.8	1.4	1.4	1.7
Nontax revenues	1.7	1.1	1.8	1.4	0.6	0.5	1.5	1.1	1.6	1.3	1.4	1.5
Donor assistance grants (to operating budget) 4/	4.5	5.3	4.6	3.9	1.0	0.8	3.9	4.4	2.4	3.8	3.3	2.9
ARTF (recurrent window)	3.6	4.3	3.5	3.1	0.8	0.6	3.1	3.1	1.7	2.7	2.4	2.1
LOTFA	0.8	0.9	1.1	0.8	0.2	0.1	0.8	1.1	0.7	0.7	0.6	0.6
Other grants	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.2	0.0	0.3	0.3	0.3
Donor assistance grants (core development budget)	2.0	2.9	5.3	8.4	1.3	0.6	4.3	4.3	4.4	5.2	7.0	7.5
Total core budget expenditure	14.0	13.9	14.7	24.1	7.0	5.4	15.7	18.9	15.8	19.0	19.0	19.6
Operating expenditure	9.8	9.4	8.9	9.1	4.5	4.1	8.9	10.5	8.5	10.1	9.4	9.1
Wages and salaries	6.5	6.6	5.6	5.7	2.8	2.8	5.7	6.5	5.6	6.0	5.7	5.6
Purchase of goods and services	2.1	1.5	1.8	2.0	1.1	1.0	2.0	2.2	1.9	2.2	2.0	1.9
Transfers and subsidies	0.3	0.3	0.1	0.5	0.2	0.0	0.3	0.9	0.3	1.0	0.8	0.7
Pensions	0.1	0.3	0.4	0.5	0.2	0.3	0.5	0.5	0.4	0.6	0.5	0.5
Capital expenditure	0.9	0.7	0.8	0.3	0.1	0.1	0.3	0.3	0.3	0.3	0.3	0.3
Interest	...	...	0.0	0.1	0.1	0.0	0.1	0.1	0.1	0.1	0.1	0.1
Core budget development spending 5/	4.2	4.5	5.8	15.0	2.5	1.3	6.8	8.4	7.2	8.9	9.6	10.5
Interim Afghanistan National Development Strategy programs	0.0	0.0										
Security	...	...	0.3	0.6	0.1	0.1	0.3	0.4	0.3	0.4	0.4	0.4
Governance, Rule of Law, and Human Rights	...	...	0.2	0.5	0.1	0.1	0.3	0.3	0.3	0.4	0.4	0.4
Infrastructure and Natural Resources	...	...	1.7	7.7	1.0	0.3	2.6	3.3	2.8	3.5	3.7	4.1
Education	...	...	0.3	1.1	0.2	0.1	0.5	0.7	0.5	0.8	0.8	0.9
Health	...	...	0.3	0.9	0.1	0.2	0.4	0.5	0.4	0.6	0.6	0.7
Agriculture and Rural Development	...	...	2.8	3.3	0.9	0.6	2.4	2.6	2.5	2.8	3.0	3.3
Social Protection	...	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Economic Governance and Private Sector Development	...	...	0.3	0.8	0.1	0.0	0.4	0.5	0.4	0.6	0.6	0.7
Operating budget balance (excluding grants)	-5.3	-4.9	-3.2	-3.4	-2.1	-1.2	-2.9	-4.1	-1.7	-2.8	-1.7	-0.9
Operating budget balance (including grants)	-0.8	0.4	1.4	0.5	-1.1	-0.5	1.0	0.3	0.6	1.0	1.6	2.0
Core budget balance (including grants)	-3.0	-1.2	0.9	-6.1	-2.4	-1.2	-1.5	-3.8	-2.2	-2.7	-1.0	-1.0
Float and adjustment 6/	0.8	0.1	-0.5	0.0	...	0.0	0.0	0.0		0.0	0.0	0.0
Sale of Nonfinancial assets 7/	0.0	0.0	0.5	0.0	...	0.5	0.0	0.5	1.1	1.2	1.9	1.9
Financing	2.3	1.1	-0.9	6.1	2.4	0.7	1.5	3.3	1.1	1.5	-0.9	-0.9
External loans (net)	2.2	5.2	1.5	2.4	0.3	0.8	1.3	1.9	1.0	1.5	1.2	1.0
Domestic (net) 8/	0.1	-4.1	-2.3	3.7	2.0	-0.1	0.3	1.4	0.1	0.1	-2.1	-1.9
Memorandum items:												
External budget expenditure 9/	33.1	35.2	27.5	24.0	...	...	24.0	26.1	17.8	18.6	12.1	4.9
Operational budget deficit excluding grants (minus mid-year additions from external budget and security)	...	...	...	-3.4	...	...	-2.9	-3.3	-1.7	-2.2	-1.2	-0.5
Known pressures in the security sector with no firm donor commitments	...	...	...	...	...	...	...	...	...	0.8	1.1	0.8
Nominal GDP (in millions of Afghanis)	225,108	284,504	362,998	442,995	442,995	419,448	442,995	419,448	516,586	494,001	574,960	658,367

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

1/ Core budget includes domestic revenues, grants, operating and development expenditure and financing that are accounted for by the central government.
2/ June 2006 budget approved by parliament.
3/ Staff estimates and projections as percent of updated GDP.
4/ Funding for the operating budget provided through the multi-donor trust funds: The Afghanistan Reconstruction Trust Fund (ARTF) (recurrent window) and the Law and Order Trust Fund (LOTFA)
5/ Government program classification based on a simple aggregation of administrative units. Expenditure is not delineated by a standard classification of purpose or function.
6/ Variation between the fiscal position recorded at MoF and DAB. This discrepancy is partially due to the difference ("float") between checks issued and checks cashed.
7/ In 2005/06 includes $40 million receipt from sale of telecommunications spectrum bandwidth and delayed overflight payment from 2004/05. 2006/07 includes another sale of spectrum bandwidth and beyond includes proceeds from planned privatizations.
8/ Net change in government deposits with DAB (excluding provincial branch balances). A positive sign corresponds to a decline in balances and a negative sign to an increase in balances.
9/ Estimates from MoF.

ATTACHMENT I

Kabul, February 27, 2007

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

Dear Mr. de Rato,

This letter supplements our letter of intent and Memorandum of Economic and Financial Policies (MEFP) of January 17, 2007 with regard to security expenditures and the 2007/08 budget, as well as external debt issues identified during preparations for the Heavily Indebted Poor Countries (HIPC) Initiative.

Despite the difficult security environment and persistent expenditure pressures, we have continued to make progress in our reform strategy, and our program under the Poverty Reduction and Growth Facility (PRGF) arrangement remains on track. Although it appears that fiscal revenue in the first three quarters of fiscal year 2006/07 fell short of the revised (indicative) target proposed for December 20, 2006, the operating budget deficit (excluding grants) during that period remained below the program ceiling, owing mainly to slow execution of expenditures in the first quarter. The revenue under-performance, which occurred only in the third quarter of 2006/07, was partly attributable to the deteriorating security situation in the south. Nonetheless, we remain committed to meeting the proposed performance criterion on fiscal revenue for March 20, 2007. We have also followed through on our structural agenda. On January 21, 2007, we made a public statement announcing the merger of the Export Promotion Bank with Bank Pashtany. In addition, the Ministry of Finance requested that the Control and Audit Office verify the 2006 reviews of the Tashkeel at the Ministry of Interior and Ministry of Education and the related arrears from 2005/06.

2007/08 Budget and Security

Our initial fiscal program for 2007/08—set out in our January 17 MEFP—provided for security expenditures in excess of the budgeted amount (up to Af 1.3 billion, or about US$26 million), to be financed by donors. However, subsequent consultations with our main donors and security partners revealed that further outlays (and financing) would be necessary to adequately strengthen our security forces. As a result, the total additional security expenditures for 2007/08 (above the fiscal program) are now estimated at Af 3.8 billion (about US$76 million). During the January 30–31 meeting of the Joint Compact Monitoring Board (JCMB) in Berlin, donors indicated their willingness to meet these extra demands.

Reflecting these developments, we request that the cap on the program adjustor for additional, fully donor-funded security expenditures, be raised from Af 1.3 billion to Af 3.8 billion. The revised version of the Technical Memorandum of Understanding is attached.

For now, we have resisted other emerging nonsecurity expenditure pressures and are leaving the programmed budget balance (excluding grants) for 2007/08 unchanged, with the understanding that well-defined and limited additional nonsecurity expenditure needs (in priority sectors) may be revisited in the context of the second review under the PRGF.

Notwithstanding the re-opening of consultations on security expenditures and the relocation of the JCMB meeting from Kabul to Berlin that delayed the final stages of budget preparation, the budget was presented to parliament on February 8. Therefore, we are no longer proposing establishing a structural performance criterion for the second review on submitting the budget to parliament. A revised Table 2 on structural performance criteria and benchmarks is attached to this letter.

Progress in Resolving External Arrears

In preparing for an assessment of Afghanistan's HIPC eligibility, we have made considerable progress in identifying and reconciling our external obligations. In doing so, we have identified possible commercial claims for which we have, as yet, been unable to ascertain their validity. In particular, we have been unable to confirm the government's guarantee of some claims and are investigating the apparent transfer of claims previously owed to a non-Paris Club official creditor. We are actively working to clarify the status of these possible claims and remain firmly committed to engaging in good-faith negotiations with our official creditors, and seeking comparable treatment in line with the recent Paris Club rescheduling agreement and our intention to seek debt relief under the HIPC Initiative.

We would like to assure you of our continued commitment to the macroeconomic objectives and reform agenda set in the MEFP. On this basis, we would like to reiterate our request for the completion of the review.

Sincerely yours,

/s/	/s/
Anwar Ul-Haq Ahady	Noorullah Delawari
Minister of Finance	Governor
Ministry of Finance	Da Afghanistan Bank

First Review Under the PRGF Arrangement

Structural Performance Criteria	Target Dates	Status
Submit to parliament the core budget's audited financial statements for 2005/06.	September 30. 2006	Implemented

Structural Benchmarks	Target Dates	Status
Appoint a new Board of Directors at Bank Pashtany.	June 30, 2006	Not Implemented 1/
Adopt by shareholders long-term restructuring plans for Bank Millie and Bank Pashtany.	September 30, 2006	Not Implemented 1/
Publish a public statement announcing the liquidation of Export Promotion Bank or its merger with another licensed commercial bank, and finalize the transfer of its deposits.	September 30, 2006	Not Implemented 1/
Establish by MoF appeals process for customs and tax administrations.	September 30, 2006	Implemented
Submit to parliament the 2004/05 and 2005/06 external audits of DAB.	September 30, 2006	Implemented 2/
Process gold held in the palace vaults into a form that qualifies as a reserve asset.	September 30, 2006	Not Implemented
Establish a certified monthly payroll system.	December 31, 2006	Implemented
Submit to parliament legislation to eliminate nuisance taxes and introduce an excise tax on selected goods from the start of 2007/08.	December 31, 2006	Not Implemented

Second Review Under the PRGF Arrangement

Structural Benchmarks	Target Dates	Status
Request verification by the Control and Audit Office of the 2006 reviews of the Tashkeel at the Ministry of Interior and Ministry of Education and the related arrears from 2005/06.	January 31, 2007	Implemented
Make a public statement announcing the liquidation of the Export Promotion Bank or its merger with another licensed commercial bank.	January 31, 2007	Implemented
Submit to Cabinet a restructuring plan for Bank Millie.	March 31, 2007	
Adopt a comprehensive restructuring/divestment plan for the public entities and government agencies engaged in commercial activities but not covered by the SOEs law.	March 31, 2007	
Implement an integrated accounting system at DAB headquarters.	March 31, 2007	

Third Review Under the PRGF Arrangement

Structural Performance Criteria	Target Dates	Status
Submit to parliament the core budget's audited financial statement for 2006/07.	September 21, 2007 3/	
Structural Benchmarks	**Target Dates**	**Status**
Develop a monthly monetary survey in line with international standards.	July 31, 2007	
Clarify the tax policy framework and system, including separating the legislation of the BRT and income taxes.	July 31, 2007	
Prepare (and submit to Cabinet) a restructuring plan for Bank Pashtany.	July 31, 2007	
Expand the automated integrated accounting system to DAB branches.	September 30, 2007	

1/ These benchmarks were not met owing to the authorities' decision in August 2006 to merge the three state-owned banks. However, the decision to merge these banks was subsequently reversed.

2/ The audits were submitted to parliament in October 2006.

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

REVISED ATTACHMENT III: TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This memorandum sets out the understandings between the Afghan authorities and Fund staff relating to the monitoring of the Poverty Reduction and Growth Facility (PRGF)-supported program approved by the IMF Executive Board on June 26, 2006. In particular, it defines the benchmarks and performance criteria for the second and the third review of the program. Section I defines the structural performance criterion and benchmarks; Section II defines the principal concepts and financial variables, including the quantitative performance criteria and indicators; and Section III relates to the reporting requirements.

I. STRUCTURAL PERFORMANCE CRITERION AND BENCHMARKS

2. The structural performance criterion and benchmarks for the second and the third review specified in Table 2 of the MEFP are defined as follows:

Performance criterion

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

Structural benchmarks

- **Request verification by the CAO of the 2006 reviews of the Tashkeel and Ministry of Interior and Ministry of Education, and the related arrears for 2005/06**. The CAO should be informed of the Tashkeel investigations and asked to verify the procedures for arriving at the new Tashkeel levels.

- **Make a public statement announcing the liquidation of Export Promotion Bank or its merger with another licensed commercial bank, and finalize the transfer of its deposits**. The public statement will be made by the shareholders.

- **Adopt a comprehensive restructuring/divestment plan for public entities and government agencies engaged in commercial activities but not covered by the state-owned enterprises law**. This restructuring/divestment plan will reflect the necessary steps and tasks entailed by the restructuring/divestment process and a schedule for their implementation. The plan will be adopted by the Cabinet.

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

- **Clarify the tax policy framework and system, including the difference between the BRT and income taxes**. The framework should set out the nature, role, supporting legislation, and expected contribution to fiscal objectives of the various taxes either currently in effect (e.g. income tax) or planned for the future (e.g. the amendments to the BRT), including separating pieces of legislation or one tax code with different chapters for different tax types.

- **Submit to Cabinet a restructuring plan for Bank Millie**. The plan will present and justify the restructuring of the bank with a view to its remaining in the public domain. The plan should specify and cost the measures that will be put in place to ensure the long-term financial sustainability of the bank, including measures aimed at strengthening management and supervision, enhancing productivity, and modernizing lending policies and procedures.

- **Implement an integrated accounting system at DAB.** The Core Banking System should address the shortcomings of the present system and allow timely completion of the DAB's financial statements for FY 1385. The system shall be capable of producing data needed for DAB's financial reporting including monthly balance sheet, monthly central bank operations table and monetary survey.

- **Prepare (and submit to Cabinet) restructuring plans for Bank Pashtany**. The plan will present and justify the restructuring of the bank with a view to its remaining in the public domain The plan should specify and cost the measures that will be put in place to ensure the long-term financial sustainability of the bank, including measures aimed at strengthening management and supervision, enhancing productivity, and modernizing lending policies and procedures.

- **Expand the integrated accounting system to DAB branches**.

II. Quantitative Performance Criteria and Indicative Targets

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

- a floor on fiscal revenue of the central government;

- a ceiling on currency in circulation;

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

A. Program Exchange Rate

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

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

B. Currency in Circulation

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

C. Net Central Bank Financing of the Government

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

D. Net International Reserves

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

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

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

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

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

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

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

E. Revenues of the Central Government

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

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

F. External Debt and Arrears

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

- Debts can take a number of forms, the primary ones being: (a) loans, (i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future—including deposits, bonds, debentures, commercial loans and buyers' credits—and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (b) suppliers' credits (i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided); and (c) leases (i.e., arrangements under which property is provided that the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property). Excluded from this limit are leases of real property by Afghan embassies or other foreign representations of the government.

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

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

- **It applies to** both debt as defined in paragraph 13 of this memorandum, and also to commitments contracted or guaranteed for which value has not been received. For the purposes of the program:

    - external debt will be considered to have been contracted at the point the loan agreement or guarantee is signed by the MoF (on behalf of the government) or DAB Governor; and

    - the guarantee of a debt arises from any explicit legal obligation of the government or DAB or any other agency acting on behalf of the government to service such a debt in the event of nonpayment by the recipient (involving payments in cash or in kind), or indirectly through any other obligation of the government or DAB to cover a shortfall incurred by the loan recipient.

- **Excluded** from the limits are refinancing credits and rescheduling operations, credits extended by the IMF, and credits on concessional terms defined as those with a grant element of at least 60 percent. The grant element is to be calculated using currency-specific discount rates based on the Organization for Economic Co-operation and Development Commercial Interest Reference Rates (CIRRs): for maturities of less than 15 years, the grant element will be calculated based on six-month averages of CIRRs; and for maturities longer than 15 years, the grant element will be calculated based on 10 year averages.

- Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract or guarantee becomes effective.

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

- **It applies to** debt as defined in paragraph 13 of this memorandum.

- **Excluded** from the limit are rescheduling operations (including the deferral of interest on commercial debt) and normal import-related credits.

- Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract or guarantee becomes effective.

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

accumulation of new arrears are: (a) arrears arising from interest on the stock of arrears outstanding as of March 20, 2006; and (b) external arrears that are subject to debt rescheduling agreements or negotiations.

G. Adjustors

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

December 20, 2006	Af 20,372 million
March 20, 2007	Af 35,276 million

and from March 20, 2007, to:

June 21, 2007	Af 5,512 million
September 21, 2007	Af 16,536 million

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

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

December 20, 2006	Af 27,972 million
March 20, 2007	Af 46,464 million

and from March 20, 2007, to:

June 21, 2007	Af 10,102 million
September 21, 2007	Af 22,145 million

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

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

20. Should the central government undertake urgent security-related expenditures in excess of budgetary appropriations (MEFP, ¶22), the NIR floor will be adjusted downward, and the NCBF ceiling and the indicative target (ceiling) for the operating budget deficit of the central government, excluding grants, will be adjusted upward to the extent that these expenditures are executed with the use of additional grants provided by donors, based on spending plans agreed between the central government and the donors. These adjustments will apply starting with the fiscal year 2007/08. The cumulative downward adjustment to the NIR floors at June 21, 2007 and September 21, 2007 will be capped at US$76 million. The cumulative upward adjustment to the NCBF ceilings and the indicative targets (ceilings) for the operating budget deficits of the central government, excluding grants, at June 21, 2007 and September 21, 2007 will be capped at Af 3.8 billion.

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

III. Provision of Information to Fund Staff

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

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

- **DAB net international reserves** should be reported weekly, no later than two weeks after the end of the week.

- **Monetary statistics, including exchange rates, government accounts with DAB, and currency in circulation** should be reported monthly and no later than three weeks after the end of the month. Monetary statistics will also include a monetary survey (quarterly, and then monthly starting in March 2007), including balance sheets of DAB and a consolidated balance sheet of the commercial banking sector.

- **Operational budget operations and their financing** should be reported monthly and no later than four weeks after the end of the month. **Core development budget operations and their financing** should also be reported monthly and no later than four weeks after the end of the month. The structure of financing (grants and loans should be separately identified) and expenditure data should be on a consistent cash basis. Core operating expenditures should be reported on a monthly basis using the budget appropriation economic (Object) and administrative classification in addition to the program and functional classification as reported in the budget documents. Core development expenditures should also be reported separately on a monthly basis using the budget program classification in addition to the economic (Object), administrative and functional classification consistent with the operating budget. All the data should also compare outturns as recorded in AFMIS against the approved budget (or figures reported in the budget documents). Core operating and development revenues and expenditures should also be reported by province, separately on the same monthly basis.

- **External budget operations and their financing** (i.e., donor funded spending outside the core budget treasury systems) should be reported at least semi-annually (more frequently if possible) and no later than eight weeks after the end of the period. External development expenditures should be reported on a disbursement basis (as currently defined in budget documents) using the budget program classification (and an administrative, functional and provincial classification where possible).

- **External debt data** should be reported quarterly and no later than six weeks after the end of the quarter. They will include: (a) details of new loans contracted or guaranteed during the quarter, including the terms of each new loan; (b) the stock of debt at the end the quarter, including short-term, and medium- and long-term debt; (c) loan disbursements and debt service payments (interest and amortization) during the quarter; (d) information on all overdue payments on short-term debt and on medium- and long-term debt, including new external arrears (if any); and (e) total outstanding amount of arrears.

- **National accounts data** should be reported annually and no later than eight weeks after the end of the quarter.

- **Consumer price indices (CPIs)** for the city of Kabul and for Kabul and five other major cities ("national" CPI) should be reported monthly and no later than four weeks after the end of the month.

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

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

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

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International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes First Review Under the Islamic Republic of Afghanistan's PRGF Arrangement and Approves US$17 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) completed today the first review of the Islamic Republic of Afghanistan's performance under the program supported by a three-year, SDR 81.0 million (about US$121.7 million) Poverty Reduction and Growth Facility arrangement (see Press Release No. 06/144). Completion of the review enables the release of an amount equivalent to SDR 11.3 million (about US$17 million), which would bring total disbursements under the arrangement to SDR 24.5 million (about US$36.8 million).

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

"Despite a difficult security environment and persistent expenditure pressures, Afghanistan's performance under the Poverty Reduction and Growth Facility supported program remains on track, with positive economic growth, lower inflation, and a better external position. The authorities have also followed through resolutely with their structural reform agenda.

"Real GDP growth of 8 percent is expected in 2006/07, but will likely strengthen in 2007/08 owing to a rebound in the agricultural sector. Inflation has declined and is targeted to remain low. The exchange rate has been relatively stable. The external current account position continues to strengthen, and the level of official reserves remains adequate to deal with external shocks.

"The authorities' fiscal strategy strikes the right balance between addressing critical spending pressures and fiscal sustainability. The 2007/08 budget, which has been submitted to parliament, accommodates additional security expenditures, if financed by donors. The fiscal program is focused on improving revenue mobilization through tax and customs reforms and moving toward a broad based consumption tax, bearing in mind the need to prepare for an eventual decline in donor assistance. Also, expenditures are to be prioritized in keeping with the objectives of the Poverty Reduction Strategy Paper (PRSP), which will be finalized by mid 2008. Efforts are under way to ensure the full participation of stakeholders in the PRSP process.

“The current monetary stance remains appropriate, and helps underpin confidence in the Afghani, the national currency. Monetary policy effectiveness is being enhanced by deepening the capital notes market and improving the monitoring of liquidity and lending by private commercial banks. The authorities have formulated restructuring strategies to deal with the state owned banks. The recently announced merger of the Export Promotion Bank with Bank Pashtany represents an important step in this regard.

“The authorities are increasing their efforts to mitigate the risks to the program. However, the security situation remains tense, with an impact on project implementation and overall macroeconomic performance that cannot be disregarded. The authorities also recognize the need to address governance concerns and speed up the pace of reforms.

“Considerable progress has been made in the negotiations on rescheduling Afghanistan’s debt to Paris Club creditors. Preparations are under way for the assessment of Afghanistan’s eligibility for debt relief under the Heavily Indebted Poor Countries Initiative,” Mr. Portugal said.

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

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

Statement by Abbas Mirakhor, Executive Director for Islamic Republic of Afghanistan
March 7, 2007

1. The authorities express their gratitude to the international community, staff, management, and the Executive Board of the IMF for their continued support to the reconstruction of the economy. They thank staff also for the balanced report and concur with the thrust of its analysis and recommendations.

2. Despite the very difficult circumstances of the country, the economy has performed well in 2006/07 under the PRGF-supported program as growth is expected to remain strong at 8 percent, inflation has declined to low level, exchange rate has remained stable, and the external sector performance as well as the international reserve position have strengthened. Economic growth rate is less than the expected 12 percent because of the severe drought that has affected agricultural production, the mainstay of the economy. All end-September quantitative and structural performance criteria as well as indicative targets were met. All structural benchmarks were also met except those related to the state-owned banks due to the need to modify the banking reform strategy. The short delay will allow a firmer basis for moving forward on restructuring the banking system. The merger of the Export Promotion Bank with another licensed commercial bank has already been announced in compliance with the end-January benchmark. The legislation to eliminate nuisance taxes was submitted to parliament, which postponed its consideration until further review is completed; it is expected that this legislation clarifies several tax issues soon. All indicative targets for end-December 2006 were also met except fiscal revenue. Among the reasons for the shortfall were: weaker-than-expected GDP growth, worsening security conditions in the South, and delays in tax collection from some large taxpayers due to temporary capacity constraints. Most of these factors are being remedied and the authorities expect better revenue performance in the last quarter of 2006/07. Their stepped-up efforts—including, inter alia, collection of tax arrears from some large taxpayers and higher customs receipts—will ensure meeting the revenue performance criterion for March 2007. The authorities are confident that for 2006/07, as a whole, fiscal revenue will exceed the 2005/06 outcome by a substantial margin. On the expenditure side, unanticipated outlays, enumerated and explained in the MEFP (paragraph 19), are projected to lead to a higher-than-programmed operating budget deficit, of which much will be covered by grants. The authorities' efforts in removing administrative and technical capacity constraints have also led to acceleration in the pace of implementation of the development budget.

3 . As the staff report indicates, the monetary authorities are on track in achieving their objectives under the PRGF-supported program for 2006/07. Prudent implementation of monetary policy has promoted price and exchange rate stability; interest rates have declined; spreads between bank lending and deposit rates are narrowing; confidence in the domestic currency (the Afghani) has continued; and bank deposits have increased. The monetary authorities have been vigorously pursuing the development and expansion of indirect instruments of monetary management. Accordingly, capital note auctions are being utilized more proactively in managing liquidity and are now open to licensed money changers.

Additionally, banks have been authorized to bid in these auctions on behalf of their clients, and an overnight credit facility has been established in which capital notes can be used as collateral. Deeply concerned by the low level of investment in the domestic economy by foreign banks operating in Afghanistan and the increasing placement of funds abroad by these institutions, a regulation was put in place to promote lending to the domestic market. This, the authorities maintain, is a temporary measure to be withdrawn once appropriate legal, supervisory, regulatory, and enforcement frameworks are established. Given the recent increase in the level of domestic lending by banks, this measure is being reconsidered in consultation with staff.

4. A wide range of structural reform measures implemented across the economy are well described in the staff report as well as in the authorities' MEFP (paragraphs 5, 7, 10, 11, and 15). The most important reforms where progress has been made are those related to the infrastructure of monetary and fiscal policies as well as the financial sector, some of which were not covered by program conditionality, as indicated in the staff report.

5. Growth rate is expected to rebound to double digits in 2007/08, price and exchange rate stability will continue, and the external sector is set to strengthen further. However, while the operating budget deficit (including grants) will decrease significantly from 2006/07, it will exceed the original target as a result of additional spending, including on security, which donors have agreed to finance. The authorities are firmly committed to the medium-term fiscal sustainability and have reaffirmed their resolve to achieve the objectives agreed with their development partners. Striving toward this goal, they will continue their efforts in: modernizing tax and customs administrations; strengthening expenditure discipline; improving overall public financial management; accelerating the pace of execution of capital expenditure; and, enhancing the effectiveness and credibility of the budget. The authorities have formulated a draft tax policy framework, in line with staff recommendation, to achieve a sustained strengthening of tax revenues. A medium-term fiscal framework (MTFF) is also in train and will be adopted by the Cabinet shortly. Importantly, the MTFF will ensure that expenditures are aligned with the objectives of the Afghanistan National Development Strategy (ANDS).

6. Prudent monetary policy, along with the flexible exchange rate regime, will ensure sustaining of confidence in the Afghani. Further efforts will be made to expand the menu and the utilization of indirect instruments of monetary policy and to deepen the domestic financial market, starting with the launching of 182-day capital notes. Additionally, a secondary market for the trading of capital notes will be established. Supervision and prudential regulation will continue to be improved and strengthened. Restructuring, merger, and/or liquidation of state-owned banks will continue. A set of core enabling laws on secure transactions, negotiable instruments, and mortgages will be developed. The authorities are also committed to the full implementation of safeguard assessment recommendations. Their efforts toward designing and implementing a comprehensive plan to restructure, divest, corporatize, or liquidate the remaining public enterprises are proceeding. Progress has been achieved in improving statistics in monetary and fiscal areas. These efforts, in support of which the authorities have requested further technical assistance, will continue within the

framework of the implementation of the Statistical Master Plan designed to address data weaknesses comprehensively.

7. Progress has been made in reaching a settlement with the remaining Paris Club creditors. The authorities are intensifying their efforts to complete the data bases needed for an assessment of HIPC eligibility that they hope to achieve soon; they appreciate the assistance of staff in this regard. They are committed to a prudent debt management strategy and have expressed intention not to contract or guarantee any nonconcessional debt.

8. The process of preparation of the Poverty Reduction Strategy Paper is on track, building on the interim ANDS and the findings of the 2005 National Risk Vulnerability Assessment. The latter, in particular, will provide a valuable foundation for poverty analysis, as it is based on a sample survey of 31,000 households across the country and the design of a poverty alleviation strategy. Concomitantly, the institutional framework for participation of stakeholders in the PRSP process is being finalized and should help achieve completion of the PRSP by mid-2008.