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### **Islamic Republic of Afghanistan:** Staff-Monitored Program: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

May 15, 2006

The following item is a Letter of Intent and a Memorandum of Economic and Financial Policies of the government of Islamic Republic of Afghanistan. The document, which is the property of Islamic Republic of Afghanistan, is being made available on the IMF website by agreement with the member as a service to users of the IMF website. This memorandum describes the policies that is implementing in the framework of a staffmonitored program. A member's staff-monitored program is an informal and flexible instrument for dialogue between the IMF staff and a member on its economic policies. A staff-monitored program is not supported by the use of the Fund's financial resources; nor is it subject to the endorsement of the Executive Board of the IMF.

Kabul, May 15, 2006

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

Dear Mr. de Rato,

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

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

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

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

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

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

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

Sincerely yours,

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

/s/  
Noorullah Delawari  
Governor  
Da Afghanistan Bank

Attachments:

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

Technical Memorandum of Understanding

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

**I. INTRODUCTION**

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

**II. RECENT ECONOMIC DEVELOPMENTS AND PERFORMANCE UNDER THE SMP**

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

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

slowdown in food prices (which increased by 2.6 percent over that period, compared with 12 percent over the same period of 2004/05) that was partly offset by accelerating rents and petroleum product prices. Rents and petroleum product prices increased by 24.8 and 26.6 percent, respectively, during 2005/06. Excluding these two items, year-on-year inflation declined to 6.8 percent in March, from 12.6 percent in September 2005.<sup>2</sup>

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

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

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

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

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

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

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

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

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

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

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

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

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

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

### III. POLICIES UNDER THE PRGF PROGRAM

#### A. Medium-Term Strategy

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

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

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

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

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

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

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

### **B. The 2006/07 Program**

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

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

## Fiscal Policy

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

- Operating expenditures are budgeted at 9.2 percent of GDP, compared to 9.3 percent in 2005/06 and an MTFF projection of 8.9 percent of GDP. Higher-than-expected spending is accounted for by: (a) the absorption of significant costs that had previously been funded directly by donors;<sup>5</sup> (b) a significant increase in the number of teachers in 2005/06;<sup>6</sup> and (c) the introduction of the pay and grading reform for the civil service.
- While the 0.2 percent of GDP budgeted increase in domestic revenue—to 5.7 percent of GDP in 2006/07—is significantly less than the 1.3 percent of GDP increase envisioned under the MTFF, it reflects in part the higher-than-expected outturn for 2005/06. The revised estimates are based on more realistic assumptions regarding the pace of key tax policy and administration reforms, including: (a) rationalizing the import tariff structure;<sup>7</sup> (b) introducing excise taxes and road tolls; and (c) the full year implementation of tax measures introduced in the third quarter of 2005/06.<sup>8</sup>

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

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

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

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

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

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

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

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

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

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

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

### **Monetary and Exchange Rate Policies and Financial Sector Reforms**

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

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

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

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

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

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

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

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

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

### **External Policies**

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

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

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

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

### **Structural Reforms**

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

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

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

### **Safeguards, Statistical Issues, and Technical Assistance**

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

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

#### IV. PROGRAM MONITORING AND CONTINGENCIES

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

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

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

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

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

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

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

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

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

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

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

4/ Concessional debt is defined as debt with a grant element of at least 60 percent calculated on the basis of currency-specific discount rates, based on the OECD commercial interest reference rates (CIRRs).

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

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

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

1/ Implemented with some delay.

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

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

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

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

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

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

3/ These performance criteria apply on a continuous basis.

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

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

INTERNATIONAL MONETARY FUND  
ISLAMIC REPUBLIC OF AFGHANISTAN

**Technical Memorandum of Understanding**

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

**I. STRUCTURAL PERFORMANCE CRITERIA AND BENCHMARKS**

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

**Performance criterion**

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

**Structural benchmarks**

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

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

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

## **II. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS**

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

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

### **A. Program Exchange Rate**

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

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

### **B. Currency in Circulation**

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

### **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.<sup>2</sup>

### **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

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

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

IMF, foreign currency cash (including foreign exchange banknotes in the vaults of DAB, but excluding cash held in DAB's branches), and deposits abroad (including balances on accounts maintained with overseas correspondent banks). Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered;<sup>3</sup> 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.

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

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

#### **F. External Debt and Arrears**

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

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

### III. PROVISION OF INFORMATION TO FUND STAFF

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

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

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

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

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

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

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

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