

**Islamic State of Afghanistan: Report on Recent Economic Developments and Prospects,  
and the Role of the Fund in the Reconstruction Process**

This report on recent economic developments and prospects, and the role of the Fund in the reconstruction process for the **Islamic State of Afghanistan** was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed on **September 18, 2002**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the **Islamic State of Afghanistan** or the Executive Board of the IMF.

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INTERNATIONAL MONETARY FUND

ISLAMIC STATE OF AFGHANISTAN

**Report on Recent Economic Developments and Prospects, and the  
Role of the Fund in the Reconstruction Process**

Prepared by the Middle Eastern Department and the  
Policy Development and Review Department

(In consultation with other departments)

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September 18, 2002

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## EXECUTIVE SUMMARY

After years of conflict, a new opportunity for the economic development of Afghanistan emerged with the fall of the Taliban regime in late 2001 and the political agreement reached between the various Afghan factions in Bonn in December 2001. The tasks ahead in rebuilding the country are enormous, however, since its social and economic structures have been largely destroyed. Reconstruction cannot be achieved without the strong support from the international community.

Since January 2002, Fund staff has been heavily involved in assisting the Afghan authorities rebuild key economic institutions and implement macroeconomic policies. Monetary and Exchange Affairs Department (MAE), Fiscal Affairs Department (FAD), and Statistics Department (STA) have started substantial technical assistance programs. Critical areas of technical assistance are rebuilding the payments system, the introduction of a new currency, central bank modernization, expenditure management, and revenue mobilization. A resident representative was stationed in Kabul in August 2002.

Policy advice has focused on issues crucial to a quick restoration of macroeconomic stability, including the preparation of a government budget and the choice of currency arrangement, as well as the design of monetary policy. The authorities have expressed strong commitments to achieve macroeconomic stability.

The government's current expenditures were budgeted at US\$460 million for March 2002–March 2003, with an additional US\$23 million in wage arrears clearance, of which US\$400 million will need to be financed by donor assistance. At this stage, donor commitments fall far short of the budgeted amount. For their part, the authorities will need to ensure that the domestic revenue target is met and resist mounting pressures to increase government spending.

In early September, the authorities announced the introduction of a new currency. The changeover will start on October 7, 2002. The logistical and promotional challenges for the introduction of the new Afghani are enormous, and the Fund as well as other donors are providing extensive technical assistance.

Despite very difficult circumstances, the authorities have made commendable efforts to put in place sound economic policies. Nevertheless, progress in strengthening macroeconomic management may continue to be slow, given the very weak starting point and limited administrative capacity, the fragile political situation, and the fact that the government does not have full control over many parts of the country.

Use of Fund resources is not envisaged for the current fiscal year. However, if a balance of payments need were to emerge, financial assistance could be provided in the next fiscal year under the Emergency Post-Conflict Assistance Facility, provided that sufficient capacity for implementing policies has been established and Afghanistan's arrears to the Fund have been cleared.

## I. INTRODUCTION

1. **Afghanistan is a country ravaged by war and natural disasters.** More than two decades of conflict, as well as droughts and earthquakes have resulted in widespread destruction and human suffering. Human resources have been severely depleted, infrastructure destroyed or degraded, and social capital and institutions eroded. Afghanistan is now among the poorest countries in the world.
2. **A new opportunity for the peaceful development of the country emerged with the fall of the Taliban regime in late 2001 and the political agreement reached between the various Afghan factions in Bonn in December 2001.** The Bonn agreement provided a road map for the creation of a peaceful, democratic state. An Afghan Interim Administration (AIA) was appointed that governed the country for six months, until a special Loya Jirga (grand council) of some 1,500 delegates could be convened in June 2002. This Loya Jirga chose a new Afghan Transitional Administration (ATA) that will remain in office for 18 months. The ATA is charged with formulating a new constitution and preparing national democratic elections to elect a fully representative government.
3. **The tasks ahead in rebuilding Afghanistan are enormous and cannot be achieved without strong support from the international community.** The international community has responded quickly to this challenge. As part of this response, the Fund is providing policy advice and technical assistance in its areas of expertise, in close coordination with the World Bank, which has been helping the authorities develop their overall reconstruction strategy.
4. **This report is intended to brief the Executive Board on Afghanistan's reconstruction efforts and in particular on the role of the Fund in this process.** Chapter II provides a brief overview of the situation inherited by the new government in Afghanistan. Chapter III describes the overall approach of the international donor community and the authorities to the reconstruction process, while Chapter IV describes the role of the Fund. Chapter V offers a brief overview of recent economic developments, and Chapter VI concludes with the main risks and challenges for the near future.
5. **Reliable statistics are not available.** All data presented in this paper are rough estimates, at best, and should be treated as such. The collection of primary data necessary for statistical compilation virtually ceased in 1995–96 with the collapse of the provincial reporting network.

## II. RECENT HISTORY AND STATE OF THE ECONOMY

6. **Afghanistan is a landlocked, mountainous, and arid country, with a wide ethnic diversity.** Its population is estimated at 18–21 million currently within its borders and up to 25 million if all refugees were to return. Afghanistan's pre-war economy was mainly based on agriculture and animal husbandry, and some light industry. The country was largely

self-sufficient in food and was even an exporter of agricultural products. Agriculture was largely concentrated in narrow river valleys and plains where irrigation water from snowmelt is available. Afghanistan experienced a modest degree of economic development until the late 1970s, when the country was still at peace. Modernization was largely concentrated in major cities, however, and government services had limited reach in rural areas.

7. **Over two decades of armed conflict started with the Soviet Union's intervention in Afghanistan in December 1979** to support the communist regime that had taken power in a military coup the previous year. The following 10 years saw fierce fighting, until the Soviet forces withdrew in 1989. In 1992, the Mujaheddin took over Kabul and installed a new government. However, much of the country remained under the control of local warlords. In response to growing lawlessness and increased factional fighting, the Taliban movement emerged. The Taliban took Kabul in 1996 after heavy fighting between the various factions that left much of the city destroyed, and they eventually controlled almost 90 percent of the country, making little effort, however, to form a civilian government and to provide public services. The military intervention following the tragic events of September 11, 2001 resulted in the collapse of the Taliban regime in late 2001 and the formation of a new government.

8. **Afghanistan's social and economic structures have been largely destroyed.** The new administration established in late 2001 was faced with a situation in which most of the country's infrastructure had been severely damaged and traditional irrigation systems had greatly suffered from destruction and lack of maintenance. Agricultural production had collapsed, livestock herds had been depleted, and industries had ceased functioning. Most skilled professionals had fled the country. Similarly dramatic was the breakdown of the state and civil society over time and the erosion of institutions, both modern and traditional. Government services, including health care and education, had essentially stopped functioning, resulting in a dramatic decline in social indicators, particularly affecting women.

9. **Rough estimates of Afghanistan's current per capita GDP range between US\$150–US\$180, placing it among the poorest countries of the world.**<sup>1</sup> An estimated 60–80 percent of the population live below the threshold of US\$1 a day or consume less than the Food and Agriculture Organization's (FAO) minimum daily caloric requirement. In 1996, Afghanistan ranked 169<sup>th</sup> out of 174 countries in the UN's Human Development Index and conditions have deteriorated further since then. The health situation is grim.<sup>2</sup> Infant mortality is estimated by UN agencies to be among the highest in the world and malnutrition affects over 50 percent of children under age five. The average life expectancy is little over 40 years. Access to health care and education is extremely limited.

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<sup>1</sup> These estimates exclude illegal poppy cultivation and narcotics production.

<sup>2</sup> AsDB, UNDP, and World Bank, Preliminary Needs Assessments for Recovery and Reconstruction, January 2002.

### III. RECONSTRUCTION STRATEGY AND PROCESS

#### A. Overall Approach and Coordination

10. **The challenges of Afghanistan's reconstruction called for a strong response from the international community, both in terms of financial assistance and coordination.**

Already before the AIA came to office, the international community organized a number of meetings on Afghanistan's reconstruction, starting in the fall of 2001. This included the creation of a Steering Group (SG) of donor governments to enhance international political support for the reconstruction process and provide strategic guidance. Co-chairs of the SG are the United States, Japan, Saudi Arabia, and the European Union. At the first meeting of the SG in Washington, D.C. in November 2001, the World Bank, the Asian Development Bank (AsDB), and the United Nations Development Program (UNDP) were asked to produce a preliminary needs assessment for Afghanistan's reconstruction. A conference to seek inputs on this from other organizations was held in Islamabad in November 2001. The preliminary needs assessment was presented at the International Conference on Reconstruction Assistance to Afghanistan in Tokyo on January 21–22, 2002. According to the assessment, US\$14½ billion would be needed over a period of 10 years in external assistance to support Afghanistan's economic and social recovery, excluding humanitarian assistance, with requirements for the first year estimated at US\$1.7 billion and, for the first two and one-half years, US\$4.9 billion.

11. **The needs assessment was well received by donors and the Tokyo conference generated pledges of assistance for Afghanistan's reconstruction totaling US\$4.5 billion over two and one-half years, with US\$1.8 billion in pledges for the first year.** Actual commitments and disbursements of assistance, however, have been slow to get started, except for emergency humanitarian assistance. By end-August 2002, US\$1 billion in assistance had been committed (including commitments made after the Tokyo conference), while an estimated US\$760 million had actually been disbursed, mostly humanitarian assistance and food aid, however.

12. **Ownership and leadership of the Afghan government of the reconstruction effort are essential for its success.** The authorities have taken the responsibility for the coordination and management of the overall reconstruction effort. They have put in place a National Development Framework, allowing assistance to be provided in support of a government program of activities. In addition, they have expressed a strong commitment to adhering to transparent budget procedures so that the use of assistance can be easily monitored. On their part, donors recognized that national ownership would be essential for the effectiveness of their assistance. To facilitate effective coordination of assistance under the overall leadership of the government, an Implementation Group (IG) was established, chaired by the Government of Afghanistan and with the AsDB, the UNDP, the Islamic Development Bank (IsDB), and the World Bank as vice-chairs. The first IG meeting was held in Kabul in April 2002, where the government presented a first draft of its National

Development Framework to the donor community, as well as the government's current budget for the 1381 solar year (or March 22, 2002–March 21, 2003). It is envisaged that the IG will evolve toward a normal Consultative Group (CG) mechanism.

13. **The objectives of the National Development Framework are poverty reduction and economic opportunity.** This framework is based on five principles: (a) the development strategy must be domestically owned, with the government in the driver's seat; (b) markets and the private sector are more effective instruments in delivering sustained growth than the state; (c) aid cannot be effective without the state investing in human capital and the creation of an institutional framework that allows the rule of law to prevail; (d) promoting sustainable economic growth requires the active participation of the population; and (e) donor-funded investment projects must be anchored in the government's development program to be successful over the longer term.

14. **The national strategy focuses on three pillars of development: (a) security and human development; (b) rebuilding physical infrastructure; and (c) enabling the creation of a viable private sector as the engine for sustainable and inclusive economic growth.** For each of these pillars, broad sectoral programs are set forth. The next step is to work out the sectoral programs in more detail and to identify and select individual projects within the overall resource envelope, based on the development framework and its priorities. This process will lead to the formulation of the development budget, which in essence will be a comprehensive list of donor-funded investment projects. The development budget was initially scheduled to be presented to donors in May 2002, but, reflecting the government's weak administrative capacity, it is now planned to be completed later this fall and to cover both the current and next fiscal year. The development budget is expected to include about US\$500 million in disbursements during this fiscal year for projects (excluding refugee assistance and food aid).<sup>3</sup>

15. **The key challenges and priorities in the short term are to quickly establish basic security for the population, revitalize agriculture, facilitate private economic activity, and rebuild basic infrastructure and social services.** Restoring security is a key priority. To some extent this has been achieved for Kabul and its immediate surroundings although there have been repeated incidents, but the government's control over many provincial areas is still very limited. To support the resumption of economic activity, a reasonable level of law and order needs to be restored and major infrastructure bottlenecks removed. Regarding the latter, immediate challenges include reestablishing communication and transportation within the country, repairing water and sanitation systems, and restoring electric power supplies. Providing social protection to the most vulnerable is also a high priority. In health care, the most urgent needs are to revive preventive and public health services, including basic

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<sup>3</sup> Some of the projects to be included in the development budget have already started.



programs of immunization, disease control, and maternal and child health care. In the education sector, a key priority is to rapidly expand primary and secondary education by rebuilding schools, rehiring teachers, and providing teaching materials.

## **B. Activities of Main Donors**

### **United Nations**

16. **The United Nations is playing a central role in supporting the Afghan authorities**, following the adoption of Security Council Resolution 1378 in November 2001. This support reaches across the political, humanitarian, as well as the development spectrum. The efforts of the various UN agencies are coordinated by the United Nations Assistance Mission in Afghanistan (UNAMA), under the leadership of the Special Representative of the Secretary-General. UNAMA has two pillars, with the first encompassing political affairs and the second, relief and reconstruction. On the political side, the UN has provided strong support in the establishment of the Interim Administration and its successor, the Transitional Administration, including by helping to organize the Loya Jirga. Humanitarian assistance is being provided by the United Nations High Commissioner for Refugees (UNHCR), the United Nations Children's Fund (UNICEF), and the World Food Programme (WFP), among others, while the UNDP is focusing on development issues, including capacity building.

17. **The UNDP set up an Emergency Trust Fund in late 2001 to provide an early mechanism to channel donor support to the authorities.** This fund was intended to meet the initial financing needs of the government; it essentially covered civil service wage payments during the first six months of the Interim Administration plus the costs of the Loya Jirga. This start-up fund ceased operating at end-July 2002.

### **World Bank**

18. **The World Bank also has a crucial role in the reconstruction effort**, notably by helping the authorities develop and coordinate their overall reconstruction strategy. The World Bank's Transitional Support Strategy (TSS), which outlines its program of assistance to Afghanistan for the immediate future, focuses on the restoration of operational and financial relations with Afghanistan and on the provision of exceptional IDA support for urgent recovery and technical assistance needs. This includes rebuilding and strengthening essential governance institutions and capacity, as well as starting high-priority, high-impact reconstruction programs to help restore livelihoods; generate economic activity; facilitate the development of the private sector; and restore essential infrastructure, communications, and social services. This is being supplemented by policy advice and analytical work to underpin the work of the international community in support of the reconstruction effort.

19. **At the Tokyo conference, the World Bank pledged US\$50–70 million in grants by end-June 2002 and US\$500 million of IDA support for the next two years.** To date, IDA has provided four post-conflict grants, totaling US\$100 million in commitments. This

included a US\$10 million Emergency Public Administration Project to rebuild capacity within the government to manage the reconstruction process, with assistance focusing on financial management, procurement, and audit. The other projects focused on infrastructure reconstruction (US\$33 million), education rehabilitation (US\$15 million), and community empowerment and public works (US\$42 million).

20. **The World Bank is also the administrator of the Afghanistan Reconstruction Trust Fund (ARTF).** The ARTF provides a mechanism to channel donor assistance to finance the government's current budget and priority investment projects. The World Bank is a member of the ARTF's management committee, together with the AsDB, IsDB, and UNDP, which is responsible for determining resource allocations in consultation with the authorities. The ARTF became effective in May 2002 and operational in July 2002, and effectively succeeded the UNDP Trust Fund. By end-August 2002, the ARTF had received firm pledges of about US\$130 million for the current fiscal year, with paid-in contributions of almost US\$70 million.

#### **Asian Development Bank**

21. **The AsDB has also pledged significant assistance to Afghanistan.** The AsDB has pledged US\$500 million over two and one-half years in assistance at the Tokyo conference. Of this, US\$200 million is planned for the first year, with a grant component of US\$50 million and a loan component of US\$150 million; the loan program is currently under preparation.

22. **The AsDB is focusing its assistance on four areas: agriculture, education and health, infrastructure, and microfinance.** In agriculture, projects will cover rehabilitation of production, irrigation systems, and provision of input supplies. Regarding infrastructure, the AsDB will support the rehabilitation of roads, power transmission, and the gas subsector. In education, efforts will focus on improving access through the rehabilitation of schools, the provision of equipment and textbooks, and teacher recruitment and training. In the health sector, the AsDB will help rebuild basic preventive and curative services.

#### **IV. ROLE OF THE FUND**

23. Since January 2002, **Fund staff have been heavily involved in assisting the Afghan government rebuild key economic institutions and implement macroeconomic policies.** The Fund is providing policy advice and technical assistance in its areas of expertise, to help the authorities establish the foundations for sound economic management. In mid-August 2002, a resident representative took up his post in Kabul.

24. At the outset, **the authorities were confronted with a very difficult situation in which the central bank and the ministry of finance (MoF) had virtually ceased to function.** In many respects, the authorities faced an even greater challenge compared to other post-conflict countries. Da Afghanistan Bank (DAB) and the MoF had in effect been reduced to little more than empty shells in terms of functions they perform. The reporting framework,

especially between the center and the provinces, had broken down completely. Office automation was completely absent. Also, when the Taliban left Kabul they took whatever money was left in DAB's vaults. On a more positive side, DAB's assets held in foreign banks estimated at close to US\$300 million, had been frozen during the Taliban years and therefore remained untouched.<sup>4</sup>

#### A. Policy Discussions (January–September 2002)

25. **The authorities have expressed their commitment to achieve macroeconomic stability as a critical foundation for the restoration of growth and poverty reduction.** For this purpose, they have sought to restore fiscal discipline and monetary control, and adhere to principles of transparency and accountability. They are committed to open and liberal exchange, payments, and trade systems (Box 1).

##### **Box 1. Afghanistan: Exchange, Payments, and Trade Systems<sup>1/</sup>**

Afghanistan appears to have fairly liberal and open exchange, payments, and trade systems, including a unified, floating, market-based exchange rate regime. In principle, DAB has a central role in the exchange and payments systems. However, in practice, since at least the early 1990s, DAB has played a very limited role. In fact, much of the normal exchange and payments functions that DAB or commercial banks would perform, such as trade financing and payment transfers, are provided by the informal moneychangers, the Hawala system. DAB quotes exchange rates based on the rates established in the informal money market.

The Hawala system is currently the most reliable, efficient, and inexpensive financial network in Afghanistan, which is built on long traditions of mutual trust and self-regulation. The moneychangers offer a diverse range of services: exchanging money, transfers of funds domestically and internationally, trade finance, micro finance, and limited deposit taking. Default risks are minimized through a confirmation-before-payment process: the remitter only pays the Hawala dealer the value of the funds remitted after the recipient has confirmed receipt of the money. Several international organizations operating in Afghanistan are using the Hawala network. With little or no supervision and no or inaccessible documentation, the Hawala system is vulnerable to abuse, such as money laundering, transferring drug money, and financing terrorism.

Importers and exporters are required to register with the ministry of commerce, and imports and exports require licenses. These licenses are essentially for recording and quality control purposes, and establishing eligibilities for export incentives. In practice, it is likely that much of the private sector trade bypasses these licensing procedures. Afghanistan has transit trade agreements with Iran and Pakistan. Estimates of trade flows in 2000 based on partial border surveys indicate imports and exports of about US\$1.2 billion each, of which some US\$800 million in imports are for reexport. In addition, there is a considerable amount of informal trade.

<sup>1/</sup> Only partial information regarding exchange, payments, and trade systems is currently available.

<sup>4</sup> Gross foreign exchange reserves are currently estimated at over US\$300 million, including about US\$200 million in gold, but it is unclear whether all these funds indeed belong to DAB (or the government); little information is available on DAB's liabilities. An audit of DAB's accounts will be required to establish its true balance sheet.

26. **Fund staff have been advising the authorities on policy issues crucial to quickly help restore macroeconomic stability.** The two most pressing issues in this regard were the preparation of a budget and the choice of currency arrangement, including the design of monetary policy.

27. **The macroeconomic framework is at this stage necessarily rudimentary,** given the limited data availability, and taking into account the weak capacity of the MoF and DAB. Output is expected to recover in 2002–03, from very depressed levels of activity last year; fiscal and monetary projections are based on an admittedly arbitrary 10 percent real growth rate. A consumer price index (CPI) for Kabul as recorded by the Central Statistics Office (CSO) witnessed large swings in 2001 and 2002. To a large extent these swings can be linked to exchange rate movements (Figure 1). Prices dropped sharply in response to the strong exchange rate appreciation that occurred after the Taliban left, with the value of the Afghani reaching AF 20,000 per U.S. dollar in early 2002, compared to levels of about AF 70,000–80,000 per U.S. dollar prior to September 2001 (Figure 2). As a result, the twelve-month inflation rate showed a decline in prices of 16 percent in March 2002. Prices started to rise again, however, in early 2002, as the exchange rate depreciated to about AF 35,000 per U.S. dollar in February 2002, partly in response to rumors about a possible dollarization. The authorities aim to limit the twelve-month inflation rate to under 20 percent by March 2003.

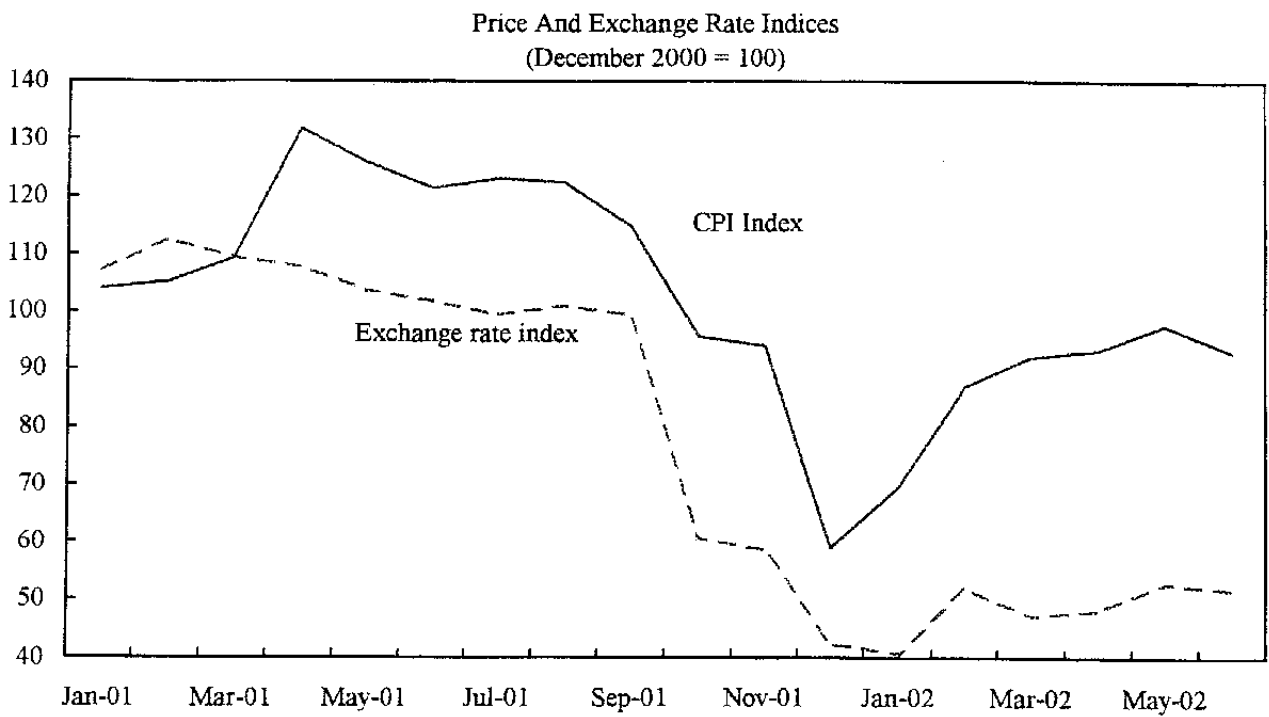
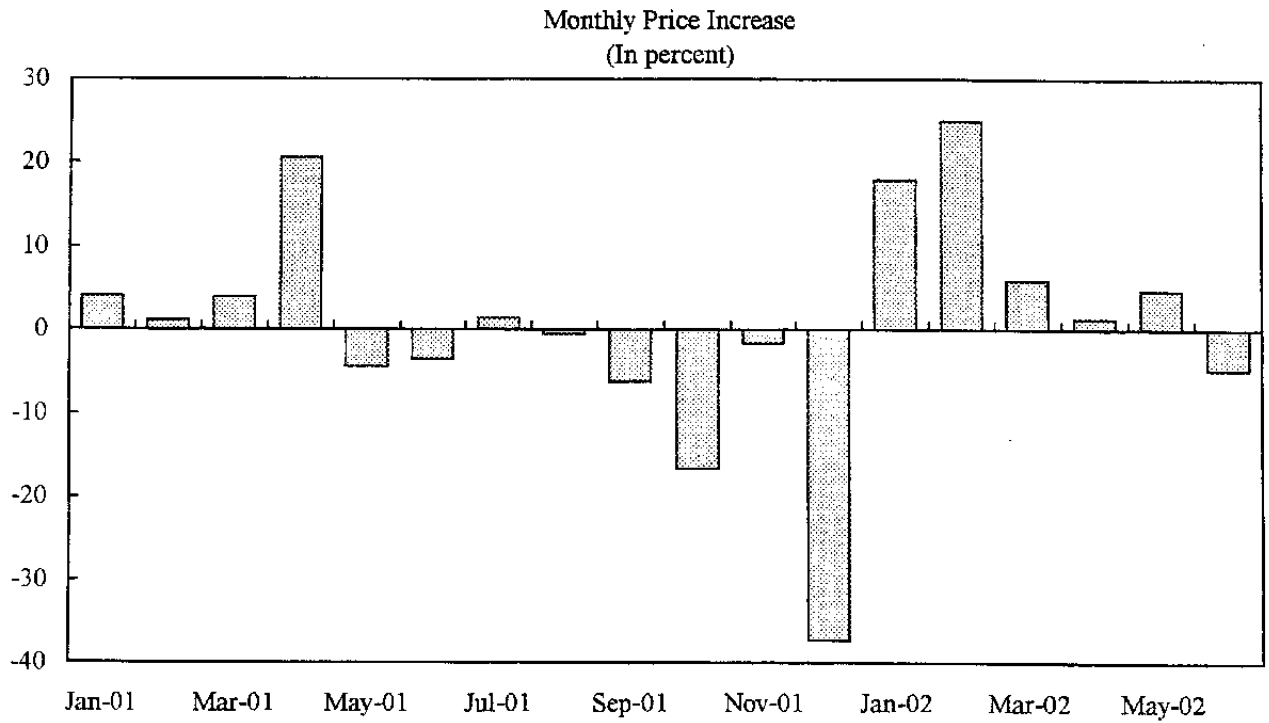
#### **Fiscal policy<sup>5</sup>**

28. **One of the first economic tasks has been the preparation of an operating budget.** The Fund and World Bank staff have assisted the authorities in preparing a current budget for the fiscal year starting March 22, 2002. This budget was adopted by the cabinet on April 6, 2002 and presented to the donors at an IG meeting in Kabul on April 10–11, 2002, to mobilize adequate financial support. Expenditures were budgeted at the equivalent of US\$460 million, plus an additional US\$23 million to clear wage arrears accumulated prior to the new government's tenure. About US\$83 million was expected to be collected in revenues, mainly customs duties, leaving a gap of US\$400 million to be financed by donor assistance (Table 1). Although the revenue target is fairly modest, it will require a considerable effort to achieve, given weaknesses in tax and customs administration and the limited control the central government has over the provinces.

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<sup>5</sup> No comprehensive data are available on Afghanistan's public debt, either external or domestic. Based on partial records and taking into account that virtually no debt service payments have been made since the early 1990s, the stock of outstanding external debt is estimated in the order of US\$2 billion. Of this, about three quarters would be owed to the former Soviet Union, valued at U.S. dollar per ruble exchange rates in the early 1990s, while US\$53 million is owed to international financial institutions. Regarding the government's domestic debt, records are also incomplete, but the cumulative overdraft at DAB is estimated at close to AF 16 trillion, equivalent to about US\$400 million at current exchange rates.

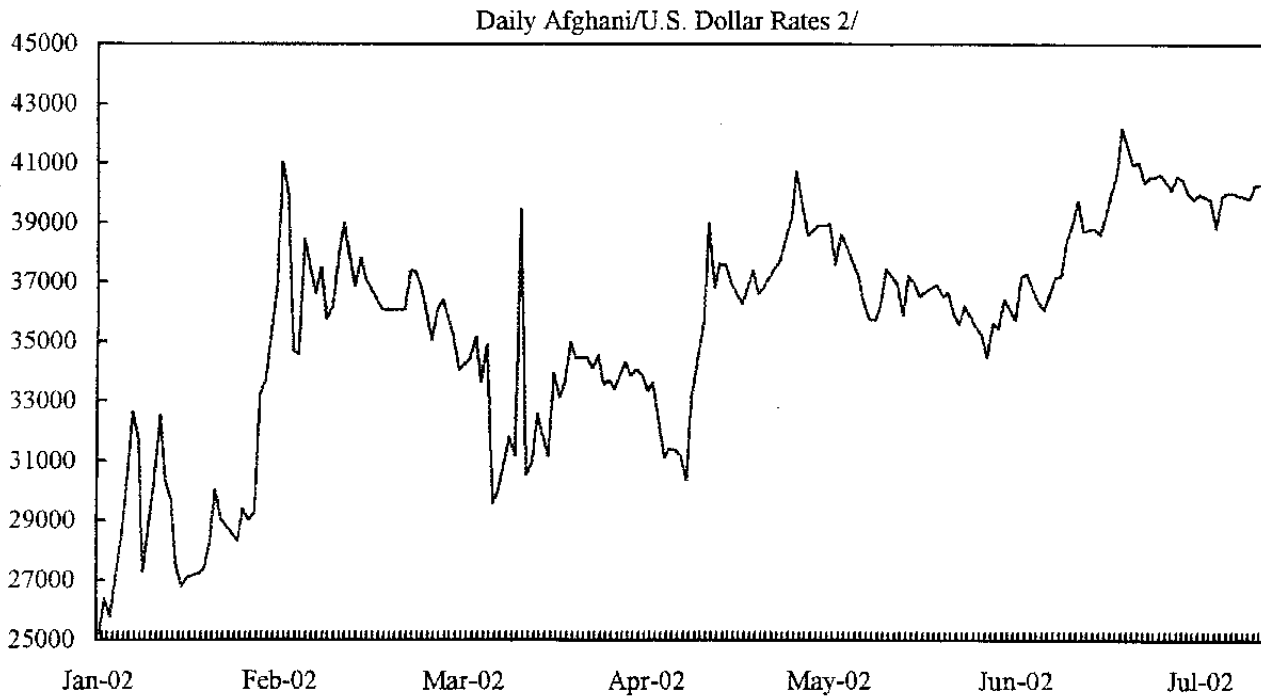
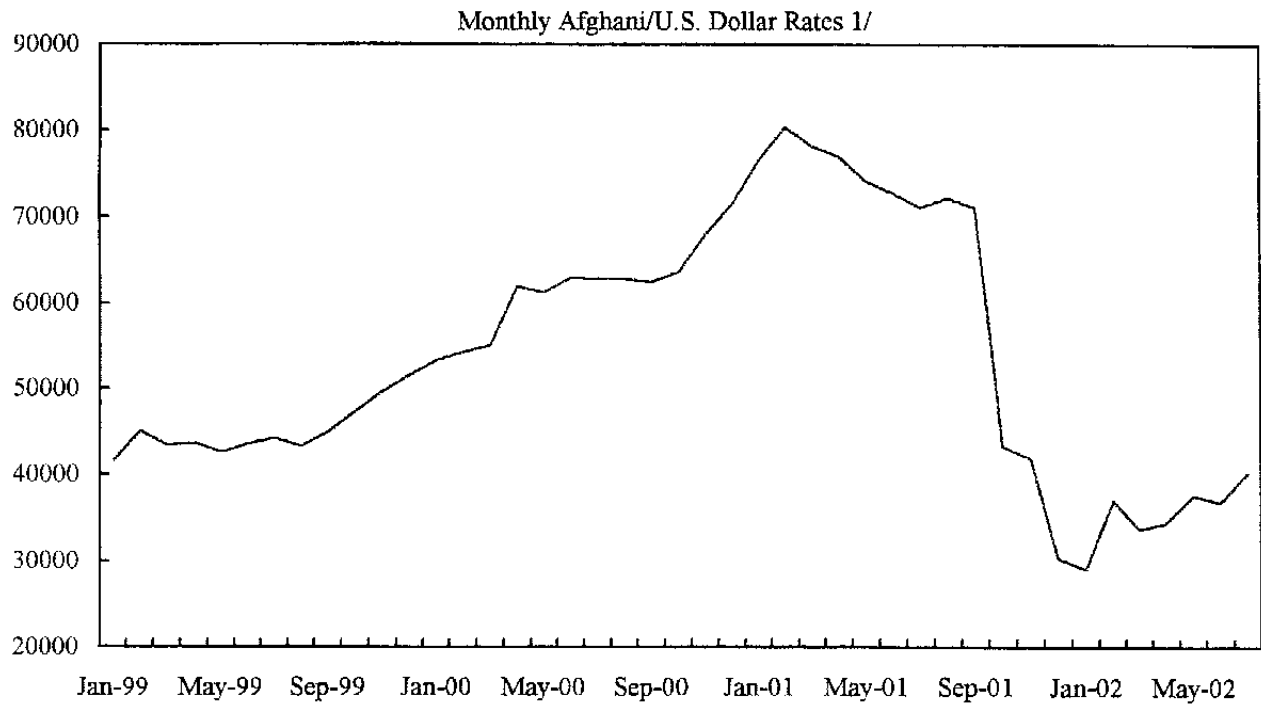
Figure 1. Islamic State of Afghanistan: Price and Exchange Rate Developments, 2001-02 1/



Source: Afghan authorities.

1/ Last observation: June 2002.

Figure 2. Islamic State of Afghanistan: Exchange Rates, 1999–2002



Source: Afghan authorities.

1/ Last observation: average for July 1–July 29, 2002.

2/ Last observation: July 29, 2002.

29. **As noted, the authorities have shown a strong commitment to maintain fiscal discipline.** The budget decree explicitly prohibits the government from taking recourse to central bank financing. This has put to an end the previous practice in which the government had automatic and unlimited access to an overdraft facility at DAB. In addition, the budget imposes ceilings on the number of civil service employees.

30. **The bulk of the government's operating expenditures are wage payments,** including for the military. Although the budget included caps on employment levels by ministry at 240,000 staff (excluding military personnel), these caps are such that they allow for all employees that had been employed prior to the Taliban regime to return to their posts.<sup>6</sup> The budget also includes provisions for wage and pension reform, as the existing pay and grading system is inadequate to attract and motivate skilled civil servants. Currently, every employee earns almost the same low wage. At present, the central government's control over employment is weak and the World Bank is assisting the government with the first steps of a civil service reform, aimed at strengthening employment controls and a decompression of pay scales. The budget allocations for wage and pension reform will only become available once a civil service reform program has been developed.

### **Monetary policy**

31. **The authorities' goal is to establish firm monetary control with a view to achieving price stability and restoring confidence in the national currency.** At the end of 2001, the authorities were confronted with an environment in which next to the official Afghani issued by DAB, at least two other sources had been issuing (counterfeit) Afghanis, while several foreign currencies were also widely used. In order to regain control over the issuance of the domestic currency, the authorities decided to introduce a new currency as soon as possible. This, however, required time because of technical considerations and, as emphasized by Fund staff, the prerequisites of policy credibility. For the interim period, the authorities discussed several alternatives with Fund staff, ranging from adopting a stable foreign currency as legal tender to the continued use of the existing Afghani (Box 2). Because a full dollarization would be expensive and difficult to reverse, the staff suggested executing the government budget in a stable foreign currency, while letting the co-circulating Afghanis float, to gain financial stability, reinforce fiscal discipline, and reduce the impact of counterfeits.

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<sup>6</sup> A decree to this effect had been issued in late 2001, before the AIA took office.

### **Box 2. Afghanistan: Choice of Currency**

At the beginning of 2002, at least three local currencies (Afghanis) circulated in Afghanistan. During the Taliban years, Afghanis were issued from the remaining supplies in the vaults of DAB in Kabul as well as by the then internationally recognized government in exile that ordered new notes from the country's regular printer and issued these in the northern parts of the country. This included notes with the same serial numbers as used in earlier years, so that the new notes could not be distinguished from those already in circulation. In addition, two warlords had issued counterfeits of the official currency. While these counterfeits are very similar to the official currency, they do have some distinguishing features and typically trade at a discount. Several foreign currencies are also widely used, including the U.S. dollar and the currencies of neighboring countries.

Within this environment, in January 2002, staff discussed with the authorities several currency options to bridge the period until a new currency could be introduced. Introducing a new currency would require time because of technical considerations (design, printing, etc.) and the need to establish credibility and stability as a prerequisite for the successful launch of the new currency. The temporary use of a stable foreign currency would have provided immediate monetary stability, as well as time to establish credibility and build up the necessary capacity at DAB. Moreover, the impact of counterfeit currencies would be eliminated or greatly reduced. Continued use of the existing Afghani on the other hand posed a larger risk of counterfeit and inflation.

One option considered was a full dollarization until the new Afghani could be issued. This would have entailed an upfront redemption of existing Afghanis that would have required considerable organization. Moreover, this approach would have been expensive, requiring significant additional donor assistance, and potentially difficult to reverse.

An alternative option favored by the staff based on pragmatic economic and technical grounds, was to use a foreign currency to conduct government transactions until the new currency could be introduced. This approach would also impose a substantial degree of transparency and discipline on both fiscal and monetary policy. Meanwhile, the public would have been free to use any mutually agreed currency for any transaction and to hold any currency. The existing Afghanis would have continued to circulate until redemption by the new currency, within a floating exchange rate regime. The government would have announced its commitment to redeem existing Afghanis for the new currency at a later to be determined rate. The risk of counterfeits would have remained, but would have had less of an impact.

The authorities, however, decided to continue to use the existing Afghani and introduce a new currency as soon as was technically possible. They viewed the Afghani as an important symbol of sovereignty and unity. Also, they believed that the risk of counterfeits had diminished based on information they received from at least some of the printers, including volumes and assurances that printing had stopped. The authorities rejected the option of introducing a higher denomination banknote of the existing Afghani and taking more time to prepare for the introduction of the new Afghani.

**32. To achieve monetary control, the authorities decided to introduce a new currency as soon as possible; the new Afghani will be introduced in early October 2002.** The introduction of the new Afghani marks an important step in the authorities' efforts to establish macroeconomic stability. The authorities decided mainly on political grounds to continue using the existing Afghani in the period prior to the introduction of the new currency. They viewed the Afghani as an important symbol of national sovereignty and unity, although they recognized the risks posed by the existence of counterfeits. The new banknotes



will have several advanced security features that will greatly reduce the risk of counterfeits. The introduction of the new currency was made public on September 4, 2002, with the actual changeover scheduled to start on October 7, 2002 and lasting for a period of eight weeks, after which the old Afghanis will cease to be legal tender. One new Afghani will replace 1,000 old Afghanis. Replacing all existing banknotes with new ones is a major operation, particularly in a country in a post-conflict situation with enormous logistical and promotional challenges. The Fund and other donors are providing substantial technical assistance to help the authorities with this operation (see below).

33. **The authorities' decision to introduce the new Afghani created the need to rapidly develop sufficient capacity at DAB to conduct monetary policy.** The authorities have requested the Fund to assist DAB in this effort. The Fund has prepared an ambitious technical assistance program (see below) and provided extensive advice on the required framework and the design of monetary policy. As prerequisites for a successful monetary policy, the authorities recognized that: (a) DAB will need to have full control over the issuance of the national currency; (b) DAB will need to be autonomous and accountable in the performance of its tasks; and (c) fiscal discipline will need to be maintained. The authorities are committed to grant DAB autonomy in the near future once it has developed adequate capacity to carry out its functions. Meanwhile, the government continues to oversee DAB. MAE has assisted the authorities in preparing a draft central bank law that would grant DAB autonomy. Regarding fiscal discipline, as indicated above, the budget decree adopted in April 2002 explicitly prohibited the government from taking recourse to central bank financing.

34. **Fund staff has assisted DAB in developing a quantified monetary program consistent with the objective of achieving low inflation.** The program aims at controlling the domestic money supply within the context of a floating, market-determined exchange rate (see below). In the absence of a functioning banking system, the domestic money supply is essentially limited to the stock of domestic currency in circulation. The ability to target inflation through the domestic currency supply is complicated by the widespread use of foreign currencies. However, there is no information on the size of foreign currency holdings in Afghanistan. In addition, it is likely that a large part of the foreign currency holdings is used to purchase imports or is held as a store of value rather than for transaction purposes, and therefore creates less inflationary pressures than a domestic currency expansion. Given the large uncertainties, the monetary program is based on cautious assumptions regarding the strength of the economic recovery and demand for the domestic currency. Targeting a twelve-month inflation rate of somewhat below 20 percent by March 2003, the monetary program aims at limiting money growth to less than 30 percent over the period March 22, 2002–March 21, 2003 (Table 2).

35. **Controlling the domestic money supply required the introduction of foreign exchange auctions.** Without any new central bank financing of the government, changes in the amount of currency in circulation are primarily driven by changes in DAB's (net) foreign asset position. The government converts the donor assistance it receives to finance the budget

at DAB into Afghani, increasing DAB's foreign assets. Without any action from DAB and given the size of budgetary assistance, this would imply a doubling of the domestic money supply within one year. To prevent this, an instrument to sterilize the monetary expansion was needed. However, without a functioning banking system or money market, the only market-based instrument that could be developed quickly was selling foreign exchange through foreign exchange auctions. Participants in the auctions are the larger money traders. Fund staff has provided extensive assistance to establish and improve these auctions; access and transparency of the auctions have been enhanced, but a further strengthening of procedures is still needed, including basic reporting by the money traders. Once financial markets, including banks, develop additional monetary instruments such as deposit auctions and central bank or treasury bills could be introduced.

### **Exchange rate policy**

36. **The authorities believe that under the present circumstances, a floating exchange rate regime is appropriate for Afghanistan.** The staff concurs with this view. Once the economy has gone beyond the early structural changes inherent to the reconstruction process and a track record of stability has been achieved, the authorities may reconsider the choice of exchange rate regime. In the staff's opinion, the only two available options at the present time are a (partial) dollarization or a free float. The middle ground of the exchange regime spectrum poses too many risks. Partial dollarization, as suggested by the staff in early 2002, would have quickly provided financial stability and reduced the risks posed by counterfeiters. But with the continued use of the Afghani and the early introduction of the new Afghani, a free float is to be preferred. Given the considerable degree of uncertainty about the appropriate level of the exchange rate in light of the large changes the Afghan economy is currently undergoing—and will continue to undergo in the near future—the risk of an exchange rate misalignment under a fixed type arrangement would be significant. Also, there would be a risk that DAB could suffer excessive losses of its reserves by defending an unsustainable rate (or to counterfeiters prior to the introduction of the new currency).

### **B. Technical Assistance**

37. **A first assessment of technical assistance needs was made by Fund staff during a multidepartmental mission in January 2002.** This was followed by diagnostic missions from the Fund's MAE, LEG, FAD, and STA departments. Based on the findings of these missions, substantial technical assistance programs have been started (see Appendices III and IV). These programs are directed at restoring essential capacity at DAB, the MoF, and the CSO. Technical assistance is being provided in coordination and cooperation with other donors, while training is also being offered by the IMF Institute. These technical assistance programs could evolve into a Technical Assistance Coordination Action Plan (TCAP). A TCAP is not feasible in the near future, however, because the authorities have indicated, and staff concurs, that they lack the capacity needed to actively manage such a complex undertaking.

38. **Building adequate capacity for macroeconomic management will take time, given the low starting point and the extremely weak absorptive capacity.** Technical assistance will be needed for several years to come and, particularly in the early stages, will need to be very much hands-on, aiming at a gradual, but steady transfer of knowledge to local staff. The long-term nature of the technical assistance needs, combined with the multitude of assistance providers, requires close coordination between donors, both in the field and between (and within) the respective headquarters.

#### **Financial sector technical assistance**

39. **An early diagnostic mission found that the financial sector, including the central bank, was not functioning at all.** Afghanistan is essentially a cash-based society, with some basic financial services provided through the informal Hawala transfer system. The few existing banks were found to be highly illiquid and had not carried out any financial intermediation for several years. Similarly, the capacity at DAB was extremely weak. No recent information existed on the financial situation of banks or even DAB's balance sheet. Moreover, there was virtually no knowledge of modern banking supervision or the conduct of monetary policy, while outdated accounting systems are being used. The payments system had all but broken down completely.

40. **The authorities, as well as several donors, have asked the Fund to take an active role in the area of central bank modernization and the reestablishment of a basic payments system.** The immediate focus of MAE's assistance is on the payments system and rebuilding capacity at DAB to conduct monetary policy, as well as the preparation for the planned banknote exchange. In addition, technical assistance focuses on central bank and banking system modernization, financial sector supervision, and financial sector accounting. Assistance is being provided through missions, as well as by a number of peripatetic resident advisors, while MAE is also actively coordinating assistance provided by other donors.

41. **Reestablishing a basic functioning payment system poses tremendous challenges, given the state disrepair of the existing infrastructure.** A working payment system is of crucial importance to execute government payments and transfers to the provinces. The current focus of assistance is to organize the payments system through seven regional hubs (including Kabul), from where mobile branches will also operate. This involves ensuring capable staff at these hubs; enhancing telecommunications, storage, and other basic facilities; and ensuring the availability of safe transportation between Kabul and these hubs, including the safety of roads.

42. **A considerable part of MAE's assistance has recently been redirected to assist the authorities with the preparations for the introduction of the new currency.** The banknote exchange in present-day Afghanistan poses huge logistical challenges. Peripatetic resident advisors from MAE and the Bundesbank are helping the authorities with the detailed planning for this exchange. MAE and LEG are also assisting the authorities in preparing a

draft currency decree to govern the exchange. Technical issues include the logistics of the printing and delivery of the new banknotes, the secure storage and delivery of banknotes to the distribution points, the promotional campaign, the length of the changeover period, and the invalidation and destruction of the old notes. The UN will be providing assistance with the logistics of the banknote exchange, while the U.K. Department for International Development (DFID) and the United States Agency for International Development (USAID) are assisting with the promotional campaign. Once the new currency has been introduced, it will be a challenge for DAB to ensure that sufficient amounts of currency will be available on a day-to-day basis in its branches throughout the country.

43. **In the area of central bank modernization, MAE, together with LEG, has provided the authorities with several drafts for new legislation**, including new central bank and banking laws, a currency decree, a financial services law, and a payments law. The main goal of the new central bank law is to establish a strong legal framework to ensure the autonomy and accountability of DAB. In addition, it would clearly establish price stability as its principal objective. The draft banking law aims at enhancing the functioning of financial intermediation in Afghanistan. In addition, MAE has provided advice on restructuring DAB's organization and operations to make these more suitable for a central bank in a modern two-tier banking system.

44. **Regarding accounting and bank supervision, MAE is assisting DAB with the introduction of a new chart of accounts and new accounting practices that are consistent with international accounting standards**, initially at the central bank and later on also at the commercial banks. Furthermore, MAE has assisted DAB in drafting new licensing and prudential regulations for banks in accordance with the Basel Core Principles for Effective Banking Supervision. The draft licensing regulations would also allow for the entry of foreign banks in Afghanistan. While MAE and other donors are assisting DAB to build capacity in banking supervision, this will take time. Allowing branches of foreign banks to open in Afghanistan would have the advantage of reestablishing financial intermediation, while these branches also remain under supervision by their home country supervisors. Staff has advised the authorities against automatic relicensing of existing banks. Relicensing should only be allowed if banks fully comply with all (new) regulations.

#### **Fiscal sector technical assistance**

45. **In the area of fiscal sector reforms, the Fund has provided recommendations and detailed technical assistance plans**. FAD's recommendations in the area of budget management, tax policy, and tax and customs administration have been endorsed by the authorities as well as the donor community. Over the near term, other donors will be implementing the recommendations made by FAD. FAD is in close contact with the implementing agencies and is coordinating and helping to direct the technical assistance efforts. Several donors have urged the Fund to play a monitoring role to evaluate the implementation of reforms and to suggest improvements through small follow-up missions.

FAD does not anticipate taking on a hands-on role, although this may need to be reevaluated if reforms are slow to develop. Priority areas of technical assistance are establishing financial management capacity and revenue mobilization.

46. **A first FAD diagnostic mission found that the legal framework for budget preparation and execution was basically sound. However, it also found that most of these practices had not been applied for many years,** particularly because the reporting by provinces had broken down completely. Moreover, in the absence of any office automation or communication facilities, actual procedures were slow and cumbersome. The limited information that was recorded was not sufficient to provide a comprehensive picture of government finances. Currently, it is not possible to track budget execution against ministerial allotments, provincial suballotments, or by economic classification. Internal controls on payments are weak and there is no commitment recording or preaudit mechanism. FAD staff made several recommendations to improve budget execution, including the establishment of a basic expenditure management and accounting operating system.

47. **The effective utilization of and control over government funds urgently required stronger capacity than existed within the administration.** Stronger fiduciary assurances were also a prerequisite for realizing pledges of donor support. To quickly rebuild capacity, IDA put in place an Emergency Public Administration project. Grants were provided to allow the government to hire qualified firms to carry out government procurement, financial management, and audit functions on an interim basis. These firms will also assess existing procedures and make recommendations for improvement, in addition to developing the administration's capacity so that it can gradually take over these functions. Contracts have been signed with three agents and the financial management agent started work in late August 2002, planning to have a basic treasury system operating in Kabul within one month.

48. **An FAD tax policy and administration mission (with participation from LEG) proposed revenue-enhancing measures for the short and medium term.** Main recommendations included the use of the market exchange rate, instead of an overly appreciated rate, for customs valuation purposes, with the impact on effective tariff rates partly offset by reducing customs tariffs, and a reduction in the number of tariff bands. Duty rates for goods that would generally be considered as excisable (gasoline, diesel, cigarettes, and cars) could be increased. In addition, several suggestions were made to improve the efficiency of income taxation, including inter alia reducing the top marginal tax rate from 60 percent to 25 percent (equal to the corporate tax rate), increasing the personal exemption and restoring wage withholding on higher-income employees.

49. **FAD has also presented a road map for building modern tax and customs administrations.** Staff provided the authorities with a detailed development and technical assistance plan for strengthening tax administration and the customs department, and to ensure that revenue is transmitted to the treasury. However, extensive technical assistance and training will be required to help the tax administration and customs department modernize and reform, while a complete overhaul of tax and customs legislation is needed.

DFID is already providing assistance in customs administration, while USAID is expected to provide support in tax administration. The success of customs reforms, however, will depend to a considerable extent on the ability to update and manage the transit agreements with neighboring countries, notably Pakistan.

### Statistics

50. **With little or no data collection since 1995–96, no reliable recent data exist**, be it for national accounts, prices, labor markets, government finance, monetary accounts, balance of payments, or external debt statistics. Developing key macroeconomic statistics is essential for effective policy design and implementation, as well as for Fund surveillance. An STA diagnostic mission has assessed that with adequate technical assistance, including training and provision of equipment, it would be possible to develop statistics in all these areas in the medium term (two–three years). Early results could be expected regarding a good consumer price index. Near-term STA technical assistance will focus on: (a) establishing rough estimates on the most relevant macroeconomic aggregates; (b) improving the CPI; (c) developing government finance statistics; (d) designing a reporting system for commercial banks; and (e) constructing an adequate balance of payments and external debt data system. STA will also assist in drawing up a work plan for the development of national account statistics, the execution of which, however, would be left to a resident advisor. A resident multisector statistics advisor has taken up his post to assist the CSO, MoF, and DAB in these efforts and to provide training. It is expected that the FAO and International Labor Organization (ILO) will assist the authorities with agricultural production and labor market statistics, respectively.

### C. Monitoring and Reporting

51. **Fund staff has been discussing with the authorities ways to establish regular monitoring of macroeconomic developments.** Several donors have shown an interest in the Fund's assessment of macroeconomic developments and prospects. Given the limited domestic institutional capacity, staff has offered to assist the authorities in preparing regular reports on macroeconomic developments and policies, including key structural and institution-building measures in the area of macroeconomic management. The staff has also been discussing with the authorities ways to convey these assessments to a wider audience. Issuing economic reports, signed by the authorities and endorsed by the Fund, on a regular basis would help provide assurances to donors on progress made by the authorities in achieving and maintaining macroeconomic stability, which could facilitate the mobilization of further financial support.

### D. Future Relations with the Fund and Clearance of Arrears

52. **The current modalities of the Fund's involvement in Afghanistan are expected to be maintained until domestic capacity is adequate to allow for the use of Fund resources, possibly in the next fiscal year.** At present, no immediate balance of payments

need exists. If such a need were to emerge, financial assistance could be extended under the Emergency Post-Conflict Assistance Facility, provided that sufficient capacity for implementing policies and a demonstrated commitment to address macroeconomic imbalances have been established. Eventually, Afghanistan could move to an arrangement under the Poverty Reduction and Growth Facility (PRGF). Although data availability will still be limited, staff will aim to conduct an Article IV consultation in 2003.

53. **Afghanistan currently is in arrears with the Fund, as well as with the World Bank and the AsDB.** Any financial assistance by the Fund to Afghanistan will require that these arrears be cleared. Arrears with the Fund are relatively small, SDR 7.7 million as of end-August 2002, of which up to SDR 4.9 million could be repaid using Afghanistan's reserve tranche. Taking into account the small size of the arrears, the authorities intend to clear the remaining amount using bilateral donor grants; some donors have already expressed their willingness to assist in this approach. The authorities are also discussing with the World Bank and the AsDB ways to clear the arrears with these institutions (US\$26.7 million and US\$16.5 million, respectively). It is envisaged that these arrears would be cleared sequentially, with the arrears to the Bank and the Fund cleared within a short period of each other later this year.

#### V. RECENT ECONOMIC DEVELOPMENTS

54. **The economy appears to be recovering, albeit from a very low level.** Indications of a recovery are strongest in certain sectors in Kabul, such as construction and services, where the main driving force to the recovery appears to be coming from emergency assistance and the spending by the international community. Major reconstruction projects are yet to begin and current budget spending is still quite limited.

55. **Inflation slowed down markedly in recent months.** The Kabul CPI increased by just over 1 percent in the first quarter of 1381 (or March 22–June 21, 2002), well below the 4½ percent envisaged in the monetary program. The Afghani/U.S. dollar exchange rate depreciated from about AF 30,000 per U.S. dollar in early March 2002 to over AF 40,000 per U.S. dollar by mid-September 2002. Prior to the announcement of the introduction of the new currency in early September, the rate briefly dropped to over AF 50,000 per U.S. dollar in response to rumors and speculation.

56. **The execution of the government's current budget has been slow.** Expenditures for the first quarter of the fiscal year recorded at the center (including transfers to the provinces inter alia for wage payments) amounted to US\$22 million, compared with US\$79 million budgeted for the general government (Table 3). In addition, the central government made an additional US\$29 million in payments in the first quarter of the 2002/03 budget year that were related to the execution of the 2001/02 budget. These were mostly wage payments, which had started slowly as initially it proved difficult to reach the provinces and adequate checks and balances needed to be put in place to ensure that wages were paid only to people actually reporting to work. Civil service staff, excluding military and security

personnel, was estimated at about 210,000 by mid-2002. Reflecting mounting pressures to increase government wages from their very low levels, government employees' food allowances were raised by 37 percent in May 2002, with further increases possibly in September when the WFP intends to cease its distribution of food in kind to government employees. In the absence of expenditure reports to the MoF, little or no information is available on the nonwage expenditures of the provinces.

57. **Revenues collected in the first quarter amounted to US\$16 million**, according to data reported by customs houses and regional fiscal offices, compared with a budgeted amount of US\$18 million. However, domestic revenues recorded at the Treasury Single Account (TSA) at DAB in Kabul were a mere US\$500,000. This discrepancy has three sources: (a) revenues collected by the provinces may not have been deposited with provincial DAB branches; (b) a lack of reporting by DAB branches to DAB headquarters; and (c) full consolidation of government accounts at DAB branches with the TSA at DAB headquarters is only required at the end of the fiscal year. If the assumption would be made that all provincial revenues have been spent by the same provinces, general government expenditures for the first quarter of the 2002/03 budget would have amounted to US\$38 million (still well below the budgeted amount).

58. **The low level of budget spending reflects limited administrative capacity, a lack of financing, and a shortage of banknotes.** Administrative capacity is expected to develop more rapidly in the second quarter, with external contractors coming on board to assist the authorities with procurement, financial management, and audit functions. Also, the quarterly budget allotments for each individual ministry for the first quarter had become available only when the quarter had been well under way.

59. **Donor assistance for the first quarter of the 2002/03 budget fell well short of the targeted amount.** US\$27 million in foreign grants were received to finance first quarter expenditures, compared to a budgeted amount of US\$60 million.<sup>7</sup> This reflects the general difficulty in mobilizing donor support, particularly for general budget support; by end-July, according to the authorities only US\$138 million of the US\$400 million needed to finance the 2002/03 budget had been committed, leaving a gap of US\$262 million. The remaining gap could in part be closed by concessional loans from IDA and the AsDB. However, the authorities prefer to avoid debt financing for current expenditures to the extent possible and are seeking additional grant financing. The authorities are keen to prevent problems of sustainability emerging given the large uncertainties surrounding available resources.

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<sup>7</sup> An additional US\$21 million was received to finance expenditures—essentially wages—of the last quarter of the previous fiscal year, ending March 21, 2002. By end-July 2002, an additional US\$34.9 million in assistance for the current fiscal year was received.



60. **The government has adhered to the no-overdraft principle.** At the end of the first quarter of 1381 (or March 22–June 21, 2002), the government had a surplus of about US\$5 million on its accounts. No information is available, however, on whether the government accumulated any arrears.

61. **Money growth in the first quarter of 1381 (or March 22–June 21, 2002) was in line with the monetary program.** Currency in circulation increased by 6 percent, slightly less than the 6½ percent provided for under the program, and up from an estimated 4½ percent in the last quarter of 1380 (or December 22, 2001–March 21, 2002).<sup>8</sup> Because DAB had ordered only a limited additional supply of the existing banknotes, DAB is currently facing a shortage of banknotes. DAB has been auctioning foreign exchange to obtain sufficient banknotes to execute budget payments.

## VI. RISKS AND CHALLENGES IN THE COMING MONTHS

62. **The risks ahead to achieving macroeconomic stability are substantial. The most prominent of these is the still fragile security situation and the lack of control by the authorities beyond Kabul.** The latter is of particular relevance to the budget, given that most domestic revenues are collected by the provinces. Proper monitoring of budget execution will also require improved reporting by provincial fiscal offices and central bank branches to the center to obtain a complete picture of the government's fiscal operations, encompassing both central and provincial transactions. This would allow the MoF to instruct surplus provinces to transfer excess revenues to the center.

63. **There is also a risk that budget ceilings could be exceeded.** Pressures to increase employment, particularly in education and defense, are mounting, as are pressures to raise government wages. Current mechanisms to monitor and control government employment are weak and need to be strengthened. On the other hand, however, like in many other post-conflict countries, there is also a possibility that the inability to execute the budget because of weak capacity may in fact result in underspending.

64. **It is uncertain whether sufficient donor financing will be available to close the budget gap.** As indicated, by end-July 2002, commitments are still some US\$262 million short of the US\$400 million needed to finance the current budget. Donors will need to ensure that adequate financing is available. Without sufficient donor financing, pressures to resort to central bank financing may reemerge. For their part, the authorities will need to ensure that the domestic revenue target is achieved.

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<sup>8</sup> DAB has no reliable information on the amount of currency in circulation; the stock is estimated as the amount of banknotes supplied over the past 25 years minus the amount of currency in DAB's vaults in Kabul. This is a rough estimate as it both overestimates currency in circulation by the amount of banknotes that may have been destroyed, including through wear and tear, and underestimates it by the amounts of counterfeits in circulation.

65. **Difficulties in executing the planned banknote exchange could destabilize the currency.** Information gaps and misperceptions, fuelled by rumors about the exchange, as well as logistical problems could lead to increased exchange rate pressures and volatility. The authorities and staff have discussed the practical challenges and risks associated with the exchange; staff emphasized the need for careful planning. Acceptance of the new currency will be crucial for the success of the authorities' economic policies.

66. **Despite the very difficult circumstances and the immense challenges, both the Interim and Transitional Administration have made commendable progress to put in place sound economic policies.** They are clearly committed to maintain fiscal discipline and achieve low inflation. To overcome the risks and challenges ahead, the authorities' efforts deserve the active support from the international donor community.

Table I. Islamic State of Afghanistan: General Government Current Budget, March 2002–March 2003

	Budget	Actual	Revised estimated quarterly allotments			Budget
	Q1	Q1	Q2	Q3	Q4	FY 2002/03
(In millions of U.S. dollars)						
Wages and salaries (excl. defense, interior, national security, and SOEs) 1/	17.6	12.9	20.2	34.9	36.3	104.3
<i>Of which:</i> allocation for wage reform	0.0	0.0	0.0	12.0	12.0	24.1
Goods and services (excl. defense, interior, and national security) 2/	13.4	2.1	17.6	19.9	21.1	60.7
Capital expenditure (excl. defense, interior, and national security) 3/	3.2	0.5	4.2	4.7	5.0	14.4
Defense, interior and national security	43.7	7.0	57.6	65.2	69.1	198.8
Subsidies to SOEs	0.0	0.0	0.0	17.1	17.1	34.1
Wages	0.0	0.0	0.0	7.9	7.9	15.9
Other	0.0	0.0	0.0	9.1	9.1	18.3
Social transfers 4/	0.7	0.1	1.0	8.8	8.9	18.8
<i>Of which:</i> allocation for pension reform	0.0	0.0	0.0	7.8	7.8	15.5
Interest	0.0	0.0	0.0	3.3	3.3	6.6
Contingency	0.0	0.0	0.0	11.3	11.3	22.5
Total	78.7	22.6	100.5	165.3	172.0	460.3
Wage arrears clearance	0.0	0.0	0.0	11.3	11.3	22.5
Revenues	18.3	0.5	24.7	28.0	29.7	83.0
Financing need	60.4	22.1	75.7	148.5	153.5	399.8
Foreign grants	60.4	26.8	66.4	32.5	12.5	138.2
Multilateral	...	16.8	56.4	12.5	12.5	98.2
UNDP	...	16.8	6.4	...	...	23.2
ARTF	...	0.0	50.0	12.5	12.5	75.0
Bilateral	...	10.0	10.0	20.0	0.0	40.0
India	...	0.0	10.0	...	...	10.0
USA	...	0.0	...	20.0	...	20.0
Pakistan	...	10.0	...	...	...	10.0
Remaining financing need (+ = surplus)	0.0	4.7	-9.3	-116.0	-141.0	-261.6

Sources: Afghan authorities; and IMF staff estimates.

1/ 1000 budget code excluding ministries of defense, interior, and national security and excluding SOEs.

2/ 2000, 3000, 4000 budget codes, excluding ministries of defense, interior, and national security, including contributions to international institutions, foreign exchange transactions, fund for past expenses, printing and publishing cost, and loans to civil servants.

3/ 5000 budget code, excluding ministries of defense, interior, and national security.

4/ 7000 budget code, excluding ministries of defense, interior, and national security, including allowance for pension reform, fund for civil and military pensions, fund for disabled and martyrs, and contribution to refugees.

5/ Checks cashed in Q1 2002/03 for total expenditure and wages. For the other items, the difference between total expenditure and wages has been prorated according to the distribution of the allotments for the first quarter.

6/ A weight of respectively 30 percent, 34 percent, and 36 percent has been applied to what remains to be paid in 2002/03 after the end of the first quarter.

Table 2. Islamic State of Afghanistan: Rudimentary Monetary Program (Da Afghanistan Bank), 2002–03

	Est.	Proj.	Est.	Proj.		
	Mar. 21 2002	Jun. 21 2002	Jun. 21 2002	Sep. 21 2002	Dec. 21 2002	Mar. 21 2003
(In billions of Afghani, unless indicated otherwise)						
Net foreign assets	10,257	11,162	11,428	12,342	13,374	14,476
Foreign assets	10,563	11,468	11,734	12,648	13,680	14,782
Foreign exchange reserves 1/	10,563	11,468	11,734	12,648	13,680	14,782
Gold	6,674	6,674	6,674	6,674	6,674	6,674
Other	3,889	4,794	5,060	5,974	7,006	8,108
Foreign liabilities	-306	-306	-306	-306	-306	-306
Net domestic assets	3,511	3,492	3,178	3,254	3,224	3,190
Domestic assets	15,075	15,075	14,245	14,345	14,345	14,345
Net claims on general government	15,075	15,075	14,245	14,345	14,345	14,345
Net claims on government before 2002/03 2/	15,857	15,857	15,127	15,127	15,127	15,127
Net claims on government in 2002/03	0	0	-100	0	0	0
Other government deposits 3/	-782	-782	-782	-782	-782	-782
Claims on nonbank public institutions	0	0	0	0	0	0
Claims on deposit money banks	0	0	0	0	0	0
Other items net	-11,564	-11,583	-11,067	-11,091	-11,120	-11,155
Reserve Money	13,769	14,654	14,606	15,596	16,598	17,665
Afghanis in circulation	13,769	14,654	14,606	15,596	16,598	17,665
Banknotes and coins issued	13,809	14,804	14,718	15,796	16,798	17,865
Less cash holdings	40	150	112	200	200	200
Bank reserves	0	0	0	0	0	0
Memorandum items:						
Dostum Afghani (billions of Afghani at Daf 2 / Af)	750	750	750	750	750	750
Reserve money growth (quarterly)	...	6.4	6.1	6.4	6.4	6.4
Reserve money growth (annual)	...	...	...	...	...	28.3
Gross international reserves (millions of U.S. dollars)	310.7	337.3	345.1	372.0	402.4	434.8
Inflation (twelve-month)	-15.7	...	-23.4	...	...	18.0
Inflation (year-on-year)	...	...	...	...	...	-2.2

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

1/ Increases reflect (net) flows plus recovered accounts abroad.

2/ Changes in Q1 2002/03 reflect expenditures made and revenues booked for the 2001/02 budget.

3/ IATA funds.

Table 3. Islamic Republic of Afghanistan: Budget Execution, 2001/02–2002/03

	Budget of 2001/02		Budget of 2002/03			Cash in 2002/03 (1)+(2)
	Actual, paid in		Budget		Actual	
	Q4	Q1	Annual	Q1	Q1	
	2001/02	2002/03 (1)		Allotment	(2)	
(In millions of U.S. dollars)						
Domestic revenue reported to MOF	...	...	83.0	18.3	16.0	...
Customs revenue	...	...	...	...	14.7	...
Central ministries	...	...	...	...	0.7	...
Noncustom provincial	...	...	...	...	0.6	...
Adjustment to central budget 1/	...	...	...	...	-15.5	...
Domestic central revenue recorded in DAB	2.0	...	...	...	0.5	0.5
Expenditure (checks issued)	5.4	28.6	482.8	78.7	28.8	57.4
Wages 2/ 3/	5.4	16.4	126.8 6/	17.6	12.9	29.3
Central government	5.4	9.2	...	...	9.2	18.4
Provinces	0.0	7.2	...	...	3.7	10.9
Other expenditure 3/	0.0	12.2	356.0	61.0	13.2	25.5
Central government	0.0	12.2	...	...	13.2	25.5
Provinces	0.0	0.0	...	...	0.0	0.0
Transfers from the center 4/	...	...	...	...	2.6	2.6
Balance (checks issued)	...	...	...	...	-28.3	...
Adjustment for float	...	...	...	...	6.3	6.3
Balance (checks cashed)	-3.4	-28.6	-399.8	-60.4	-22.0	-50.6
Financing	3.4	28.6	...	...	22.0	50.6
External financing (grants)	6.0	15.2	...	...	26.8	42.0
UNDP	6.0	15.2	...	...	16.8	32.0
Pakistan	...	...	...	...	10.0	10.0
Domestic financing 5/	-2.6	13.4	...	...	-4.7 7/	8.6

Sources: Afghan authorities; and Fund staff estimates.

1/ The government Treasury Single Account (TSA) in DAB only shows the revenue of the center (Af 18 billion) but not the provincial revenue. In fact, during the year, this account does not consolidate the provincial accounts of DAB local branches where the provincial revenue are deposited. It is only at the end of the year that the surplus in these accounts are consolidated with the TSA. Information on the operations of the DAB local branches is either not available or of poor quality.

2/ Excluding defense, interior, and national security.

3/ Checks cashed in the DAB headquarters at the center.

4/ Transfers from DAB headquarters to DAB local branches.

5/ A minus sign indicates a surplus of the government account in DAB.

6/ Including Af 750 million for wage arrears.

7/ The "no overdraft rule" means that domestic financing for the execution of the 2002/03 budget should always be zero or below.

**Islamic State of Afghanistan: Relations with the Fund**  
(As of August 31, 2002)

I. **Membership Status:** Joined 07/14/55; Article XIV.

II. <b>General Resources Account:</b>	<u>SDR Million</u>	<u>% Quota</u>
Quota	120.40	100.00
Fund holdings of currency	115.49	95.92
Reserve position in Fund	4.93	4.09
Holdings Exchange Rate		

III. <b>SDR Department:</b>	<u>SDR Million</u>	<u>% Allocation</u>
Net cumulative allocation	26.70	100.00

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

V. **Financial Arrangements:** None

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

	Overdue <sup>1</sup>	<u>Forthcoming</u>				
	<u>08/31/02</u>	<u>2002</u>	<u>2003</u>	<u>2004</u>	<u>2005</u>	<u>2006</u>
Charges/Interest	<u>7.72</u>	<u>0.19</u>	<u>0.77</u>	<u>0.77</u>	<u>0.77</u>	<u>0.77</u>
Total	<u>7.72</u>	<u>0.19</u>	<u>0.77</u>	<u>0.77</u>	<u>0.77</u>	<u>0.77</u>

**Nonfinancial Relations**

VII. **Exchange Arrangement**

For many years Afghanistan had a multiple exchange rate system based on an official rate and a free market rate. Since 1996, the two rates have been unified and the Afghani has been freely floating. At this time, it is not possible to make an assessment on whether Afghanistan's exchange and payments system is free of restrictions subject to Article VIII. In practice, virtually all nongovernment transactions are made in the free market and de facto are not subject to any official restrictions.

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<sup>1</sup> The projection of charges and interest assumes that overdue principal at the report date (if any) will remain outstanding, but forthcoming obligations will be settled on time.

### VIII. Article IV Consultation

The last Article IV consultation with Afghanistan was discussed by the Executive Board on June 12, 1991 (SM/91/78, 4/28/91). Consultations with Afghanistan are on the standard 12-month cycle. Article IV consultations since 1991 have been postponed because of the unsettled political and security situation.

### IX. Technical Assistance, 2002

Department	Date	Purpose
Interdepartmental	January 27-31	Initial assesement of TA needs
FAD	February 10-21	Fiscal management
	May 13-26	Tax policy and administration
MAE	February 27-March 7	Financial sector reform
	May 19-June 2, July 10-27	Financial sector reform
LEG	February 27-March 7	Financial sector legislation
STA	April 15-21	Multisector statistics

A resident multisector statistical advisor, Mr. Soulatha, was stationed in Kabul on July 17, 2002. Several peripatetic advisors in the area of financial sector reform are paying alternating visits to Kabul, with Messrs. Manning and Boothe covering payment system issues, Messrs. Bueno and Heng accounting issues, Mr. Magvan banking supervision issues, Mr. Rădulescu central bank modernization, and Messrs. Bergstedt and Ehlers (Deutsche Bundesbank) currency reform issues.

### X. Resident Representatives

During the first half of 2002, the Fund's resident representative in Pakistan, Mr. Ghesquiere, assisted in maintaining relations with the Afghan authorities. A new resident representative, Mr. de Schaezten, took up his post in Kabul on August 24, 2002.

### **Islamic State of Afghanistan: Relations with the World Bank**

1. A **Transitional Support Strategy (TSS)** was presented to the World Bank Board of Executive Directors on April 4, 2002. The TSS outlined a strategy for World Bank operations over the subsequent 6–9 months, making the case for utilization of up to US\$100 million in IDA grants in the 2002 fiscal year. On April 4, the World Bank's Board also approved the first IDA operation for Afghanistan since 1979—the US\$10 million **Emergency Public Administration Project**—designed to provide adequate capacity in procurement, financial management, and audit, and to build national capacity in these areas. Under this project the government has recruited three international agents to undertake these functions, all of whom are now in place in Kabul.

2. Following on from the multisector donor missions undertaken after the January Tokyo Conference, World Bank staff prepared and negotiated three additional projects to utilize remaining IDA grant funds. These projects, including an **Emergency Education Rehabilitation and Development Project** (US\$15 million), an **Emergency Infrastructure Reconstruction Project** (US\$33 million) and an **Emergency Community Empowerment and Public Works Program** (US\$42 million) were approved by the World Bank's Board on June 5, 2002. Implementation of all three projects is now under way. Preparation of new activities is also well advanced: an Emergency Transport Rehabilitation Project is ready for negotiation; an Emergency Health Rehabilitation project is under preparation; and the government has expressed interest in a broad based financial sector operation. On September 17, 2002, the Board will also consider an IFC investment in a first **Micro Finance Bank for Afghanistan**. The World Bank has also offered to provide a fiscal rehabilitation operation in support of the government's budget and arrears clearance requirements, should this be needed.

3. Afghanistan's arrears with the World Bank stand at US\$26.7 million and would need to be cleared before any further World Bank operations are approved. Several donors have indicated their willingness to provide small grants in support of arrears clearance, and one donor has indicated its willingness to provide bridge financing. At this stage the government has expressed its desire to secure further bilateral grants to help clear arrears, and not to take credit for funding budgetary costs. The government has, nevertheless, requested that the World Bank continue to support its structural reform program with a view to ultimately underpinning it with a fiscal rehabilitation operation, should this be necessary. Once arrears are cleared, Afghanistan would be an IDA-only, post-conflict country with access to limited grants in line with decisions that will be taken on implementing IDA 13 grants. At this stage it is anticipated that around 29 percent of Afghanistan's IDA allocation would be in the form of grants and that this would amount to about US\$56 million in FY03.

4. The World Bank is also administrator of the multidonor **Afghanistan Reconstruction Trust Fund (ARTF)**, which became effective in May 2002. The ARTF has received approximately US\$80 million in contributions and anticipates receiving US\$133 million or more in the current year. An amount of US\$18.5 million has been



disbursed to the government from the ARTF, in support of recurrent expenditures. The World Bank's monitoring agent, Price Waterhouse Coopers, is now in place in Kabul.

5. The World Bank has responded quickly to a range of requests from the government for technical assistance including in areas such as budget preparation and execution, civil service reform, telecommunications policy, and aid coordination. The World Bank has also actively utilized **Post Conflict Fund** and **Japan Social Development Fund** resources to provide rapid-on-the-ground support to the government and communities—including small NGO projects, water and sanitation activities, and technical assistance.

6. Over the next few years the World Bank's program is likely to grow quickly, with a solid program of technical assistance, financial support, and analytical work. This fiscal year, major pieces of analytical work are expected to be conducted in the area of provincial and district service delivery and gender assessment.

7. The World Bank's office in Kabul is now fully functional with a Country Manager in place and national staff recruitment well under way.

Islamic State of Afghanistan: Technical Assistance in Fiscal Management

Requirements	Dates/Timing	Provider	Nature of TA
<b>1 Assessment of existing systems</b>			
<b>1.1 Preliminary diagnostic</b>	Jan. 2002	IMF (interdepartmental).	Short-term mission.
<b>1.2 Review of budget preparation, budget execution, treasury, and revenue administration</b> <ul style="list-style-type: none"> <li>• evaluation of current legislation and practices;</li> <li>• assessment of current practices;</li> <li>• recommendations to improve budget execution and preliminary proposals to enhance revenue administration.</li> </ul>	Feb. 2002	IMF (FAD).	Short-term mission.
<b>1.3 Review of tax/customs policy and administration</b> <ul style="list-style-type: none"> <li>• evaluation of current legislation and practices;</li> <li>• recommendations to improve domestic revenues (including customs, excises, and income taxation);</li> <li>• proposals to amend customs and income tax laws;</li> <li>• action plans to enhance tax and customs administration.</li> </ul>	Jun. 2002	IMF (FAD).	Short-term mission.
<b>2 Customs reform</b>			
<b>2.1 Customs policy</b> Review customs law and regulations to: <ul style="list-style-type: none"> <li>• revise exchange rate for customs valuation;</li> <li>• streamline customs tariffs;</li> <li>• introduce customs tariffs on petroleum products imports.</li> </ul>	Aug. 2002/Aug. 2003	<ul style="list-style-type: none"> <li>• DFID (resident experts);</li> <li>• USAID (1 short-term mission in Aug. 2002);</li> <li>• IMF (FAD: short-term “ad-hoc” missions).</li> </ul>	<ul style="list-style-type: none"> <li>• 2 to 3 resident experts;</li> <li>• Short-term missions.</li> </ul>
<b>2.2 Customs administration</b> <ul style="list-style-type: none"> <li>• ensure availability of updated customs regulations in all customs offices;</li> <li>• establish model customs offices in Kabul, Jalalabad, and</li> </ul>	Aug. 2002/Aug. 2005	<ul style="list-style-type: none"> <li>• <b>Mostly DFID (resident experts);</b></li> <li>• Possible future EU participation;</li> </ul>	<ul style="list-style-type: none"> <li>• 2 to 3 resident experts (same as for customs policy);</li> <li>• Short-term missions.</li> </ul>

## Afghanistan: Technical Assistance in Fiscal Management

Requirements	Dates/Timing	Provider	Nature of TA
<p>Torkham and gradually expand these pilots to all customs houses;</p> <ul style="list-style-type: none"> <li>• develop a statistics database for trade information;</li> <li>• create a fraud investigation function in the customs department;</li> <li>• provide training to customs staff and establish a central training facility in the MoF;</li> <li>• provide basic infrastructure (including 5 computers) for effective operation of the customs service.</li> </ul>		<ul style="list-style-type: none"> <li>• GTZ (purchase of equipment and rehabilitation of training customs center);</li> <li>• IMF (FAD: short-term “ad-hoc” missions).</li> </ul>	
<p><b>3 Tax reform</b></p>			
<p><b>3.1 Tax policy</b> Amend tax legislation and regulations to:</p> <ul style="list-style-type: none"> <li>• impose the criterion of residence as the basis of the individual income tax;</li> <li>• extend the loss carryover period;</li> <li>• establish wage withholding on higher-income employees;</li> <li>• expand the business receipt tax to cover services provided to higher-income employees;</li> <li>• liberalize depreciation allowances to provide incentives for investment;</li> <li>• introduce excises on tobacco, petroleum products, and (possibly) automobiles;</li> <li>• create a broad-based consumption tax;</li> <li>• define a fiscal regime for petroleum and mining sectors as well as any transit pipelines.</li> </ul>	Oct. 2002/Oct. 2005	<ul style="list-style-type: none"> <li>• USAID (resident experts);</li> <li>• IMF (FAD: short-term “ad-hoc” missions).</li> </ul>	<ul style="list-style-type: none"> <li>• 1 to 2 resident experts;</li> </ul>

## Afghanistan: Technical Assistance in Fiscal Management

Requirements	Dates/Timing	Provider	Nature of TA
<p><b>3.2 Tax administration</b></p> <ul style="list-style-type: none"> <li>• ensure availability of updated tax regulations in all tax offices;</li> <li>• improve control and supervision of the MoF headquarters over tax operations in provincial offices;</li> <li>• introduce Large Taxpayers Units (as well as model offices for medium taxpayers) in 3 pilot provinces, and gradually expand the pilots;</li> <li>• establish unique Tax Identification Number (TIN) and simple PC-based taxpayer database;</li> <li>• design “risk-based” and “selective” auditing procedures;</li> <li>• improve collection and enforcement procedures at the center and in the provinces;</li> <li>• reduce current manual procedures by gradually introducing tax software;</li> <li>• provide training programs for treasury staff.</li> </ul>	Oct. 2002/Oct. 2005	<ul style="list-style-type: none"> <li>• <b>Mostly USAID</b> (resident experts);</li> <li>• IMF (FAD: short-term “ad-hoc” missions).</li> </ul>	<ul style="list-style-type: none"> <li>• 1 to 2 resident experts;</li> <li>• Short-term missions.</li> </ul>
<p><b>4 Public expenditure management reform</b></p>			
<p><b>4.1 Budget preparation</b></p> <ul style="list-style-type: none"> <li>• assist the MoF in the preparation of current and development budgets;</li> <li>• improve the budget preparation process in the MoF and line-ministries;</li> <li>• introduce GFS-consistent economic and functional classifications;</li> <li>• introduce a simple medium-term expenditure framework.</li> </ul>	Jan. 2002 continuing	<ul style="list-style-type: none"> <li>• <b>World Bank</b> (resident experts);</li> <li>• U.S. Treasury (resident expert);</li> <li>• USAID (specific program starting in Oct. 2002);</li> <li>• AsDB (resident expert);</li> <li>• IMF (FAD: short-term “ad-hoc” missions + STA resident expert for expenditure classification).</li> </ul>	<ul style="list-style-type: none"> <li>• 2 resident experts since Jan. 2002;</li> <li>• USAID might assign another resident expert;</li> <li>• 1 IMF (STA) resident expert since July 2002.</li> </ul>

Afghanistan: Technical Assistance in Fiscal Management

Requirements	Dates/Timing	Provider	Nature of TA
<p><b>4.2 Budget execution and treasury functions</b></p> <ul style="list-style-type: none"> <li>• reestablish basic accounting functions at the center and in provincial treasury offices;</li> <li>• develop a centralized reporting system to prepare monthly, quarterly, and annual consolidated financial statements (center + provinces);</li> <li>• ensure full reconciliation between budget execution data and central bank's accounts;</li> <li>• enhance coverage of the government's Treasury Single Account;</li> <li>• establish new accounting model and chart of accounts;</li> <li>• reintroduce expenditure controls (preaudit and commitment recording/control);</li> <li>• develop an integrated Financial Management Information system (GFMIS) embracing all levels of government (longer term).</li> </ul>	Aug. 2002/Aug. 2004	<ul style="list-style-type: none"> <li>• <b>Mostly World Bank</b> (The Bank finances the services of an international private consulting firm);</li> <li>• IMF (FAD: short-term "ad-hoc" missions).</li> </ul>	
<p><b>4.3 Audit</b></p> <ul style="list-style-type: none"> <li>• develop capacities of the Supreme Audit Institution (SAI).</li> </ul>	Aug. 2002/Aug. 2004	<ul style="list-style-type: none"> <li>• <b>World Bank</b> (finances the services of an international private consulting firm).</li> </ul>	
<p><b>4.4 Procurement</b></p> <ul style="list-style-type: none"> <li>• restore procurement functions in the MoF and line-ministries.</li> </ul>	Aug. 2002/Aug. 2004	<ul style="list-style-type: none"> <li>• <b>World Bank</b> (finances the services of an international private consulting firm).</li> </ul>	
<p><b>5 Payroll and civil service reform</b></p>			
<p><b>5.1 Payroll preparation</b></p> <ul style="list-style-type: none"> <li>• build capacity in the central government and provinces to prepare ministerial and provincial payroll (training and basic computerization).</li> </ul>	Sep. 2002/Sep. 2003	Not determined yet.	

## Afghanistan: Technical Assistance in Fiscal Management

Requirements	Dates/Timing	Provider	Nature of TA
<b>5.2 Payroll preaudit and verification</b> <ul style="list-style-type: none"> <li>• develop a database of legitimately employed staff;</li> <li>• establish payroll recording systems in line-ministries and provinces;</li> <li>• train comptrollers in line-ministries and provinces.</li> </ul>	Sep. 2002/Sep. 2004	<ul style="list-style-type: none"> <li>• World Bank (payroll adviser);</li> <li>• DFID (payroll database);</li> <li>• Possibly the EU.</li> </ul>	<ul style="list-style-type: none"> <li>• 1 or 2 resident experts.</li> </ul>
<b>5.3 Payroll processing</b> <ul style="list-style-type: none"> <li>• prepare monitoring reports in the MoF;</li> <li>• identify separately police, military, and staff working in government enterprises;</li> <li>• establish a specialized payroll unit in the MoF (longer term);</li> <li>• move towards computerization (longer term).</li> </ul>	Sep. 2002/Sep. 2004	<ul style="list-style-type: none"> <li>• World Bank (through financial management and ARTF monitoring agents).</li> </ul>	
<b>5.4 Payroll audit</b> <ul style="list-style-type: none"> <li>• introduce ex post audit to ensure that payments are received by intended beneficiaries.</li> </ul>	Sep. 2002/Sep. 2004	<ul style="list-style-type: none"> <li>• World Bank (through audit agent).</li> </ul>	
<b>5.5 Civil service and pension reform</b> <ul style="list-style-type: none"> <li>• decompress salary scale;</li> <li>• implement pension reform;</li> <li>• train comptrollers in line-ministries and provinces.</li> </ul>	Sep. 2002/Sep. 2004	<ul style="list-style-type: none"> <li>• World Bank (payroll adviser).</li> </ul>	<ul style="list-style-type: none"> <li>• 1 resident expert.</li> </ul>
<b>6 Macro-fiscal coordination</b> <ul style="list-style-type: none"> <li>• establish macroeconomic projection and analysis capacities in the MoF;</li> <li>• ensure coordination between DAB, CSO, and MoF on macroeconomic analyses</li> </ul>	Oct. 2002/continuing	<ul style="list-style-type: none"> <li>• US Treasury;</li> <li>• USAID;</li> <li>• AsDB</li> </ul>	<ul style="list-style-type: none"> <li>• 1 financial adviser to the MoF;</li> <li>• 1 macro-economic resident expert.</li> </ul>
<b>7 Fiscal decentralization</b> <ul style="list-style-type: none"> <li>• define tax and expenditure assignments between the different levels of government;</li> <li>• restore tax-sharing and equalization systems between provinces.</li> </ul>	Not yet determined.	<ul style="list-style-type: none"> <li>• USAID;</li> <li>• World Bank</li> </ul>	Not yet determined.

Islamic State of Afghanistan: Financial Sector Technical Assistance

	Requirement	Timing	Provider	Nature of TA
<b>I. Da Afghanistan Bank—Central Bank Modernization: Requirements for Investment and Technical Assistance</b>				
<b>I.1</b>	<b>HR issues</b>			
I.1.1	Personnel policies and procedures; personnel assessment and development; payroll cleanup.	Aug. 2002	Provisionally DFID (Adam Smith Institute)	Resident experts
<b>I.2</b>	<b>IT and communications</b>			
I.2.1	DAB participation in intragovernment IT and internet network.	Aug. 2002	World Bank	Mission and peripatetic experts
I.2.2	Support for launch of computers under 2.1, including training.	Aug.–Dec. 2002	Provisionally DFID (Adam Smith Institute)	Resident experts
I.2.3	Computers for banking supervision, accounting, payments.			Peripatetic experts
<b>I.3</b>	<b>Organizational modernization</b>			
I.3.1	Structure, work management, and physical and human resource requirements: advice on plan and implementation.	Oct. 2002	Provisionally DFID (Adam Smith Institute)	Mission and peripatetic and resident experts
<b>I.4</b>	<b>Policy issues and implementation</b>			
I.4.1	Central Banking Law: drafting and advice to reach text approved by DAB and Afghan authorities and enactment as a Presidential Decree or law.	As soon as possible	IMF	Mission
I.4.2	Banking Law: drafting and advice to reach text approved by DAB and Afghan authorities and enactment as a Presidential Decree or law.	As soon as possible	IMF	Mission

Islamic State of Afghanistan: Financial Sector Technical Assistance

	<b>Requirement</b>	<b>Timing</b>	<b>Provider</b>	<b>Nature of TA</b>
I.4.3	Currency Law and Payments Law: drafting and advice to reach text approved by DAB and Afghan authorities and enactment as a Presidential Decree or law.	As soon as possible	IMF	Mission and peripatetic expert
I.4.4	Financial Services Law: drafting and advice to reach text approved by DAB and Afghan authorities and enactment as a Presidential Decree or law.	?	IMF	Mission
I.4.5	Banknote Exchange: advice on policy and implementation.	Jul.-Oct. 2002	IMF on policy; Deutsche Bundesbank on implementation	Mission and peripatetic experts
I.4.6	Monetary policy analysis and decision making: advice and capacity building from IMF.	Ongoing	IMF	Mission and peripatetic experts
I.4.7	Monetary policy instruments and policy implementation: advice and capacity-building from the IMF and Deutsche Bundesbank.	Ongoing	IMF/Deutsche Bundesbank	Mission and peripatetic experts
I.4.8	Statistical collection and analysis with special relevance to the balance of payments: advice and capacity-building.	Ongoing	IMF	Resident expert
<b>I.5</b>	<b>Internal audit</b>			
I.5.1	Advice on procedures and their implementation.	?	Bundesbank	Peripatetic expert
<b>I.6</b>	<b>Buildings and facilities</b>			
I.6.1	Advice on a phased modernization/disposal plan, taking account of any short-term improvements made for payments purposes.	Not before decision on DAB strategy	?	Mission and peripatetic experts



Islamic State of Afghanistan: Financial Sector Technical Assistance

	Requirement	Timing	Provider	Nature of TA
<b>II. DAB Banking Supervision Function: Requirements for Investment and Technical Assistance</b>				
<b>II.2</b>	<b>Advisors</b>			
II.2.1	Long-term advisor to work with IMF peripatetic advisor to advise on procedures and methods for licensing, on-site examination and off-site monitoring, including manuals as required, to lead initial on-site inspections to assist the department's inspectors to learn on the job, and to provide continuous advice and training as required.	Start Sep./Oct. 2002	DFID, Adam Smith Institute for 6 man months  Possibly USAID (FSVC)	Resident expert
II.2.2	On-site examination specialist to give further advisory and training support, particularly during the initial round of inspections.	Start Sep./Oct. 2002	DFID, Adam Smith Institute	Resident experts
<b>II.3</b>	<b>Materials</b>			
II.3.1	Access to guidance materials, operating procedures and manuals from Basle Committee, IMF, Bank of England, Iranian Banking Institute (Farsi).	Ongoing	IMF, DFID	Mission and resident experts
<b>III. DAB Accounting Function: Requirements for Investment and Technical Assistance</b>				
<b>III.1.</b>	<b>Short-term stop-gap improvements</b>			
III.1.1	Computer facilities for input; processing and management of existing accounting arrangements on stop-gap basis; training of staff to use computers; operate input system; and access and use of financial information.	As soon as possible	Provisionally DFID (Adam Smith Institute)	Resident experts
<b>III.2.</b>	<b>Accounting law/decree</b>			
III.2.1	Review of legal basis for IAS accounting reform in: a) DAB; and b) Commercial banks	Sep. 2002	Provisionally DFID (Adam Smith Institute)	Resident experts

Islamic State of Afghanistan: Financial Sector Technical Assistance

	<b>Requirement</b>	<b>Timing</b>	<b>Provider</b>	<b>Nature of TA</b>
<b>III.3</b>	<b>IAS accounting in DAB</b>			
III.3.1	Adoption of IAS-based Chart of Accounts.	Sep./Oct. 2002	IMF	Peripatetic experts
III.3.2	Interim work to bring DAB accounts for the year ending March 2003 as close as possible to IAS standards, prior to development of full IAS reform of the system.	Ongoing	IMF	Peripatetic experts
III.3.3	IAS accounting system for DAB (planning, design, development, and implementation).	2002-04	IMF  Provisionally DFID (Adam Smith Institute) and others	Resident expert
<b>III.4.</b>	<b>IAS accounting in commercial banks</b>			
III.4.1	Adoption of IAS-based Chart of Accounts.	Jan./Feb. 2003	IMF	Peripatetic experts
III.4.2	IAS accounting in commercial banks (planning, design, development, and implementation).	2002-05	IMF  Possibly World Bank and USAID	Peripatetic experts
<b>IV. DAB Payments Function: Requirements for Investment and Technical Assistance</b>				
<b>IV.1</b>	<b>Infrastructure: buildings and vaults repaired or modernized</b>			
IV.1.1	Kabul province (HQ and 10 branches) and 6 main provincial branches ("hubs"): vault refurbishment and security doors as necessary.	By Sep./Oct. 2002	Perhaps EU	Peripatetic experts
IV.1.2	Other branches as requirements are identified.	By end Oct. 2002	?	?

Islamic State of Afghanistan: Financial Sector Technical Assistance

	Requirement	Timing	Provider	Nature of TA
IV.2.	<b>Transport: secure vehicles</b>			
IV.2.1	Armored security vehicles for cash delivery between DAB HQ, airports, and branches, if possible supplemented by air transport.	Aug.–Sep. 2002	?	?
IV.3.	<b>Communications and office equipment for payments work: short term</b>			
IV.3.1	Satellite voice and data transmission facilities for DAB HQ and hubs and training.	Aug.–Sep. 2002	Possibly DFID	?
IV.3.2	SWIFT access for DAB and training.	Aug.–Sep. 2002	USAID	Peripatetic experts
IV.4.	<b>Accounting and information processing systems</b>			
IV.4.1	Advice on procedures and support for implementation of computer-based accounting and cash management at HQ and branches, and transfers between HQ and branches.	Sep. 2002–Jan 2003	?	?
IV.5.	<b>Modern noncash payments system: medium–long term</b>			
IV.5.1	Prepare master plan for development of modern payments system, moving from reliance on cash to bank-focused facilities ultimately making transfers electronically.	Oct.–Dec. 2002	AsDB	?
IV.5.2	Tender for contract to implement the master plan resulting from 5.1 to provide system facilities and facilities within DAB, requiring investment in computer hardware and software, telecommunications facilities (using satellite or landline facilities as available and appropriate by this stage) and training of staff within DAB.	2003–05	?	?

### **Main Features of the Tax Regime in Afghanistan**

The Afghan existing tax system is based mainly on the Income Tax Law of 1965 and the Customs Law of 1974 as amended:

- The 1965 income tax law includes provisions for individual and corporate income taxation, business receipts tax (a form of sales tax on corporate entities' turnover), withholding taxes on imports and exports, and various fixed (presumptive) taxes. It is currently difficult to assert with certainty all details of the law and its application: the law has been amended by 18 separate decrees since 1965 and not all amendments have been included in a comprehensive consolidated version. In addition, tax administrators at the ministry of finance have different views about the applicable tax provisions. Finally, income tax data is not currently classified according to the revenue classification of the government due to weak administrative capacities.
- The customs law currently available specifies import duties, together with the fees and charges levied on international trade and transactions. In contrast to the income tax law, all changes to the customs law have been consolidated in the law currently available. However, its application in practice seems to vary significantly in different parts of the customs administration.
- There is no excise tax, although certain excisable goods are subject to higher customs duties. There appears to be a "monopoly tax" on petroleum products equal to 20 percent of the import value (or 30 percent of the imports if the government takes the tax in kind.)

The various taxes currently collected under the income tax and customs laws are summarized in the table below.

Afghanistan: Tax Summary  
(As of June 2002)

Tax	Rate	Taxable Base	Remarks
Corporate income tax (CIT)	Flat rate of 20 percent.	Net profits of corporations and limited liability companies.	<ul style="list-style-type: none"> <li>• Most expenses incurred to derive gross income are deductible.</li> <li>• Firms are allowed to deduct losses incurred in previous years.</li> <li>• The CIT is collected mostly in the form of withholding taxes on imports and exports creditable against the income tax (see infra).</li> </ul>
Personal income tax (PIT)	Progressive schedule comprising 21 brackets, with rates varying from 4 percent to 60 percent.	Income of employees (salaries and wages) and profits of most noncorporate entities.	<ul style="list-style-type: none"> <li>• The wage PIT which used to be collected on government's and private sector's employees (wage withholding tax) seems to have disappeared at the beginning of the 1990s. Most of the PIT is now collected in the form of fixed presumptive taxes levied on individuals engaged in business or commerce (see infra).</li> </ul>
Business receipts tax (BRT)	Two rates: <ul style="list-style-type: none"> <li>• 2 percent: gross receipts of legal persons engaged in domestic business.</li> <li>• 2½ percent: receipts of legal persons engaged in import and/or export operations.</li> </ul>	Gross receipts of corporations and limited liability companies.	<ul style="list-style-type: none"> <li>• The BRT comes in addition to the CIT on taxable profits.</li> <li>• The BRT must be paid within 6 months at the end of the fiscal year, irrespective of whether the business makes a profit or a loss.</li> <li>• Imports are not taxed under the BRT but exports are.</li> <li>• The BRT raises greater revenue than the CIT.</li> </ul>
Fixed withholding taxes on imports and exports (creditable against the income tax).	<ul style="list-style-type: none"> <li>• Imports: 4 percent for licensed importers and 3 percent for unlicensed importers.<sup>1/</sup></li> <li>• Exports: 4 percent for licensed exporters and 2 percent for unlicensed exporters.<sup>2/</sup></li> </ul>	<ul style="list-style-type: none"> <li>• Unincorporated exporters or importers.<sup>3/</sup></li> <li>• The tax is based on the duty-paid cost of imports/exports.</li> </ul>	
Presumptive taxes in lieu of the income tax.	<ul style="list-style-type: none"> <li>• Retailers: based on a 170 category classification of businesses. Taxation depends on the types of</li> </ul>	Estimated gross receipts of corporations and limited liability	The major reasons for using presumptive taxation in lieu of income tax are simplification, reducing compliance costs for the taxpayer and the tax administration, and combating tax

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	<ul style="list-style-type: none"> <li>goods sold, the size and location of businesses.</li> <li>• Limited list of specific businesses (e.g., cinemas, theaters, mills). 10 percent on estimated turnover.</li> <li>• Transportation businesses (taxis, buses, etc.). Lump sum depending on the type, size, and characteristics of the vehicles used.</li> <li>• Government contractors. From 1 percent to 8 percent of the price of the goods and services purchased by the government.</li> </ul>	companies (except importers and exporters).	evasion. <sup>4/</sup>
Import duties	25 tariff bands with rates ranging from 7 percent to 150 percent allocated across 888 tariff headings.	Cost, insurance, and freight (CIF) in Afghani value, using an exchange rate of Af 4,500 per U.S. dollar (a lower rate is used in Herat).	<ul style="list-style-type: none"> <li>• Customs tariffs currently in use were introduced in 2000.</li> <li>• Imports of petroleum, diesel, and kerosene for transportation purposes are exempt from duty (but possibly to a "monopoly tax").</li> <li>• The exchange rate used for valuation purpose is well below the open market rate (approximately Af 38,000–40,000 per U.S. dollar).</li> </ul>
Fees and charges	<ul style="list-style-type: none"> <li>• Chamber of Commerce license and valuation of imports/exports: 2.5 percent.</li> <li>• Red Crescent fee: 2.5 percent.</li> <li>• Ministry of Commerce's permit fees (e.g. cars US\$200 to US\$400, cigarettes US\$2.5 per case).</li> </ul>	For the Chamber of Commerce and the Red Crescent: CIF invoice value of exports or imports.	In addition to customs duties, there are numerous fees, charges, and other taxes levied on imports and exports that add significantly to the cost of international trade.

1/ For unlicensed importers, this tax is not creditable against the income tax.

2/ For unlicensed exporters, this tax is not creditable against the income tax.

3/ If they are incorporated, they only pay the CIT.

4/ In a presumptive tax, the concept of income tax base is replaced by indicators that are more easily measured.