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Islamic State of Afghanistan: 2003 Article IV Consultation—Staff Report; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Islamic State of Afghanistan

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of the 2003 Article IV consultation with the Islamic State of Afghanistan, the following documents have been released and are included in this package:

- the staff report for the 2003 Article IV consultation, prepared by a staff team of the IMF, following discussions that ended on **September 13, 2003,** with the officials of the Islamic State of Afghanistan on economic developments and policies. **Based on information available at the time of these discussions, the staff report was completed on November 5, 2003**. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.

- a Public Information Notice (PIN) summarizing the **views of the Executive Board as expressed during its November 21, 2003 discussion** of the staff report that concluded the Article IV consultation.

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

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

Islamic State of Afghanistan—Rebuilding a Macroeconomic Framework for Reconstruction and Growth

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

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INTERNATIONAL MONETARY FUND

ISLAMIC STATE OF AFGHANISTAN

Staff Report for the 2003 Article IV Consultation

Prepared by the Staff Representatives for the 2003 Consultation with the Islamic State of Afghanistan

(In consultation with other departments)

Approved by Mohammad Shadman-Valavi and Matthew Fisher

November 5, 2003

- The 2003 Article IV consultation discussions were held in Kabul during May 25–June 7 and August 24–September 13, 2003. The team comprised Messrs. Bennett (head), van Rooden (both MCD), Dicks-Mireaux (PDR), Kalfon (FAD), and Ms. Tomilloso (assistant, MCD). The team was assisted by the Resident Representative, Mr. de Schaetzen. Mr. Mirakhor, Executive Director, participated in some of the discussions. The team also held discussions in Herat.
- The mission met with Vice President Arsala, Minister of Finance Ghani, Minister of Education Qanooni, Minister of Planning Mohaqqeq, Minister of Commerce Kazemi, Da Afghanistan Bank (DAB) Governor Ahady, Governor Khan of Herat province, and various senior government and central bank officials in Kabul and Herat. The mission also met with UN Special Representative Brahimi.
- The last Article IV consultation with Afghanistan was concluded in 1991. Since then, Article IV consultations could not be undertaken because of the unsettled political and security situation. The resumption of Article IV consultations provides an important signal of the country's normalization and reintegration into the international community.
- Afghanistan is an Article XIV country. The authorities are currently implementing a liberal exchange and trade system, though they still need to formalize the new regime through the adoption of new laws and regulations, for which they have asked for technical assistance from the Fund.
- Data limitations are severe. While the quality of fiscal and monetary data has improved significantly over the last two years, most data presented here are staff estimates. There are very limited (and poor quality) data outside the fiscal and monetary areas. Data are sufficient for basic surveillance, however.
- The principal authors of this report are Adam Bennett and Ron van Rooden.

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List of Acronyms

AsDB	Asian Development Bank
AFMIS	Afghanistan's Management Information System
AIA	Afghan Interim Administration
ARTF	Afghanistan Reconstruction Trust Fund
ATA	Afghan Transitional Administration
DAB	Da Afghanistan Bank
DDR	Disarmament, demobilization, and reintegration
EPCA	Emergency Post-Conflict Assistance
ISAF	International Security Assistance Force
LOTFA	Law and Order Trust Fund for Afghanistan
LTU	Large taxpayer unit
MoF	Ministry of Finance
NDB	National Development Budget
NDF	National Development Framework
SMP	Staff-monitored program
PRGF	Poverty Reduction and Growth Facility
UN	United Nations
UNODC	United Nations Office on Drugs and Crime

Executive Summary

The authorities have made solid progress in rebuilding institutions and implementing sound economic policies, although huge challenges still remain. Fiscal policy has been characterized by a strong commitment to respect fiscal discipline and refrain from monetary financing. Significant progress was made in improving expenditure management. An ambitious customs policy reform package is about to be approved and is to be followed by a reform of tax policy and administration. A new currency was launched in late 2002 and monetary policy has been restrained since then. As a result, prices and the exchange rate have been broadly stable in 2003. New financial sector legislation was adopted in the summer of 2003, granting the central bank autonomy and paving the way for establishing a modern banking sector.

The economy shows strong signs of recovery. This reflects not only the end of major hostilities, but also the end of a prolonged drought and the impact of sizable donor assistance and sound economic policies. But while the formal economy is recovering, so is the informal economy, in particular the production of opium.

The economy should continue to recover during the next few years, but three serious risks remain. First, the security situation remains very fragile. Poor security complicates macroeconomic management and prevents reconstruction taking hold in most areas outside Kabul. Second, the reemergence of opium production is having a profound impact on the economy and there is a risk that its pervasive corrupting influence could become entrenched. Third, there is a risk that the financial support of international donors, which has been so critical to the recovery so far, could weaken prematurely.

Ultimately, however, Afghanistan's outlook—and the donors' willingness to support the country—will depend on the authorities' ability to maintain political as well as macroeconomic stability and to adopt strong policy measures. The authorities recognize that sustainable growth over the medium term will require substantial private investment, as this will increasingly need to take the place of official assistance. They realize that stability and security is key to fostering investment. The authorities remain strongly committed to sound economic policies and establishing a liberal and open market-oriented economy.

The Fund has been providing extensive policy advice and technical assistance to the authorities. It is envisaged that Afghanistan will enter into a staff-monitored program (SMP) in the near future that would allow the authorities to build on their already good track record and establish an adequate level of capacity for a possible future upper credit tranche arrangement with the Fund. Alternatively, emergency post conflict assistance could be considered if the conditions for such assistance were present and the authorities were to request it.

I. Introduction

1. **The starting point for Afghanistan's reconstruction at the end of 2001 was unusually dire.** After more than 20 years of conflict, interspersed with earthquakes and drought, the new Afghan authorities confronted their task with largely defunct government and financial institutions, weak administrative capacity, and the widespread destruction of the country's infrastructure (see Box 1). Social indicators were among the worst in the world.

2. **With the help of the international community, the authorities have made impressive strides in rebuilding institutions and implementing sound economic policies.**[1] The economy shows strong signs of recovery. A new currency was successfully launched, and since the completion of this operation the exchange rate has been stable and inflation close to zero. Monetary policy has been restrained, supported by the adherence to strong fiscal discipline. Important institutional and economic reforms have been undertaken, while progress has continued to be made in implementing the political road map set out in Bonn in December 2001 (see Box 2).

3. **But three serious risks remain.** First, the security situation remains very fragile (see Box 3). Poor security complicates macroeconomic management and prevents reconstruction taking hold in most areas outside Kabul. Second, while the formal economy is recovering, so is the production of opium. This is having a profound impact on the economy and there is a risk that its pervasive corrupting influence could become entrenched. Third, as often happens in post-conflict cases, there is a risk that the financial support of international donors, which has been so critical to the recovery so far, could weaken prematurely.

Box 1. Starting Conditions in the Ministry of Finance and the Central Bank

Budget policy by the end of 2001was limited to the payment of salaries, which were subject to considerable delays and arrears. The tax base had shrunk and customs revenue was withheld by the provinces. Line-ministries and provincial offices (*Mustufiats*) of the Ministry of Finance (MoF) operated bank accounts, in the regional branches of the central bank and state-owned banks, outside the purview of the MoF. There was no reconciliation between the government bank accounts and treasury accounts in the MoF. The reporting system between the center and the *Mustufiats* had broken down. No government accounts had been prepared since 1989/90. Files were missing, including all records of the government's external debt.

Afghanistan's financial system had largely ceased to function by the end of 2001. The country had become almost entirely cash-based, with banks having largely stopped functioning. Most people used the informal "*Hawala*" system to change and transfer money. Confidence in the national currency, the Afghani, was low, as it had lost much of its value following years of high inflation. Moreover, the central bank, DAB, had little or no control over the issuance of currency. At least three versions of the national currency were circulating in the country. Reflecting the limited confidence in the national currency, foreign currencies were also widely used. Communication with and reporting by DAB's regional branches had broken down. No balance sheet information was available for the central bank and what little recording took place used outdated procedures. Little or no capacity existed within DAB to design and conduct monetary policy or to supervise banks.

[1] For details about the role of the Asian Development Bank (AsDB) and the World Bank in Afghanistan, see IMF Country Report No. 03/299 (9/21/2003), Islamic State of Afghanistan—Rebuilding a Macroeconomic Framework for Reconstruction and Growth, Boxes I.1 and I.2, as well as Appendix II to this paper.

Box 2. Bonn Agreement

On December 5, 2001, under the auspices of the United Nations (UN), an agreement was reached in Bonn between various Afghan factions providing a road map for the creation of a peaceful, democratic state. An Afghan Interim Administration (AIA) was appointed, headed by President Karzai, 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 re-elected Mr. Karzai as President and chose a new Afghan Transitional Administration (ATA) that, as stipulated in the Bonn agreement, will remain in office until democratic elections can be held in mid-2004. In addition to preparing the elections (with the help of the UN), the Bonn agreement also charged the ATA with preparing a new constitution. Following a broad consultation of the Afghan population during the summer of 2003, a draft constitution will be submitted to a Constitutional Loya Jirga in December 2003.

Box 3. International Security Efforts

Under the Bonn agreement, it was acknowledged that responsibility for security throughout the country resides ultimately with the Afghan authorities themselves. However, provision was made for the support of the international community toward the establishment and training of new Afghan security and armed forces. Assistance in building a new national army is provided mostly by the United States, while Germany has taken the lead in improving the police forces. Moreover, on December 20, 2001, the UN Security Council authorized the establishment of the International Security Assistance Force (ISAF) and for it to operate in Kabul and its surrounding areas. On October 13, 2003, the security council expanded the mandate of ISAF to allow it, as resources permit, to operate in the rest of the country as well.

Establishing nationwide security is also contingent upon an effective disarmament, demobilization, and reintegration (DDR) of the existing militias. The DDR process is only just starting, however, with pilot projects under way to disarm 1,000 ex-combatants in each of six major cities.

II. Recent Economic Developments[2]

A. Output and Prices

4. **The economic recovery is strong, but comes from a very low level.** Real GDP, excluding opium production, is estimated to have grown by almost 30 percent in 2002/03, driven by donor assistance and the end to a prolonged drought (Table 1).[3] The impact of international assistance (and also of opium revenues), much of which has been spent domestically, is most visible in services and construction, which are expanding rapidly in urban centers. With Afghanistan being a largely agricultural economy, the agricultural sector contributed significantly to the recovery. Cereal production rose by over 80 percent in 2002/03, benefiting from increased rainfall and expanded acreage under cultivation.

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[2] A more detailed description of recent economic developments can be found in IMF Country Report No. 03/299, Chapter II.

[3] The Afghan solar year 1381 ran from March 21, 2002 until March 20, 2003. The solar year 1382 runs from March 21, 2003 until March 19, 2004. The Afghan fiscal year coincides with the solar year.

Agricultural production continued to increase this year—cereal production grew by a further 50 percent—and combined with further strong growth in services and construction, GDP is expected to grow by 20 percent in 2003/04.

5. **Opium production also recovered dramatically.** The ban on poppy cultivation imposed by the Taliban in 2000 was very successful, but in 2002 opium production was estimated by the United Nations Office on Drugs and Crime (UNODC) to have reached 3,400 tons, a level similar to that of the late 1990s. Production in 2003 increased to 3,600 tons. The value of exports of opium and opium derivatives accruing in 2002 to Afghan farmers and traders was estimated by the UNODC to have been about \$2.5 billion, making it by far the largest source of export earnings from domestic sources. Revenues fell slightly in 2003 to \$2.3 billion, reflecting lower prices.[4] The opium sector has a profound impact on the economy and may account for about half of overall GDP. With climatic conditions well suited for the cultivation of poppies and following many years of conflict and lawlessness, as well as a lack of alternative livelihoods, opium has become the main source of income for many farmers.

6. **Considerable progress has been made toward achieving low inflation.** In the first 8 months of 2002, inflation rates for Kabul averaged 3.5 percent per month (Figure 1). But uncertainty regarding the introduction of the new currency caused the exchange rate to depreciate sharply and the price level to jump by 60 percent during September–November 2002 (Figure 2). When exchange rate tensions eased in late 2002, prices came down as well, although by somewhat less than the appreciation of the Afghani. Following the successful completion of the currency conversion in early January 2003 and reflecting sound monetary and fiscal policies, prices have remained broadly stable so far in the first 10 months of 2003 (the average monthly inflation rate has been close to zero).

B. Fiscal Policy

7. **During 2002–03, the authorities have shown a strong commitment towards fiscal discipline and refrained from monetary financing (the "no-overdraft rule").**[5] This implied that government spending was constrained to the amount of domestic revenues the authorities were able to collect and the amount of donor assistance available. The government budget consists of an operating budget, which covers current expenditures and some capital expenditures aimed at quick repairs, and a development budget, covering reconstruction as well as humanitarian assistance projects.

[4] See "Afghanistan, Opium Survey 2003," UNODC, October 2003 for further details.

[5] Small overdrafts occurred temporarily in the third quarter of 2002/03, reflecting weak cash management at the MoF and poor monitoring of the government's accounts at DAB.

Operating budget

8. **The government's first operating budget, for 2002/03, was in essence a very rudimentary going-concern budget.** The bulk of expenditures was on wages and salaries (including in the provinces), while the rest was mostly on office refurbishment and basic equipment. The actual provision of public services was still quite limited, especially outside Kabul. After a slow start, the execution of the 2002/03 operating budget accelerated in line with the development of administrative capacity at the MoF and the more rapid disbursement of donor financing (Table 2). In Afghani terms, expenditures for 2002/03 are estimated to have reached over 90 percent of budgeted amounts. In U.S. dollars terms, this amounted to $349 million—about 8.5 percent of non-opium GDP—significantly less than the $460 million envisaged, due to the depreciation of the Afghani during the year compared to the assumption made at the time of formulating the budget. This depreciation and the associated inflation, however, meant that government expenditures in effect were squeezed in real terms in 2002/03.

9. **Domestic revenues were much higher than expected in 2002/03, at $132 million (3 percent of non-opium GDP) compared to $83 million envisaged in the budget.**[6] Combined with the depreciation of the Afghani, this reduced the 2002/03 financing requirement to an estimated $217 million, considerably less than the budgeted $400 million. The financing requirement was largely met by available donor grants—the bulk of which were channeled through the Afghanistan Reconstruction Trust Fund (ARTF)—and to a lesser extent by donor loans and one-off revenues, such as the sale of telecom licenses and the receipt of accumulated overflight rights.

10. **The execution of the 2002/03 operating budget was hampered by the fiscal system's lack of cohesion.** Only a very small amount of the revenues collected by provinces were transferred to the center ($36 million). Also, no reliable information was available on provincial nonwage expenditures, which therefore had to be estimated by the MoF at $89 million.[7]

11. **The preparation of the 2003/04 operating budget showed a marked improvement compared to the previous year.** The 2003/04 budget envisages expenditures equivalent to $550 million (11 percent of non-opium GDP), an increase of more than 50 percent over actual expenditures in the previous year. This reflects not only the enormous needs in the security, health, and education sectors following 23 years of conflict, but also the slow but steady increasing capacity to provide public services. Wages are budgeted to account for half of expenditures. Domestic revenues are budgeted to reach $200 million, leaving $350 million to be covered by foreign assistance (Table 3). Of this, $250 million in civilian expenditures is

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[6] Revenue assumptions for the 2002/03 operating budget were conservatively based on revenue collection observed in the first months following the fall of the Taliban.

[7] The difference between revenues reported by the provinces and (net) funds transferred by the provinces to the center.

expected to be financed through the ARTF, and pledges received so far are close to the amount needed. Expenditures for the existing army and police forces—largely wages and some expenditures to rebuild police stations—are to be financed from domestic revenues and by $100 million in donor assistance channeled through the Law and Order Trust Fund for Afghanistan (LOTFA) and the Army Trust Fund, but pledges thus far fall well short of this amount.[8]

12. **Preliminary data suggest that expenditures were again off to a slow start in 2003/04.** This was initially on account of delays in ministerial spending submissions for the first quarter and subsequently because of delays in payroll disbursements to the provinces and security forces. Revenue collection in the first quarter showed a considerable improvement compared to the same period last year. Moreover, almost 70 percent of the revenues reported by the provinces in the first quarter were transferred to the center. This followed the reaffirmation by provincial governors in May 2003 of their commitment to adhere to the budget law and remit provincial revenues to the center.

Development budget

13. **Assistance for reconstruction in 2002/03 was much less than aimed for at the donor conference held in Tokyo in January 2002.** According to the preliminary needs assessment prepared for the Tokyo conference, $4.9 billion would be needed for reconstruction during the first 2½ years. The Tokyo conference generated $4.5 billion in pledges for this period, but much of this was dedicated to humanitarian assistance. Of the more than $1.5 billion in assistance disbursed by donors since the beginning of 2002—in addition to support for the government's operating budget—almost two-thirds was humanitarian assistance. Although an early focus on humanitarian aid is warranted given a country's most urgent needs following the end of conflict, this has meant that actual reconstruction is still proceeding slowly. Very little of the amounts disbursed in 2002–early 2003 went through the government budget—a first provisional development budget was presented in the fall of 2002—reflecting largely the government's still very limited administrative capacity, particularly in line-ministries.

14. **In 2003/04, most donor assistance for reconstruction and humanitarian assistance is expected to be channeled through the government's development budget.** The 2003/04 National Development Budget (NDB) provides a reconstruction roadmap consistent with the strategic priorities expressed in the authorities' National Development Framework (NDF; see Box 4). It includes $1.8 billion of humanitarian and reconstruction (donor) projects, to be financed by donor grants, mainly focusing on infrastructure

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[8] Expenditures for building the new Afghan army and for DDR are outside the operating and development budgets. The majority of capital expenditures to improve the police forces are in the development budget. The costs of ISAF and U.S. military operations are the responsibility of the respective governments.

rehabilitation, health, social protection, assistance to refugees, and education.[9] Commitments received so far are still about $500 million short of this amount. Moreover, in the first half of 2003/04, disbursements against the development budget were much lower than targeted (about 30 percent), reflecting also the lack of security in the provinces, which hampered the execution of a number of large projects, and the still limited implementation capacities in line-ministries. Nevertheless, major achievements so far included a sharp increase in school enrollment, assistance to more than 500,000 refugees and 200,000 internally displaced people, large vaccination and water sanitation campaigns in the provinces, and the start of the reconstruction of the roads linking the main Afghan cities.

Box 4. National Development Framework

The authorities strengthened their responsibility to coordinate and manage the reconstruction effort by adopting a National Development Framework (NDF) in April 2002. The overall objectives of the NDF are poverty reduction and the creation of economic opportunity. The NDF, which was prepared through extensive consultations between the MoF, line-ministries, and the Cabinet, 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.

The NDF 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 these three pillars a total of twelve 12 sectoral programs has been developed and individual consultative groups have been established that provide the framework for identifying, coordinating, and implementing donor-funded projects. This process culminated in the National Development Budget (NDB), which in essence is a comprehensive agenda of donor-funded humanitarian and reconstruction projects. The 2003/04 NDB marked full ownership by the government of the development agenda and made the budget the focal point for decision-making on government policy and the allocation of domestic and external resources. For more detailed information, see IMF Country Report No. 03/299, Chapter III.

Fiscal reform

15. **The MoF has made significant progress in improving fiscal management** (see Box 5). The biggest strides were made in improving expenditure management. The authorities have also made important progress toward fiscal transparency and accountability. In mid-2002, the World Bank provided grant support for an Emergency Public Administration Project to fund the hiring of qualified international contractors in the areas of

[9] See IMF Country Report No. 03/299, Chapter III, for more details on the 2003/04 development budget.

Box 5. Major Structural Reforms in 2002–03

The Afghan authorities have undertaken several major structural reform measures in the past 1½ years. These are described in detail in IMF Country Report No. 03/299. Among them, the most important are:

Fiscal reforms:

- With World Bank assistance and in line with FAD recommendations, a computerized system for expenditure recording, payment processing, and financial reporting has been developed in the MoF ("Afghanistan's Management Information System"; AFMIS), providing detailed information on expenditures paid at the center as well as revenue data. It also accelerated budget payments through automation of check printing. The AFMIS is now being progressively rolled out to the provinces.

- USAID-trained Afghan fiscal advisors have been assigned to all MoF provincial offices to assist provincial officials with financial reporting to the center. Satellite communication facilities are being set up in the largest of these provinces to facilitate exchange of information between the MoF and its regional offices.

- Following FAD recommendations, steps have been made toward progressive consolidation of government bank accounts in order to strengthen treasury control over cash flows and minimize idle cash balances in multiple bank accounts. All government bank accounts in the provinces have been closed and replaced in each province by two new accounts, one for revenues and the other for expenditures.

- The Cabinet recently approved a customs policy decree, consistent with FAD recommendations, to (a) mandate the use of the market exchange rate in customs valuation; (b) reduce the number of tariff bands from 25 to 5; and (c) lower the tariff rates from the current range of 0 to 150 percent to (five) rates ranging from 0 to 20 percent; this decree still needs to be signed by the president to come into force. Also adopted was a decree simplifying customs clearance procedures and setting out a comprehensive five-year plan to strengthen the administration of customs.

Financial sector reforms:

- A new currency was successfully introduced, with the help of international experts from the Fund (MFD, LEG, and MCD), USAID, the Bundesbank, and the UN. This was a crucial step in the authorities' efforts to establish financial stability. With the introduction of the new currency, DAB achieved full control over the printing and issuance of the national currency.

- A new central bank law and banking law were recently adopted. These laws—which were prepared with the assistance of LEG and MFD—provide a framework for an independent, yet accountable, central bank and the creation of a sound, modern financial system.

- Foreign exchange auctions were developed, with the assistance of MCD, in early 2002 to provide DAB with an instrument to control the rate of monetary expansion. Procedures have been progressively improved to improve the transparency and operations of the auctions.

- Significant progress has been made on improving the operational capacity of DAB, with the assistance of USAID and MFD, including computerization, steps to improve the domestic payments system, facilitating international payments, and setting up a banking supervision department.

financial management, government procurement, and audit to assist the authorities in the performance of these functions and to build local capacities in order to hand over these functions to the authorities as soon as possible. Problems remain, however, in the public finances of the provinces. While provinces have transferred larger amounts of revenues to the center so far in 2003/04 and have started to report nonwage expenditures, there is no mechanism in place to verify provincial revenues and expenditures.

16. **With improved financial management, the immediate focus of reform has now shifted toward increasing revenue mobilization.** To achieve this, the authorities have started modernizing customs and are about to approve an ambitious customs policy reform package. Key elements of this package include using the market exchange rate for customs valuation and streamlining tariffs. This is to be followed by a reform of tax policy and administration. The authorities are preparing draft decrees to: (a) reduce the top marginal taxrate for individuals and increase the personal exemptions; (b) restore wage withholding on higher-income employees; (c) introduce a rent tax and an airport departure fee; and (d) expand the business receipts tax to cover certain services provided to expatriates.[10] These decrees are expected to be submitted to the Cabinet by early 2004. In parallel, a large taxpayer unit (LTU) will be established in the MoF by end-December 2003, with the specific tasks of administering the personal income tax, business receipt tax, and new rent tax.

17. **Only limited progress has been made so far in civil service reform.** Although the size of the civil service appears not to be large relative to the population, there is a serious lack of professional capacity, pervasive patronage, and over-staffing. The current pay and grading system is inadequate to attract, retain, and motivate skilled civil servants. A civil service reform commission was established in mid-2002 and a recently approved decree introduced an interim additional salary allowance for specific positions in ministerial departments considered critical for reform (e.g., customs, tax).

C. Monetary and Exchange Rate Policy

18. **A major achievement of the Afghan authorities has been the successful introduction of the new currency** (see Box 5 above).[11] With this, DAB achieved full control over the printing and issuance of the national currency.[12] Replacing all banknotes in a post-conflict country like Afghanistan in a short period posed tremendous challenges. Logistical problems during the first weeks of the conversion period and growing nervousness

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[10] Hotels, restaurants, telecommunications, and rental vehicles.

[11] One new Afghani replaced 1,000 old Afghanis. See IMF Country Report No. 03/299, Box V.1 for details on the introduction of the new currency.

[12] The amount of currency in circulation is calculated as the amount of currency delivered by the printer, less the amounts remaining in DAB's Kabul vaults. Little or no information is available on a timely basis on amounts held in the vaults of DAB's branches and therefore, until adequate communications are established with the branches, currency that may be held there is assumed to be in circulation.

among the population about whether they would be able to convert old notes into new ones in time caused the Afghani to depreciate sharply in the fall of 2002. In mid-November, following foreign exchange auctions and the announcement of an extension of the banknote exchange period until January 2, 2003, the Afghani strengthened, stabilizing at about (new) Af 46 per U.S. dollar in January 2003. Despite the many difficulties, the authorities—assisted by the international community—managed to complete the changeover successfully on January 2, 2003, without major incidents.

19. **The conduct of monetary policy in Afghanistan is complicated by the widespread use of foreign currencies and the substantial uncertainties that surround economic prospects and relationships.** DAB developed a monetary program with the assistance of Fund staff aiming to control the domestic money supply (currency in circulation) as an intermediate target, although it recognizes the limitations of this approach in a highly dollarized economy.[13] The indicative monetary program for 2003/04 targets a rate of monetary expansion of 30 percent. DAB aims to partially offset the monetary expansion that stems from donor aid being converted into local currency by selling foreign exchange through its foreign exchange auctions to the informal money market dealers—the only market-based instrument available in the absence of a functioning banking system. In the absence of data to gauge money demand—which is also likely to undergo structural shifts—to help determine how much foreign exchange to auction, DAB has used movements in the exchange rate as an early indicator of changes in the relative demand for the domestic currency. Currency in circulation grew by 22 percent in the first nine months of 2003, and by 13 percent in the first half of 2003/04, both in line with the indicative monetary program (Table 4). The rate of monetary expansion varied widely from quarter to quarter, however, possibly reflecting the volatility of money demand and seasonal factors. Reflecting DAB's policy as well as the government's continued adherence to the no-overdraft rule, money demand was entirely met by an accumulation of foreign exchange reserves. DAB's foreign exchange reserves reached an estimated $568 million by late-September 2003.[14] Reserves covered almost three months of (estimated) imports (excluding imports for reexports) and more than covered domestic currency in circulation.

20. **Since the introduction of the new Afghani in early 2003, the central bank has placed greater emphasis on limiting exchange rate volatility.** DAB has aimed to keep the exchange rate within a fairly narrow range, although this range is not firmly set nor announced. Decisions regarding the timing and volume of foreign exchange auctions have become predominantly determined by exchange rate movements and less so by the rate of monetary expansion itself (although thus far the resulting rate of monetary expansion has been consistent with the monetary program). Reflecting this shift in emphasis, the exchange rate has fluctuated in a narrow range around Af 48 per U.S. dollar since the beginning of 2003.

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[13] The level of dollarization may have increased with the reemergence of the opium trade.

[14] Including $196 million in gold valued at $279 per ounce.

21. **A major step forward in financial sector development has been the recent adoption of new central bank and banking legislation.** The new laws—prepared with assistance from MFD and LEG—provide a framework for an independent, yet accountable, central bank and the creation of a sound financial system. This paves the way for further central bank modernization and the entry of new commercial banks into Afghanistan. The first three new (foreign) banks were recently licensed. No concrete steps have been undertaken so far to deal with the highly disfunctional and barely operational state-owned commercial and development banks, although plans for their possible restructuring are under consideration.

D. External Sector

22. **The exchange and trade system is in effect very liberal and open.** Many of the restrictive rules and regulations that applied in the past may, at least formally, still be in place, as it is unclear whether they have ever been amended or repealed. But the authorities do not wish to impose or enforce any of these restrictions—which in any event would be difficult—and are implementing a liberal exchange and trade system. Thus, available information suggests that the current system is free of restrictions.[15]

23. **Although data are extremely poor, the formal balance of payments for 2002/03 is estimated to have shown a small surplus, after grants and donor assistance** (Table 5). The composition of the balance of payments and its evolution reflect in large part the donor-financed reconstruction effort and the revival of private sector activity. A large current account deficit (before grants) is funded mainly by official transfers; official loan disbursements were small.

24. **Little is known about the balance of payments including opium, but it is likely to have been in significant surplus.** As noted, exports of opium and its derivatives are believed to have amounted to some $2.5 billion in 2002/03 and $2.3 billion in 2003/04; about half of this is estimated by the UNODC to have been accrued directly to farmers and the rest to (a much smaller number of) processors and internal traffickers (see Box 6).

[15] Afghanistan is also in the process of negotiating a number of transit trade agreements with neighboring countries. See IMF Country Report No. 03/299, Box II.2, for details.

Box 6. Opium and the Balance of Payments

Macroeconomic management in Afghanistan is made especially difficult on account of the growing influence of opium production.[1/] The production of opium and its derivatives is estimated to bring in the equivalent of some $2.3 billion into Afghanistan.[2/] Depending on one's estimates of the formal non-opium economy, this means that opium could account for some 40–50 percent of GDP. Not all the $2.3 billion will be spent in Afghanistan. Some of it—perhaps about half—will be saved in cash holdings (by farmers), or banked abroad (by the more well connected processors and internal traffickers). But a substantial amount is being spent domestically, raising the standard of living of farmers and financing what little private investment is taking place. This means that efforts to eradicate opium production could have a significant depressing effect on economic growth, as well as on progress toward alleviating poverty. To offset this, as well as increase the chances that eradication will succeed, it will therefore be necessary to undertake extensive programs to develop alternative livelihoods for farmers who would otherwise grow poppies, as well as provide social support. Such programs will cost money, and will also require additional security (as poppies tend to be grown in the areas where security is weakest). The eradication of opium could therefore generate a significant balance of payments need, over and above what is being generated by the reconstruction of Afghanistan's economy and infrastructure.

[1/] See Chapter II, Annex I of IMF Country Report No. 03/299 for a more extensive discussion of the role of opium in Afghanistan's economy.

[2/] This is the estimate for 2003/04. The value of this opium and its derivatives on the open international markets is more than 10 times this. Afghanistan supplies three-quarters of the world's opiates.

III. Report on the Discussions

A. Outlook

25. **The authorities and staff agreed that the economy should continue to recover during the next few years, provided that weather conditions remain favorable, the security situation does not deteriorate, and donor support continues.** Growth would mostly be concentrated in agriculture, reflecting ongoing repairs to irrigation systems and a better quality of inputs, and in the trade, services, and construction sectors, largely driven by donor inflows and the slow but steady improvement in incomes (including from opium production). In the authorities' view, Afghanistan's prospects, as well as most data and economic relationships, were still too uncertain for a quantified medium-term scenario to be meaningful. Staff concurred with this view.

26. **Afghanistan is a predominantly agricultural economy that can be badly affected by natural events, such as prolonged droughts, or crop disease.** Afghanistan is also prone to earthquakes. Diversification of economic activity and improved agricultural and building techniques could help mitigate these effects, but this will take time and continued assistance.

27. **The authorities agreed with the staff that the outlook for Afghanistan was also clouded by the three risks of a continued lack of security, the infiltration of opium in the economy, and donor fatigue.** None of these risks can be addressed without the attention and support of the international community. The authorities intend to impress upon donors the need for their assistance in increasing security, toward developing alternative livelihoods for farmers in place of poppy, and toward underpinning Afghanistan's reconstruction.

28. **The discussions focused on the appropriate policies for achieving and maintaining financial stability—including fiscal and external sustainability—and sustainable recovery and growth.** In addition to macroeconomic policies, this includes the further development of key economic institutions.

B. Fiscal Policy

29. **Improving revenue mobilization is key to attaining fiscal sustainability.** Donor grants to fund Afghanistan's operating expenses cannot be expected to continue indefinitely and the bulk of external assistance will increasingly be allocated to development expenditures. The authorities recognize this and aim to fully finance the operating budget through domestic revenues over the medium term.

30. **Domestic resources could reach $200 million this fiscal year but this will depend on early implementation of customs reform.**[16] Progress is furthermore needed in the reform of tax policy and administration. The staff urged the authorities to move swiftly on this and to seek the establishment of a fair, transparent, and easy to implement tax system. This should include the revision of the income tax, the introduction of a wage withholding tax, and a services tax.

31. **The staff noted the important progress made in improving fiscal management.** The staff encouraged the authorities to continue to press for further improvements in the quality of fiscal data, the fiscal management of the provinces, and the monitoring of the development budget. Efforts are underway to increase the central government's control over provincial finances. The recent streamlining of the government's accounts in the provinces and their planned consolidation into the central accounts at DAB will help to achieve effective revenue centralization, but concrete progress will depend critically on provincial authorities' adherence to their commitment to transfer revenues to the center. Recent successes in this regard are encouraging. The staff urged the authorities to continue to move ahead with these efforts, despite the delicate political issues involved.

32. **The authorities emphasized that civil service reform is faced with considerable social, political, and practical difficulties.** They are well aware, however, of the central role of civil service reform in the reconstruction process in general, and in the delivery of adequate public services in particular. The staff urged the authorities to move ahead more quickly in this area with the assistance from the World Bank. An important first step would be to establish a verified payroll of government employees. The staff welcomed the recent approval of a decree introducing an interim additional salary allowance for specific positions in key ministerial departments. This procedure should be preferred to an across-the-board wage increase for entire categories of government staff, as was recently done for teachers and police officers. The staff also urged the authorities to move ahead with wage decompression,

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[16] Domestic resources include central and provincial surpluses of the previous fiscal year.

but cautioned that any across-the-board pay reforms should remain compatible with medium-term fiscal sustainability. Also, with large numbers of staff having little or no capacity, redundancies will be unavoidable and delaying these too much could prove to be costly.

33. **The restructuring of the state-owned enterprise sector has yet to begin.** Significant progress is unlikely in the near-term without strong support from the international community. But the staff was encouraged by the authorities' intention to close nonfunctioning public enterprises, or divest them to the private sector through an open and transparent process when possible.

C. Monetary and Exchange Rate Policy

34. **The current exchange rate regime is best described as a managed float.** The authorities consider a relative degree of exchange rate stability as important to instill confidence in the new currency and to support price stability, given the rapid and strong pass-through of exchange rate movements to prices. The central bank governor emphasized, however, that he does not intend to resist persistent exchange rate pressures should these emerge, and thereby risk losing reserves unduly.

35. **The staff recognized the benefits of exchange rate stability, but cautioned the authorities against allowing the unofficial "range" to become too narrow or rigid, or resisting persistent pressures on the exchange rate should these emerge.** The staff noted that the greater the management of the exchange rate, the less information it conveys regarding monetary conditions. If the exchange rate is kept within too narrow a range for an extended period, it could become more difficult to make needed adjustments in the future without adversely affecting expectations.

36. **In the staff's view, a (lightly managed) float remains the appropriate choice for Afghanistan.** The Afghan economy is undergoing large structural changes and remains vulnerable to external and domestic shocks. Under such circumstances, it would be desirable for adjustment to work through the exchange rate rather than directly impact Afghan product and labor markets. In a fixed regime, the risks of an exchange rate misalignment and an undue loss of reserves would be high. Once the economy has moved beyond the early structural changes inherent to the reconstruction process, the choice of exchange rate regime could be revisited. For the period ahead, the staff recommended that monetary policy continued to focus on maintaining low inflation by limiting monetary expansion, which would contribute to exchange rate stability.

37. **The staff welcomed the adoption of the new central bank and banking legislation.** This was a major step toward financial sector development. Financial intermediation is of crucial importance for the further development of private sector activity and economic growth. Capacity to adequately license and supervise commercial banks will need to be strengthened further. In the meantime, the staff advised the authorities to allow only reputable banks to enter that are subject to solid home country supervision. Even with the emergence of new banks, the "*Hawala*" system is likely to continue to exist, as is the case

in many other countries in the Middle East. The authorities intend to put in place, with assistance from the Fund, new legislation to counter money laundering and the financing of terrorism.

38. **Regarding the existing state-owned banks, a key concern is to avoid (potential) costs to the budget and damaging confidence in an emerging banking system.** Should an existing bank be deemed viable, the staff recommended that it be placed under new and qualified management, followed, if possible, by its privatization. Before such a bank could start operations, the staff stressed that it should reapply for a banking license. Banks that fail to meet the conditions for a new license will need to be dealt with quickly, to avoid an increase in potential future costs to the budget.

D. External Sector Policies

39. **The balance of payments outlook is fraught with uncertainty.** The current account deficit, before grants, is likely to remain sizable during the next several years, financed largely by donor grants and, much less so, loans. Exports and imports can be expected to grow in line with reconstruction efforts and the economic recovery. Whether a balance of payments need may arise depends on the scope and speed of Afghanistan's reconstruction, as well as on the efforts by the authorities—with the help of the international community—to eradicate opium and provide farmers with alternative livelihoods and social support.

40. **In the staff's view, Afghanistan's current level of international reserves provides a reasonable cushion against negative shocks and a strong backing for the national currency.** But even within the context of the current exchange rate regime, a higher level of reserves could be warranted given the large potential for adverse shocks and the country's limited access to international capital markets.

41. **Staff advised that new external borrowing should be very limited and only on highly concessional terms.** Large amounts of external assistance will continue to be required to support Afghanistan's reconstruction and development for years to come. Bilateral donors have thus far provided financial support in the form of grants, while multilateral institutions have provided a mix of grants and concessional loans. A provisional debt sustainability analysis discussed with the authorities suggested that Afghanistan's capacity to service new external debt was very limited, taking into account again its vulnerability to exogenous shocks.[17] This analysis also showed that sustainability was difficult to achieve without very generous relief of existing claims. Staff emphasized that the analysis did not suggest that financial assistance to Afghanistan should be limited, but rather that Afghanistan would need to rely overwhelmingly on grants to reach its development goals. The authorities concurred with this analysis.

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[17] For details of the debt sustainability analysis, see "Islamic State of Afghanistan—Debt Sustainability Analysis." Notwithstanding some data changes since this analysis was undertaken, the conclusions drawn from it remain valid.

42. **The Afghan authorities have sought, with some success, cancellation of existing external debt on a bilateral basis with creditors.**[18] This has been their preferred approach. Creditors so far have not pressed Afghanistan to resume debt service payments.[19] The bulk of external claims on Afghanistan, however, consists of claims of the former Soviet Union. These claims, now from the Russian Federation, are currently under dispute, as the Afghan authorities do not recognize these, because they were (largely) accumulated during the period of Soviet intervention in Afghanistan.[20] The Afghan authorities have held discussions with the Russian authorities on resolving the status of these claims, but no conclusion has been reached so far.

43. **The staff explained that if the authorities wish to approach the Paris Club for a debt restructuring, an upper credit tranche arrangement (or its equivalent) with the Fund would be required.** Also, Afghanistan could be HIPC-eligible. The staff advised the authorities that the HIPC initiative would, in principle, expire in 2004, but eligible countries would still be able to benefit from HIPC relief after that time, provided they had a Fund arrangement in place by end-2004 and their program was on track.

44. **The staff welcomed the recent establishment of a debt management unit.** Afghanistan is making no debt service payments on its existing stock of external debt, other than to the AsDB and the World Bank. However, in the future, with the contracting of new loans and/or a restructuring of existing debt, the authorities will need the capacity to keep track of debt service-related payments on a timely basis. The staff urged the authorities to set up a functioning debt management system within the new unit.

45. **The authorities intend to formally establish a liberal trade and exchange regime, and to prepare laws and regulations that conform to such a system with the assistance of the Fund.** The staff welcomed this and encouraged the authorities, once this has been achieved, to accept the obligations under Article VIII of the Fund's Articles of Agreement. The authorities noted they would consider this in due course, but that their inclination was positive.

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[18] In 2002 and early 2003, Denmark (DKr 5 million), China (£8.8 million), and Germany (€34.4 million) cancelled debts owed by Afghanistan.

[19] Afghanistan cleared its arrears to the AsDB, the World Bank, and the Fund in late 2002 and early 2003 as part of a coordinated plan supported by grant contributions from a number of donor countries. Arrears to the Fund amounted to SDR 8.1 million.

[20] Russian claims amount to almost $10 billion. In line with the 1997 Memorandum of Understanding on the Russian Federation's participation in the Paris Club this amount would be adjusted if entered into the Paris Club.

E. Role of the Fund

46. **Up to now the Fund's role in Afghanistan has been to provide policy advice and technical assistance (TA).** Fund TA in Afghanistan has involved assisting the authorities with establishing a road map for reforms, which are implemented by other TA providers that have much greater resources. Progress has been (and will be) subsequently reviewed—and the reform agenda adjusted where needed—by the Fund TA departments. In addition, the Fund has been providing TA in specialized areas, such as the currency conversion, financial sector and tax legislation, and the strengthening of statistical capacity.[21] The authorities considered this approach was adequate and met their needs.

47. **During the Annual Meetings in Dubai, the Afghan Minister of Finance requested closer Fund involvement in Afghanistan, possibly in the context of a Fund-supported program.** The main objectives of this would be to provide a more detailed framework for economic policies and strengthen policy discipline, as well as to provide a positive signal to donors. So far, donors have not been insisting on a Fund-supported program and have been content with staff statements at donor conferences. But with substantial donor support needed in the period ahead, donors may wish to see greater Fund involvement as part of a concerted international effort and to provide assurances of sound macroeconomic management. Experience in other post-conflict countries suggests that donors prefer that a Fund-supported program be in place before embarking on major reconstruction efforts.

48. **As in many other post-conflict cases, there are serious constraints that need to be taken into account when moving toward closer Fund involvement.** These include: (a) the still limited institutional and administrative capacity to carry out a program that could be supported by the Fund; (b) severe data limitations and considerable uncertainty regarding economic relationships; (c) the likelihood of a change of government in mid-2004, whose commitment to a potential Fund-program cannot be assured;[22] and (d) the continuing fragile security situation and the limited control of the government beyond Kabul.

49. **The staff stands ready to assist the authorities in addressing these concerns. Taking into account the authorities' objectives and the constraints, staff has agreed with the authorities to proceed first with an SMP.** This would allow the authorities to build on their already good track record and establish—with increased TA, including from the Fund—an adequate level of capacity for a possible arrangement under the Poverty

[21] See Appendix I, Section XI, for details on the Fund's TA program with Afghanistan.

[22] A program with the Fund in the transition period would nonetheless be useful to reduce uncertainty about the direction of macroeconomic policy.

Reduction and Growth Facility (PRGF). The staff will work with the authorities to set out an enhanced Fund TA program. Emergency Post-Conflict Assistance (EPCA) could be considered in lieu of an SMP, or as a bridge between an SMP and a PRGF, if the conditions for such assistance were present.

IV. Staff Appraisal

50. **The achievements of the AIA and its successor, the ATA, have been remarkable.** The starting point after over 20 years of conflict was extremely inauspicious, with much of the country physically and institutionally in ruins. But in the space of 18 months, important progress has been made in rebuilding key institutions and in restoring macroeconomic stability. The economy has begun to grow again.

51. **The adherence to the "no-overdraft rule," prohibiting government borrowing from the central bank, remains a crucial cornerstone of fiscal policy and contributed to achieving financial stability.** But with tight fiscal discipline, government spending is constrained by domestic revenues and available donor financing. The swift implementation of measures to make further progress in raising domestic revenue, both by deepening the sources of revenue through structural reform and by improving the enforcement of collection from the provinces, will be critical to ensure the independence of the operating budget from donor assistance in due course. While significant strides have been made in improving fiscal management, further progress is still needed, particularly to strengthen fiscal management in the provinces and fiscal reporting.

52. **The reconstruction process is still proceeding only slowly.** The preliminary needs assessment presented at the Tokyo conference in January 2002 provided an early estimate of Afghanistan's reconstruction needs. However, much of the assistance provided so far to Afghanistan has been humanitarian assistance, which was not included in the preliminary needs assessment. There is a strong case for reviewing the needs assessment, now that the international community has been in the field for nearly two years and may be in a better position to make such an assessment. To some extent, the slow progress in reconstruction reflects Afghanistan's limited absorption capacity and poor security. While a faster pace of reconstruction is needed, therefore, it must be combined with increased efforts to improve security and strengthen capacity.

53. **The progress made toward the integration of donor projects in the development budget is welcome.** The consolidation of projects into a single development budget is crucial for the comprehensive monitoring of projects, for their "ownership" by the authorities and for their consistency with the NDF. This process will become all the more important as the emphasis of donor assistance shifts away from budgetary support and toward development.

54. **The introduction of the new currency was a notable success.** The stability of its exchange rate since the conversion was completed in January 2003 is testimony to the prudent monetary policy—supported by strong fiscal discipline—that has been followed since. The exchange rate regime is a "lightly managed" float, which seems appropriate for a

country which remains vulnerable to shocks, and while the exchange rate seeks its equilibrium in the context of structural change and reconstruction. To this end, it will be important for the exchange rate to reflect and be seen to reflect market forces.

55. **Alleviating poverty in Afghanistan will require strong economic growth for many years to come.** Notwithstanding the strong start of the recovery, per capita GDP in Afghanistan—estimated at only $180–190—is still one of the lowest in the world.[23] Continued growth will depend, in the first instance, on maintaining a high level of donor support. In light of Afghanistan's very limited debt servicing capacity—even after generous relief on existing claims—this support will need to be overwhelmingly in the form of grants.

56. **Sustainable growth over the medium term will require substantial private investment**. This will increasingly need to take the place of official assistance, which cannot be expected to last forever. A significant increase in private investment will require first and foremost adequate security, but also sound economic policies, a functioning banking system, as well as a market-oriented regulatory framework, and a functioning and fair legal system to firmly establish the rule of law and the security of property rights.

57. **The commitment of the Afghan authorities to sound economic policies and toward establishing a liberal, market-oriented economy is welcome.** As outlined in their overall strategy, the NDF, economic recovery and growth is to be based on liberal and open markets, led by private sector activity with low state intervention. The authorities also aim to establish transparency in government operations and improve economic management.

58. **Afghanistan's recovery faces substantial risks, the most prominent being poor security and the limited rule of law.** Restoring adequate security throughout the country remains a key priority. The government's control over the provinces is still very limited. An adequate level of security will need to be established in the provinces to permit the implementation of reforms and projects, as well as the resumption of private economic activity and the provision of basic public services.

59. **There is a related risk that much of Afghanistan may become dominated by poppy cultivation and the production of opium.** Opium production is back to the levels of the late 1990s and its pervasive influence threatens to become entrenched. Eradication programs must be intensified, but can only hope to succeed if they go hand in hand with economic development to provide alternative livelihoods and with improved security. Without this, Afghanistan could enter into a downward spiral of violence and corruption.

60. **Another risk is that external assistance may fall short of what is required.** Putting Afghanistan back on its own feet will continue to require sizable international assistance over

[23] Including the value of opium exports accruing to Afghan farmers and traffickers brings per capita GDP to $300, which is significantly higher, but still among the lowest in the world.

the next several years. The experience of post-conflict countries shows that assistance typically starts to decline after a few years, just when the recipient country's capacity to absorb aid and use it effectively is increasing.[24]

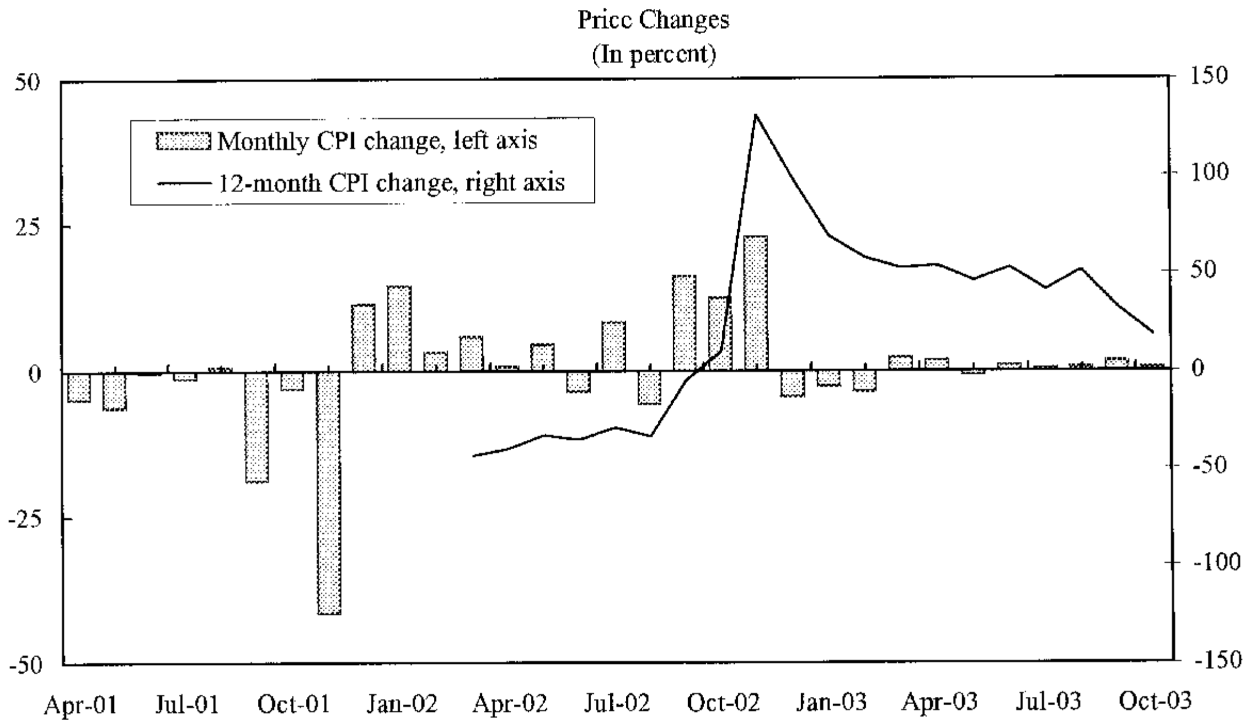
61. **Notwithstanding these risks, ultimately Afghanistan's outlook—and the donors' willingness to support the country—will depend on the authorities ability to maintain political as well as macroeconomic stability and to adopt strong policy measures.** It will be crucial to continue to adhere to strict fiscal and monetary discipline and maintain the momentum of rebuilding institutions and economic reforms, to foster private sector development, and thereby to provide donors with the necessary encouragement to mobilize the resources needed to underpin Afghanistan's revitalization in the years to come.

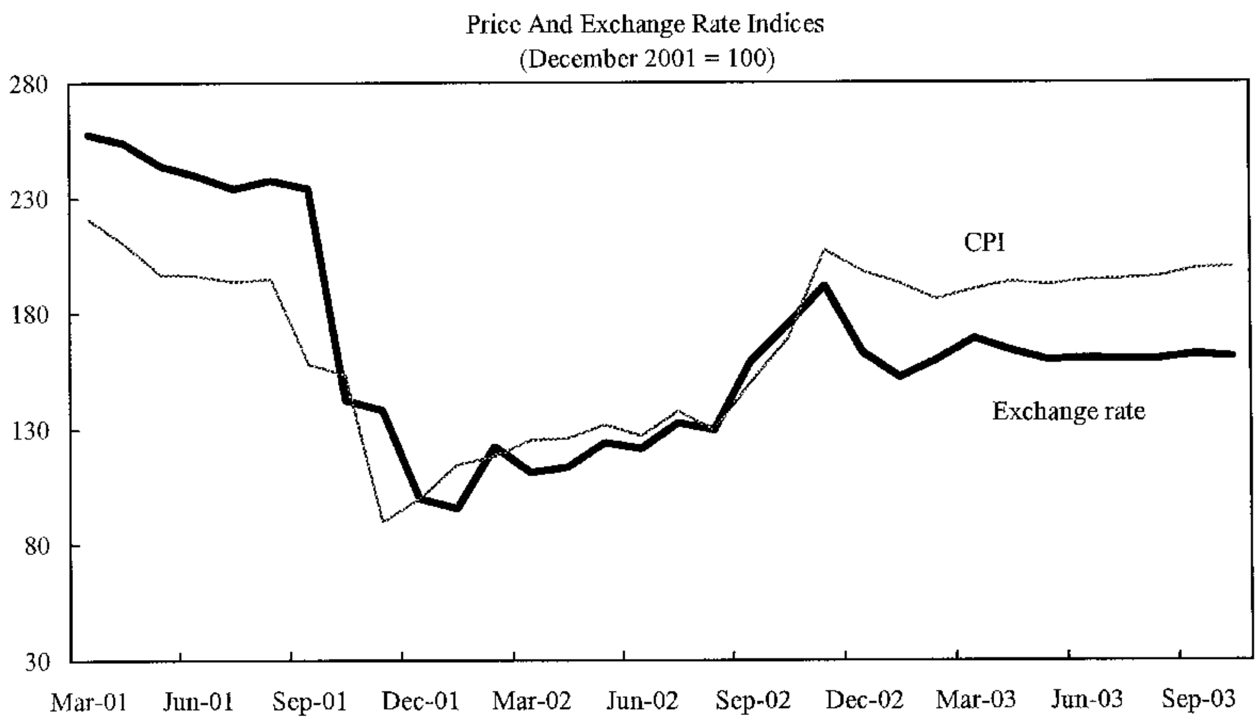
62. **The staff welcomes the authorities' intention to formally establish a liberal trade and exchange regime and urges them move swiftly on this to resolve the current vacuum.** Staff will assist the authorities in the drafting of the necessary laws and regulations with a view to prepare for the acceptance by Afghanistan of the obligations under Article VIII, Sections 2, 3, and 4.

63. It is recommended that the next Article IV consultation be held on the standard 12-month cycle.

[24] See "Aid, Policy and Growth in Post-Conflict Countries," Paul Collier and Anke Hoeffler, World Bank, 2002, for a discussion of aid effectiveness in post-conflict countries.

Figure 1. Islamic State of Afghanistan: Price and Exchange Rate Developments, 2001–03 1/

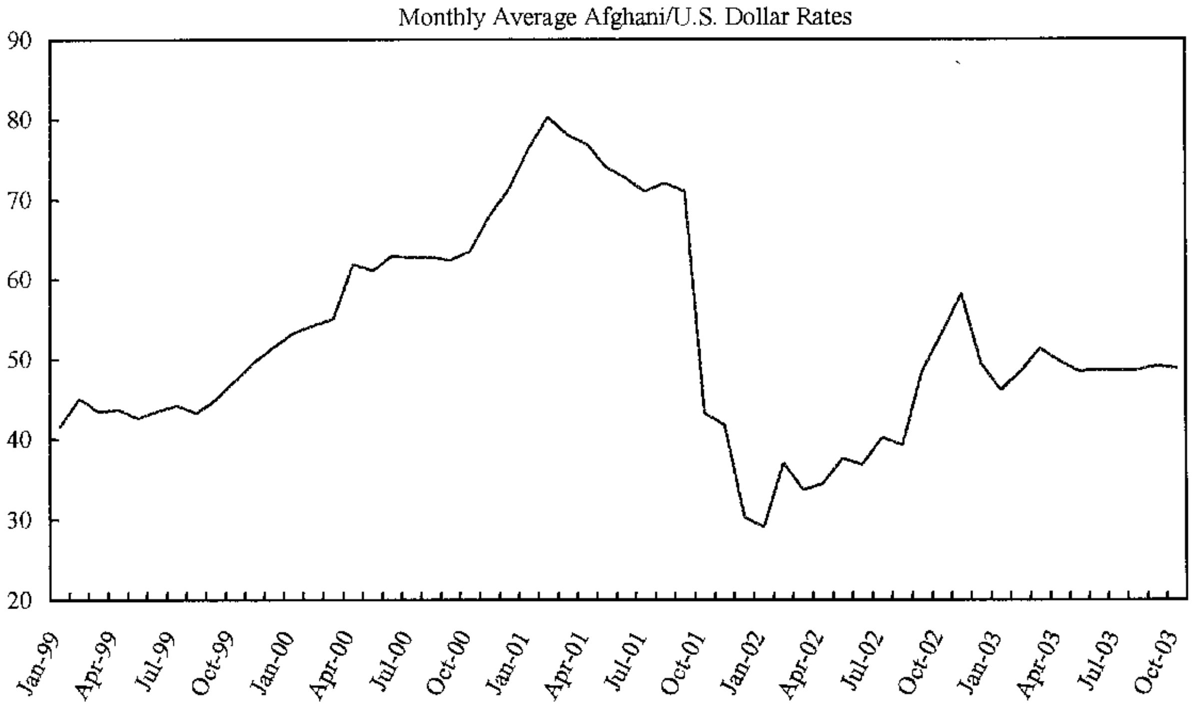


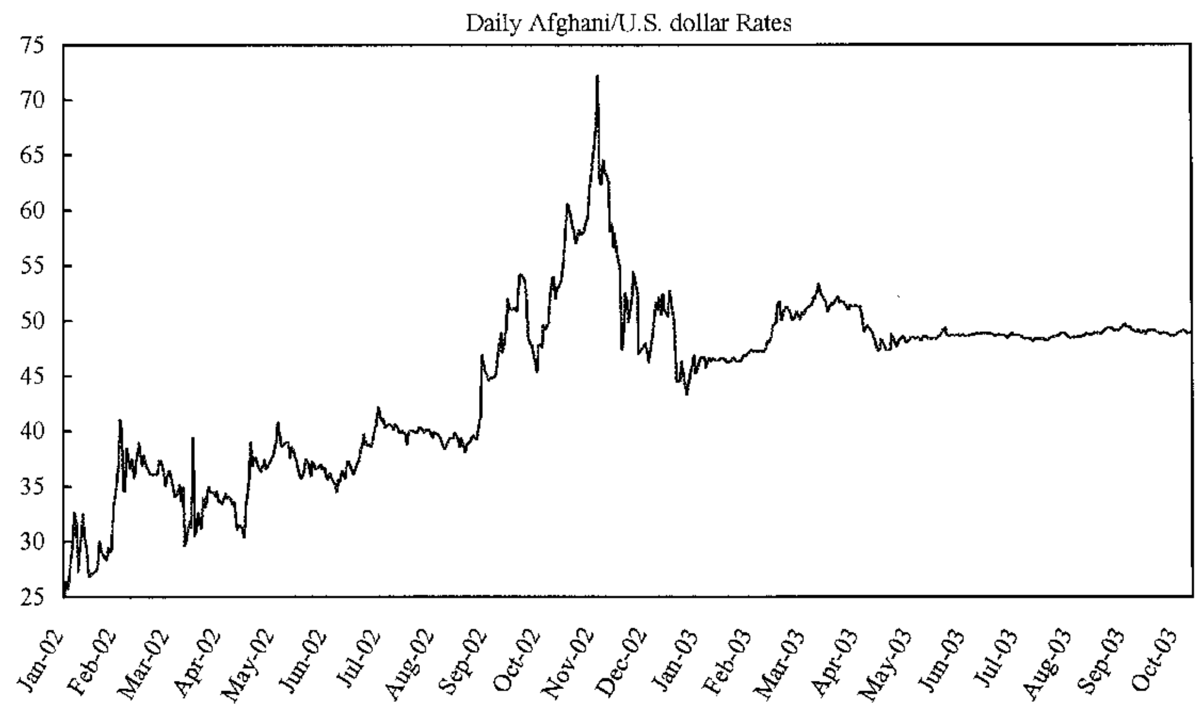


Sources: Central Statistics Office of Afghanistan; and Da Afghanistan Bank.

1/ Last observation: October 2003.

Figure 2. Islamic State of Afghanistan: Exchange Rates, 1999–2003 1/





Source: Da Afghanistan Bank.

1/ In new Afghanis; last observation: October 22, 2003.

Table 1. Islamic State of Afghanistan: Basic Data, 2001–2004 1/

I. Social and Demographic Indicators

Area	652,000 square kilometers
Population (2002/03)	21.8 million
Life expectancy at birth (2001)	42.8 years
Infant mortality per 1,000 live births (2001)	165
Under-five mortality per 1,000 live births (2001)	257

II. Economic Indicators	2001/02 Estimates	2002/03 Estimates	2003/04 Projections
a. Output			
GDP (in millions of U.S. dollars, excluding opium production)	2,463	4,048	...
GDP (in millions of new Afghani)	133,987	181,350	271,373
Real GDP growth rate	...	29	20
GDP per capita (in U.S. dollars)	123	186	...
Opium production (metric tons)	185	3,400	3,600
Opium value (in millions of U.S. dollars)	...	2,540	2,320
b. Prices			
CPI (Kabul, percentage change end solar year–end previous solar year) 1/	-43.4	52.3	14.9
CPI (Kabul, percentage change of solar year average over previous solar year average) 1/	...	5.2	24.7
c. Exchange rates			
Afghani/U.S. dollar (average during solar year) 1/	54.4	44.8	...
Afghani/U.S. dollar (end-solar year) 1/	31.0	52.6	...
d. General governement recurrent budget			
Expenditures (in millions of U.S. dollars)	...	349	550
Revenues (in millions of U.S. dollars)	...	132	200
Donor grants (in millions of U.S. dollars)	...	184	350
Balance (in millions of U.S. dollars)	...	-34	0
Donor loans (in millions of U.S. dollars)	...	25	0
On-off items (in millions of U.S. dollars)	...	39	0
Expenditures (in percent of non-opium GDP)	...	8.6	...
Revenues (in percent of non-opium GDP)	...	3.3	...
e. Monetary indicators			
Domestic currency in circulation (percentage change) 2/	...	20.1	30.0
Gross foreign exchange reserves (in millions of U.S. dollars)	...	426	565

Sources: Afghan authorities, UNDP, UNODC; and Fund staff estimates.

1/ The Afghan solar year 1381 ran from March 21, 2002 until March 20, 2003. The solar year 1382 runs from March 21, 2003 until March 19, 2004.
2/ For 2002/03 calculated by multiplying quarterly percentage changes in estimated stocks.

Table 2. Islamic State of Afghanistan: Operating Budget, 2002/03 1/

	Q1	Q2	Q3	Q4	Complimentary Period	FY Budget 9/	FY Adj. 10/	FY Act.
	(In million of U.S. dollars)							
Domestic revenue	18.0	26.9	41.0	46.1	...	83.0	63.5	131.9
Customs revenue 2/	9.9	14.3	21.2	22.3	...	...	...	67.8
Central ministries	0.6	2.3	13.4	7.1	...	...	...	23.3
Noncustoms provincial 2/	7.5	10.3	6.3	16.7	...	...	...	40.8
Expenditure	36.0	69.3	102.1	131.7	9.8	482.8	369.2	348.9
Center	18.0	34.1	67.5	67.7	5.7	...	...	193.1
Provinces (payroll only) 3/	3.0	11.0	14.8	33.6	4.1	...	...	66.5
Net presumptive provincial expenditures 4/	15.0	24.2	19.8	30.3	...	...	...	89.3
Balance (MoF)	-18.0	-42.4	-61.1	-85.6	-9.8	-399.8	-305.7	-217.0
Float and adjustment 5/	0.4	-0.7	-0.9	-6.4	-7.1	...	...	-14.8
Balance (DAB)	-17.7	-43.1	-62.1	-92.0	-16.9	-399.8	-305.7	-231.8
Donor assistance grants 6/	26.3	38.5	37.9	60.8	19.9	...	...	183.5
Bilaterals	10.0	10.0	6.4	0.0	0.0	...	...	26.4
UNDP	16.3	10.0	0.0	0.0	0.0	...	...	26.3
ARTF	0.0	18.5	30.3	56.3	19.7	...	...	124.9
LOTFA	0.0	0.0	1.2	4.5	0.0	...	...	5.7
Others	0.0	0.0	0.0	0.0	0.2	...	...	0.2
Donor assistance loans	0.0	0.0	0.0	25.0	0.0	...	...	25.0
Other financing 7/	0.0	22.8	4.2	12.0	0.0	...	...	39.0
Exchange rate adjustment 8/	-6.4	-7.4	4.0	8.4	1.5	...	...	0.1
Surplus/deficit	2.2	10.8	-16.0	14.2	4.5	...	...	15.8

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

1/ The Afghan solar year 1381 ran from March 21, 2002 until March 20, 2003.
2/ As reported to the MoF. However, a small part of this money is remitted to the center (transfers received by the MoF).
3/ Provincial salaries were paid by the center except for Herat province, which paid the salaries of its government staff out of the revenues it collected.
4/ Because no reliable data on nonwage provincial expenditures are available at the center on this date, these expenditures are assumed to equal the provincial revenues reported to the center plus net transfers from the center.
5/ Variation between the fiscal position recorded at MoF and DAB. This discrepancy is due to the difference ("float") between checks issued and cashed and the fact that the provinces' accounts in DAB branches were not consolidated into the government's central accounts at the end of the year.
6/ Does not include grants received ($51.24 million) and Afghanistan's reserve tranche in the Fund ($5.7 million) used to clear Afghanistan's arrears to the AsDB, World Bank, and IMF in FY2002/03.
7/ International Air Transport Association (IATA) accumulated overflight fees, sale of a telecommunications license, one-off transfer from the Ministry of Commerce, and transfer of previous year's provincial surpluses.
8/ This adjustment reflects the difference between the exchange rate used for donor grants (effective exchange rate at the time of deposit in the government's accounts) and the average exchange rate used to convert into U.S. dollars the other components of the table ($1 = Af 44.46).
9/ Including Af 750 million for the clearance of wage arrears related to payrolls incurred before the interim administration took over in January 2002.
10/ The approved budget was expressed in Afghanis and was converted into U.S. dollars at the time of its adoption (March 2002), using an accounting exchange rate of $1 = Af 34. The depreciation of this rate to an annual average exchange rate of $1 =Af 44.46, results arithmetically in a downwards adjustment of the U.S. dollar amount of the budget.

Table 3. Islamic State of Afghanistan: Operating Budget, 2003/04 1/

	Annual budget	Revised budget 8/	Annual project	Q1	Months 4–5	Year-to-date
			(In million of U.S. dollars)			
Domestic revenue 2/	200.0	184.4	146.6	31.4	...	...
Center	...	...	...	3.3	2.8	6.1
Provinces	...	...	...	28.1	...	...
Expenditure	550.0	507.1	507.1	76.2	55.8	132.0
Center-provinces	...	...	...	76.2	55.8	132.0
Central government	...	...	...	35.5	41.6	77.1
Of which: wages	...	...	...	22.5	23.2	45.7
Provinces	...	...	...	40.7	14.2	54.9
Of which: wages 3/	...	...	...	9.9	13.9	23.8
Economic classification	...	...	...	76.2	55.8	132.0
Wages and Salaries	...	...	...	32.4	37.1	69.5
Purchase of goods and services 4/	...	...	...	36.0	10.5	46.5
Transfers and subsidies	...	...	...	2.8	2.7	5.5
Pensions	...	...	...	0.0	2.7	2.7
Capital expenditure	...	...	...	4.9	2.9	7.8
Functional classification	...	...	...	76.2	55.8	132.0
General public services	...	...	...	6.8	7.8	14.6
Defense	...	...	...	18.6	8.7	27.2
Public order and safety	...	...	...	9.3	15.8	25.1
Education	...	...	...	5.4	10.1	15.5
Health	...	...	...	2.9	3.6	6.5
Social protection	...	...	...	0.4	2.5	2.9
Housing and communal services 4/	...	...	...	26.4	0.1	26.5
Recreation and culture	...	...	...	0.8	1.2	2.1
Economic affairs	...	...	...	5.7	5.9	11.6
Balance MoF	-350.0	-322.7	-360.5	-44.8	...	...
Float and adjustment 5/	...	...	...	26.4	...	...
Balance DAB	-350.0	-322.7	-360.5	-18.4	-43.6	-62.0
Donor assistance grants	350.0	322.7	253.9	46.6	19.6	66.2
ARTF	250.0	...	218.0	46.6	10.8	57.4
LOTFA and Army Trust Fund	100.0	...	35.9	0.0	8.8	8.8
Loans 6/	...	...	0.0	33.2	0.0	33.2
Balance end-2002/03	...	...	12.4	12.4	0.0	12.4
Transfer of 2002/03 provincial surpluses	...	...	32.0	12.5	1.0	13.6
Exchange rate adjustment 7/	...	...	...	-0.1	0.0	-0.1
Surplus net	...	...	-62.2	86.3	-22.9	63.4

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

1/ The Afghan solar year 1382 runs from March 21, 2003 until March 19, 2004. Execution during the first five months of 2003/04.

2/ Checks issued by MoF.

3/ Provincial salaries are paid by the center except for Herat province which paid the salaries of its government staff out of the revenues it collected.

4/ Including $25.2 million paid in the first month by the Minsitry of Reconstruction in Herat province for the purchase of services (advance payments to contractors).

5/ Variation between the fiscal position recorded at MoF and DAB. This discrepancy is due to the difference ("float") between checks issued and the fact that the provinces' accounts in DAB branches are not yet consolidated into the government's central accounts. The importance of this adjustment reflects that the $25 million paid by Herat province in the first month is not included in the government's central accounts at DAB.

6/ The authorities intend to channel the proceeds of this loan to the development budget before the end of the year. They are therefore not counted in the annual financing projections for the operating budget

7/ This adjustment reflects the difference between the exchange rate used for donor grants (effective exchange rate at the time of deposit in the government's accounts) and the average exchange rate used to convert into U.S. dollars the other components of the table (Af 48.81 = $1).

8/ The approved budget was expressed in Afghanis and was converted into U.S. dollars at the time of its adoption (March 2003), using an accounting exchange rate of Af 45 = $1. The depreciation of this rate to an annual average exchange rate of Af 48.81 = $1, results mechanically in a downwards adjustment of the U.S. dollar amount of the budget.

Table 4. Islamic State of Afghanistan: Indicative Monetary Program (Da Afghanistan Bank), 2001–04 1/

	2001/02			2002/03					2003/04							
	Est.			Est.					Proj.	Est.			Proj.	Est.	Proj.	
	Dec. 21	Mar. 20	Jun. 21	Jun. 21	Sep. 22	Sep. 22	Dec. 21	Mar. 20	Jun. 21	Jun. 21	Jul. 22	Aug. 22	Sep. 22	Sep. 22	Dec. 21	Mar. 19
	(In millions of new Afghani, unless indicated otherwise)															
Net foreign assets 2/	...	10,727	11,623	12,567	12,436	...	17,951	19,602	21,065	24,031	24,684	25,558	22,593	26,145	24,226	25,971
Foreign exchange reserves 3/ 4/	...	11,053	11,949	12,893	12,762	...	18,392	19,602	21,065	24,031	24,684	25,558	22,592	26,145	24,225	25,971
Gold	...	6,674	6,674	6,674	6,674	...	9,030	9,030	9,030	9,030	9,030	9,030	9,030	9,030	9,030	9,030
Other	...	4,379	5,275	6,219	6,087	...	9,362	10,572	12,035	15,001	15,654	16,528	13,563	17,115	15,196	16,941
Foreign liabilities	...	-326	-326	-326	-326	...	-441	0	0	0	0	0	0	0	0	0
Net domestic assets	...	3,041	3,030	2,038	2,268	...	1,196	1,074	1,013	-3,691	-3,077	-3,206	983	-2,862	950	912
Domestic assets	...	14,525	14,525	14,857	14,376	...	15,084	14,450	14,951	10,541	11,370	12,139	14,951	11,666	14,951	14,951
Net claims on general government	14,577	14,525	14,525	14,857	14,376	...	15,084	14,450	14,951	10,541	11,370	12,139	14,951	11,666	14,951	14,951
Net claims on government before 2002/03 (SY 1381) 5/ 6/	14,577	14,525	14,525	14,951	14,951	...	14,951	14,951	14,951	14,951	14,951	14,951	14,951	14,951	14,951	14,951
Net claims on government in 2002/04 (SY 1381/1382) 6/ 7/	0	0	0	-93	-574	...	133	-501	0	-4,410	-3,581	-2,811	0	-3,285	0	0
Domestic currency deposits 6/	0	0	0	410	-87	...	887	-344	0	-975	-327	-458	0	-1,335	0	0
Foreign currency deposits 7/	0	0	0	-503	-487	...	-754	-157	0	-3,435	-3,254	-2,353	0	-1,950	0	0
Claims on nonbank public institutions	...	0	0	0	0	...	0	0	0	0	0	0	0	0	0	0
Claims on deposit money banks	...	0	0	0	0	...	0	0	0	0	0	0	0	0	0	0
Other items net 4/	...	-11,483	-11,494	-12,819	-12,108	...	-13,888	-13,376	-13,937	-14,232	-14,447	-15,346	-13,967	-14,528	-14,001	-14,039
Reserve money	13,475	13,769	14,654	14,606	14,704	18,384	19,146	20,676	22,079	20,340	21,606	22,352	23,576	23,283	25,175	26,883
Afghanis in circulation 8/	13,475	13,769	14,654	14,606	14,704	18,384	19,146	20,676	22,079	20,340	21,606	22,352	23,576	23,283	25,175	26,883
Banknotes and coins issued	13,509	13,809	14,804	14,718	14,718	...	19,831	21,302	22,879	21,302	22,302	23,302	24,376	23,303	25,975	27,683
less cash holdings	34	40	150	112	14	...	684	626	800	962	696	950	800	20	800	800
Bank reserves	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0	0
Memorandum items:	(In percent, unless indicated otherwise)															
Reserve money growth (quarterly)	...	2.2	6.4	6.1	0.7	...	4.1	8.0	6.8	-1.6	...	...	6.8	14.5	6.8	6.8
Reserve money growth (annual) 9/	...	...	...	...	...	...	...	20.1	...	...	...	...	...	...	...	30.0
Gross international reserves (millions of U.S. dollars)	...	325.1	351.5	379.2	375.3	...	399.8	426.1	457.9	522.4	536.6	555.6	491.1	568.4	526.6	564.6
Inflation (quarterly; Kabul)	-36.8	25.2	...	1.6	18.3	...	31.9	-4.0	3.0	2.0	...	...	1.8	2.6	5.1	5.3
Inflation (twelve-month; Kabul)	...	-43.4	...	-35.3	-4.9	...	98.5	52.3	56.4	52.9	41.7	51.4	31.5	32.6	4.7	14.9

Sources: All figures are Fund staff estimates based on available data in Da Afghanistan Bank and the Central Statistics Office.

1/ The Afghan solar year (SY) 1381 ran from March 21, 2002 until March 20, 2003. The solar year 1382 runs from March 21, 2003 until March 19, 2004.
2/ Foreign currency amounts converted into Afghani at an exchange rate of Af 34/U.S. dollar until September 2002; thereafter a rate of Af 46/U.S. dollar; gold valued at $279 per ounce.
3/ Increases reflect (net) flows plus recovered accounts abroad.
4/ In Q3 2002/03 (SY 1381), includes payment by DAB of $16 million in costs for the currency exchange.
5/ Changes in Q1 2002/03 (SY1381) reflect expenditures made and revenues booked for the 2001/02 (SY 1380) budget.
6/ 600100, 701101, and 731001 accounts, corrected for reallocation of 2002/03 (SY 1381) revenues to 2001/02 (SY 1380) for funding of 2001/02 (SY 1380) wage expenditures.
7/ Including disbursed AIATF, ARTF, and LOTFA funds (accounts 701102 and 731002).
8/ September 22, 2002 stock of currency in circulation calculated as January 21, 2003 stock of new Afghani in circulation minus net issuance of new Afghani during October 7, 2002–January 21, 2003 plus net withdrawal of old Afghanis (devided by 1,000) during during September 23, 2002–January 21, 2003.
9/ Annual percentage increase in 2002/03 (SY 1381) calculated by compounding quarterly percentage changes.

Table 5. Islamic State of Afghanistan: Balance of Payments, 2001/02–2003/04 1/ 2/

	Est. 2001/02	Est. 2002/03	Proj. 2003/04
	(In millions of U.S. dollars)		
Trade balance	-874	-1,315	-1,837
Exports of goods 1/	1,657	2,290	2,870
Own exports	68	100	150
Reexports	1,589	2,190	2,720
Imports of goods	2,531	3,605	4,706
Services	...	-104	-171
Receipts	...	29	60
Donor-related	...	24	54
Other	...	5	5
Payments	...	133	231
Donor-related	...	133	230
Wages of expatriates	...	68	155
Other	...	65	75
Interest paid 3/	...	0	1
Current transfers	...	1,287	1,830
Public	...	1,081	1,656
Commodity food aid	71	94	29
Other	...	987	1,627
Private	...	206	174
Other	...	0	0
Current account balance	...	-132	-178
(before grants)	...	-1,419	-2,008
Capital financial account	...	100	203
Public loans	...	50	206
Disbursements	...	50	209
Amortization paid 3/	...	0	3
Direct investment	...	50	100
Net errors and ommisions	...	188	113
Overall balance	...	155	139
Financing	...	-155	-139
Change in net foreign assets of DAB	...	-101	-139
Arrears 4/	...	-54	0
Memorandum item: Value of opium exports	...	2,540	2,320

Sources: UNODC; and Fund staff estimates.

1/ The Afghan solar year 1381 ran from March 21, 2002 until March 20, 2003. The solar year 1382 runs from March 21, 2003 until March 19, 2004.

2/ Excludes opium (and opium derivatives) related exports which would imply a larger trade surplus in 2002/03. These would be offset by opium related imports and other external payments, as well as the banking abroad of illicit earnings. The data also do not include flows associated with U.S. army and most ISAF activities.

3/ Does not include debt service on outstanding bilateral debt, on which no debt service payments have been made since 1991.

4/ Does not take into account possible arrears of unknown size on bilateral claims in dispute.

Table 6. Afghanistan: Country Work Program, 2003–early 2004

Staff-Monitored Program

- Staff missions in December 2003 and February 2004.
- For information to Executive Board in March/April 2004.

Use of Fund Resources

- None

Technical Assistance

Fiscal issues

- Public expenditure management follow-up mission in November 2003.
- Customs and tax policy and administration mission in January 2004.

Monetary issues

Statistical issues

- Peripatetic visits by STA advisor.

Legal issues

- Exchange regulations mission in December 2003.
- Anti-money laundering mission in early 2004.

Islamic State of Afghanistan: Relations with the Fund

(As of September 30, 2003)

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

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

III. **SDR Department**:	SDR Million	% Allocation
Net cumulative allocation	26.70	100.00
Holdings	0.50	1.87

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	Forthcoming				
	August 31, 2003	2003	2004	2005	2006	2007
Principal						
Charges/Interest	0.00	0.10	0.41	0.41	0.41	0.41
Total	0.00	0.10	0.41	0.41	0.41	0.41

Nonfinancial Relations

VII. **Exchange Arrangement**

Afghanistan is an Article XIV country. At the time of the last Article IV consultation in 1991, Afghanistan maintained exchange restrictions and multiple currency practices that were subject to Article VIII. Today, the authorities are implementing a liberal exchange system. Based on information currently available to the staff, no exchange restrictions and multiple currency practices are currently in place. The authorities intend to formalize the current liberal regime through the adoption of new laws and regulations, for which they have asked for technical assistance from the Fund. At least since end-2001, the Afghani has been floating, and more recently the authorities have been implementing a managed float with no predetermined path for the exchange rate.

VIII. Article IV Consultation

The last Article IV consultation with Afghanistan was discussed by the Executive Board on on June 12, 1991. 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, 2002–03

Department	Date	Purpose
Interdepartmental	January 27–31, 2002	Initial assessement of TA needs
FAD	February 10–21, 2002	Fiscal management
	May 13–26, 2002	Tax policy and administration
	Jan 5-18, 2003	Fiscal management
MFD	February 27–March 7, 2002	Financial sector reform
	May 19–June 2, July 10–27, 2002	Financial sector reform
	December 11-16, 2002	Financial sector legislation workshop
	September 7–16, 2003	DAB restructuring program and creation of a central bank short-term debt instrument.
LEG	February 27–March 7, 2002	Financial sector legislation
	December 11-16, 2002	Financial sector legislation workshop
STA	April 15–21, 2002	Multisector statistics
	November 18–30, 2002	Consumer Price Index
	January 26–February 8, 2003	Government finance statistics
	March 1–11, 2003	Monetary and financial statistics
	June 9–20, 2003	Consumer Price Index

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 paid alternating visits to Kabul during 2002–03, 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 (Swedish Central Bank) 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 Schaetzen, took up his post in Kabul on August 24, 2002.

Islamic State of Afghanistan: Relations with the World Bank

1. A second **Transitional Support Strategy** (TSS) was presented to the World Bank Board of Executive Directors in March 2003. The TSS outlines a strategy for World Bank operations over the subsequent 18 months to 2 years until the establishment of a stable, representative government. The strategy focuses on four strategic areas: improving livelihoods, fiscal strategy, institutions and management, governance and public administration reform, and enabling private sector development.

2. In FY 2002, World Bank staff prepared and negotiated four projects to utilize IDA grant funds to a total of $100 million of which 35 percent has been disbursed. Following the clearance of Afghanistan's arrears to the World Bank and Fund, through donor contributions, the first IDA credit for $108 million for the **Emergency Transport Project** was approved by the Board in March 2003. By the end of FY 2003 an additional three projects—**Emergency Health Sector Rehabilitation** ($59.6 million), **Emergency Public Administration II** ($8.4 million), and **National Emergency Employment II** ($39.2 million) were approved bringing to $215 million the total allocation for the year.

3. Seven IDA credits/grants are anticipated for FY 2004, for a total of approximately $290 million. The first of these, the **Emergency Communications Project** ($22 million) was approved by the Board on October 7, 2003. Additional planned projects include: Customs Reform, Urban Development, National Solidarity Program, Irrigation, Polio Eradication, and Fiscal Rehabilitation.

4. The World Bank also administers the **Afghanistan Reconstruction Trust Fund (ARTF)** which became effective in May 2002 and plays a critical role in funding the recurrent costs of government. In its first year of operation (SY 1381—March 21, 2002 to March 20, 2003) the ARTF mobilized $191 million. Pledges for SY 1382 (March 21, 2003 to March 20, 2004) amount to over $260 million. ARTF is increasing its financing of investments and has the potential to support tighter donor coordination, simplified processes, and fast results.

5. The World Bank is also actively engaged in advisory services to government and continues to respond quickly to a range of requests. Current analytical work includes work on the civil service reform, urban development and land management, education policy reform, labor market and pensions, a gender assessment and oil/gas infrastructure development, as well as broader regional trade work encompassing issues with Afghanistan's neighbors. The World Bank has also actively utilized **Post Conflict Fund** and continues to use the **Japan Social Development Fund** resources to provide on-the-ground support to the government and communities.

6. The World Bank's program is growing quickly and will have a portfolio of 15 projects by the end of FY 2003. As the country situation normalizes, the Afghan constitution is promulgated and elections are held, the World Bank plans to then start work on developing a Country Assistance Strategy.

7. The World Bank's office in Kabul is fully functional and growing rapidly to take on increasing demands. A country manager, as well as several other international staff, and a growing number of national staff are now in place.

Islamic State of Afghanistan: Survey of Reporting of Main Statistical Indicators

(As of October 31, 2003)

	Exchange Rates	International Reserves	Reserve/ Base Money	Central Bank Balance Sheet	Broad Money	Interest Rates	Consumer Price Index	Exports/ Imports	Current Account Balance	Overall Government Balance	GDP/GNP
Date of latest observation	Oct. 30, 2003	Sep. 2003	Sep. 2003	...	...	...	Oct. 2003	...	...	Aug. 2003	2002/03
Date received	Oct. 30, 2003	Oct. 2003	Sep. 2003	...	...	...	Oct. 2003	...	...	Sep. 2003	Sep. 2003
Frequency of data	D	Mission	D	...	...	...	M	...	...	Mission	Irregular
Frequency of reporting	D	Mission	D	...	...	...	M	...	...	Mission	Mission
Source of data	DAB	DAB	DAB	DAB	DAB	DAB	CSO	CSO	CSO	MoF	CSO
Mode of reporting	E-mail	Mission/ e-mail	E-mail	...	...	...	E-mail	...	...	Mission	Mission
Confidentiality	Unrestricted	Confidential	Unrestricted	...	...	...	Unrestricted	...	...	Unrestricted	Unrestricted
Frequency of publication	D	...	Q	...	...	...	M	...	...	Irregular	...

Statement by Abbas Mirakhor, Executive Director
for the Islamic State of Afghanistan
November 21, 2003

Background

At the outset, my authorities express their gratitude for the Fund's policy advice and technical assistance received since January 2002. This assistance, which has been well-described in the staff document IMF Country Report No. 03/299: *Islamic State of Afghanistan—Rebuilding a Macroeconomic Framework for Reconstruction and Growth,* has focused on establishing a sound foundation for economic management and macroeconomic stability. The authorities' achievements are also well-summarized in the document as well as in the excellent staff report. My authorities also thank staff for the fruitful dialogue leading to completion of the Article IV consultation discussions with Afghanistan, the first in twelve years. This is an important step toward resumption of normal relations with the Fund and the international development community. The authorities are also immensely grateful to the international community for its role in restoring peace and security to Afghanistan and in its reconstruction. Twenty years of conflict, interspersed with severe natural disasters, had devastated the Afghan economy, destroyed government institutions, administrative capacity and infrastructure, and created a huge refugee problem and deep poverty.

With financial and technical assistance from the international community, the authorities have made major strides in restoring a credible policy framework and functioning institutions, and have achieved progress in turning the economy around in key areas. Economic growth has rebounded and macroeconomic stability is taking root. The private sector is again playing a key role in economic activity, and the Government is facilitating this role by building infrastructure needed for a liberal, market-led economy. The authorities realize the enormous challenges ahead—particularly regarding peace consolidation, economic reconstruction, dealing with undesirable informal activities, and alleviating poverty—and are resolved to address them with the continued support of the international community. They firmly believe that their solid track record of implementation of sound economic policies—with emphasis on institution building, accountability, and transparency—and their strong commitment to the development of a private-sector-led economy will provide a firm foundation for sustainable growth and poverty reduction as the security situation improves and political stability is consolidated.

Recent economic developments and policies

Real sector: Real GDP has rebounded strongly in 2002/03, while inflation has abated. Significantly, the real GDP growth of almost 30 percent (excluding opium production) has been broad-based. Agriculture—the largest sector—has shown strong growth, helped by good rainfall and increased cultivation after seven years of drought, large-scale famine, and huge unemployment in the sector. An impressive wheat and cereal harvest has resulted in self-sufficiency for some regions, while providing much-needed jobs. Importantly also, production of raisins, fruits, and walnuts—premium export crops—has recovered strongly.

Construction and services, supported by donor financing, have expanded rapidly. The housing sector activities are brisk, and repair and reconstruction work, led by the private sector, is visible in all major cities. The Afghan Commerce Department has granted more than three thousand business licenses over the last two years. Manufacturing activities are picking up slowly, but steadily. Returning expatriates are engaged in light manufacturing of furniture and construction activities, while larger-scale manufacturing projects, e.g., cement, beverages, and bottled water are gaining foothold in the economy. The carpet-weaving industry, with a high export potential, is returning to the country following its emigration during the years of conflict.. The Government has dedicated a special enclave for reinstallation and nurturing of this industry. A number of projects in the telecommunication and hotel sectors have started, and activity in the service sector is picking up momentum. In mining, a team of experts is assessing the country's potential. Afghanistan's untapped reserves of oil and natural gas are already in exploitation in the Northwestern region. Furthermore, a feasibility study is being funded by the Asian Development Bank to run a natural gas pipeline from Turkmenistan to Pakistan. Afghanistan could expect substantial revenue in transit and easement fees by allowing the Turkmen natural gas to reach South-Asian markets. Other untapped underground reserves include iron, copper, lapis lazuli, emerald, and gold.

Fiscal sector: Emerging from a chaotic situation where budget execution lacked cohesion, the authorities were able, in a short span of time, to articulate a coherent and consistent budget for 2003/04. Underpinned by the "no overdraft rule" that precludes monetary financing of the budget, fiscal discipline, accountability, and transparency have guided the authorities' policy framework. After a slow start, the pace of execution of the 2002/03 operating budget increased to reach over 90 percent of earmarked expenditure. Significantly, domestic revenues overperformed and were over 50 percent higher than budgeted. Consequently, the financing requirement was lower than projected, and was met largely from donor assistance. The development budget, however, was small as a result of administrative capacity constraints and since most of donor disbursements was focused on humanitarian aid and channeled outside the budget.

Significant progress has been made in fiscal reforms with technical assistance from the Fund, the World Bank, and USAID. Regarding expenditure, implementation, control, and transparency have been strengthened, including through computerization of expenditure recording, payment processing, and financial reporting across the country. Substantial progress has been made in the consolidation of government bank accounts to enhance efficiency in the management of treasury funds. The World Bank has funded an Emergency Public Administration Project to provide international contractors in financial management, public procurement, and audit, while helping to build local capacity in these areas. The transfer of revenue by the provinces and the reporting of non-wage expenditures have improved, and trained Afghan fiscal advisors are assisting with financial reporting to the center.

As regards revenue management, customs are being modernized, while a far-reaching policy reform package has been approved by Cabinet, including the use of market exchange rate in customs valuation, reduction in the number of tariff bands, and lowering tariffs. Customs clearance procedures are being simplified and a five-year plan to strengthen customs administration is contemplated. Tax policy and administration are being reformed, including through reduction of the top marginal rate for individuals and increasing personal exemptions, restoration of wage withholding on higher-income employees, introduction of a rent tax and airport fee, and expansion of the business receipts tax to cover certain expatriate services. Furthermore, a large taxpayer unit (LTU) is to be established by end-2003 to administer the personal income tax, business receipt tax, and the new rent tax. Concurrent civil service reform is also making progress. Remaining challenges include addressing professional capacity limitations, reducing over-staffing, and restructuring the pay system to attract, motivate, and retain skilled staff.

Monetary sector: With the assistance from the Fund and other agencies, a new Afghan currency was successfully introduced as an important symbol of national identity. The Da Afghan Bank (DAB) assumed full control over the withdrawal and destruction of old banknotes as well as the printing and issuance of the new unified national currency, which was completed without any social disruptions. The monetary policy framework is based on indicative money supply targets despite the difficulty of the task in a highly dollarized economy. A foreign exchange auction system has been developed and, currently, serves as the main instrument of monetary control. Auction decisions are based largely on exchange rate movements, and monetary growth has been in line with the DAB monetary program. Under the DAB's policy and the no-overdraft rule, the expansion of the money supply is closely matched by the accumulation of reserves.

The recent passage of new laws for the central bank and the commercial banking system has laid the foundations for an independent, accountable central bank as well as an efficient, well-supervised, and modern financial system. The DAB operational capacity has been strengthened, including through computerization and establishment of a supervisory department, while measures have been taken to improve the domestic payments system and to facilitate international payments. The stability of the exchange rate since January 2003 and the prudent monetary and fiscal policies have kept inflation in check. At present, the managed float regime is serving Afghanistan well, allowing the DAB to conduct limited sterilization operations while gradually building up reserves that reached about $568 million by September 2003 to provide a cushion against shocks. The balance of payments is driven by donor assistance, largely in form of grants, which finances a large current account deficit and allows a reserve build-up.

Economic outlook and policies for 2003/04

Sustained high growth will be critical for the socio-economic resuscitation of Afghanistan. Prospects for continued economic recovery are bright, but contingent on continued favorable weather conditions, improvement in the security situation, and donor support. In 2003/04, further strong growth in agriculture, construction, and services is expected to support real GDP growth of about 20 percent; inflation is expected to remain very low; and gross international reserves are expected to increase further. Economic diversification, led by the private sector, will be critical in achieving high growth and reducing the economy's vulnerability to shocks.

Fiscal management will be further strengthened, geared to fostering long-term sustainability. Improving revenue mobilization will be key to this effort. While significant donor assistance will be needed over the medium term, the authorities realize that they cannot indefinitely rely on donor contributions to fund their operating budget. Further effort will be made in tax policy and administration reform; staff recommendations regarding revision of the income tax, introduction of a wage withholding tax, and a service tax are being considered. The authorities regard a progressive, transparent, and simple tax system as having the best chance of maximizing compliance. Strengthening fiscal management of the provinces remains a priority, and efforts to consolidate government accounts to achieve effective revenue centralization and central government control over provincial finances will be reinforced. The authorities recognize the importance of civil service reform for fiscal sustainability, but realize that they need to proceed cautiously to minimize potential social and political costs. They intend to proceed with selective salary improvements and wage decompression, together with actions to improve capacity so as to promote a productive and well-remunerated civil service. In the same vein, while the authorities recognize the benefits of state enterprise reform, this will need to be implemented gradually. They plan closure, or divestment, of public enterprises through an open and transparent process.

The preparation of the 2003/04 budget shows a marked improvement. Domestic revenues are expected to rise significantly above the 2002/03 outcome, with collection in the first quarter of the fiscal year indicating considerable improvement over the same period last year. Although expenditure implementation started slowly, following delays in ministerial spending submissions and in payroll disbursements to provinces and security forces, it is expected to gain momentum over the year, reflecting the large reconstruction and social needs and improved administrative capacity.

The National Development Budget, based on the reconstruction road map and the priorities of the Afghan Government, is underperforming since actual donor support in the first half of 2003/04 has reached only 30 percent of the US$1.8 billion targeted for infrastructure, rehabilitation, health, social protection, assistance to refugees, and education. We welcome the recent announcement of a US$1.6 billion assistance package which will be spent on security and training of new police and conscripts of the Afghan National Army (ANA), logistics expenditure for the upcoming Presidential elections, and various emergency reconstruction projects. It is critical that other donors come forward too, so as to help ensure that the development program can be undertaken on the scale and pace required, and not be unduly constrained by shortfalls in financing. We look forward to a positive outcome from the forthcoming donors' conference planned for early next year.

Maintaining low inflation through control of monetary growth will continue to be the objective of monetary policy. While exchange rate stability will also serve as an anchor for price stability as well as engendering confidence in the new currency, the authorities intend to continue to administer the managed float cautiously and will avoid intervention for any prolonged period in order to reflect market trends and to protect foreign reserves. Following the adoption of the central bank and banking legislation, the authorities intend to further strengthen supervision and to promote financial intermediation and financial sector development. With Fund assistance, the authorities intend to put in place new legislation to counter money laundering and the financing of terrorism. Furthermore, the "*Hawala*" money transfer system will be subject to greater regulation and scrutiny. Problems of the existing state-owned banks will be addressed on a case-by-case basis to minimize budgetary costs and risks to the banking system. Options in this regard include restructuring, privatization, and closures when deemed appropriate.

While the external outlook is uncertain, being dependent on the security situation, as well as on the pace of reconstruction and economic recovery, current account deficits will remain high, and continued donor support will be critical. In addition, there is need to maintain a cushion of reserves against potential shocks. Moreover, given the present limited capacity to service new external debt, non-concessional borrowing is not a viable option. Therefore, donor grants and generous relief on existing debt will be crucial in funding the development program and ensuring external sustainability. The authorities have achieved some success in negotiating cancellation of bilateral debt. They hope to reach a resolution with the Russian Federation on claims that constitute the bulk of the external debt. A debt management system has recently been established to build capacity for tracking and ensuring timely future debt-service payments. While the de facto exchange system is free of restrictions, the authorities plan to establish the legal foundation for a liberal trade, payments, and exchange regime with Fund technical assistance and are working toward accepting obligations under Article VIII of the Fund's Articles of Agreement at the appropriate time.

Informal opium production is equivalent to 40-50 percent of GDP and generates (unrecorded) export receipts estimated at over $2 billion. It also supports the livelihood of a large number of rural population. Under the circumstance, an abrupt eradication of production is bound to have immense adverse socio-economic effects. As staff rightly indicate, a successful eradication program should be buttressed by extensive programs to develop alternative productive sources of livelihood as well as provision of requisite social support. The authorities are committed to an effective eradication program and call for maximum financial support of the international community in this regard.

Future engagement with the Fund

My authorities recognize and appreciate the Fund's role in providing the much-needed policy advice and technical assistance in managing critical areas of the economy in complementarity with the assistance from other development agencies. As the Minister of Finance indicated at the Annual Meetings in Dubai, the authorities are eager for a closer Fund involvement in Afghanistan in the context of a PRGF-supported program. This will provide a framework for policy discipline and credibility. My authorities have already demonstrated a strong commitment to implementation of sound policies and consider that closer Fund engagement will allow them to mitigate some of the very constraints and risks alluded to by staff. They believe a PRGF-supported program would send a strong signal, both domestically and internationally, of their readiness and capacity to design and implement a growth- and poverty-reduction strategy to place the economy on a sustainable and strong economic and social development path as they consolidate political and economic stability. For now, however, they agree with staff recommendation to start with a staff-monitored program to continue building on their strong policy track record. They look forward to the Board's support for a PRGF-supported program after the Presidential elections in the autumn of 2004.

Once again, my authorities are grateful to the Fund staff, management, and the Board as well as to the development community for their support. They hope that they can continue to count on this support so as to meet the difficult policy and reconstruction challenges that lie ahead.

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700 19th Street, NW
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IMF Concludes 2003 Article IV Consultation with the Islamic State of Afghanistan

On November 21, 2003, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with the Islamic State of Afghanistan.[1]

Background

The starting point for Afghanistan's reconstruction at the end of 2001 was unusually dire. After more than 20 years of conflict, interspersed with earthquakes and drought, the new Afghan authorities confronted their task with a largely defunct government and financial institutions, weak administrative capacity, and the widespread destruction of the country's infrastructure. Social indicators were among the worst in the world.

The authorities have made solid progress in rebuilding institutions and implementing sound economic policies. Fiscal policy has been characterized by a strong commitment to respect fiscal discipline and refrain from monetary financing. Big strides were made in improving expenditure management. An ambitious customs policy reform package is about to be approved and is to be followed by a reform of tax policy and administration. A new currency was launched in late 2002 and monetary policy has been restrained since then. As a result, prices and the exchange rate have been broadly stable in 2003. New financial sector legislation was adopted in the summer of 2003, granting the central bank autonomy and paving the way for establishing a modern banking sector.

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

The economy shows strong signs of recovery, albeit from very low levels of activity, reflecting not only the end of major hostilities, but also the end of a prolonged drought and the impact of sizable donor assistance and sound economic policies. Real GDP, excluding opium production, is estimated to have grown by almost 30 percent in 2002/03, driven by donor assistance and the end to a prolonged drought.[2] The impact of international assistance (and also of opium revenues, see below) is most visible in services and construction, which are expanding rapidly in urban centers. Agricultural production rose sharply in 2002/03, benefiting from increased rainfall and expanded acreage under cultivation. Agricultural production continued to increase this year, and combined with further strong growth in services and construction, GDP is expected to grow by 20 percent in 2003/04.

But while the formal economy is recovering, so is the production of opium. In 2002, opium production was estimated by the United Nations Office on Drugs and Crime (UNODC) to have reached 3,400 tons, a level similar to that of the late 1990s. Production in 2003 increased further to 3,600 tons. The opium sector has a profound impact on the economy and may account for about half of overall GDP.

Executive Board Assessment

Directors welcomed the opportunity to assess Afghanistan's economic performance and prospects for the first time in 12 years. They were strongly encouraged by Afghanistan's important progress over the past 18 months in rebuilding key institutions and restoring macroeconomic stability. Directors were particularly encouraged by the authorities' strong commitment to prudent macroeconomic policies and management, which, together with sizable international aid and the end of the drought, had provided an environment conducive to the resumption of economic growth. They expressed strong concern that any worsening in the fragile security situation might jeopardize the progress achieved so far and emphasized the need for the international community to continue to play a key role in the reconstruction process.

Directors noted that the government would require substantial resources in the period ahead in order to address more aggressively the many basic needs in the areas of security, health, education, and institutional reforms. They viewed progress in these areas as a necessary condition for promoting sustainable economic growth. In this regard, Directors underscored the importance of maintaining substantial donor assistance.

Directors supported efforts to put in place revenue-raising measures to reduce the dependence of the operating budget on donor assistance in due course. They supported measures to broaden the sources of revenue through tax policy and customs reform and improved collection, particularly from the provinces. Although significant strides have already been made in

[2] The Afghan solar year 1381 ran from March 21, 2002 until March 20, 2003. The solar year 1382 runs from March 21, 2003 until March 19, 2004. The Afghan fiscal year coincides with the solar year.

improving fiscal management, Directors looked forward to further progress in improving revenue transfers from the provinces to the central government, and budget formulation and execution.

Directors encouraged a process of meaningful civil service reform, including to the civil service wage system. They welcomed the progress toward the integration of donor projects into the development budget, which would facilitate the comprehensive monitoring of projects, and ensure their consistency with the authorities' overall strategy, as outlined in the National Development Framework, and thus promote a greater contribution of the authorities to the "ownership" of these projects. They emphasized the importance of this process, especially as donor assistance gradually shifts from budgetary support to development and reconstruction.

Directors commended the authorities on the successful introduction of the new currency and noted that introducing a new currency in a post-conflict environment such as in Afghanistan was a major accomplishment. They regarded prudent monetary policy supported by strong fiscal discipline, including the "no-overdraft" rule for budget financing that prohibits central bank financing of the deficit, as instrumental in ensuring the stability of the exchange rate of the new currency. On the exchange rate regime, Directors saw merit in a "lightly managed" float for a country which remains vulnerable to shocks, and is undergoing structural changes and reconstruction, though a few Directors cautioned against using a narrow or rigid target range for the exchange rate.

Directors welcomed the authorities' commitment to a liberal trade and exchange regime and urged them to act swiftly to clarify the regulatory environment. They supported the provision of Fund technical support to draft the appropriate laws and regulations needed for the acceptance by Afghanistan of the obligations under Article VIII, Sections 2, 3, and 4.

Directors commended the creation of a supervision department in the central bank, and emphasized the importance of further developing regulatory and supervisory capacities, and restructuring and privatizing state banks. They urged tighter control of informal mechanisms of financing, and the introduction of anti-money laundering and controlling the financing of terrorism legislation.

Directors considered that the authorities faced major challenges and risks in their efforts. They concurred that one of the most prominent risks is a lack of security and the limited rule of law, highlighted by the government's limited control over the provinces. They considered that restoring adequate security throughout the country remains a key priority to facilitate the implementation of reforms and projects, as well as the resumption of private economic activity and the provision of basic public services beyond Kabul. In this regard, Directors stressed the need for the international community to support the government in its efforts.

Directors were concerned about the serious risks posed by the rise in poppy cultivation and the production of opium in Afghanistan to levels of the late 1990s. In this regard, they urged the authorities to intensify eradication programs with the help of the international community, and to provide farmers with alternative livelihoods to avoid a downward spiral of violence and corruption.

Directors considered that poverty alleviation in Afghanistan will require strong economic growth for many years to come, as per capita GDP remains one of the lowest in the world. They observed that a key support in sustaining economic growth, and reconstruction and development, will be maintaining a high level of donor support, predominantly in the form of grants, in view of Afghanistan's limited debt servicing capacity. Directors welcomed the debt relief that had already been provided by some countries and encouraged the authorities to pursue debt cancellations from other major creditors and regularization of relations with all creditors. They welcomed the formation of a debt management unit.

Looking ahead, they emphasized the importance of Afghanistan attracting substantial private investment to eventually take the place of official assistance and in general of developing a solid private sector. They also encouraged the authorities to prepare the ground for privatization of state-owned companies. Directors saw several key areas of reform as preconditions, including putting in place a functioning financial system, a market-oriented regulatory framework, and a functioning and fair legal system to firmly establish the rule of law and the security of property rights.

Directors stressed that the process of maintaining macroeconomic stability and moving the reform program ahead will require sustained efforts to strengthen and maintain the political and public consensus for the reforms, strong policy actions, the support of the international community, and a strengthened administrative capacity. To this end, Directors supported Afghanistan's intention to undertake a staff-monitored program in the period ahead. They viewed this as an appropriate framework for improving policy formulation capacity, strengthening economic management, and better coordinating and targeting technical assistance, and an important step for the preparation for a Poverty Reduction and Growth Facility arrangement. They encouraged the authorities to make full use of donors and Fund technical assistance. In this context, some Directors referred to the possibility of a post-conflict arrangement.

In view of the poor quality of Afghanistan's macroeconomic statistics, Directors welcomed recent improvements in the quality of fiscal and monetary data and indicated that substantial efforts will be needed to bring the data quality to levels adequate for surveillance and program monitoring.

Public Information Notices (PINs) are issued, (i) at the request of a member country, following the conclusion of the Article IV consultation for countries seeking to make known the views of the IMF to the public. This action is intended to strengthen IMF surveillance over the economic policies of member countries by increasing the transparency of the IMF's assessment of these policies; and (ii) following policy discussions in the Executive Board at the decision of the Board. The Staff Report for the 2003 Article IV Consultation with the Islamic State of Afghanistan is also available.

Islamic State of Afghanistan: Selected Economic Indicators, 2001–04

	2001/02 Estimate	2002/03 Estimate	2003/04 Projection
Output			
Real GDP growth (percent, excluding opium)	...	29	20
GDP (billions of Afghani)	134	181	271
GDP (millions of U.S. dollars, excluding opium)	2,463	4,048	...
GDP per capita (U.S. dollars, excluding opium)	...	186	...
Prices			
CPI (Kabul, March–March, percent change)	-43.4	52.3	14.9
CPI (Kabul, year-on-year, percent change)	...	5.2	24.7
Exchange rates			
Afghani/US$ (annual average)	54.4	44.8	...
Afghani/US$ (end of period)	31.0	52.6	...
General government operating budget			
Revenues (millions of U.S. dollars)	...	132	200
Expenditures (millions of U.S. dollars)	...	349	550
Grants (millions of U.S. dollars)	...	184	350
Balance (millions of U.S. dollars)	...	-34	0
Monetary indicators			
Domestic currency in circulation (percent change)	...	20.1	30.0
Gross international reserves (millions of U.S. dollars)	...	426	565

Sources: Afghan authorities; and IMF staff estimates.