

Islamic Republic of Afghanistan: Sixth Review Under the Arrangement Under the Poverty Reduction and Growth Facility, Request for Waiver of Nonobservance of a Performance Criterion, Modification and Performance Criteria, and Rephasing and Extension of the Arrangement

The following documents have been released and are included in this package:

- The staff report, prepared by a staff team of the IMF, following discussions that ended on October 27, 2009, with the officials of the Islamic Republic of Afghanistan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on December 23, 2009. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- A staff statement.
- A Press Release.
- A statement by the Executive Director for Afghanistan.

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

Letter of Intent sent to the IMF by the authorities of the Islamic Republic of Afghanistan*

Memorandum of Economic and Financial Policies by the authorities of the Islamic Republic of Afghanistan *

Technical Memorandum of Understanding*

Other Background papers

*Also included in Staff Report

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

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INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF AFGHANISTAN

Sixth Review Under the Arrangement Under the Poverty Reduction and Growth Facility, Request for Waiver of Nonobservance of a Performance Criterion, Modification of Performance Criteria, and Rephasing and Extension of the Arrangement

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

Approved by Adnan Mazarei and Dhaneshwar Ghura

December 23, 2009

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Executive Summary

Afghanistan's situation is remarkably difficult. In addition to its geographical disadvantages and the damage sustained after decades of conflict, its security situation has been worsening and political uncertainty has been high. Corruption, limited administrative capacity, and political tensions also hamper policymaking.

Despite these difficulties, the authorities have been successfully implementing the 2009/10 economic program. Economic activity is recovering from last year's drought, inflation has been tamed, tax collection has exceeded expectations, and the envisaged structural reforms have been implemented.

The 2009/10 program has been adjusted to reflect recent developments but remains focused on keeping inflation low, mobilizing domestic revenues, and monitoring public enterprises that pose fiscal risks. In addition, there has been a small delay in the timing of structural measures under the Seventh Review. The main elements of the revised program are:

- Real GDP growth in the fiscal year ending March 2010 is projected at 15 percent, bolstered by a recovery in agricultural output and higher government spending and grants.
- Monetary policy is being eased in light of incipient deflation. This is consistent with the end-March 2010 inflation target of 6 percent or less.
- Fiscal policy focuses on containing nonsecurity spending while accommodating increases in security spending financed with additional grants. The operating deficit excluding grants is expected to worsen by 1.6 percent of GDP.
- Regular reports will be produced on the financial flows of the state electricity company, and a financial review will be completed for the four largest public enterprises (airline, telecom, electricity, and fuel) that pose fiscal risks.
- New controls will be implemented in customs, and border posts will be modernized to improve efficiency and limit corruption.

As the PRGF-supported program enters its last phase, the authorities are well positioned to capitalize on the progress made and complete the planned reforms. Looking ahead, and aside from much needed improvements in security, embracing an ambitious medium-term reform strategy and exerting the necessary political will to combat corruption and carry out reforms will be critical to foster sustainable growth and poverty reduction.

In light of the satisfactory performance to date and the strength of the authorities' program for the remainder of 2009/10, the staff recommends the completion of the Sixth Review. The staff also supports a three-month extension of the arrangement until June 25, 2010 to allow for the implementation of the intended reforms and discussions on a successor arrangement.

I. INTRODUCTION

1. Afghanistan faces enormous and longstanding challenges including geographical disadvantages, damage to infrastructure and administrative capacity after prolonged internal conflict, and ethnic tensions. In recent years, security has deteriorated, political uncertainty has increased, and corruption and rent seeking have worsened.¹ The informal economy, including opium production and trade, hampers governance and economic management.
2. Since mid-2006, Afghanistan has been implementing an economic program supported by the IMF's Poverty Reduction and Growth Facility (PRGF). The Executive Board concluded the Fifth Review under the PRGF arrangement on April 22, 2009.² At that time, Executive Directors supported the authorities' intention to carry out a prudent monetary policy and stressed the importance of increasing revenues and strengthening monitoring of key public enterprises.
3. Discussions on the Sixth Review were held via videoconference from Washington, D.C. during September 22–October 1, 2009 and in Kabul during October 20–27.³ In the attached Letter of Intent and Supplementary Memorandum of Economic and Financial Policies (Attachments I-III), the authorities request the completion of the Sixth Review, describe the policy framework for the remainder of the fiscal year 2009/10 (ending on March 20, 2010), and request an extension of the arrangement to June 25, 2010 and a change in the test date for the Seventh Review to coincide with the end of the fiscal year in March 2010. The authorities have also expressed interest in a successor arrangement with the Fund.

¹ Afghanistan's ranking in Transparency International fell from 172 (out of 180) in 2006 to 179 in 2009.

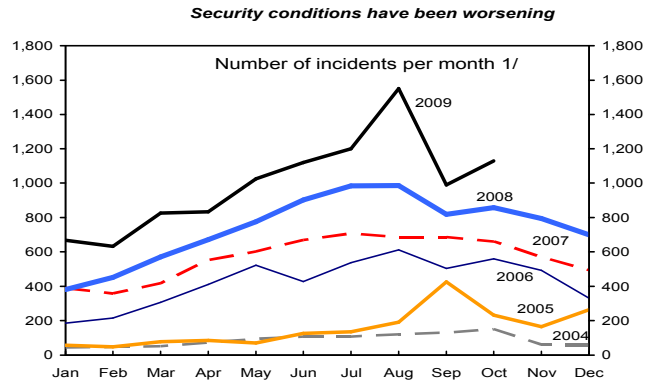
² The three-year PRGF arrangement with a total access equivalent to SDR 81.0 million (50 percent of quota) was approved by the IMF Executive Board on June 26, 2006. At the time of the Fifth Review, the Board extended the arrangement until March 31, 2010 and rephased remaining disbursements to allow for a Seventh Review. The Fund has already disbursed an amount equivalent to SDR 69.7 million, and will make available the equivalent of SDR 5.65 million upon the completion of this Review (Table 1).

³ The discussions were held with Finance Minister Zakhilwal, Central Bank Governor Fitrat, Energy Minister Khan, other officials, and representatives from the private sector and the donor community. Mr. Gelbard (Middle East and Central Asia Department) headed the staff team that also comprised Mr. Ma and Ms. Mineshima (Middle East and Central Asia Department); Ms. Asmundson (Strategy, Policy, and Review Department); Mr. Gracia (Fiscal Affairs Department), and Mr. Abdallah (the Fund's Resident Representative in Afghanistan).

II. RECENT DEVELOPMENTS AND PERFORMANCE UNDER THE PROGRAM

4. The security situation has been precarious amid heightened political uncertainty.

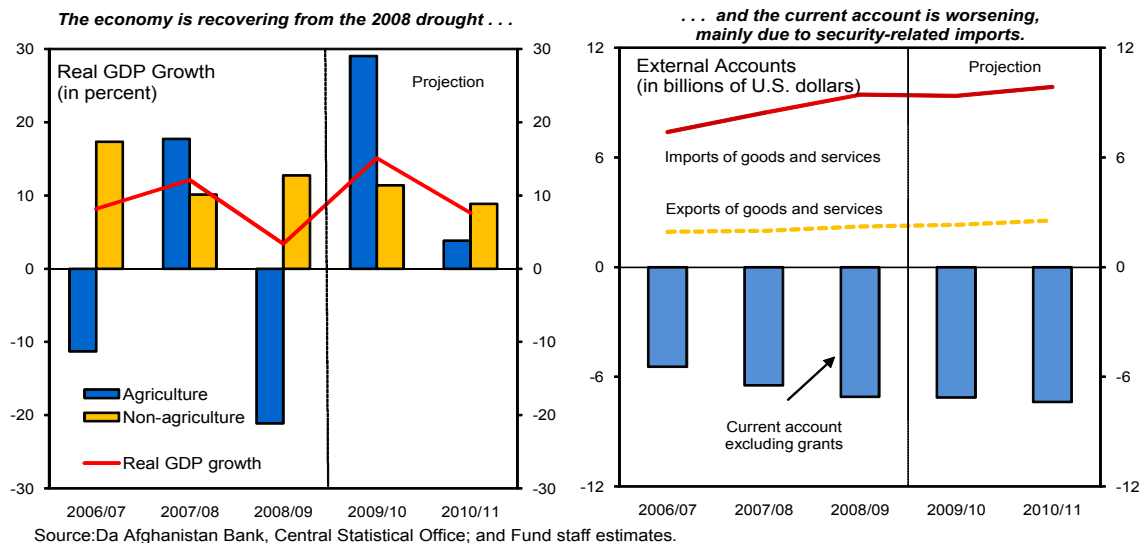
The number of violent incidents has continued to rise in 2009. Political uncertainty rose sharply in the second half of the year amid election-related complications, including fraud. In early November, President Karzai was reelected after his main contender, Dr. Abdullah, withdrew before the second round.



Source: United Nations Department of Safety and Security
 1/ Attacks and serious beating incidents perpetrated by anti-government elements throughout Afghanistan. They include suicide and stand off attacks; bombings; attacks on district centers, aid and military convoys and their contractors; night letters; assassinations; illegal check points and beatings.

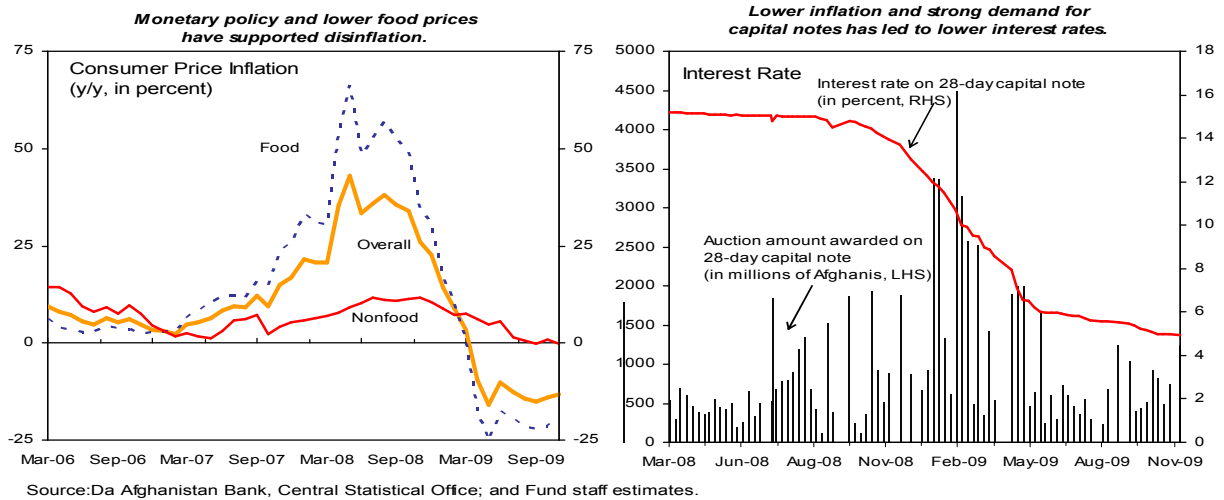
5. Economic activity has been recovering.

Real GDP is poised to climb by about 15 percent in 2009/10, driven by a rebound in agriculture after last year's drought (Table 2).⁴ In addition, higher spending by the government and coalition forces has been supporting the other sectors of the economy and contributing to higher imports (Table 3). Outside the formal sector, the United Nations Office on Drugs and Crime estimates that opium production (excluded from measured GDP) has continued to fall.

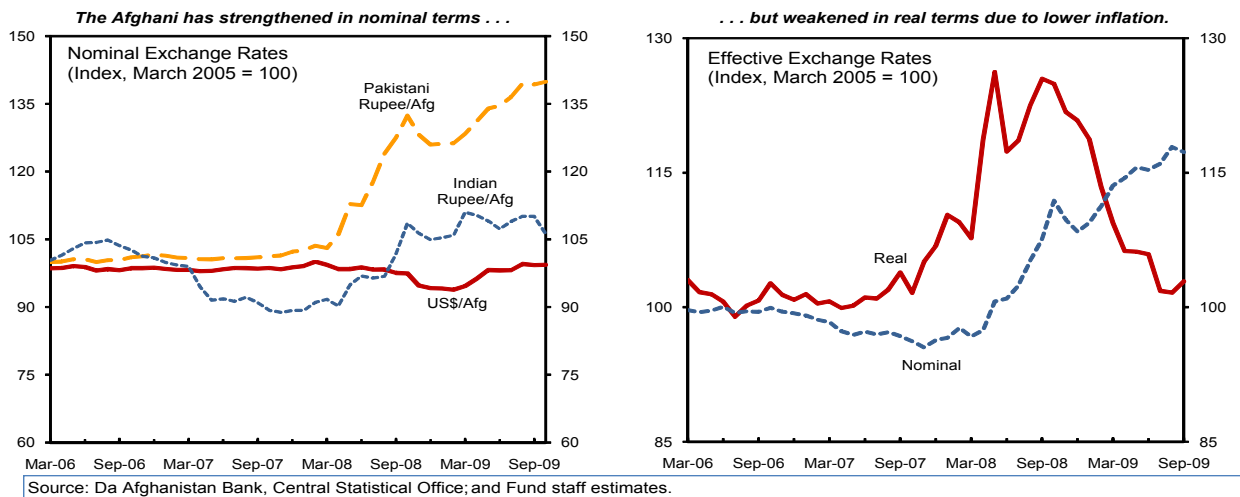


⁴ Formal agriculture accounts for 24 percent of GDP.

6. **Inflation has been on a downward path.** Lower world food prices and a prudent monetary policy have pushed down inflation. The 12-month rate of inflation fell from a peak of 43 percent in May 2008 to minus 13 percent in November 2009.⁵ Core inflation, measured by nonfood inflation, fell from 12 percent in November 2008 to minus 0.6 percent in November 2009. Paralleling inflation developments, interest rates have also declined.



7. **Monetary policy has been successful and the Afghani has been appreciating.** The growth of currency in circulation has been carefully managed to support the decline in inflation from double-digit levels in 2008. Reserve money, however, has been volatile, primarily because of unexpected changes in coalition forces' deposits. Money demand remained strong as evidenced by the decline in inflation and a nominal appreciation of the Afghani. Despite fluctuations in domestic prices (due to sizable changes in food prices), the Afghani remains close to its five-year average in real effective terms.



⁵ Food items account for 61 percent of the Consumer Price Index.

8. **Bank lending has slowed and financial intermediation remains low.** Annual growth in bank lending has decreased from about 80 percent during 2007/08 to 18 percent in September 2009. Total bank assets are about 22 percent of GDP, highlighting the country's low level of financial intermediation. Nonperforming loans remain modest at about 1 percent of total loans. However, there have been some difficulties with loan classification, suggesting that this is an underestimate.⁶

9. **Financial supervision is being strengthened.** The central bank's financial supervision department has increased its staff and the frequency of onsite visits to commercial banks. The department has established sections for AML/CFT and Islamic banking issues, has begun to automate offsite examinations, and has requested an external assessment of compliance with the Basel Core Principles on Banking Supervision.

10. **The fiscal position has turned out better than expected.** Higher domestic revenues during March-September and tightly managed nonsecurity operating expenditures have led to a lower-than-expected operating deficit. As a result, the government's discretionary cash balances have increased considerably from precarious levels last year.

11. **Tax collection has been strong.** Between March and September, domestic revenues rose by 60 percent over the previous year and exceeded program targets.⁷ Tax collection has benefited from recent reforms, namely the strengthening of large and medium taxpayers' offices, tighter controls on fuel imports, and amendments to the income tax law including the collection of the business receipts tax on imports. The authorities have also been implementing a short-term revenue action plan with measures aimed at limiting corruption.

Recent Fiscal Developments		
	March - September 2009	
	Program	Preliminary
	(in billions of Afghanis)	
Domestic revenues	25.1	28.7
Customs	8.8	9.8
Other	16.3	18.9
Grants	29.5	32.5
Operating	14.8	16.7
Development	14.6	15.8
Expenditures	57.5	56.0
Operating	37.7	38.1
Development	19.8	17.9
Overall balance		
Including grants	-3.0	5.2
Excluding grants	-32.4	-27.3
Operating balance		
Including grants	2.2	7.2
Excluding grants	-12.6	-9.4

⁶ Overdrafts with interest paid in advance comprise a significant part of total loans. As loan classification had been based on timely interest payments, such overdrafts qualified as performing loans even if the principal was not paid on time. Regulations have been recently introduced so that loans would be classified as nonperforming if principal payments are delayed.

⁷ The pace of collections slowed somewhat during August-September, possibly because of election uncertainties and seasonal factors. In addition, customs collection during April-July was boosted by traders' increases in inventories in anticipation of political uncertainty.



Source: Ministry of Finance; and Fund staff estimates.

1/ The operating balance equals domestic revenues less operating expenditures.

12. **All but one of the performance criteria for June 2009 were observed** (Table 4). The target on the minimum accumulation of international reserves was not met, but this does not reflect a policy slippage. Instead, the target was missed because it had been based on a projected stock of reserves for March that turned out to be lower than the actual stock. This occurred as result of unexpected temporary deposits at the central bank by a commercial bank that manages coalition forces' funds. As these funds were later withdrawn, there was a large decline in reserves between March and June, leading to nonobservance of the target.⁸

⁸ This problem will not recur since the updated flow targets for the remainder of the program are now based on actual data for March 2009.

13. **All structural measures envisaged for the Sixth Review have been implemented.** These included setting up additional post-clearance audit units at customs and preparing monthly reports on the collection of the business receipts tax on imports (Table 5). The measure on the publication of the audits of the fuel company was met with a delay. The audits will be important inputs to the forthcoming review of key public enterprises.

III. POLICY DISCUSSIONS

14. Discussions focused on updating the policy framework for the Seventh Review, including quantitative targets and structural measures. The revised program accommodates an easing of monetary policy, a higher revenue target and higher government spending, a realignment of quantitative test dates to coincide with the end of the fiscal year, and a slight change in the timeline for the structural measures related to customs administration and surveillance of public enterprises.

A. Monetary and Financial Sector Policies

15. **Falling inflation creates room for monetary policy easing.** The authorities have concluded that, as disinflation has been locked in, an easing of monetary policy is warranted. Accordingly, currency in circulation is programmed to grow by 22 percent during 2009/10 compared to an original ceiling of 16 percent (Table 6). The twelve-month rate of inflation is expected to be 6 percent or less.

16. **The revised program envisages a further buildup of reserves.** Net international reserves are expected to grow by about US\$339 million, keeping the gross stock at a comfortable level of about 13 months of imports. This figure includes Afghanistan's share of the Fund's new SDR allocations of about US\$200 million. The authorities intend to save the allocations given that this year's fiscal and balance of payments gaps are fully funded and that use of the funds for further fiscal expansion could compromise fiscal sustainability.

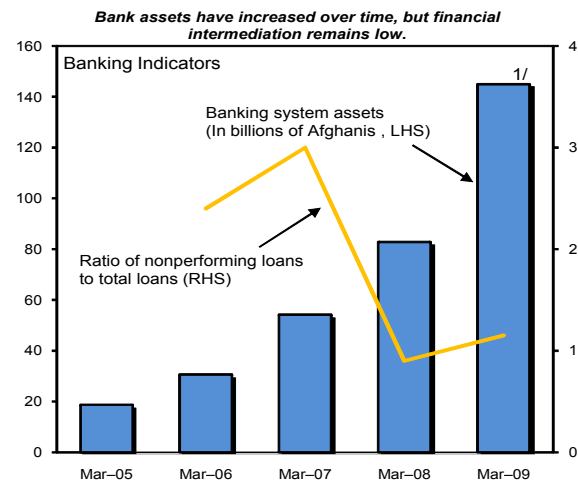
17. **The floating exchange rate regime is expected to be maintained.** In the period ahead, the Afghani may appreciate in real terms given the favorable balance of payments position and higher government and donor spending. Thus, the authorities will likely face a trade-off between allowing higher inflation, which could hurt the poor, and Afghani appreciation. The central bank has committed to focus monetary policy on containing inflation and limit foreign exchange intervention to smooth exchange rate volatility. Regarding trade in goods and services, the authorities have informed Fund staff that Afghanistan is prepared to accept the obligations under Article VIII, Sections 2-4 of the Fund's Articles of Agreement (absence of restrictions on payments for international trade and services) and requested an assessment of its exchange system for that purpose.

18. **Strengthening liquidity management and fostering the development of the money market are important.** The authorities are considering moving to targeting reserve

money rather than currency in circulation. Toward this end, they agreed on the importance of improving liquidity forecasts and enhancing cooperation between the central bank and the Ministry of Finance. The development of the money market, including a secondary market for capital notes, will also be needed together with further diversification in the maturity of the notes if liquidity conditions are appropriate.

19. **Further actions are required on central bank audit and reporting.** The completion of the 2009 audit of the central bank has been delayed because of a valuation problem with gold holdings; the audit is expected to be finalized by end-2009. Fund staff has been following up on a safeguards assessment done in 2006.⁹ The staff noted that while financial reporting and accounting controls remained relatively weak, external audit arrangements had been strengthened. The implementation of measures recommended by the assessment has been hampered by capacity constraints. The central bank expressed its commitment to implement the outstanding recommendations, and Fund staff will be monitoring these actions in coming months.

20. **Improving commercial banks' soundness is a priority.** The banking system's expansion in recent years highlights the importance of improving supervision. The authorities intend to step up banking supervision by broadening the scope of bank examinations to include other risks and improve fraud detection capacity, monitoring all banks through the electronic Core Banking System, and fostering improvements in loan quality and prudential ratios of banks with weak CAMEL ratings. In addition, the authorities committed to the prompt implementation of enforcement letters issued to noncompliant banks by the central bank's supervision department.

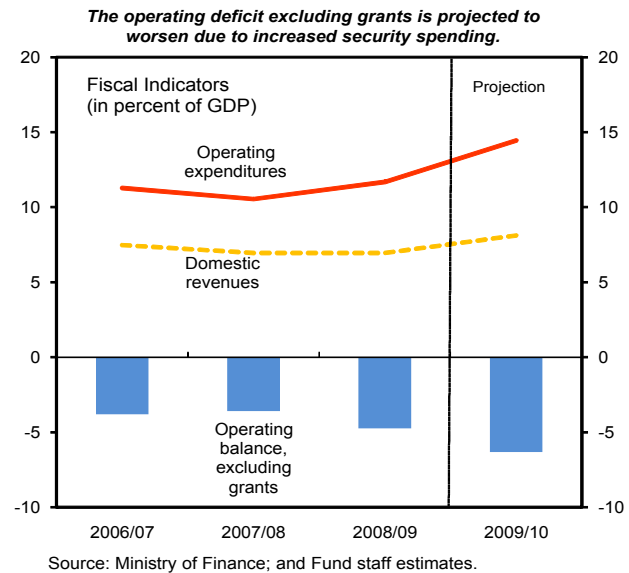


Source: Da Afghanistan Bank, and Fund staff estimates.
1/ International reserves and banking assets were temporarily large in February-March 2009, due to the inflow of allied forces' funds.

⁹ Under the Fund's safeguards assessment policy, the central bank (Da Afghanistan Bank) is subject to a safeguards assessment with respect to the PRGF arrangement approved on June 26, 2006. The assessment was completed on June 12, 2006 and updated on March 18, 2008. It revealed vulnerabilities in the central bank's audit mechanisms, as well as in its financial reporting framework and internal controls. In the event of a new arrangement, an updated safeguards assessment would be required no later than at the time of the First Review.

B. Fiscal Policy

21. **The revised fiscal framework for 2009/10 incorporates a sizable increase in security spending.** Operating spending is projected to increase by 2.3 percent of GDP, much of which is security-related (the combined size of the army and the police is expected to increase from 168,000 in 2008/09 to 205,800 in 2009/10). The budget also includes an allotment of 0.2 percent of GDP for a strategic wheat reserve. The operating deficit excluding grants is projected to worsen by 1.6 percent of GDP, but since almost all the additional security spending will be financed with grants, the operating balance including grants is expected to remain roughly unchanged (Table 7). Development spending, consistent with the Afghanistan National Development Strategy (ANDS), continues to focus on infrastructure, rural development, education, and health.



22. **The authorities have raised the revenue target.** The revised program increases the domestic revenue target for 2009/10 from Af 51 billion to Af 54.5 billion. The new figure is equivalent to 8.1 percent of GDP, compared to 7.3 percent in the original program and 6.9 percent in the past two years.

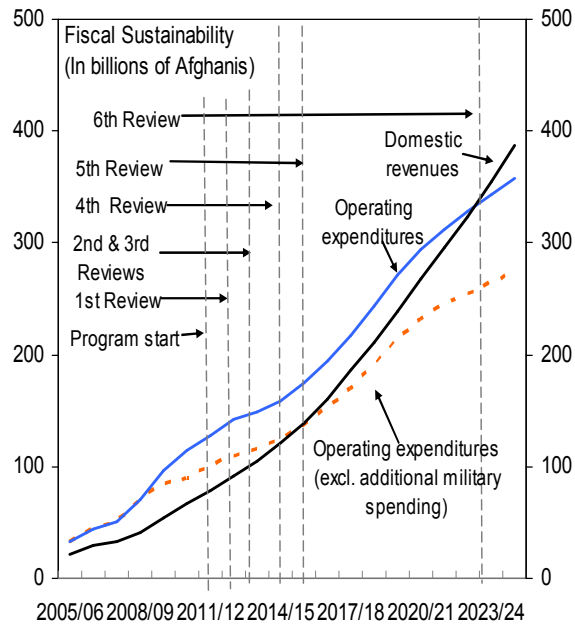
23. **Despite higher domestic revenues, the need for donor financing remains large.** Donors are expected to finance most of the increase in the size of the army and police in the short term. Over time, domestic revenues will be able to finance an increasing share of expenditures. Assuming modest increases in nonsecurity spending in coming years, higher security spending alone will move the date at which domestic revenues equal operating expenditures (defined as “fiscal sustainability”) from 2015 to at least around 2023 (Box 1).

Box 1. Fiscal Sustainability

Fiscal sustainability under the program has been defined narrowly as domestic revenues equaling operating expenditures. During 2007–09, a weak revenue performance implied a delay in the date at which fiscal sustainability would be achieved. In the past year, as the need for significantly higher levels of security spending has become evident, the authorities have been considering to at least double the size of domestic security forces by 2013 (the medium-term scenario presented here assumes that the combined size of the army and the police would reach 300,000 by 2013/14).

The medium-term macroeconomic framework envisages a rapid increase in domestic revenues and a relatively constrained profile for nonsecurity recurrent spending that preserves pro-poor and development outlays. Under the above assumptions, including a modest decline in security spending as a share of GDP after 2020, fiscal sustainability is expected to be postponed by about eight years until 2023.

Looking ahead, fiscal sustainability could be delayed by a slackening of tax collection, a need for higher or longer-lasting levels of security-related spending, and political pressures to raise other, lower-priority outlays.



C. Structural Reforms

24. **The timing of the remaining reforms has been slightly delayed.** All the measures envisaged for the Seventh Review have been retained (Box 2), but the authorities will require one to two additional months to complete implementation (Attachment II, Table 2). To improve efficiency at customs and limit corruption, the authorities will be developing a new model of customs controls and implementing the Automated System for Customs Data (ASYCUDA) in additional customs posts.

25. **Further reforms on public enterprises are high on the agenda.** These include the publication of reports on operations of the state electricity company and the financial review of key public enterprises. The authorities also concurred that another important measure to improve the oversight of public enterprises would be to shift the corresponding directorate from the Administration Department of the Ministry of Finance to either the Finance Department or the Office of the Minister. The latter will be better placed to monitor these

companies and decide on future reforms that would reduce fiscal risks. This organizational change has been added as a structural benchmark for the Seventh Review.

Box 2. Rationale for Structural Measures under the Program

Tax and customs administration. Afghanistan has one of the lowest revenues-to-GDP ratios in the world, and higher revenues will be critical to implement Afghanistan's development strategy and achieve fiscal sustainability. In this connection, broadening the tax base, limiting opportunities for corruption, and improving compliance are key objectives under the program. In 2009/10, reforms focus on strengthening large and medium taxpayers' offices, improving controls on fuel imports, collecting the business receipt tax on imports, implementing ASYCUDA at key customs posts, and rationalizing border controls by customs and other agencies.

Public enterprises. Weak governance, high costs, and nontransparent operations of public enterprises create significant fiscal risks. For instance, the electricity company needed emergency support in 2008 to finance its operations. Similarly, in mid-2009, the state airline company received a cash advance to finance the acquisition of new aircraft. While donors provided the needed support to the electricity company and most of the advance to the airline has already been repaid, the fiscal risks from these companies cannot be underestimated. This year's structural measures focus on auditing the fuel company, improving data reporting by the electricity company, and finalizing a review of financial and fiscal relations for the four largest enterprises.

26. **Implementation of a simple program approach to budgeting will help unify the budget and improve expenditure management.** The government is simplifying program structures in ministries' budgets and the associated chart of accounts. The program budgeting framework will result in the integration of the development and operating budgets and allow for a coherent set of expenditure policies focusing on objectives rather than on inputs as well as for the alignment of the budget with the development priorities set out in the ANDS.

27. **Sustained improvement in revenue collection will require deeper reforms.** The authorities are implementing a new merit-based recruitment model. They agreed on the need to minimize political interference in the hiring process and to respect the authority of the hiring departments. The authorities intend to finalize in early-2010 a medium-term reform plan to improve efficiency in revenue and customs administration. The goal would be to create effective national revenue and customs departments with increased responsibility and accountability for their provincial offices and budgets.

D. Medium-Term Outlook and HIPC Completion Point

28. **In the medium term, real GDP is projected to grow at an average of 7 percent** (Table 8). The baseline scenario assumes economic stability, a gradual improvement of security over the next five years, and a relatively ambitious economic program focused on financial sector development, strengthening revenue administration, and public enterprise reform. The baseline also takes into account the coming on stream of new mining projects (especially the large Aynak copper project) and assumes an improvement in governance and

increased efficiency in development spending. During the next decade, and despite a steady increase in domestic revenues, the baseline yields sizable fiscal and balance of payments gaps that are assumed to be financed with grants and, to a lesser extent, concessional loans.

29. **The outlook is subject to significant risks.** On the downside, key risks are linked to the domestic security situation, the role of vested interests, and the situation in Pakistan. During 2007/09, for instance, revenue collection and reforms faltered because of insufficient political will and vested interests. In addition, trade and security could be affected by instability in Pakistan (especially in border areas), and the timing and scope of mining projects could suffer. On the upside, a more rapid improvement on the security front and resolute implementation of an ambitious reform program could deliver faster and better results in terms of infrastructure investments, growth, and poverty reduction.

30. **Most of the HIPC completion point triggers have been implemented.** Eight of the eleven triggers have been implemented and work on the remaining triggers is proceeding. (Box 3) One important trigger is the one on mining, whose implementation requires finalization of appropriate regulations. This trigger is critical because of the importance of the sector to Afghanistan's economic development and governance concerns. Assuming a quick implementation of this trigger, the World Bank and IMF Executive Board meetings on the completion point could take place as early as in February 2010.¹⁰ After the completion point, Afghanistan's foreign debt from the Paris Club and other bilateral creditors is expected to be significantly reduced and in some cases eliminated.

IV. PROGRAM MONITORING

31. **The Seventh Review will focus on tax collection and fiscal risks from public enterprises.** The quantitative indicative targets and performance criteria for the Seventh Review as well as the target dates for implementation of key structural measures have been revised in light of recent developments (Attachment II, Tables 1 and 2). The authorities have requested an extension of the program until June 25, 2010 to allow for the implementation of the intended reforms and negotiations on a successor arrangement. The authorities have also requested a change in the test date for the quantitative performance criteria from December 2009 to March 2010 and modification of the performance criteria.

¹⁰ The staffs expect to submit for Board discussion the completion point report (including the HIPC debt sustainability analysis and the debt sustainability analysis for low-income countries) and the Joint Staff Advisory Note on the Annual Progress Report of the ANDS when the assessment is completed.

Box 3: HIPC Completion Point Triggers

Trigger	Status as of Mid-December 2009
Satisfactory ANDS implementation	Implemented. The joint World Bank-IMF Joint Staff Advisory Note will be presented to the respective Boards with the HIPC Completion Point documents.
Maintain macroeconomic stability as evidenced by satisfactory performance under the IMF PRGF-supported program.	Implemented. Performance under the PRGF supported program has been satisfactory; the staff is recommending the completion of the Sixth Review.
Establishment of external debt database and publication of three consecutive quarterly reports in a timely manner.	Implemented. Regular publication of the reports is expected to continue.
Alignment of public spending priorities with the ANDS.	Implemented. The budget contains a discussion of planned versus executed priority expenditures in the 2008/09 budget, along with a discussion of planned expenditures in the 2009/10 budget.
Production of medium-term fiscal framework consistent with PRGF and ANDS priorities.	Implemented. The midyear budget review and the revised medium-term fiscal framework are consistent with the program. There are also medium-term envelopes for key crosscutting fiscal issues.
Tracking poverty-related spending over a period of at least six months preceding the completion point.	Implemented. However, tracking remains limited due to classification and reporting problems. There are plans to improve budget code classifications.
Submission to Parliament for the year immediately preceding the completion point of (i) the annual budget audit report and (ii) a report on the resolution of important issues identified by the external auditor.	Implemented. The audit report was submitted to Parliament six months after the end of the fiscal year, in accordance with the law. The latest report from July 2009 describes the status of actions on issues identified in the program of entity audits and in the annual audit of Government accounts.
Design pension reform for public employees and the military.	Substantially implemented. Two laws for regulating benefits for the disabled and martyrs/survivors require amendments. The military pension regulations are expected to be approved by Cabinet in late December.
Restructure the Ministries of Agriculture, Education, Public Health, and Rural Development to strengthen core functions and service delivery mechanisms.	Substantially implemented. Restructuring is at an advanced stage, with human resource departments and reform implementation management units expected to be fully operational by March 2010.
Develop and adopt regulations and guidelines for minerals extraction and establish a fully operational hydrocarbon/mining cadastre.	In progress. A cadastre has been established, and the Mineral Law and Hydrocarbon Law have been published. Hydrocarbon regulations have been approved by Cabinet, and the mineral regulations are being finalized.
Annually publish government and third-party data on the quantity of health and education services.	Implemented. The Ministry of Health's annual report on strategy implementation was published in June 2009. The Ministry of Education regularly publishes reports on its webpage.

Sources: Afghan authorities; and World Bank and Fund staff assessments.

V. STAFF APPRAISAL

32. Despite a very difficult security and political environment, performance under the program has improved since early 2009. The economy has been growing, inflation has been tamed, tax administration reforms have been yielding positive results, and envisaged reforms on public enterprises have been implemented.
33. The revised program aims at consolidating the progress made. The authorities intend to focus monetary policy on keeping inflation low and fiscal policy on revenue collection, the expansion of security forces, and the execution of development projects. On the structural side, tax administration reforms remain paramount, alongside emphasis on public enterprises and banking system soundness.
34. A prudent monetary policy and lower food prices have fostered a successful disinflation. Although an easing of monetary policy is warranted, the authorities will need to remain vigilant and adjust the policy stance should inflationary pressures develop. To enhance monetary management, improving liquidity forecasts and fostering the development of money market and secondary transactions of capital notes are critical. At the same time, the authorities should limit foreign exchange market intervention to countering volatility.
35. This year's fiscal and balance of payments gaps are fully financed, but the respective deficits excluding grants will worsen and fiscal sustainability will be postponed. Higher security-related spending will need to be accommodated, while a prudent approach is required to prevent slippages on nonsecurity current expenditures and protect propoor and development spending. In this connection, the authorities need to press ahead with reforms to increase capacity and improve the execution of development spending by, among other things, implementing a simplified program budgeting reform.
36. Based on recent tax administration reforms, the authorities are well positioned to maintain the momentum in tax collection displayed in the first half of the fiscal year and surpass targets in the second half. Sustained improvements in this area will necessitate deeper reforms, and the staff looks forward to assisting the authorities in their new medium-term economic plan. Afghanistan's revenue potential is significant and its realization will require political commitment, effective anticorruption practices, and deeper reforms. Among the latter, a key measure will be to grant the revenue and customs departments increased responsibility for hiring decisions and for provincial offices and their budgets.
37. The authorities' strategy to improve banking system soundness is appropriate. In coming months, efforts should focus on monitoring banks with weak CAMEL ratings and ensuring full compliance of the enforcement letters issued by the supervision department of the central bank.

38. Improving transparency and efficiency of public enterprises should be high on the agenda. Financial data on these companies are inadequate, governance problems abound, and progress to reform them has been scant. In coming months, the staff looks forward to the regular reporting of operations of the state electricity company and the completion of the review of financial and fiscal relations as well as the business plans for the four largest public enterprises. Subsequently, the authorities will need to move swiftly to restructure or privatize these and other public enterprises.

39. The program faces two major risks, namely worsening security and faltering reforms. Worsening security could lead to increases in security spending, delays in fiscal sustainability, and reduced growth prospects. Faltering reforms would harm growth and weaken governance. The authorities expect that their plan to increase the size and effectiveness of domestic security forces, together with reinforcements to coalition forces, will help stabilize security. Successful reforms will require continued determination at the highest levels of government, especially through efforts to prevail over vested interests and reduce corruption.

40. The staff supports the waiver for nonobservance of a performance criterion and the completion of the Sixth Review. The nonobservance of the performance criterion on net international reserves was temporary and does not reflect a policy slippage. Program implementation has been satisfactory, and the policy framework for the remainder of 2009/10 is appropriate. The staff also supports the request for modification of the performance criteria and an extension of the program until June 25, 2010. The modification reflects the midyear update to the macroeconomic framework, and the extension would allow sufficient time for the implementation of intended reforms and for discussions on a successor arrangement.

41. Looking ahead, embracing an ambitious economic reform strategy and exercising political will to implement it will be critical. The staff welcomes the authorities' proposal to draw lessons from recent experiences and stands ready to assist them, in coordination with donors and multilateral institutions, in the formulation of a new three-year program that could be supported by the Fund.

Table 1. Islamic Republic of Afghanistan: Schedule of Reviews and Disbursements

Date	Amount of Disbursement		Conditions
	Millions of SDRs	Percent of Quota	
June 2006	13.2	8.2	Approval of arrangement 1/
March 2007	11.3	7.0	First review and September 2006 performance criteria 2/
July 2007	11.3	7.0	Second review and March 2007 performance criteria 3/
February 2008	11.3	7.0	Third review and September 2007 performance criteria 4/
June 2008	11.3	7.0	Fourth review and March 2008 performance criteria 5/
April 2009	11.3	7.0	Fifth review and September 2008 performance criteria 6/
December 2009	5.65	3.5	Sixth review and June 2009 performance criteria 7/
June 2010	5.65	3.5	Seventh review and March 2010 performance criteria 8/
Total	81.0	50.0	

Source: Fund staff estimates.

1/ Due to domestic legal obstacles, the first disbursement was drawn with a delay, on January 19, 2007.

2/ The First Review was completed on March 7, 2007 and the second disbursement was drawn on March 29, 2007.

3/ The Second Review was completed on July 9, 2007 and the third disbursement was drawn on July 23, 2007.

4/ The Third Review was completed on February 14, 2008 and the fourth disbursement was drawn on February 28, 2008.

5/ The Fourth Review was completed on July 7, 2008 and the fifth disbursement was drawn on July 15, 2008.

6/ The Fifth Review was completed on April 22 and the sixth disbursement was drawn on April 27, 2009

7/ The board meeting on the Sixth Review is expected in December 2009.

8/ The board meeting on the Seventh Review is expected in June 2010.

Table 2. Islamic Republic of Afghanistan: Selected Economic Indicators, 2006/07–2010/11
 (Quota: SDR 161.9 million)
 (Population: 28.1 million; 2008/09)
 (Per capita GDP: US\$416; 2008/09)
 (Poverty rate: n.a.)
 (Main export: carpets, US\$186 million; 2006/07)

	2006/07	2007/08	2008/09	2009/10		2010/11
				Program	Rev. Prog.	Proj.
(Annual percentage change; unless otherwise indicated)						
Output and prices 1/						
Real GDP	8.2	12.1	3.4	9.0	15.1	7.6
Nominal GDP (in billions of Afghanis)	385	481	596	694	672	771
Nominal GDP (in billions of U.S. dollars)	7.7	9.7	11.7	14.0	13.0	14.9
Consumer prices (period average)	5.1	13.0	26.8	5.5	-10.0	8.4
Consumer prices (end of period)	4.8	20.7	3.2	6.0	6.0	5.0
(In percent of GDP)						
Investment and savings						
Gross domestic investment	40.5	36.8	32.0	28.6	29.5	26.5
<i>Of which: private</i>	8.1	7.8	8.0	7.9	7.4	7.4
Gross domestic savings	35.6	37.6	30.4	24.9	25.9	24.7
<i>Of which: private</i>	11.0	15.2	15.0	11.5	12.2	14.8
Public finances						
Domestic revenues and grants	16.8	18.1	15.7	17.3	19.9	19.1
Domestic revenues	7.5	6.9	6.9	7.3	8.1	8.6
Grants	9.3	11.1	8.8	10.0	11.8	10.5
Expenditures	19.6	19.9	19.4	19.7	22.1	22.1
Operating 2/	11.3	10.5	11.7	12.1	14.4	14.8
Development	8.4	9.4	7.7	7.6	7.6	7.3
Overall balance (including grants)	-2.9	-1.8	-3.7	-2.3	-2.1	-3.0
Operating balance						
Including grants 3/	1.2	1.2	0.2	0.0	-0.1	0.0
Excluding grants 4/	-3.8	-3.6	-4.7	-4.7	-6.3	-6.2
Government debt 5/	155.0	20.8	19.4	10.1	11.2	11.7
(Annual percentage change; unless otherwise indicated)						
Monetary sector						
Reserve money	22.3	14.4	64.9	17.0	7.9	17.5
Currency in circulation	13.3	17.0	30.4	16.0	22.0	15.0
Velocity of broad money	...	...	...	...	...	...
Interest rate, 28-day capital note (end-period, in percent) 6/	7.6	14.9	8.9	...	5.5	...
(In percent of GDP; unless otherwise indicated)						
External sector 7/						
Exports of goods 1/7/ (in U.S. dollars, percentage change)	2.9	11.0	13.5	5.2	3.9	6.9
Imports of goods (in U.S. dollars, percentage change)	12.5	20.6	10.4	0.9	5.3	-2.6
Nonsecurity imports (in U.S. dollars, percentage change)	16.8	11.9	13.9	3.0	8.9	-2.0
Merchandise trade balance	-63.9	-62.1	-56.4	-47.7	-53.7	-45.1
Current account balance						
Excluding official transfers	-70.0	-62.0	-54.5	-50.5	-53.7	-44.9
Including official transfers	-4.9	0.9	-1.6	-3.7	-3.6	-1.8
Foreign direct investment	3.1	2.5	2.6	2.2	1.4	1.3
Total external debt 5/	155.0	20.8	19.4	10.1	11.2	11.7
Gross reserves (in millions of U.S. dollars)	2,040	2,784	3,462	3,332	3,781	4,065
Import coverage 8/	9.6	12.8	13.0	10.8	13.2	12.8
Relative to external debt service due	79.1	42.9	53.1	86.4	97.6	240.6
Afghanis per U.S. dollar (period average) 9/	49.9	49.8	51.0	...	49.8	...
Real effective exchange rate (annual percentage change) 10/	-2.0	3.0	16.4	...	-14.3	...
Memorandum items:						
Opium production (wet opium)						
In tons	6,100	8,200	7,700	...	6,900	...
U.S. dollars per kilogram	94.0	86.0	70.0	...	48.0	...
External budget grants (in percent of GDP) 11/	50.6	52.0	42.9	35.4	37.7	31.2
Unemployment rate (in percent)	...	...	...	...	...	...

Sources: Afghan authorities; United Nations Office on Drugs and Crime; and Fund staff estimates and projections.

1/ Excluding the drug economy.

2/ Excluding development spending and externally financed development expenditures.

3/ Defined as domestic revenues plus operating grants minus operating expenditures.

4/ Defined as domestic revenues minus operating expenditures.

5/ After HIPC and MDRI debt relief as well as debt relief beyond HIPC relief from Paris Club creditors. Debt also includes obligations to the IMF.

6/ Weighted average of successful bid rates. The 2009/10 figure is for September.

7/ Includes official recorded exports plus staff estimates of smuggling; excludes reexports.

8/ In months of next year's imports of goods and services, excluding imports for reexports and duty-free imports by donors.

9/ The figure for 2009/10 covers the period March–November 2009.

10/ The figure for 2009/10 covers the period March–September 2009.

11/ Estimated direct expenditures by donors on public projects not included in the core budget.

Table 3. Islamic Republic of Afghanistan: Balance of Payments, 2006/07–2009/10

	2006/07	2007/08	2009/10		
			Prel.	Program Rev. Prog.	
	(In millions of US dollars; unless otherwise indicated)				
Current account (including grants)	-379	83	-192	-519	-462
Current account (excluding grants)	-5,005	-5,985	-6,379	-6,636	-6,977
Trade balance	-4,933	-6,002	-6,608	-6,681	-6,971
Exports of goods (f.o.b.) 1/	1,811	1,835	2,181	2,012	2,128
Imports of goods (f.o.b.)	-6,744	-7,837	-8,788	-8,694	-9,099
Official imports	-6,049	-7,246	-8,250	-8,093	-8,550
Of which: Duty free	-3,579	-4,685	-5,374	-4,897	-5,207
Smuggling	-694	-590	-539	-601	-549
Services and income, net	-473	-425	-294	-401	-329
Of which: Interest due 2/ 3/	-17	-61	-61	-35	-35
Current transfers	5,027	6,510	6,709	6,564	6,838
Public	4,625	6,068	6,188	6,117	6,516
Private	401	441	522	447	322
Capital and financial account	194	25	287	-762	-335
Capital transfers	0	0	0	0	0
Debt forgiveness 3/	0	0	0	-1,061	-1,061
Foreign direct investment	238	243	300	312	185
Official loans (net)	155	129	121	153	392
Disbursement 4/	164	133	125	156	396
Amortization due 2/ 3/	-9	-4	-4	-4	-4
Other items (net)	-198	-347	-134	-165	149
Errors and omissions (including short-term capital)	405	372	265	0	0
Overall balance	220	480	360	-1,281	-797
Financing	-220	-480	-360	1,247	788
Changes in central bank's reserves	-255	-571	-430	157	-319
Use of Fund resources (net)	20	51	17	0	17
Exceptional financing	15	40	53	1,090	1,090
Arrears 5/	-132	-11,007	-84	0	0
Debt rescheduling, of which: 6/	117	777	80	29	29
Capitalization of interest	4	47	48	24	24
Multilateral HIPC assistance	0	3	5	5	5
Debt forgiveness, of which: 3/	30	10,270	56	1,061	1,061
HIPC	0	0	0	442	442
MDRI	0	0	0	35	35
Financing gap	0	0	0	-34	-9
Identified financing (provisional)	0	0	0	34	9
Of which: IMF PRGF	0	0	0	34	9
Remaining gap	0	0	0	0	0
Memorandum items:					
Gross international reserves	2,040	2,784	3,462	3,332	3,781
(In months of imports) 7/	9.6	12.8	13.0	10.8	13.2
(Relative to external debt service due)	79.1	42.9	53.1	86.4	97.6
(Relative to commercial bank foreign currency liabilities)	2.2	2.2	2.4	1.9	3.0
Current account balance (percent of GDP)					
Including grants	-4.9	0.9	-1.6	-3.7	-3.6
Excluding grants	-64.8	-62.0	-54.5	-50.5	-53.7
Total debt service (percent of exports, excluding reexports) 8/	1.6	1.1	1.2	0.9	0.9
Total debt stock (percent of GDP) 8/	155.0	20.8	19.4	10.1	11.2

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

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

2/ Debt service projections are based on the total stock of external debt (including estimates of unverified arrears). Interest on overdue obligations represents estimates by Fund staff.

3/ Assumes that Afghanistan will reach the HIPC completion point. Paris Club creditors are assumed to provide 100 percent debt stock reduction.

4/ Includes allocation of SDR 128.6 million.

5/ Arrears shown represent Fund staff estimates of debt service due, but not paid, on estimated overdue obligations.

6/ Debt rescheduling includes the capitalization of interest falling due to Paris Club creditors until the completion point, interim assistance from multilateral creditors, and HIPC debt relief from multilateral creditors after the

7/ Excluding imports for reexports and duty free imports by donors.

8/ After HIPC and MDRI relief as well as debt relief beyond HIPC from Paris Club creditors. Debt includes obligations to the IMF. The debt stock includes the pitalization of interest to Paris Club creditors until the completion point of the enhanced HIPC initiative.

Table 4. Islamic Republic of Afghanistan: Quantitative Performance Criteria and Indicative Targets
Under the PRGF Arrangement, June–September 2009 1/
(Cumulative changes from March 20, 2009; unless otherwise indicated)

	Mar. 20, 2009	Jun. 21, 2009			Sept. 22, 2009		Prel.
	Stocks	Performance criteria		Act.	Indicative targets		
		Orig.	Adj.		Orig.	Adj.	
		(In billions of Afghanis)					
Floor on fiscal revenues of the government	...	12.3	...	14.4	25.1	...	28.7
Ceiling on currency in circulation	76.8	2.9	...	1.2	7.1	...	9.0
Ceiling on net central bank financing of the government	-30.7	0.1	5.6	-2.1	0.0	5.3	-8.8
Indicative target (ceiling) on the operating budget deficit of the government, excluding grants	...	4.5	8.4	2.0	12.6	19.5	9.4
Indicative target (ceiling) on reserve money	106.3	3.2	...	-13.9	7.8	...	-0.2
		(In millions of US dollars)					
Floor on net international reserves of DAB	3,272	59	-46	-236	128	25	296
Ceiling on contracting or guaranteeing new medium- and long-term nonconcessional external debt by the government and DAB 2/	...	0.0	...	0.0	0.0	...	0.0
Ceiling on short-term external debt owed or guaranteed by the government or DAB 2/	...	0.0	...	0.0	0.0	...	0.0
New external payments arrears, excluding interest on preexisting arrears 2/	...	0.0	...	0.0	0.0	...	0.0
Ceiling on lending from state-owned banks to public enterprises in need of restructuring or government guaranteeing borrowing by these public enterprises 2/	...	0.0	...	0.0	0.0	...	0.0
		(In billions of Afghanis)					
Memorandum items:							
Operating budget balance of the government, including grants		1.1	...	3.0	2.2	...	7.2
<u>Reference projections for the adjustors</u>							
		Prog.	Est.	Deviation	Prog.	Proj.	Deviation
Core budget development spending		6.6	3.0	-3.6	19.8	17.9	-1.9
External financing of the core budget and sale or transfers of nonfinancial assets		10.9	9.4	-1.6	32.4	33.9	1.5
Externally financed expenditures transferred to the core operating budget		0.0	0.0	0.0	0.0	0.0	0.0
Additional security spending 3/		0.0	3.9	3.9	0.0	6.8	6.8

Source: Fund staff estimates.

1/ The performance criteria and indicative targets envisaged under the program, and their adjustors, are defined in Attachment III, Country Report 09/135.

2/ These performance criteria apply on a continuous basis.

3/ Defined in Paragraph 22 of Attachment III of Country Report 09/135.

Table 5. Islamic Republic of Afghanistan:
Structural Benchmarks Under the PRGF Arrangement, Sixth Review, March 2009–June 2009

	Target Date	Status
Implementation of the ASYCUDA transit and Declaration Processing Module in Nangarhar, Herat, and Kabul Airport inland clearing depots.	April 30, 2009	Met.
Setting up of post-clearance audit units in the Customs Directorates of Jalalabad and Mazar-e-Sharif.	May 31, 2009	Met.
Publication of the external audit report of FLGE for the period 2002/03–2007/08.	June 30, 2009	Not met on time. As the original audit company withdrew, a new one was contracted and the work was completed in September. The audit reports were posted in the Ministry of Finance website on September 30, 2009.
Issuance of first monthly report by the revenue department verifying the collection of the business receipts tax on imports.	June 30, 2009	Met.

Table 6. Islamic Republic of Afghanistan: Monetary Program (Central Bank), March 2009–March 2010 1/

	2008/09		2009/10							
	Mar. 20 2/ 3/		Jun. 21 2/ 3/		Sep. 22 2/ 3/		Dec. 21 2/		Mar. 20 2/	
	Prog.	Prel.	Prog.	Prel.	Prog.	Prel.	Prog.	Rev. Prog.	Prog.	Rev. Prog.
(In billions of Afghani, unless otherwise noted)										
Net foreign assets	165.5	181.3	168.5	168.6	172.0	184.8	174.0	185.8	175.6	187.0
Foreign assets	170.2	186.1	174.1	174.2	178.1	200.8	180.1	202.3	182.1	204.0
Foreign exchange reserves	161.8	178.1	165.7	166.8	169.7	193.9	171.7	195.5	173.7	197.1
Other foreign assets	8.4	7.9	8.4	7.5	8.4	6.8	8.4	6.8	8.4	6.8
Foreign liabilities	-4.7	-4.8	-5.7	-5.7	-6.1	-16.0	-6.1	-16.5	-6.6	-16.9
Net domestic assets	-78.8	-75.0	-78.6	-76.2	-77.5	-78.7	-76.0	-76.5	-74.1	-72.4
Domestic assets	-41.4	-53.9	-41.2	-51.3	-40.1	-53.5	-38.6	-51.3	-36.7	-47.1
Net claims on general government	-21.4	-30.7	-21.2	-32.8	-21.4	-39.5	-18.4	-36.1	-13.0	-28.7
Gross claims on government	4.7	4.7	5.6	5.6	6.1	16.0	6.1	16.4	6.5	16.9
Domestic currency deposits	-2.5	-8.3	-3.4	-2.4	-3.8	-6.4	-3.4	-6.4	-3.0	-5.7
Foreign currency deposits	-23.6	-27.1	-23.5	-36.0	-23.6	-49.1	-21.1	-46.1	-16.5	-39.9
Other claims (including capital notes)	-20.0	-23.2	-19.9	-18.5	-18.8	-13.9	-20.2	-15.2	-23.7	-18.4
Of which: capital notes	-15.7	-19.3	-15.7	-13.9	-14.6	-10.3	-16.2	-11.6	-19.8	-14.8
Other items net	-37.4	-21.1	-37.4	-24.9	-37.4	-25.2	-37.4	-25.2	-37.4	-25.2
Reserve money	86.7	106.3	89.9	92.4	94.5	106.1	98.0	109.3	101.4	114.7
Currency in circulation	75.0	76.8	77.9	78.0	82.1	85.8	84.6	90.8	87.0	93.7
Banknotes and coins issued	79.5	82.1	82.5	83.8	87.0	89.3	89.7	94.4	92.2	97.5
Less: cash holdings	4.5	5.3	4.7	5.8	4.9	3.5	5.1	3.7	5.2	3.8
Bank deposits with DAB	11.7	29.5	12.0	14.4	12.4	20.2	13.4	18.5	14.4	21.0
Memorandum items:										
Reserve money										
Year-to-date percentage change	34.5	64.9	3.7	-13.1	9.0	-0.2	13.1	2.9	17.0	7.9
Year-on-year percentage change	34.5	64.9	32.4	36.0	28.7	44.5	11.9	24.8	17.0	7.9
Currency in circulation										
Year-to-date percentage change	27.3	30.4	3.9	1.5	9.5	11.8	12.9	18.2	16.0	22.0
Year-on-year percentage change	27.3	30.4	24.0	24.2	23.3	28.9	16.2	24.6	16.0	22.0
Gross international reserves										
(in millions of US dollars)										
At market rates	...	3,462	...	3,335	...	3,957	...	...	...	...
At program rates	3,103	3,417	3,179	3,199	3,255	3,720	3,294	3,749	3,332	3,781
Net international reserves										
(in millions of US dollars)										
At program rates	2,955	3,272	3,013	3,036	3,082	3,568	3,122	3,587	3,152	3,610
Consumer prices in Kabul										
(year-on-year percentage change)	8.5	3.2	7.5	-10.0	5.0	-15.0	6.0	-8.7	6.0	6.0
Interest, 28-day capital notes 4/	...	9.5	...	6.0	...	...	...	...	...	...
Af/US\$ exchange rate										
(end of period)	52.14	52.14	52.14	50.14	52.14	49.45	52.14	...	52.14	...

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

1/ A consolidated monetary survey for the central bank and the banking system is not available yet. The authorities are working on improving the quality and timeliness of aggregate monetary data.

2/ Foreign currency-denominated components evaluated using applicable program exchange rates as of December 20, 2008.

3/ Subject to revisions after the finalization of the 2009 external audit report of DAB in December 2009.

4/ Weighted average of successful bid rates.

Table 7a. Islamic Republic of Afghanistan: Core Budget, 2007/08–2009/10 1/

	2007/08		2008/09		2009/10					Rev. Prog.		
					Q1		Q2		Q3		Q4	Year
					Prog.	Act.	Prog.	Prel.	Proj.		Prog.	
	(In billions of Afghanis)											
Domestic revenues	33.4	41.4	12.3	14.4	12.8	14.3	12.4	13.4	51.0	54.5		
Tax revenues	25.0	28.8	9.5	12.4	9.9	10.6	10.0	10.7	39.4	43.8		
Income, profits, and capital gains	7.6	8.2	2.4	3.7	2.5	3.0	2.1	2.2	10.1	11.0		
International trade and transactions (customs)	12.9	12.8	4.3	5.2	4.5	4.7	4.3	4.6	17.8	18.7		
Goods and services	3.5	6.3	2.4	3.2	2.5	2.7	3.1	3.4	9.9	12.3		
Other	1.0	1.5	0.4	0.4	0.4	0.3	0.5	0.5	1.6	1.7		
Nontax revenues	8.4	12.6	2.8	2.1	2.9	3.6	2.4	2.6	11.6	10.7		
Grants to operating budget 2/	23.1	29.5	5.6	5.0	9.2	11.7	11.4	13.7	32.9	41.8		
Afghanistan Reconstruction Trust Fund (ARTF)	14.5	15.9	2.2	0.3	3.6	6.8	2.6	3.1	13.0	12.7		
Law and Order Trust Fund for Afghanistan (LOTFA)	6.9	9.9	2.3	3.0	3.8	3.0	5.4	6.5	13.7	17.9		
Other grants	1.7	3.7	1.1	1.7	1.7	1.9	3.5	4.1	6.2	11.2		
Grants to development budget	30.3	22.7	4.4	4.1	10.3	11.7	8.8	13.0	36.4	37.7		
Total expenditures	95.7	115.7	23.4	19.5	34.2	36.6	40.8	51.5	136.7	148.3		
Operating expenditures	50.7	69.6	16.8	16.4	21.0	21.7	27.4	31.5	83.8	97.0		
Wages and salaries	33.6	47.4	11.3	12.3	14.1	16.2	19.4	22.2	56.6	70.1		
Purchase of goods and services	11.0	16.9	3.7	1.9	4.7	4.2	5.5	6.3	18.7	18.0		
Transfers, subsidies, and other	1.7	0.0	0.6	0.0	0.8	0.0	1.5	1.7	3.2	3.2		
Pensions	2.8	3.4	0.7	1.3	0.8	1.1	0.5	0.5	3.3	3.3		
Capital expenditures	1.4	1.8	0.3	0.8	0.4	0.2	0.5	0.6	1.6	2.1		
Interest	0.1	0.1	0.1	0.0	0.1	0.0	0.2	0.2	0.4	0.4		
Development expenditures 3/	45.0	46.1	6.6	3.0	13.2	14.9	13.3	20.0	52.8	51.3		
Security	1.5	0.7	0.0	0.0	0.1	0.6	0.1	0.2	0.3	1.0		
Governance, rule of law, and human rights	0.7	2.0	0.1	0.1	0.3	0.6	0.2	0.2	1.2	1.1		
Infrastructure and natural resources	19.3	19.7	2.7	0.8	5.3	4.2	6.1	9.1	21.3	20.1		
Education	3.2	4.4	0.7	0.4	1.5	2.3	1.3	1.9	5.9	5.8		
Health	2.2	3.3	0.7	0.4	1.3	0.9	1.6	2.4	5.3	5.2		
Agriculture and rural development	15.8	12.2	1.7	1.3	3.3	6.0	2.2	3.4	13.2	12.8		
Social protection	0.1	0.2	0.1	0.0	0.2	0.0	0.3	0.5	0.8	0.8		
Economic governance and private sector development	2.3	3.7	0.6	0.1	1.2	0.3	1.6	2.4	4.8	4.4		
Operating balance including grants	5.9	1.3	-4.5	3.0	-8.2	4.2	-3.6	-4.4	0.1	-0.7		
Operating balance excluding grants	-17.2	-28.2	1.1	-2.0	1.1	-7.4	-15.0	-18.1	-32.8	-42.5		
Overall budget balance including grants	-8.8	-22.1	-1.1	4.1	-1.9	1.0	-8.1	-11.4	-16.3	-14.3		
Float and adjustment 4/	9.0	10.6	0.0	-2.3	0.0	4.5	-1.1	-1.1	0.0	0.0		
Sale of nonfinancial assets 5/	0.1	4.1	0.0	0.0	0.0	0.0	2.3	0.0	0.0	2.3		
Financing	-0.2	7.4	1.1	-1.9	1.9	-5.5	6.9	12.5	16.3	12.0		
External loans (net)	6.1	3.7	1.0	0.2	2.0	1.2	3.4	5.2	7.9	10.0		
Domestic (net) 6/ 7/	-6.3	3.7	0.1	-2.1	-0.1	-6.7	3.5	7.3	8.4	2.0		
Memorandum items:												
Discretionary cash balances 8/	7.4	8.8	...	11.8	...	16.0	14.8	10.3	1.5	10.3		
Fuel subsidy to DABM/S (state electricity company)	1.7	3.4	...	...	...	...	...	...	2.1	2.0	
External budget 9/	250.2	255.6	...	...	...	...	...	...	245.9	253.6	
Of which: security	124.6	123.8	...	...	...	...	...	...	122.3	119.5	
Contingent military spending not included in the fiscal accounts 10/	...	...	...	...	...	...	...	...	10.4	0.6	

Table 7b. Islamic Republic of Afghanistan: Core Budget, 2007/08–2009/10 1/

	2007/08	2008/09	2009/10							Rev. Prog.
			Q1		Q2		Q3	Q4	Year	
			Prog.	Act.	Prog.	Prel.	Prog.	Prog.	Prog.	
(In percent of GDP)										
Domestic revenues	6.9	6.9	1.8	2.1	1.8	2.1	1.9	2.0	7.3	8.1
Tax revenues	5.2	4.8	1.4	1.8	1.4	1.6	1.5	1.6	5.7	6.5
Income, profits, and capital gains	1.6	1.4	0.3	0.5	0.4	0.5	0.3	0.3	1.5	1.6
International trade and transactions (customs)	2.7	2.2	0.6	0.8	0.6	0.7	0.6	0.7	2.6	2.8
Goods and services	0.7	1.0	0.3	0.5	0.4	0.4	0.5	0.5	1.4	1.8
Others	0.2	0.3	0.1	0.1	0.1	0.0	0.1	0.1	0.2	0.3
Nontax revenues	1.8	2.1	0.4	0.3	0.4	0.5	0.4	0.4	1.7	1.6
Grants to operating budget 2/	4.8	4.9	0.8	0.7	1.3	1.7	1.7	2.0	4.7	6.2
Afghanistan Reconstruction Trust Fund (ARTF)	3.0	2.7	0.3	0.0	0.5	1.0	0.4	0.5	1.9	1.9
Law and Order Trust Fund for Afghanistan (LOTFA)	1.4	1.7	0.3	0.4	0.6	0.4	0.8	1.0	2.0	2.7
Other grants	0.4	0.6	0.2	0.3	0.3	0.3	0.5	0.6	0.9	1.7
Grants to development budget	6.3	3.8	0.6	0.6	1.5	1.7	1.3	1.9	5.2	5.6
Total expenditures	19.9	19.4	3.4	2.9	4.9	5.4	6.1	7.7	19.7	22.1
Operating expenditures	10.5	11.7	2.4	2.4	3.0	3.2	4.1	4.7	12.1	14.4
Wages and salaries	7.0	8.0	1.6	1.8	2.0	2.4	2.9	3.3	8.1	10.4
Purchase of goods and services	2.3	2.8	0.5	0.3	0.7	0.6	0.8	0.9	2.7	2.7
Transfers, subsidies, and other	0.4	0.6	0.1	0.1	0.1	0.2	0.2	0.3	0.5	0.5
Pensions	0.6	0.6	0.1	0.2	0.1	0.2	0.1	0.1	0.5	0.5
Capital expenditures	0.3	0.3	0.0	0.1	0.1	0.0	0.1	0.1	0.2	0.3
Interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1
Development expenditures 3/	9.4	7.7	1.0	0.5	1.9	2.2	2.0	3.0	7.6	7.6
Security	0.3	0.1	0.0	0.0	0.0	0.1	0.0	0.0	0.0	0.1
Governance, rule of law, and human rights	0.2	0.3	0.0	0.0	0.0	0.1	0.0	0.0	0.2	0.2
Infrastructure and natural resources	4.0	3.3	0.4	0.1	0.8	0.6	0.9	1.4	3.1	3.0
Education	0.7	0.7	0.1	0.1	0.2	0.3	0.2	0.3	0.9	0.9
Health	0.5	0.5	0.1	0.1	0.2	0.1	0.2	0.4	0.8	0.8
Agriculture and rural development	3.3	2.1	0.2	0.2	0.5	0.9	0.3	0.5	1.9	1.9
Social protection	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	0.1
Economic governance and private sector development	0.5	0.6	0.1	0.0	0.2	0.0	0.2	0.4	0.7	0.7
Operating balance including grants	1.2	0.2	-0.6	0.5	-1.2	0.6	-0.5	-0.7	0.0	-0.1
Operating balance excluding grants	-3.6	-4.7	0.2	-0.3	0.2	-1.1	-2.2	-2.7	-4.7	-6.3
Overall budget balance including grants	-1.8	-3.7	-0.2	0.6	-0.3	0.2	-1.2	-1.7	-2.3	-2.1
Float and adjustment 4/	1.9	1.8	0.0	-0.3	0.0	0.7	-0.2	-0.2	0.0	0.0
Sale of nonfinancial assets 5/	0.0	0.7	0.0	0.0	0.0	0.0	0.3	0.0	0.0	0.3
Financing	0.0	1.2	0.2	-0.3	0.3	-0.8	1.0	1.9	2.3	1.8
External loans (net)	1.3	0.6	0.1	0.0	0.3	0.2	0.5	0.8	1.1	1.5
Domestic (net) 6/ 7/	-1.3	0.6	0.0	-0.3	0.0	-1.0	0.5	1.1	1.2	0.3
Memorandum items:										
Discretionary cash balances 8/	1.5	1.5	...	1.8	...	2.4	2.2	1.5	0.2	1.5
Fuel subsidy to DABM/S (state electricity company)	0.4	0.6	...	...	...	...	...	...	0.3	0.3
External budget 9/	52.0	42.9	...	...	...	...	...	...	35.4	37.7
Of which: security	25.9	20.8	...	...	...	...	...	...	17.6	17.8
Contingent military spending 10/	...	...	...	...	...	...	...	...	1.5	0.1
Nominal GDP (in billions Afs)	481.2	596.2	694.3	671.9	694.3	671.9	671.9	671.9	694.3	671.9

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

- 1/ Reflects the accounts of the central government, and does not include spending on public goods financed by donors outside the budget.
- 2/ Funding for operating budget from multidonor trust funds: The Afghanistan Reconstruction Trust Fund (ARTF; recurrent window) and the Law and Order Trust Fund for Afghanistan (LOTFA).
- 3/ Interim Afghanistan National Development Strategy programs.
- 4/ Variation between the fiscal position recorded at the Ministry of Finance and the central bank. This discrepancy is partly due to the difference ("float") between checks issued and checks cashed.
- 5/ In 2009/10 it includes Af 2.3 billion receipt from the cancelation of 2008/09 contracts to purchase and transport wheat.
- 6/ The difference between program and projection is mainly due to the accounting treatment of the SDR allocation amounting to Af 10.4 billion.
- 7/ Net change in government deposits with the central bank (excluding provincial branch balances). A positive sign corresponds to a decline in balances.
- 8/ Government deposits at the central bank excluding earmarked grants.
- 9/ Estimated direct expenditures by donors on public projects not included in the core budget.
- 10/ To be applied as an adjustor to the program depending on the Afghan National Army exceeding 109,000.

Table 8. Islamic Republic of Afghanistan: Medium-Term Macroeconomic Framework, 2009/10–2014/15

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15
	Projections					
(Annual percentage change; unless otherwise indicated)						
Output and prices 1/						
Real GDP	15.1	7.6	6.8	6.9	6.5	6.9
Nominal GDP (in billions of U.S. dollars)	13.0	14.9	16.5	18.2	20.0	22.1
GDP per capita (in U.S. dollars)	449	501	539	578	619	671
Consumer prices (period average)	-10.0	8.4	4.5	4.0	4.0	4.0
Consumer prices (end of period)	6.0	5.0	4.0	4.0	4.0	4.0
(In percent of GDP, unless otherwise indicated)						
Investment and savings 1/						
Gross investment	29.5	26.5	25.5	24.4	23.5	23.2
<i>Of which: private</i>	7.4	7.4	7.8	8.7	9.6	10.5
Gross savings	25.9	24.7	23.4	20.6	18.5	18.9
<i>Of which: private</i>	12.2	14.8	14.0	12.6	11.0	11.6
Public finances 2/						
Total domestic revenues and grants	19.9	19.1	19.5	19.8	20.1	20.1
Domestic revenues	8.1	8.6	9.1	9.6	10.1	10.5
Grants	11.8	10.5	10.4	10.2	10.0	9.6
Total expenditures	22.1	22.1	22.2	22.2	21.7	21.8
Operating expenditures 3/	14.4	14.8	15.0	15.0	14.4	13.8
Development expenditures	7.6	7.3	7.2	7.2	7.3	7.9
Overall balance (including grants)	-2.1	-3.0	-2.7	-2.4	-1.6	-1.6
Operating balance						
Including grants 4/	-0.1	0.0	-0.2	0.0	0.5	0.6
Excluding grants 5/	-6.3	-6.2	-5.9	-5.4	-4.3	-3.3
(In percent of GDP, unless otherwise indicated)						
External sector 1/2/6/						
Exports of goods 1/6/7/	3.9	6.9	7.4	8.6	8.8	22.4
Imports of goods 7/	5.3	-2.6	4.6	4.3	1.1	-0.6
Nonsecurity imports 7/	8.9	-2.0	5.9	5.4	3.7	2.8
Merchandise trade balance	-53.7	-45.1	-42.5	-40.0	-36.4	-31.6
Current account balance						
Excluding official transfers	-53.7	-44.9	-42.0	-39.3	-35.6	-30.7
Including official transfers	-3.6	-1.8	-2.1	-3.8	-5.0	-4.3
Foreign direct investment	1.4	1.3	1.5	2.2	2.9	3.0
External debt 8/	11.2	11.7	12.7	13.6	14.3	14.8
Gross reserves (in millions of U.S. dollars)	3,781	4,065	4,390	4,631	4,817	5,202
Import coverage 9/	13.2	12.8	12.5	12.1	11.7	11.6
Relative to external debt service due	97.6	240.6	224.9	143.0	97.1	77.7
Memorandum items:						
External budget grants (in percent of GDP) 10.	37.7	31.2	28.2	24.2	19.8	16.1

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

1/ Excluding the drug economy.

2/ After 2009/10, large fiscal and balance of payments gaps are assumed to be financed by a combination of not yet committed grants and concessional loans.

3/ Mainly current expenditures.

4/ Defined as domestic revenues plus operating grants minus operating expenditures.

5/ Defined as domestic revenues minus operating expenditures.

6/ Includes official recorded exports plus staff estimates of smuggling; excludes reexports.

7/ In U.S. dollars, percentage change.

8/ After HIPC and MDRI debt relief, as well as debt relief beyond HIPC relief from Paris Club creditors.

The debt stock also includes obligations to the IMF.

9/ In months of next year's imports of goods and services, excluding imports for reexports and duty-free imports.

10/ Estimated direct expenditures by donors on public projects not included in the core budget.

Table 9. Islamic Republic of Afghanistan: External Financing Requirement and Sources, 2006/07–2013/14

	2006/07	2007/08	2008/09 Prel.	2009/10	2010/11	2011/12 Projections	2012/13	2013/14
(In millions of U.S. dollars)								
I. Total financing requirement	5,400	17,568	6,897	8,361	6,975	7,254	7,399	7,330
Current account (excluding grants)	5,005	5,985	6,379	6,977	6,688	6,925	7,145	7,119
Amortization	9	4	4	4	3	4	13	26
<i>Of which:</i> IMF	0	0	0	0	0	0	7	13
Prepayment of debt	0	0	0	1,061	0	0	0	0
Change in reserves (increase = +)	255	571	430	319	284	325	241	185
Reduction in arrears	132	11,007	84	0	0	0	0	0
II. Available financing	5,400	17,568	6,897	8,352	6,967	7,254	7,399	7,330
Current transfers	4,625	6,068	6,188	6,516	6,425	6,579	6,448	6,128
Foreign direct investment	238	243	300	185	199	253	403	579
Short-term private financing flows	-198	-347	-134	149	54	60	148	195
Official medium- and long-term loans	164	133	125	396	284	356	394	417
IMF disbursements	20	51	17	17	0	0	0	0
Debt forgiveness	30	10,270	56	1,061	0	0	0	0
Debt rescheduling	117	777	80	29	5	5	7	12
Other	405	372	265	0	0	0	0	0
Required financing (I-II)	0	0	0	9	9	0	0	0
Financing gap 1/	0	0	0	9	9	0	0	0
Identified financing (provisional)	0	0	0	9	9	0	0	0
<i>Of which:</i> IMF PRGF	0	0	0	9	9	0	0	0
Remaining gap	0	0	0	0	0	0	0	0

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

1/ The 2009/10 program is fully financed. From 2010/11 onward, large external financing gaps are assumed to be filled by a combination of not yet committed grants and concessional loans.

Table 10. Islamic Republic of Afghanistan: Projected Payments to the Fund as of October 31, 2009

	2008	2009	2010	2011	2012	2013	2014	2015	Beyond	Total
(In millions of SDRs)										
Obligations from existing drawings										
1. Principal										
GRA repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
PRGF repayments	0.0	0.0	0.0	0.0	2.5	8.3	12.8	13.9	20.9	58.4
2. Charges and interest 1/										
PRGF interest	0.3	0.3	0.3	0.3	0.3	0.3	0.3	0.2	0.1	2.6
SDR assessments	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
SDR charges	0.2	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.4	1.1
Total obligations	0.4	0.4	0.4	0.4	2.9	8.7	13.1	14.2	21.4	62.1
(percent of quota)	0.3	0.2	0.3	0.3	1.8	5.4	8.1	8.8	13.2	38.3
Obligations from prospective drawings										
1. Principal										
PRGF repayments	0.0	0.0	0.0	0.0	0.0	0.0	6.3	8.6	48.2	63.1
2. Charges and interest 1/										
PRGF interest	0.0	0.0	0.3	0.3	0.3	0.3	0.3	0.3	0.4	2.0
Total obligations	0.0	0.0	0.3	0.3	0.3	0.3	6.6	8.8	48.6	65.1
(percent of quota)	0.0	0.0	0.2	0.2	0.2	0.2	4.0	5.4	30.0	40.2
Cumulative obligations (existing and prospective)										
1. Principal										
GRA repurchases	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
PRGF repayments	0.0	0.0	0.0	0.0	2.5	8.3	19.1	22.5	69.2	121.5
2. Charges and interest 1/										
PRGF interest	0.3	0.3	0.6	0.6	0.6	0.6	0.5	0.4	0.5	4.5
SDR net charges	0.2	0.0	0.1	0.1	0.1	0.1	0.1	0.1	0.4	1.1
Total obligations	0.5	0.4	0.7	0.7	3.1	8.9	19.7	23.0	70.0	127.1
Outstanding Fund credit	58.4	75.4	81.0	81.0	78.6	70.3	51.2	28.7	...	...
Memorandum items:										
Outstanding Fund credit										
In percent of:										
Exports of goods and services 3/	4	5	5	5	4	3	2	1	...	...
External public debt	2	3	3	3	2	2	1	1	...	...
Gross official reserves	1	1	1	1	1	1	1	0	...	...
GDP	0	0	0	0	0	0	0	0	...	...
Quota	36	47	50	50	49	43	32	18	...	...
Total Obligations										
In percent of:										
Exports of goods and services 3/	0.0	0.0	0.0	0.0	0.2	0.4	0.8	0.8	...	...
External public debt	0.0	0.0	0.0	0.0	0.1	0.2	0.4	0.4	...	...
Gross official reserves	0.0	0.0	0.0	0.0	0.0	0.1	0.2	0.3	...	...
GDP	0.0	0.0	0.0	0.0	0.0	0.0	0.1	0.1	...	...
Quota	0	0	0	0	2	6	12	14	43	79

Source: Fund staff estimates and projections.

1/ Projections are based on current interest rates for PRGF loans. The current SDR interest rate is assumed for net use of SDRs.

2/ Based on the proposed level and phasing of access, and subject to Executive Board approval.

3/ Excludes reexports.

ATTACHMENT I. LETTER OF INTENT

Kabul, December 16, 2009

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington DC 20431

Dear Mr. Strauss-Kahn,

The purpose of this letter and the attached Supplementary Memorandum of Economic and Financial Policies is to inform you about the implementation of our economic program supported by the Poverty Reduction and Growth Facility, set out policies for the remainder of the fiscal year 2009/10, and request a waiver for nonobservance of one performance criterion. We also request the seventh disbursement following the completion of the Sixth Review under the arrangement, an extension of the program until June 25, 2010, and a rephrasing of the last disbursement. The extension would allow us to implement our structural reform agenda and negotiate a new arrangement with the Fund.

We observed all of the end-June 2009 performance criteria, with the exception of the minimum accumulation of net international reserves. The nonobservance does not reflect a policy slippage since it resulted from an unexpected inflow of allied forces' deposits that raised the end-March stock of reserves and made the actual change in reserves between March and June smaller than targeted (the accumulation target was based on an estimated reserve figure for end-March that did not include these deposits).

Despite a challenging security situation, we implemented all the structural measures envisaged under the Sixth Review and we are determined to strengthen tax and customs administration and set the basis for sustainable increases in revenue collection in the period ahead. In addition, we are pressing ahead with the restructuring of the electricity sector and a financial review of key public enterprises.

We believe that the policies and measures described in this memorandum are adequate to achieve the objectives of the program and stand ready to take additional measures if needed. We will consult with Fund staff on the adoption of such measures and provide Fund staff the information required to assess progress in implementing the program. Lastly, we consent to the publication of the staff report for the Sixth Review under the PRGF arrangement, the Supplementary Memorandum of Economic and Financial Policies, and the Technical Memorandum of Understanding.

Sincerely yours,

/s/
Omar Zakhilwal
Minister of Finance

/s/
Abdul Qadeer Fitrat
Governor, Da Afghanistan Bank

**ATTACHMENT II. SUPPLEMENTARY MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES
FOR 2009/10**

October 30, 2009

1. This supplementary memorandum documents the implementation through September of the 2009/10 economic program supported by the PRGF and the policy commitments for the remainder of the extended program, including the proposed quantitative targets and structural benchmarks for the Seventh Review (Tables 1 and 2).

A. Recent Developments and Outlook

2. **Growth.** After a severe drought last year, the agricultural sector is expected to grow by 29 percent in the 2009/10 fiscal year. The pace of economic activity outside agriculture is being sustained by high donor inflows and increased security spending. As a result, we have revised our real GDP growth projection from 9 percent to 15 percent in 2009/10. We have also revised upward our import projections and expect the external current account deficit including grants to be around 4 percent of GDP.

3. **Inflation.** A prudent monetary policy and lower food prices have cut headline inflation from a peak of 43 percent in May 2008 to minus 14 percent in October. Nonfood inflation slid from 12 percent in November 2008 to zero percent in October. We maintain our target for the 12-month rate of inflation not to exceed 6 percent in March 2010.

4. **Fiscal performance.** The overall fiscal balance for the first two quarters of 2009 was better than programmed. In the first half of the fiscal year, we collected more revenues than targeted, reflecting the continuing momentum of the measures we enacted in 2008 and early-2009, including tighter control of fuel imports and introduction of the business receipts tax on imports. However, revenue performance weakened somewhat during August-September 2009 owing to increased political uncertainty and insecurity. In addition, development expenditures have been constrained by security problems, delays associated with the Ministry of Economy's management of development budget allotments, and insufficient discretionary cash balances in early 2009/10. Thanks to renewed efforts in recent months, we have been successful in increasing the execution rate of development spending.

5. **Public enterprises.** We experienced minor delays with two structural measures related to public enterprises but remain committed to move ahead with their implementation. The audit of the state fuel company (FLGE), originally scheduled for completion by end-June, was completed at end-September and the respective reports including the management letter were also published. The initiation of the work on compiling and improving the state electricity company's operating and financial indicators was delayed in part because the transfer of the assets and liabilities of the old state electricity utility (DABM) to the new state electricity

company (DABS) was delayed. The transfer, originally planned for June, took place in September, and we will begin publication of the data in December.

6. **Monetary policy.** We have kept currency in circulation within the program limits, but we were unable to observe the end-June quantitative performance criterion on the accumulation of net international reserves. This nonobservance was not a policy slippage as it was caused by a large temporary increase in coalition forces' deposits that raised the end-March stock of reserves and made the actual change in reserves between March and June smaller than targeted (the accumulation target was based on an estimated reserve figure for end-March that did not include these deposits).

7. **Financial sector.** The central bank's supervision department has increased the number of onsite teams and visits, recruited new staff, and separated onsite from offsite supervision. With assistance from World Bank staff, we have initiated the automation of offsite examinations by establishing electronic links to banks, and are upgrading our analytical capacity. We have also established AML/CFT and Islamic banking sections within the central bank and are drafting an Islamic banking law.

8. **Trade policy.** As planned, we have lowered the tariff on soft drinks from 40 percent to 20 percent, effective March 2010. In addition, we are working on simplifying our import tariffs and on becoming a member of the World Trade Organization. We remain committed to an open and transparent trade environment to foster economic activity.

9. **HIPC Completion Point.** We have implemented eight of the eleven HIPC triggers and made substantial efforts to implement the remaining three. We will intensify these efforts in coming weeks, especially on the mining and the pension triggers. We remain committed to further policy reforms in the areas identified by the triggers in close consultation with IMF and World Bank staff.

B. Fiscal Policies

10. **Revenues and fiscal balance.** Based on the good revenue performance during the first half of 2009/10 and our commitment to revenue mobilization and fiscal sustainability, we are raising our domestic revenue target for the year from Af 51 billion to Af 54.5 billion. This will allow the tax-to-GDP ratio to increase from an average of 7.1 percent in the past three years to over 8 percent this year. As part of the midyear budget review, and given the need to increase defense outlays, the operating deficit excluding grants is expected to rise from Af 32.8 billion in the original program to Af 42.5 billion.

11. **Operating expenditures.** Our midyear budget review provides for net additional operating spending of Af 13.2 billion. The increase in the wage bill equals Af 13.5 billion, of

which Af 13.3 billion is security-related.¹ The goods and services category shows a net decline of Af 0.7 billion. This amount reflects an increase of Af 4.9 billion (primarily because of a one-off expenditure of Af 1.5 billion to build up the strategic wheat reserve and an additional Af 2 billion in security) and a reduction of Af 5.7 billion (due to a displacement of Af 5.5 billion in security spending transferred to the external budget, and savings of Af 0.2 billion on other goods and services). In addition, we will maintain a balance of about Af 10 billion for cash management purposes and as a way to reduce the impact of volatile donor assistance and uncertainty in the execution of the development budget. Lastly, we remain committed to cut operating spending should revenues fall short of targets, and not to incur expenditure arrears. Given the need for further increases in security-related spending and in order to ensure long-term fiscal sustainability, we plan to contain nonsecurity recurrent spending in coming years.

12. **Development expenditures.** Despite the deteriorating security in parts of the country, we commit to keep working on improving the execution of development expenditures in the second part of the fiscal year onward. We will work closely with donors to expedite the execution of donor-financed capital expenditures. To this end, the management of development budget allotments was returned from the Ministry of Economy to the Ministry of Finance in July.

13. **Tax administration.** We are implementing with success our short-term revenue action plan. We have also begun successfully collecting income tax from traders who were notified last year, with small taxpayers having a transitional option this year of paying a fee instead. We have established a task force to develop, by February 2010, a strategy to improve the efficiency of the Revenue and Customs Departments. In line with recent technical assistance, the task force will focus on human resources issues, particularly recruiting and firing, budgetary and procurement processes, and organizational issues, including increasing the responsibility and accountability of the Revenue and Customs Departments for their provincial offices. The objective of this reform is to reduce corruption and create a modern national tax administration that is effective, efficient, and fair. This will require the Revenue Department to have increased responsibility and accountability for its provincial offices.

14. **Public financial management.** We are committed to implementing a simple program classification to unify budget presentation in order to improve allocation and management. We are revisiting the existing conceptual framework and program design in order to simplify both the program structure and its associated chart of accounts.

15. **Public enterprises.** The state electricity company will begin publishing by end-December 2009 four-monthly reports on its financial indicators with the outturn for the first

¹ Military and police. The total increase in security spending, Af 15.8 billion, includes Af 9.8 billion that was already in the budget but contingent on the availability of external financing, as part of our goal to increase the size of the army by 23,000 soldiers this year. Other security-related spending, including the increase in the police force by 14,800, adds up to Af 6 billion.

eight months of 2009/10 and forecasts for the coming year. We expect the company to improve operations and reporting after its recent corporatization. In addition, to strengthen oversight of public enterprises, we will shift by end-February 2010 the corresponding directorate from the umbrella of the Administration Department to the Finance Department or the Office of the Minister.

C. Monetary and Financial Policies

16. **Monetary program.** The recent drop in inflation has created room for monetary policy easing and we have adjusted our currency in circulation target accordingly. The revised monetary program also envisages an increase in net international reserves of about \$339 million during 2009/10. Afghanistan's share of the SDR allocation, amounting to SDR 129 million, will be used to increase net international reserves. With this buildup, we project that gross international reserves will be about 13 months of imports by end-March 2010. We will continue to closely monitor inflation developments and stand ready to tighten monetary policy should nonfood inflation exceed 5 percent. We will also maintain a managed floating exchange rate policy aimed at preserving our inflation objectives.

17. **Financial sector.** We are committed to improving the efficiency and soundness of banks and their CAMEL ratings. We will be stepping up supervision and monitoring of banks, strengthening actions to enforce collection of bad loans, and sharing with Fund staff information and updates about the implementation of required corrective actions in banks with weak CAMEL ratings. In addition, we will broaden the scope of financial supervisors' examinations to cover banks' information technology risks, disaster recovery plans, and fraud detection capacity. Lastly, we will work closely with Fund staff on AML/CFT issues and on accepting obligations under Article VIII of the Fund's Articles of Agreement.

D. Program Modifications and Monitoring

18. **Modifications.** In light of the revised economic outlook, the midyear budget review, and the understandings documented in this Memorandum and the revised Technical Memorandum of Understanding (TMU), modifications are warranted on the quantitative targets and structural measures (Attachment II, Tables 1 and 2). We are also requesting an extension of the arrangement until June 25, 2010 to facilitate completion of the envisaged structural reforms and allow sufficient time for discussions on a new arrangement supported by the Fund. In this context, we also request a move of the test date for the Seventh Review from December 2009 to March 2010 and a rephrasing of the last disbursement. Completion of the Seventh Review is envisaged on or before June 10, 2010.

19. **Monitoring.** The last six months of the program will be monitored through indicative quantitative targets for end-December 2009, quantitative performance criteria for March 2010, and structural measures (Attachment II, Tables 1 and 2). The attached Technical Memorandum of Understanding (Attachment III) contains definitions of all targets and reporting requirements.

The Seventh Review will continue to track progress in the key areas of fiscal sustainability, revenue collection, and risks from public enterprises.

Table 1. Islamic Republic of Afghanistan: Quantitative Performance Criteria and Indicative Targets
Under the PRGF Arrangement, December 2009–March 2010 1/
(Cumulative changes from March 20, 2009; unless otherwise indicated)

	Mar. 20, 2009	Dec. 21, 2009	Mar. 20, 2010
	Stocks	Indicative targets	Performance criteria
	(In billions of Afghanis)		
Floor on fiscal revenues of the government	...	41.1	54.5
Ceiling on currency in circulation	76.8	14.0	16.9
Ceiling on net central bank financing of the government	-30.7	-5.4	2.0
Indicative target (ceiling) on the operating budget deficit of the government, excluding grants	...	24.4	42.5
Indicative target (ceiling) on reserve money	106.3	3.0	8.4
	(In millions of US dollars)		
Floor on net international reserves of DAB	3,272	316	339
Ceiling on contracting or guaranteeing new medium- and long-term nonconcessional external debt by the government and DAB 2/	...	0.0	0.0
Ceiling on short-term external debt owed or guaranteed by the government or DAB 2/	...	0.0	0.0
New external payments arrears, excluding interest on preexisting arrears 2/	...	0.0	0.0
Ceiling on lending from state-owned banks to public enterprises in need of restructuring or government guaranteeing borrowing by these public enterprises 2/	...	0.0	0.0
	(In billions of Afghanis)		
Memorandum items:			
Operating budget balance of the government, including grants		3.7	-0.7
<u>Reference projections for the adjustors</u>			
Core budget development spending		31.3	51.3
External financing of the core budget and sale or transfers of nonfinancial assets		59.9	91.8
Externally financed expenditures transferred to the core operating budget		0.0	0.0

Source: Fund staff estimates.

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

2/ These performance criteria apply on a continuous basis.

Table 2. Islamic Republic of Afghanistan:
Structural Benchmarks for the Seventh Review under the PRGF Arrangement, October 2009–March 2010 1/

	Target Dates
Begin publication of four-monthly reports and forecasts for financial flows and other key variables for DABM/S.	December 31, 2009
Finalize a comprehensive review of the financial situation of Afghan Telecom, Ariana, DABM, and FLGE and their fiscal relations with the government in terms of tax owed, subsidies (if applicable), and other payables or receivables. The review will include regularization of tax payments and other cross debts and reduction of subsidies (if applicable); closure of unauthorized bank accounts; review of corporate governance procedures; business plans; and plans for divestiture, restructuring, or privatization for these enterprises.	March 30, 2010
Transfer the directorate responsible for monitoring and managing public enterprises in the Ministry of Finance from the Administration Department to the Finance Department or the Office of the Minister.	February 28, 2010
Adopt and implement the business model of border controls clarifying the role of each ministry at the border consistent with internationally accepted best practices in consultation with other stakeholders (Ministry of Commerce and Industry and Ministry of the Interior) for better customs controls at the border.	February 28, 2010
Implement the ASYCUDA transit module along Zaranj-Nimroz axis and declaration processing module at Nimroz.	March 30, 2010

1/. Selected structural measures are specified in the attached Technical Memorandum of Understanding (Attachment III).

ATTACHMENT III. TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This memorandum reflects understandings between the Afghan authorities and Fund staff in relation to the monitoring of the PRGF-supported program until June 2010. It defines selected structural benchmarks (Section I), valuation for monitoring quantitative targets under the program (Section II), quantitative performance criteria and indicative targets (Section III), adjusters (Section IV), and specifies data reporting (Section V).

I. STRUCTURAL BENCHMARKS

2. Structural benchmarks for the Seventh Review are specified in Table 2 of the Supplementary Memorandum of Economic and Financial Policies (SMEFP). The following section elaborates only on those measures that require specification.

3. Seventh Review:

- Da Afghanistan Breshna Moasisa/Sherkat (DABM/S) will begin publishing by end-December 2009 and with a three-month lag, four-monthly (i.e., three times per year) financial flows and other key variables for Kabul and other jurisdictions for the preceding year and forecast for the coming year as specified in the attached template. The first report will comprise (i) March 21–July 20, 2009, (ii) selected variables for 2008/09, and (iii) forecasts for the next three four-month periods. DABM/S will use a detailed template agreed with Fund staff (see Attachment III, Table 1 below), and the variables reported comprise sources of revenues and other receivables, power generation, expenditures, subsidies received, overall and primary balances, technical and nontechnical (theft) losses including own use, collection rates, revenues at 100 percent collection rates, and financing and other payables. Revenues and subsidies will distinguish among cash, credits, other government obligations, and payment of bills on behalf of DABM/S.
- With support from qualified external experts, the Ministry of Finance will finalize by March 30, 2010 a comprehensive review of the financial situation of Afghan Telecom, Ariana, DABM/S, and FLGE and their fiscal relations with the government in terms of tax owed, subsidies (if applicable), and other payables or receivables. The review will include regularization of tax payments and other cross debts and reduction of subsidies (if applicable). Specifically, the review will include (i) payment of bills and service charges by the line ministries; (ii) payment of taxes by these public enterprises; (iii) transfers of these public enterprises' profits to the single Treasury account; (iv) closure of unauthorized bank accounts; (v) review of corporate governance procedures detailing how decisions are made, approved, and reviewed and definition of the roles of external and internal auditors and directors, as well as the status of management information systems; (vi) business plans for these enterprises; and (vii) plans for divestiture, restructuring, or privatization.

- The Ministry of Finance (Customs Department) will adopt and implement the business model of border controls clarifying the role of each ministry at the border in consultation with other stakeholders (Ministry of Commerce and Industry and Ministry of Interior) for better customs controls at the border. The basic framework for this business model will be developed in accordance with internationally accepted best practices with TA support already at the disposal of the Ministry of Finance. Ministry of Finance shall coordinate with the Ministry of Commerce and Industry, Ministry of Interior, Ministry of Transport, and other ministries who have representation at the borders to arrive at an agreement. The Ministry of Finance will give a full implementation report focusing specifically on the changes affecting customs controls and physical placements, if any, by February 28, 2010.
- The Ministry of Finance (Customs Department) will implement the ASYCUDA transit module along Zaranj-Nimroz axis and Declaration Processing Module at Nimroz by March 30, 2010. Ministry of Finance will provide the necessary resources to the ASYCUDA program to ensure its timely implementation.

II. PROGRAM EXCHANGE RATES AND GOLD VALUATION

4. Program exchange rates are used for formulating and monitoring quantitative targets. All foreign assets and liabilities denominated in U.S. dollars will be converted into Afghani at a program exchange rate of 52.1375 Afghani per U.S. dollar, which corresponds to the cash rate of December 19, 2008. Gold holdings will be valued at US\$838.28 per ounce, the price as of December 19, 2008. Assets and liabilities denominated in SDRs and in foreign currencies other than the U.S. dollar will be converted into U.S. dollars at their respective exchange rates of December 19, 2008, as reported in the following table. Gold holdings will be valued at US\$838.28 per ounce, the price as of December 19, 2008.

Exchange Rate	Program Rate
US dollar/Canadian dollar	0.820200
US dollar/U.A.E. dirham	0.272300
US dollar/Egyptian pound	0.181800
US dollar/Euro	1.391200
US dollar/Hong Kong dollar	0.129020
US dollar/Indian rupee	0.021150
US dollar/Pakistani rupee	0.012598
US dollar/Polish zloty	0.336300
US dollar/Iranian rial	0.000101
US dollar/Saudi rial	0.266600
US dollar/Russian ruble	0.035490
US dollar/Swiss franc	0.906000
US dollar/United Kingdom pound	1.492000
US dollar/SDR	1.545010

III. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

5. The quantitative performance criteria for March 2010 specified in Table 1 of the SMEFP are:

- Floors on fiscal revenue of the central government and net international reserves (NIR); and
- Ceilings on currency in circulation (CiC); net central bank financing (NCBF) of the central government; contracting and/or guaranteeing new medium- and long-term nonconcessional external debt by the government or the Da Afghanistan Bank (DAB), the central bank, (continuous); short-term external debt owed or guaranteed by the government or the DAB (continuous); accumulation of external payment arrears, excluding interest on preexisting arrears (continuous); lending from the central bank or state-owned banks to, or government guaranteed borrowing by, public enterprises in need of restructuring (continuous).

6. The above variables also constitute indicative targets for December 2009. In addition, the program includes the following indicative targets for the next two quarters:

- Ceilings on the operating budget deficit of the central government excluding grants; and
- Ceilings on reserve money.

7. **Currency in circulation** is defined as total currency issued by the DAB. It excludes currency held in the presidential palace vault, in the DAB main vault, and in the vaults of all provincial and district branches of the DAB.

8. **Net central bank financing of the government** is defined as the difference between the central bank's claims on the government and government deposits at the DAB. These deposits exclude deposits held at the DAB's branches because of the unavailability of reliable and timely data from the DAB's branches.

9. **Net international reserves (NIR)** are defined as reserve assets minus reserve liabilities of the DAB, both of which are expressed in U.S. dollars.

- Reserve assets of the DAB, as defined in the fifth edition of the balance of payments manual (BPM5), are claims on nonresidents denominated in foreign convertible currencies, that are controlled by the DAB, and are readily and unconditionally available for the DAB to meet balance of payments financing needs, intervention in exchange markets, and other purposes. They include DAB holdings of monetary gold, SDRs, Afghanistan's reserve position in the IMF, foreign currency cash (including foreign exchange banknotes in the vaults of the DAB, but excluding

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

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

10. **Revenues** of the central government are defined in line with the Government Financial Statistics Manual (GFSM 2001) but on a cash accounting basis, excluding grants. Revenue is an increase in net worth of the central government (including its units in the provinces and agencies) resulting from a transaction.

- Revenues of the central government include taxes and other compulsory transfers imposed by central government units, property income derived from the ownership of assets, sales of goods and services, social contributions, interest, fines, penalties and forfeits and voluntary transfers received from nongovernment other than grants. The definition for program monitoring excludes grants and other noncompulsory contributions received from foreign governments and international organizations; such transfers between central government units would be eliminated in the consolidation of the fiscal reports and not recorded as revenue. Receipts collected by central government on behalf of noncentral government units should not be counted as revenue (e.g., Red Crescent fees). Receipts from the sale of nonfinancial assets, such as privatization, and transactions in financial assets and liabilities, such as borrowing but excepting interest payments, are also excluded from the definition of revenue.

- Revenues should be recognized on a cash basis and flows should be recorded when cash is received. The official Afghanistan Government Financial Management Information System (AFMIS) reports will be used as the basis for program monitoring. Exceptional advanced payments will be treated as if received on the normal due date. All revenue must be supported by the relevant documentation and revenue receivables, where a cash sum has been recorded but the revenue item has not yet been accounted for, and revenues payable, where the revenue has been reported but the cash has yet to be recorded should be separately reported on a gross basis.

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

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

12. The ceiling on **medium- and long-term external debt** applies on a continuous basis to the contracting or guaranteeing by the government or the DAB of new nonconcessional external debt with an original maturity of more than one year. For program purposes, “government” includes the central government (including government departments), as well as official agencies that do not seek profit and whose budgets are issued independent of the annual operational or development budgets. Consistent with the Public Finance and Expenditure Management (PFEM) Law, the Ministry of Finance should have sole responsibility for the contracting and guaranteeing of external debt on behalf of the government. It applies to both debt as defined in paragraph 11 of this memorandum, and also to commitments contracted or guaranteed for which value has not been received. For the purposes of the program: (i) external debt will be considered to have been contracted at

the point the loan agreement or guarantee is signed by the Ministry of Finance (on behalf of the government) or the DAB Governor; and (ii) the guarantee of a debt arises from any explicit legal obligation of the government or the DAB, or any other agency acting on behalf of the government, to service such a debt in the event of nonpayment by the recipient (involving payments in cash or in kind), or indirectly through any other obligation of the government or the DAB to cover a shortfall incurred by the loan recipient.

- Excluded from the limits are refinancing credits and rescheduling operations, credits extended by the IMF, and credits on concessional terms defined as those with a grant element of at least 60 percent. The grant element is to be calculated using currency-specific discount rates based on the Organization for Economic Cooperation and Development's Commercial Interest Reference Rates (CIRRs): for maturities of less than 15 years, the grant element will be calculated based on six-month averages of CIRRs; and for maturities longer than 15 years, the grant element will be calculated based on 10 year averages.
- Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract or guarantee becomes effective.

13. The zero ceiling on **short-term external debt** applies on a continuous basis to the stock of short-term external debt owed or guaranteed by the government (as defined in paragraph 12 of this memorandum) or the DAB, with an original maturity of up to and including one year.

- It applies to debt as defined in paragraph 11 of this memorandum.
- Excluded from the limit are rescheduling operations (including the deferral of interest on commercial debt) and normal import-related credits.
- Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract or guarantee becomes effective.

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

15. **Lending to, or guaranteeing borrowing by, public enterprises.** The zero ceiling on new lending from state-owned banks to, or government guaranteed borrowing by public enterprises in need of restructuring applies on a continuous basis.

- For the purposes of this performance criterion: (i) “state-owned banks” refers to those banks that are wholly or majority owned by the government (as defined in paragraph 12 of this memorandum); including Bank Millie, Bank Pashtany, and Export Promotion Bank; (ii) “enterprises in need of restructuring” refers to enterprises that meet any one of the following: (a) enterprises (public or private) that have not had an audited balance sheet in fiscal years 1386 and 1387; (b) public enterprises that have been identified by the Ministry of Finance for liquidation; (c) public enterprises that do not have Cabinet-approved restructuring plans; (iii) “public enterprises” refers to enterprises wholly or majority owned by the government, including those covered by the State-Owned Enterprise (Tassady) Law, and 14 state-owned corporations¹² and any other public entities and government agencies engaged in commercial activities but not covered by Tassady Law.
- It applies to any new loans (or financial contributions) extended directly from the central bank or state-owned banks to public enterprises in need of restructuring, and also to any new government guarantees (as defined in paragraph 12 of this memorandum) of borrowing undertaken by these public enterprises. It applies to loan agreements and guarantees for which value has not been received.

16. **Operating budget deficit of the central government** excluding grants is defined as revenues of the central government minus operating budget expenditure recorded in AFMIS.

17. **Reserve money** is defined to include CiC and Afghani-denominated commercial bank deposits with the DAB, including balances maintained by the commercial banks in the DAB’s overnight facility.

IV. ADJUSTORS

18. The floor on NIR and the ceiling on the NCBF of the government are consistent with the assumption that core budget **development spending** in 2009/10 will amount, on a cumulative basis from March 21, 2009, to:

December 20, 2009	Af 31.3 billion
March 20, 2010	Af 51.3 billion

19. Should core budget development spending exceed these projections, the NIR floor will be adjusted downward and the NCBF ceiling will be adjusted upward by the difference

¹² Afsotar, Afghan Teor, Aftento, Af-Turk, Afghan Cart, Afghan Naichi, Astrass, Afghan Telecom, Afghan Wireless, Afghan National Insurance Company, Afghan Textile, Ariana Afghan Airlines, Da Afghanistan Breshna Sherkat (DABS), and Hotel Intercontinental (Baghi Bala/Kabul).

between the actual level (up to the appropriated amount) and the projected level of development spending.

20. The NIR floor and NCBF ceiling are defined consistent with the assumption that the external financing of the core budget and receipts from the sale or transfer of nonfinancial assets will amount, on a cumulative basis from March 21, 2009, to:

December 20, 2009	Af 59.9 billion
March 20, 2010	Af 91.8 billion

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

22. Should some **expenditure currently financed directly by donors outside the budget be moved on to the operating budget**, the NIR floor will be adjusted downward, and the NCBF ceiling and the indicative targets (ceilings) for the operating budget deficits of the central government, excluding grants, will be adjusted upward, by the actual amount of these expenditures on the conditions that (i) the moving on budget of these expenditures is justified by a statement from donors indicating their decision to stop financing them outside the budget and (ii) they are subject to a supplementary appropriation approved by parliament. The overall downward adjustment to the NIR floors will be capped at US\$300 million.

23. Should the central government undertake **security-related operating expenditures** based on spending plans agreed between the central government and donors, the indicative target (ceiling) for the operating budget deficit of the central government, excluding grants, will be adjusted upward and, should there be quarterly discrepancies between disbursements and executions, the NIR floor will be adjusted downward, and the NCBF ceiling upward by the sum of: (i) Af 1.8 billion, contingent on the final 2009/10 Afghan National Army (ANA) headcount exceeding 86,000, with the adjustment for any force size between 86,000 and 109,000 calculated on a prorated basis; (ii) Af 4.5 billion for augmentations (“top-ups”) to the salaries of the 109,000 ANA force size with the adjustment for any force size between 86,000 and 109,000 calculated on a prorated basis; (iii) Af 2.2 billion for the salaries of the 16,000 soldiers recruited in 2008/09; (d) Af 900 million for equipment purchases by the Ministry of Defense; (iv) Af 400 million for equipment purchases by the Ministry of the Interior; and (v) Af 599 million for increasing the food allowances of the Afghan National Police. The cumulative downward adjustment to the NIR floors at each test date will be capped at US\$199.5 million. The cumulative upward adjustment to the NCBF ceilings and the indicative targets (ceilings) for the operating budget deficit of the central government, excluding grants, at each test date, will be capped at Af 10.4 billion.

V. PROVISION OF INFORMATION TO THE FUND

24. To facilitate monitoring of program implementation, the government of Afghanistan will provide the Fund through the office of the Resident Representative of the IMF in Afghanistan, the information specified below and summarized in the list of reporting tables provided to the Technical Coordination Committee.

25. Actual outcomes will be provided with the frequencies and lags indicated below.

- DAB net international reserves: weekly, no later than two weeks after the end of each week.
- Monetary statistics, including exchange rates, government accounts with the DAB, currency in circulation, reserve money, and a monetary survey: monthly and no later than three weeks after the end of the month. The monetary survey will include the balance sheet of the DAB and a consolidated balance sheet of the commercial banking sector.
- Core budget operations and their financing: monthly and no later than four weeks after the end of the month. The official reports for program monitoring will be the monthly financial statements from the Afghanistan Financial Management Information System. The structure of financing (grants and loans should be separately identified) and expenditure data should be on a consistent cash basis. Core operating expenditures should be reported on a monthly basis using the budget appropriation economic (object) and administrative classification in addition to the program and functional classification as reported in the budget documents. Core development expenditures should also be reported separately on a monthly basis using the budget program classification in addition to the economic (object), administrative and functional classification consistent with the operating budget. All the data should also compare outturns against the approved budget. Core operating and development revenues and expenditures should also be reported by province, separately on the same monthly basis.
- External budget operations and their financing (i.e., donor funded spending outside the core budget treasury systems): semi-annually (more frequently if possible) and no later than eight weeks after the end of the period. External development expenditures should be reported on a disbursement basis (as currently defined in budget documents) using the budget program classification (and an administrative, functional and provincial classification where possible).
- External debt data: quarterly and no later than six weeks after the end of the quarter. These will include: (i) details of new loans contracted or guaranteed during the quarter, including the terms of each new loan; (ii) the stock of debt at the end the quarter, including short-term debt, and medium- and long-term debt; (iii) loan

disbursements and debt service payments (interest and amortization) during the quarter, beginning with the first quarter of fiscal year 1388 (2009/10); (iv) debt relief received during the quarter; (v) information on all overdue payments on short-term debt, and on medium- and long-term debt, including new external arrears (if any); and (vi) total outstanding amount of arrears.

- National accounts data: annually and no later than eight weeks after the end of the year. Merchandise trade data should be reported quarterly and no later than eight weeks after the end of the quarter.
- Monthly consumer price indexes (CPIs) for Kabul and five other major cities (“national” CPI) with a lag of four weeks after the end of each month.
- Four-monthly financial flows and other key variables of the state electricity company (DABM/S) for Kabul and other jurisdictions for the preceding year and forecast for the coming year as specified in the attached template and with a three-month lag (see Attachment III, Table 1).

The Technical Coordination Committee (TCC) will send to the IMF reports by the end of each quarter documenting progress in implementing structural benchmarks under the program. These reports will include appropriate documentation and explain any deviations relative to the initial reform timetable, specifying expected revised completion date. Other details on major economic and social measures taken by the government that are expected to have an impact on program sequencing (such as changes in legislation, regulations, or any other pertinent document) will be sent in a timely manner to IMF staff for consultation or information.

Attachment III: Table 1. Islamic Republic of Afghanistan: Summary of Operations of Da Afghanistan Breshna Moasisa/Sherkat 1/

	2008/09	2009/10			2010/11
	Act.	March 21 - July 20	July 21 - November 20	November 21 - March 20	March 21 - July 20
		Act.	Est.	Proj.	Proj.
	(in millions of Afghanis unless otherwise indicated)				
Revenues
Total Revenues at 100 % Collection
Electricity Revenues Collected
Electricity Revenues at 100% Collection
Net Generation Plus Imports, mil kwh
Net Generation, mil kwh
Import, mil kwh
Losses (technical and nontechnical), mil kwh
Expenditures
Expenditures Excluding Interest Payments and Capital Expenditures Related to Foreign Financed Projects
Expenditures Excluding Interest Payments and Capital Expenditures (Current Expenditures)
Inputs
Purchased Power, mil kwh
Fuel, liters
Purchased Power Cost
Fuel Cost
Operation and Maintenance (O&M) Costs
Capital Expenditures
Errors and Omissions
Primary Balance 2/
Current Balance at 100% collection
Current Balance
Balance
Financing Available
Domestic Sources
Amortization, net (includes arrears reduction)
Tax Arrears
Government Subsidies
External Sources
Errors and Omissions
Financing Gap
Memorandum Items:					
Exchange Rate, Afghanis per USD
Nominal GDP

1/ This summary table is complemented by more detailed templates that include disaggregations of different categories (revenues, expenditures, and financing available) for three jurisdictions (Kabul and North-East, South and East, and West).

2/ Primary balance is defined as current revenues minus total expenditures excluding all interest payments and capital expenditures related to foreign financed projects.

INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF AFGHANISTAN

Sixth Review Under the Arrangement Under the Poverty Reduction and Growth Facility, Request for Waiver of Nonobservance of a Performance Criterion, Modification of Performance Criteria, and Rephasing and Extension of the Arrangement

Informational Annex

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

December 30, 2009

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ANNEX I. ISLAMIC REPUBLIC OF AFGHANISTAN—RELATIONS WITH THE FUND
(As of November 30, 2009)

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

II.	General Resources Account	<u>SDR Million</u>	<u>% Quota</u>
	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	<u>SDR Million</u>	<u>% Allocation</u>
	Net cumulative allocation	155.31	100.00
	Holdings	128.64	82.83

IV.	Outstanding Purchases and Loans	<u>SDR Million</u>	<u>% Quota</u>
	PRGF Arrangements	69.07	43.05

V. **Latest Financial Arrangements:**

<u>Type</u>	<u>Date of Arrangement</u>	<u>Expiration Date</u>	<u>Amount Approved (SDR Million)</u>	<u>Amount Drawn (SDR Million)</u>
PRGF	June 26, 2006	June 25, 2009	81.00	58.40

VI. **Projected Payments to Fund**

(SDR million; based on existing use of resources and present holdings of SDRs)

	<u>Forthcoming</u>				
	<u>2009</u>	<u>2010</u>	<u>2011</u>	<u>2012</u>	<u>2013</u>
Principal				2.45	8.29
Charges/Interest	<u>0.18</u>	<u>0.42</u>	<u>0.42</u>	<u>0.42</u>	<u>0.39</u>
Total	<u>0.18</u>	<u>0.42</u>	<u>0.42</u>	<u>2.87</u>	<u>8.68</u>

VII. **Implementation of HIPC Initiative:**

	<u>Enhanced Framework</u>
I. Commitment of HIPC assistance	
Decision point date	July 2007
Assistance committed (NPV terms) ¹	
by all creditors (US\$ million)	571.40
<i>Of which:</i> Fund assistance (US\$ million)	--
(SDR equivalent in million)	--
Completion point date	Floating
II. Disbursement of IMF assistance (SDR million)	
Assistance disbursed to the member	--
Interim assistance	--

¹ Net Present Value (NPV) at the decision point under the enhanced framework.

Completion point balance	--
Additional disbursement of interest income ²	--
Total disbursements	--

VIII. Implementation of MDRI Assistance: Not Applicable

Nonfinancial Relations

IX. Exchange Arrangement

Afghanistan is an Article XIV member country. The authorities are implementing a liberal exchange system. Based on information currently available to the staff, no exchange restrictions and multiple currency practices are in place. The authorities have provided documents to Fund staff related to laws and regulations on the exchange regime and have requested technical assistance from the Fund to formalize the current liberal regime. They have been implementing a managed float system with no predetermined path for the exchange rate. On December 17, 2009, the average of the buying and selling exchange rates in cash transactions on the Kabul money exchange market was Af 48.50 per US\$1.

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

X. Article IV Consultation

The last Article IV consultation with Afghanistan was discussed by the Executive Board on February 13, 2008. Consultations with Afghanistan are on the standard 24-month cycle for the Fund's program countries.

² Under the enhanced framework, an additional disbursement is made at the completion point corresponding to interest income earned on the amount committed at the decision point, but not disbursed during the interim period.

XI. Safeguards Assessment

Under the Fund's safeguards assessment policy, Da Afghanistan Bank (DAB) is subject to a safeguards assessment with respect to PRGF arrangement approved on June 26, 2006. A safeguards assessment of DAB was completed on June 12, 2006 and updated on March 18, 2008. The assessment revealed serious vulnerabilities in DAB's external and internal audit mechanisms, as well as in its financial reporting framework and system of internal controls. Capacity constraints, however, hampered the effective implementation of measures recommended by the assessment, and follow-up staff visits found that while external audit arrangements had been strengthened, financial reporting and accounting controls remain weak. DAB is continuing its implementation of outstanding safeguards recommendations. These efforts are being monitored by staff in the context of the program.

XII. Technical Assistance, 2005–09

Department	Date	Purpose
FAD	March 2004–July 2006	Resident treasury expert
	May 19–25, 2005	Seminar on reorganization of the MOF
	October 18–25, 2005	Tax policy
	February 21–March 4, 2006	Public financial management
	April 30–May 9, 2006	Tax policy
	November 15–23, 2006	Tax and customs administration
	August 18–30, 2007	Program budgeting
	August 28–September 12, 2007	GFS
	October 2007–September 2008	Resident treasury advisor
	June 24–July 8, 2008	Program budgeting
	January 27–31, 2009	Tax administration
	July 4–16, 2009	Public financial management
December 1–14, 2009	Tax administration; program budgeting	
FIN	April 2–11, 2006	Safeguards assessment
	November 9–12, 2007	Safeguards assessment
	September 20–24, 2008	Safeguards assessment
LEG	January 29–February 12, 2005	Income tax law
LEG/MCM	May 2–10, 2006	Legal framework of DAB's monetary and payment system policies
	January 13–21, 2008	Monetary policy and payment system
MCM	September 2004–April, 2006	Training coordinator
	April 2006–June 2007	Training coordinator (peripatetic)
	February 2–15, 2005	Implementation of DAB balance sheet reconstruction and capital adequacy recommendations
	May 16–25, 2005	Monetary policy and financial markets
	October 11–20, 2005	Monetary policy
	November 20–29, 2005	Financial markets
	January 22–February 5, 2006	Monetary policy
	January 22–February 5, 2006	Monetary policy
	May 2–10, 2006	Monetary policy, foreign reserve management, money markets and insurance
	November 28–December 10, 2006	Monetary policy formulation and implementation
	March 19–April 16, 2007	Central bank capacity building
	March 24–29, 2007	Banking supervision
	April 17–30, 2007	Monetary policy formulation and implementation
November 7–14, 2007	Banking supervision	

	August 27-September 11	Monetary policy formulation and implementation
Department	Date	Purpose
STA	January 15–February 15, 2005	Multisector statistics
	March 23–June 11, 2005	Multisector statistics
	July 20–August 31, 2005	Multisector statistics
	October 31, 2005–January 12, 2006	Multisector statistics
	March 6–15, 2006	Balance of payments statistics
	March 8–May 2, 2006	Multisector statistics
	March 13–April 1, 2006	Monetary and financial statistics
	May 24–July 18, 2006	Multisector Statistics
	August 2–16, 2006	Balance of payments statistics
	August 8–October 3, 2006	Multisector statistics
	September 22–October 4, 2006	Government finance statistics
	October 21–November 5, 2007	Balance of payments statistics
	November 1–December 26, 2006	Multisector statistics
	November 5–19, 2006	Monetary and financial statistics
	April 22–May 4, 2007	Monetary and financial statistics
	July 7–30, 2007	National accounts
	August 29–September 25, 2007	National accounts
	March 30–April 2, 2008	TA evaluation
	April 20–30, 2008	Monetary and financial statistics
	August 8–27, 2008	Balance of payments statistics
	October 13–29, 2008	National accounts
	November 12–December 3, 2008	Balance of payments statistics
November 23–December 5, 2008	Monetary and financial statistics	
August 30-September 9, 2009	Monetary and financial statistics	
MCD	April 16–20, 2005	Basic macroeconomic accounting and financial programming
METAC	November 15–20, 2005	Tax policy and administration
	June 8–13, 2006	Budget integration
	November 15–22, 2006	Tax policy and administration
	December 12–19, 2006	Budget integration
	December 12–22, 2006	Budget development
	March 10–21, 2007	Tax policy and administration
	March 11–22, 2007	Cash management
	March 24–29, 2007	Banking supervision
	May 19–25, 2007	Balance of payments statistics
	June 6–19, 2007	Accounting
	July 1–12, 2007	Banking supervision
	August 2007	Cash management and program budgeting
	September 1–12, 2007	Banking supervision
	November 4–8, 2007	Banking supervision
	January 5–26, 2008	Central bank accounting
	March 22–April 2, 2008	Banking supervision
	June 25–July 7, 2008	Budget preparation
	August 6–27, 2008	Balance of payments statistics
	August 24–27, 2008	Banking supervision
	September 14–24, 2008	Real sector statistics
	December 14–17, 2008	Banking supervision
	January 25–February 2, 2009	Central bank accounting
	January 28–February 2, 2009	Tax policy and administration
	March 7–19, 2009	Cash and budget management
	October 4-15, 2009	Consumer price index

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

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

XIII. Resident Representatives

Mr. de Schaetzen; August 2002–June 2005

Mr. Charap; June 2005–June 2008

Mr. Abdallah; June 2008–present

ANNEX II. ISLAMIC REPUBLIC OF AFGHANISTAN—RELATIONS WITH THE WORLD BANK

(As of December 23, 2009)

1. IDA has committed a total of \$1.7 billion to Afghanistan since 2002. To date, 31 development and emergency reconstruction projects as well as 4 development policy grants have been implemented. IDA's active portfolio comprises 26 investment projects with combined net commitment of over \$1 billion, of which more than 55% has been disbursed.
2. The Bank's involvement in Afghanistan extends to its role as administrator of the Afghanistan Reconstruction Trust Fund (ARTF). The ARTF has developed into the primary multi-donor funding mechanism, financing the essential running costs of government as well as key investments, including national programs in health, education, rural access, irrigation rehabilitation, microfinance, and the National Solidarity Program. Since 2003, 30 donors have collectively contributed over \$3.4 billion to this fund.
3. The Bank has contributed to the following areas of success: One of the primary focuses of the Bank's assistance has been to help the government set up the basic legal framework, establishing fiscal authority, and developing systems and human resources for *public financial management*. The performance of MoF regarding alignment of budgetary allocations with the country's priority needs, fiscal discipline, cash control, and aggregate transparency has contributed to macroeconomic stability and sustained external donor assistance.
4. In *rural development*, the National Solidarity Program (NSP) now reaches over 22,000 villages (68 percent of population) across rural Afghanistan through locally elected community development councils. With modest grants, the communities are empowered to make decisions about their own development priorities in drinking water supply, roads, irrigation, schools, etc.
5. The Ministry of Public Health is providing *basic health services* across the country, and the number of functioning primary health care facilities has increased from 496 in 2002 to 1,169 in 2007. This has contributed to 26 percent decline in the under-5 mortality rate—saving approximately 80,000 children lives every year.
6. The demand for *education* has continuously exceeded expectations and the capacity of supply. There are now 6 million children enrolled in school, with nearly 35 percent being girls, compared to a little more than one million five years ago, with almost no girls.
7. The *Microfinance* Investment Support Facility has contributed to a substantial expansion of credit. The sector reports over 400,000 active clients, of which 63 percent are women, for a cumulative loan disbursement of over \$500 million.

8. The Bank is helping to build the capacity of the government to exercise *strong oversight of the minerals and hydrocarbons sectors*. Supported by WBG technical assistance the tender for the Aynak copper deposit, one of the largest in the world, is expected to attract investments of \$10 billion over the next 5-10 years.

9. Looking Forward: The *Bank's strategy, as outlined in the FY09–11 Interim Strategy Note, rests on three pillars*: (i) Building the capacity and accountability of the state to its citizens to provide services that are affordable, accessible and adequate; (ii) promoting growth of the rural economy and livelihoods; and (iii) supporting growth of a formal, modern and competitive private sector.

10. The Bank's indicative *lending envelope for 2010–11 is approximately \$400 million*. Resources will be primarily *channeled to proven national programs* in health, education, microfinance, irrigation, and rural livelihood (including agriculture), where demands remain vast, to sustain and accelerate progress made so far. These areas constitute significant *platforms for improving livelihoods and building government credibility*.

11. Supporting sound national programs under the leadership of the government is the most effective use of international aid. The Bank will engage in areas where there is evidence: (i) that a strong, reform-minded, leadership is in place; (ii) where it can help leverage the support of other members of the international donor community, and (iii) where opportunities exist to develop operational frameworks for future programs. In this context, the Government has requested that the Bank play an enhanced role in working with them to determine the vision, design, and framework of their national programs.

**ANNEX III. ISLAMIC REPUBLIC OF AFGHANISTAN—RELATIONS WITH THE ASIAN
DEVELOPMENT BANK**

(As of December 19, 2009)

1. A new Country Partnership Strategy (CPS) covering the 2009–2013 period was endorsed by ADB's Board of Directors on March 5, 2009. The new CPS is fully aligned with the Afghanistan National Development Strategy (ANDS), with ADB's investments contributing to Afghanistan's further economic development. The new CPS continues ADB's narrow focus on Afghanistan's energy, transport, and agriculture and irrigation sectors, including sector governance and further institutional and human capacity development.
2. As of end-October 2009 the Asian Development Bank had committed an aggregate of some \$2.03 billion to Afghanistan's reconstruction through approved Asian Development Fund (ADF) loan- and grant-financed projects, technical assistance activities, donor grant-financed projects administered by ADB, and ADB private sector investments. ADB's ADF-financed investments totaled \$1.6 billion. Since 2007, all of ADB's public sector (ADF) assistance has been provided on a 100 percent grant basis. At the June 2008 International Conference in Support of Afghanistan ADB pledged an additional \$1.3 billion over the 2008–2013 period, making ADB Afghanistan's fourth largest donor overall (after the United States, the United Kingdom, and the World Bank).
3. Since November 2008 ADB has approved three multitranche financing facility (MFF) projects for the following: \$570 million energy sector MFF and a \$400 million transport sector MFF (November 2008); a \$300 million water resources management sector MFF for \$300 million (October 2009); and a railway project of \$165 million (October 2009). With the approval of these MFFs and the railway project, the bulk of ADB's anticipated ADF assistance over the 2008–2013 will be fully "earmarked", although with some flexibility depending on changes in Government priorities.
4. Since ADB operations in Afghanistan resumed in 2002, there have been 11 public sector loans in total \$722.2 million and 13 grants in total \$881.6 million covering 22 investment projects. This involved ADF funding resources using loan or combined loan and grant funding, and since 2007 all projects have used only ADF grant-financing. In addition, there have been 10 JFPR funded projects, 8 standalone projects and 2 combined with loan projects totaling \$110.0 million. Also, there have been 4 donor cofinancing grants from Kuwait Fund, CIDA (2) and DFID amounting to \$44.2 million. ADB's private sector operations in Afghanistan began in 2004. As of end October 2009, cumulative approvals for six private sector projects have amounted to \$208.1 million, including support for Afghanistan International Bank, Roshan Telecommunications, and the Afghanistan Investment Guarantee Facility.
5. The Asian Development Bank has been actively engaged in providing analytical and advisory technical assistance (TA) services to the Government, with total TA amounting to

some \$64.5 million as of 30 September 2009 (including \$8.2 million in donor cofinancing). Increasingly, TA is included as integral parts of ADB's grant-based investment projects, with focus on public financial management, procurement, and anti-corruption as well as institutional and human capacity development. ADB also has provided ongoing TA support to the Ministry of Finance.

6. ADB is a member of the Afghanistan Compact/ANDS Joint Coordination Management Board (JCMB) and also is a member of the Afghanistan Reconstruction Trust Fund Management Committee. ADB plays an active part in other donor coordination activities, including the JCMB Social and Economic Development Standing Committee, the Ministry of Finance's High Level Committee on Aid Effectiveness and the Inter-Ministerial Committee on Energy.

**Statement by the IMF Staff Representative on the Islamic Republic of Afghanistan
January 13, 2010**

1. This statement contains information on the Islamic Republic of Afghanistan that has become available since the staff report was circulated on December 29, 2009. The information does not change the thrust of the staff appraisal.
2. Headline **inflation** (year-on-year) was minus 13.2 percent in December, reflecting recent declines in domestic food prices. Core inflation, measured by nonfood inflation, was 0.9 percent, up from minus 0.6 percent in November.
3. Fiscal data for the period March-November 2009 show that **domestic revenues** totaled Af 39 billion, suggesting that collection will comfortably exceed the envisaged indicative target for December of Af 41.1 billion. The strong revenue performance reflects the impact of the revenue measures implemented last year and the recovery of the economy.
4. Based on preliminary **monetary data** for December, the envisaged indicative targets for currency in circulation, net international reserves, and net central bank financing of the government were met, while the indicative target for reserve money was missed by a small margin (one percent).
5. The **2008/09 audit of the central bank** has been finalized and posted on the central bank's website. The auditors had found a minor error in the gold valuation. Based on advice from the Bank for International Settlements, the gold has been revalued by discounting US\$2 per troy ounce from the official London price. The adjustment does not affect the measurement of the quantitative performance criteria on net international reserves.
6. The authorities have been unable to begin publishing **operational and financial information on the state electricity company** (structural benchmark for December 2009) because of difficulties in obtaining and reconciling financial information (the company has just been corporatized and its management replaced). The authorities intend to begin regular reporting in March 2010.
7. The authorities have implemented the **HIPC completion point trigger on mining**. World Bank staff has determined that the recently approved mining regulations are sufficient to consider the trigger to be implemented. Fund and Bank staffs are finalizing the documentation for immediate Board distribution. The authorities have requested an accelerated clearance process and an early Board meeting to be able to highlight debt relief and their achievements at the forthcoming International Conference on Afghanistan in London on January 28.



Press Release No. 10/04
FOR IMMEDIATE RELEASE
January 13, 2010

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes Sixth Review under the PRGF Arrangement for the Islamic Republic of Afghanistan

The Executive Board of the International Monetary Fund (IMF) today completed the sixth review of the Islamic Republic of Afghanistan's economic performance under the Poverty Reduction and Growth Facility (PRGF). The completion of the review allows for an immediate disbursement of SDR 5.65 million (about US\$8.89 million), which would bring total disbursements under the arrangement to SDR 75.35 million (about US\$118.53 million).

In completing the review, the Executive Board also granted a waiver for the nonobservance of a June 2009 quantitative performance criterion related to the accumulation of net international reserves. The Board also approved a three-month extension of the arrangement to end-June 2010, a rephrasing of disbursements, and the modification of the quantitative performance criteria for March 20, 2010.

The PRGF arrangement for the Islamic Republic of Afghanistan was approved in June 2006 for an amount equivalent to SDR 81.0 million (about US\$127.41 million) (see [Press Release No. 06/144](#)).

Following the Executive Board's discussion, Mr. Murilo Portugal, Deputy Managing Director and Acting Chair, stated:

“Despite a very difficult security and political situation, the Afghan authorities have been successfully implementing their 2009/10 economic program. The economy has been recovering from last year's drought, inflation has declined, and tax collection has exceeded expectations. Strong economic growth and favorable inflation developments should contribute to improving living standards and alleviating poverty.

“The revised economic program for 2009/10 aims at consolidating the progress made. The authorities intend to focus monetary policy on keeping inflation low, and fiscal policy on accommodating higher security spending, preserving pro-poor public spending, and

improving the execution of development outlays. They also remain committed to taking further measures to boost tax revenues, improve the transparency and efficiency of public enterprises, and ensure the enforcement of banking regulations.

“While security remains paramount, economic stability, support from donors, and an ambitious economic reform program focused on good governance, fiscal sustainability, and public and private investments will be essential to foster economic development and reduce poverty. The authorities have expressed interest in seeking continued Fund support after the current program expires in June 2010,” Mr. Portugal said.

**Statement by Jafar Mojarrad, Executive Director for the Islamic Republic of Afghanistan
and Abdelali Jbili, Advisor to the Executive Director
January 13, 2010**

On behalf of our authorities, we thank staff for the excellent report and the fruitful engagement with the authorities amid difficult circumstances. Our thanks go to Management and the Board for their unrelenting support to Afghanistan. The authorities have delivered on their commitment to reform and program implementation, despite well-known political and security difficulties. This bodes well for tackling further challenges in the period ahead. As the authorities continue to redouble their efforts, support from the international community must remain commensurate with the enormous challenges faced by Afghanistan. Similarly, the authorities expect the IMF to further strengthen its commitment and in-country engagement. We look forward to the forthcoming London conference on January 28th to reinforce this message.

Program implementation

The program has been fully implemented: all of end-June criteria have been observed, notwithstanding the technical deviation from the targeted minimum accumulation of international reserves in connection with unexpected movements in bank deposits of allied forces; all the structural measures governed by the Sixth Review have been implemented; and economic performance has been very good. The authorities request a waiver for the nonobservance of the performance criterion on the minimum accumulation of international reserves, completion of the Sixth Review, and disbursement of the related purchase under the arrangement. In addition, they request an extension of the program until June 25, 2010 to complete ongoing structural reforms and negotiate a new arrangement with the Fund.

Overall economic performance

Despite the difficulties and the unfavorable external environment, economic activity rebounded strongly in 2009/10, supported by a recovery of agriculture from the severe drought last year, and by increased donor financial support and higher spending on security by the government and coalition forces. The impressive growth performance of 15 percent (10 percent in the non-agricultural sector), together with the sharp fall in both headline and non-food inflation, will bring about a significant improvement in real per capita income. This is a most welcome development in light of the widespread poverty and deteriorating standards of living.

Substantial progress has been made in the fiscal area. Domestic revenue collection increased by 60 percent between March and September 2009, exceeding the program target. The improvement was broad based, reflecting tighter controls on fuel imports, the strengthening of tax administration, and the amendments to the income tax law, including the collection of

the business receipts tax on imports. Seen against the background of a slowdown in revenue collection during August-September 2009, due to political uncertainties in connection with the presidential elections, the overall revenue performance is just remarkable. On the expenditure front, the authorities have maintained tight controls on nonsecurity spending, thereby keeping the operating deficit below the program target.

Monetary policy has remained focused on reducing inflation, and has succeeded in keeping the lid on the growth of currency in circulation in line with the program target. This has helped reduce nonfood inflation to 0.9 percent in December 2009 from 12 percent in the previous year. The more dramatic fall in headline inflation to minus 13 percent mostly reflects the drop in food and fuel prices. International reserves have remained adequate and the real effective exchange rate was closed to its five-year average.

The updated policy framework for the remainder of 2009/10

The program for the remainder of fiscal year 2009/10 has been updated to take into account the positive developments in revenue mobilization, the more favorable growth and inflation outlook, as well as the sizable increase in security spending. Implementation of structural reforms will continue in line with the structural benchmarks under the Seventh review of the program.

Fiscal policy

Building on the progress achieved so far, the authorities remain committed to further strengthening revenue mobilization and achieving fiscal sustainability. To this effect, they have raised their revenue target for 2009/10 to the equivalent of about 8 percent of GDP, up from an average of 7.1 percent in the past three years. Efforts in the period ahead will focus on developing a strategy to improve the efficiency of the Revenue and Customs Departments, strengthen its organization and human resources, and increase responsibility and accountability of its provincial offices.

Notwithstanding the authorities' efforts to contain the growth of current outlays on goods and services, operating expenditures are on the rise, mainly to meet increasing security needs. While donor financing continues to cover most of the additional security spending, the part covered from the domestic budget will also increase. The authorities are committed to cutting non security operating spending, if warranted by revenue shortfalls, and will continue to work toward the objective of increasing the coverage of operating expenditure from domestic revenue. As indicated in Box 1 of the staff report, the time frame to achieve fiscal sustainability, as defined in the program, will necessarily depend on developments in security related spending, which are paramount to other broader objectives of economic development and poverty reduction.

Further efforts will be made in strengthening public finance management, including improving the rate of execution of development expenditure in close collaboration with donors, and simplifying and unifying budget preparation.

Monetary and financial sector policies

Building on the improved inflation outlook, monetary policy can afford some easing to accommodate growth in the remainder of the fiscal year and possibly beyond. As such, the growth of currency in circulation has been revised upward for 2009/10 as a whole, but will remain consistent with the need to keep inflation at, or below, 6 percent. The authorities will stand ready to tighten monetary policy if nonfood inflation exceeds 5 percent. The floating exchange rate regime will be maintained with central bank intervention geared toward smoothing excessive exchange rate volatility.

The central bank will step up its supervision and monitoring of commercial banks, including examination of information technology risks, disaster recovery plans, and fraud detection capacity. It will also strengthen actions to enforce collection of bad loans. Further preparatory work on accepting the obligations under Article VIII of the Fund's articles of agreement as well as on AML/CFT will be carried out in close collaboration with Fund staff.

Structural reforms

Structural reforms are a critical component of Afghanistan's development strategy, and the authorities are committed to advancing their agenda in several areas. Wide ranging reforms are envisaged in collaboration with the World Bank, and others are governed by the Seventh Review of the program as highlighted in Table 2 of Attachment II. Despite some delays, work is proceeding on the restructuring of the electricity sector, the financial review and monitoring of public enterprises, and the implementation of the Automatic System of Customs data (ASYCUDA). The authorities are determined to meet all structural benchmarks under the program.

HIPC Completion Point

As shown in Box 3, almost all the HIPC completion trigger points have been implemented and good progress is being made toward meeting the remaining ones. The authorities look forward to having the completion point Board meetings of the World Bank and IMF in late January, before the London Conference on Afghanistan, which will pave the way for a significant reduction of Afghanistan's foreign debt. They also look forward to working closely with staff toward completing the seventh review and start discussions on a possible successor arrangement.