International Monetary Fund

Islamic Republic of Afghanistan and the IMF

Country's Policy Intentions Documents

Islamic Republic of Afghanistan: Letter of Intent, Memorandum of Economic and Financial Policies, and Technical Memorandum of Understanding

February 3, 2005

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

Kabul, February 3, 2005

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, DC 20431
U.S.A.

Dear Mr. de Rato,

The Government of Afghanistan held discussions with Fund staff in the context of the third review of the staff-monitored program (SMP), that was put in place in March 2004. We remain pleased with the progress under the program, and with the framework it provides for enacting key reforms. The attached Memorandum of Economic and Financial Policies (MEFP) reviews macroeconomic developments and the implementation of structural reform measures during the first three quarters of 2004/05, and describes the objectives and policies the government intends to pursue for the remainder of the year and the first half of 2005/06. Given the benefits the SMP has brought in terms of macroeconomic policy formulation and the design and implementation of key structural reforms, we have also reached understandings with IMF staff on an extension of the current SMP for six months—through end-September 2005. The indicative targets and structural benchmarks set out for this period are also described in the MEFP.

We are pleased to inform you that we have met all the end-December 2004 quantitative indicators and structural benchmarks, with the exception of the benchmark on publishing the central bank and banking laws in the official gazette. The central bank law has already been published, but some technical delays have slowed gazetting of the commercial banking law—although we expect this law to be published in the immediate future. A number of benchmarks that had been established for end-March 2005 have been moved to end-June 2005 or end-September 2005, in an effort to avoid bunching and to accommodate capacity constraints partly associated with newly appointed cabinet and senior officials familiarizing themselves with their respective portfolios. We feel it is important to emphasize that this does not represent a lack of political will on behalf of the government to enact difficult reforms. Indeed, we have found the benchmarks to be very useful guideposts in the midst of a massive reform effort. Rather, it is a recognition of real capacity constraints in selected line ministries—a risk highlighted by IMF staff when the SMP was first put in place in March 2004.

The government believes that the policies and measures set forth in the attached MEFP are adequate to achieve the objectives of the program. However, we also stand ready to take any additional steps as may be needed or appropriate to meet both the letter and the spirit of the reforms outlined in the program. The Government of Afghanistan will continue to work closely with IMF staff in this regard, and will provide any information required to assess the implementation of the SMP, as updated. The Government of Afghanistan authorizes the publication and distribution of this letter, the attached MEFP and the technical memorandum of understanding, and all reports prepared by IMF staff regarding the SMP.

Sincerely,

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

/s/
Noorullah Delawari
Governor
Da Afghanistan Bank

Attachments:
Update to the Memorandum of Economic and Financial Policies
Amendment to the Technical Memorandum of Understanding

Update to the Memorandum of Economic and Financial Policies of the Government of Afghanistan

Third Review Under the Staff-Monitored Program, 2004/05

I. Introduction

1. Following the successful presidential elections of October 2004, President Karzai formed a new Cabinet in December. The new team, which comprises a number of senior officials from the interim government, has a strong reform orientation, and remains fully committed to the macroeconomic objectives and agenda of structural measures outlined in the staff-monitored program (SMP), put in place in March 2004. In this context, the government's policies for the last quarter of 2004/05 will remain guided by the targets and objectives described in the Memorandum of Economic and Financial Policies (MEFP) of March 24, 2004, and as modified on September 6, 2004, and December 29, 2004. In addition, and in light of the useful framework the SMP has provided for the formulation of macroeconomic and structural policies, the government has reached understandings with IMF staff on an extension of the current program for an additional six months—through end-September 2005.

2. This update to the MEFP reviews performance during the third quarter of 2004/05, updates the government's macroeconomic objectives for the medium term, and describes the policies and targets for the remainder of 2004/05 and the first half of 2005/06. To avoid bunching and to accommodate capacity constraints, a number of structural benchmarks initially set for end-March 2005 under the MEFP have been moved to end-June 2005 and end-September 2005. We feel it is important to emphasize that this does not represent a lack of political will on behalf of the government to enact difficult reforms. Indeed, we have found the benchmarks to be very useful guideposts in the midst of a massive reform effort. Table 2 includes the structural benchmarks that are critical to deliver the macroeconomic performance consistent with this update to the MEFP and to strengthen the government's administrative capacity. In addition, several reforms, to which we remain committed, are not included in Table 2, but are described in this document.

II. Developments Under the SMP

3. Agricultural output is expected to fall by 17 percent in 2004/05, due to adverse weather conditions. This decrease would be largely offset by buoyant activity in transportation and other services. **Overall, real GDP growth would amount to about 8 percent in 2004/05. Consumer prices in Kabul increased by 4.0 percent during the third quarter of 2004/05, reflecting a seasonal increase in food prices, and rose by**

12.6 percent through the first nine months.[1] Excluding food items, whose prices increased by 6.9 percent, the consumer price index is estimated to have risen by only 0.9 percent, due in part to a decline in rents and petroleum prices, which had increased sharply over the first half of 2004/05. Overall, year-on-year inflation amounted to 11.9 percent at end-December (6.6 percent excluding rents and petroleum products), compared to 14.1 percent at end-September.

4. Domestic revenue for the first nine months of 2004/05 is estimated at Af 8.9 billion, exceeding the SMP indicative target of Af 8.6 billion. Following a subdued start to the quarter, receipts rebounded sharply during the last month, largely due to an increase in customs revenue.

5. **The rate of government spending, particularly for development programs, continued to lag behind budget expectations.** Operating budget expenditures amounted to Af 18.2 billion during the first nine months of 2004/05, compared with the annual budgeted amount of Af 30.3 billion. This underspending is due mainly to the slower-than-expected pace of public administration reform—particularly delays in the recruitment of additional teachers, and in the main civil service restructuring program.[2] Over the same period, core budget development spending was Af 8.4 billion while direct donor spending was reported at $1.5 billion, compared to the budget estimates of Af 38.4 billion and $3.5 billion, respectively, for the year as a whole. The slow rate of development spending was due to: (i) the lack of capacity in line ministries and implementing agencies to develop and implement projects; (ii) delays in mobilizing donor funding; and (iii) concerns over the level of insecurity. Nonetheless, the total level of development spending is significantly higher than that seen in the same period in 2003/04. We also recognize that development spending varied substantially across national programs, with infrastructure relatively low, especially compared with the rate of delivery in the security sector.

6. **We continue to observe the no-overdraft policy with respect to government financing.** The rate of reimbursement from the two multi-donor grant funds—the Afghanistan Reconstruction Trust Fund (ARTF) and the Law and Order Trust Fund for Afghanistan (LOTFA)—rose significantly during the third quarter, mainly due to improvements in compliance with new financial management procedures. As a consequence, we were able to rebuild government deposits in the central bank, and fully replenish funds that had been drawn from an Asian Development Bank concessional loan to fund the operating budget. This is consistent with our commitment to utilize solely concessional loans to fund development programs and projects, and only where they demonstrate the clear

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[1] The consumer price index that includes five other major cities increased by 3.4 percent during the third quarter of 2004/05 and 8.4 percent over the first nine months of 2004/05.

[2] Total government employment was around 375,000, including 134,000 for the police and defense force, compared to a budget estimate of 406,000.

ability to deliver economic growth, increase domestic revenues, accelerate international co-operation, and promote trade and inward investment.

7. **Currency in circulation amounted to Af 37.1 billion at the end of the third quarter of 2004/05, slightly below the SMP indicative ceiling (Af 38.1 billion)**. The stronger-than-expected slowdown in monetary growth in the third quarter reflected the financing of the Hajj[3] and a slowdown in donor-related spending in the period leading up to the formation of the new government. Reflecting the persistent high level of liquidity of some banks, the interest rates on the overnight capital notes remained low (at 1–2 percent). Due in part to a further accumulation of government deposits, foreign exchange reserves continued to increase steadily during the third quarter, to $1.2 billion at end-December (equivalent to 5.3 months of 2005/06 imports). The nominal exchange rate depreciated slightly during the last two months of 2004, to about Af 48 per dollar at end-December—roughly the same level as at the beginning of the year.

8. **Further progress was made in modernizing Da Afghanistan Bank (DAB) and creating a sound financial system.** External auditors initiated an audit of DAB's 2003/04 financial statements and will present their findings to DAB's supreme council in early February. Significant progress was made toward finalizing the transfer of DAB's commercial accounts to other entities. The central bank law was published and progress was made toward the publication of the banking law. Some progress was also made in restructuring the relicensed state-owned banks. Finally, new reporting requirements for banking data have been implemented.

9. **Data for the external accounts are limited, but DAB remains committed to improving statistical capacity in this area and will actively seek donor assistance in this regard**. Based on preliminary data, the external current account (before grants) during the first three quarters narrowed to a deficit equivalent to 32 percent of GDP, down from a deficit of about 39 percent during the same period in 2003/04. This decline in the deficit appears to have stemmed from an improvement in the trade balance, including a continued increase in domestic exports. Donor inflows, predominantly in the form of grants, continued to finance the deficit, along with some private inflows in the form of foreign direct investment. Disbursements of external loans were limited, and on highly concessional terms. The positive errors and omissions entry in the balance of payments suggests the continued presence of unrecorded inflows (perhaps from opium exports, unrecorded foreign investments, or remittances).

[3] The pilgrims were required to deposit with DAB, by end-December, an amount equivalent to the cost of the pilgrimage, which are then administered by the Ministry of Hajj. The deposits, which had to be denominated in Afghani, totaled Af 2.5 billion.

10. **All quantitative indicators and structural benchmarks for end-December 2004 were met,** with the exception of the benchmark related to the publication in the official gazette of the central bank and banking laws, due to some technical delays in publishing the banking law. We expect to resolve these difficulties and publish the banking law shortly.

III. The Program for the Remainder of 2004/05 and for 2005/06

A. Macroeconomic Objectives

11. **Recent economic developments are consistent with a projected real GDP growth rate of 8 percent for 2004/05—in line with estimates agreed with IMF staff at the time of the second review**. We expect inflation to pick up slightly during the fourth quarter, reflecting higher food prices. Inflation is expected to reach about 13 percent year-on-year at end-2004/05.

12. **Going forward, real GDP is projected to grow by 10 percent in 2005/06 and over the medium term.** If achieved, this sustained increase in economic activity should create a dent in poverty. We expect growth to come primarily from non-traditional sectors, including services and industry. Agriculture is projected to maintain an average growth rate of 4.5 percent. Reflecting a tightening in monetary policy and an expected slowdown in rents, inflation is projected to decline to 10 percent in 2005/06 before tapering off to 5 percent in the ensuing years.

13. **While the medium-term outlook appears favorable, we are fully aware of the many serious challenges facing Afghanistan, including the rising share of drug-related activities in the economy and the heavy reliance on external support**. These challenges highlight the need to focus our efforts to encourage sustained and equitable economic growth. To achieve the levels of growth necessary to reduce poverty and diminish the need for external resources, investment will need to average about 24 percent of GDP over the medium term, reflecting continued donor support, and increased foreign direct and private domestic investment. As a result, private savings are projected to rise to 0.5 percent of GDP in 2007/08, up from dissavings of 10.6 percent of GDP in 2004/05. Conversely, private consumption is expected to decline from 106 percent of GDP to 94.1 percent over the same period.

14. **In responding to the challenge of the illegal opium economy, we intend to implement our multi-pronged strategy, supported by the donor community**. We expect this strategy will be particularly efficient this year, as it will be implemented at a time when many poppy farmers, faced with the current low farm gate prices and the increased risk associated with government intervention, plan to turn voluntarily to other crops. To ensure the sustainability of our efforts, this will be supported by an interdiction campaign. To limit the potentially adverse economic impact of this campaign on the most vulnerable segments of the population, we will devote our full attention to providing alternative livelihoods.

B. Fiscal Policy

15. **The shortfall in domestic revenues relative to the operating budget, is expected to be offset by a combination of lower operating expenditures and additional donor funding.** Domestic revenues are expected to total around Af 13.1 billion for 2004/05, exceeding the SMP target of Af 12.8 billion, but below the budget target of Af 15.4 billion. The shortfall in revenue is mainly the result of slower-than-anticipated implementation of the tax reform program, particularly regarding the passage of new legislation and the organizational restructuring. Consistent with the trend observed in previous years, and with the reallocation of resources to faster-spending ministries recommended during the mid-year review (MYR), recurrent expenditures are expected to rise during the last quarter of the year. Overall, the MYR adjustments will reduce the operating budget allocations by at least Af 1.9 billion. Improving compliance with the financial management procedures should continue to raise reimbursement rates from the two multi-donor trust funds, so that recurrent expenditures can be wholly funded by grants and domestic revenues.

16. **The MYR adjustments should increase the rate of development spending**.[4] The MYR introduced new projects, totaling Af 3.9 billion ($78.4 million), into the core development budget, which is wholly donor-funded.[5] These changes will affect: (i) projects that received government discretionary funds by Presidential Decree after completion of the 2004/05 budget, amounting to Af 1.3 billion ($25.8 million); (ii) a number of new projects not included in the 2004/05 budget, totaling Af 2.6 billion ($52.6 million); and (iii) the reallocation of discretionary funds within the existing budget toward faster-spending projects, reflecting our desire to increase the rate of spending on physical infrastructure. No changes were made to the external development budget, which is directly implemented by donor agencies. The MYR was approved by Presidential Decree.

17. **An acceleration of customs and tax reforms is required to boost domestic revenues**. To reinvigorate the reform effort, we will prioritize the following reforms: publication of the amendments to the revenue laws, including the new Customs code (both are structural benchmarks); introduction of the updated import valuation schedule for customs and the continued strengthening of border facilities; full implementation of the measures in last July's tax reform package—including the services tax in Kabul (where compliance has been poor)—and the airport departure tax. We will also accelerate the implementation of the Priority Reform and Restructuring (PRR) of the revenue headquarters

[4] The review covered the operating and development components of the core budget as well as a review of implementation of direct donor-funded programs within the National Development Budget. It was delayed due to the presidential elections; the proposed adjustments will impact on operations during the last quarter of the year.

[5] The funding will be provided from ARTF for an amount of Af 1 billion ($20 million), from the ADB Post-Conflict Program Loan for an amount of Af 2.8 billion ($56.4 million), and from the WB Programmatic Support for Institutional Building (PSIB) for an amount of Af 99.7 million ($2 million). The amount represents committed funds that will most likely be spent over a number of years and not in the remainder of 2004/05.

and the Kabul provincial revenue office. In addition, we will give high priority to measures aimed at improving tax administration law and corporate law, which will give the MoF enforcement and collection powers, and hope to have these published in the official gazette by end-September.

18. **Looking forward, we anticipate a slight delay in adopting the Development budget for 2005/06 and some slippage in the structural reforms, attributable to the change in government.** We intend to approve the operating budget before the start of the fiscal year (March 21) but the Core budget (which includes development spending that passes through the Treasury) will be presented shortly after. The slight delay to early April in organizing the donors forum, which is required to confirm the sources of development funding, is partially the result of the change in cabinet. We remain committed to a timely budget process and will ensure that arrangements are in place to avoid a repeat of the payment delays that occurred at the start of previous years. [6] The new budget law, which will improve the legal framework for fiscal policy, has been drafted and should be submitted to cabinet shortly. However, its publication in the Official Gazette is likely to take place in June 2005, essentially on account of the backlog of legislation with the Ministry of Justice.

19. **For FY 2005/06, we intend to maintain the no-overdraft financing rule and therefore to fund the operating budget only from domestic revenue and external grant resources**. Consistent with this approach, we are committed to enhance revenue reforms, strengthen expenditure management and to ensure that demands for expanding the public sector are sustainable. Salary costs (representing about 75 percent of operating expenditures) are expected to increase significantly over the medium term due to the ongoing public administration reforms. We are cognizant of the need to contain the growth in the wage bill—to that stemming from the ongoing reform initiatives supported by donors—in order to achieve a sustainable fiscal position. Formal arrangements aimed at containing the wage bill will be discussed with the IMF during the next review of the SMP. We will also continue to limit borrowing to highly concessional external loans to fund development expenditures.

20. **We will continue to consolidate government operations and improve fiduciary standards.** During 2004/05, the introduction of the treasury single account, the initiation of cash planning, and the piloting of new payment and payroll systems have improved control over revenue collection and expenditures. For 2005/06, a single chart of accounts has been agreed to help unify the operating and development components of the core budget.[7] The above measures will continue to be strengthened and particular attention will be given to the

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[6] The past two years have witnessed severe payment delays at the start of the year, particularly for salaries, due to the lack of coordination between the budget allotment process and the official establishment register (*Tashkeel*).

[7] The Afghan National Army (ANA) is currently being funded by external grants outside of the core budget. The incorporation of the ANA into the core budget has been proposed and would further strengthen the consolidation of the fiscal operations within the budget.

provinces. In addition, we will continue our efforts to enhance the quality of budget reporting and internal and external audit functions.

C. Monetary and Exchange Rate Policies

21. **DAB will maintain the current stance on monetary policy, aimed at maintaining low inflation while also guarding against currency instability**. For the rest of 2004/05, in view of the slowdown in consumer prices over the last few months and the monetary tightening already implied in the program for the remainder of the year, monetary policy will continue to be guided by the target for currency in circulation agreed with IMF staff at the time of the second review. In 2005/06, we expect the pace of monetization of the economy to slow somewhat, reflecting the now relatively high level of monetization and an expected increase in bank intermediation as the financial sector develops. Accordingly, and in view of the objective to reduce inflation from 13 percent in 2004/05 to 10 percent in 2005/06, the indicative targets for currency in circulation for the first half of 2005/06 are consistent with a 5 percent increase in monetization in 2005/06, compared with a projected 13 percent increase in 2004/05. The program will remain flexible, allowing us to accommodate, up to an additional 5 percent, perceived shifts in demand for Afghani, as well as to modify the target in consultation with Fund staff when warranted by exchange rate and price developments. We also stand ready to tighten the monetary stance, should inflation pressures emerge.

22. **We will actively pursue further reforms to modernize the central bank.** By end-March 2005, we will implement several measures aimed at allowing DAB to focus on its core activities, including: (i) the transfer of DAB's commercial accounts to other entities; (ii) the transfer of its commercial holdings and potential liabilities to the MoF; and (iii) the transfer to DAB of the ownership of the monetary gold and silver held in the palace vaults. These measures, together with the results of the DAB's external audit (the financial statements of which will be published by end-June 2005) will allow us to assess whether DAB is adequately capitalized. Should DAB prove undercapitalized, we will take a decision by end-June 2005 regarding its recapitalization. Finally, we will introduce an automated foreign auction system, allowing access to the commercial banks in a more market-based way.

23. **We will make further progress toward reforming the banking sector.** By end-March 2005, we will publish the banking law in the official gazette. We will further strengthen our supervision framework through the enforcement of the various regulations recently adopted by DAB. As the shareholders, we will continue to modernize the relicensed state-owned banks, partly through technical assistance. By end-June 2005, we will take a decision on, and start the implementation of, the specific resolution process for each of the three former state-owned banks that were not relicensed.

D. External Policy and Debt Management

24. **The government remains committed to an open trade and exchange system**. The introduction of a new tariff system and the use of market exchange rates for import valuation were significant steps forward in this regard. Afghanistan is now one of the most open economies in the region, with a simple average applied tariff of only 4 percent, and very few nontariff barriers. To enhance the prospects for regional trade, the government will also continue to pursue or improve upon trade and transit agreements with neighboring countries. Consideration is also being given to membership in the World Trade Organization.

25. **The outlook regarding the external accounts appears largely positive**. Caution is warranted, however, given the lack of clear and reliable data, and uncertainties regarding the level of donor support, the impact of the opium eradication campaign, and the potential level of foreign direct investment and other inflows. On current trends, the external current account (including grants) is projected at a surplus of 1.8 percent of GDP for 2004/05—roughly the same level observed in 2003/04. Foreign exchange reserves would amount to about $1.2 billion at end-2004/05, equivalent to over 5 months of prospective goods and services imports—a cushion sufficient to deal with most exogenous shocks. In 2005/06, we expect some improvement in the merchandise trade account (in terms of GDP) as the initial surge in imports associated with the post-war period begins to level off, and as our relatively small domestic export base continues to expand. Under relatively conservative assumptions regarding donor and private investment inflows, we expect the external current account balance to deteriorate to a deficit of about 2–3 percent for the next two years, before gradually improving over the medium term. However, we should still be able to maintain or even add to our substantial cushion of foreign exchange reserves—which we view as prudent given Afghanistan's vulnerability to external shocks. Key to this outlook, however, will be to ensure higher levels of domestic and foreign investment to enable an expansion of our export base and to take advantage of transit trade.

26. **We remain committed to prudent management of external debt**. Regarding the stock of debt, we have made further progress in identifying debts undertaken by previous governments, and reconciling their amounts with external creditors. It is our intention to complete a survey of these debts and a reconciliation with bilateral creditors by the end of March 2005. Simultaneously, and to ensure Afghanistan's medium- and long-term external and fiscal sustainability, we will also continue to seek generous debt relief from bilateral creditors. During the first three quarters of 2004/05, and consistent with the SMP, we have contracted external loans only on highly concessional terms. Disbursements have also been limited. To ensure that this prudent strategy remains a central pillar of Afghanistan's reconstruction and stabilization, we will seek to design and implement a comprehensive external debt management strategy by end-September 2005. In the interim, we will continue to be guided by the indicative target on the minimum level of concessionality required for new external loans established under the original SMP in March 2004.

E. Structural Reforms

27. **We remain convinced that the development of a vibrant private sector is key to attaining our medium-term objectives, particularly in light of the inherent institutional, technical, and financial limits on government action**. Consistent with this view, we will continue our efforts to eliminate constraints weighing on private sector activity, including (i) reform of the legal and judicial framework for business, with assistance from various donors; (ii) tax reforms to modernize and simplify procedures for enterprises; (iii) financial sector modernization; and (iv) gazetting of the investment law by end-September 2005. At the same time, we will work towards improving the competitiveness of the Afghan economy through reforms and accelerating some vital projects in some key sectors, including energy, transportation, and telecommunications—and will look for continued support from donors in this regard. We also are working actively to restructure state-owned enterprises, and expect to adopt a classification plan for these firms (by restructuring method) by end-September 2005.

F. Poverty Reduction Strategy

28. **We are determined to place poverty reduction at the center of our development platform**.[8] To that end, we have decided to develop a poverty reduction strategy for Afghanistan—called the National Development Strategy. An interim poverty reduction strategy paper (I-PRSP) is expected to be completed by end-October 2005, based on a preliminary consultative process in Kabul and at the provincial level. To coordinate and conduct work on the I-PRSP, we envisage putting in place an Inter-Ministerial Committee (IMC), formed of ministers and deputies from a cross-section of government, including the Ministry of Finance, the Ministry of Economy, the Ministry of Foreign Affairs, and social line ministries. Under the direction of the IMC, there will be a working group of predominantly Afghan experts who will conduct the technical work. To facilitate exchanges with partners outside the government and civil society, an External Advisory Group (EAG), formed of representatives from United Nations agencies, international financial institutions, key donors, and NGOs will be established. The EAG will provide advice on the preparation and feedback to the working group and IMC on draft documents.

G. Statistical Issues

29. **We will continue our efforts to improve the statistical database**. Consistent with the recent reorganization of the government, and with a view to help the Cabinet in its decision-making process, the Central Statistical Office (CSO) will now report to the newly created Ministry of Economy. In addition, we are working, in coordination with some key

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[8] This platform is reflected in successive National Development Budgets (2002/03; 2003/04; 2004/05), based on the National Development Framework; Securing Afghanistan's Future, which outlined the development needs of the country for the period 2004-2015; the Berlin working plan; the 12 National Priority Programs; the 16 Public Investment Programs; and strategic initiatives by key donors and multilateral institutions.

donors, on a program to help implement the statistical master plan.[9] This work program is expected to be completed by end-March 2005. At the same time, we are also seeking external support to fund the work program. We had hoped to improve our monetary and balance of payments reporting, but security concerns delayed provision of the required technical assistance.

H. Technical Assistance

30. **An evaluation of technical assistance (TA), initiated by the previous Cabinet, is now underway.** This evaluation aims at ensuring that the work remaining in various government agencies is adequately covered, and implemented in a coordinated and cost-efficient manner. We expect to complete this assessment exercise and adopt a TA plan by end-December 2005.

I. Program Monitoring

31. **The program will continue to be monitored** using the definitions, data sources, and frequency of monitoring set out in the attached Technical Memorandum of Understanding (TMU). The quantitative indicators for end-March, 2005, end-June 2005, and end-September 2005 are included in Table 1. The structural benchmarks are detailed in Table 2. The government will continue to make available to Fund staff all core data, appropriately reconciled and on a timely basis, as specified in the TMU.

32. **The Technical Committee of Coordination (TCC) has been instrumental in implementing the SMP and in providing core data to the Fund**. It will continue to do so in the months ahead, while simultaneously deepening its analytical function, and reaching out to other government agencies. It will also coordinate closely with the working group involved with the I-PRSP.

33. **The fourth review of the program is scheduled to take place in early May 2005**, based on indicative targets and benchmarks for end-March. At the time of that review, the quantitative indicators and structural benchmarks for end-June and end-September 2005 may be revised in light of developments.

J. Relations with the Fund

34. **The government of Afghanistan values highly the ongoing policy dialogue and support from the IMF under the SMP**. The close consultations with IMF staff on key macroeconomic policy choices and structural reforms have proven instrumental in building capacity and maintaining macroeconomic stability. Given the magnitude of the unfinished agenda, and the daunting economic challenges still facing Afghanistan, the government is eager to continue the close working relationship developed with the IMF. Given the strong

[9] Funding of the statistical master plan is projected at $6.5 million.

financial support provided by donors and the consequent absence of an immediate balance of payments need, a six-month extension of the current SMP (to end-September 2005) is the most logical policy choice. Extension of the current framework would allow for more time to build the administrative and statistical capacity required under a formal IMF arrangement. Further, given the need to ensure broad ownership of the reform strategy until after the legislative elections, an extension of the current framework to end-September would allow time for due consideration of a follow-on program.

Table 1. Islamic Republic of Afghanistan: Quantitative Indicators, 2004/05–2005/06

(In millions of Afghanis, unless otherwise indicated; cumulative changes from beginning of fiscal year)

	2004/05					2005/06	
	Sep. 21 Initial Indicative Target	Sep. 21 Preliminary Estimate	Dec. 20 Indicative Target	Dec. 20 Preliminary Estimate	Mar. 20 Indicative Target	Jun. 20 Indicative Target	Sep. 20 Indicative Target
Currency in circulation (ceiling) 1/	3,774	6,253	9,265	8,315	10,954	2,453	5,057
Claims of the banking system on the central government (ceiling)	0	0	0	0	0	0	0
Gross international reserves of the central bank (floor) (in millions of U.S. dollars)	29.1	277.7	115.0	469.5	115.0	0	0
Fiscal revenue of the central government (floor)	5,506	5,886	8,649	8,880	12,784	3,526	7,182
External debt							
a) New medium- and long-term nonconcessional external debt (with original maturities of one year or more) contracted or guaranteed by the government (ceiling) 2/ 3/	0	0	0	0	0	0	0
b) New nonconcessional debt with an original maturity of less than one year (ceiling) 3/ 4/ 5/	0	0	0	0	0	0	0
Memorandum item:							
Currency in circulation (level triggering consultation)	4,475	...	10,702	...	12,392	3,508	7,298

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

1/ At end-2003/04, currency in circulation amounted to Afs 28.8 billion.
2/ Excluding rescheduling arrangements, but including debt with maturities of more than one year.
3/ This benchmark will be evaluated on a continuous basis.
4/ Concessional debt is defined as debt with a grant element of at least 60 percent calculated on the basis of currency-specific discount rates, based on the OECD commercial interest reference rates (CIRRs).
5/ On a contracting or guaranteed basis. Excluding debt related to normal import transactions.

Table 2. Islamic Republic of Afghanistan: Structural Benchmarks, December 2004–September 2005

Policy Actions	Target Date	Status
Adopt new chart of accounts compatible with IMF GFS 2001 (cash basis) requirements for classifying revenue and expenditure transactions.	End-December 2004	Implemented
Prepare (by MoF) monthly cash flow projections to improve cash management and for coordination with DAB.	End-December 2004	Implemented
Publish in the official gazette the central bank and commercial banks laws.	End-December 2004	Not implemented [1/]
Introduce the auction process for a short-term DAB capital note.	End-December 2004	Implemented
Initiate an external audit of the DAB based on internationally recognized accounting standards.	End-December 2004	Implemented
Publish in the Official Gazette the amendments to the revenue laws: (i) enacting the income tax reform package; and (ii) ensuring that the revenue laws supersede all other legislation in revenue-related matters.	End-March 2005	
Consolidate all recent revenue measures into the existing revenue code and publish as a single document.	End-March 2005	
Complete the survey of external debt, including reconciliation with creditors.	End-March 2005	
Transfer of DAB's commercial holdings to the MoF, and transfer of ownership of marketable gold and silver in the palace vaults to the DAB.	End-March 2005	
Improve government payments by initiating (i) a system of non-cash payments to vendors; and (ii) a pilot for direct salary payments for the employees of two ministries. [2/]	End-March 2005	
Approve (by the Cabinet) the Customs Code.	End-March 2005	
Ensure that budget allotments and authorized staff positions are established for all budget users (center and provinces) to allow timely salary payments every month.	End-March 2005	
Publish an official estimate of the annual revenue forgone as a result of tax holidays, exemptions or concessions and a time-bound plan, approved by the MoF, to address all existing tax exemptions or concessions.	End-March 2005	
Publish in the Official Gazette the banking law.	End-March 2005	

Table 2. Islamic Republic of Afghanistan: Structural Benchmarks, December 2004–September 2005 (concluded)

Policy Actions	Target Date	Status
Adopt (by the cabinet) and publish in the official gazette the financial management law.	End-June 2005	
Publish the financial statements of the 2003/04 external audit of DAB.	End-June 2005	
Reconcile the government accounting records with the government's bank accounts. 3/	End-September 2005	
Submit to Parliament the 2004/05 financial accounts (core budget) with audit opinion.	End-September 2005	
Adopt (by Cabinet) a comprehensive external debt management strategy.	End-September 2005	

1/ Only the central bank law was published in the Official Gazette.
2/ The method of direct salary payment may be specified as either direct transfers from the MoF into the bank accounts of employees or a "pay-from-the-list" system.
3/ See relevant bullet point inserted in paragraph 14 of the TMU.

Amendment to the Technical Memorandum of Understanding

1. The following bullet points will be inserted at the end of paragraph 14:

- **Reconcile government fiscal and banking records.** The reconciliation will cover all core budget operations (recorded with AFMIS) and associated banking data from the beginning of 2005/06. It will be undertaken at least monthly. A reconciliation that leaves unexplained differences up to 5 percent of total core expenditures between the banking and accounting records will not meet the benchmark.