International Monetary Fund

Islamic Republic of Afghanistan and the IMF

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

September 26, 2005

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Kabul, September 26, 2005

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

Dear Mr. de Rato,

1. For two weeks starting August 1, 2005, we have carried out discussions with IMF staff on the fifth review under the staff-monitored program (SMP) agreed to in March 2004 and updated on September 6, 2004, December 29, 2004, February 3, 2005, and May 18, 2005, respectively.

2. We would like to report that our program remains on track. We have met all end-June 2005 quantitative targets and structural benchmarks and most of our other commitments under the SMP, as described in the May 18 Memorandum of Economic and Financial Policies (MEFP). Looking forward, we have reached understandings on the policies for 2005/06 and the first half of 2006/07 and on the priorities for the medium term. Our strategy remains focused on creating adequate conditions for sustainable economic growth and reducing poverty in the context of fiscal and external sustainability. The attached update to the MEFP reviews macroeconomic developments and implementation of structural reform measures during the first quarter of 2005/06, and our policy intentions and targets for the remainder of 2005/06.

3. The six-month extension of the SMP agreed on at the time of the third review is to end in September 2005. The SMP has contributed to the good performance of the Afghan economy over the period and the program's main objectives have been successfully achieved. While we are working on our interim national development strategy, we would like to continue with a SMP, which will provide us with a framework for maintaining the current macroeconomic policy stance and ongoing structural reforms. We therefore request an additional 12-month extension of the SMP through September 2006. Accordingly, we have reached understandings with IMF staff on a set of new quantitative targets and structural benchmarks for end-September 2005, end-December 2005, end-March 2006, end-June 2006, and end-September 2006.

4. We believe that the policies and measures set forth in the attached update to the MEFP are adequate to achieve the objectives of the program, but we will take any further measures that may become appropriate for this purpose. The Government of Afghanistan will consult with the IMF prior to adoption of any such measures and of revisions to the policies contained in the MEFP, in accordance with the IMF' s policies on such consultations. We will also provide any information required to assess the implementation of the SMP.

5. In continuing with our policy of transparency, we consent to the publication of this letter, the attached MEFP, the technical memorandum of understanding, and the accompanying Executive Board documents on the IMF's website.

Sincerely yours,

/s/	/s/
Anwar Ul-Haq Ahady	Noorullah Delawari
Minister of Finance	Governor
Ministry of Finance	Da Afghanistan Bank

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

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

Fifth Review Under the Staff-Monitored Program and Request for Extension, 2004/05–2006/07

August 16, 2005

I. INTRODUCTION

1. This update to the Memorandum of Economic and Financial Policies (MEFP) reviews performance during the fifth quarter (April–June 2005) of the Staff-Monitored Program (SMP) and describes policies and targets for the remainder of 2005/06 and the first half of 2006/07. The program will continue to be guided by the macroeconomic and structural reform policies described in the MEFP of March 2004, and in the updates of September 6, 2004, December 29, 2004, February 3, 2005, and May 18, 2005. The sixth review under the SMP is scheduled for early November 2005 and will coincide with the 2005 Article IV discussions. This review, which will take place after the September 18 general elections, will assess performance during the second quarter of 2005/06 (July–September 2005). Key issues will include the findings of the midyear budgetary review (MYR), scheduled for September/October, fiscal and external sustainability, tax and customs reforms, and progress made in bank restructuring.

2. **The SMP has contributed significantly to establishing and then maintaining macroeconomic stability**. It has provided a supportive framework for financial and monetary discipline and helped to improve coordination with the donor community. As we are still preparing our National Development Strategy (NDS), which will form the basis for an interim poverty reduction strategy paper (I-PRSP), we would like to maintain our cooperation with the IMF under the SMP, so as to continue to benefit from IMF staff advice on elaborating the framework for implementing and coordinating macroeconomic policies and structural reforms, and continue to build the capacity to implement a formal arrangement. Accordingly, we request a 12-month extension of the SMP, through end-September 2006. This extension does not preclude moving into a more comprehensive program, such as the PRGF, at some point before the SMP expires, notably once the I-PRSP is finalized.

3. **We have observed all end-June 2005 quantitative targets and structural benchmarks**. Over the next 12 months, we will continue to focus on ensuring macroeconomic stability, strengthening capacity and improving the statistical base.

II. Developments Under the SMP

4. **Macroeconomic developments during the first quarter of 2005/06 were broadly in line with program projections**. Real GDP growth for 2004/05 was revised slightly upward, from 7.5 to 8.0 percent, reflecting a more buoyant performance in the manufacturing sector than initially estimated. Economic activity during the first quarter seems to have been consistent with program projections and was led by a rebound in agriculture, as a result of winter and spring precipitation, and by continued strong growth in the manufacturing and service sectors.

5. **Year-on-year inflation declined in Kabul during the first quarter of 2005/06, to 11.5 percent at end-June from 16.3 percent at end-2004/05**.[1] This decline reflected essentially a sharp slowdown in rents, which increased by 8.1 percent during the first quarter compared with 41.2 percent a year earlier; the stability of education fees, which had almost doubled during the first quarter of 2004/05; and a slowdown in food prices. Excluding rents and petroleum products prices, year-on-year inflation declined from 11.3 percent at end-2004/05 to 9.0 percent at end-June.

6. **Opium production is expected to decline in 2005**. The intensification of the government's anti-narcotics efforts and the relatively low farm gate prices contributed to a substantial decline in cultivation. However, this decline is expected to be partly offset by a rebound in yields, which had fallen by 29 percent in 2004 because of bad weather conditions and the prevalence of diseases. Overall, we expect opium production to decline. Farm gate prices remained low during the first quarter of 2005/06, probably on account of large inventories and interdiction.

7. **Provisional data indicate that domestic revenues reached Af 4,757 million in the first quarter of 2005/06, slightly above the SMP indicative target (Af 4,629 million)**.[2] This outcome represents a significant increase, of over 75 percent, in domestic revenues compared with the same period last year. This was attributable to both an increase in customs revenue, of around 40 percent, and the delayed transfer of about Af 800 million in overflight charges accrued in previous years, which more than compensated for a decline in domestic tax revenues.

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[1] The year-on-year increase in the national CPI, which covers five major cities in addition to Kabul, declined from 11.6 percent to 10.3 percent, primarily due to lower rent increases.

[2] The Ministry of Finance has recently introduced new procedures to reconcile the revenue reports and banking data. Over time, this should enhance considerably the integrity of fiscal reporting, although discrepancies remain, which need to be resolved.

8. **Improvements in budget preparation helped to limit the payment delays, notably for wages, that had occurred at the start of previous years**. Core budget operating spending was Af 6.6 billion during the first quarter, compared with an annual budget estimate of Af 32.9 billion. Wages and salaries contributed around 60 percent of operating expenditures.

9. **A supplementary development budget was approved in June to incorporate additional donor-funded projects**. Core budget development spending is now budgeted at 16.6 percent of GDP in 2005/06, up from an outturn of 4.5 percent in 2004/05, and a preliminary budget estimate of 13.2 percent of GDP. During the first quarter of 2005/06, it amounted to Af 3.8 billion, compared with an annual budget estimate of Af 58.5 billion. Development spending continues to be hampered by: (i) the lack of capacity in line ministries and implementing agencies to develop and implement projects; (ii) the lead time required to design and initiate projects; and (iii) security concerns. To address these capacity constraints, we are building capacity in the line ministries and have recently created a National Project Support Office in the President's office to help line ministries develop and manage new projects. These initiatives should improve disbursement rates over time, more in line with the ambitious budget targets for development spending.

10. **We continue to observe our "no-overdraft" financing commitment as the core budget was funded exclusively by domestic revenues and foreign grants**. The external supplementary budget, which is executed directly by donors, remained broadly unchanged, at 45 percent of GDP in 2005/06, compared with estimated spending of 35 percent of GDP in 2004/05. Part of the external budget (equivalent of 21.3 percent of GDP) is unfunded and projects will not commence until the funding is secured.

11. **The promulgation in June of the new Public Financial Management Law, an end-June benchmark, constitutes a significant step towards a modern fiscal system**. The new budget law provides a clear and transparent budget framework, stricter guidelines for budget formulation, execution and financing, and sets out a consistent framework for internal control and internal and external audit. In support of our policy of fiscal transparency, the Ministry of Finance has begun publishing monthly statements of fiscal performance for the core budget and we intend to produce a regular quarterly fiscal bulletin during the year. The Ministry of Finance has approved a plan to integrate the former Accounting Department of the Ministry of Finance in the Treasury, in accordance with the Public Financial Management Law, and some staff have already moved under the Treasury. However, the integration process will not be completed for several months as the restructuring plan has to be submitted to and approved by the Independent Administrative Reform and Civil Service Commission.

12. **Currency in circulation increased by 3.4 percent during the first quarter of 2005/06, to Af 40.1 billion at end-June, significantly below the SMP first quarter ceiling (Af 41.2 billion)**. Due in part to the government's further accumulation of deposits with DAB, international reserves continued to increase, to $1.3 billion (equivalent to 3.8 months of 2006/07 imports). While the interest rate on the overnight capital note remained low, at

1–2 percent, the rate on the 30-day note increased slightly, fluctuating between 5 and 6 percent during the first quarter. The 30-day note auctions were no longer systematically undersubscribed, due to the participation of some private banks in addition to the two state-owned banks that had previously been the only bidders. The nominal exchange rate depreciated slightly, losing 3 percent against the U.S. dollar during the first quarter of 2005/06. The real exchange rate, which appreciated in 2004/05, remained broadly unchanged as domestic prices increased slightly faster than foreign prices.

13. **Further progress was made in modernizing the central bank**. We published the financial statements of the 2003/04 external audit of DAB. We also started implementing the recommendations of the recent IMF technical assistance mission on monetary policy and financial markets. In particular, we improved substantially the operating procedures of the foreign exchange auctions by moving to a standard auction system (with confidential bids, no renegotiation, and allowing for multiple bids) and allowing commercial banks to participate along with money-changers. We also strengthened the monetary policy institutional framework by establishing a monetary policy committee in charge of daily operational issues. We initiated the transfer of DAB's commercial activities in its city branches in Kabul and in branches located in provinces where at least one commercial bank operates. Lastly, we conducted, with the help of a local expert, a preliminary assessment of the gold and silver held in the palace vaults.

14. **The current account deficit, excluding grants, declined in 2004/05, to 45.0 percent of GDP from 50.9 percent of GDP in 2003/04, due primarily to a slowdown in imports**. The deficit continued to be financed essentially by grants, although there has been an increase in foreign direct investment and concessional borrowing. Including grants, the current account recorded a surplus equivalent to 0.7 percent of GDP, compared with 3.1 percent of GDP in 2003/04.

15. **As part of our efforts to improve balance of payments data, we started implementing the recommendations of the May 2005 IMF STA technical assistance mission**. In particular, we harmonized the sources and assumptions on trade flows, and made adjustments to account for illegal trade, private grants, and the international investment position. We are also improving collection of data on the financial accounts through various surveys and questionnaires.

III. Policies for the Remainder of 2005/06 and 2006/07

16. With the legislative election fast approaching, security is expected to remain an issue and could, to a certain extent, slow down our reform process and ultimately affect negatively the performance of the Afghan economy. Even if security improves, the establishment of a stable political and legislative environment will take time as the country has not had any recent experience with a Parliament. This could effect donor support and complicate program implementation. Against this background, we intend to build on the first quarter performance, which was in line with SMP projections, and continue our efforts to implement

prudent economic policies with the aim of maintaining macroeconomic stability and sustaining growth while fighting pervasive poverty.

A. Macroeconomic Objectives

17. **Economic policies for the remainder of 2005/06 and the first half of 2006/07 remain in line with the medium-term objectives of improving growth prospects, facilitating the development of the private sector, and maintaining fiscal and external sustainability**. For that purpose, and as indicated in our previous memoranda, increased revenue collection through sustained tax and customs administration reforms will remain a key priority. At the same time, we will improve spending efficiency and prioritization consistent with the NDS and the Millennium Development Goals.

18. **Economic developments were broadly in line with the projections made at the time of the fourth review, and growth and price projections remain unchanged**. Real GDP is expected to grow by 13.6 percent in 2005/06, reflecting the rebound of agricultural output due to better precipitation, as well as continued growth in construction, transports and telecommunications. In 2006/07, as the economy matures and agricultural growth returns to its trend, economic growth is likely to moderate somewhat, to a projected 11.2 percent. On account of the expected slowdown in rents and food prices and of the tightening of the monetary stance, inflation is expected to decline further, to 10 percent year-on-year at end-2005/06 and 8 percent year-on-year at end 2006/07.

19. **To ensure that the decline in opium production observed this year is sustained over the medium term, we will pursue the implementation of our anti-narcotics strategy**. The sharp decline in planted areas observed this year in most provinces, which arose from non-planting (i.e. farmers deciding not to plant) and to eradication, has validated our multi-pronged approach combining eradication, interdiction and alternative livelihoods. The persistence of relatively low farm gate prices should help us in pursuing our strategy. Nevertheless, to realize continued success will require major efforts and new initiatives from both our government and our development partners on all fronts. The newly created Ministry of Counter-Narcotics is coordinating the policy efforts in this area.

B. Fiscal Policy

20. **The NDS will help to define national and sectoral policies that are clear, affordable and realistic within a Medium-Term Fiscal Framework (MTFF)**. The MTFF, an end-December benchmark, will present our policy objectives and a set of integrated macroeconomic and fiscal targets, and assumptions and projections over the next three to five years, including financing requirements. This should allow us to better articulate the path towards fiscal sustainability and to provide a framework that, along with improved fiduciary standards, will encourage donors to channel, with greater predictability, an increasing proportion of their financial assistance through the core budget. The NDS and MTFF can help to improve the realism of the budget processes and outcomes, provide more

comprehensive coverage and the linking of recurrent and capital costs, enhance the predictability of budget allocations and improve the transparency in the use of resources.

21. **The scope for further budgetary adjustments will be considered, in collaboration with our development partners at the time of the MYR, scheduled for September/October**. The MYR process, established in 2004, has significantly improved the quality of budget management by allowing transparent adjustments during the year and creating a link between this year's budget execution and the preparation of the next budget. In order to improve budget execution, in particular for development expenditures, the MYR will identify and implement strategies to accelerate program delivery and to remove or reduce allocations to nonperforming programs. We also anticipate the inclusion of additional donor funds as commitments become firm during the year or projects, such as for the Counter Narcotics Trust Fund, are included in the core budget.

22. **We envisage a wage adjustment as part of the MYR, which will be consistent with medium-term fiscal sustainability**. Considering the relatively low level of current wage rates, and that no general increases have been awarded since November 2003, a nominal wage increase for non-uniformed public servants is becoming unavoidable. However, domestic revenues cover only about half of the operating budget, and wage-related costs are due to rise considerably over the medium term due to the ongoing public administration reforms and possibly the need to absorb additional security-related costs. To the extent possible, we will restrict any increase in the general pay scales for non uniformed public servants at the time of the MYR to no more than Af 600 million, which should be more than offset by additional domestic revenues. We also realize the importance of carefully quantifying and controlling any pay award and also of discussing these proposals with the main donors who finance a significant share of the budget.

23. **The current revenue-to-GDP ratio is one of the lowest in the world and the increase in domestic revenues remains our highest priority**. The SMP revenue projection for 2005/06, at 5.2 percent of GDP, is greater than the budget projection, but is achievable in light of the expected receipt of both the 2004/05 and 2005/06 overflight payments in this fiscal year, and provided that customs and tax administration reform programs are well implemented.[3] The immediate revenue reform effort will focus on strengthening the large tax payer unit, establishing tax enforcement powers by end-September 2005, and improving tax and customs administration and infrastructure. We are also considering the introduction of excise taxes in the near future.

24. **The recent legislative changes provide a solid foundation upon which modern tax and customs administrations can be built**. We are committed to reducing complexity and streamlining procedures, so as to reduce compliance costs, for both tax and customs. New regulations and procedures for customs and tax administration are now required to

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[3]The SMP revenue target is Af 18,328 million, compared to a budget target of Af 16,150 million.

support the implementation of recently enacted legislation in these areas and to ensure that the government has adequate authority to control and manage public finances. We will conduct a review of the tax structure during the year, in consultation with the private sector, with a view to abolishing the plethora of 'nuisance' taxes and illicit charges. Properly controlling duty and tax exemptions is also critical, particularly given the high value of donor imports that are duty-exempt and the risk that this causes a proliferation of unjustified exemptions and undermines the revenue base. Therefore, we will take steps to strengthen the implementation of our exemption monitoring system.

25. **Fiscal reporting and the reconciliation of fiscal and banking data have improved markedly over the last year and we will maintain our efforts in this area**. One of the major challenges to improve the domestic revenue administration and the payment and accounting systems is the reform of the provincial treasuries (Mustofiats). New regulations, procedures, systems—based on the new public financial management law—and institutional reforms are required. This includes the reorganization of the Mustofiats along functional lines reporting to the Treasury and General Presidency of Revenue. With the support of donors, we will continue to implement the plan to reform the Mustofiats over the coming year.

C. Monetary and Exchange Rate Policies

26. **As price, exchange rate, and monetary developments during the first quarter were broadly in line with SMP projections, monetary policy will continue to be guided by the 2005/06 monetary program agreed upon at the time of the third review.** The relative slow growth of currency in circulation during the first quarter should provide us with sufficient room to accommodate a potential sharp increase in money demand during the second quarter, similar to those observed in the previous two years. At the same time, the program provides for a further tightening of the monetary stance during the remainder of the year, consistent with DAB's primary objective to bring inflation under 10 percent. The exchange rate will continue to be market-determined. International reserves are expected to increase further, to about $1.7 billion at end-2005/06, equivalent to 4.8 months of 2006/07 imports.[4] The monetary program will remain flexible to account for unanticipated changes in the demand for currency on account of factors such as increased *Afghanization* or changes in financial sector developments.

27. **We continue to modernize DAB's operations**. We will restructure further DAB's balance sheet by: finalizing, by end-September 2005, the transfer of DAB's commercial accounts in its city branches in Kabul and in its branches located in provinces where at least one fully-licensed commercial bank operates; and processing the gold held in the palace

[4] The quarterly quantitative indicators (floor) for gross international reserves were set so as to be consistent with a minimum coverage of 2006/07 imports of four months at end-2005/06.

vaults into a form that qualifies as a reserve asset, and transferring, by end-September 2006, any monetary gold held in Afghanistan to an international gold center. To address more effectively commercial banks' liquidity needs, we will introduce by end-December 2005, with technical assistance from the IMF, an overnight collateralized credit facility against capital notes and allow participants in the foreign currency auctions to sell, as well as to buy, U.S. dollars. If the demand for capital notes, notably from the private banks, continues to increase, we are considering introducing longer-maturity notes. Lastly, consistent with our commitment to transparency, by end-December 2005 we will publish the capital note interest rates.

28. **We will tackle forcefully the administrative and legal impediments to the development of the banking sector**. We will work with the donor community to strengthen the banking sector regulatory and institutional framework. This is a complex issue that requires a greater understanding and implementation of existing laws. We will submit new laws and amendments to parliament, if deemed necessary to support improvements in the financial sector. We will also eliminate the registration fees for deeds, or at least reduce them sufficiently to bring them in line with international standards (end-December 2005 structural benchmark). These fees have proved to be a major deterrent to lending operations associated with immovable property.

29. **We are committed to intensifying our efforts to liquidate the former state-owned banks and to restructure the licensed ones.** To formalize our decision to liquidate the three former state-owned banks, the Ministry of Finance, as the main shareholder, will issue a statement to that effect by end-September 2005. By this date, the deposits with these former banks will be transferred to licensed banks, or reimbursed. In addition, by end-December 2005, we will appoint liquidators and start implementing the liquidation of these unlicensed banks. Regarding the three licensed state-owned banks, we will assign, by end-December 2005, new management teams, or engage management advisors, to implement their long-term strategic plans (due by end-September 2005). Based on the findings of the review of the performance of these banks under their conditional licenses, DAB will elaborate a new set of conditions and corrective actions to ensure their financial soundness and medium-term profitability.

D. External Policy and Debt Management

30. **The overall outlook for the external sector looks favorable.** The current account deficit excluding grants, is projected to reach 44.8 percent of GDP in 2005/06, down from 45.0 percent of GDP in 2004/05. While foreign direct investment and official borrowing are expected to increase further, the financing of this deficit will continue to rely heavily on grant financing. Including grants, the current account is projected to record a surplus equivalent to 0.5 percent of GDP.

31. **We will continue to improve the collection and the compilation of balance of payments data**. We will strengthen our processes for evaluation of non-recorded trade flows, based on the findings of the current survey of illegal trade flows in Herat and of upcoming

surveys in other bordering provinces, including Nangahar, Kandahar, and Balkh. We also intend to ensure extended coverage and consistency of data on grants. For that purpose, DAB will coordinate with the various government agencies and the donor community. DAB will also work closely with the banking community to establish more reliable flows of financial data for balance of payments purposes.

32. **Our external debt management strategy will remain cautious as we will continue to rely on grants and loans on highly concessional terms to meet our financing needs**. We will press ahead with our efforts for continued support from multilateral and bilateral creditors and donors to ensure medium-term fiscal and external sustainability and the soundness of our financing strategy. We will also continue to seek generous debt relief from existing bilateral creditors.

33. **We will pursue our good faith efforts to complete the external debt survey by end-September 2005.** We have already requested assistance from the Secretariat of the Paris Club to reconcile debt owed to Paris Club creditors. Regarding the non-Paris Club creditors, we have achieved some success in a number of cases. Nevertheless, others, particularly those involving countries that have since split into several new countries, may require protracted exchanges to achieve debt reconciliation. We would welcome assistance from IMF staff in facilitating contacts between the Ministry of Finance and officials of non-Paris Club creditors. Preparatory work on an external debt management strategy is progressing and we expect it to be adopted by Cabinet by end-September 2005.

E. Structural Reforms

34. **With IMF and other donor assistance, we will pursue our structural reform agenda, including reforms covered by program conditionality**. In addition to the reforms introduced in the fiscal and monetary areas already mentioned in this memorandum, we will adopt by end-September 2005 a comprehensive restructuring plan and a classification of state-owned enterprises (SOEs) by planned restructuring method. We will ensure that the retrenchment costs associated with divesting our interest in those SOEs are fiscally sustainable. Consistent with our strategy to divest from commercial activities, we will refrain from creating any new SOE, bank, or financial institution. As regards divestment more generally, we are committed to an open and transparent process that will ensure maximum income to the state from the sale of any state assets.

F. Poverty Reduction Strategy

35. **We will continue to work on the NDS, so as to complete it by end-December 2005**. We have put in place an institutional framework to conduct this process, including an oversight committee of the NDS comprising the ministers of economy, finance, foreign affairs, and rural rehabilitation, and the economic adviser of the President. The oversight committee provides the strategic guidance and coordinates the work of the various participants. A working group is in charge of the technical aspects of the work. The other component of the institutional framework include an External Advisory Group that draws on

the expertise and feedback of the United Nations agencies, the international financial institutions, key donors, and civil society. We have also launched an extensive consultation process with donors, various ministries, and civil society, to help identify the key priorities of our poverty reduction strategy building upon our recent work on the Millennium Development Goals. Over the next few months, we will continue our work to improve our social statistical data base and our understanding of the determinants of poverty. We will also focus our attention on the macroeconomic implications of our priorities.

G. Statistical Issues

36. **The building of a strong statistical database remains a pillar of the SMP.** Guided by the September 2004 statistical master plan, our priority is to first establish an adequate legal framework for collecting, processing and disseminating economic data. To that end, we are currently working on a statistical law, which is expected to be adopted by Cabinet by end-September 2005. We are also seeking support from the donor community to restructure the Central Statistics Office, reestablish its independence and fund the action plan for the implementation of the statistical master plan. Because of some technical difficulties, we will now launch the three key surveys in September 2005.[5]

H. Technical Assistance and Other Issues

37. **A comprehensive review of the technical assistance (TA) provided by various donors is progressing according to schedule and has already led to some initial changes in the use of TA**. Ultimately, this review should help the government and the donor community address the distortions and weaknesses identified so far, establish new priorities, and redeploy resources to sectors in need. We reiterate our gratitude to the IMF for the TA it has provided to date. We are looking forward for additional assistance from the IMF to review exchange rate regulations and improve monetary statistics.

38. **In July 2005, and after consultation with non-governmental organizations (NGOs) and donors, we adopted a law governing the NGOs**. The NGO community has been instrumental in reestablishing delivery of basic services in various parts of the country for many years. The new law provides an adequate framework for efficient NGO and local involvement in the provision of social services. To comply with the new law, all NGOs are expected to re-register before end-December 2005. Another feature of the law is that construction must now be delivered primarily by the private sector, where feasible. Also, to improve information on the coverage of social services by various providers, NGOs must now report on their activities to the Ministry of Economy on a quarterly basis.

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[5] These surveys, which were initially expected to be launched in June/July 2005, are: the national risk vulnerability assessment survey on rural households; the integrated living standard survey on household income and expenditure, and, the integrated business enterprise survey (which will cover a sample of about 1000 medium and large enterprises). These surveys are critical in providing a baseline of which to measure development progress.

I. Program Monitoring

39. **In monitoring the SMP, we will refer to the definitions, data sources, and frequency of monitoring set out in the attached Technical Memorandum of Understanding (TMU)**. The quarterly quantitative indicators through end-September 2006 are included in Table 1. The structural benchmarks are set out in Table 2. We realize that a large number of these structural benchmarks are set out for end-September 2005; this mainly reflects a sequencing established prior to the request for an additional 12-month extension of the SMP. Over the next reviews, and if warranted by the need to strengthen program implementation, understandings could be reached on additional structural benchmarks for subsequent quarters through September 2006. For reporting purposes, the government will continue to provide IMF staff all core data, appropriately reconciled and on a timely basis, as specified in the TMU. IMF staff will be notified prior to introducing any policy actions and developments that might affect the program.

40. **The Technical Committee of Coordination (TCC) will continue to monitor execution of the SMP and will ensure timely transmission of core data to the IMF**. We intend to encourage the TCC to consolidate its analytical capacity, reach out to various government agencies to improve its dissemination of key macroeconomic data. Also, the TCC should be instrumental in working on the macroeconomic component of the upcoming NDS.

Table 1. Islamic Republic of Afghanistan: Quantitative Indicators, 2005/06–2006/07

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

	2005/06					2006/07	
	Jun. 21	Jun. 21	Sep. 21	Dec. 20	Mar. 20	Jun. 20	Sep. 20
	Indicative Target	Preliminary Estimate	Indicative Target	Indicative Target	Indicative Target	Indicative Target	Indicative Target
Currency in circulation (ceiling) 1/	2,453	1,321	5,057	7,822	10,758	2,572	5,278
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 dollars)	-50	85	0	100	158	0	0
Fiscal revenue of the central government (floor)	4,629	4,757	8,306	12,676	18,328	4,459	9,125
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)	3,508	...	7,298	10,151	13,234	3,875	8,018

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

1/ At end-2004/05, currency in circulation amounted to Afs 38.8 billion.
2/ Excluding rescheduling arrangements, but including debt with maturities of more than one year.
3/ This benchmark will be evaluated on a continuous basis.
4/ Concessional debt is defined as debt with a grant element of at least 60 percent calculated on the basis of currency-specific discount rates, based on the OECD commercial interest reference rates (CIRRs).
5/ On a contracting or guaranteed basis. Excluding debt related to normal import transactions.

Table 2. Islamic Republic of Afghanistan: Structural Benchmarks, June 2005–September 2006

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

Table 2. Islamic Republic of Afghanistan: Structural Benchmarks, June 2005–September 2006 (concluded)

Structural Benchmarks	Target Date	Status
Publish estimate of revenues forgone as a result of customs exemptions, including due to international assistance, and income tax law exemptions.	End-March 2006	
Establish appeals process for customs and tax administrations.	End-June 2006	
Process gold held in the palace vaults into a form that qualifies as a reserve asset and transfers any monetary gold held in Afghanistan to an international gold center.	End-September 2006	
Submit to parliament the core budget's audited financial statements for 2005/06.	End-September 2006	

INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF AFGHANISTAN

Technical Memorandum of Understanding

1. This memorandum sets out the understandings between the Afghan authorities and the Fund staff relating to the monitoring of the Staff-Monitored Program (SMP).[1] It is organized as follows: Section I specifies the quantitative indicative targets; Section II provides definitions of the principal concepts and financial variables; Section III relates to the reporting requirements.

I. QUANTITATIVE INDICATIVE TARGETS

2. Monitoring of the implementation of the program will be conducted on the basis of an assessment of the observance by the Government of Afghanistan of the quantitative indicators and structural benchmarks at specified dates.

3. The quantitative indicators are specified in Table 1 of the MEFP and updated MEFPs attached to the letters of March 23, 2004, September 6, 2004, December 29, 2004, February 3, 2005, May 18, 2005, and August 16, 2005. They are as follows:

- a ceiling on currency in circulation of Da Afghanistan Bank (DAB);
- a ceiling on net claims of the banking system on the central government;
- a floor for the build-up of gross international reserves of DAB;
- a floor on fiscal revenue of the central government;
- a ceiling on new medium- and long-term nonconcessional external loans contracted or guaranteed by the government; and
- a ceiling on new nonconcessional debt contracted or guaranteed by the government with an original maturity of less than one year.

[1] The SMP initially covered the period March 2004–March 2005. At the request of the authorities, it was extended for six months through September 2005 (IMF Country Report No. 05/128). At the time of the fifth review, the authorities requested an additional 12-month extension through September 2006.

II. Definitions

A. Program Exchange Rate

4. For purposes of monitoring under the program, a program exchange rate will be used. This program exchange rate will be the average of the U.S. dollar/Afghani buy and sell cash rates, as reported by the DAB as of February 29, 2004 (49.84 Afghanis per U.S. dollar). The program exchange rate will be used to convert into Afghanis the U.S. dollar value of all foreign assets and liabilities denominated in U.S. dollars. For assets and liabilities denominated in SDRs and in foreign currencies other than the U.S. dollar, they will be converted in U.S. dollars at their respective exchange rates prevailing as of February 29, 2004, as published in the International Financial Statistics (IFS).

B. Currency in Circulation

5. Currency in circulation is defined as total currency (new Afghani) issued by DAB. It excludes currency held in the presidential palace vault, in DAB main vault, and in the vaults of DAB's provincial branches, but includes currency in the vaults of DAB's district branches.

C. Net Claims of the Banking System on the Government

6. Net claims of the banking system on the government are defined as the difference between the banking system's claims on the government and the deposits of the government with the banking system.

D. Gross International Reserves

7. Gross usable reserves of the DAB are reserve assets, as defined in the balance of payments (BOP) manual, that are controlled by the DAB, are immediately and unconditionally available to the DAB for meeting balance of payments needs, and are not earmarked by the DAB for meeting specific payments. They consist of balances on accounts maintained with overseas correspondent banks, foreign exchange banknotes in the vaults of the DAB, monetary gold, SDRs, and Afghanistan's reserve position in the International Monetary Fund.

E. Nonconcessional Public Sector or Publicly Guaranteed External Debt

8. Table 1 of the MEFP specifies limits to the contracting or guaranteeing of new external debt by the government. For program purposes, "government" includes the central government, and government departments and official agencies which do not seek profit and whose budgets are issued independent of the annual operational or development budgets. Government and government-guaranteed external debt covers all external debts incurred or guaranteed by the government.

9. The limits specified in Table 1 of the MEFP apply to the contracting or guaranteeing by the government of new, nonconcessional external debt with an original maturity of more than one year. This limit applies not only to debt as defined in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt in Fund Arrangements (Decision No. 6230-(79/140), August 3, 1979 as amended by Decision Nos. 11096-(95/100), October 25, 1995, and 12274-(00/85), August 24, 2000), but also to commitments contracted or guaranteed for which value has not been received. Excluded from this limit are leases of real property by Afghan embassies or other foreign representations. External debts will be expressed in U.S. dollar terms, with debts in currencies other than the U.S. dollar converted into U.S. dollars at the market rates of the respective currencies prevailing on February 29, 2004, as published in IFS.

10. The limits specified in Table 1 of the MEFP also apply to the contracting and guaranteeing by the government of new, nonconcessional external debt with an original maturity of one year or less. The term "debt" has the meaning set forth in point No. 9 of the Guidelines on Performance Criteria with Respect to Foreign Debt in Fund Arrangements (adopted by the Executive Board of the International Monetary Fund on August 24, 2000). Excluded from this limit are normal import-related credits. External debts will be expressed in U.S. dollar terms, with debts in currencies other than the U.S. dollar converted into U.S. dollars at the market rates of the respective currencies prevailing on February 29, 2004, as published in IFS.

11. For purposes of the program, the guarantee of a debt arises from any explicit legal obligation of the government or DAB or any other agency acting on behalf of the government to service such a debt in the event of nonpayment by the recipient (involving payments in cash or in kind), or indirectly through any other obligation of the government or DAB to cover a shortfall incurred by the loan recipient.

12. Concessionality will be based on currency-specific discount rates based on the OECD commercial interest reference rates (CIRRs). For loans of an original maturity of at least 15 years, the average of CIRRs over the last 10 years will be used as the discount rate for assessing the concessionality of these loans, while the average of CIRRs of the preceding six-month period will be used to assess the concessionality of loans with original maturities of less than 15 years. To the ten-year and six-month averages of CIRRs, the following margins will be added: 0.75 percent for repayment periods of less than 15 years; 1 percent for 15–19 years; 1.15 percent for 20–30 years; and 1.25 percent for over 29 years. Under this definition of concessionality, only loans with grant element equivalent to 60 percent or more will be excluded from the debt limits. The debt limits will not apply to loans contracted for debt rescheduling or refinancing.

F. Fiscal Revenues of the Central Government

13. Fiscal revenues of the government include revenues collected in Kabul as well as revenues collected by the provincial offices of the government and transferred to the

government account at DAB. They include revenues from corporate income tax, personal income tax, business receipts tax, fixed withholding taxes on imports and exports (and creditable against the income tax), presumptive taxes in lieu of the income tax, import duties and other charges and fees (the Chamber of Commerce import/export valuation charge, the Red Crescent fee, permit fees from the Ministry of Commerce, fees and charges from the Ministry of Communication, and over flight fees collected by the Ministry of Civil Aviation). It excludes revenue from privatizations or other sale of state assets, grants, and other direct transfers. It excludes provincial revenues accrued between March 20, 2004 and March 20, 2005 but where funds are not transferred to government's DAB accounts by April 20, 2005. It also excludes revenue accrued before February 21, 2004, even if funds are transferred to government accounts between March 20, 2004 and March 20, 2005. All revenue must be supported by the relevant documentation.

G. Structural Benchmarks

14. The structural performance benchmarks are specified in Table 2 of the MEFP and updated MEFPs attached to the letters of March 23, 2004, September 6, 2004, December 29, 2004, February 3, 2005, May 18, 2005, and August 16, 2005. They are elaborated further as follows:

- **Consolidation of all line ministry accounts into the Treasury Single Account (TSA)**. All revenue collected by ministries must be deposited into the main government account (including sub-accounts), and no ministry may have its own bank account without the explicit written consent of the Minister of Finance.

- **Regular transfer of provincial *moustoufiat* balances into the TSA at DAB headquarters**. Transfers will take place, where possible, on a weekly basis, but at a minimum on a monthly basis. Also the provinces may not make expenditures from their revenue accounts. This will be verified by the records of DAB. For each individual branch, the transferred amount will have to be credited to the TSA within 30 days of the end of each solar month.

- **Development of consolidated fiscal accounts including provinces and operating and development budgets**. This should be prepared on a monthly basis, with a six-week lag, for the operating budget, using a functional, ministerial, and economic classification. For the development budget, which would include those transactions that pass through the Treasury, these accounts must be prepared on a quarterly basis, with a six-week lag, using the classification structure under the National Development Framework. Development expenditures implemented directly by donors will be included if data are available.

- **Extension of the consumer price index survey to main cities beyond Kabul**. This must include at least 5 other cities.

- **Development of a monetary survey, including the balance sheets of commercial banks**. The survey is to include only those banks licensed under the new banking law.

- **Adoption of presidential decree precluding tax exemptions and concession**. Appropriate legal enactment to ensure statutory tax rules prevail over nonstatutory concessions in agreements.

- **Publish (by the Ministry of Finance) in a quarterly basis fiscal data**. The data should be at least quarterly, but whenever possible, should include monthly revenue and expenditures (center and by individual province) covered under the core budget, as well as financing. The structure of the revenue and expenditure data should be on the same classification as the approved budget. The data should also compare outturns against the budget. As information on the external budget depends on cooperation from the donors, the government should make a "best effort" to compile the data, and make ongoing revisions. Published data should also include principal and interest payments on external government and government-guaranteed debt, and disbursement of external loans. Publication of this information can be in either electronic or paper format.

- **Complete an assessment of the financial position of the SOE. Adopt (by Cabinet) (i) the list classifying SOEs according to proposed economic restructuring method; and (ii) the Economic Restructuring Plan.** For those nonfinancial SOEs with poor record keeping and scarce financial information, instead of an assessment of the financial position, the experts will make, at a minimum, an informed judgment of the state of the enterprise through in-site visits and thorough discussions with management and staff. If sufficient financial information becomes available, then a full-fledged assessment of the financial position of the SOE will be conducted prior to its restructuring. The Economic Restructuring Plan will reflect the various steps and tasks entailed by the restructuring process, and will be adopted by the Ministries in charge of the SOEs and presented to the Cabinet.

- **Transfer to other entities all DAB commercial activities that are inconsistent with the central bank and commercial bank laws**. At a minimum, this will include all commercial activities performed by DAB's main office. Notwithstanding the transfer of other commercial activities, the transfer of commercial accounts will, at least, comprise all accounts which are not: frozen; non-cash; or requiring audit or/and legal determination.

- **Improve government payments by initiating (i) direct electronic payments to vendor bank accounts; and (ii) a pilot for direct salary deposits to bank accounts for the employees of three ministries.** The benchmark is amended to read as follows: "Improve government payments by initiating (i) direct electronic payments to vendor bank accounts; and (ii) a pilot for direct salary payments for the employees of three ministries".

- **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.

- **A Medium-Term Fiscal Framework (MTFF) typically contains a statement of fiscal policy objectives and a set of integrated medium-term macroeconomic and fiscal targets and projections**. The next step, which would be supported by the ANDS, would be to develop medium-term budget estimates for spending agencies to link, in broad terms, the allocation of resources to the government's strategic priorities, while ensuring overall fiscal discipline. The MTFF should include (i) a fiscal table with 3-year projections of revenues, expenditures, fiscal deficit and sources of financing, and (ii) a concise description of the policy actions which sustain the projections, particularly for revenues, the wage bill, the profile of actual development expenditures (not just commitments) and the fiscal deficit(s), consistent with international definitions. Detailed sector plans or costings are not required.

III. Provision of Information to the Fund Staff

A. Data

15. To permit the monitoring of developments under the program, the government will provide to Division A of the Middle Eastern and Central Asia Department (MCD), through the office of the Resident Representative of the IMF in Afghanistan, the information specified below and summarized in the list of reporting tables provided by Fund staff to the Technical Committee. The program is designed with quarterly quantitative targets and the actual outcome should be provided within six weeks following the end of the quarter. However, in order to facilitate regular monitoring, many of the indicators should be provided with the frequencies indicated below.

- DAB gross foreign exchange reserves (weekly) from **March 20, 2004**. This should be reported no longer than 2 weeks after the end of the week.

- Monetary statistics, including exchange rate data (daily), government accounts with the DAB and currency in circulation (monthly) from **March 20, 2004**. From **September 21, 2004,** monetary statistics will also include a monetary survey (monthly), including balance sheets of DAB and a balance sheet of the commercial banks. This should be reported no longer than 3 weeks after the end of the month.

- Foreign trade statistics (imports, exports, reexports) (quarterly) from **March 20, 2004**. This should be reported no longer than 8 weeks after the end of the quarter.

- Operational budget operations and their financing should be reported on a monthly basis no more than 4 weeks after the end of the month.

- Detailed data on foreign grants and loans disbursed, contracted, or guaranteed by the central government; foreign debt amortization and interest payments, including new external arrears (if any); and total outstanding amount of arrears (quarterly) from **March 20, 2004**.

- List of short, medium, and long-term government or government-guaranteed external loans contracted during each quarter; identifying for each loan: the creditor, the borrower, the amount and currency, the maturity and grace period, and interest rate arrangements (quarterly) from **March 20, 2004**.

- National accounts data (quarterly) from **March 20, 2004**. This should be reported no longer than 8 weeks after the end of the quarter.

- Consumer price index (CPI) for the city of Kabul (monthly) from **March 20, 2004**; then starting in October 2004, CPI covering 5 major cities (monthly). These should be reported no longer than 4 weeks after the end of the month.

- Core development budget operations and their financing should be reported on a quarterly basis no more than 6 weeks after the end of the quarter. The data should be at least quarterly, but whenever possible, should include monthly expenditures covered under the core budget, as well as financing. The structure of the financing (grants and loans) and expenditure data should be on the same classification as the operating budget in addition to the program classification used by the budget. The data should also compare outturns against the budget.

B. Structural Reforms

16. **Review of the structural reforms**. The Government of Afghanistan will prepare and send to the IMF reports, with appropriate documentation, indicating progress achieved, explaining any deviations relative to the initial planning, and specifying expected revised completion date.

C. State-Owned Banks

17. The authorities will provide staff with relevant documents and information dealing with the proceedings associated with the relicensing and/or closure and resolution of commercial banks.

D. Other Information

18. 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.

19. The Technical Committee of Coordination (TCC) will provide Division A of the Middle East and Central Asia Department with any other information that may be required by the staff of the IMF for the effective monitoring of the program.

E. Program Monitoring

20. For the purposes of program monitoring, working meetings are planned, at least bi-weekly, with the participation of representatives of the MoF, the DAB, the TCC, and the IMF resident representative.