International Monetary Fund

Islamic Republic of Afghanistan and the IMF

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IMF Executive Board Completes First Review Under the Islamic Republic of Afghanistan's PRGF Arrangement and Approves US$17 Million Disbursement
March 8, 2007

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

February 27, 2007

The following item is a Letter of Intent of the government of the Islamic Republic of Afghanistan, which describes the policies that the Islamic Republic of Afghanistan intends to implement in the context of its request for financial support from the IMF. The document, which is the property of the Islamic Republic of Afghanistan, is being made available on the IMF website by agreement with the member as a service to users of the IMF website.

Kabul, February 27, 2007

Mr. Rodrigo de Rato
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. de Rato,

This letter supplements our letter of intent and Memorandum of Economic and Financial Policies (MEFP) of January 17, 2007 with regard to security expenditures and the 2007/08 budget, as well as external debt issues identified during preparations for the Heavily Indebted Poor Countries (HIPC) Initiative.

Despite the difficult security environment and persistent expenditure pressures, we have continued to make progress in our reform strategy, and our program under the Poverty Reduction and Growth Facility (PRGF) arrangement remains on track. Although it appears that fiscal revenue in the first three quarters of fiscal year 2006/07 fell short of the revised (indicative) target proposed for December 20, 2006, the operating budget deficit (excluding grants) during that period remained below the program ceiling, owing mainly to slow execution of expenditures in the first quarter. The revenue under-performance, which occurred only in the third quarter of 2006/07, was partly attributable to the deteriorating security situation in the south. Nonetheless, we remain committed to meeting the proposed performance criterion on fiscal revenue for March 20, 2007. We have also followed through on our structural agenda. On January 21, 2007, we made a public statement announcing the merger of the Export Promotion Bank with Bank Pashtany. In addition, the Ministry of Finance requested that the Control and Audit Office verify the 2006 reviews of the Tashkeel at the Ministry of Interior and Ministry of Education and the related arrears from 2005/06.

2007/08 Budget and Security

Our initial fiscal program for 2007/08—set out in our January 17 MEFP—provided for security expenditures in excess of the budgeted amount (up to Af 1.3 billion, or about US$26 million), to be financed by donors. However, subsequent consultations with our main donors and security partners revealed that further outlays (and financing) would be necessary to adequately strengthen our security forces. As a result, the total additional security expenditures for 2007/08 (above the fiscal program) are now estimated at Af 3.8 billion (about US$76 million). During the January 30–31 meeting of the Joint Compact Monitoring Board (JCMB) in Berlin, donors indicated their willingness to meet these extra demands.

Reflecting these developments, we request that the cap on the program adjustor for additional, fully donor-funded security expenditures, be raised from Af 1.3 billion to Af 3.8 billion. The revised version of the Technical Memorandum of Understanding is attached.

For now, we have resisted other emerging nonsecurity expenditure pressures and are leaving the programmed budget balance (excluding grants) for 2007/08 unchanged, with the understanding that well-defined and limited additional nonsecurity expenditure needs (in priority sectors) may be revisited in the context of the second review under the PRGF.

Notwithstanding the re-opening of consultations on security expenditures and the relocation of the JCMB meeting from Kabul to Berlin that delayed the final stages of budget preparation, the budget was presented to parliament on February 8. Therefore, we are no longer proposing establishing a structural performance criterion for the second review on submitting the budget to parliament. A revised Table 2 on structural performance criteria and benchmarks is attached to this letter.

Progress in Resolving External Arrears

In preparing for an assessment of Afghanistan's HIPC eligibility, we have made considerable progress in identifying and reconciling our external obligations. In doing so, we have identified possible commercial claims for which we have, as yet, been unable to ascertain their validity. In particular, we have been unable to confirm the government's guarantee of some claims and are investigating the apparent transfer of claims previously owed to a non-Paris Club official creditor. We are actively working to clarify the status of these possible claims and remain firmly committed to engaging in good-faith negotiations with our official creditors, and seeking comparable treatment in line with the recent Paris Club rescheduling agreement and our intention to seek debt relief under the HIPC Initiative.

We would like to assure you of our continued commitment to the macroeconomic objectives and reform agenda set in the MEFP. On this basis, we would like to reiterate our request for the completion of the review.

Sincerely yours,

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

Attachments:
Memorandum of Economic and Financial Policies for 2006/07–2007/08
Technical Memorandum of Understanding

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES FOR 2006/07–2007/08

January 17, 2007

I. INTRODUCTION

1. **The government and DAB have started implementing their reform strategy to reduce poverty and move Afghanistan to a sustainable growth path**. The strategy, as articulated in our Interim Afghan National Development Strategy (I-ANDS), was discussed with development partners at the London International Donors Conference in early 2006. Our program—consistent with the I-ANDS and supported by an IMF Poverty Reduction and Growth Facility (PRGF) arrangement—is designed to maintain macroeconomic stability and implement structural reforms to foster private sector development while addressing our acute poverty situation. This memorandum reviews progress in 2006/07 under the PRGF, updates the government's medium-term objectives and policy framework, and sets out our revised economic and financial policies for the remainder of 2006/07 and 2007/08. On the basis of these policies, we request completion of the first review under the PRGF arrangement and approval of the second disbursement.

II. PERFORMANCE UNDER THE PROGRAM

2. **Afghanistan's economy continues to grow, albeit at a slower pace**. After reaching 14 percent in 2005/06, available information suggests that GDP growth will ease to about 8 percent in 2006/07 due to a drought-induced decline in agricultural production. Inflation, as measured by the consumer price index for Kabul, subsided to about 5.4 percent (year-on-year) by September 2006, as a slower increase in rent prices largely offset a faster rise in food and energy prices. "National" year-on-year inflation, which covers Kabul and five other cities, was 5.2 percent in September.

3. **Opium production rose by almost 50 percent in 2006, reflecting a 60-percent increase in cultivated areas and a 6 percent decline in yields**. The sharp increase in production led to a substantial decline of the farm gate prices over the last 12 months.

4. **Overall fiscal performance during the first half of 2006/07 was in line with the program**. At 1.2 percent of GDP over the first two quarters, the operating budget deficit, excluding grants, was lower than projected. The operating deficit, including grants, at 0.5 percent of GDP, was also below program projections, as lower external grants (amounting to around 0.8 percent of GDP) were offset by lower spending. Together with the unanticipated sale of a telecommunication spectrum bandwidth (about 0.5 percent of GDP), this led to a slightly higher increase in government deposits relative to the program.

5. **Revenues, excluding grants, performed strongly during the first two quarters of 2006/07**, amounting to Af 12.0 billion (2.9 percent of GDP), exceeding the program target of Af 10.6 billion. Lower-than-expected customs receipts, resulting from delays in introducing a new tariff schedule and concessions made to traders,[1] were offset by a higher collection of taxes on income and profits and the business receipts tax (BRT). A draft law to eliminate nuisance taxes and introduce collection of BRT on imports was submitted to parliament (end-December 2006 benchmark) but was returned to the government, partly because of procedural issues. The government is currently reviewing ways to proceed.

6. **Operating expenditures over the first six months reached 4.1 percent of GDP, compared with 4.5 percent of GDP in the program**. While core operating spending in the first two months of the year was well below average due to delays in parliament's approval of the annual budget, it gradually recovered and reached 43 percent of the approved operating budget by September. Core development budget expenditures over the first six months, as recorded in Afghanistan's Financial Management System (AFMIS), reached only 1.3 percent of GDP.[2] However, due to technical difficulties, some development expenditures that were incurred have not yet been entered into AFMIS; accordingly, actual expenditures may have reached double the recorded figure. Furthermore, more than 40 percent of budgeted development expenditures were allotted. Development expenditures are forecast to reach about 55 percent of the approved core development budget by the end of the fiscal year. This represents a 67 percent increase over 2005/06, although it is still substantially lower than planned, due to delays in budget approval and continuing implementation difficulties, which are being addressed vigorously.

7. **The 2005/06 core budget audited financial statements were submitted to parliament in September (end-September 2006 structural performance criterion)**. In addition, a working group has been established between the ministry of finance (MoF) and the control and audit office (CAO) to follow up on the auditor's recommendations. The appeals process for customs and revenue has been established (end-September benchmark) and the training of officials is underway. Draft procedures for implementing a certified monthly payroll system (end-December benchmark) have been circulated for comments. Progress has been made on other priority reforms, which include: reorganization of the

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[1] A new tariff schedule was introduced in late August (several months later than originally planned). The reclassification of various items addressed cases of negative effective protection. There are three new tariff bands, of which two are above the previous maximum. The revenue impact of the delay in the adoption of the new tariff schedule was mitigated by reclassifying some items in the new highest tariff bands that were introduced in lieu of excises.

[2] This is equivalent to 8 percent of the approved core development budget.

budget department and the initiation of simple program budgeting pilots in selected ministries; publication of a less compressed budget calendar for 2007/08; strengthening of the large taxpayer office; and upgrading of administrative capacity in the provinces.

8. **The monetary objectives for the first six months have been attained**. Currency in circulation increased by nearly 7 percent (markedly less than the program projection of 12.5 percent) and the accumulation of net international reserves (NIR) exceeded the end-September floor by nearly US$300 million. The overperformance margins reflected the relatively slow pace of government development spending, and in the case of currency in circulation, a gradual decline in velocity. The latter possibly reflected a slowdown in the demand for Afghani cash and a gradual shift toward increased holding of Afghani deposits. Reflecting DAB's efforts to ensure compliance with prudential ratios, notably reserve requirements (to be met in Afghani) and limits on the foreign exchange open position (strictly enforced from end-August 2006), there has been marked progress in the "afghanization" of financial transactions. For their part—encouraged by sustained exchange rate stability and declining inflation—banks have begun to recognize the opportunities of dealing in local currency and have started to offer favorable conditions on deposits and transactions in Afghani, reflecting their lower costs relative to transactions in foreign exchange (especially cash).

9. **The Afghani exchange rate has remained stable due to foreign currency interventions (both selling and buying foreign exchange), while capital notes auctions have begun to play a more active role in liquidity managemen**t. Since March 2006, the Afghani-U.S. dollar exchange rate has fluctuated within a 49.5–50.5 range, except on two occasions in May when the Afghani briefly appreciated below 49.5. The interest rates on 28-day and 56-day capital notes declined from 7–8 percent in June to 5–6 percent in late September, reflecting increased demand by the banks, whose Afghani liquidity has been growing steadily (with some excess liquidity accumulating in the standing deposit facility).

10. **We continued modernizing central bank operations**. In order to foster the use of capital notes, we opened the auctions to licensed money changers, authorized the banks to bid on behalf of their clients, and introduced an overnight credit facility with capital notes as eligible collateral. We have also made progress in DAB's accounting and reporting practices. In September 2006, we began producing monthly balance sheets covering all DAB's branches. Preparations for producing the monetary survey are on track. We also completed a review of financial relations between the government and DAB and signed a service level agreement that—pending further review—preserves the status quo, which both parties found mutually agreeable.

11. **In line with the recommendations of the IMF safeguards assessment mission, the external audits of DAB's 1383 and 1384 financial statements have been completed**. The financial statements have been published on DAB's website together with the related audit opinions. The external auditors submitted to DAB a report on the reconciliation with the audited financial statements of end-1384 (March 20, 2006) NIR data reported to the IMF. Efforts are underway to address weaknesses identified by the safeguards assessment in the areas of accounting and financial reporting, internal audit, and control.

12. **Due to stronger-than-expected export performance, the trade deficit narrowed more than envisaged in 2005/06, to 34½ percent of GDP from 37½ percent in 2004/05**. There was a similar improvement in the current account deficit (excluding grants) to 42 percent of GDP and, with continued strong donor support, the current account (including grants) recorded a small surplus (around ½ percent of GDP).

13. **We redoubled our efforts to develop balance of payments statistics**. With support from an August 2006 IMF technical assistance mission, DAB compiled the results of surveys undertaken earlier in the year. The resulting draft balance of payments has been discussed with Fund staff, with a view to refining the presentation and identifying priority areas to strengthen data reporting, collection, and compilation.

14. **We have intensified our dialogue with our external bilateral creditors**. Following the July 2006 Paris Club rescheduling agreement, we have made progress toward finalizing bilateral agreements with the United States (signed in September) and Germany (draft is currently under review). We are also working on a bilateral agreement with Russia. With a view to seeking the IMF and World Bank's assessment of Afghanistan's eligibility for the Heavily Indebted Poor Countries (HIPC) Initiative, we have requested external debt data from all our bilateral creditors.[3] Most have provided the necessary data and we are following up with the remaining creditors.

15. **We have approved seven state-owned enterprises (SOE) for liquidation and appointed liquidation committees**. For three SOEs, severance packages have been granted to former employees who received job counseling and training in the context of the national skills development program. Liquidation plans are now underway, of which two are expected to be completed shortly. Lastly, we prepared corporatization procedures that are being assessed by the SOE evaluation commission.

[3] The bilateral external debt data requested for end-2004 and end-2006 are needed to assess HIPC eligibility and estimate the possible amount of debt relief at the decision point, respectively. World Bank staff have taken the lead in compiling the necessary multilateral debt data.

16. **All September 2006 quantitative performance criteria were met and we have made progress on the key structural conditions**. We also observed the continuous external debt and arrears performance criteria. While we observed the end-September 2006 structural performance criteria, we failed to meet a few structural benchmarks that reflected conscious efforts to pursue alternative approaches. We did not appoint a new Board of Directors at Bank Pashtany by end-June 2006 (benchmark) or adopt a long-term restructuring plan for Bank Pashtany by end-September (benchmark). This was due to a shift in our banking reform strategy in favor of merging Bank Pashtany with Bank Millie and the Export Promotion Bank, which was prompted by the banks' limited operational capacity and the dearth of qualified managers. The proposed merger did not however gain political support. For Bank Millie, the Board of Directors agreed on a restructuring plan in early 2006. We also postponed the processing of gold held in the palace vaults into a form that qualifies as a reserve asset (end-September 2006 structural benchmark). Implementing this measure would require transferring the gold abroad, which we felt could trigger a negative public reaction in the current volatile security context.

III. The Updated Program for 2006/07 and 2007/08

A. Macroeconomic Objectives

17. **The strategy for the remainder of 2006/07 and 2007/08 seeks to consolidate the progress achieved so far on macroeconomic stabilization, address slippages, and deepen needed financial and structural reforms**. The quantitative targets for the remainder of this fiscal year and 2007/08 have been set accordingly (Table 1). The updated program projects growth rising from 8 percent in 2006/07 to 12 percent in 2007/08, with inflation declining from 7–8 percent in 2006/07 to 5 percent in 2007/08. The original growth objective of 12 percent this year is out of reach, as agricultural production declined significantly due to insufficient rainfalls in the spring. The original inflation projection of 9 percent has been revised downward in view of the inflation outcome through midyear and the expected moderate rise in food, rent, and petroleum prices over the remainder of the year.

B. Fiscal Policy

18. **The good revenue performance is expected to continue during the second half of 2006/07**. Revenue for the year as a whole is envisaged to be around Af 27.0 billion (6.4 percent of GDP), slightly above the original program target of Af 26.6 billion and significantly exceeding the 2005/06 outcome of Af 20.7 billion (5.7 percent of GDP). In the event of a revenue shortfall, we stand ready to introduce offsetting expenditure measures.

19. **Operating expenditures are expected to reach Af 44.2 billion (10.5 percent of GDP), as some unanticipated spending pressures that emerged in the mid-year budget review (MYR) are being accommodated in an amended budget for 2006/07**. These unanticipated outlays include:

- **Expenditures previously funded by donors, namely the cost of fuel to power several electric plants (0.6 percent of GDP)**. The scope for reducing the net cost of the fuel subsidy this fiscal year is limited, except for an increase in electricity tariffs—a measure already taken—and the envisaged improvement in collection. The expected increase in electricity revenue will help bring down the net subsidy by at least Af 150 million this year. Looking ahead, we envisage offsetting measures to reduce it further (a study is currently being prepared in collaboration with donor partners), including through importation of electricity from neighboring countries.

- **Additional spending associated with the deteriorating security situation in the south** necessitated the recruitment of auxiliary police. Their employment will be temporary (based on one-year contracts). Additional donor support is expected to cover these increased security costs (about 0.2 percent of GDP).

- **Additional teachers** identified by a joint investigation of the civil service commission, the MoF, and the ministry of education (MoE) (outlined in our May 2006 MEFP) regarding the number and location of all civil servants in the MoE. This investigation revealed that about 10,000 additional teachers must be recognized in the government payroll. The corresponding cost (0.1 percent of GDP) will be covered by the contingency included in the approved budget, which, however, was not part of the fiscal program for the first half of the year but the May 2006 MEFP foresaw the possibility of accommodating this expenditure in the context of the MYR. These supplementary expenditures have been discussed and agreed with our donor partners. A similar investigation at the Ministry of Interior is under way, but since it is not complete, no adjustment will be made in this year's budget.

- **Clearing of domestic arrears**. Once the delays in paying salaries in a limited number of provinces have been confirmed by the CAO (MoF's request for verifying the Tashkeel and arrears is an end-January 2007 structural benchmark), we will make provisions to settle these obligations as soon as possible. We have also taken stock of outstanding government obligations to the telephone and electricity utilities. The total cost of all arrears is equivalent to 0.2 percent of GDP.

- **Other expenditure pressures** representing an estimated 0.2 percent of GDP were met through savings and reprioritization and will not affect our overall fiscal balance.

20. **Reflecting the above developments, the operating budget deficit, excluding grants, will be contained at 4.1 percent of GDP in 2006/07, compared with 2.9 percent originally envisaged under the program**. We expect to cover the deficit through a

combination of increased grants, receipts from the sale of the GSM license, and a drawdown of government deposits at DAB. After grants, our operating budget balance is now expected to show a surplus of 0.3 percent of GDP, compared with a programmed surplus of 1 percent of GDP.

21. **In 2007/08, the operating budget deficit excluding grants would decline to 2.8 percent of GDP; nonetheless, it will still be above the 1.7 percent projected in the original program**.[4] The higher deficit mainly reflects an increase in operating expenditures to Af 49.8 billion (10.1 percent of GDP against a program target of 8.5 percent). Higher spending is attributable to (a) the recurrent cost of the fuel subsidy;[5] (b) security-related pressures; (c) the inclusion of higher operating costs of the development budget; and (d) higher provisions for pensions. However, since donors have agreed to finance many of these additional pressures, the operating budget surplus including grants is projected to increase from 0.6 percent of GDP in the original program to 1.0 percent of GDP. In particular, our international partners have agreed to maintain the same level of funding for the multi-donor Afghanistan Reconstruction Trust Fund over the next few years and indicated their intention to increase their support to the Law and Order Trust Fund.

22. **Due to uncertainty over funding, not all the security-related expenditure pressures have been addressed in our program**. Any additional security expenditures will only be undertaken on the condition that they are fully funded by donors, thus leaving our operating budget deficit, including grants, unchanged.[6] Total additional expenditures could be as much as 0.5 percent of GDP. In order to ensure appropriate parliamentary engagement in the budget process, we will send the 2007/08 draft budget to parliament at least 45 days before the start of next fiscal year, as required by law (February 4, 2007 structural performance criterion).

23. **We remain committed to our stated objective of medium-term fiscal sustainability**. Cognizant of developments in the country, we reaffirm the objectives agreed with international partners:

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[4] The September 2007 targets on revenue and the fiscal deficit are set out in Table 1.

[5] Should any of the additions to the budget for the fuel subsidy not be needed for this purpose, we will discuss with our donor partners their reallocation.

[6] Additional security expenditures are those above what was identified in our MTFF and include: the cost of the auxiliary police; accelerated recruitment in the Afghan National Army (ANA) and Afghan National Police (ANP) to reach full staffing and more generous pay and rank reform in the ANA and ANP to encourage recruitment and retention.

- An overall objective of covering all core operating expenditures from domestic revenues. Assuming no new unfunded transfers from the external budget to the core budget, this objective would be achieved in 2010/11, one year later than originally envisaged.

- The ratio of revenue to estimated total recurrent expenditures (including estimated recurrent expenditures in the core and external development budgets), is projected to rise from 28 percent in 1383 (2004/05) to 58 percent in 1389 (2010/11).

- Afghanistan's total domestic budgetary revenue—equivalent to 4.5 percent of estimated non-opium GDP in 2004/05—will steadily increase, reaching 8 percent of GDP by 2010/11. Barring unforeseen developments, we currently expect to meet this objective one year ahead of schedule.

- We recognize that the deficit, excluding grants, may exceed the targeted level due to an unexpected increase in grant-financed expenditures. However, we will attempt to achieve the deficit target excluding grants, since we are mindful that donor support may not be permanent. Nonetheless, adjustors have been added to our NIR and NCBF targets for additional security expenditures discussed in ¶22.

24. **These targets are ambitious and we recognize the need for sustained efforts to boost revenue**. Notwithstanding progress to date in a very difficult environment, we will continue to modernize tax and customs administration. In this vein, we will:

- Clarify the tax policy framework, and system including the difference between the BRT and income taxes (end-July 2007 structural benchmark).

- Resubmit to parliament legislation to eliminate nuisance taxes (end-March 2007).

- Move towards a broad-based consumption tax by submitting to parliament the GST/BRT legislation by March 2008 and begin implementation within 6 months of passage of the bill by parliament.

- Implement by end-September 2007, on a pilot basis, the transfer of accountability for administration of all Kabul large and medium-size taxpayers directly to the revenue department.

- Clarify and document the roles of the various agencies currently operating at the borders (end-March 2007).

- Establish a steering committee chaired by the Minister of Finance to monitor implementation of the tax and customs administration modernization plans (end-January 2007).

- Study options to reverse, over the medium term, customs tariff increases as excise taxes are introduced on selected goods.

25. **We will continue to exercise expenditure discipline in the operating budget and improve overall public financial management**. In this regard, and building upon the recent progress made in restructuring our budget department along sectoral lines, we are piloting a simple program approach for the 2007/08 budget in selected ministries. These changes are expected to further consolidate the recurrent and core development budgets and improve the relationship between the MoF and line ministries. We will adopt additional measures to enhance the credibility and effectiveness of our core budget, including:

- Presenting the 1384 budget performance report to parliament as required under the PFEM Law, article 55–59 (end-January 2007).

- Promptly eliminating the backlog of development budget payments unrecorded in AFMIS (end-January 2007).

- Reviewing allotment, contracting, commitment and cash management procedures for the development budget in order to remove bottlenecks and increase their effectiveness (end-March 2007).

- Building on pilots to prepare the 2008/09 consolidated core budget according to a simple program and economic classification structure, and developing financial management capacity in the line ministries.

- Continuing to strengthen our medium-term fiscal framework as an instrument to define macro-fiscal constraints. We aim to have cabinet agreement on the medium-term fiscal strategy, consistent with our agreed program with the IMF in January 2007, and then publish this alongside our aggregate macroeconomic figures (end-March 2007).

- Strengthening the tracking of commitments and expenditures from the external development budget, including through the use of common reporting formats that we will agree to with our large donors. We will also coordinate reporting between the Aid Coordination Unit and the Treasury.

C. Monetary and Exchange Rate Policy and Financial Sector Reforms

26. **We have revised the monetary program for the remainder of 2006/07 to lower the growth in currency in circulation, consistent with the lower-than-originally expected inflation in the first half of the fiscal year**. In support of the monetary (currency in circulation) targets, we will continue to manage flexibly the exchange rate to preserve confidence in the Afghani. Our goal is to achieve the currency in circulation targets with minimum exchange rate volatility. Although the expected acceleration in government

spending is likely to cause a significant upward shift in the demand for currency during the coming months, the increase in currency in circulation should not exceed 16.6 percent (one percentage point above the projected nominal GDP growth) by end-2006/07, compared with 18.4 percent in the original program.

27. **Looking forward to 2007/08, we expect that growth in currency in circulation will be about two percentage points less than nominal GDP growth (18½ percent)**. This target reflects technological improvements in banking services—including banks' management of government payroll and other government expenditure previously paid for in cash—and increased financial deepening expected to result in a shift in the transactions demand for money away from cash toward deposits. International reserves are expected to rise prudently from slightly below \$1.8 billion in September 2006 to just above \$1.9 billion in September 2007, ensuring a reserve cover of about 5 months of the following year's imports of goods and services.

28. **We remain committed to modernizing the central bank as envisaged in the original program (paragraph 31 of our May 15 MEFP)**. To further the objectives of the program, we will also undertake the following actions in the monetary area.

- DAB will develop a monthly monetary survey in line with international standards (end-July 2007 structural benchmark).

- In order to further improve DAB liquidity management and develop the Afghani financial market, DAB will expand the volume and use of capital notes and will launch (starting end-January 2007) auctions of 182-day capital notes. The volumes of capital notes auctions will be determined by the Monetary Policy Committee in coordination with DAB's Monetary Policy Department and the Market Operations Department, taking into account the monetary policy objectives and the market's liquidity needs.

- DAB will take the necessary steps to facilitate (end-February 2007) secondary trading of capital notes. To this effect, DAB will issue procedures for clearing and settling secondary trades of CN, strengthen the legal and regulatory foundations for such trading (with technical assistance from the Fund), and discuss the process with banks.

- By end-January 2007, DAB will amend the reserve requirement regulations to set the penalty rate for bank's shortfalls in complying with the requirements at a rate 300 basis points above that of the overnight collateralized credit facility for the second consecutive offense.

- On the basis of on-site inspections, DAB's Banking Supervision Department will prepare a summary report on banks' compliance with prudential regulations, which will assess threats to the stability of the banking system (e.g., stemming from risk concentration and connected lending) (end-July 2007).

- The Directorate General of Treasury (DGT) of the MoF will prepare and submit to DAB its monthly liquidity forecast for three months ahead, and will update this forecast on a monthly basis, starting end-January 2007.

29. **We will make further efforts to restructure the state-owned banks and reform the banking sector**. With support from external advisors, the MoF will prepare a restructuring plan for Bank Pashtany. For that purpose, we have requested technical assistance with a view to having advisers in place by end-March 2007 and a restructuring plan for Cabinet submission by end-July 2007 (structural benchmark). We are also seeking Cabinet approval of our restructuring plan for Bank Millie (end-March 2007 structural benchmark) and are in the process of recruiting advisors to help in its implementation. The restructuring of the two banks will enable them to meet by end-September 2007 the licensing conditions set by DAB's Banking Supervision Department. We will continue the liquidation process for the non-licensed state-owned banks (four out of six are in various stages of liquidation). In this context, we will publish a statement announcing the liquidation of the Export Promotion Bank or its merger with another licensed commercial bank (end-January 2007 structural benchmark), and finalize the transfers of its deposits in about six months. An adviser will be working at the MoF to oversee the bank restructuring. We will also take steps to be able to adopt by end-March 2007 the set of core enabling laws for commercial banking, including laws on secure transactions, negotiable instruments, and mortgages.

30. **We are committed to improving DAB's operations consistent with the principles of good governance included in the IMF's safeguards assessment report**. To provide assurances with regard to the level of DAB's foreign reserves, we will request the external auditors to reconcile the net foreign reserves data reported to the Fund with the underlying bank/creditor statements, and we will commission special audits of reserves for each of the test dates under the program (end-July 2007). We will also proceed with the implementation of the new integrated accounting system at DAB (end-March 2007 and end-September 2007 structural benchmarks).

D. External Sector Policies

31. **The current account deficit (excluding grants) is expected to stay largely unchanged at just under 42 percent of GDP in 2006/07**. An expected pick-up in development spending in the second half of the year, as well as some increase in other

budgetary expenditures (e.g., security-related), will contribute to higher-than-originally anticipated imports. Additional external resources will ensure that reserve accumulation remains in line with the program.

32. **We expect the medium-term balance of payments position to remain manageable**. While the current account (excluding grants) should improve, it could still average around 35 percent of GDP over the next few years on account of our sizeable investment and reconstruction needs. Even with a moderate tapering off of official transfers, the current account deficit (including grants) could widen to over 7 percent by 2009/10. This underscores the importance of sustained support from the international community.

33. **We also remain committed to a prudent debt management strategy**. First, and foremost, we will rely primarily on grant financing, supplemented by highly concessional borrowing. We intend not to contract or guarantee any nonconcessional debt (continuous performance criterion) and will also work expeditiously to regularize our relations with bilateral creditors. We intend to finalize the bilateral agreements with Paris Club creditors and intensify our efforts to obtain the outstanding bilateral debt data. We aim to complete the debt database to allow for an assessment of HIPC eligibility in early 2007.

34. **We are committed to maintaining a liberal and transparent trade regime**. To this end, we will refrain from reclassifying more goods into the two new top tariff bands, and will work to unwind the tariff increases as the revenue situation allows. We are also committed to maintaining a foreign exchange system free of restrictions and to making further progress toward establishing its legal framework. In this regard, we would welcome further IMF technical support to allow us to formalize our restriction-free exchange rate system, and to accept the obligations under Article VIII, Sections 2, 3, and 4 of the Fund's Articles of Agreement.

E. Other Structural Reforms

35. **In addition to fiscal and banking reforms outlined above, and with the support of the international community, we will press ahead with measures** aimed at: (a) updating, modernizing, harmonizing and simplifying legislation, regulations and procedures related to private investment. In this context, we aim at (a) adopting by end-March 2007 laws on partnerships and corporations; (b) further disengaging the state from economic activities by liquidating or corporatizing 11 additional SOEs; and (c) adopting a comprehensive restructuring/divestment plan for public entities and government agencies engaged in commercial activities but not covered by the SOEs law (end-March 2007 structural benchmark).

F. PRSP

36. **With support from donors and building on the I-ANDS, we are actively preparing the PRSP**. We intend to use the findings of the 2005 National Risk Vulnerability Assessment (NRVA) survey—which uses a sample of 31,000 households nationwide—to build a poverty profile that will underpin our poverty analysis, and provide input for the sectoral strategies. We will continue our efforts to develop an institutional framework for ANDS consultations, organize the thematic and regional workshops, and define a set of major issues to be raised during consultations. Lastly, we are continuing preparations to ensure that the medium-term fiscal framework will be aligning expenditures with our ANDS objectives. We intend to complete the ANDS by mid-2008.

G. Statistical Issues and Technical Assistance

37. **Afghanistan has extensive technical assistance needs. We will continue to work closely with our development partners to build administrative capacity in priority areas**. These include tax and customs administration, civil service reform, monetary and exchange rate policy, and banking reform. Assistance will also be needed to improve economic statistics, notably for national accounts, the balance of payments, and social/poverty indicators. We are committed to improving the national statistical base and implementing the statistical master plan. We plan to:

- Launch the Integrated Business Enterprise Survey and the Integrated Living Standards Survey (or Household Income Expenditure Survey) by end-March 2007, the findings of which will help upgrade the social database and serve as a basis for improving the national accounts and modernizing the consumer price index;

- Strengthen mandatory reporting to DAB of balance of payments data by the nonbank sector by adopting new legal provisions (end-March 2008) specifying: (a) power and authority of DAB to request data on all resident sectors; (b) confidentiality of reported data; and (c) penalties for noncompliance, misreporting, and breach of confidentiality;

- Conduct quarterly foreign direct investment surveys using updated information from the Afghanistan Investment Support Agency records, beginning end-March 2007;

- Organize data sharing arrangements between DAB and the MoF on current transfers, capital transfers, and duty-free imports;

- Launch a second border trade survey by end-March 2007.

IV. Program Monitoring

38. **With regard to program monitoring, we are proposing quantitative performance criteria for end-March 2007 and indicative targets for end-December 2006 and end-June 2007**. The second review under the arrangement is scheduled to be completed by July 2007 and will be conditional upon compliance with the end-March 2007 quantitative performance criteria and specified structural conditionality (Tables 1 and 2). Key structural benchmarks and structural performance criteria for the second review will continue to focus on improvements in the financial and fiscal areas, strengthening our statistical capacity, and public enterprise reform.

Table 1. Islamic Republic of Afghanistan: Performance Criteria and Indicative Targets for 2006/07–2007/08 1/

(Cumulative changes from March 20, 2006; unless otherwise indicated)

	Program											
	Jun. 21, 2006			Sep. 21, 2006			Dec. 20, 2006		Mar. 20, 2007		Jun. 21, 2007	Sep.
	Indicative Targets	Adjustment Targets	Actual Performance	Performance Criteria	Adjust. Targets	Actual Performance	Original Targets 2/	Revised Targets	Original Targets 2/	Performance Criteria	Indicative Targets 3/	Ind Tar
Quantitative performance criteria and benchmarks												
	(In millions of Afghanis)											
Floor on fiscal revenue of the government	5,317	5,317	5,375	10,636	10,636	11,990	17,201	18,668	26,595	27,015	7,405	
Ceiling on currency in circulation	2,794	2,794	-1,373	5,587	5,587	3,063	6,910	4,672	8,233	7,395	1,904	
Ceiling on net central bank financing of the government	3,587	1,326	-4,801	9,042	9,134	-501	8,254	3,252	1,242	4,223	454	
Indicative target (ceiling) on the operating budget deficit of the government, excluding grants	4,561	4,561	370	9,120	9,120	5,234	12,432	11,805	12,915	17,185	5,044	
	(In millions of U.S. dollars)											
Floor on net international reserves of DAB	-124.3	-79.0	69.1	-198.6	-200.4	98.9	-217.2	69.4	-68.5	94.0	14.6	
Zero ceiling on contracting or guaranteeing new medium- and long-term nonconcessional external debt by the government and DAB 4/	0	0	0	0	0	0	0	0	0	0	0	
Zero ceiling on short-term external debt owed or guaranteed by the government or DAB 4/	0	0	0	0	0	0	0	0	0	0	0	
Nonaccumulation of new external payments arrears, excluding interest on preexisting arrears 4/	0	0	0	0	0	0	0	0	0	0	0	
Memorandum item:												
	(In millions of Afghanis)											
The operating budget deficit of the government, including grants	…	…	-2,246	…	…	2,038	…	909	…	-1,410	2,492	
Reference Projections for the Adjustors												
	Program	Actual	Deviation	Program	Actual	Deviation	Program	Revised	Program	Revised	Program	
Core budget development spending	3,741	167	-3,574	11,222	5,467	-5,755	18,704	20,372	29,926	35,276	5,512	
External financing of the core budget and sale or transfers of nonfinancial assets	4,715	6,976	2,261	11,300	11,208	-92	22,882	27,972	41,599	46,464	10,102	
Expenditure currently financed outside the budget moved onto the operating budget	0	0	0	0	0	0	0	0	0	0	0	

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

1/ The performance criteria and indicative targets envisaged under the program, and their adjustors, are defined in the Technical Memorandum of Understanding.
2/ Former indicative targets that were tentatively set at the time of the PRGF approval.
3/ Cumulative changes from March 20, 2007.
4/ These performance criteria apply on a continuous basis.

Table 2. Islamic Republic of Afghanistan: Structural Performance Criteria and Structural Benchmarks, September 2006–September 2007

First Review Under the PRGF Arrangement

Structural Performance Criteria	Target Dates	Status
Submit to parliament the core budget's audited financial statements for 2005/06.	September 30. 2006	Implemented
Structural Benchmarks	**Target Dates**	**Status**
Appoint a new Board of Directors at Bank Pashtany.	June 30, 2006	Not Implemented 1/
Adopt by shareholders long-term restructuring plans for Bank Millie and Bank Pashtany.	September 30, 2006	Not Implemented 1/
Publish a public statement announcing the liquidation of Export Promotion Bank or its merger with another licensed commercial bank, and finalize the transfer of its deposits.	September 30, 2006	Not Implemented 1/
Establish by MoF appeals process for customs and tax administrations.	September 30, 2006	Implemented
Submit to parliament the 2004/05 and 2005/06 external audits of DAB.	September 30, 2006	Implemented 2/
Process gold held in the palace vaults into a form that qualifies as a reserve asset.	September 30, 2006	Not Implemented
Establish a certified monthly payroll system.	December 31, 2006	Implemented
Submit to parliament legislation to eliminate nuisance taxes and introduce an excise tax on selected goods from the start of 2007/08.	December 31, 2006	Not Implemented

Second Review Under the PRGF Arrangement

Structural Benchmarks	Target Dates	Status
Request verification by the Control and Audit Office of the 2006 reviews of the Tashkeel at the Ministry of Interior and Ministry of Education and the related arrears from 2005/06.	January 31, 2007	Implemented
Make a public statement announcing the liquidation of the Export Promotion Bank or its merger with another licensed commercial bank.	January 31, 2007	Implemented
Submit to Cabinet a restructuring plan for Bank Millie.	March 31, 2007	
Adopt a comprehensive restructuring/divestment plan for the public entities and government agencies engaged in commercial activities but not covered by the SOEs law.	March 31, 2007	
Implement an integrated accounting system at DAB headquarters.	March 31, 2007	

Third Review Under the PRGF Arrangement

Structural Performance Criteria	Target Dates	Status
Submit to parliament the core budget's audited financial statement for 2006/07.	September 21, 2007 3/	
Structural Benchmarks	**Target Dates**	**Status**
Develop a monthly monetary survey in line with international standards.	July 31, 2007	
Clarify the tax policy framework and system, including separating the legislation of the BRT and income taxes.	July 31, 2007	
Prepare (and submit to Cabinet) a restructuring plan for Bank Pashtany.	July 31, 2007	
Expand the automated integrated accounting system to DAB branches.	September 30, 2007	

1/ These benchmarks were not met owing to the authorities' decision in August 2006 to merge the three state-owned banks. However, the decision to merge these banks was subsequently reversed.

2/ The audits were submitted to parliament in October 2006.

3/ This deadline is consistent with the requirement stated in the Public Finance and Expenditure Management (PFEM) Law that the core budget financial statements be submitted to parliament at least six months before the end of the fiscal year.

TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This memorandum sets out the understandings between the Afghan authorities and Fund staff relating to the monitoring of the Poverty Reduction and Growth Facility (PRGF)-supported program approved by the IMF Executive Board on June 26, 2006. In particular, it defines the benchmarks and performance criteria for the second and the third review of the program. Section I defines the structural performance criterion and benchmarks; Section II defines the principal concepts and financial variables, including the quantitative performance criteria and indicators; and Section III relates to the reporting requirements.

I. STRUCTURAL PERFORMANCE CRITERION AND BENCHMARKS

2. The structural performance criterion and benchmarks for the second and the third review specified in Table 2 of the MEFP are defined as follows:

Performance criterion

- **Submit to parliament the core budget's audited financial statements for 2006/07 by September 21, 2007**. The PFEM law requires the government to submit an independent audit report of the core budget financial statements to parliament at least six months before the end of the fiscal year. The report will be prepared by the Control and Audit Office in accordance with international accounting principles.

Structural benchmarks

- **Request verification by the CAO of the 2006 reviews of the Tashkeel and Ministry of Interior and Ministry of Education, and the related arrears for 2005/06**. The CAO should be informed of the Tashkeel investigations and asked to verify the procedures for arriving at the new Tashkeel levels.

- **Make a public statement announcing the liquidation of Export Promotion Bank or its merger with another licensed commercial bank, and finalize the transfer of its deposits**. The public statement will be made by the shareholders.

- **Adopt a comprehensive restructuring/divestment plan for public entities and government agencies engaged in commercial activities but not covered by the state-owned enterprises law**. This restructuring/divestment plan will reflect the necessary steps and tasks entailed by the restructuring/divestment process and a schedule for their implementation. The plan will be adopted by the Cabinet.

- **Develop a monthly monetary survey in line with international standards**. The monetary survey should be the consolidation of the accounts of DAB and of the commercial banks. The data should be presented in the format recommended by the Fund's Monetary and Financial Statistics mission of March 2006. DAB accounts will include the accounts of its headquarters, as well as those of its branches.

- **Clarify the tax policy framework and system, including the difference between the BRT and income taxes**. The framework should set out the nature, role, supporting legislation, and expected contribution to fiscal objectives of the various taxes either currently in effect (e.g. income tax) or planned for the future (e.g. the amendments to the BRT), including separating pieces of legislation or one tax code with different chapters for different tax types.

- **Submit to Cabinet a restructuring plan for Bank Millie**. The plan will present and justify the restructuring of the bank with a view to its remaining in the public domain. The plan should specify and cost the measures that will be put in place to ensure the long-term financial sustainability of the bank, including measures aimed at strengthening management and supervision, enhancing productivity, and modernizing lending policies and procedures.

- **Implement an integrated accounting system at DAB.** The Core Banking System should address the shortcomings of the present system and allow timely completion of the DAB's financial statements for FY 1385. The system shall be capable of producing data needed for DAB's financial reporting including monthly balance sheet, monthly central bank operations table and monetary survey.

- **Prepare (and submit to Cabinet) restructuring plans for Bank Pashtany**. The plan will present and justify the restructuring of the bank with a view to its remaining in the public domain The plan should specify and cost the measures that will be put in place to ensure the long-term financial sustainability of the bank, including measures aimed at strengthening management and supervision, enhancing productivity, and modernizing lending policies and procedures.

- **Expand the integrated accounting system to DAB branches**.

II. Quantitative Performance Criteria and Indicative Targets

3. The quantitative performance criteria and indicative targets specified in Table 1 of the MEFP are:

- a floor on fiscal revenue of the central government;

- a ceiling on currency in circulation;

- a ceiling on the net central bank financing (NCBF) of the central government;
- a floor on net international reserves (NIR);
- a zero ceiling on contracting and/or guaranteeing new medium- and long-term nonconcessional external debt by the government and DAB;
- a zero ceiling on short-term external debt owed or guaranteed by the government or DAB;
- a zero ceiling on the accumulation of external payment arrears, excluding interest on preexisting arrears; and
- an indicative target (ceiling) for the operating budget deficit of the central government, excluding grants.

A. Program Exchange Rate

4. Program exchange rates will be used for purposes of monitoring the quantitative targets under the program. All foreign assets and liabilities denominated in U.S. dollars will be converted into Afghanis using a program exchange rate of 49.94 Afghanis per U.S. dollar, which corresponds to the average of the US$/Af buy and sell cash rates, as reported by the DAB as of March 20, 2006. For assets and liabilities denominated in SDRs and in foreign currencies other than the U.S. dollar, they will be converted into U.S. dollars at their respective exchange rates prevailing as of February 28, 2006, as reported in the following table. Gold holdings will be valued at US$552.85 per ounce, the price as of March 20, 2006.

Exchange rate	Program rate
Dollar/Canadian Dollar	0.861700
Dollar/UAE Dirham	0.272280
Dollar/Egyptian Pound	0.174370
Dollar/Euro	1.190650
Dollar/Hong Kong Dollar	0.128841
Dollar/Indian Rupee	0.022532
Dollar/Pakistani Rupee	0.016633
Dollar/Polish Zloty	0.306876
Dollar/Iranian Rial	0.000109
Dollar/Saudi Rial	0.266640
Dollar/Russian Ruble	0.035660
Dollar/Swiss Franc exchange rate	0.760980
Dollar/UK Pound exchange rate	1.736050
Dollar/SDR	1.447570

B. Currency in Circulation

5. **Currency in circulation** is defined as total currency 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.[1]

C. Net Central Bank Financing of the Government

6. **NCBF of the government** is defined as the difference between the central bank's claims on the government and the deposits of the government with DAB. These deposits include the deposits held at DAB headquarters, but exclude the deposits held at DAB's branches.[2]

D. Net International Reserves

7. **Net international reserves (NIR)** are defined as reserve assets minus reserve liabilities of DAB.

8. **Reserve assets of DAB**, as defined in the fifth edition of the balance of payments manual (BPM5), are claims on nonresidents denominated in foreign convertible currencies, that are controlled by DAB, and are readily and unconditionally available for DAB to meet balance of payments financing needs, intervention in exchange markets, and other purposes. They include DAB holdings of monetary gold, SDRs, Afghanistan's reserve position in the IMF, foreign currency cash (including foreign exchange banknotes in the vaults of DAB, but excluding cash held in DAB's branches), and deposits abroad (including balances on accounts maintained with overseas correspondent banks). Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered;[3] claims on residents; precious metals other than monetary gold; assets in nonconvertible currencies; illiquid assets; and claims on foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options).

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[1] This definition differs slightly from international standards owing to the unavailability of reliable and timely currency data from DAB's district branches.

[2] This definition differs slightly from international standards owing to the unavailability of reliable and timely government deposit data from DAB's branches.

[3] In particular, assets that are counterpart of the government's foreign currency deposits that back letters of credit are excluded from reserve assets. However, assets that are counterpart of other government deposits are included in the reserve assets.

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

10. Reserve assets and reserve liabilities will both be expressed in U.S. dollars.

E. Revenues of the Central Government

11. **Revenues of the central government** are defined in line with the Government Financial Statistics manual (GFSM 2001) on a cash accounting basis, excluding foreign grants. Revenue is an increase in net worth of the central government (including its units in the provinces and agencies) resulting from a transaction. Revenues of the central government include taxes and other compulsory transfers imposed by central government units, property income derived from the ownership of assets, sales of goods and services, social contributions, interest, fines, penalties and forfeits and voluntary transfers received from nongovernment other than grants. A non-exhaustive list of revenues include: corporate income tax, personal income tax, business receipts tax, taxes on properties, fixed withholding taxes on imports and exports, excise taxes, presumptive taxes in lieu of the income tax, import duties, and other charges and fees. The definition for program monitoring excludes grants and other non-compulsory contributions received from international organizations and such transfers between central government units would be eliminated in the consolidation of the fiscal reports and not recorded as revenue. Receipts collected by central government on behalf of non-central government units should not be counted as revenue (e.g., Red Crescent fees). Receipts from the sale of nonfinancial assets, such as privatization, and transactions in financial assets and liabilities, such as borrowing but excepting interest payments, are also excluded from the definition of revenue.

12. Revenues should be recognized on a cash basis and flows should be recorded when cash is received. It excludes any revenues received prior to March 21, 2006 but where funds are not transferred to government's accounts at DAB by this date. Exceptional advanced payments will be treated as if received on the normal due date. All revenue must be supported by the relevant documentation and revenue receivables, where a cash sum has been recorded but the revenue item has not yet been accounted for, and revenues payable, where the revenue has been reported but the cash has yet to be recorded should be separately reported on a gross basis.

F. External Debt and Arrears

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

- Debts can take a number of forms, the primary ones being: (a) loans, (i.e., advances of money to obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future—including deposits, bonds, debentures, commercial loans and buyers’ credits—and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements); (b) suppliers’ credits (i.e., contracts where the supplier permits the obligor to defer payments until some time after the date on which the goods are delivered or services are provided); and (c) leases (i.e., arrangements under which property is provided that the lessee has the right to use for one or more specified period(s) of time that are usually shorter than the total expected service life of the property, while the lessor retains the title to the property). Excluded from this limit are leases of real property by Afghan embassies or other foreign representations of the government.

- For the purpose of the guideline, the debt is the present value (at the inception of the lease) of all lease payments expected to be made during the period of the agreement excluding those payments that cover the operation, repair, or maintenance of the property. Arrears, penalties, and judicially-awarded damages arising from the failure to make payment under a contractual obligation that constitutes debt are debt. Failure to make payment on an obligation that is not considered debt under this definition (e.g., payment on delivery) will not give rise to debt.

14. **The ceiling on medium- and long-term external debt applies on a continuous basis to the contracting or guaranteeing by the government or DAB of new nonconcessional external debt with an original maturity of more than one year.** For program purposes, “government” includes the central government (including government departments), as well as official agencies that do not seek profit and whose budgets are issued independent of the annual operational or development budgets. Consistent with the PFEM law, the MoF should have sole responsibility for the contracting and guaranteeing of external debt on behalf of the government.

- **It applies to** both debt as defined in paragraph 13 of this memorandum, and also to commitments contracted or guaranteed for which value has not been received. For the purposes of the program:

  - external debt will be considered to have been contracted at the point the loan agreement or guarantee is signed by the MoF (on behalf of the government) or DAB Governor; and

  - 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.

- **Excluded** from the limits are refinancing credits and rescheduling operations, credits extended by the IMF, and credits on concessional terms defined as those with a grant element of at least 60 percent. The grant element is to be calculated using currency-specific discount rates based on the Organization for Economic Co-operation and Development Commercial Interest Reference Rates (CIRRs): for maturities of less than 15 years, the grant element will be calculated based on six-month averages of CIRRs; and for maturities longer than 15 years, the grant element will be calculated based on 10 year averages.

- Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract or guarantee becomes effective.

15. **The ceiling on short-term external debt** applies on a continuous basis to the stock of short-term external debt owed or guaranteed by the government (as defined in paragraph 14 of this memorandum) or the DAB, with an original maturity of up to and including one year.

- **It applies to** debt as defined in paragraph 13 of this memorandum.

- **Excluded** from the limit are rescheduling operations (including the deferral of interest on commercial debt) and normal import-related credits.

- Debt falling within the limit shall be valued in U.S. dollars at the exchange rate prevailing at the time the contract or guarantee becomes effective.

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

accumulation of new arrears are: (a) arrears arising from interest on the stock of arrears outstanding as of March 20, 2006; and (b) external arrears that are subject to debt rescheduling agreements or negotiations.

G. Adjustors

17. The floor on NIR and the ceiling on the NCBF of the government are defined consistent with the assumption that core budget development spending will amount, on a cumulative basis from March 20, 2006, to:

December 20, 2006	Af 20,372 million
March 20, 2007	Af 35,276 million

and from March 20, 2007, to:

June 21, 2007	Af 5,512 million
September 21, 2007	Af 16,536 million

Should core budget development spending exceed these projections, the NIR floor will be adjusted downward and the NCBF ceiling will be adjusted upward by the difference between the actual level (up to the appropriated amount) and the projected level of development spending.

18. The NIR floor and NCBF ceiling are defined consistent with the assumption that the external financing of the core budget and the receipts from the sale or transfer of nonfinancial assets will amount, on a cumulative basis from March 20, 2006, to:

December 20, 2006	Af 27,972 million
March 20, 2007	Af 46,464 million

and from March 20, 2007, to:

June 21, 2007	Af 10,102 million
September 21, 2007	Af 22,145 million

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

19. Should some expenditure currently financed directly by donors outside the budget be moved on to the operating budget, the NIR floor will be adjusted downward, and the NCBF ceiling and the indicative targets (ceilings) for the operating budget deficits of the central government, excluding grants, will be adjusted upward, by the actual amount of these expenditures on the conditions that (a) the moving on budget of these expenditures is justified by a statement from donors indicating their decision to stop financing them outside the budget and (b) they are subject to a supplementary appropriation approved by parliament.

20. Should the central government undertake urgent security-related expenditures in excess of budgetary appropriations (MEFP, ¶22), the NIR floor will be adjusted downward, and the NCBF ceiling and the indicative target (ceiling) for the operating budget deficit of the central government, excluding grants, will be adjusted upward to the extent that these expenditures are executed with the use of additional grants provided by donors, based on spending plans agreed between the central government and the donors. These adjustments will apply starting with the fiscal year 2007/08. The cumulative downward adjustment to the NIR floors at June 21, 2007 and September 21, 2007 will be capped at US$76 million. The cumulative upward adjustment to the NCBF ceilings and the indicative targets (ceilings) for the operating budget deficits of the central government, excluding grants, at June 21, 2007 and September 21, 2007 will be capped at Af 3.8 billion.

21. The overall downward adjustment to the NIR floors will be capped at US$375 million.

III. Provision of Information to Fund Staff

22. To facilitate the monitoring of program implementation, the government of Afghanistan and DAB will provide to Division A of the Middle East 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.

23. In order to facilitate regular monitoring of the PRGF-supported program, actual outcomes should be provided with the frequencies and lags indicated below.

- **DAB net international reserves** should be reported weekly, no later than two weeks after the end of the week.

- **Monetary statistics, including exchange rates, government accounts with DAB, and currency in circulation** should be reported monthly and no later than three weeks after the end of the month. Monetary statistics will also include a monetary survey (quarterly, and then monthly starting in March 2007), including balance sheets of DAB and a consolidated balance sheet of the commercial banking sector.

- **Operational budget operations and their financing** should be reported monthly and no later than four weeks after the end of the month. **Core development budget operations and their financing** should also be reported monthly and no later than four weeks after the end of the month. The structure of financing (grants and loans should be separately identified) and expenditure data should be on a consistent cash basis. Core operating expenditures should be reported on a monthly basis using the budget appropriation economic (Object) and administrative classification in addition to the program and functional classification as reported in the budget documents. Core development expenditures should also be reported separately on a monthly basis using the budget program classification in addition to the economic (Object), administrative and functional classification consistent with the operating budget. All the data should also compare outturns as recorded in AFMIS against the approved budget (or figures reported in the budget documents). Core operating and development revenues and expenditures should also be reported by province, separately on the same monthly basis.

- **External budget operations and their financing** (i.e., donor funded spending outside the core budget treasury systems) should be reported at least semi-annually (more frequently if possible) and no later than eight weeks after the end of the period. External development expenditures should be reported on a disbursement basis (as currently defined in budget documents) using the budget program classification (and an administrative, functional and provincial classification where possible).

- **External debt data** should be reported quarterly and no later than six weeks after the end of the quarter. They will include: (a) details of new loans contracted or guaranteed during the quarter, including the terms of each new loan; (b) the stock of debt at the end the quarter, including short-term, and medium- and long-term debt; (c) loan disbursements and debt service payments (interest and amortization) during the quarter; (d) information on all overdue payments on short-term debt and on medium- and long-term debt, including new external arrears (if any); and (e) total outstanding amount of arrears.

- **National accounts data** should be reported annually and no later than eight weeks after the end of the quarter.

- **Consumer price indices (CPIs)** for the city of Kabul and for Kabul and five other major cities (“national” CPI) should be reported monthly and no later than four weeks after the end of the month.

24. The government of Afghanistan and DAB will prepare and send to the IMF reports explaining progress made in implementing structural reforms, in particular regarding those included as structural performance criteria and benchmarks in the program. These reports will include appropriate documentation to substantiate progress achieved, and will explain any deviations relative to the initial reform plans or timetable, specifying expected revised completion date.

25. 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.

26. The Technical Committee of Coordination (TCC) will provide Division A of MCD with any other information that may be required by the staff of the IMF for the effective monitoring of the program. For program monitoring purposes, working meetings are planned, at least biweekly, with the participation of representatives of the designated members of the TCC, including any party that could facilitate monitoring implementation of the program.