International Monetary Fund

The Islamic Republic of Afghanistan and the IMF

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February 14, 2008

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

January 28, 2008

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ISLAMIC REPUBLIC OF AFGHANISTAN: LETTER OF INTENT

Kabul, January 28, 2008

Mr. Dominique Strauss-Kahn
Managing Director
International Monetary Fund
Washington, D.C. 20431

Dear Mr. Strauss-Kahn,

1. The attached Memorandum of Economic and Financial Policies (MEFP) supplements and updates the understandings reached with IMF staff on our economic program supported by the Poverty Reduction and Growth Facility (PRGF) Arrangement. The new MEFP reports on quantitative performance through September 2007 and on progress in implementing Afghanistan's structural reform agenda. It sets quantitative targets through September 2008, including quantitative performance criteria for March 2008, and describes the government's policies for the remainder of fiscal year 2007/08 (ending on March 20, 2008) and, on a preliminary basis, for 2008/09.

2. We are pleased to inform you that we met all the September 2007 quantitative performance criteria, including the floor on fiscal revenue, which required redoubled efforts to strengthen revenue administration, and broaden the collection base. We also observed the continuous zero ceilings on contracting or guaranteeing of new medium- and long-term nonconcessional external debt, on short-term external debt, and on new lending from state-owned banks to, or government-guaranteed borrowing by, enterprises in need of restructuring; and the continuous performance criterion prohibiting accumulation of new external payments arrears. The program, centered on fiscal discipline and maintaining confidence in the Afghani, contributed to limiting inflationary pressures and strengthening our external position.

3. Regarding the structural conditionality for the third review, we have experienced some delays in implementing several measures. Some of the delays are not critical for the achievement of program objectives and call for corrective actions we are ready to implement. We request a waiver of nonobservance for the structural performance criterion on submitting to parliament the core budget's audited financial statement for 2006/07 by September 21, 2007. By making the submission one day later, on September 22, 2007 we have observed the Public Finance and Expenditure Management Law. We missed the structural benchmark requiring Cabinet's adoption of a comprehensive restructuring plan for the public entities and government agencies engaged in commercial activities, but not covered by the State Owned Enterprises law. We will make our best efforts to obtain Cabinet approval of this plan (currently under preparation) before end-March 2008. We also missed two structural benchmarks for end-November 2007 calling for the issuance of regulations on credit-granting standards and the credit-monitoring process, and setting limits on sector loan concentration.

4. As required by law, draft regulations have been issued to the public for comments. We intend to obtain DAB's Supreme Council final approval of both regulations and issue them in early February 2008. We have implemented partially the structural benchmark on submitting for Cabinet approval, by August 31, 2007, a restructuring plan for Bank Pashtany, based on the bank's audited financial statement. We made the submission before the required test date but, as the audit of the financial statements of the bank had not yet been finalized at that time, the restructuring plan did not fully benefit from its findings. Once the audit is finalized, the restructuring plan for Bank Pashtany will be amended to take the audit into account. All other structural benchmarks were met. We remain in consultation with IMF staff to ensure satisfactory implementation of the program.

5. The government and Da Afghanistan Bank (DAB) believe that the economic and financial policies set forth in the attached memorandum provide a sound basis for achieving the objectives and targets of the program. During the period of the arrangement, we will consult with the Fund on the adoption of any further measures that may be appropriate, at the initiative of the government or DAB, or whenever the Managing Director of the IMF requests such a consultation. In addition, we will provide the Fund in a timely manner with all information necessary to monitor implementation of the program. The government and DAB will conduct with the Fund the fourth review before end-July 2008.

6. On the basis of this performance, and on the strength of the policies set forth in the attached memorandum, we request that the IMF complete the third review under the PRGF arrangement and approve the fourth disbursement (in the amount of SDR 11.3 million). After the period of this arrangement and while Afghanistan has outstanding financial obligations to the IMF, we will periodically consult with the IMF, at the initiative of the government or DAB, or whenever the Managing Director of the IMF requests consultation on Afghanistan's economic and financial policies.

7. We remain committed to transparent policy-making and are keen on rendering the contents of this letter and those of the attached MEFP and technical memorandum of understanding, as well as the staff report for the 2007Article IV consultation and third review under the PRGF arrangement, available to the public and hereby authorize their posting on the Fund's website subsequent to Executive Board consideration of this request.

Sincerely yours,

Anwar Ul-Haq Ahady	Abdul Qadeer Fitrat
Minister of Finance	Governor
Ministry of Finance	Da Afghanistan Bank
/s/	/s/

ISLAMIC REPUBLIC OF AFGHANISTAN: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES FOR THE REMAINDER OF 2007/08 AND 2008/09

January 28, 2008

I. INTRODUCTION

1. **The Government of the Islamic Republic of Afghanistan and Da Afghanistan Bank (DAB) remain committed to the program of economic reforms aimed at reducing poverty and moving Afghanistan to a sustainable growth path**. This memorandum reviews quantitative performance through September 2007 and compliance with structural conditionality for the third review under the program supported by the Poverty Reduction and Growth Facility (PRGF) arrangement, sets out the revised economic and financial policies for the remainder of 2007/08, outlines the government's policy commitments for 2008/09, and updates Afghanistan's medium-term objectives and policy framework. Based on these policies, we request completion of the third review and approval of the fourth disbursement under the PRGF arrangement.

A. Performance Under the Program

2. **Economic developments in 2007/08 have been marked by high economic growth and a return of inflation to double-digit levels**. A rebound in agricultural production from the drought-triggered decline in 2006/07 and strong growth in other sectors, particularly services, are expected to raise GDP by 13½ percent in 2007/08. Higher prices for imported fuel and foodstuffs caused the Kabul CPI to increase by 8 percent in the first seven months of 2007/08, with 12-month (end-of-period) inflation peaking above 12 percent in September 2007 before subsiding to 9½ percent in October 2007. Despite the increase in inflation, the exchange rate of the Afghani has remained stable against the U.S. dollar.

3. **Performance under the financial program through September 2007 was strong**. Despite a slow start in the early months of 2007/08, fiscal revenue exceeded the program floor for the first half of the year by 3.4 percent (about 0.1 percent of GDP). All other quantitative performance criteria and the indicative ceiling on the operating budget deficit (excluding grants) were observed with ample margins (Table 1). The observance of the fiscal policy targets reflected mainly the consolidation of administrative efforts to increase fiscal revenue and a prudent implementation of operating expenditure. The maintenance of an appropriate monetary policy stance was instrumental to meeting the performance criteria on net international reserves and currency in circulation.

4. **We have also followed through on the structural conditionality for the third review but experienced delays in implementing several measures** (Table 2). We submitted to parliament the core budget's audited financial statement for 2006/07 on September 22, 2007—the last day of the sixth month of the Afghan solar year 1386—and thus observed the Public Finance and Expenditure Management Law; however, we missed the September 21, 2007 test date for the related structural performance criterion. We missed the structural benchmark for end-September 2007 calling for the adoption by the Cabinet

of a comprehensive restructuring plan for the public enterprises not covered by the law on state-owned enterprises (SOEs)—Tassady Law. The implementation of this measure has been delayed several times for technical reasons (lack of capacity) and the absence of broad support for the privatization of these enterprises, including among the members of the Cabinet. Nevertheless, the plan remains under preparation and we will make our best efforts to obtain Cabinet approval by March 31, 2008. We also missed two structural benchmarks for end-November 2007 calling for the issuance of regulations on credit-granting standards and the credit-monitoring process and setting limits on sector loan concentration. As required by law, draft regulations have been submitted to public for comments and we intend to obtain DAB's Supreme Council final approval of both regulations and issue them in early February 2008. We have implemented partially the structural benchmark on submitting, by August 31, 2007, for Cabinet approval a restructuring plan for Bank Pashtany, based on the bank's audited financial statement. We made the submission before the required test date, although the audit of the bank's financial statement has not yet been completed. We have met all other structural benchmarks. We have also made significant progress toward implementing, the understandings reached with Fund staff in July 2007 with regard to the elimination of the discretionary application of a 1 percent import tariff rate on raw materials and other intermediate inputs.

B. Fiscal Sector

5. **Fiscal performance during the first half of 2007/08 was stronger than programmed**. The revenue target for the first half of 2007/08 (equivalent to 3.4 percent of revised annual GDP) was comfortably met, and operating expenditure was below the programmed level by 1.1 percent of GDP, in part due to the delayed approval of the budget. As a result, the operating budget deficit (excluding grants) for the first half of 2007/08 is estimated at 1.0 percent of GDP, compared to an indicative program target of 2.0 percent. Lower than expected external grants for the operating budget were largely offset by higher grants for the development budget. Core development budget expenditure, at 3.4 percent of GDP, was in line with the program

6. **Improvements in revenue collection allowed us to exceed the midyear revenue target**. In particular, collections of the business receipts tax (BRT) improved significantly relative to last year as a result of vigorous compliance and enforcement campaigns on telecommunication services providers, hotels, and banks by the Large Taxpayers Office (LTO), and on restaurants and wedding halls by the interim Medium Taxpayers Office (MTO). Advance remittance of overflight revenues in the second quarter led to better than expected collection of administrative fees, although this revenue will not be available for collection in the fourth quarter. Customs duty receipts were lower than expected, probably reflecting ongoing changes to the tariff regime, but higher nonduty customs collections, including a 2 percent advance payment of income tax, compensated for the revenue shortfall.

7. **New information on the external budget, particularly on security outlays, indicates that direct donor-financed expenditures have been significantly higher than previously estimated**. Our international security partners have shared new information with us on the magnitude of external security spending. Based on this information, our projection for external budget spending in 2007/08 has increased by Af 124 billion (about 29 percent of GDP). Much of the new data are presented on commitment basis, and we will seek to improve our estimate of the cash impact of this spending on the Afghan economy over the coming months.

8. **Progress has continued on structural reforms in the public finances**. We met the end-July 2007 structural benchmark on clarifying the tax policy framework and published the document to this effect. Nevertheless, we continue to hear about confusion among some tax payers and there have been some cases of misclassification of "traders" by our own officials. The Afghanistan Investment Support Agency (AISA) and the Revenue Department of the Ministry of Finance (MOF) intend to conduct a public information campaign to rectify this. We have also taken steps to address staff shortages in the revenue department, published a document that clarifies the roles and responsibilities of the various agencies operating at the border, and transferred accountability for all large- and medium-sized taxpayers in Kabul, on a pilot basis, to the revenue department. In addition, we have submitted to parliament legislation amending the income tax law and will soon submit a proposal to apply the BRT to imports—a key step in the gradual transition toward a broad-based consumption tax.

9. **We continue to strengthen our Medium-Term Fiscal Framework (MTFF) in line with the commitments made at the time of the second program review**. The MTFF is increasingly being used as a tool for engaging donors to discuss external support for the recurrent budget. We are also setting out the levels of public investment needed to create enabling conditions for the implementation of the Afghan National Development Strategy (ANDS). The latest version of the MTFF is consistent with the PRGF and is part of our baseline macro-framework for the ANDS.

C. Monetary and Financial Sector

10. **Monetary policy has remained broadly consistent with the program, despite difficulties with liquidity management experienced during and after Ramadan**. Growth of currency in circulation surged from 8.5 percent during the first half of 2007/08 to 18 percent in October (or nearly 24 percent year-on-year). Continued exchange rate stability throughout this episode suggests that the surge in the money supply—related to an acceleration of government expenditure—was met with increased demand, reflecting a combination of Ramadan-related seasonality and steep increases in the prices of imported fuel and essential foodstuffs. In mid-October, DAB stepped up its foreign exchange interventions with a view to reducing the growth of currency in circulation to about 15 percent by December 2007, consistent with the program ceiling for the third quarter of 2007/08.

11. **We met the structural benchmarks in the areas of central bank accounting and reporting**. We have developed a monthly monetary survey in line with international standards (structural benchmark for end-July 2007) and are submitting it on a monthly basis to the IMF. We also have introduced the new accounting system at DAB and six regional hubs (structural benchmark for end-September 2007). The system still remains in a trial phase and the operations of the regional hubs are not yet automatically monitorable from headquarters.

12. **Rapid growth in commercial bank activity prompted us to take action to strengthen bank supervision and the regulatory framework for the banking sector**. We have completed a summary report on banks' compliance with prudential regulations based on a full round of on-site inspections, which revealed several weaknesses. We are now in the process of implementing targeted supervisory actions. Among other measures, we have instructed all banks to publish their audited financial statements. We have also enforced all licensing requirements for Bank Pashtany and Bank Millie, with the exception of the appointment of qualified managers, which would require lifting the ceilings on salary levels for state sector employees.

D. External Sector and Debt Issues

13. **Developments in the first quarter, notably strong growth of recorded exports, and early indicators of donor activity, suggest that the external position of Afghanistan will strengthen further in 2007/08**. First quarter data show that recorded exports grew by 14 percent (in U.S. dollar terms) relative to the same quarter of 2006/07. We expect this trend to continue throughout the remainder of 2007/08 and contribute to a drop in the trade deficit (by 2½ percent of GDP). The latter is expected despite a significant pick up in duty-free imports related to the increased external budget outlays, which are mainly security-related and are fully-funded by donors. As a result, we expect the current account deficit (including grants) to drop from 6.3 percent of GDP in 2006/07 to 1.4 percent of GDP in 2007/08. Foreign direct investment, debt relief from bilateral creditors, and interim assistance under the Heavily Indebted Poor Countries (HIPC) Initiative will contribute to the strengthening of our external position.

14. **We have improved the collection of balance of payments data, although important shortcomings still need to be addressed**. We have made significant progress in identifying data sources and strengthening data reporting by enhancing cooperation between the relevant government agencies and DAB. Although we have strengthened our expertise in the compilation of the balance of payments, further efforts are needed, including with technical assistance from the IMF.

15. **We have continued our efforts to regularize relations with our creditors**, after having reached the decision point under the HIPC Initiative in July 2007. In August 2007, we signed a bilateral agreement with Russia, and thus finalized the process of regularizing our debts with Paris Club creditors under the July 2006 Paris Club agreement. The agreement with Russia provides for a reduction of Russia's claims on Afghanistan by more than 90 percent, amounting to a reduction of our external debt by nearly 90 percent. During the IMF and World Bank annual meetings in October 2007, we also approached representatives

from Bulgaria and the Kuwait Fund for International Development in an attempt to regularize our debts to these creditors.

E. Other Structural Reforms

16. **We have made some progress in divesting SOEs and restructuring the state-owned banks**. Of the 24 SOEs that were scheduled to be auctioned, 11 have already been sold. We have also lowered the price of six SOEs in order to auction them successfully. In addition, the Cabinet has approved the privatization of 15 other SOEs. In the absence of a comprehensive restructuring/divestment plan for SOEs and other commercial activities of the state that are not covered by the Tassady Law, we have resisted pressures to provide budgetary support to these entities, particularly the national airline Ariana. In the financial sector, Bank Millie, following the completion of its external audit, has taken a number of steps to restructure and improve its financial status. Completion of the audit of Bank Pashtany has been delayed, but its restructuring plan was approved by the Cabinet in August 2007. The client accounts of the Export Promotion Bank have been transferred to Bank Pashtany and the merger of the two banks is expected to be completed by March 31, 2008. To preserve the value of state-owned banks, we continue to prohibit lending from these banks to enterprises in need of restructuring (continuous structural performance criterion).

17. **Progress in reforming the legislative framework for the business environment has been slow, in part due to the lengthy review process at the Ministry of Justice**. The submission to parliament of laws on partnership and corporations, secure transactions, and negotiable instruments is still pending. We are concerned that further delays in the introduction of these laws are likely to impact adversely on private sector investment and the orderly development of the financial sector.

F. Preparations for the ANDS

18. **We have made substantial progress towards the preparation of the ANDS—our PRSP—with a view to submitting it to the Boards of the IMF and World Bank by end-March 2008**. Consultations in all 34 provinces have been completed and have resulted in provincial development plans (PDPs) for each province. We have also completed a first draft of all the sectoral strategy papers, which have been circulated to civil society and our development partners for comments. The PDPs and the sectoral strategies will be used to ensure that the ANDS includes targeted policy measures that reflect the development needs of each province and each sector, and measures to not only increase investment and growth, but also to reduce poverty. With the completion of the update of the 2005 National Risk and Vulnerability Assessment (NRVA) earlier this year, and the ongoing work on the 2007 NRVA, we have also improved our capacity to track the impact of government expenditure on poverty reduction. We have consulted with donors on their likely contributions to the core and external budget over the next five years. We are in the process of preparing proposals on broad sectoral priorities, and will engage government entities and the international community to reach agreement on the ANDS sectoral expenditure envelopes.

II. The Program for the Remainder of 2007/08 and for 2008/09

A. Macroeconomic Objectives

19. **The near-term macroeconomic outlook remains positive, but inflationary pressures are expected to subside only gradually**. A record harvest and strong growth in construction and government and business services suggest that the expectation of double-digit GDP growth in 2007/08 will be fulfilled. In 2008/09, growth in agriculture is expected to return to the predrought trend, but overall GDP growth is projected at about 9½ percent owing to the strengthened fiscal impulse from donor contributions in support of the ANDS. Given the anticipated trends in international commodity prices, inflation is expected to drop below 10 percent in 2008/09, assuming that prudent fiscal and monetary policies will be successful in containing the second-order effects of the exogenous price increases.

20. **Economic growth over the medium term will depend critically on curbing corruption, overcoming infrastructure bottlenecks, and deepening structural reforms in support of private entrepreneurship**. The projected combined donor-financed investment and domestic investment will decrease from above 40 percent of GDP in 2007/08 to about 30 percent of GDP in 2011/12, assuming that private investment would replace a portion of the declining public investment component to the tune of 1–2 percent of GDP per year. Under conservative assumptions with regard to investment efficiency reflecting Afghanistan's difficult natural conditions, absorption capacity limits, and inevitably high security costs, these levels of investment would be consistent with annual GDP growth rates ranging from 9 percent in 2008/09 to 7 percent in 2012/13. Higher growth rates could be expected if structural reforms accelerate, the quality of public expenditure improves, and public investment enhances key infrastructure, notably transport and electricity.

B. Fiscal Policy

21. **We have undertaken measures to ensure that the good revenue performance will continue throughout the remainder of 2007/08**. Revenue is projected to reach Af 35.7 billion (8.2 percent of GDP) in 2007/08. This is in line with the original program and goes beyond our objective of collecting revenue equivalent to 8 percent of GDP by 2010/11, as set out in the Afghanistan Compact agreed between the government and donors in London in 2006. (The downward revision of the GDP estimates implies that we achieved that objective last year). During the remainder of this fiscal year, we will endeavor to foster greater responsibility for revenue collection at the top levels of government and strive to safeguard the tax collection system against political interference. We will reach an agreement within the government on the taxation of airlines, including Ariana. We will also work with parliament to obtain timely approval of the government's proposed amendments to the tax legislation. A steering committee for tax and customs modernization was created to address these challenges—we will use this committee as a forum for advancing sustainable revenue reforms.

22. **In October 2007, we conducted a limited midyear review of the budget for 2007/08, in line with the understandings reached at the time of the second program**

review. Both operating expenditure and grants to the operating budget (on a cash basis) have been reduced by Af 1.5 billion relative to the original program to account for the receipt of fuel-in-kind from our international partners (published documents show expenditure of Af 54.8 billion). As a result, operating expenditure through end-2007/08 is now projected at Af 53.3 billion (12.2 percent of GDP). Within this amount, we have **increased security expenditure** by 0.9 percent of GDP by identifying additional donor contributions, as provided for under the program adjustor, and by reallocating funds from other items, such as the wage bill increment related to the Pay and Grade reform (postponed until the next fiscal year). As an increased envelope for security spending has now been built into the revised program baseline, the program adjustor for additional security expenditure is no longer necessary. We deem the new agreed envelope for security spending sufficient, but will consult with IMF staff should unexpected security-related pressures arise. To reflect the carryover of approved projects from last year, we have **revised the core development budget upward** by about Af 10 billion, to Af 87 billion (19.9 percent of GDP). Nevertheless, in light of systematic underspending in previous years, for program purposes we are targeting an amount of Af 45.5 billion (10.4 percent of GDP), only Af 1.4 billion higher than in the original program for 2007/08. We also used the midyear budget review to **settle payment arrears** (to private contractors) that had accrued owing to weak financial management in several line ministries.

Adjustments to the 2006/07 Core Operating Budget in the Midyear Review

	Af billion	Percent GDP
Approved budget (excluding security adjuster)	**49.8**	**11.4**
Additions:	5.1	1.2
Security	3.7	0.9
Governance & Rule of Law	1.0	0.2
Other	0.3	0.1
Savings:	-1.5	-0.4
Pay and Grade Reform	-0.5	-0.1
Education	-0.9	-0.2
Other	-0.1	-0.0
Budget after midyear review	**53.3**	**12.2**
Difference	**-3.5**	**-0.8**
Use of agreed security adjuster 1/	-2.3	-0.5
Cash additions to core operating budget	-1.2	-0.3

1/ Security adjuster of Af 3.8 billion less "in-kind" contribution of Af 1.5 billion.

23. **Expenditure management efforts during the remainder of 2007/08 will focus on regularizing the relations between the budget and public enterprises**. To that end, we will initiate a review of the fiscal relations between the government and key SOEs (e.g., Afghan Telecom, Ariana, DABM—the electricity provider, FLGE—the petroleum trading SOE, and mining SOEs), in advance of the 2008/09 budget. The review will cover the period from 2005/06 onward and will focus on: (i) payment of bills and service charges by the line ministries; (ii) payment of taxes by SOEs; (iii) transfers of SOEs' profits to the Treasury account; and (iv) closure of unauthorized bank accounts. These measures should reduce the pressure to subsidize SOEs. Nevertheless, to obtain settlement of unpaid government bills, SOEs will need to present audited financial statements for the period of claims. We will also conclude, with assistance from the World Bank, an analysis of fiscal sustainability in the security sector.

24. **We will seek to reduce our operating budget deficit excluding grants from 4.0 percent of GDP in 2007/08 to 3.6 percent in 2008/09**. This is consistent with our medium-term fiscal objective of covering operating expenses with domestic revenue—a target that we expect to achieve by 2012/13. We are targeting domestic revenues of Af 44.5 billion (8.5 percent of GDP) for 2008/09. At the same time, operating expenditure in 2008/09 will be capped at Af 63.4 billion (12.1 percent of GDP)—this will allow us to accommodate recent decisions to increase the size of both the army and the police, accompanied by a Pay and Rank Reform in these sectors, and will provide for Af 2.8 billion in fuel subsidies for Da Afghanistan Breshna Moassesa (DABM). The ceiling on operating expenditures reflects a prudent approach to the wage bill, which seeks to encourage faster progress in the civilian Pay and Grade Reform. To that end, pay increases outside the reform process will be contained below inflation. Consistent with the PRGF program and the baseline scenario in the ANDS, core budget development expenditure is projected at Af 56.9 billion (10.9 percent of GDP) in 2008/09, representing a 25 percent increase in nominal terms over the expected outturn this year.

25. **Revenue policy in 2008/09 will focus on implementing measures to secure the success of major tax reforms slated for 2009/10**. In this two-step process, we target a revenue increase of only 0.3 percent of GDP in 2008/09, to be followed by a further increase of 0.6 percent of GDP in 2009/10, which would bring the revenue-to-GDP ratio to 9.1 percent. In 2008/09, while maintaining the necessary collection efforts to achieve the annual revenue target, we will place greater emphasis on (i) consolidating the pertinent legislation; (ii) capacity building; and (iii) expanding administrative reforms. The legislative agenda, part of which has already been submitted to parliament, includes: (i) the elimination of nuisance taxes; (ii) reforms to income taxation; and (iii) measures toward transforming the BRT into a broad-based consumption tax, such as the imposition of a BRT on imports (to become effective in 2009/10—structural benchmark for March 2009) and exempting financial services from the BRT. Once approved by parliament, we will promptly announce these measures to the public. We will also conduct an information campaign within the trader community prior to withdrawing the concessions on filing and paying taxes (structural benchmark for March 2009) that had been granted to traders. In the meantime, we will focus on key administrative reforms to maximize the benefits of the planned tax policy measures. First and foremost, we will ensure adequate resourcing of the Revenue and Customs

Departments, focusing on the retention of qualified staff and the needs of the major provincial tax offices. Based on this, we will roll out the operations of the LTO and MTO to five key provinces. We will also refine the crediting mechanism currently used for the income tax with a view to applying a similar mechanism to the BRT that will be collected on imports, thus alleviating partially the cascading of this tax. We will also continue to expand the collection net to capture high value tax payers, including airlines, security companies, and landlords.

26. **On the expenditure side, we will focus on fiscal discipline, improving the quality of public expenditure, and aligning it with the ANDS' priorities**. Several reforms are critical in this regard:

- On **budget formulation**, we will expand the program budget pilots to seven ministries and ensure that the program structure is aligned with the ANDS sector strategies. This reform will not only help integrate budget formulation in line ministries, but will also contribute to aggregate discipline as decision makers are presented with information that will facilitate prioritization (March 2008).

- We will work with our development partners to strengthen **financial management in the line ministries**. In particular, we will ensure that the government priorities, as defined in the budget, are implemented and will seek to eliminate the build up of arrears in line ministries (throughout 2008/09).

- The Treasury Department will **restructure operations** in three **provincial Mustofiats** by using the Afghanistan Financial Management Information System (AFMIS) to process transactions of these Mustofiats and by hiring the staff needed to execute treasury functions on a PRR (priority restructuring and reform) basis (March 2008).

- The MOF will implement a new procedure to integrate and **restructure allotment management arrangements** based on a commitment management system and financial plans from all budgetary units (March 2008).

- To **improve payroll management**, we will adopt, in consultation with line ministries and donors, an action plan for implementing a computerized payroll system that will allow the MOF to track payroll payments for all government employees (January 2008).

- We will take decisive actions to **contain potential fiscal drains** resulting from lack of financial discipline in the public enterprises, particularly, DABM. To this effect, we will follow through on our commitment to establish a comprehensive agreement with the DABM on a medium-term plan to reduce subsidies. For 2008/09—as we do not envisage any additional sources of electricity coming on line—we will reach an interim agreement with DABM (structural benchmark for March 2008) on quarterly reform benchmarks to be met in exchange for subsidy disbursements (see Technical Memorandum of Understanding (TMU), ¶2). Key conditions will include submitting financial statements for 2006/07–2007/08 (by June 2008), achieving measurable improvements in collection performance, and cutting physical theft of electricity. By September 2008, in collaboration with DABM, we will prepare a draft medium-term plan to gradually reduce and eventually eliminate the energy subsidy. The viability of the plan will be predicated on: (i) DABM's restructuring; (ii) optimal use of existing and new electricity sources; (iii) tariff increases for premium power users; and (iv) scheduled load shedding for residential customers (as opposed to cutting supply to control costs, as is presently the case). Moreover, we will ensure that at no stage the increase in electricity supply leads to an increase in subsidies. We will finalize this plan and agree with DABM on the timetable for its implementation by December 2008 (structural benchmark).

- We will continue to monitor **fiscal risks related to aid volatility** and work with donors on refining our projections in this area.

- Implementation of the **Pay and Grade reform** will start before September 2008.

27. **We will continue to strengthen the MTFF as a policy tool for the government**. The MTFF will be the primary instrument for setting fiscal parameters for the annual budget process and the ANDS envelope, and for analyzing fiscal sustainability. To that end, we will determine, and subsequently update on an annual basis, the fiscal parameters for the ANDS macroframework. For the 2008/09 budget, the MTFF will: (i) set out our medium-term plan to eliminate the operating budget deficit before grants; establish indicative sectoral allocations for both the core and external budgets; and (ii) provide envelopes for key cross-cutting areas, such as Pay and Grade Reform and maintenance costs associated with investment spending. The latter will build on our recent work with the World Bank and security partners to assess fiscal sustainability in the security sector. It will include concise descriptions of the policy actions necessary to meet fiscal objectives, on both the revenue and expenditure fronts. The improvements to the MTFF will be in line with the understandings underpinning the HIPC completion point triggers.

C. Monetary and Exchange Rate Policies

28. **Monetary policy will seek to contain inflationary pressures**. In this context, we consider the original currency in circulation ceiling for 2007/08 (consistent with a 19 percent growth in the demand for the Afghanis) appropriate, even though nominal GDP growth in 2007/08 is likely to exceed this figure by about five percentage points. The major contribution to growth in 2007/08 comes from agriculture, which adds comparatively less than other sectors to the demand for domestic currency. The envisaged monetary tightening will limit the increase in the prices of nontradables, and will help contain inflation. In 2008/09, we expect economic growth to be more broad-based and the demand for money to increase by about 20 percent, in line with the nominal GDP growth.

29. **Foreign exchange auctions will remain a primary instrument of monetary policy**. DAB will make no commitment to purchase Afghanis at a pre-determined rate and thus uphold the managed float character of the exchange regime. Seasonally-adjusted quarterly currency-in-circulation targets (consistent with the program currency-in-circulation ceiling) will provide guidance for DAB's foreign exchange interventions, while the degree of

flexibility will enable the DAB to smooth out short-term exchange rate fluctuations. DAB will ensure the observance of the “T + 2” rule for the settlement of the bids in foreign exchange auctions and impose adequate penalties on violators, including escalating fines and, ultimately, suspension of money changers licenses for multiple offenders.

30. **DAB will improve the standing arrangements for the provision of cash** (in Afghanis and in U.S. dollars). To this effect, DAB will satisfy the constitutional requirement of consulting with parliament on cash printing once a year when presenting its annual report, and will make advance arrangements for ensuring an adequate supply of Afghani notes during the year. The guidelines on importing and exporting U.S. currency will also be articulated clearly and incorporated in DAB’s operating procedures. DAB will also improve liquidity forecasting—in cooperation with the MOF—in order to ensure a smooth implementation of monetary policy. In particular, DAB management will strengthen the internal consultation mechanism over liquidity forecasts and intervention policy by endowing the Monetary Policy Department with greater ownership and accountability for its policy advice.

31. **DAB will be expanding the volume of capital notes auctions with a focus on managing bank liquidity and developing a yield curve**. Preparations for launching the secondary market in capital notes (CNs) will be finalized in February 2008. Subsequently, DAB will articulate the steps leading to the opening of the secondary market for CNs and promulgate the rules guiding secondary market transactions among the commercial banks. Meanwhile, DAB will increase the volume of auctions and strengthen the procedure for determining ex ante the amounts to be auctioned.

32. **We continue to develop controls against money laundering and financing of terrorism (AML/CFT) in the banking and other sectors**. We intend to have all the appropriate controls in place prior to the first AML/CFT evaluation of Afghanistan by the Asia Pacific Group on Money Laundering, which is expected to take place in the third quarter of 2008.

D. Strengthening of DAB’s Accounting and Reporting Framework

33. **The introduction of the new accounting system at DAB forms the basis for strengthening internal control and improving the quality of data available to inform policy decisions**. Nevertheless, further steps are needed to make the new system fully operational. With assistance from the Middle East Technical Assistance Center (METAC), we will work toward finalizing this task and ensure that the new accounting system at the six regional hubs is fully integrated with that at DAB’s headquarters and satisfies the standards required for central bank operations (structural benchmark for end-March 2008).

34. **We will also take steps to strengthen the quality of the monthly reporting of DAB’s operations**. To this effect: (i) by December 20, 2007, we will take stock of discrepancies between the monthly reports based on the accounting records and the reports produced by the Monetary Policy Department for program monitoring and reporting; (ii) subsequently, we will eliminate these discrepancies by correcting the errors in the source data; (iii) by the beginning of fiscal year 2008/09, and only if satisfactory reconciliation is

achieved, we will use the data based on the accounting records for program monitoring and reporting monetary operations to the IMF.

35. **Since July 2007 DAB has been producing monetary surveys of a better quality**. In the period ahead, DAB will reconcile central bank and commercial banks reporting (based on a consistent Gregorian or Solar Calendar time-frame) and publish integrated monetary surveys using a consistent time-frame.

E. Safeguards Assessment Issues

36. **We have renewed our commitment to improving DAB's operations and control framework by implementing the IMF's updated safeguards recommendations**. To provide assurances regarding the level of DAB's reserve assets, we have requested our external auditors to conduct an independent verification of these assets and their availability as of September 22, 2007 (prior action). In addition, we will take steps to complete the annual audit of financial year 1385 (2006/07) by end-December 2007, and appoint an external auditor for financial year 1386 (2007/08) by end-December 2007 (prior action). We will also continue with the process of implementing the new accounting system and addressing audit observations for the financial year 1385 concerning weaknesses in controls, with priority given to the accounting and foreign reserves management areas.

F. Bank Supervision and Financial Sector Policies

37. **To safeguard the soundness of the banking sector, we will continue to strengthen bank supervision and address banks' noncompliance with prudential regulations**. Effective immediately, we will stop awarding licenses for opening new branches to banks exhibiting "well-defined weakness" (i.e., banks with Capital adequacy, Asset quality, Management, Earnings, and Liquidity (CAMEL) ratings of 4 and 5). Also, given the absence of appropriate risk management skills and the limited effective collateral, we will limit the credit growth of such banks to 5 percent per quarter beginning end-December 2007. This limitation will remain in effect for those banks whose CAMEL ratings continue to be assessed as 4 or 5 by DAB's banking supervision department. We will notify the banks by end-November 2007 of our decision. We will also revise the enforcement regulations to ensure that corrective actions are taken promptly, and will follow up on the banks' failure to comply with these actions. To that end, we will put in place automatic measures, including fines for each day of failing to comply with DAB's orders. We are in the process of developing an off-site supervision form detailing sectoral loan classification. As of December 2007, banks will be required to report their loans to DAB based on these new forms. To increase the transparency of the legal framework for commercial bank operations, we intend to consolidate all pertinent regulations in a handbook.

38. **We will seek to enhance coherence in the regulatory framework for the banking sector in close consultation with IMF staff**. DAB's Supreme Council will repeal the decisions instituting the requirement to invest 80 percent of bank deposits in the domestic economy and raising the minimum capital requirement from US$5 million to US$20 million. DAB will issue circulars informing banks that these decisions have been repealed (structural benchmarks for end-March 2008). After consultation with IMF staff, we believe that the minimum capital requirement for commercial banks should be raised to US$10 million. The new requirement will be applicable immediately for new banks seeking licenses, while incumbent banks will be given 5 years to comply. In relaxing our position on minimum capital requirements, we are recognizing the need to ensure that small but well-run banks continue to operate.

39. **We will also modify two tax policy provisions applicable to the banking sector**. Taxation of income from bank deposits will be applied uniformly to all commercial banks, including state-owned and private banks, and the provisions calling for the withholding of taxes on interbank lending will be withdrawn. Both actions will be taken by end-2007/08.

G. External Sector Policies

40. **We are committed to a trade regime that minimizes distortions and does not discriminate across importers**. Consistent with this objective, the decree (No. 5016) allowing selected producers to import raw materials at a 1 percent tariff rate will be repealed by December 31, 2007 (prior action). The goods eligible for the 1 percent rate will be incorporated in the tariff schedule at rate(s) to be decided, with due consideration for government revenue. Moreover, we intend to repeal, by end-March 2009, the decree (No. 96) that raised the tariff rate on soft drinks from 20 to 40 percent, and reduce the applicable tariff rate to 20 percent. Fund staff and the authorities have reached an understanding that this measure will be a structural performance criterion for a later review. Furthermore, we will refrain from introducing any discriminatory trade policy measures and reclassifying goods into higher tariff bands, and will unwind previous tariff increases once the revenue situation permits. We also intend to limit changes to the tariff schedule by (i) acting in accordance with paragraph 23.2 of the customs law, which states that "the customs tariff shall be approved by the Minister of Finance upon the recommendation of the General Director of Customs;" and (ii) avoiding changes to the tariff schedule outside the annual budget process. Finally, we are committed to an even-handed application of the tariff schedule and will promptly redress any irregularities in this regard, including in the case of gasoline.

41. **We are also committed to maintaining a foreign exchange system free of restrictions**. In this regard, we look forward to receiving technical assistance from the Fund to assist us in assessing the adequacy of our legal framework and in formalizing a restrictions-free exchange system consistent with our aim of accepting the obligations under the Article VIII, Sections 2, 3, 4 of the Fund's Article's of Agreement.

42. **We will continue to make efforts to regularize relations with all our creditors while pursuing a prudent debt management strategy consistent with achieving external debt sustainability**. In this regard, we will work toward reaching agreements with our non-Paris Club bilateral and commercial creditors on terms at least comparable with those

received from Paris Club creditors, and will redouble our efforts to complete a debt relief agreement with the OPEC Fund for International Development (OFID). Moreover, we will continue to rely primarily on grants and highly concessional loans to meet our financing needs. The government and DAB will not contract or guarantee any nonconcessional external debt (continuous performance criterion).

H. Petroleum Sector

43. **We remain committed to a transparent and competitive petroleum sector, with the private sector playing the dominant role**. The recent decision of the Fuel and Liquid Gas Enterprise (FLGE) to import fuel for state-owned retail pump stations was necessary because of temporary shortages, which led to sharp increases in retail prices. Nonetheless, the government's intention, as highlighted in the Afghanistan Compact, is to withdraw from the oil sector and privatize the FLGE by March 2009. To this end, we intend to reduce gradually the FLGE's imports of petroleum products and, ultimately, limit its role to providing services to the private sector. We will ensure that fees collected for the FLGE's services will not be used to subsidize the fuel sold by FLGE, including at state-owned retail pump stations. To improve transparency in the sector, we also plan to publish a schedule of fees for FLGE's services (end-February 2008 structural benchmark). We remain mindful of the need to protect the consumer by maintaining competitive market conditions, and are in the process of formulating an anti-trust law for that purpose. To improve transparency and prepare for the privatization of the FLGE, we have commissioned an external audit of its accounts for 2007/08, which would be completed by November 2008. Upon completion of the audit, we will promptly publish the audit report (structural benchmark).

I. Other Structural Reforms

44. **We will redouble our efforts to finalize the strategic plan for the non-Tassady public enterprises and government entities engaged in commercial activities**. We will prepare a strategic plan for non-Tassady enterprises for Cabinet adoption by March 31, 2008 (structural benchmark). Regarding Ariana, we will not: (i) assume payment obligations for liabilities contracted without government guarantee; (ii) provide government guarantees for new obligations; or (iii) approve lending to Ariana by state-owned banks.

45. **We will follow through on our plans to restructure the state-owned banks (Pashtany and Millie) and will establish a timetable for finalizing the liquidation of delicensed state-owned banks**. We are also committed to resolving the outstanding issues raised in the context of the external audit of Bank Pashtany, with a view to enabling the completion of the audit report by December 20, 2007.

J. ANDS and HIPC-Related Issues

46. **Prioritization and realistic costing of sectoral strategies will be key to the quality of the ANDS**. In order to complete the ANDS on schedule, we are initially costing three sectoral strategies (education, health and roads), which will be included in the 2008/09 budget. The remaining sectoral strategies will be costed in time for the first ANDS annual progress report, which we intend to submit to the Boards of the IMF and the World Bank in

early- to mid-2009. As the financing needs implied by the sectoral strategies and PDPs are expected to exceed available resources, we will use the MTFF to balance the needs of different sectors and provinces with fiscal prudence, and to spread the implementation of the ANDS over a realistic timeline.

47. **Progress continues towards meeting our HIPC completion point triggers**. Regarding the HIPC completion point triggers within the IMF's areas of responsibility, we aim to strengthen our debt management capacity by publishing quarterly external debt reports, starting with the report for the first quarter of 2008/09 within three months of the end of the quarter, and by implementing a database system on external debt by end-September 2008. The 2008/09 budget formulation process will seek to satisfy the trigger on alignment of public spending priorities, and the MTFF published alongside the budget will be in line with the criteria set out in the HIPC trigger. We are modifying the Treasury's Chart of Accounts to enable the tracking of poverty reducing expenditures during 2008/09. Annual audits of the core budget's financial statements will proceed in line with the requirements of the HIPC trigger.

K. Statistical Issues

48. **Several initiatives are under way to improve Afghanistan's statistics in the key sectors for economic policy and the ANDS**. In August 2007, we began the 2007 NRVA, which extends the consumption module of the 2005 NRVA to a larger number of nonfood items. We have also made preparations for launching the Integrated Business Enterprise Survey in February 2008. The findings of these surveys will help upgrade the social database and serve as a basis for strengthening the national accounts.

49. **We plan to intensify our efforts to build the capacity of the Central Statistics Office** (CSO), including by appointing the head of CSO, increasing training, providing adequate resources through securing funding from donors, and restructuring its operations. In coordination with the donor community, CSO intends to develop a detailed blueprint to address the weaknesses in the national income accounts database. Finally, we plan to launch the national household census in August 2008.

50. **We will continue to work toward compiling a balance of payments for 2007/08**. To that end, DAB and AISA, in consultation with the STA expert from the IMF will jointly launch by year's end a FDI survey for 2007/08 to a sample of companies, with a view to completing it before the end of the first quarter of 2008/09. Moreover, CSO will improve the quality of merchandise trade data, including duty-free imports, and the timeliness of their reporting. It will also coordinate with the MOF to improve the consistency between the CSO trade data and those reported by the Customs Department.

III. Program Monitoring

51. The program will be monitored through quantitative performance criteria for March 2008 and indicative targets for December 2007, June 2008, and September 2008. The fourth review under the arrangement is scheduled to be completed by June 2008 and will be conditional upon compliance with the quantitative performance criteria and structural

conditionality through March 2008. The updated TMU (attached) specifies the details of program monitoring, including definitions of performance criteria and adjusters, and data provision requirements.

52. During the program period, Afghanistan will not impose or intensify restrictions on the making of payments and transfers for current international transactions, or introduce or modify multiple currency practices, or conclude bilateral payments agreements inconsistent with Article VIII, or impose or intensify import restrictions for balance of payments purposes.

Table 1. Islamic Republic of Afghanistan: Performance Criteria and Indicative Targets for 2007/08–mid-2008/09 1/

(For 2007/08, cumulative changes from March 20, 2007 and for 2008/09, cumulative changes from March 19, 2008; unless otherwise indicated)

	Mar. 20, 2007	Jun. 21, 2007			Sep. 22, 2007			Dec. 21, 2007		Mar. 19, 2008	Jun. 20, 2008	Sep.21, 2008
	Stocks	Indicative Targets	Adjusted Targets	Actual	Performance Criteria	Adjusted Perf. Criteria	Actual	Indicative Targets 2nd review	Indicative Targets Revised	Performance Criteria	Indicative Targets	Indicative Targets 2/
Quantitative performance criteria and benchmarks												
						(In millions of Afghanis)						
Floor on fiscal revenue of the government		7,037	…	6,405	14,996	…	15,501	24,310	24,600	35,721	10,207	20,983
Ceiling on currency in circulation	48,884	3,012	…	2,210	6,207	…	4,137	7,798	7,798	9,435	2,899	5,798
Ceiling on net central bank financing of the government	-28,343	-982	7,695	2,409	2,385	2,360	-4,929	4,148	81	6,201	-1,154	724
Indicative target (ceiling) on the operating budget deficit of the government, excluding grants		5,412	…	1,711	9,902	…	4,435	13,037	12,032	17,608	2,481	7,565
						(In millions of U.S. dollars)						
Floor on net international reserves of DAB	1,991.1	55.6	-119.3	132.2	45.5	44.5	300.0	44.9	230.3	166.3	110.3	127.2
Zero ceiling on contracting or guaranteeing new medium- and long-term nonconcessional external debt by the government and DAB 3/	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 3/	0	0	…	0	0	...	0	0	0	0	0	0
Nonaccumulation of new external payments arrears, excluding interest on preexisting arrears 3/	0	0	…	0	0	...	0	0	0	0	0	0
Zero ceiling on lending from State-Owned Banks to SOEs in need of restructuring or government guaranteeing borrowing by these SOEs	...	0	…	0	0	...	0	0	0	0	0	0
						(In millions of Afghanis)						
Memorandum items:												
Operating budget deficit of the government, including grants		1,019	…	830	630	...	-1,469	-1,114	-2,728	-6,009	-2,438	-3,502
Reference Projections for the Adjustors												
		Program	Actual	Deviation	Program	Actual	Deviation	Program		Program	Program	Program
Core budget development spending		5,512	2,978	-2,534	16,536	14,784	-1,752	27,560	27,063	45,483	7,107	21,320
External financing of the core budget and sale or transfers of nonfinancial assets		11,906	3,228	-8,678	24,052	24,077	25	36,449	38,980	56,889	10,742	28,161
Expenditure currently financed outside the budget moved onto the operating budget		0	0	0	0	0	0	0	...	...	...	...
Additional donor-funded security expenditures 4/		0	...	0	0	...	0	0	...	...	...	...

Sources: 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/ Will be converted into performance criteria at the fourth PRGF review.
3/ These performance criteria apply on a continuous basis.
4/ The program provided for additional Af 3,800 million in the first half of 2007/08 in donor-supported security spending. At the midyear review, the additional security spending was incorporated in the budget.

Table 2. Islamic Republic of Afghanistan: Structural Performance Criteria and Structural Benchmarks, July 2007–March 2009

Third Review Under the PRGF Arrangement		
Prior Actions	**Target Dates**	**Status**
DAB's external auditor, KPMG Afghanistan, should complete a special audit of the central bank's reserve assets reported to the IMF as of September 22, 2007. The audit should be conducted in accordance with International Standards on Auditing. 1/	Five days before Board meeting	Implemented Staff received the audit report on January 9, 2008
DAB should appoint a reputable international audit firm to audit the bank's annual financial statements for financial year 1386 (2007/2008) in accordance with International Standards on Auditing.	December 31, 2007	Implemented
Eliminate the discriminatory application of the 1 percent tariff rate on imports of raw materials and intermediate goods by repealing the Decree Nr. 5016, effective December 31, 2007.	December 31, 2007	Implemented
Structural Performance Criteria	**Target Dates**	**Status**
Submit to parliament the core budget's audited financial statement for 2006/07.	September 21, 2007	Not implemented 2/
Structural Benchmarks	**Target Dates**	**Status**
Develop a monthly monetary survey in line with international standards.	July 31, 2007	Implemented
Clarify the tax policy framework and system, including the difference between the BRT and income taxes.	July 31, 2007	Implemented
Prepare (and submit to the Cabinet) a restructuring plan for Bank Pashtany based on the bank's audited financial statement.	August 31, 2007	Partially implemented 3/
Adopt a comprehensive restructuring/divestment plan for the public entities and government agencies engaged in commercial activities but not covered by the SOEs law.	September 30, 2007	Not implemented
Expand the automated integrated accounting system to DAB's six regional hubs.	September 30, 2007	Implemented
Issue regulations on credit-granting standards and credit monitoring process.	November 30, 2007	Not implemented
Issue regulations on setting limits on sectoral loan concentration.	November 30, 2007	Not implemented
Fourth Review Under the PRGF Arrangement		
Structural Benchmarks	**Target Dates**	**Status**
Submit core budget to parliament according to the PFEM Law and accompanied by a MTFF.	February 3, 2008	
Publish a schedule of the fees charged by the FLGE for its services.	February 29, 2008	
MOF will conclude an agreement with the DABM on quarterly reform benchmarks to be met by DABM throughout 2008/09 in exchange for the subsidy disbursements.	March 21, 2008	

Table 2. Islamic Republic of Afghanistan: Structural Performance Criteria and Structural Benchmarks, July 2007–March 2009 (Concluded)

Structural Benchmarks	Target Dates	Status
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, 2008	
DAB will issue a circular informing banks that the requirement to invest 80 percent of bank deposits in domestic economy has been repealed.	March 31, 2008	
Ensure that the accounting system at DAB's six regional hubs is automatically monitorable from DAB's headquarters.	March 31, 2008	
Reconcile DAB's accounting records and the monthly reports on DAB's operations for 2007/08 prepared by DAB's Monetary Policy Department.	April 20, 2008	
Future Reviews Under the PRGF Arrangement		
Structural Benchmarks	**Target Dates**	**Status**
DAB will produce the Monetary Survey for 2007/08 using a consistent time frame (Solar or Gregorian) for the entire banking system.	June 30, 2008	
Submit to parliament the core budget's audited financial statement for 2007/08. 4/	September 21, 2008	
Publish external audit report of FLGE.	November 30, 2008	
MOF will conclude a comprehensive agreement with the DABM on a medium-term plan to reduce subsidies.	December 31, 2008	
Withdraw trader concessions on filing and paying taxes.	March 21, 2009	
Start collecting BRT on imports.	March 21, 2009	
Reduce to 20 percent the 40 percent tariff rate on soft drinks established by Presidential Decree Nr. 96. 4/	March 31, 2009	

1/ Terms of Reference for special audit have been provided by IMF staff to the authorities.

2/ The authorities made the submission on September 22, 2007 (the last day of the sixth month of the Afghan calendar), and, thus, complied with the PFEM Law. Staff supports the authorities request for a waiver of nonobservance.

3/ The restructuring plan for Pashtany bank has been sent to Cabinet, but it is not based on the audit report because the audit took longer than expected.

4/ Fund staff and the authorities have reached an understanding that this measure will be a structural performance criterion for a later review.

ISLAMIC REPUBLIC OF AFGHANISTAN: 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. It defines the structural performance criterion and benchmarks (Section I), as well as the principal concepts and financial variables, including the quantitative performance criteria and indicators (Section II). It also sets out data reporting requirements (Section III).

I. STRUCTURAL PERFORMANCE CRITERION AND BENCHMARKS

2. Prior actions for the third review and structural performance criterion and benchmarks for the fourth, fifth, and sixth reviews are specified in Table 2 of the Memorandum of Economic and Financial Policies (MEFP) are defined as follows:

A. Third Review Under the PRGF Arrangement

Prior actions

- **DAB's external auditor, KPMG Afghanistan, should complete a special audit of the central bank's reserve assets reported to the IMF as of September 22, 2007**. The audit should be conducted in accordance with International Standards on Auditing and the terms of reference provided by IMF staff to the authorities.

- **DAB should appoint a reputable international audit firm to audit the bank's annual financial statements for financial year 1386 (2007/2008) in accordance with International Standards on Auditing**.

- **Eliminate the discriminatory application of the 1 percent tariff rate on imports on raw materials and intermediate goods by repealing the Decree Nr. 5016, effective December 31, 2007**.

B. Fourth Review Under the PRGF Arrangement

Structural benchmarks

- **Submit core budget to parliament according to the PFEM Law and accompanied by a MTFF**.

- **Publish a schedule of the fees charged by the FLGE for its services**. This schedule shall be published on the external website of the Ministry of Commerce and Industry. It shall include details of the fees payable for the use of the FLGE's storage, laboratory and transport facilities, as well as any fees charged for installing and maintaining fuel pump station equipment.

- **MOF will conclude an agreement with the DABM on quarterly reform benchmarks to be met by DABM throughout 2008/09 in exchange for the subsidy disbursements**. The benchmarks will include (i) submission by DABM of audited financial statements for 2006/07–2007/08 by June 2008; (ii) targets for improvements in tariff collection (including from government entities); (iii) regularization of relationship with the budget (correct and transparent recording of tax payments and receipts of subsidies and tariffs); and (iv) targets for reducing physical theft of electricity.

- **Adopt a comprehensive restructuring/divestment plan for public entities and government agencies engaged in commercial activities but not covered by the SOEs 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 shall be adopted by the Cabinet.

- **DAB will issue a circular informing banks that the requirement to invest 80 percent of bank deposits in domestic economy has been repealed**.

- **Ensure that the accounting system at DAB's six regional hubs is automatically monitorable from DAB's headquarters**.

- **Reconcile DAB's accounting records and the monthly reports on DAB's operations for 2007/08 prepared by DAB's Monetary Policy Department**. The reconciliation will be conducted in accordance with the procedures agreed upon with the IMF.

C. Future Reviews Under the PRGF Arrangement

Structural performance criteria

- **Submit to parliament the core budget's audited financial statements for 2007/08**. The PFEM law requires the government to submit and 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 practices.

- **Reduce to 20 percent the 40 percent tariff rate on soft drinks established by Presidential Decree Nr. 96**.

Structural benchmarks

- **DAB will produce and publish the Monetary Survey for 2007/08 using a consistent time frame (Solar or Gregorian calendar) for the entire banking system**.

- **Publish external audit report of FLGE**. The audit shall cover FLGE's financial statements for 2007/08 and shall be conducted in accordance with international accounting principles. In addition, the audit shall cover FLGE's headcount and wage bill, and will include a review of FLGE's commercial dealings with the government and other state-owned enterprises. The audit report shall be published on the Ministry of Commerce and Industry's external website.

- **MOF will conclude a comprehensive agreement with the DABM on a medium-term plan to reduce subsidies**. The plan will be implemented by December 2008 and shall include steps to reduce and gradually eliminate the fuel subsidy. Key components of the plan would include: (i) measurable benchmarks on DABM's restructuring process.; (ii) an agreement on the optimal use of existing and new generation capacity; (iii) tariff increases for premium power users as the electricity supply improves; (iv) targets for improved collection from government ministries and agencies (could include centralized debits from ministry and agency budget allocations if arrears are built up); (v) a schedule of tax payments to the Ministry of Finance; and (vi) a plan for scheduled load shedding for residential customers.

- **Withdraw trader concessions on filing and paying taxes**. By March 21, 2009, the current agreement, whereby traders do not have to file any tax returns if they have paid the 2 percent fixed tax on imports in lieu of income tax, will cease. Registration with the tax authorities for BRT and income tax will be determined by the relevant thresholds as set out in legislation.

- **Start collecting BRT on imports**. By March 21, 2009, the Government will start collecting the BRT on imports, in addition to the existing 2 percent advance payment of income tax.

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 (continuous);

- a zero ceiling on short-term external debt owed or guaranteed by the government or DAB (continuous);

- a zero ceiling on the accumulation of external payment arrears, excluding interest on preexisting arrears (continuous);

- a zero ceiling on lending from state-owned banks to, or government guaranteed borrowing by, state-owned enterprises in need of restructuring (continuous); and

- a ceiling for the operating budget deficit of the central government, excluding grants (indicative target).

A. Program Exchange Rates and Gold Valuation

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 50.08 Afghanis per U.S. dollar, which corresponds to the average of the Af/US$ buy and sell cash rates, as reported by DAB as of March 19, 2007. 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 March 19, 2007, as reported in the following table. Gold holdings will be valued at US$653.47 per ounce, the price as of March 19, 2007.

Exchange Rate	**Program Rate**
U.S. dollar/Canadian dollar	0.850770
U.S. dollar/U.A.E. dirham	0.272330
U.S. dollar/Egyptian pound	0.175290
U.S. dollar/Euro	1.330750
U.S. dollar/Hong Kong dollar	0.128005
U.S. dollar/Indian rupee	0.022721
U.S. dollar/Pakistani rupee	0.016468
U.S. dollar/Polish zloty	0.343796
U.S. dollar/Iranian rial	0.000108
U.S. dollar/Saudi rial	0.266670
U.S. dollar/Russian ruble	0.038400
U.S. dollar/Swiss franc	0.825490
U.S. dollar/United Kingdom pound	1.944950
U.S. dollar/SDR	1.509310

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 all DAB's provincial and district branches.

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.[1]

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;[2] 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).

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,

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

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

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. The definition for program monitoring excludes grants and other noncompulsory contributions received from foreign governments and international organizations; such transfers between central government units would be eliminated in the consolidation of the fiscal reports and not recorded as revenue. Receipts collected by central government on behalf of noncentral government units should not be counted as revenue (e.g., Red Crescent fees). Receipts from the sale of nonfinancial assets, such as privatization, and transactions in financial assets and liabilities, such as borrowing but excepting interest payments, are also excluded from the definition of revenue.

12. Revenues should be recognized on a cash basis and flows should be recorded when cash is received. 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 Ministry of Finance (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 Cooperation and Development's Commercial Interest Reference Rates (CIRRs): for maturities of less than 15 years, the grant element will be calculated based on six-month averages of CIRRs; and for maturities longer than 15 years, the grant element will be calculated based on 10 year averages.

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

15. **The zero ceiling on short-term external debt** applies on a continuous basis to the stock of short-term external debt owed or guaranteed by the government (as defined in paragraph 14 of this memorandum) or 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 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. Lending to, or Guaranteeing Borrowing by, State-Owned Enterprises

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

- For the purposes of this performance criterion:

- "state-owned banks" refers to those banks that are wholly or majority owned by the government (as defined in paragraph 14 of this memorandum); including Bank Millie, Bank Pashtany, and Export Promotion Bank;

- "enterprises in need of restructuring" refers to enterprises that meet any one of the following: (a) enterprises (public or private) that have not had an audited balance sheet in fiscal years 1384 and 1385; (b) public enterprises that have been identified by the MOF for liquidation; (c) public enterprises that do not have Cabinet-approved restructuring plans;

- "public enterprises" refers to enterprises wholly or majority owned by the government, including those covered by the State-Owned Enterprise (Tassady) Law, and 13 state-owned corporations[3] and any other public entities and government agencies engaged in commercial activities but not covered by Tassady Law.

• **It applies to** any new loans (or financial contributions) extended directly from state-owned banks to enterprises in need of restructuring, and also to any new government guarantees (as defined in paragraph 14 of this memorandum) of borrowing undertaken by these enterprises. It applies to loan agreements and guarantees for which value has not been received.

H. Adjustors

18. The floor on NIR and the ceiling on the NCBF of the government are defined consistent with the assumption that core budget development spending in 2007/08 will amount, on a cumulative basis from March 20, 2007, to:

December 21, 2007	Af 27,063 million
March 19, 2008	Af 45,483 million

and in 2008/09 will amount on a cumulative basis from March 19, 2008, to:

June 20, 2008	Af 7,107 million
September 21, 2008	Af 21,320 million

[3] Afsotar, Afghan Teor, Aftento, Af-Turk, Afghan Cart, Afghan Naichi, Astrass, Afghan Telecom, Afghan Wireless, Afghan National Insurance Company, Afghan Textile, Ariana Afghan Airlines, and Hotel Intercontinental (Baghi Bala/Kabul).

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.

19. 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, 2007, to:

December 21, 2007	Af 38,980 million
March 19, 2008	Af 56,889 million

and in 2008/09 will amount on a cumulative basis from March 19, 2008, to:

June 20, 2007	Af 10,742 million
September 21, 2008	Af 28,161 million

20. 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.

21. 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. The overall downward adjustment to the NIR floors will be capped at US$300 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, currency in circulation, and a monetary survey** should be reported monthly and no later than three weeks after the end of the month. The monetary survey will include the balance sheet of DAB and a consolidated balance sheet of the commercial banking sector.

- **Core budget operations and their financing** should be reported monthly and no later than four weeks after the end of the month. The official reports for the purpose of program monitoring will be the monthly financial statements from the Afghanistan Financial Management Information System. The structure of financing (grants and loans should be separately identified) and expenditure data should be on a consistent cash basis. Core operating expenditures should be reported on a monthly basis using the budget appropriation economic (object) and administrative classification in addition to the program and functional classification as reported in the budget documents. Core development expenditures should also be reported separately on a monthly basis using the budget program classification in addition to the economic (object), administrative and functional classification consistent with the operating budget. All the data should also compare outturns against the approved budget (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 debt, and medium- and long-term debt; (c) loan disbursements and debt service payments (interest and amortization) during the quarter; (d) debt relief received during the quarter; (e) information on all overdue payments on short-term debt, and on medium- and long-term debt, including new external arrears (if any); and (f) total outstanding amount of arrears.

- **National accounts data,** with the exception of merchandise trade data, should be reported annually and no later than eight weeks after the end of the year. Merchandise trade data should be reported quarterly and no later than eight weeks after the end of the quarter.

- **Consumer price indexes (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.