International Monetary Fund

Islamic Republic of Afghanistan and the IMF

Press Release:
IMF Executive Board Completes First Review Under the Extended Credit Facility Arrangement for the Islamic Republic of Afghanistan, Approves US$18.2 Million Disbursement
June 29, 2012

Country's Policy Intentions Documents

E-Mail Notification
Subscribe or Modify your subscription

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

June 18, 2012

LETTER OF INTENT

June 18, 2012

Ms. Christine Lagarde
Managing Director
International Monetary Fund
Washington, DC 20431

Dear Ms. Lagarde:

We would like to thank the International Monetary Fund for supporting our economic program under the Extended Credit Facility (ECF) arrangement, approved by the Executive Board on November 14, 2011. The program has guided our macroeconomic policy formulation and structural reforms over the last six months and has helped us to manage some of the key challenges facing Afghanistan's economy, though progress in important areas such as asset recovery from Kabul Bank has been difficult and slow. Looking ahead, our program will continue to focus on safeguarding and developing the financial sector, strengthening economic governance, and moving toward fiscal sustainability.

We are pleased to inform you that we have made progress on our structural reform agenda. Albeit with delays, we have completed five out of six structural benchmarks for the first review (Table 1). At New Kabul Bank, we have closed 25 branches to improve efficiency, we have appointed a privatization advisor, and the economic committee of the cabinet approved privatization of the bank. We have submitted value-added tax legislation for a formal judicial review, are incorporating Fund's comments to the recently prepared amendments to the law on state-owned enterprises—however, amendments to the company law to strengthen oversight and control over state-owned corporation will take until the end of the year—and rolled out the new border management model to additional border crossing points on time. The ministry of finance and Da Afghanistan Bank (DAB) have signed a memorandum of understanding on central bank capitalization, and an external auditor for DAB's 2011/12 financial statements has been appointed. Finally, a national economic crimes strategy was approved and included in the National Priority Program "Justice for All."

We have also made progress on asset recovery from Kabul Bank since April. Given the, in general, poor payment performance of the existing legally binding agreements, we decided to discontinue this option for shareholders or related parties to repay their obligations to the receivership. Instead, President Karzai has given shareholders and related parties until June 4, 2012 to repay their debts in full or be referred to a special tribunal. Based on the decree, we have initiated an asset recovery process for each of the beneficiaries (individuals or corporations) identified in a forensic audit report for the amounts specified therein. Only regular borrowers who remain current on their obligations can continue to repay on their original schedule.

As of June 4, 2012, cash recoveries from Kabul Bank beneficiaries amount to US$128 million out of US$935 million identified assets transferred to the receiver—an additional US$54 million since November 2011. The presidential decree expedited the cash recovery process by bringing in US$30 million since its issuance on April 4, 2012. In addition, we have taken over properties with an estimated value of US$44 million in Dubai, and properties with a book value of US$146 million in Afghanistan. No beneficiary identified in the forensic audit report has paid in full. The two main architects of the fraud have been referred to the special tribunal, and the remaining beneficiaries will be dealt with by the Financial Dispute Resolution Committee, and, if warranted, could be referred to the special tribunal at a later date. In the case of Pamir Airways, Gulbahar Towers, and the Zahira oil tank farm, assets have been transferred to or are under the full legal control of the receiver. In order to assist our investigations and our efforts to recover assets outside of Afghanistan, we have issued mutual legal assistance requests to the United Arab Emirates, and will issue similar requests to other relevant foreign jurisdictions shortly.

We also met all but one of the end-March 2012 quantitative performance criteria. DAB contained reserve money growth to below the program ceiling while accumulating net international reserves by more than projected under the program. The government achieved its social and other priority spending objectives. We did not contract new nonconcessional external debt or accumulate external payment arrears.

However, reflecting trade disruptions at the border with Pakistan and problems in revenue administration, we missed our revenue target by a small margin. This shortfall also translated into a higher than programmed operating deficit of the government, an indicative target. Since revenue mobilization remains one of the government's top priorities, we are taking immediate measures to address the underlying problems that are under our control. Specifically, in fiscal year 2012, we have not renewed and will not renew concessions for certain taxpayer groups that have undermined our revenue base in the past. This measure is also important to ensure the success of the value-added tax introduction.

Accordingly, we would like to hereby kindly request the completion of the first review, the second disbursement of SDR 12 million, and a waiver for nonobservance of the quantitative performance criterion on revenue collection by the central government given that the shortfall was minor and that we are taking corrective action. Completion of the review will allow us to consolidate reform gains while providing necessary confidence to our development partners.

Our reform agenda ahead is ambitious. Fiscal and monetary policies will continue to be geared toward revenue generation and containing inflation. Moreover, in the coming months, we will take necessary steps to contain emerging risks in the financial sector, including tightening capital requirements and strengthening supervision. We will also submit to the ministry of justice and subsequently to parliament amendments and new laws critical to building good economic institutions, including in the areas of central banking, commercial banking, VAT, debt securities, public enterprises, anti-money laundering and countering the financing of terrorism, and establish an interagency framework for the implementation of these laws.

Our policies for the next 12 months are laid out in the attached Memorandum of Economic and Financial Policies (MEFP) and the Technical Memorandum of Understanding (TMU). The program will be monitored through quantitative performance criteria and indicative targets (Table 2) as well as structural benchmarks (Table 1). We also request that the ECF arrangement be rephased to make it consistent with the new Afghan fiscal year (Table 3).

We believe that the policies set forth in the MEFP are adequate to achieve the objectives of the program, but stand ready to take any further measures that may become appropriate for this purpose. We will consult with the Fund on the adoption of these measures and in advance of any revision to the policies contained in the MEFP, in accordance with the Fund's policies on such consultation. We will remain in close consultation with Fund staff and provide timely information necessary for monitoring economic developments and implementation of policies under the ECF-supported program.

Sincerely yours,

/s/ /s/

Omar Zakhilwal
Minister of Finance

Noorullah Delawari
Governor Da Afghanistan Bank

Tables:

Table 1. Islamic Republic of Afghanistan: Prior Actions and Structural Benchmarks
Table 2a-b. Islamic Republic of Afghanistan: Quantitative Targets
Table 3. Rephasing and Change to the Schedule of Reviews

Attachments:

Memorandum of Economic and Financial Policies
Technical Memorandum of Understanding

Table 1. Islamic Republic of Afghanistan: Prior Actions and Structural Benchmarks

Measure	Rationale	Target Date	Status as of June 10
Structural Benchmarks for the First Review			
In consultations with Fund staff, the ministry of finance and the central bank will agree, in a ***memorandum of understanding, on the central bank's capitalization*** needs and a schedule for recapitalizing the central bank as needed.	Financial sector stability, central bank independence and ability to conduct monetary policy	End-December 2011	Completed in June 2012.
Submit ***VAT law***—consistent with IMF advice—aimed at raising the revenue-to-GDP ratio to the ministry of justice ("Taqnin") for review with a view to submitting it to parliament by end-December 2012.	Support fiscal sustainability	End-December 2011	Completed in December 2011.
Submit to the ministry of justice ("Taqnin") legislation bringing ***public enterprises*** under effective monitoring and oversight of the ministry of finance.	Support fiscal sustainability and macroeconomic stability by enhancing controls and reducing fiscal risks	End-March 2012	Draft amendments to the state-owned enterprise law have been shared with staff, and we will incorporate comments received. State-owned corporations will be addressed later this year (see new end-December 2012 structural benchmark).
Roll out to at least ***two additional Border Crossing Points*** the new Border Management Model piloted at Hairatan Border Crossing Point. The model is based on a 'two-agency' approach which restricts border presence to the Afghan Border Police and the Afghan Customs Department. Under this model, the ABP will continue to fulfill immigration and security responsibilities, with ACD fulfilling all other commercial and trade-related duties.	Improve efficiency and lower corruption	End-March 2012	Completed in April 2012.
Reduce number of branches at bridge bank (New Kabul Bank) by 20 according to the updated business plan.	Minimize fiscal costs	End-March 2012	Completed. 25 branches have been closed as of end-January 2012.

Measure	Rationale	Target Date	Status as of June 10
In line with our desire to protect the financial system from abuse, the government will produce a ***roadmap with a strategy to build capacity and improve the institutional framework to respond promptly to economic crime***. This roadmap will address issues related to the prosecution system to reinforce its independence to ensure accountability for economic crimes and build capacity for investigation and prosecution of these crimes as well as determine the most appropriate institutional framework going forward.	Financial sector stability and integrity, reduce moral hazard	End-March 2012	The strategy was included in the "Justice for All" National Priority Program on May 15, 2012.
Structural Benchmarks for the Second Review			
The economic committee of the cabinet will approve the privatization plan for New Kabul Bank prepared by the privatization advisor in consultation with Fund staff. The plan includes clear criteria for bidders, precise determination of what is being sold, the procedures for sale, and public communication strategy (MEFP paragraph 25).	Advance Kabul Bank resolution	End-August 2012	

Measure	Rationale	Target Date	Status as of June 10
The bridge bank (New Kabul Bank) will be offered for sale in a transparent way, involving a pre-qualification process to ensure that controlling shareholders, beneficial owners, directors and management of intending bidders are fit and proper (which implies, inter alia, that an intending bidder is subject to a high standard of corporate governance, including risk management and internal controls, and that an intending bidder is in a sound financial and risk management state), and that the intending bidder controls adequate resources and has the necessary capacity and capability to ensure the ongoing provision of the relevant salary payments services. There will be a request for expressions of interest locally and internationally for the sale of the bridge bank. Interested parties will be given four weeks to respond with intention to participate in the bid. Once the central bank has vetted potential buyers, the ministry of finance will give them a deadline for sealed bids (MEFP paragraph 25).	Advance Kabul Bank resolution	End-September 2012	Delayed from end-June 2012 because it took longer than expected to appoint a privatization advisor. The advisor is now in place.
The independent Monitoring and Evaluation Commission will conduct an ***in-depth public inquiry*** to examine the events leading to the Kabul Bank crisis, starting with the inception of the bank, and look into the operations of the bank, activities of its shareholders, the role of supervisory and auditing bodies, and the subsequent effectiveness of the government and the criminal justice system in dealing with any crimes committed (MEFP paragraph 11).	Strengthen financial sector stability, transparency	End-September 2012	

Measure	Rationale	Target Date	Status as of June 10
Submit to parliament the ***amended or new banking law***, prepared in consultation with the Fund that will strengthen provisions on corporate governance, capital, large exposures, related parties, consolidated supervision, early intervention, enforcement, and bank resolution, where appropriate in line with the Basel Core Principles. Specifically, the law should enable us to enforce upon a bank - going concern - all necessary resolution measures and strengthen corporate governance requirements for banks (including fit and proper requirements as set by the Financial Action Task Force standards) (MEFP paragraph 21).	Promote financial sector stability by strengthening independence of bank regulators, reducing risks from bank lending, and ensuring swift processes for bank resolution	End-September 2012	Draft law is being finalized by DAB and needs to be sent to the ministry of justice next.
Strengthen our AML/CFT regime by implementing an action plan based on the recommendations of the February 2011 assessment by: (i) submitting amendments to the AML/CFT law to parliament as necessary; (ii) increasing the capacity of FinTRACA, including by hiring additional staff as needed; (iii) expanding MSP registration and implementation of reporting to MSPs in areas currently inaccessible for security reasons if and when the security situation allows; and (iv) enforcing MSP reporting by dedicated software in all reporting areas where it is technically and logistically feasible (MEFP paragraph 30).	Promote financial sector stability and integrity and strengthen AML/CFT framework	End-September 2012	
Submit legislation to the ministry of justice ("Taqnin") for review with a view to submitting it to parliament by end-March 2013 ***for the introduction of marketable debt instruments*** by the ministry of finance (MEFP paragraph 39).	Develop financial markets	End-September 2012	We have delayed submission to parliament to allow for wide consultation of the law with all relevant stakeholders.

Measure	Rationale	Target Date	Status as of June 10
The Supreme Council of Da Afghanistan Bank to approve ***strategies for banks that fall short of the minimum paid-up capital*** to be merged or closed, with the process starting no later than December 2012 (MEFP paragraph 23).	Financial stability	End-September 2012	
Structural Benchmarks for the Third Review			
Following the approval by the cabinet ***submit draft law on VAT to the parliament.*** The draft legislation will be prepared in consultation with Fund staff, limit exemptions, and require that new exemptions be introduced only through parliamentary approval in the VAT law (MEFP paragraph 34).	Fiscal sustainability, revenue mobilization	End-December 2012	
The Afghanistan Revenue Department within the ministry of finance to ***identify taxpayers*** in the medium taxpayer office and the small taxpayer office whose turnover exceeds the large taxpayer office threshold and revisit the thresholds for the large taxpayer office and the medium taxpayer office with a view to having an efficient allocation of taxpayers across the three offices. The findings and actions to be summarized in a report (MEFP paragraph 35).	VAT implementation; tax administration and revenue collection	End-December 2012	
Submit to the ministry of justice ("Taqnin") legislation bringing ***state-owned corporations*** under effective monitoring and oversight of the ministry of finance, including financial reporting to the ministry of finance and ministry of finance approving financial plans on an annual basis. The draft legislation will be prepared in consultation with Fund staff (MEFP paragraph 40).	Corporate governance; transparency; sound public financial management, fiscal sustainability (by reducing fiscal risks)	End-December 2012	
Approval by the Supreme Council of Da Afghanistan Bank of the ***new organizational structure of the Financial Supervision Department*** developed in consultation with Fund staff (MEFP paragraph 22).	Strengthening supervision; Financial soundness	End-December 2012	

Measure	Rationale	Target Date	Status as of June 10
Revise central bank regulations as well as prepare and issue informational circulars to ensure consistency with the revised banking law (MEFP paragraph 21).	Improve financial supervision	End-December 2012	
Structural Benchmarks for the Fourth Review			
Establish a senior official-led interagency steering committee (***Economic Crimes Task Force***) to oversee the passage and implementation of the new banking law, the anti-money laundering and terrorist financing laws and their provisions, and to function as a coordinating body for the implementation of the Economic Crimes Strategy and its action items (MEFP paragraph 29).	Financial integrity, financial development	End-March 2013	
Submit to the ministry of justice ("Taqnin") amendments to the income tax law, minerals law, oil and gas (hydrocarbons) law and customs code—developed in consultation with Fund staff—related to the development of a sound and robust ***natural resources fiscal regime*** to attract investment and ensure the government has a reasonable share of the economic rent (MEFP paragraph 37).	Fiscal sustainability, revenue mobilization	End-June 2013	
Sign a ***memorandum of understanding between Financial Transactions and Reports Analysis Center of Afghanistan, the Financial Supervision Department of DAB, and competent law enforcement authorities*** on information sharing as described in the attached MEFP (paragraph 30).	Financial integrity, financial development	End-June 2013	

Measure	Rationale	Target Date	Status as of June 10
Submit to parliament amendments to the central bank legislation—drafted in consultation with Fund staff—implementing the memorandum of understanding on the central bank's capitalization, that aligns the provisions on the netting and allocation of net income with international good practice (MEFP paragraph 31).	Central bank capitalization, macroeconomic stability	End-June 2013	

Table 2a. Islamic Republic of Afghanistan: Quantitative Targets, 2011/12

(cumulatively from the beginning of the fiscal year, unless otherwise indicated)

		Fiscal Year 2011/12							
	Mar. 20, 2011	June 21, 2011	Sep. 22, 2011	Dec. 21, 2011			Mar. 19, 2012		
	Stocks	Actual	Actual	Indicative targets	Adj.	Act.	Performance criteria	Est. adj.	Prel.
				(In billions of Afghanis)					
Floor on revenues of the central government	…	21.7	46.1	71.6	...	69.3	98.8	...	97.3
Indicative target (ceiling) on currency in circulation	132.4	1.3	11.9	16.6	...	15.9	23.6	...	15.7
Ceiling on net central bank credit to the central government	-46.9	29.1	26.2	17.8	37.0	26.8	24.8	38.0	25.8
Indicative target (ceiling) on the operating budget deficit of the government, excluding grants	…	1.4	12.9	33.8	33.8	28.8	52.6	52.6	53.0
Indicative target (floor) on social and other priority spending	…	4.5	9.0	13.5	...	12.7	18.0	...	18.2
Ceiling on reserve money	151.0	15.4	17.3	15.0	...	19.2	28.4	...	24.3
				(In millions of U.S. dollars)					
Floor on net international reserves of DAB	5,099	454	519	572	182	704	630	363	665
Ceiling on contracting or guaranteeing new medium- and long-term nonconcessional external debt by the public sector 2/	…	0.0	0.0	0.0	...	0.0	0.0	...	0.0
Ceiling on short-term external debt owed or guaranteed by the public sector 2/	…	0.0	0.0	0.0	...	0.0	0.0	...	0.0
New external payments arrears, excluding interest on preexisting arrears 2/	…	0.0	0.0	0.0	...	0.0	0.0	...	0.0
Ceiling on lending from state-owned banks or the central bank to public enterprises in need of restructuring or government guaranteeing borrowing by these enterprises 2/	…	0.0	0.0	0.0	...	0.0	0.0	...	0.0
Reference projections for the adjustors									
					Deviation			Deviation	
Core budget development spending	…	5.3	16.9	33.5	-1.6	31.9	53.4	0.0	53.4
External financing of the core budget and sale or transfers of nonfinancial assets	…	21.7	41.9	85.4	-18.4	67.0	115.3	-10.7	104.6
Asset recovery from banking sector institutions in liquidation	…	0.0	1.0	1.8	-0.8	1.0	3.5	-2.5	1.0
Recapitalization, net of profit distribution and revaluation of MoF securities at DAB	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Externally financed expenditures transferred to the core operating budget	…	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: Afghan authorities

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

2/ These targets apply on a continuous basis.

Table 2b. Islamic Republic of Afghanistan: Quantitative Targets, 2012–13

(cumulatively from the beginning of the respective fiscal year, unless otherwise indicated)

		Fiscal Year 2012 (interim, 9-months fiscal year)					Fiscal Year 2013			
	Mar. 19, 2012	June 20, 2012		Sep. 21, 2012		Dec. 20, 2012	Mar. 20, 2013	June 21, 2013	Sep. 22, 2013	Dec. 21, 2013
	Stocks	Indicative targets		Performance criteria		Performance	Indicative	Performance		
		Prog.	Proj.	Prog.	Rev.	criteria	targets	criteria	Proj.	Proj.
						(In billions of Afghanis)				
Floor on revenues of the central government	…	23.8	23.8	50.4	50.4	85.1	28.2	59.7	92.6	129.0
Indicative target (ceiling) on currency in circulation	148.2	1.5	4.7	12.7	18.6	28.0	3.5	13.9	20.9	27.8
Ceiling on net central bank credit to the central government	-21.1	-9.5	-11.4	-4.4	-7.7	-4.8	-2.2	-1.3	-2.5	-2.3
Indicative target (ceiling) on the operating budget deficit of the government, excluding grants	…	10.1	10.1	29.2	29.2	45.3	16.0	33.9	52.6	73.3
Indicative target (floor) on social and other priority spending	…	4.8	6.1	9.7	12.2	18.3	6.0	12.0	18.0	23.9
Ceiling on reserve money	175.3	-4.0	0.0	6.5	9.8	26.7	0.0	8.9	24.2	32.3
						(In millions of U.S. dollars)				
Floor on net international reserves of DAB	5,764	117	297	234	434	550	137	275	413	550
Ceiling on contracting or guaranteeing new medium- and long-term nonconcessional external debt by the public sector 2/	…	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Ceiling on short-term external debt owed or guaranteed by the public sector 2/	…	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
New external payments arrears, excluding interest on preexisting arrears 2/	…	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Ceiling on lending from state-owned banks or the central bank to, or government guaranteed borrowing by, public enterprises in need of restructuring 2/	…	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Ceiling on government guarantees 2/	…	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Reference projections for the adjustors										
Core budget development spending	…	4.2	4.2	23.9	23.9	49.6	15.9	33.7	52.3	72.9
External financing of the core budget and sale of nonfinancial assets	…	22.8	25.4	55.7	58.7	96.2	33.8	67.8	105.8	146.2
Asset recovery from banking sector institutions in liquidation	…	0.9	1.3	1.9	2.5	3.8	0.6	1.3	1.9	2.6
Recapitalization, net of dividend, and revaluation of MoF's promissory note	...	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Externally financed expenditures transferred to the core operating budget	…	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Source: Afghan authorities

1/ The performance criteria and indicative targets under the program, and their adjustors, are defined in the Technical Memorandum of Understanding.
2/ These targets apply on a continuous basis.

Table 3. Islamic Republic of Afghanistan: Rephasing and Change to the Schedule of Reviews

Review	Disbursement					
	Date		Amount 1/		Conditions (test dates) 2/	
	Old	New	Old	New	Old	New
Second	November 20, 2012	December 20, 2012	12.0	12.0	September 21, 2012	September 21, 2012
Third	May 20, 2013	March 20, 2013	12.0	12.0	March 20, 2013	December 20, 2012
Fourth	November 20, 2013	September 20, 2013	12.0	12.0	September 22, 2013	June 21, 2013
Fifth	May 20, 2014	March 20, 2014	12.0	12.0	March 20, 2014	December 21, 2013
Sixth	November 6, 2014	September 20, 2014	13.0	13.0	September 22, 2014	June 21, 2014

1/ SDR million.
2/ Approval of the respective review based on performance criteria set for the indicated test dates.

MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

1. **This memorandum provides an update on our economic program supported by the IMF's Extended Credit Facility (ECF) approved the IMF's Executive Board on November 14, 2011.** It reviews program implementation through early June 2012 and summarizes the government's economic objectives and policy framework for the next 12 months—a period covered by the second, the third, and fourth review. The memorandum complements our previous memorandum, attached to the letter of intent dated November 1, 2011.

2. **The policies described here are consistent with the Afghanistan National Development Strategy (ANDS), our umbrella development agenda.** Through the Kabul process, launched in 2010, we have further prioritized the ANDS through 22 National Priority Programs (NPPs) to reflect budgetary realities and provide a framework to measure results. The design, sequencing, and financing of the NPPs are currently being discussed with our development partners. The ANDS Annual Progress Report was published in September 2011 and a new progress report is being prepared.

3. **The focus of our program remains broadly appropriate.** We have made a number of achievements in key reform areas over the past six months, including in the areas of introducing a value-added tax (VAT) in 2014, improving the central bank's capitalization framework, and asset recovery from Kabul Bank. Looking forward, the program will focus on safeguarding and developing the financial system, further strengthening economic governance, and moving toward fiscal sustainability.

I. RECENT DEVELOPMENTS

4. **Macroeconomic developments in 2011/12 were impacted by adverse external factors.** Real GDP growth in 2011/12 is estimated at 6 percent—a slowdown from a year ago, largely due to the decline in agricultural output. Inflation slowed to single digits in 2011, but in recent months accelerated again to 11 percent year on year in March, mainly due to rising food and fuel prices. The current account, despite weak exports, has been sustained by continuing aid inflows. Consistent with the program, we have not incurred any new nonconcessional external debt. After having reached the HIPC completion point in 2010, we successfully negotiated debt forgiveness agreements with the United States and Germany, and we also received 100 percent debt relief from Saudi Arabia, Iraq, and Croatia. We continue to discuss debt restructuring and relief with both Paris Club and Non-Paris Club creditors.

5. **The financial sector remains underdeveloped and plays only a limited role in fostering private sector activity.** Following the collapse of Kabul Bank, confidence in the banking sector is low; after an initial fall, deposits have stagnated at about 20 percent of GDP since mid-2011. There has been virtually no new net lending during the past year, reflecting limited credit demand—partly due to low confidence—and banks' difficulties in identifying

sound lending opportunities. The interest rate on 28-day capital notes remained stable, at around 2 percent.

6. **The outlook for 2012 is challenging, but growth should still accelerate.** The global and regional economic environment is difficult, with rising oil prices and occasional trade disruptions with neighboring countries. Domestically, the low level of security and the impact of the ongoing military withdrawal will weigh on activity. On the other hand, we expect agriculture to rebound after poor harvests in the last two years. On balance, we project growth to reach about 7 percent in 2012. With some tightening of monetary policy, we aim to contain inflation to 7½ percent year-on-year by end-2012. Exports are likely to be sluggish, while fuel prices will push up our import bill. We expect that the resulting large trade deficit will continue to be covered by donor support.

II. Program Implementation Through June 2012

7. **Against the backdrop of a challenging environment, we have made good progress on our economic program through June 2012.** We have met all but one of the end-March 2012 quantitative performance criteria, and have implemented five out of six envisaged reform steps, though in some cases this took extra time.

A. Quantitative Program

8. **In the fiscal area, budget implementation improved further, but revenue collections fell slightly short of expectations.** Development spending increased by 22 percent in 2011/12 over the previous year, reaching about 6 percent of GDP. Better capacity in line ministries and more realistic budget projections led to a budget implementation rate of 52 percent. At the same time, as explained in our letter of intent, revenue collection fell short of our target and declined marginally in percent of GDP, reflecting trade disruptions at the border with Pakistan and problems in revenue administration. We restrained operating expenditure in the first half of the fiscal year, and that contributed to containing the operating budget deficit to 6.1 percent of GDP, slightly above our program ceiling.

9. **In the monetary area, we continued to build our international reserves buffer, while containing reserve money growth.** On the back of strong financial inflows, net international reserves reached US$5.9 billion at end-March 2012, US$220 million over the program floor. We sterilized some of these inflows through the capital notes issued by Da Afghanistan Bank (DAB), and reserve money growth was limited to 16 percent year-on-year in March 2012, compared to 19 percent envisaged under the program.

B. Structural Reforms

10. **We have completed five out of six structural benchmarks for the first review.** In December 2011 we submitted the VAT law to the ministry of justice for legislative review—

we have benefited from Fund's assistance in drafting this law. By January 2012, 25 branches of New Kabul Bank have been closed. In March we completed rolling out the new border management model to two additional border crossing points. In May the minister of finance and the governor of the central bank signed a Memorandum of Understanding on Central Bank's Capitalization, and an internationally reputable external auditor has been appointed for the central bank. Also in May, we prepared amendments to the legislation on state-owned enterprises to the ministry of justice (Fund's comments are now being integrated), and finalized our national strategy to build capacity to respond to economic crime which has been incorporated in the NPP on "Justice for All". Finally, following the approval on February 21, 2012 by the economic committee of the cabinet of the sale of New Kabul Bank, we have appointed a privatization advisor for the bank.

11. **We remain committed to maximizing the recovery of assets from Kabul Bank shareholders and related parties who benefited from the fraud.** Dealing with this decisively, effectively and transparently will not only reduce the enormous fiscal costs of the bail-out, but send a clear message to the public, banks, and future investors that Afghanistan's financial sector is governed and protected by the rule of law—which we know will be crucial to economic growth going forward. The independent Monitoring and Evaluation Commission is conducting an in-depth public inquiry into the Kabul Bank crisis to identify lessons learned (by September 2012; structural benchmark).

12. **Asset recovery has accelerated since the completion of a forensic audit and the issuance of a presidential decree.** A forensic audit completed in March documented the various criminal violations in the bank and determined the exact amounts owed as of August 31, 2010, totaling US$935 million, of which US$74 million are from regular borrowers. Following that, a presidential decree dated April 4, 2012 gave beneficiaries until June 4, 2012 to repay their debts, or face criminal and civil action. The decree also called for the establishment of a special tribunal, which was subsequently established by the Supreme Court on April 18, 2012. Based on the guidance from the decree, we have initiated an asset recovery process for each of the beneficiaries (individuals or corporations) identified in the forensic audit report as beneficiaries of the scheme to defraud the bank for the amounts specified therein. Given the, in general, poor payment performance of the existing legally binding agreements, we decided to discontinue this option for shareholders or related parties to repay their obligations to the receivership. Only regular borrowers can continue to repay on their original schedule.

13. **We subsequently ensured that all competent authorities have a common interpretation of their roles, responsibilities, and legal jurisdictions in asset recovery and the jurisdiction of the special tribunal mentioned in the decree.** These include the receiver, the Financial Dispute Resolution Commission, the ministry of justice, and the courts, as well as competent law enforcement authorities and the attorney general's office. The attorney general, the special tribunal, law enforcement (e.g., the Major Crimes Task Force), will concentrate their efforts, *inter alia*, on building criminal cases, conducting

investigations that identify crimes and assets owed to the receiver, engaging in international cooperation and investigations, prosecuting criminal behavior and freezing, seizing and confiscating assets. The receiver and the Financial Dispute Resolution Commission will concentrate their efforts on indentifying, taking possession of, and managing recovered assets.

14. **The decree has been implemented and the process has yielded cash and in-kind recoveries, and a number of individuals have been referred to the special tribunal.** As of June 4, 2012, cash recoveries from Kabul Bank beneficiaries amount to US$128 million out of US$935 million identified assets transferred to the receiver—an additional US$54 million since November 2011. The presidential decree expedited the cash recovery process by bringing in US$30 million since its issuance on April 4, 2012. In addition, we have taken over properties with an estimated value of US$44 million in Dubai, and properties with a book value of US$146 million in Afghanistan. No beneficiary identified in the forensic audit report has paid in full. The two main architects of the fraud have been referred to the special tribunal, and the remaining beneficiaries will be dealt with by the Financial Dispute Resolution Committee, and, if warranted, could be referred to the special tribunal at a later date. In the case of Pamir Airways, Gulbahar Towers, and the Zahira oil tank farm, assets have been transferred to or are under the full legal control of the receiver. In order to assist our investigations and our efforts to recover assets outside of Afghanistan, we have issued mutual legal assistance requests to the United Arab Emirates, and will issue similar requests to other relevant foreign jurisdictions shortly. We will report on the status of asset recovery on a quarterly basis to the public by posting progress on our website —starting in September—including on cash recoveries, taking over of nonfinancial assets, and the status of civil and criminal proceedings.

15. **There has also been significant progress on structural reforms in the fiscal sector.** First, in line with program budgeting reform, all budgetary units now prepare a single common program-based budget presentation integrating the operating and development budgets. Second, financial plans piloted in the ministry of defense and ministry of interior have been rolled out to nine additional ministries. Third, in accordance with public financial management legislation, the Internal Audit Department of the ministry of finance performs internal audits and similar departments in four additional line ministries have been strengthened. Fourth, in the increasingly important mining sector, we reviewed the consistency between our natural resource and income tax laws and have started the process of amendment; we are developing capacity in mining revenue projections and would welcome technical assistance in the design of an appropriate fiscal regime. Fifth, we continue to improve the medium term fiscal framework—for example by developing a security sector projections model—and are applying it more consistently to assess future fiscal developments. Sixth, we are developing an asset register that will enable us to evaluate more accurately the recurrent costs associated with those assets put in place by past donor investment. Finally, in consultation with the IMF, the new organizational structure for the Afghanistan Customs Department has been approved by the ministry of finance and is now

awaiting the final approval by the civil service commission. In addition, capacity continues to be bolstered for the conduct of post-clearance audits.

III. Economic Program through June 2013

16. **Our overall economic and development agenda continues to be guided by the ANDS.** We continue to aim at poverty reduction, macroeconomic and financial stability, fiscal sustainability, transparency and efficiency of public spending. To this end, we remain committed to the policies agreed under the ECF-supported program, including those spelled out in our previous memorandum from November 1, 2011. Specifically, we will continue to our efforts to enhance economic governance, safeguard and develop the financial system, and move toward fiscal sustainability, including by increasing domestic revenues, and reducing the fiscal risks from public enterprises.

A. Macroeconomic Policies

17. **Macroeconomic policies aim to provide the fiscal space for development spending while maintaining a low and stable inflation environment.** Given Afghanistan's large development needs and limited domestic resources, we remain highly dependent on donor support to meet our fiscal and external financing needs. The operating balance excluding grants is our fiscal anchor, while reserve money remains the monetary anchor. We will also take measures to support financial stability.

18. **Fiscal policies remain focused on revenue mobilization and strengthening public financial management.** The 2012 budget, approved in April, reflects our reform effort and is consistent with the program (as initially designed for 2012/13). The budget envisages domestic revenue collection to increase to 11 percent of GDP compared to 10.6 percent of GDP during the same period in 2011. Development spending, including on health and education, is targeted to grow by about ½ percent of GDP over the last three quarters of 2011 to 6.4 percent of GDP in fiscal year 2012. The budget includes the allocation of US$65 million for the 2012 amortization of the promissory note issued to DAB for the lender of last resort loan to Kabul Bank. We will also continue with the civil service pay and grade reforms.

19. **Monetary policy will be geared to contain the recent acceleration of headline inflation and potential second round effects.** Based on our estimate for money demand growth, we believe that a reserve money growth of about 19 percent by end-2012 is appropriate. This is somewhat higher than initially envisaged under the program, and is intended to provide some cushion for the anticipated changes in seasonality stemming from the shift in the fiscal year, which is likely to lead to a bunching of government spending in the final quarter of 2012. Net foreign exchange purchases will be the main driver of reserve money growth, and we will use capital notes issuances as needed to fine-tune the course.

20. **We will maintain a floating exchange rate that will allow the rate to reflect market fundamentals, with interventions aiming at smoothing out volatility and achieving our reserve money and international reserves targets.** We will also adopt measures to deepen the foreign exchange market. We will move towards a system in which foreign currency will be exchanged on an open market, with sales to the central bank as a last recourse, and the central bank using its purchases mainly to steer reserve money growth. To this end, the central bank has been reducing its role in providing currency through foreign exchange auctions by raising minimum bid amounts in these auctions and charging service fees for cash transactions

B. Structural Reforms

Safeguarding the financial sector and strengthening governance

21. **We are revising the banking law and will subsequently adapt financial sector regulations accordingly.** The revisions will strengthen provisions on corporate governance, enforcement of capital requirements, large exposures, and related parties, consolidated supervision, early intervention enforcement, and bank resolution. The revisions to the current conventional banking law were finalized in 2011 with support from the IMF, and have undergone review by the Supreme Council. We have also added provisions on Islamic banking, and will submit the revised banking law to parliament by end-September 2012 (structural benchmark). Then, by end-December 2012, we will adapt central bank regulations in the key areas in which the banking law has been revised—corporate governance, capital requirements, related parties, and large exposures— and prepare and issue informational circulars and trainings (structural benchmark). Also, because capacity constraints in the judicial system are some of the main risks to contract enforcement by banks (in particular, loan contracts), financial integrity, and financial development, we intend to create capacity amongst court officials in relevant banking laws and commercial codes, so that the courts can supplement and enhance contract enforcement efforts by banks—to that effect, by end-December 2012, we will have established a training program for these court officials.

22. **We are also further strengthening banking supervision.** We have developed a work plan to review and strengthen enforcement regulations and the draft enforcement manual, and we are working to improve timeliness for provision of enforcement actions—and hence their impact—through streamlining the examination and special supervision process, as well as monitoring and following up forcefully on the outstanding enforcement orders. We have recently hired 14 additional staff for the supervision department and hope to fill all current vacancies by end-December 2012, although attracting qualified candidates remains challenging. Moreover, we will adopt a new organizational structure for the Financial Supervision Department by end-September 2012 to better utilize existing staff (structural benchmark), and also increase the number of authorized positions from 97 to 137. Furthermore, we intend to strengthen supervisory staff protection from prosecution for good faith conduct of their duties, including through amendments to the law, where necessary.

Lastly, the mandate of the Risk Management Department will be modified to focus exclusively on risks within DAB. Staff from that department have been transferred to the Financial Supervision Department and will be trained in risk-based banking supervision.

23. **The banking sector remains weak, with 8 out of 12 domestic banks scoring in the lower range of supervisory ratings.**[1] Recognizing that a thorough examination of the sector was merited, we have completed audits of 10 smaller banks with the help of the World Bank. The audits largely confirmed the findings of Financial Supervision Department's on-site examinations: The sector's main vulnerabilities stem from inadequate capital, deficiencies in governance, and excessive exposures. On the basis of these conclusions, the Financial Supervision Department will develop strategies for all structurally weak banks which will be approved by DAB's Supreme Council by end-September 2012. These strategies will envisage that any bank that is unable to increase its minimum paid-up capital to the new level of US$20 million by June 2012 will be merged or closed, with the process starting no later than December 2012 (structural benchmark). In parallel, we will strengthen capital adequacy requirements by adapting the risk weights on assets and loan classification and provisioning requirements in line with Basel I standards. Lastly, DAB will restore reserve averaging to its minimum reserve requirement regulation in order to strengthen the incentives and options for banks to more carefully manage their liquidity.

24. **An external audit confirmed the earlier findings of DAB's on-site examination of a bank with respect to regulatory compliance by the bank, and found no fraud similar to that perpetrated at Kabul Bank.** The bank has violated exposure limits, including to a related party, and some years back, the bank appears to have been involved in a misuse of loans, though these loans have been paid back. However, over the past year, the bank has increased capital, addressed violations highlighted by the central bank and improved compliance. We agreed to the bank's request that the additional capital injection planned for March would be delayed until June to allow time to complete good faith negotiations over the sale of some real estate properties. In the meantime, we have started another regular full scope examination of the bank to determine whether additional enforcement actions are necessary. This could include, but is not limited to the injection of additional capital and/or sanctions for unaddressed (or slippages on addressed) violations identifies in DAB's own 2011 examination.

25. **New Kabul Bank has been operating according to its business plan.** The bank has provided regular prudential reports to the DAB on a monthly basis. Deposits have stabilized at around US$600 million and expenses have been cut substantially, reducing operating losses. Given our decision that New Kabul Bank should not engage in lending so that it can be presented with a clean bank at the point of sale, the bank is making monthly losses of

---

[1] New Kabul Bank is one of the 12 domestic banks but it has not yet been rated.

around US$2–3 million. The economic committee of the council of ministers approved the sale of New Kabul Bank on February 21, 2012, and President Karzai endorsed the decision on April 17, 2012. Due to delays in appointing a privatization advisor—the advisor started work only in early May—we will need to move back the benchmark on offering the bank for sale to September 2012 from June (structural benchmark). The economic committee of the cabinet will approve the privatization plan which will be prepared by the privatization advisor by end-August (structural benchmark); the plan includes clear criteria for bidders, precise determination of what is being sold, the procedures for sale, and public communication strategy. Also by end-August, we will finalize the valuation of fixed assets, thus completing the valuation of the bank's balance sheet. We will perform necessary due diligence, including on beneficial ownership of bidders, and only accept reputable, fit-and-proper, financially sound investor(s) with expertise in the banking sector and high standard of corporate governance.

26. **If there is no interest from a suitable buyer or the sale fails, we will wind down New Kabul Bank by end-December 2013.** This timeline is longer than we had previously expected because it will take longer than hoped for to hand over the salary payment function to other banks in full as well as migrate the existing deposit accounts to viable financial institutions. Intermediate steps to be taken to prepare New Kabul Bank for liquidation will include, but are not limited to, closure or transfer of credit card business, elimination of interest bearing deposit accounts, transfer of nongovernment salary related deposit accounts elsewhere, and immediate reduction of staff not required for government salary payment administration.

27. **While New Kabul Bank will continue to play a leading role in effecting salary payments for government employees, other banks are slowly taking over some of this function.** Over 400,000 government employees now receive their salaries by direct deposit to their bank accounts (largely at New Kabul Bank) or third party intermediaries. In June we awarded the new salary payment contract for the next three years to several banks that have participated in the bidding process. New national payments systems (real time gross settlement, automated clearing house, and a national switch) are expected to be operational by mid-2014. At that time, government employees will be able to select the bank in which their salaries are paid, thus introducing genuine market competition for provision of the service.

28. **Afghanistan's financial sector is nascent and the criminal justice and regulatory and institutional framework that support financial and economic activity lack capacity and experience.** These weaknesses are among the key factors that are slowing asset recovery in the case of Kabul Bank. We recognize the extreme threats and vulnerabilities which threaten economic stability, including an overwhelmingly large illicit narcotics and smuggling sector, a large cash based economy, a large amount of unregulated financial activity taking place outside the formal regulated sector, high levels of corruption, powerful

vested interests, porous borders which impede revenue collection, and vast areas of the country that cannot fall under financial supervision due to insecurity.

29. **As such, our economic crimes strategy aims to build capacity and foster cooperation among relevant government entities to enable them to respond to these risks.** To this end, we will establish a senior official-led interagency steering committee—the Economics Crime Task Force—(structural benchmark) to oversee the implementation of the new banking law, the AML and terrorist financing laws and their provisions, and to function as a coordinating body for the implementation of the economic crimes strategy and its action items. The committee will be responsible for: (i) ensuring and coordinating the education of the competent authorities on the new provisions to the laws related to economic crimes (especially, but not exclusive to) the banking law, the AML law and the CFT law); (ii) ensuring there is a commensurate issuance of necessary regulations, circulars and trainings within agencies and the private sector following the passage of the laws; (iii) increasing the capacity of the justice system to investigate, try, and hear financial crimes and related money laundering, terrorist finance and asset recovery cases/procedures; (iv) the establishment of a consolidated handbook of guidelines and procedures for investigating and trying economic crimes according to Afghan law that contains definitions of the roles and responsibilities of competent authorities including courts, the attorney general's office, the central bank, the financial intelligence unit, the Financial Disputes Resolution Committee, and the Major Crimes Task Force; and (v) monitoring the implementation of appropriate programs for competent authorities on new and existing institutional procedures, legal provisions, and regulations.

30. **We are also taking urgent actions to address deficiencies in our AML/CFT framework.** Following its first AML/CFT mutual evaluation, Afghanistan was found to be deficient in a number of areas. As part of the International Cooperation Review Group's targeted review process we have made a ministerial level commitment to an action plan to be agreed with the Financial Action Task Force in June 2012, key elements of which will be implemented by September 2012 (structural benchmark). In particular, we will submit to parliament by end-September 2012 our new AML and CFT laws. Finally, by June 2013, the AML/CFT stakeholders, including the Financial Transactions and Reports Analysis Center of Afghanistan, DAB's Financial Supervision Department, and competent law enforcement authorities, will agree in a memorandum of understanding on a mandatory exchange of AML/CFT information and analyses (structural benchmark). This memorandum will mandate the exchange of (i) analytical information—specifically in the form of biennial reports for all AML/CFT stakeholders by the Financial Transactions and Reports Analysis Center of Afghanistan identifying risks, threats, and typologies; (ii) as well as dissemination of tactical analysis products to competent law enforcement authorities in a timely fashion; (iii) dissemination of information on reporting trends and suspected instances of noncompliance (for DAB AML/CFT supervisors); and (iv) the production of annual statistical reports on the exchange of information.

Strengthening the central bank capitalization framework and governance

31. **The memorandum of understanding between DAB and the ministry of finance sets out a path toward a strengthened central bank capitalization framework.** This memorandum, *inter alia*, reconfirms that the authorized capital be five percent of the sum of currency in circulation, debt securities issued by DAB and the credit balances of commercial bank's accounts maintained on the books of DAB, and aligns the provisions on the netting and allocation of net income with international good practice. Any required recapitalization will be effected no later than 2014. According to the memorandum, we will draft the necessary amendments to the central bank law (in consultation with the Fund) and submit them to the ministry of justice by December 2012, with the view to submitting them to parliament by June 2013 (structural benchmark).

32. **The central bank is committed to ensuring timely implementation of the recommendations of the update safeguards assessment.** In this context, we will strengthen the internal audit function (with external assistance) and enhance the Audit Committee's oversight as a priority. We have recently appointed the head of the Audit Committee and intend to fill the two vacant posts by August 2012.

Moving toward fiscal sustainability while providing space for development spending

33. **Our fiscal strategy focuses on revenue generation and minimizing fiscal risks to ensure that the necessary resources are available for development spending.** Revenue generation efforts include the introduction of a VAT and designing and legislating the fiscal regime for the natural resources sector, and continued reforms in customs and tax administration.[2] We are also taking steps to improve budget planning and implementation and to contain the fiscal risk stemming from state-owned enterprises and corporations. To improve cash management, we will introduce sukuks as government securities in 2014.

34. **The VAT law is under preparation.** The law is currently being reviewed by the ministry of justice. It will be sent to cabinet for discussion in September 2012 and to parliament for approval by end-December 2012 (structural benchmark). As we finalize the draft, we will ensure that exemptions are limited to medical, education, and financial services as well as humanitarian and religious purposes, and are explicitly listed in the VAT law. We will also revise the current draft to require that any future exemptions are provided for through an amendment of the VAT law that is approved by parliament.

[2] The pilot border management model at Hairatan will be applied fully to the Hairatan railway border crossing. The Afghan Border Police and the Afghanistan Customs Department will take full control of the railway border crossing by end-September 2012, and the ministry of commerce and industries will at most provide logistical services, but no longer be in charge of operating any part of the facility.

35. **Planning for the VAT implementation has begun.** Given the VAT threshold, the tax will initially be collected only from large taxpayers registered with the large taxpayer office (LTO). Successful VAT introduction, therefore, hinges upon the identification and registration of all taxpayers whose turnover exceeds the Large Taxpayer Office (LTO) threshold. Currently, many large taxpayers (importers) pay a fixed rate (a presumptive tax) in order to avoid filing, thereby remaining outside the LTO or outside the formal tax net altogether. Therefore, by end-December 2012 and consistent with the recent Fund advice on VAT implementation, The Afghanistan Revenue Administration will identify taxpayers in the Medium Taxpayer Office (MTO) and the Small Taxpayer Office (STO) whose turnover exceeds the LTO threshold, revisit the thresholds for the large taxpayer office and the medium taxpayer office with a view to having an efficient allocation of taxpayers across the three offices—no more than 350 taxpayers in the LTO—and transfer cases into the LTO accordingly (structural benchmark) in time for the submission of the VAT law to parliament. The findings and follow-up actions will be summarized in a report. The above will be complemented with significant increases in the number of staff as well as training, which will enable the LTO to have the adequate capacity to administer all taxpayers. In order to ensure the stability of the VAT taxpayer base and to level the playing field across businesses, we will also immediately discontinue all "concessions" for importers ("traders").[3] This is an important commitment, as initially a large proportion of VAT revenues will be collected at the border. Therefore, eliminating concessions for certain taxpayer groups will prevent continued undermining of the revenue base in light of our weak revenue performance in 2011/12.

36. **Our natural resources are an important part of our economic future and we understand that a number of policy issues must be addressed to harness this wealth for the benefit of the population.** The development of our natural resource wealth, including the rate of exploitation, will be integrated into the country's long-term development program. Specifically, all revenues from extractive industries will be channeled transparently through the budgetary process where national spending priorities are set. There will be no use of earmarking or off-budget spending. We will consult closely with the World Bank and the IMF in designing the framework for managing our natural resources.

37. **We will put in place a sound and robust fiscal regime for the mining sector to attract investment and ensure the government has a reasonable share of the economic rent.** Over the past few years we have benefited from numerous studies, including by the

[3] Namely, in fiscal year 2012, we have not renewed or granted any concessions and will revoke any existing concessions by end-June 2012, effectively obliging the beneficiaries to file and pay taxes as otherwise required. We will enforce this obligation on the beneficiaries in case they fail to comply.

Fund, reviewing the current framework and recommending changes to legislation.[4] In that regard, by end-June 2013, we will submit to the ministry of justice amendments to the appropriate laws that create an effective and transparent fiscal regime for natural resources in full compliance with the Extractive Industries Transparency Initiative and in consultation with the IMF (structural benchmark).

38. **To strengthen budget planning and implementation, we are adopting program budgeting.** As part of the preparation for migration to program-based appropriations, by end-March 2013, we will conduct a thorough review of preparedness for migration, including, inter alia, verifying under the program structure the alignment of policies with budgetary allocations, consistency in program definitions across agencies, linkages between the program and agencies' organizational structures, clear rules for program level appropriation control (and other levels of expenditure control) during budget execution, clear rules for reallocation between line/economic items within each program (e.g., putting restrictions on certain line items such as salaries to prevent abuse), and a detailed appraisal of areas with capacity and accountability shortfalls of program managers to execute their budgets.

39. **We are working on the introduction of marketable sukuk securities to improve cash management with assistance from the IMF.** We have finalized an initial assessment of laws for their suitability for Islamic finance, and now are finalizing the draft sukuk law, with a view to submitting it to the ministry of justice by September 2012 (structural benchmark) and to the parliament by March 2013.[5] This is a delay compared to our earlier plans because it will take longer to ensure that the draft law is consistent with the Afghan legal tradition and we want to consult widely with all stakeholders on the law. We continue to aim for the first issuance in late 2013 or early 2014. In this respect, we will produce a sukuk implementation plan, with specific actions and a timetable by June 2012, finalize the identification of state-owned assets and development projects that would back sukuks, and set up a sukuk shariah supervisory board by September 2012.

40. **We are taking steps to identify the potential fiscal risks from public enterprises—state-owned enterprises and state-owned corporations.** The fiscal burden of these companies ranges from an immediate budgetary impact due to tax concessions or subsidies, to fiscal risks such as debt guarantees and implicit obligations in the event of failure. We have recently prepared amendments to the legislation on SOEs to bring them

---

[4] See, for example, Afghanistan: *Mining Tax and Royalties Policy*, USAID Economic Growth and Governance Initiative, 2010; *Tax Reform: The Next Steps*, International Monetary Fund, 2010; *A Review of the Consistency between Afghanistan's Tax and Mining Laws*, Adam Smith International, 2011.

[5] *Inter alia*, we have requested a legal opinion whether debt service (principal and interest) requires annual parliamentary approval, and, if so, we will assess whether an alternative mechanism would be desirable, such as automatic debt service authorization or a debt ceiling. In this respect, we will consult the Fund and prepare a legal and economic assessment of the framework for debt servicing.

under ministry of finance oversight and, after incorporating Fund's comments, will submit the draft to the ministry of justice. We are also working on amendments to the company law that will improve the financial oversight of state-owned corporations (SOCs) by the ministry of finance. We intend to send the amendments to the ministry of justice for review by end-December 2012 (structural benchmark). By 2014, we will include a fiscal risk statement related to condition of public enterprises and corporations into the published budget documents. The objective is to provide a transparent assessment of the fiscal risks involved in these companies. The state-owned enterprises department will be responsible for preparing this assessment—initially for those enterprises of which the ministry of finance is the main shareholder or owner—as part of the budget preparation process.[6] As an intermediate step, we will review the financial statements and plans provided by public enterprises to the ministry of finance and issue guidance on what information these statements and plans have to contain by December 2012.

IV. PROGRAM MODALITIES AND MONITORING

41. **In 2012, we are changing the fiscal year to facilitate budget planning and implementation.** Through 2011/12, the fiscal year corresponded to the Afghan calendar year (based on the solar year) running from March 21 to March 20 in most years. In 2012 (ministry of finance) and 2013 (central bank), we are transitioning to a fiscal year that is closer aligned with the Gregorian calendar year and runs December from 22 to December 21 in most years. The interim fiscal year 2012 has only 9 months. We request to adjust the schedule of reviews under the program to accommodate this change. Accordingly, the quantitative performance criteria and structural benchmarks are set for September 2012, December 2012, and June 2013; with indicative targets for March 2013 (Tables 1–3 of the letter of intent). The second, third and fourth reviews of the program could be completed before the end of the months of December 2012, March 2013 and September 2013 respectively. We will continue monitoring our reform agenda through our Technical Coordination Committee.

42. **Article VIII.** During the program period, we 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 restrictions for balance of payments purposes.

---

[6] At present eight SOCs, which represent 90 percent of total SOEs/SOCs assets, have the ministry of finance as their main shareholder.

TECHNICAL MEMORANDUM OF UNDERSTANDING

1. This memorandum reflects understandings between the Afghan authorities and Fund staff in relation to the monitoring of the ECF-supported program during 2012–13. It specifies valuation for monitoring quantitative targets under the program (Section I), quantitative performance criteria and indicative targets (Section II), adjustors (Section III), and data reporting (Section IV).

I. PROGRAM EXCHANGE RATES AND GOLD VALUATION

2. Program exchange rates are used for formulating and monitoring quantitative targets. All foreign assets and liabilities denominated in U.S. dollars will be converted into Afghanis at a program exchange rate of 45.3740 Afghanis per U.S. dollar, which corresponds to the cash rate of March 20, 2011. Gold holdings will be valued at US$1,418.90 per troy ounce, the price as of March 20, 2011. Assets and liabilities denominated in SDRs and in foreign currencies other than the U.S. dollar will be converted into U.S. dollars at their respective exchange rates of March 20, 2011, as reported in the following table.

Exchange Rate	Program Rate
U.S. dollars / Canadian dollar	1.016000
U.S. dollars / U.A.E. dirham	0.272300
U.S. dollars / Egyptian pound	0.168600
U.S. dollars / euro	1.418200
U.S. dollars / Hong Kong dollar	0.128200
U.S. dollars / Indian rupee	0.022160
U.S. dollars / Pakistani rupee	0.011715
U.S. dollars / Polish zloty	0.348800
U.S. dollars / Iranian rial	0.000097
U.S. dollars / Saudi Arabian riyal	0.266600
U.S. dollars / Russian ruble	0.035180
U.S. dollars / Swiss franc	1.109800
U.S. dollars / pounds sterling	1.623400
U.S. dollars / SDR	1.585700

II. QUANTITATIVE PERFORMANCE CRITERIA AND INDICATIVE TARGETS

3. **The quantitative performance criteria for September and December 2012, and June 2013, specified in Table 2 of the letter of intent, are:**

- Floors on revenue of the central government and net international reserves (NIR); and

- Ceilings on reserve money; net central bank credit to the central government (NCG); contracting and/or guaranteeing new medium- and long-term nonconcessional external debt by the public sector, (continuous); short-term external debt owed or guaranteed by the public sector (continuous); accumulation of external payment arrears, excluding interest on preexisting arrears (continuous); lending from state-owned banks or the central bank to, or government guaranteed borrowing by, public enterprises in need of restructuring (continuous).

4. **The above variables also constitute indicative targets for March 2013.** In addition, the program includes the following indicative targets for the four above-mentioned dates:

- Ceilings on currency in circulation and on the operating budget deficit of the central government excluding grants; and
- Floor on social and other priority spending.

5. The **central government** consists of the Office of the President, the ministries and other state administrations and governmental agencies, including the attorney general's office; the National Assembly; and the judiciary, including the Supreme Court.

6. **Reserve money** is defined as currency in circulation plus Afghani-denominated commercial bank deposits at the central bank, excluding deposits held at the DAB's branches (because of the unavailability of reliable and timely data from the DAB's branches), but including balances maintained by the commercial banks in the DAB's overnight facility.

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

8. **Rerouting of treasury's IMF accounts to central bank's balance sheet.** For program purposes, the government's financial positions arising from dealing with the IMF is treated as if these functions were performed by DAB on behalf of the treasury, that is as if DAB have assumed these positions and have established corresponding counterpositions vis-à-vis the treasury.

9. **Net central bank credit to the government** is defined as the difference between the central bank's claims on the government and government deposits at the DAB, excluding deposits held at the DAB's branches. Claims include the so-called "promissory note," in the amount outstanding (at face value) of DAB's claim on a bank in liquidation that has been guaranteed by the ministry of finance though issuance of a promissory note, and up to the amount specified therein.

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

- Reserve assets of the DAB, as defined in the fifth edition of the Balance of Payments Manual (BPM5), are claims on nonresidents denominated in foreign convertible currencies 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 the DAB, but excluding cash held in the DAB's branches), and deposits abroad (including balances on accounts maintained with overseas correspondent banks). Excluded from reserve assets are any assets that are pledged, collateralized, or otherwise encumbered; claims on residents; precious metals other than monetary gold; assets in nonconvertible currencies; illiquid assets; and claims on foreign exchange arising from derivatives in foreign currencies vis-à-vis domestic currency (such as futures, forwards, swaps, and options).

- Reserve liabilities are defined as short-term (original maturity) foreign exchange liabilities of 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.

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

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

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

12. **Social and other priority spending** is defined as the sum of pro-poor spending identified in accordance with the ANDS poverty profile by the Ministry of Education, Ministry of Public Health, and Ministry of Labor, Social Affairs, Martyrs, and Disabled within the central government's operating budget for a particular fiscal year.

13. For program purposes, the definition of **external debt** is set out in Executive Board Decision No. 6230-(79/140), as revised on August 31, 2009 (Decision No. 14416-(09/91).

(a) 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 as follows:

> (i) loans (i.e., advances of money) to the obligor by the lender made on the basis of an undertaking that the obligor will repay the funds in the future (including deposits, bonds, debentures, commercial loans and buyers' credits) and temporary exchanges of assets that are equivalent to fully collateralized loans under which the obligor is required to repay the funds, and usually pay interest, by repurchasing the collateral from the buyer in the future (such as repurchase agreements and official swap arrangements);
>
> (ii) suppliers' credits (i.e., contracts where the supplier permits the obligor to defer payments until sometime after the date on which the goods are delivered or services are provided); and
>
> (iii) leases (i.e., arrangements under which property is provided which 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. 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.

(b) Under the definition of debt set out in paragraph 13 (a) above, 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. **Long term and medium term external debt.** A ceiling applies, on a continuous basis, to the contracting and guaranteeing by the public sector of new nonconcessional borrowing debt with nonresidents with original maturities of one year or more. The ceiling applies to debt and commitments contracted or guaranteed for which value has not yet been

received. This applies to private debt for which official guarantees have been extended and which, therefore, constitute a contingent liability of the public sector. Excluded from the limits are refinancing credits and rescheduling operations, credits extended by the IMF, and credits on concessional terms as defined below. Consistent with the Public Finance and Expenditure Management (PFEM) Law, the MOF should have sole responsibility for the contracting and guaranteeing of external debt on behalf of the government.

- The definition of "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. The public sector comprises the government as defined above, the DAB, and nonfinancial public enterprises. Public enterprises are defined below in paragraph 17.[1]

- For program purposes, the guarantee of a debt arises from any explicit legal obligation of the public sector to service a debt in the event of nonpayment by the debtor (involving payments in cash or in kind), or from any implicit legal or contractual obligation of the public sector to finance partially or in full any a shortfall incurred by the debtor.

- For program purposes, a debt is concessional if it includes a grant element of at least 60 percent, calculated as follows: the grant element of a debt is the difference between the present value (PV) of debt and its nominal value, expressed as a percentage of the nominal value of the debt. The PV of debt at the time of its contracting is calculated by discounting the future stream of payments of debt service due on this debt.[2] The discount rates used for this purpose are the currency specific commercial interest reference rates (CIRRs), published by the Organization for Economic Cooperation and Development (OECD). For debt with a maturity of at least 15 years, the ten-year-average CIRR will be used to calculate the PV of debt and, hence, its grant element. For debt with a maturity of less than 15 years, the six-month average CIRR will be used. To both the ten-year and six-month averages, the same margins for differing repayment periods as those used by the OECD need to be added (0.75 percent for repayment periods of less than 15 years, 1 percent for 15 to 19 years, 1.15 percent for 20 to 29 years, and 1.25 percent for 30 years or more).

[1] Government control of an entity can be established based on the following criteria: (i) ownership of the majority of the voting interest; (ii) control of the board or other governing body; (iii) control of the appointment and removal of key personnel; (iv) control of key committees of the entity; (v) golden shares and options; (vi) regulation and control; (vii) control by a dominant public sector customer or group of public sector customers; and (viii) control attached to borrowing from the government.

[2] The calculation of concessionality will take into account all aspects of the loan agreement, including maturity, grace period, payment schedule, upfront commissions, and management fees.

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 public sector (as defined in paragraph 14 of this memorandum), 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, 2012 and that have not been paid at the time they are due, as specified in the contractual agreements. Excluded from the prohibition on the accumulation of new arrears are (i) arrears arising from interest on the stock of arrears outstanding as of March 20, 2012; and (ii) external arrears that are subject to debt rescheduling agreements or negotiations.

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

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

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

III. ADJUSTORS

19. The floor on NIR and the ceiling on the NCG are consistent with the assumption that **core budget development spending** will amount, on a cumulative basis from the beginning of the respective fiscal year, to:

September 21, 2012	Af 23.9 billion
December 20, 2012	Af 49.6 billion
March 20, 2013	Af 15.9 billion
June 21, 2013	Af 33.7 billion

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

20. The NIR floor and NCG ceiling are defined consistent with the assumption that the **external financing of the core budget and receipts from the sale of nonfinancial assets** will amount, on a cumulative basis from the beginning of the respective fiscal year, to:

September 21, 2012	Af 58.7 billion
December 20, 2012	Af 96.2 billion
March 20, 2013	Af 33.8 billion
June 21, 2013	Af 67.8 billion

Should external financing of the core budget (including that associated with off-budgetary spending coming on budget) and the receipts from the sale of nonfinancial assets collectively exceed (fall short of) these projections, the NIR floor will be adjusted upward (downward) and the NCG ceiling will be adjusted downward (upward) by the difference between their actual level and the projected level. The overall downward adjustment to the NIR floor will be capped at US$500 million and the overall upward adjustment to the NCG ceiling will be capped at Af 25 billion.

21. The NIR floor and NCG ceiling are defined consistent with the assumption that the **asset recovery** from banking sector institutions in liquidation applied towards DAB's claim on the ministry of finance will amount, on a cumulative basis from the beginning of the respective fiscal year, to:

September 21, 2012	Af 2.5 billion
December 20, 2012	Af 3.8 billion
March 20, 2013	Af 0.6 billion
June 21, 2013	Af 1.3 billion

Should such asset recovery exceed (fall short of) these projections, the NIR floor will be adjusted upward (downward) and the NCG ceiling will be adjusted downward (upward) by the difference between the actual recovery and its projected level.

22. Should **the ministry of finance recapitalize (receive dividend from) DAB**, the NCG ceiling will be adjusted upward (downward) by the amount of this recapitalization (dividend).

23. Should Afghanistan receive an **SDR allocation** the NIR floor will be adjusted upwards by the amount of this allocation.

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

IV. PROVISION OF INFORMATION TO THE FUND

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

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

- DAB net international reserves: weekly, no later than two weeks after the end of each week.

- Monetary statistics, including exchange rates, government accounts with the DAB, currency in circulation, reserve money, and a monetary survey: monthly and no later than three weeks after the end of the month (six weeks in the case of the monetary survey). The monetary survey will include the balance sheet of the DAB and a consolidated balance sheet of the commercial banking sector.

- Core budget operations and their financing: monthly and no later than four weeks after the end of the month. The official reports for program monitoring will be the monthly financial statements from the Afghanistan Financial Management Information System. The structure of financing (grants and loans should be separately identified) and expenditure data should be on a consistent cash basis. Core operating expenditures should be reported on a monthly basis using the budget appropriation economic 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, administrative and functional classification consistent with the operating budget. All the data should also compare outturns against the approved budget. Core operating and development revenues and expenditures should also be reported by province, separately on the same monthly basis.

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

- External debt data: quarterly and no later than six weeks after the end of the quarter. These will include: (i) details of new loans contracted or guaranteed during the quarter, including the terms of each new loan; (ii) the stock of debt at the end the quarter, including short-term debt, and medium- and long-term debt; (iii) loan disbursements and debt service payments (interest and amortization) during the quarter; (iv) debt relief received during the quarter; (v) information on all overdue payments on short-term debt, and on medium- and long-term debt, including new external arrears (if any); and (vi) total outstanding amount of arrears.

- National accounts data: annually and no later than three months after the end of the year. Merchandise trade data should be reported quarterly and no later than eight weeks after the end of the quarter.

- Monthly consumer price indexes (CPIs) for Kabul and other major cities ("national" CPI) with a lag of four weeks after the end of each month.

- Four-monthly and with a three-month lag, financial flows and other key variables of the state electricity company (DABS), aggregated as well as disaggregated by regional hubs, for the preceding 12 months and (in the last four-monthly period of the year) a forecast for the following fiscal year. The report will use the template agreed with Fund staff, with all lines filled in, but excluding the disaggregation of loses into technical and nontechnical for regions outside Kabul, which is expected by March 20, 2013.

- Financial Stability Indicators for each commercial bank: quarterly and with a one-month lag after the end of each quarter. These indicators will include banks' prudential ratios, capital adequacy ratio, liquidity ratio, portfolio quality indicators (e.g., nonperforming loans, provisions as percentage of classified loans), concentration ratio, related loan ratio, information on open foreign exchange positions, large loan and deposits statistics, income and expense information such as net income to total assets ratio (ROA), rate of return on capital, and net interest margin, and other relevant information. Monthly, balance sheet and income statement for each bank compiled from supervisory submissions, as well as the *Summary Analysis of Condition and Performance of the Banking System*.

- Lending to public enterprises from each commercial bank: quarterly with a one-month lag after the end of each quarter share a report on the following balance sheet items and operations for each bank: (i) aggregate value of outstanding loans to all public enterprises; (ii) disaggregated value of outstanding loans by public enterprise for each bank's top 10 borrowers; and (iii) indicators of the quality of these loans. For this reporting requirement, public enterprises refer to those defined in point (iii) in the first bullet of paragraph 17.

- Monthly activity and cost reports from the Kabul Bank receiver, including the status and financial details of asset recovery.

- Monthly detailed balance sheet and income statement for New Kabul Bank (with a two weeks lag) as well as quarterly reports on bank's progress against its business and financial plans (staffing, branches, etc).

- Quarterly, transactions on the Kabul Bank loan account, Kabul Bank receivership accounts and any other accounts related to the bank or asset recovery from the bank.

- Copies of documents related to asset recovery, such as mutual legal assistance requests (evidence and banking and property information redacted) to foreign jurisdictions, copies of MOUs which cover international cooperation with said jurisdictions.

- Monthly details of the discretionary cash balances held in the Ministry's AFS and U.S. dollar-denominated TSA accounts, and the discretionary development 27232 account. In addition, an update of the monthly summary report of funds under operating budget, summaries of expenditure for both the operating budget and discretionary development budgets, and the updated cash projections for the current and following fiscal years.

- Copies of documents related to the progress on structural benchmarks under the program, such as draft legislation, memoranda of understanding, strategies, implementation plans, transmittal letters, etc.

27. The Technical Coordination Committee (TCC) will send to the IMF reports by the end of each quarter documenting progress in implementing structural benchmarks under the program. These reports will include appropriate documentation and explain any deviations relative to the initial reform timetable, specifying expected revised completion date. Other details on major economic and social measures taken by the government that are expected to have an impact on

program sequencing (such as changes in legislation, regulations, or any other pertinent document) will be sent in a timely manner to IMF staff for consultation or information.