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Islamic Republic of Afghanistan: 2011 Article IV Consultation and Request for a Three-Year Arrangement Under the Extended Credit Facility—Staff Report; Staff Supplement–A Joint World Bank/IMF Debt Sustainability Analysis; Staff Statement; Public Information Notice and Press Release on the Executive Board Discussion; and Statement by the Executive Director for Islamic Republic of Afghanistan.

Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. In the context of a combined discussion of the 2011 Article IV consultation with Afghanistan and Request for a Three-Year Arrangement Under the Extended Credit Facility, the following documents have been released and are included in this package:

- The staff report for the combined 2011 Article IV consultation and Request for a Three-Year Arrangement Under the Extended Credit Facility, prepared by a staff team of the IMF, following discussions that ended on October 6, 2011, with the officials of Afghanistan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on November 2, 2011. The views expressed in the staff report are those of the staff team and do not necessarily reflect the views of the Executive Board of the IMF.
- Staff supplement dated 11/2/11 containing a joint World Bank/IMF Debt Sustainability Analysis.
- A staff statement of November 10, 2011 updating information on recent economic developments.
- A Public Information Notice (PIN) and Press Release, summarizing the views of the Executive Board as expressed during its November 14, 2011, discussion of the staff report on issues related to the Article IV consultation and the IMF arrangement, respectively.
- A statement by the Executive Director for Islamic Republic of Afghanistan.

The documents listed below have been or will be separately released.

Letter of Intent sent to the IMF by the authorities of Afghanistan*
Memorandum of Economic and Financial Policies by the authorities of Afghanistan*
Technical Memorandum of Understanding*

*Also included in Staff Report

The policy of publication of staff reports and other documents allows for the deletion of market-sensitive information.

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ISLAMIC REPUBLIC OF AFGHANISTAN

Staff Report for the 2011 Article IV Consultation and Request for a Three-Year Arrangement Under the Extended Credit Facility

Prepared by the Middle East and Central Asia Department
(In consultation with other Departments)

Approved by Adnan Mazarei and Dhaneshwar Ghura

November 2, 2011

Discussions: Took place over several missions from September 2010 to October 2011 in Kabul and Washington D.C. The missions met with Mr. Omar Zakhilwal, Minister of Finance, Mr. Abdul Qadir Fitrat, former Governor of the Central Bank, Mr. Mohibullah Safi, Acting Governor of the Central Bank, donors, and representatives from the public and private sectors. A press release issued at the conclusion of the discussions can be found at http://www.imf.org/external/np/sec/pr/2011/pr11358.htm.

Staff Team: The missions comprised Mr. Axel Schimmelpfennig (Head), Mr. Enrique Gelbard (former Head), Ms. Melissa Tullis (LEG), Messrs. Aidar Abdychev, Marcin Sasin (all MCD), Aqib Aslam, Borja Gracia (all FAD), Romain Veyrune (MCM), and Warren Coats (MCM consultant). Mr. Adnan Mazarei (MCD) participated in some of the policy discussions. The missions were supported by Mr. Wabel Abdallah, Resident Representative and Ms. Mary Woolford (MCM consultant) in Kabul, and Ms. Katrin Elborgh-Woytek (SPR) in Washington, D.C.

Exchange Arrangement: Afghanistan maintains a floating exchange rate regime, and is an Article XIV member country. The authorities maintain that they are implementing an exchange system without exchange restrictions and have requested a Fund review of laws and regulations on the exchange regime for accession to Article VIII status. Staff is currently conducting this review in order to assess the jurisdictional implications of the exchange system of Afghanistan.

Past Surveillance: The 2007 Article IV Consultation was concluded on February 13, 2008, and the report is available at http://www.imf.org/external/pubs/ft/scr/2008/cr0876.pdf.

Statistics: Data provision has significant shortcomings, but is broadly adequate for surveillance and program monitoring. The authorities are receiving IMF assistance on national accounts, consumer prices, monetary statistics and the balance of payments and Government Financial Statistics, as well as donor support in other areas of statistics. Afghanistan has been a participant in the General Data Dissemination Standard (GDDS) since June 2006.

Contents Page

Appendixes

EXECUTIVE SUMMARY

Afghanistan is one of the poorest countries in the world and relies heavily on donor grants to fund development and security spending. Over the coming three to five years, the country faces two main challenges: "transition" which refers to the withdrawal of foreign troops by 2014 and the government taking over an increasing share of security spending; and "transformation" which refers to the expected gradual decline in overall donor support over the medium term, with a larger share of donor support being channeled through the budget.

The above two developments will complicate policy-making and will be a drag on domestic spending and ultimately growth. They will also entail lower foreign inflows that will require external adjustment, initially through competitiveness gains. Fiscal policy will need to accommodate growing spending pressures, while domestic revenue is likely to be adversely affected, the future level of budget grants is uncertain, and Afghanistan has limited scope for foreign borrowing. Therefore, the government will struggle for fiscal survival in the near term, trying to make ends meet.

Afghanistan is also burdened by poor governance and a large illicit sector. Endemic corruption and the narcotics sector have undermined the rule of law and the effectiveness of government institutions as well as contributed to a poor business environment. The Kabul Bank crisis is the most prominent example of the damaging effects this has on the country.

The authorities have developed a three-year program for which they seek Fund support under the Extended Credit Facility (ECF) of SDR 85 million (52.5 percent of quota). It aims to:

- Make tangible progress on Afghanistan's social and development objectives;
- Raise the revenue-to-GDP ratio through continued revenue administration reforms and the introduction of a value-added tax (VAT) in 2014;
- Contain inflation through appropriate tightening of monetary policy, and ensure adequate central bank capitalization to preserve its independence;
- Strengthen financial sector stability by revising the banking law and regulations in light of the Kabul Bank crisis, stepping up supervision and enforcement, and enhancing the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) framework; and
- Achieve maximum recovery of Kabul Bank losses and apply Afghan law as appropriate in dealing with financial and economic crimes.

Staff believes that, on balance, the program stands a good chance of success, though there are risks. A program would strengthen reforms, even while program ownership by the government at large is mixed at best and key reforms may be delayed or thwarted altogether by vested interests. Donors can support the authorities through their continued engagement, and by shifting resources on budget, even within a decreasing overall grant envelope.

I. INTRODUCTION: AFGHANISTAN'S MAIN CHALLENGES

1. **Afghanistan has made important achievements in recent years.** The authorities have taken steps to lay the foundation for economic stability and growth, despite a very difficult security situation and the challenges associated with building political and economic institutions (Box 1). As a result, economic activity has been robust, with real GDP growth averaging more than 10 percent annually over the past five years. The government has increased revenue collection to 11 percent of GDP in 2010/11 from 8 percent in 2008/09, though current collection levels cover only about two-thirds of central government operating expenditures and less than 20 percent of total public spending (defined as central government spending plus off-budget donor spending).[1, 2]

Box 1. The Authorities' Response to Past Fund Advice

Past Fund advice focused on tax reforms toward a more efficient tax system, including transforming the Business Receipt Tax (BRT), a cascading sales tax, strengthening the capacity of the revenue administration, enhancing the monetary policy instruments by expanding the role of capital notes, and strengthening banking supervision in light of identified deficiencies in risk management at financial institutions.

The authorities have made progress toward a more efficient tax system. A main achievement was transforming the BRT, a cascading sales tax, into a broad-based consumption tax. Continued engagement in revenue administration has strengthened the capacity of the Afghan revenue and customs departments. These measures have included changes to the income tax law (including the collection of BRT on imports at the border), a strengthening of the large taxpayers office, and a tighter monitoring of fuel imports. Most recently, the ministry of finance has piloted a one-stop-shop customs border post in cooperation with other ministries, following Fund advice.

The authorities have strengthened the public financial management (PFM) systems. PFM reforms are essential for increasing the transparency and effectiveness of public spending as well as enhancing fiduciary controls. At the 2010 Kabul Conference, international donors restated commitments to bring 50 percent of development aid on budget. The government in turn pledged to strengthen PFM systems to facilitate such a transfer. Therefore, continued achievements in program budgeting and other PFM systems are an integral part of the Kabul process. At present, treasury, budgeting, and tax administration are fully functional, and the Afghanistan Financial Management Information System (AFMIS) has been rolled out to all provinces and line ministries.

The authorities have also made some progress towards enhancing monetary policy operations. The use of capital notes by the central bank has increased, but more is needed to contain inflation. The supervisory capacity of the central bank did not keep pace with a fast-growing financial sector.

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[1] "Public" spending is carried out by the central government "on-budget" (also known as "core budget") and by donors "off-budget." In this report, the off-budget spending by donors is referred to as the "external budget" or "external development budget." Due to data limitations, the size of the external development budget can only be estimated with staff taking a conservative approach that aims to take out the share of donor spending that does not affect the local economy. Figure 1 of Annex II illustrates the relative importance of the central government budget and the external budget and their financing sources.

[2] The fiscal year follows the solar calendar and runs March 21–March 20, most of the years.

2. **Some poverty indicators have improved over the last decade, but Afghanistan remains one of the poorest countries in the world.** Per-capita income was US$530 in 2010/11. The national poverty rate was 36 percent in 2007/08, as measured by the National Risk and Vulnerability Assessment, and the rates are higher in rural and mountainous areas that account for about 80 percent of the population. Afghanistan ranks in the bottom 10 percent of countries with the lowest score in the 2010 UN Human Development Index. The authorities have made inroads toward achieving some of the Millennium Development Goals. For example, child mortality was reduced and school enrollment increased, albeit from very low levels—the enrollment rate for primary schools is less than 40 percent. The latest Annual Progress Report also acknowledges that achievements in some areas are below expectations: more than 40 percent of children under the age of five are underweight and progress in increasing access to potable water and sanitation remains slow. The literacy rates for men and women aged 15 to 24 are 51 and 22 percent respectively. Overall, the low execution rate of only 40 percent of the development budget reflects a generally limited absorption capacity, and impedes more rapid progress toward poverty reduction.

3. **Poor governance and corruption are endemic and take a heavy toll.** With decades of war and extreme poverty and the absence of social safety nets, localized patronage has become reinforced as the main element of social protection. The emergence of a vibrant illicit narcotics sector has further distorted economic incentives (Box 2). This has many negative consequences for the evolution into a rules-based market economy, including significant rent-seeking behavior and high levels of crime and corruption.

4. **Last year's crisis at Kabul Bank, the largest bank in Afghanistan, exposed the country's serious governance problems, and highlighted the devastating effects of endemic corruption.** The initial intervention by the central bank and a full deposit guarantee prevented a full-blown banking crisis (Box 3). However, the subsequent crisis management was slow and somewhat reluctant to tackle some important but politically difficult issues such as asset recovery and filing charges against the main architects of the fraud. As a result, the financial system has been severely weakened and is not playing its role in facilitating private sector-led growth.

5. **Over the coming three to five years, Afghanistan will face additional challenges as the international military presence is wound down and the government has to take over spending currently financed by donors.** Foreign troops are expected to gradually withdraw by 2014. As a result, Afghanistan's security forces will have to take over more responsibility, leading to higher spending. At the same time, the government may lose revenues related to spending by foreign troops in Afghanistan. Moreover, it is likely that the donor footprint will gradually shrink, with total grants projected to decline from an estimated more than 40 percent of GDP in 2010/11 to less than 30 percent of GDP in 2013/14. These developments will weigh heavily on economic activity and require difficult decisions to ensure fiscal survival.

Box 2. The Illicit Economy in Afghanistan

Afghanistan's illicit sector is estimated to be in the range of one third to one half of the country's GDP. The largest illicit activities in Afghanistan are narcotics and corruption.[1] Smuggling, fraud, extortion and arms trading are also known to generate signification proceeds. These activities are all crimes in Afghanistan.

Narcotics

- Opium exports[2] were US$2.8 billion (about 23 percent of GDP) in 2010, and are estimated to reach up to US$4 billion in 2011.[3] Opium from Afghanistan supplies about 90 percent of the US$68 billion global retail market in opiates.
- Opium cultivation provided income for 5 percent of the Afghan population in 2011.[4] The decision to cultivate opium is strongly correlated with conflict and access to markets; however, there is also a price correlation mainly with the subsistence crop wheat. In addition, cannabis is extensively cultivated in Afghanistan and yields income of up to US$94 million.[5]
- The large profits earned by producers and traffickers are spent both inside and outside the country. In addition to funding regular consumption and investment spending, they are also used to buy patronage, influence and services, to reinvest in illicit cultivation and to finance investments outside the country. Antigovernment elements and terrorist networks often collect a share of narcotics revenue akin to a tax (*ushur*).
- Cross-border flows related to the opiate economy are not recorded in the official balance of payments statistics, and are reflected as unrecorded inflows (errors and omissions) or they finance equally unrecorded imports, i.e., smuggling, over and above the estimates included in the balance of payments.

Corruption

- Afghans paid an estimated US$2.5 billion in bribes in 2010 (20 percent of GDP).[6] One out of every two Afghans is thought to have to pay at least one bribe to a public official per year, with the request coming from the official more than 56 percent of the time.[7]
- The scale of corruption, combined with the large illicit sector, has undermined governance and development in the country.

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[1] Afghanistan is a signatory to all three international drug control conventions as well as the United Nations Convention against Corruption.

[2] The International Monetary Fund does not include the illicit sector in official estimates of GDP, or in other macroeconomic measures. The drug economy is excluded from the output and prices measurements of "Table 1. Islamic Republic of Afghanistan: Selected Economic Indicators," where opium production is listed as a memorandum item.

[3] United Nations Office on Drugs and Crime (UNODC) and Islamic Republic of Afghanistan Ministry of Counter Narcotics, *Afghanistan Opium Survey 2011, Summary Findings*, October 2011, p 4. 2011 export value is Fund staff estimate.

[4] United Nations Office on Drugs and Crime, *World Drug Report 2010.*

[5] United Nations Office on Drugs and Crime, *Afghanistan Cannabis Survey 2009*.

[6] UNODC, "Corruption in Afghanistan, Bribery as Reported by the Victims," January 2010. Note: This survey did not deal with grand corruption it only looked at bribes under US$1,000 (those likely to affect Afghans on a daily basis). Total payments related to corruption therefore are likely to be far higher.

[7] Ibid. p. 4.

Box 3. The Kabul Bank Crisis

Based on evidence available so far, it appears that Kabul Bank shareholders and top management had abused their position to engage in criminal activity, including fraud and money laundering, by manipulating the bank's loan book. Concerns over the soundness of Kabul Bank caused a run on the bank in early September 2010 during which the bank lost about half of its US$1.3 billion deposits. With one-third of the system's assets of US$4 billion, the crisis threatened the stability of the financial system. The authorities removed the management of the bank, putting the bank into conservatorship, and guaranteed all deposits. This helped stem the initial panic and stopped the run. When the dust had settled, the government had to shoulder US$825 million for the cost of the lender-of-last-resort facility loans that covered the deposit guarantee (about 5 percent of GDP).[1] Kabul Bank was subsequently put into receivership, revoking shareholders' rights altogether.

Aside from the fiscal costs, the Kabul Bank crisis has had a negative impact on intermediation, as it had by far the largest and most effective branch network in the country and an effective payments system. These helped bring individuals into the formal sector and supported the government's program of automating employee records and salary payments.

Kabul Bank has been split up into a good bank and a bad bank. The bank's deposits and good assets were transferred to a bridge bank, New Kabul Bank. For the time being, New Kabul Bank cannot extend loans and is envisaged to be privatized in 2012. The bad assets have been retained by the receiver, appointed and overseen by the independent Financial Dispute Resolution Commission (FDRC). Based on current estimates, about US$935 million (principal and interest) in the asset portfolio are sought for recovery. This amount is likely to increase as additional illegal expenses and other charges continue to be discovered by an ongoing audit. The receiver, the FDRC, the central bank, and the Attorney General, have begun the work on asset recovery and sorting out the disputed assets with the help of the audit firm. In parallel, the government has started an investigation of criminal misconduct and has brought formal charges in nine cases so far.

The Kabul Bank crisis has magnified the risks of rapid banking sector growth with inexperienced supervision and weak rule of law. Moreover, it has undermined confidence in the banking sector (preference for cash increased and deposit growth came to a halt) and further overburdened banking supervision. On the other hand, it has provided the authorities with valuable lessons and experience, if they are able to build on them. Only fit and proper persons should be allowed to own and manage banks and prudential norms should be diligently enforced.

[1] To cover the hole created in the central bank's balance sheet by the issuance of the lender-last resort loan to Kabul Bank, the ministry of finance issued a promissory note, which would yield a regular flow of payments to the central bank over an eight-year period. The annual payments on this promissory note have to be approved by Parliament as part of the budget.

6. **Against this background, the authorities seek Fund support under the ECF for their three-year economic program.** In the near term, they are focusing on resolving the problems that emerged from the collapse of Kabul Bank and ensuring the stability of the banking system. In parallel, they intend to proceed with key reforms in revenue and expenditure management, and strengthen the business environment for private sector-led growth, while improving social conditions and protecting the poor. None of these reforms will succeed in the long term unless the authorities are able to deliver on their plans to enhance governance, address endemic corruption, and prevent economic and financial crimes.

7. **The authorities' program provides a basis for continued engagement with donors on Afghanistan's development strategy, including at the December 5 Bonn Conference.** Afghanistan has extensive development needs in building its physical and institutional infrastructure, and requires continued support in transforming its economy into a competitive and vibrant market-based system. Donor assistance and a new ECF arrangement can help the government make progress toward Afghanistan's development objectives. However, such support needs to be matched by bold domestic reform, including further bolstering of government revenues, and strengthening governance, not least in the financial sector.

8. **The program is subject to two significant types of risks.** First, there are risks that program implementation falls short, especially due to inadequate political will or capacity constraints, undermining macroeconomic stability and possibly leading to further large-scale economic crime and corruption. Second, exogenous shocks, such as deterioration in the security situation, regional instability, trade disruptions, or volatility in the agriculture sector, could thwart the success of the program, even if fully implemented.

II. Recent Developments: Growth Amidst Civil Strife

9. **A standoff between the legislature and the executive over the legitimacy of last year's parliamentary elections has stymied the political process.** President Karzai has not yet been able to confirm his cabinet in full and a number of legislative acts have been significantly delayed. Recently, a compromise has been reached, and Parliament has restarted its work, although individual parliamentarians are still protesting.

10. **The security situation remains precarious and holds back economic activity.** Ongoing conflict affects the majority of Afghans. While the campaign against anti-government elements in the South has reportedly made progress, the area remains broadly insecure. Also, there are some signs that anti-government elements in the central and eastern parts of the country are gaining power, while attacks in Kabul have increased in recent months.

11. **Economic growth continues to be strong, but inflation has ratcheted up.**[3] Real GDP growth exceeded 8 percent in 2010/11, thanks to buoyant manufacturing and services. In 2011/12, growth is expected to slow to less than 6 percent, due mainly to a drought. Headline and core inflation have moderated slightly, but remain relatively high at about 10 percent year-on-year in September, owing to an expansionary monetary policy and higher international food and fuel prices. Confidence in the banking sector is low, as reflected in listless deposit growth since the September 2010 collapse of Kabul Bank. Liquidity remains high because there are few lending opportunities (Box 4). Favorable external current account

[3] See Figures 1 through 5 and Tables 1 through 7.

developments have allowed a further buildup of international reserves to about seven months of imports. Donor support was strong, and exports were boosted by coalition forces purchases of domestic goods and services. The Afghani has depreciated by 5 percent against the U.S. dollar since late March, but has stayed broadly stable in nominal and real effective terms over the past year.

Box 4. The Evolution of the Afghan Banking System and its Regulation

Modern banking, and the credit culture that accompanies it, is new to Afghanistan. For centuries, and to this day, the population has relied on informal money service providers to transfer cash and provide limited lending and deposit services. These so-called *hawala* dealers operate on the basis of personal relationships. The central bank currently licenses and regulates 320 money service providers, and some of these have several hundred agents.

Since 2002, the government and the international community have promoted the formalization of financial services. This encouraged a rapid growth of the formal banking sector with assets and deposits increasing over 50 percent annually since 2006, as banks competed vigorously to collect deposits of newly employed civil servants and to intermediate the inflow of foreign aid. Such rapid growth has generally been problematic wherever it has occurred.

Aside from five branches of foreign banks, which largely service the donor and international sector, Afghanistan's 12 domestic banks struggled to develop normal banking practices and skills. The legal and accounting infrastructure to support nonrelationship lending was nonexistent, weak, or untested, as were the procedures and skills of the banks' staffs. An ineffective judiciary and corruption hamper establishing or recovering collateral and enforcing contracts. In a country where most births are unregistered, normal documentation of all sorts is generally nonexistent. In such an environment, bank lending tends to be based on relationships rather than loan (risk) assessments. Indeed, many local banks have been established around business groups and loans are being channeled to related businesses. But when investments go wrong, the interests of the groups tend to supersede those of depositors. As the banking system in Afghanistan grew in size and political influence, asset quality and governance suffered.

Supervisory capacity was almost nonexistent and has struggled to catch up. After 30 years of protracted war it was almost impossible to find enough supervisors and regulators, even with minimal education. Talented and motivated young Afghans were and are being recruited but currently lack experience. In recognition of this problem the central bank issued a moratorium on new licenses and introduced caps on lending for the many low-rated banks. Critically, banking supervision has lacked political support for enforcing compliance with rules and regulations. This failure in governance must be addressed so that a robust financial sector can support the country's long-term development objectives.

12. **Fiscal developments were characterized by strong revenue performance combined with expenditure restraint.** Revenue effort increased by 0.7 percent of GDP between 2009/10 and 2010/11, following the introduction of tax and administrative measures in early-2009 and the consolidation of earlier reforms; and continue to outperform in 2011/12 with a 25 percent year-over-year increase for the first half of the year, while operating expenditures grew by 27 percent over the same period. Security spending rose by 1.3 percent of GDP from 2009/10 to 2010/11 as recruitment to Afghan National Security Forces grew by over 30 percent. Nonsecurity operating spending dropped by 0.7 percent of GDP between 2009/10 and 2010/11, notwithstanding the advance of civil service pay and

grade reforms and the hiring of additional teachers. As a result, the operating budget deficit excluding grants remained broadly stable at 4 percent of GDP. Development spending fell by 1.7 percent of GDP due to continued low execution rates stemming from capacity constraints, difficulties in public financial management, and a worsening security situation.

III. Policies to Put Afghanistan on a Path of Growth and Sustainability and Strengthen the Financial Sector

13. **The authorities' program aims to lay the basis for fiscal and external sustainability as well as financial sector stability.**

- The authorities recognize that restoring governance in the banking sector is a necessary condition to safeguard economic stability and convince donors to stay engaged, and they have made progress on the prior actions that address the issues that have come to the fore in the aftermath of the Kabul Bank crisis.

- In the context of the Article IV consultations, discussions focused on a strategy to move toward fiscal and external sustainability and maintain macroeconomic stability as a precondition for progress towards Afghanistan's broader development objectives.

- Against this background, the authorities have put forward an economic program for the period 2011/12 through 2013/14 that deals with the aftermath of the Kabul Bank crisis, strengthens the financial sector, and initiates reforms to ensure fiscal survival as a prerequisite for fiscal sustainability.

A. Prior Actions: Strengthening Governance and the Financial Sector

14. **The authorities have taken the necessary steps to deal with the immediate aspects of the Kabul Bank crisis.** The bank has been put under receivership, its license has been revoked, and shareholders' rights and interests have been extinguished. The authorities have established a bridge bank, New Kabul Bank, and developed a business plan to put it up for sale in 2012. An audit of Kabul Bank is ongoing to establish the amounts owed by the bank's shareholders and related parties, and to provide information for any legal actions the government may take; the inception report and the interim report have been delivered. After a slow start and while available administrative, civil, and international tools have yet to be fully applied, about US$75 million in cash (of which US$34 million from regular performing loans) and US$153 million in assets available for sale were recovered as of October 30, 2011 out of an estimated total amount of assets sought for recovery of US$935 million (of which US$80 million are regular performing loans). In parallel, repayment agreements of US$270 million have been signed, with a repayment period of

three to nine years.[4] The ministry of finance has issued an eight-year bond to recapitalize the central bank for the costs of the Kabul Bank crisis, and parliament approved the first amortization payment on October 15, 2011.

15. **The authorities have also taken actions in the case of Azizi Bank, the second largest bank.** Following an intensive on-site examination of Azizi Bank, the supervisor identified a number of areas needing improvement. An audit by a reputable international audit firm is ongoing and will provide information to the bank's management and the supervisor on the degree with which laws or regulations were breached and how to further strengthen the bank. The final audit report is expected in the first quarter of 2012. In light of the on-site examination and the preliminary audit findings, the bank and the supervisor have agreed on a path for increasing the bank's capital and reducing its large exposures. The bank's largest shareholder has stepped down as chairman of the board to address conflict-of-interest problems, as have the large shareholders of other banks in accordance with central bank regulations. Continued vigilant supervision will be needed to ensure that banks fully comply with the banking law and regulations.

B. Addressing Social Needs While Moving Toward Fiscal and External Sustainability

16. **Transition and transformation will pose significant challenges over the coming three to five years.** The growth outlook will be shaped by how these prospective developments play out and what they imply for public investment and propoor spending. The speed at which the authorities can move toward fiscal and external sustainability will depend on the future path of revenue efforts and donor engagement. There is also a trade-off with the pace of progress toward Afghanistan's development objectives.

17. **Real GDP growth over the three-year program period (2011/12 to 2013/14) will be significantly lower than the average of 10 percent over the past five years.** The slowdown will be driven by the withdrawal of foreign troops and the decline in grant-financed spending. A projected recovery in agriculture from this year's drought could temporarily boost growth in 2012/13. In addition, the nascent mining sector could also provide a positive growth impulse and would be associated with significant foreign direct investment. To fully realize the potential from mineral resources, a strong fiscal regime needs to be in place that ensures good governance. The World Bank and the Fund can advise in this area.

18. **Over the medium term, fiscal policy and the level of donor engagement will be important factors driving growth.** The baseline scenario for the medium-term macroeconomic

[4] The cash recoveries of US$75 million have been used as follows: US$41 million was collected during the conservatorship and used to pay depositors and operating expenses. US$22 million was transferred to the central bank as part of this year's amortization payment for the promissory note issued by the ministry of finance to the central bank for the cost of the Kabul Bank crisis. US$5 million paid for expenses of the receivership, and the remainder is being held at the central bank in reserve.

framework describes a cautiously optimistic outlook. Grant-financed spending declines as a share of GDP after 2012/13, leading to a slowdown of real GDP growth to a range of 4–6 percent annually beyond 2013/14. Fiscal revenues receive a boost from the mining sector and the introduction of a VAT starting in 2014/15, reaching 15 percent of GDP in 2017/18. Expenditures are expected to average 25–26 percent of GDP, assuming a gradual and restricted takeover of externally financed expenditure, and a very conservative level of operations and maintenance (O&M) spending for projects handed over by donors to the government. Annex I explores alternative scenarios. For example, by assuming a faster decline in grants and higher operations and maintenance spending, public investment is compressed, and real GDP growth could be as low as 2 percent per annum over the medium term.

19. **The authorities emphasized their commitment to the Afghanistan National Development Strategy (ANDS) as their overarching policy framework.** The ultimate objective of the ANDS is to generate sustained, inclusive growth that reduces the high incidence of poverty. The authorities noted that poverty and limited opportunities outside the illicit sector provide a fertile ground for insurgent activities. The authorities' strategy is to ensure that economic growth is broadly based and beneficial both across different tiers of society and across different regions of the country. Therefore, social programs have an important place among the government's fiscal priorities. The transition and transformation process will affect how the government can pursue its ANDS objectives.[5]

20. **The international presence has underpinned the Afghan economy beyond security.** Quantifying the impact with any precision is difficult because of a lack of data on spending by foreign troops in Afghanistan. Available evidence suggests that consumption spending in Afghanistan by foreign troops, in combination with military spending on civilian activity, is likely to have added about 2–3 percentage points to real GDP growth in recent years. The planned withdrawal by 2014 is thus expected to have an adverse net impact on growth, reducing growth by an estimated 2½ percentage points over the next three years. In addition, external inflows will be reduced, negatively affecting the international reserves position. Some offset could come from a reversal of "Dutch disease" effects associated with large-scale foreign inflows. Indeed, Afghanistan will need to gain competitiveness to facilitate the necessary external adjustment. An important factor in this adjustment process will be how much of the spending by the military and donors in the past has fallen on nontraded goods, and what the adverse demand shock for the nontraded sector implies for the real exchange rate. In the end, the adjustment could benefit the traded sector, albeit at the cost of rising foreign currency-denominated debt service payments.

21. **The expected gradual decline of donor assistance and activity over the medium term will further complicate policy-making.** In 2010/11, the overall fiscal deficit (excluding

[5] The next Annual Progress Report will be circulated to the IMF's Executive Board by the time of the second review of the ECF.

grants) was 10 percent of GDP. If we include estimated off-budget development spending by donors, the fiscal deficit could be as high as 23 percent of GDP. Aside from donor support, Afghanistan has very limited scope for market financing. Of course, once domestic government securities are available, local banks could provide some financing, but this would be insufficient to replace external grant financing and there are clear limits from the need to preserve fiscal sustainability. Moreover, the government will have to shoulder security spending currently paid for by the international community as well as the recurrent cost implications of donor-financed infrastructure projects.[6] Again, incomplete data on the local content of donor spending prevents precise estimates of these cost implications. Nevertheless, Annex II discusses possible trajectories for key fiscal aggregates.

22. **There will be a struggle for fiscal survival for years to come, with fiscal sustainability being a more distant goal.** The authorities welcomed donors' intention to channel an increasing share of their support through the budget, even if the overall envelope would shrink. They noted that donor support above and beyond the working assumption would provide fiscal space for propoor and development spending which is severely constrained in the current medium-term budget framework. They stressed that achieving fiscal sustainability, defined as revenues covering operating expenditures, remains their fiscal goal, though this has been complicated by the drawdown of the international presence in Afghanistan. Under the program, the authorities target the operating budget balance excluding grants with a view to keeping the deficit broadly unchanged.

23. **The expected decline in donor inflows also has implications for external stability.** The stability of the exchange rate in the medium to long term will depend critically on the continued flow of donor assistance. In 2010/11, the current account deficit excluding official transfers registered 40 percent of GDP. Foreign grants estimated at just over 40 percent of GDP financed this deficit. The other side of the coin is that a large share of grants—estimated at 70 percent—is spent on imports of goods and services; thus grants do not only finance the trade deficit, they also contribute to it. A decline in grant inflows and inflows related to spending by foreign troops would put pressure on the exchange rate and require a corresponding adjustment of the macroeconomic policy mix, including the exchange rate. Given the uncertainties regarding the local component of grants and military spending, it is difficult to estimate precisely the impact of the withdrawal on the exchange rate. The authorities have skillfully created international reserves buffers to manage pressures in the short term. However, they will need to maintain their flexible exchange rate regime to allow for the necessary external adjustment to occur.

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[6] Current projections of security costs assume that the Afghan National Security Forces will grow to 400,000 personnel by 2014/15 as envisaged by ISAF, but discussions about the necessary troop levels are ongoing and the final ceiling could be as low as 352,000 which would be more manageable in terms of recurrent costs.

24. **The shrinking of the donor footprint will ultimately need to be met with competitiveness gains.** To ensure that external adjustment can occur in an orderly fashion, a gradual and well-planned reduction in foreign aid would allow the exchange rate to adjust without undermining macroeconomic stability.[7] Competitiveness gains will also need to come from strengthening the business environment (Box 5). Areas where improvements can be made include: investor protection; property rights; collateral and property registration; enforcement of contracts; free trade across borders; access to financing; and general red tape combined with corruption. For instance, Transparency International's Corruption Perception Index for Afghanistan in 2010 was 1.4 on the scale from 0 (highest perception) to 10 (lowest perception), making it second to worst on the ranking of 178 countries. Moreover, the government needs to adequately support the development of small and medium-sized businesses, which can be a source of job creation, in addition to promoting large-scale mining enterprises. The authorities caution that the challenging security situation is a key obstacle to quick wins in the business environment.

25. **Afghanistan remains at high risk of debt distress, recent debt relief notwithstanding.** Debt relief under the Heavily Indebted Poor Countries initiative and the Multilateral Debt Relief Initiative reduced the net present value (NPV) of Afghanistan's debt-to-GDP ratio from 12 percent to 6 percent in 2009/10. Nevertheless, risks to the macroeconomic outlook and large financing needs, currently met by donor support, underscore the importance of substantial and long-term grant financing, in combination with a strong reform agenda and progress in security and governance. Should donors decide to reduce aid rapidly, security fail to stabilize, or delays arise in structural reforms and governance improvements, Afghanistan's debt burden could become unsustainable (see the accompanying debt sustainability analysis).

26. **Public financial management reforms are expected to improve the execution of the development budget.** Low execution rates reflect capacity constraints, unrealistic multiyear budget and spending patterns with significant front-loading of spending, and poor procurement planning and contract management. The government has developed a road map to address most of these issues and its implementation will improve the execution of development projects. The overarching aim is to facilitate the transfer of additional aid through the development budget as envisaged under the Kabul Process.

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[7] A simple back-of-the-envelope calculation suggests that the Afghani is overvalued by 20 percent or more in real effective terms. This is calculated as the real effective exchange rate depreciation necessary to bring about the external adjustment that would offset the assumed decline in donor support, net of grant-related imports, in the baseline scenario.

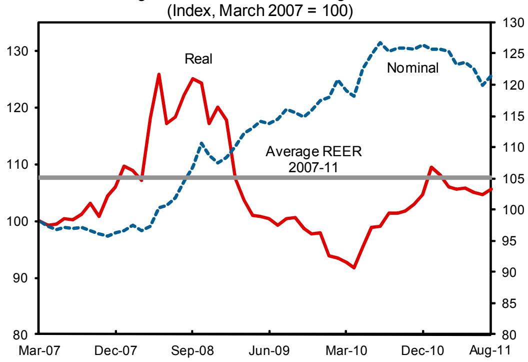
Box 5. Exchange Rate Assessment

Afghanistan's exchange rate arrangement is classified as floating. A quantitative exchange rate assessment using CGER-based methodologies is rendered difficult by data constraints and uncertainty about medium-term current account developments, including the prospective path for donor financing and earnings from mineral resources.

Since 2004/05, exports have risen steadily, and the current account deficit excluding grants has declined from 71 percent of GDP in 2006/07 to below 40 percent in 2010/11. In August 2011, the Afghani was slightly below its five-year average in real terms, reflecting a spike in 2008 (due to high domestic inflation) and a decline in the following period.

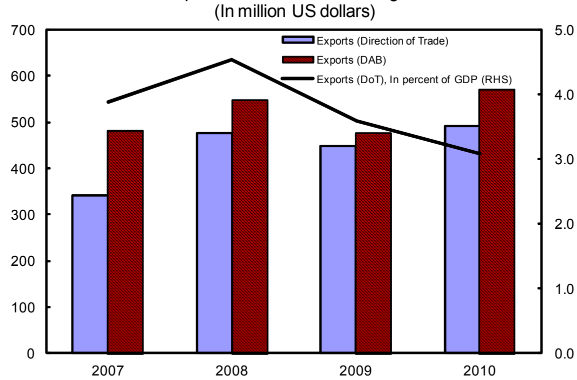
Structural impediments seem more binding for Afghanistan's competitiveness than exchange rate developments. The World Bank's *Doing Business 2012* indicators rank Afghanistan 160th out of 183 countries (falling from 154th place in the previous year), diagnosing particular challenges in investor protection. In 2010, the World Bank's Country Policy and Institutional Assessment index, measuring the quality of public policies and institutions, assigned a rating of 2.6 to Afghanistan, below the average of 3.3 for all IDA countries. While Afghanistan compared favorably with other IDA countries on macroeconomic management and budgetary and financial management, the country ranks in the bottom decile for most other components of the index, including property rights, governance, and the quality of public administration.[1]

Afghanistan: Effective Exchange Rates
(Index, March 2007 = 100)



Sources: IMF, Information Notice System; and Fund staff calculations.

Recorded Exports, 2007-2010, Excluding Transit Trade
(In million US dollars)



Sources: Da Afghanistan Bank (DAB), Direction of Trade, IMF.

[1] http://www.doingbusiness.org/reports/global-reports/doing-business-2012 and http://go.worldbank.org/S2THWI1X60.

C. The Authorities' Request for Fund Support for their 2011/12–2013/14 Economic Program under the Extended Credit Facility

27. **The authorities' program for the next three years outlines a realistic strategy to start addressing the challenges discussed above.** The main goals of the new program are to make significant progress toward a stable and sustainable macroeconomic position, move toward fiscal sustainability, strengthen the financial sector, and improve the transparency and effectiveness of public spending while protecting the poor, and strengthening the governance framework in the financial and economic sphere. The envisaged policies and reforms focus on keeping inflation low, strengthening banking supervision, achieving sustained increases in

tax collection, gradually taking over externally-financed recurrent spending, improving public financial management, keeping spending aligned with ANDS priorities, improving the capacity to deal with economic crime, and reducing fiscal risks from public enterprises. The program includes a technical assistance agenda.

28. **The focus of fiscal policy will be to make further progress on revenue generation to meet the many and growing spending needs.** Revenue measures include ongoing administrative reforms in the customs and revenue departments (medium and large taxpayers' offices), and steps toward the introduction of a VAT in March 2014. Still, the targeted increase in the revenue-to-GDP ratio amounts to only 0.6 percent of GDP over the program period—which is basically achieved this year. In addition, political and security risks could undermine revenue collection at the border.[8] If the planned reforms do not indeed yield more revenue gains, the authorities will have to consider additional measures. For example, previous Fund technical assistance recommended an excise on petroleum products.

29. **On the expenditure side, the authorities need to continue to exercise tight control over nonsecurity spending.** The ongoing public financial management reforms are essential in this context to ensure effective prioritization of spending. In particular, the authorities are in the process of identifying propoor spending within the central government budget, with the aim of improving integration of priority poverty reduction policies within line ministries' budgets (indicative target). However, due to fluctuating development budget execution rates, the pilot phase was aimed at identifying propoor operating expenditures only. In 2011/12, propoor budgeting was piloted in two ministries—the Ministry of Education and the Ministry of Labor, Social Affairs, Martyrs, and Disabled. In 2012/13, the pilot will be extended to include the ministry of public health.[9] The list will be further expanded in the coming years to better reflect all propoor spending. For consistency, the indicative target on propoor spending reported in Tables 3a and 3b covers all three ministries for both years. The overall level of propoor spending is low compared to the need and is budgeted to decline as a percent of GDP in 2012/13; the authorities will explore options for further increases to support its social and development objectives.

30. **To exercise budget control, the Ministry of Finance closely monitors its cash balances in the treasury single account.** These balances represent the government's primary resources to fund the operating budget and its own discretionary development priorities. Earlier in 2011/12, the government cut spending in anticipation of liquidity

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[8] Customs collections over the first six months in 2011/12 grew at only 15 percent compared to the same period in 2010/11, slower than total revenue growth.

[9] These three ministries were chosen as their operating budgets have the highest impact on poverty reduction and strong links to ANDS priorities. The remaining ministries being targeted have propoor spending components primarily within their development budgets, which are harder to monitor and verify.

shortages from a temporary loss of resources from the Afghanistan Reconstruction Trust Fund (ARTF). Assuming the full reinstatement of funds from the recurrent window of the ARTF, balances are projected to end the year at just short of two months worth of cover for operating expenditures, the authorities' informal prudential target. However, there is a risk that cash balances could be drawn down by more than targeted if additional transfers are made to pay for development spending carried over from the previous fiscal year. Should discretionary cash balances fall too low in 2011/12, a cash crunch could occur in the following year.[10] The government would need to monitor all outgoings very closely, rigorously prioritizing discretionary development spending while maintaining a strong revenue effort. By 2013/14, the government plans to issue securities (*sukuks*) which will diminish its cash and liquidity risks.

31. **The nominal anchor of monetary policy is inflation.** To this end, the central bank steers reserve money and currency in circulation through the use of its own paper, so-called capital notes, and the accumulation of foreign exchange reserves. With inflation running in the double digits, the authorities, therefore, see a need to tighten monetary policies in the course of 2011/12 to achieve their inflation target of 4–6 percent by reducing money growth from 30 percent in August 2011 to less than 20 percent. They note that volatile commodity prices, including food and oil, high inflation in neighboring countries, and large inflows of aid have complicated the conduct of monetary policy. In addition, due to concerns about its income and balance sheet, the central bank has been hesitant to use its capital notes and foreign exchange auctions to the full extent. The forthcoming agreement between the central bank and the Ministry of Finance regarding central bank capitalization and responsibilities for the costs of monetary policy should alleviate these constraints and strengthen central bank independence. The new marketable government securities (*sukuks*), to be introduced by 2013/14, will add a useful monetary policy instrument, contribute to the development of the domestic money market, and could gradually lessen the need for the central bank to issue capital notes.

32. **Efforts to manage the Kabul Bank crisis continue.** The ministry of finance and the central bank are committed to securing maximum asset recovery from Kabul Bank, and the government will bring legal charges where appropriate. It will be important to ensure that the repayment agreements that have been signed, and which the authorities consider to be legally binding, are being honored. Where this is not the case, they should use all available asset recovery options. Failure to do so would send the signal that economic and financial crimes pay, in particular if committed by well-connected individuals. Moreover, every dollar recovered by the government ultimately lowers the fiscal cost of the bailout and will free scarce resources for priority spending needs.

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[10] Cash shortfalls would manifest most acutely intra-year, as monthly balances could come close to zero due to seasonality in spending and revenues.

33. **The authorities intend to put New Kabul Bank up for sale by mid-2012 to a qualified investor who brings sound banking sector experience.** This is somewhat later than anticipated, mainly because it is taking longer to clean up the balance sheet of New Kabul Bank to a point where it can be presented to potential investors. One of the objectives of the sale is to reinvigorate Afghanistan's stagnant banking sector by bringing international experience and fostering competition. If the sale does not succeed, the bank would be downsized further and either merged into other financial institutions or liquidated by March 2013. In the case of liquidation, salary and other payment services will be migrated to other banks. To provide choice to government employees, migration will start in 2012 independent of privatization or liquidation.

34. **Supervision and central bank independence have been weakened in the aftermath of the Kabul Bank crisis.** The central bank regrets that its supervision department has been under aggressive investigation in the context of Kabul Bank while prosecution of Kabul Bank shareholders and officers appears to have proceeded more slowly. This has lowered morale and the effectiveness of supervision which has also been eroded by the redeployment of some critical staff to the bridge bank and the receivership. Nevertheless, the supervision department has undertaken a number of measures to strengthen its supervision, including regular reviews of bank compliance with earlier recommendations and the issuance of time-bound enforcement letters when appropriate. Moreover, audits by reputable international firms—supported by the United Kingdom's Department for International Development and the World Bank—are ongoing to provide a better view of the financial health of ten banks, including systemically important institutions. Still, the supervision department remains significantly understaffed and is ill-prepared should another banking crisis emerge. The crisis also highlighted the need to build capacity in areas related to the prevention of fraud and economic crime.

35. **To address these deficiencies and ensure strong competition in the banking sector, the authorities are in the process of better enforcing and revising the existing banking law and regulations.** The process of overhauling the banking law and regulations has been informed by an initial review of the Kabul Bank events by the central bank and will benefit from a forthcoming report by the independent Monitoring and Evaluation Committee. The revisions will aim to bring important provisions in line with the Basel Core Principles and Financial Action Task Force recommendations, in particular, strengthening provisions on corporate governance, beneficial ownership, capital, large exposures, related parties, enforcement, and bank resolution.

Box 6. Key Findings and Main Recommendations of the Assessment of the Anti-Money Laundering and Combating the Financing of Terrorism Regime

IMF staff conducted the first detailed assessment of Afghanistan's Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) framework in early 2011 using the updated 2004 assessment methodology. The Detailed Assessment Report was adopted by the Asia/Pacific Group on Money Laundering (APG) on July 21, 2011.

Afghanistan faces major money laundering and terrorist financing threats. The value of proceeds of crime generated by drug production and trafficking and corruption in the country is significant, in both relative and absolute terms. Smuggling and fraud also generate considerable amounts of illegal funds. In addition, terrorism and its financing remain a major concern both in terms of the security of Afghanistan and of the funding of terrorist individuals, organizations, and terrorist acts domestically and abroad.

Structural elements make the effective implementation of AML/CFT preventive measures challenging. They include ongoing conflict, lack of security, vested interests and corruption, capacity constraints, nascent and weak regulatory environment, porous borders, and low human capital. In addition, with a large share of economic activity taking place in the informal sector and within the context of a cash-based economy, the combination of rudimentary financial transactions and the formal sector banks, connected internationally through correspondent accounts and Society for Worldwide Interbank Financial Transactions (SWIFT), poses significant risks of money laundering and terrorist financing. Also, with the rapid expansion of the banking sector over the last decade, the lack of qualified and experienced supervisory and compliance staff resulted in critical failures in preventive measures.

The Detailed Assessment Report highlights significant deficiencies in Afghanistan's AML/CFT regime and notes that current domestic efforts are not commensurate with the high risk of both money laundering and terrorist financing in the country. Afghanistan has taken measures to fight crime, including financial crime, and to lay the foundations for an AML/CFT regime. However, Afghanistan has been rated noncompliant or partially compliant in all but one of the 49 Financial Action Task Force recommendations. Despite the authorities' efforts, there have been few investigations into money laundering and terrorist finance and none has resulted in charges being brought before the courts.

The report sets out a number of recommendations for improvement, which should be prioritized to mitigate the most serious risks that Afghanistan faces. The implementation of these recommendations will be an important element in strengthening the institutional framework for governance. Recommended actions include tightening and effectively implementing the legal and institutional framework regarding customer due diligence, supervision of financial institutions, reporting of suspicious transactions to a sufficiently independent and skilled financial intelligence unit, confiscation of criminal assets and implementation of mutual legal assistance in asset recovery. In light of the magnitude of cross-border drug trafficking and laundering of its proceeds, special attention should be given to the recommendations which address cross-border cash couriers and money service providers. The scale of corruption calls for the implementation without delay of recommendations regarding customers who are politically exposed persons. In light of the recent financial fraud, adequate fit and proper testing of financial institutions' beneficial owners should also be prioritized. Finally, due to the high terrorist financing risks, the framework for freezing terrorist funds should be revised and implemented effectively. The authorities will submit an action plan to the APG in the context of the follow-up process on their assessment.

36. **The program also includes measures to strengthen governance in the economic and financial sphere in general.** The government's first priority is to ensure that the rule of law prevails throughout the country and is protective of people, nascent institutions, the economy and the financial sector. It plans to improve its ability to deal with economic crime, and to increase transparency and accountability by tightening the application of the rule of law

in the financial sector so that it can face the extreme risks posed by criminality and corruption. As part of the Kabul Process, the government has committed to a tight deadline of critical anticorruption and governance reforms. It has established a dedicated "governance cluster" in the ANDS and reports regularly to the international community on achievements in this area. Given their criticality to governance and financial sector stability, staff encourages accelerated progress on these commitments which have slowed over the course of the last year (Box 6).

37. **The authorities plan to address delays in public enterprise reform**. With a view to strengthening the financial oversight of public enterprises and thus limiting the possibility of contingent liabilities hitting the budget while maintaining an arms-length relationship, the authorities intend to revise the existing legal framework to bring such entities under the ownership and effective control of the ministry of finance. With respect to the four largest public enterprises (airline company, power utility, fuel and gas company, and telecommunications firm), the authorities will proceed with the implementation of the restructuring and business plans to improve their financial situation and limit fiscal risks. While these are important steps, they may not go far enough to address the large contingent fiscal liabilities from these public enterprises. Building an effective state-owned enterprise monitoring capacity in the Ministry of Finance, exercising strict financial control, and properly regulating the existing public enterprises (exposing them to full competition where possible), are needed to address the risks from this sector.

IV. Program Modalities, Risks, Technical Assistance, and Data Issues

38. **Access under the program is proposed at 52.5 percent of quota (SDR 85 million, about US$134 million) phased in seven disbursements over three years** (Table 8). The conclusion of the debt sustainability analysis that Afghanistan continues to be at high risk of debt distress supports the case for moderate access. Donor inflows, on which Afghanistan is highly dependent, can be uncertain and volatile, thus calling for a sufficiently high level of foreign reserves. During 2011/12–2013/14, the projected balance of payments gap before grants amounts to US$19 billion, of which the Fund would contribute 0.7 percent (Table 9). The proposed access should be sufficient to cover residual financing gaps and contribute to reserves equivalent to about nine months of imports (excluding transit trade). Given Afghanistan's high dependency on aid, any sudden decline in aid could put pressure on reserves, especially if coupled with other external or security shocks. In the absence of broad and sustainable export opportunities, Afghanistan will require a longer adjustment period during which the reserves need to be maintained at higher levels. Debt service obligations to the Fund, including the new program disbursements, will remain moderate (Table 10).[11]

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[11] The relatively low level of obligations suggests that Afghanistan should not have trouble in servicing its debt to the Fund.

Quantitative performance criteria have been set for March 2012 and September 2012, and indicative targets for December 2011 and June 2012 (MEFP, Table 4).[12]

39. **An update safeguards assessment of the central bank is largely complete.** The central bank has strengthened elements of its safeguards framework since the 2008 assessment, but risks remain. In particular, there has been limited progress in establishing an effective internal audit function, and governance oversight should be strengthened. New risks have also emerged over the past year as a result of the Kabul Bank crisis, not least due to capacity constraints, resignation of the governor and strains on central bank autonomy. Previous safeguards recommendations on the central bank's legal structure and autonomy remain valid, including the need to gain clarification over coverage and calculation of its capital shortfall. It will also be important for the central bank to address outstanding audit recommendations and to sustain earlier progress made. The central bank is working with IMF staff to complete the assessment and is committed to implementing its recommendations thereafter, some of which could be integrated into program conditionality.

40. **The program is subject to significant downside risks**. First and foremost, vested interests and mixed ownership in the government at large could delay or thwart urgently needed reforms. An important test case in this regard will be the envisaged maximum asset recovery from Kabul Bank and bringing New Kabul Bank to the point of sale. Second, the government's ability to deal with the governance aspects of the Kabul Bank crisis in accordance with Afghan laws will be a litmus test of its commitment to the rule of law and sound economic management. Fiscal risks arise from (i) the possibility that revenue-raising reforms such as the introduction of a VAT get delayed beyond March 2014—it is not clear that this measure has yet garnered full ownership within the government; and (ii) the large uncertainties over future spending needs as well as future donor support, and contingent liabilities from poorly managed state-owned enterprises. Other risks stem from the volatile security situation that weighs on economic activity and limits the policy space for reforms. On the upside, Afghanistan's mineral resources and large potential for transit trade between Central Asia and Iran and South Asia could support growth in the coming years.

41. **A technical assistance agenda will support the program**. Technical assistance from the Fund will focus on revenue administration and tax policy reforms, public financial management (including ongoing assistance on program budgeting and on implementing the public financial management road map), monetary operations and treasury securities, banking regulation and supervision, as well as improving the national accounts, price, monetary, and external statistics.

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[12] The authorities consider switching from the current solar fiscal year (March 20–March 19) to a calendar fiscal year starting in 2013. Once that decision is finalized, program monitoring and phasing will be adjusted accordingly.

42. **Economic data are adequate for program monitoring and surveillance, but there are significant shortcomings**. The quality and timeliness of monetary and fiscal data are broadly adequate, although coverage is still deficient. Other data also suffer from weaknesses, especially data on prices, national accounts, balance of payments, and social indicators. Fund technical assistance is being provided to strengthen statistical data systems. In 2012, it will be useful to prepare a Report on the Observance Standards and Codes (ROSC) on data to help develop an economic statistics plan.

V. Staff Appraisal

43. **In a difficult environment, the authorities have made important progress in a number of areas over the past few years.** Most importantly, the government managed to raise revenues through revenue administration and tax policy reforms. Moreover, average annual real GDP growth exceeded 10 percent over the past five years, leading to an increase of per-capita GDP to US$530 in 2010/11 from US$250 in 2005/06; this increase was also helped by an appreciation of the exchange rate that could easily reverse. At the same time, as these levels show, further reforms are needed in these and other areas for Afghanistan to achieve its development objectives. The authorities have also taken politically difficult but important steps to strengthen governance in the financial sector, including initiating audits of Kabul Bank, Azizi Bank, and ten other banks, and establishing a path for asset recovery from Kabul Bank, with some down payments having been received.

44. **The planned drawdown of foreign troops by 2014 and the expected gradual decline of donor support pose very difficult macroeconomic challenges for the authorities.** Growth is likely to be adversely affected; fiscal revenues could suffer, while spending pressures will mount as the government takes over expenditures currently being financed by donors. Data limitations on the local impact of foreign troops and donor spending result in considerable uncertainties about the magnitudes of these effects. To be prepared, the authorities need to build buffers, and their targeted buildup of international reserves is an important element of this. Exchange rate flexibility will be critical to facilitate the necessary external adjustment as donor inflows slow. Donors can also contribute to building buffers by considering what level of support they can continue to provide to Afghanistan over the medium term.

45. **The authorities' fiscal program is moving in the right direction, but could be more ambitious.** Fiscal policy appropriately aims for revenue increases; however, these are modest compared to recent achievements. Introducing a VAT is by March 2014 the very latest is essential to achieve the authorities' medium-term revenue objectives, and they should consider accelerating this measure and be more ambitious in this reform area. The government's emphasis on propoor spending is welcome, but the level of spending is low and the planned increases are too little in light of the country's poverty situation. More generally, the intention of maintaining a tight spending envelope—for example, keeping nonsecurity wages constant in real terms over the forecast horizon—will be difficult to

sustain, even though it simply reflects a lack of fiscal space. Additional pressures on the government purse will come from the need to assume an increasing amount of security spending and recurrent expenditures related to donor-financed projects that the government will have to gradually take over; the projections in this report are conservative, reflecting the lack of fiscal space. Additional spending would help Afghanistan to make faster progress toward its development objectives if grant financing can be secured. Indeed, fiscal sustainability is an issue and will require continued donor support, given Afghanistan's development needs and the limited scope to raise domestic resources.

46. **The intended monetary tightening should help return inflation to the single digits.** The degree of tightening in the authorities' program for the next 12 months seems appropriate, but may need to be revisited in light of inflation developments. The central bank will have to continue relying on capital notes to steer reserve money growth. Consequently, it is important that the government and the central bank reach an agreement on the capital requirement of the central bank and modalities for addressing shortfalls. This will strengthen the independence of the central bank, make it less susceptible to possible government interference, and put it in a better position to ensure a low-inflation environment and preserve financial and external stability.

47. **The authorities seek to address the major shortcomings in the financial sector, and put it in a better position to play its role in fostering private sector-led growth.** Strengthening the legal and regulatory environment as well as ensuring effective supervision are important pillars of the plan. In this context, the ongoing prudential audits of banks will provide an independent view of the health of these financial institutions and insights into whether there are other cases of large-scale violations of regulations and the laws. These audits should be completed as quickly as possible and be followed up with any necessary supervisory action, including a close monitoring of related-party lending. Staff agrees with the authorities' intention to sell New Kabul Bank to an investor who would bring capital and thorough banking experience. Failing to find such an investor, New Kabul Bank should be liquidated by March 2013 and not become a state bank. This would, inter alia, require migrating the government salary payments to other banks.

48. **Progress in the implementation of the ANDS is mixed.** The authorities have made inroads toward achieving some of the Millennium Development Goals, but much remains to be done. At the same time, increasing fiscal pressures are likely to threaten the delivery of core social services. Efforts to prioritize the development objectives with the National Priority Programs, which were initiated at the Kabul conference in July 2010, will, therefore, be necessary to plan a development program in an increasingly resource-restricted environment. World Bank and Fund staffs recommend a careful review of current proposals for the National Priority Programs and to further balancing of the objectives in the ANDS within a viable financing approach.

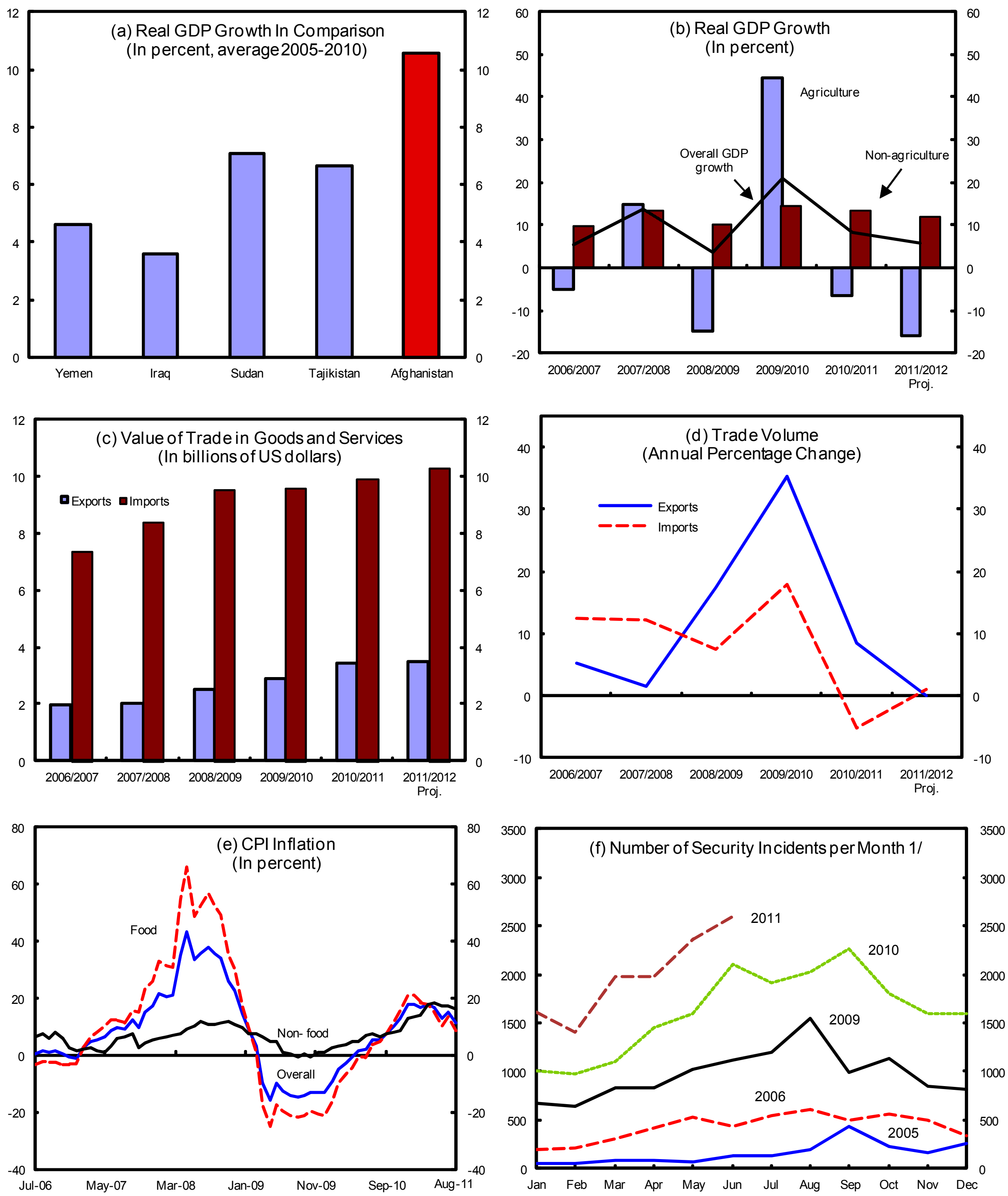
49. **Weak governance and endemic corruption are among the biggest risks to the success of the authorities' program.** The Kabul Bank crisis and the many difficulties in effectively dealing with the crisis have exposed the weakness of Afghan institutions in enforcing the rule of law. Moreover, Afghanistan has a large illicit sector that perpetuates criminal activity and one of the highest rates of corruption in the world. Significant improvements in governance and strong measures to root out corruption are needed if a vibrant private sector is to develop and provide opportunities for the whole population and be the source of sustained inclusive growth. Vested interests have the means and the potential to throw the authorities' reform program off-track and ultimately put into question Afghanistan's political and economic viability. It is imperative for the government to control these vested interests, including by fully applying Afghan law in every case of economic crime and ensuring that all those who derived benefits from such crimes pay back in full their unlawful gains.

50. **In addition to possible shortfalls in implementation, there are a number of other risks to the success of the authorities' program.** A main risk stems from a possible deterioration of the security situation as the international troops withdraw. In this scenario, economic activity is likely to suffer, leading to additional fiscal pressures on the revenue and spending side and possibly a liquidity squeeze. State-owned enterprises constitute a significant contingent fiscal liability, which the authorities' program does not address sufficiently due to capacity constraints. More generally, low capacity—and the corresponding dependence on international advisors—could lead to reform delays that could ultimately undermine fiscal and external sustainability. While most risks are clearly to the downside, there is also a possibility that growth (and fiscal revenues) may come in more strongly if the nascent mining sector develops faster and more vigorously than currently expected. This will require a strong fiscal regime for mineral resource development that promotes good governance.

51. **On balance, staff supports the authorities' request for a program, though it notes the significant risks.** Staff believes that the program stands a good chance of providing an effective macroeconomic anchor for managing the transition and transformation while initiating important structural reforms, essential for Afghanistan's economic viability. In particular, a Fund-supported program could strengthen the hand of the economic team and provide the necessary momentum to take difficult but necessary actions while ownership in the government at large is mixed. Staff expects that the program will have to be adjusted as the withdrawal of foreign troops and any decline in donor support take effect.

52. **The next Article IV consultation will be held in accordance with the relevant** decision on the consultation cycle for members with a Fund arrangement.

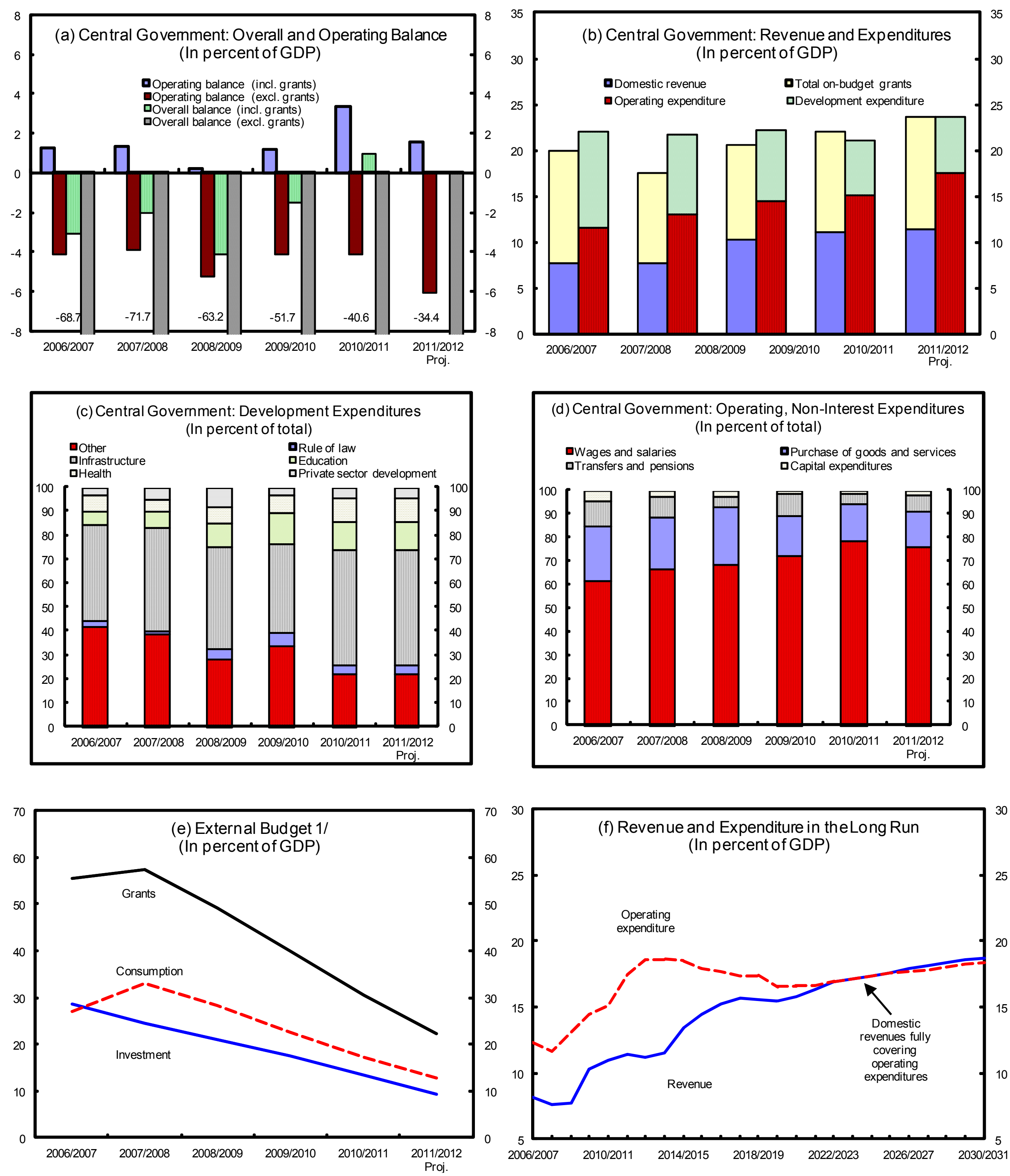
Figure 1. Afghanistan: Real Sector



Sources: Afghan authorities; IMF, WEO; United Nations Department of Safety and Security; and Fund staff estimates.

1/ Attacks and serious beating incidents perpetrated by anti-government elements throughout Afghanistan. They include suicide and stand off attacks; bombings; attacks on district centers, aid and military convoys and their contractors; night letters; assasinations; illegal check points and beatings.

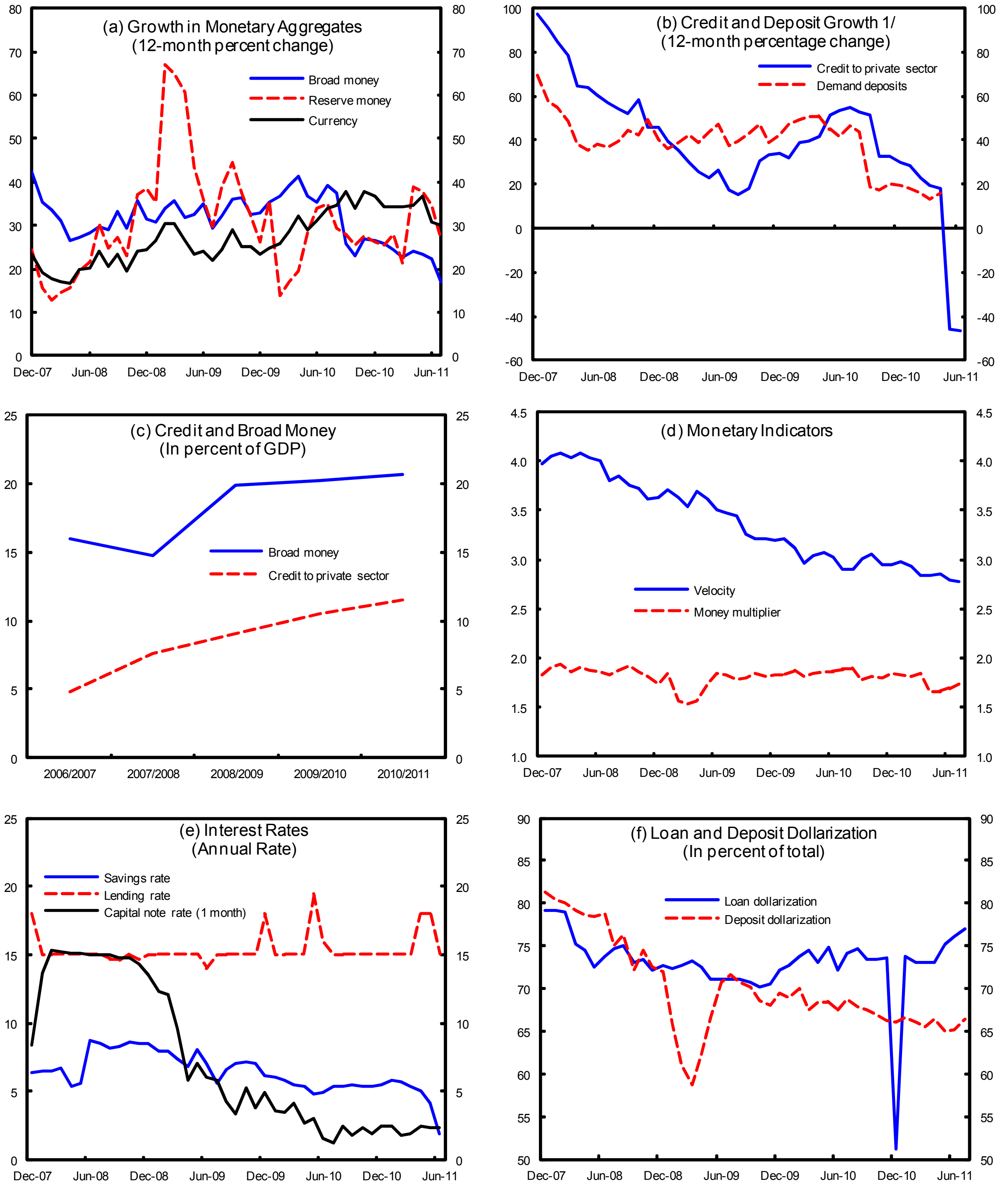
Figure 2. Afghanistan: Fiscal Sector



Sources: Afghan authorities; and Fund staff estimates.

1/ Due to data limitations, the size of the external budget can only be estimated; staff take a conservative approach that aims to take out the share of donor spending that does not impact the local economy.

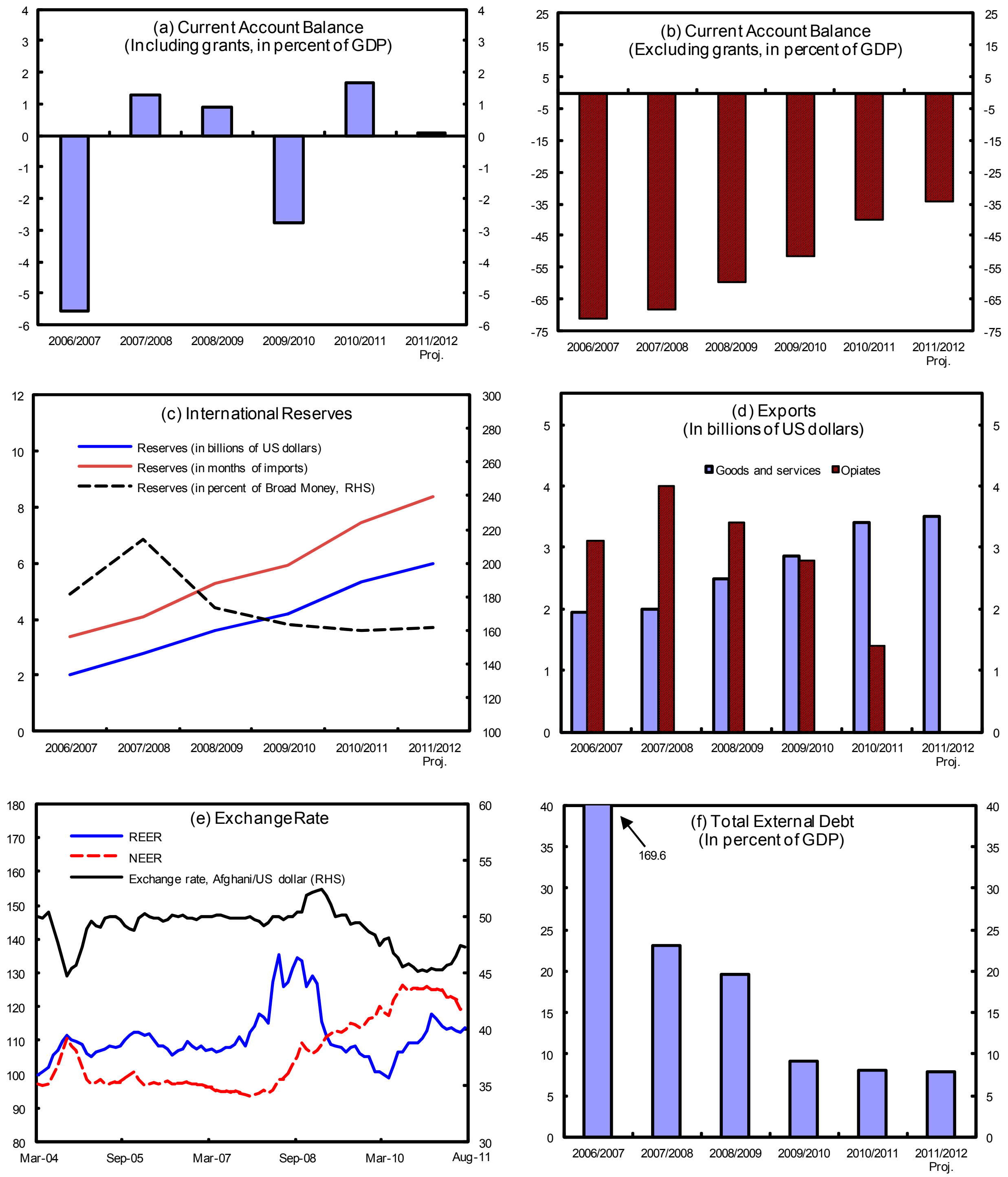
Figure 3. Afghanistan: Monetary Sector



Sources: Afghan authorities; and Fund staff estimates.

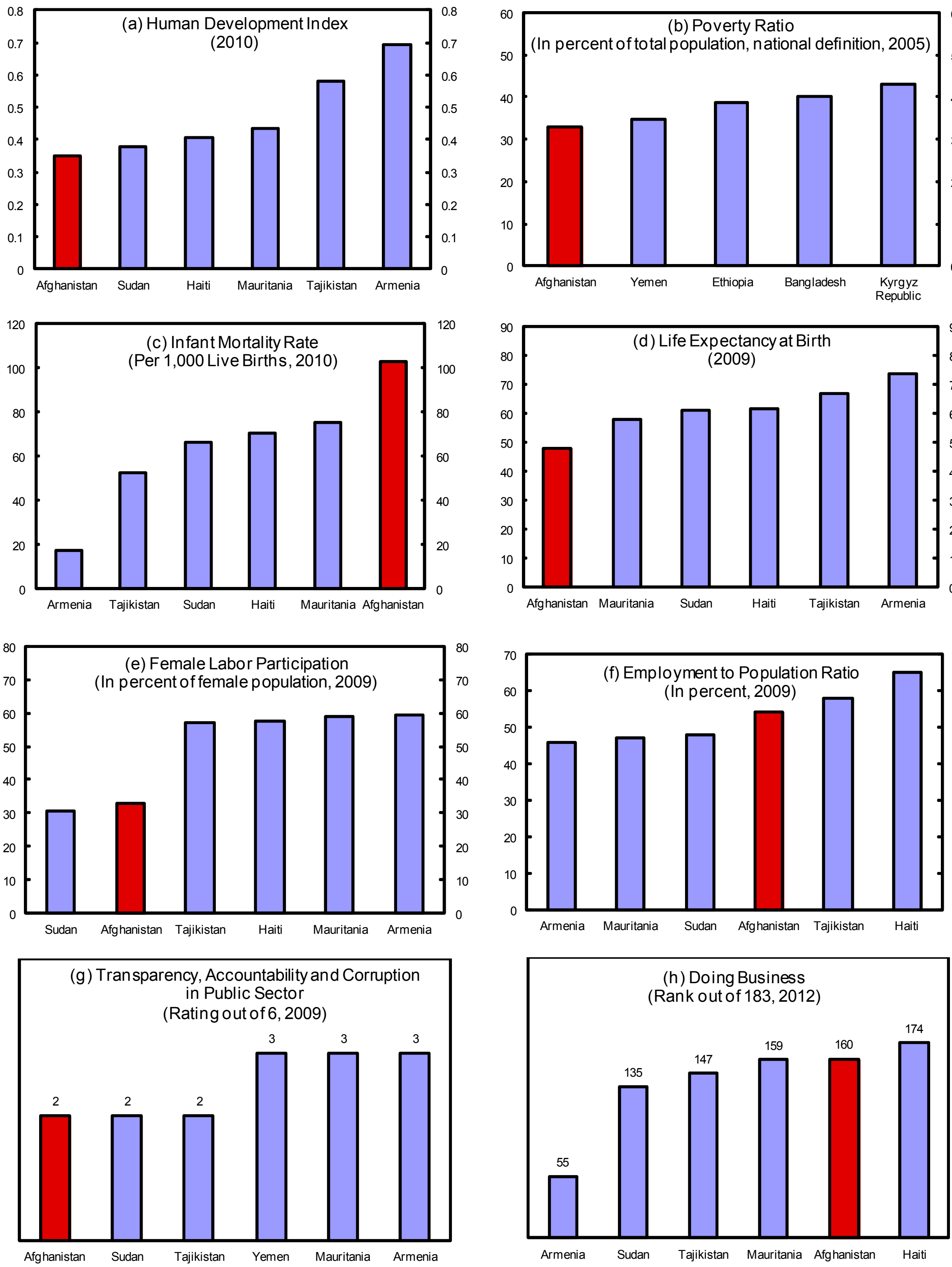
1/ The sharp drop in credit to the private sector reflects the write-off of Kabul Bank loans.

Figure 4. Afghanistan: External Sector



Sources: Afghan authorities; United Nations Office on Drugs and Crime; and Fund staff estimates.

Figure 5. Afghanistan: Social and Governance Indicators



Sources: World Bank WDI; ILO.

Table 1. Islamic Republic of Afghanistan: Selected Economic Indicators, 2006/07–2013/14
(Quota: SDR 161.9 million)
(Population: approx. 30 million; 2010/11)
(Per capita GDP: US$530; 2010/11)
(Poverty rate: 36 percent; 2007/08)
(Main export: dried fruit, US$210 million; 2009/10)

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
					Prel.	Projection		
Output and prices 1/	(Annual percentage change, unless otherwise indicated)							
Real GDP	5.6	13.7	3.6	21.0	8.4	5.7	7.1	5.8
Nominal GDP (in billions of Afghanis)	352	436	534	615	730	862	968	1,074
Nominal GDP (in billions of U.S. dollars)	7.1	8.7	10.5	12.5	15.9	18.4	19.6	21.0
Consumer prices (period average)	5.1	13.0	26.8	-12.2	7.7	10.5	4.6	5.0
Food	3.5	19.2	37.6	-19.5	7.3	8.1	4.7	...
Non-food	7.3	4.7	9.9	1.9	8.3	14.2	4.6	...
Consumer prices (end of period)	4.8	20.7	3.2	-5.1	16.6	7.7	5.0	5.0
Investment and savings	(In percent of GDP)							
Gross domestic investment	43.6	40.6	36.4	31.7	26.3	22.6	21.9	21.6
Of which: Private	8.2	8.6	9.0	8.7	8.5	8.6	8.9	9.5
Gross domestic savings	38.1	41.9	37.3	28.9	27.9	22.6	20.9	19.0
Of which: Private	5.7	12.2	14.0	7.5	9.2	8.6	9.3	8.5
Public finances								
Domestic revenues and grants	18.3	19.9	17.5	20.5	22.0	23.7	23.7	24.0
Domestic revenues	8.2	7.7	7.8	10.3	11.0	11.5	11.3	11.6
Grants	10.2	12.3	9.8	10.2	11.0	12.2	12.4	12.4
Expenditures	21.5	22.0	21.7	22.1	21.1	23.8	25.3	25.7
Operating 2/	12.3	11.6	13.1	14.5	15.1	17.6	18.6	18.7
Development	9.2	10.3	8.6	7.6	5.9	6.2	6.6	7.0
Overall balance (including grants)	-3.1	-2.0	-4.1	-1.6	0.9	0.0	-1.6	-1.7
Operating balance								
Including grants 3/	1.3	1.4	0.2	1.2	3.3	1.6	0.4	0.2
Excluding grants 4/	-4.2	-4.0	-5.3	-4.2	-4.1	-6.1	-7.4	-7.1
Monetary sector	(Annual percentage change, unless otherwise indicated)							
Reserve money	22.3	14.4	64.9	17.1	21.3	18.8	17.1	16.2
Currency in circulation	13.3	17.0	30.4	28.5	34.2	17.8	16.8	16.0
Broad money	...	31.0	35.9	39.3	22.6	18.3	15.1	17.1
Interest rate, 28-day capital note (end-period, in percent)	7.6	14.9	8.9	4.3	2.4	...	...	...
External sector 1/	(In percent of GDP, unless otherwise indicated)							
Exports of goods (in U.S. dollars, percentage change) 5/	1.4	1.8	33.0	2.1	12.7	2.5	-8.8	-3.4
Imports of goods (in U.S. dollars, percentage change)	10.0	15.6	14.8	-0.8	3.0	0.4	0.0	0.6
Merchandise trade balance	-69.7	-67.9	-61.9	-50.9	-39.6	-34.1	-33.3	-31.7
Current account balance								
Excluding official transfers	-71.1	-68.1	-59.6	-51.3	-39.8	-34.3	-33.2	-31.5
Including official transfers	-5.6	1.3	0.9	-2.8	1.7	0.1	-1.1	-2.6
Foreign direct investment	2.7	2.8	2.9	2.4	2.1	2.1	2.3	2.9
Total external debt 6/	169.6	23.0	19.7	9.2	8.0	7.9	8.6	9.1
Gross international reserves (in millions of U.S. dollars)	2,040	2,784	3,591	4,209	5,321	6,121	6,627	7,178
(Import coverage) 7/	3.4	4.1	5.3	6.0	7.4	8.4	9.0	9.5
(Relative to external debt service due)	79	43	215	213	425	425	298	165
Afghanis per U.S. dollar (average)	49.9	49.8	51.0	49.3	45.8	...	...	...
Real effective exchange rate (average, percentage change)	-2.0	3.1	14.3	-17.0	13.9	…	…	…
Memorandum items:								
Opium statistics (wet opium)								
Production (in tons)	6,100	8,200	7,700	6,900	3,600	...	...	...
Price (in U.S. dollars per kilogram)	94	86	70	48	128	...	...	...
External budget grants (in percent of GDP) 8/	55.4	57.4	49.3	39.9	30.5	22.1	19.7	16.5

Source: Afghan authorities; United Nations Office on Drugs and Crime; and Fund staff estimates and projections.

1/ Excluding the narcotics economy.
2/ Comprising mainly current spending.
3/ Defined as domestic revenues plus operating grants minus operating expenditures.
4/ Defined as domestic revenues minus operating expenditures.
5/ Includes official recorded exports, estimates of smuggling, reexports and sales to nonresidents.
6/ After HIPC and MDRI debt relief, as well as debt relief beyond HIPC relief from Paris Club creditors. Debt includes obligations to the IMF.
7/ Gross reserves in months of next year's imports of goods and services, excluding imports for reexport.
8/ Estimated direct expenditures by donors on public projects not included in the government budget.

Table 2. Islamic Republic of Afghanistan: Medium and Long-Term Macroeconomic Framework, 2010/11–2029/30

	2010/11	Projection								
		Medium Term			Long Term					
	Prel.	2011/12	2012/13	2013/14	2017/18	2019/20	2021/22	2024/25	2026/27	2029/30
		(Annual percentage change, unless otherwise indicated)								
Output and prices 1/										
Real GDP	8.4	5.7	7.1	5.8	6.6	5.6	5.4	3.9	4.0	4.0
GDP per capita (in U.S. dollars)	528	591	612	637	758	802	860	918	969	1,062
Consumer prices (period average)	7.7	10.5	4.6	5.0	5.0	4.8	4.5	4.1	4.0	4.0
		(In percent of GDP, unless otherwise indicated)								
Investment and savings										
Gross domestic investment	26.3	22.6	21.9	21.6	23.6	25.6	25.1	23.2	22.3	21.0
Of which: Private	8.5	8.6	8.9	9.5	13.7	16.2	16.1	15.0	14.6	13.8
Gross domestic savings	27.9	22.6	20.9	19.0	19.0	21.8	22.4	21.8	21.5	21.1
Of which: Private	9.2	8.6	9.3	8.5	10.7	14.7	15.7	15.9	16.0	16.0
Public finances										
Domestic revenues and grants	22.0	23.7	23.7	24.0	23.4	22.1	22.5	22.8	22.8	23.0
Domestic revenues	11.0	11.5	11.3	11.6	15.6	15.5	16.4	17.4	17.9	18.5
Grants	11.0	12.2	12.4	12.4	7.7	6.6	6.1	5.4	4.9	4.5
Expenditures	21.1	23.8	25.3	25.7	25.1	24.6	25.1	25.3	25.4	25.5
Operating 2/	15.1	17.6	18.6	18.7	17.4	16.5	16.7	17.4	17.7	18.2
Development	5.9	6.2	6.6	7.0	7.7	8.1	8.4	8.0	7.7	7.3
Overall balance (including grants)	0.9	0.0	-1.6	-1.7	-1.7	-2.5	-2.6	-2.6	-2.6	-2.5
Operating balance										
Including grants 3/	3.3	1.6	0.4	0.2	0.9	-0.9	-0.3	0.0	0.2	0.3
Excluding grants 4/	-4.1	-6.1	-7.4	-7.1	-1.7	-1.0	-0.3	0.0	0.2	0.3
External sector 1/										
Exports of goods 5/	17.8	15.8	13.5	12.2	17.3	17.5	20.1	20.3	20.2	20.1
Imports of goods	57.4	50.0	46.8	43.9	36.2	32.5	31.2	27.8	26.3	24.3
Merchandise trade balance	-39.6	-34.1	-33.3	-31.7	-18.9	-15.0	-11.1	-7.6	-6.0	-4.2
Current account balance										
Excluding official transfers	-39.8	-34.3	-33.2	-31.5	-21.3	-17.3	-14.1	-10.4	-8.5	-6.3
Including official transfers	1.7	0.1	-1.1	-2.6	-4.6	-3.7	-2.8	-1.4	-0.8	0.1
Gross reserves (in millions of U.S. dollars)	5,321	6,121	6,627	7,178	6,877	6,732	6,410	5,928	5,830	5,691
Memorandum items:										
External budget grants 6/	30.5	22.1	19.7	16.5	9.0	6.9	5.2	3.6	2.8	2.0
Total external debt 7/	8.0	7.9	8.6	9.1	10.6	11.6	12.6	14.9	16.3	17.8
Public sector debt	8.0	12.1	13.7	15.2	13.4	14.7	17.3	21.0	23.3	26.1

Source: Afghan authorities; and Fund staff estimates and projections.

1/ Excluding the narcotics economy.
2/ Comprising mainly current spending.
3/ Defined as domestic revenues plus operating grants minus operating expenditures.
4/ Defined as domestic revenues minus operating expenditures.
5/ Includes official recorded exports, estimates of smuggling, reexports and sales to nonresidents.
6/ Estimated direct expenditures by donors on public projects not included in the government budget.
7/ After HIPC and MDRI debt relief, as well as debt relief beyond HIPC relief from Paris Club creditors. Debt includes obligations to the IMF.

Table 3a. Islamic Republic of Afghanistan: Central Government Budget, 2008/09–2013/14
(In billions of Afghanis)

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
	Act.	Act.	Act.		Proj.	
Revenues and grants	93.6	126.4	160.4	204.4	229.3	257.3
Domestic revenues	41.4	63.5	80.4	98.8	109.0	124.1
Tax revenues	28.8	51.5	66.4	82.1	93.0	106.2
Income, profits, and capital gains	8.2	15.6	19.4	23.7	27.1	31.0
International trade and transactions	12.8	21.8	27.7	33.8	37.6	42.0
Goods and services	6.3	12.3	16.3	21.0	24.2	27.9
Other	1.5	1.8	3.0	3.6	4.1	5.2
Nontax revenues	12.6	12.0	14.0	16.7	16.0	17.9
Grants to operating budget	29.5	32.8	54.5	65.9	75.0	78.3
Afghanistan Reconstruction Trust Fund (ARTF)	15.9	10.9	15.4	9.4	12.1	11.2
Law and Order Trust Fund for Afghanistan (LOTFA)	9.9	14.3	24.4	28.0	31.3	31.9
NATO Training Mission - Afghanistan (NTM-A) and other grants	3.7	7.6	14.6	28.5	31.6	35.2
Grants to development budget	22.7	30.1	25.5	39.6	45.3	54.9
Total expenditures	115.7	136.1	153.8	204.8	244.4	275.6
Operating expenditures	69.6	89.1	110.5	151.4	180.3	200.6
Of which: Security	30.0	43.7	61.3	86.4	104.1	116.7
Wages and salaries	47.4	64.3	86.5	113.7	133.0	148.0
Of which: Security	26.6	37.9	55.3	73.9	90.1	101.2
Purchases of goods and services	14.2	14.9	17.2	23.3	26.2	29.0
Transfers, subsidies, and other	2.7	3.0	3.3	3.8	4.3	4.7
Pensions	3.4	5.3	1.9	6.1	11.9	12.9
Capital expenditures	1.8	1.5	1.6	3.4	3.8	4.2
Interest	0.1	0.1	0.1	1.0	1.1	1.8
Development expenditures	46.1	47.0	43.4	53.4	64.1	75.0
Of which:						
Governance, rule of law, and human rights	2.0	2.6	1.5	1.9	2.2	2.6
Infrastructure and natural resources	19.7	17.4	20.7	25.5	30.6	35.8
Education	4.4	6.1	5.2	6.4	7.6	9.0
Health	3.3	3.7	4.3	5.3	6.3	7.4
Agriculture and rural development	12.2	14.6	9.1	11.2	13.4	15.7
Economic governance and private sector development	3.7	1.5	2.0	2.5	3.0	3.5
Operating balance including grants	1.3	7.2	24.4	13.4	3.6	1.8
Operating balance excluding grants	-28.2	-25.5	-30.1	-52.6	-71.3	-76.5
Overall budget balance including grants	-22.1	-9.7	6.5	-0.4	-15.1	-18.3
Augmented overall budget balance, including grants	-22.1	-9.7	6.5	-34.5	-11.4	-15.7
Of which : Central bank capitalization	…	…	…	-34.1	3.7	2.6
Float and discrepancy	9.9	12.7	5.5	...	...	...
Sale of nonfinancial assets 1/	4.1	1.3	0.1	2.3	0.1	0.0
Financing	8.0	-4.3	-12.1	32.2	11.3	15.7
External loans (net)	3.7	3.4	2.8	7.4	9.3	9.9
Domestic (net)	4.3	-7.7	-14.9	24.8	1.9	5.8
Central bank	4.3	-7.7	-14.9	24.8	1.9	-39.3
Change in government deposits	3.4	-18.8	-14.9	-7.5	6.0	-35.9
Change in foreign currency deposits	3.8	-16.5	-16.4	-6.4	5.1	4.9
Change on domestic currency deposits	-0.5	-2.3	1.4	-1.1	0.9	-40.9
Change in central bank claims on government	0.9	11.1	0.0	32.3	-4.0	-3.3
Of which: Central bank capitalization bond issuance	…	…	…	37.6	0.0	0.0
Recoveries	…	…	…	-3.5	-3.7	-2.6
Amortization of central bank capitalization bond	…	…	…	-2.6	-2.1	-2.5
Commercial banks 2/	…	…	…	…	…	45.1
Nonbank Sector	…	…	…	…	…	…
Memorandum items:						
Domestic revenues as percent of operating expenditure	59	71	73	65	60	62
Central bank capitalization bond (end-of-period stock)	…	…	…	31.5	25.7	20.6
Security forces (National Army and Police), end of period, thousands	143	187	275	343	382	400
Indicative floor on propoor spending 3/	...	...	...	18.0	19.4	...
Discretionary cash balances 4/	6.1	9.5	23.4	20.4	5.6	33.4
External budget 5/	263.0	245.4	222.9	190.7	190.8	177.7

Source: Afghan authorities; and Fund staff estimates and projections.

1/ For 2011/12 and 2012/13, reflects signature bonus payments for the Aynak Copper Mine equivalents to US$53m and US$109m, respectively.
2/ By 2013/14 government will start to issue sukuk debt instruments.
3/ Propoor spending covers the Ministry of Education, the Ministry of Labor and Social Affairs, Martyrs, and Disabled, and the Ministry of Public Health.
4/ Government deposits at the central bank exclude earmarked grants.
5/ Estimated direct productive expenditures by donors on public projects not included in the central government budget.

Table 3b. Islamic Republic of Afghanistan: Central Government Budget, 2008/09–2013/14
(In percent of GDP)

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
	Act.	Act.	Act.		Proj.	
Revenues and grants	17.5	20.5	22.0	23.7	23.7	24.0
Domestic revenues	7.8	10.3	11.0	11.5	11.3	11.6
Tax revenues	5.4	8.4	9.1	9.5	9.6	9.9
Income, profits, and capital gains	1.5	2.5	2.7	2.8	2.8	2.9
International trade and transactions	2.4	3.5	3.8	3.9	3.9	3.9
Goods and services	1.2	2.0	2.2	2.4	2.5	2.6
Other	0.3	0.3	0.4	0.4	0.4	0.5
Nontax revenues	2.4	2.0	1.9	1.9	1.7	1.7
Grants to operating budget	5.5	5.3	7.5	7.6	7.7	7.3
Afghanistan Reconstruction Trust Fund (ARTF)	3.0	1.8	2.1	1.1	1.2	1.0
Law and Order Trust Fund for Afghanistan (LOTFA)	1.9	2.3	3.3	3.3	3.2	3.0
NATO Training Mission - Afghanistan (NTM-A) and other grants	0.7	1.2	2.0	3.3	3.3	3.3
Grants to development budget	4.3	4.9	3.5	4.6	4.7	5.1
Total expenditures	21.7	22.1	21.1	23.8	25.3	25.7
Operating expenditures	13.1	14.5	15.1	17.6	18.6	18.7
Of which: Security	5.6	7.1	8.4	10.0	10.8	10.9
Wages and salaries	8.9	10.4	11.8	13.2	13.7	13.8
Of which: Security	5.0	6.2	7.6	8.6	9.3	9.4
Purchases of goods and services	2.7	2.4	2.4	2.7	2.7	2.7
Transfers, subsidies, and other	0.5	0.5	0.4	0.4	0.4	0.4
Pensions	0.6	0.9	0.3	0.7	1.2	1.2
Capital expenditures	0.3	0.2	0.2	0.4	0.4	0.4
Interest	0.0	0.0	0.0	0.1	0.1	0.2
Development expenditures	8.6	7.6	5.9	6.2	6.6	7.0
Of which:						
Governance, rule of law, and human rights	0.4	0.4	0.2	0.2	0.2	0.2
Infrastructure and natural resources	3.7	2.8	2.8	3.0	3.2	3.3
Education	0.8	1.0	0.7	0.7	0.8	0.8
Health	0.6	0.6	0.6	0.6	0.7	0.7
Agriculture and rural development	2.3	2.4	1.2	1.3	1.4	1.5
Economic governance and private sector development	0.7	0.2	0.3	0.3	0.3	0.3
Operating balance including grants	0.2	1.2	3.3	1.6	0.4	0.2
Operating balance excluding grants	-5.3	-4.2	-4.1	-6.1	-7.4	-7.1
Overall budget balance including grants	-4.1	-1.6	0.9	0.0	-1.6	-1.7
Augmented overall budget balance, including grants	-4.1	-1.6	0.9	-4.0	-1.2	-1.5
Of which: Central bank capitalization	…	…	…	-4.0	0.4	0.2
Float and discrepancy	1.9	2.1	0.7	...	...	...
Sale of nonfinancial assets 1/	0.8	0.2	0.0	0.3	0.0	0.0
Financing	1.5	-0.7	-1.7	3.7	1.2	1.5
External loans (net)	0.7	0.6	0.4	0.9	1.0	0.9
Domestic (net)	0.8	-1.3	-2.0	2.9	0.2	0.5
Central bank	0.8	-1.3	-2.0	2.9	0.2	-3.7
Change in government deposits	0.6	-3.1	-2.0	-0.9	0.6	-3.3
Change in central bank claims on government	0.2	1.8	0.0	3.8	-0.4	-0.3
Of which: Central bank capitalization bond issuance	…	…	…	4.4	0.0	0.0
Recoveries	…	…	…	-0.4	-0.4	-0.2
Amortization of central bank capitalization bond	…	…	…	-0.3	-0.2	-0.2
Commercial banks 2/	…	…	…	…	…	4.2
Nonbank Sector	…	…	…	…	…	…
Memorandum items:						
Domestic revenues as percent of operating expenditures	59	71	73	65	60	62
Central bank capitalization bond (end-of-period stock)	…	…	…	3.7	2.7	1.9
Indicative floor on propoor spending 3/	...	...	...	2.1	2.0	...
Discretionary cash balances 4/	1.1	1.5	3.2	2.4	0.6	3.1
External budget 5/	49.3	39.9	30.5	22.1	19.7	16.5
Nominal GDP (in billions of Afghanis)	534	615	730	862	968	1,074

Source: Afghan authorities; and Fund staff estimates and projections.

1/ For 2011/12 and 2012/13, reflects signature bonus payments for the Aynak Copper Mine equivalents to US$53m and US$109m, respectively.
2/ By 2013/14 the government will start to issue sukuk debt instruments.
3/ Propoor spending covers the Ministry of Education, the Ministry of Labor and Social Affairs, Martyrs, and Disabled, and the Ministry of Public Health.
4/ Government deposits at the central bank exclude earmarked grants.
5/ Estimated direct productive expenditures by donors on public projects not included in the core budget.

Table 4a. Islamic Republic of Afghanistan: Central Bank Balance Sheet, 2009–2012
(at market exchange rates)

	2009	2010	2011				2012			
	Mar. 20	Mar. 20	Mar. 20	June 21	Sep. 22	Dec. 21	Mar. 19	June 20	Sep. 21	Dec. 22
	Act.	Act.	Actual			Proj.	Projections			
	(In billions of Afghanis, unless otherwise indicated)									
Net foreign assets	184.2	194.8	233.4	265.4	282.5	288.9	289.4	298.1	306.9	315.8
Foreign assets	188.8	209.9	248.2	280.8	297.9	305.4	305.8	315.6	324.5	334.5
Foreign exchange reserves	181.0	204.0	241.4	274.2	289.2	296.5	297.0	306.5	315.2	324.9
Other foreign assets	7.8	5.9	6.7	6.6	8.8	8.9	8.8	9.1	9.3	9.6
Foreign liabilities	-4.6	-15.2	-14.8	-15.3	-15.4	-16.5	-16.4	-17.4	-17.6	-18.7
Net domestic assets	-77.9	-70.3	-82.4	-99.0	-114.9	-122.9	-110.1	-122.7	-121.0	-120.7
Domestic assets	-53.5	-52.6	-55.5	-51.0	-60.7	-65.4	-53.9	-64.4	-59.6	-56.8
Net claims on general government	-31.2	-36.7	-48.9	-21.3	-27.2	-35.1	-27.2	-37.7	-32.6	-40.2
Gross claims on government	4.6	15.1	14.7	53.1	50.8	50.3	47.8	47.4	46.1	45.7
Of which: Capitalization bonds	...	...	...	37.8	35.4	33.9	31.5	30.0	28.6	27.1
Domestic currency deposits	-8.3	-10.6	-9.2	-4.0	-7.1	-11.7	-10.3	-11.6	-10.7	-11.6
Foreign currency deposits	-27.5	-41.2	-54.4	-70.3	-70.9	-73.8	-64.7	-73.4	-68.1	-74.4
Other claims, *of which:*	-22.3	-15.9	-6.6	-29.7	-33.4	-30.3	-26.6	-26.7	-27.0	-16.6
Capital notes	-19.3	-10.9	-16.1	-20.5	-23.9	-21.3	-17.7	-17.8	-18.0	-7.6
Lender of last resort loans	...	...	18.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other items net	-24.4	-17.7	-26.9	-48.1	-54.2	-57.4	-56.2	-58.3	-61.4	-63.9
Reserve money	106.2	124.4	151.0	166.4	167.7	166.0	179.4	175.4	185.9	195.1
Currency in circulation	76.8	98.7	132.4	133.7	143.7	149.0	156.1	157.5	168.8	174.4
Bank deposits (Afghani denominated)	29.4	25.7	18.5	32.7	24.0	17.0	23.3	17.9	17.1	20.7
Memorandum items:										
Reserve money										
Year-to-date percentage change	...	...	...	10.2	11.0	9.9	18.8	-2.2	3.6	8.8
Year-on-year percentage change	64.9	17.1	21.3	34.5	23.6	19.0	18.8	5.4	10.9	17.5
Currency in circulation										
Year-to-date percentage change	...	...	...	1.0	8.5	12.5	17.8	0.9	8.2	11.7
Year-on-year percentage change	30.4	28.5	34.2	30.8	21.4	21.3	17.8	17.8	17.5	17.0
	(In millions of U.S. dollars, unless otherwise indicated)									
Gross international reserves	3,591	4,209	5,321	5,859	5,984	6,063	6,121	6,257	6,374	6,510
Interest rate, 28-day capital notes (percent)	14.5	4.3	2.4	2.4	2.2	…	…	…	…	…

Source: Afghan authorities; and Fund staff estimates and projections.

Table 4b. Islamic Republic of Afghanistan: Central Bank Balance Sheet, 2009–2012
(at program exchange rates) 1/

	2009	2010	2011				2012			
	Mar. 20	Mar. 20	Mar. 20	June 21	Sep. 22	Dec. 21	Mar. 19	June 20	Sep. 21	Dec. 22
	Act.	Act.	Actual			Proj.	Projections			
	(In billions of Afghanis, unless otherwise indicated)									
Net foreign assets	179.3	196.1	233.4	252.8	258.4	261.1	263.7	269.2	274.7	280.2
Foreign assets	183.5	210.8	248.2	267.6	273.2	276.7	279.3	285.7	291.2	297.5
Foreign exchange reserves	176.5	205.2	241.4	261.2	264.9	268.5	271.1	277.3	282.6	288.7
Other foreign assets	7.0	5.6	6.7	6.4	8.3	8.3	8.3	8.4	8.6	8.8
Foreign liabilities	-4.3	-14.7	-14.8	-14.7	-14.7	-15.6	-15.6	-16.5	-16.5	-17.3
Net domestic assets	-73.0	-71.6	-82.4	-86.4	-90.7	-95.1	-84.4	-93.8	-88.8	-85.1
Domestic assets	-50.7	-50.7	-55.5	-49.0	-56.8	-61.3	-50.7	-60.3	-55.5	-51.8
Net claims on general government	-28.6	-35.1	-48.9	-19.6	-23.9	-31.0	-24.1	-33.6	-28.5	-35.2
Gross claims on government	4.2	14.7	14.7	52.5	50.1	49.4	47.0	46.4	45.0	44.4
Of which: Capitalization bonds	...	...	...	37.8	35.4	33.9	31.5	30.0	28.6	27.1
Domestic currency deposits	-8.3	-10.6	-9.2	-4.0	-7.1	-11.7	-10.3	-11.6	-10.7	-11.6
Foreign currency deposits	-24.5	-39.1	-54.4	-68.1	-66.8	-68.7	-60.8	-68.4	-62.8	-68.1
Other claims, *of which:*	-22.1	-15.6	-6.6	-29.5	-32.9	-30.3	-26.6	-26.7	-27.0	-16.6
Capital notes	-19.3	-10.9	-16.1	-20.5	-23.9	-21.3	-17.7	-17.8	-18.0	-7.6
Lender of last resort loans	...	...	18.1	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Other items net	-22.3	-20.9	-26.9	-37.4	-34.0	-33.8	-33.6	-33.5	-33.4	-33.2
Reserve money	106.2	124.4	151.0	166.4	167.7	166.0	179.4	175.4	185.9	195.1
Currency in circulation	76.8	98.7	132.4	133.7	143.7	149.0	156.1	157.5	168.8	174.4
Bank deposits (Afghani denominated)	29.4	25.7	18.5	32.7	24.0	17.0	23.3	17.9	17.1	20.7
Memorandum items:										
Reserve money										
Year-to-date percentage change	...	...	...	10.2	11.0	9.9	18.8	-2.2	3.6	8.8
Year-on-year percentage change	64.9	17.1	21.3	34.5	23.6	19.0	18.8	5.4	10.9	17.5
Currency in circulation										
Year-to-date percentage change	...	...	...	1.0	8.5	12.5	17.8	0.9	8.2	11.7
Year-on-year percentage change	30.4	28.5	34.2	30.8	21.4	21.3	17.8	17.8	17.5	17.0
	(In millions of U.S. dollars, unless otherwise indicated)									
Net international reserves (at program rates)	3,760	4,315	5,017	5,468	5,532	5,589	5,647	5,764	5,881	5,998
Gross international reserves (at market rates)	3,591	4,209	5,321	5,859	5,984	6,063	6,121	6,257	6,374	6,510
Interest rate, 28-day capital notes (percent)	14.5	4.3	2.4	2.4	2.2	…	…	…	…	…

Source: Afghan authorities; and Fund staff estimates and projections.

1/ Program exchange rates as of March 20, 2011 applied to evaluate foreign currency-denominated components. The Afghani per U.S. dollar rate for that day was 45.3740.

Table 5. Islamic Republic of Afghanistan, Monetary Survey, 2008–12 1/

	2008	2009	2010	2011	2012
	Mar. 19	Mar. 20	Mar. 20	Mar. 20	Mar. 19
	Act.	Act.	Act.	Act.	Proj.
	(In billions of Afghanis)				
Net foreign assets	162.2	187.7	225.6	272.2	337.2
Foreign assets	171.5	222.9	257.7	298.2	367.2
Central bank	148.0	188.8	209.9	248.2	305.8
Commercial banks	23.6	34.1	47.8	50.1	61.3
Foreign liabilities	-9.4	-35.2	-32.1	-26.0	-29.9
Central bank	-5.0	-4.6	-15.2	-14.8	-16.4
Commercial banks	-4.4	-30.5	-16.9	-11.3	-13.5
Net domestic assets	-42.6	-25.2	0.7	5.4	-8.9
Net domestic credit	5.2	17.4	29.7	31.5	12.3
Nonfinancial public sector	-33.7	-32.9	-39.4	-51.6	-30.0
Central bank	-34.9	-31.2	-36.7	-48.9	-27.2
Commercial banks	1.2	-1.7	-2.7	-2.7	-2.7
Private sector 2/	38.4	49.8	69.7	83.1	42.3
Other financial institutions	0.5	0.5	-0.6	0.0	0.0
Capital account	-52.5	-49.8	-57.5	-23.7	-64.3
Other items net	4.8	7.3	28.5	-2.5	43.2
Broad money M2	119.6	162.5	226.4	277.5	328.4
Narrow money M1	114.9	158.4	212.6	261.2	309.5
Currency outside banks	57.5	73.8	92.5	126.3	149.2
Currency in circulation	58.9	76.8	98.7	132.5	156.1
Currency held by banks	1.4	3.0	6.1	6.2	6.8
Demand deposits	57.4	84.5	120.1	134.9	160.3
Other deposits 3/	4.7	4.2	13.7	16.3	18.9
	(12-month percentage change)				
M2	31.0	35.9	39.3	22.6	18.3
M1	28.7	37.8	34.3	22.8	18.5
Currency outside banks	16.0	28.4	25.3	36.5	18.2
Currency in circulation	17.0	30.4	28.5	34.2	17.8
Net credit to the private sector 2/	78.3	29.8	39.7	19.3	-49.2
	(In percent of GDP)				
M2	27.5	30.5	36.8	38.0	38.1
M1	26.4	29.7	34.6	35.8	35.9
Memorandum items:					
M2 velocity	4.0	3.5	3.0	2.8	2.7
Reserve money multiplier	1.9	1.5	1.8	1.8	1.8
Banking sector					
Loan dollarization (percent)	75.3	73.3	74.4	73.1	77.0
Deposit dollarization (percent)	79.1	58.7	67.5	65.5	66.4
Currency-to-deposit ratio (percent)	94.8	86.6	73.8	87.6	87.1

Source: Afghan authorities; and Fund staff estimates and projections.

1/ Data underlying the survey are not fully consistent because the central bank and the public banks use the solar calendar, while commercial banks use the Gregorian calendar.
2/ The decline in 2012 reflects a write-down of bad loans in the banking sector.
3/ Comprising all claims, other than transferable deposits.

Table 6. Islamic Republic of Afghanistan: Balance of Payments, 2008/09–2013/14

	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
			Prel.		Projections	
	(In millions of U.S. dollars, unless otherwise indicated)					
Current account (including grants)	92	-347	267	18	-207	-536
Current account (excluding grants)	-6,244	-6,402	-6,343	-6,293	-6,508	-6,621
Trade balance	-6,480	-6,354	-6,303	-6,266	-6,524	-6,672
Exports of goods (f.o.b.) 1/	2,465	2,517	2,836	2,908	2,651	2,560
Official exports	547	476	571	657	749	836
Unofficial exports	1,918	2,041	2,265	2,251	1,902	1,724
Smuggling	180	141	152	157	161	162
Transit trade	1,438	1,400	1,463	1,444	1,291	1,263
Sales to nonresidents	300	500	650	650	450	300
Imports of goods (f.o.b.)	-8,945	-8,872	-9,139	-9,174	-9,174	-9,232
Services and income, net	-240	-370	-408	-423	-394	-372
Of which: Interest due 2/	-16	-19	-11	-12	-14	-17
Current transfers	6,812	6,377	6,978	6,707	6,710	6,508
Public (program grants)	6,337	6,054	6,610	6,311	6,301	6,085
Private	475	323	368	396	409	424
Capital and financial account	338	-287	612	734	760	929
Capital account	0	0	0	0	0	0
Financial account	338	-287	612	734	760	929
Debt forgiveness	0	-1,061	0	0	0	0
Foreign direct investment	300	303	329	386	447	604
Other investment	38	471	283	348	313	326
Official loans (net)	96	286	133	156	188	194
Disbursement 3/	97	287	134	158	190	206
Amortization due 2/	-1	-1	-1	-2	-2	-13
Other inflows	-57	185	151	192	125	132
Errors and omissions (including short-term capital)	541	190	-81	-116	-78	-11
Overall balance	972	-445	797	636	475	382
Financing	-972	445	-797	-636	-475	-382
Changes in central bank's gross reserves (increase = -)	-993	-621	-797	-653	-506	-404
Use of Fund resources (net)	17	0	0	17	30	22
Disbursements (PRGT)	17	0	0	18	36	36
Repayments	0	0	0	1	6	14
Exceptional financing	5	1,066	0	0	0	0
Arrears 4/	-84	0	0	0	0	0
Debt rescheduling 5/	32	5	0	0	0	0
Debt forgiveness	56	1,061	0	0	0	0
HIPC	0	442	0	0	0	0
MDRI	0	35	0	0	0	0
Financing gap	0	0	0	0	0	0
Memorandum items:						
Gross international reserves	3,591	4,209	5,321	6,121	6,627	7,178
(Import coverage) 6/	5.3	6.0	7.4	8.4	9.0	9.5
(Relative to external debt service due)	215	213	425	425	298	165
	(In percent of GDP, unless otherwise indicated)					
Trade balance	-61.9	-50.9	-39.6	-34.1	-33.3	-31.7
Current account balance, including grants	0.9	-2.8	1.7	0.1	-1.1	-2.6
Excluding grants	-59.6	-51.3	-39.8	-34.3	-33.2	-31.5

Source: Afghan authorities; and Fund staff estimates and projections.

1/ Excludes opium exports; includes official exports, estimates of smuggling, reexport, and sales to nonresidents.
2/ Debt service projections are based on the total stock of external debt (including estimates of unverified arrears). Interest on overdue obligations represents estimates by Fund staff.
3/ Includes allocation of SDR 128.6 million in 2009/10.
4/ Arrears shown represent Fund staff estimates of debt service due, but not paid, on estimated overdue obligations.
5/ Debt rescheduling includes the capitalization of interest falling due to Paris Club creditors until the completion point, interim assistance from multilateral creditors, and HIPC debt relief from multilateral creditors after the completion point.
6/ Excluding imports for reexport.

Table 7. Islamic Republic of Afghanistan: Main Socioeconomic Indicators, 2000-09

	2000	2005	2006	2007	2008	2009
Labor market						
Employment-to-population ratio, (in percent, ages 15+)	54.7	54.2	54.9	54.6	55.5	54.2
Youth employment-to-population ratio, ages 15-24, (in percent)	42.2	41.7	42.6	42.2	43.3	41.6
Unemployment, total (in percent of total labor force)	…	8.5	…	…	…	…
Female (in percent of female labor force)	…	9.5	…	…	…	…
Male (in percent of male labor force)	…	7.6	…	…	…	…
Labor participation rate, (in percent of total population, ages 15+)	58.9	59.3	59.4	59.6	59.7	59.8
Income, inequality and poverty						
Income share held by lowest 20 percent (in percent)	…	…	…	…	9.0	…
Income share held by highest 20 percent (in percent)	…	…	…	…	38.7	…
Gini index	…	…	…	…	29.4	…
Poverty rate (headcount at the national poverty line, in percent of population)	…	33.0	…	42.0	36.0	…
Gender equality and empowerment						
Proportion of seats held by women in the parliament (in percent)	…	27.3	27.3	27.3	27.7	27.7
Ratio of female to male school enrollment (in percent)						
Primary	…	59.5	63.6	62.7	65.1	67.3
Secondary	…	32.9	36.8	38.0	43.3	49.0
Tertiary	…	…	…	…	…	23.9
Population, female (in percent of total)	48.2	48.2	48.2	48.2	48.3	48.3
Share of women employed in the nonagricultural sector (in percent)	…	…	…	…	…	…
Education and health						
Health expenditure (in percent of GDP)						
Public health expenditure (in percent of GDP)	2.3	2.1	2.1	1.8	1.6	1.6
Public health expenditure (in percent of government spending)	2.8	4.1	4.3	3.7	3.7	3.7
Hospital beds (per 1000 people)	…	…	…	0.4	0.4	0.4
Life expectancy at birth (in years)	45.3	46.6	46.9	47.2	47.5	47.9
Female	45.4	46.7	47.0	47.3	47.7	48.1
Male	45.2	46.5	46.8	47.1	47.4	47.8

Sources: World Bank World Development Indicators (WDI) database, ILO LABORSTA database, UN MDG indicators.

Table 8. Islamic Republic of Afghanistan:
Proposed Schedule of Reviews and Disbursements Under New ECF Arrangement

Date	Amount of disbursement		Conditions
	Millions of SDRs	Percent of quota 1/	
November 21, 2011	12.0	7.4	Approval of arrangement
May 20, 2012	12.0	7.4	First review and March 19, 2012 performance criteria
November 20, 2012	12.0	7.4	Second review and September 21, 2012 performance criteria
May 20, 2013	12.0	7.4	Third review and March 20, 2013 performance criteria
November 20, 2013	12.0	7.4	Fourth review and September 22, 2013 performance criteria
May 20, 2014	12.0	7.4	Fifth review and March 20, 2014 performance criteria
November 6, 2014	13.0	8.0	Sixth review and September 22, 2014 performance criteria
Total	85.0	52.5	

Source: Fund staff estimates.

1/ Percentages do not add up to the total due to rounding.

Table 9. Islamic Republic of Afghanistan:
External Financing Requirement and Sources, 2010/11–2013/14

	2010/11	2011/12	2012/13	2013/14
	Projections			
	(In millions of U.S. dollars)			
I. Total financing requirement	7,142	6,949	7,022	7,052
Current account (excluding grants)	6,343	6,293	6,508	6,621
Amortization	1	3	8	27
Of which: IMF	0	1	6	14
Prepayment of debt	0	0	0	0
Change in reserves (increase = +)	797	653	506	404
Reduction in arrears	0	0	0	0
II. Available financing	7,142	6,949	7,022	7,052
Current transfers	6,610	6,311	6,301	6,085
Foreign direct investment	329	386	447	604
Short-term private financing flows	151	192	125	132
Official medium- and long-term loans	134	158	190	206
IMF disbursements	0	18	36	36
Debt forgiveness	0	0	0	0
Debt rescheduling	0	0	0	0
Other	-81	-116	-78	-11
Financing gap	0	0	0	0

Sources: Afghan authorities; and Fund staff estimates and projections.

Table 10. Islamic Republic of Afghanistan: Indicators of Capacity to Repay the Fund, 2010–18

	2010	2011	2012	2013	2014	2015	2016	2017	2018
		Projections							
Fund obligations based on existing credit (in millions of SDRs)									
Principal	0.0	0.0	2.5	8.3	12.8	14.5	15.1	12.6	6.8
Charges and interest	0.1	0.0	0.3	0.3	0.2	0.2	0.2	0.1	0.1
Total obligations based on existing and prospective credit 1/									
In millions of SDRs	0.1	0.0	2.8	8.7	13.2	14.9	15.4	16.6	15.5
In millions of U.S. dollars	0.1	0.0	4.4	13.8	21.0	23.6	24.4	26.1	24.5
In percent of Gross International Reserves	0.0	0.0	0.1	0.2	0.3	0.3	0.3	0.4	0.4
In percent of exports of goods and services	0.0	0.0	0.4	1.0	1.3	1.0	0.8	0.7	0.7
In percent of debt service	10.7	1.9	231	110	80	269	220	241	222
In percent of GDP	0.0	0.0	0.0	0.1	0.1	0.1	0.1	0.1	0.1
In percent of quota	0.1	0.0	1.7	5.3	8.2	9.2	9.5	10.2	9.6
Outstanding Fund credit									
In millions of SDRs	75	87	109	125	137	122	107	91	76
In billions of U.S. dollars	0.1	0.1	0.2	0.2	0.2	0.2	0.2	0.1	0.1
In percent of Gross International Reserves	2.2	2.3	2.6	2.8	3.0	2.6	2.4	2.1	1.8
In percent of exports of goods and services	12.1	12.9	14.4	14.9	13.6	7.8	5.2	4.1	3.2
In percent of debt service	8,942	8,239	9,040	1,579	829	2,206	1,531	1,324	1,087
In percent of GDP	0.7	0.8	0.9	0.9	1.0	0.8	0.6	0.5	0.4
In percent of quota	46.5	54.0	67.3	77.0	84.5	75.5	66.2	56.2	46.8
Net use of Fund credit (millions of SDRs)	5.7	12.0	21.6	15.7	12.2	-14.5	-15.1	-16.2	-15.2
Disbursements	5.7	12.0	24.0	24.0	25.0	0.0	0.0	0.0	0.0
Repayments and Repurchases	0.0	0.0	2.5	8.3	12.8	14.5	15.1	16.2	15.2
Memorandum items:									
Nominal GDP (in millions of U.S. dollars)	15,928	18,364	19,603	21,015	22,477	24,273	26,170	28,132	29,626
Exports of goods and services (in millions of U.S. dollars)	952	1,074	1,206	1,330	1,598	2,473	3,252	3,496	3,719
Gross International Reserves (in millions of U.S. dollars)	5,321	6,121	6,627	7,178	7,278	7,349	7,059	6,877	6,626
Debt service (in millions of U.S. dollars) 2/	1.3	1.7	1.9	12.5	26.2	8.8	11.1	10.9	11.0
Quota (millions of SDRs)	161.9	161.9	161.9	161.9	161.9	161.9	161.9	161.9	161.9

Sources: IMF staff estimates and projections.

1/ Includes prospective ECF disbursements of SDR 85 million (52.5 percent of quota).
2/ On accrual basis. Total debt service includes IMF repurchases and repayments.

APPENDIX I. ISLAMIC REPUBLIC OF AFGHANISTAN: LETTER OF INTENT

November 1, 2011

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

Dear Ms. Lagarde:

We would like to thank the International Monetary Fund (IMF) for its advice and support over the last year as the government of Afghanistan and Da Afghanistan Bank dealt with the crisis at Kabul Bank that came to the fore in September 2010 and its consequences. In response to the crisis, we have taken important steps to mitigate its adverse effects, minimize the fiscal costs, and safeguard good governance and the rule of law over the last 12 months.

Against this background, we entered into discussions with IMF staff on a new program that could be supported under the Extended Credit Facility (ECF). The three-year program through 2013/14 establishes a macroeconomic framework that will support our efforts at economic stabilization and implementation of structural reforms. In particular, the ECF arrangement will help us make significant progress toward a stable and sustainable macroeconomic position, while managing the challenges of the withdrawal of the international presence in Afghanistan, as well as strengthening the financial sector. These are key pillars of our development strategy that aims at sustained poverty reduction. Given our large dependence on donor support, we require external assistance to build a more resilient and self-sustaining economic structure as well as reinforce our balance of payments position.

We hereby kindly request the approval by the Executive Board of a three- year ECF arrangement in an amount equivalent to SDR 85 million (52.5 percent of Afghanistan's quota). To monitor progress in implementing our reform agenda, the program includes a set of prior actions, quantitative performance criteria, indicative targets, and structural benchmarks, outlined in the attached Memorandum of Economic and Financial Policies (MEFP) and the Technical Memorandum of Understanding (TMU).

The government believes that the policies set forth in the attached MEFP are adequate to achieve the objectives of its program, but it will 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 intend to 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. In addition, the government stands ready to take any further measures that might be required to ensure that the overall objectives of the program are attained.

In line with our commitment to transparency, we hereby request that the staff report, this letter of intent, and the attached MEFP and TMU (including all annexes and attachments), as well as all other ECF-related documents, be published on the IMF website.

Sincerely yours,

/s/

Omar Zakhilwal
Minister of Finance

/s/

Mohibullah Safi
Acting Governor
Da Afghanistan Bank

Attachments:
Memorandum of Economic and Financial Policies
Technical Memorandum of Understanding

ATTACHMENT I. AFGHANISTAN: MEMORANDUM OF ECONOMIC AND FINANCIAL POLICIES

1. This memorandum reviews recent economic developments and summarizes the government's economic objectives and policy framework for 2011–14, for which we are seeking support under a new three-year arrangement with the IMF.

2. **The government of Afghanistan and Da Afghanistan Bank (DAB) have made a number of important achievements under our economic program for 2006–10.** In January 2010, we fulfilled the conditions for reaching the completion point under the Enhanced Heavily Indebted Poor Countries (HIPC) initiative, bringing together four years of important and successful efforts despite an increasingly challenging security situation. We strengthened basic economic institutions, made strong progress in restoring fiscal control and improving public financial management, fostered trade and growth, and managed inflation well. Tax collection, which was relatively weak during the first two years of the program, has improved significantly since early-2009. We also improved the monitoring of the four largest public enterprises, although the problems at Kabul Bank that came to the fore in the fall of 2010 highlighted the costs of weak corporate governance and the need to tackle vulnerabilities and prevent abuse in the financial system.

3. **Looking ahead, much remains to be done.** In particular, we will focus our efforts on safeguarding financial stability, strengthening the banking system, promoting responsible lending for investment and growth, improving the business environment for the private sector, moving decisively toward fiscal sustainability, and improving fiscal planning and expenditure management. We believe this will complement commitments by donors to channel additional support through the budget and allow us to raise spending in line with our development objectives.

I. RECENT DEVELOPMENTS

4. **Growth and inflation.** Economic activity remains robust, with projected real GDP growth of about 6 percent in 2011/12, following a growth of 8 percent in 2010/11. While agriculture has suffered from fluctuations, growth outside agriculture has been strong due to increased security spending and expansion of construction and trade. Inflation has increased again owing to rising international food prices, adverse conditions in neighboring countries, and an accommodative monetary policy. The 12-month rate of inflation peaked at 18 percent in January-April 2011, rising from 2 percent in June 2010. It has since moderated again to 11 percent in August. During the same period, core inflation (which excludes cereals, fats, and transportation) rose from 5 percent to 13 percent.

5. **Fiscal performance.** Fiscal performance in 2010/11 remained strong. The overall fiscal deficit including grants fell from 1.6 percent of GDP in 2009/10 to about balance in 2010/11. The improvement came mainly from a decline in development spending and a tight control over nonsecurity spending, but also from improved domestic revenue collection

which was up by about 1 percent of GDP in 2010/11. Revenues in 2011/12 remain buoyant, with a 25 percent increase in the first half over the same period in 2010/11. We continued implementing pay and grade reforms, and recruited almost 60,000 personnel in the security sector leading to an increase in security spending of 1.5 percent of GDP in 2010/11.

6. **Development spending.** Development spending fell by 1.7 percent of GDP in 2010/11, the third year of consecutive decline. This was a result of the combined effect of earmarked donor funding that could not be reallocated, worsening security that prevented the execution of projects in some regions and capacity constraints at line ministries. Other problems include ambitious multi-year spending plans (with large carry-overs), incentives for the donors and line ministries to "front-load" the budget, difficulties with procurement planning and execution, slow approval processes, and poor contract management. We are addressing these issues through the Public Financial Management Road Map, which was prepared in consultation with IMF staff. In addition, we are working closely with line ministries to enhance their budget execution capacity and we will continue to engage with donors to increase flexibility of funding according to their bilateral and multilateral commitments.

7. **Fiscal reforms.** We have made progress with structural reforms in the fiscal area. First, the Medium and Large Taxpayer Offices now report directly to headquarters in Kabul instead of to the Ministry of Finance's provincial offices, an important measure in our goal to create a national tax administration organized along functional lines. Second, we simplified the chart of accounts to reduce risks associated with the implementation of program budgeting reform. Third, with the implementation of the Afghanistan Financial Management Information System (AFMIS) in Nuristan in 2010, we completed the AFMIS roll-out across the country. This is a significant achievement, which provides timely information on budget expenditures and subjects them to a high degree of fiduciary control. Fourth, the implementation of the Automated System of Customs Data at the Nimroz customs post has begun. A business model for border controls in line with best practice (a critical measure to fight corruption at customs) was introduced in September 2011 at the Hairatan Border Crossing Post. The model envisages the presence of only two ministries at the border (Interior and Finance). Following successful implementation of the pilot, the model will be rolled out to additional border crossing posts by end-March 2012.[1]

8. **Public enterprises.** Financial reviews and business plans by four key public enterprises—Ariana (an airline), Da Afghanistan Breshna Sherkat (DABS, a power utility),

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[1] In addition, we had the largest positive increase in Public Expenditure and Financial Accountability (PEFA) scores of any country with two assessments. We remain committed to increases in budget transparency. Although still low in absolute terms, we had a 160 percent increase in our Open Budget Index score from 8 to 21 percent and have committed to at least 30 percent in the next review.

Afghan Telecom, and The Afghanistan Fuel and Liquid Gas Enterprise (FLGE)—were finalized in 2010. The financial reviews revealed a number of shortcomings, such as a lack of management and financial reporting systems in the companies, over-staffing (Ariana), lack of competitiveness (Ariana, Afghan Telecom, FLGE), collection problems (DABS), and serious corporate governance issues (FLGE). The business and restructuring plans that are now being implemented address these deficiencies.[2]

9. **Financial sector and Kabul Bank**. Over the past four years, the central bank has strengthened its capacity for banking supervision. Still, the rapid growth of the banking sector proved challenging as illustrated by the Kabul Bank crisis that came to the fore in the fall of 2010. In August/September 2010, due to concerns over operation of Kabul Bank, the largest commercial bank, we removed the two major shareholders from management, put the bank into conservatorship and suspended shareholder rights. However, public concern over its stability caused a run on the bank. With one-third of the system's assets of US$4 billion, the run threatened the stability of the whole banking system. In order to prevent further instability we promptly announced that its deposits would be guaranteed. This action contained the run and prevented contagion. Nonetheless, Kabul Bank lost about one-half of its deposits and the central bank had to extend a lender-of-last-resort (LoLR) facility for US$825 million. Subsequently, Kabul Bank was put into receivership, revoking shareholders' rights altogether. Its deposits and good assets were transferred to a bridgebank—New Kabul Bank—which is being prepared for sale. It was established that about US$865 million (principal and interest) in the asset portfolio of the bank are questionable.

10. **Monetary developments.** We responded to the initial run at Kabul Bank in September 2010 with sufficient cash notes to repay depositors. At the same time, by sterilizing the impact of the LoLR loan to Kabul Bank with a fraction of our foreign reserves, we prevented the bank's crisis from destabilizing the exchange rate. The interest rate on 28-day capital notes remained at around 3 percent. However, monetary aggregates grew by more than envisaged, mainly reflecting the increased preference for cash by the public in the aftermath of the Kabul Bank crisis, but also high aid inflows.

11. **External current account**. The external current account balance was favorable, facilitating a further buildup of international reserves to about 7 months of imports. After reaching the HIPC completion point in 2010, we are following up with Paris Club creditors on

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[2] At Ariana, the ministry of finance-appointed implementation team has installed a new chief financial officer, the amendments of the charter of the company is in process, and an advisor was recruited to work on maintenance, safety, and quality assurance. In the past year, DABS has improved revenue collection and introduced a procurement manual and new human resources' procedures. Afghan Telecom has been expanding its capacity. As for FLGE, the company no longer enjoys an effective monopoly on fuel storage.

their debt relief commitments, and carrying out negotiations with other creditors on comparable terms.[3]

12. **Structural reforms.** While there were delays in the implementation of the structural measures agreed under the previous program for implementation by March 2010, all but one of those measures have been implemented (Table 1). The pending benchmark on the protocol for border controls is being carried over to the new program.

II. THE ECONOMIC PROGRAM FOR 2012–14

13. **The program.** Our three-year economic program is a key component of the government's development strategy going forward. It is an integral part of the comprehensive framework for security, development, and governance presented at the Kabul Conference in July 2010 and it establishes the economic parameters for Afghanistan's transition, which is to be agreed at the Bonn Conference in December 2011. Within this broader development agenda, the program aims at consolidating the gains achieved so far and invigorating reforms to foster growth and poverty reduction. To this end, the key objectives of the program will be to: (i) make significant progress toward a stable and sustainable macroeconomic position while managing the challenges of the withdrawal of the international presence in Afghanistan; (ii) strengthen the banking system and address the governance and accountability issues highlighted by the Kabul Bank crisis; (iii) move toward fiscal sustainability; and (iv) improve the transparency and efficiency of public spending and services to protect the poor. We will pursue policies to keep inflation low, improve banking supervision and financial integrity, amend the banking law, and strengthen the framework to deal with financial crime. In addition, we intend to achieve sustained increases in domestic revenues (with proper focus on the extractive industries sector), prioritize public spending and improve expenditure management, and reduce fiscal risks from public enterprises.

14. **Macroeconomic outlook**. Despite an expected decline in overall donor assistance, our goal is to sustain annual real GDP growth at about 6–7 percent over the next three years, supported by an expansion in the nonagricultural sector and mining investment. Cognizant of the negative effects of inflation, particularly on the poor, and in line with our goal to protect vulnerable segments of our population, we will strive to bring inflation down. Sustained donor funding and a stable economy will support the balance of payments. We intend to keep international reserves at around 7 months of imports.

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[3] A 100 percent debt forgiveness agreement with the United States in the amount of US$109 million came into effect in September 2010, and we signed a final debt forgiveness agreement with Germany in the amount of US$17 million in January 2011. Saudi Arabia, Iraq, and Croatia also provided 100 percent debt relief. We are still discussing debt restructuring and relief with Non-Paris Club creditors, namely Bulgaria, Iran, Kuwait and OPEC.

15. **Prioritizing development spending.** In early 2010, we developed the cluster approach to better prioritize the Afghanistan National Development Strategy (ANDS) and improve coordination and implementation.[4] We grouped line ministries in six clusters (security, governance, infrastructure, agriculture and rural development, human resource development and private sector development) that focus on the delivery of selected large-scale national priority programs which, combined, account for over 80 percent of the development budget through 2013/14. We are also taking steps to address bottlenecks in the execution of the development budget. The objective is twofold: for the government to improve the delivery of services; and for donors to align development assistance with our national priorities and channel more resources through the budget. The government believes that improvements in governance will give donors the confidence to increase the proportion of these funds channel through the budget, and we have steadily implemented Kabul conference commitments on governance and corruption and maintain a matrix of achievements.

16. **Poverty reduction.** Our policies are guided by the ANDS and based on low inflation, propoor budgeting, and economic growth. Although it will be necessary to allocate increasing amounts of spending to security, we will also allocate adequate resources to help the poor. To monitor results, we will improve the collection and analysis of poverty indicators. In 2011/12, we will update the ANDS poverty profile using the 2007/08 National Risk and Vulnerability Assessment as a baseline, and integrate the allocation and tracking of propoor outlays into the budget process. Based on the existing poverty profile, propoor operating spending in the 2011/12 budget is programmed to be about Af 16.3 billion (25 percent of nonsecurity operating spending) compared with Af 13.6 billion in 2010/11 (25 percent of nonsecurity operating spending) (indicative target).[5]

A. Monetary and Exchange Rate Policy

17. **Low inflation, an exchange rate regime capable of absorbing shocks to the economy, and effective coordination of monetary and fiscal policies are key ingredients for macroeconomic stability.** To this end, we will continue to promote price stability, strengthen monetary policy operations, and improve coordination between the central bank and the ministry of finance.

18. **Monetary and exchange rate policies**. Monetary policy will aim to lower core inflation to about 4 to 6 percent, while still recognizing that many drivers of inflation are

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[4] The cluster process is not a new strategy for development nor does it substitute the budget process. It is a way to better prioritize activities for the purposes of budget planning, with an emphasis on improving governance, job creation and the delivery of public services.

[5] Separately, we also estimate that around 45 percent of the development budget is propoor spending, but this will not be yet included in the program because of uncertain execution rates.

external and beyond our control. To this end, we will regularly monitor leading indicators of inflation, including monetary aggregates and headline inflation, to steer monetary policy. We will maintain a floating exchange rate system that will allow the rate to reflect market fundamentals, while intervention will aim at smoothing out volatility and achieving our international reserves targets. We remain committed to an independent central bank that sets monetary policy with a view to maintaining low inflation and managing shocks or persistent changes in foreign exchange inflows without overburdening fiscal policy.

19. **Monetary program.** In line with improved operational capacity at the central bank, we switched in 2010 to reserve money targeting. Given our estimate for money demand growth and the recent rise in inflation, we target reserve money growth of 19 percent during 2011/12. We also intend to slow the growth of currency in circulation from 34 percent in 2010/11 to 18 percent in 2011/12.

20. **Foreign exchange risk**. We will adopt measures to reduce the central bank's exposure to foreign exchange risk. Currently, large foreign currency inflows from coalition forces are converted to Afghanis by the central bank. These inflows remain in a dollar account, except for an appropriate working balance in Afghanis. 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. 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.

21. **Monetary operations**. By January 2012, we will restore the averaging of required reserves that was in effect before the introduction of the blocked account system. This will facilitate banks' liquidity management, stabilize interbank rates, and foster the development of the interbank market. We will also increase the stock of the central bank's capital notes to facilitate monetary policy implementation and to enable open market operations. To prevent the capital note market from being dominated by a few participants, we have introduced a percentage ceiling on the amount of capital notes that a successful bidder can obtain.

22. **Ministry of finance and central bank coordination**. The cost of monetary policy over the past few years has negatively affected the equity of the central bank. This has highlighted the need to implement the framework for central bank capitalization in a manner that ensures autonomy of the central bank, safeguards its resources, adheres to international accounting standards and best practices, and is fiscally sustainable. To this end, the ministry of finance and the central bank will reach agreement by December 2011 on the central bank's capital requirements and its calculations, possible amendments to the central bank law, and modalities for addressing the central bank's capital shortfalls or surpluses. Subsequently, the ministry of finance will recapitalize the central bank as required. To strengthen the conduct of monetary policy, facilitate public fiscal cash management, and promote market development we will finalize legislation—with timely IMF assistance—to set up a sukuk

(Sharia compliant treasury bill) market with a view to submit the bill for parliamentary approval by September 2012.

B. Financial Sector

23. **We have designed and started implementing a comprehensive strategy to strengthen the banking system, to lower fiscal costs associated with Kabul Bank's failure, and to address governance issues (Table 3).** This strategy, outlined in the attached action plan, includes resolving Kabul Bank, drawing lessons from its failure, promoting transparency, governance and the framework for protecting the financial system from economic crime, as well as addressing moral hazard, and strengthening banking supervision, and safeguarding a financial system based on integrity and the rule of law.

24. **Resolution of Kabul Bank.** We are proceeding to resolve Kabul Bank to lower fiscal costs and protect the banking system. The bank has been put under receivership and its license has been revoked. Shareholders' rights, including ownership rights, have been extinguished. Moreover, shareholders that have been found not fit and proper according to the banking law and central bank regulations will be banned from future ownership of any bank in Afghanistan. The bad assets of Kabul Bank (along with the US$825 million LoLR liability) remain with the receiver, which, with the help of an asset management specialist, will continue to effectively pursue their recovery domestically and internationally through all available legal, regulatory, and administrative means, in accordance with Afghan law and relevant international treaties. A bridge bank was established by transferring to it Kabul Bank's remaining deposit liabilities of US$633 million, remaining good assets of about US$208 million (consisting of physical assets and the remainder from the first LoLR loan) as well as US$425 million of new financing (funded by a second LoLR loan of that amount extended to Kabul Bank before its receivership). The bridge bank, New Kabul Bank, will be put up for sale by June 2012. The sale will be conducted in a fully transparent manner, and only "fit and proper" qualified applicants will be considered. If the sale does not materialize, the bank will be downsized and merged into other financial institutions or liquidated by March 2013. A share of salary and other payment services will be migrated to other banks to allow government employees a choice of bank starting in 2012. In case privatization fails, the migration would be accelerated in line with the objective of merging or liquidating the bank by March 2013. The receiver and New Kabul Bank will produce monthly reports including management accounts to allow the ministry of finance and the supervisor to monitor their financial performance.

25. **Financing of Kabul Bank's insolvency.** To compensate the central bank for the costs of resolving Kabul Bank, the ministry of finance issued a zero-coupon government bond with net present value of Af 37.6 billion (equivalent to US$825 million), taking over DAB's lender of last resort claim on Kabul Bank. The bond has an 8-year maturity and a quarterly increasing amortization schedule. It will yield a regular flow of payments to the central bank and allow the government to honor this obligation with fiscal resources. The

characteristics of this zero-coupon bond are equivalent to a financial instrument with a two percent yield. The first amortization installment will be paid immediately after the financing has been approved by parliament. In addition, over time, the amounts recovered from Kabul Bank's impaired assets will be paid to the central bank and reduce the outstanding amount of the bond. Request for payment of the first year's installment of US$73 million through the national budget was initially rejected by parliament because parliamentarians wanted to better understand the issue. After a period of engaging with parliament, a bill was resubmitted to parliament for a payment of US$51 million, with the remaining US$22 million having been transferred to the central bank from the receiver out of asset recoveries. The bill was approved by parliament on October 15, 2011, and the government made the payment on October 24, 2011.

26. **Moral hazard.** Governance problems and fraud are the causes of Kabul Bank's failure. The government is investigating and will prosecute any criminal acts related to the bank's failure and will pursue maximum asset recovery using all appropriate legal and regulatory mechanisms. To this end, we have implemented a strategy for prosecution of crimes committed at Kabul Bank and a prosecutorial team has been formed in the Attorney General's Office, equipped with the necessary mandate, expertise and resources. Evidence of wrongdoing at Kabul Bank has been and continues to be referred to law enforcement authorities according to the Afghan law. Lastly, in order to promote stability in the financial sector, in cooperation with development partners, we will prepare by March 2012 a roadmap with a medium-term strategy to build capacity and strengthen the institutional framework to deal promptly and effectively with economic crime.

27. **Asset Recovery.** An audit is expected to be completed by end-March 2012 to establish the financial liabilities of the shareholders and provide the basis maximum asset recovery (below); the auditor has requested some additional time compared to our earlier understandings because the analysis of the group loans is taking longer than expected. We received the interim report for Kabul Bank on September 20, 2011 and shared it subsequently with IMF staff. The interim report for Azizi Bank is expected for November and will also be shared with staff. As criminal investigations into Kabul Bank have commenced, the legal system will be used to facilitate asset recovery domestically and internationally, including through the use of relevant international treaties and mutual legal assistance provisions. To date, asset recovery efforts resulted in US$75 million recovered in cash—including from performing loans, under legally binding agreements with cooperating shareholders and related parties, and outside such agreements—along with physical assets available for sale valued at about US$153 million, and we are working to make further progress on asset recovery in the coming weeks. We have also initiated legal proceedings, including in the field of asset recovery, where appropriate and where shareholders were not cooperating. We have requested training in asset recovery and are tasking an audit firm currently working in Kabul to advise on how to make asset recovery more effective, both domestically and internationally.

28. **Transparency and accountability.** DAB issued a written public statement explaining the events leading to the collapse of Kabul Bank, the action taken, and the envisaged resolution strategy; the statement was posted on DAB's website (http://www.centralbank.gov.af/) in May 2011. In addition, to draw on the lessons from the collapse of Kabul Bank, the ministry of finance and DAB have referred the case to the independent Monitoring and Evaluation Committee (which was set up as part of the Kabul Process) to conduct an in-depth public inquiry. This inquiry will 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. The final report will be published by September 2012.

29. **Identifying vulnerabilities.** We have started audits by internationally reputable audit firms of all banks in the system with a CAMEL (Capital, Asset Quality, Management, Profitability, and Liquidity) rating of 3 or worse, beginning with systemically important banks. The terms of reference for the audits of Kabul Bank and Azizi Bank have been agreed with the IMF. For Kabul Bank, the aim is to document accounting irregularities and possible crimes, such as fraud and money laundering – the results will also serve to support prosecution and asset recovery. For Azizi Bank, the audit is expected to identify potential problem areas and help develop additional corrective measures if needed—ultimately contributing to strengthening banking supervision. We are committed to having the audits finalized by end-March 2012.

30. **Banking supervision.** To improve banking soundness, the central bank is stepping up monitoring of banks and enforcing previous supervisory orders. Our approach to strengthening supervision began with a detailed "lessons learned from Kabul Bank" operational strategy to strengthen supervision. In addition, the central bank established an interdepartmental committee to review compliance with regulations by banks and issued supervisory orders to all banks with weak CAMEL ratings regarding corrective actions previously recommended. The committee is responsible for monitoring enforcement orders and imposing sanctions for noncompliance (e.g., fines, suspension of profit distribution, restriction on bank branching or lending, conservatorship, and bankruptcy), and monitoring enforcement orders and supervisory measures, including on AML/CFT recommendations. We are also working to improve capacity for off-site supervision that has been lagging. We also seek to restore the capacity and effectiveness of the banking supervision department that have been weakened, including because some staff moved to the receiver.

31. **Regulatory framework.** We have reinforced the governance framework for banks. The central bank has published a circular clarifying the criteria that banks' shareholders and managers must meet in order to be "fit and proper." In addition, we have fully enforced a

circular meant to prevent conflict of interests and governance issues that arise when shareholders hold management positions.

32. **Legal framework.** We intend to improve governance in the banking system by strengthening the banking law and encouraging consolidation through higher capital requirements. We will finalize a replacement or amendments to the banking law by end-March 2012 with a view to strengthening provisions on corporate governance, capital, large exposures, related parties, consolidated supervision, early intervention, enforcement, and bank resolution.[6] We will submit the law or the amendments to parliament by September 2012. We have already started reviewing the existing central bank regulation in light of these changes to speed up their implementation once they become law. To strengthen the banking system's capacity to absorb losses and encourage consolidation of small banks, we have doubled the minimum capital requirement to US$20 million and the central bank will request a recapitalization plan for the banks that have not been able to increase their capital to the new ratio by September 2012 while encouraging them to consider merging with another bank. In addition, a moratorium on increasing the number of banking licenses is in place.

33. **AML/CFT**. Cognizant of the threat that corruption, drug trafficking, and the financing of terrorism poses to our financial system and our security, we will strengthen our AML/CFT regime by implementing an action plan based on the recommendations of the February 2011 assessment. To this end we will submit to parliament amendments to our AML/CFT legislation as necessary, strengthen the capacity of the financial intelligence unit (FinTRACA), publish its annual report, implement (by enforcement where there is electricity and security and by encouragement in areas where there is not) the reporting arrangements for money service providers (MSPs) via dedicated software. This year we have strengthened our AML/CFT regime by increasing the intensity of the training FinTRACA gives to financial sector compliance officers, we have completed the registration of roughly 80 percent of the MSPs outside of Helmand and Kandahar, we have encouraged the use of dedicated reporting software for all MSPs, and we have issued terms of references for AML/CFT interagency coordinating bodies (at the working and high level).[7]

[6] Corporate governance and consolidated supervision amendments are intended to address weaknesses that leave the banking sector vulnerable, including risks from mismanagement and bad accounting. Amendments related to the enforcement of supervision orders are being put forward to increase the efficacy of bank supervision and legal implementation, while amendments regarding problem bank resolution are designed to limit the costs to the government and damage to the financial sector in the event of bank failure.

[7] The financial intelligence unit of the central bank will also continue training counterpart institutions in AML/CFT regime implementation, including the filing of suspicious transaction reports.

C. Fiscal Policy and Governance

34. **Going forward, our objectives in the fiscal area are to achieve sustained increases in revenue collection, a gradual takeover of externally-financed operating spending, and an expenditure allocation consistent with ANDS priorities in line with improvements in public expenditure management, fiscal policy formulation, and accountability in public enterprises.** To this end, the program envisages actions to broaden the tax base, deepen tax and customs reforms, strengthen budget processes, program budgeting, and the Medium-Term Fiscal Framework, and increase transparency, governance and efficiency in public enterprises (Table 2).

35. **We will take further steps to move toward fiscal sustainability**. Fiscal sustainability will depend on sustained increases in revenues together with prioritized spending reflecting development and security priorities. The program envisages an increase in domestic revenues of 0.6 percent of GDP in the next three years. Looking beyond the program period, the planned introduction of a VAT in March 2014 is expected to raise an additional 2 percent of GDP, and we are aiming for a revenue-to-GDP ratio of about 16 percent of GDP by 2017/18.

36. **Expenditures.** On the spending side, the baseline scenario projects an increase in the size of security forces (national army and police) from 275,000 in March 2011 to a planned maximum of 400,000 by April 2014. In 2011/12, wages will increase by 1.4 percent of GDP, of which security accounts for 1 percent of GDP.[8] We plan to continue reforms in education, the civil service and other ANDS priorities. Other spending pressures, emanating from the security transition and the gradual takeover of operations and maintenance of capital projects, will lead to an increase of 0.8 percent of GDP in nonsecurity spending as a share of GDP. Development spending is projected to increase by 0.3 percent of GDP. Given the agreement with donors to gradually phase out ARTF grants to the operating budget by US$25 million per year, we will increase the domestic financing of the operating budget accordingly. The large increase in security spending in nominal terms means that the share of operating spending financed by domestic revenues is expected to first increase and then fall in the third year.

37. **Tax administration.** Our goal is to further increase the efficiency and equity of tax collection. To this end, we intend to implement additional measures to strengthen the medium and large taxpayers' offices (MTOs and LTOs) including the consistent application of these offices' selection criteria. In addition, the Standard Integrated Government Tax Administration System was implemented in July in the LTO, allowing for automated collection systems. Lastly, specialized units will be created in the Revenue and Customs departments to use

[8] Security forces will increase by 60,000 in 2011/12

budgets strategically and in a manner consistent with reform plans. These units will report directly to the Directors of Revenue and Customs and will be in charge of budgeting, procurement, personnel planning, and monitoring budget execution.

38. **Customs administration**. In September we started implementing a new business model of border control at the Hairatan customs post in line with best practice. The new model envisages only two agencies at the border (Afghan Customs Department and Afghan Border Police), streamlining the number of agencies involved to improve collections and reduce opportunities for corruption. We will roll out this new business model to two additional border posts March 2012—three if the security situation permits. In addition, we will move forward with post-clearance audits and set up risk management approaches to cargo verification by June 2012. These two reforms will limit interaction between taxpayers and customs officials thus facilitating trade, improving efficiency, and reducing opportunities for corruption.

39. **Tax policy.** We will initiate a major tax policy reform centered on the introduction of a VAT by March 2014, with the aim of broadening the tax base significantly and achieving our long-term goal of raising revenue-to-GDP ratio to levels comparable with similar countries. We will move forward with the VAT legislation by preparing an implementation plan with support by IMF staff, sending a draft law to the Ministry of Justice ("Taqnin") for review by end-December 2011, and submitting the law for parliamentary approval by end-December 2012. Lastly, we will set up an effective and transparent fiscal regime for mining, and seek full compliance with the Extractive Industries Transparencies Initiative (EITI) by September 2012.[9]

40. **Public financial management**. We plan to strengthen our public financial management systems with a view to ensuring that (i) policies reflect social needs; (ii) the budget is used to assign responsibilities for development outcomes, (iii) resources are allocated in an efficient manner; and (iv) officials are accountable and services are delivered with a focus on helping the poor. In this connection, donors signaled their willingness to increase the share of development aid delivered through the budget over the next few years, including through multi-donor trust funds. For our part, we will implement the Public Financial Management Road Map with priority reforms in budget preparation, budget execution, and transparency and accountability.

41. **Budget presentation and execution.** We will improve the capacity and involvement of provincial authorities in budget planning and project implementation, reduce procurement

[9] Afghanistan became an EITI candidate country in February 2010. In addition to the four sign-up criteria that were met to achieve EITI candidate status, the Afghanistan EITI (AEITI) Multi-Stakeholders Group and National Secretariat have been established to run and oversee EITI implementation. Currently AEITI stakeholders are undertaking EITI training and capacity building activities.

delays by ensuring that key line ministries adhere to the revised legal framework, and incorporate financial and nonfinancial performance targets in budget submissions. We will also improve financial planning and reporting, including reports on the financial operations of the general government (extra-budgetary agencies, municipalities, and estimated disbursements by donors through the "external" budget).

42. **Transparency and accountability.** To increase the transparency and accountability of public spending, we will continue to implement Article 61 of the Public Finance Expenditure Management Law. The Internal Audit Department of the Ministry of Finance performed audits on four key line ministries in the past year. We will audit 10 additional line ministries in 2011/12. External audits will be enhanced by strengthening the independence of the Control and Audit Office under a new audit law which was submitted to parliament on May 10, 2011.

43. **Governance.** To improve governance and strengthen anti-corruption measures, we have established an Anti-Corruption Unit in the Attorney General's Office and the Anti-Corruption Court within the Supreme Court, enhancing our ability to investigate and prosecute corruption-related offenses. We also adopted a detailed "strategy and policy for anti-corruption and administrative reform," and have ratified the United Nations Convention against Corruption in August 2008. In July 2008, the President issued a Decree establishing a High Office for Oversight and Anti-Corruption (HOO) as the highest office for the coordination and monitoring of the implementation of Afghanistan's anti-corruption strategy and for the implementation of administrative procedural reform in the country. Despite delays including some beyond government control, an independent Monitoring and Evaluation Committee was inaugurated on May 11, 2011.

44. **Program budgeting.** We will continue the program budgeting reform by creating a simple results framework directly linked to line ministries' performance indicators, as defined in the ministries' budget submissions. This will allow linking public spending to intended results and increasing the efficiency and effectiveness of spending (particularly propoor spending). Furthermore, we have introduced in the 2011/12 budget a common presentation of the operating and development budgets across all budgetary units. Parliamentary appropriations on a program basis will take place in subsequent years after sufficient progress is achieved. During this year, we will also develop and implement a communication strategy to explain this reform to key stakeholders.

45. **Medium-Term Fiscal Framework.** We have been strengthening our medium-term fiscal framework by preparing short- and medium-term policy trade-offs and financing constraints to make it a more effective tool for fiscal policy formulation. Going forward, we plan to (i) improve revenue projections through sensitivity analysis and plausible macroeconomic assumptions; (ii) incorporate line ministries' estimates of future spending; and (iii) improve the analysis of security spending. Ultimately, our objective is to move toward a

medium-term budget framework including projections of spending by line ministries in line with the priorities of a multi-year framework.

46. **Public enterprises.** We are taking steps to strengthen the financial oversight of public enterprises to contain fiscal risks, reduce opportunities for corruption, and foster reforms; and will seek donor assistance to build capacity. We are ensuring the implementation of the restructuring and business plans of the four large public enterprises. Specific actions include finalizing HR reforms at Ariana by June2012, ensuring a continued reduction of subsidies for DABS, and developing a timebound plan by June 2012 for the reform and rationalization of FLGE into a commercial entity—including an asset inventory and audited financial statements—that does not require any subsidies or special treatment, and discontinue its current monopoly and unauthorized collection of fees. Finally, we will strengthen capacity at the Department of State-Owned Enterprises and, by end March 2012, submit to the Ministry of Justice changes to the legal framework governing public enterprises that will bring such entities under ownership and effective control of the Ministry of Finance.

D. Program Modalities and Monitoring

47. **We will continue monitoring our reform agenda through our Technical Coordination Committee (TCC).** The first year of the new three-year economic program to be supported by the ECF arrangement will be monitored through quantitative performance criteria for March and September 2012, indicative targets for December 2011 and June 2012; as well as selected structural benchmarks. The first and second reviews of the program could be completed in May 31, 2012 and November 30, 2012, respectively. The central bank will work with IMF staff to ensure timely completion of the update safeguards assessment and is committed to implementing its recommendations thereafter. Quantitative targets and structural measures are specified in Tables 4–5 and defined as needed in the attached Technical Memorandum of Understanding (TMU).

48. **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.**

Table 1. Islamic Republic of Afghanistan: Structural Benchmarks for the Seventh Review of the ECF Arrangement, December 2009-March 2010

	Target Date	Status as of September 25, 2010
Begin publication of four-month reports and forecasts for financial flows and other key variables for Da Afghanistan Breshna Moassessa/Sherkat (DABM/S).	Dec. 31, 2009	Delayed. Implemented in July 2010. Most data were provided in March 2010 and the remaining data were submitted in July 2010.
Finalize a comprehensive review of the financial situation of Afghan Telecom, ARIANA, DABS, and the Liquid Fuel and Gas Enterprise (FLGE) and their fiscal relations with the government in terms of tax owed, subsidies (if applicable), and other payables or receivables. The review will include regularization of tax payments and other cross debts and reduction of subsidies (if applicable); closure of unauthorized bank accounts; review of corporate governance procedures; business plans; and plans for divestiture, restructuring, of privatization for these enterprises.	Mar. 30, 2010	Partially delayed. Review of all SOEs (except FLGE) was implemented by March 2010. The review of FLGE was completed in October 2010.
Transfer the directorate responsible for monitoring and managing public enterprises in the MOF from the Administration Department to the Finance Department or the Office of the Minister.	Feb. 28, 2010	Delayed. Implemented in April 2010.
Adopt and implement the business model of border controls clarifying the role of each ministry at the border consistent with internationally accepted best practices in consultation with other stakeholders (Ministry of Commerce and Industry and Ministry of the Interior) for better customs controls at the border.	Feb. 28, 2010	Not implemented. The delay is due to difficulties in clarifying the roles of various ministries and ensuring good governance. Measure has been reformulated and included in the program to be supported under the new ECF arrangement.
Implement the Automated System for Customs Data (ASYCUDA) transit module along Zaranj-Nimroz axis and declaration processing module at Nimroz.	Mar. 30, 2010	Delayed. Implemented in June 2010.

Table 2. Islamic Republic of Afghanistan: Fiscal Measures

Measure	Timing
1. Tax Policy	
VAT	
a) Finalize a VAT implementation plan;	End-December 2011
b) Submit VAT legislation to Ministry of Justice's Taqnin;	End-December 2011
c) Submit VAT legislation to Parliament following Cabinet approval;	End- December 2012
d) Begin implementation of VAT.	End-March 2014
Mining	
a) Review the consistency of mining and tax laws;	End-November 2011
b) Develop MoF's capacity for medium-term projections of mining-related revenue;	End-March 2012
c) Ensure a transparent mechanism for licensing, contracting, and collecting taxes, royalties, and fees;	End-March 2012
d) Prepare a medium- to long-term strategy to restructure and corporatize public enterprises in the mining sector.	End-March 2012
2. Tax and Customs Administration	
Resourcing	
Specialized units will be created at ARD and ACD to enhance their capacity to use budgets strategically and consistently with reform plans. These units will report directly to the Director General of Revenue and the Director General of Customs and will be in charge of budgeting, procurement, personnel planning, and monitoring budget execution.	End-March 2012
Implement SIGTAS in the LTO	Completed
Establish pilot of a Border Management Model at Hairatan Border Crossing Point (BCP), based on a 'two-agency' approach which restricts border presence to the Afghan Border Police (ABP) and the Afghan Customs Department (ACD). Under this model, the ABP will continue to fulfill immigration and security responsibilities, with ACD fulfilling all other commercial and trade-related duties.	Completed
Border Management Model to be rolled out to at least two additional Border Crossing Points—three if the security situation permits.	End-March 2012
Improve post-clearance audits by improving the unit resources and introducing risk management.	End-March 2012

Table 2. Islamic Republic of Afghanistan: Fiscal Measures

Measure	Timing
Finalize (End-September 2011) and approve (End-December 2011) the new organizational structure of ACD along best international practices in consultation with IMF staff.	End-December 2011
Introduce risk management to cargo verification.	End-June 2012
3. Budget and Treasury Departments – PFM Roadmap	
Program budgeting	
Prepare a single common program-based budget presentation integrating the operating and development budgets across all budgetary units. For Budget Statement purposes, submit to the Cabinet and Parliament a program-based presentation, along with the traditional line-budget basis presentation until such time as appropriations are done on a program basis (not to happen until, at least, 1392).	Completed
MoF develops and implements a communication strategy consistent with commitments under the PFM roadmap.	Implementation underway.
Conduct a full review before a decision is made to transition to program based appropriations, which is unlikely before the 1392 Budget at the earliest.	End-September 2012
FPU	
Start developing a tax policy capacity at the FPU in line with IMF staff recommendations.	End-December 2011
Enhance the MTFF and other budget documents by:	
a. Analyzing explicitly the medium-term security related operating spending, including various assumptions, to assess the impact on the resource envelope available for non-security spending;	End-December 2011
b. Including robust extractive industry revenue projections;	End-March 2012
c. Updating projections of existing and new major fiscal pressures;	Ongoing
d. Costing fiscal pressures of new reforms.	Ongoing
Budget execution and fiscal reporting	
Enhance AFMIS functionality to meet the requirement for commitment control of all commitments approved by the Special Procurement Committee based on allotments issued.	Completed
Prepare financial plans for the Ministries of Interior and Defense taking into account their procurement plans. Annual allotments with monthly breakdown based on these financial plans will be issued on a pilot basis for operating budget expenditures for the rest of the year. Based on a successful implementation for these two ministries, we intend to extend this pilot to as many ministries as possible during the next fiscal year, 2012/13.	End-November 2011

Table 2. Islamic Republic of Afghanistan: Fiscal Measures (Concluded)

Measure	Timing
Issue 2001 GFSM-based biannual reports on the financial operations of the general government, including extra-budgetary agencies, and estimated disbursements by donors through the External Budget (based on information provided by donors). For municipalities, the reports will be annual. The reports will be quarterly for the centre after a year and remain biannual for the remainder.	TBD
4. Audit	
Internal audit	
The Internal Audit Department of the Ministry of Finance will perform internal audits in accordance with Article 61 of the PFEM law and strengthen the internal audit departments in four line ministries (Ministry of Public Health, MoTCA, MRRD, and Ministry of Energy and Water) by reviewing their institutional arrangements, methodologies, procedures and staff capacity.	Completed
The Internal Audit Department of the Ministry of Finance will perform internal audits in accordance with Article 61 of the PFEM law and strengthen the internal audit departments in an extra ten line ministries.	End-March 2012
The Internal Audit Department of the Ministry of Finance will perform internal audits in accordance with Article 61 of the PFEM law and strengthen the internal audit departments in all remaining line ministries.	End-March 2013
External audit	
Submit to parliament the new audit law.	Completed

Table 3. Islamic Republic of Afghanistan: Banking System Action Plan

Objective	Measures	Target Date
Minimize fiscal costs and protect the banking system	1. Kabul Bank will be placed in receivership and its banking license revoked. All shareholder share ownership and related rights and interests will be extinguished. The receiver will split assets and liabilities into a good bank and the remaining Kabul Bank estate. The good assets, the legitimate deposits, the DAB current account liability, and the salary payments services will be transferred to a bridge bank, aka the good bank, which will be a newly incorporated entity with a new banking license.	Done in April 2011
	2. The central bank will issue a banking license for the bridge bank and its shares will be temporarily owned by the Ministry of Finance. The FDRC will approve an asset/liability split from the balance sheet of the receivership, which will include the transfer of a current account position with the central bank held by the former Kabul Bank and the assumption of its legitimate deposit liabilities. This current account balance will include the proceeds of a lender-of-last-resort facility agreed upon by the conservator prior to the decision of receivership.	Done in April 2011
	3. Enforce the regularization and repayments of Kabul Bank loans extended to shareholders and major borrowers via legally binding agreements for the full amounts attributed to them as of date. Agreements should identify collaterals, including real estate title deeds or physical assets – and cash repayments. Agreements will not preclude collection of additional debt, should such debt be identified during subsequent audits, nor will they preclude prosecution in case of violation of the Afghan law. Registration and perfection of security interests in all identified collateral will occur within a reasonable period from the date of the agreements. Those failing to comply with the attributed amounts will be pursued through the legal system.	See Table 5.
	4. Finalize an 18-month fully-funded business plan for the bridge bank, focused on its rapid downsizing. The plan, together with related official documentation, will contain the following elements: (i) preparation for sale within 5 months and, if the sale fails, a provision that the bank will be liquidated no later than September 2012; (ii) quarterly budgets; (iii) strict limits on operations with no new lending; (iv) semi-annual targets for the reduction of staff and branches and shedding of business products, including credit card business to reduce costs and the systemic importance of the bank; (v) migration of Kabul Bank's salary payments activities to other banks capable of performing the service, beginning with the allocation of some salary payments contracts to other banks in an open bidding to be conducted as soon as possible. Request for proposals for the bidding will be aligned with sound practice to ensure that banks that are not sufficiently qualified to perform the service will not be included; (vi) to ensure legitimate remaining deposits will be honored, deposits affiliated with shareholders and related interests will be excluded and deposits larger than $500,000 will be reviewed; (vii) prepare monthly activity reports including management accounts; and (viii) impose service charges and reduce interest rates on deposits effective May 1, 2011. The plan will also mention a commitment to have the bank audited on an annual basis by an external audit firm.	Done in April 2011

Table 3. Islamic Republic of Afghanistan: Banking System Action Plan

Objective	Measures	Target Date
	5. The authorities will publicly announce the government's overall strategy to enforce the laws of Afghanistan with respect to ensuring accountability for economic crimes, including any crimes found to have been committed at Kabul Bank or associated with the Kabul Bank crisis that are prosecuted by the authorities. Among other things, the strategy will outline key steps to be taken and establish a timeframe for these steps. The Government will include reference to the approach and timeline that will be taken by this team in the public statement issued by DAB. Any crimes committed at Kabul Bank or associated with the Kabul Bank crisis that are prosecuted by the authorities, will be handled by a prosecution task force/team within the Anti Corruption Unit of the AGO appointed by the attorney general. The team will operate according to its defined work procedures and timelines, and shall have the roles, powers and independence given to its office under the relevant Afghan law; documentation describing this shall be provided to the IMF. The team will be supported by members who possess knowledge and expertise on financial issues.	Pending (prior action)
	6. The receivership management team, supported by an asset management specialist, will work on the recovery of the receivership's assets and other assets collected from shareholders and non-performing loans with the primary purpose of realizing maximum recoverable value for claimants. All related parties' loans even if restructured or collateralized will be included in the assets to be recovered by the asset management team. The receiver will produce monthly activity reports, including management accounts, and be audited on an annual basis by an external audit firm.	Ongoing
	7. The authorities will pursue through mutual legal assistance the possibility of identifying, freezing, seizing and confiscating laundered property and proceeds used or intended for use in money laundering and other offenses related to Kabul Bank. The authorities will seek advice from the audit firm on the format of the requests.	Ongoing
	8. A legally binding agreement between the Ministry of Finance and the central bank will be executed to capitalize the central bank for the amount of the lender of last resort (LOLR) loans needed to finance Kabul Bank resolution. Under the agreement, the Ministry of Finance will issue a debt instrument to the central bank with net present value of 37.6 billion Afghani, equivalent to $825 million, with an eight year maturity and quarterly payments totaling 3.4 billion Afghani in the first year ($73 million), which will increase over time as required to fulfill the commitment. Annual payments will be explicitly recorded in the budget and the medium-term fiscal framework, beginning with an approved attachment to the 2011/12 budget, to be passed during the current fiscal year. The agreement will specify that its purpose is to fund the deposit guarantee extended to Kabul Bank depositors, explain the exceptional nature of such support, and commit the Ministry of Finance to make amortization payments to the central bank as required in the future.	Done in October 2011

Table 3. Islamic Republic of Afghanistan: Banking System Action Plan

Objective	Measures	Target Date
	9. Final resolution.	
	i. The bridge 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, it will give them a deadline for sealed bids.	End-June 2012
	ii. If there is no interest from a suitable buyer or the sale fails, salary and other payment services will migrate to other banks as a part of branch closings and deposit migrations. Unwanted branches will be offered at negative prices or be closed. By end-March 2013, all remaining deposits will be transferred to other banks and the bridge banks' license will be revoked.	July 2012 to End-March 2013
	10. In consultations with Fund staff, the Ministry of Finance and the central bank shall agree on the interpretation to be accorded to the framework for central bank's capital requirements and on the possible amendments to the central bank law in this regard, in a manner that ensures the financial autonomy of the central bank in conducting monetary policy, safeguards central bank's resources (including the use international reserves and the provision of the lender of last resort facility), adheres to international accounting standards and best practices, and is fiscally sustainable. The Ministry of Finance and the central bank shall sign a memorandum of understanding that will, accordingly, spell out the modalities of and procedures for the ministry's interventions in addressing potential central bank's capital shortfalls. Subsequently, the Ministry of Finance will recapitalize the central bank as required.	End-December 2011
Promote transparency, reduce moral hazard, and address banking system vulnerabilities	11. Issue a detailed public statement describing (i) key events leading to the run at Kabul Bank; (ii) actions taken and to be taken to protect depositors and the financial system; (iii) the condition of the bank; (iv) actions taken and to be taken to address suspicions or evidence of fraud, misreporting, money laundering, and corruption; (v) the envisaged resolution strategy, and (vi) the way in which the insolvency will be funded (including the responsibility of the Ministry of Finance and the intention to pay with government revenue) and efforts to recover the bank's assets.	Done in April 2011

Table 3. Islamic Republic of Afghanistan: Banking System Action Plan

Objective	Measures	Target Date
	12. Initiate an audit of Kabul Bank and Azizi Bank to be carried out by a reputable international audit firm. The work will focus on investigations aimed at determining the presence of accounting or other irregularities, as well as compliance with prudential and other regulations and laws. In relation to ECF conditionality, the firm chosen to conduct the audit (the "Auditor") and the terms of reference will be agreed with IMF staff and all communications and reports including management letters will be shared promptly with IMF staff. The Auditor will have unrestricted access to the banks, their records, their shareholders, management, and staff. The Auditor will also be authorized to communicate with third parties to gather information on matters related to the audit and the central bank will authorize the Auditor to communicate with IMF staff. The Auditor will issue interim reports within 30 days of commencing work. The audits will include, but not be restricted to, an assessment of (i) the banks' management; (ii) the quality of the banks' assets, (iii) the completeness of liabilities, including off-balance sheet commitments; (iv) liquidity position and use of the lender of last resort facility from the central bank (if any); (v) the accuracy of reports and information submitted to the central bank since 2005; (vi) compliance with prudential regulations; and (vii) any illegal activity, including, but not exclusive to, related party lending, fraud and compliance with AML/CFT law and regulations.	Done in August 2011
	13. Audit company issues inception reports.	Done in September 2011
	14. An independent in-depth public inquiry into the Kabul Bank crisis will be launched, with terms of reference to be agreed with IMF staff. The inquiry will cover the period from the licensing of Kabul Bank to February 2012 and will focus on the appropriateness, effectiveness, and timeliness of the response of the government, the central bank, and the justice system for the purposes of safeguarding the financial sector, deal with governance issues, and implement Afghan law. The independence of the body conducting the inquiry will be described and guaranteed in the terms of reference, and the budget for the inquiry, including salaries, should be independently administered. The body conducting the inquiry will have the right to determine its own agenda and the powers to enquire under Afghan law. The goal is to increase awareness, transparency and draw lessons that could be used to protect the financial sector and prevent similar events in the future.	End-September 2012
	15. In line with the authorities' 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.	End-March 2012

Table 3. Islamic Republic of Afghanistan: Banking System Action Plan

Objective	Measures	Target Date
	16. Reputable international firm/s will initiate financial audits of 10 additional banks.	End-October 2011
	17. Audit reports are finalized and issued.	End-March 2012
	18. The report of the public inquiry will be published.	End-September 2012
Strengthen banking supervision	19. Drawing on the February 2010 on-site inspection of Kabul Bank and on the experience of central bank staff involved in Kabul Bank's conservatorship, the central bank will prepare an operational note, including a summary of lessons learned and a checklist of key procedures for use during future on-site inspections of banks.	Done in December 2010
	20. The central bank's enforcement committee will	
	i. review all banks' compliance with previous enforcement measures and issue supervisory orders with timetables for compliance and sanctions for failure to comply with the key corrective actions previously recommended;	Done in September 2011
	ii. after that, the committee will review on a monthly basis progress with compliance and impose sanctions in line with the Enforcement Regulation (e.g., fines, suspension of profit distribution, restriction on bank branching or lending, conservatorship, and bankruptcy).	Ongoing
	21. The central bank will enforce in full banking regulations and circulars by	
	i. removing shareholders from serving as Chairman and CEO of the bank they own;	Done in October 2011
	ii. continuing the evaluation of the qualifications of shareholders and management and removing those who are not "fit and proper" as they become apparent.	Ongoing
	22. The central bank will issue an enforcement letter to Azizi Bank based on an ongoing on-site examination with a strict timetable and enforcement actions for non compliance. The actions will include i) specific capitalization requirement; ii) budget and business plan requirements for improvement in profitability; and iii) detailed plan for reduction of overlimit business lines.	Done in August 2011
	23. As part of off-site supervision, the central bank will compile quarterly reports based on the data submissions from banks, including Financial Stability Indicators, including banks' prudential ratios, capital adequacy ratio, liquidity ratio, concentration ratio, related loan ratio, and other relevant information statistics, such as loan and deposit amounts for largest borrowers and depositors for each bank.	Throughout, beginning June 2011

Table 3. Islamic Republic of Afghanistan: Banking System Action Plan (Concluded)

Objective	Measures	Target Date
	24. The central bank will review the existing Enforcement Regulation in light of amendments to the Banking Law as submitted to Parliament (supervisory warnings, orders, plans to take corrective action, and orders to take prompt corrective action by commercial banks). The central bank will prepare revisions of the Enforcement Regulation so as to be ready for implementation of the revised Banking Law when enacted.	End-April 2012
Improve legal and regulatory framework	25. 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 the authorities 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 FATF standards).	End-September 2012
Accounting standards, insolvency and creditors' rights, AML/CFT	26. Implement plan to address bulk cash movement at Kabul airport (all passengers including VIP to complete serialized inbound/outbound currency declaration forms and space for the central bank to process forms and conduct identifications and checks) with a view to deterring transfers of proceeds of crime and fraud.	End-December 2012
	27. Request an insolvency and creditor rights assessment (ICR ROSC) from the World Bank to identify remaining weaknesses and design action plan to resolve them, including legislative proposals for foreclosure of collateral and loan recovery.	End-June 2012
	28. Following IMF assessment of the AML/CFT regime in 2011 and presentation to and adoption by the Asia Pacific Group, the central bank will devise and begin implementing an action plan with a timeframe (involving relevant authorities), to address the findings and recommendations of the assessment.	End-September 2012
	29. The central bank will prepare and distribute guidance and training materials to financial institutions along with a schedule of on-site training for 2011/2012, with a view to ensuring that key money laundering and terrorist finance risk and lessons learned from Kabul Bank are properly reflected in those materials.	End-March 2012
	30. Establish a government-led National Steering Committee (NSC) to coordinate, supervise and direct financial reporting and auditing reforms. The NSC will develop an action plan (including short, medium and long-term measures) to develop accounting and auditing capacity in Afghanistan in line with the recommendations of the 2009 ROSC.	End-May 2012

Table 4. Islamic Republic of Afghanistan: Quantitative Targets, 2011-13 1/
(on a cumulative basis from the beginning of the respective fiscal year, unless otherwise indicated)

		FY 2011/12				FY 2012/13			
	Mar. 20, 2011 Stocks	June 21, 2011 Actual	Sep. 22, 2011 Actual	Dec. 21, 2011 Indicative targets	Mar. 19, 2012 Performance criteria	June 20, 2012 Indicative targets	Sep. 21, 2012 Performance criteria	Dec. 20, 2012 Projection	Mar. 20, 2013 Projection
					(In billions of Afghanis)				
Floor on revenues of the central government	…	22.2	46.7	71.6	98.8	23.8	50.4	78.2	109.0
Indicative target (ceiling) on currency in circulation	132.4	1.3	11.3	16.6	23.6	1.5	12.7	18.3	26.2
Ceiling on net central bank credit to the central government	-48.9	29.3	25.0	17.8	24.8	-9.5	-4.4	-11.2	1.9
Indicative target (ceiling) on the operating budget deficit of the government, excluding grants	…	0.5	12.0	33.8	52.6	10.1	29.2	44.7	71.3
Indicative target (floor) on social and other priority spending	…	4.5	9.0	13.5	18.0	4.8	9.7	14.5	19.4
Ceiling on reserve money	151.0	15.4	16.7	15.0	28.4	-4.0	6.5	15.7	30.6
					(In millions of U.S. dollars)				
Floor on net international reserves of DAB	5,017	450	514	572	630	117	234	351	468
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
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
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
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	0.0	0.0
Memorandum items:					(In billions of Afghanis)				
Operating budget balance of the government, including grants	…	17.1	19.3	18.4	13.4	5.1	4.8	9.8	3.6
Reference projections for the adjustors									
Core budget development spending	…	5.3	16.7	33.5	53.4	4.2	23.9	41.7	64.1
External financing of the core budget and sale or transfers of nonfinancial assets	…	21.1	43.6	85.4	115.3	22.8	55.7	94.7	129.8
Asset recovery from banking sector institutions in liquidation	…	0.0	0.9	1.8	3.5	0.9	1.9	2.8	3.7
Recapitalization, 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 5. Islamic Republic of Afghanistan: Prior Actions and Structural Benchmarks

Prior Actions	Status
Kabul Bank will be put under receivership and its banking license revoked. All shareholder ownership and related rights and interests will be extinguished. The receiver will split assets and liabilities into a good bank (bridge bank) and the remaining Kabul Bank estate.	Done in April 2011
Finalize an 18-month business plan for the bridge bank.	Done in April 2011
Issue detailed public statement about the events leading to the collapse of Kabul Bank and the actions taken and to be taken to deal with the crisis.	Done in April 2011
Finalize legally binding agreements with cooperating Kabul Bank shareholders for the repayment of the full amounts attributed to them as of date. Agreements should identify collaterals, including real estate title deeds or physical assets—and cash repayments.	As of October 30th, we estimate the assets sought for recovery at US$935 million, including US$80 million in regular loans to parties other than the shareholders and related parties. Legally binding agreements for US$270 million have been signed so far with cooperating shareholders and related parties, pledging collateral of US$232 million. Under these legally binding agreements, US$36 million in cash has been collected. In addition, US$153 million in ceded assets are available for sale by the receiver. Including the regular loans, payment plans and ceded assets indicate a recovery of US$483 million is possible—US$350 million from legally binding agreements and performing loans plus assets ceded to the receiver not covered by the legally binding agreements. Of this, total cash receipts since August 31, 2010 amount to US$75 million taking together payments under the legally binding agreements, payments made outside an agreement framework and from the performing loans. The Government acknowledges that complexity of the fraud has slowed recovery effort; however, based on improved cooperation by bank executives and the work of the forensic auditors, it is confident that legally binding agreements for additional recoveries will be reached. In parallel, formal charges have been brought against 2 shareholders representing over 50 percent of assets sought for recovery and 7 officers of the bank. Negotiations over additional legally binding agreements are ongoing.

Ministry of Finance to issue 8-year bond to capitalize the central bank to cover the cost of Kabul Bank's resolution ($825 million) and obtain parliamentary approval for a budget appropriation to service the bond.	Done. An US$825 million promissory note was issued on April 10, 2011, and Parliament approved the budget appropriation for FY2011/12 on October 15, 2011.
Formulate and announce strategy to enforce Afghan laws in relation to any financial crimes committed at Kabul Bank. The strategy will include steps and a timetable as well as documentation on the roles, powers, qualifications, and independence of the prosecution team.	Authorities have shared draft strategy with staff.
Complete inception report for audits of Kabul Bank and Azizi Bank.	Done. Report for Kabul Bank completed in July 2011, for Azizi Bank—in September 2011.
The central bank will issue an enforcement letter for Azizi Bank (in consultation with Fund staff) based on a recent on-site examination listing key actions to be undertaken, a timetable, and penalties and sanctions for non-compliance.	Done in August 2011.
The central bank will issue supervisory orders to selected banks with timetables for compliance and sanctions for failure to comply with key corrective actions previously recommended.	Done in September 2011.
The central bank will enforce in full conflict-of-interest regulations and circulars in the banking sector by removing shareholders from serving as Chairman and CEO of the bank they own.	Done as of October 31, 2011.

Structural Benchmarks for the First Review	Rationale	Status/Comments
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
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
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

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
Reduce number of branches at bridge bank (New Kabul Bank) by 20 according to the updated business plan.	Minimize fiscal costs	End-March 2012
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

Structural Benchmarks for the Second Review	**Rationale**	**Status/Comments**
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, it will give them a deadline for sealed bids.	Advance Kabul Bank resolution	End-June 2012
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.	Strengthen financial sector stability, transparency	End-September 2012

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 FATF standards).	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
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..	Promote financial sector stability and integrity and strengthen AML/CFT framework	End-September 2012
Submit legislation to Parliament for the introduction of marketable debt instruments by the Ministry of Finance.	Develop financial markets	End-September 2012

ATTACHMENT II. 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 2011–12. 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 March and September 2012 specified in Table 4 of the MEFP 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 December 2011 and June 2012.** 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, 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. **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. These deposits exclude deposits held at the DAB's branches because of the unavailability of reliable and timely data from the DAB's branches.

9. **Net international reserves** (NIR) 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.

10. **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, such as privatization, and transactions in financial assets and liabilities, such as borrowing but excepting interest payments, are also excluded from the definition of revenue.

- 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.

11. **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.

12. For program purposes, the definition of **external debt** is set out in Executive Board Decision No. 12274, 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 12 (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.

13. **Long term and medium term external debt.** A ceiling applies 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 16.

- 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.[1] 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).

14. 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 13 of this memorandum), with an original maturity of up to and including one year.

- It applies to debt as defined in paragraph 12 of this memorandum.

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

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[1] 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.

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

15. 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, 2011 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, 2011 and (ii) external arrears that are subject to debt rescheduling agreements or negotiations.

16. **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 13 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).

17. **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

18. 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 March 20, 2011, to:

December 21, 2011	Af 33.5 billion
March 19, 2012	Af 53.4 billion
June 20, 2012	Af 4.2 billion
September 21, 2012	Af 23.9 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.

19. 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 or transfer of nonfinancial assets** will amount, on a cumulative basis from March 20, 2011, to:

December 21, 2011	Af 85.4 billion
March 19, 2012	Af 115.3 billion
June 20, 2012	Af 22.8 billion
September 21, 2012	Af 55.7 billion

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

20. The NIR floor and NCG ceiling are defined consistent with the assumption that the **asset recovery** from banking sector institutions in liquidation applied towards MoF assets or liabilities at DAB will amount, on a cumulative basis from March 20, 2011, to:

December 21, 2011	Af 1.8 billion
March 19, 2012	Af 3.5 billion
June 20, 2012	Af 0.9 billion
September 21, 2012	Af 1.9 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.

21. Should **DAB be recapitalized by the MoF**, the NCG ceiling will be adjusted upward by the amount of this recapitalization.

22. Should **MoF receive profit distribution from DAB**, the NCG ceiling will be adjusted downward by the amount of this profit distribution.

23. 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 $300 million.

IV. PROVISION OF INFORMATION TO THE FUND

24. 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.

25. 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. 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 (object) and administrative classification in addition to the program and functional classification as reported in the budget documents. Core development expenditures should also be reported separately on a monthly basis using the budget program classification in addition to the economic (object), administrative and functional classification consistent with the operating budget. All the data should also compare outturns against the approved budget. 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 eight weeks after the end of the year. Merchandise trade data should be reported quarterly and no later than eight weeks after the end of the quarter.

- 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 and other relevant information.

- 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; (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 16.

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

- Monthly progress reports, interim reports, and final reports by the auditor conducting the forensic audits of Kabul Bank and Azizi Bank.

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

- Quarterly, details on the amortization payments for the promissory note issued by the Ministry of Finance to recapitalize the central bank.

- Monthly details of the discretionary cash balances held in the Ministry's Afghani and U.S. dollar treasury single accounts (TSA), 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.

26. 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.

APPENDIX II. ESTIMATING THE IMPACT OF MILITARY TRANSITION AND TRANSFORMATION

Economic development over the medium term will depend on the impact of the envisaged draw-down of large-scale foreign military (transition) and civilian engagement with Afghanistan (transformation), beginning in 2012 and expected to be largely finalized by 2014.[1] *The baseline scenario for macroeconomic projections optimistically assumes that security will stabilize throughout the phase of the military withdrawal, and that civilian foreign assistance will be phased out gradually over the long term.*[2] *Alternative scenarios explore possible outcomes if these optimistic assumptions, while clearly desirable, are not met.*

Framework for transition and transformation

1. **The impact of foreign withdrawal from Afghanistan will reverse the economic effects of large-scale military and civilian foreign presence over the past decade.** The presence added to aggregate demand; provided budget resources and took over directly certain spending; supported the exchange rate and, potentially lowered competitiveness; provided civilian employment; and the affected sector-specific allocation of resources. The economics of withdrawal of foreign entities are determined in good measure by the local content of their expenditure and procurement and their employment of local staff.

2. **The reduction in foreign presence affects the Afghan economy through the following transmission channels:**[3]

- *Income effects* would come from lower aggregate demand are a function of lower local expenditure of foreign civilian organizations and staff; the associated decline in local procurement; and lower numbers of local employees of foreign civilian organizations.

- The *fiscal impact* will mainly result from higher on-budget security spending from the transfer of Afghan National Security Forces (ANSF) expenditures to the operating budget under the Law and Order Trust Fund Afghanistan (LOTFA) and the NATO

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[1] Following authorization by UN Security Council Resolution 1386 on December 20th, 2001, the International Security Assistance Force (ISAF) has been operating in Afghanistan for almost 10 years.

[2] According to the "Declaration by the Heads of State and Government of the Nations contributing to the UN-mandated NATO-led International ISAF at the 2010 Lisbon Summit, "ISAF and the Government of Afghanistan are entering into a new phase of our joint effort, which allows us to help set the conditions for irreversible transition to full Afghan security responsibility and leadership … by the end of 2014."

[3] Due to data constraints, the analysis does not take into account possible macroeconomic effects of more limited technical assistance on capacity building in public administration and the associated path for structural reforms.

Training Mission - Afghanistan (NTM-A), higher on-budget operations and maintenance spending, and lower revenues reflecting the adverse impact on growth. With external development spending being reduced, there will be increasing pressure to finance development spending through the budget. In addition, expenditure for operations, equipment, and maintenance are likely to be substantially higher as projects are brought on budget as part of the transformation.

- The *external sector* will be affected by a possible reduction or reversal of the terms-of-trade effects of foreign presence "Dutch disease;" and trade balance effects resulting from lower imports by foreign civilian missions.

- *Labor market* effects could include higher unemployment, due to lay-offs of local staff by foreign civilian organizations; lower employment in sectors closely linked to the presence of foreign entities; and, as a result, downward pressure on local wages.

Baseline Scenario

3. **Real GDP growth declines over the long term and stabilizes at around 4 percent per annum, periodically peaking as a result of the mining sector production cycle (Figure 1).** The expected withdrawal of foreign troops would contribute 2–3 percentage points to the decline in overall growth. The baseline scenario assumes that foreign military presence will be reduced from currently 139,000 troops to 68,000 by October 2012, and a minimal presence by 2014. In parallel, the ANSF will grow from about 304,000 at present[4] to 400,000 by end-2014 under current government projections.[5] In 2011, total appropriation by ISAF is estimated at US$160 billion, out of which the United States accounts for US$118 billion. With an assumed local content of this ISAF expenditure of 1.7 percent, the withdrawal would reduce GDP by 2½ percent per year over the period 2012–14. Sectors most likely to be affected include construction, wholesale and retail trade, and transport and storage**.**

4. **The withdrawal raises fiscal pressures and pushes back fiscal sustainability—defined as domestic revenues covering total operating expenditures—to 2024/25.** The fiscal impact of transition and transformation will mainly come from increasing pressure to take over externally-financed operating expenditures (security and nonsecurity); decreasing grants to the development budget; and a continuing decline in the external budget with certain expenditures being brought on-budget. As the fragility of the country's economy is likely to be most acute during this phase, the baseline scenario (Table 2) assumes a stable

[4] As of mid-October, 2011: consisting of 169,000 members of Afghanistan National Army, and 135,000 members of Afghanistan National Police and the Afghan Air Force. (Source: NTM-A)

[5] However, the Joint Coordination and Monitoring Board recently capped the final force size to 352,000. This number is under discussion with the government.

donor presence over the period of the program. However, by 2020, a reduction in donor grants to the budget by about 50 percent (to 27 percent of central government expenditure) is envisaged. Shifts in budgetary allocations to national security could have negative implications for social indicators, due to more limited poverty reduction-related expenditure.

5. **An improvement in basic security could generate a "peace dividend" for economic activity.** With improved security, activity across sectors should benefit, foreign direct investment (including in telecommunications) could increase, and there is a possibility that tourism picks up. Moreover, a "brain gain" for the local economy (both private and public sectors) could result from the reversal of the "brain drain" seen over the past decade. These domestic factors could be complemented by external developments, despite the decline in exports to nonresidents entailed by transition and transformation. Over the longer term, exports could get a boost from enhancing regional trade, including through the development of regional transportation links. Government imports will continue to be aligned with import-related fiscal expenditures, reflecting the decline in these aggregates.

Alternative Scenarios

6. **Two alternative scenarios illustrate the sensitivity of the baseline scenario to its main assumptions.** The sequential transition and transformation periods represent two phases in Afghanistan's future economic development that can be shocked. The first alternative scenario examines the sensitivity of the framework to a lower growth outlook, with the negative impact of transition/transformation on growth being larger than assumed in the baseline. The second alternative scenario evaluates the economy's prospects under more rapid donor grant withdrawal than during the transformation phase.

7. **In a "lower growth" scenario, transition and transformation could have a more negative effect on growth than assumed in the baseline.** Given the limited information on local content and multipliers, there is considerable uncertainty about the impact of transition and transformation on growth. The "lower growth" scenario traces the macroeconomic effects of transition and transformation, reducing growth by an additional 4–5 percentage points compared to the baseline. This would lead to lower fiscal revenues which would reduce the government's resource envelope, putting crucial security and development spending at risk, potentially leading to further adverse growth effects. In response to this, donors are assumed to increase grants to the development budget in subsequent years.

8. **In a "faster donor withdrawal" scenario, a swifter donor exit in the transformation period compromises development spending and ultimately growth.** In this case, grants to the external and development budgets decrease at a faster rate than in the baseline, while the handover of security expenditures remains the same. The assumption is that donors maintain the funding of national security forces while divesting resources in the broader economy. Part of this process of withdrawal involves moving large operations and maintenance expenditures onto the budget. This leads to rapidly rising fiscal deficits,

reflecting spiraling expenditures and lagging revenue efforts due to a loss of donor support for vital reforms. Pressures will mount rapidly as the government will be forced to choose between its security and various development priorities.

9. **In both alternative scenarios, the government can create some fiscal space through borrowing, but this is unlikely to provide a full offset.** Once the government has introduced domestic securities (*sukuks*), it can tap the domestic banks for financing, though the cumulative scope is limited even under a regime of financial repression. Access to external borrowing is also likely to be limited, though it is not constrained for the sake of exposition in the alternative scenarios. As the debt sustainability analysis shows, Afghanistan is at high risk of debt distress, and should restrict any borrowing to highly concessional financing for specific projects with a clearly identified economic return.[6] There will also be risks to the monetary outlook should pressure be applied to the central bank to monetize government deficit ("fiscal dominance").

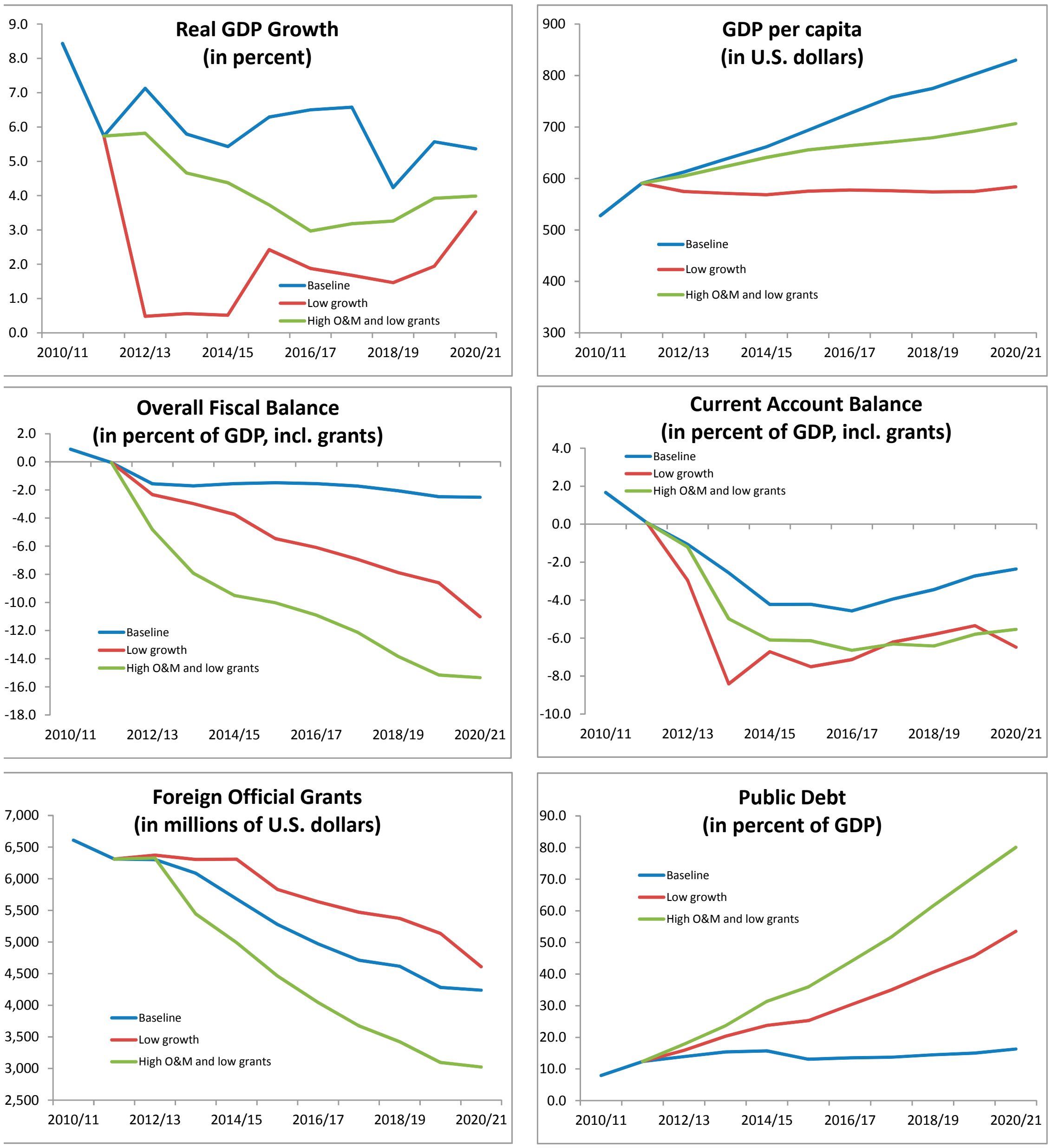
10. **Lastly, a scenario in which security deteriorates rapidly could have devastating economic consequences, but this is not modeled here.** A destabilization in security represents the worst possible equilibrium for Afghanistan. Adequate and effective levels of security spending are a necessary condition for maintaining stability and potentially generating improvements which would spillover to economic development.

An Upside Scenario: "Transition Dividend"

11. **Donors can provide additional stimulus to the Afghan economy by moving support on budget.** Donors could transfer part of the funds spent on maintaining their contributions to the ISAF military architecture to development within Afghanistan. A number of donors are also considering channeling a larger share of their support through the budget even as the overall grant envelope declines. Taken together, a "transition dividend" could be generated leading to higher growth. According to case studies, the local content of donor spending is in the range of 20–25 percent, while the local content of on-budget development spending is 30–35 percent. Thus, by moving a share of the external budget (both security and development)—currently about 30 percent of GDP—on budget, donors would provide an extra stimulus to the local economy. For example, shifting 5 percent of GDP in grants on budget would boost GDP growth by ½ of a percentage point or more, depending on the size of the multiplier. Such a shift may imply a somewhat lower quality of the built capital stock. At the same time, operating and maintaining a more indigenous capital stock would be more affordable in light of the government's limited resources.

[6] In all scenarios, the interest rate on domestic borrowing is held constant at 5 percent throughout whole period.

Figure 1. Afghanistan: Alternative Growth Scenarios



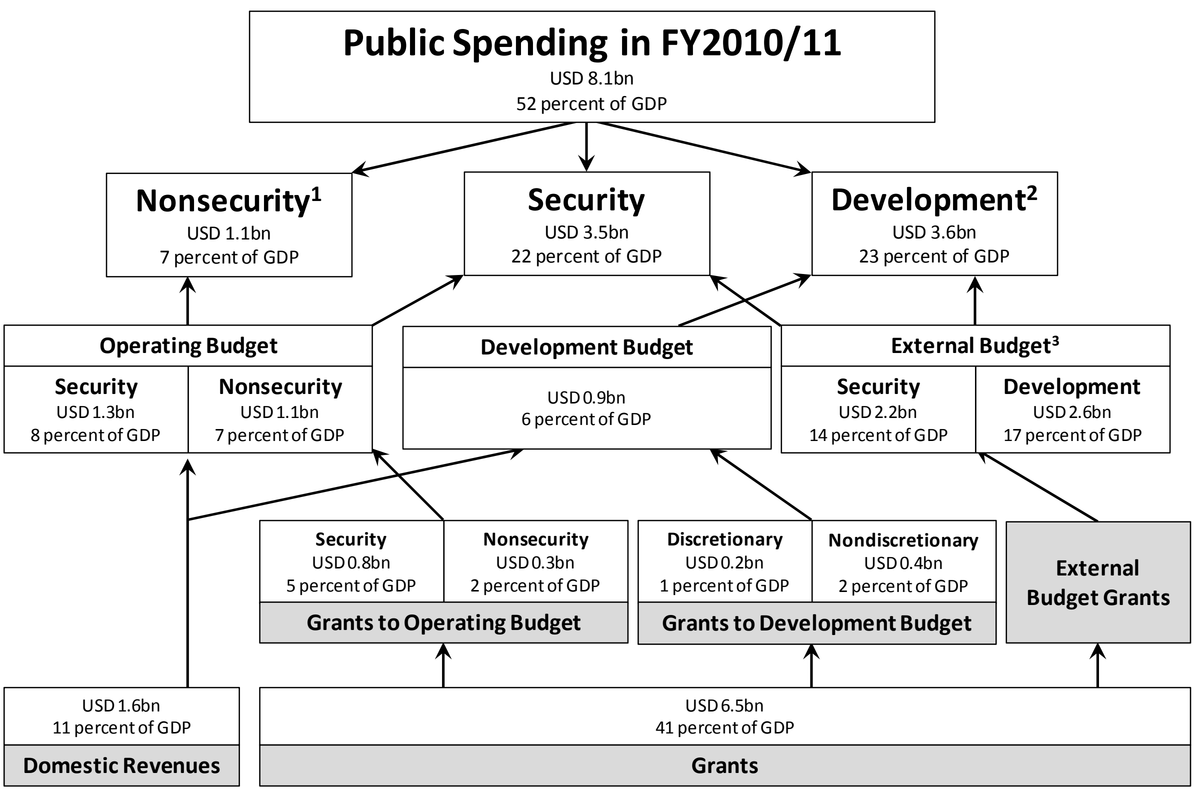
Source: IMF staff simulations

APPENDIX III. FISCAL SURVIVAL AND FISCAL SUSTAINABILITY

This annex discusses alternative fiscal scenarios as the government takes over donor financed activities and certain recurrent costs of donor financed investments. In the near term, fiscal survival is likely to become the key operating principle as the government takes over spending currently financed by donors and balances this with development spending needs while exploring options of how to generate additional fiscal space. Indeed, the need to take over donor-financed spending is likely to push back fiscal sustainability—defined as domestic revenues covering total operating expenditures—to 2024/25.

1. **Afghanistan remains heavily reliant on donor grants within multiple budget streams (Figure 1).** As of 2010/11, the central government's operating budget is 49 percent grant-financed, and the development budget is 59 percent grant-financed. This is in addition to a large donor-funded external budget estimated at 30 percent of GDP in 2010/11. Domestic revenues at present pay for only 52 percent of central government expenditures.

Figure 1. Afghanistan: Sources and Uses of Funds



[1] This category covers spending on education, health and all other nonsecurity sectors across government.
[2] Development expenditures include significant noncapital security spending, e.g. private protection companies.
[3] Estimated local spending content ('cash impact') of external budget. 100 percent donor-financed.

2. **The government faces a tough balancing act as international engagement gradually declines to more normal levels.** Over the next five years and beyond, fiscal policy needs to find ways to balance the takeover of externally-financed security spending and other expenditures, while increasing propoor and development outlays within a tight budget constraint.[1] In this context, the concept of fiscal sustainability is reduced to one of fiscal survival in the short term as the limited availability of government resources will dictate the capacity to absorb operating expenditures, while continuing to fund necessary development priorities.

3. **Revenue effort is the backbone of fiscal survival.** The government has achieved impressive improvements in revenue collections in the space of five years (a quadrupling in absolute terms between 2005/06 and 2010/11). Realizing further gains depends heavily on the speed and determination with which the fiscal reform agenda is implemented as well as exogenous political and economic developments, e.g., border disputes with neighbors. Two key future sources of revenues include the introduction of a Value Added Tax (VAT) and the opening of the Aynak and Hajigak mines, both of which are projected to generate additional revenues by 2014/15. The VAT, in particular, is estimated to boost revenue effort by close to 2 percent of GDP at inception, while the mining sector will eventually add an additional 1 percent of GDP per year to revenues once the mines become fully operational.

4. **The speed and extent of the transition process is the key determinant of the need to finance security spending from budget resources.** At present, security-related grants are assumed to peak in 2013/14 in absolute terms, but peak as a percentage of total security expenditures in the current fiscal year. Given the overarching importance of maintaining and improving security, the government will have to dedicate significant resources in this area. The exact trajectory of support from the international community, including via grants from the NATO Training Missions - Afghanistan (NTM-A) and the Law and Order Trust Fund Afghanistan (LOTFA), will—in the short run—determine how much fiscal space the government has for other spending priorities.

5. **Given the expected security spending needs, the government believes that it will have to contain nonsecurity expenditure growth to 10 percent per annum over the three years of the program.** As a result, nonsecurity wages (in critical propoor areas such as education and health) are set to decline as a percentage of GDP from 4.6 percent in 2011/12 to 4.3 percent in 2013/14. Though clearly undesirable, whether this is a feasible

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[1] Due to the magnitude of on- and off-budget contributions, the government would only take over a fraction of total externally-financed spending. This is likely to comprise ongoing support to existing projects alongside new priority spending.

trajectory depends partly on the interplay between pay and grade reforms (covering also pensions) and the rate of recruitment in to the civil service ("Tashkeel").[2]

6. **Growing operations and maintenance (O&M) costs constitute another source of spending pressures.** As donor-financed development projects are surrendered to the Afghan government, the tight resource envelope means that the government will have to evaluate the viability of the existing capital stock (e.g., roads, schools, hospitals, bridges, etc.) put in place by donors.[3]

7. **Taken together, these developments suggest that fiscal sustainability can be achieved only by 2024/25 in the baseline scenario.** Grants to the central government budget are projected to peak in percent of GDP in FY2012/13, and decline thereafter, together with an ongoing gradual decline in the external budget.[4] The government is assumed to take over some minimal O&M, but many donor projects would be allowed to depreciate.[5] The baseline assumes that the significant O&M costs from the security sector will continue to be borne by donors. There is insufficient information to quantify these security-related O&M costs which cover a number of categories, including vehicle and equipment maintenance, training, utilities for military bases, fuel costs, etc. ISAF continues to evaluate the overall cost of operations that would need to be transferred to the government. Recent estimates have seen downward revisions from US$7 billion to US$3.5 billion.

8. **Alternative scenarios are modeled to gauge the sensitivity of these projections to key assumptions.** First, the decline in donor grants to both the development and external budgets is accelerated. The resulting profile for O&M is plotted in Figure 2. O&M costs are seen to decline faster (as the number of projects that generate O&M expenses declines). As

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[2] There are significant costs in the pipeline in the nonsecurity sector. Apart from the structurally important pay and grade reforms, there are the potentially large replacement costs of the "second civil service"—the absorption onto the government payroll of those civil servants paid for by donors (e.g., UNDP, World Bank, etc.) at wages many multiples higher than the standard Tashkeel salaries. This would be on top of existing pressures from the natural and targeted recruitment rates for the civil service, particularly in the health and education sectors.

[3] Projects have been undertaken across Afghanistan by both military and civilian assistance teams. In the case of the former, ISAF's Provincial Reconstruction Teams and Commanders' Emergency Response Programs have invested significant resources in the local communities by providing a mixture of assets. These projects are designed to generate 'goodwill' but can sometimes produce assets which the provincial communities are unable to maintain.

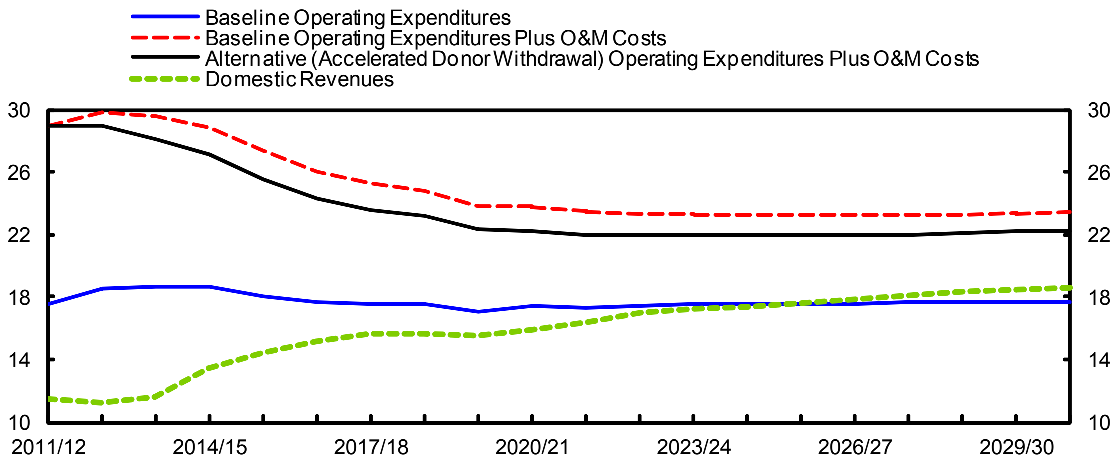
[4] The latter assumption encapsulates the continued impetus to move certain expenditures onto the central government budget, while the former captures the government's growing requirement to finance domestic expenditures on its own terms, be it revenues or additional borrowing.

[5] O&M costs eventually decline as a proportion of GDP as development expenditures fall and capital accumulation declines. In this way, O&M is "self-limiting" in the long run.

can be seen, in each case fiscal sustainability is delayed from 2024/25 to beyond the long-term horizon.

Figure 2. Afghanistan: Operations and Maintenance Costs under Baseline and Alternative Scenario with Rapid Decline in Donor Grants

(In percent of GDP)



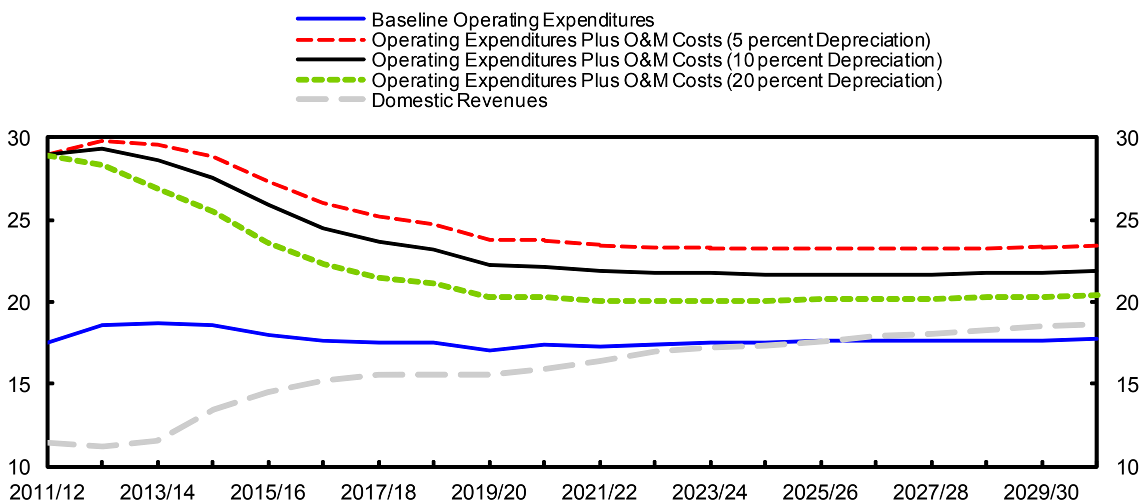
Source: Fund staff estimates.

9. **In the case of declining grants, it is possible that development expenditures could also decline as donor funds dry up and the government is unable to take them over.** The result would be a premature halt in infrastructure investment. On the other hand, should development spending be maintained and increasingly financed by the government as donors withdraw, government borrowing would increase beyond levels needed to cover O&M as well as any existing government overhang from the operating budget. This could trigger a potentially dangerous debt dynamic (see the accompanying debt sustainability analysis).

10. **In a second scenario, the rate of depreciation of capital is raised to reflect the fact that donor-financed projects, which are further away from the central government budget, are less likely to be maintained.** Figure 3 shows again how operating expenditures increase significantly, delaying fiscal sustainability to beyond 2030/31.

Figure 3. Afghanistan: Operations and Maintenance Costs under Alternative Baselines with 5 Percent, 10 Percent, and 20 Percent Depreciation

(In percent of GDP)



Source: Fund staff estimates.

11. **Fiscal survival translates into the government ensuring that their revenue and spending paths are consistent with a predictable, and ideally gradual, reduction of grants to both the central government and external budgets.** However, as the medium-term strategy for transition and transformation remains unclear, the overall nature of the donor footprint remains unpredictable.[6] As the simulations show, even conservative estimates for O&M costs from the nonsecurity sector alone will require difficult decisions from the government dictated by the constraints of fiscal survival.

[6] Donor support is typically uncertain, as plans are established on an annual basis and depend on national appropriations processes, in consultation with the Afghan government. However, the economic and political uncertainty surrounding transition has lowered predictability of the donor stance to an even greater extent.

Box 1. Estimating Operations and Maintenance Costs

The potential impact of taking on budget O&M related to donor projects is modeled based on assumptions about the accumulation of a public sector capital stock.[1] The trajectory of capital accumulation over time depends on assumptions about grants and the central government and external budgets.

Investment in year t, I_t, can be viewed as a function of the capital expenditure components of the operating, development and external budgets as follows:

$$I_t = OB_{K,t} + \theta_1 DB_t + \theta_2 EB_t,$$

where $OB_{K,t}$ is the capital expenditure component (code 25) of the operating budget for year t; DB_t, is development spending in year t (covering spending on all ANDS priorities), and EB_t captures the external budget in year t. θ_1 and θ_2 are parameters which determine the proportion of the development and external budgets which goes toward building the public capital stock. The reason for assuming only a fraction is that it is very likely that these budgets include several noncapital expenditures, in particular related to the provision of security for donor projects. In addition, donor-financed spending is typically priced at international prices rather than Afghan price levels, such that actual costs are inflated. Ministries have also been known to use the development budget for some elements of current spending, while other unwanted costs could include wages and salaries of consultants hired to oversee projects. Therefore it is necessary to make adjustments to strip out these recurrent costs.

Investment then feeds in to a standard dynamic capital accumulation equation:

$$K_t = (1 - \delta)K_{t-1} + I_t,$$

Where δ captures the rate of depreciation of the capital stock, in this case the donor projects established in Afghanistan. The final step of the estimation involves an assumption as to the proportion, γ_t, of these capital outlays each year that needs to be financed in order to keep them running (operations and maintenance costs):

$$O\&M_t = \gamma_t K_t.$$

The parameters δ and γ_t capture assumptions about the rate at which the capital stock will erode and those assets which are actually needed by the country respectively. In the case of depreciation, the further away projects are from the oversight and control of the Afghan budget, i.e., the less 'ownership' by the government, the higher the rate of depreciation that can be assumed. For example, maintenance on projects executed under the external budget are more likely to be neglected, compared to those undertaken at the discretion of the government. The proportion of capital expenditure that actually accounts for O&M is related to the needs of the country. The higher the variable, γ_t, the higher the perceived need for the existing project. However, there are question marks over whether donor-determined needs for Afghanistan, and those determined by the authorities will always coincide.

[1] The framework used was developed by Steven Symansky under projects financed by FS Share/USAID, the US Treasury, and Adam Smith International/DFID.

INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF AFGHANISTAN

Staff Report for the 2011 Article IV Consultation and Request for a Three-Year Arrangement Under the Extended Credit Facility

Informational Annex

Prepared by the Middle East and Central Asia Department

November 2, 2011

Contents Page

ANNEX I. ISLAMIC REPUBLIC OF AFGHANISTAN—RELATIONS WITH THE FUND

(As of September 30, 2011)

I. **Membership Status**: Joined July 14, 1955; Article XIV.

II. **General Resources Account**	SDR Million	% Quota
Quota	161.90	100.00
Fund holdings of currency	161.92	100.01
Reserve position in Fund	0.00	0.00
Notes issuance		
Holdings Exchange Rate		

III. **SDR Department**	SDR Million	% Allocation
Net cumulative allocation	155.31	100.00
Holdings	128.29	82.60

IV. **Outstanding Purchases and Loans**	SDR Million	% Quota
ECF Arrangements	75.35	46.54

V. **Latest Financial Arrangements:**

Type	Date of Arrangement	Expiration Date (SDR Million)	Amount Approved	Amount Drawn (SDR Million)
ECF[1]	Jun 26, 2006	Sep 25, 2010	81.00	75.35

[1] Formerly PRGF.

VI. **Projected Payments to Fund**

(SDR million; based on existing use of resources and present holdings of SDRs)

	Forthcoming				
	2011	2012	2013	2014	2015
Principal		2.45	8.29	12.81	14.51
Charges/Interest	0.02	0.26	0.24	0.22	0.21
Total	0.02	2.71	8.53	13.03	14.71

VII. **Implementation of HIPC Initiative:**

	Enhanced Framework
I. Commitment of HIPC assistance	
Decision point date	Jul 2007
Assistance committed by all creditors (US$ million, NPV)[1]	582.40
Of which: IMF assistance (US$ million)	--
(SDR equivalent in millions)	--
Completion point date	Jan 2010
II. Disbursement of IMF assistance (SDR million)	
Assistance disbursed to the member	--
Interim assistance	--
Completion point balance	--
Additional disbursement of interest income[2]	--
Total disbursements	

[1] Net Present Value (NPV) at the decision point under the enhanced framework.
[2] Under the enhanced framework, an additional disbursement is made at the completion point corresponding to interest income earned on the amount committed at the decision point, but not disbursed during the interim period.

VIII. **Implementation of MDRI Assistance:** Not Applicable

Nonfinancial Relations

IX. **Exchange Arrangement**

Afghanistan is an Article XIV member country. The authorities are implementing a liberal exchange system. Based on information currently available to the staff, no exchange restrictions and multiple currency practices are in place. The authorities have provided documents to Fund staff related to laws and regulations on the exchange regime and have requested technical assistance from the Fund to formalize the current liberal regime. They have been implementing a managed float system with no predetermined path for the exchange rate. On September 30, 2011, the average of the buying and selling exchange rates in cash transactions on the Kabul money exchange market was 48.3925 Afghanis per U.S. dollar.

To conduct monetary policy, the authorities rely on foreign exchange auctions since May 2002, and on short-term capital note auctions since September 2004. The foreign exchange auctions were initially open only to licensed money changers, but since June 2005 they are also open to commercial banks. The capital note auctions are open to commercial banks. Auctions are linked to the overall monetary program and are held on a regular basis.

X. Article IV Consultation

The last Article IV consultation with Afghanistan was discussed by the Executive Board on February 13, 2008. Article IV consultation with Afghanistan are held in accordance with the decision on consultation cycles approved on July 15, 2002.

XI. Safeguards Assessment

Under the Fund's safeguards assessment policy, the Da Afghanistan Bank (DAB) was subject to a safeguards assessment with respect to the ECF arrangement approved on June 26, 2006. An initial safeguards assessment of the DAB was completed on June 12, 2006 and updated on March 18, 2008. The initial assessment revealed serious vulnerabilities in the DAB's external and internal audit mechanisms, as well as in its financial reporting framework and system of internal controls. An update safeguards assessment is currently in progress in the context of a proposed new ECF arrangement. A safeguards mission visited the DAB in July 2010 and found that safeguards risks had been addressed in several areas, although risks remain. The DAB implemented the majority of the previous safeguards recommendations, strengthening its external audit mechanism, financial reporting and accounting controls. Progress in establishing an effective internal audit function continues to be slow, however, and governance oversight should be enhanced. New risks have also emerged over the last year as a result of the Kabul Bank crisis, not least due to capacity constraints, resignation of the governor and strains on central bank autonomy. The central bank is working with IMF staff to complete the update assessment and is committed to implementing its recommendations.

XII. Technical Assistance, 2006–11

Department	Dates	Purpose
FAD	February 2004–May 2006	Treasury Advisor
	February 21–28, 2006	Public Financial Management (budget and treasury procedures)
	March 1–4, 2006	Public Financial Management (budget and treasury procedures)
	April 30–May 9, 2006	Tax Policy Mission
	November 14–23, 2006	Tax and Customs Administration
	October 23–November 27, 2008	Resident Public Financial Management Advisor
	July 4–16, 2009	Organizational structure
	December 2–12, 2009	Revenue administration
	December 6–16, 2009	Program budgeting reform
	April 3–17, 2010	Revenue Administration (Customs)
	April 6–19, 2010	Program budgeting reform
	June 6–19, 2010	Revenue Administration (Customs)
	September 14–27, 2010	Tax Policy Reform
	October 16-28, 2010	Public Financial Management (with METAC)
	January 22-February 4,2011	Customs Administration

	April 1–13, 2011	Customs Administration
	September 15-22, 2011	Program Budgeting
	December 2011	Revenue Administration (VAT implementation - PLANNED)
LEG	May 2–10, 2006	Legal framework for monetary and payment systems
	May 27–28, 2010	Islamic banking law
MCD	August 29, 2011–present	Resident monetary policy and banking advisor
MCM	September 2004–April, 2006	Training coordinator
	January 22–February 5, 2006	Monetary policy
	April 2006–June 2007	Training coordinator (peripatetic)
	May 2–11, 2006	Monetary policy, foreign reserve management, money markets
	November 28–December 10, 2006	Monetary policy formulation and implementation
	March 19–April 16, 2007	Central bank capacity building
	March 24–29, 2007	Banking supervision
	April 17–30, 2007	Monetary policy formulation and implementation
	November 7–14, 2007	Banking supervision
	January 13–21, 2008	Banking law (with LEG)
	August 27-September 11, 2008	Monetary policy formulation and implementation
	August 2009	Monetary operations
	June 20-24, 2010	Debt/money markets, sukuks (with METAC)
	September 2010 –present	Resident advisor on Banking Resolution
	October 25-November 4, 2010	Banking crisis management (with MCD)
	February 7-14, 2011	Banking crisis management (with MCD)
	July 24-27, 2011	Islamic Finance (sukuk workshop)
	October 1–12, 2011	Banking supervision
	November 13-17, 2011	Islamic Banking (PLANNED)
	December 10-15, 2011	Banking regulations (PLANNED)
STA	October 31, 2005–January 12, 2006	Multisector statistics
	March 6–15, 2006	Balance of payments statistics
	March 8–May 2, 2006	Multisector statistics
	March 13–22, 2006	Monetary and financial statistics
	May 24–July 18, 2006	Multisector Statistics
	August 2–16, 2006	Balance of payments statistics
	August 8–October 3, 2006	Multisector statistics
	September 22–October 4, 2006	Government finance statistics
	November 1–December 26, 2006	Multisector statistics
	November 5–19, 2006	Monetary and financial statistics
	April 22–May 4, 2007	Monetary and financial statistics
	July 7–30, 2007	National accounts
	August 29–September 13, 2007	Government finance statistics
	September 09–October 05, 2007	National accounts
	December 02–13, 2007	National accounts
	April 20–30, 2008	Monetary and financial statistics
	August 6–27, 2008	Balance of payments statistics
	October 13–29, 2008	National accounts
	November 12–December 3, 2008	Balance of payments statistics
	November 23–December 5, 2008	Monetary and financial statistics

	August 30-September 9, 2009	Monetary and financial statistics
	September 27–October 07, 2009	Balance of payments statistics
	September 18–29, 2010	Government Finance Statistics
	September 20-October 1, 2010	National Accounts Statistics
	October 23-November 3, 2011	Monetary Statistics
	December 12-23, 2011	National Accounts Statistics (PLANNED)
METAC	May 2006	Treasury modernization (Resident treasury advisor)
	June 8–13, 2006	Budget integration
	September 2006	Banking supervision (Training)
	November, 2006	Price statistics (Training)
	November 15–22, 2006	Tax policy and administration
	December 12–19, 2006	Budget integration
	December 12–22, 2006	Budget development
	March 10–21, 2007	Tax policy and administration
	March 11–22, 2007	Cash management
	March 24–29, 2007	Banking supervision
	May 19–25, 2007	Balance of payments statistics
	June 6–19, 2007	Accounting
	July 1–12, 2007	Banking supervision
	August 2007	Cash management and program budgeting
	September 1–12, 2007	Banking supervision
	November 4–8, 2007	Banking supervision
	January 5–26, 2008	Central bank accounting
	March 22–April 2, 2008	Banking supervision
	June 25–July 7, 2008	Budget preparation
	August 24–27, 2008	Banking supervision
	September 14–24, 2008	Real sector statistics
	December 14–17, 2008	Banking supervision
	January 25–February 2, 2009	Central bank accounting
	January 28–February 2, 2009	Tax policy and administration
	March 7–19, 2009	Cash and budget management
	February 13-24, 2010	Public Financial Management
	May 17-28, 2010	Consumer price index
	June 20-30, 2010	Banking Supervision (with MCM)
	September 19-30, 2010	Customs Reform
	January 2-11, 2011	Financial Planning, Budget Classification
	January 10-14, 2011	Tax Information Systems (workshop)
	August 2-4, 2011	Consumer price statistics
	November 12-21, 2011	Consumer price statistics (PLANNED)

Afghanistan is a participant in the Middle East Technical Assistance Center.

XIII. **Resident Representatives**

Mr. de Schaetzen; August 2002–June 2005

Mr. Charap; June 2005–June 2008

Mr. Abdallah; June 2008–present

ANNEX II. ISLAMIC REPUBLIC OF AFGHANISTAN—RELATIONS WITH THE WORLD BANK

(As of September 22, 2011)

1. IDA has committed a total of over US$2.3 billion to Afghanistan since 2002. To date, 25 development and emergency reconstruction projects including 3 development policy grants have been implemented. IDA's active portfolio comprises 24 investment projects with combined net commitment of over 1.2 billion, of which almost 50 percent (US$536.1 million) has been disbursed.

2. The Bank's involvement in Afghanistan extends to its role as administrator of the Afghanistan Reconstruction Trust Fund (ARTF). The ARTF has developed into the primary multi-donor funding mechanism, financing the essential running costs of government as well as key investments, including national programs in health, education, rural access, irrigation rehabilitation, microfinance, and the National Solidarity Program. Since early 2002, 32 donors have contributed over US$4.3 billion to this fund, making it the largest contributor to the Afghan budget for both operating costs and development programs.

3. In January 2010, the World Bank's International Development Association (IDA) and the International Monetary Fund (IMF) agreed to support debt relief for Afghanistan. The Boards of both institutions agreed that Afghanistan had taken the necessary steps to reach the completion point under the enhanced Heavily Indebted Poor Countries (HIPC) Initiative. This will generate total debt service savings of US$1.6 billion, which include US$1.3 billion from the HIPC Initiative, US$260 million from Paris Club creditors beyond HIPC, and US$38.4 million from the Multilateral Debt Relief Initiative (MDRI).

4. The International Finance Corporation (IFC), the World Bank Group's private sector development arm, continues to work with its investment partners in Afghanistan. IFC now has an investment portfolio totaling more than US$90 million in six companies. This includes commitments in the financial, telecom, hospitality and healthcare sectors.

5. One of the primary focuses of the Bank's assistance has been to help the government with legal and regulatory reform, establishing fiscal authority, and developing systems and human resources for public financial management and the civil service as a whole. The performance of the Ministry of Finance regarding alignment of budgetary allocations with the country's priority needs, fiscal discipline, cash control, and aggregate transparency has contributed to macroeconomic stability and sustained external donor assistance.

6. In rural development, the National Solidarity Program (NSP) has reached over 18 million Afghans in approximately 28,000 communities across rural Afghanistan through locally elected community development councils. With modest grants, the communities are empowered to make decisions about their own development priorities in drinking water supply, roads, irrigation, schools, etc. To date, NSP has financed 57,400 community infrastructure projects of which 46,000 have been completed.

7. With support of the World Bank, the Ministry of Public Health improved health service coverage through financing 432 health care facilities in 18 provinces between 2003 and 2009. This has contributed to a 28 percent decline in the under-5 years-old mortality rate. Health service utilization increased among project area populations from a rate of 0.3 consultations per capita annually at the outset to 1.44 per capita by mid-2009.

8. The demand for education has continuously exceeded expectations and supply capacity. There are now 7 million children enrolled in schools, with nearly 40 percent being girls, compared to a little more than one million seven years ago, with almost no girls.

9. Since the implementation of an Automated System for Customs Data, the collection of transit fees in major transit corridors in Afghanistan has improved and customs revenues have increased from US$50 million in 2004 to US$700 million in 2010. To date, customs processes have been automated at major Inland Customs Depots, including at the Kabul Airport which receives approximately 55 percent of all the country's customs declarations.

10. The Bank is helping to build the capacity of the government to exercise strong oversight of the minerals and hydrocarbons sectors. Private sector investment has been facilitated through the successful tender of the Aynak copper deposit, one of the largest such deposits in the world. The total amount of the investment will be around US$10 billion over the next 5-10 years, and an initial payment of US$80 million has been received by the Government.

11. Looking forward, the Bank's indicative lending envelope for 2011–12 is approximately US$290 million. Resources will be primarily channeled to private and financial sector development as well as proven national programs in education and rural livelihood (including agriculture), where demands remain vast, to sustain and accelerate progress made so far. These areas constitute significant platforms for improving livelihoods and building government credibility.

12. Supporting sound national programs under the leadership of the government is the most effective use of international aid. The Bank will engage in areas where there is evidence: (i) that a strong, reform-minded, leadership is in place; (ii) where it can help leverage the support of other members of the international donor community, and (iii) where opportunities exist to develop operational frameworks for future programs. In this context, the Government has requested that the Bank play an enhanced role in working with them to determine the vision, design, and framework of their national programs.

ANNEX III. ISLAMIC REPUBLIC OF AFGHANISTAN—IMPLEMENTATION OF THE JOINT MANAGEMENT ACTION PLAN ON BANK-FUND COLLABORATION

(AS OF OCTOBER 19, 2011)

1. **Joint Management Action Plan (JMAP)**. This memorandum, endorsed by Mr. Schimmelpfennig (IMF mission chief) and Mr. Krafft (World Bank country director), documents the annual consultations between Afghanistan country teams of the World Bank and the IMF, undertaken under the JMAP. Discussions were held on September 29 in Washington and October 5, 2011 in Kabul.

2. **Bank's work during the past year.** The Bank has supported the Government with a wide array of projects comprising the development of broad-based education and health services, the reconstruction of infrastructure, provision of rural infrastructure, technical assistance to the mining sector as well as structural reforms in public administration, and customs administration and the financial system. Sector specific activities aside, the World Bank work interfaced with the Fund's engagement in several areas: the Afghanistan Reconstruction Trust Fund (ARTF)-funded Incentive Program assisted the Government in strengthening the Public Financial System (e.g., through issuing a new audit law), improving oversight mechanisms, accelerating reforms in public administration, and increasing domestic revenues through custom reforms. A new financial sector project was approved following the Kabul Bank crisis which will, among other things, finance audits of 10 banks. The World Bank also provided technical assistance and analytical work on a number of fronts including a debt management performance assessment, notes on sub-national finance reforms and a poverty profile. Moreover, the World Bank is undertaking a major piece of analysis on the impact of the "transition process" on the outlook for fiscal sustainability, poverty and long term economic growth.

3. **Fund's work during the past year.** The Fund focused its efforts on helping the authorities resolve the Kabul Bank crisis and safeguard financial sector stability. An action plan has been developed with a goal to minimize fiscal costs of the crisis, protect the banking system, promote transparency, reduce moral hazard, strengthen banking supervision, and improve the legal and regulatory framework. The plan is currently being implemented. The authorities made progress on a set of measures and prior action and, accordingly, a staff-level agreement on a new ECF-supported program was reached on October 6, 2011. In its advice, the Fund emphasized the need to preserve fiscal sustainability and offered recommendations to that effect. Finally, between October 2010 and September 2011, the Fund has fielded over 10 technical assistance missions, including on banking resolution, financial sector supervision, public financial management, tax policy, revenue administration, Islamic finance and statistics.

4. **Bank-Fund collaboration during the past year** proceeded according to the last JMAP. Both institutions worked closely on the strategy to resolve the Kabul Bank crisis as well as on issues related to macroeconomic stability and fiscal sustainability. As noted above,

in support of Fund conditionality the Bank Board approved a new financial sector investment to finance audits of ten banks. The Fund shared its macroeconomic projections with the Bank, as requested.

5. **Key medium- and long-term objectives**. Staffs exchanged views on the main medium- and long-term economic priorities and challenges facing Afghanistan. The key areas identified during the previous JMAP period remain valid—they are: (i) sustaining macroeconomic and financial stability; (ii) preserving fiscal sustainability and improving prioritization and management of expenditures; (iii) reducing red tape and promoting private sector development and trade; (iv) harnessing mineral resources for development; and (v) ensuring rule of law, reducing corruption and improving governance.

6. **The challenge of "transition."** That notwithstanding, the most important short- and medium-term challenge is proper management of the "transition" process. Transition entails an accelerated reduction of the international military presence by 2014, and a timeline for rationalization (scaling down) of donors' assistance. Accordingly, the government of Afghanistan is expected to provide for an increasing share of security expenditures from its domestic revenues and gradually take full responsibility for its development agenda.

7. **Bank–Fund Collaboration.** The teams agreed to the following cross-support and exchange of information:

- The teams agreed to continue to share and consult at the early stage, on their envisaged program conditionality and benchmarks, and to ensure that these conditions are complementary and mutually reinforcing;

  The teams agreed to continue to support each other in those aspects of the respective work programs that lay in the scope of leadership and expertise of the other institution. Particularly, the Bank will support the Fund in the area of banking sector audits, payment systems, anti-money laundering, mining, social spending and other structural reforms, while the Fund will share with the Bank macroeconomic data and projections as well as its assessment of macroeconomic policies. Both institutions will work collaboratively on better understanding the economic consequences of transition and the appropriate policies to mitigate any negative impact;

- The teams further agreed to participate in each other's formal and informal review processes as requested and to exchange information as necessary.

8. Table 1 below lists the teams' separate and joint work program for October 2011–September 2012

Table 1. Afghanistan: Bank's and Fund's Planned Activities in the Area of Joint Interest, October 2011–September 2012

	Products	Preparations/Mission Timing[1]	Delivery[1]
Fund	Article IV Consultation	October 2011	November 2011
	Extended Credit Facility (ECF, new arrangement)	October 2011	November 2011
	First Review under the ECF	April 2012	May 2012
	Areas of Technical Assistance: Banking restructuring, financial sector supervision, revenue administration, customs and border management, tax policy, public financial management, foreign exchange regulation, AML/CFT, banking law, treasury securities, statistics (national accounts, prices, government finance, monetary, balance of payments, GDDS)		
Bank	Development Policy Grant	November 2011–May 2012	May 2012
	Financial Sector Strengthening Project, Supervision	November 2011–August 2012	October 2011
	ARTF IP Program (SY 1391), Preparation of MoU	November 2011–March 2012	March 2012
	Study: Transition and Sustainability in Afghanistan	Throughout 2010/11	December 2011
	Study: Long Term Sources Economic Growth	TBD	
	Policy Notes: Sub-National Finance	January 2012–June 2013	June 2013
	Position Note: Management of Mineral Revenues	Throughout 2010/11	February 2013
	Economic Monitoring	Continuous	
Joint	Financial Sector Assessment Program	TBD	TBD
	AML/CFT follow-up and workshop	November 2011	
	Dialogue on Mineral Revenue and Expenditure Management	TBD	
	Dialogue on the transition process	Continuous	
	Strengthening of the banking sector	Continuous	
	Improving payment systems	Continuous	

[1] Timing is tentative.

ANNEX IV. ISLAMIC REPUBLIC OF AFGHANISTAN—RELATIONS WITH THE ASIAN DEVELOPMENT BANK

(As of September 25, 2011)

1. A new Country Partnership Strategy (CPS) covering the 2009–2013 period was endorsed by ADB's Board of Directors on March 5, 2009. The new CPS is fully aligned with the Afghanistan National Development Strategy (ANDS), with ADB's investments contributing to Afghanistan's further economic development. The new CPS continues ADB's narrow focus on Afghanistan's energy, transport, and agriculture and irrigation sectors, including sector governance and further institutional and human capacity development.

2. As of end-August2011 the Asian Development Bank had committed an aggregate of some US$2.21 billion to Afghanistan's reconstruction through approved Asian Development Fund (ADF) loan- and grant-financed projects, technical assistance activities, donor grant-financed projects administered by ADB, and ADB private sector investments. Since 2007, all of ADB's public sector (ADF) assistance has been provided on a 100 percent grant basis. At the June 2008 International Conference in Support of Afghanistan, ADB pledged an additional US$1.3 billion over the 2008–2013 period, making ADB Afghanistan's fourth largest donor to Afghanistan (after the United States, the United Kingdom, and the World Bank).

3. Since November 2008, ADB has approved three multi-tranche financing facility (MFF) projects as follows, a US$570 million energy sector MFF and a US$400 million transport sector MFF (November 2008); a US$300 million water resources management sector MFF (October 2009); and a railway project of US$165 million (October 2009). With the approval of these MFFs and the railway project, the bulk of ADB's anticipated ADF assistance over the 2008–2013 will be fully "earmarked", although with some flexibility depending on changes in Government priorities.

4. Since ADB operations in Afghanistan resumed in 2002, there have been 11 public sector loans in total US$722.2 million and 14 grants in total US$963.1 million covering 23 investment projects. This involved ADF funding resources using loan or combined loan and grant funding, and since 2007 all projects have used only ADF grant-financing. In addition, there have been 10 Japan Fund for Poverty Reduction funded projects, 8 standalone projects, and 2 combined with loan projects totaling US$110.0 million. Also, there have been 5 donor cofinancing grants from Japan’s Fund for Poverty Reduction, Kuwait Fund, CIDA (2) and DFID amounting to US$106.45 million. ADB's private sector operations in Afghanistan began in 2004. As of end June 2010, cumulative approvals for seven private sector projects have amounted to US$208.1 million, including support for Afghanistan International Bank, Roshan Telecommunications, and the Afghanistan Investment Guarantee Facility.

5. The Asian Development Bank has been actively engaged in providing analytical and advisory technical assistance (TA) services to the Government, with total TA amounting to

some US$64.6 million as of 25 September 2011 (including US$8.2 million in donor cofinancing). Increasingly, TA is included as integral parts of ADB's grant-based investment projects, with focus on public financial management, procurement, and anti-corruption as well as institutional and human capacity development. ADB has also been providing ongoing TA support to the Ministry of Finance.

6. ADB is a member of the Afghanistan Compact/ANDS Joint Coordination Management Board (JCMB) and also is a member of the Afghanistan Reconstruction Trust Fund Management Committee. ADB plays an active part in other donor coordination activities, including the JCMB Social and Economic Development Standing Committee, the Ministry of Finance's High Level Committee on Aid Effectiveness, and the Inter-Ministerial Committee on Energy.

ANNEX V. ISLAMIC REPUBLIC OF AFGHANISTAN—STATISTICAL ISSUES
(As of September 21, 2011)

I. Assessment of Data Adequacy for Surveillance

General. Data provision has some shortcomings, but is broadly adequate for surveillance and program monitoring. The statistical system has improved significantly since 2002. Nonetheless, organizational weaknesses, poor staffing, and lack of equipment—in addition to difficult security situation—continue to hamper the compilation and dissemination processes. The IMF continues to provide technical assistance through peripatetic statistical advisors, as well as short-term topical missions.

National Accounts and Prices. Although the Central Statistics Organization (CSO) has been improving national accounts statistics—with technical assistance from the IMF and other providers—the national accounts compilation process is hampered by the general lack of source data and limited resources and capacity. The compilation broadly follows the *System of National Accounts 1993 (1993 SNA)* and is rather basic. Estimates of value added are prepared by industrial sectors. Private consumption expenditure is derived as a residual and includes changes in inventories and all discrepancies. Validation of GDP calculations is needed using independent estimates of private consumption and income from abroad, as well as improvement in price, industrial classifications, surveys and sources—ultimately followed by a revision of official time series. National account aggregates monitored by the IMF exclude the narcotics sector, which constitutes about 20 percent of the economy.

The CSO compiles and publishes monthly consumer price indices for the capital city, Kabul, and five other major cities. Although in some cases the procedures may not necessarily follow best practices, in general, the current CPI compilation methods adhere to internationally accepted standards. This is a remarkable achievement given insecurity and the scarce resources devoted to the CPI unit: 17 staff nationwide including price collectors, four computers, a few bicycles for transportation, and Afghan post for data transmission. The CSO is undertaking a major overhaul of the CPI, namely (i) implementation of full, five-digit Classification of Individual Consumption by Purpose (COICOP); (ii) update of consumer basket weights using data from a recent household survey (current weights date back to 1987); and (iii) expansion of coverage from six to ten cities/provinces (out of 34). Concordance matrices between the old classification, the COICOP, and the survey are ready, weights have been estimated, and price collection has been going on in new provinces for some time. The IMF currently monitors Kabul CPI only, because of its timeliness and reliability, but intends to switch to a new, nationwide CPI as soon as it is rolled out in 2012.

Government finance statistics. Fiscal data are compiled on cash basis based on the *Government Finance Statistics Manual 2001 (GFSM 2001)*. The timeliness and quality of the central government budget data ("core budget") have been improving, particularly after completion of the roll out and connectivity of the Afghanistan Financial Management Information

System (AFMIS) to all central government line ministries and agencies in Kabul and all provincial offices. With IMF support, the Ministry of Finance is gradually implementing *GFSM 2001*. A workshop on Government Finance Statistics for the Ministry of Finance and the Central Statistics Office officials was held in late 2009. Following that workshop, the authorities started to report monthly GFS data to the IMF for the central government budget. The ministry is also working on expanding the coverage of monthly and quarterly GFS data to general government. Nevertheless, progress has been mixed, hindered by other priorities and limited technical capacity.
Monetary and Financial Statistics. The scope and quality of data reporting by the central bank have improved. Da Afghanistan Bank (DAB) now produces its balance sheet on a monthly basis. Since 2007, commercial banks have been reporting data to DAB regularly using templates developed for the purpose of supervision and monetary statistics compilation. The IMF is assisting DAB in bringing the reporting in compliance with the IMF's Monetary and Financial Statistics Manual. DAB is reporting the Standardized Report Forms for Monetary and Financial Statistics to the IMF for publication in the International Financial Statistics (IFS) database on a monthly basis. A country page for Afghanistan was reintroduced in IFS in March 2008.
Balance of payments. Balance of payments statistics are compiled according to the fifth edition of the *Balance of Payments Manual*. Although improving, the compilation process suffers from a paucity of source data, low organizational capacity, and limited resources. Customs coverage of overland foreign trade is weak and there are no reliable estimates of unrecorded border trade, which constitutes a significant proportion of international trade. Source data to estimate services, income, transfers, foreign direct investment, and other statistics are weak. Surveys of enterprises suffer from poor response, sampling problems, and lack of human, financial, and technological resources. Further, lack of an adequate legal framework hinders the ability of DAB to collect information from enterprises in the nonfinancial sector. DAB compiles rudimentary quarterly balance of payments statistics; however, additional work is required to improve the coverage and accuracy of the estimates to levels that would make the data acceptable for broader dissemination. Regarding external debt, the reconciliation of record has been completed in the context of Paris Club rescheduling, the completion of the HIPC initiative in 2010, and subsequent debt relief. Debt management and reporting systems are in place and functional at the Ministry of Finance. No International Investment Position statistics are produced due to lack of capacity.

II. Data Standards and Quality	
Afghanistan has been a GDDS participant since June 2006.	No data ROSC has been published

III. Reporting to STA
The authorities are reporting data for the Fund's *International Financial Statistics, Government Finance Statistics Yearbook*, and the *Balance of Payments Statistics Yearbook*.

Afghanistan: Table of Common Indicators Required for Surveillance

(As of September 21, 2011)

	Date of latest observation	Date received	Frequency of Data[7]	Frequency of Reporting[7]	Frequency of publication[7]
Exchange Rates	09/21/11	09/21/11	D	D	D
International Reserve Assets and Reserve Liabilities of the Monetary Authorities[1]	August 2011	09/03/11	M	M	M
Reserve/Base Money	August 2011	09/03/11	M	M	M
Broad Money	June 2011	09/07/11	M	M	M
Central Bank Balance Sheet	August 2011	09/03/11	M	M	M
Consolidated Balance Sheet of the Banking System	June 2011	09/07/11	M	M	M
Interest Rates[2]	09/21/11	09/21/11	D	M	M
Consumer Price Index	August 2011	09/05/11	M	M	M
Revenue, Expenditure, Balance and Composition of Financing[3] – General Government[4]	--	--	--	--	--
Revenue, Expenditure, Balance and Composition of Financing[3]– Central Government	May 2011	09/10/11	M	M	M
Stocks of Central Government and Central Government-Guaranteed Debt[5]	20011/12 Q1	07/13/11	Q	Q	Q
External Current Account Balance	2010/11 Q3	02/14/11	Q	Q	Q
Exports and Imports of Goods and Services	2010/11 Q3	02/14/11	Q	Q	Q
GDP/GNP	2009/10	12/15/10	A	A	A
Gross External Debt	20011/12 Q1	07/13/11	Q	Q	Q
International Investment Position[6]	--	--	--	--	--

[1] Any reserve assets that are pledged of otherwise encumbered should be specified separately. Also, data should comprise short-term liabilities linked to a foreign currency but settled by other means as well as the notional values of financial derivatives to pay and to receive foreign currency, including those linked to a foreign currency but settled by other means

[2] Both market-based and officially-determined, including discount rates, money market rates, rates on treasury bills, notes and bonds.

[3] Foreign, domestic bank, and domestic nonbank financing.

[4] The general government consists of the central government (budgetary funds, extra budgetary funds, and social security funds) and state and local governments.

[5] Including currency and maturity composition.

[6] Includes external gross financial asset and liability position vis-à-vis nonresidents.

[7] Daily (D), Weekly (W), Monthly (M), Quarterly (Q), Annually (A); Not Available (--).

INTERNATIONAL MONETARY FUND AND
INTERNATIONAL DEVELOPMENT ASSOCIATION

ISLAMIC REPUBLIC OF AFGHANISTAN

Joint World Bank/IMF Debt Sustainability Analysis

Prepared by the Staffs of the International Monetary Fund and the International Development Association

November 2, 2011

Approved by Adnan Mazarei and Dhaneshwar Ghura (IMF) and Jeffrey D. Lewis and Ernesto May (World Bank)

Afghanistan continues to be at a high risk of debt distress.[1, 2] *Following debt relief under the enhanced Heavily Indebted Poor Countries (HIPC) initiative and Multilateral Debt Relief Initiative (MDRI), Afghanistan's external and public debt burden indicators improve in the near term. However, and as noted in the HIPC Initiative Paper prepared in early 2010, debt burden indicators could deteriorate rapidly if the country's substantial financing needs were met with new loans, even concessional ones, instead of the current grant financing.*[3] *In a nutshell, Afghanistan should restrict any borrowing to highly concessional financing for specific projects with a clearly identified economic return. The baseline scenario is optimistic, not least in terms of the assumption on security, and the probability of the alternative scenarios (or stress tests) is high; in many ways, the outlook could be characterized as bi-modal. The alternative scenarios, therefore, do not only illustrate Afghanistan's vulnerability, but depict possible outcomes that reflect the challenges of envisaged transition and transformation in the wake of the withdrawal of large-scale foreign presence.*

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[1] The results presented here are based on an update of the debt sustainability analysis (DSA) based on the joint IMF/World Bank debt sustainability framework for low-income countries (LICs) (see http://www.imf.org/external/pubs/ft/dsa/lic.htm and http://www.imf.org/External/np/pp/eng/2005/032805.htm)

[2] The LIC DSA compares the evolution over the projection period of debt-burden indicators against policy-dependent indicative thresholds, using the three-year average of the World Bank's Country Policy and Institutional Assessment (CPIA). With an average 2010 CPIA of 2.6, Afghanistan is classified as a "weak performer" according to the Debt Sustainability Framework (DSF).

[3] Afghanistan: HIPC Initiative Paper, IMF Country Report No. 10/40 (http://www.imf.org/external/pubs/ft/scr/2010/cr1040.pdf); and Memorandum and Recommendation of the President of the International Development Association to the Executive Directors on Assistance to the Islamic Republic of Afghanistan under the Enhanced Heavily Indebted Poor Countries Initiative and the Multilateral Debt Relief Initiative Report No.51184-AF.

A. Baseline Scenario

1. **The baseline macroeconomic scenario depicts an optimistic outlook predicated on a stable security situation.** The political and economic backdrop in Afghanistan has altered since January 2010. The financial sector crisis and periods of foreign military withdrawal (transition) and gradual donor disengagement (transformation) are important developments that have entered the projections. Accordingly, the baseline has been revised in light of these recent changes. It also assumes that security will remain stable during the transition phase and that civilian foreign assistance will be reduced only gradually over the longer-term transformation. While this is clearly a desired outcome, it is by no means guaranteed. In comparison to the previous debt sustainability analysis (DSA),[4] external and fiscal sustainability remains vulnerable to external shocks (Tables 1–6), and Afghanistan remains at risk of high debt distress.

Box 1. Macroeconomic Assumptions Comparison Table

	Previous DSA		Current DSA			Differences (current vs. previous)	
	MT	LT	2011	MT	LT	MT	LT
Real growth (%)	6.9	5.7	5.7	6.1	4.6	-0.9	-1.1
Inflation (GDP deflator, %)	4.0	3.5	11.7	6.2	4.3	2.2	0.8
Nominal GDP (Bil. Afghani)	949	2662	862	1082	2947	133	284
Revenue and grants (% GDP)	19.8	18.2	23.7	24.0	23.0	4.2	4.7
Grants (% GDP)	10.1	5.5	12.2	11.4	5.5	1.3	0.0
Primary expenditure (% GDP)	22.0	20.6	23.8	25.3	25.4	3.3	4.9
Primary deficit (% GDP)	-2.1	-2.0	-0.1	-1.2	-2.0	0.9	0.0
Exports of G&S (% GDP)	7.0	8.0	5.8	6.3	9.1	-0.7	1.1
Imports of G&S (% GDP)	59.2	36.7	54.6	48.4	32.4	-10.8	-4.3
Noninterest current account deficit (% GDP)	-3.4	-4.7	0.1	-2.5	-1.5	0.9	3.2

Note: For current DSA, MT stands for medium term and reflects average over 2011-2015, and LT refers to long term reflecting average over 2016-2030. For previous DSA (January 2010), MT and LT correspond to the periods 2010-2014 and 2015-2029 respectively.

2. **Projections are based on the progress made in 2010/11, marked by successful disinflation and economic growth.** Under the baseline scenario, continued economic reforms, including improvements in governance and the business environment, will allow for major investment in the mining sector, agriculture, transport, and reconstruction. Accordingly, the nonagricultural sector is expected to outperform agriculture. In particular, Afghanistan has considerable potential in the mining industry, with exploitation of mineral

[4] Afghanistan: HIPC Initiative Paper, IMF Country Report No. 10/40, February 2010.

wealth expected to begin in 2014/15.[5] Over the medium term (2011/12–2015/16), real GDP growth is expected to average 6 percent, compared with 10 percent in the recent decade. Over the longer term (2025/26–2030/31), growth is projected to converge to 4 percent.[6]

Table 1. Islamic Republic of Afghanistan: Medium and Long-Term Macroeconomic Framework, 2010/11–2029/30

		Projection								
	2010/11	Medium Term			Long Term					
	Prel.	2011/12	2012/13	2013/14	2017/18	2019/20	2021/22	2024/25	2026/27	2029/30
		(Annual percentage change, unless otherwise indicated)								
Output and prices 1/										
Real GDP	8.4	5.7	7.1	5.8	6.6	5.6	5.4	3.9	4.0	4.0
GDP per capita (in U.S. dollars)	528	591	612	637	758	802	860	918	969	1,062
Consumer prices (period average)	7.7	10.5	4.6	5.0	5.0	4.8	4.5	4.1	4.0	4.0
		(In percent of GDP, unless otherwise indicated)								
Investment and savings										
Gross domestic investment	26.3	22.6	21.9	21.6	23.6	25.6	25.1	23.2	22.3	21.0
Of which: Private	8.5	8.6	8.9	9.5	13.7	16.2	16.1	15.0	14.6	13.8
Gross domestic savings	27.9	22.6	20.9	19.0	19.0	21.8	22.4	21.8	21.5	21.1
Of which: Private	9.2	8.6	9.3	8.5	10.7	14.7	15.7	15.9	16.0	16.0
Public finances										
Domestic revenues and grants	22.0	23.7	23.7	24.0	23.4	22.1	22.5	22.8	22.8	23.0
Domestic revenues	11.0	11.5	11.3	11.6	15.6	15.5	16.4	17.4	17.9	18.5
Grants	11.0	12.2	12.4	12.4	7.7	6.6	6.1	5.4	4.9	4.5
Expenditures	21.1	23.8	25.3	25.7	25.1	24.6	25.1	25.3	25.4	25.5
Operating 2/	15.1	17.6	18.6	18.7	17.4	16.5	16.7	17.4	17.7	18.2
Development	5.9	6.2	6.6	7.0	7.7	8.1	8.4	8.0	7.7	7.3
Overall balance (including grants)	0.9	0.0	-1.6	-1.7	-1.7	-2.5	-2.6	-2.6	-2.6	-2.5
Operating balance										
Including grants 3/	3.3	1.6	0.4	0.2	0.9	-0.9	-0.3	0.0	0.2	0.3
Excluding grants 4/	-4.1	-6.1	-7.4	-7.1	-1.7	-1.0	-0.3	0.0	0.2	0.3
External sector 1/										
Exports of goods 5/	17.8	15.8	13.5	12.2	17.3	17.5	20.1	20.3	20.2	20.1
Imports of goods	57.4	50.0	46.8	43.9	36.2	32.5	31.2	27.8	26.3	24.3
Merchandise trade balance	-39.6	-34.1	-33.3	-31.7	-18.9	-15.0	-11.1	-7.6	-6.0	-4.2
Current account balance										
Excluding official transfers	-39.8	-34.3	-33.2	-31.5	-21.3	-17.3	-14.1	-10.4	-8.5	-6.3
Including official transfers	1.7	0.1	-1.1	-2.6	-4.6	-3.7	-2.8	-1.4	-0.8	0.1
Gross reserves (in millions of U.S. dollars)	5,321	6,121	6,627	7,178	6,877	6,732	6,410	5,928	5,830	5,691
Memorandum items:										
External budget grants 6/	30.5	22.1	19.7	16.5	9.0	6.9	5.2	3.6	2.8	2.0
Total external debt 7/	8.0	7.9	8.6	9.1	10.6	11.6	12.6	14.9	16.3	17.8
Public sector debt	8.0	12.1	13.7	15.2	13.4	14.7	17.3	21.0	23.3	26.1

Source: Afghan authorities; and Fund staff estimates and projections.

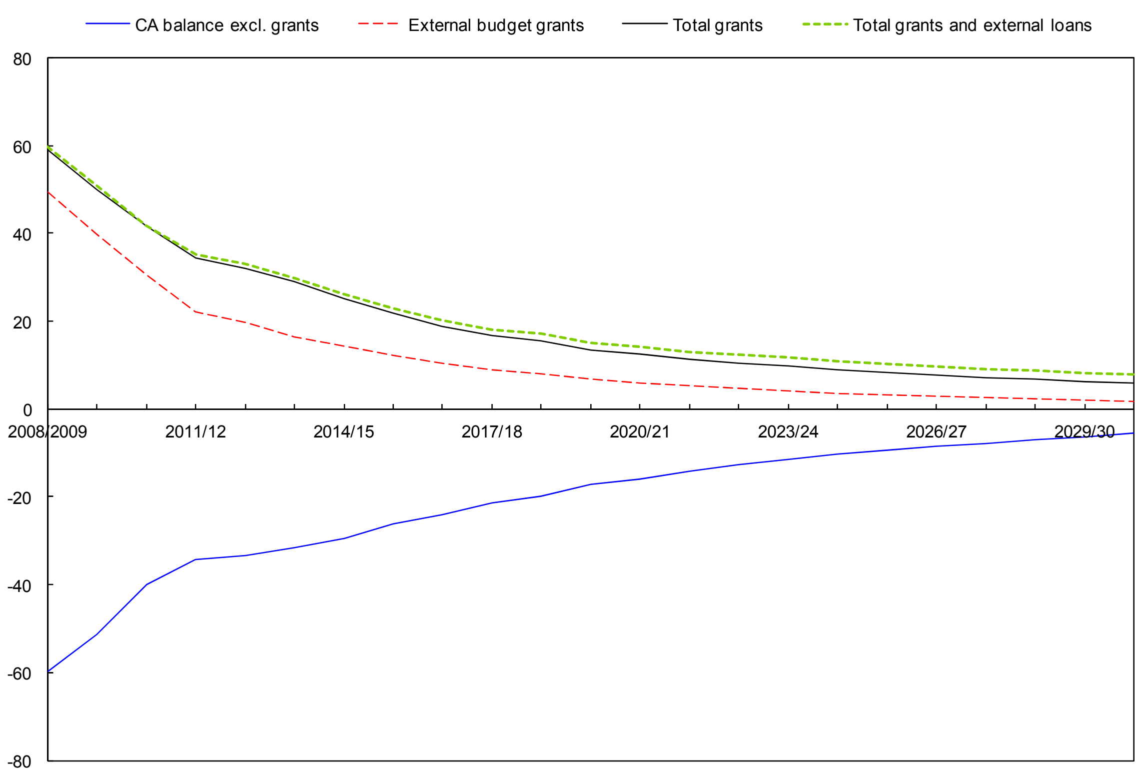
1/ Excluding the narcotics economy.
2/ Comprising mainly current spending.
3/ Defined as domestic revenues plus operating grants minus operating expenditures.
4/ Defined as domestic revenues minus operating expenditures.
5/ Includes official recorded exports, estimates of smuggling, reexports and sales to nonresidents.
6/ Estimated direct expenditures by donors on public projects not included in the government budget.
7/ After HIPC and MDRI debt relief, as well as debt relief beyond HIPC relief from Paris Club creditors. Debt includes obligations to the IMF.

[5] Under the baseline scenario, the production of copper from the Aynak mine is assumed to start in 2014/15 at 20,000 tons and to increase to 200,000 tons by 2016/17. Based on copper price projections from the IMF's World Economic Outlook Database, the value of copper production (assumed to equal the value of exports) is expected to reach US$2 billion in the outer years of the projection period. Iron exports from Hajigak and other mining projects are estimated to begin in 2019/20 at about US$200 million and increase thereafter to around US$1.4 billion in 2030/31.

[6] Private investment as a share of GDP is projected to increase from about 9 percent at present to about 16 percent by the end of this decade.

3. **While the overall macroeconomic situation is expected to improve, Afghanistan will likely remain dependent on donor support in the foreseeable future.** Large financing gaps are projected for the remainder of this decade, and total donor support to finance both operating and development expenditures (on- and off-budget) is expected to remain substantial, at about US$3–4 billion per year by 2030/31. However, as the economy becomes increasingly self-sustained over time through economic growth, higher exports, and higher foreign investment, the share of total external support (the sum of grants and loans) to GDP is projected to decline from 35 percent in 2011/12 to 9 percent by the end of the 20-year projection period. While revenues are projected to increase to just under 19 percent of GDP by 2030/31, the share of grants in total external support is expected to decline gradually from 97 percent in 2011/12 to 76 percent at the end of projection period (equal to 6 percent of GDP). Such an increase in revenues over the long term will only be possible if the security situation is stable and the authorities implement key reforms in a timely manner.

Figure 1. Afghanistan: Current Account Balance Excluding Grants
(In percent of GDP)

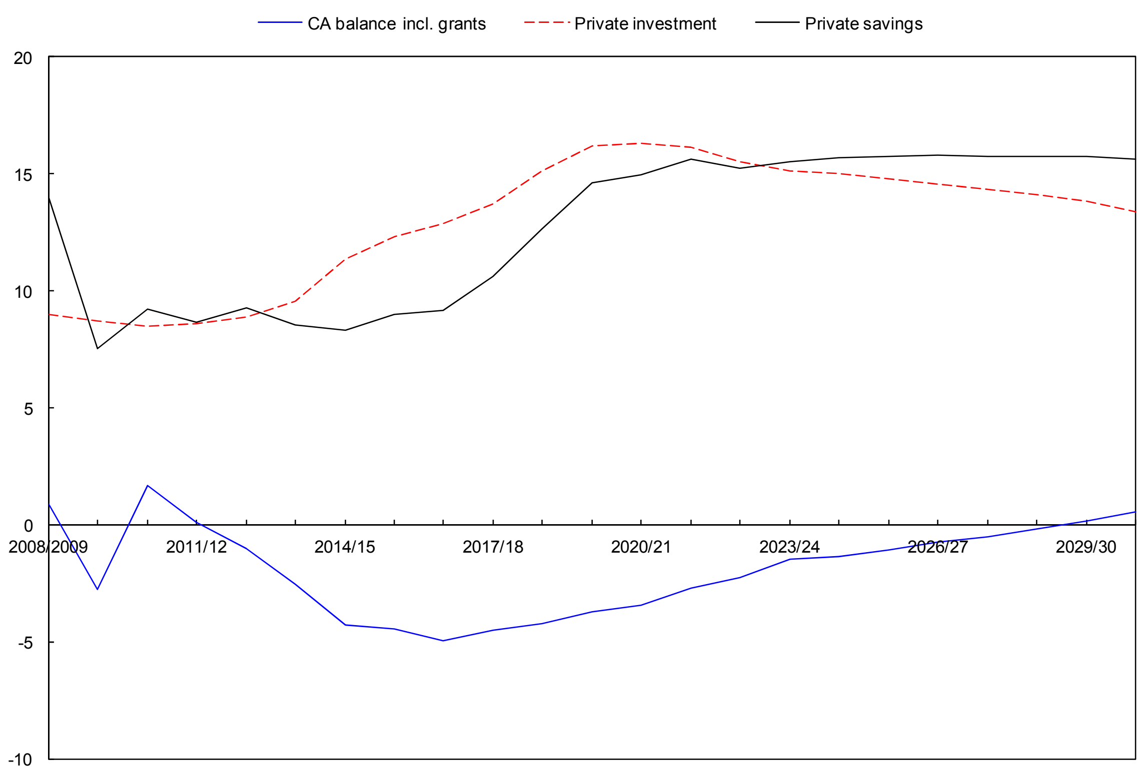


4. **Over the projection period, exports are expected to increase significantly, while somewhat lower growth in imports is associated with a decline of government-related imports, resulting from lower donor expenditure.** Projections are based on the assumption that improvements in security, regional stability and economic reforms in combination with an enhanced investment climate, including in the mining sector, will contribute to higher

total factor productivity. Basic infrastructure is expected to improve, allowing for some import substitution in light industries. In view of its unique geographical position, Afghanistan could develop into a regional hub in transit trade, with significant potential for exports of transportation services associated with trade between the Middle East and Central Asia. These are clearly very tenuous assumptions.

5. **The current account deficit is projected to decline over the projection period.** In 2010/11, officially recorded exports accounted for only 3 percent of GDP, while officially recorded imports reached 46 percent of GDP (of which donor-related imports amounted to 25 percent of GDP). Accordingly, the current account deficit (excluding official transfers)—which was high at 40 percent of GDP—is projected to decline to 26 percent by 2015/16 and further to about 6 percent at the end of the projection period, mirroring the projected decline in grants, in particular external budget grants (Figure 1). The improvement in the current account will be supported by a continuous increase in exports and some import substitution. Under a more favorable scenario, if Afghanistan's potential in the mining industry and in transit trade should be greater than assumed in the baseline, the current account deficit could decline faster in the outer years.

Figure 2. Afghanistan: Current Account Balance Including Grants
(In percent of GDP)



B. External Debt Sustainability Analysis

6. **Following debt relief under the enhanced HIPC initiative and MDRI, Afghanistan's external and public debt burden indicators have improved significantly.** Afghanistan's external public and publicly guaranteed debt amounted to US$1.3 billion, or 8 percent of GDP, in 2010/11. The bulk of this debt was owed to Paris Club and multilateral creditors. In present value terms, it reached about 4 percent of GDP at end-2010/11, or 72 percent of exports. Public external debt service was equivalent to 0.8 percent of exports of goods and services.

7. **The present value of public external debt would gradually increase to about 12 percent of GDP by the end of the projection period under the baseline scenario.** However, the present value of the debt-to-exports ratio is expected to breach the 100 percent threshold in the outer years of the projection period (Figure 3), implying the potential for debt distress. The indicative thresholds for the low-income country (LIC) DSA could be breached toward the end of the projection period.

Table 2. Islamic Republic of Afghanistan: Public and Publicly-Guaranteed External Debt, 2009/10–2015/16

	2009/10	2010/11	2011/12	2012/13	2013/14	2014/15	2015/16
	Act.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.
	(In millions of U.S. dollars)						
Total government external debt 1/	1,146.9	1,279.6	1,454.1	1,678.7	1,908.9	2,147.1	2,390.0
Bilateral creditors	13.6	13.6	13.2	12.7	12.2	11.6	11.0
Of which: Paris Club creditors 2/	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Multilateral creditors	1,133.3	1,263.3	1,441.7	1,692.2	1,911.1	2,129.2	2,349.6
Of which: use of Fund resources	92.4	89.7	111.4	173.3	197.8	216.8	193.8
Service on government external debt	19.8	12.5	14.4	22.2	43.6	66.4	56.2
Of which: to the Fund	1.7	0.1	1.1	6.5	14.9	21.6	23.9
Amortization paid	1.1	1.3	2.6	7.9	26.9	47.2	32.0
Of which: to the Fund	0.0	0.0	0.9	5.9	14.3	21.0	23.2
Interest paid	18.7	11.2	11.8	14.4	16.8	19.2	24.2
Of which: to the Fund	1.7	0.1	0.1	0.5	0.6	0.6	0.6
	(In percent of GDP)						
Total government external debt	9.0	8.0	8.2	8.7	9.2	9.7	10.0
Bilateral creditors	0.1	0.1	0.1	0.1	0.1	0.1	0.0
Of which: Paris Club creditors 2/	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Multilateral creditors	8.9	7.9	8.1	8.8	9.2	9.6	9.8
Of which: use of Fund resources	0.7	0.6	0.6	0.9	1.0	1.0	0.8
Service on government debt	0.2	0.1	0.1	0.1	0.2	0.3	0.2
Amortization	0.0	0.0	0.0	0.0	0.1	0.2	0.1
Interest	0.0	0.0	0.0	0.0	0.0	0.0	0.0

Sources: Country authorities; and staff estimates and projections.

1/ According to the BOP Manual, a debt reorganization operation is considered to be completed and can be fully reflected in the balance of payments only if all preconditions mentioned in agreements are fulfilled. For agreements with the Paris Club, this provision is interpreted flexibly by regarding the signature of the Agreed Minute with the Paris Club as sufficient to treat such an agreement as completed in the BOP. The latter treatment has been followed by the staffs in preparing this Debt Sustainability Analysis.
2/ Excludes Russian claims prior to their regularization via a Paris Club rescheduling.

Alternative Scenarios

8. **Risks to the outlook are heavily on the downside, linked to security prospects, the strength of future reforms, and a deteriorating fiscal outlook.**[7] Should security remain fragile or worsen, economic growth would consequently suffer. Figure 3 presents the results of a customized alternative "lower-growth" scenario, in line with the scenario depicted in, Appendix II of the staff report. The "lower-growth" scenario (A1) depicts the absence of gains in security, governance, and public sector reforms, as well as a slower reform path with respect to financial sector reform and the business environment. A fragile security situation, in combination with delays in key reforms, would potentially discourage investment and external support, and result in lower exports, as well as a slowdown in revenue effort. With the possibility of delays of mining production, revenues from this sector would also suffer. Under this scenario, real GDP growth falls from 2 percent on average (instead of 6 percent in the baseline) in the medium term (2011/12–2015/16) to 1½ percent (instead of 4 percent in the baseline) in the long term (2025/26–2030/31). The present value (PV) of the debt-to-GDP ratio would reach 138 percent by the end of projection period, while the PV of the debt-to-exports ratio would reach 1,239 percent. Under this scenario, the remaining thresholds would also be breached with a significant margin. The second alternative scenario (A2) implies a deterioration of the fiscal outlook with lower resources and use of funds. Under this scenario, Afghanistan would face a rapid deterioration of debt- burden indicators, with the PV of the debt-to-GDP ratio reaching 118 percent and the PV of the debt-to-exports ratio projected at 1,068 percent by the end of the projection period.

9. **Afghanistan remains at high risk of external debt distress.**[8] Given the sustained and large breaches of the thresholds under the alternative scenarios, the staffs of the IMF and World Bank continue to classify Afghanistan as "high risk", based on guidance for debt distress assessments. A mild deterioration in the profile of donor grants even in the baseline could increase the risk of debt distress, further strengthening the rationale for the classification.

C. Fiscal Debt Sustainability

10. **Public debt indicators grow markedly under the baseline (Table 5 and Figure 4).** To enhance the monitoring of the domestic debt burden in the long run, the LIC DSA explicitly includes net domestic financing (NDF) and service obligations on this debt.[9]

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[7] This DSA does not include standard stress tests, as these would not be characterized by additional vulnerabilities.

[8] Afghanistan is classified as a "weak performer" and its thresholds therefore: 30 percent of net present value for the debt-to-GDP ratio; 100 percent of NPV for the debt-to-exports ratio; 200 percent for the debt-to-revenue ratio; 15 percent for the debt service-to-exports ratio; and 25 percent for the debt service-to-revenue ratio.

[9] An interest rate of 5 percent is assumed on NDF.

Security-related expenditure will continue to account for a large share of operating expenditures. The baseline scenario assumes that (i) a value-added tax (VAT) will be introduced in 2014/15; (ii) a national tax and customs administration will be established in order to minimize political interference; (iii) the taxpayers segmentation approach will be strengthened further by enhancing the small, medium and large taxpayers offices; (iv) corruption will be combated by adopting modern business models and IT systems; (v) management will be strengthened to ensure that the reform momentum is maintained and more weight given to strategic planning of tax and customs operations; and (vi) minimal operations and maintenance expenditure (O&M) beyond those already included by the government in the operating budget. While development spending is expected to increase and raise potential GDP, investment will depend on the strength of reforms and a stable environment. In view of strong expenditure pressures expected on the budget, debt service of 6 percent of fiscal revenues by the end of the forecast period (over 2 percent of which is for servicing domestic debt) is of concern. The expansion of domestic debt reinforces the risk of a high debt distress rating.

11. **The alternative scenarios and stress tests demonstrate the fragility of Afghanistan's economy.** Under the scenario with permanently lower GDP growth (A1), debt service reaches about 34 percent of revenues by the end of the forecast period, leaving very limited fiscal space for investments or social expenditure. Risks to the outlook are also linked to revenue potential and grant financing. Figure 4 also presents the results of a customized alternative "lower sources and higher uses" scenario (A2).

12. **The alternative scenarios look at risks to revenue targets and expenditure control.** The "lower sources and higher uses" scenario assumes a reduction in revenues and grants while spending pressures increase. Specifically, the scenario incorporates a one-year delay in the implementation of the VAT as well as a reduction in revenue efficiency due to lagging reforms. This translates into an erosion in total revenue effort of approximately 1 percent of GDP on average over the horizon. At the same time, donors are assumed to disengage at a faster rate, through both on-budget and off-budget grants, with grants leveling off at the same proportion of GDP by 2030/31. To this we add increased operating expenditures from nonsecurity operations and maintenance (O&M) costs due to the takeover of projects and existing capital stocks from donors.[10] Current estimates put these costs in the order of US$900 million in 2011.[11] The customized scenarios highlight the importance of a stable revenue outlook and a level of grants and concessional borrowing in line with baseline projections. The explosive trajectory for expenditures due to O&M costs highlights the need

[10] The O&M costs excluding those that arise from the security sector are also likely to be substantial and are much harder to quantify. See Appendix III: "*Fiscal Survival and Fiscal Sustainability*" of the staff report.

[11] World Bank, forthcoming, "Transition in Afghanistan Looking Beyond 2014," Washington, D.C.

for continued donor involvement, without which the primary balance moves into excessive deficit, triggering significant debt distress.

D. Conclusions

13. **Afghanistan remains at high risk of debt distress after the HIPC completion point and the delivery of debt relief under the MDRI.** Despite the substantial amount of debt forgiven under the HIPC and MDRI,[12] continuing risks to the macroeconomic outlook and large financing needs underscore the importance of substantial and long-term grant financing, in combination with a strong reform agenda and progress in security and governance. Should donors decide to reduce aid rapidly and security fail to stabilize, or structural reforms and governance improvements lag, Afghanistan's debt burden would quickly become unsustainable.

14. **The authorities recognize the risks and are committed to ensuring debt sustainability.** The government is cognizant of its responsibilities, but remains very concerned about the speed of donor withdrawal. Rapid exit by the international community could jeopardize the long-term reform process, which is critical to ensuring a favorable business and investment environment, and would place significant additional pressure on an already constrained pool of resources.

[12] A 100 percent debt forgiveness agreement with the United States in the amount of US$109 million came into effect in September 2010, and the authorities signed a final debt forgiveness agreement with Germany in the amount of US$17 million in January 2011. Saudi Arabia, Iraq, and Croatia also provided 100 percent debt relief. The authorities are still discussing debt restructuring and relief with non-Paris Club creditors, namely Bulgaria, Iran, Kuwait and OPEC.

Table 3.: External Debt Sustainability Framework, Baseline Scenario, 2008-30 1/
(In percent of GDP, unless otherwise indicated)

	Actual			Historical Average 0	Standard Deviation 0	Projections								
	2008	2009	2010			2011	2012	2013	2014	2015	2011-2015 Average	2020	2030	2016-2030 Average
External debt (nominal) 1/	**19.8**	**9.0**	**8.0**			**8.2**	**8.7**	**9.2**	**9.7**	**10.0**		**12.3**	**18.5**	
o/w public and publicly guaranteed (PPG)	19.8	9.0	8.0			8.2	8.7	9.2	9.7	10.0		12.3	18.5	
Change in external debt	-3.1	-10.7	-1.1			0.2	0.5	0.5	0.5	0.3		0.5	0.4	
Identified net debt-creating flows	-7.5	-2.8	-4.3			-2.6	-1.8	-0.8	0.3	0.1		-0.9	-3.4	
Non-interest current account deficit	**-1.0**	**2.7**	**-1.7**	**3.4**	**5.6**	**-0.1**	**1.0**	**2.5**	**4.2**	**4.4**	**2.4**	**3.4**	**-0.7**	1.9
Deficit in balance of goods and services	83.1	70.4	56.4			48.8	45.1	41.9	39.7	37.0		28.4	16.2	
Exports	8.4	6.5	6.0			5.8	6.2	6.3	6.5	6.5		7.8	11.1	
Imports	91.5	76.9	62.4			54.6	51.2	48.2	46.1	43.5		36.2	27.3	
Net current transfers (negative = inflow)	-65.1	-51.1	-43.8	-58.5	15.9	-36.5	-34.2	-31.0	-27.2	-23.6	-30.5	-14.2	-7.4	-12.2
o/w official	-60.5	-48.5	-41.5			-34.4	-32.2	-29.0	-25.3	-21.8		-12.6	-6.2	
Other current account flows (negative = net inflow)	-19.0	-16.6	-14.3			-12.4	-9.9	-8.4	-8.2	-9.0		-10.8	-9.5	
Net FDI (negative = inflow)	**-2.9**	**-2.4**	**-2.1**	**-2.6**	**1.0**	**-2.1**	**-2.3**	**-2.9**	**-3.6**	**-3.8**	**-2.9**	**-3.8**	**-2.3**	-3.0
Endogenous debt dynamics 2/	**-3.7**	**-3.1**	**-0.6**			**-0.4**	**-0.5**	**-0.4**	**-0.3**	**-0.4**		**-0.4**	**-0.5**	
Contribution from nominal interest rate	0.1	0.1	0.0			0.0	0.1	0.1	0.1	0.1		0.2	0.2	
Contribution from real GDP growth	-0.7	-3.5	-0.6			-0.4	-0.5	-0.5	-0.5	-0.6		-0.6	-0.7	
Contribution from price and exchange rate changes	-3.1	0.3	…			…	…	…	…	…		…	…	
Residual (3-4) 3/	**4.4**	**-7.9**	**3.2**			**2.8**	**2.3**	**1.3**	**0.2**	**0.2**		**1.4**	**3.8**	
o/w exceptional financing	0.0	-8.5	0.0			0.0	0.0	0.0	-0.1	-0.1		0.0	0.0	
PV of external debt 4/	...	4.7	4.3			4.6	5.1	5.5	5.9	6.1		7.8	12.5	
In percent of exports	...	71.4	71.7			78.9	82.8	87.3	91.0	93.9		99.8	112.6	
PV of PPG external debt	**...**	**4.7**	**4.3**			**4.6**	**5.1**	**5.5**	**5.9**	**6.1**		**7.8**	**12.5**	
In percent of exports	**...**	**71.4**	**71.7**			**78.9**	**82.8**	**87.3**	**91.0**	**93.9**		**99.8**	**112.6**	
In percent of government revenues	**...**	**45.0**	**39.0**			**40.2**	**45.3**	**47.8**	**43.9**	**42.4**		**49.3**	**66.3**	
Debt service-to-exports ratio (in percent)	**1.2**	**1.9**	**0.8**			**0.8**	**1.2**	**2.5**	**3.7**	**2.7**		**3.8**	**4.6**	
PPG debt service-to-exports ratio (in percent)	**1.2**	**1.9**	**0.8**			**0.8**	**1.2**	**2.5**	**3.6**	**2.7**		**3.8**	**4.6**	
PPG debt service-to-revenue ratio (in percent)	**1.2**	**1.2**	**0.4**			**0.4**	**0.6**	**1.4**	**1.8**	**1.2**		**1.9**	**2.7**	
Total gross financing need (millions of U.S. dollars)	-391.3	45.4	-592.8			-400.6	-237.2	-53.4	195.6	169.0		-50.9	-1,358.7	
Non-interest current account deficit that stabilizes debt ratio	2.1	13.4	-0.6			-0.4	0.5	1.9	3.8	4.1		2.9	-1.1	
Key macroeconomic assumptions														
Real GDP growth (in percent)	3.6	21.0	8.4	9.1	6.3	5.7	7.1	5.8	5.4	6.3	6.1	5.4	4.0	4.6
GDP deflator in US dollar terms (change in percent)	15.6	-1.5	17.7	8.8	6.7	9.0	-0.4	1.3	1.4	1.6	2.6	0.9	1.2	1.1
Effective interest rate (percent) 5/	0.5	0.7	0.5	0.5	0.2	0.5	0.9	1.2	1.4	1.6	1.1	1.5	1.2	1.3
Growth of exports of G&S (US dollar terms, in percent)	38.1	-7.1	17.1	30.1	39.0	12.8	12.4	10.2	9.3	9.0	10.7	9.8	8.8	9.5
Growth of imports of G&S (US dollar terms, in percent)	14.1	0.2	3.6	19.7	26.1	0.9	0.1	0.8	2.3	2.0	1.2	5.9	2.9	2.5
Grant element of new public sector borrowing (in percent)	...	...	38.6	…	...	37.3	36.4	36.7	36.8	39.2	37.3	39.2	39.2	39.2
Government revenues (excluding grants, in percent of GDP)	7.8	10.3	11.0			11.5	11.3	11.6	13.4	14.4		15.8	18.8	17.0
Aid flows (in millions of US dollars) 7/	1,025	1,276	1,782			2,294	2,493	2,670	2,541	2,395		2,354	2,737	
o/w Grants	1,025	1,276	1,746			2,249	2,439	2,610	2,473	2,319		2,220	2,466	
o/w Concessional loans	0.2	0.2	36.0			45.0	54.1	60.5	67.9	76.0		134.1	270.9	
Grant-equivalent financing (in percent of GDP) 8/	...	...	11.3			12.6	12.9	12.8	11.4	10.0		7.1	5.0	6.5
Grant-equivalent financing (in percent of external financing) 8/	...	...	95.6			95.4	94.6	94.6	93.9	94.0		89.9	83.8	87.6
Memorandum items:														
Nominal GDP (millions of US dollars)	10,471	12,481	15,928			18,364	19,603	21,015	22,477	24,273		33,576	55,817	
Nominal dollar GDP growth	19.7	19.2	27.6			15.3	6.7	7.2	7.0	8.0	8.8	6.4	5.3	5.7
PV of PPG external debt (in millions of US dollars)		590	690			819	982	1,142	1,302	1,465		2,578	6,865	
(PVt-PVt-1)/GDPt-1 (in percent)			0.8			0.8	0.9	0.8	0.8	0.7	0.8	0.8	1.0	0.9
Gross remittances (millions of US dollars)	…	…	…			…	…	…	…	…		…	…	
PV of PPG external debt (in percent of GDP + remittances)	...	4.7	4.3			4.6	5.1	5.5	5.9	6.1		7.8	12.5	
PV of PPG external debt (in percent of exports + remittances)	...	71.4	71.7			78.9	82.8	87.3	91.0	93.9		99.8	112.6	
Debt service of PPG external debt (in percent of exports + remittances)	...	1.9	0.8			0.8	1.2	2.5	3.6	2.7		3.8	4.6	

Sources: Country authorities; and staff estimates and projections.

1/ Includes both public and private sector external debt.

2/ Derived as [r - g - ρ(1+g)]/(1+g+ρ+gρ) times previous period debt ratio, with r = nominal interest rate; g = real GDP growth rate, and ρ = growth rate of GDP deflator in U.S. dollar terms.

3/ Includes exceptional financing (i.e., changes in arrears and debt relief); changes in gross foreign assets; and valuation adjustments. For projections also includes contribution from price and exchange rate changes.

4/ Assumes that PV of private sector debt is equivalent to its face value.

5/ Current-year interest payments divided by previous period debt stock.

6/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

7/ Defined as grants, concessional loans, and debt relief.

8/ Grant-equivalent financing includes grants provided directly to the government and through new borrowing (difference between the face value and the PV of new debt).

Table 4a.Afghanistan: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2011-2030
(In percent)

	Projections						
	2011	2012	2013	2014	2015	2020	2030
PV of debt-to GDP ratio							
Baseline	5	5	6	6	6	8	12
A. Alternative Scenarios							
A1. Lower growth	4	5	5	6	7	29	138
A2. Lower sources and use of funds	4	4	5	7	12	56	118
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2012-2013	5	5	6	6	6	8	13
B2. Export value growth at historical average minus one standard deviation in 2012-2013 3/	5	5	5	6	6	8	12
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-2013	5	5	6	6	6	8	13
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-2013 4/	5	4	1	2	2	4	11
B5. Combination of B1-B4 using one-half standard deviation shocks 5/	5	6	4	4	5	6	11
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 6/	6	7	7	8	8	11	17
PV of debt-to-exports ratio							
Baseline	79	83	87	91	94	100	113
A. Alternative Scenarios							
A1. Lower growth	62	74	86	96	102	364	1,239
A2. Lower sources and use of funds	62	69	77	109	179	715	1,068
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2012-2013	76	81	86	90	92	98	111
B2. Export value growth at historical average minus one standard deviation in 2012-2013 3/	79	81	83	87	90	95	108
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-2013	76	81	86	90	92	98	111
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-2013 4/	79	60	19	26	32	55	96
B5. Combination of B1-B4 using one-half standard deviation shocks 5/	79	96	72	80	82	94	114
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 6/	76	81	86	90	92	98	111
PV of debt-to-revenue ratio							
Baseline	40	45	48	44	42	49	66
A. Alternative Scenarios							
A1. Lower growth	31	42	52	61	64	243	1,133
A2. Lower sources and use of funds	31	38	42	60	91	372	621
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2012-2013	40	48	50	46	45	52	70
B2. Export value growth at historical average minus one standard deviation in 2012-2013 3/	40	44	47	43	42	48	65
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-2013	41	46	49	45	43	50	68
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-2013 4/	40	33	10	12	14	27	57
B5. Combination of B1-B4 using one-half standard deviation shocks 5/	40	50	36	33	33	40	58
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 6/	54	61	65	60	58	67	90

Table 4b.Afghanistan: Sensitivity Analysis for Key Indicators of Public and Publicly Guaranteed External Debt, 2011-2030
(In percent)

Debt service-to-exports ratio

Baseline	1	1	2	4	3	4	5
A. Alternative Scenarios							
A1. Lower growth	1	1	3	5	4	33	121
A2. Lower sources and use of funds	1	1	3	7	12	67	104
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2012-2013	1	1	2	4	3	4	5
B2. Export value growth at historical average minus one standard deviation in 2012-2013 3/	1	1	2	4	3	4	4
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-2013	1	1	2	4	3	4	5
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-2013 4/	1	1	2	2	2	3	3
B5. Combination of B1-B4 using one-half standard deviation shocks 5/	1	1	3	3	3	4	4
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 6/	1	1	2	4	3	4	5

Debt service-to-revenue ratio

Baseline	0	1	1	2	1	2	3
A. Alternative Scenarios							
A1. Lower growth	0	1	2	3	2	22	111
A2. Lower sources and use of funds	0	1	2	4	6	35	60
B. Bound Tests							
B1. Real GDP growth at historical average minus one standard deviation in 2012-2013	0	1	1	2	1	2	3
B2. Export value growth at historical average minus one standard deviation in 2012-2013 3/	0	1	1	2	1	2	3
B3. US dollar GDP deflator at historical average minus one standard deviation in 2012-2013	0	1	1	2	1	2	3
B4. Net non-debt creating flows at historical average minus one standard deviation in 2012-2013 4/	0	1	1	1	1	2	2
B5. Combination of B1-B4 using one-half standard deviation shocks 5/	0	1	1	1	1	2	2
B6. One-time 30 percent nominal depreciation relative to the baseline in 2012 6/	1	1	2	2	2	3	4
Memorandum item:							
Grant element assumed on residual financing (i.e., financing required above baseline) 6/	37	37	37	37	37	37	37

Sources: Country authorities; and staff estimates and projections.

1/ Variables include real GDP growth, growth of GDP deflator (in U.S. dollar terms), non-interest current account in percent of GDP, and non-debt creating flows.
2/ Assumes that the interest rate on new borrowing is by 2 percentage points higher than in the baseline., while grace and maturity periods are the same as in the baseline.
3/ Exports values are assumed to remain permanently at the lower level, but the current account as a share of GDP is assumed to return to its baseline level after the shock (implicitly assuming an offsetting adjustment in import levels).
4/ Includes official and private transfers and FDI.
5/ Depreciation is defined as percentage decline in dollar/local currency rate, such that it never exceeds 100 percent. Net current transfers modelled as minus 1.5 times standard deviation.
6/ Applies to all stress scenarios except for A2 (less favorable financing) in which the terms on all new financing are as specified in footnote 2.

Table 5.Afghanistan: Public Sector Debt Sustainability Framework, Baseline Scenario, 2008-30
(In percent of GDP, unless otherwise indicated)

						Projections								
	2008	2009	2010	Average	Standard Deviation	2011	2012	2013	2014	2015	2011-15 Average	2020	2030	2016-30 Average
Public sector debt 1/	19.8	9.0	8.0			8.7	11.2	13.5	14.3	12.1		16.7	29.4	
o/w foreign-currency denominated	19.8	9.0	8.0			8.2	8.7	9.2	9.7	10.0		12.3	18.5	
Change in public sector debt	-3.1	-10.7	-1.1			0.8	2.5	2.2	0.8	-2.2		1.4	0.9	
Identified debt-creating flows	-0.1	-2.1	-2.8			2.8	3.6	2.9	2.1	-0.9		1.6	1.0	
Primary deficit	4.1	1.6	-0.9	1.5	1.8	0.1	1.6	1.6	1.3	1.2	1.2	2.2	1.8	1.9
Revenue and grants	17.5	20.5	22.0			23.7	23.7	24.0	24.4	24.0		22.5	23.2	
of which: grants	9.8	10.2	11.0			12.2	12.4	12.4	11.0	9.6		6.6	4.4	
Primary (noninterest) expenditure	21.7	22.1	21.1			23.8	25.3	25.6	25.8	25.2		24.6	25.0	
Automatic debt dynamics	-3.5	-3.4	-1.9			-0.7	-0.6	-0.6	-0.7	-0.8		-0.5	-0.8	
Contribution from interest rate/growth differential	-1.4	-3.4	-0.8			-0.5	-0.7	-0.7	-0.7	-0.8		-0.7	-0.9	
of which: contribution from average real interest rate	-0.6	0.1	-0.1			-0.1	-0.1	-0.1	0.0	0.0		0.1	0.2	
of which: contribution from real GDP growth	-0.8	-3.4	-0.7			-0.4	-0.6	-0.6	-0.7	-0.8		-0.8	-1.1	
Contribution from real exchange rate depreciation	-2.0	-0.1	-1.1			-0.2	0.0	0.0	0.0	0.0		...	...	
Other identified debt-creating flows	-0.8	-0.2	0.0			3.4	2.6	1.9	1.4	-1.4		0.0	0.0	
Privatization receipts (negative)	-0.8	-0.2	0.0			-0.3	0.0	0.0	0.0	-2.3		0.0	0.0	
Recognition of implicit or contingent liabilities	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Debt relief (HIPC and other)	0.0	0.0	0.0			0.0	0.0	0.0	0.0	0.0		0.0	0.0	
Other (specify, e.g. bank recapitalization)	0.0	0.0	0.0			3.7	2.7	1.9	1.4	1.0		0.0	0.0	
Residual, including asset changes	-3.0	-8.7	1.7			-2.0	-1.1	-0.7	-1.2	-1.3		-0.2	-0.1	
Other Sustainability Indicators														
PV of public sector debt	0.0	4.7	4.3			5.2	7.6	9.8	10.5	8.2		12.2	23.4	
o/w foreign-currency denominated	0.0	4.7	4.3			4.6	5.1	5.5	5.9	6.1		7.8	12.5	
o/w external	...	4.7	4.3			4.6	5.1	5.5	5.9	6.1		7.8	12.5	
PV of contingent liabilities (not included in public sector debt)	...	...	...			...	...	...	...	...		...	...	
Gross financing need 2/	4.1	1.6	-0.9			0.1	2.1	4.1	5.5	5.7		5.8	12.5	
PV of public sector debt-to-revenue and grants ratio (in percent)	0.0	22.6	19.5			21.8	32.2	40.7	43.0	34.3		54.4	100.9	
PV of public sector debt-to-revenue ratio (in percent)	0.0	45.0	39.0			45.0	67.8	84.5	78.3	57.0		77.0	124.7	
o/w external 3/	…	45.0	39.0			40.2	45.3	47.8	43.9	42.4		49.3	66.3	
Debt service-to-revenue and grants ratio (in percent) 4/	0.2	0.1	0.1			-0.1	0.1	0.7	1.3	1.3		2.0	4.5	
Debt service-to-revenue ratio (in percent) 4/	0.4	0.2	0.2			-0.3	0.2	1.4	2.4	2.2		2.9	5.6	
Primary deficit that stabilizes the debt-to-GDP ratio	7.2	12.3	0.2			-0.7	-1.0	-0.6	0.5	3.4		0.8	0.9	
Key macroeconomic and fiscal assumptions														
Real GDP growth (in percent)	3.6	21.0	8.4	4.6	6.3	5.7	7.1	5.8	5.4	6.3	6.1	5.4	4.0	4.6
Average nominal interest rate on forex debt (in percent)	0.5	0.7	0.5	0.5	0.2	0.5	0.9	1.2	1.4	1.6	1.1	1.5	1.2	1.3
Average real interest rate on domestic debt (in percent)	...	...	...	...	...	...	-3.0	-0.6	0.5	1.9	-0.3	5.4	3.5	4.5
Real exchange rate depreciation (in percent, + indicates depreciation)	-9.5	-0.3	-13.1	-7.8	4.5	...	...	...	...	...	...	...	...	...
Inflation rate (GDP deflator, in percent)	18.2	-4.7	9.4	9.1	6.5	11.7	4.8	4.9	4.8	4.7	6.2	4.6	4.0	4.3
Growth of real primary spending (deflated by GDP deflator, in percent)	0.0	0.2	0.0	0.2	0.1	0.2	0.1	0.1	0.1	0.0	0.1	0.1	0.0	0.0
Grant element of new external borrowing (in percent)	...	...	38.6	…	…	37.3	36.4	36.7	36.8	39.2	37.3	39.2	39.2	39.2

Sources: Country authorities; and staff estimates and projections.

1/ [Indicate coverage of public sector, e.g., general government or nonfinancial public sector. Also whether net or gross debt is used.]

2/ Gross financing need is defined as the primary deficit plus debt service plus the stock of short-term debt at the end of the last period.

3/ Revenues excluding grants.

4/ Debt service is defined as the sum of interest and amortization of medium and long-term debt.

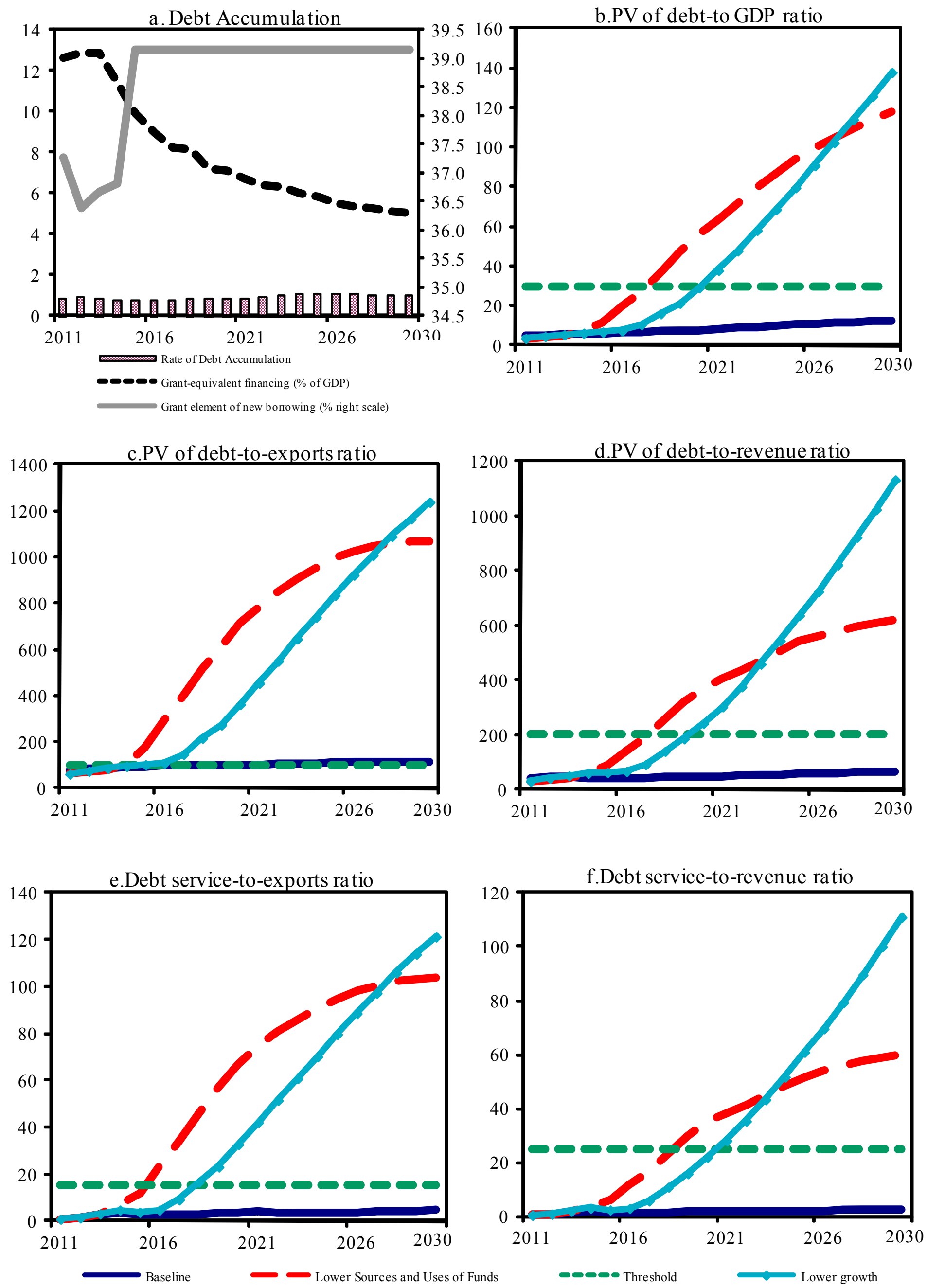
5/ Historical averages and standard deviations are generally derived over the past 10 years, subject to data availability.

Table 6.Afghanistan: Sensitivity Analysis for Key Indicators of Public Debt 2011-30

	Projections						
	2011	2012	2013	2014	2015	2020	2030
PV of Debt-to-GDP Ratio							
Baseline	5	8	10	11	8	12	23
A. Alternative scenarios							
A1. Lower growth	4	8	13	18	20	49	158
A2. Lower sources and use of funds	4	11	17	26	31	76	138
B. Bound tests							
B1. Real GDP growth is at historical average minus one standard deviations in 2012-2013	5	8	10	11	9	14	29
B2. Primary balance is at historical average minus one standard deviations in 2012-2013	8	12	14	15	12	16	28
B3. Combination of B1-B2 using one half standard deviation shocks	5	8	11	12	10	15	29
B4. One-time 30 percent real depreciation in 2012	7	9	11	12	9	13	26
B5. 10 percent of GDP increase in other debt-creating flows in 2012	15	18	20	21	19	24	37
PV of Debt-to-Revenue Ratio							
Baseline	22	32	41	43	34	54	101
A. Alternative scenarios							
A1. Lower growth	18	34	53	65	77	211	759
A2. Lower sources and use of funds	18	45	78	116	138	352	551
B. Bound tests							
B1. Real GDP growth is at historical average minus one standard deviations in 2012-2013	22	33	42	45	37	63	123
B2. Primary balance is at historical average minus one standard deviations in 2012-2013	34	51	59	60	51	72	119
B3. Combination of B1-B2 using one half standard deviation shocks	22	35	46	49	41	67	126
B4. One-time 30 percent real depreciation in 2012	29	39	46	48	39	59	111
B5. 10 percent of GDP increase in other debt-creating flows in 2012	64	74	83	85	78	108	161
Debt Service-to-Revenue Ratio							
Baseline	0	0	1	1	1	2	5
A. Alternative scenarios							
A1. Lower growth	0	0	1	2	2	8	34
A2. Lower sources and use of funds	0	0	1	3	4	13	25
B. Bound tests							
B1. Real GDP growth is at historical average minus one standard deviations in 2012-2013	0	0	1	2	2	3	7
B2. Primary balance is at historical average minus one standard deviations in 2012-2013	0	1	2	3	3	4	7
B3. Combination of B1-B2 using one half standard deviation shocks	0	0	1	2	2	3	7
B4. One-time 30 percent real depreciation in 2012	0	1	1	2	2	4	8
B5. 10 percent of GDP increase in other debt-creating flows in 2012	0	3	4	5	5	6	12

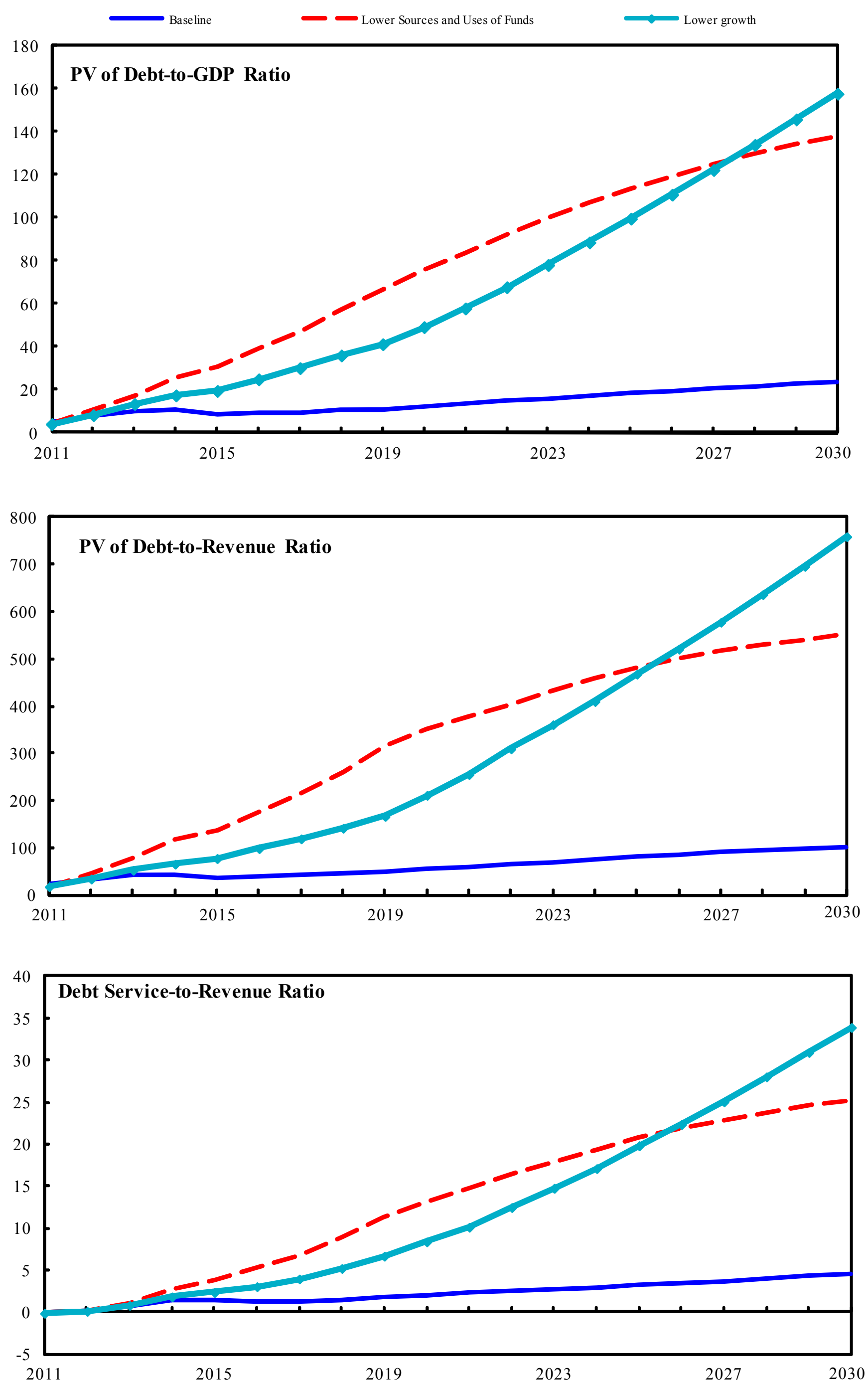
Sources: Country authorities; and staff estimates and projections.
1/ Assumes that real GDP growth is at baseline minus one standard deviation divided by the square root of the length of the projection period.
2/ Revenues are defined inclusive of grants.

Figure 3. Afghanistan: Indicators of Public and Publicly Guaranteed External Debt under Alternative Scenarios, 2011-30



Sources: Country authorities; and Fund staff estimates and projections.

Figure 4. Afghanistan: Indicators of Public Debt Under Alternative Scenarios, 2011-30 1/



Sources: Country authorities; and Fund staff estimates and projections.
1/ Revenues are defined inclusive of grants.

Statement by the IMF Staff Representative on the Islamic Republic of Afghanistan
November 14, 2011

This statement updates Directors on the status of the two remaining prior actions: (1) a strategy to enforce Afghan laws in relation to crimes committed at Kabul Bank; and (2) finalizing legally binding agreements with Kabul Bank shareholders. The first prior action has been completed, but the second is partially completed. Staff believes that the partial completion of the second prior action is regrettable, but considers that progress is sufficient to allow the Fund to move forward with a program. Staff will continue to monitor closely the status of asset recovery, and this would be a focus of the first review under the proposed program. These developments do affect the staff assessment.

Strategy to enforce Afghan laws in relation to any financial crimes committed at Kabul Bank—*completed on November 3, 2011*.

1. The Attorney General made a statement "On Progress in Prosecution of Economic Crimes in Afghanistan and Development of [an] Economic Crimes Strategy" on October 19, 2011. It was published on the internet at http://ago.gov.af/en/page/4811 on November 3, 2011.

2. The statement elaborates the government's two overarching objectives of punishing any violation of Afghan laws and maximizing asset recovery, and explains how these two considerations are being balanced. For example, the two main shareholders have been taken into custody, but are being periodically released under close supervision to facilitate asset recovery. The authorities have stated their intent to enforce Afghan laws regarding any criminal wrongdoing, and are in the process of completing their investigations and preparing the legal cases. In the coming year, the government also intends to review the systemic failures that led to the Kabul Bank collapse, develop a comprehensive strategy to improve institutional structures, and build capacity to prevent and promptly respond to economic crimes.

Finalize legally binding agreements with cooperating Kabul Bank shareholders for the repayment of the full amounts attributed to them as of date, and identifying collateral and cash repayments to be made—*partially completed as of November 9, 2011*.

3. Since the staff report was finalized, staff has reviewed individual agreements which the authorities have made available to document the progress they have made on asset recovery under this prior action. This review has revealed some weaknesses in the agreements, which led staff to conclude that the prior action was met only partially.

4. To date, the authorities have signed 21 agreements with eight former Kabul Bank shareholders and related parties over repayment of US$270 million out of US$935 million in total assets sought for recovery.[1] In addition, they have US$153 million in ceded assets available for sale outside such agreements.[2] The remainder is largely still disputed between the receiver and the ultimate beneficiaries.

- *Legally binding nature:* The authorities have assured staff that these agreements are legally binding in Afghanistan, noting that US$36 million in payments under these agreements have been received through end-October.[3] Staff confirms that the agreements reviewed thus far include the key elements one would generally expect to see in a legally binding document: the parties involved, the date of agreement, an acknowledgement of amounts owed, the interest rate, and a reference to a repayment schedule. However, in terms of specificity, the overall quality of the agreements appears to fall short of what one might see in other jurisdictions. The enforceability of the agreements through the courts has yet to be tested, and there is a risk that individuals may default on their payments in the future.
- *Cooperating shareholders:* Staff notes that one of the main shareholders allegedly responsible for a majority of the alleged fraud has thus far shown only limited cooperation and has not yet agreed to sign any agreements himself until amounts attributable to him are established. Two other former shareholders are also not cooperating and have not signed agreements.
- *Amounts attributed:* The agreements cover the full amounts attributed to the cooperating shareholders and related parties with one exception.[4] The authorities acknowledge that the amounts in some of the agreements may need to be revised once the final report of the forensic audit is available; the report is expected to provide substantiated information on the amounts attributed to the individuals. In this regard, it is understood that these repayment agreements do not preclude attribution of additional amounts owed.
- *Collateral and repayment schedule:* While the level of specificity varies across the agreements, the agreements purport to pledge collateral and establish cash installment repayment schedules. In this regard, most of the agreements refer to collateral in general terms, and only some identify specific assets. The receiver is working with

[1] Kabul Bank had 16 shareholders of which 11 have allegedly benefited from the fraud.

[2] These assets include real estate in Afghanistan and Dubai.

[3] In addition, debt service payments on regular Kabul Bank loans have been made, and a total of US$75 million has been received in cash as reported in the MEFP.

[4] In one instance, the agreement is for a lower amount than what is attributed to the party because the authorities believe that if they had insisted on the full amount, the party would have had to declare bankruptcy.

the individuals to identify specific assets that can serve as collateral and estimate their market value. Moreover, the agreements also include a provision that the receiver can take recourse to all of the signing parties' assets if those already identified cannot cover the amounts owed.

5. It should also be noted that the authorities have not precluded asset recovery through the criminal justice system and mutual legal assistance from other countries. They have specifically asked a reputable international audit firm help them with this, as well as with a global asset trace. They have also sought dedicated training in this regard from the World Bank, and have discussed asset recovery via the criminal justice system with Fund staff since September 2010.

Staff Appraisal

Staff views the prior action on legally binding agreements as being partially met, mainly because the collateral is not always fully specified, and at least in one instance a lower amount than what is believed to be the case has been attributed. While this is regrettable, staff notes that the authorities have made significant progress to date, while disentangling the fraudulent loan book has turned out to be more challenging than initially anticipated. The authorities' next steps will have to be informed by the outcome of the ongoing forensic audit which should be finalized by March 2012. It is expected that the audit results could lead to upward revisions of some agreements, though downward revisions cannot be ruled out. Staff will continue to monitor closely the status of asset recovery from Kabul Bank shareholders and related parties, including finalizing legally binding agreements and cash recoveries. Progress on these two areas would be a focus of the first review under the proposed program.

INTERNATIONAL MONETARY FUND
Public Information Notice
EXTERNAL
RELATIONS
DEPARTMENT

Public Information Notice (PIN) No. 11/140
FOR IMMEDIATE RELEASE
November 16, 2011

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2011 Article IV Consultation with Afghanistan

On November 14, 2011, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation with Afghanistan.[1]

Background

Afghanistan has made important achievements in recent years. The authorities have taken steps to lay the foundation for economic stability and growth, despite a very difficult security situation and the challenges associated with building political and economic institutions. As a result, economic activity has been robust, with real GDP growth averaging more than 10 percent annually over the last five years (8 percent in 2010/11). The government has increased revenue collection to 11 percent of GDP in 2010/11 from 8 percent in 2008/09. Still, current collection levels cover only about two-thirds of central government operating expenditures and less than 20 percent of total public spending (defined as central government spending plus off-budget donor spending). Headline and core inflation have moderated slightly, but remain relatively high at about 10 percent year-on-year in September.

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[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board. At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Last year's crisis at Kabul Bank, the largest bank in Afghanistan, exposed the country's serious governance problems, and highlighted the devastating effects of endemic corruption. The initial intervention by the central bank and the government's decision to provide a full deposit guarantee prevented a full-blown banking crisis. However, the subsequent crisis management was slow, and somewhat reluctant to tackle some important but politically difficult issues such as asset recovery and filing charges against the main architects of the fraud. As a result, the financial system has been severely weakened and is not playing its role in facilitating private sector led growth.

Over the coming three to five years, Afghanistan will face additional challenges as the international military presence is wound down and the government has to take over spending currently financed by donors. Foreign troops are expected to gradually withdraw by 2014. As a result, Afghanistan's security forces will have to take over more responsibility, leading to higher spending. At the same time, the government may lose revenues related to spending by foreign troops in Afghanistan. Moreover, it is likely that total grants decline from an estimated over 40 percent of GDP in 2010/11 to less than 30 percent of GDP in 2013/14.

These developments will weigh heavily on economic activity and require difficult decisions. Fiscal policy will need to accommodate growing spending pressures, while domestic revenue is likely to be adversely affected, the future level of budget grants is uncertain, and Afghanistan has limited scope for foreign borrowing. Therefore, the government will struggle to make ends meet in the near term. Moreover, the withdrawal of the international presence will entail lower foreign inflows that will require external adjustment, initially through competitiveness gains.

In this context, making quick progress towards Afghanistan's social and development objectives will be challenging. Afghanistan remains one of the poorest countries in the world, with a per-capita income of US$530 in 2010/11 and a national poverty rate of 36 percent in 2007/08. The authorities have made inroads toward achieving some of the Millennium Development Goals. For example, child mortality was reduced and school enrollment increased, albeit from very low levels—the enrollment rate for primary schools is less than 40 percent. At the same time, the authorities also acknowledge that achievements in some areas are below expectations: more than 40 percent of children under the age of five are underweight; progress in increasing access to potable water and sanitation remains slow; and the literacy rates for men and women aged 15 to 24 are 51 and 22 percent respectively. Overall, the low execution rate of only 40 percent of the development budget reflects a generally limited absorption capacity, and impedes more rapid progress toward poverty reduction.

Executive Board Assessment

Executive Directors commended the authorities for the important achievements in recent years, despite the difficult political and security environment. Economic growth has been strong, the fiscal position has improved, inflation has remained moderate until recently, and the central bank has built up international reserves. There has also been improvement in some poverty indicators.

Directors agreed that the Extended Credit Facility (ECF)-supported program, accompanied by a technical assistance agenda, provides an appropriate framework for addressing the considerable challenges lying ahead, and a basis for continued engagement with the donor community. They highlighted in particular the importance of enhancing financial sector stability, strengthening revenue performance and expenditure management, improving the business environment, and reducing poverty. Noting the significant risks to the program, Directors stressed that strong commitment and ownership by the authorities of the program will be paramount.

Directors acknowledged the initial actions taken by the authorities to contain the crisis at Kabul Bank. However, subsequent efforts to manage the crisis have been slow. Directors urged the authorities to step up efforts in the areas of asset recovery, and ensure that banking regulations and relevant laws are fully enforced, including by bringing charges against the architects of the fraud. They stressed the importance of fully meeting the relevant prior action before the first review under the program. Directors also urged the authorities to press ahead with efforts to strengthen financial sector supervision and the overall legal and regulatory framework, including the Anti Money Laundering/Combating the Financing of Terrorism (AML/CFT) framework. Restoring confidence in the banking system will be important for Afghanistan’s economic development in the upcoming transition period.

Directors noted that the planned withdrawal of foreign troops and the expected gradual decline of donor support will have implications for growth, external adjustment, and the fiscal position, which will need to be managed carefully. While welcoming the progress on revenue generation, Directors encouraged the authorities to aim for more ambitious targets to ensure fiscal and debt sustainability. Expediting the introduction of the Value Added Tax (VAT), improving revenue administration, and consideration of additional measures if needed would be important steps in this regard. On the expenditure side, public financial management reforms will ensure effective prioritization of spending, especially pro-poor spending.

Directors welcomed the authorities’ intention to tighten monetary policy to address inflation concerns. For monetary policy to be effective, they encouraged the authorities to enhance the independence of the central bank and reach an agreement on the capital requirement of the bank.

Directors stressed that significantly enhancing governance and taking wide-ranging measures to combat corruption and address the illicit economy are critical for Afghanistan’s economic development. They urged the authorities to implement reforms to improve the business environment, while maintaining a policy focus on inclusive growth and poverty reduction. Addressing delays in public enterprise reform and developing a framework to fully realize the potential from mineral resources will also be important.

Public Information Notices (PINs) form part of the IMF's efforts to promote transparency of the IMF's views and analysis of economic developments and policies. With the consent of the country (or countries) concerned, PINs are issued after Executive Board discussions of Article IV consultations with member countries, of its surveillance of developments at the regional level, of post-program monitoring, and of ex post assessments of member countries with longer-term program engagements. PINs are also issued after Executive Board discussions of general policy matters, unless otherwise decided by the Executive Board in a particular case.

Islamic Republic of Afghanistan: Selected Economic Indicators, 2006/07–2011/12

(Population: approx. 30 million; 2010/11)

(Per capita GDP: US$530; 2010/11)

(Poverty rate: 36 percent; 2007/08)

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12
					Prel.	Proj.
Output and prices[1]	(Annual percentage change, unless otherwise indicated)					
Real GDP	5.6	13.7	3.6	21.0	8.4	5.7
Nominal GDP (in billions of U.S. dollars)	7.1	8.7	10.5	12.5	15.9	18.4
Consumer prices (period average) [2]	5.1	13.0	26.8	-12.2	7.7	10.5
Public finances						
Domestic revenues and grants	18.3	19.9	17.5	20.5	22.0	23.7
Domestic revenues	8.2	7.7	7.8	10.3	11.0	11.5
Grants	10.2	12.3	9.8	10.2	11.0	12.2
Expenditures	21.5	22.0	21.7	22.1	21.1	23.8
Operating[3]	12.3	11.6	13.1	14.5	15.1	17.6
Development	9.2	10.3	8.6	7.6	5.9	6.2
Overall balance (including grants)	-3.1	-2.0	-4.1	-1.6	0.9	0.0
Operating balance (excluding grants)[4]	-4.2	-4.0	-5.3	-4.2	-4.1	-6.1
Monetary sector	(Annual percentage change, unless otherwise indicated)					
Reserve money	22.3	14.4	64.9	17.1	21.3	18.8
Broad money	...	31.0	35.9	39.3	22.6	18.3
External sector[1]	(In percent of GDP, unless otherwise indicated)					
Exports of goods (in U.S. dollars, percentage change) [5]	1.4	1.8	33.0	2.1	12.7	2.5
Imports of goods (in U.S. dollars, percentage change)	10.0	15.6	14.8	-0.8	3.0	0.4
Current account balance						
Excluding official transfers	-71.1	-68.1	-59.6	-51.3	-39.8	-34.3
Including official transfers	-5.6	1.3	0.9	-2.8	1.7	0.1
Foreign direct investment	2.7	2.8	2.9	2.4	2.1	2.1
Total external debt[6]	169.6	23.0	19.7	9.2	8.0	7.9
Gross international reserves (in millions of U.S. dollars)	2,040	2,784	3,591	4,209	5,321	6,121
(Import coverage)[7]	3.4	4.1	5.3	6.0	7.4	8.4
Afghanis per U.S. dollar (average)	49.9	49.8	51.0	49.3	45.8	...
Memorandum items:						
Opium production (in tons)	6,100	8,200	7,700	6,900	3,600	...
External budget grants[8]	55.4	57.4	49.3	39.9	30.5	22.1

Source: Afghan authorities; United Nations Office on Drugs and Crime; and IMFstaff estimates and projections.

[1] Excluding the narcotics economy.
[2] For Kabul only.
[3] Comprising mainly current spending.
[4] Defined as domestic revenues minus operating expenditures.
[5] Includes official recorded exports, estimates of smuggling, reexports and sales to nonresidents.
[6] After debt relief.
[7] Gross reserves in months of next year's imports of goods and services, excluding imports for reexport.
[8] Estimated direct expenditures by donors on public projects not included in the government budget.

Press Release No. 11/412
FOR IMMEDIATE RELEASE
November 15, 2011

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Approves US$133.6 Million Arrangement Under the Extended Credit Facility for the Islamic Republic of Afghanistan

The Executive Board of the International Monetary Fund (IMF) today approved a three year, SDR 85 million (about US$133.6 million) arrangement under the Extended Credit Facility (ECF) for Afghanistan which is designed to support the nation's economic program from 2011 to 2014. The approval will immediately enable an initial disbursement of an amount equivalent to SDR 12 million (about US$18.9 million).

The IMF-supported economic program's key objectives are to make significant progress toward a stable and sustainable macroeconomic position while managing the challenges of the withdrawal of the international presence in Afghanistan; strengthening the banking system and addressing the governance and accountability issues highlighted by the Kabul Bank crisis; moving toward fiscal sustainability; and improving the transparency and efficiency of public spending and services to protect the poor.

Following the Executive Board's discussion of Afghanistan, Ms. Nemat Shafik, Deputy Managing Director and Acting Chair, said:

"Despite a difficult political and security situation, Afghanistan has made important achievements in recent years. Growth has averaged over 10 percent in the last five years, inflation was moderate, and domestic revenues increased by 3 percent of GDP.

"After the collapse of Kabul Bank, the authorities took action to contain the situation and prevent a broader financial meltdown, including providing a full deposit guarantee. Since then, Kabul Bank was split into a good bank and a bad bank, and an in-depth audit is under way to establish who benefited from the fraudulent activities. Asset recovery and legal actions against the architects of the fraud have lagged and need to be pursued more forcefully. It is important that the relevant prior action is fully met before the first review of the program.

"Over the next three to five years, the withdrawal of the international military presence and an expected decline in foreign aid will pose significant economic policy challenges. The government will have to take over activities currently financed by donors, including shouldering a larger share of security spending. Thus, while donor support is projected to remain substantial, the expected gradual decline will curtail the fiscal space and require external adjustment.

"The authorities' three-year program, supported by the Fund's Extended Credit Facility, will help address these short and medium-term challenges and provide the basis for sustained inclusive growth and poverty reduction in line with Afghanistan's National Development Strategy. It is important that the authorities accelerate measures to enhance governance, including strengthening the banking law and financial sector supervision, as well as the framework for anti-money laundering and combating the financing of terrorism. They are also encouraged to be more ambitious on domestic revenue mobilization, which may require measures in addition to the planned revenue administration reforms and the introduction of a value-added tax in 2014."

ANNEX

Recent Economic Developments

The authorities have taken steps to lay the foundation for economic stability and growth, despite a very difficult security situation and the challenges associated with building political and economic institutions. As a result, economic activity has been robust, with real GDP growth averaging more than 10 percent annually over the past five years. The government has increased revenue collection to 11 percent of GDP in 2010/11 from 8 percent in 2008/09, though current collection levels cover only about two-thirds of central government operating expenditures.

Some poverty indicators have improved over the last decade, but Afghanistan remains one of the poorest countries in the world. Per-capita income was US$530 in 2010/11. The national poverty rate was 36 percent in 2007/08, as measured by the National Risk and Vulnerability Assessment, and the rates are higher in rural and mountainous areas that account for about 80 percent of the population.

Program Summary

Stabilizing the economy. Despite an expected decline in overall donor assistance, the authorities' goal is to sustain annual real GDP growth at about 6–7 percent over the next three years, supported by an expansion in the nonagricultural sector and mining investment. Cognizant of the negative effects of inflation, particularly on the poor, the authorities also plan to strive to bring inflation down. Sustained donor funding and a stable economy will support the balance of payments and provide the basis for high and inclusive growth.

Strengthening the banking and financial sectors. The authorities have designed and started implementing a comprehensive strategy to strengthen the banking system, to lower fiscal costs associated with Kabul Bank's failure, and to address governance issues. This strategy includes resolving Kabul Bank, drawing lessons from its failure, promoting transparency, governance and the framework for protecting the financial system from economic crime, as well as addressing moral hazard, and strengthening banking supervision and safeguarding a financial system based on integrity and the rule of law.

Moving toward fiscal sustainability. Fiscal sustainability will depend on sustained increases in revenues together with prioritized spending reflecting development and security priorities. The program envisages an increase in domestic revenues of 0.6 percent of GDP in the next three years. Looking beyond the program period, the planned introduction of a VAT in March 2014 is expected to raise an additional 2 percent of GDP, and the authorities are aiming for a revenue-to-GDP ratio of about 16 percent of GDP by 2017/18.

Prioritizing development spending. In line with the the government's Afghanistan National Development Strategy (ANDS), which aims at improving the delivery of government services, aligning foreign development assistance with Afghanistan's national priorities, and channeling more resources through the budget. In particular, although it will be necessary to allocate increasing amounts of spending to security, adequate resources will be allocated to help the poor.

Islamic Republic of Afghanistan: Selected Economic Indicators, 2006/07–2013/14
(Population: approx. 30 million; 2010/11)
(Per capita GDP: US$530; 2010/11)
(Poverty rate: 36 percent; 2007/08)
(Main export: dried fruit, US$210 million; 2009/10)

	2006/07	2007/08	2008/09	2009/10	2010/11	2011/12	2012/13	2013/14
					Prel.	Projection		
Output and prices [1]	(Annual percentage change, unless otherwise indicated)							
Real GDP	5.6	13.7	3.6	21.0	8.4	5.7	7.1	5.8
Nominal GDP (in billions of U.S. dollars)	7.1	8.7	10.5	12.5	15.9	18.4	19.6	21.0
Consumer prices (period average) [2]	5.1	13.0	26.8	-12.2	7.7	10.5	4.6	5.0
Public finances								
Domestic revenues and grants	18.3	19.9	17.5	20.5	22.0	23.7	23.7	24.0
Domestic revenues	8.2	7.7	7.8	10.3	11.0	11.5	11.3	11.6
Grants	10.2	12.3	9.8	10.2	11.0	12.2	12.4	12.4
Expenditures	21.5	22.0	21.7	22.1	21.1	23.8	25.3	25.7
Operating [3]	12.3	11.6	13.1	14.5	15.1	17.6	18.6	18.7
Development	9.2	10.3	8.6	7.6	5.9	6.2	6.6	7.0
Overall balance (including grants)	-3.1	-2.0	-4.1	-1.6	0.9	0.0	-1.6	-1.7
Operating balance (excluding grants) [4]	-4.2	-4.0	-5.3	-4.2	-4.1	-6.1	-7.4	-7.1
Monetary sector	(Annual percentage change, unless otherwise indicated)							
Reserve money	22.3	14.4	64.9	17.1	21.3	18.8	17.1	16.2
Broad money	...	31.0	35.9	39.3	22.6	18.3	15.1	17.1
External sector [1]	(In percent of GDP, unless otherwise indicated)							
Exports of goods								
(in U.S. dollars, percentage change) [5]	1.4	1.8	33.0	2.1	12.7	2.5	-8.8	-3.4
Imports of goods								
(in U.S. dollars, percentage change)	10.0	15.6	14.8	-0.8	3.0	0.4	0.0	0.6
Merchandise trade balance	-69.7	-67.9	-61.9	-50.9	-39.6	-34.1	-33.3	-31.7
Current account balance								
Excluding official transfers	-71.1	-68.1	-59.6	-51.3	-39.8	-34.3	-33.2	-31.5
Including official transfers	-5.6	1.3	0.9	-2.8	1.7	0.1	-1.1	-2.6
Foreign direct investment	2.7	2.8	2.9	2.4	2.1	2.1	2.3	2.9
Total external debt [6]	169.6	23.0	19.7	9.2	8.0	7.9	8.6	9.1
Gross international reserves								
(in millions of U.S. dollars)	2,040	2,784	3,591	4,209	5,321	6,121	6,627	7,178
(Import coverage) [7]	3.4	4.1	5.3	6.0	7.4	8.4	9.0	9.5
Afghanis per U.S. dollar (average)	49.9	49.8	51.0	49.3	45.8	...	...	...
Memorandum items:								
Opium production (in tons)	6,100	8,200	7,700	6,900	3,600	...	...	...
External budget grants [8]	55.4	57.4	49.3	39.9	30.5	22.1	19.7	16.5

Source: Afghan authorities; United Nations Office on Drugs and Crime; and Fund staff estimates and projections.

[1] Excluding the narcotics economy.
[2] For Kabul only.
[3] Comprising mainly current spending.
[4] Defined as domestic revenues plus operating budget grants minus operating expenditures.
[5] Includes official recorded exports, estimates of smuggling, reexports and sales to nonresidents.
[6] After debt relief.
[7] Gross reserves in months of next year's imports of goods and services, excluding imports for reexport.
[8] Estimated direct expenditures by donors on public projects not included in the government budget.

Statement by Mr. Jafar Mojarrad, Executive Director for Islamic Republic of Afghanistan and Mr. Abdelali Jbili, Advisor To Executive Director

November 14, 2011

On behalf of our Afghan authorities, we thank management and staff for their unrelenting efforts to bring this program to the Board, which will pave the way for Afghanistan to make further progress in implementing its stabilization and structural reform strategy with the needed support from the international community. Staff dedication and hard work have been instrumental in helping the authorities deal with the difficulties caused by the near collapse of Kabul Bank and the critical need to strengthen the financial system. The authorities have now taken key measures to address the Kabul Bank crisis, identify and address the remaining risks to the financial system, and are determined to vigorously pursue Afghanistan's stabilization and development objectives, even though the anticipated withdrawal of foreign troops and decline in grants will make their task more challenging.

Building on the achievements in recent years, the authorities have developed a medium-term program for which they have requested Fund support under a successor Extended Credit Facility (ECF) arrangement. The reform agenda will seek to strengthen the foundations of growth and poverty reduction in line with the objectives set out in the Afghanistan National Development Strategy (ANDS), while preparing to manage the impact of reduced international presence in Afghanistan. Implementation of all prior actions, despite the many hurdles involved, attests to the authorities' determination in this regard.

Recent developments

Afghanistan has made important progress toward achieving its development and poverty reduction objectives. The economy has been growing by 10 percent on average since 2006/07, with non-agriculture sectors exhibiting strong performance; per-capita GDP has doubled since 2005/06; inflation declined significantly during the past two years, although it has picked up in 2010/11 in part due to higher international food and fuel prices; and some key poverty indicators have improved: child mortality has decreased, and school enrollment has increased, in particular for females. These achievements, which are detailed in the staff report and the Memorandum of Economic and Financial Policies (MEFP), must be seen against the difficult and deteriorating security situation and the volatile global and regional environment. This progress notwithstanding, further reducing poverty which is unacceptably high, while achieving security and ensuring macroeconomic stability and fiscal sustainability in an environment conducive to private sector-led growth, remains central to the authorities' program.

Fiscal performance improved in 2010/11, including from continued progress in revenue mobilization and public financial management (¶ 7.MEFP). Building on the tax measures and administrative reforms introduced earlier, domestic revenue increased by 3.2 percent of GDP since 2008/09, and has remained buoyant, as evidenced by the 25 percent increase in revenue collection during the first half of 2011/12. Tight control on non-security spending has been maintained, thereby keeping the lid on the operating budget deficit despite implementation of necessary pay and grading reforms and hiring of new teachers. However, while spending on security has increased, development spending has been on a downward trend since 2008/09, reflecting difficulty with some donors in reallocating funding, the deteriorating security situation, and under-execution mainly related to capacity constraints in line ministries.

The impact of the Kabul Bank crisis on financial sector development has been contained. The staff report covers how the Kabul Bank crisis unfolded and rightly points to the rapid growth in banking services in an environment of nascent regulation and supervision as a key contributing factor (Boxes 3 and 4). Recognizing the risks to the stability of the financial system, the authorities moved decisively on several fronts to contain a run on Kabul Bank and prevent a run on other banks by guaranteeing bank deposits and putting Kabul Bank into conservatorship. Subsequently, the authorities placed Kabul Bank into receivership, which resulted in the revocation of all shareholders' rights and the extinction of their interests in the bank. The major shareholders were removed from management of this and other banks. In addition, a comprehensive forensic audit of Kabul Bank by an independent, internationally recognized firm commenced in June 2011.

Despite the magnitude of the crisis, critical banking transactions were never disrupted. Payment of government wages and salaries in particular continued without interruption. While the immediate aftermath of the crisis saw a withdrawal of funds from the banking system as a whole, much of it has been reversed. The central bank extended a lender-of-last resort facility to repay Kabul Bank depositors, which was subsequently made up through recapitalization of the central bank by the government. Further progress is underway in resolving the crisis by splitting Kabul Bank into a good bank (the New Kabul Bank) and a bad bank, as highlighted in Box 3, accelerating the recovery of assets, and preparing the New Kabul Bank for privatization.

Medium-term outlook

The medium-term outlook hinges on a wide range of factors and risks. Steadfast implementation of reforms, together with improved security and regional stability and cooperation, would support investment and growth, including in the promising mining sector. Conversely, the withdrawal of international presence in Afghanistan and a possible decline in donor support are likely to curb growth and adversely affect macroeconomic stability, as highlighted in the staff scenarios (Appendix II). While it is difficult to know at this stage how these factors will play out, the authorities are firmly determined to act on the factors that are under their control, namely continue to increase domestic revenue, to implement their strategy under the ANDS and the proposed program supported by the ECF arrangement, while seeking to manage the downside risks. They look forward to the forthcoming Bonn Conference in December 2011, which is expected to establish the economic parameters for Afghanistan's transition.

Debt sustainability

Following debt relief under the HIPC initiative and MDRI, the updated DSA concludes that while debt burden indicators will improve over the near term, the risk of external debt distress remains high, potentially stemming from financing with loans instead of grants, and the withdrawal of large-scale foreign presence and increased domestically-financed security expenditures that would reduce available resources for investment and growth. The authorities agree with these findings and will rely primarily on grants to finance development spending while increasing the share of domestic resources in the financing of operating budget expenditure. They will also sustain their broad-based reform agenda, as envisaged under the ANDS.

The economic program for 2011/12-2013/14

Growth and poverty reduction

The program aims at anchoring growth and poverty reduction objectives in macroeconomic stability while strengthening the financial system and better preparing the transition to the withdrawal of foreign presence in Afghanistan. The economy is expected to grow at about 6–7 percent in 2011/12, underpinned by an expansion in the non-agricultural sector and mining investment. High priority will continue to be given to pro-poor spending, which is expected to account for 25 percent of non-security operating spending in 2011/12.

Fiscal policies

The program aims at further strengthening domestic revenue collection, aligning expenditure with the ANDS priorities, gradually integrating externally-financed operating expenditure in the national budget, and further improving fiscal management, accountability, and good governance. A broad range of fiscal measures aimed at moving toward fiscal sustainability are planned. Domestic revenue is to increase by 0.6 percent of GDP over the program period, underpinned by sustained efforts to improve tax administration and ongoing implementation of a business model of border customs control that would improve collection and reduce the opportunities for corruption. Even though the envisaged improvement in revenue over the program has already been achieved this year, the authorities are working towards ensuring that revenue performance will be better than programmed.

The authorities also plan to launch a major tax reform with Fund technical assistance, including the introduction of a VAT by March 2014, which would raise additional revenue, estimated at 2 percent of GDP. Moreover, development of the mining sector is expected to boost revenue, and the authorities are preparing a strong and transparent fiscal regime in this area with assistance from the World Bank and the IMF. This, together with further steps to enhance the efficiency of tax administration, would help achieve the authorities' goal of bringing domestic revenue to 15.6 percent of GDP by 2017/18.

The planned security transition and gradual takeover of operations and maintenance of capital projects will put pressure on spending plans, which must also accommodate the need to increase wages to attract better qualified staff and pro-poor expenditure. Stepped up efforts will be made to strengthen public financial management, by implementing the Public Financial Management Road Map, with a particular focus on budget preparation and execution, and increased transparency and accountability, as highlighted in the MEFP. The expected channeling of an increasing share of donor support through the budget, and development of a government securities market, should ease financing constraints and budget implementation.

Monetary and financial sector policies

The authorities will seek to reduce inflation to about 4 to 6 percent in 2011/12. In an effort to enhance effectiveness of monetary policy, the central bank started in 2010 using reserve money as its operational target, while maintaining a flexible exchange rate system that allows the rate to reflect market fundamentals. Further efforts will aim at improving banks' liquidity management and developing the secondary market for the central bank's Capital Notes to facilitate the conduct of open market operations, pending issuance of government securities (sukuks).

The authorities are moving forward to complete the resolution of Kabul Bank. As detailed in the MEFP and the Banking System Action Plan (Table 3), New Kabul Bank will be put up for sale by June 2012, or if the sale does not materialize, be downsized and merged into other financial institutions, or liquidated. Asset recovery continues to be vigorously pursued and evidence of wrongdoing has and will be referred to law enforcement authorities.

Drawing lessons from this crisis, the authorities' strategy seeks to strengthen the supervision of the financial system. Wide ranging efforts are being carried out to identify vulnerabilities in the banking system, including through onsite inspections and audits by internationally reputable firms. An onsite inspection and audit of another large bank are being carried out and actions have been taken to strengthen the bank's capital, reduce its large exposure, and address conflict-of-interest issues. Moreover, the central bank is strengthening bank supervision and reinforcing the regulatory framework (¶ 30 and 31 of the MEFP). Efforts to improve governance will be stepped up by strengthening the banking law, encouraging consolidation of small banks, and upgrading the provisions on corporate governance, large exposure, and consolidated supervision.

AML/CFT

The authorities are committed to strengthening their AML/CFT regime, as part of their broader efforts to rid the economy of corruption, drug trafficking, and the financing of terrorism. An action plan based on the recommendations of the February 2011 assessment will be implemented; amendments to the AML/CFT legislation will be submitted to parliament; and the capacity of the financial intelligence unit will be strengthened.

Public enterprises

The authorities will move forward in implementing the restructuring plans of the four largest state-owned enterprises, and clarifying the legal framework governing these enterprises to bring them under the ownership and effective control of the Ministry of Finance. Steps will be taken to improve reporting and strengthen the capacity at the Department of State-Owned Enterprises (¶ 46 of MEFP).

Governance issues

Consistent with the ANDS and the program outlined in the Kabul Conference Communiqué of June 20, 2010, the authorities have taken wide-ranging measures to strengthen governance and the rule of law, improve transparency and accountability, and fight corruption. Major steps include the establishment of the Anti-Corruption Unit in the Attorney General's Office and the Anti-Corruption Court with the Supreme Court, as well as the issuance of the President's Decree establishing a High Office for Oversight and Anti-Corruption for coordination of the authorities' strategy. Monitoring of the anti-corruption strategy will be carried out by an independent Monitoring and Evaluation Committee, which was inaugurated in May 2011.

Conclusion

Afghanistan's path toward macroeconomic stability, growth and poverty reduction has been strewn with formidable obstacles, including security, global and regional volatility, governance issues, and low implementation capacity. Yet, progress has been achieved in many areas as outlined above, which should not be overshadowed by setbacks, such as the Kabul Bank crisis. The reform agenda in the years ahead is ambitious and will require perseverance, flexibility, and sustained donor support, within the framework of partnership that has demonstrated its effectiveness in serving agreed objectives. The authorities highly appreciate Fund advice and assistance, and are determined to deliver on their commitments under the new program.