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Islamic State of Afghanistan: 2004 Article IV Consultation and Second Review Under the Staff-Monitored Program—Staff Report; Staff Statement; Public Information Notice on the Executive Board Discussion; and Statement by the Executive Director for the Islamic State 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 2004 Article IV consultation with the Islamic State of Afghanistan and second review under the staff-monitored program, the following documents have been released and are included in this package:

- the staff report for the 2004 Article IV consultation and second review under the staff-monitored program, prepared by a staff team of the IMF, following discussions that ended on November 3, 2004, with the officials of the Islamic State of Afghanistan on economic developments and policies. Based on information available at the time of these discussions, the staff report was completed on January 4, 2005. 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.

- a staff statement of January 19, 2005 updating information on recent developments.

- a Public Information Notice (PIN) summarizing the views of the Executive Board as expressed during its January, 19, 2005 discussion of the staff report that concluded the Article IV consultation.

- a statement by the Executive Director for the Islamic State of Afghanistan.

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

Letter of Intent sent to the IMF by the authorities of the Islamic State of Afghanistan*
Memorandum of Economic and Financial Policies—Update*
Technical Memorandum of Understanding—Update*
Selected Issues Paper and Statistical Appendix
* May also be 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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INTERNATIONAL MONETARY FUND

ISLAMIC STATE OF AFGHANISTAN

Staff Report for the 2004 Article IV Consultation and Second Review Under the Staff-Monitored Program

Prepared by the Middle East and Central Asia and Policy Development and Review Departments

(In consultation with other departments)

Approved by Saleh M. Nsouli and Matthew Fisher

January 4, 2005

- Discussions for the 2004 Article IV consultation and the second review under the Staff-Monitored Program (SMP) were held in Kabul from October 20–November 3, 2004. The mission met with Vice-President Arsala, Minister of Finance Ghani, Minister of Foreign Affairs Abdullah, Da Afghanistan Bank Governor Ahady, and other senior officials, as well as representatives of the diplomatic community, nongovernmental organizations, the business community, and international organizations. The Afghan authorities published the concluding statement and have agreed to publish the staff report, the updated Memorandum of Economic and Financial Policies (MEFP), and the Letter of Intent after their distribution to the Executive Board.
- The 12-month SMP covers the fiscal year 2004/05 (March 20, 2004–March 20, 2005). It aims at maintaining financial stability and building institutional capacity. If implemented successfully, and assuming a balance of payments need, it may pave the way for an arrangement under the Poverty Reduction and Growth Facility (PRGF).
- In concluding the 2003 Article IV consultation (the first such consultation since 1991), Executive Directors noted that prudent macroeconomic management had, together with sizable aid and the end of the drought, provided an environment conducive to the resumption of economic growth. They underscored the need for donors to continue to provide substantial assistance, and noted that revenue-raising measures would be needed to ensure the independence of the operating budget in due course. They saw merit in a "lightly managed" float for a country that remains vulnerable to shocks and is undergoing structural change and reconstruction. They were concerned about the risks posed by the opium economy and urged the authorities to intensify eradication, while offering alternative livelihoods.
- The mission members consisted of Messrs. Symansky (head), Bessaha, Martin (all MCD), Schneider (PDR), and Thomas (FAD). The mission was assisted by the resident representative, Mr. de Schaetzen. Mr. Farhadi (Advisor to Mr. Mirakhor) participated in some of the policy discussions.
- The security situation, while stable in the run-up to the presidential election, could deteriorate in the period preceding the parliamentary elections currently scheduled for April 2005. The United Nations (UN) continues to rate Afghanistan at Security Phase III.
- Looking beyond March 2005, the authorities indicated that they would like to continue with the SMP and, in the absence of any immediate balance of payments need, wait until after the forthcoming elections before considering a Fund-supported arrangement. In the interim, they have initiated consultations on the PRSP process.

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List of Acronyms

AML/CFT	Anti-Money Laundering and Combating the Financing of Terrorism
ARTF	Afghanistan Reconstruction Trust Fund
CIRRs	Commercial Interest Reference Rates
CPI	Consumer Price Index
DAB	Da Afghanistan Bank
ISAF	International Security Assistance Forces
MDGs	Millennium Development Goals
MEFP	Memorandum of Economic and Financial Policies
MoF	Ministry of Finance
OECD	Organization for Economic Cooperation and Development
PRGF	Poverty Reduction and Growth Facility
SMP	Staff-Monitored Program
SOEs	State-Owned Enterprises
TCC	Technical Committee of Coordination
TA	Technical Assistance
TSA	Treasury Single Account
UN	United Nations
UNODC	United Nations Office on Drugs and Crimes
WTO	World Trade Organization

Executive Summary

- **Economic performance under the SMP has been broadly in line with program commitments**. The quantitative indicators and structural benchmarks in the SMP have largely been met, despite weak administrative capacity, security concerns, and political considerations. GDP continues to grow steadily, although slower than expected largely because of a prolonged drought, while inflation has been moderate. Domestic revenue has been slightly higher than programmed, while both current and development expenditures have been below budget. However, further progress could have been made in implementation of some structural measures.

- **The drug economy continues to increase**. The government and the international community are tackling this issue, but this could lead to social, economic, and political instability over the near term. Success in this area will depend upon a multi-faceted approach, including developing alternative livelihoods, while continuing with macroeconomic and structural reforms conducive to sustained growth.

- **The authorities would like to continue with an SMP, at least until after a Parliament is elected, to sustain the reform momentum and build capacity**. Although the SMP has been on target, the country faces major economic and social risks.

- **The authorities' medium-term strategy is articulated around**: increased security; private sector-led growth; strengthened revenue efforts; prudent monetary policy; eliminating the drug economy; and institution-building. Successful implementation of structural reforms will be critical.

- In the context of a managed float, the authorities agreed to continue implementing a monetary policy anchored by a target for currency in circulation.

- The authorities are committed to introduce an ambitious structural fiscal reform agenda to achieve fiscal sustainability over the medium term.

I. BACKGROUND AND OVERVIEW

1. **Afghanistan's first direct presidential election, which took place on October 9, 2004, represents an important milestone in rebuilding the nation's institutional framework**. President Hamid Karzai was elected with 55 percent of the vote. Following his inauguration on December 7, and after a lengthy consultative process, President Karzai appointed a new cabinet on December 23, 2004, giving more prominence to technicians to the detriment of regional factions. The new economic team, who signed the attached Letter of Intent, is expected to pursue the current agenda of economic reforms.[1] Parliamentary elections are currently scheduled for April 2005.

2. **While economic policies have been essentially in line with Fund staff recommendations and the SMP (Section III), further progress could have been made in implementation**. In many instances, the authorities complied with the program benchmarks, but follow-through has been weaker than envisaged—often due to weak administrative capacity, security concerns, or political considerations.

3. **The security situation remains unpredictable but generally calm**. The longer-term implications of the kidnapping (and release) of UN staff members remain a matter of concern among security experts. Although the situation is expected to remain volatile until the general elections, the international community remains actively involved in the country.

4. **The foremost challenge facing the authorities is the drug economy**. Drug activities have continued to increase, and there is a substantial risk that Afghanistan will (or already has) become a narco-state. The latest United Nations Office on Drugs and Crimes (UNODC) report indicates that poppy production continued to rise in 2004, with cultivation spreading to new areas of the country and involving an increasing share of the population. Drug revenue is estimated to have risen to \$2.8 billion, equivalent to about 60 percent of nondrug GDP.[2] Despite a higher export value, a steep drop in the average farm gate price cut farmers' gross drug income by 40 percent to about \$600 million, while proceeds to traders and laboratories rose sharply (more than 70 percent) to \$2.2 billion. The government and the international community are developing a common strategy to abate the drug economy. The manner in which this strategy is implemented will be critical in maintaining social, economic, and political stability.

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[1] Mr. Ahady, formerly Governor of Da Afghanistan Bank (DAB), was appointed Minister of Finance. Mr. Delawari, formerly president of the Afghanistan Investment Support Agency, was named Governor of DAB.

[2] While poppy cultivation expanded by 64 percent to a record level (2.9 percent of agricultural land), total production rose by only 17 percent, still below the record level in 1999. The decline in the average yield resulted from adverse weather, disease, parasites, and the inexperience of new farmers.

5. **The return of peace and the ensuing resumption of economic growth have led to some improvement in Afghanistan's social indicators**, which are among the lowest in the world. Refugees have returned to their lands; school enrollment has increased; vaccination campaigns against some deadly diseases were conducted; and food security has improved. Nonetheless, the challenges remain daunting as infant and maternity mortality are still among the highest in the world. Illiteracy still affects 57 percent of men and 87 percent of women, and only 40 percent of the population are reported to have access to drinking water. Electricity is provided to only 17 percent of the rural households. Poverty remains widespread, especially in rural areas.

6. **While still relatively strong, real GDP growth has slowed over the past 18 months, and was lower than expected (Tables 1 and 2)**. This slowdown reflects primarily the negative impact of adverse weather conditions on agricultural production, which notably led to the 25 percent fall in cereal production during the first half of 2004/05. This fall was only partially offset by expansion in other sectors. Increased opium activity, together with the heavy reliance on external support, highlights the fragility of Afghanistan's economic recovery. Increases in rent and fuel prices led to a rise in inflation over the last 12 months, but moderated somewhat during the second quarter of 2004/05 (Figure 1). Year-on-year inflation amounted to 14.1 percent at end-September. Excluding rents and petroleum products, it amounted to 8.3 percent. Reflecting a strong balance of payments, the nominal and real exchange rates vis-à-vis the U.S. dollar have appreciated.

7. **The authorities have maintained their commitment to fiscal discipline and have continued to improve fiscal management**. The government continues to observe the "no-overdraft" financing rule prohibiting borrowing from Da Afghanistan Bank (DAB), as the operating budget continues to be financed by donor grants and concessional disbursements (Table 3). Central government control of provincial revenue and expenditure has sharply improved. Further, the authorities adopted, for the first time in 2004/05, a '*core budget,*' to improve coordination and control over donor flows.[3] Over the last 18 months, domestic revenues have exceeded program projections, while expenditures were constrained by delays in recruitment and general procurement. All line ministry accounts have been consolidated into the Treasury Single Account (TSA) and revenue from provincial accounts are now regularly deposited into the TSA. These measures bolstered the central government's ability to monitor and collect revenue, of which 70 percent is collected in the provinces.

[3] See paragraph 7 of MEFP, IMF Country Report No. 04/364, November 9, 2004 and Box 1 of the Selected Issues Paper, (www.imf.org), for a detailed explanation of the various budget concepts. The operating budget covers essentially current expenditures; the core budget consolidates the operating budget with development expenditures channeled through the treasury's accounts; and the external budget refers to fiscal operations implemented directly by donors.

8. **Despite a paucity of monetary instruments, DAB's flexible approach to monetary policy, in the context of a "managed float," has been largely successful in limiting both inflation and exchange rate volatility**. Monetary policy continues to be implemented almost entirely through foreign currency auctions, the only market-based instrument until the recent introduction of short-term capital notes. Monetary policy is guided primarily by indicative targets for currency in circulation (as set out in the SMP). However, in view of the substantial uncertainties surrounding relationships between key macroeconomic variables, DAB uses all available indicators to assess changes in the demand for domestic currency. As illustrated by the recent revision of the monetary program (paragraph 22), DAB stands ready to adjust its monetary stance when necessary to preserve macroeconomic stability.

9. **The government introduced a number of important structural reforms**. Following the adoption of commercial banking legislation, the regulatory framework has been strengthened further through DAB's adoption of banking regulations. Three state-owned commercial banks were granted conditional licenses, while eight private banks—all foreign-owned—were licensed and are now operating. However, only limited progress has been made in restructuring the relicensed state-owned banks, and in resolving the three that were not relicensed. Considerable trade regime reforms have been implemented. As a result, Afghanistan is now one of the most open economies in the region (Box 1). Other important structural reforms include: the introduction of a computerized system for expenditure and revenue operations; the simplification of customs clearance procedures; and the adoption of five-year plans to improve customs and tax administrations.

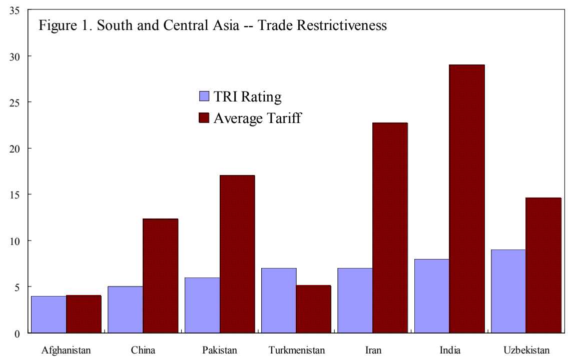
II. Performance Under the Staff-Monitored Program

10. **All end-September 2004 quantitative and structural benchmarks under the SMP were observed**, with the exception of the benchmark related to the Anti-Money Laundering/Combating the Financing of Terrorism (AML/CFT) legislation, which was enacted with a short delay. This strong performance was achieved despite a volatile security situation and the mobilization of considerable resources for the presidential election.

11. **After consultation with Fund staff, DAB allowed money growth to exceed its second quarter SMP indicative target** (Table 4). Currency in circulation increased by 22 percent during the first half of 2004/05, compared with an objective of 13 percent (Figure 2). This increase was justified by the sharp appreciation of the Afghani, which, along with the slowdown in inflation, pointed to an increase in money demand (Box 2). DAB's decision to accommodate this increase was instrumental in stabilizing the exchange rate. After appreciating by 20 percent in the first five months of 2004/05, reaching Af 42 per dollar in the third week of August, the exchange rate stabilized in the Af 45–46 per dollar range. Reflecting its foreign exchange activity and a further increase in government foreign currency deposits, DAB's accumulation of international reserves exceeded its indicative floor for the first half of 2004. At end-September, the international reserves were equivalent to over four months of imports (Figure 3).

Box 1. Afghanistan's Trade Regime

Establishment of an open and transparent trade regime has been a consistent priority of the Afghan authorities—moving in tandem with sweeping reforms to the tariff regime and customs administration. The result has been a significant improvement in transparency and simplicity, leaving Afghanistan as one of the most open economies in the region, although significant work remains to eliminate informal barriers and address governance issues.



Under the trade regime inherited by the transitional government, there were 25 tariff bands, with rates ranging from 7 to 150 percent—with a simple average of about 43 percent (although the effective tariff was much lower, due to the use of a lower exchange rate in import valuation). An overhaul of the tariff system brought the number of rates to six (2.5, 4, 5, 8, 10, and 16 percent), with a relatively low level of dispersion. By virtue of this rationalization, the average tariff also declined to 4 percent. Even with the addition of a range of "fees" (both legitimate and illegitimate), the estimated average applied tariff is only 5.3 percent—the lowest in the region. The effective tariff rose considerably, however, given the authorities' decision to use market exchange rates in import valuation. Afghanistan maintains bans on only a few products (largely for religious purposes), and imposes no seasonal restrictions, quotas, or other nontariff barriers. Further, licensing requirements—reformed effective April 2004—have been drastically simplified. The import license application process, which previously involved 42 steps, 58 signatures, and several weeks of processing, now involves only three steps, six signatures, and 48 hours to process.

A number of problems remain, however. Some provincial governments reportedly prohibit the use of foreign trucks. There are also other *ad hoc* fees imposed by local governments, warlords, and commanders, but these appear to be evenly applied to all transport, and not just on imported goods. Customs clearance in some areas (for example, in some of the more problematic areas on the border with Pakistan) can also be cumbersome. From a government policy perspective, however, substantial progress is being made to simplify customs administration—including computerization and the introduction of a customs single administrative document.

With regard to international trade policy, the emphasis thus far has been regional—reflecting the large potential for immediate gains from facilitating transit trade with such countries as India, Pakistan, and Iran. This process is expected to continue, with the Afghan authorities seeking to codify relationships with other neighboring economies. On the multilateral level, Afghanistan has recently requested observer status from the World Trade Organization (WTO). Accession to the WTO is a future goal, although the authorities have indicated that a significant number of legal reforms will be required to meet WTO requirements.

Box 2. The Deepening of the Domestic Currency Market or "Afghanization"

Since the introduction of the new Afghani in late 2002, currency in circulation has increased substantially faster than nominal GDP. Afghanis in circulation rose by 41 percent during 2003/04 and by 22 percent during the first six months of 2004/05, while nominal GDP growth amounted to 23 percent in 2003/04 and is projected at 19 percent in 2004/05. Overall, the velocity of currency in circulation is estimated to have declined by 13 percent in 2003/04 and by an additional 10 percent during the first six months of 2004/05 (Figure 2).

This decline in velocity, at a time of moderate inflation and an appreciating currency, points to an increase in demand for the Afghani. While year-on-year inflation has increased during the first part of 2004/05, from 7 percent at end-December 2003 to 14 percent at end-September 2004, this largely reflects non-monetary factors. Excluding petroleum products, rents, and education, inflation has remained moderate, at 7 percent at end-September 2004 (compared with 6 percent at end-2003). At the same time, the Afghani has steadily appreciated since end-2003, gaining 7 percent vis-à-vis the dollar during the first nine months of 2004.

This higher demand for the Afghani seems to result from both a monetization and a dedollarization of the economy.[1/] The use of the local currency as a means of exchange has benefited from: (i) administrative measures aimed at encouraging its use (DAB has insisted that all goods and services be priced in Afghani); (ii) its increasing use by the donor community, such as the U.S. Army for the payment of contractors and Afghan National Army salaries, which has contributed to its diffusion, notably in the rural areas; and (iii) an increased confidence resulting from its stability over the recent period. There is anecdotal evidence that the Afghani is now the preponderant currency for transactions. However, the U.S. dollar remains widely used in a few sectors, such as the telecommunication sector, the trade sector, and the opium economy.[2/] Hence, preliminary data for end-August 2004 indicate that 91 percent of deposits at private commercial banks were in U.S. dollars, reflecting the preferences of their depositors, mostly traders and large companies.

With a level of monetization similar to that of other least-developed economies, the financial deepening of the Afghan economy is expected to come from the development of the banking sector (Figure 4). The ratio of reserve money to GDP, at 13 percent at end-September, is slightly higher than that observed in other least-developed countries. This is partly explained by the low level of development of the banking sector, which until recently provided few investment opportunities. Deposits with commercial banks and lending activities represented 1.8 percent and 0.4 percent of GDP, respectively at end-August (these numbers include foreign currency deposits and dormant accounts). As a result, Afghanistan's broad money to GDP ratio was significantly lower than in similar developing countries. As the banking sector develops, this ratio should increase substantially, while the ratio of currency on circulation to GDP may decline somewhat.

1/ Due to the lack of reliable data on cash holdings in U.S. dollars, it is not possible to estimate the respective contribution of financial deepening (i.e. increase in the *broad* currency in circulation, including foreign currency holdings) and dedollarization (i.e. decline in currency substitution).

2/ The use of the Pakistani rupee and the Iranian rial, which was sizeable in some of the provinces, now appears marginal.

12. **Domestic fiscal revenue for the first half of 2004/05 reached Af 5.9 billion, exceeding the program target of Af 5.5 billion**. The sharp increase in revenue over the same period last year was attributed to more timely sweepings of provincial revenue into the TSA and to the gradual implementation of customs and domestic tax reforms. Operating budget spending reached Af 12 billion during the first half of 2004/05, compared with the annual budgeted amount of Af 30.3 billion. The rate of security-related spending, representing 51 percent of total operating expenditures, was in line with the budget, while spending on education and social services remained significantly under budget, mainly due to problems in recruiting qualified staff. Core budget development spending reached Af 3.5 billion during the first half of 2004/05, compared with the budgeted Af 38.4 billion, reflecting the late approval of the core budget, the poor security environment, and the limited implementation capacity of line ministries and other agencies.[4] For similar reasons, external budget spending was also quite low, as donors reported disbursements of $103 million during the first half of 2004/05, compared with annual commitments of $2.6 billion.

13. **The authorities maintained their "no-overdraft" financing rule but drew down a significant amount of government deposits to finance the operating budget deficit**. As reimbursement from the multi-donor trust funds were lower than expected during the first half of 2004/05, the operating budget deficit was partly financed by a draw-down of domestic deposits, of Af 1.6 billion, and funds from a highly concessional loan, amounting to $12 million.

14. **Balance of payments data remain of very poor quality**. Nevertheless, preliminary data indicate that the current account deficit narrowed to 12 percent of GDP in the first half of 2004/05, down from 22 percent a year before, and was primarily financed by external grants (Table 5).[5] The decline in the deficit appears to reflect an improvement in the trade balance, including an increase in domestic exports but also a slowdown in imports, likely attributable to delays in project implementation. External borrowing, which is on highly concessional terms, remained limited, reaching an estimated $104 million during the first semester. The authorities continue to make progress in verifying external obligations to bilateral creditors, and a survey of external debt and reconciliation with creditors is expected to be completed by end-March 2005.

15. **Progress was made in implementing structural reforms under the SMP**. Efforts have focused on implementing tax reforms, extending the consumer price index (CPI) coverage, ensuring a more timely transfer of provincial revenue to the central government accounts, restructuring the state-owned enterprises (SOEs), drafting a private investment law, and establishing a legal framework for extractive industries. In the financial sector, bank

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[4] The 2004/05 core development budget was not approved until end-June, after the start of the fiscal year (March 20) and the Berlin donors' conference.

[5] The balance of payments trends reported here do not incorporate developments in the opium economy or flows associated with U.S. military or activities of the International Security Assistance Forces (ISAF).

regulation was strengthened through enactment of AML/CFT legislation and the adoption of bank reserves requirements. DAB also successfully introduced a short-term capital note (end-December benchmark), a significant step toward establishing a benchmark interest rate. Progress in other areas, however, remained slow. The restructuring of the three relicensed state-owned banks (a requirement under their relicensing) and the resolution of the other state-owned banks appear stalled. Moreover, the recent opening of the foreign exchange auctions to the commercial banks has not been satisfactory as the banks only have access to a fixed allocation, sold on a noncompetitive basis after each auction.[6]

16. The overall process of drafting, adopting, and giving force of law to key reform legislation has encountered a number of bottlenecks in the intergovernmental process, including the limited capacity of the Ministry of Justice. As a result, publication in the official gazette has been delayed for key economic legislation. While a dialogue is underway to remove these obstacles, the process is far from complete.

III. MACROECONOMIC OUTLOOK AND POLICY FRAMEWORK FOR THE REMAINDER OF 2004/05

17. Discussions with the authorities on the program for the remainder of 2004/05 focused on: (i) maintaining macroeconomic stability in a period of political transition and persistent insecurity; (ii) strengthening capacity; and (iii) stepping up structural reforms to spur private investment and improve delivery of government services. The macro-framework was updated and understandings were reached to step up revenue collection, strengthen expenditure management, and improve the business regulatory framework.

18. **Modifications were made to the structural benchmarks for the rest of the year.** Several end-December 2004 benchmarks were moved to end-March 2005: the benchmark related to the transfer to other entities of all DAB commercial activities, because of difficulties in identifying and contacting the owners of commercial accounts opened at DAB; the benchmark related to the piloting of a system to pay salaries and vendors directly, mainly resulting from the limited coverage of the banking system; and the benchmarks related to the publication in the official gazette of the financial management law, to the consolidation of all recent revenue measures into the revenue code, and to the adoption of a list classifying the SOEs according to proposed economic restructuring method, due to administrative delays linked to the lengthy political transition period between the presidential election and the appointment of a new Cabinet. In addition, the end-March 2005 benchmark for asset transfers between the DAB and the Ministry of Finance (MoF) now covers only DAB's commercial holdings, which will be transferred to MoF, and the gold and silver in the

[6] While not affecting significantly the monetary policy implementation, as the size of these transactions are relatively limited, this fixed allocation creates potential arbitrage opportunities for the commercial banks, as it is available for up to one week (on a first come first serve basis) at the auction exchange rate.

Presidential palace vaults, which will be transferred to DAB.[7] The two institutions will work together to resolve issues related to remaining liabilities, mostly related to Russian claims, currently housed at DAB. Finally, an end-March 2005 benchmark related to the publication of tax amendments in the official gazette was added. The delay in the publication of the revenue laws should not affect significantly the SMP revenue target.[8]

A. Macroeconomic Framework

19. **The authorities and staff agreed on a revised short-term outlook, with substantially lower growth, and unchanged inflation**. The downward revision of growth, from 16 percent to 8 percent, reflected the sharp reduction in agricultural output during the first half of the year and lingering drought in the southern provinces. At the same time, growth in other sectors was revised upward, as their better-than-anticipated performance during the first half is expected to continue.

B. Fiscal Policy

20. **Staff concurred with the authorities that the budget revenue target for the year remains ambitious but achievable**. Meeting the budget target for domestic revenue, which, at Af 15 billion (5.6 percent of GDP), is higher than the program target (Af 12.8 billion), will require a significant improvement in revenue collection, including from the provinces, during the second half of the year and is contingent on the implementation of customs and tax reforms and the collection of sizeable over flight charges near the end of the fiscal year (paragraph 16 of MEFP).

21. **Donor funding should be sufficient to finance the core budget in 2004/05**. Budgeted revenue, grants, and program loans for the approved core budget exceed projected expenditures by $305 million. The government initially planned to allocate this 'surplus' funding to specific development projects at the time of the mid-year review. However, due to the postponement of this review on account of the elections, and given the slow pace of core budget development spending, this additional funding will likely be carried over to subsequent years.

C. Monetary and Exchange Rate Policies

22. **In view of Afghanistan's vulnerability to external and domestic shocks, it was agreed that a flexible exchange rate remained appropriate and that monetary policy should continue to be anchored on targets for currency in circulation**. Flexibility remains key, however, and, given the stronger-than-expected money demand, the monetary targets for

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[7] The minister of finance has no specific plan (at this juncture) on how to eventually privatize the best assets transferred from DAB. Recent technical assistance from the U.S. Treasury is intended to help address this issue.

[8] While they still have to be published, the revisions to the income tax laws have started to be implemented by the authorities, in accordance with the Ministry of Justice view that they have currently status of law.

the remainder of the year were revised upward. The revised targets still imply a significant tightening of monetary policy in the coming months, as year-on-year money growth is expected to decline from more than 50 percent at end-September 2004 to a maximum of 38 percent at end-March 2005. The revised program should allow DAB to accommodate the anticipated further increase in demand for Afghanis without feeding inflation. As money demand is highly uncertain, the program will remain flexible and will be carefully monitored. In particular, the authorities reiterated their commitment to closely follow price and exchange rate developments and to tighten the monetary stance, should prices accelerate. Finally, in light of the foreign exchange accumulation during the first six months, the authorities agreed to revise upward the indicative floors for international reserve growth for the remainder of the year, to levels consistent with import coverage of 3.5 months at end-2004/05.[9]

D. External Sector

23. **While limited data render projections for the balance of payments difficult, continued reconstruction and relatively strong economic recovery would suggest a 2004/05 outcome similar to that estimated in 2003/04**. The current account deficit including grants (currently projected at 3.4 percent of GDP) would be more than adequately financed by inward flows, allowing for a continued accumulation of reserves—keeping coverage in terms of imports constant at about four months. Given the large structural changes taking place in the economy, however, staff stressed the need to remain vigilant to emerging pressures on the balance of payments. External borrowing is expected to remain relatively light, given the authorities' cautious approach to new obligations and the current availability of grant financing.

E. Structural reforms

24. **The authorities recognize the continued presence of structural impediments to private sector activities and investment, and are pursuing reforms to eliminate these obstacles**. In addition to ongoing fiscal and financial reforms, they are pressing ahead with measures to reform public enterprises, and improve governance and transparency, and the legal and institutional environment for private sector investment.[10]

25. **Developing a more robust legal framework is an important component of the strategy to reestablish the rule of law and promote a market-based economy**. A significant amount of economic legislation is at various stages of preparation, including a public financial management law and a customs code (both of which should be approved within the current fiscal year), revisions to the income tax law, and laws to regulate the mining, oil, and gas sectors.

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[9] See IMF Country Report No. 04/110, March 26, 2004, paragraph 19 for an explanation why the floor on international reserves is set at a level lower than the one implied by the monetary projections.

[10] The nonfinancial public enterprise sector in Afghanistan is small, thus limiting the fiscal impact of its restructuring.

26. **Key public expenditure management reforms are being implemented with donor support**. They include: (a) automating the payments system, with electronic funds transfer and a verified payroll (initially for Kabul-based ministries only); (b) improving general compliance with financial management procedures; (c) combining operating and development spending in line with a single new chart of accounts; and (d) reestablishing internal and external audit functions.

27. **Donors are also funding a number of programs to restructure ministries and attract appropriately skilled and experienced Afghan professionals to core managerial and technical positions (see paragraph 27 of MEFP)**. Recognizing that these programs are likely to increase the already high share of the operating budget devoted to salaries over the medium term, the authorities intend to undertake a comprehensive pay and grading review which should be linked to the goal of achieving sustainable fiscal position within a few years (see Selected Issues Paper, "Medium-Term Structural Fiscal Reforms," (www.imf.org)).

28. **The authorities continue to modernize and reform the banking sector**. The transfer of DAB's commercial activities and noncore assets to the MoF will allow the central bank to focus on its primary functions. Taken together with an external audit, this will help clarify DAB's financial situation and facilitate an assessment of whether it is adequately capitalized. Also, the commercial banking regulatory framework will be further strengthened. The authorities are also committed to allowing private banks to play a more prominent role in the foreign exchange market, and to deepen interest in DAB's short-term capital notes.

F. Technical Assistance

29. **Afghanistan's track record of implementing Fund technical assistance (TA) recommendations is satisfactory**. The Fund's priority has been to provide policy advice and TA to help Afghanistan establish a sound foundation for economic management and macroeconomic stability. In many areas, where institution building requires extensive resources, the Fund approach has been to set the overall framework, leaving other partners to deliver detailed TA (paragraph 6 of IMF Country Report No. 03/299; September 10, 2003). Recent TA from the Fund under the SMP helped the authorities pass AML/CFT legislation, extend CPI coverage, prepare a balance sheet for DAB, and provide training for DAB officials. However, progress in implementing Fund TA recommendations in customs has thus far been slow. While the authorities praised Fund's assistance and reiterated their interest in continuing to receive TA, they also expressed disappointment that the Fund has not always been able to deliver, because of security concerns, on TA that was promised in key areas—delaying implementation of structural reforms.

G. Data Issues

30. **Afghanistan's statistical framework is improving but substantial weaknesses remain.** The mission welcomed the progress made in compiling basic real sector data, extending CPI coverage, and improving the reliability and timeliness of fiscal and monetary data. Although broadly adequate for surveillance and program monitoring, the current

provision of data falls short of international standards in terms of quality, frequency, and dissemination. Staff welcome the recent adoption of a statistical master plan and encourage the authorities to establish a clear work program and mobilize the needed resources.

H. Program Monitoring

31. The Technical Committee of Coordination (TCC) is playing an important role by improving collaboration between the MoF, DAB, and the Central Statistics Office, which has enabled close monitoring of the targets and benchmarks. The program will be monitored through the quantitative indicators and structural benchmarks specified in Tables 1 and 2 of Attachment II.

IV. Medium-Term Outlook and Reform Strategy

32. **Afghanistan's current economic and institutional environment present a number of positive features**. The institutional and political frameworks are broadly in place and economic reforms are progressing. Important tax policy measures combined with ambitious tax and customs administration reforms are helping the central government to regain control over revenue. A financial management law, soon to be adopted, will provide an adequate legal framework for fiscal policy. Modernization of the central bank and reform of the financial system are progressing, although the sector is still in its infancy. The regulatory framework for private investment is expected to receive a boost from the new private investment law and the establishment of a legal framework for extractive industries—an area of potential for new investment and growth. Private investment should also benefit from the privatization of SOEs.

33. **These achievements notwithstanding, Afghanistan still faces major challenges,** including a volatile security situation, a fragmented political environment, a growing drug economy, the continued strength of warlords, an ineffective legal system, poor governance, and widespread poverty. Against this background, staff welcome the government's formulation of a broad-based strategy. This strategy is articulated around: (a) increased security; (b) private sector-led growth; (c) strong revenue efforts to allow funding of recurrent costs within a medium-term horizon; (d) eliminating the drug economy (Box 3); and (e) institution-building. If appropriately followed, this strategy should contribute toward the accomplishment of the 2015 Millennium Development Goals (MDGs).

34. Against this background, staff engaged the authorities in discussions on their medium-term policies only in broad terms as their limited capacity currently precludes a more in-depth discussion. Generally, however, the authorities concurred that Fund staff policy advice was consistent with their long-term strategy as envisioned in the *Securing Afghanistan's Future*.

Box 3: Key Elements and Macroeconomic Impact of a Strategy to Fight the Drug Economy

The 2005 campaign
The authorities adopted in early 2003 a multiyear anti-narcotics strategy, which aims at completely eliminating opium production by 2012. Although current efforts, including the 2004 eradication campaign, have not been very successful, the expansion of the drug economy would have likely been even more vigorous without them. With the support from donors, the government intends to focus on five key areas during the 2005 campaign:

- An information campaign that will reemphasize the illegal nature of these activities.
- A broad alternative livelihood strategy, focusing especially on rural rehabilitation and development(see Box 4).
- Centralization and intensification of eradication under the responsibility of a newly created department in the Ministry of the Interior.
- Intensification of interdiction actions aimed at traffickers and laboratories.
- Strengthening of the laws, courts, and penal systems to work against production and trading.

In addition, counter-narcotics efforts are being mainstreamed in the government's overall development and reconstruction program. This takes into account the complexity of the drug issue and aims at limiting the social and economic disruptions caused by eradication (physical elimination of the poppy fields) and/or interdiction (legal action against the producers, processors, and traffickers).

Macroeconomic impact
The drug economy, which is excluded from GDP, adds to the demand for domestic products and improves the balance of payments. It impacts the nondrug economy primarily through the income it generates, and the use of this income varies according to the economic actor. **Farmers**, who accounted for less than 25 percent of the estimated $2.8 billion of drug income in 2004, consume a large part of their earnings, mostly on domestic goods. **Processors and traffickers**, while consuming some domestic and imported goods, probably save, or spend, much of their income outside the country. This group imports raw materials and drug-related capital goods (for transport, processing, and security), and also invests part of its savings domestically (the current construction boom appears to be partly financed through drug revenue). As opium is exported, and as long as some income is spent domestically, the drug economy contributes positively to the balance of payments. However, the drug economy negatively affects the competitiveness of other domestically produced goods through high wage rates and a higher real exchange rate (similar to "Dutch disease"). The macroeconomic effect of a counter-narcotic campaign will depend on the method used. Eradication tends to raise farm gate prices due to lower production, while interdiction tends to lower farm gate prices due to lower demand by traffickers. Thus, these policies create different incentives and rates of return for farmers and traffickers.

A successful campaign could adversely affect GDP growth, the balance of payments and government revenue. Due to a highly inelastic demand, an eradication campaign could result, at least temporarily, in higher incomes for farmers, but also for the traffickers, which would be able to sell their stocks at higher prices.[1/] A multi-pronged strategy, if successful, should however result in a lower drug income, leading to a slowdown in real growth in the nondrug economy and a deterioration of the balance of payments, putting downward pressure on the exchange rate. The relative magnitude of this shock to GDP would be less to the extent that the burden falls on traffickers. On the external side, the high foreign savings and import content associated with drug revenue suggest that the impact on the balance of payments would be substantially less than the total decline in drug revenue. However, this impact could be temporarily accentuated by capital flight, as some traders and traffickers may want to protect their assets from increased scrutiny. The slowdown in growth and the decline in imports will in turn affect negatively government revenue.

Overtime, the reallocation of resources to the nondrug sector will allow higher recorded growth. Cetibus paribus, the real depreciation of the exchange rate resulting from lower demand and the deterioration of the balance of payments, will contribute to the reallocation of resources to the export sector. Depending on monetary policy, this depreciation will come from a nominal depreciation and/or a relative decline in domestic prices. The current level of international reserves will allow the central bank, through a tightening of its monetary stance, to avoid unwarranted exchange rate depreciation.

1/ While the overall impact on farmers revenue would be positive, the social impact could be substantial, as the farmers directly touched by the eradication campaign would lose their main source of revenue.

A. Macroeconomic Framework

35. While recognizing that recent growth rates will be difficult to maintain, the authorities expect an average annual growth rate of 9 percent over the medium term will be needed to address poverty and unemployment and meet the MDGs (Box 4). In support of this target, investment is expected to average about 25 percent of GDP over the next five years, reflecting: (a) continued donor support averaging about 29 percent of GDP; (b) a gradual rise in foreign private sector investment (mostly in the form of foreign direct investment); and (c) higher levels of productivity from accelerated structural reforms. Fiscal policy targets a level of current spending averaging about 12 percent of GDP, while capital spending would decline to 17 percent of GDP by 2007/08, facilitating an expansion of private sector investment. Consumption, reflecting structural changes underway, is projected to fall to 100 percent of GDP over the same period, down from 110 percent of GDP in 2004/05. As structural reforms take hold, the gray economy shrinks, the banking system develops, and security improves, income is expected to rise and alter the household's expenditure and savings patterns. As a result, private savings are projected to rise to 4.1 percent of GDP in 2007/08, up from -5.3 percent of GDP in 2004/05.

36. **This outcome is predicated on:** (a) efficient public spending that supports development and creates an enabling environment for private investment while maintaining fiscal stability; (b) public enterprise reform; and (c) accelerating market reform and promoting the rule of law and greater transparency. But even more important, the government must overcome deeply rooted problems impeding reform (paragraph 33). Furthermore, although official statistics are not available, there is evidence that wage rates have become relatively high for the region, largely driven by the aid and drug economies.

B. Medium-Term Fiscal Policy

37. The authorities are committed to promote fiscal sustainability over the medium term. Their fiscal policy is designed to ensure that the government achieves its policy objectives within the resources available, deliver basic government services efficiently, and facilitate budget execution and monitoring. The authorities intend to continue implementing a broad structural fiscal reform agenda centered around (a) continuing to consolidate fiscal management; (b) rebuilding and broadening the domestic tax base; and (c) developing an effective public administration and public expenditure management system (see Selected Issues Paper, "Medium-Term Structural Fiscal Reforms" (www.imf.org)).

C. Monetary and Exchange Rate Policies

38. **Monetary policy will be implemented under a managed float**. It will continue to be anchored by a target for currency in circulation but will avoid large and unwarranted changes in the exchange rate, as long as such policy is consistent with maintaining low inflation. The central bank will develop its arsenal of market-based instruments to strengthen its capacity to implement monetary policy. As the banking sector develops and more reliable

Box 4. The Sources of Growth in Afghanistan

Following two years of crisis management, the government adopted in early 2004 a broad-based strategy called "Securing Afghanistan's Future". The strategy aims at building a financially self-sustaining state, with the capacity to meet basic social needs and address poverty reduction. Central to this strategy is the need to sustain an annual growth rate in the nondrug economy of at least 9 percent to raise per capita income from $135 by end-2001 to $350 by 2015 and to reduce unemployment.

Over the past three years, growth has rebounded—reflecting sound macroeconomic policies, sizable aid flows, favorable weather conditions, reconstruction efforts, and essential structural reforms. Non-opium GDP growth reached 29 percent in 2002/03, and almost 16 percent in 2003/04. Agriculture, which represents 48 percent of GDP, was the main engine of this growth. The strong performance in this sector was due largely to the return of some 3 million refugees to farmlands, the timely availability of fertilizers and other inputs, and a temporary end to drought conditions. Other sectors that fueled growth, albeit to a lesser extent, included construction and services, which represent respectively 5 percent and 30 percent of GDP.

Growth is now expected to slow as various factors that supported the economy in the immediate post-conflict period gradually diminish. Agricultural growth will be limited by the lingering drought, which is expected to continue as a result of a long-term pattern, and the low potential for a further rise in yields under current techniques (yields are now similar to those in neighboring countries). Value-added in livestock will also suffer from the drought. The boom in construction and services is expected to continue, but will not be sufficient to support the economy. Afghanistan will therefore need to exploit the full potential of existing sectors and identify other leading sources of economic growth.

Assuming the country addresses the structural impediments constraining private sector investment, including insufficient power and a difficult regulatory environment, economic expansion could be secured not only from some existing sectors but also from new sectors:

- In the agricultural sector, expansion could come from: (a) extension of the irrigated areas (presently only 40 percent of the cultivated area is under irrigation) to break the total dependence on erratic winter snows and spring rains for water; (b) use of machines, chemical fertilizers, and pesticides to improve the yields and the quality of the grain and other staples; (c) strengthening transportation networks to ensure distribution of food and other goods; and (d) growing staples with more value added, including cotton and sugar beet on an industrialized scale.
- Other sectors with significant scope for growth are trade, construction, and transportation. Trade links are expected to grow over time with neighbors as the country slowly builds its transportation network. The highway system requires total reconstruction, and regional road are in total disrepair.
- New sectors that can contribute to sustained growth include extractive industries. The country is endowed with natural resources, including extensive deposits of natural gas, petroleum, copper, coal, chromites, talk, barites, sulfur, lead, zinc, iron, salt, and precious and semiprecious stones.

monetary data become available, DAB will base its monetary policy decisions on a broader set of indicators, including reserve money and broad money. The authorities will work to strengthen the financial sector legal framework — which currently hinders bank financing of the private sector.

D. External Policy and Debt Sustainability Analysis

39. **The external accounts will likely be driven by the pace of reconstruction, the availability of new trade opportunities and the impact of recent changes to trade policy**. Over the medium term, as the external impact of donor projects lessens and the domestic supply of goods and services gradually supplants imports, the current account is projected to improve, reaching a deficit of 2.6 percent of GDP by 2008/09. This should facilitate a similarly gradual accumulation of foreign exchange reserves—to about five months of imports. While conservative, these projections are subject to downside risks, stemming notably from the high share of exports linked to agriculture and animal husbandry products, and from the positive impact of unrecorded capital inflows.

40. **The current cautious approach to external borrowing will remain a key component of economic policy for the near term.** This reflects Afghanistan's fragile economic position, its relatively scarce foreign exchange earnings (excluding donor flows and drug-related trade), extremely low level of domestic revenue, and lack of clarity regarding the status of some pre-existing bilateral claims. Staff emphasized the need to adopt an explicit strategy to guide external debt management over the medium term. A debt sustainability analysis (see Selected Issues Paper, "Debt Sustainability Analysis," (www.imf.org)), conducted as part of the current Article IV consultation, highlighted the potential risks and vulnerabilities associated with external borrowing under different scenarios. The results indicate that, assuming a "clean slate" with regard to old bilateral claims, and reasonably strong economic and revenue performance, there is a comfortable margin with regard to key sustainability thresholds. Through successive macroeconomic and other shocks outlined in the various scenarios, however, this margin quickly diminishes, leading to situations where Afghanistan's debt and debt service burden would be deemed unsustainable.

41. **The authorities recognized the need to provide the legal framework that conforms to their liberal trade and exchange rate regime to pave the way for accepting the obligations under Article VIII of the Fund's Articles of Agreement**. This would send a positive signal to investors. Staff reiterated the Fund's willingness to provide TA in this area.

V. Fund Relations

42. **The authorities view a formal arrangement with the Fund as one possible pillar in the strategy to fight poverty and unemployment**. However, until a new parliament is in place, and in the absence of any immediate balance of payments needs, they favor continuing

with an SMP to sustain the reform momentum, improve policy formulation, and strengthen administrative capacity. Staff were encouraged by the decision to initiate, in cooperation with the donor community, work on an Interim Poverty Reduction Strategy Paper.

VI. Staff Appraisal

43. **Under the current SMP, Afghanistan is making headway in macroeconomic management and structural reform**. Prudent fiscal and monetary policies have helped to contain inflation and facilitate relatively high levels of growth. Afghanistan’s performance during the first semester of the SMP is encouraging. Notwithstanding an array of challenges and demands, the authorities implemented a demanding program, more heavily focused on structural reforms than on quantitative targets, and have largely met every benchmark.

44. **At the same time, there is a need for a forceful response to the rise in opium production, which threatens the very fabric of Afghan society**. Staff support recent efforts by the government and its international partners to develop a multi-pronged strategy to deal with the opium economy. However, staff recognize that eradication cannot be accomplished in isolation, and could have a significant economic impact—particularly on some of the most vulnerable segments of the population.

45. **In addition, Afghanistan is still faced with significant challenges in policy implementation due to serious capacity constraints and weak institutions**. The widespread shortages of skilled civil servants and weaknesses in the public administration hinder the absorptive capacity. In many cases, these capacity constraints have meant that the effectiveness of reforms was less than envisaged under the program, particularly with regard to revenue administration, and restructuring of the banking system. Failure to address these issues will hinder efforts to attract private investment which is the backbone of Afghanistan’s future growth prospects. Staff welcome the authorities intention to press ahead with planned reforms, and urge them to strengthen these efforts. Staff look forward to further progress in the reform program with the new government. The forthcoming general elections constitute another step toward broadening ownership of economic reforms.

46. **The thrust of the macroeconomic policies in the current SMP strikes an appropriate balance between the requirement to support growth during this period of transition and the crucial need to remain vigilant with regard to potential risks.** As the fiscal program will be a key component, staff urge the authorities to develop a comprehensive medium-term budget framework that maintains fiscal discipline. The authorities should continue in their efforts to enhance revenue and strengthen expenditure management. The high share of wages and security-related outlays might have been appropriate until now. A gradual shift away from security and reconstruction is the most desirable avenue for expenditure policy to support more broad-based sustainable development in the medium term.

47. **Continued donor support is key to ensuring success of the government's reform strategy**. To enhance ownership and coordination of the reform program, donor funding should be integrated into one consolidated medium-term budget framework (moving away from a collection of donor-implemented programs). More direct donor grant support to the budget would simplify fiscal management and help coordinate donor funds. This will require continued improvement in fiduciary standards and the mechanisms for promoting accountability.

48. **The current framework for monetary policy, based on a monetary anchor and aimed at ensuring low inflation and currency stability, appears appropriate.** The flexibility imbedded in the monetary program has allowed DAB to react promptly to shifts in money demand, ensuring moderate inflation and limiting exchange rate volatility. DAB needs to remain vigilant with respect to inflation and exchange rate developments. Looking beyond 2004/05, staff encourage the monetary authorities to extend their set of market-based instruments and improve monetary statistics. As the banking sector expands and more reliable monetary data become available, DAB should base its monetary policy decisions on a broader set of monetary indicators.

49. **Sustained economic growth, employment opportunities, and export prospects will require further structural reforms to improve the business climate**. The new investment law is a valuable step forward. Staff advised the authorities to now focus on introducing property rights, bankruptcy laws, contract enforcement, and a transparent and effective judicial system. Staff also view the cooperation of all government ministries and agencies, along with a political commitment at the highest levels in creating a clear and level playing field for business, as the cornerstone of the government's strategy of creating private sector-led growth.

50. **The mission encouraged the authorities to intensify efforts to rationalize the public enterprise sector.** While the state-owned banks may not represent a systemic risk, staff urge the authorities to take measures to restore the profitability of those which were relicensed and to resolve those which were not relicensed.

51. **Failure to strengthen the legal system could undermine Afghanistan's economic reform program and medium-term outlook.** Key economic legislation remains in limbo due to low capacity at the Ministry of Justice. Staff have urged the government to elicit donor aid and technical support to the benefit of the Ministry of Justice.

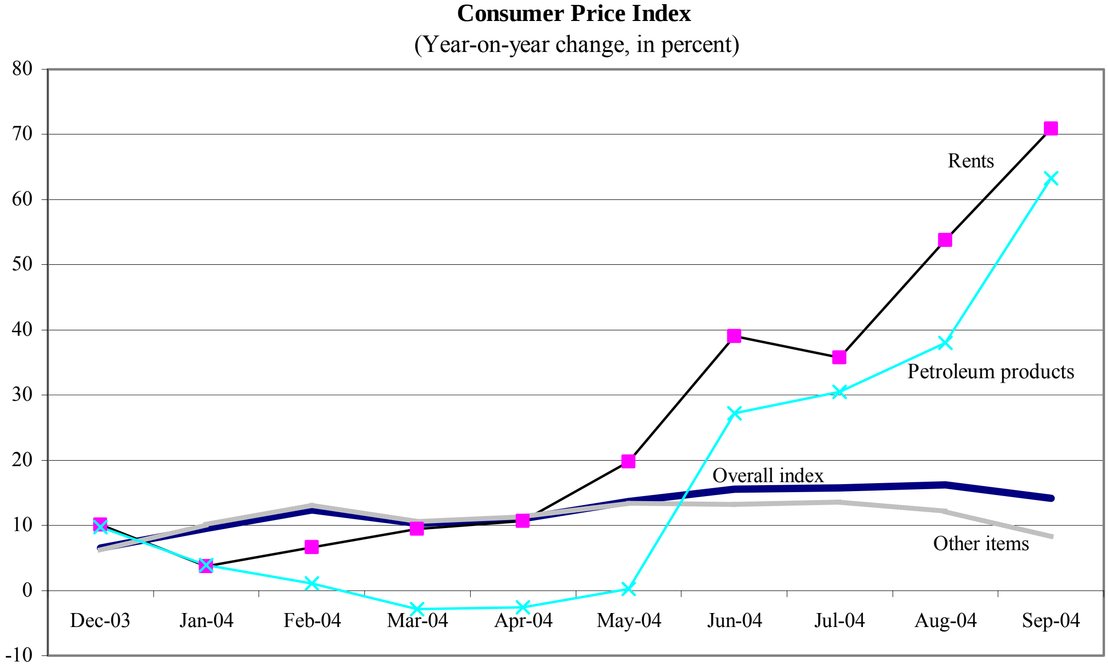
52. **Building on the achievement of the TCC, staff encouraged the authorities to consolidate program ownership** further and enable the TCC in making inroads into policy and analytical roles.

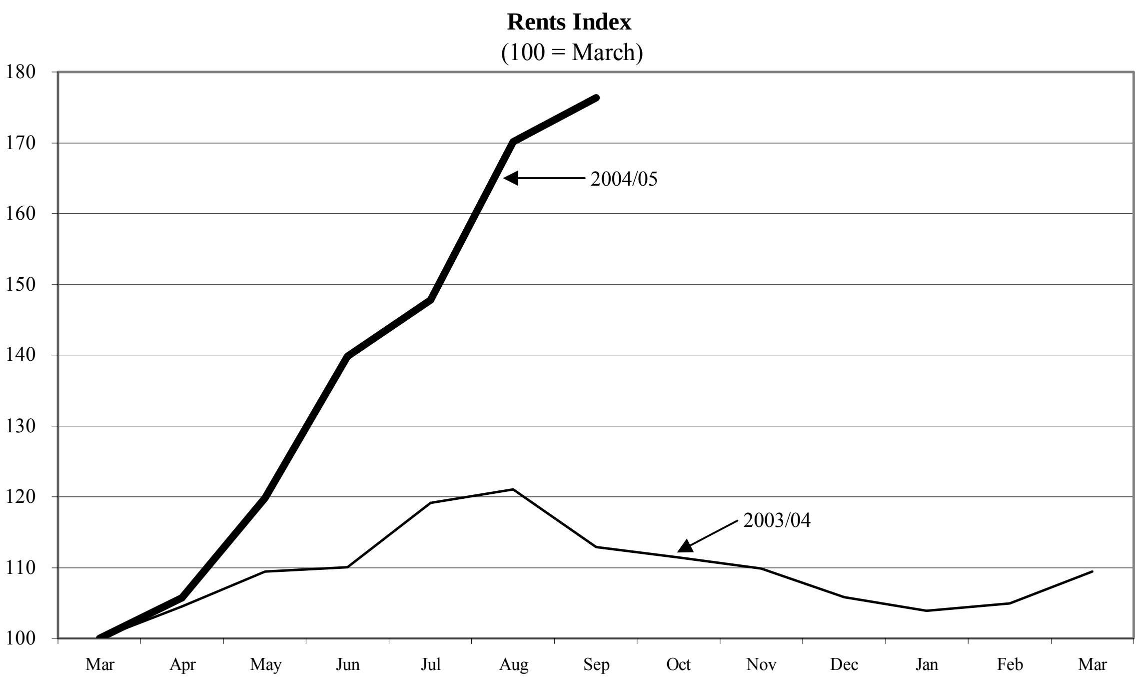
53. **Notwithstanding progress so far, particularly in the fiscal area, much remains to be done in the governance area**. The perception of widespread corruption, the rise in drug activities, and the lack of transparency in many areas have undermined the business environment. Staff welcome the authorities' determination to address these issues forcefully.

54. **There are a number of risks to the program.** The security situation and the limited control of the government over the provinces constrain reconstruction. Political risks remain substantial and, especially in the run-up to the parliamentary elections, could complicate program implementation. The eradication of drug activities, if not handled properly, could cause major macroeconomic and social disruptions, especially in rural areas already affected by the lingering drought. All these factors could cloud Afghanistan's future. However, the government's track record so far is testimony of its resolve to move forward in its reform agenda. The authorities' program for 2004/05, aimed at strengthening macroeconomic stability and Afghanistan's long-term prospects, therefore deserves continued support from the Fund. Staff recommend completion of the second review and concur with the authorities strategy to continue within an SMP.

55. It is proposed that the next Article IV consultation with Afghanistan be held on the standard 12-month cycle.

Figure 1. Islamic State of Afghanistan: Price Developments, 2003–04 1/

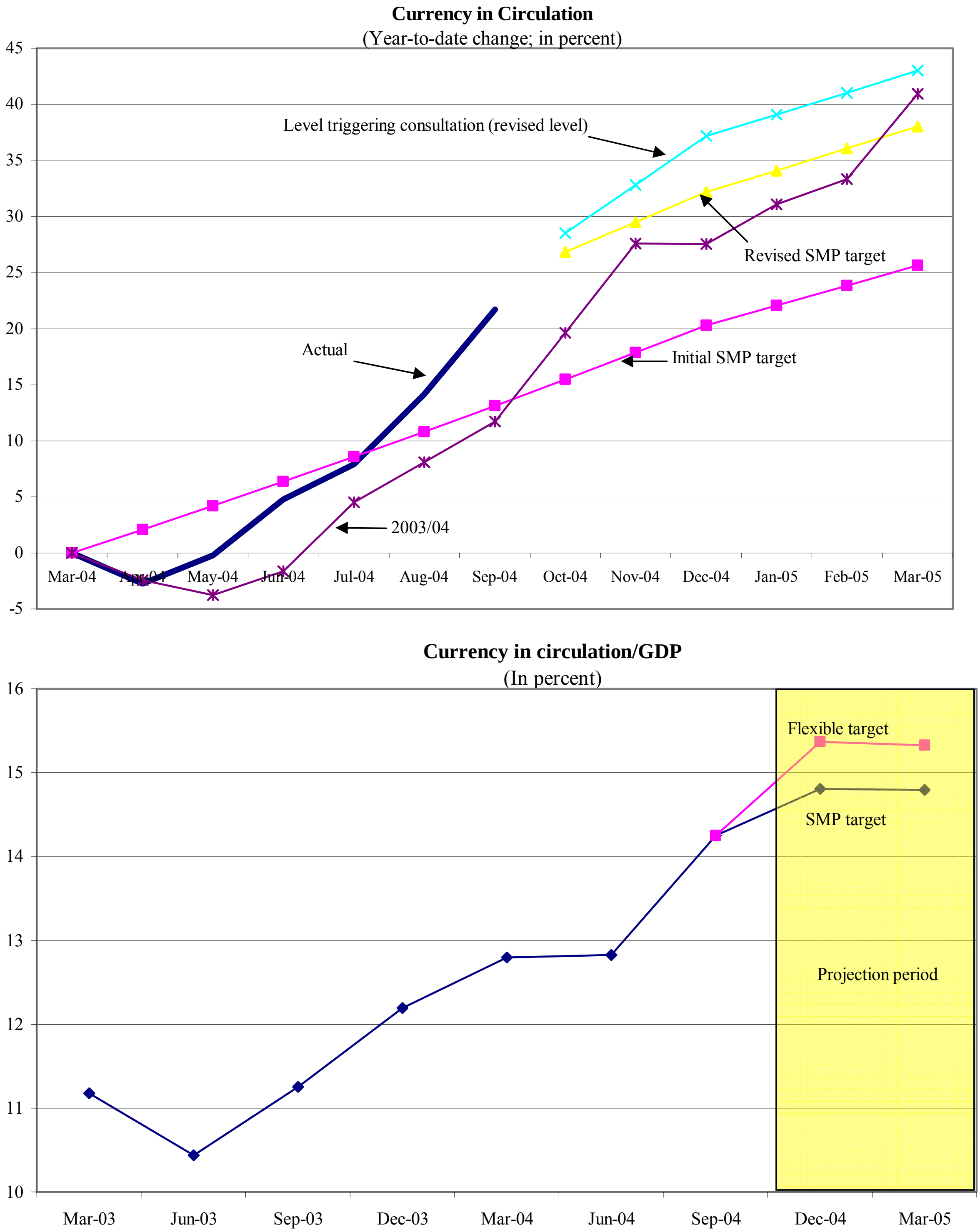




Sources: Central Statistics Office of Afghanistan; and Fund staff estimates.

1/ Last observation: September 2004.

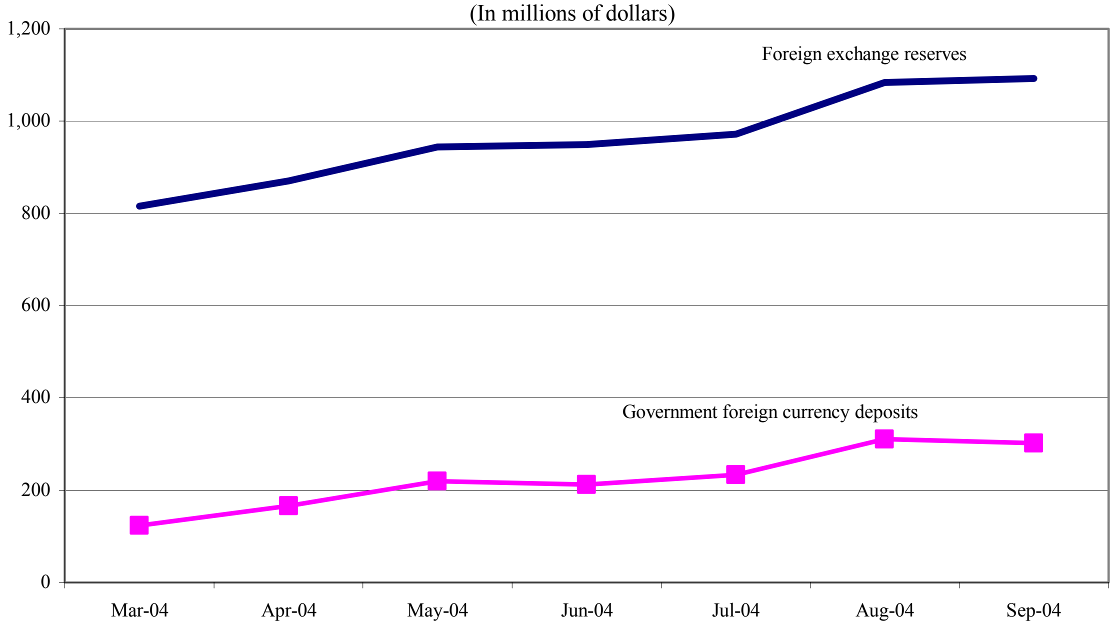
Figure 2. Islamic State of Afghanistan: Monetary Developments, 2003–05 1/



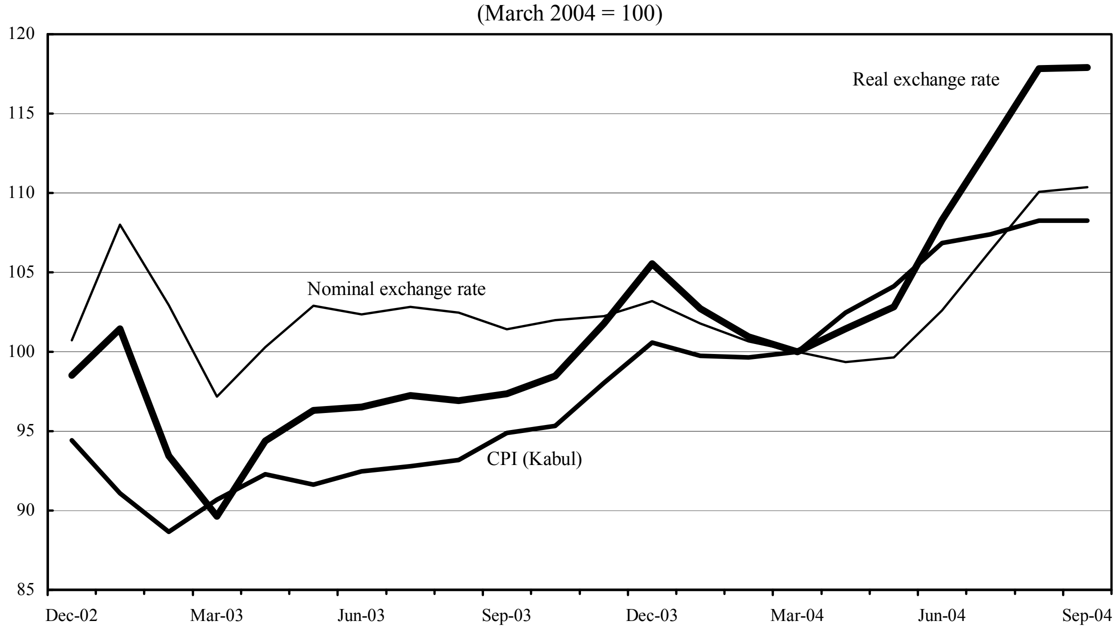
Sources: Central Statistics Office of Afghanistan, Da Afghanistan Bank; and Fund staff estimates.
1/ Last observation: September 2004.

Figure 3. Islamic State of Afghanistan: Foreign Exchange Reserves and Real Exchange Rate, 2003–04 1/

Foreign Exchange Reserves and Government Foreign Currency Deposits
(In millions of dollars)



Price and Exchange Rate Indices 2/
(March 2004 = 100)

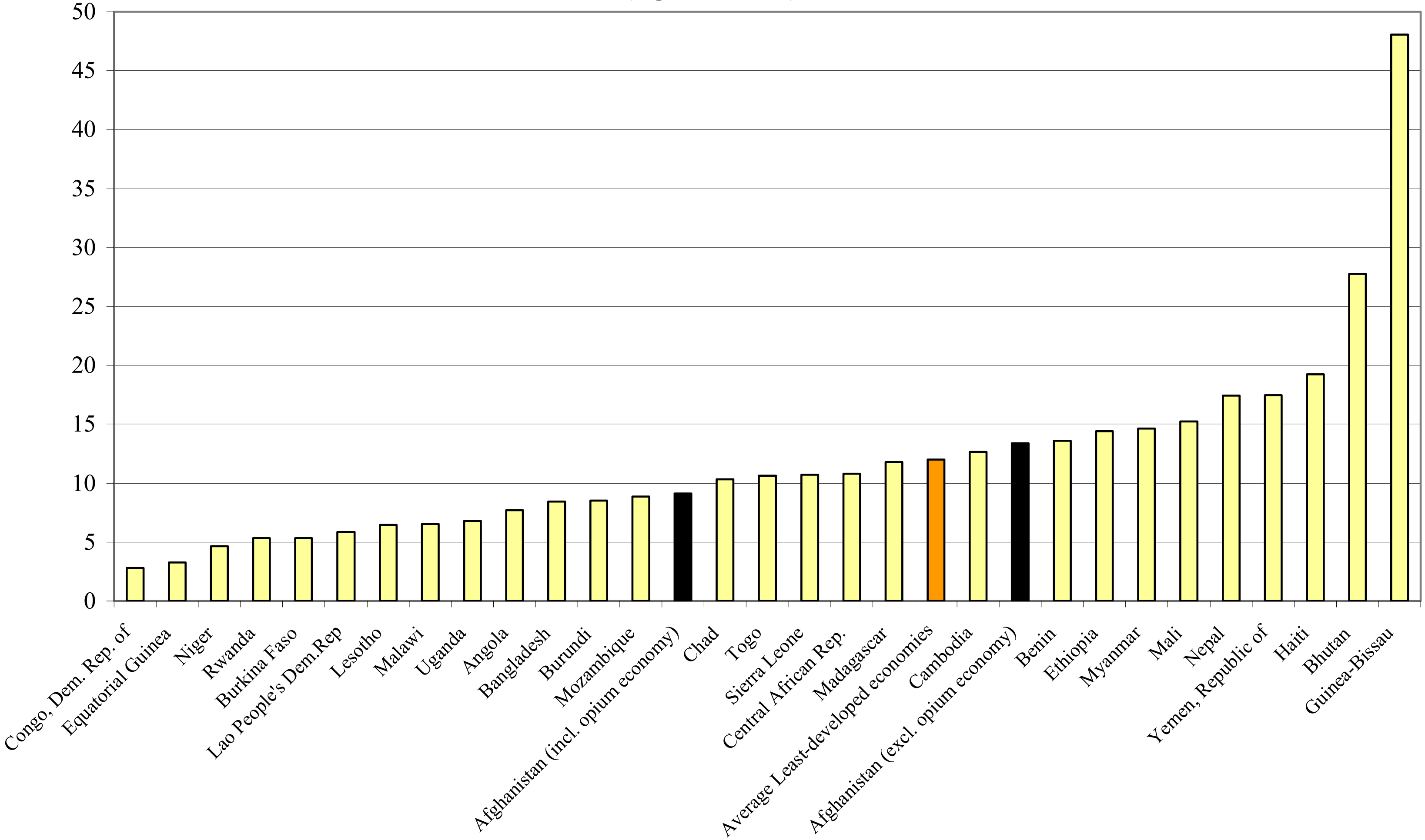


Sources: Central Statistics Office of Afghanistan, Da Afghanistan Bank; and Fund staff estimates.

1/ Last observation: September 2004.

2/ An increase in the exchange rate indices corresponds to an appreciation. The real exchange rate is estimated using the U.S. and Afghan CPIs.

Figure 4. Islamic State of Afghanistan. Reserve Money to GDP Ratio 2003-04 1/
(In percent of GDP)



Sources: WEO; Da Afghanistan Bank; Central Statistics Office of Afghanistan; and Fund staff estimates.
1/ Latest data: 2003 or latest available; end-September 2004 for Afghanistan.

Table 1. Islamic State of Afghanistan: Basic Data, 2001/02–2004/05 1/

	2001/02	2002/03	2003/04		2004/05	
	Est.	Est.	Prel. Est. 2/	Revised Est.	Init. Proj. 2/	Revised Proj.
I. Economic and Financial Indicators						
Production						
GDP (in millions of U.S. dollars, excluding opium production)	2,463	4,084	4,585	4,585	5,802	5,392
GDP (in millions of new Afghani)	133,987	182,862	225,108	225,108	289,180	268,738
Real GDP growth rate (in percent)	...	28.6	15.7	15.7	16.0	7.5
GDP per capita (in U.S. dollars)	123	182	199	199	246	228
Opium production (metric tons)	200	3,400	...	3,600	...	4,200
Opium value (in millions of U.S. dollars)	...	2,540	...	2,300	...	2,800
Consumer prices						
CPI (Kabul, year-on-year change; in percent)	-43.4	52.3	10.3	10.3	10.2	10.2
CPI (Kabul, average change; in percent)	...	5.2	24.2	24.2	12.3	12.3
	(In millions of U.S. dollars, unless specified otherwise)					
General government recurrent budget						
Revenues	...	132	207	207	256	256
Expenditures	...	349	451	451	609	609
Donor grants and loans	...	209	205	205	352	300
Revenues (in percent of non-opium GDP)	...	3.2	4.5	4.5	4.4	4.8
Expenditures (in percent of non-opium GDP)	...	8.6	9.8	9.8	10.5	11.3
Monetary indicators						
Domestic currency in circulation (annual change; in percent)	...	20.1	40.9	40.9	25.7	38.0
Gross foreign exchange reserves	...	426.1	815.5	815.5	977.0	1,105.3
	(In millions of U.S. dollars, unless specified otherwise)					
External sector						
Exports of goods (including reexports)	708.9	1,248.3	1,700.8	1,820.0	1,822.5	2,030.9
Exports of goods (annual change; in percent)		76.1	36.2	45.8	7.2	11.6
Imports of goods	1,645.0	2,407.6	3,758.9	3,414.5	4,134.1	3,425.9
Imports of goods (annual change; in percent)		46.4	56.1	41.8	10.0	0.3
Imports of oil	...	...	...	...	...	...
Current account deficit (excluding grants)	...	-1,305.5	-2,578.2	-1,944.8	-2,838.7	-1,721.3
Current account deficit (including grants; in percent of GDP)	...	-2.1	-0.9	-1.8	-1.6	-3.4
Afghani/U.S. dollar (average during fiscal year)	54.4	44.8	49.0	49.0	...	...
Afghani/U.S. dollar (end-fiscal year)	31.0	52.6	50.3	50.3	...	...
	(In percent of GDP)					
Investment and savings						
Gross investment	...	28.3	37.6	27.2	43.2	21.9
Domestic savings	...	-3.7	-18.6	-15.2	-5.7	-10.1
II. Social and Demographic Indicators						
Area	652,000 square kilometers					
Population (2002/03)	21.8 million					
Life expectancy at birth (2001)	42.8 years					
Infant mortality per 1,000 live births (2003)	115					
Under-five mortality per 1,000 live births (2003)	172					

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

1/ The fiscal year 2004/05 runs from March 20, 2004 until March 20, 2005.

2/ First review under the staff-monitored program (IMF Country Report No. 04/364; November 9, 2004).

Table 2. Islamic State of Afghanistan: Savings-Investment Balances, 2002/03–2007/08

	2002/03	2003/04	2004/05		2005/06		2006/07	2007/08
			Init.	Rev.	Init.	Rev.	Rev.	Rev.
	Est.	Est.	Proj.	Proj.	Proj.	Proj.	Proj.	Proj.
				(In millions of U.S. dollars)				
Domestic expenditures	5,389	6,529	8,641	7,113	9,881	8,792	9,757	10,808
Consumption	4,235	5,282	6,134	5,934	7,517	6,940	7,658	8,677
Public 1/	318	407	545	512	699	670	791	930
Private 2/	3,917	4,875	5,589	5,423	6,818	6,270	6,866	7,746
Gross fixed capital formation	1,154	1,248	2,507	1,179	2,364	1,852	2,099	2,131
Public	1,104	1,190	2,175	1,029	1,916	1,390	1,527	1,456
Private 3/	50	58	332	150	448	462	573	676
Net exports of goods and services	-1,305	-1,945	-2,839	-1,721	-2,865	-2,314	-2,272	-2,193
Exports of goods and services (excluding reexports)	328	459	774	624	1,011	862	1,006	1,087
Imports of goods and services (excluding reexports)	-1,633	-2,404	-3,613	-2,345	-3,876	-3,176	-3,278	-3,279
Domestic savings	-151	-697	-332	-542	-501	-462	-173	-62
Public savings	-187	-200	-288	-255	-357	-329	-365	-413
Private savings	36	-498	-44	-287	-144	-133	192	352
GDP at market prices	4,084	4,585	5,802	5,392	7,016	6,478	7,485	8,615
				(In percent of GDP)				
Domestic expenditures	132.0	142.4	148.9	131.9	140.8	135.7	130.4	125.5
Consumption	103.7	115.2	105.7	110.1	107.1	107.1	102.3	100.7
Public	7.8	8.9	9.4	9.5	10.0	10.3	10.6	10.8
Private	95.9	106.3	96.3	100.6	97.2	96.8	91.7	89.9
Gross fixed capital formation	28.3	27.2	43.2	21.9	33.7	28.6	28.0	24.7
Public	27.0	25.9	37.5	19.1	27.3	21.5	20.4	16.9
Private	1.2	1.3	5.7	2.8	6.4	7.1	7.7	7.8
Net exports of goods and services	-32.0	-42.4	-48.9	-31.9	-40.8	-35.7	-30.4	-25.5
Exports of goods and services (excluding reexports)	8.0	10.0	13.3	11.6	14.4	13.3	13.4	12.6
Imports of goods and services (excluding reexports)	-40.0	-52.4	-62.3	-43.5	-55.2	-49.0	-43.8	-38.1
Domestic savings	-3.7	-15.2	-5.7	-10.1	-7.1	-7.1	-2.3	-0.7
Public savings	-4.6	-4.4	-5.0	-4.7	-5.1	-5.1	-4.9	-4.8
Private savings	0.9	-10.9	-0.8	-5.3	-2.0	-2.1	2.6	4.1
Memorandum items:								
Real GDP growth (annual change; in percent)	28.6	15.7	16.0	7.5	12.0	11.3	10.0	9.6
Nominal GDP growth (annual change; in percent)	33.8	23.1	28.5	19.4	20.9	20.1	15.5	15.1
Sectoral shares of GDP (in percent)								
Agriculture	49.8	48.5	47.0	39.7	46.9	37.2	35.5	34.0
Industry	20.1	21.3	20.7	24.3	20.8	25.6	26.5	22.5
Services	30.1	30.2	29.4	36.0	29.5	37.2	37.9	43.5
GDP per capita (in U.S. dollars)	182	199	246	228	288	266	299	334
Domestic government revenue (in percent of GDP)	3.2	4.5	4.4	4.8	4.9	6.1	6.5	6.7

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

1/ Data originating from the fiscal accounts.
2/ Determined as a residual.
3/ Equivalent to foreign direct investment reported in the balance of payments, and some new private investment.