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Islamic Republic of Afghanistan: First Review Under the Extended Credit Facility Arrangement, Request for Waiver of Nonobservance of a Performance Criterion, Modification of Performance Criteria, and Rephasing of Disbursements—Staff Report; Staff Supplement; Staff Statement; Press Release on the Executive Board Discussion; and Statement by the Executive Director for the Islamic Republic of Afghanistan.

In the context of the Islamic Republic of Afghanistan: First Review Under the Extended Credit Facility Arrangement, Request for Waiver of Nonobservance of a Performance Criterion, Modification of Performance Criteria, and Rephasing of Disbursements, the following documents have been released and are included in this package:

- The staff report for the Islamic Republic of Afghanistan: First Review Under the Extended Credit Facility Arrangement, Request for Waiver of Nonobservance of a Performance Criterion, Modification of Performance Criteria, and Rephasing of Disbursements, prepared by a staff team of the IMF, following discussions that ended on May 16, 2012, 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 June 19, 2012. 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 supplement dated June 19, 2012 containing a joint World Bank/IMF Debt Sustainability Analysis.
- A staff statement of June 28, 2012 updating information on recent developments.
- A Press Release summarizing the views of the Executive Board as expressed during its June 29, 2012 discussion of the staff report that completed the request and/or review.
- A statement by the Executive Director for the 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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INTERNATIONAL MONETARY FUND

ISLAMIC REPUBLIC OF AFGHANISTAN

First Review Under the Extended Credit Facility Arrangement, Request for Waiver of Nonobservance of a Performance Criterion, Modification of Performance Criteria, and Rephasing of Disbursements

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

Approved by Adnan Mazarei and Dhaneshwar Ghura

June 19, 2012

Discussions: In May 2012, a mission met in Kabul with Minister of Finance Zakhilwal, Governor Delawari, Senior Minister Arsala, the Attorney General, and other high-ranking government officials, as well as donors, and private sector representatives.

Staff Team: The mission consisted of Mr. Axel Schimmelpfennig (Head), Ms. Melissa Tullis (LEG), Messrs. Aidar Abdychev and Marcin Sasin (all MCD), Ms. Jeta Menkulasi, Mr. Aqib Aslam (all FAD), and Mr. Warren Coats (MCM consultant). The mission was supported by Mr. Wabel Abdallah, Resident Representative, Mr. Nabil Hashad (MCD long-term advisor), 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 believe 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 2011 Article IV Consultation was concluded on November 14, 2011, and the report is available at http://www.imf.org/external/pubs/ft/scr/2011/cr11330.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 is a participant in the General Data Dissemination Standard (GDDS).

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EXECUTIVE SUMMARY

Afghanistan is embarking on a very difficult path toward self-reliance. The country faces widespread underemployment and poverty, and a challenging security situation and economic governance issues. Sound macroeconomic policies are important for economic development and poverty reduction, but noneconomic factors can frustrate policy efforts and even reverse hard-earned gains. Donor engagement will be a necessary condition for success.

To be successful, the country will need high and prolonged donor support. The security handover from the International Security Assistance Force (ISAF) is about 75 percent complete, and expected to be finalized by end-2014. Insurgent groups remain very active, and continue to stage high profile attacks including in Kabul. The May 2012 NATO summit in Chicago generated commitments for security aid—about US$3 billion annually through 2017 (or 15 percent of GDP in 2012)—but donors called for Afghanistan to become self-reliant over the coming decade. At the July Tokyo Conference, Afghanistan will seek donor support for its development agenda of about US$4.4 billion annually through 2015.

In this context, the IMF-supported economic program tries to address key macroeconomic challenges. The program provides the framework to manage the economic impact of the withdrawal of foreign troops, and identifies financing needs and sources. Moreover, the program seeks to safeguard the financial sector, strengthen economic governance, and move toward fiscal sustainability.

However, program implementation to date has been weak and raises concerns. The authorities have completed all but one of the structural benchmarks for the first review, but with delays. Cash recoveries from Kabul Bank reached US$128 million through June 4, 2012 out of a total of US$935 million owed to the receiver; the authorities will seek further recoveries through legal channels. They also request additional time for two benchmarks set for the second review. The limited technical capacity and the heavy workload in the run-up to the Tokyo Conference partly explain the slow reform pace. The lack of ownership by the government at large and opposition from vested interests are also formidable obstacles.

Looking ahead, Afghanistan faces pressing challenges that require determined policy implementation. Corruption and poor governance take their toll on the economy. Moreover, weaknesses in the banking sector are a major risk that needs to be addressed urgently. Over the medium term, fiscal pressures will emerge, leading to a fiscal financing gap of over 20 percent of GDP over the coming decade and beyond.

Notwithstanding the delays in program implementation, staff recommends the completion of the first review and supports the authorities' request for a waiver. The authorities made substantial progress on their reform objectives under the program during difficult times. Going forward, the program provides the macroeconomic anchor in challenging waters, addresses the key issues facing Afghanistan, and helps generate the necessary political support for this reform agenda. Risks to the program are very high, and future slippages cannot be ruled out. Overall program implementation needs to improve considerably before the second review.

I. Background: Afghanistan Sets Out on a Path Toward Self-Reliance

1. **The security and political situation remains very difficult.** Insurgents continue to stage high-profile attacks, including in Kabul. Recent targets include foreign embassies and a high-ranking member of the High Peace Commission which is supposed to engage in talks with the Taliban. The 2014 presidential election may impact the pace of reforms.

2. **Afghanistan development, humanitarian and governance challenges are formidable.** After decades of war, Afghanistan ranks in the bottom 5 percent of countries on the 2011 UN Human Development Index. Unemployment and underemployment are widespread, the poverty rate was 36 percent in 2007/08, and female literacy (ages 15–24) stood at only 22 percent. Key problems include large and active militant groups, poor governance, low levels of human capacity, a massive illicit sector, a large cash based economy, and porous borders. This, combined with the post-2001 surge of military, development, and humanitarian aid has contributed to distorted economic incentives, rent-seeking behavior, and helped entrench powerful vested interests.

3. **Afghanistan is at an important juncture in its transition to self-sustained security.** The hand-over of security responsibilities from ISAF to the government is well advanced. Afghan forces are now in charge of three quarters of the country, and ISAF intends to withdraw most foreign troops, end combat operations, and limit their activities to training by December 31, 2014. By 2017, the costs of the Afghan police and military are projected to be US$4.1 billion. At the May 2012 NATO summit in Chicago, donors pledged to contributed about US$3 billion, and asked that Afghanistan gradually phase out its need for security aid by 2025. Unless the security situation were to stabilize much faster than anticipated and security costs turn out lower than the projected 14½ percent of GDP, this could be very difficult, given that domestic revenue (including from natural resources) is likely to reach only 17 percent of GDP by that time.

4. **Next to security, development is the second overarching policy objective for which the government will need donor support.** The authorities have prioritized the Afghanistan National Development Strategy (ANDS), embedding it into 22 National Priority Programs (NPPs). Even with this prioritization and sequencing, the authorities ambitiously target development spending at US$4.4 billion annually in the coming years. They seek donor support for this development agenda beyond 2014 at the forthcoming Tokyo Conference on July 8, 2012. Donors have stated that they are looking for tangible progress on governance before making long-term commitments. Ultimately, development and the security situation will evolve interdependently either in a virtuous or vicious circle. Hence, finding the appropriate balance between these two key objectives will be important.

5. **Against this background, the IMF's Executive Board approved a three-year Extended Credit Facility (ECF) arrangement for Afghanistan on November 14, 2011.**[1] The main goals of the program are to make 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 resolution of failed Kabul Bank, including asset recovery, features prominently throughout the program to ensure that accountability and the rule of law are enforced, and that fiscal costs are contained.

II. Recent Economic Developments and Outlook

6. **Macroeconomic developments in 2011 were mixed, but the economy was sustained by donor inflows.** Real GDP growth slowed to around 6 percent, from over 8 percent in 2010, reflecting a poor harvest. After dropping into single digits during 2011, inflation accelerated again in recent months, reaching 11 percent year on year in March. Nonfood inflation—14 percent in March—remains persistently high. Exports weakened, but the current account deficit of about 40 percent of GDP (excluding grants) was more than financed by aid inflows. Gross international reserves increased to US$6.2 billion (7 months of imports). The exchange rate has depreciated by 10 percent during 2011—driven by higher than programmed purchases by the central bank—but has remained stable, at around 50 Afghanis per U.S. dollar, for the past six months. Deposits in the banking sector have stagnated at about 20 percent of GDP since mid-2011, reflecting a continued lack of confidence. There has also been virtually no new net bank lending during the past year, mostly for lack of sound lending opportunities and the general economic and political uncertainty. The interest rate on the central bank's 28-day notes has remained stable, at around 2 percent.

7. **In 2012, agriculture should more than offset the drag on growth from the external economic environment.** The global and regional economic environment is difficult, with elevated oil prices and occasional trade disruptions with neighboring countries. Domestically, the low level of security and the impact of the ongoing military withdrawal also hold back activity. However, agriculture is expected to rebound and boost real GDP growth to about 7 percent. With international commodity prices set to stabilize, inflation could decelerate to 7½ percent year-on-year by end-2012. Exports are likely to be sluggish due to weak external demand, while the higher fuel prices will inflate Afghanistan's import bill. The resulting large trade deficit will continue to be covered with grants.

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[1] See IMF Country Report No. 11/330 (http://www.imf.org/external/pubs/ft/scr/2011/cr11330.pdf).

III. PROGRAM IMPLEMENTATION

8. **The authorities have broadly met their program objectives, but implementation has suffered from delays.** The authorities have achieved their end-March quantitative targets in the monetary sector (Table 2 of the attached letter of intent). However, the revenue target has been missed by a small margin. Progress has also been made on a number of structural reforms, including on introducing a value-added tax (VAT) and establishing an agreed-upon capitalization framework for the central bank (Table 1 of the attached letter of intent). Notwithstanding this, a number of structural benchmarks have been implemented with long delays or need follow-up actions to make them consistent with program objectives; one structural benchmark will only be fully completed later this year.

9. **Importantly, the authorities have now initiated an asset recovery process for each Kabul Bank beneficiary.** Through a Presidential Decree, the authorities modified their asset recovery strategy on April 4, 2012. Previously, they relied on legally binding agreements with former Kabul Bank shareholders and related parties for repayment of the amounts owed.[2] However, actual repayments under these agreements fell significantly short of obligations, and the authorities concluded that the approach was not working. Instead, President Karzai gave Kabul Bank shareholders and related parties until June 4, 2012 to repay in full the amounts attributed to them in a forensic audit report. Failing to do so would result in the beneficiary being referred to a special tribunal as a civil or criminal case. As the authorities report in the attached letter of intent (LOI) and paragraph 14 of the attached memorandum of economic and financial policies (MEFP), cash recoveries on June 4, 2012 had reached US$128 million out of US$935 million total receivables identified in the forensic audit report—about US$54 million since the program approval in November 2011, of which about US$30 million were collected since the presidential decree, including US$5 million from regular borrowers. No beneficiary identified in the forensic audit report has paid in full. The two main architects of the fraud have been referred to the special tribunal, and the remaining beneficiaries will be dealt with by the Financial Dispute Resolution Committee, and, if warranted, could be referred to the special tribunal at a later date. The Financial Dispute Resolution Committee has been working closely with the receiver on asset recovery, and is the appropriate institution to rule on civil cases. The authorities have also issued requests for mutual legal assistance requests to the United Arab Emirates to recover assets outside of Afghanistan. Lastly, they will report public on asset recovery going forward.

10. **Staff welcomes the progress made, but has concerns over the quality of the steps taken.** In particular, staff notes that the referrals to the special tribunal make no mention of the evidence of the forensic audit report. This is surprising, given that, at the time of the

[2] A prior action on asset recovery for the approval of the ECF arrangement was only partially completed at the time. In approving the program, Executive Directors requested that the measures be completed before the first review.

program request, the authorities argued that they needed more time to show progress on asset recovery until the results of the forensic audit would be available. Staff also notes the limited legal capacity to pursue asset recovery, and the lack of clarity over the role of the Financial Dispute Resolution Committee. Moreover, it is unclear whether the government at large has the necessary political will to pursue asset recovery through the legal system in earnest. As such, there is a risk that the process initiated now will not lead to substantial asset recovery beyond what has been collected to date.

A. Quantitative Program for End-March 2011

11. **Monetary policy was tightened appropriately given the renewed acceleration of inflation**. The central bank reduced reserve money growth to 16 percent year-on-year in March 2012 (compared to over 21 percent for the previous year and the 19 percent ceiling envisaged under the program). Currency in circulation grew by 12 percent year-on-year, below the indicative ceiling. On the back of strong financial inflows, net international reserves reached US$5.9 billion at end-March 2012, or US$220 million over the program floor.

12. **Fiscal developments were marked by a shortfall in revenue collection.** While revenue collection edged up marginally to 11.1 percent of GDP in 2011/12 from 11.0 percent of GDP in 2010/11, the program target was missed by a small fraction because of unanticipated disruptions at the border with Pakistan and problems in revenue administration. Given their objective to gradually increase the revenue to GDP ratio, the authorities have committed to phasing out the use of "concessions" which allow certain taxpayers to pay a minimum presumptive tax rather than file for corporate income tax and business receipts tax. The revenue shortfall also meant that the operating budget deficit at 6.1 percent of GDP slightly exceeded the indicative program target, despite expenditure restraint in the first half of the fiscal year. Development spending increased by 22 percent in 2011/12, reaching 6 percent of GDP. Encouragingly, better capacity in line ministries and more realistic budgeting led to an implementation rate of 52 percent. Social spending reached 2 percent of GDP meeting the program target. As the budget had sufficient external financing, net central bank credit to the government remained within program targets.

13. **The authorities refrained from nonconcessional borrowing and did not accumulate arrears.** Consistent with the program, no new nonconcessional external debt, no short-term external debt and no new external arrears have been incurred. Afghanistan remained in compliance with its Article VIII commitments.[3]

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[3] Since April 2012, a cabinet decision restricts the amount of cash a person can take out of the country to US$20,000 per trip. The decision aims to tackle illicit money transfers. It has not yet been reflected in the laws. Given that there are no limits on the making of payment or transfers out of the country through the banking system, including through credit cards, this measure does not give rise to an exchange restriction on the making

(continued)

B. End-December 2011 and End-March 2012 Structural Benchmarks

14. **The ministry of finance and the central bank signed a memorandum of understanding on central bank capitalization framework in May.** This memorandum, *inter alia*, aligns the framework with good international practices and recommits parties to fully implement the recapitalization provisions as soon as the required amendments to the central bank law have been approved. In parallel, on May 21, 2012, Da Afghanistan Bank (DAB) retained KPMG as its external auditor for its 2011/12 financial statements. The auditor had already been present at the end-year cash count. The appointment had been delayed since December 2011 by the council of ministers which has to approve DAB's proposal.

15. **The draft VAT law was submitted to the ministry of justice for legislative review in December 2011.**[4] Although broadly consistent with Fund advice, the law contains some clauses, such as giving the minister of finance authority to grant VAT exemptions, which risk undermining the effectiveness of the VAT and need to be revisited. The authorities have committed to addressing the issue by limiting exemptions in the law and requiring that additional exemptions can only be introduced with parliamentary approval and have to be included in the VAT (structural benchmark for the third review).

16. **New Kabul Bank has been operating broadly according to its business plan.** By February, 25 branches of New Kabul Bank have been closed, deposit rates have been reduced, deposits have stabilized at around US$600 million (somewhat higher than previously expected) and expenses have been cut substantially. In anticipation of privatization, the bank is not engaging in any new lending and, therefore, making monthly losses of around US$2–3 million.

17. **A national strategy to build capacity and improve the institutional framework to prevent and effectively respond to economic crimes was finalized in May 2012.** While the strategy took longer than planned, it addresses gaps in existing governance programs and prioritizes addressing economic-governance related vulnerabilities in institutional frameworks. The strategy was included in the Governance National Priority Program "Justice for All."

18. **Insufficient progress has been made on bringing state-owned enterprises and state-owned corporations under effective control of the ministry of finance.** The authorities shared draft amendments to the law on state-owned enterprises with staff, and it was agreed that they fell short of the objective of bringing these enterprises under effective

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of payments and transfers for current international transactions and is thus consistent with Afghanistan's Article VIII obligations.

[4] However, due to the unfamiliarity of the ministry of justice with the subject, the draft has been returned to the ministry of finance for further clarification.

control of the ministry of finance. Staff has provided specific comments to strengthen the draft amendments. More importantly, amendments to the company law to bring state-owned corporations under the effective control of the ministry of finance will take more time. The authorities have added a structural benchmark on this for end-December 2012. State-owned corporations pose a much larger fiscal risks and, therefore, need to be addressed urgently.

19. **The authorities also made welcome progress in a number of other structural reform areas.** The new border management model was rolled out to two additional border-crossing points in March (structural benchmark). In the fiscal area, progress has been made in program budgeting, financial planning, medium-term fiscal framework, internal audit, and the reorganization of the customs department. In the banking sector, an audit of a bank found no fraud similar to that perpetrated at Kabul Bank—the bank has violated exposure limits, including to a related party, and some years back, the bank appears to have been involved in a misuse of loans, though these loans have been paid back. The bank is working closely with the authorities to address the various shortcomings and to return the bank to regulatory compliance, including through additional recapitalization, though the supervisor has given an extra three months (until June) for the capital injection agreed last year.

IV. Policy Discussions

20. **Discussions centered on four areas:**

- ***Macroeconomic policy mix:*** The challenge is to assure continued donor support and balance security, social, and development spending needs within a limited domestic resource envelope, while building buffers and returning inflation to single digits. This would form the prerequisite for sustained inclusive growth and poverty reduction.

- ***Safeguarding the financial sector***: The authorities will address structurally weak banks, strengthen the legal and regulatory environment of the financial sector, further enhance banking supervision, and sell or liquidate New Kabul Bank;

- ***Strengthening economic governance***: Further progress on asset recovery from Kabul Bank through the special tribunal is the primary focus of the authorities. In addition, they will address deficiencies in economic and financial sector governance, including in their anti-money laundering and combating the financing of terrorism (AML/CFT) framework;

- ***Moving toward fiscal sustainability***: The authorities will continue the work to introduce a VAT in 2014, develop a fiscal regime for natural resources, introduce sukuks, strengthen public financial management, and start tackling the fiscal risks from state-owned enterprises and corporations.

A. Macroeconomic Policies Through June 2013[5]

21. **The authorities and staff agree that the macroeconomic policy mix remains broadly appropriate.** Fiscal policy focuses on development spending and revenue mobilization, while monetary policy focuses on inflation and financial stability. The operating balance excluding grants remains the fiscal anchor, and reserve money the monetary anchor. The authorities remain committed to a floating exchange rate regime that, combined with their international reserves buffer, will help cushion potential external and domestic shocks. They emphasized that, given the country's large security and development needs and limited domestic resources, they will need significant long-term donor support to meet their external and fiscal financing needs.

22. **Fiscal policy aims to increase the revenue-to-GDP ratio and further improve development budget implementation capacity.** The 2012 budget is consistent with the program (as initially designed for 2012/13, MEFP paragraph 18). Domestic revenue collection is expected to increase to 11 percent of GDP in April–December 2012—a transitional fiscal year—from 10.6 percent of GDP during the same period in 2011.[6] Compared to a normal fiscal year, 2012 will see a temporary dip in revenue collection because it does not include January–March which is traditionally the strongest quarter. Development spending, including on health and education, is targeted to grow by about ½ percent of GDP to 6.4 percent of GDP. The budget also includes an allocation of US$65 million for the amortization of the promissory note issued to DAB for the lender of last resort loan to Kabul Bank. The authorities target an operating deficit (excluding grants) of 5.9 percent of GDP and an overall deficit (excluding grants) of 12.3 percent of GDP. The deficit will be covered by grants, and a small amount of concessional external borrowing.

23. **Monetary policy will aim at reducing inflation** (MEFP paragraph 19). Given the estimate for money demand and a need to accommodate a change in seasonality related to a shift in the fiscal year, the authorities and staff agreed that a reserve money growth of about 19 percent over 2012 should be sufficient to bring headline inflation down to about 7½ percent by end-2012. Foreign exchange auctions will continue to be the main policy instrument, complemented as needed with sales of capital notes.

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[5] Afghanistan will change its fiscal year during 2012. Previously, the fiscal year was based on the solar calendar and ran March 21 through March 20 (in most years). Starting in 2012, the fiscal year will end on December 21 (in most years), aligning it more closely with the Gregorian calendar. The authorities hope that this will facilitate development budget implementation by moving the last quarter during which most expenditure takes place to one with more conducive weather conditions. 2012 as the transition year will have only 9 months, March through December.

[6] For the full calendar year, revenue collection in 2012 would be 11.3 percent of GDP compared to 11.0 percent of GDP in 2011.

B. Safeguarding the Financial Sector

24. **The authorities are concerned about the high number of structurally weak banks in the system.** 8 out of 12 domestic banks have a CAMEL rating of 4 or lower.[7] A number of these banks are expected to not meet the increase in the regulatory minimum paid-up capital to US$20 million by June 2012 from the current US$10 million. The authorities intend to either close or merge those banks that do not meet the new minimum paid-up capital (structural benchmark, MEFP paragraph 23). Subsequently, they will review the remaining domestic banks and assess whether they are on a path of improvement, or whether there is a need to close or merge additional banks.

25. **The new banking law will help strengthen the system.** The new, consolidated banking law, once enacted, will help prevent, mitigate, and effectively respond to the problems in the financial sector.[8] The revisions strengthen corporate governance provisions, regulate capital requirements, large exposures, and related parties, as well as enhance supervision and bank resolution (MEFP paragraph 21). Under the program the authorities committed to submitting the draft law to parliament by end-September 2012 (structural benchmark), followed by adapting central bank regulations accordingly, and preparing informational circulars and trainings by end-December 2012 (structural benchmark). To supplement these efforts and improve the contract enforcement infrastructure, the authorities will also establish, by end-December 2012, a training program for court officials to create capacity in relevant banking laws and commercial codes.

26. **The authorities' program further strengthens banking supervision** (MEFP paragraph 22). This will be done through administrative improvements, such as reviewing and strengthening of enforcement regulations, improving the timeliness of enforcement actions, and the monitoring of the outstanding enforcement orders. In addition, the central bank will hire additional staff, provide more training in risk-based banking supervision, implement a new organizational structure for the Financial Supervision Department (structural benchmark), and change the mandate of the Risk Management Department (to focus on risks within DAB only). In addition, DAB intends to strengthen the legal protection of supervisory staff from rogue, corrupt or politically motivated elements, in good faith conduct of duties.

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[7] The 12 banks include New Kabul Bank, which has not yet been rated.

[8] In 2011 the Fund advised on drafting the previous version of draft amendments to the banking law and also, separately, provided extensive advice on the earlier version of a separate Islamic Banking Law. The authorities are currently merging these two laws so that a consolidated banking law comprehensively covers all—conventional and Islamic—banking provisions and products. The new banking law will have to be reviewed by the Supreme Council of the central bank and the ministry of justice before it is submitted to parliament. Fund staff will be further consulted.

27. **The authorities also intend to strengthen the central bank capitalization framework.** They will implement the provisions of the recently signed memorandum of understanding, including through changes in the law where necessary—to be finalized by December 2012 and sent to parliament by June 2013 (structural benchmark, MEFP paragraph 31). A recapitalization, if needed, will be effected no later than 2014. Going forward, to fully regularize the financial relations between the central bank and the ministry of finance, a service agreement between the parties should mandate the central bank paying market interest rates on government deposits and the ministry paying market or cost based fee for services rendered to it by the bank.

28. **Reflecting delays in appointing a privatization advisor, offering New Kabul Bank for sale will take longer than anticipated.** The economic committee of the cabinet has approved the sale of New Kabul Bank on February 21, 2012, and the privatization advisor, financed by DfID, started his work in May. Developing the privatization plan will take until August 2012 (structural benchmark), and the bank can then be offered for sale by end-September (structural benchmark), and not in June 2012 as previously envisaged under the program (MEFP paragraph 25). If there is no interest from a suitable buyer or the sale fails, the authorities plan to wind down the bank by end-December 2013—taking longer than previously expected because handing over the salary payment function to other banks as well as migrating the existing deposit accounts to viable financial institutions capable of accommodating them is likely to take more time. Over 400,000 government employees receive their salaries by direct deposit to their bank accounts—largely at New Kabul Bank. The recently awarded new salary payment contract—to Azizi Bank and new Kabul Bank—will allow an additional bank to start expanding coverage and building capacity in this field. The authorities note that civil servants will be able to freely choose the bank in which their salaries are paid once the new national payments systems (real time gross settlement, automated clearing house, and a national switch), financed by the World Bank, will be operational in mid-2014.

C. Strengthening Economic Governance

29. **The authorities have made a high-level commitment to tackle the deficiencies in their AML/CFT framework in line with the targeted review process of the Financial Action Task Force International Cooperation Review Group** (MEFP paragraph 30)**.** In May, the authorities met with the Regional Review Group and made a ministerial level commitment to an action plan designed to bring them into compliance with FATF recommendations. The action plan will be agreed with the Financial Action Task Force in June 2012. The authorities agreed to implement the elements of the action plan according to a timeline discussed and agreed in May (structural benchmark). In this context, they will also strengthen information sharing among the various entities involved in AML/CFT (structural benchmark).

30. **Following up on their economic crimes strategy, the authorities will establish a task force to steer and oversee work in this area.** The economic crimes task force will be

led by a senior official and, for example, oversee the passage and implementation of new laws, and function as a coordinating body for the various entities concerned with economic crimes (structural benchmark, MEFP paragraph 29).

D. Moving Toward Fiscal Sustainability

31. **The authorities stressed the importance of the VAT in their strategy for revenue generation and fiscal sustainability.** In line with the objective of introducing a VAT in 2014, the draft law will be sent to cabinet for discussion by September 2012, and to parliament for approval by end-December 2012 (structural benchmark, MEFP paragraph 34). In the meantime, the authorities will prepare for the VAT implementation by: (i) identifying large taxpayers who are not currently filing with the Large Taxpayer Office (LTO)—but should do so based on their turnover—with a view to transferring them to the LTO; (ii) revisiting the LTO threshold so as to optimize the number of businesses in the office; and (iii) strengthening office's capacity through internal staff transfers and trainings (structural benchmark, MEFP paragraph 35).

32. **The authorities are putting in place a fiscal regime for natural resources.** The objective is to attract investment and ensure that the government has a reasonable share of the economic rent (MEFP paragraphs 36 and 37). Importantly, they are committed to channeling revenues transparently through the budgetary process, without earmarking or off-budget spending. To that end, by June 2013, they intend to finalize amendments to the appropriate laws that create an effective and transparent fiscal regime for natural resources in full compliance with the Extractive Industries Transparency Initiative and in consultation with the IMF and the World Bank (structural benchmark).

33. **The authorities regret that it will take more time to work on the law on marketable sukuk securities.** Sukuks are intended mainly to improve cash management; the authorities noted that they did not envisage using them to finance future budget deficits. The ministry of finance is finalizing the draft law, with a view to submitting it to the ministry of justice by September 2012 (structural benchmark) and to the parliament by March 2013 (MEFP paragraph 39). This is later than initially planned (sending the law to parliament by September 2012) to allow for wide consultations with all stakeholders and ensure that the law is fully consistent within the Afghan legal framework. In the meantime, a sukuk implementation plan with specific actions and a timetable will be prepared for the actual issuance, intended for late 2013 or early 2014.

E. Fiscal and External Debt Sustainability Analysis[9]

34. **The authorities will seek substantial and prolonged financial support from donors at the forthcoming Tokyo Conference.** Afghanistan's financing needs will decline

[9] See Islamic Republic of Afghanistan, Joint World Bank/IMF Debt Sustainability Analysis Update below.

from about 47 percent of GDP at present (including off-budget development and operating spending paid for directly by donors) to just over 20 percent of GDP by 2020. Based on Fund and World Bank staff estimates, Afghanistan's financing needs will remain at this elevated level for some time. If the Tokyo Conference does not generate the hoped-for support, staff advises that the authorities build up spending very carefully and only in line with their sustainable resource envelope. This will require very difficult choices and could imply that Afghanistan's development ambitions will take longer to realize. Fund staff is developing a model-based framework that will allow quantifying the macroeconomic effects of the decline in the military presence and aid, and illustrate policy trade-offs.

35. **Expenditure pressures come from three sources: security, development and the take-over of the recurrent costs implications of donor projects.** First, security spending needs are projected to be high—stabilizing at about 15 percent of GDP after 2020—compared with other low-income countries.[10] Second, staff believes that development spending should stabilize at about 10 percent of GDP. The authorities would prefer to frontload investment until 2020 to reach 16 percent of GDP on average but decline to below 10 percent of GDP thereafter. However, given likely resource constraints and limited implementation capacity, it is unlikely that such a high level of development spending can be achieved. Third, the budget will have to accommodate the recurrent costs of projects currently financed by donors of about 4½ percent of GDP. Taken together, government expenditures could reach close to 40 percent of GDP in 2025, a level much higher than what governments in comparable countries would spend.

36. **Domestic revenues would barely cover half of projected government spending.** Successful implementation of a VAT in 2014 should generate about 2 percent of GDP, while an excise tax (not yet a part of the program, but assumed for 2018), could yield an additional 1 percent of GDP. Furthermore, under a cautiously optimistic scenario, mining revenues could yield about 2 percent of GDP by 2025 (the authorities hope that mining will yield about 3 percent of GDP). Taken together, domestic revenue could increase to about 17 percent of GDP by 2020, from today's 11 percent of GDP.

37. **With these trends, the government will continue to run large fiscal deficits of about 20–22 percent of GDP in the long run.** Only a fraction of this amount can be financed by external concessional loans or through issuance of domestic debt. Under these circumstances, fiscal sustainability (defined as domestic revenues covering operating expenditures) falls beyond the projections' horizon. Without high and prolonged donor support, the proposed strategy is not viable.

[10] Security cost projections are based on ISAF estimates. Most of the projected reduction is expected to take place during 2015–17, reflecting the envisaged managed troop reduction from 352,000 to 228,500. The authorities have not yet committed to this reduction, and keeping the troop size at 352,000 would carry a price tag of about US$700 million in 2017 or 2½ percent of GDP.

38. **As a result, Afghanistan remains at high risk of debt distress even after the HIPC completion point and delivery of debt relief under the MDRI.** External public and publicly guaranteed debt amounted to US$1.2 billion, or 7 percent of GDP, in 2011, most of which was owed to multilateral creditors.[11] Under the baseline scenario of the debt sustainability analysis, the present value of public external debt would reach about 5 percent of GDP by the end of the projection period, below the indicative debt-burden threshold applying to a country like Afghanistan.[12] However, should donors decide to reduce aid rapidly or provide loans rather than grants, or should security fail to stabilize, or structural reforms and governance improvements lag, Afghanistan's debt burden would become unsustainable. Risks to the outlook are tilted to the downside, linked to security prospects, the strength of future reforms, and a possible deterioration of the fiscal outlook with more limited access to grants.

V. PROGRAM MODALITIES

39. **The program is fully financed and access remains appropriate.** Donor inflows, on which Afghanistan is highly dependent, can be uncertain and volatile, thus calling for a sufficiently robust level of foreign reserves. The proposed access should be sufficient to cover any residual financing gaps and contribute to reserves equivalent to about seven months of imports.

40. **The authorities request a waiver and some program design modifications.**

- ***Waiver of nonobservance.*** The slippage in revenue collection is minor (less than 0.2 percent of GDP) and, given that it reflects trade disruptions at the border with Pakistan, temporary and beyond authorities' control. In staff's view, the slippage does not jeopardize successful implementation of the program. In addition, the authorities have taken immediate remedial measures to strengthen revenue collection: specifically, they committed to phasing out all existing concessions for certain taxpayer groups that have hitherto undermined the revenue base (MEFP paragraph 35).

- ***Modification of quantitative performance criteria for end-September 2012.*** The request reflects changing circumstances and new information. In fact, two of the three performance criteria proposed for modification entail some tightening. The third one, the ceiling on reserve money, needs to be adjusted to accommodate a change in seasonality related to a shift in the fiscal year.

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[11] After debt relief under HIPC and MDRI, as well as from Paris Club creditors. Negotiations with the one remaining Paris Club creditor (Russia) on the delivery of its debt relief commitments continue, as well as with other creditors on comparable terms.

[12] Afghanistan is classified as a "weak performer" and its thresholds therefore: 30 percent of NPV 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 20 percent for the debt service-to-revenue ratio.

- ***Modification of benchmarks for the second review.*** The authorities believe that more time is needed to complete the structural benchmark on offering New Kabul Bank for sale and submitting the sukuk law to parliament. They have introduced intermediate steps to document progress toward these important objectives.

41. **The authorities are requesting a rephasing of the arrangement, including a change to the schedule of reviews, in order to align it with the new fiscal year.** In 2012 the government is changing its fiscal year (Footnote 5), and asks to align the review cycle with the new fiscal year. Through 2011/12, the fiscal year corresponded to the Afghan calendar year (based on the solar year) running from March 21 to March 20 in most years. Starting in 2013, the fiscal year will run from December 22 to December 21 in most years. 2012 will be a transition year with only nine months in the fiscal year (March–December). Accordingly, the schedule of test dates and reviews, starting with the third review, is brought forward by three months (implying an interval of three months between the second and third review), with a corresponding change to the schedule of disbursements. Thus, the second, third and fourth reviews of the program would be based on performance through September 2012, December 2012 and June 2013, respectively—the quantitative performance criteria and structural benchmarks have been set accordingly. The conditionality under the third and fourth review will be revisited at the time of the second review.

42. **The authorities and staff agreed to clarify some definitions in the technical memorandum of understanding.** The clarifications include the definitions of reserve money, net central bank credit to the government, two adjustors and the treatment of treasury's IMF accounts. These changes are for clarification only, and do not bring any material changes to the design of the program, including to the quantitative performance criteria.

43. **An update safeguards assessment of the central bank was finalized in December 2011.** It found that while most of the previous safeguards recommendations had been implemented, an effective internal audit mechanism had still not been established and governance oversight was weak. The assessment also made recommendations to address risks emerging as a result of the Kabul Bank crisis including with respect to central bank autonomy. Since the assessment, some recommendations have been implemented, albeit with delay. The central bank is committed to implementing the remaining safeguards recommendations, with priority assigned to development of the internal audit function (with external support) and strengthening of Audit Committee oversight.

44. **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. It will be useful to prepare a Report on the Observance Standards and Codes on data to help develop an economic statistics plan.

VI. Staff Appraisal

45. **The authorities have made notable progress in a number of important reform areas.** The ministry of finance has sent a draft VAT law to the ministry of justice for review and rolled out the new border management model to two additional crossings. DAB and the ministry of finance have agreed on the central bank's capitalization framework. And, the government has included its new economic crimes strategy in its NPPs.

46. **Notwithstanding this, program implementation has been weak and needs to improve for the second review.** While the individual missed quantitative targets or delays in structural benchmarks can all be explained, the fact remains that only a select few measures have been implemented as described in the authorities' program request. Going forward, additional delays have been flagged, and more could occur. This raises questions over the authorities' capacity to implement a program and ownership in the government at large. For a successful second review, reform implementation has to become more timely and in line with the commitments' spirit.

47. **Asset recovery from Kabul Bank has been disappointing despite the boost over the last eight weeks after the Presidential Decree.** One and a half years after the failure of Kabul Bank, cash recoveries have been low, including because the receiver did not have sufficient capacity to follow up on nonpayments under the previously existing legally binding agreements. With the Presidential Decree, cash recoveries have picked up, and a special tribunal is now considering the cases of the two main shareholders, while the Financial Dispute Resolution Committee will deal with the remaining shareholders and related parties. Staff has concerns over the quality of the process that has been initiated, and encourages the authorities to send a strong signal that the rule of law holds in Afghanistan. Failing that, there is a risk that asset recovery going forward may be fairly limited. The authorities should also report quarterly to the public on their asset recovery progress starting in September 2012, and take the necessary actions that will provide the environment in which seized properties in Afghanistan can be sold at a reasonable price.

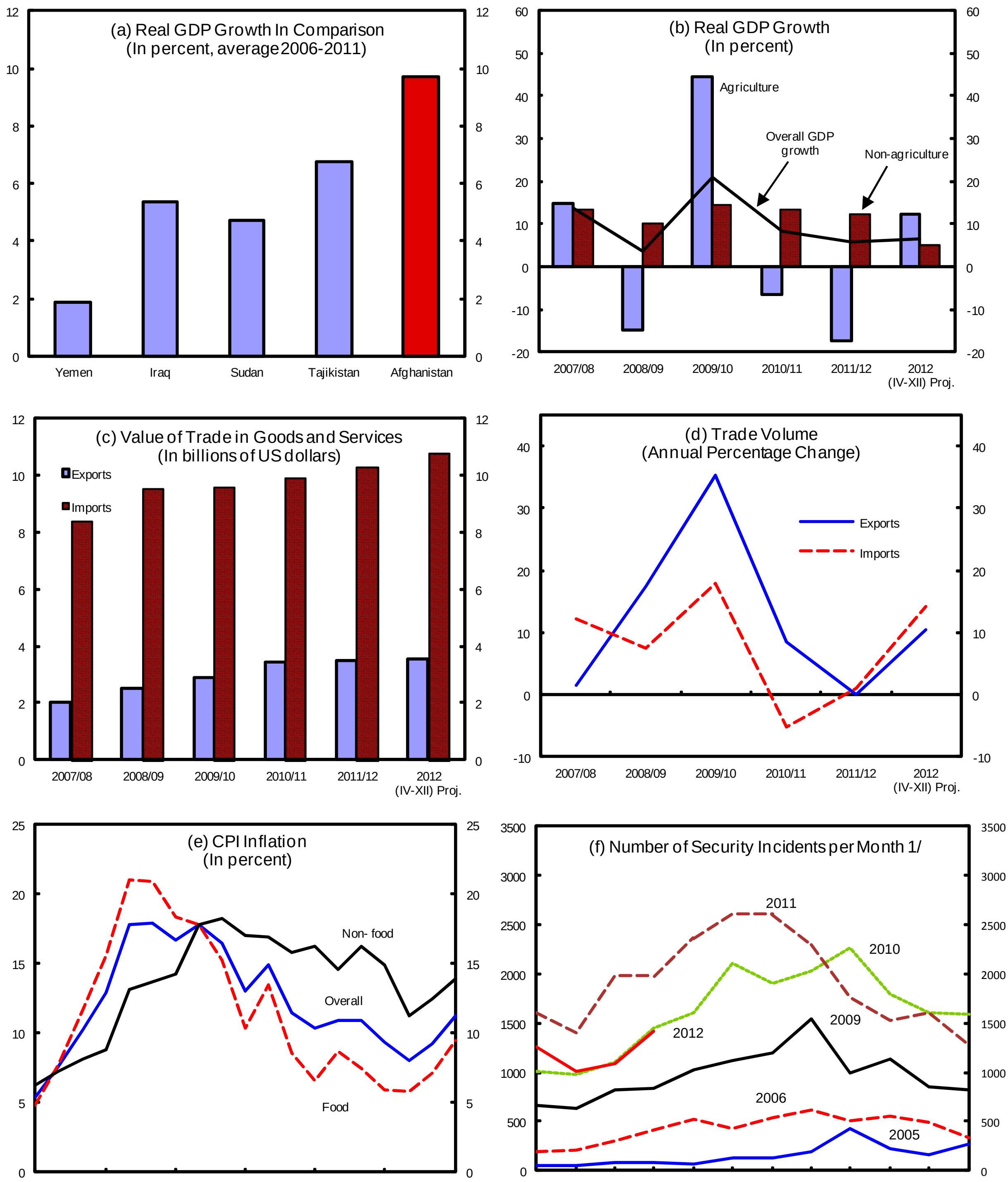
48. **The authorities' program for the coming year is appropriately focused on three areas.** First, financial sector weaknesses constitute vulnerabilities and can be costly, as evidenced by the Kabul Bank failure. The supervisor should ensure that all banks have adequate capital that is commensurate with their risk exposure. More generally, banking sector weaknesses are part of the reason why the sector is not playing a role in facilitating private sector led growth. The sale of New Kabul Bank could be an important milestone for financial sector development, but only if a proper investor is identified. If no suitable investor steps forward, the bank should be wound down as quickly as possible. Second, poor economic governance is a macroeconomic risk that could derail the authorities' growth and development objectives. And third, given Afghanistan's security and development spending requirements, the authorities need to act decisively to strengthen domestic revenue mobilization, including by introducing a VAT and putting in place a sound fiscal regime for the natural resource sector.

49. **The authorities' development objectives over the coming decade are very ambitious.** The NATO summit has generated significant pledges, but has also sent a signal that donors are unwilling to make indefinite commitments. Even with the planned domestic revenue efforts, the targeted spending level implies large financing needs beyond the projection horizon. The outcome of the Tokyo Conference will determine how ambitious the authorities can be in their development agenda. If pledges fall short of the proposed financing needs, the authorities need to constrain spending to within the available resource envelope or find additional ways to raise domestic revenues. Afghanistan has only very limited scope for debt financing, and cannot afford to build up expenditure expectations that cannot be delivered.

50. **The program is subject to significant risks.** First, powerful vested interests have the means and the potential to paralyze political will and obstruct reforms. As these vested interests may ultimately put into question Afghanistan's political and economic viability, it is imperative that the government stand firm on its governance and rule of law agenda and fully apply Afghan law. Second, the reduction in international presence, including withdrawal of combat troops and decrease in donor activity could have more severe than expected economic repercussions, leading to fiscal and external pressures. Third, deterioration in the security situation would reduce growth and make it impossible to implement reforms.

51. **Despite the delays and implementation difficulties, staff recommends the completion of the first review.** The reform agenda is ambitious, given implementation capacity. In this context, the Fund program is an effective mechanism to generate support for the reform agenda and maintain momentum for the difficult measures needed to create an environment for high and inclusive growth. The program also acts as a catalyst for donor support, with some donors explicitly linking their support to the program. Staff supports the request for a waiver of nonobservance for the end-March 2012 performance criterion on central government revenue collection, given that the authorities are taking corrective action. Lastly, staff also supports the requested modification of September 2012 performance criteria and the rephasing of disbursements.

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.