FOR AGENDA

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July 19, 1984

To: Members of the Executive Board

From: The Acting Secretary

Subject: Afghanistan - Staff Report for the 1984 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1984 Article IV consultation with Afghanistan. A draft decision appears on page 16.

This subject will be brought to the agenda for discussion on a date to be announced.

If Executive Directors have technical or factual questions relating to this paper prior to the Board discussion, they should contact Mr. Chabrier (ext. 77497) or Mr. Drees (ext. 76122).

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INTERNATIONAL MONETARY FUND

AFGHANISTAN

Staff Report for the 1984 Article IV Consultation

Prepared by the Staff Representatives for the
1984 Consultation with Afghanistan

Approved by A. S. Shaalan and Subimal Mookerjee

July 17, 1984

I. Introduction

The 1984 Article IV consultation discussions with Afghanistan were held in Kabul during the period May 24-30, 1984. The Afghan representatives were led by the General President of Da Afghanistan Bank and included the First Deputy Governor, the Deputy Ministers of Finance, Commerce, Agriculture and Agrarian Reform, Mines and Industry, and senior officials of several ministries and agencies, as well as members of the Central Committee of the People's Democratic Party of Afghanistan. The mission was composed of Messrs. P. Chabrier (Head, MED), F. Drees (MED), J. Modi (FAD), and S. Thayanithy (MED), and Ms. L. Allardice (Secretary, MED). Mr. G. Salehkhou and Mr. M. Benachenhou, Executive Directors for Afghanistan in the Fund and in the World Bank, respectively, attended the policy meetings.

Afghanistan continues to avail itself of the transitional arrangements of Article XIV.

II. Economic Background

Since 1978, the Afghan Government has embarked upon fundamental changes in the country's economic policies, including a land reform, the strengthening of the public sector, and the reorientation of trade and financial transactions toward East European countries. However, economic progress has been jeopardized by a number of adverse factors. On the domestic side, these have been internal security problems and the resulting damage to infrastructure and production facilities, 1/ the mobilization of manpower resources for the security forces, and population movements from rural to urban areas and to neighboring countries; the hostilities of the past few years have also limited the ability of the authorities to implement policies and have weakened the efficacy of some policy instruments. The major external factors have

1/ The damage to physical assets between 1978 and 1983 has been officially estimated at Af 35 billion, i.e., equivalent to the development spending made in the past three years.

been the cessation of aid by certain foreign countries and international organizations, the dwindling of workers' remittance inflows, as well as impediments to Afghanistan's external trade.

The Afghan authorities were cooperative in providing information for the consultation discussions. However, the low quality of some basic data and statistical inconsistencies have made it difficult to carry out a comprehensive analysis of economic and financial developments. The last assessment of the Afghan economy by the IBRD dates back to 1977 (see Appendix II).

Following several years of depressed economic activity, real net material product (NMP) is officially estimated to have increased by 1.7 percent and 4.5 percent in 1982/83 and 1983/84, respectively. 1/2/ The financial situation has deteriorated steadily since 1981/82. In 1982/83 and 1983/84, budget revenue rose only at an average of 7 percent a year, i.e., much less than NMP at current prices. Most of the increase in tax revenue was due to an upward revision of the import valuation base and the collection of tax arrears; other main categories of taxes rose only little because of their low built-in flexibility, the absence of discretionary changes, depressed activity levels in some sectors, and difficulties in collecting some taxes. Despite a significant increase in revenue from the export of gas, nontax revenue virtually stagnated because of the weaker financial position of several public enterprises and the fact that these enterprises were permitted to retain up to half of their profits for financing their investment and workers' incentive funds. Total expenditure rose at an annual average rate of 20 percent on account of substantial increases in outlays for public order and defense--largely reflected, in turn, in the sharp growth of expenditure on the wages and salary bill and of purchases of materials and supplies--and repairs of damage to basic infrastructure. In addition, extrabudgetary expenditures amounting, on average, to 15 percent of total expenditures were incurred in both years; these were caused by the need to reconstruct damaged facilities and presumably also due to transfers to public sector enterprises to cover operating losses that had not been envisaged in the budget. In contrast, development outlays stagnated because of financial and implementation constraints. As a result of the faster growth of expenditure (20 percent) than of revenue (7 percent), the overall budget deficit rose from Af 4.8 billion (3 percent of NMP) in 1981/82 to Af 15.8 billion in 1983/84 (8 percent of NMP), and domestic bank financing from Af 1.7 billion (3.6 percent of the opening broad money stock, M2, in 1981/82) to Af 9.8 billion (14.7 percent of M2) in 1983/84 (see Basic Data, Appendix III).

1/ Corresponding to Afghan years 1361 and 1362 ended March 20.

2/ Afghanistan compiles national accounts data on the basis of the system used in CMEA countries. The "net material product (NMP)" is somewhat lower than GDP at market prices.

Recourse by the Government to the banking system was the major factor responsible for the sharply increased credit expansion in 1982/83 (43 percent) and in calendar year 1983 (47 percent). However, a large part of this liquidity injection was absorbed by the balance of payments deficits, with the result that domestic liquidity rose by 17 percent in each period. Given the difficult supply situation, this rate of monetary expansion has led to an acceleration in the rate of increase in the retail price index for Kabul to close to 20 percent in the past few years; this increase is an underestimate of the underlying rate of inflation since the index contains products whose prices are administered and/or subsidized and which have been adjusted only little in recent years. While agreeing that monetary expansion had played a role, the Afghan representatives pointed to a number of additional reasons for the increase in prices, including the use of the more depreciated bazaar rate (a legally permitted parallel exchange rate) for a growing proportion of imports, the unpredictability and higher freight costs of the transit trade through Pakistan, the diversion of domestic supplies (in particular vegetables and fruits) to neighboring countries, and dislocations in the internal transportation and distribution system. Efforts made by the Government in procuring essential goods, including the import of foodstuffs, had helped maintain an adequate supply of essentials at low prices in the cities, a task that had been more difficult in the countryside.

Following several years when the balance of payments was in overall surplus because of sizable receipts of workers' remittances mainly from the Islamic Republic of Iran, foreign aid, and rising exports of natural gas to the U.S.S.R. at close to world prices, the external position weakened considerably after 1980/81 (Table 1). Overall deficits, totaling US$271 million, were incurred in each of the following three years with the deterioration particularly pronounced in 1982/83 and 1983/84. Although the very large shift, from an inflow to an outflow, in errors and omissions after 1981/82--which presumably reflects, in part, inappropriate valuation and a misclassification of several items--makes it difficult to adequately analyze the developments of the balance of payments in recent years, the deterioration appears to be due to the failure of exports to grow, the dwindling of emigrants' remittances, and reduced levels of external assistance. Even though the export price of natural gas was further increased, export receipts have stagnated after 1980/81 as both the prices and volumes of some other exports declined; the decline in volume was on account of production and internal transportation problems, the withdrawal of landing rights for the national airline in certain European countries, and protectionist measures in industrial countries against certain Afghan agricultural exports. Imports declined by 10 percent in the two years ended 1983/84 on account of slower investment project implementation, lower prices of key imports (e.g., petroleum products), and delays in receiving goods transiting through Pakistan.

Table 1. Afghanistan: External Sector Indicators

(In millions of U.S. dollars)

	1981/82	1982/83	1983/84	Official Projection 1984/85
Trade balance	-350	-251	-260	-549
Exports	(691)	(708)	(681)	(688)
Imports	(-1,041)	(-959)	(-941)	(-1,237)
Services (net)	56	94	74	60
Current deficit	-294	-157	-186	-489
(In percent of NMP)	(11.2)	(6.0)	(6.7)	(15.5)
Capital	164	147	111	240
Errors and omissions	97	-60	-93	56
Overall deficit	-33	-70	-168	-193
Bilateral	29	-73	-149	-183
Convertible	-62	3	-19	-10
Memorandum items				
Net foreign assets 1/	922	851	683	490
Gross official reserves 1/	591	475	293	...
(In percent of imports) 2/	(60)	(62)	(50)	(24)
Of which:				
convertible reserves 1/	281	238	206	...
External debt 1/3/	2,368	2,411	2,421	2,471
(In percent of exports of goods and services)	(292)	(285)	(303)	(319)
Debt service ratio	(14.5)	(15.8)	(15.1)	(12.8)
Bazaar exchange rate (Afghanis per US$1)	57	77	99	113

Source: Based on data provided by the Afghan authorities.

1/ End of period.
2/ Of the following year.
3/ Excludes commercial loans with maturities of 7-10 years, which public sector enterprises obtained from suppliers in the U.S.S.R. In the three years ended 1983/84 such loans amounted to US$55 million.

The balance of payments deficits of the three years ended 1983/84 have resulted in a reduction both in the official convertible exchange reserves (to the equivalent of two months of 1984/85 imports) and in the credit balances under bilateral payments agreements with the nonconvertible area. Another indication of the weakening external position has been the increase in the outstanding external debt in the past four years to US$2.4 billion in March 1984, an amount more than three times the current annual value of exports of goods and services. Over 80 percent of the external debt is owed to the CMEA countries (mostly the U.S.S.R.) in long maturities and at relatively low interest rates. Repeated debt relief granted by the U.S.S.R.--the terms of which could not be disclosed--has contained debt service payments to a range of 15-17 percent of exports of goods and services in the last three years, with the ratio projected to decline to 13 percent in 1984/85.

The exchange and trade system has remained relatively free of restrictions. 1/ Afghanistan has historically maintained a complex exchange rate system. Transactions with the nonconvertible area, cotton export proceeds, and external payments financed through the budget are effected at the official rate of Af 50.00-51.20 per US$1; this rate has not been changed since September 1981. A second official rate, the "operational" rate, set at Af 55.00-56.25 per US$1 since 1981, is used for exports other than those at the official rate and for the sale of official convertible exchange to public sector companies. However, in the recent past, surrender requirements for most exports to the convertible area have been abolished, karakul and wool exports have been offered incentive rates, and virtually all public sector companies have been denied access to official exchange at the operational rate; the private sector has been denied such access since 1980 (see Appendix I). As a result, very few transactions are now effected at the operational rate as both private importers and public entities have to obtain their foreign exchange requirements either from the bazaar or from the sales of convertible export proceeds by exporters at rates close to the bazaar rate.

The increased demand for foreign exchange from the bazaar combined with the lower supply due to the fall in workers' remittances have led to a depreciation of the bazaar rate from about Af 57 per US$1 in January 1982 to Af 114 per US$1 on June 14, 1984. From early 1982 to April 1984, the official exchange rate appreciated by about 50 percent in real effective terms. Besides this real appreciation of the Afghani, Afghanistan's competitive position has also suffered from other factors, such as the security situation.

1/ For details about the exchange and trade regime, in particular the timing of recent changes in the exchange system, see the Recent Economic Developments report on Afghanistan (to be issued shortly).

III. Discussions on Prospects and Policies

The challenge faced by the Afghan authorities in the economic field in the short term is to maintain adequate supplies of essential goods for the population and to revive domestic production, while containing inflation and keeping the balance of payments deficits to levels that can be financed by concessional aid. In the past three years, the impact of the deterioration in the domestic financial situation on prices could be mitigated only because Afghanistan was able to incur large balance of payments deficits. As the external reserve position has become considerably weaker, the possibility to absorb through the balance of payments a large part of the liquidity injected through credit expansion has become more limited. A much larger overall balance of payments deficit than in previous years is projected by the Afghan authorities for 1984/85, which they expect to finance through the bilateral payments agreement with the U.S.S.R. The prospective magnitudes of such current and overall balance of payments deficits, the sharp increase in external debt levels they imply, and the constraints they impose on economic policy management, indicate the need to introduce measures in several policy areas aimed at both reducing such balance of payments deficits and at containing the rate of net domestic credit expansion. Under the present conditions, development prospects can only be modest and spending decisions must be made in the light of the above objectives and constraints.

1. Production policies

Given the uncertainties relating to the security situation, the authorities now conduct economic policies on the basis of yearly "Socio-Economic Development Plans" that spell out objectives and policies for the forthcoming year. The Afghan representatives emphasized that as soon as conditions permit, a five-year plan would again be formulated.

Concerning production developments in recent years, which show NMP to have risen by 1.7 percent in 1982/83 and by 4.5 percent in 1983/84, the mission observed that the increased imports of foodgrains, depressed levels of production in the textile and food processing industries, the decline in imports of inputs, and the diversion of manpower to the security forces, pointed to a lower growth of production. The Afghan representatives replied that the upswing in activity was due to a recovery in the production of natural gas and electricity, to the improved provision of modern inputs to agriculture, and to greater financial incentives for industrial workers. Moreover, the developments mentioned by the mission were, in their opinion, not inconsistent with the rates of economic growth shown by official statistics. Indeed, the increased foodgrain imports were necessary to ensure adequate supplies in all parts of the country and the reduction in other imports had not been a serious constraint on economic growth. Also, workers in essential enterprises had been exempted from the draft and stepped up vocational

training had permitted an increase in the pool of skilled labor. As for 1984/85, the Plan projects a deceleration in real economic growth to 2.9 percent, attributable to an expected stagnation of agricultural production due to inadequate snowfall last winter; but industrial production is projected to increase by 9 percent because of a larger and more reliable supply of electricity and other inputs.

The development of agriculture is given a high priority. The main effort to promote agriculture consists of the expansion of the network of service cooperatives, the supply of modern inputs, the provision of veterinary services, and the continuation of the land reform. To ensure further progress in land reform, under which so far about 30 percent of the cultivable land has been redistributed, small holdings and cooperatives have recently been exempted from land taxation, and irrigation water is provided free of charge. The mission emphasized the impact of such policies in terms of lost revenue, waste of scarce water resources, and inadequate maintenance of the irrigation network. The Afghan representatives did not share this concern; they explained that the main canals would be constructed and maintained through the use of general government funds, while farmers would provide voluntary services for the maintenance of the feeder canals.

The Afghan representatives noted that the difficulties that were being encountered in the production and marketing of cash crops (cotton, sugar beet, etc.) were due to the prevailing security situation and not to inadequate production incentives. Procurement prices for cotton and sugar beet had been raised by 40 percent and 60 percent, respectively, for the 1983/84 season and the level and structure of agricultural producer prices were now appropriate. Official policy was to keep procurement prices at remunerative levels.

The Afghan representatives indicated that official policies fully supported the role played in economic development by the private manufacturing sector, which accounts for about one quarter of the modern industrial sector. The private sector is free to operate in any field except heavy industries, a position that will be reaffirmed by a new law under preparation. Foreign private investment is also welcome.

Natural gas is Afghanistan's main export commodity with the bulk of production being sold to the U.S.S.R. In recent years, production from existing fields has leveled off because of the aging of the fields and the resulting decline in reservoir pressure. As a consequence, no significant increase can be expected for the next four to five years from the existing fields. However, the Afghan representatives stated that three new fields had recently been discovered which were expected to come on stream by the late 1980s. It was too early to gauge their size and annual production.

2. Fiscal and pricing policies

In the 1984/85 budget, total revenue is estimated to show virtually no increase compared with the provisional actuals of 1983/84. Despite a small rise in gas export proceeds, nontax revenue is estimated to be slightly lower than in 1983/84, reflecting a pronounced decline in receipts from administrative fees and charges. Discretionary measures were introduced in the 1984/85 budget, in particular tighter income tax and import duty collection procedures; nevertheless tax revenue is estimated to increase by only 4 percent. This modest increase reflects the very low buoyancy of the tax system and administrative difficulties in tax collection. Total government expenditure is budgeted to decline by 7.6 percent. Taking into account a reclassification of Af 2.5 billion outlays for repairs of damaged facilities from ordinary expenditure to development spending, the ordinary expenditure is budgeted to rise by 7 percent and the development expenditure to decline by 4 percent, and by more in real terms. No provision has been made for extrabudgetary expenditure. The salary and wages bill is estimated to increase by 6 percent while allocations for material and supply expenditures have been kept at a minimum; by contrast, expenditures on subsidies and transfers are forecast to increase by nearly 20 percent. Consequently, the overall deficit is budgeted at Af 11.8 billion (5 percent of NMP, compared with 8 percent in 1983/84) and net recourse by the Government to the banking sector at Af 4.1 billion (5.2 percent of M2) as compared with Af 9.8 billion (14.7 percent) in 1983/84.

The mission observed that notwithstanding the authorities' efforts to restrain expenditure, it was likely that the 1984/85 budget outturn would be much less favorable than initially estimated: (i) with the continuation of the difficult security situation, emergency expenditures would probably be incurred again; (ii) the allocation for wages and salaries appeared to be low in view of the average annual increase of 25 percent in the salary bill in the previous four years and the 18 percent general salary increase granted in April 1984, the first since an increase of 27 percent in 1981/82; and (iii) allocations for material and supplies, at nearly one-fifth less than in 1983/84, appeared underestimated. The Afghan representatives agreed that there might well be unanticipated outlays as in previous years; however, they were confident that the budget allocations for wages and materials would not be exceeded. The large increases in the wage bill in the previous years had reflected a dramatic growth in public employment when new ministries and institutions had been created; in 1984/85, no growth was anticipated in public employment and overtime payments had been eliminated. As regards outlays on materials and supplies, the Government had decided to postpone less essential purchases (e.g., cars, furniture) and to run down inventories.

The mission explored with the authorities specific revenue and expenditure measures that could be implemented to contain the budget deficit. In view of the administrative difficulties of enforcing

income tax collections under the present circumstances, an across-the-board increase in import duty rates by 5 percentage points--which would help raise up to Af 2-3 billion in duties in a full year while not being large enough to significantly raise the cost of living--was the most promising measure. On the expenditure side, there was considerable scope for reducing subsidy outlays on gasoline, the price of which had not been raised since 1976 and was now far below the international price. 1/ The Afghan representatives said that they were in the process of assessing various options to reduce the budget deficit. In addition to discretionary measures and the encouragement of self-help economic activities, they stressed that a better budget position crucially depended on an improvement in the security conditions in the country and, in the meantime, upon obtaining larger amounts of external assistance. Following the return of the mission to Washington, it was informed that on June 7, 1984 gasoline and diesel fuel prices had been raised by 135 percent and 75 percent, respectively. 2/

The financial position of public enterprises has weakened in recent years because of low capacity utilization rates due to frequent interruptions in the supply of inputs, and insufficient price flexibility. The Afghan representatives noted the dual objectives of official pricing policy, namely to maintain an adequate financial position for public enterprises and to protect the living standards of the population; for instance, the prices of certain textiles had been increased by about 10 percent in 1983/84 following the adjustment in the procurement price of cotton. Administered prices were applicable to the purchase of about 20 basic items by public sector employees who received coupons that entitled them to purchase wheat flour and vegetable oil at subsidized prices, and other essentials at a price that included only a nominal profit margin. In order to minimize the increase in the cost of living, legislation was being drafted to limit profit margins of private wholesalers and retail merchants to 5 percent and 7 percent, respectively, of the costs of imported items. Also, cooperatives would purchase domestic goods (flour, vegetables) in bulk in the provinces and sell them in competition with the private traders. The aim of the new legislation was not to reduce the role of the private sector but to protect the consumer.

The Afghan representatives said that the autonomy of managers of public sector enterprises had recently been enlarged as a law permitted such enterprises to retain part of their profits for certain uses. The mission cautioned that it was important to ensure that the profits of enterprises were of an economic rather than of an accounting

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1/ In May 1984, the gasoline price per U.S. gallon was the equivalent of US$0.63 converted at the official rate but US$0.29 converted at the bazaar rate.

2/ The staff has estimated that such increases could generate up to Af 3 billion of revenues in a full year if the new prices apply to all users, including the Government.

nature, particularly since the present costing practices were deficient on several counts: depreciation allowances were mostly calculated on the basis of historical rather than replacement values; public companies benefited from subsidized inputs (electricity and coal, for instance), from an overvalued exchange rate, and from negative real interest rates on their bank loans. In the absence of appropriate costing and pricing practices, wrong investment decisions would be taken and resources would be misallocated.

3. Monetary policy

Since 1981/82, all banks have been operating under annual credit plans worked out at the beginning of the Afghan year in the light of the public and private sectors' requirements that are consistent with economic objectives under the Socio-Economic Plan and the budget. No adjustment is made in the credit plan in the course of the year, even when credit demand from one sector turns out to be larger than initially forecast, as was the case for the Government in 1982/83 and 1983/84.

The mission urged a more active use of credit policy as a demand management tool, particularly as developments so far suggested that there would be another large expansion in domestic credit and liquidity in 1984/85, which would tend to exacerbate inflationary pressures. A tightening of monetary policy, therefore, appeared in order, particularly since credit policies had been eased in 1983/84 when the authorities granted a delay of up to 18 months in the repayment of credit extended by banks to some traders and reduced import deposit margins for public corporations. The Afghan representatives justified these credit policy measures by the fact that the traders' cash position had been seriously affected by delays in import shipments through Pakistan; in the case of import deposits, the authorities' intention was to treat public corporations on the same basis as private importers. They shared, however, the mission's view that tight credit policies needed to be applied in the present circumstances.

The mission observed that both deposit and lending interest rate levels were considerably lower than the rate of inflation. 1/ An increase in those rates would tend to attract deposits (in particular, longer-term) into the banking system 2/ while contributing to a rational allocation of scarce financial resources. Given the present interest rate levels, it was not only profitable for traders and industrialists to keep large inventories but also for holders of liquid assets in local currency to convert them into foreign denominated assets where they could earn interest at rates generally higher than those for Afghani denominated financial assets. The Afghan representatives did not think that under the present circumstances an upward

1/ Rates paid on savings and time deposits range from 4-10 percent and lending rates from 6-12 percent a year.

2/ The share of time and savings deposits in the (broad) money stock has remained stagnant in recent years at about 17 percent.

adjustment of interest rates was called for, as higher rates might adversely affect costs, prices, and investment intentions; also, the main factor in attracting deposits had been the ongoing expansion of the network of bank branches.

4. Balance of payments policies

In the absence of multi-year planning, the Afghan authorities have not yet worked out a medium-term scenario for the balance of payments and external debt, nor was the mission in a position to make such a quantitative projection. There was agreement, however, that under the prevailing circumstances, the balance of payments would remain under considerable pressure for the foreseeable future.

Regarding the prospects for 1984/85, official projections showed that the current account deficit would more than double to US$489 million, the equivalent of 16 percent of NMP, compared with 7 percent in 1983/84 (Table 1). The major reason for the projected deterioration was an estimated increase in imports by 31 percent. Part of the increase reflects the expectation of speedier transit of goods through Pakistan and the consequent increase in the flow of imports which had been held up in that country in 1983/84. The substantially larger overall balance of payments deficit in 1984/85 (US$193 million) would be incurred predominantly with bilateral partners and its financing would lead to a building up of debit balances in bilateral accounts. The Afghan representatives noted that no limit had been set by the bilateral partners on such debit balances.

In response to the concern of the mission about the impact of the projected large current and overall deficits on future external debt levels and servicing, the Afghan representatives said that a sizable part of the assistance received from the East European countries was in the form of grants while loans, predominantly long-term, carried low interest rates. The concessional nature of such external assistance would limit the debt servicing burden over the next few years. They also noted that Afghanistan had received generous debt service rescheduling from the U.S.S.R. in recent years. They emphasized that Afghanistan was not in arrears with respect to debt servicing or on any other external payments obligation.

The Afghan authorities said that a number of measures had been taken or were under consideration in order to boost exports. Incentive exchange rates had been introduced for karakul and wool and the surrender of proceeds from all other exports (except cotton) to the convertible area had been abolished, thereby de facto offering the bazaar exchange rate to those exporters. Quality controls were being intensified (in particular for raisins and other dried fruits) and marketing techniques improved. Carpet-making machines were to be imported to supply the domestic market, thereby releasing higher valued handmade carpets for export. Favorable export prospects were seen for medicinal herbs, mineral products, and leather goods.

5. Exchange and trade policies

The mission noted that changes in the recent past in the exchange system had been in the right direction, as an increasing share of transactions in convertible currencies was now being effected at the bazaar rate or close to it. The changes, however, had increased the fragmentation of the exchange rate structure. While unification of existing exchange rates at a realistic level should be the ultimate goal, an interim regime might have to be adopted as an initial step under the present circumstances. For instance, all bilateral as well as a very limited number of transactions in convertible currencies could be effected at the bank exchange rate that should be substantially depreciated from its present level and adjusted regularly afterwards. All other transactions through the banking system would be effected at a rate close to that in the bazaar and adjusted periodically in line with developments in the bazaar rate. Such a system would improve the allocation of resources in the economy.

While agreeing on the merits of a simplification of the exchange system, the Afghan representatives outlined the approach of the authorities now under consideration. Basically, in the short term, all exporters would be required to surrender a portion of their convertible exchange proceeds--which would vary according to commodities--to banks at the operational rate of Af 55 per US$1; the remainder could be used freely for the financing of imports and other transactions. The banks, in turn, would resume selling foreign exchange to public entities at the operational rate. For the longer term, the Government was considering extending reasonable controls over imports, in particular those financed through the bazaar, so that their composition would better conform to national priorities and social objectives.

The mission expressed concern that the above proposals would not only increase the number of effective exchange rates, as different retention percentages would be applied to different categories of exports, but that pressures would be exerted by exporters to change the percentage in their favor, possibly leading to frequent changes and uncertainty. Smuggling and falsification of invoices by exporters might also increase. More importantly, the average exchange rate for exports would be less favorable than at present, while imports from the convertible area would be made cheaper, an action the country could ill-afford at present. Moreover, as long as large differences persisted between the bazaar rate and the effective rate for exports, there would be leakages from the official market to the bazaar. The most appropriate way for the authorities to gain greater control over the foreign exchange transactions would be for banks to quote exchange rates at realistic levels which would attract foreign exchange to official channels. The social essentiality of imported goods could best be taken care of through an appropriate customs tariff structure. The Afghan representatives responded that the changes under consideration had been discussed with exporters who appeared to be satisfied

with the measures. As for falsification of invoices, it would be minimized by tight monitoring of the declared export prices to check deviations from international prices.

Until recently, Afghanistan had four bilateral payments agreements, two of which--with Hungary and China--were with Fund members. The Afghan authorities informed the staff that the agreement with Hungary had been terminated in March 1984 and that there were no balances left in the clearing accounts. Regarding the agreement with China, the Afghan representatives stated that it covered both trade and payments aspects. However, over the last five years the usual annual trade protocol had not been signed and trade had dwindled. At the end of March 1984 the outstanding debit balance in the account was only US$0.1 million. Due to noneconomic considerations, the Afghan representatives did not consider it advisable at this time to initiate action to terminate the agreement.

6. Statistical issues

In recent years, the Afghan authorities have made considerable efforts to expand the country's statistical data base, and progress has been made, in particular in the field of banking statistics. Still, with the exception of external reserve and exchange rate data, the country page in International Financial Statistics (IFS), is not current (for details see Appendix IV). The authorities have expressed their readiness to supply the needed data in the other areas covered by IFS on a current and regular basis.

IV. Staff Appraisal

In the past several years, the performance of the Afghan economy has been severely affected by adverse domestic security conditions and external developments; the latter have taken, inter alia, the form of a sharp reduction in external assistance from the convertible area, disruptions in the smooth flow of external trade, and low prices for some of Afghanistan's exports. As a result, production in many sectors has been depressed, the hardships on the population have intensified, the fiscal position has weakened, and pressures on the balance of payments and prices have intensified. Inflation rates would have been much larger than those actually experienced in the past three years had it not been for the large absorption of liquidity through the balance of payments; other factors that limited inflation were the provision by the authorities of food and other essential commodities in the cities and the efficient functioning of the bazaar market.

The Government has recently taken steps to encourage production and exports, contain budget outlays, and price petroleum products at more realistic levels. Also, most exports to and imports from the convertible area are taking place at rates close to free market exchange rates. Notwithstanding these measures, economic prospects

for the period ahead are not favorable. This is so because the present security situation and the constraints it places on economic policy formulation and the efficacy of some policy instruments will severely affect economic activity and export performance, disrupt the flow of supplies, and intensify the structural weakness of the budget. In view of the low level of foreign exchange reserves, the scope for the balance of payments to absorb large amounts of liquidity generated by the bank financing of the budget deficit is considerably reduced. Although Afghanistan is expected to obtain large amounts of balance of payments support in 1984/85, it is important that further measures be taken in the financial and exchange rate areas in order to moderate the growth of domestic expenditure, particularly in the public sector, and liquidity expansion so as to avoid an intensification of the already strong inflationary pressures and to reduce the balance of payments deficit.

The staff welcomes the intention of the authorities to maintain agricultural producer prices at remunerative levels. It is also essential that the private distribution system be kept relatively free of controls, as it has proved highly efficient in the supply of commodities. Attempts by the authorities at setting profit margins of wholesalers and traders in order to limit inflation may well prove counterproductive. In the view of the staff, a more appropriate approach would be to contain demand through financial and exchange rate policies.

The main effort in the policy area should be aimed at reducing the budget deficit. Weak tax collection, insufficient pricing flexibility, and increased current outlays have weakened the fiscal position despite the fact that investment outlays have not risen. The staff believes that, under the circumstances, an across-the-board increase in import duty rates would be the most efficient way to mobilize additional revenue for the budget. Tighter discipline on spending ministries and greater pricing flexibility, in particular for less essential products, are necessary. Given the domestic resource and implementation constraints, scrutiny of expenditure allocation, including investment outlays, is also required in order to achieve a budget position consistent with the price and balance of payments objectives. As regards the greater autonomy now granted to public corporations in the use of their profits, it is important that proper costing practices be introduced in such areas as depreciation provisions, prices of inputs, exchange rates, and interest rates, so as to ensure that the profits are indeed of an economic rather than of an accounting nature. In addition, the increased availability of funds should not lead these enterprises to excessive spending decisions that, under the present circumstances, would only exacerbate the inflation and balance of payments pressures.

Monetary policy has been accommodative and has not been used actively as a tool of economic management. The authorities should consider pursuing a more active policy stance by limiting credit

expansion to a rate that is consistent with their other objectives. An increase in interest rate levels would also be useful in order to contain domestic demand, reduce the accumulation of excessive inventories by traders and producers, and encourage savings in domestic financial assets in longer maturities.

The external payments position has weakened substantially in recent years and another large overall deficit is envisaged for 1984/85. This deterioration in the external position has resulted in a substantial depreciation of the bazaar exchange rate, a reduction in imports financed with official exchange reserves, a decline in international reserves, and a growing external debt level. Even though most foreign loans were obtained on concessional terms and debt relief has been granted in recent years, debt servicing is a considerable burden in the balance of payments and is likely to increase further unless the balance of payments improves soon. Because of the security conditions and the various disruptions to trade, essential imports (food, petroleum products) will remain large and the resumption of the growth of exports other than that of gas will face formidable constraints in the period ahead. Pressures on the balance of payments will therefore remain strong. However, a combination of tighter financial policies, flexibility in exchange rate management, and specific measures to improve the availability, marketing, and quality of export products can help reduce the current and overall deficits to levels that can be financed without an excessive increase in the external debt servicing burden.

An important measure for improving the balance of payments would be a simplification of the exchange rate system and the maintenance of realistic official exchange rates through frequent adjustments in the light of developments in the free market and other relevant factors. The exchange measures now under consideration are not likely to improve the balance of payments situation or lead to a better allocation of resources. In view of the complexity of the present exchange rate regime and the lack of firm plans on the part of the authorities to take steps towards a unification of the exchange system, the staff does not recommend approval by the Executive Board of the multiple currency practices. The staff welcomes the elimination of the bilateral payments arrangement with a Fund member.

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

V. Proposed Decision

The following draft decision is proposed for adoption by the Executive Board:

1. The Fund takes this decision relating to Afghanistan's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1984 Article XIV consultation with Afghanistan in the light of the 1984 Article IV consultation with Afghanistan conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Afghanistan's present exchange regime involves exchange restrictions and multiple currency practices as described in SM/84/... . The Fund welcomes the transfer of most external transactions in convertible currencies to more depreciated rates, but notes that the present exchange rate structure is unduly complex. It, therefore, recommends a simplification of the exchange rate system with a view toward the eventual establishment of a unified exchange rate regime. The Fund welcomes the termination of a bilateral payments agreement with a Fund member and encourages Afghanistan to terminate the remaining agreement with a Fund member.

Afghanistan - Fund Relations

(As of June 30, 1984)

(Amounts in millions of SDRs, unless otherwise indicated)

I. Membership Status

Date of membership:	July 1955
Status:	Article XIV

A. Financial Relations

II. General Department (General Resources Account)

Quota:	SDR 86.7 million.
Total Fund holdings of Afghanis:	SDR 81.9 million equivalent to 94.5 percent of quota.
Reserve tranche position:	SDR 4.8 million.

III. Stand-by Arrangement and Reserve Tranche Purchase

A. A stand-by arrangement in the amount of SDR 8.50 million for a period of one year was approved in July 1975; the amount was fully drawn.

B. In October 1983, Afghanistan made a reserve tranche purchase of SDR 15.08 million.

IV. SDR Department

Net cumulative allocation:	SDR 26.7 million.
Holdings:	SDR 14.1 million and 52.8 percent of net cumulative allocations.

B. Nonfinancial Relations

V. Exchange Rate Regime

Afghanistan has a multiple exchange rate system. The major (buying) rates per US$1 are: (1) the official rate of Af 50, (in effect since August 1981), which applies to all bilateral transactions, the export proceeds of cotton, and government payments; (2) the operational rate of Af 55, which became effective in January 1982 for other convertible public sector transactions and for exports other than those at the official

rate. Karakul export proceeds must be surrendered at the rate of Af 110 = £1, and 70 percent of wool export earnings must be surrendered at this rate, while the rest may be retained. The surrender requirement for all other convertible export proceeds has been abolished. Virtually all public sector companies are now denied access to official exchange at the operational rate. As a result, very few transactions take place at the operational rate. Both private importers and public entities have to obtain their foreign exchange from exporters or from the bazaar. Rates at which those exporters sell exchange directly to importers are believed to be close to the bazaar rate; (3) the freely floating bazaar rate, which on June 14, 1984 stood at Af 113.90, and which applies to all convertible private sector transactions other than the exports specified above.

VI. Last Article IV Consultation

February 1983; the Staff Report (SM/83/109) was discussed by the Executive Board (EBM/83/112) on July 27, 1983. In view of the uncertainties regarding the situation in Afghanistan, the Board did not set a specific time for the next Article IV consultation. The Board Decision (No. 74/76 (83/112)) was as follows:

1. The Fund takes this decision relating to Afghanistan's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1983 Article XIV consultation with Afghanistan in the light of the 1983 Article IV consultation with Afghanistan conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Afghanistan's present exchange regime involves exchange restrictions and multiple currency practices as described in SM/83/115. The Fund hopes that the authorities will pursue a more flexible exchange rate policy, with a view toward the eventual establishment of a unified exchange rate system. The Fund encourages Afghanistan to terminate the bilateral payments agreements with two Fund members.

VII. Technical Assistance

A statistical advisor, provided to Da Afghanistan Bank under CBD auspices, took up his assignment in March 1983; his term expires in March 1985.

Afghanistan - Relations with the World Bank Group

1. The last World Bank economic mission visited Afghanistan in April-May 1977. The report "Afghanistan: The Journey to Economic Development" was issued in March 1978.

2. Afghanistan has not received Bank loans but has received a number of IDA credits. The amount disbursed as of April 30, 1984 was US$67.96 million; repayments totaled US$0.97 million (for details see table below). Afghanistan has discharged all its debt service commitments to the Bank that fell due. In addition, IFC in 1973 made a US$0.32 million investment in the Industrial Development Bank of Afghanistan, which in 1976 was sold to the Government of Afghanistan.

3. In December 1979, IDA had 15 ongoing projects in Afghanistan involving credits totaling US$177.5 million. In addition, there were two projects which had not yet become effective, the Highways III Project for US$17.6 million and the Rural Development Project for $16.5 million. Since June 1979, IDA has been unable to send regular supervision missions to Afghanistan due to increasing security problems; on April 9, 1980, IDA suspended disbursements on all projects. Due to the continuing security situation and its impact on proper supervision of projects, IDA decided in October 1981 to cancel the undisbursed portions of all IDA credits at their closing dates. The table below shows the projects under implementation as of December 1979 and the disbursements and cancellations.

IDA Projects under Implementation as of December 1979;
Disbursements and Cancellations 1/

(In millions of U.S. dollars)

Year	Project	Closing Date	Original IDA Amount	Actual Amount Disbursed	Amount Cancelled
1976	Khanabad I Supplementary Financing	12.31.81	10.0	5.3	4.7
1973	Aviation I	06.30.80	2.5	1.2	1.3
1973	Livestock I	09.30.81	9.0	7.8	1.2
1973	IDBA I	12.31.81	2.0	1.9	0.1
1973	Highways II	12.30.81	11.5	10.6	0.9
1975	Agricultural Credit II	12.31.81	13.0	12.96	0.04
1975	Kabul Water Supply I	12.31.82	9.0	7.6	1.4
1976	Power I	06.30.79	10.0	10.0	--
1976	Livestock II	12.31.82	15.0	3.9	11.1
1976	Education II	04.30.82	6.0	0.3	5.7
1977	Agricultural Credit III	03.31.82	12.0	5.2	6.8
1978	Irrigation II	06.30.83	22.0	0.1	21.9
1978	Fruit and Vegetable	06.30.85	18.0	1.1	--
1979	Kabul Water Supply II	12.31.83	16.5	--	16.5
1979	Education III	12.31.84	21.0	--	--
	Total		177.5	67.96	71.64
1979	Highways III 1/		17.6	--	17.6
1979	Rural Development 1/		16.5	--	16.5

1/ As of April 30, 1984.
2/ Did not become effective and lapsed.

Afghanistan - Basic Data

Population 17.22 million (estimate for mid-1983)

Afghan year ended March 20	1980/81	1981/82	1982/83	1983/84 1/
Production				
Foodgrains (in thousand tons)	4,329	4,453	4,462	4,549
Raw cotton (in thousand tons)	65	60	45	50
Natural gas (million cubic meters)	2,790	2,675	2,583	2,767
Cotton textiles (million square meters)	43	37	39	38

(In millions of Afghanis)

	1980/81	1981/82	1982/83	1983/84	Budget 1984/85
Government finances					
Revenue, of which:	26,139	29,811	32,555	34,120	34,365
Sales proceeds from natural gas	(11,509)	(13,556)	(14,792)	(15,137)	(15,286)
Expenditure	30,142	34,593	49,041	49,941	46,164
Ordinary expenditure	(18,883)	(22,669)	(27,621)	(32,755)	(32,541)
Development expenditure	(12,157)	(10,849)	(11,863)	(11,606)	(13,623)
Other expenditure 2/	(-898)	(1,075)	(9,557)	(5,580)	(--)
Overall deficit	-4,003	-4,782	-16,486	-15,821	-11,799
External financing 3/	(6,037)	(3,046)	(6,245)	(6,021)	(7,699)
Domestic bank financing 4/	(-2,034)	(1,736)	(10,241)	(9,800)	(4,100)

(In millions of U.S. dollars)

	1980/81	1981/82	1982/83	1983/84
Balance of payments				
Trade balance	-193	-350	-251	-260
Exports, f.o.b., of which:	(705)	(691)	(708)	(681)
Natural gas	[233]	[273]	[284]	[302]
Imports, c.i.f.	(-898)	(-1,041)	(-959)	(-941)
Services (net)	81	56	94	74
Current account deficit (-)	-112	-294	-157	-186
Multilateral	(32)	(27)	(79)	(82)
Bilateral	(-144)	(-321)	(-235)	(-268)
Nonmonetary capital (net)	300	164	146	111
Multilateral	(14)	(19)	(6)	(--)
Bilateral	(286)	(146)	(140)	(111)
Errors and omissions	7	97	-60	-93
Overall surplus or deficit (-)	195	-33	-70	-168
Multilateral	(-69)	(-62)	(3)	(-19)
Bilateral	(264)	(29)	(-73)	(-149)

1/ Provisional
2/ Mostly extrabudgetary expenditures; also includes discrepancies due to timing.
3/ Includes external grants.
4/ As derived from banking statistics.

Afghanistan - Basic Data (concluded)

Afghan year ended March 20	1980/81	1981/82	1982/83	First 9 Months 1983/84
	(In millions of Afghanis)			
Monetary changes				
Money and quasi-money	8,073	8,581	9,841	7,736
Net foreign assets	12,197	-609	-3,623	-2,232
Net domestic assets, of which:	-4,125	9,191	13,464	9,968
Claims on Government (net)	(-2,034)	(1,736)	(10,241)	(7,500)
Net unclassified assets	(-6,175)	(3,208)	(-1,116)	(1,696)
	1980/81	1981/82	1982/83	1983/84
	(In millions of U.S. dollars)			
Gross official reserves (end of period)				
Convertible assets	341	281	238	206
Bilateral assets	281	310	237	87
External public debt				
Amount disbursed (end of period)	2,257	2,368	2,411	2,421
Debt service in percent of exports of goods and services	(6.5)	(14.5)	(16.8)	(15.8)
	(In Afghanis per U.S. dollar)			
Exchange rate				
Average bazaar rate	46.13	56.62	76.75	99.31
	(In percent)			
Changes in key economic indicators				
Net material product at constant prices	-2.7	1.2	1.7	4.5
Consumer prices	12.6	21.5	16.6	19.6
Money and quasi-money	20.3	17.9	17.3	11.6
Imports	24.2	15.8	-7.8	-1.9
Exports	42.7	-2.0	2.5	-3.8
Gas export prices	95.8	25.3	10.2	-1.3
	(In percent of NMP) 1/			
Ratios				
Overall budget deficit	3.5	3.4	9.9	7.6
Balance of payments 2/				
Current account deficit (-)	-4.5	-11.2	-6.0	-6.7
Overall surplus or deficit (-)	7.8	-1.3	-2.7	-6.1
External debt 2/	90.7	90.3	92.4	87.4

1/ NMP in current prices was calculated from NMP at constant prices by using the Kabul Price Index.

2/ NMP data were converted into U.S. dollars at the average between the official exchange rate and the bazaar rate.

Afghanistan - Statistical Issues

1. Coverage, currentness, and reporting of data in IFS

			Latest Data in June 1984 IFS
Real Sector	-	National Accounts	n.a.
		Prices	December 1981
		Production	n.a.
		Employment	n.a.
		Earnings	n.a.
Government Finance	-	Deficit/Surplus	n.a.
		Financing	n.a.
		Debt	n.a.
Monetary Accounts	-	Central Bank	Q1, 1983
		Deposit Money Banks	Q2, 1982
		Other Financial Institutions	n.a.
External Sector	-	Merchandise Trade: Values	Q4, 1982
		Merchandise Trade: Prices	n.a.
		Balance of Payments	n.a.
		International Reserves	February 1984
		Exchange Rates	April 1984

The reporting of data for inclusion in IFS during the past year has been unsatisfactory.

2. Outstanding statistical issues

a. General

The coverage of data published in IFS is generally inadequate with no data for balance of payments, government finance, and national accounts. Furthermore, apart from international reserves and exchange rates, the data are not current.

b. Monetary accounts

Recently, the Afghan authorities have made substantial revisions in the monetary data which were discussed during the mission. The authorities undertook to provide more details on these revisions so that the data in IFS can be suitably revised and updated.