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SM/83/109
Correction 1

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INFORMATION

June 15, 1983

To: Members of the Executive Board
From: The Secretary
Subject: Afghanistan - Staff Report for the 1983 Article IV Consultation

The following corrections have been made in SM/83/109 (5/31/83):

Page 5, 2nd full para., line 11: for "18 per cent" read "21 per cent"
line 12: for "12 months" read "21 months"

A corrected page is attached.

Att: (1)

Other Distribution:
Department Heads

years. Other measures include an extension of farmers' cooperatives, increased provision of modern inputs facilitated by larger credit to be provided through the Agricultural Bank, and a sizable upward adjustment of procurement prices for cotton (60 per cent) and sugar beets (40 per cent) announced in February 1983.

2. Domestic financial developments

Following a decline in 1980/81, net domestic assets of the banking system rose sharply in 1981/82 and at an even sharper rate in the first nine months of 1982/83. An adequate explanation of these developments is not possible because the available fiscal and monetary data do not corroborate each other, and the monetary accounts attribute over two thirds of the increase in domestic credit to the expansionary effect of net unclassified items. There are indications that the fiscal position in 1981/82 and 1982/83 came under pressure despite a reduced level of development spending. Factors that have affected the budgetary situation include a leveling off in the growth of gas export proceeds, an increase in debt service payments as well as in outlays for defense and for subsidies, and a 27 per cent salary adjustment for public sector employees in 1981/82. These factors would tend to suggest that bank financing of the Government in 1981/82 and 1982/83 may have been larger than indicated by the fiscal accounts and may in fact explain part of the unusually large expansionary impact of the unclassified items. Contributing reasons for the rise in bank credit were the construction and rehabilitation of food and petroleum storage facilities by official entities and possibly increased credit needs of industrial companies whose financial positions were affected by production declines and price controls. In addition, it appears that public sector companies and official entities obtained less external aid during 1981/82-1982/83 than in previous years, thereby increasing their domestic financing requirements.

The mission observed that all but a small part of the banking system's net domestic assets consisted of claims on the Government and on other parts of the public sector (fully or partly government-owned enterprises and various official entities). Private enterprises have traditionally played a small role in the modern sector of the Afghan economy and part of their credit needs is being met in the money bazaar. Therefore, changes in net domestic assets of the banking system could be taken as an approximate measure of the impact of the public sector's operations. These changes had clearly been highly expansionary in the past two years. The growth in credit, although in part offset by a decline in foreign assets, had led to relatively high monetary expansion rates (21 per cent per annum during the 21 months ended December 1982) at a time of declining production. In addition, the recent rapid depreciation of the exchange rate in the bazaar exchange market (see subsection 4 below) had made the Afghani a less attractive "store of value" than during the period of appreciation, 1971-78, and thus presumably had resulted in an increase in the velocity of money. Because of these factors, as well as the increased local currency costs of imports and higher costs of domestically produced goods, in part related to transportation difficulties, there had been an

acceleration in the rate of inflation. This rate was presumably somewhat higher than the 20-22 per cent rise recorded by the consumer price index for Kabul during the past two years. The mission, therefore, suggested that it was necessary to contain credit expansion so as not to exacerbate the imbalance between the availability of, and claims on, resources and welcomed the authorities' intention to pursue tight control of budgetary expenditures in 1983/84, to improve revenue collection, to review tax rates, and to limit the rise in credit to other sectors of the economy. As interest rates charged and paid by banks are currently far below the inflation rate, the mission suggested that the interest rate level be reviewed. The authorities believe that higher interest rates, while desirable as an incentive to savers, would adversely affect investments and add to the pressure on prices.

3. Balance of payments

For the first time in more than a decade, Afghanistan incurred an overall balance of payments deficit (US\$25 million) in 1981/82, with the deterioration occurring exclusively in transactions channeled through bilateral payments accounts which, nevertheless, continued to be in surplus. This development reflected mainly an increase in the trade deficit and sharply lower net capital inflows due to a substantial decline in grant aid and increased debt repayments, as the relief granted by the U.S.S.R. in an agreement of the mid-1970s came to an end. The trade deficit rose due to stagnating exports, largely because of lower volumes and prices of carpets and karakul skins. Gas export receipts continued to rise, albeit at a reduced rate as a further price increase was partly offset by a reduction in shipments. Import growth slowed, mainly reflecting a reduction in aid-financed imports.

A balance of payments estimate for 1982/83, made by the Afghan authorities on the basis of actual data for the first nine months of the year, shows an overall deficit of about US\$100 million, most of it with bilateral partners. A continuing rise in the trade deficit is estimated as gas shipments apparently have declined further due to insurgent activities. In addition, exports of fruits, wool and, in particular, carpets are estimated to have fallen. Imports are believed to have remained about unchanged from the previous year, a development which the Afghan representatives attributed, in part, to transportation difficulties on the traditional transit routes. The sharply higher local currency costs of private imports (see subsection 4 below) may also have been a cause. Another factor accounting for the deterioration in the external position was a further sharp decline in net external assistance, mostly due to higher amortization payments, which are estimated to have reduced net inflows to the lowest level in six years. The Afghan representatives stated that the balance of payments outcome for 1983/84 was subject to a number of uncertainties and added that the external economic situation would continue to be difficult.