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Minutes of Executive Board Meeting 08/60-2

10:03 a.m., July 7, 2008

2. Islamic Republic of Afghanistan—Fourth Review Under the Three-Year Arrangement Under the Poverty Reduction and Growth Facility and Request for Waiver of Performance Criterion

Documents: EBS/08/76 and Supplement 1, and Supplement 2

Staff: Elhage, MCD; van der Willigen, PDR

Length: 38 minutes

Executive Board Attendance

M. Portugal, Acting Chair

Executive Directors	**Alternate Executive Directors**
	S. Itam (AE)
	R. N'Sonde (AF), Temporary
	J. Maciel (AG), Temporary
	S. Duggan (AU), Temporary
	O. Demirkol (BE), Temporary
	A. Maciá (BR), Temporary
	J. He (CC)
	A. Guerra (CE), Temporary
J. Fried (CO)	
	A. Lahreche (FF), Temporary
K. Stein (GR)	
	P. Ray (IN), Temporary
	F. Spadafora (IT), Temporary
	D. Kihara (JA), Temporary
J. Mojarrad (MD)	M. Daïri (MD)
A.S. Shaalan (MI)	
	M. Tanasescu (NE), Temporary
	J. Bergo (NO)
	A. Lushin (RU)
A. Alazzaz (SA)	
	J. Agung (ST), Temporary
	A. Raczko (SZ)
M. Lundsager (UA)	
A. Gibbs (UK)	

L. Hubloue, Acting Secretary
J. Hellström, Assistant

Also Present

IBRD: B. Hansl, M. Scuriatti. Asia and Pacific Department: M. Saxegaard. Fiscal Affairs Department: B. Gracia, J. Tyson. Finance Department: J. Grochalska. Legal Department: C. Ogada. Middle East and Central Asian Department: K. Abdallah, A. Bannett, J. Carlos Di Tata, J. Charap, M. Elhage, N. Erbas, M. Farahbaksh, L. Perez, J. Wieczorek. Office of the Managing Director: G. Schwartz. Policy Development and Review Department: P. Alonso-Gamo, T. van der Willigen. Secretary's Department: O. Vongthieres, M. Yslas. Senior Advisors to Executive Directors: M. Choueiri (MI), R. Gesami (AE), S. Rouai (MD), A. Tolstikov (RU). Advisors to Executive Directors: A. Jbili (MD), K. Mogensen (NO), F. Parodi (UA), R. Perez (BR), H. Rab (UK) H. Yung (CC).

2. ISLAMIC REPUBLIC OF AFGHANISTAN—FOURTH REVIEW UNDER THE THREE-YEAR ARRANGEMENT UNDER THE POVERTY REDUCTION AND GROWTH FACILITY AND REQUEST FOR WAIVER OF PERFORMANCE CRITERION

The staff representative from the Middle East and Central Asia Department (Mr. Elhage) submitted the following statement:

> This statement summarizes information that became available since the issuance of the staff report on June 23, 2008, concerning the implementation of the three prior actions. It also provides an update on the Kabul CPI in June 2008.
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> Two of the three prior actions have already been met. These include: (i) the prior action calling for the issuance by the Ministry of Finance (MOF) of an instruction to the Afghan Customs Department to ensure timely updates of reference prices for petroleum products; and (ii) the prior action consisting of the signing by MOF and the Ministry of Commerce and Industry of a memorandum of understanding to clarify customs procedures for fuel products stored at the Fuel and Liquid Gas Enterprise.
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> The third prior action calling for the collection by the MOF of at least 79 million Afghani corresponding to on the business receipt tax (BRT) and nontax receipts (landing/parking right fees) from airlines has not yet been met. As of July 2, 2008, the authorities reported having collected 69.3 million Afghani and provided the staff with documents confirming this amount. The documentation provided by the authorities, although not fully complete, confirms that the payments were made by the airlines or on their behalf.[1] Moreover, the MOF's Revenue Department informed the staff that the amounts collected correspond to the tax and nontax liabilities accrued by the eligible entities during the period prior to the end of the third quarter of 2007/08. The authorities have arranged for an additional 10.5 million Afghani (about $200,000) to be collected from two airlines before the July 7, 2008 Board meeting.

[1] A large portion of the eligible liabilities was netted out against the transfers made by the Ministry of Hajj, totaling Af 30.4 million, to cover the overdue payments for services provided by one of the airlines.

Inflation receded significantly in June 2008, mainly on account of a fall in prices of bread and cereal (14 percent), following two months of unprecedented growth. The CPI for Kabul showed a 6 percent decline relative to May 2008. As a result, year-on-year inflation subsided from 43 percent in May 2008 to 33 percent in June 2008. Food prices declined by 9 percent, while nonfood prices rose by 1.4 percent, owing mainly to an increase in prices of transportation services.

Mr. Mojarrad and Mr. Jbili submitted the following statement:

On behalf of our authorities, we thank management and the staff for their continued support for Afghanistan's reforms under the PRGF. The authorities are also grateful to the international community for the strong support expressed during the Paris Conference in June 2008 and the generous pledges made by donors. They hope that this spirit of cooperation will continue to prevail and they look forward to the timely disbursements of donors' commitments.

Performance under the PRGF-supported Program in 2007/08

During the second half of FY 2007/08, Afghanistan faced an increasingly difficult environment. The security situation continued to deteriorate, prices of imported fuel and foodstuffs increased substantially, and the harsh winter affected adversely livestock and private sector imports. Notwithstanding these developments, the economy is estimated to have grown by a comfortable 11½ percent in 2007/08 as a whole. The sharp rise in fuel and food import prices was compounded by disruptions in exports of wheat in regional markets. Consequently, inflation increased at a higher rate than expected.

The fiscal outcome in 2007/08 was better than programmed despite a revenue shortfall. The operating budget deficit (excluding grants) was lower due to under-spending, while development expenditure was in line with the program. The external position strengthened, with the current account position, including grants, shifting from a deficit of 4.9 percent of GDP in 2006/07 to a surplus of 0.9 percent of GDP. Gross international reserves increased to the equivalent of about 11 months of imports, reflecting mainly the improvement in the current account. The Afghani appreciated slightly against the U.S. dollar.

Despite the many constraints faced by Afghanistan, the authorities continued to implement their reform program. While the preparation of the Afghanistan National Development Strategy (ANDS) and the Paris Conference absorbed considerable time and resources, the authorities continued to focus their attention on the various policy actions and structural reforms agreed under the PRGF-supported program. As highlighted in the Supplementary Memorandum of Economic and Financial Policies (SMEFP), all quantitative performance criteria and indicative targets for end-2007/08 were met, with the exception of the March 2008 criterion on domestic revenue, for which the authorities are seeking a waiver. In the structural area, a number of structural benchmarks were met, while more complex reforms, such as the restructuring and privatization plan for the public enterprises not covered by the law on state-owned enterprises, proved to be more challenging and would require more preparatory time. Nonetheless, the authorities are committed to taking remedial measures to accelerate the reform progress in this area in the context of the 2008/09 program. They have also implemented two of the three prior actions for the completion of the fourth review under the PRGF-supported program and are in the process of confirming implementation of the third one.

Outlook and Reform Program for 2008/09

The authorities intend to take full advantage of the momentum created by the political and social consensus that was built around the ANDS and by the Paris Conference to forge ahead with their reform program in 2008/09 to achieve their medium-term objectives of sustained growth and poverty reduction. They are determined to preserve macroeconomic stability in spite of the rise in energy and food prices, make up for the past delays and shortcomings in completing key structural reforms, and lay the foundations for sustained private sector development and growth.

The outlook for 2008/09 is clouded by the drought, which is expected to lower real GDP growth to about 7½ percent, while average 12-month CPI inflation is projected to increase as a result of the world-wide increase in fuel and food prices. However, efforts underway by the government and donors to improve the supply of wheat from regional sources could help contain inflationary pressures and soften the impact on the poor. To ease price pressure in the market, the authorities are in the process of importing 50,000 tons of wheat flour from Pakistan. The outlook for exports, FDI, and aid inflows is favorable, which would help further improve the external position.

Fiscal Policy

The revised fiscal program aims at stabilizing the revenue-to-GDP ratio, which is a challenging task, given the run-up in food inflation and the fact that food is not taxed. Ongoing revenue collection measures, together with the additional measures outlined in the SMEFP, will increase revenue by 33 percent over the 2007/08 outcome, which will be a considerable improvement by any standard. On the expenditure side, while operating expenditure will be contained, the program provides for additional outlays that may be needed to accelerate recruitment in the military. Overall, the core budget deficit will be slightly higher than envisaged, but its financing will be available from the privatization of Afghan Telecom.

The authorities are also determined to carry out a number of structural reforms in the fiscal area. These include modernization of the civil service, strengthening the financial management system to enhance absorptive capacity, and regularization of relations between the budget and public enterprises. Finally, the authorities will give priority to mitigating the impact of increased food prices on the poor and intend to work closely with the donors to develop appropriate mechanisms to this effect.

Monetary and Financial Sector Policies

Monetary policy will be geared toward containing inflation in a challenging environment of uncertainty regarding energy and food prices, while continuing to enhance confidence in the Afghani. To achieve these objectives, the central bank (DAB) will maintain the growth in currency in circulation below that of nominal GDP, while also monitoring the growth of reserve money through indicative targets. To further enhance the monetary policy framework, DAB intends to launch open-market operations in CNs and take measures to develop a secondary market for this instrument. It also plans to strengthen liquidity forecasting and develop a mechanism for the monitoring of commercial banks' liquidity on a weekly basis. In the financial sector, DAB's efforts will continue to focus on building its capacity in several areas, including accounting, reporting, and internal control. It will also strengthen the legal and regulatory framework of the banking sector, including regulations on risk management and bank supervision.

Structural Reforms

The authorities intend to accelerate implementation of their structural reform agenda, as outlined in the ANDS, and look forward to cooperating closely with development partners. As highlighted in the SMEFP, these wide-ranging reforms will cover the electricity sector, a number of state-owned enterprises that will be restructured or privatized, and further improvements in the regulatory environment.

Debt Sustainability Analysis

The debt sustainability analysis carried out by the staffs of the World Bank and the IMF confirms that Afghanistan continues to face a high risk of debt distress and that external debt sustainability hinges on continued availability of grants and highly concessional loans. Nonetheless, some positive elements have emerged, which could improve the outlook. These include higher GDP growth rates based on sustained inflows of grants and FDI, as well as the promising prospects of the mining sector in Afghanistan. The analysis also underscores the importance of debt relief under the enhanced HIPC-Initiative and MDRI, which would reduce Afghanistan's debt to sustainable levels. In this regard, the authorities will be working toward reaching the HIPC completion point in mid-2009 and will maintain a prudent fiscal policy to avoid a rapid domestic debt build-up.

Mr. Shaalan and Ms. Choueiri submitted the following statement:

We thank the staff for a set of excellent reports, which document progress made under the PRGF-supported program in the second half of 2007/08, to restore macroeconomic stability while promoting economic development in Afghanistan. Notwithstanding a difficult security and political environment, as well as severe capacity limitations, this effort has contributed to a rebound in GDP growth and a strengthened external position, as conveyed by Messrs. Mojarrad and Jbili in their informative buff statement. Inflation picked-up significantly, however, reflecting sharp increases in the prices of imported fuel and food products. Program performance weakened, notably with regard to the fiscal revenue target and the implementation of structural reforms. Nevertheless, considering stepped-up efforts aimed at addressing the missed targets, including the strengthened structural conditionality in key reform areas, we support the proposed decision. The authorities' determined commitment to the objectives of the PRGF arrangement, in addition to continued, timely and coordinated delivery of technical and financial support by the donor community, will be essential to implement the comprehensive reform strategy. Going forward, the security situation will be an important determinant in this regard.

Fiscal policies and reforms should remain at the core of the authorities' efforts, in order to balance Afghanistan's pressing development needs with the goal of achieving medium-term fiscal sustainability. We take positive note of the prior actions aimed at addressing the sources of revenue leakages, which resulted in a revenue shortfall of 0.5 percent of GDP in 2007/08. Measures to ensure the viability of the revenue objective in 2008/09 are also encouraging. In this connection, we found Box 1 of the staff report, explaining the rationale for added structural conditionality, very helpful. The staff indicates that, despite the revenue measures incorporated in the program, the revenue-to-GDP ratio is not expected to rise in 2008/09. We would be grateful for the staff's views on whether the revenue measures listed in box 1 would be sufficient to generate 2.3 percent of GDP over the medium term, as projected in the program. If not, what additional measures does the staff consider important to that effect?

Although the fiscal position was slightly stronger than envisaged, on account of lower than projected operating expenditure, continued efforts are needed to meet the government's frequently deferred objective of covering operating expenditures with domestic revenue, over the medium term. Further efforts should aim at using the Medium-Term Fiscal Framework as an instrument for integrating the operating and development budgets, and aligning them with priorities under the Afghanistan National Development Strategy. The commitment to improve public financial management, envisaged in the program, should yield further benefits in this regard. As mentioned above, the precarious security situation remains a concern in this regard.

Monetary policy is rightly targeted at containing inflationary pressures. We welcome Da Afghanistan Bank's (DAB) intention to set an indicative ceiling on reserve money in addition to the quantitative performance criterion on currency in circulation, given the need to improve the effectiveness of the monetary framework. The staff points to the significant upside risk facing the inflation outlook. Should such a risk materialize, would the approach described in paragraph 19 of the staff report be sufficient to contain inflation, in the absence of a developed secondary market and in light of persisting dollarization, which limits the effectiveness of monetary policy? The staff's comments would be welcome.

The recent rebound in inflation calls for increased reliance on market-based instruments, which will further strengthen DAB's control on liquidity and improve the effectiveness of monetary policy. The authorities' intention to increase the role of capital notes' auctions and develop the secondary market for these instruments is encouraging in this regard; so is their assurance that DAB's operations in capital notes will be carried out with due consideration for interest rate developments. Closer coordination with the Ministry of Finance to enhance liquidity management remains essential as a large portion of public expenditures, notably in the security and development areas, continues to be executed and financed directly by donors, in the context of the external budget.

We welcome the authorities' intention to mitigate the impact of increased wheat prices on the poor by working with donors to elaborate mechanisms to provide assistance to the needy. We join the staff in encouraging them to adopt targeted cash transfers to help avoid distorting the market and to ensure that support can be made available promptly.

Sustaining high growth and poverty reduction and strengthening competitiveness will require comprehensive structural reforms, including establishing an enabling environment for private sector-led growth. To that end, it is essential to enhance governance, overcome infrastructure bottlenecks, and reduce the government's involvement in the economy. The authorities should also continue their efforts to improve the quality of statistics.

With these remarks, we wish the authorities success in meeting the policy challenges ahead.

Mr. Bakker and Mr. Tanasescu submitted the following statement:

We thank the staff for the well-written set of papers and Mr. Mojarrad and Mr. Jbili for their helpful buff statement. Since the last review, Afghanistan's program performance has stayed broadly on track, with implementation of all quantitative performance criteria and indicative targets, with the exception of the floor on domestic revenue. At the same time, four out of seven structural benchmarks were met. Indeed, despite continued security concerns, Afghanistan's economic growth has been strong. However, inflation surpassed 20 percent in March 2008, due mainly to higher prices of imported oil and foodstuffs. The fiscal position has strengthened, and the fiscal deficit, excluding grants, is estimated to narrow to 3.6 percent of GDP, lower than programmed. We agree with the staff's appraisal and support completion of the fourth review with the requested waivers.

Fiscal Policy

The revenue shortfall by more than 0.5 percent of GDP underscores the need for corrective measures, as agreed with the staff, to bolster revenue collection in the next years. An increase in domestic revenue, which remains one of the lowest in the world in proportion to GDP, is crucial for the authorities to achieve policy autonomy and financial independence from donor financing. Regarding the medium-term outlook, the macroeconomic projections of Afghanistan are subject to significant uncertainties and risks. In this context, we urge the authorities to implement a macroeconomic framework anchored in the fiscal discipline to achieve fiscal sustainability, by improving the fiscal administration and prioritizing the use of resources. In the face of significantly higher inflation, the fiscal policy should play a more active role, and we welcome the authorities' commitment to a revised fiscal program for 2008/2009, which aims at stabilizing the revenue-to-GDP ratio. We share the staff's view that Afghanistan still has a high risk of debt distress. At the same time, we welcome the authorities' efforts to regularize relations with the external creditors, as required under the Enhanced HIPC Initiative, and we expect that a full delivery of debt relief under the HIPC initiative would reduce debt to sustainable levels.

Monetary Policy and Financial Sector

Large foreign aid inflows and higher prices of imported fuel and foodstuffs, have increased inflationary pressures and already high dollarization. In this connection, we are encouraged that DAB will aim to contain inflationary pressures, and will strengthen its capacity to modernize its operations, developing the secondary market in capital notes (CNs), which should help to better manage liquidity and improve the effectiveness of monetary policy, but which will also be helpful regarding dollarization. Given the rapid growth in the banking sector, we concur that the authorities are moving in the right direction by strengthening the regulatory and supervisory frameworks, and developing an action plan to address the weaknesses identified in the banking sector. We are encouraged by actions taken by the authorities to raise banks' minimum capital requirement, and we urge them to accelerate the restructuring process of state-owned banks to further eliminate potential fiscal pressures.

Structural Reforms

Structural reforms remain essential to enhance competitiveness and the overall efficiency of the economy. Accelerated structural reforms are needed to reduce the role of the government in key sectors, particularly the oil and mining sectors, to strengthen an environment for business activity and to attract direct investment to offset the projected decline in donor inflows. The state's heavy involvement in the petroleum sector distorts market signals and creates supplementary pressure on the fiscal side. We look forward to the authorities' commitment to preparing for the privatization of the state-owned petroleum company, and to clarify the relationship between the budget and public enterprises.

Mr. Sadun and Mr. Spadafora submitted the following statement:

We thank the staff for the informative set of papers and Mr. Mojarrad and Mr. Jbili for their useful buff statement.

Similar to several other countries, Afghanistan has to cope with a surge in inflation that is challenging macroeconomic stability and is all the more unwelcome given the many serious problems facing the country. In light of the recent Board discussion on food and fuel price increases, we agree with the staff that providing aid via targeted cash transfers can be a relatively more efficient and effective way to reach those most in need.

While we understand the rationale for adopting an ambitious inflation objective, we share the staff's concerns that the inflation outlook is subject to a significant upside risk, which also represents the main threat to the program.

The missed performance criterion on fiscal revenues is unfortunate in light of the importance of structurally enhancing revenue collection with a view to achieving a zero operating budget balance and mitigating, in the longer-term, the country's aid dependence. The projected deceleration of growth will not help in this regard.

In the same vein, the non-observation of the structural benchmark on adopting a comprehensive restructuring/divestment plan for key SOEs, as well as of the commitment to regularize the fiscal relations between SOEs and the government, runs counter to the objective of reducing the scope for public subsidies and placing SOEs on a sound fiscal footing.

We thus welcome the three prior actions incorporated into the program to address the main factors underlying the recent revenue shortfall, namely inadequate enforcement efforts and undervaluation of petroleum imports by customs. We ask the staff to further elaborate on the reasons, other than weak enforcement, behind the accrued tax and non-tax liabilities due from airlines.

We whole-heartedly commend the Da Afghanistan Bank (DAB) for its anti-inflationary monetary policy, the increased attention to strengthen its supervisory capacity and the several initiatives to reinforce its operational framework. In a context of increasing issuances of Capital Notes (CNs), we welcome DAB's intentions to develop the secondary market for such notes, as this could help make CNs the primary instrument of monetary policy and overcome some limits in the effectiveness of foreign exchange auctions. The planned introduction of an indicative ceiling on reserve money is another proper step toward the adoption of an operational target more closely linked with inflation than currency in circulation.

We are pleased to learn that development expenditure was broadly in line with program projections. We nonetheless reiterate the emphasis we placed at the time of the Afghanistan National Development Strategy (ANDS) discussion on the urgent need for establishing clear priorities among programs and investments, in order to more closely align them with the goal of poverty reduction and to deal with the country's limited absorptive capacity.

The authorities' undertaking of some budget pilot programs to help ally public spending priorities with the ANDS is an initial welcome step in this regard. We would like to know from the staff whether program prioritization constituted an issue for discussion at the Paris Conference of June 2008.

We also welcome the preparation of another competitive bid for an FDI project in the mining sector: as evidenced in the Debt Sustainability Analysis paper (Paragraph 2), exploiting the country's mineral endowment has positive and sustained direct and indirect effects on growth.

However, given the emphasis that the ANDS places on the authorities' commitment to developing a private sector-based market economy, it is undesirable that they have fallen behind in submitting to Parliament laws deemed critical for fostering an enabling business environment.

On the account of the authorities' continued efforts and commitments and the strengthened structural conditionality in critical areas, we support the completion of the fourth review as well as the requested waiver.

With these remarks, we wish the authorities well in their future endeavors.

Mr. Kishore and Mr. Krishnan submitted the following statement:

We thank the staff for the focused set of papers and Mr. Mojarrad and Mr. Jbili for the informative buff statement. The overall macro-economic performance of Afghanistan has been sound given the setbacks in the security situation, while performance under the PRGF-supported program has weakened.

We are in agreement with the staff report which has focused on areas, which are necessarily limited, where the authorities could fruitfully expend their efforts. We limit our comments to the following issues:

During the discussion on the Afghan National Development Strategy (ANDS) last month this chair had emphasized that fiscal effort was key to its success and we would again encourage the authorities to focus their attention on fiscal policy and reforms—ensuring that the agreed upon measures in the program to improve tax compliance and collection and public expenditure and financial management are expeditiously implemented.

We note from the SMEFP (Paragraph 23) that there are plans to privatize Afghan Telecom. While privatization is a desirable medium-term objective, given the present security scenario it is not clear whether there would be adequate competitive interest in the company. The staff's views on the appropriate timing of such privatization are invited.

The staff paper refers in the passing to the peaking of opium production in 2007-2008 and a fall in farm-gate prices. In a situation where wheat prices have risen substantially, is there the prospect of an increasing switchover to wheat and other food grains? Are the authorities looking to encourage such a switchover? The staff's comments are welcome.

Given the difficult situation, the Afghan authorities require continued support from the international community. While substantial donor support has been pledged in the Paris conference, timely disbursal and some augmentation may be essential.

We support the completion of the fourth review and the granting of the proposed waivers. We encourage the authorities to act effectively in implementing the program and carrying out reforms thereby enhance credibility. We wish them success in their endeavors.

Mr. Stein and Ms. Rieck submitted the following statement:

We thank the staff for the candid report and Messrs. Mojarrad and Jbili for their helpful buff statement. The Afghan authorities face enormous challenges, notably due to a difficult security situation, and there is no doubt about the need for continued assistance from the international community. At the same time, the Fund-supported program provides the necessary macroeconomic framework for the authorities' policies. Given the domestically and internationally difficult situation, program performance has been rather mixed. Nevertheless, we can endorse the completion of the fourth PRGF review, conditional on the implementation of the envisaged prior actions. In this regard, we would appreciate the staff's clarification concerning the eventual observance of the prior action on airline tax collection.

Our support notwithstanding, we underscore the need for a credible commitment to sound policies and leadership on the part of the political administration. We strongly encourage the Afghan authorities to accelerate the reform process and urge them to step up anti-corruption efforts. Indeed, the insufficient implementation of the measures announced under the program is regrettable. Decisive action is required particularly in the following areas:

The mobilization of domestic revenues as well as the efficient and effective use of financial resources is key for promoting fiscal independence in the medium term. To be successful, corrective measures to address the undershooting of the fiscal revenue target require high-level political support. We note that the domestic revenue ratio is projected to remain at its current low level of 7% of GDP over the course of this year, even with implementation of the prior actions and further reforms. On the expenditure side, the authorities should be careful not to burden the budget with untargeted reactions to the increase in food prices but rather direct their limited means to the most vulnerable groups. In order to improve the conduct of fiscal policy, reforms should tackle the severe shortcomings in budget formulation, execution, and monitoring as well as the integration of operating and development budgets.

We endorse the benchmark concerning the review of the fiscal relationship between the government and state-owned enterprises, which should help to contain fiscal risks and promote transparency.

On monetary policy, the central bank needs to remain focused on the considerable inflationary pressures. Strict observance of the target growth for currency in circulation while allowing for a possible appreciation of the Afghani is therefore warranted. Strengthened liquidity forecasting and monitoring as well as auctions of capital notes (given the existing market environment) should help to plan and conduct monetary policy more effectively. In order to strengthen the institutional framework, we encourage the authorities to continue implementing the recommendations of the safeguards assessment.

The central bank also needs to ensure that the risks from rapid growth in commercial bank activities are contained. The authorities' efforts to identify and address gaps in the legal framework, strengthen enforcement procedures, and introduce regulations on risk management are well taken.

Strengthening the rule of law together with continued state disengagement in economic activity will promote private sector development, which is indispensable for broad-based and sustainable growth.

Mr. Murray and Mr. Duggan submitted the following statement:

We thank the staff for their paper and Mr. Mojarrad and Mr. Jbili for their informative buff statement.

Two years into Afghanistan's three-year PRGF arrangement, we again take this opportunity to commend the Afghan authorities on the substantial progress that they have made in the context of a very difficult security environment. Economic growth is robust, the budget position has improved, on-budget development expenditures have increased and the external position has strengthened markedly. While inflation has risen over the last year, the drivers have been exogenous factors outside the authorities' control, with a continuation of prudent macroeconomic management expected to support a return to single-digit inflation over the medium-term.

It is regrettable, therefore, that program performance declined during the period of the fourth review. Three of the seven structural benchmarks and the quantitative performance criterion on fiscal revenue were not met. The revenue shortfall is particularly disappointing given the importance of the revenue targets for the authorities' fiscal objectives and the integrity of Afghanistan's ambitious National Development Strategy. The staff report notes that the primary drivers were inadequate enforcement efforts and undervaluation of petroleum imports by customs—factors seemingly within the authorities' control. We also note that the breach has been building for some time, with the Executive Board informed at the third review that the indicative target was breached in December 2007 and in cumulative terms over the first three quarters of 2007/08. We support the introduction of the additional prior actions and structural conditions to bring government revenues back on track—and endorse completion of the fourth review on this basis—but question why the authorities did not take the necessary corrective actions sooner.

Looking ahead, we support the structural performance criteria and benchmarks proposed for the fifth and sixth reviews and concur with the broader priorities articulated in the staff appraisal. However, we would appreciate further information from the staff on two issues:

First, while we understand that keeping the inflation assumption for 2008/09 on the low side has kept the overall program targets tight, we wonder whether basing the fiscal and monetary policy objectives on a seemingly unrealistic inflation forecast risks undermining their integrity. We would like to better understand why introducing this tension was considered preferable to presenting a more balanced inflation forecast and revising the program accordingly.

Second, we note that the target date for covering operating expenditures with domestic revenues has slipped again. As shown in figure 4 of the staff report, the target date was set at 2010/11 at the first PRGF review in March 2007, slipped to 2012/13 at the third PRGF review and has now slipped again to 2013/14. While the driver at the fourth review is the shortfall in revenues, Figure 4 indicates that the revenue forecasts for 2010/11 have been relatively stable over time at around 60 billion Afghani, suggesting that the primary cause of fiscal slippage over the life of the program has been the expenditure side of the budget. The interaction of the floor on fiscal revenue and the indicative target on the operating budget deficit provide an implicit restraint on spending. However, it is striking that the only structural condition proposed for the fifth and sixth reviews that directly targets further improvements in public financial management is a structural benchmark on reviewing fiscal relations between the government and key SOEs. We would appreciate clarification from the staff on why the program does not explicitly target broader public financial management and civil service reforms along the lines of those emphasized in paragraphs 17 and 29 of the staff report.

With these comments, we wish the authorities every success in the period ahead.

Ms. Lundsager and Mr. Parodi submitted the following statement:

We agree with the sobering staff appraisal and support the completion of this review. The authorities' performance during this review period has fallen short of expectations. Moving forward, significantly improved performance will be needed. We agree with the staff that political resolve to tackle difficult issues will be critical to the success of the program. The international donor community remains committed to Afghanistan, and we welcome the recent pledges of more than $20 billion to support the authorities' development vision. In turn, it is time for Afghanistan to take concerted action to set the country on a stronger macroeconomic footing, as envisioned in this program. In this respect, we welcome Messrs. Mojarrad and Jbili's assurances that the authorities intend to take full advantage of the political consensus that was built around the ANDS and Paris Conference.

We are disappointed about the continued fiscal slippages. Fiscal revenues this year are projected to be 1.5 percentage points of GDP lower than originally envisaged at the program's outset. This has resulted in the unwelcome postponement of the zero operating budget balance rule to 2013/14. Recent slippages do not bode well for the prospects of meeting the medium-term fiscal targets, and long-term fiscal sustainability. As international aid is expected to decline over the long term, sustained revenue improvements are urgently needed in order to achieve the revised long-term fiscal targets. The authorities have no option but to sustain this effort by considerably improving tax administration, fiscal transparency, and public financial management to ensure that donor funds are used effectively. In addition, the government should quickly outline and implement the specific anti-corruption measures committed to in exchange for additional international resources.

We support the authorities' vision of private sector development as an engine for growth, which is also a necessary condition to increase the government's revenue base. The absence of transparency in the energy sector and prevalence of ad hoc state interventions undermines fiscal sustainability and impedes the private sector investment necessary for strong economic performance. We therefore regret that the authorities did not fulfill their commitments to review fiscal relations between the government and state owned enterprises, and submit to parliament laws that are critical for improving the business climate.

Inflation has become a very serious problem. The authorities should produce the 2007/08 monetary survey as soon as possible to help DAB to improve monetary management. We also urge continued implementation of the recommendations of the safeguards assessment.

Finally, we welcome the authorities' focus on achieving debt sustainability, both with regard to external and domestic debt.

Mr. He and Mr. Yung submitted the following statement:

We support completion of the fourth review under the PRGF-supported arrangement for Afghanistan and the requested waiver for non-observance of the quantitative performance criterion on fiscal revenue. Overall, Afghanistan's program performance has been mixed, falling short of staff's expectations. We can understand the various obstacles the authorities have faced given the security problems and capacity constraints in the country. Despite the difficulties, the authorities continue their efforts to mitigate the program risks, as reflected in the addition of new structural benchmarks to improve revenue performance and public financial management, further develop monetary policy framework, and enhance banking supervision. We commend the authorities' commitment that is critical to the success of the program.

We fully agree that there is a need to enhance revenue performance and speed up the revenue reforms. Indeed the significance of this issue has been repeatedly emphasized during the last (third) review of the PRGF and the recent discussion of the Afghanistan National Development Strategy. The authorities are cognizant of the risks and have taken appropriate measures to rectify the situation. Unfortunately, Afghanistan's revenue-to-GDP ratio, currently among the lowest in the world, is not expected to improve much in the near term despite the authorities' efforts. Going forward, we encourage the authorities to continue the structured fiscal reforms to strengthen the medium- and long-term fiscal outlook and reduce reliance on foreign aid flows over time.

We welcome the authorities' intention to enhance the monetary policy framework by starting open market operations in capital notes and promoting the development of a secondary market. In this connection, we note that the Da Afghanistan Bank (DAB) will strengthen the liquidity forecasting and monitoring. A well-established monetary policy framework would help facilitate the DAB to guard against inflationary pressures. Nevertheless, we note that the authorities have made a rather optimistic inflation assumption for monetary and fiscal targets. Given the lingering concern over fuel and food prices, we urge the authorities to remain vigilant and gear the monetary policy towards containing inflation.

We share the staff's view that the rapid growth of commercial bank activities calls for further strengthening of the regulatory framework and enforcement procedures. Banking supervision and the related enforcement procedures are important to address emerging risks in the banking sector.

With these remarks, we wish the authorities every success in the program.

Mr. Fried and Mr. Ladd submitted the following statement:

We thank the staff for a well-written paper and Mr. Mojarrad and Mr. Jbili for their buff statement. We agree to the completion of the 4th review with the requested waiver of the performance criterion on the floor on fiscal revenue. We agree with the broad thrust of the staff appraisal and offer the following specific comments.

We congratulate the authorities for meeting all but one of the March 2008 quantitative performance criteria. However, as we pointed out at the last two reviews, the failure to respect the quantitative performance criterion with respect to fiscal revenue is serious. The underpricing of petroleum imports for customs purposes suggests that the fiscal authorities lack the strength to uphold their regulations. A revenue shortfall of 0.5 percent of GDP and declining revenue-to-GDP effort puts off the time when own-source revenues will cover recurrent expenses and encourages firms, be they domestic or foreign, to be less cooperative. The behavior of the airlines is particularly flagrant in this regard. A strengthened revenue effort is particularly important given the high level of reliance on donor funds.

Monetary policy, the administration of Da Afghanistan Bank (DAB) and the continued improvement in bank supervision remain relative bright spots of the PRGF-supported program and in Afghanistan's post-war institutional development. A comparable effort on public financial management reform is critical to developing a robust Afghan state and to reassuring the international community that progress against corruption will be possible. The MEFP (Para. 12) states that both the Ministry of Finance and line ministries have run into difficulties. We would ask the staff to identify these difficulties and what lies behind them.

We are particularly concerned about the financial administration of state-owned enterprises. It is critical that key utilities be run on an economically sound basis, with strong management and proper financial oversight. We would prefer that the governance framework for the electrical utility be established prior to major capacity and production improvements, and welcome the authorities' determination to have competent management and financial controls in place (MEFP Paragraph 22). The World Bank staff's comments would be welcome, including on an economically sound, fair and practical tariff approach for the electrical utility and the soon-to-be-privatized fuel distributor. We also reiterate our concern that the fiscal framework is not adequately protected from Ariana.

The authorities are frank about their lack of progress on structural benchmarks in the last two review periods (MEFP Paragraph 3). This is a source of concern because of the ambitious structural reform agenda that lies ahead, as reflected in both performance criteria and benchmarks (MEFP Table 2). In our view, there is the potential to improve the tempo of reform if all ministers and legislators properly understand the authorities' undertakings and their link to the broader development strategy. Absent Cabinet unity and cooperation from parliament and provincial and local government, structural reform will continue to be slow.

The Afghan authorities were among the first to identify the food crisis in their country, to appeal for additional help, and to drop tariff rates on food. Their prompt action is commendable. We support their ongoing cooperation with donors, including the World Food Programme, to get assistance targeted to the needy. However, we also understand why the authorities might be daunted by the prospect of administering a cash transfer program to targeted households. As the staff pointed out at the June 27 briefing on food and fuel prices, there are alternative targeting methods if a program of conditional cash transfers to identified households is impractical. Given the FAO's pessimistic forecast for the domestic harvest and the likelihood of persistent high prices, what alternative approaches can the staff offer?

Finally, we agree with the staff that the current state of the statistical base is inadequate for monitoring, reporting, and ensuring proper accountability in the implementation of the National Development Strategy (ANDS). A credible strategy is needed to strengthen the Central Statistical Office, improve statistical coverage and reliability and to establish a focal point for monitoring implementation of the ANDS.

With this, we thank the staff for their continued efforts on behalf of Afghanistan and wish the authorities well as they pursue the PRGF-supported program.

Mr. Fayolle submitted the following statement:

We commend the staff for this candid review as well as for the informative debt sustainability report. We thank Mr. Mojarrad for his helpful buff statement.

Since we broadly concur with the assessment and recommendations in the report, we would like to make only the following points.

At the international conference in support of Afghanistan, held in Paris on June 12 2008, the authorities and the international community reaffirmed their long-term partnership to serve the people of Afghanistan, their security, prosperity and human rights. With pledges exceeding $ 20 billion, the conference marked a new commitment to work more closely together under Afghan leadership to support the Afghanistan National Development Strategy.

Turning to the fourth review under the PRGF, we welcome the favorable economic developments in the second half of 2007/2008 and commend the authorities for the progress made on economic growth and macroeconomic stabilization.

We note that the high level of inflation, with 12-month CPI inflation reaching 20.7 percent in March 2008, is largely due to the sharp increase of food prices following the imposition of export restrictions on wheat by Afghanistan's regional trading partners. We welcome the authorities' commitment, as expressed in Mr. Mojarrad's buff statement, to gear monetary policy toward containing inflation. Like Mr. Stein, we encourage the authorities to continue implementing the recommendations of the safeguards assessments.

We take note that program performance during the second half of 2007/08 was mixed, although the reforms of the central bank were implemented according to the timetable.

In particular, the performance criterion on domestic fiscal revenue was missed, despite early warning and remedial actions being proposed by the staff. At the same time, the updated debt sustainability analysis underscores the vulnerability posed by Afghanistan's reliance on official transfers. In order to gradually achieve fiscal sustainability and move away from long-term aid dependence, we encourage the authorities to undertake further structural fiscal reforms, such as the review of the fiscal relations between the government and the largest state-owned enterprises and the strengthening of the financial management system, to focus on the quality of public spending rather than on its level, and to increase domestic revenue. Consequently, we welcome the statement made by the authorities on timely implementation of the three prior actions on revenue mobilization, as they address adequately key sources of revenue leakages and noncompliance in 2007/08 and are critical for ensuring the viability of the revenue objectives for 2008/09.

In the light of Mr. Mojarrad's buff statement underscoring the authorities' commitment to take remedial measures and to accelerate the reform progress, we also support the new structural benchmarks agreed for the fifth review, especially the one related to a comprehensive restructuring of state-owned enterprises, since it addresses a key obstacle to improved business environment.

The achievements reached under the PRGF-supported program have been supported by the country's qualification under the Enhanced HIPC Initiative. We welcome the last debt restructuring agreements with Iraq and Saudi Arabia and call on all remaining creditors, sovereign as well as commercial, to reach similar agreements before the completion point.

We agree with the staff that the authorities should increase cash transfers targeted on the most vulnerable populations rather than importing wheat directly, in order to limit market distortions.

At the Paris conference, the international community has agreed to provide increased resources and to use them in a more effective way. The Afghan Government has committed itself to pursuing political and economic reform. In addition, the Afghan Government committed itself to support private sector growth, to improve revenue collection and to create a legislative and regulatory environment that will attract investment and generate employment. In the light of these commitments, we are hopeful that the next review of the PRGF will show strong progress in the structural reforms.

Mr. Alazzaz submitted the following statement:

I thank the staff for an excellent set of papers and Mr. Mojarrad and Mr. Jbili for their informative buff statement. I am encouraged by the staff's assessment that economic developments in the second half of 2007/08 were broadly favorable with robust growth and strengthened external position, despite the deterioration in the security situation. Also, all quantitative performance criteria and indicative targets for end-2007/08 were observed except for one.

These developments notwithstanding, further efforts are needed to maintain macroeconomic stability and advance structural reforms, especially in view of the substantial rise in inflation. Also, as the staff notes, three out of seven structural benchmarks were not met and many other commitments specified in the Memorandum of Economic and Financial Policies of January 28, 2008 were not fulfilled. In this regard, the three prior actions to bring government revenues back on track and the authorities' commitment to reinvigorate the structural reform agenda are reassuring.

On the fiscal front, I note the better than programmed outcome in 2007/08. However, the revenue shortfall highlights the need for corrective measures. In this connection, the prior actions detailed in the staff report should help in achieving the revenue objective for 2008/09. Going forward, I am encouraged by the authorities' plan to strengthen the fiscal outlook while increasing spending to meet the priorities under the Afghanistan National Development Strategy (ANDS). To this end, I endorse the focus on modernizing the civil service and strengthening the financial management system, especially given the recent donors' pledge of about $20 billion for implementing the ANDS.

Turning to monetary and financial sector policies, Da Afghanistan Bank (DAB) deserves credit for observing the year-end currency in circulation (CiC) ceiling. Nevertheless, higher commodity prices, especially wheat, contributed to a substantial increase in inflation last year. Against this background, DAB's plan to maintain CiC growth at or below the nominal growth in GDP is welcome. In this regard, I note the efforts to develop the secondary market in capital notes (CNs), which should help in managing liquidity and improving the effectiveness of monetary policy. I also welcome the efforts to strengthen the legal and regulatory framework of the banking system, which should increase confidence in the financial sector and enhance intermediation.

On the external sector, the expected further increase in reserves in 2008/09 and the projected improvement in the current account deficit over the medium term are reassuring. However, the updated debt sustainability analysis underscores the need for extra vigilance in view of the high risk of debt distress, absent debt relief.

With these remarks, I support the proposed decision and wish the authorities further success.

Mr. Guzmán and Mr. Guerra submitted the following statement:

We want to thank the staff for a clear set of papers. We would also like to thank Mr. Mojarrad and Mr. Jbili for their comprehensive buff statement that clearly highlights the major policy challenges for Afghanistan. We broadly endorse the staff assessment and support the completion of the fourth review under the PRGF including the requested waivers.

The authorities of Afghanistan have made a continued effort to improve economic policy and have advanced in the reform agenda in the context of very difficult security problems and capacity constraints. Looking forward, we are assured by the commitment of the authorities to continue with these efforts and to speed up reforms while cooperating closely with development partners.

Monetary Policy and Commodity Prices Shocks

In regard to commodity prices shocks, we fully support the authorities' efforts that give priority to mitigating the impact of food prices on the poor, and we hope that they will continue to work closely with donors and multilateral agencies, in particular the World Food Programme.

One of the biggest risks to the program relates to higher inflation if the jump in food prices is not partially reversed. Indeed, the increase in food prices accounts for most of the recent upswing in inflation. Nevertheless, in this case, as in the case of many developing countries, there is the risk that protracted inflationary pressures can be reflected in increased overall inflation in the medium-term. Inflation can have a negative effect on the fiscal stance, reduce investment and growth, and, last but not least, erode household income affecting in particular the poor. In this regard, we support the staff assessment that monetary policy should remain focused on containing inflationary pressures, trying to avoid the second round effects of these price shocks on general inflation.

Although food prices are very important for inflation, based on the analysis recently presented to the Board, a shock on fuel prices can have a major impact on the external accounts of Afghanistan. We would appreciate if the staff could elaborate on the impact of an additional shock of fuel prices on overall inflation, fiscal accounts, and debt sustainability.

Fiscal Policy and Capacity Building

We commend the authorities' commitment to carry out a number of structural reforms in the fiscal area. In addition to the need to adopt a strategic approach to developing a modern tax administration, we want to highlight the necessary improvement of the budgetary process.

We continue to support the staff’s view that, given the uncertainty surrounding available resources and absorption capacity, there is a need for prioritization of sectoral expenditure in order to have a greater impact on poverty reduction; specially, we would add, within the present context of increased risks due to higher food prices that affect the poorest sector of the population. In relation to this issue, we regard the development of organizational and human capacity in the government as a key factor to achieving implementation of the strategy. The regional technical assistance center has played a significant role in this regard and we will continue to support this important capacity building effort.

With these remarks, we wish the authorities success in their endeavors.

Mr. Raczko and Mr. Gasiorowski submitted the following statement:

We would like to thank the staff for the interesting paper and Mr. Mojarrad and Mr. Jbili for their insightful buff statement.

While GDP growth was favorable, economic imbalances are growing. In particular, inflation is rising significantly. The fragile political situation and governance problems are main obstacles to speed up the implementation of the reform agenda. On the other hand, significant progress is needed to improve infrastructure, enhance public sector administration and promote development of the private sector.

From this perspective, although the hike of international food and fuel prices had a significant impact on headline inflation, we are concerned that the most important causes of inflation are structural and institutional. Therefore, we think that the staff's inflation scenario may be too optimistic. Hence, we advise the authorities not to hope for a more favorable international and regional context, but rather to implement structural measures, to improve coordination and cooperation between monetary and fiscal policies and to allow for the exchange rate to appreciate. When inflation is rising so fast, it is crucial that inflationary expectations are fought vigorously.

Our main concern relates to the fiscal policy because Afghanistan has one of the lowest revenue-to-GDP ratio. Hence, the broadening of the fiscal revenue base and improvement of tax compliance should be on the top of the government's priorities. Tax administration definitely needs to be strengthened and strong international support, in the form of technical assistance, is needed to accelerate the reforms. Evident progress in this field is necessary to improve fiscal sustainability and to decrease Afghanistan's dependence of foreign aid in the long-term.

We also call for more visible progress on the expenditure side. Support to the SOEs is still pervasive. The lack of focus of the ANDS could result in inefficient public spending. On the other hand, the increase of food and oil prices call for action of the authorities. Could the staff comment on what kind of fiscal measures the authorities envisage to address high food prices?

Security still remains a key problem. The illegal drug economy is thriving, mainly because the government has difficulties controlling the whole country. According to UNODC reports, a large quantity of opium is stored in areas out of government control. Not only is the security situation likely to remain very serious, but decisive action is called for to improve governance and to enforce law. The growing scale of opium production is a sign that structural reforms and the consolidation of the power of the central government are not progressing sufficiently.

We welcome the commitments and the pledges made at the Paris conference to help rebuild Afghanistan. The authorities can now show ownership of their development plans with the adoption of the ANDS. We urge the authorities to take action on the main criticisms regarding governance, absorption capacity, prioritization and monitoring so that donors are reassured that their aid money will be spent efficiently. We would be interested to hear from staff how it assesses international coordination in Afghanistan.

The updated DSA shows the significant benefits of debt relief. We take note of the countries that took part in the restructuring process and urge the authorities to continue negotiating with the remaining creditors. The DSA's results should serve as motivation for the authorities to fully implement this program, so that the country benefits from debt relief at completion point. On the other hand, the influence of foreign aid is very strong. We realize that the Paris Conference might have provided some certainty, but a drop in foreign support could still have serious consequences. Therefore, structural reforms and economic diversification are of utmost importance.

We regret that the performance under the PRGF-supported program is not fully satisfactory, in particular in the fiscal area. We note that the inclusion of three new prior actions and eight new structural benchmarks is a sign that decisive corrective action is necessary to keep the program on track. In view of the volatile security situation and of the inadequate administrative capacity, we think that overburdening the authorities with so many new obligations might not be the best way for them to focus on the main program objectives. Hence, we suggest to concentrate on the criterion of fiscal revenue and expect a more ambitious effort of the authorities in this respect.

Finally, we support the staff's decision to complete the fourth review and accept the request for a waiver of performance criterion. We hope that prior actions proposed by the staff will improve the commitment of the authorities to the program.

Mr. Bergo and Ms. Mogensen submitted the following statement:

We support completing the fourth review and granting the associated waiver. We look forward to an update with respect to the remaining prior action to be taken. Our main concern is the performance in public finances, and we associate ourselves with the views expressed by Ms. Lundsager and Mr. Parodi. We offer a few points for emphasis, but would also like to comment on the suggested approach to the response to the food price crisis.

We reiterate the importance of increasing domestic revenue collection to prevent long-term aid dependency and support the staff's appropriate attention to this matter in the program. We regret the mixed performance in this area and note the striking Figure 4 of the staff report demonstrating that the target for achieving a balanced operating budget has—again—been postponed.

Improving public financial management will be crucial, highlighted by the fact that inadequate enforcement efforts and undervaluation by customs were the main reasons for the recorded revenue slippage. We agree with the authorities that the reform process has to be accelerated, and note that, for instance, the review of the fiscal relations with key state-owned enterprises has seemingly not been initiated yet. The problem of corruption has to be dealt with seriously in return for the expected additional aid money to implement the ANDS. Likewise, on the expenditure side, the absorptive capacity is a real challenge that has to be addressed adequately in order to reduce risks of mismanagement of funds, ineffectiveness and corruption.

Turning to the response to the food price crisis, we agree that targeted subsidies to vulnerable households would be a first-best solution. However, we note the authorities' reluctance to this approach due to the lack of appropriate identification and distribution mechanisms to provide direct cash transfers. We would be interested if the staff could elaborate on how they see these problems overcome, bearing in mind the commitment to ensuring ownership in the Paris declaration on aid effectiveness.

On a separate note, we welcome the progress made by the authorities in regularizing relations with external creditors. We are also pleased to note the improved quality of statistics in areas critical for program monitoring.

We acknowledge the many challenges facing the Afghan authorities, not least in the face of a deteriorating security situation. Nevertheless, the authorities must make every effort to deliver both on program conditionality and on the other commitments specified in the Memorandum of Economic and Financial Policies and the Supplement. We welcome the authorities' intention to take full advantage of the momentum created by the political and social consensus on the ANDS and hope that performance will improve for the next reviews.

Mr. Kiekens and Mr. Demirkol submitted the following statement:

We thank the staff for the good set of papers and Messrs. Mojarrad and Jbili for their helpful buff statement. Afghanistan's economic performance has been satisfactory even with the deteriorating security conditions and external shocks. However, there is a visible slowdown in the implementation of policies envisaged under the PRGF-supported program, notably on the fiscal side as shown in Figure 4 of the staff report. We broadly agree with the staff's analysis and we will make the following comments for emphasis.

Given the weak revenue performance, we reiterate our call from the last Board meeting on the Afghanistan National Development Strategy (ANDS), for the strong implementation of fiscal reforms, particularly on the revenue side. They should push forward with the tax policy and administration reforms so that revenue performance lends further confidence to international donors and boosts the credibility of the authorities. In this respect, we welcome the new prior actions incorporated under the program.

We support the authorities' intention to set an indicative ceiling on reserve money along with the quantitative performance criterion on CiC and efforts to strengthen liquidity forecasting and monitoring. Given the rising inflationary pressures, the limited scope for effective monetary policy action and the staff's conservative inflation assumption, could the staff please comment on why they refrained from presenting a more balanced inflation forecast and revised program as suggested by Mr. Murray and Mr. Duggan.

We commend the authorities for taking the necessary action and working with donors to mitigate the impact of the rising food prices on the poor. While direct cash transfers remain the most efficient channel, we see some merit in the authorities' recent decision to supply low-cost imported wheat to domestic market because of Afghanistan's current conditions. We are confident that the authorities would take other concrete steps with the help of donors and the international community to alleviate the dire consequences of the rising food prices on the poor.

We share the staff's concerns on the implementation of the structural reform agenda. The staff rightly recognizes the authorities' inability to deliver on structural reforms as an emerging risk to the program. It is important that the authorities implement fiscal structural reforms aimed at increasing the transparency and overall efficiency of the public sector without any delay.

While welcoming many of the initiatives to support private sector development, we remain skeptical about the feasibility of these initiatives and the implementation capacity under the deteriorating security environment. In this respect, we share the comments made by

Messrs. Kishore and Krishnan on Afghan Telecom. We would also like to hear from the staff how they are planning to proceed in helping the authorities in prioritizing policies and identifying the intermediate steps for policy implementation in several areas under the ANDS.

While we support the completion of the Fourth Review and granting of the requested waivers under the PRGF-supported program, we urge the authorities to strengthen overall program implementation and wish them every success in their challenging endeavors.

Mrs. Sucharitakul and Mr. Agung submitted the following statement:

We thank the staff for the well-written set of reports and Messrs. Mojarrad and Jbili for their insightful buff statement. Despite the difficult political and security situation, the Afghanistan economy managed to grow at an estimated 11½ percent in 2007/2008 and external position strengthened. Recent escalating inflation poses key challenge for the authorities to maintain macroeconomic stability. The authorities have strived to keep their PRGF-supported program largely on track, with all the quantitative performance criteria and indicative targets for end-2007/08 met, with the exception of the criterion on the fiscal revenue. Against this background, we support the completion of the fourth review under the PRGF and the authorities' request for waiver of non-observance of the quantitative performance criterion on the floor on fiscal revenue.

On fiscal front, domestic revenue enhancement should remain the key authorities' priority to strengthen the fiscal sustainability. It is disappointing to note that the revenue shortfall in 2007/2008 was primarily due to inadequate enforcement efforts and undervaluation of petroleum imports by customs. We therefore join the staff in encouraging the authorities to broaden tax base and address governance issues in customs administration to achieve the long-term fiscal objectives. Structural reforms in public financial management are also imperative to strengthen fiscal outlook. In this regard, we are pleased to note that the authorities remain committed to modernize the civil service. Also, high on the agenda of the authorities is the need to ensure a robust public financial system to manage the scaled-up aid in the context of the ANDS.

To mitigate the impact of the rise in wheat price to the poor, the authorities' reluctance to target cash transfer is understandable given the complex distribution mechanism in the absence of proper identification. Instead, the government currently plays the role in wheat price stabilization by importing wheat and selling to the local market at cost-recovery level. We note from Messrs. Mojarrad and Jbili's statement that the authorities intend to collaborate with donors to mitigate the impact of increased food prices on the poor. Could the staff elaborate more on the possible mechanisms that would be developed by donors or with the assistance of donors?

On monetary and financial policies, the authorities have been vigilant in responding to the current inflationary pressures as reflected in a lower growth of currency in circulation (CiC) relative to that of nominal GDP. In light of increasing non-cash transaction and large inflows of foreign exchange, we welcome DAB's plan to enhance the monetary policy framework by introducing an indicative ceiling on reserve money in addition to the current framework of CiC target. The DAB's intention to increase the role of capital notes auctions and developing the secondary market for these instruments will help support the reserve money targeting framework. At the same time, plans to strengthen liquidity forecasting and commercial banks' liquidity monitoring would provide the basis for decision on open-market operation. We note that in designing the program, the staff adopted an ambitious inflation assumption. We are concerned over the extent of which demand management policies can be used reign in inflationary pressures from the supply side due to food and oil price shocks. The staff's comments are welcome.

We concur with the staff that much more needs to be done to accelerate the structural reforms in order to enhance private sector and growth opportunities, with the infrastructure development and utilities provision as a key area for improvement. Predictability of the investment regime and business certainty as well as law enforcement would be key to enhancing private sector development and foreign direct investment. We also welcome the authorities' plan to privatize the DABS, although we would stress that the improvement of governance and corporatization of the petroleum company should be prioritized before embarking on full privatization. The staff's comments are welcome.

With these remarks, we wish the authorities continued success in their endeavors.

Mr. Rutayisire submitted the following statement:

We thank the staff for an insightful paper and Mr. Mojarrad and Mr. Jbili for their helpful buff statement.

Despite the difficult security and political environment, Afghanistan's recent economic developments have been broadly favorable. Real GDP growth rose to 11.5 percent despite the rapid deterioration in the inflation outlook. High oil and food prices raised headline inflation above 20 percent.

Performance under the program was mixed. The domestic revenue target was missed and three out of seven structural benchmarks were not met. Against this backdrop, program discussions appropriately focused on accelerating the implementation of structural reforms and mechanisms to address the effects of rising food prices. The introduction of measures to enhance revenue performance –also at the center of policy discussions– remains critical, and we agree that the prior actions described in paragraph 14 of the staff report would help address some of the sources of weak revenue performance including in the areas of tax receipts from imported petroleum products and airlines fees.

Fiscal Policy

We urge the authorities to strengthen their efforts to improve domestic revenue performance, as it is one of the lowest in the world. Domestic revenues declined from 7.5 percent of GDP in 2006/07 to 7.0 in 2007/08. We note that the revenue shortfall was mainly due to inadequate enforcement efforts and undervaluation of petroleum imports by customs, and we welcome the measures taken to address their impact on fiscal revenues.

Despite the weak revenue performance, the budget deficit has narrowed to 3.6 percent. We commend the authorities for keeping development expenditures broadly in line with program projections.

We welcome progress made in expanding the program budget pilots to help align public spending priorities with Afghanistan's PRSP and the reforms initiated to strengthen tracking of poverty related spending through reporting on government budget execution. However, we urge the authorities to strengthen the linkage between budget formulation and subsequent execution and monitoring and accelerate progress in integrating the operating and development budgets.

Monetary Policy

Despite strong inflationary pressures, we commend the authorities for their efforts to mitigate the impact of high oil and food prices on the population, including by keeping currency in circulation significantly below the nominal GDP growth rate and increasing interest rates. We note that the strength of the currency against the dollar also contributed to reduce inflationary pressures.

We welcome the measures introduced to further enhance the conduct of monetary policy and the development of the secondary market for conducting open market operations using capital notes.

External Sector

Notwithstanding high oil and food prices, the current account strengthened in 2007/08 registering a surplus of 0.9 percent of GDP compared to a deficit of 4.9 percent in 2006/07 due to improvements in the trade balance and higher than expected aid inflows. International reserves stood at 11 months of imports.

Structural Reforms

We welcome the authorities' commitment to reinvigorate the structural reform agenda. Efforts to place key SOEs on a sound financial footing with a view to creating conditions for their restructuring or privatization and strengthening the legal framework for private sector development are commendable steps in the right direction.

We note from the updated debt sustainability analysis that Afghanistan continues to have a high risk of debt distress. The authorities have made good progress in regularizing relations with external creditors and we encourage them to continue their efforts in this regard. This should help accelerate the delivery of additional debt relief by the country's creditors.

With these remarks, we wish the authorities success in their future endeavors.

Mr. Kotegawa and Mr. Harada submitted the following statement:

We thank the staff for their concise and informative papers and Mr. Mojarrad and Mr. Jbili for their helpful statement. Having stressed during the last review the importance of the mining sector for the country's future economic development, we appreciate the information on this sector, presented in Box 2 of the staff report, and hope the staff continues to provide updates on mining-sector- related information.

As the security situation continues to deteriorate, we are sympathetic toward the authorities' difficulties in making progress with their reform agenda. Nonetheless, this is the timing when the Fund's close engagement with the authorities is expected to anchor sound and sustainable macro economic policies. In this regard, we are grateful for the authorities' further commitment, expressed in the Supplementary Memorandum of Economic and Financial Policies for 2008/9 and, at the time of the future review, we look forward to reviewing their progress.

We broadly agree with the staff's appraisal and support the authorities' request for a waiver of the performance criterion. However, we note that one of the prior actions has not yet been met, and we would like to ask the staff to provide an update on this front.

Additionally, we would like to comment on the following issues.

Fiscal Policy and Debt Sustainability

While we understand Afghanistan's difficult situation, we regret the nonobservance of the quantitative performance criterion regarding the fiscal revenue floor. Given the country's great dependence on aid and its high risk of debt distress, as indicated in the Debt Sustainability Analysis (DSA) paper, revenue mobilization is high-priority urgent matter. Although it is encouraging to see the international community's strong support, as seen at the recent Paris Conference, the authorities should strive to reduce its reliance on donor support in the medium to long-term, and move toward a self-sustained economy. In this regard, we encourage the authorities to make further efforts to mobilize revenue by strengthening the customs and tax administration and improving the country's business environment. Additionally, we encourage the authorities to develop the country's high-potential mining sector and, consequently, increase revenue and achieve further economic growth.

Monetary and Exchange Rate Policies

As we mentioned in the previous board meeting, given that the CiC fluctuates not only as a result of economic growth but also due to influences in temporary seasonal demand, setting a currency in circulation (CiC) target to stabilize inflation rates would not be the most effective measure (neither would it be to set a reserve money target). Indeed, according to Figures 1 and 2 of the staff report, there seems to be no clear correlation between the CiC and the inflation rates, which is natural in highly-dollarized economies such as that of Afghanistan.

The main challenges to enhancing the effectiveness of monetary policy are to dedollarize the Afghan economy and deepen its financial market. In order to dedollarize the economy, it might be workable to increase the cost of holding dollars, e.g., by increasing the required reserve ratio or capital adequacy ratio in response to the amount of dollars held by banks. Regarding financial deepening, we welcome the increased issuance of capital notes (CN). We share the staff's view that a deepening CN market would strengthen the effectiveness of monetary policy.

Other Issues

Finally, we encourage the authorities to fight corruption and to put forth their best efforts to replace the opium-based economy with a licit economy. These are key issues that need to be addressed in order to enhance the effectiveness of sound macroeconomic policy.

With these remarks, we wish the authorities every success in their future endeavors.

Ms. Agudelo and Mr. Perez submitted the following statement:

We thank the staff for the well-written paper and Messrs. Mojarrad and Jbili for their informative buff statement.

The economic development of the Islamic Republic of Afghanistan has been acceptable during FY 2007/08, despite the continued deterioration of the security environment and the increase of food and oil prices. The performance of the PRGF-supported program is weak with regard to the implementation of structural reforms and the fiscal revenue target. We welcome the support of the international community for Afghanistan expressed during the Paris conference in June 2008, where donors pledged about $ 20 billion for the implementation of the ANDS.

Inflation has picked up and has become the biggest threat to the PRGF-supported program. We welcome the authorities' commitment to contain inflation with a strengthened monetary policy to reach the target of currency in circulation. In regard to the high and persistent dollarization of the Afghani economy, we would appreciate staff's view regarding the effectiveness of monetary policy to contain inflation. In relation to the banking sector, we encourage the authorities to improve the regulatory framework given the growth of commercial banks.

The fiscal position was stronger than the projections, although the missed performance criterion on revenue still shows the dependence on the long-term aid. We encourage the authorities to move forward to improve the tax collection and work in the minimum-term budget that is a key element in the implementation of ANDS. Given the security environment and capacity constraints of Afghanistan, we would appreciate the staff's view about the timing effect in conditions and price that could affect a possible transaction.

We welcome the involvement of the government in the wheat market with the intention to mitigate the increase of prices for the poor. Like the staff, we encourage the authorities to adopt targeted cash transfers to vulnerable households.

We welcome the commitment of the authorities to address the missed targets of the PRGF-supported program and improve the quality of the statistics. We support the waiver of nonobservance of the quantitative performance criterion on the floor of fiscal revenue and the completion of the fourth review under the PRGF, given the commitment that the authorities are showing to keep the program on track.

With these remarks, we wish the authorities success in dealing with the difficult development challenges that lie ahead.

Mr. Gibbs and Mr. Rab submitted the following statement:

We are grateful to the staff for a clear report and Messrs. Mojarrad and Jbili for a useful statement. Much of the discussion from the Third Review under the PRGF and the recent Joint Staff Advisory Note on Afghanistan's ANDS remains relevant. We also broadly agree with the staff appraisal. We therefore note a few points for emphasis.

We commend the authorities for maintaining sound macroeconomic performance over the course of the program. However, several challenges remain including revenue mobilization, policy-based budgeting and expenditure, and structural reforms for private sector development. These are heightened by capacity constraints, security issues and rising food and fuel prices. It is disappointing that several commitments in the January 2008 Memorandum of Economic and Financial Policies have not been met. With the recent presentation of the Afghanistan National Development Strategy, we think that more is needed on economic reforms for successful implementation of the strategy.

On fiscal policy, revenue mobilization continues to pose challenges. Difficulties in meeting targets under the program have led to delays in the Fourth Review. More effort is needed both on policy and administration to generate sustained change in revenue mobilization. We note that the target for covering recurrent expenditure through domestic revenue has now slipped by one year.

On the expenditure side, we commend the authorities for maintaining control and discipline. Though we also agree with the staff on the need for further progress in Public Finance Management reforms. A number of the priorities highlighted in the staff report are recurring themes including better policy orientation of the budget, regularizing the relations between the budget and State Owned Enterprises and public administration reform. We welcome the authorities' commitment to maintaining the operating budget deficit under control. Though we would note that without proper integration of the development and recurrent budgets, these targets may underestimate the actual operating budget deficit.

We note that Afghanistan's external position is relatively stable, with a comfortable level of foreign exchange reserves and a projected improvement in the current account deficit (excluding grants). Though our sense is also that there may be continuing challenges in compiling accurate balance of payments data. We think this is an area that needs to be addressed along with broader statistical capacity strengthening.

The debt sustainability analysis highlights that lower than expected official transfers and slower than expected export growth could lead to high risk of debt distress in the absence of debt relief. We therefore think that continued reliance on concessional assistance is important and progress towards HIPC Completion Point essential.

We commend the authorities for maintaining monetary discipline, including through increased use of Capital Notes. Though we also support the staff's comments that Capital Notes' auctions need to be commensurate with market conditions to avoid unnecessary interest volatility.

Containing inflationary pressures will pose challenges. But this is clearly a priority along with addressing the impact of rising prices on the poor. Targeted schemes are essential in this regard. We note that there are challenges to proper targeting and distribution. But the authorities have been implementing a number of successful national programs, which provide potentially important conduits for addressing the impact of rising prices.

We look forward to further discussion at the next review and wish the authorities success with implementation of the ANDS and supporting reforms.

The staff representative from the Middle East and Central Asia Department (Mr. Elhage) made the following statement:

As Directors most likely heard this morning, there was a tragic event in Kabul, where a car bomb exploded in front of the Indian Embassy and a significant number of people lost their lives. We are in contact with the Fund's security expert in Afghanistan. All Fund staff on the ground are fine.

I would also like to update Directors on the status of the prior action that was still pending when we issued a statement on July 3, 2008. Our statement indicated that the authorities have arranged for an additional 10.5 million Afghani to be collected from airlines before this Board meeting. We have been informed this morning that a payment of 5 million Afghani was made by one airline, which brings the total amount collected to 74.3 million Afghani. The national airline, Ariana, which was supposed to make another payment of 3.5 million Afghani, was however not able to raise the funds before the Board meeting.

We believe that the Ministry of Finance made all efforts to collect 79 million Afghani. Given that 94 percent of the required amount was collected, the staff recommends the completion of the fourth review. Efforts will continue to be made on this front, and we expect the remaining amount of 4.7 million Afghani—about $90,000—to be collected before the Fifth Review.

Mr. Mojarrad expressed his dismay and regret of the tragic event at the Indian Embassy in Kabul, which had taken the lives of innocent people, and conveyed his sympathy and condolence to the victims' families and to the Indian authorities. The tragic event was a reminder of the fragility of the security situation in Afghanistan and of the need for continued support by the international community.

The staff representative from the Middle East and Central Asia Department (Mr. Elhage), in response to questions and comments from Executive Directors, made the following statement:

> I will address the questions that were raised in the gray statements by topic. I will start with the questions on the fiscal sector. A few directors asked about the reasons behind the accrued tax and non-tax liabilities due from airlines. It is important to note that the situation among the three main airlines is somewhat different. Ariana, the state-owned airline, is badly mismanaged and has serious cash flow problems. While the airline is delinquent on tax bills some government ministries are delinquent on service bills to the airline.
>
> The other two airlines, which are privately owned, use leverage and connections to either avoid or delay paying taxes and charges. In addition, one of the two airlines performed services for the Ministry of Hajj, and reportedly was not paid on time. This gave the airline an additional reason not to pay taxes.
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> We believe that the prior action introduced for the completion of this review on collection of the accrued tax and non tax liabilities from the airlines will go a long way to help instill a culture of tax payment among the airlines.
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> We were asked to clarify why the program does not explicitly target broader public financial management and civil service reforms along the lines of those emphasized in paragraphs 17 and 29 of the staff report. The way the program is designed now, conditionality focuses on the relations between the budget and SOEs because this is an area, where fiscal risks could be significant and also because the unreformed status of these enterprises is a major constraint to growth.
>
> Other PFM measures related to strengthening of expenditure tracking, program budgeting, and audit functions feature among the floating completion point conditionality under the HIPC Initiative. We are monitoring progress toward their implementation and will report on their status in the context of the next review. In addition, the authorities have committed to more specificity in terms of civil service reforms as mentioned in paragraph 11 of the MEFP. The staff will monitor these commitments and may introduce future conditionality in the event of any slippage.

There was a question on whether the measures listed in box 1 of the staff report are sufficient to generate revenues corresponding to 2.3 percent of GDP over the medium term, as projected in the program. The revenue measures listed in Box 1 focus on conditionality that is most critical for: expanding the tax base, including through elimination of exemptions and rollout of the Large Taxpayers Office; moving the BRT toward a broad based consumption tax by imposing the BRT on imports; and improving collection efficiency. These measures will yield additional revenue—especially the collection of BRT on imports. To achieve an increase in revenue of 2.3 percent of GDP during the medium term we are also assuming progress in customs and tax administration in line with Fund technical assistance recommendations. However, consistent with streamlining conditionality, these measures are not included in box 1.

We were asked to identify the difficulties in the PFM systems encountered by the MOF and line ministries. There have been some difficulties in implementing the PFM reforms that would help align public spending with government priorities, and reforms that would track poverty reducing expenditures. Some of the problems encountered thus far include: slow progress on the integration of operating and development budget staff in the line ministries; complications in defining programs and modifying the Chart of Accounts; lack of clarity on how to align the programs with existing organizational structures that are used to determine the payroll budget; donor fragmentation in terms of supporting the program budgeting pilots; and weak linkage between program pilots and provincial budgeting. The authorities intend to correct these problems and to that end they will be relying on TA from the Middle East Technical Assistance Center.

There were three questions on the ANDS and the Paris Conference. There was a question on how the staff is planning to proceed in helping the authorities in prioritizing policies and identifying the intermediate steps for policy implementation in several areas under the ANDS.

During the Board discussion of the ANDS and the JSAN it was established that there is a need for prioritization of sectoral programs. We have been advising the authorities on the appropriate macroeconomic policies needed to implement the ANDS. Under the current PRGF-supported program, we also have defined the appropriate expenditure envelopes that would maintain macroeconomic stability and achieve fiscal sustainability over the medium-term. Since expenditures will have to fit within these expenditure envelopes the authorities will need to cost their sectoral strategies and prioritize projects within each strategy. As for cross-sectoral prioritization and sectoral prioritization these areas are outside our expertise and will have to be done by experts and our colleagues at the World Bank.

There was a question on whether program prioritization constituted an issue for discussion at the Paris Conference last Month. Yes it did. In particular, during the preparatory meeting which was held on June 4. During that meeting the Bank and Fund staffs discussed issues related to the absorptive capacity of the economy and the need for prioritizing sectoral spending. Other regional institutions and many donors also stressed the need for stronger prioritization and streamlining of programs in the ANDS.

There was a also question on international coordination in Afghanistan. This was another important topic that was discussed during the preparatory meeting in Paris. The Bank staff presented a paper on aid effectiveness. All participants agreed that lack of coordination among donors has been a challenge for Afghanistan, as two-thirds of aid-driven spending still occurs off-budget, and thus outside the government's control and ownership. Participants stressed that with improved prioritization, donors should be able to better align their financial assistance with the Government's priorities.

There were few questions on the inflation assumption used by the staff, which few Directors considered to be ambitious. When we were in Kabul in late April 2008 we projected average inflation for 2008/09 at about 18 percent compared to 13 percent in 2007/08 and we prepared the macro framework accordingly. It turned out that inflation was 20 percent in April-May. The main reason behind the increase in the inflation rate was the large increase in food prices which increased by 19.0 and 10.2 percent, in April and May, respectively. There was a market disruption in wheat supply in Afghanistan due to Pakistan further tightening of border controls to enforce the export ban on wheat which was introduced last year. Also, in April, Kazakhstan imposed export ban on wheat.

The increase in food prices and particularly wheat took place at the same time when the government of Afghanistan took initiative to import wheat for sale in the domestic market and donors were also bringing additional wheat into the country. With these developments and the fact that the authorities were telling us that prices will come down we renegotiated the program with the authorities and agreed on a revised inflation target of 24 percent. We knew that this is an ambitious inflation objective and would require tight fiscal and monetary policies which are built in the program. Since we made that call, the overall CPI for Kabul in June declined by 6 percent relative to May 2008 mainly on account of a fall in prices of bread and cereal which declined by 14 percent. If inflation does not come down as we are projecting, the program's assumptions and policies to contain inflation will be revisited at the time of the next review.

We were asked to comment on the effectiveness of the current monetary policy in particular if inflation turned out to be higher than projected. If inflation exceeds expectations because of exogenous shocks, monetary policy is unlikely to be effective in a significant way to contain their impact. This is a dollarized economy with limited effective monetary instruments. The strategy adopted for the program is to use monetary policy to contain inflationary expectations and control second-order effects, such as indexation of nominal contracts based on inflationary expectation exceeding the assumed level. Since the authorities will have to rely mainly on the sale of foreign exchange to achieve the relatively tight path for growth in CiC and RM some appreciation of the exchange rate should be expected. If that occurs, it would provide a welcome signal of strengthened confidence in the Afghani.

There was a question on the impact of an additional increase of fuel prices on overall inflation, fiscal accounts, and debt sustainability. Since most of the petroleum products are imported by the private sector we would expect that, with the introduction of the new system for timely updates of reference prices for petroleum products to be used by the customs department in assessing the amount of applicable duties, an increase in fuel prices will lead to an increase in revenue. At the same time, there might be pressure on the budget because of additional operating cost and subsidy for the electricity company. As for the impact on overall inflation, electricity, fuels, and transportation account for 8.7 percent of the CPI. Assuming a 50 percent pass through of fuel price increase in these sectors a 10 percent increase in the price of petroleum product will lead to about half a percent increase in the CPI. Second order effects, may raise the CPI by another half a percent.

As for the impact on debt sustainability, we are projecting that oil imports on average will be about $1.2 billion per year during 2008-10. So for every 10 percent increase in fuel oil prices, the current account deficit excluding official transfers would widen by about 1 percentage point of GDP but since large amounts of fuel are imported to cover the needs of foreign troops and the expatriate community, a good part of the increased import bill for fuel will be covered by official transfers.

There was a question on whether the fall in farm-gate prices of opium in 2007/08 and the significant increase in wheat prices have improved the prospect of increasing switchover from opium to wheat and other food grains? In response to both efforts by the authorities to deter opium poppy cultivation and sharply higher wheat prices, there are signs that some Afghan farmers are shifting their short-run cropping patterns, at least at the margin, from opium poppy to wheat. However, wheat is not a suitable or sustainable alternative crop to replace opium poppy over the medium term. In addition to wheat being much lower-value than opium, the bulk of Afghanistan's rural population would not be self-sufficient in terms of food consumption even if they cultivated all of their land with wheat, and therefore have to cultivate cash crops and/or engage in other activities in order to make ends meet. Also, some farmers particularly in the east and south are in debt to drug traders who provide advance payments which these farmers use mainly to meet household consumption needs before the harvest; this debt may also constrain any shift in cropping patterns toward wheat.

Although wheat is Afghanistan's most important crop in terms of cultivated area and thus plays a very important role in the rural economy and rural livelihoods, the way forward for reducing dependence on opium production over time is development of cash crops and other economic activities such as livestock that will provide adequate and sustainable livelihoods for the rural population. Donor-supported programs are encouraging the cultivation of fruits, nuts, and other high-value crops including for export to neighboring countries, but insecurity and corruption (e.g., checkpoints on the roads at which bribes are demanded from transporters of such goods) are among the factors constraining such development, especially in the south.

There were a number of questions related to the increase in food prices and what mechanisms could be developed by donors or with the assistance of donors to mitigate the impact of increased food prices on the poor?

The UN Food and Agricultural Organization is involved in importation and distribution of food in Afghanistan. Until recently, its main focus was in the rural areas. Since early this year, it has expanded its operations to the urban areas. Food interventions in rural areas target food insecure households, mainly through community-based works, aimed at rehabilitating agriculture and irrigation infrastructure and rural road networks.

Regarding the intervention in urban and semi-urban areas, several options are being considered including: standard WFP distribution modalities; blanket distributions with delivery through an appropriate market intervention, and selling the food at subsidized prices.

The staff is of the view that the government could facilitate the work of WFP and other donors by playing a supporting role in providing transportation, storage, and security for the distribution of wheat.

There was a question on the timing of the privatization of Afghan Telecom and whether there will be adequate competitive interest in the company given the present security situation. This is outside our area of expertise and the deal has been carefully prepared by experts. When we discussed this issue during the last mission with the experts helping in the privatization process, they were optimistic that they will be able to get a good price and that there were a couple of interested buyers. Also, the most likely buyers are the companies that are already present in the Afghanistan telecommunications market.

There was a question on the governance framework for the electrical utility, what would be a fair and practical tariff approach for the electrical utility, and the soon-to-be-privatized fuel distributor, and a broader concern about the financial administration of state-owned enterprises.

We have consulted with our World Bank colleagues and the following answer incorporates their inputs. There has been further progress in the restructuring of the power company (DABM). Following the Cabinet approval of the Articles for corporatization of DABS, the corporation was established with the appointment of the Board of shareholders (several key ministries, including the Ministry of Finance and the Ministry of Water and Energy, and the Afghanistan Investment Support Agency) and the interim CEO (Minister of Economy) in April 2008. A group of senior management advisers is expected to be hired within the next six months through a Bank project to assist in the corporatization.

Regarding the prospect for electricity tariff increases, there is an agreement among experts and the authorities that there must be a meaningful improvement in supply conditions before an increase in tariffs could be considered. Program conditionality focuses on the fiscal relations between the MOF and DABS, which need to be clarified in the form of an agreement on quarterly reform benchmarks to be met in exchange for subsidy disbursements. Key conditions in this agreement will include: production of financial statements; achieving measurable improvements in collection performance and cutting physical theft of electricity. The authorities have also committed to prepare by December 2008 a draft medium-term plan to gradually reduce and eventually eliminate the energy subsidy.

As for the question on the state-owned Fuel and Liquid Gas Enterprise (FLGE), the authorities' intention is to privatize it by March 2009. In our discussions with the authorities we have stressed that the government should not be in the business of fuel distribution at a retail level and that operations of FLGE should be conducted in a way that do not lead to fiscal cost and more broadly undermine economic governance. Program conditionality has been broadened to address these problems and improve transparency within FLGE.

Mr. Fried thanked the staff for detailed answers and Mr. Mojarrad for an informative buff statement. While the staff considered the enforcement of tax and non-tax collections from airlines as a test for establishing good governance, the challenge of corruption spanned beyond the airline industry. Was there any intention to address pervasive corruption in a more comprehensive and strategic manner?

The staff representative from the Middle East and Central Asia Department (Mr. Elhage), in response to further questions and comments from Executive Directors, made the following statement:

> The prior action that was introduced on the airlines had a number of objectives. One objective is to go after the large taxpayers in Afghanistan. We believe that the Ministry of Finance has done an excellent job in going after two privately held airlines that have not been paying taxes.
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> The efforts that were made in the last months go beyond collecting the 79 million Afghani that was imposed as a prior action. We believe that the culture of tax collection has been put on the table. More importantly, program conditionality now requires that the airlines remain current on the payment of taxes; and lending and parking fees. The staff will be monitoring this issue.
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> Regarding the second issue on the petroleum enterprise (FLGE) that has been subject to allegations of governance issues. The staff has introduced a structural benchmark that was implemented in February 2008 that improved the transparency of the relationship between this public enterprise and the private sector. In fact, the fees that the private sector needs to pay for using the storage facilities and services of the petroleum enterprise have been posted on its website.
>
> The second important issue is for the petroleum enterprise to have an audited balance sheet by November 2008. We are building the components needed for the eventual privatization of the petroleum enterprise and trying to strengthen the transparency issues within FLGE.
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> Regarding governance and corruption in general, I will leave this issue to others involved in Afghanistan to address as it goes beyond our mandate. However, when it comes transparency issues regarding fiscal and monetary policies, program conditionality has been strengthened to address them.

Mr. Mojarrad made the following concluding statement:

I would like to thank my colleagues for their expression of support to Afghanistan, and understanding of the difficult circumstances under which the current PRGF-supported program is being implemented. I will faithfully convey to my authorities the views and policy recommendations made by Directors, and I am sure that they will take them into consideration in shaping the next phase of implementation of their program.

Mr. Elhage has fully responded to Directors' questions and I have nothing to add to his answers. I would simply reiterate my authorities' commitment to persevere with their reform program. They are fully aware that the next phase of reforms will be challenging, and intend to marshal the political resolve and the technical capabilities to achieve their objectives. In particular, the authorities will tighten the fiscal and monetary policy stance to reduce inflation.

I thank Mr. Elhage and his team for their hard work and dedication. This is Mr. Elhage's last mission to Afghanistan and I am pleased to convey to him my authorities' deep gratitude for his valuable contribution to their reform efforts. I wish him full success in his new assignment.

The Acting Chair (Mr. Portugal) made the following summing up:

Executive Directors welcomed the recent strong growth of the Afghan economy, while noting that the authorities are facing enormous challenges to implement their PRGF-supported program amidst an increasingly difficult political and security environment. The sharp increase in food and fuel import prices has further complicated economic management and the reform process. The revenue target for end-FY 2007/08 was not observed and progress on structural reforms has been slow. Directors emphasized the need for decisive action and faster progress on the reform agenda, which will also be key to obtaining debt relief under the Enhanced HIPC Initiative.

Directors commended the authorities for adhering to the budgetary ceilings in 2007/08, and for adopting a prudent fiscal stance for 2008/09. They underscored the importance of fully implementing the additional measures to address the slippage in revenue collection, and to stabilize the revenue-to-GDP ratio. Reforms of tax policy and tax and customs administration should be expedited, as a matter of priority, to reduce aid dependence and lay the basis for fiscal sustainability over the long term. At the same time, efforts should continue to further strengthen the quality of public expenditure and public financial management. Directors encouraged the authorities to move forward with civil service reform aimed at linking the compensation system to skills and performance. Given the country's limited absorptive capacity, it will be important to prioritize the projects outlined in the Afghanistan National Development Strategy. Directors noted that this comprehensive reform agenda received broad political support from the international community, and will require well-coordinated technical and financial assistance for its implementation.

Directors considered it a priority to review the relationship between the budget and key state-owned enterprises, with a view to preventing the emergence of fiscal drains and fostering good corporate governance, particularly with respect to the national airline and the state-owned electricity company, both of which remain to be restructured. Directors also encouraged the authorities to follow up on their commitments to improve transparency in the domestic petroleum sector, and prepare for the privatization of the government-owned Fuel and Liquid Gas Enterprise. They also looked forward to sustained progress on the authorities' commitment to carry out anti-corruption measures.

Directors noted with concern the resurgence of inflation, caused by the sharp increase in food prices, and welcomed the priority given to mitigating its impact on vulnerable groups. Stressing the importance of limiting market distortions, Directors encouraged the authorities to work closely with the World Food Program and other donor agencies to develop mechanisms for the provision of aid through targeted cash transfers to vulnerable households. It will be important for these mechanisms to take into account domestic implementation constraints.

Directors stressed the importance of focusing monetary policy on containing inflationary pressures. They encouraged the Da Afghanistan Bank (DAB) to adhere to the ceilings on currency in circulation under the program, and not to resist possible pressures toward a nominal appreciation of the Afghani. Directors welcomed the intention to increase the role of capital notes in the conduct of monetary policy, while being mindful of interest rate developments and spreads between U.S. dollar- and Afghani-denominated instruments. The authorities were encouraged to implement the recommendations of the safeguards assessment fully.

Directors welcomed the measures taken recently by the DAB to strengthen bank supervision, and noted that the rapid growth of commercial bank activities calls for a further strengthening of the regulatory framework and enforcement procedures.

Directors stressed the need for further improvements in Afghanistan's statistical database. They encouraged the authorities to seek donor support to enhance the capacity of the Central Statistics Office and to broaden the coverage and reliability of statistical data.

The Executive Board took the following decision:

Islamic Republic of Afghanistan—Poverty Reduction and Growth Facility—Three-Year Arrangement—Review, and Waiver of Performance Criterion

1. The Islamic Republic of Afghanistan has consulted with the Fund in accordance with paragraph 4 (ccc) of the three-year arrangement for the Islamic Republic of Afghanistan under the Poverty Reduction and Growth Facility (PRGF) (EBS/06/66, Sup.2, 6/28/06) to review program implementation.

2. The letter of the Minister of Finance and the Governor of Da Afghanistan Bank dated June 23, 2008 (the "June 2008 Letter"), together with its attached Memorandum of Economic and Financial Policies (the "June 2008 MEFP") and Technical Memorandum of Understanding (the "June 2008 TMU"), shall be attached to the three-year PRGF Arrangement for the Islamic Republic of Afghanistan, and the letters of the Minister of Finance and the Governor of Da Afghanistan Bank dated May 15, 2006, June 10, 2006, January 17, 2007 and February 27, 2007, June 21, 2007, and January 28, 2008, together with their attachments, shall be read as supplemented and modified by the January 2008 Letter and its attachments.

3. Accordingly, the PRGF Arrangement for the Islamic Republic of Afghanistan shall be amended as follows:

A. New paragraphs 2 (f) and 2 (g) shall be added to read as follows:

“2 (f) The sixth disbursement, in an amount equivalent to SDR 11.3 million, will be available on or after January 15, 2009, at the request of the Islamic Republic of Afghanistan, and subject to paragraphs 4 and 5 below;”

“2 (g) The seventh disbursement, in an amount equivalent to SDR 11.3 million, will be available on or after May 31, 2009, at the request of the Islamic Republic of Afghanistan, and subject to paragraphs 4 and 5 below”

B. A new paragraph 4 (aaaaa) shall be added to read as follows:

“4(aaaaa) If the Managing Director of the Trustee finds that, with respect to the sixth disbursement, the data as of September 21, 2008, and with respect to the seventh disbursement, the data as of March 20, 2009, indicate that the ceilings and floors referred to in paragraphs 4 (a)(i) to 4(a)(iv) of this arrangement, as specified in table 1 of the June 2008 MEFP and further specified in the June 2008 TMU, were not observed; or”

C. New paragraphs 4 (bbb), 4 (bbbb) and 4 (bbbbb) shall be added to read as follows:

“4 (bbb) If, with respect to the sixth disbursement, the Islamic Republic of Afghanistan has not carried out its intentions with respect to submitting to parliament by September 21, 2008 the core budget’s audited financial statements for 2007/08, as specified in table 2 attached to the June 2008 MEFP and as further specified in the June 2008 TMU; or”

“4 (bbbb) If, with respect to the sixth disbursement, the Islamic Republic of Afghanistan has not carried out its intentions with respect to the submission, by September 30, 2008, of DABM’s audited financial statements for 2006/07-2007/08, as specified in table 2 attached to the June 2008 MEFP and as further specified in the June 2008 TMU; or”

“4 (bbbbb) If, with respect to the seventh disbursement, the Islamic Republic of Afghanistan has not carried out by March 31, 2009 its intentions with respect to reducing to 20 percent the 40 percent tariff rate on soft drinks established by Presidential Decree Nr. 96, as specified in table 2 attached to the June 2008 MEFP and as further specified in the June 2008 TMU; or”

D. New paragraphs 4 (cccc) and 4 (ccccc) shall be added to read as follows:

“ 4(cccc) Until the Trustee has determined that, with respect to the sixth disbursement, the fifth program review referred to in paragraph 4 of the June 2008 Letter, has been completed.”

“4 (ccccc) Until the Trustee has determined that, with respect to the seventh disbursement, the sixth program review to be completed at a date to be specified in the context of the fifth review, has been completed”

4. The Fund decides that the fourth review contemplated in paragraph 4 (ccc) of the PRGF Arrangement for the Islamic Republic of Afghanistan is completed, and that the Islamic Republic of Afghanistan may request the fifth disbursement referred to in paragraph 2 (e) of the arrangement notwithstanding the nonobservance of the March 2008 performance criterion on the floor on fiscal revenue of the government, as specified in paragraph 4 (a) (i) of the PRGF arrangement, on the condition that the information provided by the Islamic Republic of Afghanistan on performance on this criterion, and on the implementation of the measures specified as prior actions for completion of the fourth review set out in table 2 of the June 2008 MEFP, as further specified in the June 2008 TMU, is accurate.

Decision No. 14139-(08/60), adopted
July 7, 2008

APPROVAL: October 30, 2008

SHAILENDRA J. ANJARIA
Secretary