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SM/85/299

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November 6, 1985

To: Members of the Executive Board

From: The Secretary

Subject: Afghanistan - Staff Report for the 1985 Article IV Consultation

Attached for consideration by the Executive Directors is the staff report for the 1985 Article IV consultation with Afghanistan, which will be brought to the agenda for discussion on a date to be announced. A draft decision appears on page 18.

Mr. Drees (ext. 4527) is available to answer technical or factual questions relating to this paper prior to the Board discussion.

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INTERNATIONAL MONETARY FUND

AFGHANISTAN

Staff Report for the 1985 Article IV Consultation

Prepared by the Staff Representatives for the
1985 Consultation with Afghanistan

Approved by A. S. Shaalan and J.T. Boorman

November 5, 1985

I. Introduction

The 1985 Article IV consultation discussions with Afghanistan were held in Kabul during the period September 7-17, 1985. The Afghan representatives were led by the First Deputy Governor of Da Afghanistan Bank and included senior officials of the Ministries of Finance, Commerce, Agriculture and Agrarian Reform, Mines and Industry, and Light Industry and Food, the Council of Ministers' Office, the State Planning Committee, and the Central Statistical Office. The mission also met with the General President of Da Afghanistan Bank and the Deputy Minister of Finance. The mission was composed of Messrs. F. Drees (Head, MED), S. Thayanithy (MED), L. Wolfe (ADM), and M. Zavadjil (MED) and Miss M. Pirret (Secretary, MED).

Afghanistan continues to avail itself of the transitional arrangements of Article XIV. It also maintains restrictions and multiple currency practices subject to approval under Article VIII, Sections 2 and 3.

II. Economic Background

In recent years, economic developments in Afghanistan have been affected by fundamental changes in economic policies and the internal security situation. Since 1978 Afghanistan has initiated a land reform, reoriented its trade and financial relations toward Eastern European countries, and expanded the public sector. Nevertheless, virtually all of agriculture, the handicraft sector, most of the retail trade, and a sizable part of the import and export trade, and of the manufacturing and the transportation sectors continue to be in private hands. The internal security situation has resulted in widespread damage to infrastructure and production facilities; a disruption of transportation facilities; the mobilization of manpower for the security forces; population movements from rural to urban areas and to neighboring countries; the dwindling of workers' remittances; and the termination of aid by certain countries and international financial institutions.

Although the authorities were forthcoming in providing information on economic developments, the lack of comprehensive and up-to-date statistics, in particular on the financial transactions of the Government and the official entities, together with some difficulties in reconciling data, hampers economic analysis. According to official data, national income (NMP) at constant prices, 1/ after declining for several years, rose at an average annual rate of about 2 percent in the period 1981/82-1983/84; 2/ in the latter year it virtually reached the pre-1978 level. Recourse to the banking system by the Government was the main reason for the large credit expansion during this period. The overall fiscal deficit rose from about Af 9 billion to Af 21 billion (from 18 percent to 31 percent, respectively, of broad money), with the financing being increasingly provided by the banking sector. Government revenues rose at an annual rate of 9 percent, in large part due to higher gas export receipts, while expenditures increased by 22 percent; the increase in expenditure was in current and extra-budgetary outlays. The latter, which in this three-year period accounted for 15 percent of total spending, includes expenditures to repair facilities and, presumably, also transfers to public sector enterprises to cover losses. Although a large part of the credit expansion was absorbed by external deficits during the three years ended 1983/84, there was also a significant increase in domestic liquidity (averaging 15 percent per annum). This, along with the various supply side disturbances, was a major factor contributing to a domestic inflation rate of about 20 percent per year; the velocity of money increased because holding local currency assets became increasingly less attractive in view of the depreciation of the Afghani in the bazaar exchange market and the emergence of negative interest rates in real terms.

Afghanistan's balance of payments deteriorated during the three years ended 1983/84 with the cumulative current account deficit reaching US$750 million and the overall deficit exceeding US$300 million. The latter was financed mostly by a drawdown of assets on bilateral payments accounts that had been accumulated following the sharp increase in gas export prices in the late 1970s. The deterioration was mainly due to a decline in net capital inflows and an increase in the trade deficit. While import payments increased somewhat between 1980/81 and 1983/84, export receipts were largely stagnant despite a significant growth in gas export proceeds. As a consequence, gross official reserves (both convertible and bilateral but excluding gold) declined nearly 50 percent to US$327 million. The balance of payments pressures were also reflected in a depreciation of the exchange rate in the bazaar from Af 53 per U.S. dollar in March 1981 to Af 111 in March 1984.

1/ Afghanistan compiles national accounts data following the concepts of Net Material Product (NMP) accounting used in CMEA (Council for Mutual Economic Assistance) countries; current price data are not compiled.

2/ All statistics are on the basis of the Afghan year, which ends March 20. The Afghan year 1362 corresponds to 1983/84.

Afghanistan has traditionally conducted a large portion of its trade through bilateral payments agreements. In part because of the sharp increase in gas export proceeds to the U.S.S.R. and the dwindling of aid received in convertible currencies, this share is now much higher than before 1978; e.g., in the case of imports, it has doubled from about one third to two thirds. At present Afghanistan maintains bilateral payments agreements with Czechoslovakia, the German Democratic Republic, the U.S.S.R., and one with a Fund member, China. Private sector imports are relatively free of restrictions, while those of the public sector are determined by an annual import plan which is administered flexibly.

Historically, Afghanistan has had a complex multiple exchange rate system, with most of the external transactions of the private sector and some of the public sector handled through the bazaar market where rates fluctuate freely. At present, the exchange rate system is fragmented with rates for the Afghani ranging from the official rate of Af 50.60 per U.S. dollar (unchanged since September 1981) to the bazaar rate, which stood at Af 132 per U.S. dollar in early October 1985. The official rate applies to transactions under bilateral payments agreements (except for karakul and parts of wool and raisin exports, for which various more depreciated rates apply), payments financed through the budget, and cotton exports. Surrender requirements have been abolished for most exports. To the extent that they are not being effected at the official rate, payments in convertible exchange may be made by using retained export earnings, in certain cases by acquiring convertible exchange from Da Afghanistan Bank, or with exchange purchased in the bazaar market. Afghanistan's exchange restrictions and multiple currency practices remain unapproved. 1/

III. Report on Discussions

The consultation discussions centered on economic developments in 1984/85 and on prospects and policies for 1985/86. Under the circumstances, it was not feasible to quantify the medium-term balance of payments outlook; indications are, however, that if the present environment and policies continue severe pressures will persist. In the discussions, the mission was guided by the views of the Executive Board as reflected in the Chairman's Summing Up of the 1984 Article IV consultation with Afghanistan. This statement emphasized that the main effort needed to be made in the fiscal field, that public enterprises should pursue more flexible costing and pricing policies, and that simplification of the exchange rate system was a matter of importance.

1/ For details on the exchange system see Appendix I and the report on Recent Economic Developments in Afghanistan (to be issued shortly).

Imbalances in the Afghan economy have become more pronounced since the last mission visited Kabul in May 1984, mainly because of increased recourse to bank financing by the Government and supply constraints. The Kabul price index showed an average increase of 27 percent in 1984/85 compared with 20 percent the year before; the current account deficit of the balance of payments more than doubled to US$0.6 billion (equivalent to 41 percent of imports); the overall deficit at $175 million remained very substantial; and the average bazaar rate depreciated by 23 percent. Hence, the need for corrective action has become more pronounced. The Afghan authorities are cognizant of the problems facing the economy and have taken, or are considering, some corrective measures. They pointed out, however, that the security situation prevailing in Afghanistan placed constraints on what could be done.

1. Production and planning

Preliminary data show that national income growth at constant prices slowed to 1.7 percent in 1984/85, less than half the rate of the preceding year. The slowdown was mainly due to a small decline in grain production which the Afghan representatives attributed to inadequate snow and rainfall. Industrial, mining, and handicraft output is estimated to have increased by nearly 5 percent, even though electricity generation by power stations was slightly below the previous year's level. The Afghan authorities noted that some companies had overcome electricity shortages by installing diesel generators; moreover, whenever shortages had occurred, industrial plants had been given priority. Official projections for 1985/86 envisage a national income growth of 3.3 percent, due to an accelerated rise in industrial activity and a recovery of the output of the agricultural sector. However, the authorities consider it likely that there will be a shortfall from this target, in particular because cereal production, which is again suffering from unfavorable weather conditions, may decline by 4 percent from the previous year's level.

Government policy aims at promoting agriculture in view of the predominant role that sector has in the economy; it employs 85 percent of the labor force and accounts for two thirds of national income and for virtually all exports other than natural gas. Accordingly, the Government has established cooperatives and provides improved inputs and veterinary services. A cornerstone of agricultural policy is the ongoing land reform under which holdings in excess of 6 hectares are being redistributed; so far about 20 percent of the cultivated land has been handed over to about 300,000 families. The authorities also place great emphasis on the rehabilitation of the irrigation system. The mission suggested that the introduction of water user fees would make more funds available for the maintenance of the irrigation system and would result in a more careful use of water. The Afghan representatives responded that provision of free irrigation water was a major plank of their agricultural policy.

Official statistics indicate that there has been an upward trend in the production of cereals, fruits, and vegetables in recent years. It has, nevertheless, been necessary to import sizable quantities of cereals to ensure an adequate supply. The output of some cash crops for industry, on the other hand, is still well below the levels of the late 1970s, despite some recovery in 1984/85. In the case of sugar beets, for example, output has fallen by three quarters and only a small fraction of the crop is actually delivered to the sugar refinery, which operates at less than 10 percent of capacity; the remainder of the crop is used as animal fodder. While destruction of production facilities and transportation difficulties appear to have been partly responsible for these developments, the mission suggested that insufficient procurement prices might also have played a role, as cotton and sugar beet prices had been raised only once during the past five years. The Afghan authorities replied that the insufficient number of purchasing centers was the major problem; action was being taken to overcome this obstacle.

Most modern industry in Afghanistan has traditionally been government-owned. Since the nationalization measures of the mid-1970s, public and mixed enterprises have accounted for about three quarters of manufacturing output. The Afghan representatives pointed out that the private sector was free to operate in any field except heavy industry and had set up a number of projects in recent years. The 1975 Investment Law is currently being redrafted to reaffirm the role of the private sector; the draft is to be submitted shortly to the Revolutionary Council for approval.

For a number of years Afghanistan has conducted its economic policies on the basis of annual development plans. With the experience gained in recent years, the authorities intend to revert to multi-year planning and at present are in the process of drawing up a five year plan, covering the period 1986/87-1990/91. In their view, the timing is propitious since the plan would run concurrently with the five-year plans of the member countries of the CMEA. They noted that given the statistical and other uncertainties, planning would not be of a directive nature. Details of the plan had not yet been worked out but monetary, fiscal, exchange rate, and pricing policies would continue to play a significant role as policy tools; the mission welcomed this, and noted that appropriate pricing and exchange rate policies would contribute to a rational allocation of resources.

2. Government finances and prices

The lack of actual accounts for 1984/85 makes it difficult to analyze fiscal developments in that year and to evaluate prospects for 1985/86. These difficulties in assessment are compounded by the emergence in recent years of large extrabudgetary outlays as well as by the absence of data on the financial transactions of the two official entities (the Food Procurement Department and the Petroleum Monopoly) that provide basic commodities at subsidized prices. The lack of data on these entities, whose finances are closely linked to those of the Government proper, make the analysis of fiscal developments all the more difficult as their recourse to bank financing (as shown in the monetary accounts) was unusually large in 1984/85 (Af 6.3 billion compared with Af 1.0 billion the year before) for reasons that could not be fully clarified.

Data on external assistance and banking statistics show that the government deficit (including that of the official entities) rose from Af 21.0 billion in 1983/84 to Af 24.6 billion in 1984/85 and bank financing from Af 15.0 billion to Af 16.9 billion, an amount equivalent to 23 percent of broad money at the beginning of the year. On the basis of budgetary data for 1984/85 (Table 1), revenues remained about unchanged from the actual 1983/84 level. Taking into account a reclassification of about Af 2.5 billion in outlays for repairs of damaged facilities from ordinary to development expenditures, ordinary spending was to increase by 13 percent in part due to higher subsidies and transfers, while development outlays were budgeted to decline somewhat because of difficulties in project implementation as well as financial constraints. The Afghan authorities noted that these budget data did include a supplementary appropriation of Af 2 billion for the reconstruction of schools, mosques, and hospitals, but excluded an increase in government salaries by 18 percent in April 1984 and the impact of raising retail prices of some petroleum products in June 1984. Commenting on the sharp increase in bank financing of the official entities in 1984/85, the authorities said that it reflected, at least in part, the purchase of trucks and the buildup of wheat stocks.

The 1985/86 budget estimates provide for a 28 percent increase in revenues over the previous year's budget, mostly attributable to higher import duty collections reflecting recent increases in the valuation base and in tariff rates on some luxury imports (e.g., TV sets); in addition, contributions by public enterprises are budgeted to rise sharply. Ordinary expenditures are projected to increase by 23 percent because of a higher wage and salary bill which reflects increased employment of teachers to carry out an intensified literacy campaign, the establishment of a Ministry of Islamic Affairs, and a new policy to have representatives of ministries in all provinces. There is no provision for a general increase in government salaries, only for a small improvement in fringe benefits. The projected 17 percent increase in development expenditures reflects resumption of work on all uncompleted projects and increases in development spending in the provinces. As a result, the budget deficit is to fall to Af 14.7 billion. This, together with an expected increase in external aid, is estimated to reduce bank financing to Af 5.9 billion. As in previous years, no provision has been made for the financing of extrabudgetary outlays in the course of the year. As for credit to official entities, the authorities thought that it could be reduced to Af 1.5 billion, about one fourth of the 1984/85 level. Thus, initial estimates project an overall fiscal deficit of Af 16.2 billion and recourse to bank credit of Af 7.4 billion.

Table 1. Afghanistan: Selected Domestic Economic Indicators 1982/83-1985/86

Afghanistan ending March 20	Actual 1982/83	1983/84	1984/85	Proj. 1985/86
	(Changes in percent)			
Real national income (NMP)	1.7	4.0	1.7	3.3
Of which:				
Agriculture	0.6	1.7	0.6	2.0
Manufacturing, mining, and handicraft	3.9	12.0	4.7	9.0
Production of:				
Foodgrains	0.2	2.0	-1.8	1.1
Natural gas	-3.4	7.1	1.9	-4.3
Electricity	-4.0	6.5	-1.2	...
Money (M1)	15.9	9.4	13.7	...
Money and quasi-money (M2)	17.3	10.8	11.0	...
Kabul price index	16.6	19.6	27.4	...
	(In billions of Afghanis)			
Budget revenues	32.6	34.1	34.4 1/	43.9
Ordinary expenditures	-27.6	-32.8	-34.5 1/	-42.6
Development expenditures	-11.9	-11.6	-13.6 1/	-16.0
Extrabudgetary expenditures 2/	-9.6	-9.8	-4.5 1/	...
Official entities' deficit	-0.2	-1.0	-6.3	-1.5
Overall fiscal deficit 3/	-16.7	-21.0	-24.6	...
Financed through:				
Net external assistance	6.2	6.0	7.7	8.8
Domestic bank credit	10.5	15.0	16.9	...
(In percent of opening stock of M2)	(18.5)	(22.4)	(22.9)	(...)

Source: Based on data provided by the Afghan authorities.

1/ Budget data.
2/ Also includes discrepancies (believed to be relatively small) between budgetary and financing data, as the budget is not strictly on a cash basis.
3/ Includes the deficits of the Central Government, the Food Procurement Department, and the Petroleum Monopoly.

In reviewing the above projections, the mission welcomed the intention of the authorities to reduce the budget deficit, but remarked that such a reduction might be difficult to achieve for a number of reasons. Given the projected 14 percent decline in imports in 1985/86, the duty revenue forecast appeared on the high side, and under the present circumstances it was unlikely that transfers from public and mixed enterprises (other than banks) would more than double. In addition, extrabudgetary outlays might emerge again. Moreover, the credit needs of the official entities might be underestimated, given that there had been no change in their sales prices. Thus, the mission estimated that the overall deficit was likely to rise to at least Af 28 million, an increase of 15 percent over the previous year. If aid reached the projected level, bank financing of the Government would would then amount to at least Af 19 billion, equivalent to 23 percent of broad money at the beginning of the year. Accordingly, the mission inquired what corrective measures were envisaged. While acknowledging that excessive reliance on bank financing tended to increase pressure on resources, the Afghan representatives noted that a considerable part of bank financing was used for investment projects, returns on which would generate future revenues as well as boost production. They furthermore stressed that the options open to policymakers with respect to expenditures were limited, given the need to repair damage caused by the conflict. Notwithstanding these constraints, the Government was doing its best to contain the deficit. In any case, the fiscal situation would be reviewed when actual data for the first half of the current year became available.

While recognizing the exceptional circumstances under which fiscal policy had to be implemented, the mission explored with the authorities a number of measures that could improve the budget position. Although only two pay increases had been granted during the past five years, the wage and salary bill had risen at an annual rate of 23 percent, suggesting a substantial increase in the number of government employees. Consideration could thus be given to a slowdown in the hiring of civil servants. Also, the subsidies could be reduced by limiting them to essential goods; in particular, the prices for petroleum products needed to be reviewed as the Petroleum Monopoly apparently continued to incur losses, even after the price increases of June 1984. Although an increase in direct taxes might not be administratively feasible under present circumstances, thought should be given to a small across-the-board increase in import duties supplemented by further selective increases for nonessential goods. Finally, measures should be taken to increase the net contribution of public sector enterprises to the budget.

The profitability of public enterprises has weakened in recent years, because of their low capacity utilization and the rising costs of both local and imported inputs. At the same time, the Government has maintained strict controls on output prices; in fact, over the past two years there have been only two significant price increases granted to manufacturers--a 10 percent increase for cotton textiles in 1983/84 and a similar rise for woolen textiles in 1984/85. The mission encouraged the authorities to permit enterprises to set their prices at levels that cover their costs and provide an adequate return on their investment. The mission also suggested that the authorities review the costing procedures of industrial enterprises as costs were generally understated. Examples of such understatement of economic costs of inputs were the subsidized prices of coal and electric energy; imports made at the (overvalued) official exchange rate; the provision of bank credit at interest rates substantially below the rate of inflation; as well as low rates of depreciation (maximum 6 percent per annum) and a calculation of depreciation allowances on the basis of historical rather than replacement costs, which did not permit enterprises to finance replacement of capital equipment. More adequate costing and flexibility in price setting would permit public enterprises to make the proper investment decisions as well as to finance a larger part of their investments.

The Kabul retail price index, which is based on prices in the market place, showed an average increase of 27 percent in 1984/85 compared with 20 percent the year before. The mission mentioned that some factors would tend to intensify price pressures further in 1985/86 such as another large bank-financed fiscal deficit, the projected declines in the cereal crops and in imports, and the shift in domestic liquidity holdings by the public from quasi-monetary deposits to currency and demand deposits. The authorities responded that they were confident that there would be no acceleration in the inflation rate in 1985/86; a deceleration had already occurred in the first quarter of the year, a development supported by the modest appreciation in the bazaar exchange rate in recent months. They also noted that the 1984/85 price increases had, in part, been due to the upward adjustment in gasoline and diesel prices. As part of the effort to contain price increases, a law had recently been adopted that, inter alia, limited the profit margins for imported goods; however, this law was being implemented only gradually. The mission welcomed this, noting that excessive controls on price determination could lead to shortages and, therefore, intensify price pressures further.

3. Monetary policy

Credit operations of the organized banking system are determined by an annual credit plan that allocates credit to both private and public sector corporations, but does not cover financing of the Government. It should be noted, however, that a substantial part of private sector credit for trade as well as other transactions, both domestic and external, has traditionally been financed through the money bazaar. The authorities stated that it continued to be their policy to let the bazaar market operate freely.

The Afghan authorities pointed out that the focus of their monetary and credit policy in 1984/85 had been to limit credit expansion so as to contain pressures in the economy, and they had been fairly successful in holding down the growth of credit to the nongovernment sector. Credit to public sector companies had risen less than in 1983/84 while private sector credit had in fact declined, in part because importers whose goods had been held up in a transit port had been able to repay their credits when the goods were released. This cautious credit policy with respect to the nongovernment sectors was again reflected in the credit plan for 1985/86.

With the rise in the domestic inflation rate, interest rates in the banking sector have become increasingly negative in real terms. 1/ The mission pointed out that negative rates tend to lead to a misallocation of resources as they encouraged capital-intensive projects and an undue buildup of stocks. Furthermore, they made the holding of domestic financial assets less attractive than either real or foreign assets, which might be one reason for the decline in time and savings deposits in 1984/85. The Afghan authorities replied that raising nominal interest rates above the inflation rate would increase costs and hence put further pressure on prices.

4. Balance of payments

The current account deficit of the balance of payments more than doubled to US$578 million in 1984/85, an amount equivalent to 41 percent of the imports of goods and services, compared with 23 percent in the year before (see Table 2). For the first time in several years exports showed a significant increase (8 percent); however, the mission was informed that the export figure might be revised downward following a review of the data. The deterioration in the current account reflects a 35 percent increase in imports, with special factors accounting for much of the rise. These include the purchase of three planes by the national airline and of trucks by the Petroleum Monopoly; more importantly, about US$130 million worth of goods, previously held up in Karachi, were received in the course of 1984/85. Because these goods had been paid for earlier 2/ and external assistance from CMEA countries increased sharply, the overall balance of payments deficit declined to US$170 million in 1984/85, compared with US$215 million in the year before.

1/ The nominal rates for time and savings deposits are 4-9 percent and the lending rates 6-13 percent.

2/ This apparently was the main reason for the emergence of a large positive "errors and omissions" item in 1984/85.

Table 2. Afghanistan: Selected External Sector Indicators

(In millions of U.S. dollars)

Afghan year ending March 20	1982/83	1983/84	1984/85	Proj. 1985/86
Trade balance	-245	-295	-597	-485
Exports	(708)	(729)	(788)	(701)
Imports	(-953)	(-1,024)	(-1,385)	(-1,186)
Services (net)	70	47	19	20
Current deficit	-175	-248	-578	-465
(In percent of imports) 1/	(17.6)	(23.3)	(40.7)	(38.2)
Capital inflows (net)	153	120	185	185
Errors and omissions	-48	-87	223	120
Overall surplus or deficit	-70	-215	-170	-160
Convertible	(-73)	(-150)	(-252)	(-55)
Bilateral	(3)	(66)	(81)	(-105)
Net foreign assets 2/ 3/	562	347	176	16
Gross official reserves 2/ 3/	483	327	243	...
(In percent of the following years' imports) 1/	(45.4)	(23.0)	(20.0)	(...)
External public debt 3/	2,498	2,519	2,576	2,634
(Debt service/exports ratio) 1/	(16.2)	(14.7)	(15.0)	(16.0)
Bazaar exchange rate 4/	76.3	99.3	122.0	136.1

Source: Based on data provided by the Afghan authorities.

1/ Of goods and services.
2/ Excluding gold (965,000 troy ounces).
3/ At end of period.
4/ Average annual rate for 1982/83-1984/85; for 1985/86 average for first half of the year.

Official projections for 1985/86 show a decline of the current account deficit to US$465 million (38 percent of imports), as a small decline in exports, mainly due to lower fruit exports, is to be more than offset by a 14 percent reduction in imports. With an unchanged capital inflow and a much lower but again positive "errors and omissions" item, the overall deficit would be the same as in 1984/85. In response to the mission's query that the projected decline in imports was difficult to reconcile with the projected 3 percent growth of the economy, the substantial increase in budgeted development expenditures and the likely decline in foodgrain production, the Afghan representatives referred to the special factors that had inflated the 1984/85 import level and pointed out that public sector imports were to be held down in accordance with the import plan. However, they agreed that imports might exceed the projected level. Given the volatility of the "errors and omissions" item and the possible underestimation of imports, the mission noted that the 1985/86 overall balance of payments deficit might be higher than in 1984/85.

The Afghan representatives agreed that the persistent large external deficits were a matter of concern and called for corrective action. However, they pointed to a number of factors beyond their control that were affecting the balance of payments. These included a decline in the output of some export commodities due to the security situation; the interruption of several development projects; increased imports of food and other consumer goods as well as capital and intermediate goods for new projects and for reconstruction; increased difficulties and costs for goods transiting through Pakistan; difficulties in obtaining spare parts from certain suppliers necessitating costly imports through third countries; trade barriers imposed by certain Western countries and cessation of aid by them and international financial institutions; and the dwindling of workers' remittances. Notwithstanding these problems, the Government was making efforts to arrest the deterioration of the balance of payments. Export promotion measures were being taken with the aim of improving the quality of Afghan exports, overcoming internal transportation problems, and expanding markets. New machinery for sorting, cleaning, packaging, and maintaining quality control of raisins was being installed. Cotton producers had been provided with financial facilities, higher producer prices, and more collection centers. Stricter quality control was exercised in the export of karakul skins. Cooperatives were being established for improving the quality and design of handicrafts and to help in their marketing. Import substitution efforts were being undertaken in the field of agricultural goods, textiles, cement, coal, and a number of other industrial products. In addition, the coming on stream of newly discovered gas fields would increase production by 10-20 percent from 1990 onward and hence greatly augment the supplies available for export.

5. External debt and reserves

With most of the external assistance being provided on a grant basis, the outstanding amount of Afghanistan's medium- and long-term debt has risen relatively little in recent years. As of March 1985, it stood at US$2.6 billion, an amount equivalent to three years' exports of goods and services; about 80 percent of this amount is owed to bilateral payments countries. Except for bilateral debit balances of about US$155 million, Afghanistan has no short-term external debt. Most of the debt was obtained at highly concessional terms; in addition, there have been repeated reschedulings by the U.S.S.R. Therefore, in recent years, actual principal and interest payments were equivalent to only about 4 percent and 1 percent, respectively, of the outstanding debt, and the debt service ratio was held to 15-16 percent of the exports of goods and services. The Afghan authorities did not provide debt service projections beyond 1985/86. However, they were concerned that debt service payments in the coming years would be burdensome.

The Afghan representatives stated that they were current in their payments to external creditors except that since early 1985 arrears had been incurred in servicing IDA credits. 1/ The mission expressed its concern about the emergence of overdue payments and stressed the importance of a prompt and full settlement. The Afghan representatives attributed the delays in payment on IDA credits to technical problems and stated that the arrears were being settled. It was the policy of the Government to effect prompt repayment to all creditors. Regarding Afghanistan's relations with the World Bank, they felt that the Bank was not justified in discontinuing its assistance on the grounds that the security problems impeded proper project supervision; the Afghan authorities had provided all assurances for the safety of World Bank officials and experts working on projects.

Since 1982/83 Afghanistan has been using the large bilateral balances accumulated in the late 1970s and early 1980s to finance the bulk of its balance of payments deficits. During 1984/85 sizable debit balances were incurred, in particular vis-a-vis the U.S.S.R., and the official projections envisage a further substantial increase in 1985/86. The authorities explained that this did not present a problem as there was no ceiling on the swing facilities provided under the bilateral agreement with the U.S.S.R. They added that it was their policy to conserve, to the extent possible, their convertible currency holdings. Nevertheless, in the four years to March 1984, gross official convertible reserves (excluding gold) fell by about one half to US$206 million, a level still equivalent to five months' imports of goods and services (payable in convertible currency) of the following year. In 1984/85 official convertible reserves rose by US$37 million.

1/ These arrears amounted to about US$0.6 million in early October 1985; see also Appendix II on relations with the World Bank Group.

The rise was partly due to the provision of US$23 million in convertible exchange by the U.S.S.R. against a debit to the bilateral account. Also, over the past two years that country had permitted use of the account for the financing of US$80 million of imports from third countries, thereby helping Afghanistan to effect a saving in convertible reserves. According to official projections, the increase in convertible reserves in 1984/85 will be more than offset by the decline envisaged for 1985/86.

6. Exchange and trade system

The mission noted that, while the establishment of rates more depreciated than the official rate had been a step in the right direction, the present system had serious disadvantages. Given the relatively large price increases in Afghanistan and the other developments affecting its competitive position, the official rate was now clearly overvalued. It was thus not conducive to an efficient allocation of resources and to balance of payments adjustment. Furthermore, the fragmented exchange rate system encouraged misreporting of transactions and smuggling and imposed considerable administrative burdens. The mission, therefore, recommended a simplification of the system by creating a unified exchange rate for all bank transactions at a substantially depreciated level and its periodic adjustment in light of developments in the economy and in particular of the bazaar rate. The Afghan representatives agreed that the exchange rate system was not working to the best advantage of the country. Consideration was, therefore, being given to a simplification of the system by reducing or eliminating the multiplicity of exchange rates. However, details had not yet been formulated and it was thus not possible to give a timetable or other specifics.

With the conclusion of a bilateral payments agreement with the German Democratic Republic at the beginning of 1985, Afghanistan now has three agreements with countries that are not members of the Fund. They cover all transactions except exports of karakul, which are fully, and wool and raisins, which are partly being settled in convertible exchange. In the authorities' opinion, Afghanistan has benefited from these bilateral trade and payments agreements, and in particular from the agreements with the U.S.S.R. They noted that the agreements provided an assured market for Afghan exports during a period in which Western countries had created obstacles. Moreover, Afghanistan was able to finance imports through the clearing accounts at a time when its convertible currency holdings were declining. By setting prices for a year at a time, the trade agreements had also contributed to price stability. Finally, the debit balances in the bilateral accounts carried only a nominal rate of interest. As for the payments agreement with China, the only remaining one with a Fund member, the Afghan representatives stated that it had little practical significance; during the past two years only one transaction had been channeled through this account. The authorities hoped that the current small debit balance of about US$0.1 million would be eliminated by a purchase of goods by China and that the agreement would then lapse. They added that for noneconomic reasons the Afghan authorities did not consider it advisable at this time to initiate action to terminate the agreement.

7. Statistical issues

In recent years, the Afghan authorities have made efforts to improve and expand the country's statistical data base and progress has been made, in particular in the field of banking statistics. Nevertheless, with the exception of external reserve and exchange rate data, the country page in International Financial Statistics (IFS) is not current (for details see Appendix IV). The authorities have expressed their readiness to provide available data. The mission underlined the need to improve the coverage and timeliness of economic statistics.

IV. Staff Appraisal

Since the late 1970s the Afghan economy has been severely affected by adverse domestic security conditions, external developments, relative price distortions, and a pronounced weakening in the fiscal position. As a consequence, domestic production has been sluggish, the rate of inflation has been high, and large deficits have emerged in the current and overall balance of payments. In 1984/85 these imbalances became more pronounced; the fiscal situation deteriorated further, cereal production declined, domestic price increases accelerated, the current account deficit doubled, and both net foreign assets and gross official reserves showed further substantial declines. It is unlikely that domestic and external pressures will abate much in the foreseeable future.

The Afghan authorities are cognizant of the problems facing the economy and have taken, or are considering, some corrective measures, although they emphasize that the prevailing situation imposes constraints. While it is true that the present security environment is a major constraint to policy formulation and implementation, the staff believes that more determined efforts in various policy areas would help contain the imbalances in the economy. Such policy initiatives should be reflected in the forthcoming five-year development plan. In this regard, the staff welcomes the authorities' statement that pricing and exchange rate policies will continue to play a significant role in the management of the economy.

As noted by the Executive Board during the discussions on the 1984 Article IV consultation, the economic adjustment efforts must be made mainly in the fiscal field. In 1984/85, bank financing of government transactions rose further and accounted for virtually all of the domestic credit expansion. It is likely that there will be another increase in the bank financing of the Government in 1985/86. This development underlines the need for action on the fiscal front. Inadequate revenue growth, weak public enterprise finances, sharply rising current expenditures, as well as large deficits of official entities that supply basic commodities have eroded the fiscal position. The Afghan authorities believe that with respect to expenditures the options open to policy makers are limited; however, within the constraints imposed by the present security situation, they intend to make efforts to contain the the fiscal deficit. The staff believes that risks involved in a large recourse by the Government to bank financing necessitate careful scrutiny of government spending, both current and development. The Government should give consideration to such measures as the containment of the rapid rise of the government work force; limitation of subsidization to essential consumer goods; an across-the-board increase in import duties; and, in particular, more flexible pricing policies of public sector enterprises.

Although a large part of the credit expansion has been absorbed by the balance of payments deficits in recent years, monetary growth has been excessive and has contributed to the pressure on prices, inasmuch as holdings of Afghanis have become a less attractive store of value, a development which has led to an increase in the income velocity of money. It is, therefore, to be welcomed that the authorities have recently succeeded in containing the extension of credit to the nongovernment sectors and that they intend to continue a cautious credit stance and their noninterference in the bazaar credit market. The authorities should also consider raising interest rates, which at present are negative in real terms. Such a move would contribute to containing demand and make the holding of domestic financial assets, especially in longer term maturities, more attractive.

Reflecting both supply constraints and the growing demand pressures caused by the fiscal deficits, the external payments position has weakened in recent years, in particular in 1984/85 when another large overall deficit was incurred. As a consequence, the bazaar exchange rate has depreciated, external reserves have declined sharply, and the external debt has risen. Although foreign borrowing is being obtained on concessional terms, the large current and overall balance of payments deficits are likely to increase the external debt service burden. The continuing security problems and the prospects for further large fiscal deficits suggest that the balance of payments is likely to remain under pressure in the foreseeable future. The staff welcomes the steps the authorities have taken, or are considering, to promote exports by improving the quality of products and by better marketing. These measures should, however, be supplemented by a tighter fiscal policy stance and a more flexible exchange rate policy.

Over the past few years, Afghanistan's exchange rate regime has become highly complex. The staff believes that maintenance of such a fragmented system is not in the best interest of the country. Since the majority of the external transactions is effected at the overvalued official rate, most imports are implicitly subsidized and exports implicitly taxed. In addition, the multiple exchange rate regime encourages misrepresentation of transactions, involves administrative costs, and is not conducive to an effective allocation of resources and to balance of payments adjustment. The staff, therefore, is gratified that the Afghan authorities are considering a simplification of the exchange system by reducing or eliminating the multiplicity of exchange rates, and expresses the hope that this policy will involve a substantial depreciation of the official rate. However, since the details and a timetable have not yet been worked out, the staff does not recommend approval by the Executive Board of the multiple currency practices. The staff encourages the Afghan authorities to eliminate the bilateral payments arrangement with a Fund member.

The staff notes that Afghanistan has made efforts to improve the coverage and timeliness of statistical data. However, in several areas, and in particular in the fiscal field, serious deficiencies continue to persist and every effort should be made to remedy this situation.

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

V. Proposed Decision

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

1. The Fund takes this decision relating to Afghanistan's exchange measures subject to Article VIII, Sections 2 and 3, and in concluding the 1985 Article XIV consultation with Afghanistan in the light of the 1985 Article IV consultation with Afghanistan conducted under Decision No. 5392-(77/63), adopted April 29, 1977 (Surveillance over Exchange Rate Policies).

2. Afghanistan's present exchange regime involves exchange restrictions and multiple currency practices as described in SM/85/___. The Fund welcomes the transfer of most external transactions in convertible currencies to more depreciated rates, but notes that the present exchange rate structure is unduly complex. The Fund therefore recommends a simplification of the exchange rate system with a view toward the eventual establishment of a unified exchange rate at a more depreciated level. The Fund encourages Afghanistan to terminate the remaining bilateral payments agreement with a Fund member.

Afghanistan - Fund Relations

(As of September 30, 1985)

(Amounts in millions of SDRs, unless otherwise indicated)

I. Membership Status

Date of membership:	July 1955
Status:	Article XIV

(A) Financial Relations

II. General Department (General Resources Account)

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

III. Reserve Tranche Purchase

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

IV. SDR Department

Net cumulative allocation:	SDR 26.7 million.
Holdings:	SDR 12.7 million and 47.5 percent of net cumulative allocations.

(B) Nonfinancial Relations

V. Exchange Rate Regime

Afghanistan has a multiple exchange rate system. The official rate, which has remained unchanged at US$1 = Af 50.00/51.20 since September 1981, applies to transactions under bilateral payments agreements, except for karakul and parts of wool and raisin exports, for which various more depreciated rates apply, payments financed through the budget and cotton exports. Surrender requirements do not apply to other exports. Payments in convertible exchange by the public sector, to the extent that they are not being effected at the official rate, may be made by using retained export earnings (the company's own exchange or funds bought from another public sector unit), by acquiring convertible exchange from Da Afghanistan Bank, which sells it at the rate it has paid to the exporter (with an Af 1 per U.S. dollar margin) or, in exceptional cases, with convertible exchange bought in the bazaar market. Private sector convertible payments may be made by using or buying retained export earnings, although some limitations apply to their use for import financing, or by recourse to the bazaar. The bazaar rate stood at US$1 = Af 132 in early October 1985.

VI. Last Article IV Consultation

The Staff Report (SM/84/175) was discussed by the Executive Board (EBM/84/143) on September 14, 1984. The summing up indicated a standard 12-month cycle for the next Article IV consultation. The Decision (No. 78/10-(84/143) was as follows:

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

2. Afghanistan's present exchange regime involves exchange restrictions and multiple currency practices as described in SM/84/187. The Fund welcomes the transfer of most external transactions in convertible currencies to more depreciated rates, but notes that the present exchange rate structure is unduly complex. It, therefore, recommends a simplification of the exchange rate system with a view toward the eventual establishment of a unified exchange rate regime. The Fund welcomes the termination of a bilateral payments agreement with a Fund member and encourages Afghanistan to terminate the remaining agreement with a Fund member.

VII. Technical Assistance

A statistical advisor was provided to Da Afghanistan Bank under CBD auspices from March 1983 to March 1985.

Afghanistan - Relations with the World Bank Group

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

2. Afghanistan has not received Bank loans but has received a number of IDA credits. The amount disbursed as of August 31, 1985 was US$83.86 million; repayments totaled US$1.4 million. In addition, IFC in 1973 made a US$0.3 million investment in the Industrial Development Bank of Afghanistan, which in 1976 was sold to the Government of Afghanistan.

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

4. Since February, 1985, Afghanistan has ceased to make regular debt service payments due to IDA. However, in early October 1985 a payment of US$33,029 was received. The amounts overdue amounted to US$606,909 on October 8, 1985.

Afghanistan: IDA Credits, Disbursements, and Cancellations 1/

(In millions of U.S. dollars)

Year	Project	Closing Date	Original IDA Amount	Actual Amount Disbursed	Amount Can- celled
1965	Education	08.31.71	3.5	--	3.5
1969	Highway	12.31.77	5.51	5.51	--
1970	Agricultural Development Bank	12.31.75	5.29	5.29	--
1971	Khanabad Irrigation I	06.30.79	5.06	5.03	0.03
1976	Khanabad I Supplementary Financing	12.31.81	10.0	5.24	4.76
1973	Aviation I	06.30.80	2.5	1.21	1.29
1973	Livestock I	09.30.81	9.0	7.83	1.17
1973	IDBA I	12.31.81	2.0	1.90	0.10
1973	Highways II	12.30.81	11.5	10.63	0.87
1975	Agricultural Credit II	12.31.81	13.0	12.96	0.04
1975	Kabul Water Supply I	12.31.82	9.0	7.58	1.42
1976	Power I	06.30.79	10.0	10.0	--
1976	Livestock II	12.31.82	15.0	3.94	11.06
1976	Education II	04.30.82	6.0	0.33	5.67
1977	Agricultural Credit III	03.31.82	12.0	5.23	6.77
1978	Irrigation II	06.30.83	22.0	0.09	21.91
1978	Fruit and Vegetable Exports	06.30.85	18.0	1.09	16.91
1979	Kabul Water Supply II	12.31.83	16.5	--	16.5
1979	Education III	12.31.84	21.0	--	21.0
	Total		196.86	83.86	113.00
1979	Highways III 2/		17.6	--	17.6
1979	Rural Development 2/		16.5	--	16.5

1/ As of August 31, 1985.
2/ Did not become effective and lapsed.

Afghanistan - Basic Data

Population — 17.22 million (estimate for mid-1983)

Afghan year ended March 20	1981/82	1982/83	1983/84	1984/85
Production				
Foodgrains (in thousand metric tons)	4,491	4,500	4,590	4,507
Raw cotton (in thousand metric tons)	60	45	50	68
Natural gas (in million cubic meters)	2,675	2,583	2,767	2,820
Cotton textiles (in million square meters)	37	39	38	45
Electricity (in million kilowatt hours)	1,017	976	1,039	1,027

				Budget	
	1981/82	1982/83	1983/84	1984/85	1985/86
	(In billions of Afghanis)				
Government finances					
Revenue, of which:	29.8	32.6	34.1	34.4	43.9
Sales proceeds from natural gas	(13.6)	(14.8)	(15.1)	(15.3)	(15.5)
Expenditure	34.5	49.1	54.1	52.7	58.6
Ordinary expenditure	(22.7)	(27.6)	(32.8)	(34.5)	(42.6)
Development expenditure	(10.8)	(11.9)	(11.6)	(13.6)	(16.0)
Other expenditure 1/	(1.0)	(9.6)	(9.8)	(4.5)	(...)
Overall deficit	-4.7	-16.5	-20.0	-18.3	(...)
External financing 2/	(3.0)	(6.2)	(6.0)	(7.7)	(8.8)
Domestic bank financing 3/	(1.7)	(10.3)	(14.0)	(10.6)	(...)
Overall deficit (including official entities)	-8.8	-16.7	-21.0	-24.6	...
Overall bank financing (including official entities) 3/	5.8	10.5	15.0	16.9	...

	1981/82	1982/83	1983/84	1984/85
	(In millions of U.S. dollars)			
Balance of payments				
Trade balance	-340	-245	-295	-597
Exports, f.o.b., of which:	(691)	(708)	(729)	(788)
Natural gas	[273]	[284]	[305]	[314]
Imports, c.i.f.	(-1,031)	(-953)	(-1,024)	(-1,385)
Services (net)	21	70	47	19
Current account deficit balance	-319	-175	-248	-578
Nonmonetary capital (net)	175	153	120	184
Errors and omissions	111	-48	-87	223
Overall balance	-33	-70	-215	-170
Multilateral	(-62)	(3)	(-66)	(81)
Bilateral	(29)	(-73)	(-150)	(-252)

Afghanistan - Basic Data (concluded)

	1981/82	1982/83	1983/84	1984/85
	(In millions of Afghanis)			
Monetary changes				
Money and quasi-money	8,581	9,841	7,197	8,164
Net foreign assets	-574	-3,601	-10,440	-8,895
Net domestic assets, of which:	9,155	13,442	17,637	17,059
Claims on Government (net)	(1,700)	(10,268)	(14,002)	(10,606)
Claims on official entities	(4,075)	(225)	(961)	(6,323)
	(In millions of U.S. dollars)			
Gross official reserves (end of period) 4/				
Convertible assets	281	238	206	243
Bilateral assets	313	245	121	1
External public debt				
Amount disbursed (end of period)	2,427	2,498	2,519	2,576
Debt service in percent of exports of goods and services	(14.9)	(16.2)	(14.7)	(15.0)
	(In Afghanis per U.S. dollar)			
Exchange rate				
Average bazaar rate	56.62	76.75	99.31	122.01
Average official rate	50.20	50.60	50.60	50.60
	(In percent)			
Changes in key economic indicators				
Net material product at constant prices	1.2	1.7	4.0	1.7
Consumer prices	21.5	16.6	19.6	27.4
Money	19.1	15.9	9.4	13.7
Money and quasi-money	17.9	17.3	10.8	11.0
Imports	16.0	-7.6	7.5	35.3
Exports	-2.0	2.5	3.0	8.1
Gas export prices	25.3	10.2	0.7	0.2
	(In percent)			
Ratios				
Bank financing of the government and official entities/opening stock of money and quasi money	12.1	18.4	22.4	22.9
Current account deficit of the balance of payments/imports of goods and services	28.8	7.5	23.3	40.7

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

Afghanistan--Statistical Issues

1. Outstanding statistical issues

a. Real sector

No data have been reported for prices and foreign trade since September 1983.

b. Government finance

The 1984 GFS Yearbook does not include a statistical presentation for Afghanistan due to the fact that no replies have been received to the GFS questionnaire that is sent every year.

c. Monetary accounts

The latest data for Da Afghanistan Bank (DAB) and the deposit money banks relate to June 1984 and March 1983, respectively. No new updates have been received from the authorities. Monetary data have been revised to incorporate, beginning March 1982, a new data classification. However, additional details about a number of accounts are still needed to assure appropriate IFS classification.

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

The table below shows the currentness and coverage of data published in the country page for Afghanistan in the October 1985 issue of IFS. The data are based on reports sent to the Fund's Bureau of Statistics by Da Afghanistan Bank, which during the past year have been provided on an infrequent basis.

Status of IFS Data

		Latest Data in October 1985 IFS
Real sector	- National accounts	n.a.
	- Prices	1981
	- Production	n.a.
	- Employment	n.a.
	- Earnings	n.a.
Government finance	- Deficit/surplus	n.a.
	- Financing	n.a.
	- Debt	n.a.

Monetary accounts	- Monetary authorities	June 1984
	- Deposit money banks	March 1983
	- Other financial institutions	n.a.
External sector	- Merchandise trade:	
	Value - Export	Q4 1982
	- Import	1982
	- Balance of payments	n.a.
	- International reserves	May 1985
	- Exchange rates	July 1985