

**REPORT AND RECOMMENDATION
OF THE
PRESIDENT
TO THE
BOARD OF DIRECTORS
ON A
PROPOSED LOAN
TO
AFGHANISTAN
FOR THE
POSTCONFLICT MULTISECTOR PROGRAM**

November 2002

CURRENCY EQUIVALENTS

(as of 5 November 2002)

Currency Unit	–	afghani (Af)
Af1.00	=	\$0.01923
\$1.00	=	Af52

On 4 September 2002, Afghan President Hamid Karzai announced a new currency for his country; the new afghani will be worth one thousand old afghanis. Please refer to para. 6 of the main text for details.

ABBREVIATIONS

AACA	–	Afghan Assistance Coordination Authority
ADB	–	Asian Development Bank
ADF	–	Asian Development Fund
AIA	–	Afghanistan Interim Administration
ARTF	–	Afghanistan Reconstruction Trust Fund
CBO	–	Community-based organization
CNA	–	comprehensive needs assessment
CSC	–	Civil Service Commission
DAB	–	Da Afghanistan Bank
FAO	–	Food and Agriculture Organization of the United Nations
GDP	–	gross domestic product
GNP	–	gross national product
IDA	–	International Development Association
IDP	–	Internally displaced person
IFI	–	International Financial Institution
IMF	–	International Monetary Fund
ITGA	–	Islamic Transitional Government of Afghanistan
MOC	–	Ministry of Commerce
MOF	–	Ministry of Finance
MOMI	–	Ministry of Mines and Industry
MOP	–	Ministry of Power
MOPH	–	Ministry of Public Health
MOT	–	Ministry of Transport
MPW	–	Ministry of Public Works
MWP	–	Ministry of Water and Power
NDF	–	National Development Framework
NGO	–	nongovernment organization
OAA	–	Office of Administrative Affairs
PMPL	–	Postconflict Multisector Program Loan
SY	–	Solar Year
TA	–	technical assistance
TAC	–	technical assistance cluster
UNDP	–	United Nations Development Programme

NOTES

- (i) The fiscal year (FY) of the Transitional Government begins on 22 March. FY before a calendar year denotes the year in which the fiscal year ends (e.g., FY2002 ends on 21 March 2002).
- (ii) In this report, "\$" refers to US dollars.

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LOAN AND PROGRAM SUMMARY

Borrower	Afghanistan
Classification	Core poverty intervention
Environment Assessment	Category C. Environmental implications were reviewed, and no significant adverse environmental impacts were identified.
Program Description	<p>By extending a postconflict multisector program loan to Afghanistan, the Asian Development Bank (ADB) will support policy and institutional reforms to improve governance and strengthen the financial, transport, and energy sectors; and promote economic recovery and growth within the framework of a market economy.</p>
Rationale	<p>More than 20 years of war and civil turmoil, together with 4 years of drought beginning in 1999, have devastated Afghanistan's economy and affected the conditions of governance. An appropriate policy and governance framework must be established at all levels of government and all sectors to support reconstruction and rehabilitation of the economy.</p> <p>At the macro level, the Islamic Transitional Government of Afghanistan (ITGA) is committed to ensuring noninflationary growth and macroeconomic stability. The minister of finance has outlined an ambitious reform agenda across a range of issues including (i) revenue administration and expenditure management, (ii) budget preparation, (iii) central bank management, and (iv) other issues such as commercial banking and functional payments systems. In addition to governance and financial sector reforms, ITGA is committed to substantial policy and institutional reforms in key sectors of the economy, including the transport and energy sectors.</p> <p>In partnership with ITGA, ADB is working closely with the International Monetary Fund (IMF), the World Bank, and other aid agencies to identify the selected sectors for support under the program loan and define the required policy and institutional reforms and actions. The highly concessional loan funds will meet the adjustment costs associated with these reforms and associated rehabilitation activities. ADB's ongoing technical assistance cluster to Afghanistan will further support the reform process.</p>

Objective	<p>The program objective is to promote economic growth and poverty reduction through support for market-based policy reforms, public infrastructure investment, and institutional capacity building. The purpose is to enhance opportunities for economic revival by addressing key policy and institutional constraints to the efficient and effective functioning of the financial, transport, and energy sectors within a transparent and accountable governance structure. The Program supports ITGA's National Development Framework (NDF) and National Development Budget (NDB) and is consistent with the operational thrusts of ADB's Initial Country Strategy and Program for Afghanistan (2002–2004).</p> <p>The program reform agenda will be complemented by the TA cluster (TAC) approved by the Board on 30 May 2002, which is helping to strengthen the capacity of key government agencies and civil society institutions.</p>
Cost Estimates	<p>The adjustment and other costs of the policy and institutional reforms addressed by the program loan are estimated to be at least about \$158 million.</p>
Financing Plan	<p>ITGA has requested a loan equivalent to \$150 million from ADB's Special Fund resources to support the proposed program, as indicated in the attached development policy letter. The loan will be released in two installments upon satisfactory compliance with agreed-upon conditions. The first tranche of \$100 million equivalent will be made available upon loan effectiveness. The second tranche of \$50 million equivalent will be made available about 12 months later upon satisfactory compliance with agreed-upon conditions, as well as continued compliance with all previous tranche conditions.</p>
Loan Amount and Terms	<p>A loan of SDR113,496,000 will be provided from ADB's Asian Development Fund (ADF) to support the program. The program loan will have a repayment period of 40 years, including a grace period of 10 years, and carry an interest rate of 1.0% per annum. In addition, the interest charge during the grace period will be capitalized and charged to the Loan Account.</p>

Allocation and Relending Terms	The proceeds of the loan will be used to finance the foreign exchange costs of items produced and procured in ADB member countries (except items specified in the negative list and imports financed by bilateral and multilateral sources) and to finance high-priority rehabilitation projects. The Government will certify that the volume of imports exceeds the amount of ADB's projected disbursements under the loan for the given period. Counterpart funds generated by the Postconflict Multisector Program Loan (PMPL) will be used by the Government to meet program expenditures and related costs of reforms. No relending is planned under the program. ADB will retain the right to audit the use of the loan proceeds and to verify the accuracy of the Government's certification. To facilitate the timely release of funds to meet adjustment costs, the loan proceeds may be used to finance eligible imports incurred within 180 days before the date of loan effectiveness.
Period of Utilization	The program loan will be disbursed within a period of 18 months, beginning from the date of loan effectiveness.
Estimated Project Completion Date	30 June 2004
Implementation Arrangements	The Ministry of Finance (MOF) will be the Executing Agency (EA) and will be responsible for disbursing the loan proceeds and maintaining records. MOF, Da Afghanistan Bank (DAB), Office of Administrative Affairs (OAA), Civil Service Commission (CSC), Ministry of Public Works (MPW), Ministry of Transport (MOT), Ministry of Commerce (MOC), Ministry of Mines and Industry (MOMI), and Ministry of Water and Power (MWP) will be implementing agencies (IAs). Each will be responsible for implementing the relevant policy and institutional reforms in its sector. A steering committee will be formed, chaired by the minister of finance or his representative, to coordinate policy decisions that may need to be taken to pursue reforms under the PMPL.
Executing Agency	Ministry of Finance
Consulting Services	No consulting services will be provided under the program. Considering that the program will address governance and basic policy and institutional reforms in the transport, energy, and financial sectors, however, necessary provisions were made for investment and capacity building in these areas by linking program monitoring and implementation with the activities of ADB-funded advisors already working in the concerned ministries and departments under an ongoing TAC. ¹

¹ ADB. 2002. *Technical Assistance to Afghanistan for Capacity Building for Reconstruction and Development*. Manila.

Program Benefits and Beneficiaries

The Program will (i) provide critically needed fiscal support to the Government, enabling it to continue providing essential services and rehabilitate and reconstruct the physical and social capital of Afghanistan; and (ii) contribute to economic recovery, employment generation, higher productivity, improved per capita incomes, and social stability. Specific beneficiaries are hard to identify a priori due to the nature of the Program, but might reasonably be expected to include, among others, the rural and urban poor, returning refugees, internally displaced persons, demobilized combatants, and women. Specifically the following benefits will be directly or indirectly attributable to the different Program components.

In terms of governance and financial sector development: (i) improved public sector; efficiency and effectiveness, (ii) improved resource mobilization from domestic and foreign sources for rehabilitation and reconstruction, (iii) improved macroeconomic management and payments system, and (iv) development, diversification and deepening of the financial sector.

In terms of infrastructure development: (i) improved national road network, (ii) improved maintenance of roads, (iii) increased sub-regional cooperation and foreign private investment in electricity and natural gas development, and (iv) increased production and distribution of natural gas and electricity.

Risks and Assumptions

Implementation of the program entails a number of risks:

Government commitment to the reform process could weaken. Despite recent policy statements by the president and the minister of finance, other ministers and senior officials may have vested interests or opposing philosophies with regard to the role of the government and the public sector. There is therefore a risk that political will to implement the proposed reforms will be tested in the months ahead. There is also a risk that a change in Government after the national elections scheduled for June 2004 might result in a policy shift. However, the PMPL does not cover politically sensitive areas, such as reforms in the social sectors and agriculture, and prospects for a change in Government that would significantly alter the broad macroeconomic and policy orientation appear relatively remote at this stage.

The overall political and security situation remains volatile, and it is yet to be seen how much the situation will improve. ADB will need to closely monitor the situation.

Weak implementation capacity may delay implementation of reforms. ITGA has limited capacity for planning and implementing even basic rehabilitation and reconstruction. In addition, there is limited understanding of the policy and institutional reform process, and of the importance of synchronization and appropriate phasing. ADB's TAC will help mitigate this problem. MOF has assumed a lead role in eliminating development constraints and bringing the PMPL and other reform programs to fruition.

The macroeconomic and budgetary situation may worsen, causing a diversion of funds from meeting adjustment and other costs associated with the program's policy and institutional reforms. The Government and the international community are providing significant levels of relief and rehabilitation assistance to affected groups. The situation will be carefully monitored.

Aid coordination requirements are extensive. The Program was formulated with the Government, in close consultation with the aid community especially the World Bank and IMF. The coordination process will need to be further enhanced during program implementation.

AFGHANISTAN POSTCONFLICT MULTISECTOR PROGRAM LOAN



I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed loan to Afghanistan for the Postconflict Multisector Program.

II. THE MACROECONOMIC CONTEXT

2. Since the catastrophic events of September 11, which catapulted Afghanistan onto the international stage, the world has witnessed the removal of the Taliban from power; the signing of a power-sharing agreement calling for a “broad-based, moderate and unitary Afghan state” by representatives of the major Afghan factions in Bonn in December 2001; the installation of an interim administration; the preparation of an ordinary budget,¹ strategy for recovery and reconstruction, as outlined in a national development framework (NDF)² and national development budget (NDB);³ and the convening of a *Loya Jirga* (a traditional council of elders) in June 2001, that allowed for a smooth and orderly transfer of power to a legitimate transitional government led by H.E. Hamid Karzai, to rule Afghanistan for a further 2 years and prepare the ground for elections by June 2004. Throughout this period, the Government and people of Afghanistan have sought to assert their own leadership in the recovery and reconstruction effort. Recent statements by Government leaders indicate a strong commitment to political, economic, and social development; to a free and competitive economic system, and private-sector-driven growth that invites domestic and foreign investment—to create jobs and increase income; and, to this end, to undertaking a series of necessary policy and institutional reforms.

3. **Economic Performance.** The absence of reliable economic data for Afghanistan makes it difficult to report with any degree of accuracy on its past and recent performance.⁴ Afghanistan’s gross national product (GNP) was estimated at \$6.7 billion in 1997/98, giving a per capita GNP of \$280.⁵ Per capita GNP is currently estimated at only \$182 in 1998 dollars (or

¹ In April 2002, the Government announced an ordinary budget of \$463 million for Solar Year (SY) 1381 (22 March 2002-21 March 2003) to cover ordinary expenditures including wages, salaries, and other recurrent expenses. Refer to para. 7 for details.

² The goal of the National Development Framework (NDF) is to provide a strategic plan for the development of Afghanistan, around which all actors can unite, to address poverty and provide economic opportunity through a series of concrete programs and projects. The NDP is based on five principles: (i) the development strategy must be domestically owned, with the Government in the driver’s seat; (ii) markets and the private sector are more effective instruments than the state in delivering sustained growth; (iii) aid cannot be effective without the state investing in human capital and the creation of an institutional framework that allows the rule of law to prevail; (iv) promoting sustainable economic growth requires the active participation of the population; and (v) externally-funded investments must be anchored in the Government’s development program to be successful over the longer term. The NDF focuses on three pillars of development: (i) security and human development, (ii) rebuilding physical infrastructure, and (iii) enabling the creation of a viable private sector as the engine for sustainable and inclusive economic growth. Restoring security and reestablishing law and order, administrative and financial reform, and gender are crosscutting priorities. The key challenges and priorities in the short term are to quickly establish basic security for the population, revitalize agriculture, facilitate private economic activity, and rebuild infrastructure and social services. Please refer to Appendix 8 for an official NDF summary.

³ The Ministry of Finance presented a national development budget (NDB) to a meeting of the Implementation Group in Kabul on 12-13 October 2002. The NDB translates the priorities of the NDF into programs and projects while simultaneously providing a vehicle for policy development. It provides an outline of ongoing and proposed investments for 2002-2004 and consolidates investments based around 12 programs presented within the NDF.

⁴ Compilation of most macroeconomic statistics was discontinued in the mid-1990s, except for the consumer price index. The International Monetary Fund has placed a resident statistics advisor in Kabul to assist in capacity building and implementing a number of recommendations regarding data compilation. Much of the macroeconomic data presented here are estimates and the best information available to ADB as of November 2002.

⁵ The exchange rate in 1997-98 was approximately \$1=Af4,679.

\$205 in 2002 dollars), reflecting the effects of the war, civil turmoil, and 4-year drought.⁶ A rebound in economic growth is expected in 2002–2003.

4. **Poverty.** Poverty has worsened over the past two decades, with an estimated 60–80% of the population living below the threshold of \$1 a day.⁷ It is estimated that 80% of the rural population is in need of emergency assistance, as cereal production declined by 50% between 1998 and 2001. Vulnerable groups include small farmers, landless laborers, sharecroppers, debtors, internally displaced persons (IDPs, estimated at 1.1 million), returning refugees, ex-combatants, war widows and orphans, and the disabled (800,000, of whom 200,000 were mine victims).⁸ IDPs are particularly indigent, as they receive little or no assistance, in contrast to returning refugees who have some resources of their own.

5. **Inflation.** Consumer prices increased by almost 70% between 1994 and 1998, or at an annual compound rate of inflation of 14%. According to the Kabul-based consumer price index (CPI) produced by the Central Statistical Office (CSO), prices have fluctuated widely over the past year — first deflating as a result of the appreciation of the afghani following September 11. The Kabul CPI increased by just over 1% in the second quarter of 2002, well below the 4.5% envisaged in the monetary program.

6. **Exchange Rate.** The official exchange rate of Af45:\$1 set in 1963 was adjusted to Af3,000:\$1 in April 1996, reflecting, among other factors, a weakening of monetary discipline under the Jamiat regime. During the late 1990s, the currency further depreciated as a result of market forces. By 2000, the foreign exchange market had become more fragmented and volatile, with wide divergence between official, spot, and black market rates and also between Taliban and opposition-controlled areas. By September 2001 the rate had depreciated to Af79,000. Following the start of the war on terrorism in Afghanistan, the currency appreciated significantly to under Af30,000:\$1 by December 2001. Since then, the afghani has weakened to Af35,000–Af40,000 to the dollar. Most recently, the exchange rate plunged to Af60,000 or lower, as a result of the announcement that the Government would introduce a new currency.⁹ An upsurge of violence also exacerbated the exchange rate volatility.

7. **Fiscal Developments.** On 6 April 2002, the Afghanistan Interim Administration (AIA) adopted an ordinary budget of \$460.3 million for FY2003.¹⁰ A development budget, which is

⁶ ADB staff estimates. The population in 2002 is estimated to be 26.4 million. Per capita gross domestic product is likely underestimated by \$15–41, or more, reflecting illegal trade in drugs and arms. Transfer from abroad are about \$1 billion annually, adding to the gross national product (GNP).

⁷ Reliable statistics on poverty are not available.

⁸ ADB, United Nations Development Programme, and the World Bank. January 2002. *Afghanistan: Preliminary Needs Assessment for Recovery and Reconstruction*.

⁹ On the evening of 4 September, President Hamid Karzai announced a new currency. The new currency will still be called afghani, but each new afghani will be worth 1,000 old ones. The operation will remove from circulation an inflated currency that has been cumbersome to use, requiring an excessive number of notes for most transactions. The operation to exchange the old notes for new ones is expected to take about 2 months. The IMF issued a statement following the President's announcement saying: "The authorities' decision to introduce a new currency is an important step in their efforts to establish macroeconomic stability and to create an environment that is conducive to restoring sustainable economic growth in Afghanistan. The new afghani will be a symbol of national sovereignty and unity. The authorities fully recognize that the outlook for the currency will to a large extent depend on the fiscal and financial policies of the government, and the Fund welcomes the authorities' demonstrated commitment to implement sound fiscal and monetary policies. The introduction of a new currency is a major operation with numerous logistical challenges to overcome. Preparations for the change over are well under way."

¹⁰ The Fiscal year starts on 21 March. FY2003 refers to 21 March 2002–20 March 2003.

essentially a list of externally-funded investment projects, covering both the current FY2003 and FY 2004, was presented in October 2002 and is estimated at about \$3.2 billion. For financing, the ordinary (recurrent) budget, the Government projected \$83 million or 18% of total expenditures sourced from domestic revenue, with the remainder financed by external assistance.¹¹ The budget gap could be higher due to the fact that a portion of domestic revenues will be needed to cover \$22.5 million in back salaries for civil servants for August–December 2001. According to a report prepared by the Ministry of Finance (MOF) in October,¹² domestic revenues in the first quarter amounted to \$22.7 million (mainly from customs duties) against planned revenues of \$16 million; however, transmittal of revenues by provincial offices has been problematic partly due to the difficulty of determining surpluses in provinces that are to be submitted to the central Government. Foreign assistance for recurrent expenditures has also fallen short of expectations. In addition, \$285.4 million in grants from multilateral (e.g., AIA and Land and Order Trust Funds of the United Nations Development Programme (UNDP) and the Afghanistan Reconstruction Trust Fund (ARTF), and bilateral sources¹³ are expected, against the required \$377.3 million. It follows that the revised budget for FY 2003 includes a net financing gap of \$91.9 million. A fiscal crisis has so far been avoided; however, the situation is expected to change in the coming months and financial resources are urgently needed. The World Bank is processing direct support of \$100 million through its International Development Association (IDA) resources. While the Development Budget will need to be largely foreign financed for the foreseeable future, the ordinary budget will eventually be financed from domestic revenues. As the authority of the central Government extends over the entire country, revenue collections from both direct and indirect sources should increase substantially.

8. Monetary Developments. Da Afghanistan Bank (DAB), the central bank, is responsible for monetary policy. During the Taliban regime, however, DAB had little authority over currency regulation. In September 2002, ITGA announced that it would introduce a single Afghan currency to replace the multiple Afghani currencies that are currently in circulation. To this effect, DAB has been assigned full authority over the issuance of currency. DAB has decided to issue completely new Afghani banknotes with higher security features to prevent counterfeiting, and to withdraw the existing multiple variations now in circulation. Conversion of the currency will get underway in October 2002. As noted earlier, the announcement has triggered a sharp depreciation of the currency, reflecting that currency traders and the public alike lack understanding of the conversion process. To extend its currency control, DAB will encourage foreign exchange transactions through the banking system. Further, it will be involved in auctioning foreign exchange to ensure that money creation is limited by the holding of foreign exchange reserves at DAB. According to the IMF, the increase in the money supply during the first quarter of 2002 was consistent with the Government's target of limiting the 12-month inflation rate to 18%. Absence of a modern banking system makes formulating and implementing a monetary policy difficult. DAB is not yet fully operational and commercial and other banks are much less so. The country depends on the traditional *hawala* system for money transfer, the only effective operational payments system.

9. External Account. Available data indicate that Afghanistan has experienced large current account deficits since the late 1990s. Official capital transfers and unofficial transactions (e.g., the drug trade) financed the gap. A survey sponsored by the World Bank found that

¹¹ Assumed exchange rate is Af34,000=\$1.

¹² Ministry of Finance, Transitional Islamic State of Afghanistan. Report on Donor Assistance for the Afghanistan Ordinary Budget. A report submitted to the Implementation Group Meeting, 12-13 October, Kabul.

¹³ Of this amount, \$54 million is categorized as "Expected, Unannounced."

Afghanistan's total trade in 2000 was \$2.5 billion, comprising \$1.2 billion in imports and \$1.2 billion in exports, most of which was comprised of reexports.¹⁴ Trade has since fallen sharply, except for emergency food aid and other imports and perhaps exports of opium. The AIA and ITGA have extended the Taliban-imposed ban on poppy cultivation and opium production, but there is no machinery to enforce it. In fact, it is reported that poppy cultivation has picked up considerably and Afghanistan is once again the world's largest producer of opium, estimated at 2,952 tons in 2002, up from 74 tons in 2001. Reported collections of customs duties give an insight into the level of imports. In the first quarter of 2002, customs collections were about \$20 million, which implies an annual official import volume of at least \$600 million, assuming an average tariff of 20%, and coverage rate of 67%. Imports are likely to grow at the rate of 15–20% annually over the next few years but exports will likely grow more slowly.

10. **External Debt.** The external debt¹⁵ situation is very sketchy with the exception of debt to international financial institutions (IFIs). Arrears to the IFIs total about \$54 million (i.e., about \$27 million with IDA, about \$17 million with ADB, and about \$10 million with IMF). Once arrears to the IFIs are cleared, outstanding debts to the IFIs of about \$86 (of which \$15.8 million is to ADB) would be serviced. The total debt to Paris Club members (excluding Russia) is estimated at about \$473 million. Outstanding Russian loans amount to \$5.9 billion as of 1991, valued at one-to-one with the US dollar. After including the outstanding balance (deficit) of Afghanistan's bilateral payments agreements as of 1991, total debt owed to Russia amounts to Rubles 6.6 billion. Under the agreement on Russia's participation in the Paris Club as a creditor, Afghanistan would be eligible for an upfront discount of 80 percent prior to any future concessional rescheduling. Other than these information, given the very weak database and considerable uncertainties about Afghanistan's economic prospects, as well as uncertainties about economic projects, as well as the absence of the precise foresight on how the existing debt might be rescheduled or forgiven, the debt sustainability analysis is very difficult. The results depend very much on the assumptions made on macroeconomic scenarios and debt rescheduling arrangements. While precise conclusions cannot be drawn from the preliminary analysis, general implications are: (i) achievement of debt sustainability will probably require debt relief that goes beyond the normal terms of debt restructuring, (ii) debt indicators appear to worsen in the initial period, the duration of which depends on the macro scenario, before leading to a robust improving trend, and (iii) debt sustainability is very sensitive to positive or negative shocks to output and export growth. The macroeconomic situation needs close monitoring over the medium term before it can be said with any degree of certainty whether the Afghan economy is on a desired path. Of course, stability in the security situation and Government commitment to sound macroeconomic management are prerequisites to debt sustainability.

11. **Aid Flows.** The international community pledged \$5.1 billion in assistance at the International Conference on Reconstruction Assistance to Afghanistan in Tokyo in January

¹⁴ World Bank, 2001. Afghanistan's International Trade Relations with Neighboring Countries 2001.

¹⁵ Based on the latest ADB staff analysis with inputs from IMF staff reflected. Work is underway by IMF staff on the sustainability of Afghanistan's debt. In this work, the implications of different scenarios are being explored regarding the extent of debt relief, the mix of external financial assistance (nonconcessional and concessional, including grants), the quality of economic policies and their implementation, and different growth and exports assumptions. Although this work is at a preliminary stage, the early implications are that given the initial level of Afghanistan's external debt, the achievement of debt sustainability will depend importantly on positive policy and growth outcomes and the extent of concessional financing.

2002. Some donors made multi year pledges and commitments of various timeframes.¹⁶ Revised pledges for 2002 total \$1.94 billion, about \$1.73 billion of which has been committed for specific projects.¹⁷ As of October 2002, however, disbursements per capita are far lower in Afghanistan than in other recent post conflict settings, suggesting that there is an urgent need to “shift gears” and accelerate program delivery so as to meet Afghanistan’s huge reconstruction needs. Specifically, about \$1.31 billion, or 67% of pledges for 2002, has been disbursed (i.e. has been placed in a bank account of the implemented or in one of several trust funds for Afghanistan). The breakdown of this amount follows: \$195 million has been deposited in various trust funds, \$50 million was committed for “large ticket items” such as United Nations Humanitarian Air Services (UNHAS) flights and agency information services; \$20 million supported Afghan refugees outside Afghanistan; about \$630 million was committed for humanitarian/relief activities; and \$420 million went to reconstruction-related activities. The last two categories are hard to pin down. Much of the reconstruction assistance is emergency/short-term assistance to provide education or basic sanitation to IDPs/refugees, for example, or for de-mining activities.

12. **Need to Fast-Track Assistance.** ITGA has launched an ambitious nation-building agenda. It is committed to far-reaching policy and institutional changes to set the stage for reconstruction and development. The opportunity cost of delayed assistance by the aid community to underwrite investments required for reconstruction and development is very high, in both human and political terms. The cost would be both national and regional. With the country’s economy restored and on a solid growth path, and with social stability, the considerable potential for subregional cooperation and mutual benefits among neighboring countries could be realized.

III. THE SECTORS

A. Sector Descriptions and Performance

13. The objective of ADB’s initial strategy and operations in Afghanistan is to assist the Government in making a seamless transition from humanitarian to reconstruction and development assistance. This will take place under the overall vision of the NDF. The emphasis is on broad-based growth within a multi-ethnic society, which is essential to reducing poverty and securing peace and stability. Broad-based growth will be inclusive, engaging the productive potential of the poor, including women, returned refugees and IDPs, and other vulnerable groups, and ensuring that they are an integral part of the growth process. To achieve this objective, ADB will work with the leadership of the ITGA, together with Afghan civil society, local communities, the private sector, and other development partners, to bring about the policy and institutional changes required for sound future investments.

14. The Postconflict Multisector Program loan (PMPL) will address policy and institutional reforms concerning governance and the financial, transport, and energy sectors. Reforms in these sectors and areas will help pave the way for the sustained long-term growth of Afghanistan’s economy. These sectors constitute the focus of the program because (i) the Executing Agency requested that the program focus on these sectors, (ii) ADB plans to provide

¹⁶ The preliminary needs assessment estimated that \$1.7 billion in external contributions would be required for the first year of Afghanistan’s recovery to jump-start reconstruction effectively, \$4.9 billion in the first 2.5 years, \$10.2 billion in the first 5 years, and \$14.6 billion over the first decade.

¹⁷ Based on information provided by Afghan Assistance Coordination Authority at the Implementation Group Meeting on 12-13 October 2002 in Kabul.

grant financing for pilot projects involving rehabilitation of small-scale irrigation systems and education and health facilities, and (iii) bilateral sources are already providing considerable assistance for agriculture and the social sectors. In addition, ADB's ongoing TAC, a \$150 million emergency rehabilitation project planned for early 2003, and a social sector program loan proposed for later in 2003 will address the social and agriculture sectors, with the result that key sectors will be supported by ADB.¹⁸ In this context, it is useful to review the current situation of the financial, transport, energy, education, health, and agriculture sectors.

1. Financial and Public Sector Management

15. The financial sector is extremely weak. DAB, the country's central bank, is still not fully functional and lacks the instruments for effectively managing monetary policy. Multiple domestic currencies exist and replacing them with a new single national currency will be extremely difficult and potentially destabilizing in the short run. The price of money fluctuates sharply and there is no official reference interest rate, either in the central bank or the few commercial banks.¹⁹ Urgently needed policy and institutional reforms include modernizing of the central bank, separating of central and commercial banking activities, developing accounting standards and prudential rules, exercising bank supervision, establishing payments system, regulating currency, managing foreign exchange, and modernizing and expanding the banking system. In the absence of a stable monetary system and an accessible credit system, reviving economic activities to their potential will remain extremely problematic. After all, farmers need short- and medium-term credit to resume agricultural activity; trade and commercial activities cannot resume without working capital support; and industrial (small- and medium-scale) activities require both short- and longer-term credit. Also, the absence of credible financial institutions hampers savings mobilization and financial intermediation. The capital market is undeveloped and modern savings and investment instruments are almost nonexistent.

16. Regarding fiscal management, in April 2002 ITGA announced an ordinary budget of \$460 million for FY2003 to cover recurrent expenditures including wages and salaries. More than 80% of the ordinary budget will have to be financed by foreign assistance, but commitments as of September 2002 for this purpose were still short by \$166 million.²⁰ The development budget will more than double the need for foreign assistance.

17. War and civil turmoil spanning more than two decades have severely undermined significant elements of the administration. Responsibility for overall management of the civil service is diffused and the division of responsibilities within and between the central and provincial governments is unclear. Many ministers and ministries have little experience in policy making and in directing the public service. The Cabinet needs technical assistance in support of the policy and institutional reform process. The Office of Administrative Affairs (OAA) serves the

¹⁸ The Minister of Finance requested ADB on 1 September 2002 to process an emergency rehabilitation and reconstruction project of at least \$150 million, for consideration in early 2003, in addition to the PMPL. The project loan will focus on rehabilitation of priority infrastructure, including national roads, petroleum storage facilities, irrigation schemes, civil aviation facilities, among others.

¹⁹ DAB nominally has 89 branches, 20 of which have been destroyed and 14 are dysfunctional. There are also six banks (two commercial banks, a trade finance bank, an agriculture development bank, a housing bank and an industry bank). However, none of these are performing intermediation functions.

²⁰ Transitional Government of Afghanistan, Ministry of Finance, 2002. Afghan Ordinary Budget and Donor Assistance, Report by Ashraf Ghani, Finance Minister to the Co-Chairs, Afghanistan Reconstruction Steering Committee (ARSG), 6 July 2002.

Council of Ministers, but is not very effective, partly because of its centralized approach. Developments during the past two decades have resulted in (i) considerable weakening of controls in managing financial resources; (ii) a breakdown in the revenue system and collection and management of basic information for decision making; and (iii) a nontransparent system of appointments of staff. Although there have been some recent improvements, basic systems and skills for preparing budgets, programs, and projects are very weak. Operational problems include (i) inability to produce an accurate payroll or to make timely payment of salaries; (ii) insufficient checks and balances in the payroll system; (iii) poor management of personnel records; and (iv) absence of merit-based recruitment or effective control of recruitment caps.

2. Infrastructure

18. Afghanistan is a large country (about the size of France) with a population of approximately 24 million, widely dispersed over mountainous terrain. It is also a landlocked country. Consequently, road and air transport are vital to Afghanistan's development prospects. Road transport is also vital to facilitating humanitarian aid and the return of refugees. The road network includes about 5,800 kilometers (km) of national roads, 2,700 km of secondary roads, and 15,000 km of provincial roads. Only 2,400 km of national roads were originally paved. The remaining network of roads has either gravel or earthen surface. Their state has not yet been surveyed systematically, although it is apparent that the road system generally is substandard. More than two decades of conflict combined with lack of maintenance has resulted in serious damage to extended road sections, critical structures, bridges, and the snow galleries on the approach to the Salang Tunnel. A recent survey of some sections of the network shows the road conditions have further deteriorated. The Ministry of Public Works (MPW) urgently needs assistance to rebuild confidence following the assassination of Vice President and Minister of Public Works Muhammad Haji Kadir in July 2002 and long-standing managerial problems. The ministry is considerably overstaffed and the financial and asset management system must be thoroughly strengthened.

19. Afghanistan is well endowed with natural gas, coal and hydropower. Geological studies carried out with financial and technical assistance from the former Soviet Union show that the country is potentially rich in hydrocarbon resources. Afghanistan's energy sector infrastructure is in disarray because of a combination of factors: the direct effects of war and conflict, shortage of expertise, and unavailability of spare parts, tools, and equipment due to lack of funding. As a result, sector entities are unable to operate, repair, and maintain the system. Gas production, transmission, and distribution systems suffer from severe operating problems and urgently need rehabilitation. The gas supply is grossly inadequate to meet current requirements mainly due to loss of production facilities and a high rate of leakage. Gas leakage represents not only a loss of revenue but also a major safety hazard. State institutions are basically dysfunctional. Electricity networks are located around big cities and industrial areas; there is no national power grid. The power sector is characterized by daily rationing of electricity, loss of power generation capacity, missing overhead transmission and distribution lines, and high system losses. The country imports most of its requirements of petroleum products. A significant part of the infrastructure for storing, transporting, and distributing petroleum products has been damaged while the remaining capacity is in need of rehabilitation. As a result the supply of petroleum products is unregulated and distribution is very costly.

20. Significant gas reserves were discovered in the early 1960s near the city of Sheberghan. Commercially, natural gas is the most important primary energy source. Potential gas reserves are estimated to be about 250 billion cubic meters (m³). The reserves are spread over eight fields in the northern area of the country. Two fields have been brought into production, but the

remaining six have not been exploited and the field structure has not been delineated. The first gas field was developed and put into commercial operation in 1967 for export to the former Soviet Union. A pipeline was built from the gas field to the border with Uzbekistan, where it connected to a major pipeline to the Soviet Union. The second gas field was developed in 1980. Gas exports ended in 1987 with the end of Soviet domination in Afghanistan. For domestic gas consumption, a transmission pipeline was built from Sheberghan to Mazar-i-Sharif, a distance of about 135 km. Gas production in the 1980s amounted to an average 2.8 million m³ per day, of which about 2.4 million m³ was for export and the remaining 400,000 m³ was for domestic consumption. Thus, 86% of the gas produced was exported. The current gas production is about 550,000 m³ per day, that is, about one fourth the level of production in the 1980s.

3. Social Sectors

21. The social sectors are not included as components of the PMPL (para.13), as to do so would place too many demands on the PMPL. Instead, ADB is addressing the social sectors through other instruments, including (i) an ongoing cluster TA, (ii) a \$4 million grant-funded project for community-based, gender-sensitive basic education from ADB's Japan Fund for Poverty Reduction (JFPR), financed by the Government of Japan, and (iii) the possible provision of additional grant assistance for a \$3 million pilot project for health, and a social sector program Loan for \$50 million in 2003. It is further noted that ADB and the Government led the preparation by the aid community of the preliminary and comprehensive needs assessments (CNA) for Afghanistan's education sector, which serve as the basis for many programs and projects supported by ADB's development partners. Although the PMPL does not directly address the social sectors, the activities of other aid agencies working with ITGA in addressing education policy and institutional reforms will benefit importantly from the findings and recommendations of the CNA. In this context, it is useful to review briefly the current situation of the social sectors.

22. The Afghan education system suffered badly as a result of 23 years of war, widespread physical destruction, restructuring under the Communist regime, and successive governments use of the nation as a political and religious pawn. The capacity to supply education in terms of both quantity and quality was decimated, even as the demand expanded in both quantity and complexity. The regime change in December 2001 and the relative political stability, together with extensive foreign assistance for the education sector, have given renewed opportunity for children to attend school. Despite serious deficiencies in school structures and teaching materials, and salary arrears of several months to teachers and school administrators, the numbers of students and teachers who have returned to school as a result of the back-to-school campaign have far exceeded expectations. The United Nations Children Fund estimates that 3 million are in search of schooling opportunities.

23. The most informed estimates suggest that Afghanistan's education indicators are among the worst in the world, with girls and rural populations being particularly disadvantaged.²¹ Before installation of the AIA in December, the gross enrollment rate (GER) for primary education was estimated at 38% for boys and 3% for girls; that for secondary education was estimated at 5–11% for boys and as low as 1–2% for girls. Moreover, 80% of school buildings at all levels were estimated to have been damaged or destroyed, as well as all but two of the teacher training colleges. Most of the vocational-technical facilities were either damaged or

²¹ UNESCO EFA 2000 report.

destroyed. A large number of qualified teachers fled the country or were killed during the war years and civil turmoil, or took jobs outside of education.

24. Afghanistan's economy is heavily based on agriculture (crops, horticulture, and livestock). Indeed, the sector supports about 85% of the population and accounts for about 50% of gross domestic product (GDP). Almost 70% of the labor force is engaged in agriculture.²² Further, agriculture accounted for most merchandise exports and a large share of imports (65% and 38%, respectively) in 1999.²³ Agricultural production has been badly affected by the protracted period of war and civil turmoil, population displacement, 4 years of severe drought, land loss through mines, dysfunctional irrigation systems, and degradation of natural resources (soil erosion from cultivation of steep hillsides, stripping of brushwood for fuel, and reduced land productivity due to the use of animal dung for fuel rather than fertilizer). Less than 10% of the land or 7.91 million hectares (ha) is arable. About 30% of total arable and permanent cropland was irrigated in 1999, much of it through community-based small and medium-scale irrigation (river valley) schemes. Most of the irrigation facilities are now in serious disrepair, and significant parts are inaccessible due to land mines. In addition, large-scale facilities exhibit management problems, waterlogging, and salinity from overuse. Substantial assistance is required to rehabilitate the irrigation infrastructure to revitalize agriculture. Wheat is the main crop, comprising 80% of total grain production.²⁴ Wheat production declined by over 50% between 1998 and 2000, from a relative high of 2.83 million metric tons to 1.49 million tons. Resurgence of poppy production signals the need for a strategic approach of providing opportunities for alternative income sources for poppy farmers and workers, and/or for support measures by the authorities. Livestock has been a major source of cash income, including the sale of dairy items, mutton, wool, animal hides, and the skins of karakul sheep (accounting for 14% of exports).²⁵ However, the 4-year drought has reduced herd numbers by 40% (footnote 8). Loss of grazing land due to mines has also affected livestock herds. Horticultural production and exports have similarly declined. In the 1970s, horticulture exports accounted for 40% of total exports (footnote 8); in 1999 they accounted for about 30%.²⁶

B. Issues and Opportunities

25. **Need for Appropriate Policy and Institutional Framework.** It is urgent that the governance, policy, and institutional frameworks necessary for a well-functioning economy be established. This is a necessary condition for significant investment in Afghanistan's reconstruction, and to inspire confidence in private investors (domestic and foreign) to participate in development opportunities. Transparency, accountability, community participation, and the rule of law form the basis for good governance, which must be established at all levels of government, from the center to the community and local levels. Policy reforms are needed to help mobilize resources and to ensure these are used productively. Substantial institutional capacity building is needed to ensure effective reconstruction and development of the economy and social systems.

²² *Encyclopedia Britannica*, Yearbook 2002. Country Profile for Afghanistan.

²³ Data are taken from Food and Agriculture Organization (FAO). 2001. *Compendium of Food and Agriculture Indicators 2001*. Rome, country table of Afghanistan.

²⁴ Other crops include barley, corn, rice, beans, cotton, fruits, nuts, rice, sugar beet, potato, opium, vegetables, and fodder crops (alfalfa and clover). Source: *Encyclopedia Britannica 2002*.

²⁵ Khan, Ulfat-un-Nabi, and Muzaffar Iqbal. 1999. *Role and Size of Livestock Sector in Afghanistan*. World Bank, Islamabad, p.11

²⁶ Data are taken from FAO. 2001. op. cit.

26. **Need for Prudent Fiscal and Monetary Management.** ITGA is committed to fiscal and monetary policies consistent with noninflationary growth and macroeconomic stability. To improve revenue performance and expenditure management, wide-ranging policy and institutional reforms will be undertaken in budget preparation and execution, domestic resource mobilization, tax policy laws, the incentive framework for private investment, customs administration, intergovernmental fiscal relationships, rationalization and privatization of state enterprises, and cost recovery and user charges in relevant sectors. The minister of finance has outlined an ambitious reform agenda across range of issues including (i) revenue policy, administration, and expenditure management, (ii) budget preparation, (iii) central banking, and (iv) broader economic policy issues including, but not limited to, privatization and commercial banking. In the same vein, ITGA is committed to substantial policy and institutional reforms in all key sectors of the economy, including agriculture, and the social, transport, and energy sectors. ADB is working in partnership with ITGA and aid agencies, notably IMF and World Bank, to elaborate the required policy and institutional reforms and actions. This consultation and analysis form the basis for providing technical assistance and highly concessional loans to help meet the adjustment and other costs associated with policy and institutional reforms.

27. **Need for Currency Conversion.** Currency conversion is a perfect example of the reforms that must be undertaken. The Government issued on 4 September 2002 a currency decree authorizing the introduction of a single national currency to replace the multiple Afghani notes that are currently in circulation. A single currency is a prerequisite for establishing a functional national payments system and creating a sound basis for economic development. The decree pursues three objectives: (i) improve the credibility of and efficiency of the Afghan currency system, (ii) convert the debt owed by central and local governments, debt owed to public sector entities, as well as debt owed by or to DAB, into debt denominated in the new currency, and (iii) remove from circulation currencies previously issued by authorities other than DAB. Although envisaged as a transitional measure in lieu of an early enactment of a new currency law and a new central bank law, the decree empowers DAB to be the sole issuer of currency conversion, mandates continuity of contractual relationships, and outlines the implementation arrangements. Thus, what appears to be a simple reform measure (however difficult logistically) in fact has far-reaching implications and will ultimately prove an important contributing factor to Afghanistan's development prospects.

28. **Need to Strengthen the Financial Sector.** The transition from subsistence farming to a modern commercial and diversified economy depends highly on the strength of the financial sector. This is a major challenge to the authorities. Reforms include replacing the 1994 Law on Money and Banking with a Central Bank Act-Decree and Banking Decree-Law; introducing a new currency; privatizing the commercial banking activities of DAB so as to establishing a two-tier banking system; adopting and implementing prudential regulations; implementing an effective monitoring and reporting system; establishing modern payments system; and enacting laws on bankruptcy and foreclosure. ADB's cluster TA addresses some of these requirements, but a great deal more needs to be done to strengthen the sector.

29. **Need to Reconstruct Public Administration and Restore the Effective Functioning of the Government Machinery.** Significant reconstruction efforts are required to establish basic administrative procedures and systems of accountability in the Afghan public service. Data on the size of the public sector are very poor, but estimates suggest about 240,000 with a large proportion located in Kabul. Staff are unevenly distributed and there is an imbalance between professional and administrative staff. Wages and salaries are very low and pensions negligible. ITGA has started working on (i) improved payroll processes, (ii) building the capacity of staff by

establishing capacity building groups, (iii) a merit basis for recruitment and promotion, (iv) improving the policy management process, (v) the pay and grading review, and (vi) improved monitoring of staffing totals. The ITGA is also considering a new budget planning process.

30. The longer term challenges facing public administration include defining and implementing sound relationships between central, regional, provincial, and district governments; creating a sustainable fiscal management process including issues concerned with budget revenues; rationalizing the role and number of institutions and ministries and retraining and reducing staff accordingly; and providing a social safety net that can make retrenchment of surplus staff feasible.

31. Opportunity to Strengthen Public Consultation and Involvement of Civil Society. ITGA faces enormous challenges over the next 2 years, as it prepares to conduct national elections, draft and promulgate a new constitution, train and deploy new national armed forces, demobilize 200,000 faction-based soldiers, and implement a multibillion dollar reconstruction program. In addition, much more needs to be done to nurture national unity and participation by civil society. The ITGA's attempts to meet these challenges are complicated by the imperatives set forth by the International Security Assistance Force (ISAF) and coalition forces in Afghanistan, whose concerns for long-term stability and participatory governance appear to be overshadowed by more immediate efforts to root out terrorism. On the brighter side, there appears to be considerable interest in and willingness for a more participatory process. However, more needs to be done to nurture national unity and support the emerging civil society organizations, including NGOs. Participation of these more inclusive institutions in public decision-making processes is necessary to reinforce and decentralize modern institutions. There is need to empower communities and strengthen community-based organizations so as to develop social and physical capital. At the national level, a gender policy and action plan is required to improve women's access to resources and services and to ensure integration of gender into community development strategies. Service delivery policies need to consider the role of civil society in providing services and in conducting social audits of services provided by the government.

32. Need to Rebuild the Transport System and Improve Management of the Sector. ITGA has declared that reconstruction and rehabilitation of the road system, especially of national roads, is the country's top priority in reconstruction. Improved roads will not only facilitate the physical and political integration of Afghanistan but also help unify the significant informal trade and the formal international trade of Afghanistan. Rebuilding the road network is also critical in facilitating humanitarian and development assistance. The reconstruction and rehabilitation work will be labor intensive, providing much-needed employment and income generation. It will contribute to social stability, by engaging among others refugees and ex-combatants. Production and trade and commerce will be promoted, thereby expediting economic recovery and growth. A strengthened transport system will serve regional interests, with the possibility of reestablishing Afghanistan as a trade hub. The benefits for Afghanistan would be enormous. Substantial investment will be required to rehabilitate and improve the road network and to pursue a regional approach. To ensure effective use of investment resources and to improve the efficiency of the sector, policy and institutional reforms are essential. These include restructuring the transport sector, promoting market-based competition, introducing privatization and commercialization, improving governance, and encouraging beneficiary participation and cost recovery. MPW must draw on international experience in engaging the private sector in road construction, maintenance, and management. There is an important opportunity for reviving, developing and upscaling the domestic road construction industry. There is also scope for commercializing the road department. As in the case of other taxes and

levies, toll collection on national and provincial highways is irregular, unsupervised, and unaudited. Further, much of the revenues collected from tolls are not received by the central Government. Such revenues should be an important source of funds for road maintenance, which has been very substandard. MOF proposes to take over toll collection as a central revenue item. A modern road asset management system is needed.

33. Need to Reform the Legal and Regulatory Framework of the Energy Sector. To facilitate the growth of the natural gas and electricity subsectors, state enterprises will be made more efficient in preparing for the transition to greater involvement by the private sector. The Policy and regulatory functions of the concerned ministries must be separated, so as to minimize conflicts of interest. The legal and regulatory framework will have to be reviewed and revised, and gaps in the framework filled. Greater attention must be paid to cost recovery. Necessary reforms must be undertaken to promote energy trade.

34. Opportunities for Regional Cooperation. Trade patterns indicate that, in 1999, Pakistan accounted for 32.4% of Afghanistan's exports and 19.2% of its imports. According to a World Bank survey,²⁷ abstracting from third-country trade, Pakistan accounted for 88.2% of exports and 47.3% of imports in 2000–2001, followed by Iran with 11.3% and 46%, and Turkmenistan with 0.5% and 6.7%, respectively. Pakistan is obviously the main trading partner of Afghanistan. Reexports to Pakistan through unofficial channels are an important component of total trade. An open trade regime and other forms of regional cooperation will generate many benefits for Afghanistan and the neighboring countries. Cooperation in road transport and energy development will foster regional cooperation in trade. Improved governance is needed to curtail corruption, which is a serious nontariff barrier to trade. Streamlining of customs and border procedures and improving the quality of information are other much needed measures to foster regional trade. Regional cooperation in developing and distributing natural gas and electricity has great potential. Iran and Turkmenistan have vast natural gas reserves, and the Kyrgyz Republic and Tajikistan have large hydroelectric potential. The possibilities for regional power trade include (i) export of power from hydroelectric projects in Afghanistan, (ii) resumption of export of natural gas from Afghanistan, (iii) export of natural gas from Iran to India via Afghanistan and Pakistan, (iv) export of natural gas from Turkmenistan to India via Afghanistan and Pakistan, and (v) and export of electricity from Turkmenistan to Afghanistan. Further, there is considerable scope for regional cooperation in water resource management, given that many rivers originate in the Afghan highlands and flow to neighboring countries. The headwater watersheds of the Indus and Amu Darya are in the northern highlands of Afghanistan. A beginning could be made with meteorological and hydrologic monitoring and data sharing.

IV. THE PROPOSED PROGRAM

35. A program loan of \$150 million is proposed for Afghanistan, with the first tranche to be disbursed upon loan effectiveness, expected before end-2002. As discussed in the Initial Country Strategy and Program for Afghanistan (2002–2004), approved by ADB's Board of Directors on 28 May 2002, the quick-disbursing nature of a program loan is appropriate, given the need to expedite assistance to the country. The focus of the program is appropriate, given the importance of policy and institutional reform as a basis for sustained economic growth and poverty reduction. The flexible nature of the program loan modality is also appropriate, given the

²⁷ World Bank. 2001. *Afghanistan's International Trade Relations with Neighboring Countries*.

difficulty-of ensuring full compliance with all conditionalities-in light of the problematic nature of the current security situation.

36. ITGA not only appreciates the importance of undertaking far-reaching policy and institutional reforms, but is in fact leading the reform process. The proposed Program is consistent with the vision and priorities for Afghanistan's development as expressed in the NDF. The Program supports policy and institutional reforms to improve governance and to strengthen the financial, transport, and energy sectors. Thus, it will contribute to economic recovery and growth within the framework of a market-based system. The proposed reforms are aligned therefore with Pillar II of the NDF, which calls for "external assistance to build the physical infrastructure that lays the basis for a private sector-led strategy of growth, in such a manner as to support the building of human and social capital"; and Pillar III, which calls for the "creation of sustainable growth, where a competitive private sector becomes both the engine of growth and the instrument of social inclusion through the creation of opportunity."²⁸ In addition, the Program complements the administrative and financial reform objectives included in the NDF.

37. Program formulation was closely coordinated with various stakeholders. The proposed program of policy and institutional reforms was drawn up based on the NDF as well as the various assessments covering for the financial, transport, and energy sectors, on which Government officials worked closely with ADB staff who assisted in further elaborating of key reforms. During a meeting at the MOF on 1 September, the minister concurred with ADB support for implementing of necessary reforms in governance and the financial, transport, and energy sectors. The development policy letter of ITGA and the policy matrix are in Appendix 1. The program framework is in Appendix 2. Sector backgrounds are in Appendix 3. The expected poverty reduction impact of the program is presented in Appendix 4. The estimated adjustment costs of the program are in Appendix 5. Appendix 6 lists the ineligible items. Appendix 7 presents the development coordination matrix. The NDF is summarized in Appendix 8. The summary of the national development budget is in Appendix 9. Appendix 10 gives the chronology of the PMPL.

38. It will be noted (para. 57) that the adjustment costs of the policy and institutional reforms agreed upon in the PMPL policy matrix are expected to be as large as or larger than the loan amount. It is also expected that the reforms, backed by ADB support, will prompt the Government to invest in the identified sectors — particularly in the transport and energy sectors. The quick-disbursing nature of the PMPL will enable it to serve as "bridge-financing" for reform-related adjustment costs, although the loan proceeds may not immediately be used for financing the adjustments. The reforms and initiatives under the PMPL are envisaged to generate substantial incremental benefits, offsetting the adjustment and other costs associated with the loan.

39. As outlined by the minister of finance in the development policy letter, Afghanistan's fiscal position is critical. However, as the minister stated:

"The reform process cannot wait until the fiscal situation improves. On the contrary, acceleration of the reform process is an essential part of strengthening the fiscal position—both directly and indirectly. Directly in that reform of the revenue system is critical to strengthening the central government's fiscal position. Indirectly in that reform

²⁸ National Development Framework, Draft for Consultation (Version 2), Kabul. April 2002.

of the policy and regulatory framework is critical to creating a positive environment for private sector enterprise and investment.”

40. It is proposed that loan disbursements be phased over an 18-month period through June 2004, to allow sequencing of the reforms and appropriate pacing of the accompanying investments and capacity-building initiatives.

A. Objectives and Scope

41. The proposed program will contribute to poverty reduction by supporting market-based policy and institutional reforms—fundamental to economic growth—leading to new employment and income opportunities throughout the country. The objective of poverty reduction is vital, as the majority of the Afghan people are living below the poverty threshold of \$1 per day. But for extensive humanitarian assistance, and now the beginning of extensive development assistance, famine and other hardship would be widespread. By helping to improve governance and to strengthen sectors essential to economic recovery, the program will make a major contribution to the rehabilitation and reconstruction of Afghanistan.

42. The Program draws extensively from the NDF and NDB and the reform agenda prepared by the Government. With regard to governance, the Program will address transparency, budgetary management and revenue generation, together with measures to strengthen and rationalize the public service. With regard to the financial sector, the Program will assist the central bank in becoming fully operational; facilitate the establishment of a modern commercial banking system, including appropriate licensing, regulation, accounting and supervision; and help to establish a national payments system. With regard to the transport sector, the Program will support the establishment of the legal, regulatory, and institutional framework necessary for an efficient transport system, one that maximizes private sector participation and cost recovery. Program support will also contribute to transparency and full community participation in planning and implementing transport investments. The program funds are expected to facilitate rehabilitation and reconstruction of national roads. With regard to the energy sector, the Program will support the establishment of the legal, regulatory, and institutional framework necessary for efficient development of the natural gas and hydropower subsectors. The objectives include improving the domestic supply of energy and facilitating export opportunities for natural gas and electricity. The Program will help rationalize the energy sector, promote private sector participation, and minimize subsidies to the extent acceptable.

43. The Program will promote employment opportunities for women and other forms of gender equity. The Program will be pro-poor in that some of the benefits of improved governance and of strengthening the energy, transport, and financial sectors will reach the majority of Afghans who are poor. It will also assist in strengthening sectors vital to economic recovery in all areas of the country. Further, the Program will contribute to regional stability, for it will encourage regional cooperation in the transport and energy sectors.

44. An ongoing \$14.5 million TA cluster (TAC) for capacity building in Afghanistan, approved by the Board on 30 May 2002, will support monitoring of the program reform agenda.

B. Policy Framework and Actions

1. Improving Governance and the Financial Sector

45. Reforms under this component deal with four important areas of concern. First, the financial sector must be strengthened through market-based policy and institutional reforms. The starting point is the introduction of a new national currency as a basis for macroeconomic stability. In addition, a suitable institutional framework, and proper monetary policy instruments will need to be evolved. DAB, the central bank, is very weak and strengthening it will require time and substantial assistance. Progress is not only critical to regaining effective management of monetary policy but also to the credit operations of commercial and other banks, and to savings mobilization and general financial intermediation. Reform measures will focus on establishing the legal and regulatory framework for efficient and effective operation of the financial sector. DAB will gradually divest its commercial banking functions, restricting itself to traditional central bank roles. Bank licensing, regulation, and supervision will be strengthened. Prudential regulations will be introduced, together with internationally accepted accounting principles and standards. Second, the financial system will be improved by modernizing the payments system on a suitable legal basis with the enactment of a payments law and establishment of clearing and settlement facilities for interbank operations. Third, a wide range of budgetary management reforms will be undertaken in preparing ordinary and development budgets and improving efficiency and transparency in revenue, expenditure, and other budgetary matters (e.g., debt management and public sector accounting). Finally, improving the efficiency and effectiveness of the Afghan civil service is imperative. A strategy and action plan will be prepared for designing and implementing a payroll system, and suitable checks and balances for the payroll in line ministries, departments, and provinces will be evolved. In addition, the Civil Service Commission will review government functions in key ministries, and in the financial, transport, and energy sectors; and establish appropriate staffing (or retrenchment) and retraining programs for an efficient and effective civil service.

2. Improving the Transport and Energy Sectors

46. The weak state of existing transport infrastructure is paralleled by the weak policy and institutional framework for the sector. The prolonged period of war and conflict has significantly undermined the capacity of key ministries and agencies to develop and implement policies and projects. The ministries concerned include MPW, which is responsible for implementing all infrastructure development programs; Ministry of Transport (MOT), which owns and operates government-owned trucks and buses and is responsible for assisting and regulating the largely private-sector-run road transport industry; the Ministry of Rehabilitation and Rural Development (MRRD), which plans and implements rural development projects including support for rural roads; and the Ministry of Civil Aviation and Tourism (MCAT), which manages all airports and runs the government-owned airline and tourism business. Lack of capable staff seriously constrains these ministries, which are responsible for leading the rehabilitation and reconstruction of the transport sector. A generation of professional expertise was lost during the conflict, as most of the capable and qualified staff left the country. The small number of professionals who stayed in Afghanistan is reaching retirement age. Due to lack of additional training during the conflict period, there is a large gap in capacity that needs to be filled by recruiting and training a new generation.

47. Rehabilitating and reconstructing road transport infrastructure and capacity building are top priorities for the responsible ministries. Other sector issues must also be addressed: institutional reforms such as merging some responsibilities on functional lines, decentralization,

increasing involvement of the private sector, introducing cost recovery and self-financing measures, direct participation of beneficiaries/communities in development activities, environmental safeguards and ensuring environmental considerations in all development projects, safeguards for indigenous peoples and affected ethnic minorities, proper resettlement procedures for project-affected persons, and incorporating gender considerations in developing transport sector projects.

48. Thus, transport sector reforms will focus on (i) creating an enabling framework for market-based competition and efficiency; (ii) establishing efficient, safe, and reliable transport services that meet gender, environmental, and involuntary resettlement objectives; (iii) improving institutional efficiency and effectiveness of the concerned agencies; (iv) establishing a regulatory framework for the road transport subsector; (v) introducing good governance in the sector; (vi) instituting cost recovery mechanisms; (vii) promoting private sector participation in developing infrastructure and delivering public services; (viii) establishing a system for beneficiary participation in planning and design of transport projects; and (ix) establishing a system for national road maintenance and upgrading that will sustain subregional transit traffic. Accordingly, a working group will be established to draft a transport sector policy statement for the government to consider. A plan for restructuring transport sector institutions will be finalized and approval sought from the Government. In addition, the sector will be restructured, separating operational and regulatory functions. Appropriate guidelines and transparent procedures for procurement will be developed. Transparent procedures for regulating transport operations will be put in place. A report on existing road financing arrangements will be completed and cost recovery mechanisms in the sector will be adopted and implemented. A legal and regulatory framework will be developed to encourage private investment in the sector. An action plan will be developed for the participation of beneficiaries/users in public sector transport projects. A plan for national road maintenance and upgrading will also be developed.

49. Similar actions are planned for the energy sector. The Ministry of Water and Power (MWP) is responsible for the electricity sector and development of renewable energy. Until recently, MWP had about 6,600 staff positions, most of which were vacant. Some 4,000 staff recently reported back for duty. Da Afghanistan Bresha Moassese (DABM), an enterprise under MWP, is responsible for generating, transmitting, distributing, and selling electricity. The serious lack of experienced professional staff and poor work facilities prevent MWP/DABM from making much progress in reconstructing and rehabilitating the electricity sector. MWP is also in need of assistance in formulating policies and strategies for sector development, and for efficient management and human resource development.

50. ITGA gives high priority to development of natural gas as a major source of energy for the country. Long-term sustainability requires development of natural gas resources on a least-cost basis, in an environmentally sound and socially acceptable way. External assistance is needed in formulating policy and institutional reforms to improve the efficiency of the energy sector, and opportunities for investment and development.

51. Accordingly, a number of policy actions are envisaged for the energy sector. First, to create an efficient, safe, reliable, and environmentally sound energy system that meets gender, environmental, involuntary resettlement objectives, an energy sector policy statement will be drafted and government approval sought. Second, policy, regulatory, and operational functions in the oil and gas sector will be assessed to improve efficiency and minimize potential conflicts of interest, and the relationship between MWP and power sector enterprises will be reviewed and their staffing and skills mix evaluated. Third, a capacity-building plan will be developed and

implemented at all levels for the ministries and agencies responsible for the sector. Fourth, the Government will begin preparing a master plan for institutional strengthening of MVP and sector enterprises. Fifth, electricity and gas pricing, billing, and collection operations will be reviewed to improve cost recovery, and an agreement will be sought to reduce gas subsidies to an acceptable level. Sixth, the Government will prepare a policy statement on private investment in oil and gas exploration and development for consideration. Finally, institutional capacity will be created for improving corporate governance in the petroleum subsector, and negotiating and monitoring private investments in exploring and developing oil and gas resources.

C. Important Features

52. An important feature of the PMPL is the very high degree of Government ownership of the policy and institutional reforms included in the Program. Consultation with the Government in formulating the policy matrix has been extensive and maximum effort was made to reflect the special circumstances of Afghanistan so as to ensure a practical and realistic agenda. Consultation with other aid agencies has also been extensive, especially with IMF and the World Bank. The Government is determined that development assistance to Afghanistan will be well coordinated, hence the emphasis on complementarity of all assistance with the NDF and NDB. The proposed conditions are designed such that they reinforce one another as well as those under the World Bank's proposed fiscal rehabilitation operation in support of the Government's budget in 2002, supported by a \$100 million IDA credit.

53. Another important feature of the PMPL is its timeliness. While the Government has hesitated to request loan assistance out of concern for long-term debt implications and other considerations, it now recognizes that highly concessional loan assistance should be part of the financing effort for Afghanistan's reconstruction. Because of the large grant element embodied in the PMPL, it will only marginally affect Afghanistan's debt service burden. Moreover, the program design fully considers the Government's concern that loan funds be used productively and prudently. Most critically, the fast-disbursing nature of the program responds to the Government's request that the international aid community accelerate the disbursement of pledged assistance to Afghanistan.

54. Yet another important feature of the PMPL is its flexibility. The policy matrix is deliberately more adaptable than is typical for program loans. Besides reflecting Afghanistan's extremely difficult circumstances, including increased security concerns, this formulation draws from ADB's overall experience with program loans as reported on by the Operations Evaluation Office. In the past, overly ambitious and numerous conditionalities have contributed to disappointing program performance.

55. Finally, another feature of the PMPL is that it addresses factors fundamental to transition to a more market-based, modern economy. This objective was drawn to the attention of the Board Members during Afghanistan's participation at ADB's 35th annual meeting in Shanghai:

"The nation we are endeavoring to rebuild is a modern Afghanistan, consistent with our religious and cultural beliefs. Our strategy is designed to recover lost time, to put the country on a faster development track and place it firmly in the 21st century. We want

up-to-date technologies and policies and programs in line with regional requirements and global realities.”²⁹

56. The PMPL meets the spirit of this vision. For example, it supports the introduction of a new national currency and the process of currency conversion. It also highlights the importance of a strong and independent central bank, while recognizing that a great deal of reform and capacity building is needed before this can be realized. Moreover, the PMPL focuses on the critical need to create the policy, regulatory, and institutional framework for an efficient banking system, without which private sector investment and enterprise will flounder. Reform of the civil service is another essential step in securing the foundation for economic growth and poverty reduction; hence, several program elements address this reform. Other governance initiatives include strengthening transparency and community participation in forming the development agenda. Finally, the Program emphasizes and contributes to regional cooperation.

D. Financing Plan

57. ITGA has requested a loan of \$150 million from ADB’s Special Fund resources, with the interest charge during the grace period to be capitalized and charged to the Loan Account, to support the proposed program, as described in the development policy letter and the policy matrix (Appendix 1). The loan amount was determined on the basis of the adjustment and related costs of the proposed policy and institutional reforms. Four cost elements are considered: (i) costs of compliance with the new legal and regulatory systems and standards, (ii) costs of capacity building, (iii) costs of enforcement, and (iv) costs of price adjustments. Adjustment costs cover technical expert inputs, administrative support, training, compensation, building and equipment associated with compliance, capacity building and enforcement. In addition, costs of price adjustments have been included, where appropriate. The major cost elements under reforms of governance and finance are costs associated with (i) introducing the new official afghan currency, (ii) implementing the national payments system, (iii) completing a diagnostic review of customs procedures, simplifying customs procedures, and rationalizing the customs tariff structure, and (iv) enhancing efficiency and effectiveness of the civil service. The major cost elements under reforms of the transport sector are costs associated with (i) finalizing a plan for restructuring transport sector institutions, (ii) adopting and implementing cost recovery mechanisms in the transport sector, which includes construction of toll booths and weighing stations, and (iii) national road reconstruction and maintenance. The major cost elements under reforms of the energy sector are costs associated with (i) improving the efficiency of sector ministries and institutions, (ii) developing capacity, (iii) creating a market framework, (iv) promoting cost recovery, and (v) promoting private sector participation. These and related costs are estimated to be at least about \$158 million, consisting of the following major cost categories:

- (i) market-based policy and institutional reforms (about \$29 million),
- (ii) financial system reforms (about \$17 million),
- (iii) fiscal policy reforms (about \$9 million),
- (iv) improved institutional efficiency in the transport sector (about \$8 million),
- (v) improved cost recovery in the transport sector (about \$14 million), and
- (vi) road rehabilitation and maintenance system (about \$62 million).

²⁹ Address to ADB’s Board of Governors, 9 May 2002, by H.E. Hedayat Amin-Arsala, then Minister of Finance, now Vice President of ITGA.

58. Details of estimated adjustment costs and underlying assumptions are in Appendix 5.

59. The program loan will have a repayment period of 40 years, including a grace period of 10 years, and carry an interest rate of 1.0%, with the interest charge during the grace period to be capitalized and charged to the Loan Account, on an exceptional basis. The loan proceeds will be available for disbursement in two tranches, upon satisfactory compliance with agreed-upon conditions from the date of loan effectiveness until 31 December 2004.

E. Implementation Arrangements

1. Program Management

60. MOF will be the Executing Agency for the PMPL and will be responsible for disbursing the loan proceeds, maintaining program records, and ensuring compliance with all policy-related conditions. MOF will appoint a program coordinator and assign appropriate staff to assist in monitoring and supervising program activities. MOF, DAB, OAA, Civil Service Commission (CSC), MPW, MOT, Ministry of Commerce (MOC), Ministry of Mines and Industry (MOMI), and MWP will be Implementing Agencies (IAs). MOF and the IAs will assume responsibility for implementing all conditions and program components within their regulatory and development mandates. Each IA will appoint a program officer, who will liaise with the program coordinator on policy decisions concerning the PMPL. MOF and the IAs will liaise closely with consultants assigned under the cluster TA for capacity building, which will be utilized to sort out institutional development and policy reform issues and otherwise to facilitate compliance with program conditions in all sectors. Program implementation will require considerable input from ADB staff, who will backstop program implementation and coordination activities.

61. In addition, a national program steering committee chaired by the minister of finance will be established to provide program oversight. Committee members will be deputy ministers of concerned ministries. The Afghan Assistance Coordination Authority (AACAA) will serve as the committee's secretary. The steering committee will meet at least quarterly to review program implementation and to resolve interdepartmental and other issues. The Program will be implemented in close coordination with other aid agencies, especially the World Bank and IMF, to avoid duplication and enhance impact.

2. Implementation Period

62. The program loan will be implemented within 18 months, starting from the date of loan effectiveness. The loan will be released in two tranches upon satisfactory compliance with agreed-upon conditions from the date of loan effectiveness up to 31 December 2002.

3. Procurement and Disbursement

63. The loan proceeds will be used to finance the foreign exchange costs of items produced and procured in ADB member countries (other than items specified in the negative list and imports financed by other bilateral and multilateral sources). The Government will certify that the volume of eligible imports exceeds the amount of ADB's projected disbursements under the loan for the given period. ADB reserves the right to audit the use of the loan proceeds and verify the accuracy of the Government's certification. The Government will open an account (the deposit account) with a bank acceptable to the ADB into which the loan proceeds will be deposited and through which all withdrawals will be made. Monthly statements of the deposit

account will be attached to the semiannual report of PMPL implementation to be submitted by the AACCA to ADB.

4. Consulting Services

64. No consulting services will be provided under the Program. But because the Program will address basic policy and institution reforms in governance and the transport, energy, and financial sectors, investment and capacity building in those sectors were ensured by linking program monitoring and implementation with the activities of ADB-funded advisors already working in the concerned ministries and departments under an ongoing TAC for capacity building.³⁰ Significant progress has been made with recruiting and fielding consultants under the TAC. These consultants, together with those financed by other external funding agencies, will support ITGA and various ministries in securing compliance with first- and second-tranche conditions of the policy matrix. In particular, technical assistance provided by IMF, Department for International Development, and ADB will help DAB and MOF to comply with the governance and finance policy conditions. Policy actions in the transport sector will be facilitated by the TAC and technical assistance provided by Swedish International Development Cooperation Agency while those in the oil and gas subsector will be supported by the TAC.

5. Counterpart Funds

65. The Government will use the local currency counterpart funds generated by the PMPL to meet program expenditures and the adjustment costs of reform.

6. Monitoring and Tranching

66. The loan will be released in two tranches upon satisfactory compliance with the agreed-upon conditions. The first tranche, equivalent to \$100 million, will be made available upon loan effectiveness. The second tranche of \$50 million will be made available about 12 months later upon satisfactory compliance with agreed-upon conditions, as well as continued compliance with all previous tranche conditions. The conditions for release of the first and second tranches are as follows:

a. Conditions for First-Tranche Release

i. Governance and the Financial Sector

- (i) Prepare drafts of a Central Bank Decree-Act and Banking Decree-Law, to replace the 1994 Law on Money and Banking
- (ii) Issue new currency decree
- (iii) Complete preparation of a time-bound action plan for phasing out commercial banking activities of DAB.
- (iv) Prepare a time-bound action plan for modernizing the payment system

³⁰ ADB. 2002. *Technical Assistance to Afghanistan for Capacity Building for Reconstruction and Development*. Manila.

- (v) Prepare and announce a development budget for the current fiscal year
- (vi) Establish a civil service commission
- (vii) Identify technical assistance requirements to improve payroll and personnel systems and processes

ii. **Transport**

- (i) Establish a working group to prepare a transport sector policy statement
- (ii) Begin preparing a plan for restructuring ministries and departments in the transport sector
- (iii) Begin developing a regulatory framework for road transport industry operations
- (iv) Begin drafting standard procurement guidelines, regulations, and documentation meeting international standards
- (v) Begin a comprehensive assessment of legal and nonlegal barriers, including policy and regulatory frameworks, to private participation in road construction and maintenance, and transport services
- (vi) Assign staff and consultants to prepare a plan for maintaining and developing the national road network

iii. **Energy**

Power

- (i) Establish a working group to prepare an energy sector policy statement (ESPS).
- (ii) Begin reviewing the relationship between MWP and power sector public enterprises
- (iii) Begin developing a plan to improve the financial management system and billing and collection operations
- (iv) Begin reviewing the current tariff and cost structure and begin developing a pricing strategy for cost recovery

Oil and Gas

- (i) Complete the terms of reference for a study to establish policy, institutional and regulatory frameworks for the oil and gas subsectors
- (ii) Complete the terms of reference for a study on safety and efficiency improvement in the gas subsector
- (iii) Establish a working group to study policy, regulatory, and operational functions in the oil and gas subsector
- (iv) Begin assessing the institutional capacity of the key entities responsible for rehabilitating and reconstructing of the oil and gas subsector
- (v) Agree on the need for cost recovery from natural gas users and on minimizing subsidies to acceptable levels

- (vi) Begin preparing a policy statement on private investment in oil and gas exploration and development
- (vii) Begin preparing standard procurement guidelines and procedures for importing petroleum products
- (viii) Begin reviewing the safety and environmental codes for petroleum storage, transport, and distribution

b. Conditions for Second-Tranche Release

i. Governance and the Financial Sector

- (i) Draft decrees on bank licensing, regulation, and supervision and submit to the Cabinet for approval
- (ii) Establish an accountancy board.
- (iii) Establish a Banking Supervision Department at DAB, and prepare a strategic plan for the development of bank supervision functions
- (iv) Complete draft payments decree-law in line with international best practice
- (v) Begin implementing a national payments system
- (vi) Announce ordinary and development budgets for FY2004 (SY 1382)
- (vii) Finalize a draft policy statement on public debt management, including establishment of a debt information system
- (viii) Begin simplifying customs procedures and rationalizing the tariff structure
- (ix) Begin issuing monthly reports on public spending and revenue at the center
- (x) Finalize a plan for establishing a central employee database for controlling the payroll
- (xi) Finalize a strategy for designing and implementing payroll and personnel records systems for line ministries, departments, and provinces

ii. Transport

- (i) Submit a final draft TSPS for government consideration and for use by the aid community
- (ii) Finalize an action plan for restructuring transport sector institutions
- (iii) Draft key regulatory provisions and decree-laws, identifying ways and means to ensure that regulatory functions are free from conflicts of interest with the government.
- (iv) Adopt a time-bound action plan for implementing of procurement guidelines and regulations in the transport sector
- (v) Report on existing road financing and maintenance arrangements and recommend sustainable financing mechanisms in the transport sector

- (vi) Prepare draft legal and regulatory framework to promote private investment in the transport sector and submit to Government for consideration
- (vii) Finalize a plan for upgrading, maintaining and developing the national road network and submit to Government for consideration

iii. Energy

Oil and Gas

- (i) Begin a study on the policy, institutional, and regulatory framework for the gas subsector
- (ii) Begin study to establish codes and safety standards for the gas subsector
- (iii) Study policy, regulatory, and operational functions in the oil and gas sector
- (iv) Begin implementing capacity-building plans
- (v) Finalize an action plan for improved cost recovery from gas consumers
- (vi) Prepare a policy statement on private investment in oil and gas exploration and development
- (vii) Establish quantity standards for petroleum products

Power

- (i) Submit ESPS for consideration by the Government
- (ii) Develop plan to improve system stability and control
- (iii) Begin assessing current staffing and skills mix and personnel requirements for MWP and power utilities
- (iv) Begin preparing a master plan to strengthen MWP and sector enterprises
- (v) Develop and begin training programs for public servants responsible for the power sector

67. The integrated benefits and impacts are expected to outweigh the costs, given the likelihood of the risks occurring.

7. Accounting, Auditing, and Reporting

68. ADB reserves the right to audit the use of the loan proceeds and verify the accuracy of the Government's certification. The Government will open a deposit account in a bank acceptable to the ADB into which the loan proceeds will be deposited and through which all withdrawals will be made. Monthly statements of the deposit account will be attached to the semiannual report on PMPL implementation that AACCA will submit to ADB.

8. Program Performance Monitoring and Evaluation

69. ADB will closely monitor the progress of PMPL implementation and the impact of the reforms on governance and finance, and the transport and energy sectors. The Government and ADB will continue to engage in active policy dialogue throughout PMPL implementation,

including additional reforms that may be considered necessary or desirable for the sustained development of the concerned sectors. ADB will also pay close attention to the poverty impact of reforms, particularly during the transition phase between the first and second tranches. Adequate compensation and fair treatment for workers who seek to retire voluntarily from public enterprises will be closely monitored.

70. AACA will be responsible for monitoring progress of implementing the program reforms during 2002–2004. Monitoring will involve coordination with the Central Statistical Office, MOF, DAB, and partner ministries, and support will be mobilized to rapidly develop information systems at central, provincial, and local levels. There are, however, serious capacity gaps in skills relating to field surveys, data collection and analysis, computer systems, management feedback, and report writing. In short, the Government's capacity to carry out monitoring is almost nonexistent. In any case, AACA will provide ADB with semi-annual reports on PMPL implementation, in particular policy actions set out in the development policy letter and policy matrix, and the accomplishment of objectives and purposes. The reports will be submitted in such form and detail, as ADB may reasonably request. They must include information on progress made and problems encountered during the period in review, steps taken or proposed to be taken to remedy problems encountered, the proposed detailed activity for PMPL implementation, and expected progress during the next half year or period of review. On completion of the PMPL, but in any event not later than 6 months after program completion, the Government will prepare and furnish ADB with a comprehensive report on the overall impact of the policy reforms.

9. Program Review

71. ADB will field trimesterly Program review missions. A midterm review will take place in September 2003. In addition, the Program Steering Committee chaired by the minister of finance will periodically review the Program. AACA will prepare a summary of the discussions of the steering committee and send the summary to ADB.

V. TECHNICAL ASSISTANCE

72. The Program will address governance and basic policy and institutional reforms in the transport, energy, and financial sectors. Accordingly, investment and capacity building in these sectors will be provided by linking Program monitoring and implementation with the activities of ADB-funded advisors already working in the concerned ministries and departments under an ongoing TAC.³¹ Grant cofinancing to build the capacity for monitoring and implementing Program reform measures may be considered.

³¹ The TA objective is to strengthen policy formulation and programming in different ministries for rehabilitation and reconstruction as well as for longer-term development through provision of long- and short-term advisory services and training opportunities. The project will also provide office equipment and supplies for the effective operation of ministries and departments.

VI. PROGRAM BENEFITS, IMPACTS, AND RISKS

A. Benefits

73. The Program will provide critically needed fiscal support to enable the Government, to continue providing essential services and rehabilitating and reconstructing the physical and social capital of Afghanistan. It will contribute to economic recovery, employment generation, higher productivity, improved per capita incomes, and social stability. Specific beneficiaries are hard to identify a priori due to the nature of the Program, but they may include, among others, the rural and urban poor, returning refugees, IDPs, demobilized combatants, and women. Specifically, the following benefits will be directly or indirectly attributable to different Program components.

74. Improved governance and financial sector development will lead to (i) improved efficiency and effectiveness of the public sector, (ii) improved resource mobilization from domestic and foreign sources for rehabilitation and reconstruction, (iii) improved macroeconomic management and payments system, (iv) increased credibility in the financial sector, and (v) development, diversification, and deepening of the financial sector.

75. Infrastructure development will lead to (i) improved national road network, (ii) improved maintenance of roads, (iii) increased subregional cooperation and foreign private investment in electricity and natural gas development, and (iv) increased production and distribution of natural gas and electricity.

B. Risks

76. Implementation of the Program entails a number of risks:

- (i) Government commitment to the reform process could weaken. Despite recent policy statements by the President and the minister of finance, other ministers and senior officials may have vested interests or opposing philosophies on the role of the Government and the public sector. Political will to implement the proposed reforms will be tested in the months ahead. There is also a risk that a change in Government after the national elections scheduled for June 2004 may result in a policy shift. However, the PMPL does not cover politically sensitive areas, and prospects for a change in Government that would significantly alter the broad macroeconomic and policy orientation appear relatively remote at this stage.
- (ii) The overall political and security situation remains volatile, and it is yet to be seen how much the situation will improve. ADB will need to closely monitor the situation.
- (iii) Weak implementation capacity may delay implementation of reforms. ITGA has limited capacity for planning and implementing even basic rehabilitation and reconstruction. In addition, there is limited understanding of the policy and institutional reform process, and of the importance of synchronization and appropriate phasing. ADB's TAC will help mitigate this problem. MOF has assumed a lead role in eliminating development constraints and bringing the PMPL and other reform programs to fruition.

- (iv) The macroeconomic and budgetary situation may worsen, causing a diversion of funds for meeting adjustment and other costs associated with the Program's policy and institutional reforms. The Government and the international community are providing significant levels of relief and rehabilitation assistance for affected groups. The situation needs to be carefully monitored.
- (v) Aid coordination requirements are extensive. The Program was formulated with the Government, in close consultation with the aid community, especially the World Bank, IMF, and United States Agency for International Development. Coordination needs to be further enhanced during Program implementation.

77. The integrated benefits and impacts are expected to outweigh the costs, given the risks.

C. Impact on Poverty

78. The direct impact of the Program is partially pro-poor, provided the Government allocates funds made available through the loan for employment-creating investments such as rehabilitation of roads, schools, and irrigation systems. The indirect impact, which will be more substantive, will be generally pro-poor as the majority of the population is poor. The actions under the Program will contribute to institution building for efficient public sector administration and policy making conducive to private sector led economic growth, which will naturally reduce aggregate poverty. Indirect impacts can benefit the poor disproportionately through improved access to public services, which were previously limited to urban population groups.

79. Rehabilitation of roads and other labor-intensive civil works will create important direct short-term employment. Little is known about the possible indirect short-run impact. Indirect medium-term impact will include improved functioning of labor markets. Major groups affected are unskilled labor (directly) and entrepreneurs (indirectly). Prices of goods and services will have positive indirect short-run impact because of stable prices due to macroeconomic stability. Over the medium term, benefits will accrue from improved functioning of the goods markets, enhanced productivity, and regained private sector confidence. The economy in general and the entire population will benefit from price and macroeconomic stability. This impact will also be magnified in both the short-run and medium-term due to enhanced public sector planning and execution, improved user confidence, and greater public sector-NGO collaboration in delivering of services. Further indirect medium-term impact will accrue from improved security and property rights, and improved access to financial assets. The poor, especially the IDPs, will benefit from this channel. Over the medium term, the poor will benefit from improved fiscal space for pro-poor transfers as well as improved room for private transfers.

VII. ASSURANCES

A. Specific Assurances

80. In addition to the standard assurances, the Government has given the following assurances, which are incorporated in the legal documents:

- (i) The policies and actions taken before the date of the Loan Agreement as described in the development policy letter and the policy matrix will continue to be in effect for at least the duration of the PMPL.
- (ii) The Government will adopt the other policies included in the PMPL and specified in the development policy letter and the policy matrix in a timely manner and will ensure that the policies and actions continue to be in effect for at least the duration of the PMPL.

B. Conditions for Disbursement

- (i) The loan will be released in two installments upon satisfactory compliance with agreed-upon conditions as specified in the development policy letter and policy matrix. The first tranche, equivalent to \$100 million, will be made available upon loan effectiveness. The second tranche of \$50 million will be made available about 12 months later upon satisfactory compliance with agreed-upon conditions, as well as continued compliance with all previous tranche conditions.
- (ii) Before submitting to ADB the first application for withdrawal from the loan account, the Government will open a deposit account in a bank acceptable to ADB into which loan proceeds will be deposited and through which all withdrawals will be made. Monthly statements of the deposit account will be attached to the semiannual report of PMPL implementation that AACA will submit to ADB.
- (iii) No withdrawal will be made from the loan account in respect of the second tranche unless the ADB is satisfied, after consultation with MOF, that sufficient progress has been achieved in carrying out the Program and, in particular, that ITGA has fulfilled the conditions for the release of the second tranche as specified in the policy matrix.

VIII. RECOMMENDATION

81. I am satisfied that the proposed loan would comply with the Articles of Agreement of ADB and recommend that the Board approve

- (i) the loan in various currencies equivalent to Special Drawing Rights 113,496,000 to Afghanistan for the Postconflict Multisector Program, from ADB's Special Funds resources with a term of 40 years, including a grace period of 10 years, an interest charge at the rate of 1% per annum, and such other terms and conditions as are substantially in accordance with those set forth in the draft Loan Agreement presented to the Board. In addition, the total amount of the interest charge during the grace period will be capitalized and charged to the Loan Account;
- (ii) in respect of such loan, a variation from the existing loan terms under ADF resources on an exceptional basis; and
- (iii) also, the variation from the previous ADB practice that all arrears to ADB must be cleared before Board consideration, and instead that the Board consider the loan conditional on the clearance of arrears.

18 November 2002

TADAO CHINO
President

Development Policy Letter

04 November 2002

Mr. Tadao Chino
President
Asian Development Bank
Manila, Philippines

Dear Mr. Chino,

The Asian Development Bank has earmarked \$200 million in concessional assistance for Afghanistan in 2002 - including \$50 million in grants. We are beginning to benefit from ADB's grant assistance, and I understand that more such assistance will be operational soon. It is now opportune to make ADB's offered loan assistance operational.

On behalf of the Islamic Transitional Government of Afghanistan, I would like to confirm agreement with ADB to proceed with support for a Postconflict Multisector Program Loan, whereby the first tranche will be available later this year. Consistent with ADB's program lending modality, the program will facilitate policy reforms of priority interest to the Government. Accordingly, the program will address basic policy and institutional reforms in budgetary management and in the transport, energy, and financial sectors. Reforms in these areas will greatly contribute to Afghanistan's recovery and reconstruction. Again consistent with ADB's program loan modality, provision will be included for investment and capacity building components in each of these sectors, by linking program monitoring and implementation with the activities of ADB-funded advisors working in concerned ministries and department under TA3874-AFG: Capacity Building for Reconstruction and Development, approved for \$14.5 million on 30 May 2002.

With reference to the attached policy matrix, I am pleased to inform you that the agreed reforms and accompanying investment and capacity building initiatives reflect the wishes of the Government, as the representative of the people of Afghanistan. Further, these reforms are practical and consistent with our National Development Framework, and will contribute significantly to economic growth and poverty reduction. It follows that we were able to conclude negotiations with ADB officials and finalize a mutually acceptable policy matrix without difficulty. Extensive consultation with other donor agencies, notably the International Monetary Fund and World Bank, during preparation of this policy matrix will ensure that ADB assistance is fully complementary with the Government's development program and coordinated with the activities of our development partners.

As you may be aware, the Government has been reluctant to enter into loans for the rehabilitation and reconstruction of Afghanistan. Grant assistance is the much-preferred form of assistance, so as to minimize encumbrances on the next generation. At this juncture it is hard for many Afghan people to foresee the economic basis that would support an increased debt burden. A further consideration is the obligation of foreign governments to help Afghanistan recover from a history plagued by geopolitical interventions. These considerations were reflected in the generous degree of grant assistance included in the \$4.5 billion in reconstruction assistance pledged so far by the donor community to Afghanistan. It is recognized that loan assistance – on highly concessional terms – is an important component of these pledges. This is especially the case for ADB, Islamic Development Bank, and World Bank. Thanks to your

leadership on this issue, ADF loan terms for this Program were modified on an exceptional basis, to increase loan concessionality and reduce any debt burden to a more manageable level. Your understanding of our situation and support was an important factor in enabling us to develop the necessary political consensus to borrow from the ADB. Accordingly, we request that ADB fast-track processing of the Postconflict Multisector Program Loan.

We recommend an amount of \$150 million on concessional ADF terms, with disbursements phased over an 18-month period beginning in 2002. This would allow phasing and sequencing of the reforms, and appropriate pacing of the accompanying investments and capacity-building initiatives. The reforms and initiatives we have agreed upon are expected to stimulate growth and generate incremental benefits totaling more than \$2 billion over the next decade, more than offsetting the adjustment and other costs associated with the program loan.

As you well know, there is great urgency in fast-tracking international assistance for Afghanistan. Our situation is extremely serious, as evidenced by the fact that the majority of Afghan people are living below the poverty threshold. The protracted war and civil turmoil have resulted in a devastated economy and badly strained national unity. Further, four years of drought – together with land mines and other disruptions – have cut agricultural production by half. But for extensive humanitarian assistance, famine would be widespread. The challenge of reconstruction and rehabilitation is being compounded by unexpectedly high numbers of return refugees.

Our efforts to respond have been severely hampered by the Government's extremely weak fiscal situation. In April 2002, an Ordinary Budget of \$460.3 million was approved, mostly for wages and salaries of public employees (including teachers and health workers). At the time of approval, it was expected that 18 percent of the Ordinary Budget (or \$83.0 million) would be financed from domestic revenues (mainly customs duties) and the rest by foreign assistance. Unfortunately, in both cases the expectation is proving difficult to meet. Revenues have fallen badly short of target and foreign assistance for ordinary expenditures has fallen far short of what is needed to sustain basic government functions.

In addition, the Development Budget must be financed. While not yet finalized, this will likely exceed the Ordinary Budget in financing requirements – which will be 100 percent dependent on foreign assistance. It is vital that the Ordinary and Development Budgets be in close tandem, so as to avoid the current/capital imbalance that so often undermines essential services and public investment in developing countries. Moreover, public sector operations conducted in an effective, accountable and transparent manner will provide a sound basis for future development.

The reform process cannot wait until the fiscal situation improves. On the contrary, acceleration of the reform process is an essential part of strengthening the fiscal position – both directly and indirectly. Directly in that reform of the revenue system is critical to strengthening the central government's fiscal position. Indirectly in that reform of the policy and regulatory framework is critical to creating a positive environment for private sector enterprise and investment.

In April of this year, a National Development Framework (NDF) was formulated and presented at the first meeting of the Afghanistan Reconstruction Implementation Group (IG) in Kabul. The NDF constitutes the basis for our reconstruction strategy and presents a vision for a prosperous, secure, and self-reliant Afghanistan, setting out strategic directions and overarching principles to guide all interventions. Very briefly, our strategy has three pillars. These include:

humanitarian assistance and human development; reconstruction of infrastructure; and the pivotal role of the private sector. This last point is important. Our government has decided that the private sector should be the main engine of growth and development in Afghanistan. Therefore, we have drafted and are finalizing a liberal legal framework, which would enable the private sector to play an active role in the country's future. The laws will provide investors with necessary protections, incentives and facilities to foster domestic and foreign investment. We are also adopting a series of macroeconomic policy measures, which will create an environment conducive for enterprise development. Our hope is the external private sector will commit not only to playing a key role in Afghanistan's reconstruction program, but also to a longer-term and broad-based role. Since becoming Minister of Finance in June, I have helped spearhead a number of such macro- and micro-economic reforms including budgetary management and financial sector reform.

I should note also that the reform process is critical to reestablishing trade and other forms of economic cooperation with neighboring countries, and to participating effectively with the international community more generally. Afghanistan was once a vital land bridge between Central Asia and the Sub-continent, and between the East and West. We want to regain the status of a vital trade partner, on modern terms consistent with our religious beliefs and our traditions. Our landlocked nature and difficult terrain underscores the importance of rehabilitating the country's national road network.

Decidedly, Afghanistan is at a historic crossroads. Progress in installing a progressive government and stabilizing the political situation offers a window of opportunity to rebuild the economy – providing the basis for improved incomes, reduced poverty and renewed national unity. There are growing signs of this improvement and renewal throughout the country. Businesses are springing to life, small and modest but nonetheless helping to give meaning to a market-based economy. Children are returning to school, and houses are being rebuilt. We are rebuilding our national army and police forces, so as to ensure stability. Besides this being essential for the security of Afghan people, it is a necessary condition for effective and efficient foreign assistance.

I think you will agree with me that Afghanistan has considerable potential. With proper water resource management and other elements of sustainable development, the agriculture sector can be revitalized to its former strength. Perhaps more than any other factor, this is at the heart of poverty reduction. More than 80 percent of the Afghan people are wholly dependent on this sector. With guidance on rehabilitation, reconstruction and development of Afghanistan's energy potential, a current deficit can be converted into a future surplus. For future growth of the gas and power sector, public sector enterprises must be made operational during a transitional phase as the basis for greater private sector involvement is established. Accordingly, policy and regulatory functions of concerned ministries will be separated; legal and regulatory frameworks will also be developed. Greater attention will also be paid to cost recovery and administrative reform requirements. The energy sector is one area in which the needs and opportunities for economic cooperation are well understood by the countries of the subregion, and there are strong incentives for cooperation and trade. Finally, with the proper policy and regulatory environment supported by an efficient and effective financial system, Afghan's long-standing expertise in trade and small business will reemerge and lay the foundation for modernization and commercialization of the economy.

The Government with ADB assistance has designed a reform program that will move this country forward on a clear path toward sustainable development. I think you will agree with me that Afghanistan's development framework coincides well with that of ADB. Our top priority

is poverty reduction, based on a community-based participatory process that identifies how best to restructure our education, health, and other essential services. We are committed to an open, competitive economy, where government helps facilitate private enterprise rather than extensively intervening in the employment of productive resources. Very importantly, our government is committed to full transparency and accountability. As agreed with ADB officials, these principles and views are included in the proposed Postconflict Multisector Program Loan for Afghanistan.

I am pleased to inform you that the Government has initiated significant initiatives over the past several months with respect to policy and institutional reforms at both macroeconomic and sector levels, thereby setting the stage for undertaking reconstruction and development work within a consistent framework. As a matter of fact, we have been able to achieve all the first tranche conditions included in the attached policy matrix. All relevant documentation and other supportive evidence to substantiate this claim are available for review by ADB upon request.

I trust that ADB will expedite the loan agreement and that our partnership will continue to strengthen in a most favorable and constructive manner.

Sincerely yours,

Ashraf Ghani Ahmadzai
Minister of Finance

Policy Matrix

Policy Objectives	Actions Prior to First-Tranche Release	Actions Prior to Second-Tranche Release
Program objective: Promote economic growth and poverty reduction through support for market-based policy reforms, public infrastructure investment, and institutional capacity building		
Program purpose: Enhance opportunities for economic revival by addressing key policy and institutional constraints to the efficient and effective functioning of the financial, transport, and energy sectors		
A. Finance and Governance		
1. Improve finance and governance		
1.1 Create an enabling framework for market-based policy and institutional reforms in the financial sector	<ul style="list-style-type: none"> • DAB shall have prepared and submitted to ADB, a draft Central Bank Decree-Law and a Banking Decree-Law to replace 1994 Law on Money and Banking. • ITGA shall have issued a Currency Decree. • DAB shall have finalized a time-bound action plan for the phasing out of commercial banking activities of DAB. 	<ul style="list-style-type: none"> • DAB shall have finalized the drafting of a Decree on bank licensing, regulation and supervision, and submitted to Cabinet for its approval. • MOF shall have established an Accountancy Board with a mandate to (1) develop accounting standards in conformity with international accounting standards, and (2) license practicing chartered accountants. • DAB shall have established a Banking Supervision Department, and shall have prepared and submitted to ADB for its review, a strategic plan for the development of bank supervision functions.
1.2 Improve working of the financial system	<ul style="list-style-type: none"> • MOF shall have commenced drafting of a time-bound action plan for modernizing the payment system. 	<ul style="list-style-type: none"> • DAB shall have drafted a Payments Decree-Law in line with international best practices. • DAB shall have commenced the implementation of a national payments system.
1.3 Improve fiscal management and transparency.	<ul style="list-style-type: none"> • MOF shall have prepared and announced the development budget for FY03 (21 March 2002 – 20 March 2003). • MOF shall have completed a review of the customs procedures. 	<ul style="list-style-type: none"> • MOF shall have prepared and announced the ordinary and development budgets for FY04. • MOF shall have finalized a draft policy statement on public debt management and submitted to ADB for its review, including on the establishment of debt information system. • MOF shall have commenced the simplification of customs procedures and rationalization of tariff structure. • MOF shall have commenced the implementation of public financial accounting procedures.

Policy Objectives	Actions Prior to First-Tranche Release	Actions Prior to Second-Tranche Release
		<ul style="list-style-type: none"> MOF shall have commenced the issuance of monthly reports on public spending and revenue at the central government.
1.4 Improve personnel management in key government agencies	<ul style="list-style-type: none"> ITGA shall have established Civil Service Commission (CSC). 	<ul style="list-style-type: none"> MOF shall have finalized a plan for establishing a central employee database for controlling the payroll. MOF and CSC shall have finalized the strategy for the design and implementation of payroll and personnel records systems for implementation in line ministries, departments and provinces.
B. Transport		
2. Improve efficiency of the transport sector		
2.1 Create an enabling framework for market based competition and efficiency in the transport sector 2.2 Establish safe and reliable transport services that meet gender, environmental and involuntary resettlement objectives.	<ul style="list-style-type: none"> MPW, MOT and MCAT shall have established a working group for the preparation of a Transport Sector Policy Statement (TSPS). 	<ul style="list-style-type: none"> The working group on the preparation of the TSPS shall have submitted the TSPS for consideration by the Government, and for use with the donor community.
2.3 Improve institutional efficiency and effectiveness of ministries and departments in the transport sector	<ul style="list-style-type: none"> The Government shall have initiated the drafting of an action plan for the restructuring of ministries and departments in the transport sector. 	<ul style="list-style-type: none"> The Government shall have finalized an action plan for the restructuring the transport sector institutions.
2.4 Establish regulatory framework for the road transport subsector	<ul style="list-style-type: none"> MOT shall have initiated the preparation of a regulatory framework for operations of the road transport industry. MPW, MOT and MCAT shall have identified institutions to function as regulators in the transport sector, which shall be separate from operations. 	<ul style="list-style-type: none"> MOT shall have finalized the drafting of key regulatory provisions and decree-laws for the road transport subsector. This shall include provision aimed at ensuring the separation of regulatory functions from government operations.

Policy Objectives	Actions Prior to First-Tranche Release	Actions Prior to Second-Tranche Release
2.5 Improve transparency and accountability in transport sector operations	<ul style="list-style-type: none"> AACA, MPW, MOT and MCAT shall have initiated the drafting of standard procurement guidelines, regulation and documentation in accordance with international standards. 	<ul style="list-style-type: none"> AACA, MPW, MOT and MCAT shall have adopted a time bound action plan for the implementation of procurement guidelines and regulations in the transport sector.
2.6 Institute a mechanism for cost recovery in the transport sector		<ul style="list-style-type: none"> MPW and MOF shall have finalized a report on the road financing and maintenance arrangements in place and shall have prepared recommendations on sustainable financing mechanisms in the transport sector.
2.7 Encourage private sector participation in the transport sector	<ul style="list-style-type: none"> MPW, MOT and MCAT shall have commenced the preparation of a comprehensive assessment of legal and non-legal barriers, including policy and regulatory frameworks, for participation of the private sector in road construction and maintenance, and transport services. 	<ul style="list-style-type: none"> MPW, MOT and MCAT shall have finalized a draft legal and regulatory framework aimed at promoting private investment in the transport sector and submitted it to Government for its consideration.
2.8 Establish a system for upgrading national road maintenance and upgrading to meet international standards and to be adequate for sustaining subregional transit traffic	<ul style="list-style-type: none"> MPW shall have initiated the preparation of a plan for the maintenance and development of a national road network. 	<ul style="list-style-type: none"> MPW shall have finalized a plan for the upgrading, maintenance and development of the national road network and shall have submitted such plan to Government for its consideration.
C. Energy (electricity, oil, and gas)		
3. Improve efficiency of the energy sector, and opportunities for investment and development		
3.1 Create efficient, safe, and reliable energy system that meets gender, environmental, involuntary resettlement objectives.	<u>Oil and Gas</u> <ul style="list-style-type: none"> MMI shall have completed the Terms of Reference for a study aimed at evaluating the establishment of the policy, institutional and regulatory framework in the gas sub-sector. MMI shall have completed the Terms of Reference for a study on safety and efficiency improvement in the gas sub-sector 	<u>Oil and Gas</u> <ul style="list-style-type: none"> MMI shall have commenced a study on policy, institutional and regulatory framework for the gas subsector. MMI shall have commenced a study on codes and safety standards for the gas subsector and shall have initiated the preparation of procedures to enforce agreed standards

Policy Objectives	Actions Prior to First-Tranche Release	Actions Prior to Second-Tranche Release
	<p><u>Power</u></p> <ul style="list-style-type: none"> MWP shall have established a working group for the preparation of an Energy Sector Policy Statement (ESPS). 	<p><u>Power</u></p> <ul style="list-style-type: none"> The working group on the preparation of the ESPS shall have submitted the ESPS to ADB for its review. MWP shall have developed a plan to improve system stability and control.
3.2 Separate policy making, regulatory and operational functions for the energy sector to improve efficiency	<p><u>Oil and Gas</u></p> <ul style="list-style-type: none"> MOC and MMI shall have established a working group to study policy, regulatory and operational functions in the oil and gas sector. 	<p><u>Power</u></p> <ul style="list-style-type: none"> MWP shall have initiated the review of the relationship between MWP and power sector public enterprises.
3.3 Develop capacity of ministries and agencies responsible for the energy sector to manage electricity and gas production, transmission and distribution more efficiently	<p><u>Oil and Gas</u></p> <ul style="list-style-type: none"> MOC and MMI shall have commenced a assessment of institutional capacity of the key entities responsible for rehabilitation and reconstruction of the oil and gas sector. 	<p><u>Oil and Gas</u></p> <ul style="list-style-type: none"> MMI shall have commenced the implementation of institutional capacity building for key entities responsible for the rehabilitation and reconstruction of the oil and gas sector. <p><u>Power</u></p> <ul style="list-style-type: none"> MWP shall have commenced the preparation of a master plan for the institutional strengthening of MWP and sector enterprises MWP shall have commenced the preparation of training programs for public servants responsible for the power sector.
3.4 Improve cost recovery	<p><u>Oil and Gas</u></p> <ul style="list-style-type: none"> MMI shall have expressed, in writing, its intent to introduce cost recovery from natural gas users to minimize subsidies. <p><u>Power</u></p> <ul style="list-style-type: none"> MWP shall have commenced the development of a plan to improve financial management systems as well as the billing and collection operations in the power sector. 	<p><u>Oil and Gas</u></p> <ul style="list-style-type: none"> MMI shall have prepared an action plan for improved cost recovery from gas consumers and shall have submitted such plan for consideration by the Government

Policy Objectives	Actions Prior to First-Tranche Release	Actions Prior to Second-Tranche Release
	<ul style="list-style-type: none"> MWP shall have commenced a review of the current tariff and cost structure and shall have initiated the development of a pricing strategy for cost recovery. 	
3.5 Encourage private investment in the energy sector	<u>Oil and Gas</u> <ul style="list-style-type: none"> MMI shall have initiated the preparation of a policy statement on private investment in oil and gas exploration and development. 	<u>Oil and Gas</u> <ul style="list-style-type: none"> MMI shall have prepared a policy statement on private investment in oil and gas exploration and development, and shall have submitted such policy for consideration by the Government
3.6 Improve corporate governance in the petroleum subsector	<ul style="list-style-type: none"> MOC shall have initiated the drafting of standard procurement guidelines and procedures for the import of petroleum products. MOC shall have initiated a comprehensive review of safety and environmental codes for petroleum storage, transportation and distribution. 	<ul style="list-style-type: none"> MOC shall have issued guidelines for petroleum product quality standards.

PROGRAM FRAMEWORK

Design Summary	Performance Indicators/ Targets	Monitoring Mechanisms	Assumptions and Risks
<p>Goal</p> <p>Market-based policies and institutions, sustainable public financing, and improved efficiency of public sector services</p>	<p>Well-defined public sector role, policy and planning capacity, and institutional capability</p>		<p>Government commitment to institution building and reform</p> <p>Political stability</p> <p>Stable security situation</p>
<p>Purpose</p> <p>Improved governance and financial sector efficiency</p> <p>Improved transport and energy sector efficiency</p>	<p>Government capacity for policy making and planning</p> <p>Efficient and effective ministries/concerned agencies</p>	<p>Government public expenditure review</p> <p>Government financial statistics</p> <p>ADB postprogram assessment</p>	<p>Sustained Government commitment to the reform process</p> <p>Macroeconomic stability</p> <p>Technical assistance is implemented effectively</p>
<p>Outputs</p> <p>Governance and financial sector reforms</p> <p>Transport sector reforms</p> <p>Energy sector reforms</p> <p><i>(See policy matrix for details.)</i></p>	<p>Government approval by 30 June 2004</p> <p>Government approval by 30 June 2004</p> <p>Government approval by 30 June 2004</p>	<p>ADB program completion report</p> <p>Government promulgations / acts / decrees</p> <p>ADB review missions</p> <p>Tripartite meeting</p> <p>Aid agency</p>	<p>Government commitment to the reform process</p> <p>External assistance (especially from World Bank, IMF, EU and major bilateral services) in governance and the financial sector, transport and energy is appropriate and forthcoming</p> <p>Risk: ITGA inability to implement the agreed-upon reforms</p>
<p>Activities</p> <p>Preparation and Government approval of priority policy reforms, institutional frameworks, and time-bound action plans.</p> <p><i>(Specific reform measures are detailed in the policy matrix.)</i></p>	<p>Start: October 2002</p> <p>Complete: 30 June 2004</p> <p>Responsible: Cabinet. EA: MOF IAs: MOF, DAB, OAA, CSC, MPW, MOT, MOC, MOMI, and MWP</p>	<p>TA progress reports</p> <p>ADB review missions</p> <p>Tripartite meetings</p> <p>Aid agency</p>	<p>Risk: volatile political situation</p> <p>Risk: unpredictable security situation</p> <p>Risk: adjustment costs higher than ADB anticipated, necessitating a waiver or revision of certain conditionalities</p>
<p>Inputs</p> <p>ADB Postconflict Multisector Program Loan</p>	<p>Resources</p> <p>1st tranche: \$100 million</p> <p>2nd tranche: \$50 million</p>	<p>ADB disbursement records</p>	<p>Advisors under TA 3875-AFG to monitor the reform program closely</p>

ADB = Asian Development Bank, CSC = Civil Service Commission, DAB = Da Afghanistan Bank, EA = executing agency, EU = European Union, IAs = implementing agencies, IMF = International Monetary Fund, ITGA = Islamic Transitional Government of Afghanistan, MOC = Ministry of Commerce, MOF = Ministry of Finance, MOMI = Ministry of Mines and Industry, MOT = Ministry of Transport, MPW = Ministry of Public Works, MWP = Ministry of Water and Power, OAA = Office of Administrative Affairs.

SECTOR ANALYSIS

A. Macroeconomic and Fiscal Performance

1. Macroeconomic Development

1. The macroeconomic performance of Afghanistan cannot be properly assessed due to the absence of reliable statistics.¹ The 1997/98 gross national product (GNP) is estimated at \$6.738 billion, giving a per capita GNP of \$280.² The current level of per capita GNP is expected to be down by at least 37%, which would be about \$182 in 1998 dollars or \$205 in 2002 dollars.³ Given the current deteriorated economic base, a rebound in economic growth is expected in 2002/03. If the short- and medium-term strategies articulated in comprehensive needs assessment (CNA) of key sectors are implemented together with required policy and institutional reforms, the GNP of Afghanistan could return to the level of 1997/98 by FY2006.

2. Monetary Development

2. The need assessment exercises led by the Asian Development Bank (ADB), United Nations Development Programme (UNDP), and World Bank highlighted the importance of a functioning central bank, prudent monetary and fiscal policy, and establishment of a payments system to facilitate transactions and other essential services of the government and other

¹ Compilation of key macroeconomic statistics such as national accounts, prices, labor, government finance, monetary and financial statistics, balance of payments, external debt, and trade statistics was discontinued in the mid-1990s, with the exception of the consumer price index. An International Monetary Fund (IMF) statistics mission to Kabul in April 2002 made a number of recommendations to resume data compilation and capacity building, and an IMF resident statistics advisor was assigned to Kabul in July 2002. Much of the macroeconomic data presented here are ADB staff' estimates based on best available information as of November 2002.

² At the exchange rate of \$1=Af4,679 as quoted in the *Encyclopaedia Britannica, Yearbook 2002*. Country Profile Afghanistan. Population is estimated at 24.1 million in 2002.

³ ADB staff estimate. The Gross Domestic Product (GDP) estimate was derived from an estimate of wheat production prepared by the Food and Agriculture Organization (FAO) and World Food Program (WFP) (Special Report, FAO/WFP Crop and Food Supply Assessment Mission to Afghanistan, 16 August 2002). Applying relevant value added and GDP sector coefficients to the value of wheat production, value added in grain production was derived, to which GDP sector coefficients were applied to obtain first the estimate of value added in agriculture. Total value added (GDP) in 2002 was then estimated at about \$4.4 billion. Adding an estimated \$1.0 billion in net factor income from abroad including transfers, the GNP for 2002 was calculated as \$5.4 billion. Per capita GNP was estimated as \$205 in 2002 in current prices on the basis of a total estimated population of 26.4 million. In 1998 prices, per capita GNP is placed at \$182 on an assumed dollar inflation rate of 3% per annum between 1998 and 2002. It is estimated that the per capita GNP in 2002 prices is underestimated by about \$12-\$26 due to non-accounting of poppy cultivation and by an additional amount of about \$2-\$2.8 due to non-accounting of illegal arms trade. These estimates were derived as follows. **Unaccounted-for value added in poppy cultivation:** In the late 1990s poppy cultivation covered some 90,000 ha (quoted in Food and Agriculture Organization [FAO] and World Food Program [WFP]. Special Report) producing about 5,000 tons of opium before the Taliban succeeded in imposing a complete ban. Recent revival seems to have covered 1-3% of land in some provinces. It is uncertain how much land is now devoted to poppy cultivation. Assuming 90,000 ha has reverted to poppy cultivation (unlikely, 40-50% more likely), the estimated value of production at farmgate is in the range of \$400-\$900 million at \$10,000 per ha (figure quoted by Ashraf Ghani at IG meeting in April in Kabul). Corresponding value added would be \$280 million-\$630 million (value added coefficient is assumed to be 0.7 perhaps a slight overestimation). If we assume that none of it is captured in national accounts statistics, the total value added per capita in 2002 would be underestimated by about \$12-\$26. **Weapons:** As for weapons, legitimate value-added component is value added in illegal arms trade, which is very difficult to estimate. Trade was 11.3% of GDP in 1993. Illegal arms trade could not have been more than 15-20% of it or 1.7-2.3% of GDP, which would translate into \$2.0-\$2.8 per capita in 2002.

entities. The situation on the ground, however, is different. A functioning monetary policy is not yet in place, exchange rates fluctuate widely, and the central bank and commercial banks give no official interest rates. Much work needs to be done to reform accounting for the financial sector, bank supervision, payments system, problems of currency and liquidity, foreign exchange management, and operationalization and modernization of the central bank and the banking system. In the absence of a stable monetary system and an accessible institutional credit system, revival of economic activities will remain problematic. Farmers need short- and medium-term credit to resume agricultural activities, scarcity of working capital will hamper trade and commerce, and unavailability of short- and long-term credit will constrain small and medium enterprises. Absence of credible financial institutions also hamper savings mobilization and financial intermediation. The capital market is undeveloped and modern savings and investment instruments are almost nonexistent. Da Afghanistan Bank (DAB) operates with 89 branches, of which 20 are destroyed and 14 are nonoperational. There are also six banking institutions (two commercial banks, a trade finance bank, an agriculture development bank, a housing bank, and an industry bank), none of which is reported to perform any intermediation functions. Afghanistan will move away soon from the current multiple currency system to a unique currency that would have public confidence and maintain a stable value internally and externally. Liquidity needs of the economy will have to be assessed and decisions taken with regard to the price of money (i.e., interest rate) and the external value of money (i.e., the exchange rate). In principle, the central bank can set the base rate, but allows market forces to determine lending rates to various sectors and individuals. On the exchange rate, a free-floating exchange rate regime that worked well in the past has been adopted.

3. The agricultural development bank is not lending now, as it has no stocks of input or equipment; it is burdened with large loan arrears, much of which is not recoverable; and the real value of loans was reduced by inflation and currency depreciation. The informal credit market, which has been operating through friends and relatives, landowners, shopkeepers, and moneylenders, is the main provider of financial services. For poor farmers, wheat/opium had been a good basis for obtaining credit from moneylenders and shopkeepers. Reviving the financial sector, making the central bank operational, restoring confidence in the financial system, and opening up lines of credit for farmers, other producers, traders and other commercial operators are matters of high priority. In due course, Afghanistan will also have to consider opening up the financial market to foreign banks and, insurance and finance companies.

4. DAB, the central bank for the country, is responsible for monetary policy. During the Taliban regime, the central government was not involved at all in the printing of money, as the Russian company responsible did not deliver it to DAB. The (ATA) has now given DAB full authority over issuance of currency. DAB has decided to completely change afghani banknotes, withdraw the existing banknotes issued by various sources, and introduce new banknotes with much higher security features. It remains to be seen how quickly this can be done. The issuance of new unified banknotes is being discretely planned to avoid speculative actions. To extend control over the currency, DAB will encourage foreign exchange transactions through the banking system and will be involved in auctioning of foreign exchange to ensure that money creation is limited by the holding of foreign exchange reserves at DAB. According to the IMF, the increase in money supply over the first quarter is consistent with the government's target of limiting 12-month inflation to 18%. Formulating and implementing of a monetary policy are difficult without a functioning and modernized banking system. DAB is not yet fully operational and commercial, and other banks are much less so. The country depends on the traditional *hawala* system for money transfer, the only effective payment system in place, and the informal credit market meets the demand for liquidity.

5. The National Development Framework highlights the importance of establishing a central monetary authority for monetary control, payments system, and banking supervision; and establishing a commercial banking system. For the medium- to longer-term, attention is drawn to microfinance, rural finance, and small- and medium-sized enterprises (SME) credit and leasing. A legal framework for banking will be required. While a banking law is being drafted, emergency banking regulations will have to be issued. For microfinance, experience of nongovernmental organizations (NGOs) is positive in the country and internationally, a wide range of options are available, of which the most suitable need to be adapted for Afghanistan. Streamlining the operations of the existing banks and inviting foreign joint ventures can revive commercial banking. Agricultural credit can be provided by a restructured ADB as well as a rural bank. The latter can also finance nonagricultural activities in rural areas. Examples can be drawn from the Bank of Agriculture and Agricultural Cooperatives of Thailand and the Bank Rakyat Indonesia. Growth of private banking with possible support of the International Finance Corporation (IFC) can fill the credit need of SMEs. Banks as well as leasing companies can handle leasing. Financial, institutional, and economic sustainability need to be addressed in all cases. To initiate any of these efforts, external technical support will be required since local capacity is limited or nonexistent.

3. Inflation

6. Consumer prices increased by 68.9% between 1994 and 1998, giving an annual compound rate of inflation of 14%.⁴ Most recently, measured by the available Kabul-based consumer price index (CPI) produced by the Central Statistical Office (CSO), the months following the ouster of the Taliban saw a sharp deflation reflecting the appreciation of afghani, followed by a sharp inflation in the first quarter of 2002, and then followed by a fairly stable price increase in the second quarter of 2002 at 1% monthly, well below the 4.5% envisaged in the monetary program.⁵

4. Exchange Rate

7. The official exchange rate of Af45:\$1 set in 1963 was adjusted to Af3,000:\$1 in April 1996, reflecting among—other factors—weakening of monetary discipline under the Jamiat regime. During the late 1990s, further depreciation of the currency occurred as a result of market forces. BY 2000, the foreign exchange market became more fragmented and volatile, with wide divergence between official, spot, and black market rates and also between Taliban and opposition-controlled areas. By September 2001 the rate had depreciated to Af79,000. Following the start of the war on terrorism in Afghanistan, the currency appreciated significantly, to under Af30,000:\$1 by December 2001. Since then, the afghani has weakened to Af35,000–Af40,000 to the dollar. By September 2002, the exchange rate plunged to Af58,000 or lower, as a result of the announcement that the Government would introduce a new currency.⁶ An upsurge in violence also exacerbated exchange rate volatility.

⁴ University of Nebraska, UN-Omaha Afghanistan Atlas Project.

⁵ Information obtained from IMF mission visiting Kabul.

⁶ On the evening of 4 September, President Hamid Karzai announced a new currency. The new currency will still be called the afghani, but each new afghani will be worth 1,000 old ones. The operation will remove from circulation an inflated currency that has been cumbersome to use, requiring an excessive number of notes for most transactions. The operation to exchange the old notes for new ones is expected to take about 2 months. IMF issued a statement following the President's announcement, saying: "The authorities' decision to introduce a new currency is an important step in their efforts to establish macroeconomic stability and to create an environment that is conducive to restoring sustainable economic growth in Afghanistan. The new afghani will be a

5. Fiscal Development

8. The Ministry of Finance (MOF) needs to quickly develop adequate capacity to formulate and implement a responsible fiscal policy through a comprehensive and unified government budget. Policies on the mobilization of domestic and external resources as well as expenditure policies need to be clearly laid out. Old sources of tax and nontax revenue need to be streamlined and new sources of revenue conceived. An efficient tax administration system must also be put in place. The central Government does not collect much in the form of domestic revenues at present. For the most part, provincial governments retain the amounts collected on border trade. On the expenditure side, an early review of expenditure policies will make government recurrent expenditures manageable and investment expenditures productive and sustainable. During the first years, inevitably the budget will have large deficits, which have to be covered through domestic borrowing and foreign loans and grants. The international community is prepared to transfer a considerable amount of resources on a grant basis, but the country must also be prepared to borrow to jump-start the reconstruction process.

9. On 6 April 2002, the Afghanistan Interim Administration (AIA) adopted an ordinary budget for FY2003 of \$460.3 million.⁷ A development budget, essentially a list of aid-funded investment projects - which covers both FY03 and FY04 - was presented in October 2002 and is estimated at about \$3.2 billion.⁸ The Government projected \$83 million or 18% of total recurrent expenditures in the ordinary budget will be covered by domestic revenue, while the remaining 80% would be financed by external assistance.⁹ According to a report prepared by MOF in October,¹⁰ domestic revenues in the first quarter amounted to \$22.7 million (mainly from customs duties) against planned revenues of \$16 million; however, transmittal of revenues by provincial offices to the central Government and foreign assistance for recurrent expenditures have fallen short of expectations. In addition, \$285.4 million in grants from multilateral (e.g., AIA and Land and Order Trust Funds of the UNDP and the Afghanistan Reconstruction Trust Fund [ARTF] comanaged by ADB) and bilateral sources¹¹ are expected, against the required \$377.3 million. It follows that the revised budget for FY2003 (Table A3.1) includes a net financing gap of \$91.9 million. A fiscal crisis has so far been avoided; however, this is expected to change in the coming months and financial resources are urgently needed. The World Bank is processing direct recurrent budget support of \$100 million through its International Development Association (IDA) resources. While the development budget will need to be largely foreign-financed in the foreseeable future, the ordinary budget will eventually be financed from domestic revenues. As the authority of the central Government extends over the entire country, revenue collections from both direct and indirect sources should increase substantially.

symbol of national sovereignty and unity. The authorities fully recognize that the outlook for the currency will to a large extent depend on the fiscal and financial policies of the government, and the Fund welcomes the authorities' demonstrated commitment to implement sound fiscal and monetary policies. The introduction of a new currency is a major operation with numerous logistical challenges to overcome. Preparations for the change-over are well underway."

⁷ The Fiscal year starts on 21 March. FY2003 refers to 21 March 2002–20 March 2003.

⁸ The Ministry of Finance presented a draft national development budget totaling \$3.18 billion covering 2 fiscal years - SY 1381 and 1382 (22 March 2002 to 21 March 2004) - at a meeting of the Implementation Group in Kabul on 12-13 October 2002.

⁹ Assumed exchange rate is Af34,000=\$1.

¹⁰ Ministry of Finance, Islamic Transitional Government of Afghanistan 2002. Report on Donor Assistance for the Afghanistan Ordinary Budget. A report submitted to the Implementation Group Meeting, 12-13 October 2002, Kabul.

¹¹ Of this amount, \$54 million is categorized as "Expected, Unannounced."

10. MOF has set out to develop a smooth payments system and put in place effective accounting, auditing, and expenditure control measures. As a measure of budget management, cost recovery principles should be followed to reduce the burden on public resources and promote financial sustainability of investment or service provision. For financing investments, mobilization of domestic savings and foreign private investment will be important and will require an enabling policy and institutional environment, including the eventual development of a capital market.

Table A3.1: Financing Requirement and Potential Aid for Operating Budget

Item	SY1381 (21 March 2002–20 March 2003) (\$ million)
Domestic Revenues	83.0
Current Expenditures	460.3
Current Domestic Surplus (Deficit)/ Financing Requirement	(377.3)
Financing Sources	
<i>Donor Assistance Grants</i>	
Multilateral	-
AIATF	26.5
ARTF	159.8
Military Trust Fund	0.5
LOTFA	19.2
Bilateral	
India	10.0
Pakistan	10.0
Denmark	3.4
USA, military salaries	2.0
Expected, Unannounced	54.0
<i>Total Potential Financing</i>	285.4
Net Current Surplus (Deficit)	(91.9)
Pay Arrears	(22.5)
Accumulated IATA Revenue ^a	22.8
Total Surplus (deficit)	(91.6)

^a This has been reserved by the cabinet for the development budget, but deposited in the Treasury Single Account, temporarily supporting ordinary budget expenditures.

AIATF=Afghanistan Interim Administration Trust Fund (UNDP), ARTF=Afghanistan Reconstruction Trust Fund (ADB, IsDB, UNDP, World Bank), IATA = International Air Transport Association, IsDB = Islamic Development Bank, LOTFA=Law and Order Trust Fund for Afghanistan (UNDP), UNDP = United Nations Development Programme.

Source: Ministry of Finance, Islamic Transitional Government of Afghanistan, 2002, Report on Donor Assistance for The Afghanistan Ordinary Budget, submitted to a meeting of the Implementation Group, 12-13 October, Kabul.

6. External Account

11. Available data indicate that Afghanistan has experienced large current account deficits since the late 1990s. Official capital transfers and unofficial transactions (e.g., the drug trade) financed the gap. According to a survey sponsored by the World Bank,¹² Afghanistan's total

¹² World Bank, 2001, "Afghanistan's International Trade Relations with Neighboring Countries 2001."

trade in 2000 was 2.5 billion, comprising \$1.2 billion in imports and \$1.2 billion in exports, most of which comprised reexports. Trade has since fallen sharply, except for emergency food aid and other imports and perhaps exports of opium. The Afghanistan Interim Administration (AIA) and Islamic Transitional Government of Afghanistan (ITGA) have extended the Taliban-imposed ban on poppy cultivation and opium production and eliminated \$8 billion worth of drugs, the ban has been difficult to enforce and poppy cultivation has reportedly picked up once again from 74 tons in 2001 to 2,952 tons in 2002, up from 74 tons in 2001. Reported collections of customs duties gives an insight into the level of imports. In the first quarter of 2002, customs collections were about \$20 million, which implies an annual official import volume of at least \$600 million, assuming an average tariff of 20% and coverage rate of 67%. Imports are likely to grow at the rate of 15–20% annually over the next few years, but exports will likely grow more slowly.

7. External Debt¹³

12. Arrears to the IFIs total about \$54 million (i.e., IDA at about \$27 million, ADB at about \$17 million, and IMF at about \$10 million). Once these arrears are cleared, outstanding debts to the IFIs of about \$86 will be serviced - about \$70 million to IDA and \$15.8 million to ADB. IMF does not have any outstanding debt after arrears are cleared. However, the data on debt to bilateral creditors are very sketchy. The total debt to Paris Club members (excluding Russia) is estimated at about US\$473 million. Outstanding Russian loans amount to \$5.9 billion as of 1991, valued at one-to-one with the US dollar. After including the outstanding balance (deficit) of Afghanistan's bilateral payments agreements as of 1991, total debt owed to Russia amounts to Rubles 6.6 billion. Under the agreement on Russia's participation in the Paris Club as a creditor, Afghanistan would be eligible for an upfront discount of 80 percent prior to any future concessional rescheduling. Other than these information, given the very weak database and the considerable uncertainties about economic prospects, as well as the absence of the precise foresight on how the existing debt might be rescheduled or forgiven, the debt sustainability analysis is very difficult. The results depend very much on the assumptions made on macroeconomic scenarios and debt rescheduling arrangements. While precise conclusions cannot be drawn from the preliminary analysis, general implications are: (i) the achievement of debt sustainability will probably require debt relief that goes beyond the normal terms of debt restructuring; (ii) the debt indicators appear to worsen in the initial period, the duration of which depends on the macro scenario, before they start to show a robust improving trend, and (iii) debt sustainability is very sensitive to positive or negative shocks to output and export growth. The macroeconomic situation needs close monitoring over the medium term before it can be said with any degree of certainty that the Afghan economy is on the desired path. Of course, stability in the security situation and Government commitment to sound macroeconomic management are prerequisites to debt sustainability.

¹³ Based on the latest ADB staff analysis with inputs from IMF staff reflected. Work is underway by IMF staff on the sustainability of Afghanistan's debt. In this work the implications of different scenarios are being explored regarding the extent of debt relief, the mix of external financial assistance (nonconcessional and concessional, including grants), the quality of economic policies and their implementation, and different growth and exports assumptions. Although this work is at a preliminary stage, the early implications are that given the initial level of Afghanistan's external debt, the achievement of debt sustainability will depend importantly on positive policy and growth outcomes and the extent of concessional financing.

B. Infrastructure

1. Transport

13. Road transport plays a major role in delivering humanitarian aid, facilitates the return of refugees and necessary imports, and is vital for the economic recovery of the country. However, more than two decades of conflict combined with continued lack of maintenance has resulted in damage to the road infrastructure including critical structures and bridges and the 2.8 km Salang tunnel that provides vital access to the northern parts of the country. Overall, the road network has been rendered only partly usable, and that too at a significantly high transportation cost. The prolonged state of conflict has also resulted in large-scale deterioration of the civil aviation infrastructure. In addition to lack of maintenance, heavy damage inflicted during the recent military operations further accelerated deterioration.

14. Afghanistan, as a landlocked country, relies on surface and air transport. The road network (Table A3.2) comprises about 6,000 kilometers (km) of national roads, of which 3,300 km are primary highways including 2,400 km roads that were originally paved. The national primary road network consists largely of the ring road (Kandahar–Kabul–Mazar-e-Sharif–Sheberghan–Meymaneh–Herat) and the six international links¹⁴ to neighboring countries. The 615-km Sheberghan-Herat section of the ring road is only partly constructed and is generally unpaved. The remaining network comprising 2,700 km of secondary national roads and 15,000 km provincial roads has either gravel or earthen surface. The coverage and condition details of the tertiary road network consisting of village access roads are not known,¹⁵ except that these roads are all unpaved. Though the road density of 0.03 km of road per square km and 0.88 km per thousand people is far lower than in most developing countries, the road network touches all the major population centers and reaches to a certain extent the remote areas. During the preconflict period, the recorded traffic on the primary network varied between 250 and 1,000 vehicles per day. Recent field visits have confirmed that the traffic levels were improving and in some cases exceed these figures. Based on a recent survey of some sections of the network, the road conditions have further deteriorated, with the Ministry of Public Works (MPW) still in a state of flux due to lack of clear terms of reference of staff, little activity is undertaken except what is carried out by the maintenance division. The ministry is clearly overstuffed and the financial and asset management system is in virtual disarray.

Table A3.2: Major Road Network

Road Classification	Length (km)
National Primary	3,280
National Secondary	2,785
Subtotal	6,065
Province Primary	8,882
Province Secondary	6,043
Subtotal	14,925
Total	20,990

Source: Asian Development Bank, United Nations Development Programme, and World Bank, August 2002, Comprehensive Needs Assessment, Transport Sector, Draft Final Report.

¹⁴ The international links are to Iran (1), Pakistan (2), Tajikistan (1), Turkmenistan (1), and Uzbekistan (1).

¹⁵ According to rough estimates, this is about 15,000 to 20,000 km.

15. Only 26% of the national roads are in fair condition; national roads in poor condition have increased to 54%. Large sections of roads in the southeast (Kabul-Kandahar) and east (Kabul-Jalalabad-Torkham) have been lost. The concrete road from the southeast to the west (Kandahar-Herat-Torghundi) is only partly traffic-worthy due to joint failures and other damages. Only the road to the north (Kabul-Pol-e-Khomri-Konduz-Mazar-e-Sharif) is generally in a better condition after the Salang pass. Between Kabul and the Salang tunnel, 13 bridges require replacement, as well as reconstruction on some sections and deep patching and strengthening on other sections. The Salang tunnel at 3,300-meter elevation is a major constraint, as the tunnel, interior road, and snow gallery are badly damaged and usable only for one-way traffic over a 10 km section.

16. Though the pavement structure has been severely damaged, the road embankment has held up reasonably well despite two decades of civil war and neglect. The effect of recent military actions is most pronounced in the form of damaged and destroyed bridges.¹⁶ Some road improvement activities undertaken during the Taliban period (1996-2001) include asphalt overlay of a 50 km section of the Kabul-Kandahar road beginning from the outskirts of Kabul city. Although all 50 km received base course, the wearing course could only be applied to some 40 km. Similarly about 195 km of the concrete Kandahar-Herat road was repaired by sealing the transverse cracks to provide a smoother surface. It was noted that enterprising transporter were doing patching and minor repairs works to reduce vehicle operating costs in the absence of any Government-financed initiative, particularly on the Kandahar-Spin Boldak road (an important transport artery that leads from Kandahar to the border with Pakistan).

17. Road conditions are perhaps best reflected in travel time. During field visits in March-April 2002, data was collected on actual travel time taken by a four-wheel drive vehicle on major road sections (Table A3.3).

Table A3.3: Travel Time on Primary Road Network

Road	Length (km)	Travel Time (hours)	Average Speed (km/hr)
Kabul-Torkham	227	6.5	35
Kabul-Kandahar	506	20	25
Kandahar-Spin Boldak	105	2.5	42
Kandahar – Herat	560	8.5	64
Kabul- Mazar-e-Sharif	399	15	27
Mazar-e-Sharif-Heraitan	57	2	38
Pol-e Khomri-Shir Khan Bandar	164	12	14

Source: Asian Development Bank, United Nations Development Programme, and World Bank, August 2002. Comprehensive Needs Assessment, Transport Sector, Draft Final Report.

18. The two decades of conflict has affected not only infrastructure, but also the institutions whose capacity to evolve and enforce policies and to develop and implement projects have been significantly depleted. They include MPW which implements all infrastructure

¹⁶ For example, 11 bridges have been damaged on Road Kabul-Mazar-e-Sharif, 1 on Road Kabul-Torkham, and 2 on Kandahar-Spin Boldak.

development programs; Ministry of Transport (MOT), which runs the government-owned vehicles and is responsible for assisting and regulating the largely private-sector-run road transport industry; Ministry of Rehabilitation and Rural Development (MRRD), which plans and implements rural development projects including rural roads; and Ministry of Civil Aviation and Tourism (MCAT), which manages all airports and runs the government-owned airline and tourism business. Lack of capable staff seriously constrains these institutions, which are responsible for leading the recovery and reconstruction efforts in the transport sector. A generation of professional expertise was lost during the conflict period, as most of the knowledgeable staff left the country, and the few who stayed are reaching retirement age. Because no trained human resources were added during this period, a large gap in capacity needs to be filled by recruiting and training the younger generation.

19. As for the role of the private sector, a number of Afghan road contractors, transporters, and equipment suppliers have relocated to neighboring Pakistan and Iran over the past decade as a consequence of the prolonged state of conflict, where they continue to pursue their respective business activities. Some 24 small Afghan road construction contractors¹⁷ operate in those two countries, but are now keen to return to Afghanistan in view of the potential for major development activities. However, their equipment capabilities are limited, and they will need access to financing and capacity building in contract management to gradually take up major road construction contracts directly. Since the beginning of 2002, several of these contractors have returned and established offices in Afghanistan in anticipation of the upcoming development activities.

2. Energy

20. **Gas.** The energy sector is underdeveloped and much of the available capacity has been destroyed. Sales of electricity and natural gas have plummeted. Gas production is now minimal. Afghanistan's proven and probable gas reserve was placed at 5 trillion cubic feet in the 1970s.¹⁸ From a peak of 275 million cubic feet per day (MMcf/d) in the 1970s, output gradually declined to 220 MMcf/d in the 1980s due to declining reserves from producing fields. In the late 1970s Afghanistan exported 70-90% of its natural gas output to the Soviet Union, but exports were discontinued in late 1980s. Gas infrastructure needs to be rehabilitated and upgraded, including wells in the Sheberghan area¹⁹ and pipeline to Mazar-e-Sharif and new pipeline to Kabul. This is a sector with very high potential for the future growth of the Afghan economy. Afghanistan is also strategically located as the transit route for oil and gas export pipelines from central Asia to India and the Arabian Sea.

21. **Electricity.** In the power sector, the current peak demand of 130 megawatts (MW) for electricity in Kabul is largely unmet, as was the 1996 demand of 250 MW. War damage, looting, and lack of spare parts and maintenance have seriously hampered power production and distribution. Lack of funds makes it difficult to procure supplies. It is estimated that power-generating capacity declined from 377 MW in the early 1990s to the current 240 MW. The capacity needs urgent upgrading. Hydroelectric dams are important sources of power supply. Drought-related water shortage affected power supply in recent years, including in the main plants at Naghlu and Sarobi. Important dams include the Kajakai Dam in Helmand Province

¹⁷ With an average annual turnover of about \$1 million each, these contractors are mostly working as subcontractors for civil work activities related to earthworks, aggregate and equipment supply, and some base course and sub-base course works.

¹⁸ U.S. Department of Energy, Energy Information Administration, September 2001.

¹⁹ The Jorqaduk, Khowaja Gogarak, and Yatimtaq gas fields are all located within 20 miles of Sheberghan.

near Kandahar (49.5 MW), Mahipar Dam (66 MW), and Breshna-Kot Dam in Nangarhar Province near Jalalabad, and the Dahla Dam in Kandahar Province. In addition, there is the small gas-fired Mazar-e-Sharif power plant (35 MW). Kabul is fed by three hydroelectric power stations, whose output is downgraded to about 80 MW from a total nameplate rating of 188 MW because the Kabul River on which the dams are sited is fed mainly by melting snow, and the reservoir flow has to be carefully rationed every day. Kabul also has two gas turbine stations: one of 44 MW capacity is no longer economic to run and the second of 45 MW is too expensive for the Ministry of Water and Power (MWP) (4 million a year) to run. Transmission lines from Turkmenistan supply power to cities in northwestern Afghanistan including Herat and Andkhov. This remains an important power supply for the region. Mazar-e-Sharif imported power from Uzbekistan, but payment problems in 1999 interrupted this power supply. This option has to be explored again. MWP is responsible under the 1964 Electricity Act for the electricity sector, and is also responsible for developing of new and renewable energy. MWP has about 6,600 staff positions most of which were occupied 20 or so years ago. About 4,000 staff recently reported back for duty. The Da Afghanistan Bresha Moassese (DABM) is an enterprise under MWP that is responsible for generating, transmitting, distributing, and selling electricity. A serious lack of experienced professional staff in various fields and poor conditions of the offices and workshops prevent MWP/DABM from making any progress in reconstructing and rehabilitating of the electricity sector. It is also necessary to support MWP in devising policies and strategies for sector development, efficient institutional management, and human resource development.

C. Environment

22. No natural resource is more precious in Afghanistan than water, and water management systems throughout the country have been severely damaged during years of internal strife. As the country looks ahead to peace and prosperity, both rural and urban residents alike are looking to the restoration of water management systems to support domestic supplies, irrigation, industry, generation of hydropower, and the natural environment. Several water-related issues are especially significant from a natural resources management perspective, land degradation from poor irrigation practices, groundwater management, and hydropower development. Any efforts to develop the country's enormous hydropower potential through other than mini-hydropower schemes also will need to apply accepted international norms for environmental and social planning and protection such as those based on the recommendations of the World Commission on Dams. One of the most critical environmental problems of Afghanistan is massive deforestation and overgrazing, which can be aggravated by the return of the refugees, especially if their livelihoods cannot be restored quickly and they employ environmentally unsound practices. The hostilities of the past 20 years caused extensive deforestation. By 1991, the forest cover had declined from 3.4% to 2.6% of total land area. Since then, continued timber harvesting and the use of forest resources for fuel have reduced the forest cover to less than 2% of the total area. The consequences are degradation of watersheds, soil erosion, and desertification, all of which reduce soil productivity. Reservoir siltation will adversely affect hydropower generation. Land degradation has also been caused by land mines, which reduce access to agricultural land and irrigation. The country's 40 million ha of pasture cover has remained under threat. Uncontrolled urbanization in Kabul and Herat and, to a lesser extent, in Mazar-e-Sharif and Kandahar, and encroachment on fertile lands are threatening agricultural sustenance to the cities. Lack of safe water and sanitation and inadequate management of solid waste have damaged environmental health.

23. Other environmental issues include toxic residues from chemical warfare, use of agrochemicals, and degradation of wetlands. The approach to environment preservation and

enhancement has to be based on local traditional knowledge and people's participation. People have to have choices and means to take rational environment-friendly decisions. Costs of environmental degradation and benefits from environmental preservation have to be made transparent. An appropriate policy and incentive framework will ensure that individuals and communities contribute to sustainable development. Mainstreaming environmental concerns in all sector development projects will either prevent actions threatening to the environment or put appropriate mitigation measures in place. Some key actions related to environmental management include preparation of a national conservation strategy, development of baseline data and a relevant training program, creation of capacity to formulate policies, an institutional framework and guidelines, environmental monitoring, establishment of protected areas, stabilization of natural forests, development of a sustainable grazing system, and drafting of an environmental law. The proposed program loan lays the foundation for environmentally sound infrastructure reconstruction and development, especially in the road transport, oil and gas and power sectors. In addition, ADB is assisting the government to develop renewable energy in small towns and rural areas of Afghanistan, which will contribute significantly to improved health conditions as well as reduce pressure on fuelwood supply.

Poverty Impact Matrix

Channel of Impact	Direct Short-Run	Indirect Short-Run	Indirect Medium-Run	Major Groups Affected
Labor market	Employment creation through rehabilitation activities		Improved functioning of labor markets	Direct – unskilled labor Indirect – entrepreneurs
Prices of goods and services		Stable prices through macroeconomic stability	Improved functioning of goods markets, enhanced productivity, and regained private sector confidence	The economy in general will benefit.
Access to public services		Improved access to public services through enhanced public sector planning and execution	Cost-effective delivery of public services, Improved user confidence	Mainly the poor will benefit from this channel.
Access to assets			Improved security and property rights, Improved access to financial assets	The poor, especially internally displaced persons will benefit from this channel
Transfers			Improved fiscal space for pro-poor transfers Improved room for private transfers, too.	Mainly the poor would benefit from this channel

Net Impacts: The direct impact of the Program is partially pro-poor to the extent that the loan proceeds end up financing physical rehabilitation investments. The indirect impact can be generally pro-poor as the majority of the population is considered poor.

Narrative: The actions taken under the Program will contribute to institution building for efficient public sector administration and policy making conducive to private-sector-led economic growth, which will naturally reduce aggregate poverty. Indirect impacts can benefit the poor disproportionately through improved access to public services that have been otherwise limited to the urban population.

Note: Due to the absence of any poverty assessment and sheer lack of relevant data, the analysis here is based purely on logic and envisaged stylized intention of generic institutional reform type programs.

ADJUSTMENT COSTS

A. Underlying Principles

1. The proposed Postconflict Multisector Program Loan (PMPL) for Afghanistan considered four associated costs with intertemporal, distributional, political economy, and developmental dimensions. Under any circumstances, adjustment is a change process that takes time, depending on the preprogram situation, vested interest, underlying structural rigidities, and to response and effect lags. In the case of Afghanistan, a beginning is being made through the proposed loan to rebuild an appropriate policy and institutional framework for the economic sectors and support the operation of a market-based economy. For this, capacity has to be developed to elaborate and introduce reform measures, enforce and sustain these measures, and make provision for other costs associated with relative price changes, essential reconstruction and rehabilitation, and structural changes. Institutional reforms and related capacity building are likely to extend well beyond the usual administrative life of a program loan. Specific provisions will have to be made for two types of intertemporal costs. First, there are the broad costs of the process of adjustment that include possible structural changes, institutional changes, attendant resource reallocation and market realignments, reabsorption into new structures, and compensation for those who may lose from the reform. Second, there are the real financial costs of the institutional change, such as compensatory payments, loss of revenue, new recurrent costs, and other changes in public expenditure.

2. Closely related to the lagged effects and intertemporal issue of policy change are the implications for intra- and intertemporal distribution of income, and compensation for losers.¹

3. It is recognized that both policy reforms and institutional reforms proposed here have a predominantly developmental characteristic, and involve the dismantling and reforming of existing underperforming institutions while at the same time developing, through investment-type activity, new institutional arrangements for future development. It will take time for the entire process to work out. A practical implication of this is that the entire package needs to be placed in the context of medium-term recurrent budgeting and funded from internal and external resources as required. Importantly, unless the reformed institution receives sufficient recurrent spending (e.g., for operation and maintenance expenses), the performance is likely to decline even in its reformed state. In the case of the PMPL, reforms are thus regarded as the creation of policy and institutional assets that require maintenance through recurrent spending, part of which is provided under the proposed PMPL. Given the insufficiency of domestic budget resources for capital and recurrent items, a future need for additional external recurrent cost financing is likely. Estimates will become known through the medium-term expenditure framework (MTEF), to be developed with support from the ADB-financed technical assistance cluster and the PMPL.

B. Estimation

4. Four cost elements are considered for the proposed program: (i) costs of compliance with the new legal and regulatory systems and standards, (ii) costs of capacity building, (iii)

¹ The envisaged poverty impact of policy change measures supported under the PMPL is presented qualitatively in Appendix 4, taking account of probable distributional and intertemporal effects.

costs of enforcement, and (iv) costs of price adjustments. Adjustment costs cover technical expert input, administrative support, training, compensation package, and building and equipment associated with compliance, capacity building and enforcement. Where appropriate, costs of price adjustments are also to be included. Due to the dynamic and hard-to-trace political economy circumstances, stakeholder and distributional aspects of the adjustment costs were beyond the scope of the estimation exercise here. Costs of capacity building are included as proxies for costs of institutional changes and development required to achieve the desired outcomes, which may well underestimate the real institutional costs involved.

5. The summary of the adjustment costs is shown in Table A5. Detailed assumptions are in Annex 1 (available upon request). The major costs under reforms of governance and finance are costs associated with (i) the introduction of the new official Afghan currency; (ii) the implementation of the national payments system; (iii) simplification of customs procedures and rationalization of customs tariff structure; and (iv) enhancing efficiency and effectiveness of civil service. The major costs for reforms of the transport sector are costs associated with (i) finalizing a plan for restructuring transport sector institutions; (ii) adopting and implementing of cost recovery mechanisms, such as construction of toll booths and weighing stations; and (iii) the establishment of a sustainable financing mechanism of national road reconstruction and maintenance. The major costs for reforms of the energy sector are costs associated with (i) improving the efficiency of sector ministries and institutions, (ii) developing capacity, (iii) creating a market framework, (iv) promoting cost recovery; and (v) promotion of private sector participation.

6. The estimation exercise here was carried out based on many uncertain assumptions and should not be seen in the same nature as cost estimates of well-defined investment projects. It should also be noted that the particular nature of the proposed loan makes it difficult or inappropriate to directly link the way loan proceeds will be actually utilized within the proposed utilization period to the adjustment costs estimated here. The latter will arise inherently over the medium term, and much may accrue without the loan to the extent that the Government sustains its ownership of and commitment to the program. Therefore, the policy matrix presented in Appendix 1 and the associated adjustment costs presented here should be seen in light of reinforcing/supporting the Government's efficient and sustainable implementation of the rehabilitation and reconstruction activities to follow once the basic institutions and policy framework are put in place.

Table A5: Adjustment Costs ^{a,b}

Item	Amount (\$ million)
A. Governance and Finance	
Market-based policy and institutional reforms	28.8
Financial system reform	17.1
Fiscal policy reform	8.8
Structural reform of government	3.5
Subtotal	58.2
B. Transport	
Creating a market framework in the transport sector	0.7
Improving institutional efficiency in the transport sector	7.8
Establishing regulatory framework for the transport sector	2.3
Improving private investment in the transport sector	1.3
Promoting cost recovery in the transport sector	1.0
Promoting private investment in the transport sector	1.0
Establishing a system of national road reconstruction and maintenance	61.5
Subtotal	88.5
C. Energy	
Oil and Gas	
Creating a market framework in the power sector	1.7
Separating regulatory and operational functions in the gas sector	0.7
Capacity development in the gas sector	1.2
Promoting cost recovery in the gas sector	0.8
Promoting private sector participation in oil and gas sector	1.1
Promoting improved corporate governance in the petroleum subsector	1.4
Power	
Creating a market framework in the power sector	1.1
Separating regulatory and operational functions in power sector	0.4
Capacity development in the power sector	1.2
Promoting cost recovery in the power sector	1.5
Subtotal	11.2
Total Adjustment Costs	158.2

^a Four cost elements are involved: (i) costs of complying with the new legal and regulatory systems and standards; (ii) costs of capacity building; (iii) costs of enforcement; and (iv) costs of price adjustments. Adjustment costs cover technical expert input, administrative support, training, compensation package, and building and equipment associated with compliance, capacity building and enforcement. Where appropriate, costs of price adjustments are included.

^b The estimated amounts are rounded off at \$1 million. Details of the assumptions are available upon request

INELIGIBLE ITEMS

1. The proceeds of the loan will be utilized to finance the foreign exchange expenditures for the reasonable cost of imported goods (excluding any duties or taxes) required during the execution of the Postconflict Multisector Program Loan. All imported goods financed from the proposed loans must be produced in, and procured from, the Asian Development Bank member countries.

2. Notwithstanding the provisions of paragraph 1 above, no withdrawals will be made from the loan proceeds for the following specified items:

- (i) expenditures for goods included under the following groups or subgroups of the United Nations Standard International Classification, Revision 3, or other successor groups or subgroups under future revision:

Group	Subgroup	Description of Items
112		Alcoholic beverages
121		Tobacco, unmanufactured tobacco refuse
122		Tobacco, manufactured (whether or not containing tobacco substitutes)
525		Radioactive and associated materials
667		Pearls, precious and semiprecious stones, unworked or worked
718	718.7	Nuclear reactors, and parts thereof; fuel elements (cartridges) nonirradiated, for nuclear reactors
897	897.3	Jewelry of gold, silver or platinum group metals (except watches and watch cases) and goldsmiths' or silversmiths' wares (including set gems)
971		Gold, nonmonetary (excluding gold ores and concentrates)

- (ii) expenditures in the currency of the Borrower or of goods supplied from the territory of the Borrower;
- (iii) expenditures for goods intended for military or paramilitary purpose or for luxury consumption;
- (iv) expenditures for pesticides categorized as extremely hazardous or highly hazardous in classes 1a and 1b, respectively, of the World Health Organization's Classification of Pesticides by Hazard and Guidelines to Classification;
- (v) expenditures for goods supplied or to be supplied under any contract that a national or international financing institution or any other financial agency has financed or agreed to finance, including any contract financed or to be financed under any loan from the Asian Development Bank; and
- (vi) expenditures incurred more than 180 days prior to the effective date.

DEVELOPMENT COORDINATION MATRIX

Institution Building and Reform Agenda	Dates/Timing	Provider
<p>- ADB's proposed loan (\$150 million) and World Bank's IDA loan (\$100 million) are the only proposed loan assistance in 2002. Sector level reforms have yet to commence - the proposed ADB program will be the first of the kind handling infrastructure subsectors.</p> <p>- This table mainly covers financial management and governance capacity building, while ADB's technical assistance related to transport, energy, education, health, agriculture, environment, and women's affairs are not covered below.</p> <p>- The summary table below benefited from and builds on the information provided by IMF.</p>		
<p>1 Payments System</p> <p>1.1 Support for the immediate operationalization of the payments system in Kabul Preparation of a master plan the developing of a national payments system</p>	Oct 02 / Oct 03	- ADB-funded technical advisors
<p>2 Customs Reform</p> <p>2.1 Customs policy Review customs law and regulations to</p> <ul style="list-style-type: none"> - revise exchange rate for customs valuation; - streamline customs tariffs; - introduce customs tariffs on petroleum products imports. <p>2.2 Customs administration</p> <ul style="list-style-type: none"> - ensure availability of updated customs regulations in all customs offices; - establish model customs offices in Kabul, Jalalabad, and Torkham and gradually expand these pilots to all customs houses; - develop a statistics database for trade information; - create a fraud investigation function in the customs department; - provide training to customs staff and establish a central training facility in MOF; - provide basic infrastructure (including 5 computers) for effective operation of the customs service; 	<p>Aug 02 / Aug 03</p> <p>Aug 02 / Aug 05</p>	<ul style="list-style-type: none"> - DFID (resident experts) - USAID (1 short-term mission in Aug 02) - IMF (short-term missions) - Mostly DFID (resident experts) - Possible future EU participation - GTZ (purchase of equipment and rehabilitation of training customs center) - IMF(short-term missions). - ADB-funded MOF advisor (Sep 02 - Mar 04)
<p>3 Tax Reform</p> <p>3.1 Tax policy Amend tax legislation and regulations to</p> <ul style="list-style-type: none"> - impose the criterion of residence as the basis of the individual income tax; - extend the loss carryover period; - establish wage withholding on higher-income employees; - expand the business receipt tax to cover services provided to higher-income employees; - liberalize depreciation allowances to provide incentives for investment; - introduce excises on tobacco, petroleum products, and (possibly) automobiles; - create a broad-based consumption tax; - define a fiscal regime for petroleum and mining sectors as well as any transit pipelines. <p>3.2 Tax administration</p> <ul style="list-style-type: none"> - ensure availability of updated tax regulations in all tax offices; - improve control and supervision of the MOF headquarters over tax operations in provincial offices; - introduce large taxpayers units (as well as model offices for medium taxpayers) in 3 pilot provinces, and gradually expand the pilots; - establish unique Tax Identification Number (TIN) and simple PC-based taxpayer database; - design "risk-based and "selective" auditing procedures; - improve collection and enforcement procedures at the center and in the provinces; - reduce current manual procedures by gradually introducing tax software; 	<p>Oct 02 / Oct 05</p> <p>Oct 02 / Oct 05</p>	<ul style="list-style-type: none"> - USAID (resident experts) - IMF (short-term missions) - ADB-funded MOF Advisor (Sep 02 - Mar 04) - Mostly USAID (resident experts) - IMF (short-term missions) - ADB-funded MOF Advisor (Sep 02 - Mar 04)

Institution Building and Reform Agenda	Dates/Timing	Provider
- provide training programs for Treasury staff.		
4 Public Expenditure Management Reform 4.1 Budget preparation - assist MOF in the preparing the current and development budgets; - improve the budget preparation process in MOF and line ministries; - introduce GFS-consistent economic and functional classifications; - introduce a simple medium-term expenditure framework (medium-term) 4.2 Budget execution and Treasury functions - reestablish basic accounting functions at the center and in provincial treasury offices; - develop a centralized reporting system to prepare monthly, quarterly, and annual consolidated financial statements (center + provinces); - ensure full reconciliation between budget execution data and central bank's accounts; - enhance coverage of the government's Treasury single account; - establish new accounting model and chart of accounts; - re-introduce expenditure controls (pre-audit and commitment recording/control); - develop an integrated financial management information system embracing all levels of government (longer term). 4.3 Audit - develop capacities of the Supreme Audit Institution (SAI). 4.4 Procurement - restore procurement functions in MOF and line ministries.	Jan 02, continuing Aug 02/Aug 04 Aug 02/Aug 04 Aug 02/Aug 04	- World Bank (resident experts) - US Treasury (resident expert) - USAID (specific program starting in October 2002) - ADB-funded MOF Advisor (Sep 02 - Mar 04) - IMF (short-term missions + resident expert for expenditure classification) - Mostly World Bank (finances the services of an international private consulting firm) - IMF (short-term missions) - World Bank (finances the services of an international private consulting firm) - World Bank (finances the services of an international private consulting firm)
5 Payroll and Civil Service Reform 5.1 Payroll preparation - build capacity in the central government and provinces to prepare ministerial and provincial payroll (training and basic computerization). 5.2 Payroll pre-audit and verification - develop a database of legitimately employed staff; - establish payroll recording systems in line ministries and provinces; - train comptrollers in line ministries and provinces. 5.3 Payroll processing - prepare monitoring reports in the MOF; - identify separately police, military, and staff working in government enterprises; - establish a specialized payroll unit in the MOF (longer term); - move towards computerization (longer term) 5.4 Payroll audit - introduce ex-post audit to ensure that payments are received by intended beneficiaries. 5.5 Civil service and pension reform - decompress salary scale; - implement pension reform; - train comptrollers in line ministries and provinces.	Nov02 Sept 02/Sept 04 Sept 02/Sept 04 Sept 02/Sept 04 Sept 02/Sept 04	- ADB technical assistance - World Bank (payroll adviser); - DFID (payroll database); - ADB technical assistance - World Bank (through financial management and ARTF monitoring agents) - World Bank (through audit agent) - World Bank (payroll adviser)
6 Macro-Fiscal Coordination - establish macroeconomic projection and analysis capacities in the MOF; - ensure coordination between DAB, CSO and MOF on macro-economic analyses	Oct 02/ continuing	- US Treasury - USAID - ADB

ADB = Asian Development Bank, ARTF = Afghanistan Reconstruction Trust Fund, CSO = Central Statistics Office, DAB = Da Afghanistan Bank, DFID = Department for International Development, EU = European Union, GFS = Government Financial Statistics, GTZ = Deutsche Gesellschaft Technische Zusammenarbeit, IDA = International Development Association, IMF = International Monetary Fund, MOF = Ministry of Finance, USAID = United States Agency for International Development.

THE NATIONAL DEVELOPMENT FRAMEWORK
Official Summary
Kabul, April 2002

Preface

The following is an early first draft of the Afghanistan National Development Framework. The draft reflects directions provided by the Board of the Afghan Assistance Coordination Authority (AACCA), chaired by the Chairman of the Interim Administration and individual consultations carried out by the Ministry of Planning, the Ministry of Reconstruction and the AACCA. The draft is based on inputs from the government departments, Joint Needs Assessment process and inputs from other actors on the ground.

This document attempts to set out national strategy and includes national priorities and policy directions.

This early first draft is presented to the participants of the Implementation Group in order to convey an early sense of the direction taken by the Interim Administration in the development of the country, and to place in an appropriate context the priority projects presented in the course of the meeting. It is envisaged that within six weeks a National Development Budget will have been finalized. Finalization will entail a further series of extensive consultations with ministries, international organizations and the NGO community.

The ongoing process to create the national development budget has included the establishment of the Development Budget Commission, composed of the Ministry of Planning, Ministry of Finance, Ministry of Reconstruction and the AACCA. All projects are expected to be anchored in one of the programs identified within the National Development Framework, unless exceptional circumstances apply. In this regard mechanisms for project and program review are being established.

The National Development Framework

There is a consensus in Afghan society: violence as a means of compelling the majority to submit to the will of a minority must end. The people's aspirations must be represented and reflected in an accountable government that delivers value on a daily basis. This consensus forms the foundation for a vision of a prosperous and secure Afghanistan. The current poverty of the country is painfully obvious; this vision of a peaceful and prosperous future is a beacon that can mobilize the energies of an enterprising and independent people, guide them in their collective and individual pursuits, and reinforce the sense of national unity, mutual dependence and participation in a common enterprise.

Our people are poor, the majority is illiterate, but the sophistication of political debate and awareness is remarkable, in great part due to the international media. Despite the years of war, our opinions are also shaped by a myriad of networks that link us to the international community. There is a widespread desire to retain the current international interest in our country, and to channel it in ways that would lay the basis for multiple partnerships between different groups in our society and the global community.

This desire for engagement is premised on the hope that international engagement will be an instrument for ending our poverty, the re-establishment of our sovereignty and national unity,

and a foundation for sustainable prosperity. Our people's expectations have been raised by the promises of world leaders that they will be with us for the long haul. The succession of visits and delegations are a sign to our people that the engagement is continuing.

Discussions of development, however, remain abstract. Public opinion is shaped by concrete manifestations. If the general discussions are not connected to changes in the daily lives and experiences of the people, public opinion could easily turn skeptical.

Afghans have been disappointed by the international community before. Hope could then be replaced by frustration, and frustration, in a context of raised expectations, is a recipe for anger, discord and finally conflict. For us to capitalize on the current consensus, then, we must deliver, and deliver soon; as words become deeds, belief in the possibility of a safe and prosperous future will grow.

Delivering rapidly, however, does not mean delivering unwisely. We must internalize the lessons of 50 years of experience of international assistance. Afghanistan offers a unique opportunity to prove to the skeptics that the aid system is relevant in a post-conflict context, and that difficult challenges can be met with determination, partnership and vision.

Five lessons stand out:

- First, the developmental agenda must be owned domestically, and the recipient country must be in the driver's seat.
- Second, the market and the private sector is a more effective instrument of delivering sustained growth than the state.
- Third, without a state committed to investing in human capital, the rule of law, the creation of systems of accountability and transparency, and providing the enabling environment for the operation of the private sector, aid cannot be an effective instrument of development.
- Fourth, people in general and the poor in particular are not passive recipients of development but active engines of change. Sustainable development requires citizen participation and adopting of methods of governance that enable the people to take decisions on issues that affect them and their immediate surroundings.
- Fifth, donor- funded investment projects, unless they are anchored in coherent programs of government, are not sustainable. Structural adjustment programs, unless they are translated into feasible projects, do not result in reform.

There is an emerging consensus that the budget must be the central instrument of policy, and that the country should have the capacity to design programs and projects that are part of a coherent developmental strategy. All interventions must have clear outcomes, and be properly monitored.

The Strategy

Our developmental strategy has three pillars: The first is to use humanitarian assistance and social policy to create the conditions for people to live secure lives and to lay the foundations for

the formation of sustainable human capital. The second is the use of external assistance to build the physical infrastructure that lays the basis for a private sector- led strategy of growth, in such a manner as to support the building of human and social capital. The third pillar is the creation of sustainable growth, where a competitive private sector becomes both the engine of growth and the instrument of social inclusion through the creation of opportunity.

Cutting across all our activities will be the issues of security, of administrative and financial reform, and of gender.

A brief outline of the programs and sub-programs contained in each pillar will be provided here, the Annexes contain a more detailed description.

Pillar 1 – Humanitarian and Human and Social Capital

We are still in the midst of a humanitarian crisis. We are keenly aware of the needs and conditions of our vulnerable people. We need immediate action in the following areas: Refugees and returnees; between 1.4 to 2m refugees are expected to return to their homes, along with thousands of internally displaced. A systematic and integrated approach will be required if we are to help them re- integrate safely and develop secure livelihoods rather than end up in shanty towns. Education, after years of neglect and worse, will be the foundation of economic growth and poverty reduction. Vocational training is a priority, in particular to assist the mujahadeen, many of whom have sacrificed so much in the cause of freedom **(1.1.2)**, and to assist women **(1.3.1)**. Health and nutrition will require massive and long-term investment if we are to lift Afghanistan from 169 in the human development index **(1.2.1)**. Two areas need particularly urgent attention, malnutrition, and better obstetric care that will bring down the unacceptably high levels of maternal and infant mortality rates **(1.2.2)**. Afghans have shown a remarkable ability to survive in the face of disaster, but there is a need to invest in livelihoods to facilitate our enterprise in the search for a good living. And finally, after the ravages of the Taliban, we must act fast to preserve our national heritage, we must remember the vital role of culture in the process of national reconstruction and defining Afghan identity.

It is vital that we take an integrated and programmatic approach to all work in this pillar.

We cannot afford sectoral and localized projects that lead to disconnects. So we are initiating two, large-scale, integrated programs as the foundation of much work in this pillar. Firstly we will initiate a national community development program, known as National Solidarity, which will deliver block grants to communities across the country **(1.4.1)**. And secondly we have designated 10 key areas for special attention because they have been worst affected by human rights abuses and will be centers of refugee and IDP return **(1.4.2)**. We are requesting the UN agencies and bilateral donors to help us develop rapidly a series of projects in these areas.

Pillar 2 – Physical Reconstruction and Natural Resources

We intend to begin the reconstruction and expansion of the physical infrastructure as soon as possible. The government is committed to launching public works programs immediately in order to offer opportunities to the unemployed and under-employed **(1.1.1)**. We have identified a number of programs in this area and are in the process of preparing specific projects within each of the programs. For example, roads **(2.1.1)**, water and sanitation **(2.2.1)**, and the energy sector **(2.3.1)** all need urgent attention. As the country will be rebuilt by its families, we also need to ensure people have access to building materials **(2.3.2 & 3)**.

In urban management our aim is to invest in a balanced urban development program across the country to create viable cities that are hubs of economic activity, and organically linked to rural areas **(2.4.1)**. With the concentration of population in some cities, they would play a major role in the overall improvement of human development indicators. In terms of municipal infrastructure we need to focus on some immediate and pressing needs such as roads and transport **(2.4.2 & 3)** sewerage, waste management, drinking water and sanitation.

As much of the physical infrastructure of government has been destroyed, we will implement a national program of construction that will create or restore the physical infrastructure of government across the country.

Our approach to physical infrastructure is based on lessons from international experience. The state will define the areas of priorities, but it will not be the implementing agency. Instead, we will turn to the national and international private sector to help us design and implement our projects. Communities and NGOs will be asked to participate in identification, monitoring and evaluation of these programs and projects. We will pay serious attention to the operation and maintenance costs of these projects and will be looking closely at their financial and economic sustainability. The issue of medium to long-term consequences of short-term interventions has already become clear in the health sector. For example, there has been considerable interest in the rehabilitation or construction of hospitals in Kabul. But our health experts are pointing out that the recurrent costs of hospitals located in the capital could be a serious drain on resources that could be more usefully directed towards preventative medicine.

Pillar 3 –Private Sector Development

The implementation of the infrastructure program will give some impetus to the development of the private sector, but it is in the development of a competitive export-oriented economy that our real hopes for the private sector lie. We are in the fortunate position that the European and American markets are open to our exports. We are in the process of being granted most favored nation status and we are receiving strong support from the US Administration and Congress for textile quotas.

We need to meeting international standards on health, organic agriculture, child labor, certificates of origin, and other technical requirements. We will need assistance in these areas and consultations with our entrepreneurs to explain the opportunities that exports to Europe will provide. The development of the export market for our agricultural and horticultural products is critical to our strategy of eliminating poppy cultivation. With high-value and low-volume products, we can be confident of offering our farmers secure livelihoods. We are planning to use our OPIC guarantee to assist in the development of an agricultural processing industry.

Recognizing the enormous international interest in Afghanistan, we are creating a “Made in Afghanistan” label and “Made in Afghanistan by Women” label to enable Afghan producers to realize the maximum from their labors. We hope to link Afghan producers to a number of large department stores. Afghanistan has considerable assets; sustainable use and development of these assets will require foreign direct investment. We are working on the relevant policy and legal frameworks that would attract investment, including, for example, the urgent need for a basic regulatory and licensing framework for telecommunications **(4.1.2)**.

We must also use internal trade as a way of binding the country back together again, economically as well as politically. Alongside the roads programs already mentioned, this will mean reinvestigating our market places in secondary and tertiary towns **(3.1.1)**.

Governance, financial management and administrative reform

We know that good governance is a precondition for attracting direct foreign investment. We are addressing the issues of financial management, auditing and procurement through hiring international private firms chosen on the basis of direct competition. Our goal is to have a budgetary process that would meet the international standards for receiving direct donor support for reconstruction and development projects. Building the domestic revenue collecting ability of Afghanistan will be a key part of the reconstruction process. Revenue capacities, and particularly the national unity of the revenue collection system, have been in disarray during the recent period and need to be rebuilt.

The degradation of our financial institutions in fact offers us an opportunity to move forward with speed and determination in creating management systems that will provide the underpinning for accountability, efficiency and transparency. Our banking sector requires a major over-haul, and we are embarking on this process. The Central Bank's role is being strengthened and the government has made a commitment in its budget decree to observe financial discipline and not resort to overdraft. We are emphasizing the need for urgent capacity building in the Central Bank and the banking sector and are requesting urgent technical assistance in this area. We are examining the relevant laws and regulations and are preparing a series of measures to provide a firm legal basis for a modern financial sector.

Rule of law is the basis of good governance. The administration has strictly abided by the Bonn agreement and is determined to see the Emergency Loya Jirga take place on time. We are determined to use the time remaining to the Interim Administration to prepare proposals and plans for strengthening the rule of law and to implement measures that would enhance the confidence of our people in their government.

We view the principle of accountable government as applying as much to our development policy as our administrative and judicial. We in the advanced stages of planning a national community empowerment program, called National Solidarity, that will deliver a series of block grants to communities to enable them to make decisions in a participatory manner on their key priorities. We are planning to cover at least 1 to 2 districts in every province under this program. This approach should enable members of the communities to choose their local leaders, and to strengthen their collective efforts in mobilizing their own resources to supplement those provided by the government.

We must get the balance right between Kabul and the provinces, between the urban centers and the rural areas. This is important both to ensure an equitable balance in our investments, and in terms of the political and administrative relationship. All interventions, whether roads, sanitation, power or drinking water, will be chosen on the basis of an even-handed approach to spatial development that focuses on needs not on ethnic group. While Kabul's needs are immense, and there is an urgent need for a comprehensive reconstruction plan of the city, our focus must be the entire country. The physical infrastructure of government is either destroyed or severely damaged. We are therefore planning a major program of construction of the physical infrastructure of governance across the country. Each ministry and district must have a minimum number of facilities **(4.1.3)** and these facilities should be equipped with means of communication to enable speedy flow of information between levels of government and to connect Kabul to the provinces **(4.1.1)**. Only then will we be able to link up the country under a unified government.

We have carried out an assessment of the capacity of our line ministries and have reached the conclusion that we need an innovative approach to the rapid building of capacity as well as a strategy for reform of the administrative system. Our approach to the immediate problem is to create implementation cells of between 10 and 40 people in line ministries. The staff of these cells, to be recruited on the basis of clear criteria of merit, technical competence and clear definition of tasks, will be provided with the resources to translate our overall programs into specific projects and oversee the implementation of these projects by the private sector, NGOs and international contractors. They will be supported by technical assistance from donors and will work closely with AACA to enhance coordination between communities, the government, donors, NGOs and the UN.

We will be adopting a similar approach to the provincial administration.

The years of conflict degraded the civil service. We now need to start work in earnest on the important task of creating a modern and efficient civil service.. The Civil Service Commission has been selected and will start its work soon. It will need to be supported by strong analytic work and by inputs from key actors in the development arena to formulate and implement a comprehensive agenda of reform. Of particular importance will be training, in both management and technical areas. A civil service training college is being proposed.

Pay scale is a critical issue. NGOs, bilateral, multilateral organizations and the UN system have pay scales that exceed the government's pay scale by a factor of 50 for their national staff. The differential in pay between international staff and government staff is a factor of 1000 to 2000. Such an uneven playing field militates against the building of capacity. While the market cannot be controlled, there has to be an imaginative and principled approach to addressing this critical issue. Donors should make a clear commitment to increasing the number of their Afghan national staff and should join the government in setting up a task force to propose sustainable solutions to this problem. Without a workable solution, this problem will haunt all our good intentions for creating capacity.

Security and the Rule of Law

Rule of law and good governance depend on security. The Afghan state must have a legitimate monopoly of violence, a corollary of which is that its citizens will not need to pay for the cost of protection as individuals. Freedom of movement, for commodities and ideas, is constrained by perceptions of security. For example, many donors now insist on staying in Kabul, and starting projects there. Kabul's needs are immense, but in our judgment, there are other parts of the country that are more secure than Kabul. Thus does the perception of insecurity exclude areas urgently in need of development assistance from receiving attention.

We have prepared a detailed program for the creation, training and deployment of a national police force. We have, however, been constrained from implementing our program by lack of funds and exclusion of support for the police from the UNDP administrated Trust Fund. This constraint is being removed, and we hope to embark on our program very rapidly. We have also formulated our plan for the formation of a national army and the first battalion of the new army has been trained and deployed as the National Guard.

We will also need to provide for absorption back into society of the mujahadeen, who have sacrificed so much for the independence and dignity of this country. Absorption of the mujahadeen into the economy, society and polity is a significant challenge. We plan to meet this challenge through a series of measures. A large-scale program of vocational training, based on

an analysis of the needs of an expanding economy, will be a critical part of this program and we are inviting donors to assist us in implementing this program quickly. Demining is also an urgent priority and a precondition for agricultural recovery and freedom of movement **(4.2.2)**.

We are counting on finding solutions to meeting the expenses of the security sector quickly. In Geneva, there have been extensive discussions on meeting the costs of the national army and police and we now need to act rapidly. Our developmental efforts depend on the provision of security, as without the perception and reality of security of person and property, people will not feel safe to invest.

The judicial system will be revived through a program that provides training, makes laws and precedents available to all parts of the system, and rehabilitates the physical infrastructure and equipment of the judicial sector **(4.2.1)**.

Our vision of security, however, is broader than the services provided by the security sector to the citizens. Security of livelihood is critical to our endeavor, to eliminate poverty, to provide social justice, remove barriers to inclusion and to create a society where all citizens are provided with access to equality of opportunity.

Gender

Gender is a critical issue for us. Subjected to the segregationist policies of the Taliban, our girls and women need special attention. We do not want gender to be a ghetto. There must be specific programs directed to enhancing the capabilities of our girls and women. More importantly, all programs must pay special attention to gender, and not include it as an afterthought. We have to engage in a societal dialogue to enhance the opportunities of women and improve cooperation between men and women on the basis of our culture, the experience of other Islamic countries, and the global norms of human rights.

Research, information management and policy-making

As a living document, this framework will be amended, modified and transformed in the light of new research, experience and knowledge. Its implementation will thus depend on access to and management of information. Currently, very little reliable information exists, often information is fragmented and hoarded. This hampers the government's ability to respond to predictable crises and to make policy based on evidence of what works and what does not.

The government will create and maintain an information management system on all donor activities **(4.1.4)**. Standards for information gathering need to be set, and information shared promptly and widely. Timely monitoring and evaluation of programs and projects will be built into their design. The Afghanistan Information Management System (AIMS) will be one component of this larger strategy. We have already received assistance and are in the process of implementing this policy. All information management systems created by individual donors should provide inputs to the government's information management system currently at the AACA that will be eventually transferred to the Central Statistical Office.

The Role of the State

Finally, our strategy of development provides a clear role for the state. The state must provide security, invest in human capital, and articulate and implement a social policy focused on assistance to the vulnerable and excluded and the elimination of poverty. It must create an

enabling environment for the activities of the private sector, make effective use of aid to attract trade and investment, and put the economy on a sustainable path to growth.

We thus need an effective central government that re-establishes the national unity of the country on the basis of strong institutions and the rule of law. Simultaneously, we are committed to building on community level participation and effective management at the local level. We do not see government as the producer and manager of the economy, but as regulator and promoter of the entrepreneurial energies of our people. The state will enter into a direct managerial role only when social justice demands its presence. The government will act in partnership with communities, NGOs, donors, UN organizations and the national and international private sector to implement its programs, and realize its vision. As the legitimate representative of the people, it is the key task and challenge of the government to create the institutions and organizations that would embody principles and practices of good governance.

NATIONAL DEVELOPMENT BUDGET SY 1381-82
Official Summary¹
October 10, 2002

Background

1. The 1381-1382 National Development Budget (NDB) attempts to translate the priorities on the National Development Framework (NDF) into programmes and projects whilst simultaneously providing a vehicle for policy development. It provides an outline of ongoing and proposed investments for the period and therefore consolidates investments based around the 12 programme groups presented within the NDF.
2. The objective of the NDB is to provide the financial means for Government investments to achieve the objectives stated in the NDF. Specific objectives include:
 - i. Develop the capacities of the public administration for good governance;
 - ii. Accelerate reconstruction of basic infrastructure and services;
 - iii. Accelerate economic growth as the precursor to any policy for poverty reduction;
 - iv. Improve the competitiveness of the economy and reduce national and household vulnerability to economic shocks; and,
 - v. Extend access to basic services (education, health etc.).
3. This budget has been prepared through an extensive consultation process involving both Government Ministries and the international donor assistance community. Initially programme secretariats provided support to some Government Ministries in the elaboration of strategic priorities for investment. Thereafter the Ministries of Reconstruction, Finance and Planning convened consultation meetings with all lead Ministries, the UN Agencies and donors to elaborate the final development budget.
4. The budget comprises the portfolio of projects and programmes at varying stages of development (from ongoing project to project concepts) which the public sector (in a broad sense) intends to execute in the present and following fiscal years. The figures listed as 'budget' represent the priorities identified by the Ministries and their partners. These figures have not yet been modified to take into account either the overall resources available to the Government, or the relative priority the Government places on each program. In this regard, the figures identified as budget are not yet endorsed as priority Government projects. This process will be undertaken over the next five months as the priorities are revised and greater clarity from donors allows the overall resource envelope and the extent of any earmarking within that envelope to be understood.
5. Importantly, the NDB provides a springboard to enhance direct donor assistance to government and prepares the way for a more comprehensive approach to planning and budgeting through a medium term budgeting and planning process. To enhance development cooperation, the Programme Secretariat structure, which has served an invaluable platform, will be superseded by Consultative Groups. This will enable direct Government–Donor interaction around the planning and budgeting of assistance to Afghanistan.

¹ Transitional Government of Afghanistan, Ministries of Planning, Reconstruction and Finance, "Working Draft – Plan and Budget for 1381-1382 – National Development Programme" (Kabul, 10 October 2002).

6. Cross cutting issues such as governance, drugs, gender, environment have been mainstreamed within each programme and sub-programme.

7. The NDB comprises the following programmes: refugee return, education, health and nutrition, rural livelihoods and social protection, cultural heritage, media and sports, transport and telecommunications, energy and mining, natural resource management, urban management, trade and investment, public administration and security and rule of law.

Budget Limitations

8. The budget process has allowed for wide participation of both the Government and international community however, the following constraints to this budget must be recognized and indeed will need to be addressed in preparation of the 1382 budget.

- i. Budget calculations are based on assessment of present and future commitments by each sub-programme area, as reported by lead Ministries. The budgets have been cross referenced with the Donor Assistance Database where possible;
- ii. Sectoral budget allocations for programmes have still to be established;
- iii. It has not been possible to catch all commitments and expenditures because of complexity of multi-agency funding arrangements and the delays in reporting. This is particularly so for NGO related projects;
- iv. The 1381 development budget does not include recurrent costs for public administration. These are included in the Ordinary budget approved in April and will be integrated with the development budget for 1382. Implementing partner operational costs have yet to be documented;
- v. The total population of Afghanistan remains transient and imprecisely known affecting calculations for health and education coverage;
- vi. Institutional responsibilities need to be clarified in a number of sub-programme areas;
- vii. It has not been possible to consult with provincial Governors and offices this time around and this will be addressed in the following fiscal year;
- viii. The size of the Afghan National Army and border guards has yet to be established – rough budget estimates are therefore accorded only. Estimates for Disarmament, Demobilisation and Reintegration therefore remain provisional.

Investment Priorities for 1381 and 1382

9. In the light of the experience gained so far in 1381, with a heavy focus on humanitarian and not reconstruction assistance, the Government wishes to refocus the investment programme towards the following areas — as priorities for donor engagement:

- i. National Solidarity Program and Emergency Public Works Program;
- ii. Education Infrastructure Project;
- iii. Urban Infrastructure Project;
- iv. Water Resource Investment Project;
- v. National Governance Infrastructure Project; and
- vi. Transport Project (major roads and airports).

Preferred Investment Funding Mechanisms

10. It is essential that the Government strengthen financial coordination mechanisms to enhance the effectiveness of development. The Government can be supported financially by one of three mechanisms – through direct contribution to the Ministry of Finance; through Trust Funds administered by International organizations before being contributed to the Ministry of Finance; or by direct support to private sector organizations to carry out government identified priority projects.

11. **Direct Contribution to Ministry of Finance:** As the approach preferred by the Afghanistan Government, contributions can be made directly to the Ministry of Finance for either general budget support to finance the range of expenditures identified in the approved budget, or for designated purposes or projects identified by the donor, consistent with government priorities. Funds can be deposited into a separately identified government account at Da Afghanistan Bank, or into a separate account at one of the Bank's offshore account locations (preferably Abu Dhabi). A standard financing agreement for use between Government and Donor is currently being developed for direct contributions. Processing and accounting will be carried out by the Treasury Department in accordance with the accounting framework, using the computer data-base accounting system currently being installed under the World Bank Emergency Public Administration Project contracted to KPMG Consulting Inc.

12. Trust Fund Arrangements

- i. *Afghanistan Reconstruction Trust Fund (ARTF):* The ARTF, administered by the International Development Association, has been established to allow donors to provide funds to the Government for recurrent and capital expenditures, and for returning Afghan expatriates and training. Donors are required to establish an Agreement with the Trust Fund Administrator and deposit funds into accounts nominated by the Administrator. In addition, project funds can be earmarked by donors for specific investments. The Ministry of Finance has opened special accounts to receive funds from the ARTF in accordance with statement of expenditures furnished to the Administrator by the Government, which are monitored by a separate Agent. Once funds are in the special accounts they will be processed and accounted for by the Ministry of Finance Treasury Department using the new accounting system.
- ii. *Law and Order Trust Fund for Afghanistan (LOTFA):* The LOTFA, administered by the UNDP, has been established to receive funds for Police related expenditures, including salaries, identified in the approved budget, which are not eligible for funding from the ARTF. Donors would provide funds to the LOTFA, which in turn provides the funds to the Government account to be administered by the Ministry of Finance for Police purposes in accordance with government financial management procedures. Once funds are in the account they will be processed and accounted for by the Treasury Department using its new system.
- iii. *Military Trust Fund:* The UN Assistance Mission in Afghanistan (UNAMA) administers a Trust Fund for paying salaries and benefits to the Afghanistan National Army. This UN Trust Fund provides funds to the Da Afghanistan Bank for payments processed and accounted for by the Ministry of Finance Treasury Department, in co-ordination with Ministry of Defence developed payroll of eligible military personnel.

13. **Direct Private Sector or NGO Support:** Donors may wish to provide funding directly to private sector entities or NGOs to carry out projects or development activities identified by the Government in the National Development Framework released in April 2002. Options for funding NGOs through the National Solidarity Programme also remains an important funding route. Under this arrangement, project agreements, banking and accounting arrangements would be determined between the donor and the entity.

14. **UN Transitional Assistance Programme to Afghanistan (TAPA):** Agreement has been reached between the Government and the UN that the TAPA will be complementary to the Government's budget and that it will focus on humanitarian support only. TAPA will remain the fourth priority funding channel after direct support to the MoF, to the Trust Funds and through support provided to the private sector and NGOs.

15. **The Planning Framework for the 1382 Budget Submission:** Based upon the experiences gained in developing the 1381 budget the following new orientations will form the basis for strengthened Government – Donor coordination:

- i. Consultative Groups will be established to support the development of a Medium Term Expenditure Strategy and Framework;
- ii. A progressive move from a narrow humanitarian approach towards reconstruction focused investments;
- iii. Government will remain central to the development of the national budget around which donors and the UN will coordinate assistance and jointly prioritise investments;
- iv. The private sector will remain the engine for growth although expanded donor assistance will still be required; and
- v. The 1382 budget will present both operating and development expenditures in an integrated fashion.

16. In the run up to the 1382 budget submission, the Government will be in the driving seat, albeit through a process of consultation. In future, it is critical for the parties to the budget process to give a high priority to meeting the scheduled milestones in the narrative summaries attached. The efforts of the Government will include:

- i. reviewing carefully the budget instructions and forms and submitting budget requests in a timely fashion in conformity with the instructions and the guidance letters presented by the Ministry of Finance,
- ii. working directly with donors to make sure that integrated donor and ministry estimates are captured in the budget requests, and
- iii. considering carefully the observations of the provincial government in the process of determining the final set of priorities for review by the Cabinet.

17. The donors' role is critical. Donor support must be based on consultation with the ministries. Thus, in order to make the process effective, donors will need to:

- i. work with ministries in developing donor estimates for the 1382–1384 period for inclusion in the ministries' budget requests;
- ii. review with ministries any adjustments ministries make to their budget requests to reflect governments' recommendations; and

- iii. after the March 2003 IG meeting, make any necessary adjustments in donor support levels for the period.

18. Most importantly, all donor intentions need to be reflected in the 1382 ministry budget requests (including those for 1383 and 1384), recognizing that these may change. The Budget Law of Afghanistan requires that all donor assistance to the government, whether in cash or in kind, is to be reflected in the budget. While that has been difficult to accomplish during 1381, consistent application of this rule will be a priority for 1382.

BACKGROUND STUDIES, CHRONOLOGY OF PROCESSING STEPS AND APPROACH

1. The program content is based on intensive consultation with all stakeholders and a wide range of analytical studies undertaken on Afghanistan by various bodies and authors including the Asian Development Bank as well as other relevant documents.

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2. The following key steps and staff were involved in processing the program:

- Fact-finding Mission: 26 August to 6 September 2002. The Mission comprised Craig Steffensen, Mission Leader/Senior Programs Officer, SAOC; Manabu Fujimura, Economist, SAOC; and Mohiuddin Alamgir, SAOC Staff Consultant. The Mission was assisted in the field by Salim Qayum, Senior Liaison Officer, Special Liaison Office/Kabul; and Jawed Sulaiman, Finance & Administration Specialist, Special Liaison Office/Kabul. In addition, Frank Polman, Senior Advisor, SARD, and Afghanistan Program Director, visited Kabul during 31 August–5 September to provide guidance to the Mission and to pay courtesy calls on Transitional Government officials and representatives of key international organizations and major embassies in Kabul. Klaus Gerhauesser, Director, SAGF; Renato Limjoco, Lead Financial Sector Specialist, SAGF; and Barbara Ericsson, Principal Financial Sector Specialist, SAGF, joined the Mission during 31 August–5 September, and provided inputs for the policy matrix on governance and the financial sector, and participated in key meetings. Natin Patel, Principal Project Management Specialist, SAID; Hasan Masood, Transport Specialist, SAID; and Najeeb Jung, Senior Energy Specialist, SAID, visited Kabul at various times during the Fact-Finding Mission on other mission travel, provided valuable inputs to the Mission on the transport and energy sections of the policy matrix, and participated in key meetings. Jouko Sarvi, Education Specialist, SASS; and Leah Gutierrez, Project Economist, SASS, also joined the Mission at various intervals while on other mission travel, and provided inputs for the main text on the social sectors and participated in key meetings. Finally, Donneth Walton, Rural Development Specialist, SAAE, also joined the Mission during 26 August–3 September while on other mission travel and provided inputs for the main text on the agriculture sector and participated in key meetings.
- Consultations with H.E. Ashraf Ghani Ahmadzai on the sidelines of Afghanistan Reconstruction Steering Group meetings in Paris (10 July 2002) and Washington, DC (26 September 2002), and the Afghanistan Reconstruction Implementation Group Meeting in Kabul (14 October 2002).
- Management Review Meeting (MRM): 17 September 2002.
- Staff Review Committee Meeting/2nd MRM: 23 October 2002.
- Loan Negotiations: 5-6 November 2002.

3. In formulating the program, ADB has followed a process-based approach with intense stakeholder consultation. There is considerable understanding within Afghanistan of the issues impeding reconstruction and development. These were discussed at some length with the Transitional Authority at various levels during PNA, CNA and appraisal missions. Through intense policy dialogue with senior government officials and the aid community, a convergence of views with regard to the reform agenda was achieved, which should help direct reconstruction and development on a sounder basis. The dialogue will continue as new issues emerge during program implementation.