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ADVICE ON THE AFGHAN MONETARY AND FINANCIAL SYSTEM

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Submitted by

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PREFACE

At the request of the Office of the A.I.D. Representative for Afghanistan Affairs, the Nathan/Berger Joint Venture supplied the services of a monetary expert to provide advice to the Afghan Interim Government (AIG) on issues associated with establishing an independent monetary system and on other matters of importance to the AIG's Ministry of Finance. This assignment was undertaken by Dr. Donald Syvrud, an internationally respected monetary and fiscal expert who has served in senior positions at the International Monetary Fund and in the U.S. Department of the Treasury as well as in advisory positions in developing countries. Dr. Syvrud travelled to Pakistan in November, 1989. There he submitted three memoranda to the AIG and O/AID/REP containing his views on pertinent subjects:

-- Outline of an Economic and Financial Program of Action for the Afghanistan Interim Government;

-- Considerations Concerning the Issuance of a Currency by the AIG; and

-- Proposed Training Program to Improve Operations of AIG Finance Ministry Personnel.

Edited versions of these memoranda constitute the substance of this final report.

Outline of an Economic and Financial Program of Action for the Afghanistan Interim Government
November 22, 1989

This memorandum outlines the major economic and financial issues which the Minister of Finance (MOF) should be prepared to deal with following takeover of the Government by the AIG.

Macroeconomic

As the chief economic officer of the Government, the Minister of Finance (MOF). is responsible for the macro-economic policy orientation of the Government, with particular emphasis on fiscal policy, tax policy, monetary policy, pricing policies, wage policy and the budget. These policies must be established within the framework of the national economic policy objectives set by the Government.

Fiscal Policy

A constant major issue facing the MOF is how to finance government expenditures. Where is the money coming from to cover all the expenditures wanted by the other ministers? How to resist pressures from other ministers to increase spending?

How much of the spending can be covered by existing taxes? Can improvements be made in the enforcement and implementation of existing tax system? What new taxes may be needed to finance the budget? What is the impact of existing taxes and any proposed new taxes on the economy?

How can the deficit be financed? How much domestic financing is available ? How much foreign financing? How can the foreign financing be maximized to supplement the savings of the economy? How to identify projects suitable for foreign financing? (This is normally the responsibility for the financing of these projects.)

How to avoid financing the deficit by resort to the printing press (borrowing from the central bank, issuing currency)? Inflationary financing of the budget will always be one of the major concerns of the MOF.

Managing the public debt. Will the AIG accept responsibility for the debt, both domestic and foreign, of the deposed regime? How to manage the debt in such a manner as to minimize the cost to the Government?

Public Sector Wage Policy

The largest single item in the budget is normally the wages for public sector employees. What level of wages is consistent with economic efficiency, equity, and the constraints of the budget? Will wage levels of the AIG in exile set a precedence?

Budget Policy

What level of Government spending is consistent with economic growth, price stability and balance in the international accounts. In preparing the budget, the MOF will wish to see that total expenditures and the composition of expenditures are consistent with the major economic objectives of the Government. The first issue is what are the available financing sources for the budget? The allocation of resources within the budget involves all ministries, but the financing of the budget is the sole responsibility of the MOF.

International Relations

The MOF is normally the Governor of the International Monetary Fund and frequently Governor of the World Bank and the Asian Development Bank and other national and international financial institutions. During the first days in an operational capacity programs with these institutions will require considerable staff time of the MOF. Since other economic ministers have a direct responsibility over specific projects, an immediate issue will be the nature of the coordination among these ministers. Should the AIG establish a form of Advisory Committee to deal with the external institutions? Aside from the specific projects, the macro-economic policy issues of involved in negotiating a standby with the Fund or a structural adjustment loan with the World Bank are the same as otherwise noted, budgetary, monetary, fiscal, taxation, management of public enterprises, and wage policy.

Financial Policies

What level of monetary expansion is consistent with price stability, economic growth, and balance of payments equilibrium?

What is the exchange rate policy? Will AIG set a fixed rate, a flexible rate, adjustable peg, or a floating rate?

What will be the interest rate policy — a market oriented interest rate or fixed rates, or a substitute for interest rates? The decision on the approach to interest rates will affect every aspect of the financial structure of the country: savings, investments, and domestic and foreign financial flows.

What pricing policies will be pursued — price supports for basic foodstuffs or will the prices be determined in the market?

What will be the policy regarding the currency? See the memorandum on considerations affecting the issuance of a separate currency, which follows this memorandum.

Public Enterprises

Will public enterprises be expected to operate on a competitive basis, earn a profit to contribute to Government revenues, or will they be subsidized? Will they be permitted to establish prices to cover their costs or will their prices be fixed by the Government?

Auditing of Government Operations

As the chief financial officer of the Government, the Minister of Finance must set the standards of integrity and ensure that all ministries, agencies and public enterprises adhere to proper standards of integrity. Thus, the function of the Inspector General or General Accounting Office, as it is called in some countries, is essential to the MOF. Controlling expenditures and maximizing revenues depend on the integrity of the system.

Retirement Pensions

What level of pensions is consistent with equity and the budget level? The MOF will have to resist pressures from this source just as with the public payroll. The decision to establish salary and pension levels is normally taken by the head of state but the MOF must ensure that the financial implications of any such decision is taken into account.

Considerations Concerning the Issuance of a Currency by AIG

November 22, 1989

This memorandum outlines the potential objectives to be achieved by a currency issue, the economic and technical questions concerning its issue, and some implications and some exploratory steps regarding possible implementation.

The first issues to be decided by the AIG are the objectives to be achieved by the currency issue and the timetable for implementation to:

- Plan for eventual takeover of country;
- Disrupt operations of the Kabul Government;
- Finance AIG operations; and
- Replace the Afghans with a strong currency.

Discussion

(1) Economic and financial planning, including what to do about the currency, should be an integral part of the AIG's planning for the eventual takeover of the Afghanistan Government. This includes a decision as to whether to replace the Afghans completely, with a conversion to a new currency, or to continue operating with the existing Afghans.

(2) Flooding the country with a new currency might for a time disrupt the Kabul Government, but it would also disrupt economic activity in Afghanistan, adversely affect the economic conditions of AIG supporters and thus could weaken the political support for the AIG.

(3) Issuance of a currency to finance AIG operations could only be effective for a short period and it would have the same adverse effects as point 2. The objective of financing the AIG on a continuing basis could only be achieved if the currency is accepted as a store of value. This acceptability must be based on confidence in its convertibility to other currencies or its usefulness to pay taxes or in other financial transactions.

(4) An AIG currency, fully backed by convertible currencies and/or a reliable tax base, might be acceptable within the AIG controlled areas and if maintained in a fully convertible status, could remain stable and therefore contribute to the credibility of the AIG. The stability of a fully backed AIG currency could be a positive contrast to the inflating Afghans.

Economic and Technical Questions

Once a political decision is made on the objectives to be achieved, several economic and technical questions must be addressed.

Backing for the New Currency

As noted above, to achieve any positive objective the prospective new currency must be fully backed by convertible currencies and/or a reasonably solid tax base if it is to achieve a degree of acceptability. Under present circumstances with no tax base and no legal basis, any new currency should have complete backing.

While not applicable to the circumstances of the AIG, some methods used in other countries are:

- Partial fiduciary issue. A fixed amount laid down by law which is covered only by Government securities, while all notes in excess of this amount must be fully covered by gold or hard currency. This was method used by England until 1939.

- Legal maximum to note issue in the form of an amount fixed from time to time and without any gold or hard currency cover. A system of a flexible maximum note issue, without any statutory requirement of a minimum reserve of gold or foreign exchange, provides for a high degree of elasticity in the note circulation, but it also lends itself to facilitating inflation.

- Fully covered by specified Government bonds carrying the privilege of note cover and limited to the amount of those bonds as well as the paid up capital of the bank of issue.

- Prescribe a minimum percentage gold reserve (or foreign exchange) against the note issue, the remainder of the notes to be covered by specified assets such as trade bills and Government securities and a minimum gold reserve against the deposits of the Central Bank. By 1982, this system had spread over a large part of the world. It provides the highest degree of elasticity compatible with adequate security in the note circulation and may be an appropriate system once the AIG has taken over.

This could be part of the contingency plan or Blueprint for Action.

Aid Program Support for New Currency

Could elements of the various aid programs contribute to providing appropriate backing? The education program of the United States, for example, is financing 10,000 to 12,000 teachers in Afghanistan, at an annual rate of $25 million. Could these resources be deposited in an AIG financial institution and reserved as backing for a limited issuance of currency? What would be the U.S. reaction to this?

Tax Base

What tax base could be provided to back the prospective currency? Could customs duties, payable in the prospective currency, be collected at the borders, and is there any other tax source acceptable to the parties to the AIG?

Currency Functions

What functions of money does the AIG have in mind: medium of exchange, store of value, standard of value? The answer to this question is relevant to the decision on objectives to be achieved. A currency that is inflating rapidly would not be held, therefore would not serve as a store of value nor a standard of value. It would serve only as a medium of exchange for a limited number of transactions. Only a currency that is soundly backed and convertible would serve all three functions.

Control

What degree of control does the AIG have over the area in which the currencies are to be issued? The answer to this question is relevant to the ability to tax, and the willingness and ability of the population to hold and use the prospective currencies. In the absence of the taxing capability, the proposed currency would have to be fully backed.

Cross Border Trade

What is size and nature of cross border trade? What currencies are used for these transactions? The use of the prospective currency in cross border operations would enhance its credibility in the AIG held areas and, if stable in value, might also be used in areas partly controlled by the Kabul Government.

Currency Holders

What persons and institutions will be permitted to hold the new currency? Are there banks or non bank institutions in Afghanistan or elsewhere willing to hold it? Once new currency is issued, its quantity will be determined also by the holders, who may use it as the basis for extension of credit. This raises a question about the ability of the AIG to control this credit. In the absence of control over the credit creating institutions, the currency might well contribute to an inflationary environment, even if fully backed.

Other

- Categories of institutions whose liabilities are included. Are they government agencies, commercial banks, nonbank financial intermediaries?

- Geographical locations of the liability issuing institutions?

- Types of liabilities to be included: coins and currency, demand or sight deposits?

- Currency denomination of liabilities? The decision here would be based on the experiences with the Afghans and the acceptability and use of various denominations to the intended users/holders. The answer to this question is also related to the next question.

- At what exchange rate will the new currency trade? What would be an appropriate rate vis-a-vis the rupee, the U.S. dollar, SDR, or other currency?

- Who will control the issuance of the new currency? Will the currency be issued by the treasury or a banking institution, i.e. Central Bank? Could the AIG establish a Central Bank, or a branch of a Central Bank in Peshawar?

Treasury Versus Bank Notes

Governments today appear to favor a Central Bank issue because of the temptations on the part of Government to expand spending and the comparative ease with which governments can force their notes into circulation. Government paper money can be put into the channels of

circulation in exchange for services and goods and need not be preceded by any demand from them.

Central Banks, on the other hand, issue notes only as they are required and drawn by banks on behalf of their customers, including for the Government, for payroll or other disbursements, and notes are returned by the central bank or other by banks as their customers deposit notes in excess of their normal requirements or by the Government according to taxes or other forms or revenue paid in the form of notes.

Quantitative Analysis

On the basis of available data (through December 1987) and some heroic assumptions for 1988 and 1989, the currency in circulation is estimated at 236 billion Afghans at the end of November 1989 (see Table 1). The estimates for 1988 and 1989 are based on the 45 percent devaluation of the Afghans relative to the rupee in the bazaar foreign exchange market from July 1988 to June 1989. Note that from December 1986 to December 1987, the currency in circulation increased by 58 percent.

Assuming a continuation of the 45 percent annual increase in the currency in circulation, the Kabul government is issuing an estimated 106 billion Afghans annually or a monthly rate of 9 billion Afghans. Assuming further the bazaar market exchange rate for July 1988 of 190 Afghans per $US, the estimated $US value of the Afghans in circulation at the end of 1987, the last date for which actual data are available, would be $US 592 million. Finally, applying the current bazaar market exchange rate of 400 Afghans per U.S. dollar, the estimated value of the 236 billion Afghans in circulation would be $590 million. [1]

Are these money supply and currency figures consistent with what is known about the trend of prices? see Table 1. The low, 8 percent, rise in prices in the Kabul consumer price index for 1986/87 is consistent with the 36.8 percent increase in the money supply for 1987 only if one assumes: (1) the price index includes price controlled items; and (2) there is a significant lag between the rise in money supply and prices. Both assumptions appear realistic. One report indicated that the prices of controlled items in Kabul are only a fraction of their market prices. The dislocations of the war would extend the time lag for an increase in money supply to have its impact on prices.

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1. Note the consistency of this estimate with the end of 1987 estimate of $590 million.

Next Steps

Before the AIG decides to issue its own currency, it should make some tentative decisions on the objectives to be achieved and the timetable for implementation. Assuming that the objective is to replace the Afghans with a strong and stable currency, the Finance Ministry might begin exploring along the following lines:

- What are the prospective sources of backing for the currency? Discussions with the U.S., Saudi Arabians and other major donors would be useful.

- What potential sources of tax revenue might be tapped? Continue discussions with the Government of Pakistan regarding the possible tapping of customs revenues in cross border trade.

- What financial institutions currently engaged in financing the border trade would be able to use the new currency, in Hindi transactions, for example? Discreet discussions with leaders in these institutions might be useful.

- How might the AIG organize and establish a central banking operation which could be the issuer of the currency? Continue discussions with the Government of Pakistan on the potential opening of a Central Bank branch or the use of another existing financial institution located in Pakistan.

- The denomination of the currency notes, the rate of exchange vis-a-vis other currencies, and other technical questions concerning the printing of the notes might be studied by a working group under the chairmanship of the Finance Ministry.

- Meanwhile the Finance Minister or his designated person might begin (continue) discussions with a reputable printer of currencies regarding the many technical issues involved and the prospective timetable.

Table 1. Afghanistan Money Supply and Currency in Circulation
December 1982-November 1989

	1982	1983	1984	1985	1986	1987	1988	(Nov) 1989
Currency Outside Banks 1/	46.7	53.8	58.7	64.4	71.4	112.5	163.0e	236.0e
Percent Increase	--	15.2	9.1	9.7	10.9	57.6	45.0e	45.0e
Money Supply 1/	52.2	60.6	66.1	73.1	83.2	130.6	189.4e	274.6e
Percent Increase	--	15.9	9.0	10.5	4.4	36.8	45.0e	45.0e

Exchange Rate-Bazaar Market 2/	1988 July	1989 June
Afs/Rupee	10.06	15.4
Rupee/US$	10.15	21.5
Afs/US$	192.04	331.1

		1982/3	1983/4	1984/5	1985/6	1986/7	1987/8	1988/9
Kabul Consumer Price Index 2/								
(1978/79 = 100)	3/	175.2	209.5	266.9	292.8			
	4/	165.7	201.1	241.3	260.1	280.9		
Percentage Change	3/	16.6	19.6	27.4	9.7			
	4/	16.2	21.4	20.0	7.8	8.0		

1/ Source: Database, Table A I-2 for 1982-87, projections for 1988 and 1989.
2/ Source: Table A V-23.
3/ Source: Table A IV-6.
4/ Table A IV-5.
e/ Estimates for 1988 and 1989 are based on the movement in the Bazaar market exchange rate, in which the Afghani devalued 45 percent vis-a-vis the rupee from July 1988 to July 1989.

Proposed Training Program to Improve Operations of AIG Finance Ministry Personnel
November 20, 1989

The Minister of Finance Hedayat Amin-Arsala outlined the organization and functions of the Afghanistan Interim Government (AIG) Finance Ministry as shown in the Attachment A. In addition to the 14 divisions in the Finance Ministry, the Minister of Finance (MOF) currently has responsibility for the Ministry of Commerce (trade policy) and the Central Bank (monetary policy).

Qualifications

The qualifications needed for the major functions of the ministry are the following:

- Tax collection: The tax officials should have accounting and/or legal education and experience. Administrative and management experience would be desirable for the senior officials.

- Expenditure Control: The senior expenditure control officials should also have accounting education, and budgeting experience, with administrative and management experience for the top officials.

- Computer expertise is essential for key personnel in expenditure control, but also important for revenue.

- Budgetary: Accounting, legal, economic, computer, education, and budgeting experience.

- Economic Research: Macro-economic education, and economic policy experience.

- Monetary Policy: Macro-economic education, and banking experience.

- Debt Management: Macro-economic and financial, education, and banking experience.

The Finance Ministry currently has an interim staff of about 80 persons. The interim staff in Peshawar is expected to increase to 250, of whom 50

are political, with an economic staff of 200. All of the personnel in the AIG Ministry of Finance staff need training. The priority requirement is for accounting, macro-economic policy (fiscal, monetary, taxation) and computerization. Computer, macro-economic, and accounting training can be generalized. Courses could be provided for computers (data base, word processing (Wordperfect), spreadsheet (Lotus 123), fiscal policy, monetary policy, and accounting. Specific training programs could be organized for tax collectors, tax assessors, with focus on current tax system accounting practices, budgeting and expenditure control methodology.

Program Development

The Finance Minister should assign one of his most capable staffers to prepare the initial draft of a training program, which would be submitted to the USAID or other donors, with requests for assistance in undertaking and financing the training.

One might imagine a two phase program, the first concentrating on the senior personnel, with two weeks each in computer operations, accounting and macro-economic policy (monetary and fiscal), all of which are general qualifications desired for the major functions of a Finance Ministry, Central Bank and budget office. The second phase of the training program might focus on the specific requirements of tax assessing, collecting, budgeting, and expenditure control. The training need not be limited to Finance Ministry personnel; other economic ministers may wish to participate.

The training sessions could be arranged in Peshawar, bringing in instructors from adjoining countries, preferably. This would be helpful from a language viewpoint because few of the personnel in the Finance Ministry are fluent in English. One should assess their language capability before initiating a training program.

In sum, one might proceed as follows:

- Prepare an assessment of the functional and linguistic personnel capabilities,

- Determine the range of training and prepare a brief scope of project for the Finance Ministry to discuss with USAID or other donors. (Nathan/Berger has the capability to organize the training with instructors from other nations. Other consulting firms can do the same, but this project might well come under the existing USAID project with Nathan/Berger.)

See the Attachment A regarding the divisions and major functions of the Finance Ministry.

ATTACHMENT A

Divisions of AIG Finance Ministry and Major Functions

The following are the divisions and major functions of the AIG Finance Ministry.

- Budget - serves as budget office for entire AIG, with functions to prepare the budget and ensure compliance.

- Comptroller - pre-audits, expenditure vouchers, and maintains financial ledgers for the Government. (The Finance Ministry has a comptroller assigned to work in each of the ministries).

- Treasurer - issues payment orders for approved expenditures and maintains AIG financial balances (deposits) in the financial institutions. Also manages the domestic and foreign debt.

- Internal Revenue - collects income taxes and other forms of revenue (except customs) and audits taxes.

- Customs - collects customs duties and audits firms engaged in trade.

- Religious Income - monitors voluntary contributions from religious organizations and individuals.

- Public Enterprises - monitors financial developments in these enterprises, collects profits and/or pays subsidies.

- Retirement - manages the retirement system for civil servants, and pays retirees.

- Public Property Management - keeps accounts for and manages the properties owned by the Government.

- Inspector General - performs ex post audits of all financial operations of the Government, ministries, agencies and public enterprises.

- **International Relations** - oversees AIG financial relations with foreign nations and international financial institutions.

- **Economic Research** - research and analysis of economic developments in Afghan economy and to the extent necessary, the world economy.

- **Administration** - manages buildings and supplies, prepares budget for, and handles personnel of, the Finance Ministry.

- **Secretariat** - manages the paperwork flow for the Minister of Finance. Maintains files of the Minister's office.