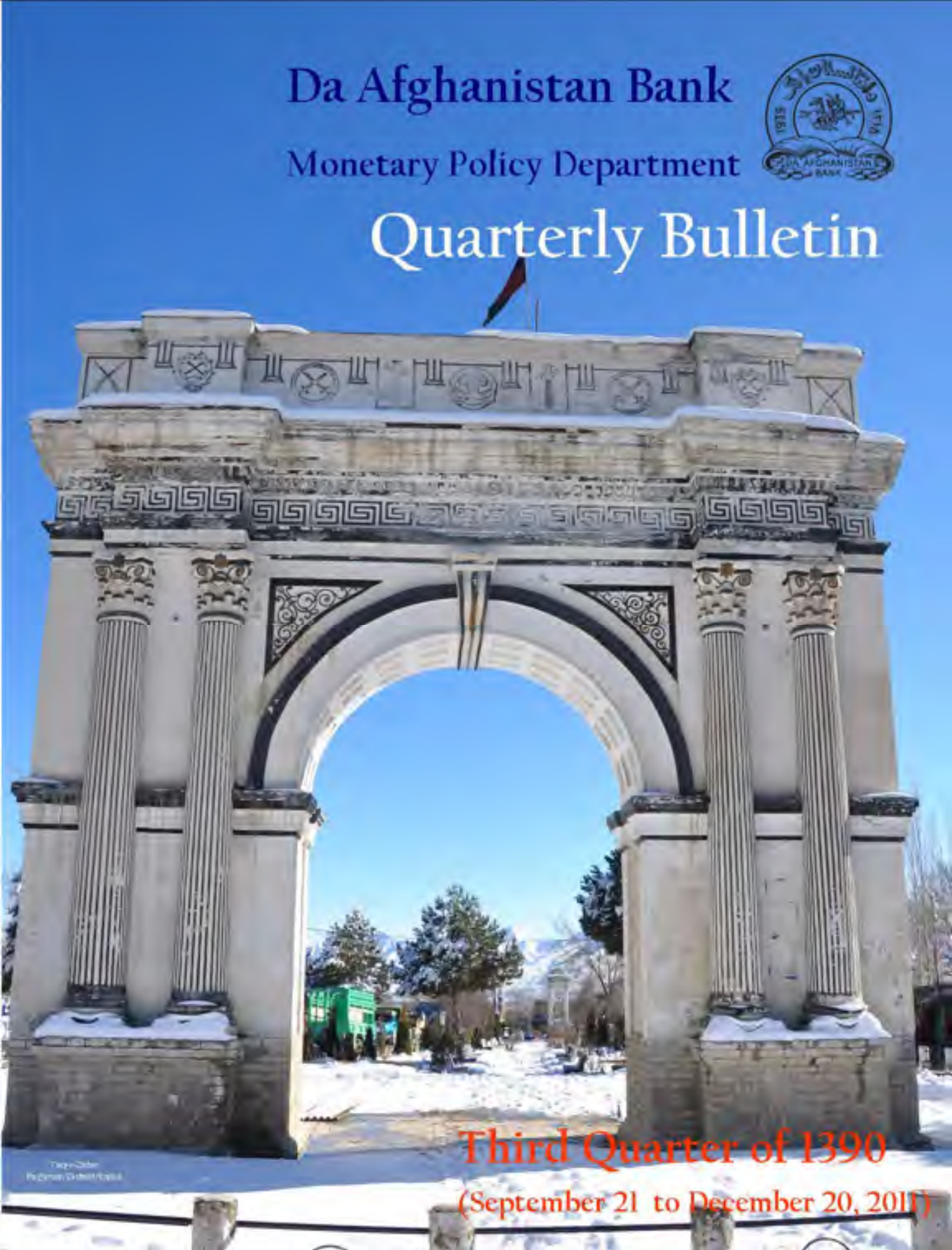
Da Afghanistan Bank

Monetary Policy Department

Quarterly Bulletin



Third Quarter of 1390

(September 21 to December 20, 2011)

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(September 21 to December 20, 2011)

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Note:
Afghanistan Fiscal year is Solar Year which begins on March 21 each year. This Quarterly Bulletin describes developments in the third quarter of 1390 which is equivalent to September 21, to December 20, 2011.

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ABBREVIATIONS

DAB	Da Afghanistan Bank
GOA	Government of Afghanistan
FEMA	Foreign Exchange Market in Afghanistan
LCs	Letters of Credit
CPI	Consumer Price Index
MOF	Ministry of Finance
CMEA	Ex-Soviet Trading Block
ARTF	Afghanistan Reconstruction Trust Fund
LOTFA	Law and Order Trust Fund for Afghanistan
GDP	Gross Domestic Product
ODCs	Other Depository Corporations
CSO	Central Statistics Office

GOVERNOR'S STATEMENT

GOVERNOR'S STATEMENT

Quarterly Economic and Statistical Bulletin

On behalf of the Supreme Council, I am pleased to present this release of the Quarterly Economic and Statistical Bulletin of Da Afghanistan Bank (DAB) for the third quarter of 1390 (September 21 to December 20, 2011). This quarterly bulletin serves as the DAB's primary tool of disseminating information and analysis for government and non-government agencies, economic units, and other users, both, inside and outside the country. According to IMF, the global recovery is threatened by intensifying strains in the euro area and fragilities in other parts of the world during the fourth quarter of 2011. Financial conditions have deteriorated, growth prospects have dimmed, and downside risks have escalated. According to the United Nations Industrial Development Organization (UNIDO), the world manufacturing output grew in the fourth quarter of 2011 compared to the same period of the previous year. The two major economies that contributed to the ongoing world growth were China and the United States.

On quarterly basis, the world trade volume increased by 0.3 percent in the fourth quarter of 2011, however down from 1.4 percent recorded in the third quarter. Trade volume in advanced economies showed a negative growth, while in emerging economies it indicates a growth of 2.5 percent.

In Afghanistan, monetary aggregates exhibited mixed performance in the reporting period, reserve money (RM), the primary target, was achieved in the third quarter of the year. Likewise, currency in circulation which constitutes one of the crucial components of reserve money remained below the target in the reporting period. On the other hand, narrow money (M1) increased by 21 percent (Y-o-Y) in the third quarter of the year. Broad money (M2) demonstrated similar behavior growing by 21.31 percent.

Meantime, afghani depreciated against the U.S. dollars by almost 8 percent in the third quarter of 1390.

Foreign exchange auction is the primary instrument used by DAB to control money supply. Total FX auctioned at the end of third quart of 1390 stood at USD 1.74 billion. The second monetary policy instrument used by DAB to control the liquidity in the market is the capital notes. The outstanding stock of 28 day notes at the end of the quarter under review was AF 8.2 billion, while the stock outstanding of 182 day notes hit a record increase of AF 0.80 billion compared to the preceding

quarter, making the outstanding of AF18.0 billion. The total outstanding stock of both maturities stood at AF25.2 billion at the end of the reporting period. Da Afghanistan Bank (DAB) has accumulated USD 805 million on its net reserves at the end of the third quarter of 1390 which is well above the target of USD 387 million. DAB has achieved NIR accumulation target for first, second and third quarters of 1390, ending at USD 5.82 billion. Accumulation of NIR boosts confidence on the domestic currency and supports balance of payments.

In Afghanistan, the decelerating trend in inflation that began in the first quarter of 1390 continued its way into the second quarter and maintained its downward trend in the third quarter as well. By all measures, inflation decreased in the third quarter of 1390.

In the external sector, merchandise trade deficit almost doubled in the quarter under review due to a substantial expansion in imports. The trade deficit as percentage of GDP increased from 5 percent in the third quarter of 1389 to 10 percent in the third quarter of 1390. On the other hand, exports decreased by 27 percent in the third quarter of 1390 compared to the same period of last year.

The banking system gained momentum in third quarter of 1390 after recovering from weak performance in the second quarter of 1390. Total assets of the banking system increased by 2.47 percent (year-on-year) at the end of third quarter of 1390 (December 2011) reaching AF197.17 billion, up from AF192.42 billion in the same period of last year. Deposits were up by 13.4 percent from the same period of last year. The entire banking sector was well capitalized in the quarter under review, while it was a negative figure last year (December, 2010), on account of AF 18.12 billion lenders of last resort loans from DAB to Kabul bank and AF 39.85 billion Loan loss reserves created for the bad assets of the above mention bank.

At the end, I would like to appreciate the tireless efforts of numerous individuals from several departments of the Bank that contributed to this publication, particularly team of Monetary Policy Department

Kabul, May 2012

Noorullah Delawari

Governor

Da Afghanistan Bank

EXECUTIVE SUMMARY

The content of this publication reflects the main results of the BAB's activities during the third quarter of 1390 (September 21 – December 20, 2011) aimed at keeping inflation rate low, maintaining stability of the national currency and developing a robust banking sector in support of sustainable economic growth.

According to IMF, during the quarter under review, the global recovery was threatened by intensifying strains in the euro area and fragilities elsewhere. Financial conditions deteriorated, growth prospects have dimmed, and downside risks have escalated.

According to the United Nations Industrial Development Organization (UNIDO), world manufacturing output grew by 4.2 percent in the fourth quarter of 2011 compared to the same period of the previous year, the lowest quarterly growth rate in 2011. While it was estimated at 0.7 percent decline in the fourth quarter of 2011 on the basis of quarter-on-quarter changes. The two main economies that contributed to the ongoing growth were China and United States.

The world manufacturing output had a positive start in the first quarter of 2011 indicating a recovery from the financial crisis of 2008-2009. However this process stalled since the second quarter, especially due to the deteriorated financial situation in the Euro-zone.

During the fourth quarter of 2011, manufacturing production in developing countries slowed down, where for the first time after the financial crisis, the growth rate was below 10 per cent. The group of developing countries increased its manufacturing production by more than 9 percent in the fourth quarter and continues to be the strongest driver of growth in the world manufacturing.

According to the Netherlands Bureau for Economic Policy Analysis (CPB), the world trade volume increased by 5.6 percent in 2011 down from 14.9 percent in 2010. In the fourth quarter of 2011 (quarter-to-quarter) world trade volume increased by 0.3 percent down from 1.4 percent in the previous quarter of the same year. Trade volume in advanced economies showed a negative growth of 1.1 percent in the fourth quarter of 2011. While, emerging economies shows a growth of 2.5 percent.

In Afghanistan, monetary aggregates exhibited mixed performance, reserve money (RM), the primary target, was achieved in the third quarter of 1390 after a breach in the second quarter due to post-Kabul Bank crisis.

In the first quarter of 1390, the reserve money increased dramatically above the target level and the situation continued throughout the second quarter mainly due to influx of afghani in Kabul Bank's current account, where DAB acted as the lender of the last resort to safeguard public's deposits with the bank. On the other hand, narrow money (M1) increased by 21 percent on a year-on-year basis. Broad money (M2) demonstrated similar behaviour growing by 21.31 percent.

Meantime, the exchange rate of afghani against the U.S. dollars depreciated by almost 8 percent in the third quarter of 1390 – the exchange rate of afghani moved in a corridor of AF 45-49 against US dollars during the reporting period.

Foreign exchange auction is the primary instrument used by DAB to control money supply. The total foreign exchange sold by DAB reached USD 1.74 billion at the end of the quarter under review. Capital Note is the other instruments used by DAB in order to control liquidity in the local market. The weighted average interest rate for 28 day notes noticed a decrease of 0.04 basis points, resulting a 2.10 percent interest rate on 28 day CN.. Similarly, the weighted average interest rate for 182 day notes posted a decline of 0.06 basis points, reaching 3.24 percent.

The stock of Afghanistan's net international reserves (NIR) stood at USD 5.822 billion at the end of the quarter under review. DAB achieved NIR accumulation target for the first, second and third quarters of 1390, ending at USD 5.82 billion at the end of the third quarter of 1390, up from USD 5.017 billion at the beginning of the year.

The decelerating trend of inflation that began in the first quarter of 1390 continued its way into the second quarter and seemed to maintain its downward trend in the third quarter as well. By all measures, inflation decreased in the third quarter of 1390. The headline inflation, Kabul CPI was 9.38 percent (Y-o-Y) in the third quarter of 1390 down from 12.85 percent recorded in the same quarter of last year. The decrease in the inflation rate was driven primarily by a decline in food prices. The rate of inflation in food sub-index, which comprises 61.3 percent of the CPI basket, declined sharply to 5.88 percent from the previous year's of 15.6 percent. However, core inflation, which excludes the important components of bread and cereal, oil and fat, and transportation is currently at a relatively higher level of 11.45 percent (year-on-year), but lower than 12.55 percent core inflation last year, indicating that inflation persisted beyond these basic commodities.

Nationwide inflation remained unchanged on annual basis compared to the same quarter of previous year. Here, the rapid fall in the rate of inflation in food prices was offset by increase in the rate of inflation in non-food prices. In addition, rentals fall less rapidly nationwide than that in Kabul, while inflation in transport costs rose rapidly.

When the quarter-on-quarter changes in inflation are observed, the picture is somewhat different. The Kabul headline inflation in the third quarter of 1390 increased slightly to 3.8 percent from 3.4 percent in the second quarter. Prices of foodstuff such as oil and fat, milk and cheese, and bread and cereals increased at a lower rate, while prices of fuel and electricity increased sharply in the reporting period.

The nationwide quarter-on-quarter changes in inflation showed different patterns than changes-pattern in Kabul. The headline inflation increased noticeably in comparison to the second quarter, whereas Kabul inflation showed slight increase compared to the previous quarter. The nationwide inflation in rents increased slightly from the second quarter but the increase was not as significant,

while inflation in food prices increased significantly.

In the external sector, merchandise trade deficit in the third quarter of 1390 almost doubled due to a substantial expansion in imports compared to the same period of last year. Merchandise trade deficit expanded by about 99 percent from USD 1,031.85 million in the third quarter of 1389 to USD 1,896 million in the third quarter of 1390. The trade deficit as percentage of GDP increased from 5 percent to 10 percent in the quarter under review.

In the quarter under review, the aggregate imports and exports stood at USD1,896 million and USD92.62 million respectively, showing an increase in imports from USD1,031.85 million and decrease in exports from USD127.29 million recorded in the third quarter of 1389. This resulted in the expansion of merchandise trade deficit from USD 904.56 million in the third quarter of 1389 to USD 1,803.4 million in the third quarter of 1390. The expansion in trade deficit is a reflection of the sluggish recovery of the global economy and high level of domestic demand for capital goods and industrial supplies.

Exports decreased by 27 percent to USD92.62 million from USD127.29 million in the third quarter of 1389. Exports are mainly dominated by food items such as fresh and dry fruits that decreased significantly by almost 43 percent and medical seeds which decreased by 10 percent in the reporting period compared with the similar period of last year. On the other hand, imports of goods increased considerably by 84 percent from USD 1,031.85 million to USD 1,896 million in the quarter under review. As the statistics show, imports of almost all importing categories increased except for fuel and lubricants which decreased about 8 percent. Imports are mainly dominated by industrial supplies and capital goods which increased in the third quarter of 1390 by 150 percent and 51 percent respectively compared with the corresponding period last year.

Afghanistan's public and publicly guaranteed external debt stock stood at USD 2,381.19 million in the quarter under review which shows an increase of 3 percent compared with the same quarter of last year.

In the fiscal sector, considerable efforts have been made by Afghan government over the past years to inculcate financial discipline by pursuing a sound fiscal policy. The Finance Ministry managed to achieve sustain increase in revenue collection, to permit the gradual takeover of externally financed operating spending. According to Ministry of Finance reports, total revenues exceeded core expenditures at the end of the third quarter of 1390, leading to a budget surplus of AF 6,826.80 million or 5.27 percent. Total domestic revenues collected in the third quarter of 1390 were AF 23,143.08 million, showing a 12.76 percent increase from the third quarter of 1389. Meanwhile, total domestic revenue collection in 1390, year to date, was 6.58 percent, above the target set by IMF. Total domestic revenues in the quarter under review accounted for 3.1 percent of GDP.

Total core expenditures in the quarter under review increased to AF 53,797.39 million, up from AF 38,270 million in the same quarter of 1389, which represents a 40.57 percent

increase. Total expenditures in the quarter under review account for 10 percent of GDP.

The total donor contribution (grants) allotted to both, operating and development expenditures increased to AF50,189.34 million in the quarter under review, up from AF43,628 million in third quarters of 1389, which shows 15 per cent increase.

The banking system gained momentum in the third quarter after a weak performance in the second quarter of 1390. Total assets of the banking system increased by 2.47 percent (Y-o-Y) or AF 4,749 million at the end of the third quarter of 1390 (December 2011) reaching AF197.17 billion, up from AF192.42 billion in the same period of last year. Deposits were largely denominated in US dollars (63.15 percent) with afghani denominated deposits lagging at 33.48 percent. AF-denominated deposits indicated a growth rate of 11.77 percent, while USD-denominated deposits were up by 14.97 percent. The entire banking sector has adequate capital, and it stood at AF 15.96 billion, while it was a negative figure last year (December, 2010). The decrease in the gross loans of the system ascribed to a number of financial institutions, but mainly to split of Kabul Bank into New Kabul Bank and Receiver.

The capital adequacy ratio (CAR) of the banking sector was 23.51 percent. On cumulative basis, the banking sector has incurred losses amounting to AF1.78 billion down by AF 37.31 billion since December 2010. The significant decrease in losses was mostly due to credit provisions to Kabul bank (now split into New Kabul Bank and Receiver). The return on assets (ROA) improved in the quarter under review registering -1.17 in December 2011 compared to -26.66 recorded in December 2010. Similarly, return on equity (ROE) improved from -27.86 in the third quarter of 1389 to -18.71 in the quarter under review. Only branches of foreign banks ended up with profit, while local private banks and state-owned banks ended up with losses at the end of the third quarter of 1390.

CHAPTER I

GLOBAL ECONOMIC ENVIRONMENT

1

GLOBAL ECONOMIC ENVIRONMENT

The global recovery is threatened by intensifying strains in the euro area and fragilities elsewhere during the fourth quarter of 2011 (by IMF). Financial conditions have deteriorated, growth prospects have dimmed, and downside risks have escalated. For the year 2012, the IMF anticipates an annual global growth rate of 3.3 percent. For the advanced economies the IMF expects a growth rate of 1.2 percent for 2012 compare to 1.6 percent in 2011. This is largely because the euro area economy is now expected to go into a mild recession in 2012 as a result of the rise in sovereign yields, the effects of bank deleveraging on the real economy, and the impact of additional fiscal consolidation. Growth in emerging and developing economies is also expected to slow because of the worsening external environment and a weakening of internal demand. It is expected to grow by 5.4 percent in 2012 compared to 6.2 percent in 2011.

According to the United Nations Industrial Development Organization (UNIDO), world manufacturing output grew by 4.2 percent in the fourth quarter of 2011 compared to the same period of the previous year, the lowest quarterly growth rate in 2011. While, it was estimated at 0.7 percent decline in the fourth quarter of 2011 on the basis of quarter-on-quarter. The two main economies that contributed to the ongoing world growth are China and the United States.

The world manufacturing output had an impressive start in the first quarter of 2011 indicating a recovery from the financial crisis of 2008-2009. However this process stalled since the second quarter, especially due to the deteriorated financial situation in the Euro-zone countries.

During the fourth quarter of 2011, manufacturing production in developing countries slowed down, where for the first time after the financial crisis, the growth rate was below 10 per cent. The developing countries increased its manufacturing production by more than 9 percent in the fourth quarter and continue to be the strongest driver of growth in world manufacturing.

According to the Netherlands Bureau for Economic Policy Analysis (CPB), the world trade volume increased by 5.6 percent in 2011 down from 14.9 percent in 2010. In the fourth quarter of 2011 (quarter-on-quarter) world trade volume increased by 0.3 percent down from 1.4 percent in the previous quarter of the same year. Trade volume in advanced economies showed a negative growth of 1.1 percent in the fourth quarter of 2011. While, in emerging economies it indicates a growth of 2.5 percent.

In the fourth quarter of 2011 world exports declined by 0.1 percent while world imports increased by 0.6 percent

1. THE GLOBAL ECONOMY

Global economic growth slowed down to 3.8 percent in 2011, compared with 5.2 percent in the 2010, according to the World Economic Outlook-IMF. OECD anticipates a growth rate of 0.7 percent for the G20 during the fourth quarter of 2011. However, this figure was recorded at 0.9 percent in the third quarter of 2011.

As a whole, the GDP growth of G20 rose by 2.8 percent in 2011, a marked deceleration compared with the 5.0 percent growth recorded in 2010.

For the Euro area, the IMF expects a GDP growth rate of 1.6 percent. The economic growth slowed down by the European debt crisis on one hand, and by the political standstill due to the household debate in the USA on the other. Impulses for the global economy keep coming from the developing and emerging countries, whose economy is expected to keep growing in the year 2011 by an average of 6.2 percent.

The global economy experienced a slump in growth during the course of 2011. While economic activity maintained its dynamism in emerging markets, economic expansion slowed down in many industrial nations. In particular the worsening of the sovereign debt crisis in several EU countries weighed on the global economic climate.

1.1 Global Industrial Production

According to a report released by the United Nations Industrial Development Organization (UNIDO), world manufacturing production rose by 4.2 per cent in the fourth quarter of 2011 compared to the same period in 2010. The United States and China significantly contributed to this rate through consolidated and robust growth and continuous high growth rates, respectively. This has been the lowest quarterly growth on year-on-year basis in 2011.

World manufacturing had an impressive start with 7.5 percent growth in the first quarter of 2011, indicating a recovery from the financial crisis of 2008–2009, however, this process has stalled since the second quarter due to the deteriorated financial situation in the euro-zone countries and the considerable loss of production in Japan's manufacturing sector

following the Tsunami disaster. Manufacturing output of industrialized countries increased by merely 2 percent in the fourth quarter 2011 compared to the same period of the previous year. The growth of manufacturing output in these countries was equal to that of the previous quarter. This report also states that the fourth quarter of 2011 has also shown signs of a worsening economic situation in Europe's industrialized countries, which is affecting the manufacturing production of developing countries where the growth rate was below 10 percent for the first time since the financial crisis.

The manufacturing output of developing countries increased at a relatively high rate of 9.2 percent. A number of major developing economies, which heavily rely on the export of their manufactured goods, were affected by the sluggish demand in external markets. Within the group of developing countries China's manufacturing sector continued to enjoy very strong growth of 13.1 percent. The newly industrialized countries grew at a rate of 3 percent. On the regional level, Asia's growth was estimated at 11 percent, Latin America's at 1.7 percent and the other developing countries at 4.9 percent.

Manufacturing growth in major developing economies, with the exception of China, was below 5 percent. India manufacturing output rose by 4.1 percent and Indonesia by 2.3 percent. However, Brazil's manufacturing output fell by 1.9 percent compared to the same period of the previous year.

Meanwhile, this report also states that the highest growth rates in manufacturing on the global level compared to the same period of 2010 were found in the medium-high and high-technology sectors, especially in transport equipment manufacturing. The automotive sector grew by 8.1 percent and other transport equipment sectors by 10.2 percent. A number of resource-based sectors maintained high growth rates in the fourth quarter: basic metals (6.1 percent), non-metallic mineral products (6 percent), leather products (5.7 percent) and food products (5.1 percent). Negative growth was found in paper products (-0.2 percent) and the printing and publishing sector (-1.1 percent).

1.2 Global Inflation

According to the World Bank, inflation has fallen in the past year, on average, in both high-income OECD and developing countries. Inflation has declined rapidly in most of the high-income countries, while outcomes have been more varied in developing countries that nevertheless show an overall, declining trend. The decline in inflation has been driven by real- and financial aftereffects of the first financial crisis, and importantly by related developments in commodity markets. Producers and exporters of electronics and machinery have offered substantial price discounts linked to the massive buildup of inventories during the global growth downturn

of 2009. This latter effect echoes the increasing importance of global factors, particularly the expansion of manufacturing production in East Asia, in determining inflation in the rich countries. Moreover, commodity price shocks have had a major impact on inflation during this period among the industrialized economies. In particular, international oil prices surged to near-record highs following the cut-off of Libyan crude oil in 2011, driving both increases in fuels prices and in food prices, the latter due to higher transport costs, increased prices for fertilizers, and reduced supply—as bio-fuel mandates shifted land usage towards the production of ethanol. As is widely recognized, rising food prices contribute more to inflation in developing than in advanced economies, because food's share of the consumption basket in the former tends to be much larger than in the latter. For example, food accounts for 15 percent of the U.S. (CPI) basket but 50 percent of the consumption basket of the Philippines.

The World Bank expects crude oil price around 104 dollars per barrel for 2011, then slowly easing down to around 98.2 dollars in 2012. However, we think that the global oil prices may increase in the 2012 due to the intense sanctions on Iran and violence in the Middle East. In addition, fast growing of industrial production in the emerging economies particularly, China and India will push up the global oil demand.

1.3 Global Trade and Investment

According to the Netherlands Bureau for Economic Policy Analysis (CPB), over the whole of 2011, trade went up by 5.6 percent down from 14.9 percent in 2010. In the fourth quarter of 2011 (quarter-on-quarter) world trade volume increased by 0.3 percent down from 1.4 percent in the previous quarter of the same year. Trade volume in advanced economies showed a negative growth of 1.1 percent in the fourth quarter of 2011. While, in emerging economies it indicates a growth of 2.5 percent.

In the fourth quarter of 2011 world exports declined by 0.1 percent while world imports increased by 0.6 percent.

UNCTAD estimates that the global FDI will recover to its pre-crisis level in 2011, increasing to USD 1.4–1.6 trillion, approaching its 2007 peak in 2013. This positive scenario holds, barring any unexpected global economic shocks that may arise from a number of risk factors still in play. For the first time, developing and transition economies together attracted more than half of the global FDI flows. Outward FDI from those economies also reached record highs, with most of their investment directed towards other countries in the South. Furthermore, the interregional FDI between developing countries and transition economies has been growing rapidly. In contrast, FDI inflows to developed countries continued to decline.

2. ADVANCED ECONOMIES

2.1 The United State Economy

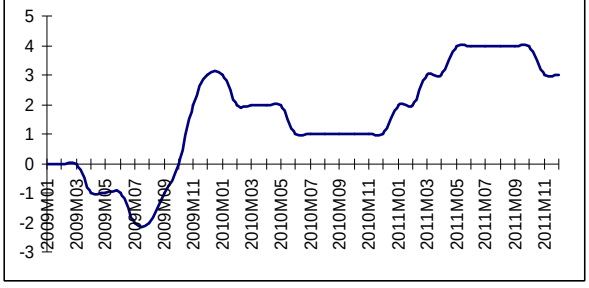
United State's real GDP growth increased by 1.7 percent in 2011 (that is, from the 2010 annual level to the 2011 annual level), compared with an increase of 3.0 percent in 2010.

The increase in real GDP growth in 2011 primarily reflected positive contributions from personal consumption expenditures, exports, and nonresidential fixed investment that were partly offset by negative contributions from state and local government spending, private inventory investment, and federal government spending. On the other hand, imports increased in the same period.

Real gross domestic product — the output of goods and services produced by labor and property located in the United States — increased at an annual rate of 3.0 percent in the fourth quarter of 2011 (that is, from the third quarter to the fourth quarter), according to the "third" estimate released by the Bureau of Economic Analysis. In the third quarter, real GDP growth increased 1.8 percent.

The monthly inflation rate in the United States was reported at 3 percent ending December 2011, while it was recorded at 1 percent in the same month of preceding year.

Figure 1.1: United State, CPI price, % Δ Y-o-Y, Nominal Seas. Adj. (Jan. 2009 – Dec. 2011)



Source: World Bank, Global Economic Monitor (GEM)

The U.S. Bureau of Labor Statistics reports that the unemployment rate in the United States declined to 8.5 percent in December 2011 compared with 9.4 percent in December 2010. The United States monthly international trade deficit increased in December 2011, according to the U.S. Bureau of Economic Analysis and the U.S. Census Bureau.

2.2 The Euro Area Economy

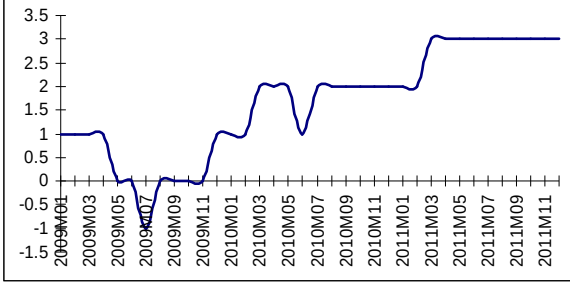
According to European Central Bank, euro area economy expanded by 1.4 percent in 2011, lower than 1.9 percent in 2010. Real GDP grew by 0.7 percent (quarter-o-quarter) in the fourth quarter of 2011. The inflation rate in Euro area was last reported at 2.7 percent in December of 2011, based on the data released on trading economics website.

According to the Euro stat, the EU 17 current account balance surplus stood at € 20.8 billion in the fourth quarter of 2011, compared with a deficit of € 1.2 billion in the third quarter of 2011. The balance of trade in goods was in surplus by € 18.9 billion, compared with a

surplus of € 1.7 billion in third quarter of 2010. In contrast, the balance of trade in services declined from a surplus of € 21 billion in the third quarter of 2011 to € 13.7 billion in the reference quarter.

According to the Euro stat estimates, the euro area seasonally-adjusted unemployment rate was 10.4 percent in December 2011, unchanged from November 2011. However, it was 10.0 percent in December 2010.

Figure 1.2: Euro Area, CPI price, % Δ Y-o-Y, Nominal Seas. Adj. (Jan. 2009 – Dec. 2011)



Source: World Bank, Global Economic Monitor (GEM)

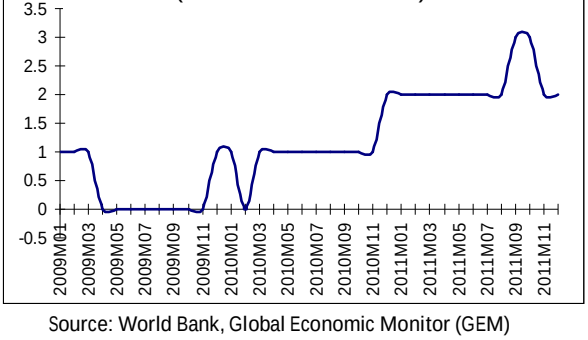
2.3 The Germany's Economy

According to the OECD, the German economy contracted by 0.2 percent in the fourth quarter of 2011 over the previous quarter. However, compare to the same quarter of last year it increased by 2 percent. Historically, from 1991 until 2011, Germany's average quarterly GDP Growth was 0.31 percent reaching an historical high of 2.10 percent in June of 2010 and a record low of -3.70 percent in March of 2009. Germany - the largest economy in Europe. The German economy is heavily export-oriented. In fact, exports account for more than one-third of national output. As a result, exports traditionally have been a key element in German macroeconomic expansion, accounting for over half of the economic growth in recent years. Germany is a strong advocate of closer European economic integration, and its economic and commercial policies are increasingly determined within the European Union (EU).

According to the German Federal Employment Agency, the unemployment rate in 2011 was 7.1 percent. The unemployment increased from 67,000 in November-2011 to 2,780,000 in December-2011. This increase was weaker than in the previous years; there was a minus in seasonally adjusted terms (22,000). Compare to the previous year, the number of unemployed persons declined by 231,000.

In December 2011, the consumer price index (CPI) for Germany was 2.1 percent compared with the same month of 2010, slightly lower than 2.4 percent in November 2011. The annual CPI for all items was 2.3 percent in 2011, almost doubled from 1.1 percent in 2010.

Figure 1.3: Germany, CPI price, % Δ Y-o-Y, Nominal Seas. Adj. (Jan. 2009 – Dec. 2011)



Source: World Bank, Global Economic Monitor (GEM)

2.4 The Economy of France

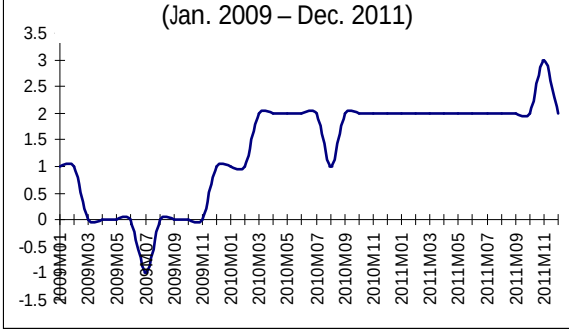
As per the OECD, the Real GDP growth of France increased by 0.2 percent in the fourth quarter of 2011.. In the meantime, it increased by 1.4 percent in the fourth quarter of 2011 compared with the similar period of last year. Based on trading economics analysis, France is the second largest economy and second trading nation in Europe. France, as with many modern industrialized nations, has a large and diverse industrial base. Economic growth rates in France have been steady for decades due to conservative planning of the economy which in comparison to other western European countries is more centralized by the government in France.

France is the third-largest trading nation in Western Europe. The main exports are: machinery and transportation equipment, aircraft, plastics, chemicals, pharmaceutical products, iron and steel, beverages, wheat, beef, pork, poultry, dairy products and wine. French principal imports are: machinery and equipment, vehicles, crude oil, plastics and chemicals.

The trading economics website indicates that the unemployment rate in France was 9.8 percent in the fourth quarter of 2011.

In December 2011, the consumer price index (CPI) for France was 2.5 percent compared with the same month of 2010. The annual CPI for all items was 2.1 percent in 2011, much higher than 1.5 percent in 2010.

Figure 1.4: France, CPI price, % Δ Y-o-Y, Nominal Seas. Adj. (Jan. 2009 – Dec. 2011)



Source: World Bank, Global Economic Monitor (GEM)

2.5 United Kingdom

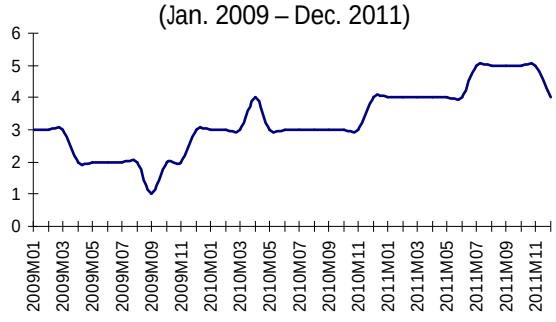
The real GDP growth in the United Kingdom contracted by 0.2 percent in the fourth quarter of 2011 over the previous quarter, however, compare to the fourth quarter of 2010 it increased by 0.8 percent. Services sector, in particular, the banking, insurance, and business services, account by far for the largest proportion of GDP growth, while industry continues to decline. Over the past two decades, the government greatly reduced public ownership and contained the growth of social welfare programs.

According to the Office for National Statistics (ONS), U.K. unemployment rate was 8.4 percent of the economically active population, up 0.1 in the fourth quarter 2011. There were 2.67 million unemployed people, up 28,000 on the quarter. The unemployment rate has not been higher since 1995.

According to the OECD, the consumer price index (CPI) in United Kingdom was 4.2 percent in December of 2011 compared to the December 2010. However, it shows a little

increase of 0.4 percent over the previous month. From 1989 until 2010, the average inflation rate in United Kingdom was 2.72 percent reaching an historical high of 8.50 percent in April of 1991 and a record low of 0.50 percent in May of 2000.

Figure 1.5: UK, CPI price, % Δ Y-o-Y, Nominal Seas. Adj. (Jan. 2009 – Dec. 2011)



Source: World Bank, Global Economic Monitor (GEM)

2.6 The Economy of Japan

According to OECD, Japan's real GDP growth declined by 1.0 percent in the fourth quarter of 2011 compare to the same quarter of 2010. Meanwhile, it decline by 0.6 percent in the reference quarter over the previous quarter.

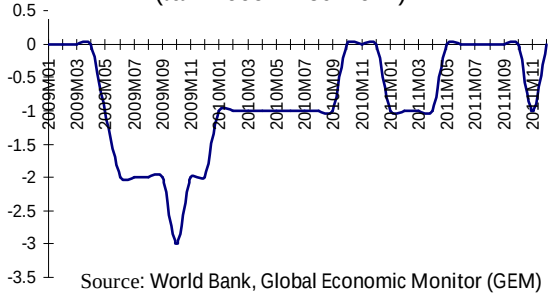
As Japan is industrialized, free market economy and is the second-largest economy in the world, its economy is highly efficient and competitive in terms of international trade, but productivity is far lower in protected areas such as agriculture, distribution, and services sectors.

Based on the trading economics, unemployment rate in December 2011 was 4.5 percent, down from 5.1 percent in December 2010. While, compare to previous month, it remained unchanged.

Japan suffered a trade deficit of JPY 690.4 billion in December 2011, while it enjoyed a trade surplus of JPY 157.6 billion in the same month of 2010. Meanwhile, Japan's trade deficit expanded surprisingly by 145 percent to JPY 690.4 billion in December 2011 from JPY 281.8 billion in November 2011.

According to OECD, the consumer price index (CPI) for Japan was -0.2 percent in December 2011 compared with the same month of 2010, slightly upper than -0.5 percent in November 2011. The annual CPI inflation for all items was -0.3 percent in 2011, while it was -0.7 percent in 2010.

Figure 1.6: Japan, CPI price, % Δ Y-o-Y, Nominal Seas. Adj. (Jan. 2009 – Dec. 2011)



Source: World Bank, Global Economic Monitor (GEM)

3. EMERGING ECONOMIES

During 2012–13, growth in emerging and developing economies is expected to average 5.75 percent—a significant slowdown from the 6.75 percent growth registered during 2010–11, according to the IMF-World Economic Outlook projections. This reflects the deterioration in the external environment as well as the slowdown in domestic demand in key emerging economies. Despite a significant

downward revision of 0.75 percentage point, developing Asia is still projected to grow most rapidly at 7.5 percent on average during 2012–13.

In emerging and developing economies, pressure expected to drop, as both growth and food price inflation slows. However, inflation is expected to remain persistent in some regions.

Overall, consumer prices in these economies are projected to decelerate, with inflation around 6.25 percent during 2012, down from over 7.25 percent in 2011.

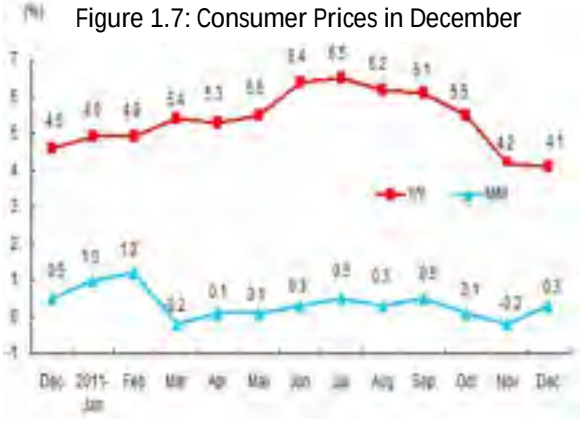
According to the IMF-WEO, economic activity in the Middle East and North Africa is expected to accelerate in 2012-13, driven mainly by recovery in Libya and the continued strong performance of other oil exporters. But most oil-importing countries in the region face muted growth prospects due to longer-than-expected political transitions and an adverse external environment. The impact of the global slowdown on sub-Saharan Africa has to date been limited to a few countries—most notably, South Africa—and the region's output is expected to expand by around 5.5 percent in 2012.

3.1 The Economy of China

According to the mirror data or trading-partners website of China, gross domestic product (GDP) in China expanded by 2.0 percent in the fourth quarter of 2011 over the previous quarter. Historically, from 2011 until 2011, China's average quarterly GDP growth was 2.15 percent reaching an historical high of 2.20 percent in June of 2011 and a record low of 2.10 percent in March of 2011. China's economy is the second largest in the world after that of the United States of American. During the past 30 years, China's economy has been gradually changing from a centrally planned system that was largely closed to international trade to a more market-oriented with inducement to private sector growth. A major component supporting China's rapid economic growth has been exports.

According to the report released by National Bureau of Statistics of China, in December 2011, the consumer price index (CPI) went up by 4.1 percent year-on-year. The prices grew by 4.1 percent both in cities and in rural areas. The food prices went up by 9.1 percent, while the non-food prices increased by 1.9 percent. The prices of consumer goods went up by 4.9 percent and the prices of services grew by 2.0 percent. In December, the month-on-month change of consumer prices was up by 0.3 percent. Of which, prices in cities and rural went up by 0.3 percent simultaneously. The food prices grew by 1.2 percent, while the non-food prices decreased by 0.1 percent. The prices of consumer goods rose by 0.5 percent, and the prices of services went down by 0.2 percent. The CPI inflation in 2011 went up by 5.4 percent over the previous year.

Figure 1.7: Consumer Prices in December



Source: National Bureau of Statistics of China

3.2 The Economy of India

The India's gross domestic product (GDP) expanded by 6.1 percent in the fourth quarter of 2011 over the previous quarter as reported by trading economics website. Historically, from 2000 until 2011, India's average quarterly GDP growth was 7.45 percent reaching an historical high of 11.80 percent in December of 2003 and a record low of 1.60 percent in December of 2002. India's diverse economy encompasses traditional village farming, modern agriculture, handicrafts, a wide range of modern industries, and a multitude of services. Services are the major source of economic growth, accounting for more than half of India's output with less than one third of its labor force. The economy has posted an average growth rate of more than 7% in the decade since 1997, reducing poverty by about 10 percentage points. According to the IMF estimates, India's inflation for the year 2011 is 7.5 and unemployment is 11.11 percent.

4. ASSETS AND COMMODITY PRICES

4.1 Financial Markets[1]

Financial markets play critically important role in the economic developments globally. Developments in financial markets during the fourth quarter of 2011 largely reflected substantial downward revisions of market participants' expectations of growth in several major economies. Over this period, global equity prices declined by 11 percent on average, with larger falls in Europe and slightly smaller falls in emerging market economies (EMEs). Large declines in prices of cyclically sensitive assets pulled down average prices. Corporate credit spreads generally widened, with greater increases for lower-rated debt, which is more vulnerable to non-payment in a downturn. In addition, reflecting expectations of weaker demand for these key production inputs, prices of energy and industrial metals decreased sharply.

Much of the reassessment of growth trajectories occurred between late July and mid-August. Growth-sensitive asset prices dropped particularly sharply during this period. On 29 July 2011, new US GDP figures showed not only that growth in the second quarter was weaker than expected, but also that the level of GDP was around 1 percent lower than previously recorded. In Europe, growth slowed markedly in the second quarter, according to data published on 16 August 2011, with a

[1] Bank for International Settlement, BIS Quarterly Review September 2011
International banking and financial market developments

particularly sharp deceleration in Germany. Furthermore, survey-based indicators pointed to an additional slowdown in the third quarter.

For example, purchasing manager surveys published on 1 August 2011 indicated that growth in manufacturing activity had slowed across Asia, Europe and the United States in July 2011. Global equity prices fell by 2 percent on average on the following day. The S&P 500 Index of US equity prices then declined by 4.5 percent on 18 August 2011, when a measure of US manufacturing activity in August 2011 published by the Federal Reserve Bank of Philadelphia plunged to levels only previously recorded shortly before or during recessions. Throughout the late July to mid-August 2011 period, some of the largest falls in equity prices occurred in countries for which survey-based indicators pointed to the sharpest third quarter growth slowdowns. It may be recalled that economic growth also appeared to be faltering in mid-2010. But growth-sensitive asset prices did not fall as sharply then as they have in the past few months. In mid-2010, market participants expected that additional monetary and fiscal easing would support growth. And, those expectations turned out to be correct, as US authorities cut payroll taxes, extended the duration of income tax cuts and unemployment benefits, and launched a second round of quantitative easing. At the same time, local governments in China provided more financing for infrastructure and housing developments.

In contrast, market participants currently report that they see only limited scope for macroeconomic easing to support growth, including in some EMEs. As a result, they do not expect EMEs to drive global growth as strongly as previously. With all of this in mind, forecasters marked down their projections of growth in several major economies for 2012 and 2013, as well as the remainder of 2011. Prices of cyclically sensitive equities fell more sharply than they did in mid-2010.

4.2 Global Commodity Markets[2]

Given that major developed economy's central banks have had little or no scope for further policy interest rate cuts for some time, market participants watched for signals that authorities would engage in alternative forms of monetary stimulus. Expectations of such measures increased as some inflation pressures diminished during the review period. Many commodity prices fell, for example, leading to lower inflation expectations implied by swap contracts for some major developed economies. In the United States, the Federal Reserve announced on 9 August 2011 that it expected to keep its policy rate at exceptionally low levels until at least mid-2013. This pushed down federal funds futures rates and, hence, longer-term interest rates and boosted US and international equity prices. Equity prices also increased somewhat after Chairman Bernanke's Jackson Hole speech on 26 August 2011. This noted that a range of

[2] Bank for International Settlement, BIS Quarterly Review September 2011
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tools to provide additional monetary stimulus remained available to the Federal Reserve, use of which would be discussed at an extended monetary policy meeting towards the end of September 2011.

Meanwhile, on 4 August the Bank of Japan announced a ¥10 trillion expansion of its asset buying program, with the TOPIX index of Japanese equity prices subsequently maintaining its value amid sharp falls in other major international equity price indices.

Investors also reassessed the prospects for monetary policy in the euro area and in EMEs. The ECB raised its main policy rate by 25 basis points to 1.5% on 7 July to help anchor inflation expectations. In response to news about weakening economic activity, however, prices of futures on short-term interest rates in the euro area started to decline shortly afterwards. Some EME central banks also raised policy interest rates during the period under review, including in China and India. The People's Bank of China further tightened monetary policy by broadening the scope of reserve requirements to cover margin deposits after inflation reached a three-year high of 6.5 percent in July 2011. In contrast, the central banks of Brazil and Turkey cut policy rates in reaction to signs of slower growth. But with expectations of inflation in the major EMEs remaining elevated, forecasters predict that short-term interest rates in these countries will stay close to current levels through to the second half of 2012.

With high and rising stocks of government debt, market participants also reported that they perceived less scope for advanced economies' fiscal policies to be loosened than had been the case in mid-2010. In the euro area, IMF-EU program tied some heavily indebted governments to fiscal consolidation, while others followed the same course due to the high compensation demanded by investors to hold their bonds.

In contrast, investors were willing to finance deficits of the US government at ever lower interest rates.

By early September 2011, however, further signs of weakness in the US economy led the US President to propose a USD 447 billion fiscal stimulus package to Congress, although the reaction of equity markets was muted.

Market participants also thought that additional fiscal stimulus was unlikely to be introduced in the near term in many EMEs. Although debt stocks are in several cases lower than in advanced economies, fiscal stimulus would put upward pressure on exchange rates, which have appreciated further during the review period in a number of EMEs.

4.3 Global Exchange Rate Movements[3]

Fears of recession in some mature economies and serious strains in the euro area sovereign bond markets increased the demand for traditional safe haven assets. As a result, yields on some of the most highly rated and liquid

[3] Bank for International Settlement, BIS Quarterly Review September 2011International banking and financial market
developments

sovereign bonds fell markedly during the period under review. Ten-year yields on US, German and Swiss government debt fell below 2 percent, while real interest rates on long-term US and UK inflation-linked bonds entered negative territory. Nominal yields on some short-dated US

Treasury bills even fell below zero in early August 2011, although this coincided with Bank of New York Mellon's announcement that it would begin charging fees on large deposits. Also, the price of gold set new historic records and the Swiss franc appreciated sharply as investors moved into Swiss assets. These included Swiss government bonds, which had negative yields out to two-year maturities for much of August 2011.

The Swiss National Bank (SNB) reacted strongly to the appreciation of its currency. On 3 August 2011, the SNB announced that it would cut its target interest rate to "as close to zero as possible". It also boosted the amount that it lends in the interbank market from CHF 30 billion to CHF 200 billion, reducing interbank borrowing rates at all maturities. This contributed to a decline in the value of the Swiss franc of over 10 percent against the euro. It began to appreciate again at the beginning of September, however, prompting the SNB to state on 6 September 2011 that: "With immediate effect, it will no longer tolerate a EUR/CHF exchange rate below the minimum rate of CHF 1.20. The SNB will enforce this minimum rate with the utmost determination and is prepared to buy foreign currency in unlimited quantities."

Other countries also introduced measures to counter upward pressure on the value of their currencies. In Japan, for example, the authorities sold yen in the foreign exchange markets from early August 2011. After a short-lived depreciation of around 2 percent, the value of the yen stabilized against the dollar for the remainder of August and into September 2011. And the Brazilian government introduced on 27 July 2011 a 1 percent transaction tax on onshore foreign exchange derivatives trades that result in US dollar short positions over $10 million. Since then, the Brazilian real has depreciated by around 5 percent against the US dollars.

CHAPTER II

MONETARY AND CAPITAL MARKET DEVELOPMENTS

2

MONETARY AND CAPITAL MARKET DEVELOPMENTS

Monetary and capital market developments evaluates monetary program under Enhanced Credit Facility (ECF) program, monetary aggregates, foreign exchange rates, net international reserves (NIR) as well as open market operations. The DAB's ultimate goal is to maintain domestic price stability, to achieve its goal; DAB uses, both primary and indicative tools. In the third quarter of 1390, monetary aggregates exhibited mixed performance, reserve money (RM), the primary target, was achieved for the third quarter after two consecutive breaches in first and second quarters due to the crisis started in the then Kabul bank. Currency in circulation constitutes one of the crucial components of the reserve money with more than 85 percent contribution to the reserve money with a significant correlation.

In the first quarter of 1390, the reserve money increased dramatically above the target level and the situation continued throughout the second quarter mainly due to influx of afghani in Kabul Bank's current account, where DAB acted as the lender of the last resort to safeguard public's deposits with the bank. Therefore, DAB was not able to achieve the reserve money target in the second quarter of 1390. On the other hand, narrow money (M1) increased by 21 percent on a year-on-year basis. Broad money (M2) demonstrated similar behavior growing by 21.31 percent.

In the meantime, the exchange rate of afghani against the U.S. dollars depreciated by almost 8 percent in the third quarter of 1390 – the exchange rate of afghani moved in a corridor of AF 45-49 per U.S. dollar at the end of third quarter of 1390.

Foreign exchange auction, the primary instrument used by DAB to control money supply, at the end of the third quarter DAB's intervention reached a total of USD 1.74 billion.

Capital notes are the other instruments used by DAB in order to control liquidity in the local market. The weighted average interest rates of 28 day notes noticed a decrease of 0.04 basis points during the quarter under review which caused the interest rate of 28 day notes to decrease to 2.10 percent. Similarly, the

weighted average interest rate for 182 day notes posted a decline of 0.06 basis points at the end of the quarter under review, reaching 3.24 percent.

The stock of Afghanistan's net international reserves (NIR) recorded at USD 5.822 billion and increase of USD 418 million whereas the target for the third quarter was at USD 5.40.

1 – ENHANCED CREDIT FACILITY (ECF) PROGRAM

Reserve money (RM), which is the primary target for the central bank and performance criteria under the ECF program ended at AF 170,736.12 million compared to the ceiling of AF 172,300.27 million at the end of third quarter of 1390. Since the ultimate objective of monetary policy is to maintain price stability aims to influence the reserve money, the operational target (performance criterion), in order to achieve its ultimate goal. The RM growth was calculated based on the expected economic growth and expected inflation rate. Reserve money constitutes of currency in circulation, current accounts of commercial banks with central bank (afghani denominated), overnight deposit facility (ONDF) and the required reserves of commercial banks.

Based on discussions with IMF, taken into account the inflationary pressure in domestic economy, the ceiling for RM growth in 1390 was revised to 18.8 percent and for currency in circulation it was revised to 17.7 percent respectively.

The Central Bank was not able to achieve its target, both for first and second quarters due to Kabul Bank crises, where central bank acted as the lender of last resort in order to guarantee public deposits. The actual RM ended at positive growth of 10.25 percent for the first quarter, 11.16 percent for second quarter, and finally 13.03 percent at the end of the third quarter, where the targets were 4.7 percent, 9.40 percent, and 14.14 percent respectively.

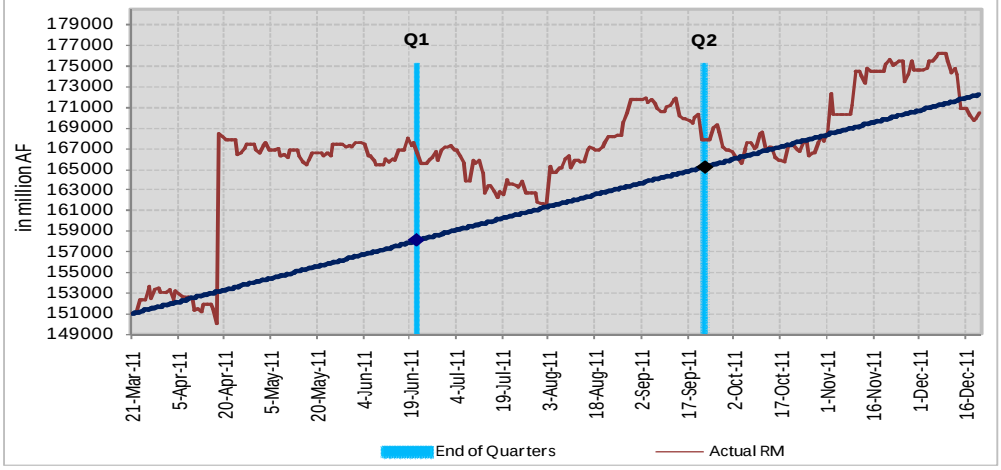
Table 2.1 and Figure 2.1 depict reserve money growth at the end of third quarter 1390.

Table 2.1: Reserve Money Summary

	Q1 (June 21, 11) Target breached	Q2 (Sept 22,11) Target breached	Q3 (Dec 21, 11) Target achieved	Q4 (Mar 20, 12)
ECF RM ceilings (%)	4.70	9.40	14.10	18.80
MPD RM ceilings (%)	4.38	8.75	13.13	17.50
Actual RM (%)	10.25	11.16	13.03	-
ECF RM (Millions AF)	158,105.51	165,202.89	172,300.27	179,397.65
MPD RM (Millions AF)	157,614.73	164,221.34	170,827.94	177,434.55
Actual RM (Millions AF)	166,487.08	167,857.16	170,686.45	-

Source: Monetary Policy Department/DAB

Figure 2.1: Reserve Money Trend



Source: Monetary Policy Department/DAB

According to the monetary and financial statistics manual [MFS Compilation Guide 2008, Para 3.61], monetary bases (Reserve Money) is defined as "Central Bank liabilities in the form of currency issuance, liabilities to ODCs, and deposits accepted from other sectors (excluding the central government)". However, in the context of the ECF program, reserve money is defined as central bank liabilities in the form of currency issuance and afghani-denominated liabilities to commercial banks (ODCs) excluding capital notes.

Reserve money, the primary target is based on the definition provided above – the annual ceiling on reserve money growth for 1390 was revised to 18.8 percent, while the ceiling on currency in circulation growth was revised at 17.7 percent.

2. MONETARY AGGREGATES

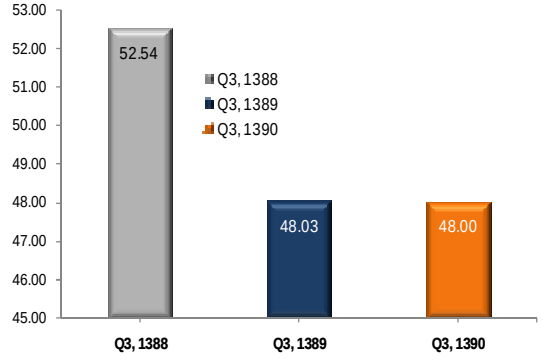
The monetary aggregates -- narrow money and broad money -- are compiled based on the MFS methodology and definition. Narrow money as referred (M1) grew by 21 percent (Y-o-Y) in the third quarter of 1390 compared to 25 percent growth in the same quarter of 1389 (2010-11). The increase in M1 was attributed mainly to the increase in demand for local currency and people's confidence to use afghani as medium of exchange and store of value. The demand deposits, a component of M1, increased from 16 percent in the third quarter of the 1389 to 21.23 percent in the third quarter of 1390.

On the other hand, the stock of broad money (M2) ended at AF 311,433 million in the reporting period. The overall growth in M2 in the third quarter of 1390 was recorded at 21.31 percent (Y-o-Y) down from 26.90 percent growth in the third quarter of 1389. M1 is the main contributor to the growth in M2 since M1 constitutes the largest portion of Broad Money (M2).

Quasi money or time deposits of the commercial banks -- the other component of M2 -- grew by 25.75 percent at the end of the third quarter of 1390. However, because quasi money constitutes the smallest component of the M2, therefore, the impact of changes in M2 is negligible. The year-on-year difference of afghani-denominated time deposits for the third quarter of 1390 was AF 1,829 million and for foreign currency denominated time deposits the difference was recorded at AF 2,412 million.

Meanwhile, bank deposits as share of broad money grew by 48 percent (Y-o-Y) in the third quarter of 1390 down from 48.03 percent in the third quarter of previous year. (Figure 2.2)

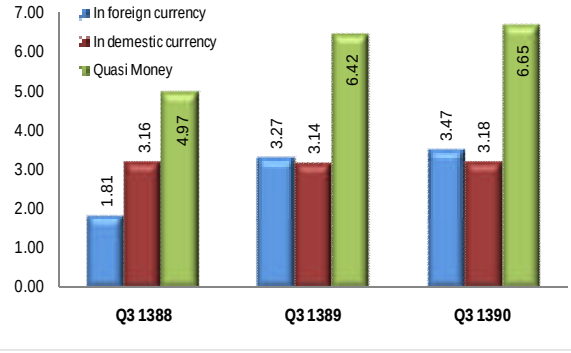
Figure 2.2: Bank Deposits as share of M2 (%)



Source: Monetary Policy Department/DAB

Likewise, the share of quasi money in total broad money stood at 6.65 percent in the quarter under review. Afghani-denominated time deposits constituted 3.18 percent of broad money, while share of foreign currency denominated time deposits in M2 stood at 3.47 percent in the quarter under review.

Figure 2.3: Quasi Money as Share of M2 (%)
(Changes Y-o-Y)



Source: Monetary Policy Department, DAB

In the third quarter of the previous year, the quasi money amounted AF 16,470 million (AF 8,064 million afghani-denominated time deposits and AF 8,406 million in foreign currency denominated time deposits), while in the third quarter of current year, quasi money reached AF 20,711 million (AF 9,893 million in afghani-denominated time deposits and AF 10,818 million in foreign currency denominated time deposits) which shows an increase of 25.75 percent (Y-o-Y).

Table 2.2: Monetary Aggregate, third quarter of 1330 (in millions AF)

	1388 (2009-10) Q3 Amount	1389 (2010-11) Q3 Amount	Y-o-Y Changes	Difference	1390 (2011-12) Q3 Amount	Y-o-Y Change (Q3 1389 – Q3 1390)	Difference (Q3 1389 – Q3 1390)
1- Net Foreign Assets	**218,364**	**248,141**	**13.6%**	**29,776**	**338,082**	**36.25%**	**89,941**
(a) Foreign Assets	247,289	279,091	12.9%	31,802	370,880	32.89%	91,789
DAB Foreign exchange reserves	206,672	226,828	9.8%	20,156	303,738	33.91%	76,910
Gold	34,641	37,611	8.6%	0.000	45,232	20.26%	0.000
Other	172,031	189,217	10.0%	17,186	258,507	36.62%	69,290
Other foreign assets	40,616	52,262	28.7%	11,646	67,141	28.47%	14,879
(b) Foreign Liabilities	28,924	30,950	7.0%	2,025	32,798	5.97%	1,848
2. Net Domestic Assets	**-14,120**	**8,086**	**-157.3%**	**22,206**	**-26,199**	**-424.00%**	**-34,285**
(a) Net Domestic Credit	12,503	20,001	60.0%	7,499	-36,265	-281.31%	-56,266
Net Credit to Nonfinancial Public Sector	-52,239	-64,060	22.6%	-11,821	-78,472	22.50%	-14,412
Net Credit to Central Government	-51,745	-63,979	23.6%	-12,234	-78,226	22.27%	-14,247
Credit to Central Government	20,859	19,644	-5.8%	-1,215	20,292	3.30%	648
Liabilities to Central Government	72,604	83,622	15.2%	11,018	98,518	17.81%	14,895
Net Credit to State & Local Government	0	0	0.000	0.000	0.000	0.000	0.000
Net Credit to Public Nonfinancial Corporations	-494	-81	-83.5%	413	-246	202.28%	-165
Credit to Private Sector	64,742	84,062	29.8%	19,319	42,207.17	-49.79%	-41,854
Net Credit to Other Financial Corporations	0	0		0	0.00		0
(b) Capital Accounts	49,767	480	-99.0%	-49,287	36,800	7559.08%	36,320
(c) Other Items Net	23,144	-11,435	-149.4%	-34,579	46,866	-509.85%	58,301
3- Broad Money (M2)	**202,231**	**256,727**	**26.9%**	**54,496**	**311,433**	**21.31%**	**54,706**
Narrow Money (M1)	192,177	240,257	25.0%	48,080	290,722	21.00%	50,465
Currency outside depository corporations	85,922	116,953	36.1%	31,031	141,245	20.77%	24,292
Demand Deposits	106,255	123,304	16.0%	17,049	149,477	21.23%	26,172
Quasi Money	10,054	16,470	63.8%	6,415	20,711	25.75%	4,242
In Afghani	6,393	8,064	26.1%	1,671	9,893	22.69%	1,829
In Foreign currency	3,662	8,406	129.6%	4,744	10,818	28.70%	2,412
Securities Other Thank Shares	0	0.000	0.000	0.000	0.000	0.000	0.000

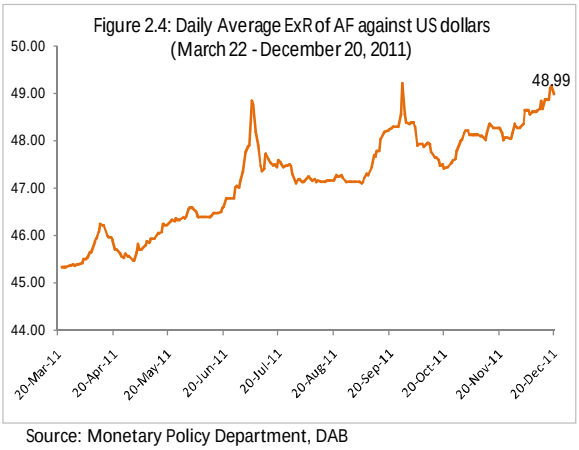
Source: Monetary Survey Section, Monetary Policy Department /DAB

3. FROEIGN EXCHANGE MARKET

3.1 Foreign Exchange Rates

The nominal exchange rate of afghani against US dollars depreciated by 8.03 percent (Y-o-Y) at the end of the third quarter of 1390 compared to the same period of last year. Afghani was traded at 49.04 per USD at the end of third quarter (December 21, 2011) compared to AF 45.27 on December 21, 2010. The historical review of the exchange rate indicates that afghani/USD nominal exchange rate, as of third quarter of 1390 (December 21, 2011) is shown in Figure 2.4.

Figure 2.4: Daily Average ExR of AF against US dollars (March 22 - December 20, 2011)

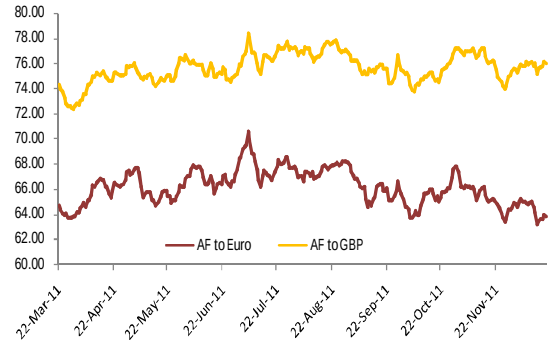


Source: Monetary Policy Department, DAB

The nominal exchange rate of afghani has depreciated against major currencies particularly US dollar in the local markets.

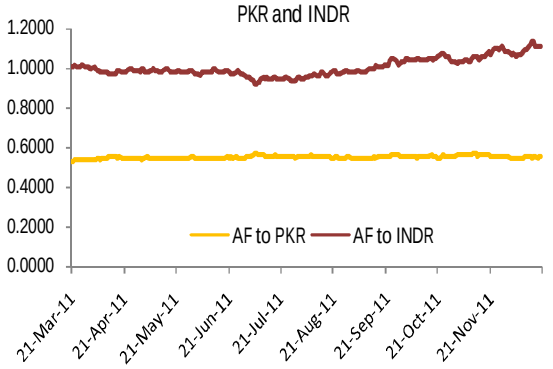
The comparison of historic review of the daily average exchange rate of afghani against some major currencies for the third quarter of 1390 is shown in Figures 2.5 and 2.6 below:

Figure 2.5: Daily Average Exchange Rate of AF Against Euro and GBP



Source: Monetary Policy Department, DAB

Figure 2.6: Daily Average Exchange Rate of AF Against PKR and INDR



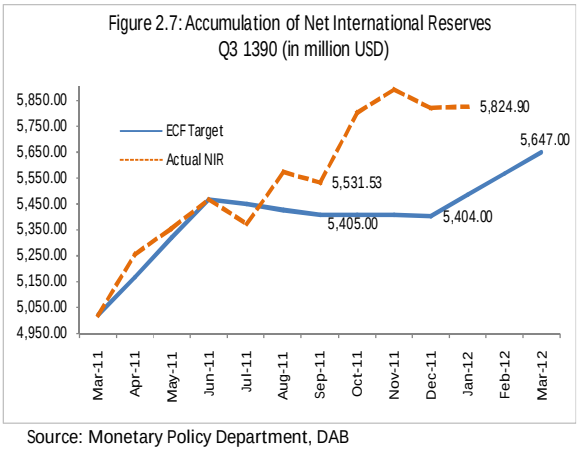
Source: Monetary Policy Department, DAB

3.2 Net International Reserves (NIR)

Da Afghanistan Bank (DAB) has accumulated USD 805 million on its net reserves at the end of the third quarter of 1390 at a program exchange rate which is well above the target of USD 387 million. DAB has achieved NIR accumulation target for first, second and third quarters of 1390, ending at USD 5.82 billion at the end of third quarter of 1390 from USD 5.017 billion at the beginning of the year. Accumulation of NIR boosts confidence on the domestic currency and supports balance of payments. The NIR position grew by large amounts in the first and second quarters of 1390. Since DAB uses FX auction as a tool to control the currency in circulation, a significant portion of the foreign reserves (US dollar) is sold on a bi-weekly basis in the form of auction which affects the total amount of net international reserves negatively.

DAB anticipates NIR to be around USD 6 billion by the end of 1390 (2011-12). Furthermore, the gross international reserves stood at USD 6.2 billion at the end of the third quarter (December 21, 2011).

Figure 2.7: Accumulation of Net International Reserves Q3 1390 (in million USD)



Source: Monetary Policy Department, DAB

3.3 Foreign Exchange Auction

Open Market Operations, in particular, the Foreign exchange auction is the primary instrument of monetary policy used by the DAB

to control the level of money supply. Foreign exchange auction size is determined by a liquidity forecasting framework, which takes into account the money demand on one hand and the ceiling on currency growth agreed by DAB with the IMF under the enhanced credit facility (ECF) program.

DAB's intervention reached a total of USD 1,736.55 million at the end of third quarter of 1390 (USD 441.80 million in the first quarter, USD 581.60 million in the second quarter, and finally USD 713.15 million in the third quarter), while the total amount announced was USD 1,785 million (USD 495 million in the first quarter, USD 570 million in the second quarter and for the third quarter USD 680 million).

Recently, the DAB has increased the volume of auction due to excess liquidity in local economy, compared to the second quarter of 1389 of USD 977.37 million.

Table 2.3: DAB Foreign Exchange Auction Summary, 1390 (in million USD)

Auction Date	No of Bidders	High Price	Low Price	Cut off Price	Market Ex Rate	Amount Announced	Amount Awarded	No of Awarded Bidders	Total Amount demanded
27-Mar-11	45	45.38	45.18	45.37	45.37	30.00	31.85	21	44.70
3-Apr-11	41	45.52	45.31	45.49	45.52	35.00	26.40	23	35.70
10-Apr-11	39	45.92	45.61	45.90	45.93	30.00	24.25	24	34.30
17-Apr-11	44	46.05	45.90	45.98	45.96	40.00	40.90	35	46.70
24-Apr-11	39	45.60	45.45	45.53	45.57	40.00	38.25	30	41.30
1-May-11	40	45.50	45.38	45.46	45.49	40.00	25.85	18	44.20
8-May-11	40	45.86	45.51	45.84	45.87	40.00	36.55	19	49.70
15-May-11	35	46.06	45.90	46.04	46.06	40.00	39.70	18	46.80
22-May-11	34	46.40	46.10	46.31	46.33	40.00	38.70	22	44.80
29-May-11	44	46.37	46.21	46.34	46.36	40.00	34.60	25	44.40
5-Jun-11	45	46.45	46.31	46.41	46.42	40.00	35.00	36	41.20
12-Jun-11	42	46.37	46.00	46.35	46.38	40.00	31.85	25	43.20
19-Jun-11	45	45.58	46.38	46.55	46.58	40.00	37.90	23	52.00
26-Jun-11	44	47.03	46.71	46.93	47.03	40.00	37.25	37	45.60
3-Jul-11	50	47.84	47.40	47.76	47.88	40.00	46.80	35	56.10
9-Jul-11	48	47.94	47.40	47.88	47.92	25.00	36.00	32	42.90
12-Jul-11	44	47.45	47.11	47.37	47.42	25.00	34.20	32	37.90
16-Jul-11	46	47.53	47.91	47.40	47.53	30.00	31.60	31	39.90
19-Jul-11	46	47.44	47.25	47.42	47.45	30.00	28.05	19	45.10
23-Jul-11	47	47.46	47.19	47.43	47.44	30.00	30.55	25	42.20
26-Jul-11	54	47.50	47.00	47.48	47.50	30.00	38.65	26	54.90
30-Jul-11	39	47.11	46.51	47.07	47.12	30.00	22.75	21	29.50
2-Aug-11	50	47.12	46.91	49.09	47.12	30.00	21.90	21	40.80
6-Aug-11	47	47.25	47.01	47.21	47.26	20.00	20.95	19	36.80

9-Aug-11	41	47.15	46.87	47.11	47.18	20.00	21.10	27	24.70
13-Aug-11	43	47.13	46.92	47.10	47.13	20.00	21.75	25	29.20
16-Aug-11	42	47.16	46.85	47.14	47.17	20.00	20.90	19	30.30
20-Aug-11	32	47.16	47.00	47.14	47.16	20.00	10.95	11	26.60
23-Aug-11	41	47.28	46.81	47.25	47.26	20.00	17.85	18	29.10
27-Aug-11	39	47.10	46.80	47.07	47.14	40.00	24.65	20	33.90
3-Sep-11	33	47.13	46.90	47.09	47.13	40.00	20.20	21	23.90
6-Sep-11	40	47.23	47.00	47.22	47.22	20.00	23.30	17	34.70
10-Sep-11	38	47.42	47.27	47.41	47.44	20.00	11.45	11	32.60
13-Sep-11	34	47.83	47.50	47.78	47.79	20.00	19.80	15	30.90
17-Sep-11	32	48.22	48.21	48.15	49.19	20.00	20.40	23	24.60
20-Sep-11	42	48.23	47.97	48.23	48.28	20.00	20.55	22	31.50
25-Sep-11	39	48.54	48.00	48.56	48.53	20.00	16.15	14	30.90
27-Sep-11	36	49.29	48.71	49.21	49.00	20.00	26.10	32	26.90
1-Oct-11	39	48.30	48.00	48.37	48.16	30.00	24.75	26	29.60
4-Oct-11	44	48.22	48.00	48.32	48.16	30.00	33.05	31	38.90
8-Oct-11	45	47.94	47.45	47.93	47.83	25.00	29.40	34	34.70
11-Oct-11	40	47.96	47.75	47.95	47.95	25.00	28.15	22	38.20
15-Oct-11	42	47.61	47.01	47.65	47.51	30.00	24.75	25	31.10
18-Oct-11	43	47.49	47.11	47.49	47.42	30.00	24.90	24	34.30
22-Oct-11	46	47.45	47.45	47.46	47.44	30.00	29.10	19	44.90
25-Oct-11	45	47.58	47.00	47.58	47.58	30.00	31.90	21	43.90
29-Oct-11	39	48.00	47.71	47.99	47.95	25.00	25.25	24	32.40
1-Nov-11	38	48.23	47.14	48.23	48.16	25.00	27.20	26	33.30
12-Nov-11	38	47.97	47.10	48.03	47.80	50.00	30.10	33	34.30
15-Nov-11	38	48.35	47.50	48.34	48.20	20.00	21.90	28	25.30
20-Nov-11	45	48.35	48.00	48.28	48.21	25.00	30.85	35	34.30
22-Nov-11	41	47.97	47.51	48.02	47.85	25.00	23.95	22	31.30
26-Nov-11	41	47.98	47.66	48.04	47.92	30.00	33.35	27	40.50
29-Nov-11	42	48.31	48.18	48.32	48.28	30.00	40.80	23	51.60
3-Dec-11	45	48.36	48.15	48.36	48.30	30.00	30.00	30	48.50
7-Dec-11	41	48.56	48.31	48.57	48.51	30.00	23.65	23	32.30
10-Dec-11	33	48.60	48.00	48.62	48.48	30.00	36.65	32	38.70
13-Dec-11	47	48.87	48.51	48.86	48.86	30.00	47.95	43	49.30
17-Dec-11	49	48.87	48.65	48.87	48.81	30.00	34.25	26	46.50
20-Dec-11	49	48.98	48.55	49.04	48.55	30.00	39.00	38	46.80
Total FX						**1,785.00**	**1,736.55**		**2,291.00**

Source: Monetary Policy Department/Market Operations, DAB

4. CAPITAL MARKETS AND LIQUIDITY CONDITIONS (UPATES NOT AVAILABLE)

4.1 Capital Note Auctions

Capital notes are short-term Afghani denominated securities sold by the central bank at weekly auctions. Capital notes are discount securities, which mean that they are issued and traded at a discount to face value. Discount securities make only one payment – the face value—on the maturity date. The difference between what is paid for the capital notes at purchase date and the face value is the interest component. Currently, the capital notes on offer are for maturity periods of 28 days (1 month), and 182 days (six months). Only licensed commercial banks and money changers can participate in the auctions. Private individuals seeking to purchase capital notes can do so through their accounts maintained with the commercial banks.

The amount to be auctioned is announced every Monday to the banks electronically. The auction is a multiple price auction with each bidder paying the price they bid. The auction is held on Tuesday with settlement T+1 except when it coincides with public holidays. In the auction, investors bid to purchase desired values of capital notes at different discount prices. Bids have to be submitted before 10:00 am on the auction day.

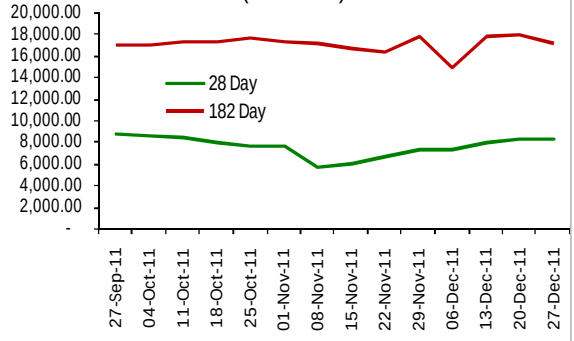
4.1.1 Analysis and Market Information

The amounts awarded in the quarter under review fluctuated between AF 1.7 billion and AF 3.0 billion for 28 day notes, while for 182 day notes it ranged between AF0.2 and AF3.5 billion. The weekly announced amounts for both 28 day and 182 day notes were AF200 million and AF 100 million per week respectively.

In the quarter under review, the outstanding stock of 28 day notes fluctuated between AF 5.7 billion and 8.7 billion. The quarter ended with outstanding amount of AF 8.2 billion. On the other hand, the stock outstanding of 182 day notes hit a record increase. It increased by AF 0.80 billion compared to the preceding quarter, making the outstanding of AF 18.0 billion. The quarter under review ended with AF 17.1 billion.

The total outstanding stock of both maturities stood at AF 25.2 billion at the end of the reporting period. (Figure 2.4)

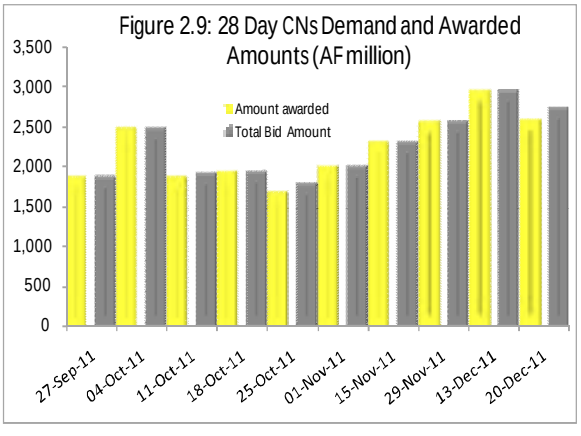
Figur 2.8: Capital Notes Stock outstanding (million AF)



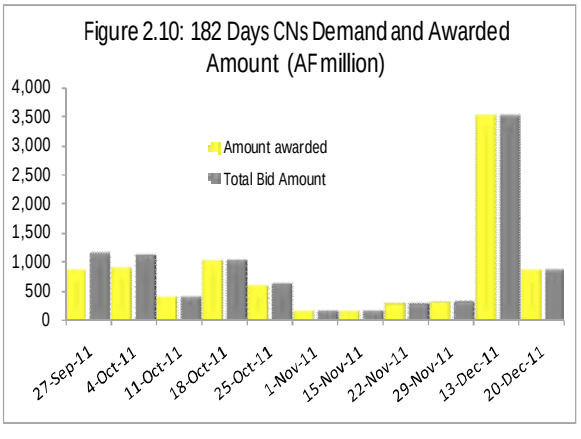
Source: Market Operations Department, DAB.

The high demand for CNs is reflected in the cover ratio, the ratio of amounts bid to amounts awarded. In the quarter under review, the average bid amount for 28 day notes was AF 2.3 billion while the awarded

amount stood at AF2.3 billion for a cover ratio of 1.01. The bid amount for 182 day notes was AF 0.90 billion and amount awarded was AF 0.853 billion for a cover ratio of 1.05. Comparing the cover ratio in the third quarter with that in the preceding quarter, the cover ratio for 28 day note was 1.16 and for 182 day note it was 1.24. The ratio of amount awarded to the amount announced (fixed at AF 200 million for 28 day and AF 100 million for 182 day CNs) was 11.40 and 8.99 for 28 day and 182 notes respectively. This indicates that there is still high demand for CNs, despite large amount of supply by DAB. (Figure 2.5 and Figure 2.6)



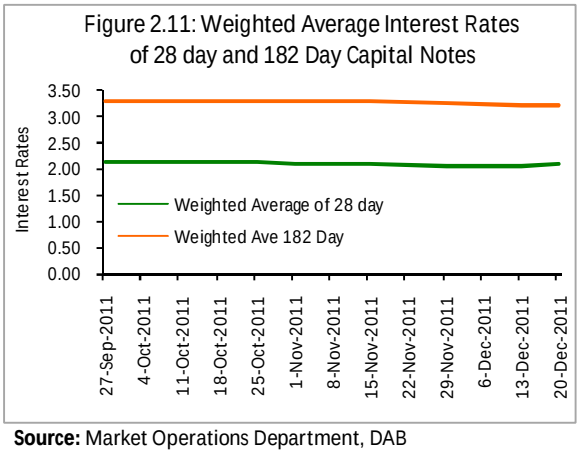
Source: Market Operations Department, DAB



Source: Market Operations Department/ DAB

The weighted average interest rates for 28 day notes noticed a minimum decrease of 0.04 basis points during the quarter under review which caused the interest rate of 28 day notes to decrease to 2.10 percent. Similarly, the weighted average interest rate for 182 day notes posted a decline of 0.06 basis points at the end of the quarter under review, reaching 3.24 percent.

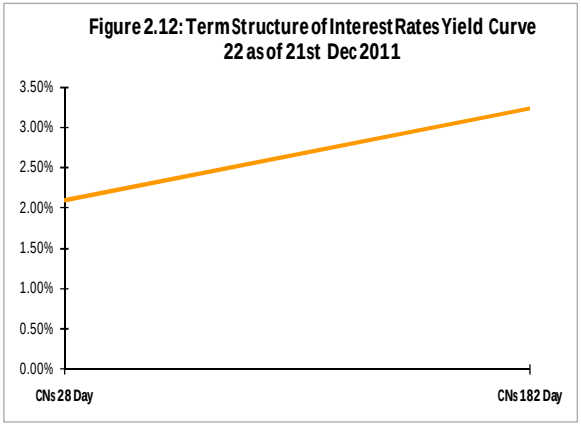
The interest rates in the second quarter were 2.15 percent and 3.30 percent for 28 day and 182 day notes respectively. (Figure2.7)



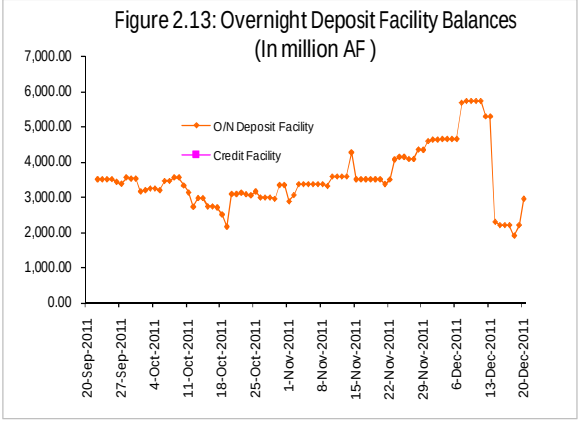
Source: Market Operations Department, DAB

4.2 Term Structure of Interest Rates

The yield of the capital notes is the annualized percentage increase in the value of the CNs. The yield curve for December 21, 2011 is positive.



Source: Market Operations Department, DAB



Source: Market Operations Department, DAB

4.3 Required and Excess Reserves

Overnight standing facilities were first introduced at the beginning of the year 1385 (2006-2007). The purpose of introducing the standing facility was to provide commercial banks with facilities to better manage their liquidity and to provide them with a vehicle where they can invest their excess reserves.

Overnight Deposit Facility: This facility is available to all commercial banks to gain interest on excess balances and provides a floor for rates on capital notes, so it is not counted towards required reserves. The interest rate on the overnight deposit facility is now 350 basis points below 28 auction cut-off rate (based on a circular to all banks approved by DAB Supreme Council on Feb 27, 2007). The outstanding amount of deposit facility balances fluctuated between AF 1.9 billion and AF 5.7 billion. The quarter under review ended with stock outstanding amounting to AF 3.0 billion.

Overnight Credit Facility: This facility is used by banks for short term cash needs. The facility allows banks to borrow Afghani from Da Afghanistan Bank on an overnight basis when they face a short fall in cash flow. The rate that the banks are charged for this facility is 350 basis points above the cut off rate of the last 28 day CNs auction. This borrowing is collateralized with outstanding capital notes only (according to the circular of Feb 27, 2007). During the quarter under review none of the banks benefited from credit facility.

During the quarter, required reserves averaged AF 715 million per bank. This figure was AF693 million.

Required reserves were remunerated at 350 basis points below the cut off rate of 28 day capital notes auction rate or equal to the deposit facility rate.

Table 2.4: Auction of 28 Day Capital Notes (million AF)

Date	Auction Amount	Amount awarded	Total Bid Amount	Winning Bids	No. of total bids	Cut of Rate	Low Bid	Weighted Average
27-Sep-11	200	1,900	1,900	3	3	2.15%	2.14	2.14
04-Oct-11	200	2,500	2,500	3	3	2.15%	2.13	2.14
11-Oct-11	200	1,890	1,940	3	3	2.14%	2.10	2.13
18-Oct-11	200	1,950	1,950	3	3	2.14%	2.13	2.13
25-Oct-11	200	1,700	1,810	2	2	2.13%	2.12	2.13
01-Nov-11	200	2,030	2,030	4	4	2.13%	2.11	2.12
15-Nov-11	200	2,320	2,320	4	4	2.12%	2.10	2.12
29-Nov-11	200	2,580	2,580	6	6	2.11%	2.00	2.08
13-Dec-11	200	2,970	2,970	8	8	2.11%	2.00	2.09
20-Dec-11	200	2,600	2,750	5	6	2.11%	2.09	2.10

Source: Market Operations Department, DAB

Table 2.5: Auction of 182 Day Capital Notes (million AF)

Date	Auction Amount	Amount Awarded	Total Bid Amount	Winning Bids	No. of total bids	Cut of Rate	Low Bid	Weighted Average
27-Sep-11	100	885	1,170	4	4	3.30%	3.29	3.30
4-Oct-11	100	925	1,125	3	4	3.30%	3.28	3.30
11-Oct-11	100	440	440	2	2	3.30%	3.29	3.29
18-Oct-11	100	1,040	1,040	3	3	3.30%	3.28	3.29
25-Oct-11	100	630	650	3	3	3.30%	3.28	3.29
1-Nov-11	100	200	200	1	1	3.30%	3.29	3.29
15-Nov-11	100	200	200	1	1	3.27%	3.25	3.29
22-Nov-11	100	325	325	2	2	3.27%	3.24	3.26
29-Nov-11	100	350	350	2	2	3.26%	3.23	3.24
13-Dec-11	100	3,500	3,510	7	7	3.26%	3.20	3.24
20-Dec-11	100	885	885	4	4	3.26%	3.23	3.24

Source: Market Operations Department, DAB

CHAPTER III

THE INFLATION TREND AND OUTLOOK

3

THE INFLATION TREND AND OUTLOOK

The decelerating trend in inflation that began in the first quarter of 1390 continued its way into the second quarter and seemed to maintain its downward trend in the third quarter as well. By all measures, inflation decreased in the third quarter of 1390.

For example, Kabul headline inflation (year-on-year) was 9.38 percent in the third quarter of 1390, which still is a high number, but lower than the inflation rate of 12.85 percent recorded in the third quarter of 1389. The decrease in the inflation rate on the year-on-year basis was caused primarily by a decline in inflation in food prices. The rate of changes of food prices, which comprises 61.3 percent of the index, declined sharply to 5.88 percent from the previous year's value of 15.6 percent. However, core inflation, which excludes the important components of bread and cereals, oils and fats, and transportation is currently at relatively high level of 11.45 percent (year-on-year), but lower than 12.55 percent inflation of last year, suggesting that inflation persisted beyond these basic commodities.

Nationwide, year-on-year inflation remained unchanged compared to the same quarter of previous year. Here, the rapid fall in the rate of headline inflation in food prices was offset by increase in the rate of inflation in non-food prices. Interestingly, however, inflation in rents was falling less rapidly nationwide than that of Kabul city.

When the quarter-on-quarter changes in inflation are observed, the picture is somewhat different. The Kabul headline inflation in the third quarter of 1390 increased slightly to 3.8 percent from 3.4 percent in the second quarter. Prices of foodstuffs such as oil and fats, milk and cheese, and bread and cereals increased at a slower rate, and the rate of inflation in rents also declined. However, these positive changes were almost completely offset by a significant increase in inflation in fuel and electricity price-index.

The quarter-on-quarter changes in nationwide inflation showed different patterns than in Kabul. Headline inflation indicates a significant increase when compared with the second quarter, whereas Kabul headline inflation showed slight increase compared to the

previous quarter. Kabul and nationwide quarterly inflation are exhibiting similar rate of inflation currently. Also, nationwide inflation in rents increased slightly from the second quarter but the increase was not significant, while inflation in food prices increased significantly and is now quite high.

1. INFLATION EASED IN THE THIRD QUARTER

1.1 Annual Changes in Kabul Headline Inflation

In the third quarter of 1390, the Kabul headline inflation, when measured on a year-on-year basis, was somehow better than was recorded in the same quarter of 1389. The headline inflation rate in the quarter under review was 9.38 percent, compared to the 12.85 percent inflation observed the same period of previous year.

The Consumer Price Index (CPI) basket is intended to reflect all of the items a typical family buys to achieve a minimum standard of living in a base period (currently 2004). The CPI does not count the price of each item equally, but weights each according to its share of total household expenditures in the base period, so that changes in the index from one period to the next are broadly reflective of changes in a representative household's current cost of living.

To analyze the contributing factors to the decrease in inflation in this quarter, it is necessary to decompose the CPI basket and expound on the components that have the most significant weights in the calculation of the CPI. First, we will analyze those significant components that showed the largest favorable changes which are clearly visible and then we will look at those components that showed unfavorable changes in inflation from the previous year.

The food inflation is the major driver of pushing the prices downward. Unsurprisingly, the main cause of a 3.47 percentage-point decrease in the inflation rate was mainly driven by decrease in the rate of inflation in most components of food sub-index. The food prices, which increased by an alarming rate of 15.60 percent (Y-o-Y) in the third quarter of 1389, rose by a far less significant rate of 5.88 percent in the third quarter of 1390. After declining from its peak experienced in 1387, food prices rose again rapidly in 1389. In Afghanistan, agricultural production was relatively lower in 1389 and 1390 compared with 1388, but 1391 is expected to be a favorable year for agricultural products due to a good winter season and better weather conditions which will put less pressure on prices.

Inflation in non-food prices increased significantly – to 14.89 percent (Y-o-Y) from 8.80 percent in the same quarter of previous year – while its effects on overall inflation was not as pronounced as the food prices, but still contributed to offset the decline in the headline inflation.

The most favorable development was a sharp decrease in the rate of inflation in bread and cereals. The prices of bread and cereals rose on a year-on-year basis in the third quarter of 1390 by only 2.73 percent, compared to a rapid 12.55 percent increase in the same period of last year. This 9.82 percentage-point decrease in bread and cereals was very important, because bread and cereals comprises 28 percent of the CPI basket, by far the largest individual component. It is worth mentioning that global prices of cereals have fallen and are expected to decrease further in 2012.

In the third quarter of 1390, meat prices (6 percent of the CPI) increased by 7.20 percent (Y-o-Y), compared to 24.24 percent increase in the same period of last year. This significant 17.04 percentage-point decrease in the rate of inflation could be due to low prices of cereals and grains in the current quarter compared to the previous periods.

Prices of oil and fats also showed lower increases. Oil and fats, another important component of CPI (4.9 percent weight), displayed significantly lower rates of inflation in the quarter under review. This price-index rose in the third quarter of 1390 by 13.40 percent (Y-o-Y), again a lower inflation rate from an inflation rate of 28.45 percent in the same period last year. This decrease of 15.05 percentage points in the rate of inflation could be attributed to the supply side.

The vegetables prices also contributed to a decrease in the overall inflation. The same factors affected the prices of bread and cereals are thought to have an impact on the prices of vegetables (4.9 percent of the CPI). After showing a high inflation in the third quarter of 1389 (a 29.70 percent), vegetables prices fell in the third quarter of 1390 to -6.64 percent, a significant decrease of 36.34 percentage points.

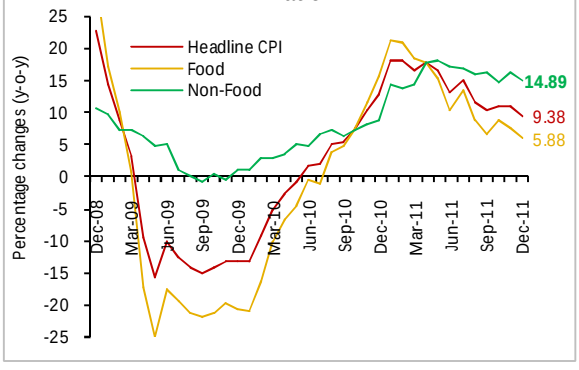
The rents price-index, one of the largest non-food components with 7.1 percent contribution to total CPI basket, has been increasing sharply at the beginning of 1390, reaching its highest of 34.65 percent (Y-o-Y) in the last six years. On a year-on-year basis, the rents sub-index stood at 15.16 percent, in the third quarter of 1390, compared to 27.48 percent a year ago. The decelerating rate of inflation in rents, down by 12.32 percentage points, could be attributed to some seasonal movements of Afghans to Pakistan due to the cold winter as well as reduction in the number of NGOs inside Kabul which reduced pressure on the demand for housing.

Holding back this overall drop in the rate of inflation were several unfavorable changes. First, the household goods increased by a staggering 32.5 percentage points to 34.62 percent (Y-o-Y) in the reporting quarter. As household goods are generally imported goods, the depreciation of Afghani against US dollars may have had a strong influence. Clothing also exhibited a noticeable increase in the quarter under review, up by 8.18 percentage points to 9.23 percent.

Fruit prices have been increasing rapidly, an important factor contributing to partially offset the favorable changes in overall inflation. The prices of fruits rose by 26.83 percent (Y-o-Y) in the third quarter 1390, a sharp increase from the 13.96 percent inflation observed in the third quarter of 1389.

Fuel and electricity prices were following worldwide upward trend. Prices of fuel and electricity (6.8 percent of the CPI) rose by 8.17 percent (Y-o-Y) in the third quarter of 1390, compared with 6.22 percent recorded the previous year. This 1.95 percentage-point increase, which was also one of the noticeable increases among non-food items, was largely due to increases in world energy prices.

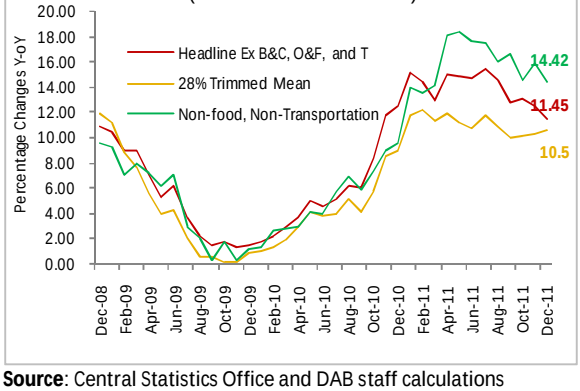
Figure 3.1: Breakdown of Kabul Headline Inflation



Source: Central Statistics Office and DAB staff calculations

Core inflation, which excludes the volatile components of bread and cereals, oils and fats, and transport decreased over the past year, but still remains higher than headline inflation. The reason that core inflation is higher than the headline inflation is the exclusion of bread and cereals, on which the inflation rate is very low relative to the overall index. And the reason that its decline was not as significant as the decline in headline inflation was that it excludes both oils and fats and bread and cereals, both of which had substantial declines in inflation over the past year.

Figure 3.2: Core Inflaiton (Mar 2008 to March 2012)



Source: Central Statistics Office and DAB staff calculations

Table 3.1: Breakdown of Kabul Headline CPI

(Percent changes year on year)

Consumer Price Index (March 04=100)

	Weights	1388				1389				1390		
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Headline Inflation	**100.00**	**-10.00**	**-14.90**	**-13.20**	**-5.20**	**1.50**	**5.30**	**12.85**	**16.62**	**12.97**	**10.29**	**9.38**
Food and Beverages	**61.30**	**-17.50**	**-21.90**	**-20.70**	**-10.10**	**-0.60**	**4.70**	**15.60**	**18.32**	**10.29**	**6.52**	**5.88**
Bread and Cereal	**28.00**	-30.20	-35.90	-36.00	-22.50	-6.50	3.20	12.55	24.79	7.08	0.86	2.73
Meat	**6.00**	-0.30	-1.40	-1.70	5.30	7.20	21.50	24.24	20.06	19.33	7.85	7.20
Milk and cheese	**5.60**	4.70	0.60	1.30	-2.60	1.90	2.00	5.48	3.62	8.77	10.77	8.85
Oil and Fat	**5.30**	-17.50	-21.20	-5.50	-0.20	5.10	7.60	28.45	24.41	28.04	35.07	13.40
Fresh & dried fruits	**4.90**	15.40	9.80	0.30	-2.50	-5.70	-6.30	13.96	13.76	17.42	16.31	26.83
Vegetables	**4.90**	-0.10	-1.10	1.20	4.80	14.00	8.00	29.70	13.27	0.84	-2.65	-6.64
Sugar & Sweets	**1.80**	16.30	18.20	20.80	22.90	14.10	10.40	13.52	7.89	12.13	11.46	6.80
Spices	**1.10**	8.40	5.60	2.50	7.20	10.20	5.30	6.08	5.33	3.08	2.87	2.71
Tea & Beverages	**2.00**	2.10	0.30	-0.90	1.20	1.80	-0.50	4.87	7.04	12.90	16.36	18.15
Tobacco & Cigarettes	**1.70**	3.20	2.10	3.10	4.30	5.60	8.60	10.55	9.47	7.82	5.18	5.09
Non – Food	**38.70**	**5.00**	**-0.80**	**0.90**	**3.00**	**4.80**	**6.30**	**8.80**	**14.20**	**17.01**	**16.21**	**14.89**
Clothing	**7.20**	6.80	3.00	1.30	1.30	0.70	-2.10	1.05	3.51	7.40	9.68	9.23
Housing	**17.20**	7.10	-2.30	0.40	4.50	6.90	11.60	15.53	15.06	16.92	13.44	12.12
Rents	**7.10**	8.60	3.80	4.30	6.40	11.50	19.20	27.48	28.69	30.56	22.57	15.16
Construction materials	**3.20**	1.00	-14.10	-11.50	-2.40	3.90	14.40	14.62	9.64	13.02	6.95	16.00
Fuel and Electricity	**6.80**	7.70	-3.40	0.70	4.90	3.80	4.50	6.22	4.74	5.57	6.52	8.17
Household goods	**7.00**	3.00	2.50	2.60	1.00	0.30	-0.50	2.12	30.09	42.73	45.36	34.62
Health	**2.00**	19.30	7.20	4.90	-0.20	-0.50	-0.60	0.61	2.53	2.35	5.09	5.23
Transportation	**2.30**	-14.00	-11.90	-2.30	5.40	14.50	10.30	0.22	14.91	20.76	12.42	20.48
Communications	**0.90**	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00	0.00
Educations	**1.20**	0.60	0.10	-0.60	-0.40	-1.70	-0.90	0.46	11.75	12.96	12.51	10.71
Miscellaneous	**0.90**	12.60	8.40	4.80	0.10	1.00	-1.30	10.07	13.27	13.06	15.98	23.32
Core inflation (28% TM)		4.20	0.50	0.80	1.80	3.80	4.10	8.99	11.37	10.78	10.00	10.51
Core infl. (Headline excl. B & C, O & F, and T)		6.20	1.40	1.50	2.90	4.60	5.90	12.55	12.98	14.63	12.81	11.45

Source: Central Statistics Office and DAB staff calculations

1.2 Annual Changes in National Headline Inflation

The nationwide headline inflation; measured on a year-on-year basis, showed different characteristics from the Kabul inflation rate. The 9.7 percent (Y-o-Y) nationwide inflation in the third quarter of 1390 was almost the same as the inflation rate of 9.8 percent experienced in the same quarter of 1389. The favorable changes noticed in certain goods and services (most of the foodstuffs and rents) were partially offset by unfavorable changes in the rates of inflation in fruits, clothing, milk and cheese, and household goods. Again, the food sub-index remained as the main contributing factors that pushed the overall CPI inflation.

The decrease in bread and cereals prices was also a very significant factor responsible for nationwide headline inflation. Throughout

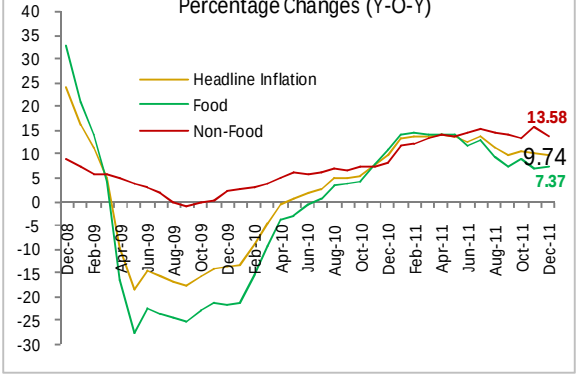
Afghanistan, prices of bread and cereals rose in the third quarter of 1390 on a year-on-year rate of only 5.3 percent. This level of inflation represented a 4.4 percentage-point decrease compared with the previous year. In fact, the pace of decrease in nationwide bread and cereals prices was lower than in Kabul.

The oil and fats also experienced rapidly-falling inflation in the current quarter, when compared to the previous year. Inflation in oil and fats prices decreased by a 19.4 percentage points from the previous year, and ended up at 5.8 percent (Y-o-Y). The level of inflation in this component was lower than it was in Kabul and the decrease in inflation from the previous period was higher than in Kabul as well.

In contrast to the situation in Kabul, decreases in the rate of inflation in rents were moderate. Rental prices increased nationwide in the third quarter of 1390, on a year-on-year basis, by 6.8 percent, which is noticeably lower than the 13.8 percent rate of inflation recorded in the previous year. Although inflation in rents was much lower nationwide than in Kabul, but it indicates that the migration to Pakistan due to the cold winter is observed all over the country, not only Kabul.

Milk and cheese price inflation rose quite substantially nationwide, higher than the increases in Kabul. The 7.1 percentage point increase in the rate of inflation in milk and cheese was somewhat higher than the overall headline inflation.

Figure 3.3: Headline inflation, National CPI, Percentage Changes (Y-O-Y)



Source: Central Statistics Office and DAB staff calculations

Table 3.2: Breakdown of National Headline CPI
(Percentage changes year-on-year)
Consumer Price Index (March 2004=100)

	Weight	1388				1389				1390		
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Headline Inflation	**100.0**	-14.6	-17.7	-13.7	-4.5	1.9	4.9	9.8	13.7	12.7	9.9	9.7
Food	**61.3**	-22.4	-25.2	-21.6	-9.1	-0.5	3.9	11.0	14.0	11.7	7.2	7.4
Bread & Cereals	**28.0**	-34.9	-38.7	-34.8	-19.0	-6.2	2.1	9.7	15.9	11.5	2.9	5.3
Meat	**6.0**	5.6	5.0	5.4	4.9	9.2	15.6	16.6	17.5	15.6	8.9	9.3
Milk & Cheese	**5.6**	2.4	-0.9	-2.4	-3.0	-0.5	0.7	3.4	4.5	8.6	9.4	10.5
Oils & Fats	**5.3**	-24.0	-27.1	-13.1	1.4	3.0	10.5	25.2	21.6	25.3	24.2	5.8
Fresh & Dried Fruits	**4.9**	7.7	10.8	3.1	3.5	-0.4	-5.9	7.6	10.2	15.1	18.9	22.9
Vegetables	**4.9**	-6.0	-6.8	-8.6	-0.1	13.6	6.3	17.0	15.6	2.7	2.2	-0.2
Sugar and Sweets	**1.8**	11.7	16.1	20.4	23.5	18.7	17.5	12.8	7.7	8.1	6.3	4.9
Spices	**1.1**	14.4	4.7	1.2	0.0	5.0	4.1	3.7	4.3	13.9	27.2	28.4
Tea and Beverages	**2.0**	7.0	3.7	4.5	2.5	2.5	2.5	2.6	6.7	11.5	13.9	17.6
Cigarettes and Tobacco	**1.7**	10.3	13.7	10.4	5.7	5.2	3.8	1.9	4.0	4.0	4.8	6.7
Non-Food	**38.7**	3.0	-0.8	2.3	3.8	6.0	6.5	8.0	13.3	14.4	14.2	13.6
Clothing	**7.2**	9.3	5.6	2.2	2.5	3.4	3.7	3.7	4.3	9.2	15.4	18.8
Housing	**17.2**	3.3	-1.9	4.3	5.9	7.9	8.4	11.2	12.4	12.4	11.3	9.8
Rents	**7.1**	3.6	6.0	5.1	6.1	11.9	8.4	13.8	13.9	12.8	11.3	6.8
Construction Material	**3.2**	0.5	-6.1	-3.6	-0.6	2.5	8.0	10.9	11.6	12.7	10.8	11.6
Fuel & Electricity	**6.8**	3.9	-6.9	6.0	7.8	6.1	8.5	9.4	11.4	11.9	11.5	11.8
Household goods	**7.0**	3.6	3.2	1.1	0.8	3.4	3.5	9.4	26.4	28.4	26.4	15.8
Health	**2.0**	8.3	4.1	1.2	-2.6	-0.8	0.8	0.4	2.6	3.0	3.0	4.4
Transportation	**2.3**	-12.3	-16.7	-6.2	4.3	12.2	13.3	2.3	26.3	22.1	19.6	30.3
Communications	**0.9**	0.5	1.2	1.2	1.7	-3.1	-3.1	-3.0	-3.8	2.5	2.6	3.0
Educations	**1.2**	3.8	3.8	0.1	-0.8	-1.9	-0.6	1.0	4.9	9.6	11.2	16.2
Miscellaneous	**0.9**	9.5	11.1	10.4	7.5	6.5	7.0	9.3	9.3	12.4	9.9	15.2
Core inflation (28% TM)		4.3	2.0	1.4	2.3	4.0	5.0	7.2	9.8	11.2	11.1	11.2
Core inflation (Headline excl. B&C, O&F, and T)		4.2	1.7	2.3	3.4	5.8	5.5	9.3	11.5	11.9	11.9	11.2

1.3 Current Quarter Changes in Kabul Headline CPI

To see more closely what was happening to inflation in the most recent time periods, we may compare the quarter-on-quarter changes in the overall CPI and its various components in the third quarter of 1390 with the inflation rates experienced in the second quarter of 1390. Unfortunately, there was slight increase in quarterly inflation. The quarterly rate of headline inflation was 3.8 percent, up from 3.4 percent in the previous quarter. After two straight quarters of low inflation so far in 1389, the increase in headline inflation in third quarter of 1390 may indicate that inflation has gained a bit of momentum again.

The reason behind increase in headline inflation in the current quarter from the previous quarter is mainly attributed to sharp increases in housing and fuel & electricity sub-indices. Prices of those key commodities increased to 6.0 percent and 11.1 percent (q-o-q) respectively, in contrast to a 2.8 percent and 3.8 percent inflation recorded in the previous quarter. This is the third consecutive quarters in which fuel and electricity prices increased. This unfavorable changes, however, was almost completely offset by a decrease in inflation on a few components, such as bread and cereals (1.4 percent from 3.6 percent), milk and cheese (3.1 percent from 5.8 percent), oil and fat (0.7 percent from 7.9 percent), and the last item experienced favorable developments was the rental costs declining to 1.2 percent in third quarter of 1390 from 2.6 percent in the second quarter of 1390.

Table 3.3: Quarter-on-Quarter Changes in Kabul Headline CPI

(Percentage Changes Quarter-on-quarter)
Consumer Price Index (March 2004 = 100)

	1388				1389				1390		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Headline	-1.5	2.1	-2.3	-3.5	5.4	5.9	4.7	-0.2	2.1	3.4	3.8
Food and Beverages	-2.5	2.3	-5.1	-5	7.9	7.8	4.7	-2.8	0.5	4.1	4.1
Bread and Cereal	-3.5	-0.3	-8.7	-11.8	16.6	9.9	-0.5	-2.2	0.0	3.6	1.4
Milk and Cheese	-6.3	-0.1	1.5	-1.2	-2	3.9	4.9	-3.0	2.9	5.8	3.1
Oil and Fat	-2.2	-0.1	0.5	1.7	3	2.2	19.9	-1.5	6.0	7.9	0.7
Non – Food	0.2	1.7	2.3	-1.1	1.9	3.1	4.7	3.8	4.4	2.4	3.5
Housing	0.5	1.4	3.7	-1.1	2.8	6	7.3	-1.5	4.4	2.8	6.0
Rents	0.6	2.2	0.7	2.7	5.4	9.3	7.7	3.7	7.0	2.6	1.2
Fuel and Electricity	0.9	2.2	7.6	-5.5	-0.2	2.9	9.4	-6.8	0.6	3.8	11.1
Transportation	0.7	2.7	8.3	-5.9	9.4	-1.0	-1.6	7.9	5.1	0.8	5.4

Source: Central Statistics Office/Monetary Policy Department, DAB staff calculations

1.2 Current Quarter Changes in National Headline Inflation

Nationwide, inflation rose sharply over the previous quarter, a faster increase than that in Kabul. The headline rate of inflation reached 4.6 percent (q-o-q) in the third quarter of 1390, up from 1.7 percent in the second quarter. The pattern of changes in the rate of inflation across the components, however, was different from what was experienced in Kabul.

For example, the nationwide bread and cereals price-index increased to 4.5 percent (q-o-q) in the third quarter from -0.3 percent in the second quarter. However, the inflation rate in bread and cereals actually declined in Kabul. The different pattern in Kabul and nationwide bread and cereals prices indicates that those obstacles that were holding back supply have been eliminated in Kabul, but still exist nationwide.

The same pattern was observed in nationwide inflation in milk and cheese, housing, and fuel and electricity prices Increasing to 3.0 percent, 7.2 percent, and 13.7 percent (q-o-q) from 2.9 percent, 2.6 percent, and 4.3 percent in the second quarter respectively

In the housing sub-index, rental costs increased slightly by 1.1 percent nationwide in the third quarter, almost the same rate of increase observed in the second quarter. Again, this is the opposite of what was observed in Kabul, where rents increased at a slower rate in the third quarter compared to the preceding quarter. Although, nationwide inflation in rents was slightly lower than in Kabul, this pattern may indicate that rents prices are becoming more similar across the country.

Table 3.4: Quarterly Changes in National Headline CPI

(Percent changes quarter on quarter)
Consumer Price Index (March 2004=100)

	1388				1389				1390		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Headline Inflation	-3.7	1.4	-0.1	-2.1	2.8	4.3	4.6	1.4	1.9	1.7	4.5
Food and Beverages	-5.7	1.3	-2.5	-2.4	3.3	5.7	4.2	0.2	1.2	1.5	4.3
Bread and Cereal	-8.6	-0.8	-4.8	-6.2	5.9	8.0	2.2	-0.8	1.8	-0.3	4.5
Milk and Cheese	-2.9	1.0	-0.7	-0.5	-0.3	2.2	2.0	0.6	3.6	2.9	3.0
Oil and Fat	-0.5	-2.7	1.9	2.7	1.1	4.4	15.4	-0.3	4.3	3.5	-1.7
Non – Food	-0.1	1.7	3.9	-1.7	2.0	2.2	5.4	3.2	2.9	2.1	4.8
Housing	0.2	3.1	5.9	-3.1	2.1	3.5	8.7	-2.2	2.1	2.6	7.2
Rents	0.1	5.6	0.4	0.0	5.5	2.3	5.4	0.1	4.5	1.0	1.1
Fuel and Electricity	0.6	2.4	12.5	-6.9	-1.0	4.6	13.4	-5.2	-0.6	4.3	13.7
Transportation	0.1	-0.7	10.3	-4.9	7.6	0.4	-0.4	17.4	4.1	-1.7	8.5

Source: Central Statistics Office/Monetary Policy Department, DAB staff calculations

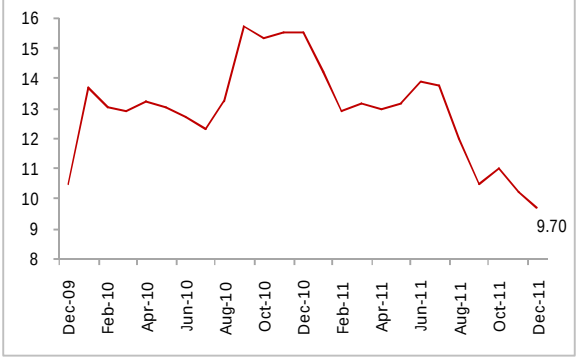
2. THE REGIONAL INFLATION

2.1 Inflation Trend in Pakistan

Inflation in Afghanistan lost momentum after the first quarter of 1390, on a year-on-year basis and is, in fact, now a bit lower than inflation in Pakistan. In December 2011, the year-on-year inflation rate in Pakistan was 9.7 percent, which was significantly lower than the 15.50 percent recorded in December 2010, and slightly lower than the rate of 10.50 percent observed in September 2011. As in Afghanistan, decreases in food prices were driving the overall rate of inflation to decline; while, there was an increase in the rate of inflation in non-food prices which partially offset the those positive changes. Pakistan's Year-on-Year food inflation in December 2011 was 9.50 percent, compared with non-food inflation of 9.90 percent. The food inflation rate was substantially lower than the 20.50 percent rate observed in December 2010, while the non-food inflation rate was slightly lower than the 12 percent rate observed a year ago. Inflation in Pakistan is still high, but appears to be stabilizing at a high level. In Afghanistan, the decrease in inflation was due to a decline in the rate of inflation in food items which was similar to what was observed in Pakistan, but the rate of inflation in non-food items increased in a way opposite to those observed in Pakistan.

Core inflation, which excludes the food and energy components, is still quite high and has been increasing somewhat. In December 2011 the year-on-year core inflation rate was 10.20 percent, up slightly from 9.80 percent in December 2010, and slightly down from 10.60 percent recorded in September 2011. On a monthly basis, core inflation also was declining in the recent months.

Figure 3.4: Pakistan Headline Inflation (Y-o-Y)



Source: State Bank of Pakistan

Table 3.5: Breakdown of Pakistan Headline Inflation

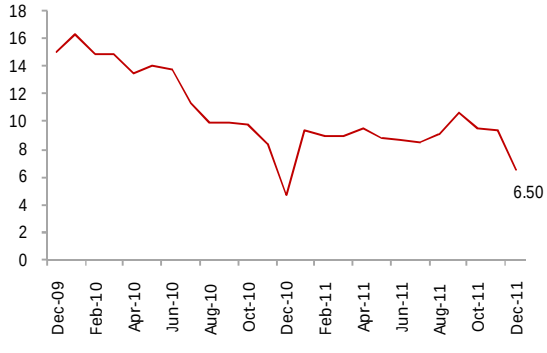
	CPI			Core Inflation		WPI
	Overall	Food	Non-food	NFNE*	Trimmed	
Dec-10	15.50	20.50	12.00	9.80	13.40	22.50
Jan-11	13.90	20.20	9.70	9.90	12.10	20.90
Feb-11	12.80	17.60	9.70	9.70	12.00	22.10
Mar-11	13.00	17.90	9.70	9.70	12.10	24.30
Apr-11	12.50	16.50	9.80	9.50	12.00	24.90
May-11	12.60	15.80	10.50	9.80	12.10	22.30
Jun-11	13.30	15.90	11.60	9.90	12.40	22.80
Jul-11	12.40	17.10	9.30	9.60	11.90	20.30
Aug-11	11.60	13.20	10.40	10.10	12.40	18.70
Sep-11	10.50	9.90	10.90	10.60	11.70	17.00
Oct-11	11.00	11.70	10.40	10.50	11.70	15.40
Nov-11	11.20	10.00	10.30	10.40	11.50	12.00
Dec-11	9.70	9.50	9.90	10.20	10.60	8.30

* NFNE is Non-food Non-energy inflation,
Source: State-Bank of Pakistan

2.2 Inflation in India

India is experiencing much lower inflation compared to Pakistan and Afghanistan. In December 2011, the CPI rose on a year-on-year basis by 6.5 percent. This rate of inflation, in a normal range, was down significantly from the 10.60 percent recorded in September 2011, while it remained unchanged compared to the same period of last year. The headline inflation decreased mainly as a result of decline in food prices, but the manufacturing momentum was strong. The India's food price inflation fell to its lowest rate of 9 percent since beginning of October 2011. But any encouragement that the country's politicians might have taken from the improved data has been offset by a failure to curb persistently high fuel prices. This requires even tighter monetary policy than would otherwise be required in order to bring down the inflation rate to manageable levels.

Figrure 3.5: India CPI Inflation (Y-o-Y)



Source: Reserve Bank of India

3. INFLATIONARY OUTLOOK

Inflation, measured on a quarter-to-quarter basis, has been rising throughout 1390 compared to the previous three quarters. However, as previously mentioned, the latest quarterly data show a very small increase in inflation compared to the previous quarter and it is expected to fall in the fourth quarter of 1390. Worldwide, inflation is somehow expected to diminish. Falling food costs are expected in the coming year of 1391.

Offsetting the benefits of falling food prices, however, the political uncertainty in the Middle East raises fears that inflation will persist, because of its effect on oil prices. Oil prices are also becoming more volatile and harder to predict, raising the cost of hedging. These increases in oil prices will find their way eventually into increases in the prices of many other goods besides fuel and electricity, such as edible oils and fats. The prices of other essential commodities, however, are expected to decline, as the possibility of another recession in Europe emerges and the United States continues its slow-growth pattern.

CHAPTER IV

EXTERNAL SECTOR DEVELOPMENTS

4

EXTERNAL SECTOR DEVELOPMENTS

This chapter highlights developments in the external sector of the Afghan economy for the third quarter of 1390, in comparison with the levels recorded in the corresponding quarter of previous year. All the data are compiled and analyzed by the Monetary Policy Department (MPD) of DAB. In addition, it attempts to meet the objective of monitoring key external sector performance indicators of the economy in order to identify areas of policy needs. Merchandise trade deficit in the third quarter of 1390 compared with the similar period of last year almost doubled due to a substantial expansion in imports. Merchandise trade deficit expanded by about 99 percent from USD 1,031.85 million in the third quarter of 1389 to USD 1,896 million in the third quarter of 1390. The trade deficit as percentage of GDP increased from 5 percent in the third quarter of 1389 to 10 percent in the quarter under review.

In the quarter under review, aggregate imports and exports stood at USD 1,896 million and USD 92.62 million respectively, while these figures were recorded at USD 1,031.85 million and USD 127.29 million in the third quarter of 1389. This resulted in the expansion of merchandise trade deficit from USD 904.56 million in the third quarter of 1389 to USD 1,803.4 million in the third quarter of 1390. The expansion in trade deficit is a reflection of the sluggish recovery of the global economy and high level of domestic demand for capital goods and industrial supplies.

In the third quarter of 1390, exports decreased by 27 percent to USD 92.62 million from USD 127.29 million in the third quarter of 1389. Exports are mainly dominated by food items such as fresh and dry fruits that decreased significantly by almost 43 percent and medical seeds which decreased by 10 percent in the reporting period compared with the similar period of last year. On the other hand, imports of goods increased considerably by 84 percent from USD 1,031.85 million to USD 1,896 million in the quarter under review. As the statistics show, imports of almost all importing categories increased except fuel and lubricants which decreased about 8 percent. Imports are mainly dominated by industrial supplies and capital goods which increased in the third quarter of 1390 by 150 percent and 51 percent respectively compared with the corresponding period last year.

At the end of the third quarter of 1390, Afghanistan's public and publicly guaranteed external debt stock stood at USD 2,381.19 million which shows an increase of 3 percent compared with the same quarter last year. During the quarter, service charges paid to the IDA (World Bank) and ADB (Asian Development Bank) while IDA as a major multilateral creditor to Afghanistan made debt forgiveness on service charges.

The NIR (net international reserves) increased notably by almost 31.43 percent in the third quarter of 1390 compared with the similar period last year. This figure was USD 4429.71 million in the third quarter of 1389 which increased to USD 5822.03 million in the third quarter of 1390.

1. MERCHANDISE TRADE

Afghanistan's merchandise trade deficit widened in the third quarter of 1390 following a substantial expansion in imports compared with the similar period of last year. Merchandise trade deficit expanded by 99 percent from USD 904.56 million in the third quarter of 1389 to USD 1,803.4 million in the third quarter of 1390. Total exports in the third quarter of 1390 declined by 27 percent to USD 92.62 million from USD 127.29 million in the third quarter of 1389. Trade statistics show a notable decline in all exporting categories except in medical seeds and others for the third quarter of 1390 compared to the same quarter of last year. Exports are mainly dominated by food items (fresh and dry fruits) which decreased by 43 percent from USD 74.13 million to USD 42.37 million, while medical seeds, the second largest export component increased by 10 percent compared with third quarter of 1389. Similarly, carpets and rugs declined from USD 11.82 million to USD 10.9 million and leather and wool from USD 11.68 million to USD 6.6 million in the quarter under review.

On the other hand, during the quarter, total imports increased significantly compared with the same quarter of last year. In the same quarter of earlier year, total imports were recorded at USD 1,031.85 million which increased by 84 percent to USD 1,896 million in the third quarter of 1390. Based on merchandise trade statistics, imports of the most importing items show increments at different levels. Imports are mainly dominated by industrial supplies which increased by 150 percent (the largest boost) from USD 324.42 million to USD 810.9 million in the third quarter of 1390 compared with the similar period last year. Similarly, imports of capital goods and others increased notably by 51 percent from USD 524.76 million to USD 791.6 million and imports of consumer goods increased by 64 percent from USD 173.8 million to USD 285.34 million in the quarter under review compared with similar period of last year. Conversely, import of fuel and lubricants decreased from USD 8.9 million in the third quarter of 1389 to USD 8.2 million in the third quarter of 1390, roughly 8 percent.

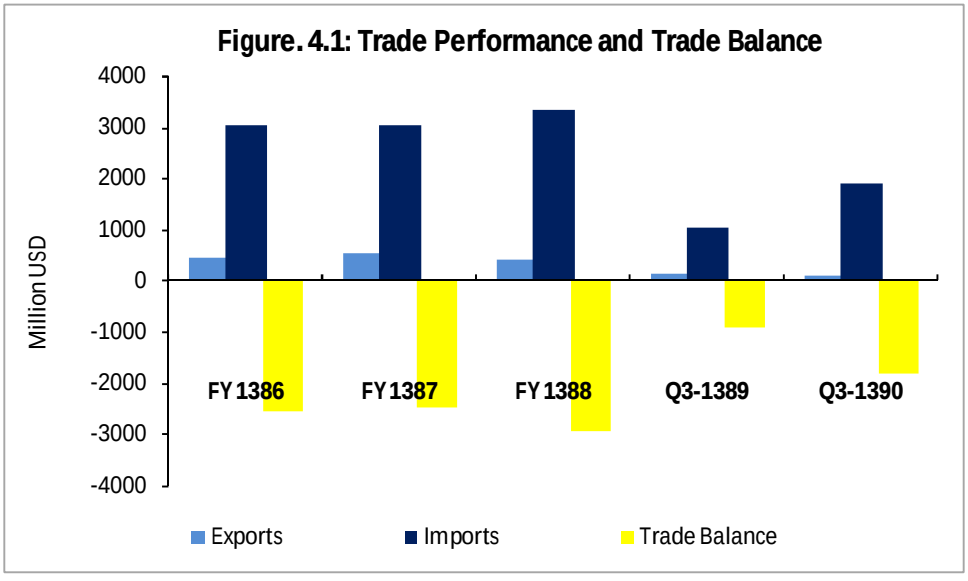
As a result, a significant change in the import structure in favor of industrial supplies has been observed during the third quarter of 1390. The share of industrial supplies in total imports increased from about 31.4 percent in the third quarter of 1389 to about 43 percent in the third quarter of 1390. Imports of industrial supplies mainly comprise petroleum oil, metals, fertilizer and cement which are the essentials for economic development. High imports of such goods are an obvious evidence of developments in industrial and construction sectors. The second largest share in total imports was recorded for capital goods and others at 42 percent; however it declined from 51 percent in the third quarter of 1389. Simultaneously, the share of consumer goods in total imports declined slightly from 16.8 percent in Q3 1389 to 15 percent in Q3 1390. Finally, the trade balance deficit as percentage of GDP increased from 5 percent in the third quarter of 1389 to 10 percent in the quarter under review.

Table 4.1 illustrates main categories of the merchandise trade, percentage share of main categories of exports and imports from 1386 up to the third quarter of 1390.

Table 4.1: Merchandise Trade (in million USD)

Years	1386		1387		1388		Q3 1389		Q3 1390	
	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)
Imports	**3,021.86**	**100%**	**3,019.86**	**100%**	**3,336**	**100%**	**1,031.85**	**100%**	**1,896.0**	**100%**
Industrial supplies	692.04	22.9%	797.78	26.4%	1001.43	30.0%	324.42	31.4%	810.90	42.8%
Fuel and Lubricants	108.49	3.6%	101.83	3.4%	36.07	1.1%	8.88	0.9%	8.20	0.4%
Consumer goods	641.86	21.2%	689.88	22.8%	692.07	20.7%	173.79	16.8%	285.34	15.0%
Capital goods and other	1,579.47	52.3%	1,430.37	47.4%	1,607	48.2%	524.76	50.9%	791.58	41.7%
Exports	**454.13**	**100%**	**544.56**	**100.0%**	**403.06**	**100%**	**127.29**	**100%**	**92.62**	**100%**
Carpets & Rugs	211.76	47%	153.05	28.1%	68.8	17.1%	11.82	9.3%	10.90	11.8%
Food Items	158.86	35%	283.08	52.0%	201.84	50.1%	74.13	58.2%	42.37	45.7%
Leather & Wool	25.77	6%	29.29	5.4%	24.66	6.1%	11.68	9.2%	6.60	7.1%
Medical seeds & others	57.74	13%	79.14	14.5%	107.78	26.7%	29.66	23.3%	32.75	35.4%
Trade Balance	**-2,567.73**		**-2,475.30**		**-2,933.39**		**-904.56**		**-1,803.40**	
Trade Balance as % of GDP	**-26%**		**-21%**		**-23%**		**-5%**		**-10%**	

Source: Central Statistics Office and DAB staff calculations



Source: Central Statistics Office and DAB staff calculations.

Note:

The classification of the importing items has slightly been changed therefore, in the upcoming reports there will be some difference in the figures of import categories. In this rectification, exports will remain unchanged. In the previous quarters, Petroleum Oil and Tire and Tube items were categorized under Industrial Supplies and Fuel and Lubricants which are now reclassified under Fuel and Lubricants and Consumer Goods, respectively.

2. DIRECTION OF TRADE

Afghanistan's major trading partners in the third quarter of 1390 were recorded for Pakistan, India, Iran and Commonwealth of Independent States (CIS). Direction of exports and imports during the third quarters of 1389 and 1390 is summarized in Tables 4.2 and 4.3. The merchandise trade indicates that the total exports contracted by about 27 percent from USD 127.29 million in the third quarter of 1389 to USD 92.62 million in the quarter under review. This fall in the value of exports is thought to be due to low external demand for Afghan products and sluggish economic recovery in most of the export destinations of Afghanistan. Pakistan remains the largest export destination with about 32 percent share of total exports in the quarter under review compared to 45 percent in the third quarter of 1389.

Exports to Pakistan declined significantly by 48 percent from USD 55.15 million in the third quarter to 1389 to USD 28.7 million in the third quarter of 1390. Exports to Pakistan were mainly concentrated on carpets and rugs and food items such as fresh and dry fruits. During the quarter, export of nearly all items to Pakistan declined due to low demand. Export of carpets and rugs decreased by nearly 11 percent from USD 10.52 million in the third

quarter of 1389 to USD 9.37 million in the quarter under review. Export of food items to Pakistan declined surprisingly by 82 percent from USD 30.75 to USD 5.26 million which was mainly dominated by export of fresh fruits that decreased by 94 percent from USD 21.9 million in the third quarter of 1389 to USD 1.3 million in the current quarter. Similarly, export of leather and wool to Pakistan decreased from USD 3.1 million to USD 1.7 million, this represents approximately 46 percent. While, export of medical seeds and others grew by almost 14 percent to USD 12.2 million from USD 10.76 million recorded in the same quarter of last year. Export of carpets and rugs still mains the important part of exports to Pakistan.

India was the second largest export destination for Afghan commodities during the quarter. Exports to India considerably increased from USD 20.44 million in the third quarter of 1389 to USD 27.4 million in the quarter under review, nearly 34 percent increase. Export of food items to India which forms the largest share increased by 6.32 percent from USD 15.5 million in the third quarter of 1389 to USD 16.5 million in the quarter under review. Similarly, export of medical seeds and others to India increased from USD 4.76 million to USD 10.87 million, exports of leather and wool increase from USD 0.02 million to USD 0.04 million. On the other side, exports of carpets and rugs to India declined significantly.

The Commonwealth of Independent States (CIS) acquired the third position in the export destination of Afghan products, while Iran came to the fourth position. Exports to CIS decreased significantly by 45 percent from USD 13.72 million in the corresponding quarter last year to USD 7.5 million in the reporting quarter. This decline in exports to CIS was mainly affected by a decrease in export of food item particularly, dry fruits which decreased from USD 13.5 million in the third quarter of 1389 to USD 7 million in the reporting quarter.

During the quarter, exports to Iran declined to USD 4.15 million from USD 6.37 million in the third quarter of 1389. Likewise, exports of Afghan commodities to China have contracted to USD 0.81 million from USD 2.53 million in the corresponding quarter of last year.

Table 4.2: Direction of External Trade: Q3 1389 (in million USD)

Country Name	Exports	% Shares	Imports	% Share	Trade Balance
Pakistan	55.15	43.33%	89.76	8.70%	-34.61
India	20.44	16.06%	26.70	2.59%	-6.26
Iran	6.37	5.00%	84.35	8.17%	-77.98
Germany	1.00	0.79%	47.60	4.61%	-46.60
Common Wealth of Independent States (CIS)	13.72	10.78%	377.60	36.59%	-363.88
China	2.53	1.99%	92.56	8.97%	-90.03
Saudi Arabia	0.86	0.68%	0.00	0.00%	0.86
Japan	0.00	0.00%	149.71	14.51%	-149.71
England	0.00	0.00%	2.93	0.28%	-2.93
United States	0.00	0.00%	12.71	1.23%	-12.71
Other Countries	27.22	21.38%	147.93	14.34%	-120.71
Total	**127.29**	**100.00%**	**1031.85**	**100.00%**	**-904.56**

Source: CSO and DAB staff calculations

Table 4.3: Direction of External Trade: Q3 1390 (in million USD)

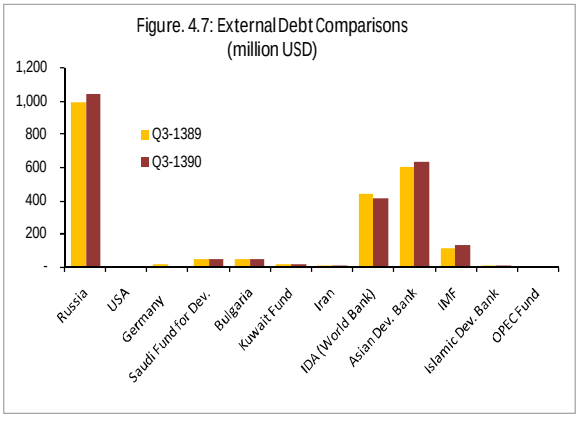
Country Name	Exports	% Shares	Imports	% Share	Trade Balance
Pakistan	28.70	30.99%	197.50	10.42%	-168.80
India	27.39	29.57%	24.40	1.29%	2.99
Iran	4.15	4.48%	137.68	7.26%	-133.53
Germany	0.25	0.27%	55.00	2.90%	-54.75
China	0.81	0.87%	146.50	7.73%	-145.69
England	0.00	0.00%	8.28	0.44%	-8.28
Saudi Arabia	0.65	0.70%		0.00%	0.65
USA	0.00	0.00%	20.20	1.07%	-20.20
Common Wealth of Independent States (CIS)	7.49	8.09%	765.76	40.39%	-758.27
Japan	0.00	0.00%	103.10	5.44%	-103.10
Other Countries	23.18	25.03%	437.60	23.08%	-414.42
Total	**92.62**	**100%**	**1,896.02**	**100%**	**(1,803.40)**

Source: CSO and DAB staff calculations

Furthermore, Non-Paris Club credits which includes Saudi Fund for Development, Bulgaria, Kuwait Fund and Iran stood at USD 131.4 million in the third quarter of 1390.

On the other hand, multilateral credit stood at USD 1,205.81 million compared to USD 1,172.36 million at the end of the similar quarter of last year which shows an increase of about 2.85 percent.

Figure 4.8 compares Afghanistan's external debt stock for the third quarters of 1389 and 1390.



4. NET INTERNATIONAL RESERVES

Da Afghanistan Bank (DAB) holds international reserves which are consist of monetary gold, reserve position and holdings with the IMF and special drawing rights (SDR) as well as in foreign exchange including US dollars, Euro, British Pound and other major currencies. The net international reserves (NIR) of DAB which are expressed in US dollars are defined as reserve assets minus reserve liabilities.

In the quarter under review, Afghanistan's NIR increased significantly by 31.4 percent to USD 5,822.03 million from USD 4,429.71 million in the third quarter of 1389.

The boost in NIR was mainly dominated in a significant increase in the reserve assets which increased by 28 percent from USD 4801.88 million in the third quarter of 1389 to USD 6,158.17 million in the quarter under review. On the other hand, reserve liabilities declined to USD 336.14 million in the third quarter of 1390 compared to USD 372.17 million in the same quarter of last year, approximately 9.7 percent decline. The decrease in reserve liabilities is mostly attributed to the commercial bank deposits in foreign currency. It decreased by 15.7 percent from USD 256.9 million in the third quarter of 1389 to USD 216.55 million in the quarter under review. Conversely, the reserve liability of use of Fund resources increased from USD 115.16 million in the third quarter of 1389 to USD 119.48 million in the reporting quarter. Similarly, the reserve liability of nonresident deposits in foreign currency slightly increased by 0.04 percent compared with the similar period of last year.

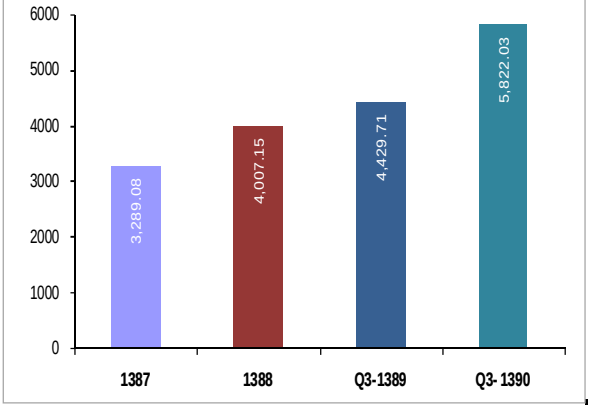
Table 4.5: Net International Reserves, Q3 1390 (in millions USD)

Changes on the previous quarter	1387	% change	1388	% change	Q3 1389	% change	Q3 1390	% change
Net international Reserves (million US Dollar)	3,289.08	23.22	4,007.15	21.83	4,429.71	10.55	5,822.03	31.43
Reserve Assets	3,416.63	22.71	4,208.52	23.18	4,801.88	14.10	6,158.17	28.24
Reserve Liabilities	127.55	10.91	201.37	57.88	372.17	84.82	336.14	-9.68
Commercial bank deposits in foreign currency	37.05	4.00	85.95	132.03	256.90	198.88	216.55	-15.71
Nonresident deposits in foreign currency	0.27	-89.57	0.25	-7.38	0.11	-55.74	0.11	0.04
Use of Fund resources	90.23	17.53	115.16	27.63	115.16	0.00	119.48	3.75
Gross Intl. Reserves (in months of import)					13.96		9.74	
Net Intl. Reserves (in months of import)					12.88		9.21	

Source: Monetary Policy Department, DAB

The increase in NIR could be attributed to considerable inflows of foreign exchange, particularly from foreign donations and personal remittances. The current level of NIR is providing a good cushion of the maneuverability of monetary policy and support of balance of payments. Currently, NIR on average supports nearly 9.2 months of imports. Figure 4.9 represents the net international reserves of Afghanistan for the past few quarters.

Figure 4.8: Net International Reserves, (in million USD)



Source: Monetary Policy Department, DAB

CHAPTER V

FISCAL DEVELOPMENTS

5

FISCAL DEVELOPMENTS

The sound fiscal position is an essential pre-requisite for achieving macroeconomic stability, which is increasingly recognized as a critical ingredient for promoting strong and sustained economic growth and lasting poverty reduction. A prudent fiscal management can mobilize domestic savings increase the efficiency of resource allocation influence the level of aggregate demand in the economy and help meet development goals.

Considerable efforts have been made by Afghan government over the past years to inculcate financial discipline by pursuing a sound fiscal policy and were able to achieve the main objectives of fiscal area which were sustained increases in revenue collection, to permit the gradual takeover of externally financed operating spending and to ensure an expenditure allocation consistent with ANDS priorities. Other goals include improvements in public expenditure management, fiscal policy formulation, and efficiency in public enterprises, and tax and customs administration.

The revenue and expenditure trends in this review show that local government expenditures continue growing strongly in real terms. Total core budget at the end of third quarter of 1390 was in surplus, according to Ministry of Finance reports. Total revenues exceeded core expenditures at the end of quarter under review, leading to a budget surplus of AF 6,826.80 million or 5.27 percent.

Total domestic revenues collected in the third quarter of 1390 was AF 23,143.08 million, showing a 12.76 percent increase from AF 20,524.99 million collected during the third quarter of 1389. Meanwhile, total domestic revenue collection in 1390, year to date, was 6.58 percent above the target set by IMF. Total domestic revenues in the quarter under review accounted for 3.1 percent of GDP.

Total core expenditures in the quarter under review increased to AF 53,797.39 million, up from AF 38,270 million in the same quarter of 1389, which represents a 40.57 percent increase. Total expenditures in the quarter under review account for 10 percent of GDP.

Donor contributions are used to finance both operating and development

expenditures. The total donor contribution (grants) allotted to both, operating and development expenditures increased to AF 50,189.34 million in the quarter under review, up from AF 43,628 million in third quarters of 1389, which shows 15 per cent increase.

The main donor contributors to both, development and operating expenditures are as follows: ARTF, LOTFA, ADB, DFID, EC, World Bank, CSTC, US and USAID.

1. REVENUES

The Government has channeled its efforts towards raising revenues and bringing equity and efficiency in the tax system by operating on functional lines by ensuring uniform application of laws with integrity, efficiency, and high degree of professionalism. Total revenues and grants exceeded total Hamal - Qaws 1390 outturn by 14.19 percent, driven mainly by improvements in domestic revenue mobilization, particularly by customs division of the GRA and the advent of tax revenues. Total domestic revenues collected in the third quarter of 1390 indicate that the government will be able to achieve the target agreed with IMF under the Extended Credit Facility (ECF) program.

Total revenues collected in the nine months of 1390 amounted to AF 136,265.40 million exceeded by 14.19 percent or AF 16,936.93 million from total amount collected at the same period of last year.

Total domestic revenues in the quarter under review was AF 23,143.08 million, representing 14 percent increase from AF 20,524.99 million of corresponding period in 1389. The sharp increase was predominantly due to favorable economic developments, but also to some positive especial factors.

The main contributors in the total of revenues were tax revenues and custom revenues of AF 20,001.41 million, social contributions of AF 756.46 million, donor contributions of AF 25,094.67 million, and other revenues of AF 2,385.22 million respectively. Total revenues accounted for 6 Percent of GDP.

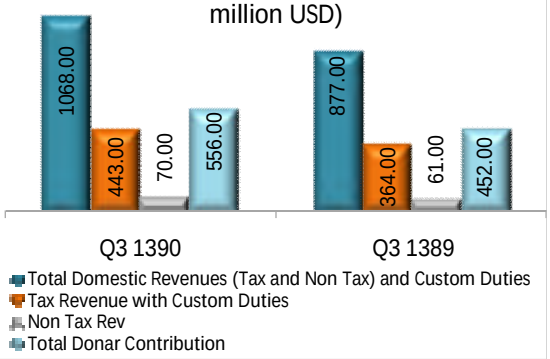
The third quarter gains were driven primarily by improvements in the certain sets of well defined reforms, including expanding the tax bases, improving tax compliance, and enhancing the capacity of tax administration staff, in addition due to a strong and sustained real economic growth. Total domestic revenue collections from the beginning of the year under review totaled AF 69,880.98 million compared to AF 57,807.92 million collected in the third quarter of 1389, which shows an increment of 20.88 percent or AF 12,073.07 million.

Total tax collections grew in the year under review. According to receipts, overall tax revenues increased from AF 47,390.48 million to AF 53,349.55 million during nine months of 1390 and from AF 17,565.85 million to AF 20,001.41 million in the quarter under review compared to

corresponding period of year, which represents 14 percent or AF 2,435.56 million increment. Total fixed taxes and tax receipts for third quarter of 1390 declined slightly to AF 2,371.43 million, compared to AF 2,372.03 million in the third quarter of 1389, this shows only 0.61 percent decrease. Income tax showed an increase of AF 1,040.38 million with the receipts of AF 3,820.24 million compared to the third quarter of preceding year's receipts of AF 2,779.85 million, representing 37 percent of augment. Property tax collections made up from AF 52.69 million to AF80.58 million with 53 percent increase from the third quarter of previous year. Total revenues from custom duties increased by 3 percent or AF 7,348.21 million to AF 7,578.48 million in the quarter under review, which constitutes the largest source of revenues in Afghanistan. In addition, higher growth in imports, coming from Herat and other provincial custom offices-- as new routes are introduced recently-- added into total of domestic revenues. However, 7 percent decline was reported in other tax revenues.

Collections in the major revenue categories are shown in Table 5.1.

Figure 5.1: Total Domestic Revenues (in million USD)



Source: Ministry of Finance website and DAB staff calculation.

Table 5.1: Revenue Collection (in million AF)

	Q3 1390 Revenue Actual	Q3 1389 Revenue Actual	% Δ from Q3 1389 to Q3 1390
Total Domestic Revenues (Tax and Non Tax)	48,237.75	42,339	14%
Tax Revenues	20,001.41	17,565.85	14%
Non Tax Revenues	3,142	2,959.14	6%
Total Donor Contribution	25,094.67	21,814.06	15%

Source: Ministry of Finance website and DAB staff calculation.

Table 5.2: Revenue Collection (in million USD)

	Q3 1390	Q3 1389
Total Revenue (Tax & non-Tax revenue)	1056	878
Tax Revenue	438	364
Non Tax Revenues	69	61
Total Donor Contribution	549	452

Source: Ministry of Finance website and DAB staff calculation

End Period Average Exchange Rate according to DAB was for Q3, 1390 was AF 48.26 per USD, while it was AF 45.17 per USD in Q3 1389.

Table 5.3: Breakdown of Total Domestic Tax and Non-tax Revenues (in million AF)

Tax and non-Tax Revenues	Q3 1389	Q3 1390	% Changes
Taxation & Customs Revenues			
Fixed Taxes	2,372.03	2,371.43	0%
Income Taxes	2,779.85	3,820.24	37%
Property Taxes	52.69	80.58	53%
Sales Taxes	4,401.11	5,118.77	16%
Excise Taxes	0.00	0.00	0.00
Other Taxes	449.02	916.31	104%
Tax Penalties and Fines	162.92	115.60	-29%
Customs duties	7,348.21	7,578.48	3%
Total taxation revenues	**17,565.85**	**20,001.41**	**14%**
Social contributions	406.44	756.46	86%
Retirement contributions	406.44	756.46	86%
Total social contributions	**54.29**	**120.61**	**122%**
Other revenue	970.39	1,200.17	24%
Income from Capital Property	1,438.23	2,259.64	57%
Sales of Goods and Services	6.83	20.29	197%
Administrative Fees	80.22	131.27	64%
Royalties	(8)	43.15	-623%
Non Tax Fines and Penalties	-8.25	-1,399.39	16862%
Miscellaneous Revenue	10.99	9.47	-14%
Sale of Land and Buildings	2,552.70	2,385.22	-7%
Total other revenue	**2,701.31**	**4,813.74**	**78%**
ARTF	8,041.97	6,171.10	-23%
LOTFA	4,686.30	9,304.11	99%
CSTC - MoD	-	-	-
Foreign loans	46.32	122.24	164%
World Bank	749.06	203.58	-73%
ADB	8.42	2.19	-74%
Other	-	-	-
Donor revenue	934.18	1,641.46	76%
World Bank	-	-	-
EC	1,960.58	1,334.41	-32%
ADB	-	-	-
DFID	928.42	167.39	-82%
US & USAID	1,757.50	1,334.46	-24%
Others	21,814.06	25,094.67	15%
Total Donor Contributions	**2,372.03**	**2,371.43**	**0%**

Source: Ministry of Finance website and DAB staff calculation.

2. EXPENDITURES

The government is moving ahead on its agenda to improve expenditure management and fiscal transparency. Total core expenditures for the first nine months of 1390 amounted to AF 129,438.60 million (17 percent of GDP), compared to AF 100,347.30 million (13 percent of GDP) recorded in the corresponding period in 1389. This represents an increase of 28.99 percent. The surge in the pace of government spending was mainly on account of increased expansion in discretionary spending particularly by the Ministries, Departments and Agencies. In addition, core expenditures rose by AF 15,527.05 million presenting 40.57 percent increment, reaching AF 53,797.39 million during the first three months of 1390 versus

AF 38,270 million during the same period of 1389. Total core expenditures in the quarter under review accounted for 7 percent of GDP.

Total core expenditures are classified into development and operating expenditures. Development expenditures increased to AF 15,032.23 million in the quarter under review, up from AF 12,161.37 million in the third quarter of 1389, which represents 23.61 percent increase. Total development expenditures accounted for 2 percent of GDP.

The current or operating expenditures increased to AF 38,765.16 million in the quarter under review, up from AF 26,109 million in the third quarter of 1389, this represents 48 percent increase that accounted for 5 percent of GDP.

The main causes of a slight change in expenditures for development budget in the quarter under review were sluggish budget planning by line ministries, especially MRRD where their budget execution process was very slow, as well as additional unspent projects from the last year. The development budget is almost fully funded by donor contribution and a small amount of loans.

Operating expenditures are consists of the following five categories: (a) compensation of employees, (b) goods and services, (c) subsidies and grants, (d) interest payment, (e) acquisition of non-financial assets.

Recurrent expenditure on compensation of employees increased to AF 28,478.06 million compared to AF 20,630.95 million collected at the corresponding period of 1389, representing 38.04 percent or AF 7,847.11 million increment. According to FPU/MoF, the increased spending on wages and salaries was mainly due to the special allowance given to all public servants or paid to the additional security forces (Afghan National Army and Afghan National Police). It is estimated that almost all of the budgeted amount on employee compensations will be expended by the end of the year, as the recruitment process of ANP and ANA accelerates, together with the relatively faster implementation of Pay and Grading Reform in the second half of the year.

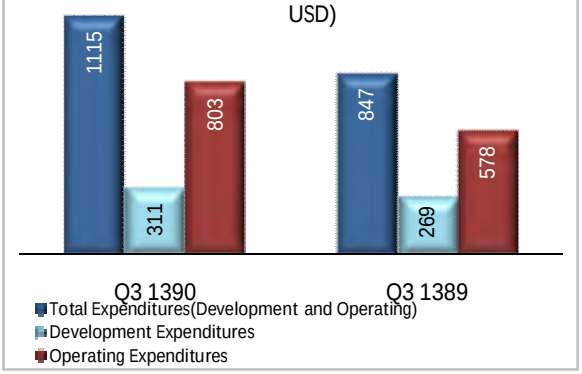
Expenditures on interest payments increased to AF 39.74 million in the quarter under review, up from AF 34.79 million in the third quarter of 1389; this indicates 14.24 percent increase.

According to the MoF's Fiscal Bulletin, interest payments are only a small proportion of total operating expenditures of the government due to the fact that the government has only a small amount of concessional loans. Such loans are mostly given to Afghan government on concessional basis to help it to finance its development projects.

Subsidies, grants, and social transfers are the third largest components of the recurrent expenditures, this includes

subsides to state-owned enterprises, capital transfers to municipalities and pensions to retired public servants. Around 37 percent of the total expenditures on these items are spent on social transfers, and principally pensions. Expenditures on subsidies, grants and contribution increased to AF 1,999.00 million in the quarter under review, up from AF 1,483.59 million in the third quarter of 1389, this represents 34.74 percent increase. According to the FPU/MoF, operating expenditures on social security are likely to increase in future as relatively strong growth is expected in the registration and number of retired civil servants as well as army officials (see Tables 5.3 and 5.4).

Figure 5.2: Core Expenditures (in million USD)



Source: Ministry of Finance website and DAB staff calculation

Table 5.4: Core Expenditures, Q3- 1390 (in million AF)

Particulars	Q3 1390 Expenditures Actual	Q3 1389 Expenditures Actual	% Changes
Total Expenditures(Development and Operating)	53,797.39	38,270	41%
Development Expenditures	15,032.23	12,161.37	24%
Operating Expenditures	38,765.16	26,109	48%

Source: Ministry of Finance website and DAB staff calculation.

Table 5.5: Core Expenditures (in million USD)

	Q3 1390	Q3 1389
Total Expenditures	1115	847
Development Expenditures	311	269
Operating Expenditures	803	578

Source: Ministry of Finance website and DAB staff calculation.

Note: End Period Average Exchange Rate for Q3 1390 was AF 48.26/USD, and for Q3 1389 it was AF 45.17/USD

Table 5.6: Total Development Expenditures (in million AF)

Particulars	Q3 1390	Q3 1389	% Changes
Travel	118.50	59.10	101%
Communications	-	-	-
Contracted services	3,617.50	3,428.95	5%
Repairs and maintenance	84.76	37.89	124%
Utilities	48.85	23.05	112%
Fuel	9.15	23.97	-62%
Tools and materials	308.22	75.99	306%
Other	337.47	160.47	110%
Advances and return of expenditure	964.28	678.95	42%
Total supplier expenses	**5,488.75**	**4,488.36**	**22%**
Grants	-	-	-
Grants to foreign governments	-	-	-
Social security benefits cash	-	-	-
Social assist benefit in cash	-	-	-
Advance Subsides Grants	-	-	-
Total subsidies, grants, contributions and pensions exp.	-	-	-
Buildings and structures	4,233.90	5,424.36	-22%
Machinery and equip (>50,000)	1,421.56	473.30	200%
Valuables	0.00	2.00	-100%
Land	7.11	5.87	21%
Capital advance payments	3,880.92	1,767.48	120%
Total capital expenditure	**9,543.49**	**7,673.00**	**24%**
Interest	-	-	-
Total interest expenditure	-	-	-

Source: Ministry of Finance website and DAB staff calculation.

Table 5.7: Total Operating Expenditures (in million AF)

Expenditure Splits	Q3 1390	Q3 1389	% Changes
Employees			
Salaries in cash	23,598.96	17,307.86	36.35%
Salaries in kind	4,785.78	3,179.68	50.51%
Salaries and wages advance	-21.17	69.46	-130.48%
Social benefits in cash	114.50	73.95	54.83%
Social benefits - in kind	-	-	-
Total employee expenditure	**28,478.06**	**20,630.95**	**38.04%**
Supplier Expenditure	**432.77**	**270.93**	**59.74%**
Travel	-	-	-
Communications	61.67	135.67	-54.55%
Contracted services	1,192.87	455.10	162.11%
Repairs and maintenance	371.15	667.34	-44.38%
Utilities	1,015.86	684.16	48.48%
Fuel	1,485.77	1,316.72	12.84%
Tools and materials	2,837.97	407.40	596.61%
Other	267.74	(253.95)	-205.43%
Advances and return of expenditure	7,665.80	3,683.36	108.12%
Total supplier expenses	**5.50**	**9.60**	**-42.71%**
Subsidies, grants, contributions and pensions	-	-	-
Grants	1,605.50	1,325.11	21.16%
Grants to foreign government	91.02	243.40	-62.61%
Social security benefits cash	296.98	(94.52)	-414.20%
Social assist benefit in cash	1,999.00	1,483.59	34.74%
Advance Subsides Grants	194.47	40.32	382.34%
Total subsidies, grants, contributions and pensions expenditure	354.31	221.13	60.22%
Capital expenditure	0.82	-	-
Buildings and structures	7.72	26.56	-70.92%
Machinery and equip (>50,000)	25.24	(11.73)	-315.16%
Valuables	582.56	276.28	110.86%
Land	39.74	34.79	14.24%
Capital advance payments	39.74	34.79	14.24%
Total capital expenditure	**23,598.96**	**17,307.86**	**36.35%**
Interest	**4,785.78**	**3,179.68**	**50.51%**
Interest	-21.17	69.46	-130.48%
Total interest expenditure	**114.50**	**73.95**	**54.83%**

Source: Ministry of Finance website and DAB staff calculation

3. FINANCING THE CORE BUDGET

The total donor contribution (grants) allotted to both operating and development expenditures increased to AF 66,384.42 million in 1390 year to date, up from AF 61,520.56 million in the corresponding period of 1389, which represents 7.91 percent increase.

According to FPU/MoF, the donor contributions comprise an important part of the national budget. Donor grants finance major expenditure items in the operating budget, especially security related expenditures. Grants finance the majority of the development budget with the remainder financed through concessional loans.

In Afghanistan's context, fiscal sustainability is defined as total operating budget is being financed by total domestic revenues. Fiscal sustainability was a major objective under the IMF and WB/PRGF program with Afghanistan.

The donor grants for operating expenditures in the quarter under review reached AF 15,595.07 million; up from AF 12,734.58million in the same quarter of last year, showing 22.46 percent increase, meanwhile, it was up to AF 9,499.60 million from AF 9,079.48 million for the development expenditures, representing only 4.63 percent increase compared to the same period of 1389.

The main donor contributors to the development expenditures are as follow: ARTF, LOTFA, ADB, DFID, EC, World Bank, CSTC, US and USAID (See Table 5.8).

Table: 5.8: Total Donor Contribution, Q3 1390 and Q3 1389 (in million AF)

Donor contributions	Q3 1390	Q3 1389	% Changes
Afghanistan Reconstruction Trust Fund	4,813.74	2,701.31	78%
Law and Order Trust Fund - Afghanistan	6,171.10	8,041.97	-23%
CSTC - MoD	9,304.11	4,686.30	99%
Foreign loans	-	-	-
World Bank	122.24	46.32	164%
Asian Development Bank	203.58	749.06	-73%
Other	2.19	8.42	-74%
Donor revenue	-	-	-
World Bank	1,641.46	934.18	76%
European Commission	-	-	-
ADB	1,334.41	1,960.58	-32%
DFID	-	-	-
US and USAID	167.39	928.42	-82%
Others	1,334.46	1,757.50	-24%
Total donor contributions	25,094.67	21,814.06	15%

Source: Ministry of Finance website and DAB staff calculation

Table 5.9: Breakdown of Donor Contribution for Q3 1390 (in million AF)

Donor contributions	Operating Grants	Development Grants
Afghanistan Reconstruction Trust Fund	100.48	4,713.25
Law and Order Trust Fund - Afghanistan	6,171.10	-
CSTC - MoD	9,304.11	-
Foreign loans	-	-
World Bank	-	122.24
Asian Development Bank	-	203.58
Other	-	2.19
Donor revenue	-	-
World Bank		1,641.46
European Commission	-	-
ADB	-	1,334.41
DFID	-	-
US and USAID	-	167.39
Others	19.38	1,315.08
Total donor contributions	15,595.07	9,499.60

Source: Ministry of Finance website and DAB staff calculation

CHAPTER VI

BANKING SYSTEM PERFORMANCE

6

BANKING SYSTEM PERFORMANCE

The banking system gained momentum in third quarter of 1390 after showing a weak performance in the second quarter. Total assets of the banking system increased by 2.47 percent (year-on-year) or AF 4,749 million at the end of third quarter of 1390 (December 2011) reaching AF 197.17 billion, up from AF 192.42 billion in the same period of last year. Deposits stood at AF 172.74 billion up by 13.37 percent from the same period of last year. Deposits were largely denominated in US dollars (63.15 percent) with afghani denominated deposits lagging at 33.48 percent. AF-denominated deposits indicated a growth rate of 11.77 percent, while USD denominated deposit were up by 14.97 percent. The entire banking sector was well capitalized, and the capital of the system stood at AF 15.96 billion, while it was a negative figure last year (December, 2010), on account of AF 18.12 billion lenders of last resort loans from DAB to Kabul bank and AF 39.85 billion Loan loss reserves created for the bad assets of the mention bank.

The capital adequacy ratio (CAR) of the banking sector was 23.51 percent.

Gross Loans depicted a decrease of AF 40.95 billion (or 51 percent) standing at AF 40.23 billion. The decrease in the gross loans of the system ascribed to a number of financial institutions, but mainly from the splitting of crises stricken bank into New Kabul Bank and Receivership. Good assets came under the New Kabul Bank and bad assets (mainly loans) gone to receiver.

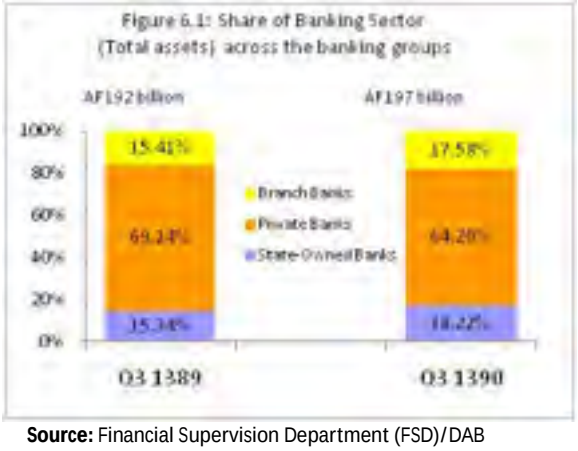
On cumulative basis, the banking sector incurred losses amounting to AF1.78 billion down by AF 37.31 billion since December 2010. The significant decrease in the losses was mostly due credit provisions to Kabul bank (now split into New Kabul Bank and Receivership). The return on assets (ROA) improved in the third quarter of 1390 (Dec 2011) registering -1.17 compared to -26.66 in December 2010, while return on equity (ROE) improved to -18.71 from -27.86 in the same period of last year. Only branches of foreign banks ended up with profit, while private banks and state-owned banks ended up with losses for the period under analysis.

1. ASSETS OF THE BANKING SYSTEM

Total assets of the banking system at the end of Qaws 1390 stood at AF 197.17 billion (USD 4.01 billion) up by 2.47 percent or AF 4.75 billion since December 2010, lower than 20.99 percent growth in the third quarter of 1389. Figure 6.1

The components of total assets depicted mixed performance; the most obvious increase was registered in "investment" (up by AF 3.78 billion or 184.51 percent). The second major increase was posted by cash in vault ad claims on DAB (AF26.13 billion or 44.31 percent) followed by interbank claims and net due from (AF 1.37 billion and AF412 million respectively), while "other" category of the total assets and net loans have shown decreases (by 58.50 percent and 1.13 percent respectively) for the period under analysis. Comparing to the last quarter (September 2011) the asset base of the system contracted by 9.59 percent, this decrease was on account of decrease in "other assets" category of total assets and NDF, while rest of the assets' components have shown increases since last quarter.

The most important components of the system's total asset portfolio were cash in vault/claims on DAB (43.15 percent), interbank claims (20 percent), net loans (19.63 percent) and "other assets" (9.27 percent). While the share of other components of total assets were negligible, Table 6.1



Source: Financial Supervision Department (FSD)/DAB

Table 6.1: Composition of Assets & Liabilities (in million AF)

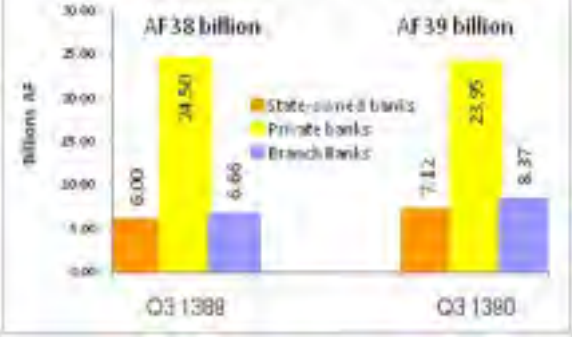
Assets	1389 Dec. 2010	1390 Dec. 2011	% of Total	Y-O-Y
Loans (Net)	39,893	38,719	19.63	-1.13
Cash in vault and claims on DAB	58,970	85,100	43.15	44.31
Interbank claims	38,076	39,441	20.00	3.58
Investments	2,046	5,821	2.95	184.50
NDF	9,408	9,820	4.98	4.38
Others	44,029	18,271	9.27	-58.50
Total	192,422	197,171		2.47
Liabilities				
Deposits	152,371	172,742	95.32	13.37
Borrowings	21,620	1,649	0.91	-92.37
NDT	188	564	0.31	200
Others	35,155	6,255	3.45	-82.21
Total	209,334	181,209		-13.44

Source: Financial Supervision Department (FSD)/DAB

1.1 Interbank Claims

Interbank claims are the second largest among various asset categories, currently comprising AF 39.44 billion – 20 percent of total assets, posted 3.58 percent increase since December 2010, attributed to a number of banking institutions, indicating that the banking sector has channeled a portion of its attracted funds as deposits in other financial institutions, if credible borrowers were not found. These institutions are both, inside and outside the country. Later on, if needed for liquidity purposes or after getting loan application from low-risk borrowers, these assets can be substituted to higher income earning assets. Figure 6.2

Figure 6.2: Share of Inter bank Claims among banking groups



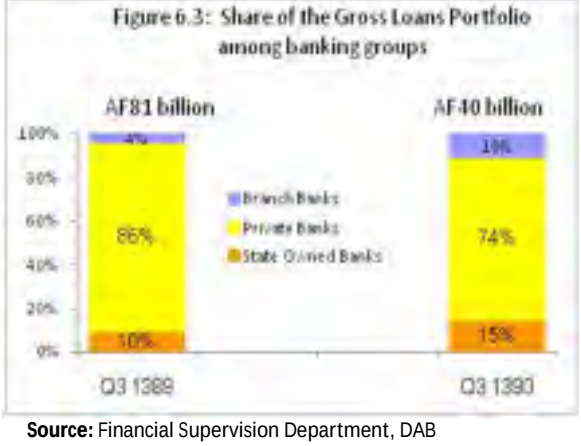
Source: Financial Supervision Department, DA*B*

Private Banks are the leading creditors, but comparing to the previous period their portfolio both in absolute terms as well as percentage of total loans has depicted a decrease, currently standing at AF 29.86 billion or 74.15 percent of total loans, this decrease in private banks portfolio was mainly due to splitting of the crises stricken bank in to New Kabul Bank and Receiver. Good assets came under the New Kabul Bank and bad assets (mainly loans) gone to receiver. The portfolio of State-owned banks and branches of foreign banks' share and amount were AF 6.19 billion (15.39 percent) and AF 4.21 billion (10.46 percent) respectively.

1.2 Net Loans

The loans/ advances portfolio of the system was AF 38.72 billion (USD 787 billion) as of December 2011 – down by AF 452 million or 1.13 percent, making 19.63 percent of total assets. Increases in lending were observed at nine banking institutions, where as in five, decreases have been observed, while two of the banking organizations did not participate and for one the portfolio remained the same, however more than two-third of the growth is still attributable to private bank's group.

Figure 6.3: Share of the Gross Loans Portfolio among banking groups



Source: Financial Supervision Department, DAB

1.3 Loan Loss Reserves

While assessing the level of credit risk, banks have to give due attention to credit

risk mitigation tools within its risk mitigation framework. Banks are required to make both, general reserves (on standard assets) and specific provisions (on non standard assets) in order to mitigate their credit risk.

By the end of Qaws 1390 (December 2011), total provision cover of the system was 3.87 percent of total gross loans in comparison with 50.88 percent of last year (December 2010).

1.4 Distribution of Credit

Sector wise analysis shows that the major portion of the loan portfolio is designated to "other commercial loans" (65.97 percent), mainly in trade sector (26.41 percent). Increases have been observed both in absolute and percentage of total loans in manufacturing, services, mining, agriculture, and "all other loans" category of total loans. The concentration in other commercial loans and mortgage loans to the exclusion of all other types of lending has been the dominant trend. Lending in the commercial and real estate and construction loans, residential mortgage loans to individuals, trade, communications, utilities and consumer loans have witnessed decline during this period. Loans in SMEs and Micro Credits stat AF 7.64 billion (USD 155 million) provided by eight banking institutions, was down by AF 3.25 billion since previous period, came from a number of banking institutions. But, still lending is picking up, although not sufficient enough in some loans categories related to important sectors of the economy, e.g. agriculture and mining and communication sectors have not benefited much. About 79.2 percent of the loans were designated in Kabul with Balkh and Herat provinces in the second and third places respectively. The proportion of loans in other provinces was negligible. The designation of loans sectorally, geographically and institutionally is not properly diversified, but we hope that as time goes over the distribution of loans will become more diversified. It is desirable that all banks take active part in lending, so as to diversify lending services Table 6.4

Table 6.2: Sectoral Distribution of Credit

Ratios	1386 (Mar 2008)	1387 (Mar 2009)	1388 (Mar 2010)	1389 (Mar 2011)	1390 (Dec.2011)
Commercial Real Estate and Construction Loans	9.54	0.19	19.92	25.98	2.95
Other Commercial Loans	79.14	-	-	-	-
Mining	N.A	-	-	0.02	0.95
Manufacturing	N.A	0.01	1.22	2.72	14.53
Trade	N.A	0.51	32.29	34.16	26.41
Communication	N.A	0	1.04	1.23	0.73
Service	N.A	0.09	4.84	6.72	12.63
Utilities	N.A	0.01	2.47	0.03	0.07
Others	N.A	0.09	25	8.42	10.66
Agricultural Loans	0.13	0	0.88	0.75	1.80
Consumer Loans	2.17	0.02	1.33	1.01	0.88
Residential Mortgage Loans to Individuals	2.28	0.01	7.3	8.95	16.06
All Other Loans	6.74	0.05	3.69	10	12.35

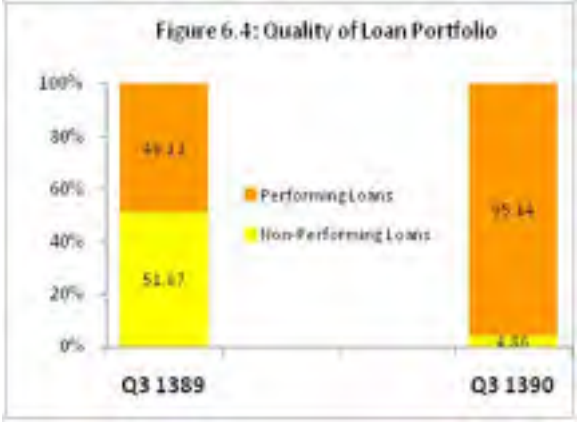
Source: Financial Supervision Department/DAB

1.5 Non-performing loans (NPLs)

Banks should try to strengthen credit risk management measures to curtail the level of NPLs. This is essential for banks to evaluate credit application carefully and closely monitor financial condition of their borrowers, to ensure that credit expansion will not pose a threat to the stability of the financial system.

By the end of Qaws 1390 (December 2011) the growth in NPLs has decelerated to AF1.96 billion (USD 40 million) or 4.86 percent of gross loans down by AF 40.19 billion compared to the previous period (December 2010) where Non-performing loans were AF 42.14 billion, and 97 percent of the NPLs were related to Kabul Bank.

Comparing to the last quarter, non-performing loans indicated AF 531 million decrease during this quarter, mainly due to four banking institutions. Table 6.5



Source: Financial Supervision Department, DAB

1.6 Adversely-classified loans

Adversely-classified loans (substandard, doubtful) stood at AF 2.79 billion (USD 57

million), posting AF 556 million decrease by the end of Qaws 1389 (December 2011) which was AF 3.35 billion in the previous period (December 2010). The percentage share of adversely-classified loans in total gross loans increased to 6.94 percent, from 4.12 percent in the same period last year, the increase in percentage was due to increase in denominator of the ratio.

1.7 Loans Classified Watch

Loans under "Watch" category stood at AF 1.68 billion (USD 345 million) or 4.2 percent of the total gross loans which was AF 1.56 billion or 1.91 percent of the gross loans in the previous period. This category of loans need close monitoring to see if it is a leading indicator of future increases in adversely-classified loans, or if it is just an indication that the classification of loans is becoming more conservative.

1.8 Loans classified loss

Loans classified loss amounts to AF 291 million (USD 6 million) down by AF 39.07 billion (were mostly attributed to Kabul Bank) or 0.72 percent of total gross loans since previous period, mostly came from one banking institution.

1.9 Cash in Vault and Claims on DAB

Cash in vault and claims on DAB remains the largest category, increasing both in absolute as well as in percentage of total assets since previous period (December 2010), registering AF 85.10 billion or 44.31 percent increase during this period. The banking sector is considering compliance with required reserves, or deploying slowly and prudently the attracted funds into other types of assets.

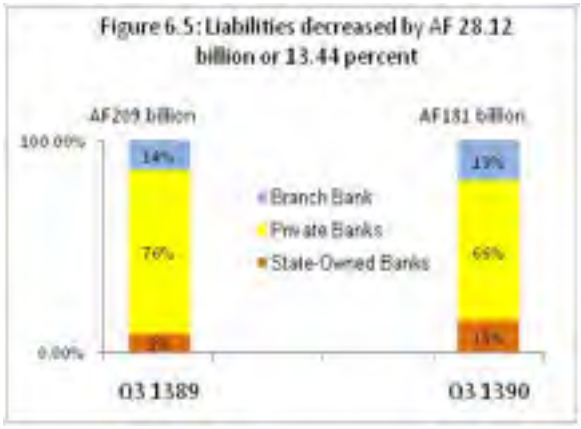
1.10 Investment

The growth in investments accelerated significantly by 184.5 percent or 2.95 percent of total assets, amounting to AF 5.82 billion by the end of Qaws 1389 (December 2011). Major part of the investment took place outside Afghanistan in First Gulf Bank and TAQA bonds (UAE), Euro bonds (Pakistan) and trading companies (USA, UK) by two commercial banks and a branch of foreign bank.

2. LIABILITIES

Total liabilities of the banking sector were AF 181.21 billion (USD3.68 billion), down by 13.44 percent. The drop down in total liabilities were due to significant decrease in "other liabilities" and borrowings.

Major portion of liabilities are made up of deposits (95.32 percent, this is an indication of growing public confidence and good public relations and marketing policies of the banking sector), with "other liabilities "at second and borrowings at third place. Table 6.2



Source: Financial Supervision Department, DAB

2.1 Deposits

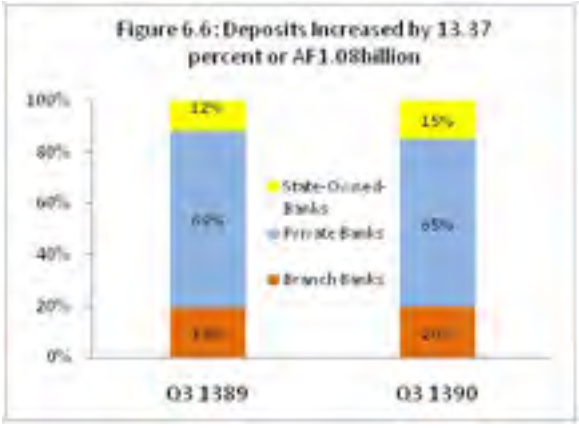
Deposits remained the main source of funding in the banking sector, accounting for 95.32 percent of the total liabilities, depicted 13.37 percent growth from 16.31 percent last year (December 2010) afghani denominated deposits indicated 11.77 percent growth, accounting for 33.48 percent of the total deposits, whilst the US dollars Denominated deposits registered 14.97 percent increase making 63.15 percent of the total deposits of the system.

The share of state-owned banks increased to AF 25.96 billion (up by 43.32 percent), which was AF 18.12 billion in December 2010.

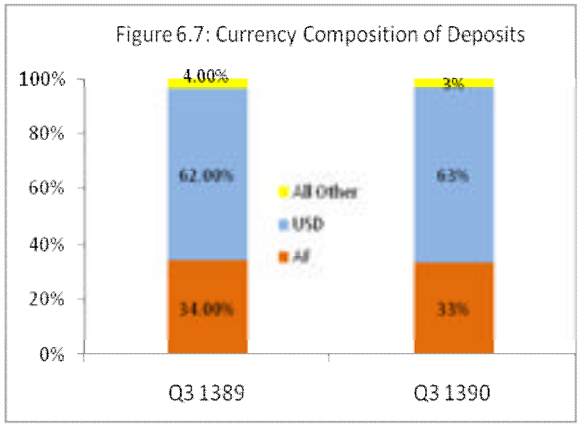
Private Banks attracted AF 112.98 billion, which is up by 7.54 percent since previous period, where it was AF 105.06 billion.

The share of branches of foreign banks increased to AF 33.81 billion (up by 15.75 percent), which was 19.19 billion in previous period (December 2010).

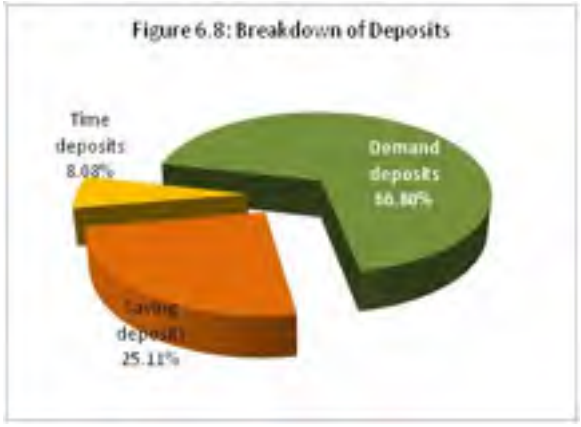
In terms of types of deposits, demand deposits accounted for 66.80 percent of the total deposit base, up by 7.84 percent, saving deposits with 25.11 percent of total deposits was in the second place, depicting 25.19 percent increase, and time deposits making 8.08 percent of the total deposit portfolio, was up by 30.31 percent since December 2010.



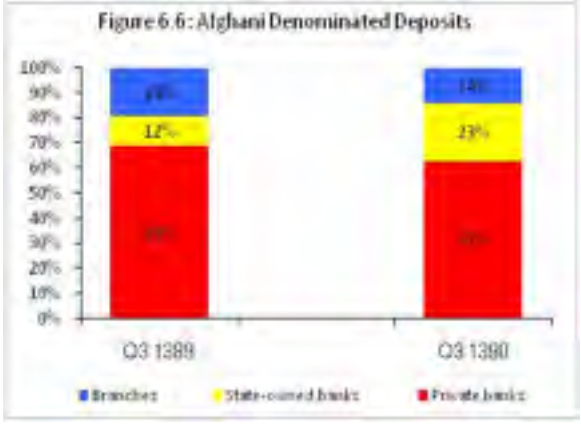
Source: Financial Supervision Department, DAB



Source: Financial Supervision Department, DAB



Source: Financial Supervision Department, DAB



Source: Financial Supervision Department, DAB

2.2 Borrowings

The share of borrowings in total funding structure of the system decreased significantly, standing at AF 1.65 billion (USD 33.50 billion) by the end of the December 2011, down from AF 21.62 billion in December 2010, making 0.91 percent of total liabilities in comparison with 10.33 percent in the same period of previous year .This significant decrease in borrowing has come from three banking institutions, but mainly due to the disappearance of AF 18.11 billion lender of the last resort funds to Kabul Bank by DAB. This borrowing is attributed to only one bank during this period, where it was attributed to four banks last year.

2.3 Liquidity

The liquidity risk can be defined as the risk of not having cash or liquid assets to meet the demand of borrowers and depositors. All the banks are required to maintain a reasonable level, in order to avoid any liquidity problem. For this reason, banks have asset liability committee (ALCO); one of its tasks is the liquidity management of the bank through gap analysis, stress testing, scenario analysis, cash flow analysis, etc. according to policies of the bank.

2.4 Liquidity Ratio (broad measure)

Banks are required to maintain liquid assets ratio not less than 15 percent. This provides a comfortable safeguard against any liquidity shortfall.

Generally, a surplus liquidity position was observed in the banking sector during the reporting period. Analysis show 42.2 percent increase in access liquid assets. 55 percent of the total assets comprises of liquid assets. Ratio of the broad liquidity as a median for the all system stood at 59.8 percent. All the banking institutions were well above the minimum required level. Table 6.5

2.5 Capital

In order to strengthen the capital base of the banking system and enhance its

stability, DAB has increased the minimum financial capital requirement to AF1.00 billion, and all banking institutions are given two year time period to meet this requirement4.

Currently only four banking institutions met this requirement; the rest will need to infuse further capital to comply with the new required level during the next three months. One bank in the system falls far below this requirement, while the capital of the crises stricken bank, which has been split recently is a negative figure (the mentioned bank has no common stock and the core income of the bank which is the main source of income is negative), DAB Supreme Council has given this bank forbearance for the size and structure and regulatory ratios of the capital till its privatization from Ministry of Finance.

Overall system is well capitalized and the capital of the system stands at AF 15.96 billion (USD 324 million), which was a negative figure amounting to AF 16.91 billion last year (December 2010), on account of AF 18.19 billion lender of the last resort loans from DAB to Kabul Bank and AF 39.85 billion loan loss reserves for the bad assets of the mentioned bank.

On aggregate basis, capital adequacy ratio of the banking sector was 23.51 percent. Disaggregated analysis show that all banks in the system registered capital adequacy ratio above the minimum threshold (12 percent of risk-weighted assets), except one bank (which is given forbearance for the size and structure and regulatory ratios of the capital), while two other banks in the system are close to the minimum threshold.

If the 20 percent capital/assets ratio or assets support by capital is taken as benchmark which is an internationally applied ratio for the banks, the AF 15.96 billion makes 8.09 percent of AF 197.17 billion, which is far below the benchmark, while total assets of the full-fledged commercial banks are AF 162.50 billion .

Branches of foreign banks do not have separate capital. The most analogous concept to positive capital is the Net Due to Related Depository Institutions, primarily the home office and other branches of the same bank (NDT), while the closest analogue to negative capital is the Net Due from related depository institutions, primarily the home office and other branches of the same bank (NDF). NDF is probably a normal situation for a foreign branch bank in the first year or so of existence when the branch is establishing itself and seeking loan customers and other investment opportunities. Supervisory action will only be required if the branch persists for another year or two bank's overall worldwide condition and performance is deteriorating.

In the period under review, there was an increase of AF 412 million in NDF standing at AF 9.82 billion as compared to the last

[4] DAB Supreme Council resolution dated 16/03/1389

period (December 2010), when it was AF 9.41 billion.

In the period under review, NDT position amplified manifold and increased by AF 376 million and stood at AF 564 million, where it was AF 188 million in the previous period. Only two banks were at favorable NDT position, much smaller than the relatively large, unfavorable NDF positions for the remaining three. Put differently, only two banks are actively seeking investment outlets for the funds they have attracted, while the rest are simply sending their acquired funds to their international networks. The NDF position of one bank has increased, while two banks have a decrease. The largest NDF position by a branch of foreign bank was AF 8.44 billion, increased by AF 1.47 billion from AF 6.96 billion in previous period December 2010.

Table 6.3: Key Financial Soundness Indicators of the banking Sector

Ratio	1386	1387	1388	1390	1390	1390
	(Mar 08)	(Mar 09)	(Mar 10)	(Mar 11)	(Mar 11)*	(Dec. 11)
Total Capital Adequacy Ratio	31.77	29.81	25.81	-14.46	30.39	23.51
Teir 1 Capital Adequacy Ratio	31.16	29.72	24.19	-14.51	30.29	22.95
Non-Performing Loans to Total Gross Loans	0.68	1.15	0.5	48.4	3.75	4.86
Return on Assets (ROA)	1.8	1.74	1.41	-20.08	0.24	-1.17
Return on Equity (ROE)	9.89	10.61	10.35	-520.66	1.9	-18.67
liquidity Ratio (Broad Measure Median)	40.02	40.02	59.19	63.32	63.83	59.81
liquidity Assets to Total Assets	23.8	23.8	0.38	40.58	47.01	54.99

*without Crises stricken Bank
Source: Financial Supervision Department/ DAB

2.6 Profitability

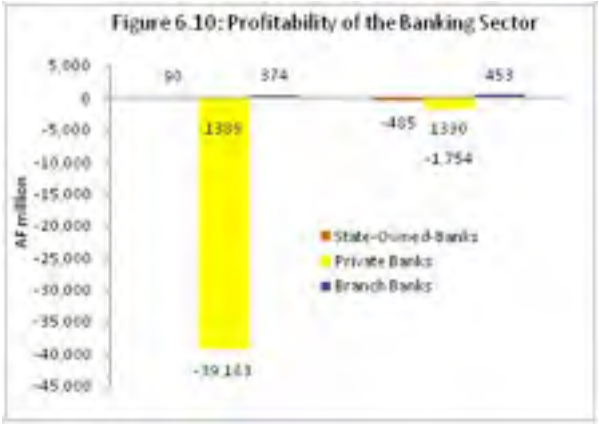
On cumulative basis, the banking sector has incurred losses amounting to AF 1.78 billion (USD 36.40 million), down by AF 37.31 billion since December 2010. The significant decrease in the losses were mostly due to the disappearance of AF 39.12 billion credit provisions related to Kabul bank (which is now split into New Kabul Bank and Receivership), despite this, the banking portfolio witnessed a decrease in the net interest income, (the main source of income) increase in taxes and FX losses, while operating costs registered slight decrease.

The return on assets (ROA) of the system reached -1.17 percent; where it was -26.66 percent in the previous period (December 2010), while return on equity (ROE) improved in the quarter under review recording –18.67 percent, compared to -27.86 percent recorded in the previous

period. On cumulative basis, five banks have incurred loss of AF 3.21 billion, where this figure was AF 40.04 billion in the previous period with six banks at loss. On core income basis, three banks ended with losses mainly on account of decrease in total income.

The efficiency ratio, (net interest income + trading account gain/loss + other non-interest income divided by operating expenses) of the system as a median stood at 1.71, eight banking institutions ended up with lower efficiency ratios by the end of Qaws 1390 (December 2011).

On cumulative basis, only branches of foreign banks were profitable, while Private Banks and State-owned Banks ended with losses.



Source: Financial Supervision Department/ DAB

Table 6.4: Profit of the banking sector (in million AF)

items	1389 (Dec. 2010)	1390 (Dec. 2011)	Y-O-Y
interest income	6,446	4,847	-25
interest expense	2,055	1,578	-23
Net interest income	4,391	3,270	-25
Non-interest income	3,052	2,965	-3
Non-interest expenses	3,483	3,402	-2
Salary cost	2,362	2,371	0.3
Credit provisions	40,503	2,032	-95
P/L before tax	-38,904	-1,570	-96
P/L after tax	-39,091	-1,787	-95

Source: Financial Supervision Department/DAB

Source: Financial Supervision Department/DAB

Source: Financial Supervision Department/DAB

2.7 Foreign Exchange Risk

The level of overall open FX position risk being taken by banks is largely within the levels set by DAB. In general, all the banking institutions were within the limits set for overall open FX position, except four banking institutions holding open FX position on overall and on an individual currency (USD short & long positions) basis crossed the set limits, remained unchanged from the previous year. (Branches of foreign banks are not subject to limitations on open FX position, since that risk is managed on a whole-bank basis and not branch-by-branch).

The impact of change in exchange rate upon regulatory capital of the system reveals that a 20 percent change in exchange rate would increase the regulatory capital by AF 5.20 billion and vice versa. Similarly, a 4 percent change would correspond to AF 4.82 billion and vice versa.

2.8 Interest Rate Risk

The Overall banking institution is in interest-rate sensitive position. However, calculation made from the Interest Rate Sensitivity Schedules of all banks reveals that, the net-interest income of the system over the next 12 months will increase by AF 67 million in the event of increase in the market interest rate (upward interest rate shock) by 3 percentage points. Conversely, if the interest rate decreases by 3 percentage points (downward interest rate shock) the interest income will decline by AF 67 million. For five banking institutions, if the interest rate increases by 3 percentage points, that will decrease in their net interest income over the next 12 months. (Branches of foreign banks are not required to file the interest-rate sensitivity schedule, because like FX risk, interest-rate sensitivity of the banks is the large excess of risk is managed on a whole-bank basis).

The major reason for the overwhelming asset-sensitivity of the banks is the large excess of interest-bearing assets over interest-bearing liabilities. Although it may improve the net interest margin and overall profitability of the bank, but this situation makes the banks more vulnerable to a sudden decrease in market rates.

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