

Da Afghanistan Bank



Economic & Statistical Bulletin



Annual Bulletin FY1391

(March 21, 2012 to December 20, 2012)

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(March 21, 2012 to December 20, 2012)

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Note:

Afghanistan's new Fiscal year has changed recently effective from FY1391. The fiscal year begins on December 21 each year. This Annual Bulletin describes developments in the fiscal year 1391 which covers March 21, 2012 to December 20, 2012.

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LIST OF 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 |

FOREWORD



DAB's policies/efforts are geared towards protecting the most vulnerable segments of society by focusing on price stability -DAB's primary mission- through implementing a sound and effective monetary policy.

Noorullah Delawari

Governor

It is my pleasure to present the economic and statistical bulletin of Da Afghanistan Bank (DAB) for FY1391 (2012). This annual bulletin reflects the results of the Bank's main activities aimed at keeping inflation low, maintaining stability of the national currency and developing a more robust banking sector in support of sustainable economic growth.

The fiscal year 1391 was relatively favorable year for Afghanistan with an increase in growth rate and low inflation. The real GDP growth gained momentum in the year under review estimated at 10.9 percent, while inflation remained in the comfort zone of a single digit.

The global economic developments hint the persistence of the 2008-2009 global financial crises. Despite the expansionary monetary policy adopted by the central banks of advanced economies, as well as the fiscal stimulus packages, the deleveraging process in both, firms and households still continues in advanced economies. The recovery has not reached the desired level, as a result, the global aggregate demand, in particular in the trading partners of Afghanistan was not promoted enough to encourage Afghanistan exports.

DAB maintained the same monetary policy stance using monetary aggregate targeting framework and reserve requirement ratios.

DAB maintains the managed floating exchange rate regime which is well consistent with the current economic conditions of the country

and has performed relatively well during the past years.

In Afghanistan, inflation continued to be low in the comfort zone of a single digit, representing a year-on-year rate of 5.8 percent at the end of FY1391. Thank to the favorable weather condition and seasonal rainfalls that contributed to an increase in domestic wheat and grain production.

On the other hand, monetary aggregates depicted mixed performance. DAB successfully achieved the end-year target for reserve money (RM), the operational target under IMF-ECF program, as well as the ceiling on currency in circulation (CiC).

Narrow money (M1) grew by about 9.8 percent and broad money (M2) demonstrated similar behavior growing by 8.80 percent.

Meanwhile, the nominal exchange rate of afghani against the U.S. dollar witnessed somewhat depreciation in the year under review.

In the external sector, the trade deficit widened further in the year under review as a result of significant decrease in exports driven by the low aggregate demand in the trading partners of Afghanistan. On the other hand, imports increased considerably indicating a growing domestic demand for foreign goods, mainly consumer goods, industrial supply, and capital goods.

The banking sector performance improved in the reporting period from a weak performance in the preceding year. The total asset of the banking system recorded an increase of about 14 percent. Similarly, there was an increase in total deposits, and total gross loans of the system. The overall losses of the system improved compared to the last year. The increase in total deposits indicates a rebound in people's confidence in the banking sector. The entire banking sector was well capitalized

with an increase in total capital of the system compared to a year ago.

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 the Monetary Policy Department team for a superb job in preparation of this bulletin.

Supreme Council



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EXECUTIVE SUMMARY

The fiscal year 1391 was relatively favorable year for Afghanistan with an increase in growth rate and a low inflation. The real GDP growth gained momentum in the year under review estimated at 10.9 percent, while inflation remained in the comfort zone of a single digit.

The global economic developments suggest that the 2008-2009 global financial crises persist. Despite the expansionary monetary policy adopted by the central banks of advanced economies, as well as the fiscal stimulus packages, the deleveraging process in both, firms and households still continues in advanced economies. The recovery has not reached the desired level, as a result, the aggregate demand, in particular in the trading partners of Afghanistan was motivated enough to encourage Afghanistan exports.

In 2012, world economic growth moderated, continuing a downward trend that began in the early 2011 and the global economic environment became challenging relative to the previous year. In the concerning year, the world economy witnessed a weak growth in most developed countries and one of the slowing economic growth in developing countries.

Undesirable global growth as well as the ongoing fiscal problems in the advanced economies caused to sustain volatility in the international financial markets. Advanced economies had an uneven growth with the US

experiencing a broken recovery and the Euro Area remaining in recession.

In the concerning year, the international trade was affected by weak economic conditions that adversely impacted economic activities in emerging economies and most emerging economies expanded at a much lower rate compared to the pre-crisis average growth rate since weakness in key economies of the world affected the rest of the economy of the world.

Demand for manufactured goods from developing economies, especially China recorded a decrease in 2012. The decrease was contributed by the Euro sovereign debt crisis as well as the US policy uncertainty due to the fiscal problems in the FY 2012 that resulted in lower prices in the commodity markets. Besides that, in late 2012, following strong commitments and important measures taken to resolve the European debt crisis improved market trends.

In 2012, due to the weak global demand and more favorable supply conditions on the other hand, except the prices of crude oil, the prices of all other goods were lower in the international commodity markets.

In Afghanistan, monetary aggregates had mixed performance; reserve money, the operational target under the ECF program, had an increase of about one percent reaching about AF176,707.89 million which is well below the ECF target of 15.22 percent growth. Currency in circulation “an indicative target under the ECF program”, increased by only 1.1 percent standing at AF150,007.34 million. DAB

successfully achieved the annual ceiling targets of RM and CiC in the reporting period, while on the other hand, breached the floor for net international reserve accumulation of USD 990 million by USD414 million.

Narrow money (M1) stood at AF319,164 million, indicating an annual growth rate of 9.78 percent. Broad money (M2) demonstrated similar behavior growing by 8.80 percent reaching AF338,840 million at the end of the year under review.

In order to control the reserve money as well as to stabilize the exchange rate of afghani against foreign currencies, DAB utilizes two main instruments: FX auction (selling of FX to commercial banks and licensed exchange dealers through a bi-weekly auction), and issuing capital notes to commercial banks through a weekly auction. DAB has auctioned a total of USD2.53 billion in the year under review. Total outstanding amount of CNs stood at AF36 billion in the same period.

In the meantime, nominal exchange rate of afghani against US dollar depreciated by 5.55 percent in the year under review.

Inflation, as measured by year-on-year percentage changes in national CPI, decreased significantly at the end of the year under review.

The nationwide headline inflation increased by 5.8 percent (Y-o-Y), which is significantly lower than the inflation rate of 9.7 percent observed in the same period of 2011.

The year-on-year Kabul based headline CPI inflation decreased by 2.9 percentage points at the end of the FY1391 representing an inflation rate of 6.5 percent, as result of decline in the prices of both, food and non-food sub-indices. Moreover, core inflation, which excludes the important components of bread and cereals and oils and fat, recorded an annual rate of 6.5 percent compared to 11.4 percent observed in 1390.

When the quarter-on-quarter changes are observed, however, the picture is different. National headline inflation in the fourth quarter of 2012 increased significantly posting an inflation rate of 4.78 percent, up from 0.71 percent in the third quarter. The prices of bread and cereals, oils and fats, meat, vegetables, and household goods, increased significantly in the reporting quarter. The increase in the prices of clothing, housing, electricity and gas was responsible for the increase in quarterly headline inflation.

The quarterly changes in Kabul CPI showed almost similar patterns, although it was less significant than what was observed nationwide. Inflation increased when compared with the third quarter of 2012, but less than what was noted nationwide. In addition, food prices increased, while non-food sub-index posted a decline.

Afghanistan's Balance of Payments (BOP) statistics is an important part of external sector statistics, covering current and capital account

transactions, identifying the goods, services, income, and current transfers as principal components of the current account. In addition, data for external sector statistics include external debt and foreign exchange reserves.

The overall balance for the FY1391 defines a surplus of USD 200 million down from a surplus of USD 592 million in the preceding year. The outcome in the reporting year was due to trade deficit which has widened by almost 46 percent from USD 4,206.05 million to USD 6,158.04 million in the FY 1391.

The current account balance which is the key measure of an economy's saving and spending behavior, recorded a surplus of US dollar 327 million in the year under review, lower than a surplus of USD 800 million in the preceding year. This outcome in the current account was mainly attributed to the widening trade deficit on account of an increase in import expenditures due to both, higher volume as well as prices during the year under review.

Earnings from exports decreased by almost 10 percent standing at USD261.63 million compared to USD289.81 million recorded in the previous year. The decrease in exports was mainly attributed to carpet and rugs, which declined significantly by 74 percent to USD 8.43 million, down from USD31.94 million. Medical seeds and others categories also posted a decline of 9 percent, standing at USD

122.15 million, down from USD 134.38 million in the preceding year. On the other hand, some exporting items such as leather and wool and food items (fresh and dry fruits) posted an increase of almost 21 percent and 3 percent respectively.

Meanwhile, imports increased considerably by 43 percent to USD 6,419.67 million in FY1391, which shows a growing domestic demand for foreign goods, mainly to consumer goods, industrial supply, and capital goods.

Consequently, the trade deficit expanded to USD6,158.04 million in FY1391 compared to USD 4,206.05 million in FY 1390, an increase of about 46 percent. The trade deficit stood at about 31 percent of GDP in FY 1391.

During the period under review, Afghanistan's public and publicly guaranteed external debt stock stood at USD 2,403.33 million, lower than USD2,422.19 million recorded last year.

The net international reserves (NIR) exhibited an increase of about 11.5 percent from USD5,803 million in FY1390 to USD 6,471.94 million in the current year. The reserve assets increased to about 11.51 percent from USD 6,158.18 million in FY 1390 to USD 6,866.79 million in the reporting year. On the other side, the reserve liabilities increased by 11.17 percent, from USD355.17 million in 1390 to USD 394.85 million in the reporting year.

The real GDP growth in FY1391 was satisfactory, increasing to 10.9 percent, up from 8.7 percent recorded in 1390. The major contribution to the favorable economic growth came from a tremendous performance of the

services sector. The other sectors also exhibited good performance. The agriculture sector rebounded and performed satisfactory showing a positive growth rate in the year under review. Thanks to a favorable weather condition and seasonal rainfalls that helped the wheat and other agricultural production to increase.

In terms of components, the major boost to real GDP was an upsurge in fixed government investment, government real expenditures, and private consumptions. The export also posted an increase in the reporting year, which is good news.

Economic growth in Afghanistan, which was rapid by all measures, did not seem to be much affected by the continuing weak performance of the global economy. Because Afghanistan is not an exporting country, weak demand for goods overseas is not reflected in a weak manufacturing sector in Afghanistan.

The fiscal sustainability indicator in FY1391 was only 67 percent, down from 73 percent recorded a year ago. However, the decline was due to increase in operating expenditure specifically in the security sector. And it is expected that operating expenditures will keep increasing that will lead to continue deficits.

That aggregation, however, masks the fact that the second-and third-largest sources of general domestic revenues were taxes and non-taxes revenues, and both showed high performance amounting to AF 99,200.319 million in the fiscal year 1391, up from AF 80,491.85 million and were over the targets estimation

respectively. Ongoing revenues other than the individual custom duty revenues grew at a lethargic AF30,546.40 million, up from AF27,623.20 million screenings only 11 percent augments, though custom duty performance was considered not as good as expected. Other attributes such as fixed taxes, indicated a slight increase of 11 percent, Income tax revenues stood at AF12,557.20 million representing 22 percent incline. Though sales taxes presented 14 percent increase, fell behind the targeted amount in the year 1391. Income from capital property increased respectively, observing 889 percent increment in the period under review. On the other hand, during fourth quarter, non-tax revenue was highly considered to be the second category that had contributed to increase in the total domestic revenue, due to receipts from extractive industry.

Over the course of 1390, GIRA adopted standard mechanisms and techniques to project revenues on higher frequency in order to allow GIRA to prioritize development projects across the country, improve budget and expenditure planning and attain operational efficiency.

Total budget amounted to AF258,318.00 million, though only 77 percent was implemented. Core expenditures increased by 31 percent amount of 201,961.20 million in 1391. Operating expenditures increased to 149,293.60 million in 1390, representing an increase of 36 percent. The current budget execution rate was 96 percent. In addition, the development expenditures also increased to

52,667.50 million which shows 20 percent increment. However, total core budget was still in deficit by the end of 1390. This mainly explains the sluggish performance of fiscal sustainability. The major reason for deficit was continues increase in operating budget due to government gradually taking up security responsibility from international troops, that has also been the main reason for the deteriorated security situation in any part of the country.

Besides, high performance of domestic revenue collections, government been able to increase the execution rate of development expenditure comparing to year 1389, though while implementation the development expenditure remained comparable, actual expenditure against the development budget was slightly lower than in 1389.

Almost one of the third parts of operating budget was financed by donor grants, while entire development expenditure is being financed by donors. Allotted grants for both expenditures increased and indicated 24 percent of increase in the year under review.

The banking sector performance was satisfactory in the FY1391. The asset base of the banking sector grew by 13.57 percent compared to 2.48 percent increase in the FY1390. The asset base of the banking sector

stood at AF223.97 billion compared to AF197.21 billion in the same previous period.

Gross loans depicted 4.62 points growth, standing at AF42.16 billion since December, 2011, while deposits stood at AF192.24 billion, up by 11.28 percent from the previous period. Deposits were largely denominated in USD (66.92 percent) with Afghani denominated deposits lagging at 29.53 percent. AF-denominated deposits exhibited a decrease of 1.85 percent, while USD denominated deposit were up by 17.94 percent.

The capital base of the banking sector remained strong at AF16.63 billion, increased by 3.92 percent mostly on account of injections. The capital adequacy ratio (CAR) of the banking sector was 21.78 percent.

On a cumulative basis, the banking sector incurred losses amounting to AF943 million, annualized figure, compared to AF2.05 billion recorded in March 2012, a decrease of AF1.11 billion, mostly driven by an increase in net-interest income. The return on asset (ROA) improved to -0.59 percent while return on equity (ROE) was -8.13 percent against -1.01 percent and -14.98 percent, respectively. Private Banks and branches of foreign banks finished with profits, while state-owned banks ended up with losses for the period under analysis.



CHAPTER I

GLOBAL ECONOMIC ENVIRONMENT



1

GLOBAL ECONOMIC ENVIRONMENT

In 2012, world economic growth moderated, continuing a down trend that began in the early 2011 & the global economic environment became challenging relative to the previous year. In the concerning year, the world economy witnessed a weak growth in most developed countries and one of the slowing economic growth in developing countries.

Undesirable global growth as well as the ongoing fiscal problems in the advanced economies caused to sustain volatility in the international financial markets. Advanced economies had an uneven growth with the US experiencing a broken recovery and the Euro Area remaining in recession.

In the concerning year, the international trade was affected by weak economic conditions that adversely affected economic activities in emerging economies and most emerging economies expanded at a much lower rate compared to the pre-crisis average growth rate since weakness in key economies of the world affected the rest of the world's economies.

Demand for manufactured goods from developing economies, especially China

recorded a decrease in 2012. The decrease was contributed by the Euro sovereign debt crisis as well as the US policy uncertainty due to the fiscal problems in the FY 2012 that resulted in lower prices in the commodity markets. Besides that, in late 2012, following strong commitments and important measures taken to resolve the European debt crisis improved market trends.

In 2012, due to the weak global demand and more favorable supply conditions on the other hand, except the prices of crude oil, the prices of all other goods were lower in the international commodity markets.

1. ADVANCED ECONOMIES

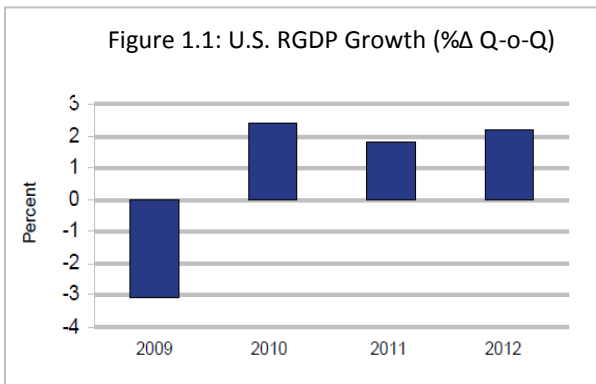
2.1 The United States Economy

According to the U.S. Bureau of Economic Analysis, real GDP in the United States increased by 0.1 percent in the fourth quarter of 2012 (that is, from the third quarter to the fourth quarter), compared with an increase of 3.1 percent in the previous quarter.

Real GDP increased 2.2 percent in 2012 (that is, from the 2011 annual level to the 2012 annual

level), compared with an increase of 1.8 percent in 2011.

The increase in real GDP in 2012 primarily reflected positive contributions from personal consumption expenditures, nonresidential fixed investment, exports, residential fixed investment, and private inventory investment that were partly offset by negative contributions from federal government spending and from state and local government spending. Imports, which are a subtraction in the calculation of GDP, increased.



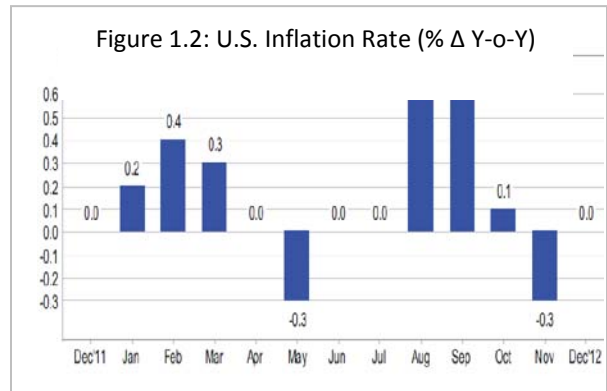
Source: U.S. Bureau of Economic Analysis

The acceleration in real GDP in 2012 primarily reflected a deceleration in imports, upturns in residential fixed investment and in private inventory investment and smaller decreases in state and local government spending and in federal government spending that was partly offset by decelerations in personal consumption expenditures, exports, and nonresidential fixed investment.

According to the U.S. Bureau of Labor Statistics, the consumer price index for all urban consumers in the United States was

unchanged in December 2012 on a seasonally adjusted basis. Over the last 12 months, the all items index increased 1.7 percent before seasonal adjustment.

One-month percent change in CPI for all urban consumers, seasonally adjusted, Dec. 2011 - Dec. 2012



Source: U.S. Bureau of Labor Statistics

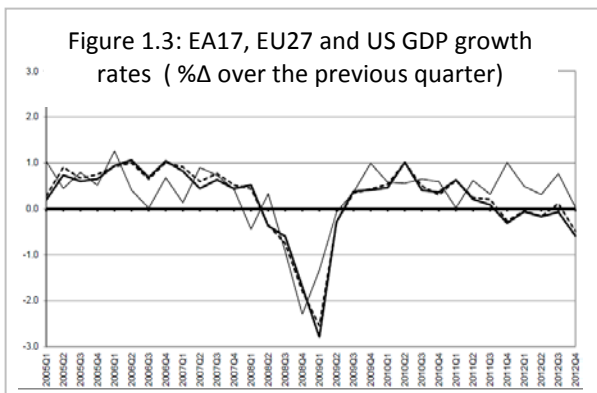
The unemployment rate in the United States was at 7.8 percent in December 2012 compared with November, based on the U.S. Bureau of Labor Statistics report. Total nonfarm payroll employment increased by 155,000 in December 2012. In 2012, employment growth averaged 153,000 per month, the same as the average monthly gain for 2011. Employment increased in health care, food services and drinking places, construction, and manufacturing.

According to the U.S. Census Bureau and the U.S. Bureau of Economic Analysis, aggregate exports and imports of the United States in December 2012 were USD 186.4 billion and USD

224.9 billion, respectively. As a result, the trade deficit stood at USD 38.5 billion, down from USD 48.6 billion in November. The goods and services deficit decreased USD 13.2 billion from December 2011 to December 2012. Exports were up USD 8.6 billion, or 4.9 percent, and imports were down USD 4.6 billion, or 2.0 percent.

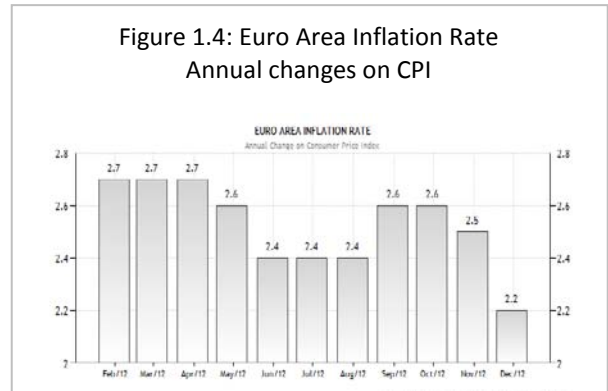
2.2 The Euro Area Economy

According to Eurostat, Euro Area’s GDP fell by 0.6 percent in the fourth quarter of 2012 compared with the previous quarter. In the third quarter of 2012, growth was -0.1 percent. Moreover, Euro Area’s GDP (q-over-q) also fell by 0.9 percent in the fourth quarter of 2012, after minus 0.6 percent decline in the previous quarter.



Source: Eurostat

In December 2012, inflation rate in the Euro Area was recorded at 2.2 percent, down from 2.5 percent in August and 3 percent in December of 2011.



Source: Trading Economics Website

According to Eurostat, Euro Area enjoyed a current account surplus of EUR 59.6 billion in the fourth quarter of 2012, compared with the surplus of EUR 40.8 billion in the third quarter of 2012. Euro Area’s balance of trade in goods recorded a surplus amounting to EUR 37.9 billion in the fourth quarter of 2012; while, it was recorded at EUR 30.3 billion in the third quarter.

Conversely, the balance of trade in services decreased from a surplus of EUR 27.0 billion in the third quarter to EUR 21.0 billion in the quarter under review.

The seasonally-adjusted unemployment rate in the Euro Area was 11.7 percent in December 2012, stable compared with November; however, it has risen markedly compared to December 2011, when it was 10.7 percent.

2.3 The German Economy

According to the OECD, the German economy contracted by 0.6 percent in the fourth quarter of 2012 over the previous quarter, the first

GDP contraction since early 2009. While, compare to the same quarter of the previous year Germany’s real GDP increased by 0.4 percent.

Among the member states of the Euro Area, Germany recorded the second lowest rate of unemployment after Austria at 5.3 percent in December 2012. During the period, the youth unemployment rate was 8 percent in Germany (according to Eurostat).

Consumer prices in Germany rose by 2.0 percent on an annual average in 2012 compared with 2011. Based on the Federal Statistical Office (Destatis) report, the year-on-year rate of price increase thus was lower than in the previous year (2011: +2.3 percent). Both in 2010 and 2009, the annual price rise had been clearly below two percent (2010: +1.1 percent; 2009: +0.4 percent). In December 2012, the inflation rate as measured by the consumer price index amounted to 2.1 percent. Thus it was slightly higher than in November (+1.9 percent).

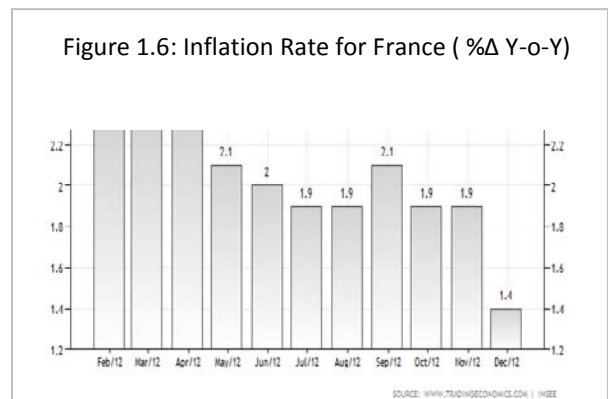


Source: Federal Statistical Office of Germany

2.4 The Economy of France

According to OECD, France economy contracted in the fourth quarter of 2012 by 0.3 percent, against positive growth rate in the previous quarter (0.1 percent). The unemployment rate in France increased slightly from 10.5 in the third quarter of 2012 to 10.6 percent in the fourth quarter. Historically, from 1996 until 2013, France Unemployment Rate averaged 9.48 Percent reaching an all time high of 11.20 Percent in June of 1997 and a record low of 7.50 Percent in March of 2008.

On the other hand, inflation rate in France decreased significantly to 1.4 percent in December 2012 from 1.9 percent in November. The inflation rate in France was recorded at 2.5 percent in December of 2011. Historically, from 1958 until 2013, France inflation rate averaged 4.77 percent reaching an all time high of 18.80 percent in June of 1958 and a record low of -0.70 percent in July of 2009.



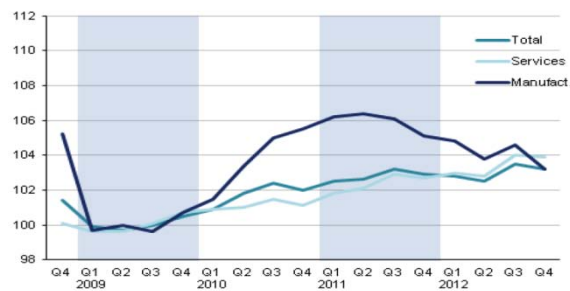
Source: tradingeconomics.com

2.5 The United Kingdom Economy

UK gross domestic product (GDP) in volume terms decreased by 0.3 percent between the third and fourth quarter of 2012; however, in current prices GDP increased by 0.1 percent for the same period.

The downward trend in UK’s real GDP in the fourth quarter of 2012 was mainly dominated by manufacturing (decreased by 1.3 percent) and services (decreased by 0.1 percent), following an increase of 0.7 percent and 1.2 percent respectively.

Figure 1.7: United Kingdom Output indices, CVMSA



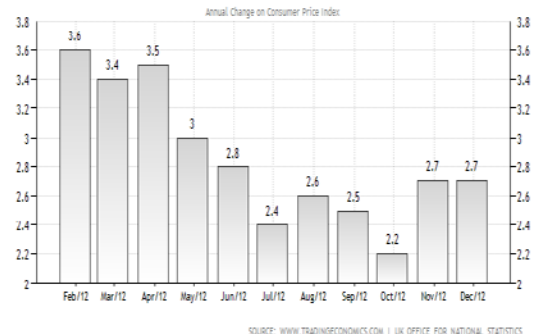
Source: UK Office for National Statistics

According to the UK’s Office for National Statistics, unemployment rate was 7.8 percent in October to December 2012, down 0.1 percentage points from July to September 2012 and down 0.6 from a year earlier. The number of unemployed people was 2.50 million in October to December 2012, down 14,000 from July to September 2012 and down 156,000 from a year earlier.

Based on statistics released by the trading economics website, inflation rate in the United Kingdom was 2.7 percent in December 2012,

with no changes compared to November rate; however, compared to December 2011 it declined significantly when it was 4.8 percent.

Figure 1.8: United Kingdom Inflation Rate (%Δ Y-o-Y)



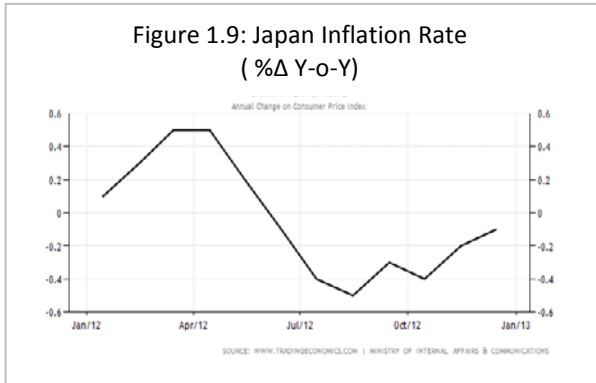
2.6 The Economy of Japan

According to the OECD, the real GDP in Japan contracted by 0.1 percent in the fourth quarter of 2012 over the previous quarter; while, compared to the same quarter of last year it has slightly expanded by 0.1 percent.

Japan’s trade deficit narrowed to USD 7.25 billion in December 2012 compared with 11.31 billion in November 2012. For 2012, Japan recorded a trade deficit of USD 78.24 billion as energy imports soared and the sovereign debt crisis in the euro zone and political tension with China hurt exports. Japanese exports to China, the nation’s largest trading partner, fell 15.8 percent in 2012.

The unemployment rates in Japan were invariable from September to December 2012 at 4.2 percent; however, compared with the December 2011 it decline when it was 4.5 percent.

The inflation rate in Japan slightly declined from minus 0.2 in November to minus 0.1 percent in December 2012. Historically, from 1958 until 2013, Japan inflation rate averaged 3.19 percent reaching an all time high of 25 percent in February of 1974 and a record low of -2.52 percent in October of 2009.



Source: tradingeconomics.com

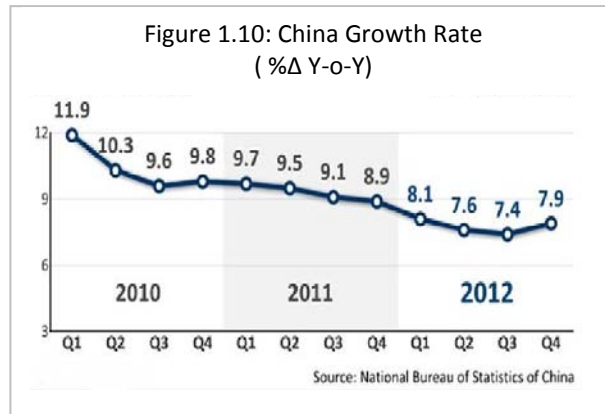
2. EMERGING ECONOMIES

3.1 The Economy of China

In 2012, China recorded a growth rate of 7.8 percent, according to the National Bureau of Statistics of China. In the fourth quarter of 2012, the country's economy grew at a pace of 7.9 percent, a bit better than the expectations expressed by the economists. The growth was quickened to 7.9 percent on strong trade as well as improvement of consumption and investment. The GDP reached USD 8.28 Trillion in 2012 according to the preliminary statistics. The growth in GDP was contributed by agriculture sector 9.7 percent, Industry 46.6 percent, and services 43.7 percent.

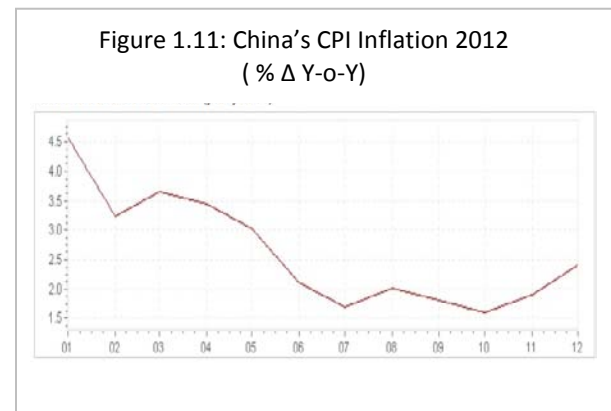
The industrial production growth rate reached 10.3 percent (Y-o-Y) in 2012 versus

expectations of 10.2 percent growth. Fixed Asset Investment also increased to 1.53 percent from November to December.



Source: www.tradingeconomics.com

In the year 2012, China's consumer price index (CPI) decreased to 2.6 percent (Y-o-Y) compared to 5.4 percent in the year before, National Bureau of Statistics of China (NBSC). In December 2012, the CPI went up by 2.6 percent (Y-o-Y) while the month-on-month change of the CPI was up by 0.8 percent. The food prices grew by 4.2 percent, while the non food prices increased by 1.7 percent. The prices of consumer goods went up by 2.5 percent and the prices of services grew by 2.5 percent.

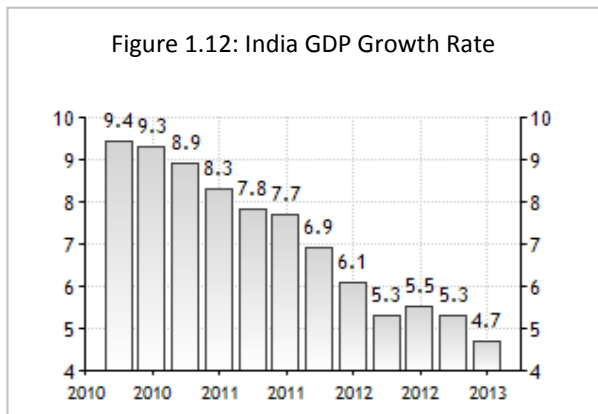


China’s export, a key driver of the economy, also trumped market forecasts to grow 14.1 percent (Y-o-Y) in December, up from November’s 2.9 percent. In 2012, the country exports increased to USD 2.021 trillion in compared to USD 1.899 trillion in the previous year while its import increased to USD 1.78 trillion from USD 1.74 trillion in 2011. Thus, in 2012, China’s current account balance stood at USD 170.8 billion in 2012.

China’s revenue in 2012 was USD 1.838 trillion while its expenditure was USD 2.031 trillion. The figures show a deficit of USD 0.193 trillion..

3.2 The Economy of India

India GDP in the fourth quarter of 2012 grew only by 4.5 percent due to the widespread weakness in farm, mining, and manufacturing output. In 2012, the country GDP reached USD 1.85 trillion (official exchange rate) and recorded the 10th largest economy globally in nominal terms. Expansion is expected to continue in the near term and the IMF has forecast GDP growth of 4.9 percent in 2012 and 5.7 percent in 2013.

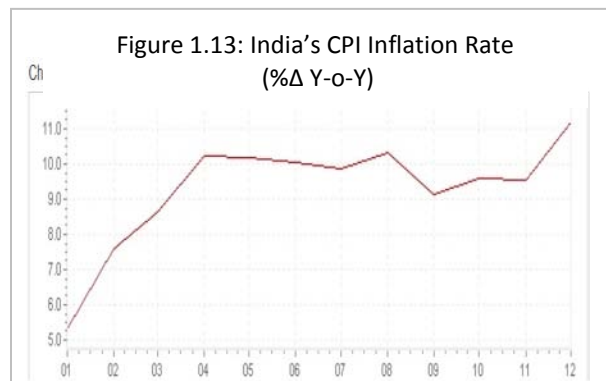


Source: www.tradingeconomics.com

Manufacturing output grew only 2.5 percent, while the mining sector recorded an annual fall of 1.4 percent. Farm output gained 1.1 percent. The construction output expanded 5.8 percent and financing, insurance, real estate and business services grew 7.9 percent.

India’s inflation based on a year-on-year wholesale price index (WPI), stood at 7.6 percent in 2012 over 2011 as compared to 7.2 percent for the previous year. This is while India has had an average inflation rate of 7.6 percent since 2008. The IMF projects 10.8 percent inflation in India for the fiscal year 2013.

The index for food stuff declined by 0.5 percent in the previous month due to the lower price of coffee (5 percent), fruit and vegetables each 4 percent, and gram and fish each 3 percent. The index for non-food stuff rose by 0.8 percent for the previous month.



Source: www.tradingeconomics.com

According to the RBI, India recorded a current account deficit of USD 32.63 USD billion in the fourth quarter of 2012. Hereby the country had a current account deficit of 5.10 percent of the

country GDP in 2012. In 2012 the total export of the country is estimated at USD 500.3 billion while for the year 2011, it was estimated USD 490 billion. India's export reached USD 309 billion in 2012 while in 2011 it was estimated USD 305 billion.

India had been recording sustained trade deficits due to lower export base and high imports of coal and oil for its energy needs. India is leading exporter of petroleum products, gems and jewelry, textiles, engineering goods, chemicals and services. Main trading partners are European Union countries, United States, China and UAE. This page includes a chart with historical data for India Balance of Trade.

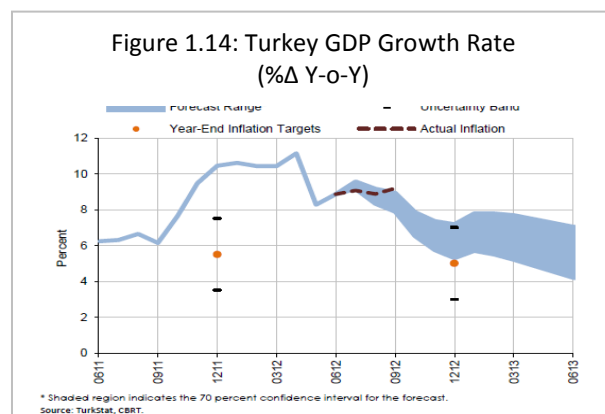
For the FY 2012, reserve of foreign exchange and gold of India is estimated USD 287.2 billion while in the FY 2011 it was estimated USD 297.9 billion.

3.3 The Economy of Turkey

Real Gross Domestic Product (RGDP) growth slowed from 8.5 percent in 2011 to 2.6 percent in the year 2012 (Y-o-Y) and its GDP reached USD 786 billion. The growth in GDP was contributed by agriculture 8.9 percent, industry 28.1 percent and services 63 percent. GDP growth is forecasted to remain almost constant in 2013 rise slightly but gradually to 3.4 percent in 2013 and 3.7 percent in 2014 according to the IMF.

Private consumption growth has slowed sharply in 2012, owing to a strong base effect from 2011 spending surge, slower employment growth, decelerating credit growth and the impact of a weaker Lira on demand for imported consumer goods. Based on the estimations, public consumption growth is accelerating from 5.3 percent in 2012 to 6.5 percent in 2013 and 7.6 percent in 2014, an election year.

In 2012, turkey recorded an inflation rate of 8.9 percent according to the IMF World Economic Outlook published in April 2013, while in 2011 it was reported 5.76 percent by the Turkish National Statistics Office.



In 2012, Turkey had a current account deficit of USD 59 billion or 7.5 percent of its GDP for the concerning year.

The stock value of FDI stood at USD117 billion at year-end 2012. Inflows have slowed because of continuing economic turmoil in Europe, the source of much of Turkey's FDI.



CHAPTER II

MONETARY AND CAPITAL MARKET DEVELOPMENTS

2

MONETARY AND CAPITAL MARKET DEVELOPMENTS

Monetary and capital market developments evaluate monetary program under the Extended Credit Facility (ECF) program. During the year under review, monetary aggregates had mixed performance; reserve money, the operational target under the ECF program, had an increase of about one percent at the end of the year reaching AF176,707.89 million. The actual reserve money stood below the ECF target of 15.22 percent. Currency in circulation “an indicative target under the ECF program”, increased by 1.1 percent at the end of the year under review, reaching AF150,007.34 million. DAB achieved the annual targets of RM and CiC ceilings with a considerable margin, but breached the floor for net international reserves. DAB has managed to accumulate a total amount of USD576 million, down from the target of USD990 million. Narrow money (M1) grew to AF319,164 million indicating an annual growth rate of 9.78 percent (Y-o-Y). Broad money (M2) demonstrated similar behavior growing by 8.80 percent (Y-o-Y) reaching AF338,840 million at the end of the year under review.

DAB targets the reserve money which consists of currency in circulation, eight percent required reserves of commercial banks, the

current account of commercial banks held with DAB, and the overnight deposit facility under the ECF program. In order to maintain reserve money below the ceiling, DAB utilizes two main instruments; foreign exchange auction and selling of capital notes to Commercial Banks which absorbs excess liquidity of the banking system.

In the year under review, DAB has auctioned USD2.53 billion of FX in the local market to manage the liquidity in the market, and to stabilize the fluctuation in the exchange rate of afghani against the foreign currencies.

The outstanding stock for 182 day notes followed an upward trend during the fiscal year 1391. The stock increased from AF 22.8 billion to 30.3 billion before it dropped back to AF 27.6 billion during the last month of the year under review. On the other hand, the stock for 28 day notes remained uneven throughout the period under review. It fluctuated between AF 11.2 billion and AF 4.1 billion AF. The reporting period ended with 28 day stock of 6.6 billion AF and 27.6 billion AF for 182 day notes, these figures were 5.6 billion and 22.8 billion AF respectively at the end of the preceding year.

The total outstanding stock for both maturities stood at AF 36.4 billion at the end of the reporting period

In the meantime, nominal exchange rate of afghani against US dollar depreciated by 5.55 percent in the year under review.

1 – MONETARY PROGRAM UNDER ECF PROGRAM

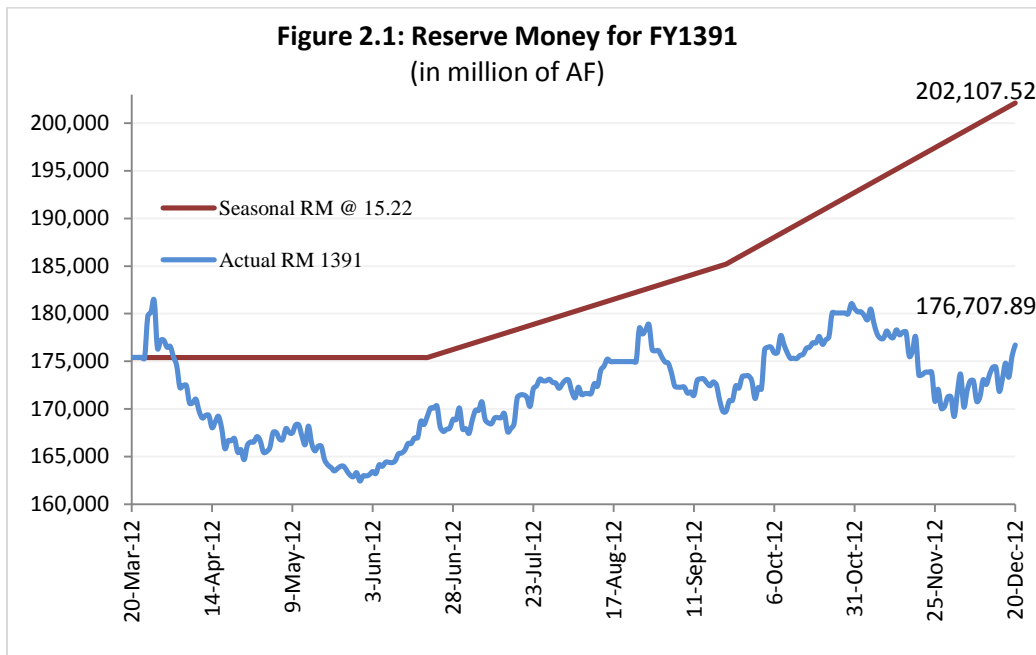
The Monetary Policy Framework is designed under the Extended Credit Facility (ECF) program of the International Monetary Fund (IMF). For the fiscal year 1391, the key operational target (performance criterion) was reserve money (RM), while currency in circulation was set as the indicative target designed for achieving DAB's primary objective of domestic price stability. Changing operational target to reserve money will rightly lead DAB toward achieving its primary objective, while keeping a close eye on growing financial sector as well as substantial improvements made by DAB in monetary and financial statistics to analyze and track the changes in financial sector.

According to the monetary and financial statistics manual [MFS Compilation Guide 2008, Para 3.61], monetary base (reserve money) is defined as "central bank liabilities in the form of currency issuance, liabilities to

other depository corporations (ODCs), and deposits accepted from other sectors (excluding the central government)". However, in the context of ECF program, reserve money is defined as central bank liabilities in the form of currency issuance and Afghani-denominated liabilities to commercial banks excluding capital notes.

The right amount of reserve money conducive for supporting the domestic price stability is determined using the quantitative theory of money. Hence, the ECF target is based on expected economic growth and inflation for the current year. For FY1391, the target for reserve money growth was revised downward from 17.1 percent to 15.22 percent, while the ceiling for currency in circulation growth was set at 18.7 percent. However, the actual reserve money ended at about one percent, well below the ceiling. This is a signal for a sluggish overall economic activity driven mainly by concerns over 2014, the withdrawal of international peacekeeping forces from Afghanistan. DAB continued to conduct a tight monetary policy in the reporting period in order to absorb excess liquidity as well as to prevent volatility in the nominal exchange rate of afghani against foreign currencies.

The Figure below presents the ceiling and the actual reserve money for the year under review.



Source: Monetary Policy Department/DAB

NET INTERNATIONAL RESERVES

Da Afghanistan Bank (DAB) holds international reserves which consist of monetary gold, reserve position and holdings with the IMF and Special Drawing Rights (SDR) as well as major foreign exchange such as USD, Euro, Great British Pound and others. The Net International Reserves (NIR) of Afghanistan expressed in terms of the USD is defined as reserve assets minus reserve liabilities.

In the past few years, Afghanistan’s NIR had a substantial steady growth which is an important indicator of ability to repay the external debts, and/or finance the foreign trade deficit. NIR floor was set at an accumulation of USD 550 million at the start of the year, but later on it was revised to

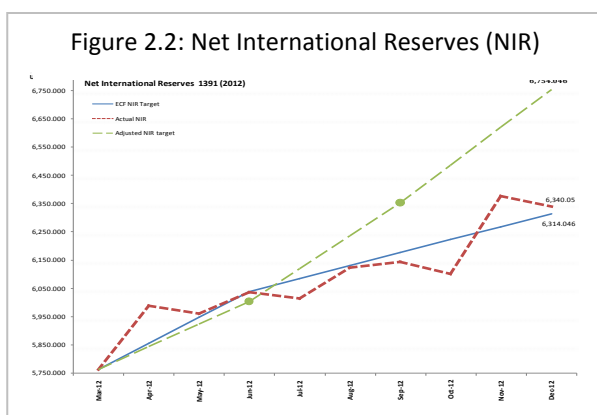
USD990 million which was adjusted in respected to the donor’s contribution. DAB accumulation reached USD 576 million at the end of the year 1391 which breached the quantitative performance criteria under the ECF program for consecutive two years.

DAB had increased the level of its auction size in order to reduce the fluctuation in the exchange rate which was creating panic in domestic economy due to high demand for dollars from one side and speculation from the other side, DAB pumped USD 2.53 billion in the domestic economy to sterilize the currency.

Commercial bank deposits in foreign currency increased from USD 216.55 million in 1390 to USD 245.00 million in the year under review. Furthermore, the reserve liabilities for use of fund resources

increased by 8.10 percent from USD 138.51 million in 1390 to USD 149.73 million at the end of the year under review. However, the reserve liabilities on non-resident deposits in foreign currency remained fixed throughout the year at USD 0.11 million in 1390.

The increase in the NIR is attributed to inflows of foreign exchange particularly from export earnings, donor's contribution and inflows from the US Army Forces.



2. MONETARY AGGREGATES

The monetary aggregates -- narrow money (M1) and broad money (M2) -- are compiled following the MFS methodology and definition. Narrow money as referred (M1) grew by 9.78 percent on a year-on-year basis. The increase in M1 is attributed mainly to the increase in demand for local currency and confidence that people hold Afghani and use it as a medium of exchange, although the growth in demand deposit was 18.01 compared to the end of 1390 which grew by 21.23 percent.

On the other hand, the stock of broad money (M2) grew to AF 338,840 million; an overall growth of 8.80 percent (Y-o-Y), which is lower than 21.23 percent growth at the end of 1390. M1 is the main contributor to the growth in M2.

Quasi money or time deposits of commercial banks which is the other component of M2 had negative growth of 5 percent at the end of 1391 in comparison with the same period of 1390. However, because quasi money roughly constitutes 7 percent of broad money, therefore, the impact of changes on M2 is negligible. The year-on-year difference of Afghani denominated time deposits for the end of 1391 was AF -2,815 million and foreign currency denominated time deposits difference recorded AF 1,779 million.

Meanwhile, bank deposits as a share of broad money grew by 52.06 percent (Y-o-Y) in the year of 1391 up from 48 percent in the previous year.

Similarly quasi money as a share of broad money declined to 5.81 percent at the end of 1391 down from 6.65 percent in the same period of 1390. Afghani-denominated time deposits constitute 2.09 percent of broad money, while foreign currency denominated deposits contributed 3.72 percent of M2.

The table below summarizes monetary aggregates of Depository corporations.

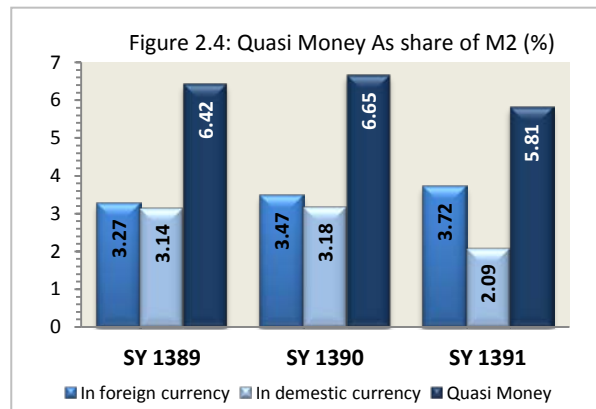
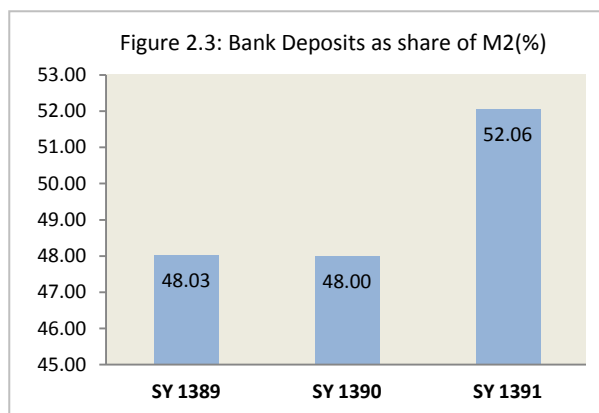


Table 2.1: Monetary Aggregates, 1389 to 1391 (in million AF)

| | 1389 | 1390 | Y-o-Y Δ | Difference | FY1391 | | |
|--|----------------|----------------|----------------|----------------|----------------|----------------|----------------|
| | Amount | Amount | | | Amount | Y-o-Y Δ | Difference |
| 1- Net Foreign Assets | 248,141 | 338,082 | 36.2% | 89,941 | 425,376 | 25.82% | 87,294 |
| (a) Foreign Assets | 279,091 | 370,880 | 32.9% | 91,789 | 455,731 | 22.88% | 84,851 |
| DAB Foreign exchange reserves | 226,828 | 303,738 | 33.9% | 76,910 | 372,713 | 22.71% | 68,975 |
| Gold | 37,611 | 45,232 | 20.3% | 0.000 | 60,424 | 33.59% | 0.000 |
| Other | 189,217 | 258,507 | 36.6% | 69,290 | 312,289 | 20.81% | 53,782 |
| Other foreign assets | 52,262 | 67,141 | 28.5% | 14,879 | 83,018 | 23.65% | 15,876 |
| (b) Foreign Liabilities | 30,950 | 32,798 | 6.0% | 1,848 | 30,354 | -7.45% | -2,443 |
| 2. Net Domestic Assets | 8,586 | -26,649 | -410.4% | -35,235 | -86,537 | 224.73% | -59,888 |
| (a) Net Domestic Credit | 30,501 | -26,715 | -187.6% | -57,216 | -44,492 | 66.55% | -17,777 |
| Net Credit to Nonfinancial Public Sector | -54,060 | -68,472 | 26.7% | -14,412 | -86,566 | 26.43% | -18,094 |
| Net Credit to Central Government | -53,979 | -68,226 | 26.4% | -14,247 | -86,267 | 26.44% | -18,041 |
| Credit to Central Government | 29,644 | 30,292 | 2.2% | 648 | 32,831 | 8.38% | 2,539 |
| Liabilities to Central Government | 83,622 | 98,518 | 17.8% | 14,895 | 119,097 | 20.89% | 20,579 |
| Net Credit to State & Local Government | 0 | 0 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 |
| Net Credit to Public Nonfinancial Corporations | -81 | -246 | 202.3% | -165 | -299 | 21.71% | -53 |
| Credit to Private Sector | 84,062 | 42,207 | -49.8% | -41,854 | 43,024.05 | 1.94% | 817 |
| Net Credit to Other Financial Corporations | 500 | -450 | -190.0% | -950 | -950.00 | 111.11% | -500 |
| (b) Capital Accounts | 480 | 36,800 | 7559.1% | 36,320 | 83,686 | 127.41% | 46,886 |
| (c) Other Items Net | -21,435 | 36,866 | -272.0% | 58,301 | 41,641 | 12.95% | 4,775 |
| 3- Broad Money(M2) | 256,727 | 311,433 | 21.3% | 54,706 | 338,840 | 8.80% | 27,406 |
| Narrow Money(M1) | 240,257 | 290,722 | 21.0% | 50,465 | 319,164 | 9.78% | 28,442 |
| CiC (Currency outside depository corporations) | 116,953 | 141,245 | 20.8% | 24,292 | 142,761 | 1.07% | 1,516 |
| Demand Deposits | 123,304 | 149,477 | 21.2% | 26,172 | 176,403 | 18.01% | 26,926 |
| Other Deposits (Quasi Money) | 16,470 | 20,711 | 25.8% | 4,242 | 19,675 | -5.00% | -1,036 |
| In Afghani | 8,064 | 9,893 | 22.7% | 1,829 | 7,079 | -28.45% | -2,815 |
| In Foreign currency | 8,406 | 10,818 | 28.7% | 2,412 | 12,597 | 16.44% | 1,779 |
| Securities Other Than Shares | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 | 0.000 |

Source: Monetary Survey Section, Monetary Policy Department/ DAB

4. FOREIGN EXCHANGE MARKET

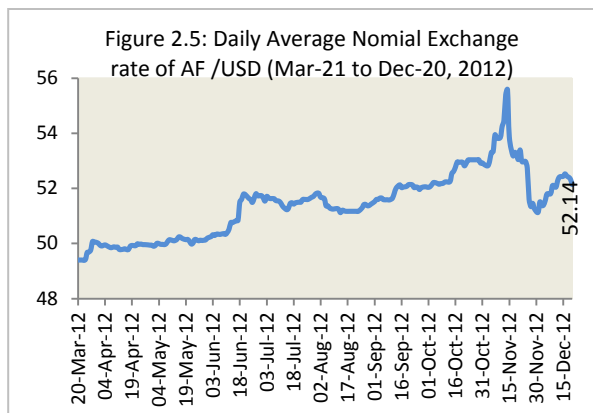
3.1 Foreign Exchange Rates

Da Afghanistan Bank’s (DAB) ultimate goal is maintaining price stability in domestic economy, utilizing its instruments effectively with sound policy implementation.

In order to control the supply of money, DAB is targeting reserve money through a weekly capital notes auction and by-weekly foreign exchange auction.

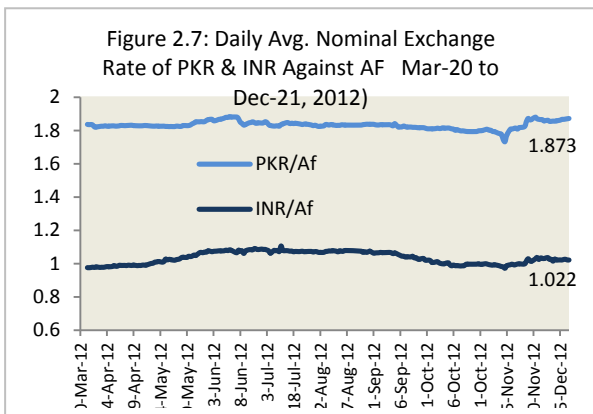
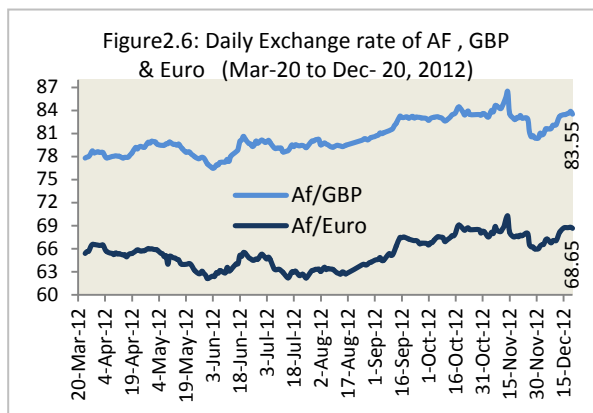
DAB does not target the nominal exchange rate of the domestic currency against foreign currencies are pegged to USD, however, it is important to monitor the exchange rate fluctuation which will impact the economic indicators negatively that pressurizes Bank to intervene in the local market via managed floating exchange rate regime.

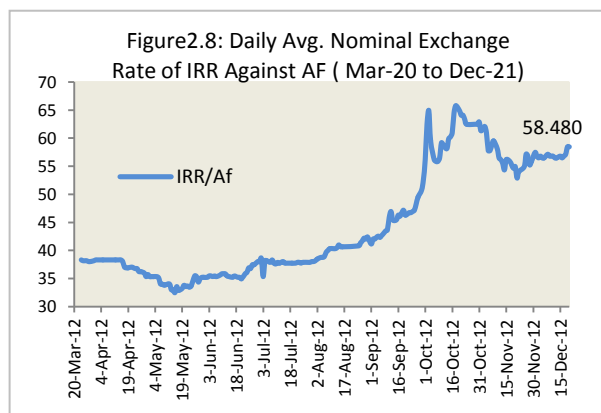
The daily historic review of the average exchange rate of AF against USD for 1391 is shown in Figure below. The exchange rate of Afghani against US dollar had gradually downward trend, depreciating by 5.55 percent from AF 49.40 per USD at the beginning of the fiscal year with a 52.14 at the end of the year under review.



Source: MPD/ MoD/ DAB

The comparison of historic review of the daily average exchange rate of Afghani against some major foreign currencies for the year under review is shown in Figures below.





3.2 Foreign Exchange Auction

Foreign exchange auction is the primary instrument used by DAB to control growth of money supply which is defined as currency in circulation in the context of ECF program.

Since currency in circulation is not the indicative target, DAB has increased foreign

exchange auction which has resulted in the actual currency in circulation below the target by a significant margin.

The size of the foreign exchange auction is determined by a liquidity forecasting framework, which takes into account the money demand on one hand and the currency growth ceiling agreed by the DAB with the IMF under the ECF on the other.

DAB's intervention reached a total of USD 2,530.50 million in the year under review.

Table 2.2 summarizes the result of DAB foreign exchange auctions during the period of March 27, 2011 to Dec 18, 2012.

Table 2.2: Summary of Foreign Exchange Auction for the FY 1391 (March 21 to Dec 20, 2012)

| Auction Date | Market Ex Rate | Cut off Price | Amount Announced (Million USD) | Amount Awarded (Million USD) | No of Awarded Bids | Total Demand (Million USD) |
|--------------|----------------|---------------|--------------------------------|------------------------------|--------------------|----------------------------|
| 27-Mar-12 | 49.76 | 49.70 | 30.00 | 24.40 | 21 | 54.10 |
| 31-Mar-12 | 50.02 | 49.90 | 30.00 | 43.10 | 47 | 56.30 |
| 03-Apr-12 | 49.93 | 49.91 | 30.00 | 26.15 | 22 | 57.00 |
| 07-Apr-12 | 49.85 | 49.82 | 35.00 | 31.40 | 25 | 60.00 |
| 10-Apr-12 | 49.86 | 49.85 | 35.00 | 38.50 | 30 | 65.40 |
| 14-Apr-12 | 49.79 | 49.75 | 40.00 | 29.30 | 28 | 58.10 |
| 17-Apr-12 | 49.78 | 49.77 | 40.00 | 27.40 | 12 | 68.00 |
| 21-Apr-12 | 49.92 | 49.92 | 35.00 | 24.55 | 16 | 52.40 |
| 24-Apr-12 | 49.98 | 49.98 | 35.00 | 31.00 | 22 | 50.00 |
| 28-Apr-12 | 49.95 | 49.94 | 35.00 | 25.00 | 22 | 41.50 |
| 01-May-12 | 49.90 | 49.88 | 35.00 | 11.65 | 9 | 40.30 |
| 05-May-12 | 49.97 | 49.95 | 35.00 | 31.70 | 26 | 55.30 |
| 08-May-12 | 49.99 | 50.01 | 35.00 | 16.85 | 14 | 51.60 |
| 12-May-12 | 50.10 | 50.07 | 35.00 | 40.70 | 29 | 56.70 |
| 15-May-12 | 50.24 | 50.17 | 35.00 | 41.45 | 38 | 50.60 |
| 19-May-12 | 50.14 | 50.08 | 30.00 | 30.70 | 42 | 46.60 |
| 22-May-12 | 49.98 | 49.93 | 30.00 | 23.55 | 27 | 35.90 |
| 26-May-12 | 50.10 | 50.06 | 30.00 | 28.60 | 31 | 42.00 |

| | | | | | | |
|--------------|-------|-------|-----------------|-----------------|----|-----------------|
| 29-May-12 | 50.12 | 50.10 | 30.00 | 33.85 | 26 | 45.30 |
| 02-Jun-12 | 50.25 | 50.21 | 25.00 | 29.20 | 26 | 43.80 |
| 05-Jun-12 | 50.34 | 50.32 | 25.00 | 33.35 | 31 | 46.10 |
| 09-Jun-12 | 50.36 | 50.33 | 30.00 | 36.90 | 37 | 46.00 |
| 17-Jun-12 | 50.84 | 50.76 | 60.00 | 28.25 | 24 | 70.70 |
| 24-Jun-12 | 51.60 | 51.00 | 80.00 | 81.95 | 53 | 92.30 |
| 01-Jul-12 | 51.66 | 51.45 | 80.00 | 98.95 | 43 | 148.30 |
| 08-Jul-12 | 51.56 | 51.35 | 80.00 | 81.15 | 50 | 129.35 |
| 22-Jul-12 | 51.50 | 51.45 | 80.00 | 57.85 | 27 | 146.00 |
| 04-Aug-12 | 51.63 | 51.40 | 50.00 | 69.05 | 56 | 69.05 |
| 07-Aug-12 | 51.29 | 51.21 | 40.00 | 43.20 | 26 | 66.05 |
| 11-Aug-12 | 51.27 | 51.21 | 40.00 | 40.25 | 36 | 53.80 |
| 14-Aug-12 | 51.21 | 51.12 | 35.00 | 36.90 | 18 | 57.45 |
| 25-Aug-12 | 51.22 | 51.29 | 40.00 | 35.65 | 28 | 56.05 |
| 28-Aug-12 | 51.35 | 51.37 | 40.00 | 55.80 | 40 | 89.30 |
| 15-Sep-12 | 52.13 | 52.00 | 25.00 | 44.85 | 40 | 57.15 |
| 18-Sep-12 | 52.06 | 52.00 | 25.00 | 34.55 | 29 | 55.90 |
| 22-Sep-12 | 52.13 | 52.00 | 25.00 | 44.25 | 54 | 54.45 |
| 25-Sep-12 | 52.04 | 51.97 | 25.00 | 29.75 | 26 | 50.30 |
| 29-Sep-12 | 52.06 | 52.00 | 30.00 | 41.50 | 36 | 52.85 |
| 02-Oct-12 | 52.07 | 52.04 | 30.00 | 23.70 | 14 | 57.75 |
| 06-Oct-12 | 52.16 | 52.10 | 35.00 | 51.55 | 47 | 59.45 |
| 09-Oct-12 | 52.18 | 52.16 | 35.00 | 35.95 | 29 | 61.15 |
| 13-Oct-12 | 52.25 | 52.29 | 35.00 | 35.50 | 18 | 71.20 |
| 16-Oct-12 | 52.77 | 52.72 | 35.00 | 37.40 | 31 | 73.75 |
| 20-Oct-12 | 52.95 | 52.76 | 60.00 | 60.95 | 44 | 96.45 |
| 30-Oct-12 | 52.95 | 52.85 | 40.00 | 39.95 | 35 | 62.30 |
| 03-Nov-12 | 52.35 | 52.76 | 40.00 | 41.05 | 19 | 86.30 |
| 06-Nov-12 | 53.34 | 53.29 | 40.00 | 40.25 | 25 | 93.85 |
| 10-Nov-12 | 53.85 | 53.78 | 40.00 | 40.80 | 35 | 79.10 |
| 13-Nov-12 | 55.40 | 55.20 | 40.00 | 43.90 | 27 | 87.30 |
| 17-Nov-12 | 53.19 | 52.90 | 80.00 | 62.95 | 32 | 106.00 |
| 20-Nov-12 | 53.05 | 52.91 | 80.00 | 67.65 | 34 | 76.65 |
| 24-Nov-12 | 52.74 | 52.65 | 70.00 | 65.65 | 38 | 66.85 |
| 27-Nov-12 | 51.34 | 51.21 | 70.00 | 52.05 | 35 | 56.30 |
| 01-Dec-12 | 51.13 | 51.60 | 60.00 | 54.30 | 29 | 60.00 |
| 04-Dec-12 | 51.39 | 51.38 | 60.00 | 66.65 | 30 | 76.86 |
| 08-Dec-12 | 51.81 | 51.75 | 50.00 | 70.60 | 43 | 70.60 |
| 11-Dec-12 | 52.05 | 51.99 | 50.00 | 48.75 | 31 | 54.75 |
| 15-Dec-12 | 52.44 | 52.41 | 50.00 | 51.85 | 28 | 63.40 |
| 18-Dec-12 | 52.41 | 52.35 | 50.00 | 55.85 | 34 | 57.85 |
| Total | | | 2,525.00 | 2,530.50 | | 3,889.86 |

Source: Market Operations Department and Monetary Policy
Department staff calculations

4. CAPITAL MARKETS AND LIQUIDITY CONDITIONS

4.1 Capital Note Auctions

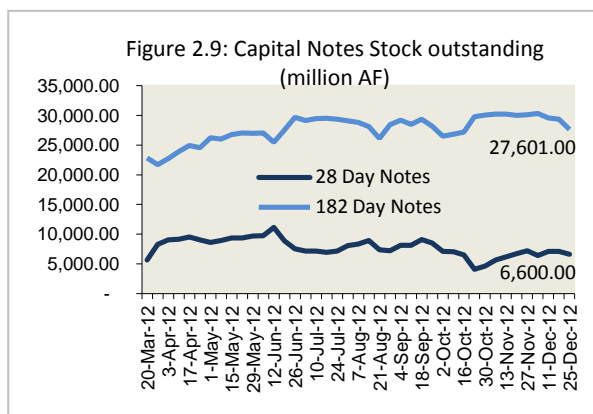
Capital notes are short-term Afghani denominated securities sold by the central bank at weekly auctions. Capital notes are discount securities, which mean that they are issued and traded at a discount to face value. Discount securities make only one payment – the face value—on the maturity date. The 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 commercial bank.

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.

The outstanding stock for 182 day notes followed an upward trend during the fiscal year 1391. The stock increased from AF 22.8 billion to 30.3 billion before it dropped back to AF 27.6 billion during the last month of the year under review. On the other hand, the stock for 28 day notes remained uneven throughout the period under review. It fluctuated between AF 11.2 billion and AF 4.1 billion AF. The reporting period ended with 28 day stock of 6.6 billion AF and 27.6 billion AF for 182 day notes, these figures were 5.6 billion and 22.8 billion AF respectively at the end of the preceding year.

The total outstanding stock for both maturities stood at AF 36.4 billion at the end of the reporting period (Figure 1.6).

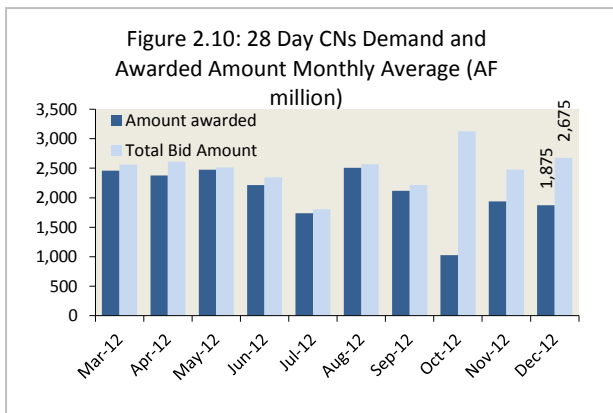
It is worth mentioning that during the year 1391 the announcement amount remained constant for both 28 day and 182 day notes at AF 200 million and AF 100 million respectively.



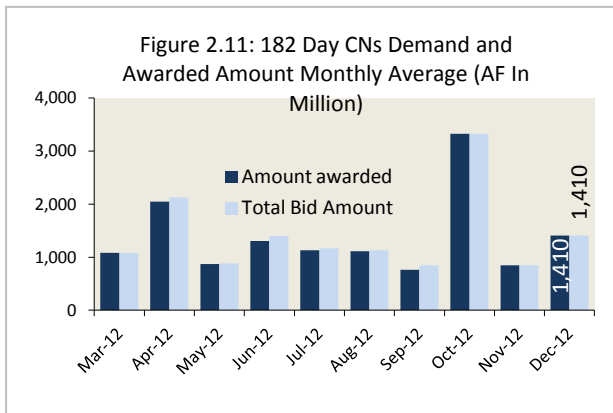
Source: Market Operations Department, DAB.

High demand for CNs is reflected in the cover ratio, the ratio of amounts bid to amounts

awarded. In the year under review, the bid amount for 28 days notice was AF 92.5 billion and the amount awarded was AF 76.5 billion for a cover ratio of 1.12. Per Auction average for bid amount was AF 2.4 billion and awarded amount was AF 2.0 billion. The bid amount for 182 day note was AF 54.3 billion and the amount awarded was AF 47.4 billion for a cover ratio of 1.15. Comparing the cover ratio in the year 1391 to that in the previous year, the cover ratio for the 28 day note was 1.12 and for 182 day note it was 1.09.



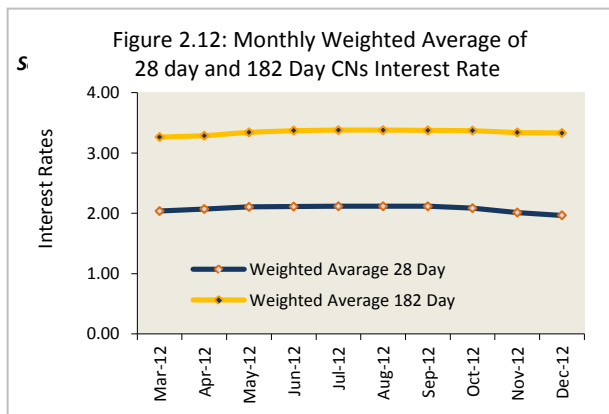
Source: Market Operations Department, DAB.



Source: Market Operations Department, DAB.

The weighted average interest rate remained somehow even throughout the period. The interest rate witnessed minimum changes only.

The weighted average interest rates ranged between 2.122 percent and 1.958 percent 28 day notes; and between 3.380 percent and 3.279 percent for 182 day maturity. The weighted average interest rates in the previous year ranged between 2.410 percent and 2.030 percent for 28 day notes and between 3.420 and 3.220 percent for 182 day notes.



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 100 basis points below 28 auction cut-ff rate (based on a circular to all banks approved by the DAB Executive Board on June 09, 2010). The outstanding amount of the deposit facility

balances fluctuate between AF 8.04 billion and AF 2.94 billion during the year of 1391. These figures were AF 6.4 billion and AF 1.9 billion during the year 1390.

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 shortfall in cash flow. The rate that the banks are charged for this facility is 350 basis points above 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 period under review only AF 0.7 billion worth credit facility was utilized.

During the year under review required reserves averaged AF 800,582,921.65 per bank. This figure was 674,527,899.81 during the year 1390.

Required reserves were remunerated at 1 basis points below the cut-off rate of 28 days

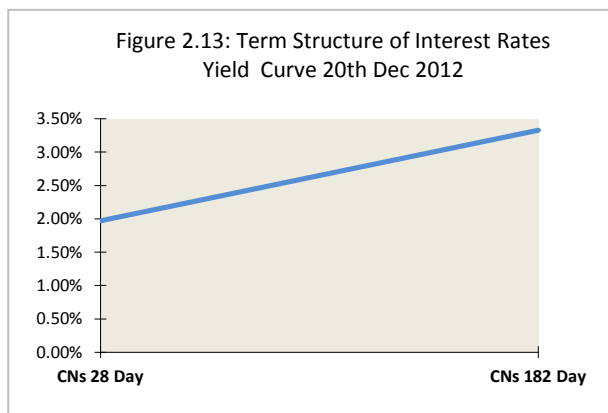
capital notes auction rate or equal to the deposit facility rate.

4.3 Term Structure of Interest Rates

The term structure of interest rates, also called the yield curve, is the relation between the interest rate (cost of borrowing) and the time to maturity of a security. The yield of the capital notes is the annualized percentage increase in the value of the CN.

The yield curve for Dec 20th, 2012 is positive.

The yield curve for Mar 20th, 2012 is positive.



Source: Market Operations Department, DAB

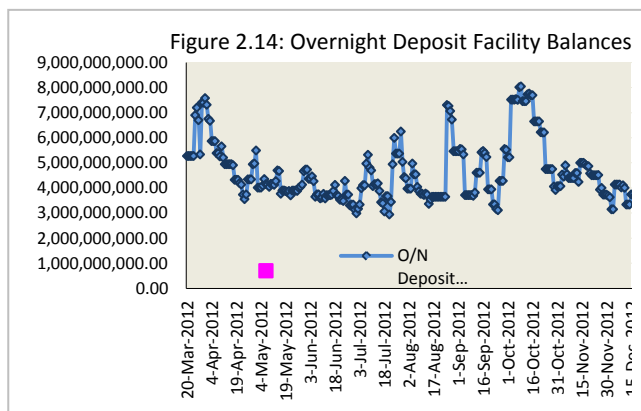


Table 2.3: Auction of 28 Day Capital Notes (million AF)

| Start Date | Auction Amount | Amount awarded | Total Bid Amount | No. of Winning Bids | No. of total bids | Cut off Rate (%) | Low Bid | Weighted Average |
|--------------|----------------|----------------|------------------|---------------------|-------------------|------------------|---------|------------------|
| 27-Mar-2012 | 200 | 3,502 | 4,002 | 5 | 6 | 2.090 | 2.037 | 2.052 |
| 3-Apr-2012 | 200 | 2,850 | 2,975 | 6 | 7 | 2.090 | 2.020 | 2.060 |
| 10-Apr-2012 | 200 | 2,800 | 3,100 | 5 | 6 | 2.090 | 2.040 | 2.070 |
| 17-Apr-2012 | 200 | 360 | 360 | 2 | 2 | 2.090 | 2.080 | 2.083 |
| 24-Apr-2012 | 200 | 3,000 | 3,000 | 3 | 3 | 2.100 | 2.060 | 2.073 |
| 1-May-2012 | 200 | 2,450 | 2,455 | 4 | 5 | 2.110 | 2.080 | 2.089 |
| 8-May-2012 | 200 | 3,125 | 3,125 | 6 | 6 | 2.130 | 2.050 | 2.095 |
| 22-May-2012 | 200 | 3,000 | 3,100 | 4 | 4 | 2.130 | 2.100 | 2.115 |
| 29-May-2012 | 200 | 2,750 | 2,750 | 3 | 3 | 2.130 | 2.110 | 2.117 |
| 5-Jun-2012 | 200 | 3,200 | 3,300 | 4 | 5 | 2.130 | 2.090 | 2.117 |
| 12-Jun-2012 | 200 | 2,200 | 2,300 | 3 | 4 | 2.123 | 2.090 | 2.115 |
| 19-Jun-2012 | 200 | 700 | 1,030 | 3 | 3 | 2.123 | 2.120 | 2.122 |
| 26-Jun-2012 | 200 | 1,400 | 1,658 | 3 | 5 | 2.123 | 2.050 | 2.096 |
| 3-Jul-2012 | 200 | 2,850 | 2,850 | 4 | 4 | 2.123 | 2.050 | 2.112 |
| 10-Jul-2012 | 200 | 2,200 | 2,200 | 3 | 3 | 2.123 | 2.080 | 2.114 |
| 17-Jul-2012 | 200 | 500 | 500 | 1 | 1 | 2.121 | 2.121 | 2.121 |
| 24-Jul-2012 | 200 | 1,600 | 1,600 | 3 | 3 | 2.121 | 2.120 | 2.120 |
| 31-Jul-2012 | 200 | 3,750 | 3,850 | 5 | 5 | 2.121 | 2.100 | 2.119 |
| 7-Aug-2012 | 200 | 2,500 | 2,500 | 3 | 3 | 2.122 | 2.100 | 2.113 |
| 14-Aug-2012 | 200 | 1,100 | 1,200 | 3 | 3 | 2.122 | 2.120 | 2.120 |
| 28-Aug-2012 | 200 | 3,600 | 3,700 | 5 | 5 | 2.122 | 2.100 | 2.117 |
| 4-Sep-2012 | 200 | 3,400 | 3,600 | 4 | 4 | 2.122 | 2.110 | 2.110 |
| 11-Sep-2012 | 200 | 1,110 | 1,210 | 4 | 4 | 2.122 | 2.090 | 2.119 |
| 18-Sep-2012 | 200 | 960 | 1,060 | 4 | 4 | 2.122 | 2.120 | 2.121 |
| 25-Sep-2012 | 200 | 3,000 | 3,000 | 4 | 4 | 2.122 | 2.090 | 2.115 |
| 2-Oct-2012 | 200 | 2,000 | 3,200 | 2 | 3 | 2.116 | 2.110 | 2.110 |
| 9-Oct-2012 | 200 | 1,100 | 2,050 | 3 | 5 | 2.104 | 2.090 | 2.104 |
| 16-Oct-2012 | 200 | 400 | 2,950 | 2 | 7 | 2.089 | 2.080 | 2.089 |
| 23-Oct-2012 | 200 | 600 | 4,300 | 2 | 6 | 2.068 | 2.060 | 2.068 |
| 30-Oct-2012 | 200 | 2,500 | 2,600 | 3 | 3 | 2.056 | 2.050 | 2.056 |
| 6-Nov-2012 | 200 | 2,150 | 3,150 | 2 | 4 | 2.045 | 2.040 | 2.042 |
| 13-Nov-2012 | 200 | 950 | 2,000 | 2 | 6 | 2.020 | 2.010 | 2.019 |
| 20-Nov-2012 | 200 | 1,100 | 1,630 | 2 | 5 | 2.000 | 2.005 | 2.002 |
| 27-Nov-2012 | 200 | 3,000 | 3,000 | 4 | 4 | 2.000 | 1.970 | 1.990 |
| 4-Dec-2012 | 200 | 1,350 | 1,350 | 2 | 2 | 1.990 | 1.970 | 1.983 |
| 11-Dec-2012 | 200 | 1,650 | 1,650 | 4 | 4 | 1.990 | 1.950 | 1.979 |
| 18-Dec-2012 | 200 | 1,100 | 3,400 | 2 | 4 | 1.970 | 1.950 | 1.958 |
| Total | | 76,607 | 92,595 | | | | | |

Source: Market Operations Department, DAB

Table 2.4: Auction of 182 Day Capital Notes (million AF)

| Start Date | Auction Amount | Amount awarded | Total Bid Amount | No. of Winning Bids | No. of total bids | Cut off Rate (%) | Low Bid | Weighted Average |
|--------------|----------------|----------------|------------------|---------------------|-------------------|------------------|---------|------------------|
| 27-Mar-12 | 100 | 1,900 | 1,900 | 5 | 5 | 3.290 | 3.230 | 3.276 |
| 3-Apr-12 | 100 | 1,950 | 2,174 | 4 | 6 | 3.290 | 3.280 | 3.285 |
| 10-Apr-12 | 100 | 1,637 | 1,721 | 5 | 6 | 3.290 | 3.250 | 3.279 |
| 17-Apr-12 | 100 | 2,700 | 2,700 | 5 | 5 | 3.300 | 3.270 | 3.282 |
| 24-Apr-12 | 100 | 630 | 630 | 2 | 2 | 3.310 | 3.300 | 3.301 |
| 1-May-12 | 100 | 1,856 | 1,856 | 6 | 6 | 3.330 | 3.280 | 3.330 |
| 8-May-12 | 100 | 330 | 330 | 2 | 2 | 3.350 | 3.330 | 3.335 |
| 15-May-12 | 100 | 950 | 950 | 4 | 4 | 3.360 | 2.370 | 3.328 |
| 22-May-12 | 100 | 600 | 650 | 2 | 2 | 2.360 | 2.360 | 3.360 |
| 29-May-12 | 100 | 300 | 300 | 1 | 1 | 3.370 | 2.360 | 3.363 |
| 5-Jun-12 | 100 | 30 | 210 | 1 | 3 | 3.380 | 3.380 | 3.380 |
| 12-Jun-12 | 100 | 1,950 | 1,950 | 4 | 4 | 3.380 | 3.350 | 3.371 |
| 19-Jun-12 | 100 | 2,937 | 3,137 | 5 | 6 | 3.380 | 3.360 | 3.374 |
| 26-Jun-12 | 100 | 2,600 | 2,655 | 5 | 5 | 3.380 | 3.370 | 3.370 |
| 3-Jul-12 | 100 | 150 | 150 | 1 | 1 | 3.380 | 3.380 | 3.380 |
| 10-Jul-12 | 100 | 890 | 990 | 1 | 4 | 3.380 | 3.380 | 3.380 |
| 17-Jul-12 | 100 | 870 | 870 | 4 | 4 | 3.380 | 3.370 | 3.379 |
| 24-Jul-12 | 100 | 670 | 670 | 3 | 3 | 3.380 | 3.380 | 3.380 |
| 31-Jul-12 | 100 | 350 | 350 | 4 | 4 | 3.380 | 3.380 | 3.380 |
| 7-Aug-12 | 100 | 500 | 500 | 4 | 4 | 3.380 | 3.380 | 3.380 |
| 14-Aug-12 | 100 | 817 | 867 | 6 | 6 | 3.800 | 3.370 | 3.378 |
| 28-Aug-12 | 100 | 3,210 | 3,260 | 5 | 5 | 3.380 | 3.370 | 3.378 |
| 4-Sep-12 | 100 | 759 | 951 | 5 | 6 | 3.380 | 3.380 | 3.380 |
| 11-Sep-12 | 100 | 1,087 | 1,137 | 5 | 5 | 3.380 | 3.380 | 3.380 |
| 18-Sep-12 | 100 | 850 | 950 | 4 | 4 | 3.380 | 3.380 | 3.380 |
| 25-Sep-12 | 100 | 350 | 350 | 3 | 3 | 3.380 | 3.350 | 3.370 |
| 2-Oct-12 | 100 | - | 2,722 | 0 | 0 | 0.000 | 0.000 | 3.370 |
| 9-Oct-12 | 100 | 1,976 | 2,722 | 4 | 6 | 3.375 | 3.360 | 3.380 |
| 16-Oct-12 | 100 | 3,070 | 4,657 | 5 | 7 | 3.366 | 3.360 | 3.380 |
| 23-Oct-12 | 100 | 3,207 | 3,207 | 6 | 6 | 3.366 | 3.350 | 3.370 |
| 30-Oct-12 | 100 | 1,620 | 1,620 | 4 | 4 | 3.369 | 3.360 | 3.369 |
| 6-Nov-12 | 100 | 470 | 470 | 3 | 3 | 3.368 | 3.350 | 3.364 |
| 13-Nov-12 | 100 | 970 | 1,020 | 5 | 6 | 3.348 | 3.320 | 3.348 |
| 20-Nov-12 | 100 | 620 | 690 | 3 | 3 | 3.350 | 3.345 | 3.350 |
| 27-Nov-12 | 100 | 420 | 420 | 3 | 3 | 3.350 | 3.340 | 3.340 |
| 4-Dec-12 | 100 | 220 | 220 | 2 | 2 | 3.340 | 3.340 | 3.340 |
| 11-Dec-12 | 100 | 1,220 | 1,663 | 4 | 6 | 3.340 | 3.320 | 3.330 |
| 18-Dec-12 | 100 | 2,708 | 2,708 | 6 | 6 | 3.340 | 3.320 | 3.332 |
| Total | | 47,374 | 54,327 | | | | | |

Source: Market Operations Department, DAB



CHAPTER III

THE INFLATION TREND

AND OUTLOOK

3

THE INFLATION TREND AND OUTLOOK

The downward inflationary trend in Afghanistan that began in the first quarter of 2012, continued and seemed to maintain momentum until the fourth quarter. By most measures, inflation decreased significantly and was lower than the fourth quarter of 2011.

For example, nationwide, year-on-year inflation decreased significantly from the same quarter in the previous year. Again, a decline in the rate of increase in both food and non-food prices drove the index. The year-on-year headline inflation in the fourth quarter of 2012 was 5.8 percent, which is significantly lower than the inflation of 9.7 percent observed in the fourth quarter of 2011.

The year-on-year Kabul headline CPI inflation in the fourth quarter of 2012 was 6.5 percent, which is lower than the inflation rate of 9.4 percent recorded in the fourth quarter of 2012. This decrease was led by falling prices of both, food and non-food, the two significant broad components of the CPI. Moreover, core inflation, which excludes the important components of bread and cereals and oils and fat, is currently at the lower level of 6.5

percent compared to 11.4 percent observed in the same quarter of 2011.

When the quarter-by-quarter changes in inflation are observed, however, the picture is different. National headline inflation in the fourth quarter of 2012 increased significantly posting an inflation rate of 4.78 percent, up from 0.71 percent in the third quarter. The prices of bread and cereals, oils and fats, meat, vegetables, and household goods actually increased significantly in the reporting quarter. The increase in the prices of clothing, housing, electricity and gas were the main drivers behind the increase in the quarter-to-quarter inflation rate.

The quarterly changes in Kabul CPI showed almost similar patterns, although it was less significant than what was observed nationwide. Inflation increased when compared with the third quarter of 2012, but less than what was noted nationwide. In addition, food prices increased, while non-food sub-index posted a decline.

1. INFLATION EASED IN THE FY1391

1.1 Annual Changes in National Headline Inflation

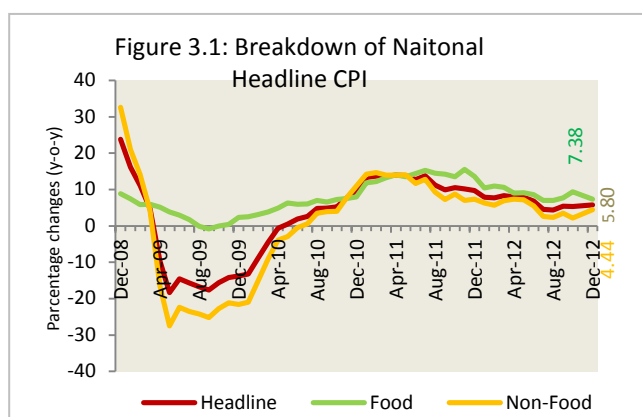
In the fourth quarter of 2012, inflation, when measured as the percentage change year-on-year in the CPI, was much better than it was recorded in the same quarter of 2011. The national headline inflation rate was 5.8 percent in the reporting period, which is significantly down from 9.7 percent inflation observed in the same period of the previous year.

The CPI measures the average price of a fixed set (or basket) of goods and services. The 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 March 2011). 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, which has recently been changed from March 2004 to March 2011. Based on the new CPI basket, 52 percent weight has been assigned to the food components and 48.0 percent to the non-food components, 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 of increment in inflation this year, it is necessary to discuss the behavior of inflation in those components that have the most significant weights in the calculation of the CPI. First, we will analyze those significant components that showed the largest unfavorable changes in inflation from the previous year, and then we

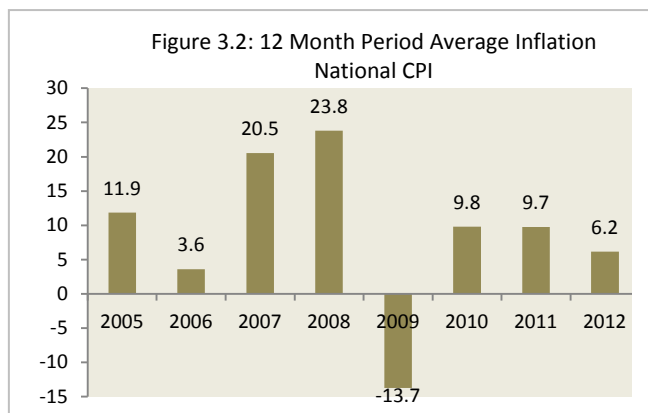
will look at the components that showed favorable changes.

The 3.9 percentage point decline in national headline inflation was attributed to the decreases in the rate of inflation in both, food and non-food price indices. Food prices, which had increased by 7.4 percent (Y-o-Y) in the fourth quarter of 2011, fell significantly to 4.4 percent in the fourth quarter of 2012.



Source: Central Statistics Office and DAB staff calculations

The non-food prices also decreased during the reporting period exhibiting an inflation rate of 7.4 percent, down from 13.6 percent recorded in the previous year – and its impact on overall inflation was as pronounced as the food prices. Another good aspect of the current quarter's data is that compared with previous quarters the major components of the CPI basket posted a decline which offset significantly the impacts of components that increased during the reporting period.



Source: Central Statistics Office and DAB staff calculations

The most unfavorable development was the rise in the rate of inflation in bread and cereals. The prices of bread and cereals rose on a year-on-year basis in the fourth quarter of 2012 by 8.4 percent, an increase from 5.3 percent in the same period last year. Moreover, bread and cereals comprise 17.7 percent weight in the CPI basket, by far the largest individual good or service component. It is worth mentioning that global prices of cereals have increased and expected to increase further in 2013. Moreover, meat, which is one of largest individual goods or services components, increased slightly to 10.2 percent in the fourth quarter of 2012 from 9.3 percent recorded in the same quarter of last year.

Prices of Vegetables also showed some increases. Vegetables, another important component of the CPI basket, displayed slightly higher rates of inflation compared to the previous year. Prices of vegetables stood at 1 percent (Y-o-Y) in the fourth quarter of 2012,

an increase from a deflation of 0.2 percent observed in the same period last year.

The only component in the non-food category, that displayed an increase, was the health component. Prices of health rose in the fourth quarter of 2012 by 7.7 percent (Y-o-Y), again an increase from 4.4 percent in the same period of last year.

The most favorable development was a fall in the rate of inflation in milk, cheese and eggs. The prices of milk, cheese and eggs fell in the fourth quarter of 2012 by 8.8 percent (Y-o-Y), a decline from an inflation rate of 10.5 percent in the same period last year. Prices of oils and fats also declined, which is another important component of the CPI basket representing a higher weight in the basket, displayed significantly lower rates of inflation in the fourth quarter of 2012, exhibiting an inflation rate of 3.5 percent (Y-o-Y) down from 5.8 percent recorded in the same period a year ago.

Fresh and dried fruit prices have been falling rapidly, another important factor contributing to the favorable changes. These prices fell to -6.4 percent on a year-on-year basis in the fourth quarter 2012, a sharp decrease from the 22.9 percent inflation observed in the same quarter of 2011.

In the non-food category clothing prices have also fallen. In the fourth quarter of 2012, clothing prices decreased by 7.7 percent (Y-o-

Y), after an increase from 18.8 percent in the same period a year ago.

Core inflation showed exhibited a similar pattern with the headline inflation. CPI excluding volatile components increased by 5.7 percent in the fourth quarter of 2012 compared to 11.2 percent a year ago

For example, core inflation (excluding bread and cereals, oils and fats, and transport) was 5.7 percent (Y-o-Y) in the fourth quarter of 2012, less than the headline inflation rate of 5.8 percent, significantly below than the last year's rate of 11.2 percent. The reason that the

core inflation rate was lower than the headline inflation rate is because of certain excluded components from the core inflation like bread and cereals, oil fats and transportation.

When core inflation is measured by the 28 percent Trimmed Mean, almost the same pattern appears. The decrease in the rate of core inflation, 6.0 percent (Y-o-Y) in the fourth quarter of 2012 compared to 11.2 percent in the same quarter of last year was slightly more than the level of decrease in the headline inflation rate.

Table 3.1: Breakdown of National Headline CPI
(Percent changes year on year)
Consumer Price Index

| | 1390 | | | | 1391 | | |
|--|-------------|-------------|-------------|-------------|------------|------------|------------|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 FY |
| Headline Inflation | 12.7 | 9.9 | 9.7 | 8.4 | 6.8 | 5.4 | 5.8 |
| Food and beverages | 11.7 | 7.2 | 7.4 | 7.0 | 5.5 | 3.5 | 4.4 |
| Bread and Cereals | 11.5 | 2.9 | 5.3 | 2.3 | 2.2 | 4.6 | 8.4 |
| Meat | 15.6 | 8.9 | 9.3 | 12.2 | 13.8 | 12.9 | 10.2 |
| Milk, cheese and eggs | 8.6 | 9.4 | 10.5 | 14.4 | 9.7 | 7.9 | 8.8 |
| Oils and fats | 25.3 | 24.2 | 5.8 | 7.8 | 5.2 | 0.3 | 3.5 |
| Fresh and dried fruits | 15.1 | 18.9 | 22.9 | 18.3 | 16.1 | 6.3 | -6.4 |
| Vegetables | 2.7 | 2.2 | -0.2 | 5.6 | 5.1 | -4.4 | 1.0 |
| Sugar and sweets | 8.1 | 6.3 | 4.9 | 0.0 | 0.5 | -2.8 | -0.3 |
| Spices | 13.9 | 27.2 | 28.4 | 34.4 | 26.7 | 11.8 | 15.3 |
| Non-Food | 14.4 | 14.2 | 13.6 | 10.4 | 8.6 | 7.7 | 7.4 |
| Clothing | 9.2 | 15.4 | 18.8 | 17.6 | 13.7 | 8.3 | 7.7 |
| Health | 3.0 | 2.9 | 4.4 | 2.2 | 1.7 | 4.4 | 7.7 |
| Transportation | 22.1 | 19.6 | 30.3 | 12.4 | 13.1 | 6.6 | -0.3 |
| Communication | 2.5 | 2.6 | 3.0 | 4.8 | 0.2 | -2.7 | -4.3 |
| Education | 9.6 | 11.2 | 16.2 | 15.8 | 10.6 | 1.9 | 5.3 |
| Miscellaneous | 12.4 | 9.9 | 15.2 | 21.4 | 19.2 | 17.7 | 9.1 |
| Core inflation (28% TM) | 11.2 | 11.1 | 11.2 | 10.6 | 8.1 | 5.7 | 6.0 |
| Core inflation (Headline excl. B&C, O&F and T) | 11.9 | 11.9 | 11.2 | 11.1 | 7.7 | 5.9 | 5.7 |

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

1.2 Annual Changes in Kabul Headline Inflation

The Kabul headline inflation when measured on a year-on-year basis, showed almost similar characteristics to the national inflation. The 6.5 percent inflation rate in the fourth quarter of 2012 is well below from 9.4 percent, experienced in the same quarter of 2011. The causes of the decrease in the Kabul inflation were also similar to those affecting nationwide inflation. Again, both food and non-food sub-indices were responsible for such a decline in overall inflation.

The rise of inflation in bread and cereal prices was the most significant factor in Kabul CPI. Bread and cereal prices moved up in the fourth quarter of 2012 by 7.6 percent representing a year-on-year inflation rate of 10.3 percent (Y-o-Y). However, the Kabul headline CPI went up by a faster rate compared to what was observed nationwide. Moreover, meat, which is one of largest individual components of the CPI basket increased significantly to 14.2 percent (Y-o-Y) in the fourth quarter of 2012, up from 7.2 percent recorded in the same quarter last year.

Milk and cheese prices fell in Kabul, similar to the decreases nationwide CPI. The prices of milk and cheese fell in the fourth quarter of 2012 by 5.3 percent (Y-o-Y), a decline from an inflation of 8.8 percent in the same period last year.

Oil and fat sub-index also experienced rapid falling trend compared with the previous year. Inflation in oil and fat prices decreased significantly by 12.7 percentage points from the previous year ending at 0.7 percent. The level of inflation in this component was lower than it was observed nationwide.

Fruit prices have also exhibited a falling trend, another important factor contributed to the decline in headline inflation. These prices fell to -12.6 percent (Y-o-Y) in the fourth quarter of 2012, a sharp turnaround from the 26.8 percent inflation observed in the same quarter of 2011.

In the non-food sub-category, clothing prices have also declined. In the fourth quarter of 2012, clothing prices decreased by 5.1 percent (Y-o-Y), after an increase of 9.2 percent over the same period a year ago.

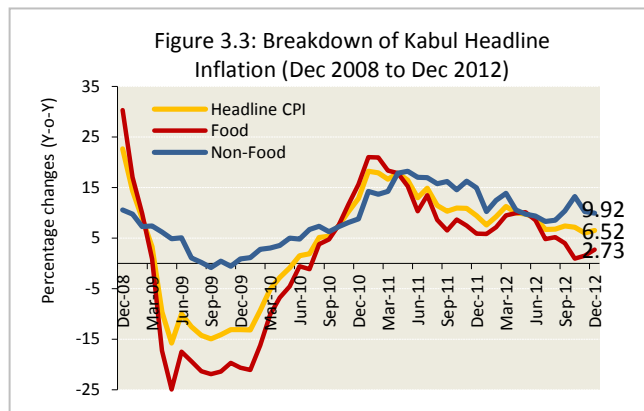


Table 3.2: Breakdown of Kabul Headline CPI

(Percent changes year on year)

Consumer Price Index

| | 1390 | | | | 1391 | | |
|---|-------------|-------------|-------------|-------------|------------|-------------|------------|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 FY |
| Overall Index | 13.0 | 10.3 | 9.4 | 11.3 | 9.0 | 7.4 | 6.5 |
| Food and beverages | 10.3 | 6.5 | 5.9 | 9.5 | 8.5 | 4.0 | 2.7 |
| Bread and Cereals | 7.1 | 0.9 | 2.7 | 3.2 | 6.7 | 7.2 | 10.3 |
| Meat | 19.3 | 7.9 | 7.2 | 15.0 | 15.8 | 15.5 | 14.2 |
| Milk, cheese and eggs | 8.8 | 10.8 | 8.8 | 15.5 | 9.6 | 6.1 | 5.3 |
| Oils and fats | 28.0 | 35.1 | 13.4 | 15.0 | 9.8 | -0.7 | 0.7 |
| Fresh and dried fruits | 17.4 | 16.3 | 26.8 | 28.3 | 27.4 | 11.9 | -12.6 |
| Vegetables | 0.8 | -2.7 | -6.6 | 9.4 | 4.9 | -3.5 | -3.2 |
| Sugar and sweets | 12.1 | 11.5 | 6.8 | -1.5 | -1.6 | -4.7 | -2.3 |
| Spices | 3.1 | 2.9 | 2.7 | 22.2 | 29.7 | 35.6 | 37.9 |
| Non-Food | 17.0 | 16.2 | 14.9 | 13.9 | 9.4 | 10.3 | 9.9 |
| Clothing | 7.4 | 9.7 | 9.2 | 8.0 | 3.6 | 3.8 | 5.1 |
| Health | 2.3 | 5.1 | 5.2 | 3.7 | 6.2 | 15.9 | 18.9 |
| Transportation | 10.4 | 12.4 | 20.5 | 12.9 | 5.3 | 1.8 | -2.1 |
| Communication | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | -0.4 | -0.4 |
| Education | 13.0 | 12.5 | 10.7 | 0.8 | 0.5 | 1.2 | 1.3 |
| Miscellaneous | 13.1 | 16.0 | 23.3 | 20.7 | 22.5 | 19.5 | 4.4 |
| Core inflation (28% TM) | 10.8 | 10.0 | 10.5 | 11.1 | 7.1 | 6.6 | 3.7 |
| Core inflation (Headline excl. B&C, O&F and T) | 14.6 | 12.8 | 11.5 | 14.3 | 9.8 | 8.3 | 6.5 |

Source: Central Statistics Office/DAB staff calculations

1.3 Current Quarter Changes in National Headline CPI

To see more clearly, what is happening to inflation in the most recent times, we may compare the quarter-on-quarter changes in the CPI and its various components in the fourth quarter of 2012 with the third quarter of 2012. The situation is different when the quarterly changes are calculated. The quarterly rate of headline inflation was significantly higher compared to the previous quarter, reaching 4.8 percent (Q-o-Q), up from 0.7 percent in the

previous quarter. After three straight quarters of lower inflation so far in 2012, the rise in the fourth quarter inflation may indicate that inflation has gained momentum.

Nationwide, inflation increased significantly over the previous quarter. The headline inflation reached 4.8 percent (Q-o-Q) in the fourth quarter of 2012, up from 0.7 percent in the third quarter.

Nationwide bread & cereals prices increased significantly in the fourth quarter of 2012, standing at 8.4 percent (Q-o-Q), up from 2.2

percent in the preceding period. The increase in the prices of cereals is thought to be mostly driven by the supply side. Vegetables, another important component of food sub-index,

displayed a higher inflation rate of 14.5 percent (Q-o-Q) in the reporting quarter compared to a deflation rate of 8.8 percent in the previous quarter.

Table 3.3: Quarter-on-Quarter Changes in National Headline CPI
(Percent changes quarter-on-quarter)
Consumer Price Index

| | 1390 | | | | 1391 | | |
|---------------------------|------------|------------|------------|-------------|-------------|-------------|------------|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 FY |
| Headline Inflation | 1.6 | 2.0 | 4.4 | 0.1 | 0.2 | 0.7 | 4.8 |
| Food and beverages | 1.1 | 1.6 | 4.3 | -0.2 | -0.3 | -0.4 | 5.3 |
| Bread and Cereals | 1.7 | -0.2 | 4.5 | -3.6 | 1.6 | 2.2 | 8.4 |
| Meat | -0.7 | 1.3 | 4.7 | 6.6 | 0.7 | 0.5 | 2.1 |
| Milk, cheese and eggs | 3.6 | 2.9 | 3.0 | 4.1 | -0.6 | 1.2 | 3.9 |
| Oils and fats | 4.3 | 3.5 | -1.7 | 1.6 | 1.7 | -1.2 | 1.4 |
| Fresh and dried fruits | 2.7 | 5.9 | 8.3 | 0.5 | 0.7 | -2.9 | -4.7 |
| Vegetables | -7.1 | 0.4 | 8.4 | 4.5 | -7.5 | -8.8 | 14.5 |
| Sugar and sweets | -0.4 | 7.4 | -0.7 | -5.8 | 0.1 | 3.8 | 1.9 |
| Spices | 9.8 | 14.6 | -0.2 | 7.0 | 3.5 | 1.2 | 2.9 |
| Non-Food | 2.3 | 2.7 | 4.6 | 0.5 | 0.6 | 1.9 | 4.3 |
| Clothing | 4.5 | 6.3 | 4.4 | 1.4 | 1.0 | 1.2 | 3.9 |
| Health | 0.8 | 0.3 | 1.0 | 0.1 | 0.2 | 3.0 | 4.3 |
| Transportation | -1.4 | 3.8 | 8.5 | 1.2 | -0.8 | -2.1 | 1.5 |
| Communication | 2.8 | 0.1 | 0.4 | 1.4 | -1.7 | -2.7 | -1.3 |
| Education | 4.3 | 9.5 | -2.0 | 3.4 | -0.3 | 0.9 | 1.2 |
| Miscellaneous | 2.5 | 1.8 | 10.7 | 5.1 | 0.6 | 0.5 | 2.6 |

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

1.2 Current Quarter Changes in Kabul

Headline Inflation

In this chapter, we may compare the quarter-on-quarter changes in Kabul CPI and its various components in the third quarter of FY1391 with those experienced in the second quarter. The quarterly headline inflation in the third

quarter was higher, 3.0 percent (Q-o-Q), up from 1.8 percent in the previous quarter.

The reason that inflation increased compared to the previous quarter is because of a sharp increase in the prices of bread and cereals. The prices of these key commodities went up slightly in the fourth quarter by 4.3 percent (Q-o-Q), in contrast to 4 percent increase in the

previous quarter. Likewise, vegetables, increased by 20.3 percentage-points in the reporting quarter representing a quarterly inflation rate of 13.8 percent, up from -6.5

percent observed in the third quarter. Vegetables in Kabul CPI showed similar behavior as it was observed in Nationwide.

Table 3.4: Quarter-on-Quarter Changes in Kabul Headline CPI
(Percent changes quarter-on-quarter)

Consumer Price Index

| | 1390 | | | | 1391 | | |
|---------------------------|------------|------------|------------|------------|-------------|-------------|------------|
| | Q1 | Q2 | Q3 | Q4 | Q1 | Q2 | Q3 FY |
| Overall Index | 2.1 | 3.4 | 3.8 | 1.5 | 0.0 | 1.8 | 3.0 |
| Food and beverages | 0.5 | 4.1 | 4.1 | 0.5 | -0.4 | -0.2 | 2.8 |
| Bread and Cereals | 0.0 | 3.6 | 1.4 | -1.7 | 3.4 | 4.0 | 4.3 |
| Meat | 0.5 | 1.3 | 2.8 | 9.9 | 1.2 | 1.1 | 1.7 |
| Milk, cheese and eggs | 2.9 | 5.8 | 3.1 | 3.0 | -2.5 | 2.4 | 2.3 |
| Oils and fats | 6.0 | 7.9 | 0.7 | 0.0 | 1.2 | -2.4 | 2.1 |
| Fresh and dried fruits | 1.1 | 7.9 | 16.7 | 0.8 | 0.4 | -5.3 | -8.8 |
| Vegetables | -5.8 | 1.5 | 13.5 | 0.8 | -9.7 | -6.5 | 13.8 |
| Sugar and sweets | 1.9 | 8.0 | -0.5 | -10.0 | 1.8 | 4.5 | 2.0 |
| Spices | 0.9 | 0.0 | 0.5 | 20.4 | 7.1 | 4.5 | 2.2 |
| Non-Food | 4.4 | 2.4 | 3.5 | 2.8 | 0.4 | 3.3 | 3.1 |
| Clothing | 2.3 | 2.4 | 1.5 | 1.5 | -1.8 | 2.6 | 2.7 |
| Health | 0.1 | 2.6 | 0.9 | 0.1 | 2.5 | 12.0 | 3.5 |
| Transportation | 5.1 | 0.8 | 5.4 | 1.1 | -2.0 | -2.5 | 1.4 |
| Communication | 0.0 | 0.0 | 0.0 | 0.0 | 0.1 | -0.6 | 0.0 |
| Education | 0.3 | 0.2 | -1.3 | 1.7 | -0.1 | 0.8 | -1.1 |
| Miscellaneous | -0.2 | 2.6 | 18.4 | -0.4 | 1.3 | 0.1 | 0.0 |

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

2. INFLATION OUTLOOK

According to the United Nations, four years after the eruption of the global financial crisis, the world economy is still struggling to recover. During 2012, global economic growth has weakened further and growth in the major developing countries and economies in transition has decelerated notably. The current upward trend of the global food prices will undoubtedly affect Afghanistan, where food is a significant share of national expenditure.

However, the economic outlook for Afghanistan is broadly positive. Growth and

inflation were beyond the expectations in 2012 as the agricultural output is estimated to rebound in the year under review which in turn will push real GDP growth to 12 percent and will help moderate inflation. In 2013, the economy will continue to grow and inflation is expected to be stable. However, the next two years before the Government of Afghanistan assumes full responsibility for security in 2014 will remain critical. Security and political uncertainties, including upcoming presidential election will shadow the overall condition in the country.



CHAPTER IV

EXTERNAL SECTOR

DEVELOPMENTS

4

EXTERNAL SECTOR DEVELOPMENTS

This chapter highlights developments in the external sector of the Afghanistan's economy in the FY1391 in comparison with the preceding year.

External sector statistics are the key economic indicators for central banks and monetary authorities to reflect the size and composition of the country's external trade position as well as its financial transactions with the rest of the world. It also provides information on the nation's international asset and liability position, including its external liquidity and debt. These are crucial variables in order to assess current and future developments in a country's vulnerability to external shocks. Balance of payments (BoP); which comprise current account, financial account and net international reserves, is a comprehensive statistical framework for the external sector.

Afghanistan's Balance of Payments (BOP) statistics is an important part of External Sector Statistics, covering current and capital account transactions, identifying the goods, services, income, and current transfers as principal components of the current account. In addition, data for external sector statistics

include external debt and foreign exchange reserves.

The overall balance for the FY 1391 defines a surplus of USD 200 million down from a surplus of USD 592 million in the earlier year. This outcome in the reporting year was due to trade deficit which is widened almost 46 percent to USD 6,158.04 million during the FY 1391 from USD 4,206.05 million in the previous years.

The current account balance which is the key measure of an economy's saving and spending behavior, recorded a surplus of US dollar 327 million in the year under review, lower than a surplus of US dollar 800 million in the preceding year. This outcome in the current account was mainly attributed to the widening trade deficit on account of an increase in import expenditures due to both, higher volume as well as prices during the year under review.

In the year under review, the capital and financial account recorded an outflow of USD 127 million, lower from an outflow of almost

USD 208 million in FY 1390, a significant decrease of 39 percent mainly led by lower foreign direct investment (FDI) inflow during the year under review.

Earnings from exports have decreased by almost 10 percent to USD 261.63 million compared to USD 289.81 million recorded in the previous year.

The decrease in the exports was mostly dominated by carpet and rugs, which declined significantly by almost 74 percent to USD 8.43 million, from USD 31.94 million, and medical seeds and others which declined by about 9 percent to USD 122.15 million from USD 134.38 million in the reporting year. Other exporting items such as leather and wool and food items (fresh and dry fruits) showed an increase of almost 21 percent and 3 percent respectively in the year under review. At the same time, imports considerably increased by 43 percent to USD 6,419.67 million in FY 1391, which shows a growing domestic demand for foreign goods, mainly to consumer goods, industrial supply, and capital goods.

Consequently, the trade deficit expanded to USD 6,158.04 million in FY 1391 compared to USD 4,206.05 million in FY 1390, an increase of about 46 percent. The trade deficit stood at about 31 percent of GDP in FY 1391.

During the period under review, Afghanistan's public and publicly guaranteed external debt stock stood at USD 2,403.33 million, lower from USD 2,422.19 that were recorded last year.

Afghanistan owed USD 1,016.66 million mainly to the Russian Federation as a member of the Paris Club and other Non-Paris Club creditors. Non-Paris club debts stood at about USD 127.49 million at the end of FY 1391. With respect to multilateral debts, Afghanistan's total debt stood at USD 1,259.17 million at the end of FY 1391.

The net international reserves (NIR) exhibited an increase of about 11.53 percent from USD 5,803 million in FY 1390 to USD 6,471.94 million in the FY 1391. The reserve assets increased to about 11.51 percent from USD 6,158.18 million in FY 1390 to USD 6,866.79 million in the reporting year. While on the other side, the reserve liabilities increased by 11.17 percent, from USD 355.17 million in FY 1390 to USD 394.85 million in the reporting year.

1. THE BALANCE OF PAYMENTS

Despite the huge outflow in the capital and financial account deficit increasing in line with the widened trade deficit (46 percent), the higher inflows to the current account (current transfers) resulted in the overall BoP, recording a surplus of US dollar 200 million in FY 1391, much lower from a surplus of USD 592 million in FY 1390.

Foreign direct investment (FDI) had slightly increment of 11 percent from USD 405 million in FY 1390 to USD 451 million in FY 1391; this indicates increased inflows of capitals in the country.

Table 4.1: Afghanistan Balance of Payments (amounts in millions USD)

| | 2010/11 | 2011/12 Proj. | %Change | 2012/13 | |
|---|---------------------|------------------|------------|------------|---------|
| | Est. | | | Proj. | %Change |
| | 1389 | 1390 | | 1391 | %Change |
| Current account (including grants) | 538.0 | 800.0 | 48.7 | 327 | -59 |
| Current account (excluding grants) | -7,558.0 | -8,490.0 | 12.3 | -9,239 | 9 |
| Trade balance | -7,559.0 | -8,530.0 | 12.8 | -9,298 | 9 |
| Exports of goods (f.o.b.) 1/ | 2,694.0 | 2,613.0 | -3.0 | 2,549 | -2 |
| Imports of goods | -10,253.0 | -11,143.0 | 8.7 | -11,847 | 6 |
| Services and Income, net | -386.0 | -367.0 | -4.9 | -358 | -2 |
| Of which: Interest due | -12.0 | -10.0 | -16.7 | -15 | 50 |
| Current transfers | 8,483.0 | 9,696.0 | 14.3 | 9,984 | 3 |
| Public | 8,097.0 | 9,290.0 | 14.7 | 9,566 | 3 |
| Private | 386.0 | 407.0 | 5.4 | 418.00 | 3 |
| Financial accounts | 237.0 | -208.0 | -187.8 | -127 | -39 |
| Foreign direct investment | 371.0 | 405.0 | 9.2 | 451 | 11 |
| Official loans (net)2/ | 27.0 | 59.0 | 118.5 | 63 | 7 |
| Disbursement | 29.0 | 61.0 | 110.3 | 76 | 25 |
| Amortization due | -2.0 | -2.0 | 0.0 | -13 | 550 |
| Other investment flows | -161.0 | -672.0 | 317.4 | -642 | -4 |
| Errors and omissions | 241.0 | 0.0 | -100.0 | 0 | |
| Overall balance | 1,016.0 | 592.0 | -41.7 | 200 | -66 |
| Financing | -1,016.0 | -592.0 | -41.7 | -200 | -66 |
| Central bank's gross reserves,-; = accumulation | -1,035.0 | -606.0 | -41.4 | -243 | -60 |
| Use of Fund resources (net) | 19.0 | 14.0 | -26.3 | 43 | 207 |
| Exceptional financing | 0.0 | 0.0 | | 0 | |
| Financing Gap | 0.0 | 0.0 | | 0 | |
| Memorandum items: | | | | | |
| Gross international reserves | 6,208.0 | 6,867.0 | 10.6 | 7,110 | 4 |
| (Imports coverage) 3/ | 7.1 | 7.3 | 2.8 | 7.3 | 0 |
| | (In percent of GDP, | Unless otherwise | indicated) | | |
| Trade balance | -42.0 | -42.8 | 1.9 | -44.3 | 4 |
| Current account balance, including grants | 3.0 | 4.0 | 33.3 | 1.6 | -60 |
| Excluding grants | -42.0 | -42.7 | 1.7 | -44.0 | 3 |
| Total debt service (percent of exports) 3/ | 1.3 | 1.1 | -15.4 | 1.9 | 73 |
| Total debt stock | 6.9 | 6.6 | -4.3 | 6.8 | 3 |

Sources: Afghan authorities; and Fund staff estimates and projections.

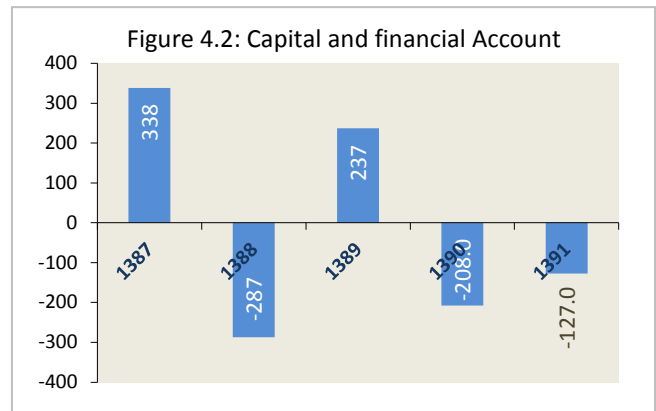
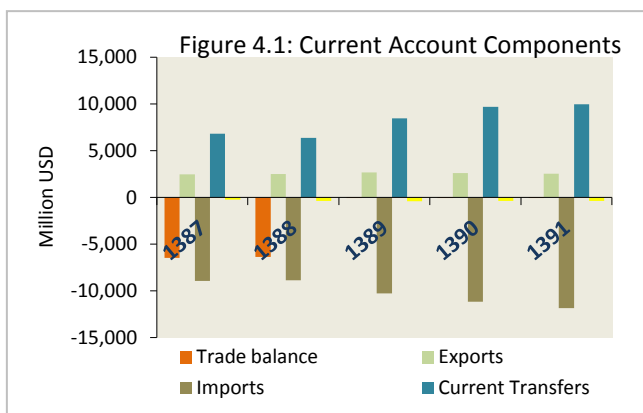
1/ Excludes opium exports; includes official exports, estimates of smuggling, re-export, and sales to nonresidents.

2/ Excluding IMF credit.

3/ Excluding reexport-related flows.

The current account balance (CAB), the key measure of an economy’s saving and spending behavior, recorded an extensive decline of 59 percent to USD 327 million in the FY 1391, much lower from a surplus of USD 800 million recorded last year. This decline in the current account balance (CAB) was mainly because of a sharp decrease in the trade balance. Based on the balance of payment statement, during the period under review, exports of goods declined by around 2 percent from USD 2,613 million in FY 1390 to USD 2,549 million in FY 1391, and at the same time imports of goods increased by 6 percent to USD 11,847 million, from USD 11,143 million.

Among the import figures, services and income are also estimated to decrease by about 2 percent from USD 367 million in FY 1390 to USD 358 million in the year under review. Table 4.1 illustrates Afghanistan’s Balance Of Payments (BoP) from 1389 to FY 1391.



1.1 Merchandise Trade

According to the data provided by the Central Statistics Organization, Afghanistan’s merchandise trade recorded a deficit of USD 6,158.04 million in the FY 1391 compared to a deficit of USD 4,206.05 million in FY 1390, about 48 percent increase. The trade deficit makes up approximately 31 percent of GDP. The deficit in the trade balance was mainly attributed to growing of imports than exports in FY 1391, compared with the previous year. Imports increased significantly by about 43 percent, while exports declined by almost 10 percent in the FY 1391 compared to those recorded in the FY 1390. According to merchandise trade statistics, total imports for FY 1391 were recorded at USD 6,419.67 million, where this figure was USD 4,495.86 million in the FY 1390. The boost in expenditure of total imports was dominated by almost all importing categories except for fuel and lubricants. In particular, imports of consumer goods increased notably by almost 113 percent from USD 590.39 million in FY

1390 to USD 1,255.48 million in the year under review. Imports of industrial supply increased by 112 percent from USD 458.55 million in the FY 1390 to USD 969.88 million in the period under review. Imports of capital goods and others increased by 54 percent from USD 2,020.83 million in the FY 1390 to USD 3,110.66 million in this period. On the other hand, Imports of fuel and lubricants decreased by almost 24 percent from USD 1,426.09 million in the FY 1390 to USD 1,083.65 million in the period under review.

On the other hand, in the period under review, total Exports declined by around 10 percent from USD 289.81 million in FY 1390 to USD 261.63 million in FY 1391.

This decline in total export items was mainly due to carpets and rugs, which decreased significantly by almost 74 percent from USD 31.94 million in FY 1390 to USD 8.43 million in the period under review, and medical seeds and others decreased by 9 percent from USD 134.38 million in the FY 1390 to USD 122.15 million in the current period. While, export of leather and wool increased by about 21 percent from USD 109.35 in FY 1390 to USD 166.97 million in 1391, and food items such as fresh and dry fruit increased by almost 3 percent from USD 101.38 million in the FY 1390 to USD 104.23 million in the current period.

Table 4.2: Merchandise Trade (in million USD)

| Years | FY 1387 | | FY 1388 | | FY 1389 | | FY 1390 | | FY 1391 | |
|--|------------------|--------------|------------------|------------|------------------|------------|------------------|------------|------------------|------------|
| | Total | Share (%) | Total | Share (%) | Total | Share (%) | Total | Share (%) | Total | Share (%) |
| Imports | 3,019.86 | 100 | 3,336.45 | 100 | 5,154.31 | 100 | 4,495.86 | 100 | 6,419.67 | 100 |
| Industrial supplies | 313.36 | 10.4 | 294.24 | 8.8 | 602.48 | 11.7 | 458.55 | 10.2 | 969.88 | 15.1 |
| Fuel and Lubricants | 484.42 | 16.0 | 707.19 | 21.2 | 1022.66 | 19.8 | 1426.09 | 31.7 | 1083.65 | 16.9 |
| Consumer goods | 791.71 | 26.2 | 728.14 | 21.8 | 803.67 | 15.6 | 590.39 | 13.1 | 1255.48 | 19.6 |
| Capital goods and other | 1,430.37 | 47.4 | 1,607 | 48.2 | 2725.50 | 52.9 | 2020.83 | 44.9 | 3110.66 | 48.5 |
| Exports | 544.56 | 100.0 | 403.07 | 100 | 388.37 | 100 | 289.81 | 100 | 261.634 | 100 |
| Carpets & Rugs | 153.05 | 28.1 | 68.8 | 17.1 | 68.83 | 17.7 | 31.94 | 11.0 | 8.43 | 3.2 |
| Food Items | 290.38 | 53.3 | 224.80 | 55.8 | 156.35 | 40.3 | 101.38 | 35.0 | 104.23 | 39.8 |
| Leather & Wool | 29.29 | 5.4 | 24.67 | 6.1 | 53.84 | 13.9 | 22.11 | 7.6 | 26.82 | 10.3 |
| Medical seeds & others | 71.84 | 13.2 | 84.82 | 21.0 | 109.35 | 28.2 | 134.38 | 46.4 | 122.15 | 46.7 |
| Trade Balance | -2,475.30 | | -2,933.38 | | -4,765.94 | | -4,206.05 | | -6,158.04 | |
| Trade Balance as percent of GDP | -21 | | -23 | | -28 | | -23 | | -31 | |

Source: CSO and DAB staff calculations

1.2. Direction of Trade

Afghanistan's direction of trade with its trading partners is shown in Tables 4.3 and 1.4. Primarily, Afghanistan's major trading-partners' are Pakistan, India, China and Iran. The merchandise trade statistics indicate that Afghanistan's exports decreased by 10 percent from USD 289.81 million to USD 261.63 million. This is due to relatively low foreign demand for Afghanistan's exports. However, exports show signs of recovery.

During the period under review, exports to Pakistan were 30 percent of total exports, as a result, Pakistan remained on top among our export destination despite exports declined.

During the year under review, Afghanistan's exports to Pakistan stood at USD 78.48 million compared to USD 147.01 million in the FY 1390. However, in the year under review exports of carpets and rugs to Pakistan decreased by almost 74 percent and exports of medical seeds and others also decreased by almost 9 percent. This indicates that Pakistan demanded less Afghanistan's exports in FY 1391.

India ranked the second largest export destination. During the period under review, exports to India were 26.55 percent of total exports, higher than 16.42 percent recorded last year. Afghanistan's exports to India stood at USD 69.46 million in FY 1391 compared to USD 47.58 million in FY 1390. Major export items to India were medical seeds, food items such as (fresh and dry fruits) and carpets and rugs.

According to the available data, all the export items to India increased by almost 46 percent during the reporting period. Similarly, the Commonwealth of Independent States (CIS) still remained the third export destination among others in FY 1391. Afghanistan's exports to (CIS) in FY 1391 compared to FY 1390 increased by 12.77 percent. Afghanistan exports to CIS were recorded at USD 33.41 million in FY 1391 compared to USD 25.04 million recorded in FY 1390. However, Iran and China remained the final export destination for Afghanistan in the reporting period. Exports to Iran and China increased by about 8.74 percent and 3.58 percent respectively.

Table 4.3: Direction of External Trade: For FY 1391 (in million USD)

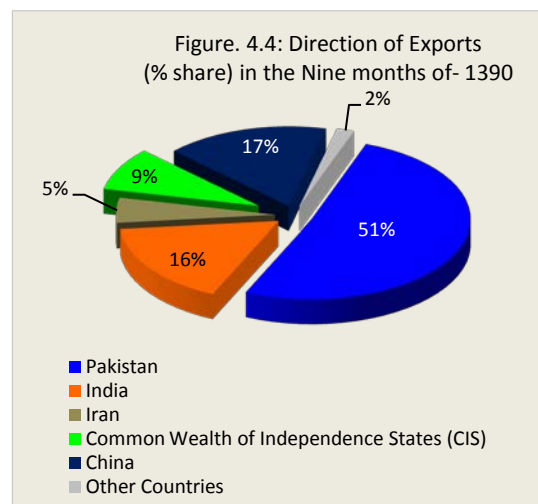
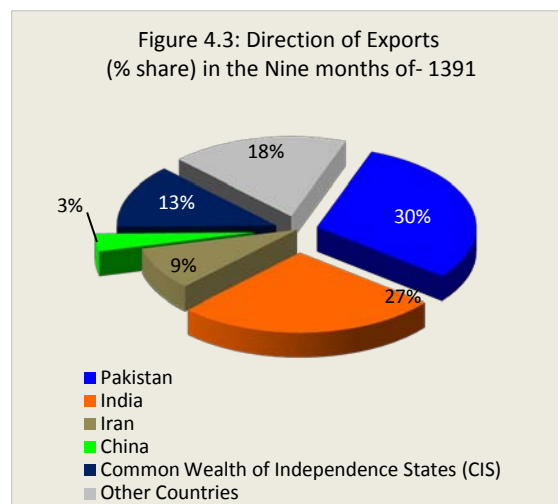
| Country Name | Exports | % Shares | Imports | % Share | Trade Balance |
|---|----------------|-------------|-----------------|-------------|-------------------|
| Pakistan | 78.48 | 30.00% | 1442.06 | 22.46% | -1363.58 |
| India | 69.46 | 26.55% | 173.17 | 2.70% | -103.71 |
| Iran | 22.86 | 8.74% | 773.61 | 12.05% | -750.75 |
| Germany | 0.60 | 0.23% | 249.89 | 3.89% | -249.29 |
| China | 9.37 | 3.58% | 445.16 | 6.93% | -435.79 |
| England | | 0.00% | 82.07 | 1.28% | -82.07 |
| Saudi Arabia | 0.60 | 0.23% | | 0.00% | 0.60 |
| USA | | 0.00% | 92.02 | 1.43% | -92.02 |
| Common Wealth of Independent States (CIS) | 33.41 | 12.77% | 1543.71 | 24.05% | -1510.30 |
| Japan | | 0.00% | 112.62 | 1.75% | -112.62 |
| Other Countries | 46.85 | 17.91% | 1505.36 | 23.45% | -1458.51 |
| Total | 261.634 | 100% | 6,419.67 | 100% | (6,158.04) |

Source: CSO and DAB staff calculations

Table 4.4: Direction of External Trade: For FY1390 (In million USD)

| Country Name | Exports | % Shares | Imports | % Share | Trade Balance |
|--|---------------|----------------|----------------|----------------|-----------------|
| Pakistan | 147.01 | 50.73% | 603.78 | 13.43% | -456.77 |
| India | 47.58 | 16.42% | 70.07 | 1.56% | -22.49 |
| Iran | 14.54 | 5.02% | 339.59 | 7.55% | -325.05 |
| Germany | 1.65 | 0.57% | 166.82 | 3.71% | -165.17 |
| Common Wealth of Independence States (CIS) | 25.04 | 8.64% | 1635.24 | 36.37% | -1610.20 |
| China | 5.09 | 1.76% | 447.46 | 9.95% | -442.37 |
| Saudi Arabia | 1.21 | 0.42% | | 0.00% | 1.21 |
| Japan | | 0.00% | 341.02 | 7.59% | -341.02 |
| England | | 0.00% | 17.20 | 0.38% | -17.20 |
| United States | | 0.00% | 62.29 | 1.39% | -62.29 |
| Other Countries | 47.69 | 16.45% | 812.39 | 18.07% | -764.71 |
| Total | 289.81 | 100.00% | 4495.86 | 100.00% | -4206.05 |

Source: CSO and DAB staff calculations



Source: CSO and DAB Staff calculations

1.3 Composition of Trade

The composition of total Imports is illustrated in Figures 4.6 and 4.7. These Figures compare the composition of imports in the FY1391, with the similar period a year ago.

The composition of imports that comprises industrial supplies, capital goods & others, fuel & lubricants and consumer goods are presented in percent share of total imports baskets.

During the period under review, imports of all items increased, except for fuel and lubricants.

The composition of imports in the FY1391 indicates that imports of capital goods and others had the largest share in the total basket of imports, which has increased by 51 percent from 47 percent recorded a year ago. Imports of capital goods and others that were recorded at USD 1,229.25 million in the FY1390, has remarkably increased to USD 2,298.41 million (almost 87 percent) in the period under review.

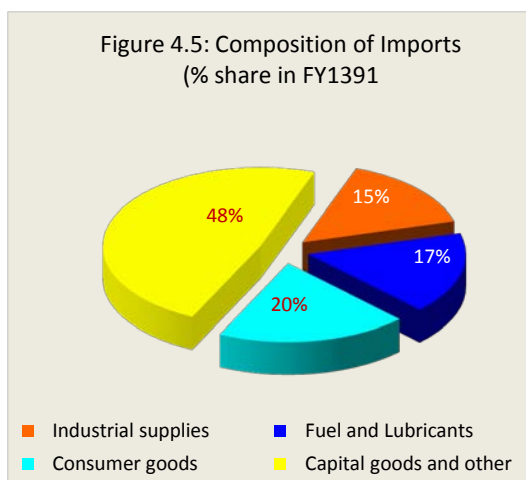
The second largest share was recorded for consumer goods which has increased notably by about 20 percent in the current period, from 11 percent recorded last year.

According to available data, expenditure on imports of consumer goods increased considerably by 199 percent, from USD 296.85 million in the FY1390 to USD 886.99 million in the period under review. This increase in the consumer goods is mainly due to higher domestic demand for foreign goods, which incurred expenditure on certain food items in the quarter under review.

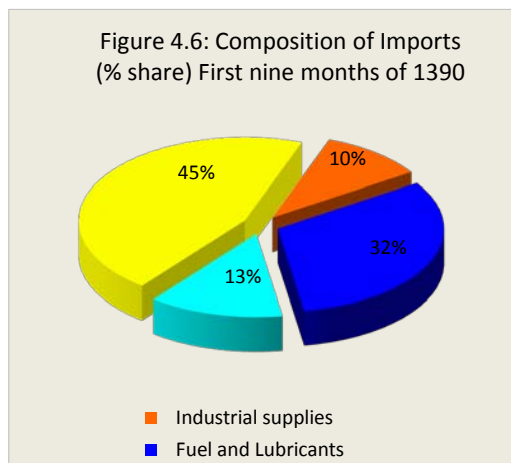
Similarly, industrial supplies had the third largest share in total of imports, which increased by about 16 percent during the reporting period, from 12 percent last year. Likewise, expenditure on imports of industrial supplies remarkably increased by about 144 percent, from US dollar 303.55 million to USD 741.53 million in the period under review. Industrial supplies normally cover metals,

fertilizer, chemical, and cements, so the demand for these items has been increasing due to the implementation of development projects all over the country and shows the country’s need to import these materials for sustained economic growth in the long-run.

Conversely, expenditure on imports of fuel and lubricants (petroleum oil) in total imports reduced by about 23 percent, from USD 770.19 million with a share of 30 percent in FY 1390 to USD 596.83 million with a share of 13 percent in the current period.



Source: Central Statistics Office and DAB staff calculations



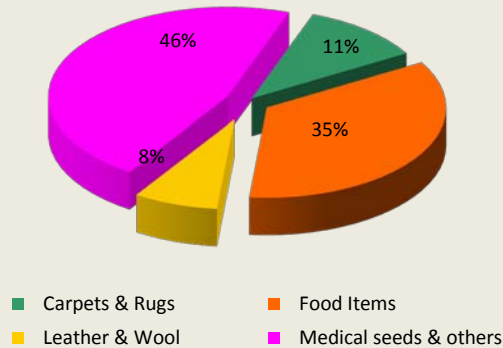
On the other side, Figures 4.8 and 4.9 compare the composition of total exports for FY1390 with that in the FY1391. Figure 4.8 shows the breakdown of exports in the FY1390 by main commodities and products. In the FY1390, the share of food items such as fresh and dry fruits which had the largest share of total exports, was calculated at 35 percent, while, it was 39 percent in the FY1391. As shown in Figure 4.9, medical seeds and others remained the largest share in total exports with almost 47 percent in the FY1391; despite its value declined by 9 percent from USD 134.38 million to USD 122.15 million.

The second largest share recorded for food items that have increased to 40 percent in FY 1391 from 35 percent FY 1390. In addition, the share of leather and wool increased from about 8 percent in FY 1390 to around 10 percent in FY 1391.

Finally, the share of carpets and rugs which are considered the main component of Afghan exports in the past decades, decreased from 11 percent in FY 1390 to almost 3 percent in the year under review. The reason could be low international demand.

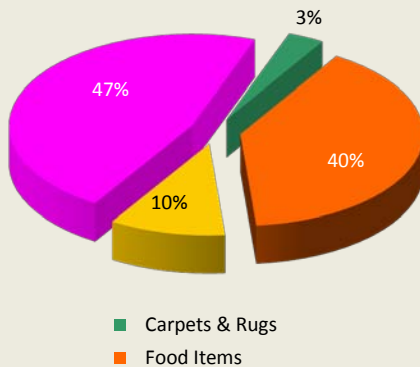
Figures 4.8 and 4.9 demonstrate the composition of main exporting items for the years 1390 and 1391.

Figure 4.7: Composition of Exports (share%) First nine months of 1390



Source: Central Statistics Organization/DAB staff calculation

Figure 4.8: Composition of Exports (% share%) FY1391



Source: Central Statistics Organization/DAB staff calculation

As can be seen from Figures 4.8 and 4.9, foreign demand for domestically produced items such as medical seeds and others remained almost unchanged. The share of food items increased to 40 percent, up from 35 percent in the FY 1390, the share of leather & wool increased from almost 8 percent in FY1390 to 10 percent in the FY 1391. While the shares of carpets & rugs decreased significantly

to 3 percent in FY 1391, down from 11 percent in FY 1390.

As a result, in order to improve the export of above mentioned items require capital goods and machineries to replace the traditional manufacturing systems to improved and enhanced schemes.

2. EXTERNAL DEBT

Afghanistan's public and publicly guaranteed external debt stock stood at USD 2,403.33 million as of 20 December 2012. During the FY1391, only service charges paid to the International Development Association (IDA) and Asian Development Bank (ADB). In addition, during the FY1391, just International Development Association (World Bank) as a number of creditors to Afghanistan made some debt forgiveness of only service charges. While the United States and Germany as members of the Paris-club provided with 100 percent debt relief. Based on Ministry of Finance's data, outstanding loan amounts payable to Paris-club creditors at the end of FY1391 stood at USD 1,016.66 million which is only payable to the Russian Federation. In other words, Afghanistan's total debt only from the Paris-club members stood at about 42.30 percent of total external debt.

Table 4.5 summarizes Afghanistan's external debt for FY 1391.

Table 4.5: External Debt: For FY1391 (December 19, 2012)

In units indicated

| | In million USD | Percent of total |
|-----------------------------|----------------|------------------|
| Total external debt | 2,403.33 | 100.00 |
| Bilateral | 1,144.16 | 47.61 |
| Paris Club | 1,016.66 | 42.30 |
| Russian Federation | 1,016.66 | 42.30 |
| United States | - | 0.00 |
| Germany | - | 0.00 |
| Non-Paris Club | 127.49 | 5.30 |
| Multilateral | 1,259.17 | 52.39 |
| of which: IDA (World Bank) | 420.21 | 17.48 |
| Asian Development Bank | 679.88 | 28.29 |
| International Monetary Fund | 130.25 | 5.42 |
| Islamic Development Bank | 27.06 | 1.13 |
| OPEC Fund | 1.77 | 0.07 |

Source: Debt Asset Management Unit, Ministry of Finance, Afghanistan

On the other side, non-Paris Club credits stood at USD 127.49 million at the end of FY 1391 in which Saudi Fund for Development (USD 2,314.1 million), Bulgaria (USD 2,537.6 million), Kuwait Fund (USD 1,093.5 million) and Iran (USD 498.5 million).

As a result, Afghanistan owed USD 1,144.16 million in bilateral debt which accounted for about 47.61 percent of the total debt, while in multilateral debt; Afghanistan owed USD 1,259.17 million at the end of FY 1391, which held the highest share of roughly 52 percent of the total debt.

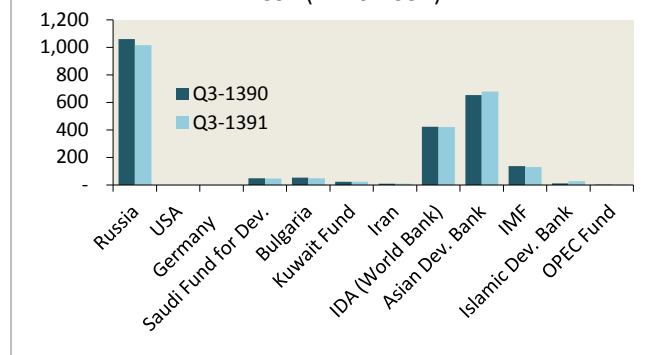
3. NET INTERNATIONAL RESERVES

The net international reserves (NIR) held by the DA Afghanistan Bank (DAB) consist of monetary gold, reserve position and holdings with the IMF and special drawing rights (SDR), as well as holdings of foreign exchange such as USD, Euro, British Pound and other major currencies, both inside Afghanistan and abroad. The net international reserves (NIR) of DAB expressed in USD are defined as reserve assets minus reserve liabilities.

The NIR had considerable steady growth during the past few years, which is denoted repaying ability of the external debts, currency defense or finance the foreign trade deficit.

During the year under review, NIR increased by 11.53 percent to USD 6,471.94 million, from USD 5,803 million in FY 1390. The boost in the NIR was mainly dominated by a substantial increase in the reserve assets which increased by 11.51 percent from USD 6,158.17 million in

Figure 4.9: External Debt Comparisons: FY1391 (million USD)



the FY 1390 to USD 6,866.79, million in the year under review.

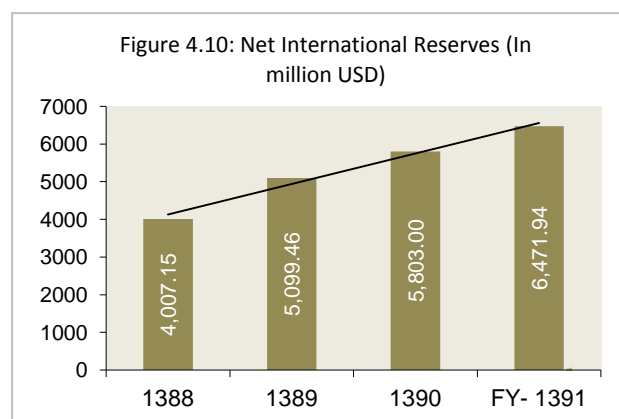
On the other hand, reserve liabilities increased substantially by about 11.17 percent from USD 355.17 million in FY 1390 to USD 394.85 million in the reporting period which shows that reserve assets are clearly higher than the reserve liabilities.

The net increase in the reserves reflected the fundamentals of the economy with foreign exchange inflows generated mainly from export earnings, foreign direct investment, current transfers, injections of foreign exchange by donors, earning on foreign exchange deposits in foreign deposit-taking corporations and multi-national forces.

Table 4.6 illustrates the net international reserves starting from FY 1388 to FY 1391.

The increase in NIR could be attributed to considerable inflows of foreign exchange, particularly from foreign donations and personal remittances. The current position of the NIR is considerably strong enough to finance about 9 months of imports, while countries with 6 months coverage of imports enjoy a relatively comfortable reserve position.

Figure 4.11 represents the net international reserves of Afghanistan for the past few years.



Source: Market Operations and MPD/DAB

Table 4.6: Net International Reserves, FY1391 (million of USD)

| Changes in the previous quarter | 1388 | Percent Changes | 1389 | Percent Change | 1390 | Percent change | FY1391 | Percent change |
|--|----------|-----------------|----------|----------------|----------|----------------|----------|----------------|
| Net International Reserves (million US Dollar) | 4,007.15 | 23.22 | 5,099.46 | 27.26 | 5,803.00 | 13.80 | 6,471.94 | 11.53 |
| Reserve Assets | 4,208.52 | 22.71 | 5,403.21 | 28.39 | 6,158.17 | 13.97 | 6,866.79 | 11.51 |
| Reserve Liabilities | 201.37 | 10.91 | 303.75 | 50.84 | 355.17 | 16.93 | 394.85 | 11.17 |
| Commercial bank deposits in foreign currency | 85.95 | 4.00 | 184.15 | 114.24 | 216.55 | 17.59 | 245.00 | 13.14 |
| Non-resident deposits in foreign currency | 0.25 | -89.57 | 0.11 | -55.72 | 0.11 | 0.00 | 0.11 | 0.00 |
| Use of Fund resources | 115.16 | 17.53 | 119.48 | 3.75 | 138.51 | 15.93 | 149.73 | 8.10 |
| Gross Intl. Reserves (in months of import) | 15.14 | | 12.58 | | 4.11 | | 3.21 | |
| Net Intl. Reserves (in months of import) | 14.41 | | 11.87 | | 3.87 | | 3.02 | |



CHAPTER V

THE REAL SECTOR

DEVELOPMENTS

5

THE REAL SECTOR DEVELOPMENTS

In the FY 1391, the available data reveals that the Afghan economy gained momentum. Based on the estimates done by the DAB and the Central Statistics Organization (CSO), the real GDP growth in FY1391 was satisfactory, increasing to 10.9 percent, up from 8.7 percent recorded in 1390. The major contribution to the favorable economic growth was attributed to the tremendous performance of the services sector. The other sectors also exhibited good performances. The agriculture sector rebounded and performed satisfactory showing a positive growth rate in the year under review. Thanks to a favorable weather condition and seasonal rainfalls that helped the wheat and other agricultural production to increase.

In terms of components, the major boost to real GDP was an upsurge in fixed government investment, government real expenditures, and private consumptions. The exports also posted an increase in the reporting year, which is good news.

Economic growth in Afghanistan, which was rapid by all measures, did not seem to be much

affected by the continuing weak performance of the global economy. In other words,

Afghanistan in 1391 did not really reflect global economic trends. Because Afghanistan is not an exporting country, weak demand for goods overseas is not reflected in a weak manufacturing sector in Afghanistan.

1. GROSS DOMESTIC PRODUCT (GDP) BY SECTORS PRODUCTION

The Afghan economy performed well in FY1391. Based on the recent available data from the Central Statistics Organization (CSO), the economy recorded real GDP growth of 10.9 percent in the year under review, up from 8.7 percent in 1390.

The improvement in economic activity is attributed to the satisfactory increase in the agricultural production as well as a precipitous increase in the services sector. The services sector contribution to the GDP growth in FY 1391 is obvious; which recorded a growth rate of 16 percent (Y-o-Y). In particular, the wholesale, retail trade, transport, storage, and communications, and restaurants & hotels contributed to the increase in the services sector to grow fast. The services sector accounts for almost half of the GDP growth in

the FY 1391, up from 47.83 percent a year ago. The overall value of services sector stood at AF 546,075 million or 50.3 percent GDP.

On the other hand, the industry sector registered the second largest growth with annual growth rate of 7.8 percent, lower than 9.8 percent last year. The overall value of industrial sector stood at AF222,766 million in FY1391 compared to AF193,371 million in 1390.

The agriculture sector posted a increase of 3.2 percent in the FY1391. However, the growth rate of agriculture was lower compared to last year.

GDP per capita increased by 10 percent over the last year growing from USD709 to USD779, based on the CSO data.

The Services Sector picked up

Compared to other sectors, the services sector grew faster by 16 percent in FY1391, higher than 10.3 percent growth recorded last year. This increase in the services sector was attributed to almost all sub-sectors. The main driver of services sector was the wholesale and retail trade, restaurants and hotels which grew by 25 percent in FY1391, up from 10.8 percent in the preceding year. The other sub-sectors that posted increase were transport, storage and communications, finance insurance, and real estate and business, pushing the overall services sector to grow faster.

In Afghanistan, the financial sector consists mainly of banks, which depicted weak performance in the FY1391. Income from

ownership of dwellings increased substantially, growing by 7 percent compared to an increase of 5.9 percent last year.

Industrial Sector loses momentum

Industrial production was mixed in the year under review with all sub-sectors except 'mining and quarrying' sub-sector, posting higher growth rate compared to a year ago.

Primarily, the slightly decline in the industries sector is attributable to the mining and quarrying sub-sectors which posted a negative growth rate of 0.9 percent in FY1391 compared to 89.6 percent growth recorded last year. As a result, industrial production lost momentum. On the positive side, the manufacturing sub-sector increased substantially in FY 1391 with growth performance of 7.4 percent well above the growth rate of 3.0 percent recorded a year ago. The increase in manufacturing sub-sector is mainly attributed to a tremendous increase in the metal basic sub-sector which has increased sharply by 758.8 percent in the year under review. The upsurge in the metal basic sub-sector was due to newly installed steel plants inside the country which increased domestic production and income from this industry.

Agriculture Sector

The agriculture sector dominates the economy with participation in GDP around 25.5 percent in FY1391, slightly down from 27 percent in 1390.

Afghanistan continues to be an agricultural country, although its share in total economic

activity has been declining for a long time. Data for FY1391 reveals that services constitute 50.3 percent of GDP, agriculture 25.4 percent, and industry 20.5 percent respectively.

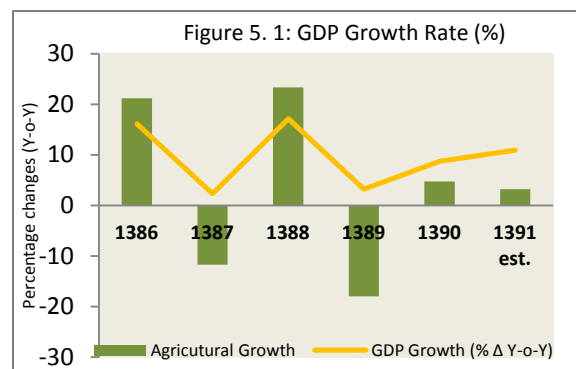
Agricultural production is estimated to return to its average level in FY1391, but because of the recorded level growth in 1390 the agriculture sector growth rate is estimated to be lower compared to the previous year.

Agriculture sector, one of the main contributors of GDP in Afghanistan, is expected to maintain upward trend in FY1392, thanks to a favorable weather condition, reasonable snow and seasonal rain falls. On the other hand, the stimulating measures taken by the Afghan government helped agricultural products. The government implements different development projects such as horticulture and livestock project, on-farm water management, rural business support project, agriculture market infrastructure project, rural micro-finance and livestock support program, land lease and management one stop window, reopening of agriculture development bank and many others, which, will boost the agriculture production and export of agriculture products.

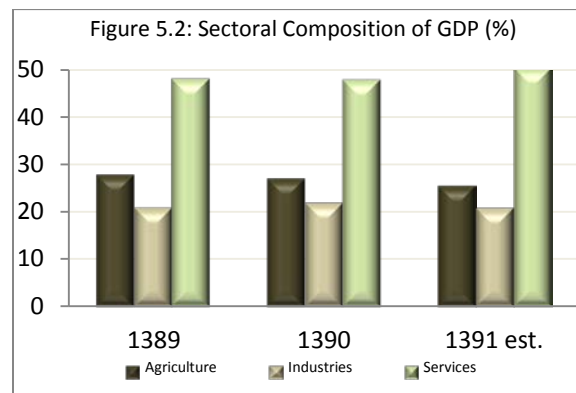
Total wheat production is expected to be about 3.2 million metric tons, this may result in a declining wheat and cereal prices throughout the country. Due to the importance of the wheat which comprises about 70 percent of

the diet for more Afghans, these favorable conditions helped to boost living standard. Income from livestock shows an increase of 0.5 percent in the FY1391; however the growth rate is lower than 3 percent recorded the previous year.

Income from fruits also was lower in the FY1391 representing an annual rate of 8 percent, somewhat lower from 10.3 percent in the previous year.



Source: Central Statistics Organization/DAB staff calculations



Source: Central Statistics Organization/DAB staff calculations

Table 5.1: Real GDP Growth by Sectors of Production (in percent)

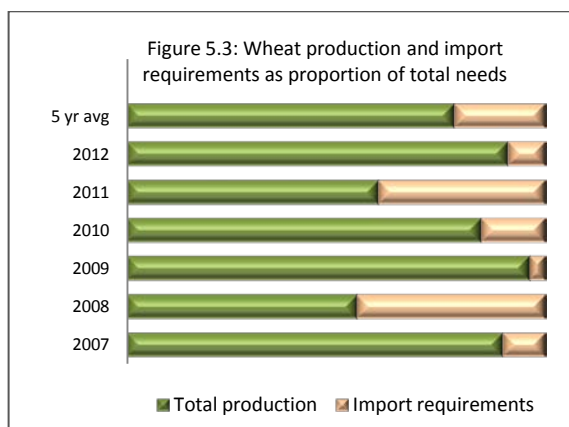
| | 1389 2010-11 | 1390 2011-12 | 1391 est. 2012-13 |
|---|-----------------|-----------------|----------------------|
| Agriculture | -18.0 | 4.7 | 3.2 |
| Cereals and other crops | -23.3 | 4.2 | 3.0 |
| Fruits and nuts | 22.6 | 10.3 | 8.0 |
| Livestock | -1.1 | 3.0 | 0.5 |
| Others | -31.4 | 24.4 | -16.2 |
| Industries | 6.3 | 9.8 | 7.8 |
| Mining and quarrying | 43.0 | 89.6 | -0.9 |
| Manufacturing | 3.8 | 3.0 | 7.4 |
| Food, beverage, & tobacco | 3.8 | 3.1 | 5.0 |
| Textile, wearing apparel & leather | 7.9 | -1.3 | 1.1 |
| Wood & wood prod, incl. furniture | -9.7 | 1.9 | 4.9 |
| Paper, paper prod, printing, publishing | 7.7 | -2.7 | 4.1 |
| Chemicals & chem. petroleum, coal , rubber, plastic | 6.1 | -0.6 | 0.6 |
| Non metallic mineral except petroleum and coal | 0.1 | 1.8 | 7.0 |
| Metal basic | 5.3 | 5.0 | 758.8 |
| Electricity, gas and water | -0.2 | -9.4 | -9.4 |
| Construction | 7.7 | 13.3 | 8.9 |
| Services | 18.1 | 10.3 | 16.0 |
| Wholesale & retail trade, restaurants & hotels | 5.3 | 10.8 | 25.0 |
| Wholesale & retail trade | 3.2 | 8.4 | 27.0 |
| Restaurants & hotels | 23.8 | 27.9 | 12.8 |
| Transport, storage and communications | 23.1 | 10.1 | 20.6 |
| Transport, storage | 6.2 | 9.0 | 28.1 |
| Post and telecommunications | 65.7 | 11.8 | 9.0 |
| Finance, insurance, real estate and business | 14.3 | -44.4 | 3.0 |
| Finance | 14.4 | -45.4 | 2.1 |
| Insurance | 5.0 | 728.1 | 68.3 |
| Real estate and business services | 1.1 | 1.5 | 3.4 |
| Ownership of dwellings | 1.9 | 5.9 | 7.0 |
| Community, social and personal services | 5.5 | 8.9 | 13.3 |
| Government services | 27.0 | 22.0 | 11.6 |
| Other services | 16.4 | 11.5 | -14.8 |
| Total | 3.0 | 8.6 | 10.6 |
| Less: Imputed bank service charge | | | |
| Taxes on imports | 10.2 | 9.8 | 18.7 |
| GDP Growth (%) | 3.2 | 8.7 | 10.9 |

Source: Central Statistics Organization

Table 5.2: GDP Composition by Sectors (in percent)

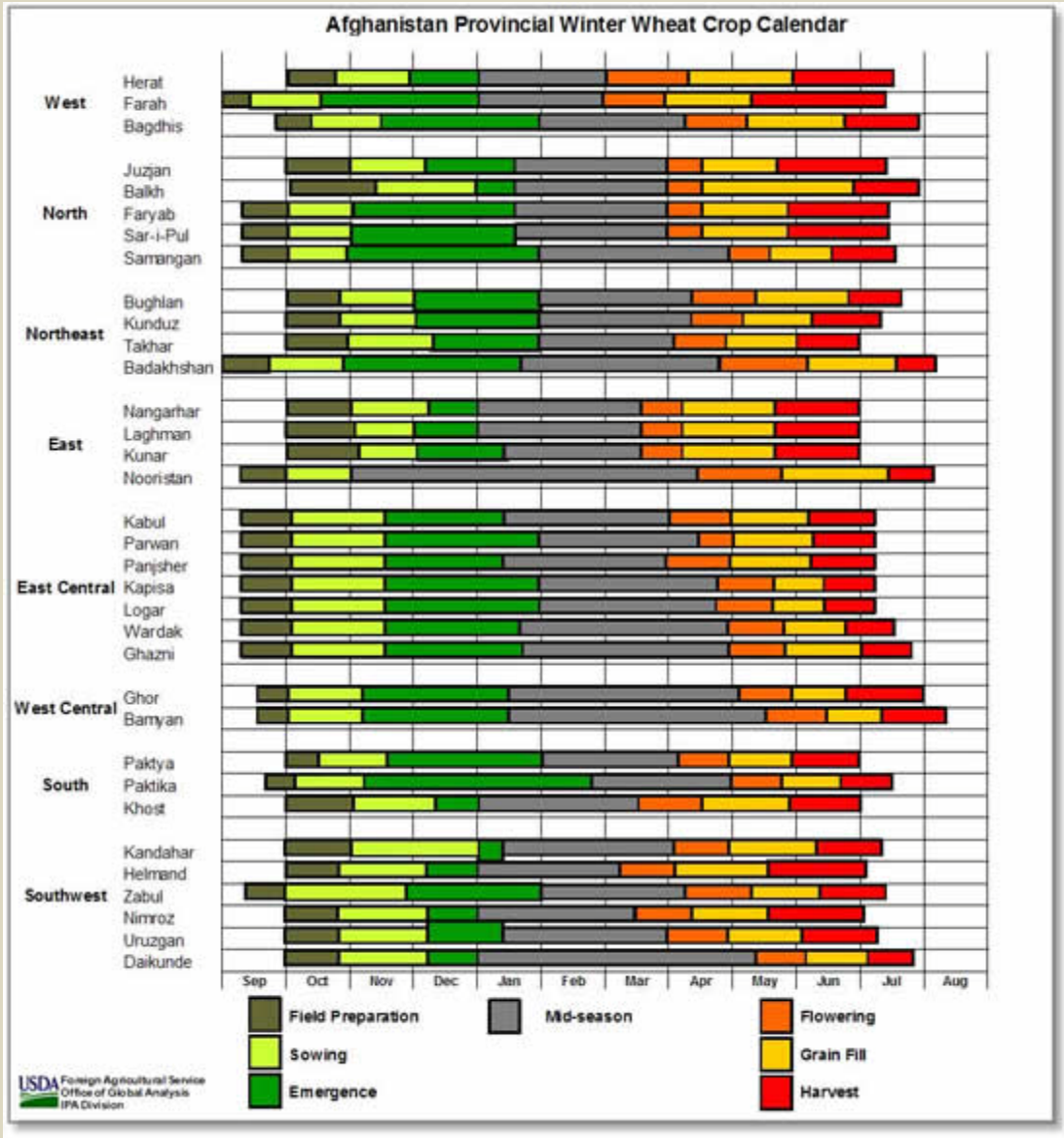
| | 1389 (2010-11) | 1390 (2011-12) | 1391 (2012-13) |
|-------------|-------------------|-------------------|-------------------|
| Agriculture | 27.76 | 26.98 | 25.41 |
| Industries | 20.57 | 21.58 | 20.52 |
| Services | 48.02 | 47.83 | 50.30 |

Source: Central Statistics Organization



Source: Ministry of Agriculture, Irrigation and Livestock (AIL)

Box 1: Afghanistan Provincial Winter Wheat Crop Calendar



Source: USDA

1.1 Gross Domestic Production by Expenditure Categories

One of the most common measures for calculating the Gross Domestic Product (GDP) is the expenditure method. Most market-based economies use this measure in order to assess and analyze the private consumption expenditures, private and public investment expenditure and net exports.

Private consumption expenditures are the most important expenditure category in Afghanistan. Private consumptions constitute about 84 percent of GDP in FY1391. However, the private consumption grew by 11 percent in FY1391, down from 13 percent recorded at the previous year.

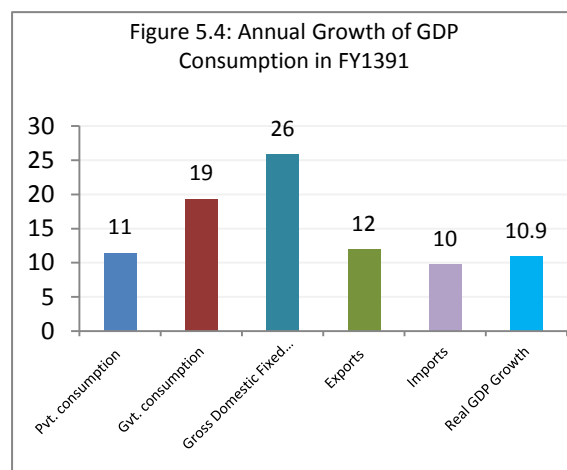
The government expenditure increased sharply by 14 percentage points in the FY1391. The government expenditures grew by 19 percent growth, up from 5 percent a year ago.

The share of real gross fixed investment in total GDP increased in the year under review standing at 16.4 percent, slightly up from 15.8 percent in the preceding year.

Export of goods and non factor services (NFS) increase sharply to 12 percent in FY1391 compared to a negative growth rate of 29 percent in 1390. This increase in exports could be attributed to both, supply and demand side.

On the other hand, import of goods and non factor services (NFS) showed somewhat decline in the reporting period. The NFS

declined by 5 percentage points from 15.4 percent in the year 1390 to about 10 percent in the fiscal year 1391.



Source: Central Statistics Office

2. OUTLOOK FOR 1391

Going forward, the outlook for the real GDP growth is favorable, despite some concerns about political, security, and the economic situation after 2014. The early economic growth projection of 3.1 percent for fy1392 was revised to 1.5 percent by the international monetary fund. However, DAB expects the economic growth about 4 percent for FY1392, primarily due a good performance of the agriculture sector as a result of favorable weather condition and seasonal snow falls. On the other hand the Afghan government initiated some measures to stimulate domestic agricultural productions which may help agricultural production.

The services sector is expected to decline somewhat in FY1392 due to withdrawal of

international forces which will affect the overall services, in particular the transportation and logistics, housing and rental services.

The industrial sector will maintain its current trend. Based on the figures from the Afghanistan Investment Supporting Agency

(AISA), the investment in this sector has been increasing steadily, which will lead to further economic growth. Nevertheless, foreseeable downside risks remain. These risks include a decline in overall capital inflows. However, the expected increase in income from mining sector will somewhat offset this loss.



CHAPTER VI

FISCAL SECTOR DEVELOPMENTS



6

FISCAL DEVELOPMENTS

Most definitions of fiscal sustainability all over the world are to build on the concept of solvency – the ability of the government to meet its future obligations, in formal terms the government’s ‘inter-temporal budget constraint’ requires it to raise enough revenue in future to cover all its non-interest spending, also to service, and eventually to pay off its outstanding debt over an infinite time horizon. This chapter defines fiscal sustainability information of the Afghan economy in the year 1391 and analyses implementation of budget, developments in domestic revenues and donor grants for the financing of both operating and development budgets compared to 1390. In the past few years, despite significant progress of Government of the Islamic Republic of Afghanistan (GIRA) in domestic revenue collection and broadening tax base, the fiscal sustainability indicator was only 67 percent in the FY1391, which shows a decline from 73 percent in the same period a year ago. However, the decline was due to increase in operating expenditure specifically in the security sector. And it is expected that

operating expenditures will keep increasing that will lead to continue deficits.

That aggregation, however, masks the fact that the second and third largest sources of general domestic revenues, were taxes and non-taxes revenues, and both showed high performance amounting to AF 99,200.319 million in the fiscal year 1391, up from AF 80,491.85 million and were over the targets estimation respectively. Ongoing revenues other than the individual custom duties revenues grew at a lethargic AF30,546.40 million, up from AF27,623.20 million screening only 11 percent augment, though custom duties performance was considered not as good as expected. Other attributes such as fixed taxes, indicated a slight increase of 11 percent, Income tax revenues stood at AF12,557.20 million representing 22 percent incline. Though sales taxes presented 14 percent increase, fell behind the targeted amount in the year 1391. Income from capital property increased respectively, observing 889 percent increment in the period under review. On the other hand, during fourth quarter, non-tax revenue was highly considered to be the second category that

had contributed to incline in the total domestic revenue, due to receipts from extractive industry.

Over the course of 1390, GIRA adopted standard mechanisms and techniques to project revenues on higher frequency in order to allow GIRA to prioritize development projects across the country, improve budget and expenditure planning and attain operational efficiency.

Total budget amounted to AF258,318.00 million, though only 77 percent was implemented. Core expenditures increased by 31 percent amount of 201,961.20 million in 1391. Operating expenditures increased to 149,293.60 million in 1390, representing an increase of 36 percent. The current budget execution rate was 96 percent. In addition, the development expenditures also increased to 52,667.50 million which shows 20 percent increment. However, the total core budget was still in deficit by the end of 1390. This mainly explains the sluggish performance of fiscal sustainability. The major reason for the deficit was continued increase in operating budget due to government gradually taking up security responsibility from international troops, that has also been the main reason for the deteriorated security situation in some parts of the country.

Besides, high performance of domestic revenue collections, government been able to increase the execution rate of development expenditure comparing to year 1389, though while implementation

the development expenditure remained comparable, actual expenditure against the development budget was slightly lower than in 1389.

Almost one of the third parts of operating budget was financed by donor grants, while entire development expenditure is being financed by donors. Allotted grants for both expenditures increased and indicated 24 percent of increase in the year under review.

1. REVENUES

Total domestic revenue target was agreed upon to AF 87,909.9 million, based on the negotiation between Ministry of Finance (MoF) and the International Monetary Fund (IMF), under the Extended Credit Facility, Poverty Reduction and Growth Facility (PRGF-ECF) program. However, during the nine months of the fiscal year 1391 total revenues collected was below the target due to a decrement in the total revenue collected from custom duties.

Total domestic revenues stood at AF82,184.75 million in the FY 1391, below the target of AF 87,90.00 million showing a decrease of 6 percent or amount of AF6,200.00 million. Domestic revenues showed 17 percent lower collection compared to AF99,420.06 million collected in 12 months of FY1390. However, total collection compared to the nine months of fiscal year 1390 showed 18 percent increased from AF69,880.98 million to AF82,184.75 million in the same period of

last year. Besides the increase in the total collection of domestic revenue compared to 1390, it fell behind the target collection for the fiscal year 1391.

Most of the gap was due to lower anticipation of the total collection of tax revenues and custom duties due to decline in import volume during FY 1391. On the positive side, total domestic revenues increased compared to twelve months of 1390. Total tax revenues amounted to AF38,638.20 million, down from AF44,983.37 million compared to twelve months of 1390, showing a 12 percent decrease. However, compared to nine months of 1390 total collections showed a 26 percent increase with the total collection of AF30, 773.51 million. The total tax revenue collection also fell behind its annual target of AF41,400.00 million. The main contributors in tax revenues were sales taxes, income taxes, property taxes, fixed taxes, tax penalties and fines, custom duties and other taxes.

Sales tax revenue continued to be the major provider of tax revenue for almost four years. However, during FY1391 sales tax revenues presented a 20 percent of decrease by total collection of AF14,894.72 million, which is below the total collection of AF18,630.22 million in 1390. Although, with the comparison to nine months of 1390, total sales tax collection showed a 18 percent increase over AF12,670.52 million in 1390. Sales tax revenues not only showed a decrease compared to previous year it

also remained behind the annual target of AF17,054.8 million for FY 1391. The main reason for this reduction was slight changes in the contributors of sales taxes. The main contributors in this category were BRT (Receipts Private Entities) and tax imposed on government contracts for goods and services.

Revenues collected from fixed taxes amounted to AF8,223.18 million during FY 1391, down from AF10,080.58 million in 1390, showing a considerable decrease of 18 percent. However, with comparison to nine months of 1390 it showed 20 percent increase, a collection of AF6,876.73 million compared to the same period last year. The major collections were from three taxes were from imports by licensed businesses, fixed taxes on the government contracts, and imports by unlicensed businesses.

Income taxes increased to AF13,530.90 million, up from AF12,599.34 million, representing 7 percent increment due to withholdings from taxes on employee's salaries and wages, as well as tax on interest and construction. On the positive side income tax also showed 54 percent rise compared to the nine months of 1390. According to MoF, the major reason for the rise is government's enforcement measures and letters to the innumerable companies that ran into better performance of incorporate income tax. On the other hand, property taxes puffed-off to amount of AF215.02 million in FY1391 from AF389.98 million, indicating an extensive decrease of

45 percent compared to 1390. Conversely, tax penalties and fines also showed the same percentage of decrement with the total collection of AF317.36 million, down from AF574.41 million which depicts a 45 percent decline. In addition, the other taxes amount also indicated 45 percent decrease with total collection of AF1,457.02 million in the FY1391, down from AF2,708.85 million in the first nine months of 1390.

Besides the sluggish enactment of tax revenues, total collection was also mainly affected by its major contributor, custom duties, which also showed lower performance. Custom duties total collection amounted to AF21,402.11 million, down from AF30,546.44 million, representing 30 percent decrease. On the negative side, with comparison to the nine months of 1390, it also showed a slight decrease of 5 percent. Not only it screened decrease it also fell behind the annual target of AF30,797.9 million. Custom duties total collection mostly consists of fees collected from custom offices at the borders or airports. The reason behind the shortfall was also caused by lower taxable imported goods in general, specifically in vehicles and some luxury items.

The second major contributor in domestic revenues was non-tax revenues with a total

compilation of AF19,527.98 million in the FY1391, down from AF20,904.85 million recorded in the year 1390, showing a slight decrease of 7 percent. However, non-tax revenue hit over the annual target of AF13,141.5 million by 37 percent. Non tax revenues incorporate of income from capital property, sales of goods and services, administrative fees, royalties and non-tax penalties and fines. Nevertheless, according to MoF, the largest portion of this category was revenue collected from Mobile Telephone services.

Social contribution which includes government employee contributions for retirement and pension also presented a decrease of 12 percent with a total collection amount of AF2,616.45 million in FY1391, down from AF2,985.39 million in 1390. Most of the social contribution was coming from the shares of employee's in the fund and pension plans of government salaries and wages.

On the whole, the collections of domestic revenue during fiscal year 1391 were sluggish due to shortfalls in import volumes as well as in the custom duties. However, the reason behind the shortfalls is mainly due to concerns about the Transition of NATO forces from Afghanistan in 2014.

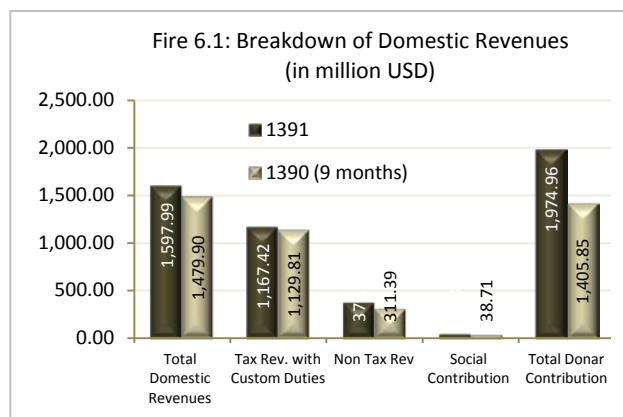


Table 6.1: Revenue Collection, (in million AF)

| Tax and Non- Tax Revenues | FY1391 Actual | 1390 (9 moths) Actual | 1390 (12 months) | 1390 (9 months) | % Δ 1391 to 1390 |
|--|---------------|-----------------------|------------------|-----------------|------------------|
| Total Domestic Revenues (Tax and Non Tax) and Custom Duties | 183,756.71 | 136,265.40 | 195,171.06 | 142% | -33% |
| Tax Revenues with Custom Duties | 60,040.32 | 53,349.55 | 75,529.82 | 13% | -21% |
| Non-tax Revenues | 19,527.98 | 14,703.65 | 20,904.85 | 33% | -7% |
| Social Contribution | 2,616.45 | 1,827.78 | 2,985.39 | 43% | -12% |
| Total Donor Contribution | 101,571.96 | 66,384.42 | 95,751.01 | 53% | 6% |

Source: Ministry of Finance (Financial Statement) website and DAB staff calculation

Table 6.2: Revenue Collection (in million USD)

| Tax and Non- Tax Revenues | FY1391 Actual | 1390 (9 months) | 1390 (12 months) |
|--|---------------|-----------------|------------------|
| Total Domestic Revenues (Tax and Non Tax) and Custom Duties | 501.22 | 2,600.18 | 515.47 |
| Tax Revenue and Custom Duties | 391.34 | 718.87 | 371.26 |
| Non-tax Revenues | 152.32 | 299.95 | 144.20 |
| Social Contribution | | | |
| Total Donor Contribution | 794.89 | 1,519.11 | 425.46 |

Table 6.3: Breakdown of Tax and Non-tax Revenues (in million AF)

| Tax and Non- Tax Revenues | FY1391 Actual | 1390 (9 months) | 1390 (12 months) | % Δ 1391 to 9 mth. 1390 | % Δ 1391 to 12 mth 1390 |
|--|-------------------|------------------|------------------|-------------------------|-------------------------|
| Fixed Taxes | 8,223.18 | 6,876.73 | 10,080.58 | 20% | -18% |
| Income Taxes | 13,530.90 | 8,767.65 | 12,599.34 | 54% | 7% |
| Property Taxes | 215.02 | 256.84 | 389.98 | -16% | -45% |
| Sales Taxes | 14,894.72 | 12,670.52 | 18,630.22 | 18% | -20% |
| Excise Taxes | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Other Taxes | 1,457.02 | 1,810.51 | 2,708.85 | -20% | -46% |
| Tax Penalties and Fines | 317.36 | 391.26 | 574.41 | -19% | -45% |
| Customs duties | 21,402.11 | 22,576.04 | 30,546.44 | -5% | -30% |
| Total taxation revenues | 60,040.32 | 53,349.55 | 75,529.82 | 13% | -21% |
| Retirement contributions | 2,616.45 | 1,827.78 | 2,985.39 | 43% | -12% |
| Total social contributions | 2,616.45 | 1,827.78 | 2,985.39 | 43% | -12% |
| Income from Capital Property | 2,927.23 | 2,644.49 | 2,775.66 | 11% | 5% |
| Sales of Goods and Services | 7,953.69 | 3,476.83 | 7,374.15 | 129% | 8% |
| Administrative Fees | 6,573.95 | 6,177.29 | 8,950.66 | 6% | -27% |
| Royalties | 199.25 | 126.03 | 279.54 | 58% | -29% |
| Non Tax Fines and Penalties | 407.24 | 428.44 | 671.38 | -5% | -39% |
| Extractive Industry | 141.30 | 74.49 | 166.70 | 90% | -15% |
| Miscellaneous Revenue | 1,147.55 | 1,737.79 | 627.81 | -34% | 83% |
| Total other revenue | 177.78 | 38.30 | 58.95 | 364% | 202% |
| Afghanistan Reconstruction Trust Fund (ARTF) | 26,420.18 | 10,640.22 | 20,139.09 | 148% | 31% |
| Law and Order Trust Fund – Afghanistan (LOTFA) | 18,837.49 | 18,181.89 | 25,074.91 | 4% | -25% |
| CSTC – MoD | 32,503.59 | 27,406.22 | 29,183.28 | 19% | 11% |
| Foreign loans | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| World Bank | 423.64 | 185.41 | 657.46 | 128% | -36% |
| Asian Development Bank | 1,399.43 | 676.91 | 1,226.75 | 107% | 14% |
| Other | 348.00 | 153.52 | 322.73 | 127% | 8% |
| Donor revenue | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| World Bank | 5,352.42 | 3,643.09 | 6,173.91 | 47% | -13% |
| European Commission | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| ADB | 8,818.14 | 2,376.15 | 7,474.83 | 271% | 18% |
| DFID | 154.89 | 12.14 | 23.18 | 1176% | 568% |
| US & USAID | 3,921.07 | 1,235.93 | 2,925.46 | 217% | 34% |
| Others | 3,393.12 | 1,872.95 | 2,549.40 | 81% | 33% |
| Total Donor Contributions | 101,571.96 | 66,384.42 | 95,751.01 | 53% | 6% |
| Loan from IMF | - | - | - | | |

2. EXPENDITURES

According to the worldwide classification, government expenditure is regularized to operational and development expenditures.

Total integrated budget allocated for 1391 were AF265,320.7 million that indicates the increment of 3 percent over the total allocated budget of AF258,318.00 million in the year 1390.

From the billed expenditure, the government executed only 77 percent while the execution rate of current budget was 86 percent compared to 96 percent in 1390. On the contrary, the implementation rate of development expenditure was 49.7 percent that is indicating 0.3 percent of descend comparing to the same period of 1390.

Overall payout expenditures amounted to AF189,200.56 million during FY1391 down from AF198,247.41 million in 1390, showing 5 percent or AF9,046.84 million decrease. However, with comparison to the nine months of previous year it is showing 46 percent of increment from AF129,438.60 million in the same period of 1390. Although, total core budget were AF 76,120.14 million less than allocated budget it made up to 24.3 percent of GDP. The current or operating expenditure decreased from AF149,301.29 million to AF135,792.13 million during the FY1391, showing a 9 percent decline, accounted for 17.5 percent of GDP. The final allocated budget for operating expenditures was AF157,970.6 million, up from AF155,943.1 million during FY1391 compared to the preceding year.

On the contrary, development expenditures were expanded to AF53,408.43 million from a sum of AF48,946.12 million, indicating 9 percent or AF4,462.32 million of increment. However, final budget allocated for development expenditures increased to AF107,350.1 million in the FY1391, compared to AF102,374.9 million in the s

year 1390. Development expenditures accounted for 6.9 percent of GDP.

Current expenditures incorporate five categories: compensation of employees, goods and services, subsidies and grants, interest payments and acquisition of non-financial assets.

Compensation of employees that includes wages and salaries, food for employees, transportation, advance payments and some minor social benefits, decreased from AF111,716.74 million to AF98,405.41 million in the FY1391, which indicates a slight decrease of 0.12 percent. Although compared to nine months of 1390, the total collection presents 29 percent increase from amount of AF76,555.34 million. The increment in spending usually comes from attribution of rapid addition in the tashkeel of ANSF and implementation of the pay and grading reforms which has lead to increase in the level of civil servants employment.

Supplier expenses also decreased to AF25,159.37 million in the FY1391, down from AF25,864.80 million in 1390, this represents a slight decline of 0.03 percent. However, with comparison to nine months of 1390 it shows a significant increase of 74.6 percent, from an amount collection of AF14,407.05 million. This category contains travel, communication, contracted services, repairs and maintenance, utilities, fuel sections and is accounted for 3.2 percent of GDP. Based on the information from MoF the higher collection occurred due to supplement from the transfer of fuel

expenditure by the government budget, which was governed directly by the donors.

The category that has a major role in spending of operating expenditure includes pension payments to retired civil servants and officers in the police and army, subsidies to state owned enterprises and capital transfer. This category also fell behind the target of AF15,784.0 million. Total collections for this category were AF8,320.72 million in FY1391, down from AF8,936.03 million in 1390, showing a slight decrease of 0.07 percent. Nonetheless, with comparison to the nine months of 1390 it showed 54 percent of augment from total collection of AF5,397.42 million. The performance of this category is based on the total allocation to pension's new system where higher benefits are arranged.

Expenditures on interest payments declined to AF90.39 million in the FY1391, down

from AF91.98 million in 1390 indicating only 0.02 percent decrease. Interest payment is a small sum of concessional loans that helps a government to finance its development projects. Afghanistan is one of the most aid dependent countries that have received significant foreign aids since 2001. After the establishment of the transitional government, the international community committed significant assistance to the rebuilding of Afghanistan.

GIRA borrows on highly concessional terms to finance a limited number of discretionary development projects.

Comparatively, smaller but rapidly growing parts of the operating budget were subsidies, grants and social transfers. Subsidies to state owned enterprises, capital transfers to municipalities, and social expenditures such as pensions are included here.

Table 6.4: Core Expenditures (in million AF)

| Particulars | 1391 Expenditure Actual | 1390 Expenditure Actual (9months) | 1390 Expenditure Actual (12 months) | % Δ from 1391- to 1390 (9 months) | % Δ from 1391- to 1390 |
|--|-------------------------------|--|--|--|------------------------------|
| Total Expenditures(Development and Operating) | 189,200.56 | 129,438.60 | 198,247.41 | 107% | 0% |
| Development Expenditures | 53,408.43 | 31,884.54 | 48,946.12 | 68% | 9% |
| Operating Expenditures | 135,792.13 | 97,554.06 | 149,301.29 | 39% | -9% |

Source: Ministry of Finance website and DAB staff calculation

Table 6.5: Core Expenditures (in million USD)

| Particulars | 1391 9 months | 1390 9 months | 1390 12 months |
|--|------------------|------------------|-------------------|
| Total Expenditures(Development and Operating) | 3,678.80 | 2,741.18 | 4,150.91 |
| Development Expenditures | 1,038.47 | 675.23 | 1,024.83 |
| Operating Expenditures | 2,640.33 | 2,065.95 | 3,126.07 |

Source: Ministry of Finance website and DAB staff estimation

End Period Average exchange rate of FY1390 (ER=47.73) and FY1389 (ER=45.7)

Table 6.6: Breakdown of Development Expenditures (in million AF)

| Particulars | 1391 | 1390 | Year 1390 | % Δ FY1391 to 9 months of 1390 | % Δ FY1391 to 12 months 1390 |
|--|------------------|------------------|------------------|--------------------------------|------------------------------|
| Employees | | | | | |
| Salaries in cash | - | - | - | - | - |
| Salaries in kind | - | - | - | - | - |
| Salaries and wages advance | - | - | - | - | - |
| Social benefits in cash | - | - | - | - | - |
| Social benefits - in kind | - | - | - | - | - |
| Total employee expenditure | - | - | - | - | - |
| Supplier Expenditure | | | | | |
| Travel | 381.87 | 193.53 | 358.97 | 97% | 6% |
| Communications | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Contracted services | 16,179.39 | 8,051.72 | 16,060.45 | 101% | 1% |
| Repairs and maintenance | 154.36 | 151.51 | 757.30 | 2% | -80% |
| Utilities | 208.77 | 98.15 | 173.84 | 113% | 20% |
| Fuel | 70.22 | 27.53 | 93.81 | 155% | -25% |
| Tools and materials | 693.63 | 431.40 | 902.74 | 61% | -23% |
| Other | 722.83 | 502.38 | 721.51 | 44% | 0% |
| Advances and return of expenditure | 3,254.31 | 2,127.91 | 1,777.16 | 53% | 83% |
| Total supplier expenses | 21,665.38 | 11,584.12 | 20,845.76 | 87% | 4% |
| Subsidies, grants, contributions and pensions | | | | | |
| Grants | 0.00 | 0 | 0.00 | 0.00 | 0.00 |
| Grants to foreign government a | 0.00 | 0 | 0.00 | 0.00 | 0.00 |
| Social security benefits cash | 0.00 | 0 | 0.00 | 0.00 | 0.00 |
| Social assist benefit in cash | 0.00 | 0 | 0.00 | 0.00 | 0.00 |
| Advance Subsidies Grants | 0.00 | 0 | 0.00 | 0.00 | 0.00 |
| Total subsidies, grants, contributions and pensions expenditure | 0.00 | 0 | 0.00 | 0.00 | 0.00 |
| Buildings and structures | 20,788.10 | 9,301.83 | 20,176.71 | 123% | 3% |
| Machinery and equip (>50,000) | 3,583.94 | 2,798.88 | 5,712.31 | 28% | -37% |
| Valuables | 1.14 | 3.00 | 3.00 | -62% | -62% |
| Land | 131.91 | 16.73 | 132.43 | 688% | 0% |
| Capital advance payments | 7,237.96 | 8,179.97 | 2,075.91 | -12% | 249% |
| Total capital expenditure | 31,743.05 | 20,300.42 | 28,100.36 | 56% | 13% |

Source: MoF website (Financial Statement) and DAB staff calculations

Table 6.7: Breakdown of Operating Expenditures (in million AF)

| Particulars | FY1391 | 1390 (9 months) | 1390 (12 months) | % Δ FY1391 to 1390 | % Δ FY1391 to (12 month 1390 |
|--|------------------|--------------------|------------------------|-----------------------|------------------------------------|
| Salaries in cash | 81,377.75 | 64,718.80 | 94,765.13 | 26% | -0.14 |
| Salaries in kind | 16,550.88 | 11,170.39 | 16,495.88 | 48% | 0.00 |
| Salaries and wages advance | 10.60 | 299.65 | 5.03 | -96% | 1.11 |
| Social benefits in cash | 466.18 | 366.50 | 450.69 | 27% | 0.03 |
| Social benefits - in kind | - | - | - | - | - |
| Total employee expenditure | 98,405.41 | 76,555.34 | 111,716.74 | 29% | -0.12 |
| Supplier Expenditure | | | | | |
| Travel | 1,124.64 | 979.36 | 1,407.25 | 15% | -0.20 |
| Communications | 0.00 | 0.00 | 0.00 | 0.00 | 0.00 |
| Contracted services | 546.34 | 168.24 | 1,797.84 | 225% | -0.70 |
| Repairs and maintenance | 1,154.70 | 1,844.55 | 3,791.95 | -37% | -0.70 |
| Utilities | 6,981.79 | 992.28 | 2,208.40 | 604% | 2.16 |
| Fuel | 4,658.65 | 2,515.71 | 4,883.30 | 85% | -0.05 |
| Tools and materials | 4,734.68 | 3,376.66 | 6,222.32 | 40% | -0.24 |
| Other | 5,240.25 | 3,355.60 | 4,450.47 | 56% | 0.18 |
| Advances and return of expenditure | 718.32 | 1,174.65 | 1,103.27 | -39% | -0.35 |
| Total supplier expenses | 25,159.37 | 14,407.05 | 25,864.80 | 74.6% | -0.03 |
| Subsidies, grants, contributions and pensions | | | | | |
| Grants | 1,045.98 | 34.10 | 1,146.77 | 2967% | -0.09 |
| Grants to foreign government a | 148.92 | 0.00 | 4.30 | 2% | 33.63 |
| Social security benefits cash | 6,804.71 | 4,532.83 | 7,429.56 | 50% | -0.08 |
| Social assist benefit in cash | 296.74 | 123.51 | 278.61 | 140% | 0.07 |
| Advance Subsidies Grants | 24.37 | 706.98 | 76.79 | -97% | -0.68 |
| Total subsidies, grants, contributions and pensions expenditure | 8,320.72 | 5,397.42 | 8,936.03 | 54% | -0.07 |
| Buildings and structures | 1,503.82 | 363.85 | 739.55 | 313% | 1.03 |
| Machinery and equip (>50,000) | 2,110.35 | 497.10 | 1,380.99 | 325% | 0.53 |
| Valuables | 11.92 | 0.92 | 1.27 | 1191% | 8.39 |
| Land | 186.67 | 127.30 | 527.49 | 47% | -0.65 |
| Capital advance payments | 3.47 | 120.60 | 42.44 | -97% | -0.92 |
| Total capital expenditure | 3,816.23 | 1,109.78 | 2,691.74 | 244% | 0.42 |
| Interest | 90.39 | 84.48 | 91.98 | 7% | -0.02 |
| Total interest expenditure | 90.39 | 84.48 | 91.98 | 7% | -0.02 |

Source: MoF website (Financial Statement) and DAB staff calculations

3. FINANCING THE CORE BUDGET

Grants finance almost the entire development budget and one third of operating budget with the remaining part is financed through concessional loans. The Afghan government receive the grants from various donors, trusts and international committees to finance variety of programs in both, operating and development expenditures. Integrated grants increased in the FY1391 compared to 1390. Moreover, total grants financed only one third of the operating expenditures and the entire development expenditure. However, total allocated grants for the operating budget has increased in percentage, on the other hand, grants on the development budget decreased compared to the same period last year.

Total development and operating grants in the FY1391 amounted to AF101,571.96 million, up from AF95,751.01 million in 1390 showing 6 percent of increase, from which the operating grants were AF65,642.06 million in FY1391, up from AF62,400.00 million in 1390, showing 8.6 percent of increase. On the other hand, development grants stood at AF 35,929.89 million. However, during the year 1390 the total development grants were AF83,100.00 million, from which only 32 million were new grants and the rest was carried over from the year 1389. Nevertheless, grants received from LOTFA scheme has decreased to AF18,837.49 million in the FY1391, down from AF25,074.91 million in 1390, representing 25 percent decline. On the other hand, grants received from ARTF scheme increased to AF26,420.18

million in the year under review compared to AF20,139.09 million in 1390, this represents a 31 percent increase. Generally, the turn down in grants from ARTF is going to be gradually done while government is able to cover the expenditure from its own domestic revenues and accepting the responsibilities. ARTF funds the salaries to non-uniform government's employees.

Grants received from CSTC- MoD scheme increased to AF32,503.59 million in 1391, up from AF29,183.28 million in 1390, showing 11 percent of increase. Mostly, LOTFA grants finances the salaries and food expenditures of the Afghanistan National Police and the Prison Department of Ministry of Justice.

Besides the addition of extractive industry in domestic revenues, which is the mineral resource from Aynak, government has not been able to finance both operating and development budgets. Donor grants made up significant part of the total expenditures, almost 60 percent of the budget while, the remaining portion of expenditure was financed using the concessional loans and partly through domestic revenue. Due to increase in operating expenditure, the government budget is in deficit. However, the government is required to make more efforts to increase domestic revenues in order to move toward sustainability, where total revenue collection either equals or to exceed total expenditure. In addition, the government should keep up with the current level of the development execution rate.

Moreover, the government is continuing to take the security responsibility of the remaining provinces of the country during transition period until 2014.

Fiscal management and public administration reform (FMPAR), sponsored by ADB is to develop systems and procedures supported by enhanced capacity aimed at improving budget programming, strengthening revenue mobilization, developing the civil service and improving monitoring capabilities of public finances. More specifically, FMPAR will:

(i) Strengthen fiscal management,

(ii) Strengthen public administration,

(iii) Strengthen public financial management,

(iv) Develop a framework for public service delivery,

This program will contribute to fiscal management, revenues reforms and budget financing.

Government uses any surplus to increase the cash reserves at Treasury Single Account (TSA), or to repay debts and reduce its liabilities. A budget deficit is financed through cash reserves at TSA, or loans, which increases liabilities.

Table 6.8: Donor Contributions, 1390 (in million AF)

| Donor Contribution | Operating Grant | Development Grants |
|---|------------------|--------------------|
| Afghanistan Reconstruction Trust Fund | 14,238.66 | 12,181.52 |
| Law and Order Trust Fund - Afghanistan | 18,837.49 | |
| CSTC - MoD | 32,503.59 | |
| Foreign loans | | |
| World Bank | | 423.64 |
| Asian Development Bank | | 1,399.43 |
| Other | | 348.00 |
| Donor revenue | | 0.00 |
| World Bank | | 5,352.42 |
| European Commission | | 0.00 |
| ADB | | 8,818.14 |
| DFID | | 154.89 |
| US and USAID | | 3,921.07 |
| Others | 62.33 | 3,330.79 |
| Total donor contributions | 65,642.06 | 35,929.89 |

Source: Ministry of Finance website and DAB staff calculation

Table 6.9: Breakdown of Donor Contribution, FY1391 (in million AF)

| Donor contributions | FY 1391 | FY 1390 (9 months) | 12 months 1390 | % Δ |
|--|-------------------|--------------------|-------------------|------------|
| Afghanistan Reconstruction Trust Fund | 26,420.18 | 10,640.22 | 20,139.09 | 148% |
| Law and Order Trust Fund - Afghanistan | 18,837.49 | 18,181.89 | 25,074.91 | 4% |
| CSTC - MoD | 32,503.59 | 27,406.22 | 29,183.28 | 19% |
| Foreign loans | | | | |
| World Bank | 423.64 | 185.41 | 657.46 | 128% |
| Asian Development Bank | 1,399.43 | 676.91 | 1,226.75 | 107% |
| Other | 348.00 | 153.52 | 322.73 | 127% |
| Donor revenue | 0.00 | 0.00 | 0.00 | 0% |
| World Bank | 5,352.42 | 3,643.09 | 6,173.91 | 47% |
| European Commission | | | | |
| ADB | 8,818.14 | 2,376.15 | 7,474.83 | 271% |
| DFID | 154.89 | 12.14 | 23.18 | 1176% |
| US and USAID | 3,921.07 | 1,235.93 | 2,925.46 | 217% |
| Others | 3,393.12 | 1,872.95 | 2,549.40 | 81% |
| Total donor contributions | 101,571.96 | 66,384.42 | 95,751.0 | 53% |

Source: Ministry of Finance website and DAB staff calculations.



CHAPTER VII

BANKING SYSTEM

PERFORMANCE



7

BANKING SYSTEM PERFORMANCE

A sset base of the banking sector grew by 13.57 percent over the FY1391 (2.48 percent in Dec.2011) or AF 26.76 billion, reaching AF223.97 billion compared to AF197.21 billion in the same previous period.

Gross loans depicted 4.62 points growth, standing at AF42.16 billion since December, 2011,

While deposits stood at AF192.24 billion, up by 11.28 percent from the previous period.

Deposits were largely denominated in USD (66.92 percent) with Afghani denominated deposits lagging at 29.53 percent. AF-denominated deposits exhibited a decrease of 1.85 percent, while USD denominated deposit were up by 17.94 percent.

The capital base of the banking sector remained strong at AF16.63 billion, increased by 3.92 percent mostly on account of injections. The capital adequacy ratio (CAR) of the banking sector was 21.78 percent.

On a cumulative basis, the banking sector incurred losses amounting to AF943 million annualized compared to AF2.05 billion

recorded in March 2012, a decrease of AF1.11 billion, mostly driven by an increase in net-interest income. The return on asset (ROA) improved to -0.59 percent while return on equity (ROE) was -8.13 percent against -1.01 percent and -14.98 percent, respectively. Private Banks and branches of foreign banks finished with profits, while state-owned banks ended up with losses for the period under analysis.

1. ASSET OF THE BANKING SYSTEM

The asset size of the banking sector grew by 13.57 percent against that of 2.48 percent in the same previous period. Figure 7.1

The breakdown of total assets reveals that the most obvious increase was registered with Inter-bank claims (up by AF 17.53 billion or 44.46 percent) The second major increase was posted by investments (up by AF 1.46 billion or 25.09 percent), cash in vault and claims on DAB showed AF 15.81 billion or 18.57 percent increase; while NDF category witnessed decreases.

The most important components of the system's total asset portfolio were cash in vault/claims on DAB (45.05 percent), inter-bank claims (25.44 percent), net loans (18.04 percent) and "other assets" (8.44

percent). While the share of other components of total assets were negligible.

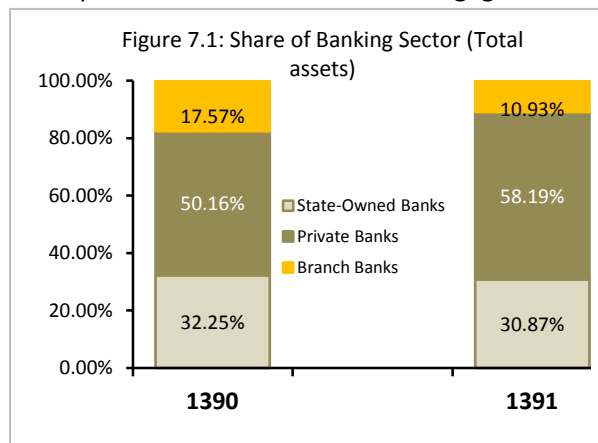
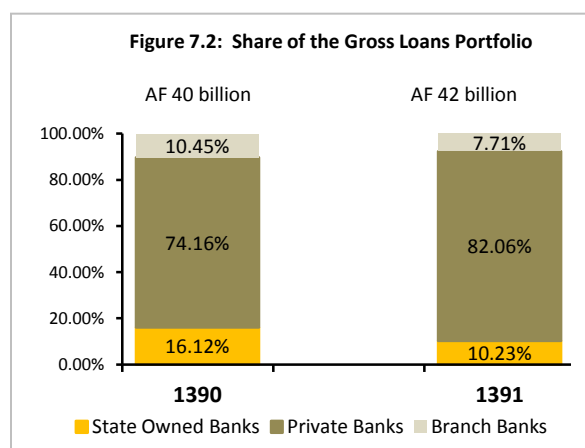


Table 7.1: Composition of Assets and Liabilities

| Assets | Qaws 1390 Dec. 2011 | Qaws 1391 Dec. 2012 | % of Total | Y-0-Y |
|---------------------------------|------------------------|------------------------|------------|--------------|
| Cash in vault and claims on DAB | 85,100 | 100,909 | 45.05 | 18.57 |
| Inter-bank claims | 39,441 | 56,974 | 25.44 | 44.46 |
| Investments | 5,821 | 7,282 | 3.25 | 25.09 |
| Loans (Net) | 38,686 | 40,412 | 18.04 | 4.46 |
| NDF | 9,820 | 1,498 | 0.67 | -84.74 |
| Others | 18,344 | 18,901 | 8.44 | 3.03 |
| Total | 197,212 | 223,976 | | 13.57 |
| Liabilities | | | | |
| Deposits | 172,751 | 192,247 | 92.72 | 11.28 |
| Borrowings | 1,649 | 3,349 | 1.62 | 103.09 |
| NDT | 564 | 1,507 | 0.73 | 167.19 |
| Others | 6,243 | 10,240 | 4.94 | 64.02 |
| Total | 181,207 | 207,343 | | 14.42 |
| Equity Capital | | | | |
| Equity Capital | 16,005 | 16,633 | | 3.92 |

1.1 Gross Loans

Total gross loans exhibited an increase of AF1.87 billion since the previous period (December 2011), constituting 18.83 percent of the total assets. Increases in lending were observed at seven banking institutions, whereas seven banking institutions decreased their portfolio. The remaining two did not participate in lending.



Source: Financial Supervision Department/DAB

Private Banks are the leading lenders, compared to the previous period their portfolios both in absolute terms as well as percentage of total loans has increased, currently standing at AF 34.60 billion or 82.06 percent of total loans. The portfolio of state-owned banks and that of branches of foreign banks were AF 4.31 billion (10.23 percent of the total loans) and AF 3.25 billion (7.71 percent of the total loans) in percent share and amount respectively.

1.1.1 Loan Loss Reserves

While assessing the level of credit risk, banks must give due attention to credit risk mitigation tools within their 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 FY1391 (December, 2012), a total provision cover of the system was 4.15 percent of total gross loans in comparison with 4 percent in the same previous period.

1.1.2 Distribution of Credit

Sector wide analysis shows that major portion of the loan portfolio is classified as “other commercial loans” (69.15 percent compared to 65.99 percent in December 2011), mainly in trade (28.30 percent), services (15.94 percent), manufacturing (11.88 percent). Agricultural loans showed a reasonable increase making 2.66 percent of total loans. Concentration in trade, services, mortgage loans and manufacturing loans to the exclusion of all other types of lending has been the dominant trend. Lending in trade, communication, services, utilities, agriculture and “all other loans” category of total loans have witnessed an increase during this period (Table 7.4). Loans to SMEs and Micro Credit sectors decreased to AF6.51 billion provided by seven banking institutions. Still, lending is picking up, although not significant in some loan

categories related to important sectors of the economy, e.g. agriculture, mining and communication sectors. About 79.07 percent of the loans were designated in Kabul with Herat and Balkh provinces in the second and third places respectively. The proportion of loans in other provinces was

negligible. The designation of loans by sector, geography and institution are not adequately diversified, but it is expected to improve. It is desirable that all banks take active part in lending, so as to diversify lending services and properly perform their role in financial intermediation.

Table 7.2: Sectoral Distribution of Credit

| Ratios | 1386 | 1387 | 1388 | 1389 | 1390 | 1391 |
|---|----------|----------|----------|----------|----------|-----------|
| | (Mar 08) | (Mar 09) | (Mar 10) | (Mar 11) | (Mar 12) | (Dec. 12) |
| Commercial Real Estate and Construction Loans | 9.54 | 0.19 | 19.92 | 25.98 | 2.85 | 2.29 |
| Other Commercial Loans | 79.14 | - | - | - | - | - |
| Mining | N.A | - | - | 0.02 | 0.72 | 0.11 |
| Manufacturing | N.A | 0.01 | 1.22 | 2.72 | 13.32 | 11.88 |
| Trade | N.A | 0.51 | 32.29 | 34.16 | 27.84 | 28.30 |
| Communication | N.A | 0 | 1.04 | 1.23 | 0.94 | 2.35 |
| Service | N.A | 0.09 | 4.84 | 6.72 | 11.95 | 15.94 |
| Utilities | N.A | 0.01 | 2.47 | 0.03 | 0.3 | 0.07 |
| Others | N.A | 0.09 | 25 | 8.42 | 10.89 | 10.50 |
| Agricultural Loans | 0.13 | 0 | 0.88 | 0.75 | 2.06 | 2.66 |
| Consumer Loans | 2.17 | 0.02 | 1.33 | 1.01 | 0.82 | 0.74 |
| Residential Mortgage Loans to Individuals | 2.28 | 0.01 | 7.3 | 8.95 | 15.65 | 14.46 |
| All Other Loans | 6.74 | 0.05 | 3.69 | 10 | 12.65 | 10.71 |

Source: Financial Supervision Department/DAB

1.5 Non-performing loans

Banks should try to strengthen credit risk management measures to curtail the level of NPLs. It is essential for banks to evaluate credit applications carefully and closely monitor the 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 the December, 2012 the growth in non-performing loans accelerated by AF 223 million reaching to AF2.24 billion or 5.31 percent of gross loans against AF 2.02 billion in the same preceding period, with 52 percent of the NPLs related to one of the commercial banks.

The sector wide distribution of NPL reveals that a major portion originates from commercial loans and residential and mortgage loans to individuals and consumer loans. Credit quality in residential mortgage loans to individuals showed a slight improvement, while in commercial, consumer and agriculture sectors depicted deterioration.

1.6 Adversely-classified loans

Adversely classified loans (substandard, doubtful) ¹ amounting to AF 2.59 billion , as of December 2012, shown a decrease of AF 303 million, making 6.15 percent of the total gross loans, compared to the preceding period (December, 2011) when adversely classified Loans were AF 2.89 billion or 7.19 percent of the total gross loans.

1.7 Loans classified Watch

Loans classified in the “watch” category stood at AF1.04 billion, which makes 2.45 percent of total gross loans, decreased by 42 points since the December 2011. This category of loans requires close monitoring, as it may lead to more adversely classified loans (Substandard, Doubtful) in the future.

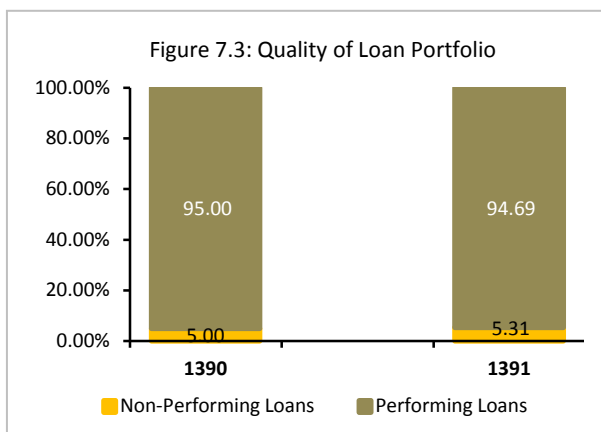
1.8 Loans classified loss

Loans classified loss amounted to AF 249 million or 0.59 percent of total gross loans were down by AF 43 million since previous period.

1.9 Inter-Bank Claims

Inter-bank Claims are the second largest among various asset categories, currently comprising

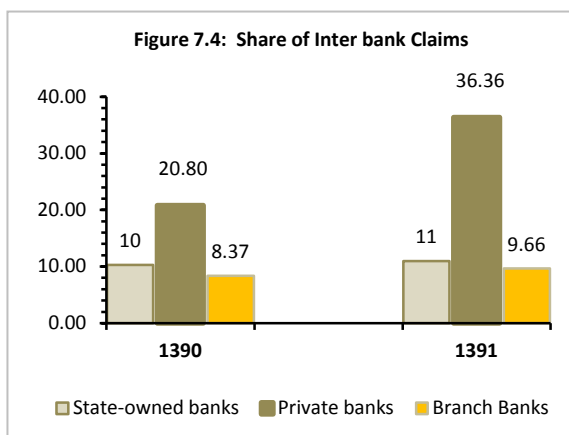
AF 56.97 billion – 25.44 percent of total assets registered AF 17.53 billion increases since last year (Dec. 2011), attributed to a number of banking institutions, still indicating that the



¹ Assets on which the payment of principal or interest is due and remains unpaid for 61-90 days (Substandard) and for 91-180 days (Doubtful)

³ Assets on which the payment of principal or interest is due and remains unpaid for 31-60 days (Watch)

banking sector has channeled a portion of its attracted funds as deposits in other financial institutions, if creditable borrowers were not found. These institutions are both inside and outside the country. Later on, if needed for liquidity purposes or after receiving applications from low-risk borrowers, these assets can be substituted to higher income earning assets Figure 7.4



1.10 Investment

The investment portfolio of the banking sector increased by 25.09 percent standing at AF 7.28 billion or 3.25 percent of total assets over the previous period mostly came from two banking institutions. A major part of the sector’s 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 a foreign bank.

1.11 Cash in Vault and Claims on DAB

Cash in vault and claims on DAB remains the largest category, increasing, both in absolute as

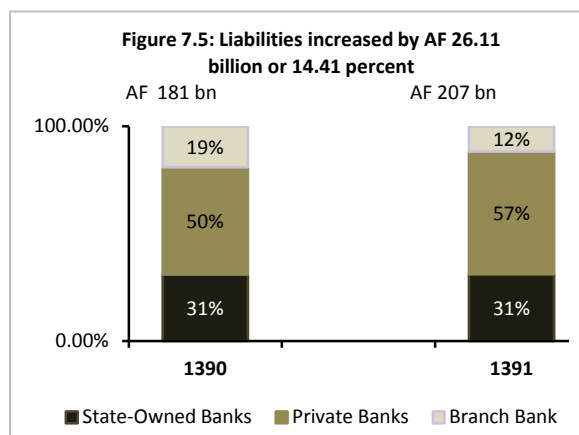
well as in percentage of total assets since last year posting an AF 15.81 billion or 18.57 percent increase.

The banking sector is fully compliant with required reserve regulations and is deploying slowly and prudently the attracted funds into other types of assets.

2. LIABILITIES

Total liabilities of the banking sector increased by AF 26.13 billion or 14.42 percent, standing at AF 307.34 billion compared to AF 181.21 billion recorded in the preceding period (Dec. 2012). All components of total liabilities have shown increases.

The majority of liabilities is made up of deposits (92.72 percent). This indicates public confidence, as well as good public relations and marketing policies of the banking sector, with “other liabilities” at the second and borrowings in third places.



Source: Financial Supervision Department, DAB

2.1 Deposits

Deposits, the main funding source, increased by AF19.49 billion since Dec. 2011, this exhibits a steady growth of 11.28 percent, which is an indication of the strength of the economy and the apposite outlook for the future. Despite some negative media reporting on the banking sector, depositors retained their trust in the system. Afghani denominated deposits indicated a 1.85 percent increase, accounting for 29.53 percent of total deposits, while US dollar denominated deposits registered a 17.94 percent increase making up 66.92 percent of total deposits of the system.

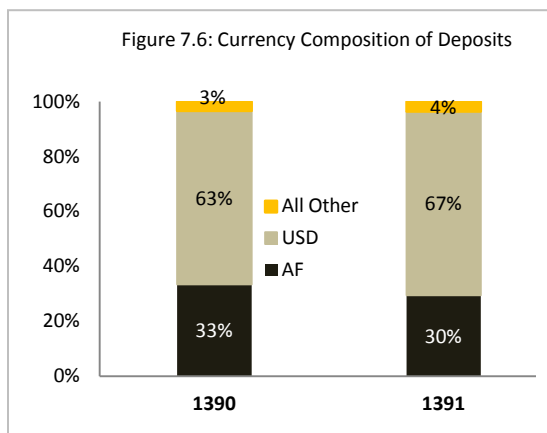
Private Banks attracted AF110.94 billion, increasing by 31.41 percent, making 57.71 percent of the system’s deposits.

The share of state-owned banks has increased to AF59.21 billion since the previous period (Dec. 2011) accounting for 30.79 percent of the system’s deposits, while state-owned banks appear to be losing market share.

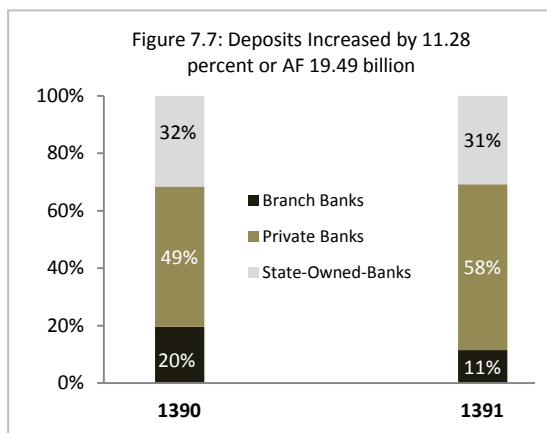
The share of branches of foreign banks decreased by 34.63 percent standing at AF 22.09 billion, making 11.49 percent of total deposits of the system.

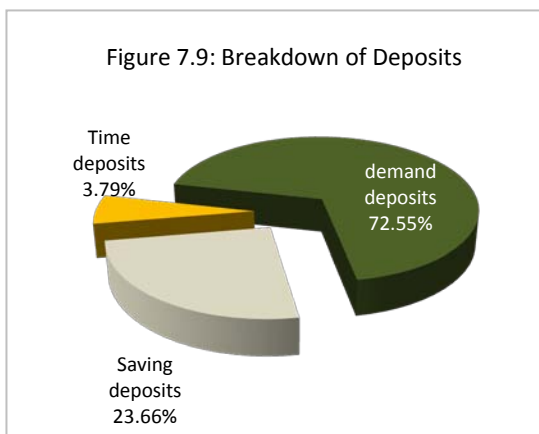
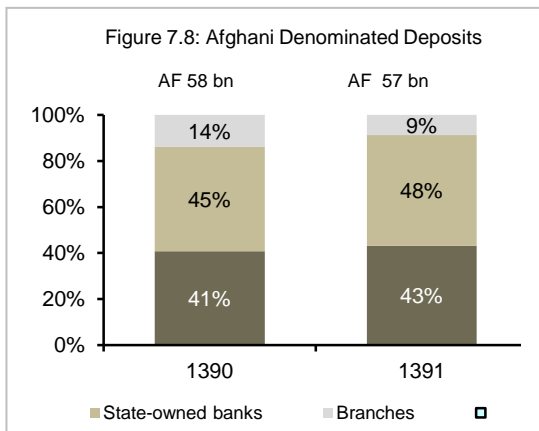
The major decrease in deposits of the branches of the foreign banks and increase in deposits of private banks could be attributed to the transfer of Standard Chartered Bank (a branch of a foreign bank) operations to AIB (private commercial bank) during the month of September, 2012.

In terms of types, demand deposits accounted for 72.55 percent of the total deposit base, up by 20.86 percent, saving deposits with 23.66 percent of total deposits was in the second place, depicting 4.83 percent increase, and time deposits making up 3.79 percent of the total deposit portfolio, was down by 47.79 percent since Dec. 2011.



Source: Financial Supervision Department, DAB





2.2 Borrowings

The share of borrowings in the total funding structure of the system increased significantly by 103 percent, standing at AF 3.35 billion at the end of the December 2012, making 1.62 percent of total liabilities compared to 0.91 percent in the December 2012. The current borrowing position is attributed to three banks.

2.3 Liquidity

Liquidity risk can be defined as the risk of not having sufficient liquid assets to meet the

demand of borrowers and depositors. All banks are required to maintain a reasonable level, in order to avoid any liquidity problem. For this reason, banks should maintain an 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 the policies of the bank.

2.3.1 Liquidity Ratio (Broad measure)

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

Generally, a surplus liquidity position was observed in the banking sector during this period. Analysis shows 37.60 percent increase in the excess liquid assets, against 42.17 percent growth in the previous period (Dec.2011). 65.81 percent of the sector’s total assets are comprised of liquid assets. The ratio of the broad liquidity as a median for the whole system stood at 72.13 percent. All banking institutions were well above the minimum required level.

2.4 Capital

In order to strengthen the capital base of the banking system and enhance its stability, DAB increased the minimum Paid-in-capital requirement to AF 1.00 billion, and all banking institutions were given two year deadline to

meet the requirement². Currently the deadline for the capital increase is over, two banking institutions are still falling short of the requirement.

The financial capital of one bank in the system is a negative figure, the DAB Supreme Council has given this bank forbearance for the size and structure and regulatory ratios of capital until its privatization from Ministry of Finance.

The capital fund of the banking sector stands at AF 16.63 billion, increased by 3.92 points since Dec.2011.

On an aggregate basis, the Capital Adequacy Ratio of the banking sector stands at 21.79 percent.

Disaggregated analysis shows that all banks in the system registered capital adequacy ratio above the minimum threshold (12 percent of risk-weighted assets), except one bank (under regulatory forbearance).The Basel benchmark for capital to risk weighted is 8 percent.

Branches of foreign banks do not have separate capital. The most analogous concept of 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 analogy to negative capital is the Net Due from related depository institutions(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 in maintaining an NDF position for another year or two, or if the bank's overall worldwide condition and performance is deteriorating.

For the period under review, the NDF position decreased by AF 8.32 billion standing at AF 1.49 billion, mostly attributed to the closure of Standard Chartered Bank. While the NDT position increased by a significant 167.19 percent the NDT position for two previously holding branches of the foreign banks has increased and is in a favorable NDT position, greater than the unfavorable NDF position for the remaining two banks. Put differently, two banks are actively seeking domestic investment outlets for the funds they have attracted, while the rest two are simply sending their acquired funds to their international networks. The NDF position of one branch of the foreign bank has increased, while the other one has a decrease in its position.

² DAB Supreme Council resolution dated 16/03/1389

Table 7.3: Key Financial Soundness Indicators of the banking Sector

| | 1386 (Mar 2008) | 1387 (Mar 2009) | 1388 (Mar 2010) | 1390 (Mar 2011) | 1390 (Mar 2011)* | 1390 (Mar 2012) | 1391 (Dec. 2012) |
|--|-----------------------|-----------------------|-----------------------|-----------------------|------------------------|-----------------------|------------------------|
| Total Capital Adequacy Ratio | 31.77 | 29.81 | 25.81 | -14.46 | 30.39 | 23.06 | 21.79 |
| Tier 1 Capital Adequacy Ratio | 31.16 | 29.72 | 24.19 | -14.51 | 30.29 | 23.98 | 18.25 |
| Non-Performing Loans to Total Gross Loans | 0.68 | 1.15 | 0.5 | 48.4 | 3.75 | 5.15 | 5.51 |
| Return on Assets (ROA) | 1.7 | 1.74 | 1.41 | -20.08 | 0.24 | -1.21 | -0.59 |
| Return on Equity (ROE) | 9.89 | 10.61 | 10.35 | -520.66 | 1.9 | -17.9 | -8.13 |
| liquidity Ratio (Broad Measure Median) | 65.95 | 40.02 | 59.19 | 63.32 | 63.83 | 57.37 | 72.13 |
| liquidity Assets to Total Assets | 23.8 | 23.8 | 0.38 | 40.58 | 47.01 | 55.82 | 65.81 |

*Excluding Kabul Bank

Source: Financial Supervision Department/ DAB

2.5 Profitability

On a cumulative basis for the fiscal year 1391, the banking sector posted AF 943 million annualized³ losses against AF 2.05 billion losses in Hoot 1390 (March, 2012). The losses declined significantly resulted in an ROA⁴ of – 0.59 percent annualized improved from -1.01 percent in March. 2012.

The major contributors of decrease in losses of the system as compared to the previous period were the increase in net-interest income and non-interest income, while non-interest expenses, credit provisions, salary cost and taxes shown increases. On a cumulative basis, 5 out of 16 banks have incurred losses of AFN 3.16 billion annualized, against AFN 3.72 billion losses in the previous period with 5 banks were at loss out of 17 banks. On core income basis, 3

banks ended with losses against 4 banks in the previous period mainly on account of a decrease in total income.

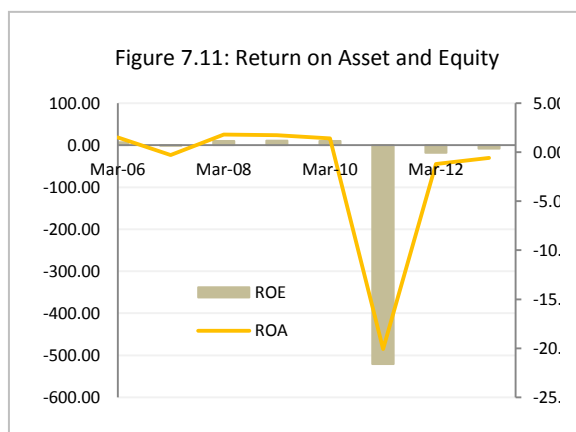
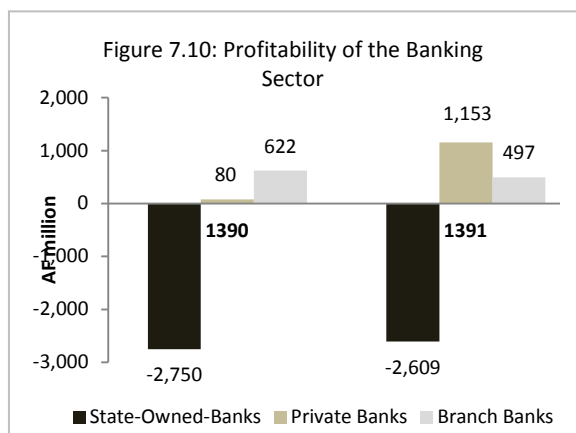
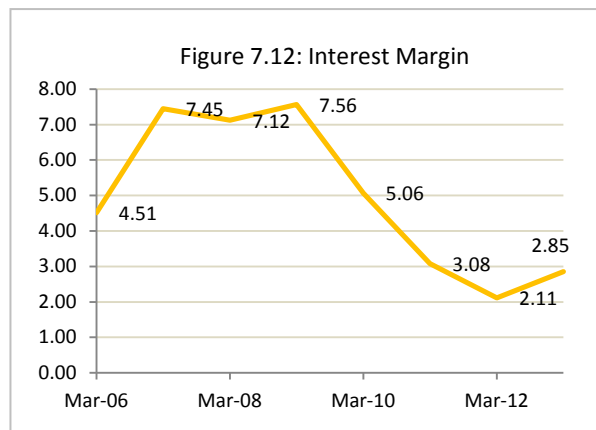
The decrease in the losses of the banking sector resulted in the improvement of the ROA and ROE. The return on assets (ROA) improved to –0.59 from -1.01 and the return on equity (ROE) reached –8.13 against -14.98 in the corresponding period in 2011.

On an aggregate basis, private banks and branches of foreign banks ended with profits, while State-owned banks ended up with losses.

³ Annualize formula (P or L/9*12)

⁴ ROA (Return On Assets)

| | 1391 (Mar. 12) | 1391 (Dec. 12) | % Changes |
|-----------------------|-------------------|-------------------|--------------|
| Interest income | 6,451 | 7,846 | 21.62 |
| Interest expense | 2,138 | 1,803 | -15.66 |
| Net interest income | 4,313 | 6,043 | 40.11 |
| Non-interest income | 4,143 | 4,763 | 14.96 |
| Non-interest expenses | 4,308 | 4,738 | 9.98 |
| Salary cost | 3,140 | 3,331 | 6.08 |
| Credit provisions | 2,736 | 3,107 | 13.56 |
| P/L before tax | -1,728 | -370 | -78.58 |
| P/L after tax | -2,048 | -943 | -53.96 |



2.6 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 the overall open FX position, except five banking institutions holding open FX positions on the overall and on an individual currency (USD short & long positions) basis violated the limits. Branches of foreign banks are not subject to limitations on the open FX position, since that risk is theoretically managed on a whole-bank basis and not branch-by-branch.

The impact of changes in exchange rate upon the regulatory capital of the system reveals that a 20 percent change in the exchange rate would increase the regulatory capital by AF 844 million and vice versa. Similarly, a 4 percent change would correspond to AF 169 million and vice versa.

2.7 Interest Rate Risk

Overall the banking system is in an interest-rate sensitive position. However, calculations made from the Interest Rate Sensitivity

Schedules of all banks reveal that, the net-interest income of the system over the next 12 months may increase by AF 759 million in an event of an 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) interest income will decline by AF 759 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 theoretically 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, this situation makes the banks more vulnerable to a sudden decrease in market rates.

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