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FOREWORD

It gives me great pleasure to present this first issue of the Quarterly Economic and Statistical Bulletin of Da Afghanistan Bank for 1385 (2006-07). The Bulletin reviews overall economic developments, as well as progress in financial sector reform and developments in formulation of monetary policy besides fiscal and external sector developments in the Afghanistan economy.

On this occasion, I would like to express my thanks and indeed, admiration for Dr. Narendra Jadhav for his painstaking efforts in bringing out this issue in a thoroughly revised and comprehensive format and that too,in a timely manner. I would also like to place on record my appreciation for the Monetary Policy Department of Da Afghanistan Bank in general and to Mr. Aziz Babakarkhail in particular, for their untiring efforts. Thanks are also due to other colleagues especially John Ewald, Glenn Tasky and M. Ali Aazem.

This edition of the Bulletin is richer and broader than our previous issues. It would be our endeavor to continue the efforts to improve the coverage, quality and timeliness of the Quarterly Bulletin in future as well.

Noorullah Delawari

Governor, Da Afghanistan Bank

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LIST OF ABBREVIATIONS

DAB	Da Afghanistan Bank
GOA	Government of Afghanistan
EMA	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 Afghanis
GDP	Gross Domestic Product
ODCs	Other Depository Corporations

I Macroeconomic Overview

1.1 Economic Growth and Per Capita Income:

The Afghan economy continued to perform very well during the fiscal year 1384 (2005-06). Real GDP growth is estimated to be 14 per cent compared to the previous year (1383) growth of 8.0 per cent. Economic growth in the year 1384 was supported by all sectors, especially the agriculture sector which is estimated to have grown by 11 per cent in 1384(2005-06) in comparison to the year 1383(2004-05) when it had declined by 17 per cent. The agricultural turnaround in growth was thus 28 per cent from the previous year. The greater momentum to real GDP growth also seems to be emerging from sustained domestic growth from industrial sector and services sector such as construction, communication and transportation and other types of private sector activities.

The GDP data for the last four years are presented in Table 1.1, below:

Table 1.1: GDP and Per Capita Income 2002/03–2005/06

	2002/03 (1381)	2003/04 (1382)	2004/05 (1383)	2005/06 Estimated (1384)	Average for the period 1381(2002-03-) to 1384(2005-06)
GDP (in millions of U.S. dollars)	4,084	4,585	5,971	7,309	5,444
Real GDP growth rate (in percent)	28.6	15.7	8.0	14.0	16.6
Nominal GDP growth (annual change)	33.8	23.1	26.4	27.6	27.7
Per Capita income(US dollars)	182	200	253	293	232

Note: Central Statistics office (CSO) estimates for year 2005/06 are still not available; the estimates here are based on the IMF data and projections; these data exclude opium production.

Over the last four years from 1381-1384 (2002/03-2005/06), the Afghan economy has made significant progress with a strong real cumulative growth of more than 66 percent, with annual real GDP growth averaging more than 16 per cent per annum as shown in Table 1. The surge in growth rate, albeit from a very depressed base, was due to continued donor support, construction boom in urban centres, and good harvest in year 1384(2005-06). The economy is expected to continue to achieve high growth rates during the next few years.

The Afghan Industrial sector has shown an impressive growth of 16 per cent in the year 1384(i.e., 2005/06) although it was less than 32 per cent growth of the previous year. The services sector particularly construction, power, communication and transportation have turned in good performances as well. Comparing the year 1383(2004-05) to year 1384(2005-06) however both industrial and services sectors have shown slower growth. In other words, the turnaround in agriculture in the year 1384(2005/06) has contributed significantly to maintain the growth momentum in 1384.

Per capita income during the last four years has increased quite remarkably; it has increased from US$ 182 to US$ 293 or as much as 62.12 per cent during the four year period i.e., 1381-1384(2002-03 through 2005-6) or around 15.5 per cent per annum.

1.2 Structure of Production

The break-up of real GDP growth by industrial origin over the last four years is presented in Table 1.2.

Table 1.2: GDP by Industrial Origin (annual percentage)

Industrial Origin	2002/03 (1381)	2003/04 (1382)	2004/05 (1383)	2005/06 (1384)	Average for the period of 1381(2002-03) to 1384(2005-06)
Agriculture	27.7	17.0	-17	11	9.68
Industry	21.2	12	32	16	20.30
Services	39.5	14	35	14	25.62
Total Real GDP growth	29	16	8	14	16.75

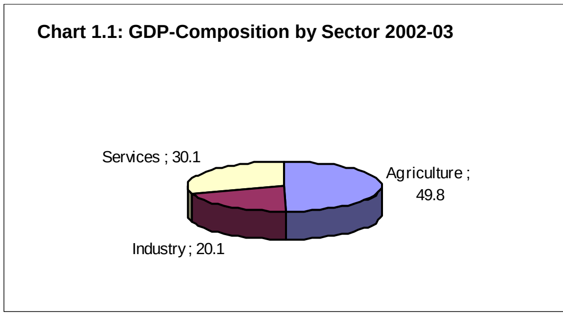
All figures based on IMF data and projections

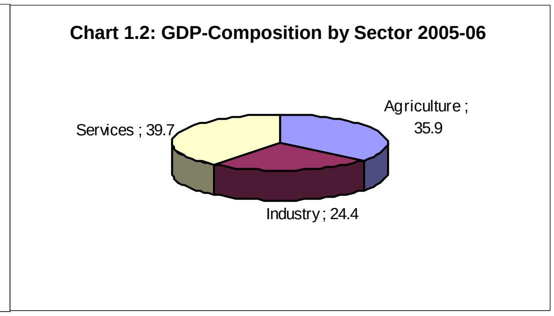
Despite the fact that the share of services and industry have increased significantly in the last four years, the economy continues to be predominately agricultural as is evidenced from Table 1.3.

Table1.3: GDP - Composition by Sector (per cent)

Industrial Origin	2002/03 (1381)	2003/04 (1382)	2004/05 (1383)	2005/06 estimated (1384)
Agriculture	49.8	48.5	37.2	35.9
Industry	20.1	21.3	24.4	24.4
Services	30.1	30.2	38.3	39.7

All figures based on IMF data and projections





Analysis of the consumption, savings, and investment in the Afghan economy for the last four years is presented in Table 1.4.

Table 1.4: Consumption, Savings and Investment 1381-1383 (2002/03–004/05) (Per cent of GDP)

	1381	1382	1383	1384
Domestic expenditures	133.5	151.0	145.2	142.6
Consumption	99.0	108.9	101.9	102.3
-Public	7.8	9.4	9.1	9.1
-Private	91.2	99.5	92.7	93.2
Gross fixed capital formation	34.5	42.0	43.4	40.3
-Public	27.0	34.0	34.9	30.8
-Private	7.5	8.1	8.5	9.6
Domestic savings	1.0	(-8.9)	(-1.9)	(-2.3)
-Public savings	(-4.6)	(-4.4)	(-4.2)	(-3.4)
-Private savings	5.6	(-4.5)	2.3	1.1

All figures based on IMF data and projections

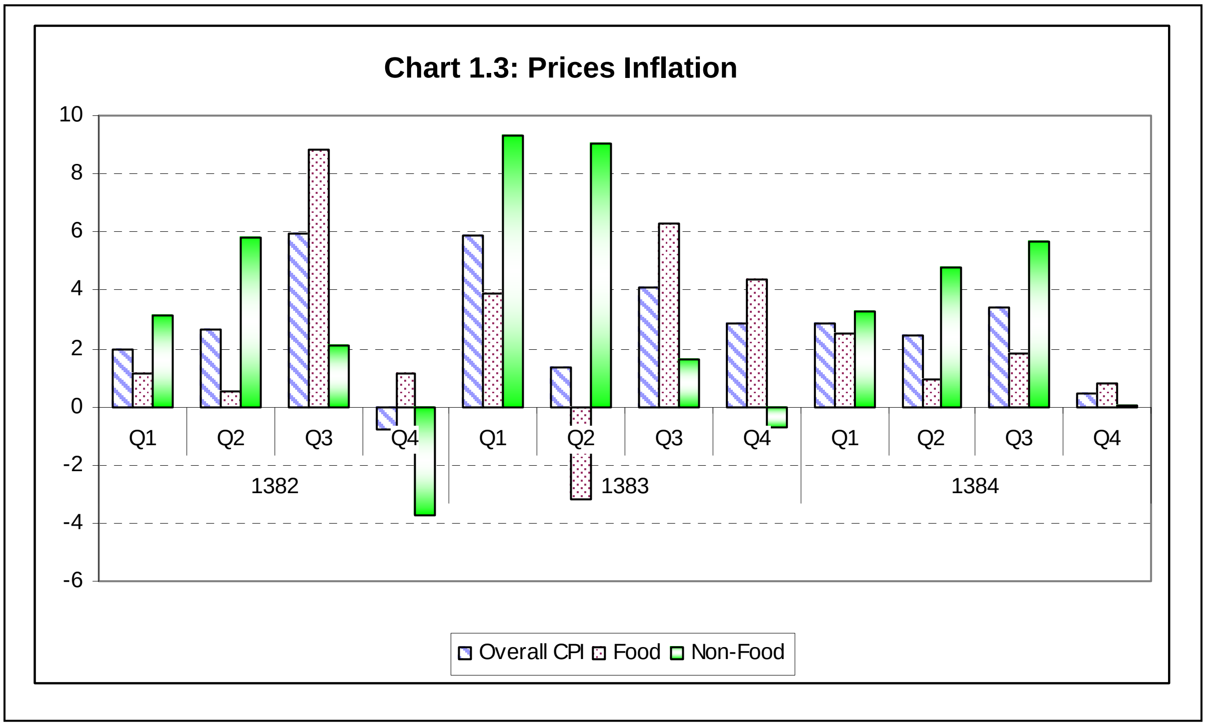
Several observations are in order here:

- Domestic expenditure in 1384(2005-06) was as much as 142.6 per cent of GDP of which 102.3 per cent was consumption expenditure while 40.3 per cent was investment expenditure.
- As a percentage of GDP, domestic expenditures in year 1384(2005-06) were less than those during the years 1382(2003-04) and 1383(2004-05) while more then those in the year 1381(2002-03).
- Domestic savings in the year 1384 (2005-06) were around -2.3 percent of GDP comprising 1.1 per cent private savings which were offset by government dis-saving to the extent of 3.4 per cent of GDP.
- During the period 1381-1384 (2002-03 through 2005-06) public sector showed negative savings or dis-saving. On the other hand, the private savings were negative during the years 1382 (2003-04) but remain positive during the years 1384 (2005-06),1383(2004-05),and 1381(2002-03)
- Low domestic savings of -2.3 per cent during the year 1384(2005-06) is the result of the continuing dis-savings in the public sector which offset private savings. Notably, the extent of dis-saving in the latest year, 1384 (2005-06) has come down significantly compared to the year 1382(2003-04).
- During the year 1384(2005-06), investment growth was 40.3 per cent of the GDP, and of this, public investment accounted for the bulk, although there was some welcome pick-up in private investment especially in construction and other activities.

1.3 Inflation

Kabul Based CPI (March 2004 = 100)

The quarterly overall inflation rate based on Kabul-Based CPI, at the end of Hoot 1384 (March 2006) was placed at 0.48 per cent compared to the rate of 3.39 per cent registered during the previous quarter ending Qaus 1384 (December 2005). During this 3-months period food prices increased by 0.77 per cent, while the non-food prices rose by about 0.07 per cent. Both food and non-food prices have distinctly decelerated during the last quarter of 1384 (i.e. 2005-06) as shown in Chart 1.3.



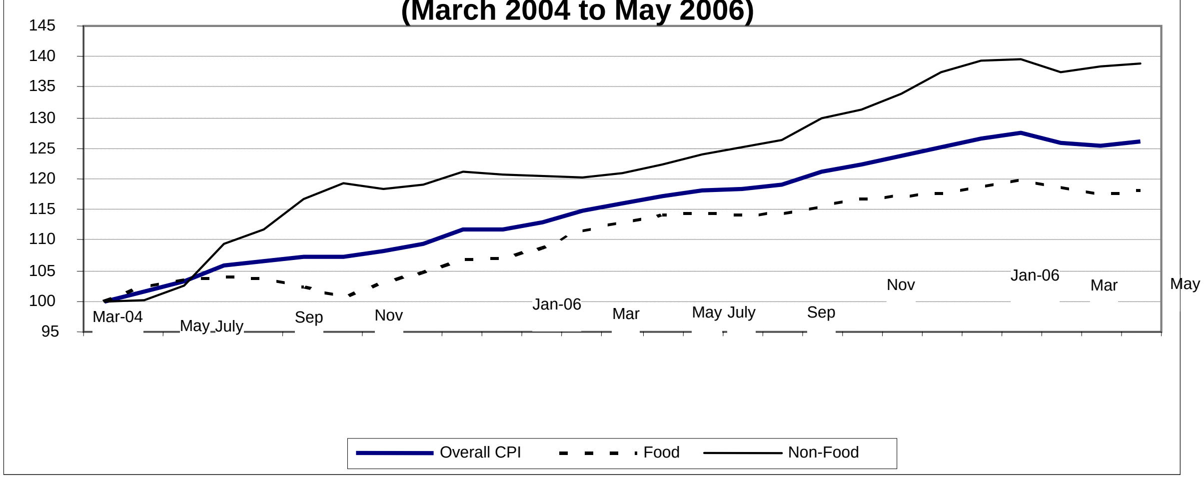
Cumulatively, since March 2004, the overall price index recorded an increase of 26.1 per cent up to May 2006 (26 Months) which works out to an annual rate of about 12.0 per cent. Both food and non-food inflation were factors in the overall CPI inflation with food prices rising at an annual rate of 8.35 per cent while the non-food prices rose by 17.96 per cent during the 26-month period ending May 2006.

Kabul based CPI data on monthly basis from March 2004 to May 2006 are presented in Table 1.5 and illustrated in Chart 1.4.

Table 1.5: Kabul based CPI

Period	Overall Index	Food, Beverages & Tobacco	Non Food Items	Monthly Change(%)
Mar-04	100.00	100.00	100.00	-
April	101.50	102.20	100.30	1.50
May	103.20	103.50	102.60	1.67
June	105.90	103.90	109.30	2.62
July	106.50	103.80	111.70	0.57
August	107.20	102.40	116.60	0.66
Sep	107.30	100.60	119.20	0.09
Oct	108.30	103.00	118.30	0.93
Nov	109.50	104.60	119.00	1.11
Dec	111.70	106.90	121.10	2.01
Jan-06	111.80	107.00	120.70	0.09
Feb	112.90	108.60	120.40	0.98
Mar	114.90	111.60	120.20	1.77
Apr	116.00	112.90	121.00	0.96
May	117.20	114.00	122.30	1.03
June	118.20	114.40	124.10	0.85
July	118.40	114.20	125.10	0.17
August	119.00	114.30	126.30	0.51
Sep	121.10	115.50	130.00	1.76
Oct	122.40	116.70	131.40	1.07
Nov	123.70	117.20	134.00	1.06
Dec. 05	125.20	117.60	137.40	1.21
Jan-06	126.60	118.60	139.30	1.12
Feb	127.50	119.80	139.60	0.71
Mar	125.80	118.50	137.50	-1.33
Apr	125.50	117.40	138.30	-0.24
May	126.10	118.10	138.90	0.48

Chart 1.4: Prices Inflation: Kabul Based CPI (March 2004 to May 2006)

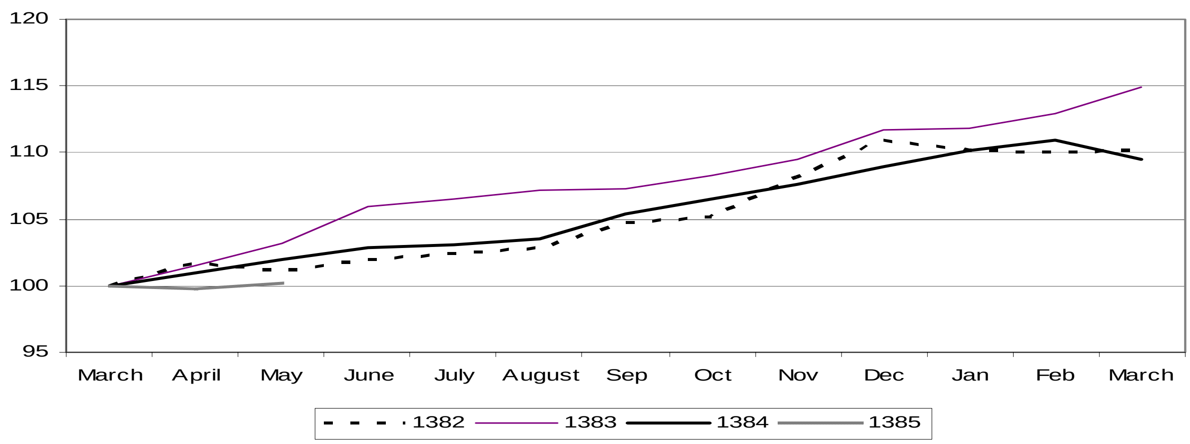


A comparative picture of inflation for the years 1382, 1383, 1384 and the first two months of 1385 is presented in Table 1.6 and illustrated in chart 1.5.

Table 1.6: Overall Inflation (Kabul-based CPI)

Year	Overall CPI	Food	N-Food
1382 (March 2003 - March 2004)	10.10	11.89	7.27
1383 (March 2004 - March 2005)	14.90	11.60	20.20
1384 (March 2005 -March 2006)	9.49	6.18	14.39
1385 (first two months) (March 2006 to May 2006)	0.24	-0.337	1.02

Chart 1.5: Annual Inflation Trends (Kabul-Based CPI)



As can be seen from Table 1.6, the annual inflation rate for the overall CPI has been 10.1 per cent and14.9 per cent for the years 1382 and 1383 respectively. The overall price index recorded an increase of about 9.49 per cent during the year 1384 (March 05 to March 06) with food and non-food components of the CPI rising by 6.18 per cent and 14.39 per cent. Rents, transportation, fuel and housing prices which are more structural than monetary in nature, were the fastest growing component of the non-food items of the CPI, increasing by 24.81 per cent, 7.83 per cent, 25.07 per cent and 22.57 per cent respectively, during the 12-months period ending Hoot 1384 (March 2006). As can be seen from Table 1.7, the overall inflation excluding rents, housing and fuel, turns out to be 8.1 per cent in 1382, 10 per cent in 1383 and 7.7 per cent in 1384. There is thus a distinct deceleration of the “core inflation” in the year 1384.

Table 1.7: "Core Inflation" in Afghanistan (Kabul-based CPI)

Year	Overall CPI	Food	N-Food	Overall CPI Excl. rents, housing and fuel
1382 (March 2003 - March 2004)	10.10	11.89	7.27	8.10
1383 (March 2004 - March 2005)	14.90	11.60	20.20	10.01
1384 (March 2005 -March 2006)	9.49	6.18	14.39	7.71
1385 (first two months) (March 2006 to May 2006)	0.24	-0.337	1.02	-

National CPI

The national CPI (March 2004 = 100) includes surveys for six cities representing the regions of Kabul, Herat, Kandahar, Jalalabad, Mazar-e-Sharif and Khost. Quarterly inflation rate based on the overall Consumer Price Index (CPI) was about 1.09 per cent in March 2006 (Hoot 1384) compared to the increase of 3.54 per cent in the quarter ending December 2005 (Qaus 1384). Cumulatively, since March 2004 the national CPI rose by 19.7 per cent with the food and non food components increasing by 16.8 per cent and 24.4 per cent respectively which is shown in Chart 1.6 and presented in Table 1.8.

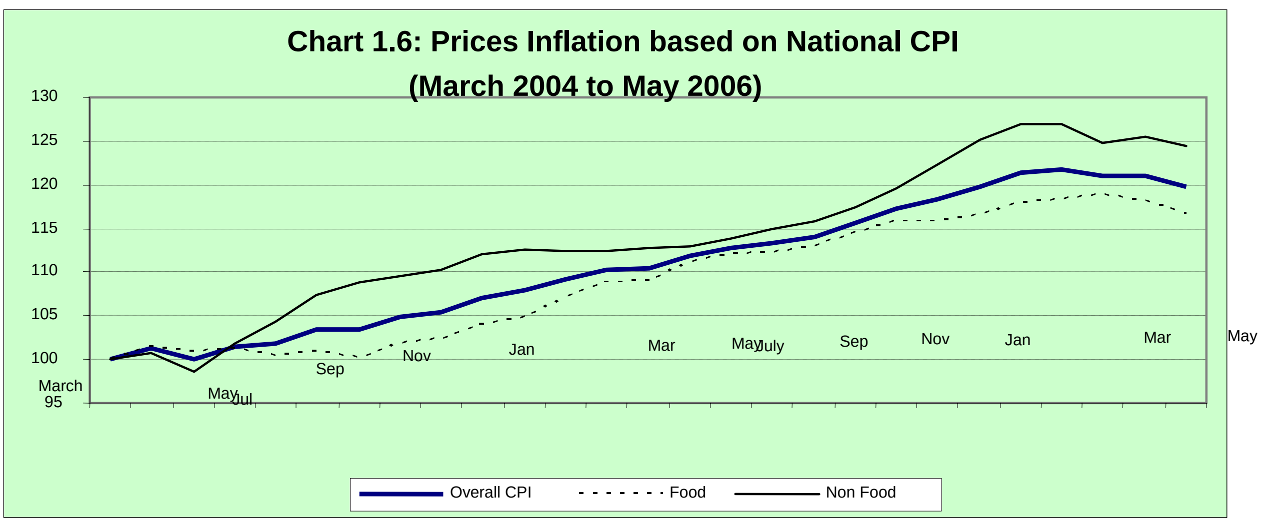


Chart 1.6: Prices Inflation based on National CPI (March 2004 to May 2006)

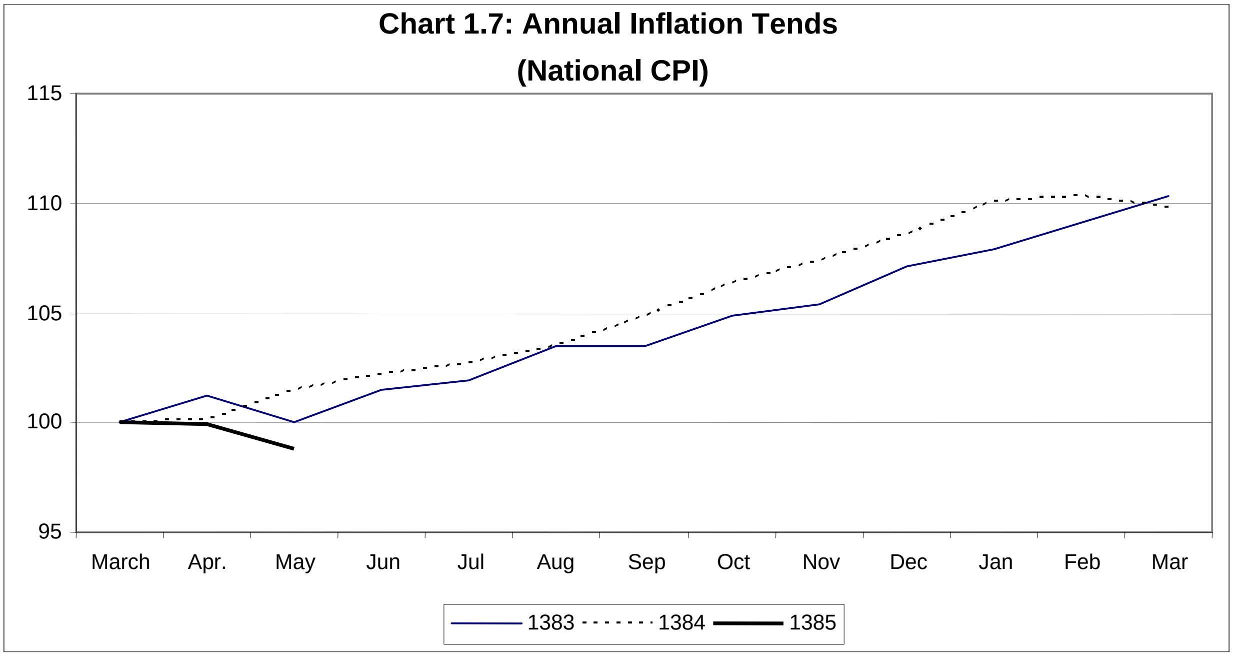
Table 1.8: National CPI

Period	Overall CPI	Food	Non-food	% Change
March	100	100	100	-
Apr.	101.2	101.4	100.8	1.2
May	100	100.9	98.6	-1.19
Jun	101.5	101.3	101.9	1.5
Jul	101.9	100.4	104.3	0.39
Aug	103.5	101	107.4	1.57
Sep	103.5	100.2	108.8	0
Oct	104.9	101.8	109.6	1.35
Nov	105.4	102.4	110.2	0.48
Dec	107.1	104	112	1.61
Jan	107.9	104.9	112.6	0.75
Feb	109.1	107	112.4	1.11
Mar	110.3	108.9	112.5	1.1
Apr	110.4	109	112.7	0.09
May	111.9	111.2	113	1.36
June	112.7	112	113.9	0.71
July	113.3	112.2	115	0.53
Aug	114.1	112.9	115.9	0.71
Sep	115.7	114.6	117.5	1.4
Oct	117.3	115.9	119.6	1.38
Nov	118.4	115.9	122.3	0.94
Dec. 05	119.8	116.5	125.1	1.18
Jan	121.4	117.9	126.9	1.34
Feb	121.7	118.4	126.9	0.25
Mar	121.1	118.8	124.8	-0.49
Apr	121	118.1	125.6	-0.08
May	119.7	116.8	124.4	-1.07

The annual inflation trends as presented in Table 1.9 and shown in Chart 1.7 indicate a notable success in containing inflation in the year 1384 (i.e., 2005-2006). Moreover the overall inflation rate during the first two months of 1385 has actually declined by about 1.16 per cent.

Table 1.9: Overall Inflation (National CPI)

Year	Overall CPI (%)	Food (%)	Non Food(%)
1383	10.30	8.90	12.50
1384	9.79	9.09	10.93
1385 (first two months)	-1.16	-1.68	-0.32



"Core inflation" (i.e., excluding rents, housing and fuel) rates based on National CPI are presented in Table 1.10.

Table 1.10: "Core Inflation" (National CPI)

Year	Overall CPI (%)	Food (%)	Non Food(%)	Overall CPI Excl. rents, housing and fuel
1383	10.30	8.90	12.50	7.24
1384	9.79	9.09	10.93	7.12
1385 (first two months)	-1.16	-1.68	-0.32	-

These data also indicate the deceleration of inflation during the year 1384 *vis-à-vis* the previous year. This is again symptomatic of the notable success that has been achieved by the monetary policy of the DAB.

II. Monetary Policy and Market Operations

2.1 Monetary Aggregates

The monetary aggregates in Afghanistan contain the following:

1. M1 or narrow money
2. M2 or broad money

Narrow Money (M1)

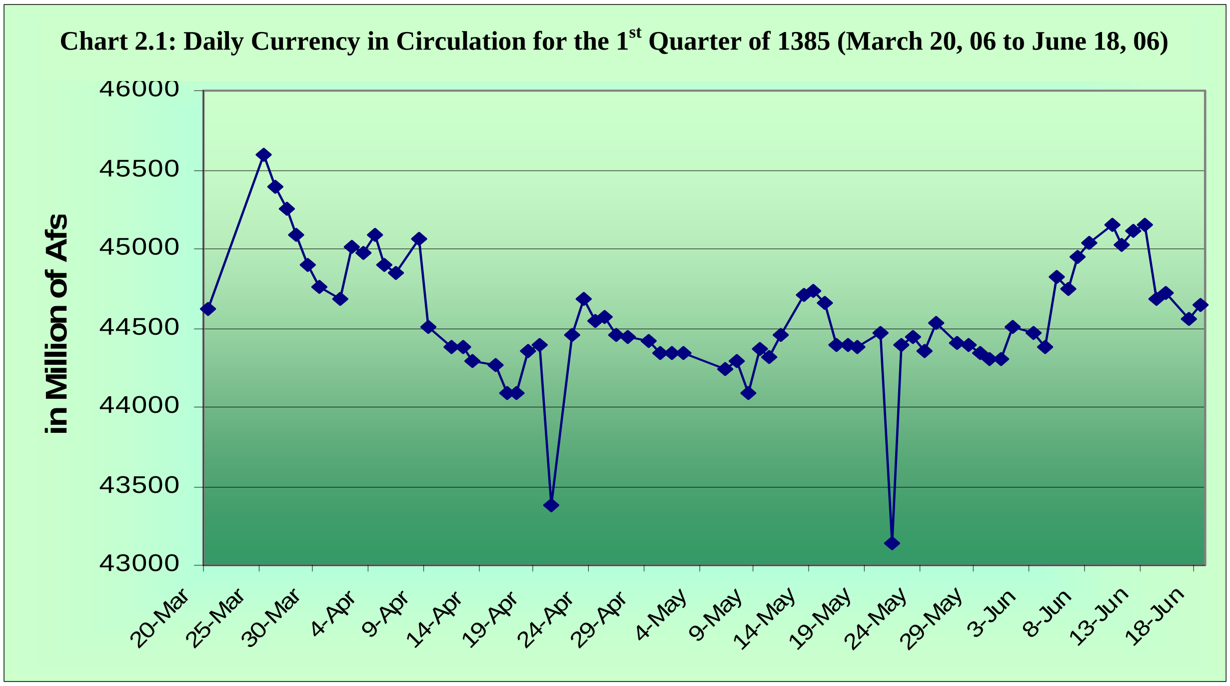
M1 is composed of currency in circulation and demand deposits. Currency in circulation is equal to total issued money less cash in vaults of the DAB Head office and its branches. Demand deposits or transferable deposits are those claims of customers on the banking sector which are less liquid than currency in circulation and can be withdrawn easily (with no penalties).

A. Currency in Circulation

Currency in circulation had been steadily growing according to the path projected by the International Monetary Fund (IMF) and Da Afghanistan Bank (DAB). Currency in circulation grew by 37.5 per cent during the year 1383 (2004/05). During 1384 (2005/06) the growth of currency in circulation decelerated below the projected path and grew by 15.2 per cent, mainly due to the large sterilization by DAB in order to bring down the inflation rate.

A daily time series data for currency in circulation, which is the main operating target of monetary policy, is shown in the Chart 2.1. On end quarter basis the currency growth rate was only about 0.05 percent from Afs.44.62 billion in the last quarter of 1384 (20 Mar,2006) to Afs.44.64 billion in first quarter 1385 (18 June, 2006).On quarterly average basis, the narrow money stock remained virtually unchanged compared with the last quarter.

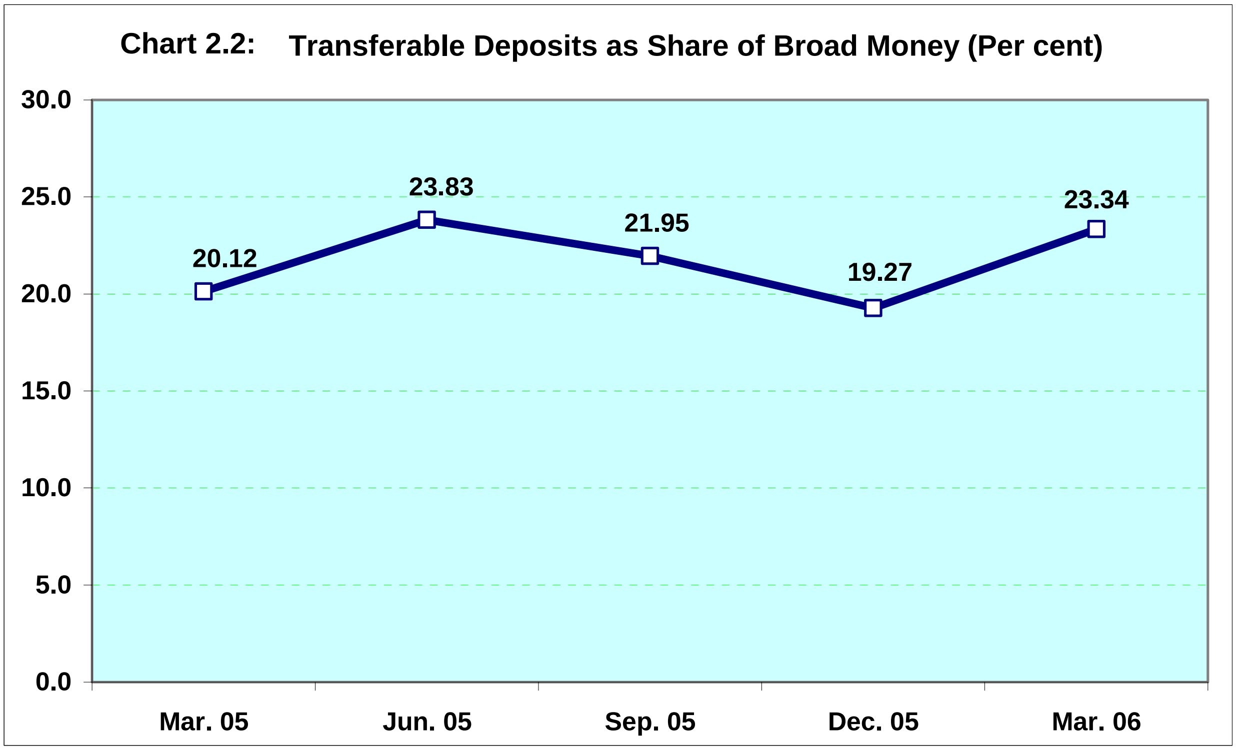
In the recent months, the currency in circulation is well below the IMF projection for the quarter. The DAB started to fill the gap between the actual currency in circulation and the IMF projections, keeping in view the policy options for the monetary policy of the Da Afghanistan Bank.



The lower than expected growth of currency in circulation during the Q1, 1385 was due to smaller injection by Ministry of Finance since they had budget approval constraints imposed by the Parliament. Now that the budget is approved, the injection may increase substantially in the quarter ahead. Yet another reason for the low growth of currency in circulation was, perhaps the development of banking sector; the public is partially converting their cash into deposits and there is a hope that bank deposits will increase further with the advent of new interest rate structure that is emerging. Finally, there is dollarization; most contracts of heavy procurements are done in US$ or in other convertible currencies. The Afghani is used mainly for the retail. The slow progress of 'Afghanisation' may also be holding down the demand for Afghani lending to less than expected growth of currency in circulation.

B. Demand Deposits

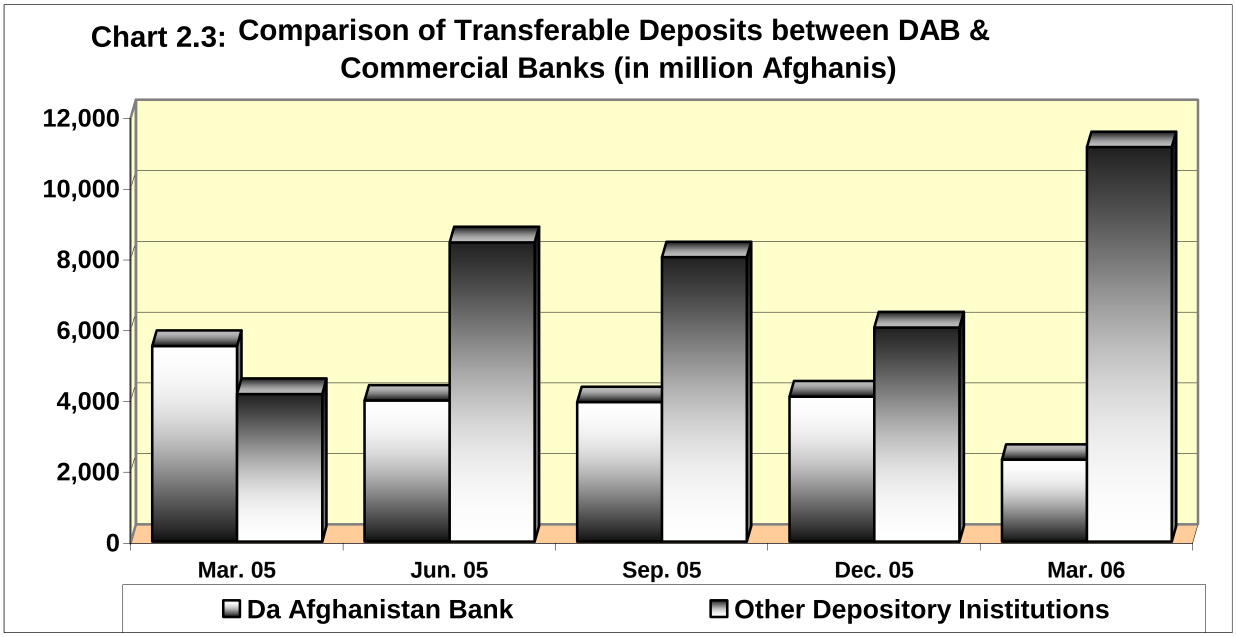
Demand deposits or transferable deposits, which, as noted above, are less liquid than currency in circulation, are the other item of M1. In DAB these deposits mainly belong to the Government and other public organizations. There are few demand deposits which belong to individuals or the private sector.



Source: Monetary Survey (estimated) 2005/06, Monetary Policy Department, DAB

Chart 2.2 shows the movements in demand deposits from March 2005 through March 2006 as a share of broad money (M2). These deposits have been fairly stable over time as a share of broad money (M2). The minimum share was 19.27 per cent (December 21, 2005) and the maximum share was recorded as 23.8 per cent (June 21, 2005) of broad money. This shows that there was little improvement in overall demand deposits. Demand deposits are used primarily for transaction-based account settlements. However, the transaction settlements are mainly taking place in cash. Shifting from cash settlements to account settlements would be a crucial step for the development of financial sector in Afghanistan.

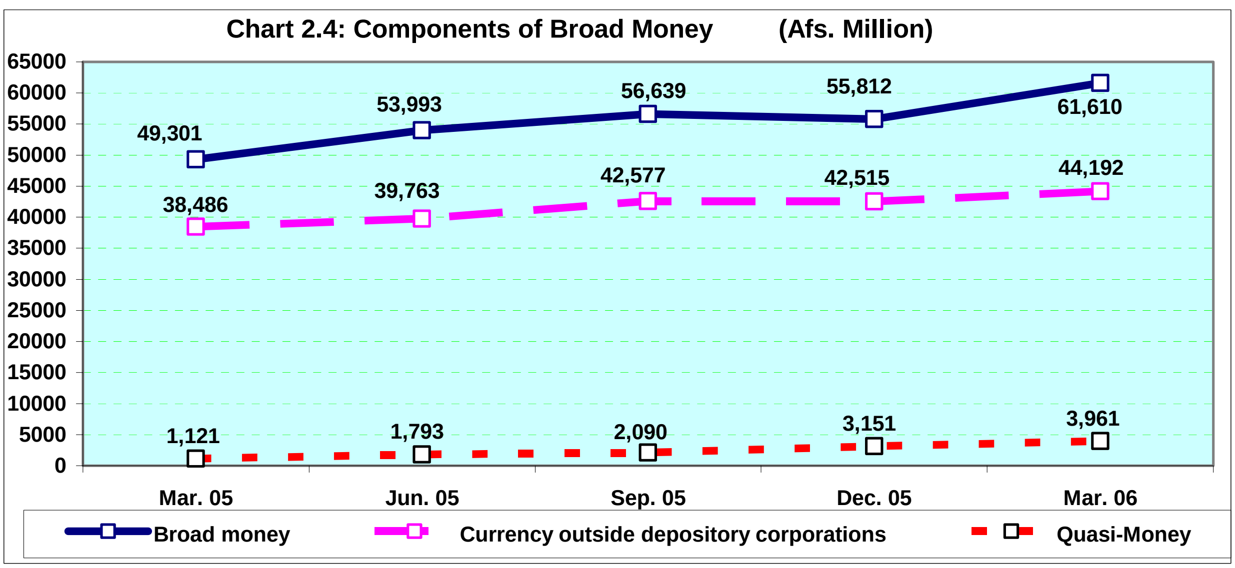
Interestingly, a comparison of the transferable deposits with DAB and those with other depository corporations (ODCs) over time shows a distinct improvement in transferable deposits with ODCs. The commercial banks are doing well in terms of attracting the customers to deposit their money as demand deposits and the DAB is also encouraging the customers to deposit in commercial banks. The DAB has already put an end to its own commercial activities, which has helped in this regard. Chart 2.3 presents an illustration of the improvement in commercial banks' demand deposits.



Source: Monetary Survey (estimated) 2005/06, Monetary Policy Department, DAB

M2 or Broad Money

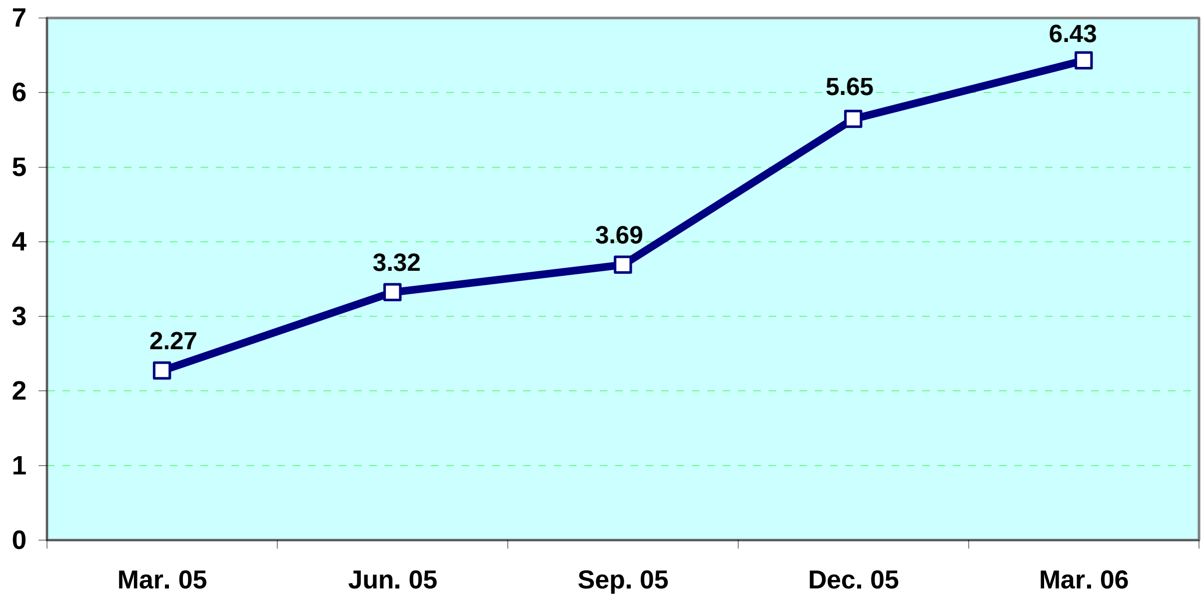
M2 is equal to M1 plus quasi-money. Broad Money (M2) grew from Afs. 49.3 billion in March 2005 to Afs. 61.6 billion in March 2006, thus registering an expansion of nearly 25 per cent during the year. This was led mainly by the currency outside depository corporations. The movements in various components of broad money are illustrated in Chart 2.4.



Source: Monetary Survey (estimated) 2005/06, Monetary Policy Department, DAB

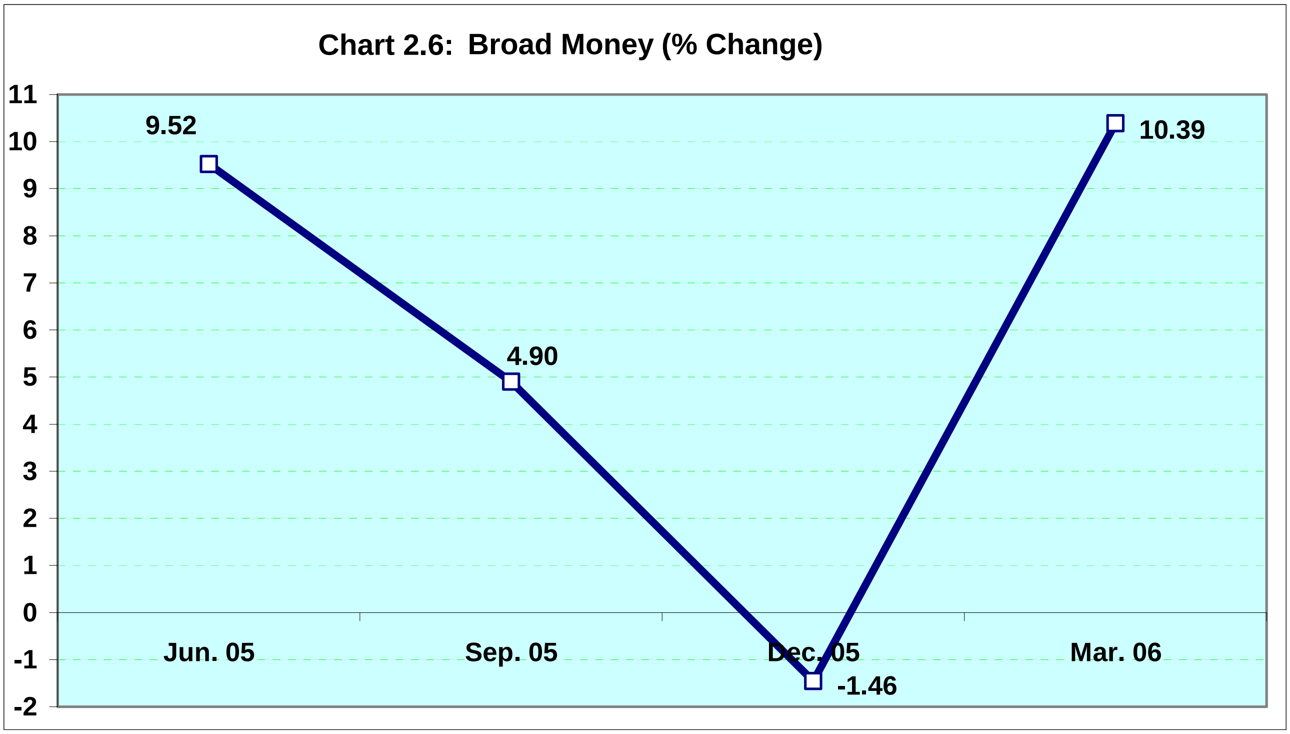
Quasi-money includes time and saving deposits plus foreign currency deposits. Quasi-money has grown from 2.3 per cent of broad money in March 2005 to 6.4 per cent of broad money in March 2006. This indicates that people are inclined to put their money in the banks for longer maturities. Compared to demand deposits, time and saving deposits are increasing as a ratio of broad money. Chart 2.5 shows a growing trend in quasi-money during March 2005 and March 2006 as a share of broad money. This increase however, is mainly driven by foreign currency deposits. Nevertheless, it is a sign of improvement that the banking system is attracting more customers.

Chart 2.5: Quasi-Money as Share of Broad Money (Per cent)



Currency in circulation continues to be the largest item within broad money in Afghanistan. In many developing countries the currency in circulation and demand deposits are the smallest items, and the quasi-money is the largest component of broad money. By contrast, in Afghanistan quasi-money constitutes a small share of broad money. But the situation is improving, albeit at a very slow pace.

Chart 2.6 presents the broad money movements on quarterly basis from March 2005 to March 2006. There was a large increase of 9.5 per cent during March-June 2005 and this growth pace decelerated to 4.9 per cent and then to -1.5 per cent in the next two quarters before rising again 10.39 per cent during Dec-Mar 2006. During the Q3 of 1384, there was actually a decline in broad money stock, which was followed by a strong recovery in the last quarter of 1384 (2005-06).

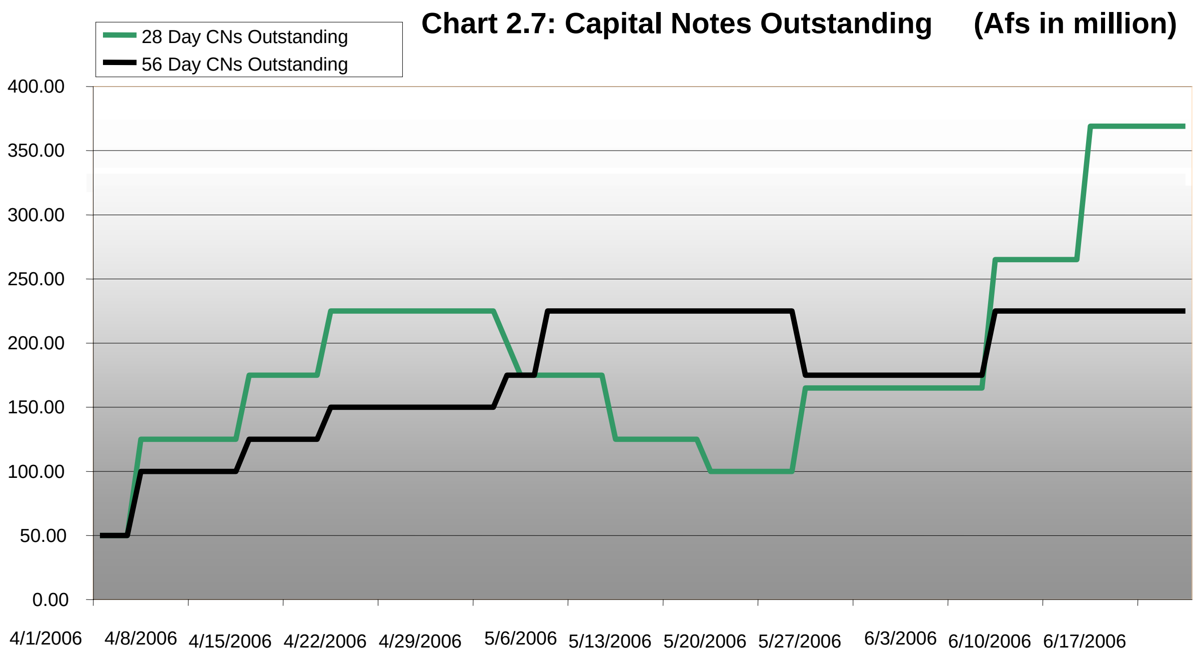


2.2 Market Operations

A. Capital Note Auctions

From the introduction of the new discounted Capital Notes (CN) on March 28, 2006 until the auction of June 20, Capital Notes outstanding have risen to Afs.775 million (Chart 2.7**)**. Participation has grown from 2 to 4 banks (Money Changers have not participated as yet) (Table 2.1). While participation and growth has been uneven, the cover ratio (i.e. amounts bid/amounts offered) has recently risen to 250 per cent for 56 day Notes and rose modestly above 100 per cent for 28 day Notes for the first time in the June 13 auction. Interest rates on these Notes rose from 6.5 per cent to around 8.0 per cent (Chart 2.8) on both maturities with the 56 day Notes having slightly higher rates. There have been no secondary trades of these Notes.

Over the same period the new overnight deposit facility balances, which yield 2.50 per cent per annum, received their first deposits in early May and have risen rapidly close to Afs.500 million (Chart 2.9). As a result, the ratio of bank excess reserves to deposits has fallen from 4.7 per cent during the March 17 to April 13 reserve maintenance period to 3.1 per cent during the May 11 to June 8 period. No banks have borrowed from the Standing Credit Facility, as yet.



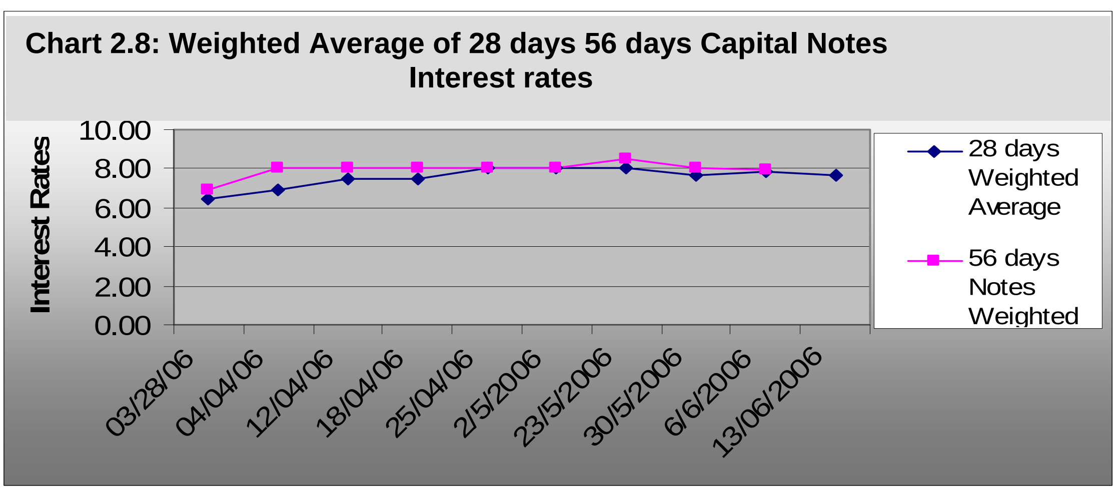
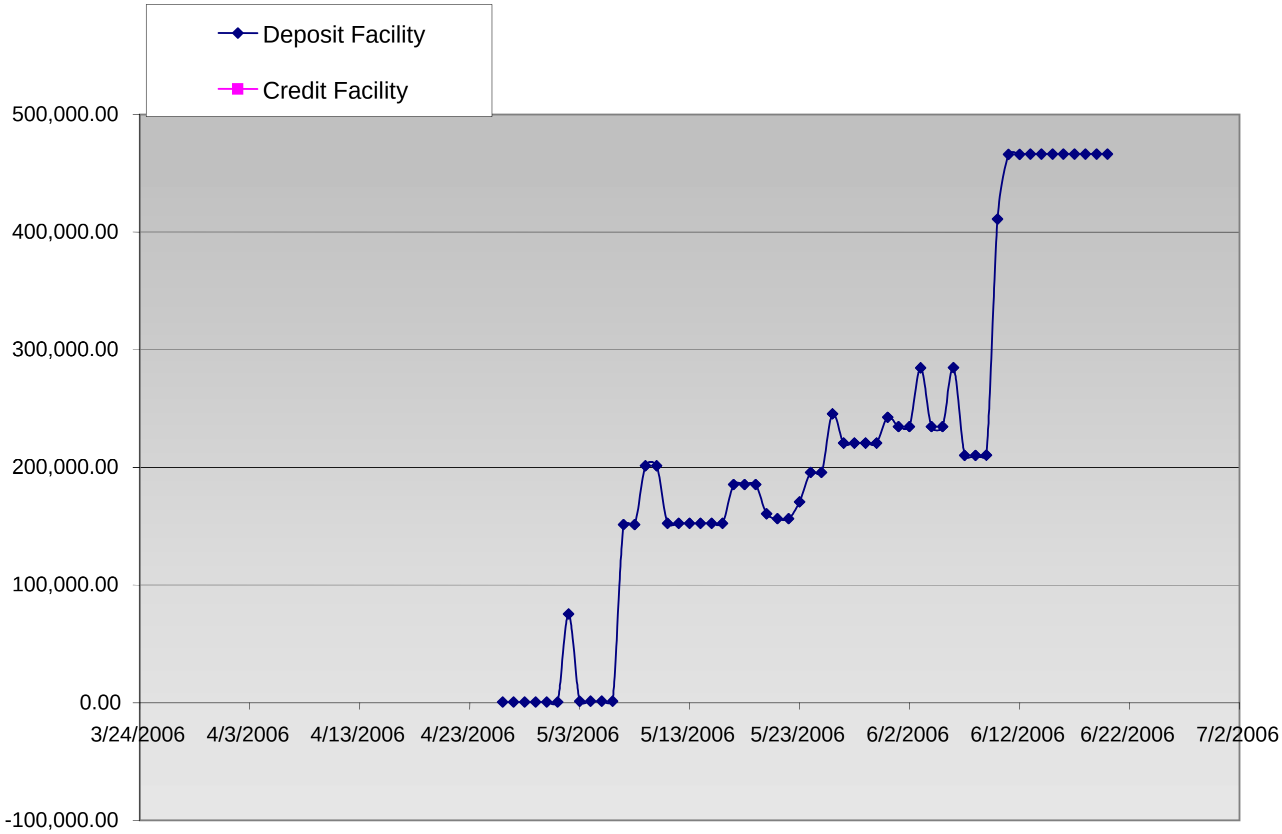


Chart 2.9: Standing Facilities Outstanding (Afs in



Four developments are noteworthy:

a) Banks' excess reserves have declined significantly over this period;

b) Capital Note bidding cover ratios have increased significantly for 56 day Capital Notes (cover ratio of 250 per cent);

c) Overnight deposits have grown rapidly and significantly; and

d) Interest rates on Capital Notes have remained around 8 per cent.

The recent rapid growth in overnight deposits, decline in bank excess reserves, and the increasing over subscription of the CN auctions suggest that banks are gradually improving their liquidity management. DAB has issued more 28 day notes than 56 day notes while demand has been greater for the 56 day notes.

The failure of interest rates on Capital Notes rates to rise above approximately 8 per cent suggests that the supply is insufficient. The relatively large overnight deposits at a very low interest rate, suggests the same thing.

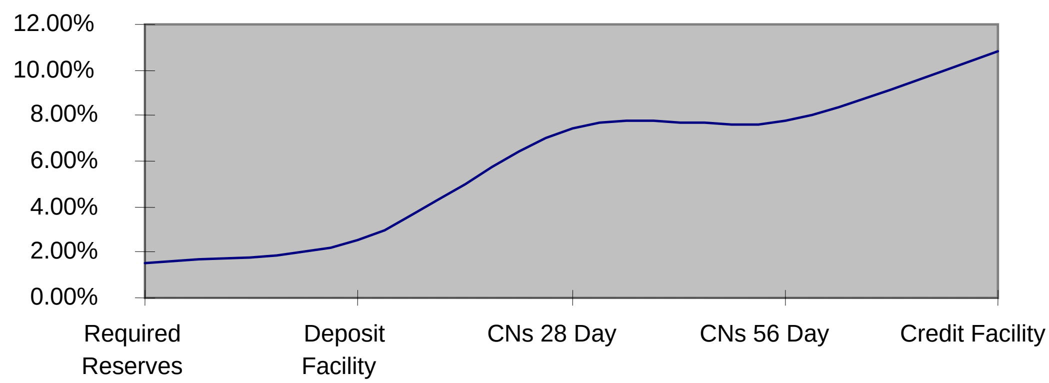
Table 2.1: Auction of Discounted Capital Notes

	Da Afghanistan Bank, Capital Notes 28 Days Auctions Report (Afs in Million)						
Date	Auction Amount	Amount awarded	Total Bid Amount	No. of bidders	High Bid	Low Bid	Weighted Average
23/5/2006	100	50	50	2	8.00	8.00	8.00
30/5/2006	100	100	100	3	7.85	7.50	7.63
6/6/2006	100	100	100	1	7.95	7.85	7.86
13/06/2006	125	125	146	3	7.95	7.40	7.67
20/06/2006	100	100	125	2	7.85	7.75	7.82
Total	**525**	**475**	**521**				

	Da Afghanistan Bank, Capital Notes 56 Days Auctions Report (Afs in Million)						
Date	Auction Amount	Amount awarded	Total Bid Amount	No. of bids	High Bid	Low Bid	Weighted Average
2/5/2006	25	25	25	2	8.00	8.00	8.00
30/05/2006	50	50	100	2	8.50	8.50	8.50
6/6/2006	50	50	125	3	8.00	8.00	8.00
13/06/2006	75	75	125	2	7.98	7.98	7.98
20/06/2006	50	50	150	3	7.92	7.97	7.90
Total	**250**	**250**	**525**				

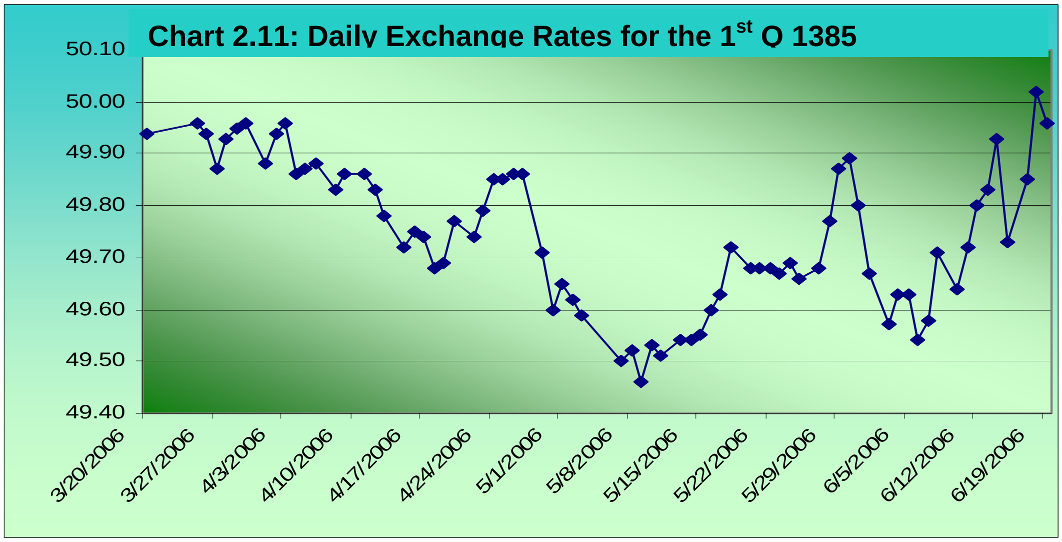
With the recent policy initiatives by the DAB, an yield curve has emerged for the first time in the Afghan financial system. Yield curve on June 27, 2006 is presented in Chart 2.10 below:

Chart 2.10: Yield Curve 27th June 2006



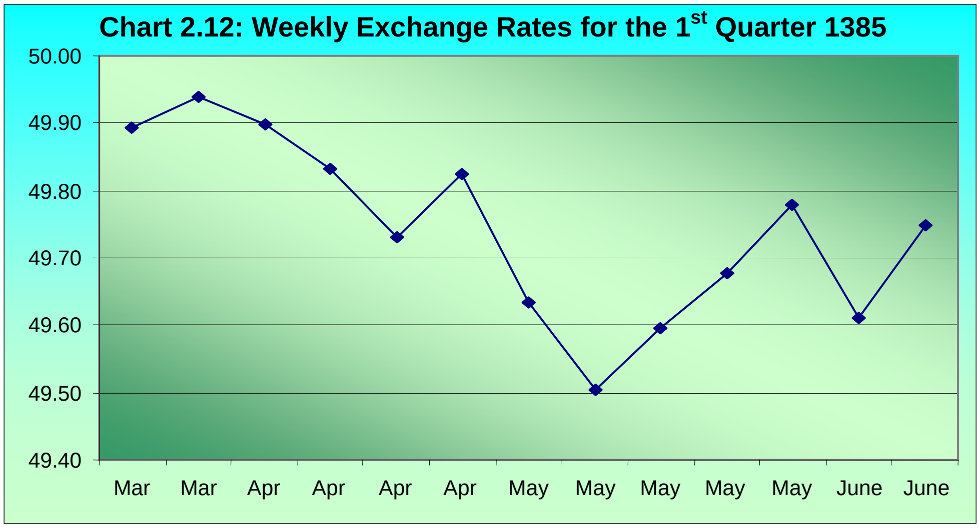
B. Foreign Exchange Market

The historic review of the daily exchange rate, Afs. *vis a vis* US$, for the first quarter of 1385 (20 Mar, 06 to 21 June, 06) is shown below in Chart 2.11. On the whole, the exchange rate of Afghani moved in the corridor of Afs.49.5 to 50 per US$, throughout the quarter. On the end quarter basis, the Afghani depreciated by 0.04 per cent from Afs.49.94 per US$ at the start of the quarter to Afs.49.96 per US$ at the end of the quarter. On quarterly average basis on the other hand, the Afghani appreciated by 0.6 per cent from the last quarter (Afs.50.08 per US$) ended on 20 Mar, 2006, to the present quarter (Afs.49.7 per US$).



The exchange rate movements on the weekly basis are depicted in Chart 2.12, given below, which shows two distinct phases. In phase one, the Afghani started appreciating *vis-à-vis* the US$ in Mar 2006 which continued up to mid-May 2006, from Afs.49.89 per US$ to Afs.49.50 per US$. In the phase two, starting from mid-May 2006 until mid-June 2006, the Afghani depreciated from Afs.49.50 per US$ to Afs.49.75 per US$ A possible reason behind the phase one appreciation was that the DAB started decentralization of the foreign exchange auctions and extended the auction mechanism to the zonal hubs. It was successfully implemented initially in Herat and it is expected to take place in other zones in the near future as well. Early indications are that it will help in stabilizing the Afghani exchange rate and making it uniform throughout the country over time. The other possible factor was that the Ministry of Finance had smaller injections especially in the month of Hamal (Mar-Apr 2006).

The standard deviation and the coefficient of variation of the exchange rate movements for the quarter Q1, 1385 (STD 0.14, CV 0.3 per cent) as compared with the last quarter (STD 0.35, CV 0.7) shows that exchange rate of Afghani has been quite stable in the current quarter compared with the last quarter ended on 20 Mar, 2006.



In sum, the exchange rate scenario suggests that the exchange rate movements were under control throughout the first quarter of 1385 with the minimum volatility. This shows that the foreign exchange auction program by the DAB is going on smoothly.

C. Foreign Exchange Auctions:

For achieving stability of the exchange rate, Da Afghanistan Bank has continued using its main policy instrument viz., the foreign exchange auctions for the periodic intervention in the market to smoothen the fluctuations in the exchange rates and to control the growth of money supply. The Da Afghanistan Bank has maintained this bi-weekly sterilization policy to mop up extra liquidity arising principally from government expenditures and the peace keeping foreign forces. The foreign exchange auction size is determined by a liquidity forecasting framework, which takes in account the money demand on one hand and the currency growth ceiling agreed between the DAB with the IMF on the other.

Table 2.2 summarizes the results of DAB foreign exchange auctions during the period from 11 Dec, 2005 to 20 June, 2006, which covers the last two quarters. Overall, net intervention in the foreign exchange market of Afghanistan by DAB amounted to US$.93.37 million in Q1, 1385. In the last quarter of 1384, the DAB intervention was much larger amounting to US$ 149 million. The weighted average of all the 18 awarded auctions rate (sale price of the US$) was 49.97 during Q4, 1384 in which total number of awarded bidders were 385. In Q1, 1385 there were 23 auctions and the average of cut-off rate was Afs. 49.70, with the participation of 324 bidders.

Table 2.2: Foreign Exchange Auctions

Auction Date	No of Bidders	High Price	Low Price	Cut off Price	Amount Awarded	No of Awarded Bidders
11-Dec-05		50.07	49.92	50.03	12.60	24
18-Dec-05		50.07	49.90	50.05	12.20	26
25-Dec-05		50.20	49.90	50.15	10.50	25
1-Jan-06		50.40	50.22	50.34	13.60	32
15-Jan-06		50.45	50.20	50.31	11.20	29
21-Jan-06		50.65	50.40	50.60	13.15	29
29-Jan-06		50.70	50.50	50.64	12.30	31
5-Feb-06		49.97	49.80	49.90	7.10	22
7-Feb-06		50.44	50.44	50.44	5.10	15
11-Feb-06		49.27	49.00	49.27	3.50	14
14-Feb-06		49.45	49.25	49.42	6.60	12
19-Feb-06		49.75	49.00	49.61	7.20	18
21-Feb-06		49.74	49.55	49.70	6.20	15
25-Feb-06		49.92	49.70	49.86	9.85	24
28-Feb-06		50.00	49.70	49.84	5.45	14
4-Mar-06		50.05	49.70	49.86	5.50	20
7-Mar-06		49.86	49.70	49.83	8.00	24
11-Mar-06		49.86	49.50	49.83	6.50	18
14-Mar-06		49.91	49.70	49.88	6.15	15
18-Mar-06		50.14	49.50	50.06	11.10	28
26-Mar-06		49.96	49.80	49.92	7.15	20
28-Mar-06		49.97	49.80	49.95	6.20	15
1-Apr-06		49.86	49.60	49.86	0.02	1
4-Apr-06		49.96	49.70	49.86	10.05	25
8-Apr-06		49.86	49.70	49.80	6.30	25
11-Apr-06		49.85	49.70	49.83	3.05	9
15-Apr-06		49.75	49.60	49.71	6.05	19
18-Apr-06		49.65	49.50	49.62	2.50	7
22-Apr-06		49.78	49.00	49.74	7.75	26
25-Apr-06		49.87	49.69	49.85	3.45	11
29-Apr-06		49.85	49.60	49.68	4.30	18
2-May-06		49.65	49.53	49.60	4.65	18
6-May-06		49.52	49.40	49.48	4.75	17
9-May-06		49.40	49.13	49.40	1.80	4
13-May-06		49.52	49.25	49.50	3.45	16
16-May-06		49.62	49.50	49.60	2.70	13
20-May-06		49.72	49.60	49.68	5.10	18
23-May-06		49.71	49.40	49.69	2.40	11
27-May-06		49.72	49.62	49.67	3.05	12
30-May-06		49.75	49.60	49.71	2.00	7
3-Jun-06		49.60	49.40	49.56	2.30	11
6-Jun-06		49.55	49.40	49.54	2.25	10
20 Jun-06		49.99	49.90	49.96	2.10	11
Current Quarter Total					**93.37**	

D. Foreign Exchange Reserves

Da Afghanistan Bank's foreign exchange reserves consist of the US Dollar(US), British Pound(GBP), Euro(EUR), Swiss Franc(SF), Canadian Dollar(CDN), UAE Dirham(DIR), Hong Kong Dollar(HKG), Poland Zloty (PZ), Russian Ruble (RUB), Saudi Riyal (SIR), Indian Rupee (IR), Pakistan Rupee (PR), Iranian Rial (RI), French Franc(FF) and Egyptian Pound (EPD). The Reserves are held in the short term deposits in various international banks, in UK Treasury bills, US Treasury Bills and Notes and also in the Call account and Current account for the transaction purpose, besides the Vault cash. The Call account earns interest on overnight basis.

The total foreign exchange of DAB amounted to US$1.9 billion at the end of Q1, 1385. At the beginning of the year 1385 the level was US$1.8 billion. Monthly data on foreign exchange reserves are illustrated in Chart 2.13.

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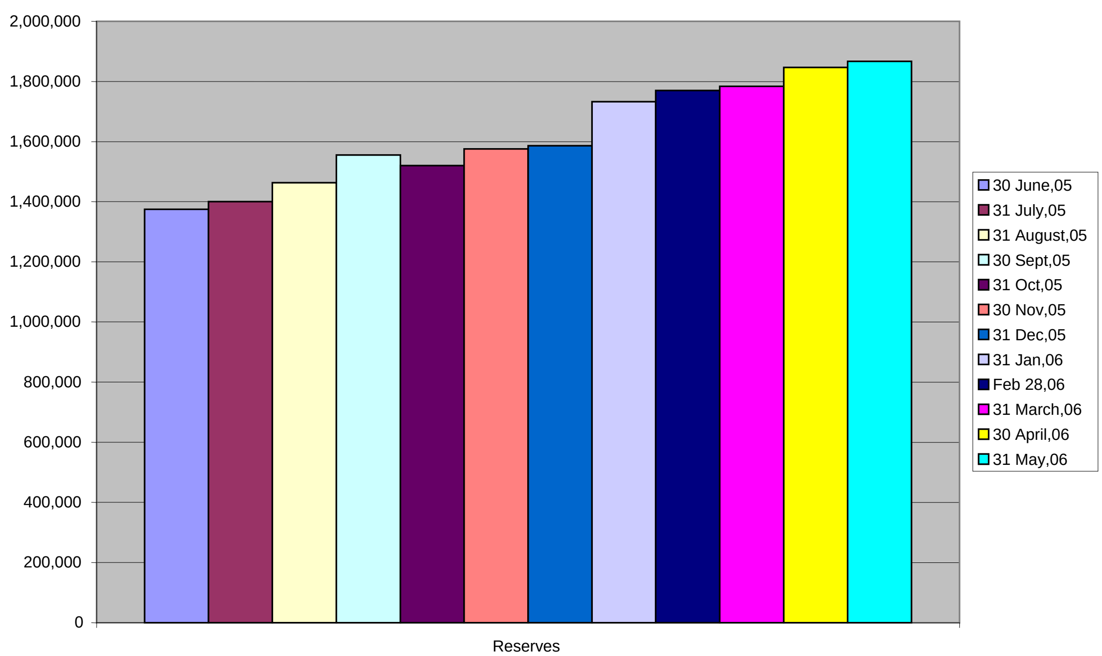
Chart 2.13: Foreign Exchange Reserves (In billion US$)



June, 05-May, 06 monthly basis

III. Financial Sector Developments

3.1 Banking Sector

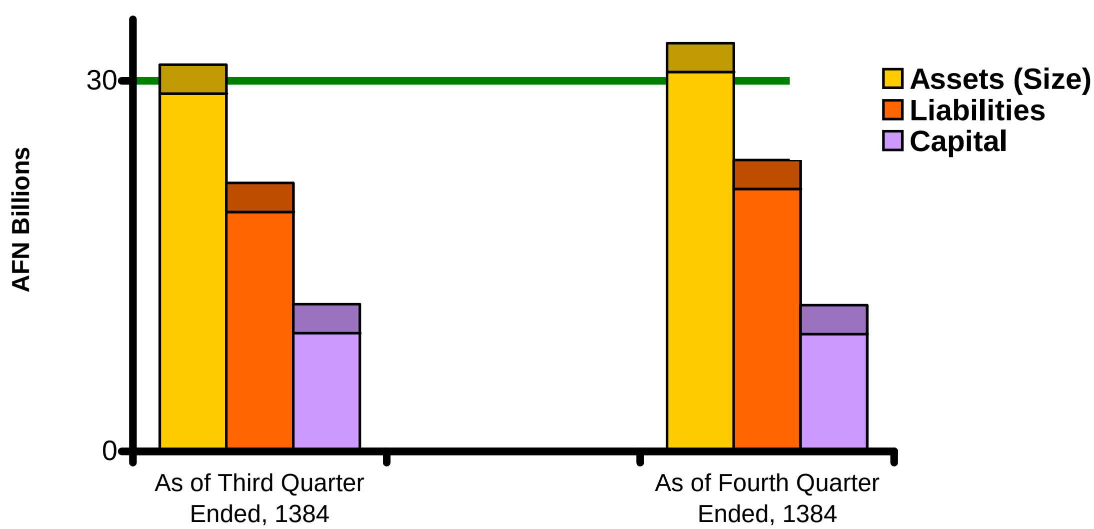
The Banking Sector in Afghanistan consists of 13 duly licensed and permitted banking organizations:

- 3 re-licensed State-owned banks (with 17 branches in Kabul and 15 branches outside Kabul)
- 5 full-fledged private banks (with 17 branches in Kabul and 21 outside Kabul, and)
- 5 branches of foreign banks.

A. **Assets of the Banking System**

The Afghan banking system continues to grow. Total size of assets of the banking system were around Afs. 31 billion at end Q4, 1384, up by 6 per cent (or by Afs. 1.7 billion) from the last quarter which is a respectable growth rate. (Chart 3.1)

Chart 3.1: Banking Sector Growth



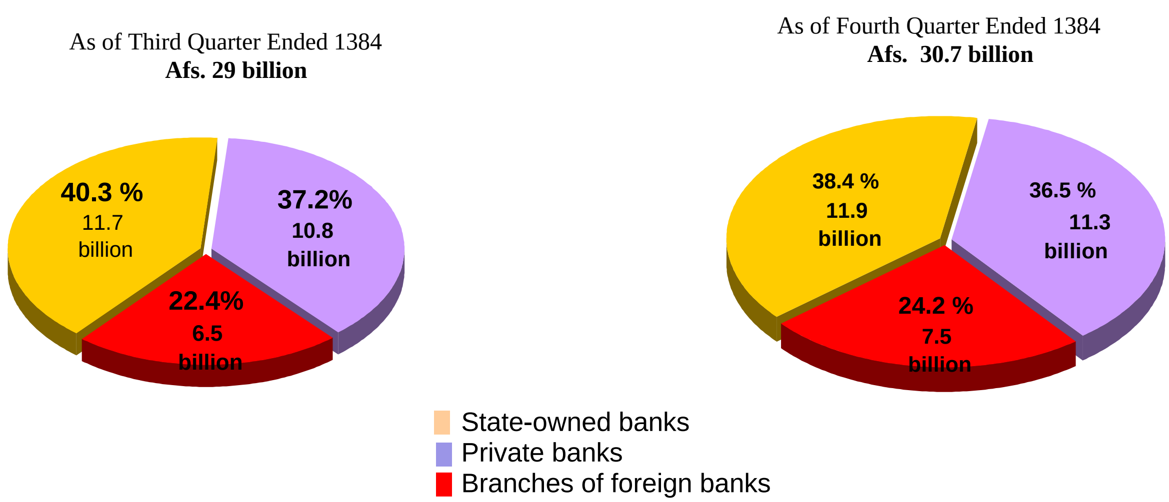
The shares of aggregate assets of banking sector among different categories of banking organizations are summarized in Table 3.1:

Table 3.1: Share in Aggregate Assets (Per cent)

	Third Quarter Ended 1384	Fourth Quarter Ended 1384
State-owned Banks	40.3	38.4
Private Banks	37.2	36.5
Branches of Foreign Banks	22.4	24.2

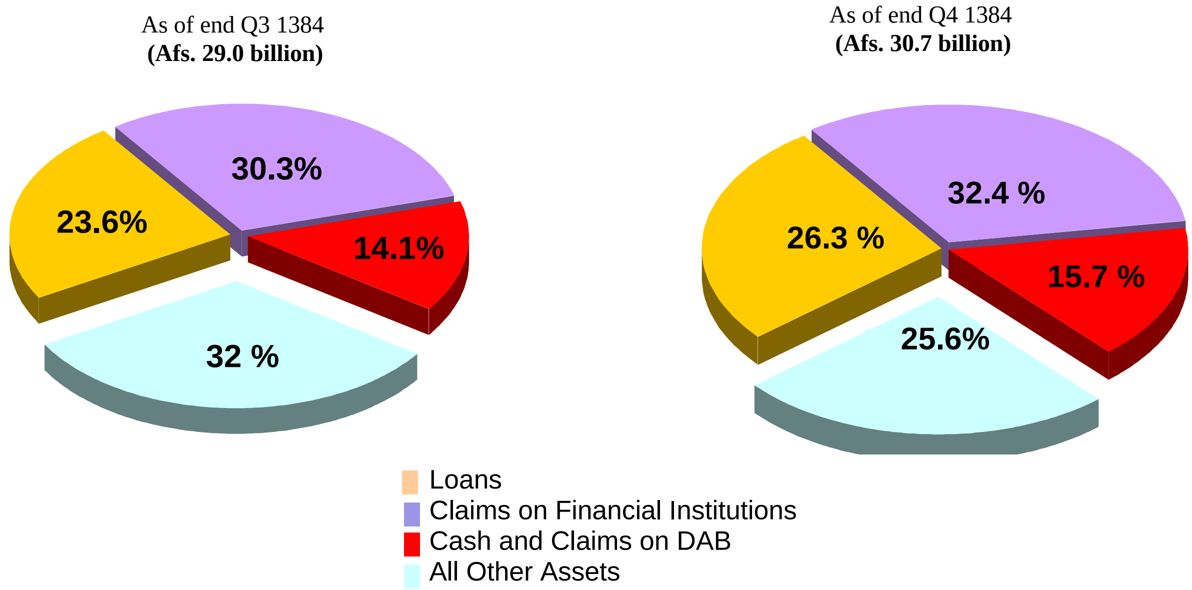
The overall size of the banking system rose from Afs. 29 billion to Afs. 30.7 billion – by around 5.9 per cent. Of this, the size (assets and liabilities of unrelated parties) of branches of foreign banks expanded by Afs. 1 billion or 59 per cent of the total increase in assets of the banking system, the highest among the three peer groups. Private banks accounted for one third of the increase, while the State-owned banks ended up with the remaining 12 per cent. (Chart 3.2)

Chart 3.2: Total Assets (Size)



The major components of assets, in the descending order as a percentage of total assets, are illustrated below: (Chart 3.3)

Chart 3.3: Major Asset Categories



Excess Liquid Assets

Excess liquid assets[1] of the banking sector were placed at Afs. 15.5 billion at the end of the fourth quarter, up from Afs. 14 billion at the end of the third quarter. The aggregate increase was fairly evenly spread across the banking organizations, with 9 of them showing increases and the remaining 3 showing slight decreases. The foreign branches accounted for 39 per cent of aggregate excess liquid assets, followed by the State-owned banks at 38 per cent and private banks at 23 per cent.

Excess liquid assets are significant for monetary policy, because they potentially lead to a loss of correlation between increases in the monetary base (currency held by the nonbank public plus eligible assets) and increases in the supply of credit to the economy. In other words, the

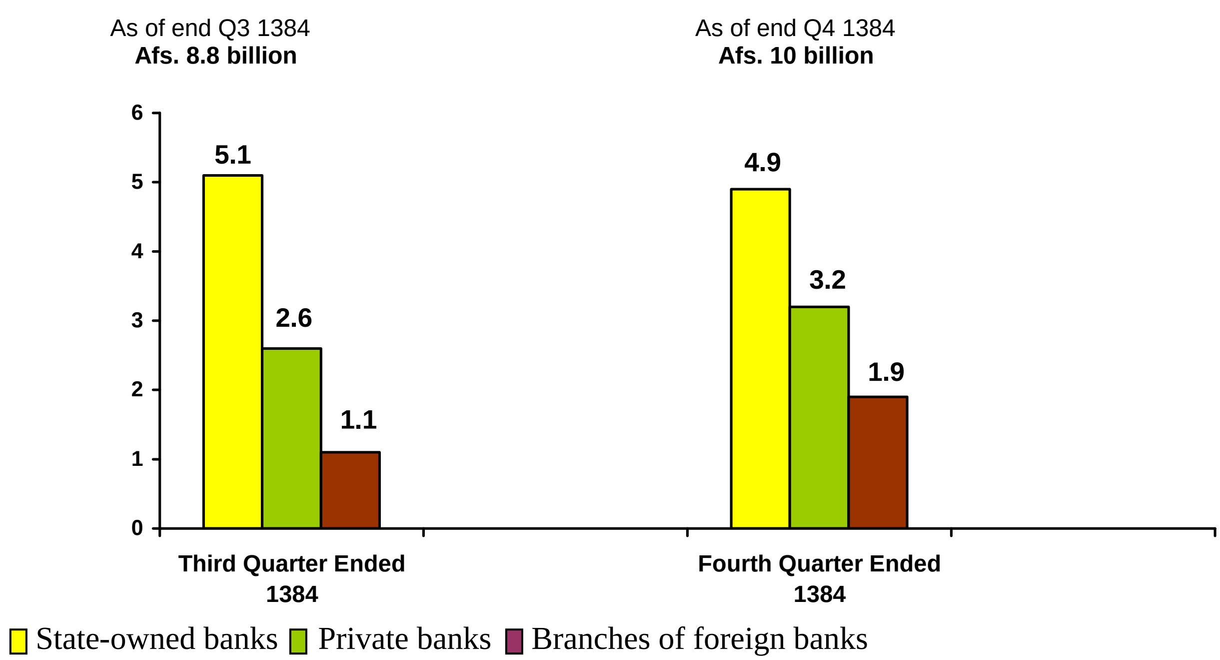
[1] Excess liquid assets were calculated on a bank-by-bank basis and then aggregated for the sector. The excess is defined as the amount of liquid assets in excess of the amount required to comply with the 15 per cent minimum broad liquidity ratio (liquid assets as a percentage of attracted funds). It should be noted that if a bank complies with this requirement, it can comply with the 8 per cent reserve requirement for monetary policy purposes (eligible assets as a percentage of customer deposits), simply by achieving the proper composition of liquid assets, because eligible assets are a subset of liquid assets and customer deposits are a subset of attracted funds. Accordingly, the measure of excess liquid assets used in this analysis is in excess of every regulatory requirement. For branches of foreign banks, "net due from related depository institutions" – which represents amounts owed to the branch in Afghanistan by the home office and other branches of the same bank – is considered to be a liquid asset. It should be noted that the foreign branches are not subject to the minimum broad liquidity ratio requirement. However, the requirement can be used as an estimate of the amount of liquid assets they might wish to hold if they were "fully loaned up."

normal transmission mechanism for monetary policy – an increase in the monetary base leading to an increase in customer deposits, which in turn provide banks with the funds to increase the supply of credit – can be circumvented. Banks can increase the supply of credit to the economy simply by drawing down their excess liquid assets, regardless of the behaviour of the monetary base.

Claims on Financial Institutions

Claims on Financial Institutions are by far the largest among various asset categories, comprising Afs. 10 billion at end Q4, 1384 – a 13 per cent increase over the Q3, 1384 – or 32.4 per cent of total assets. Branches of foreign banks and private banks increased their claims, while there was a decline in respect of the State-owned banks. Foreign bank branches' claims on financial institutions were Afs. 1.9 billion, up by 73 per cent, or 67 per cent of the total increase for this category. Demand deposits with banks which is one of the sub-items of this category, accounted for the bulk of the increased amount over the previous quarter. (Chart 3.4)

Chart 3.4: Claims on Financial Institutions



Net Loans

Net Loans Portfolio is the second largest component of total assets, placed at Afs. 8.1 billion at end Q4, 1384 – an 18 per cent increase over the previous quarter – or 26.3 per cent of total assets. Increase in lending was observed at all but five of the banking organizations. Private banks outperformed the other groups by increasing their net loans portfolio up to Afs. 1.1 billion, or 92 per cent of the total increase in net loans portfolio. It is noteworthy that one private bank's loans portfolio (commercial loans) increased so substantially that it constituted more than two-third of the amount increased over the previous quarter for all banks. Increases in net loans portfolio were mainly concentrated in one sub-category, commercial loans. Other sub-categories changed insignificantly. In other words while lending is picking up, it is still not sufficiently large in some loan categories related to important sectors of the economy, e.g. agriculture. (Chart 3.5, and 3.6)

Chart 3.5: Loans Portfolio

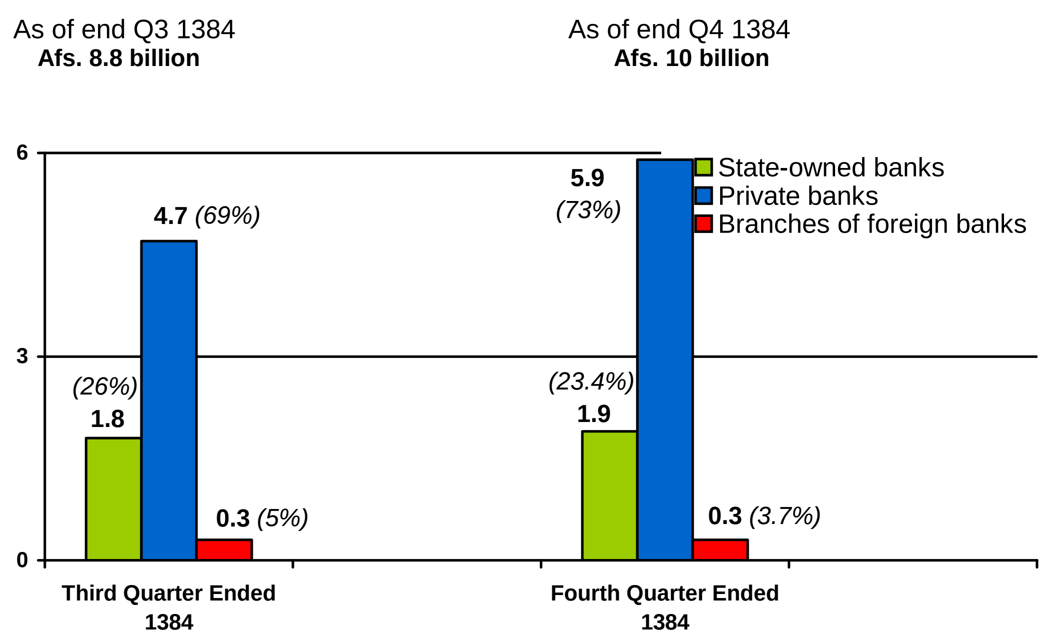
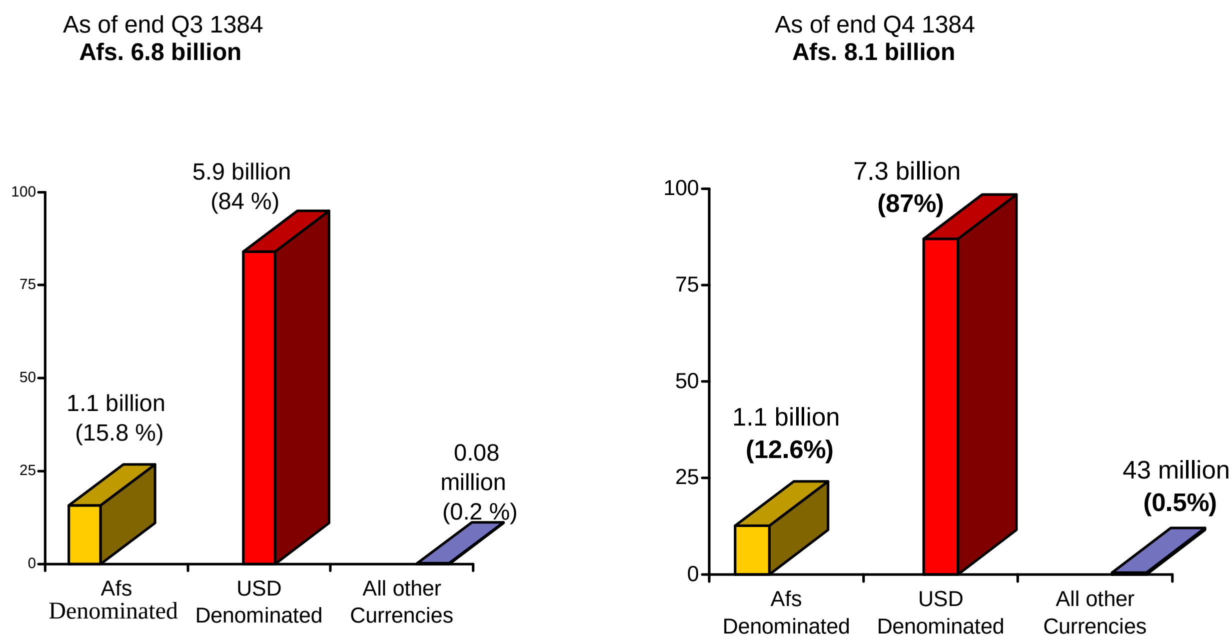


Chart 3.6: Currency Composition of Loans



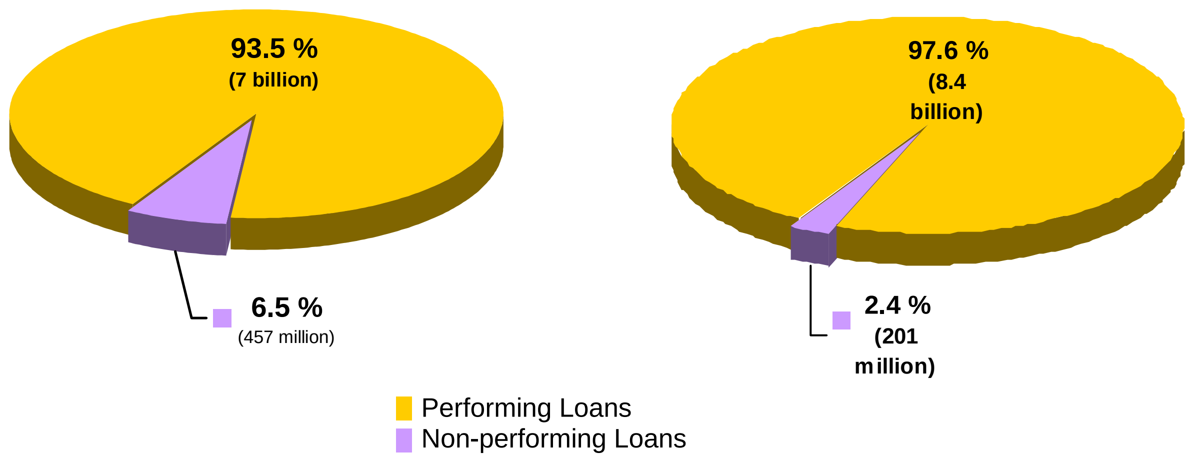
Private banks are the leading creditors, increasing their portfolio both in absolute terms as well as percentage of total loans. State-owned banks' share as percentage of total loans dropped by 2.6 percentage points, although is improved in absolute terms. Branches of foreign banks' absolute amount remained unchanged, while their share came down by 1.3 percentage points.

Asset Quality (Adversely classified assets & Past due status)

The overall quality of loans portfolio of the Afghan banking system is highly satisfactory, with 82 per cent of the loans classified as standard. However, on-site examinations would confirm the accuracy of these data.

There are two indicators of loans quality: non-performing loans (NPL) and adversely classified loans (ACL). Because of the way these indicators are defined, NPL should be less than ACL. In DAB, the focus is on the sum of loans, past due 91 days or more (non-accrual) and other non accrual loans. These loans are called non-performing loans (NPLs). The total amount of non-performing loans was Afs. 201 million at end Q4, 1384, while adversely classified loans (loans classified Substandard, Doubtful, and Loss) were Afs. 252 million. The latter must be higher or at least equal to the former. NPLs are currently 2.4 per cent of gross loans, down by 4.1 percentage points over the previous quarter. (Chart 3.7)

Chart 3.7: Quality of Loan Portfolio



Cash in Vault and Claims on DAB

Cash in Vault and Claims on DAB remains the third largest category, which registered increases both in absolute terms as well as a percentage of total assets. Claims on DAB increased by 39 per cent from the previous quarter, presumably because of banks coming into compliance with reserve requirements.

B. Liabilities

Total liabilities of the banking sector at the end of Q4, 1384 were placed at Afs. 21.2 billion, up by 9.4 per cent from the last quarter. This is certainly an indication of growing public confidence in the banking system and good marketing policies of the banking sector. (Chart 3.8)

Chart 3.8: liabilities

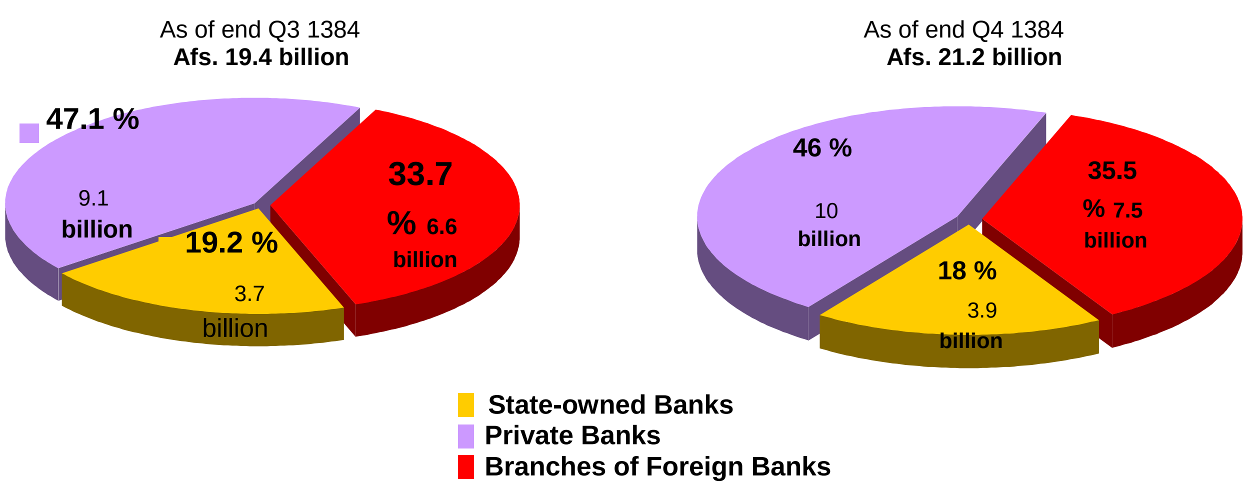
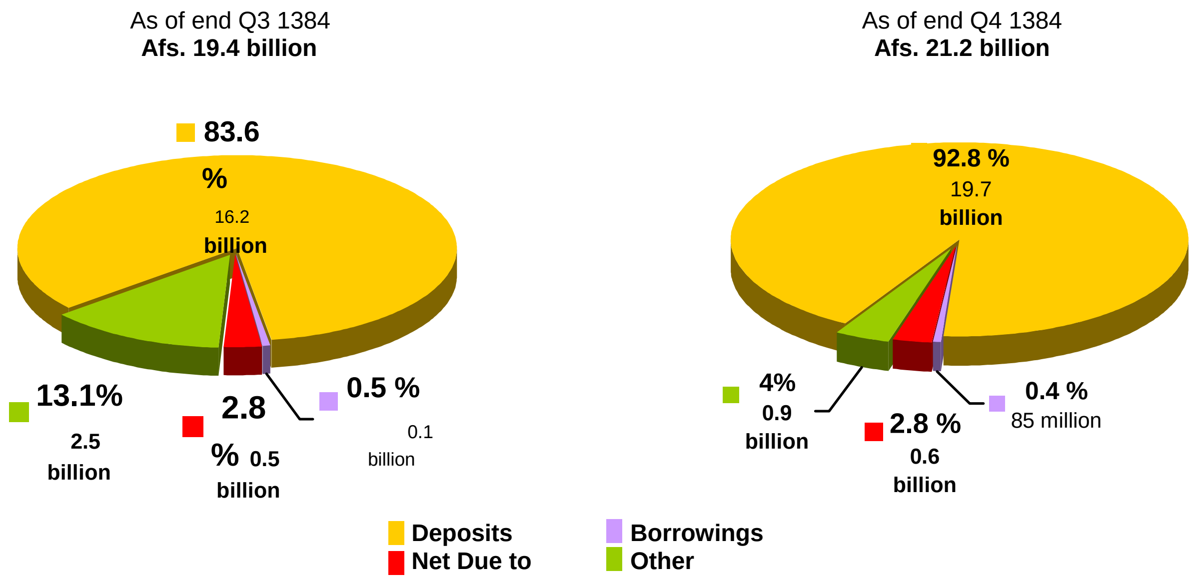


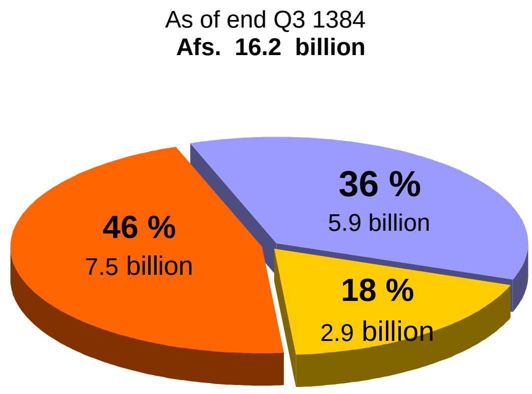
Chart 3.9: Composition of Liabilities

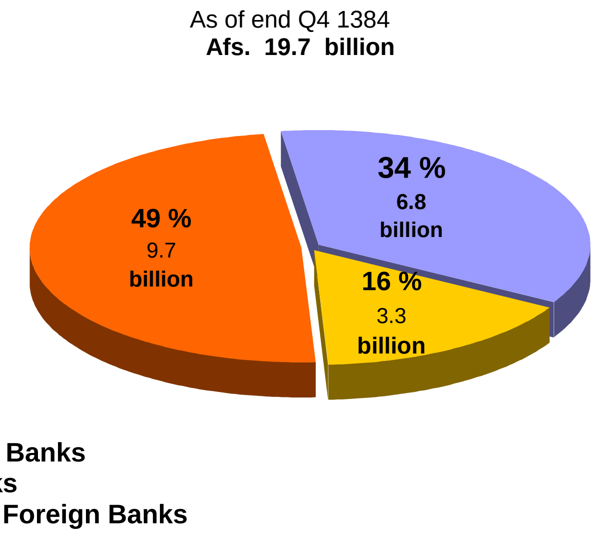


Deposits are the major component of liabilities, currently equal to Afs. 19.7 billion, a 22 per cent increase over the previous quarter. Almost 63 per cent of total increase belonged to private banks, 26 per cent to branches of foreign banks, and the remaining 11 per cent to the State-owned banks. Total deposits of the banking system increased in absolute terms as well as percentage of total liabilities. Total deposits of private banks also increased both ways. Even though deposits of State-owned banks and branches of foreign Banks are expanding, they are not growing as fast as the expansion of total deposits of the banking system, leading thereby to shrinkage of their shares.

Shares of deposits denominated in Afs. US$, and all other currencies remained mostly unchanged over the Q4, 1384, despite favourable movements in Afs. and US$ denominated ones in absolute terms. Increases in deposits of foreign banks branches were reflected as comparable increases in total assets with unrelated parties for the period, indicating a shift from a source of funds for the home office towards active engagement in the country. (Chart 3.10)

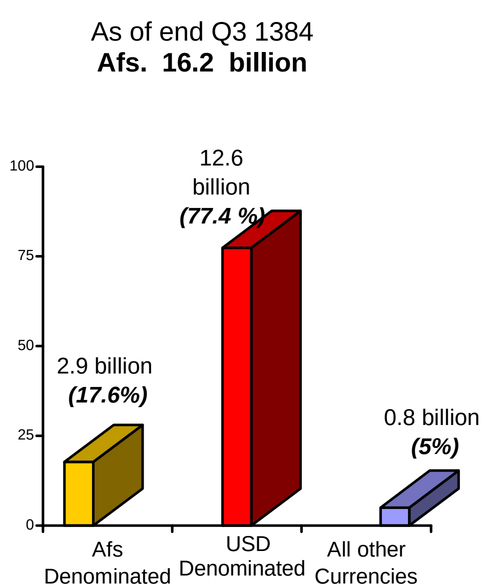
Chart 3.10: Deposits





Of the total Afs-denominated deposits, the State-owned banks are still the biggest holders, while private banks are improving their share, but not by a great margin. In fact, there is an imperative need for the banking organizations to do more to make Afs. denominated deposits more attractive for customers. (Chart 3.11, 3.12)

Chart 3.11: Currency Composition of deposits



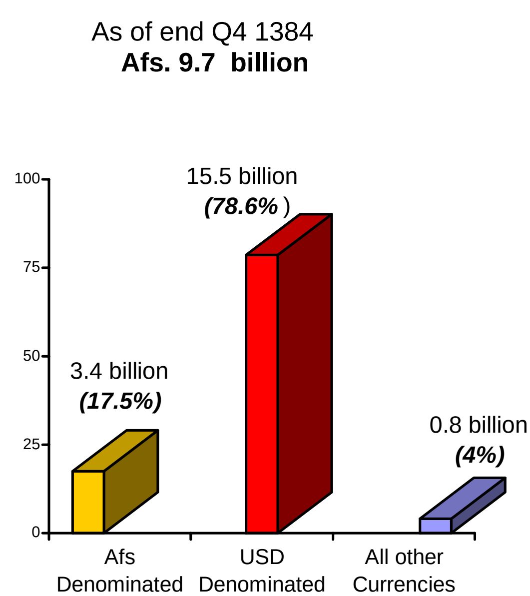
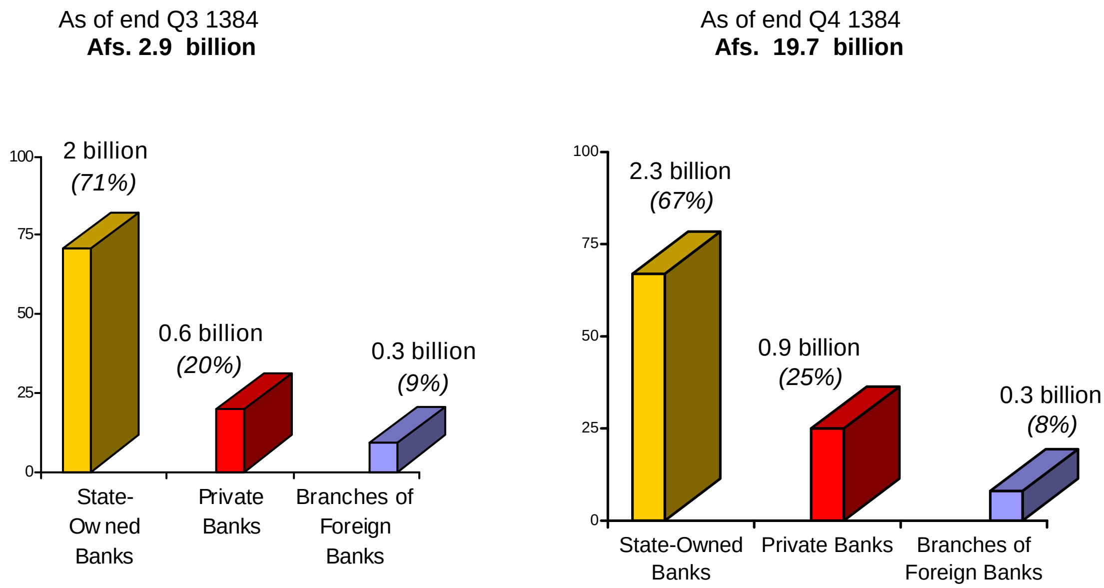


Chart 3.12: Afghani Denominated Deposits



Other liabilities except Interest Payable remain the second major component of liabilities which was down by 67 per cent, or 4 per cent of total liabilities over the quarter.

Capital

The banking system, as a whole, is very well capitalized. Total capital at full-fledged banks was Afs. 9.5 billion at end Q4, 1384, down by 0.8 per cent from the previous quarter. If the 20 per cent capital/assets ratio or assets support by capital is taken as the benchmark (which is an internationally applied ratio for the banks), the Afs. 9.5 billion can support assets of Afs. 47.5 billion, while total assets at the end of quarter were Afs. 31 billion.

Branches of foreign banks do not have separate capital. The most analogous concept to positive capital is the Net Due to Related Depository Institutions, primarily the home office and other branches of the same bank (NDT), while the closest analogue to negative capital is the Net Due from Related Depository Institutions, primarily the home office and other branches of the same bank (NDF).

The NDT and NDF positions of branches of foreign banks were the same as in the previous quarter. So, two of them are in a favourable NDT position, much smaller than the relatively large, unfavourable NDF positions for the remaining three. Put differently, only two of them are actively seeking investment outlets for the funds they have attracted, while the others are simply sending their acquired funds to their international networks.

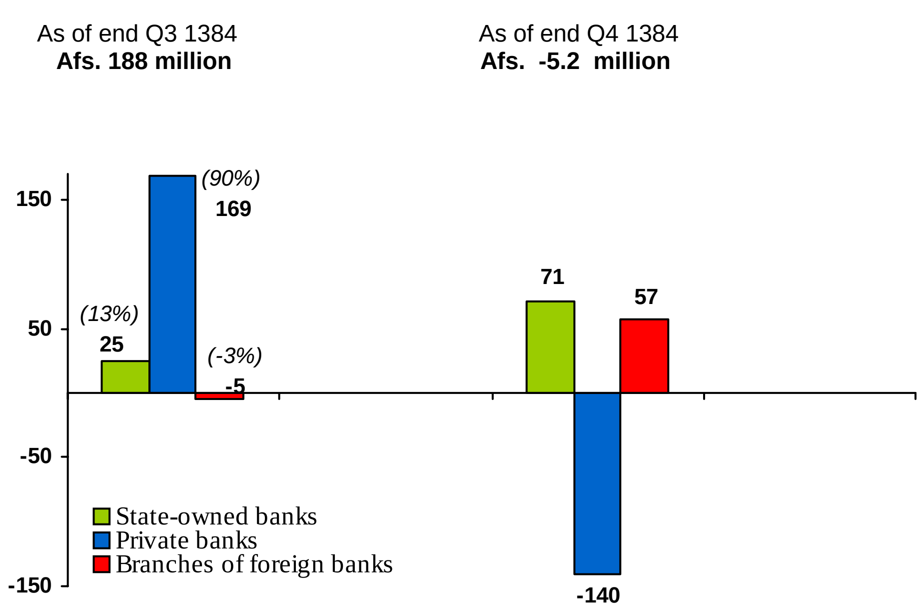
NDF is probably a normal situation for a foreign branch in the first year or so of existence when the branch is establishing itself and seeking loan customers and other investment opportunities. Supervisory action will only be required if the branch persists for another year or two in a NDF position or the bank's overall worldwide condition and performance is deteriorating.

Profitability

The banking system as a whole became unprofitable in the fourth quarter, 1384. Because of unequal size-distribution of banking sector and different accounting procedures, changes in individual banks can significantly affect the overall profitability of the banking sector.

Total net profit of the banking sector for the Q4, 1384 was Afs. -5.2 million, down by Afs. 193 million, resulting in an overall return on assets (ROA) of -0.07 per cent. However, six banks ended up with higher profitability than before.

Chart 3.13: Profitability



Because of the large losses some banks, private banks as a group were unprofitable. The State-owned banks and branches of foreign banks were more profitable than in the last quarter, but not sufficient enough to more than completely offset the negative impact of private banks' net losses.

Banks can also be classified according to whether they earn most of their income from interest or non-interest sources. In terms of "orientation" (interest vs. non-interest), all three groups of banks in Afghanistan turn out to be interest-oriented with exceptions among each group that are non-interest oriented.

The major component of income was net interest income (NII) with total amount of Afs. 371 million, up by 18 per cent from the previous quarter. Of this increase, more than half was earned by private banks. State-owned banks earned one quarter of the total NII.

The second major component of income is other non-interest income totalling Afs. 193 million, an 8 per cent increase over the previous quarter. State-owned banks ended up with 40 per cent of total other non-interest income, whereas the other peer groups shared the balance equally.

The most important component of expense is the non-interest expense (NIE), placed at Afs. 370 million at end Q4, 1384, a 29 per cent increase from the previous quarter. Private banks were at the top at Afs. 252 million, while the State-owned banks balance were at Afs. 40 million; 68 per cent and 11 per cent of total NIE, respectively.

Efficiency Ratio (*net interest income + trading account gain/loss + other non-interest income* divided *by operating expenses*) of the system dropped from 2.15 in the third quarter to 1.36 for the fourth quarter, but still remained satisfactory. Seven banking institutions ended up with lower efficiency ratios. Despite increases in both numerator and denominator of the ratio, it was faster rise in the denominator that brought about the decline.

Foreign Exchange Risk

Banks are still taking considerable foreign exchange risk. In general, the long open FX positions of all private banks are way above the thresholds set by DAB and getting worse. This prompted the issuance of enforcement actions to those ones in violation of set limits. According to Open Positions in Foreign Currencies' Regulation, the overall open position in all foreign currencies shall not exceed 40 per cent of the institution's regulatory capital. So far, the majority of the banks are above the limit. (Branches of foreign banks are not subject to limitations on open FX position, since that risk is managed on a whole-bank basis and not branch-by-branch). The enforcement actions require the elimination of these excess long positions by August 31, 2006.

- Most banks that have open positions have long position, either in individual currencies or overall.
- No bank has short positions in these currencies.
- A general depreciation of the Afghani (appreciation of foreign currency) from \$1= Afs. 50 to \$1 = Afs. 60 would cause capital of the banking system to increase by 11.5 per cent.
- A general appreciation of the Afghani (depreciation of foreign currency) from \$1= Afs. 50 to \$1 = Afs. 40 would cause capital of the banking system to decrease by 11.5 per cent**.**
- This impact on the banking system should be taken into account in managing exchange rate targets.

Interest Rate Risk

Interest rate sensitivity of the banks changed during the last quarter of 1384, and all banks are in asset sensitive position (benefiting from an increase in the interest rate). (Branches of foreign banks are not required to file the interest-rate sensitivity schedule, because like FX risk, interest-rate risk is managed on a whole-bank basis). The major reason for the overwhelming asset-sensitivity of the banks is the large excess of interest-bearing assets over interest-bearing liabilities. Although it may improve the net interest margin and overall profitability of the bank, this situation makes the banks more vulnerable to a sudden decrease in market rates.

The current situation could be summarized as below:

- Banks are becoming more asset-sensitive
- At the same time, core income [(*net interest income* + *trading account gain/loss* + *other non-interest income)* minus *operating expenses]* is declining slightly, making banks less able to withstand declines in NII caused by a shock.
- An upward shock of 3 percentage points would increase the net interest income of full-fledged commercial banks (State-owned and private) by Afs. 252 million over one year.

- A downward shock of 3 percentage points would decrease the net interest income of the full-fledged commercial banks by Afs. 252 million.

The traditional cause of interest-rate risk, the mismatch between the maturities of interest-earning assets and interest-costing liabilities, has not emerged in Afghanistan as yet.

IV. Fiscal Sector

4.1 Budgetary System

In Afghanistan, the fiscal year starts on March 21 and ends on March 20 of the following year. There are three types of budgets to be dealt with each fiscal year:

1. Operating or Ordinary Budget ;
2. Development Budget (under the control of the Government) ;
3. Development Budget (also called the external budget, which is not under the control of the Government).

The operating budget is partly financed by the Government domestic revenues and partly by two specific donor funded accounts of ARTF and LOTFA, which are two means of supporting the operating budget of the Government. The development budget under the control of the Government is totally financed by donor money. There is a multiyear allocation of donor money by the Government, which is being implemented by the line ministries of the Government. Finally the third type is external budget or development budget which is controlled and implemented by the donors and the Government has little or no role in that. This budget is in the form of economic projections of donor inflows by the Government. In the London Conference a pledge of around US dollars 10 billion was made to Afghanistan; 50 per cent of this money is supposed to be provided directly to the Government while the remaining 50 per cent is to be injected through the NGOs and other international organizations.

4.2. Fiscal Trends-1385 (2005-06)

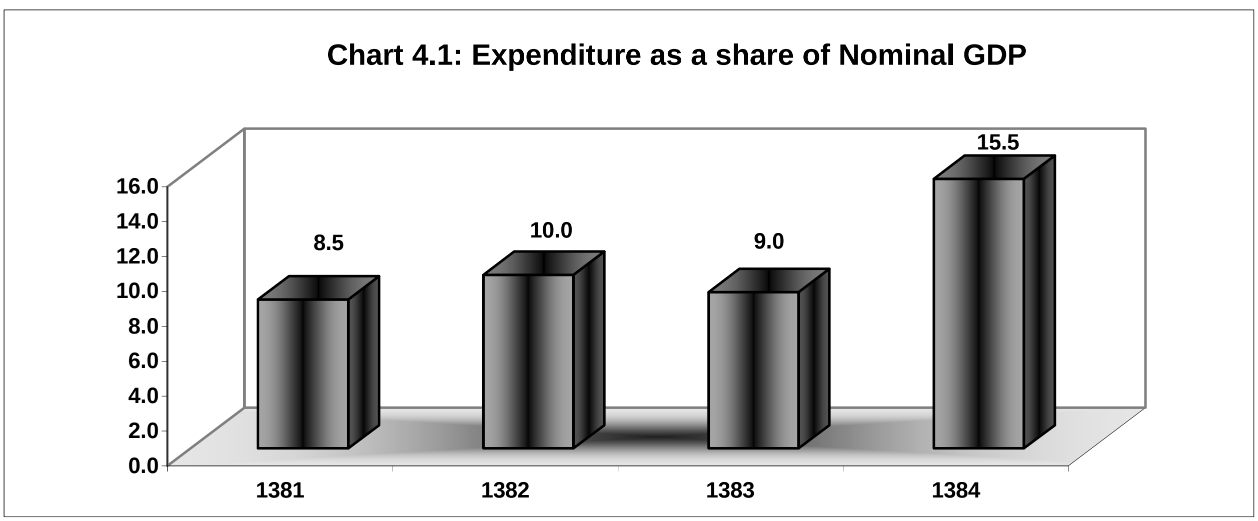
The budget for 1385 fiscal year was finally approved by the Parliament. During the first two months of the fiscal year 1385 the budget was reviewed and checked by the Parliamentarians and they recommended some broad changes in the ceiling of the budget, especially in the wages and salaries of the Government employees and allowances to martyrs' families and disabled. It was not possible to change the budget ceiling. Accordingly, the ceiling was maintained by reducing some development expenditures of Ministries. The wages and salaries were raised by Afs. 300 in general and allowances to martyrs' families and disables were raised by Afs. 100 in general. The main reason behind the Government's inability to change the budget ceiling was that most of the operating budget is being supported by external grants and changing the ceiling of operating expenditure cannot be covered in the future in case this external support ceases.

Domestic Revenue

Domestic revenue has been steadily growing during the 1381-84 fiscal years. It has increased from $131.9 million in 1381 to $448.6 million in the 1384 fiscal year. The main contributor to this revenue has been custom duties and taxes on imports. Income tax was implemented during the third quarter of 1384, which improved the tax revenues significantly.

Expenditure

Total Government expenditure has been rising over time as a share of GDP; this is a matter of concern as the domestic revenue support to total expenditure is very low.



Source: Ministry of Finance and MPD staff estimates

Operating expenditure

The operating expenditure was budgeted to be US$ 692.8 million during the 1384 fiscal year. Total actual operating expenditure was US$ 667 million (which accounts for 96.3 per cent of total budgeted operating expenditure). Out of this total operating expenditure, 67 per cent was covered by domestic revenue and the rest was covered through grants. A major medium term objective of the Afghan Government is to cover all its operating expenditure through domestic revenues.

Development expenditure

Development expenditure is fully financed through external grants. During the 1384 fiscal year US$ 434.8 million were spent for development projects by the Government. The budgeted development expenditure was US$ 1,046.7 million. Only 41.5 per cent of the budgeted expenditure was spent. This was mainly because of the very low capacity of spending by the line Ministries.

Table 4.1: **Afghanistan Operating Budget**
(March 21-March 20)
Execution for 1381-84
(In million dollars)

	Annual Budget 1384	Actuals			Months (Actuals) 1384				YTD	% of Annual Budget 1384
		1381	1382	1383	Q1	Q2	Q3	Q4		
Donor Revenue	946.2	255.1	257.3	312.7	141.1	218.4	83.7	298.7	741.9	78.41
Operating Budget	348.0				37.5	139.6	50.3	117.7	345.0	
Development Budget	598.2				103.6	78.9	33.5	181.0	396.9	
Domestic revenue	468.5	131.9	209.8	252.3	98.1	82.4	135.8	132.3	448.6	95.75
Taxation	270.7	91.1	160.3	210.1	55.3	61.6	63.1	91.2	271.1	100.17
Income tax					1.0	1.1	0.2	6.7	8.9	
Profit taxes legal entities					0.4	2.5	3.8	0.9	7.7	
Income and profit taxes					1.8	2.0	1.8	2.1	7.8	
Taxes on immovable property					0.5	0.5	0.4	0.4	1.9	
Sales tax					0.0	0.0	0.0	0.0	0.0	
Taxes on gross receipts					2.2	4.4	3.8	3.9	14.3	
Taxes on specific services					0.1	0.1	0.1	0.3	0.6	
Motor vehicle taxes					2.4	1.8	1.3	1.3	6.7	
Other taxes good and services					0.5	0.8	0.8	0.8	3.0	
Custom duties and taxes imports					45.6	47.3	50.1	73.8	216.7	
Custom duties and taxes exports					0.6	0.8	0.1	0.2	1.7	
Other taxes					0.1	0.4	0.6	0.8	1.9	
Other Revenues	197.8	40.8	49.5	42.2	42.8	20.7	72.8	41.1	177.4	89.70
Total Government Expenditure	1,739.5	348.8	456.7	535.1	214.9	271.9	232.5	382.5	1,101.8	63.34
Development Expenditure	1,046.7	0.0	0.0	0.0	78.3	105.8	78.7	172.0	434.8	41.54
Salaries and allowance					2.6	1.0	1.3	1.7	6.6	
Goods and services					47.1	75.3	44.5	128.4	295.2	
Pension payments					0.0	0.0	0.0	0.0	0.0	
Grants					0.7	2.4	0.0	-1.0	2.2	
Capital expenditure					27.9	26.8	32.9	42.8	130.4	
Interest payments					0.0	0.3	0.1	0.0	0.4	
Operating Expenditure	692.8	348.8	456.7	535.1	136.6	166.0	153.7	210.6	667.0	96.27
Salaries and allowance					83.1	109.6	102.2	126.3	421.2	
Goods and services					28.4	38.2	33.9	46.1	146.6	
Pension payments					7.7	8.2	10.5	5.3	31.7	
Grants					0.0	0.2	0.1	0.9	1.3	
Capital expenditure					16.1	9.1	6.0	31.8	63.0	
Interest payments					1.3	0.7	1.0	0.1	3.1	
Operating Budget Balance	-224.3	-216.9	-246.9	-282.8	-38.6	-83.7	-17.9	-78.3	-218.4	97.36
Overall Balance	-324.8	38.2	10.4	30.0	24.3	28.9	-12.9	48.4	88.7	
Float and adjustment 1/					-24.3	-28.9	12.9	-48.4	-543.3	
Total Financing					0.0	0.0	0.0	0.0	-454.6	
Donor assistance grants					0.0	0.0	0.0	0.0	345.0	
ARTF					0.0	0.0	0.0	0.0	259.2	
LOTFA					0.0	0.0	0.0	0.0	83.9	
Other Grants					0.0	0.0	0.0	0.0	1.9	
External Loans					0.0	0.0	0.0	0.0	109.6	
Domestic Loans (net)									-196.6	

V. External Sector Developments

Merchandise Trade

The Central Statistics Office (CSO) is responsible for import and export data collection from all custom offices in the country. CSO is the main source of data for the central bank. The Balance of Payments Section of the Monetary Policy Department of DAB compiles the merchandize trade and external sector developments on quarterly basis. The central bank also receives data from the IMF. A substantial share of the country's imports and exports is not in the record of the customs offices. Accordingly the amounts that are in the record of customs and get enumerated are underestimates. The CSO figures thus tend to understate the volume of Afghan trade. It is clear that the reported figures by CSO received from the customs administration do not reflect the underlying trends. On the other hand, the IMF team in Afghanistan collects data from the partner countries to arrive at some adjustments to estimate merchandise trade of Afghanistan. The partner countries' data involve using export data from other countries (such as Pakistan, Iran and Japan) to Afghanistan as a means of estimating Afghanistan's imports. Conversely, the other countries' imports from Afghanistan are used to estimate Afghanistan's exports. The main problem with the partner countries data is that the import figures generated are actually at higher levels than the CSO. This is due to the fact that some of our trading partners are also facing the underestimation problems as Afghanistan does, so that the partners' data may not be completely enumerating their actual levels of trade. Comparing both of the above plus some of its own survey work, the DAB team makes further adjustments in estimating the trade statistics.

There are no firm figures about the magnitude of smuggling from the neighbouring countries i.e. Iran and Pakistan. According to an un-official survey of DAB Statistics Unit conducted at the beginning of 2005 and using data from recent surveys and working closely with the CSO, it is estimated that approximately 20 per cent of recorded imported items are re-exported. Smuggled exports are estimated to be equal to 30 per cent of recorded exports, and that smuggled imports are estimated to be roughly 30 per cent of recorded imports.

The official trade statistics did not include the active smuggling activities along Iranian and Pakistani boarders in the previous years. The real dimensions are still unknown but based on the unrecorded trade survey conducted by the DAB Statistical Unit in July 2005 and the discussions held with recent IMF mission to Afghanistan regarding closing the gap in the estimation of trade, suitable adjustments are being made. These adjustments begin with 1384 (March 21st 2005 to March 20th 2006). The trade data shown in Tables 5.1and 5.2 also include estimates of unrecorded trade. The IMF recorded and unrecorded trade figures shown in Tables5.1 and 5.2, (which are much higher than the CSO estimates) are based on the consumption pattern of the country and the GDP growth. On the other hand, the CSO and DAB work from the trade data surveys which do not take consumption activities directly into consideration in their estimation. A comparison of the two sets of data for 1382, 1383 and 1384 is presented below:

Table 5.1: Comparison of Trade Statistics (in million of US$)

Items	1382	1383		1384	
	CSO	IMF	CSO	IMF	CSO
Trade balance	-2031.8	-2113.8	-1969.8	-2324.71	-2218.98
Exports of goods	815	1750	826.4	780.34	992.98
Recorded	144	457.2	304.8	232.8	383.72
Unrecorded	617	1292.8	521.6	547.54	609.26
Imports of goods	2846.8	3863.9	2796.2	3105.05	3211.96
Recorded	2,101.0	3196.4	2150.9	2388.5	2470.74
Unrecorded	745.8	667.5	645.3	716.55	741.22

The above two sets of figures reflect the current status of the two approaches being used to estimate Afghanistan's trade flows. Efforts are now underway to improve the capacity of the CSO through the implementation of a large-scale Statistical Master Plan and through more intensive communication between the relevant institutions. It is clear that CSO is the best long term source for getting the correct numbers regarding the trade and other economic and social data.

The Monetary Policy Department of the Central Bank is ready to launch a beneficial survey for the main seven Provinces to estimate the correct figures of the unrecorded trade. Based on the outcomes of the surveys and as the CSO's coverage capacity improves, the statistical base of the external sector of the country would be improved. Progress along these targeted lines will be reported in future issues of this Bulletin.

While analysing the trade account of Afghanistan on the basis of currently available statistics certain degree of caution is warranted since the trade data are still having some drawbacks. The data reported by CSO for 1384 (March 21st 2005 to March 20th 2006), shows that recorded imports rose to a level of $2470.74 million and the total recorded exports were estimated to be approximately US $ 383.72 million. Estimates for unrecorded import data are subject to a considerable degree of uncertainty, but were reckoned to be on the order of magnitude of US$ 678.3 million in 1380 (2001/02), US$ 928.8 million in 1381 (2002/03), US$ 745.8 million in 1382 (March 2003 to March 2004), and US$ 645.3 million in the year 1383. Total recorded imports were estimated to be US$ 2470.74 million during 1384 (March 21st 2005 to March 20th 2006). Assuming the levels of unrecorded imports (30 per cent of recorded imports), it follows that unrecorded imports were in the range of US$ 741.22 million for 1384 (March 21st 2005 to March 20th 2006). The total amount of recorded exports was estimated to be $383.72 million and the unrecorded exports together with re-exports, excluding exports of opium, was estimated to be at the level of US $ 609.26 million for 1384 (March 21st 2005 to March 20th 2006).

The trade deficit for 1384 (March 21st 2005 to March 20th 2006) estimated by both DAB and CSO, excluding opium exports, works out to be roughly US $2219 million or about 31.28 per cent of GDP (see Table 5.2).

As long as the donor support continues and the deficit is declining as a percentage of GDP, this should be a manageable and appropriate level of deficit given the magnitude of the country's reconstruction requirements, particularly in the area of infrastructure. Importantly, the trade deficit appears to be declining as a percentage of GDP. However, continued progress is needed along these lines. (See Chart 5.1)

Chart 5.1: Trade Deficit as Per cent of GDP

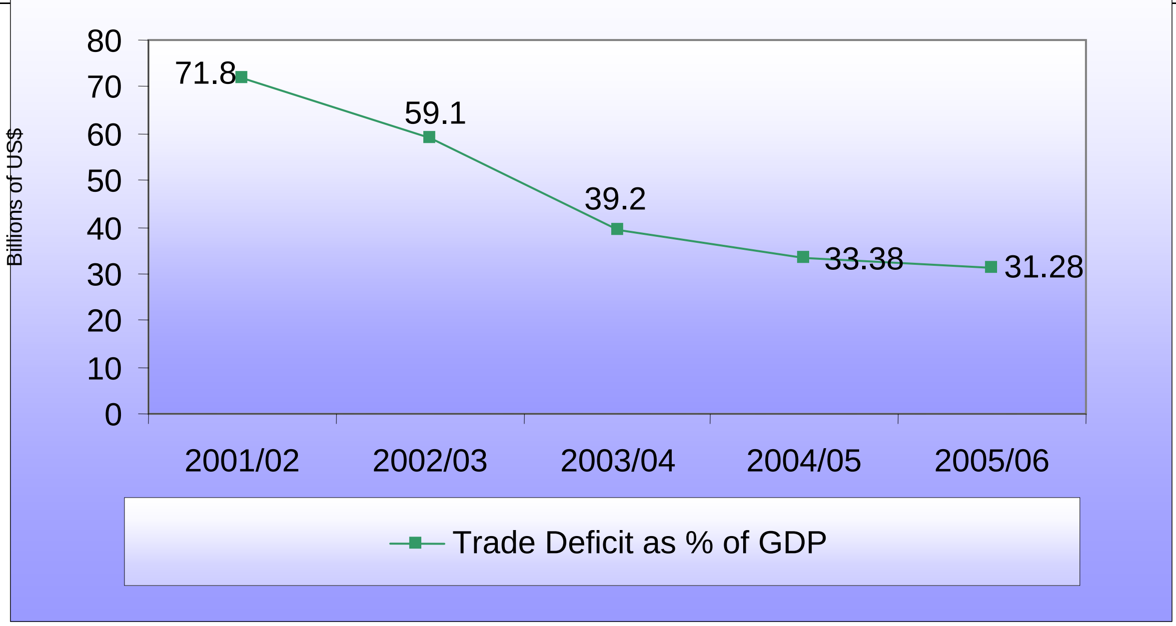
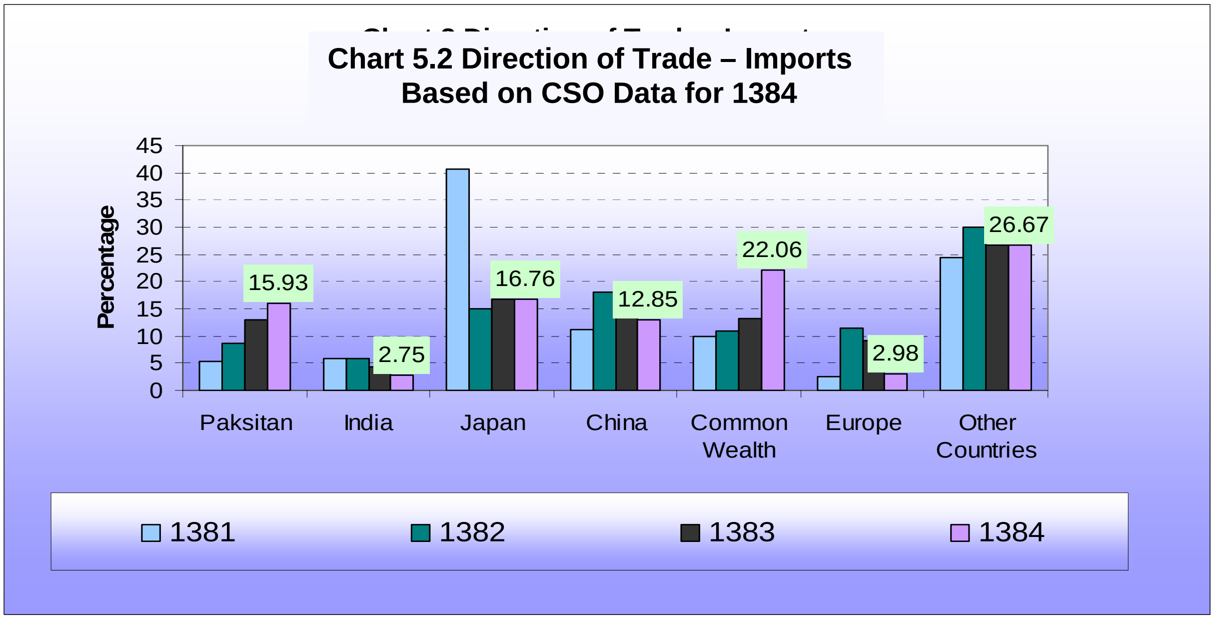


Table 5.2: Merchandise Trade (in US$ Million)

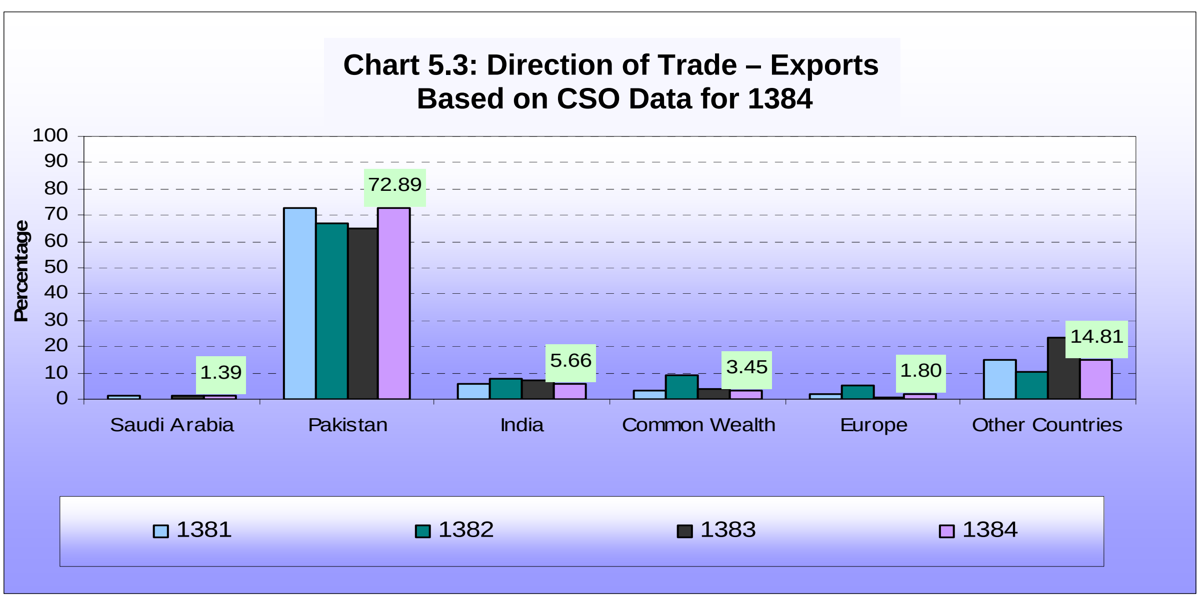
		1380	1381	1382	1383	1384
Imports:	(from previous period)	2,374	3,250.90	2,846.80	2796.2	3211.96
	Recorded Imports	1695.7	2322.1	2101	2150.9	2470.74
	Consumer goods	872.4	767.5	903.4	383.3	478.63
	Industrial supplies & materials	245	807.8	399.2	667.4	541
	Capital goods & others	562.3	724.4	777.4	1034	1206.5
	Fuel and lubricants	16	22.4	21	66.2	244.61
	Unrecorded	678	928.8	745.8	645.3	741.22
Exports:		604.2	836.7	815	826.4	992.98
	Domestic	68.2	100.1	144	304.8	383.72
	Re-exports & shuttle trade	536	736.6	617	521.6	609.26
Trade balance:		**-1769.8**	**-2414**	**-2031.8**	**-1969.8**	**-2218.98**
Trade Balance as per cent of GDP		**71.8**	**59.1**	**44.3**	**33.4**	**31.28**

Direction of Trade

The direction of trade for Afghanistan has been analyzed using unadjusted CSO trade data. Charts 5.2and 5.3 show the direction of trade, for both imports and exports, for Afghanistan during the period 1381 to 1384 (March 21st 2005 to March 20th 2006). The statistics reported by CSO in the 1384 show that “Other countries” remained the largest source of imports to Afghanistan placed at about 26.67 per cent. They were followed by Common Wealth with share of 22.06 per cent, Japan with 16.76 per cent, and Pakistan with 15.93 per cent of total imports. China stood at about 12.85 per cent, Europe with 2.98 per cent, and India with 2.75 per cent share of imports to Afghanistan.



In the field of exports, Pakistan remained Afghanistan's largest customer by a large margin. Pakistan's share of total exports from Afghanistan increased in 1384 (March 21st 2005 to March 20th 2006) to 72.89 per cent from 65.03 per cent in 1383, 'Other Countries' share was 14.81 per cent, and India was third at 5.66 per cent. Common Wealth share of total exports was placed at 3.45 per cent, Europe 1.80 per cent and Saudi Arabia 1.39 per cent.



Composition of Trade

The composition of imports during 1384 (March 21st 2005 to March 20th 2006) indicates that imports of 'Other Equipments' had the largest share of 27.90 per cent with Machinery & Equipments at 21.74 per cent, Construction Material at 13.05 per cent, followed by Food Items at 13.26 per cent, "Textile Clothing & Footwear" totalling 10.90 per cent, Fuel at 9.90 per cent, and Transportation Equipments & Spare parts at 3.25 per cent. (See Chart 5.4).

A comparison of imports for the year 1383(2004-05) with year 1384(2005-06) shows that the composition has changed considerably. The share of Machinery and Equipments has increased in the year 1384(2005-06) to 21.74 per cent from only 1.32 per cent in the year 1383(2004-05) while on the other hand, the share of the transportation equipment and spare parts has declined to 3.25 per cent during the year 1384(2005-06) from 31.75 per cent in the year 1383(2004-05).

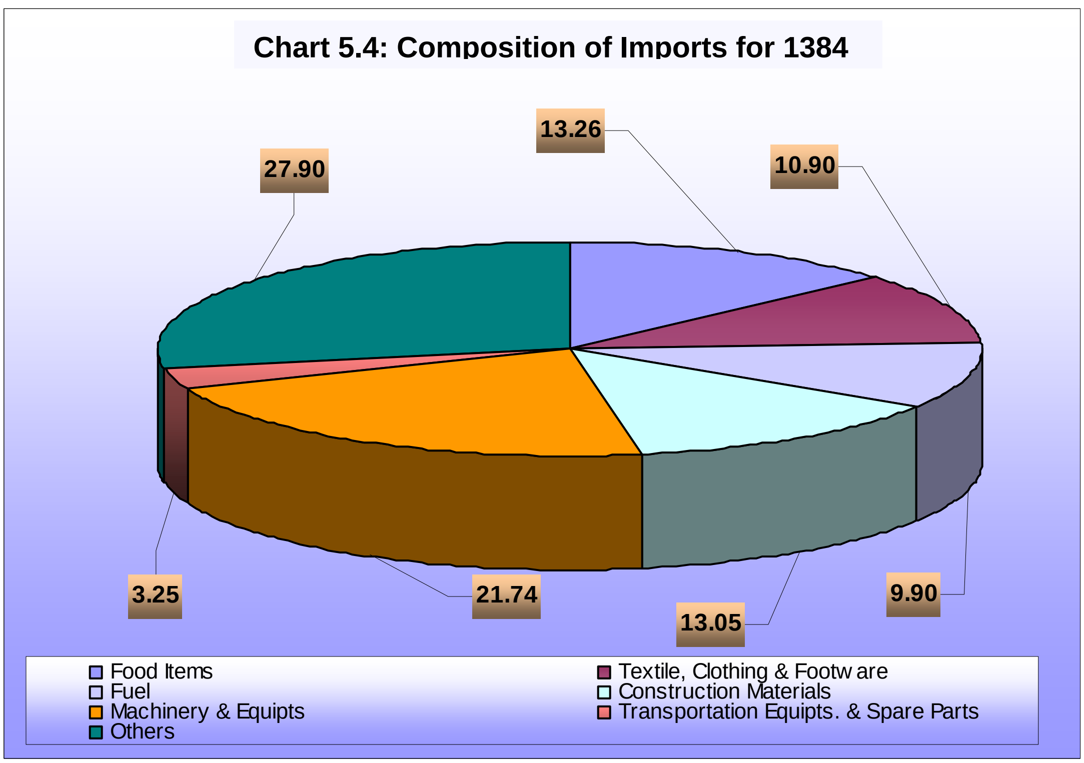
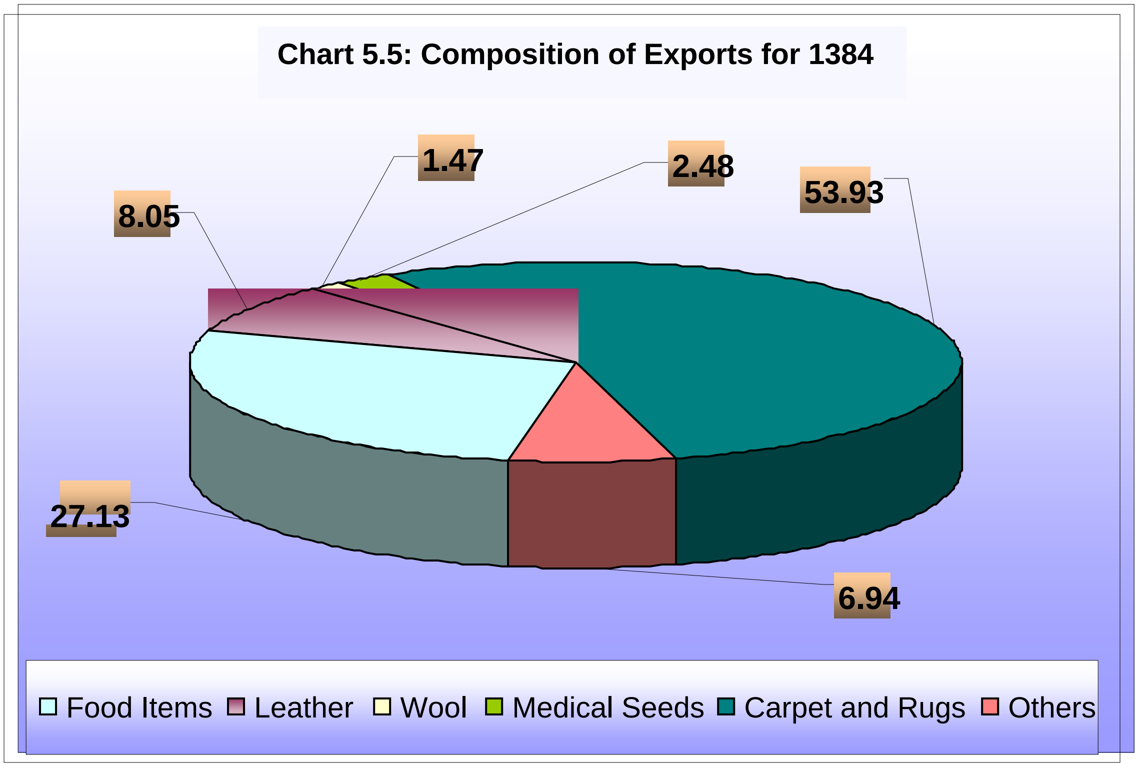


Chart 5.5 shows composition of the total exports for 1384 (March 21st 2005 to March 20th 2006) by the main commodities and products, "Carpet & Rugs" with 53.93 per cent is the largest export component followed by "Food Items" witch constituted some 27.13 per cent of total exports, Leather 8.05 per cent "Other" 6.94 per cent, Medical Seeds at 2.48 per cent, and Wool at 1.47 per cent.

Comparing the composition of exports of the year 1383(2004-05) with year 1384(2005-06) it is clear that the composition is almost the same. There is only slight shift in the pattern; notably the share food items has decreased from 31.52 per cent in the year 1384(2005-06) to 27.13 per cent in the year 1383(2004-05)



VI. Special Feature

The Emerging Afghan Economy and the Role of Da Afghanistan Bank.

The Afghan Economy is well on its way to sustained economic growth and development. Over the last four years, form 1381 (2002-03) to 1384 (2005-06), the average real GDP growth has been placed at around 16.6 per cent per year which is most impressive by any standards – with comparison with Afghanistan's growth record in the past and as well as in terms of the cross-country evidence. In step with the strong recovery and growth, per capita income has also improved sharply, from US$ 182 in 1381 (2002-03) to around US$ 300 in 1384 (2005-06). As the central bank of the country, Da Afghanistan Bank had been playing an important role in achieving and sustaining high economic growth and in improving the standard of living of Afghan People.

As the central bank of the country, the primary task of Da Afghanistan Bank is to conduct monetary policy of the country in a manner that would contain inflationary pressures while maintaining stability in the external value of Afghani and supporting the growth impulses in the country. The DAB conducts monetary policy using the biweekly auctions of foreign exchange as its operating target, and has had notable success over the years.

DAB's prudent monetary policy stance has achieved a remarkable success in containing inflationary pressures in the country. Illustratively, in terms of the Kabul-based consumer price index (CPI), the overall inflation rate in the economy had come down from 14.9 per cent in 1383 to a single digit level for the first time in 1384 reaching 9.5 per cent. During the first two months of 1385, the CPI inflation has been placed at only 0.24 per cent. The 'core inflation' in Afghanistan (i.e. overall inflation excluding rents, housing and fuel) has been brought down from 10 per cent in 1383 to 7.71 per cent in 1384. Similar trends are evident in terms of the National CPI as well. The importance of DAB's noteworthy success in containing inflationary pressures needs to be appreciated. Inflation is the most regressive form taxation which hurts the poor the most. DAB's success in achieving greater price stability is a major relief to the poor people of this country. Furthermore, over the years, the exchange rate of Afghani per US dollar has remained remarkably stable. For example, the exchange rate moved in the range (Afs. 48.61 – Afs. 50.82) during the year 1384 and in the range (Afs. 49.56 – Afs. 50.30) in the current year so far.

Over the last four years, we have succeeded in adding more and more to the country's foreign exchange reserves – US$ 390 million in 1382, US$ 445 million in 1383, and US$ 459 million in 1384. Our foreign exchange reserves are around US$ 1.9 billion today.

The DAB has recently introduced discounted capita notes (from March 28, 2006) for 28 and 56 days and with that, for the first time in Afghanistan, a market determined interest rate has now emerged. With the overnight deposit facility becoming operational, a yield curve for the Afghanistan economy has also emerged for the fist time.

The DAB has been actively engaged in the process of monetary policy formulation with a view to serve the interest of the country in the best possible manner.

As the central bank of the country, Da Afghanistan Bank is dedicated to developing a strong and resilient financial system in Afghanistan. As a part of this mandate, the DAB has been striving to place the Afghan baking system on sound footings in conformity with the global standards.

The banking system in Afghanistan today consist of 13 duly licensed and permitted banking organizations – 3 re-licensed State-owned banks, 5 private full-fledged banks and 5 branches of foreign banks. These banks are engaging themselves in wide range of activities under supervision by the central bank. Recently, one of the private banks has introduced the Islamic banking in Afghanistan.

The DAB has now established a Financial Intelligence Unit (FIU) to check money laundering activities. The FIU has already developed Large Cash Transactions Report/ Suspicious Transactions Report and is in the process of developing cross-border currency reporting system. This unit has been working with international organizations and has obtained membership of Asia Pacific Group on Money Laundering and has an Observer Status in Eurasia Group on Money Laundering.

Regional management Offices have been established in 7 provinces: Kabul, Mazar-e-Sharif, Kunduz, Nangarhar, Kandahar, Herat, and Ghazni. Modernization of the central bank using the state-of-the-art information technology is currently underway. The growing computerized network is expected to yield a significant improvement in the operational efficiency through better communication system between the DAB and the Regional Management Offices. Communication between DAB and all other international and global international organizations through SWIFT has already been established.

With special initiatives from the DAB, Afghanistan has started playing its due role among the comity of nations in the regional and global arena. Recently Afghanistan has joined the General Data Dissemination Standard (GDDS) of the International Monetary Fund (IMF) under which data on Afghanistan's economy would now be made available on the IMF website. Following Afghanistan's membership of the SAARC – association for regional cooperation in South Asia, DAB has started taking active interest in its financial organ i.e. SAARCFINANCE. We have also started actively participating in other forms of developing countries such as the group of 24 (G-24).

In the ultimate analysis, the ability of DAB to continue to contribute to the growth and development of Afghan economy and serving the best interest of the Afghan people depends on its internal capacity building. In DAB, we have been giving a special attention to this crucial aspect. More Future Leaders have been identified and a medium tern strategic plan for training has been drawn up consistent with VIDION 1387 aimed at achieving self-reliance and ending dependence on foreign advisors in the central bank.

Trite as it may sound, one can rightly say that much has been done, but much remains to be done. No doubt there are formidable challenges that lay ahead of the central bank. Looking at the progress achieved so far, however, I feel fully confident that the DAB would be able to take on these challenges and move on. There is a lot to cheer about, looking into the future.

Oil Price Hike: Implications for SAARC Countries[2]

This paper has been prepared at the instance of SAARCFINANCE and is based on inputs received from seven central banks participating in SAARCFINANCE. The paper deals with the recent oil prices hike and its implications for monetary fiscal and exchange rate policies in the context of the seven SAARCFINANCE countries–viz; Bangladesh, Bhutan, India, Maldives, Nepal, Pakistan and Sri Lanka.

The paper has been divided into six sections. The first Section entitled provides an overview of the macroeconomic situation of the SAARC members. In Section II,' the importance of oil sector in the SAARC countries has been examined in detail. In Section III, theoretical and

[2] Prepared by Dr. Narendra Jadhav, Senior Macroeconomic Advisor to Governor, Da Afghanistan Bank. This brief provides an Executive Summary of a Special Study with the same name prepared by Dr. Narendra Jadhav, Dr. Rajiv Ramjan and Sujan Hajra, and released by the Reserve Bank of India on behalf of SAARC FINANCE. The full study is available of http://www.rbi.org.in The study assumes special importance in the context of Afghanistan joining the SAARC recently.

empirical impact of rise in oil prices on various sectors of the economies is analyzed. In order to get a more complete picture on the impact of oil prices on the SAARC region, the next section analyses the impact of previous oil price shocks on the countries of this region. The next Section V provides country-wide case studies for all SAARC members to gauge the impact of the current phase of oil price rise at the individual country level. The final section provides concluding observations.

Over the past two decades, especially since the I990s, most of the SAARC countries have achieved high growth rates. The growth performance of SAARC countries since the 1980s has been better than the global growth rate. Unlike many other developing and emerging market economies, especially those in Latin America and Eastern Europe, inflation rates in the SAARC countries have not been high since the 1970s. Along with improved growth performance and contained inflation, the SAARC countries have' made important strides in improving domestic savings and investment rates over the last few decades. The external trade performance of SAARC countries, in terms of both export and import growth, has generally surpassed the corresponding global rates. Since 2001, India and Pakistan and since 2002, Bangladesh was maintaining current account surpluses. The situation, however, changed drastically in 2004-05 and 2005-06, with the bulging of oil import bill. Import coverage of foreign exchange reserves of many of the SAARC countries witnessed general improvement over the decades, although there have been some reversals in this regard as well since 2004-05.

Notwithstanding the improved macroeconomic performance and increased resilience of these economies. The SAARC countries are highly dependent on imported oil products and the share of oil imports in total imports is among the highest in the world. Oil imports as a proportion of merchandise imports, has declined over time for the world as a whole, while it has increased for the SAARC countries. Oil imports as a proportion of GDP is also much higher for most SAARC members as compared to the global average. In terms of share of fuel in total imports, India and Pakistan ranked 41"1 and 59th, respectively in 1970. In 2003, India had the third highest share of fuel in overall imports and Pakistan had the tenth highest share in the world. High dependence on imported oil, low level of efficiency in energy use combined with high income elasticity of demand for imported fuel products in the SAARC countries accentuate the problem for these countries in the face of rising oil prices.

Cross-country studies indicate that during the previous oil price shocks. There were large variations across countries in terms of the adverse impact of oil prices on macroeconomic and sectoral performance. In general, output loss, inflationary spirals and adverse balance of payments developments have been much more marked on low-income oil importing countries than the oil-importing industrialized countries. Moreover, the expansionary effect of oil price shocks in oil exporting countries has generally been much less than the concretionary impact in oil importing countries, resulting in a slowdown in global growth. The past experiences suggest that the first and second oil price shocks were followed by. Sharp deceleration in GDP growth in most of the SAARC countries. The oil price hardening during the late 1990s was associated with growth deceleration particularly in Nepal and Sri Lanka. Moreover, while growth rates in most SAARC countries did not dip in the face of oil price hike of the late 1990s, the opportunities for further improving the growth performance could have been compromised in the face of such adverse developments. The most pronounced impact of international oil price rise during the first two oil price shocks in the SAARC countries has been the rise in the proportion of oil imports in total imports. These two shocks also resulted in considerable increase in the current account deficits of the SAARC region. The adverse impact of oil shocks on the external account of the SAARC region is also observed in terms of across-the-board deterioration of net barter terms of trade for the members.

The lesson from the previous oil crises is that while a Central Bank cannot prevent oil prices giving a one-off boost to inflation, it must try to prevent this feeding into higher wages and prices of other goods and services. The relationships between international oil prices and consumer price index (CPI) in SAARC countries indicate that significant increase in international oil price coincided with marked rise in consumer price inflation with the first oil price shock exerting the most noticeable impact on CPI across- the SAARC countries. In the recent years, there has been less observable impact of increases in international oil prices on the consumer price inflation of the SAARC countries, except for Sri Lanka. This, to a large extent, reflects better management of inflationary situation by the SAARC Central Banks and also general softening of global inflationary situation since the late 1990s. Moreover, with substantial improvement in the operating procedures for the conduct of monetary policies in the recent past, Central Banks from the SAARC region have been able to control inflation relatively successfully. However, there is a limit to which monetary policy could be effective in taming inflation in the wake of spiralling oil prices, given the structural constraints in the developing countries. Moreover, eventually inflationary expectations would factor in higher oil prices once it is clear that such price rises are more permanent than transitory which would reduce the manoeuvrability in controlling inflation. Under such a situation, inflation management would be increasingly difficult in the developing countries as the oil price rises. Given the structural factors and lag in transmission of various types of monetary impact, the extent of impact of oil price shocks on money supply in the SAARC countries have not been uniform. The experience of these countries in managing the oil price shocks suggests that such developments throw many challenges to the conduct of monetary policy and in most of the cases, the monetary policy authorities have to perform an extremely difficult balancing act to maintain growth and price stability.

A significant rise in international oil prices is likely to deteriorate the fiscal balance. Government and/or government-controlled agencies often share a part of the burden of oil price rise. Therefore, by assuming a fiscal burden, authorities in SAARC countries try to reduce the extent of adverse welfare effect of oil price rise on general public, especially the vulnerable sections of the population. Moreover, other stakeholders such as oil companies and oil importers also shared the burden of less than perfect pass-through effect of international oil price hike and to that extent such quasi-fiscal costs are not reflected in the deterioration of fiscal balance of the Central Governments in the SAARC countries. It is, however, important to note that fiscal balance of developing countries including those from the SAARC region are affected by various structural factors and therefore, such structural factors often make it difficult to segregate the exact impact of oil price rise on fiscal balance. Notwithstanding all these factors, significant oil price rise has generally been associated with worsening of fiscal balance of the Central Governments in the SAARC region. It is important to note that the levels of fiscal deficit as well as outstanding government deficits for the SAARC countries are among the highest in the world. Therefore, there is very little additional headroom to absorb increased international oil prices through fiscal means. Full pass-through of international oil prices would, however, adversely affect vulnerable sections of population and reverse the considerable progress made in the SAARC region towards achieving the targets of poverty reduction set by the Millennium Development Goals.

The inflationary consequence of international oil price rise, especially given the absence of headroom to neutralise part of such effects through fiscal means, has serious implications for the SAARC countries through reduced price competitiveness. During the previous oil price shocks, most of the SAARC countries were relatively closed economies. However, over the last two decades, the SAARC countries have undertaken significant trade liberalisation. This has increased substantially the shares of exports and imports in GDP. The domestic pricing systems for tradable products have also got aligned to international prices. Therefore, the inflationary situation created by the current oil price shock could erode the competitiveness of the countries and adversely affect the output, employment, exchange rate and external balance position. Increased oil prices would feed directly into manufacturing prices through higher input prices. For example, the captive power units maintained by various manufacturing units are run on diesel and, therefore, higher diesel prices would increase the input costs of such industries. Higher oil prices would increase the input costs for the agriculture sector as a significant part of irrigation in many SAARC countries is diesel based. In addition, inputs cost in the agriculture sector could increase due to increase in cost of transportation and chemical fertiliser. In most of the SAARC countries major public utility services including electricity generation, railway transportation and road transportation use oil products extensively. In the absence of budgetary support, such utility prices would go up and thereby the cost of production in all sectors could be adversely affected. While higher oil prices would also affect industries and agriculture in other regions of the world as well, the impact would be particularly marked. in this region because (i) the levels of efficiency in energy use in this region is low, (ii) the region is growing comparatively faster, and (iii) oil intensity of production in the region is high and growing very fast. Reduced competitiveness, in turn, would adversely affect the already serious unemployment and poverty situations in the SAARC region.

While the SAARC countries are increasingly passing through considerable part of the rise in price of crude oil and oil products in the international markets to the retail consumers, the extent of such pass-through is generally not full. In developing countries, in the wake of rising oil prices, governments have to walk on a very thin line in order to balance the demand of all the stakeholders - government, oil companies/importers and the consumers. The bearing, of burden of rising oil prices by each of the stakeholders has different implications in the short run, but the end result in most of the episodes of oil shock have been reduced growth rate, high inflation, rising fiscal deficit, widening current account deficit, deteriorating terms of trade and balance of payments positions and decline in welfare of the consumer.

The high global petroleum prices pose a considerable risk to the Bangladesh economy. Higher petroleum prices have an adverse effect on business investment, contribute to inflationary pressures, and strain the balance of payments situation. The real GDP losses in Bangladesh on account of high oil prices have been around Tk. 5.0 billion each year during the last few years.

Higher oil prices in the international markets have also posed considerable risks to the balance of payments of Bangladesh. Higher petroleum prices could depress demand for Bangladesh's exports. Heightened pressures on the domestic balance of payments could affect the imports of capital goods and raw materials. Direct inflationary effect of the oil price increase has been limited due to the incomplete pass-through in view of the administered retail price of petroleum products in the domestic market. There has been substantial increase in oil imports. Between July 2003 and September 2005, the government raised domestic fuel prices in a number of incremental steps, although among the SAARC members retail prices for petroleum and diesel in Bangladesh remain the lowest. The higher import prices of oil, together with the administered retail prices, have threatened the financial viability of the state-owned oil major.

In the case of Bhutan, the impacts of increased global petroleum prices are exerting adverse effects on their inflation level. In particular, higher international fuel prices are likely to push up domestic prices in other sectors such as transport. The major adverse impact would be felt by the manufacturing, construction and the service sectors especially the tourism sector. The increase in oil prices is also likely to reduce consumer-spending power, in the same way as when a new excise tax is passed along by oil producers, which could pull down the rate of consumption and savings in the "economy. The Royal Monetary Authority of Bhutan feels that in the short-run, the country cannot do much rather than bear out the adverse implications of rising prices. However, in the longer-term, countries need to adopt strong, effective, and collective initiatives to reduce the vulnerabilities of the oil importing developing countries from international oil price shock. The initiatives might be in the form of improving the standard of the fuel economy through various cost-effective technologies and provisioning for the nation's energy security.

The recent international oil price rise has adversely affected the Indian economy through various channels. The most obvious impact has been on the price levels. In order to arrest the acceleration in inflation, the Reserve Bank took measures in a calibrated manner with a view to stabilising inflation. The Cash Reserve Ratio was raised by one-half of one percentage point to 5.0 per cent in September 2004. The fixed reverse repo rate, the main short-term signalling rate, was hiked by 25 basis points each during October 2004, April 2005, October 2005 and again in January 2006 under the liquidity adjustment facility of the Reserve Bank. The Government of India has also undertaken various fiscal measures, including reduction in duties on petroleum products and steel. The Government has also postponed raising of retail prices for certain oil products. While the apt policy measures adopted by the Central Bank and the Government have so far averted sharp price rise by keeping inflationary expectations within check, going forward it would be increasingly difficult to control domestic price levels if international prices do not soften considerably. As indicated above, due to reduction in tax rates on oil products and absorption of part of burden of international oil price rise by public sector oil companies, India's fiscal position has been adversely affected. Higher oil prices have also led to sharp widening of India's merchandise trade balance. This has resulted in emergence of current account deficit during 2004-05 after recording current account surpluses for three consecutive years until 2003-04 and the first quarter of 2004-05.

During the past episodes of rise in international oil price, the authorities in Maldives kept a close watch on the situation and initiated steps to ensure that the designated oil importing agency had access to adequate foreign exchange to meet the oil import bill. According to the Maldives Monetary Authority, the impact of oil price rise on the external sector of the economy though serious, is unlikely to destabilise the economy because of two factors. First, the external current account deficit of the economy has narrowed down considerably in the recent past. Second the share of oil imports in total imports has also gone down substantially from 16 per cent in 1990 to 12 per cent in 2003. Given the comfortable situation in terms of both inflation and the external current account situation, the rising international oil price is unlikely to pose much dampening effect on the growth process of the country. However, considerable increase in domestic demand for oil products in the recent periods, as reflected in sharp rise in the quantum of imports, could be a cause for concern. It appears that the sharp jump in the number of vehicles in Maldives is a major reason for the rise in such demand.

Nepal is fully dependent on imported oil products. The country is poised to make a transition from an administered to an automatic mechanism for changes in domestic oil prices. The revision in administered oil prices during 2004-05, resulted in rising inflation in the country. The trading losses of the majority state owned oil importing company also had a marginal impact on money supply. There has also been increase in the import bill. The Nepalese Government has initiated measures so as to ensure least disruption in the macroeconomic performance of the country due to higher oil prices. Measures are already in place to guarantee long-term supply of oil products in the country. In the past, Nepal has faced deterioration in the balance of payments position due to rising oil prices. Nepal feels that the international community should aid oil importing low-income countries by providing soft loans and by helping in technology transfer and capacity creation. The need for regional cooperation and experience sharing in the management of volatility in oil prices has also been emphasised.

During the current phase of oil price shock, State Bank of Pakistan anticipates a negative impact on balance of payments and inflation. By October 30, 2004, the government had absorbed an impact amounting to around Rs. 20 billion (US $350 million). In October 2004, State Bank of Pakistan had announced that all payments of oil import bill will be met from its foreign exchange reserves. The State Bank of Pakistan feels that at the global level. Major oil exporting countries and cartels should be encouraged and given some incentives to maintain supplies consistent with global demand. Domestically, the Pakistani authorities are taking measures to increase domestic production of oil significantly so as to lessen dependence on imports if not attain self-sufficiency. Major concessions and incentives to private companies have been provided to encourage them to expedite the exploration and drilling for oil. Additionally government is encouraging other sources of energy such as Liquefied Petroleum Gas and Compressed Natural Gas.

In order to finance the increased fiscal burden for safeguarding general public from the burden of high oil prices and also to reduce demand for auto fuel, Sri Lankan authorities have taken various measures. More such steps were incorporated in the Budget 2005 proposals. Special credit policy measures have been taken to promote the use of alternative energy sources in transportation. Sri Lankan government has successfully negotiated an extended suppliers' credit facility from Iran and a credit line with India to finance oil imports. In the wake of rising oil prices, the formula based domestic oil pricing policy linked to international prices was not implemented during February - July 2004. The government provided subsidies to oil companies for non-implementing the pricing formula during this period. Under the current situation, it is felt that if the oil prices remain at elevated levels; this would be reflected in domestic prices, which would lead to increase in input costs. The rise in oil prices is also likely to adversely impact the value added in highly energy intensive segments of manufacturing and services sectors such as transport and power generation. In the public sector budget deficit will increase due to the rigidities in government expenditure and subsidy payments to oil companies. An increase in oil prices will further affect the balance of payments. The deterioration of the balance of payments will exert downward pressure on exchange rates. In order to deal with the impact of oil prices, Sri Lankan authorities partially passed on the burden to the consumers by increasing domestic prices of diesel and petrol during the second half of 2004.

Available evidence during 2004-05 suggests that in all SAARC countries high international oil prices have resulted in significant rise in inflation and fiscal deficit. Members with current account surpluses have registered deficits and the deficits have widened in other member countries. Most members have been compelled to pass on a part of international oil price rise to the domestic prices, which adversely affected welfare output and general price levels. Measuring exact amount of output losses in the ~AARC region is difficult, especially since most of these countries maintained their recent high growth performances. There are however, indications that sacrifices in terms of potential output loss have been substantial in most of these countries. All these adverse impacts are likely to accentuate further if international oil prices do not soften significantly in the immediate future. This is so because lack of fiscal headroom and deteriorating balance sheet positions of the public sector oil companies/importers in the region would require increased pass-through of higher international oil prices to the ultimate consumers.

The International Monetary Fund (lMF) has taken initiatives to examine in depth these issues and come out with some suggestions, which is a welcome step. Some of these suggestions include improving oil sector data, generating hedging instruments, developing global standards for regulation and taxation of the oil sector, encouraging conservation and development of alternate energy sources and increasing energy efficiency. It should, however be recognised that conservation of oil and energy is essentially a medium-term process and is unlikely to provide immediate relief though vigorous policy actions may influence the expectations and thus prices. There is a strong need for collective international action to address the volatilities of oil prices. Initiatives for effective engagements between the oil sellers and buyers are very important in this context. International agencies, in particular the IMF, may need to adopt a more proactive role in addressing the balance of payment difficulties faced by the oil importing low-income countries including those from the SAARC region, which are extremely vulnerable to the rise in international oil prices. In the past, during most of the previous oil price shocks, many SAARC countries had to take large scale recourse to external financing including borrowing from the IMF. In the current episode of rising oil prices, it is felt that despite an easy liquidity situation many low income countries (including. SAARC countries) could find it difficult to raise required external finance from international markets at reasonable rates. The need for access to the IMF resources could prove to be much larger than what is currently being contemplated by the Fund. Towards this end and also to provide assurance and confidence to the market, a need for a dedicated oil facility at the IMF is strongly felt at this juncture.

Overall it is felt that in view of the strong output and price effects of the rising oil prices in the past, the impact of the current episode of rising oil prices would be even more pronounced since the disequilibrium in the oil market seems to be more fundamental and long-term this time around than in the past. It is expected that current account situation of some of the SAARC countries would deteriorate considerably and for countries with surplus in the current account. Rising oil prices has led to the emergence of deficit. With rising short-term interest rates in the industrialised countries, particularly the US, some slowing down of capital inflows could take place in the region. In some countries financing of current account deficit could be a cause for concern. The rising oil prices would continue to be burden on the fisc as well. The conduct of monetary policy would be saddled with uncertainties in view of deterioration in inflationary situation and expectations. Thus, the adverse impact of rise in oil prices during the current episode could be more widespread than in the past necessitating greater coordinated action.