Quarter II Issue (1388, 2009-10)

Publisher's Statement

The Quarterly Economic and Statistical Bulletin is produced by support of several departments under coordination of Monetary Policy Department of Da Afghanistan Bank. The bulletin provides macroeconomic data and analysis of economic trends over the quarter.

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Data Notes

Afghanistan uses the Persian calendar also known as the Jalali calendar, which was introduced on March 15, 1079 by the Seljuk Sultan Jalal-u-ddin Malik Shah I, based on the recommendations of a committee of astronomers, including Omar Khayyam, at the imperial observatory in his capital city of Isfahan. It is a solar calendar in which each year begins on March 21. This Quarterly Bulletin covers developments in the second quarter of 1388 which is equivalent June 22, to September 21, 2009 in the Gregorian calendar.

Afghanistan figures are in current afghani unless otherwise specified.
Billion means 1,000 million

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LIST OF ABBREVIATIONS

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

GOVERNOR'S STATEMENT

On behalf of the Supreme Council, I am pleased to present the Quarterly Economic and Statistical Bulletin of Da Afghanistan Bank (DAB) for second quarter of 1388 (June 22 – September 21, 09). This quarterly bulletin reflects the main results of the Bank's activities aimed at keeping inflation low, maintaining stability of the national currency and developing a robust banking sector in support of sustainable economic growth.

The second quarter of 1388 was a favourable quarter for Afghanistan with a significant increase in the wheat harvest due to reasonable rainfalls at the beginning of the year. The global recession paced to emerging market countries, especially trading partner countries of Afghanistan, which caused low demand and low inflation. The global recession will have a silver lining for net-food importing countries like Afghanistan as the decline in commodities prices is likely to lead to a decline in imported inflation going forward. In Afghanistan headline inflation, as measured by year-on-year percentage changes in Kabul CPI continued to be negative in the second quarter of the year.

The global economy has shown positive signs indicating the recession is coming to an end. The global outlook improved as production bounced back and global trade revived. International financial markets also continued to stabilize, but remained weak. The economic recovery was mostly driven by policy (fiscal and monetary) measures taken by major economies, and changes in the global inventory cycle.

The pace of economic recovery was uneven in the advanced and emerging economies. The rate of recovery was stronger in major emerging economies, especially the leading economies in Asia, compared to advanced economies like United States, Germany and Japan. However, it is expected that the global growth will be more balanced as the recovery solidifies in the quarters to come.

Monetary and capital market performance was positive in the quarter under review. The central bank kept liquidity at an adequate level which was favourable to overall economic activity.

Narrow Money (M1) grew by 11.54 percent during this period, up from 4 percent in the previous quarter. The main drivers of the increase in M1 were currency outside depository corporations (CODC) which grew by 10.52 percent, up from 1.1 percent in the previous quarter, and demand deposits which grew by 12.37 percent, up from 6.9 percent in the previous quarter. Another determinant of monetary growth is net foreign assets (NFA) which increased 10 percent in the second quarter of 1388, up from -7 percent in the previous quarter. Reserve money (RM) recorded an increase of 15 percent growth in the quarter under review.

Headline inflation is currently experiencing deflationary pressures as a result of international economic slowdown which caused low demand.

Headline consumer price index (CPI), for Kabul stood at 165.19 at the end of the second quarter of 1388, representing an inflation rate of -14.94 percent down from 35.71percent in the same period a year ago.

The decrease in headline CPI was mainly attributed to decreases in the prices of bread & cereals, meat, oil and fats, construction materials, fuel and electricity, and transportation. The food price index fell dramatically by 21.94 percent because of a decrease in demand in the international markets as well as significant wheat harvest inside the country. The central bank remains committed to ensuring sound monetary and financial policies in support of sustainable economic growth.

On the fiscal side, government finances remained on track to meet revenues and spending targets. Total domestic revenues increased to AF 14,041 million in the quarter under review compared to AF 9,982 million in the second quarter of FY1387, this represents a 41 percent increment. Total domestic revenues in the quarter under review accounted for 2.21 percent of GDP.

On the other side, total core expenditures in the quarter under review increased to AF 36,525 million up from AF 28,383 million in the second quarter of FY1387, showing 29 percent increase. Total expenditures in the quarter under review accounted for 5.7 percent of GDP.

Total expenditures are classified into development and operating expenditures. Development expenditures increased to AF 14,819 million in the quarter under review up from AF 11,965 million in the second quarter of 1387, this represents 34 percent increase. On the other hand operating expenditures increased to AF 21,706 million up from AF 17,318 million in the second quarter of 1387, showing a 25 percent increase.

Total core expenditures exceeded total domestic revenues significantly in the quarter under review, therefore, budget deficit in the quarter under review stood at AF 22,484 million.

The banking system continued to perform satisfactorily. Total assets of the banking system were AF 144 billion (USD 2.93 billion) as of September 2009, up by 42 percent or AF 42.27

billion since September 2008. Loans amounted to AF 58 billion (USD 1.17 billion) an increase of AF 9.14 billion (USD 186 million) or 19 percent since September 2008. Deposits stood at AF 118 billion (USD 2.40 billion) over the period under review; a 48 percent increase since September 2008. Deposits were largely denominated in USD (66 percent) with Afghani denominated deposits lagging at 30 percent. However, the AF-denominated deposits increased to AF 36 billion (USD 723 million), as compare to the last period (September 2008), where it was 22 billion (USD 447 million) in the previous period (September 2008). Total capital of the banking system stood at AF 20.08 billion (USD 408 million), up 16 percent since September 2008. The banking sector overall was profitable earning profit of AF 1,125 million (USD 22.88 million) since the beginning of 1388. An overall return on assets (ROA) decreased by 1.61 percentage points as compared to the previous year's 3.24. The main causes of the decrease in ROA is due to the increase in average total assets is more than increase in profitability. Private Banks are the most profitable institutions in the overall banking system.

On the external sector, balance of payments statistics reflect essential activities in the economy and flows of fund specifically foreign exchange.

Merchandize trade recorded a deficit of USD 624 million in the second quarter of SY 1388 compared with a USD 490 million trade deficit in the second quarter of SY 1387. In the quarter under review the trade deficit accounts for almost 5 percent of GDP.

In the second quarter of SY 1388 exports decreased by 10 percent from USD 105 million to USD 94.55 million. This decline is an indication of mainly two factors. First, comparatively low demand in Afghanistan's exports destination and secondly the economic hardship in Afghanistan's trading partners.

Abdul Qadeer Fitrat

Governor, Da Afghanistan Bank

(Central Bank)

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INTERNATIONAL ECONOMIC ENVIRONMENT

SUMMARY

Following a broad, deep and synchronized global downturn in late 2008 and early 2009, most of the advanced and emerging economies posted positive growth rate in the second quarter of 1388 [Note that the second quarter of solar year 1388 is equivalent the third quarter of 2009 in the Gregorian calendar]. The global outlook improved as production bounced back and global trade revived. International financial markets also continued to stabilize but remained weak. The economic recovery was mostly driven by policy (fiscal and monetary) measures taken by major economies, and changes in the global inventory cycle

The pace of economic recovery was uneven in the advanced and emerging economies. The rate of recovery was stronger in major emerging economies, especially the leading economies in Asia, compared to advanced economies like United States, Germany and Japan. However, it is expected that the global growth will be more balanced as the recovery solidifies in the quarters to come.

1. GLOBAL ECONOMY

As the economic recovery took hold, the global economy expanded at a growth rate of 4.7 percent (quarter over quarter annualized) in the quarter under review (Figure 1.1). Much of the contribution to global economic growth came from emerging economies. Emerging economies recorded 8.5 percent growth in the third quarter of 2009, outpacing the preceding quarter by 6 percentage points. Advanced economies grew by 2.4 percent. In the second quarter of 1387, the world, advanced economies and emerging economies had registered growth rates of -0.5, -2.4 and 2.9 respectively.

Figure 1.1: Global GDP Growth, Quarter over Quarter

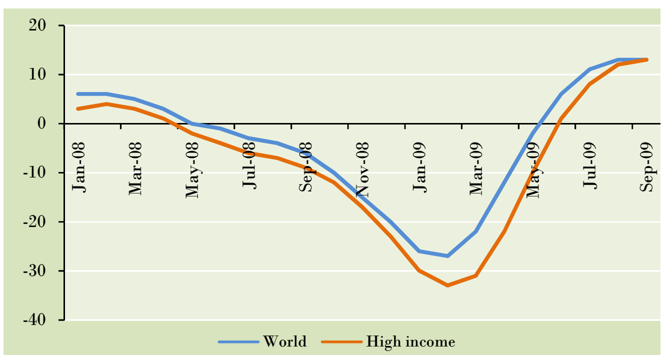
Source: International Monetary Fund

1.1 Industrial Production

In the real economy, world industrial production expanded at 12.6 percent y-o-y in the quarter under review (Figure 1.2). Industrial production in high income economies recorded 12.2 percent y-o-y increase. Second quarter growth of industrial production was 1.2 percent (Figure 1.3).

Global trade also improved but remained sluggish in the third quarter of 2009. On a quarterly base, growth rates of global trade turned positive in recent months.

Figure 1.2: Industrial Production, World and High Income Economies



Source: World Bank

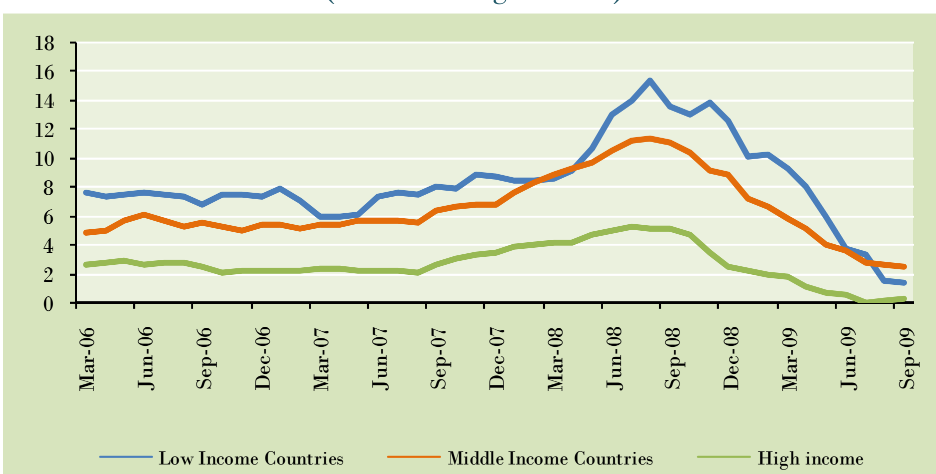
Figure 1.3: Industrial Production in OECD, Q3-2009

Source: World Bank

1.2 Global Inflation

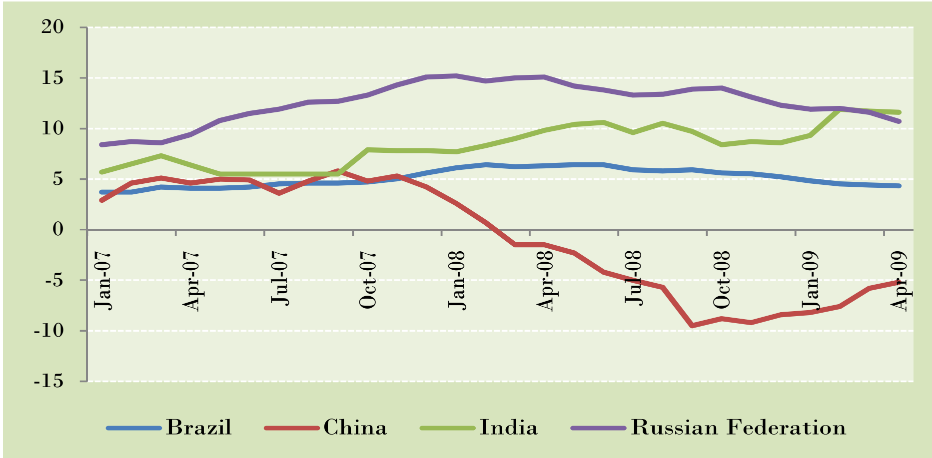
A precipitous decline of commodity prices combined with unprecedented slowdown in the global economy in first half of 2009, and ample spare capacity worldwide caused inflation in the middle-income countries to decline from a peak of 12.4 percent in mid-2008 to only 2.6 percent in Q3 2009. However, in high-income countries - excluding Japan, the rates of headline and core inflation stayed stable. Core inflation in Japan registered a negative rate in the quarter under review.

Figure 1.4: Headline Inflation: High, Low, and Middle Income Countries (Percent changes Y-o-Y)



Source: International Monetary Fund

Figure 1.5: Headline Inflation in BRICs
(Percent changes Y-o-Y)



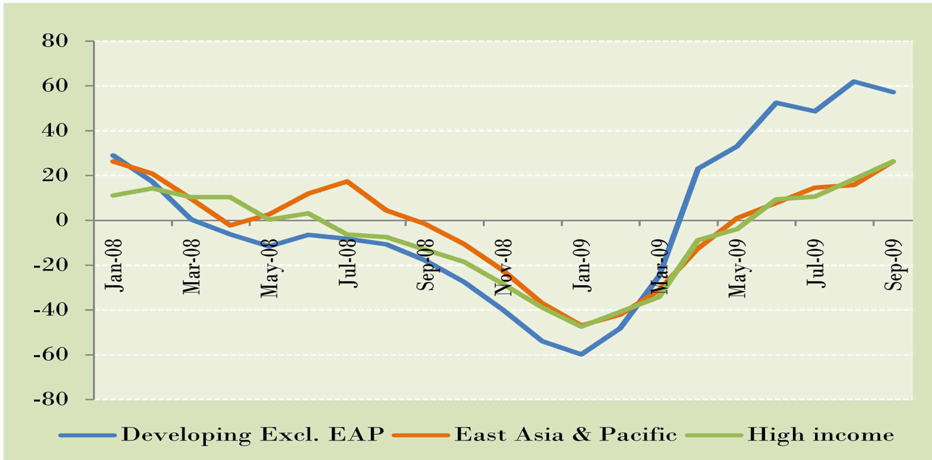
Source: World Bank

1.3 Global Trade and Investment

Broadly speaking, both the global trade and industrial production followed somewhat similar patterns. However, compared to industrial production global trade fell deeper and its pace of recovery was slower. The lag of the global trade rebound has been attributed to a continuation of the depressed level of global investment activity. According to UNCTAD, FDI flows in the third quarter stayed stable after a sharp fall in the first quarter and a slight rebound in the second. However, when compared to the same quarter in 2008, global FDI flows remained much lower in the third quarter of 2009. The Global FDI Quarterly Index in the third quarter in 2009 was 36 points lower than the level in the previous year.

On a quarter to quarter comparison, global trade expanded significantly from the middle of 2009. Trade in 23 major economies representing 85 percent of world trade reached $1.5 trillion indicating an 8.5 percent increase in the third quarter from the previous quarter. In terms of volumes, global trade had contracted 22 percent by March 2009. It improved later in the third quarter but remained far below its pre-crisis level. However if falling commodity prices and exchange rate fluctuations are not taken into account the decline in volume terms of global trade was moderate. In terms of dollar value, world exports and imports fell 25.6 and 26.2 percent, respectively (Table 1.1).

Figure 1.6: Global Exports Growth Rate (%)



Source: **World Bank**

Table 1.1: Quarterly World Merchandise Trade by Region and Selected Economy (Percent Changes Y-o-Y)

	Exports					Imports				
	2008		2009			2008		2009		
	Q3	Q4	Q1	Q2	Q3	Q3	Q4	Q1	Q2	Q3
World	23.2	-11.6	-31.3	-33.0	-25.6	23.7	-8.4	-29.9	-32.7	-26.2
North America	16.6	-6.8	-25.4	-30.0	-25.0	14.2	-9.0	-29.2	-34.0	-28.0
South and Central America	35.6	-11.6	-30.4	-30.2	-30.9	38.1	8.7	-21.0	-33.3	-31.2
Europe	17.3	-15.1	-31.5	-33.7	-23.5	19.5	-15.0	-32.1	-35.8	-26.6
Commonwealth of Independent States	57.2	-7.7	-47.3	-47.6	-41.3	46.5	5.3	-34.6	-41.5	-40.5
Asia	20.9	-5.2	-26.3	-26.3	-21.1	29.3	-5.1	-31.1	-28.5	-22.5

Source: UNCTAD

Comparing merchandise trade and services trade, the latter has been more resilient than the former. According to The World Tourism Organization, tourism arrivals were 7 percent lower in the first six months of 2009 compared to the same period in 2008. The largest fall has been registered in Central and Eastern European nations (11 percent). On the contrary, Africa registered a modest rise in tourist arrivals.

2. ADVANED ECONOMIES

2.1 The United States Economy

According to the US Bureau of Economic Analysis, real GDP in the United States grew at an annual rate of 2.2 percent quarter-to-quarter in the third quarter of 2009. This was the first expansion after four consecutive quarters of contraction.

The main forces that shaped the recovery in the US economy were the economic stimulus package introduced by the US government, positive growth in private consumption and in residential fixed investment. On a quarterly basis, personal consumption expanded by 2.8 percent in the third quarter in contrast to a 0.9 percent decrease in the second quarter.

Gross private investment bounced backed from -23.7 percent in the second quarter and registered a positive rate of 5.0 percent in the third quarter. This growth was driven by the sharp rise in the residential fixed investment which recorded an 18.9 percent jump after a -23.3 percent drop in the preceding quarter. However, the positive contributions by federal government spending and residential fixed investment were partly offset by the continued contraction in non-residential fixed investment.

Real exports expanded by 17.8 percent in the quarter under review. It had decreased 4.1 percent in the second quarter.

Imports also expanded from -14.7 in the second quarter to 21.3 percent in the third quarter.

Nevertheless, compared with the corresponding quarter in the previous year, gross domestic product (GDP) in United States shrank by 2.6 percent, narrowing from the 3.3 percent and 3.8 percent in the two preceding quarters. Personal consumption eased dropping by 0.2 percent.

Private investment remained sluggish, registering a decline of 25.9 percent. The value of imports and exports fell further posting decreases of 10.7 and 14.0 percent, respectively. The consumer price index (CPI) remained in negative territory at -1.6 percent. The increase in the rate of unemployment from 9.1 the second quarter to 9.6 percent in the third quarter indicated that the labour market deteriorated further in the third quarter of 2009.

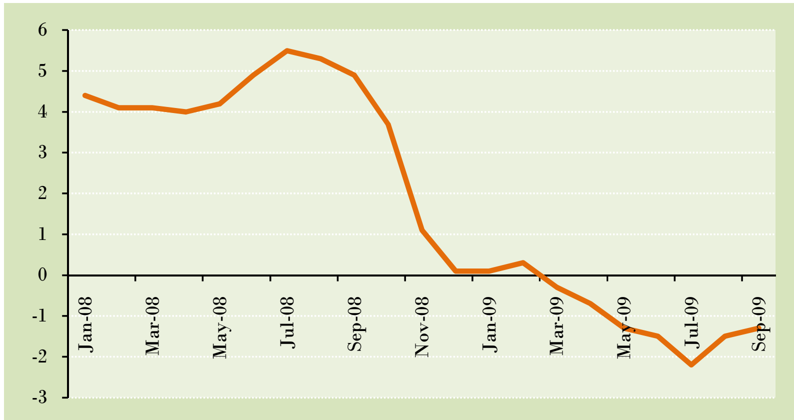
Figure 1.7: Real Gross Domestic Product in United States (Changers form Preceding Period)

Source: US Department of Commerce Bureau

Figure 1.8: Quarterly Changes in the GDP of United States

Source: US Department of Commerce Bureau of Economic Analysis

Figure 1.9: US Consumer Price Index (Y-o-Y)



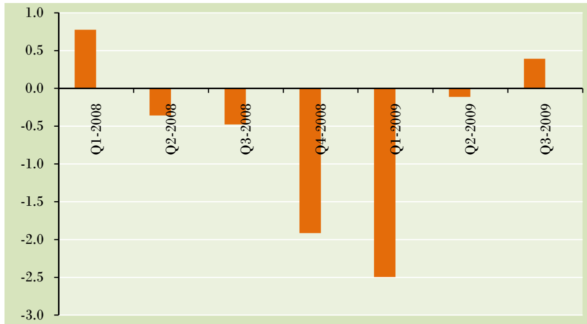
Source: World Bank

2.2 Euro Area Economy

Thanks to increased government consumption expenditure and a slower contraction of fixed capital formation and exports, the euro area economy improved in the third quarter of 2009. GDP in the euro area rose from -0.2 percent in the second quarter of 2009 to 0.4 percent in the third quarter on a quarter on quarter basis.

Compared with the third quarter of last year the rate of annual contraction slowed slightly and GDP shrank by 4.1 percent y-o-y. This rate was -4.9 in the second quarter of 2009. Government consumption expenditure rose by 2.5 percent, gross fixed capital formation contracted by 10.4 percent in the third quarter. Export decreased by 13.9 percent and the unemployment rate remained high at 9.3 percent. On the inflation front, the consumer price index fell by 0.4 percent mainly due to lower food and energy prices. The two largest economies in the euro zone, France and Germany, posted positive rates of economic growth for two consecutive quarters. The improvement was largely driven by efforts to stimulate consumer spending.

Figure 1.10: Euro Area; GDP Growth Rate Compared to Previous Quarter



Source: OECD

2.3 Germany Economy

Despite contracting exports, German GDP rose from 0.4 percent in the second quarter to 0.7 percent in the third quarter on a quarter to quarter basis. On a year-over-year basis however, the German economy shrank for fifth consecutive quarter, but the rate of contraction slowed from 7.0 percent in the second quarter to 4.7 percent in the third.

The dollar value of exports and imports in the quarter under review decreased by 19.5 percent and 19.7 percent respectively. The consumer price index dropped into negative territory at -0.2 percent year-over-year change. The unemployment rate remained stable decreasing by 0.1 percentage point to 8.2 percent.

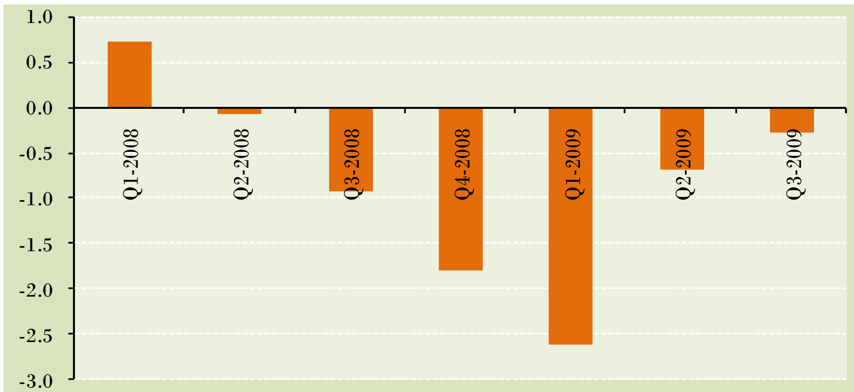
2.4 France Economy

The French economy narrowly registered positive growth for the second consecutive quarter and rose by 0.3 percent quarter-on-quarter. However, year- on-year GDP in France shrank by 2.3 percent, marking the fifth consecutive quarter of negative growth. Exports and imports remained sluggish in the third quarter as the value of merchandise fell by 16.9 and 21.8 percent year-over-year respectively. The consumer price index fell by 0.4 percent. Unemployment rose by 3 percentage point.

2.5 United Kingdom Economy

The rate of contraction in the UK economy lessened to 5.1 percent year-on-year in the third quarter of 2009 from 5.8 percent in the second. At a rate of -0.3 percent quarter-to-quarter, GDP growth in the UK economy remained in negative territory for the sixth consecutive quarter, registering one of the longest economic recessions on record. Meanwhile unemployment remained unchanged at 7.8 percent. The consumer price index rose to 1.5 percent.

Figure 1.11: UK GDP Growth Rate, Quarter-over-Quarter



Source: OECD

2.6 Japan's Economy

Gross domestic product fell by 5.2 percent year-on-year in the third quarter. However, GDP growth improved on a quarter-to-quarter comparison. The improvement came from private consumption related to government policies, net exports and capital spending in the non residential sector. Core inflation in Japan decreased by 2.2 percent in the third quarter and unemployment rose by 0.2 percentage points.

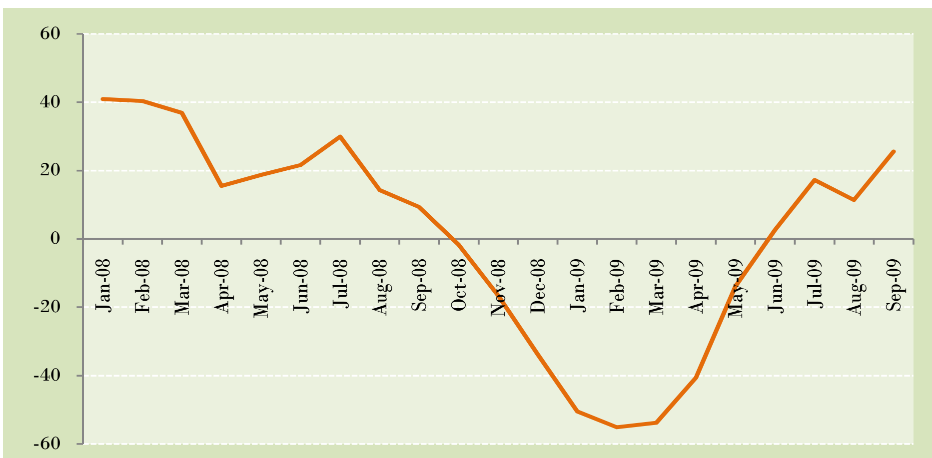
3. MAJOR EMERGING ECONOMIES

Emerging economies were less affected by the global financial crisis compared to advanced economies. However, due to growing global economic and financial integration these economies also did not remain unscathed. Production and trade declined dramatically between September 2008 and March 2009 due to a precipitous decline in the global demand for durable and investment goods. However, the downward trend slowed in the third quarter. Driven by recovering exports and domestic demand, the Asian Emerging Market Economies led the global recovery.

3.1 China

GDP in the Peoples Republic of China continued to expand from 7.9 percent y-o-y, in the second quarter to 9.1 percent in the third quarter of 2009, exceeding the government's 8 percent target. The massive stimulus policies adopted by the Chinese government to minimize the impact of the global financial crisis were the main driver behind the country's economic growth. These policies included expansionary credit policy, government infrastructure spending, increases in transfers and consumer subsidies and tax cuts. In terms of volumes, total domestic product in China was 3.18 trillion US dollars in the first three quarters of 2009. Industrial output expanded by 12.4 percent in the third quarter. Investment contributed the most in reversing the downward trend and shaping relatively fast economic growth in China. The demand for Chinese goods and services outside China continued to contract at 8.3 percent year-on-year for the third consecutive quarter. However, the negative impact of the contraction in exports was offset by aggressive stimulus policies to expand domestic demand. The consumer price index remained negative at -1.1 percent y-o-y, unchanged from the previous quarter.

Figure 1.12: China's Exports, January 2008 – September 2009 (in billion USD)



Source: World Bank

3.2 India

In India, GDP grew 7.9 percent y-o-y in the second quarter of 1388. Industrial production expanded by 9.2 percent, compared with 5.1 percent in the corresponding quarter of the preceding year, registering the swiftest pace of growth since the first quarter of 2008. Compared with the previous quarter, the Indian economy grew at a 13.9 percent annualized pace from the previous quarter. The government's stimulus polices, domestic demand and low interest rates supported growth in industrial production, investment and exports in the

Indian economy. In September, consumer prices reached a two-year low of 6 percent y-o-y. Imports contracted at a faster rate than exports, thus the current account deficit is expected to decline to 5 percent of GDP in 2009.

On the trade front, India grew 12.1 percent in the third quarter. This improved the India's position in the Global Trade Flow Index produced by Capgemini Consulting (India ranked 15 in the index)

4. ASSET AND COMMODITY PRICES

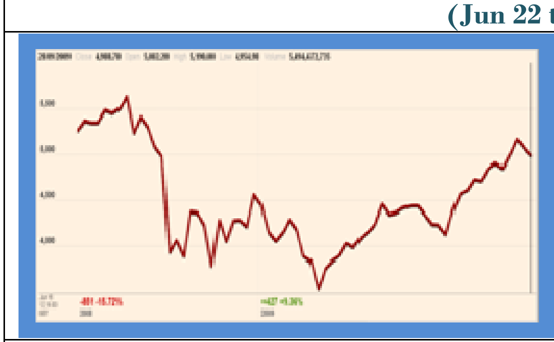
4.1 Financial Markets

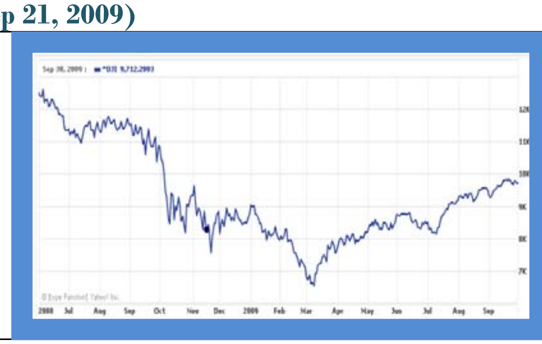
In the quarter under review, equities continued to rally. Gains by major European markets outpaced the preceding quarter while some emerging markets rose at a slower pace. Markets in the Eastern European economies recorded a strong performance during the quarter. The MSCI Emerging Markets Index rose by 21 percent.

Expecting further strengthening of the recovery, the S&P 500 rose 56 percent from its low at the end of the first quarter, but still remained 7 percent below its year-ago level and 32 percent below its all-time high of October 9, 2007.

US equities registered strong returns over the quarter. In the UK, stocks rallied, rising a over a fifth and the headline FTSE 100 Index recorded its strongest ever quarter. In contrast, based on disappointing consumption related data, Japanese equities underperformed during the quarter.

Figure 1.13: Stock Markets' Performance in the Second Quarter of 1388 (Jun 22 to Sep 21, 2009)



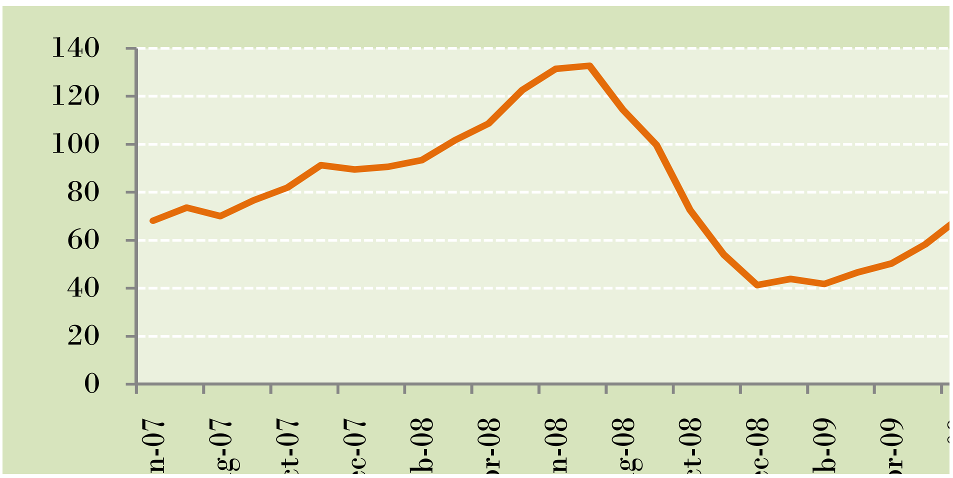


Source: Yahoo Finance

4.2 Commodity Markets

Having collapsed in the wake of the global economic downturn, commodity prices and demand staged a modest recovery in the quarter under review. In the commodity markets almost all major commodities registered positive growth. The upward trend was driven by the improved outlook in the global economic recovery and Chinese demand for key metals were among the factors supporting the commodity prices, which have recovered about one-third of their earlier declines.

Figure 1.14: Crude Oil Prices, USD/Barrel



Source: World Bank

4.3 Global Exchange Rate Movements

During the third quarter, the US dollar depreciated against nearly all major currencies (except the pound sterling) The dollar depreciated significantly against euro, averaging USD 1.43 per euro in the third quarter. The appreciation of euro against the US dollar in the period under review was largely driven by the recovering risk appetite in global markets. The dollar lost ground vis-a-vis the Japanese yen between the first and the third quarters of 2009. On average, ¥93.57 was traded per dollar in the third quarter, close to ¥91.00 in September 2009.

The pound sterling depreciated against the US dollar on the grounds of concerns that the UK economy will not keep pace with other advanced economies in the economic recovery. The rebound of investor sentiment for prospects of economic growth in emerging economies caused the regional currencies to rally vis-a-vis the US dollar during the third quarter.

Table 1.2: Exchange Rats, (LDC/USD)

	2008	2009		
	Q4	Q1	Q2	Q3
Euro	0.76	0.77	0.73	0.70
Japan	96.01	93.52	97.4	93.57
Brazil	96.01	93.52	97.4	93.57
Russia	27.35	34.09	32.18	31.31
India	48.79	49.83	48.83	48.4
China	6.84	6.84	6.83	6.83
South Africa	9.94	9.95	8.477	7.81

2

MONETARY AND CAPITAL MARKET DEVELOPMENTS

SUMMARY

In the quarter under review, monetary aggregates had mixed performance. Currency in circulation (CiC) followed an upward trend, well below the Poverty Reduction and Growth Facility (PRGF) ceiling up to the end of the quarter under review. Currency in circulation grew sharply at the end of the quarter reaching at almost 12 percent. The positive growth of CiC in the quarter under review is attributed to budget disbursements which were delayed in the first quarter resulting a negative growth.

Reserve money (RM), which had grown by 65 percent in the previous year mainly because of huge foreign deposits with commercial banks, recorded an increase of 15 percent growth in the quarter under review. The increase in RM is attributed mainly spending by International Security Assistance Force (ISAF) as well as execution of the budget that resulted an increase in CiC and in demand deposits of the commercial banks with the central bank.

On the other hand, narrow money (M1) grew by 11.54 percent during this period, up from 4 percent in the previous quarter. The main drivers of the increase in M1 were currency outside depository corporations (CODC) which grew by 10.52 percent, up from 1.1 percent in the previous quarter and demand deposits which grew by 12.37 percent up from 6.9 percent in the previous quarter.

Broad money (M2) increased by 12.18 percent in the quarter under review compared to 4.8 percent in the previous quarter.

The outstanding stock of capital notes (CNs) declined by 29 percent in the quarter under review. While the stock of 182-day capital notes declined by 18 percent, the stock of 28-day CNs declined by 76 percent mainly because commercial banks had used them to invest their short-term liquidity corresponding to foreign demand deposits. By the end of the quarter the total stock of capital notes was AF 10.27 billion with about AF 2.1 billion in 28-day CNs and the remaining in 182-day capital notes.

The excess liquidity in the banking system pushed down the interest rates on capital notes with the weighted average interest rates falling from 9.39 percent to 5.3 percent for 28-day CNs; and from 10.57 percent to 7.6 percent for 182-day CNs.

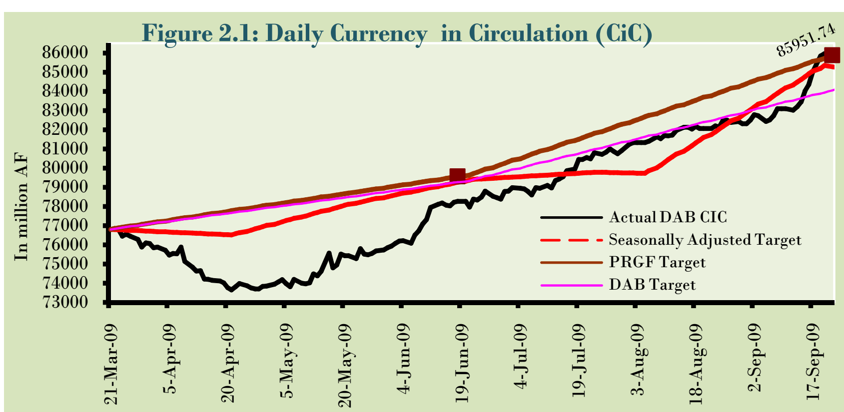
In the meantime, the afghani appreciated by 1.38 percent in the second quarter of 1388 with the exchange rate falling from 50.14 afghani to one US dollar to 49.45 afghani per US dollar. This appreciation is attributed to a wealth effect due to a good harvest season in Afghanistan and an unprecedented influx of foreign funds.

PRGF MONETARY PROGRAM

Currency in circulation (CiC) is a performance criterion for the DAB under the PRGF arrangement with the IMF. The CiC ceiling set for the second quarter of 1388 was 11.91 percent while the annual growth for this variable was 22 percent. The DAB achieved this target when actual CiC grew 11.91 percent in the quarter under review.

Considering the tight ceiling on currency in circulation, DAB continued to aggressively purchase afghani in FX auctions to prepare for any surprise injections of liquidity by the government. The amount of dollars sold at FX auctions in the quarter under review stood at USD 873.20 million compared to USD 553.00 million in the same period a year ago. Furthermore, the increase in the size of FX auctions was due to an increase in the number of NATO troops in Afghanistan which caused additional spending, as well as an increase in the salaries of national police and national army by the government. The high demand for afghani due to the Eid festival in the quarter under review caused CiC to grow sharply by 12 percent.

Figure 2.1 shows the trend of currency in circulation during the past six months.



Source: Monetary Policy Department

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

The PRGF program has also an indicative target for reserve money based on the definition provided above. The annual ceiling on reserve money growth for the fiscal year 1388 is 17 percent while the target for the second quarter of 1388 was 9 percent. Reserve money had grown by 15.1 percent in the quarter under review as a result of a 41 percent increase in commercial banks deposits with DAB.

2. MONETARY AGGREGATES

The monetary aggregates -- narrow money and broad money -- are compiled following the MFS methodology and definition.

In the quarter under review, narrow money (M1) grew to AF 184,089 million indicating a quarterly growth of almost 12 percent which is higher than the 4.2 percent growth recorded in the previous quarter. Narrow money includes currency outside depository corporations and demand deposits in almost equal proportion. Commercial banks' demand deposits grew by 12.4 percent leading the growth in M1.

On the other hand, broad money, which adds to narrow money the time deposits of commercial banks (quasi money), grew by 12.2 percent. Though quasi money grew by 32.5 percent in the second quarter, it only constitutes about 3 percent of broad money, which means that its significant growth was not reflected in M2. Both afghani and foreign currency-denominated time deposits recorded double digit growth in the second quarter of 1388. Afghani denominated deposits grew by 26.5 percent lower growth than in the first quarter which ended at 42.4 percent. Foreign currency denominated deposits grew by 40.9 percent, higher than the 10.6 percent of the first quarter of 1388. At the end of second quarter of 1388 (23 Sep, 2009), the stock of broad money was AF 191,083 million.

According to the monetary program, reserve money increased by 15 percent which was attributed to an increase of 41 percent in bank deposits with DAB. CiC increased by 10 percent in the second quarter of 1388. Reserve money stood at AF 106,039 million at the end of second quarter for the 1388 fiscal year.

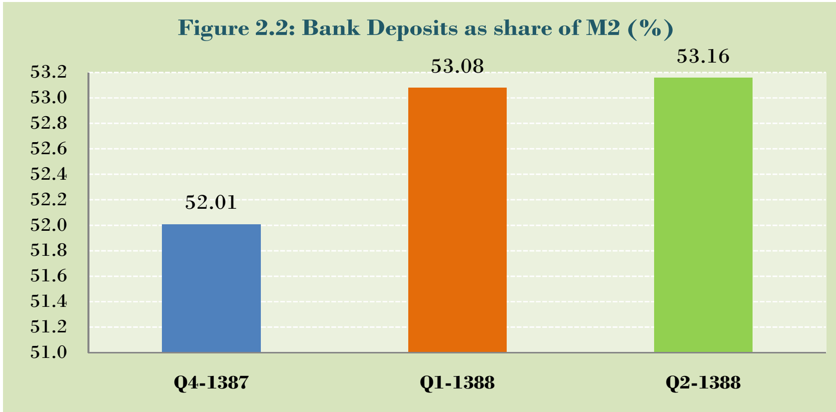
Net foreign assets increased by 10 percent in the quarter under review, up from -7 percent in the previous quarter. Net claims on general government, which is a key component of Domestic Assets, increased by 20 percent in the second quarter of 1388 up from 4 percent in the previous quarter. This is mostly driven by Gross Claims on Government which decreased by 185 percent in the quarter under review after rising 19 percent in the previous quarter.

Table 2.1 summarizes the monetary aggregates of depository corporations. Meanwhile bank deposits as a share of broad money rose to 53.16 percent in the second quarter of 1388 up from 53.08 percent in the first quarter of 1388. (Figure 2.2)

Table 2.1: Monetary Aggregate, Second Quarter 1388 (in million AF)

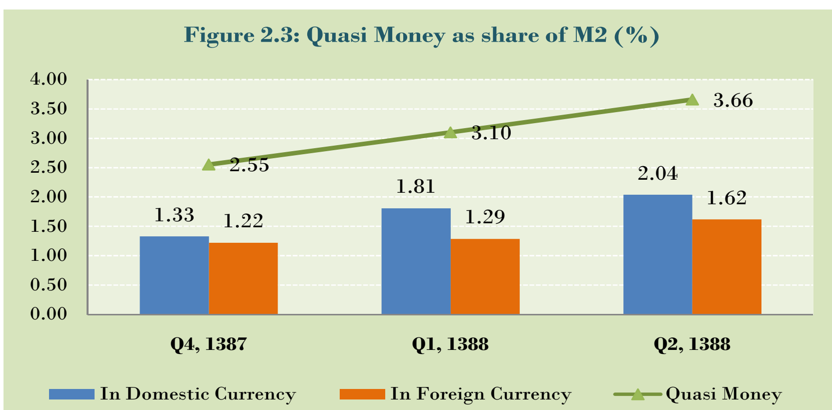
	1387		Quarter Change (Q4-Q1)	Difference (Q4-Q1)	1388	Quarter Change (Q1 – Q2)	Difference (Q1-Q2)
	Q4	Q1			Q2		
	Amount	Amount			Amount		
1. Net Foreign Assets	**183,997**	**193,851**	**5.4%**	**9,854**	**224,479**	**15.80%**	**30,628**
(a) Foreign Assets	219,112	213,187	-2.7%	-5,926	240,447	12.79%	27,261
DAB Foreign exchange reserves	185,037	175,358	-5.2%	-9,679	200,441	14.30%	25,084
Gold	34,641	34,641	0.0%	0.000	34,641	0.00%	0.000
Other	150,396	140,717	-6.4%	-9,679	165,800	17.83%	25,084
Other foreign assets	34,075	37,829	11.0%	3,754	40,006	5.75%	2,177
(b) Foreign Liabilities	35,115	19,335	-44.9%	-15,779	15,968	-17.41%	-3,367
2. Net Domestic Assets	**-21,447**	**-23,507**	**9.6%**	**-2,060**	**-33,373**	**41.97%**	**-9,866**
(a) Net Domestic Credit	6,717	10,928	62.7%	4,211	7,399	-32.29%	-3,528
Net Credit to Non-financial Public Sector	-43,591	-39,606	-9.1%	3,985	-47,371	19.60%	-7,765
Net Credit to Central Government	-44,609	-44,724	0.3%	-115	-53,150	18.84%	-8,426
Credit to Central government	6,659	7,452	11.9%	793	17,632	136.62%	10,181
Liabilities to Central government	51,268	52,176	1.8%	908	70,782	35.66%	18,606
Net Credit to State and Local Government	0.000	0.000	0.000	0.000	0.000	0.000	0.000
Net Credit to Public Non-financial Corporation	1,017	5,118	403.0%	4,101	5,779	12.92%	661
Credit to Private Sector	49,842	49,741	-0.2%	-101	53,543	7.64%	3,803
Net Credit to Other Financial Corporations	466	793	70.2%	327	1,227	54.66%	434
(b) Capital Accounts	49,846	52,765	5.9%	2,920	63,246	19.86%	10,481
(C) Other Items Net	21,682	18,331	-15.5%	-3,351	22,474	22.60%	4,143
3. Broad Money (M2)	**162,527**	**170,329**	**4.8%**	**7,802**	**191,083**	**12.18%**	**20,754**
Narrow Money (M1)	158,376	165,050	4.2%	6,674	184,089	11.54%	19,039
CiC (Currency outside depository corporations)	*73,842*	*74,645*	1.1%	803	*82,500*	10.52%	7,856
Demand Deposits	*84,534*	90,405	6.9%	5,871	101,589	12.37%	11,184
Other Deposits (Quasi Money)	4,151	5,279	27.2%	1,128	6,994	32.47%	1,714
In afghni	2,164	3,082	42.4%	918	3,898	26.49%	816
In foreign currency	1,988	2,198	10.6%	210	3,096	40.85%	898
Securities Other than Shares	0.000	0.000	0.000	0.000	0.000	0.000	0.000

Source: Monetary Survey Section, Monetary Policy Department DAB



Source: Monetary Survey Section, Monetary Policy Department DAB

Similarly quasi money as a share of broad money grew to 3.66 percent in the quarter under review, up from 3.10 percent in the first quarter of 1388. The growth was led by afghani-denominated time deposits included in quasi money which grew by e26.5 percent. Afghani-denominated time deposits constitute 2.04 percent of broad money while foreign currency denominated deposits made 1.62 percent of M2.



Source: Monetary Survey Section, Monetary Policy Department DAB

2. CAPITAL MARKETS AND LIQUIDITY CONDITIONS

2.1 Capital Note Auctions

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

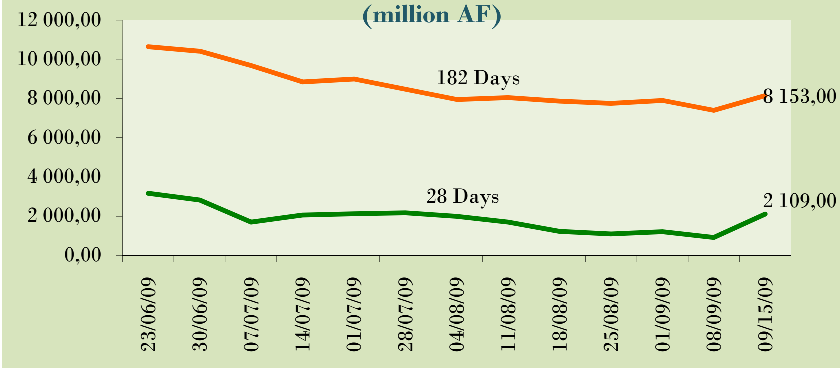
The amount to be auctioned is announced electronically every Monday to the banks. The auction is a multiple price auction with each bidder paying the price they bid. The auction is held on Tuesdays with settlement T+1 except when it coincides with public holidays. In the auction, investors bid to purchase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

The amounts awarded in the quarter under review fluctuated between AF 229 million and AF 1.2 billion for 28 day notes and between 65 million and AF 1.4 billion for 182 day notes. The amounts announced for 28 day and 182 day notes were AF 200 million and AF 100 million respectively.

In the quarter under review, the outstanding stock of 28 day notes fluctuated between AF 0.909 billion and AF 3.165 billion. It dropped by AF 900 million at end of the second quarter to the outstanding amount of AF 2.1 billion. Similarly, the stock outstanding of 182 day notes noticed a decrease of AF 2.6 billion, making the outstanding amount decrease to AF 8.1 billion, at end of the quarter under review.

The total outstanding stock of both maturities stood at AF 10.27 billion at the end of the reporting period. (Figure 2.4)

Figur 2.4: Capital Notes Stock Outstanding (million AF)



Source: Market Operations Department, DAB.

The high demand for CNs is reflected in the cover ratio, the ratio of amounts bid to amounts awarded. In the quarter under review, the bid amount for 28 days notes was AF 8,347 million and the amount awarded was AF 6,052 million for a cover ratio of 1.38. The bid amount for 182 day notes was AF 7,519 million and the amount awarded was AF 4,949 million for a cover ratio of 1.52. Comparing the cover ratio in the second quarter to that in the previous quarter, the cover ratio for the 28 day note was 3.08 and for 182 day note it was 4.03. The ratio of amount awarded to auction announced amount (fixed at AF 200 million for 28 day and AF 100 million for 182 day) was 2.72. This reflects that there is still a high demand for CNs from commercial banks, despite a large supply by DAB (figure 2.5 is for 28 day CNs and figure 2.6 is for 182 day CNs).

Figure 2.5: Demand and Awarded Amounts for 28 Day Capital Notes, (million AF)

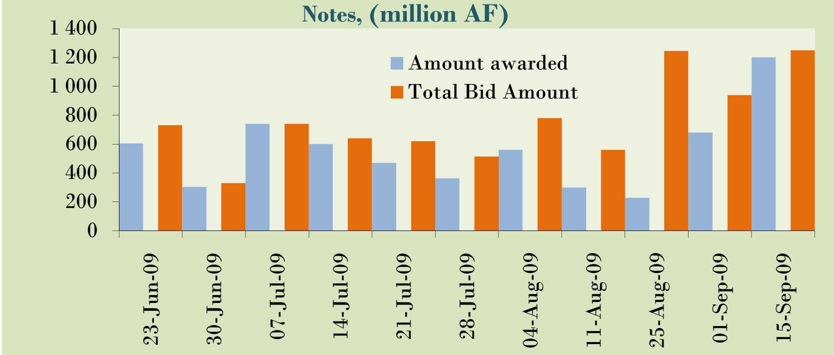
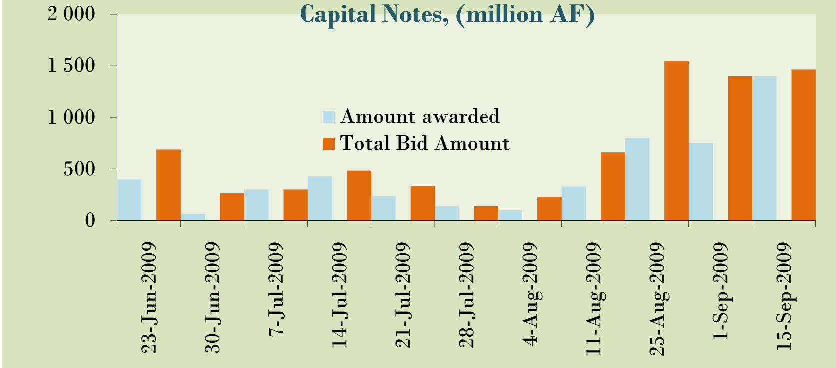


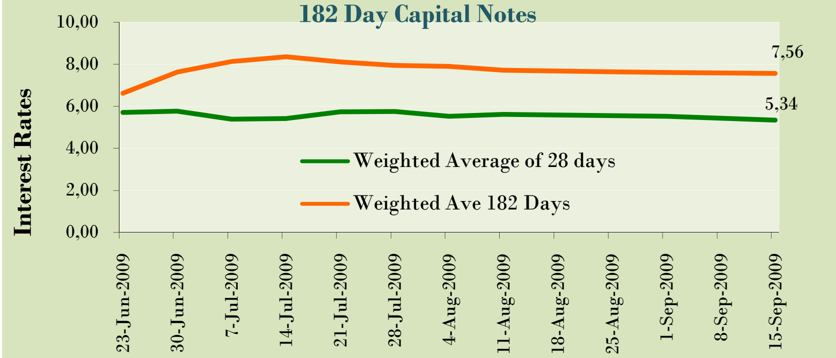
Figure 2.6: Demand and Awarded Amounts for 182 Day Capital Notes, (million AF)



Source: Market Operations Department, DAB

The weighted average interest rates for 28 day notes showed a gradual decrease of 40 basis points during the quarter under review which lowered the interest rate for 28 day notes to 5.34 percent. On the other hand, the weighted average interest rate for 182 day notes increased by 170 basis points at the beginning of the quarter before it dropped down to 7.56 percent at the end of the quarter. The previous quarter ended with a weighted average interest rate of 5.70 percent for 28 day notes and 6.70 percent for 182 day notes (Figure2.7).

Figure 2.7: Weighted Average Interest Rate of 28 Day and 182 Day Capital Notes



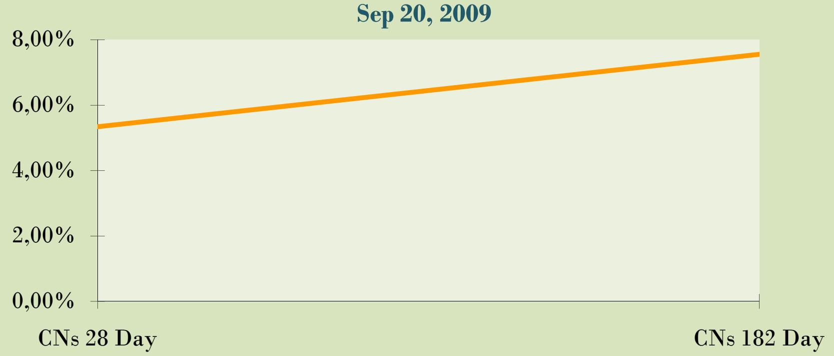
Source: Market Operations Department, DAB

2.1 Term Structure of Interest Rates

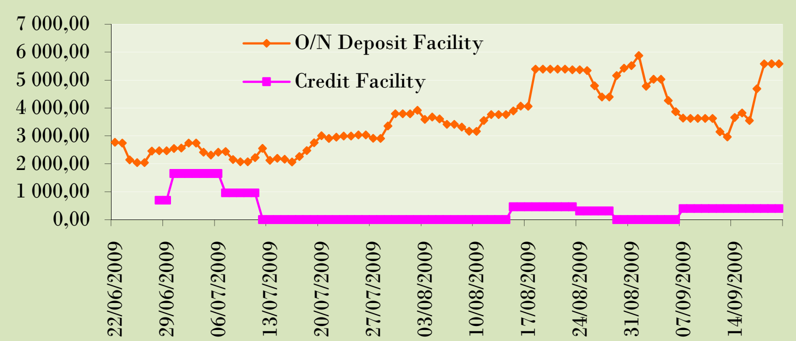
The term structure of interest rates, also called the yield curve, is the relation between the interest rate (cost of borrowing) and the time to maturity on a security. The yield of the capital notes is the annualized percentage increase in the value of the CN.

The yield curve on September 20, 2009 was positive.

Figure 2.8: Term Structure of Interest Rates Yield Curve Sep 20, 2009



Figur 2.9: Overnight Deposit Balances (million AF)



Source: Market Operations Department, DAB

2.2 Required and Excess Reserves

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

Overnight Deposit Facility: This facility is available to all commercial banks to earn interest on excess balances and it provides a floor for rates on capital notes deposits are not counted towards required reserves. The interest rate on the overnight deposit facility is now 350 basis points below 28 auction cut-off rate (based on a circular to all banks approved by the DAB Supreme Council on Feb 27, 2007). The outstanding amount of deposit facility balances fluctuated between AF 2 billion and AF 6 billion. The quarter under review ended with a stock outstanding amounting to AF 5.6 billion.

Overnight Credit Facility: This facility is used by banks for short term cash needs. The facility allows banks to borrow Afghani from Da Afghanistan Bank on an overnight basis when they face a shortfall in cash flow. The rate that the banks are charged for this facility is 350 basis points above the last 28 day CNs auction. This borrowing is collateralized with outstanding capital notes only (according to the circular of Feb 27, 2007).

It is worth mentioning that during the quarter under review four banks used the credit facility, a total of AF 2.5 billion. During the quarter, required reserves averaged AF 464 million per bank. This figure was AF 388 million.

Required reserves are remunerated at 350 basis points below the cut off rate of 28 days capital notes or the same as the deposit facility rate.

Figure 2. 10: Excess Reserves (deposit facility not included) (million AF)

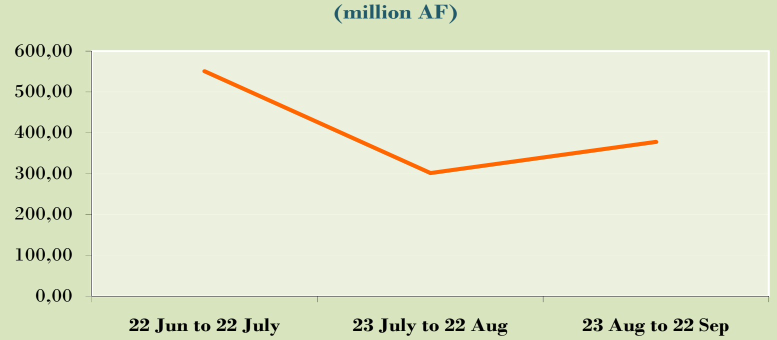


Table 2.2: Auction of 28 Day Capital Notes (million AF)

Date	Auction Amount	Amount awarded	Total Bid Amount	Winning Bids	Total bids	Cut off Rate
23-Jun-09	200	605	730	5	6	5.99%
30-Jun-09	200	304	329	4	5	5.98%
07-Jul-09	200	740	740	4	4	5.90%
14-Jul-09	200	600	640	2	3	5.85%
21-Jul-09	200	470	620	3	4	5.80%
28-Jul-09	200	364	514	4	4	5.80%
04-Aug-09	200	560	780	5	7	5.70%
11-Aug-09	200	300	560	1	4	5.62%
25-Aug-09	200	229	1,244	3	5	5.59%
01-Sep-09	200	680	940	6	7	5.55%
15-Sep-09	200	1,200	1,250	2	3	5.50%
Total	**2,200**	**6,052**	**8,347**			

Table 2.3: Auction of 182 Day Capital Notes

Date	Auction Amount	Amount awarded	Total Bid Amount	Winning Bids	Total bids	Cut off Rate
23-Jun-09	100	398	688	2	5	6.70%
30-Jun-09	100	65	265	2	3	8.25%
07-Jul-09	100	300	300	2	2	8.49%
14-Jul-09	100	430	485	2	4	8.40%
21-Jul-09	100	236	336	1	2	8.10%
28-Jul-09	100	140	140	2	2	8.00%
04-Aug-09	100	100	230	1	3	7.90%
11-Aug-09	100	330	660	3	4	7.80%
25-Aug-09	100	800	1,550	3	3	7.75%
01-Sep-09	100	750	1,400	3	5	7.65%
15-Sep-09	100	1,400	1,465	3	4	7.60%
Total	**1,100**	**4,949**	**7,519**			

3. FOREIGN EXCHANGE MARKET

3.1 Foreign Exchange Rates

Though Da Afghanistan Bank (Central Bank) does not target the nominal exchange rate of afghani against other foreign currencies, maintaining stability in domestic price levels is one of the main mandates of DAB. Price stability is implemented by controlling currency in circulation. Nevertheless, the central bank monitors nominal exchange rates for large fluctuations as these will have a negative impact on economic indicators, especially the inflation rate. Therefore, stability in the value of afghani and reducing excessive fluctuations against foreign currencies is one of the goals of DAB.

DAB maintains a managed floating exchange rate where the exchange rate of afghani is determined by the market. DAB engages in the market by selling and buying US dollar through auctions on a bi-weekly basis primarily for controlling currency in circulation which is a monetary target.

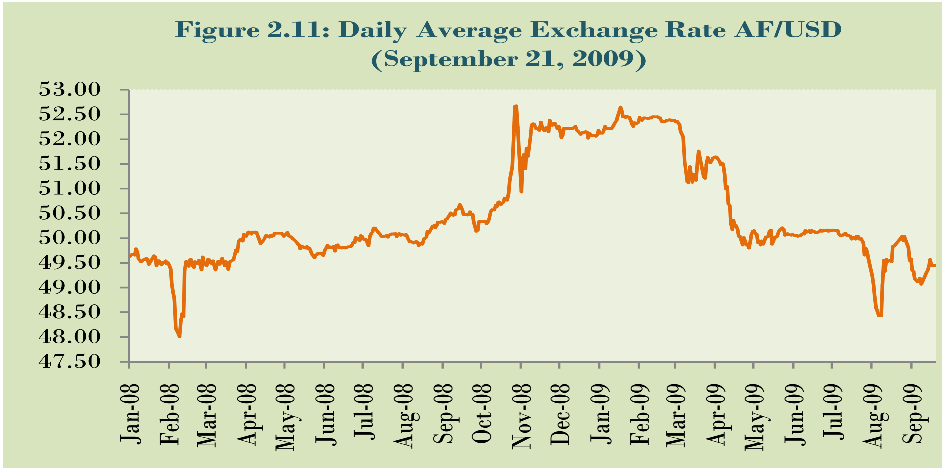
The review of the exchange rate, AF against USD for the second quarter of 1388 (September 21, 2009) is shown in Figure 2.11. The nominal exchange rate of afghani against the US dollar appreciated sharply at the beginning of the quarter under review and stabilized before reaching AF 48.43 per USD on Aug 6, 09. The nominal exchange rate of afghani against US dollar reached AF 49.45 per USD at the end of the quarter. The main reasons behind this appreciation are: 1- large amount of foreign inflows, 2- increased demand for afghani with growing confidence in its credibility as a store of value, and 3- de-dollarization momentum.

Likewise, the afghani appreciated against the Pakistani rupee (PKR) and euro by 12.12 percent and 7.18 percent, respectively, in the quarter under review.

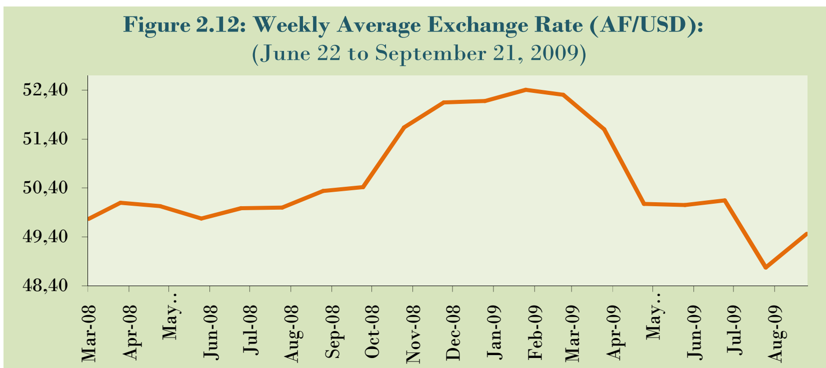
Table 2.4: Exchange Rate of AF Against Selected Currencies Q2 1387

Period	USD	PKR	EURO
Average for Q2 1388	49.65	0.6049	70.36
Average for Q2 1387	50.15	0.6883	75.80
% Appreciation (-) or depreciation(+) of AF against respective currency	**-0.99**	**-12.12**	**-7.18**
Closing rate on Sep 19, 09	49.45	0.6013	72.38
Closing rate on June 21, 09	50.14	0.6228	70.29
% Appreciation (-) or depreciation(+) of AF against respective currency	**-1.34**	**-3.45**	**2.97**

Source: Monetary Policy Department/ Market operations Department/ DAB



Source: Monetary Policy Department/ Market operations Department/ DAB



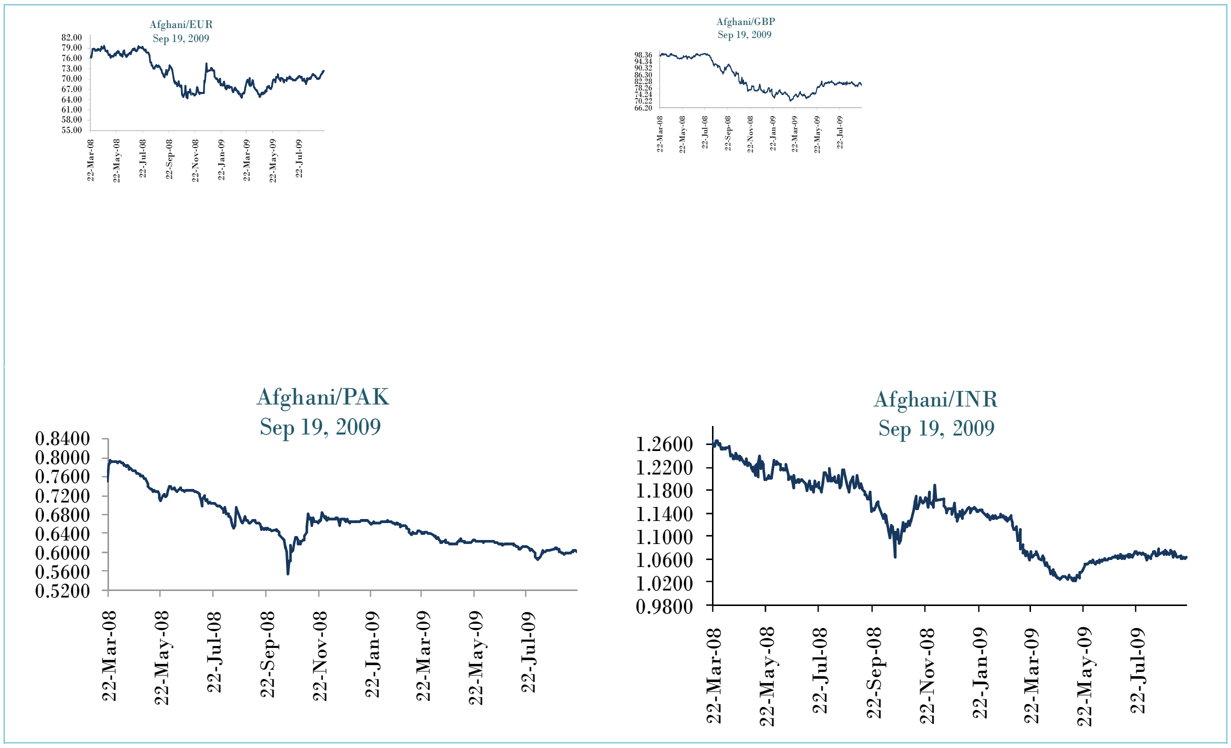
Source: Monetary Policy Department

The exchange rate movement of the afghani against the USD on a weekly basis appreciated sharply at the beginning of the quarter under review and became somewhat volatile throughout the quarter. The weekly movement is depicted in Figure 2.12. The afghani started appreciating against the USD from the beginning of March 2009, and continued up to end of April 2009, from AF 52.31 to AF 49.89 per USD. The Afghani then depreciated slightly to the end of the quarter under review reaching AF 49.45 per USD.

The standard deviation of the exchange rate movement for Q2-1388 stood at 0.46 compared to 0.21 in the same quarter a year ago. The difference in standard deviation between the two quarters shows that the exchange rate of afghani against US dollar was less stable in the quarter under review.

The comparison of historical daily average exchange rate of afghani against some major foreign currencies for Q2 of 1388 is shown in Figure 2.13

Figure 2.13: Daily Exchange Rates of AF against Some Major Currencies



Source: Market Operations Department and Monetary Policy Department Staff calculations.

3.2 Foreign Exchange Auction

In the absence of other monetary policy tools, the foreign exchange auction is primarily used to control the growth of the money supply which is defined as currency in circulation in the context of the PRGF program. However, given the above, the foreign exchange auction could possibly be used to smooth fluctuations in the exchange rate.

DAB has maintained the bi-weekly sterilization policy, to withdraw extra liquidity arising principally from government expenditures and foreign inflows. The foreign exchange auction size is determined in a liquidity forecasting framework, which takes into account money demand on one hand and on the other, the currency growth ceiling agreed by the DAB with the IMF under the PRGF.

In the quarter under review DAB dollar totaled USD 428.40 million. The weighted average rate of the entire 24 FX auction sessions (sale price of USD) was 49.48, covering June 23 to Sep 15, 2009; while in the previous quarter there were 27 FX auction sessions totaled USD 491.35 million. The weighted average selling rate was 50.40.

Table 2.6 summarizes the result of DAB foreign exchange auctions during the period of March 22 to June 21, 2009.

Table 2.5: DAB Foreign Exchange Auction Summary, Q1- 1388 (million USD)

Auction Date	No of Bidders	High Price	Low Price	Market Ex Rate	Cut off Price	Amount Announced	Amount Awarded	No of Awarded Bidders
23-Jun-09	35	50.16	50.01	50.14	50.13	17.50	12.05	16
27-Jun-09	45	50.16	51.01	50.16	50.13	20.00	18.00	26
30-Jun-09	47	50.16	50.08	50.15	50.14	20.00	14.45	22
4-Jul-09	41	50.18	50.07	50.15	50.15	20.00	14.45	22
7-Jul-09	37	50.06	49.75	50.05	50.04	20.00	13.25	19
11-Jul-09	47	50.07	49.95	50.10	50.05	20.00	15.85	23
14-Jul-09	39	50.06	49.90	50.05	50.04	20.00	11.45	21
18-Jul-09	42	50.05	50.08	50.02	49.99	20.00	14.40	30
21-Jul-09	33	50.01	49.77	50.03	49.77	20.00	15.00	33
25-Jul-09	45	49.85	49.00	49.91	49.55	20.00	19.10	42
28-Jul-09	49	49.74	19.31	49.73	49.50	20.00	31.55	46
1-Aug-09	60	49.22	48.50	49.25	49.00	20.00	20.60	47
4-Aug-09	53	48.27	47.30	48.58	48.05	20.00	19.30	39
8-Aug-09	53	48.43	48.09	48.43	48.38	20.00	18.50	27
11-Aug-09	60	49.45	48.80	49.33	49.38	20.00	21.30	22
15-Aug-09	52	49.61	49.21	49.55	49.45	20.00	21.80	42
18-Aug-09	49	49.94	49.15	49.84	49.79	20.00	14.25	18
25-Aug-09	51	49.93	49.55	49.95	49.88	30.00	20.80	21
29-Aug-09	51	49.79	49.25	49.80	49.71	20.00	20.70	33
1-Sep-09	49	49.36	48.93	49.36	49.17	20.00	16.70	36
5-Sep-09	47	49.14	48.90	49.12	49.08	20.00	18.65	25
8-Sep-09	42	49.10	48.00	49.07	49.04	20.00	11.25	9
12-Sep-09	51	49.21	49.05	49.30	49.18	20.00	19.65	21
15-Sep-09	56	49.61	49.20	49.57	49.52	20.00	25.35	32
		Total FX Announces and awarded				**487.50**	**428.40**	

Source: Market Operations Department and Monetary Policy Department staff calculations

3

THE INFLATION TRENDS AND OUTLOOK

SUMMARY

Headline inflation is currently experiencing a negative trend as a result of the international economic slowdown which caused low demand. The Presidential and Provincial Council elections could be another reason behind this slowdown in economic activities inside the local economic territory.

Headline consumer price index (CPI), the broadest measure of the rise in the general level of prices for Kabul stood at 165.19 at the end of the second quarter of 1388, representing an inflation rate of -14.94 percent down from 35.71percent in the same period a year ago.

The decrease in the headline CPI was mainly attributed to decreases in the prices of bread & cereals, meat, oil and fats, construction materials, fuel and electricity, and transportation. The food price index fell dramatically by 21.94 percent because of a decrease in demand in the international markets as well as significant wheat harvest inside the country.

Core inflation calculated as headline inflation excluding bread and cereals, oil and fats, and transportation also decreased by 1.41 percent in the quarter under review down from 11.97 percent in the same quarter a year ago. Core inflation calculated by Trimmed Mean also depicts a downward trend reaching at 0.5 percent in the quarter under review compared to 14.5 percent in the same quarter a year ago.

1. INFLATION CONTINUED TO BE NEGATIVE IN THE SECOND QUARTER

1.1 Annual Changes in Kabul Headline Inflation

Headline inflation, as measured by year-on-year percentage changes in Kabul CPI continued to be negative in the second quarter of the year. Headline inflation declined dramatically to -14.9 percent at the end of the quarter under review compared to 35.7 percent in the same quarter a year ago.

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

The breakdown of Kabul headline CPI inflation is presented in Table 3.1 and illustrated in Figure 3.1. The decrease in Kabul headline CPI to -14.9 percent in the second quarter of 1388 compared to 35.7 percent in the same quarter a year ago was largely due to the following factors:

First, the food sub-index accounts for 61.3 percent of the CPI basket: this price index declined sharply by 21.9 percent as a result of low demand driven by the global recession. The global recession will have a silver lining for net-food importing countries like Afghanistan as the decline in commodity prices is likely to lead to a decline in imported inflation going forward.

Favorable climate conditions and significant rainfalls at the beginning of the year contributed to an increase in domestic cereal production. The domestic wheat production increased significantly and may meet a significant proportion of the total wheat requirements of the country.

Another reason behind this decline could be the measures taken by the government in response to the food shortage that occurred last year.

Second, bread and cereals sub-index accounts for 28 percent of the CPI basket: this price index fell dramatically to -35.9 percent in the quarter under review down from 91.9 percent in the same quarter a year ago. The main causes of this decrease are attributed to both domestic and international factors. on the international side, the world economic slowdown pulled down aggregate demand in the international markets. On the domestic side, agricultural production increased notably in the current year.

Third, the Non-food sub-index accounts for 38.7 percent for the CPI basket. This sub-index fell to -0.8 percent in the quarter under review compared to 10.8 percent in the same quarter a year ago. The main components that decreased were construction material, transportation, and fuel and electricity.

Table 3.1: Breakdown of Kabul Headline CPI

(Percent changes year on year)
Consumer Price Index (March 04=100)

	Weights	1386				1387				1388	
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2*
Headline	**100.0**	**8.1**	**12.1**	**17**	**20.7**	**33.3**	**35.7**	**22.6**	**3.3**	**-10.04**	**-14.9**
Food and Beverages	**61.3**	**11.8**	**15.8**	**25.6**	**30.6**	**48.6**	**52.7**	**30.3**	**0.9**	**-17.50**	**-21.9**
Bread and Cereal	28.0	13	21.5	42.6	51.8	91.4	91.9	49.4	-3.6	-30.18	-35.9
Meat	6.0	1.1	-5.9	-0.8	4.1	5.9	11.0	7.0	-0.6	-0.3	-1.4
Milk and cheese	5.6	18.9	22	24.1	21.7	8.8	9.6	7.3	9.7	4.65	0.6
Oil and Fat	5.3	43	36.7	42.5	45.2	20.2	27	-1.7	-14.1	-17.50	-21.2
Fresh & dried fruits	4.9	5.0	8.9	5.1	5.2	3.9	15.3	12.8	15.0	15.4	9.8
Vegetables	4.9	4.0	13.2	8.8	6.0	27.6	28.4	23.3	16.6	-0.05	-1.1
Sugar & Sweets	1.8	-2.3	-6.2	-6.6	-5.5	-3.2	8.8	7.8	10.4	16.3	18.2
Spices	1.1	7.6	7.1	7.8	2.7	11.6	20.7	22.5	18.7	8.4	5.6
Tea & Beverages	2.0	3.4	3.5	1.5	3.9	13.3	15.7	17.2	12.6	2.1	0.3
Tobacco & Cigarettes	1.7	4.0	2.7	5.8	5.7	7.0	8.4	6.6	7.3	3.2	2.1
Non – Food	**38.7**	**3**	**7.1**	**5.4**	**6.9**	**10.3**	**10.8**	**10.5**	**7.4**	**5.01**	**-0.8**
Clothing	7.2	3.0	4.5	5.8	6.7	5.6	11.0	9.0	8.8	6.8	3.0
Housing	17.2	1.3	10	5.4	6.5	10.3	9.9	10.3	7.2	7.06	-2.3
Rents	7.1	-25.3	-19.9	-2.8	1.8	6.8	7.6	8.8	9.1	8.55	3.8
Construction materials	3.2	-5.3	8.7	17.1	17.9	15.6	17.3	11.2	4.2	0.95	-14.1
Fuel and Electricity	6.8	52.8	58.4	9.5	7.5	11.9	9.5	11.2	6.6	7.67	-3.4
Household goods	7.0	2.2	2.0	2.0	1.9	2.7	3.5	2.9	3.7	3.0	2.5
Health	2.0	4.4	4.3	3.8	3.3	7.8	19.2	21.3	23.9	19.3	7.2
Transportation	2.3	16	8.5	14.6	23.9	40.5	25.9	21.3	1.0	-14.03	-11.9
Communications	0.9	-2.9	-2.9	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Educations	1.2	0.3	-0.7	-1.1	-0.8	0.5	1.6	2.1	1.4	0.6	0.1
Miscellaneous	0.9	10.2	9.5	6.5	13.7	15.8	22.6	27.0	17.9	12.6	8.4
Core inflation (28% TM)		**5.1**	**6.5**	**6.2**	**7.3**	**9.8**	**14.5**	**11.8**	**7.6**	**4.2**	**0.5**
Core infl. (headline excluding bread and cereals, oil and fats, and transportation)			**7.1**	**5.7**	**6.2**	**8.9**	**12.0**	**10.8**	**9.0**	**6.2**	**1.4**

Source: Central Statistics Office and DAB staff calculations

Fourth, construction materials sub-index accounts for 3.2 percent for the CPI basket. This sub-index declined to -14.1 percent in the quarter under review, compared to 17.3 percent in the same quarter a year ago. The main reason behind this decline is thought to be the uncertainty in the political situation driven by the Presidential and Provincial Council elections.

Fifth, the transportation sub-index accounts for 2.3 percent of the CPI basket. This sub-index declined by 11.9 percent in the quarter under review compared with 25.9 percent in the same quarter a year ago. The main reason behind this decline could be the global recession which caused low demand in the international markets. The second reason is thought to be the completion of reconstruction work of some highways such as the Kabul – Turkham highway which reduced the transportation cost of imported goods.

On the other hand the following category posted an increase:

First, the sugar and sweets sub-index accounts for 1.8 percent of the CPI basket. This sub-index increased by 18.2 percent in the quarter under review, compared to 8.8 percent in the same quarter a year ago.

Figure 3.1: Breackdown of Kabul Headline Inflation
Percentage changes Y-o-Y

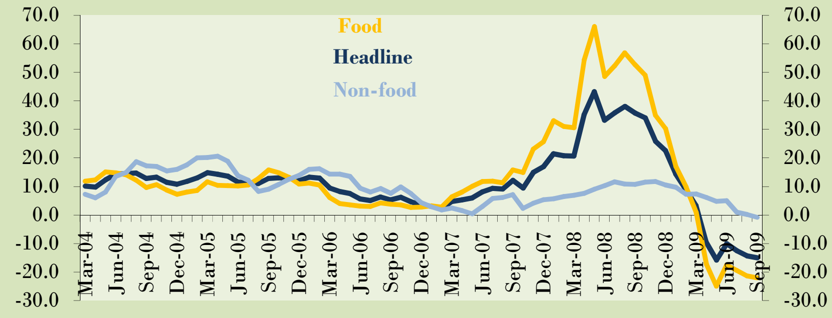
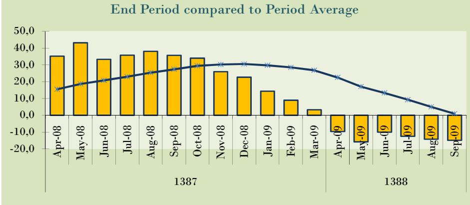


Figure 3.2: Kabul Headline Inflation,
End Period compared to Period Average



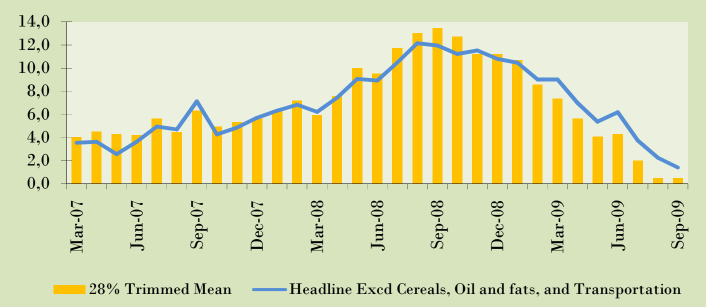
Source: Central Statistics Office and DAB staff calculations.

The volatility of Kabul inflation as measured by the standard deviation was 1.4 percentage points in the second quarter of 1387, down from 1.7 percentage points in the same quarter a year ago.

The breakdown of headline inflation includes a measure of core inflation because comparing one period's price statistics with some other period gives a crude measure of inflation. But such a measure does not discriminate between relative price changes and inflation, so an increase in the price of a single item, such as food, may cause a price index to rise. For this reason, a measure of core inflation, which is obtained by excluding the most volatile items in the CPI basket Trimmed Mean is one of the preferred methods to calculate the core inflation. The most volatile items from both top and bottom of the CPI basket are trimmed and the average of the remaining items represents the core inflation. This is often interpreted as measuring the long run or persistent component of the index. Trimmed mean inflation was 13.5 percent over the second quarter of 1387.

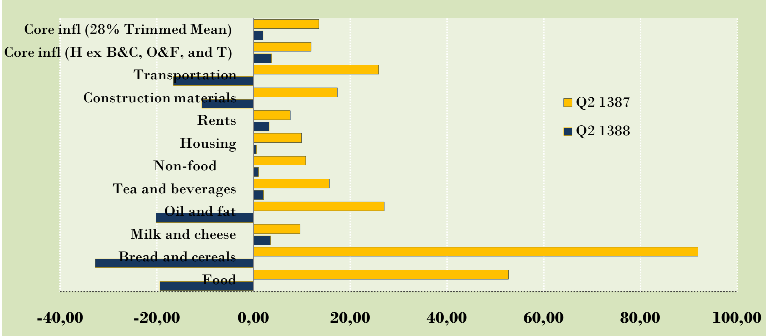
Trimmed mean inflation for Kabul CPI is illustrated in Figure 3.4.

Figure 3.3: Core Inflation



Source: Central Statistics Office and DAB staff calculations

Figure 3.4: Contribution to Kabul Headline CPI



Source: Central Statistics Office and DAB staff calculations

1.2 Annual Changes in National Headline Inflation

This section analyzes trends in national CPI on a year-on-year basis.

Headline inflation, as measured by year-on-year percentage changes in the national CPI continued to be in negative territory in the second quarter of 1388. Headline inflation decreased dramatically to -17.7 percent in the quarter under review compared to 38.8 percent in the same quarter a year ago. The main drivers of this decrease are food and non-food sub-indexes. The political uncertainty due to the Presidential and Provincial Council elections also caused a slowdown of economic activities inside the country. The breakdown of national CPI into its respective components is presented in Table 3.2 and illustrated in Figure 3.6.

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

	Weight	1386				1387				1388	
		Q1	Q2	Q3*	Q4	Q1	Q2	Q3	Q4	Q1	Q2*
Headline	**100.0**	**9.6**	**14.9**	**20.5**	**24.3**	**41.5**	**38.8**	**23.82**	**4.8**	**-14.6**	**-17.7**
Food and Beverages	**61.3**	**13.0**	**16.8**	**27.1**	**31.9**	**57.9**	**56.8**	**32.63**	**4.3**	**-22.4**	**-25.2**
Bread and Cereal	28.0	16.2	20.8	41.8	50.0	100.4	97.4	51.49	3.0	-34.9	-38.7
Milk and cheese	5.6	10.9	15.1	14.7	15.6	14.8	13.7	10.64	8.8	2.4	-0.9
Oil and Fat	5.3	24.5	40.3	42.2	52.3	40.6	27.3	0.25	-18.8	-24.0	-27.1
Non – Food	**38.7**	**4.4**	**11.9**	**11.0**	**12.2**	**14.6**	**10.5**	**8.85**	**5.9**	**3.0**	**-0.8**
Housing	17.2	3.7	15.0	12.1	13.3	13.9	9.5	6.32	3.8	3.3	-1.9
Rents	7.1	-12.8	-3.7	4.7	11.7	9.1	3.5	4.28	3.3	3.6	6.0
Construction mat	3.2	-1.0	10.0	13.4	13.4	13.6	10.2	7.76	6.3	0.5	-6.1
Fuel and Electricity	6.8	28.6	40.4	18.6	14.8	18.7	14.3	7.55	3.4	3.9	-6.9
Transportation	2.3	11.7	11.1	20.5	27.9	36.4	27.9	17.13	-1.3	-12.3	-16.7
Core inflation (28% TM)		**6.7**	**10.4**	**10.5**	**11.3**	**14.1**	**12.6**	**10.6**	**7.8**	**4.3**	**2.0**
Core inflation (Headline exc B&C, O&F, and T)		**5.5**	**10.7**	**9.7**	**10.3**	**12.5**	**11.2**	**10.5**	**8.5**	**4.2**	**1.7**

Source: Central Statistics Office and DAB staff calculations

The decrease in national CPI inflation to -17.7 percent in the second quarter of 1388 from 38.8 percent in the same quarter a year ago was mainly attributed to the following factors:

First, the bread and Cereals sub-index accounts for 28 percent of the CPI basket: this price index declined sharply to 38.7 percent at the end of quarter under review from 97.4 percent at the end of the same quarter a year ago. The main reasons behind this decrease are thought to be the decline in aggregate demand in the international markets as a consequence of global recession. The second reason could be a solid wheat harvest and good performance of the agriculture sector due to favorable seasonal rainfalls.

Second, Oils and fats sub-index accounts for 5.3 percent of the CPI basket: this sub-index declined slightly to 27.1 percent at the end of second quarter of 1388 down from 27.3 percent in the same quarter a year ago.

Third, construction materials sub-index accounts for 3.2 percent of the CPI basket: this sub-index fell to -6.1 percent at the end of the second quarter of 1388 down from 10.2 percent in the same quarter a year ago.

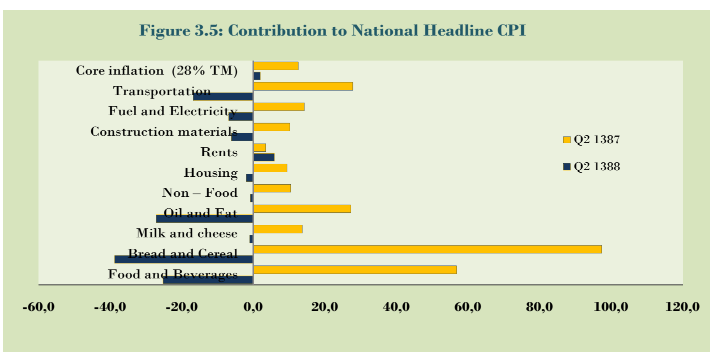
Fourth, the transportation sub-index accounts for 2.3 percent of the CPI basket: this sub-index declined sharply to -16.7 percent at the end of the second quarter of 1388 compared to 27.9 percent at the end of the same quarter a year ago. The main reasons behind this decrease are thought to be the decrease in oil prices in international markets. The second reason is thought to be the completion of construction works on some highways which caused a decrease in transportation costs.

On the other hand one category of the national CPI shows increase:

First, rents sub-index accounts for 7.1 percent of the CPI basket: this sub-index increased to 6 percent at the end of the quarter under review from 3.5 percent at the end of the same quarter a year ago. The breakdown of national CPI is presented in figure 3.5.

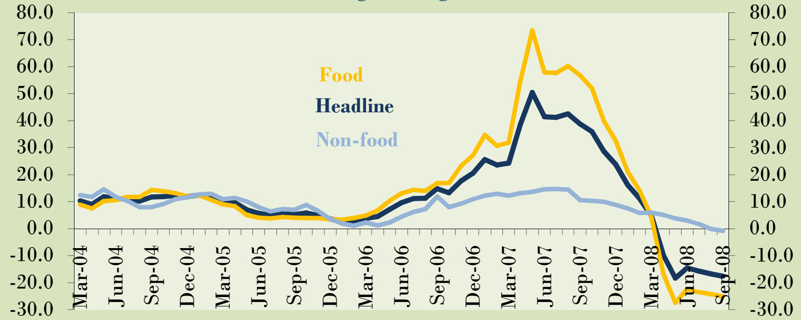
The volatility of inflation for the national CPI as measured by the standard deviation in the second quarter of 1387 was 1.9 percentage points, down from 2.1 percentage points in the same quarter a year ago. The lower volatility of inflation may reflect positively on monetary policy.

Figure 3.6 presents the inflation trend for national CPI.



Source: Central Statistics Office and DAB Staff calculations

Figure 3.6: Breakdown of National Headline CPI
Percentage changes Y-o-Y



Source: Central Statistics Office and DAB Staff calculations

1.3. Quarterly changes in Kabul headline CPI

This section analyzes trends in quarter-on-quarter changes in Kabul headline CPI.

The Kabul headline CPI in the second quarter of 1388 increased 2.1 percent compared to -1.5 percent in the first quarter of 1388. The increase in quarter-on-quarter inflation can be traced to the following major categories:

Food and Beverages: this sub-index rose 2.3 percent in the quarter under review from -2.5 percent in the first quarter 1388 due in part to a 3.8 percent rise of milk and cheese. However, the bread and cereals sub-index is still in negative territory, but it increased in the quarter under review compared to the first quarter of 1388.

Non-food: This price index rose to 1.7 percent in the quarter under review from 0.2 percent in the first quarter of 1388, due to an increase of 2.2 percent in rents, 2.2 percent in fuel and electricity, and 2.7 percent in transportation.

Table 3.3 presents quarter-on-quarter changes in Kabul CPI.

Table 3.3: Quarterly Changes in Kabul Headline CPI
(Percent changes quarter on quarter)
Consumer Price Index (March 2004=100)

				1386	1387				1388	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Headline	**2.4**	**6**	**5.9**	**5**	13.1	7.9	-4.3	-11.6	-1.5	2.1
Food and Beverages	**4.7**	**5.3**	**9.4**	**8.3**	19.1	8.2	-6.7	-16.2	-2.5	2.3
Bread and Cereal	5.7	8.2	17	13.4	33.3	8.6	-8.6	-27.1	-3.5	-0.3
Milk and Cheese	9.8	7.2	2.9	0.5	-1.8	8.0	0.8	2.7	-6.3	3.8
Oil and Fat	23.0	-1.1	8.3	10.2	1.8	4.5	-16.2	-3.6	-2.2	-0.1
Non – Food	**-0.7**	**7.1**	**0.8**	**-0.3**	**2.5**	**7.6**	**0.6**	**-3.2**	**0.2**	1.7
Housing	-2.9	11.5	0.6	-2.3	0.6	11.1	1.0	-5.0	0.5	1.4
Rents	-3.6	6.1	-0.9	0.4	1.1	6.9	0.2	0.7	0.6	2.2
Fuel and Electricity	-4	16.4	1.7	-5.4	-0.1	13.9	3.3	-9.3	0.9	2.2
Transportation	4.3	12.0	1.3	4.3	18.4	0.3	-2.4	-12.8	0.7	2.7

Source: Central Statistics Office and DAB Staff calculations

1.4. Quarterly changes in national headline CPI

This section analyzes quarter-on-quarter changes in national headline CPI.

The national headline CPI rose to 1.4 percent in the quarter under review from -3.7 percent in the first quarter of 1387. The increase in quarter-on-quarter inflation can be traced to the following major categories:

Food and Beverages: this price index increased 1.3 percent in the second quarter of 1388, compared to -5.7 percent in the first quarter of 1388. The bread and cereals sub-index fell by 0.8 percent and oil and fat by 2.7 percent, while milk and cheese rose to 1.0 percent from -2.9 percent in the first quarter of the year.

Non Food: rose by 1.7 percent with the housing sub-index increasing by 3.1 percent, rents 5.6 percent, and fuel and electricity 2.4 percent. Meanwhile, transportation fell by 0.7 percent compared with 0.1 percent in the first quarter of 1388.

Table 3.4 presents quarter-on-quarter changes in national CPI.

Table 3.4: Quarterly Changes in National Headline CPI
(Percent changes quarter on quarter)
Consumer Price Index (March 2004=100)

	1386				1387				1388	
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2
Headline	**3.8**	**7.2**	**7**	**4.4**	**18.2**	**5.2**	**-4.6**	**-11.6**	**-3.7**	**1.4**
Food and Beverages	**5.8**	**5.8**	**10**	**7.2**	**26.7**	**5.0**	**-7.0**	**-15.8**	**-5.7**	**1.3**
Bread and Cereals	8.3	6.9	16.7	11	44.7	5.3	-10.4	-24.5	-8.6	-0.8
Milk and Cheese	3.9	5.4	3.6	1.9	3.1	4.4	0.8	0.2	-2.9	1.0
Oil and Fat	15.2	12.0	8.5	8.7	6.4	1.5	-14.6	-12.0	-0.5	-2.7
Non – Food	0.6	**9.5**	**2.3**	**-0.4**	**2.8**	**5.6**	**0.7**	**-3.1**	**-0.1**	**1.7**
Housing	0.2	13	2.5	-2.3	0.7	8.5	-0.5	-4.6	0.2	3.1
Rents	2.1	8.7	0.6	0	-0.3	3.2	1.3	-1.0	0.1	5.6
Fuel and Electricity	-3.1	18.6	5	-4.8	0.2	14.2	-1.2	-8.5	0.6	2.4
Transportation	5.6	11.5	7.0	1.5	12.6	4.6	-2.0	-14.5	0.1	-0.7

Source: Central Statistics Office and DAB Staff calculations

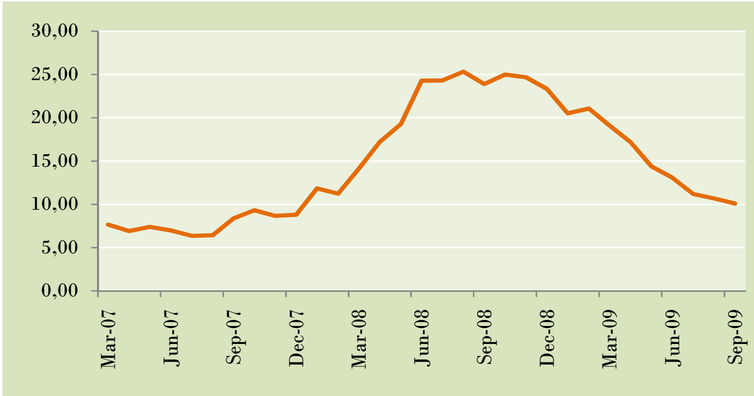
2. Regional Inflation

This section analysis inflation trends in some regional countries. The significant moderation in global inflation that had started with the onset of the global crisis in 2008-09, continued in 2009-10. Several advanced countries experienced negative inflation due to sharp fall in commodity prices in the second half of 2008-09 and the sustained recession in aggregate demand. Prices of food, fuel and metal had bottomed in December 2008 and have been firming up moderately since then. Sluggish global demand and the presence of unutilized capacity have, however, contained the risk of inflation, thereby allowing the central banks around the world to sustain their accommodative monetary policy stance to spur economic growth. Like the advanced economies, regional countries also experienced negative inflation in the second half of 2009-2010. The inflationary trend of some regional countries has been tracked.

2.1 Inflation Trend in Pakistan

Headline inflation continued to decline on a y-o-y basis, reaching 10.1 percent during September 2009 compared to 10.7 percent in the preceding month and 23.9 percent during the corresponding month last year. The declines were visible in both, food and non-food groups. CPI inflation (m-o-m) also declined during September 2009 to 0.5 percent compared to 1.7 percent in August 2009.

Figure 3.7: Pakistan Headline CPI (Y-o-Y)



Source: State Bank of Pakistan

Table 3.5: Breakdown of Pakistan Headline Inflation

	CPI			Core Inflation		WPI
	Overall	Food	Non-food	NFNE*	Trimmed	
Sep 08	23.91	29.9	19.2	17.3	21.2	33.2
Oct 08	25.00	31.7	19.7	18.3	21.7	28.4
Nov 08	24.68	30.4	20.2	18.9	21.3	19.9
Dec 08	23.34	27.9	19.8	18.8	21.7	17.6
Jan 09	20.52	21.6	19.7	18.9	19.6	15.7
Feb 09	21.07	22.9	19.6	18.9	20.8	15.0
Mar 09	19.1	19.7	18.5	18.5	19.3	11.1
Apr 09	17.2	17.0	17.3	17.7	17.6	8.3
May 09	14.4	12.1	16.3	16.6	16.7	4.7
Jun 09	13.1	10.5	15.4	15.9	15.5	4.1
July 09	11.2	10.7	11.6	14.0	13.9	0.5
Aug 09	10.7	10.6	10.8	12.6	13.1	0.3
Sep 09	10.1	10.0	10/2	11.9	12.4	0.7

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

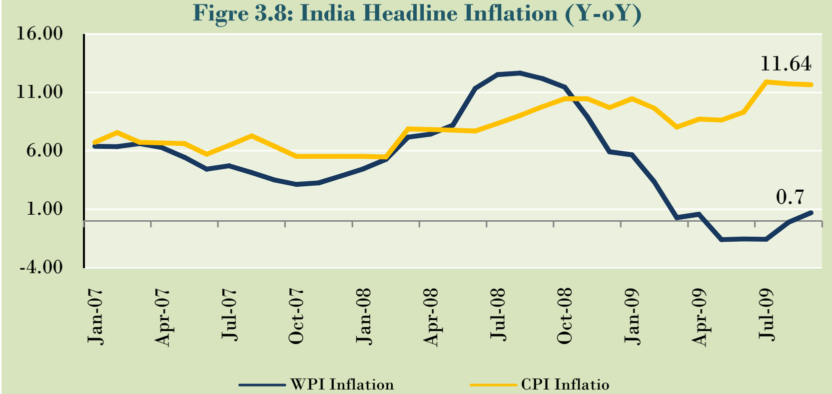
Core inflation measured by both non-food non-energy (NFNE), and the 20 percent trimmed mean declined during the month under review compared to both September 2008 as well as August 2009. NFNE inflation reached 11.9 percent on a y-o-y basis during September 2009 compared to 17.3 percent in the same period a year ago. Likewise, the 20 percent trimmed mean inflation y-o-y dropped, reaching 12.4 percent compared to 21.2 percent in the same period a year ago.

2.2 Inflation in India

Year-on-year WPI inflation during 2009-10 has been significantly volatile, and in recent months inflation has firmed up, reflecting the increase in food and fuel prices as well as the waning impact of the base effect. WPI inflation was negative during June-August 2009, before turning positive in September.

Overall, WPI inflation in India has shown significant firming up in recent months, with the pressure coming from primary articles and manufactured food products. The dominance of food prices as the key driver of inflation in recent months indicates a limited role for demand management in effectively curbing the price pressures. Consumer price inflation continues to remain firm and the divergence between CPI and WPI inflation still persists. Unlike the inflationary episode of the first half of 2008 when external supply shocks conditioned the inflation path, the current episode is characterized by a dominance of domestic supply side pressures largely emanating from deficient South-West monsoon and its impact on food-grain production. Persistence of food price inflation over a long period could erode the purchasing power of the public at large who may be compelled to devote a larger share of their disposable income to food consumption. Moreover, high food inflation and elevated CPI inflation could potentially generate wage-price spiral and raise inflationary expectations.

Figre 3.8: India Headline Inflation (Y-oY)

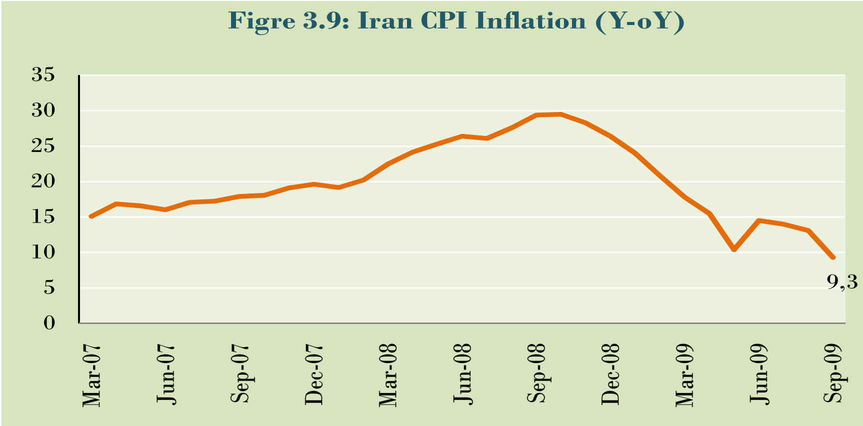


Source: Reserve Bank of India

2.3 Inflation in Iran

The Consumer Price Index (CPI) went up 13.5 percent in the first six months of 1388 compared to the same period a year ago. The CPI increased 0.4 percent in September 2009. The overall CPI stood at 202.9 in September 2009 representing a y-o-y inflation rate of 9.3 percent.

The breakdown of headline CPI is presented in Table 3.6.



Source: Central Bank of Islamic Republic of Iran

Table 3.6: Breakdown of Iran Headline Inflation

Description	Base Year Weight	Index Number in Sept 2009	Percentage Changes	
			Prev. month	Sep 2009 compared to Sep 2008
General Index	**100.00**	**202.9**	**0.4**	**9.3**
1. Food and Beverages	28.49	219.3	-0.7	6.6
2-Tobacco	0.52	223.3	0.9	43.0
3-Clothing and Footwear	6.22	178.0	0.5	10.1
4-Housing, Water, Electricity, Gas and other Fuels	28.60	220.5	1.0	12.0
5-Furnishings, Household Equipment and Routine-Household Maintenance	6.26	185.4	-0.9	1.2
6-Medical Care	5.54	228.9	3.0	19.7
7-Transportation	11.97	156.8	0.4	3.4
8-Communication	1.63	97.4	0.0	0.9
9-Recreation and Culture	3.80	146.7	1.8	9.2
10-Education	2.07	206.5	0.4	15.0
11-Restaurants and Hotels	1.72	214.3	0.3	14.2
12-Miscellaneous Goods and Services	3.18	205.7	0.9	12.2
Special Groups:				
1-Goods	57.13	188.4	-0.3	5.1
2-Services	42.87	222.1	1.2	14.2
3-Housing, Water, Electricity, Gas and other Fuels	28.60	220.5	1.0	12.0

Source: Central Bank of Islamic Republic of Iran

3. INFLATIONARY OUTLOOK

Afghanistan is experiencing deflationary pressures from the beginning of the year. The headline inflation as measured by percentage changes Y-o-Y is expected to turn positive at the end of the year as a result of some easing in monetary policy as well as recovery from the global downturn, which may improve the aggregate demand.

However, upside risks to inflation include international price shock for oil and food.

3.1 Risks to inflation remain

Foreseeable risks to future inflation remain. These risks include further increase in grain prices and prolonged liquidity surge given expectations of steady foreign exchange inflows from remittances, the illegal opium trade and donor funds. Additional risks include the secondary effects of inflation on asset prices. Inflation will depress real returns to saving, bringing real (inflation-adjusted) deposit rates to negative levels. Negative real interest rates would lead to record high loan growth. A negative interest rates scenario favors barrowers, and risks fuelling asset inflation and sparking a housing property boom.

4

FISCAL DEVELOPMENTS

SUMMARY

The overall fiscal performance in the second quarter of 1388 was more volatile. Core expenditures exceeded total revenues significantly in the quarter under review. Some fiscal indicators showed good performance while the others did not.

On the positive side income from the capital property increased to AF 125.161 million in the quarter under review compared to AF 89.804 million in the second quarter of 1387. This represents 39 percent increase. Non-tax Fines and Penalties increased to AF 53.983 million in the quarter under review compared to AF 26.913 million in the second quarter of 1387, representing 87 percent increment. Sale of land and buildings also increased to AF 10.582 million in the quarter under review compared to AF 10.527 million in the same quarter a year ago, representing 1 percent increase. Retirement contributions increased to AF 232.707 million in the quarter under review compared to AF 207.269 million in the same quarter a year ago, this represents a 12 percent increase.

Fixed taxes increased to AF 1,601.455 million in the quarter under review compared to AF 815.714 million in the second quarter of FY1387, representing 96 percent increase.

Sale taxes increased to AF 2,659.557 million in the quarter under review from AF 1,591.882 million in the second quarter of FY1387, this shows a 67 percent increment.

Income Taxes increased to AF 1,427.583 million in the quarter under review compared to AF 1,215.203 million in the second quarter of FY1387, representing 17 percent increase.

Custom duties increased to AF 4,662.572 million in the quarter under review compared to AF 3,018.977 million in the second quarter of FY1387, representing a 54 percent increment.

On the negative side, tax penalties and fines declined to AF 59.345 million in the quarter under review compared to AF

118.907 million in the second quarter of FY1387, this represents 95.5 percent decline.

Other taxes declined to AF 183.787 million in the quarter under review compared with AF 237.489 million in second quarter of FY1387, this represents a 23 percent decline.

Total core expenditures exceeded total domestic revenues significantly in the quarter under review, therefore, budget deficit in the quarter under review stood at AF 22,484 million.

Total domestic revenues increased to AF 14,041 million in the quarter under review compared to AF 9,982 million in the second quarter of FY1387, this represents a 41 percent increment.

Total domestic revenues in the quarter under review accounted for 2.21 percent of GDP, which shows little contribution to GDP compared to the other indicators.

On the other side, total core expenditures in the quarter under review increased to AF 36,525 million up from AF 28,383 million in the second quarter of FY1387, this shows a 29 percent increase. Total expenditures in the quarter under review accounted for 5.7 percent of GDP.

Total donor contribution (grants) allotted to both, operating and development expenditures increased to AF 22,007 million in the quarter under review up from AF 18,320 million in the second quarter of FY1387, this reveals a 20 percent increase.

The main contributors to the development expenditures are ARTF, LOTFA, ADB, EC, World Bank, CNTF and others.

1. REVENUES

The budgeted revenue target for the fiscal year 1388 is AF 50.6 billion (PRGF target is AF 51 billion), compared to the 1387 target of AF 41.5 billion, an increase of 23 percent.

Total domestic revenues in the second quarter of 1388 stood at AF 14 billion which exceeds the target of AF 12.8 billion, this represents an increase of 10.9 percent.

Total revenues in the first six months of 1388 stood at AF 28.7 billion, compared to the AF 18.2 billion collected in the first half of 1387, this represents a 57.7 percent increase. The increase in revenue collection is mainly due to the good performance of both tax revenue (partly new tax measures), and customs duties (partly through improved custom administration). Total domestic revenues in the first six month of the year accounted for 2.21 percent of GDP.

Total domestic revenues increased to AF 14,041 million in the quarter under review up from AF 9,982 million in the same quarter a year ago, this represents a 41 percent increment. Total domestic revenues are composed of tax and non-tax revenues. Both, tax revenues and customs duties increased to AF 10,642 million in the quarter under review compared to AF 7,035 million in the second quarter of FY1387; this represents a 51 percent increase.

On the other hand, non-tax revenues increased to AF 3,399 million in the quarter under review compared to AF 2,947 million in the same quarter a year ago, this represents a 15 percent increase.

Non-tax revenues which include (income from capital property, sales of goods and services, administrative fees, royalties and non tax fines, and penalties etc.) increased to AF 3,399 million in the quarter under review up from AF 2,947 million in the second quarter of FY1387, which shows a 15 percent increase (see table 4.1).

Main contributors to the increase in total tax revenues were sales taxes, in particular business receipt tax (BRT), fixed taxes, and income taxes, in particular corporate income tax, mainly contributed to the total tax revenues, (see table 4.3). Large tax office (LTO) and medium tax office (MTO) have jointly collected AF 2.2 billion or 16 percent of the total tax revenues, highlights Kabul province's role as the economic heart of the country. Almost 86 percent of the total customs revenue collections have been collected by the top five provinces and the remaining 14 percent has been collected by line ministries along with other provincial customs offices. Nangarhar, Balkh, Heart and Nimroz customs surpassed their quarterly targets by large margins, collecting AF 1.3 billion (63 percent above the target), AF 1.1 billion (14 percent above the target), AF 1.4 billion (11 percent above the target), and AF 346 million (35 percent above the target) respectively. However, Khandahar failed to achieve its target and only collected 49 percent of the second quarter target.

Revenues from customs duties increased to AF 4,663 million in the quarter under review up from AF 3,019 million in the second quarter of FY1387, this represents a 54 percent increment.

Sale tax revenues increased to AF 2,660 million in the current quarter up from AF 1,591 millions in second quarter of FY1387, this shows a 67 percent increment.

Total social contribution increased to AF 233 million in the quarter under review up from AF 207 million in the second quarter of FY1387, which represents a 12 percent increment. (See table 4.3)

Income tax revenue increased to AF 1,428 million in the quarter under review up from AF 1,215.203 million in the second quarter of FY1387, this represents a 17 percent increase.

Income from capital property increased to AF 125 million in the quarter under review up from AF 89.804 million in the second quarter of FY1387, this represents a 39 percent increase.

Table 4.1: Revenue Collection as of Second Quarter 1388 (million AF)

	Q2 1387 Revenue Actual	Q2 1388 Revenue Actual	% Δ from Q2 1387 to Q2 1388
Total Domestic Revenues (Tax and Non Tax)	9,982	14,041	41%
Tax Revenues	7,035	10,642	51%
Non Tax Revenues	2,947	3,399	15%
Total Donor Contributions	18,320	22,007	20%

Source: MoF website and DAB staff estimation

Table 4.2: Revenue Collections(in million USD)

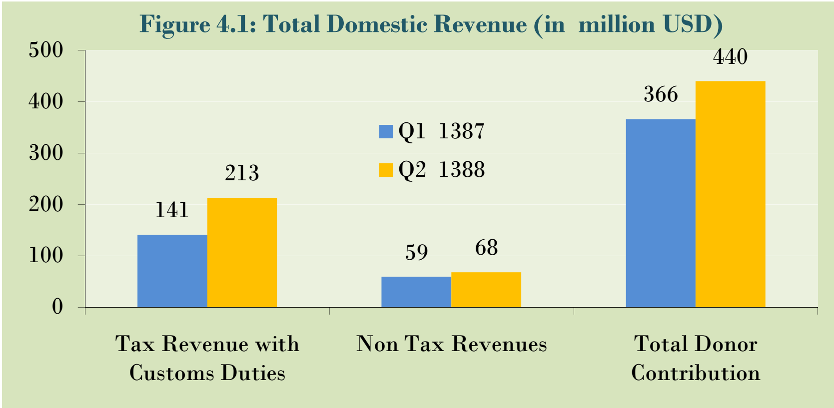
	Q2-1387	Q2-1388
Total Domestic Revenues (Tax & non- Tax revenue)	200	281
Tax Revenue with Customs Duties	141	213
Non Tax Rev	59	68
Total Donor Contributions	366	440

Source: MoF website and DAB staff estimation

Table 4.3: Breakdown of Total Domestic Tax and Non-tax Revenues (in thousand AF)

Tax and non-Tax Revenues	Q2-1388	Q1-1388	% Δ Q1 to Q2-1388	Q2-1387	% Δ Q2-1387 to Q2-1388
Taxation & Customs Revenues					
Fixed Taxes	1,601,455	1,842,916	-13%	815,714	96%
Income Taxes	1,427,583	1,828,738	-22%	1,215,203	17%
Property Taxes	47,803	46,968	2%	37,137	29%
Sales Taxes	2,659,557	3,168,455	-16%	1,591,882	67%
Excise Taxes	-	-		-	
Other Taxes	183,787	251,760	-27%	237,489	-23%
Tax Penalties and Fines	59,345	62,137	-4%	118,907	-50%
Customs duties	4,662,572	5,162,789	-10%	3,018,799	54%
Total taxation revenues	**10,642,103**	**12,363,761**	**-14%**	**7,035,131**	**51%**
Social contributions					
Retirement contributions	232,707	175,044	33%	207,269	12%
Total social contributions	**232,707**	**175,044**	**33%**	**207,269**	**12%**
Other revenue					
Income from Capital Property	125,161	50,006	150%	89,804	39%
Sales of Goods and Services	798,286	764,013	4%	573,338	39%
Administrative Fees	1,476,952	1,361,156	9%	1,437,257	3%
Royalties	12,799	70,255	-82%	11,574	11%
Non Tax Fines and Penalties	53,983	38,442	40%	28,913	87%
Miscellaneous Revenue	921,023	(381,545)	-341%	588,262	57%
Sale of Land and Buildings	10,582	7,615	39%	10,527	1%
Total other revenue	**3,398,785**	**1,909,942**	**78%**	**2,739,675**	**24%**
Afghanistan Reconstruction Trust Fund (ARTF)	8,087,253	922,252	777%	11,679,211	-31%
Law and Order Trust Fund – Afghanistan (LOTFA)	2,995,800	2,999,400	0%	2,717,870	10%
CSTC - MoD	1,765,871	1,707,174	3%	696,600	153%
Foreign loans	-	-		-	
World Bank	101,306	24,095	320%	235,214	-57%
Asian Development Bank	942,844	97,284	869%	949,354	-1%
Other	158,961	107,655	48%	-	
Donor revenue	-	-		-	
World Bank	6,676,009	1,778,307	275%	887,060	653%
European Commission	-	-		-	
ADB	704,192	1,585,564	-56%	408,357	72%
CNTF	97,060	-		100,020	-3%
Others	477,718	776,821	-39%	646,519	-26%
Total Donor Contributions	**22,007,014**	**9,998,552**	**120%**	**18,320,205**	**20%**
Loan from IMF	**-**	**-**		**921,420**	

Source: MoF website and DAB staff estimation



Source: Ministry of Finance website and DAB staff calculations

2. EXPENDITURES:

The Government's expenditure programs are planned within a pragmatic and sustainable medium term macroeconomic and fiscal framework (MTFF). Enhancing revenue mobilization, as part of this framework is a necessary condition to provide the required resources to support the implementation of the Afghanistan national development strategy (ANDS).

Total core budget expenditures are classified into operating and development expenditure. The targeted core budget for 1388 ads up to AF 215 billion compared to AF 186 billion of 1387 targeted budget, this represents an increase of 17 percent. The increase in expenditures is mainly attributed to security related expenditures. The operating budget for the year amounts to AF 94 billion while the remaining AF 121 billion is for development budget expenditures. The 1388 budget exceeds the budget for 1387 by 16 percent which reflects the increased expenditure on army and police expansion as well as the rise in teachers' salaries. Total operating budget grew by around 27 percent in 1388 as compared to AF 73 billion allocated to the operating budget in 1387. The development budget increased by around AF 10 billion from AF 112 billion budgeted in 1387 to AF 122 billion in 1388.

Total expenditures increased to AF 36,525 million in the quarter under review up from AF 28,383 million in the second quarter of 1387, this represents a 29 percent increase. Total expenditures accounted for 5.7 percent of GDP in the quarter under review.

Total expenditures are classified into development and operating expenditures.

Development expenditures increased to AF 14,819 million in the quarter under review up from AF 11,965 million in the second quarter of 1387, this represents 34 percent increase.

On the other hand operating expenditures increased to AF 21,706 million up from AF 17,318 million in the second quarter of 1387, showing a 25 percent increase.

Recurrent expenditures are classified into the following five categories:

(a) Compensation of employees,

(b) Goods and services,

(c) Subsidies and grants,

(d) Interest payment,

(e) Acquisition of non-financial assets.

Expenditure on compensation of employees in the quarter under review increased to AF 16,154 million up from AF 11,802 million in the second quarter of 1387, this reveals a 37 percent increment. The increase in expenditures on employees' compensation was mainly observed in wages and salaries in cash. This reflects the pay and grading reform which started from the fourth month of 1388, along with wages paid to the increased security personnel.

Expenditures on supplies increased to AF 4,230 million in the quarter under review up from AF 4,103 million in the second quarter of 1387, this represents a 3 percent increase.

Expenditures on interest payments declined to AF 21 million in the quarter under review down from AF 52 million in the second quarter of 1387, this indicates a 58 percent decline. Interest payments account for around 0.2 percent of the operating budget for 1388, because the government of Afghanistan borrows only externally at highly concessional rates. It is to be noted that most of the external support is in the form of grants rather than loans. It is expected that AF 201 million will be paid as interest payments up to end of 1388. Around 50 percent of the annual interest payment (AF 100 million) is to be paid to the World Bank while the remaining AF 100 million will be paid to the IMF, Asian Development Bank and Islamic Development Bank.

Subsidies, grants and social transfers are the third largest component of the recurrent expenditure, this item includes subsides to state-owned enterprises, capital transfers to municipalities and pensions to retired public servants. Around 80 percent of the expenditure on this item is spent on social transfers, principally pensions. Expenditures on subsidies, grants and contribution increased to AF 1,065 million in the quarter under review from AF 1,093 million in the second quarter of 1387, this represents a 3 percent decrease.

Table 4.4: Core Expenditures as of Second Quarter 1388 (in million AF)

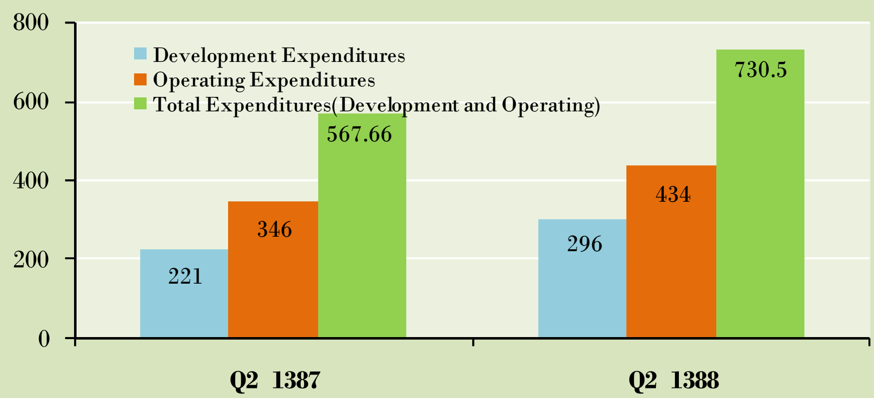
Particulars	Q2-1387 Expenditure Actual	Q2-1388 Expenditure Actual	% Changes
Total Expenditures(Development and Operating)	28,383	36,525	29%
Development Expenditures	11,065	14,819	34%
Operating Expenditures	17,318	21,706	25%

Source: Ministry of Finance website and DAB staff estimation

Table 4.5: Core Expenditures (in million USD)

	Q2-1387	Q2-1388
Total Expenditures	567.66	730.5
Development Expenditures	221	296
Operating Expenditures	346	434

Figure 4.2: Core Expenditures (in million USD)



Source: Ministry of Finance website and DAB staff estimation

Table 4.6: Total Development Expenditures (in thousand AF)

Expenditure Splits	Q2-1388	Q1-1388	% Δ Q1 to Q2 1388	Q2-1387	% Δ Q2 1387 to Q2 1388
Employees					
Salaries in cash		-		-1,898,962	
Salaries in kind		-		0	
Salaries and wages advance		-		0	
Social benefits in cash		-		0	
Social benefits - in kind		-		0	
Total employee expenditure		-		-1,898,962	
Supplier Expenditure					
Travel	42,973.878	7,269	491%	23,661,007	82%
Communications	12,849.114	6,904	86%	8,402,184	53%
Contracted services	3,207,966.434	901,020	256%	2,277,269,900	41%
Repairs and maintenance	178,835.296	19,287	827%	175,252,375	2%
Utilities	965.882	267	261%	398,316	142%
Fuel	7,084.268	622	1038%	5,621,511	26%
Tools and materials	90,628.620	2,574	3421%	20,250,357	348%
Other	79,810.092	5,148	1450%	31,226,561	156%
Advances and return of expenditure	564,278.014	243,475	132%	293,294,595	92%
Total supplier expenses	4,185,391.598	1,186,566	253%	2,835,376,805	48%
Subsidies, grants, contributions and pensions					
Grants	297.863	-		0	
Grants to foreign government a	-	-		0	
Social security benefits cash	-	-		0	
Social assist benefit in cash	-	-		0	
Advance Subsides Grants	19,236.059	-		0	
Total subsidies, grants, contributions and pensions expenditure	19,533.922	-		0	
Buildings and structures	5,204,219.757	866,786	500%	2,887,390,433	80%
Machinery and equip (>50,000)	453,830.014	44,836	912%	798,807,466	-43%
Valuables	645.349	-		0	
Land	-	15,102	-100%	1,729,600	-100%
Capital advance payments	4,955,710.823	1,003,287	394%	4,543,568,019	9%
Total capital expenditure	10,614,405.942	1,930,011	450%	8,231,495,518	29%

Source: Ministry of Finance website and DAB staff estimation

Table 4.7: Total Current Expenditures (in thousand AF)

Expenditure Splits	Q2-1388	Q1-1388	% Δ Q1 to Q2 1388	Q2-1387	% Δ Q2 1387 to Q2 1388
Employees	**13,414,288.509**	**9,680,214**	**39%**	**9,365,230,451**	**43%**
Salaries in cash	2,468,435.446	2,330,184	6%	2,287,831,696	8%
Salaries in kind	93,694.073	122,396	-23%	43,336,249	116%
Salaries and wages advance	177,836.544	186,903	-5%	105,950,164	68%
Social benefits in cash	-	-		0	
Social benefits - in kind	16,154,254.572	12,319,697	31%	11,802,348,560	37%
Total employee expenditure	**13,414,288.509**	**9,680,214**	**39%**	**9,365,230,451**	**43%**
Supplier Expenditure					
Travel	257,893.753	230,667	12%	269,683,745	-4%
Communications	132,878.809	98,665	35%	109,916,801	21%
Contracted services	210,548.001	99,008	113%	81,081,943	160%
Repairs and maintenance	442,340.926	249,021	78%	328,851,148	35%
Utilities	141,935.618	119,602	19%	218,697,538	-35%
Fuel	675,901.991	302,563	123%	579,261,135	17%
Tools and materials	1,960,792.017	606,753	223%	1,078,300,656	82%
Other	272,118.641	164,647	65%	291,212,411	-7%
Advances and return of expenditure	135,662.681	70,773	92%	1,146,484,006	-88%
Total supplier expenses	**4,230,072.437**	**1,941,698**	**118%**	**4,103,489,383**	**3%**
Subsidies, grants, contributions and pensions					
Grants	1,200.000			-350,000	-443%
Grants to foreign government a	-	-			#DIV/0!
Social security benefits cash	1,026,390.222	910,801	13%	917,692,511	12%
Social assist benefit in cash	66,460.774	135,779	-51%	45,952,960	45%
Advance Subsides Grants	(29,210.774)	260,000	-111%	130,000,000	-122%
Total subsidies, grants, contributions and pensions expenditure	**1,064,840.222**	**1,306,580**	**-19%**	**1,093,295,471**	**-3%**
Buildings and structures	24,533.302	25,273	-3%	43,341,976	-43%
Machinery and equip (>50,000)	199,959.690	40,354	396%	200,308,859	0%
Valuables	50.000	-		0	
Land	3,261.956	2,463	32%	1,574,062	107%
Capital advance payments	7,651.169	757,472	-99%	21,512,895	-64%
Total capital expenditure	**235,456.117**	**825,563**	**-71%**	**266,737,792**	**-12%**
Interest	21,473.311	32,176	-33%	51,738,353	-58%
Total interest expenditure	**21,473.311**	**32,176**	**-33%**	**51,738,353**	**-58%**

Source: Ministry of Finance website and DAB staff estimation

3. FINANCING THE CORE BUDGET

Total grants in the quarter under review amounted to AF 22.007 million (see Table 4.7). Grants finance nearly all the development budget with the remainder financed through concessional loans. The operating budget is funded by domestic revenues, however, grants make up a significant proportion, in particular for the security sector.

Donor grants for development expenditures in the quarter under review stood at AF 11,651 million, while the operating donor grants stood at AF 10,446 million.

The second largest funding remained the programmatic support for institution building program (PSIBP) funded by the World Bank, through which the government received AF 1.8 billion in the second quarter of 1388.

The National Solidarity Program (NSP) was created by the Ministry of Rural Rehabilitation and Development in 2003 to develop the ability of Afghan local communities to identify, plan, manage, and monitor their own development projects. Through the promotion of good local governance, the NSP works to empower rural communities to make decisions affecting their own lives and livelihoods. Empowered rural communities collectively contributed to increase human security. The program is inclusive, supporting entire communities including the poorest and vulnerable people.

Afghanistan has significant mineral resources, including copper, iron, gold, coal, and semi-precious stones.

Despite considerable exploration and deposit identification, large-scale mining has had limited development, and represents less than one percent of GDP.

In November 2007, Afghanistan tendered the right for exploration of its first large-scale copper mine. The mine is considered to be the world's second largest untapped copper deposit, with estimated reserves of up to 13 million tons. When Aynak reaches its expected peak, fiscal revenues in terms of royalties and taxes are projected at USD 200 million a year.

Total FDI inflows associated with the project at USD2.8 billion over the next six years, enabling annual production of up to 200,000 tons (1.3 percent of current world production), which will amount to 2 percent of GDP in ten years.

An ambitious program is also being planned to build the necessary infrastructure, which will boost activity in construction, water and electricity, coal, and transport.

Table: 4.8: Donor Contribution, Grants and Loans Q1-1388

Donor contributions	Q2-1388	Q1-1387	%∆ Q1 to Q2 - 1388	Q2-1387	%∆ Q2-1387 to Q2 1388
Afghanistan reconstruction trust fund	8,087,252.67	922,252	777%	11,679,210,860	-31%
Law and order trust fund - Afghanistan	2,995,800.00	2,999,400	0%	2,717,870,360	10%
CSTC - MoD	1,765,871.41	1,707,174	3%	696,599,887	153%
Foreign loans	-	-		0	
World Bank	101,306.23	24,095	320%	235,214,483	-57%
Asian Development Bank	942,843.66	97,284	869%	949,353,876	-1%
Other	158,961.10	107,655	48%	0	
Donor revenue	-	-		0	
World Bank	6,676,008.95	1,778,307	275%	887,059,566	653%
European Commission	-	-		0	
ADB	704,191.93	1,585,564	-56%	408,356,919	72%
CNTF	97,060.00	-		100,020,000	-3%
Others	477,717.55	776,821	-39%	646,519,255	-26%
Total donor contributions	**22,007,013.50**	**9,998,552**	**120%**	**18,320,205,206**	**20%**
Loan from IMF	**-**	**-**		**921,419,705**	

Source: Ministry of Finance website and DAB staff estimation

Table 4.9: Breakdown of Donor Contributions, Q2-1388 (in million AF)

Donor contributions	Operating Grants	Development Grants
Afghanistan reconstruction trust fund	6,796,706	1,290,546
Law and order trust fund - Afghanistan	2,995,800	0
CSTC - MoD	1,765,871	0
Foreign loans	0	0
World Bank	0	101,306
Asian Development Bank	0	942,844
Other	0	158,961
Donor revenue	0	0
World Bank	0	6,766,009
European Commission	0	0
ADB	0	704,192
CNTF	0	97,060
Others	92,334	385,383
Total donor contributions	**11,650,711**	**10,446,301**

Source: Ministry of Finance website and DAB staff estimation

5

BANKING SYSTEM PERFORMANCE

SUMMARY

Total assets of the banking system were AF 144 billion (USD 2.93 billion) as of September 2009, up by 42 percent or AF 42.27 billion since September 2008. Loans amounted to AF 58 billion (USD 1.17 billion) an increase of AF 9.14 billion (USD 186 million) or 19 percent since September 2008. Deposits stood at AF 118 billion (USD 2.40 billion) over the period under review; a 48 percent increase since September 2008. Deposits were largely denominated in USD (66 percent) with Afghani denominated deposits lagging at 30 percent. However, the AF-denominated deposits increased to AF 36 billion (USD 723 million), as compared to the last period (September 2008), where it was 22 billion (USD 447 million) in the previous period (September 2008). Total capital of the banking system stood at AF 20.08 billion (USD 408 million), up 16 percent since September 2008. The banking sector overall was profitable, earning profit of AF 1,125 million (USD 22.88 million) since the beginning of 1388. An overall return on assets (ROA) decreased by 1.61 percentage points as compared to the previous year's 3.24. The main causes of the decrease in ROA is due to the increase in average total assets is more than increase in profitability. Private Banks are the most profitable institutions in the overall banking system.

1. ASSETS OF THE BANKING SYSTEM

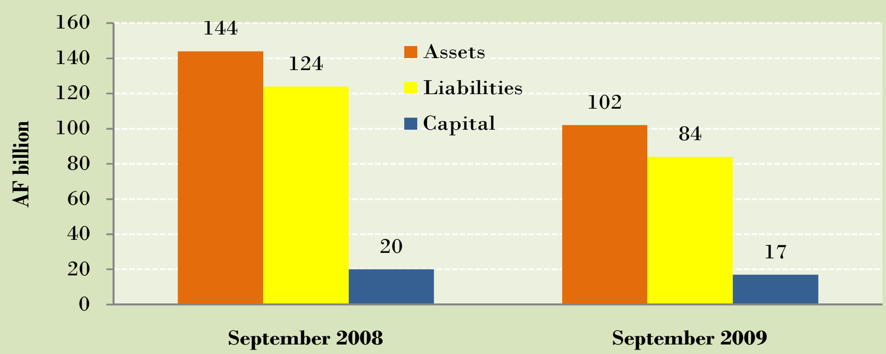
The banking system continues to grow at a brisk rate. Total assets of the banking system at the end of the quarter under review stood at AF 144 billion (USD 2.93 billion) up by 42 percent or AF 42.27 billion (USD 860 million) from the same quarter a year ago (Figures 5.1 and 5.2).

The major components of this increase were increases in cash in vault claims on DAB (up by AF 25 billion) and loans (up by AF 19 billion) and claims on financial institutions (up by AF 10.4 billion). Moreover, the remaining part is made up of other asset categories such as loans other assets except interest receivable and

Net Due from (NDF). Comparing to the last quarter, there is an increase of AF 10 billion in total assets, AF 4 billion in loans and AF 4 billion in claims on financial institutions, but there is a decrease of AF 17 billion in cash in vault/claims on DAB.

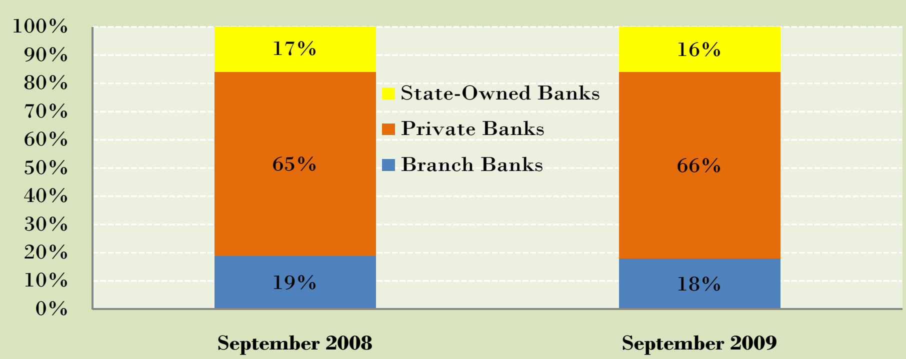
The most important components of the system's total asset portfolio are loans (38 percent), cash in vault/claims on DAB 31 percent, claims on financial institutions 15 percent, net due from 8 percent, and other assets except interest receivable 4 percent. Other components of total assets are negligible.

Figure 5.1: Banking System Growth Rate
Grwoth rate = 42 percent of AF 42 billion



Source: Financial Supervision Department, DAB

Figure 5.2: Size of the Banking Sector (total assets)
Increased by 42 percent or AF 42 billion

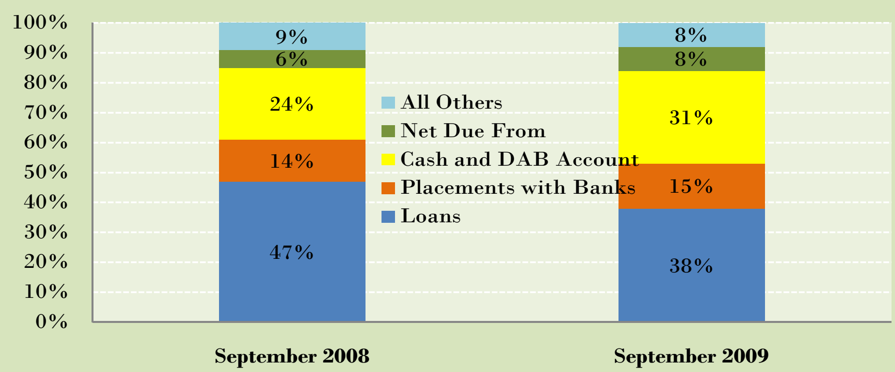


Source: Financial Supervision Department, DAB

1.1 Claims on Financial Institutions

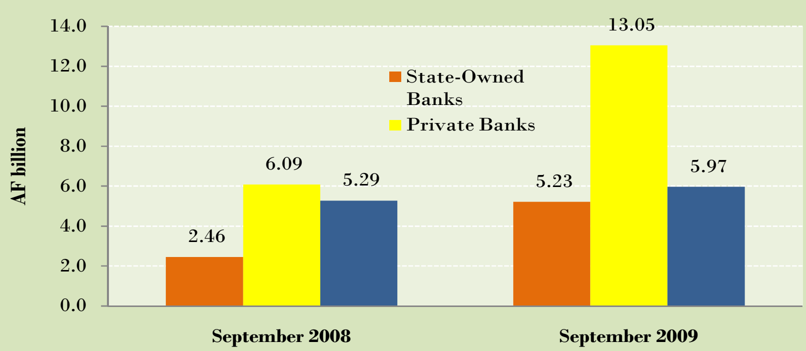
Claims on financial institutions are the third largest among various asset categories, currently comprising AF 24 billion – 15 percent of total assets, 75 percent increase since September 2008, indicating that the banking sector channeled a portion of its attracted funds as deposits in other financial institutions, if credible borrowers were not found. These institutions are both inside the country and outside the country. Later on, if needed for liquidity purposes or after getting loan application from low-risk borrowers, these assets can be substituted to higher income earning assets.

Figure 5.3: Major Asset Categories (As Percentage of Total Assets)



Source: Financial Supervision Department, DAB

Figure 5.4: Claims on Financial Institutions



Source: Financial Supervision Department, DAB

Private Banks are the leading creditors, increasing their portfolio both in absolute terms as well as percentage of total loans, currently at AF 46 billion or 82 percent of total loans. The portfolio of State-owned banks and branches of foreign banks' share and amount were as AF 7.1 billion and AF 2.9 billion respectively.

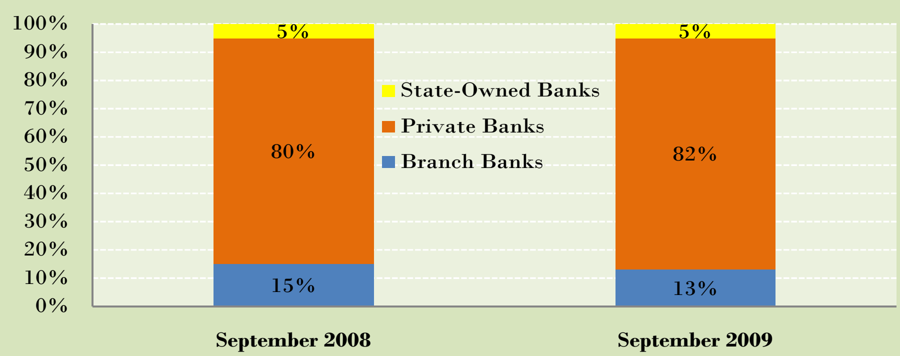
1.2 Net Loans

The loan portfolio continues to grow, totaling AF 56 billion (USD 1.1 billion) as of September 2009 – up by AF 8.6 billion or 18 percent since September 2008 – or 3 percent of total assets; the highest amount as well as percentage share in total assets among different asset categories. The increase occurred in gross loan portfolio, loss reserves as percentage of gross loans remained unchanged at around 1 percent. Increases in lending were observed at

all but three of the banking organizations; however more than two-third of the growth is still attributable to private bank's group; and more than half to one banking institution. As compared to the last quarter, there is an increase of AF 4.6 billion in the current quarter September 2009.

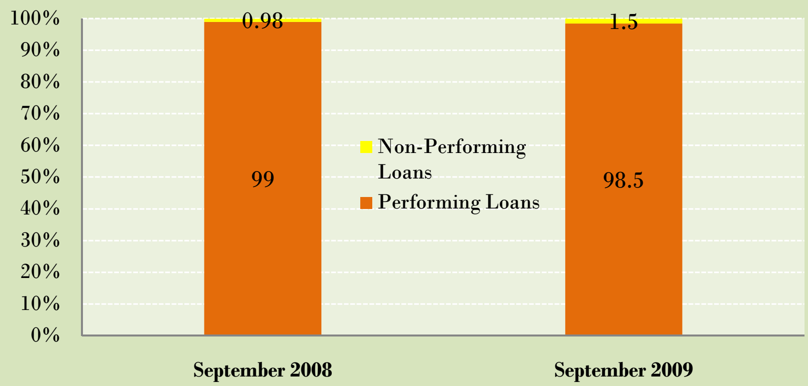
By far, the major component of loan portfolio is "other commercial loans (70 percent). This concentration in other commercial loans, to the exclusion of all other types of lending, has been the dominant trend. As a new piece of information in this major share of loans we do have SME and Micro Credit Loans amounting AF 5.8 billion (USD119 million) by nine banking institutions. Thus, lending is picking up, but still not sufficient in some loans categories related to important sectors of the economy, e.g. agriculture has not benefited much from this increase.

Figure 5.5: Loans Portfolio Increased 39 percent (As of TA) or AF 8.6 billion



Source: Financial Supervision Department, DAB

Figure 5.6: Qulity of Loan Portfolio



Source: Financial Supervision Department, DAB

1.3 Non-performing loans

The system's non-performing loans consists of 1.50 percent of gross loans and has increased to AF 847 million, up by AF 432 million or by 104 percent since September 2008. The ratio of non-performing loans to total loans has increased to 1.50 percent, which was 0.86 percent in the previous period (September 2008).As compared to the last quarter non-performing loans increased by AF 43 million or 5 percent. Although the ratio is not alarming, the trend is of concern.

1.4 Adversely-classified loans

Adversely-classified loans (Substandard-Doubtful) decreased to AF 1.4 billion (USD 28.89 million) in the current quarter ending September 2009, which was AF 1.7 billion in previous period (September 2008). The percentage share of adversely-classified loans in total loans decreased to 2.5 percent, which was 3.5 percent in previous period (September 2008).According to the new definition of adversely-classified loans we have excluded loss loans from the total of adversely-classified loans in the previous periods (September and June) while comparing with the current quarter. Loans under the "Watch" category increased to AF 4.6 billion in the current quarter from AF 2.9 billion in the previous period. As compared to last quarter Adversely-classified loans increased by 8 percent in the current quarter ending September. This trend should be monitored closely, to see if it is a leading indicator of future increases in adversely-classified loans, or if it is just an indication that the classification of loans is becoming more conservative. Adversely-classified loans are greater than non-performing loans, which is what one would expect given the definitions of these two indicators of problem assets.

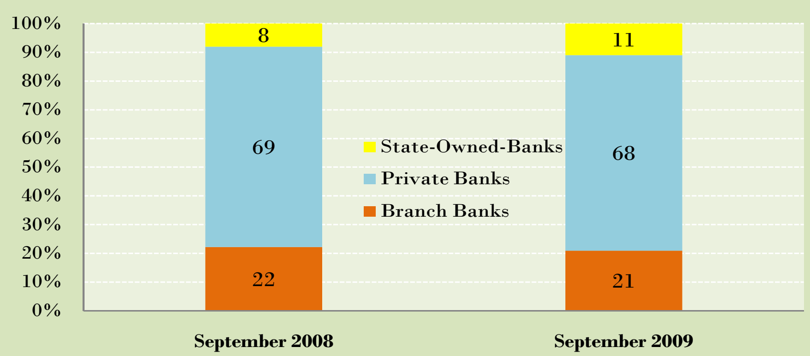
1.5 Cash in Vault and Claims on DAB

Cash in vault and claims on DAB remains as the second largest category, increasing both in absolute as well as percentage of total assets. The banking sector is considering compliance with required reserves, or deploying slowly and prudently the attracted funds into other types of assets.

2. LIABILITIES

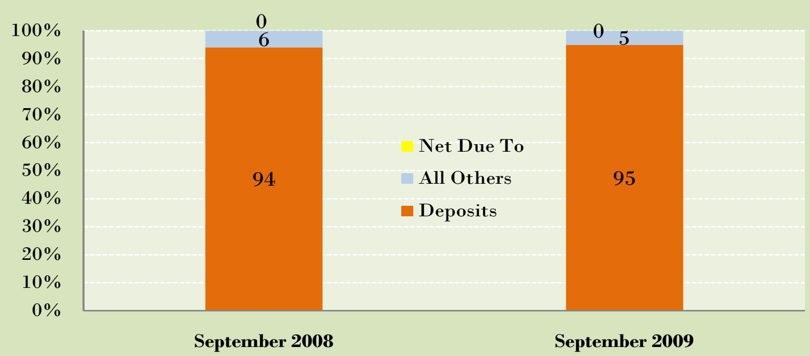
Total liabilities of the banking sector were AF 124 billion, up by 47 percent from September 2008. This is an indication of growing public confidence and good public relations and marketing policies of the banking sector. As compared to last quarter June 2009 total liabilities are up by AF 9.6 billion or 8.4 percent.

Figure 5.7: Liabilities Increased by 47 percent or AF 39 billion



Source: Financial Supervision Department, DAB

Figure 5.8: Major Liability Categories



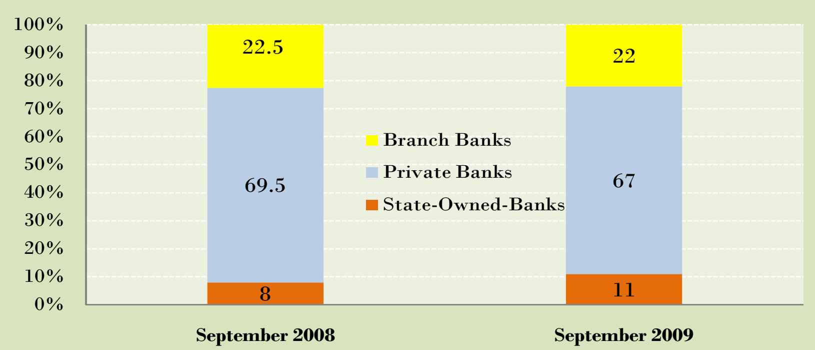
2.1 Deposits

Deposits are the major components of liabilities, currently equal to AF 118 billion, 48 percent or a AF 38 billion increase since September 2008, when it was AF 79.6 billion(USD 1.6 billion). The share of state-owned banks increased to AF 13 billion (up by 104 percent), which was AF 6.3 billion in September 2008.

Private Banks attracted AF 79.64 billion or a 44 percent increase since previous period (September 2008), when it was AF 55.33 billion.

The share of branches of foreign banks increased to AF 26 billion (up by 42 percent), which was 18 billion in the previous period (September 2008). Increases in deposits of branches were reflected as highly 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. As compared to last quarter deposits increased by 10 percent in the current quarter (September 2009).

Figure 5.9: Deposits Increased by 48 percent or AF 38 billion



Source: Financial Supervision Department, DAB

2.2 Capital

The system, as a whole, is well capitalized. Total financial capital at full-fledged banks is AF 20.08 billion (USD 408 million), up by 16.23 percent since September 2008. If the 20 percent capital/assets ratio or assets support by capital is taken as a benchmark which is an internationally applied ratio for the banks, the AF 20.08 billion consists of 13.9 percent of AF 144 billion, which is far below the benchmark, while total assets of the full-fledged commercial banks are AF 94.89 billion. Three banks Financial Capital is below the new initial and ongoing minimum monetary amount of capital which is USD 10 million or equivalent (Currently AF 490 million).

Branches of foreign banks do not have separate capital. The most analogous concept to positive capital is the Net Due to Related Depository Institutions, primarily the home office and other branches of the same bank (NDT), while the closest analogue to negative capital is the Net Due from Related Depository Institutions, primarily the home office and other branches of the same bank (NDF). NDF is probably a normal situation for a foreign branch 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 the bank's overall worldwide condition and performance is deteriorating.

For the current quarter we have a decrease in NDF by AF 943 million standing at AF 9,131 million as compared to the last quarter June 2009, where it was AF 10.1 billion. NDT position has climbed up by AF 53 million in the current quarter and stands at AF 182 million. In the current quarter one bank is in a favorable NDT position, much smaller than the relatively large, unfavorable NDF positions for the remaining four. Put differently, only one bank is actively seeking investment outlets for the funds they have attracted. The NDF position of one bank has increased, and that of two banks has decreased because of the activeness of one bank out of the three which has covered the high NDF position of the other. While the rest are simply sending their acquired funds to their international networks. The largest NDF position by a branch of foreign bank was AF 7.01 billion, down by 10 percent since last quarter.

2.3 Profitability

The banking sector overall is profitable. Total net profit of the banking sector during the quarter ending September (2009) is AF 1.13 billion, resulting in an overall return on assets (ROA) of 1.63. Overall profit in the previous period (September 2008) was AF 988 million resulting in an overall return on assets (ROA) of 3.24.

The main causes for the decrease in ROA are significant increases in expenses and credit provisions. For the quarter ending September 2009, private banks are profitable. But the profit is attributed to two banking institutions only, the rest are earning a loss. State-owned banks are quite profitable in the current quarter. Branches of foreign Banks are also more profitable in the current quarter

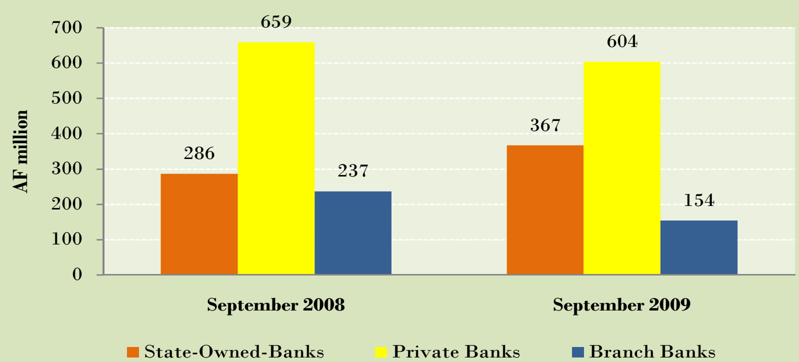
September (2009), than the last quarter June 2009.The main reasons for profitable operations of the system was a gain in FX revaluation, higher net interest income, less credit provisions and extraordinary gains. The system on core income basis is not good, and it is far below the benchmark which is 2 percent of the average total assets, that the banks should strive for.

The major component of income was Net Interest Income (NII) with total amount of AF 3.7 billion, up by 3 percent since September 2008 and 92 percent since June 2009. The second major component of income is other Non-Interest Income totaling AF 1.10 billion, AF 293 million increases since September 2008 and AF 581 million since June 2009.

The most important component of expense is the Non-Interest Expense (NIE), currently equal to AF 1.86 billion, a 28 percent decrease compared to previous year, where it was AF 2.59 billion. The efficiency ratio, (net interest income + trading account gain/loss + other non-interest income divided by operating expenses) of the system as a

Median stands at 2.65, up by 0.65 percentage point since last year. Nine banking institutions ended up with lower efficiency ratios.

Figure 5.10: Profitability



Source: Financial Supervision Department, DAB

2.4 Foreign Exchange Risk

The level of overall open FX position risk being taken by banks is largely within the levels set by DAB.

In general, all banking institutions are within the limits set for overall open FX position for the current quarter ending September 2009. In September 2008 two banking institutions were holding open FX position on individual currency basis above the maximum regulatory threshold. In the last quarter only one bank was holding open FX position on individual currency basis above the maximum regulatory threshold. This indicates that the number of banks in violation of regulatory limits is on decrease. (Branches of foreign banks are not subject to limitations on open FX position, since that risk is managed on a whole-bank basis and not branch-by-branch).

The impact of the change in exchange rate upon regulatory capital of the system reveals that a 20 percent change in exchange rate would increase the regulatory capital by AF 337 million and vice versa. Similarly, a 4 percent change would correspond to AF 67 million.

2.5 Interest Rate Risk

Overall, the banking institution is in interest rate sensitive position. If the interest- rate increases by 3 percentage points then there will be an increase of AF 760 million in net interest income over the next 12 months. Conversely if the interest rate decreases by 3 percentage points then the interest income will decline to AF 760 million. For the two banking institutions if the interest-rate increases by 3 percentage points, that will decrease their net interest income over the next 12 months. (Branches of foreign banks are not required to file the interest-rate sensitivity schedule, because like FX risk, interest-rate sensitivity of the banks is the large excess of risk is managed on a whole-bank basis).

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

6

EXTERNAL SECTOR DEVELOPMENTS

SUMMARY

According to global financial stability report (GFSR) of IMF, financial conditions have slightly improved, as unprecedented policy actions undertaken by central banks and governments to stimulate economic activities. There are indications that the level of financial crisis moderated and large economies are back on the recovery track.

Merchandize trade recorded a deficit of USD 624 million in the second quarter of SY 1388 compared with a USD 490 million trade deficit in the second quarter of SY 1387. Therefore, the trade deficit was recorded at 27 percent higher in the second quarter of SY 1388. In the quarter under review the trade deficit accounts for almost 5 percent of GDP.

In the second quarter of SY 1388 exports decreased by 10 percent from USD 105 million to USD 94.55 million. This decline is an indication of mainly two factors. First, comparatively low demand in Afghanistan's exports destination and secondly the economic hardship in Afghanistan's trading partners. Moreover, in the quarter under review Afghanistan's exports were dominated by food items.

On the other hand, imports jumped to USD 718 million in the second quarter of SY 1388 compared to USD 595 million in the second quarter of SY 1387. Imports are dominated by capital goods & others that is almost 50 percent of total imports. Imports of capital goods & others recorded USD 349 million in second quarter of SY 1388 compared to USD 226.75 million of similar period SY 1388. This is an indication of considerable increase of 54 percent. Furthermore, the increase in capital goods and others indicates that Afghanistan imported more machinery, mechanical tools and equipments for the domestic production.

Afghanistan's public and publicly guaranteed external debt reached USD 2,249.75 million. Afghanistan owed USD 1,142.31 million in bilateral debt in the second quarter of 1388. Loans from the three Paris Club creditors (Russian Federation, United States, and Germany) is almost at USD 1,011.92 million. Afghanistan's multilateral debt stands at USD 1,107.44 million. Non Paris Club credit reached to USD 1,237.82 million.

Da Afghanistan Bank (DAB) holds international reserves in monetary gold and foreign currencies. In addition, foreign exchange constitutes major part of Net International Reserves (NIR) which are denominated in US dollar, euro, and Pound Sterling. In the second quarter of SY 1388 the NIR increased by 29 percent from USD 2,766.12 million to USD 3,567.60 million in the second quarter of 1387.

1. MERCHANDISE TRADE

The level of financial hardship in advanced and large economies slightly moderated. However, Afghanistan's export destinations are still not fully recovered. As a result, the merchandize trade recorded a deficit USD 624 million in the second quarter of SY 1388 compared with USD 490 million trade deficit in the second quarter of SY 1387. Therefore, the trade deficit was recorded at 27 percent in the second quarter of SY 1388. In the quarter under review the trade deficit accounts for almost 5 percent of GDP. The trade deficit could be attributed to a relatively high domestic demand for foreign goods. This demand arises from producing firms, construction sector and households for capital goods, construction materials and food items respectively.

Exports declined by 10 percent in the second quarter of SY 1388 compare to the similar period last year. This decline is an indication of mainly two factors. First, comparatively low demand in Afghanistan's exports destination and secondly the economic hardship in Afghanistan's trading partners in particular export destinations. Moreover, in the quarter under review Afghanistan's exports were dominated by food items. Notwithstanding the economic reasons that are mentioned-above. There are some structural impediments to Afghanistan's exports e.g. Pakistan imposed 4 percent import tax and a 14 percent sales tax on Afghan vegetables and fruit. This decision significantly decreased Afghan exports to Pakistan, which resulted in reduced income for farmers in Nangarhar, Laghman, Bamyan, Wardak, and Parwan provinces. However, exports are expected to grow in the upcoming quarters.

Table 6.1: Merchandise Trade (Million USD)

Years	1384		1385		1386		Q2-1387		Q2- 1388	
	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)
Imports	2,471	100	2,744	100	3,022	100	595.03	100	718.7	100
Industrial supplies	541	21.9	68	2.48	692.04	22.90	202.55	34.04	215.9	30.04
Capital goods & others	1,207	48.83	1,133	41.29	1,579	52.27	226.75	38.11	349.3	48.60
Fuel & lubricants	245	9.9	354	12.9	108.49	3.59	26.4	4.44	18.9	2.63
Exports	**384**	**100**	**416**	**100**	**454.13**	**100**	**105.1**	**100**	**94.55**	**100**
Carpets & Rugs	207	53.93	187	44.8	211.76	46.63	28.6	27.21	11.45	12.11
Food items	104	27.13	165	39.66	158.86	34.98	47.5	45.20	48.5	51.30
Leather & Wool	37	9.51	31	7.39	25.77	5.67	11.90	11.32	16.00	16.92
Medical seeds & others	36	9.42	34	8.16	57.74	12.71	17.1	16.27	18.6	19.67
Trade Balance	**-2,087.02**		**-2,327.73**		**-2,567.73**		**-489.93**		**-624.15**	
Trade Balance as % of GDP	**31.28**		**-28.19**		**-25.30**		**-3.76**		**-4.79**	

Source: Central Statistics Office and DAB staff calculations

The value of overall imports increased as a result of increasing domestic demand for capital goods, industrial supplies and consumer/household goods. The demand for these items is not totally fulfilled domestically. Therefore, this excess demand is satisfied by importing from trading-partner countries. Imports jumped to USD 718 million in the quarter under review compared to USD 595 million in the second quarter of 1387. Imports were dominated by capital goods and others (USD 349 million) in the reporting quarter. On the contrary, exports indicate a slight decline in the quarter under review. The decline in exports was due to low demand for Afghan carpets and food items in Pakistan. Afghanistan is a landlocked country. Therefore, Afghanistan's external sector recovery is dependent upon the security and economic upturn in Pakistan. According to USINFO, the carpets and rugs exported to Pakistan are exported back by Pakistan to its major export destinations. The demand for Pakistani carpets and other products is weakened by Pakistan's major exporting destinations which negatively affected Afghanistan's external sector.

2. DIRECTION OF TRADE

Table 6.2 and 6.3 indicate Afghanistan's direction of trade with its trading-partners. Primarily, Afghanistan's major trading-partners' are Pakistan, India, China and Iran. The merchandize trade indicates that Afghanistan's exports decreased by 10 percent from USD 105 million to USD 94.55 million. This is due to relatively low foreign demand for Afghan exports. However, exports show signs of recovery. It is expected to increase in the upcoming quarters.

In the second quarter of 1388 exports to Pakistan were 41 percent of total exports. As a result, Pakistan remained on top among our export destinations. In the quarter under review, Afghanistan's exports to Pakistan were USD 39 million compared to USD 55 million in the second quarter of 1387. On the other hand, Afghanistan exports to Pakistan constituted 41 percent of total exports in the second quarter of 1388. However, demand for Afghan carpets, rugs and dry fruits declined in Pakistan. In the quarter under review, Carpets and rugs exports to Pakistan decreased by 58 percent while Pakistan demanded 23 percent less dry fruits compared to the second quarter of SY 1387. India is the second largest export destination. Exports to India increased to almost 11 percent from USD 14 million to USD 16 million in the reporting quarter. Major export items to India were dry fruits and medical seeds. Only dry fruit exports jumped by 22 percent in the reporting quarter. Afghanistan's exports to Commonwealth of Independent States (CIS) decreased by 25 percent still it secured the third position however. CIS is one of the economies hit by hard financial crisis.

Exports to CIS were approximately USD 11 million. Dry fruits exportation to CIS decreased by 25 percent while exports of fresh fruits remained the same in this quarter compared to the second quarter of 1387. Exports of carpets shrank by around 50 to Commonwealth of Independent States.

Table 6.2: Direction of External Trade: Q2- 1387 (Million USD)

Country Name	Exports	% Shares	Imports	% shares	Trade Balance
Pakistan	55.90	53.19%	108.21	18.19%	-52.31
India	14.50	13.80%	21.23	3.57%	-6.73
Iran	2.9	2.76%	48.35	8.13%	-45.45
Japan	0	0.00%	27.60	4.64%	-27.60
Germany	0.00	0.00%	5.25	0.88%	-5.25
China	0.50	0.48%	85.95	14.44%	-85.45
Common Wealth	13.60	12.94%	177.40	29.81%	-163.80
England	0	0.00%	1.80	0.30%	-1.80
Saudi Arabia	3.40	3.24%	0	0.00%	3.40
Other Countries	14.3	13.61%	119.24	20.04%	-104.94
Total	**105.10**	**100.00%**	**595.03**	**100.00%**	**-489.93**

Table 6.3: Direction of External Trade: Q2- 1388 (Million USD)

Country Name	Exports	% Shares	Imports	% Share	Trade Balance
Pakistan	38.70	40.93%	88.5	12.31%	-49.80
India	16.12	17.05%	34.2	4.76%	-18.08
Iran	8.00	8.46%	64.5	8.97%	-56.50
Japan	0	0%	51.9	7.22%	-51.90
Germany	0.50	0.53%	24.6	3.42%	-24.10
China	3.33	3.52%	86.4	12.02%	-83.07
Common Wealth	10.20	10.79%	243.9	33.94%	-233.70
England	0	0%	5.1	0.71%	-5.10
Saudi Arabia	0.40	0.42%	0	0.00%	0.40
Other Countries	17.30	18.30%	119.6	16.64%	-102.30
Total	94.55	100%	718.7	100%	-624.15

Source: CSO and DAB staff calculations

Figure 6.1: Direction of Exports (% share) in Q2-1387

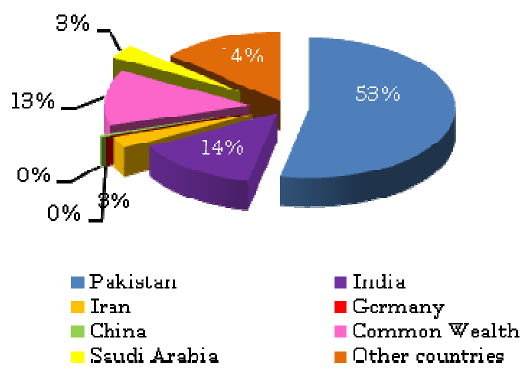
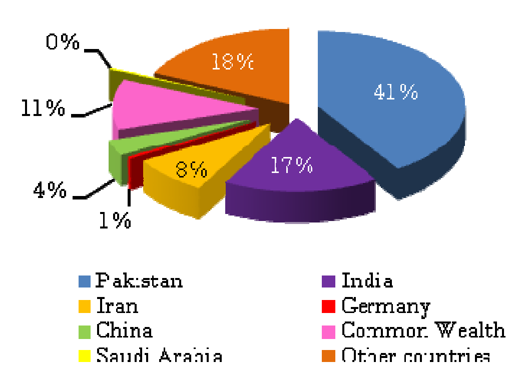


Figure 6.2: Direction of Exports (% share) in Q2-1388



Source: CSO and DAB staff calculations

2.1 Composition of Trade

Composition of imports is illustrated in the figures 6.3 and 6.4. The composition of imports comprises industrial supplies, capital goods & others, fuel & lubricants and consumer goods. In the quarter under review, capital goods and others dominated imports. Capital goods and others share is 48 percent of total imports. Similarly, Industrial supplies had 30 percent, consumer goods had 19 percent and fuel & lubricants had 3 percent of total imports shares respectively in the reporting quarter.

Figure 6.3: Composition of Imports (% share) in Q2-1387

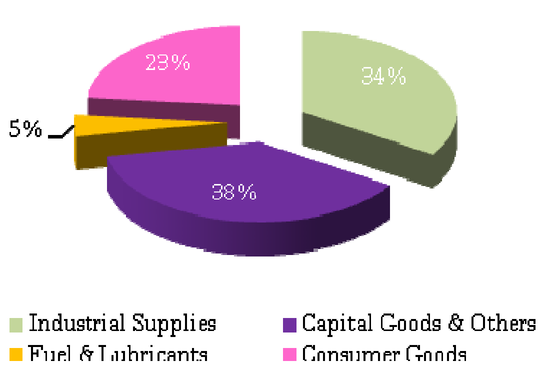
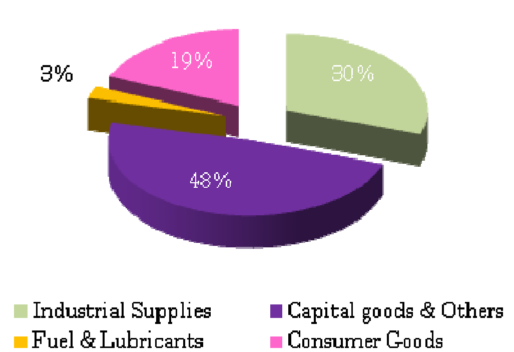


Figure 6.4: Composition of imports (% share) in Q2-1388



Source: CSO and DAB staff calculations

Composition of imports slightly changed in the reporting quarter. On the one hand, the capital goods & others as well as industrial supplies imports increased. On the other hand, the importation of consumers' goods and fuel & lubricants decreased. Capital goods & others dominated Afghanistan's imports. There is a sizable increase in the imports of capital goods & others that reached to USD 349 million. This indicates an increase of 54 percent in the reporting quarter compared to second quarter of 1387. The increase in capital goods & others indicates that Afghanistan imported more capital goods such as: machinery, tools and equipments to increase domestic production. Industrial supplies dominated the second position. It increased by around 6 percent from USD 202 million to USD 216 million in the second quarter of 1388. Imports of mechanical spare parts increased in the reporting quarter which pushed up the overall industrial supplies. Imports of consumer goods shrank by 3 percent from USD 139 million to USD 134 million. Fuel and lubricants decreased by 28 percent from USD 26 million in the second quarter of 1387 to USD 19 million in the reporting quarter. The increase in imports of capital goods & others and industrial supplies means that Afghanistan's manufacturing sector is rapidly expanding and Afghanistan is importing more means of production. Government is also building infrastructure and facilitating investment in the industrial sector by enacting investment and business friendly rules and policies.

Figure 6.1 and 6.2 show the direction of exports for the second quarters of 1387 and 1388 respectively. In the second quarter of 1388, food items dominated exports of Afghanistan. Food items reached to USD 48 million in the reporting quarter and had an increase of 2 percent. Medical seeds gained the second position. It reached to USD 18 million in the reporting quarter from USD 17 million. Medical seeds increased by almost 6 percent. Similarly, leather and wool increased by 34 percent. It reached to USD 16 million in the reporting quarter compared with USD 11 million in second the quarter of 1387. In the reporting quarter, carpets and rugs had poor performance. Carpets and rugs exports value indicated USD 28 million in the second quarter of 1388 compared with USD 11 million in the reporting quarter. This indicates that carpets and rugs exports shrank almost by 60 percent. This could be attributed to the decline in exports to Pakistan.

Figure 6.6: Composition of Exports (% share) in Q2-1388

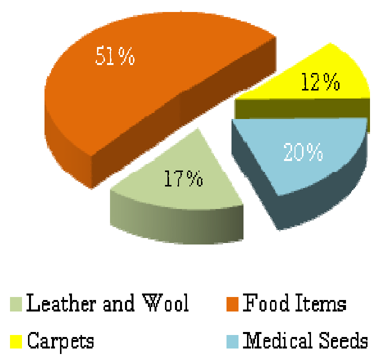
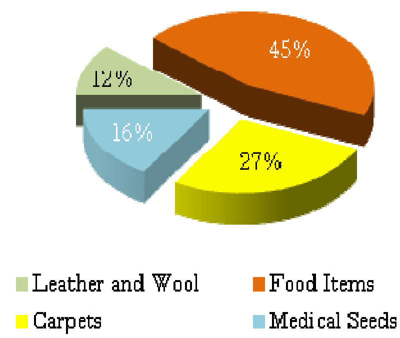


Figure 6.5: Composition of Exports (% share) in Q2-1387



Source: CSO and DAB staff calculations

3. EXTERNAL DEBT

Afghanistan's public and publicly guaranteed external debt reached to USD 2,249.75 million. During the quarter, principle amount and service charges are paid on some of the loan. Moreover, some debt forgiveness is made on principle amount and service charge.

Afghanistan owed USD 1,142.31 million in bilateral debt in the second quarter of 1388. Russian Federation, United States and Germany are the major creditors to Afghanistan. Bilateral loan extended to Afghanistan has easy repayment terms and lower interest rates. Loan from the three Paris Club creditors (Russian Federation, United States, and Germany) is almost at USD 1011.92 million. Russian Federation is the major creditor. It extended the loan of USD 787.53 million. United States is the second largest Paris Club creditor by extending loan of USD 116.28 million. Germany extended USD 17.11 million loan.

Afghanistan is indebted from International Development Association (IDA), International Monetary Fund (IMF), Asian Development Bank (ADB) and Islamic Development Bank (IDB) in multilateral debt. Afghanistan's multilateral debt stands at USD 1,107.44 million. ADB is the largest creditor in multilateral debt by extending USD 523.21 million, IDA the second largest creditor stands at USD 469.73 million and IMF stands at USD 110.8 million. Non Paris Club credit reached to USD 1,237.82 million.

Bilateral debt amounted to nearly 50.77 percent of debt stock while multilateral debt amounted to 49.23 percent of debt stock. Paris Club and Non Paris Club creditors accounted for 45 and 55 percent of debt to Afghanistan respectively.

The changes in debt can be ascribed to the valuation effects, repayments and accrued interest. Furthermore, no new loan was taken in the quarter under review. In the reporting quarter accumulated interest reaches to USD 21 million while the remaining accumulated total interest from the beginning of loans reaches to USD 114 million. Valuation changes are negative and decreased our External debt by approximately USD 2 million.

Table 6.4: External Debt in the Second Quarter of 1388 (in units indicated)

	In million USD	Percent of total
Total external debt	2,249.75	100.00
Bilateral	1,142.31	50.77
Paris Club/1	1011.92	44.98
Russian Federation	878.53	39.05
United States	116.28	5.17
Germany	17.11	0.76
Non-Paris Club	1237.82	55.02
Multilateral	1107.44	49.23
of which: Asian Development Bank(ADB)	523.21	23.26
International Development Association(IDA)	469.73	20.88
International Monetary Fund(IMF)	110.80	4.92

1/ The cancellation of approximately $10.4 billion in external debt amounts to a total 92% reduction of Afghanistan's debt to its three Paris Club creditors, Germany, the Russian Federation and the United States on July 19, 2006 while the cancellation of the rest of the debt will be made after the completion point of Heavily Indebted Poor Country (HIPC) initiative.

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

4. NET INTERNATIONAL RESERVES

Da Afghanistan Bank (DAB) holds international reserves in foreign currencies and gold. A major part of net international reserves includes US dollar, euro, and Pound Sterling. Net International Reserves (NIR) are growing at a fast pace over the years. Due to efficient management of reserves during the financial crisis and consequently, earnings on reserves increased. NIR increased by 29 percent from USD 2766.12 million in the second quarter of 1387 to USD 3567.60 million.

Gross International Reserves (GIR) amounted to USD 3719.94 million in the reporting quarter compared to USD 2901.19 million in the second quarter of 1387. The increase in GIR is 28 percent. Reserve liability is USD 152 million. The reserve liability includes commercial banks deposits in foreign currency, non-resident deposits in foreign currency and use of fund resources. Reserve liability increased by approximately 12 percent.

NIR increased over the past few years. The increase in NIR is because of export earnings, current transfers, foreign direct investment, injection of FX by donors and earnings of DAB on its deposits abroad and other multinational forces.

The NIR increased significantly and is strong enough to finance almost 15 months of imports in the quarter under review compared to nearly 14 months of import financing in the second quarter of 1387.

Figure 6.7: Net International Reserves for Q2-1387 and Q2-1388

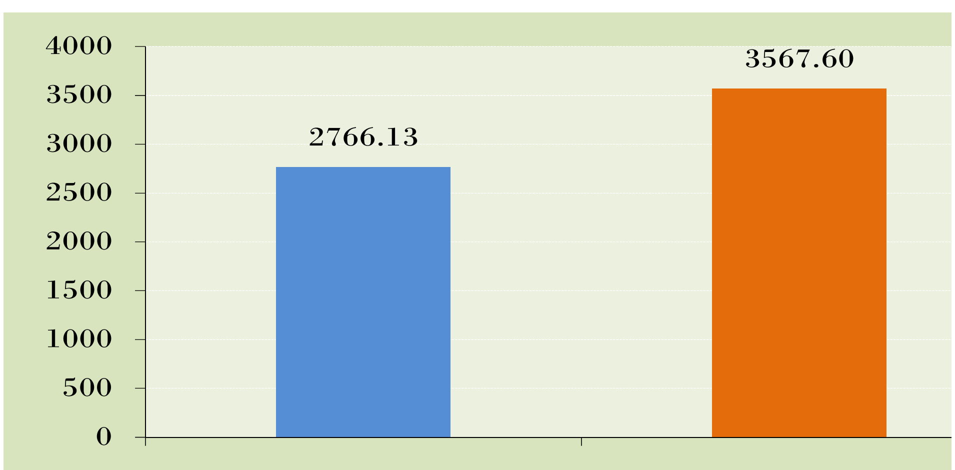


Table 6.54: Net International Reserves: Q2 – 1388 (in million USD)

	1386		1387		1388	
Changes on the previous quarter	Yearly	% change	Q2	% change	Q2	% change
Net international Reserves (million USD)	2,669.32	43.68	2766.13	25.21	3567.60	28.97
Reserve assets	2,784.33	43.06	2901.19	26.46	3719.94	28.22
Reserve Liabilities	115.00	30.11	135.06	59.16	152.34	12.79
Commercial bank deposits in foreign currency	35.62	-23.49	38.25	26.85	44.38	16.02
Nonresident deposits in foreign currency	2.61	-57.90	1.62	-38.55	0.27	-83.26
Use of Fund resources	76.77	115.44	95.19	82.81	107.69	13.13
Gross Intl. Reserves						
(in months of import)	11.06		14.63		15.53	
Net Intl. Reserves						
(in months of import)	10.60		13.95		14.89	

Box 2: Carpet Industry in Afghanistan

The carpet industry has long history in South Asia specifically in Afghanistan. It is believed that when kings in Afghanistan sought to give valuable gifts, carpets were their first choice. It is still believed to be precious as people still prefer to decorate their houses, offices, private business, and government organizations with beautiful hand-woven Afghan carpets. The participation of Afghan women in carpet-making is high as it is a home-based and family business and they can earn their livelihood for their families.

In the global market, Afghan carpets are of significant importance because of its unique and matchless patterns. Afghan carpets have attained first position in recent exhibition held in Germany. The Afghan carpets were given the position because of its attractiveness and different varieties of natural colors. Interestingly, it is adage in Afghanistan that carpets gain more value as they get older. The carpets produced in Afghanistan are long-lasting and it is playing important role in bring employment for approximately one million people in Afghanistan.

Afghan carpet industry faced numerous challenges over the last 30 year. During the civil strife, a bigger percentage of carpet industry migrated to Pakistan and Iran and consequently, it negatively affected the domestic industry. Afghan carpet export faced rapid decline. The migration of carpet industry brought new challenges to Afghanistan and gave new opportunities to the neighboring countries for further strengthening their carpet industries or constructing new infant industries for them specifically Pakistan and Iran. The migrants started weaving carpets in the neighboring countries when they faced unemployment. They once again set up the looms and started weaving carpets. It is worth to be mentioned that Afghanistan was still exporting wool to neighboring countries to support Afghan nationals weaving carpets in the neighboring countries.

Afghanistan carpet industry deteriorated in the last 30 years of war. In contrast, the neighboring countries' carpet industry strengthened by employing more experienced and skilled labor migrated from Afghanistan. However, In 2001 yet again our carpet industry started to improve as new government established and new efforts were made to improve the industry. According to UNHCR, Approximately 5 million migrants returned back to Afghanistan. The returnees included carpet weavers and small carpet traders while some numbers of Afghan migrants, experts in weaving carpets, were given permanent citizenship and some other incentives and encouragements with the intention that Afghan migrants hosting countries' carpet industry remain unaffected with repatriating of skilled labor back to Afghanistan. Afghanistan carpet industry improved significantly. In SY 1387, Afghan carpet exports were 28 percent of the total exports and forming the second largest category and approximately 82 percent of Afghan carpets were exported to Pakistan while Pakistan's main carpet export destinations are USA, United Kingdom, Italy, Germany and some Middle East countries. This implies that our carpets are exported to Pakistan and then Pakistan is exporting to their export destinations.

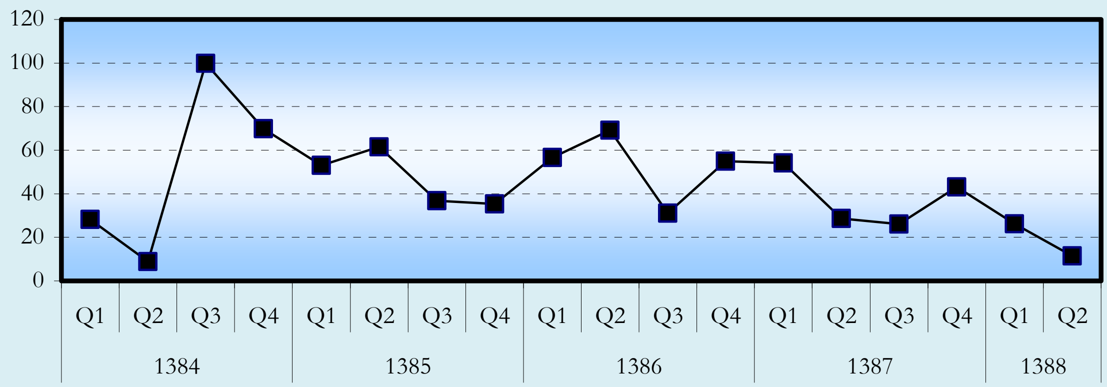
Afghan carpet industry is subject to high competition from Pakistan, Iran, Kashmir and India. The low priced carpets by the other exporting countries are diverting the proportion of demand from Afghan carpets. Afghanistan currency is stronger compared to Pakistan and Iran. The carpets exported by Pakistan and Iran are cheaper in USA, European and Middle East markets compared to Afghan carpets. In 2008, the currency of Pakistan further depreciated which had adverse effect on the carpet exports of Afghanistan.

UNICEF, the Society and some other charity organizations announced that child labor exits in the carpet-weaving industry chiefly in Pakistan, Nepal, India and Morocco. A mission by the Society's Secretary General revealed that large amount of child labor work in sickening and poor conditions making carpets in Pakistan. The Society had some further findings which show that most of the growth in carpet industry has been achieved through the exploitation of child labor in Pakistan, Nepal, India, and Morocco. There are two main advantages of child labor to the carpet producer. First, they are paid low wages and second, they can work in very poor working conditions without facilities. The South Asian Coalition on Child Servitude estimates that 200,000 to 300,000 children are involved in carpet industry in Pakistan, approximately the same amount in India and up to 150,000 in Nepal. UN Working Group on Contemporary Forms of Slavery and the International Labor Organization (ILO) called on the governments of these countries to enforce their own laws and to stop the use and exploitation of child labor.

The global financial crisis had an unpleasant effect on the carpet industries in the carpet exporting countries. Indian exports fell by 31 percent to USD 600.06 million in 2008-09 from USD 875.71 million in 2007-08. According to The Nation (Nov 25, 2009), Pakistan exports had halved from USD 300 million in 2007-08 to USD 145 million in 2008-09. On the other hand, Iran carpet exports increased significantly. Iran employed approximately 1.2 million people in hand-woven carpets and is having USD 418 million exports in 2008-09 compared to USD 398 million in 2007-08. Kashmiri carpet industry is hit by the global financial crisis and faced 80 percent decline compared to the previous years. Before global financial crisis, Kashmir carpet industry was exporting USD 50 million per year while more than 200,000 artisans were employed in producing carpet. The demand for Afghan carpets fluctuating from time to time. On average 80 to 83 percent of Afghan carpets are exported to Pakistan and then from Pakistan they are exported to USA, Germany, Dubai, Italy, Middle East and United Kingdom.

According to the deputy head of Afghan Rug Export Union, the global economic recession is the principal reason for the reduction in our exports. The production capacity in Afghanistan is much higher but exports of our carpets are contingent on the production of carpets in Pakistan and the foreign demand for Pakistani carpets. In the global financial crisis and worsening security situation in Pakistan shrank Pakistani exports which resulted in the decline of Afghan carpet exports to Pakistan. As it is shown in figure 01, Afghan carpet exports declined in 1387 and the first quarter of 1388 as result of a drastic decline in our exports to Pakistan.

Figure 01: Carpet exports in million USD (Q1,1384-Q1,1388)



Source: Central Statistics Office Data and DAB staff calculations

According to Afghanistan Investment Support Agency (AISA), Afghan carpet industry lacks adequate investment. The cutting, washing and finishing facilities hardly exist in Afghanistan. Therefore, the carpets produced in Afghanistan are exported to Pakistan for cutting, washing and finishing and then exported to global markets which restrict Afghan traders from international markets. Moreover, USINFO staff wrote that very small fraction of Afghan carpets are sold abroad as Afghan products. The reason for this is that 90 percent of Afghan carpets are exported to Pakistan and then those carpets are exported to foreign markets with labels that say "made in Pakistan." To strengthen our carpet industry we need to attract more direct investment and encourage the domestic businessmen to invest in the domestic carpet industry. Earnings from the carpets to Afghanistan will be more than double if exported to the actual export destinations such as USA, European Union, United Kingdom and Middle East compared to the current earnings on Afghan carpets exported to Pakistan.

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