

Da Afghanistan Bank



Quarterly Bulletin

Third Quarter of 1389



Quarterly Issue, Third Quarter of 1389 (September 22 to December 21, 2010)

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Publisher's Statement

The Quarterly Economic and Statistical Bulletin of Da Afghanistan Bank was produced with the support of several departments and coordination by the Monetary Policy Department. The bulletin presents macroeconomic data and analysis of economic trends during the third quarter of 1389.

Da Afghanistan Bank



Quarterly Bulletin

Third Quarter of 1389

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Note:

Afghanistan Fiscal year is Solar Year which begins on March 21 each year. This Quarterly Bulletin covers developments in the third quarter of 1389 which is equivalent to September 22 to December 21, 2010.

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ABBREVIATIONS

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

GOVERNOR'S STATEMENT

Quarterly Economic and Statistical Bulletin

It is with pleasure that I, on behalf of the Supreme Council, present this release of the Quarterly Economic and Statistical Bulletin of Da Afghanistan Bank (DAB). This Bulletin reviews and examines events during the third quarter of 1389 (September 22 to December 21, 2010) and reflects DAB's primary objectives of fostering price stability, developing a sound financial system conducive to macro-economic stability, and encouraging broad-based economic growth.

The economic environment in Afghanistan during the third quarter showed several positive trends but also a couple areas of potential softness. The trade deficit remained flat with respect to GDP, the banking sector expanded and remained profitable, the country's net international reserves grew, and DAB smoothed exchange rate fluctuations while maintaining appropriate control over the money supply. Meanwhile, early winter snowfall was light, raising concerns for next year's harvest, and consumer prices rose sharply as a result of regional and global supply shocks to food production. DAB will continue to monitor both of these areas of concern and will act appropriately if needed.

The global economy is on the path of recovery. However, the outlook of the global economy still remains uncertain as some advanced and emerging economies are still at risk of a double-dip recession. In contrast, some of the emerging economies had a strong rebound from crisis particularly, China and India. Policy responses to the crisis included accommodative monetary

policies, fiscal stimulus and strong financial support policies adopted by both advanced and emerging economies helped reduce the impact of the crisis. According to the World Economic Outlook (WEO), the global economy expanded 3.7 percent in the second half of 2010 compared to 5.2 percent in the first half of 2010. In addition to supportive policy responses, improved confidence in 2010 resulted in higher industrial production, inventory rebuilding and trade.

Global food and fuel prices surged in 2010 which had considerable impact on overall inflation in emerging economies over the course of 2010. Inflation for emerging and developing economies surged by 6.2 percent in 2010 compared to 5.2 percent in 2009. The increase was mainly driven by food and fuel indices, which have higher weights in their overall consumer price indexes. On the other hand, inflation in advanced economies reached 1.6 percent in 2010 compared to 0.1 percent in 2009. Advanced economies observed relatively low inflationary pressures and were more or less in the range of their inflation targets.

In the quarter under review, monetary aggregates had mixed performances; reserve money (RM), the operational target under ECF program, had an increase of 10.77 percent, well below its maximum ceiling of 16.23 percent. Currency in circulation, an indicative target under the ECF program, had an increase of 23.8 percent in the quarter under review reaching AF 122,148 million.



On the other hand, narrow money (M1) grew to AF 240,257 million in the quarter under review, indicating annual growth rate of almost 25.02 percent mainly due to increase in demand for afghani as a result of growing people's confidence on local currency. Broad money (M2) demonstrated similar behaviour growing by 26.69 percent (Y-o-Y) recording AF 256,202 million at the end of the quarter under review. Nominal exchange rate of afghani against US dollar remained stable throughout the quarter ending at AF 45.27 per US dollar in December 21, 2010.

The stock of net international reserves (NIR) stood at USD 4.43 billion at the end of the third quarter of 1389.

The banking sector performed well in the quarter under review, with a 21 percent increase in total assets of the banking system. Loans increased by 32.3 percent compared to the same period of last year, while deposits had an increase of 16.3 percent compared to the same period last year. Excluding one banking institution, the overall banking sector was profitable in the third quarter of 1389. Branches of Foreign banks were leading in profitability followed by State-owned Banks and Private Banks.

Afghanistan's merchandise trade deficit widened in the third quarter of 1389 following a

substantial expansion in imports compared with the similar period last year. However, the trade deficit as percentage of GDP remained unchanged.

This report was written by the Monetary Policy Department (MPD) with tireless efforts of and close cooperation between numerous individuals from several departments of the Bank. Encouragement and support from EGGI/USAID Advisors at MPD is greatly appreciated.

Kabul, March 2011

Abdul Qadeer Fitrat

Governor, Da Afghanistan Bank
(Central Bank of Afghanistan)

EXECUTIVE SUMMARY

This publication constitutes DAB's Quarterly Economic and Statistical Bulletin for the third quarter of 1389. The content 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 global economy is on the path of recovery. However, the outlook of the global economy still remains uncertain as some advanced and emerging economies are still at risk of a double-dip recession. In contrast, some of the emerging economies had a strong rebound from crisis particularly, China and India. Policy responses to the crisis included accommodative monetary policies, fiscal stimulus and strong financial support policies adopted by both advanced and emerging economies helped reduce the impact of the crisis. According to the World Economic Outlook (WEO), the global economy expanded 3.7 percent in the second half of 2010 compared to 5.2 percent in the first half of 2010. In addition to supportive policy responses, improved confidence in 2010 resulted in higher industrial production, inventory rebuilding and trade.

Global food and fuel prices surged in 2010 which had considerable impact on overall inflation in emerging economies over the course of 2010. Inflation for emerging and developing economies surged by 6.2 percent in 2010 compared to 5.2 percent in 2009. The increase was mainly driven by food and fuel indices, which have higher weights in their overall consumer price indexes. On the other hand, inflation in advanced economies reached 1.6 percent in 2010 compared to 0.1 percent in

2009. Advanced economies observed relatively low inflationary pressures and were more or less in the range of their inflation targets.

Global merchandise trade increased 17 percent in the fourth quarter of 2010 over the same quarter a year earlier. Over the course of 2010, the value of merchandise exports went up by 22 percent. Similarly, merchandise imports recorded an increase of 21 percent in 2010. In the month of December 2010, world merchandise trade decreased. However, 2010 merchandise trade value was above pre-crisis level of December 2008. South and Central America recorded the largest growth rate of 25 percent in exports and 30 percent in imports. Also, Asian exports increased 23 percent and imports went up by 22 percent mainly attributed to the significant increase in China's merchandise trade, an increase of 25 percent in exports and 30 percent in imports.

In Afghanistan, monetary aggregates were well-managed in the quarter under review. In the quarter under review, monetary aggregates had mixed performances; reserve money (RM), the operational target under ECF program, had an increase of 10.77 percent, well below the maximum ceiling of 16.23 percent. Currency in circulation, an indicative target under the ECF program, had an increase of 23.8 percent in the quarter under review reaching AF 122,148 million.

Narrow money (M1) grew to AF 240,257 million in the quarter under review, indicating annual growth rate of almost 25.02 percent mainly due to increase in demand for afghani as a result of growing people's confidence on local currency. Broad money (M2) demonstrated similar

behaviour growing by 26.69 percent (Y-o-Y) reaching AF 256,202 million at the end of the quarter under review.

Capital notes (CNs) auction is one of the instruments used by DAB to control reserve money growth and withdraw excess liquidity of the banking system. In the quarter under review, the 28 day stock outstanding had an initial balance of AF 2.5 billion, the highest amount for the third quarter of 1389, before it dropped by AF 900 million at the end of quarter under review. The quarter ended with an outstanding amount of AF 1.6 billion for 28 day notes. On the other hand, the 182 day CNs outstanding amount noticed an increase in its balances. The quarter began with an amount of AF 8.4 billion and ended with AF 8.9 billion, with an increase of AF 400 million only. The outstanding amount for the end of last quarter was AF 2.4 billion for 28 day notes and AF 8.5 billion for 182 days notes.

The outstanding amount gap (the difference between 28 day notes stock and 182 day notes stock) between these two notes widened from AF 5.6 billion to AF 6.4 billion on average basis during the quarter under review. The change was due to increase in 182 day balances and decrease in 28 day notes balances.

The total outstanding stock of both maturities stood at AF 17.7 billion at the end of the reporting period. This figure was AF 10.9 billion at the end of preceding quarter (Figure

In the meantime, nominal exchange rate of afghani against US dollar remained stable that ended at AF 45.27 per US dollar in December 21, 2010.

The stock of net international reserves (NIR) stood at USD 4.43 billion at the end of the third quarter of 1389.

Kabul headline inflation increased rapidly in the quarter under review. The accelerating trend in headline inflation that began in the first quarter of 1389 continued throughout the second quarter of the year. By all measures, inflation was increasing in the first nine months of the year. The situation was the same, whether the Kabul CPI or National CPI is used to measure price changes.

Kabul headline CPI, measured on a year-on-year basis increased sharply by 12.9 percent in the third quarter of 1389 compared to the same period last year when there was actual deflation of 13.2 percent. This sharp turnaround from the previous year was concentrated, both in the food and non-food components. In contrast to 1388, when prices were declining in most food components, 1389 saw increase in almost all components. The main factor responsible for the increase in headline inflation in the current quarter was a dramatic increase in the prices of bread and cereals. Bread and cereals prices had fallen in the same quarter of last year, so the sharp increase in the current quarter was surprising. Other factors contributing to the surge in prices in the second quarter of 1389 were dramatic increase in prices of meat, oils & fats, vegetables, rents, construction materials, fuel and electricity, and transportation.

The situation of core inflation changed at the beginning of the third quarter of 1389. When the effects of significant price changes in bread and cereals, oil and fats, and transportation are excluded from the figures, the year-on-year rate of core inflation in the third quarter of 1389 recorded 12.55 percent increase at the end of the third quarter of 1389 compared to 1.5 percent at the same period last year which is a matter of concern for policy making side.

When core inflation is measured by the 28 percent trimmed mean, the same pattern

appears. Core inflation, measured by 28% TM increased by 9 percent at the end of the third quarter of 1389 compared to 0.8 percent in the same period last year.

The pattern observed nationwide was similar to the pattern observed in Kabul, with a few exceptions. Headline inflation, which had been negative in the third quarter of 1388, became strongly positive (9.8 percent) in the quarter under review.

The key objectives in the fiscal area are to achieve sustained increases in revenue collection, to permit the gradual takeover of externally financed operating spending and to ensure an expenditure allocation consistent with ANDS priorities. Other goals include improvements in public expenditure management, fiscal policy formulation, and efficiency in public enterprises, and tax and customs administration.

Like other emerging and less developing economies around the world, a budget imbalance exists in Afghanistan. Total core expenditures exceeded total domestic revenues in the third quarter of 1389, leading to a budget deficit of AF 17.745 billion.

Total domestic revenues increased to AF 20.525 billion in the third quarter of 1389 up from AF 15.077 billion in the third quarter of 1388, representing 36 percent increase. Total domestic revenues in the quarter under review accounted for 2.6 percent of GDP.

Total core expenditures in the quarter under review increased to AF 38.270 billion up from AF 31.009 billion in the third quarter of 1388, which represents 23 percent increase. Total expenditures in the quarter under review account for 5 percent of GDP.

Donor contributions are used to finance both operating and development expenditures. The

total donor contribution (grants) allotted to both operating and development expenditures increased to AF 21.814 billion in the quarter under review, up from AF 15.884 billion in third quarter of 1388, which shows 37 percent increase. Total donor contributions account for 2.8 percent of GDP in the quarter under review.

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

The banking system performed well in the quarter under review. Total assets of the banking system stood at AF 192.73 billion (USD 4.26 billion) at the end of the third quarter of 1389, up by 21 percent or AF 33.4 billion (USD 739.4 million) from the same period last year. Loans amounted to AF 81.25 billion (USD 1.79 billion) an increase of AF 19.81 billion (USD 438.07 million) or 32.25 percent since December 2009. Deposits stood at AF 152.37 billion (USD 3.37 billion) over the period under review; a 16.31 percent increase since previous period. Deposits were largely denominated in USD (62.19 percent) with Afghani denominated deposits lagging at 34.05 percent. Afghani denominated deposits rose to AF 51.88 billion (USD 1.18 billion) since Qaws 1388 (December 2009), when it was AF 40.06 billion (USD 840 million). Total capital of the banking system excluding Kabul Bank stood at AF 18.34 billion (USD 405.50 million), while inclusion of Kabul Bank put a huge impact on the financial capital position of the system. Excluding Kabul Bank, the overall Banking sector was profitable earning profit of AF 510 million (USD 11.28 million) up to third quarter of 1389, down by AF 454 million since December 2009. However, the size of losses of Kabul Bank distorts the figure for the whole sector and turns the overall return on assets (ROA) to -26.81 percent from 0.35

percent.. For the quarter under review only branches of foreign bank are profitable, while state-owned banks and private banks are at loss.

In the external sector, merchandise trade deficit widened in the third quarter of 1389 following a substantial expansion in imports compared with the similar period last year. The merchandise trade deficit expanded by almost 31 percent in the quarter under review compared to the same period last year. Merchandize trade deficit stood at USD 904.56 million in the third quarter of 1389 up from USD 692.27 million in the third quarter of 1388. However, the trade deficit as percentage of GDP remained unchanged at 5 percent.

In the quarter under review, aggregate imports and exports stood at USD 1,031.9 million and USD 127.29 million, respectively, compared to USD 780.50 million and USD 88.23 million in the third quarter of 1388. This resulted in the expansion of the merchandise trade deficit from USD 692.27million in the third quarter of 1388 to USD 904.56 million in the third quarter of 1389. The expansion in the trade deficit is a reflection of the slow recovery of the global economy.

In the quarter under review, exports increased notably by around 44 percent to USD 127.29 million from USD 88.23 million in the third quarter of 1388. Exports are mainly dominated by food items that increased by about 60 percent and carpets and rugs that increased by about 48 percent in the quarter under review compared with the similar period last year. On the other hand, imports of goods increased by about 32 percent from USD 780.5 million in the

third quarter of 1388 to USD 1,031.9 million in the quarter under review. Imports of almost all items increased in the third quarter of 1389 compared to the similar period last year except consumer goods which decreased about 16 percent. Imports of capital goods increased by almost 64 percent in the quarter under review, recording USD 524.76 million, up from USD 320.06 million in the same quarter of last year, while industrial supplies increased by about 33 percent from USD 244.80 million to USD 324.42 million.

Afghanistan's public and publicly guaranteed external debt stock stood at USD 2,322.09 million as of December 21, 2010. During the quarter, service charges are paid only to the International Development Association (IDA). In addition, United States as part of the Paris Club made enormous debt forgiveness on principal amount and IDA gave some debt forgiveness on service charges during the third quarter of 1389.

The net international reserves increased by 18.8 percent in the third quarter of 1389. In the corresponding quarter of last year, NIR stood at USD 3,711.63 million and that increased to USD 4,408.88 million in the third quarter of 1389.

On the other side of the balance sheet, reserve liabilities increased by 91.86 percent compared to the same period last year. The reserve liabilities are dominated by commercial bank deposits in foreign currencies which increased by 252.4 percent while the use of fund resources increased by 6.94 percent. In contrast, nonresident deposits in foreign currency decreased by around 58.8 percent in the quarter under review.

The image features three stacks of coins of varying heights and colors (gold, silver, and copper) in the foreground. The background is a blurred blue and white circular pattern, possibly a logo or seal. The text 'Global Economic Environment' is overlaid in a yellow serif font.

Global Economic Environment

1

1

GLOBAL ECONOMIC ENVIRONMENT

The global economy is on the path of recovery. However, the outlook of the global economy still remains uncertain as some advanced and emerging economies are still at risk of a double-dip recession. In contrast, some of the emerging economies had a strong rebound from crisis particularly, China and India. Policy responses to the crisis included accommodative monetary policies, fiscal stimulus and strong financial support policies adopted by both advanced and emerging economies helped reduce the impact of the crisis. According to the World Economic Outlook (WEO), the global economy expanded 3.7 percent in the second half of 2010 compared to 5.2 percent in the first half of 2010. In addition to supportive policy responses, improved confidence in 2010 resulted in higher industrial production, inventory rebuilding and trade.

Global food and fuel prices surged in 2010 which had considerable impact on overall inflation in emerging economies over the course of 2010. Inflation for emerging and developing economies surged by 6.2 percent in 2010 compared to 5.2 percent in 2009. The increase was mainly driven by food and fuel indices, which have higher weights in their overall consumer price indexes. On the other hand, inflation in advanced economies reached 1.6

percent in 2010 compared to 0.1 percent in 2009. Advanced economies observed relatively low inflationary pressures and were more or less in the range of their inflation targets.

Global merchandise trade increased 17 percent in the fourth quarter of 2010 over the same quarter a year earlier. Over the course of 2010, the value of merchandise exports went up by 22 percent. Similarly, merchandise imports recorded an increase of 21 percent in 2010. In the month of December 2010, world merchandise trade decreased. However, 2010 merchandise trade value was above pre-crisis level of December 2008. South and Central America recorded the largest growth rate of 25 percent in exports and 30 percent in imports. Also, Asian exports increased 23 percent and imports went up by 22 percent mainly attributed to the significant increase in China's merchandise trade, an increase of 25 percent in exports and 30 percent in imports.

1 – GLOBAL ECONOMY

The global economy is on the path to recovery. However, the outlook of the global economy remains uncertain. Advanced and emerging economies adopted policy responses such as accommodative monetary policies and fiscal stimulus and financial support policies to

mitigate and reduce the impact of the global financial crisis. According to the World Economic Outlook (WEO), global economic growth expanded 3.7 percent in the second half of 2010 compared to 5.2 percent in the first half of 2010. Moreover, improved confidence in 2010 resulted in higher industrial production, inventory rebuilding and merchandise trade. In fact, reduced excess capacity coupled with accommodative policies, and further improvements in confidence and financial conditions encouraged investment and sharply enhanced job markets. In turn, this led to higher overall economic activity and accelerating global activity.

Over the course of 2010, world output expanded by 5 percent compared to a 0.5 percent decline in 2009. The increase in world output is mainly driven by emerging economies. Emerging economies expanded by 7.3 percent in 2010 as compared to a 2.7 percent increase in 2009. China, the world's second largest economy, recorded an increase of 10.3 percent while India recorded an increase of 10.4 percent in 2010. Advanced economies expanded by 3 percent in 2010 compared to a -3.4 percent decline in 2009. The US economy expanded by 2.8 percent in 2010 after a significant decline in 2009. However, the risk of double-dip recession remains high in advanced economies with high unemployment. Moreover, output is still below the potential level.

Looking ahead, robust growth in many emerging market economies will play a vital role in pulling the recovery in the near term. In most, the recovery seems to have entered a self-sustaining phase, although high unpredictability and, particularly, sovereign risk, bank funding

and unfinished regulatory reform remain causes for concern. Nevertheless, the global economy is expected to have growth of 4.4 percent for 2011 and 4.5 percent for 2012.

1.1 Industrial Production

During the global financial crisis, industrial production started to decelerate from 0.5 percent in the second quarter of 2008 to -5.8 percent in the first quarter of 2009. The decline was mainly attributed to sluggish global demand. Finally, in the second quarter of 2009, global industrial production recorded an increase of 0.96 percent with gradual improvements over the forthcoming quarters. In the fourth quarter of 2010, global industrial production accelerated by 1.8 percent reaching USD 3.4 trillion compared to USD 3.3 trillion in the third quarter of 2010. On annual basis, industrial production recorded an increase of 7 percent in the reporting quarter.

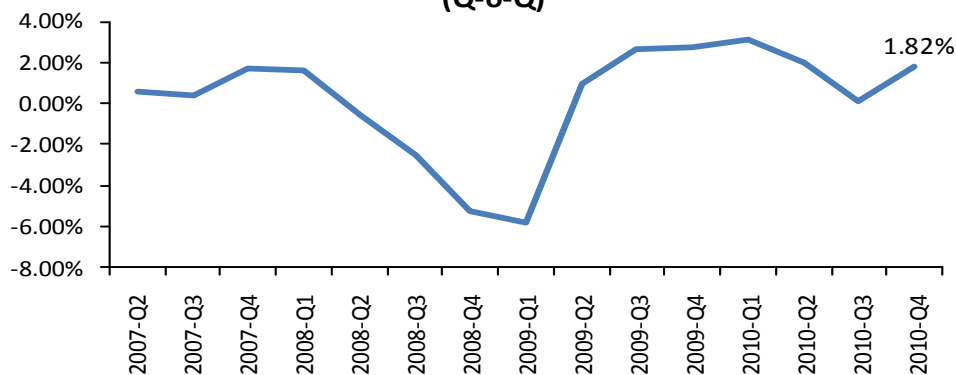
In the second half of 2010, Industrial production in developing countries returned back to its original trend level. In other words, it is also called full capacity utilization. All together, developing countries regained full capacity utilization. Among developing countries, China and India were 0.5 percent and 6.1 percent above capacity although; industrial activity in Central Asia and Europe remained 17 percent below capacity. Conversely, high income countries remained 11.3 percent below the pre-crisis level. Moreover, global industrial production is still 0.7 percent below the pre-crisis level.

To put it differently, industrial production in developing countries was less affected by the crisis compared to high income countries and

the rebound was stronger with an earlier recovery. In addition, among developing countries significant deviations were observed in the level of recovery and spare capacity. The recovery in developing countries was largely driven by China, recording an output growth of 27.2 percent in May 2009. Similarly, India recorded significant growth. However, growth in

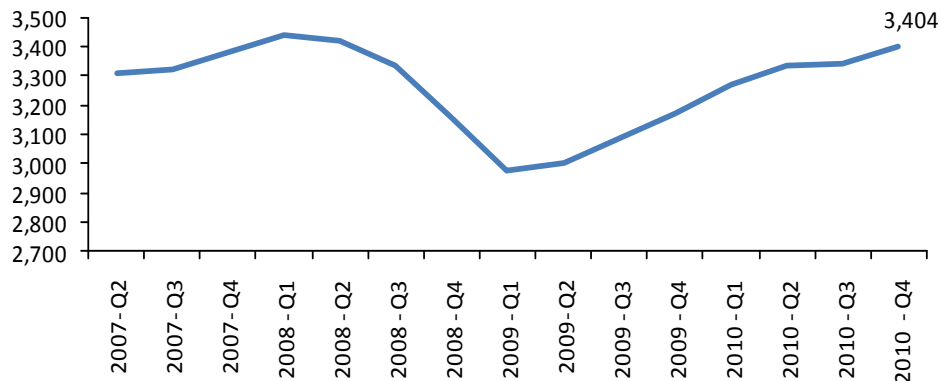
developing Europe and Central Asia was strongly affected by the crisis and as with high income countries, significant spare capacity remains and industrial production levels are still around 17 percent below the pre-crisis trend levels and output is about 6.7 percent below the pre-crisis levels.

Figure 1.1: Industrial Production, Percentage change (Q-o-Q)



Source: World Bank.

Figure 1.2: Industrial Production, Constant, Seas. Adj. (Billion USD)



Source: World Bank

1.2 Global Inflation

Global food and fuel prices surged in 2010 which pulled up overall inflation in emerging economies over the course of 2010. Inflation for emerging and developing economies surged by 6.2 percent in 2010 compared to 5.2 percent in 2009. The increase was mainly driven by food and fuel indices, having higher weights in their overall consumer price indexes. On the other hand, inflation in advanced economies increased by 1.6 percent in 2010 compared to 0.1 percent in 2009. Advanced economies observed relatively lower inflationary pressures and were more or less in the range of their inflation targets.

Looking ahead, advanced economies are expected by the IMF to experience an inflation rate below 2 percent in 2011 and then to decline to 1.5 percent in 2012. Similarly, emerging and developing economies are expected to experience 7 percent inflation in 2011 and 5 percent in 2012.

1.3 Global Trade and Investment

According to the World Trade Organization (WTO), global merchandise trade increased 17

percent in the fourth quarter of 2010 over the same quarter a year ago. In 2010, merchandise exports value went up by 22 percent as compared to that in 2009. Similarly, merchandise imports had an increase of 21 percent in 2010 over the previous year. In the month of December 2010, world merchandise trade decreased, however, 2010 merchandise trade value is above the pre-crisis level of December 2008. South and Central America recorded the largest growth rate of 25 percent in exports and 30 percent in imports in global merchandise trade. In the meantime, Asian exports increased by 23 percent and imports went up by 22 percent mainly due to a significant increase in China's merchandise trade which recorded an increase of 25 percent in exports and 30 percent in imports.

According to the World Investment Report, global foreign direct investment (FDI) flows had a modest recovery in the first half of 2010 after a drastic decline in 2009. In 2010, global FDI inflows are expected to reach USD 1.2 trillion, and will increase to USD 1.3 to 1.5 trillion in 2011.

**Table 1.1: World Merchandise Trade by Region and Selected Economies
Fourth Quarter of 2010 (percent change)**

	Exports		Imports	
	Y-o-Y	Q-o-Q	Y-o-Y	Q-o-Q
World	17	9	17	7
North America	18	9	16	1
United States	18	9	16	0
Canada	17	10	15	2
South and Central America	25	4	30	1
Brazil	38	2	34	-3
Europe	10	12	12	12
European Union (27)	10	12	11	11
—intra EU	7	13	7	13
—extra EU	14	10	18	9
Commonwealth of Independent States (CIS)	17	14	23	13
Russian Federation	18	15	26	11
Africa and the Middle East	21	16	13	8
Asia	23	5	22	5
China	25	3	30	4
India	28	16	2	2
Japan	19	5	21	5
Six East Asian traders	21	6	22	5

Source: World Trade Organization

2 – ADVANCED ECONOMIES

2.1 United States

The U.S economy performed well in the fourth quarter of 2010. Rebuilding manufacturing inventories and fiscal stimulus spending were the main drivers behind the economic recovery in the United States. According to the US Bureau of Economic Analysis, US GDP in current dollars stood at USD 14.6 trillion for 2010 compared to USD 14.1 trillion in 2009, having 3.8 percent growth rate in 2010. On a yearly basis, the US economy grew at a growth rate of 4.1 percent compared to the same quarter a year ago. Economic growth relies mainly on the private consumption in the US economy, which constitutes the largest share in US GDP.

Conversely, both private non-residential and residential fixed investments showed significant declines in 2010.

In 2010, the US economy experienced low inflationary pressures and remained close to the desired level. End period inflation stood at 1.5 percent in the last quarter of 2010, while period average inflation was 1.6 percent. The Federal Reserve continued its accommodative monetary policy. Monetary policy in the US will be committed to keep the policy rate at its current level for an extended period of time. Looking ahead, Federal Reserve expects low inflation in 2011.

The total volume of industrial production declined in the fourth quarter of 2010, while in the months of October and December business

surveys in manufacturing and total manufacturing excluding motor vehicles and parts showed improvement. In the fourth quarter of 2010, unemployment was slightly lower at 9.4 percent compared to 9.6 percent in the third quarter of 2010, showing slight improvement in the job market. The labor market is improving as roughly 1.2 million new jobs were created in 2010.

On the other hand, US international trade in goods had a negative contribution to the overall balance in goods and services, while the US international trade in services' contribution was positive. Trade deficit in goods decreased to USD 156.2 billion in the fourth quarter of 2010 compared to USD 170.8 billion in the third quarter of 2010. US net exports in services showed USD 39.4 billion surplus in the fourth quarter of 2010 compared to USD 38.2 billion in the third quarter of 2010.

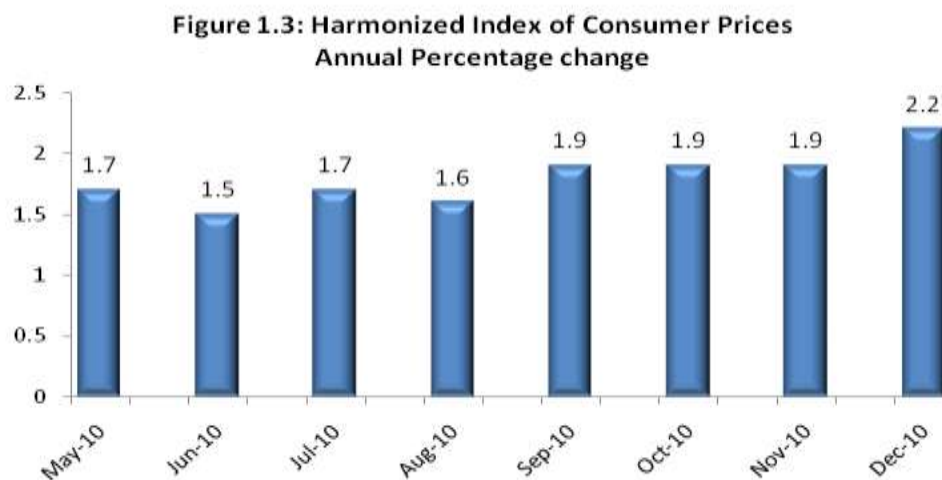
2.2 Euro Area Economy

According to Eurostat, the euro area economy expanded by 0.3 percent in the fourth quarter of

2010 compared to the previous quarter. Lower than expected growth rates in three major economies (Germany, France and Italy) had a significant impact on the overall economic performance of the euro area. The sluggish growth rate in the fourth quarter of 2010 indicates that some countries in the euro area are still suffering from lower growth and competitiveness.

Industrial production had an increase of 0.6 percent in the fourth quarter of 2010 compared to the previous quarter. Industrial production increased by 7.4 percent in the fourth quarter of 2010 compared to the same quarter a year ago. Retail trade volume had an increase of 0.3 percent in food and drinks and 0.8 percent in non-food sector. Looking ahead, it is expected that industrial production will further improve in the first quarter of 2011.

Euro area job markets showed increases in the quarter under review as significant improvements were observed in industrial orders and production.



Source: OECD statistics

2.3 Germany

In the second half of 2010, the German economy recorded sluggish economic growth. The growth in the third quarter of 2010 of 0.7 percent was affected by a significant decline in industrial and construction sectors, while in the quarter under review, the German economy expanded by 0.4 percent compared to the previous quarter. The growth was mainly attributed to the increase in net exports. Furthermore, consumption and capital formation both in machinery and equipment went up.

German industrial production recovered quickly from a sharp decline in 2008. Industrial orders in the month of November 2010 jumped by about 11.1 percent compared to the same month a year ago. Compared to the previous quarter, industrial production recorded a decrease of 0.6 percent. According to the Ministry of Economy of Germany, industrial production for the month of December 2010 recorded a decline of 1.5 percent compared to previous quarter mainly as a result of lower than expected growth in construction sector due to a cold winter season. The construction sector recorded an increase of 10 percent in the month of December 2010 compared to December 2009.

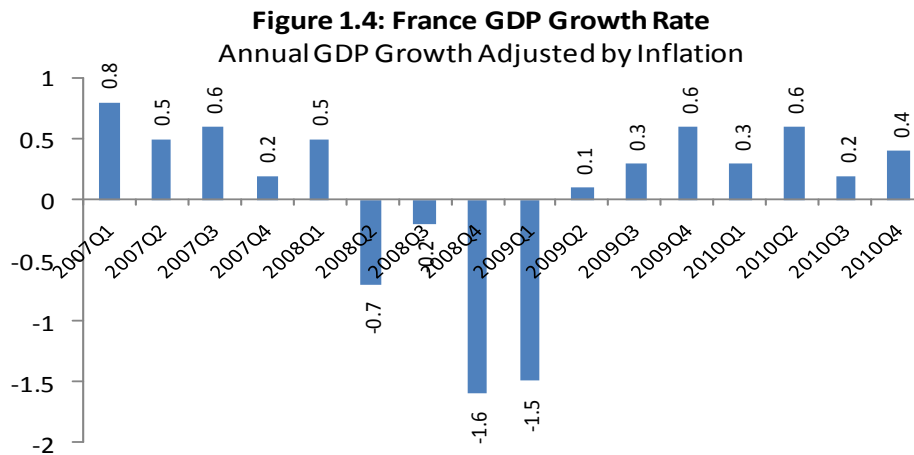
In the last month of 2010, inflation stood at 1.9 percent as prices rose, while average inflation was 1.2 percent in 2010. Inflation recorded in

December 2010 was the highest since October 2008 but, still below the price stability definition of the European Central Bank. Looking ahead, average inflation is expected to be 1.8 percent in 2011.

2.4 France

France's economy expanded by 0.4 percent in the fourth quarter of 2010, while it increased by 0.2 percent in the previous quarter. Industrial production rose unexpectedly with a growth rate of 0.3 percent in December 2010 over the previous month. In the fourth quarter of 2010, industrial production had an increase of 0.8 percent over the previous quarter, while in 2010 it rose by 5.8 percent over the previous year. The increase in industrial production was mainly attributed to the significant increase in mining, energy and water supply. On the other hand, goods manufacturing fell by 0.1 percent.

CPI inflation went up by 1.77 percent in December 2010 compared to the same month a year ago. The current account recorded a deficit of USD 16 billion in the fourth quarter of 2010 compared to a deficit of USD 14.3 billion in the third quarter of 2010. The total value of France's exports reached USD 45 billion in the fourth quarter of 2010, representing an increase of 5 percent over the previous quarter. Similarly, imports rose by 5.4 percent reaching USD 53.33 billion in the fourth quarter of 2010.



Source: INSEE National Statistics Office

2.5 United Kingdom

The UK economy started picked up in the first three quarters of 2010, but in the fourth quarter of 2010, the UK experienced a negative growth rate of 0.5 percent. The decline in the current quarter was mainly due to falling output in services industries, specifically business services and finance which fell by 0.8 percent. Transport, storage and communication fell by 1.7 percent. Moreover, household expenditure, government final consumption expenditure and gross fixed capital formation had declines of 0.3 percent, 0.4 percent, and 1.8 percent, respectively. The UK Office of National Statistics attributed this performance to bad weather conditions which had an adverse effect on the services sector, representing around 75 percent of UK GDP. Some analysts believe that recovery has lost momentum and the UK economy may experience a double-dip recession—a concern supported by the recent contraction.

Industrial production in the UK measures the output of industrial sectors mainly

manufacturing, mining, and utilities. Industrial production expanded by 0.5 percent in December compared to November 2010. The main driver behind this increase was a sharp increase in output of utilities. On a yearly basis, industrial output increased by 3.6 percent in the month of December 2010. Output decreased in 7 subsectors. The manufacturing sector had a decline of 0.1 percent.

The UK is facing some inflationary pressures in the current months. Inflation reached 3.7 percent in December 2010 compared to 3.2 percent in November 2010. The unemployment rate was reported at 7.9 percent in December 2010.

The current account had a deficit of £ 10.5 billion in the fourth quarter of 2010. This deficit was mainly attributed to high deficit in current transfers and trade in goods. On the other hand, the income account positively contributed to the current account by having an increase of £ 1.1 billion to £ 10.3 billion. The current account deficit accounted for about 2.6 percent of GDP in the fourth quarter of 2010.

Figure 1.5: United Kingdom's GDP Growth (Y-o-Y)
Annual GDP Growth Adjusted by Inflation

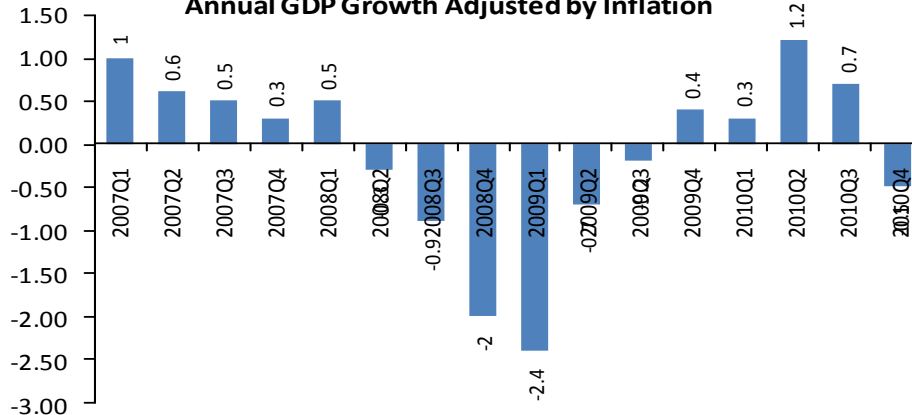
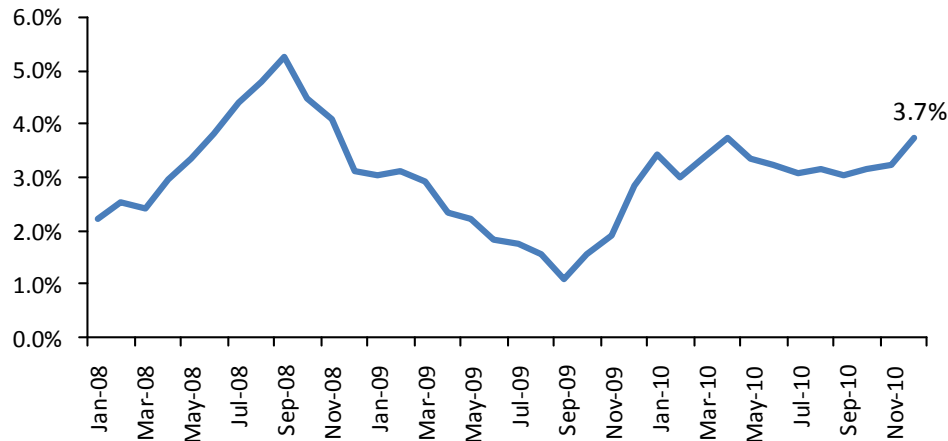


Figure 1.6: inflation rate (Y-o-Y)



2.6 Japan

In the quarter under review, Japan's economy contracted by 0.3 percent compared to the third quarter of 2010 while it shrank by annualized rate of 1.1 percent. The main reasons behind this decline were slowdown in exports due to appreciation of yen and weaker domestic consumer demand as a result of rising taxes in the fourth quarter of 2010. In 2010, real GDP growth was 3.98 percent mainly driven by fiscal stimulus and a rebound in exports. Nominal GDP reached USD 5.47 trillion. Japan gave up its

position as the world's second-largest economy on an annual basis after GDP growth contracted by 0.3 percent in the last quarter of 2010. GDP growth in 2010, secured third spot for the Japan economy after the United States and China. Analysts believe that Japan's move as a third-largest economy and China's as second-largest economy seems to be permanent.

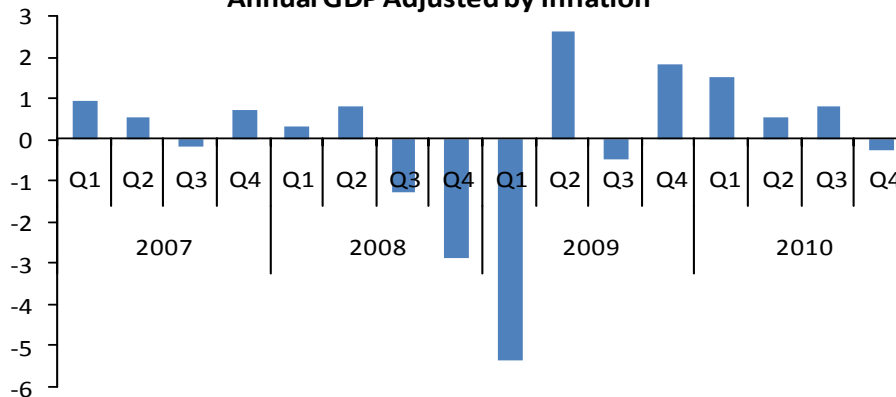
According to WTO, Japan's exports reached USD 769.8 billion and imports were around USD 693 billion in 2010. Exports fell by 0.7 percent. In fact the main drivers behind Japan economic growth in the past few quarters were exports of

consumer electronics, automobiles and semiconductors which performed poorly in the quarter under review. The main trading partners of Japan are the United States, China and European Union.

The GDP deflator fell by 1.6 percent in the fourth quarter of 2010 compared to the fourth quarter of 2009, while it stood at 2.5 percent

compared to the previous quarter. Consumer price index inflation stood at about 0.1 percent in the reporting quarter. According to WEO, consumer prices recorded a decline of 0.7 percent in 2010. Likewise, the unemployment rate stood at 5.2 percent in the quarter under review. Japan experienced 2.5 percent current account deficit as percent of GDP in 2010.

**Figure 1.7: Annual GDP Growth Rate
Annual GDP Adjusted by Inflation**



Source: TradingEconomics.com

3 - EMERGING ECONOMIES

Emerging economies had a quick rebound from global financial crisis compared to advanced economies. During the crisis period, large capital inflows were observed as emerging economies higher economic growth resulted in higher confidence and encouraged investors.

Both, China and India experienced strong economic growth. China's economy had significant growth in the quarter under review, having the second largest share in the global economy in 2010. China had annual GDP growth of 9.8 percent in 2010. Indian economy recorded 8.2 percent economic growth in the fourth quarter of 2010 over the same quarter a year ago. The Indian economy is depending on

the services sector, which is accounting for more than half of India's output. Likewise, manufacturing and mining and quarrying sub-sectors continued to expand substantially.

3.1 China

The pace of economic growth was significantly above the expectations for China's economy. In the fourth quarter of 2010, China recorded 9.8 percent economic growth compared to 9.6 percent in the third quarter of 2010. The major driving factor behind China's rapid economic growth was exports growth. The balance of risks has again swung toward overheating, exacerbated by strong capital inflows. Downside risks remain from an uncertain external environment and the weak US recovery; risks of protectionism have also increased due to

frustration abroad over the pace of RMB currency appreciation (BBVA Research, Fourth Quarter Bulletin, 2010).

Inflation which is a major concern for emerging market economies, particularly China and India, reached 3.3 percent for 2010 breaching the target of 3 percent. On the other hand, in December, consumer prices went up by 4.8 percent compared to 5.1 percent in the month of November 2010. Inflation had a declining trend, but ordinary people still shows their concern about rising food prices. Looking ahead, many economists expect the pace of inflation to pick up again in coming months, because the adverse weather conditions and other seasonal factors will most likely cause higher household spending and rising wages leading to higher inflation.

Exports remained strong and recovered to above their pre-crisis peak in nominal terms. China's top export destinations are still the EU and US; however, the share of exports to other countries is rising. China's exports to EU and US account for about 40 percent while to Latin America it accounts for above 6 percent. Manufacturing products are still the major component in China's export structure.

3.2 India

The Indian economy recorded 8.2 percent growth in the fourth quarter of 2010 over the same quarter a year before, mainly driven by strong growth in services sector which accounts for more than half of India's output. Likewise, manufacturing, mining and quarrying sub-sectors made positive contributions to the economic growth in India.

According to the Indian Ministry of Statistics, industrial production increased 1.6 percent in December 2010 compared to December 2009.

The growth in industrial production was mainly driven by mining, manufacturing and electricity sectors.

In the middle of 2009, inflation entered into negative territory and increased rapidly in the fourth quarter of 2009. This momentum continued in the first six months of 2010, with double-digit inflation rate for some months. A low monsoon in 2009 had significant impact on agriculture production resulting in higher food prices. For the fourth quarter of 2010, inflation is expected to be around 12 percent. To curb inflation, the Reserve Bank of India (RBI) is gradually tightening monetary policy.

On the other hand, international financial assets of India stood at USD 407.5 billion by the end of fourth quarter of 2010. Reserve assets reached to USD 297.3 billion, increasing 4.5 billion over the previous quarter. Similarly, direct investment abroad reached USD 92.4 billion, representing an increase of USD 3.2 billion during the reporting quarter, while international financial liabilities increased to USD 628.6 billion, showing a 22.7 billion increase in the reporting quarter compared to the previous quarter.

4 – ASSET AND COMMODITY PRICES

4.1 Financial Markets

In 2010, global financial markets continued to recover from the impact of the financial crisis. Broadly speaking, financial markets showed improved performance in the quarter under review. Every asset class showed strong gains in spite of significant market ups and downs. Investor's confidence grew as risks continued to reduce and corporate earnings continued to improve. The S&P 500, an index of large US stocks, rose by 10.8 percent in the fourth

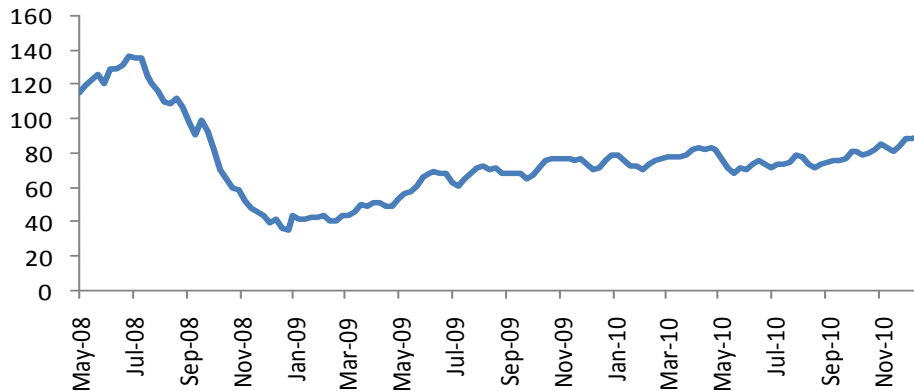
quarter of 2010 and 15.1 percent in 2010. The Russell 2500, an index of small capitalization equities, surged by 14.9 percent in the quarter under review and ended up 26.7 percent higher for 2010. On the other hand, the debt crisis in Europe reduced returns in the European stock markets, while other stocks still managed to turn in positive returns. The MSCI EAFE, developed market stocks index, increased by 6.2 percent in the fourth quarter of 2010 and managed a 4.9 percent return for the year. In short, the financial markets in emerging economies relatively performed well compared to advanced economies.

4.2 Commodity Markets

Global commodity prices surged in 2010 after a significant decline during the global financial crisis. Some of the commodities had relatively small increases such as energy prices and some of the commodities like precious metals had larger gains. In 2010, oil prices were quite stable, but a rise in the fourth quarter helped

generate gains for the year. In the month of December 2010, crude oil prices surged to USD 90 per barrel, an increase of 24 percent since December 2009. Strong surplus capacity and high stocks kept the crude oil prices below its pre-crisis level but long term upside risks persist for some commodities particularly, those in the extractive industries. The higher demand for some commodities particularly oil will more or less cause oil prices to rise in the forthcoming quarters.

Base metal prices recorded an increase of 6 percent in December 2010. For the year 2010, it rose by 26 percent. Among precious metals, silver prices had an increase of 66 percent in 2010, while gold prices had an increase of 23 percent. Similarly copper prices rose by around 8 percent. Looking ahead, energy prices are expected to rise in 2011 despite large surplus capacity. Base metal prices are expected to increase by around 10-15 percent. The expected increase in base metals will depend on demand by China, falling stocks and supply constraints.

Figure 1.8: World Crude Oil Prices (USD Per Barrel)

4.3 Global Exchange Rate Movements

During 2010, the US dollar experienced some volatility against major currencies. In the fourth quarter of 2010, US dollar appreciated against Euro by 3 percent from € 0.735 in the third quarter of 2010 to € 0.755 in the fourth quarter of 2010. Similarly, the US dollar appreciated by 8 percent against GBP, and 2 percent against the Chinese Yuan. On the other hand, US dollar depreciated by 4 percent against Swiss Franc from CHF 0.976 in the third quarter of 2010 to CHF 0.941 in the fourth quarter of 2010. Over the course of 2010, the US dollar depreciated about 12 percent against Swiss Franc. Likewise,

US dollar depreciated around 2 percent against Japanese Yen.

The recent appreciation of Chinese Yuan is attributed to the significant pressure on Chinese government to let its currency appreciate. Chinese government has maintained a policy of intervening in currency markets to limit the appreciation of its currency, aimed to boost its exports. Some of the analysts and policy makers believe that the current RMB exchange rate has made the Chinese exports to the United States significantly cheaper, and US exports to China much more expensive and this leads to the extensive loss of US manufacturing jobs and results in huge US trade deficits with China.

Table1.2: Exchange Rate of US dollar Against Some Major Currencies (USD/1 unit)

Currency	Code	Q4-2009	Q1-2010	Q2-2010	Q3-2010
Canadian Dollar	CAD	0.9599	0.9815	0.9542	0.9719
Swiss Franc	CHF	0.9672	0.9398	0.9217	1.0245
British Pound	GBP	1.5989	1.5072	1.5071	1.5809
Japanese Yen	JPY	0.010898	0.010791	0.011282	0.011955

Source: OANDA.com



**Monetary
and
Capital Market
Developments**

2

2

MONETARY AND CAPITAL MARKET DEVELOPMENTS

*M*onetary and capital market developments evaluates monetary program under Extended Credit Facility (ECF) program, monetary aggregates, foreign exchange rates, net international reserves, as well as open market operations. In the quarter under review, monetary aggregates had mixed performances; reserve money, the operational target under ECF program, had an increase of 10.77 percent reaching AF 138,900 million. The actual reserve money was below the PRFG-ECF target of 16.23 percent. Currency in circulation, which is an indicative target under the ECF program, had an increase of 23.80 percent in the quarter under review reaching AF 122,148 million. Da Afghanistan Bank breached the CIC ceiling of 16.22 percent mainly because of the excess money demand.

On the other hand, narrow money (M1) grew to AF 240,257 million in the quarter under review, indicating annual growth rate of almost 25.02 percent mainly due to increase in demand for afghani as a result of growing people's confidence on local currency. Broad money (M2) demonstrated similar behaviour growing by 26.69 percent (Y-o-Y) reaching AF 256,202 million at the end of the quarter under review.

Capital notes (CNs) auction is one of the instruments used by DAB to control reserve

money growth and withdraw excess liquidity of the banking system.

In the quarter under review, the 28 day stock outstanding had an initial balance of AF 2.5 billion, the highest amount for the third quarter of 1389, before it dropped by AF 900 million at the end of quarter under review. The quarter ended with an outstanding amount of AF 1.6 billion for 28 day notes. On the other hand, the 182 day CNs outstanding amount noticed an increase in its balances. The quarter began with an amount of AF 8.4 billion and ended with AF 8.9 billion, with an increase of AF 400 million only. The outstanding amount for the end of last quarter was AF 2.4 billion for 28 day notes and AF 8.5 billion for 182 days notes.

The total outstanding stock of both maturities stood at AF 17.7 billion at the end of the reporting period. This figure was AF 10.9 billion at the end of preceding quarter (Figure

In the meantime, nominal exchange rate of afghani against US dollar remained stable that ended at AF 45.27 per US dollar in December 21, 2010.

The stock of net international reserves (NIR) stood at USD 4.43 billion at the end of the third quarter of 1389.

1. PRGF-ECF MONETARY PROGRAM

Monetary Policy Framework was designed under extended credit facility of poverty eradication and growth facility (PRGF-ECF) of International Monetary Fund (IMF). For the year 1389, our key operational target (performance criterion) is reserve money (RM), while currency in circulation (CiC) is set as indicative target designed for achieving DAB's primary objective of domestic price stability. Changing operational target to reserve money will lead DAB toward achieving its primary objective of domestic price stability, while keeping a close eye on growing financial sector. DAB has made substantial improvements in the monetary and financial statistics to analyze and track the changes in financial sector.

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

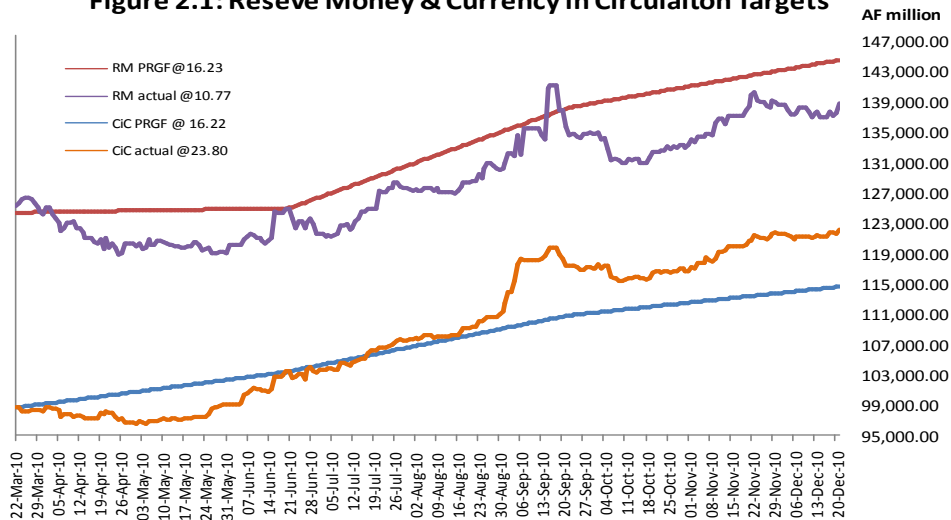
The right amount of reserve money conducive for supporting the domestic price stability is

determined using the quantity theory of money. Hence, the PRGF-ECF target is based on expected economic growth and expected inflation for the current year. For 1389, the target for reserve money has been revised from 22 percent to 21 percent, while the target for CiC growth was revised to 29.9 percent. By implementation of a sound monetary policy; actual reserve money stood at 10.77 percent whereas the target was at 16.23 percent for the third quarter of 1389.

Considering the reserve money as primary target, DAB has eased the pressure on the ceiling for currency in circulation in the eve of reducing the amount of FX auction in local markets which has escorted the actual CiC above the target. Thus, DAB will be in a position to accumulate its foreign reserve assets. On the other hand, DAB has increased the volume of capital notes auction for depository institutions.

For the year 1389, the CiC ceiling is 29.9 percent projected growth under the PRGF-ECF, while the ceiling for the reporting quarter was set at 16.22 percent. CiC, the major component of reserve money, had an increase of 23.80 percent in the quarter under review reaching AF 122,148.73 million breaching the ceiling of 16.22 percent projected growth. The increase in CiC was mainly because of the excess money demand.

Figure 2.1 provides detailed information on reserve money and currency in circulation growth until end of the third quarter of 1389.

Figure 2.1: Reseve Money & Currency in Circulaiton Targets

Source: Monetary Policy Department/DAB

2. MONETARY AGGREGATES

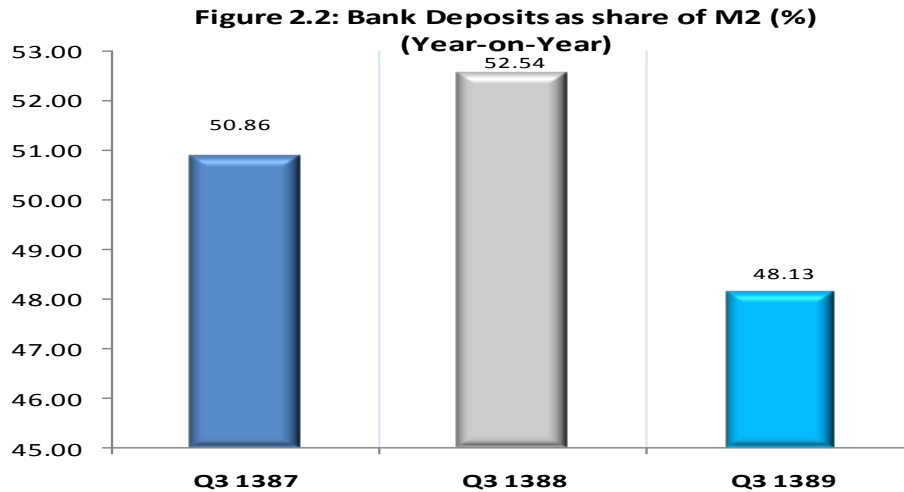
The monetary aggregates -- narrow money (M1) and broad money (M2) -- are compiled following the MFS methodology and definition. Narrow money (M1) grew by 25.02 percent on a year-on-year basis in the third quarter of 1389. The increase in M1 is attributed mainly to the increase in demand for local currency and confidence that people hold afghani and use it as medium of exchange, although the growth in demand deposit was sluggish compared to the third quarter of 1388.

On the other hand, the stock of broad money (M2) grew to AF 256,202 million; an overall growth of 26.69 percent (Y-o-Y), which is lower than 33 percent growth in the third quarter of

1388. M1 is the main contributor to the growth in M2 since M1 constitutes 90 percent of M2.

Quasi money or time deposits of commercial banks which is the other component of M2 grew by 58.59 percent. However, because quasi money roughly constitutes 7 percent of broad money, this significant growth was not reflected in M2. The year-on-year difference of afghani denominated time deposits for the third quarter of 1389 was AF 1,599 million and foreign currency denominated time deposits difference recorded AF 4,292 million.

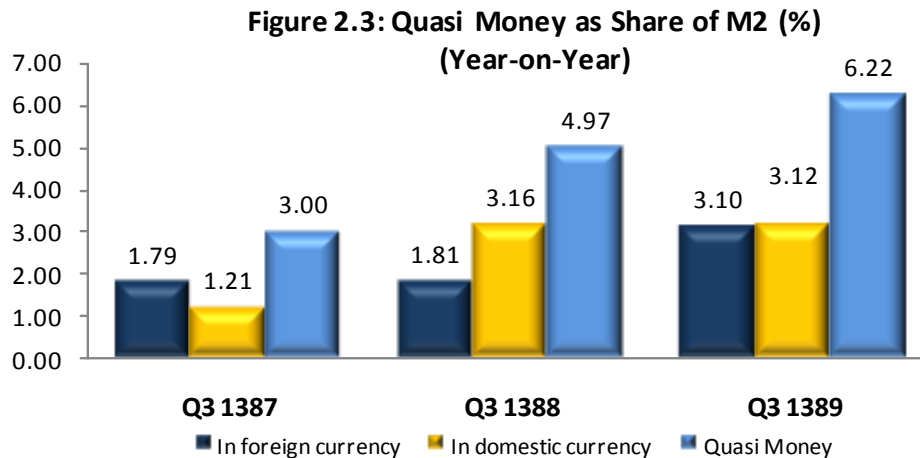
Meanwhile, bank deposits as share of broad money grew by 48.13 percent (Y-o-Y) in the third quarter of 1389 down from 52.54 percent in the third quarter of previous year.



Source: Monetary Survey Section, Monetary Policy Department DAB

Similarly quasi money as share of broad money grew to 6.22 percent in the quarter under review up from 4.97 percent in the third quarter of 1388. Afghani-denominated time deposits constitute 3.12 percent of broad money, while

foreign currency denominated deposits contributed 3.10 percent of M2. Table 2.1 summarizes monetary aggregates of Depository corporations.



Source: Monetary Survey Section, Monetary Policy Department DAB

Table 2.1: Monetary Aggregates, Third Quarter of 1389 (in million AF)

	1387	1388	Y-o-Y Changes	Difference	1389	Y-o-Y	Difference (Q3 1389 -Q3 1388)
	Q3	Q3			Q3	Change (Q3 1388 – Q3 1389)	
	Amount	Amount			Amount		
1- Net Foreign Assets	174,914	226,700	29.6%	51,786	258,905	14.21%	32,205
(a) Foreign Assets	192,573	247,473	28.5%	54,900	279,091	12.78%	31,617
DAB Foreign exchange reserves	161,734	205,068	26.8%	43,334	226,828	10.61%	21,760
Gold	33,368	34,641	3.8%	0.000	37,611	8.57%	0.000
Other	128,366	170,427	32.8%	42,061	189,217	11.03%	18,790
Other foreign assets	30,839	42,405	37.5%	11,566	52,262	23.25%	9,857
(b) Foreign Liabilities	17,659	20,774	17.6%	3,114	20,185	-2.83%	-588
2. Net Domestic Assets	-22,912	-24,469	6.8%	-1,557	-2,703	-88.95%	21,766
(a) Net Domestic Credit	12,950	10,380	-19.8%	-2,570	16,851	62.33%	6,470
Net Credit to Nonfinancial Public Sector	-36,259	-55,890	54.1%	-19,631	-67,211	20.26%	-11,321
Net Credit to Central Government	-40,983	-55,396	35.2%	-14,413	-67,630	22.08%	-12,234
Credit to Central Government	6,855	17,208	151.0%	10,353	15,993	-7.06%	-1,215
Liabilities to Central Government	47,838	72,604	51.8%	24,766	83,622	15.18%	11,018
Net Credit to State & Local Government	0	0	0.000	0.000	0.000	0.000	0.000
Net Credit to Public Nonfinancial Corporations	4,723	-494	-110.5%	-5,217	419	-184.71%	913
Credit to Private Sector	48,354	64,742	33.9%	16,388	84,061.6	29.84%	19,319
Net Credit to Other Financial Corporations	855	1,528	78.7%	673	0.00	-100.00%	-1,528
(b) Capital Accounts	43,476	61,644	41.8%	18,167	11,245	-81.76%	-50,399
(c) Other Items Net	7,614	26,795	251.9%	19,181	-8,309	-131.01%	-35,103
3- Broad Money(M2)	152,002	202,231	33.0%	50,229	256,202	26.69%	53,971
Narrow Money(M1)	147,449	192,177	30.3%	44,728	240,257	25.02%	48,080
CiC (Currency outside depository corporations)	70,143	85,922	22.5%	15,779	116,953	36.12%	31,031
Demand Deposits	77,307	106,255	37.4%	28,948	123,304	16.05%	17,049
Other Deposits (Quasi Money)	4,553	10,054	120.8%	5,502	15,945	58.59%	5,891
In Afghani	1,835	6,393	248.3%	4,557	7,992	25.01%	1,599
In Foreign currency	2,717	3,662	34.7%	944	7,954	117.21%	4,292
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

3. CAPITAL MARKETS AND LIQUIDITY CONDITIONS

3.1 Capital Note Auctions

Capital notes are short-term afghani-denominated securities sold by Da Afghanistan Bank (DAB) at weekly auctions. Capital notes are discount securities that 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 day (1 month), and 182 day (six months). Only licensed commercial banks and money changers can participate in the auctions. Private individuals seeking to purchase capital notes can do so through their commercial bank.

The amount to be auctioned is announced electronically every Monday to the banks. The auction is a multiple price auction with each bidder paying the price they bid. The auction is

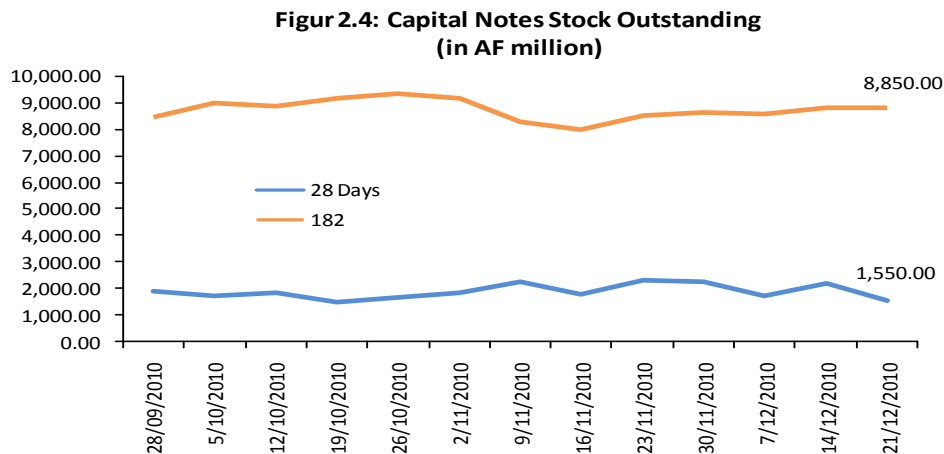
held on Tuesdays with settlement T+1 except when it coincides with public holidays. In the auction, investors bid to purchase desired values of capital notes at different discount prices. Bids must be submitted before 10:00 am on the auction day.

The 28 day stock outstanding had an initial balance of AF 2.5 billion, the highest amount for the third quarter of 1389, before it dropped by AF 900 million at the end of quarter under review. The quarter ended with an outstanding amount of AF 1.6 billion for 28 day notes. On the other hand, the 182 day CNs outstanding amount noticed an increase in its balances. The quarter began with an amount of AF 8.4 billion and ended with AF 8.9 billion, with an increase

of AF 400 million only. The outstanding amount for the end of last quarter was AF 2.4 billion for 28 day notes and AF 8.5 billion for 182 days notes.

The outstanding amount gap (the difference between 28 day notes stock and 182 day notes stock) between these two notes widened from AF 5.6 billion to AF 6.4 billion on average basis during the quarter under review. The change was due to increase in 182 day balances and decrease in 28 day notes balances.

The total outstanding stock of both maturities stood at AF 17.7 billion at the end of the reporting period. This figure was AF 10.9 billion at the end of preceding quarter (Figure 2.4).



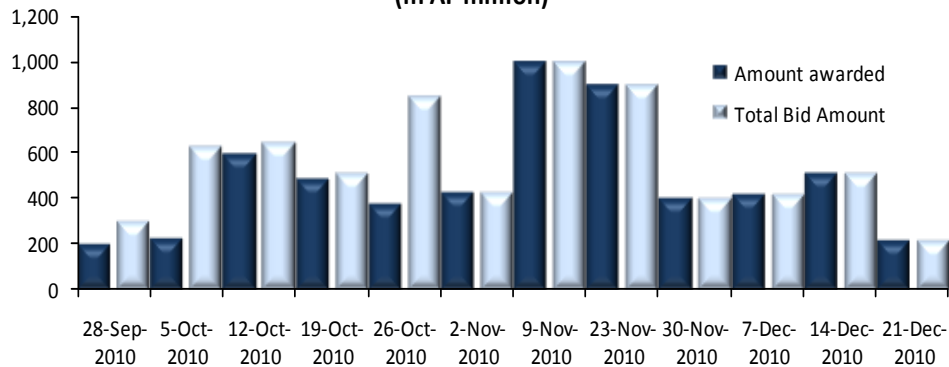
Source: Market Operations Department, DAB.

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 day notes stood at AF 568 million, while the amount awarded was AF 481 million for a cover ratio of 1.18. The bid amount for 182 day note was AF 617 million, while the amount awarded was AF 468 million for a cover

ratio of 1.32. These figures were AF 893 million, AF 723 million, cover ratio of 1.24 and AF 410 million, AF 327 million and cover ratio of 1.25 for 28 day and 182 day notes respectively.

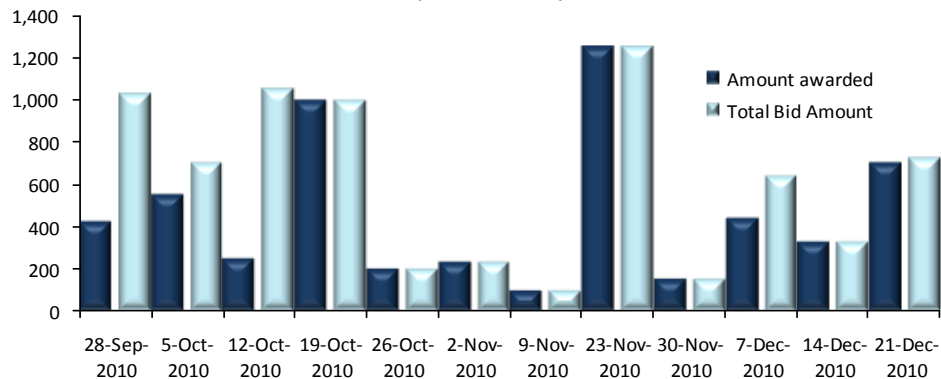
The cover ratio above 1.00 is clear indication of higher demand for both of these notes (Figure 2.5).

**Figure 2.5: 28 Days Capital Notes, Demand and Awarded Amount
(in AF million)**



Source: Market Operations Department, DAB

**Figure 2.6: 182 Day Capital Notes Demand and Awarded Amount
(in AF million)**



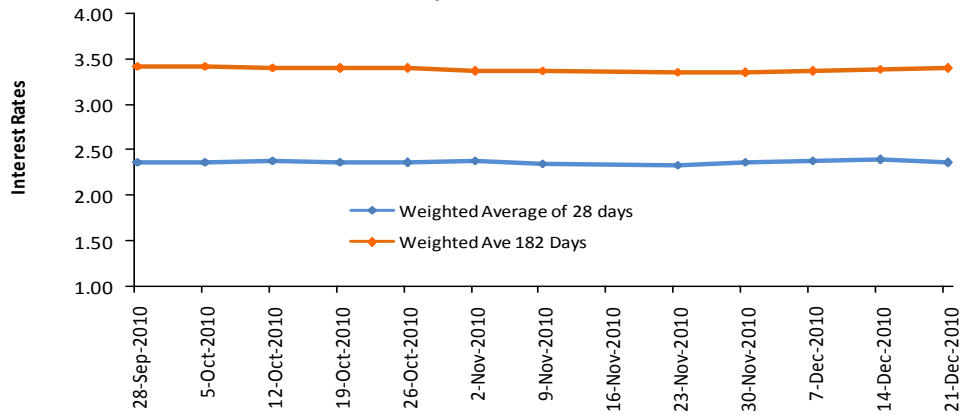
Source: Market Operations Department, DAB

The interest rates for both maturities followed almost an even shape with little fluctuations. The 28 day notes interest rates during the quarter under review ranged between 2.33 percent and 2.39 percent. The quarter ended with weighted average interest rate of 2.36 percent. On the other hand, the weighted average interest rates for 182 day CNs noticed a decline. The quarter under review began with

an interest rate of 3.43 percent and ended with 3.40 percent representing a decline of 0.03 bps. The weighted averages interest rates for preceding quarter were 2.40 percent for 28 day and 3.43 percent for 182 day notes.

Throughout the quarter, the spread between the rates of these securities remained unchanged at 1.02 percent compared to last quarter (See Figure1.3).

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



Source: Market Operations Department, DAB

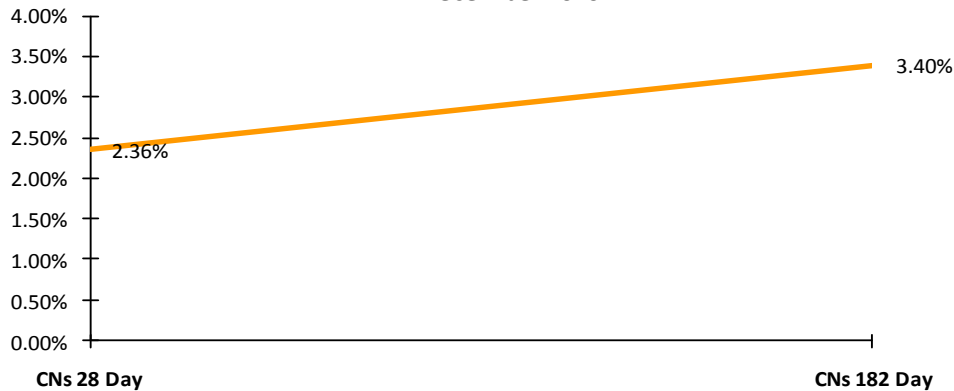
3.2 Term Structure of Interest Rates

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

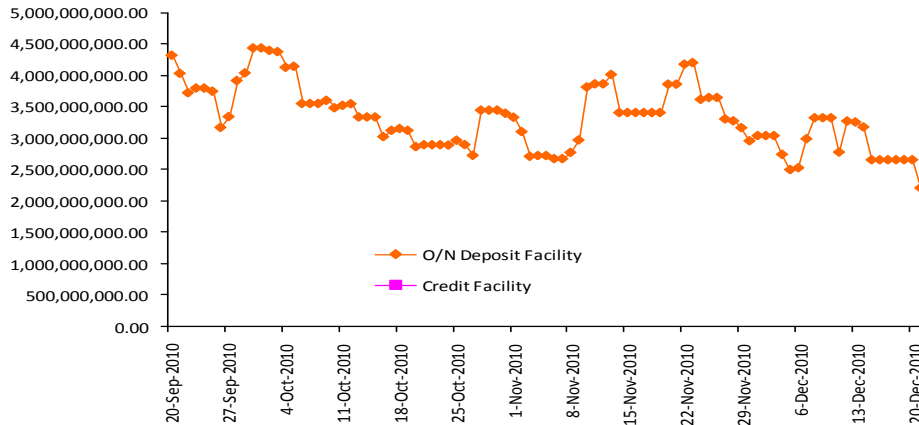
notes is the annualized percentage increase in the value of the CN.

The yield curve as of December 21 2010 is positive.

Figure 2.8: Term Structure of Interest Rates Yield Curve 21 December 2010



Source: Market Operations Department, DAB

Figur 2.9: Overnight Deposit Balances (amount in AF)

Source: Market Operations Department, DAB

3.3 Required and Excess Reserves

Overnight standing facilities were first introduced at the beginning of 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 100 basis points below the last 28 day CNs auction cut-off rate.

The outstanding amount for Deposit Facility Account noticed a gradual decrease in the balances throughout the period under review. It decreased from AF 4.3 billion to AF 2.2 billion throughout the period under review. The decrease in deposit facility was due to increase in Capital Notes outstanding amount.

The quarter ended with stock outstanding amounting of AF 2.2 billion. This figure was AF 3.7 Billion in the preceding quarter.

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

During the quarter under review no bank benefited from this Facility.

During the quarter, required reserves averaged to AF 458 million. This figure was AF 665 million during preceding quarter per bank.

Required reserves were remunerated at 100 basis points below the cut off rate of 28 days capital notes auction or equal to the deposit facility rate.

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

Date	Auction Amount	Amount awarded	Total Bid Amount	Winning Bids	Total bids	Cut off Rate
28-Sep-2010	200	200	300	3	4	2.42%
5-Oct-2010	200	230	630	2	4	2.41%
12-Oct-2010	200	600	650	3	3	2.40%
19-Oct-2010	200	485	510	4	4	2.40%
26-Oct-2010	200	375	850	4	6	2.39%
2-Nov-2010	200	430	430	3	3	2.39%
9-Nov-2010	200	1,000	1,000	4	4	2.39%
23-Nov-2010	200	900	900	5	5	2.38%
30-Nov-2010	200	400	400	3	3	2.38%
7-Dec-2010	200	420	420	3	3	2.40%
14-Dec-2010	200	510	510	3	3	2.40%
21-Dec-2010	200	220	220	3	3	2.40%

Source: Market Operations Department, DAB

Table 2.3: Auction of 182 Day Capital Notes (in million AF)

Date	Auction Amount	Amount awarded	Total Bid Amount	Winning Bids	Total bids	Cut off Rate
28-Sep-2010	100	420	1,030	2	3	3.44%
5-Oct-2010	100	550	700	4	4	3.44%
12-Oct-2010	100	250	1,050	5	1	3.42%
19-Oct-2010	100	995	995	4	4	3.42%
26-Oct-2010	100	200	200	1	1	3.40%
2-Nov-2010	100	230	230	3	3	3.42%
9-Nov-2010	100	100	100	1	1	3.39%
23-Nov-2010	100	1,250	1,250	3	3	3.39%
30-Nov-2010	100	150	150	2	2	3.40%
7-Dec-2010	100	440	640	3	4	3.40%
14-Dec-2010	100	330	330	3	4	3.40%
21-Dec-2010	100	700	725	3	3	0.034

Source: Market Operations Department, DAB

4. FOREIGN EXCHANGE MARKET

4.1 Foreign Exchange Rates

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

In order to control the supply of money, DAB is targeting reserve money through a weekly

capital notes auction and weekly foreign exchange auction.

Da Afghanistan Bank does not target the nominal exchange rate of domestic currency against foreign currencies (USD); however, it is important to monitor the exchange rate for excessive fluctuations which will impact the economic indicators negatively that coerces Central Banks to intervene in local market via managed floating exchange rate regime.

The daily historic review of the average exchange rate of AF against USD for third quarter of 1389 is shown in Figure 2.10. In the third quarter of 1389 the fluctuation in nominal exchange rate of afghani against US dollar

remained flat to some extent appreciated to 45.03 at the beginning of the quarter though. The nominal exchange rate of afghani against US dollar reached AF 45.27 per USD at the end of the quarter.

Figure 2.10: Daily Average Nominal Exchange Rate AF/USD



Source: Monetary Survey Section, Monetary Policy Department DAB

The comparison of historic review of the daily average exchange rate of afghani against some

major foreign currencies for the quarter under review is shown in Figures 2.11 and 2.12.

Figure 2.11: Daily Exchange Rate of Afghani Against Euro and GBP

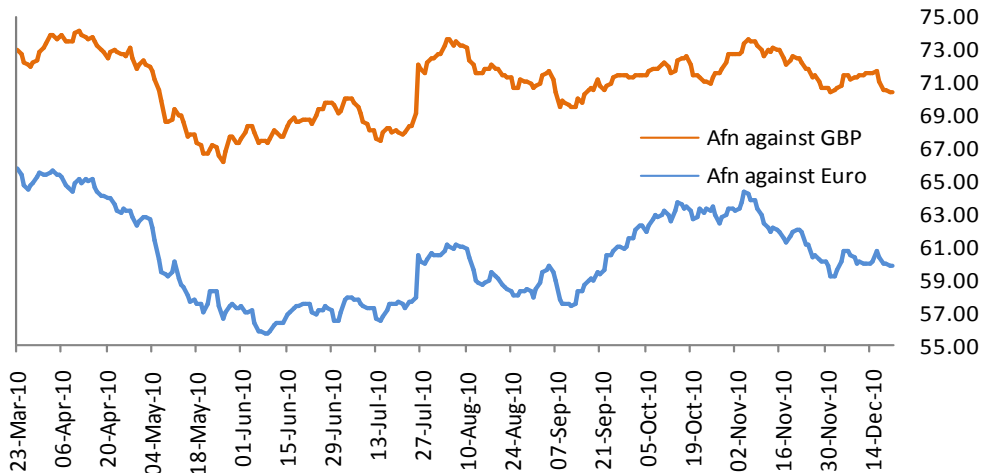
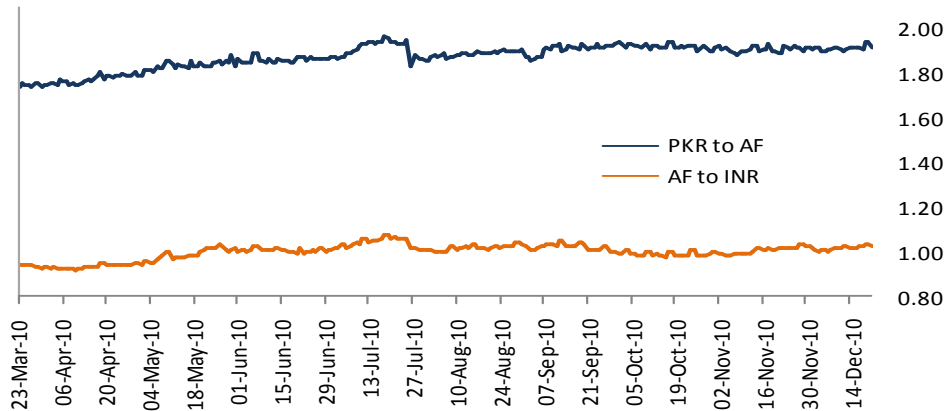


Figure 2.12: Daily Exchange Rates: PKR to AF and INR to AF



Source: Monetary Survey Section, Monetary Policy Department DAB

4.2 Net International Reserves

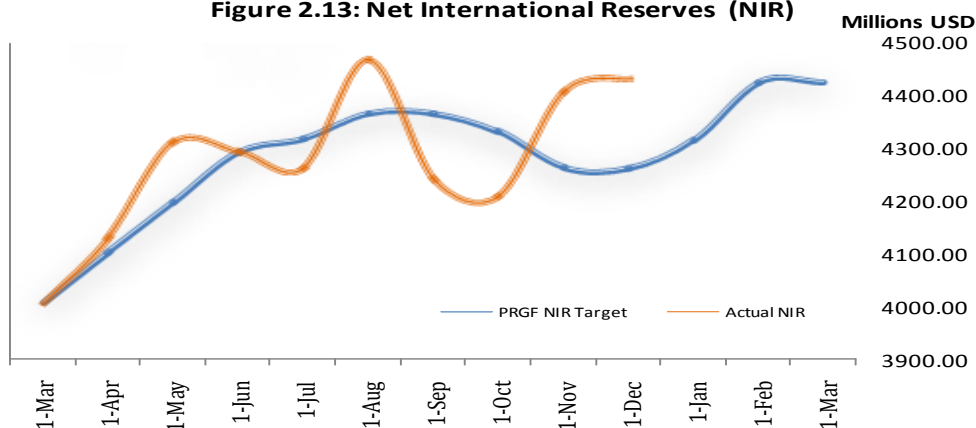
Afghanistan’s net international reserves (NIR) recorded USD 4.43 billion at the end of the third quarter which is higher than the target of USD 4.26 billion for the third quarter of 1389. The increase in NIR was attributed to both, allocation of new SDR by IMF in September for providing member countries with liquidity, influx of US dollars along with sound decision making of the investment committee members.

Accumulation of net international reserves builds up confidence on domestic currency which stabilizes the local currency indirectly.

The revised IMF target predicts USD 417 million accumulations in net international reserves by the end of 1389. Further the gross international reserves stood at USD 4.80 billion in the quarter under review which includes foreign liabilities.

The following graph gives detailed picture on NIR for the third quarter of 1389.

Figure 2.13: Net International Reserves (NIR)



Source: Monetary Survey Section, Monetary Policy Department DAB

4.3 Foreign Exchange Auction

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

Since currency in circulation is not the indicative target, DAB has eased the pressure on foreign exchange auction which has resulted actual currency in circulation above the target by a significant margin.

The size of foreign exchange auction is determined by a liquidity forecasting

framework, which takes into account the money demand on one hand and the currency growth ceiling agreed by the DAB with the IMF under the ECF on the other.

DAB intervention reached a total of USD 1,150.43 million at the end of the quarter under review.

Table 2.4 summarizes the result of DAB foreign exchange auctions during the period of March 23 to December 19, 2010.

2.4: DAB Foreign Exchange Auction, Third Quarter of 1389 (in million USD)

Auction Date	No of Bidders	High Price	Low Price	Cut off Price	Market Ex Rate	Amount Announced	Amount Awarded	No of Awarded Bidders	Total amount demanded
23-Mar-10	41	48.250	48.000	48.120	48.270	25.00	18.40	31	23.90
27-Mar-10	54	48.362	48.100	48.320	48.340	25.00	23.85	28	37.60
30-Mar-10	50	48.430	48.210	48.400	48.450	25.00	29.95	27	37.90
03-Apr-10	52	48.310	48.050	48.270	48.340	25.00	26.05	25	40.70
06-Apr-10	53	48.220	48.020	48.170	48.240	25.00	20.80	29	29.95
10-Apr-10	47	48.090	47.700	48.050	48.100	25.00	21.85	25	29.95
13-Apr-10	42	47.725	47.400	47.680	47.760	25.00	23.65	27	27.25
17-Apr-10	47	47.350	47.110	47.260	47.370	25.00	21.50	34	24.05
20-Apr-10	48	47.320	47.000	47.260	47.360	25.00	24.85	33	31.60
24-Apr-10	39	47.130	46.950	47.070	47.170	25.00	21.50	25	25.05
27-Apr-10	45	47.040	46.500	47.020	47.130	25.00	15.35	17	20.70
01-May-10	54	47.051	46.800	47.020	47.090	25.00	23.35	31	29.65
04-May-10	42	46.850	46.500	46.740	46.790	25.00	20.95	29	23.25
08-May-10	44	46.220	46.000	46.170	46.260	25.00	13.00	25	17.60
11-May-10	46	46.330	46.000	46.300	46.350	25.00	23.15	26	28.00
15-May-10	51	46.500	46.000	46.470	46.550	25.00	17.60	26	25.70
18-May-10	46	46.405	46.212	46.380	46.440	25.00	15.45	24	19.60
22-May-10	38	46.190	46.020	46.140	46.250	25.00	15.00	26	20.00
25-May-10	30	45.950	45.710	45.940	46.000	25.00	7.15	7	20.20
29-May-10	34	46.500	46.150	46.480	46.480	20.00	11.10	13	19.60
01-Jun-10	26	46.500	46.100	46.420	46.500	20.00	9.95	15	11.20
05-Jun-10	32	46.460	46.250	46.430	46.480	20.00	14.30	20	17.30
08-Jun-10	42	46.481	46.280	46.460	46.490	20.00	13.05	23	17.90
12-Jun-10	26	46.380	46.100	46.340	46.390	20.00	11.60	18	19.50
15-Jun-10	26	46.310	46.050	46.270	46.340	20.00	8.35	15	13.10
19-Jun-10	29	46.291	46.010	46.050	46.340	20.00	12.25	28	13.00
22-Jun-10	27	46.210	46.000	46.250	46.060	20.00	16.95	24	17.70
26-Jun-10	37	46.180	46.000	46.200	46.110	20.00	17.40	24	21.00
29-Jun-10	32	46.070	45.880	46.140	46.010	20.00	15.20	28	16.20
03-Jul-10	27	45.930	45.700	45.980	45.880	20.00	9.80	16	13.20

06-Jul-10	25	45.660	45.000	45.680	45.600	20.00	7.60	14	14.50
10-Jul-10	23	45.080	44.750	45.110	45.030	20.00	7.15	16	9.50
13-Jul-10	25	44.610	44.030	44.560	44.550	20.00	3.20	8	9.50
17-Jul-10	24	44.330	44.010	44.330	44.200	10.00	6.95	21	7.50
24-Jul-10	32	44.700	44.600	44.700	44.510	15.00	10.75	25	12.70
27-Jul-10	33	45.950	45.000	46.020	45.800	15.00	11.30	28	13.50
31-Jul-10	28	46.240	46.000	46.250	46.200	15.00	14.60	21	16.60
03-Aug-10	23	46.140	46.030	46.150	46.100	15.00	15.40	23	17.70
07-Aug-10	24	45.750	45.150	45.810	45.600	20.00	8.75	19	10.10
10-Aug-10	31	45.720	45.200	45.760	45.650	20.00	11.35	21	13.40
14-Aug-10	28	45.780	45.600	45.850	45.750	15.00	13.15	17	17.40
17-Aug-10	30	45.990	45.640	46.060	45.950	15.00	14.55	17	18.80
22-Jun-10	27	46.210	46.000	46.250	46.060	20.00	16.95	24	17.70
26-Jun-10	37	46.180	46.000	46.200	46.110	20.00	17.40	24	21.00
29-Jun-10	32	46.070	45.880	46.140	46.010	20.00	15.20	28	16.20
03-Jul-10	25	45.930	45.700	45.980	45.880	20.00	9.80	16	13.20
21-Aug-10	29	45.850	45.630	45.870	45.770	15.00	12.45	21	15.80
24-Aug-10	28	45.680	45.580	45.710	45.640	15.00	14.00	21	16.00
28-Aug-10	28	45.660	45.400	45.670	45.610	15.00	17.40	24	18.50
31-Aug-10	33	45.480	45.160	45.510	45.460	15.00	13.60	17	18.80
04-Sep-10	23	58.400	54.500	58.780	56.000	51.42	10.54	20	5.30
07-Sep-10	59	58.150	56.200	58.190	57.000	38.70	49.79	53	41.90
14-Sep-10	54	57.300	56.250	57.440	57.000	51.34	26.89	25	34.00
21-Sep-10	63	58.800	57.600	58.720	58.530	39.23	41.52	31	46.70
25-Sep-10	57	60.300	59.100	60.300	60.200	20.13	24.56	23	34.30
28-Sep-10	48	60.460	59.500	6.390	6.490	20.21	20.47	15	34.20
02-Oct-10	43	45.050	44.750	45.050	45.010	20.00	23.65	22	32.80
05-Oct-10	46	45.010	44.810	45.050	45.000	20.00	19.05	20	30.00
09-Oct-10	32	45.000	44.600	45.040	44.981	20.00	3.25	30	25.50
12-Oct-10	34	45.070	44.750	45.090	45.050	20.00	9.30	11	22.70
16-Oct-10	39	45.220	45.000	45.210	45.191	15.00	9.75	15	23.00
19-Oct-10	37	45.220	45.000	45.180	45.195	15.00	8.50	10	22.80
23-Oct-10	30	45.180	45.020	45.200	45.150	15.00	11.00	17	17.30
26-Oct-10	24	45.120	44.810	45.150	45.100	15.00	8.10	10	15.30
30-Oct-10	23	45.230	45.100	45.230	45.223	15.00	3.70	4	18.00
02-Nov-10	20	45.260	45.010	45.230	45.224	15.00	7.15	11	10.80
06-Nov-10	27	45.350	45.200	45.350	45.311	15.00	12.90	18	15.70
09-Nov-10	25	45.180	45.000	45.210	45.100	15.00	8.85	19	10.70
13-Nov-10	27	45.180	45.000	45.230	45.070	15.00	11.30	21	12.90
20-Nov-10	28	45.140	45.020	45.130	45.071	15.00	10.15	21	12.00
23-Nov-10	25	45.040	44.850	45.060	45.000	15.00	10.65	20	13.20
27-Nov-10	39	45.175	45.000	45.210	45.151	15.00	17.05	22	22.70
30-Nov-10	30	45.180	45.050	45.180	45.100	15.00	15.35	25	16.20
04-Dec-10	34	45.172	45.010	45.170	45.120	15.00	18.05	31	19.00
07-Dec-10	33	45.173	45.010	45.180	45.130	15.00	17.90	25	20.90
12-Dec-10	33	45.121	44.910	45.170	45.060	30.00	20.65	27	22.90
19-Dec-10	39	45.120	45.020	45.190	45.090	35.00	25.30	21	33.80
Total FX announced & awarded						1,546.03	1,150.93		1,537.37

Source: MOD & MPD, DAB



The Inflation Trend and Outlook

3

3

THE INFLATION TRENDS AND OUTLOOK

Headline inflation increased rapidly in the quarter under review. The accelerating trend in headline inflation that began in the first quarter of 1389 continued throughout the second quarter of the year. By all measures, inflation was increasing in the first six months of the year. The situation was the same, whether the Kabul CPI or National CPI is used to measure price changes.

Kabul headline CPI, measured on a year-on-year basis increased sharply by 12.9 percent in the third quarter of 1389 compared to the same period of last year when there was actual deflation of 13.2 percent. This sharp turnaround from the previous year was concentrated, both in the food and non-food components. In contrast to 1388, when prices were declining in most food components, 1389 saw increase in almost all components. For example, bread and cereals increased to 12.6 percent from -35.9 percent in the same quarter last year, meat increased to 24.2 percent from -1.7 percent, oil and fats increased to 28.5 percent from -5.5 percent, vegetables rose to 29.7 percent from 1.2 percent, rents rose to 27.5 percent from 4.3 percent, construction materials rose to 14.6 percent from -11.5 percent, and fuel and electricity rose to 6.2 percent from 0.7 percent.

The main factor responsible for the increase in headline inflation in the current quarter was a dramatic increase in the prices of bread and cereals. Bread and cereals prices had fallen in the same quarter of last year, so the sharp increase in the current quarter was surprising. Other factors contributing to the surge in prices in the second quarter of 1389 were dramatic increase in prices of meat, oils & fats, vegetables, rents, construction materials, fuel and electricity, and transportation.

The situation of core inflation changed at the beginning of the third quarter of 1389. When the effects of significant price changes in bread and cereals, oil and fats, and transportation are excluded from the figures, the year-on-year rate of core inflation in the third quarter of 1389 recorded 12.55 percent increase at the end of the third quarter of 1389 compared to 1.5 percent at the same period last year which is a matter of concern for policy making side.

When core inflation is measured by the 28 percent trimmed mean, the same pattern appears. Core inflation, measured by 28% TM increased by 9 percent at the end of the third quarter of 1389 compared to 0.8 percent in the same period last year.

The pattern observed nationwide was similar to the pattern observed in Kabul, with a few exceptions. Headline inflation, which had been negative in the third quarter of 1388, became strongly positive (9.8 percent) in the quarter under review.

1. INFLATION IN AFGHANISTAN HITS DOUBLE DIGITS AGAIN

1.1 Current Quarter Changes in Kabul Headline Inflation

To see more closely what is happening to the inflation in the most recent time period, it is necessary to compare the quarter-on-quarter changes in the CPI and its various components. The dramatic surge in Kabul headline inflation in which began in the first quarter of 1389 continued throughout the second quarter of the year. The headline inflation as measured by (Q-o-Q) changes eased in the third quarter of 1389 recording 4.7 percent inflation rate, down from 5.9 percent in the previous quarter.

The main factor responsible for the decline in headline inflation is thought to be a sharp decline in bread and cereals sub-index. Prices of bread and cereals which consists 28 percent of total weight of the CPI basket dropped in the third quarter of 1389 by 0.5 percent, in contrast to 9.9 percent increase in the previous quarter. This favorable effect, however, was offset by a huge increase in inflation rate on oil and fats sub-index – up by 19.9 percent from 2.2 percent the previous quarter. Fuel and electricity also showed a substantial increase posting 9.4 percent inflation rate in the quarter under review compared to 2.9 percent in the second quarter of the year.

Another favorable change in the quarter under review was a decline in the prices of rent sub-index. Rent price index fell to 7.7 percent (q-o-q) in the third month of 1389 down from 9.3 percent in the previous quarter.

Table 3.1: Quarter-on-Quarter Changes in Kabul Headline CPI

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

	1387				1388				1389		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Headline	13.1	8.0	-4.3	-11.6	-1.5	2.1	-2.3	-3.5	5.4	5.9	4.7
Food and Beverages	19.1	8.1	-6.6	-16.2	-2.5	2.3	-5.1	-5.0	7.9	7.8	4.7
Bread and Cereal	33.3	8.6	-8.6	-27.1	-3.5	-0.3	-8.7	-11.8	16.6	9.9	-0.5
Milk and Cheese	-1.8	8.0	0.8	2.7	-6.3	-0.1	1.5	-1.2	-2.0	3.9	4.9
Oil and Fat	1.8	4.5	16.2	-3.6	-2.2	-0.1	0.5	1.7	3.0	2.2	19.9
Non – Food	2.5	7.7	0.5	-3.2	0.2	1.7	2.3	-1.1	1.9	3.1	4.7
Housing	0.6	11.1	1.0	-5.0	0.5	1.4	3.7	-1.1	2.8	6.0	7.3
Rents	1.1	6.9	0.2	0.7	0.6	2.2	0.7	2.7	5.4	9.3	7.7
Fuel and Electricity	-0.1	13.9	3.3	-9.3	0.9	2.2	7.6	-5.5	-0.2	2.9	9.4
Transportation	18.8	0.3	-2.4	-12.8	0.7	2.7	8.3	-5.9	9.4	-1.0	-1.6

Source : Central Statistics Office and DAB Staff calculations

1.2 Current Quarter Changes in National Headline Inflation

In contrast to the situation in Kabul CPI, the nationwide headline CPI observed slight upward trend in the third quarter of 1389. On a Quarter-on-Quarter basis, national headline CPI rose to 4.6 percent in the quarter under review up from 4.3 percent in the previous quarter. The pattern of changes in the rate of inflation across the components, however, was almost similar to what was experienced in Kabul. Oil and fats increased significantly in the third quarter of 1389 representing 15.4 percent increase compared to 4.4 percent in the previous quarter. vegetables increased sharply to 10.9 percent in the quarter under review up from 0.9 percent in the previous quarter as a result of

devastating flood in Pakistan as well as the recent flood in most agrarian parts of the country led to a shortage in the supply of agricultural products, especially vegetables. Fuel and electricity recorded 13.4 percent increase compared to 4.6 percent in the previous quarter. Rents increased to 5.4 percent up from 2.3 percent in the previous quarter. Housing price-index increased to 7.1 percent in the quarter under review as a result of increase both in rents and fuel & electricity price-indexes.

Other components that posted decrease in the quarter under review were bread & cereals (2.2 percent), meat (4.4 percent), sugar and sweets (0.6 percent). These favorable changes acted as a partial offset to the overall increase in headline inflation.

Table 3.2: Quarter-on-Quarter Changes in National CPI
(Percent Changes; Quarter-on-Quarter)
Consumer Price Index (March 2004=100)

	1387				1388				1389		
	Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Headline	18.2	5.2	-4.6	-11.6	-3.7	1.4	-0.1	-2.1	2.8	4.3	4.6
Food and Beverages	26.7	5.0	-7.0	-15.8	-5.7	1.3	-2.5	-2.4	3.3	5.7	4.2
Bread and Cereal	44.7	5.3	-10.4	-24.5	-8.6	-0.8	-4.8	-6.2	5.9	8.0	2.2
Milk and Cheese	3.1	4.4	0.8	0.2	-2.9	1.0	-0.7	-0.5	-0.3	2.2	2.2
Oil and Fat	6.4	1.5	-14.6	-12.0	-0.5	-2.7	1.9	2.7	1.1	4.4	15.4
Non – Food	2.8	5.6	0.7	-2.6	-0.1	1.7	3.9	-1.7	2.0	2.2	5.4
Housing	0.7	8.5	-0.5	-4.6	0.2	3.1	5.9	-3.1	2.1	3.5	8.7
Rents	-0.3	3.2	1.3	-1.0	0.1	5.6	0.4	0.0	5.5	2.3	5.4
Fuel and Electricity	0.2	14.2	-1.2	-8.5	0.6	2.4	12.5	-6.9	-1.0	4.6	13.4
Transportation	12.6	4.6	-2.0	-14.5	0.1	-0.7	10.3	-4.9	7.6	0.4	-0.4

Source: Central Statistics Office and DAB staff calculations

1.3 Changes from Same Quarter, Last Year in Kabul Headline Inflation

It is important to compare the rate of inflation in the current quarter (third quarter of 1389) to the rate of inflation in the same quarter of the previous year (third quarter of 1388). The main reason for this comparison is to eliminate any possible effect of seasonality.

By this measure, the headline rate of inflation in Kabul, increased sharply to 12.85 percent (Y-o-Y) in the third quarter of 1389 compared to the same quarter last year, when there was actual deflation. This sharp turnaround from the previous year was concentrated, both in the food and non-food components. In contrast to 1388, when prices were declining in most food components, 1389 saw increase in almost all components. For example, bread and cereals increased to 12.6 percent from -35.9 percent in the same quarter last year, meat increased to 24.2 percent from -1.7 percent, oil and fats increased to 28.5 percent from -5.5 percent, vegetables rose to 29.7 percent from 1.2 percent, rents rose to 27.5 percent from 4.3 percent, construction materials rose to 14.6 percent from -11.5 percent, and fuel and electricity rose to 6.2 percent from 0.7 percent.

To understand the main factors responsible for an increase of 12.85 percent in the rate of inflation in the quarter under review, it is necessary to look at the individual components of the CPI. First, we will analyze those components that showed the largest unfavorable changes in inflation from the previous year.

Food sub-index Accounts for 61.3 Percent of the CPI Basket: This price-index increased

dramatically in the quarter under review. Their prices, which had been fallen sharply in the same quarter last year, turned around and rose sharply. The (Y-o-Y) changes in food prices increased to 15.6 percent in the quarter under review, in contrast to the same quarter of previous year, when there was actual deflation of 20.7 percent. Among the other factors behind the increase in food prices, bad climate situation which caused vast destructive flood in Pakistan as well as in Afghanistan impacted the agriculture product negatively. The next reason could be the increase in aggregate demand in the international markets due to improvements in the global recession. The main components responsible for the increase in food price-index are as follow:

First, the Bread and Cereals Sub-index Accounts for 28 Percent of the CPI Basket: This price-index rose dramatically to 12.55 percent in the quarter under review compared to the same quarter last year, when there was actual deflation of 36 percent which in turn pulled the headline inflation up.

Second, the Meat price-index Accounts for 6 Percent of the CPI Basket: This sub-index increased sharply to 24.2 percent, up from actual deflation of 1.7 percent in the same quarter last year as a result of destructive flood in Pakistan combined with rainfalls and flood inside Afghanistan which destroyed thousands of livestock. Another reason behind the increase in the prices of meat could be the rapid rising in the prices of cereal grains.

Third, the Oil and Fats price-index Accounts for 5.3 percent of the CPI Basket: This price-index displayed a significant increase in the quarter under review. Prices of oil and fats increased by

28.5 percent (Y-o-Y) at the end of the quarter under review, a sharp turnaround from the same quarter a year ago, where there was actual deflation of 5.5 percent.

Fourth, the Vegetables price-index Accounts for 4.9 percent of the CPI Basket: The same factors affected the prices of bread and cereals driven the prices of vegetables in the quarter under review. Prices of vegetables increased sharply to 29.7 percent from 1.2 percent in the same quarter last year.

On the other hand, prices of sugar and sweets posted a decline of 13.2 percent in the quarter under review down from 20.8 percent in the same quarter last year which partially offset the increase in the rate of inflation.

Non-food sub-index Accounts for 38.7 Percent of the CPI Basket: This sub-index increased sharply to 8.8 percent (Y-o-Y) in the quarter under review compared to 0.9 percent in the same quarter of last year. The increase in non-food sub-index was attributed to the increase in the prices of rents, construction materials, fuel and electricity, and miscellaneous sub-indexes. The main components responsible for the increase in non-food price-index are as follow:

First, the Rents sub-index Accounts for 7.1 percent of the CPI Basket: This price-index is one of the most important components of the housing sub-index. Rents prices rose dramatically to 27.5 percent in the quarter under review, a sharp turnaround from 4.3 percent in the same quarter last year. The accelerating rate of inflation in rents is thought to be the expanded population in Kabul as a

result of internal displacements from the outlying areas, as well as growing number of returning migrants from abroad, mainly from Pakistan and Iran.

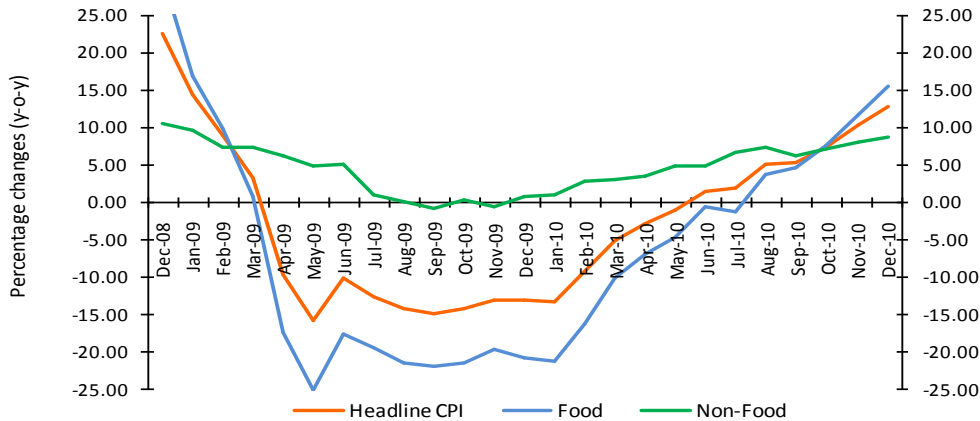
Second, the Construction materials sub-index Accounts for 3.2 percent of the CPI Basket: This price-index rose sharply to 14.6 percent (Y-o-Y) in the current quarter, a sharp turnaround from a deflation rate of 11.5 percent in the same quarter last year, as a result of boom in construction of new residential and commercial buildings in Kabul. A high demand for housing caused rental prices go up which in turn encourages construction activities in the economy.

Third, the Fuel and electricity sub-index Accounts for 6.8 percent of the CPI Basket: This price-index rose to 6.2 percent (Y-o-Y) in the current quarter compared to 0.7 percent inflation rate recorded in the same quarter last year.

Fourth, the Transportation sub-index Accounts for 2.3 percent of the CPI Basket: This prices index was highly volatile from the beginning of 1389 as a result of changes in the prices of oil in the international markets. This price index increased slightly at the end of the quarter under review recording an inflation rate of 0.2 percent compared to the same quarter of last year where there was actual deflation 2.4 percent. The increase in transportation was mainly attributed to the increasing demand for oil in the international markets.

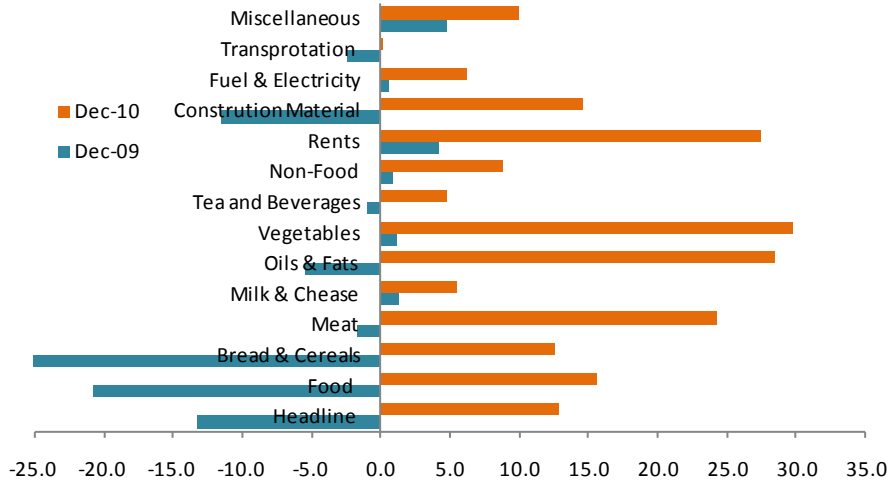
Breakdown of Kabul headline inflation is shown in Table 3.3 and illustrated in Figures 3.1 and 3.2

Figure 3.1: Headline inflation, Kabul CPI



Source: Central Statistics Office and DAB staff calculations.

Figure 3.2: Contribution to Kabul CPI Inflation (y-o-y)



Source: Central Statistics Office and DAB staff calculations.

The situation of core inflation changed at the beginning of the third quarter of 1389. When the effects of significant price changes in bread and cereals, oil and fats, and transportation are excluded from the figures, the year-on-year rate of core inflation in the third quarter of 1389 recorded 12.55 percent increase at the end of the third quarter of 1389 compared to 1.5

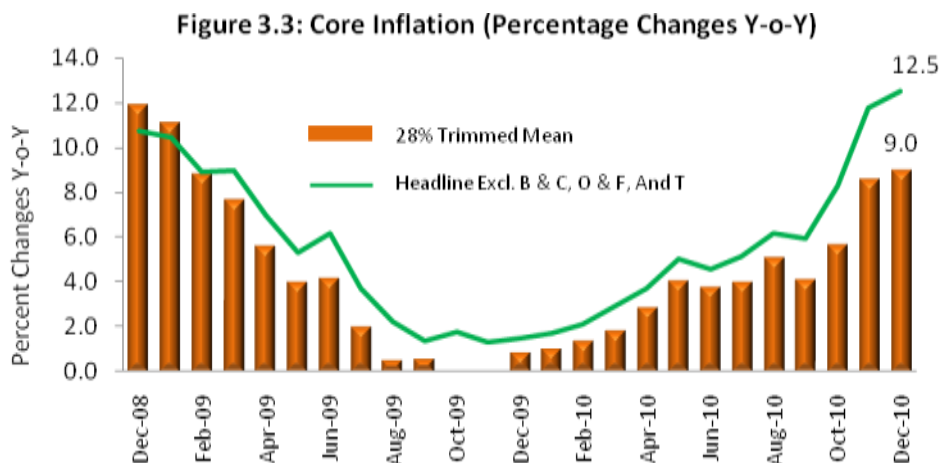
percent at the same period last year which is a matter of concern for policy making side.

When core inflation is measured by the 28 percent trimmed mean, the same pattern appears. Core inflation, measured by 28% TM increased by 9 percent at the end of the third quarter of 1389 compared to 0.8 percent in the same period last year.

Table 3.3: Breakdown of Kabul Headline CPI
(Percent changes year on year)
Consumer Price Index (March 04=100)

	Weights	1387				1388				1389		
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Headline	100	33.3	35.7	22.7	3.2	-10.0	-14.9	-13.2	-5.2	1.5	5.3	12.9
Food and Beverages	61.3	48.6	52.7	30.3	0.9	-17.5	-21.9	-20.7	-10.1	-0.6	4.7	15.6
Bread and Cereal	28	91.4	91.9	49.4	-3.6	-30.2	-35.9	-36.0	-22.5	-6.5	3.2	12.5
Meat	6	5.9	11.0	7.0	-0.6	-0.3	-1.4	-1.7	5.3	7.2	21.5	24.2
Milk and cheese	5.6	8.8	9.6	7.3	9.7	4.7	0.6	1.3	-2.6	1.9	2.0	5.5
Oil and Fat	5.3	20.2	27.0	-1.7	-14.1	-17.5	-21.2	-5.5	-0.2	5.1	7.6	28.5
Fresh & dried fruits	4.9	3.9	15.3	12.8	15.0	15.4	9.8	0.3	-2.5	-5.7	-6.3	14.0
Vegetables	4.9	27.6	28.4	23.3	16.6	-0.1	-1.1	1.2	4.8	14.0	8.0	29.7
Sugar & Sweets	1.8	-3.2	8.8	7.8	10.4	16.3	18.2	20.8	22.9	14.1	10.4	13.5
Spices	1.1	11.6	20.7	22.5	18.7	8.4	5.6	2.5	7.2	10.2	5.3	6.1
Tea & Beverages	2	13.3	15.7	17.2	12.6	2.1	0.3	-0.9	1.2	1.8	-0.5	4.9
Tobacco & Cigarettes	1.7	7	8.4	6.6	7.3	3.2	2.1	3.1	4.3	5.6	8.6	10.5
Non – Food	38.7	10.3	10.8	10.5	7.4	5.0	-0.8	0.9	3.0	4.8	6.3	8.8
Clothing	7.2	5.6	11.0	9.0	8.8	6.8	3.0	1.3	1.3	0.7	-2.1	1.1
Housing	17.2	10.3	9.9	10.3	7.2	7.1	-2.3	0.4	4.5	6.9	11.6	15.5
Rents	7.1	6.8	7.6	8.8	9.1	8.6	3.8	4.3	6.4	11.5	19.2	27.5
Construction materials	3.2	15.6	17.3	11.2	4.2	1.0	-14.1	-11.5	-2.4	3.9	14.4	14.6
Fuel and Electricity	6.8	11.9	9.5	11.2	6.6	7.7	-3.4	0.7	4.9	3.8	4.5	6.2
Household goods	7	2.7	3.5	2.9	3.7	3.0	2.5	2.6	1.0	0.3	-0.5	2.1
Health	2	7.8	19.2	21.3	23.9	19.3	7.2	4.9	-0.2	-0.5	-0.6	0.6
Transportation	2.3	40.5	25.9	21.3	1.0	-14.0	-11.9	-2.3	5.4	14.5	10.3	0.2
Communications	0.9	0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0	0.0
Educations	1.2	0.5	1.6	2.1	1.4	0.6	0.1	-0.6	-0.4	-1.7	-0.9	0.5
Miscellaneous	0.9	15.8	22.6	27.0	17.9	12.6	8.4	4.8	0.1	1.0	-1.3	10.1
Core inflation (28% TM)		9.8	14.2	11.8	7.6	4.2	0.5	0.8	1.8	3.8	4.1	9.0
Core infl. (headline excluding bread and cereals, oil and fats, and transportation)			12.0	10.8	9.0	6.2	1.4	1.5	2.9	4.6	5.9	12.6

Source: Central Statistics Office and DAB staff calculations



Source: Central Statistics Office and DAB staff calculations

1.4 Changes from Same Quarter, Last Year in National Headline Inflation

The pattern observed nationwide was similar to the pattern observed in Kabul, with a few exceptions. Headline inflation, which had been negative in the third quarter of 1388, became strongly positive (9.8 percent) in the quarter under review.

The contributors to this substantial increase in inflation were concentrated both in the food and non-food categories. To understand the main factors responsible for increase of 9.8 percent in the quarter under review, it is necessary to look at the individual components of the CPI. First, we will analyze those components that showed the largest unfavorable changes in inflation rate from the previous year.

Food sub-index Accounts for 61.3 Percent of the CPI Basket: This price-index increased sharply in the quarter under review. Their prices, which had been fallen sharply in the same quarter last year, turned around and rose

sharply. The year-on-year changes in food prices increased to 10.96 percent in the quarter under review, in contrast to the same quarter of previous year, when there was actual deflation of 21.5 percent. The main components responsible for the increase in food price-index are as follow:

First, the Bread and Cereals Accounts for 28 percent in the CPI Basket: This price-index rose sharply in the third quarter of 1389, recording 9.7 percent increase (Y-o-Y). This was an increase of 44.5 percentage points, similar to the increase in inflation noted in Kabul CPI.

Second, the Meat price-index Accounts for 6 percent in the CPI Basket: This sub-index increased sharply in the quarter under review as a result of destructive flood in Pakistan during the summer combined with rainfalls and flood inside Afghanistan which destroyed thousands of livestock. Another reason behind the increase in the prices of meat could be the rapid rising in the prices of cereals and grains.

Third, the Oils and fats price-index Accounts for 5.3 percent of CPI Basket: This price-index

increased by an alarming rate of 38.3 percentage points from the same quarter of last year, and ended up at 25.2 percent (Y-o-Y) in the quarter under review. Both the level of inflation in this component, and the increase in inflation from the previous period, were higher than in Kabul.

Fourth, the Vegetables price-index Accounts for 4.9 percent of CPI Basket: This price index, which had been negative in the same quarter last year, turned around and rose sharply in the quarter under review. Vegetables prices rose to 17 percent, compared to a deflation rate of 8.6 percent recorded in the same quarter last year.

These factors leading to an increase in the food inflation rate were partially offset by a dramatic decline in the rate of inflation in some components. For example, cigarettes and tobacco (1.7 percent weight) fell dramatically to 1.9 percent in the quarter under review compared to 10.4 percent in the same quarter of last year.

Non-food sub-index Accounts for 38.7 Percent of the CPI Basket: This price-index increased sharply in the quarter under review. The year-on-year changes in non-food prices increased to 8.02 percent in the quarter under review up from 2.3 percent in the same period last year. The main components responsible for the increase in non- food price-index are as follow:

First, the Rents Price-index Accounts for 7.1 Percent of the CPI Basket: In contrast to the situation in Kabul, increases in the rate of inflation in rents prices were moderate. Rental prices increased nationwide in the third quarter of 1389, recording an increase of 13.8 percent (Y-o-Y). The difference between the rapid rising rates of rental inflation in Kabul and a moderate

increase nationwide is because of instable and lack of job opportunity in the provinces, which forces people to move toward big cities, particularly to Kabul, creating a serious housing shortage.

Second, the Construction Materials sub-index Accounts for 3.2 percent of the CPI Basket: This price index increased sharply to 10.9 percent in the quarter under review compared to the same quarter last year when there was actual deflation of 3.6 percent as a result of boom in the construction sector.

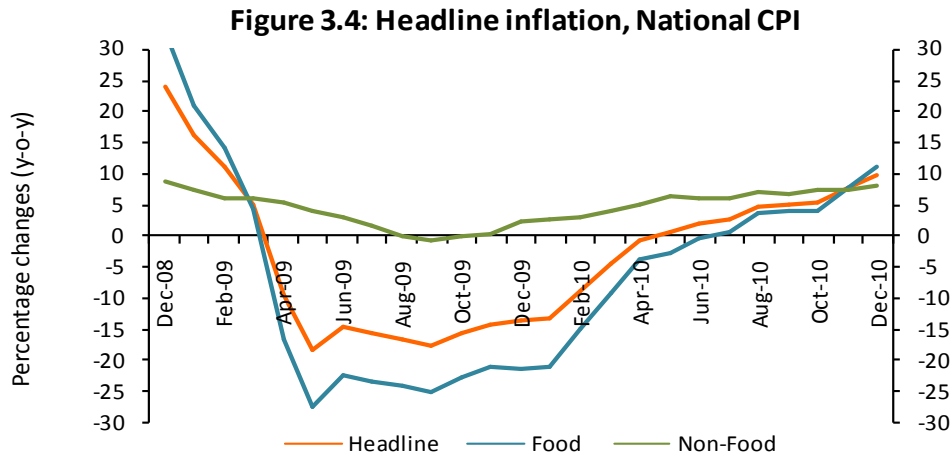
Third, the Fuel and Electricity Sub-index Accounts for 6.8 percent of the CPI Basket: This price-index also rose in the quarter under review, representing a sharp increase of 9.4 percent, up from 6 percent in the same period last year as a result of increase in the prices of oil in the international markets.

Fourth, the Household Goods Sub-index Accounts for 7 percent of the CPI Basket: This price-index exhibited a sharp increase in the quarter under review representing 9.4 percent increase compared to 1 percent in the same period last year.

Fifth, the Transportation Sub-index Accounts for 2.3 percent of the CPI Basket: This price index exhibited a volatile trend from the beginning of the year 1389. Their prices which jumped to a double digit in the first month of the year continued through the end of the second quarter of 1389, eased in the third quarter of 1389. One of the main factors responsible for the changes in the rate of inflation in transportation could be the prices of petrol and diesel in the international markets. For more details see Table 3.2.

These unfavorable changes were partially offset by favorable changes in the rate of inflation on other goods and services. Noteworthy among these were declines in the prices of health (2 percent weight) declined to 0.9 percent

compared to 1.3 percent in the same quarter last year. Communications (0.9 percent weight) turned negative in the quarter under review, posting 3.1 percent decline compared to 1.2 percent inflation in the same quarter last year.



Source: Central Statistics Office and DAB staff calculations.

Table 3.4: Breakdown of National Headline CPI

(Percentage changes year-on-year)

Consumer Price Index (March 2004=100)

		1387				1388				1389		
		Q1	Q2	Q3	Q4	Q1	Q2	Q3	Q4	Q1	Q2	Q3
Headline	100	41.5	38.8	23.8	4.8	-14.6	-17.7	-13.7	-4.5	1.9	4.9	9.8
Food and Beverages	61.3	57.9	56.8	32.6	4.3	-22.4	-25.2	-21.6	-9.1	-0.5	3.9	11.0
Bread and Cereal	28	100.4	97.4	51.5	3.0	-34.9	-38.7	-34.8	-19.0	-6.2	2.1	9.7
Milk and cheese	5.6	14.8	13.7	10.6	8.8	2.4	-0.9	-2.4	-3.0	-0.5	0.7	3.4
Oil and Fat	5.3	40.6	27.3	0.3	-18.8	-24.0	-27.1	-13.1	1.4	3.0	10.5	25.2
Non – Food	38.7	14.6	10.5	8.9	5.9	3.0	-0.8	2.3	3.8	6.0	6.5	8.0
Housing	17.2	13.9	9.5	6.3	3.8	3.3	-1.9	4.3	5.9	7.9	8.4	11.2
Rents	7.1	9.1	3.5	4.3	3.3	3.6	6.0	5.1	6.1	11.9	8.4	13.8
Construction mat	3.2	13.6	10.2	7.8	6.3	0.5	-6.1	-3.6	-0.6	2.5	8.0	10.9
Fuel and Electricity	6.8	18.7	14.3	7.6	3.4	3.9	-6.9	6.0	1.1	6.1	8.5	9.4
Transportation	2.3	36.4	27.9	17.1	-1.3	-12.3	-16.7	-6.2	4.3	12.2	13.4	2.3
Core inflation (28% TM)		14.1	12.6	10.6	7.8	4.3	2.0	1.4	2.3	4.0	5.0	7.2
Core inflation (Headline exc. B&C, O&F, and T)		12.5	11.2	10.5	8.5	4.2	1.7	2.3	3.4	5.8	5.5	9.3

Source: Central Statistics Office and DAB staff calculations.

2. THE REGIONAL INFLATION

Data on inflation in neighboring countries are not readily available with the same amount of detail as for Afghanistan. However, some useful comparisons can still be made.

For example, while inflation in the spring quarter of 1388 in Afghanistan was negative, in the neighboring countries of India, Pakistan, and Iran, it was high and positive. Inflation in these countries is picking up in the quarter under review.

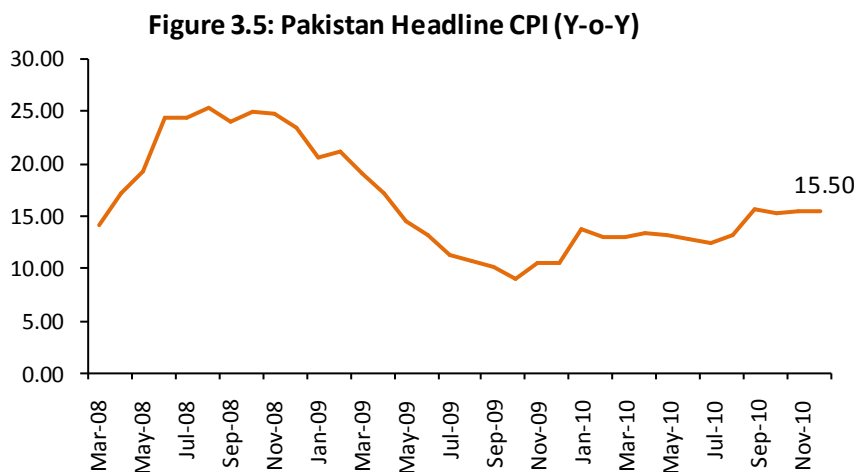
As previous sections of this analysis have shown, inflation has substantially increased in Afghanistan over the previous year, and the turnaround has been much sharper than the mild increases and decreases in inflation observed in the neighboring countries.

2.1 Inflation Trend in Pakistan

Overall inflation in Pakistan as measured by Year-on-year percentage changes stood at 15.5 percent in December 2010, up from 10.5 percent in December 2009. In both the year-on-year and monthly data over the period, there were increases and decreases, but no obvious trend.

In terms of components, it can be said that food price inflation in Pakistan has been generally higher than non-food inflation; the differences are significant in the quarter under review. For example, in December 2010, food price inflation (year-on-year) was 20.4 percent, while non-food inflation was 11.4 percent.

Core inflation in Pakistan (non-food, non-energy), stood at 9.5 percent in December 2010, down from 10.79 percent in December 2009. Month-to-month core inflation rates have also been slightly declining in recent months.



Source: State Bank of Pakistan

Table 3.5: Breakdown of Pakistan Headline Inflation

	CPI			Core Inflation @		WPI
	Overall	Food	Non-food	NFNE*	Trimmed	
Dec-09	10.5	10.9	10.2	10.7	10.4	15.0
Jan-10	13.7	15.5	12.2	10.3	12.7	19.6
Feb-10	13	14.9	11.5	10.1	12.4	19.3
Mar-10	12.9	14.5	11.6	9.9	12.7	21.8
Apr-10	13.3	14.5	12.2	10.6	12.7	22
May-10	13.1	14.8	11.7	10.3	12.5	21.2
Jun-10	12.7	14.5	11.2	10.4	11.7	17.6
Jul-10	12.3	12.8	12	10.3	12	18.7
Aug-10	13.2	15.6	11.2	9.8	12.5	19.2
Sep-10	15.7	21.2	11	9.4	12.8	21.5
Oct-10	15.3	21.1	11.3	9.3	12.8	23.8
Nov-10	15.5	21.5	11.1	9.5	13.4	24.7
Dec-10	15.5	20.4	11.4	9.5	13.6	25.7

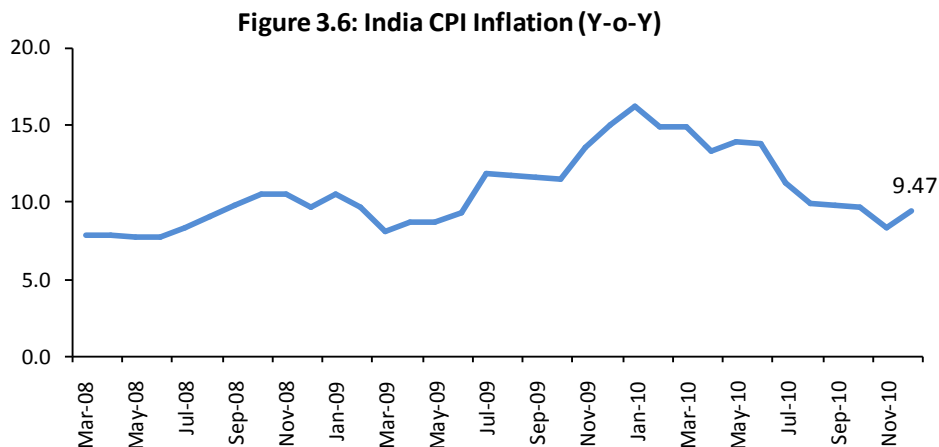
* NFNE is Non-food Non-energy inflation,

Source: State-Bank of Pakistan

2.2 Inflation in India

Consumer price inflation in India increased over the last several months of 2009, but has declined somewhat in 2010. As of December 2010, the year-on-year rate of change in prices paid by urban non-manual employees was 9.47 percent. This was lower than the 14.97 percent recorded in December 2009. Like other

neighboring countries of Afghanistan, food prices in India were rising, increasing by 9.2 percent (year-on-year) in August 2010. However, unlike the neighboring countries, food prices were actually rising more slowly than the price level overall. A higher rate of inflation was observed in housing costs, which rose by 21 percent over the last year.



Source: Reserve Bank of India

2.3 Inflation Trend in Iran

Consumer price inflation in Iran also remains high. The headline rate of inflation in December 2010 was 12.8 percent year-on-year, compared to 7.4 percent in December 2009 and 10 percent in September 2010. Like other neighboring countries of Afghanistan, prices of food and beverages are rising rapidly in Iran, increasing to 18.9 percent since December 2009. Prices of other goods and services are also rising rapidly. For example, the cost of medical care has increased by 17.5 percent over the previous

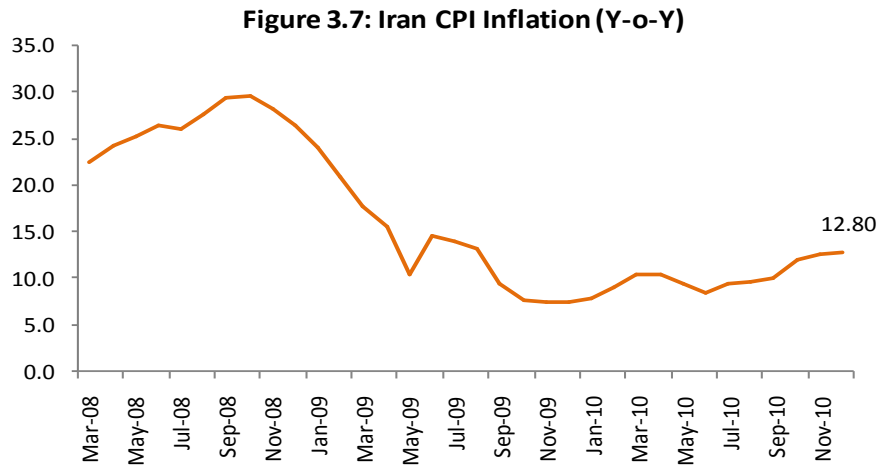
year, restaurant and hotel services have gone up by 17.3 percent, and clothing and footwear expenses have increased by 12.6 percent. However, in contrast to Afghanistan, prices of housing, water, electricity, gas and other fuels have been rising only moderately, increasing by 7.2 percent since December 2009.

A detailed breakdown of the components of the headline CPI reveals that food price inflation increased sharply to 18.9 percent in December 2010.

Table 3.6: Breakdown of Iran Headline inflation

Description	Base Year Weight	Index Number in Dec 2009	Percentage Changes	
			Prev. month	Dec. 2010 compared to Dec 2009
General index	100	223.3	1.5	12.8
1. Food and beverages	28.49	226.6	2.4	18.9
2. Tobacco	0.52	223.4	0.1	-2.7
3. Clothing and footwear	6.22	207.7	1.4	12.6
4. housing ,water Electricity , Gas and other Fuels	28.6	240	1.3	7.2
5. Furnishings, Household, Equipment and Routine-Household Maintenance	6.26	209.8	0.8	11.9
6. Medical Care	5.54	278.5	1	17.5
7. Transportation	11.97	178.2	0.7	11.4
8. Communication	1.63	97.4	-0.2	0.0
9. Recreation and Culture	3.8	165	0.1	10.7
10. Education	2.07	258.4	3.9	10.5
11. Restaurants and Hotels	1.72	263.1	0.9	16.6
12. Miscellaneous Goods and Services Special Groups;	3.18	241.1	0.8	13.2
1. Goods	57.13	219.1	1.8	15.0
2. Services	42.87	252.1	1.3	10.4
3. Housing Water ,Electricity ,Gas and other Fuels	28.6	240	1.3	7.2

Source: Central Bank of Islamic Republic of Iran



Source: Central Bank of Islamic Republic of Iran

3. INFLATIONARY OUTLOOK

Inflation, measured quarter-to-quarter, has been very high so far in 1389 compared to 1388. However, as mentioned earlier, the recent quarterly data show a decline in the inflation rate. It is not clear, however, if the declining trend in inflation will persist into the fourth quarter of 1389. Worldwide, inflation is not expected to decline in the near future. Rising food costs are expected throughout 2011. For example, the United Nations forecasts global food prices to rise by 20 percent in 2011. This global supply shock will undoubtedly affect Afghanistan, where food is already a significant share of national expenditure.

The political instability in the Middle East also raises fears that inflation will persist, because of its effect on oil prices. Currently, spot crude oil

prices are around \$113 per barrel, an increase of more than 20 percent from last quarter. Oil prices are also becoming more volatile and harder to predict, raising the cost of hedging. These increases in oil prices will find their way eventually into increases in the prices of many other goods besides fuel and electricity, such as edible oils and fats.

Inflation caused by supply shocks poses great problems for policymakers, since efforts to curb price rises on individual goods and services (for example, through price controls) are usually failures, and applying traditional demand-side measures (tighter monetary and fiscal policy) will decrease economic growth at a time when Afghanistan needs jobs and higher incomes more than ever.



Fiscal Developments

4

4

FISCAL DEVELOPMENTS

The key objectives in the fiscal area are to achieve sustained increases in revenue collection, to permit the gradual takeover of externally financed operating spending and to ensure an expenditure allocation consistent with ANDS priorities. Other goals include improvements in public expenditure management, fiscal policy formulation, and efficiency in public enterprises, and tax and customs administration.

Like other emerging and less developing economies around the world, a budget imbalance exists in Afghanistan. Total core expenditures exceeded total domestic revenues in the third quarter of 1389, leading to a budget deficit of AF 17.745 billion.

Total domestic revenues increased to AF 20.525 billion in the third quarter of 1389 up from AF 15.077 billion in the third quarter of 1388, representing 36 percent increase. Total domestic revenues in the quarter under review accounted for 2.6 percent of GDP.

Total core expenditures in the quarter under review increased to AF 38.270 billion up from AF 31.009 billion in the third quarter of 1388, which represents 23 percent increase. Total expenditures in the quarter under review account for 5 percent of GDP.

Donor contributions are used to finance both operating and development expenditures. The total donor contribution (grants) allotted to both operating and development expenditures increased to AF 21.814 billion in the quarter under review, up from AF 15.884 billion in third quarter of 1388, which shows 37 percent increase. Total donor contributions account for 2.8 percent of GDP in the quarter under review.

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

1. REVENUES

The ratio of revenue to GDP in industrialized countries is typically around 45-55 percent, while for the least developed countries it is close to 20 percent. With a revenue ratio of 3 percent in the quarter under review, Afghanistan remains an outlier even in this group. Tax revenues, 2 percent of GDP are only one-fourth the average for low-income countries.

Improving revenue collections is also a key target under the extended credit facility (ECF) (a new three year IMF package), and PRGF programs, that the Government is undertaking in partnership with the IMF.

Total domestic revenues (fixed taxes, income taxes, property taxes, sales taxes, excise taxes, custom duties) increased to AF 20,525 million in the quarter under review up from AF 15,077 million in the third quarter of 1388, this represents 36 percent increase. The main contributors were Tax revenue of AF 17,566 million, custom duties AF 7,348 million, and retirement contribution AF 406 million, which were 53 percent, 57 percent, and 108 percent respectively. Total domestic revenues accounted for 2.6 percent of GDP (See Table 4.1).

Revenues from customs duties increased to AF 7,348 million in the quarter under review, up

from AF 4,688 million in the third quarter of 1388, this represents 57 percent increase. According to Fiscal Policy Unite/(MoF) about 85 percent of customs duties revenues have been collected from the major customs offices in five provinces (Herat, Balkh, Nangarhar, Kandahar and Nimroz) and the remaining 15 percent was collected by line ministries and other customs offices in the remaining provinces. Customs duties constitute the largest source of revenues in Afghanistan, as in many developing countries, largely because they are relatively simple to administer.

Table 4.1: Revenue Collection as of Third Quarter of 1389 (in million AF)

	Q3 1389 Revenue Actual	Q3 1388 Revenue Actual	% Δ from Q3 1388 to Q3 1389
Total Domestic Revenues (Tax and Non Tax)	20,525	15,077	36%
Tax Revenues	17,566	11,490	53%
Non Tax Revenues	2,959	3,587	-17%
Total Donor Contribution	21,814	15,884	37%

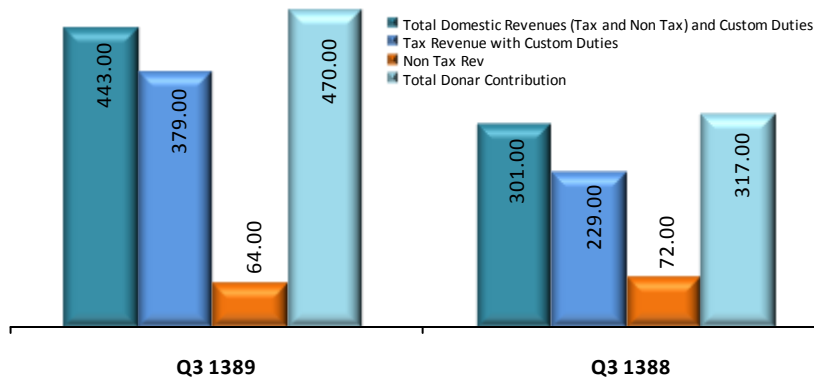
Source: Ministry of Finance website and DAB staff estimation

Table 4.2: Total Revenues in USD (in million USD)

	Q3 1389	Q3 1388
Total Revenue (Tax & non-Tax revenue)	443	301
Tax Revenue	379	229
Non Tax Revenues	64	72
Total Donor Contribution	470	317

Source: Ministry of Finance website and DAB staff estimation

End Period Average Exchange Rate for Q3-1389 was AF 46.37 per USD, while it was AF 50.10 per USD in Q3 1388.

Figure 4.1: Total Domestic Revenues (in million USD)**Table 4.3: Breakdown of Total Domestic Tax and Non-tax Revenues (in million AF)**

Tax and non-Tax Revenues	Q3 1389	Q3 1388	% Changes
Taxation & Customs Revenues			
Fixed Taxes	2,372	1,661	43%
Income Taxes	2,780	1,912	45%
Property Taxes	53	37	43%
Sales Taxes	4,401	2,882	53%
Excise Taxes	-	-	0%
Other Taxes	449	159	183%
Tax Penalties and Fines	163	152	7%
Customs duties	7,348	4,688	57%
Total taxation revenues	17,566	11,490	53%
Social contributions			
Retirement contributions	406	195	108%
Total social contributions	406	195	108%
Other revenue			
Income from Capital Property	54	64	-15%
Sales of Goods and Services	970	782	24%
Administrative Fees	1,438	1,215	18%
Royalties	7	10	-31%
Non Tax Fines and Penalties	80	55	47%
Miscellaneous Revenue	(8)	1,258	-100.7%
Sale of Land and Buildings	11	8	33%
Total other revenue	2,553	3,392	-25%
ARTF	2,701	3,964	-32%
LOTFA	8,042	3,124	157%
CSTC - MoD	4,686	2,366	98%
Foreign loans			
World Bank	46	450	-90%
ADB	749	681	10%
Other	8	91	-91%
Donor revenue			
World Bank	934	1,968	-53%
EC	-	-	0%
ADB	1,961	697	181%
DFID	-	-	0%
US & USAID	928	765	21%
Others	1,757	1,778	-1%
Total Donor Contributions	21,814	15,884	37%
Loan from IMF	-	840	-100%

Source: Ministry of Finance website, and DAB staff estimation

2. EXPENDITURES

The fiscal performance in Afghanistan is different from the rest of the world. Core expenditures are not able to be funded by domestic core revenues, only about 80 percent of the operating expenditures are financed by domestic generated revenues, while the remaining part of the operating expenditures and all of development expenditures are financed through external grants. Like that in last year, core expenditures exceeded core revenues in the quarter under review.

Total core expenditures in the quarter under review increased to AF 38,270 million up from AF 31,009 million in the third quarter of 1388, which shows 23 percent increase. Total expenditures in the quarter under review accounted for 5 percent of GDP.

Total core expenditures are classified into development and operating expenditures. Development expenditures decreased to AF 12,161 million in the quarter under review down from AF 12,496 million in the third quarter of 1388, which shows 3 percent decline.

The current or operating expenditures increased to AF 26,109 million in the quarter under review up from AF 18,513 million in the same quarter of 1388, this represents 41 percent increase.

The main causes of decrease in expenditures for the development budget in the quarter under review were sluggish budget planning by line ministries, and lower development budget execution by some line ministries.

Operating 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, compensation of employees of AF 20,631 million, goods and services of AF 3,683 million, subsidies and grants AF 1,484 million, interest payments of AF 35 million and acquisition of non-financial assets of AF 276 million, which were 50 percent, 7 percent, -4 percent, -12 percent and -188 percent in the same quarter of last year respectively.

Table 4.4: Core Expenditures, Third Quarter of 1389 (in million AF)

Particulars	Q3 1389 Expenditure Actual	Q3 1388 Expenditure Actual	% Changes
Total Expenditures(Development and Operating)	38,270	31,009	23%
Development Expenditures	12,161	12,496	-3%
Operating Expenditures	26,109	18,513	41%

Source: Ministry of Finance website and DAB staff estimation

Table 4.5: Core Expenditures (in million USD)

	Q3 1389	Q3 1388
Total Expenditures	825	619
Development Expenditures	262	249
Operating Expenditures	563	370

Source: Ministry of Finance website and DAB staff estimation

End Period Average Exchange Rate for Q31389 was AF 46.37/USD, and for Q3 1388 it was AF 51.1/USD

Table 4.6: Total Development Expenditures (in million AF)

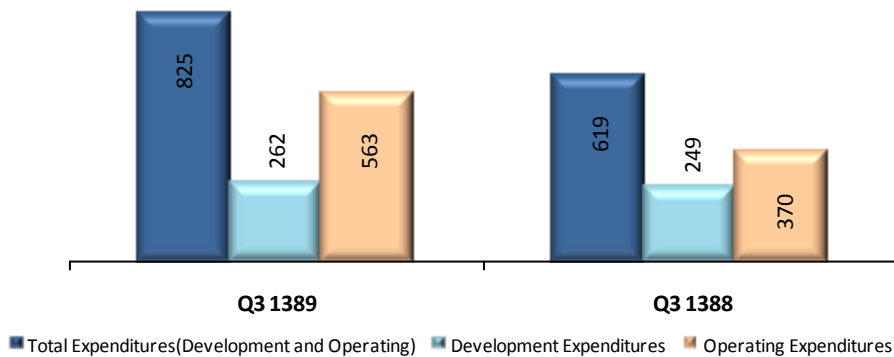
Particulars	Q3 1389	Q3 1388	% Changes
Travel	59	41	46%
Communications	-	19	-100%
Contracted services	3,429	2,895	18%
Repairs and maintenance	38	58	-34%
Utilities	23	3	602%
Fuel	24	9	175%
Tools and materials	76	111	-32%
Other	160	52	210%
Advances and return of expenditure	679	574	18%
Total supplier expenses	4,488	3,762	19%
Grants	-	-	0%
Grants to foreign governments	-	-	0%
Social security benefits cash	-	-	0%
Social assist benefit in cash	-	-	0%
Advance Subsidies Grants	-	-	0%
Total subsidies, grants, contributions and pensions exp.	-	-	0%
Buildings and structures	5,424	5,942	-9%
Machinery and equip (>50,000)	473	2,488	-81%
Valuables	2	1	50%
Land	6	0	1344%
Capital advance payments	1,767	302	485%
Total capital expenditure	7,673	8,734	-12%

Source: Ministry of Finance website and DAB staff estimation

Table 4.7: Total Operating Expenditures (in million AF)

Expenditure Splits	Q3 1389	Q3 1388	% Changes
Employees			
Salaries in cash	17,308	11,713	48%
Salaries in kind	3,180	1,886	69%
Salaries and wages advance	69	0	-
Social benefits in cash	74	193	-62%
Social benefits - in kind	-	-	0%
Total employee expenditure	20,631	13,792	50%
Supplier Expenditure	271	328	-17%
Travel	-	132	-100%
Communications	136	65	109%
Contracted services	455	407	12%
Repairs and maintenance	667	209	220%
Utilities	684	798	-14%
Fuel	1,317	1,134	16%
Tools and materials	407	339	20%
Other	(254)	40	-736%
Advances and return of expenditure	3,683	3,453	7%
Total supplier expenses	17,308	11,713	48%
Subsidies, grants, contributions and pensions			
Grants	10	1	0%
Grants to foreign government	-	-	0%
Social security benefits cash	1,325	1,019	30%
Social assist benefit in cash	243	47	421%
Advance Subsidies Grants	(95)	475	-120%
Total subsidies, grants, contributions and pensions expenditure	1,484	1,541	-4%
Capital expenditure			
Buildings and structures	40	66	-39%
Machinery and equip (>50,000)	221	121	82%
Valuables	-	1	0%
Land	27	3	752%
Capital advance payments	(12)	(504)	-98%
Total capital expenditure	276	(313)	-188%
Interest	35	40	-12%
Total interest expenditure	35	40	-12%

Source: Ministry of Finance website and DAB staff estimation

Figure 4.2: Core Expenditures in million USD

Source: Ministry of Finance website and DAB staff estimation

3. FINANCING THE CORE BUDGET

The total donor contribution (grants) allotted to both operating and development expenditures increased to AF 21,814 million in the third quarter of 1389 up from AF 15,884 million in the same quarter of 1388, which represents 37 percent increase.

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

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

The donor grants for development expenditures in the quarter under review reached AF 12,735 million, while for the operating expenditures it was AF 9,079 million.

The main donor contributors to the development expenditures are as follow: ARTF, LOTFA, ADB, DFID, EC, World Bank, CSTC, US and USAID (See Table 4.8).

Table 4.8: Total Donor Contribution, Q3 1389 and Q3 1388 (in million AF)

Donor contributions	Q3 1389	Q3 1388	% Changes
Afghanistan Reconstruction Trust Fund	2,701	3,964	-32%
Law and Order Trust Fund - Afghanistan	8,042	3,124	157%
CSTC - MoD	4,686	2,366	98%
Foreign loans	-	-	0%
World Bank	46	450	-90%
Asian Development Bank	749	681	10%
Other	8	91	-91%
Donor revenue	-	-	0%
World Bank	934	1,968	-53%
European Commission	-	-	0%
ADB	1,961	697	181%
DFID	-	-	#DIV/0!
US and USAID	928	765	21%
Others	1,757	1,778	-1%
Total donor contributions	21,814	15,884	37%

Source: Ministry of Finance website and DAB staff estimation

Table 4.9: Breakdown of Donor Contribution for Q3 1389 (in million AF)

Donor contributions	Operating Grants	Development Grants
Afghanistan Reconstruction Trust Fund	-	2,701
Law and Order Trust Fund - Afghanistan	8,042	-
CSTC - MoD	4,640	46
Foreign loans	-	-
World Bank	-	46
Asian Development Bank	-	749
Other	-	8
Donor revenue	-	-
World Bank	-	934
European Commission	-	-
ADB	-	1,961
DFID	-	-
US and USAID	-	928
Others	53	1,705
Total donor contributions	12,735	9,079

Source: Ministry of Finance website and DAB staff estimation



Banking System Performance

5

5

BANKING SYSTEM PERFORMANCE

The banking system performed well in the quarter under review. Total assets of the banking system stood at AF 192.73 billion (USD 4.26 billion) at the end of the third quarter of 1389, up by 21 percent or AF 33.4 billion (USD 739.4 million) from the same period last year. Loans amounted to AF 81.25 billion (USD 1.79 billion) an increase of AF 19.81 billion (USD 438.07 million) or 32.25 percent since December 2009. Deposits stood at AF 152.37 billion (USD 3.37 billion) over the period under review; a 16.31 percent increase since previous period. Deposits were largely denominated in USD (62.19 percent) with Afghani denominated deposits lagging at 34.05 percent. Afghani denominated deposits rose to AF 51.88 billion (USD 1.18 billion) since Qaws 1388 (December 2009), when it was AF 40.06 billion (USD 840 million). Total capital of the banking system excluding Kabul Bank stood at AF 18.34 billion (USD 405.50 million), while inclusion of Kabul Bank put a huge impact on the financial capital position of the system. Excluding Kabul Bank, the overall Banking sector was profitable earning profit of AF 510 million (USD 11.28 million) up to third quarter of 1389, down by AF 454 million since December 2009. However, the size of losses of Kabul Bank distorts the figure for the whole sector and turns the overall return on assets (ROA) to -26.81 percent from 0.35 percent. For the quarter under review only branches of foreign

bank are profitable, while state-owned banks and private banks are at loss.

1. ASSETS OF THE BANKING SYSTEM

The banking system continues to grow at a brisk rate. Total assets of the banking system was AF 192.73 billion (USD 4.26 billion) at the end of the quarter under review, up by 20.99 percent or AF 33.44 billion (USD 739.39 million) from December 2009, Figures 5.1 and 5.2.

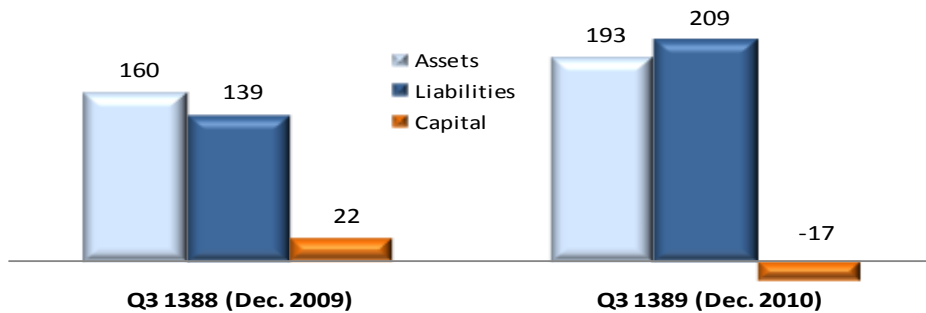
All the major components of assets have witnessed increases; the most obvious increase was registered by “loan loss reserves” (up by AF 39.51 billion) mainly attributed to one big banking institution. The second major increase was posted by “other assets” category of total assets (up by AF 30.79 billion, 545.61 percent) that is attributed to number of banking institutions and mainly to one. The third largest increase was observed in total gross loans (up by AF 19.81 billion) followed by Claims on Financial Institutions (up by AF 9.15 billion). Moreover, the remaining part is made up of cash in vault and claims on DAB, premises and other fixed assets, unconsolidated investments, net due from (NDF), intangible assets, trading and investment accounts and interest receivables. Comparing to the last quarter, the asset base of the system contracted by 14.22 percent, this decline was mainly due to

contraction in net loans caused by significant increase in loan loss reserves (by AF 39.33 billion) by one of the big banking institutions. While Claims on financial institutions, gross loans, net due from (NDF), and “premises and other fixed assets” have shown increases by AF 4.47 billion, AF 3.24 billion, AF 0.44 billion, and AF 0.41 billion respectively. While cash in vault and claims on DAB and intangible assets have decreased in the current quarter.

The most important components of the system’s total asset portfolio are cash in vault/claims on DAB (30.55 percent), loan loss reserves (21.23 percent), net loans (20.93 percent), Claims on financial institutions (19.76 percent), “other assets” (19.10 percent) and Net Due From (4.88 percent). Other components of total assets are negligible.

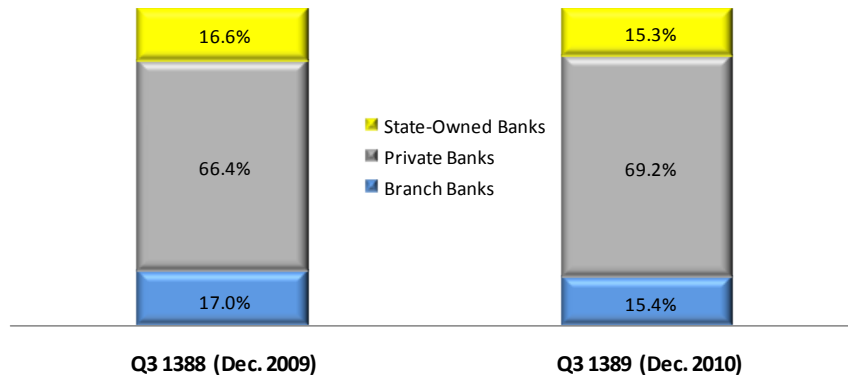
Figure 5.1: Banking System Growth Rate (AF billion)

Asset Growth rate = 21 percent or AF 33.44 billion
 Liabilities Growth Rate = 52.05 percent or AF 71.64 billion



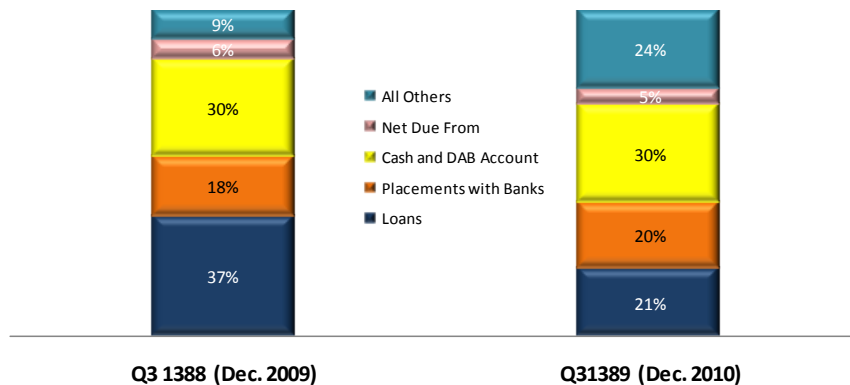
Source: Financial Supervision Department, DAB

**Figure 5.2: Size of the Banking Sector (total assets)
 Increased by 21 percent or AF 33.44 billion**



Source: Financial Supervision Department, DAB

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



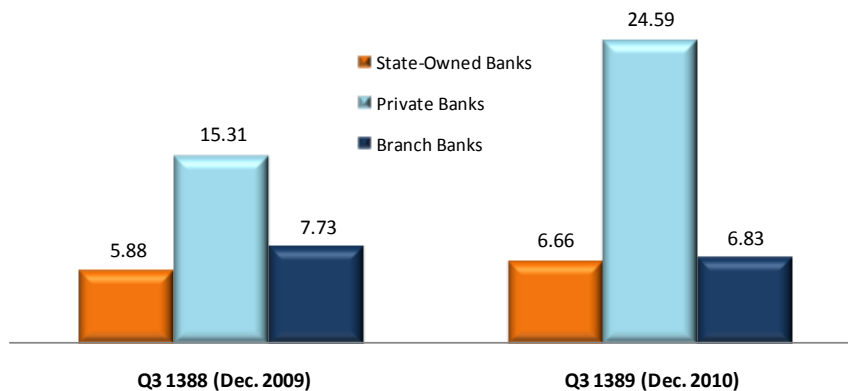
Source: Financial Supervision Department, DAB

1.1 Claims on Financial Institutions

Claims on financial institutions are the fourth largest among various asset categories, currently comprising AF 38.08 billion – 19.76 percent of total assets, which represents a 31.65 percent increase since December 2009. This indicates that the banking sector channeled a portion of its attracted funds as deposits in other financial institutions, when 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 applications from low-risk borrowers, these assets can be substituted to higher income earning assets. Quarter on quarter analysis shows 9.29 percent (AF 3.24 billion) growth, which had decreasing trend in the last quarter.

Figure 5.4: Claims on Financial Institutions (in AF billion)



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 70.22 billion or 86.42 percent of total loans. The portfolio of State-owned banks and branches of foreign banks' share and amount were as AF 7.81 billion (9.61 percent) and AF 3.22 billion (3.97 percent) respectively.

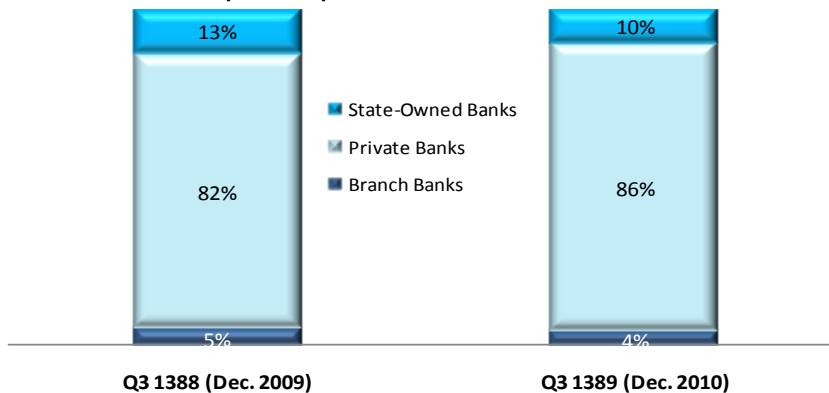
1.2 Net Loans

The loan portfolio continues to grow, totaling AF 40.34 billion (USD 891.82 billion) as of December 2010 – down by AF 55.70 billion or 92.78 percent since December 2009 or 20.93 percent of total assets; this significant decline in the net loan of the system is due to AF 38.69 billion increase in Loan Loss Reserves mainly attributed to one banking institution. Loss reserves as percentage of gross loans are 50.36 percent, this increase is mainly come from one big banking institution. Increases in lending were observed at all but five of the banking organizations; where in four of them decreases in their loan portfolios have been observed, while in one bank remained unchanged. However, more than two-third of the loan growth is still attributable to private banks and

more than half to one banking institution. Net loan portfolio contacted by 47.22 percent or AF 36.08 billion in the current quarter which ended December 2010.

Segment-wise analysis shows that the major portion of the loan portfolio is designated as “other commercial loans” (55.97 percent), mainly in trade sector (29.82 percent). This concentration in other commercial loans, to the exclusion of all other types of lending, has been the dominant trend. Loans in SME and Micro Credit Loans amounting AF 22.06 billion (USD 487.71 million) by nine banking institutions, up by AF 12.45 billion since last quarter September 2010, mostly came from one banking institution. But still, lending is picking up, although not sufficient enough in some loans categories related to important sectors of the economy, e.g. agriculture and mining have not benefited much from this increase. The designation of Loans sectorally, geographically and institutionally is not properly diversified, but we expect that as time goes on the distribution of loans will become more diversified. It is desirable that all banks take active part in lending, so as to diversify lending services.

**Figure 5.5: Loans Portfolio Increased 32.3 percent
(as of TA) or AF 19.8 billion**



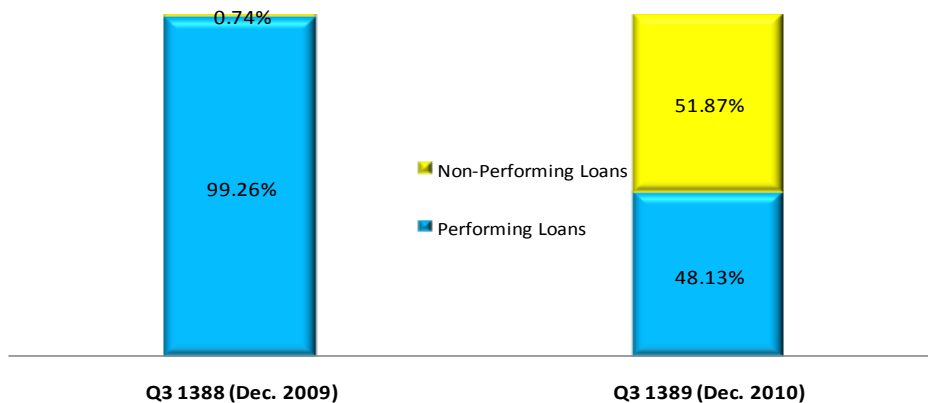
Source: Financial Supervision Department, DAB

1.3 Non-performing loans

The growth in non-performing loans (NPLs) which had a downward trend in the first two quarters of 2010 grew by 3.92 percentage

points in the last quarter and by 47.36 percentage points in the quarter under review reaching AF 42.14 billion. However, the increase in NPL is more pronounced in one big banking institution.

Figure 5.6: Quality of Loan Portfolio



Source: Financial Supervision Department, DAB

1.4 Adversely-classified loans

Adversely-classified loans (substandard, doubtful) were AF 3.34 billion (USD 73.84 million), indicating an increase of AF 2.71 billion

(USD 59.92 million) in the current quarter ending December 2010, up from AF 630 million in the year-ago period (December 2009). The percentage share of adversely-classified loans in total gross loans increased to 4.11 percent, up

from 1.02 percent in previous period (December 2009). Loans under the “watch” category stood at AF 1.56 billion in the current quarter, compared to AF 1.65 billion in the previous period (December 2009). Compared to the previous quarter, adversely-classified loans declined by AF 2.03 billion in the quarter under review, a result of shifting to NPLs. The upward trend in watch category of loans 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 generally should be greater than non-performing loans, which is what one would expect given the definitions of these two indicators of problem assets. The present situation in this analysis is mostly due to one banking institution, the assets of which are still being worked out.

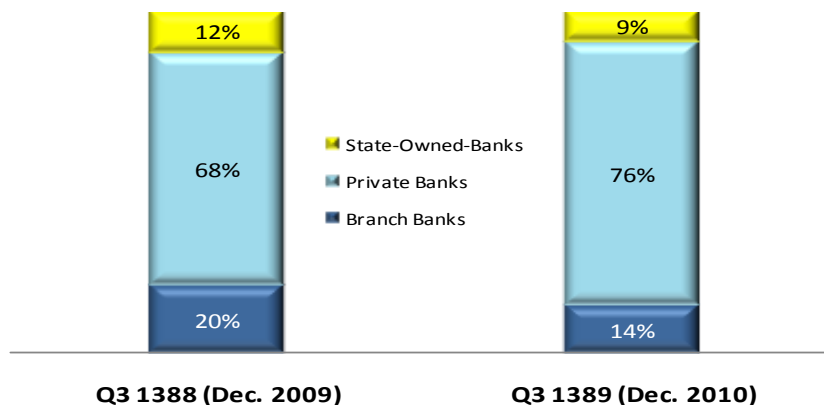
1.5 Cash in Vault and Claims on DAB

Cash in vault and claims on DAB remained the second largest category, increasing both in absolute as well as percentage of total assets since previous period (December 2009), but decreased by AF 2.16 billion (3.55 percent) compared to the last quarter. The banking sector is maintaining compliance with required reserves, and deploying slowly and prudently the attracted funds into other types of assets.

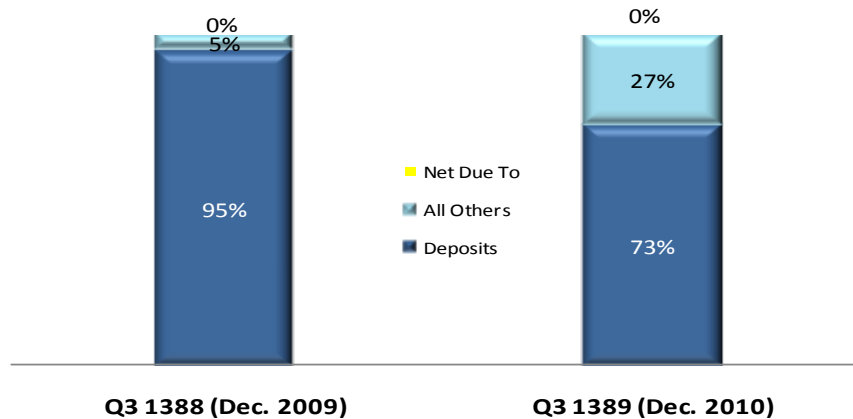
2. LIABILITIES

Total liabilities of the banking sector were AF 209.26 billion, up by 52.05 percent from December 2009. This is an indication of growing public confidence and good public relations and marketing policies of the banking sector. As compared to last quarter, September 2010, total liabilities are up by AF 7.79 billion or 3.87 percent.

Figure 5.7: Liabilities Increased by 52.05 percent



Source: Financial Supervision Department, DAB

Figure 5.8: Major Liability Categories as percent of TL

Source: Financial Supervision Department, DAB

2.1 Deposits

Deposits are the major components of liabilities, currently equal to AF 152.37 billion (USD 3.37 billion), which is a 16.31 percent or AF 21.37 billion increase since December 2009, when it was AF 131.00 billion (USD 2.75 billion). Afghani denominated deposits of the banking system stood at AF 51.88 billion (USD 1.15 billion), up by AF 29.5 billion or 24.8 percent of total deposits, while USD-denominated deposits were AF 94.76 billion (USD 2.09 million), up by AF 11.36 billion or 45.3 percent of total deposits of the banking system.

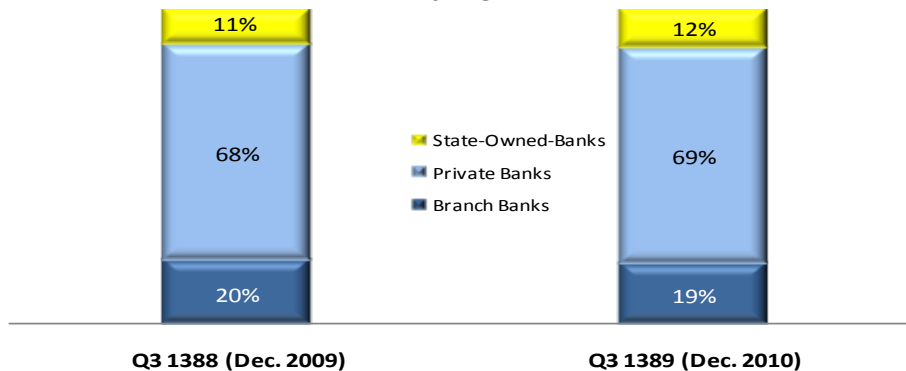
The share of state-owned banks increased to AF 18.12 billion (up by 21.67 percent), which was AF 14.89 billion in December 2009.

Private Banks attracted AF 105.07 billion or 17.28 percent increase since previous period (December 2009), when it was AF 89.58 billion.

The share of branches of foreign banks in total deposits increased to AF 29.21 billion (up by 10.06 percent), which was 26.53 billion in previous period (December 2009). As compared to last quarter, deposits increased by 3.31 percent in the current quarter (December 2010).

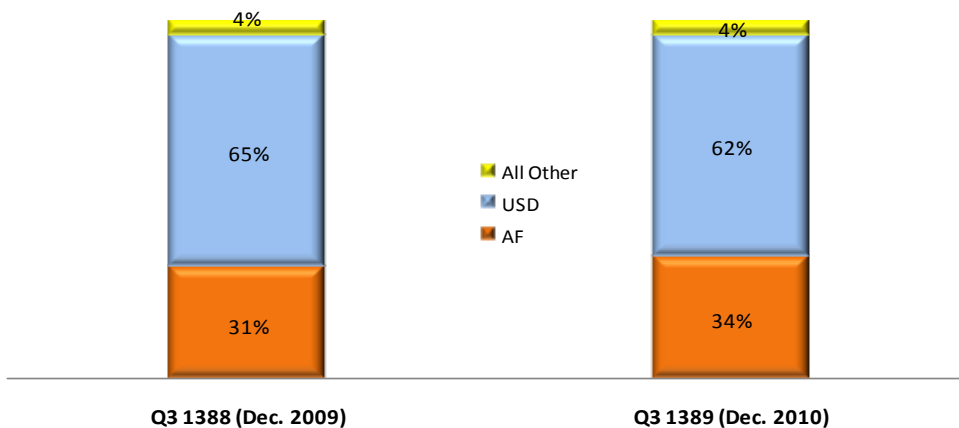
Borrowings remained the third major component of liabilities, up by AF 19.99 billion since December 2009, or 10.33 percent of total liabilities, where a major share came from one banking institution.

Figure 5.9: Deposits Increased by 16.3 percent or AF 21.4 billion



Source: Financial Supervision Department, DAB

Figure 5.10: Currency Composition of Deposits



Source: Financial Supervision Department, DAB

2.2 Capital

Excluding one Bank the system was well capitalized and the capital of the system stood at AF 18.34 billion (USD 405.50 million).

In comparison to the 20 percent benchmark for the capital/assets ratio or assets support by capital (which is an internationally applied ratio for banks), the system's 12.64 percent (AF 18.34 billion of AF 145.15 billion), is far below the benchmark. In order to strengthen the capital

base of the banking system and enhance its stability, DAB has raised the minimum financial capital requirement to AF 1.00 billion, and all banking institutions are given two years time to meet this requirement. One bank in the system falls far below this requirement.

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 situation persists for another year or the bank's overall worldwide condition and performance is deteriorating.

For the current quarter there was an increase in NDF by AF 441 million, reaching AF 9.41 billion as compared to the last quarter, September 2010, when it was AF 8.97 billion. NDF position has increased by AF 183 million in the current quarter and stands at AF 188 million, when it was AF 5 million in the previous quarter (September 2010). Only two banks have a favorable NDF position, compared to the relatively large, unfavorable NDF positions for the remaining three. Put differently, only two banks are actively seeking investment outlets for the funds they have attracted, while the rest are simply sending their acquired funds to their international networks. The NDF positions of two banks have increased, and decreased at one bank. The largest NDF position by a branch of a foreign bank is AF 6.96 billion, decreased by AF 380 million from AF 7.34 billion since last quarter (September 2010). As compared to the previous period, December 2009, NDF position has decreased by AF 397 million, while NDF position decreased by AF 343 million. One bank in NDF position in the last quarter has switched to NDT position in this quarter.

2.3 Profitability

Total net cumulative profit without Kabul Bank for the first nine months of 1389 (December 2010) is AF 510 million (USD 11.28 million), down by AF 940 million or 64.82 percent. This resulted in ROA of 0.35 percent annualized, which is down by 1.01 percentage points from 1.63 percent in the same previous period. On a cumulative basis, six banks have incurred a loss of AF 421 million, where it was AF 249 million the same period last year with six banks at loss. The above mentioned deterioration in profitability has mostly come from a decrease in net-interest income, FX losses, extraordinary losses and more credit provisions.

Including Kabul Bank, the system is at a cumulative loss equal to AF 39.32 billion (USD 869.22 million), resulting in ROA of -26.81 percent. This deterioration is due to AF 39.12 billion provision by the mentioned bank.

For the quarter ending December 2010 (Qaws 1389), excluding Kabul Bank, the banking institutions are profitable as a whole. Branches of Foreign banks are leading in profitability followed by State-owned Banks and Private Banks.

The major component of income was Net Interest Income (NII) with total amount of AF 3.45 billion.

The second major component of income is other Non-Interest Income totaling AF 2.48 billion.

The most important component of expense is the Non-Interest Expense (NIE), currently equal to AF 2.22 billion. The salary cost is AF 3.71 billion for the quarter ending December 2010.

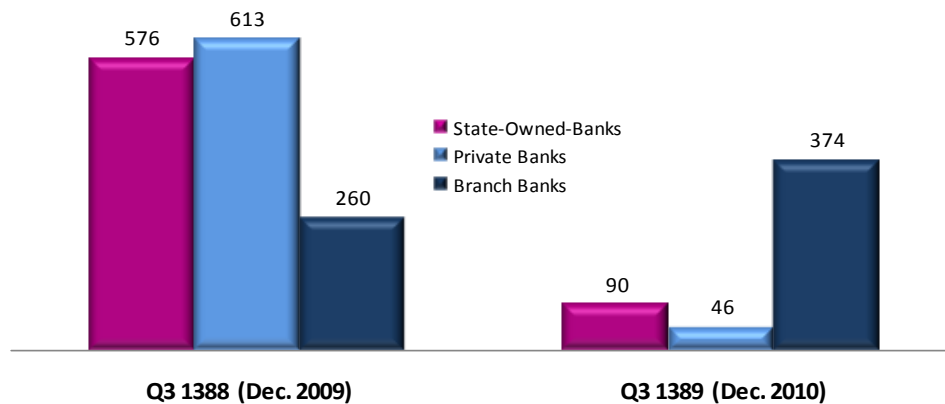
The efficiency ratio, (*net interest income + trading account gain/loss + other non-interest income* divided by operating expenses) of the system as a Median stands at 1.44. Seven

banking institutions ended up with lower efficiency ratios for the quarter ending December 2010.

On a core income basis, four private banks are at a loss for the quarter ending December 2010.

The main reason for this poor performance is high operating expenses which appears to be a kind of permanent situation for these banks, comparing to last quarter September 2010.

Figure 5.11: Profitability (in AF million)



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. Most banking institutions are within the limits set for overall open FX position for the current quarter ending December 2010, with the exception of three banking institutions which were holding open FX position on overall and on an individual currency (USD long & short position) basis above the maximum regulatory threshold. In the previous period all the banking institutions were within the limit on overall and on an individual currency basis. This indicates that the number of banks in violation of regulatory limits is increased for the quarter ending December 2010. (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 a 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 885.77 million and vice versa. Similarly, a 4 percent change would correspond to AF 182.04 million and vice versa.

2.5 Interest Rate Risk

Overall, banking institutions are in an interest-rate sensitive position. If the interest rate increases by 3 percentage points then there will be an increase of AF 1.56 billion 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 by AF 1.56 billion. For two banking institutions if the interest rate increases by 3 percentage points, that will decrease in their net interest income over the next 12 months. (Branches of

foreign banks are not required to file the interest rate sensitivity schedule, because like FX risk, interest-rate sensitivity of the banks is the large excess of risk is managed on a whole-bank basis).

The major reason for the overwhelming interest rate 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.



**External
Sector
Developments**

6

6

EXTERNAL SECTOR DEVELOPMENTS

This chapter highlights developments in the external sector of the Afghan economy for the third quarter of 1389 in comparison with the corresponding quarter of the previous year. Based on the available statistics, Afghanistan's merchandise trade deficit widened in the third quarter of 1389 following a substantial expansion in imports compared with the similar period last year. The merchandise trade deficit expanded by almost 31 percent from USD 692.27 million in the third quarter of 1388 to USD 904.56 million in the third quarter of 1389. However, the trade deficit as percentage of GDP remained unchanged at 5 percent.

In the quarter under review, aggregate imports and exports stood at USD 1,031.9 million and USD 127.29 million, respectively, compared to USD 780.50 million and USD 88.23 million in the third quarter of 1388. This resulted in the expansion of the merchandise trade deficit from USD 692.27 million in the third quarter of 1388 to USD 904.56 million in the third quarter of 1389. The expansion in the trade deficit is a reflection of the slow recovery of the global economy.

In the quarter under review, exports increased notably by around 44 percent to USD 127.29 million from USD 88.23 million in the third

quarter of 1388. Exports are mainly dominated by food items that increased by about 60 percent and carpets and rugs that increased by about 48 percent in the quarter under review compared with the similar period last year. On the other hand, imports of goods increased by about 32 percent from USD 780.5 million in the third quarter of 1388 to USD 1,031.9 million in the quarter under review. Imports of almost all items increased in the third quarter of 1389 compared to the similar period last year except consumer goods which decreased about 16 percent. Import of capital goods increased by almost 64 percent from USD 320.06 million to USD 524.76 million and industrial supplies increased by about 33 percent from USD 244.80 million to USD 324.42 million.

Afghanistan's public and publicly guaranteed external debt stock stood at USD 2,322.09 million as of December 21, 2010. During the quarter, service charges are paid only to the International Development Association (IDA). In addition, United States as part of the Paris Club made enormous debt forgiveness on principal amount and IDA gave some debt forgiveness on service charges during the third quarter of 1389.

The net international reserves increased by 18.8 percent in the third quarter of 1389. In the corresponding quarter of last year, NIR stood at

USD 3,711.63 million and that increased to USD 4,408.88 million in the third quarter of 1389.

On the other side of the balance sheet, reserve liabilities increased by 91.86 percent compared to the same period last year. The reserve liabilities are dominated by commercial bank deposits in foreign currencies which increased by 252.4 percent while the use of fund resources increased by 6.94 percent. In contrast, nonresident deposits in foreign currency decreased by around 58.8 percent in the quarter under review.

1. MERCHANDISE TRADE

Afghanistan's merchandise trade deficit widened in the third quarter of 1389 following a substantial expansion in imports compared with the similar period last year. Merchandise trade deficit expanded by about 31 percent from USD 692.27 million in the third quarter of 1388 to USD 904.56 million in the third quarter of 1389. Total exports in the third quarter of 1389 rose by 44 percent to USD 127.29 million. In the quarter under review, almost export of all items increased significantly. Export of food items increased to USD 68.72 million from USD 42.82 million in the previous quarter. Export of food items which includes fresh and dry fruits was the main driver of the increase in exports during the quarter under review. Similarly, export of medical seeds and others increased by 20 percent from USD 29.2 million in the third quarter of 1388 to USD 35.07 million in the quarter under review. Export of carpets and rugs, leather, and wool increased by 48 percent and 42 percent from USD 7.98 million to USD 11.82 and USD 8.23 million to USD 11.68 million respectively.

Simultaneously during the quarter, total imports also increased significantly compared to the same quarter last year. Total imports increased by almost 32 percent in the third quarter of 1389, rising from USD 780.50 million in the third quarter of 1388 to USD 1,031.9 million in the third quarter of 1389. According to the balance of payments statistics, imports of all items increased except food items which declined by approximately 16 percent compared with the similar period last year. Nevertheless, imports are mainly dominated by capital goods and others which increased by 64 percent in the third quarter of 1389 compared to the similar period last year. In the third quarter of 1389, the second largest increase was recorded in industrial supplies indicating an increase of 33 percent. Conversely, imports of consumer goods decreased by 16 percent from USD 206.74 million in the third quarter of 1388 to USD 173.79 million in the third quarter of 1389.

As a result, a significant change in the import structure in favor of capital goods and others has been observed during the third quarter of 1389. The share of capital goods and others in total imports increased from 41 percent in the third quarter of 1388 to approximately 51 percent in the third quarter of 1389. High imports of capital goods relies on the developments in the industrial sector which requires imports of factories, machinery, tools, equipment and spare parts which are used to produce other products for consumption. Furthermore, the share of industrial supplies, and fuel and lubricants as compared with the same period last year remained unchanged. While the share of consumer goods in total imports decreased notably from 26.5 percent in the third quarter of 1388 to 16.8 percent in the

third quarter of 1389. Finally, the trade deficit as a percentage of GDP remained unchanged at 5 percent compared with the same period last year.

Table 6.1 illustrates the main categories of the merchandise trade, and the percentage share of main categories of exports and imports from 1385 up to the third quarter of 1389.

Table 6.1: Merchandise Trade (in million USD)

Years	1385		1386		1387		Q3 1388		Q3 1389	
	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)	Total	Share (%)
Imports	2,744.0	100%	3,022	100%	3,020	100%	780.50	100%	1,031.9	100%
Capital goods and other	1,364.8	49.7%	1579.47	52.3%	1,430	47.4%	320.06	41.0%	524.76	50.9%
Industrial supplies	596.7	21.7%	692.04	22.9%	797.78	26.4%	244.80	31.4%	324.42	31.4%
Fuel and Lubricants	100.0	3.6%	108.49	3.6%	101.83	3.4%	8.90	1.1%	8.88	0.9%
Consumer goods	683.0	24.9%	642	21.2%	689.88	22.8%	206.74	26.5%	173.79	16.8%
Exports	417.0	100%	454.13	100%	544.56	100%	88.23	100%	127.29	100%
Carpets & Rugs	187.0	45%	211.76	46.6%	153.1	28.1%	7.98	9.0%	11.82	9.3%
Food items	165.0	40%	158.86	35.0%	283.08	52.0%	42.82	48.5%	68.72	54.0%
Leather & Wool	31.0	7%	25.77	5.7%	29.29	5.4%	8.23	9.3%	11.68	9.2%
Medical seeds & others	34.0	8%	57.74	12.7%	79.14	14.5%	29.20	33.1%	35.07	27.6%
Trade Balance	-2,327.2		-2,567.73		-2,475.3		-692.27		-904.56	
Trade Balance as % of GDP	-30%		-27%		-21%		-5%		-5%	

Source: Central Statistics Office and DAB staff calculations

2. DIRECTION OF TRADE

During the quarter under review, Pakistan, India, Iran, China and Commonwealth of Independent States (CIS) accounted as the major trading partners of Afghanistan. Direction of Afghanistan's exports and imports during the third quarter of 1388 and third quarter of 1389 are summarized in Tables 6.2 and 6.3. The merchandise trade statistics indicate that Afghanistan's exports increased remarkably by around 44 percent from USD 88.23 million in the third quarter of 1388 to USD 127.29 million in the quarter under review. The increase in the value of exports is considered to be due to high external demand for Afghan products and economic recovery in most of the export

destinations of Afghanistan. Pakistan remained the largest export destination with nearly 43.33 percent share of total exports in the quarter under review compared to 36.16 percent in the third quarter of 1388.

Exports to Pakistan increased significantly by 73 percent from USD 31.90 million in the third quarter of 1388 to USD 55.15 million in the third quarter of 1389. Exports of food items such as fresh and dry fruits to Pakistan increased significantly by 105 percent from USD 15 million to USD 30.7 million. Similarly, export of leather and wool, carpets and rugs, and medical seeds to Pakistan increased by 72 percent, 48 percent and 35 percent respectively.

India was the second largest export destination for Afghan commodities during the quarter. Exports to India increased from USD 17.7 million in the third quarter of 1388 to around USD 20.4 million in the quarter under review, an increase of approximately 15 percent. Export of medical seeds and others to India increased sharply by 164 percent from USD 1.8 million in the third quarter of 1388 to USD 4.76 million in the quarter under review. However, exports of food items to India declined slightly by 1 percent from USD 15.7 million in the third quarter of 1388 to USD 15.5 million in the third quarter of 1389. Simultaneously, exports of carpets and rugs to India declined by 20 percent compared with the similar quarter last year.

In the quarter under review, Commonwealth of Independent States (CIS) maintained its third

position in the ranking of export destinations of Afghan products. Exports to CIS increased by approximately 22.5 percent from USD 11.20 million in the corresponding quarter last year to USD 13.72 million in the reporting quarter. However, share of exports to CIS in total exports declined from 12.7 percent to around 10.8 percent in the third quarter of 1389. In addition, exports to China increased from USD 0.51 million in the third quarter of 1388 to USD 2.53 million in the third quarter of 1389. Exports to China mainly encompass leather and wool and medical seeds. On the other hand, exports to Iran contracted significantly by around 55.5 percent from USD 14.3 million in the third quarter of 1388 to USD 6.37 million in the third quarter of 1389.

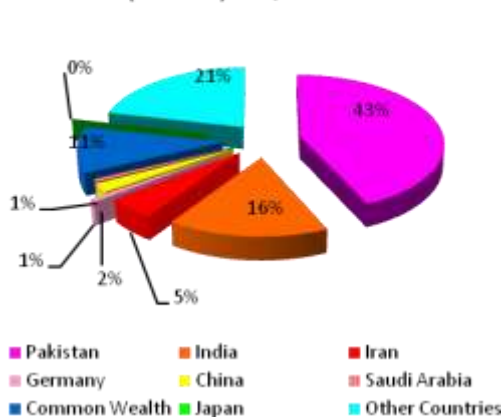
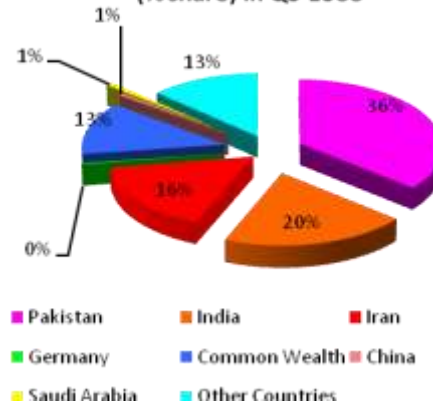
Table 6.2: Direction of External Trade: Q3 1388 (in million USD)

Country Name	Exports	% Shares	Imports	% Share	Trade Balance
Pakistan	31.90	36.16%	37.20	4.77%	-5.30
India	17.70	20.06%	20.80	2.66%	-3.10
Iran	14.32	16.23%	44.40	5.69%	-30.08
Germany	0.25	0.28%	33.60	4.30%	-33.35
Common Wealth	11.20	12.69%	402.60	51.58%	-391.40
China	0.51	0.58%	60.78	7.79%	-60.27
Saudi Arabia	0.78	0.88%	0.00	0.00%	0.78
Japan	0.00	0.00%	68.89	8.83%	-68.89
England	0.00	0.00%	1.90	0.24%	-1.90
Other Countries	11.57	13.11%	110.33	14.14%	-98.76
Total	88.23	100%	780.50	100%	-692.27

Source: CSO and DAB staff calculations

Table 6.3: Direction of External Trade: Q3 1389 (in million USD)

Country Name	Exports	% Shares	Imports	% Share	Trade Balance
Pakistan	55.15	43.33%	89.76	8.70%	-34.61
India	20.44	16.06%	26.70	2.59%	-6.26
Iran	6.37	5.00%	84.35	8.17%	-77.98
Germany	1.00	0.79%	47.60	4.61%	-46.60
China	2.53	1.99%	92.56	8.97%	-90.03
England	0.00	0.00%	2.93	0.28%	-2.93
Saudi Arabia	0.86	0.68%	0.00	0.00%	0.86
USA	0.00	0.00%	12.71	1.23%	-12.71
Common Wealth	13.72	10.78%	377.60	36.59%	-363.88
Japan	0.00	0.00%	149.71	14.51%	-149.71
Other Countries	27.22	21.38%	147.93	14.34%	-120.71
Total	127.29	100%	1,031.85	100%	-904.56

Figure 6.1: Direction of Exports (% share) in Q3 1389**Figure 6.2: Direction of Exports (% share) in Q3 1388**

Source: CSO and DAB staff calculations

2.1 Composition of Trade

In the quarter under review, the composition of imports is presented in Figures 6.3 and 6.4. These figures compare the composition of imports in the third quarters of 1388 and 1389. The composition of imports is presented in percent share of total imports baskets. In the third quarter of 1389, the composition of imports indicates that capital goods are still dominating the largest share in the basket of

imports. Notably, imports of capital goods and others increased remarkably by around 64 percent in the quarter under review. Moreover, the share of capital goods and other also increased from 41 percent in the third quarter of 1388 to about 51 percent in the third quarter of 1389. Consequently, imports of capital goods which mainly comprise those goods which are used to produce other products for consumption are considered very important in industrial development and import substitution

in Afghanistan. Such types of goods are important economic factors because they are key to developing a positive return from manufacturing other products and commodities.

In addition, imports of industrial supplies also increased significantly from USD 244.8 million in the third quarter of 1388 to USD 324.4 million in the quarter under review. However, the share of industrial supplies in total imports remained unchanged at 31.4 percent. Therefore, the demand for the industrial supplies such as cement, chemical materials, fertilizer, and

petroleum increased due to implementation of development projects throughout Afghanistan. In contrast, imports of consumer goods decreased considerably by about 16 percent. Imports of consumer goods recorded USD 206.74 million in the third quarter of 1388 and USD 173.8 million in the quarter under review. Finally, consumer goods' share declined significantly from almost 26.5 percent in the third quarter of 1388 to 16.8 percent in the third quarter of 1389.

Figure 6.3: Composition of Imports (% share) in Q3 1388

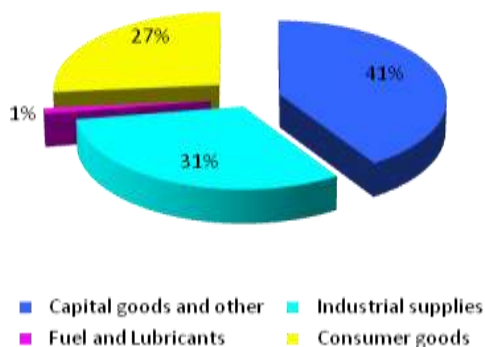
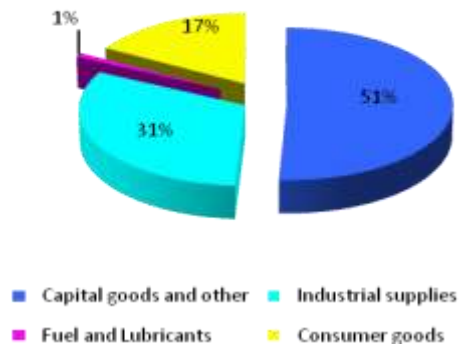


Figure 6.4: Composition of Imports (% share) in Q3 1389



Source: CSO and DAB staff calculations.

Figures 6.5 and 6.6 show the composition of the main export items for the third quarters of 1388 and 1389.

In the quarter under review, the largest share was recorded for food items (fresh and dry fruits) which possessed about 54 percent of total exports. The share of food item increased from 48.5 percent in the third quarter of 1388 to around 54 percent in the third quarter of 1389. In addition, share of carpets and rugs which

were considered the main component of Afghan exports in past decades increased slightly from 9 percent in the third quarter of 1388 to almost 9.3 percent in the quarter under review. Finally, the share of medical seeds and others shrank from 33 percent in the third quarter of 1388 to 27.6 percent in the third quarter of 1389. However, exports of medical seeds and others increased by 20 percent compared with the similar period last year.

Figure 6.5: Composition of Exports (% share) in Q3 1388

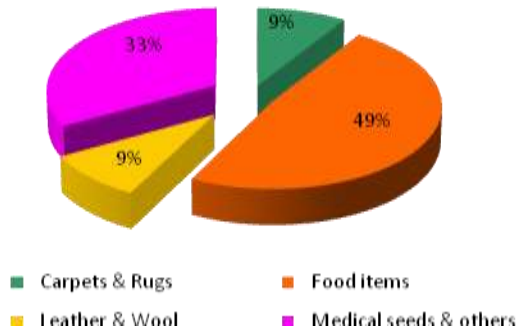
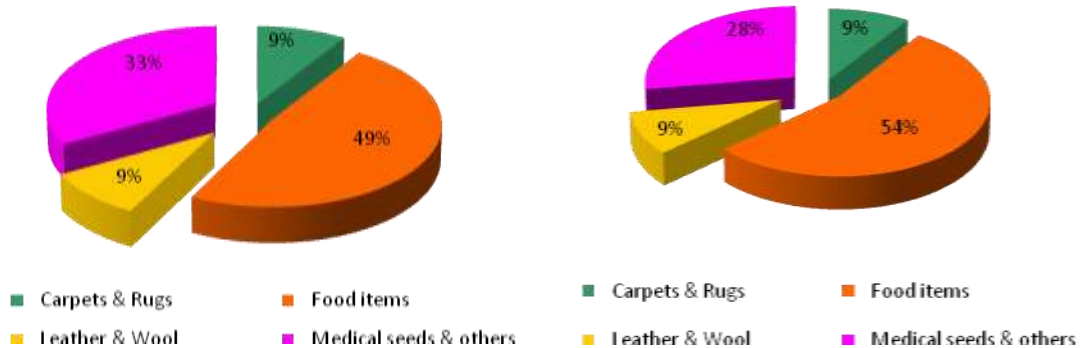


Figure 6.6: Composition of Exports (share%) in Q3 1389



Source: CSO and DAB staff calculations.

3. EXTERNAL DEBT

Afghanistan's public and publicly guaranteed external debt stock stood at USD 2,322.09 million at the end of the third quarter of 1389. During the third quarter of 1389, service charges were paid to Asian Development Bank and International Development Association (IDA). United States creditors, as a member of the Paris Club, made a considerable debt forgiveness of principal amounts during the third quarter of 1389. Specifically, the United States provided Afghanistan with 100 percent debt relief as Afghanistan achieved some certain economic programs with international

authorities and certain economic and social benchmarks and reached the Completion Point as defined by the Heavily Indebted Poor Country (HIPC) initiative. As a result, Afghanistan's total debt to the Paris Club creditors stood at USD 1,018.25 million in the third quarter of 1389 or Afghanistan's total debt only from the Paris Club members stands at around 43.9 percent of total current external debt. Furthermore, IDA made some debt forgiveness in service charges during the third quarter of 1389.

On the other hand, Non-Paris Club debt stood at USD 131.48 million in the third quarter of 1389. Table 6.4 depicts Afghanistan's External Debt for the third quarter of 1389.

Table 6.4: External Debt in the Third Quarter of 1389 (in units indicated)

	In million USD	Percent of total
Total external debt	2,322.09	100.00
Bilateral	1,149.73	49.51
Paris Club/1	1,018.25	43.85
Russian Federation	999.86	43.06
United States	-	0.00
Germany	18.39	0.79
Non-Paris Club	131.48	5.66
Multilateral	1,172.36	50.49
of which: IDA (World Bank)	440.19	18.96
Asian Development Bank	603.61	25.99
International Monetary Fund	115.61	4.98
Islamic Development Bank	11.16	0.48
OPEC Fund	1.78	0.08

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 which consist of monetary gold, reserve position and holdings with the IMF and Special Drawing Rights (SDR) and as well as in foreign exchange including US dollars, Euro, British Pound and other major currencies. The DAB net international reserves (NIR) which are expressed in US dollars is defined as reserve assets minus reserve liabilities.

In the quarter under review, Afghanistan's NIR increased by 18.8 percent to USD 4,408.88 million from USD 3,711.63 million in the third quarter of 1388.

The boost in NIR is mainly due to a significant increase in reserve assets which increased by 21.90 percent from USD 3,876.81 million in the

third quarter of 1388 to USD 4,725.79 million in the quarter under review. On the other hand, Afghanistan's reserve liabilities also increased significantly to about USD 316.91 million in the third quarter of 1389 compared to USD 165.18 million in the same quarter last year. The growth in reserve liabilities is attributed to the commercial bank deposits in foreign currency, non-resident deposits in foreign currency and use of fund resources.

Commercial bank deposits in foreign currency increased significantly from USD 57.22 million in the third quarter of 1388 to USD 201.64 million in the quarter under review. Furthermore, the reserve liability on use of fund resources increased from USD 107.69 million in the third quarter of 1388 to USD 115.16 million in the quarter under review. On the other hand,

reserve liability of non-residents deposits in foreign currency decreased by minus 58.79 percent in the third quarter of 1389.

The increase in NIR could be attributed to the inflows of the foreign exchange, particularly, from export earnings, current transfers and foreign direct investment.

The current level of NIR is providing a good cushion of the maneuverability of monetary policy and support of balance of payments. Currently, NIR on average supports 12.82 months of imports.

**Table 6.7: Net International Reserves
(in million USD)**

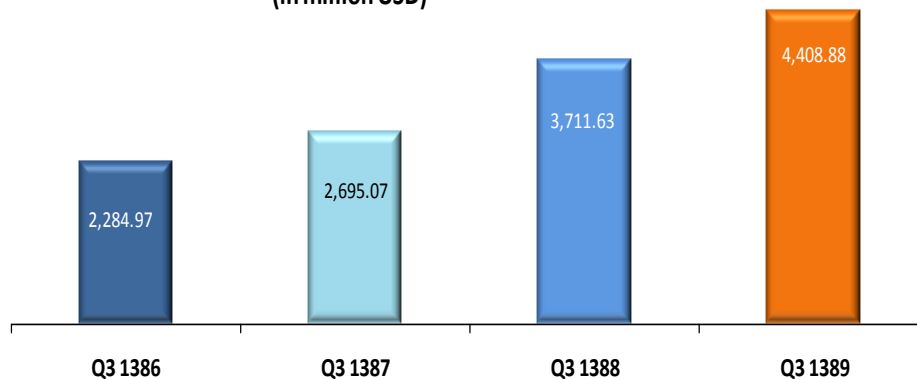


Table 6.5: Net International Reserves, Q3 1389 (in million USD)

Changes on the previous quarter	Q3 1386	% change	Q3 1387	% change	Q3 1388	% change	Q3 1389	% change
Net international Reserves (million USD)	2,284.97	23.17	2,695.07	17.95	3,711.63	37.72	4,408.88	18.79
Reserve Assets	2,376.98	25.80	2,851.19	19.95	3,876.81	35.97	4,725.79	21.90
Reserve Liabilities	92.01	168.63	156.12	69.67	165.18	5.80	316.91	91.86
Commercial bank deposits in foreign currency	37.75	48.75	65.71	74.07	57.22	-12.92	201.64	252.38
Nonresident deposits in foreign currency	2.19	-75.32	0.18	-91.72	0.27	49.23	0.11	-58.79
Use of Fund resources	52.07	52.07	90.23	73.27	107.69	19.35	115.16	6.94
Gross Intl. Reserves (in months of import)	11.06		16.80		14.90		13.74	
Net Intl. Reserves (in months of import)	10.60		16.17		14.27		12.82	

Note: Program Exchange rates used in calculations (March 2010)

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